CENTRAL BANKS AND FINANCIAL STABILITY: LESSONS LEARNED AND FUTURE CHALLENGES

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FINANCIAL DEVELOPMENT AND STABILITY

- From the viewpoint of central banks, there are two main interpretations to the title "Financial development and stability", namely:

  1. That economic growth and the financial system need to be accompanied by stability in respect of prices and the financial system as a whole.

     These objectives are especially related to monetary and financial stability policies and, in particular, to **macroprudential policy**.

  2. That the growth of financial institutions (banks, insurance companies, investment funds, etc.) and the innovations which the financial system incorporates (fintech, new forms of financing, etc.) should not jeopardise the stability of these institutions.

     This goal is mainly linked to **microprudential policy** and the **new resolution policy**.

- Central Banks face the challenge of combining these three policies: monetary, macroprudential and microprudential, to ensure that the financial system grows in a stable manner. In this connection, one of the main lessons learned from the crisis was the need to strengthen macro- and microprudential policies.

FINANCIAL DEVELOPMENT AND STABILITY: THE CRISIS IN SPAIN

The Spanish financial crisis is an example of the importance of balancing and coordinating these three policies. Between 2000 and 2008:

- **Monetary policy:** the adoption of the euro from 1999 led to a common monetary policy, which maintained an expansionary stance during those years, with a substantial reduction in interest rates.
- **Microprudencial policy:** then determined by the Basel I and II Accords, microprudential policy was reinforced in the case of Spain by Banco de España accounting regulations requiring structured investment vehicles to be included in credit institutions' balance sheets (thus avoiding the subprime problem).
- **Macroprudential policy:** the Banco de España established that dynamic provisions (countercyclical) should be accumulated during the upturn in the cycle and released during the recession, cushioning the impact of the economic cycle on banks' profit and loss accounts and solvency ratios. They were the forerunners of the current counter-cyclical capital buffer (CCyB), although they were questioned at the time:
    - By other jurisdictions and international organisations because they were based on the prudent valuation accounting principle (instead of incurred loss).
    - By the industry because they placed banks at a competitive disadvantage.

FINANCIAL DEVELOPMENT AND STABILITY: THE CRISIS IN SPAIN

- The combination of these policies was not enough to avoid Spain's financial crisis. Savings banks were solvent from a microprudential standpoint and had been strengthened with dynamic provisions which, however, were calibrated to resist the types of banking crises that the Spanish financial system had experienced in the past but **not crises of the magnitude of the Great Recession** (they did not prevent the crisis but were very useful in reducing its cost).
- Spain's financial system was affected by the international financial crisis and by its own imbalances:
  - Excess credit expansion: during 2001-2007 credit to the private sector increased by 221%, vis-à-vis nominal GDP growth of 67%, and was mainly concentrated in the real estate sector.
  - Euro shock: there was too much confidence in the stabilising effect of the euro; the expansionary stance of the European monetary policy was appropriate for the area as a whole, but was no doubt overly expansionary for Spain.
  - Demographic shock: the population rose by around five million people between 2000 and 2007, an unprecedented increase in such a short period.

THE NEW MACROPRUDENTIAL POLICY: THE TOOLKIT

- There was a scarcity of macroprudential tools before the crisis (dynamic provisioning being a pioneer), and microprudential instruments were considered to be sufficient anyway. In the wake of the crisis, banking legislation in the countries concerned introduced new tools to mitigate and prevent systemic risks. Together, these tools determine "macroprudential policy", and include:
  - **New analytical frameworks:** more sophisticated frameworks have been developed with a broader range of indicators and more data-intensive supervision methodologies, such as: (i) early warning models and heat maps; (ii) top-down stress tests, prepared by regulators, evaluating the possible impact of adverse macroeconomic scenarios on the system as a whole.
  - **New capital requirements**: Basel III incorporates macroprudential elements such as the countercyclical capital buffer and an additional buffer for systemically important institutions.
- **The ongoing debate between provisions and capital requirements:** the Banco de España has a tradition of requiring provisions, which are more flexible to apply than increasing capital resources.

THE NEW MACROPRUDENTIAL POLICY: INSTITUTIONAL ARCHITECTURE

- The European Union's institutional framework for regulation and supervision has undergone significant changes, marked by two major milestones:
  - **In 2010:** the creation of the European System of Financial Supervision, comprising **three new European regulatory agencies for the banking sector** (EBA), **securities and market** (ESMA) and **insurance** (EIOPA), and a **new macroprudential authority** — European Systemic Risk Board, ESRB.
  - **In 2014:** creation of the Banking Union, transferring supervisory powers to the European Central Bank (ECB) in coordination with national authorities through the Single Supervisory Mechanism (SSM), and setting up a Single Resolution Mechanism (SRM).
- Macroprudential policy is decentralised to country level ("one size does not fit all"). Nevertheless, there are two European authorities with macroprudential competences:
  - The ESRB: an inter-institutional forum bringing together the various national and European authorities (central banks and banking, securities market and insurance market supervisors) to address macroprudential issues, chaired by the president of the ECB.
  - The ECB: in two key areas: (i) the requirement to report proposed macroprudential measures to the ECB, and (ii) the ECB's option of applying stricter macroprudential measures (i.e. topping up national measures).

MICROPRUDENTIAL POLICY

In the microprudential area, the Basel Committee on Banking Supervision (BCBS) developed a new regulatory framework known as "Basel III" between 2010 and 2011. This made substantial changes to the preceding accord (Basel II) to enhance its transparency and consistency. The main reforms agreed so far include:

- An increase in the minimum capital required and improvement to the definition and quality of capital.
- Creation of an additional capital conservation buffer.
- Development of a framework of limits on large exposures.
- Introduction of a minimum leverage ratio.
- Introduction of two minimum liquidity standards: one short term, the other medium term.
- Improvements in the treatment of market risk, off-balance-sheet transactions, securitisations and requirements for the calculation of exposures to counterparty risk.

The Basel Committee is currently working on a set of reforms whose main objectives include reducing the undue variability of risk-weighted assets (RWAs).

RESOLUTION OF INSTITUTIONS

During the crisis the authorities found themselves obliged to bail out institutions whose bankruptcy would bring down the financial system (the “too-big-to-fail” problem). Some of the measures adopted internationally to address institutions considered too big to fail have centred on developing effective resolution mechanisms. These measures include:

- “**Key Attributes of Effective Resolution Regimes for Financial Institutions”:** these standards, developed by the FSB in 2011, establish the key principles to ensuring orderly resolution, such as including the development of a bail-in tool to avoid recourse to public funds during resolution.

- **TLAC (Total Loss-Absorbing Capacity):** the FSB developed this international standard in 2015 with the aim of ensuring sufficient loss absorption and recapitalisation capacity to allow orderly resolution to be carried out while minimising the impact on financial stability, ensuring the continuity of critical functions and avoiding the use to public funds.

At the European level, the **Bank Recovery and Resolution Directive (BRRD)** establishes minimum requirements for own funds and eligible liabilities (MREL).

OTHER MICROPRUDENTIAL REFORMS

Together with the prudential regulation authority pillars, the G-20 has also promoted a series of additional regulatory reforms in the international arena, namely, a broad set of measures which include, most notably:

- **Strengthening and harmonisation of international accounting standards**: in response to the weaknesses identified in the "incurred loss" model, the International Accounting Standards Board (IASB) published in 2014 the international accounting standard which switches to an "expected loss" model, something which was already anticipated by Spanish dynamic provisions. The international standard will be binding in 2018.

- **Improvement in remuneration and corporate governance practices:** the FSB has led the initiatives on this front, by publishing guidelines on remuneration policies and establishing working groups to identify best practices in corporate governance.

- **Strengthening of the regulation and monitoring of non-banking sectors:** the FSB performs monitoring tasks and has published recommendations in order to avoid the risk of banking activities migrating to sectors of the financial system which are unregulated or less regulated (shadow banking).

CONCLUSIONS

- Financial stability is a key issue for central banks. The ambitious regulatory reform which has been promoted by the Basel Committee since the outbreak of the crisis (Basel 3) includes micro- and macroprudential factors in its structure which have strengthened financial stability. Authorities are currently better placed to adopt more proactive policy stances and, even, preventive stances faced with a potential systemic crisis.

- However, it is necessary to be aware of the challenges that still lie ahead:

  - Macroproducential policy is still in its infancy. Other instruments could be developed over the next few years to add to the tools currently available.
  - The effectiveness of most macroprudential instruments is still being tested. It is clearly an area which needs more work and research so as to be able to take more informed decisions especially about their calibration, implementation and effects.
  - Microprudential policy has attempted to strengthen institutions' resilience as well as the need to enlarge surveillance of another series of relevant variables (leverage), and key items of banks' balance sheets (liquidity).
  - The financial system is constantly evolving. It is our duty to remain alert to detecting and handling new sources of risk and vulnerabilities.

THANK YOU FOR YOUR ATTENTION