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Macro- and micro-prudential tools for preventing and managing financial crises

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Today I would like to focus my remarks on two main issues. First, I would like to address the use of microprudential tools for macroprudential purposes, in particular acknowledging the difficulty for the capital and liquidity buffers to work effectively both when the risks are building up and when they effectively materialise. Second, I would like to elaborate on some thorny issues linked with the design and implementation of an effective framework for crisis management and resolution – in particular, I would like to stress the care with which these issues need to be handled in a period in which the banking sector is facing an enormous pressure in the markets for term funding.

1. The use of microprudential tools for macroprudential purposes

One of the key lessons of the crisis is that macroprudential supervision should be developed in order to reduce systemic risk and, in particular, make sure that financial institutions build up buffers of resources in good times that can be used to cover losses or to counter liquidity stress, if and when they actually materialise.

A first option for the policy makers is the simple correction of the functioning of microprudential tools, which typically neglect the time-dynamics of risk, especially of credit risk, and tend to operate in a procyclical fashion. Under this approach, the buffer aims at being neutral and its functioning is relatively automatic and symmetric: the maximum amount of the buffer is predefined and the process of accumulation and depletion is ruled by preset variables. Some discretion may be left to the policy maker, but it is typically residual.

In a more ambitious perspective, the macroprudential buffers would aim at making the cost of credit higher in booms, thus contributing to lean against the wind. By reducing banks' incentives to expand credit and leverage in buoyant economic conditions, the countercyclical buffers would limit the amount of loans that are granted in good times and, possibly, avoid credit bubbles. In this case, much more discretion is needed and the policy maker needs to be endowed with a significant degree of freedom in adapting the policies to the specific juncture.

In the European Union we are developing – consistently with the Basel 3 Accord – a suite of macroprudential tools, which allow national authorities to act promptly and decisively to prevent the build up of systemic risk and safeguard financial stability. Macroprudential authorities should be in a position to manoeuvre a series of variables – capital buffers, liquidity requirements, risk weights, loan to value ratios, etc. – so as to tailor them to the specific risk outlook for all or a subset of banks in a certain jurisdiction. Such ambitious approach raises two challenges.

First, if some degree of discretion is required in the activation of macroprudential policies, how could we preserve consistency across the Single Market and avoid that such discretion impairs the level playing field in the application of microprudential requirements?

The reform advocated in the report of the high level group chaired by Jacques de Larosière rests on two pillars, the establishment of a setting for macroprudential policy and the introduction of a single rulebook*, i.e.* a set of rules that are directly binding throughout the Single Market so that no room is left for regulatory arbitrage. It would be ironic if the implementation of macroprudential supervision ended up jeopardising the other twin objective of the reform, the single rulebook.

I believe that the only way to address this challenge is by establishing a regime of constrained discretion. In a nutshell, greater discretion needs to be balanced with some pre-agreed principles on how discretion can (or cannot) be exercised, and *ex post* reviews should be conducted to ensure that such principles have indeed been respected.

In the European Union, the European Systemic Risk Board (ESRB) should play the central role in designing and enforcing this constrained discretion framework.

The functioning of the countercyclical buffer – a key element of the macroprudential toolbox – is a good example. As currently foreseen, national authorities will be given the possibility to activate additional buffers reflecting the conditions of the credit cycle in their jurisdiction. The *ex ante* guidance, to be issued by the ESRB, coupled with an effective *ex post* peer review process should guarantee that these tools do not alter the level playing field and are compatible with the single rulebook. The approach followed for designing such a tool could be followed also for the introduction of others components of macroprudential suite.

Let me now turn to the second challenge, more linked to the practical implementation of macroprudential tools. Capital and liquidity buffers are to be used dynamically, *i.e.* they are intended to be and should actually move counter-cyclically. This may be problematic. In good times, authorities may find resistance – even some sort of political pressure – when they request banks to build-up buffers, since this may penalise national champions – by the way, another good reason for having predefined and harmonised criteria for the deployment of the buffers. This might create a bias towards forbearance. In bad times, the release of the buffer may be even more difficult, as in a period of stress investors would like to see extra safety in place to keep financing the banks. The release of the buffers is likely to be seen as a negative signal, which would not only affect confidence in the banking sector, but also in the entire economy. And in any case individual banks may well face strong pressure from the markets and even if the supervisor calls for the utilisation of the buffers banks might be unable to do so.

These concerns – frequently raised by the industry during the consultation process – should not be neglected. In fact, current behaviours of market participants – and to be fair of regulators and policy makers themselves – point to the difficulty in releasing the buffers in crisis times. This is, for instance, what is happening now, with banks stockpiling liquidity for signalling strength: something rational at the individual level; undesirable looking at the repercussions on the functioning of the money market and at the entire financial system.

It is a difficult issue and there is not a final answer yet. Let me however try to put this in perspective.

Current market reactions – *i.e.*, the increasing pressure for both higher capital and liquidity buffers – are not the consequence of macroprudential policies, but of the lack thereof. Since buffers were not accumulated in good times, market participants require now banks to build them up.

Credible time-varying buffers should be based and stay on the top of credible minimum requirements. Basel 2 minima are not perceived anymore as credible. Under Basel 3 standards – stricter in terms of both quality and quantity of capital – things might well change.

If there is no clarity on how macroprudential tools are operated, wrong expectations may lead to wrong decisions. Banks and market participants would be less likely to accept and adapt to policy changes, thus reducing their impact. Under a well-designed constrained discretion framework, the uncertainty should be kept to a minimum, making the management of the buffers easier both in good and bad times.

Having said that, I believe it is fair to say that supervisors should further discuss how the release phase would work in practices, in light of the experience of the crisis.

2. Building an effective framework for crisis management and resolution

Any progress in achieving a stronger and more internationally integrated framework for prudential supervision would risk being spoiled if we don't manage to set in place an effective framework for crisis management and resolution. This entails making the orderly exit of large and complex institutions from the market a credible option and providing the framework for a more coordinated approach at the international level.

The road to follow has been clearly indicated at the international level. Following the positions expressed by the G20, the FSB issued a consultation document that sets out proposed policy recommendations which comprise the following building blocks:

- strengthened national resolution regimes which should all comprise the same comprehensive range of resolution powers and tools;
- cross-border cooperation arrangements in the form of bilateral or multilateral institution-specific cooperation agreements to allow for integrated resolution of cross-border entities;
- improved resolution planning by firms and authorities through recovery and resolution plans (RRPs) that should ensure effective resolvability;

At the EU level, a formal legislative proposal by the Commission on harmonization of crisis management and resolution is forthcoming and extensive work has been carried out through various consultation documents – the EBA issued its opinion on the most recent one in March 2011.

I will focus my remarks on three features which I believe are key and need to be further examined, both at the international and EU level: (i) RRPs and resolvability of cross-border groups; (ii) implementing resolution on a cross-border basis and financing of group-wide resolution schemes; (iii) bail-in.

RRPs and resolvability. Resolution planning needs to be a fundamental pillar of the new regime. Indeed, authorities cannot afford anymore to find themselves in a position where they have no choice but rescuing an ailing bank with taxpayers' money. Exit and orderly resolution needs to be a credible option also for systemically important financial institutions (SIFIs). The goal underpinning resolution planning and assessment of resolvability is twofold: on the one hand it should foster firms' knowledge of their structure and their awareness of the potential weaknesses; on the other hand it should help competent authorities to stand ready to rapidly implement resolution tools on a short notice, and should help home and host authorities to discuss and coordinate themselves in advance on the possibility to reach integrated, value enhancing resolution for cross-border groups. There is an urgent need to promote cross-border cooperation during emergency situations with cross-border financial institutions, and to prevent fragmented national responses.

Since the crises of Banco Ambrosiano in the late seventies and BCCI in the nineties, supervisors have devoted great efforts to ensure that in banking groups risks are managed in an integrated fashion, on a firm-wide basis. During the crisis, various calls have been addressed to cross-border groups to enhance their ability to define risk appetite and have a robust framework for monitoring in place at the group level, as well as to have integrated IT and ability to swiftly aggregate information for the whole firm. Resolvability assessment should not contradict this approach and lead to segmentations across national and business lines that jeopardise the supervisory objective of enhanced firm-wide measurement and management of risks. Indeed, I see the possibility that the use of "preventative powers" by the authorities (*i.e.*, the powers to address impediments to resolvability) lead to mandatory fragmentation and ring-fencing of cross-border groups, whenever home and host authorities lack mutual trust and overlook to consider the benefits of integrated cross-border groups.

We have to prevent this unintended consequence. I think that the institutional setting envisaged by the Commission in its consultation document makes important steps in the right direction. Objective criteria and procedures are envisaged for assessing resolvability, which could be identified through binding technical standards drafted by the EBA. The EBA would be assigned a binding mediation role in case of disagreement between home and host supervisors during the preparatory and preventative stage of the crisis management framework (*i.e.*, exercise of the powers to address and remove impediments to resolvability; assessment of recovery plans; coordination of early intervention powers across the group). A legal framework for "intra-group financial support" would be designed, where the interest of the group as whole is officially recognised and the institutions of the group will be able to enter into agreements to provide each other financial support in case of financial difficulties, with appropriate safeguards for creditors and minority shareholders of the various entities.

The areas where I believe that the proposals, at the global as well as European level, should be more ambitious are those of implementing resolution for cross-border banks, and financing of group-wide resolution.

Implementation of resolution of cross-border banks. I fully share the Commission's and FSB's proposals that colleges comprised of the competent authorities (be it named "resolution colleges" or "crisis management groups") should develop and sign off a group resolution scheme, setting out how a group resolution might be carried out taking into account the responsibilities of national authorities and the different resolution tools at their disposal.

However, the mechanisms work on a voluntary basis, since national authorities retain the power to hold out if they deem it appropriate, and I wonder whether this cooperation framework can be conducive to cross-border resolution in practice. In fact I think we lack the right institutional incentives to spur national authorities to converge on coordinated actions, given that national legal obstacles to cross-border resolution persist, and national arrangements to fund resolution differ one from the other, making it difficult to pool financial resources together on a cross-border basis. We then need to make progress on both points.

As to the legal framework, we need to converge at the international level on legal underpinnings that allow for interlocking national procedures and constrain authorities to look for cooperative solutions, with equitable treatment of all stakeholders across jurisdictions. Having the same resolution toolkit in each jurisdiction is a first step. But further advancements need to be explored: at least for cross border groups, we could envisage the set-up of an optional legal regime for groups in order to overcome the discrepancies between the different national regimes in key areas, such as insolvency (*e.g.*, the different rankings of creditors) and company laws (*e.g.*, the shareholders' right to challenge corporate restructuring actions).

In the European Union we also have to go beyond the idea that rescue operations are solely a matter for national budgets. This approach prevents integrated resolution and is at the very origin of the interconnection between banks and their sovereigns that at the core of the current phase of the crisis. It completely overlooks the strict web of relations that has been established between financial institutions within the Single Market, which makes systemic risk an area-wide concern, spanning well beyond national borders.

The real step forward in this area would then be the establishment of a fully fledged European System of Resolution Funds, financed *ex ante* through contributions of cross-border groups and following the same operational rules. As envisaged also in the Commission consultation, this European System would ensure a substantial contribution of the private sector to crisis resolution and provide an institutional underpinning for coordinated support operation in the limited cases in which this would be warranted. Of course, this should be implemented over the long perspective – say 10 years – in order to allow for enough time to gradually build up the capacity of the fund and to strengthen supervisory convergence and cooperation, which is a necessary condition for sharing responsibilities for crisis resolution at the EU level.

Bail-in. Finally, let me briefly consider the issue of bail-in. Bail-in could be defined in general terms as the possibility to restore a failing bank's viability (and to reduce the social costs stemming from its resolution) through the write-down or the conversion into equity of uninsured and unsecured liabilities, imposed by the competent authority when specific triggers are hit.

I believe that the idea is supported by a strong economic rationale. From an *ex ante* perspective, bail-in restores debt market discipline, since it makes creditors contribute to the bank's recovery, curbing the moral hazard problem and the consequent implicit subsidy on funding which large and complex banks have enjoyed so far. *Ex post*, once failure occurs, bail-in reduces the probability of public intervention and its fiscal impact. Bail-in then decreases both the probability of default and the (social) loss given default.

Bail-in should be beneficial also for the same creditors which are affected by it. Indeed the overarching principle of any bail-in scheme would be that it can be activated only if creditors are not "worse off" than they would be if the bank were liquidated in an ordinary way. Hence bail-in represents a Pareto-efficient solution, if its legal underpinnings are properly applied.

However, practice is different from theory and any legislative proposal on bail-in raises complex issues from the legal and operational standpoint, which bring us to face relevant trade-offs. Just to mention two of them: the possible scope of bail-in and its cross-border application.

On the possible scope, the main and clear advantage of a wide scope for bail-in is that it would give competent authorities the discretion needed to calibrate the bail-in to the actual amount of capital required to restore viability of the bank involved, and reduce the possible impact on each liability affected. However, this lack of certainty and predictability on the scope of application may have serious drawbacks: it may jeopardize creditors' ability to appropriately value the nature and risks of their exposures; it exposes competent authorities to the risk of legal litigation; it may have the unintended consequences of provoking a systemic contagion or spurring a bank run among creditors in front of unfounded rumours on the firms' viability. A possible remedy to alleviate these counter-effects would be to give national authorities some discretion or having the regulation identify *ex ante* classes of creditors which are excluded from bail-in (*e.g.*, uninsured depositors; short-term creditors). Yet these are second best solutions, since supervisors' discretion does not alleviate *ex ante* uncertainty, and may in fact spur supervisory arbitrage, while exclusions by regulation can in turn affect banks' funding pattern, creating an incentive to regulatory arbitrage among different kinds of debts and securities.

On cross-border application, we need to keep in mind that bail-in may affect the ranking of creditors which belong to the same class of priority in case of insolvency, and requires harmonization of priorities in national insolvency law, which is the benchmark against which the respect of the principle “no creditor worse off” is assessed in each jurisdiction. Furthermore, in the case of a cross-border group, bail-in requires mutual recognition of some aspects, such as the identification of the authority triggering it (home or host), the type of shares to be issued in case of conversion, which issuers would be affected.

I am not mentioning these problems to argue that bail-in cannot be implemented, rather I want only to stress that it needs to be properly framed by EU legislation, and EBA guidelines and technical standards may help providing certainty and a level playing field on some of the above features.

The most important point I would like to raise on bail-in concerns timing. At present we are experiencing and extraordinary disturbance in bank funding markets which have made the issuance of unsecured debt either impossible or extremely expensive, due to the deterioration of the sovereign debt crisis in the euro area. The introduction of bail-in at this juncture would risk exacerbating the current difficulties. In order to avoid this scenario, it would be appropriate that any legislative proposal on this issue could clearly provide for the entry into force of bail-in provisions only with reference to debt issued after a certain date, *e.g.*, 1st January 2015. I realise that these cut off dates bring the risk that excessive funding takes place before the cut-off date, potentially pushing to excessive risk taking. But I do not think this would apply under current circumstances, when banking markets are still far from healing the wounds left by the crisis and new, harsher regulatory requirements are gradually being phased in.

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The action of regulatory repair that has been deployed at the international and European level since 2008 has already gone a long way in addressing the main weaknesses highlighted by the crisis. However, there are still areas in which we need to do further work. In my remarks today I tried to identify few very complex issues that call for further debates. To summarise the red line of my thinking, we need to keep on the table ambitious, game changing reforms, while we should be wary that such discussions affect the behaviour of market participants right now and may well make it more difficult to handle the crisis we have yet to overcome.