High level Euro-mediterranean Workshop
IMPACT OF FINANCIAL REFORMS IN THE EURO-MEDITERRANEAN AREA

Financial reforms: priorities and challenges

Giorgio Gobbi

Banca d'Italia
Financial Stability Directorate

Marseille - 4 May 2018

Priorities

- Full, timely and consistent implementation of completed reforms
- Completion of G20 outstanding financial reform priorities
- Monitoring of emerging risks
- Evaluations of the effects of reforms

Issues discussed in this presentation

- **Resolution regimes and instruments to deal with banking crises**
- **Vulnerabilities from asset management activities**
- **FinTech**

Bank crisis management: where do we stand?

Global issues

- The trade-off of bank crisis management
- Bail-inable liabilities

European Issues

- MREL
- Application of the BRRD
- Insolvency procedures

The trade-off of bank crisis management

THE PAST: Bail-out *expected*

- "Constructive ambiguity" often resulted in ex-post stability concerns overcoming moral hazard, tax concerns
- Worked (more or less) for a long time
- But caused enormous costs to taxpayers during crisis

THE PRESENT: Bail-in / liquidation *mandated*

- A drastic regime shift
- Expected to reduce moral hazard, distortions, taxpayer burden
- Potential negative spillovers on financial stability?

Global issues: who buys bail-inable debt?

- Banks? Hardly (contagion)
- Retail customers? Hardly (highly non-linear risk difficult to evaluate; conflict of interest when banks sell their own subs)
- Long-term institutional investors? Possibly, however IC & PF tend to buy equity; workers and pensioners could be hit in case of losses
- Investment funds? Most likely, but in a run professional investors are the first/fastest to run; can turn idiosyncratic crisis into systemic distress

European issues

- **MREL**
- **Application of BRRD**
- **Insolvency procedures**

MREL

- Imposed to all significant institutions (unlike TLAC)
- 25/27% of RWA → Need for the European banks to make up a large shortfall of eligible liabilities
- Shortfall particularly relevant for medium size banks that often do not issue neither convertible instruments nor subordinated debt
- Possible significant impact on the cost of funding and on credit supply

Application of the BRRD

Need to preserve a fine balance of commitment and flexibility and to take care of "devil in the detail"

Flexibility must be preserved, to avoid risk of:

- Too inefficient outcomes due to tied-hands decisions
- Need for sudden change of rules in a crisis
- Political unsustainability

An example on the need for flexibility

- Assets of banks in resolution/liquidation have to be valuated at market prices
- However the market can be very illiquid → low prices, bail-in more costly than it would be with a flexible framework for bank crisis management
- The use of public resources and deposit guarantee funds with receivership functions could be allowed to mitigate the issue (eg. bridge-banks)

Insolvency procedures

The *new regime* will increase the number of failing banks subject to ordinary insolvency/liquidation procedures

Need for *financial institution specific insolvency procedures* to

- Increase efficiency of the overall liquidation process of small and medium-sized institutions that do not meet the requirements for the application of the common resolution framework
- Reduce costs for retail creditors
- Guarantee the provision of financial services at local communities

Efficient insolvency procedures are key to ensure financial stability in the new bail-in regime

Asset management sector

- **Opportunities and risks**
- **Entity based VS activity based regulation**
- **Way forward**

Asset management: opportunities and risks

Over the past decade, the asset management sector has experienced strong growth

- On the one hand, this enhanced the resilience of the financial system through greater diversification
- On the other, it may lead to new risks for financial stability
  - Liquidity transformation
  - Risks are higher depending on size, level of interconnections and leverage of investment funds

Several attempts at regulation have been made globally to mitigate these risks: FSB recommendations, 2017; IOSCO standards; European Commission proposals, 2017; ESRB, 2017

Entity based VS activity based regulation

Both approaches to macroprudential regulation are needed

- Activity based regulation (FSB recommendations, 2017)
  - pre-emptive measures: improve disclosure and transparency regarding the liquidity of the open-end funds, limiting liquidity mismatches, leverage constraints, stress test by individual funds
  - post-event measures: strengthening and harmonizing liquidity management tools used by asset managers (gates, suspension of redemptions)

Entity based regulation (EC proposal, 2017)

- Define procedures to identify systemically relevant asset management companies according to their activities and their size

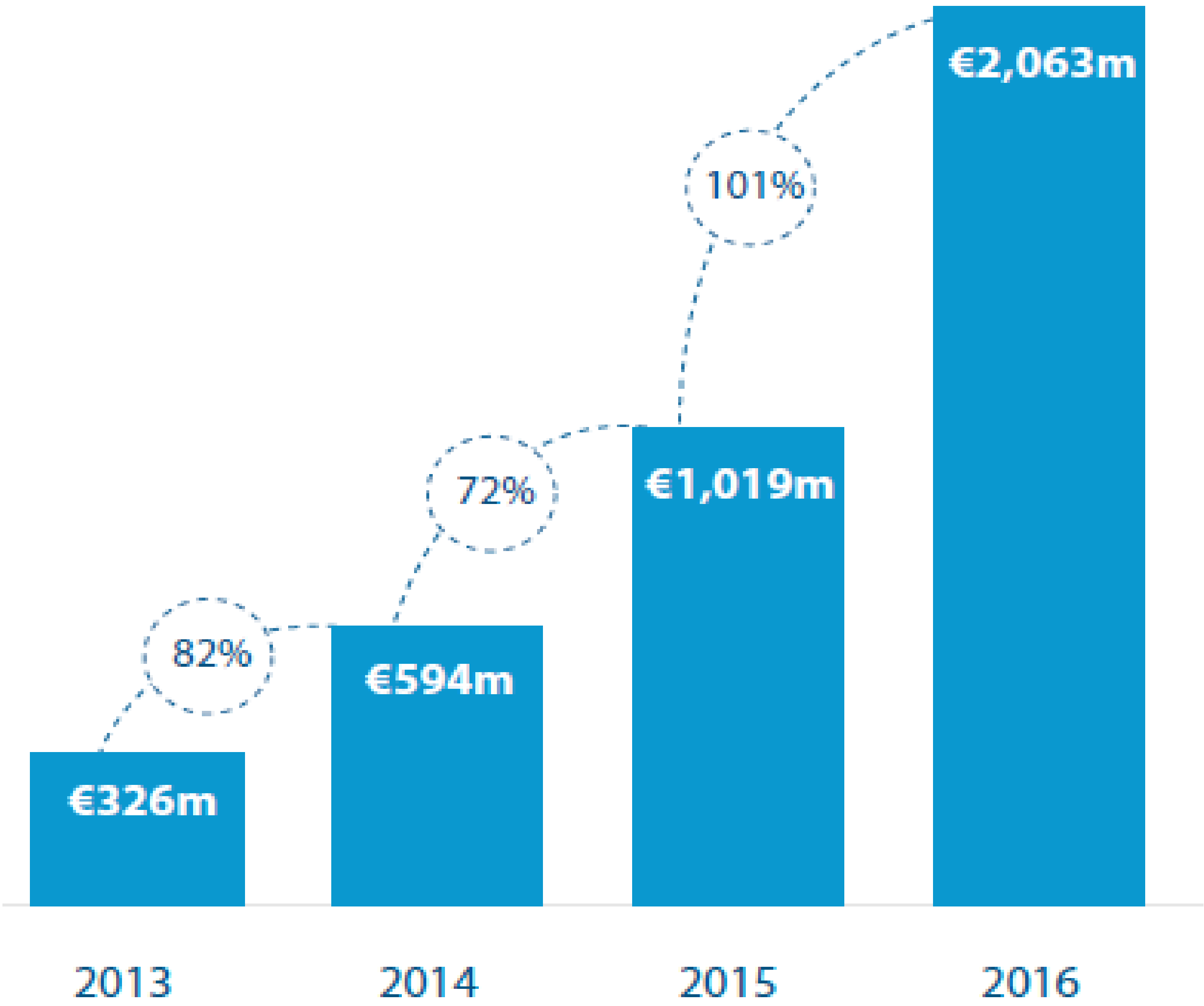
Way forward

- Building a harmonized and coherent macroprudential approach across jurisdictions
- Strengthening regulatory guidance in the context of liquidity risks (e.g. authorities should provide direction on the use of exceptional liquidity measures)
- Developing an active macroprudential monitoring framework
  - System-wide stress test to assess the impact of a large volume of redemptions of open-end investment fund shares on the liquidity of markets
  - Identify market segments where new risks may arise (ETF, leveraged loans)
  - Identify market conditions when different type of institutional investors may turn procyclical

FinTech

- FinTech financing in Europe
- Banks’ spending on IT technologies
- Digital innovation and the future of the financial sector
- Open questions

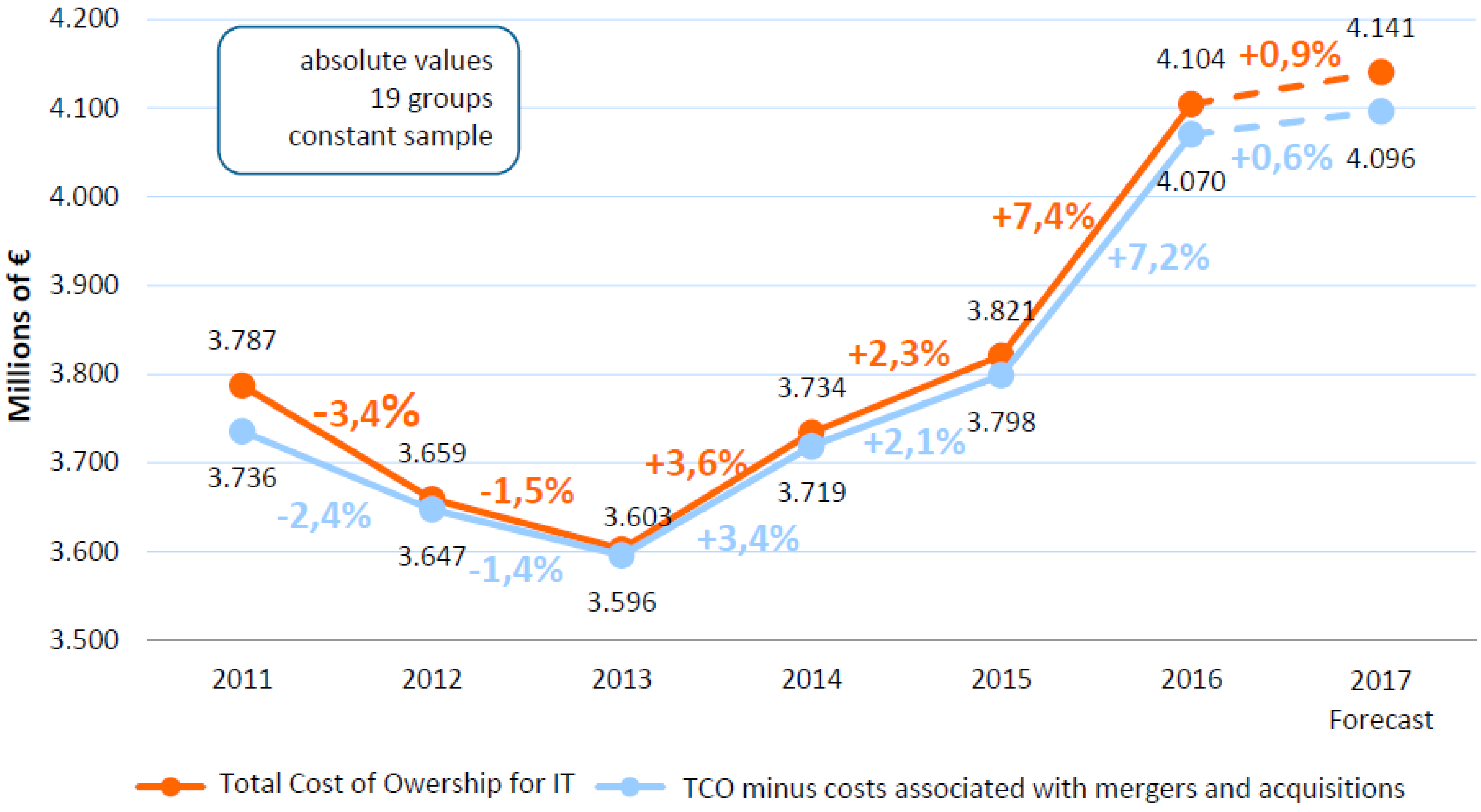
Fintech financing in Europe (ex. UK)



Source: 3° European alternative finance industry report – Cambridge Center for Alternative Finance.

Banks' spending on IT technologies

Sample of representative Italian banks



Source: Banca d'Italia. For more information: www.cipa.it

Digital innovation and the future of the financial sector

- Banks benefit from economies of scope (multi-product firms), while most FinTech firms are highly specialized (e.g. only payment services, only trade finance, etc.) …will we see the emergence of FinTech platforms?

- Information asymmetries and the role of trust in financial services create significant market power for incumbents

- It's too early to say whether banks will disappear *tout-court*, but competition will be fiercer (digital technologies lower entry costs), innovation will be faster, e.g. through investments in FinTech-type initiatives (incubators, facilitators, innovation hubs)

Some open questions

- **New risks to financial stability: New types of interconnectedness through tech-service providers**

- **Are regulators prepared? Too many economists, too few computer scientists?**

- **What's the role of policy makers? The European Commission FinTech Action Plan takes a welcome pro-active approach**

Thank you for your attention

Completion of G20 outstanding financial reform priorities

- Addressing vulnerabilities from asset management activities
- Reducing misconduct risk (governance and compensation)
- Reducing risks connected to central counterparties
- Enhancing resilience to cyber risk (developing a common lexicon)
- Supporting financial inclusion and sustainable finance

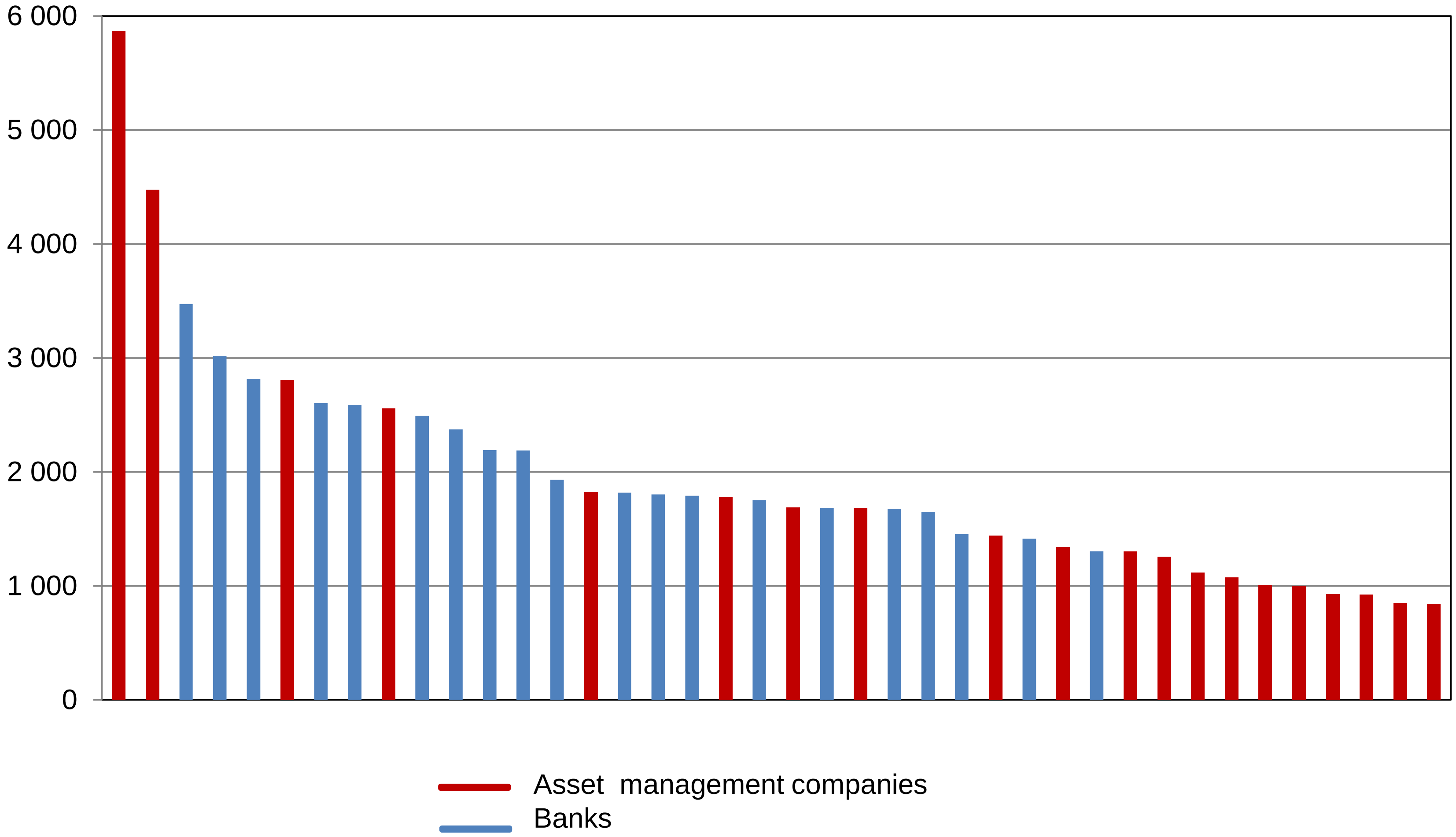
Evaluations of the effects of reforms

- On: financial intermediation; incentives to centrally clear OTC derivatives

- Future evaluations: effects of TBTF reforms

Top 20 asset managers versus top 20 banks

(billions of US dollars; 2016)

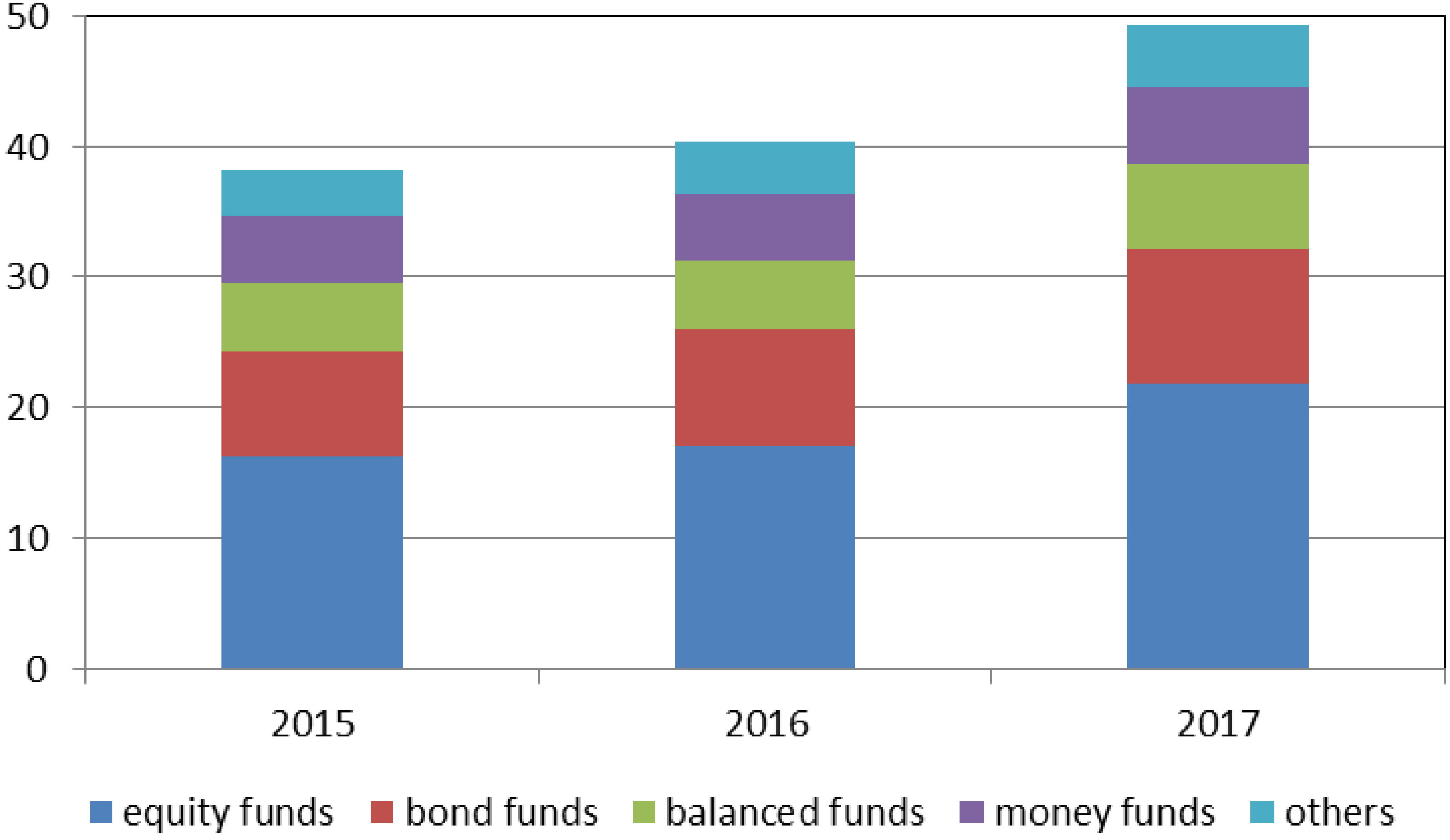


Source: IPE and S&Ps.

BANCA D'ITALIA
EUROSISTEMA

Assets under management are growing strongly

(billions of US dollars; 2016)



Source: IIFA.

BANCA D'ITALIA
EUROSISTEMA