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The 'banking reform package': CRD 5/ CRR 2/ BRRD 2

Introduction

Mr President, honourable Senators,

Let me first thank you also on behalf of the European Banking Authority (EBA) for inviting me to speak about the new legislative proposal on the banking reform package, which the European Commission published last November and which is about to be negotiated by the the European co-legislators.

Overall, the European banking sector has made remarkable progress since the financial crisis broke out, in terms of the level and quality of capital, deleveraging, diversification of funding and availavility of liquidity buffers. However, among the many challenges banks are currently facing are the outstanding issues of profitability, business models, and non performing loans (NPLs). On the latter issue, which is particularly relevant for Italy and other Member States, the adjustment process is making progress: at EU level, the ratio of NPLs to total gross loans has started to decrease since the end of 2014. However, the sheer volume of NPLs remains excessively high – just below one trillion euros for the whole EU, if we consider the banks in our sample. In ten Member States, including Italy, the ratio is above 10% and this has a negative impact on banks' profitability and lending to the economy. It is crucial to take further policy measures to speed up the cleaning of banks' balance sheets. The EBA has done a lot of work on this and put forward some concrete proposals.

Since its establishment in 2011, the EBA has been contributing to the banking reform process through the development of a Single Rulebook for banking, a common set of rules through which the European Union has implemented the international standards - designed by the Financial Stability Board (FSB), developed by the Basel Committee and approved by the G20 Leaders – to remedy the regulatory shortcomings that the financial crisis revealed. The EBA has also initiated and coordinated EU-wide stress tests and supported recapitalisation exercises, which have helped banks reach satifactory levels of capital. The establishment of the Banking Union has further contributed to a more stable, integrated and efficient banking system.

The EBA is fully aware of the crucial role international standards play for the good functioning of European and global markets and is working relentlessly to ensure the European Union is in line with these standards, while still catering for some EU specificities. Besides the regulatory review, which we are discussing today, the reform of important chapters of the Basel standards is currently being negotiated. This includes, among other things, the use of internal models and operational risk requirements. In particular, on the issue of internal models and on the reliability of risk weighted assets' estimates, the EBA has done considerable work and has strived to represent the European stance at the Basel table, with the aim of contributing to the achievement of a compromise.

The revised regulatory package

First of all, I would like to focus my remarks on the preparatory work the EBA has done on the proposed amendements to the Capital Requirements Regulation (CRR), Capital Requirements Directive (CRD) and Bank Recovery and Resolution Directive (BRRD), which are part of the new banking reform package.

In response to the several calls for advice from the European Commission, but also on its own initiative, the EBA has drafted and published a number of Reports on the following topics: (i) leverage ratio (LR) – August 2016, (ii) net stable funding ratio (NSFR – December 2015); (iii) fundamental review of the trading book (FRTB – November 2016); (iv) implementation of the new International Financial Reporting Standards (IFRS9); v) minimum requirement for own funds and eligible liabilities (MREL – December 2016). These Reports were supported by in-depth impact assessments covering also the implications of international standards on small and medium-sized banks as well as on banks with a simple or specialised business model. We have also carefully assessed the impact of regulation on lending to the real economy and to small and medium-sized entreprises, something that is particularly relevant for countries like Italy.

In general, we recommended the European Commission to strictly comply with global standards, except for some adjustments catering for some specialised intermediaries and business models, i.e. central counterparties and – only in relation to the NSFR - the case of interdependent assets and liabilities arising for instance in mortgage lending. We are quite satisfied that most of our suggestions have been taken on board. However, there are some areas where the Commission decided to deviate from our advice in view of introducing preferential treatments or exemptions for certain entities or types of transaction, often leaving substantial discretion to national authorities to interpret them. If such exemptions were to be confirmed in the final legislative texts, it would be crucial to mandate the EBA to monitor these deviations from international standards so as to ensure a sufficiently harmonised and prudent application.

Proportionality is definitely the most important element of the banking reform package. And the EBA fully supports this approach. We believe that proportionality should not be a mere request for less regulation, nor a call for ‘local’ rules applied to ‘local’ banks. On the contrary, and this is also confirmed by all the feedback gathered by the European Commission during its public consultation, proportionality is about a simplified application of common European rules, taking into account the specific features of business models and the need to avoid an unwarranted increase in operational and administrative costs.

Proportionality can be applied to different areas. In the context of market risk, the Commission has taken on board the double proportionality threshold approach, which we had recommended: (i) banks with a very limited trading book will not be subject to market risk regulation and can rely on rules applied to the banking book. On the other hand, (ii) banks with a limited trading book can continue to use the current standardised approach, which is less complex - but also less risk-sensitive - than the approach proposed by the Basel Committee.

In the context of the leverage ratio and of the NSFR, the proposed proportionality approach envisages a specific treatment or an exemption for certain entities or transactions. We have suggested some of these treatments, whereas others, such as the exemption from the leverage ratio for exposures towards promotional banks or officially guaranteed export credits have been introduced by the European Commission. We believe that these exemptions might need further regulatory specification so as to avoid being inappropriately applied.

In the context of supervisory reporting, the Commission proposed to reduce the reporting frequency for small banks from semi-annual to annual. In this area, we have sent our advice to the European Commission, clarifying that lower reporting frequencies can result in additional *ad hoc* requests, which are not necessarily harmonised, or can generate an additional burden via more frequent on-site inspections. We are fully aware of the costs and operational burden of supervisory reporting and, therefore, we welcome the European Commission’s proposal to mandate the EBA to assess the related compliance costs. A proportionate implementation of supervisory reporting is already high in the EBA’s agenda. The European Commission has also introduced in the new reform package our proposal to develop an interactive platform through which banks can easily identify and consult the appropriate supervisory reporting templates based on their size and business model.

I would also like to touch on the proposal to review the capital Requirements Directive on Pillar 2, the supervisory review process. In this area, the Commission has taken on board the EBA’s recommendations. In particular, the proposal: (i) explicitly states that Pillar 2 measures are to be considered as legally binding; (ii) clarifies the concept of Maximum Distributable Amount (MDA), i.e. restrictions to earnings distribution; (iii) introduces the concept of 'capital guidance' through which competent authorities notify banks of the level of regulatory capital that they are expected to maintain, especially in relation to stress test results; (iv) clarifies the microprudential nature of Pillar 2 measures, whereas other instruments can be used for macro-prudential purposes. We believe that these reviews will lead to a more harmonised Pillar 2 across the EU. For example, the EBA observed that national supervisors have used the outcomes of stress tests differently: some authorities have used them to set a capital guidance above the combined capital buffers, whereas other supervisors have used them to quantify the minimum Pillar 2 requirements.

Moving to the European Commission's proposal related to the recovery and resolution of banks and investment firms, the EBA agrees with the proposed amendments to implement the total loss-absorbing capacity (TLAC), which was designed by the FSB for global systemically important banks (G-SIBs), and to specify the characteristics of the minimum requirement for own funds and eligible liabilitiese (MREL), for all the banks other than G-SIBs. A clear and stable definition of the regulatory framework is an important step to ensure resolution authorities can determine the requirement and banks can comply with it through adequate issuances of debt or capital instruments.

The EBA supports the European Commission's proposal to amend the BRRD in relation to the bank creditors' hierarchy in insolvency and resolution, introducing a new category of liabilities, the so called 'senior non-preferred' liabilities. This category, which sits between senior liabilities and subordinated liabilities, aims at facilitating the use of the bail-in power, while taking into account the potential impact on banks' funding costs. This new class of debt instruments, clearly eligible for bail-in, can also provide a higher protection to senior unsecured debt and deposits above € 100.000, which would rank higher in the hierarchy.

A greater transparency on the level of MREL elgible liabilities would help other creditors assess in a more accurate way the probability with which the instruments they own may be written down or converted into equity. This is why we think it is crucial to accompany this important regulatory reform with more comprehensive transparency requirements. The European Commission's proposal rightly requires all issuers to provide full transparency on the composition of MREL liabilities, once the MREL requirement has been fully met. The EBA has argued that it would be important that the composition of the eligible liabilities is disclosed already during the transition phase and that the MREL requirement set by the authority is also disclosed, at least as of the moment banks have reached the requested level. I think providing full transparency is important for a correct assessment of the bail-in risk affecting the different categories of creditors and, therefore, for a correct pricing of the different instruments.

I am aware that the BRRD, an in particular the rules on bail-in, are rather controversial in Italy, where more radical requests for change have been put forward. However, I would like to draw your attention to some elements worth considering, also in light of the recent cases to which the new regulatory framework was applied.

i. It would be wrong to go back to the wide-ranging bailout policies of the past - but we need to boost intervention tools at European level.

The financial crisis showed that broad and unconditional public guarantees on banks' liabilities are neither fair nor sustainable. In many countries, during the crisis a considerable onus has been placed on public finances to support ailing banks, while private investors – including other banks and institutional investors – continued to receive coupon payments on capital instruments, such as subordinated debts, which had been included in those banks' regulatory capital under the assumption they would have absorbed the losses. In addition, in some Member States, the size of the banking system relative to GDP calls into question the fiscal sustainability of systemic crises. This is particularly relevant for those countries with high government debt and/or with a particularly large banking sector.

Implicit or explicit public support can trigger a vicious link between the stability of banks and that of the respective Member States. To break this link, the Banking Union has envisaged common support mechnisms, such as the Single Resolution Fund (SRF). In order to limit the potential cost of public intervention, it has been made clear that private investors have to be first in the line to absorb losses. It would be wrong and dangerous to reverse course. We would run the risk of creating a divide in the Banking Union between those countries that have the fiscal capacity to protect senior creditors and depositors and those countries that cannot afford it. This would also create a divide in the cost of funding and could have potentially negative implications on market inegration as well as on the sustainability of the institutional framework.

At the same time, it is important, and I think also necessary, that public intervention mechanisms at European level are stregthened. For example, I have recently argued in favour of establishing a European asset management company (AMC) to deal with non performing exposures, which could support the cleaning of banks' balance sheets. I am aware that it would be difficult to achieve a political agreement on a full integration of public intervention mechanisms on the European banking sector until the post-crisis adjustement process won't be completed in all Member States. This is why we have designed a proposal that avoids any form of risk mutualisation among Member States and suggested to press ahead with common blueprints for national AMCs, in the absence of a consensus on a European AMC. But in the medium-term, it will be necessary to develop common instruments to ensure a faster restructuring of the banking system after a systemic crisis.

ii. Resolution is not just about bail-in: it is a mechanism aiming at ensuring continuity of banks' critical functions and at preserving value – but the recent developments deserve serious reflection.

In the Italian debate, I noticed that the new resolution regime is often considered as one and the same thing as bail-in. And often, people disregard the fact that the concrete application of bail-in can have very different impacts on the different categories of creditors and that, for some of them, being actually bailed-in is extremely unlikely. The real added value of the BRRD is the design of a series of instruments, including bail-in, which have been identified as best practices at global level from the FSB to manage banking crises minimising the impact on (i) the parties directly affected, (ii) banks' critical functions to the financial system and the economy at large, and (iii) the Government budget. The aim of resolution is to ensure the continuity of critical functions, contrary to liquidation, which is triggered when no public interest has been identified and can, therefore, lead to a sudden interruption of banks' activities and to greater losses for individual creditors. The involvement of private investors is a crucial step in the resolution process to ensure the sharing of losses is proportionate to the risk undertaken (as well as to the returns enjoyed) by the different categories of investors, as well as to limit any form of public support, including from the resolution fund. But resolution is much more than this: it is a mechanism that preserves value, both for individuals as well as for the entire community.

The first resolution and liquidation cases to which the BRRD has been applied raise some issues that need to be addressed and which may call for a reconsideration of certain aspects of the legislative framework.

In particular, the 'no creditor worse off' (NCWO) principle is key in resolution. As no creditor should be worse off in resolution than in liquidation, I also believe that, conversely, no creditor should be better off in liquidation than in resolution, given that the latter triggers a series of public safeguards to preserve the continuity of critical functions.

I don't think this principle has been successfully applied in the case of the two banks from Veneto recently put into liquidation. On one hand, a truly integrated framework for managing banking crises should include harmonised rules on ordinary liquidation. On the other hand, I think it showed that public interest is assessed differently at European and at national (or regional) level. This potentially paves the way to different national preferences on the use of public support mechanisms. In turn, it can have negative effects on the level playing field within the Single Market, also through differences in the cost of funding for banks based in different Member States, on the basis of the respective goverments' fiscal capacity.

Finally, the decision taken by the Single Resolution Board (SRB) to consider that in the case of the banks in Veneto a resolution action was not warranted in the public interest seems to point to very stringent conditions for triggering resolution tools. The decision was based on the assessment that there were no critical functions. However, the amount of loans to the local economy, especially to small and medium-sized enterprises was significant and the insured deposits, which should have been reimbursed by the Italian deposit guarantee fund (Fondo Interbancario di Tutela dei Depositi) were also rather significant. Although it would be wrong to apply this SRB decision to other cases in a mechanical way, the precedent of the two banks in Veneto seems to point to a potentially high number of European banks that could be subject to ordinary liquidation in case of a crisis. In this case, in line with the EBA Regulatory Technical Standards, banks would not be asked to meet additional MREL requirements, as it would be enough for them to comply with the minimum capital requirements. This would give even less protection in case a Government decided to provide State aid, as it was the case in Italy.

iii. The protection of retail investors is best achieve by making them aware of the risks posed by the different investment products

In some Member States, including Italy, banks have placed with their retail customers capital or debt instruments - often quite complex - which are eligible for write down or conversion in resolution. In 2014, together with EIOPA and ESMA, the EBA reminded banks that the risks and complexity of such instruments, as well as the issuer's potential conflict of interest, require rigorous compliance with the conduct rules on investor protection, namely with the provisions set out in MiFID. The option to ban the distribution of complex capital instruments to retail investors is also being dicussed – this solution has been adopted in some countries for additional Tier 1 instruments, featuring particularly complex mechanisms for the suspension of coupon payments, conversion and write down. My view is that as individual retail investors are entitled to purchase bank equity, they should also be allowed to invest in subordinated or senior non-preferred debt, as long as they are adequately informed of the potential risks attached to such financial instruments. What is crucial is that all issuers comply with the relevant conduct rules and that competent authorities enforce them in a rigorous manner.

Arguments have also been raised claiming that the BRRD has retroactively altered the riskiness of such financial intruments. This is not actually the case for subordinated debt instruments (Tier 2 capital), so far the only instruments that have been actually written down in Italy. It is worth reminding that the loss absorption capacity requirement for subordinated debt instruments dates back to the first Basel Capital Accord of 1988, which has been implemented in the EU by the second banking Directive in 1989 (Directive 89/646/EEC). Having this in mind, I do not think it is fair to blame the new European rules for requiring subordinated debt holders to bear the losses in case of crisis. The problem rather lies in the failure of some banks to comply with investor protection rules – MiFID 1, in force as of 2004 – when placing these instruments with retail investors without clearly explaining their underlying risk profile.

From a legal point of view, both the Court of Justice (case C‑526/14, *Kotnik*) and thereafter the Italian Regional Administrative Court of Lazio (TAR Lazio, Section II/quater, judgment n. 166/2017) have ruled out the application of the principle of legitimate expectations of the parties to shield shareholders and creditors from writing down their instruments. The rationale being that in case of liquidation, and therefore regardless of any write down by the authority, shareholders have to bear losses first for the full equity amount, followed immediately by subordinated creditors where additional losses have to be absorbed.

iv. How should transition be handled for retail investors?

It is true that in the current phase of early application of the BRRD, retail investors may not feel at ease with the riskiness of the instruments in their portfolios. In light of the potential domino effect and social consequences, requiring these investors to bear significant losses in case of crisis may, therefore, prove difficult.

I would like to highlight that in some Member States senior creditors were also hit in the context of crisis management measures. This was the case in Denmark, Greece (with voluntary exercises) Austria, Portugal, Croatia and Cyprus (in the latter two Member States, the application of bail-in was extended to depositors above € 100.000).

In any case, if resolution authorities consider it would be difficult in a crisis to write down or convert retail bondholders, then such instruments should not be considered eligible for the MREL requirement.

It is crucial that active policies for banks' liabilities management are implemented as soon as possible. To ensure a smooth transition to the new regime, banks should consider performing liability management exercises (LME) – arguably they should have already done so, given that the BRRD entered into force three years ago. They could for instance offer to buy back instruments from those retail investors, who are not at ease with their risk characteristics in the new legal environment, and substitute them with less risky instruments, which would of course carry a lower yield.

At the same time, it is also important that the issuance of new capital instruments and other loss absorbing liabilities is accelerated. These instruments should be placed with wholesale or retail investors, duly informed about the level of risk of the products. The Guidelines issued by ESMA are helpful in this respect, as they define all instruments eligible for bail-in as complex products (in line with the MiFID provisions) and make the placement of these products with retail investors subject to the provision of independent advice. Also the European Commission's proposal to harmonise the creditors' hierarchy by introducing the new category of senior non-preferred debt could facilitate this process. To speed up the transition, the European co-legislators could announce the inclusion of grandfathering clauses so as to ensure the eligibility of senior non-preferred instruments issued before the adoption of the final legislative text.

Based on the analysis carried out by the FSB, it is good news that many G-SIBs have already made considerable progress in complying with the TLAC requirement, which is to be met by 2022. The high demand for loss-absorbing instruments (i.e. eligible for TLAC/MREL) is encouraging, especially considering the scepticism raised by many when the term sheet was adopted. However, medium and small-sized banks have made more limited progress in meeting the new requirements. This is not a satisfactory outcome, especially if we consider the current favourable market conditions with exceptionally low interest rates and investors' search for more attractive yields.

We need to acknowledge that the regulatory framework still needs to be completed and resolution authorities have not yet set the level of the MREL requirement for each individual bank. In the context of resolution colleges, the EBA has pointed out to resolution authorities that the MREL requirement should be set as soon as possible. We urge that such decisions are taken in the next resolution planning cycle, which will start in autumn.

However, the sense of direction is clear and given the favorable market conditions banks should be more active in issuing loss-absorbing instruments. The more MREL requirements are met with loss-absorbing instruments placed with well informed professional or retail investors, the more senior creditors and non insured depositors will be protected in case of a crisis. In addition, the lack of an adequate buffer of loss-absorbing liabilities held by private investors makes it more difficult for banks to orderly exit the market and may also entail a need for the government to intervene at significant cost.

Conclusions

To conclude, I think that the Banking Package contains an approach to proportionality that is both necessary and worth of support. Through the implementation of the TLAC standard, and the clarification of the MREL discipline, the proposal completes the crisis management regulatory framework by making it more effective and credible. The EBA stands ready to provide all the support needed to implement the proposals. To this end, the EBA reminds the co-legislators of the importance of monitoring the effects of the legislative changes to ensure the correct application of the new rules, to avoid regulatory arbitrage and ultimately to maintain financial stability.