BANCA D'ITALIA
EUROSISTEMA

1st Biennial Banca d'Italia and Bocconi University Conference on Financial Stability and Regulation

Welcome address by Ignazio Visco
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It is a pleasure for me to open this conference on "Financial Stability and Regulation" and welcome all of you who are here today. This will be the first of a biennial series of conferences on financial stability that Banca d'Italia has decided to organise with the Baffi Centre for Applied Research on International Markets, Banking, Finance and Regulation. I would like to thank the organisers, the contributors to the four sessions, the keynote speakers and the panellists of the policy roundtable that will conclude the conference tomorrow afternoon.

In the last ten years or so the objective of promoting and maintaining financial stability has strongly returned to being at the centre of the attention of policy makers in governments, central banks and supervisory and regulatory authorities. Since the global financial crisis, the regulatory framework has been substantially reformed, through the work of the Financial Stability Board, international standard-setters, regional bodies such as the European Commission, and the new laws and regulations established in jurisdictions all over the world.

A question that is now often raised is whether enough has been done to safeguard our economies and financial systems from the risks we face from the financial complexity and interconnections that characterise our rapidly changing global environment. But a symmetrical question is also raised, i.e. whether we have gone too far with the introduction of new requirements for financial intermediaries' capital, liquidity, leverage, not to mention disclosure, reporting and so on. In a nutshell, the issue is whether all this might unfavourably affect the financing needs of the real economy.

Answers to these questions are now being debated in international fora such as the Financial Stability Board and the Basel Committee on Banking Supervision. But they are also very much the subject of substantial research, carried out for academic purposes but also by central banks, supervisory agencies and international institutions.

This is confirmed by the very large number of papers submitted to this conference and the exceptional quality of the ones that will be presented today and tomorrow. Indeed,

benefiting from the perspective of academics and of policy makers, this conference focuses on some of the most hotly debated financial stability issues. Evidence will be presented on how regulation and policy interventions may lead to spillovers that could produce unintended consequences, requiring careful analysis of the policy design and calibration.

As the opacity and complexity of structured financial products were among the culprits of the global financial crisis, their impact on financial stability has also been very much scrutinised. In recent years the regulatory landscape for these instruments has been overhauled, with the objective of increasing their transparency and standardisation. The overall impact of these reforms is now the subject of careful evaluation.

Other more traditional issues, such as maturity mismatches and the reduction of banks' fragility to runs coming from the transformation of shortterm deposits into longterm loans, have also, again, been studied in depth. The relevance of liquidity and leverage risks has continued to underpin the introduction of new requirements in the banking sector. However, more should most likely be done, as the issue is not limited to banks that are generally subject to strict regulation and careful supervision, but extends also to the large and somewhat unexplored shadow banking sector. The global financial crisis has forcefully reminded us that excessive leverage, dramatic shortages of liquidity and bank runs are not just a matter of interest solely to economic historians. Indeed, new research has been fostered to understand how runs could be generated in a much deeper and extended financial environment, which tends so much to reflect the effects of the extremely rapid and profound technological innovations that are changing our everyday lives.

Three areas of interest not only for policy makers and regulators but also for current and future academic research seem to me particularly important today.

The first is about macro-prudential policy and tools. To tame systemic risks in the banking sector, banks' resilience to shocks is being increased with the introduction of countercyclical and other capital buffers. In particular sectors where price misalignments may become extremely severe, the reduction of the build-up of risks is pursued through the use of specific sectoral constraints. To limit funding risks, the recourse to new liquidity tools is recommended. Yet, much should be done to shed light on the costs and benefits of each tool, on how to best calibrate the ones which are currently being used, and on how new, more effective, macro-prudential instruments, if needed, should be developed.

As has long been recognised, the possibility of conflicts between the mandate of macro-prudential policies and that of micro-prudential supervision of financial intermediaries is compounded by the fact that the two policies share some of the same instruments while their objectives, however, might be conflicting in some points of the cycle. For instance,

during downturns macro-prudential policy interventions would imply the loosening of equity buffers, while a purely micro-prudential perspective may aim to preserve or even tighten capital requirements. How to best coordinate the two approaches is a matter which is still unresolved. In the European Union this difficulty combines with the institutional framework, which is characterised by different layers of central and domestic authorities.

Also, most importantly, the interaction of macro-prudential policy with monetary policy, both in its conventional and unconventional forms, provides ample possibilities for future research. In the medium run they reinforce each other. Monetary policy aims at maintaining price stability, which is a pre-condition for a sustained and balanced growth. At the same time, financial stability cannot easily be achieved in a persistently depressed economy. In the short run things are however a bit more controversial. On the one hand, macro-prudential policy can mitigate unintended consequences of monetary policy, such as excessive risk taking in times of very low interest rates. On the other hand, macro-prudential policy can interfere with the transmission of monetary policy to economic activity through its tightening or loosening effects on credit conditions. Research can provide insights on the extent to which macro-prudential authorities should internalise the macroeconomic consequences of their decisions, and on how to smooth short-run conflicts between monetary and macro-prudential policies (as well as those of the latter with other policies and measures in fields such as those of taxation and environmental protection).

Dramatic developments in financial technology (Fintech) are creating new services, enlarging the pool of potential competitors of traditional intermediaries, and setting new challenges for macro-prudential authorities. There are many issues that could be fruitfully explored in this second area of interest. Perhaps this is where possible conflicts may arise between traditional banking institutions and new institutions operating in the shadow banking system. There might also be complementarities, the more so if banks learn how to take advantage of instruments such as crowd-funding and/or lending based on major advances provided by technology, for instance the use of big data, the diffusion of machine learning or the recourse to distributed ledgers.

A field that is very much under investigation at a policy level is that of the so-called cryptoassets, as the best-known of which being bitcoin. At present, as we concluded two weeks ago in the G20 meeting in Buenos Aires, these assets do not appear to provide serious financial stability risks. However, besides raising concerns from an anti money laundering and counter terrorist financing viewpoint, today's cryptoassets are all characterised by a number of fundamental problems, such as huge energy consumption, limited scalability and high price volatility, which prevent their use as a reliable means of payment, store of value or unit of account. This also explains why some of us prefer

to refer to them as crypto-assets rather than crypto-currencies, as they are more often called, and why issues like the need to preserve market integrity and to ensure consumer protection, are emphasised so much.

However, some of these 'first-generation' cryptoassets might evolve. It cannot be excluded that stable, sustainable, nonanonymous crypto-assets may end up contributing to the efficiency of the payment systems and to the stability of financial institutions. And perhaps a regulatory framework for Initial coin offerings which guarantees investor protection may foster the use of crypto-assets as a source of fundraising for innovative, high-tech start-ups, promoting innovation and helping new firms to differentiate their sources of funding, with benefits for the overall stability of the financial system. All this clearly deserves serious investigation.

There is also a more general question about the future of the technology underlying the functioning of most crypto-assets, the distributed ledger technology (DLT). In financial markets, a complicated system with lots of intermediaries is required to transfer assets, verify who owns what, and reconcile the various records: banks providing custodian services, brokers processing trade orders, exchanges and clearing houses settling transactions. A DLT has the potential to combine the services of these various layers in one single technology, resulting in a cheaper, less intermediated, and potentially more secure system. Transparency in transactions and asset holdings stored on distributed ledgers can also improve regulators' ability to assess financial system risks and monitor compliance with regulations. The DLT certainly holds the promise of significant economic benefits in the future, but it is still relatively immature and untested. More research is needed to determine whether these changes will ever actually take place.

The third area of research that seems to me to deserve further, important consideration concerns the management of banking crises. This issue will certainly be discussed at length tomorrow morning in the last session of this conference, on bank resolution, and in the policy panel on banking crises in the afternoon. As is well known, the response to the global financial crisis also addressed the regulatory landscape for bank recovery and resolution. In Europe, the substantial costs of the public recapitalisation of banks in many countries motivated the introduction of a new bank resolution framework (*Bank Recovery and Resolution Directive*, BRRD), which increases the burden of losses borne by the private stakeholders of institutions in distress, with the aim of reducing the cost for taxpayers. The use of bail-in tools as a general principle is certainly welcome as long as it is expected to reduce banks' risk-taking incentives and to reduce distortions to competition associated with too-big-to-fail market perceptions. Yet, when it comes to the specific use of the BRRD, the old saying of "the devil is in the detail" remains valid, as

witnessed by the inadequacies of the new framework that emerged during recent cases of bank crisis. As I have mentioned on other occasions, the use of public funds could be less restrained to avoid financial stability risks and economic disruptions that may be caused by a routine recourse to private burden sharing.

Of course, this is not to say that, in the different forms that banks' resolution and liquidation may take, shareholders should not bear the cost of the resolution or the liquidation, administrators and managers should not be removed, or careful recovery plans should not be required. But I am still worried that the straightforward application to banks of the insolvency proceedings normally applied to non-financial companies could lead to unintended consequences, via confidence disruption and contagion, to the rest of the system and to the real economy. And I believe that the issue of how to resolve banking crises in the European banking union in an orderly, quick and efficient manner, also given the difficulty of effectively coordinating all the authorities and institutions involved, still needs to be satisfactorily addressed.

This is not to dispute that a well-thought out implementation of bail-in procedures or a proper application of state aid rules in the case of well identified threats to market competition would not be useful. However, theoretical and empirical research should foster a better understanding of the conditions under which a bailin approach is socially optimal. In-depth empirical analysis of the impact of the current implementation of the BRRD on the banking sector and on the real economy is of the utmost importance. The development of effective analytical tools to assess the potential systemic spillovers from different private loss absorption requirements in real-life cases is necessary to guide the decisions of resolution authorities. More generally, how different approaches to loss absorption in the resolution of failing banks affect (and are affected by) the degree of sustainability of public finances is a subject that should be further investigated. As I have said, I expect that the contributions of the papers presented in the bank resolution session and the policy panel that will conclude the conference will provide useful and meaningful grounds to discuss these issues.

To conclude, the post-crisis regulatory overhaul that has *de jure* or *de facto* provided central banks with a new or a renewed financial stability mandate is here to stay. High quality research, both theoretical and empirical, and fora like this conference, in which recent experiences and new ideas are exchanged in an open minded atmosphere, speed up the pace at which policymakers can learn how to most effectively fulfill such financial stability mandates.

With this expectation, I wish all the participants in this conference two very constructive days of open discussion and fruitful exchanges.

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