Financial reforms: priorities and challenges

Giorgio Gobbi
Banca d’Italia
Financial Stability Directorate

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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
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

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Cost of Ownership for IT</th>
<th>TCO minus costs associated with mergers and acquisitions</th>
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</thead>
<tbody>
<tr>
<td>2011</td>
<td>3.787</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>3.736</td>
<td>-3.4%</td>
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<tr>
<td>2013</td>
<td>3.659</td>
<td>-2.4%</td>
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<tr>
<td>2014</td>
<td>3.603</td>
<td>-1.5%</td>
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<td>2015</td>
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<td>2016</td>
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<tr>
<td>2017</td>
<td>4.096</td>
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<tr>
<td>2017 Forecast</td>
<td>4.141</td>
<td>+0.9%</td>
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</tbody>
</table>

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.
Assets under management are growing strongly

(billions of US dollars; 2016)

Source: IIFA.