EBA European Banking Authority

European System of Financial Supervision

Developing a Single Rulebook in banking

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Ladies and Gentlemen,

My main topic today will be the Single Rulebook, the main path ahead of us to achieve the objectives of the new European institutional framework established with the endorsement of the recommendations of the de Larosière report. I will primarily focus on owns funds, as this is a key issue for re-establishing the regulatory framework on a sound footing and the EBA is currently running a public consultation on this. I will also briefly touch on another important component of the Single Rulebook: the liquidity requirements. However, before tackling these issues, I would like to give you an overview of the first year of existence of the EBA and especially of the work done to face the challenges posed by the current crisis.

1. The efforts of the EBA in tackling the financial crisis

In the first year of its life, the priorities of the EBA had to be focused on the challenges raised by the deterioration of the financial market environment. The stress test exercise we conducted in the first part of 2011 focused on credit and market risks but also, in recognition of the risks that subsequently crystallised, incorporated sensitivity to movements in funding costs. Banks were also required to assess the credit risk in their sovereign portfolios. In many respects, I believe the exercise was successful: in order to achieve the tougher capital threshold, anticipating many aspects of the new Basel standards, banks raised € 50 bn in fresh capital in the first four months of the year; we set up a comprehensive peer review exercise, which ensured consistency of the exercise across the Single Market, notwithstanding the many differences in national regulatory frameworks; the exercise included an unprecedented disclosure of data (more than 3200 data points for each bank), including amongst other things detailed information on sovereign holdings.

However, the progress of the stress test was tracked by a significant further deterioration in the external environment. The main objective of restoring confidence in the European banking sector was not achieved, as the sovereign debt crisis extended to more countries, thus reinforcing the pernicious linkage between sovereigns and banks. Most EU banks, especially in countries under stress, experienced significant funding challenges.

In this context, the IMF and the European Systemic Risk Board (ESRB) called for coordinated supervisory actions to strengthen the banks' capital positions. The EBA assessment was that without policy responses, the freeze in bank funding would have led to an abrupt deleveraging process, which would have hurt growth prospects and fuelled further concerns on the fiscal position of some sovereigns, in a negative feedback loop. We then called for coordinated action on both the funding and the capitalisation side. While advising the establishment of an EU-wide funding guarantee scheme, the EBA focused its own efforts on those areas where it had control, primarily bank capitalisation.

To this end, the Board of Supervisors, comprising the heads of all 27 national supervisory authorities, discussed and agreed that a further recapitalisation effort was required as part of a suite of coordinated EU policy measures. Our Recommendation identified a temporary buffer to address potential concerns over EU sovereign debt holdings and required banks to reach 9% CT1. The total shortfall identified was € 115 bn. The measure was agreed in October and enacted in December 2012. It was swiftly followed by the ECB's long term refinancing operations (LTROs), arguably the key "game changer" in this context. But the recapitalisation was a necessary complementary measure: while banks needed unlimited liquidity support, to avoid a credit crunch, they had to be asked to accelerate their action to repair balance sheets and strengthen capital positions.

These measures have bought time but should not bring complacency. The recapitalisation plan has seen banks make significant efforts to strengthen their capital position without disrupting lending into the real economy. The EBA's intensive monitoring of the process shows that 96% of the shortfall identified was met by direct capital actions. Moreover, there has been a strong spirit of cooperation between home and host supervisors in discussing and taking forward these plans through colleges of supervisors, which has acted as a meaningful counterweight to the trend for national concerns to come to the fore in the current environment. Going forward, heightened attention to addressing residual credit risk, making efforts to meet the new CRD IV requirements, setting in place plans to gradually restore access to private funding and exit the extraordinary support of the ECB will be key.

2. The Single Rulebook in banking

As the finalisation of the new legislative framework for capital and liquidity requirements was coming closer, the focus of the EBA work has been increasingly moving to our tasks in the rule-making process.

The key task that the reform proposed by the de Larosière report assigns to the EBA is the establishment of a Single Rulebook, ensuring a more robust and uniform regulatory framework in the Single Market and preventing a downward spiral of competitive relaxation of prudential rules. The EBA is asked to draft technical standards that, once endorsed by the Commission, will be adopted as EU Regulations. The standards will therefore be directly applicable to all financial institutions operating in the Single Market, without any need for national implementation or possibility for additional layers of local rules.

I see that at the moment, while the negotiations on the capital requirement directive and regulation (CRD4-CRR) are entering the final stages, there is a call for more national flexibility. It is often argued that minimum harmonisation is all that is needed, as the decision of a national authority to apply stricter requirements would only penalise financial institutions chartered in that jurisdiction. This argument neglects the fact that we have lived in a world of minimum harmonisation until now, and this has delivered an extremely diverse regulatory environment, prone to regulatory competition. It is a fact that the flexibility left by EU Directives has been a key ingredient in the run-up to the crisis. The Directives left significant flexibility to national authorities in the definition of key prudential elements (e.g., definition of capital, prudential filters for unrealised gains and losses), the determination of risk weights (e.g., for real estate exposures), the approaches to ensure that all the risks are captured by the requirements (e.g., effectiveness of risk transfers). All these elements of flexibility have been used by banks to put pressure on their supervisors, triggering a process that led to excessive leverage and fuelled credit and real estate bubbles. The heterogeneity of the regulatory environment also complicated significantly the effective supervision of cross-border groups, which were at the epicentre of the crisis: supervisors had serious difficulties both building up a firm-wide view of risks and acting in a timely and coordinated fashion. Furthermore, regulatory arbitrage drove business decision.

This problem has not been fixed yet. In its first year of activity, the EBA identified a number of differences in regulatory treatment that lead to very material discrepancies in key requirements. For instance, the EBA staff conducted a simple exercise on the data collected for the recapitalisation exercise. The capital requirement for the same bank were calculated using the less stringent and the most restrictive approaches in four areas where national rules present important differences – the calculation of the Basel I floors, the application of the prudential filters, the treatment (deduction from capital or inclusion in assets with a 1250% weight) of IRB shortfalls and of securitisations. As a result, the ratio was 300 bps lower when the stricter methodologies were applied, showing that differences can be very material and difficult to spot.

In integrated financial markets, these differences can have very disruptive effects. Once risks generated under the curtain of minimum harmonisation materialise, the impact is surely not contained within the jurisdictions that adopted less conservative approaches. Without using exactly the same definition of regulatory aggregates and the same methodologies for the calculation of key requirements, the problem will not be fixed.

At the same time, it is absolutely true that the new regulatory framework has to be shaped in such a way to leave a certain degree of national flexibility in the activation of macroprudential tools, as credit and economic cycles are not synchronised across the EU. Also, there could be structural features of financial sectors, or components thereof, which might require tweaking prudential requirements to prevent systemic risk. But the same source of systemic risk should be treated in a broadly consistent manner in different jurisdictions across the Single Market, to avoid an unlevel playing field and less stringent approaches that might subsequently generate spillovers in other countries.

The ideal long-term solution for avoiding conflicts between the flexibility needed for macroprudential supervision and the degree of regulatory harmonisation called for by the Single Rulebook is constructing a suite of macroprudential instruments along the blueprint of the countercyclical buffer. This provides a significant leeway for tightening standards while the European Systemic Risk Board (ESRB) is entrusted with the task of drafting guidance on the activation of the tool and of conducting ex post reviews. At the same time, reciprocity in the application of the tool allows for cross-border consistency and reduces the room for regulatory arbitrage. So, we may well have a single rule, adopted through an EU Regulation, while this rule provides for flexibility in its application, with a framework that the Basel Committee has labelled as "constrained discretion".

3. Giving life to the Single Rulebook: the new regulatory framework of bank capital and liquidity

In giving life to the Single Rulebook in banking, the EBA is facing a major challenge. The CRD4-CRR proposal envisages around 200 tasks, more than 100 technical standards - 40 of which will have to be finalised by the end of this year. We will have to ensure standards of high legal quality as they will be immediately binding in all 27 Member States when endorsed by the

European Commission. We will have to respect due process, with wide and open consultations and adequate impact assessments.

As to the substance of the new regulatory framework, I will focus today on the definition of capital and the quality of own funds, which I consider as one of the cornerstones of the Single Rulebook in banking.

3.1. Own funds

The definition of capital has been a major loophole in the run-up to the crisis. As financial innovation brought about increasingly complex hybrid instruments, national authorities have been played against each other by the industry, with the result that the standards for the quality of capital were continuously relaxed. As a consequence, once the crisis hit, a significant amount of capital instruments proved to be of inadequate quality to absorb losses. In several cases, taxpayers' money was injected while the holders of capital instruments continue to receive regular payments.

The Basel Committee has done an outstanding job in significantly strengthening the definition of capital and we must make sure that this is not lost in the implementation of the standards.

The EBA already achieved some progress in the use of stringent uniform standards when imposing the use of a common definition of capital for the purpose of the stress test and the recapitalisation exercise. This proves that collective enhancements can be reached when necessary. But what can be done in periods of stress must be perpetuated in normal times.

For this purpose, on 4 April, the EBA published a consultation on a first set of regulatory technical standards on own funds. These cover most areas of own funds, fleshing out the features of instruments of different quality (from CET1 to Tier 2 instruments). The consultation will provide appropriate input from interested parties and regular contacts with banks and market participants are already under way.

The standards elaborate on the characteristics of the instruments themselves, as well as on deductions to be operated from own funds. It is indeed crucial to ensure that there is a uniform approach regarding the deduction from own funds of certain items like losses for the current financial year, deferred tax assets that rely on future profitability, defined benefit pension fund assets. It is also necessary to ensure that, where exemptions from and alternatives to deductions are provided, sufficiently prudent requirements are applied. The standards cover also several areas affecting more directly cooperative banks and mutuals, whose particular features have to be taken into adequate account. At the same time, it is necessary to define appropriate limitations to the redemption of the capital instruments by these institutions. The standards will also contribute to increase the permanence of capital instruments more generally by strengthening the features of the latter and by specifying the need for supervisory consent when reducing own funds. Finally, the standards will also increase the loss absorbency features of eligible hybrid instruments, in line with the objective to bring investors closer to shareholders and share losses on a *pari passu* basis. In order to complete its current work on own funds, the EBA will soon publish a technical standard on disclosure by institutions.

The work of the EBA on own funds will not be concluded with the endorsement of the new technical standards. Indeed, although technical standards, like EU Regulations, should not leave room for interpretation, it cannot be excluded that some provisions will not work as they are meant to. This is the reason why a close review of the application of the standards is necessary to detect potential loopholes and propose changes when needed.

A framework should be developed, probably in the form of a Q&A platform, in order to address technical issues that may well emerge in the practical application of the standards.

Furthermore, an important task that has been attributed to the EBA is the publication of a list of instruments included in Common Equity Tier 1 (CET1) as well as the monitoring of the quality of capital instruments.

I believe the current text of the CRD4-CRR does not go far enough in ensuring a strong control on the instruments that will be included in the capital of higher quality. I understand the decision of the EU institutions to follow an approach that privileges substance over form: the definition of Common Equity Tier 1 will not be restricted to ordinary shares, as there is no harmonised EU-wide definition that could be relied upon. Instead, the legislation will require that only instruments that are in line with all the principles defined by the Basel Committee will qualify. In order for this to ensure a strict control on the quality of these instruments, strong mechanisms should be put in place to make sure that there is no room for watering down the requirements. The "substance" needs to be checked and has to be the same across the Single Market.

From my perspective, the list that the EBA will keep should be legally binding. There should be an in-depth scrutiny of the instruments conducted at the EU level by the EBA, in cooperation with national supervisors, to confirm the inclusion in the list. If an instrument is included in the list, it should be accepted throughout the Single Market. If it is not included in the list, no authority should have the possibility to consider it eligible as CET1. The present text limits the role of the EBA to the publication of an aggregated list only based on the assessment done at national level. This would not bring any added value compared to a situation where Member States would be required to publish by themselves a list of instruments recognised in their jurisdictions. On the contrary, this could be misleading, as it could convey the impression that the instruments have received an EU-wide recognition.

In any case, even if the legislative framework does not provide the EBA with the necessary legal tools, we are committed to fully exploiting the draft

Regulation's provisions that require the EBA to monitor the quality of own funds across the Single Market and to notify the Commission in case of evidence of material deterioration in the quality of those instruments. If we consider that some instruments that are not of sufficient quality have been accepted, we also have the possibility to open formal procedures for breach of European law. Having strong enforcement tools is essential: supervisors have lost control of the definition of capital once and we should not allow this to happen again. We are acutely aware that the new rules will trigger a new wave of financial innovation, aimed at limiting the restrictive impact of the reform. Indeed, this is already under way. We already hear that new ways are being devised to smooth the impact of permanent write-downs or to circumvent the prohibition of dividend stoppers for hybrid instruments.

Our monitoring of capital issuances is ongoing. The EBA recently decided to develop a set of benchmarks for hybrid instruments to give more clarity on what are the terms and conditions – in terms of permanence, flexibility of payments, loss absorbency – that make an instrument compliant with applicable rules. The work in this area will begin when the final legislation is in place and a sufficient number of new issuances are available, in order to have a meaningful sample of instruments to assess. In the future, hopefully, this work could move a step further, towards providing common templates, which could lead to the harmonisation of the main contractual provisions of hybrid capital instruments, in line with the objectives of a Single Rulebook. A concrete illustration of these common templates has already been given by the EBA when publishing a common term sheet for the convertible instruments accepted for the purpose of the recapitalisation exercise.

3.2. Liquidity

The new liquidity standards represent a second important area of work for the EBA.

The first deliverable is due at the end of 2012, when we will have to provide for uniform reporting formats. The framework is currently under development and is expected to be released for public consultation over the summer. However, we can already foresee that the reporting is likely to be fairly similar to that used by the Basel Committee for the quantitative impact study, which many European banks are already familiar with.

But the most important and delicate area of work is the definition of liquid assets and, more generally, the calibration of the new requirements.

We are aware that the banking industry has raised serious concerns on the two liquidity standards defined by the Basel Committee, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The Basel Committee itself is reviewing the calibration of the ratios, recognising that some underlying assumptions are excessively conservative, even if confronted with the toughest moments of the financial crisis.

The key principles underlying the LCR and the NSFR are sound and cannot be given up by regulators: banks need to have sufficient buffers of liquid assets to withstand a shock for some time without the need for public support; maturity transformation needs to be constrained to some extent, so as to prevent banks from adopting fragile business models relying excessively on volatile, short term wholesale funding to support longer term lending. But it is essential to get the calibration right, as funding is and will increasingly be the main driver of the deleveraging process at EU banks.

Time is needed to do a proper job: we have to ensure that data of adequate quality is available – hence the need for a uniform reporting provided at the end of 2012 – and to allow for in-depth analyses.

The first impact assessments on LCR and the NSFR are due in 2013 and 2015 respectively. The EU has taken the decision to use the monitoring period until 2015 for the LCR and 2018 for the NSFR, before proposing legislation for a final calibration of the liquidity ratios. This monitoring phase exactly mirrors the Basel Committee's timeline. It is in my view the right choice to allow for this extensive observation period. I would strongly argue that we should avoid making any policy choice before proper evidence on the potential impact of the two ratios.

Conclusions

Ladies and gentlemen,

Today I tried to convey to you a bird's eye picture on the difficult challenges the EBA is facing. In the first year of activity we have already done a huge effort to strengthen the capital position of EU banks and to restore confidence in their resilience. The work is not over in this area. The liquidity support provided by the ECB avoided an abrupt deleveraging process, but banks are still in the process of repairing and downsizing their balance sheets and of refocusing their core business. We, as supervisors, need to accompany this process and do our utmost to ensure that it occurs in an ordered fashion, without adverse consequences on the financing of the real economy.

One way to support the process is the introduction of the reforms on capital and liquidity standards endorsed by the G20. I strongly believe that we need to exploit this opportunity to move to a truly harmonised regulatory framework, a Single Rulebook that ensures that high quality standards are enforced throughout the Single Market.

We have to be particularly rigorous on the definition of capital, as this is the basis for most prudential requirements. We cannot afford anymore financial innovation that allows instruments to be accepted as capital, while not respecting the key principles of permanence, flexibility of payments and loss absorbency. The control on eligible capital instruments needs to be very strict and should be performed at the EU level. Ideally, the co-legislators should give the EBA the legal basis to perform this difficult task. But in any case we will conduct a close monitoring of capital issuances, as we consider our duty to ensure that only the instruments of the best quality are accepted as regulatory capital.

As to liquidity standards, I believe that while the principles embodied in the Basel text are absolutely shared, we need to do more work on the calibration of the requirements. We understand the concerns expressed by the industry, but it is important that we collect solid empirical evidence before taking any decision in this delicate area, which will provide a major driver for the needed changes in banks' business models.

Thank you for your attention.