Challenges and the Way Forward: pursuing financial reforms, improving financial stability, ensuring inclusive economic growth

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***** *The opinions expressed in this presentation are those of the author and not necessarily coincide with those of Banco de Portugal or the Eurosystem.*

Outline

A. Microprudential Reforms

- I. Where we are
- II. National Specificities in Portugal
- III. Challenges and the way forward

B. Macroprudential Policy

C. Conclusions

I. Where We Are

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- The financial crisis that unfolded in 2007 and 2008 paved the way for significant reforms of the regulatory framework at EU level with the purpose of making the banking sector more resilient, with the ultimate goal of enhancing financial stability.

- One of the challenges faced by the EU legislators is how to strike the right balance between an increase in institutions' resilience and the possible costs to economic growth resulting from new requirements, in particular when their impact flows through the lending channel. This requires a proper and well-substantiated calibration of the policies to be adopted.

- Proportionality appears as a principle of Better Regulation, placing responsibility on legislators to design proper frameworks with simpler rules to be applied to smaller, less complex and non-systemic institutions without compromising the robustness of the prudential regime and without creating different tiers of institutions competing in the single market.

In response to the financial crisis of 2007-08, the international community has launched significant reforms ...

International Context

Bases for a more robust banking system

European Union

Harmonization and reinforcement of the regulatory framework.
Euro Area*: Deepening financial integration and greater separation between the banking sector and the sovereign, with the creation of the Banking Union.*

Reform of the regulatory framework

Basel III

Reforms since 2010

- ✓ Capital ratios
- ✓ Capital Buffers
  Leverage ratio
- ✓ Liquidity: LCR / NSFR
- ✓ Market risk
- ✓ Large exposures

+ Principles underlying Resolution Regimes (FSB)

Single rulebook

- ✓ International standards adoption
  CRR/CRD
- ✓ BRRD
- ✓ EU specificities

Reform of the institutional framework

SSM Regulation

Single Supervisory Mechanism

- ✓ Ensuring the resilience and soundness of the European banking system
- ✓ Increasing financial integration and stability
- ✓ Ensure a consistent supervision

SRM Regulation

Single Resolution Mechanism
(Single Resolution Board + Single Resolution Fund)

- ✓ Ensure an orderly resolution of banks with significant vulnerabilities, minimizing costs to the economy

- Standards discussed in the Basel Committee are meant to apply to large, international banks. In the EU, such prudential standards are applied consistently to all banks.
- This approach implies that requirements must include elements of flexibility that allow for a sensible, proportionate application to banks of very different sizes, with various degrees of operational complexity, different business models and risk profiles.

… but it is necessary to conclude the Banking Union

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Basel III

Reforms finilized by the end of 2017

- ✓ SA e IRB *review*
- ✓ *Output floor*
- ✓ *Leverage ratio surcharge for G-SIIs*

Single rulebook

- ✓ Implementation of the New Basel Standards (CRR/ CRD)

European Deposit Insurance Scheme (EDIS)

- ✓ Common deposit guarantee mechanism in the Banking Union

Backstop to the Single Resolution Fund

- ✓ In case of SRF resources are not temporarily sufficient

Basel DP on the regulatory treatment of sovereing exposures

Risk reduction measures

- ✓ Basel Committee “has not reached a consensus”

Risk reduction measures

- ✓ NPL prudential backstop

II. National Specificities in Portugal

Prudential Framework in force in Portugal

CRDIV/CRR	→	Credit Institutions Investment Firms
UCITS /AIFMD	→	Asset Management Companies
Non-EU harmonized framework	→	Other financial institutions: Loan originators; Others

- Simplified framework based on CRR rules, defined in accordance to: (i) the limited set of activities these entities are legally permitted to carry on and (ii) their complexity.
- Other financial institutions that are loan originators represent less than 1% of the Portuguese banking sector's assets.

Most of financial institutions fall within the regulatory perimeter reducing significantly the relevance of Shadow Banking in Portugal

III. Challenges and the Way Forward

Without prejudice to the positive contribution to financial stability in the medium-term, some challenges persist for the financial system stemming from the regulatory and institutional framework at European level:

Completion of Banking and Monetary Unions

- ✓ Impact of asymmetric shocks or shocks with asymmetric effects on Member States are not addressed by a proper supporting mechanism in the monetary union
- ✓ Decision-making is centralized, **but risks to financial stability must be mitigated at national level**. This is compounded by the fact that national authorities in each Member State currently have a rather more limited set of instruments to address these risks
- ✓ The creation of the European Stability Mechanism, the Single Rulebook, the SSM and SRM are crucial steps towards the **establishment of a Banking Union**. However, until its third pillar – **the European Deposit Insurance Scheme (EDIS) -** is finalized, risks to financial stability in each Member State will remain very substantial

Build up of Resolution Instruments

- ✓ **Banks are being required to build up bail-in-able debt** in a context where banks in some economies are still in a transitional phase following a very severe economic and financial crisis
- ✓ **European banks have to comply with the MREL**, and several of them (including the Portuguese banks) will need to access international financial markets
- ✓ These instruments will tend to **entail higher financing costs**, given the level of subordination of such instruments and the credit rating of Portuguese banks. The ensuing pressure on profitability and, in particular, net interest income will depend on banks’ capacity to pass through increases in funding costs to the price of lending and services provided
- ✓ To reduce issuance volumes and the impact on their profit and loss account, **institutions may also adopt balance sheet optimization strategies**, more specifically the reduction in risk-weighted assets. These strategies, as well as their repercussion on the supply of credit to the non-financial private sector, will be conditional on the requirements to be defined for each institution

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Build up of Resolution Instruments (cont.)	✓ Challenges to the placement in market may create **incentives to sell these instruments in the retail market** ✓ Indeed, as regards the investor base, it is worth considering whether and how retail investors should be able to invest in these instruments, to prevent mis-selling practices that **may lead to reputational risks and thus affect customers' confidence in banks** ✓ The **placement of such instruments must seek geographical diversification of investors and prevent reciprocal cross holding of these assets by financial institutions**, thus mitigating contagion effects ✓ In this context, **it is relevant that the phased-in introduction of this requirement extends over a sufficient period of time**, so as to minimize the impact on institutions' funding costs, at a time when banks are still adjusting their balance sheets
Dealing with Nonproductive Assets	✓ **Non-performing loans are a legacy from the** severe economic and financial **crisis** ✓ Initiatives from supervisors (and now from a legislative proposal from European Commission) will exert **pressure on the capital ratios of the banks** ✓ Measures to be adopted by the banks in their **NPL reduction strategies should avoid fire sales**, with a potentially negative impact on the banking sector and on economic activity, and the solution **for some assets must involve their timely sale or their active and effective management** ✓ Against this backdrop, the **distinction between different types of assets** (and thus between different types of solution) **is key**, taking into consideration the significant heterogeneity of NPLs on banks' balance sheets. With regard to NFCs in particular, it is essential to thoroughly assess their economic and financial viability, in order to better define the measures to be applied. ✓ **In Portugal, the strategy for reducing nonproductive assets is based primarily on three interdependent and complementary pillars:** (i) revision of the legal, judicial and fiscal framework; (ii) microprudential supervisory actions, under the SSM; and (iii) management of the NPL portfolios, including possible systemic measures ✓ Although severely affected by the crisis, **Portuguese banks have been able to over-achieve the NPL reduction targets agreed with the supervisory authorities**

III. Challenges and the Way Forward

Without prejudice to the positive contribution to financial stability in the medium-term, some challenges persist for the financial system stemming from the regulatory and institutional framework at European level:

Implementing the New Regulatory Standards	✓ While the significant revision of the CRDIV / CRR is taking place, **a further revision of legal texts will be necessary** to incorporate the Basel III reform package concluded by the end of 2017 ✓ **The reforms are aimed at increasing the resilience of institutions,** so that banks can better support economic activity during the various phases of the economic cycle ✓ Institutions and supervisors **will have to implement reforms in a consistent way in the EU** ✓ **Policy makers must question the impact of such reforms on the economy** (what is the optimal capital level?) ✓ Special attention should also be given to the appearance of **new shadow banking *entities*** (stringent regulatory framework induces creativity) – **In Portugal this is not an issue at the moment**
Dealing with Technological Innovation applied to Financial Services	✓ **Technological evolution is a challenge** and will also **expand business areas** (Fintech) ✓ Growing digitalization of financial services may give a systemic dimension to some Fintech enterprises, which, overall, **are not subject to the same prudential and regulatory requirements applied to banks** ✓ **Competent authorities must monitor technological innovation** in the financial system to ensure: (i) a level playing-field among competing institutions; (ii) the identification of risks stemming from the provision of technology-based financial services; and (iii) the adoption of adequate regulatory and supervisory initiatives at national and European level

B. Macroprudential Policy

Interaction with monetary policy

- **Is it a source of conflict or complementarity?**
  - Low interest rate environment may be an incentive for risk-taking and leverage, leading to the emergence of speculative asset price bubbles
  - But low interest rates also contribute to lower debt service and credit risk (particularly relevant for over-indebted economies) – a less accommodative monetary policy stance may exacerbate these risks in the transition phase to a lower debt level
  - Significant heterogeneity of financial cycles in euro area countries implies that the single monetary policy stance may be inappropriate at national level
- **Can macroprudential policy mitigate possible negative effects of a single monetary policy stance?**
  - Economic literature seems to suggest that macroprudential policy may counter negative monetary policy shocks and contribute to financial stability – e.g. Brzoza-Brzezina et al. (2013), Quint and Rabanal (2014) and Rubio and Carrasco-Gallego (2016), relying on DSGE models with collateral constraints
  - Efficacy of macroprudential policy relies on its preemptive nature – important to take into account effects of a future change in the stance of monetary policy

Interaction with monetary policy of borrower-based measures

- Banco de Portugal recently adopted a macroprudential measure aimed at promoting the adoption of prudent credit standards on new mortgage and consumer loans granted by the Portuguese financial system to households, in order to enhance the resilience of the financial sector and the sustainability of households' financing.

- This measure introduces:
  - Limits to the loan-to-value ratio (LTV)
  - Limits to the debt service-to-income ratio (DSTI) – the calculation of this ratio considers:
    - **interest rate increases** – the value of the indicator resulting from a loan granted at a variable or mixed rate accommodates an expected rise in interest rates
    - **income reductions** – the probable reduction in the borrower's income upon retirement is taken into consideration
  - Limits to the maturity of loans
  - Requirement of regular payments of interest and capital

- The three limits are introduced simultaneously – limits to LTV, DSTI and maturity – because they complement one another when signalling credit-related risks or losses, and, when applied simultaneously, contribute to a mutual reinforcement of their respective efficacy.

- Includes all credit institutions and financial companies having their head office or branches in the Portuguese territory, authorised to grant this type of credits in Portugal.

- Applies to credit agreements concluded as of 1 July 2018.

Interaction with monetary policy of borrower-based measures

- In the design of this borrower-based measure, special attention was devoted to the implications for financial stability of the current and future EA monetary policy (MP) stances.
- The limits were calibrated in order to:

• *Prevent excessive risk taking by the financial sector*

- **Motivation**: less restrictive credit standards have been observed in the Portuguese banking sector and, due to the prolonged low interest rate environment, this trend was expected to intensify.
- **How**: Limits were calibrated to have an impact on loans to borrowers with a higher risk profile.

• *Allow the accomodation of an expected rise in interest rates*

- **Motivation**: in Portugal most credit relating to residential immovable property is granted at a variable rate, the most common being agreements index-linked to the Euribor rate.
- **How**: interest rate increases of, at most, 3 p.p. were considered in the calculation of the limit of the DSTI, to mitigate the occurrence of credit defaults.

<u>Current Monetary Policy Stance</u>:

Low interest rate environment

(*risk-taking and leverage channel*)

<u>Future Monetary Policy Stance</u>:

Rise in interest rates

(*credit channel*)

Main challenges in dealing with the implementation of macroprudential policy

1. Improvement of micro-data coverage and development of methodological frameworks

- Access to micro-data (loan-level data) is crucial to calibrate borrower targeted macroprudential measures focusing on the RRE sector and to evaluate their impact on lending.
- Confidentiality issues may be involved, though.
- To calibrate the instruments and assess *ex-ante* their potential impact on key macro-financial variables.
- General equilibrium frameworks, econometric analysis and structural models should be developed well in advance.

2. Selection and operationalization of the instruments

- The choice of the type of instruments should be motivated by the phase in the cycle of the financial stability risk.
- **Borrower-based measures** restrain the flow of new lending, so are more appropriate in the case the risk is starting to building up and policymakers wish to take a pre-emptive action.
- **Capital-based instruments** also affect the stock of credit and may be more adequate when systemic risk is already elevated and close to materialize.
- Choice between rules and discretionary actions; binding or non-binding measures; permanent or transitory measures; with or without a phase-in period.
- **HOWEVER, the recovery from the global financial crisis has been characterised in Portugal by:**
- Heterogeneous banking system, where large international banks directly compete with domestic ones (facing different constraints)
- MREL eligible instruments issuance challenges

Main challenges in dealing with the implementation of macroprudential policy (*cont.*)

3. Communication challenges

- The communication strategy of borrower-based measures should be defined more carefully, because they have a direct impact on potential borrowers
- Capital-based measures, in turn, will only indirectly affect credit consumers
- Banco de Portugal has put forward a tailor-made strategy to communicate borrower-based measures including: press conference, TV interview with the member of the Board of Directors in charge of financial stability, creation of a dedicated internet page with FAQ.

4. Fintech

- The potential for lending through other (fintech) channels than the traditional banking ones poses important challenges to macroprudential authorities, such as the expansion of the shadow banking and a larger scope for regulatory arbitrage.

B. Macroprudential Policy: The way forward

Limitations of macroprudential policy:

- Fiscal policy can represent an incentive to debt (favorable tax treatment of debt compared to equity)
- Excessive reliance on bank financing by non financial corporations (NFC)
- Low savings rate of households
- Difficulty in dealing with cross-border issues (e.g. Domestic commercial real estate market dominated by international funds)

The way forward: improved interaction with other policies and more innovative instruments (beyond the scope of traditional macroprudential instruments)

- Promoting access of NFC to other sources of financing (in Portugal NFC need to strengthen their governance structures and transparency in order to be able to access capital markets)
- Development of instruments to promote savings (within the context of reforms in pension systems)
- Expand the coverage of macroprudential policy instruments beyond banking and national frontiers (improved reciprocity)

C. Conclusions

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- Need to complete the Monetary Union and the Banking Union.

- The Monetary Union needs to have the adequate mechanisms in place to improve its resilience to adverse shocks. This will be the only way to avoid financial fragmentation and ensure sustainable growth.

- The completion of the Banking Union will allow the alignment of incentives, which is not the case at the moment as decisions are taken at a centralized level while individual countries need to tackle significant financial stability challenges with a reduced set of instruments at their disposal.

- For a country like Portugal, the main challenge going forward both for micro and macroprudential regulation is the ability to strike the right balance between dealing with the legacy of the crisis, but at the same time being able to counteract emerging risks.

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Thank You for your attention!