BANCA D'ITALIA
EUROSISTEMA

Credit Day

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Rome, 5 October 2023

Two years ago, my long membership of the Basel Committee came to an end. I took the opportunity of the 2021 Credit Day to share some thoughts on my experience, and sketch out an evaluation of the set of regulatory reforms promoted by the Committee over the years to strengthen banks' capital and liquidity.

With the approval of the final version of Basel III, the cycle for revising standards had essentially come to a close at the end of 2017, although the transposition of the standards into the actual supervisory rules of individual jurisdictions had not yet been completed two years ago (and in fact, it is still not complete). I intended to convey a largely positive assessment of its effects, not only in the abstract, but also in light of the resilience effectively shown by the banking system during the 2020 pandemic crisis. This seemed (and still seems) to me a valid argument bearing out the appropriateness of the reforms implemented, as well as a spur to carrying out the rest of them.

I did, however, point out that these standards were the result of some difficult compromises, and I did not refrain from pointing out that certain improvements would have been advisable, especially as regards liquidity.

What has happened in the meantime seems to me to have confirmed, even reinforced this idea. The bank failures that occurred last March in the US regional bank sector and in Switzerland focused the attention of the authorities, observers and the industry itself on certain regulatory issues; and also on issues concerning the international framework for crisis management, a topic I did not cover two years ago.

Two years on, I would like to share once again my thoughts on international regulatory standards, in light of what has happened in the meantime. I shall cover both issues.

Prudential standards

Implementing the remaining elements of the Basel III standards remains a priority. We do not have far to go; and whilst it is true that many years have gone by since the crisis that gave impetus to the reform, perhaps too many, it is also true that time has made it possible to fine-tune the regulatory process for the more complex issues, such as market risks, and to achieve, especially at the European level, the necessary convergences of objectives.

All in all, the political agreement that has now been reached in Europe seems satisfactory. Most of the deviations from international standards will be transitory. The choice to apply the Basel standards to all banks stands confirmed, albeit with some appropriate simplifications for banks that are smaller and less complex because of their operational set-up or their estimated exposure to risks.

This generalised application is an important choice, and one which Europe has made from the start. This is not the case everywhere. The United States, in strict adherence to the concept of 'internationally active banks' established as the minimum frame of reference for the Basel standards, have so far limited their full application to the largest banks. The banks hit by the recent crises, though anything but small (Silicon Valley Bank, SVB, was roughly comparable in size to largish Italian banks like BPM or ICCREA), were held to be of regional concern and therefore not required to comply with the most rigorous standards. As I shall say shortly, in the circumstances that led to the SVB crisis, the standard for short-term liquidity coverage would have rung alarm bells in plenty of time, and would have helped to prevent the crisis, or at least to intervene swiftly to limit the consequences.

The far-reaching effects of the American regional banks crisis and the resulting fears of contagion, even at the global level, also highlighted something that had hitherto not been paid enough attention. Dangers for financial stability do not only stem from the very big and interconnected banks, but also, regardless of size, from intermediaries with a specific kind of imbalance, if fears spread on the market that other, more or less similar intermediaries might have similar problems. This is what I call 'contagion by analogy': a form of contagion that has nothing to do with the exposures of other banks to those in difficulty, or with other direct or indirect relationships they may have, or with any of the other factors currently considered to assess an intermediary's systemic status. I think it is to be appreciated that, drawing from this experience, in their proposal for transposing the final Basel III rules recently submitted for consultation, the US authorities have expressed their intention to extend the list of banks that will be required to apply the Basel standards.[1]

After so many years, completing the application of Basel III is necessary, but it is also advisable to move forward.

In order to discuss this point, let me provide a very general premise on the goals of regulation. As everyone knows, the banking system performs (among other things) two fundamental functions: leverage and maturity transformation. Both these functions

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1 In the USA, for banks with assets of over 100 billion dollars ('large banks'), the Basel rules are currently applied gradually according to a subdivision into four groups: the largest banks, i.e. globally systemic ones, apply the complete version of the standards, while those with assets of between 100 and 250 billion dollars apply an abridged version of the standards. In the new proposal, the application of the Basel Committee standards will be envisaged for all banks with assets above 100 billion dollars and for those performing significant trading activities (i.e. with a trading portfolio of over 500 million and accounting for 10 per cent of total assets).

are necessary for supporting the efficient functioning and growth of the economy, but they also entail fragility and risks. Such risks can hit not only the intermediary itself and its shareholders, but also a wide range of other entities, especially if there are information asymmetries. Examples include damaging unsuspecting depositors, triggering contagion by interconnection or 'analogy', and creating instability, crises of confidence and even panic. The range of these externalities is such that a system of rules and prudential supervision is needed that, without calling into question the ability of banks to carry out these two fundamental functions, imposes certain controls and limits on them, which, imperfect though they may be, will mitigate the inherent risk to the system.

The existing system of global prudential standards pays a great deal of attention to the risks linked to the first element (leverage), via a structured set of requirements. However, it has so far dealt with the second (maturity transformation) far less systematically. As I recalled here two years ago, it was only with Basel III that liquidity requirements were introduced in the global system of standards, and this was the first attempt to introduce a safeguard for a risk linked to the transformation of maturities. For the interest rate (IR) risk, also originated from maturity transformation, there are Pillar II requirements that are not very harmonised, not very binding, and that are currently based – as far as international standards are concerned – on a methodology that is too simplified and rigid.

Recent events have clearly highlighted the problems connected with this deficiency. After a long period of highly accommodative monetary policies, central banks, facing the materialisation of inflation risks, rapidly reversed the course. A swift and generalised rise in interest rates has put pressure on intermediaries that, owing to an excessive imbalance between the financial duration of assets and of liabilities, are highly exposed to IR risks.

Another issue has emerged in all its importance. Technological innovation and digitalisation have been the source of great progress, enabling banks to lower costs and improve the quality and range of the services they provide. At the same time, innovation has created new risks, including those linked to the marked increase in the potential speed of an outflow of deposits. The latter effect has been magnified by the role of social media in spreading news and influencing the expectations of operators.

The issue of IR risk is among those that the Basel Committee decided to look into following the crisis of last spring. Various solutions are possible.

Including it among the risks covered by Pillar I, however justified it might be in theory given its proven importance, might not be the best solution in practice, because a suitably flexible approach is needed to mitigate it. IR risk changes in distribution and size according to times and places and, as things stand, it would not be easy to conceive of and quantify a standard model amenable to general application, as required by Pillar I. (Neither does it seem advisable, given the experience in other fields, to rely too much on banks' internal models for prudential purposes).

Stronger Pillar II rules could enable requirements to be set that are calibrated according to circumstances and to the exposure of individual intermediaries. This already happens in Europe via the 'required' element of Pillar II ('P2R'), which is almost as binding as Pillar I and, compared with the latter, permits greater flexibility in its design.

At the global level, it will therefore be useful to verify, first of all, how the existing standards are actually applied in different jurisdictions. Standards require the use of Pillar II instruments, but in ways that are left to the discretion of local authorities. Based on that, it would then be useful to assess whether greater harmonisation, or a better toolbox, or both, are needed.

Maturity transformation in itself is not covered by the Basel standards, except in the very simplified form of the net stable funding ratio (NSFR). I mentioned last time our belief (which has so far attracted few proselytes) that a more granular indicator should have been constructed. The NSFR only makes a distinction between durations of more and less than one year, hence it does not consider the entire maturity structure of the balance sheet, as in our view it should; it is therefore inadequate for fully capturing the risk of an excessive exposure to a maturity mismatch. This was clearly the case for SVB: although the bank was characterised by an obvious imbalance of maturities (a large share of long-term securities on the asset side, and of highly concentrated and uninsured sight deposits on the liabilities side), it appears that, even if the requirement had been imposed, it would have not signalled an anomaly.

In my view it would not be a bad idea to establish prudential limits on maturity transformation that are explicit and sufficiently comprehensive, such as those that used to be imposed for this purpose, years ago, by the Bank of Italy: requirements that are perhaps somewhat crude, but are effective nonetheless. They might take the form of an evolution of the NSFR, which as it stands has not proven to be of much use so far. To those who might object that exposure to liquidity and interest rate risks stemming from a maturity mismatch would in any case be picked up by other, more specific requirements (the LCR, Pillar II safeguards) and that an 'NSFR+' would therefore be a duplication, we would respond that it would follow a backstop logic. This would be much the same logic that Basel III standards follow, as they complement capital requirements based on a granular risk assessment, often built on models, with certain rule-of-thumb safeguards meant to mitigate model risk, such as the output floor and the leverage ratio. Specifically, for the IR risk, given the considerations above (and even assuming an improvement in the current schemes), it seems hard to find a model that is robust enough to adapt to all circumstances; a simple 'guardrail' – conceived, like the leverage ratio, not to be binding most of the time – would be very useful in my opinion.

As for the LCR, it must first be said that experience has confirmed its usefulness. It is worth emphasising that in the case of SVB, as I mentioned previously, had the LCR been in place, it would have effectively signalled (unlike the NSFR) that risk was approaching, thereby alerting in good time, not only the supervisory authorities, but also the bank's senior management, who had not perhaps fully realised what was happening. In any case, the headlong and ultimately fatal run on deposits that took place made everyone aware of one key point: that the volatility of deposits has greatly increased because of (a) the ever-increasing speed with which funds can be moved, and (b) the fact that news and fears, justified or otherwise, can spread at lightning speed on social media. Standard setters therefore need to start a review of the hypotheses on the behaviour of sight deposit holders on which the calibration of the requirement is currently based. The concentration of deposits (another SVB weakness) will also need to be considered, as will the level of protection afforded by guarantee funds. On the last point, we should start thinking, especially in Europe, about the possibility of raising the guaranteed threshold. I shall return to this issue later on.

The Basel Committee is already discussing a revision of the LCR. This does not rule out in principle an even wider-ranging discussion about supplementary or alternative tools for managing short-term liquidity stress. I am referring here in particular to the possibility of requiring that banks have a minimum level of assets that can be used to obtain liquidity support from the central bank.[2] This would be a distinct paradigm shift compared with the current set-up; it needs therefore to be examined with due care and attention.

Changes in the regulatory framework such as those suggested above take time. In the meantime, though, banks have to start their own work. They should review their risk management systems, fine-tune the instruments used to assess exposure to maturity transformation risk (also bearing in mind possible relationships between interest rate and liquidity risks), and adopt all the improvements necessary.

The debate on crisis management

The bank failures that occurred in the United States and Switzerland also invite us to reflect on the adequacy of the principles for effectively managing bank crises introduced in 2011 at the global level ('key attributes'),[3] as well as on how the authorities dealt with these failures.

One fact appears clear. The bail-in, a cornerstone of the reform, has never actually been applied to a big bank. The only exception to this in the Banking Union is the case of Banco Popular in Spain, where the solution to the crisis consisted in swift intervention by another bank, and in which the bail-in was limited to capital instruments (and despite this, six years on, the ensuing complex legal disputes have yet to be resolved). In the recent case of Credit Suisse – the first failure of a global systemically important bank ('G-SIB') since the category was created – despite stating that they would be ready to implement a resolution if necessary, the Swiss authorities actually opted for an alternative solution, because they apparently feared that applying a bail-in might have had disproportionate repercussions on financial stability in Switzerland and elsewhere.

The Financial Stability Board has started a debate on the lessons learned from this crisis. The initial analyses point to confirming the adequacy of the regulatory framework regarding resolution, while bringing some significant applicative problems to light. I would not dispute that resolution standards have improved the cooperation and crisis-readiness of both banks and authorities, thanks especially to (a) an improved ability of intermediaries

2 A proposal like this was recently put forward by Mervyn King, former Governor of the Bank of England.

3 FSB, *Key attributes of effective resolution regimes*, 2011.

to provide the authorities with the information needed to weigh up possible solutions, and (b) the requirement that banks issue securities that can absorb losses in the event of a resolution. However, it seems to me that an in-depth discussion is still needed on the impact on markets of hypothetical bail-in based resolutions for large banks, and on the effective conditions needed to apply this tool, especially to cross-country groups.

One specific, but important, question concerns AT1 instruments, which have been introduced into the prudential system to provide a buffer that can absorb a bank's losses in a 'going concern' situation, i.e. before reaching a point of no return. In theory, AT1 instruments provide an ailing, but curable bank with the option of cancelling interest payments. However, the possible immediate signalling/reputational damage and the resulting repercussions for the cost and availability of liquidity funding are a strong disincentive to activating this option. The same fear of negative market reactions is an incentive for the issuer to exercise the option of early repayment of this instrument even in cases where the refinancing needed to do it makes this move economically disadvantageous. Furthermore, at the macro level there is no shortage of examples of risks of contagion 'by analogy'. The Basel Committee has launched an in-depth study on specific critical aspects. I believe this is a chance to have a fully-fledged discussion of the issue; as well as reviewing the technical details, consideration should be given to the more fundamental question of the suitability of AT1 instruments as an effective tool for covering 'going concern' business losses.

The recent episodes have also highlighted the topic of how, and how much, to protect deposits in the digital age. As I have already pointed out, the speed at which large outflows from two American banks occurred in March this year highlights the role played by a large share of uninsured deposits in accelerating liquidity crises. This fact has triggered a debate worldwide on the scope and level of protection provided by the guarantee systems, in connection to the various functions provided by deposits (means of payment, financial investment).

There is no doubt that high levels of protection reduce the risks of instability, but it is equally clear that unlimited, or even very high, protection levels would not be manageable, not least because they would overly increase the risk of moral hazard. It should also be borne in mind that the higher the level of protection, the greater the burden for the banking system; any increase in this burden (we can assume) would partly be passed through to depositors.

An assessment of the chance to increase the European threshold, set at €100,000 since 2010, is under way, and we are following this work closely. Even back in 2010, the threshold was set at a considerably lower level than in the United States ($250,000).[4] There have also been proposals[5] to set differentiated levels of protection, for example giving greater

4 As well as a direct effect on the confidence of depositors and the reduction of the risk of a deposits outflow, an increase in the protection threshold would contribute indirectly, by making it possible more often to find a solution to a crisis that ensures a continuity for depositors in access to their funds because of its effects on the least cost test.

5 FDIC, Options for Deposit Insurance Reform, May 2023 https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf

protection to deposits that – in view of specific contractual features, such as duration or remuneration – only function as a means of payment; however, the technical and conceptual obstacles are not trivial. The International Association of Deposit Insurers is going to publish a report on the implications of the recent bank crises for deposit guarantee schemes by the end of the year.[6]

No deposit guarantee scheme can ever totally shelter the banking system from instability risks. Experience teaches us that crises of confidence and contagion risks require flexibility in the use of instruments and sometimes exceptional measures – such as a 'systemic risk exception', like the one that in the case of the US regional banks made it possible to prevent the spread of contagion – as well as the availability of a public liquidity backstop. This option should not be ruled out a priori, but neither can it be codified in detail; it needs to be looked at on a case-by-case basis. In a second-best world such as the one we have, I think we should preserve a certain dose of what used to be called 'constructive ambiguity', namely the ability of the authorities to decide case by case according to the actual circumstances, in order to prevent banks and investors from relying too heavily on the intervention of the authorities and to reduce moral hazard risks.

In Europe, the Bank Recovery and Resolution Directive (BRRD) and the establishment of the Single Resolution Mechanism (SRM) have set up procedures for timely interventions where necessary, and aim to create a harmonised crisis management system. This has resulted among other things in intense data gathering, coordination and forward planning.

Nevertheless, the framework needs to be completed, especially for small and medium-sized banks, by strengthening the capacity of deposit guarantee schemes (DGSs) to intervene. Such interventions can be very effective in fostering an orderly market exit and lowering the overall cost of a crisis. The success of similar strategies traditionally adopted by the US Federal Deposit Insurance Corporation (FDIC) bears witness to this, and I believe we should look at it very carefully.

In April, the European Commission published a comprehensive proposal for reviewing the system. The proposal confirms the possibility for DGSs to carry out preventive interventions to prevent failure, and alternative interventions to repaying deposits should a bank be liquidated. Two innovations would facilitate the use of these instruments: i) the removal of the favourable treatment accorded to protected deposits in the insolvency hierarchy ('super-priority'); and ii) more consideration given to the indirect costs connected with a bank's failure, which would make approval of a DGS intervention easier, based on the least-cost principle.[7]

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6 IADI strengthens its role as global standard setter and reflects on lessons learnt from the recent banking turmoil, Press release 29 September 2023. FSB Press Release (iadi.org)

7 These are different costs from the direct financial burden that a DGS may be required to bear in order to refund the depositors of a bank in crisis, and refer for example to potential contagion effects.

This proposal also envisages a significant extension of the list of banks subject to resolution, currently limited in Europe to the bigger banks and a few dozen less significant ones. Since defining a bank as being subject to resolution entails the obligation to issue liabilities that can be used in the event of a crisis (MREL), any future extension should be well calibrated to take account of the greater difficulties that small banks face in accessing wholesale capital markets.[8]

Some concerns are raised by the proposal to introduce even stricter limits on precautionary recapitalisation, which would make it very difficult to use them. There is also no provision for a safety valve, similar to the US 'systemic risk exception' mentioned above, to make it possible to overcome ordinary constraints when necessary to tackle situations of systemic instability. The solution chosen by the American authorities to resolve the March crisis, and prevent the contagion from spreading, would not have been legally possible in Europe.

Finally, one regrets the total absence of progress towards establishing a European deposit insurance scheme, a key element that is needed to complete the banking union. With a view to fostering progress in the negotiations, one could point to the much reduced differences in riskiness between national systems,[9] as such differences have so far prevented an agreement from being reached. It is beyond question that the system could and should be devised in such a way that no ex ante expectations of transfers between States would arise. The American federal system centred on the FDIC has been around for ninety years, and it works.

Learning from experience is important. In my view, the things that have happened recently confirm both the worth of many regulatory choices made in the past (if accompanied by strong and intrusive supervision), and the need to take further steps, both in Europe and at the global level. We are pushing these ideas in the technical fora. We stand ready, as always, to provide technical assistance as far as we can to policy makers, who must have the last word on the underlying regulatory framework.

8 We should also think about the authority not being allowed to consider a potential DGS intervention to support a sale when a resolution is being planned, which would make it possible to reduce the MREL calibration.

9 For example, the gradual convergence of non-performing loan ratios.

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