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**Conference on “Banks, Systemic Risk,
Measurement and Mitigation”**

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I am particularly glad to address this conference since I believe that promoting a debate on systemic risk among academics, practitioners and supervisory authorities can prove very useful for developing and effectively implementing best practices. So let me thank La Sapienza and Marina Brogi for inviting the Bank of Italy to take part in this two-day event with papers and discussants. Let me also add that it is an honour for me to share this room with Professor Engle, who developed one of the most robust and economically meaningful instruments for gauging the exposure of institutions to systemic shocks, i.e the Conditional Capital Shortfall Measure.

The role of capital tools

In the aftermath of the financial crisis, policymakers have focused on macroprudential policies to address systemic risk.¹

The dual macroprudential objectives of ‘protecting the banks from the financial cycle and protecting the financial cycle from the banks’² have been pursued by introducing a new set of capital buffers. The ‘new’ macroprudential role of capital coexists with its traditional microprudential objective, making a proper governance structure for these partially overlapping policy areas crucial to ensure coordination between the two. This is particularly important during a contractionary phase of the cycle, as policymakers may face a short-run trade-off between safeguarding the resilience of individual financial institutions (microprudential objective) and easing credit access to speed up economic recovery (macroprudential objective).³

Let me briefly recall the main decisions on capital-based measures taken to date by the Bank of Italy:

- (i) Every year the Bank of Italy identifies and calibrates the additional requirements for global systemically important banks (G-SIBs) authorized to operate in Italy, in accordance with the methodology developed by the Basel Committee on Banking Supervision (BCBS) and with EU regulations.⁴ Based on end-2015 data, one banking group has been allocated to the lowest subcategory of global systemic importance; the

¹ De La Rosière Group (2009), Report (http://ec.europa.eu/finance/general-policy/docs/de_larosiere_report_en.pdf).

² Borio, C., ‘Macroprudential frameworks: (Too) great expectations?’, in *Macroprudentialism*, Voxeu ebook, 2014.

³ Alessandri, P. and Panetta, F. ‘Prudential policy at times of stagnation: a view from the trenches’, Banca d’Italia, *Questioni di economia e finanza (Occasional Papers)*, 300, December 2015.

⁴ Commission Delegated Regulation (EU) No. 1222/2014.

corresponding G-SIBs buffer will be implemented according to the phase-in period envisaged under the CRD IV (Directive 2013/36/EU).

In line with the BCBS recommendations, each year the Bank of Italy also identifies other systemically important institutions (O-SIIs), whose failure triggers externalities that could have a significant impact on the domestic financial system. For the first time, the three banks identified this year will be required to maintain an O-SII buffer. The buffer rate reflects each institution's degree of systemic importance and is subject to a four-year phase-in period starting in January 2018.

- (ii) To prevent excessive credit growth and the build-up of system-wide risk, the BCBS recommends using early warning indicators to detect imbalances and trigger the activation of the countercyclical capital buffer (CCyB). As for Italy, the BCBS methodology for estimating the credit-to-GDP gap, which empirical evidence suggests is the best indicator, has been fine-tuned to prevent excessive volatility in the results.⁵ Based on this adjusted indicator, current macrofinancial conditions, while improving, still appear to be generally weak, thus providing a rationale for keeping the CCyB rate at zero for the first quarter of 2017.
- (iii) Finally, turning to the capital conservation buffer (CCoB), in October the Bank of Italy exercised the option to implement the transitional arrangement provided by the CRD IV. This amends its previous decision to apply the fully loaded buffer without any phase-in period and aligns the Italian regulatory framework to that of other euro-area countries.

But is capital alone enough?

In addressing the moral hazard problems posed by institutions perceived as 'too big to fail', the Financial Stability Board proposed an approach based not only on higher capital requirements but also on reinforced supervision, including annual stress tests, and more efficient resolution mechanisms.

In fact, exclusive reliance on higher capital requirements might end up weakening the financial sector's ability to perform an efficient and growth-conducive intermediation of funds towards the real economy.

⁵ Alessandri et al., 'A note on the implementation of the countercyclical capital buffer in Italy', Banca d'Italia, *Questioni di economia e finanza (Occasional Papers)*, 278, 2015.

Moreover, systemic risk may have multiple sources and in some circumstances other – non-capital – tools designed to address specific market failures may prove more appropriate.

I wish to focus, in particular, on two sources of systemic risk which entail specific responsibilities at national level.

- **First, the real estate sector.** It is widely acknowledged that systemic crises are frequently preceded by credit-financed housing bubbles. At the Bank of Italy we have developed an analytical framework for assessing financial stability risks arising from this sector.⁶ We find that variables such as the number of residential transactions and the ratio of value added of construction to GDP are good predictors of banks' vulnerability to households' real-estate debt. Should the indicators suggest the emergence of fragilities in this sector, policymakers can mitigate them by using borrower targeted instruments such as loan-to-value or loan-to-income caps.
- **Second, the role of governance.** The history of banking crises has confirmed the key role of corporate governance in ensuring that managers' incentives are aligned with those of the banks' stakeholders and the public at large. It is undeniable that for some of our banks the effect of the recession has been amplified by weaknesses in their ownership and governance. Better governance is not just good *per se*, but actually (if properly complemented), is a key factor in strengthening the resilience of the banking system.

So what has been done to address corporate governance issues?

Several reforms have been enacted in recent years, notably in Italy, tackling a broad range of issues including governance.

In 2015 significant changes were introduced for cooperative banks (*banche popolari* or BPs), requiring those with total assets of more than €8 billion to be transformed into joint stock companies. Originally conceived for small and local banks, the cooperative form is in fact no longer optimal for BPs that have greatly increased their size and complexity: some of these banks now operate at the national or international level and in several cases are listed on the stock market. Indeed, continuing reliance on cooperative features (such as caps on capital shareholdings, the 'one person, one vote' rule, and limits on proxy votes) causes two main inefficiencies: 1) weak corporate governance (limited shareholder activism, self-referential

⁶ Ciochetta et al., 'Assessing financial stability risks arising from the real estate market in Italy', Banca d'Italia, *Questioni di economia e finanza (Occasional Papers)*, 323, 2016.

management, undue influence by organized special interest groups); 2) constraints and disincentives to capital contributions that hamper recapitalization. The reform is expected to address these distortions and, in the longer term, increase BPs' ability to attract more capital.

In 2016 a new regulatory framework was introduced requiring small mutual banks (*banche di credito cooperativo* or BCCs) to be part of a mutual banking group in order to hold a banking license. While improving corporate governance, the reform would also increase banks' capitalization, facilitate the acquisition of investors and boost profitability through economies of scale. The greater the financial and managerial cohesion within cooperative banking groups, the better able they will be to comply with European prudential rules and SSM supervisory standards, not to mention to address individual members' difficulties, without necessarily triggering a resolution.

A number of specific initiatives have also been taken to prevent the anticompetitive effects of cross directorships in the boards of competing firms by prohibiting interlocking directorates in the credit, insurance and financial sectors.

At EU level, excessive remuneration of financial institutions' managerial and control bodies has been addressed in order to curb excessive risk-taking.

Insurance companies

While systemic risk stems mainly from banks, as suggested by the title of this conference, it is not just about banks. Let me briefly mention the role of the insurance industry, which in Italy is supervised by Ivass, whose governance and organization are closely integrated with those of the Bank of Italy.

Traditionally insurers have been viewed as shock absorbers and as a major source of 'patient' risk capital;⁷ recognition of their importance for overall stability has grown as the financial crisis has laid bare the inter-linkages and potential contagion between the insurance sector, the banking sector and the real economy.⁸

⁷ International Monetary Fund (2016). *Global Financial Stability Report* – Chapter 3 Insurance Sector, April. Insurance Europe (2016) *European Insurance — Key Facts*, August.

⁸ The European Systemic Risk Board (2015). *Report on systemic risks in the EU insurance sector*, December: 'Insurers play a significant role in the funding of governments and banks'. In the same report the ESRB identified four main channels of systemic risk transmission from insurers: (1) Insurers may amplify shocks due to their growing involvement in so-called non-traditional and non-insurance (NTNI) activities, closer to the financial services offered by other intermediaries; (2) Insurers may act procyclically in terms of investment and pricing; (3) Life insurers may undergo widespread distress in a scenario of prolonged low risk-free rates and suddenly falling asset prices ('the double-hit scenario'); (4) Finally, key players may be difficult to substitute in certain classes of insurance vital to economic activity such as marine, aviation and transport insurance.

In recent times the contribution of insurers to systemic risk has certainly increased, essentially due both to a departure from their traditional core business (as a number of changes in product supply and investment behaviour increased their exposure to aggregate, non-diversifiable risk⁹) and to rising interest rate sensitivity.

While capital is the first line of defence against asset losses for banks, for insurance companies the emergence of risks covered by policies initially affects technical provisions;¹⁰ this is why particular attention is currently being devoted by regulators to possible revisions in the methodology for calculating technical provisions, in order to make them more accurate.¹¹

Regarding the imposition of a capital surcharge for globally systemic insurers on top of the existing Solvency Capital Requirement (SCR), the International Association of Insurance Supervisors (IAIS) is currently working so as to find a commonly agreed ‘international capital standard’.

As regards the issue of corporate governance, the Solvency II directive sets stricter requirements at the EU level. Indeed, the risk management function is a lynchpin of the new directive, which calls for own evaluation of the company’s health through an Own Risk and Solvency Assessment (ORSA). ORSA is a structured process whereby insurers must demonstrate continuous sufficient capitalization in a forward-looking perspective and taking account of all possible risks. The implementation of these rules in Italy found fertile ground: secondary legislation in the field of insurance had already foreseen strict requirements, especially in terms of professional standards (the ‘fit and proper’ criteria) and the responsibilities of those in charge of investment strategies.

The challenges ahead

Macroprudential policy has the potential to prevent financial crises so long as regulators succeed in meeting the important challenges that lie ahead.

The most difficult challenge is that of identifying all the pressure points and of coming up with the most appropriate tool (or combination of tools) to tackle every aspect of systemic risk. For example, incentive distortions have traditionally been identified as the first area in

⁹ International Monetary Fund (2016), *Global Financial Stability Report*, April.

¹⁰ Salvatore Rossi, IVASS Annual Report 2015 – Remarks by the President. Thimann, C., ‘Insurance and Systemic Risk: No Easy Conclusions’, <http://voxeu.org/article/insurance-and-systemic-risk-no-easy-conclusions>, 31 May 2016.

¹¹ The current regulation is already based on a risk-sensitive market consistent approach. Great efforts are currently being made to review the technicalities involved in calculating technical provisions such as a possible downward change in the risk free rate used for discounting.

need of regulatory intervention, but at the same time the responses of expectations and behaviour to policy actions is a topic about which quantitative approaches have so far offered little guidance.¹²

This leads us to the second challenge policymakers face, namely the need to improve data quality. Currently data collection exercises and systemic risk measurement methodologies are consistent with the two-step approach proposed by the literature.¹³ In step one financial institutions report their exposures to regulators according to a set of standardized risk factors; in step two regulators use the reports to assess the endogenous risks posed by each institution, as proxied by its contribution to overall systemic risk. The data collection stage is crucial for systemic risk measurement and improving it would help policymakers to identify areas where interventions are needed.¹⁴

There is no doubt that data collection is also costly. This is true in part because firms are typically reluctant to share private information as this could undermine profit opportunities and engender confidentiality and legal issues. But favouring the wider sharing of firm-level balance sheet data is desirable to price and manage systemic risk more effectively, strengthen market discipline, and improve macroprudential policy actions.

Another important challenge lies in interaction with other policies. Efforts should be made to distinguish between microprudential and macroprudential policies, to enhance coordination and to reduce overlaps. When conflicting objectives arise, financial stability should be given priority. Side effects from monetary policy to macroprudential targets, and vice versa, need to be tackled too. Changes in the monetary stance can affect banks' risk-taking behaviour, while macroprudential policies can smooth the feedback between the financial and real cycles.

Looking ahead, as greater productivity becomes possible through digitalization and as traditional banks face new non-bank competitors, regulation should be equipped to address the risks posed by technological innovation and the increasing number of financial technology firms (FinTechs). The main contribution expected from regulators in this field is the adjustment and updating of the regulatory perimeter so that the same regulatory and

12 Committee on the Global Financial System, CGFS Paper No.56, 'Experiences with the ex ante appraisal of macroprudential instruments', July 2016.

13 See Brunnermeier, M.K., G. Gorton, and A. Krishnamurthy (2012): 'Risk Topography', NBER Macroeconomics Annual 2011, 26, 149-176.

14 In this respect, for example, the ESRB recently issued a [recommendation](#) on closing data gaps in the real estate sector. The recommendation concerns both the residential and the commercial real estate sector and aims at providing national macroprudential authorities with a harmonized set of indicators to monitor risks in this area.

supervisory approach and constraints are applied to the same financial activity, irrespective of the entity which undertakes that activity, so as to ensure a level playing field and to preserve financial stability.

Let me conclude by stressing the importance of cooperation for macroprudential policy. A clear lesson from the 2007-09 financial crisis is that in a financially integrated world local shocks can easily turn global, which is what makes an internationally coordinated approach to address systemic risk so important. The Financial Stability Board has played a remarkable role in ensuring just such a global policy and regulatory approach to strengthening the international financial system; it is important that this role be maintained and even reinforced in the future. Streamlining the macroprudential architecture, both in terms of the authorities involved (and their respective roles), and in terms of the instruments available, can only strengthen international cooperation. In the recent European Commission's public consultation on the review of the EU macroprudential framework, the Bank of Italy remarked that greater flexibility on the instruments should not come at the expense of the coherence of the framework or the integrity of the internal market.

Major crises have historically called for close coordination between public and private players; being here today with representatives from both sides of the financial system (regulators and private players) is a clear illustration of another, but equally crucial, form of cooperation.