Institute of International and European Affairs

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Post-crisis regulatory reforms: the push to completion

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

Introduction

Ladies and Gentlemen,

I would like to thank the Institute for International and European Affairs for inviting me to discuss the regulatory reforms implemented following the Global Financial Crisis (GFC) and Sovereign Debt Crisis and to explore the challenges to completing the Banking Union.

As we meet today, I sincerely hope that we are at the beginning of the end of the most traumatic health crisis that any of us will have seen in our lifetimes. The last twelve months have sent shock waves around the world and caused significant personal and economic loss. At the same time, we take comfort and encouragement from the resilience of front line workers, in Ireland and across the European Union (EU), whose professionalism and capacity to deal with this enormous and unprecedented challenge is universally acknowledged.

While there are clear differences, the magnitude of the challenges now faced will undoubtedly evoke memories of the financial world when, following the collapse of Lehman Brothers in 2008, the foundations on which banking was based crumbled across the globe, including in Ireland. Broadly held beliefs in how the system operated were torn apart. Those events set in motion a decade long process of reform that has transformed our approach to the regulation and supervison of banks.These measures are now showing their value. However, it is also important to acknowledge the process is not complete. Covid-19 has the potential to generate further stress in the financial system and so we must use this time to push for completion of those reforms, in order to deliver on promises made and afford the citizens of EU the level of protection and financial stability that they demand.

Across the EU this point is being understood and it is subject to active consideration. Given that the effects of the crisis were acutely felt in Ireland, it is helpful that both the current European Commissioner for Financial Stability, Financial Services and the Capital Markets Union, and the Eurogroup President, are from your jurisdiction and so can bring that practical experience to the debate.

The financial crisis: the need for reform

Much has been written over the years about the origin and causes of the GFC that commenced in 2007 and accelerated so dramatically in September 2008, following the failure of Lehman Brothers. It is now clear that there were many contributory factors. After years of low inflation and stable growth, there was a widely held belief that we were in a period of 'Great Moderation', brought about through factors such as structural changes in the economy and improvements in the understanding of monetary policy. This gave rise to a period of excessive risk-taking which, coupled with innovations in financial markets, meant that financial stability risks were not clearly understood.

It is also clear that the system of regulation governing banks had become far too relaxed. Poor governance had seen banks pursue high short term financial targets at the expense of prudent long term strategies. Inappropraite incentives for management prompted greed and bad behaviours. Capital, both quality and quantity, had been reduced to levels that facilitated excessive leverage and failed to provide a buffer against market disruption. Liquidity requirements had largely fallen off the international regulatory agenda and, when trust in the system disappeared, institutions could not meet their liabilites as they fell due.

The chaos that followed also exposed the absence of proper crisis management procedures in Europe and across the globe. The First Banking Coordination Directive, aimed at encouraging cross-border banking in the EU had been in place since 1977, and measures such as the Winding Up Directive put in place to deal with the failure of banks. However, it was not until the GFC was experienced that the full complexity of resolution was understood and a more holistic framework developed.

The end result of this was that the losses incurred by banks were socialised, with taxpayers in Ireland and elsewhere, forced to inject huge sums into the banking system to keep it functioning. The rightful anger that this provoked forced legislators back to the drawing board to fundamentally recast the regime and the approach to enforcement.

A decade of strengthening

The framework that exists today is unrecognisable from what was in place in 2007, both in terms of the institutional arrangements and the regulatory regime. This year the EBA celebrates 10 years in existence. Together with the European Securities and Markets Authorities (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Systemic Risk Board (ESRB) and national supervisors, it is part of the European System of Financial Supervision (ESFS). This structure, established in response to the crisis, has seen a shift away from national regulation and introduced a more standardised European approach to the oversight of the financial sector.

In 2012, we saw European leaders come together and agree to work towards the establishment of the Banking Union. This initiative laid the foundation for the creation of a single supervision mechanism, a single resolution mechanism and a common deposit insurance framework. The Single Supervisory Mechanism came into being in late 2014 and was followed by Single Resolution Board at the beginning of 2015. A single deposit insurance framework is not yet functioning, and I will return to this shortly.

In terms of the prudential framework currently applicable to banks, the situation has changed substantially. On capital, for instance, just before the pandemic took hold in the EU the average Common Equity Tier 1 ratio of EU banks was 14.3 % compared to 9% in 2009. At the end of 2020, the ratio stood at 15.3%. The regulatory regime has added new buffer requirements in the form of the systemic risk buffer, the countercyclical capital buffer and capital conservation buffers. The use of these buffers has allowed the authorities to apply flexibility when the pandemic struck.

Low liquidity buffers and inappropriate funding structures were, in many cases, the key weakness that necessitated public interventions in banks during the crisis. Since that time, the EBA has proposed specific calibrations of the newly introduced Leverage Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), which establish prudent liquidity and funding requirements. These capture all key elements of a banks business and take into consideration, for instance, the risk weight and residual maturity of mortgages. A recent EBA publication noted that at the outbreak of the pandemic in the EU, the LCR rate was almost 150% compared to the required 100%. At the end of 2020, the ratio stood at 173%.

In the area of crisis management, the Bank Recovery and Resolution Directive (BRRD), which came into force at the beginning of 2015, established a modern framework in the EU for dealing with failing or failed banks. All jurisdictions in the EU now have competent authorities dedicated to resolution, dealing exclusively with planning for the failure of institutions and the execution of such plans. Their actions, together with additional powers for supervisory authorities to intervene early in stressed banks, as well as obligations on banks to maintain their own recovery plans, transforms the landscape for handling idiosyncratic and systemic failures.

So what can we tell about the efficacy of the measures taken? It is difficult to compare the financial market turmoil of 2008/9 or 2014 with the effects of the pandemic. However, it seems reasonable to believe that had we entered into the pandemic with the thin capital buffers, weak liquidity requirements and poor governance requirements that existed at the commencement of the GFC, the financial stability implications would have been far more damaging than observed to date. Instead, with the exception of sharp rises in money market spreads twelve months ago at the commencement of the crisis, the system has remained stable with regulators able to relax capital and liquidity buffers in a manner that enables the regulatory system to be used as a stabiliser rather than an amplifier of the shocks.

The new structures and regime have also changed the landscape in Ireland. The inflow of institutions following Brexit shows that the regulatory system is considered to be in line with international standards. While high capital requirements have been associated with a reduction in the number of banks providing retail services, it seems that factors outside the regulatory regime, in particular recovery rates on loans, are a key contributor to Ireland being an outlier on certain capital metrics assets.

But more remains to be done

Notwithstanding the paradigm shift in the system, there is certainly no room for complacency. The government supports that have been deployed over the last year must eventually be faded out. When that occurs, it seems assured that the level of non-performing loans will increase. Banks that entered the crisis with lower capital levels, poor business models and riskier exposures may face challenges. So, now is the time to re-double efforts, take a big picture view and make the system as robust as possible by completeing the goals and ambitions that were so evident to all in the immediate wake of the crisis.

In the Banking Union, a pressing issue is the need to deliver the common deposit insurance framework. While extensive work has been carried out to put the European Deposit Insurance Scheme (EDIS) in place, this third leg of the new regime has not been completed, almost nine years after the measure was announced. Much has been done in the interim, not least, the adoption of the Risk Reduction Measures Package in May 2019. This measure gave the EBA over 100 mandates to develop regulatory products, mainly focused in the areas of governance and remuneration, large exposures, resolution as well as reporting and disclosure. The vast majority of these have now been delivered to the Commission. However, notwithstanding that we have seen improvements in risk metrics across the EU, this third pillar remains elusive and leaves a clear gap in the framework of the Banking Union.

There are other structural gaps that could be a source of fragility should financial stability be threatened. One clear example is the lack of a harmonised insolvency regime for banks in the EU. The variation in domestic insolvency requirements across the EU creates a situation where the liquidation of similar banks in different jurisdictions is likely to generate dissimilar outcomes. This can be due to differences in areas such as the grounds for insolvency, the procedures and tools that are available and sources of external funding that may be available. Also, many national insolvency regimes, which normally have general application to corporate entities and are not bank specific, are not aligned with the provisions of the BRRD. This can result in a situation where the Directive's requirements deeming a bank as failed or likely to fail, are inconsistent with the domestic regime for determining insolvency. The case of the Latvian bank, ABLV S.A. is interesting in this regard.

Other areas where the EBA is pushing for rapid progress includes the need for banks to meet the targets they have been set for minimum requirement for eligible requirement (MREL), internal MREL requirements being established, solutions found for dealing with small and medium sized banks that have not been able to raise MREL and removing barriers to effective bailing in of debt quoted on EU and third country exchanges.

Of course, there also remains the important objective identified so vividly in the 2014 sovereign debt crisis of breaking the bank/sovereign nexus or 'doom loop' as it became known. Progress on breaking this link has been slow and this remains a very difficult subject. Recent analysis conducted by the EBA shows that total sovereign exposures of European banks increased in the period from end 2018 to June 2020[1].However, it was also noted that banks are now slightly more diversified and relative to Tier 1 capital, the exposure has been reduced. In particular, in terms of home bias, on average, the proportion of the exposures of the home sovereign towards the total sovereign for the sample is now at 51% compared to 54% in 2018. Of course, in this area it is important to be aware that progress will be impacted by loans recently granted under public guarantee schemes in response to Covid-19. While the position is understandable, the end result must not result in higher risks to the stability of the financial system. Discussions on potential solutions in this area are ongoing.

Conclusion

The long and extensive process of reform that followed the GFC and the subsequent sovereign debt crisis has transformed the regime that governs the way banks operate. The establishment of the Single Supervsiory Mechanism (SSM) has fundamentally altered the way banking supervision is conducted, while the set up of the Single Resolution Mechanism (SRM) and national resolution authorities has, for the first time, put in place a dedicated regime to deal with the failure of banks. These measures, coupled with radically strengthened prudential requirements, have ensured that the impact of the pandemic on the banking sector has been limited to date.

I would observe that Ireland has gained from this overhaul, as evidenced by the significant influx of financial institutions to the jurisdiction following Brexit.

However, notwithstanding that it is over 12 years since the banking world was shaken to its foundations and over six years since the subsequent sovereign debt crisis, the Banking Union is still not complete. For the regime to deliver on its objective it is essential that the third pillar of the regime, a common deposit insurance scheme, is completed. Additionally, the way needs to be paved to allow the free and effective movement of capital and liquidity across borders so that the full benefits of the Single Market can be gained and resolution of failed banks can occur through straightforward loss transfer mechanisms.

The supports provided to economies throughout the pandemic provide a window of opportunity to complete the process and avail of the full benefits and strength of the Banking Union as envisaged when proposed in 2012. It is important that we do not wait until a major crisis develops and the financial system is again on a cliff edge, before taking the decisions necessary for that to happen. This will require legislators to set aside national positions and deliver the stable infrastructure that the public has demanded.

[1] Based on a large sample of banks across the jurisdictions