

# FINANCIAL STABILITY CONFERENCE

FIFTH JOINT CONFERENCE ON EU REGULATORY REFORMS



## REPORT 2017

EU AT CROSSROADS: HOW TO RESPOND TO MISALIGNMENTS IN BANK  
REGULATION AND ACHIEVE A CONSISTENT FINANCIAL FRAMEWORK?

FINANCIAL  
RISK AND  
STABILITY

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**NETWORK**



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18 October 2017, Berlin

**JACQUES DELORS INSTITUT**  
BERLIN

Dear Conference Participants, dear All,

The Financial Stability Conference 2017 was a great success in regard to its aim and motivation. An excellent line-up of speakers and panellists represented an exceptional mixture of different views and perspectives, while a large audience of more than 200 participants actively and controversially debated the agenda topics. It was the 5<sup>th</sup> conference I have been organising, and let me take this occasion to make some remarks on the conference and its reasoning.



I started developing the concept for the first conference in 2012. It was at the height of the sovereign debt crisis when the Euro area was at the brink of breaking up. A debt crisis which was triggered by the financial crisis and its tremendous costs: The crisis caused a massive decline in output and a most severe economic downturn with enormous losses that have been placed mostly on sovereigns and taxpayers. The International Monetary Fund estimated the costs of the crisis at about 2.3 trillion U.S. dollars. And according to the European Central Bank, government debt in the Euro area increased by 27 percent between 2008 and 2014 sharply narrowing the room for fiscal manoeuvre and public expenditures, forcing member states to adopt austerity measures.

The sheer magnitude of the impact on economies, jobs and households has to be remembered sometimes when discussing regulatory and financial stability frameworks ten years after, because it slides more and more into oblivion. For me, the crisis has been the motivation to launch a critical, open and independent platform for serious debate on regulatory reform and financial stability issues. Main activity is this conference, and the concept follows its motivation. It is not based on a business-driven event model and does not follow specific stakeholders' interests. I am confident that we do need a public and controversial discussion format on crucial issues of financial regulation frameworks at such level on an ongoing basis. We shall not leave the debate only to the industry and to closed shops of expert circles in authorities and central banks.



In this respect, this conference is indeed unique. Looking back, this is well appreciated and the very positive feedback gives me a strong motivation to move forward. The initiative will therefore be transformed into a non-profit organisation by beginning 2018 to move on and to develop further activities. I think, there is a strong relevance and reasoning for further debate. Paradigms change, and this also holds true for financial reforms. There is no reason for relaxation and complacency. A consistent common policy vision for an integrated regulatory financial system is not reached. With new rules in place and new designs of institutional regulatory and supervisory architecture established, the financial reform paradigm has lost its significance to policymakers and in public attention.

What we see are signs of regulatory fragmentation and surging national regulatory policy competition. Inconsistencies, which undoubtedly exist, are at the same time taken as an entry to engage against unwanted regulatory requirements. Overall, we see a shift away from the financial reform agenda, and a strong focus on the growth paradigm. The reiterated narrative is, that too strict regulation hinders growth. In my opinion there is no contradiction. In the contrary, tight regulation strengthens the economy, for the long term.

At the Single Resolution Board Conference in September 2017 Klaas Knot, Governor of the Dutch Central Bank, called to not lose momentum, and that we should resist the pendulum swinging back, and not watering down regulatory rules. He said that roll backs to international standards are very troubling, and that he noticed symptoms of 'cold feet'.

This can also be observed as regards implementation and application of agreed standards and rules, which remain challenging tasks. And we are still far from having harmonisation and consistent application. Other considerations at national levels play an increasingly important role. This is not only reflected in international policy developments like Brexit and the U.S. elections giving rise to changes in policy attitudes vis-à-vis financial sector policies. It is also visible in amendments of financial regulation in the EU to make regulation more efficient.

Therefore, we took a foremost political perspective when setting the topics for this year's conference as there were international regulatory cooperation, the logic of current regulation, the policies of central banks, the implementation of rules in the EU and the future of the European financial system against the backdrop of changing political conditions. Each of these topics contains sufficient discussion and gives rise to a detailed analysis. The relevance of these topics is manifested primarily in the following three developments:



On the one hand, it is clear that important projects in the EU are not being pursued in an adequate way, and rules are not being implemented as required to the necessary extent. This applies, in particular, to the Banking Union, the stabilisation of the financial sector and the implementation of the BRRD. Italy's handling of crisis banks and the somewhat allowing observer role of EU member states suggest that national political will stay a dominant factor. Moreover, there has been little progress with regard to the state-bank nexus and implicit guarantees for big banks. The now pretended certainty about financial stability seems disastrous, because problems still remain unresolved and national interests have moved in the foreground.

The second development originates, above all, from politics, but it also has implications for the financial system and financial stability. Brexit, the U.S. elections, and populist movements in the EU are bringing significant changes to the financial sector as well as to the international regulatory and supervisory architecture. One example is the lack of agreement in the Basel Committee regarding the conclusion of Basel III. At the same time, surging competition between financial centers and the tendency of softening regulatory standards are moving into the focus. Regulatory arbitrage and a race to the bottom may prove to be a serious danger with negative consequences. A number of statements by politicians make this danger seem realistic.

The third development is a tectonic shift in the role and function of central banks. The scientific based consensus on the foundations of monetary policy has reached its limits. This is clearly reflected in the behavior of the European Central Bank in recent years as the only credible actor in times of crisis. Added to this is the discussion about the extension of roles and mandates, particularly in the case of stability policy decisions. Central banks are no longer perceived as independent but as politically acting institutions. National one-dimensionality in the perception and explanation of monetary policy contains

immense potential for conflict within the Monetary Union. The politicisation of central banks is also driven by governments and policy, namely as a tool to better achieve their economic policy ideas and promises. At the same time, there is a lack of transparency and democratic control in the face of the de facto extended scope of action by central banks.

These three developments are intertwined, not only in terms of time but probably also of mutual effects and interactions. When the EU places competition policy at the center of the argument about regulatory standards, this reflects the stalemate in international negotiations on new regulatory standards. National interests, failure to consolidate the banking sector, and the missing level playing field within the EU again place the ECB under pressure. The populist movements are partially on the rise because the financial crisis has caused financial burdens which have been placed on taxpayers to a large extent. Ongoing low interest rate policy by the ECB again is taken as an argument against the Monetary Union by political groups.

This is indeed a comprehensive discussion agenda for an event and a broad look beyond the horizon. In such times, however, it does not seem appropriate to dedicate to details and technical questions of single regulatory requirements. Rather, we found it more useful to face some more complex contexts and examine some broader correlations in view of the above-described developments. The scientific discussion and analysis of the called-up topics, their interdependencies and their impacts are essential when it comes to achieving a stable and resilient financial system that fulfills its crucial functions in serving the economy and society. This also involves a better coordination and cooperation at the relevant political levels in the EMU. Insofar, the focus is set on policy and policy choices, in addition to a focus on regulation – always related to financial stability and the question of how to achieve a sustainable financial order in the EU.



These questions are hardly asked anymore almost ten years after the onset of the financial crisis. However, in view of the cyclical history of regulation and deregulation, they are legitimate as ever. The debate is also relevant in view of the increasing (mis-)use of regulation as competition policy. It goes as well hand in hand with the issue of risk distribution in the Euro area and the future roles of the ECB. The narrow fiscal scope, low growth in EU southern countries, government debts and structural reforms are subject of massive conflicting political interests. And here, the fundamental political positions and options for action are to be debated seriously and responsibly along every single policy proposal. Otherwise the EU will not progress on these issues.

For this debate, the Financial Stability Conference presents a forum, providing a framework for discussion, and thus contributing to the exchange of views on possible solutions. The discussion of the agenda topics and the drafting of a more developed, possibly future policy framework for the EU-27 with regard to regulation and financial stability appears to be considerably interesting and attractive also from a scientific point of view. The event provides a wide range of suggestions and points of reference for policy-oriented, at the same time scientifically based analysis of causal relations and options for action. This year, I brought together a group of early-stage researchers from different institutions and with different backgrounds to prepare contributions on topics of the conference which you find at the end of this report and on our webpage.



We should move on with the debate. There is no permanent stability. And it is an illusion to believe that we can finetune the instruments such that they have exactly the effect we want them to have. Authorities as well as politics should be dedicated to stay on track and not letting the pendulum swinging back.

At this point, let me quote three observations from the participants' feedbacks illustrating the relevance of the conference, first: 'I recommend the event to all researchers who would like to come down from the ivory tower and join forces with politics, industry and NGOs to contribute to a more stable and sustainable financial system.' As the second: 'The diversity of the audience and the openness regarding the possibility to be part of the event itself reveals the inclusive and transparent approach of the network and is a proof of its commitment towards fostering policy dialogue. The conference was a perfect chance to bridge academic and policymaking expertise, two crucial aspects that, unfortunately, are not usually taken into consideration in a comprehensive manner.' And the third: 'The conference brings together senior policymakers, practitioners, academics and civil society for in-depth public discussions on a range of highly topical subjects, eschewing the usual focus on media coverage and industry sponsorships in favour of high-quality discourse and an unusual degree of freedom from political and industry bias.'

I am convinced that bringing together different groups and stakeholders in an open, public discussion on the financial reform agenda is a very sensible thing to do. Generating this debate on critical issues is also necessary to continue building a more resilient financial system which fulfils its vital functions in serving the economy and society. I also believe that the financial sector should be interested in having such an open discussion format, and I would very much appreciate your feedback on this.

Good regulation and hence smooth functioning of the financial sector can only come from having an ongoing public debate on regulatory issues. And we also need to overcome national interests and to take action in a cooperative manner at all political levels. That is in my view what made the conference agenda relevant.

**Martin Aehling**



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## Organiser

**Martin Aehling**, Head, Financial Risk and Stability Network

## Scientific Co-Organisers

**Dr. Franziska Bremus**, Research Associate, DIW Berlin

**Prof. Henrik Enderlein**, Director, Jacques Delors Institut Berlin

**Prof. Jörg Rocholl**, President, ESMT Berlin

**Dr. Guntram Wolff**, Director, Bruegel

## Motivation



Making headway for a better and safer financial system has come to a halt. Oblivion of the costs of crisis, manifold calls for more efficiency in regulation, and recent policy developments all indicate a return to somewhat laxity in the financial reform process and in implementing rules. Obvious signs are that the finalisation of the Basel III accord is put on ice, that weak banks are still protected by their governments, and that according to comments in the U.S. and the U.K. we have to suspect a loosening of regulatory standards and practice. Inconsistencies, complexity and complaints about the burden of regulatory requirements mix with increasingly using regulation as national competition policy.

Taking in mind that problems of today have partly been caused by the financial crisis and its aftermath, and that the EU cannot withstand another crisis, this is a hazardous drift away. The conference therefore takes a foremost policy-oriented stance to discuss some of the most crucial issues lying ahead. Central questions are the future prospects for international cooperation on regulation, and how to tackle the challenges for achieving a sustainable financial order in the EU. In this respect, the logic of existing bank regulation, the ECB policy as regards financial stability, and the issue of how to deal with non viable banks are controversial topics to be discussed.

The conference brings together regulators, scientists, politicians, industry and organisations. We are convinced that generating an open, public and critical debate is very reasonable and also necessary to build a more safe and resilient financial system which better fulfills its vital functions in serving the economy and society. In this regard, the conference presents an inspiring opportunity.

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Figures

- 30 speakers, panelists and moderators
- 270 guest registrations
- 220 attended participants



Participants breakdown by groups

- Regulatory authorities: 33
- Banks: 22
- Financial institutions and consultancy: 31
- Policy and political organisations: 24
- Ministries: 14
- Scientists and research institutions: 64
- Organisations: 8
- Associations: 8
- Press: 10
- Others: 6



"The FRSN's Financial Stability Conference has become a fixture in the political and academic calendars across Europe – and rightly so. It provides a unique forum for an informed dialogue between policy-makers, regulators, representatives of the financial sector, academics and the public about financial stability, supervision and regulation. The high-cadre list of speakers at the FSC ensures that discussions are relevant and informed."

**Dr. Matthias Kollatz-Ahnen**, Senator for Finance, Berlin

"The Financial Stability Conference is a unique opportunity to meet politicians, regulators, practitioners and academics in a truly international environment to discuss the future of regulation and financial stability. It was my second year attending and I'm still very much impressed by the various and deep insights offered into different ways of thinking about financial stability and by the forward-looking and constructive debates that focus on shaping the future financial system. The Financial Stability Conference is a much needed platform for top international experts to share, discuss and develop valuable ideas and concepts."

**Prof. Stefan Janßen**, Professor for Corporate Finance and Banking, Jade University of Applied Science

"Thank you for the very stimulating conference, and being such a wonderful host. As always you brought together an impressive line-up of key financial policy makers, and it was nice to connect to the latest debate at EU and international level. If I could make one comment, it would be that the keynote speeches last year, were more stimulating, perhaps even provocative."

**Dr. Alex Lehmann**, Visiting Fellow, Bruegel

"Thank you for inviting me for the Financial Stability Conference 2017. It exceeded my expectations, which were already high based on the impressive list of announced speakers and panelists. I have enjoyed every minute of it. I wish you all the best and I am looking forward to next year's conference!"

**Boudewijn Berger**, Head Recovery and Resolution Planning, ABN Amro

"It has been a pleasure to meet you at the Financial Stability Conference. Thank you for organising the conference and for being such a gracious host. I very much enjoyed attending the conference, which provided a great opportunity to both hear the official statements from top policymakers in finance, and engage in more in-depth conversation on the sidelines of the event. I flew to Berlin just for the conference, and it was worth it."

**Dr. Peter Knaack**, Postdoctoral Research Fellow, Blavatnik School of Government, University of Oxford

"The conference was excellent with up to date treatments of relevant issues in the current policy debate by participants coming from different backgrounds such as academia, industry and regulation."

**Prof. Xavier Vives**, Professor of Economics and Finance, IESE Business School

"The conference has been an optimal venue for discussing the most significant and pressing financial stability concerns. Not only was the meeting an enriching experience in terms of the debate that was generated, but also in relation to the different voices and stakeholders involved. And by this, I am not just referring to panelists or moderators. In fact, the diversity of the audience and the openness regarding the possibility to be part of the event itself reveals the inclusive and transparent approach of the network and is a proof of its commitment towards fostering policy dialogue. On a different note, another aspect that has distinguished the Financial Stability Conference from other events was its dynamism and the fact that it touched upon key topics not just from a theoretical perspective, but from a practical and policy-oriented too. Indeed, the event was a perfect chance to bridge academic and policymaking expertise, two crucial aspects that, unfortunately, are not usually taken into consideration in a comprehensive manner."

**María Cecilia del Barrio Arleo**, PhD Candidate, School of International Studies, University of Trento

"Let me thank you for putting together and executing a very impressive event. I found the conference very focused, involved all the relevant and interesting people and provided a very good sense of where we stand at this moment."

**Dr. Maria Demertzis**, Deputy Director, Bruegel

"Thank you for inviting me to the conference. I enjoyed the conference because it gave me the opportunity to listen and interact with many interesting people in one place in one day. I really hope to have a chance to meet you another time. I do not have any specific suggestions. Perhaps a format which is effective is to ask one person to draft and present an executive brief summarising the different views on a specific issue and taking a stance."

**Prof. Alessandro Penati**, President, Quaestio Capital Management

"The financial stability conference stands out with its balanced panels composed of experts from different stakeholder groups. It brought valuable insights into regulatory lessons learnt, latest regulatory reforms and ongoing challenges to deal with the trade-off between financial stability and efficiency. The event will certainly spill over into the research community. I recommend it to all researchers who would like to come down from the ivory tower and join forces with politics, industry and NGOs to contribute to a more stable and sustainable financial system. I am looking forward to next year's conference."

**Prof. Doris Neuberger**, Chair of Money and Credit, University of Rostock

"The Financial Stability Network's Annual Conference, now in its fifth year, is a unique event. It brings together senior policymakers, practitioners, academics and civil society representatives for in-depth public discussions on a range of highly topical subjects, eschewing the usual focus on media coverage and industry sponsorship in favour of high-quality discourse and an unusual degree of freedom from political and industry bias."

**Christian Stiefmüller**, Senior Policy Adviser, Finance Watch

09:00

## Opening

Martin Aehling, Head, Financial Risk and Stability Network

09:15

## Address

Dr. Matthias Kollatz-Ahnen, Senator for Finance, Berlin



09:30

## Panel I - Impulses

Dr. Vincenzo La Via, Italian Ministry of Economy and Finance  
 Dr. Ludger Schuknecht, German Federal Ministry of Finance

09:50

## Panel I - Discussion

**The Changing Bias of international financial Order:  
 A global and political Perspective**

- Policy Changes and Revisions to Regulation: Where are we heading now?
- Regulatory Arbitrage Spillovers: What Implications for financial Stability?
- Regulatory and monetary Policy Coordination: How to deal with Conflicts?
- Transformation of the global financial Sector: Time for pivotal Responses!



Denis Beau, Deputy Governor, Banque de France  
 Rebekah Goshorn Jurata, Deputy Assistant, Financial Stability,  
 U.S. Department of the Treasury  
 Dr. Vincenzo La Via, Director General of the Treasury,  
 Italian Ministry of Economy and Finance  
 Prof. Xavier Vives, Professor of Economics and Financial Management,  
 IESE Business School  
 Dr. Ludger Schuknecht, Chief Economist, German Federal Ministry of Finance  
 Moderation: Dr. Maria Demertzis, Deputy Director, Bruegel

11:30

## Controversy I

**The Logic of financial Regulation and Reality:  
 Lost in Complexity and Competition Policy?**



Andrea Enria, Chairperson, European Banking Authority  
 Prof. José Manuel González-Páramo, Executive Board Director, BBVA  
 Dr. Beverly Hirtle, Executive Vice President, Federal Reserve Bank of New York  
 Dr. Sven Schelo, Partner, Linklaters  
 Moderation: Prof. Xavier Vives, Professor of Economics and Financial  
 Management, IESE Business School

13:30

Panel II

### Financial Stability in times of Changing Central Bank Policy: How to address Trade-offs



- Price Stability versus financial Stability: Threat to Cohesion of the Euro Area?
- Public and private Debt Sustainability: Are they ruling Central Bank Policy?
- Moral Hazard and Reforms Backlog: Should Shifts in monetary Policy help?
- Raising Interest Rates: How to deal with negative Effects on Bank Solvency?

Dr. Ignazio Angeloni, Member of the Supervisory Board,  
European Central Bank

Dr. Lorenzo Bini Smaghi, Chairman, Société Générale

Leo Hoffmann-Axthelm, Research and Advocacy Coordinator, Eurozone  
Economic Governance, Transparency International

Francesco Mazzaferro, Head of the Secretariat, European Systemic Risk Board

Prof. Helmut Siekmann, Goethe-University Frankfurt, and Director,  
Institute for Monetary and Financial Stability

Moderation: Prof. Jörg Rocholl, President, ESMT Berlin

14:40

Controversy II - Impulses



Dr. Elke König, Single Resolution Board

Prof. Alessandro Penati, Quaestio Capital Management

Controversy II - Discussion

### Banks in Distress and precautionary Recapitalisation Approach: Relief without Cleanup?

Dr. Elke König, Chair, Single Resolution Board

Prof. Alessandro Penati, President, Quaestio Capital Management

Christian Stiefmüller, Senior Policy Adviser, Finance Watch

Matthias Wargers, Spokesman of the Managing Board,

Erste Abwicklungsanstalt

Moderation: Dr. Andy Jobst, Adviser to the Managing Director and  
Chief Financial Officer, World Bank



16:10

Keynote

### Sectoral Regulations and SIFIs Interdependencies

Odile Renaud-Basso, French Ministry for the Economy and Finance

16:30

Panel III - Impuls

Klaus Regling, European Stability Mechanism



16:40

Panel III - Discussion

**Looking forward:**

**How to tackle unfinished Business in a new EU political Constellation?**

- Enhancing Resilience and solving Banking Problems: Will it stay a Fallacy?
- Shifts in Market Structures and tight Bank-State-Nexus: How to address?
- Ensuring Stability and Protecting Tax Payers: How can we combine both?
- Risk Distribution and Banking Union: What is a common Agenda to follow?



Dr. Levin Holle, Director General, Financial Markets Policy Department,  
German Federal Ministry of Finance

Philippe Lamberts, Member of the European Parliament, Co-Chair,  
Group of the Greens/European Free Alliance

Klaus Regling, Managing Director, European Stability Mechanism

Odile Renaud-Basso, Director General of the Treasury,  
French Ministry for the Economy and Finance

Luigi Federico Signorini, Deputy Governor, Banca d'Italia

Emiliano Tornese, Acting Head, Resolution and Crisis Management Unit,  
European Commission, and Visiting Professor, College of Europe in Bruges

Moderation: Prof. Alessio Paces, Professor of Law and Finance,  
Erasmus School of Law, Erasmus University Rotterdam

18:10

Closing

Martin Aehling, Head, Financial Risk and Stability Network

18:15

Get together



### Address

**Dr. Matthias Kollatz-Ahnen**, Senator for Finance, Berlin

Senator Matthias Kollatz-Ahnen opened his address by thanking for the invitation and emphasised that this conference has become a fixed item in the political calendar of many domestic as well as European policy-makers, regulators and scholars, thus reaching influence even beyond Europe's shores by now. He congratulated the organiser Martin Aehling on this remarkable achievement and thanked him for realising such a highlight in Berlin.



For Berlin, after a successful stabilisation the challenge is to deal with the legacies of the past. This entails further reduction of the debt level and to wind-down the bad bank.

Similar to financial markets in Europe, Berlin has managed a remarkable turnaround that already started in 2005. For a third year running, Berlin has recorded the highest GDP growth rate as well as the highest rate of job growth of 2.7 per cent above the German average of 1.2 per cent. For the sixth year in a row Berlin will close with a solid financial surplus. In the process, it was not merely about financial consolidation, but about consolidation paired with a remarkable increase in the volume of public sector investment by more than 50 per cent since 2013. In sum, after a long period of economic stagnation, Berlin is back on track and on a sound path to prosperity, Matthias Kollatz-Ahnen illustrated.

He critically noted that looking merely at recent developments and rates of change can, however, paint a misleading picture. This holds true for Berlin as much as for the European financial system, since in both cases, much progress has been made, but that we are not yet where we want to be. For Berlin, after a successful stabilisation the next challenge is to deal with the legacies of the past. First of all, this entails the further reduction of the debt level, which still stands at 46 per cent of local GDP and secondly to wind-down the bad bank that dates back to the failure of a regional bank in 2001. The corresponding risk for Berlin has already been reduced significantly, and he expects this chapter to be closed by the end of the decade. This may serve as a stark reminder that dealing with bad debt requires a long time even in an overall benign environment.



For financial markets, the benchmark for assessing the progress in reforming the global financial system is the FSB's April 2008 report. There's no denying that much of the agenda has been worked off and in fact, few people would have predicted at the time that the international community would be willing and able to make such progress. And yet, there are some glaring gaps in the report in terms of zero progress on curbing the reliance on rating agencies, almost no progress in aligning accounting systems, hardly anything happened on removing the preferential risk weighting for sovereign debt and little has been done to bring the shadow banking sector within the purview of supervisors.

Matthias Kollatz-Ahnen suggested that, on the other hand, there are areas in which progress has given birth to new issues that were not given sufficient thought at the start of reform. One example is the sensible and useful regulatory decision to replace bilateral clearing with central counterparties. Yet, this clearly requires measures to control the systemic risk that these CCPs pose as a consequence, which is something that is only now being addressed.





The consensus from 2008 and 2012 that existed in the international and financial community on the need and the direction of reform has evaporated.

Also in the EU and despite great achievements overall, the ambitious plan for a full Banking Union has not yet been realised. As has been shown this year, bank restructuring laws and practices still differ across the Union, and the transition towards a European deposit insurance system is also still incomplete.

Matthias Kollatz-Ahnen expressed scepticism on whether these gaps in regulatory frameworks will be closed. He said he realised that the consensus from 2008 and 2012 respectively that existed in the international and financial community on the need and the direction of reform has evaporated. For him, this is the result of at least four developments. First, the apparent loss of urgency: Nothing concentrated political minds in the global community as much as when they stared into the abyss together in the autumn of 2008. Similarly, at no time were European leaders more willing to move to the next level as when the European Monetary Union was visibly on the brink of breaking up in 2012. This sense of calmness is mistaken, since the financial system has been stabilised, but it is not stable. Moreover, some of the measures that have helped to stabilise the financial system, such as central bank policies, have themselves become a source of uncertainty and could, arguably, become a source of instability.

Second and related to the first point, as the world has moved on from the financial crisis, other policy objectives have reasserted themselves. Thus, growth is once again pitted against financial stability. Similarly, banking structures are stipulated as a pre-condition rather than a consequence of financial regulation. Third, in politics the resurgence of nationalism. Especially the fact that the new US administration has distanced itself from the idea of multilateralism has severely damaged international cooperation, dependent as it is on good will and soft law. In Europe, Brexit and the resentment of supra-national structures have not helped the cause of neither the Capital Markets Union nor the Banking Union.



Financial regulation constitutes a social progress, and the objectives and instruments must be the result of a constant democratic discourse.

And last, as new regulations have taken effect, unintended consequences have become evident, but there is not a consensus on whether these require countermeasures or simply represent an unwanted, yet inevitable price to pay for reform. The same holds true for the apparently inexorable tendency towards ever higher complexity in financial regulation. In addition, the financial industry as the object of regulatory drive is slowly shedding its pariah status and has resumed lobbying.

As a closing remark, Matthias Kollatz-Ahnen put forward that there are no easy answers to these questions and noted that the optimal regulatory system is an elusive and unattainable goal. Rather, financial regulation constitutes a social progress characterised by trial and error in the spirit of Karl Popper. The objectives and instruments must be the result of a constant democratic discourse, because preferences shift over time, because the financial system is dynamic, and because other social sub-systems, to which the financial system is connected, also evolve over time. Therefore, the Financial Stability Conference is a perfect venue for this kind of discourse.

Panel I - Impulse I

**Dr. Vincenzo La Via**, Director General of the Treasury,  
Italian Ministry of Economy and Finance



Regulatory reforms need to be implemented in a globally consistent manner and the tendency to soften post-crisis regulation must be resisted.

Vincenzo La Via began his impulse with the notion that almost ten years after the outbreak of the financial crisis the global financial system is much safer and more resilient today. However, this task is not yet complete. Regulatory reforms need to be implemented in a globally consistent manner and the tendency to soften post-crisis regulation must be resisted.

On a global level, large banks are better capitalised and subject to greater market discipline than a decade ago. Toxic forms of non-banking and shadow banking activities, which were at the core of the crisis, are now less of a threat to financial stability. Other non-banking activities are now subject to more rigorous rules that aim at transforming such activities into resilient market-based finance. Ongoing reforms of the OTC derivatives markets have reduced the opacity and complexity of these transactions. Financial infrastructures such as CCPs are also operating on a considerably more solid foundation. In spite of these achievements, Vincenzo La Via stressed that one must remain vigilant for possible sources of future instability of the financial system that may arise from global and local issues. As for global factors, the aspects of shadow banking and FinTech deserve greater attention. The bulk of new international banking regulation in the aftermath of the financial crisis has created spaces for increased disintermediation with a rapid development of market-based finance that has shifted activities towards other non-banking financial intermediaries, such as asset managers. The resulting space for regulatory arbitrage created by shadow banking is closely monitored on an international level, first of all by the FSB, and it has been addressed through the development of specific regulations. Vincenczo La Via recommended that the focus and attention of regulators and supervisors on the shadow banking sector should not be lowered. Another emerging trend that is rapidly changing the global financial environment is the phenomenon of FinTech. Technological innovations may pose risks in terms of financial stability, but can also present significant opportunities for business development and client reach, addressing potentially the de-risking issue and transforming banks' business models. Therefore, the FinTech evolution must be closely monitored on the double risk/opportunity perspective. Given the global dimension of the issue, the continuous work of the FSB will be crucial.



A full-fledged Banking Union is essential for reducing market fragmentation and creating a level playing field for financial firms across the EU.

As for Europe, significant steps have been taken in addition to the globally agreed reforms. In particular the strengthening of the Single Market has advanced the creation of the Banking Union and Capital Markets Union, both of which need to be urgently finalised. A full-fledged Banking Union is essential for reducing market fragmentation and creating a level playing field for firms across the EU. It also needs an appropriate matching between risk reduction and risk sharing measures. The main achievements aimed at reducing risks have been strengthening the prudential safeguards of banks with increased capital and liquidity requirements, reinforcing supervision through in-depth EU wide stress tests by the EBA, creating the SSM as well as implementing domestic legislation following the BRRD and establishing the SRM. EDIS would significantly improve the Banking Union's functioning ensuring more resilience, boosting confidence and in turn reducing risks.



The European banking sector is facing new challenges to recover an adequate level of profitability. Restructuring should be first of all a managerial objective.



It is important to keep in mind the interconnectedness of the financial system and therefore to continue the global coordination of policy actions.

Vincenzo La Via pointed out that another important element for strengthening the European financial system and enhance its resilience is the development of a truly effective Capital Markets Union, that would allow to diversify the sources of financing, including those for SMEs, and to deepen the Single Market. Moreover, it will enhance the shock-absorbing capacity against EU-wide shocks, making the overall Economic and Monetary Union more resilient. The European Commission's recent mid-term review of the CMU action plan should help accelerating the process. EDIS and the common backstop have long been agreed upon in principle, but actions for completion are still lagging behind and therefore it is time to make concrete and significant steps forward.

Subsequently, Vincenzo La Via pointed out the important issue of potential risk embedded in the banking sector that come from legacy problems resulting in the low profitability of banks and high NPL levels. The whole European banking sector is facing new challenges to recover an adequate level of profitability. Restructuring should be first of all a managerial objective. Banks have to develop industrial plans and set credible and ambitious targets, in order to raise capital on the market, if needed, and strengthen their capital position, thus increasing their possibility to effectively tackle the NPL issue. The restructuring effort pursued by banks should be backed by national structural reforms aimed at fostering consolidation and concentration processes and thus at facilitating capital increases. Vincenzo La Via noted that with regard to single banks a high NPL level is not per se a signal of non-viability, since banks with a good capital position can manage without disposing them in a short time. For other banks, a cleaning-up of balance sheets coupled with ambitious industrial plans is an essential condition for regaining sustainable profitability. The development of markets for distressed debt in Europe is a priority. Information asymmetry is recognised to play a major role in explaining the limited number of transactions, but a weak legal framework and lengthy judicial procedures constitute the key obstacle here. The set-up of national Asset Management Companies (Bad Banks) might help to achieve larger volumes in transactions, thus fostering standardisation both in legal conditions and in the information provided to investors. Such a scheme could work only if it features participation by banks on a voluntary basis.

At the European level, the Financial Services Committee set up an NPL subgroup that issued a report last June. The suggested areas of intervention relate to supervision, structural issues including insolvency, secondary markets and restructuring of the banking system. In July Ecofin agreed on an action plan to tackle NPLs in Europe, which envisions a comprehensive approach combining a mix of complementing policy actions, both at national and European level. By the end of 2017, the Commission will develop a blueprint for the potential set-up of Asset Management Companies and by summer 2018 a European approach to foster the development of secondary markets for NPLs will be released.

For a final remark, Vincenzo La Via resumed that Europe's financial system is not yet complete and the work needs to be urgently finalised learning from past experience and the evidence from the transition to a new environment. In this respect, it is important to keep in mind the interconnectedness of the financial system and therefore to continue the global coordination of policy actions, especially through the G20 and FSB, that has proved so effective in addressing the financial crisis.

Panel I - Impulse II

**Dr. Ludger Schuknecht**, Chief Economist and Director General  
Fiscal Policy and International Financial and Monetary Policy,  
German Federal Ministry of Finance

Ludger Schuknecht started his impulse by noting that trust and confidence have to be restored in the financial sector in order to fulfil its intermediary role without the risk of crisis or burdening of taxpayers. This requires action at the global, European and national level, and so far significant progress has been made.



Achievements on improving financial stability should not be underestimated, given that respective regulation and supervision is a global concern that requires global solutions.

On a global level, the FSB is an important technical forum to prepare political decisions to be made in the G20. In the finance area, a universal collaboration and support of the agenda at the G20 took place. Related achievements on improving international financial stability should not be underestimated, given that respective regulation and supervision is a global concern that requires global solutions. Otherwise, problems of regulatory arbitrage as well as risk exports from country to another occur. The notion of “Too-Big-To-Fail” has been addressed by establishing better regulations and supervision as well as ensuring the resolvability of the largest financial institutions, including banks, insurances and CCPs. Financial market resilience has been enhanced through stronger international standards for banks’ capital and liquidity in the Basel III package. Beyond banking, the shadow banking sector as an important subject of regulation has been transformed into a more resilient market-based finance sector. This was done via addressing the banks’ relation to shadow banks, money market funds and other relevant actors that yielded significant risks in the past, such as hedge funds, structured investment vehicles, securitisation, repo-markets and securities lending. Finally, it was key to ensure a level playing field based on stability and appropriate incentives across the main jurisdictions with the help of well designed and balanced rules, their consistent implementation and enhanced evaluation.



Basel III represented the most important gap in the regulatory package in terms of how to treat banks’ risk assessment models. However, a consensus is now emerging including output floors.

Moving on to the German G20 presidency, Ludger Schuknecht elaborated on respective achievements and its focus on closing regulatory gaps, implementation and evaluation. With regards to “Too-Big-To-Fail”, the G20 welcomed guidance, such as CPMI, FSB, IOSCO, aimed at enhancing resilience and the recovery and resolvability of CCPs. On shadow banking, FSB recommendations addressed vulnerabilities of asset management activities, such as liquidity mismatch and leverage problems, and G20 mandated IOSCO with the swift operationalisation. Basel III represented the most important gap in the regulatory package in terms of how to treat banks’ risk assessment models. However, a consensus is now emerging including output floors, and the implementation of all its parts will be crucial. G20 also started a new agenda on cyber security and mandated the FSB with the stocktaking of released regulation and supervision to identify effective practices. Ultimately, a framework and foundation for strong evaluation was established, which presented a very difficult task including the identification of the right evaluation methodology.

On the European agenda, Ludger Schuknecht noted that consistency with a global agenda is key and advancing integration and implementation presents one of the greatest challenges. Significant progress has been made in terms of



Guidelines for and the implementation of bail-in with sufficient bail-in-able finance, closed national loopholes and appropriate MREL have to be finalised.

the common rulebook, SSM and SRM. What is needed now, is implementation and more risk reduction, especially tackling the high stocks of NPLs. In this regard, the SSM's move to tighten bank requirement to deal with NPLs is very welcomed. Also, guidelines for and the implementation of bail-in with sufficient bail-in-able finance, closed national loopholes and appropriate MREL have to be finalised. At the moment there are some elements of the SSM that could lead to a late resolution of banks and hence a delayed problem management. Also, forbearance bias and zombie banks need to be addressed effectively. On a closing remark on Europe, Ludger Schuknecht questioned whether a common deposit insurance and a backstop beyond the ESM is indeed necessary considering moral hazard issues, but put it out for debate.

Ludger Schuknecht concluded with some final observations on public finances. The financial crisis was not only due to insufficient supervision and regulation. In turn, loose fiscal and monetary policies in the run-up to the crisis stocked boom-bust-cycles and left the economy with too little buffers in the fiscal area. Therefore, stability always requires fiscal stability. In order to solve the bank-state-loop, the government side has to be addressed regarding the implementation of the Stability and Growth Pact and debt reduction. This would undoubtedly send a signal of confidence and trust in the European institutional framework. This is also related to fiscal risks on banks' balance sheets, with exposure limits and risk weighting, which would decrease once government finances were to become safer. All of this helps to solve the bank-government-loop and, more importantly, to protect the European Central Bank from risks on its balance sheets thereby preventing fiscal dominance, which is crucial for the credibility and future stability of the Euro area.



Panel I - Discussion**The Changing Bias of international financial Order:  
A global and political Perspective**

with **Denis Beau**, Deputy Governor, Banque de France; **Rebekah Goshorn Jurata**, Deputy Assistant Secretary, International Financial Stability and Regulation, U.S. Department of the Treasury; **Dr. Vincenzo La Via**, Director General of the Treasury, Italian Ministry of Economy and Finance; **Dr. Ludger Schuknecht**, Chief Economist and Director General Fiscal Policy and International Financial and Monetary Policy, German Federal Ministry of Finance; **Prof. Xavier Vives**, Professor of Economics and Financial Management, IESE Business School; moderated by **Dr. Maria Demertzis**, Deputy Director, Bruegel

Maria Demertzis started off the discussion by introducing the panellists and making four remarks on the resilience of the financial system. Firstly, persisting global financial imbalances raise the question of how the financial system must be created to prevent future imbalances or at least to cushion them. Secondly, the financial crisis demonstrated that risks have to be handled cautiously, but how should a system be regulated if there is uncertainty and limited knowledge about its interdependencies and complexity. Third, geo-political challenges arise with an US administration that seemingly pursues a more antagonistic and less cooperative agenda, and fourth the event of Brexit that left the EU seemingly dispensable and with potentially serious financial implications.



Denis Beau said, that the completion of Basel III has to be in line with the G20 mandate and should not translate into significant capital requirement increases.

The first question regarded whether the financial system is now efficient enough or even overregulated. In response, Denis Beau observed a current shift from regulatory design towards implementation and evaluation. "Despite some significant achievements so far, some design issues still call for work, such as Basel III", he said. With respect to the output floor of internal models and respective calibration, the completion of Basel has to be in line with the G20 mandate, such that getting rid of unwarranted risk weighted asset variability does not translate into significant capital requirement increases. Moreover, fundamental changes due to CCPs should not allow for systemic risks to develop outside the EU. Therefore, an appropriate clearing policy is needed to provide authorities with the capacity to handle systemic risks caused by CCPs. Denis Beau advocated the timely implementation of Basel III to enhance stability and a level playing field, which should go hand in hand with the evaluation of the regulatory framework and its impact on the financial system and the real economy. An example of a regulatory side effect from trying to make financial intermediaries more resilient against shocks was the impact on market liquidity, which as a result became more fragile and concentrated. "Therefore, it is important to monitor how markets adjust to this new environment to prevent potential vulnerabilities." Both, implementation and evaluation are essential conditions for strengthening the system's collective capacity to absorb shocks, Denis Beau pointed out.

Subsequently, Maria Demertzis went on to the G20 agenda addressing the role of the US as an international player. On the falsely perceived US protectionism regarding financial regulation, Rebekah Goshorn Jurata reassured that the US administration is committed to the continuous involvement with the



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international bodies of G20 and FSB on regulatory issues. "The US Treasury recognises that international cooperation is critical in a global financial system", she said. In addition, it is not planning to unwind previous regulatory actions. However, after a decade of numerous regulations for US banks, it is now time for an evaluation based on the principle of promoting US interests first. That is, the specific aspects of the US banking sector, such as a vast number of community banks and the direct financing channel via the financial market, versus the European markets have to be accounted for in international debates and regulatory provisions, she explained. According to Rebekah Goshorn Jurata, the US Treasury approach on systemically important and internationally active US banks does not deviate from international agreements. "The current US Treasury report seeks to find potential areas of regulatory relief in order to increase capital flows and facilitate capital formation in line with an economic growth agenda", she stated.



It is not completely clear whether we got the regulatory design right, it's still evolving, and whether the current regulatory architecture will survive the next crisis, Xavier Vives noted.

Maria Demertzis then turned to the intersection of the financial sector and monetary policies questioning the regulatory design and whether macroprudential tools are sufficient. On this, Xavier Vives considered the coordination between monetary policy, macroprudential tools and capital and liquidity requirements as challenging. "It is not completely clear whether we got the regulatory design right – it's still evolving." It remains to be seen whether the current regulatory architecture will survive the next crisis, he said. He addressed the main obstacle of a monetary policy model that failed due to limited understanding of how monetary policies interact with macroprudential tools, the combination of which is crucial for a proper regulatory design and should be coordinated at the central bank. Moreover, Xavier Vives called for a holistic approach of prudential regulations in terms of capital and liquidity requirements. In the crisis, increased transparency and disclosure requirements for banks entailed destabilising effects, which were not counteracted appropriately by improved liquidity requirements. The interdependencies between monetary policies and financial stability are important.



Vincenzo La Via stressed that although the current system is resilient vis-à-vis past and commonly understood shocks, crises are typically completely unanticipated.

Eventually, Maria Demertzis inquired the entire panel on future challenges and priorities for a more diversified and resilient financial sector and corresponding responses. Vincenzo La Via stressed the factors of confidence in policy making, complacency with achievements and the importance of global consistency. Although the current system is resilient vis-à-vis past and commonly understood shocks, crises are typically completely unanticipated. "We are much better equipped than we were ten years ago, but we should not lower the guard", he stressed.

Ludger Schuknecht suggested that bond market stability and developments constitute great future challenges considering potentially changing interest rates and existing market distortions due to central bank intervention. On a global level, issues of cyber security are important, and yet the interaction with growing geopolitical tensions impeding a full-fledged cooperation in G20 should be viewed cautiously. Moreover, financial integration in Europe remains key, but requires mutual trust in each other's fiscal and regulatory resilience as well as a holistic approach. On the European front, Denis Beau suggested that a more advanced and blended model between banking finance and market finance would be ideal. "This would enhance resilience and stability of the economy's financing due to diversified sources." He added that digitalisation



in the financial sector challenges business models and allows for new entrants and innovations, but also entails new risks. Agreeing with Ludger Schuknecht, this outlook calls for more international cooperation beyond institutions and borders especially regarding cyber security. Xavier Vives also resonated with this view and suggested that the upcoming technological transformation poses challenges for levelling the playing field between small market entrants of FinTech versus large entrants such as Google and Amazon.

Rebekah Goshorn Jurata reiterated the importance of international cooperation and the work of the FSB, but also noted that implementing the agreed upon regulations hopefully does not jeopardise the market's core functions. "Sustained economic growth is crucially important for financial stability", she said. In contrast, Xavier Vives called for not to reduce regulations and reforms, but to make it simpler, less complex and to keep in mind problematic compliance cost increases for banks.



Ludger Schuknecht said that banks should not hold each others' subordinate bonds, and that it needs a right balance between the banking and corporate system to hold bail-in-able funds.

The first question from the audience referred to the bail-in-able instruments for financial stability and whether sufficient transparency on who holds these instruments existed. Ludger Schuknecht said that banks should not hold each others' subordinate bonds, and that it needs a right balance between the banking and corporate system to hold bail-in-able funds. Higher returns have to be associated with greater risk. Moreover on transparency, Denis Beau opened the aspect of risk shifting, especially liquidity risk that has been shifted from the banking to the asset management sector, for which the introduced supervisory initiatives still need improvement.

On the issue of financial literacy, the entire panel agreed that it is vital in a modern-day economy and crucial to make the system more resilient. For the US, Rebekah Goshorn Jurata elaborated on the initiative by the US Securities and Exchange Commission to invest in financial literacy pushing forward a plain English agenda so that investors and broker-dealers fully understand the product they purchase or recommend. Xavier Vives even proposed to ban some financial products and to introduce financial literacy tests for customers buying certain products.

Another input from the floor pointed out that complexity is usually not the best solution to complex systems and how the panel considered the increased regulation. Vincenzo La Via recognised the trade-off from more complexity and highlighted the FSB's task to entangle past reforms from unintended consequences and to shape a better regulatory framework that addresses issues instead of adding to the complexity of compliance. Denis Beau continued that there is a need for re-sensitivity and for making regulation as simple as possible, but that limits to regulatory simplicity exist given the complexity of the system itself. Xavier Vives agreed that rules have to be clear and simple.



There is a need for re-sensitivity and for making regulation as simple as possible, but limits to regulatory simplicity exist given the complexity of the system itself, Denis Beau pointed out.

Another question regarded the official US Treasury position on a statement by US Congress man Patrick McHenry criticising American involvement in international negotiations on financial regulation with global bureaucrats allegedly lacking transparency, accountability and authority. Rebekah Goshorn Jurata replied that the US will stay engaged in international forums, but that transparency of the FSB and international bodies needs to be improved, since stakeholders affected by these regulations cannot track what is agreed upon



Xavier Vives pointed out that current efforts for more centralised solutions, such as a common backstop, EDIS and the Single Resolution Fund, lack completion.



Ludger Schuknecht made a case for pragmatic, incentive compatible and politically viable solutions in the European context instead of polarising on the issue of EDIS or a lack of safe assets.

behind closed doors. International bodies such as FSB, IOSCO, IAIS and Basel Committee should stay in line with their international mandate and overlap between them should be reduced.

Moreover, it was suggested whether segmentation in US banking with a few large banks at the top and a vast number of local banks is comparable to the European banking structure. Thus, small local banks like Sparkassen should not be subject to the same level and complexity of regulation as large banks like Commerzbank. Ludger Schuknecht pointed out that this is already adjusted for in the European Union, since small banks are subject to national supervisors and lower capital requirements, but he admitted that more work might be necessary in this regard. Xavier Vives put forward lower compliance costs and uniform rules for small banks without softening regulation overall. He mentioned the additional syndrome of “Too-Many-To-Fail”, that is, many small institutions pursue the same correlated strategy of, for instance, risk taking in the mortgage sector, which should be carefully considered besides the issue of “Too-Big-To-Fail”.

In a round of final thoughts, Rebekah Goshorn Jurata perceived a great consistency across the panel in terms of supporting the FSB’s actions to promote the safety of the banking system, but noted that regulation must be carefully calibrated in terms of size and complexity. Considering general financial stability in Europe, Xavier Vives pointed out that the financial crisis overrode the initial plan to use market discipline instead of bail-out. At the same time, current efforts for more centralised solutions, such as a common backstop, EDIS and the Single Resolution Fund, lack completion. In stability terms, there is no halfway solution between market discipline and sustaining the Euro and corresponding EU-institutions. Maria Demertzis resonated with the importance of the Euro and its relation to financial stability in Europe.

The panel considered global and European implementation as well as evaluation as crucial. Ludger Schuknecht made a case for much needed pragmatic, incentive compatible and politically viable solutions in the European context instead of polarising on the issue of EDIS or a lack of safe assets. Sound public finances will be a prerequisite for financial stability. Vincenzo La Via called for more integration in Europe and the completion of the Banking Union and Capital Markets Union, which would increase the overall confidence in the European project.

## Controversy I - Introduction

**Prof. Xavier Vives**, Professor of Economics and Financial Management, IESE Business School

Xavier Vives started out with a brief recapitulation of the major economic crises during the last century and how the most recent financial crisis stands in comparison. The series of banking crises between 1900 and 2008 started with the Panic of 1907 in the US and the Great Depression later on followed by a prolonged period of stable financial conditions with a completely regulated banking system after World War II. With eventually relaxed regulations, financial crises occurred in emerging markets and more prominently the first global financial crisis materialised.



Generally, the regulatory response to the financial crisis was to override competition policy concerns in the name of financial and economic stability.

Looking back, some contemporary problems regarding the shadow banking sector already prevailed in the Panic of 1907 with trust companies as shadow banks. A hundred years later in 2007, the first more recent banking panic occurred at Northern Rock in the UK and embraced many issues similar to its historical counterpart, even if market mechanisms were more important by then. Overall, the last century witnessed a cycle of regulation and even over-regulation followed by more excessive de-regulation. Xavier Vives pointed out that the ultimate global crisis reveals instances of regulatory failure, such as a lack of consideration for systemic effects, built-in incentives for risk taking, regulatory arbitrage, a lack of credible resolution mechanisms, faulty design of regulation and absent or lax capital and liquidity requirements.

All these issues point to the question why the banking sector is so different and entails so many crises. Can banking exist as a normal sector with both market competition and stability? Given the cycle of regulatory failures, will we ever be able to regulate banks? Generally, the regulatory response to the financial crisis was to override competition policy concerns in the name of financial and economic stability. For example, mergers in the UK and US took place that otherwise would not have been allowed by competition policy authorities. This may have resulted in a market structure that is less conducive to competition.

Finally, on the general issue of why it is so difficult to regulate banks, Xavier Vives argued that all conceivable forms of market failure as thought of by economists are present in banking and the financial sector. This includes asymmetric information, externalities, behavioural and market power problems as well as a system that is constantly subject to financial innovation, such that regulators frequently lag behind. In addition to that, the public sector guarantees some of the safe assets, which gives rise to difficult political economy links between banks and the public sector.

## Controversy I - Discussion

### The Logic of financial Regulation and Reality: Lost in Complexity and Competition Policy?

with **Andrea Enria**, Chairperson, European Banking Authority; **Prof. José Manuel González-Páramo**, Executive Board Director, BBVA; **Dr. Beverly Hirtle**, Executive Vice President, Federal Reserve Bank of New York; **Dr. Sven Schelo**, Partner, Linklaters; moderated by **Prof. Xavier Vives**, Professor of Economics and Financial Management, IESE Business School



Andrea Enria indicated that as regards G-SIBs, respective areas for intervention relate to increasing capital buffers, reducing complexity in their structures and making them more resolvable.

To initiate the discussion, Xavier Vives presented the topics of regulatory lessons and trade-offs between stability and efficiency and asked all panel members to name the most valuable regulatory lessons from the crisis. Andrea Enria described his insights on how to deal with globally and systemically relevant institutions as most important. "In this regard, respective areas for intervention relate to increasing capital buffers for such institutions, reducing complexity in their structures and making them more resolvable." In addition, harmonising and coordinating an international framework for these players to avoid risk shifting is essential. More EBA-specific insights are that increased transparency, standardised and comparable information on European banks and models, a common terminology on NPLs across the EU and collective regulatory tools matter a lot. A remaining issue in the regulatory framework is the reliability and comparability of internal risk models and respective outcomes for banks' capital requirements, since banks were perceived to have tweaked them during the crisis.

José Manuel González-Páramo agreed with many of Andrea Enria's points and stressed the importance of closely monitoring systemic risk, which was not done extensively before the crisis. He argued that some macroprudential policies can be seen as rather suboptimal consequences of the crisis. A second important insight was that taxpayers should not foot the bill of the crisis due to fairness and efficiency reasons and since it generates wrong incentives in institutions. "Therefore, bail-in is the notion of the day for good reasons." Further work on ensuring banks resilience and resolvability remains critical for financial stability. Resonating with Andrea Enria's position, the crisis ultimately demonstrated the need for a globally coordinated response and for staying vigilant against fragmentation of the global financial system.



The supervisory toolkit should include a forward-looking perspective on capital and gains, and embrace the development of market values as early market signals for regulatory actions, said Beverly Hirtle.

Beverly Hirtle focussed her observations on capital regulations, emphasising the important constitution of Common Equity Tier 1 requirement as a key measure for banks' capital. Furthermore, the supervisory toolkit should include a forward-looking perspective on capital as well as respective gains, and it should embrace the development of market values as early market signals for regulatory actions. On this point, Andrea Enria echoed that changes in the quality and quantity of capital requirements were a regulatory game changer after the crisis. In addition, Sven Schelo highlighted the rules in the BBRD and the Single Resolution Mechanism on dealing with failing banks as a remarkable regulatory achievement. Still, bank adjustments and restructuring are important to create structures for proper rule implementation. "Information is key. Regulators have to understand their banks better and develop a system of transparency."



Andrea Enria considered the regulatory response as effective in terms of the chosen tools, but as less effective in terms of consistency and the ability to restore a stable international financial order.



José Manuel González-Páramo said that since reforms were hastily introduced, a consistency of regulatory elements was not ensured and has led to current redundancies in the system.



Sven Schelo expressed reservations on whether appropriate consequences currently exist for banks that failed the stress test, expect for their obvious need for capital.

Xavier Vives put forward the question of the most and least effective regulatory changes for financial stability considering reform aspects such as the Volcker Rule, the Vicker's proposal and ring fencing agreed upon regulations. Andrea Enria considered the regulatory response as effective in terms of the chosen tools, but as less effective in terms of consistency and the ability to restore a stable international financial order. Hence, some additional capital and liquidity requirements for international players were retained to individual jurisdictions, cross-border banking plummeted and domestic ring-fencing took place for protectionist reasons bearing the deficient side effect of decreased financial market integration. Renewed international cooperation agreements on how to handle the problem of cross-border establishments and the reversal of some previous policies are needed to deepen financial integration again.

José Manuel González-Páramo emphasised the focus on capital quality and the new notions of leverage and liquidity as successful reform aspects while disapproving on the inappropriate approach to banks' structural reforms. "Moreover, since reforms were hastily introduced, a consistency of regulatory elements was not ensured and has led to current redundancies in the system." For instance, if capital serves as a good signal of solvency, then less liquidity may be needed, especially when liquidity means less profitability and generates greater volatility, which eventually impinges on capital and capital buffers. José Manuel González-Páramo called for more certainty in regulation, which is also necessary for banks to plan their capital strategies.

Beverly Hirtle referred to credible stress testing regimes as one of the most effective regulatory changes. Equally important has been the supervisory part of obliging banks to establish internal processes for determining their capital risks and requirements. In contrast, the Volcker rule might need revision in achieving its goal to prevent speculation on taxpayer insured funds. Sven Schelo reiterated the effectiveness of the new bank recovery resolution regime including the SRM for restoring market discipline. However, challenges arise from loopholes and avoidance of these new rules, such as precautionary recapitalisation. Further investments in suitable bank structures to which these new tools can be implemented are needed.

Xavier Vives returned to the importance of stress tests, to which Andrea Enria replied that it has become a standardised component of the supervisory toolbox. The first European stress test had been perceived as less effective than the US counterpart, which was due to shortcomings in coordinated supervision and asset quality review, which, however, has been corrected for subsequently. Positive progress has been made in terms of sharpened methodology and enhanced transparency, while each test contributed to enhanced capital positions of banks. Nonetheless, Sven Schelo expressed reservations on whether appropriate answers and consequences currently exist for banks that failed the stress test, expect for their obvious need for capital.

Subsequently, Xavier Vives touched upon the issue of FinTech regarding stability as well as the potential of RegTech. Andrea Enria advocated a measured approach to FinTech. "We must be careful as regulators not to jump the gun and regulate everything that moves." Understanding the risks and benefits of innovations like virtual currencies, crowd funding and big data is crucial. While legislative loopholes regarding, for instance, money laundering



need to be closed, competitive dynamics from FinTech are healthy in challenging banks' business models. Moreover, a new debate on the definition of banking may be recommendable, since present banking activities can be decomposed and transferred to different entities outside traditional banking.

In response, José Manuel González-Páramo even demanded the revision of what characterises a financial activity. Regulatory arbitrage that originates from activities being treated differently for banks and non-banks has not played a large role yet, but in the process of digitisation operations can quickly escalate from "Too-Small-To-Care" to "Too-Big-To-Fail". Regulation must not be softened due to FinTechs' relatively small size, since this can quickly change and create systemic problems. Instead, Fintechs' activities need to be reviewed.



Beverly Hirtle stressed that RegTech should not be considered as alleviating burden, but rather as making compliance regimes more effective and less costly.

In this respect, Beverly Hirtle stressed the importance of links from FinTech back to the banking sector, which is similar to pre-crisis links from shadow banks and should be analysed carefully. In addition, RegTech should not be considered as alleviating burden, but rather as making compliance regimes more effective and less costly. Big data and language processing among other things may help the supervisory community to better understand and assess market developments. Finally, Sven Schelo summarised that outside the traditional banking sector, FinTech activities can have a close resemblance to banking services. "The business model of banks is under pressure with those new entrepreneurial challenges from FinTech." In times of over-regulation, complexity and low interest rates the traditional banking system should not be burdened excessively or else completely unregulated actors enter traditional banking activities.

Turning to the audience, one question related to whether the focus on capital and liquidity requirements and avoiding state aid while neglecting profitability could be problematic. Andrea Enria agreed that regulators should not ignore profitability. However, high returns on equity in the banking sector prior to the crisis were due to excessive leverage and low funding costs based on implicit state guarantees. After removing these two components, decreased profitability was an expected as well as desired regulatory effect. Still, current capital requirements are not excessive, since in more than ten EU Member States the average return on equity is above ten percent and above cost of equity. In turn, supervisors should promote further restructuring and faster cleaning of banks' balance sheets, as it is the only way to recover profitability.



For José Manuel González-Páramo legacies in banks' balance sheets produce low revenues, and reputational issues lie at the bottom of the profitability problem.

Beverly Hirtle added that the current banking system is safer and bears lower risks, which inevitably results in lower returns. In turn, this does not counteract but enhance the overall profitability of the system due to its greater resilience to potential risks. José Manuel González-Páramo shared the view that increases in capital requirements have a big impact on lending and growth, but are less associated with low profitability. Instead, legacies in banks' balance sheets produce low revenues, regulatory requirements have increased compliance costs and reputational issues lie at the bottom of the profitability problem. The digital revolution of FinTech affecting profits speaks to overcapacities in the banking sector. Therefore, banks have to change more from within, cooperate with FinTechs or even transform themselves into FinTech-like companies. "Traditional banks have no place in this new world."

Regarding the observation from the floor that the Canadian banking system was spared from crisis presumably due to its oligopolistic structure, Xavier Vives argued that in contrast, there were other concentrated systems like the UK that managed the crisis poorly. Thus, other factors such as the amount of wholesale financing, the quality of prudential supervision and the type of balance sheets by banks were important for how the crisis affected different countries and markets.



Panel II**Financial Stability in times of changing Central Bank Policy:  
How to address Trade-offs?**

Ignazio Angeloni said that according to recent simulations and stress tests, banks are expected to easily absorb the effects of changing or increasing interest rates.



For future resilience, Lorenzo Bini Smaghi identified banks' profitability as a key factor that is in turn linked to the structure of the banking sector.



On risks, Francesco Mazzaferro expressed concern about geo-political tensions and a scarcely comprehensible and enormous moderation of interest rate volatility.

with **Dr. Ignazio Angeloni**, Member of the Supervisory Board, European Central Bank; **Dr. Lorenzo Bini Smaghi**, Chairman of the Board of Directors, Société Générale; **Leo Hoffmann-Axthelm**, Research and Advocacy Coordinator, Eurozone Economic Governance, Transparency International; **Francesco Mazzaferro**, Head of the Secretariat, European Systemic Risk Board; **Prof. Helmut Siekmann**, Goethe-University Frankfurt, and Director, Institute for Monetary and Financial Stability; moderated by **Prof. Jörg Rocholl**, President, ESMT Berlin

Jörg Rocholl introduced the panel and the topic of economic trade-offs that arise between changing central bank policies and financial stability. The first question focussed on how a sustained low interest rate period affects banks' solvency and long-term sustainability and what would happen if interest rates were to increase again. Ignazio Angeloni replied that the central bank's target of price stability has to be reconciled with financial stability and that both components combined do not threaten the cohesion of the Euro area at the moment. Having analysed different scenarios, regulators have identified three different channels through which interest rates affect banks' balance sheets. One relates to the interest rate margins that have been compressed for a long time. Another channel operates through the broader economy, as the occurring economic recovery was partly due to low interest rates and improved banks' conditions in terms of assets. Finally, interest rates affect the market values of assets and liabilities with a long duration in the balance sheets. According to recent simulations and stress tests, banks are expected to easily absorb the effects of changing or increasing interest rates. "All in all, there is a good awareness of potential risks and how to manage them."

The incomplete Banking and Capital Markets Union, however, poses a major risk to financial stability, and respectively Lorenzo Bini Smaghi added that European banks face great difficulties compared to the US, since economic recovery just started to pick up, while interest rates remain low. For future resilience, he identified banks' profitability as a key factor that is in turn linked to the structure of the banking sector. Countries with profitable and stable banks usually exhibit high levels of market power and concentration. For the EU to move towards an integrated capital market, it requires cross-border players instead of excessive regulation. "The system is more stable today, but is it ideal to support the European economy?" In his view, a clear future vision for the European financial system appears to be missing.

On the issue of systemic risks, Francesco Mazzaferro expressed concern about geo-political tensions and a scarcely comprehensible and enormous moderation of interest rate volatility. Such moderation could be explained by an invisible and unnoticed accumulation of risk or by previous regulatory instruments that indeed enhanced more resilience. To appropriately catch the risks, Francesco Mazzaferro highlighted the joint approach of stress tests, macroprudential tools and bank exits. Additional systemic risks that go beyond banking have to be controlled not only as bank-originated factors, but also across the line.



Although some measures may be justified during a crisis, Helmut Siekmann stressed the ECB's primary goal is to secure price stability in contrast to financial stability.

Regarding the role of central banks as well as respective measures taken in the US and EU, Helmut Siekmann emphasised the ECB's primary goal to secure price stability in contrast to financial stability. The important factor of time entails that some policy measures may be justified during a crisis, but can develop into the new normal or become economically or legally problematic going forward. Hence, ideally, the ECB policy should be changed given now sound macroeconomic conditions and that the main argument is on time. Regarding the FED system, in which the reduction of banks' balance sheets is currently considered as a central bank instrument, the sheer volume and composition of balance sheets present a major difference to the Euro system. Addressing Ignazio Angeloni, he agreed that overall resilience in the EU has increased, but noted that it varies across countries. Member States with a vast number of small banks should therefore be judged empirically in terms of their NPLs on their asset side and differently vis-à-vis large banks. In response to the issue of differently sized banks in the EU, Lorenzo Bini Smaghi stressed that supervision should account for this diversity, but should neither become an industrial policy instrument nor keep banks with unsustainable business models alive in times of low interest rates.



Leo Hoffmann-Axthelm observes a lack of agreement on finalising the institutional architecture, which becomes critical once the ECB withdraws from its broad role.

Jörg Rocholl turned to Leo Hoffmann-Axthelm for an evaluation of the ECB's current institutional condition. "The ECB has saved the Euro probably more than once", he stated. Enabled by its independence and supranational institutional set-up, the ECB has taken on various responsibilities after the crisis including banking supervision and participating in the SSM and the Troika. Therefore it is now under enormous pressure of fulfilling these responsibilities, whereas for accountability reasons the ECB should rather focus on its narrow mandate. On the other hand, Member States currently try to agree on reforms to deepen European Monetary Union and complete the Banking Union. However, there appears to be a fundamental lack of agreement on finalising the respective institutional architecture, which becomes more critical once the ECB withdraws from its broad role.



Ignazio Angeloni said that for the ECB, the sustainability of debt translates into the sustainability of a business model that has to be robust in different conditions.

Regarding the ECB's stretched functionality and responsibilities, Lorenzo Bini Smaghi reiterated that its mandate of price stability should not be changed. Being thankful for the ECB for having stepped into the SSM and acting independently, he put forward the hypothesis that the degree of supervisory independence pre-crisis is negatively correlated to the amount of bail-out and taxpayers' money used post-crisis. Leo Hoffmann-Axthelm added that the ECB's narrow mandate in theory serves to constrain its activities, and anything beyond the mandate leads to trade-offs and risks of fiscal dominance. Therefore, conflicts of interest given its independence should be addressed with proper instruments.

Jörg Rocholl then referred to the issue of fiscal dominance when looking at private debt sustainability in the context of banks. Ignazio Angeloni denied any major fiscal dominance and noted that banks as financial intermediaries live off debt to develop their assets. "For the ECB, the sustainability of debt translates into the sustainability of a business model that has to be robust under different economic conditions." Furthermore, the root of many banking problems originates from governments, but with limited and implicit instruments, supervisors can never act on governments directly.



Helmut Siekmann questioned whether the independence of an authority with sovereign powers is comparable with the principle of democracy as well as constitutional requirements.

The subsequent question regarded whether independence is best guaranteed when allocated in an already functioning institution. Helmut Siekmann countered with the question of whether the independence of an authority with sovereign powers is comparable with the principle of democracy as well as constitutional requirements, especially in terms of banking supervision. With the existing ECB including a large-scale guarantee of independence, which is also entrenched in the European Union law as well as German constitutional law, the transfer of banking supervisory powers was executed. So far, no other institutional set-up has proven superior, but it remains to be seen whether an institution on European level is more efficient in the long-term.

Returning to the issue of system risks, Francesco Mazzaferro noted that the SRB was the first institution to raise attention to risky sovereign bonds and exposures as well as adjustments of the regulatory framework. A current proposal foresees the creation of securitised bonds as a pool of government bonds with threefold tranches. With this, given an emergence of risk, there would be capital flights between tranches instead of sovereigns. Without direct powers, the SRB can simply identify such issues and pass on recommendations to political bodies to decide.



The first question from the audience regarded the effect of ECB's monetary policies on everyday life, including factors such as housing prices. Lorenzo Bini Smaghi replied that the US serves as a good example, as authorities there initiated TARP, stopped buying assets, increased short-term interest rates and are about to reduce the size of balance sheets. Still, long-term rates and housing prices did not go up, which might indicate that monetary policy is not so relevant for housing prices and underlying financial conditions anymore. Instead, long-term rates are determined by global factors, such as excessive saving over investment originating from individual savings behaviour.

## Controversy II - Impulse I

**Dr. Elke König**, Chair, Single Resolution Board



Bank resolution and precautionary recapitalisation address banks in similar, but distinctly different situations and provide different procedures of dealing.

Elke König began her impulse by characterising the contemporary resolution regime as a fairly young discipline that did not yet exist when the financial crisis emerged ten years ago. At the time, markets had the two likely awful choices of either risking financial stability or taking taxpayers' money, the latter of which eventually represented the response to the crisis. Nowadays and with the SRB three years in existence, a sequence of noteworthy events occurred this summer. Initially, the Spanish Banco Popular was resolved under the BRRD/SRMR regime illustrating a textbook example for resolution. Selling the failed and resolved Banco Popular to Banco Santander went smoothly, such that neither Spanish government bonds nor other major bond charts displayed irregularities from this transition. In addition, precautionary recapitalisation under the BRRD was applied in the case of the Italian Banca Monte dei Paschi di Siena, and finally two Italian banks in the Veneto region were resolved under national insolvency procedures.

Against this backdrop, Elke König emphasised that bank resolution and precautionary recapitalisation under the BRRD address banks in similar, but distinctly different situations and provide different procedures of dealing with them. The important lesson from the financial crisis together with the political will behind the BRRD/SRMR entails that in banking, as for any business, the failure has to be paid by equity holders and creditors and not by the general public. Elke König considered precautionary recapitalisation as a concept for fairly unique situations, which is not and should never be understood as bail-out in disguise, which also in the light of its legal requirements is far from the intention of the legislator. From the perspective of the SRB as the central resolution authority within the Banking Union, it is of great importance that the prescriptive conditions are applied with all due rigour in all cases. Precautionary recapitalisation is the exception to the rule that State Aid normally leads to the bank being considered failing.



Precautionary recapitalisation is reserved for solvent banks and may not be used to offset losses the bank has incurred or is likely to incur.

Monitoring the fulfilment of these conditions is within the remit of the European Commission's Directorate for Competition. In order not to trigger resolution, Member States Aid must comply with the terms as foreseen under Article 32 paragraph 4 (d) of the BRRD. In particular, precautionary recapitalisation is reserved for solvent banks and may not be used to offset losses the bank has incurred or is likely to incur. Second, the intervention is required to remedy a serious disturbance in the economy of a Member State with the clear purpose of preserving financial stability. Third, it is of a precautionary and temporary nature and must be strictly limited in time. Therefore, it serves to strengthen market confidence by providing funds, which must be paid back in full once the market has returned to normal. Fourth, it is conditional upon final approval under the State Aid Framework and the institution in question must not be failing or likely to fail.

Subsequently, Elke König elaborated on further aspects of precautionary recapitalisation requiring additional consideration. Public support measures that involve capital instruments are limited to the amount needed to address a capital shortfall established in a stress test. From the European State Aid perspective, only measures necessary to cover a capital shortfall arising under



A good way forward might be to request a mandatory Asset Quality Review to ensure precautionary recapitalisation is not used to cover hidden losses.

the adverse scenario of a stress test could be eligible for precautionary recapitalisation. Capital shortfalls under the baseline scenario and impairments detected in an asset quality review (AQR) should be covered by private means or trigger insolvency or resolution. Stress tests are thus a determining factor whether there can be public support or not. Elke König indicated that there are proposals with the aim to improve their design for that purpose that merit discussion. However, she argued that a better way forward might be to request a mandatory AQR to ensure precautionary recapitalisation is not used to cover hidden losses. Limiting the time between the stress test and recapitalisation would ensure that precautionary recapitalisation is based on actual stress test data and AQR.

Another crucial condition for such State Aid and for drawing the line in terms of resolution is the solvency criteria. Currently, the criterion of a bank being solvent is assessed at the point in time of determination, which, however, is too static. For this reason, the lawmaker has created the second criterion of a bank being "failing or likely to fail", which in turn presents a forward looking concept accounting for the overall viability of a bank. These two concepts need to be better aligned. Moreover, a restructuring plan for the bank must include a reimbursement plan, and this has to be a realistic expectation rather than an outside chance. The Recovery and Resolution Directive has now gained some maturity and therefore it requires a thorough review and amendment, where appropriate, as already foreseen in the BRRD text. Overall, precautionary recapitalisation can play an important role if well confined.



As a concluding remark and in addition to the precautionary recapitalisation triggers and conditions, Elke König summarised other areas that require further progress. Further progress is for instance required in harmonising national insolvency and administrative laws, solving the liquidity conundrum in resolution, the build-up up credible and sufficient MREL, addressing NPLs and, of course, completing the Banking Union with EDIS. Also, a review of the European Commission's State Aid requirements for Liquidation Aid in national insolvency proceedings as set out in the 2013 Banking Communication would be appropriate. The applicable criteria should be examined against the implementation of the new resolution regime. The possibility of State Aid in insolvency should not create wrong incentives and instead insolvency and resolution should ideally come to likely outcomes regarding the involvement of creditors.

Finally, Elke König pointed out that in past years a lot of progress has been made and that the introduction of the BRRD/SRMR is clearly a solid pillar of the Banking Union that contributes to financial stability. It has seen its first test in 2017 and it is now up to all stakeholders to align the various concepts in line with the spirit of the BRRD/SRMR.



## Controversy II - Impulse II

**Prof. Alessandro Penati**, President, Quaestio Capital Management

Alessandro Penati presented some insights from his involvement in the set-up of the now largest European fund investing in NPLs and troubled assets, which presents a global benchmark in terms of asset backed securities based on NPL notes. In this regard, he illustrated three major observations.



The BRRD appears to be a framework that wants to achieve too many objectives at once, and I am concerned on whether they can be achieved by just one law due to immanent trade-offs.

The first comment related to the BRRD, which in his view appears to be a legal framework that wants to achieve too many objectives at once. One objective is to constitute a bankruptcy law for financial institutions that minimises bankruptcy costs by specifically maximising the value of residual assets as an absolute priority. At the same time, the BRRD wants to limit state aid and state involvement and thus includes an antitrust component. As another aim it also pursues to somehow redefine the banking industry, which in fact may present a declining industry due to the issue of dated business models in the light of future challenges. Even though Alessandro Penati shared these three overall objectives, he expressed serious concern on whether they can be achieved by just one law due to immanent trade-offs.

The second observation was on regulatory complexity, which does not refer to just the number of rules and regulations. Instead, excessive discretion in applying rules and uncertainty about the interpretation of the regulator poses a major problem. For instance, the precautionary provision obliges the private sector, namely stakeholders, to bear the cost of likely to be incurred losses. In turn, negotiations on what precisely constitutes "likely to be incurred losses" take up a disproportionate amount of time. Meanwhile, the relevant and bank-specific specification of such costs can change within months given the dynamic and competitive banking environment in terms of clients and liquidity.



There is too little attention on the initiative to create a broad, liquid and deep asset-backed security market in Europe in order to solve the access problem for institutional investors.

The final observation referred to the issue of NPLs and that no European market for NPLs exists yet. The micro-structure of such a market would require special services without conflicts of interests, that is shareholders should not be investors or banks, the capability of engaging rating agencies, the capability of doing structured finance, an information technology structure in order to price and assess huge portfolios, and finally to have legal templates, such as for rapidly setting up a warranty contract for a complex portfolio including bad loans and leasing among other things. In addition, a NPL market requires banks with business models not exclusively based on dealing with bad loans, but instead industrial companies offering special services. For example, Banca Monte dei Paschi di Siena changed its business model towards selling infrastructure. The respective new company is dedicated to special services, and in order to avoid a conflict of interest it is the only listed Italian company with dispersed shareholders.

Overall, from the regulator point of view there is too little attention on the initiative to create a broad, liquid and deep asset-backed security market in Europe in order to solve the access problem for institutional investors in this market.

On a concluding remark, Alessandro Penati mentioned the predominance of American institutions in the instances of private equity, rating agencies and placing large asset-backed securities in the American market. However, promoting European investment banks with a sufficiently large capital base to underwrite for instance a 2.6 Billion Euro asset-backed security note would be a severe mistake. Instead, establishing the appropriate micro-structure and actors in the context of a European asset-backed security market is fundamental for solving the NPL problem in Europe for good.



## Controversy II - Discussion

### **Banks in Distress and precautionary Recapitalisation Approach: Relief without Cleanup?**

with **Dr. Elke König**, Chair, Single Resolution Board; **Prof. Alessandro Penati**, President, Quaestio Capital Management; **Cristian Stiefmüller**, Senior Policy Adviser, Finance Watch; **Matthias Wargers**, Spokesman of the Managing Board, Erste Abwicklungsanstalt; moderated by **Dr. Andy Jobst**, Adviser to the Managing Director and Chief Financial Officer, World Bank

Andy Jobst introduced the panel speakers and situated the discussion against the background of the evolving NPL situation in Europe. He also put forward the topics of distressed debt markets, whether bail-in-able liabilities are sufficient for the system, exemptions under BRRD with precautionary recapitalisation as well as an outlook on how to make the European resolution framework work in the light of constraints regarding the political economy of the EU.



For Cristian Stiefmüller the ideal future legal framework would entail an industry that is set up to forestall the emergence of NPLs and is capable of healing itself.

The panel first discussed the current vulnerabilities in the European banking sector and how a healthy banking sector can be restored through faster debt restructuring, disposals, and write-offs. Persistently high NPLs pose significant challenges to financial stability and are likely weighing on credit growth and economic activity. NPLs influence bank lending through three interrelated key channels – profitability, capital, and funding. Together, these factors result in a combination of higher lending rates, reduced lending volumes, and increased risk aversion. Low provisioning and write-off rates also hinder necessary corporate restructuring and prolong the debt overhang, depressing credit demand.

Christian Stiefmüller acknowledged that dealing with distressed debt is cleaning up after most of the damage has already been done. “The ideal future legal framework would entail an industry that is set up to forestall the emergence of NPLs and is capable of healing itself.” Regarding legacy issues, NPLs arise primarily for reasons of poor governance, inadequate risk systems and structural deficiencies in the banking sector. Structural issues like overcapacity and fragmentation vary hugely across Europe. While some countries have seen a significant consolidation of the banking sector, the fragmentation of the banking sector – often combined with outdated business models, such those of savings and corporate banks in Germany and Austria, remains a key challenge and is linked to the NPL issue. A viable distressed debt market together with an efficient resolution and liquidation framework would allow marginal players with poor risk management and limited capacity to deal with NPLs to exit.



Matthias Wargers highlighted in this respect that creating viable distress debt markets goes hand in hand with banks’ internal capacity to deal with bad assets.

Matthias Wargers agreed and added that creating viable distress debt markets goes hand in hand with banks’ internal capacity to deal with bad assets, stating that NPLs “represent an impact rather than the cause of the disease.” Elaborating on the case of WestLB’s bad bank, no additional capital was injected, and when the bank failed, the distressed assets were liquidated and transferred to a separate legal entity, which benefitted from a guarantee scheme to ensure liquidity. He argued that a common institutional framework for distressed debt – possibly via an asset management company (AMC) –

has to be organised urgently to complement the current provisions under the BRRD.

On the question of whether a private sector AMC solution was preferable to a public private solution, Matthias Wargers argued that minority public ownership was one of several elements necessary for NPL resolution to be compatible with EU State aid rules outside cases of systemic distress such as the financial crisis. On public private solutions, Christian Stiefmüller added that the public sector is generally not perceived as a good owner of financial assets and institutions. Neither is it in a better position than a private owner to take on a risky asset, price it correctly and hold it. Recovery rates should not differ between the private and public solution. If the cost of capital and the asset price were the same for both, the asset should be given to the private purchaser to unburden the public. However, if the private purchaser paid more due to implicitly lower capital costs there is no reasonable motivation for the public investor to attach a lower risk premium.



Transferring NPLs from a bank's balance sheet to an AMC must happen at market values. You cannot white-wash NPLs, Elke König emphasised.

Regarding this issue of the pricing gap between the cost of acquiring distressed debt and the NPL book value of banks, Alessandro Penati explained the current situation in Italy. He offered two reasons for optimism on the NPL problem. Firstly, to reduce the pricing gap, governments need not intervene, but such intervention could be limited to guaranteeing that the distressed bank does not fall below a certain rating threshold to ensure access to funding. This would provide banks with sufficient time to absorb capital losses and resolve NPLs organically. Secondly, Italian portfolios hold great wealth stock of real estate-related loans. Many foreign investors see good prospects in a recovery of real estate market – with Italy as the only EU country where house prices have not increased significantly over the last few years.

Elke König remarked that it is important to keep in mind that NPLs mean different things in different jurisdictions. On the NPL price gap issue, it takes cleaning up and providing transparency on bad assets, as this will also determine NPL values. Moreover, the effectiveness and efficiency of insolvency laws need to be addressed. Transferring NPLs from a bank's balance sheet to an AMC must happen at market values, but can bear potential losses for which proper valuation frameworks are essential. "You cannot white-wash NPLs", she said.



Christian Stiefmüller criticised that the possibility of precautionary recapitalisation has turned into an escape clause undermining the intention of the BRRD.

In the following, Andy Jobst addressed the permissibility of precautionary recapitalisation under BRRD if a bank would experience a capital shortfall under an adverse stress test scenario. Elke König's lesson from the case of the Italian Banca Monte dei Paschi di Siena was that this should be a temporary measure, which was added to the BRRD to support the ECB's Asset Quality Review. She stated that "precautionary recapitalisation is for very unique situations and should never become a bail-out in disguise." In turn, Christian Stiefmüller criticised that the possibility of precautionary recapitalisation has turned into an escape clause undermining the intention of the BRRD. "This clause moves access to State aid and public funding much too close to the actual standard process of resolution as it should be under BRRD with shareholders' and creditors' money." Hence, important pillars of this framework are at risk of being undermined, such as the burden sharing clause as well as the prerequisite of solvency.



Elke König underlined that precautionary recapitalisation should be considered as a seldom and ultimate measure when markets go crazy.



Alessandro Penati pointed to the lack of market discipline on debt in Europe, especially in contrast to the US, which causes the confusion of having different provisions meshed together in the BRRD.

Matthias Wargers considered precautionary recapitalisation as a medicine for merely healthy entities but the cost to taxpayers should be kept to the minimum. As financial systems differ, any measure would also be linked to a clear roadmap, including consolidation and market exit. Elke König responded that financial and economic stability concerns should not be used as an excuse to prohibit moving forward. She stated that “if a bank fails, it either goes into insolvency, unfortunately not harmonised across countries, or in case of systemic importance for critical functions or financial stability, resolution is the framework to go, while public funds ought to be excluded. Precautionary recapitalisation should be considered as a seldom and ultimate measure when markets go crazy.”

Matthias Wargers echoed this view and highlighted that it would be critical to distinguish between resolving a single bank or addressing structural issues that call for consolidation and exit instruments. “A capital injection that leaves the bank running just as before is ineffective.” As a final remark, Alessandro Penati pointed to the major lack of market discipline on debt in Europe, especially in contrast to the United States, which causes the confusion of having bankruptcy law, State aid rules and fiscal policies meshed together in the BRRD.

The panel also addressed several questions from the floor in the Q&A session of the discussion. The first question referred to whether precautionary recapitalisation is in fact considered an exception to the rule. Elke König agreed that it should be confined as much as possible and presents an exception rather than a tool in the regulatory kit.

In regards to the perception that debt could work if banks were to handle it properly and if institutional capacities were efficient to manage insolvency, Matthias Wargers replied that both internal and external restructuring units can coexist, but a potential conflict of interest has to be accounted for, which was echoed by Elke König.

In review of the recent liquidation of two Italian banks in the Veneto region, Christian Stiefmüller pointed out critical inconsistencies in the framework on the definition of a systemically important institution. Some frustrations with current implementation of banking resolution in the EU stems from the fact that it is out of sync with the spirit of the BRRD – possible liquidation of non-systemically important banks under the national solvency regime, as we have seen in the case of two Italian Venetian banks. That law applies in the cases where systemically important banks fail, meaning it was not used for the two smaller Italian banks, which were dealt with under national insolvency rules. Hence, on a macroprudential level, there is the need for a clear and consistent mechanism of determining systemic relevance and its implications for the application of respective capital measures. Elke König clarified that the SRB recognised that both Veneto banks were in great distress, but looking at them individually as well as jointly there was no risk for financial stability and thus there was no case for resolution.

Keynote**Sectoral Regulations and SIFIs Interdependencies**

**Odile Renaud-Basso**, Director General of the Treasury,  
French Ministry for the Economy and Finance



The sectoral approach has inevitably led to a degree of heterogeneity in both the level of progress across sectors and in the overall nature of SIFI regulations.

As an introductory note, Odile Renaud-Basso pointed out that SIFI regulations have progressed significantly over the past years at the international and European level. Nevertheless, progress has been achieved through a predominantly sectoral approach, whereby issues pertaining to systemic banks were dealt quite separately from systemic insurers, which themselves in turn were isolated from the work on other systemic actors such as central counterparties. This approach has inevitably led to a degree of heterogeneity in both the level of progress across sectors and in the overall nature of SIFI regulations.

Analysing first those sectoral regulations and highlighting the challenges for the coming months at the European level, Odile Renaud-Basso made the following points: First, the regulation of SIFIs began with the banking sector. In November, the identification by the FSB of global systemically important banks will provide for the seventh time a list of institutions that will be subject to higher loss absorbency requirements. Two issues on European G-SIBs regarding their identification as well as the regulatory consequences of this identification deserve particular attention. Relating to the former, a number of recent initiatives, such as the single rulebook, the EU resolution framework and the Banking Union, should be taken into account in the methodology to identify G-SIBs. Intra-Eurozone banking activities are currently taken into account the same way as activities carried out in non-Eurozone or third countries for determining the cross-border activity indicator. This does not incentivise Eurozone banks to seek exposures to other Eurozone countries, thus limiting the development of a truly unified European market. Therefore, the Banking Union should be considered as a single jurisdiction when assessing the systemic impact of institutions.



For of a truly unified European market, the Banking Union should be considered as a single jurisdiction when assessing the systemic impact of institutions.

As on the consequences of being identified as a G-SIB, not all risks are concentrated on these institutions. One must be careful to consider the continuum of importance ranging from G-SIBs to domestic SIBs, significant institutions and so on. It should be ensured that solvency requirements are proportionately higher for the most systemic institutions without creating a diverging framework that would reduce the overall level of prudence in the banking system. Therefore, we are fervent defenders of the single rulebook that should be applied to all credit institutions within the European Union. Further, the resolution framework illustrates well the need to not focus only on G-SIBs. It is crucial to go beyond the resolvability of G-SIBs. The last crisis in Europe demonstrated that medium and small banks have, relative to their size, borne the highest losses. Hence, even relatively small banks can be judged systemic in a stressed environment. A tiering approach in the European Union with the biggest institutions on the one hand and medium and small banks on the other hand, would not be prudent. A same resolution framework should apply to meet two overall objectives. First, to ensure financial stability by making all banks that could not be wound up resolvable and second, to provide a level playing field within the EU and across G-SIBs' jurisdictions.



For resolution for insurers, it may in some cases not be possible to rely on traditional tools, particularly in those cases, in which the business model is complex.

On the second general point regarding sectoral regulations and the insurance sector, Odile Renaud-Basso argued that international discussions are challenging. The FSB has been designating systemic insurers from 2013 onwards and these efforts shall be pursued. Useful policy measures are associated with the designation, notably enhanced group-wide supervision through the development of liquidity risk management plans and group-wide recovery and resolution planning within crisis management groups. But focussing on the resolution for insurers, in some cases it may not be possible to rely on traditional tools, particularly in those cases, in which the business model is complex or there is no corresponding market for portfolio transfers. The traditional tools may not be sufficient either to mitigate the systemic impact of a sudden deterioration in the viability of a larger, complex insurance group engaging in non-insurance activities.



An initiative at European level as regards recovery and resolution in insurance, taking into account the specificity of this sector, will have real added value.

The FSB has developed a set of standards dedicated to the resolution in insurance issued in June 2016. Work is now ongoing to develop an assessment methodology, which will be used for international peer reviews with the objective to mainstream resolution in insurance. In this spirit, an initiative at European level for resolution in insurance is needed. Whereas, in January 2016, the Solvency II prudential framework entered into force, this directive does not address recovery and resolution for insurers. Recent reports from the EIOPA and the ESRB have stressed the importance of introducing such a recovery and resolution framework at European level. Against this background, some countries, such as France and the Netherlands, are developing national recovery and resolution regimes in insurance. An initiative at European level, taking into account the specificity of the insurance sector, will have real added value. Besides, issues regarding national insurance guarantee schemes should be addressed by the Commission in order to enhance consumer protection.



CCPs are with their growing centrality and corresponding interconnectedness indeed a topical case of new systemic institutions that have not been yet fully addressed.

The third aspect of this sectoral review concerns the issue of CCPs, as they are indeed a topical case of new systemic institutions that have not been yet fully addressed by the FSB. In order to make derivatives markets safer, there has been a strong push for central clearing of an increasing variety of financial instruments in the aftermath of the financial crisis. Since 2009, central clearing of OTC derivatives has grown exponentially. With this dramatic expansion of central clearing, the industry has experienced a parallel trend of concentration of these exposures in a few global CCPs, since the economics of a CCP favours concentration and tends naturally to some degree of monopoly. This growing centrality and the corresponding interconnectedness have casted a crude light on the necessity for sound risk management, strengthening the resilience of individual CCPs and, most recently, the continued provision of clearing services if a CCP goes into recovery or resolution.

At the European level, these issues have been tackled in the EMIR framework, which aims at increasing transparency in the OTC derivatives markets and at mitigating credit and operational risks. This framework is currently under review. The Commission has also adopted a legislative proposal on CCP recovery and resolution. The aim of this proposal is to ensure that a consistent recovery and resolution framework is in place should a CCP experience some difficulties. France pays a very close attention to these issues, which demonstrate that it is imperative to foster a more unified architecture of supervision and resolution frameworks for these critical infrastructures.



The CCP Recovery and Resolution framework, however, does not address another major issue that a significant volume of financial instruments denominated in the currencies of Member States is still cleared in non-EU countries. This is possible thanks to the equivalence regime granted under EMIR, which envisages that authorisation and supervisory regimes in non-EU countries can be considered equivalent to the EU rules. Why is this an issue or rather, why is this not a non-issue? In a situation of crisis or default of several members of the CCP, it is a concern to imagine that the EU might be subject to the decisions of a third country's supervision authority. And it is not clear that mutual supervision alone can fully address this type of extreme, but plausible, scenario. In other words, the actions of a third-country CCP can have an impact on the financial stability of the EU and its Member States and therefore raise significant concerns for EU central banks. With the departure of the United Kingdom from the EU, France's feeling is that there is an urgent need to address them, for the few super-systemic CCPs, through a sound and operative location policy that would address as much as possible its side effects. This is why the Commission proposed an EMIR review and France strongly supports such an initiative.



When assessing the consistency of SIFIs regulation, the issue of interdependencies will be key, especially when a systemic institution faces a situation of stress.

As a final point, Odile Renaud-Basso noted that while work remains to be done for regulating SIFIs at international and European level, it is now time to assess the consistency of the rules that were framed for each sector. In this vein, France welcomes and supports the task force on systemically important banks and insurers that has been set up by the IAIS and the BCBS to develop specific proposals to fill gaps, address inconsistencies or unintended consequences in the overall G-SIB and G-SII frameworks. Such work is very promising, and hopefully the IAIS and the BCBS will further pursue their common work to improve the consistency of the SIFIs regulation.

When assessing the consistency of SIFIs regulation, the question of interdependencies between SIFIs will be key. When a systemic institution faces a situation of stress, does the regulation take into account the interdependencies between the stressed institution and its systemic counterparties and the side effects produced by regulation heterogeneity among sectors? There is obviously no single or easy answer to this question and Odile Renaud-Basso suggested that this work remains largely to be undertaken collectively, but she proposed some lines of approach, especially around unintended consequences. Contagion and disruption effects among systemic and potentially stressed institutions may come about by way of interdependencies and interconnections such as exposures, legal arrangements, shared systems and services. The implementation of 'bail-in' in some countries has raised questions regarding contagion and litigation risks. And it should also make sure that current regulation fully addresses moral hazard risks associated with SIFIs.

To conclude, Odile Renaud-Basso highlighted these questions as crucially important for the international regulatory community to address in the coming period. Therefore, policy makers, supervisors and academia members should tackle this issue and join forces with the regulatory community. This issue is a key topic of the stability of the financial system.



Panel III - Impulse**Unfinished Business in the new EU political Constellation****Klaus Regling**, Managing Director, European Stability Mechanism

Klaus Regling started off his impulse on the notion that financial stability in Europe is closely linked to the Euro. One of the goals of the Economic and Monetary Union was, and remains to this day, to have a large area of financial and monetary stability. Having such an area is conducive for growth and creates a true competitor for the other large economic regions of the world, the United States and China. Some may say the Economic and Monetary Union failed miserably given the Euro debt crisis, which presented a serious setback. At the same time, it is important to recall that Europe had also experienced major crises before the single currency. And without the Euro, the global financial crisis would equally have caused tremendous currency volatility in Europe, at a large economic and possibly political cost.



With the significant steps taken the last decade in response to the crisis, the Euro area is now more robust. Its institutional architecture is also much stronger, with a range of new institutions.

Klaus Regling argued that with the significant steps taken in response to the crisis during the last decade, the Euro area is now more robust. Its institutional architecture is also much stronger, with a range of new institutions. There is now a single supervisor for the 130 largest systemically important banks, and a single resolution mechanism to wind them down when they are a gone concern. And with the ESM, a new function was created to provide assistance loans to countries that land in trouble during a crisis. As a result of these programmes, countries that needed emergency financing have tackled their problems through fiscal adjustments, improvements in competitiveness and repairs of their banking systems. At the European level, there is a tighter and broader economic surveillance and better policy coordination. All these steps have made monetary union more robust, and will help financial stability in the future.

Klaus Regling went on to note that politicians are currently talking about reforms to further strengthen the Euro area. The debate focuses on the completion of Banking Union, fiscal arrangements and developing the mandate of the ESM, including possibly a greater focus on crisis prevention. All these steps will bring more financial stability and are therefore part of the 'unfinished business'.



A backstop for the SRF is required to make it more credible in the eyes of financial markets. There is a growing consensus that this is a role the ESM could fulfil.

Considering the current discussion, Klaus Regling first looked at the Banking Union. A backstop for the SRF is required to make it more credible in the eyes of financial markets. There is a growing consensus that this is a role the ESM could fulfil. EDIS is the second important step to complete Banking Union. If depositors know that their money in the bank is protected by the entire Euro area, not just by their own government, the chances of a sector-wide bank run in one country are slim. Therefore, setting up a deposit insurance is the best guarantee that it will never be needed in any major way. But this can only happen if legacy problems with banks in some countries are tackled first. Healthy banks in one country cannot be expected to pay for mistakes made in the past by banks in another country.

Another reform that is needed is the broad harmonisation in the European Union of corporate, bankruptcy and tax laws known as Capital Markets Union.



Completing the Banking Union and creating a Capital Markets Union would strengthen financial integration in the Euro area and thus increase risk sharing.

This would boost cross-border investment and open up new financing channels for companies. It would have the added benefit of reducing Europe's heavy reliance on bank funding and would greatly enhance economic risk sharing through private markets. Completing the Banking Union and creating a Capital Markets Union would certainly strengthen financial integration in the Euro area and thus increase risk sharing.

Secondly on fiscal issues, Klaus Regling argued that the EU does not need a full fiscal union with larger transfers between countries. The existing EU budget already allows for significant transfers to poorer countries, which can amount to up to four per cent of their economy. Also, there is no need for a large additional budget to counter a deep crisis hitting the region. The simultaneous increase in fiscal deficits during the global financial crisis of 2008 and 2009 showed that Europe can successfully fight a crisis in truly exceptional cases under the existing rules.



There is room in the Monetary Union for a facility that deals with economic shocks hitting one individual country, a so-called asymmetric economic shock.

However, there is room in the Monetary Union for a facility that deals with economic shocks hitting one individual country, a so-called asymmetric economic shock. For instance, it helps to think of Ireland if it were hit by a particularly hard Brexit. Different ways to establish such a facility are possible. Rainy day funds or a complementary unemployment insurance, which exist in most US states, could be attractive options, because they do not lead to permanent transfers or debt mutualisation between the participants. Rainy day funds, for instance, pay out during a crisis, but states have to reimburse the money when they recover. Such a fiscal capacity could be combined with a more predictable and transparent system for burden sharing with private creditors in case of a sovereign debt restructuring. Until now, this has happened on an ad-hoc basis, as was the case with the Greek Private Sector Involvement.

In Klaus Regling's view, this should be done by including stricter collective action clauses in the Euro area bond documentation. The ESM could take on the role of organising so-called London Club-type restructurings to assure a fair outcome for all parties involved. There are suggestions for automatic maturity extensions whenever a country requires an ESM programme. Klaus Regling considered this a risky option, as such automaticity would be pro-cyclical and make problems worse rather than solve them. Finally, the development of the ESM as described would also help to make monetary union more resilient, and thus contribute to financial stability.

As a final remark, Klaus Regling said that there is enough 'unfinished business' in Europe. In bank regulation and financial market supervision and, more broadly, in deepening the monetary union. Fortunately, the political impetus for further Euro area integration is now as good as ever. In recent elections, Europe's citizens have shown their commitment to a tradition of multilateralism. The popularity of the Euro is at record heights and this gives politicians a clear mandate to pursue the reforms that will, among others, bring greater financial stability to the Euro area.

Panel III - Discussion**Looking forward: How to tackle unfinished Business in a new EU political Constellation?**

with **Dr. Levin Holle**, Director General, Financial Markets Policy Department, German Federal Ministry of Finance; **Philippe Lamberts**, Member of the European Parliament, Co-Chair, Group of the Greens/European Free Alliance; **Klaus Regling**, Managing Director, European Stability Mechanism; **Odile Renaud-Basso**, Director General of the Treasury, French Ministry for the Economy and Finance; **Luigi Federico Signorini**, Deputy Governor, Banca d'Italia; **Emiliano Tornese**, Acting Head, Resolution and Crisis Management Unit, European Commission, and Visiting Professor, College of Europe in Bruges; moderated by **Prof. Alessio Paces**, Professor of Law and Finance, Erasmus School of Law, Erasmus University Rotterdam

Alessio Paces introduced the panel topic of unfinished business in tackling financial instability problems in Europe. In his view, this presents a threefold issue including: a) legacy problems that need to be overcome before b) moving on from national to European authorities to decide on banks, which in turn is only possible with c) a credible backstop. Emiliano Tornese started out that in terms of completing the institutional architecture of the EU and the Banking Union, the Commission's recent Banking Union communication can be considered a landmark. It shows that eventually it is for the co-legislator to decide what important policy choices have to be made. "The Commission wants to play the role of an honest broker putting forward ideas so that the co-legislator can decide on how to move forward on the important topic of EDIS." The communication addresses the policy objective of protecting depositors across the Euro area as well as legacy and moral hazard problems that need to be tackled in order to create a level playing field. Therefore, the Commission proposes the co-legislator to consider an EDIS which simply provides liquidity in the first phase excluding any risk of losses and continues to a second phase if need be.



Emiliano Tornese reported that the Commission's Action Plan for NPLs expected for spring 2018 entails the objective of creating a secondary market with price recovery and transparency.

Moreover, the Commission's Action Plan for NPLs expected for spring 2018 entails the objective of creating a secondary market with price recovery and transparency. "Within this roadmap the tensions between risk sharing and risk reduction go in parallel and achieve the ultimate objective of financial stability in the Euro area." Alessio Paces summarised the Commission's position to run the two agendas of reducing risk and sharing already existing risks in parallel, which is difficult to frame from an economic perspective, but might make more sense from a political standpoint.



Philippe Lamberts proposed to design EDIS similar to the Euro, but with more consistent criteria that countries have to meet in order to join and to access a full co-insurance room in the next phase.

In regards to Klaus Regling's previous impulse, Philippe Lamberts challenged the view that the current political constellation favours the European project, as Euro-scepticism is on the rise according to political election outcomes in Germany, France and Austria. To begin with, there was a low desire among Member States to complete EDIS, and efforts by the Commission did not change that. In turn, recent actions in Italy formed the recipe for EDIS to fail, since demanding more risk reduction before taking any action presents a political deadlock. Philippe Lamberts proposed to design EDIS similar to the Euro, but with more consistent criteria that countries have to meet in order to join and to access a full co-insurance room in the next phase. "With this



Philippe Lamberts emphasised that fixing disparities across countries via solidarity conditioned on responsibility is vital for the Euro to sustain.



In response, Klaus Regling insisted that in Europe significant transfers already took place through EU budgets promoting real convergence.



Luigi Signorini added that permanent transfers are no solution to economic diversity problems in Europe since they create a structure of dependency.

different approach at least you get the ball rolling, as momentum counts and I am afraid that currently we are stuck." On the issue of political momentum, Odile Renaud-Basso opened the alternative perspective that recent political events in the US served as a strong impetus to unify and build a strong Europe at the international scene. In addition, Brexit demonstrated the value-added of being part of the EU and politically it turned the dynamics towards more integration.

Making the case for Europe, Philippe Lamberts went on to suggest that a federal currency with a European Central Bank and federal monetary rules could not function without financial solidarity mechanisms. "There is no currency union without a transfer union." Moreover, there is no such thing as a homogenous monetary union neither on a EU nor country scale, but nonetheless fixing disparities across countries via solidarity conditioned on responsibility is vital for the Euro to sustain. There appears to be a lack of political willingness in the Council and in political campaigns to recognise cohesion between European Member States and to act accordingly. "It is not because we have the Euro that we belong together, but it is the other way around." The benefits from the monetary union come with a price tag and there is no free lunch for neither debtor nor creditor countries.

In response, Klaus Regling insisted that in Europe significant transfers already took place through EU budgets promoting real convergence, and secondly the ESM loans represent significant transfers to receiving countries. On the issue of solidarity, Luigi Federico Signorini added that permanent transfers are no solution to economic diversity problems in Europe since they create a structure of dependency. "Compensating for different starting points through state intervention and endless permanent transfers is no way to resolve economic imbalances, but rather to entrench them." Nonetheless, some kind of financial compensation and risk mutualisation with a larger pool to insure against risks would be advisable.

Alessio Paces returned to the issue of risk sharing and risk reduction pointing out that someone has to pay for losses on banks' balance sheets and posed the question whether bail-outs can be avoided. Levin Holle answered that given a properly structured system addressing legacy issues, appropriate incentives and bail-in-able buffers bail-outs can be avoided. First, as legacy issues are clearly cut so far, they present less of a concern. However, the question remains whether the right level of protection and future incentives prevail, including sufficiently high and clearly subordinated bail-in-able buffers. Given the bank-sovereign-circle, bail-ins can potentially pose a risk and the issue of risk concentration in banks' balance sheets needs to be addressed. Finally, for the system to work, a better alignment of insolvency, corporate and tax law is required in Europe, from which banks' balance sheets, the Banking Union and the Capital Markets Union would benefit. Odile Renaud-Basso echoed that great progress has been made with respect to substantially increased capital buffers, the demonstrated functionality of the SRB in recent events, and in spite of remaining legacy issues, one should not be overly pessimistic on bail-in.

In contrast, Philippe Lamberts argued that the bail-in approach yields a lot of uncertainty and that he is therefore in favour of banks' capital increases with leverage ratios of ten per cent to effectively reduce risks. Whereas efficiency has been pushed harder than resilience, an appropriate balance must be found.





Luigi Federico Signorini resonated with Levin Holle and Odile Renaud-Basso that for bail-in to be usable and credible it has to be prepared carefully.

"It was a mistake to not have a transition period when introducing the BRRD for the first time", Luigi Signorini said. In its revision, a minimum of flexibility has to be accounted for as well as the transition management of aligning expectations of the bail-in-able liabilities, especially regarding subordinated debt, such that investors know what they buy. He also highlighted potential trade-offs from ex-ante incentives and avoiding moral hazard versus tackling financial stability issues. From a European perspective, risk reduction is in the interest of everybody, and so is risk neutralisation, since insurance, once it is set up, can work more efficiently and credibly with a large and diverse pool of insured units. However, to not do anything before all pending issues of risk reduction are solved is not helpful either. The ongoing progress on risk reduction should not be forgotten.



Alessio Paces moved on towards the potential role of the ESM presenting a credible backstop to provide certainty for financial markets. However, as it is not part of EU institutions and works with unanimity as an international treaty, the question arises whether the ESM is challenged to provide such certainty. Klaus Regling concurred that the ESM's governance works differently, which is unlikely to change in the short-term. While most Member States favour the integration of the ESM, this may, however, entail complicated legal changes in the EU treaty. "It would be easier with decisions based on qualified majorities, but during the last five years the ESM was always capable of reaching unanimous decisions."

Emiliano Tornese underlined that it takes a homogenous EU architecture with respective tools and bail-in as the rule that is applied to all liabilities and should not be confused with solidarity.



In the following, the alternatives of promoting solidarity and integration through a European insurance against economic shocks in contrast to increasing individual Member States' responsibility in dealing with their own shocks was debated. Philippe Lamberts challenged the notion of country-specific shocks and instead considered shocks to be systemic to the overall EU Single Market. "As EU citizens we belong together and therefore there is a serious and conditioned degree of financial solidarity between us. It is about the balance between solidarity and responsibility and we should have both." In turn, Emiliano Tornese articulated that risk sharing measures already entails risk reduction. Even without homogeneity across countries, it takes a homogenous EU architecture with respective tools and bail-in as the rule that is applied to all liabilities and should not be confused with solidarity. As a backstop institution, EDIS remains important to provide stability even if it just is there and not necessarily used.

Levin Holle stressed that the Banking Union is not about organising transfers, but about creating a more stable system and having banks on the European level organise an insurance.

Levin Holle stressed a fundamental difference between the Banking Union debate and a fiscal debate. "The Banking Union is not about organising transfers, but about creating a more stable system and having banks on the European level organise an insurance." Moreover, the common backstop has to be fiscally neutral and serves as a liquidity source, which already exists today through the ESM with the mere difference of conditionality due to heterogeneity in banking sectors across the Union. Luigi Signorini agreed. However, he pointed out that the combination of a single monetary policy given the Banking Union with a fiscal policy characterized by distributed sovereignty generates a suboptimal constellation at the moment. On the issue of budget, Odile Renaud-Basso added that it should not be put under an issue



On the issue of budget, Odile Renaud-Basso said that it should not be put under an issue of solidarity versus responsibility, but under the issue of a good functioning of the Monetary Union.

of solidarity versus responsibility, but under the issue of a good functioning of the Monetary Union, where economic shocks may be asymmetric or have an asymmetric impact across the Union, for which appropriate instruments are required.

Finally, Alessio Paces initiated a concluding round on whether enhanced governance of the EU is called for, considering bank regulation and supervision in the light of imbalances and differences in financial and economic stability across Europe. Odile Renaud-Basso proposed that governance is required only after necessary actions and instruments are agreed upon in the first place. Especially given economic imbalances and problems of convergence that current instruments do not address, a coordination of economic policies is needed to prevent the current gaps in terms of economic dynamics to grow even more. Philippe Lamberts opted for a new European federal constitution with simpler and less politicised treaties, a common rulebook applicable at a federal level and enforceable through federal courts, to which the European people would consent.

In contrast, Klaus Regling argued that the EU does not need a federal budget and increased transfers to survive. Levin Holle agreed. What is needed is the completion of the Banking Union to guarantee more risk sharing through the markets, a common defence budget, a common tax basis for corporate entities and targeted fiscal facilities in case of asymmetric shocks and to promote macroeconomic stability.



Emiliano Tornese suggested that the Commission might want to better explain the accomplished benefits and synergies from the Euro and Single Market in order to create consensus for future joint projects. Following this, Levin Holle recommended to first define the projects where sovereignty is best exercised at European level and then to build the corresponding structure to promote such projects. Finally, financial means have to be adjusted to effectively serve these projects. Luigi Federico Signorini noted that a large number of responsibilities have already been transferred from Member States to the European level. While matters other than economics and finance should be transferred as well, it is crucial to ensure a governance structure appropriate for this type of sovereignty transfer.



Contributions

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Motivated by the conference and encouraged by Martin Aehling, three scientific policy contributions have been prepared and published by early-stage and PhD researchers, accompanying and following-up selected topical issues of the Financial Stability Conference 2017.

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Contribution I**Upgrading the current EU Resolution Framework –  
A Focus on Bail-in and Precautionary Recapitalization**

**Lukas Köhler**, PhD Candidate in Financial Regulation, Bucerius Law School, Hamburg

**Marcello Tumino**, Research Assistant, LL.M., Corporate Governance and Financial Regulation, University of Warwick, Coventry

**1. Introduction**

EU banking regulation has gone through a massive set of changes in the past decade, but, even if substantial improvements have been made, the realization of a fully-fledged Banking Union is still an unfinished business under many aspects. Recent case studies suggest that any pledge to avoid bailouts in the future is strictly linked to two main aspects: the fine-tuning of bail-in rules on one side and, on the other, the enhancement of the legal certainty about the limits imposed on publicly funded recapitalisations.

After the Global Financial Crisis (GFC), policymakers and financial regulators at the international level recognised that addressing the ‘too-big-to-fail’ issue posed by many financial institutions was an essential prerequisite for economic recovery. In particular, it is almost uncontested that banks play a pivotal role within a financial system since they provide key economic functions and represent an essential source of funding for the real economy. The policy of bail out credit institutions in financial troubles has a long history and it has usually been vindicated with the claim that letting them fail would imply higher costs, both in terms of overall public expenditures and economic slowdown. However, many analyses highlighted how this policy choice actually poses a serious threat to public finances, hinders competition and favours a risk-taking culture that magnifies the issue of moral hazard [e.g. Huertas, 2015]. These problems were severely felt in Europe, where they have been aggravated by the Sovereign Debt Crisis that exposed a perverse link between sovereign debts and the banking sector.

Indeed, in the European context, the new awareness on these issues led to a gradual but determined shift towards a policy based on burden sharing and investors’ involvement in bank crisis management. On one hand, there was the need of improving the banking regulation and supervision (from both a micro and macro perspective), mainly with the introduction of a more forward-looking approach and adequate supervisory tools such as periodical stress tests or asset quality reviews. Within this domain, the aim is to prevent bank crises or to halt them at their onset. On the other hand, one of the greatest challenges was making even systemically important banks resolvable or ‘safe to fail’, curbing the bail-out practice. Here, the main objectives are re-stabilising ailing banks or minimising the effects their failure may have on financial stability. Firstly, to address the latter issue, a wide set of reforms has been mandated at the G20 level since 2009. Then, the work on this field has been conducted by the Financial Stability Board (FSB), which since 2011 develops and refines the principles and key attributes a sound resolution regime should possess to be effective. Substantial contributions in this field

have been made also by another international standard setter, the Basel Committee on Banking Supervision (BCBS) hosted by the Bank of International Settlements (BIS).

Along these lines - and in the light of the de Larosière Report which exposed the criticalities of the EU system of financial supervision in 2009 - the EU co-legislators launched the ambitious project of the Banking Union (BU) in June 2012. It should be noted, however, that avoiding bailouts as a strategy option in bank crisis management was already a priority under the State Aid framework enforced by the EU Commission. Its 2013 Banking Communication (the latest iteration of the so-called 'crisis communications') tries precisely to strike a balance between avoid distortions of competition in the single market and preserving financial stability.

Radically reshaping the former architecture of bank regulation and supervision, the BU was supposed to rest on three pillars: a Single Supervisory Mechanism (SSM) under the aegis of the European Central Bank, a Single Resolution Mechanism (SRM) led by an independent resolution authority (the Single Resolution Board – SRB) and a European Deposit Insurance Scheme (EDIS). The overall aim was to break the vicious circle between banks and sovereigns (the so-called 'doom loop'), put an end to the practice of bailing out financial institutions using taxpayers' money, curb moral hazard and ensure financial stability. Steps ahead towards these objectives have been made, but progress seem to advance on a bumpy road. This is even more apparent with regard to a common deposit guarantee scheme to ensure depositors in the euro-area.

## 2. EU Bank Crisis Management: the Road so far and the Way ahead

The present article is focused on the EU resolution framework, which is based on two major pieces of legislation: the Bank Recovery and Resolution Directive (Dir. 2014/59/EU, 'BRRD'), that broadly applies to all credit institutions within the EU, and the Single Resolution Mechanism Regulation (Reg. 806/2014, 'SRMR'), which covers euro-area banks. In general terms, this framework ensures the burden sharing principle by introducing 'bail-in' powers that the relevant resolution authority could use to write-down and/or convert into equity eligible debt instruments or other hybrid liabilities of a failing – or likely to fail - institution, according to a predetermined hierarchy. The aim is to improve market discipline by placing shareholders and certain debtholders at the forefront in case of financial distress, while also preserving the continuity of banks' critical economic functions. The detailed bail-in discipline is laid down in Article 43 et seq. of the BRRD. However, when it comes to the possibility of recapitalising an ailing bank, a tension arises between this general principle and its exception. Indeed, while many passages of the BRRD reiterate that a certain percentage of a bank's total liabilities should be bailed-in before any injection of public funds could take place, Article 32 mandates that Member State governments can apply for a so-called 'precautionary recapitalisation' if a detailed set of criteria are met.

Certain aspects of this framework are currently being reviewed by the EU Commission, that - in line with the roadmap decided by the ECOFIN – in

November 2016 presented a 'banking reform package' which will also amend the Capital Requirements package (CRR and CRD). With regard to the resolution framework, one of the most relevant amendments will be the refinement of the minimum requirement for own funds and eligible liabilities (MREL) applicable to EU banks, which constitutes an essential prerequisite for an effective application of the bail-in resolution tool. According to Article 45 of the BRRD, the level of MREL is currently determined by the relevant resolution authority on a case-by-case basis and it is expressed as a percentage of a bank's total liabilities including regulatory capital. However, this rule deserves further improvements. For instance, MREL levels do not have a minimum threshold and the bank-specific targets identified by the SRB in the previous year are not binding or enforceable. Therefore, the EU Commission's proposal amending this area will constitute a much-needed improvement, also because it will adapt and integrate the Total Loss Absorbing Capacity (TLAC) requirement developed by the FSB for global systemically important banks (G-SIBs) into EU law. As the chairperson of the European Banking Authority (EBA) Andrea Enria highlighted in many occasions [e.g. Enria, 2017], consistency and proportionality will be key. Considering the specific needs and business models of different credit institutions will allow co-legislators to lower compliance, operational and administrative costs, with positive effects on bank lending and profitability.

A second weakness of the EU resolution framework is represented by a lack of harmonisation among Member States' insolvency laws, in particular the area of creditor hierarchy and subordination. These differences among Member States' legal frameworks severely undermine the legal certainty of resolution processes, increase legal risks and costs under the 'no-creditor-worse-off' principle and weaken the application of bail-in. In addition, this interplay between BRRD rules and domestic legislations results in increased bank funding costs. The current EU Commission's proposal to address this issue and harmonise the creditor hierarchy in case of bank insolvency may need further refinement and its analysis is outside the scope of the present article, but gradually steer toward more harmonisation while taking into account the profitability of the sector seems to be a step in the right direction.

### **3. What could be done to render the Bail-in more credible? A Proposal for the Introduction of a special Group of preferred Shareholders**

Bail-in powers serve as an instrument to overcome time-series problems by enabling governments and regulators to commit to a future behaviour: not bailing out financial institutions. In this regard, the terms of converting debt into equity are crucial. It seems preferable to have relatively easily triggered and therefore regular conversions with only little impact on the financial system as a whole. As external pressures on the authorities will be lower, such an incremental approach makes bail-ins more likely to happen, thereby reinforcing the instrument's credibility. As a starting point, the conversion into equity poses a strong incentive for shareholders not to burden the company with too much leverage. Societal costs associated with a non-optimal business model will be borne by shareholders whose part in the company would be diluted on conversion, providing a parade example for the internalization of external costs. John C. Coffee expands on this idea and argues for the

conversion of debt into voting preferred stock [Coffee, 2011]. For reasons we will expand on in the following, it is worthwhile to consider establishing a special class of preferred shareholders carrying voting rights even before bail-in is triggered as well as rights of action to enforce bail-in terms.

First, this would create a new constituency more senior than ordinary shareholders in terms of loss absorbency: only if ordinary shareholders are not being paid any dividends, will preference shareholder have to absorb losses. Put differently, they are the last to suffer from a financial crisis of the institution. If calibrated rightly, they stand to lose in situations in which ordinary shareholders' incentives are already skewed towards externalizing systemic risk on creditors and society as a whole. It follows from this that giving preference shareholders a say in the running of the company ex-ante the triggering of bail-in could counterbalance the risk-seeking behaviour of ordinary shareholders as a class. Ideally, the number of preference shareholders would be significant enough as to pre-empt the need to "internally resolve" institutions by bailing-in debtors in the first place.

Second, and building on this, special groups of private claimants could also be deployed to enforce – rather, threaten to enforce – the contractually determined conversion triggers vis-à-vis resolution authorities and accordingly make the success of "internal resolutions" more credible. We showed that authorities' legal and factual discretion in situations of extreme financial distress raises doubts among market participants about the actual enforcement of bail-in. This is because regulators, banks and holders of bail-inable debt form a special interest group. As such, they not only have reason to but also the necessary incentives to push for ultimately avoiding bail-in. In contrast, taxpayers constitute a large and dispersed group with accordingly lower incentives to lobby for the prevention of bail-outs. As a consequence, there is a strong need for a special interest group highly motivated to have bail-in enforced: a special group of preferred shareholders could perform this function. To this end, regulation could mandate financial institutions to issue a certain amount of preference shares. These would be lower ranked than the bail-inable debt (say, AT 1 bonds) but higher ranked than the claims the debt would be converted into (say, ordinary shares). As a result, these shareholders have an interest in bail-in taking place for they would like to get rid of the debt claimants benefitting from fixed payments. As preference shareholders, however, the conversion does not dilute their priority claims. What's more, this class should be equipped with a right of action vis-à-vis governments and regulatory authorities ("enforcement shareholders") allowing them to "kick down" the bail-inable debtors once the trigger point is reached. If calibrated rightly, the mere threat of this enforcement helps to restrict the regulator's discretion and in consequence render bail-in credible. Ideally, the preferred stock would be held by relatively few institutions with high-powered incentives and practical capabilities to sue. By suing – or threatening to sue – an agency that might otherwise shirk away from triggering or alternatively have courts enforce a bail-in, these enforcement shareholders functionally proxy for the general public and its interest in the enforcement of bail-in.

#### 4. Precautionary Recapitalisation

Despite preventing future bailouts was one of the guiding principles behind the decision to create the Banking Union, Article 32 of the BRRD – which, in general, sets the conditions that trigger a resolution – does not entirely expunge this possibility. On the contrary, its paragraph 4(d)(iii) envisages the use of precautionary recapitalizations as an *extrema ratio* that shall be used to ensure financial stability and prevent that a bank's collapse may threaten a Member State's broader economy. This is consistent with Article 107(3)(b) of the Treaty on the Functioning of the European Union, which clarifies how state aid may be deemed compatible with the rules on the internal market on the condition that it is granted to 'remedy a serious disturbance in the economy [...]'. The EU Commission's Banking Communication of 2013 further specifies the parameters for such public interventions. Since the only two other options in which extraordinary public financial support could be granted – namely State guarantees on newly issued liabilities or to back liquidity facilities (Article 32 4(d)(i) and (ii)) – are meant to deal with liquidity issues [Olivares-Caminal and Russo, 2017], precautionary recapitalization is currently the sole available tool to increase the capital of a bank with public funds. However, the wording of Article 32 shows several criticalities which have a negative impact on legal certainty and leave room for different interpretations, as detailed below.

Article 32 (4)(d) of the BRRD lays down a set of conditions that should be simultaneously met to unlock the possibility of using public funds to recapitalize a credit institution. First, as mentioned above, a precautionary recapitalization should be used in order to 'remedy a serious disturbance in the economy of a Member State and preserve financial stability' (Art. 32 (4)(d)(iii)). It is also specified that the recapitalization must be 'proportional to remedy the consequences of the serious disturbance'. Second, it must not 'confer an advantage upon the institution'. Third, at the time the public support is granted the bank should not be considered 'failing or likely to fail'. Moreover, it is stressed that precautionary recapitalizations are measures 'of a precautionary and temporary nature' that should be confined to 'solvent institutions' and for the sole purpose of addressing a 'capital shortfall resulting from stress tests and/or quality reviews conducted at the EU or domestic level. They are not intended to 'offset losses that have occurred or are likely to occur in the near future'. Finally, any recapitalization is 'conditional on final approval under the EU State Aid framework'.

After its entry into force at the beginning of 2015, the EU recovery and resolution framework has been tested on several occasions. In 2015 the EU Commission approved the precautionary recapitalization of two Greek banks, i.e. Piraeus Bank and National Bank of Greece (NBG). Early this year, Banco Popolare di Vicenza (BPV) and Veneto Banca (VB) in Italy have been deemed not eligible neither for a resolution nor for a precautionary recapitalization, hence paving the way to their liquidation under the Italian insolvency law (*liquidazione coatta amministrativa* or forced administrative liquidation). Conversely, Banca Monte dei Paschi di Siena (MPS) has been deemed to meet all the conditions required for a precautionary recapitalization, which eventually has been approved by the EU Commission in July 2017. Finally, the case of Banco Popular in Spain currently represents the only resolution that has been conducted under the full responsibility of the SRB. Drawing on these practical applications of the EU's bank recovery and resolution rules,



many commentators highlighted the shortcomings of the current framework. Moreover, since Article 129 of the BRRD mandates that a broad review of its implementation should be carried out by the EU Commission in mid-2018, a reflection on possible paths for reform is due.

At the time of writing, even if different reform proposals and policy recommendations have been put forward [Hellwig, 2017; Olivares-Caminal and Russo, 2017; Philippon and Salord, 2017; Véron, 2017], it is possible to identify certain aspects on which the literature seems to agree. The first and, presumably, less contentious issue that should be addressed is given by the discrepancies among different language versions of the BRRD. More precisely, while in the English version of the directive it is stated that the extraordinary use of public funds should seek to 'remedy a serious disturbance in the economy [...]', the German version uses the verb 'to prevent'. Moreover, as odd as it may sound, both the French and Italian versions use the phrase 'to prevent or remedy'. Choosing between one of the two options, or conversely keeping both the verbs, could alter (lowering or raising) the level of Member States' discretion in requesting a precautionary recapitalization. Whatever the choice, which also depends on the calibration of other passages of Article 32, the sentence should be consistent in all the different language versions.

It would be desirable to address, or at least reduce, the vagueness affecting certain key aspects. As Véron noted, there are too many instances in the wording of Article 32(4) that are too open to interpretation. Due to space constraints, the following will be used as the sole explanatory example. Concepts such as 'a serious disturbance in the economy' and the point at which this last is likely to put 'financial stability' in danger lack a clear and precise legal definition, even if efforts to clarify the latter circumstance have been made by the EU Commission. Olivares-Caminal and Russo argued that even if this ambiguity may hinder legal certainty, on the other hand it allows the relevant authorities to exercise a desirable level of discretionary flexibility on a case-by-case basis. However, as Hellwig pointed out, the current set-up runs the risk of delaying a prompt intervention and it is likely to create tensions between Member States and the relevant authorities at the EU level, exacerbating the political climate. Placing the discipline of 'extraordinary public financial support' outside Article 32, which is dedicated to the conditions for resolution, could be a first step to rationalize the matter. Secondly, the very scope of the objectives of an extraordinary public support may be restricted. Alternatively, a bold – and politically difficult – move would be to refine the above-mentioned concepts and then lift the competence for precautionary recapitalizations at the EU level altogether. This would require further harmonization, and more burden-sharing among Member States, but also constitute a solid step towards a truly integrated BU.

A third problem is the protection of retail investors. Since the State aid rules always require some sort of private investor participation, further harmonization – above the level envisaged under the current EU Commission's proposal on creditors' hierarchy – is required among domestic bank insolvency regimes as an essential complement to the BRRD/SRM framework. More uniformity is needed about the kind of investors that can buy bail-in-able instruments and on the conditions under which they will be converted. This issue, exemplified by the recent Italian cases, should be tackled also from a supervisory perspective. Many mis-selling practices have been put in place on

a large scale and amounted to a regulatory and supervisory domestic failure. Enhancing financial literacy and investors' awareness would also constitute a useful, albeit not sufficient, improvement.

Lastly, both Hellwig and Véron noted that the conditions laid down in Article 32 (4)(d) for a precautionary recapitalization may undermine the very success of the operation and are, to some extent, mutually incompatible or even unrealistic. For instance, it is difficult to imagine how an extraordinary public support, granted to an institution that it is not able to raise funds on its own in the market – as exemplified by Veneto Banca and Banca Popolare di Vicenza -, could not constitute an 'advantage'. However, this shortcoming is one of the less serious if compared with the other restrictions. All together, they deserve an in-depth analysis and careful consideration.

This is only a brief summary of the issues that need to be addressed in the short term. However, even if there is room for improvement, the rationale for the introduction of a 'precautionary recapitalization' tool is still strong and any proposal to discharge it altogether from the BRRD should be cautiously considered. Indeed, as Véron noted, this tool has been introduced within the EU resolution framework for both transitional and permanent reasons. The former was to phase in the 'bail-in' rationale within Member States legal frameworks, while the latter was to envisage a measure to deal with extremely adverse banking crises and is still present. This is the same line of reasoning recently expressed by the chair of the SRB Elke König at the 2017 Financial Stability Conference in Berlin, who expressly stressed how it is always better for a regulator to have as much tools as possible in its regulatory toolbox, despite the fact they will be actually used or not. Even if Philippon and Salord indeed pushed for ratcheting up the conditions for granting extraordinary public financial support with sound arguments – in particular by imposing more creditor burden-sharing – a compromise is needed between what would be ideal and what is politically feasible, especially at present.

## 5. Conclusion

In the next years, the banking sector will face many difficult changes. While the sheer amount of NPLs still constitutes a serious legacy issue affecting bank's profitability, with negative effects on their lending capacity, other problems such as competition from new technologies and regulatory compliance costs will further impact on their businesses. As the EBA highlighted, it will be important to fine tune the current banking reform proposals in order to ensure a certain degree of proportionality. Considering the specific needs and business models of regulated banks will allow co-legislators to lower compliance, operational and administrative costs, with beneficial effects on the banking sector and, in turn, the real economy. Of course, this should not amount to a reduction in the quality of supervision.

With regard to the bail-in, as Véron noted, shifting from a bail-out policy to a bail-in approach that forces private investors to bear the losses and share the burden of ailing banks' costs still represents the more advisable policy option. However, the effectivity of bail-in powers significantly depends on the extent to which the relevant authority can and intends to restrict its discretion.

Although the use of regulatory bail-in powers is encouraging in this respect, their proliferation alone is not enough to make a successful resolution of financial institutions credible. For this purpose, private claimants with an interest in enforcing the terms and condition of the regulatory determined contingent convertible contracts should be installed. To this end, regulation should mandate the creation of a class of preferred shareholders with an interest to “kick down” bail-inable debtors.

On the other hand, the reasons which originally pushed policymakers towards the implementation of the precautionary recapitalization are still present at the moment. However, the literature has highlighted various shortcomings in the current BRRD/SRMR framework that should be addressed. Firstly, the inconsistencies among different language versions should be fixed. More in general, the ambiguity of certain key concepts undermine the legal certainty regarding precautionary recapitalization procedures and may trigger or sharpen political disputes between EU regulators and domestic governments. Secondly, investor protection should be strengthened by improving bail-in rules and priority rankings among bondholders. This represents a true challenge especially in precautionary recapitalizations, during which Member States may be led more by political considerations than sound economic policies. With this regard, the harmonisation of domestic bank insolvency regimes would represent a much-needed improvement. Lastly, it would be advisable for Member States - even if it seems not politically viable in the short-term - to develop a common approach towards the integration of a public intervention mechanism at the European level.

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Contribution II**EU Competition Policy in the European Banking Union – are the good old Policies good enough?**

**Maria Ana Barata**, PhD Researcher, Law Department, European University Institute, and Florence School of Banking and Finance

**Agnieszka Smoleńska**, PhD Researcher, Law Department, European University Institute, and Florence School of Banking and Finance

*This paper explores how the balance between different policy objectives in the financial sector has been struck within the European Banking Union (EBU) context. In particular, we focus on the implementation of competition and financial stability policies, suggesting institutional amendments and policy calibration oriented at facilitating a better aligned and more transparent balancing of objectives.*

**1. European Banking Union beyond Financial Stability**

During the Great Financial Crisis, financial stability achieved an unprecedented centrality as a policy objective in the European Union (EU). Stability, it is argued, is necessary given the role finance plays as the infrastructure underpinning modern economies and to avoid the social costs of instability and financially driven downturns in terms of dampened GDP growth and increased public debt. 10 years on, financial stability remains a primary objective for EU's financial supervisors and central banks, who take the lead in post-crisis supervision of our banks. Financial stability, however, is one, but not the only, aim of public intervention in the banking sector. It exists along other, dynamic and forward-looking aims: such as protection of creditors and depositors or delivery of critical functions by credit institutions, such as lending to the real economy. Additionally, horizontal modes of regulation, such as competition policy in the EU, seek not only to ensure that free market processes lead to efficiency gains and innovation, but also enhance consumer welfare and – following the German ordoliberal tradition – restrain private market power. Combined, policy implementation by different authorities should facilitate the operation of EU banking markets which are efficient, effective, inventive and adaptable to change through the right mix of incentives, business freedom and rules. Coordination between policy implementation is required to ensure consistency and coherence.

As the GFC subsides, a debate is re-emerging, however, as to what is the socially desirable balance between multiple policy objectives and tools of governing the financial sector which often pull in antithetical directions, most notoriously, albeit not only, in the case of financial stability and competition policy. Trade-offs in policy implementation exist not only between bank-specific (financial regulation) and non-bank specific regulation (such as competition or data protection), but also between different modes of regulation (microprudential, macroprudential and/or resolution regimes). Excessively restrictive regulation could come at a cost of lower growth, distorting lending incentives. Good governance requires transparency and equity in the process of balancing various objectives, given the social and economic (including distributional) consequences of this process. Arguably,

increased transparency of the decision-making processes can also lead to outcomes more beneficial to consumers and to the economy at large as well as to alleviate dangers of regulatory capture exasperated in a highly-concentrated market.

In this context, policy implementation within the European Banking Union (EBU) is somewhat problematic, since only decision-making with respect to financial regulation is centralised within the Single Supervisory and Single Resolution Mechanisms, without (or with few) specific arrangements for coordination with other policy objectives, such as competition or consumer protection. The implementation of other policies was not necessarily adjusted to the new realities of the EBU, including the specific challenges which the latter brings about. Such (incomplete) push for centralisation leads to an asymmetric policy balancing process in the EU banking market. We argue that such symmetry is essential – in the absence of explicit prioritisation of objectives at a political level – also as a system of checks and balances. This is especially as it is not a foregone conclusion that the flurry of regulatory reform in the aftermath of the Great Financial Crisis has, or is able to, achieve its stated stability aims in the long-term – in fact, by some accounts, there is more risk in the banking system today than there was before 2008.

## 2. EBU and Market Integration

The EBU – also by promoting a more integrated EU banking market - is presented as the antidote to ineffective financial supervision over the banking sector in the EU before the GFC, seeking to break the vicious circle between the sovereigns and the banks, while restoring the safety and soundness of the latter. More integration of the EU banking market – also through higher consolidation levels - is believed to be one of the most efficient ways to reinforce the EBU and to restore financial stability. To this end, recent research has questioned whether the EU is not overbanked, that is whether the existing number of institutions and branches causes inefficiencies in the sector. To attain the EBU objectives, emergence of EU bank champions is seen as a potential solution that would restore banks' profitability, transforming the so far predominantly national landscape of EU retail banking sector. Consolidation and market integration have been promoted by EU's supervisors, for example by calls for further harmonisation of substantive rules. A substantial restructuring of the EU banking sector is already taking place, and according to ECB's statistics, the number of credit institutions in the Eurozone has declined by 25% since 2008. Such decline can be partially explained by the exit from the sector of inefficient banks, either through resolution or liquidation in the post-crisis regulatory and supervisory EU regime. The increasing concentration in the EU banking sector, however, raises several concerns from the competition policy perspective in the long-term, these relating in particular to the impact of growing market power of large market players. This trend could furthermore lead to entrenching the position of too-big-to-fail financial institutions, rather than make banks "safe to fail" as the post-crisis regime claims to do. Consequently, as the implementation of the EBU moves forward, pushing for a more integrated and homogenous EU banking market and for the centralisation of financial supervision powers with the European Central Bank (ECB), questions which arise are how other policies



should be enforced in the context of banks supervised within the Single Supervisory Mechanism (SSM). Here we explore whether in particular a specific competition policy regime should not be established to mirror EBU oversight.

This question should be placed in the context of broader adjustments of the EU banking sector to the new regulatory regime, as well as business model transformations under pressures from new technologies, including FinTech. In empirical terms, some post-crisis characterisations of the financial sector are relevant here: (a) risk-taking is not necessarily decreasing at least by the known measures; (b) diversity of banking models in the sector is decreasing; and (c) there is increasing concentration in the sector by various measures. While this triple scanning does not necessarily indicate the failures or inefficiency of regulatory policies as the transition to the new regime takes place, it nevertheless suggests a more long-term approach to regulating the EU banking sector may be required to prevent a destabilising financial repression scenario. Such long-term regulatory approach should include all the policy tools at the disposal of EU authorities, and competition policy in particular. In this brief paper, we focus on the merger control, however similar considerations could apply to other antitrust areas as well.

### 3. EU Competition Policy in the Banking Sector before and during the great Financial Crisis

#### – EU Competition Policy

The European Commission is the EU competition authority and therefore, through the Directorate-General for Competition, DG COMP, it directly enforces the EU competition rules under EU Treaties. Articles 101 to 106 TFEU (together with the EC Merger Regulation) refer to merger control and anticompetitive behaviour, whereas Articles 107 to 109 TFEU relate to state aid. The European Commission is primarily responsible for the EU's competition policy, which, very briefly, focuses on the application of rules to ensure that companies (regardless of the sector) compete equally and fairly with each other.

Within the EU's competition policy, depending on whether it covers state aid or merger control, the competences of the European Commission vary. Competition policy in the EU – as opposed to the US antitrust – could be seen as having played a triple role under the EU legal system: by being a tool for European integration in the internal market in the 1990s and seeking to establish a level playing field to ensure a competitive market; by promoting economic efficiency of market; and by seeking to increase consumer welfare (since restraints on competition can produce a deadweight loss for the economy and harm to consumers).

In merger control, the task of overseeing companies' concentrations is shared between the European Commission and the national competition authorities (NCAs). Merger control relies on a one-stop-shop rule according to which companies apply for regulatory clearance for a concentration. The notification of the envisaged merger, depending on specific turnover or market share thresholds, is made to the European Commission or to the competent NCA.

Such repartitioning of responsibilities in the merger control assessment partially resembles the competences set-up under the SSM, although the EC does not enjoy the ultimate control over the repartitioning of competences as the ECB does within the Banking Union. The EC Merger Regulation introduced a referral system between the European Commission and the NCAs to ensure a case allocation mechanism (regardless of the turnover or market shares thresholds) that picks the best authority to deal with each concentration, in accordance with the subsidiarity principle.

#### – EU Competition Policy in the Banking Sector

There was nothing in the Rome Treaty that – in theory - prevented the full application of articles 85 and 86 (currently articles 101 and 102 TFEU) to the EU banking sector. Nonetheless - in practice - the European Commission did not enforce competition in the banking sector before the early 1980s. Only in 1981 the European Court of Justice (ECJ) ruled that competition rules were applicable in full to credit institutions. Although the parties argued that banking undertakings were “entrusted with the operation of services of general economic interest” (and therefore were not subject to the Treaty rules on competition), the Court did not accept this argument. This ruling, which allowed for a number of substantive actions to be taken by the European Commission to ensure the level the playing field in EU financial and banking markets, was coupled with a period of significant liberalisation of financial activities. After this liberalisation period, progressive harmonisation of EU banking law and the establishment of the single currency, facilitated cross-border banking activity in the EU. Since then, while the integration of financial supervision was still lagging behind at this stage, EU competition policy was applied with full vigour, not only by prosecuting anticompetitive behaviours (such as cartels and abuse of dominant position), but also through state aid and merger control (the latter, only introduced in 1989). Since the current EC Merger Regulation was put in place, only between 1 January 2004 and 15 September 2008 (i.e. the date of collapse of Lehman Brothers), the European Commission was notified in 103 cases for merger operations within the financial sector. In the great majority of the cases (99 notifications), the European Commission cleared the operation without demanding any kind of remedy prior to the clearance. During this 4-years-period, the merger control policy in the EU banking sector could therefore be considered shallow, which partially explains the lack of preparation of the European Commission when the Great Financial Crisis reached Europe. Furthermore, lax approach towards banking mergers (between 2004 and 2008) partially explains the size and interconnectedness of some EU banks, which made the crisis management much more complex.

EU competition policy enforcement has already been historically somewhat calibrated in the banking sector - a business activity which due to a combination of unique characteristics is particularly fragile and susceptible to instability. The traditional economic debate on the potential trade-off between financial stability (pursued inter alia via regulation) and competition (including merger control), spanned arguments which go both ways: increased concentration in the banking sector may improve financial stability by better aligning risk-taking incentives of borrowers (challenging the trade-off claim), or, in the alternative, more competitors may cause instability in the banking sector, where low franchise value due to competitive pressures induces more

risky behaviours by banks (supporting the trade-off claim). Across a number of jurisdictions, the enforcement of competition and financial stability is controlled by different entities, begging for coordination between both. Recent research, however, nuances significantly the existence of a trade-off between the two policy objectives, by pointing to conditions on supply and demand sides of the banking markets as affecting the trade-off. Vives, for example, emphasises the central importance of the institutional arrangements in achieving an optimal balance between the two policy objectives, especially when these policy objectives are pursued by distinct authorities.

Consequently, the main question which arose under the 'trade-off' paradigm was whether the objectives of banking competition and European financial stability should be weighted case by case or rather whether a permanent exception should be made for either of the policies (and mainly, whether the banking competition objective should always be subordinate to the financial stability objective). If the two objectives must be weighted, then the role of the EU institution empowered to take the final decision is vital to determine – in casus – the weight given to the objectives of stability and competition. The nuanced post-crisis approach, supported by empirical evidence undermining the crude 'trade-off' thesis, suggests that where the enforcement remains distinct, institutional set-up and symmetry in institutional clout and toolbox are necessary to ensure an optimal balancing of objectives.

#### – EU Competition Policy in the Banking Sector during the GFC

When the Great Financial Crisis reached Europe, there were neither bank specific insolvency nor resolution regimes in place at a EU-level, nor specific 'financial stability' tools. As a consequence, as soon as EU banks started being hit, the European Commission made use of the existing tools to prevent the contagion and spill-over effects, that is state aid rules in particular, to facilitate the coordination of crisis measures at EU level. State aid control under Article 107 TFEU was more lenient than prior to the GFC and as such criticised for being too permissive. Supporters of this lenient approach argue that the temporary relaxation of the state aid rules was the less of two evils, in particular where early calls were made for full suspension of competition policy for reasons of public interest in financial stability. The application of EU antitrust rules meanwhile continued to apply – formally at least – in the same way as prior to the GFC. Nonetheless, at a national level, some Member States adopted a more lenient control of banking mergers. In particular, when parties to a banking merger invoked the failing firm defence argument, some national competition authorities accepted it and cleared the merging operation with view of stability of the financial sector.

Regardless however, of whether rules were applied less or more leniently over the course of the Great Financial Crisis, it remains the case that the European Commission remained exclusively competent for the enforcement of competition policy in the context of activity falling within the scope of EU law. The crisis-specific rules which have been put in place, furthermore, are explicitly of a temporary nature.

#### **4. Competition Policy following the GFC and after the Birth of the EBU – Tensions between Competition and financial Regulation**

The post-crisis decade brought about a reframing of the aims of financial regulation, and therefore also – at the institutional level - the terms of engagement between different financial regulators and competition authorities in the EU and Member States. More precisely, the EBU established a centralised (albeit in a dynamic way) mechanism for supervision of EU banks. The primary objectives of establishing the EBU are to ensure safety and soundness of financial institutions (via microprudential supervision), their resolvability and resilience (through EU resolution law) and, also the stability of the financial system as a whole (with macroprudential supervision). EBU's supervisors have also been (both explicitly and implicitly) empowered with competition policy-related competences such as prudential control over mergers and acquisitions in the banking sector and competences which affect the conditions of entry and/or exit for market participants or the level playing field in the sector. The institutional trend in some national jurisdictions has been towards combining in the same entity the coordination between several competition and financial stability concerns. Arguments for a separate and distinct enforcement remain strong however, including the lack of transparency and potential hierarchizing which can occur when pursuit of multiple aims is conferred to the same institution.

Within the EBU, financial supervisors and resolution authorities (both national and European) are expected to take into consideration competition concerns, although they cannot enforce competition rules. Financial supervisory actions and, to some extent, resolution actions, have an impact on the structure of the EU banking sector, and therefore the terms of competition. Regulation can, for example, distort incentives or favour particular market players. This is acknowledged by the EBU framework and substantive EU microprudential law for banks – inter alia, by requiring that the conditions imposed on market players are proportionate. Even if indirectly, the pursuit of microprudential supervision goals may affect long-term efficiency of the EU banking sector beneficial to the financial consumer.

The enforcement of competition policy remains predominantly with the competent competition authority (either the European Commission or NCAs). However, the exact cooperation models of policy implementation within the EBU-context are still being ironed out, with calls for “new forms of engagement” already being made. The structural evolution in the EU banking sector, which tends to more concentration after the GFC, raises the question of the new emerging risks in this regard, including entrenching too-big-to-fail positions, as well as raising entry barriers and stifling “good innovation”.

#### **5. Challenges in Enforcement Competition Policy under the EBU**

A reassessment of the competition-financial stability policy implementation in the EBU specific context is therefore required. In particular, the pursuit of safety and soundness of EU credit institutions through implementation of microprudential supervision (within the SSM), should not increase the risk of excessive market concentration in the EU banking sector, which would stifle

the competitive processes. Such cause-effect reaction is especially relevant in a sector where market power is particularly important and barriers to entry are often prohibitively high to new market entrants. Considering the EBU aims for (more) market integration, in multiple ways, it encourages cross-border banking mergers and creates incentives for market concentration in the EU banking sector. A more concentrated banking market will entail less, yet bigger banks. Under the EBU framework, EU banks are subject to different supervisory and resolution rules and solutions, depending on their size and/or importance. In general terms, larger financial institutions benefit from premia associated with the safeguards of the resolution regime, which allows for more favourable conditions; whereas small, insignificant banks are more likely to be liquidated in accordance with insolvency regimes (as was the case for small Italian banks Veneto Banca and Banca Popolare di Vicenza recently). The lowering of cross-border entry barriers (e.g. in terms of regulatory differences) is another factor increasing big banks' geographic presence in different Member States. Although the increasing market concentration is also partially a consequence of pressures on existing bank business models after the GFC, from a competition policy point of view, it seems that a specific and ongoing assessment is required to assess the interaction between competition and financial regulation goals. Furthermore, a re-calibration of competition policy implementation by the European Commission in the banking sector could be required for several reasons we explore below.

## 6. Symmetry between Competition and financial Regulation under the EBU

Balancing the goals of competition and financial stability requires symmetry in their enforcement. However, a symmetric enforcement also requires a (still non-existent) symmetry between the content of applicable legislation. EU competition policy control is only partially inbuilt into the EBU bank supervision and resolution procedures, typically when the provision of state aid is at stake. The remaining antitrust regime – specially merger control between banks - is not specifically covered by the post-crisis supervisory and resolution EU framework. This example shows immediately that there is no full symmetry between the implementation of the two objectives under the EBU framework. We find lack of convergence in two further dimensions: firstly, at which level (national or European-wide) policy implementation occurs; and secondly, the timing of enforcement. Extreme cases of bank failures in particular show problems in effecting coherent policy implementation which may arise because of such asymmetry.

### – Level of Policy Implementation

Within the EBU, some tasks were centralised while others were left to the Member States. Consequently, some supervisory and resolution actions are taken at a EU-level whereas others have exclusively a national-wide dimension. The same happens with competition policy, both in state aid and merger control assessments. Under EBU however, the level of policy implementation is not symmetric to that of other policies such as competition policy.

Failure of an EU bank can trigger a resolution procedure or start a liquidation process. The choice between one path or the other is usually perceived as a

financial topic, despite having distinct competition implications, potentially undermining the level playing field in the market. For instance, in cases sale of business (of a failing bank) is the chosen resolution tool, the search for a private buyer (for the business) may lead to a banking merger with a community dimension. This being the case, the European Commission will play its role as EU competition authority and will assess the banking merger from a competition perspective (as in the case Banco Santander/ Banco Popular Español S.A (BPE) merger discussed below). However, no specific competences are conferred on the European Commission when the failing entity is liquidated and sold in accordance with national law – even when it was the ECB (EU-level) declaring the bank as failing or likely to fail. This means that, the trigger for bank resolution or insolvency at EU-level does not necessarily trigger an EU-wide competitive assessment of any subsequent actions. To converge competition and financial stability (“resolution”) policy implementations, it is necessary therefore, to reconsider the criteria for community dimension in merger control within the EBU.

Secondly, while European Supervisory Authorities, also in the EBU context, have an on-going role in the shaping of the regulatory environment, and so does the ECB via its administrative rule-making, limited role in rule-setting to this end is played by competition authorities. A stronger advocacy role for competition and its benefits to the financial consumer could be envisaged for the European Commission as well as tailoring of anticompetitive behaviour control to the particularities of the banking sector.

#### – Timing of Policy Implementation

The second dimension where the lack of symmetry in policy implementation is evident concerns the time where within administrative procedures financial supervisors and competition authorities play a role, where parallelism of procedures – where these are not properly adjusted – could lead to under-enforcement of one of them. An example of a failing bank resolved through a private sector measure (such as sale of business) is illustrative of this point, a pioneering example most recently being the takeover of Spanish BPE by Banco Santander in 2017.

In the beginning of June 2017, the liquidity situation of BPE rapidly deteriorated, and on 6 June 2017 the bank was declared failing or likely to fail by the ECB. EU resolution law foresees three alternatives in such cases: (a) a private sector measure; (b) normal insolvency of the bank; or (c) intervention through resolution by authorities. In the case of BPE, a (private) buyer was found (Banco Santander). Under the resolution scheme adopted by SRM transfer of the failing bank to Banco Santander for EUR 1, inclusive of BPE’s liabilities, was agreed.

The acquisition fell within the scope of EC Merger Regulation given the market share/turnover of the banks concerned, thereby requiring that both resolution and competition policies were applied by relevant EU authorities. In the light of the urgency of the transaction to ensure the continuity of the critical functions performed by BPE, in a decision dated 6 June 2017, the European Commission allowed the merger to go ahead before its final approval. Only a preliminary market assessment was performed by the European Commission (through the DG COMP) at that stage, which considered that the market



share of the joint new entity would be below 20-30% in the market for credits, consumer funds or in terms of number of branches, and close to 20-30% in in SMEs lending.

The derogation was conditional on Banco Santander submitting a complete notification of the transaction. The acquiring bank was required to take only actions that were necessary to restore BPE's viability and to ring-fence BPE's business until the final decision by the European Commission was taken. The acquisition was approved under EU merger rules on 8 August 2017 without objections. The European Commission's investigation concluded that the transaction did not raise competition concerns, as the parties' combined market shares would generally remain limited (below 25%) and strong competitors would remain in all affected markets. The transaction was therefore cleared unconditionally. Pursuant to the transaction, Banco Santander holds the biggest market share in Spain for SME (25%), loans (19.5%), and customer funds (18.8%).

First, the case proves, that although merger control was formally exercised, its timing might have precluded a full assessment of the transaction before its completion. Secondly, the BPE/Santander merger raises the question of whether situations where a resolution procedure is triggered do not require an adjustment of the merger control policy to the banking sector. In order words, resolution procedure requires a tailored-made merger control policy. This question might suggest that, to ensure a competitive process in the long-term, also other competition policy tools, apart from merger control, might be used in the banking sector, such as market studies. This is especially relevant since the outlook of competition policy tends to be more dynamic than the prudential supervision stance. Furthermore, an exclusive focus on the safety and soundness of the banking sector may lead to moral hazard situations, may create lower quality inefficiencies, may decrease consumers' choice or may facilitate abuse of dominant position.

#### – A tailor-made Approach of Competition Policy under the EBU

Competition law tools (and not only state aid) should therefore be adjusted to the banking sector. But how? There are two possible views towards the merger control policy which has been followed by the European Commission since the beginning of the EBU: either it has been pursuing a merger-constraining policy by dynamically using its powers to block potential concentrations; or, in alternative, it has been pursuing an integrationist policy by building up larger European firms through banking mergers. A 'merger constraining' policy means that the European Commission has been vigorously using its legal powers vis-à-vis mergers that risk increasing the market power of firms, in particular if those firms already have such power. Thus, mergers have been blocked by the European authority or when approved, they have been subject to tough conditions that offset gains in market power. An 'integrationist policy' results in a significant number of approved mergers that increase the market power of firms, if they also enhance European integration. This being the case, the European Commission would rarely use its powers to investigate, impose conditions or block mergers, particularly if these are cross-border concentrations which will deepen European integration. The BPE/Santander merger suggests that the European Commission is taking an integrationist approach. Where the prudential supervision and implementation of resolution

policy seems to take the lead in terms of promoting market integration., competition policy enforcement should focus on the role of safeguarding the competition processes and conditions in the sector across the EBU and EU as a whole.

However, since the European Commission is bound by the best interest of the EU and seeking to keep a level playing field, it might not be able to choose between an integrationist or a merger constraining approach. A more integrated EU banking market might reflect higher levels of market concentration; whereas a rigid approach towards banking mergers may not be compatible with the resolution regime foreseen by the EBU framework.

To seek a more integrated EU banking market, the European Commission may clear most of the notified banking mergers, yet demand a specific set of procedures and commitments to safeguard a level playing field in the sector (by applying a bank-specific competitive assessment). Such commitments may include geographic constraints of specific financial activities in some of the potential affected markets: retail banking, corporate banking, investment banking, leasing, factoring, payment cards, financial market services or asset management. They can also include temporal constraints, to avoid medium or long-term competition distortions in a specific national banking sector, e.g. commitment to divest one specific branch in a 5-years-period since the regulatory clearance.

Alternatively, the constraining approach of merger control can be combined with a policy of rescue mergers (of banks), when a financial institution is failing or likely to fail. In this context, the concept of rescue merger is not new to the EU competition policy. The Great Financial Crisis was, nonetheless, the first time where this question was dealt with within the financial sector. This created the situation where competition authorities allowed systemically important banks – that would not be allowed to exist the market - to engage in a rescue merger, as an alternative to the use of state aid measures. However, rescue mergers have further potentially destabilising implications (on top of the moral hazard) shared with direct State assistance.

Similar to the enforcement of a rescue merger policy is the use of the failing firm defence in a banking merger. There are three criteria that must be fulfilled before the failing firm defence may be invoked. The first criterion is that, without the proposed merger, the allegedly failing firm would be forced out of the market. A further criterion for failing firm is that, the asset of the firm will inevitably exit the market, unless this merger takes place. The damage to financial stability that results from a bank failure is not exclusively caused by the assets leaving the market, but also through the two mechanisms, interconnectedness and intra-market contagion. The final criterion for the failing firm defence is that there is no less anticompetitive alternative to the banking merger. If the European Commission, under the EBU goals, accepts the use of the failing firm defence (by the parties to a banking merger), it means that more transactions will be cleared unconditionally without taking duly into account the long-term implications for incentives and the competitive structure of the sector.

## 7. Transition from Crisis to 'steady-state' Policy Implementation

As a result of the deep economic impact of the GFC, regulatory reform in the EU reframed both substantive rules and institutional arrangements for the oversight of the banking sector. The complex post-crisis architecture of financial oversight with numerous new authorities as well as new regulatory objectives raises concerns from the perspective of high barriers to entry and differentiated impact of regulation on market actors. The challenge of ensuring contestability of financial markets as well as a level playing field remains a key concern from a competition point of view in emerging areas such as FinTech, growing challenges such as consumer protection as well as established fields such as competition policy enforcement.

The possibility of producing additional negative externalities/external social costs by bank failures (partially) justifies the need for a specific insolvency regime for failing banks: resolution. If the new EU resolution framework accepts that for financial stability concerns, insolvency proceedings cannot be started, some banks will not be allowed to fail (again). Hence, the post-crisis regulatory EU regime will put under resolution those banks whose failure could affect the EU financial system. In other words, the new EU resolution regime will continue to favour the safeguarding of financial stability over banking competition concerns. Increased market concentration – with the potential emergence of EU bank champions – is perceived as stabilising by supervisors. While such an approach undoubtedly can be justified from a prudential perspective, to ensure a socially optimal balance between various policy objectives EU, a calibration of EU competition policy in the banking sector is required. Lack of convergence and symmetry between competition and supervision/resolution procedures is particularly noticeable in extreme cases of bank failures, where policy implementation rather than the overall regime determines a de facto hierarchy of objectives.

As evidenced by recent cases as well as general market trends, one could ask whether the combined application of the post-crisis regulatory and supervisory EU framework might not result in an emergence of too-big-to-fail institutions. There seems to be plenty evidence that competition policy was applied in a somewhat more lenient way over the course of the Great Financial Crisis, as the crisis subsides however, and in the context of the EBU in particular, there are plenty of arguments to support a tailor-made – yet proactive – competition policy implementation in the banking sector which is becoming increasingly concentrated, even if financial stability concerns remain paramount. This requires a shift of thinking from using EU competition policy as a crisis management fire-fighting tool, to employing it in a forward-looking dynamic manner.

Ultimately, a healthy and growing economy also depends on a competitive and efficient banking market. This is an important lesson learnt from the Great Financial Crisis. The expected outcome of competition policy enforcement is dynamic efficiency in the financial sector, optimising long-term performance and behaviour of market players; whereas, the expected outcome of financial supervision and regulation is the focus on the current state of supervised entities (rather than on longer term processes) and the safeguarding of financial stability. Still, although competition and financial regulation policies seek different goals, their enforcement should be carried out – also in

institutional terms – in a way which ensures financial and banking markets are robust in the long-term. Lack of specific rules which provide for symmetry and convergence in implementation of various policies under EBU obscures the process of balancing of various objectives. Lack of transparency precludes the accountability of relevant actors in the long-term.

### Contribution III

## **The Role of Monetary Policy and macro-prudential Tools for financial Stability in the Euro Area**

**Daniel Detzer**, Advisor on Financial Market Policies, and PhD Candidate, Carl von Ossietzky University Oldenburg

**Jan-Martin Frie**, Economic Policy Analyst, European Political Strategy Centre (in-house think tank of the European Commission)

### **Introduction**

Proponents of macroprudential regulation as a tool to maintain financial stability have been vocal for a long time but the concept has been given serious attention only after the great financial crisis (GFC). One stream of this discussion, aims to revisit the role of central banks' in preserving financial stability. More narrowly, a long-standing discussion of how central banks should react to asset price booms or bubbles had gained new traction shifting the tides for those in favour of using interest rates to „lean against the wind (LATW)“.

In the following we will shortly review the discussion around the role for central banks in financial stability and using the interest rate as a tool to this end in particular. We approach this question with a focus on the Euro area. Here we develop a compelling case against using the interest rate to react to asset price inflations. We then shortly outline some more effective and efficient instruments. For those more suitable instruments we will draw up some thoughts of whether the responsibility of their use should be placed with the European Central Bank, another EU-level institution or whether the centre of gravity should remain at the national level.

### **The theoretical Debate**

There has been a long-standing discussion on how a central bank should react towards asset price bubbles. The different positions in this discussion include on the one hand, different varieties of what Jean Claude Trichet called the „orthodox view“. This school of thought argues that there should be „no special role for asset prices“ or in another version that the Consumer Price Index used to define the central banks objective should be explicitly extended to include asset prices. It is argued within this view that asset prices can be seen as a proxy of future consumption prices and as such the central bank should be concerned with them, since she should ensure not only stable prices for output today, but also for future output. In both views financial stability is of no special concern for the central bank and the focus remains on the maintenance of stable prices for consumption goods.

On the other hand, others advocate for a role of the central bank in preserving financial stability. An extreme, but today less supported position of this view is that central banks should attempt to prick bubbles. This means with a decisive move in interest rates the central bank forces the most extreme positions to

liquidate and so helps to deflate a bubble. A more moderate version of this view is the so called „leaning against the wind“ position, which argues that interest rates should cautiously be increased beyond what inflation predictions would warrant when a potentially detrimental asset price boom is detected (Trichet 2005).

Before the GFC, the prevailing opinion in academic circles and the larger central banks of the world was the former of those views, according to which central banks should largely ignore asset price booms and only clean up afterwards. Arguments in favour of this view are:

- It is impossible to detect asset price bubbles or to distinguish them from rational shifts in expectations (some authors even doubt that from a theoretical point of view the existence of bubbles)
- Intervention would risk making matters worse
- Central banks are better placed to clean up the damage afterwards

Other prominent figures, for example from the Bank for International Settlements, advocated for a long time the potential benefits of leaning against-the-wind policies and more generally stressed the importance of the stability of the financial system for central banks to effectively pursue their monetary policy (Borio and White 2004, Caruana 2016). Recent research, but in particular the experience of the GFC have questioned much of the conventional wisdom and have strengthened the case of those arguing in favour of the leaning against the wind view.

- Research has shown that with a couple of indicators such as debt levels and asset prices the build-up of imbalances and the occurrence of a bust and financial crisis can be predicted with a relatively low margin of error
- The bursting of asset price bubbles, in particular in the wake of the GFC, have demonstrated the enormous and lasting costs
- Finally, the argument that central banks alone could, through accommodative monetary policy, stabilize the economy and limit the damage after the burst has been put into question by the GFC, when conventional monetary policy was unable to get the crisis under control and despite extraordinary measures many countries slipped into deflation. Finally, only substantial government intervention was able to stabilize the financial sector.

We largely agree with the arguments of the second view, that advances in supervisory practice make the detection of asset price misalignments significantly more reliable and that their bursting can impair the financial system with potentially high costs for the economy as a whole. Therefore we would agree that such misalignments should be addressed by appropriate instruments but we have serious doubts that the short-term interest rate is the right instrument to do so. In the following we will outline our concerns and argue that in particular in the Euro area there are good reasons against its use.



### **Why the short-term Interest Rate is not the right Instrument to avoid the Built-up of Asset Price Bubbles**

Firstly, the effect of changes in the interest rate on financial stability is not well researched. The Bundesbank for example argues that monetary policy and risk taking by private actors is connected through the so-called risk-taking channel. However, at the same time she argues that an increase in the interest rate may actually weaken financial stability if debt levels are high already and LATW increases debt service burdens. Also, she argues that there may be second order effects which may lead some actors to actually increase risk taking. These theoretical arguments for ambiguous effects of monetary policy on financial stability are supported by empirical research by Blot et al (2015), which does not find a stable relation between financial and price stability. This draws into doubt the suitability of the interest rate as an appropriate instrument to address asset price bubbles.

Secondly, it has to be doubted that a reasonable increase could flatten an asset price boom by much. An interest rates increased by 2-3 percentage points (which would a substantial increase given today's low rates) will most likely not be able to substantially dent a bubble when expected returns are in a range of 10 to 20 per cent. Surely, a central bank can always increase interest rates much higher but that may come at the cost of damaging the economy and causing a crisis in the financial sector itself.

In addition to these general reasons opposing the use of the interest rate to support financial stability, the specific setting of the Euro area adds some additional arguments rooted in practical and political economy considerations.

### **Why the Euro Area is special**

Firstly, asset price booms are often spatially limited. House price bubbles are often only relevant at a regional level, stock price booms mostly national. Before the outbreak of the crisis, we have seen real estate booms in Ireland, Spain and to a certain degree in the Baltic states. Would that have been reason enough to increase the interest rate, even though other EMU members already suffered from a too high real rate? Currently, the situation is reversed. In Germany in certain areas real estate prices are booming, while much of the rest of the Euro area is still recovering from the crisis. Confronted with such differing situations in the Euro area, how should the ECB react? It would have to weigh the sacrifice of some output of the Euro area against the potential taming of a bubble occurring in one or only a few countries. This problem is aggravated by the fact there is little private and public risk-sharing in the Euro area. If for example a real estate bubble affects some of the states of the USA, it could be argued that the costs of a bust are shared by all states to some degree via federal unemployment schemes, tax systems and cross border exposures of private actors. Therefore, it can be better justified to use a blunt instrument like the interest rate (in the absence of better suited instruments) which does affect all other member states equally, since they also would share into the costs of a bubble. Consequently, the low degree of risk sharing does not allow to make a similar case for the Euro area.

Secondly, while the primary objective of the ECB is keeping inflation at its target level according to its statute it has also a responsibility to support growth and employment in the Euro area. Before the crisis, some have criticised that she has in the past been overly zealous regarding inflation at the cost of output and as a result employment losses being higher than necessary. Giving the ECB explicitly the additional task of safeguarding financial stability would mean in practice according to the Bundesbank „a monetary policy stance that tends to be stricter in upswings, even in the absence of inflationary pressure, and is aggressively eased during a marked downturn, but a less persistent expansionary policy stance following a period of economic downturn“.

Finally, giving a mandate for financial stability to the ECB would have further political drawbacks. As we will outline below, there is a range of promising instruments proposed in academic and professional discussions or already in place in some member states. Mandating the central bank now to use the interest rate to ensure financial stability would strengthen voices against the creation of further workable instruments even further, since they could point at this already existing instrument and responsibility at the central bank, knowing it most likely would not be used.

### So what's the Way forward?

As outlined, the interest rate is not a particularly well-suited instrument to address accumulating financial imbalances. Academics from different areas as well as practitioners in financial markets, regulation and supervision have proposed a range of well targeted instruments which seem promising to achieve the envisioned goals at lower cost. At the core of for instance borrower-based-instruments is the idea to limit the ability to borrow too much from the demand side. For real estate markets loan-to-value and debt-to-income ratios seem promising measures. Prior to the GFC these instruments were used primarily outside of the EU so that the more recent introduction of such measures in the EU will need to be closely monitored and evaluated. First assessments from for instance the Central Bank of Ireland, which has introduced caps on loan-to-value and loan-to-income ratios in early 2015, are encouraging (Donnery 2017).

For a general credit boom countercyclical capital requirements or loan loss provisions are potential targeted instruments on the supply side. Finally, so called asset based reserve requirements could be a highly flexible instrument. Research suggests that borrower based instruments such as loan to value and debt to income ratios as well as supply-side measures such as limits on leverage and dynamic provisioning are particularly effective in slowing credit growth and house prices (Cerutti et al. 2015). However, the design of the specific instruments needs to be informed for instance by the micro-structure of the local housing market and the overall position in the financial cycle.

However, these instruments face strong opposition from various vested interests. As a result, by today, only few countries have made a wide range of instruments available. A telling example is Germany. Following a recommendation of the financial stability committee the ministry of finance

proposed a law giving the supervisors a flexible tool box to address real estate bubbles. In parliament however, heavy lobbying has reduced the originally envisaged tool box to only two instruments, which in addition have been blunted by wide ranging exceptions.

Here, the European level could play a more prominent role than it does today. In fact, the EU is currently revising the macro-prudential framework. The current framework, which is focused on banking and made up of five pieces legislation, has evolved gradually over the past years. As a result of this evolving character, the tools available under EU legislation overlap in parts, creating inconsistencies in the way the instruments are activated and feature complex processes in how they are coordinated. The review hence intends to clarify responsibilities and ensure instruments are used more effectively. The key aim is to ensure the right balance between national flexibility, and community control is achieved. This may involve streamlining the toolset of instruments, changing the activation procedures for these instruments, enhancing the role of the ESRB as a macro-prudential hub, and clarifying the SSM's role in the framework.

We support to strengthen and expand the mandate of the ESRB in coordinating macro prudential policy in the EU, as part of a network of responsible national competent authorities. While in theory we see merits to entrust the EU level with the full set of macro-prudential tools, we are cautious that the European authority that would apply macro-prudential might be used as a scapegoat by national politicians, who understand the need to act but face domestic opposition to such a move. Giving the European level the full responsibility to ensure financial stability and reining in national bubbles will put it in an even more precarious situation. Should it not use its powers and a bubble bursts it will be criticised as ineffective on these grounds. If it uses its instruments however and successfully prevent bubbles it will be criticised to have acted without reason. In both cases anti-EU sentiments will be furthered.

The mounting criticism of politicians against the ECB monetary policy, which prevented the Euro area from falling apart, provides a telling example of what to expect when it will increase national loan to value ratios in a real estate boom. Eventually, as already mentioned above, because fiscal costs of a crisis must be borne nationally the final decisions of applying macro prudential tools should stay with national authorities. Those in turn should be given the right incentives and independence to be able to take the necessary measures. A publicly visible comply or explain approach could be envisaged. Potentially, here incentives could be strengthened by limiting access to EU support and funds if a national authority ignored a warning and so failed to prevent a crisis.

The current framework should be underpinned by legislation that ensures that the national and the EU level has full access to all information relevant to understand fully the current state of financial stability and ensure that the full tool box is available to the competent national authority. Some instruments would benefit from better data available to supervisors and regulators. The establishment of credit registers, such as the Central Credit Register of the Irish Central Bank and AnaCredit, the ECB's analytical credit datasets, can go a long way to improve the situation and should be set up and interlinked at all levels throughout the EU.

Finally, macro prudential policy coordination at EU level should include all relevant actors that contribute to financial (in)stability also beyond banking.

**To sum up:**

- The experience of the GFC and advancement in the methodology to detect asset bubbles suggest that macro-prudential policy should be pursued more actively.
- Contrary to some voices, the short term interest rate is not an adequate instrument to meet the build-up of asset price bubbles.
- A comprehensive toolbox of borrower-based and financial-institutions based instruments seems more promising.
- Given that costs are born at the national level and that these instruments need to be informed by local knowledge, we believe that the instruments are best placed with a system of national supervisors, where the ESRB should play a central role.
- It will be crucial that the European as well as the national level have all the data they need in order to monitor market developments.
- Some harmonisation of available macro-prudential tools would be important and should also include relevant actors other than banks.

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## EU at Crossroads: How to respond to Misalignments in Bank Regulation and achieve a consistent Financial Framework?

Conference, 18 October 2017, ESMT Berlin

The Financial Risk and Stability Network is an independent initiative focusing on regulation and financial sector reforms in the EU. The mission is to offer a frame for open discussion and views exchange, to stimulate debates and to contribute to information on these issues from a public interest point of view. One main activity is the Financial Stability Conference in Berlin.

### Organisation & Coordination:

Financial Risk and Stability Network

Martin Aehling

Head

Willmannsdamm 17

D 10827 Berlin

[info@frsn.de](mailto:info@frsn.de)

[financial-stability.org](http://financial-stability.org)

