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FROM THE EDITOR

For the first time, in the 15 years of history of our journal, we are publishing an issue composed of speeches given by the majority of speakers taking part in an international conference on the financial stability framework, hosted by the Bank Guarantee Fund in Warsaw.

From 17 to 21 October 2011 the 10th International Association of Deposit Insurers (IADI) Annual General Meeting and Annual Conference was held in Warsaw, Poland. The event was co-organized by the Polish Bank Guarantee Fund and the IADI Secretariat. The Annual Conference was entitled "Beyond the Crisis: the Need for Strengthened Financial Stability Framework". The conference was attended by over 270 representatives of deposit insurance schemes from all over the world and participants representing central banks, including the National Bank of Poland, supervision authorities, ministries of finance and international financial institutions, such as the World Bank, International Monetary Fund, European Commission, Bank for International Settlements (BIS) and the Organization for Economic Co-operation and Development (OECD). Representatives of 60 countries were present at the events.

Poland was the first member state of the European Union that hosted the IADI Annual General Meeting and Annual Conference. The events coincided with the Presidency of Poland in the Council of the European Union. Both, the 10th IADI AGM and Annual Conference gained the Patronage of the Presidency of Poland in the Council of the EU.

While designing the Conference in 2009, the organizers entitled it "Beyond the Crisis: The Need for Strengthened Financial Stability Framework". On one hand, the title contained the idea for searching solutions that would strengthen the financial stability in the post-crisis times. On the other hand, it included hope, that the deliberations would be held during more favourable, from the point of view of the global financial crisis run, period of time for credit institutions. However, it has turned out that we are dealing with an unusual, considering the past experiences, crisis, as well as new challenges to tackle on the globalized financial market.

The diversity, as well as originality of opinions expressed during plenary sessions, speaks for having them publicized in a magazine devoted to the issues of stability of the financial system, published by the Polish Deposit Protection Scheme.

Despite the editors' efforts, it was not possible to procure the publishing materials from all the speakers, hence the selection. However, the electronic recording of all the plenary speeches can be found at: www.bfg.pl/en/strefa-dokumentow/10th-iadi-annual-conference.

The sequence of the rendered compilations is compliant with the order of presentations, according to the Conference's agenda, which consisted of 6 sessions:

- ❖ Global Economic Outlook
- ❖ New Macroprudential and Microprudential Safety Nets
- ❖ Crisis Management – the Role of the Resolution Regime
- ❖ How to Cope with the 'Too Big to Fail' Problem
- ❖ The Role of Deposit Insurance Schemes in the Financial Safety Net
- ❖ Financial Inclusion.

Taking into account the position of the authors as well as their institutional functions, the editors have decided to desist from any editorial interference with the content of compilations, with the exception of adding, in a few cases, captions, in order to facilitate keeping track of the structure of the text to the readers. In some compilations, the authors have included slides from their conference presentations in their original form.

The first two texts of the hereby issue – the summary of the speech by Martin J. Gruenberg, the President of IADI and Acting Chairman, Federal Deposit Insurance Corporation (USA) and the speech of Jacek Rostowski, the Polish Minister of Finance – come from the opening remarks of the Conference, but also include messages far beyond the usual frames and find reference in the following compilations, grouped according to the accepted division into subject sessions. Apart from that, it should be underlined that Minister Jacek Rostowski, was mentioned in the agenda as keynote speaker. The author of the third speech, John Lipsky, Special Adviser to the Managing Director, IMF, was also a keynote speaker.

From the point of view of the message for practical action, arising from the discussions held at the Conference, it is especially recommended to pay attention to the concluding remarks of the Conference, made by Jerzy Pruski, the President of the Bank Guarantee Fund, Poland. These are the closing remarks of the hereby issue.

I am deeply convinced that the evaluations, conclusions and ideas included in the compilations, will prove interesting to our readers, and their significance for creating the financial stability and development of the globalized world, is, without a shade of doubt, worth documenting in the journal entitled "Safe Bank".

Jan Szambelańczyk

Warsaw, May 2012

10th IADI AGM
& Annual
Conference
17-21 October 2011
Warsaw, Poland

10TH IADI ANNUAL CONFERENCE "BEYOND THE CRISIS: THE NEED FOR STRENGTHENED FINANCIAL STABILITY FRAMEWORK"

Warsaw, Poland

PROGRAMME

19 October 2011

Keynote speech
Jan Vincent-Rostowski, Minister of Finance, Poland

Welcoming remarks

- Olgierd Dziekoński, Secretary of State, Cabinet of the President of the Republic of Poland
- Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation and President, International Association of Deposit Insurers

Keynote speech
Sheila C. Bair, former Chairman of the Board of Directors, Federal Deposit Insurance Corporation

Session 1:

Global Economic Outlook

Chair:

José Viñals, Financial Counselor and Director, Monetary and Capital Markets Department, International Monetary Fund

Panelists:

- Pier Carlo Padoan, Deputy Secretary-General and Chief Economist, Organisation for Economic Co-operation and Development
- Wilson Ervin, Senior Advisor to the Chief Executive Officer,, Credit Suisse Securities Limited
- Dariusz Filar, University of Gdansk, former Member of the Polish Monetary Policy Council (the National Bank of Poland)

Session 2:

New Macroprudential and Microprudential Safety Nets

Panelists:

- Stefano Cappiello, Principal Policy Expert, European Banking Authority
- Marek Belka, President, the National Bank of Poland
- Per Callesen, Governor, Danmarks Nationalbank

Session 3:

Crisis Management – the Role of the Resolution Regime

Chair:

Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation and President, International Association of Deposit Insurers

Panelists:

- Lars Nyberg, Deputy Governor, Sveriges Riksbank
- Mikhail I. Sukhov, Member, the Board of Directors, the Bank of Russia

Session 4:

How to Cope with the Too Big to Fail Problem

Chair:

Gary H. Stern, former President, Federal Reserve Bank of Minneapolis

Panelists:

- Stanisław Kluza, Chairman, Polish Financial Supervision Authority
- Stephen G. Cecchetti, Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements
- Alessandro Profumo, former Chief Executive Officer, UniCredit Group

20 October 2011

Session 5:

The Role of Deposit Insurance Schemes in the Financial Safety Net

Chair:

Mohammed Al-Ja'fari, Director General, Jordan Loan Guarantee Corporation

Panelists:

- ❖ Alex Kuczynski, Director, Corporate Affairs, Financial Services Compensation Scheme (UK)
- ❖ Ridvan Cabukel, Vice President, Savings Deposit Insurance Fund of Turkey
- ❖ Hiroyuki Obata, Deputy Governor, Deposit Insurance Corporation of Japan
- ❖ Fred Carns, Director, International Affairs, Federal Deposit Insurance Corporation

Keynote speech

John Lipsky, Special Advisor to the Managing Director, International Monetary Fund

Session 6:

Financial Inclusion

Chair:

Barbara Ryan, Chief of Staff to the Acting Chairman, Federal Deposit Insurance Corporation

Panelists:

- ❖ Pierre-Laurent Chatain, Lead Financial Sector Specialist, the World Bank Financial Market Integrity Unit
- ❖ Stefan Staschen, Policy Advisory Consultant to the World Bank's Consultative Group to Assist the Poor
- ❖ Rose Detho, Director, Deposit Protection Fund Board (Kenya)
- ❖ G. Gopalakrishna, Executive Director, Deposit Insurance and Credit Guarantee Corporation (India)

Closing Remarks

Jerzy Pruski, President, Bank Guarantee Fund, Poland

Welcoming remarks

Martin J. Gruenberg[*]

SUMMARY OF WELCOMING REMARKS

Prior to the crisis, deposit insurance was largely seen as a means for depositor protection. As a result of the crisis, it is now understood that effective systems of deposit insurance are essential to maintaining public confidence and financial stability, particularly during times of stress.

It was in response to this that the Financial Stability Forum, the predecessor to the Financial Stability Board (FSB) of the Group of 20 (G-20) countries, recommended, in March 2008, that national authorities develop a set of international Core Principles for Effective Deposit Insurance Systems, and utilize a draft set of Core Principles that had been developed by IADI as a starting point.

Pursuant to that recommendation, IADI and the Basel Committee on Banking Supervision (BCBS) then undertook a joint effort to develop a set of Core Principles, a project that was completed in June 2009.

IADI and the BCBS then collaborated with the International Monetary Fund (IMF) and the World Bank (WB), as well as the European Commission (EC) and the European Forum of Deposit Insurers (EFDI), to develop methodology for the implementation of the Core Principles.

That project was completed in late 2010, whereupon the Core Principles were added to the FSB's list of Key International Financial Standards, and were approved by the IMF and WB for use in their Financial Sector Assessment Program (FSAP) reviews of national systems of financial regulation.

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[*] Martin J. Gruenberg is the President of International Association of Deposit Insurers and the Acting Chairman, Federal Deposit Insurance Corporation.

For the first time, we now have an internationally recognized set of standards for the operation of effective systems of deposit insurance that can be utilized for the purpose of FSAP reviews and national self-assessments. The FSB is now undertaking a thematic peer review of the deposit insurance systems of the G-20 countries, utilizing the Core Principles.

In order to advance the utilization of the Core Principles, IADI has sponsored training programs for the IMF and WB officials, as well as for officials of deposit insurers in all regions of the world.

Going forward, IADI will hold additional training programs on the Core Principles, as well as on other aspects of the operations at deposit insurance systems, such as risk-based assessments, funding, and governance. It is also developing a technical assistance capacity to assist deposit insurers with operational challenges, as well as expanding support for research on deposit insurance issues.

Deposit insurance has now achieved a new status of priority in the framework of international financial regulation, one that IADI is committed to support and enhance.

*Jacek Rostowski**

IS THERE A DANGER OF A VICIOUS CIRCLE DEVELOPING?

The world economy is facing an extremely serious situation. It is quite obvious, particularly in the case of Europe, that there is a danger of a vicious circle developing. A vicious circle in which weakness in sovereigns leads to doubts about the adequacy of the capitalization of banks. It can be translated into calls for provisioning which would effectively mark the sovereign assets of banks. It does not require an enormous amount of astuteness to understand that this puts further strains on the sovereigns themselves, because it requires recapitalization of the banks. This recapitalization, in the first instance, needs to be carried out through the private sector. However, it is clear that the recapitalization may not be fully available from private sector sources, in which case, if we need to reach for sovereign backstops, we have extra burdens placed on the position of sovereigns themselves. We also have a clear feedback loop, which can continue feeding on itself in a vicious circle.

Furthermore, there are indications that there will also be effects, resulting from this situation, on the availability of term-lending in the banking system. Some of the solutions that have been proposed are in the area of sovereign guarantees to term-lending. These would clearly impose further strains on the sovereigns.

There is an interesting story about the Great Depression, that may come useful here. It states that the real problem began when somebody from one of the US supervisory institutions came up with a bright idea that it would be prudent to

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* Jan Vincent-Rostowski is the Minister of Finance of Poland.

send inspectors to the banks and check how the great Wall Street crash of 1929 had affected their capital. Of course, once this had been done it turned out that the banks' capital positions were dramatically worse than had been previously assumed. This is not necessarily true and does not confirm that that was really the source of the banking crisis which followed a year or two after the Wall Street crash. Nevertheless, it shows the kind of consequences that we could have, if the above mentioned vicious circle was allowed to develop.

One of the problems is the fact, that over the last twenty or thirty years, a system of supervision control support over the financial, particularly banking, system has been built. There are supervisors, who are separate from the central banks, in the European Union, particularly in the Eurozone and there are very strong and strict limits on what the central banks are allowed to do. The net result and the reason for building up these systems, was essentially twofold. The first was that the main threat was seen to be the threat of inflation. It was believed that this kind of fragmentation of responsibility was likely to make inflation less probable. One of the aspects of this fragmentation was the creation, or rather strengthening of the independence of the central banks. The other aspect, or reason lying at the source of such fragmentation, was that by fragmenting, creating and imposing rules for the fragmented parts of the supervisory system, the hope was that one would reduce the expectation of bailout, and therefore reduce moral hazard.

All this is well known to everybody, and was absolutely sensible and correct at the time. The unfortunate thing is that we are in a situation similar to the one before the fall of Singapore in 1941. There are the most wonderful defences, the most massive cannons facing out to sea, well prepared for an attack by the imperial navy. Unfortunately, the threat that we are actually facing, is the imperial army coming through the jungle from the rear. In other words, we are facing a completely different set of challenges, and the institutions that we have built correctly to face one set of challenges actually find it extremely difficult, for extremely sound, legal reasons of institutional culture, to face the challenges that we now have. This is particularly true in Europe, where, in order to achieve a single currency, certain strong concerns about moral hazard had to be laid.

Therefore, the challenge is of an especially grave kind, because with the fragmentation of responsibility comes a natural tendency for bureaucracies to essentially stick to their mandates, to say "This is not our responsibility", to play, what in England is called 'pass the parcel', meaning 'pass the parcel of responsibility'. We have to realize just how dangerous this situation is, because the institutions and political systems have been lagging behind the curve. From that point of view, another analogy is that of Tarquin and the Sibyl, who was willing to sell Tarquin the Sibylline books for vast amounts of money and when he refused, she burned half of them and then insisted on the same amount of money, then she burned another half, and finally he bought the remains for the original amount of money. We are finding ourselves always moving too late, and in the end getting to where we do not want to be without the effect that we were hoping to have.

It is worth pondering for a minute about what will happen, if we continue in this direction. The threat we are facing today should not be underestimated. The longer we behave in the way we have been behaving, the greater will be the cost in terms of undermining the fundamental, liberal and free market order that we have been creating over the last sixty years. We are in serious danger of finding that more and more of what we have taken for granted in terms of free markets, free capital movements, and so on and so forth, will be under threat, unless we are willing to behave in ways that today seem to be extremely unconventional. We have to save what we can. We have to act in ways that we may find, at the moment, to be unpalatable in terms of what we have developed as far as structures, cultures and rules are concerned, in order to save the rest.

John Lipsky*

MACROPRUDENTIAL POLICY: WHAT IT IS AND HOW TO DO IT

Financial stability lies at the heart of the current global economic issues. This is a lesson we learned painfully in 2008, and we can see it playing out again today in Europe. In this complex interconnected world, it no longer makes sense to draw a clear defining line between the macroeconomy and the financial sector. One aspect of bolstering financial stability is especially worth taking a closer look at: the challenge of designing and implementing macroprudential policies.

What are the biggest intellectual challenges facing the IMF? Where is the most pressing need to conduct new research? The answer is immediate. Given the lessons of the last few years of crisis, the world needs a much clearer understanding of what are called 'macrofinancial linkages'. That is, how does the macroeconomy affect financial markets, and how do financial markets affect the macroeconomy? There is also a need to better understand how macroprudential policies work.

In this area, the IMF is already taking a leadership role. Olivier Blanchard, the Fund's Economic Cousellor, and the Director of our Research Department, together with his colleague Stijn Claessens, are working on analyzing and modeling macro-financial linkages.

Jose Viñals, the head of our Monetary and Capital Markets Department (MCM) and the principal representative at the Financial Stability Board, and his MCM colleagues have published a series of relevant documents on the topic of macroprudential policies on the website, www.imf.org. In April, a paper entitled,

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* John Lipsky is the Special Advisor to the Managing Director, International Monetary Fund.

“Macroprudential Policy: An Organizing Framework”, was published, followed by three companion papers: “Towards Effective Macroprudential Policy Frameworks – An Assessment of Stylized Institutional Models”, “Macroprudential Policy Tools and Frameworks. Progress Report to G20”, and finally “Macroprudential Policy: What Instruments and How to Use them? Lessons from Country Experiences” in August. In addition to these four papers, the September 2011 Global Financial Stability Report contains a chapter on macroprudential policy issues.

What is macroprudential policy? The goal of macroprudential policy is to limit the systemic risk. Macroprudential analysis looks at the intersection of the real economy and the financial sector, providing a birds-eye view of the entire system instead of focusing on individual instruments or individual institutions. Looking to the safety and soundness of individual institutions is important, but we must not miss the big picture–how everything comes together to affect the stability and resilience of the financial system in its totality.

The instruments of macroprudential policy are prudential and thus familiar in broad terms. But macroprudential analysis and policies are especially complex because they must deal explicitly with expected interactions between macroprudential policies on one hand, and monetary and fiscal policies on the other. Of course, this interaction makes it much harder to gauge the expected impact of macroprudential policy measures on the macroeconomy. It is obvious that these linkages have been understood imperfectly, which is one reason why the virulence of the 2007–2009 financial crisis was surprising.

What are the key elements of the Fund’s work on macroprudential policies?

❖ Identifying and monitoring systemic financial risk, something that was not done well enough prior to the crisis;
❖ Specifying and calibrating the potential instruments of macroeconomic policy;
❖ Creating the instruments and governance arrangements that will be needed to guide macroeconomic policy.

First, identifying and monitoring systemic risks. In the account of senior Obama administration officials’ discussions on how to deal with the unfolding crisis in the U.S. financial system during 2009, one can observe a striking thing: the role played by data gaps when policy makers were considering alternative actions. In many cases, data about exposures and interlinkages simply were not known, and policymakers ended up fumbling in the dark.

Obviously, having the right data is an essential starting point for understanding many systemic issues. These include aggregated indicators of imbalances in the macroeconomy, but also indicators from the balance sheets of various sectors, including data on leverage, the credit-to-GDP ratio, credit growth, and other potentially useful advance indicators of systemic imbalances. We also need to look at measures of market conditions such as spreads, measures of risk appetite, and measures of market liquidity. A further element would be metrics of risk concentrations.

There is a need to think in terms of network models and the kind of analysis that underpins the designation of the G-SIFIs to understand the potential impact of risk concentrations. Equally essential is to move to macro-level stress testing, adding considerations of market dynamics and macro-financial feedbacks, as well as to pay attention to experience and to integrate the monitoring systems. That means it is necessary to think about how to take country-specific or contract-specific factors into account in assessing the implications of macro indicators for systemic stability and to incorporate the shadow banking system and the risks around it, a matter currently being addressed by the Financial Stability Board.

Doing all of this successfully means addressing data gaps. This includes such aspects as being able to analyze maturity and liquidity mismatches, being able to monitor and understand risk exposures, and being able to track CDS and OTC derivative markets. If these markets are not understood, there is no understanding of systemic stability issues.

Turning to the instruments of macroprudential policy, it is important to remember that the relevant instruments are not traditional economic policy tools, but prudential ones. These include instruments to limit excessive credit growth, such as time-varying capital requirements, dynamic provisioning, credit growth limits, reserve requirements, loan-to-value ratios, and deposit-to-income ratios. Instruments to deal with the amplification of systemic risk include limitations on maturity mismatches, limitations on foreign exchange lending and limitations on non-core funding.

Anticipating and dealing with the potential impact of failure lies at the very heart of the supervisor's mandate. This is consistent with the goals of the capital surcharges that are proposed for G-SIFIs. In addition, the IMF carried out a study for the June 2010 G20 Toronto Summit that examined alternative ways in which G20 countries' financial systems could bear the cost of their own resolution, rather than burdening the public purse. A broad systemic risk charge for this purpose was proposed. There were also proposals for a financial transaction tax (FTT). Typically, these proposals call for earmarking FTT receipts for specific, yet obviously mutually exclusive, purposes. In the report, it was noted that an FTT, while implementable, has some inherent technical weaknesses. These include possibly regressive incidence, which means that the burden of the tax ultimately may be borne by ordinary financial sector clients, the creation of unhelpful distortions, as activity is restructured in order to minimize the added tax burden, and relatively high administrative costs.

If authorities wish to levy a tax uniquely on the financial sector, the Fund study suggested a Financial Activities Tax (or FAT), which effectively compensates for the general exemption of the financial system from the value added taxation. At the same time, it is important that any effort to increase the financial system's tax burden should be carefully integrated with the other financial reforms now under way. If not, there is a risk that there could be an outsized, and unwanted, withdrawal of credit at a time when the economy needs financial support to sustain growth.

The third issue to keep in mind in this context is the instrumentation of macroprudential policies. Experience suggests that such policies have been used in various combinations, in some cases by different authorities within the same country. The use of multiple instruments means effective communication between the relevant authorities is especially important. For example, credit limits have tended to be very specific, such as controls over mortgage lending. Moreover, this type of instrument has been applied in a judgmental, rather than rules-based, fashion. These aspects underscore the need for a clear overview regarding the design and implementation of these policies.

With the rising importance of macroprudential policies, policy coordination will become more important. For example, the Basel III agreement will institutionalize such policies on a broad scale. The agreement calls for the application of a maximum leverage ratio, the creation of a capital conservation buffer, and a countercyclical capital buffer. At the national level, new controls on SIFIs also imply that coordination between various regulatory and supervisory authorities will increase. That is also true globally, as indicated by the creation of a peer review council for G-SIFIs. In addition, securities market infrastructure is being developed to enhance systemic stability, such as the creation of central counterparties and other measures under consideration in IOSCO, but they will require successful communication and coordination to be successful.

Finally, there is the case of the governance of macroprudential policies. The relevant issues are varied and broad, including the mandate of the macroprudential authority, its powers, its available instruments, the form of its accountability, its transparency, the composition of decision-making, and its coordination with other authorities–including international coordination.

In this regard, two documents, incredibly revealing about the causes and results of the 2008 crisis, are worth mentioning. These are the Senior Supervisors Group October 2009 report entitled “Risk Management Lesson from Global Banking Crisis” and the follow-up report published in December, 2010. These reports examined the risk management processes in presumptive G-SIFIs. The conclusions were quite disturbing. They concluded that many major financial institutions did not have adequate processes in place to manage their risks.

There are at least two reasons why this conclusion is tremendously disturbing. First, it raises questions about corporate governance. Where were the boards of directors when they should have been evaluating senior management? Where were senior managers when they should have been evaluating their risk officers and their practices? How could market discipline have failed so comprehensively, so that leading financial institutions were running risks they did not understand and could not manage? How can it be avoided in the future? The second question relates to the supervisors – if they could see the shortcomings after the fact, why could not they see them beforehand?

There is no simple answer to either of these questions. The answer cannot be just a better regulation, but has to involve also strengthened supervision, credible resolution mechanisms, and independent assessment of the application and effectiveness of regulations and supervision. The IMF papers mentioned earlier contain some preliminary conclusions regarding the application of macroprudential policies that has emerged from the experience to date:

- First, for macroprudential structures to be effective, central banks need to play a key role.
- Second, institutional fragmentation of the responsibility for macroprudential policies must be avoided. The more fragmented the authority, the more onerous the burden of coordination.
- Third, treasury participation is useful, but treasuries should not take the leading role, because of potential conflicts of interest.
- Fourth, systemic risk prevention and crisis management are different functions and should be supported by separate and different arrangements.
- Fifth, at least one institution must have access to all data. Someone must put it all together. It does not work if everybody has some of the data and nobody has all of the data.
- Sixth, the institutional mechanisms need to support action and not just understanding. In other words, the relevant question is not "What did you know, and when did you know it?", but "When you knew it, what did you do about it?"
- Seventh, macroprudential authorities should be identified and should be accountable.
- Finally, macroprudential actions should not compromise the authority of other agencies and prevent their policies from being effective.

In conclusion, these are the challenges in creating effective macroprudential policies. The issues discussed above will be out there for some time to come, and they will be subject to intense debate. Nonetheless, real progress in enhancing systemic stability must be made. Success will require new thinking, new analysis, new organizations, and a comprehensive approach.

Session 1:

Global Economic Outlook

Pier Carlo Padoan[*]

THE GLOBAL ECONOMY AT A TURNING POINT[1]

1. INTRODUCTION

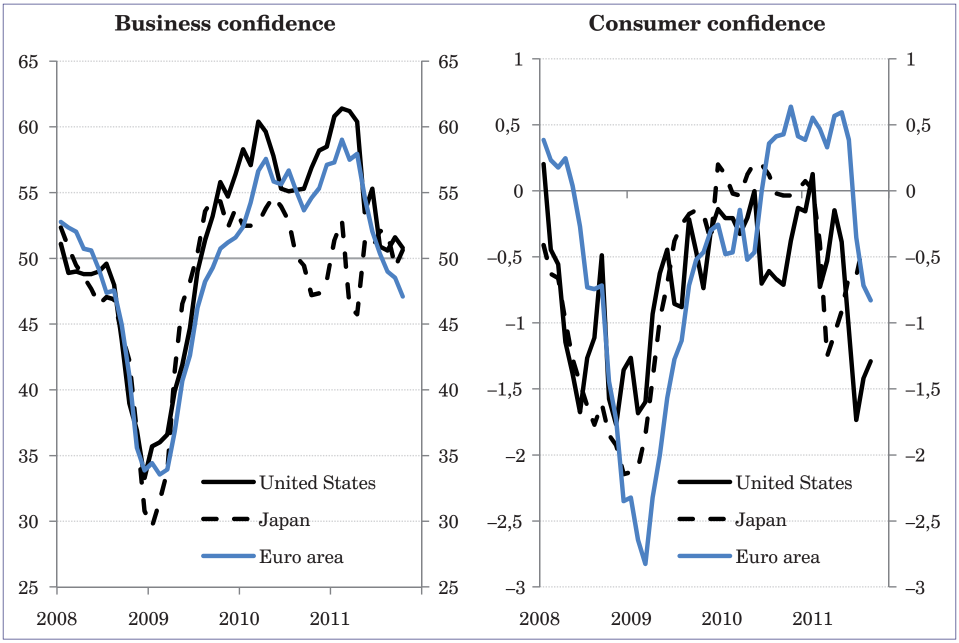
According to the *OECD Economic Outlook* of November 2011 (No. 90), the recovery in the OECD area has slowed to a crawl, despite a technical rebound in activity following the disaster in Japan. In most economies business and consumer sentiments have plummeted since the summer, in the wake of a renewed bout of financial market turbulence, especially for banks in the euro area (Figure 1). Trade indicators point towards weak global activity in the near future (Figure 2). While widening of sovereign yield spreads has become generalised beyond the euro area programme countries (Figure 3), the flipside has been a substantial decrease in the yields of "safe-haven" government bonds and top-rated corporate bonds, in some cases to historic lows. Financial conditions have been tightening overall in the OECD area (Figure 4), and have become less supportive of growth in the emerging markets. In some countries the household balance sheets have begun to weaken once more, due to lower equity prices and persistent housing market weakness. In addition, a widespread slack in labour markets and a pick-up in

* Pier Carlo Padoan is the Deputy Secretary-General and the Chief Economist, Organization for Economic Co-operation and Development.

1 This paper is an updated version of an address delivered at the IADI Annual Conference on 19 October, 2011 in Warsaw, Poland. It is based on the *OECD Economic Outlook* No. 90, parts of which were first released on 31 October 2011, with a full release on 28 November 2011.

inflation, alongside the recent declines in consumer confidence are holding back household consumption.

Figure 1. Confidence is weakening

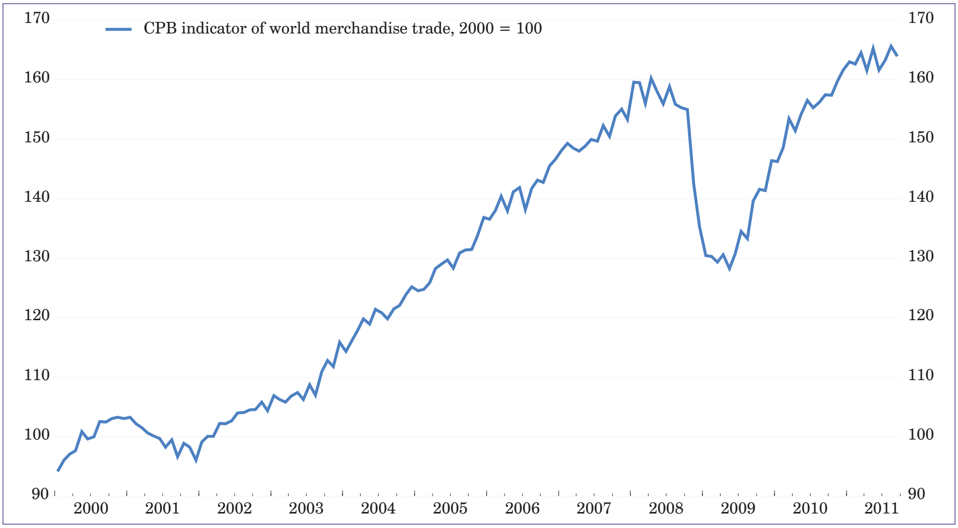


Note: Business confidence: manufacturing sector; values greater than 50 signify an improvement in economic activity. Consumer confidence: values below zero signify levels of consumer confidence below the period average.

Sources: Markit Economics Limited, OECD Main Economic Indicators.

Where will we go from here? In view of very large uncertainties, instead of presenting a "central" projection qualified by upside and downside risk, the *Economic Outlook* presents three scenarios: a baseline scenario, a downside scenario and an upside scenario. The *baseline scenario* is one of "muddling through", in which no major (credit) events happen but also no decisive policy moves towards a resolution of the current predicaments materialise. In this scenario, growth will be weak, although no deep recession is envisaged. The *downside scenario* features an acute confidence crisis and an ensuing deep recession, if not depression, triggered by a major adverse event such as a disorderly sovereign default in the euro area and/or excessive fiscal tightening in the United States. The *upside scenario*, in which the recovery resumes as confidence is restored, is based on the assumption that credible and effective resolution measures are taken to avert such events.

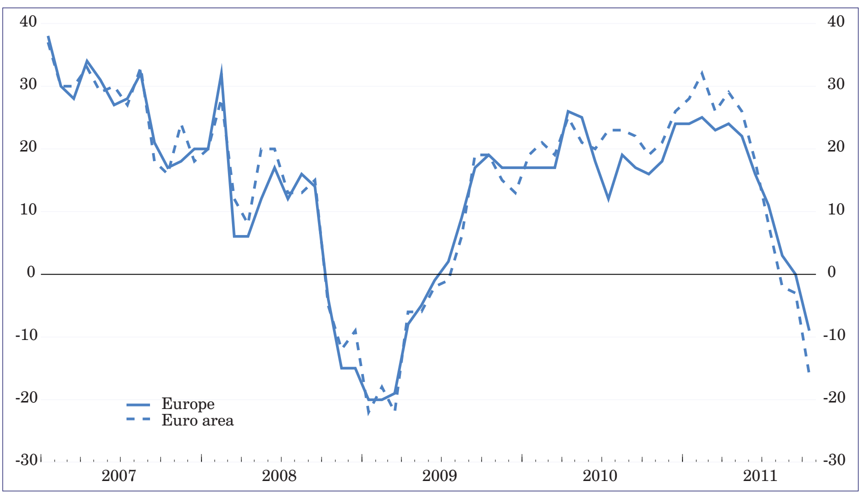
Figure 2. World trade is stagnant



Source: *CPB, OECD Economic Outlook 90 database; and Markit Economics Limited.*

Figure 3. European financial sector confidence has plummeted

Financial services confidence indicator, balances, in percentage points

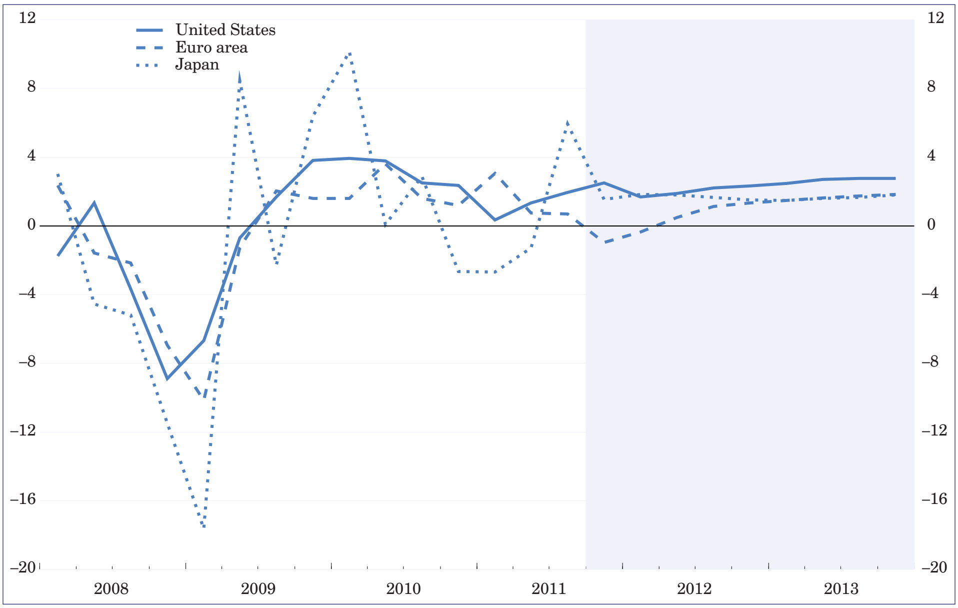


Note: The confidence indicator is the arithmetic average of the balances (in percentage points) for the questions on business conditions, as well as past and expected evolution of demand. Balances are the differences between the percentages of respondents giving positive and negative replies. Data are not seasonally adjusted. Europe includes Czech Republic, Germany, Spain, France, Italy, Luxembourg, Hungary, the Netherlands, Poland and the United Kingdom. Euro area includes Germany, Spain, France, Italy, Luxembourg, and the Netherlands.

2. THE BASELINE SCENARIO: MUDDLING THROUGH

The baseline scenario rests on two assumptions: that the sovereign debt and banking problems in the euro area can be contained and that excessive, pre-programmed fiscal tightening in the United States will be avoided. Against this backdrop, the key features of the baseline scenario for the major economies are as follows:

Figure 4. The recovery is projected to resume only slowly in the OECD area
Annualised quarter-on-quarter real GDP growth, in percent

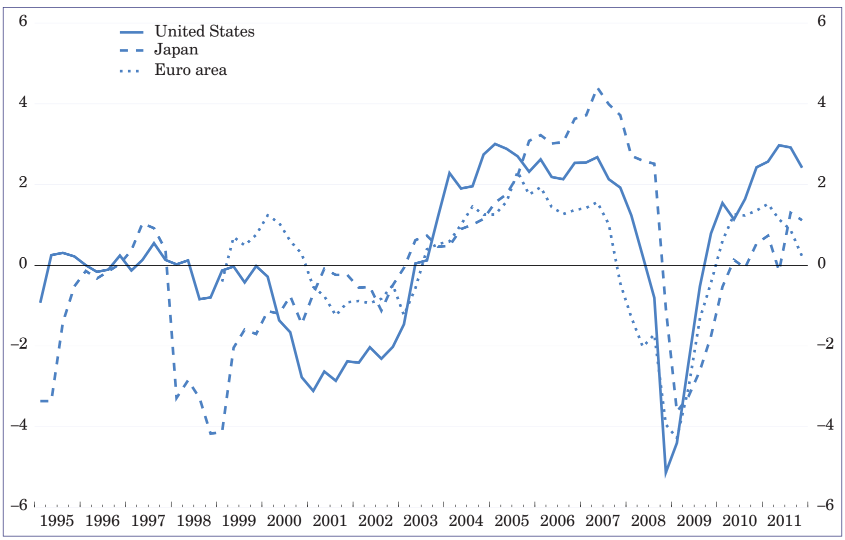


Source: *OECD Economic Outlook 90 database.*

❖ In the *United States*: weak confidence, persistently high unemployment and the renewed pressure on balance sheets from lower asset values are likely to damp consumers' expenditures. Heightened uncertainty should also moderate business investment in the short term, despite healthy corporate balance sheets. Continued fiscal consolidation will also hold back activity. With confidence recovering during 2012, accommodative monetary policy and strengthening external demand should buoy activity through 2013. But the unemployment rate is projected to remain high at around 8.5% by the end of 2013.

- The *euro area* has entered a mild recession, which will be followed by a merely hesitant pick-up in activity. Worsening of financial conditions and fiscal consolidation – both ongoing and announced in response to sovereign debt concerns – will act as a drag on the economy in both 2012 and 2013. Softening confidence, deteriorating labour markets conditions and renewed balance sheet problems should weigh on private consumption, while private investment is expected to be very weak in light of downbeat output expectations. In this muddling through scenario confidence should begin to recover from the second half of 2012 onwards, but slack will persist and the unemployment rate will remain high at just over 10% by the end of 2013.
- After an initial rebound in activity following the disruptions by the earthquake and the Fukushima disaster, the pace of recovery is moderating in Japan. Improved financial conditions and the planned fiscal package are likely to boost growth in 2012. As public reconstruction efforts fade, stronger business investment and a gradual improvement of labour market conditions should provide growth impetus, although the recovery will be checked by soft global growth and the appreciation of the exchange rate.

Figure 5. Financial conditions are generally tightening
OECD Financial Conditions Index



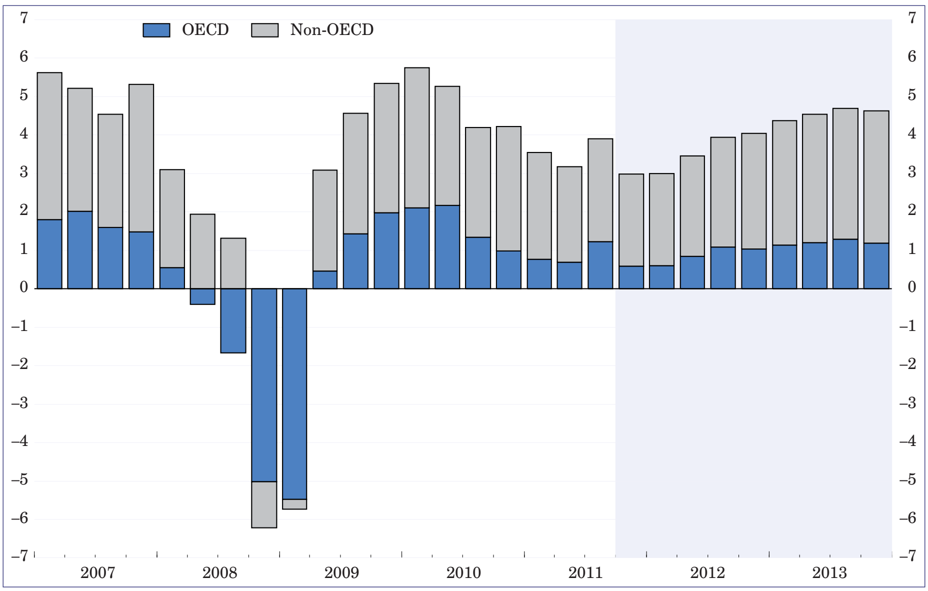
Note: A unit increase (decline) in the index implies an easing (tightening) in financial conditions sufficient to produce an average increase (reduction) in the level of GDP of 0.5 to 1% after four to six quarters. See details in Guichard et al. (2009). The estimation is done with available information up to 17 November 2011.

Source: Datastream; OECD Economic Outlook 90 database; and OECD calculations.

❖ The contribution of emerging markets to the global growth is set to remain substantial (Figure 6). Even so, the output growth in China is projected to be well below the potential in the near future. Domestic demand is buoyed by spending on social housing, but the net trade is likely to act as a drag on activity. As inflation and monetary conditions ease, growth is projected to pick up to rates close to 10% in 2013. India also experiences a soft patch, but growth should pick up to over 8% in 2013. In Brazil, domestic demand is projected to remain solid with more sluggish net exports providing some offset, with growth in the 3%–4% range. Sustained by constantly high oil prices, growth in Russia should be around 4% per annum.

Figure 6. World growth will be sustained by the non-OECD countries

Contribution to annualised quarterly world real GDP growth, percentage points



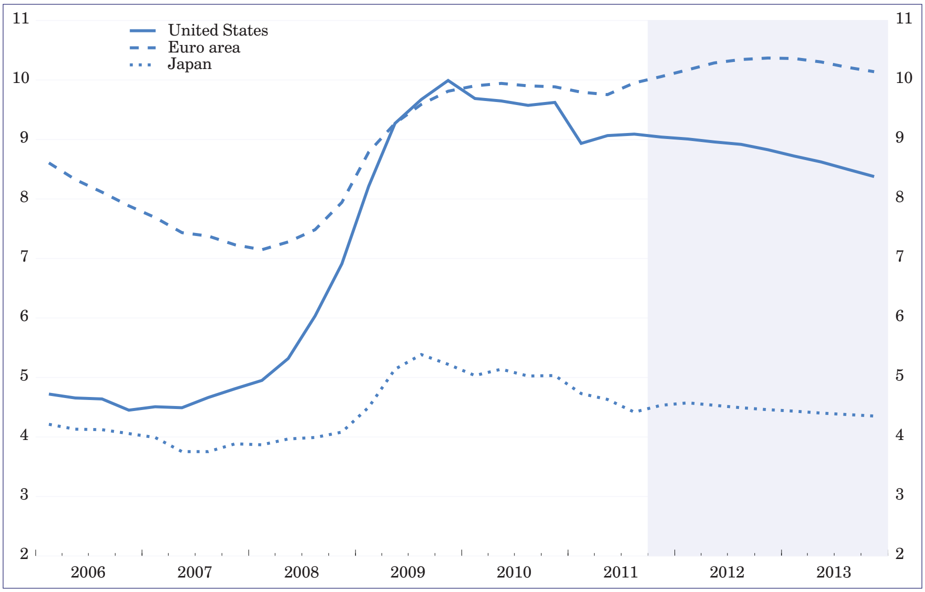
Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities.

Source: OECD Economic Outlook 90 database.

Headline inflation rates in most OECD and emerging market economies have started to decline, mostly due to the impact of hikes in waning commodity prices. Although core inflation has been drifting up in most countries, due to sharp increases in indirect taxes and administered prices in OECD countries along with capacity constraints in the BRICS countries, inflation expectations remain reasonably well anchored. These tendencies are set to continue, more so as slack in product and labour markets should bear down on wage and price inflation.

Following a brief period of improving outcomes, unemployment is rising once more in several economies, especially in Europe (Figure 7). In the baseline projection, the total OECD employment rises by between 0.5% and 0.75% in 2012 and 2013, with job growth in the United States offset in part by job losses in Europe and Japan.

Figure 7. Unemployment is expected to remain high for an extended period
Unemployment rate, percentage of labour force

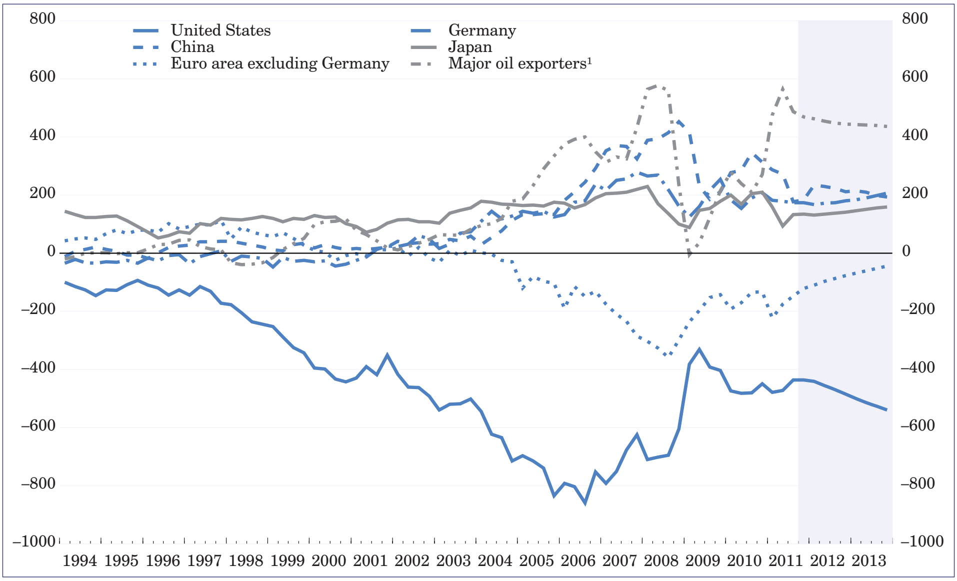


Source: *OECD Economic Outlook 90 database.*

The narrowing of global imbalances since the advent of the crisis in 2008 has now slowed, and little further rebalancing is expected over the projection period (Figure 8). Global imbalances are set to persist, at least in part, due to large increase in the external surpluses of the oil-exporting economies on the back of continually high oil prices. In fact, some of the recent rebalancing among major economies is related to oil price developments as well, with most of the decline in the Chinese trade surplus explained by a rise in energy imports. In contrast, over the projection period, developments in current accounts largely reflect differences in the respective cyclical positions, with the US external deficit widening by 0.5% of GDP, the euro area surplus widening by around 1% of GDP and the Chinese surplus narrowing to around 2.25% of GDP in 2013.

The main risks around these projections are tilted to the downside. Aside from possible events arising from the evolution of the euro area debt crisis and fiscal policy in the United States, these risks stem from inter alia: (i) uncertainty about

Figure 8. Global imbalances will continue to be pronounced
Current account balances, in US$ billions



Note: 1. Includes Azerbaijan, Kazakhstan, Turkmenistan, Brunei, Timor-Leste, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates, Yemen, Ecuador, Trinidad and Tobago, Venezuela, Algeria, Angola, Chad, Rep. of Congo, Equatorial Guinea, Gabon, Nigeria and Sudan.

Source: OECD Economic Outlook 90 Database; and OECD calculations.

power shortages as a result of continuing nuclear plant suspensions and closures in Japan; (ii) tightening monetary conditions and its impact on property and financial asset values in China; (iii) continued strong demand for crude oil in emerging economies and its impact on oil prices; and (iv) slower potential output growth associated with heightened risk aversion in financial markets.

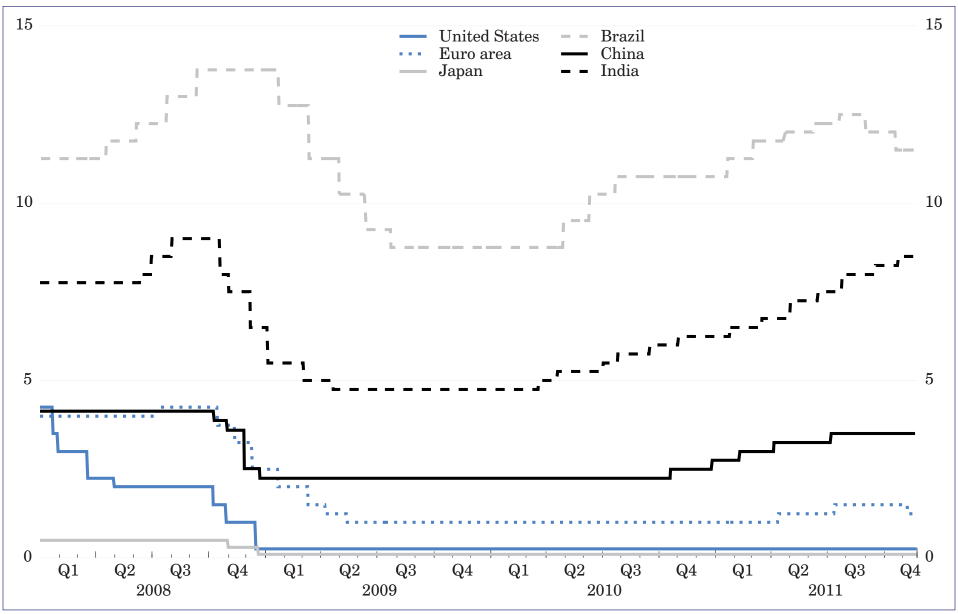
Continued accommodative monetary policy is warranted against this backdrop. In addition, central banks should provide ample liquidity to calm tensions in financial markets. In some OECD economies, where monetary tightening has already started, policy interest rates should be reduced. Near zero-rate policies are not costless as they can prompt excessive risk taking and capital misallocation. Nevertheless, such considerations are outweighed by the need to provide monetary accommodation in the current context.

Notably in the euro area, the weak prospects for the economy and fading inflation argue for further prompt reductions in interest rates, supported by non-conventional monetary policies to extend the balance sheets of central banks

(Figures 9 and 10). Furthermore, monetary authorities in most countries and areas should prepare contingency plans to be implemented swiftly if downside risks materialise. In large emerging market economies outside the OECD, inflationary pressures are mitigating but in several cases inflation still exceeds targets, limiting the room for policy easing. In China, monetary authorities are well advised to allow an effective appreciation of the exchange rate so as to improve the scope for domestic policy to stem a possible downward spiral between property prices and bank capitalisation if some of the downward risks materialise.

In most cases the fiscal policy assumptions employed in the projections are based on existing government programmes, though normative assumptions have been made where there is a particular uncertainty about budget policies in 2012 and 2013. Specifically, in the United States it has been assumed that that the fiscal tightening will amount to 0.5% and 1% of GDP in 2012 and 2013, respectively. This compares with a fiscal tightening embodied in current legislation of about 2% and 3% in 2012 and 2013, respectively, which would be excessive in the current macroeconomic situation. In Japan, the fiscal policy is officially programmed to be eased by 0.5% over the projection period, incorporating reconstruction expenditure

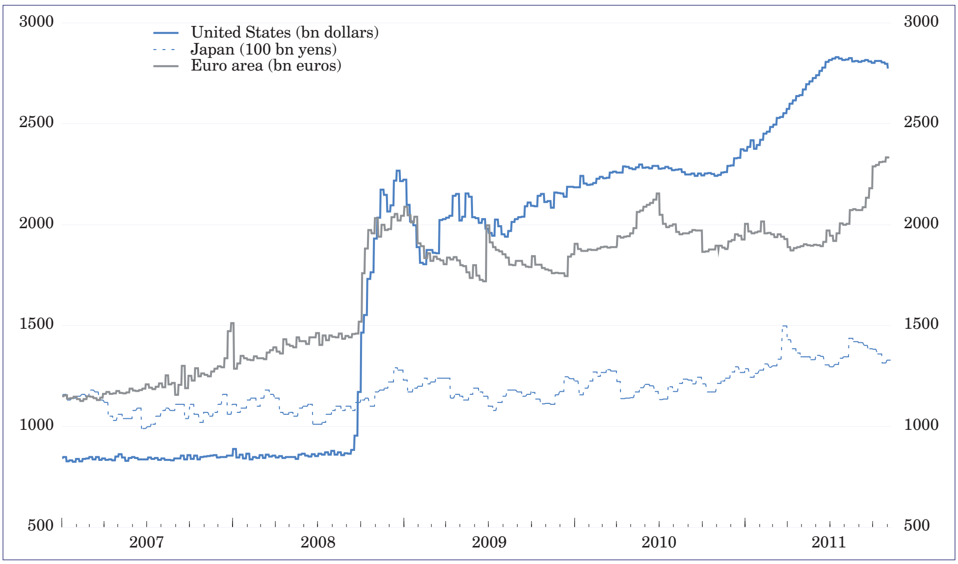
Figure 9. Policy interest rates are again becoming more accommodative in some countries
Policy interest rates, in percent



Source: Datastream; Central Bank of Brazil; Reserve Bank of India; and CEIC.

amounting to some 2% of GDP. In the euro area, the fiscal projections are also based on announced policies, with an aggregate consolidation of 1.5% and 1% of GDP assumed in 2012 and 2013, respectively. In the United Kingdom, the projection embodies consolidation of 1.25% of GDP in both years in line with the government's medium-term consolidation strategy. Healthy public finances generally permit an expansionary stance of fiscal policies in emerging market economies, not least because high growth rates tend to ease debt dynamics, except in Brazil and India, where consolidation is underway and should remain a priority.

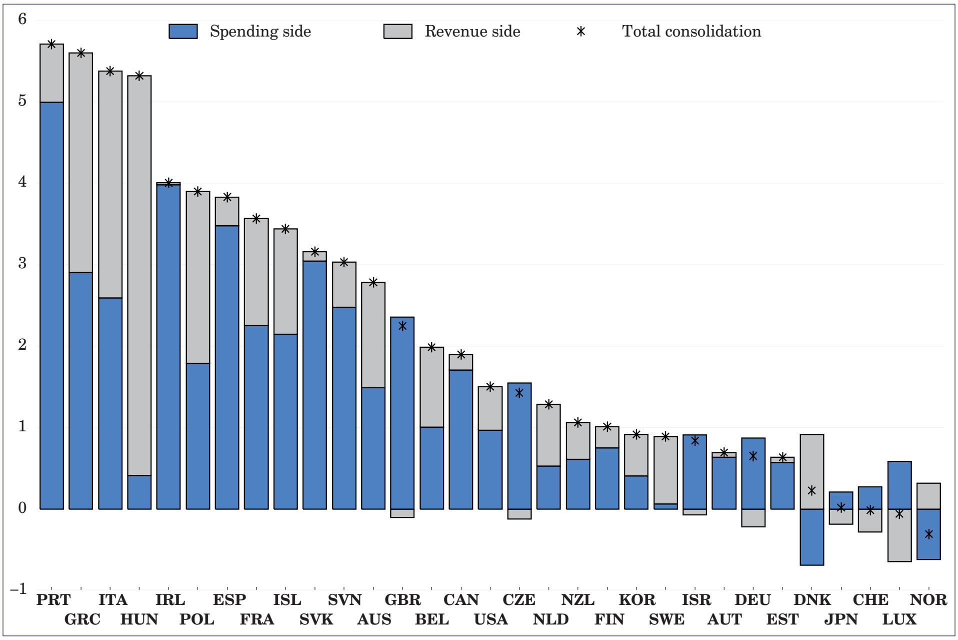
Figure 10. Unorthodox monetary measures have been strengthened
Central bank liabilities, local currency



Source: Federal Reserve; Bank of Japan; European Central Bank.

For most countries, present consolidation plans envisage some mix of spending restraint and revenue-raising measures (Figure 11). The choice of consolidation instruments needs to take into consideration their impact on a range of policy objectives beyond budget consolidation, including short-term aggregate demand, economy-wide efficiency and equity, as well as their political acceptance. Each consolidation instrument has its advantages and disadvantages, but the possible trade-offs may be less stark when considering a broad package of different measures that contribute to both raising potential output and consolidating budgets. In practice, this means that budget-friendly structural reform and growth-friendly fiscal consolidation largely overlap.

Figure 11. Consolidation plans combine spending cuts with tax increases
Change in the underlying primary balance 2011–13, in per cent of potential GDP



Note: Total consolidation is the projected difference in the underlying primary balance; revenue side is the projected increase in the underlying receipts excluding interest earned on financial assets; and spending side is the projected decline in the underlying primary spending excluding interest payments on debt.

Source: OECD Economic Outlook 90 database; and OECD calculations.

Reforming disability, sickness and unemployment benefit schemes, along with old-age pension systems and *de facto* early retirement schemes, could contribute to immediately improving fiscal balances while boosting employment and thereby raising tax revenues in the longer term. Public spending efficiency is another key policy area where reforms could allow for reduced expenditure, while maintaining or even increasing outputs. In particular, improving the efficiency of education systems is the key policy objective in almost all OECD countries and improving health care sector efficiency could deliver even larger fiscal gains. Public subsidies, when not addressing market failures, distort resource allocation and hurt productivity.

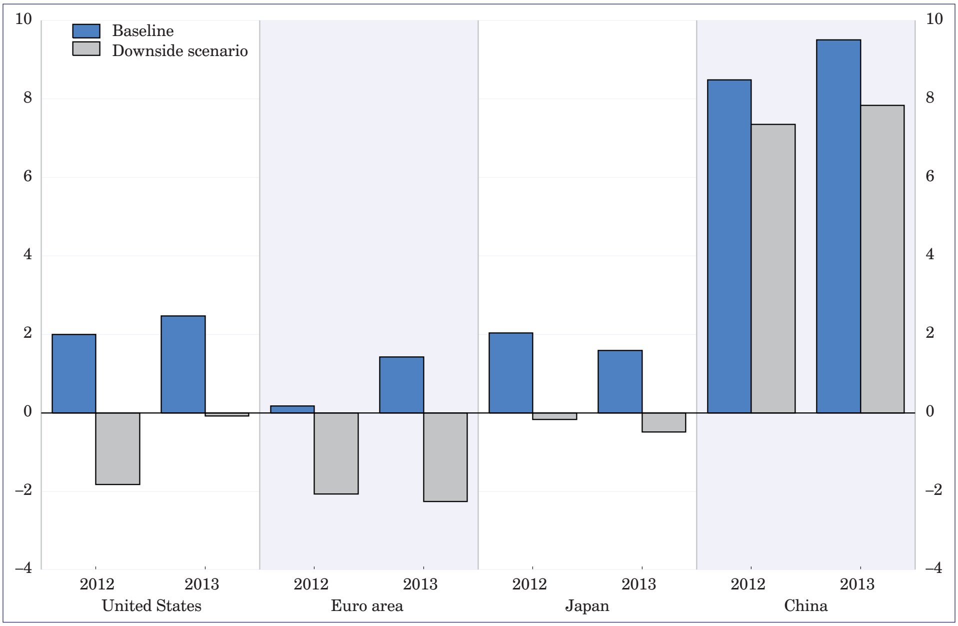
On the revenue side, while difficult to quantify, tax expenditures have probably increased over time, notably in order to address market failures or income distribution concerns. In several countries, broadening tax bases by reducing tax expenditures would enhance the efficiency of the tax system by enabling a reduction in tax rates and by cutting economic distortions and administrative compliance. Improving the effectiveness of tax administrations in tax collection and the fight against tax evasion is an important way to both enhance tax efficiency and reduce fiscal deficits, and the amounts of tax revenues involved can be significant. Even if the revenue is neutral, tax reforms can also make some indirect contribution to fiscal consolidation through their medium-term effects on income, productivity and tax receipts. For instance, cuts in labour tax wedges to offset increases in indirect taxes could have positive effects on employment and indirectly contribute to fiscal consolidation, as higher employment implies more tax revenues and less spending over the medium run. Finally, policies to tax public "bads", such as pollution, could enhance welfare (though not GDP as conventionally measured) while assisting fiscal consolidation.

Financial market policy has a key role to play in restoring confidence by insisting on more solid capital bases of banks. For instance, in the euro area, the immediate concern is that accounting rules allow sovereign debt held in banking books to be valued at acquisition cost and not at market prices when they intend to hold these securities to maturity. This has opened a gap between market and accounting measures of these assets. There are also concerns that some banks outside the euro area have large exposures to vulnerable euro area countries and banks, especially through credit default swaps. To strengthen confidence in banking systems, the EU governments have announced plans to strengthen the core capital ratios of the major European banks. To avoid generalised undue bank deleveraging, regulators should insist that banks increase their capital levels rather than shrinking the assets. Where needed, this may have to involve public capital injections, preferably in the form of ordinary shares so as to give tax payers, not only in potential losses, but also potential upsides. Coordination at the EU level should be employed to avoid stigma effects and associated disruptive cross-border capital flight.

3. ALTERNATIVE SCENARIOS

The *OECD Economic Outlook* elaborates a number of downside risks associated with the sovereign debt crisis in the euro area and the fiscal stalemate in the United States which, if they came to a head would result in a deep recession in the United States, the euro area and – to a lesser extent – Japan, while emerging market economies such as China would also be adversely affected (Figure 12). In addition to the downside scenario, the *Outlook* also presents an upside scenario in which it is assumed that credible and decisive policy action is taken in the euro area while fiscal consolidation in the United States remains at a measured pace as in the baseline scenario (Figure 13).

Figure 12. Downside scenario
GDP growth, percent per annum



Source: OECD calculations.

3.1. The downside scenario

Intensified concerns about sovereign debt sustainability in larger euro area countries with high or rapidly rising debt, as well as the contagion to countries with relatively solid public finances, have the potential to escalate to massive economic disruption. This is the case of not only Italy, where long-term government bond yields have risen rapidly, but also of Spain and Belgium. The interaction between public finance and banking woes could result in self-reinforcing feed-back loops: banking problems requiring costly public interventions, which in turn would raise long-term interest rates with additional adverse effects on economic growth, banks, etc. If unchecked, such a development could lead to fears of sovereign and banking defaults. A deep euro area crisis would have significant adverse effects outside the euro area. Aside from the exposure of banks in the United States and Japan to Europe, equity markets in the two countries would be hit as their exports to Europe would fall, as would earnings of their subsidiaries in Europe. Falling risk appetite more generally would hit emerging market economies through large-scale capital outflows.

The *Economic Outlook* provides some illustrative estimates of the possible outcomes (incorporated in the Figure above), pointing to sharp falls in the growth rate of output in the OECD economies relative to the already relatively weak baseline projection of the order of 2–3% in 2012 and 2013, a decline in the level of world trade relative to the baseline of up to 9–10% by the end of 2013, and likely deflation in many OECD economies by 2013. This is based on an assumed deterioration in credit condition, corporate bond spreads and equity prices of the same order of magnitude as in the 2008–09 crisis. Moreover, long-term bond yields in this scenario are assumed to rise by 350 basis points in Italy, Spain and Belgium.

Though this is not quantified in the *Economic Outlook*, this downside scenario could be strongly accelerated and amplified if it was accompanied by one or several countries leaving the euro and re-establishing their own currencies – or even just expectations thereof. For instance, this could be prompted by the need to restore external competitiveness after large erosion since entry into the currency union. If everything came to a head, the political fall-out would be dramatic and pressure for the euro area exit could be intense. The establishment and likely exchange rate changes of the new national currencies could imply large losses for debt and asset holders, including banks that could become insolvent. Such turbulence in Europe, with the massive wealth destruction, bankruptcies and a collapse in confidence in the European integration and the cooperation it entails, would most likely result in a deep depression in both the exiting and remaining euro area countries as well as in the world economy.

As discussed above, a second downside risk around the baseline projection stems from uncertainty about the likely path of fiscal policy in the United States. Existing legislation implies that in the absence of offsetting action there could be a fiscal tightening of, respectively, up to 2% and 3% of GDP in 2012 and 2013, when the extension of the 2001–03 tax cuts are set to expire and automatic expenditure cuts worth around 0.75% of GDP would kick in. This is a much stronger consolidation than assumed in the baseline projection. Model simulations of this additional fiscal tightening on the United States suggest that the US economy would move close to recession in 2012 and experience only weak growth in 2013, with the unemployment rate rising by over half a percentage point. There would be negative, but relatively mild, spillover effects elsewhere. If the additional fiscal consolidation in the United States were to also lead to a depreciation of the US dollar, then the effects on US activity would be muted and the effects on activity in other economies somewhat larger.

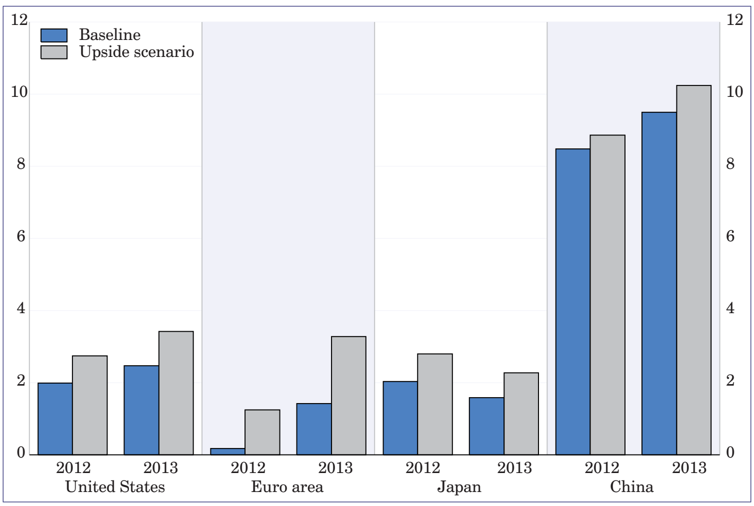
In the event that additional fiscal consolidation in the United States occurred in combination with the euro area downside scenario materialising, OECD GDP would be lower by around 6% after two years. Unemployment would rise sharply, by more than 2.5% in the United States and by over 2% in Europe. Deflation would likely be widespread.

3.2. The upside scenario

A successful blocking of contagion, the establishment of strengthened medium-term fiscal and structural policies in the euro area could offer significant near-term benefits for the economic outlook. In particular, there would likely be a marked reduction in the long-term government bond spreads in many euro area countries, as well as a more general improvement in financial conditions and restoration of confidence. An illustrative scenario (incorporated in Figure 13), assumes a reduction in euro area government bond yield spreads and the rapid reversal of the decline in financial conditions since August. The results suggest that OECD output growth would be 1.25–1.5 percentage points higher in 2013 than in the baseline projection, and considerably higher than would be the case if the downside scenario (both in the euro area and the United States) materialised.

Figure 13. The Upside scenario

GDP growth, percent per annum

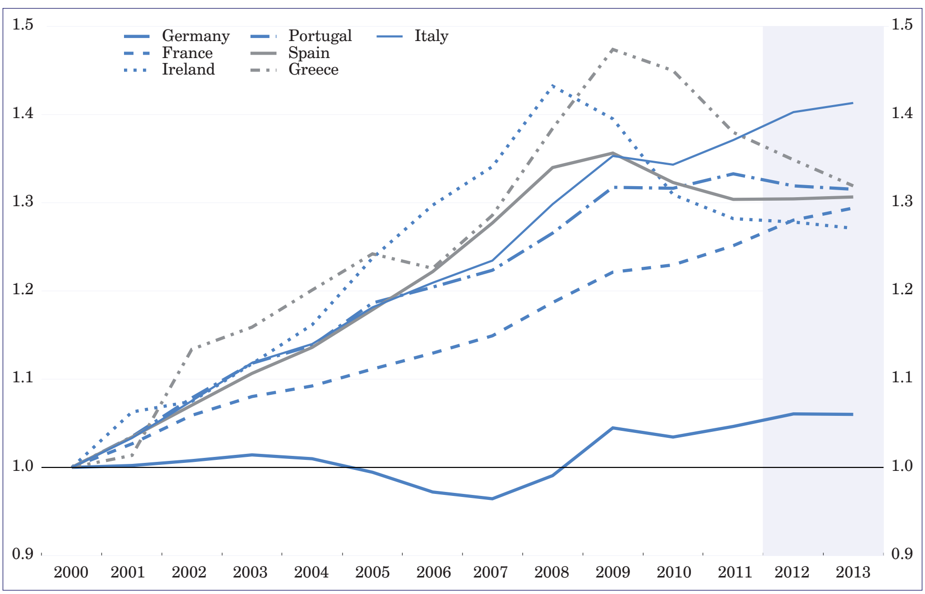


Note: Prerequisites for achieving the upside scenario:
The euro area:
The 26 October package must be implemented, including:
1. Stabilisation by means of leveraging reserves in the European Financial Stability Fund (EFSF).
2. A voluntary exchange of Greek sovereign bonds by private investors, with a nominal 50% discount.
3. Shoring up the banking sector through recapitalisation.
4. Be ready to provide guarantees for term liquidity to the banking sector if needed.
5. Overhaul of euro-area governance, combined with substantive structural reforms.
These measures need to be followed up at the next ECOFIN Council on 9 December.
The United States:
Efforts need to be redoubled to reach an agreement on a credible fiscal programme.
Source: *OECD calculations.*

What should be done to achieve this outcome? The firewall represented by the resources available for the EFSF and ESM have been signifcantly strengthened and ECB has intervened strongly to provide liquidity to the banking system in the euro area through the LTRO. At the same time as mobilising adequate resources, it is important to strengthen fiscal governance in the euro area to counter the potential moral hazard from intervening to block contagion. Possible, not mutually exclusive, options are: stronger enforcement of existing rules all the way to establishing a "fiscal compact; the creation of blue/red bonds; or establishing a framework for orderly sovereign debt default to discipline fiscal behaviour through the market".

Is this sufficient for achieving the upside scenario? Probably not. It is important to bear in mind that the present crisis has its origins in the build-up of economic imbalances among the euro area countries (Figure 14). Among the weaker economies' symptoms there are: weak competitiveness, loss of market shares and external deficits, low growth exacerbating fiscal imbalances through adverse debt dynamics and over-reliance on domestic demand to drive growth. Amongst the stronger economies, growth has been excessively reliant on exports, and domestic saving has exceeded domestic investment with surplus saving flowing to finance consumption, government spending and low-productive real estate development in the weaker economies.

Figure 14. Rebalancing in the euro area also requires unit labour cost adjustments
Unit labour costs, 2000 = 1



Source: *OECD Economic Outlook 90 Database.*

Against this backdrop, there is a need to not only establish sound fiscal policies, but also to ensure that private saving and investment decisions are based on sound incentives; ensure that cumulated competitiveness problems converge quickly; and ensure that growth is not held back by policy barriers. Structural reforms, including those associated with a stronger single market, are crucial for achieving rebalancing and for speeding up adjustment at the EU level. In addition, stronger growth spurred by structural reforms would help improve the debt dynamics, which is particularly urgent in the countries faced with serious credibility problems. In the financial sector, a truly unified banking system, where all regulatory and supervisory responsibilities are transferred to the euro area level, is essential to eliminate the return of adverse feedback loops.

4. THE OECD STRATEGIC RESPONSE

The OECD Strategic Response outlined in the *Economic Outlook* identifies country-specific policy actions that need to be implemented if the downside scenario discussed above materialises: the financial sector must be stabilised and the social safety net protected; further monetary policy easing should be undertaken; and fiscal support should be provided where it is practical and feasible. At the same time, stronger fiscal frameworks should be adopted to reassure markets that the public finances can be brought under control.

Beyond this, the Strategic Response identifies a wide range of structural measures which, though desirable in their own right, will become even more urgent. While priorities vary from country to country, such policies include the removal of barriers in product and labour markets that inhibit economic activity and employment. Appropriate labour market policies are needed to deal with the consequences of unemployment which is turning from cyclical to structural, thereby sapping potential growth, hitting confidence and undermining public finances. More specifically, the following country-specific reforms would become urgent:

❖ *Product market reforms*. Product market reforms targeted at increasing competition in general or network industries (e.g. France, Mexico and Turkey), professional services (Germany, France, Italy), and retail services (France) would spur growth and encourage innovation. Increased privatisation would also be appropriate (Italy and Poland). Further integration of national services markets in the European Union could provide a boost to demand and confidence. Outside the OECD area, product market reforms are called for in China and South Africa.

❖ *Trade, foreign investment and financial reforms*. Increased international openness would be appropriate in Japan and Korea, as well as in the Russian

Federation and India. Higher inward foreign direct investment could boost investment levels and increased trade openness in countries with buoyant activity should raise real incomes and support exports from countries with weaker activity. Rapid implementation of already decided financial reforms would become more urgent in the United States. Also, enhancing the possibility of refinancing mortgage loans at a low rate could be a particularly effective device.

- ❖ *Labour market reforms*. Labour market reforms can raise long-term sustainable employment levels and provide fiscal room for manoeuvre while also easing adjustment; therefore they become more urgent in a crisis. Such reforms are warranted in around half of all OECD countries (including Italy, United Kingdom, Canada, Belgium, Estonia, Ireland, Portugal, Slovenia, Spain, Sweden and Turkey) and outside the OECD area, in Indonesia and South Africa.
- ❖ *Public sector reforms*. Increasing the drive for public sector efficiency, including in the United Kingdom (notably in the NHS) and New Zealand, could help to generate increased space for fiscal manoeuvre in the near term. Pension, early-retirement and disability/sickness reforms would be called for in several countries (including Belgium, Denmark, Finland, Norway, the Slovak Republic and Slovenia) to reduce the future public costs of population ageing and increase confidence in the future strength of public finances. Revenue-neutral tax reform aimed at reducing taxes on labour and corporate incomes and increasing indirect taxes and other (*e.g.* green) taxes could stimulate growth in Japan, Germany, France and Canada. Outside the OECD area, tax reform would be particularly urgent in Brazil.

5. CONCLUDING REMARKS

The world economy is at a critical juncture and it could take different paths going forward. The projections presented in the *Economic Outlook* portray a scenario that rests on the assumptions that monetary policy remains very supportive (and, in some places, becomes more so), that sovereign debt and banking sector problems in the euro area are contained and that excessive fiscal tightening will be avoided. From the second half of 2012, confidence is assumed to recover gradually as it becomes clearer that worst-case outcomes have been avoided.

Alternative scenarios are possible, and may be even more likely than the baseline. A downside scenario would be characterised by materialisation of negative risks and the absence of adequate policy action to deal with them. An upside scenario could arise if policy action were successful in boosting confidence and no significant negative events occurred. In the downside scenario, the implications of a major negative event in the euro area will depend on the channels at work and their virulence. The results could range from relatively benign to highly devastating outcomes. A large negative event would, however, most likely send the OECD area as a whole into recession, with marked declines in activity in the United States and Japan, and prolong and deepen the recession in the euro area. Unemployment would rise even further. The emerging market economies would not be immune, with global trade volumes falling strongly, and the value of their international asset holdings being hit by weaker financial asset prices.

What would be required for an upside scenario to materialise? A credible commitment by euro area governments that contagion would be blocked, backed by clearly adequate resources. To eliminate contagion risks, banks will have to be well capitalised. Decisive policies and the appropriate institutional responses will have to be put in place to ensure smooth financing at reasonable interest rates for sovereigns. The increases in the capacity of the EFSF and the anticipation of the lauch of the ESM together with, more decisive action by the ECB to support the banking systems in the euro area have significantly increased the effectiveness of the firewall. Such forceful policy action, complemented by appropriate governance reform to offset moral hazard, could result in a significant boost to growth in the euro area and the global economy.

An upside scenario also requires substantial and credible commitment at the country level, in both advanced and emerging market economies, to pursue a sustainable structural adjustment to raise long-term growth rates and promote global rebalancing. In Europe, such policies are also needed to make progress in resolving the underlying structural imbalances that lie at the heart of the euro area crisis. Deep structural reforms will be instrumental in strengthening the adjustment mechanisms in labour and product markets that, together with a robust repair of the financial system, are essential for the good functioning of the monetary union. By raising confidence, lowering uncertainty and removing impediments to economic activity, rapid implementation of such reforms could raise consumption, investment and employment.

If combined, stronger macroeconomic and structural policies might raise OECD output growth by as early as 2013. The largest benefits would be felt in the euro area, though these could take some time to emerge. Stronger activity and trade, and the consequent rise in asset values in the OECD economies, should boost activity in the emerging market economies as well.

In view of the persisting great uncertainty policy makers confront, they must be prepared to face the worst. The OECD Strategic Response identifies country-specific policy actions that need to be implemented if the downside scenario materialises: the financial sector must be stabilised and the social safety net protected; further monetary policy easing should be undertaken; and fiscal support should be provided where it is practical. At the same time, stronger fiscal frameworks should be adopted to reassure markets that the public finances can be brought under control. Beyond this, a wide range of structural measures, which are desirable in their own right, will become urgent. While priorities vary from country to country, such policies include the removal of barriers in product and labour markets that inhibit economic activity and employment. Appropriate labour market policies are needed to deal with the consequences of unemployment which is turning from cyclical to structural, thereby sapping potential growth, hitting confidence and undermining public finances.

The difference between the upside and the downside scenarios reflects the impact of credible, confidence building policy action. Such action, as we have seen, requires measures to be implemented at the euro area level as well as at the country level throughout the OECD, especially in the structural policy domain. In the case of a downside scenario, policy action would clearly be needed to avoid the worst outcomes. But then the question arises of why policy efforts are not taken to deliver the upside scenario even if the worst case does not materialise. Why, in other words, should we settle for less?

Wilson Erwin[*]

REMARKS ON "CHAPTER 2" OF THE FINANCIAL CRISIS

1. INTRODUCTION

A personal story shall serve as an introduction to the financial crisis topic. I was talking with my father a few weeks ago about my family's history and noticed a namesake – my great-grandfather in the chart – and asked what had happened to him. He lived in Iowa, in the middle of the US. He was a farmer, apparently good at breeding strong horses, and was also involved in a local bank. But he was not particularly good at the banking side, and when banks started failing in the 1930's all across the Midwest, he lost everything. It's an interesting personal window on banking and deposit insurance for the "little guy". We often deal with these issues at an abstract, high level – but what all of us do is extremely important to the prosperity of these little guys.

A while ago everyone thought the crisis was over. But it seems there are a few "chapters" to this crisis. The first chapter was triggered largely by mortgage and financial excess, and then spread via financial contagion through the banking system to even the biggest of banks. Ultimately, it took extraordinary government action to control it.

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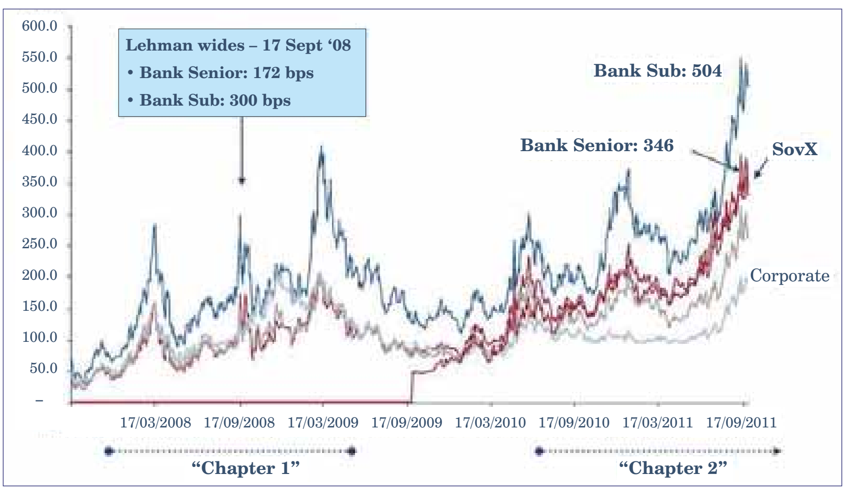
2. WHAT DO WE KNOW ABOUT "CHAPTER 2" OF THE FINANCIAL CRISIS

We are now in chapter 2. We know it has a different trigger but we do not know how it will end. Therefore, what do we know about chapter 2? First of all, sovereign debt is no longer considered risk free. Secondly, chapter has 2 intertwined crises, meaning that sovereign woes and financial stress are interrelated with each other. That is a fundamental, almost a Gordian knot, type of problem. That has given rise to a sense of chronic and endemic crisis and meant that a fundamental solution has been elusive. All the exits seem to be blocked. New money has become extremely wary of the financial sector. Debt investors now believe they are truly at risk when they invest in banks. That may be a good structural feature – during the previous crisis they were immune. Policy makers have done a lot of good, hard work in the U.S. and in the E.U. to put debt investors on the hook for their investments. That is important in separating the financial and sovereign aspects of the crisis but it is not enough – current markets assess this risk way above the fundamentals.

The financial conditions are likely to dominate the short term economic outlook. You can see that to some extent in trading, you have a highly correlated, "risk on", "risk off" mindset in the markets. And that is a useful parallel for the real economy, where we have possible binary outcomes: possibly a severe double dip or a nice rebound. A lot of that depends on our policy choices from here.

We have looked at some financial markets graphs for chapters 1 and 2 of this crisis.

Chart 1. European debt market trends



Source: Credit Suisse, as at 28 September 2011; spreads are for 5 year debt instruments.

You can see a few key themes here:

- first is the return of serious fear in chapter 2 – fear that approximates the level during the darkest days of the first chapter of the crisis.
- second, the fear in the sovereign sector has moved up, especially in Europe. That is quite different from the first phase, and matches, almost exactly, to what is happening to the bank senior spreads in Europe. Obviously, the sovereign crisis and the bank crisis are intertwined, not just conceptually, but in the mind of the market.
- third, bank senior spreads are 346 basis points – what does this mean? In present value terms, this means investors are pricing in about **17% expected loss over 5 year period** for senior bank paper. That is an expected loss on a gigantic scale for their assets – enough to eat through equity, capital securities, subordinated securities, and well into senior paper. That is much bigger than what we saw from the most troubled banks in the crisis, which illustrates the degree of fear sitting with debt investors. It is an important issue to address specifically with some policy actions.

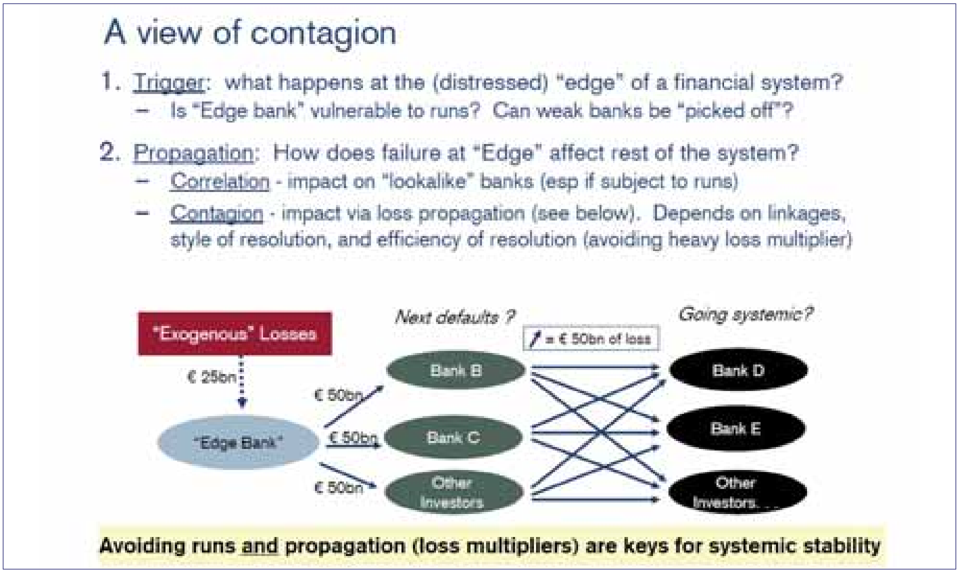
Why is this occurring and what are possible ideas for solutions? First, some thoughts on the contagion – it relates to two factors: a trigger and a propagation mechanism. A trigger is what happens to banks that are in the greatest distress at the edge of the financial system. Is the "edge" bank vulnerable to a run – whether it is a 1930's style run or a 2008 style run? Can weak banks be picked off and transmit that stress to the next bank? Secondly, how do these fears get transmitted through the financial system – how does the failure of the edge bank impact others?

The focus is on two channels:

- correlation to "lookalike" banks. If people see a failure at a certain institution, they immediately read across to institutions that look a lot like the failed bank: "better get out of the lookalike". That is especially an issue where a bank is subject to runs if there is trouble at the edge of the system.
- contagion – how do direct losses propagate through the system? If failure is disorderly and expensive – the failure at the edge bank can create ballooning losses for the rest of the financial system- then we can put a lot of stress on the whole system. In the given case, there was a 25bn loss at the edge bank that was enough to push it over, but where the losses to its liabilities were 6 times larger. That kind of system puts a significant load on the downstream parts of the financial system. If that is enough to knock off that next tier of banks, it can propagate further through the system and start to lead to the fear and gridlock that gripped a lot of the financial markets in 2008 and 2009. Therefore, avoiding runs and propagation are the keys to solving contagion and avoiding financial lockdown.

  What does this mean for today's crisis in chapter 2?

Chart 2. A view of contagion



Source: Author's slide no 5 of the presentation at the Conference session.

Chart 3. Chapter 2: Does Greece = Lehman?

- ☑ Would default give new information re: "too big to fail" policy for sector?
- ☑ Size: Lehman liabilities = ca \$600bn vs Greek debts = ca €350 bn

- ☒ Loss given default was <u>severe</u> in Lehman (91% senior (CDS) loss)
- ☒ Market shock: Lehman traded @~85% pre-BK; Greek debt much lower
- ☒ Accrual books: 21% Greek loss recognized in Q2 without major damage
- ☒ Complexity: far fewer financial links (e.g. swaps, repo) in Greek case

- ◈ At Lehman failure, several "lookalikes" also in distress / run situation
- ◈ Authorities seen to be unprepared for Lehman: "no plan B??"
- ◈ Ability to stem contagion was unclear (though sovereign credit was largely unquestioned in '08)
- ◈ Rules of the road were deeply uncertain and unpredictable

Source: Author's slide no 6 of the presentation at the Conference session.

Triggers: does Greece equal Lehman Brothers? There are a few factors on either side of this. Would the default of Greece be "new information" to the market that was as unexpected as the failure of Lehman was to many? There is a question of size – Lehman had a 600bn balance sheet and Greek debts are not so different in scale. There are some differences, however.

The loss given default in Lehman was severe. Debt traded in the single digits the following week, meaning that losses were something like in 91% in senior debt. These bonds have rebounded since then but losses were still severe. Secondly, the market was unprepared for what Lehman debt was trading in the mid-80's and the week before – the difference was gigantic. In Greece we have already seen markets trade lower so they are better prepared. We've already seen a 21% loss taken through the accrual books in many of the major banks in Europe without huge damage.

Lastly, complexity – there are far fewer financial links in Greece, when compared to what an institution like Lehman would have through swaps or repo.

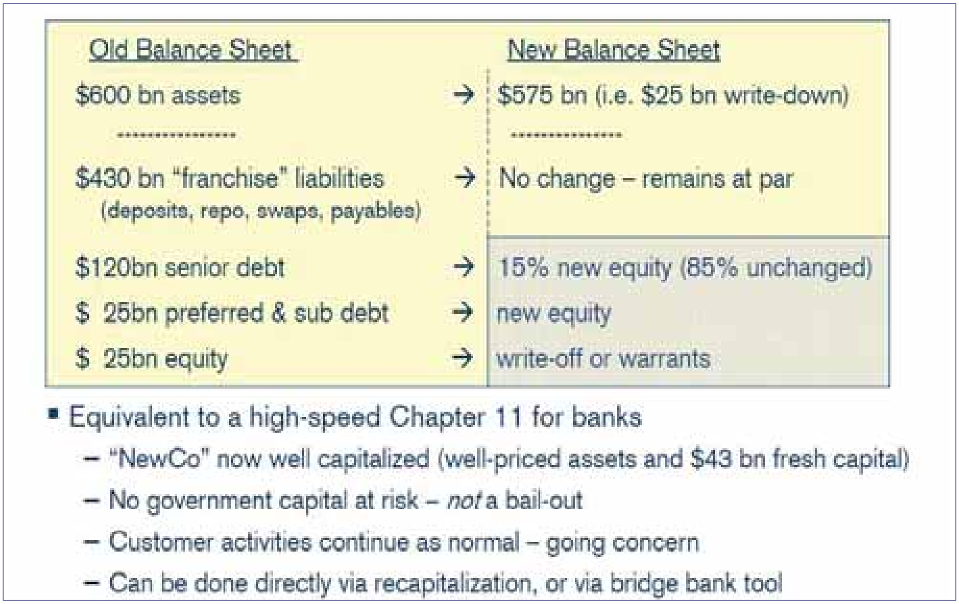
Overall, there are both some important similarities and differences. In Lehman there were several lookalike banks that were also under stress. But the same issue may be applied to certain peripheral sovereigns in Europe – are they sufficiently analogous or sufficiently different? In terms of preparation, the authorities seemed to be unprepared for the Lehman failure. That was a surprise and there was no "Plan B". And the ability to stem contagion was unclear at that time. And finally, one thing that was true then and is true today is that the rules of the road were deeply uncertain and unpredictable. When the markets do not know the rules of who will get what and what is going to happen to their investments, they have a tendency to break down and become dysfunctional.

3. A FEW CONSEQUENCES FOR POTENTIAL SOLUTIONS

What may that imply for potential solutions? Is this Gordian knot of banks and sovereigns that are intertwined – is this something we are stuck with or something we can solve? Probably, more capital and efficient bank resolutions are the keys to cutting this knot. In particular, the bail-in resolution is an important tool to separate these two crises and to help mitigate contagion. It could access trillions of Euros of additional potential equity capacity if needed. If the rules were predictable and clear ex-ante, it would actually <u>tighten</u> spreads and help re-open markets. That is a controversial statement in many banking circles – but bringing predictability back to the system will do wonders for how investors respond to banks. It would help establish a more stable economic process – more sustainable rules of the road that would help the economy and the financial sector to revive.

What does bail-in look like? Here is one example to put a more tangible face on what this means.

Chart 4. What a Bail-in might look like – example



Source: Author's slide no 8 of the presentation at the Conference session.

On the left-hand side of the chart below is a simplified balance sheet of a financial institution with 600bn in assets. It is funded by 430bn of "franchise liabilities" including deposits, repo funding, payables in the transaction system, as well as several classes of investor capital – equity, preferred stock and senior debt. Moving to the right hand side, let us assume that some of those assets are troubled. If you have 25bn of imbedded losses from a financial crisis and bad decisions, that means your assets are only worth 575 bn now. Because balance sheets have to balance, the difference has to go somewhere. In a bail-in, we would not touch the franchise liabilities – depositors, market transactions, collateralized transactions. Instead, losses would be applied to investor capital, and equity would be the first source of loss absorption. In this case, if we had to absorb the 25bn losses that would exhaust the amount of existing equity in the bank, and we would have to create new equity going forward. Therefore, we would turn the junior classes into equity and a small slice of the senior debt.

This would leave us with 43bn of equity capital in the new institutions against well valued assets. This new company would be very well capitalized. No government money would be used here – market activity would continue as normal. If we had these tools in 2008, we could have had very different outcome then we do today.

What is the reason for the strange numbers? These are basically the numbers of Lehman Brothers in 2008. If you had had the restructuring we show on the right hand side of the chart instead of the disorderly bankruptcy that did occur, we would have had a dramatically better outcome.

Chart 5. What Bail-in might look like – Impact on the System

	Actual Lehman	Bail-in Pro Forma
1) Equity	wipe out	warrants
2) Sub debt	wipe out	shares
3) Senior debt	10% to 25%	~par (85% + shares)
Investor Impact	**~$150bn of loss**	**~ $25 bn loss**
– Customers*:	large losses	no loss
– Counterparties*:	large losses	no loss
– Markets:	massive unwinds & deleveraging	relief rally?
– Know Result?	up to 10 years	now

*Incentive for customers/counterparty run is very different between 2 scenarios

Source: Author's slide no 9 of the presentation at the Conference session.

If we look at what that outcome would have meant for the system compared to what actually happened in the Lehman case, there are also large advantages. Bankruptcy wiped out the equity and the sub-debt – the senior debt bounced back a little bit but it still took huge losses. The total investor impact was well over 150bn.

If we could have restructured this like we do with many corporates in the U.S. in a more going concern recapitalization, perhaps it would have been possible to limit those losses to the intrinsic ones on the balance sheet or about 25bn. Importantly, customers and counterparties could have been saved from loss. Instead of a market free fall, we would have seen a relief rally.

Importantly, in this system, the customers and the counterparties have much less incentive to run. Unfortunately, the incentive to run was all too rational in 2008. In the bail-in system, that incentive has been removed. It does not mean runs will be eliminated entirely, but taking the economic incentive out of the picture changes the game quite dramatically.

The lower loss percentages to the investor class would also be important. For example, in the Lehman bail-in scenario, we would not see the money market fund at The Reserve Fund break the buck the next day, which was an event that transmitted the stress into another sector of the financial system in the U.S. We would see a fairly transformative difference if you think about contagion in terms of triggers and propagation – if you move from what we had in 2008 to a system that involved creditor finance recapitalization or bail-in.

4. CONCLUSION

In conclusion: our current situation is complicated, with interlocking crises and some major sovereign issues that need to be addressed. But it is also critical to separate the sovereign crisis from the financial crisis. Separation gives a much better chance at resolving each one of these crises.

Bail-in could be a key tool to address the financial side of this crisis. It would avoid tax-payer bailouts and the stress on government finances. It creates new equity for the system, at the point where it is needed, that can help avoid a deleveraging cycle. The amount of capital it can access is huge, literally trillions of euros. It can handle bigger crises than 2008.

Many people are wary of a clear, strong financial reform, which would be a dramatic change. We should be more concerned about not having such a reform. Previous crises have been met successfully with strong reforms, for example in the 1870's, where we saw the invention of modern central bank. In the 1930's we created deposit insurance in the U.S., and eventually in other countries. These have proven to be transformative economic reforms – fundamental advances that lasted and strengthened the financial system. "Too-big-to-fail" is probably the key challenge of our times. It is not easy to solve, but it is not impossible. And failure is simply not an acceptable option.

Dariusz Filar[*]

THE SECOND PHASE OF THE EVOLVING FINANCIAL CRISIS AND THE GROWING PROBABILITY OF NEXT RECESSION

1. INTRODUCTION

When the global crisis of financial markets set off as of mid-2007, it was difficult to foresee that the crisis would have substantial ability to evolve and that turbulence of financial markets (of the US mortgage market especially) represented only its first, initial phase. As the five-year period 2007–2011 went on, two parallel phenomena could be seen more and more clearly. First, the evolving financial crisis, moving from the territory of investment banks and other financial institutions into the domain of sovereign debt. Second, succeeding phases in the atypical business cycle, with a serious threat of the next recession coming after a very short period of sluggish expansion. These two phenomena developed simultaneously, overlapped to some extent and had a mutual impact on each other, but to each of them a certain autonomy could be also attributed.

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2. SOME REMARKS ON THE SECOND PHASE OF THE EVOLVING FINANCIAL CRISIS

Already on the turn of 2006/2007 many economies were heading towards cyclical contraction following exceptional world growth in the period of 2003–2006. In the summer of 2007 turbulence of the US mortgage market has sparked off a severe financial market crisis which, just one year later – since the summer of 2008 – significantly accelerated and deepened the foreseeable recession. The worst of this recession came in the first half of 2009.

Until the turn of 2008/2009, fiscal activism did not enjoy a very good image. Among economists, the opinion predominated that the best instrument for overcoming a recession is monetary policy. However, in view of the depth of the 2008/2009 recession and the poor operation of the monetary transmission mechanism, many governments decided to implement fiscal stimulus policies as an alternative strategy to counteract the recession and strengthen a recovery of confidence.

Fiscal program measures contributed to a gradual recovery which started in the second half of 2009. But, the governments which put forward these measures significantly increased fiscal deficits and did not avoid huge increases in government borrowing, thus increasing the public debt and raising doubts about their fiscal sustainability. An adverse reaction in financial markets – strong increase of yields of many countries' government bonds – was only a matter of time. The deterioration of public deficits in selected countries at the turn of 2008/2009 is shown in Table 1.

Table 1. The public deficits 2007–2010

	2007	2008	2009	2010
€uro Area	0.7%	2.0%	6.3%	6.0%
USA	2.9%	6.3%	11.3%	10.5%
Japan	2.4%	2.1%	7.1%	7.7%

Source: Eurostat, OECD.

In consequence, at the turn of 2009/2010, the financial markets were slowly getting back to normal, but their crisis transformed into a sovereign debt crisis. The last one could be classified as a second phase of the evolving, general financial crisis. Simultaneously, the recession phase ended in the second half of 2009. It opened the way to sluggish expansion (with modest growth and high unemployment).

The sovereign debt crisis which fully developed in 2011, meant the inability of some governments to borrow at reasonable interest rates. Many investors were unlikely to buy the debt of the small peripheral countries (Greece, Ireland and Portugal) and numerous funds were reluctant to buy the debt of Spain and

Italy, too (Italy could still borrow in public markets, but only at rates that seemed unsustainable). These troubled countries' spread with German debt, which has become the reference point for the entire European region, and American Treasuries, shot up to the highest levels since the euro came into being. The public debt spreads (ten year government bonds) with German Bunds and US Treasuries on Wednesday, October 19, 2011, are shown in Table 2.

Table 2. Bonds – ten year government spreads vs Bunds and Treasuries

Country	Bid Yield	Spread vs Bund	Spread vs US Treasuries
Greece	25.10	+23.02	+22.94
Portugal	12.21	+10.13	+10.05
Ireland	8.70	+ 6.63	+ 6.54
Italy	5.92	+ 3.85	+ 3.76
Spain	5.39	+ 3.32	+ 3.23
Belgium	4.46	+ 2.38	+ 2.30
France	3.20	+ 1.12	+ 1.04

Source: ThomsonReuters.

It is worth noticing that huge spreads in the eurozone debt markets are at complete variance with the theoretical framework of Optimum Currency Area (OCA) created by R.A. Mundell and J.C. Ingram. According to these authors, the evenness of the long-term interest rates represents one of the basic features of Optimum Currency Area and excessive diversity in this realm indicates the lack of proper integration of financial markets which is required to delineate OCA.[1]

The sluggish expansion which extended since mid-2009, seemed to approach its end in the summer of 2011. The significant deterioration of many economic activity indicators could be observed and the main indicator, gross national product (GDP), started to record diminishing advances (especially in Europe). In most of the advanced economies the growth forecasts for 2012-2013 were tending to be lowered and fears rose that the developed world might be tipping back into recession.

Two recessions narrowly separated by short (about 20-22 months) and sluggish expansion represent a rather atypical business cycle, but such occurrence on no account could be perceived as unprecedented. Since 1929 the National Bureau of Economic Research (NBER) identified at least three episodes when new recession came after a short-lived expansion (see Table 3).

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1 See Ingram, J.C., *Comment – The Currency Area Problem,* in: *Monetary Problems of the International Economy* (Mundell, R.A., Swoboda, A.K., eds.), Chicago 1970.

Table 3. Duration of expansion and contraction phases (in months)

Date the recession started	Duration of preceding expansion phase	Duration of recession phase
September 1929	21	43
May 1960	24	10
August 1981	12	16

Source: NBER.

3. CONCLUDING REMARKS

Probability of the next recession of unknown depth and duration is not the only uncertainty regarding the medium-term outlook which emerged at the end of 2011. At the same time, the serious sovereign debt crisis that came from the financial markets crisis starting in 2007, seemingly began to move into the territory of central banks. Because of this, the third phase of the global financial crisis could be constituted by the undermined credibility of central banks and the elevated inflation.

The risk that the evolving financial crisis would eventually encompass central banks results from the fact that troubled governments seem keen to pass their debt burden exactly in this direction. During the two-year period 2010–2011 monetizing debt became a broadly used tool of macroeconomic policy. The Bank of England launched at least two rounds of buying governments bonds with newly created money, known as quantitative easing (QE). The US Federal Reserve made two extensive attempts at quantitative easing before beginning a new policy called Operation Twist. Even the European Central Bank, which remains faithful to German tradition of conservative central banking, decided to buy – in the secondary market – the bonds of Italy and Spain, just after making significant purchases of the Greek bonds.

The extraordinary actions of central banks have resulted in big expansion of their balance sheets – those of the US Federal Reserve and Bank of England have tripled, while the ECB's has almost doubled. This extensive monetization of public debts didn't create excessive inflationary pressures at the time of modest growth and subdued credit expansion. Financial institutions that sold sovereign bonds were in search of a safe asset, and this was primarily central bank money. That money was accumulated in a form of additional liquidity and was not used to expand credit – dynamic of money supply, described by the M3 aggregate, stood at relatively low levels and did not lead to a notable rise in inflation. However, it is not clear what could be the effect of the heightened central banks' balance sheets in a longer term. Probably, at the end of 2011, it was still not the time to profile the “exit strategies”, but neither was it the time to neglect the risk of high inflation some future day. Eventually, the likely route out of the sovereign debt crisis (the second phase of the financial crisis) could be through inflation (the third phase of the financial crisis).

The combination of weakening economic activity and central banks reaching the limits of their own credibility created an environment with vast amounts of headline risks. Unfortunately, this combination gives the impression of being an unavoidable component of the nearest future.

Session 2:

New Macroprudential and Microprudential Safety Nets

Marek Belka*

THE NEED FOR MACROPRUDENTIAL SUPERVISION

1. INTRODUCTION

The need for macroprudential supervision is being currently discussed in many countries. However, macroeconomic (or macroprudential) supervision, sometimes called systemic supervision, has not been a hot topic recently in Poland. Most probably because the awareness of the crisis in this country is generally very low, simply because there was no bank crisis but mere asset freeze. The extended access to repo operations and a fistful of foreign exchange swaps were enough to satisfy the demand for additional liquidity in Polish banks.

However, those experiences were not typical. In general, the global banking crisis accentuated the importance of financial stability role of central banks that started to be apparent as early as in the late nineties. Central banks limited their activity in this field mostly to preparing Financial Stability Reports and some moral suasion. The current crisis has proved that this approach was insufficient. What became apparent during the crisis was that inefficiencies of the financial sector may have really grave and real effects. The crisis also illustrated – what is equally important and not frequently realized – that large imbalances and vulnerabilities may develop in the real economy even if the financial sector looks stable and is relatively stable as was the case for example in Spain. Thus, now the need to extend the framework of macroprudential policy is obvious.

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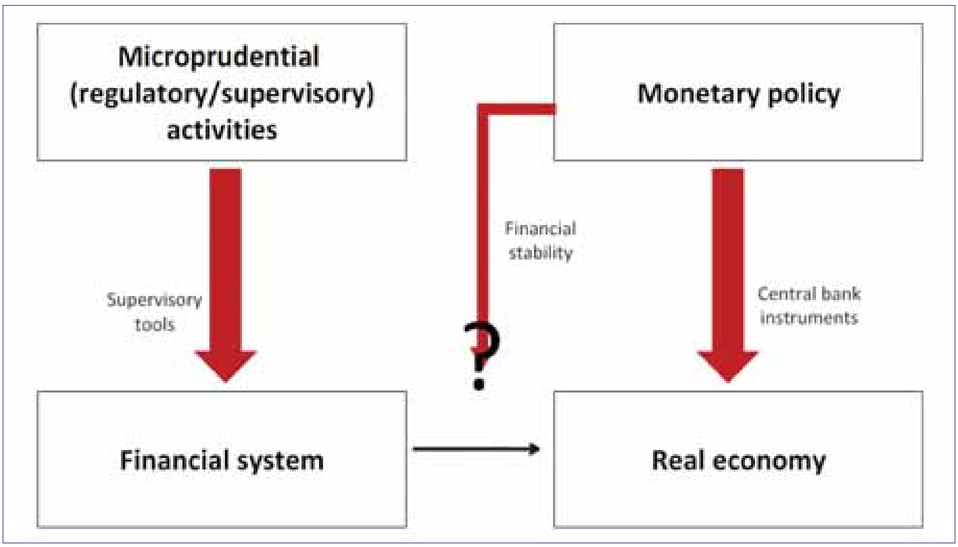
2. OUTLINE OF TWO MODELS

Before the crisis, monetary policy and banking supervision were effectively separated. Central banks were responsible for price stability. Supervisory authorities were responsible for the solvency of individual, especially systemically important, banks. Macroprudential policy was regarded as potentially important but with no dedicated tools (with the exception of moral suasion) it was toothless. Now this has changed in the sense that central banks treat the financial stability mandate much more seriously and macroprudential policy is treated as a legitimate, second target of the central banks. However, if central banks are responsible for macroprudential policy, they should be equipped with proper and effective tools.

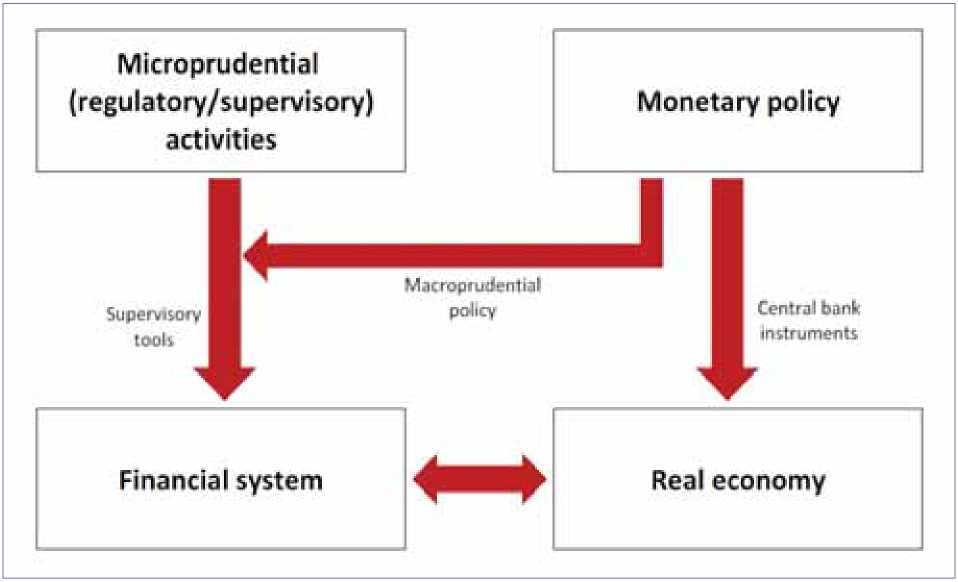
Chart 1. Microprudential supervision and monetary policy segmented model



Source: Author's slide no 3 of the presentation at the Conference session.

One of the crucial issues is having a clear understanding of what are the tasks of macroprudential policy. How should the financial stability and the tasks of the macroprudential policy be defined? In the literature there are quite many definitions of financial stability. They stress a number of factors. Firstly, the financial system is providing efficiently financial intermediation and risk management services to the non-financial sector. This is the main issue. The second is the low probability of a systemic crisis, however the word "systemic" usually refers to the financial system. Financial stability is also defined as a situation where financial institutions have high enough capital to absorb their potential losses.

Chart 2. Microprudential supervision and monetary policy correlated model



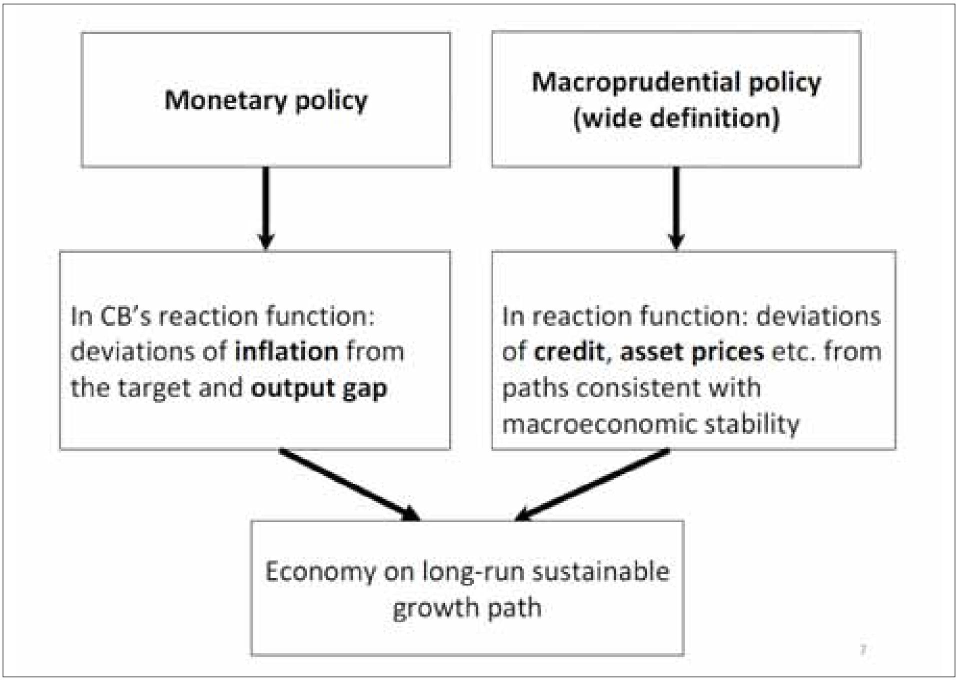
Source: Author's slide no 4 of the presentation at the Conference session.

3. THE ROLE AND THE MAIN OBJECTIVE OF FINANCIAL STABILITY POLICIES

What is the role of financial stability? What is the main objective of financial stability policies? Let us assume that such objective is to prepare the financial system for low probability but high impact events. Such an approach is still dominating in the literature, but it is a narrow definition of macroprudential policy tasks. There is definitely a need for a wider definition of macroprudential policy task. As was highlighted by Charles Goodhart and Olivier Blanchard, macroprudential policy should be an additional weapon of a central bank for stabilizing the economy. Thus the task for macroeconomic policy should be stabilizing the output gap, i.e. fluctuation of GDP around the potential output. In this broader definition, macroprudential policy would be more effective also in stabilizing the financial sector, because implementation of such approach would lead to a more active and forward looking use of macroprudential instruments.

The monetary policy can be described as a central bank reaction function, which includes deviations of inflation from the target and changes in the output gap. This is the operational objective of the central bank. In the macroprudential policy realm the reaction function includes also deviations of credit, asset prices

Chart 3. Functions of monetary policy and macroprudential policy in sustainable growth:



Source: Author's slide no 7 of the presentation at the Conference session.

and other relevant variables from paths consistent with macroeconomic stability. Together, the monetary policy and the macroprudential policy should make the economy remain on the long-run sustainable growth path.

Why should this wider definition of macroprudential policy tasks be used? Are the current central bank instruments not efficient enough? The recent crisis illustrated that they are not. The reasons are the growing role of the financial sector, lower sensitivity to monetary policy instruments in boom times, and also some special cases like with countries being in the ERM II. Such countries may have a problem how to reconcile the low inflation with keeping exchange rates within a certain band. Additional challenge for policy makers is how to react to asset price booms that do not result in apparent financial system instability.

Let us imagine the cases when macroprudential policy action would be a necessary (or at least beneficial) macroeconomic tool even if there was no outright threat to the financial stability. Spain is a useful example. In the core of the financial sector – the banking sector — macropolicies have preserved the basic stability of the Spanish financial sector. Of course, it is the special case of

Spanish ‘caixas’. What is important is that the core banks in Spain are healthy and strong. The microprudential instruments used for macroprudential purposes were effective in preserving the strength of the Spanish banking sector. However, from the macroeconomic point of view, it proved to be insufficient. Spain got into a severe economic crisis resulting from the long-term unsustainable lending boom, followed by a bust. This is a striking example that the narrower definition of macroprudential policy task is not sufficient.

Focus the attention on Poland, what are the lessons from the unfortunate Spanish experiences for this country? The fact that Spain and Poland are very similar in a sense that both were, or are at a certain stage of their development “a catching-up” country cannot be escaped from. Spain probably cannot be called “a catching-up” country anymore. Poland certainly can. It is going through the similar road of economic development as Spain went through in the 1980s and the 1990s.

4. THE NEED FOR MACROECONOMIC PERSPECTIVE IN MACOPRUDENTIAL POLICY

The next important issue is why the macroeconomic perspective is needed in the macroprudential policy. The narrow understanding of the macroprudential policy stresses vulnerabilities (risk exposures) and the loss absorption capacity of the financial sector. However, there might be unintended macroeconomic consequences of actions targeted at reducing risk exposures. We can reduce risks within the financial sector, but those risks will reappear somewhere else. They will reappear in the real sector. Here are two rough examples.

Let us first consider an example of a catching-up economy: one of the possibilities is that such an economy suffers from a shortage of savings. This is a textbook case. It is not necessarily the case all over the global economy, but certainly it is typical for Central Europe. The shortage of domestic savings is supplemented with foreign capital inflows. Therefore, the banks, especially if the general situation is conducive to it, resort to foreign financing. They bring in foreign currency capital and they lend it out. This phenomenon is often described and explained using demand-side view, namely that borrowers, households and corporates, especially the smaller companies, are tempted to borrow in foreign currencies because of the interest rate differential. That is true, but let us look at this from the other point of view: that the banks have a market for loans. They want to expand those markets. Thus, they bring in foreign capital and they lend it out. From the risk management perspective, as far as market risk factors are concerned, the easiest option for a bank is to lend in foreign currencies. The result is pushing over the risk to unhedged borrowers. This way the banks avoid the risk accumulation and the currency mismatch within the bank at the cost of the real sector (credit risk is not considered here, but the recent experience shows that banks tend to put less emphasis on credit risk management during boom periods). Which comes first: is the supply side or the demand side more important? Clearly, if one wants to avoid risk within the financial institution, one has to unload those risks into the real sector.

The next example is related to the maturity transformation. Again, a look at that matter from the perspective of a situation where a financial institution is necessary. Long-term mortgages are lent, so they need to be balanced out with long-term liabilities. But in the balance sheet there are short-term deposits of the non-financial sector. This is more a potential than what is really happening, a tendency of the banks, especially as a consequence of the crisis, to try to go away with the maturity mismatch and resort to some longer term liabilities. Where to find them? For instance in the investment funds which would provide such long-term instruments. However, then the banks would not be interested in taking short-term deposits anymore. They would make short-term deposits less attractive and push the depositors to invest in other instruments, more risky, like mutual funds. Again, the result would be a sub-optimal structure of assets on the part of non-financial sector agents. If the maturity mismatch is to be eliminated within financial institutions, something needs to be done to unload this kind of risk to someone else. And this “someone else” is the real sector. Therefore, thinking of macroprudential supervision only in terms of financial sector instability, may be too narrow a meaning. It may be insufficient to notice imbalances developing beyond the financial sector, in the real sector, even if they originate in the financial sector.

5. CONCLUSION

The summary is basically a plea to understand the macroprudential stability function, macroprudential supervision in its broader sense. It makes sense to consider macroprudential supervision in terms of stabilizing the output gap, identifying and stabilizing macroimbalances that may develop not only within the financial sector but also outside of it.

*Per Callesen**

NEW MACROPRUDENTIAL AND MICROPRUDENTIAL SAFETY NETS

1. INTRODUCTION

In my presentation I will focus on macroprudential policy issues. Remarks will also be made on the treatment of government bonds in financial regulation as well as resolution regimes. I think both issues are important, also from a macroprudential perspective.

The crisis made it clear that we need a new framework and a battery of instruments for macroprudential policy. One way to define macroprudential policies would be policies targeting system-wide financial stability which are conceptually in-between macroeconomic instruments on the one hand and firm-level microprudential instruments on the other hand. A comprehensive framework for macroprudential policies has not been developed yet, but we are moving closer to it. The ESRB is an important step. International financial regulation is working at high speed. National macroprudential institutions are at a somewhat earlier stage.

In terms of the framework for national macroprudential institutions, we need to ensure focus, develop instruments and take specific actions. One of several challenges is that a variety of institutions such as legislators/governments, central banks and supervisors are in charge of the instruments.

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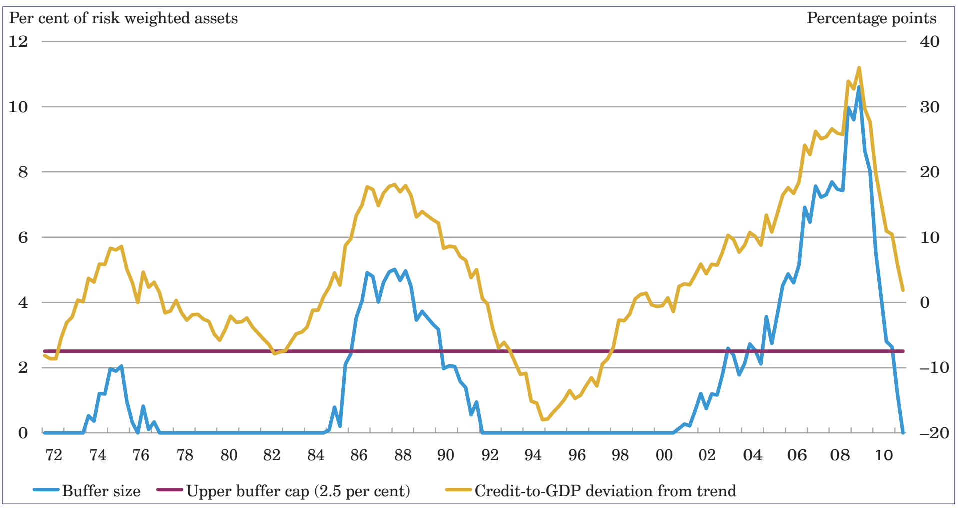
A national macroprudential council is a good idea. It can preferably be anchored at a central bank level, where it can rely on sufficiently independent analyses and where the risk of getting trapped by firm-specific issues is small. But the council can be broader and include ministries, supervisors and independent experts. It is not realistic to have a broad shift of decision power on all instruments to such a council. But strong peer pressure is needed. We need formal recommendations, a voting procedure and a comply-or-explain system.

2. MACROPRUDENTIAL INSTRUMENTS

When it comes to macroprudential instruments, I will start off with the countercyclical capital buffer. Looking at the credit-to-GDP deviation from trend, a buffer based on credit growth – such as proposed by the Basel committee – had clearly been helpful in my country before the crisis. The calculation of the historical credit-to-GDP gap in Denmark shows that a cap on the buffer requirement of 2.5 per cent would not have been very ambitious, cf. chart 1.

Chart 1. Countercyclical capital buffer with no upper cap



Source: Danmarks Nationalbank.

The next crisis will likely differ and it would be risky to base the future countercyclical buffer entirely on credit growth. Other important indicators can be:
- ❖ Credit-to-GDP gap in households and non-financial enterprises, respectively
- ❖ General asset prices, houses and equities

- Balance sheets and leverage
- Depreciations and interest margins
- Market indicators for banks, stock prices and CDS-spreads
- Lending surveys.

We need a broader set of instruments and in that context one can raise concerns about the Commission's CRD-IV proposal, which strives for maximum harmonization. There are good arguments for maximum harmonization, as it ensures a level playing field. However, we have to shift the balance of emphasis – at least to some extent – from promoting the small annual efficiency gains in normal times to preventing the rare but large losses in crises-times.

The Commission suggests only three macroprudential instruments for use by national authorities: The countercyclical buffer, LTV and risk weights. I will argue that we need more. Candidates include liquidity, large exposures, transparency and dynamic provisioning.

On provisioning, I am among those who are skeptical towards the current accounting rules on provisioning which were implemented from 2005. The risk associated with lending is taken when the loan is provided, not after asset prices have fallen. Accounts grossly overstated the underlying profitability of financial institutions and fooled investors into excessive risk-taking. I understand that the rules on provisioning are being revised, but is it sufficient?

A final point on macroprudential instruments: One should never underestimate how difficult it is to take unpopular decisions in good times. Strong macroprudential councils can help a lot. But automaticity is better. Automaticity could be built into legislation directly, such as with dynamic provisioning. The countercyclical buffer is also a strong potential automatic stabilizer. Other indicators could equally trigger specific action.

3. LIQUIDITY

While we move ahead with better macroprudential regulation, we should be careful not to introduce new legislation which can be destabilizing. One such risk relates to the upcoming liquidity requirements. Sound requirements for liquidity may be helpful, but the definition of liquidity is not trivial and there are large institutional differences between countries to be taken into account. One can make big mistakes.

The proposed initial Basel standards on liquidity suggest preferential treatment of all government securities when counting liquid assets towards the LCR. According to that proposal only 40 per cent of the liquidity requirement can be met by, for instance, covered bonds, irrespective of their quality. Such preferential treatment of government bonds may be helpful in boosting demand for bonds from governments facing financing challenges. However, as regards financial stability, such preferential treatment would hardly be credible. It could potentially be destabilizing as markets are unlikely to perceive all government bonds as being fully liquid at all times.

My point here is not that the financial sector in my own country will have no chance of meeting such requirement due to a "shortage" of government bonds. Banks in Denmark would by and large be forced to buy up close to 100 per cent of all outstanding government debt to meet the requirement. That national problem can in principle be solved second best with an exception for countries with insufficient amounts of Basel standard "liquid" assets, in this case government bonds.

My concern is the financial stability in Europe at large and that I find it conceptually wrong to group the liquidity of assets solely on the basis of the institutional origin of the issuer. One thing is to insist that government securities are always risk free. For such securities to always be fully liquid is an even stronger (and less credible) requirement. Note that liquidity in this context is solely the marketability of the assets, namely the ability to sell the assets at short notice, at predictable prices and without creating market disruptions. It is positive that the Commission in the CRD-IV proposes to base the definition of liquidity on their actual performance ensuring their necessary qualities. That is at the same time safer, more credible and economically sound.

As an example, I can add that the actual liquidity performance of Danish mortgage bonds has been strong even at the worst of times during the crisis, and as strong as that of government bonds.

4. RESOLUTION SCHEMES

Finally, I will make a few remarks on resolution schemes. Resolution is of course at first glance more about crisis management than macroprudential policies. But the two issues interact. On one hand, the absence of credible resolution regimes gives rise to well-known moral hazard problems and put tax payer money at risk. On the other hand, evidence of creditor losses can trigger rating down-grades and upset funding due to contagion.

The experience of the Danish resolution regime may have some interest. Insightful people claim that they followed our resolution policies with interest. As a starting point, I would like to point out that all EU countries share the same deposit guarantee system – with a ceiling of 100,000 Euros – and EU competition law suggests no special treatment to creditors of banks as compared to creditors of other private enterprises. However, in Europe – unlike the US – practice has been much more lenient. Authorities have, on a case by case basis, done their utmost to manage resolution in such a way that also uninsured depositors and senior bond holders bear no losses. In part, this may have been due to an absence of other practical arrangements to ensure the stability for bank customers and payment systems etc.

The point of the Danish resolution regime is that we found a practical way to manage resolution over a weekend including full take over of the bank, allocating losses as appropriate and still ensuring that all customers have continued access to their savings and payment services on Monday morning. That is not possible through normal bankruptcy proceedings.

According to the Danish resolution regime, the distressed bank is taken over by our so-called Financial Stability Company (FSC). Based on a government relending facility, the FSC injects capital and liquidity into a bridge bank. Shareholders, providers of hybrid capital and subordinated debt holders bear losses. For unsecured creditors and uninsured depositors an initial haircut – if necessary – is applied. The haircut is based on a very conservative gone-concern assessment of the assets by independent auditors. The creditors will typically receive more funds later when a new assessment is made after 3 months and eventually when all assets are sold. For the first bank (those dealt with under the resolution regime have been small banks) managed under the system in early 2011 an initial haircut of 41 per cent was 3 month later revised down to 15 per cent.

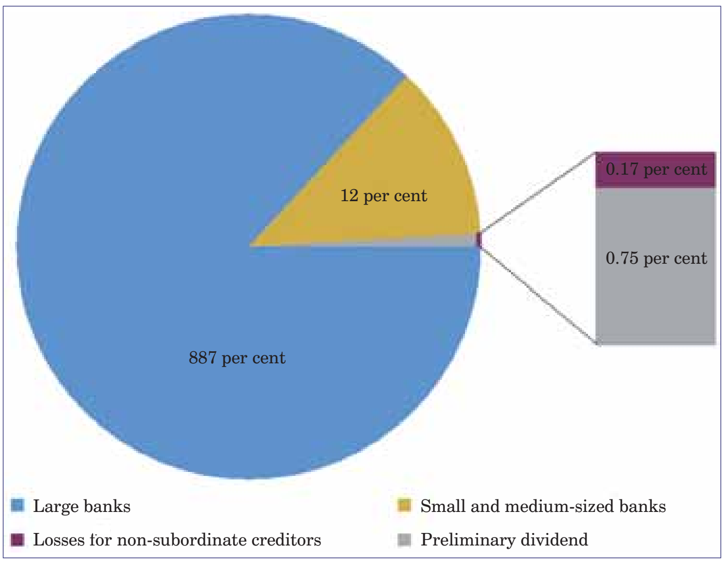
Four points should be made on the Danish experiences so far:

- ❖ First, this is the preferred kind of solution. Distressed banks should acknowledge their trouble much earlier and seek mergers with more healthy banks. In September 2011, another small bank was managed in such a manner, assisted by some new legislation allowing for a dowry provided by the government on the basis of the imputed loss otherwise to be born by government due to losses on government guaranteed funding. Admittedly also, the regime is unlikely to be applied for large banks were they to become distressed.
- ❖ Second, the heated public debate on the resolution regime has been out of proportion. The vast majority of the Danish banking sector is in good shape. The larger banks all passed the 2011 EBA-stress test with high margins. Among more than 100 small banks, most have sound fundamentals. But there is a minor tail of vulnerable small banks which before the crisis exposed themselves not least to risky property developers. The two failed banks in Spring 2011 made up less than 1 per cent of the sector. The temporary haircut of 15 per cent applied for them thus compares to less than 0.2 per cent of total non-subordinated debt in Danish banks, cf. chart 2.
- ❖ Third, according to anecdotic evidence, foreign funding for other Danish banks was nevertheless negatively affected during spring, possibly triggered by rating down-grades of the so-called systemic support element for banks, and an exaggerated public debate. It is more difficult to offer hard evidence of funding

stress during the spring. Funding definitely took place and in the context of a fairly healthy liquidity position other banks no doubt postponed new funding contracts. The stress observed in funding markets in the second half of 2011 appears to be due to the general European issues.

❖ Fourth, banks appear to be speeding up their consolidation efforts across the board, pointing to a healthier sector a few years ahead, although possibly to some extent, at the expense of their lending. Such a sound resolution regime will contribute to a healthier sector looking ahead, but the transition is harder in the absence of a level playing field. Several other Member States are moving in the same direction, although with no actual resolution being implemented yet on those lines. We therefore look forward to the EU-Commission's proposal for a common resolution and crisis management framework and hope a sound proposal will be backed by Member States.

Chart 2. Non-subordinated debt in Danish banks



Source: Danmarks Nationalbank.

Session 3:

Crisis Management – the Role of the Resolution Regime

Martin J. Gruenberg*

SOME REMARKS ON THE CRISIS RESOLUTION REGIME FROM THE FDIC PERSPECTIVE

1. INTRODUCTION

The FDIC has been given significant new responsibilities under the Dodd-Frank Act to resolve systemically important financial institutions (SIFIs). Prior to the Dodd-Frank legislation, there was no authority in the United States for the FDIC to place a large non-bank financial institution into public receivership. The FDIC had the authority to place banks into receivership, and has closed over 400 to date since the beginning of the crisis. With the failure of Lehman Brothers, it became apparent that bankruptcy courts are not prepared to handle such failures of large, non-bank institutions. The new legislation provides the FDIC with public authority to place any financial institution into a public resolution process, including those designated as systemic.

2. NEW AUTHORITIES GRANTED TO THE FDIC UNDER THE DODD FRANK ACT

Specific new authorities granted to the FDIC under the Dodd Frank Act include an Orderly Liquidation Authority to resolve bank holding companies and non-bank financial institutions, if necessary, and a requirement for resolution plans that will

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give regulators additional tools with which to manage the failure of large, complex enterprises.

The FDIC has taken a number of steps over the past year to carry out these responsibilities.

First, the FDIC established a new Office of Complex Financial Institutions to carry out three core functions:

- ❖ Monitor risk within and across these large, complex firms from the standpoint of resolution;
- ❖ Conduct resolution planning and the development of strategies to respond to potential crisis situations; and
- ❖ Coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year, this office has been developing its own resolution plans in order to be ready to resolve a failing systemic financial company. These internal FDIC resolution plans – developed pursuant to the Orderly Liquidation Authority, provided under Title II of Dodd-Frank – apply many of the same powers that the FDIC has long used to manage failed-bank receiverships to a failing systemically important financial institution. If the FDIC is appointed as the receiver of such an institution, it will be required to carry out an orderly liquidation in a manner that maximizes the value of the company's assets and ensures that creditors and shareholders appropriately do not bear any losses. The goal is to close the institution without putting the financial system at risk. This internal resolution planning work is the foundation of the FDIC's implementation of its new responsibilities under Dodd-Frank.

In addition, the FDIC has largely completed the related rulemaking necessary to carry out its responsibilities under Dodd-Frank. In July, the FDIC Board approved a final rule implementing the Orderly Liquidation Authority. This rulemaking addressed, among other things, the treatment of similarly situated creditors, protection for employees of covered financial companies that continue to work for the company following failure, and protection for policyholders of insurance companies under the orderly liquidation process.

3. TWO NEW RULES REGARDING RESOLUTION PLANS: "LIVING WILLS"

The FDIC Board also recently adopted two rules regarding resolution plans that systemically important financial institutions themselves will be required to prepare – the so-called "living wills".

The first resolution plan rule, jointly issued with the Federal Reserve, implements the requirements of Section 165(d) of the Dodd-Frank Act. This section requires bank holding companies with total consolidated assets of $50 billion or more and certain nonbank financial companies that the Financial Stability Oversight Council designates as systemic, to develop, maintain and periodically submit resolution plans to regulators. The plans will detail how the top-tier legal entity in the enterprise – as well as any subsidiary that conducts core business lines or critical operations – would be resolved under the U.S. Bankruptcy Code.

Complementing this joint rulemaking, the FDIC also issued an Interim Final Rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain and periodically submit plans outlining how the FDIC would resolve it through the FDIC's traditional resolution powers under the Federal Deposit Insurance Act.

These two resolution plan rulemakings are designed to work in tandem and complement each other by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm. Both of these resolution plan requirements will improve efficiencies, risk management and contingency planning at the institutions themselves. They will supplement the FDIC's own resolution planning work with information that would help facilitate an orderly resolution in the event of failure.

4. CONCLUDING REMARKS

We expect that the process of developing these plans – or "living wills" – will be a dialogue between the regulators and the firm. It is not a simple "check-the-box" exercise, and it must take into account each firm's unique characteristics. The planning process must also be iterative, especially for the largest and most complicated firms.

Together, these efforts will ensure comprehensive and coordinated resolution planning for both the insured depository and its holding company and affiliates in the event that an orderly liquidation is required.

Lars Nyberg [*]

CRISIS MANAGEMENT – THE ROLE OF THE RESOLUTION REGIME[1]

1. RESOLUTION REGIME WILL INFLUENCE OTHER BANK REGULATION

Bank regulation should be based on backward induction. It means that we must not confound the timing of events and the logic of incentives. Of course supervision will precede crisis management, which in turn would precede bank resolution. But the importance of resolution regime lies not least in its incentives for bank behaviour, which in turn has implications for how supervision and crisis management should be set up.

2. NORMAL BANKRUPTCY IS NOT ALWAYS AN OPTION FOR BANKS

Why are we reluctant to let a bank go bankrupt, like any other corporation?

Banks, at least of a certain size, are often systemically important. This is because the payment system is crucial to the modern economy, and because banks are tightly interconnected.

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[1] „Although the views expressed here are not very controversial, they are mine and do not necessarily represent those of my colleagues or the official policy of Sveriges Riksbank" [Lars Nyberg].

Banks are not only more important to the overall economy than other firms – they are also more vulnerable. This is mainly because banks' lending is long-term, while the financing is mostly short-term. Even rumours about problems may induce creditors to retrieve their money almost immediately.

A bankruptcy implies that payments are suspended, pending an investigation of assets and their distribution among creditors. But for the reasons mentioned above, suspending a bank's payments can have severe effects on the overall economy.

The combination of a pivotal role and a special sensitivity of banks make it necessary with a special framework for handling banks in trouble. While banks are more strictly regulated and supervised than most other firms, we cannot rule out problems. When that happens, policymakers and regulators may have to let a systemically important bank live on, at least for a while. That may apply also to small banks.

3. WE NEED A LEGAL FRAMEWORK FOR DISTRESSED BANKS

Policymakers and regulators must have the power to intervene on time. 'On time' means as soon as banks do not measure up to the legal standards, or even before that.

The need for swift intervention implies that governmental authorities, rather than courts, should handle the matters. Needless to say, shareholders and creditors must have a legal protection. However, the government's intervention must not be delayed, and owners must not benefit from it. Therefore the protection should be in form of an *ex post* compensation – should such a compensation be judged appropriate.

4. THE AUTHORITIES NEED APPROPRIATE TOOLS

The authorities dealing with bank recovery and resolutions need appropriate tools.

It is often efficient to find a buyer or a stronger player willing to merge with the distressed bank. Such a sale may require government guarantees for certain assets or divestitures of some activities. In some cases, minimizing costs to the public purse may require preferential treatment of some creditors. The authorities may need that mandate. However, it should be applied with restriction and only when it does not hurt other creditors more than a bankruptcy.

With this mandate, an authority may for example split up banks into a good and a bad bank. The good bank, or bridge bank, could then live on and be sold. Such a separation helped solve the Swedish banking crisis in the early 1990s.

The authorities also need the ability to secure the financing of the distressed institution. They should not be encumbered by a general payment restriction. Payments must be allowed, taking into consideration not only shareholders and creditors, but the whole financial system. In some situations, the government must eliminate all uncertainty by nationalizing the bank and then recapitalize it.

As is known, in recent years policymakers have been rather busy coming up with new solutions to strengthen the resilience of individual banks and the financial system. National inquiries, EU, the Basel committee and the G 20 Financial Stability Board are all considering ways of making creditors contribute to troubled banks, in an orderly fashion. One important idea is the so-called *bail-in bonds* – debt instruments that are junior to other debt and that can be written down immediately after equity. Another idea is so-called *CoCos* – bonds that can be converted into capital, for example when the equity ratio has fallen below a certain threshold – either automatically or based on supervisory judgment.

However, there are important considerations to be made before implementing such instruments. Suffice it to say that rules have to be thought through and transparent, in order to avoid unintended effects.

5. THE CRISIS HAS SPURRED REGULATORY INITIATIVES

The experience since 2008 has triggered regulatory initiatives worldwide. First, we see a development of national regulation. The Dodd-Frank Act in the United States is perhaps the most comprehensive and well-known, but similar work is going on also for instance in the EU Commission and in the United Kingdom. Another strand of regulation is the development of regulation and resolution tools for large, systemically important and complex financial institutions. This work is underway both nationally and internationally.

6. RECOVERY AND RESOLUTION PLANS SHOULD FACILITATE ORDERLY CRISIS MANAGEMENT

An important outcome of the regulatory work are RRPs – recovery and resolution plans. They are currently under development in many countries. *Recovery plans* serve as a guide to distressed banks while they are still under control of management. They include plans to conserve capital and liquidity, divest businesses, restructure liabilities, and so on. Recovery plans are written by banks, and reviewed by the supervisor. *Resolution plans* guide authorities on how to resolve banks if recovery fails. They address systemic activities, legal and business structures, cross-border issues, vital IT systems, etcetera. Resolution plans are written by authorities (home and host) on the basis of information provided by banks. SIFIs lacking a credible RRP could be subject to regulatory sanctions, as suggested for instance by the Vickers commission in the UK. The Basel Committee and FSB will be requiring G-SIBs – global systemically important banks – to have a framework for crisis management in place. These are all important steps. However, RRPs are unlikely to be a panacea.

7. INTERNATIONAL BANKING REQUIRES ADDRESSING CROSS-BORDER RESOLUTION

Over the last decades, banking has become a truly global business. When virtually all major banks have international operations, cross-border issues have to be an integral part of resolution planning. It is not necessary to dwell on Fortis or Icesave to make the point.

Therefore, cross-border issues must be integral to resolution planning. All countries need a national crisis management and resolution framework. They must be effective and build on a common philosophy on how to tackle problems when they occur. National frameworks have to be compatible. Effective cross-border resolution also requires cooperation and preparations for burden-sharing.

8. THE NORDIC-BALTIC INTEGRATION IS ONE EXAMPLE

In the Nordic-Baltic region the interconnectedness was discovered when – if not before – Estonia, Latvia and Lithuania were hit by the crisis in 2008. Two Swedish banking groups had relatively large business in the Baltic countries, and the banking sector in those countries became crucial to financial stability also on our side of the Baltic Sea. In addition, banks headquartered in Sweden have a considerable market share in the other Nordic countries.

Our – meaning the Nordic-Baltic – response to the current situation has been an intensified cooperation. The memorandum of understanding of 2008 between all supervisory authorities, central banks and finance ministries in EU was a good first step. Signing the MoU was not the end of a cooperation process – but rather the first step in a process to build trust and exchange information. As was agreed in the MoU for EU, all European authorities should set up cross-border stability groups when they have common financial stability concerns.

And cooperation builds on confidence, which takes some time to build. The Nordic-Baltic stability group involves the finance ministries, central banks and supervisory authorities in the five Nordic and three Baltic countries. The task is to set up procedures on how to act in a crisis situation. Ultimately this should enhance the preparedness for managing a crisis.

9. BURDEN-SHARING NEEDS TO BE THOUGHT THROUGH

Finally, there is the issue of burden-sharing.

Higher capital standards, new macroprudential and resolution frameworks will remove or at least reduce the use of taxpayer funds, which is very welcome. Nevertheless, resolutions will still require money (either through bail-in or the use of resolution funds). Therefore, there will be a need to agree on how the cost of resolutions should be shared. Unfortunately, the division of the financial burden in cross-border resolution has hitherto often seemed to be too hot a topic.

Ex ante agreement on procedures, in order to prepare for *ex post* burden-sharing is the realistic approach. We will not foresee all possible outcomes, but when the crisis hits, short-sighted national concerns may lead to valuable time being lost. The knowledge that necessary procedures are in place will foster cooperation and improve crisis management.

10. WE NEED A COOPERATIVE SPIRIT IN THE YEARS AHEAD

There are certainly many challenges for the international financial sector in the years ahead. Closer cooperation and more information-sharing will lead to us making better decision. Therefore let us hope that we all – central bankers, supervisors, finance ministry employees and legislators alike – could keep a cooperative spirit in the years to come.

*Mikhail Sukhov**

THE EXPERIENCE OF THE RESOLUTION REGIME DURING THE CRISIS IN RUSSIA

1. INTRODUCTION

Russia is one of the countries that have made a full use of fast and effective resolution regime during the crisis. Until the peak of the recent crisis, we had tried to preserve a purely market approach towards insolvency issues in banking sector. The authority of the Deposit Insurance Agency to resolve financially troubled banks appeared in the law as late as October 2008. Before the changes in the Law, difficulties of six banks were resolved on case-by-case basis. Then, it became obvious that systemic stability in banking sector needs to be supported by a resolution function of special institution. The initial decision to carry out resolution function until 2011 is being currently reconsidered and the Law will be preserved on a permanent basis.

In November and December 2008, effective and fast implementation of the Law in 18 cases helped to preserve trust not only to these specific institutions. Fast resolution of bad banks is of a higher importance for the trust of creditors in the rest of the banks, especially in respect to smaller institutions. At the same time we felt that resolution regime may not be the basic and only way to overcome difficulties in financial sector during the crisis. The amount of public funds used for resolution

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was about 20 percent of the total amount of assistance to banks by different means. But as a supporting measure its significance is hard to overestimate.

2. REMARKS ON THE MAIN REASON FOR FINANCIAL DIFFICULTIES OF BANKS IN RUSSIA

In Russia, financial rehabilitation is considered to be an anti-crisis tool. At the same time its practical implementation discovered, that the reasons for financial difficulties of the resolved banks in most of the cases have very few links to the macroeconomics of the crisis. We had only one serious influence of shock at stock exchange at financial standing of a bank. For the rest of the resolved banks, the financial difficulties were the result of mismanagement or fraud. In most cases mismanagement was caused by underestimation of concentration of credit risks, particularly for the business of owners of banks. Heavy investments in real estate are a typical example. Before the crisis, real estate was an attractive asset with dynamic price increase.

Unfortunately for some of the banks, financial fraud was the main reason of difficulties. In the recent case – Bank of Moscow – former managers withdrew at least $5 bn. These funds can be returned to the bank only by means of criminal prosecutions or other legal actions.

Comparing different ways of financial rehabilitation, it is necessary to stress the importance of the private sector. We tried to make full use of finding new private owners to resolved banks. Long deposits from the Deposit Insurance Agency served for them as enough stimulus to motivate them to financial rehabilitation.

In most cases we used this method instead of investments in capital of the bank. We feel more comfortable when managerial duties in a bank during its financial rehabilitation are not carried out by government authorities. We considered direct investment in capital by the Deposit Insurance Agency as the last and undesirable possibility. After investing funds in the capital of 7 banks 3 of them had already been merged to others.

3. THE NEED TO PRESERVE MARKET DISCIPLINE IN THE PROCESS OF FINANCIAL REHABILITATION

Our experience shows the need to preserve market discipline in the process of financial rehabilitation. All financial obligations of private investors that attract government funds for resolution of banks should be, first, guaranteed by collateral and, second, made public. These are the means of making private investors accountable for the results of their business in banking resolution area.

In our case the participation of the private sector in the financial rehabilitation of banks does not receive any public resistance or criticism. It was an amazing fact for our country that a massive support of the banking sector did not result in a wave of embarassed bankers. The recent case of the Bank of Moscow is an exemption. The reasons of $5 bn loss are now being studied by different authorities.

Another important issue for market discipline in the resolution process are the relations of new investors and the Deposit Insurance Agency with former owners and managers of the resolved banks. Needless to say, in any case of financial fraud respective persons should be properly prosecuted. But the results of financial rehabilitation can be more effective if the former stakeholders cooperate with the new owners. Under these terms prosecution may not be needed. The current losses in the value of the assets may be overcome in the future if new investors get control over temporally illiquid investments made by former managers.

4. GOVERNMENT FUNDS AND CENTRAL BANK LOANS FOR THE PURPOSE OF RESOLUTION PROCESS

The experience of our country shows the possibility of effective use of government funds or loans from the Central Bank for the purpose of resolution process in the banking sector. Its total amount was about 1.2 percent of GDP for 2008. In this respect we cannot ignore the discussion about the use of public funds for resolution purposes. Unfortunately, problems in banks appear to be large when they are disclosed. It is very difficult to make the industry accumulate enough funds to cover the problems of any of the banks that should be rehabilitated taking into account its systemic importance. In Russia, the abovementioned 1.2 percent of GDP was an equivalent of 14 percent of capital of all banks. Total funding at the expense of the private sector is hard to imagine without significant costs that would damage profitability and investment attractiveness of the rest of financially solvent banks. Thus, the role of government funding, in our opinion, is difficult to replace without more undesirable consequences for systemic stability. Moreover, the use of loans of Central Bank for the purpose of resolution of banks appears to be fast and effective. We also did not find any influence of these operations on inflation.

Market discipline during resolution regime should be preserved by other means then prohibition of using public funds. The resolution authority may have an obligation to contribute a full disclosure of the reasons for financial difficulties and provide a clear way of returning public funds used for resolution. At the same time the role of the private sector should have an obvious priority over government participation in the management of resolved banks.

5. ISSUES OF SYSTEMICALLY IMPORTANT BANKS

We think that the concept of systemically important banks should be developed on a national level. During the crisis and up to nowadays we have not yet made such announcements. But in practice, before each case of financial rehabilitation of an individual bank, we prepare the conclusion of systemic importance for ourselves and it is also obligatory.

In Russia, before making decision to disclose the list of systemically important banks, we would try to solve two difficulties. First, a list of banks should not give them any competitive advantage. That is why all banks that are recognized as systemically important should have clear duties and may have additional responsibilities. Second, a list of systemically important banks should not be a closed list for the possibility of resolution support, especially in crisis and should not be a mandate for resolution in any case.

We hope that our experience in the implementation of resolution tools achieved its aim to preserve trust in banks. We are looking forward to future developments in banking and hope that in spite of all considerations the resolution function will not be used as often as three years ago.

Session 4:
How to Cope with the "Too Big to Fail Problem"

Gary H. Stern*

TOO-BIG-TO-FAIL AND THE DODD-FRANK LEGISLATION[1]

1. INTRODUCTION

In 2004, Ron Feldman and I wrote "Too Big To Fail: The Hazards of Bank Bailouts". Published by the Brookings Institution, the book has two principal themes. First, from the perspective of early in the previous decade, we argued that the too-big-to-fail (TBTF) problem had not been addressed effectively and was only getting worse. And the second theme was a set of recommendations explicitly designed to rein in TBTF.

Of course, time has passed since the book first appeared and, while we have been vindicated by events, the public policy challenge of TBTF persists. Importantly, major financial reform legislation, the Dodd Frank (D-F) Act, was passed in the summer of 2010 and is being put into effect. And so a critical question today is: does D-F effectively address TBTF?

The short and direct answer to this question is that we don't know, although we can say with confidence that D-F is sufficiently broad and far reaching to potentially address TBTF. However, as I will explain, the "fate" of TBTF depends on what policy makers, regulators, and supervisors do, and not on what they assert. The balance of this note presents a framework for addressing TBTF and

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[1] Comments to the paper were presented at the conference "Beyond the Crisis: The Need for Strengthened Financial Stability Framework" 19–20 October 2011.

identifies those aspects of D-F which require or permit implementation of the framework. Against these criteria, D-F looks promising, and one must hope that financial institution regulators have the courage to get it right.

2. SYSTEMIC FOCUSED SUPERVISION

Several years ago, Ron Feldman and I offered a proposal called "systemic focused supervision" intended to curb TBTF significantly. The name of the proposal is not important, but its key ingredients are. The three components of the systemic focused supervision (SFS) framework are:

- ❖ Preparation
- ❖ Enhanced prompt corrective action
- ❖ Communication.

As previously noted, D-F either permits or mandates all three elements of the SFS framework.

For a number of reasons, preparation is essential to dealing effectively with TBTF, and the component of the D-F legislation most pertinent in this regard is the requirement that systemically important financial institutions (SIFIs) prepare "living wills", or orderly wind-down or resolution plans. Such plans have to be approved by the relevant supervisor and are intended to enable the closure of a troubled SIFI in a timely and orderly way, without significant negative spillover effects on other major financial institutions or markets. In short, the plans are intended to assure that contagion effects, if any, are effectively contained.

This aspect of D-F is constructive but it is critical that wind-down plans are prepared properly. This means, essentially, that the regulators must be intimately involved in their preparation. There are two reasons for this recommendation. The first has to do with incentives. If we ask about the quality and quantity of resources a SIFI is going to devote to preparation for its own demise, the answer I think of is obvious. Thus, the regulators have to be sufficiently involved to assure the quality and comprehensiveness of the plans.

Second, the regulators should be deeply involved so that they "buy in" to the plans and have effectively pre-committed to employ them under the appropriate circumstances. Such a buy in is exceedingly valuable in my experience because in its absence regulators will likely find a plethora of excuses to engage instead in a bail out.

3. ENHANCED PROMPT CORRECTIVE ACTION

Prompt corrective action (PCA) was a major element of the FDICIA financial reform legislation passed in 1991, and at the time many of its proponents asserted that it effectively curtailed TBTF. Feldman and I have been perpetually skeptical, and events have borne us out. Among the shortcomings of PCA were its reliance on book value accounting and failure to include market signals in assessing the condition of what SIFIs essentially are. Thus, when we speak of enhanced PCA, we are specifically advocating market value accounting and incorporation of market data—for example, equity values relative to those of peers, credit default swap pricing, subordinated debt spreads—in evaluating the financial health of SIFIs.

We realize that these proposals are controversial, especially in an environment where expectations of TBTF protection are deeply entrenched. But if the wind-down plans are credible and, make no mistake, credibility is essential, then uninsured creditors should come to understand that they are at risk and market pricing should more accurately reflect risk. Indeed, this is a significant additional benefit of preparation for the failure of SIFIs in that it will serve over time to improve market discipline.

4. COMMUNICATION

The third ingredient of our SFS proposal is communication. Uninsured creditors and other market participants are not mind readers, so they need to be told that regulators are aggressively preparing to make SIFIs “safe to fail” and that creditors will experience losses in the event. The communication should describe fundamental aspects of the wind-down plans and the market data regulators are using to help assess institutions. In short, transparency is essential here so that creditors understand that the regime has changed, that they cannot count on TBTF protection, and that they need to adjust their behavior accordingly.

5. CONCLUSION

In our view, D-F gives financial industry regulators more than enough tools and authority to significantly reduce TBTF protection, and expectations of such protection, of uninsured creditors of SIFIs. This is distinctly positive development but, unfortunately, victory is not yet at hand. At the end of the day the real issue is not whether regulators can take appropriate action but, rather, will they take appropriate action when a SIFI is in trouble?

Stanisław Kluza[*]

REFLECTIONS ON "TOO BIG TO FAIL"

1. THE ORIGIN AND SCOPE OF "TOO BIG TO FAIL" CONCEPT

A hundred years ago the first famous debates about the role and responsibility of the state for the consequences of private mismanagement that would have negative impact on the public interest appeared.[1] At that time the case was how to provide financial aid to New York City.

The issue of too big to fail banks came back in 1984 at the Congressional hearing, when the government rescued Continental Illinois Bank. The Congressman Stewart McKinney raised the point that the government had created a new class of banks, those too big to fail.

From the nineties, increased interest in exploring the issue of too big to fail was observed. It was both from the scientific and the policy making sides.

The concept of too big to fail may refer not only to the scale of the activity of the specific financial institution. It also takes into consideration both the public and economic aspects of the whole economy. State aid is nothing but taxpayers' money. When the state decides to rescue a bank, it is de facto weighing the social and economic consequences of such an action. In the case of the too big to fail dilemma, it might be more profitable to invest public resources in saving the institution than

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1 Louis D. Brandeis, "Other people's money, and how the bankers use it", Frederick A. Stokes Company Publishers, New York, 1914.

to allow it to fail. Big failures can even lead to riots. They diminish the reputation of the state and weaken the economy.

The consolidation and globalization processes were bringing a lot of benefits of scale for the financial sector institutions. The profitability advantage was additionally strengthened by the arguments that this process is risk-lowering. It was argued that big size should increase the stability by higher resistance to the shocks. Additionally, higher products range and regional diversification should create negative correlations that diminish sensitivity to local volatilities and lack of synchronization in business cycles. In the times of crisis, this way of thinking turned out to be wrong.

Huge financial institutions changed their role from market players to market makers. They became the market. As a result they accumulated a large systemic risk. The conclusion is that growing the size should cause increased responsibility. It should be especially visible in the costs of activity.

Recent developments of G20 and Financial Stability Board emphasize the issue of systemic and moral hazard risks associated with systemically important financial institutions (SIFIs).[2] List of 29 key global SIFIs[3] was presented based on BCBS[4] methodology. Additionally, the focus was on establishing general policy measures addressed to all the too big to fail entities. Four major policies were agreed: resolution regimes should be equipped with powers to resolve failing financial firms, strengthen cross-border resolution management, increased loss absorption capacity adjusted to the impact of possible default, increased supervisory powers and expectations in the area of risk management functions, data aggregation, internal control, etc. The purpose of the reform is not only to increase the efficiency of resolution regimes. Another issue is to diminish the possible contagion risks.

Security is a cost, but it brings benefits in the long run. It means that providing banks with capital is a cost for their owners. The same can be said about the fulfilment of liquidity norms and the increased diligence in the process of checking creditworthiness (which additionally makes the process lasting longer). However, the latter factor fairly quickly brings benefits in the form of a better credit portfolio and lower overall costs.

The lack of well-organised regulatory architecture for the financial system in the EU generated an enormous capital shortfall which would have been at

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[2] Financial Stability Board (FSB), "Policy Measures to Address Systemically Important Financial Institutions", Nov. 2011.

[3] Bank of America, Bank of China, Bank of New York Mellon, Banque Populaire CdE, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Deutsche Bank, Dexia, Goldman Sachs, Group Crédit Agricole, HSBC, ING Bank, JP Morgan Chase, Lloyds Banking Group, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Santander, Société Générale, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, Wells Fargo.

[4] BCBS – Basel Committee on Banking Supervision.

present necessary for covering the losses resulting from banks bad investments and engagements. The results of stress tests and the autumn estimates of the EBA for the key European banks indicate that the shortfall is no lesser than €100 bn. Much bigger amounts appear in private sector analyses (Credit Suisse estimated that the capital shortfall amounts to €400 bn).

Looking back to the evidence of last years, unfortunately, risks generated by the largest financial institutions – the systemically important ones – have not decreased since the financial crisis. That requires revision of the effectiveness in the behaviour of the government institutions at the national and European levels.

2. ACTIVE ROLE OF THE STATE

The role of the state is to maximize the social welfare and the stability of the economy and its growth. If instability occurs in the financial sector, it is expected from the state to react and diminish its negative consequences. The financial stability is treated as a public good.[5] The state may not be passive if the consequences of failures of financial institutions were damaging to the stability of the whole economy. It should be active especially, if the cost of government bailout was lower than the scope of bankruptcy negative consequences to the whole economy. On the other hand, the state is using public money for those purposes. Public money is taxpayers' money. Moreover, taxpayers may not be accused of those failures.

If it is the state that pays for the consequences of the mismanagement in the financial sector, then the state should in advance protect itself from possible significant failures or diminish the cost of their economic consequences by introducing proper regulatory framework.[6] It should cover a number of areas. First of all it should decrease the profitability of too risky activities and include the implications of scale into prudential analysis. Next, higher transparency of complex financial groups and their portfolios should be expected. Additionally, the role of the deposit guarantee schemes should be strengthened to collect preventive funds for crisis management purposes. Fast track for bank resolution regimes should be established. The new regulatory architecture should emphasise that the state's

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5 Stanisław Kluza, "New Regulatory Architecture towards Safety and Stable Growth", Subtitle: "Role of regulating and monitoring the financial system in strengthening the financial stability of the EU"; European Integration Process in the New Regional and Global Settings, Wydawnictwo Naukowe Wydziału Zarządzania Uniwersytetu Warszawskiego, Warszawa, 2012, pp. 205–222.

6 Jacques de Larosiere, "The high-level group on financial supervision In EU", European Commission, Brussels, Feb. 2009.

interest does not accept the too big to fail entities. Everyone, regardless to size, who is not meeting the free market competition rules, should be allowed to fail. It is necessary to convince the financial sector that the taxpayers will not pay for its accidents and that this is going to be benchmark behaviour of the state during the financial crisis. Otherwise it will create unnecessary moral hazard.[7]

The central focus of any new regulatory initiative should be on how to prevent institutions from becoming too big to fail and how to make them resolvable in case of a failure. The list of necessary and possible actions seems to be long.

- ❖ The problem of too big to fail should be addressed at the level of the whole group and of its components. Consolidated supervision (though needed) will not solve problems of subsidiaries. With the European authorities still lacking sufficient supervisory tools, national supervisors are the key instance capable of dealing with too big to fail institutions and its components. We should not forget about those local supervisory mechanisms that proved to be effective.[8] We should ensure that regulations do not create incentives for large and complex institutions to grow even bigger and more complex. It is important to bear in mind the danger stemming from the enhancement of the already strong inter-linkages within financial groups. Additionally, liquidity management at the consolidated level would bind entities within groups even more tightly to each other. This way the parent company will strengthen its status as too-big-to-fail. This must be avoided. Too-big-to-fail financial institutions distort competition and deliberately create complexities and fragilities.
- ❖ The European New Regulatory Architecture should limit benefits of scale within financial sector. Fewer incentives for becoming large would stop the trend of becoming too big to fail. Additionally, higher risk of scale should be recalculated and represented in capital requirements.
- ❖ It is necessary to control and reduce possibilities of regulatory arbitrage: not only within the group's products and legal entities but also between countries. Capital requirements should be established on a risk-based approach. The capital is more expensive than other forms of financing. As a result financial sector companies shifted their activities to unregulated intermediaries (e.g. banks set up a number SIFIs in recent times). On the other hand, if systemically important financial institutions are required to keep substantially more capital, their incentive for moral hazard is growing.

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7 Benton E. Gup, "Too Big to Fail: Policies and Practices in Government Bailouts", Westport, Connecticut: Praeger Publishers, 2003; Stern Gary H., Feldman, Ron J., "Too big to fail: the hazards of bank bailouts", Brookings Institution Press, Washington DC, 2004.

8 Avinash Persuad, "Dear prudence: Regulation needs to be more macro and more national", in Dialogue on Globalization occasional paper no 42 "Re-Defining the Global Economy", Friedrich Ebert Stiftung, New York, April 2009, pp. 59–65.

- ❖ Higher capital requirements should also be connected with the size of leverage on risk based analysis. Proper stress tests should disclose weaknesses of financial institutions. In case of worse institutions stress tests should be performed more frequently on a regular basis (e.g. quarterly).
- ❖ Poland can be shown as a good example of implementation liquidity requirements. They were launched in 2008[9], even though it was not predicted then, that turbulences in banking sector would have come so quickly. The experience shows that liquidity norms should be the standard for conducting banking activity. Implementation of quantitative limits should allow managing liquidity risk.
- ❖ Countercyclical buffers at country level should be implemented. The purpose is to flatten the roughness of the business cycle with special focus on prosperous and lean periods. It is important to remember that every single economy is different and sources of crises have local origin. Then all the capital add-ons must be kept at the local level.
- ❖ There is an increasing need to clarify the relations between powers vs. responsibility. First, between home and host countries. Second between EBA and local supervisors. It is not prohibited to transfer powers between authorities. However, shifts in powers should be followed by shifts in responsibilities. The responsible authority should be obliged to cover all the costs of consequences of wrong decisions or decisions not taken but if no action caused negative consequences.
- ❖ The "arm's-length" principle ought to remain one of the cornerstones of the initiatives towards financial stability. This is the best way to ensure that global systemically important financial institutions will not endanger solvency of the countries in which they operate. The current principles of a clear legal separation between entities belonging to the same financial group should be preserved.
- ❖ Managerial benefits should be lagged. The later payoff should take into account the postponed and distributed in time effects of managerial decisions. The concern about this issue is growing with the scale of entity's activity.
- ❖ Contagion effect can be limited by imposing more restrictions on single-counterparty engagements. It should decrease the negative effects of high interconnectedness within the financial sector. Additionally, higher capital buffer related to the size should be considered. The cost of this buffer in good times can be less expensive than lack of capital in a recession. From policy making perspective it is easier to enforce "contingent capital" in prosperity periods.

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[9] Komisja Nadzoru Finansowego (Polish Financial Supervision Authority), „Polski rynek finansowy w obliczu kryzysu finansowego w latach 2008–2009", May 2010.

Resolvability in the case of failure should be among the key criterions in the benchmarking of systemically important financial institutions. Measures to enhance resolution and bail-in within the resolution regimes can effectively reduce moral hazard associated with the too big to fail problem. The likelihood that the institution would be resolved or restructured in an orderly manner if it were to fail should also be fundamental theme in the benchmarking of these institutions. It is important to preserve the rights for competent national authorities to conduct resolution at local level.

3. CONCLUSIONS

It is crucial to ensure that differentiating between the systemically important institutions and other market players does not result in a perception that big institutions are safer, which could distort the level playing field. It must be clear that even the largest bank can fail and that authorities have instruments to liquidate them in an orderly manner. The rule of "too big to fail" violates the free market conditions. The market economy should always allow the possibility of bankruptcy. If something is not able to fail then it is not fully private. Actually, the financial stability is a public good. Historical accidents and the current crisis show, that the state has no choice and has to intervene in critical moments.[10] Such an expectation is the reason why the state should protect its taxpayers from potential future costs of financial market turbulences. The state ought to be especially proactive in preventive initiatives. The state should establish the "rules of the game" that will not allow to "privatize the profits" of the financial sector in prosperous years and as a consequence "nationalize the losses" in lean periods.

10 Louis D. Brandeis, "Other people's money, and how the bankers use it", Frederick A. Stokes Company Publishers, New York, 1914.

Stephen G. Cecchetti[*]

HOW TO COPE WITH THE TOO-BIG-TO-FAIL PROBLEM?[1]

1. INTRODUCTION

"Too big to fail" is the single most important policy issue that has emerged from the crisis. In a market-based financial system, the right to succeed is the right to fail. The orderly entry and exit of firms, combined with an appropriate relationship between risk and return, means that risk-takers that stand to profit also stand to lose.

The too-big-to-fail problem and the associated moral hazard costs affect these core preconditions for competitive markets. That is why addressing the too-big-to-fail problem is of fundamental importance.

Here I use the term "too big to fail". It will be used in a broad sense. Clearly, being too big is a major part of the problem, but it is not all just about size. Excessive interconnectedness of financial institutions, reliance on a single or few firms for the provision of key financial infrastructure, and complexity of operations and cross-border activity are all part of "too big to fail". In combination, all these characteristics of a financial institution raise the impact of its failure on the financial system, and thereby give rise to the too-big-to-fail problem.

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1 Comments prepared for the 10th Annual Conference of the International Association of Deposit Insurers, "Beyond the Crisis: The Need for a Strengthened Financial Stability Framework". I would like to thank Neil Esho for his help in preparing these remarks. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

There is a sense in which the session, "How to *cope* with the too-big-to-fail problem?", is mislabeled. We cannot and should not merely cope with institutions that are too big or too interconnected to fail. Rather, we should force these institutions to face head on and pay for the systemic risk that they create.

2. WHY ARE ADDITIONAL MEASURES NEEDED FOR SYSTEMICALLY IMPORTANT BANKS?

The rationale for putting in place some specific policy measures for banks considered too big to fail is based on externalities which Basel III does not directly address. Basel III sets the minimum requirements for the ratio of risk-weighted assets to common equity Tier 1 capital. It therefore meets the microprudential, institution-specific objective of addressing the traditional tendencies of managers to take on too much risk. Elements such as limited liability and deposit insurance give rise to such inappropriate risk-taking incentives. Basel III does not, however, capture the risk to others, or to the system as a whole, created by an individual institutional failure – though policies designed to target specific financial market externalities directly are difficult to implement, as the externalities themselves are difficult to observe and quantify.

In the light of such uncertainty and measurement problems, the objectives of regulatory policies developed to address the too-big-to-fail problem have been designed to:

- ❖ reduce the probability of failure of global systemically important banks (G-SIBs);
- ❖ reduce the extent or impact of the failure of such G-SIBs;
- ❖ level the playing field by reducing the competitive advantages in funding markets that these institutions have.

The combination of capital surcharges, better resolution regimes, living wills, more robust financial market infrastructures and central clearing, and more intense supervision of systemically important financial institutions (SIFIs) together will contribute to achieving these objectives.

In the remainder of these comments I will describe these three key objectives and the policy responses developed by the Basel Committee on Banking Supervision and the Financial Stability Board (FSB).

3. REDUCING THE PROBABILITY OF FAILURE OF G-SIBS

Reducing the likelihood of insolvency of G-SIBs is the cornerstone of the regulatory response to the too-big-to-fail problem. Raising the quantity and quality of going-concern capital for these institutions through the application of a capital surcharge will lower their *probability* of failure. This, in turn, will lower the ex ante expected *impact* of their bankruptcy.

The Basel Committee has developed a methodology for identifying G-SIBs that brings together a number of indicators that proxy for the systemic importance of a bank. These are: size, interconnectedness, substitutability, global activity and complexity. Based on this methodology, G-SIBs are allocated into buckets according to their relative systemic importance. The proposal is to allocate banks to four buckets and apply a surcharge ranging from 1 to 2.5%. In addition, an initially empty bucket sits at the top, with a surcharge of 3.5% as a disincentive to a G-SIB becoming even more systemically important.

To see what this means, take the example of a bank that faces a 2% surcharge. Such a bank would face a 4.5% minimum, plus a 2.5% conservation buffer, plus the 2% surcharge, for a total risk-based capital of 9%. Taking into account Basel III's tougher definition of capital, the result is a substantial and necessary increase in minimum requirements.

Some jurisdictions have announced their intention to have even higher capital requirements. This is in line with the fact that Basel III sets a minimum and that some countries' banking systems are very large relative to the rest of their economy. That is, in some places, banks are not only too big to fail, they are also too big to save.

4. REDUCING THE IMPACT OF FAILURE

The simplest way to reduce the impact of a firm's failure is to reduce its systemic importance directly (e.g. by placing limits on the firm's size or business functions).

Restrictions on the activities that banks can undertake have been proposed in some countries. For example, the Vickers Report in the United Kingdom proposes ring-fencing traditional retail banking business activities. The Volcker Rule in the United States proposes restrictions on proprietary trading by banks and limits on owning and investing in hedge funds.

Such proposals aim to separate fundamental, essential banking services from more speculative investment activity. The aim is to reduce the impact of the failure of certain banks and the potential cross-subsidization from safe retail banking business to riskier wholesale banking functions and investments. In the same way that an airline company should restrict its operations in oil and currency futures markets to hedging its profits from flying people around the world, banks should confine itself to activities that serve its customers' needs and not use deposits as a source of funds for its proprietary trading operations.

At the international level, efforts to reduce the impact of a G-SIB's failure have focused on improving recovery and resolution regimes and promoting bail-in within resolution. These measures target the problem that certain firms are difficult to resolve or place into resolution. This applies in particular to large, complex cross-border firms.

While it is probably fair to say that we remain a long way from achieving a global cross-border resolution regime, a number of jurisdictions are carrying out reforms of their national resolution regimes to enhance their domestic powers. This process has been facilitated by the FSB's release of the *Key attributes of effective resolution regimes*, which sets out new international standards for the resolution of distressed financial institutions. These measures are complementary to, and not substitutes for, higher loss absorption capacity.

5. LEVELING THE PLAYING FIELD BY REDUCING TOO-BIG-TO-FAIL FUNDING ADVANTAGES

Finally, I turn to level-playing-field considerations. A number of studies have attempted to quantify the funding advantages enjoyed by banks that are perceived as too big to fail (see, for example, Ueda and Weder di Mauro (2011)[2]). The conclusion is that these advantages are significant, with a funding subsidy of as much as 60 basis points during normal times and even more during crises. After all, if an elderly relative asked you where to deposit their savings, wouldn't you tell them to put their deposit in an institution that you thought the government would be likely to support in a crisis?

The policy responses discussed above- the capital surcharge, restrictions on business activities, and improvements in recovery and resolution regimes – all help to reduce this subsidy. Rather than think of these as disadvantaging big banks, think of it as making things fairer for small banks.

In addition, the Basel III framework now requires all regulatory capital to fully absorb losses at the point of non-viability before taxpayers are exposed to loss. This can be achieved either through contractual means or via a statutory resolution regime. It seeks to address the problem that, during the financial crisis, Tier 2 capital instruments (mainly subordinated debt), and in some cases Tier 1 instruments, did not absorb losses incurred by certain large internationally active banks. The work on resolution and bail-in would extend gone-concern loss-absorbing capacity to other parts of the capital structure.

2 K. Ueda and B. Weder di Mauro, „Quantifying the value of the subsidy for systemically important financial institutions", mimeo, 2011.

6. CONCLUDING THOUGHTS

Prior to the crisis, numerous academic studies and banking textbooks discussed the too-big-to-fail problem and moral hazard more generally. However, even for those who have written about these issues for many years, the true depth and seriousness of the concerns were only revealed during the recent financial crisis. It is quite surprising to hear the occasional voices of those claiming that the too-big-to-fail problem is overstated.

It is imperative that we not only cope with the too-big-to-fail problem, but that we also manage it effectively. The capital surcharge for global systemically important banks introduced by the Basel Committee is a significant step in the right direction. The same is true of the progress on improving recovery and resolution planning.

Finally, the Macroeconomic Assessment Group, has issued its final report on the economic impact of requiring additional loss absorbency for global systemically important banks.[3] The results show that the transitional costs of higher capital requirements for global systemically important banks are very small, and that the long-term economic benefits are very large.

Therefore, the conclusion is: too big to fail is too big to exist.

[3] Macroeconomic Assessment Group. *Assessment of the macroeconomic impact of higher loss absorbency for global systemically important banks*. October 2011.

Session 5:

THE ROLE OF DEPOSIT INSURANCE SCHEMES IN THE FINANCIAL SAFETY NET

Alex Kuczynski[*]

THE ROLE OF DEPOSIT INSURANCE SCHEMES IN THE FINANCIAL SAFETY NET

1. THE OBJECTIVES OF THE DGS

There are two primary objectives of the DGS – to support consumer and market confidence, and to support financial stability. They are connected. The DGS is, of the safety net players, the one with the closest, most direct relationship and contact with individual consumers (i.e. depositors). The Ministry of Finance or regulator may not expect to deal with large numbers of individual consumers. Whatever form protection takes, whether "least cost", "loss" or "risk minimiser", or "paybox", protection must support those two objectives, and the DGS must be equipped operationally to do so.

Recent events have also emphasised the need to promote awareness of the DGS, independently from the safety net, albeit collaboration with both regulators and the industry is required to raise awareness. Whether awareness is of a DGS brand or of the scope of protection is an open question – but the DGS needs to manage consumer awareness of the protection in order to support the objectives of confidence and financial stability.

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2. THE PRE-CONDITIONS

In addition to the 18 core principles themselves, the IADI Core Principles for Effective Deposit Insurance System helpfully set out the necessary pre-conditions for an effective deposit insurance system. These importantly refer to standards required for setting the scope and framework within which the deposit insurer can operate e.g. the legal framework, an established insolvency process with a corporate (albeit this may now be regarded as inadequate) or a special regime, and the requirement for established and effective regulation – such supervisor to be a “partner” of the DGS. It is worth noting that the costs of the DGS may be considered an element of the cost of regulation.

3. THE RELATIONSHIPS OF THE DGS

The obvious relationships are with the safety net players i.e. the Ministry of Finance, the Central Bank, the supervisor and (if different) the resolution authority.

To engage in such relationships, the DGS needs a clear mandate with established powers for execution of its role. It needs to be adequately resourced and funded to be able to fulfil that duty. The independence of a DGS from other safety net players provides reassurance to consumers and to the industry. Consumers can be satisfied the DGS will not be influenced by political or regulatory issues when deciding on intervention or payout; this independence also protects the industry as the levy payer and funder of the DGS. However, the DGS must be accountable to the authorities, whether the regulator and/or Ministry of Finance or other governmental bodies. In practice, this may be delivered by an independent board accountable by statute (or by agreement).

Between the multiplicity of safety net players, responsibilities should be understood and documented. Although maligned during the crisis, the Memorandum of Understanding remains a useful tool for such purpose.

The need for and benefit of close relationships with safety net players are evidenced in contingency planning, for example access to data required for payout (such as the single customer view). In the UK, the “SCV” data allows FSCS to provide “payout reports” to assist the resolution authority in its decision making (as payout may be preferred to more invasive resolution methods). Contingency planning, scenarios and simulations need to be developed in partnership with the regulatory authorities.

4. INVESTOR AND POLICYHOLDER PROTECTION SCHEMES

Increasingly, such schemes have prominence within the safety net, even if generally considered to address issues which are less systemic than deposit insurance. Within Europe, Directives require investor compensation and may mandate insurance guarantee schemes, albeit at present there is a varied approach across the Member States.

There are clearly shared interests between protection schemes relating to consumer protection and market confidence, and the role of consumer awareness to engender market confidence and financial stability. There are advantages to integration provided by combined resource and critical mass, and an arguably higher state of operational readiness. In any event, schemes need to share information, and consider working together both to plan for a crisis and failures, and also to deliver both protection itself and clear and consistent messages to consumers.

5. THE LAST RESORT

The DGS is neither the first nor the last resort – indeed the last resort is likely to be temporary public ownership (or nationalisation). Recovery comes before resolution or deposit payout, managed through supervisory responsibilities.

Whether the introduction of the DGS is before, with, or after resolution may depend between jurisdictions. In the UK, the liquidation and payout option is to be considered, and deployed or discarded, before more invasive resolution measures (such as transfer of deposits and assets or a bridge bank). In any event, FSCS may contribute to the costs of a transfer of deposits, insofar as the amount does not exceed the cost of payout in an insolvency.

Wherever the DGS ranks, the importance of contingency planning and collaboration between the authorities at an early stage cannot be underestimated. The DGS should be part of the regulatory and resolution process and not introduced as an afterthought.

6. IS THE ROLE OF THE DGS ENHANCED?

Following the crisis, governments are determined to protect the taxpayers from future costs. This elevated the importance of the role of the DGS during the crisis and since the crisis in reform measures. The DGS must provide consumer protection, support financial stability, but be funded by the industry. This is emphasised by the work around the IADI Core Principles.

Many DGS have gained additional powers, resources and responsibilities following the crisis and have improved operability – for example faster payout. In Europe, Member States are responding to the more rigorous requirements in the Deposit Guarantee Schemes Directive. The crisis has also led to closer relationships between the authorities as evidenced by MoUs. It is important the DGS has the opportunity to influence policy development, reflecting the benefit of practical experience.

The DGS has the contact with the consumer – it is the DGS which protects "the little guy". In view of the increased importance of that role, and additional new powers and resources, there are the commensurately increased expectations of the DGS to deliver protection. The position has moved on markedly from 2007/2008 and the DGS needs to be ready to respond to the future challenges.

Fred Carns*

THE ROLE OF DEPOSIT INSURANCE SCHEMES IN THE FINANCIAL SAFETY NET

The recent evolution of deposit insurance (DI) in the United States, which involves primarily the reforms prescribed in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), and the global evolution of DI more generally in recent years, are, to a degree, parallel stories. Clearly, there is a trend toward expanded powers for DIs within the financial safety-net with increasing emphasis on effective DI operation as an essential component of the larger financial stability framework. The role of DIs is both expanding and deepening throughout the global architecture for maintaining financial stability.

For historical context, it is helpful to begin with a look at the growth in the sheer number of DI systems worldwide over the past seven decades. The first national system of DI was established in the USA, where the Federal Deposit Insurance Corporation (FDIC) began operations in 1934. The next system did not appear until 1961, when India established its DI system. During the subsequent 20 years, 15 DI systems were established. Since 1980, 118 systems have been created. The rise to prominence of explicit DI systems within the global stability framework has been a relatively recent phenomenon.

Experience has taught us that DI provides essential confidence, especially during times of crisis. With the development of Core Principles and a Methodology

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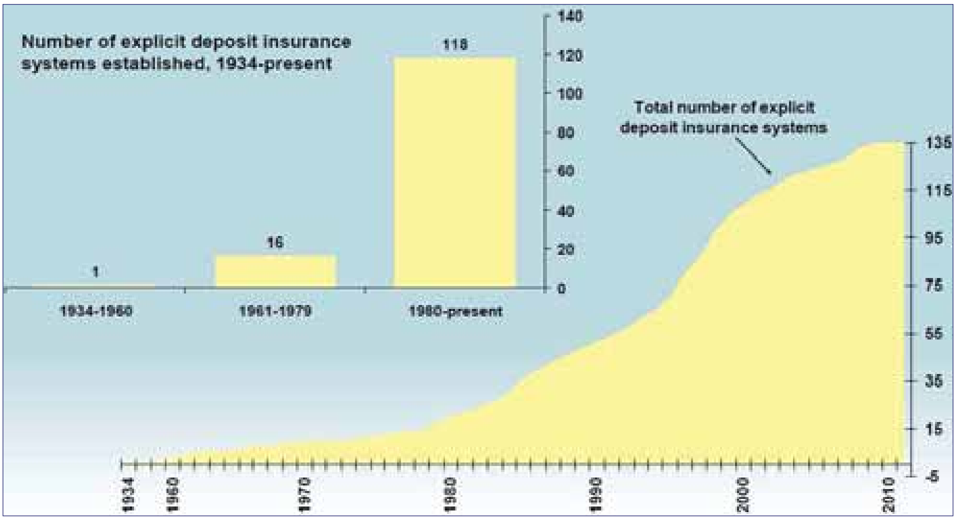
for assessing compliance, there is a global focus on making DI systems function as effectively as possible[1]. The Financial Stability Board (FSB) has included the Core Principles among its 12 key standards and is currently using these to conduct a thematic review of DI systems among G20 countries. And the IMF and World Bank will use the Core Principles and Methodology for their Financial Sector Assessment Program.

Chart 1. The number of deposit insurance systems has increased significantly over time[2]



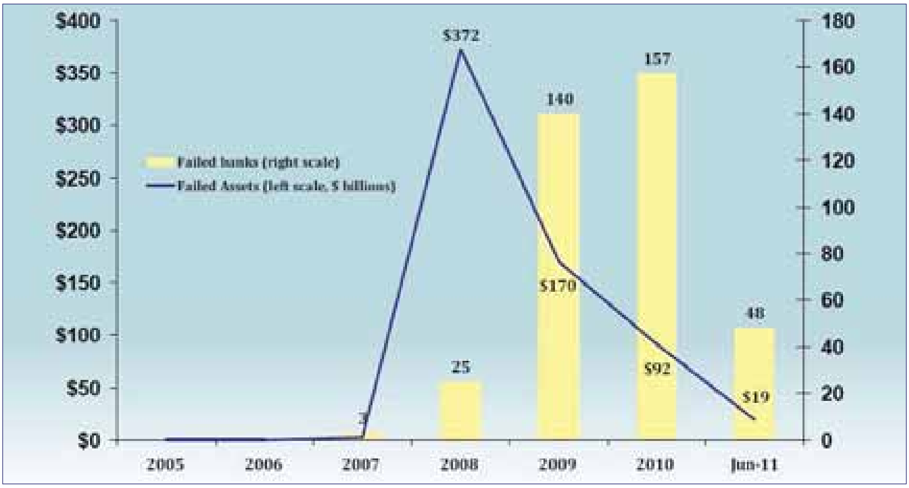
Source: Author's slide no 2 of the presentation at the Conference session.

Looking at recent experience in the USA, the DI system proved to be very effective in preventing bank runs during the crisis despite a substantial number of bank failures. Chart 2 shows that bank failures in the US rose from 0 in 2006 to 140 in 2009 and 157 in 2010 before moderating this year, and that 48 banks failed as of June 11, 2011. The updated number is 80 failures as of October 14, 2011. The upshot is that we have had a very large number of failures over the past 3 years in the US without experiencing any bank runs.

1 As of May 8, 2012, IADI shows 139 individual deposit insurance systems across 111 jurisdictions.

2 Core Principles for Effective Deposit Insurance Systems were developed by the International Association of Deposit Insurers and the Basel Committee on Banking Supervision in 2009.

Chart 2. Despite bank failures in the recent crisis, there have been no bank runs in the U.S.[3]



Source: Author's slide no 4 of the presentation at the Conference session.

Chart 3. Dodd-Frank reform has expanded the role of deposit insurance in the U.S.

Source: Author's slide no 5 of the presentation at the Conference session.

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3 As of year-end 2011, the number of bank failures in the U.S. was 92, comprising $32.9 billion in assets.

As part of the financial reforms enacted with the Dodd-Frank Act in the wake of the crisis, the role of the FDIC was expanded significantly. The new responsibilities include: resolution authorities for both banking institutions and non-bank financial institutions that are determined to be systemically important financial instutions (SIFIs); new authority shared with the Federal Reserve Board (FRB), to determine the content of resolution plans, or so-called “living wills”, submitted by SIFIs and impose restrictions on institutions that fail to submit adequate resolution plans; strengthened authority for back-up examinations and information-sharing; more discretion for the FDIC to determine the optimal size of the insurance fund; permanently higher coverage limits; and several technical changes designed to enhance the effectiveness of DI operations.

The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) charged with monitoring macro-stability, viewing the “big picture”, and with identifying the universe of nonbank-SIFIs that should be subject to enhanced prudential supervision by the FRB. The FDIC is a member of the FSOC along with the other federal financial regulatory agencies and there is also a seat on the Council for an independent member with insurance industry expertise. The FSOC is chaired by the Secretary of the Treasury. A number of standing committees have been established by the FSOC to help carry out its functions, and the FDIC serves on those committees that align with its expanded responsibilities.

Chart 4. The FDIC has taken several actions in line with its expanded powers

Source: Author’s slide no 7 of the presentation at the Conference session.

The FDIC has taken several actions post-crisis that reflect its expanded powers. It has created a new internal organization for monitoring risk and resolving the failures of SIFIs, and for addressing the international aspects of cross-border monitoring and failure resolution.

The FDIC also established a Systemic Resolution Advisory Council of outside experts to provide advice on a broad range of issues relating to SIFI resolution.

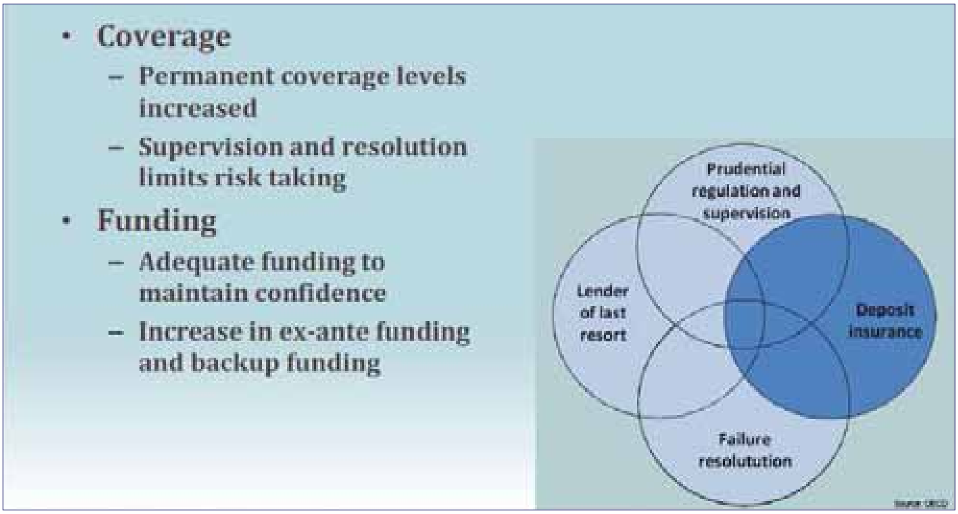
Chart 4 indicates the actions taken by the FDIC pursuant to its new authorities, and these are in various stages of completion. One update to Chart 4 is that the very important rule on resolution plans (or "Living Wills") is no longer a proposed rule, but is now final. All banking organizations larger than $50 Billion in assets and all other designated SIFIs will now be required to submit resolution plans that meet the criteria specified by the FDIC and FRB.

Chart 5. The global evolution of deposit insurance, in some ways, parallels that of the FDIC

Source: Author's slide no 8 of the presentation at the Conference session.

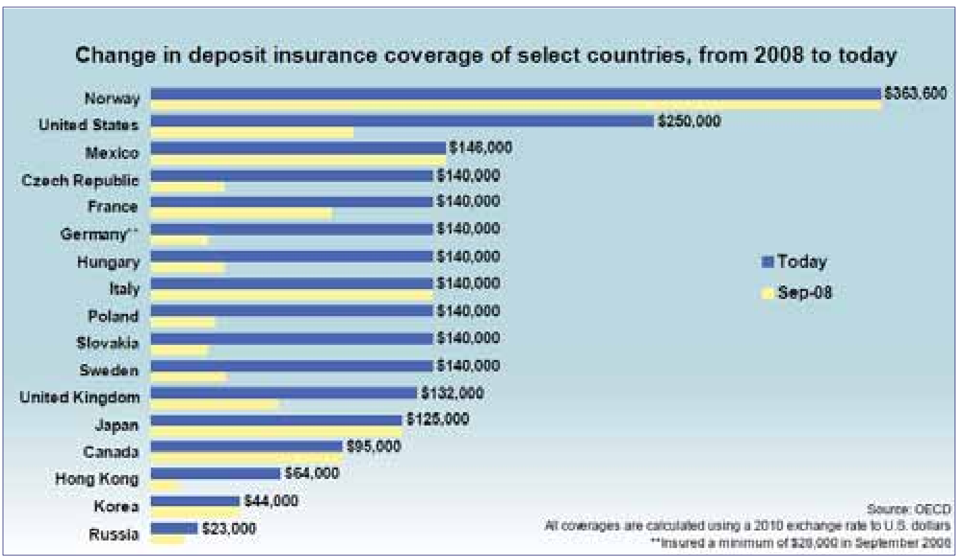
It is worth pointing out that what is happening globally with DI resembles, in varying degrees, what was just described for DI in the US. We all appear to be learning the same types of lessons together. As we look at the trends in DI systems worldwide, we see increased depositor protection combined with stronger supervision, more integration and closer coordination of safety-net functions, attention to crisis management in safety-net design, and expanding resolution authority to address the problems of the too-big-to-fail financial institutions and cross-border operations.

Chart 6. Deposit insurance is more embedded in the financial stability framework



Source: Author's slide no 9 of the presentation at the Conference session.

Chart 7. Deposit insurance coverage has generally increased as a result of the crisis



Source: Author's slide no 10 of the presentation at the Conference session.

DI is now recognized around the world as more than simple depositor protection. A well-functioning DI program is considered essential for maintaining confidence in, and promoting the stability of, the larger financial system. Correspondingly, we see a strong focus on establishing adequate coverage levels and securing adequate funding of DI systems *ex-ante*.

Chart 7 documents the point that coverage levels in many countries have been permanently increased as a result of the financial crisis. Across the world, coverage levels on average are higher today by a good margin than they were at the beginning of the financial crisis.

Chart 8. Deposit insurance continues to spread globally

Source: Author's slide no 11 of the presentation at the Conference session.

Chart 9. The role and features of deposit insurance system are evolving

Source: Author's slide no 12 of the presentation at the Conference session.

With the Core Principles in place to guide DI design, advances in capacity for rapid data collection and faster payout, and with harmonization of processes across borders, we can expect to see the continued advancement of DI around the globe and continued enhancements to established DI systems and their supporting structures.

While the institutional details may differ, countries around the world will continue, out of necessity, to develop and enhance the functions relating to effective DI systems, including resolution processes for SIFIs, means for cross-border harmonization, and coordinated systems of macroprudential supervision. The essential interconnectedness of these functions for maintaining financial stability compels policymakers to adopt decision-making structures that include all of the key safety-net participants, DIs in particular. Indeed, that is what we observe around the world and expect to continue as we move forward. As a result, this is a time of great opportunity for DIs, and we can seize that opportunity by continuing to work through the International Association of Deposit Insurers (IADI) to ensure that DI systems achieve their full potential for contributing to global financial stability.

Session 6:

Financial Inclusion

Barbara Ryan*

WHY FINANCIAL INCLUSION MATTERS FOR DEPOSIT INSURERS

1. INTRODUCTION

It is estimated that more than two billion adults around the world do not have access to formal or semi-formal financial services. The proportions of the world's adult population that are estimated to be unbanked vary widely among countries across the globe, from less than 10 percent to 75 percent or even higher. In many regions of the world, lack of access to financial services among the poor is being addressed through initiatives and innovations in new channels and technologies, including microfinance institutions (MFIs), branchless banking, and e-money.

While much work has been conducted on the topic of financial inclusion, there is no single universally accepted definition of financial inclusion. The term has been defined in various ways, and most recently, in a white paper prepared by the Consultative Group to Assist the Poor (CGAP) on behalf of the Group of 20 (G-20) Global Partnership for Financial Inclusion, as "a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers".[1]

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* Barbara Ryan is the Chief of Staff to the Acting Chairman, Federal Deposit Insurance Corporation.

1 Consultative Group to Assist the Poor (CGAP) white paper issued on behalf of the G20's Global Partnership for Financial Inclusion (GPFI), "Global Standard-Setting Bodies and Financial Inclusion for the Poor – Toward Proportionate Standards and Guidance", October 2011.

2. FINANCIAL INCLUSION AND DEPOSIT INSURANCE

Financial inclusion is related to deposit insurance in a number of ways.

First, broad access to safe and affordable small savings accounts can promote financial inclusion and help households prepare for unexpected expenses and plan for a more secure financial future.

Second, deposit insurance, which insures the safety of depositors' savings in the event of bank failure, can play a key role in protecting small, unsophisticated savers.

Third, through public awareness initiatives, deposit insurance systems can play a meaningful role to ensure that poor and low-income depositors are informed about safe methods of storing their money and can help build trust in formal financial institutions.

Finally, by promoting financial stability as a component of the financial safety net and ensuring the safety of depositors' savings in the event of the failure of a bank, explicit deposit insurance systems can promote confidence in formal financial institutions and the banking system and help broaden access to the mainstream financial sector.

In all of these ways, deposit insurance can play a direct or indirect role in promoting financial inclusion.

In recognition of this link, in 2009, as part of its commitment to improving access to financial services for the poor, the G-20 called upon the International Association of Deposit Insurers (IADI) along with other standard-setting bodies, to consider how they can further contribute to encouraging financial inclusion, consistent with their respective mandates".[2]

In response, during 2010, IADI established a Financial Inclusion and Innovation Subcommittee to engage with other entities, including the World Bank, CGAP, and the standard setting bodies. To date, IADI's subcommittee has been focused on 1) identifying issues that are raised for deposit insurance by the existence of unbanked populations; 2) exploring the implications for deposit insurance due to financial inclusion innovations through technology, new channels, or other means; and 3) conducting research on issues relevant to deposit insurance and financial inclusion, including a recent survey of deposit insurance systems to identify the range of practices related to deposit insurance and financial inclusion.

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2 See G-20 Communiqué, Meeting of Finance Ministers and Central Bank Governors, Busan, Republic of Korea, June 5, 2010.

3. FINANCIAL INCLUSION ISSUES OF INTEREST TO DEPOSIT INSURERS

Through the work of IADI's subcommittee, a number of financial inclusion issues of interest to deposit insurers have emerged that are being considered.

First, with respect to financial stability, an important consideration for deposit insurers (as well as other regulatory authorities) is the need to strike the right balance between controlling risks and encouraging innovation in the promotion of financial inclusion. Regulators and deposit insurers need to ensure that the institutional framework and regulatory oversight supporting the expansion of financial inclusion promotes and does not undermine financial stability. A deposit insurance system is most effective if a number of external elements or preconditions are in place, including a sound banking system with strong prudential regulation and supervision and a supportive legal framework.

Second, a number of important issues and questions are beginning to arise with the introduction and growth of new products and channels of service delivery that lie outside the scope of the traditional deposit insurance system, including:

- Whether membership in the deposit insurance system is or should be open to new types of providers and under what terms and conditions;
- The level and scope of coverage protection and whether it includes or extends to innovations such as e-money and/or depositors with the smallest deposit denominations and if so, under what terms and conditions;
- The deposit insurance funding systems employed, whether they extend to new providers and under what terms and conditions;
- The need for adequate consumer protections and public awareness of the availability and/or limitations of deposit insurance, particularly among small saver households that may be the target of financial inclusion initiatives and innovations; and
- The potential impact of financial inclusion initiatives and innovations on the risk exposure faced by deposit insurance systems, including consideration of emerging issues such as e-money.

IADI recently conducted a survey of deposit insurers to collect data on the range of practices of deposit insurers related to financial inclusion issues. The survey was administered from June – August 2011 and sent to over 100 deposit insurers. It asked a number of questions on a variety of related topics, including: whether the deposit insurers mandate relates to financial inclusion; observed trends in microfinance activity; and deposit insurer response to microfinance activities, including membership, coverage, public awareness, funding, and resolution. Analysis of the survey results is underway and the subcommittee hopes to share the complete survey results during the coming year.

*Pierre-Laurent Chatain**

MOBILE MONEY, FINANCIAL INCLUSION AND POLICY CHALLENGES[1]

1. INTRODUCTION

For the purpose of this note, financial inclusion is defined as a state in which all working age adults have effective access to credit, savings, payments, and insurance from legitimate service providers[2]. As a result, promoting universal access to a wide range of financial products to everyone, including small and medium enterprises is a key development objective for many developing countries[3].

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1 This article is an extended version of his presentation given in Warsaw, Poland, on October 20, 2011 during the 10th IADI Annual Conference titled "Beyond the Crisis: the Need for Strengthened Financial Stability Framework". The author is especially grateful to Mr Jerzy Pruski, President of the Bank Guaranted Fund's Management Board for initiating and supporting this publication. He would also like to express his sincere thanks to Harish Natarajan and Maria Teresa Chimienti, of the World Bank (FFIFI) as well as Michael Tarazi and Pedro Xavier Faz de los Santos, from the Consultative Group to Assist the Poor (CGAP) for their advice and guidance. This work also benefited from consultation with Mario Guadamillas, Massimo Cirasino and Douglas Pearce (World Bank).

2 See also the White Paper prepared by CGAP, Global Standard-Setting Bodies and Financial Inclusion for the Poor, Toward Proportionate Standards and Guidance, p.1, 2011.

3 Financial inclusion is broader than just payments: it encompasses notably access to credit and insurance products. However, for the purpose of this article, the author will focus on payments only.

Extending the reach of the financial sector to sections of the society and/or to geographic areas that were neglected in the past, however, is a challenging objective. There are many barriers to accessing financial services, ranging from limited literacy, to lack of awareness about financial services and products, to high transaction costs and inadequate infrastructures.

Lack of access to banking services is currently forcing many people in emerging markets to rely on a cash-based economy that is relatively inefficient and often unsecure. Given this context, the G20 has recently encouraged the development of new modes of financial services delivery capable of reaching the poor. The rapid development of mobile banking[4] and mobile money is creating unprecedented opportunities for poor people in developing countries to more actively participate in the economy. With more than 80% of the world's population now within mobile coverage, burgeoning efforts to enable people to send, receive, and store money using their mobile phones have the potential to greatly improve people's lives and leapfrog more conventional banking models to safer, more affordable alternatives (Christen, 2011)[5].

The expansion of mobile money raises, however, multiple policy challenges. In particular, concerns have been expressed about funds protection and the need to explore funds safeguarding of some sort for m-money users in case a non-bank mobile banking provider goes bankrupt[6].

This note is arranged in introduction and four sections. They analyse the functioning of mobile money and describes the interactions between different players; next outlines the impact of mobile money solutions on financial inclusion while following section explains why they are a powerful tool for inclusive finance. In the last one, the author discusses policy challenges from a deposit insurer perspective.

2. HOW DOES MOBILE MONEY WORK?

The beauty of mobile money is that it allows users to perform through their handsets a wide range of operations such as purchase of goods, money transfers (including overseas), bill payment, cash deposit and withdrawal. To function, mobile money usually involves three main players, a client, a bank and an agent[7].

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4 In this article, mobile banking is defined as banking services which a retail customers of a financial institution can access using a mobile phone. Mobile money is defined as an electronic money product where the record of funds is stored on the mobile phone or a central computer system and which can be draw-down through specific payment instructions from the bearers of mobile phones.

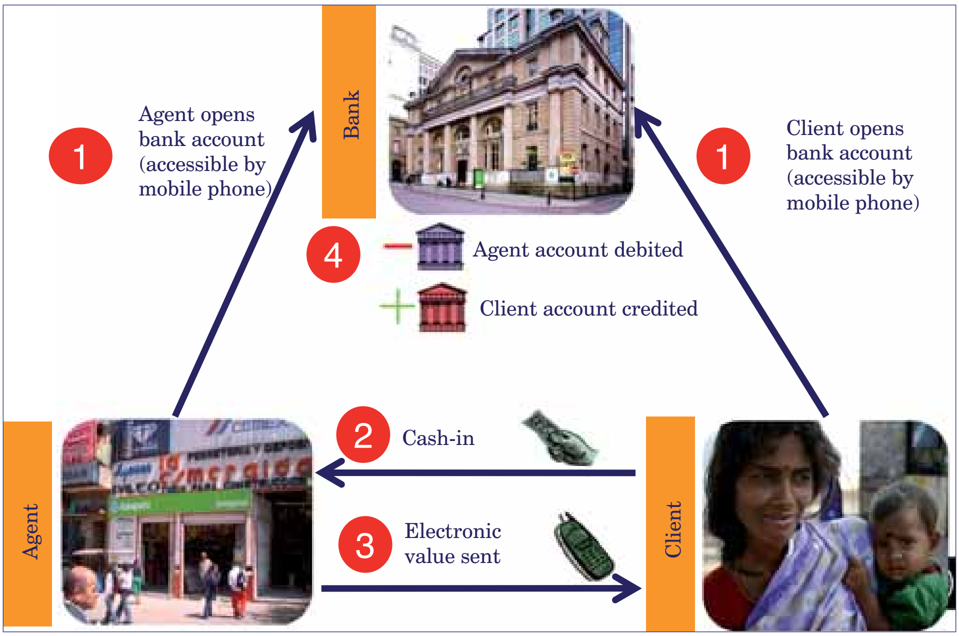
5 Bob Christen, see Foreword, xi, in Protecting Mobile Money against Financial Crimes, Global Policy Challenges and Solutions, The World Bank, 2011.

6 Other issues like interoperability between operators and overall efficiency are also legitimate concerns.

7 Agents are typically small retailers –"mom-and pop-"shops.

The chart below provides an example of basic – yet very popular – *cash in* operation. Both the customer and the agent hold a special bank account accessible remotely by mobile phone. In order to deposit money on its mobile account, the customer goes to an accredited agent. Then, the merchant converts the cash received into electronic value. As a result, on the bank's books, the agent's account is debited and the customer's account is credited. For cash out transactions, it is the other way around. The customer can redeem cash from his mobile account at an agent store who will transform electronic value into cash.

Chart 1. An Example of Basic Cash in Operation



Source: Michael Tarazi, CGAP, 2011.

At first glance, the system looks simple; however, there are multiple business models operating around the world. These systems can be grouped in two categories; the bank-led model on the one hand, the non-bank-based model on the other. It is noteworthy that Governments have increasingly found this distinction inadequate to describe and categorize the plethora of models that have emerged over the last years. But for the sake of simplicity, we will use this binary approach in this article. To find appropriate ways to regulate mobile money, it is indeed important to understand how the money moves through the systems and how the different players interact with each other.

Under the bank-based model, customers have a direct contractual relationship with a bank or similar prudentially regulated and supervised institution and it is this institution that is licensed to provide the service. An example of this is the Smart Money system in the Philippines. Smart Money is a re-loadable payment card issued by Banco de Oro that may either be accessed through a Smart mobile phone or a MasterCard powered card, similar to a debit/cash card. The *Bangko Sentral Ng Plipinas* approved the service in 2004 as an electronic banking product of the Banco de Oro, subject to existing circulars governing electronic banking.

In the case of a non-bank-based model (also called Telco-led model), customers have direct contractual relationship with a non-bank service providers (e.g. a mobile network operator – MNO – or an issuer of stored-value payment instruments) and it is this non-bank that is licensed to provide the service. In Kenya for example, Safaricom (a subsidiary of the UK based telecom company Vodafone) has created M-Pesa, an innovative mobile transfer solution that enables customers to transfer money from peer-to-peer, from individual to businesses and redeem cash at designated outlets. Kenyans can also pay for their goods at supermarkets using the M-Pesa service. Another example of Telco-led model is G-Cash in the Philippines, created by Global Telecom. G-Cash is a method of transforming a mobile phone into a virtual wallet[8].

3. WHAT IS THE IMPACT OF MOBILE MONEY ON FINANCIAL INCLUSION?

Mobile phones hold great potential to become a common way of conducting financial transactions on a global scale. People around the world use mobile phones to communicate, and the technology has even become accessible to low income and remote populations in recent years. For the billions of people who currently do not have access to formal financial services, mobile technology offers new means for them to access financial services[9].

Indeed, more than 80% of the world's population is now within mobile coverage. In 2009, the Groupe Speciale Mobile Association (GSMA) reported that there were more than 4 billion mobile subscriptions globally, with 80% percent of new connections in

8 GX Change, a subsidiary of Globe Telecom, holds the relationship with the bank. GX Change is the one who is regulated by BSP as a dedicated e-money issuers and is registered with BSP as a "remittance agent".

9 As observed by the Payments System Development Group (PSDG) of the World Bank, "in terms of usage, innovative payment products are still much lower in comparison to traditional retail payment products however they are important for financial inclusion in over 10% of the countries"; see for a complete analysis the outcomes of the Global Payment Systems Survey 2010, available at www.worldbank.org/paymentsystems.

emerging markets and mostly for lower-income consumers[10]. At the same time, there are enormous discrepancies between mobile coverage and access to formal financial services. An early-2009 study by CGAP, the GSMA, and the McKinsey Group (CGAP 2009) shows that almost 4 billion people worldwide remain without access to formal financial services. Of this number, 1 billion do not have a bank account, but do possess a mobile phone – a number expected to grow to 1.7 billion by 2012.

Therefore, mobile phones can be leveraged to provide formal financial services to unbanked population. In this regard, the case of Kenya is a good illustration of the potential of m-money. In only a few years, M-Pesa has acquired more than 13 millions of users, which accounts for about 40% of Kenya's population and an estimated 50% of these users are unbanked; 98% of users report being happy with the service and 84% claim that losing M-Pesa would have a large, negative effect (Svenssen, 2011)[11]. M-PESA provides a range of other payment services like remittances and bill payment and, with the introduction of M-Kesho in tie-up with Equity bank, it also offers traditional banking products structured to meet the needs of hitherto unbanked[12].

In the Philippines, over $100M flows through the GCASH system daily. GCASH and rival Smartmoney are accepted in establishments that take credit cards, giving the unbanked the ability to conduct cashless transactions, a benefit previously limited to credit card customers. In India, the government has understood the potential of mobile phones in financial inclusion and is working aggressively towards enabling this system as penetrative as possible. In Haiti, research has already demonstrated the capacity of mobile banking to reach more previously unbanked and low-income people than the largest micro finance institution in the country in a shorter period of time[13]. In Rwanda, 30% of the population now pays for their electricity using a new mobile phone payment system.

Of course, it could be argued that the success story of M-Pesa in Kenya is not necessarily replicable everywhere. Whatever it might be, it is commonly admitted that mobile banking and m-money services have a multiplier impact on the lives of people drawn into the formal financial system. When the poor get access to financial services, their cash flow management gets better, their financial planning

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10 The source of those data (Wireless Intelligence, GSMA's marketing information unit) is available at https://www.wirelessintelligence.com/

11 Pål Svenssen, M-Pesa: Financial Inclusion through Mobile Payments, PaymentsFrontier, 5 January 2011.

12 Yet usage of M-PESA currently is primarily for remittances. As per a survey cited in a recent report, 88% of the time incoming funds into an M-Pesa account were withdrawn the same day, a further 5% within one day and in only 3% of the instances incoming funds were retained in the account for a period longer than 1 week. Guy Stuart and Monique Cohen: Cash in Cash Out Kenya: The Role of M-PESA in lives of low-income people, September 2011.

13 Center For Financial Inclusion, Publication 12, 2011, Opportunities and Obstacles to Financial Inclusion.

is enhanced and their savings are increased with increased options for providing for themselves for their old age (Agrawal, 2010)[14].

4. WHY MOBILE MONEY IS A POWERFUL TOOL FOR FINANCIAL INCLUSION?

Mobile money products offer many features that make it a powerful instrument for inclusive finance[15]. They can be grouped in 3 main categories. They are simple to use, they are usually cheaper than other methods of payment and they are effective tools for operating financial transactions.

Simplicity is certainly the most distinctive attribute of m-money. It is user-friendly and can be easily understood by the masses. For example, in the Philippines with Smartmoney, users can purchase items by simply sending an SMS message containing the seller's merchant number and payment amount. In Kenya, to enable an M-Pesa account, a customer gets credit towards his virtual account by paying cash to a registered agent. To transfer funds, customers access a menu-driven application, built into their SIM card that allows them to send money to other mobile phone users. If the receiver is another M-Pesa user, the funds get added to his account. Otherwise, the virtual money can be cashed in with any registered agent[16]. Simplicity also dominates the account opening process. There is minimum paper work required since subscribers can register for the service by filling up a simple form. In South Africa, a face-to-face account origination is not needed under certain conditions. Moreover, in certain countries, users are required to submit only the identity proof to get the service started, making the "know-Your-Customer" process easier for prospective clients[17].

Affordability is another key aspect of m-money. Most of the providers keep the pricing of the product very transparent and lower than other alternatives. Free registration, no monthly fee (often but not always), no minimum balance makes m-money products very attractive, particularly for the poor[18]. The user is only

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[14] Mohit Agrawal, Socio-Economic Benefits of Mobile Money Transfer, Telecom Circle, 1/27/10 available at: http://www.telecomcircle.com/2010/01/benefits-of-mobile-money-transfer/

[15] For more details, see Ignacio Mas and Amolo Ng'weno, Bill & Melinda Gates Foundation, Three keys to M-PESA's success: Branding, channel management and pricing at: http://mmublog.org/wp-content/files_mf/keystompesassuccess4jan.pdf

[16] using a secret code and an I.D. See Ben Lorica, Mobiles and Money in the Developing World, O'Reilly Radar, April 2009.

[17] For undocumented people in particular, national regulations in some countries allow applicants to produce alternative forms of ID, e.g. a certificate issued by the village master, (Tanzania), voter card (Uganda), birth certificate (Malaysia).

[18] It is noteworthy that mobile banking is cheaper than other solutions if both direct and indirect costs are considered all together. Regarding policy fees, readers can found a comparative analysis of practices in the Global Payment Systems Survey 2010.

charged a flat fee for available services. For cross-border operations in particular, migrant workers are now resorting to mobile money to send money to their home country because it offers a competitive advantage over wire transfers and informal finance channels. According to CGAP, m-money services are 26% cheaper than traditional banks. From a provider standpoint also, offering these types of products can reduce the costs of doing business, because they use existing technologies (phones) and existing infrastructures (agents)[19].

Effectiveness also characterizes m-money solutions. The service automates transactions that are done manually on paper in many jurisdictions. Electronic transactions are automatically stored and quickly traced. Password protection and other personal identification systems contribute to the overall effectiveness as well. M-money transactions are also real-time transactions because customers use instant messaging. In a matter of seconds, money can be transferred or cash withdrawn. Effectiveness can also be achieved through the use of multiple agents like groceries stores, pharmacy, gas stations, increasing people outreach and coverage. Mobile technology also facilitates transfer of funds of various government schemes like social security pensions and wages paid to a mobile linked account, like in Mexico or India. It is also noteworthy that when a good payment system infrastructure is in place, other channels, including using mobile phones for accessing the service, are more efficient.

5. POLICY CHALLENGES: HOW TO PROTECT CUSTOMERS' FUNDS?

In most countries were m-money is growing, policy makers are facing multiple challenges to regulate these types of services, including, but not limited to, competition, integrity and consumer protection. In this last regard, the issue of funds protection for m-money solutions is one of the most complicated to address in the non-bank led model. Under this configuration, taking money from the public, even for the purpose of making payments rather than for saving, is close to accepting public deposits, something that has almost been always reserved for prudentially regulated finance institutions (Tarazi and Breloff, 2010)[20].

Besides, unlike banks and other financial entities, mobile network operators are neither prudentially regulated nor supervised by financial oversight bodies

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19 CGAP's experiments with providers show that using branches could cost 30 times more to set-up than using third-party agents equipped with point-of-sale. Replacing the point-of-sale device with a cell phone will have further cut cost in half.

20 See Michael Tarazi and Paul Breloff, published by CGAP (Consultative Group to Assist the Poor), Focus Note 63, July 2010, 12 pages, available at: http://www.cgap.org/p/site/c/template.rc/1.9.45715/

and as such not subject to strict liquidity and capital requirements. Therefore, concerns have been expressed about the safety of customer's funds and the protection mechanisms that can be put in place in case an m-money service provider goes bankrupt[21]. In practice, policy responses seem to converge towards funds safeguarding of some sort. Whoever the service provider is, customer's funds need to be protected, liquidity must be ensured, traceability must be granted and ownership of the funds in the bank account must be guaranteed (Malaguti, 2011)[22]. There are two lines of defense that can be distinguished.

In the first line of defense two options, Fund Safeguarding on the one hand and Fund Isolation on the other have been considered and applied. In countries where MNOs are legally allowed to provide mobile money services, issuers are required to maintain liquid assets equivalent to the total value of the customer's funds collected. Other measures consist in prohibiting the MNO from using the funds to finance operating expenses or for lending purposes. Fund safeguarding can also consist in requiring electronic money providers to keep funds in bank accounts or invested in Government securities. All these practices aim to ensure availability of funds when redeemed by customers against electronic value (e.g. Indonesia, the Philippines, Cambodia, Malaysia, India and Kenya)[23].

The second option called Fund Isolation is designed to ensure that in case the MNO goes bankrupt, electronic funds cannot be captured by MNO's creditors. Indeed, funds may still be at risk if the customer's ownership of the funds is unclear. While funds can be safeguarded in accounts of prudentially regulated institutions, such funds are often pooled and held in the name of the issuer, not in the name of the customers. Thus, the non-bank issuer is the legal owner of the accounts, thereby making the underlying funds vulnerable to claims by the issuer's creditors in case of bankruptcy (Tarazi and Breloff). As shown in the diagram below, M-Pesa customers in Kenya are isolated from creditor claims by the use of a trust account that is administered by a third party trustee and held in different banks for the benefit of M-Pesa customers.

The second line of defense may be conceived as a response to a more serious situation where not only an MNO but also a bank could go bankrupt. To the extent that underlying customer funds are kept in bank accounts, such funds are exposed

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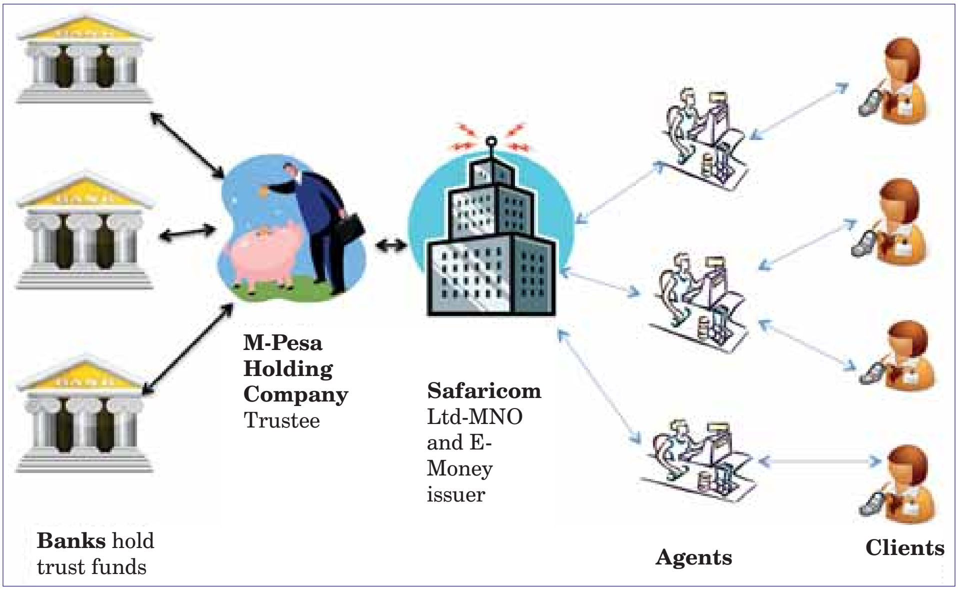
21 For mobile banking, this discussion is not relevant since the mobile banking service is attached to a traditional bank account.

22 For further details, see Maria Chiara Malaguti, Regulating Mobile Payments, Key Issues: Financial Infrastructure Week, 2011, Rio de Janeiro, 14–17 March 20-11, also in Massimo Cirasino and Malaguti, From remittances to m-payments: understanding "alternative" means of payment within the common framework of retail payment system regulation", World Bank, forthcoming.ftp://ftp.worldbank.org/pub/FIWEEK2011/15_17MARPayment_Systems/17_March/PS_Legal2_MALAGUTI_17032011.pdf

23 See Michael Tarazi and Paul Breloff for a complete analysis.

Chart 2. Found Isolation Scheme



Source: Author's slide no 14 of the presentation at the Conference session.

to the risks of bank failure and the 2008 crisis has precisely shown that funds held in prudentially regulated institutions are not risk-free. In this context, how e-money customers can retrieve their funds and should the funds be covered by a deposit insurance mechanism are legitimate concerns. In practice however, there is no consensus about what needs to be insured and whether or not e-money funds are eligible for safety net[24].

There is indeed diverging views as to whether electronic money is a deposit. In many countries, e-money is not a deposit and thus not eligible to a safety net mechanism (e.g. in the Philippines or in Afghanistan). In sharp contrast, some are advocating in favor of extending deposit insurance protection to e-money users under certain conditions[25] because e-money products are increasingly being used as saving vehicles[26].

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[24] For an extensive discussion, see Tilman Ehrbeck and Michael Tarazi, Putting the Banking in Branchless Banking: Regulation and the Case for Interest-Bearing and Insured E-money Saving Accounts, The Mobile Financial Services Development Report, 2011.

[25] In the US, funds underlying stored-value cards are considered as deposit and thus covered by deposit insurance scheme as long as such funds are held in an insured institution, a mechanism called "pass through" deposit insurance.

[26] In this regard it is important to highlight one risk – the risk of loss of record of individual e-money accounts from the e-money system of the service provider. While the funds could be

Also, before opting for a safety net system for e-money, national authorities will have to consider other aspects, in particular the financial implications of such mechanisms. Deposits insurance is funded by premiums paid by participating financial institutions, which typically pass these cost along their customers. Thus, putting e-money under a deposit insurance umbrella may make it more expensive, especially in developing countries where, as discussed in section 4 above, affordability has been a determining factor for success. This could, in turn, negatively affect financial inclusion. Also, a safety net will require a sound regulatory and supervisory regime, conditions that are not always met in developing countries.

safe, if there is a loss of record, how would one decide who has how much in his/her e-money account? In the case of a bank, the risk might be limited since they are subject to strong operational reliability requirements. In the case of an MNO, the issue might be more relevant.

Rose Detho*

FINANCIAL INCLUSION – A CASE FOR KENYA[1]

1. INTRODUCTION

Kenya plays a significant role in the East African Economy where it accounts for 40% of the region's GDP and 30% of the region's population. Kenya is classified as a Low Income Country in which 30% of the population lives on less than $1.25 a day and 40% live on less than $2 a day. However, Kenya has been experiencing rapid growth and in 2010 its GDP growth was estimated at 5%. One of the most important sectors that largely account for the country's economic growth is the financial sector.

The Kenyan financial landscape comprises forty three (43) commercial banks; one (1) mortgage finance company; three (3) Representative Offices of Foreign Banks; two (2) Credit Reference Bureaus; six (6) Deposit Taking Microfinance Institutions; and one hundred and twenty four (124) Foreign Exchange Bureaus. The Branch network has grown significantly from 772 bank branches in 2008 to 1,102 bank branches in June 2011 (42.7% growth).The deposits in the banking sector have also risen from Ksh. 573.5b in 2006 to Ksh. 1,420b in June 2011. The number of adults with bank accounts rose from 14% of the population in 2006 to 22% in 2009.

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1 The following sources contributed to the compilation of this paper: 1. Deposit Protection Fund Board Statistical Reports; 2. FinAcess (Kenya) 2009 Survey Report; 3. Findings of a Case Study on Kenya's engagement with the financial sector standard setting bodies and the implications for financial inclusion (2011) by The Centre for Financial Regulation & Inclusion.

Kenya's Economic Development Plan was formulated in 2006 under the banner of Vision 2030. It sets out policy objectives and action plans that are geared towards transforming Kenya into a middle income level country by the year 2030. Vision 2030 pays specific attention to the development of the financial services sector and embodies a policy commitment to financial inclusion. The goal is to expand banking services to parts of the excluded population, i.e. the rural areas in order to act as a catalyst for greater pool of savings with which to finance productive investments. The Kenyan Government is committed to providing policy support for financial players acting in support of financial inclusion.

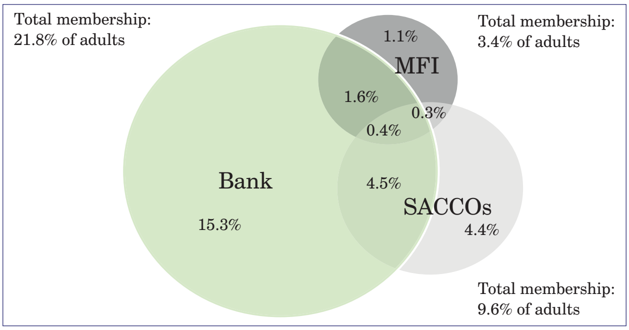
2. FINANCIAL INCLUSION INITIATIVES

The Kenyan Government passed a deliberate policy of promoting financial inclusion in order to reach the unbanked and promote savings to drive investments and economic growth. This policy also seeks to alleviate poverty among the Kenyan citizens. Key initiatives to drive this policy objective include the following:

- ❖ Deposit Taking Microfinance Institutions have been licensed by the Central Bank of Kenya and this has expanded the deposit base by reaching out to new segments of the market.
- ❖ Agency Banking: this model has allowed banks to spread their reach to more customers without having to invest in expensive "brick and mortar" branch-network.
- ❖ Savings and Credit Cooperative Societies ("SACCOs") sector has been streamlined through legislative framework.
- ❖ Credit Referencing has been introduced to improve the credit culture and promote credit expansion at affordable cost while ridding the banking sector of the incidence of bad debts.
- ❖ Innovations by non-bank telecom service providers have promoted and deepened financial access through mobile telephony and other electronic payment platforms. The M-PESA mobile model in Kenya has revolutionized money transfer in the financial and telecom sectors.
- ❖ Partnerships in Global Financial Inclusion forums to keep with the current trends and standards.
- ❖ Kenya seeks to broaden and deepen its financial sector and reach a large population financially excluded from formal financial system.

Research has shown that Kenya has significantly expanded the reach to financial services. According to the FinAccess Survey of 2006 and 2009 formal financial inclusion increased from 26.4% in 2006 to 40% in 2009; the number of financially excluded population decreased from 38.4% in 2006 to 32.7% in 2009; and in urban areas, financial exclusion was cut by half from 42.9% in 2006 to 20.9% in 2009. The research also revealed that Banks, MFIs and SACCOs serve about 27% of adult population (banks serve 25%; SACCOs 9.6%; MFIs 3.4%) and many of the customers are served by more than one type of institution. The chart below illustrates the composition of the customer base for the three types of financial institutions.

Chart 1. Comparative client bases of Banks, MFIs and SACCOs (percentage of adults 16 years and older)



Source: FinAccess, 2009.

3. OVERVIEW OF FINANCIAL INCLUSION IN KENYA

3.1. A fast-changing financial sector landscape

There has been a rapid expansion of bank branches within Kenya and across the neighbouring countries that form the East African Community. The country has further witnessed the licensing of new banks and deposit-taking MFIs. There has also been a proliferation of new innovative business models that have revolutionized the banking system, e.g. agency banking and mobile-phone money transfers. The increased complexity in the financial industry brought about by innovations such as the convergence of financial services with the telecommunications industry has complicated the industry and presented new risk profiles from a deposit insurance perspective.

3.2. Transformational impact of innovation in mobile payments

The largest mobile telecommunication company in Kenya, Safaricom, launched a mobile payment system known as “M-PESA” in March 2007. Thereafter, other service providers launched similar services, i.e., Airtel Money, Yu Cash, Orange Money & Tangaza. The initial focus of M-PESA was geographic money transfers and electronic payment of bills. However, the service has since been expanded to include linkage with partner banks to provide a range of banking services through the M-PESA platform, e.g. depositing cash into one's bank account by transacting through the telephone handset. By August 2011, 18.5 million users of mobile payment systems across the four networks were being served by 52,689 agents. These users accounted for a monthly average of 39.3 million transactions with a value of Kshs.107.3 billion. M-PESA remains the dominant service and it controls over 90% of this market segment.

3.3. New generation of banks and micro-finance deposit-taking institutions leading the way

A number of commercial banks in Kenya have specifically focused on the Microfinance arena and thereby succeeded in extending financial services to the previously un-served population. A good example of this is Equity Bank, which was registered in 1984 as a Building Society and then transitioned to a Commercial Bank in 2004. Since then, Equity Bank has registered phenomenal growth and by June 2011, it held 5.8m accounts, representing 40.7% of total accounts in the banking sector. Equity Bank has partnered with Safaricom to link with M-PESA electronic money transfer platform to its banking platform through a service known as "M-KESHO". Other players in the industry that have a focus on the mass market include Kenya Commercial Bank; Co-operative Bank of Kenya; Family Bank; and K-REP Bank.

3.4. The Microfinance Act, 2006

The Microfinance Act, 2006 became operational in May, 2008. The Act facilitates the transformation of credit-only Microfinance Institutions ("MFIs"), upon meeting set criteria, into Deposit-Taking MFIs ("DTMs"). After conversion, the DTMs now have the ability to access additional funds from customer deposits for on-lending. The DTMs fall within two major categories, *viz*, (1) National outreach, or (2) Community based. The Central Bank of Kenya has, since 2009, licensed 6 DTMs, which had a deposit base of Ksh.9.6 billion as at June 2011. The MFIs that are deposit taking are also subjected to the insurance cover under the deposit protection scheme.

3.5. Participation in the global financial inclusion initiatives

The Central Bank of Kenya ("CBK") is a founding member of the Alliance for Financial Inclusion ("AFI"), formed in 2009. AFI is a global network of policy makers from eighty one (81) developing countries in Asia, Latin America and Africa. AFI seeks to promote sharing of cutting edge financial inclusion policies. Kenya's Financial Inclusion initiatives have benefited from experiences gained within the AFI network. For instance, the Agency banking model was informed by experiences of AFI members in Brazil and Colombia. Through AFI, CBK was nominated as a non G20 partner of the Global Partnership for Financial Inclusion ("GPFI") in 2010. Through GPFI, a case study on Kenya's experiences with Standard Setting Bodies ("SSB's") including IADI was released in October 2011. The case studies on Kenya and four other countries have been shared with SSB's in order to review standards and inform development.

3.6. Strengthening Kenya's financial inclusion initiatives

Kenya is promoting an evidence based financial inclusion policy and in this regard, an updated National Financial Access Survey is targeted for release in 2012. The country also aims at enhancing consumer empowerment by development of national financial education strategy undertaken through public-private partnership. There is a move to strengthen disclosures/transparency of charges and lending rates within the banking sector. Another policy objective is directed at providing proportionate regulation to support development of the widespread financial service delivery channels/touch points across the country. Finally, deposit protection/safety net mechanisms are being strengthened.

4. PRACTICAL ISSUES/CHALLENGES

4.1. Challenges with safety net players and other standard setting bodies (IADI, BCBS & CPSS)

The regional expansion by Kenyan banks within the East African countries is posing cross-border risks that need to be addressed. As the financial services broaden, there is need for increased consumer protection and financial education with an emphasis on provision of sound financial products. The newly introduced agency banking has created a new set of players who bring with them a new risk profile. Along with this, comes the challenge of defining who a "bank customer" is.

4.2. New innovative payment models have changed overall risk landscape for banking

Mobile payment systems operate float accounts that are held in trust by Kenyan banks. With the growth of mobile payment systems, the deposits held in these float accounts are subjected to further uncertainty. The mobile payment systems are currently outside the direct oversight of the banking regulator (CBK) yet market confidence partially depends on the regulator's ability to protect the soundness of the financial system.

4.3. What constitutes banking business requires rethinking of BCBS Principle 2 on Permissible Activities

Recent innovations in the mobile payments systems will necessitate rethinking the BCBS Principle 2 on Permissible Activities. There are systemic links between banks, mobile network operators and payment systems in the overall banking landscape. The nexus of these players creates a need for interaction between the respective regulators and the respective standard-setting bodies. BCBS and CPSS should establish a demarcation on what constitutes "banking business and deposit-taking" and how mobile payment systems fits within the greater risk framework. Mobile payment systems may not constitute banking business as funds collected are not inter-mediated by the mobile payment service provider. The deposits held in Kenyan banks as float accounts imply some level of responsibility for the banking regulator.

4.4. CPSS Principles yet to find way into legislation

In 1998, Kenya began a modernisation programme for its national payment system. In this regard, the Nairobi Clearing House was automated in 1998. The Kenya Electronic Payments System ("KEPPS"), a Real Time Gross Settlement (RTGS) System was implemented in 2005. High Value Capping was introduced in 2009 and all payments from bank accounts in excess of Kshs.1 million must be made by Electronic Funds Transfer. A Cheque Truncation System (i.e. paperless clearing house) has been implemented starting in 2011.

4.5. The national payments systems bill, 2011

The Bill seeks to regulate and supervise payment systems and payment service providers, and for connected purposes. The Bill addresses payment instruments whether tangible or intangible that enables a person to obtain money, goods and services, or to otherwise make payment. The Bill defines a "Payment Service Provider" as anyone who acts as a provider in relation to sending, receiving, storing or processing of payments or the provision of other services in relation to payment services through any electronic system. This Bill, once enacted, will bring on board a legal framework according the central bank the oversight mandate, among others, and streamline innovations in the financial sector that are technologically driven.

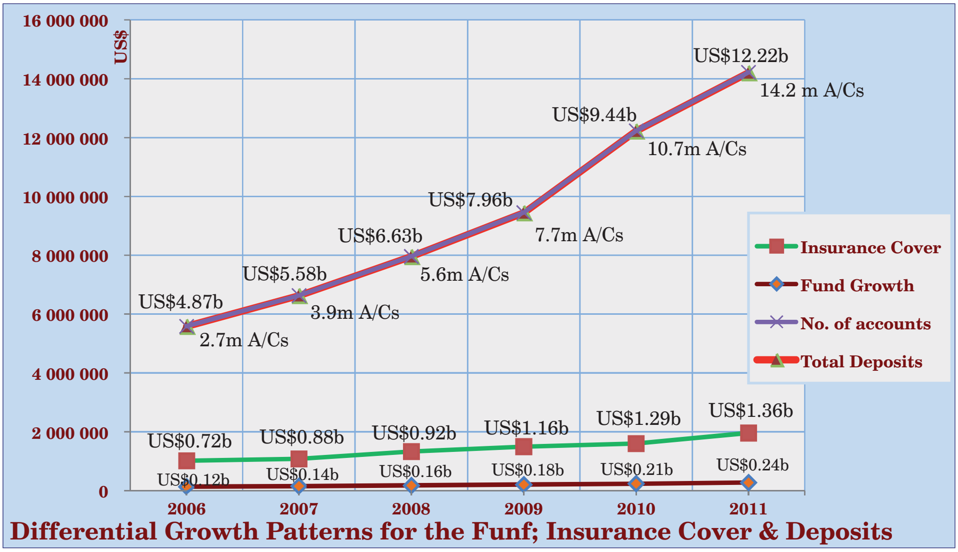
4.6. Financial inclusion and deposit insurance

It is difficult to keep pace with growth in deposits unleashed by the financial inclusion drive (See DPFB coverage statistics below). Are IADI guidelines on 20–40% coverage relevant for Kenya? DPFB needs to rethink how to expand current insurance coverage and what the ideal level of coverage should be. DPFB has the difficult task of balancing the need for fund growth against the desire to keep access to deposit services as inexpensive as possible in order to encourage financial inclusion.

Table 1. Protection & Exposure Indicators as at 30th June, 2011

	Banking Sector Deposits	30/06/2010	30/06/2011	%Change
1.	Total Deposits(Kshs. M)	1,222,160	1,420,457	16.20%
2.	Total Protected Deposits (Ksh.m.)	136,291	168,120	23.30%
3.	Protection Level (2/1)	11.15%	11.830%	0.68%
4.	Fund Balance (Ksh.m.)	24,101	28,124	16.70%
5.	Effective Cover (4/2)	17.68%	16.730%	(0.95%)
6.	Number of Deposit accounts ('000')	10,676	14,213	33.00%
7.	Number of accounts fully protected ('000')	10,057	13,365	32.80%
8.	Share of Protected accounts (7/6)	94.00%	94.000%	0.00%
9.	Exposure Level 2 – 4/2)	82.30%	83.300%	1.00%

Chart 2. Effect of Financial Inclusion on Deposit Insurance as at 30.06.2011



Source: Author's slide no 22 of the presentation at the Conference session.

- Number of fully insured accounts – 13,365,472 (94% of total accounts).
- Effective cover – 16.7% (against an international benchmark of 40%).

4.7. Risk landscape complicated by Kenyan banks regional expansion

The recent rapid expansion by Kenyan banks into Uganda, Tanzania, Rwanda and South Sudan has complicated the risk landscape. The major challenge is in how to assess the risk of financial difficulties in other jurisdictions and the potential impact on the domestic protection regime. Many of these neighbouring countries do not have deposit insurance and the question therefore arises on whether this large deposit insurance risks can be transferred to Kenya. Additionally, the exposure of Kenyan banks to risky business environments outside Kenya may impact their stability in Kenya, thereby putting local deposits at risk.

4.8. How should DPFB handle mobile payment models

The current model entails holding the float for M-PESA and other mobile payment systems accounts in Trust accounts in commercial banks. DPFB provides insurance cover for each depositor and the cover is not extended to individual agents who have each deposited their funds into the pooled trust accounts. This means that in case of failure by a bank holding such an account, the individual agents would not be in a position to lodge separate claims. DPFB acknowledges that some M-PESA clients use their mobile phone accounts for short-term savings and these do not enjoy deposit insurance protection in their favour. How then can deposit insurance be made more relevant for various mobile payment models and how should this be implemented? Deposit insurance coverage for funds in the mobile payment systems therefore, requires consideration by IADI members. There is also the need to harmonize with other non-bank financial institutions e.g. SACCOs; Insurance Companies; Capital Markets players; in a financial inclusion approach.

G. Gopalakrishna[*]

FINANCIAL INCLUSION: THE INDIAN EXPERIENCE

1. INTRODUCTION

Financial Inclusion in the Indian context has been defined as the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups, such as weaker sections and low income groups, in particular at an affordable cost in a fair and transparent manner by mainstream institutional players.

Financial inclusion has become one of the most critical aspects in the context of achieving inclusive growth and development. Financial inclusion helps accelerate economic growth by reducing economic vulnerability of the poor leading to improvement in the quality of life. Access to affordable credit is one of the most significant requirements of the poor. This coupled with safe savings, transfer of money and insurance will mostly satisfy the dire financial requirements of the poor.

2. EXTENT OF FINANCIAL INCLUSION

Out of the 600,000 villages in India, till recently, only about 30,000 villages had a bank branch. Out of the 1.2 billion population of the country only 45% of the people had bank accounts, 10% of the people had Life Insurance, 0.6% people had

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some kind of non-life insurance, 13% had debit cards and only 2% had credit cards. The mainstream financial institutions have an important role to play in the effort towards achieving total financial inclusion for the country.

Our broad objective is to take banking to all excluded sections of the society, rural and urban. Our attention was specifically accorded to provide banking services to all the 600,000 villages and meet their financial needs through basic financial products like savings Bank Account, credit facilities and remittance facilities.

3. BOTTLENECKS

The bottlenecks and difficulties in achieving complete financial inclusion in our country are fairly well known. The major obstacles are:

- ❖ Non-availability of appropriate banking technology till a few years ago. Lack of proper physical infrastructure, digital connectivity, etc. in some parts of the country. If Financial Inclusion is to take place, it can only be achieved through Information and Communication Technology (ICT) based models.
- ❖ Lack of proper Business Models. Banks still perceive this as a burden and an imposition and not as a viable Business Model.
- ❖ Lack of cost effective scalable Delivery Models. There is no facilitating and effective Delivery Model especially when problems are encountered. Business Correspondent (BC) based Delivery Model is still in the evolutionary stage.
- ❖ The costs of administering low value transactions and of financial intermediation are perceived to be on the higher side.
- ❖ Planned, strategic and concerted efforts were lacking. It requires massive efforts from all stakeholders.

4. STRATEGY

Our broad strategy for achieving planned, sustained and structured Financial Inclusion has been through a planned approach to the entire gamut of issues Reserve Bank has advised banks:

- ❖ to formulate a Board approved Financial Inclusion Plan (FIP) for the next three years. We have not imposed a uniform model so that each bank is able to build its own strategy in line with its Business Model and comparative competitive advantage.
- ❖ to integrate FIPs with the normal Business Plans of the banks. We have freed interest rates and have also allowed banks to charge their customers for

other transactions. We believe that banking to the poor is a viable business opportunity but a cost-benefit analysis needs to be done by the banks to make Financial Inclusion congruent with their Business Models. Banks must view Financial Inclusion as a viable Business Model.

- ❖ to view Financial Inclusion as a huge business opportunity and perfect their Delivery Models. BC based delivery model has been made more flexible and inclusive.
- ❖ to fix technology aspects first including completion of Core Banking Solution (CBS) in all their branches and those of sponsored RRBs, and seamless integration of front-end devices with the back-end systems. Without this, it would not be possible to scale up the activities.
- ❖ to increase the bouquet of products currently being offered. banks have been advised to provide a minimum of four products to the account holder, viz:
  a. A savings cum overdraft account
  b. A pure savings account, ideally a recurring or variable recurring deposit
  c. A remittance product to facilitate EBT and other remittances, and
  d. Entrepreneurial credit products like a General Purpose Credit Card (GCC) or a Kisan Credit Card (KCC)

  Apart from these minimum basic products, banks can offer any other product like insurance, mutual funds, etc. to the account holders.
- ❖ that for a village to be considered covered by banking services, either a bank branch has to be present or a Business Correspondent (BC) outlet has to be made available in that village. There must be a bifurcation between villages with more than 2000 population and those with less than 2000 population. The plan needs to cover in an integrated manner both categories of villages. The name of the BC / branch covering a particular village needs to be indicated on the banks website.
- ❖ to provide Special focus on Financial Inclusion at Urban and Metro centers through a functional approach.
- ❖ to Involve all the stakeholders in the process. Governments, both Central and State, NGOs, technology vendors, Industry Associations, Insurance and Mutual Fund companies, society at large

5. RBI INITIATIVES

RBI's efforts have been to remove all regulatory bottlenecks for facilitating greater Financial Inclusion. Pricing has also been made free. Some of the initiatives taken by RBI in this direction are detailed below:

5.1. Provision of new products

- **Opening of no-frills accounts:** Banks were mandated to offer basic banking 'no-frills' accounts with 'nil' or very low minimum balances as well as charges that make such accounts accessible to vast sections of the excluded population. **As of March 2011, 74.4 million 'no frills accounts' have been opened by banks with outstanding balance of 65.66 INR billion.**
- **Small Overdrafts in No-frills accounts:** With a view to make No Frill accounts transactions; Banks have been advised to provide small ODs in such accounts. **Up to March 2011, banks had provided 4.18 million ODs amounting to INR 2.0 billion.**
- **General Credit Cards (GCCs)/Kisan Credit Cards (credit cards designed for farmers)-KCCs-:** Banks have been asked to consider introduction of a General Purpose Credit Card (GCC) facility up to INR 25,000/- at their rural and semi-urban braches. The objective of the scheme is to provide hassle-free credit to banks' customers based on the assessment of cash flow without insistence on security, purpose or end-use of the credit. This is in the nature of revolving credit entitling the holder to withdraw up to the limit sanctioned. **As of March 2011, banks had provided credit aggregating INR 13.08 billion in 0.95 million General Credit Card (GCC) accounts.** As regards KCCs, the total no. of accounts as of March 2011 was 2.25 million.

5.2. Regulatory measures

- **Relaxation on KYC norms:** Know Your Customer (KYC) requirements for opening bank accounts were earlier relaxed for small accounts in August 2005, simplifying procedure by stipulating that introduction by an account holder who has been subjected to full KYC drill would suffice for opening such accounts or the bank can take any evidence as to the identity and address of the customer to the satisfaction of the bank.
- **Simplified branch authorisation:** To address the issue of uneven spread of Bank branches, domestic scheduled commercial banks are permitted to freely open branches in Tier 2 to Tier 6 centres with population of less than 100,000 under general permission, without the need to take permission from Reserve Bank in each case, subject to reporting.
- **Opening of branches in unbanked rural centres:** Banks have been mandated in April 2011 to allocate at least 25 per cent of the total number of branches to be opened during a year in unbanked rural centres.
- **Engaging Business Correspondents:** In January 2006, the Reserve Bank permitted banks to engage business facilitator and business correspondent (BC)

as intermediaries for providing financial and banking services. The BC model allows banks to provide door step delivery of services especially 'cash in – cash out' transactions at a location much closer to the rural population, thus addressing the last mile problem. The list of eligible individuals/entities who can be engaged as BCs is being widened from time to time. With effect from September 2010, "For-profit companies" have also been also allowed to be engaged as BC's.

5.3. Supportive measures

- **Special package for North Eastern States:** To improve banking penetration in the North-Eastern Region of the country, where the problem of exclusion is extreme, the Reserve Bank has offered to fund the capital and running costs for five years to banks for opening of bank branches.
- **Roadmap for providing Banking Services in unbanked villages:** With an objective of ensuring uniform progress in provision of banking services in all parts of the country, banks were advised to draw up a roadmap by to provide banking services through a banking outlet in every unbanked village having a population of over 2,000, by March 2012. RBI advised banks that such banking services need not necessarily be extended through a brick and mortar branch but could also be provided through any of the various forms of ICT – based models, including of Business Correspondents (BCs). About 72,800 of such unbanked villages have been identified and allotted to various banks through State Level Bankers committee (SLBC), for providing banking services by March 2012. As of March 31, 2011, 24,710 villages have been provided with banking outlets.
- **Financial inclusion Plans:** In January 2010, all public and private sector banks were advised to put in place a Board approved three-year financial inclusion plan (FIP) and submit the same to the Reserve Bank by March 2010. These banks prepared and submitted their FIPs containing targets for March 2011, 2012 and 2013, to Central Office. These plans broadly include self-set targets in respect of rural brick and mortar branches opened; business correspondents (BC) employed; coverage of unbanked villages with population above 2000 as also other unbanked villages with population below 2000 through branches/BCs/other modes; no-frill accounts opened through BC-ICT; Kisan Credit Cards (KCC) and General Credit Cards (GCC) issued; and other specific products designed by them to cater to the financially excluded segments. Banks were advised to integrate Board-approved FIPs with their business plans and to include the criteria on financial inclusion as a parameter in the performance evaluation of their staff. The implementation of these plans is being closely monitored by the Reserve Bank on a quarterly basis.

Table 1. Progress on Financial Inclusion (all public and private sector banks)

SR	Particulars	As of Mar 10	As of Mar 11	As of Jun 11
1.	Total No. of BC deployed	33042	58361	64752
2.	Total Villages Covered	54757	99840	107604
3.	Villages Covered – with population >2000	27743	53397	59640
4.	Villages Covered – with population <2000	27014	46443	47964
5.	Villages covered through Branches	21499	22684	22870
6.	Villages covered through BCs	33158	76801	84274
7.	Villages Covered through other Modes	99	383	460
8.	Urban Locations covered through BCs	423	3653	4524
9.	No Frill A/Cs (No. in millions)	49.55	74.39	79.09
10.	Amount in No Frill A/Cs (Amt in INR billion)	48.95	65.66	59.48
11.	KCCs outstanding – No. in millions	19.52	22.49	20.29
12.	KCCs outstanding – Amt In INR billion	1075.19	1438.62	1361.22
13.	GCC outstanding – No. in millions	0.63	1.00	1.07
14.	GCC outstanding – Amt In INR billion	8.14	13.08	23.56

6. WAY FORWARD

In order to review the progress of banks in the implementation of FIPs and making way for accelerated progress in future, RBI has been conducting Annual FIP Review Meetings with banks. Based on the discussions and action points emanating from the meetings held during May-September 2011, the way forward for banks to move towards achieving the goals under financial inclusion has been outlined as given below:

❖ Banks to perceive FI as a profitable business model and not as an obligation. This would be possible only if banks strive towards offering more and more credit products to customers captured as part of the FIP. The key is to establish an appropriate Business Delivery Model through the involvement of all stakeholders to make Financial Inclusion a reality.

- ❖ In addition to providing banking services in villages with more than 2000 population, banks to focus on providing banking services in peripheral villages with population of less than 2000.
- ❖ In future, banks to focus more towards opening of Brick & Mortar branches in unbanked villages. It may be a low cost intermediary simple structure comprising of minimum infrastructure for operating small customer transactions and supporting up to 8–10 BCs at a reasonable distance of 2–3 kms. This will lead to efficiency in cash management, documentation, redressal of customer grievances.
- ❖ Remuneration of BCs should be made attractive. The remuneration of BCs should be a combination of fixed and variable pay. This will encourage BCs to strive harder for bringing in more business for the bank.
- ❖ Banks need to formulate accounting system for booking transactions done through BC channel. As cash of customers with BC is bank's cash, banks must ensure that it is reflected as cash in bank's books & is reported accordingly. Care should also be taken to ensure that the BC's transaction account is separated from his account maintained with the bank as a customer.
- ❖ Banks to expand its financial inclusion initiatives in urban and semi-urban areas by targeting pockets of migrant workers and small vendors, leveraging Aadhaar enrollment for opening banks accounts.
- ❖ Public Sector Banks have been advised to formulate Financial Inclusion Plans for all Regional Rural Banks sponsored by them and develop an effective monitoring mechanism so that targets assigned to the RRBs are also achieved meticulously.
- ❖ Banks need to encourage routing of EBT based payments under NREGA etc. through ICT based solutions with the support of state Governments. This will ensure direct credit to the beneficiaries account and eliminate unnecessary leakages in the process.
- ❖ Banks should initiate action for registering with the Unique Identification (UID) authorities, if not already done so, and ensure that UID enrolments of villagers are done at the earliest. Banks should start opening accounts on the basis of Aadhaar information. Bank's BCs should also be able to undertake Aadhaar enrolment.
- ❖ For the success of the ICT based model, resolving technology related issues is a key. Seamless integration with Core Banking Solution (CBS) needs to be ensured in all the bank branches to reduce the glitches. Infrastructure related to Smart card devices, hand held devices need to be strengthened. Technical glitches need to be addressed quickly and proper care needs to take that it does not stop the banking services in villages for a longer periods.

Table 2. What we plan to achieve by 2013

SR	Particulars	Mar 12-Target	Mar 13-Target
1.	Villages Covered – Branches	24995	26440
2.	Villages Covered – BCs	192249	323699
3.	Villages covered – Other modes	1330	2130
4.	Villages Covered – TOTAL	218574	352269
5.	No Frill A/Cs (No. in millions)	112.51	158.29
6.	Amount in No Frill A/Cs (Amt in INR billion)	74.50	88.72
7.	No Frill A/Cs with OD (No. in millions)	18.36	28.65
8.	No Frill A/Cs with OD (Amt In INR billion)	10.08	16.36
9.	KCCs-Total – No. in millions	27.66	35.04
10.	KCCs-Total – Amt In INR billion	1446.86	1727.75
11.	GCC-Total – No. in millions	3.73	6.12
12.	GCC-Total – Amt In INR billion	42.66	67.15
13.	ICT Based A/Cs – through BCs (No. in millions)	64.17	10.15

Closing remarks

Jerzy Pruski[*]

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.