The lack of a Banking Union in the EU: promoting effective supervision and regulation in the EU

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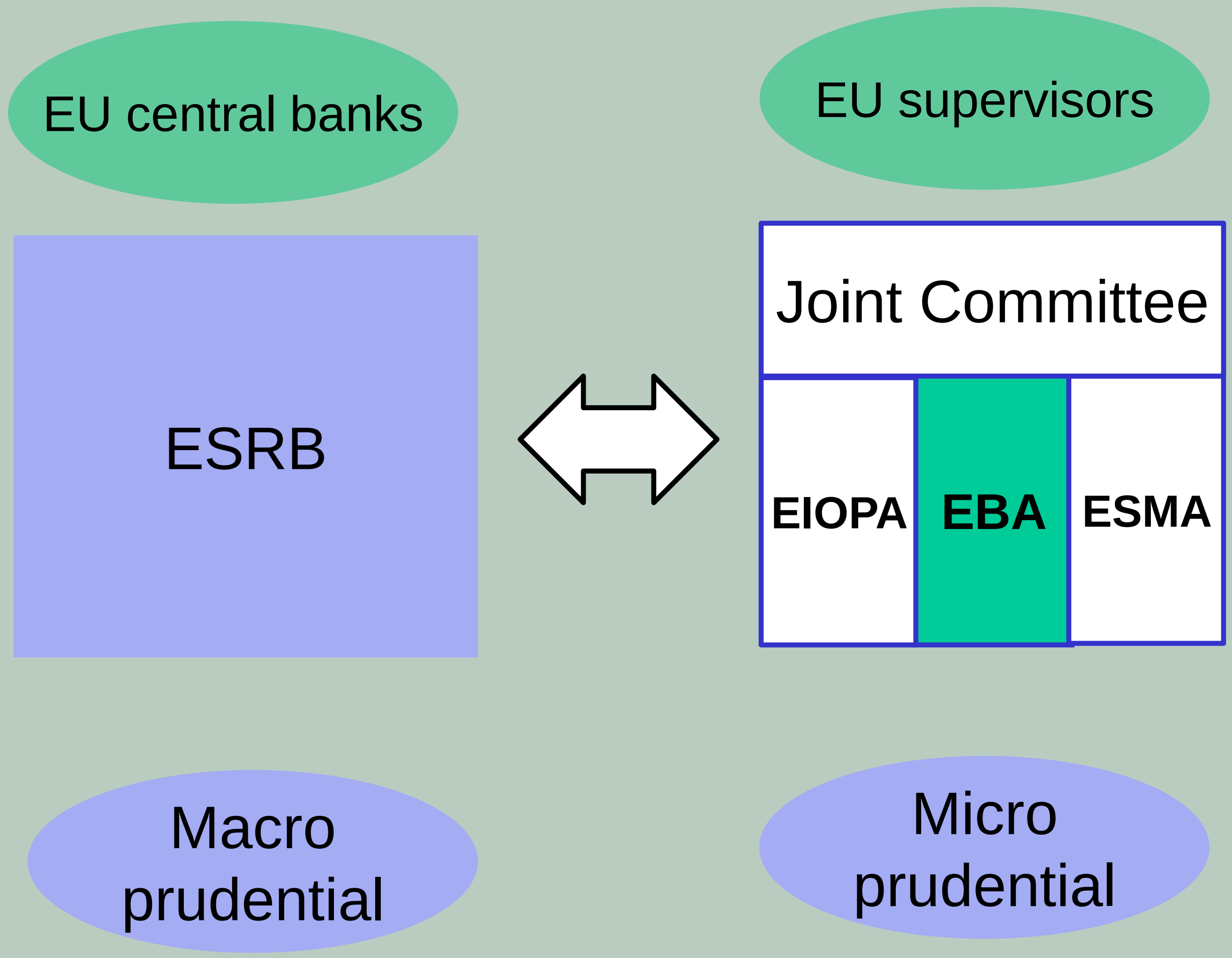
Outline

- **Our present institutional setting: objectives and tasks for the EBA**

- **First year of the EBA: starting-up in a challenging environment**
  - The 2011 EU-Wide Stress Test
  - The Recapitalisation exercise

- **Looking ahead: the Single Rulebook and more**
  - Rationale for a Single Rulebook in the EU
  - The debate on the Single Rulebook

Present institutional setting



The European Banking Authority

Objectives

Establishing EU single rule book

Upgrading quality and consistency of supervision

Reinforcing oversight of cross-border groups

Early warning of upcoming vulnerabilities

Effective early intervention and bank resolution

Consumer protection and financial innovation

Main tasks

Develop binding technical standards, guidelines, recommendations

Promoting common supervisory culture / supervisory practices

Risk dashboards for major financial groups

Monitoring effectiveness colleges

EU-wide risk assessments and stress tests

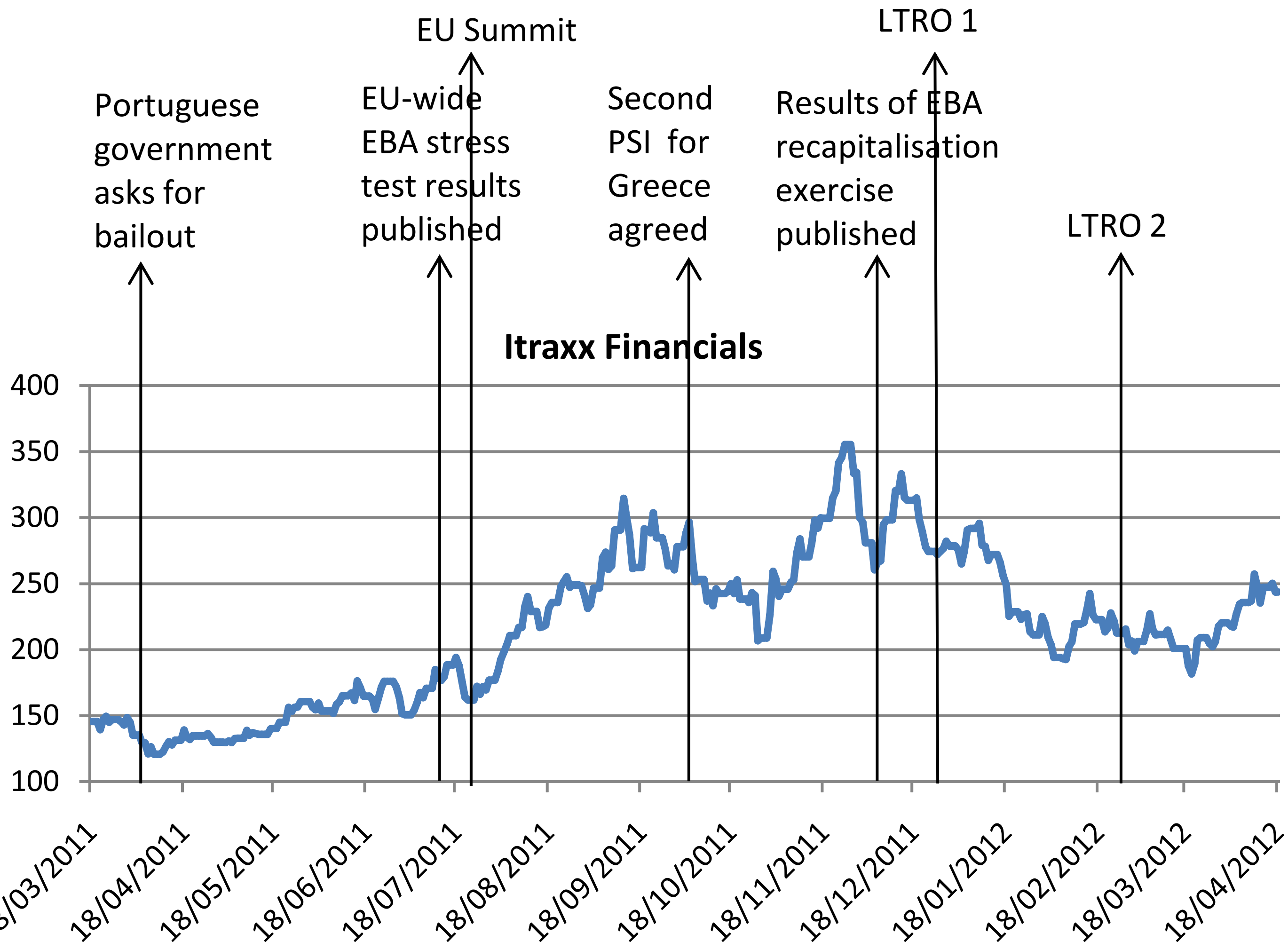
Reacting on risk warnings

Handling of emergency situations

Monitor financial innovation and consumer issues

Constraining the distribution of certain financial products

Starting-up in a challenging environment …



2011 EU-Wide Stress Test - Key features

- **Key figures**
  - 91 banks - 21 countries – 60% of total assets
  - A consistent capital benchmark of 5% CT1
- **A strong methodology**
  - Stringent assumptions and definitions to ensure consistency
  - Anticipation of many aspects of the new Basel standards
  - Quality assurance and peer review process
- **Transparency**
  - More than **3.000 data point** for each bank including sovereign holdings
- **Outcome:**
  - **€50bn in fresh capital** in the first four months of the year
  - **BUT** progress was tracked by a significant further deterioration in the external environment (sovereign debt crisis, funding challenges for banks)

2011 EU-Wide Stress Test - Recommendations for follow-up

- EBA received plans from the 8 banks that had a CT1 ratio below 5% after two years of stress
  - EBA is satisfied with progress in the fulfilment of the July 2011 Recommendation
    - Actions undertaken: capital strengthening, disposal of non-core assets and restructuring
    - Banks in countries which are under EU/IMF programmes are under the separate monitoring of the Troika

- EBA July 2011 Recommendation has been strengthened by the EBA December 2011 Recommendation

EBA 2011 Capital exercise

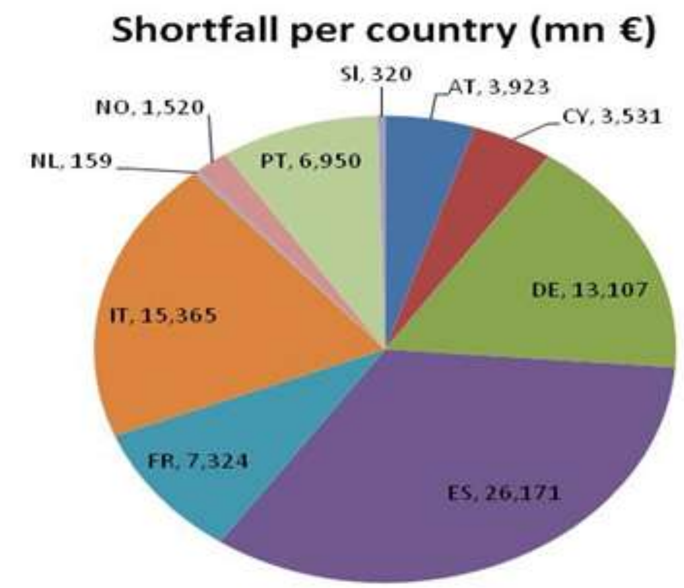
2011 Capital Exercise

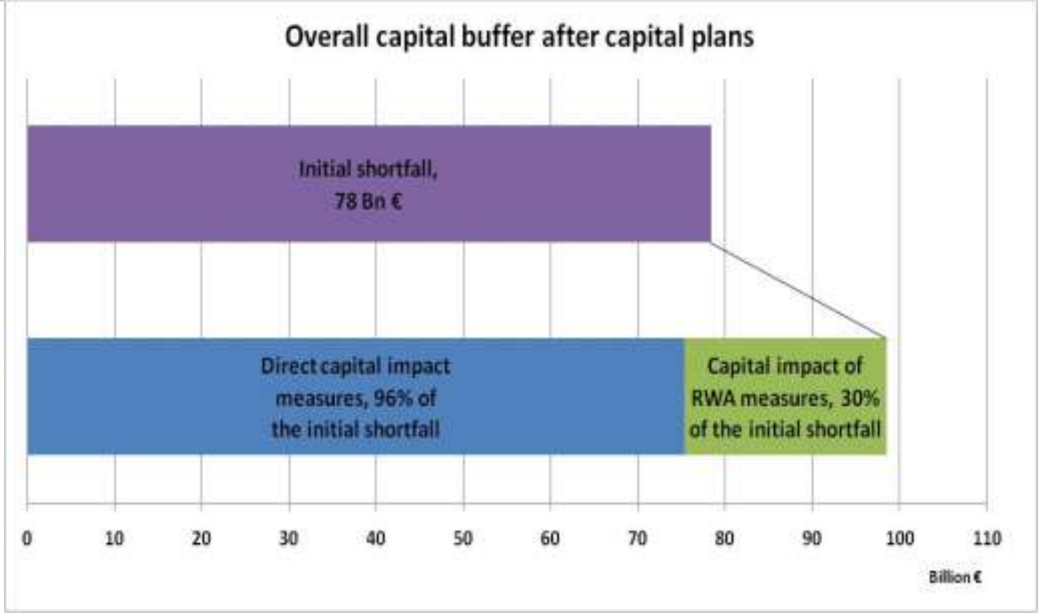
- **IMF and ESRB** called for coordinated supervisory actions to strengthen the banks' capital positions. Endorsement by the **European Council**.
- The **EBA December 2011 Recommendation** requires banks included in the sample to strengthen their capital positions:
  - By building up an exceptional and temporary capital buffer against sovereign debt exposures to reflect market prices as at the end of September.
  - By establishing an exceptional and temporary buffer such that the Core Tier 1 capital ratio reaches a level of 9%
- The sovereign capital buffer is a **one-off measure**. The EBA will **reassess the continued need and size** of capital buffers against banks' sovereign exposures
- Followed by the **ECB's long term refinancing operations** (LTROs) to address funding challenges.

2011 Capital Exercise

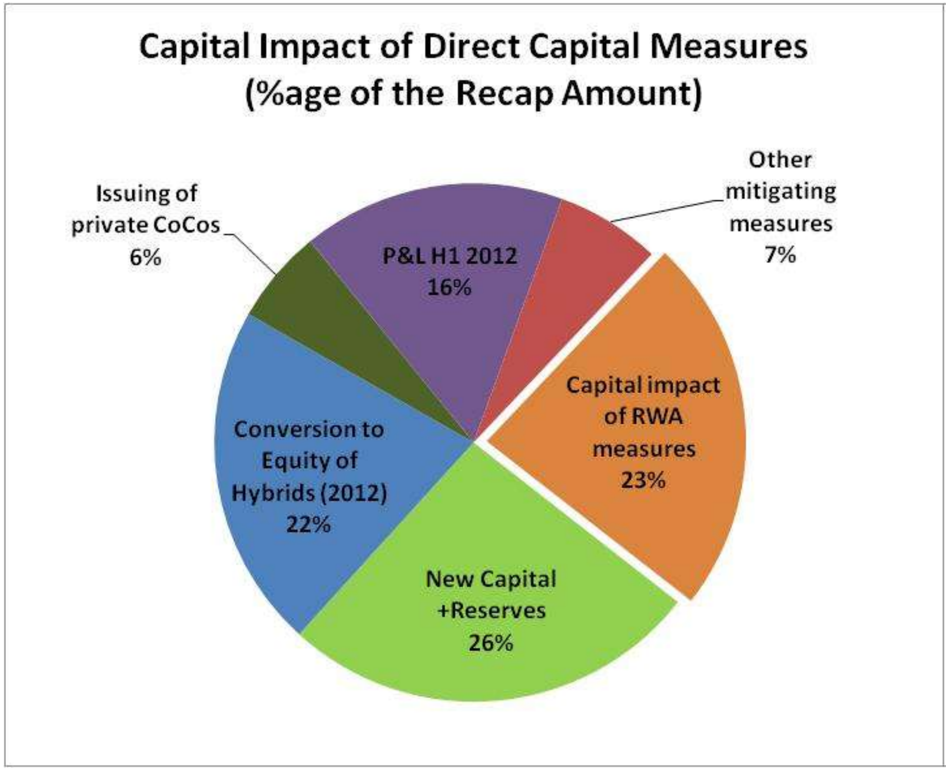
- Shortfall figure Sept 2011: **€115bn**.
  – Exceptions: €30bn attributed to Greek banks and €7bn to banks under major restructuring process

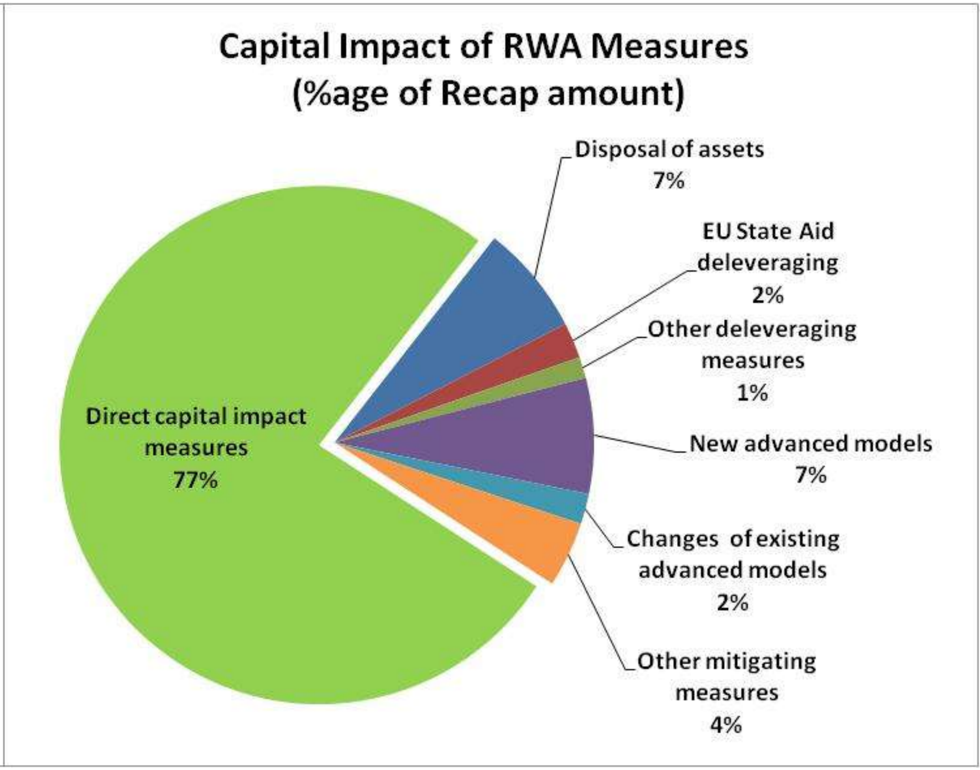
- Remaining shortfall figure: **<u>€78bn – 28 banks:</u>**
  – Direct Capital Measures (€74bn)
  – Capital Impact of RWA Measures (€23bn)





Capital Plans: Direct Capital and RWA





The rationale for a Single Rulebook

- During the last decade the speed of EU financial markets integration was not paired by the same degree of legal harmonization

- The crisis showed that ***minimum harmonization*** brings in:
  - "competition in laxity" (*e.g.* definition of own funds) with the negative impact on financial stability as well as fair competition;
  - obstacles to a truly coordinated supervision of cross-border (*e.g.* reporting);
  - increased administrative costs and constraints for integrated group-wide risk management (*e.g.* liquidity requirements)

The rationale for a Single Rulebook

- **‘Single rulebook’**
  - exactly the same rules across the Single Market (no room for regulatory competition)
  - proportionality to capture differences across financial institutions, be it bigger or smaller than standard norm
  - direct visibility to financial institutions, clear distinction with national rules
- How to achieve it: the **CRR/CRD proposal and the EBA Binding Technical Standards (BTS)**
  - Due process: impact analysis and public consultation
  - Legal acts endorsed by the European Commission
- Further **EBA instruments to foster convergence**: Power to investigate breaches of EU regulations (including BTS); Guidelines and Recommendations (comply or explain), Opinions; Mediation (binding and non-binding) in case of disagreement among NSAs; Supervisory Colleges; Peer Review

Building the Single Rulebook

- **CRD/CRR**

Task	EBA
RTS	72
ITS	35
GL	20
Report/GL	1
Report	9
Consultation	17
Publication	5
Monitor	1
Participation	1

- Around **40% of the BTS due by 1.1.2013**

- **2012 priorities**:

  - quality and quantity of capital
  - liquidity requirements: monitoring and the way forward
  - single reporting
  - examination of RWAs

The debate on the Single Rulebook

Four arguments usually raised against the Single Rulebook (SR):

a) why not allow for **“gold-plating”** (*i.e.* stricter national rules) as long as minimum harmonization is achieved?

b) SR would prevent the operation of **macro-prudential supervision**

c) SR would overlook the needs of smaller, local institutions and **disregard national legal/institutional peculiarities**

d) F**iscal responsibility:** if the rules miss the target the impact is national

A) Gold-plating, what are the drawbacks?

- **Gold-plating (GP) implies minimum harmonization** (MinH), it is in fact the other flip of this same coin

- As with MinH, **GP leads to patchwork financial regulation** across the EU, hence once again hampering effective coordination of supervision on cross-border groups, and their effective management

- As with MinH, **GP has a high risk of regulatory arbitrage** entering through the backdoor: financial regulation is made by complex technical rules/mechanisms Higher capital requirements in one country may well turn out to be more lenient if the application is based on laxer technical rules or implementation (the devil is in the details)

B) SR would hamper macro-prudential supervision?

- We already have SRs at national level and they grant supervisors the discretion/flexibility necessary to face specific risks
- The same pattern can be followed at EU level. Indeed, the CRR/CRD4 July proposal incorporates several aspects of flexibility:
  - The **countercyclical capital buffer**, which can be set on a system wide basis up to 250 bps without constraints;
  - Under **article 443**, the Commission is granted the possibility to set higher prudential requirements on a temporary basis
  - **Colleges of Supervisors** provide the opportunity for home and host authorities to set capital requirements to reflect specific risks in cross border groups. CRR/CRD4 provides more scope in this area through:
    - an expanded pillar 2 capacity
    - the possibility to tighter capital requirements for real estate exposures

B) SR would hamper macro-prudential supervision?

- **The flexibility package (**in progress): Article 124 (a) CRD introduces the possibility for Member States to introduce a systemic risk buffer for the domestic banking sector as a whole or parts thereof. This buffer is intended to mitigate non-cyclical macroprudential risks.

- **Article 443** (a) CRR gives Member States the possibility to propose to the Commission to tighten own funds, large exposure and disclosure requirements to address changes in the intensity of macro-prudential risks.

B) SR would hamper macro-prudential supervision?

- Need to have national **discretion for effective macro prudential policy.**
- **However,** for this to be effective the discretion must be constrained within an EU framework through ***ex ante* guidance** and ***ex post* review** by the ESRB (*e.g.* countercyclical buffer)
- **Objective**: avoiding arbitrary application of macro-prudential tools and unintended consequences stemming from uncoordinated implementation of macroprudential tools:
  - If full discretion is left to national authorities, there is no guarantee that same sources of systemic risk are addressed in the same way in different jurisdictions. But the repercussions of a possible crisis cannot be circumscribed to less conservative countries
  - Lack of comparability would also follow from uneven (and possibly time-varying) capital requirements, jeopardising microprudential supervision and market discipline
  - Macroprudential tools might be deployed in a procyclical fashion (buffers would be used for trapping capital and liquidity in domestic markets when things go wrong)

B) SR would hamper macro-prudential supervision?

Plumbing in the macroprudential system

- **<u>Leakages</u>**: In a single market uncoordinated national measures will not have the desired impact if there are significant leakages *(Aiyar, Calomiris, Wieladek, 2012).* Leakages render the macro prudential policy largely ineffective unless clearly coordinated at an EU level to ensure a consistent policy across the single market

- **<u>Spillovers</u>**: It is possible that national measures on a cross border bank constrain capital, and associated activities, to the extent that they impact host country operations. This is particularly likely when capital is severely constrained and domestic lending sticky. This is also true in good times as capital is always costly

- **<u>+ Risk of conflicts between home and host authorities</u>** if the macroprudential instruments can affect <u>directly</u> the foreign markets

B) SR would hamper macro-prudential supervision?

- Some examples under different regulatory scenarios
  - **Countercyclical buffer**: based on mutual trust and strong coordination (ex ante, with ex post review), mandatory reciprocity (up to 2.5%, voluntary beyond), can be applied at the “host” sub-consolidated level ⇒ ☺ ideal interaction micro and macro-prudential tools
  - **Systemic risk buffer**
    - only for domestic exposures, but with weak coordination (at least up to 3%), unclear on reciprocity: incentives to operate via branches (they don’t pay any capital requirement) if there is not reciprocity, ineffective if most exposures are abroad ⇒ 😐 risks due the use of the same instrument for two policy objectives; risk of re-fragmentation of the Single market
    - for all exposures with/without Commission approval: incentives to operate via branches; without coordination, host authorities can require the buffer to be held at the local subsidiaries; if not allowed to do so, possible use of Pillar 2 buffers for retaliation ⇒ ☹ perverse interaction micro and macro-prudential tools, risk of re-fragmentation of the Single market

C) Need to take into account national specificities

- This need is acknowledged and is at the basis of the distinction between CRR and CRD (supervisory review process, corporate governance, sanctions, etc.)

- Furthermore **even when EU rules are directly applicable, proportionality would still apply**, as it is the case in the national context, where the same general rules cover big and small businesses but allow for lighter/harsher application given the nature, scale or complexity of institutions

- *E.g.* the Consultation Paper on next ITS on Reporting (consultation closed 26 March) takes into account complexity, nature and scale of the financial institutions when designing a uniform framework for supervisory reporting

D) Fiscal Responsibility

- Banks have been “international in life but national in death”

- Is it still a (financially and politically) viable solution *after the crisis* ?
  – spill-over effects of “national” crises
  – the vicious circle between sovereign and banks
  – the risks of regulatory capture/forebearance and moral hazard by national authorities with respect to “national champions”

- Two opposite ways forward:
  – **national ring fencing/retrenchment**: less opportunities of financing; worse risk diversification; inferior capacity of the economies to absorb shocks. In a word: break-up of the Single Market
  – **deeper and more integrated financial markets** through common EU rules, shared supervisory infrastructures, common resolution financing arrangements

Conclusion: if the SR is essential in good times it is critical in bad times

- **Level playing field across the EU**
- **Integrity of the EU single market**
  - remove obstacles
  - match market developments (good or bad): industry competitiveness; asset bubbles
  - resist retrenching and fragmentation
- **Further EBA instruments to foster and ensure harmonisation in bad times / repressive tools**
  - Binding mediation: in case of disagreement among CAs
  - Breach of union Law: power to investigate breaches of EU regulations (including BTS)
- **Helpful collective tools**
  - Guidelines and Recommendations (comply or explain)
  - Opinions

Thank you, any *questions?*

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