EUROPEAN BANKING AUTHORITY

BPFI Annual Risk Management & Supervisory Conference

Dublin, 24/01/2020

Banking Regulation & Supervision – Are we there yet?

The title of this conference, "Banking Regulation & Supervision – Are we there yet?" makes me think of a glass of Irish whiskey that can be either half full or half empty. Depending on whom you ask, they may tell you about the excellent whiskey they have just enjoyed or the flavour they will experience in the future. Sometimes there is just no clear cut answer to such a question. This is especially the case for the fast developing environment of banking and financial services in general. Fortunately, at the EBA there may be never a moment where all regulation and supervision is put on hold. However, with the finalisation of Basel 3, we are reaching the end of a decisive chapter in post-crisis European regulation. The increasing pace of digitalisation, growing interest in sustainability issues and the realisation that low for long has come to stay with us, already dictates the trend of the next regulatory chapter. Nonetheless, whenever you reach the end of one chapter, it is good to draw conclusions, to take stock and to learn lessons for the future. This certainly helps to provide clarity – a request often coming from other stakeholders.

In that regard, this conference is quite timely as it almost coincides with the start of the new European Commission and the launch of a new legislative cycle.

Today, I will start by illustrating where the EBA stands right now and then move on describing what our priorities for the future are.

The recent EBA Transparency Exercise published in November 2019 conveyed an encouraging message. It confirmed the strong capital position of European banks and the steady decline of non-performing loans (NPLs). On average, the stock of NPLs has effectively halved since 2015 although some dispersions across European Member States are persisting. Also capital ratios have increased in recent years. For instance, the Common Equity Tier 1 ratio increased from 11.5% in 2014 to 14.4% as of 3rd quarter of 2019 on a fully loaded basis. This trend was supported by banks' de-leveraging and de-risking, which resulted in a Risk Weighted Assets reduction of slightly less than 10% during the last ten years. However, the increase in capital was far bigger, reaching more than 40% between 2009 and now.

On the flipside, we have clearly identified a concern on EU banks' profitability, which is not recovering and is driven by high costs in some banks especially. In a lower for longer interest rate environment, the effort for further cost reductions, enhancing efficiency, restructuring and consolidation of the banking sector must continue. This process should favour that more efficient institutions may continue to gain market share, while weaker, less efficient institutions exit the market resulting in improved service and profitability in the industry. At the same time, banks need to continue to enhance their investments in their risk management and technological transformation to address their medium-term challenges.

After many years of de-leveraging, we have observed a recovery in lending. In addition, lending towards riskier sectors increases like for instance in small and medium-sized enterprises (SMEs), commercial real estate and consumer credit. Moreover, EU banks' valuation has not recovered, especially in contrast to US peers. Just 28% of publicly traded EU banks trade at price-to-book values of more than 1. In contrast to that, 80% of US banks trade at price-to-book ratios of more than 1. The reasons behind these divergences are multifaceted including the macro-economic conditions, impact from monetary policy, credit growth and competitive dynamics. Regulatory uncertainties may add to that. Hence, let me shed some light on our regulatory agenda.

Clearly, the Basel 3 finalisation will continue to be one of this year's top priorities. Let me emphasise that the set of standards agreed at the Basel table is a compromise where a lot has been achieved for EU banks. But a good compromise is when every participant is equally unhappy. From that perspective, the rules agreed on international level should apply equally to all jurisdictions in order to preserve the level playing field and to retain an open global banking market. At the EBA, we are advocating for a comprehensive translation of the entire agreement throughout the EU. We are confident that it is the right signal as the transition phase will be quite long reaching up until 2027. Moreover, the macro-economic impact assessment shows that there are modest transitional costs which fade over time, while the longer-run benefits are substantial due to higher long-term growth and lower profitability of financial crisis.

The EBA's impact assessment of the final Basel 3 standards using conservative assumptions is that capital requirements may increase by 24,4% on weighted average terms. Let me add a few words on the EBA methodology to understand that the impact in not purely driven by the final Basel 3 rules. First, the impact is pondering primarily on large and systemically important banks while medium-sized and small banks see their capital requirements increase from the baseline level by

11,3% and 5,5% respectively. And this diverging impact was intended as systemic banks are most ardent users of internal-ratings based (IRB) models and posed the largest risk during the financial crisis. Therefore 99% of capital shortfall – amounting to EUR 134 billion – is in the large institutions. Among the smaller ones, many actually show surplus capital.

In addition to that, a major share of impact in the EBA's assessment comes from reversing EU specific policies such as the SME supporting factor and CVA exemptions. These exceptions are not compliant with the international set of Basel rules. Finally, the estimated impact assumes that existing Pillar 2 and other buffers remain at current levels. However, to the extent that those address Pillar 1 weaknesses, the existing buffers may well be revised in order to avoid duplications.

Part of our regulatory agenda this year will be the work on the 100 plus mandates stemming from the Risk Reduction Package. Our recently published roadmaps accounting for 50% of these mandates provided clarity on sequencing, execution and supervisory stance in the fields of large exposures, Pillar 2, supervisory reporting and disclosure, governance and remuneration as well as resolution. On all these mandates, we are committed to deliver as quickly as possible. In addition to that, the EBA will continue its efforts to create a reporting framework that is fit for purpose, proportionate and comprehensive. In parallel, the EBA will assess - in close coordination with the ECB and other EU and national institutions – the feasibility of creating a consistent and integrated system for collecting statistical, resolution and prudential data. The ambition is to develop a system that makes the compliance with reporting and disclosure obligations easier and more efficient for banks. In that regard, we welcome the specific proposal in the European Commission's consultation on the next banking reform package to make the EBA a Pillar 3 data hub. According to this proposal once EUCLID is fully implemented, the EBA will become the disclosure data hub and may serve as a single platform for users of information to have common access to the quantitative data disclosed by institutions in their Pillar 3 reports. The Pillar 3 data hub should also contribute to further reduce compliance costs for institutions, starting with small and non-complex institutions, by relieving them from the Pillar 3 obligations.

On Anti-Money Laundering (AML), the review of the EBA Founding Regulation has also allocated some limited new powers and tasks to the EBA. These will allow us to lead policy development and to coordinate as well as monitor the efforts of national supervisors in order to strengthen AML practices across the Single Market. Our new tasks include establishing an EU-wide AML/CFT information database, performing risk assessments on national competent authorities and, when required, asking authorities to investigate and consider taking action on individual financial sector actors. The new AML Standing Committee at the EBA will have its first meeting mid-February and it will help to ensure cross-border information exchange and coordinated action. Going forward however, more will be needed to step up the fight against money laundering and against the financing of terrorism. Moving from principles-based to rules-based regulation may be a significant change in this field and may further ensure comparable approaches, consistent outcomes and full accountability for relevant authorities.

2020 will also be the year of a new stress testing exercise. Compared to last exercises, no fundamental changes have been introduced for this year. The exercise remains a constrained bottom-up and will serve as key input for the supervisory review and evaluation process while being at the same time a comprehensive disclosure exercise. For this exercise, we agreed to publish Pillar 2 requirements and clarify how the maximum distributable amount (MDA) rules are applied, which should make the publication of the results more informative. Throughout the different stress tests over the years, we have gone a long way and they have helped to increase the transparency of banks' capital position. However, we are currently looking into the lessons learnt and have identified some shortcomings. We have started a dialogue in the supervisory community and with stakeholders on those issues identified. The main points for consideration are how to increase the clarity on the implications of the stress test results in terms of capital distribution, how to increase its usefulness for supervisors and banks and how to review the constrained bottom-up approach.

Going forward, the EBA seeks to make the two components of the stress-testing exercise more explicit in the format of a two-leg exercise. As a result, the exercise would have a supervisory leg and a bank leg. The former would be similar to the current exercise with banks submitting bottom-up projections based on methodological constraints. Banks would not be required to sign off the results from this leg. In the other leg, the bank leg, banks would follow a less prescriptive methodology but containing common templates for reporting. No quality assurance would be needed from the supervisors therefore reducing the burden for banks. These two legs would then build the basis for discussion between banks and supervisors. The two outcomes could be either reconciled or they could be kept separately in order to disclosure them both and explain their differences. Looking even further into the future, the EBA has the ambition to develop a full top-down model, at least as a support to the quality assurance process. This would also give us flexibility to perform ad hoc analyses, to detect more tailor-made sensitivities on specific business models, and to focus on specific risks.

A new chapter of the regulatory agenda has just been opened by financial innovation. Here regulators have to keep pace with the accelerated pace of changes. Financial products, services and business models, as well as the structure of the financial sector in general, are evolving fast. We need to ensure that the EU framework enables the adoption of new technologies that will bring potential for efficiency gains and new forms of competition, whilst at the same time effectively mitigating risks to consumers, the integrity of the banking system and, ultimately, financial stability.

To date, the EBA has provided guidelines to banks to strengthen governance and mitigate risks in the areas of outsourcing to the cloud and ICT risk. We have also advised the European Commission on cyber security and the applicability and suitability of EU law to crypto-assets recommending a holistic approach. To ensure technological neutrality is in place, by drawing on knowledge and experience from across the EU in dealing with new technologies, we established the EBA's FinTech Knowledge Hub and, along with the other ESAs, the European Forum for Innovation Facilitators (EFIF), which we are currently hosting. The EFIF provides a platform for supervisors to meet regularly, and interact with firms through innovation facilitators, to share technological expertise, and to reach common views on the regulatory treatment of innovative products.

I will now turn to one of the topics of utmost importance which is sustainability and sustainable finance in particular. The European Commission's communication on a Green Deal underlined that the topic of sustainable finance will indeed figure prominently on the regulatory agenda in the immediate time to come. Sustainable finance and the incorporation of environmental, social and governmental – so-called ESG – factors are already a core part of the EBA's work, as outlined by our draft guidelines on loan origination. As the taxonomy has now been concluded on European level, the EBA is committed to improve the current regulatory framework for institutions to foster their operations in a sustainable manner (contributing to sustainable development objectives and managing ESG risks) and introduce sustainability considerations in institutions' strategy and risk management. Moreover we will provide supervisors with adequate tools to understand, monitor and assess ESG risks in their supervisory practices. Our numerous mandates in that respect stemming from the risk reduction measures package and the review of our EBA Founding Regulation will guide our way as outlined in our recently published Sustainable Finance Roadmap. What becomes however clear at this stage is that any decision on the prudential treatment of green finance should be grounded in an adequate risk assessment. Getting the right data to ensure sufficient risk-sensitivity for any such proposal remains challenging at this point in time. We remain therefore sympathetic to the 2025 deadline for putting forward a report on the potential introduction of a Green Supporting Factor.

Finally, let me zoom out from the immediate EBA's regulatory agenda to some final general remarks on the state of the Banking Union. In the past, the EBA has made contributions to the debate in particular on home-host issues. The EBA has already stated that ring-fencing of the national banking sector – a de facto territorial approach – comes at a cost for the entire Single Market. We have to continue asking the question whether the distinction between home and host supervisors is still compatible with the idea of a banking union. Especially if we seek to advance with other projects such as the capital markets union post-Brexit, we cannot wait to address the remaining obstacles and to find a pragmatic solution. We urgently need to seek agreement on the adequate safeguards for host countries and to progress on joint assessments of the group-wide risks. And of course, pragmatism and political will ultimately be needed to progress on the controversial files such as EDIS, some sort of sovereign bond backed security and the harmonisation of insolvency law. But I am starting to enter the political arena at that point so let me back to the EBA and the clarity we can provide in my concluding remarks.

Let me conclude by saying that we have travelled the long list of items on the regulatory agenda, which would need to be finalised, for instance Basel 3, pending mandates from the Risk Reduction Package. We are finalising the chapter of the imminent post-crisis regulation. In the meantime however, new trends and developments shape additional and new regulatory projects. It will be best to continue going on this path together with input from stakeholders and ongoing supervisory dialogue.