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The new role of the European Banking Authority in the Banking Union

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Introduction

When I read the title proposed by the organisers of this Conference for my speech today, I seriously considered proposing a change. Why a *"new"* role for the European Banking Authority (EBA)? Indeed, the package establishing the Single Supervisory Mechanism (SSM), the first building block of the Banking Union, includes changes to the founding regulation of the EBA, but does not fundamentally change its role. However, on second thought, I came to the conclusion that the title was right: the tasks of the EBA remain fundamentally the same, but the Banking Union represents a major shift in the institutional set up, which is triggering an important adjustment, and possibly a new role, for the EBA.

First, while the tasks remain fundamentally unchanged, the Banking Union introduces a new sense of urgency in the performance of our tasks and calls for a higher degree of ambition in a number of areas. *In primis*, this is the case for the delivery of the Single Rulebook, a truly uniform and integrated set of rules for banks in the whole Single Market. If national discretions were to remain, they would complicate enormously the task of the SSM, which would then be required to enforce different rules for the banks falling under its responsibility. But the point applies also to our efforts in the area of harmonisation of key prudential definitions and enhanced disclosure of comparable data, as an effectively integrated market can function well only on the basis of reliable information.

Second, the EBA has to take up a new role in safeguarding the integrity of the Single Market. The crisis, in particular the adverse loop between banks and their sovereigns which has hampered the

functioning of bank funding markets and led to a fragmentation of bank lending along national lines, have seriously damaged the Single Market. To a large extent, the origin of the disease has to be traced in a fault in the design of the Economic and Monetary Union, which the Banking Union is expected to repair. Single supervision and an integrated safety net will go a long way in addressing the banking problems experienced during the sovereign debt crisis. But at least for some time, the SSM and the proposed Single Resolution Mechanism (SRM) will not encompass the whole European Union. Addressing the current segmentation of the Single Market will require a more focused effort to restore seamless operating capacity for banks throughout the Single Market. In order to get an idea of the relevance of this task, let me remind you that out of the 43 large EU cross-border banking groups that are subject to the monitoring of the EBA, only 5 have business exclusively within the euro area. More than two thirds of the banking groups headquartered in the euro area have significant market shares in other Member States, and the same proportion of European groups headquartered in those Member States have significant business within the euro area. This means that the EBA will have to play a new role in ensuring that the SSM and the other competent supervisory authorities in the EU develop common supervisory methodologies and practices, which can support stricter cooperation in colleges of supervisors and the capacity to effectively anticipate and deal with the crisis of a cross-border group. Of course, the Single Rulebook is a key ingredient also in the repair of the Single Market, as the lack of room for regulatory arbitrage and competition is a necessary condition to restore trust and cooperation amongst supervisors.

Let me try to give you more details on the main areas in which the EBA will have to focus its efforts going forward.

The Single Rulebook

The Single Rulebook is a very simple idea at the core of the reform advocated by the de Larosière report, which led to the establishment of the EBA. In a nutshell, it envisages key technical rules to be adopted through EU Regulations, which are directly applicable in all 28 Member States and leave no room to national choices. The EBA is playing a key role in designing technical standards.

The establishment of the SSM requires further progress in building the Single Rulebook under two complementary points of view.

On the one hand, a single set of rules is clearly an indispensable complement to a single authority. But according to the SSM regulation, national law will remain relevant for those matters governed by EU Directives or where the ECB has no relevant powers and instructs national authorities to act in accordance with national law. Hence, the wider the span of application of the Single Rulebook, the less heterogeneous will be the rules that the ECB applies to banks in different Member States. And it would be very difficult to justify, and unprecedented too, that a supervisory authority applies different rules to two otherwise identical banks under its jurisdiction, just because they happen to have their headquarters located in a different area.

On the other hand, the Single Rulebook is also the necessary lens to provide a common view on banks operating in all Member States, irrespective of whether they participate in the SSM or not – i.e. to re-establish the integrity of the Single Market. The Banking Union is a major step forward in the integration of banking markets, but we must also be alert to the risk of a split, two-tier regulatory regime within the Single Market.

We are getting closer to the objective of a Single Rulebook. For the first time a large part of the prudential standards for banks is adopted through a Regulation (the Capital Requirement Regulation, CRR) and the EBA is entrusted with drafting a large number of technical standards: 35 Technical Standards will be completed in 2013, 67 in 2014. A significant number of Technical Standards is envisaged also in the draft Recovery and Resolution Directive and in other pieces of European legislation in the pipeline.

The EBA also plans to give physical visibility to the Single Rulebook, with a web-based solution that through hyperlinks will make accessible in one single point the primary legislation, all the related Technical Standards and Guidelines issued by the EBA, and all the questions and answers addressing practical application issues on the same subject.

The progress in undeniable, but we cannot declare ourselves satisfied. The CRD4 and even the CRR still leave room for national discretion – according to a consultancy firm, more than 140 provisions include elements of flexibility for national authorities. Of course, not all these discretions have a relevant impact; many are probably needed to reflect the diverse nature of the banking sector in the EU, which include firms of different size, legal form and business model. However, there are areas in which the lack of fully harmonised rules might have an adverse impact on the functioning of the Single Market; and areas where some discretion granted to competent authorities would need to be constrained within a well-structured European framework in order to avoid distortions and possible barriers to cross-border business.

The first example that I would like to mention is the definition of regulatory capital. In general, I believe it is of paramount importance that key prudential definitions are exactly the same throughout the EU. Otherwise, we would lose any possibility of ensuring data comparability, ensuring a level playing field and building a reliable EU-wide view of the banking sector. This is particularly important for regulatory capital, which is the yardstick used in most prudential requirements. The legislation sets principles, which need to be assessed by competent authorities. We have to make sure that these principles are strictly adhered to and that no opportunity is left for national authorities to accept weaker capital instruments, so as to provide a competitive advantage to their national champions. The CRR attributes to the EBA an important role and we are equipping ourselves to exercise a rigorous control on the definition of capital, also in light of financial innovation. The relevance of what seem tiny technical details is often overlooked, whereas it is important that they are aligned across European banks. We have also raised the issue of the methodology for calculating the so-called “Basel 1 floors”, which limit the possibility of capital ratios calculated with internal models to fall below a certain proportion of the Basel 1 requirements. In the course of our recapitalisation exercise, we noticed two different approaches used by national authorities. Of course, the different methodologies have no rational justifications: they just reflect different interpretations of the legislation and of the Basel standards. But they have a major impact, which is not easily noticed by market participants: we calculated the capital requirements on our sample of banks with the two methodologies, and the difference was a staggering amount: EUR 45 bn.

A second example could be taken from the draft Recovery and Resolution Directive (RRD) and the proposed Single Resolution Mechanism (SRM), for which a Single Rulebook is also indispensable. In particular, I am concerned by the requests for national flexibility in the implementation of bail-in tools, which will determine the distribution of losses to the various categories of creditors in a failing bank. If not constrained within a European framework of cooperation and coordination among home and host

authorities, such discretion carries the risk of choices made on a case by case basis. It could also embody a home bias – they could for instance lead to a preference for bail-outs when the losses would be borne mainly by domestic players, and a strict application of bail-in when most creditors in a certain category are resident in foreign jurisdictions. Moreover, the discretion could provide national authorities with tools that can significantly affect the cost of funding, and therefore the competitive position, of national champions. Finally, the possibility of using national exemptions can affect cooperation between the home and the host authorities. Similar considerations apply for the minimum requirement of bail in-able liabilities (MREL), which is crucial to make resolution work. National authorities are supposed to decide on the individual minimum requirement based on the bank's business model in accordance to a number of very general criteria. The Council General Approach correctly provides for a joint decision process, but it does not accompany this with guidelines or harmonised standards to ensure convergence of the requirement, and support mediation in case of disagreement.

I realise that having a big bang to a Single Rulebook could be very challenging and rather unrealistic, having in mind the complex institutional set-up of the EU. But we need to gradually develop mechanisms that identify the areas where the differences in rules are hampering the functioning of the Single Market and escalate the issue to the attention of the law makers. I believe the EBA could usefully play this role in banking legislation, through a wider recourse to our advisory role. We have already sent to the European Commission, Council and Parliament some Opinions, for instance on the definition of capital. A formal recognition of this role of "guardian of the Single Rulebook" would be helpful. The forthcoming review of the European System of Financial Supervision could provide an opportunity to consider strengthening our advisory role.

I would like to stress that the Single Rulebook also has a central role in underpinning market discipline in the EU. Anybody who works with data of European banks has experienced frustration from the lack of truly comparable, consistent data. Since its establishment, the EBA has put a lot of emphasis in enhancing the quality and comparability of bank disclosures. The first step was accomplished with our 2011 stress test, where we published around 3,400 data points for each bank participating in the exercise.

But the real game changer is the Technical Standard on supervisory reporting the EBA Board approved in July. The application of this standard will deliver maximum harmonisation of a very large part of the European regulatory reporting, including own funds and capital requirements, large exposures, liquidity and leverage ratios, financial reporting. Comparable data using harmonised definition is essential for conducting EU-wide analyses, identifying potential concentration risks, building up of exposures and interconnections between financial institutions. The EBA standard will deliver a truly comprehensive set of supervisory data, which will enable us to compare all EU institutions, within and outside the euro area.

We also noticed a lack of comparable information on banks' asset quality and level of asset encumbrance too, which has contributed to increased concerns about the banks' resilience and availability of collateral. The EBA will shortly finalise a harmonised definition of non-performing and forborne loans, as well as of asset encumbrance, and these definitions will be used in regulatory reporting and will allow for meaningful comparisons across European banks.

The harmonisation of reporting is not only a tool for supervisors. Eventually, when the new system for regulatory reporting will be in place, it will make sense to develop guidelines ensuring that a minimum

set of key information, prepared according to common definitions, are regularly disclosed to market participants, so as to put them in a better position to understand the risk calculations performed by banks and the differences in results. Ideally, the information should be made available on a common platform, as it already happens in the US. This progress should be accompanied by greater harmonisation of Pillar 3 disclosures, as recommended also by the Enhanced Disclosure Task Force (EDTF) established under the aegis of the Financial Stability Board (FSB).

Again, this work of the EBA could be seen as pursuing two, interrelated objectives: on the one hand, it is already contributing to the establishment of the SSM, which will be able to start fulfilling its tasks on the basis of a fully harmonised reporting framework; on the other hand, it will support a better functioning of the Single Market in the whole EU.

Supervision and resolution of cross-border groups

The segmentation of the Single Market that has accompanied the latest phase of the crisis has been driven primarily by a drastic fall in cross-border banking exposures to other financial institutions. This is due to a large extent to a malfunctioning of the interbank markets during the crisis. But I am convinced that also the increasing compartmentalisation of the activities of cross-border groups in each Member State also played an important role. Both banks and competent authorities have pursued an increasing matching of assets and liabilities in each country, thus leading to a serious impairment in the functioning of the Single Market as a mechanism to channel savings from surplus countries to deficit countries.

Besides the Single Rulebook, additional policy tools need to be activated in order to re-create an environment that supports the smooth conduct of cross-border business. The relevance of cross-border establishments between the euro area and the rest of the Single Market signals that effective oversight through colleges of supervisors becomes more, not less, important with the start of the SSM.

The EBA has already taken important actions, conducting investigations into potential breaches of European law, performing in a number of cases non-binding mediation, formally or informally, often with positive results. However, there are limits to what the EBA could achieve if supervisory methodologies and practices remain very diverse. Joint decision processes and binding mediation could effectively deliver genuinely integrated outcomes only if competent authorities agree on and perform their tasks within a commonly agreed framework.

I would like to provide three examples of the work that the EBA is conducting to strengthen supervisory convergence: (i) the Single Supervisory Handbook, (ii) the thematic work and benchmarking of supervisory approaches and (iii) approaches for recovery and resolution. All this work will support the efforts of the ECB in its move to a single supervisory role within the SSM, and the EBA work will also function as an effective interface between the ECB and other competent supervisory authorities.

The revised founding regulation of the EBA introduces a new mandate to develop a Single Supervisory Handbook, which “shall set out supervisory best practice in methodologies and processes” (amended Article 29). A recital of the revised EBA Regulation clarifies the purpose of the Handbook, clarifying that it “…should set out metrics and methodologies for risk assessment, identification of early warnings and criteria for supervisory action;… the use of the Handbook should be considered as a significant element in the assessment of the convergence of supervisory practices

and for the peer review referred to in the EBA Regulation". The EBA already started working on a first pilot chapter of the Handbook, focused on Business Model Analysis (BMA). The objective is to describe the processes supervisors should adopt in this field, the methodology they are expected to apply, including any appropriate quantitative metrics, the framework for the exercise of supervisory judgements, and the potential supervisory response to issues highlighted by the BMA, including what supervisory actions could be applied and when.

The thematic work and benchmarking of supervisory approaches is currently focusing on the (lack of) consistency of Risk Weighted Assets (RWAs) calculated by EU banks on the basis of their own internal models. Its objective is to identify material differences in RWAs outcomes, to understand the sources of such differences and formulate policy solutions to enhance convergence between banks' calculation methods and to improve disclosure. This work is essential to restore the credibility and comparability of key regulatory benchmarks, such as risk-weighted capital requirements, which have been put into serious question during the crisis. Moreover, greater disclosure, higher convergence in supervisory approaches and regular benchmarking of bank practices could also overcome the simplistic and misleading interpretations prevailing in the current debate, according to which the dispersion would simply reflect a split between virtuous and lax countries.

The last strand of work I would like to mention is aimed at delivering greater convergence in supervisory practices on bank recovery and resolution. Credible recovery and resolution plans, commonly agreed by home and host authorities are an essential pre-condition to overcome the tendency towards a renationalisation of banking business. If authorities are convinced that in case of crisis there would again be recourse to un-coordinated national responses, the rational policy would be to take pre-emptive action in good times and ring fence the local establishments. On the contrary, if there is a reliable commitment to cooperative solutions, greater degrees of freedom could be granted in developing cross-border business and reshuffling capital and liquidity within cross-border groups, in accordance to agreed criteria.

The EBA has already issued a Recommendation on the preparation and assessment of group recovery plans and launched three public consultations on draft technical standards on the content, scenarios and assessment of recovery plans. On such basis, we will soon be in a position to launch benchmarking exercises on recovery plans.

In order to build full trust between home and host authorities, comprehensive discussions and joint decisions on resolution plans and strategies are needed. Here I would like to flag a disappointing feature of the draft Recovery and Resolution Directive, as it does not make it mandatory to reach a joint decision on the resolution plans for cross-border groups: resolution authorities can decide to follow a non-coordinated approach. Against the background of the Single Resolution Mechanism, this shortcoming becomes even more serious, as it might lead to a unified approach within the SSM, but a completely lack of coordination between the SSM and the other jurisdictions in the Single Market.

Recovery and Resolution Plans will in any case remain "incomplete contracts", to be adapted to the specific features of a banking crisis. Hence, mediation is not only indispensable in the phase of planning and prevention, but also when resolution occurs, to facilitate agreements on the best course of action between home and host authorities.

In the field of supervisory tasks, another important interface area between the EBA and the SSM will be the assessment of risks and, in particular, through stress tests on the EU banking system. The

forthcoming asset quality review and stress test will provide an important pilot exercise for the new institutional arrangements. The EBA and the ECB are working in close cooperation, to make sure that these exercises are fully coordinated, deliver a single set of results, for the SSM and for other Member States, and are communicated jointly. The allocation of responsibilities is clear: the ECB is a competent supervisory authority and has a legal mandate to conduct an asset quality review and a stress test for the banks under its responsibility (the so-called Balance Sheet Assessment); the EBA has to define the broad framework for asset quality reviews and to initiate and coordinate the stress test at the EU level.

Conduct of business and consumer protection

Finally, it is important to point out that the ECB has been attributed a wide range of tasks in the area of prudential supervision, but conduct of business and consumer protection remain in the remit of national competent authorities. In this area, the EBA has a general mandate at EU level and is currently intensifying its efforts and bolstering its resources. For instance, we are working on responsible lending in the area of mortgages, on complaints handling, on product oversight and governance, on how banks place their instruments to retail customers, on structured funding products.

The interconnection between prudential and conduct of business supervision has become vividly clear in recent months, when episodes of misconduct by a number of banks have led to very substantial sanctions by competent authorities, which in turn have seriously impacted the capital position of the banks. Moreover, banks that were struggling to strengthen their capital position and to rebalance their funding structure, as requested by the more rigorous prudential standards, have sometimes engaged in dubious selling practices, which might have misled retail customers about the real risk of certain products.

But besides these interconnections, we always have to remember that the Single Market has been designed to deliver benefits for the final users of the financial services.

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In conclusion, the institutional set up for banking regulation supervision and resolution is becoming increasingly European, but not necessarily less complex. The establishment of the SSM (and soon of the SRM) will provide new colours to the tasks of the EBA too. The added value that we can bring to the new institutional set up builds on the work we have accomplished so far. The Single Rulebook becomes increasingly important, also for the performance of the tasks of the ECB. The need for coordination between the authorities of participating and non-participating Member States becomes a necessary condition to preserve the existence and restore the functioning of the Single Market. In turn, this requires the development of common benchmarks and methodologies for the conduct of supervision in the whole Single Market.