Dagens Industri

Stockholm, 11 May 2022

A regulatory perspective on the developments of the European banking industry- time to prepare for structural changes beyond the regulatory pause

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Dear Ladies and Gentlemen,

It is an honour to join you here in Stockholm for this year's Banking Summit organised by Dagens Industri. After the recent period of travel restrictions triggered by the pandemic, it is a pleasure to meet stakeholders in person again, and I trust that resuming in-presence meetings will have a positive impact on the quality of our interactions and discussions, as we continue to return back to normality.

Today I would like to share with you some reflections on the benefits I think we took from the regulatory pause but also on the need to actively prepare for the highly structural challenges that come onto the banking industry. The regulatory pause that took place since the last 5 years as we agreed on the Basel 3 set of global standards by end of 2017 proved to deliver benefits and showed that the traditional prudential regime, as it is now and will soon be updated, is crisis-proof and just rightly flexible. While it will be decisive to go for a swift and loyal implementation of Basel III in Europe, it is clear that our overarching priorities include addressing the new challenges faced by the European banking system, notably related to environmental risks and digital innovation. I will conclude my speech by spending some words on the significant progress made towards the much-needed modernisation of the resolution framework, to ultimately better protect financial stability.

Prudential reforms will further enhance the banking system resilience and support the economy

The ***EU Single Rulebook has proven successful*** in harmonising prudential regulation and ensuring a level playing field in EU, therefore contributing to a more effective functioning of the Single Market in finance and a more resilient banking system. The prudential framework that we have in place in Europe has shown to be ***robust and able to withstand*** the Covid-19 pandemic, where large parts of the economy came to a halt, maintaining the provision of credit by ***making use of the flexibility embedded*** in the system, quick fixes and the implementation of moratoria. Also, in the present circumstances, as we scrutinise some of the specific conditions for the economic flows and refugees, the embedded flexibility seems to work well with no apparent need to fix the system. As the world continues to change, and we move from one crisis to another, we need to continue building resilience and further strengthen the banking system to cope with the recurring crises we are facing, so that banks are able to play a constructive role in supporting the EU economy through the cycles and ensure a credit flow that backs the recovery.

Transposing ***Basel 3 into the European framework is a necessary improvement*** to the prudential framework, as it closes existing gaps and maintains a risk sensitive approach. With the political negotiations now ongoing, we are hoping for a speedy adoption that will finally allow to complete the reform package and meet the planned implementation date on 1 January 2025.

Adhering to international standards is now more important than ever, while parsimony and an evidence-based approach should be the anchor of potential EU adjustments.

While the legislative proposal by the Commission is broadly respectful of the Basel standards, it is not exempt from deviations. When we go into the details of the proposals, there are adjustments that raise concerns from a prudential point of view. Notably, the proposed lower risk weights in the credit risk framework, which reduce consistency and conservatism, the implementation of the operational risk internal loss multiplier, and keeping in place EU-specific deviations introduced earlier in the framework, such as the CVA exemptions. The transitional arrangements for mortgage risk weights are also problematic as they provide relief to mortgage risk weights, at a time when the build-up of vulnerabilities in residential real estate is becoming a very relevant topic for several EU countries, including Sweden, where monetary policy recently tightened, while potential second round effects from the Russian invasion of Ukraine may affect households' debt repayment capacity.

The supervisory toolkit includes national macroprudential measures for targeting asset bubbles in the residential property sector, as used by the Swedish Authority by setting risk weights floors for residential real estate, to address concerns that historical low credit losses may yield artificially low risk weights by internal models. Going forward, there may be potential interactions between the Basel 3 floors and the macroprudential tools, but for the time being, as the EBA's reply to the review of the macroprudential framework notes, it seems premature to draw any conclusions and this shall be revisited once the input and output floors become fully applicable.

So my ***message regarding Basel 3 is clear and twofold***.

On the one hand in terms of ***implementation, there should be no hesitation***. The long-term benefits of strengthening the resilience of the financial system will fully offset the transitory costs of implementing Basel 3 . The Swedish banking system is in a good position to adjust smoothly to the revised framework, with EBA estimates showing that the impact of the reforms on capital shortfall remain limited and that the gap has been closing over time.

On the other hand, the constraints introduced in the Basel 3 package such as the output floor should be seen as set of ***virtuous limitations serving as a backstop and having a buffer function, and leave room for simplification***. Those constrains are crucial elements of the reform that will ensure a level playing field among banks using the standardised approached and IRB, and represent a backstop against sliding towards ever lower risk weights. Clarifying the possible interaction among the output floor and Pillar 2 requirements (P2R) and the Systemic Risk Buffer (SyRB), as all these measures address risks that are similar in nature, is a high priority of the EBA which is committed to reducing the complexity of the buffers and facilitate their usability. The EBA stance, as presented to the European Commission in the reply to the Call for Advice on the Implementation of Basel 3 in Europe, is that once the output floor becomes binding, the appropriate level of P2R and SyRB should be reconsidered to prevent double counting. I understand this is of particular relevance in Sweden, where a SyRB of 3% applies to selected credit institutions, against the background of a large, concentrated and interlinked banking system. Indeed, these concerns have been duly addressed by the Commission who has introduced safeguards to prevent unjustified increased in P2R and SyRB overlapping with the output floor. This will be achieved by freezing those requirements to avoid automatic increases that are not warranted by associated increases in macroprudential or systemic risks, until the competent authority reviews if the calibration remains appropriate in light of the output floor. Reducing this complexity in the capital stack and clarifying the provisions is reiterated in the advice recently delivered by the EBA when it comes to the macroprudential framework and as requested from the Commission.

Structural challenges matter the most and need to be tackled with strong determination.

First as a transition let me note that going beyond the Basel III technical aspects, the Commission proposal in the ***CRD also introduces a number of additional positive elements, which are key for the banking sector in light of the new structural challenges it will have to face***. In the area of governance, which is key for the soundness of institutions, the framework is enhanced on topics like the fit and proper assessments and sanctioning, where it is rightly recognised that we need a common EU approach. Regarding third country branches, the introduction of a harmonised prudential regime is highly welcome and will imply a common implementation stance on many issues, which were previously dealt with in an uncoordinated manner. Access to our impressive and attractive single market, for banking, investment or other third services providers requires a single approach. Furthermore, the reporting and disclosure framework has been strengthened, for instance through the ambition to move further on integrating reporting requirements. Finally, the issue of Environmental Social and Governance (ESG) risks is explicitly included in the framework, which is a positive recognition of the importance of this topic, which is indeed one of the key EBA priorities and will remain so going forward.

Secondly, ***Europe is at the forefront of the banking sector contribution towards a zero-carbon economy***. The taxonomy has been quite a driver already. At the EBA, we have been leading the international debate through the recent launch of a Discussion Paper (DP) on the role of environmental risks in the prudential framework, which is now open for public consultation. I would very much encourage you to read the paper and reflect on the topics opened for discussion, as we are seeking broad feedback from stakeholders to inform our final report on the matter, which is due in 2023. The discussion paper explores a very timely question for regulators and the broader banking community, as the risk picture is changing, which raises the question if the current prudential framework is sufficiently equipped to deal with these new challenges. The paper is anchored on a risk evidence approach, on the premise that the prudential framework should be reflective of underlying risks to ensure the resilience of financial institutions. This means that the approach is not to achieve specific environmental objectives *per se*, although these could be indirectly supported by the risk-based framework, particularly if coupled with other policy actions. We structure the discussion by first analysing the extent to which the current framework already captures environmental risks through existing mechanisms, then reviewing the empirical evidence on risk differentials and related measuring challenges and then we open a broad discussion on potential ways of addressing the matter, such as the incorporation of forward-looking elements in the prudential framework or the potential use of green supporting factors, where we look forward to stakeholders' input.

While the discussion paper focuses on Pillar 1 own funds requirements, it is recognised that environmental risks are better captured through a holistic approach. In this sense, the EBA has already contributed with broader work in the area of ESG risks. This includes fostering transparency, which is indeed one of the pillars of the Commission's Action Plan on Sustainable Finance, where the EBA has notably produced Pillar 3 qualitative disclosures on ESG risks for large institutions. Another milestone is the EBA Report on ESG risks management and supervision published in June 2021, which broadens and greens the supervisory review and evaluation process (SREP) through the inclusion of ESG considerations. Furthermore, the EBA has started exploratory work to build regular climate risk stress tests or scenario analyses. The EBA already conducted a pilot sensitivity analysis on climate risks, paving the way for developing a robust assessment of environmental risks.

Lastly ***another new frontier has to attract our highest attention, digital finance***. Technological innovation in the banking system has led to a new landscape, notably through the changes to value chains, increasing dependencies on digital platforms and the emergence of mixed-activity groups, including BigTechs, which could have the potential to disrupt markets.

These developments require that we exercise ***close monitoring to ensure regulation and supervision are fit for purpose***. This is particularly challenging considering how the new digital world brings ***a shift in paradigm from an entity-based to an activity-based approach***. This represents a radical change from what was done in the past. Not only has the EBA facilitated capital allocation to software investments via its technical standards on software but it also acknowledges the possible need to shift to activity or transaction based approaches instead of solely relying on an entity-based supervision. The tailored prudential framework for investment firms is a good example of this. Also issues that have been traditionally looked from the consumer protection angle are gaining prominence and there may be merit in exploring them from a prudential perspective as well. This is the case for instance for the crypto currencies or assets. Also the recently published EBA Report on non-bank lending notes how there is room for prudential requirements to be enhanced in activity-based regulation to allow for more effective supervision in cases where there is no entity-based supervision. On this note, the Mortgage Credit Directive comes to mind, where strengthening this provision may allow supervisors to conduct a more effective oversight.

Banks are clearly stepping-up investments in digital transformation in order to be able to compete in this new world, keeping the momentum gained though the pandemic, which acted as an accelerator of digitalisation in some areas. Banks ***need to plan accordingly, also to account for challenges related to skill shortages that may hinder the full use of the opportunities*** that digitalisation may bring, for instance to reap the potential benefits of artificial intelligence, which requires highly specialised staff. Artificial intelligence is indeed a very interesting topic, where we have seen for example that machine learning has been increasingly leveraged by banks for business purposes, although the use remains limited within the internal models used to calculate capital requirements. This is due to the complex nature of those models, and related problems in interpreting and justifying the results to supervisors, coupled with data protection concerns. The EBA is closely monitoring the situation, where exploratory work is already underway, notably through the publication of a related discussion paper to help set supervisory expectations. I would like to stress that when approaching the new frontiers of digitalisation, our guiding principle is technological neutrality, to ensure that regulatory and supervisory approaches facilitate technological change and its scalability across the Single Market whilst continuing to safeguard consumer protection, and the resilience and stability of the banking system.

Transitioning to the digital world will not come without operational challenges for institutions. The ***operational resilience*** of the financial system is carefully being assessed and will be notably addressed through the Digital Operational Resilience Act (DORA), where the EBA has received several related mandates to contribute to its implementation. This will allow to put in place a comprehensive framework on digital operational resilience and to consolidate and upgrade the ICT risk requirements that have so far been spread over the financial services legislation.

Bringing the crisis preparedness and resolution framework up to date

I would like to close my intervention by referring to another priority of the EBA in this changing world, and which is the modernisation of the crisis preparedness and resolution framework. Bringing resolution up to date in Europe was a much-needed task, particularly in comparison with the stage of development in the United States. We are painfully closing the gaps. At a time where sustainability, digitalisation transform the landscape, accelerating towards the modernisation and effectiveness of our resolution framework should go in parallel. Probably this is also where the buffers usability is hindered given the absence of clarity when things go less well. There is a need for additional clarity through the implementation in the EU of a process of bail-in mechanics to each step of the process of writing down and converting instruments. This is a key element to ensure adequate recapitalisation and the subsequent operational continuity of banks. That is why the EBA puts a strong emphasis on its Guidelines on improving banks' resolvability published earlier this year and that are milestone in this respect.

A better recovery and resolvability framework, which is made much more practical and operational is needed. Based on the practical experience gained so far, the EBA's focus will be placed on critical elements that may be in need of review. In the context of crisis preparedness, the EBA will continue to monitor evolving practices in relation to recovery planning and on the quality of the cooperation and interaction between supervisory and resolution authorities, which is crucial to ensure an effective framework in the ultimate interest of better protecting financial stability and the economy as a whole.

Thank you very much for your attention