STRENGTHENING FINANCIAL STABILITY:
THE CONTRIBUTION OF DEPOSIT INSURANCE

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Good morning. I would like to welcome all of you to the Bank of Italy. We are very pleased to be able to host this year's conference on financial stability and the contribution of deposit insurance.

1. The EU banking sector after the crisis

Three years after the onset of the financial crisis, the EU banking system has made important strides. These have been a long and difficult three years, but positive signs are evident. In the first half of 2010, profits rose at the major EU banks. In some cases income was significantly higher than in 2009; other banks reporting negative results last year have now returned to profitability. Loan impairment and bank provisions were reduced, as the recovery in the real economy gained momentum. The EU-coordinated stress tests published in July showed that banks have strengthened their capital base and are in a position to bear additional losses should the macroeconomic outlook deteriorate.

However, despite these positive trends, considerable uncertainty still surrounds the banking sector. Credit risk remains high and if, as recent signs indicate, the international recovery decelerates, credit risk could increase further. While moderate economic growth remains the most likely scenario for Europe, it remains vulnerable to a moderation in international trade. It is also not ensured that bank earnings will continue to be as sustained as in past months when they were supported by factors that may prove to be temporary: trading profits have been falling; and net interest income, though still strong, could be negatively impacted by a sudden flattening of the yield curve.

Especially worrisome are risks stemming from the interplay between sovereign debt problems and fragility in the banking sector; these are particularly acute in EU countries with large fiscal imbalances. In past months, we saw budgetary pressures having dramatic spill-over effects on bank funding in some countries; at the same time, signs of instability in the banking sector had negative repercussions on sovereign issuers.

Bank refinancing is another major concern. EU banks will soon need to begin rolling-over very large amounts of debt. Given that public-sector requirements will also be rising, access to market funding could become even more difficult.

In fact, we are observing greater polarisation among banks. Stronger institutions can access the markets. Others are experiencing difficulty and remain dependent on government support and central bank financing.

Today policy makers face a very demanding task. Dispelling market concerns over sovereign debt risk is imperative: progress in fiscal consolidation must remain a priority for EU member states. Yet equal attention must be devoted to supporting growth in the medium term. In evaluating longer-term sustainability, markets are paying increasing attention to a country's ability to generate economic growth. Therefore, to the greatest degree possible, consolidation measures should be growth-friendly and accompanied by structural reforms in the EU.

The goals for regulators and supervisors are no less challenging. We must safeguard the stability of the financial sector, and rebuild its solidity, while ensuring that the provision of credit and financial services to the economy is not impaired. Weaknesses and distortions revealed in the crisis must be corrected, so that credit institutions can fully support economic growth in the future.

It is essential that in coming years we have fully restored the banking sector's ability to perform activities essential to our economies. This is possible when there is a solid and stable system.

2. The regulatory reform: priorities ahead

A fundamental step towards achieving these objectives has been made by the Basel Committee on Banking Supervision (BCBS) with the agreement on the new bank capital and liquidity standards. The standards will markedly increase the resilience of the banking system, by constraining the build-up of excessive leverage and maturity mismatches that provided the fuel to this crisis. It is clear that the new rules will impose some costs – in terms of profitability – for the banking industry. However, these costs will be compensated by the fact that we will all (including bankers) live in a safer financial environment. Moreover, the transition phase to the new rules has been designed so that costs can be absorbed in a gradual manner and the recovery is not jeopardized.

The Basel agreement, for all its importance, does not however exhaust the need of reform in the financial system. An urgent step is to solve the moral hazard problems associated with systemically important financial institutions (SIFIs), also known as the "too-big-to-fail" (TBTF) problem.

These problems have increased as a consequence of the extraordinary public interventions during the crisis and probably represent the most daunting legacy that regulators must now confront. If we do not address this issue with determination,

SIFIs will continue to have incentives to engage in excessively risky activities; accurate monitoring by investors will be much weaker than desirable, with the result that future crises may be more likely.

Finally, we must be aware that the public will not accept a repetition of the widespread bailing-out of SIFIs that was necessary during this crisis. A clear political message has emerged at international level (Pittsburgh G-20 meeting Sept.2009), strongly backed by the EU, that taxpayer money should not be used again to cover bank losses.

Elaborating measures to effectively tackle "too big to fail" is now the priority of the Financial Stability Board (FSB), which will present its recommendations to the G20 in November. The FSB is assessing a broad range of policy options to reduce the probability and the impact of a crisis involving SIFIs. They include *inter alia* the introduction of prudential instruments, such as capital and liquidity surcharges above those agreed in Basel, the use of contingent capital (i.e. the possibility to convert debt into equity either by statutory resolution mechanisms or by private contractual arrangements) and the standardization and trading of OTC derivatives on electronic platforms with clearance by central counterparties to reduce the interconnectedness of financial institutions.

But particularly important, especially to establish the right set of incentives for SIFIs, is the FSB's program to set up effective resolution regimes, both at the domestic and cross-border level, to be able to manage in an orderly way the eventual failure of SIFIs.

Only if we succeed to organise a mechanism through which SIFIs are allowed to fail, while limiting to the maximum extent the systemic risk involved, can we ensure that SIFIs behave in a correct manner and thus reduce the probability of future crises.

The issue therefore merges into the broader question of establishing principles and tools for an effective crisis management system, a theme that involves many aspects that will be addressed in the rest of this conference. Let me briefly touch upon some of them.

3. Strengthening the toolbox

Role of authorities, preventive action and resolution regimes. A first crucial issue involves the role and powers of authorities. The crisis has highlighted that the intensity and effectiveness of the supervision of SIFIs must be stepped up, particularly with regard to both preventive action and resolution powers. This will be possible, in some cases, only by reinforcing the mandates, independence and resources of national supervisors.

With regard to preventive action, supervisory powers and resources must be reinforced so that Authorities can quickly detect early signs of deterioration and intervene as soon as possible to reduce the probability and impact of a SIFI failure. National supervisors should have the powers to apply differentiated supervisory requirements for institutions based on the risk they pose to the financial system. They should have the power to intervene effectively at an early stage, to mandate changes within an institution, to prevent unsound practices and ensure appropriate countermeasures including capital and liability restructuring.

With regard to resolution powers, an effective resolution regime must provide Authorities with the powers and tools to wind-down a firm quickly and safely, while ensuring the continued performance of essential financial functions and uninterrupted access of insured depositors to their funds in order to contain systemic risk.

Authorities must possess all the tools that facilitate "gone concern" restructuring and wind-down measures, including the establishment of a temporary bridge bank to take over and continue operating critical functions.

Cross border perspective. A second crucial aspect for an effective resolution mechanism regards cross-border multinationals. In the past three years, cross border issues have added a layer of complexity in dealing with bank crises. The international dimension of financial institutions increases the scope for cross-border contagion and thus the likelihood of a systemic crisis across countries. Moreover, reaching rapid and clear agreements at cross border level proved to be, in some circumstances, a very complicated exercise. Perhaps this should come as no surprise. To some extent, it is a direct consequence of the inconsistency between, on one hand, the size, complexity and interconnectedness of large banking groups – operating far beyond national boundaries – and, on the other hand, the enduring fragmentation of the national legal and regulatory frameworks.

The Basel Committee recently published a report on Cross Border Resolution, which contains a set of recommendations intended to strengthen national resolution powers and cross-border implementation. The report underlines, *inter alia*, the need to further converge on a common set of effective tools and improve information sharing in crisis management.

The report addresses the issue of complex banking group structures and recommends using regulatory incentives when complexity could create an obstacle to an orderly and cost-effective resolution; capital or other prudential requirements should be designed to encourage organizational structures that facilitate effective resolution.

The Financial Stability Board is also working to remove obstacles that can obstruct the effective implementation of recovery and resolution measures in complex cross-

border institutions. It has identified four technical areas that need to be addressed: i) complexities arising when trades are marketed, booked, funded and risk-managed in different legal entities and jurisdictions; ii) difficulties in disentangling group structures when the parent or lead bank has issued guarantees to support particular transactions by affiliate entities in foreign jurisdictions; iii) the preservation of global payment operations; and iv) the adequacy of a firm's ITC systems to provide firm-wide and single legal entity information, especially to support recovery and resolution actions.

Moreover, on the prompting of the FSB, Cross-Border Crisis Management groups have been established worldwide for most of the largest global financial institutions. The focus of these groups is to establish firm-specific Recovery and Resolution Plans that will help authorities and firms handle emergency situations and enhance mutual trust among key home and host authorities. Further progress on the recovery and resolution plans could be achieved by reforming resolution regimes in different countries.

At EU level, it appears necessary to work in two directions. First, cooperation among authorities must be improved in dealing with emergency situations involving cross border groups. The June 2008 Memorandum of Understanding on cooperation between the financial supervisory authorities, central banks and finance ministries of the European Union on cross-border financial stability needs to be fully applied and strengthened. Second, we must proceed quickly to better harmonize insolvency laws across the Union, starting with those principles and procedures most directly connected with crisis management.

A building block of any crisis management system is the effective and efficient work of colleges of supervisors. They are the natural body where possible and viable ways forward on a co-ordinated approach to crisis resolution can be discussed and organised (contact lists, stock-taking on legal and regulatory frameworks, data collection, procedural and organisational aspects of crisis management including possible scenarios of burden sharing). As a home supervisor, the Bank of Italy has put much effort in setting up these colleges and making them work, coordinating the process for all cross-border groups it supervises, and convening meetings of the Cross-Border Stability Groups and Crisis Management Teams for Italian banking groups.

The new European Banking Authority will certainly play a crucial role in developing an effective system to deal with crisis situations in Europe.

4. Funding the recovery or the orderly resolution. Who bears the cost?

A harmonised approach for dealing with weak or ailing institutions necessarily raises the question, "Who shall bear the costs?".

Based on the principle that taxpayers should never again bear the burden of future financial crises, priority clearly must always be given to private-sector solutions (including recapitalizations, ownership transfers, purchases & assumptions), ahead of any other source of support and certainly before taxpayer money is tapped.

However, as these options may prove insufficient or unviable in particularly serious cases, we must also prepare valid alternatives. Various mechanisms are being discussed, including:

<u>Haircuts</u>. Haircuts on creditors or "bail in" instruments have been recently proposed as one of the most promising tools for increasing the loss absorbing capacity of financial firms, beyond the capital base. Statutory bail-in would allow authorities in a going concern situation to wipe-out creditors, before the collapse of the firm. However, it would entail harmonizing global rules on creditor preferences and imposing bail-in conditions on pre-existing contracts. Contractual bail-in, on the other hand, would force institutions to issue a portion of senior debt, to be determined by regulation, that could be either written down or converted into equity in a public intervention procedure. There are also potential drawbacks in this option as it would introduce a distinction between "investors" and "customers", with the latter being less concerned about a careful monitoring of the bank. Nevertheless, it is clear that this is a route to be further explored.

<u>Private Resolution funds</u>. A privately-financed European Recovery Fund has also been proposed. This would be designed to facilitate emergency medium-term funding when liquidity shocks, in distressed capital markets, threaten banks that are otherwise solvent and profitable. It would be financed by voluntary contribution of the top twenty European banks. Although private, the fund would only intervene when European authorities determine that a bank needs support, providing guarantees at market conditions. This could be an important resource for overcoming difficulties in certain situations, but it is essential for authorities to consider the capacity of the banking system to finance both a resolution fund and an insurance scheme; an additional question is whether a private resolution fund would duplicate DGS that act as "beyond pay box" instruments.

<u>Ex-ante resolution funds</u>. In addition, the EU Commission has recently proposed establishing a system of EU-harmonized resolution funds (COM 2010/254), aimed to facilitate the resolution of failing institutions. The funds would be financed by imposing levies on banks. To avoid moral hazard, these funds should be activated only as instruments of last resource, after exhausting all private sources of financing. Within a clear resolution framework, it could provide a useful instrument to help

authorities liquidate banks in an orderly manner, by covering administrative costs, financing the total or partial transfer of assets and/or liabilities, or financing bridge banks.

A number of countries have recently introduced (Sweden and Hungary) or announced plans to introduce (Germany, France and the UK) bank levies, though the objectives and implementation schemes differ significantly. Considering the current conditions of the financial sector and the costs that banks will incur to conform with the new capital standards, in my opinion the timing of additional expense should be assessed carefully. However, if such initiatives are pursued, it is important that they proceed in a coordinated manner and, in this sense, the Commission's proposal appears to be a sensible way forward; a number of issues, related for example to the precise scope, financing and governance of resolution funds still need to be addressed.

The role of DGS. Deposit Guarantee Schemes should be able to absorb the impact of medium magnitude crises or, where possible, to promptly intervene to avoid bank failures in the interest of depositors. The more effective a DGS, the greater will be depositor confidence, reducing the risk of bank runs and limiting contagion from banks in distress.

Much work is underway at international fora to strengthen the role of DGS. The effort to harmonise and enhance their risk minimiser role is particularly welcomed. The contribution that DGS can bring to open market solutions, helping to preserve the continuity of important business activities and avoid the disruption of customer relationships, mainly in the interest of depositors, will be increasingly important.

The important collaboration between the Basel Committee and the International Association of Deposit Insurers (IADI), who joined forces to address a range of issues including coverage, funding and reimbursement, resulted in the "Core Principles" focusing on, among others, public awareness and cooperation with other safety-net participants, including central banks and supervisors. The principles are designed to be adaptable to a broad range of country circumstances, settings and structures.

The "Core Principles" form a non-compulsory framework for deposit insurance. However, they are testimony of the will to establish best practices for national authorities committed to enhance or put in place effective deposit insurance schemes.

The EU Directive on DGS. Steps taken in the EU to strengthen the regulation on DGS move in the right direction.

The Commission proposal of July 2010 aims to enhance depositor protection and convergence of EU DGS by harmonizing scope, coverage and funding mechanisms.

It raises fixed coverage to €100,000 per depositor, significantly reduces the payout delay, and institutes a funding mechanism based mainly on ex-ante contributions.

The proposal also explicitly provides for the preventive intervention of DGS to avoid bank failure. There are still technical issues to be addressed, since the current proposal lacks reference to the least cost criteria and authorisation processes. Nevertheless, the recognition of DGS as preventive actors in helping to avert worst crisis scenarios is welcomed. It could provide the necessary impulse for implementing this feature in EU countries where DGS currently lack such role.

Pan-European Deposit Guarantee Scheme. In the course of recent work to strengthen the European financial system, the question has been raised repeatedly as to whether a single pan-European deposit guarantee scheme could be a feasible option. It would certainly allow for significant savings in administrative costs (estimated at about €40 million per year). Moreover, a pan-European scheme could ensure better management of bank failures because the impact of a bank failure on a large scheme would be smaller than on an individual Member State DGS. Furthermore, in a cross-border banking crisis, a pan-European scheme could provide incentives for a pooled solution in the interest of all depositors, regardless of nationality. However, owing to the complex legal issues arising from differences in national legal frameworks and the absence, at the moment, of an integrated European supervisory and crisis management framework, this idea is still a longer-term project.

5. Conclusions

Let me conclude my remarks by stressing two aspects that, in my opinion, are at the core of the issues addressed at this conference.

First, international cooperation and rule harmonization must be significantly stepped up. Establishing an effective crisis management system, including a clear resolution framework, is the road we must undertake to reduce the likelihood of future crises and contain their damage should they nevertheless occur. In a context where financial institutions operate globally, we can succeed only by increasing cooperation, coordinating action and reaching a much higher degree of harmonization of our domestic systems. In Europe, this is of utmost importance if we wish to strengthen the single market and ensure a level playing field for all financial actors.

Second, in the field of supervision, the harmonization of practices is at least as important as the harmonization of rules. The introduction of a common set of rules, powers and tools should be complemented by the development of common methodologies, among supervisors, to assess the ongoing risks faced by cross-border banking groups and to develop common assessment. This is essential to achieve

shared decisions and would greatly facilitate coordinated solutions in an emergency situation.

Progress must be made rapidly, now, taking advantage of the momentum in international cooperation that has gained ground with the crisis. It would be unforgivable to remain unprepared. It would mean confronting future emergencies from a much weaker position than we had when this crisis first emerged. At the European level, there are encouraging signs that we are moving in the right direction. There is increasingly greater awareness of our interconnectedness and the response, though hesitant at first, has been more Europe, not less. I have no doubts that the new financial supervisory architecture and the authorities that will come into force next year will make great strides to provide the impulse and vigour to move forward and achieve the necessary goals of this process.