European Banking Authority

Opening of VI Conference on banking turmoil and regulatory reform (IESE Banking Initiative)

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Banking turmoil: some reflections for prudential regulation and supervision

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Good morning and thank you for inviting me to open this conference today in Barcelona to discuss the recent banking turmoil and regulatory reforms.

I believe the Irish writer James Joyce captures very well the essence of mistakes in his quote “Mistakes are the portals of discovery”. Mistakes can happen because we took the wrong actions or because we failed to foresee the implications of a situation. In both cases, they are a golden opportunity to learn and improve. In my eyes the agenda set for today strikes very well the issues that may have contributed to the banking turmoil faced by the banking sector in early 2023 and the actions taken to address it. And I am sure this conference today at IESE will be a portal for discovery.

My understanding of « the banking turmoil », the title of today’s conference, is that we are broadly referring to the failure of a few US regional banks, as well as the emergency acquisition of Credit Suisse by UBS and the actions taken by authorities around those episodes. Reflections of these recent episodes can offer important lessons for the supervisory and regulatory banking community.

Inflationary pressures and monetary policy response and implications on banking sector

Before discussing the lessons from those specific episodes, allow me a broader reflection. The cracks caused in some banks by the sudden change in the interest rate environment, was cited as one of the many reasons of the banking crisis in March 2023. It is true that as a response to unusually high inflation rates seen globally in 2022 and 2023, central banks reacted aggressively by increasing interest rates to rein in inflation.

The causes of high inflationary pressures may not be directly relevant to today's conference. Still, it is important to analyse the banking turmoil under the spectrum of the challenges the banking sector was facing. A pandemic had disrupted global supply chains leading to shortages of goods. In Europe, a war and geopolitical crisis arose that led to additional tensions and further fed the inflationary pressures. This led to a coordinated and rapid increase of interest rates across the western world after a decade of the lowest interest rates and largest liquidity provision in history.

It is not hard to guess that this mix would have implications for financial institutions. I must admit, and I cross my fingers, that looking at the performance of the banking sector in Europe, and financial markets more broadly, I am pleasantly surprised that the number of negative surprises (or turmoils) that we have encountered has been limited.

Silicon Valley bank (SVB), the biggest US institution that failed during the banking turmoil in March 2023, was exactly confronted with by now well-known problems related to the movement of interest rate, the size of its fixed income portfolio and its management of interest risk and its deposit base.

Crédit Suisse, because of its size and track record, had been a source of concern for some time. At the time of its acquisition by UBS, Credit Suisse was the second-largest bank in Switzerland and one of the global systemic important institutions. Its failure was a culmination of scandals, management shifts, significant losses due to the collapse of Archegos Capital and Greensill Capital investment firms. Finally, its insufficiencies in managing risks and maintaining a sustainable business model ultimately triggered a lack of investor confidence. Its size and interconnexion in the global financial system was a source of concern for potential contagion.

I will not try to summarise the lessons learnt from these episodes in my remarks. I will only focus on the key messages that I took from the lessons learnt exercises that were undertaken by the U.S. and Swiss authorities in these cases, as well as the Basel committee.

All these reports highlight the importance of failures in the institution's management. Deficiencies in its key role in setting the strategy, the credibility of the institution, its business model and risk appetite, and the proper internal risk management and controls. The reports also highlight the importance and timing of supervisory action. Its intrusiveness and capacity to provide timely and clear requests for remediation by the supervised entities. Also, the findings highlight the importance of preparedness, particularly for resolution and of cross-border cooperation.

Third, the reports also look at the role of the regulatory framework, in particular in two areas: i) liquidity and interest risk management: the way liquidity is assessed, the role of digitalisation and social media, and the management of interest risk by banks and within the regulatory framework; ii) the role that regulatory capital plays, particularly on the valuation of assets (held to maturity vs mark to market), and the ability to absorb losses of the different capital instruments.

As we start thinking about potential lessons we could extract from the turmoil for regulation, and in particular prudential regulation, we should first remember what prudential regulation is supposed to achieve. Let me remind you that prudential regulation – and Basel IIIis explicit on this – is not calibrated to produce "zero failures", but seeks to reduce the likelihood and impact of banking stress. Bank failures should be a natural outcome of poor management or other events. The goal of the regulation is to ensure that the stress caused from bank failures, and in particular systemic crisis, is minimised.

I will argue that judging from what happened last year, the events were traumatic, as exceptional measures had to be taken by authorities, but the overall financial stability was preserved. In that sense we should be pleased for what has been achieved in the last years. Of course, the exceptional measures that were taken by the authorities involved a significant component of improvisation and ad hoc reaction. In that sense, we could argue we were not sufficiently prepared. So we cannot be complacent, and we should continue to enhance our ability to provide authorities with the appropriate toolkit to manage these crises. We should also require authorities to do as much planning and preparatory work as possible to avoid crises. And if a crisis cannot be avoided, they should at least manage these situations in a manner that can be as predictable as possible.

Many of these lessons on management, governance and the regulatory function have been very well discussed in the papers distributed for the conference and I am sure they will be thoroughly covered in the panel discussions today.

So I would prefer not to dedicate the rest of my time to addressing them individually, but rather to take advantage of this academic setting of IESE that allows a deeper interaction., Let me, instead, focus on three broad aspects that have arisen from these episodes and which I believe deserve further assessement of how to address them in the future. They are all partially related to bank supervision but I think they are broader than that in nature. None of them is actually totally new, but I think they require a new look and bigger emphasis going forward.

Liquidity and maturity transformation in a digitalised world

The first theme is how we should view the provision of liquidity and maturity transformation in the future digital world: what is liquidity and who does maturity transformation.

Reality is never as cleanly delineated as we draw it in our models or in the regulatory framework. We assume a simple world in which maturity transformation is done by banks that take sight deposits from citizens and lend money over the long term to investors. At the same time, they are

able to guarantee depositors liquidity by having access to the central bank, while regulators and supervisors heavily supervise banks for that exceptional right of access to the central bank. I am afraid this world, never really existed so neatly.

There was always an alternative to that transformation by banks: securities markets. But those securities markets also required liquidity to be efficient.

It has been the case over many decades that the role of maturity transformation and liquidity provision has been shifting into financial entities other than banks. This was partially a result of some of the banking regulation introduced after the great financial crisis in 2008.

So far, we have been managing that transformation by a combination of measures. Partially, we assume that the banks will ultimately act as an intermediary providing adequate liquidity to those other financial entities that may need it. In the case of some asset management products, like managed funds (be it for highly liquid funds such as money market or for highly illiquid like real estate funds), we also rely on regulation . I mentioned these two cases, because they are well identified as sources of vulnerabilities in the past and are still in search for a proper regulatory treatment.

The last decade has put a test on this model. At the macro level, our concerns on the functioning of nonbank financial intermediation are increasing, and the Financial Stability Board (FSB) just put forward additional warnings on this issue.

The new era has also introduced digitalisation, instant payments, and crypto technology. At one extreme, some academics see the interaction between these technologies as a way in which maturity transformation will be fully decentralised and the matching of savers with investors will be done in a decentralised manner and at all maturity horizons. Savers, as part of their portfolio, will choose the financial assets that will also match their desired maturity of each of their investment. They will rely on financial markets for the intermediation of these financial assets and generation of liquidity out of them, if needed. If they want risk-free liquidity, they will deposit that at the central bank. No need to have financial intermediaries that do maturity transformation in the economy. Furthermore, there will be no need to provide further guarantees on liquidity than what the central bank will provide on its deposits. In this scenario, the vast majority of the current banking regulation possibly will not be needed. .

I am not sure whether we will see such a future, but I am sure it will not be in my professional career. Yet, I think that such a scenario is pointing us in a specific direction.So we need to manage this evolution. Ultimately, we will need to decide whether we think is desirable or not and regulate accordingly.

In the interim, we do see an increase in the demand for immediacy and speed in the use of deposits and savings in the economy. Innovation has made it faster and easier to move money, from the creation of the ATM to modern digital banking apps, alongside faster payments and reduced settlement windows. Social networks have also made it easier to communicate and to

coordinate actions in a manner in which more herd behaviour is likely to take place (rational or irrational).

If we want to continue down that path of providing continuous instantaneous access to liquidity (mainly bank deposit for simplifying the argument) we need to make sure that the system is capable of doing it.

This starts, of course, from the banks. There is a need to critically assess their behavioural models on deposits, the true source of diversification in their deposit base, the quality, preparedness and availability of their collateral to access central bank liquidity, and their ability to truly liquidate assets at stressed prices.

It also requires to review actions by the supervisors. The need to assess the frequency, and type of supervisory evaluation and reporting.

I think we should also question the regulation, and not just its calibration but its principles. For instance, the liquidity coverage ratio (LCR requires banks to hold sufficient liquid assets to meet a 30-day stress outflow period. A more fundamental question is whether we should still expect banks to be able to survive a liquidity stress for 30 days without some sort of intervention, be it public or private.

Which brings the question also to other authorities beyond supervisors. Starting with the providers of liquidity (the central banks). Beyond the issue I raised before on who should have access to central bank liquidity and focusing exclusively on banks. Should we review the way and speed in which liquidity is provided? We have seen in a number of stress cases that the banks involved were not able to operationally generate the liquidity they were expecting from the central bank (operational issues got on the way, collateral was not well documented, or not provided on time). Should we require collateral to be prepositioned at the central bank? But how about the central bank? Should its liquidity window be open 24hours, 7 days a week?

Resolution authorities also have to reassess the way they interact in this context. We have been discussing the issue of liquidity in resolution for a long time. We have also discussed the time needed for resolution (is it a weekend? Can it be done overnight?). How about instant resolution? How do I assess failing or likely to fail, and proper valuation of an entity while ensuring instant access to deposits?

Finally, there is a need to review the way deposit insurance schemes function. Evidence suggests that the degree of deposit insurance in the EU is very large. In that sense this might be comforting. However, surveys also indicate that the largest concern by depositors is not whether their deposits are safe or not (i.e. where deposit insurance will ultimately work) but whether those deposits are liquid in case their bank goes in liquidation/resolution. When will they have access to the deposits in case liquidation occurs. Assurances in that regard to depositors by the deposit guarantee schemes will help generate confidence.

Role of market prices in supervisory management

The second broad area for reflection is even older or more classical. It has to do with markets as mechanism for price formation and the interaction between market prices and action by supervisory and resolution authorities, which of course implies what should be the role of market prices in the regulatory framework .

Markets play an essential role in price formation and information disclosure.

But as Oscar Wilde popularised at the end of the XIX century, in "the picture of Dorian Gray": «Nowadays people know the price of everything and the value of nothing.»

A quote by the way which today would have been considered plagiarism from a XVII century Spanish poet Francisco de Quevedo, who in 1611 said « solo un necio confunde valor y precio ».

Anyway, despite the beauty and wisdom in these words, I will argue that market price is by far the best signal that we have on the future value of any asset at any point in time. At the same time, we should not forget that markets are not always efficient, nor deep enough to reflect what inframarginal value may be for inframarginal transactions, particularly when we know those markets are not sufficiently liquid.

The experience from last year in the banking turmoil, indicated again how markets interact, and in particular the linkage between equity prices, hybrid instruments of capital (such as AT1) and other markets for debt or credit default assets. All of them traded assets, all of them in what are likely to be very thin markets.

I see here a number of challenges arising. First, the use of these prices as automatic triggers for action, be it in risk management by financial institutions, or in triggering action by supervisors. Should supervisors allow/encourage its use by banks? When should it be part of the regulatory framework? Of course, this debate is not new and to some extent it reminds me of the debate on the excessive reliance (and automatic reliance) on the regulation of credit ratings and credit rating agencies of a decade ago. Nevertheless, it is embedded in many of our prudential regulation and we should assess its proper functioning.

A second aspect has to do with the interaction between market prices and accounting or historical prices as determinants for action by supervisory or resolution authorities. Here again, market prices add a piece of information that is invaluable from historical prices which is a forward looking assessment, an assessment that reflects confidence and expectations, and we need to better understand how to embed that aspect within the regulatory framework. It also poses a large number of questions on the reliance of supervisory (and resolution) authorities on regulatory metrics, the vast majority based on historical information, and their ability to assess timely supervisory and resolution action.

More forward looking assessment on supervision/regulation

Which brings me to the third theme that I would like to reflect upon. How can we improve the introduction of a forward looking perspective on the supervisory action and regulatory framework.

At present that forward looking assessment is introduced in the regulation through three different channels: the use of market prices when available (the traditional way); since the global financial crisis, through the performance of forward looking exercises (mainly ICCAP, ILAAP and stress tests); and, through the assessment of the so called « sustainability of the business model » within the supervisory review process. The outcome of these analyses gets then incorporated into pillar 2 supervisory requirements.

Going forward, forward looking assessment needs to be reinforced. I will highlight two immediate examples. How do we properly incorporate climate and sustainability risks into the measurement of risk weighted assets when all existing methodologies to build regulatory models rely either on market prices (for which limited assets exist) or historical databases of default rates to assess risk? How do we incorporate in the regulation methodologies that rely on scenarios analysis, stress test or other forward looking elements? Second, the links between the sustainability assessment of a business model and supervisory action need to be strengthened. Particularly, if we expect that supervisory action to be timely and effective.

Let me conclude. I fear that I have not shed much light on any of the issues that you will discuss in this conference. On the contrary, I have put forward a large number of questions, most of them that you probably knew. Some of them I hope you may have answers to. But I could not give up this opportunity of being in an academic context to request your efforts to try to address some of these broader themes. I look forward to hearing the discussions for the rest of the day and learning some of those answers.