Closing remarks

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CONCLUDING REMARKS FROM THE 10TH IADI ANNUAL GENERAL MEETING & ANNUAL CONFERENCE, WARSAW, POLAND, 19-20 OCTOBER 2011[1]

Here are some concluding remarks.

First of all, at the outset that the caliber of speakers gracing the conference reflects the complexity and difficulty of tackling a topic like the need for a strengthened financial stability framework. Their contribution to finding a solution to the vexed problem of the global financial crisis, which thus far has been elusive, is unparalleled.

This remark is of particular relevance for developed economies, which have been struggling to identify a means of coping with the crisis more decisively. Secondly, so many interesting thoughts have been shared at this conference over the past few days, that more time is needed to analyse it thoroughly. Therefore, the following remarks do not purport to be an exhaustive recapitulation of all that's been discussed, but rather an ad hoc response to some of the main points.

The discussion that emerged over the course of the conference validates our a priori assumptions with respect to adopting a holistic approach to understanding the essence of the crisis and identifying some tools to cope with it, and this was reflected in the structure of this conference.

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1 The text appearing herein has been slightly edited to meet the requirements for publication.

As a starting point of the discussion, we confronted the global economic outlook in order to understand where we are and where we are heading. What follows are a few interesting points from that perspective.

The current stage of the crisis reveals very serious sovereign debt problems of the OECD countries. This is compounded by the fact that economies are overly reliant on banking sector financing, which has resulted in massive overleveraging. The ability to boost economies by fiscal stimulus has already become exhausted, while the effectiveness of monetary policy has also been declining in recent years.

Therefore some countries face the serious challenge of how to cope with the current crisis without adequate tools at their disposal to boost domestic demand, at least in the short run. At the same time these economies are also coming up against long-term problems with insufficient competitiveness. An improvement in this respect can only be achieved by structural reforms, which require strong determination of governments, often without public support. Positive results from these reforms are only envisaged in the long run. So it is very clear that a microeconomic dimension poses an additional major challenge for effective tackling of the current crisis. So we lack sufficient tools for a short-term boost of the economy, while the instruments used to improve long-term competitiveness are difficult to introduce as the costs of implementation are borne instantaneously, while the benefits can be reaped only gradually and in the long run. It should also be stressed that in contrast to the previous crisis, which took place during the 1980's, 1990's and the early part of the previous decade, the current one pertains to developed countries, as opposed to emerging markets.

Such a macroeconomic environment is not very conducive to a necessary rapid improvement of the stability of the financial sector. Therefore the next two sessions were devoted to identifying important, substantial gaps in the financial safety net. The speeches unequivocally confirmed that we need new institutions for macroprudential oversight and effective and orderly winding up of distressed financial institutions. It also emerged that, in order to ensure their effectiveness, these new institutions should be established within a coherent legal framework and equipped with sufficient tools.

One of the conclusions coming from the current crisis is the importance of macroprudential oversight, which seems to be as important as microprudential supervision. The structure of the financial safety net in almost all countries worldwide is composed of the Ministry of Finance, the central bank with its liquidity function, and a microprudential authority. Such a combination is evidently sub-optimal as long as the fundamentals of a crisis, as is the case with the current one, are rooted in macro imbalances. To deal with this, an appropriate macroprudential authority should complement the existing safety net institutional framework.

According to a narrow approach, macroprudential oversight should focus only on financial stability issues like the dynamics of credit expansion, maturity mismatches and financial asset bubbles. On the other hand, in wishing to adopt a broader scope, the issue of how to address macroeconomic imbalances, like excessive pro-cyclicality, GDP gap and current account deficit, should also be included in the macroprudential framework. Some features of the narrower approach may already be found in the mandate of already existing financial safety net institutions, mainly in the tasks of the central bank and microprudential supervision authority. However, the question of macroeconomic imbalances has not been reflected in the actions undertaken by financial regulators. Therefore, the creation of a macroprudential institution with the authority to deal with both financial stability issues as well as macroeconomic imbalances is a pressing challenge for policymakers.

An additional critical missing element of the financial safety net, especially in Europe, is an effective resolution regime. We have also learned from the current financial crisis that the overall costs of disorderly liquidation of financial institutions, especially large ones, are onerous not only for individual economies, but also for the global market. Without a resolution framework, the only alternative practical option in the hands of governments is to nationalize failing banks, which also results in tremendous costs to taxpayers. Having taken lessons from the previous crisis, many countries outside Europe have already incorporated a resolution authority with an effective toolkit of instruments into the safety net. This procedure allows costs to taxpayers to be minimized and also contains the costs of liquidation of a credit institution for the whole economy.

The second missing element for an effective financial stability network is a full-fledged resolution framework. It is of particular importance in Europe and many non-European countries, not to mention North America, but also Asia, have already adopted this solution. We have already learned from these countries' experience that traditional resolution tools have been tested and have proved their effectiveness with respect to small and medium sized banks. Therefore having in mind the unprecedented size of European banking groups with respect to the GDP of their respective countries, the real challenge is not only to implement resolution framework in Europe, but how to design it to cope with cross-border large banking groups.

In terms of the instruments that can be drawn on from the resolution toolkit, purchase and assumption (P&A) has been widely used by resolution authorities in different countries. However, their experience clearly indicates that their usefulness has been confirmed with respect to small and medium sized banks. The essence of such transactions is to sell the whole bank or part of it to private sector buyers. When it comes to Systemically Important Financial Institutions (SIFIs), not to mention global SIFIs, effective application of this instrument within a short-run framework of time poses a huge challenge because of their enormous interconnectedness and complexity. An interesting point of reference in this respect would be the application of the new powers granted to the Federal Deposit Insurance Corporation (FDIC) by the Dodd-Frank act.

Supplementing the safety net with two above-mentioned elements is a necessary but insufficient measure to maintain stability of the financial system in times of financial turbulence. Which brings us to the fourth point of our conference, namely, institutions that are "Too Big to Fail".

To this end, there are a number of different approaches at our disposal. We could establish new capital and liquidity requirements for SIFIs, adopt more effective supervision, or even consider splitting large banks into separate investment and retail components, as is proposed in the Vickers report. Moreover, in Europe to cope with the cross-border dimension of SIFIs, a number of pan-European solutions have been discussed and are even being gradually implemented. The latest striking changes in the structure of the European Union safety net have been the establishment of the European Systemic Risk Board and the European Banking Authority.

The next point to stress is the evolution of the role of Deposit Guarantee Schemes (DGS) across the world. Needless to say, during the recent crisis DGSs have proven themselves to be a critical component of the financial stability framework. They are very well suited to building and maintaining depositor confidence, a factor which cannot be overestimated in times of crisis. Therefore, even in such a severe crisis, bank runs or bank panics were on the whole successfully averted.

At the same time, in order to better serve the cause of financial stability, DGSs have undergone a significant change. They have improved their funding structure, as an increasing number of DGSs have adopted ex ante financing, as opposed to an ex post system. In addition, there's been a shift to significantly higher levels of coverage and very short periods for reimbursement of deposits. Their mandate has expanded to include a resolution function as a logical complement of their traditional paybox function. This last modification is of particular importance, as it is crucial for the maintenance of market discipline and the mitigation of moral hazard.

At the same time, the International Association of Deposit Insurers (IADI) has become an officially recognized international rule-setter delivering, along with the Basel Committee on Banking Supervision, a comprehensive set of guidelines in the form of the Core Principles for Effective Deposit Insurance Systems, followed by the Assessment Methodology for the Core Principles for Effective Deposit Insurance Systems. The adoption of the Core Principles ensures proper operating standards for DGSs and underpins the structure of the financial safety net.

Global crisis of the order that we have experienced has obvious serious ramifications not only for economies, but also for social and political life. Therefore, in order to complement our discussion of the financial crisis, the issue of financial inclusion was incorporated into our deliberations. The importance of financial inclusion has been recognized by the G20 group of countries and while it pertains particularly to emerging markets, its significance with respect to developed economies also cannot be overlooked.

In conclusion, it would appear the conference has provided lucid insight into the major issues pertaining to global financial stability and charts a way forward.