STRENGTHENING THE EU BANKING SECTOR

Ensuring transparency in the European financial system

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

1. Introductory remarks

Perfect knowledge and transparency are preconditions for competitive markets[1]. For this reason, all large corporates are subject to some kind of disclosure requirements. The purpose is to make those enterprises accountable towards different stakeholders but also, and more importantly, to allow investors to price risk and assess what assets are worth. Adequate disclosure makes information more readily available and reduces transaction costs of gathering it.

Banks are subject to transparency rules that are stricter and more comprehensive than those for non-financial enterprises. The rationale for the more stringent regulation is that the business that credit institutions carry out tends to be more opaque and, thus, the actual quality of corporate assets is hard to assess for outsiders, generating uncertainty and possibly financial instability. As a matter of fact, the value of financial investments depends on proprietary information on the counterparties that the bank is not necessarily willing to share and, in

[1] Stigler G. J., (1957), "Perfect Competition, Historically Contemplated, Journal of Political Economy, p.65.

addition, banks' assets are largely illiquid, so that financial markets cannot provide a price that can be used as a reference[2]. The empirical evidence confirms that regulations that impose informational transparency and promote market discipline tend to support sounder banking[3].

The financial crisis is a clear example of the consequences of banks' opacity on financial stability. There is broad agreement on the reasons that brought to the eruption of the financial crisis: complex financial products and easy availability of cheap funding contributed to building a major bubble, with large financial institutions taking up excessive leverage and fragile liquidity positions. Poor governance, wrong incentives for bank management and lax supervision were also essential ingredients.

However, these factors have been exacerbated by the limited understanding of banks' exposures and the uncertainty on the extent of these problems. In particular, the crisis "*has challenged the usual role of information transmission. Information has been scarcer, less accurate, and less timely*".[4]

When the crisis broke out in 2007, subprime losses started materialising and a series of reports began conjecturing possible consequences for banks. However, there was no certainty on the scale of the problem, the accuracy of loss estimates, the intermediaries involved. Anecdotal evidence suggests that market participants, missing any clear information, feared that the banks were downplaying their losses and exposure[5]. The panic which followed the default of Lehman Brothers was also mostly due to the limited information available on banks' exposures, the uncertainty on capital levels, and the mistrust on the loss absorbency capacity of capital instruments issued by banks. The sudden illiquidity of the financial markets that followed had, in turn, an adverse effect on the level of transparency that asset pricing provides.

The second wave of the crisis, started in 2009 and centred on the euro area, was largely the result of the institutional foundation of the single currency. With the introduction of the euro, banks were encouraged to look at the currency area, and at the Single Market, as their domestic market. At the same time, as the crisis hit, no EU-wide safety net was made available and bail-

[2] For a survey see Boutant R., Crnogorac D. and Resti A. (2015), "Transparency and Market Discipline", in Quagliariello M. (2015), Europe's New Supervisory Toolkit, RiskBooks.

[3] Barth J. R., Caprio G. and Levine R. (2006), "Rethinking Bank Regulation", Cambridge University Press.

[4] Freixas X. and Laux C. (2012), "Disclosure, transparency, and market discipline", in Dewatripont M. and Freixas X. (eds), The crisis aftermath: New regulatory paradigms, CEPR.

[5] Laux C. and Leuz C. (2010), "Did Fair-Value Accounting Contribute to the Financial Crisis?", Journal of Economic Perspectives, 24(1).

outs were conducted under the responsibility of national governments. Moreover, the composition of the banks' sovereign portfolio had remained significantly biased towards bonds issued by their home country's governments. As a result, banks started to be assessed by market participants on the basis of the credit standing of the sovereign providing them with the safety net and of the amount and quality of their sovereign exposures. However, at that time, there was virtually no public information available on banks' sovereign exposures. Funding pressure started to mount as the result of actual problems as well as investors' concerns due to poor disclosure, leading to the freezing of the area-wide money market.

Towards the end of 2011, European banks – especially those in countries under stress – were on the edge of the abyss, with a significant dependence on wholesale funding but with no investor willing to finance the sector. The volatility of deposits also started to increase, with the wholesale and corporate funds often moving out of the most fragile countries.

The response of the central banks and the supervisory community, both at the global level and in Europe, has been decisive for addressing the roots of the crisis. The mix of unconventional monetary policy measures, stricter and more harmonised rules on banks' operations and capital levels, as well as increased disclosure on bank's exposures contributed to overcome the deepest stages of the sovereign crisis. In particular, the capital strengthening of European banks, which started in 2011, has reassured market participants and allowed banks to move a long way in the right direction.

Areas of uncertainty on asset quality, valuations of EU banks' balance sheets as well as on the reliability of the outcome of internal models for determining own fund requirements called for further ad-hoc actions and extensive EU-wide asset quality reviews.

2. The EBA's efforts in restoring confidence in the EU banking sector

Since its establishment, the EBA has consistently pushed for additional disclosure and transparency in the EU banking sector. Despite lacking an explicit mandate, we considered the dissemination of banks' data as an integral part of our responsibility of monitoring risks and vulnerabilities and preserving financial stability in the Single Market. Indeed, we have been conducting transparency exercises at an EU-wide level on an annual basis since 2011, either

linked to concurrent stress tests, like in 2011 and 2014, or to one-off policy measures, like the 2011-12 capital exercise, or as standalone transparency exercises, as in 2013 and 2015.

Financial information is a public good and authorities have an important role to play in this area. Reducing opaqueness requires not only disclosure of information but also that disclosed information reaches the right stakeholders, is presented in the correct format, is comparable and, thus, properly interpreted. This may prove complex and expensive for both banks and investors. Also, banks could be reluctant to disclose information, especially in crisis times.

However, transparency brings along several tangible benefits in terms of restoring confidence, stabilising market developments and allowing investors to allocate resources efficiently. Transparency reduces the costs associated to uncertainty and leads to the decline of the "opacity discount" and, thus, of risk premia investors require. It also provides a positive signal to investors and calms down panic particularly when markets are turbulent: more problematic banks will be disciplined by investors and other stakeholders, while stronger institutions will be rewarded through better access to financial markets or lower cost of funding[6]. This is not only fair, but also necessary to avoid that key banking functions are impaired: if investors are unable to assess the distribution of exposures and risks across institutions, the whole funding market may well go into shutdown, as it happened during the crisis, thus disrupting the provision of key services also by banks less affected by the market turmoil.

As highlighted in an old paper of the Basel Committee, *"the fact that disclosure may cause problems when a bank is in a weak condition does not refute the proposition that disclosure provides incentives for healthy banks to continue conducting their operations in a sound and efficient manner. Moreover […] disclosure will likely cause correction of problems at an earlier stage. Finally, […] a bank's disclosure of negative information can even have a positive impact on the market's evaluation of a bank if it increases the credibility of its management […] thereby improving the market's confidence"*.[7] Conversely, when markets lose confidence in the integrity of information provided by banks and can no longer trust them, the negative effects are likely to be more widespread, dramatic and long-lasting.

[6] Petrella G. and Resti A. (2016), "The interplay between banks and markets: supervisory stress test results and investor reactions", mimeo.

[7] Basel Committee for Banking Supervision (1998), "Enhancing Bank Transparency".

Back to 2011, the first EU-wide stress test carried out by the EBA was crucial in providing the market with the ability to discriminate among different levels of risk for financial institutions, providing detailed information on capital composition, geographical breakdown of exposures as well as sovereign holdings. We filled an informational gap and provided comparable data on banks' solvency ratios, front-loading – with some simplifications – the global definition of Common Equity Tier 1 then under discussion at the Basel Committee. Over time, the EU-wide stress test has traditionally focused on providing consistent transparency on banks' exposure to risks. In that respect, our stress test is a complement rather than a substitute to other supervisory stress tests.

Progress between 2011 and 2016 is noticeable: we moved from a major shortage of publicly available data on EU banks in 2011 to a regular and consistent disclosure of comparable figures afterwards. The EBA has established a tradition of disseminating detailed bank-by-bank data designed to improve the understanding of the EU banking sector and foster market discipline in the Single Market.

In parallel, and starting from scratch, we have also worked on building our own capacity to collect, quality assure, explore and disseminate granular bank data. In this context, the 2015 EU-wide transparency exercise represented a milestone since it mostly relied on the information reported to the EBA on a regular basis through the supervisory reporting framework. For the first time, data templates were filled directly by the EBA and only sent for verification to banks. Only in the case of two topics (sovereign exposures and leverage ratio), for which supervisory reporting data at the required level of detail is not available, data was collected from banks as in previous exercises. In this process, the EBA processed and disclosed up to 13,600 data points for each bank involved. That amounted to over 1.3 million data points published in aggregate on the EBA's website. We provided not only raw data for each bank, but also metadata and interactive tools designed to facilitate the exploration of data as well as the visualisation of key figures.

This approach reduced the burden on banks and showed our commitment to significantly trim down *ad-hoc* data collection now that common supervisory reporting standards are available. We are currently working on the 2016 stress test, which will also be complemented by extensive transparency on banks' data. Since the sample of banks involved in the stress test is far more limited than in the past, we are also considering possible options for ensuring continuity in our disclosure for a larger set of EU banks. A possibility is to link the transparency exercise to our

regular analysis of banks' risks and vulnerabilities. We could, for example, opt for a yearly publication of bank-by-bank data as a complement to our risk assessment reports.

Our determination in fostering a better understanding of EU banks is not limited to the disclosure of data but also covers thematic analyses on specific topics of general concern. Our work on the consistency of the outcomes of banks' internal models is a good example. Also in this case, we realised that market analysts, rating agencies and investors had lost confidence in the outcome of internal models – the calculation of risk-weighted assets (RWA). A number of market analyses studied the wide dispersion in RWA density – the ratio of risk weighted assets to unweighted assets – and concluded that it was difficult to explain it on the basis of available information. Several observers started questioning the reliability of regulatory ratios as a yardstick to measure banks' resilience.

We have then started conducting regular analyses for assessing dispersion across banks and identifying the sources of variability of risk-weighted asset estimation. Our analyses have been accompanied by transparency concerning the use and outcomes of models. As a matter of fact, the Capital Requirements Regulation (CRR) already conditions the use of internal models to the disclosure of specific information on risk-weighted assets.

Following the mandate set out in the Capital Requirements Directive (CRD), the EBA has also developed technical standards to assist competent authorities in assessing the quality of internal models through the use of benchmark portfolios. In particular, the EBA has defined the standards for the assessments as well as the procedures for sharing the conclusions and the benchmarking portfolios used in the assessment. This year, the first regular benchmarking exercises organised under these technical standards will be conducted by all institutions that currently use internal models to determine their own funds requirements, both for credit and market risks, and will play a crucial role in improving comparability of capital requirements calculated by all institutions across the EU.

The EBA has also sought to enhance transparency about internal models and their outcomes via disclosure of data under a consistent format and using harmonised definitions. This objective has been pursued, for instance, in our Guidelines requiring more frequent disclosures by at least some of the most important institutions. Ensuring that IRB models are improved and credibly deliver more reliable and consistent results would not be enough, if these improvements were not perceived by market participants.

3. *Comparability as a prerequisite for effective disclosures*

Disclosure of financial information is certainly important, but it does not come without challenges. Disclosure works properly only if the underlying data is consistent, of high quality, and reliable. Only *disclosure* of well-understood and comparable data really delivers *transparency*.

In fact, common standards are a prerequisite for transparency and bring positive externalities. "*Just as everyone benefits from common weights and measures in the physical world, or from common standards for electronic media like DVD encoding, there's a social benefit from financial statements following a single standard, including key concepts, common definitions and principles, and, to the extent possible, common formats*"[8].

In 2014, the EBA finalised and rolled out a single set of supervisory reporting standards in the form of Common Reporting Requirements (COREP) and Financial Reporting Requirements (FINREP). The EU reporting standards provide fully harmonised information on banks' own funds and balance sheet data. In practice, all banks are subject to the same standards for supervisory reporting, to ensure adequate information and coverage for both micro- and macro-prudential purposes.

The development of EU-wide reporting went hand in hand with the identification of common definitions, with the objective of bringing together supervisory, accounting and prudential aspects. This is the case, for instance, for our standards on the definitions of non-performing exposure and asset encumbrance. Indeed, before the crisis, the lack of a Single Rulebook made it very difficult to organise microprudential assessment and supervision of cross-border institutions in a truly coordinated manner. Supervisory reporting based on national requirements resulted in large sunk costs for cross-border banks, challenges in comparing bank data across the border and poor data sharing among supervisors.

This was true in general, but particularly for the assessment of credit risk, where the identification of non-performing and forborne loans followed very country-specific and hardly comparable definitions. Our technical standards on non-performing exposures (NPE) and debt forbearance, finalised in 2014, ensured uniformity across the Single Market, at least for

[8] Caruana J. (2011), "Financial stability and risk disclosure", Keynote speech to the FSB Roundtable on risk disclosure.

supervisory reporting. They have been a precondition for carrying out the asset quality review on a consistent basis in 2014, thus also supporting a smooth start of the Banking Union. In 2015, as part of the EU-wide transparency exercise, we have published bank-by-bank data on NPE and forbearance providing, for the first time, fully comparable information on asset quality for a large sample of major EU banks.

Similarly, the technical standards on asset encumbrance, also completed in 2014, enriched supervisory reporting with additional information on banks' funding and established a common definition of encumbered assets. This allows supervisory authorities to measure banks' reliance on central bank funding as well as assess and compare the degree of structural subordination of unsecured creditors and depositors across institutions.

The awareness that comparability is essential also for banks' own disclosures gave impulse to greater standardisation of the information released to markets. Disclosure requirements were introduced by the Basel Committee as a tool for market discipline back in 2004 – the so-called Pillar 3, complementing minimum requirements (Pillar 1) and the supervisory review process (Pillar 2). More recently, the Pillar 3 framework has been enhanced following the crisis storyline, with a view to both improving the information available to investors and mirroring the regulatory changes in Pillar 1 requirements. Over time, banks have been asked to deepen their disclosures on the composition of supervisory capital; the drivers of capital requirements in the case of use of internal models for credit, market and operational risk; risk management of securitisations; exposures linked to the sponsorship of off-balance sheet vehicles. New risk metrics for market risk – for example the stressed VaR and the incremental risk charge – also led to new qualitative and quantitative disclosures regarding their value and the underlying estimation assumptions.

At the same time, we acknowledged that those requirements should be proportionate and should not endanger banks' business by imposing the disclosure of sensitive or proprietary information. Accordingly, our guidelines clarify how institutions have to assess possible needs for more frequent disclosure as well as apply the concepts of material, proprietary and confidential information in relation to the disclosure requirements.

In order to improve comparability across banks, disclosure requirements were accompanied by specific templates and definitions. Common templates have been introduced in a number of areas, including own funds, leverage ratio, countercyclical capital buffer, asset encumbrance and indicators for the identification of global systemically important banks (G-SIBs).

We are currently working on guidelines implementing in the EU the revised Pillar 3 requirements issued by the Basel Committee in 2015. Once these guidelines are finalised, we will have a comprehensive document specifying the format for most of the disclosure requirements in the CRR.

We have closely followed banks' progress in implementing Pillar 3 requirements. Since the outbreak of the crisis, the EBA has regularly published its assessments of banks' public disclosure and noted the gradual improvements in the quantity and quality of information made available to the public. Our last assessment, conducted in 2015, was the first to review the compliance of credit institutions' disclosures with the new requirements introduced by the CRR.

The assessment covered areas where the CRR introduced the most important changes compared to the previous requirements, including risk management, own funds, capital requirements, indicators of global systemic importance, unencumbered assets, market risk, remuneration policy, and use of the internal models for credit risk. The main finding is that the introduction of standardised formats has increased the consistency of the information disclosed. On the other hand, lack of consistency and poor comparability remain a challenge where standardised formats do not exist. Further improvements are still needed to fully comply with the new requirements introduced by the CRR, such as those on risk management and credit risk under the internal ratings-based (IRB) approach.

There is, therefore, a long way to go for both banks and regulators. A further harmonisation of Pillar 3 requirements is one of our priorities for the next years. With our transparency exercises we have already established a hub where data on EU banks can be easily accessed, explored and downloaded through scalable and user-friendly interfaces. Organising and coordinating this kind of exercises remains a rather complex process, but transparency should ideally become more frequent and wider in scope. I also believe that there is a real need to have banks' disclosure readily accessible for market participants and to complement – possibly integrating – the EBA's transparency with the banks' Pillar 3 disclosures. Our ultimate goal is to have Pillar 3 requirements as aligned as possible with supervisory reporting definitions and templates so as to achieve greater integration of different data sources and reduce the burden for banks and data-users. In the – hopefully not too distant – future, we should envisage a central repository available on the EBA website where all EU banks' Pillar 3 data would be collected in an editable format and disclosed, as it already happens for G-SIBs disclosure.

4. *Transparency of authorities' action*

I have focused so far on banks' transparency. However, there are two pieces of the new regulatory framework that, in my view, introduce a new dimension in the discussion on transparency in banking.

First, one of the main implications of the crisis on banking regulation is that the cost of bank failures should be borne first and foremost by its shareholders and creditors. Support with taxpayers' money should be used only as a last resort, when there is a proven concern for systemic stability. Bail-ins of private investors is expected to substitute, to a large extent, bail-outs financed by governments.

Second, the new macroprudential framework has introduced the principle of "capital conservation" which requires banks to restrict payouts – in terms of dividends, coupons and bonuses – to a "maximum distributable amount" (MDA) if they are unable to meet the cumulative macroprudential buffers (the "combined buffer") above Pillar 1 and Pillar 2 requirements.

The shift from bail-out to bail-in and the MDA concept have important implications for market dynamics, since the decisions of the supervisory authorities directly affect the payoff of several banks' stakeholders. The question is, therefore, whether supervisory decisions on, for instance, Pillar 2 requirements and actions possibly triggering the suspension of payments to stakeholders should be transparent.

Unquestionably, increased transparency reduces the magnitude and frequency of bank problems, as it allows market participants to impose market discipline at an early stage and more effectively. Transparency cannot prevent banks' failures, but it may force prompt recognition of losses, the dismissal of assets, and potentially a quicker recovery. Disclosure also forces the closure of clearly insolvent institutions, thus contributing to reduce overcapacity following a boom-and-bust cycle[9].

However, the traditional view on the disclosure of supervisory decisions is that it may generate instability and possibly lead to a bank run. The disclosure of sensitive information

[9] Rosengren E. (1998), "Will Greater Disclosure and Transparency Prevent the Next Banking Crisis?", Boston Fed Working Papers.

concerning supervisory assessments – such as, for instance, additional capital requirements under Pillar 2 – may indeed trigger self-fulfilling processes. As investors learn about negative signals, they might choose to claim back their funds irrespective of any evidence for immediate danger, simply because they want to benefit from the "first-mover's advantage", should things go wrong. This would point to confidentiality. Indeed, most jurisdictions have traditionally disclosed little, if any, of their supervisory assessment of banks.

But under the new regulatory setting, what would happen if relevant information is not disclosed and investors bear losses due to measures they were not aware of when taking decisions? And how can certain instruments issued by banks be correctly priced if key information concerning the triggers that may lead to suspension of payments or even to write-down or conversion into equity are not known to investors? Lack of disclosure of supervisory decisions may also increase legal and reputational risks for supervisors, for instance if investors subscribe a capital increase of a fragile bank that shortly afterwards is put into resolution.

This is clearly a slippery territory and it is important to deal with these issues without preconceptions. I believe that an open debate on pros and cons of unveiling supervisory decisions is necessary and cannot be delayed.

Indeed, uncertainty on how supervisors operate and make decisions may affect market valuations on banks. We have witnessed this in early 2016, when the European markets for additional tier 1 (AT1) instruments have been significantly disrupted, with primary issuance volumes falling and secondary market yields and spreads rising sharply. This was certainly linked to the weak economic environment and compressed bank profitability, but also to the ambiguity and confusion amongst investors on the application of the new supervisory framework.

For this reason, the EBA recommended supervisors to disclose their decisions to request additional capital under the supervisory review and evaluation assessment (SREP). The push for increased transparency reflects our belief that market participants should be aware of Pillar 2 requirements since these affect the risk/return profile of their investments and they should be able to price it.

Similarly, in the bail-in world, investors need to have access to relevant information on additional loss absorbency requirements imposed by resolution authorities. The future decisions on the minimum requirement for own funds and eligible liabilities (MREL) should be used to make

sure that all actors – resolution authorities, prudential supervisors, conduct authorities, issuing banks and investors – have the same understanding of the requirements and of the hierarchy of claims in going concerns and in resolution.

My call for transparency is particularly topical for the marketing of subordinated or long term debt to retail investors. The mis-selling of risky instruments to retail clients, unaware of the underlying risks, has created challenges in resolution both during the crisis and more recently. Some have suggested a complete ban for the distribution of instruments subject to write-down or conversion into equity to retail customers. I think that as retail investors may buy shares, they should be allowed also to buy subordinated debt instruments. However, it is essential that they are fully aware of the risks that they assume.

The Markets in Financial Instruments Directive (MiFID) already requires that investors are carefully informed about the risks of the products being proposed to them and makes clear that particular care needs to be exercised to actively manage the conflict of interest when a financial institution is selling its own liabilities. Along with ESMA and EIOPA, we have issued, in June 2014, a paper reminding financial institutions to strictly adhere to these requirements in light of the regulatory reforms pushing banks to strengthen their capital and to issue loss absorbing liabilities. More recently, ESMA clarified that all instruments subject to write down and conversion should be considered "complex" and should be distributed to retail customers only after they have benefited from independent advice. A strict enforcement of these requirements should ensure sufficient protection of consumers.

5. *Conclusions*

The financial crisis has significantly affected my thinking about transparency. My experience at the EBA has made me acutely aware that opaqueness is a powerful crisis accelerator. If market participants are unable to compare and contrast the situation of banks vis-à-vis a specific risk, they are naturally inclined to think the worst of each and every bank. The whole market grinds to a halt. If authorities act in an unpredictable way, for instance by taking different courses of action in apparently similar cases or by concealing the information that is at the basis of their decisions, volatility is likely to increase and any shock can easily destabilise the system.

This is why we, at the EBA, have consistently focused our efforts in increasing the quantity and quality of bank disclosures, enhancing the comparability and accessibility of bank data, and recommending greater disclosure of authorities' assessments.

The transparency of bank data is particularly important in the EU, where the lack of comparability of key bank information across countries has been a major hindrance to the functioning of the Single Market, and even to supervisory cooperation.

As I tried to document in this lecture, we have already made good progress. I am confident that we will soon move to a new setting, in which any interested party can easily access all relevant bank information, drawn from supervisory reporting (i.e., without any additional burden for banks), on a regular basis – ideally quarterly –, and in a single place – the EBA website. This is what is already happening in the United States, and we should aim at achieving at least the same results in the Single Market. Ideally we should exploit all the possible synergies between Pillar 3 disclosures and supervisory reporting, thus achieving an integrated set of information, easily available and consistent across banks.

I am also convinced that, in the new regulatory setting, supervisors and resolution authorities will have to become more and more transparent about their own decisions, especially when these may affect the payments to investors or even the value and nature of the financial instruments they hold. If the buck is going to stop with shareholders and creditors of a bank, it will be the duty of authorities to put them in a position to exercise their role in an effective way, correctly pricing capital and debt instruments and imposing an adequate level of discipline on bank management.

Thank you very much for your attention.