Progress in banking sector and institutional repair in the European Union

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

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Ladies and Gentlemen,

It is a great honour for me to be here today to address this distinguished audience, and I would like to thank Tim Adams and the IIF for having given me this opportunity.

The European Union has been at the forefront of the process leading to an increased international integration of banking and financial markets. The legal and institutional underpinnings of the Single Market and the introduction of the single currency in the euro area supported an unprecedented expansion in cross-border banking business in the first decade of the century. Not surprisingly, when the crisis spread across frontiers, the EU has been severely hit. The banking crisis morphed into a sovereign debt crisis and became a threat for the whole institutional set up, spreading fear in markets, well beyond the boundaries of the Union.

Important and courageous policy decisions have been taken by the European authorities, which have contributed to easing the level of stress in financial markets. But uncertainties in the management of the crisis in Cyprus and remaining fragilities in the financial sector show that the work is not finished yet.

I will try to bring to your attention the progress achieved, and the steps yet to be taken, in three areas: first, ***regulatory repair***, i.e. the action to strengthen the framework for bank regulation and supervision, in line with the international agreements; second, ***banking sector repair***, aimed at improving the resilience of European banks; third, ***institutional repair***, in particular the momentous agreement to establish the key pillars of a Banking Union – a single supervision, a single resolution mechanism, common resources to directly support banks under stress in the euro area and in the other Member States willing to join.

A lot has been done. A lot remains to be done. But the sense of direction is clear. I will argue that the main challenge is to invert the trend towards a ring fencing and re-nationalisation of banking business. If we succeed, there will be important lessons to be considered also at global scale.

1. Regulatory repair in the EU

Already in 2009, the G20 identified the main lines of the regulatory response to the crisis, which in the field of banking regulation has been embodied in the so-called Basel III agreement: a stronger definition of capital; higher capital requirements, especially for systemically relevant institutions; the introduction of a leverage ratio, not dependent on banks' internal models; a harsher calibration of the requirements for trading book exposures; harmonised liquidity requirements, aimed at establishing strong buffers of liquid assets to withstand shocks and at constraining the reliance on flighty wholesale funding; and rules on compensations that corrected the incentives to excessive risk taking.

Other aspects have been opened in the debates on banking regulation, in the EU as in other jurisdictions. But I strongly believe that our first priority must be to complete the implementation of the Basel III agreement and give certainty to market participants. The reform intends to drive to a significant change towards safer and sounder business models. Banks have already started moving in that direction, but they are rightly asking that all the rules are put in place, so that they can coherently plan their next steps.

In the EU, the political agreement on the legislative texts that will implement the Basel III package has been achieved. Let me stress an important change in the EU legal framework: the introduction of the so-called Single Rulebook which implies that the bulk of the reformed framework is adopted through European Regulations that are directly binding in all 27 Member States. Moreover, an extensive number of technical details are delegated to standards to be drafted by the European Banking Authority, which, once adopted by the European Commission, will become directly binding throughout the Single Market. The EBA has already conducted public consultations on a number of standards and is ready to finalise them as soon as the primary legislation is published.

Going forward, banks will face a single framework for supervisory reporting in the EU; key prudential concepts will be based on truly uniform definitions – for instance, for the first time we will have common definitions of non-performing loans, forbearance, asset encumbrance; this in turn will lead to more reliable and comparable disclosures by the banks, which will support enhanced market discipline; the questions on the implementation of the rules raised by the banks will be addressed at the European level and channelled through the EBA, limiting the room for divergence in the application of the same rules; most importantly, the possibility to use the regulatory lever to favour the competitive position of national champions will be significantly reduced. Some important elements of flexibility are left at the national level, as one lesson of the crisis is that the requirements might need to be tightened during credit upswings, which are likely to be country-specific. But there will be a European framework for exercising this discretion.

In some areas, such as the definition of capital, the complexities of the European legal set up led to the introduction of elements of national discretion, which have also caused concerns of a deviation of our rules from the Basel blueprint. I would like to point out that the EBA is attributed an important role to ensure that the principles enshrined in the global standards are abided by, and we are already organising ourselves to perform this role in a rigorous fashion.

In line with the G20 agreements on the gradual phasing in of the various elements of the Basel III package, some important requirements are yet to be fully fleshed out. In particular, the EBA is requested to produce reports for the final calibration of the liquidity requirements and the leverage ratio, reflecting also the reviews undertaken by the Basel Committee. Let me stress that while a more in depth analysis could show that adjustments to the requirements are warranted, as it has been the case for the liquidity coverage ratio (LCR), it is important to maintain the commitment to finalise all the elements of the Basel III reform, according to the agreed time schedule. I would strongly encourage European banks to contribute to a serious completion of the reform package, instead of arguing that we should stop in the middle of the road.

Another important component of the reform programme is a robust framework for bank recovery and resolution, which endows the authorities with the powers and tools to orderly wind down also large and complex institutions, without a lasting impact on public finances. Bank creditors, with the exception of insured depositors and few other investors, should be made aware that they can and will take losses if the banks default. But this needs to happen in a framework of legal certainty. The solution chosen for the Cypriot crisis has been the only option available, given the peculiar liability structure of the banks and the imbalance between their size and the fiscal capacity of the country. But the process has been far from optimal, and the absence of a clear legal framework at the European level has generated much uncertainty amongst depositors and investors. This uncertainty must be swiftly remedied. The Directive on Bank Recovery and Resolution is being finalised and should be agreed by June this year.

2. Repair in the EU banking sector

While the regulatory reforms are being completed, the action for repairing banks' balance sheets and business models is also making progress. Often EU authorities are criticised for not having acted swiftly and decisively enough in addressing the weaknesses of the banking sector. I acknowledge that the absence of a common fiscal capacity and the complexity of our decision making mechanisms have made the management of the crisis particularly challenging, causing delays and uncertainties in the policies for the banking sector. Nonetheless, we made significant progress.

When the EBA started working in 2011, we witnessed a progressive deterioration of market confidence in EU banks. With the deterioration of the sovereign debt crisis, funding markets froze; the risk of a disordered deleveraging became very material; serious concerns emerged that the European economy would have suffered a major impact. Our stress test, published in July 2011, had several positive effects, as banks scrambled to raise EUR 50 bn fresh capital in the run up to the test while an unprecedented level of disclosure and coordinated supervisory pressure led to a restructuring of several banks which were poorly capitalised and with significant exposures to sovereigns under stress. But the exercise failed to push the required adjustment in a single shot. Few months after the conclusion of the stress test, the EBA put forward a Recommendation, the so-called recapitalisation exercise, to build an extraordinary capital buffer, leading all major banks to a Core Tier 1 ratio above 9% after taking into account the deterioration in the market valuations of sovereign exposures. We referred to a very tight definition of capital, anticipating many elements of the Basel III standards and enforcing it in a rigorous manner.

Overall, the EBA Recommendation led to a strengthening of EU banks' capital positions by over EUR 204 bn. We faced a lot of criticism that our request, not backed by a common European backstop, would push banks to achieve the target by reducing asset levels, instead of raising capital. But, on the contrary, our Recommendation prevented this outcome and the bulk of the adjustment occurred through increases in the level of Core Tier 1 capital. Moreover, we coordinated the discussion in colleges of supervisors, to prevent a home bias in the limited actions aimed at reducing asset levels.

A report[1] we recently published, shows that from December 2011 to June 2012, – the period the banks had to comply with our recommendation – the capital shortfall of European banks with reference to the full implementation of the Common Equity Tier 1 (CET1) requirements defined by Basel III decreased by 43.5%. The average CET1 ratio is in line with the levels achieved in other major jurisdictions and most of the EU banks are close to fulfilling or have already fulfilled the CET1 target level set for 2019.

Besides the strengthening of EU banks' capital position, other important policy initiatives contributed to easing the pressure on European banks. The ECB launch of the 3 year lending programmes (Long Term Refinancing Operations, LTROs), in December 2011 and February 2012, has allowed euro area banks, especially those in countries with financially-stressed sovereigns, to rely on an affordable and stable source of funding and to avoid an abrupt contraction in lending activities. In addition, the ECB's Outright Monetary Transactions (OMT) announcement in August 2012 represented a real circuit breaker and played a pivotal role in calming the sovereign debt markets.

As a result of this set of policy measures, market sentiment has shifted visibly: senior credit default swaps spreads for EU banks – a good proxy for market sentiment on banks' probability of default – dropped by about 50%, from 338 to 160 bps between December 2011 and the beginning of April this year; cash spreads – i.e., the cost for banks to issue senior bonds – also collapsed by about 70%, from 285 to 85 bps; share prices rose by 25% since August and volatility has continued its downward trend; subordinated debt issuances have also met with a notable increase in demand. These positive developments are sustained by a reversal in the capital flight of foreign investors, as demand is coming also from Asia-Pacific and North America – including US prime money market mutual funds, which are often seen as a bellwether for funding market sentiment regarding EU banks.

However, there are also clear indicators pointing to the need to continue, and if possible speed up, the process of balance sheet repair at EU banks. While the policy action has so far focused on capital levels, more attention should now be paid to the asset side. The main areas calling for attention are the rather slow pace of the deleveraging process and the deterioration in asset quality.

Banks' balance sheets contracted in a number of countries, but on average at EU level the downsizing has yet to take place. We have not seen the same scale of aggressive writedowns and disposal of

[1] Report on the results of the Basel III monitoring exercise as of 30 June 2011, published 4 April 2013 (http://eba.europa.eu/Publications/Quantitative-Impact-Study/Basel-III-monitoring-exercise.aspx)

assets at deep discounts that have characterised other jurisdictions, which have successfully removed the excess capacity built up in the run up to the crisis and restored the banks' lending capacity. Provisioning levels and risk weighted assets have not been reflecting the deterioration in the macroeconomic outlook and in the quality of bank assets. There is a raising concern that loan forbearance could disguise inadequate loss recognition. This is adversely affecting the market expectations for a recovery in bank profits and contributes to bank shares being still traded at a significant discount with respect to book values.

Asset quality reviews have been conducted in a number of European countries, contributing to restoring market confidence in the effective cleaning of bank balance sheets. The EBA is empowering supervisors with the proper tools to assess the level of both non-performing exposures and forbearance activities on a comparable basis, developing truly harmonised definitions to be applied across the EU. An in-depth balance sheet review will have to accompany the handing over of supervisory responsibilities from the national to the European level. This represents a unique opportunity to complete the process, with an EU-wide asset quality review.

The EBA is also developing a wider and deeper analysis on the consistency of risk-weighted assets in the banking book across European banks. We intend to identify any material difference in banks' assessments of risks and to understand the main drivers of such differences. The analysis already completed shows that enhanced transparency could help market participants understand – and therefore trust – bank risk weighted assets. But it might not be enough and we should stand ready to consider additional guidance to ensure consistency and reliability of risk-weighted capital ratios.

3. Institutional repair

Regulatory reforms and the strengthening of bank balance sheets would not be sufficient in the EU, as the crisis has unveiled significant pitfalls in our institutional set up, which call for urgent repair.

In building the Single Market, European policy makers made clear to banks that they should consider the EU as their domestic market. The introduction of the euro has further reinforced this development, as also financial market places outside the euro area played an important role in the integration of euro-denominated money and banking markets. Indeed, European banks have taken up a continental dimension, developing their cross-border business and engaging in the early 2000s in a series of mergers and acquisitions. The asset size of the largest banking groups in relation to the EU GDP has grown to levels very similar to those of the largest US banks. However, quite a different picture emerges if we look at the ratio of banking assets to the GDP of the home country of each bank: the largest 10 European banks are all above 50% of their home country GDP, with 5 of them above 100%. In a nutshell, in growing European, they also grew too big with respect to the fiscal capacity of their home country.

When the crisis struck, and the political decision was taken that national governments should bear the exclusive responsibility of supporting their banks, the whole construction became unsustainable. Market participants started assessing the banks on the basis of the credit standing of the countries providing them with the safety net, and focused more and more their attention on the concentration of sovereign exposures in domestic markets. An inextricable and vicious loop developed between the banks and their sovereigns, which led bank funding markets to a halt, with an immediate repercussion on lending activity and growth in the countries under direct stress and a more general impairment in the functioning of the Single Market.

In the last two years, banking markets have increasingly segmented along national lines. The restructuring of banks' balance sheets and the de-risking process occurred with a significant reduction in foreign claims, especially vis-à-vis other euro area countries. Both bank managers and national authorities have searched a better matching of assets and liabilities on a country-by-country basis. Relatively healthy banks in financially distressed countries are still experiencing difficulties in accessing unsecured interbank financing at acceptable conditions. An increased dispersion in lending rates across countries points to a substantially weakened allocation of capital, with market segmentation affecting the access to credit of small and medium enterprises in some countries. The key function of the Single Market as a mechanism for recycling savings from surplus countries to deficit ones is impaired.

Confronted with this threat, European policy makers have provided a strong response, agreeing to swiftly implement the key elements of a Banking Union. In a few months, the legislation to confer supervisory responsibility to the ECB, with the creation of the Single Supervisory Mechanism (SSM), will enter into force. The SSM has been given extensive powers in prudential supervision and will be operational next year. The EBA will continue its work in setting out the regulatory standards, monitoring risks and fostering supervisory convergence for the whole Single Market. Following the completion of the legislation on bank recovery and resolution, the Commission will present already, in June, a proposal for a Single Resolution Mechanism (SRM). The effective centralisation of supervisory responsibilities will also allow the direct recapitalisation of banks by the European Stability Mechanism, funded by all euro area Member States.

I sometimes hear criticisms pointing to the fact that the Banking Union is built without a common deposit guarantee scheme and a full, unlimited, area-wide fiscal backstop. I don't think these criticisms are fair. If all the agreed elements of the Banking Union are ambitiously implemented, as it has been the case for the SSM, I am convinced we can go a very long way in breaking the vicious circle between the banks and their sovereigns.

I believe the greatest challenge will be in the construction of a comprehensive and credible resolution system. The first challenge will be to ensure that the Single Resolution Mechanism has all the powers and tools to effectively deal with the cross-border dimension of the crisis within its own jurisdiction. This means that shared private financing solutions will be needed and that clear rules of engagement will have to be defined for the provision of the liquidity lines that need to assist the resolution efforts. If this resolution mechanism ends up covering only the countries joining the SSM, as it is likely, the second challenge will be to avoid that some degree of segmentation remains in the Single Market, as a consequence of the divergent underlying safety nets on which European cross-border groups will rely. I will briefly focus my attention on this second challenge, as it has relevant implications also beyond the boundaries of the EU.

The crisis showed that voluntary agreements are not sufficient: the strong incentives to diverge from the original agreements when a crisis materialises need to be set-off by credible and binding arrangements. How can we overcome mutual mistrust and ensure that these arrangements would effectively work once resolution occurs? The Financial Stability Board (FSB) is exploring the possible mechanisms to ensure the *ex ante* certainty that this kind of coordination would take place *ex post*, when the crisis kicks in. The Bank of England and the US FDIC are intensifying their joint efforts to achieve this result. Also, the IIF published, in June 2012, a very interesting proposal for a new International Agreement.

In the same spirit of these international efforts, I think that in the EU we should explore the possibility to entrust a European authority with the power to ensure that these agreements are put in place and effectively enforced. Common resolution strategies, be they “Single Point of Entry”, i.e. focused on the holding company, or “Multiple Point of Entry”, i.e. centred on the individual entities, need to be agreed *ex ante* and jointly tested through resolvability assessments. The role for a European authority should possibly be coupled with European legislation setting out the conditions and safeguards under which cross-border groups, subject to their voluntary decision (opt-in option), could be run in an integrated way. This would restore full freedom of capital and liquidity movements within cross-border groups and ensure equal protection of depositors, other creditors and minority shareholders, across all the entities of the group.

In the current environment, in which market segmentation prevails, cross-border groups are under increasing pressure, undergoing what in fact could be described as a “soft break-up”. I believe it is our duty in the EU and at the global level, to strive to find institutional solutions, cooperation arrangements and practical mechanisms which provide sufficient reassurance to home and host authorities that cross-border groups could be smoothly resolved, without imposing organisational structures that unduly constrain the most efficient use of capital and liquidity.

4. Concluding remarks

The root of the word crisis is in the ancient Greek verb κρίνω, which means to separate, choose, judge. It indicates a turning point, for instance in a disease. I am convinced that the hesitations and the delays in dealing with the banking crisis in the European Union have their origin in the difficulty of acknowledging the pitfalls in the institutional framework, the specific complication coming from our imperfect set up. For a long time, each Member State has been looking at the problem through the lenses of national interest. The judgment was obfuscated and we didn’t manage to reach a true turning point.

The decision to tackle the institutional pitfalls and move to truly integrated European regulation, supervision and crisis resolution could be this turning point. But we still face many challenges in bringing forward the repair of the regulatory framework, of the banking sector and of the institutional set up. At this juncture, I believe the efforts should focus on three main objectives.

In the regulatory field, we should aim at a rigorous completion of the Basel 3 package, which would give certainty to the restructuring process under way in the banking sector, and to the harmonisation of the framework for bank recovery and resolution, which is badly needed to give certainty to investors and depositors. In both areas, we need to pursue uniform rules, a true Single Rulebook. National discretions in the rules on bail in, for instance, could crystallise the segmentation across national markets and unduly differentiate the banks' cost of funding, also opening room to the use of the regulatory lever to favour national champions – a mistake we wouldn't like to repeat.

As to the banking sector repair, the efforts need to concentrate on asset quality reviews, which dispel the remaining concerns on the permanence of pockets of vulnerabilities. The establishment of the Single Supervisory Mechanism will provide an opportunity for progress in this area.

Finally, the process of institutional repair needs to be completed, putting in place all the agreed elements of the Banking Union. In particular, in the next months, we will have to put our efforts to establish a Single Resolution Mechanism. From the EBA perspective, it will be essential that the centralisation of responsibilities for supervision and resolution in the Member States that will join the SSM is accompanied by mechanisms that ensure a continued functioning of the Single Market for the entire Union. In particular, we should reverse the recent trend to segmentation of banking activities along national lines. Only by setting in place mechanisms that reassure all involved authorities that a cross-border group can be resolved in a coordinated fashion will we manage to remove the incentives to ring fencing.

Thank you very much for your attention.