Federal Reserve Bank of New York and Banca d'Italia

Post crisis financial regulation: Experiences from the two sides of the Atlantic

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Ten years have passed since the default of Lehman Brothers, which was a turning point in the global financial crisis that had started earlier on, in the summer of 2007. The crisis spread rapidly from the structured products market linked to US subprime mortgages to all financial markets, and ultimately to the real economy, sparking the worst global recession since World War II.

The policy makers' reaction to these extraordinary developments was quick and remarkably well-coordinated. Central banks around the world rapidly lowered official interest rates, and injected liquidity in unprecedented quantities and through a wide range of monetary policy instruments. Fiscal policies became expansionary and supportive of the real and financial sectors, and more serious negative consequences were avoided.

Although some of the long-lasting consequences of those events are still apparent today in many economies – in Italy, for instance, GDP as of last December was still 5 per cent lower than in 2007 – a decade later we are finally exiting from the exceptional policy measures taken since then. Central banks in the major advanced economies have gradually started to normalize their monetary policy stance, albeit with different timing reflecting the differences in cyclical conditions across the major economies.

The response to the crisis has led to important changes in the rules of the game for banks and financial firms, which are the subject of the analyses presented in the two workshop sessions today. In the immediate aftermath of the crisis, the G20 Leaders established the Financial Stability Board (FSB), building upon its predecessor, the Financial Stability Forum, to promote the repairing of the financial system through a broad agenda of reforms of the international regulatory framework. The reforms were intended to address the imbalances that had gradually been accumulating in the global financial system well before 2007, by strengthening the resilience of financial intermediaries, markets and infrastructures, tackling moral hazard issues and reducing procyclicality in the financial system. In particular, for institutions which pose systemic risks, reforms were aimed at enhancing their capacity to absorb shocks and, in the event of failures, making their resolution easier.

To date, substantial progress has been made towards a more stable and resilient global financial system. First, banks' capital has been substantially increased, and ad hoc capital buffers have been built by systemically important banks. Second, banks' liquidity positions have also been strengthened with the introduction of rules such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio. Third, the vulnerability of the financial system to contagion on a global scale has been curtailed, by providing incentives to clear over-the-counter (OTC) derivatives centrally. And fourth, the market for complex and opaque securitizations – a form of financial intermediation which played an important role in the run-up to the crisis – has virtually disappeared. In Europe, new rules have been approved in order to promote simple, transparent, and standardized securitizations.[1] However, cases such as the recent strong growth of the collateralized loan obligation market in the United States need to be kept under strict scrutiny to avoid repeating past errors.

In spite of such progress, significant challenges remain ahead of us and we must maintain the momentum of reform.

A significant source of potential vulnerability concerns the non-bank financial sector. Post-crisis reforms of the regulatory framework have been much less advanced in this sector than in the banking sector. Perhaps also as a consequence of this, the share of non-bank financial intermediation has grown seamlessly since the end of the last decade, with non-bank financial intermediaries often performing functions typically carried out by banks, without being subject to comparably stringent regulation and supervision. According to the Financial Stability Board, at the end of 2016, non-bank financial intermediaries held $160 trillion in total assets, about one and a half times the level at the end of 2008, while over the same period banks' assets have risen only marginally. The non-bank financial intermediaries performing bank-like functions in 2016 held $45 trillion of assets. The asset management industry, the largest sector of non-banking intermediation, has almost doubled in size over the past decade.

The growth of non-bank financial intermediation is increasing the sources of finance for the economy, reducing dependence on bank lending

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[1] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 lays down a general framework for securitization and creates a specific framework for simple, transparent and standardized securitization.

and strengthening the financial system's resilience. In this respect, it is a welcome complement to bank intermediation, in particular in many European economies, including Italy, which have traditionally been characterized by a bank-centric financial system, with limited room for market-based finance and non-bank financial intermediaries.

At the same time, we cannot neglect the risks it may create for financial stability. Some risks are similar to those faced by banks, as non-bank financial institutions are also exposed to risks related to liquidity/maturity transformation and leverage.[2]

Other risks, however, are of a different nature. The spread of high-frequency, quantitative/automated trading and passive management strategies contributes to making the highly concentrated asset management industry vulnerable to procyclical behaviour, which in turn has the potential to amplify market reactions to macroeconomic news, sometimes in destabilizing ways. A case in point is what happened at the beginning of last February, when some apparently innocuous news on US wage growth led to a stock market crash, with a sudden unwinding of crowded trades, and hugely negative consequences for some market players (who had bet on low volatility). Fire sales and contagion can take place during this kind of events, which could end up having unsettling effects on financial stability, to the extent that they could threaten the resilience of financial intermediaries.

Other significant developments that need to be monitored closely due to possible financial stability implications concern technology and financial innovation. The profound changes in financial technology are enabling new institutions, often operating outside the banking system, as well as large technology corporations to offer services which challenge the traditional role of bank intermediaries. These changes blur the distinction between the financial and technology sectors, raise questions concerning the perimeter of current financial regulation, and give rise to new risks, such as those deriving from an increasing dependency on third-party service providers.

As the adoption of digital technologies for the provision of financial services spreads, policy makers need to continue monitoring the risks from a financial stability perspective, and consider whether FinTech should be

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[2] A preliminary initiative on this front is the FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 12 January 2017.

regulated, who the regulator should be, and what type of regulation would be appropriate. In addressing these issues, we should be guided by the principle of 'same business, same risks, same rules'. In Italy, the banking law has recently been updated in order to bring the regulatory framework for finance companies, investment firms and other non-bank finance intermediaries more in line with the regime applicable to banks.[3] The rationale behind this reform was, among other things, to avoid new forms of potential regulatory arbitrage stemming from the differences in the regulatory frameworks for institutions with similar types of business.

A related area is that of crypto-assets. Their financial stability implications are currently limited given the size of the market, as observed by the FSB report published in October. However, this assessment could change over time, as suggested by some experiences, such as the very large swings in their prices, the very rapid expansion in some countries of initial coin offerings,[4] the growth of crypto-asset exchanges, and the emergence of crypto-asset funds, futures and similar financial products. Wider use and greater interconnectedness with the core financial system could pose financial stability risks if they occurred without material improvements in the resilience of crypto-asset markets.

To support a timely identification of emerging financial stability risks and to explore the possible policy options to pre-empt the build-up of risk and to ring-fence the financial system if risks from crypto-assets become significant, a strengthening of the analysis of the crypto-asset market structure is necessary.

Yet the challenges that are facing us today are not only about dealing with the new risks (and opportunities) of financial innovation. After the intense, prolonged reform effort, we need to ensure that the new framework is effectively implemented, thereby providing regulatory certainty and stability so that the financial system can operate in support of economic growth.

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[3] The reform is based on Legislative Decree 141/2010, which amended the TUB (Consolidated Law on Banking); it was completed by Ministerial Decree 53/2015, which identified the activities subject to reserve. Supervisory regulations for financial intermediaries and groups of financial intermediaries are set out in Banca d'Italia Circular No. 288 of 3 April 2015.

[4] Initial coin offerings (ICOs) are public offerings of crypto-assets in exchange for sovereign fiat currencies or popular private crypto-currencies (e.g. bitcoin) through which companies raise capital to fund the early stage development of projects or businesses. ICOs are conceptually analogous to initial public offerings for stocks.

A key issue concerns the need for consistent implementation by all jurisdictions, in order to prevent fragmentation of the financial system. In principle, rules commonly agreed upon by the FSB and the Basel Committee on Banking Supervision (BCBS) should lead to a more stable and resilient financial sector and to a better integrated financial system. However, differences in reform implementation across countries might increase the fragmentation of financial systems. An example taken from banking supervision concerns ring-fencing practices adopted by host authorities on banks' international branches. This is rational from the single regulator's perspective but could lead to more fragmented global banking and liquidity. Hence, efforts should also be made in the direction of assessing reform implementation, with the aim of achieving a more homogenous application of the agreed rules across regions, including through truly open cooperation and coordination.

The large scale of the post-crisis reforms requires a thorough and honest assessment of their effects and of the possible implementation challenges. Work on this front is ongoing in several forums. The FSB has recently prepared two different reports to evaluate the effects of reforms on infrastructure finance and on incentives to clear OTC derivatives centrally. A new project has been started to assess the effects of reforms on SME financing and another is planned to evaluate the implications of the reforms aimed at addressing the systemic and moral hazard risks associated with global systemically important banks (G-SIBs). The FSB is also planning an initiative to explore ways to address the risk of market fragmentation.

Reform evaluations naturally entail an appraisal of their unintended consequences. For instance, analyses of the effect of the leverage ratio on banks' provision of client clearing services have been carried out by the Financial Stability Board together with the relevant standard-setting bodies, and are informing the ongoing effort by policy-makers to improve the regulatory framework.

Implementation challenges can also arise in relation to what I see as a trade-off between the ex-ante desire for perfection and the ex-post effectiveness of new regulations. Let me give you two examples.

We have had the Bank Recovery and Resolution Directive (BRRD) in Europe since 2014. In the spirit of the Key Attributes for Resolution Regimes agreed by the FSB, this directive aims to strengthen and harmonize

bank crisis management in the EU, as well as to minimize the cost to the taxpayers. Among other provisions, the new directive sets a 'minimum requirement for own funds and eligible liabilities' (MREL) – similar to the Total Loss-absorbing Capacity (TLAC) requirement for global systemically important banks – to ensure that, in the event of resolution, banks will have sufficient own funds and other liabilities to absorb losses and reconstitute capital. At the same time, its introduction could substantially raise bank funding costs and reduce bank lending. While estimates of these costs are highly uncertain, there are risks of a non-negligible impact on GDP growth. Banca d'Italia has stressed the need to alleviate the adverse effects of the rules on banks' loss-absorbing liabilities by ensuring that the amount and quality of funds are proportionate to the actual demands of the resolution, and that the transition period is long enough to allow the banks to build up the requirement gradually. Yet when looking at the initial experiences with the application of the new bank resolution regime in Europe, it is clear that more flexibility in applying the available tools would help make the crisis management framework more effective in dealing with problem banks. A useful lesson in this regard can be that of the United States, where flexibility and pragmatism are key ingredients of the policy decisions in this realm. However, for the lesson to be learned, the members of the European Union – a relatively young union – need to reinforce mutual trust, which is the essential glue of any union, but that nevertheless has recently been weakened more than once. All in all, implementation challenges could well lead to some regulations being reconsidered.

A second example of the trade-off between an ex-ante desire for perfection and ex-post effectiveness is given by looking at specific components of the banks' capital. Capital is a key element of bank regulation and it has therefore been a main target of the post-crisis reform, as will be discussed in the second session of today's workshop. A major innovation of Basel III is the possibility granted to banks to compute the Contingent Convertible bonds (CoCos) as 'Additional Tier 1' capital. The favourable regulatory treatment of this instrument has spurred a very strong growth in the CoCo market in Europe. However, while CoCos are designed to strengthen bank solvency on a going concern basis, their use may ultimately come at the cost of increasing financial stability risks. Recent research by Banca d'Italia[5]

[5] Bologna, P., Miglietta, A., and Segura A., Contagion in the CoCos market? A case study of two stress events. Banca d'Italia Working Papers (Temi di Discussione), 1201, November 2018.

has shown that the adverse dynamics of the CoCo market that occurred in 2016 following worrying news about an issuer cannot only be explained by the banks' fundamentals and hence that CoCos might in fact themselves be a source of financial instability. Although some of the instability may have been transitory, the analysis suggests that this market should be closely monitored and that authorities may need to rethink the role of CoCos, should they prove unable to provide for a smooth bank recapitalization.

This brings me to my final remark. There is a concrete risk of losing the reform momentum and conceding ground to calls that are not always disinterested and to mounting pressure to roll back the existing regulations. As recently pointed out by the International Monetary Fund, this pressure should be resisted. We need to learn from the past. Each and every time either regulation or supervision has become lax, excessive risks have been taken and leverage has increased, often leading to abrupt and recessionary swings in the financial cycle. So, during economic expansions we should be aware of the possible illusory perception of things looking more benign than they actually are.

To conclude, central banks have emerged from the trial of the financial crisis with a strengthened responsibility in the area of financial stability, which needs to be honoured. High quality analyses and meetings like this one represent a unique opportunity to compare experiences and continue the debate, thus helping policy makers to carry out their mandate more effectively.

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