Five Years after Lehman’s Collapse: Where are we going to?

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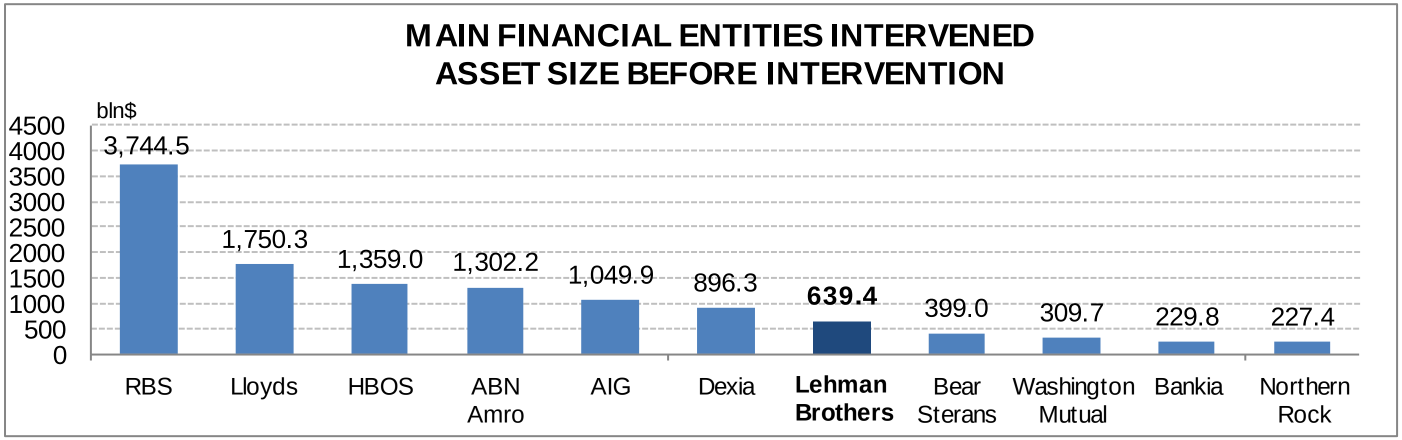
XCVII MEETING OF CENTRAL BANK GOVERNORS OF THE CENTER FOR LATIN AMERICAN MONETARY STUDIES

São Paulo

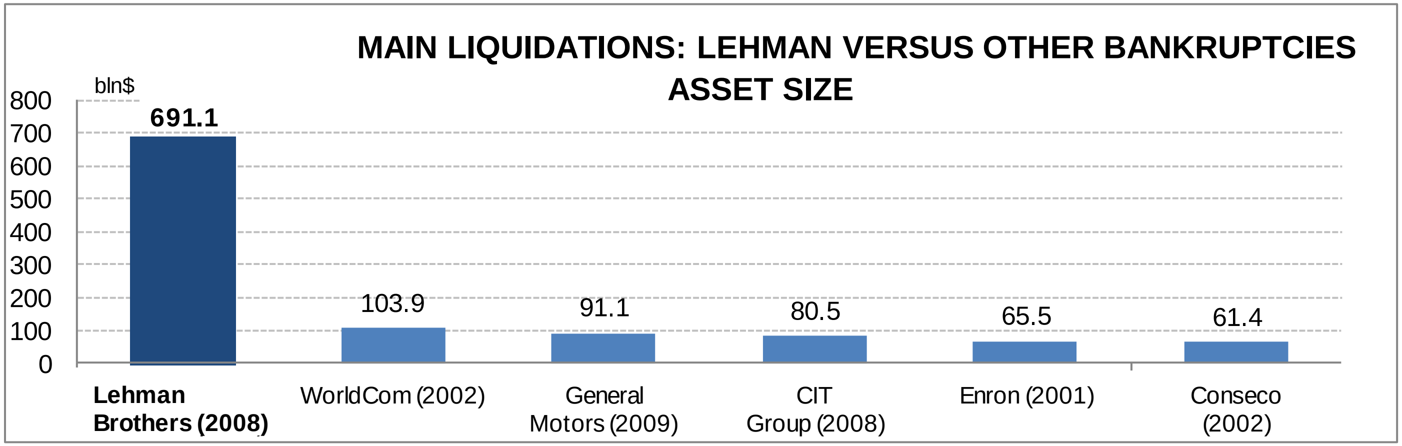
28 April 2014

LEHMAN BROTHERS:

Lehman was not one of the biggest failed banks

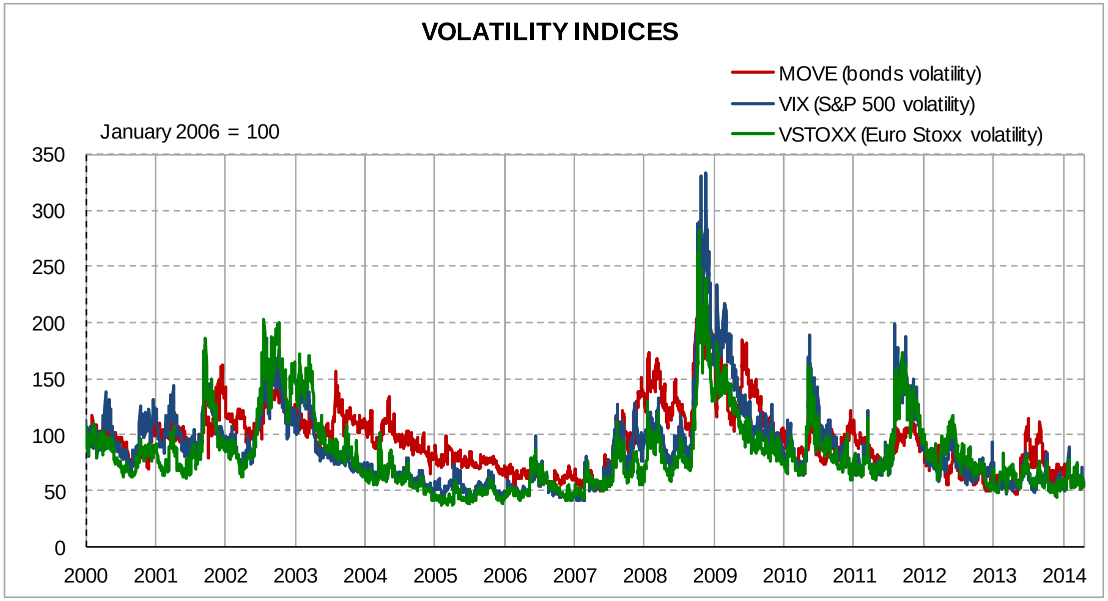


… but it was one of the biggest and more complex firms to be orderly liquidated by traditional channels

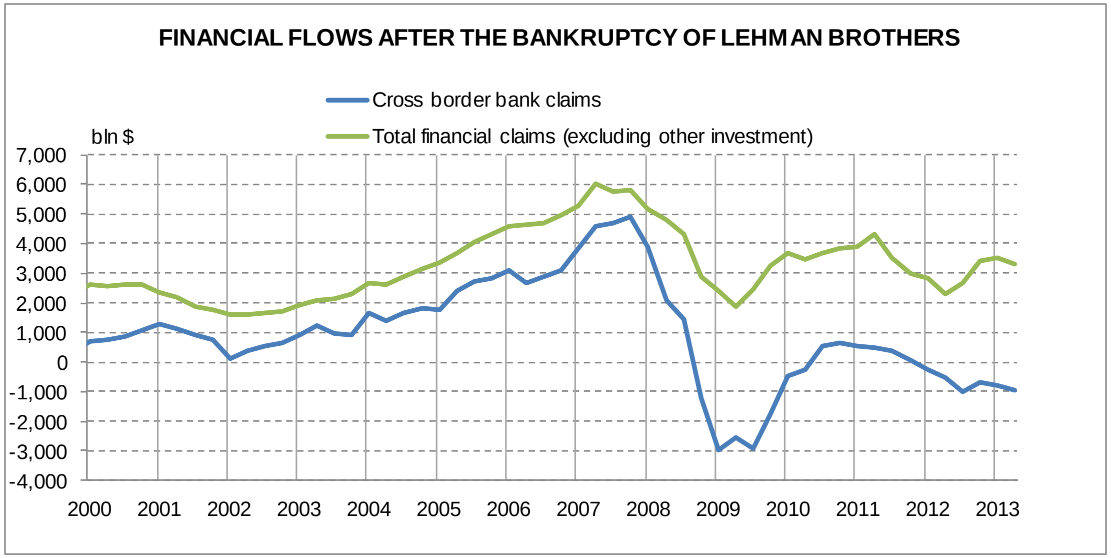


Lehman's liquidation revealed how demanding was to solve complex and interconnected financial firms

Something that exacerbated global uncertainty



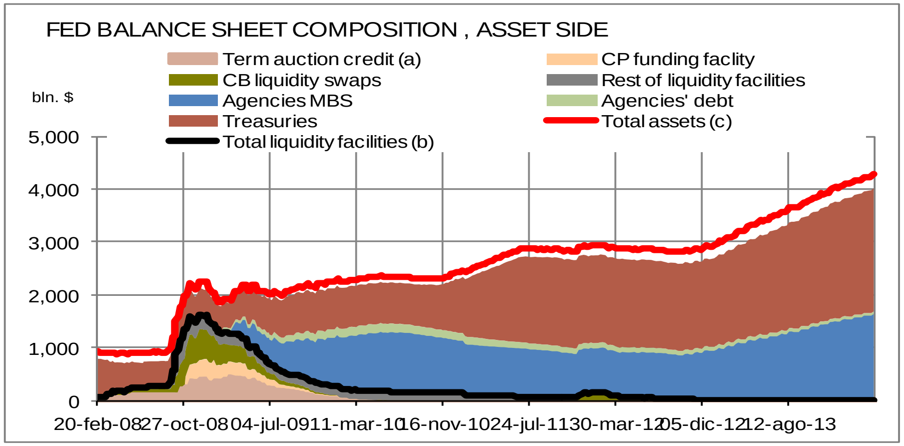
and reduced cross border financial flows

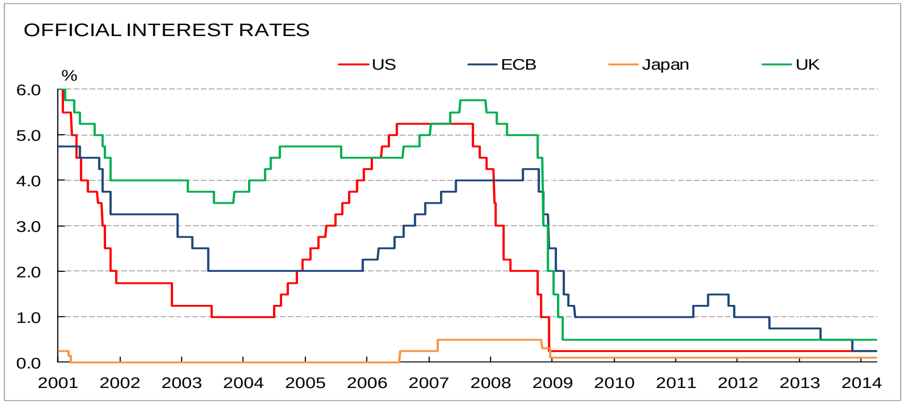


BANCO DE ESPAÑA
Eurosistema

Public authorities reacted with all the available tools to avoid a financial collapse

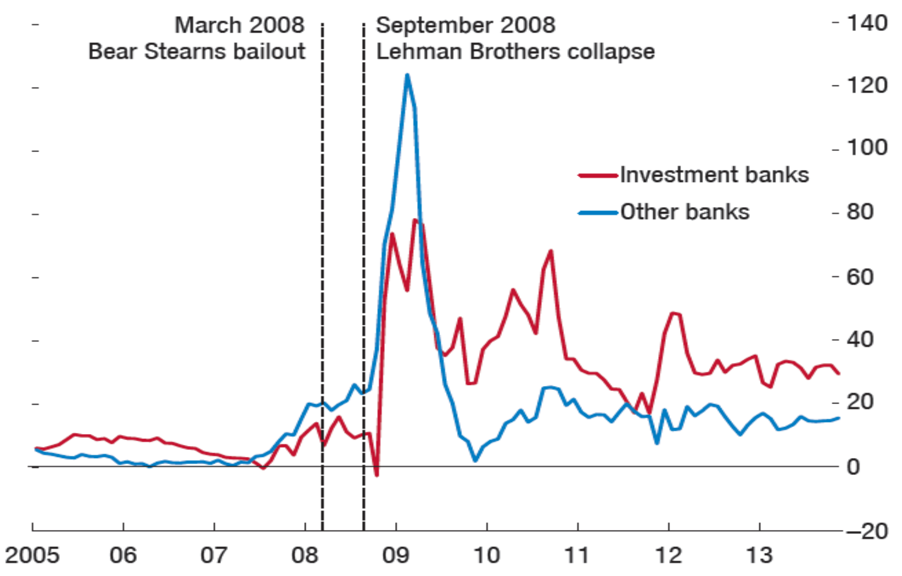
With conventional and unconventional monetary policies…





… at the risk of validating expectations that failed systemic banks will eventually be bailed out

Figure 3.9. Implicit Subsidy by Type of Bank in the United States
(Basis points)



Sources: Markit; Moody's CreditEdge; and IMF staff estimates.
Note: Estimated with the contingent claim analysis approach.
Investment banks comprise Morgan Stanley and Goldman Sachs.

NEW INTERNATIONAL ECONOMIC ORDER

G-7 → **G-20**

Reform of Bretton Woods IFIs

International Monetary Fund

- Strengthened surveillance
- Quadrupling of resources
- New lending policy
- Governance

World Bank

- Increased resources
- Enlarged lending policy
- Governance

New pillar of the International Economic Order

Financial Stability Board (FSB)

(Sep. 2008- April 2009)

- Regulation
- Supervision

FSB. – PRIORITY AREAS OF THE REGULATORY REFORM

FSB

(in coordination with other International Committees and Organisations)

Assessment of vulnerabilities ("EWEs")

Information gathering (*Data gaps*, *shadow banking* monitoring)

Leadership and coordination of financial regulatory reform in response to the 2007-2008 crisis

Priority Areas

Building resilience of financial institutions

"Basel III"

SIFIs Project (Systemically Important Financial Institutions)

***Ending Too-Big-To-Fail* (TBTF)**

Shadow Banking

OTC derivatives market reforms

Other areas of the regulatory reform:

- ➔ Reform of compensation practices
- ➔ Enhancement and convergence of accounting standards
- ➔ Reducing reliance on CRA's ratings
- ➔ Macro-prudential supervisory frameworks and tools
- ➔ Underwriting practices for residential mortgages, etc.

Monitoring of implementation of internationally agreed standards and recommendations

Peer Reviews

FSB. – “ENDING TOO-BIG-TO-FAIL” PROJECT

Identification of G-SIFIs capital surcharges

- TARGET: Reducing probability of failure of a G-SIFI
- Annual publication of the list of G-SIBs (Global Systemically Important Banks)
- Capital surcharges, 5 buckets: 1%, 1,5%, 2%, 2,5% and a 5th “empty bucket” with a 3,5% surcharge (to avoid that firms become more systemic)

Resolution

- TARGET: Reducing the impact in case of failure of a G-SIFI
- *Key Attributes of Effective Resolution Regimes* (“KA”) ➔ New international standard for the resolution of financial institutions

Intensity and Effectiveness of Supervision

- TARGET: Reducing probability of failure of a G-SIFI
- Supervisory Independence and Resources
- Enhancing supervisory practices of systemic groups.

FSB – "ENDING TBTF" – RESOLUTION OF SYSTEMIC INSTITUTIONS

Key Attributes of Effective Resolution Regimes

(FSB, October 2011)

Legislative Reforms
"bail-in"

Recovery and Resolution Plans
("RRP")
Resolution Strategies

Resolvability Assessments
("RAP")

"SPE"
Single Point of Entry

"MPE"
Multiple Point of Entry

GLAC

Gone-concern Loss Absorbing Capacity

STRUCTURAL REFORM PROPOSALS

A comparison of selected structural reform proposals			
	Volcker	**Liikanen**	**Vickers**
Broad approach	**Institutional separation** commercial banking and investment activities have to be separated	**Subsidiarisation** Proprietary and high-risk trading activity in separate legal entities	**Ring-fencing** Structural separation of activities via a ring fence for retail banks

- **Alternative domestic initiatives**
- **Need for international coordination**

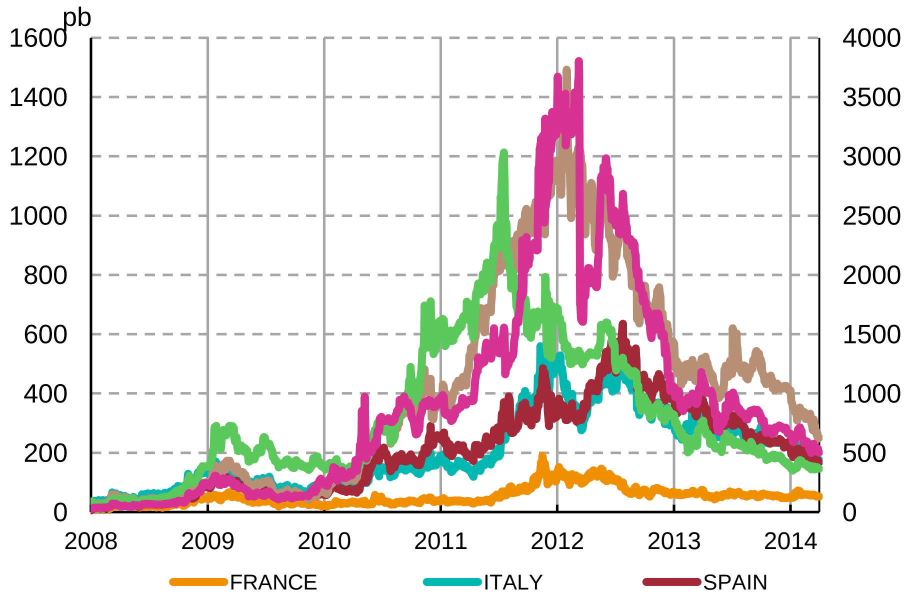
- **Regulatory and supervisory initiatives in response to the international financial crisis (in particular after Lehman failure)**
  - **New institutions + significative reform of existing ones**
  - **New rules, especially for internationally active banks**
- **A credible and effective global resolution regime for SIFIs**
  - **Advances but still some key aspects under discussion**
- **Impact of regulatory and supervisory changes in financial intermediation**
  - **Financial stability, financial complexity and financing of growth**
  - **Perspectives for bank businesses**
    - Structural reforms

EURO AREA : CRISIS AND AUTHORITIES' RESPONSE

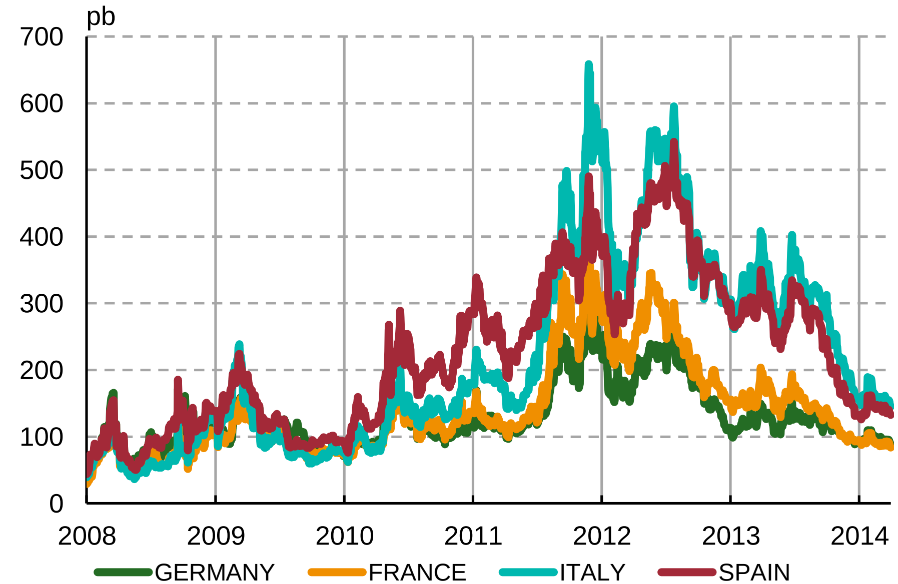
THE EUROPEAN SOVEREIGN DEBT CRISIS

- The Greek crisis expanded to Euro area countries that had accumulated macroeconomic imbalances and vulnerabilities.
- Fragmentation of financial markets
- Sovereign and banking risk link

TEN YEARS SOVEREIGN SPREADS OVER GERMANY



5 YEARS BANKS CDS



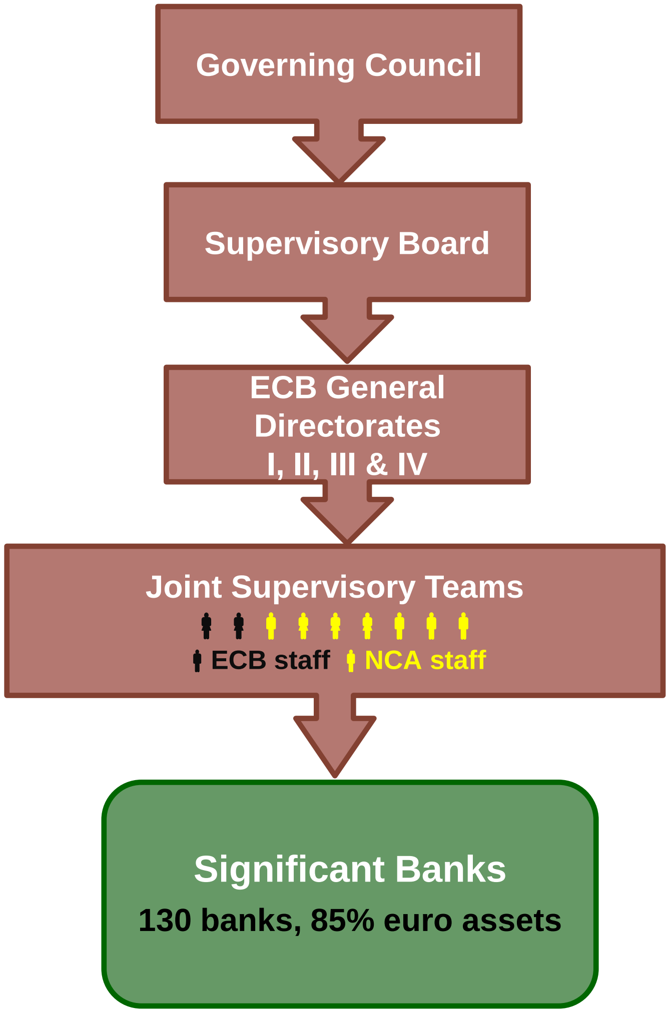
BANKING UNION

	Single Supervisory Mechanism	Single Resolution Mechanism	Deposit Guarantee Scheme
Legal Framework	**Council Regulation 1024/2013 (SSMR)** ECB: macro and micro prudential tasks **CRD IV- CRR** **EBA** - Single Rule Book	**Banking Resolution Directive (BRRD)** **Agreement:** December 2013 **Approval:** April 2014 (pending final revision)	**Deposit Guarantee Scheme Directive (DGS)** **<u>Harmonization</u> of Deposit Guarantee Schemes** **Agreement:** February 2014 **Approval:** April 2014 (pending final revision)
Institutional Framework	**SSM** A mechanism integrated by the ECB and the NCAs	**SRM** Single Resolution Mechanism and National Resolution Authorities	**European System of Deposit Guarantee Schemes**

SINGLE SUPERVISORY MECHANISM
(MICRO PRUDENTIAL SUPERVISION)

SSM = ECB supported by National Competent Authorities (NCAs)

- **Perimeter: euro zone plus opt-in non euro countries**
- **Significant banks**
  - Size: Assets > €30 billion
  - Importance: > 20% GDP
  - Cross-border activities
  - The three most significant credit institutions in each jurisdiction
- **Micro prudential supervision**
  - Significant Banks ➔ ECB Direct supervision ➔ Joint Supervisory Teams
  - Other Banks ➔ ECB indirect supervision ➔ NCAs
- **Joint Supervisory Teams (JST)**
  - ECB Coordinator
  - National Subcoordinators
  - Supervisors ≈ 1 BCE by 3,3 NCAs



COMPREHENSIVE ASSESSMENT

- Two main elements: **Asset Quality Review and Stress Test**
- Objective twofold: improve transparency and recapitalize viable banks with inadequate solvency levels → **final objective: strengthen confidence in the soundness of European banks**
- The **Asset quality Review** will examine the asset side of bank balance sheets as at 31 December 2013
- **The stress test** is a forward-looking exercise, which analysis the ability of institutions to maintain adequate solvency levels in stressed scenarios
- The relevant **thresholds already established**: 8% CET1 in the baseline scenario ; 5.5% under the adverse scenario
- **Publication of the results in late October,** before the ECB takes over the supervision of significant institutions on 4 November

MACROPRUDENCIAL POLICY IN THE EU

- **Microprudential policy was not enough , there is a need to address system-wide risks**
  - **Risks across the banking sector:** Size, interconnections, complexity, etc.
  - **Cyclical risks: Excessive credit growth, possibly concentrated (eg: real estate),** excessive maturity mismatch, misaligned incentives, excessive leverage, etc.

Identification of systemic risk sources → **Macroprudential instruments**: Dynamic provisions, countercyclical capital buffer, capital surchages for systemic institutions → **EU institutional framework**

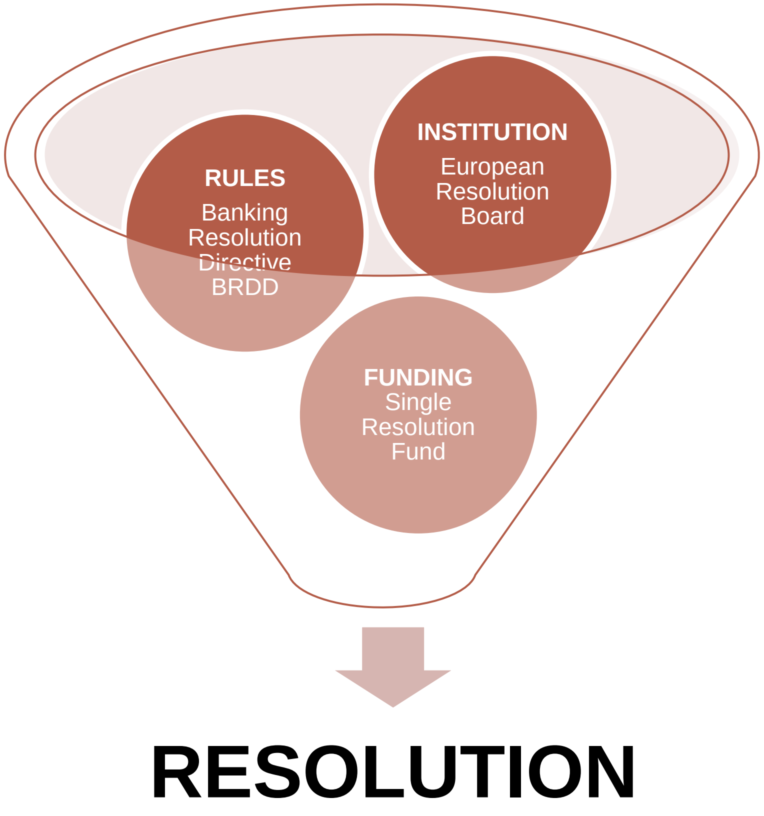
- **ESRB:** Macroprudential oversight of the financial system within the EU
- **ECB:** Share macroprudential powers with SSM national authorities
- **National Authorities:** Implement macroprudential policies at national level

SINGLE RESOLUTION MECHANISM (SRM)

- **Geographical Scope: as the SSM**
- **Single Resolution Board (SRB):**
  - Plenary Board ➔ General Rules
  - Executive Board: 5 members and the National Resolution Authority on an ad-hoc basis➔ For a specific bank
- **Single Resolution Fund (SRF)**
  - Industry contributions ranging from €55-60 billion
  - National buckets
  - Progressive mutualization from 40% in 2016 up to 100% in 2023
- **Decision process: as in the SSM**
  - SSM Significant banks and cross border entities ➔ Direct Resolution by the SRB
  - Other entities ➔ National Authorities
- **Resolution steps**
  1. Bail- in: minimum 8% assets
  2. Single Resolution Funds

     1st National buckets

     2nd Other buckets (mutualization calendar)
  3. Additional industry contributions, or national public backstop



- **International Coordination:**
  - How much international coordination of financial regulation is needed? Are we making (un)even progress depending on the topic at stake? Are there any areas requiring further harmonization? Is the system becoming too complex?
  - Banks versus other intermediaries and their role in financial intermediation: Implications for financial stability and economic growth.
  - Is there a need for greater cooperation and harmonization on entities' supervision and resolution?

THANK YOU FOR YOUR ATTENTION