

# Building Resilience and Managing Financial Crises

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## Key take-aways and concluding remarks

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Let me conclude this [OeNB-SUERF-Yale-JVI conference](#) on “[Building Resilience and Managing Financial Crises](#)”. While I am aware that JVI colleagues are going to task ChatGPT to produce a conference summary, let me offer some personal and selective takeaways the old-fashioned way. In other words, you are witnessing a horse-race between a human economists’ brain and AI. My aim is to summarize this full-day conference in 10 minutes.

### **1. The conference started out with current key vulnerabilities and how to strengthen resilience.**

We are currently in a rather uncertain phase of the financial cycle. Many may not fully understand risks, their interconnections, and the need to build resilience.

There are several potential blind spots in the current supervisory framework: under-regulation of NFBIs; the rapid pace of technological innovation, which exacerbates cyber-risks; the evolving nature of climate-related risks; and rising geopolitical risks, which are difficult to manage and mitigate, because of their uncertain nature, scope and transmission. Election uncertainties entail mounting sovereign vulnerabilities.

Tightened financial regulation and supervision post-GFC, notably macroprudential policy measures, delivered to a high degree on their promises. As we are gaining experience and in the light of a rapidly changing environment, these frameworks need to be continuously evaluated and developed further. Ensuring financial firms’ governance is key. There is no panacea for models that can reliably predict financial crises. Often, crisis triggers are unexpected shocks exogenous to the models.

Ongoing mergers in the financial sector highlight tradeoffs between economies of scale and the quest for internationally competitive institutions vs a further exacerbation of the too-big-to-fail problem. As banking systems become increasingly concentrated, the interplay between micro and macropru may need re-consideration.

### **2. Regarding crisis containment and digital bank runs,**

digitalization has altered the nature, and (potentially?) boosted the speed of, bank runs. Liquidity regulation, while important, has its limitations given volumes involved. Also, we should not try to avoid bank runs by abolishing banks. Extending deposit insurance would create excessive moral hazard. Instead, banks’ business should be tightly monitored – liquidity runs are usually rooted in deeper vulnerabilities.

For this, supervisors need adequate powers and have the courage to act in time (“supervisory culture”). An effective emergency lending system by central banks is key – the ECB’s ELA seems to work better than the Fed’s.

So far, digital bank runs have become more of an issue in the US than the EA, as evidenced in March 2023. Ultimately, interest rate risk sits somewhere: it is not obvious whether it is better if at banks (US) or at households and enterprises (Europe) – we should be aware of possible tradeoffs between banking system fragility and lower economic growth.

Rigid compliance requirements are increasingly hampering cross-border banking for depositors, undermining the EU’s single market for financial services. Regulators should refrain from introducing artificial frictions and avoid the impression that the financial system is rigged against counterparties.

The digital euro will be designed to resemble the nature of physical cash. Attention is taken to avoid people from excessively flocking into CBDC in the event of bank runs.

Overall, the “stickiness” of bank deposits (in other words: customer loyalty) is falling. This reduces the de facto duration of banks’ funding. The rise of NBFIs is also the direct consequence of post-GFC tighter banking regulation – indeed, the intention was to remove risks from banks.

### **3. Our keynote dealt with how to navigate through financial turbulences.**

There will always be bank runs and failures. Regulators and central banks aim to contain spill-overs. The bank failures of 2023 in the US and in Switzerland tested how we manage to deal with too-big-to-fail institutions by now. The failures of Credit Suisse, SVB and First Republic have shown that we have made important progress. But more work is to be needed.

What are lessons to be drawn from recent tension episodes?

1. Financial supervisors need to act boldly and assertively.
2. Even smaller banks can become systemic.
3. Central banks need to provide extensive emergency lending with adequate operational schemes in place.
4. Resolution plans and rules need sufficient flexibility.
5. Cross-border cooperation is key for successful resolution.

There is currently a discrepancy between sanguine market pricing of risk and high global political and economic uncertainty. Abrupt market repricing may result going forward.

### **4. The first afternoon panel adopted a balance sheet perspective to crisis intervention.**

Various types of guarantees, e.g. bank debt guarantees, account guarantees and blanket guarantees are suitable to address different problems. Capital injections are the most direct method to help undercapitalized banking systems. They can usefully be combined with bank liability or asset guarantees. Combining interventions may signal that a country has credible resources to intervene effectively.

The negative experience after the GFC has taught us that regimes for dividend retention and re-capitalization can be useful to contain post-crisis credit crunches and enhance macro-resilience. Contrary to several other countries, the US authorities did not suspend bank dividends during the pandemic. Future stress tests in the US should extend the range of banks, including those whose business model is not entirely clear and those which are heavily engaged in commercial real estate.

In Europe, the mandatory bail-in, while appropriate overall, can cause problems for regional European banks. Separate national ELA and deposit guarantee schemes in the EA cause frictions and biases and hinder the full creation of a European Banking Union.

#### 5. The final session asked how to address a crisis-related surge in distressed assets.

Obviously, the best way to manage large volumes of NPLs is to not let them build up in the first place. Both banks and supervisors need to be proactive. Once NPLs are there, the first step is for banks to acknowledge there is a problem which will not go away by itself. Correct classification is key to appropriate loan valuation. Dealing with NPLs is a huge strain on resources and requires special skills. Banks need to set up the needed systems in time. Forbearance is a cornerstone of NPL management, besides debt enforcement. NPL securitization takes a lot of initial efforts to get running.

The last two decades were full of shocks (“black swans”) with direct impacts for banks’ loan books. Dealing with NPLs involves numerous risks for banks: complexity, reputational risks, regulatory and legal hurdles for NPL sales, different enforcement rules across jurisdictions, legal costs of debt enforcement and conflicts with consumer protection rules, high costs of asset repossession, and finding the right price in case of the establishment of a bad bank.

As illustrated by the experience of Greece during the GFC/Sovereign Debt Crisis, dealing with huge amounts of NPLs requires flexibility and improvisation. Securitizing NPLs is a key instrument for dealing with the huge volumes involved in acute crisis situations. Urgent law making under time pressure can cause loopholes, as evidenced by “strategic defaulters” during the Greek crisis.

Setting up centralized asset management companies (AMCs) involves opportunities and risks. They can establish a floor on falling asset prices, help banks to refocus on their core lending activity, optimize debt recovery and promote sounder and uniform practices on the valuation of distressed assets. But AMCs are no panacea: set-up costs are high, politics may interfere and cause reputational risks, moral hazard is a real risk. Establishing a fair and prudent transfer price is key. If NPLs are priced too high, an AMC only defers taxpayer losses. AMCs need to be funded adequately (not by the central bank), their mandate needs to be targeted and time-bound, sound governance and controls are key.

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**To conclude**, it is important that lessons from the past are not forgotten and to pool best practices by bringing together experienced experts – if today’s conference contributed to that, much was already achieved.

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