The future of EU regulation

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1. Introduction

I would like to thank Angela Knight and the British Bankers Association for inviting me to speak at this conference to share with you some thoughts on the future of regulation in the European Union. Since I took up my new position in March, all public attention on the European Banking Authority has been focussed on the EU-wide stress test which is now in the final stages and should be published in July. I will not dwell on this subject as our focus today is regulation. However, I understand many of you have an interest to know about the state of play of our work in this area so let me very briefly provide you with an update.

As a result of the quality assurance and peer review process, which is conducted by a team of EBA staff, experts from national supervisory authorities, the ECB and the European Systemic Risk Board (ESRB), we have asked banks to review their results with a view to ensuring conservatism and consistency across the sample. In early June the EBA provided banks additional guidance in a number of areas to address inconsistencies and excessive optimism. The guidance covered a number of areas including funding costs, risk weighted assets and interest income in the trading book and exposures to sovereigns and financial institutions. On the latter point, we updated the haircuts to sovereign exposures in the trading book where market developments have overtaken the scenario and we clarified that although no haircut to banking book exposures is required all banks are expected to hold provisions against sovereign debt in line with current regulatory practices. Importantly, we set a floor to sovereign risk parameters based on publicly available information, such as external ratings. We understand that market analysts and investors would like to see possible sovereign defaults factored into the exercise, but as supervisors we cannot deviate from the policy options currently being considered by European institutions. We believe our approach is appropriate in the current circumstances and importantly is complemented by extensive and detailed disclosure of positions by country, accounting book and maturity, which we are aware will be used by market analysts to undertake their own analysis.

As you would expect an effective quality assurance process takes time. We are still receiving the resubmissions of the results by the banks and in the coming days we will be looking at the quality of the data. At that point we will be in a position to estimate when we can realistically publish the results. I have seen a number of speculations on the outcome of the exercise and I would like to stress that they are completely unfounded, as the results have not yet been put together and, especially, they have not gone through the final round of quality assurance and peer review process.

As I said this strand of work is just one task of the EBA and it is refreshing to think about life after the stress test and consider the important challenges that the EBA has to meet in the areas of rule-making, supervisory practices, crisis management and resolution, and consumers issues.

I would like to focus my remarks today on two key areas:

The first one concerns the ***consistency in the implementation of global reforms and of the single rulebook in the European Union***. I am convinced that we need to target the maximum possible level of consistency at the global level, with effective peer review processes to ensure that the commonly agreed standards are effectively applied in all jurisdictions. In the European Union, we have to go much further than that, ensuring that exactly the same rules apply to banks across the Single Market in a number of key areas.

The second area relates to ***the effectiveness and fairness of the new regulatory framework***. While I do not share the industry's concerns that the reform package is too tough, I believe that the tightening of bank regulation needs to proceed hand in hand with decisive action in three areas: (i) restoring a level playing field with players performing *de facto* banking functions outside the regulatory umbrella -the so-called shadow banking sector: (ii) ensuring stronger prudential supervision, with proper benchmarks for convergence to best practices; and (iii) making the orderly exit from the market a viable option for crisis management and resolution, also for large and complex cross-border groups.

2. *The single rulebook*

Let me start from the single rulebook, one of the main objectives assigned to the newly established European Supervisory Authorities (ESAs) following the recommendations of the de Larosière report. It is a simple idea and a real game changer.

Until now the bulk of financial services regulation has been harmonised through EU Directives, which required to be transposed into national rulebooks. As a result, the latter were all that mattered for EU banks, and cross-border groups had to comply with a collation of national rulebooks, which in several cases remained very diverse, notwithstanding the common origin. The Committee of European Banking Supervisors (CEBS) developed a web-based tool to access, in a single portal, all the national provisions implementing the Capital Requirements Directive. Anyone who has spent some time on this website has surely realised how different the national rulebooks developed under the very same Directive provisions are.

This diversity had several detrimental effects. Most importantly, it left the door open to regulatory competition. The regulatory lever has been used to attract business in national marketplaces or to support the competitive position of national champions, thus lowering the defences for financial stability in the Single Market as a whole. The clearest example is the definition of capital. Once a hybrid capital instrument was accepted as high quality regulatory capital in one jurisdiction, the pressure on other supervisors to follow the same course of action was difficult to resist. Although some supervisors managed to stick to stricter approaches, in general the quality of capital at EU banks deteriorated significantly as a result of this regulatory competition, a weakness that had major consequences when the losses materialised during the crisis.

The lack of a single rulebook has also made it very difficult to organise the supervision of cross-border groups in a truly coordinated fashion. When the requirements differ through countries the primary task for supervisors is to ensure compliance with the national rulebook, and coordination at the group-wide level comes as a second order objective. The CRD, especially with the amendments introduced lately in the so called CRD 2, has introduced legal obligations to establish colleges and coordinate the assessment of risks, but this task is not made easy if the national rulebooks remain so heterogeneous.

There is also an issue of efficiency: having exactly the same requirement implemented in a different way at the national level fragments the compliance process for cross-border groups into separate bits and pieces, thus increasing administrative costs without any obvious benefit in terms of safety and soundness. The most common example is supervisory reporting: the forms that banks have to compile to report their position with respect to the capital requirements has for long been different across countries. Also the remittance dates and the IT platform for sending the information to the supervisors differ across countries. This is perceived as a dead-weight cost, hampering the integration of financial markets in the EU.

Finally, there is an issue of accountability: the complexity of the implementation process – often broken down into national legislation and administrative rules issued by competent supervisory authorities – made it extremely difficult to understand what part of the rules came from the EU level and what was added or changed at the national level. This blurred responsibilities and did not help enforcing a due process in the public consultation and in the impact assessments.

The idea of the single rulebook is quite straightforward: key technical regulations should be adopted by means of standards defined at the EU level and adopted through EU regulations, so that they are directly applicable to all financial institutions operating in the Single Market, without any need for national implementation or possibility for additional national rules. The proposal was first launched by Tommaso Padoa-Schioppa in the early 2000s. In his vision, the rulebook any EU bank has to comply with should be composed of two sections: the first, European, exactly the same for all EU banks, coming from a technical authority that could easily adapt the rules to rapidly changing market conditions; the second, national, reflecting some specificities of local markets, especially in the interface with other components of the legal framework (e.g., insolvency laws) and the role of small, local institutions.

This is the framework that has been introduced with the regulations establishing the EBA and the other European authorities (the European Securities Markets Authority – ESMA, and the European Insurance and Occupational Pension Authority – EIOPA). We will have the task of drafting regulatory or implementing technical standards that, once endorsed by the Commission, will become legally binding across the EU.

Existing legislation has already identified a number of areas where the EBA will have to issue technical standards. But the implementation of Basel 3 in the EU will provide a true opportunity for giving real content and operational life to the single rulebook. My understanding is that the legislative proposal that the Commission will put forward will contain provisions calling on the EBA to draft technical standard in more than forty areas. We will have to deliver in line with these requests, but in my view the acid test on the functioning of the new institutional framework will be in the following areas:

- We will have to ensure that all Member States have exactly the same rules on the *definition of capital* and maintain them up to date in a coordinated fashion in light of financial innovation.
- We will have to develop the technical standards for *liquidity requirements* and follow them during the observation period envisaged by Basel 3.
- We have to adopt a truly uniform *reporting framework*, simplifying reporting requirements for cross-border banks and allowing the pooling of high quality data for the performance of risk assessments by the EBA and the European Systemic Risk Board (ESRB).
- Finally, we need to ensure that the same rules apply in the area of *compensation practices*, to avoid the possibility of lax or weaker standards being adopted in a competitive fashion, to attract the best human resources from other jurisdictions.

While developing technical work in these areas, we need to ensure that our standards are of an appropriate quality and are endorsed following the due process, with an extensive involvement of all stakeholders, effective public consultations and impact assessments. The Banking Stakeholder Group that we have just established is expected to provide assistance in this difficult task. We will also establish technical tables for dialogue with market participants and other interested stakeholders, surely in the area of capital and liquidity standards.

After having praised the benefits of uniform rules let me also stress that there are good reasons for leaving some room for flexibility at the national level. Macro-prudential supervision - the other pillar of the new institutional framework for financial stability in the EU - may require that certain prudential requirements are adjusted having regards to the stability of the system as a whole. It is however essential that this flexibility does not undermine the achievement of the single rulebook. Macro-prudential tools should, therefore, be operated within a framework of constrained discretion, under *ex ante* guidance and *ex post* review by the ESRB. This is the framework that is being proposed for the countercyclical buffer and should be extended also to other macro-prudential instruments. In order to accommodate for the need to experiment new macro-prudential tools it is also possible that the legislation attributes to the ESRB, also with the support of the EBA, a general task to oversee and coordinate the policies of national authorities, so as to ensure that the level playing field is maintained.

3. *The need for global consistency*

Of course consistency in regulation is a global issue that goes well beyond the EU. The fact that the crisis eventually impacted national budgets has given some arguments in support of the idea that a good deal of flexibility should be left in shaping regulations, so as to reflect the different preferences of national taxpayers and policy makers. But this neglects a major lesson from the crisis, i.e. that in open financial markets, contagion spreads across borders and laxer regulatory and supervisory standards in one country are bound to affect the stability of financial institutions in more rigorous and conservative jurisdictions.

Now it is quite common that international standards, and in particular the Basel 2 agreement, are blamed for the crisis, although the requirements were not actually implemented in core jurisdictions. On the contrary, the problem should be traced back to the *lack of international standards in key areas*, such as liquidity risk requirements, or the *inability to ensure a common implementation of the existing standards in front of financial innovation*, as in the definition of regulatory capital.

These arguments point quite forcefully to the need for a strict implementation of the Basel 3 package and of the other components of the reform at the global level, accompanied by a thorough monitoring and peer review process conducted by the Basel Committee and the FSB.

There are of course arguments for some degree of flexibility, but these are well identified and need to remain extremely limited. In the EU, Basel 3 will be applied to all the banks and investment firms, differently to other non EU jurisdictions, where the tougher requirements will be binding only for international banks. The wider application to smaller savings and cooperative banks will require some minor adjustments, in most cases already recognised in the Basel 3 text, as will the coordination of the new provisions with existing and forthcoming legislation in connected areas, such as financial conglomerates. In no case these adjustments should be alleviating the overall stringency of the reform.

Industry representatives are already raising concerns of a softer implementation of key regulatory requirements in other jurisdictions to lobby national policy makers to loosen the requirements. I believe regulators should listen to all comments and criticisms, especially in those areas where the new requirements may have unintended consequences. But eventually they should stand as a single body behind the international agreements and avoid any uncoordinated responses.

Not surprisingly, the banking industry is also raising concerns with reference to the overall impact of the new requirements, which following the announcement of the Group of Governors and Heads of Supervision (GHOS) will soon be completed with the measures for additional loss absorbency at systemically important banks (SIBs). I do not want to enter into the analysis of the differences between the regulators' and industry's estimates of the impact of the new requirements on growth and employment - although I cannot refrain from arguing that the industry's assessments do not seem to give enough weight to the argument that higher capital and liquidity buffers will have a positive effects on the cost of equity and more generally on the cost of funding. But there is a more fundamental point. Banks, investors, market analysts seem to converge in setting medium term profitability targets for banks still at very high levels, not far from those prevailing before the crisis – with the ROE in the high teens. If these levels of profits are considered as an exogenous variable, it is no surprise that the new requirements are not considered sustainable. But at the system-wide level, high profitability targets could be achieved only through excessive risk taking. The new regulatory requirements endorsed at the highest level by the G20 Leaders pursue a clear objective of bringing the profitability of the banking sector to levels compatible with systemic stability. This policy decision does not seem to be completely factored into market assessments. Strong consistency in the implementation of the reform package is therefore necessary also to enforce this policy decision and to make sure that the outcome is fair and has a neutral effect on competition in banking markets.

4. *Effectiveness and fairness of the new regulatory framework*

This brings me to the second main issue I would like to address: is the new regulatory framework effective in remedying the loopholes that led to the crisis? And is overall fairness achieved in the effort of strengthening regulatory requirements?

There have been arguments brought forward supporting the idea that the calibration of the new capital requirements could be too mild and a further tightening might be warranted in the medium to long term. The study published by the Bank of England and the speech of Lord Turner at the Cass University point in this direction. On the other hand, there have been equally authoritative analyses, for instance by Jacques de Larosière, arguing that some requirements – especially those on liquidity – could be excessively severe and damage business models that have fared well during the crisis.

I believe that decisions have been taken and it is now time to implement them. The phasing in period will be long enough to allow some adjustments if the evidence shows that they are warranted. Liquidity requirements will be subject to an observation period, which will allow checking for possible unintended consequences.

While the debate is still very much focused on the prudential rules for banks, I am convinced that the effectiveness and fairness of the reform crucially depend on the ability to take coordinated action in three areas.

4.1 Dealing with the shadow banking sector

The so-called shadow banking sector remains an area of concern and should rank high on the regulatory agenda. For a long time systemic risk has been associated with the peculiar risk and liquidity transformation function traditionally performed by credit institutions and with bank's interconnections stemming out of the interbank market and payments systems. The crisis of Long Term Capital Management (LTCM) rang a first alarm bell, showing that systemic events may well be triggered in securities and derivatives markets. The reaction of regulators has been focused on enhancing transparency and relying on the indirect monitoring performed by banks and other regulated entities lending to highly leveraged institutions. But the recent crisis has shown that this is indeed not sufficient. Systemic risk can build up also in other financial institutions or through chains of transactions involving an array of different institutions, now able to replicate exactly the liquidity creation function traditionally performed by banks. And the indirect monitoring performed by banks does not provide sufficient safeguards – to use an understatement.

To me shadow banking is an oxymoron: everything that is "banking" cannot be in the shadow, at least for the eyes of supervisors. I see only two possible ways forward. Either we manage to bring under the regulatory umbrella all the activities with a potential to generate systemic risk, which is in line with the recommendations issued by the G20 already in April 2009. Or we commit to enforce a strict licensing regime, which allows only banks and other strictly regulated institutions to engage in risk and liquidity transformation activities that generate systemic risk. Both solutions would be incredibly challenging. Even gathering meaningful empirical evidence to support informed policy decisions will be difficult, let alone enforcing and policing stricter requirements.

However difficult, an attempt has to be made and the work under way under the aegis of the FSB is to be praised. The tightening of capital and liquidity requirements of banks could provide incentives for shifting risks and maturity transformation outside the regulated sector and prove less effective in constraining risk taking in the financial system as a whole. Furthermore, there would also be an issue of fairness, as traditional, brick and mortar banks would have to adjust significantly their behaviour, while other players outside the regulatory umbrella would remain unconstrained in their business decisions – and the commitment not to extend the safety net to them in case of troubles might lack credibility, in light of the experience of the crisis.

4.2 Converging to best supervisory practices

The second area where action is warranted is convergence in supervisory practices. The international and European debate so far focused almost exclusively on regulatory repair and less attention has been devoted to the effectiveness in supervision.

By tightening the rules incentives are generated for market participants to engineer new products and business practices that minimise the impact of the new requirements. Merton and Bodie noted already in the early 1990s that the lag with which regulators were able to respond to new products and business practices – especially those aimed at circumventing the rules – was widening more and more, thanks to the increasing speed of technological and financial innovation. This is even more true now and will be a major challenge in the years to come.

Appropriate supervisory monitoring tools will have to be devised, so as to (i) review the developments in market practices and business models in response to the reform; and (ii) "decompose" financial innovation and ensure that the same risks have the same regulatory treatment, although they are embodied in new products and business practices. This requires strict coordination between supervisors. For instance, at the EBA we are considering how to best monitor new capital instruments and make sure that they receive a consistent treatment across the EU, thus avoiding that regulatory competition is triggered again.

More generally, we do have to reflect on ways to strengthen day-to-day supervision in a coordinated fashion. For more than a decade we have been engaged in endless discussions of institutional architecture – whether sectoral supervision should have been substituted with integrated supervision for all financial sectors, whether prudential and conduct of business supervisions should be unified or attributed to separate authorities, whether supervisory responsibilities should be allocated to central banks or to separate agencies, etc. I do not want to play down the relevance of these debates on institutional design. But we have to acknowledge that there must be other, more practical dimensions that matter, as for each institutional setting we can find successful examples and ineffective ones.

In central banking the exit from the period of high inflation of the 1970s and early 1980s saw the emergence of a consensus view on monetary policy, and these blueprints were then incorporated in the operating framework of the ECB and the Eurosystem. The financial crisis has not yet brought about a consensus view on the key ingredients of good supervision. The debate has started: the FSB has developed useful recommendations for effective and intensive supervision of systemically important banks: the IMF published a paper reflecting the experience gained in Financial Sector Assessment Programmes (FSAPs) on the respect of the Basel Committee's core principles of effective supervision; in the UK the Bank of England and the FSA issued a paper fleshing out the approach to banking supervision. I believe there is general agreement that supervision needs to be more effective and intrusive, but not on the best operational framework for achieving this result. We have to move from high-level recommendations to more focused conclusions on the basic tools and practices for supervisors.

In the last two decades we moved away from an administrative, rules-based approach to supervision, centred on checking compliance with a set of quite simple, one-size-fits-all rules. In front of financial innovation and regulatory circumvention, a more process-oriented approach to supervision has emerged, which focuses and relies on the internal measurement and management of risks within the firms. This delegation of responsibilities to the regulated entities has occurred with a very variable degree of supervisory scrutiny. Several reports have recently highlighted the significant dispersion in the ratio of risk-weighted assets to balance sheet totals across banks, also ones with broadly similar portfolios. Some degree of dispersion in results is acceptable and even desirable, as risk measures need to capture idiosyncratic features of the different business models. But the differences should remain within a certain range and the supervisory review should ensure consistency across banks.

In my view we should resume work on Pillar 2, the supervisory review process. We should aim at much more ambitious targets in terms of convergence in the assessment of risks and in shaping the reaction function of supervisors in front of those risks. Robust methodologies need to be agreed for the supervisory review and evaluation process (SREP) and peer review mechanisms should be designed to make sure that these methodologies are applied consistently across countries. An in-depth technical debate needs to be opened and it is my intention to do so at the EBA.

This point is crucial for ensuring the effectiveness and fairness of the reform in the EU: we will have a single rulebook, implementing most of the Basel 3 requirements, but if the supervisory approaches to apply and enforce these rules remain widely different the supervisory outcomes are bound to diverge. Besides a clear level playing field issues, there is also an issue of effectiveness: even extremely tough rules may turn out to be ineffective if they are not accompanied by strict supervision.

4.3 Coordinating crisis management and resolution on a cross-border basis

Finally, let me quickly turn to crisis management and resolution. The debate is mostly focused on the tools that should be available to responsible authorities, including the possibility for "bail in" and the ways for ensuring creditors' contribution to restoring the viability of a bank. These are most important issues. More attention should be devoted to the issue of the interoperability of these tools on a cross-border basis and on the coordination between home and host authorities. The lack of credible and effective mechanisms for coordinating crisis management and resolution for cross-border groups would leave competent authorities only with corner solutions: either ring-fencing, accepting that in a crisis a banking group turns out to be a collection of individual entities, which may selectively fail; or bail out by one authority, probably from the home country. Potentially, more efficient, intermediate solutions would be ruled out. In all likelihood, the solution of the crisis would leave some conflicts open between home and host authorities.

The proposals put forward by the Commission in January contain several interesting and ambitious suggestions for moving to more coordinated crisis management and resolution in the EU. They should be further sharpened, resisting the Westphalian temptation of total independence in all matters that might eventually affect budgetary responsibilities of Member States. Coordination could make all parties better off. And more uniform rules, applied consistently across the board, would require that coordinated actions are taken when banks are not anymore in a position to stay in the market.

5. Conclusive remarks

Finally, I would like to close my remarks by stressing that we are in a moment of real change in EU regulation. The EBA has been attributed relevant powers in rule making, as well as in acting in case of breaches of Community legislation. Banking rules are to be substantially overhauled as a result of the reform endorsed by the G20. This will provide an exceptional opportunity for giving life to the idea of the single rulebook and produce a much more integrated regulatory framework in the Single Market. The immediate focus of the EBA in the coming months and years will be on this objective.

At the same time, we should not lose sight of other relevant issues, which in the medium to long term may have a crucial importance in ensuring that the reform package achieves its goals, delivering an effective and fair regulatory environment. A more unified framework on the scope of regulation, the depth of supervision and the coordination of cross border crisis management has to be built through time, at the EU-wide level, but also globally.

The EBA is a very young organisation and is facing an enormous pressure to deliver, in a wide number of areas. The first years will be very challenging, also due to resources constraints. But we are committed to bring about the change that is expected of us.