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Crisis prevention and management in an era of digital financial services

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Introduction (slide 2)

The international financial system has been hit by major turbulence over the past 18 months, affecting both traditional financial players following the collapse of SVB, and players operating in the new digital financial system in the wake of the FTX collapse. **This turbulence is the consequence of the crystallisation of traditional risks to which financial players are usually exposed, but whose impact has been amplified, and of the contagion within the financial system fuelled by increasing digitalisation of banking and financial activities.**

This amplification becomes clear when we examine the case of SVB and its consequences: the collapse of this bank was initially the result of poor governance and inadequate management of traditional liquidity and interest rate risks. However, it was accelerated by the digitalisation of finance, which has facilitated massive withdrawals in record time of the overnight deposits of customers who were mainly tech companies. These customers withdrew ever larger amounts in record time – we could say "in just a click" – reflecting both their financial and digital literacy.

This role of contagion within the financial system, via the emerging links between traditional finance and an alternative 'finance' based in particular on new tokenised assets (crypto-assets) issued on a blockchain, is also apparent from the series of consequences triggered by the collapse of the FTX platform, which dragged Signature and Silvergate banks down with it. Conversely, the failure of SVB – yes, SVB again! – threatened the reserves of Circle (issuers of USD Coin) which were invested in this bank.

Ultimately, the effects of this turbulence were not systemic and did not have a major or lasting impact on the financial system as a whole or on the real economy – and we should be delighted

at this. Nevertheless, their occurrence illustrates emerging new weaknesses in the financial system, fuelled by its ongoing digital transition, raising questions about how to prevent such risks from crystallising and how to limit their consequences.

From the standpoint of institutions like the Banque de France and the ACPR, tasked with overseeing the stability of our financial system, **these new weaknesses raise the issue of the appropriateness of the prevention (regulation and supervision of financial intermediaries) and crisis management frameworks (provision of liquidity and resolution tools) we use to ensure financial stability, both in traditional and decentralised – or disintermediated – finance.** In my view, based on the early lessons that can be drawn from the turbulence of recent months, we need to devise a **cautious and differentiated response** to the issue of the appropriateness of crisis prevention and management frameworks in the era of digital financial services, depending on whether we are dealing with traditional or "decentralised" finance. In the case of traditional finance, I believe the priority would appear to be more effective deployment and adaptation of this framework, whereas for decentralised finance, it is time to develop and apply it in a consistent manner.

I. A crisis prevention and management framework for traditional finance that needs to be implemented more effectively and adapted (slide 3)

A- Priority needs to be given to implementing the regulatory framework and to enhancing oversight

As regards the crisis prevention framework for traditional finance, based on regulation and individual supervision of financial intermediaries – known as "micro-prudential" supervision – priority should be given to more effective implementation due to the following lessons that can be drawn from the "in just a click" bank run on SVB in the United States.

First off, this framework – **which for banks is based on regulations issued by the Basel Committee on Banking Supervision (BCBS) – has not been invalidated by the collapse of SVB. On the contrary, SVB's demise illustrates the consequences of insufficient implementation rather than the ineffectiveness of this framework, for at least 2 reasons:**

- since 2019, under the principle of proportionality, SVB had been subject to **lighter regulation** than under the Basel framework, especially with regard to the twin liquidity and interest rate risks whose crystallisation triggered its collapse.
- the post-mortem analyses performed and published by the Fed suggest that, had it been subject to these regulations, **SVB would not have complied with minimum international standards** – neither the liquidity coverage ratio nor the alert threshold for sensitivity to interest

rate risk stipulated under the Basel framework. Had these been applied, several warning lights would have turned red and alerted the oversight authority.

However, these observations do not mean that there is no lessons to be learned in terms of regulatory developments from the role of new technologies and social networks in accelerating the liquidity stress suffered by SVB. The Basel Committee has identified a number of avenues that could be explored, such as run-off rates for certain deposits – especially large deposits not covered by guarantee mechanisms. (slide 4)

In a nutshell, as regards the crisis prevention framework, **we don't need another framework, we need more of this one!** Because of the multiple interconnections that underpin the financial system, banks that are considered to be less important cannot be exempt simply because of their size. We should note that this is the path that the FED has just embarked upon – its recent proposal concerning the implementation of "Basel III" rules argues in favour of broader application of this prudential framework.

Fortunately, in this respect the situation in Europe is radically different and more reassuring. Basel regulations are applied in full to all banks in Europe. I should add in passing that Europe is about to finalise the transposition into EU law of the latest regulations designed to bolster the Basel III Accords. As regards oversight, there is a single supervisor for the euro area, the European Central Bank, which has extensive supervisory powers, including stress testing and conducting on-site inspections in a proactive and intrusive manner.

And this is another fundamental aspect that needs to be borne in mind: **good regulation implemented globally is a necessary but not a sufficient condition for guaranteeing the stability of a banking system. It cannot be at its most effective without rigorous, proactive oversight**, which the FED itself admits was lacking in the SVB collapse. The "Pillar 2" framework and related solutions devised by the Basel Committee provide for both the principle of such supervision together with its deployment: in addition to "Pillar 1", which sets out standardised automatic requirements, and "Pillar 3", which covers rules on transparency and financial reporting, "Pillar 2" facilitates oversight based on an analysis of all of a bank's risks. This provides the supervisor with the means to impose additional requirements on a case-by-case basis. So, could these requirements be strengthened further, by introducing new alert thresholds for example – particularly for liquidity risk management? I definitely think they could. The Basel Committee is also currently working on this issue.

B- Priority needs to be given to adapting the crisis management framework (slide 5)

Prudential regulation, combined with rigorous supervision, facilitates anticipation and prevention of most crises but it cannot prevent them all. Hence the importance of crisis management tools in limiting the related impacts.

Among these tools, the recent crises have demonstrated the importance of the exceptional measures **taken by central banks to provide liquidity to banks in difficulty, against a backdrop of accelerating liquidity stress driven by the growth in digital services, making it possible to manage accounts and access banking services remotely – rapidly or even instantaneously – on a continuous basis.** In the midst of the crises affecting their regional banks and Crédit Suisse, the American and Swiss authorities activated this type of framework and this was decisive in restoring financial stability.

The euro area also benefits from these mechanisms of last resort, however **we still lack a single mechanism – adopted by all central banks within the Eurosystem – that can rapidly meet the liquidity requirements of a failing bank subject to the resolution process.** It is therefore necessary to adapt the European framework by bolstering it and making it rapidly operational in the event of a crisis. **In my opinion, this is a priority that the growth of digital financial services can only serve to reinforce.**

Another lesson we have learnt from recent crises is that **the authorities need to be better prepared to activate all of the resolution tools at their disposal.** Since 2016 and the Bank Recovery and Resolution Directive (BRRD), the focus has been on paving the way for a “bail-in”. This is the cornerstone of the resolution process, ensuring that both shareholders and creditors pay their fair share in the event of a crisis. However, **recent banking crises have confirmed that, in addition to bail-ins, it must be possible to mobilise transfer strategies (sale of entities, subsidiaries or assets) more rapidly, and this applies to large banks as well.**

In the case of Crédit Suisse, for example, the Swiss authorities ultimately decided that a bail-in was not the best option in terms of financial stability - this was one of the reasons they opted to set aside the resolution procedure and force the sale of Crédit Suisse to its competitor UBS.

A final lesson relates to the scope of banking crisis management frameworks. International standards currently apply to approximately thirty global systemically important banks (G-SIBs). In Europe, we have opted to apply these rules more broadly to around a hundred major banking groups. But this is not the case for example in the United States. Yet the crises of American 'regional' banks – i.e. not classified as systemic – has had repercussions throughout the world,

especially in Switzerland, reinforcing depositors' distrust of Crédit Suisse, which had already been in an unsettled state for a number of months. **We therefore have a collective interest in ensuring that even those banks that are not classified within this systemic category have sufficient loss-absorbing capacity in resolution, which can then be used to recapitalise them in the form of a bail-in. This is the direction in which the US authorities wish to go and we fully approve.**

It is against this backdrop that EU Member States and the European Parliament are currently discussing a proposal to reform the European banking crisis management framework, namely the CMDI (Crisis Management and Deposit Insurance) programme.

From the standpoint of the Banque de France and the ACPR, this reform should provide an opportunity to extend the application of the European resolution framework. This should be the benchmark for managing banking crises, not only in the largest banking groups but also in small- and medium-sized banks. Since it came into effect in 2015, this framework has been short-circuited much too often by national approaches that are less demanding in terms of tackling moral hazards, and often more costly for the public purse.

To sum up, banking crisis management tools are already well established both in Europe and throughout the world. Instead of undermining them, recent crises have demonstrated the importance of adapting and rounding them out and extending their scope, while continuing to give the authorities at the heart of the crisis some room for manoeuvre.

II- The direction in which finance is moving, under the impetus of new technologies, requires regulations that need to be extended and deployed in a more standardised way (slide 6)

A- The transformation of the financial landscape calls for an extension of regulation

I would now like to focus on the transformations in finance being wrought by new technologies and the regulatory issues they raise.

New forms of finance and the underlying tech innovations loom large in our reflections at the Banque de France and the ACPR in terms of our financial stability mandate because the flipside of their highly dynamic and creative development can be an increase in both risks and losses for the players involved and their customers. In the realm of tokenised 'finance' for example, some of these risks have crystallised in spectacular fashion, with the collapse over the past 18 months of the third-largest stablecoin platform, Terra-Luna, the bankruptcy of FTX, one of the world's largest

crypto-asset exchange platforms, and the severe jolt experienced by other players within their ecosystem, particularly liquidity providers.

Aside from these individual examples and the specific case of "tokenised" finance, our focus is based on the observation that **this emerging finance is likely to result in instability on at least two levels**: by shaking up existing business models and recalibrating value chains, technological innovations can first and foremost transform the competitive landscape very quickly. This "creative destruction" can then result in bankruptcies and undesirable market concentration and may even reinforce the dependence of certain players on their technical service providers. In addition, in plainer terms, the technologies and innovative tools deployed by financial players may themselves contain increased risks: cyber risks, for example as well as consumer protection risks – whether in terms of access to financial services in the case of online distribution, or discrimination risks in the case of AI.

But these innovations clearly bring benefits as well, in terms of both the efficiency of the financial sector and customer services.

To capture these benefits without compromising financial stability, at the Banque de France and the ACPR we believe that it is important to build an appropriate regulatory framework, not only at national but at European and international level as well. By creating an environment in which competitors are placed on an equal footing – without fear of being in competition with 'rogue' players – by clarifying the obligations of innovative players, and by limiting risks, regulation can be a powerful vector for building trust.

To illustrate both the form and the path that adapting regulations needs to take, let me look at two examples: one very concrete, the other a little more forward-looking.

In terms of sharing financial data, the European Commission recently published a proposal for a Financial Data Access regulation (FIDA). This text, which is currently under discussion, is a good example of the legislator's efforts to build a regulatory framework that will allow Fintechs to deploy their creativity in order to provide consumers with innovative financial services within a secure framework. FIDA draws upon the mixed results of the Payment Services Directive (the starting point for Open Banking), while maintaining a highly protective framework for consumers.

The proposal essentially focuses on **data-sharing methods** that data holders and users will have to **develop together**, which they will then **have to adhere to.** It introduces the principle of data use payments - which should encourage the different players to work together - while providing a framework for pricing such payments. At the same time, FIDA establishes a **protective framework for customers**. Consumers will be able to choose whether or not to share their data

and they will have access to a dashboard that makes it easier to view and manage the rights granted. Similarly, to ensure that data is shared securely, open finance players who use this data will need to obtain an **authorisation**.

A second important example is provided by decentralised finance or "DeFi" – at the Banque de France and the ACPR, we prefer the term "disintermediated" – based on distributed ledger technology (DLT or, more simply, the blockchain). Blockchain technology provides a means of storing and sharing information in a decentralised, secure and transparent way, without the need for a central control structure. In this domain, regulators' focus is more forward-looking: Banque de France is pioneering thinking here and the ACPR published a document in April exploring possible regulatory frameworks for DeFi. From the ensuing public consultation process, we drafted a summary document which we have just published, setting out the possible regulatory frameworks taking shape on each of the three DeFi 'floors': (1) ensuring the resilience of the blockchain infrastructure, public or otherwise, through security standards (2) certifying smart contracts, even if this raises a number of operational issues - and (3) regulating DeFi entry points to protect users.

Our approach to innovation based around digital assets and DeFi remains the same as for other types of innovation; this innovation is welcome, but it cannot be achieved at the cost of less regulation. As we have seen elsewhere, this would merely work against the interests of the players themselves.

B- This transformation also calls for a review of the services offered by central banks (slide 7)

New distributed ledger technologies – and blockchains in particular – are driving new financial services, based mostly around tokenisation. Tokenisation involves issuing a financial security on a blockchain and it is attracting growing interest from traditional investors and issuers, as well as from new players such as BigTechs and Fintechs, because it promises to enhance the settlement and delivery of financial assets by making processes faster, cheaper and more transparent. Although tokenisation currently represents only a marginal proportion of financial market capitalisation, its development could still generate counterparty, liquidity and liquidity fragmentation risks which could become systemic. This is why central banks must remain vigilant. We have a duty to anticipate and secure such developments so that players can fully benefit from the potential of tokenisation. How can we do this? By ensuring that at least the most sensitive transactions from a financial stability standpoint – i.e. those between financial intermediaries – are settled in central bank money, the safest and most liquid settlement asset of all.

However, while central bank money is currently available to commercial banks in digital form in our centralised payment systems (in the euro area this means the TARGET2 system), **it is not currently available on blockchain**. In other words, central bank money cannot be used to buy and settle tokenised assets directly on blockchain (equities, bonds, units in funds recorded on a blockchain). But if we do not adapt central bank money to the tokenised world, players could turn to other, less secure settlement assets, generating both counterparty and liquidity risk and, ultimately, financial stability risk. If this were to happen, it would be a real step back in terms of financial stability.

Indeed, these other settlement assets – first-generation crypto-assets such as Bitcoin, or second-generation assets, also known as stablecoins – do not possess the three attributes of a currency (i.e. a unit of account, instrument of exchange and store of value) and cannot therefore be characterised as one. They also represent specific money laundering, liquidity, market and operational risks that may turn out to be systemic and raise monetary sovereignty issues for global stablecoins such as the one launched by Paypal.

To deal with these risks and ensure financial stability, it is vital to establish a clear and appropriate regulatory framework: the European MiCA regulation, which came into force in June 2023, covers the issuance of and provision of financial services on crypto-assets and stablecoins and is a major step forward. However, regulation is only one building block: **central banks need understand these new technologies and innovate to be able to provide central bank money services adapted to a financial system in digital transition**, both for exchanges between financial intermediaries, which have the greatest impact on financial stability, and for day-to-day payments made by citizens, both domestically and across borders. The ECB and Eurosystem NCBs have made a major commitment in this area with the digital euro project, which has just entered a new preparatory phase with experiments in "wholesale" central bank digital currency exchanges between financial intermediaries (slide 8)

The Banque de France is playing a highly proactive role in this quest to pave the way for the issuance of a central bank digital currency. This is especially the case for uses between financial intermediaries, on which we have been conducting experiments since 2020, aimed at offering central bank money directly on blockchain. We have carried out twelve experiments with both private and public players, and we are actively participating in the exploratory work launched by the Eurosystem in this area.

Conclusion

The turbulence experienced over recent months shows that the ongoing digital transition of financial services – which has been fuelling this same turbulence – is both an opportunity and a risk for the financial sector. This transition will therefore only provide lasting benefits if it develops within a crisis prevention and management framework that will need to be adapted for the benefit of everyone – both for traditional and “decentralised” finance – using differentiated processes. Central banks and supervisors have a major role to play in this crucial effort to adapt and we are eager to welcome new talent – and I am thinking of you here – to help meet these expectations, both among the players who are actually driving the digital transformation, and among central banks and supervisors such as the Banque de France and the ACPR.