Q&A

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New challenges in an evolving financial system

WHAT ARE THE KEY CHALLENGES FOR FINANCIAL STABILITY TEN YEARS AFTER THE FINANCIAL CRISIS, AND WHAT ROLE IS THE FSB PLAYING?

Ten years ago, in response to the global financial crisis, the Financial Stability Forum was re-established as the Financial Stability Board (FSB). Since then, the FSB has largely focused on the implementation of the G20 financial reform agenda to create a more resilient global financial system. The reform agenda includes tightening regulation, intensifying supervision and strengthening international cooperation. Now, after ten years a significant part of the regulatory reform agenda has been completed and we are entering a new phase. The upcoming period will focus on finalizing the implementation of reforms, evaluating whether the reforms have achieved the desired effects and identifying new vulnerabilities in a financial sector which continues to evolve.

With the Standing Committee on Assessment of Vulnerabilities (SCAV) the FSB has a leading role in assessing the impact of evolving market structures and technological innovation on global financial stability. Two specific areas that would benefit from global coordination are cyber resilience and non-bank financial intermediation.

First, the financial sector is becoming increasingly technology-dependent, and financial institutions are more frequently targets of state actors and organized criminal groups. Cyberattacks are a potential threat to business models and the stability of the financial system. In close cooperation between its standing committees, the FSB will continue to work to enhance cyber resilience. The Standing Committee on Supervisory and Regulatory Cooperation (SRC) will identify and assess the best practices relating to a financial institution's response to a cyber incident. The SCAV will

continue to analyze the systemic consequences of operational and cyber incidents.

Second, as a result of regulation, risks tend to shift to less regulated areas: the 'waterbed' effect. Non-bank financial intermediaries play a growing role in the financial system and their share of the financial system is currently the largest on record. They are becoming important players in areas where banks have traditionally played dominant roles. Authorities need to remain vigilant in addressing financial stability risks that emerge as a result of non-bank financing, through enhanced data collection, improved risk analysis and implementing appropriate policy measures. This includes the FSB's policy recommendations for addressing structural vulnerabilities from asset management activities.

WHICH STRUCTURAL CHANGES ARE IMPORTANT?

As mentioned, the financial sector is becoming increasingly technology-dependent and there is a shift towards non-bank financial intermediation. Another topic that requires further attention in the coming years is for example the effect of energy transition risk on the activities of financial institutions and the stability of the financial sector. At DNB we have conducted several studies on this topic. Under the Paris Agreement almost 200 countries pledged to keep the global temperature rise well below 2 degrees Celsius. This pledge translates into a transition to a low-carbon economy and energy system. From a financial stability perspective, we have developed a stress test to gain insight in the potential financial stability effects. The stress test shows that a disruptive energy transition for the financial sector in the Netherlands can lead to significant losses for financial institutions. Policymakers can help avoid unnecessary losses by implementing timely, reliable and effective climate policies. Individual financial institutions should take energy transition risks into account in their risk management.

IS MARKET FRAGMENTATION AN IMPEDIMENT TO A RESILIENT FINANCIAL SYSTEM?

Market fragmentation is a complex phenomenon. Detecting and addressing sources of market fragmentation is important for maintaining an open and resilient financial system. Market fragmentation could for example stem from cultural differences, investor preferences, differences in the development of the financial system, as well as domestic policies, financial regulation and supervision. Market fragmentation arising from differences in regulation reflecting domestic mandates could increase the resilience of financial systems, whereas fragmentation limiting opportunities for cross-border diversification and risk management reduce the resilience of the financial system. The implementation of international standards could play a central role in harmonizing regulation and reducing negative effects of market fragmentation. To this end, enhancing the effectiveness and efficiency of international cooperation is key to ensuring new regulations are implemented consistently across the board.

WHICH FURTHER STEPS COULD CONTRIBUTE TO A STRONGER FINANCIAL SYSTEM IN EUROPE?

Over the years we have made progress in integration and harmonization of policy, standards and regulation in the EU. With the establishment of the Banking Union, the EU was given the responsibility for supervision and resolution of large banks. The establishment of the Capital Markets Union constitutes a step towards further integration of capital markets of the EU Member States. I would like to make the case once again for deepening financial integration and deliver on the Capital Markets Union.

The Capital Markets Union will make it easier for savers and investors to diversify their investments within the EU, will provide business with better access to funding, can reduce Europe's strong dependency on banking intermediation and can enhance private risk sharing via cross-border integration. Finally, and maybe most importantly, a well-diversified Capital Markets Union improves the functioning of the monetary union and enhances the resilience to asymmetric shocks in the European economy and financial system.

WHAT IS THE WAY FORWARD TO A COMMON AND PREDICTABLE BANK RESOLUTION REGIME IN EUROPE?

With the adoption of the Bank Recovery and Resolution Directive (BRRD) for the EU as a whole and the creation of the Single Resolution Mechanism (SRM) within the Banking Union, historic steps were taken to create a common European framework for the orderly resolution of failing banks. The application of resolution tools such as bail-in or sale of business that are provided by the BRRD is however restricted to cases where a resolution action is needed to safeguard the public interest. In particular for smaller banks, the implication is that liquidation through national insolvency procedures still remains the default approach for bank failures. In my view, the challenge we are currently facing in the EU – and the Banking Union in particular – relates to the significant diversity of national insolvency regimes. Different frameworks imply different options and outcomes in insolvency for similar banks, dependent on the Member State in which they are located. And because the outcome of liquidation through insolvency can be different, it also confronts supervisors and resolution authorities with country-specific trade-offs in determining whether the application of resolution tools is warranted to safeguard the public interest in particular cases.

Taking a closer look at the Banking Union, creating a common pool of funds through a European Deposit Insurance Scheme (EDIS) would strengthen the financial capacity of national Deposit Guarantee Schemes (DGSs). For a larger group of banks, it would increase the credibility of liquidation through insolvency procedure as a resolution strategy. This is because such strategies are dependent on the capacity of the DGS to reimburse depositors. Hence, the introduction of EDIS would indeed constitute the next step in creating a common and predictable bank resolution regime for the Banking Union.

However, EDIS does not solve all issues related to the strong differences in national insolvency regimes. This relates in particular to risk sharing within EDIS, because differences in insolvency regimes lead to different recovery rates in insolvency. While this discussion is still in its early stages, there seems to be merit in studying options to harmonize the toolkit available in insolvency at the European level in order to minimize the potential for different outcomes in orderly liquidation. Furthermore, as long as differences remain between Member States in expected recovery rates, liquidity sharing could be considered as an intermediate step as this already provides the largest benefits necessary to further strengthen the bank resolution regime in the Banking Union. ●