Chamber of Deputies – Committee VI Finance

Cognitive survey of the Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and the Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

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1. The main content of Basel III and of the proposal for implementation in the EU

The crisis in the global economic system since 2007 has revealed the weaknesses in the banking and financial sector.

The combination of macroeconomic imbalances, lax monetary policies, financial innovation, the inability of operators to price excessively complex financial assets properly, and the uncontrolled increase in financial leverage all played a key role, enabling the instability that was initially confined to a particular area to spread to global level.

Regulation and financial supervision could not prevent the accumulation and materialisation of risks. On the strength of the discretion allowed under the international rules and the wide variety of supervisory practices, inadequate capital instruments were accepted to cover risks, some types of intermediary – including potentially systemic intermediaries – did not come within the scope of the prudential rules, innovative and highly risky instruments benefited from inappropriate prudential measures, and liquidity risk management was neglected.

In 2009, in its recommendations for reforming European financial supervision and regulation, the High Level Group chaired by Jacques De Larosière emphasised the need to move towards a single European rule book, with truly uniform rules throughout the Single Market, strengthening the requirements on the quantity and quality of capital, reducing pro-cyclicality by requiring that buffers are built up in good times to be used in bad ones, and introducing specific mechanisms to contain liquidity risks.

The same emphasis on stronger and internationally consistent rules on capital and liquidity was expressed by the G20 in September 2009, confirmed and recognised by the Basel Committee on Banking Supervision in the agreement (Basel III) reached in September 2010, and approved by the G20 in November that year. In July 2011, the European Commission accordingly produced a proposal for legislation to reform the regulation of banks, making the European Union the first jurisdiction to embark on the process of implementing Basel III.

In keeping with the text of the Basel Agreement, the first – perhaps the most important – objective of the proposal is to strengthen the quality of capital. The crisis has shown that relaxing the criteria for defining capital instruments, with national systems 'competing in laxity', is extremely damaging to financial stability. Only instruments of the highest quality in terms of permanence, loss absorbency and flexibility of payments, can be included in Core Tier 1 (CT1) of European banks. In this respect, the proposal is the last step in a long process of harmonising the European rules started by the Committee of European Banking Supervisors (CEBS). In 2007, the Committee had already drawn attention to the need to remedy the differences in the definition of capital adopted in the various legal orders. The Commission's proposal achieves this result by accepting the principles adopted by the CEBS in its 2010 guidelines and by the EBA in the stress test conducted in 2011.

The second key point in the reform is increasing the minimum capital requirements and limiting leverage. The leverage ratio provides a 'backstop' to the risk that the models used by banks to calculate capital requirements may cause them to underestimate the actual risks to which banking activities are exposed. It is designed to complement the risk weighted capital requirements: the leverage ratio imposes a comprehensive and residual limit on debt, irrespective of the level of risk attached to assets; the risk weighted requirements ensure that use of the leverage ratio does not distort the banks' commitments and investments, causing them to take more risks in the quest for higher returns.

Another area to be covered is reducing the risk of pro-cyclicality inherent in the financial system. The financial sector is inclined to encourage increased – often excessive – credit in periods of major expansion; funds may suddenly cease to be readily available in the reverse part of the cycle. The introduction of macro-prudential instruments is one of the most significant innovations in response to the crisis. The Commission's proposal, in line with Basel III, introduces a new countercyclical buffer designed to build up capital in the good times so as to enable the banks to absorb any losses that may be incurred when the economic cycle is reversed.

Lastly, the Commission's proposal introduces the new framework for liquidity risk management provided for in Basel III. This area had not been addressed in the prudential regulations, and standards differed widely from one country to another. The diversity of the rules was not conducive to integrated liquidity management, particularly by cross-border groups, restricting mobility, reducing efficiency and causing tension when the markets were in serious trouble. As said, two provisions are made. The first, the liquidity ratio (LCR), requires banks to maintain a stock of liquid assets that will enable them to cope with an exceptional outflow of funds during a 30-day period without recourse to the market or to refinancing by the central bank. The second, the net stable funding ratio (NSFR), meets the need to avoid structural imbalances between the liabilities to be met and the balance sheet assets. The rules on liquidity will enter into force gradually, with final calibration in 2015 for the short-term indicator and in 2018 for the structural indicator.

The banking industry has often expressed concern about the increasingly strict requirements and the adverse effects they may have on intermediaries' ability to support the real economy, reducing prospects of growth and influencing employment prospects. The empirical analyses conducted by the Financial Stability Board (FSB), the Basel Committee and the OCSE suggest that these concerns are excessive. According to the OCSE, which provides specific estimates for the euro area, the new rules – in the worst-case scenario – would reduce the gross domestic product growth rate by approximately 0.23% per annum (0.15 on average for the euro area, the United States and Japan). That possible cost should be compared with the benefits of rendering future crises and a further drop in GDP less likely.

It should also be borne in mind that, in reality, the increase in the cost of collection by the banks, which is the implicit assumption of these impact assessment models, is not actually discounted: higher levels of capital will help to reduce the probability of individual institutions defaulting and will, therefore, reduce the cost of collection and render the possibility of systemic crises more remote. This is the best way of enabling the banks to continue developing their true role of supporting firms and families.

2. The implementation of Based III, maximum harmonisation and the role of the EBA.

In the Commission's proposal for legislation, the full set of rules designed to implement Basel III is contained in two legislative instruments: a directive and a regulation. This division marks the transition to a new legislative base, consisting largely of European rules on 'maximum harmonisation', and it represents an important advance on the previous scheme of things.

European banking regulation has so far proceeded exclusively on the basis of directives, that is to say on the principle of 'minimum harmonisation' and 'mutual recognition' of Member States' respective systems of regulation and supervision. As a result of the intense integration of the European financial system over the past 10 years, thanks to the introduction of the single currency, and the consequent emergence of European banks, that approach is now clearly inappropriate for the purpose of ensuring the stability of the European financial system. The crisis has shown that minimum harmonisation is perfectly compatible with significant differences in the rules applied and in the supervisory practices of the Member States, with the result that operators who are subject to stricter controls are placed at a competitive disadvantage. Also, the diversity of the rules causes inefficiency in the management of cross-border banking groups and prevents coordination of the various national authorities' supervisory activities in this connection.

Moreover, an approach based on maximum harmonisation and the creation of a single European rule book does not necessarily ignore the fact that there are areas of banking regulation in which national peculiarities, legal, institutional and economic, may be duly reflected in national standards. These are precisely the areas covered in the directive, which is part of the Commission's whole proposal.

The European Banking Authority (EBA) is to have a central role in establishing the new regulatory system. Both the directive and the regulation provide for the EBA to be entrusted with the task of defining 'binding technical standards' that will subsequently define and specify the content of European standards at the highest level, with a view to ensuring uniform application in the Single Market. The technical standards will be drafted by the EBA and submitted to the European Commission for formal approval in appropriate regulations which, in turn, may be open to objection by the European Parliament or the Council of the

European Union. The technical standards will be directly applicable in the Member States and will represent a fundamental part of the single rule book.

This is a substantial task, which will entail drafting more than 100 binding technical standards in the next few years; approximately 40 are to be issued by 1 January 2013.

The most important objectives of this first set of standards are to complete the harmonisation of the definition of capital and to make arrangements for monitoring the introduction of the liquidity coverage ratio.

The Commission's proposal on the definition of capital requires compliance with all the substantive requirements contained in the Basel Agreement, except for the legal definition of capital instruments in the respective legal orders. The choice of criterion, giving precedence to substance rather than form, means that the EBA will be involved to a significant extent when it comes to verification: the Authority is, in fact, asked to publish and update the list of capital instruments to be included in the definition of highest quality capital for the purposes of the regulation. It would be advisable for the regulation to make it absolutely clear that only instruments on this list can be counted as highest quality capital. This is the only way that the EBA can prevent financial innovation leading to more capital instruments with unsatisfactory features.

The Commission's proposal also provides that the new liquidity requirements are to be introduced only after a period of monitoring by the EBA, which is to prepare a report with suggestions on the correct calibration of the measures. The approach deliberately shows the risk that incorrect calibration of the requirements may have unwelcome consequences for the operation of the money market and for funding the economy.

The implementation of the proposal for a directive and a regulation therefore represents a particularly difficult task for the EBA, in terms of both quantity and quality, especially for an Authority that has recently completed its first year. We are therefore determined to meet the deadlines for preparing the rules within our competence, and to do so without abandoning our usual procedure based on dialogue with all potentially interested parties, on impact analyses of the new rules, and on public consultation.

The national supervisory authorities' contribution will be essential in the process of drafting the new technical rules. It should always be borne in mind that the EBA and the national authorities, with the European Systemic Risk Board and the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), together constitute the European System of Financial Supervision. We are currently trying out new ways for EBA staff to work with national authorities' staff, and the results so far have been most encouraging.

3. Open questions

The Commission's proposal represents a consistent implementation of the Basel Agreement and faithfully reflects the contents of that Agreement. In some cases, for example in the treatment of insurance holdings and joint cooperative society holdings, it departs from the international standards in order to take specific features of the European regulatory base into account. In others, deviations from the Basel text are due to the fact that the scope of the European rules includes all banks and investment companies, whereas, in other legal orders, it covers only banks operating at international level. This explains the particular emphasis on the principle of proportionality in the European rules and the attention to certain specific aspects, such as the impact of the new rules on the funding of small and medium-sized enterprises (SMEs).

On this point in particular, the EBA was requested to analyse and report by 1 September 2012 on the current risk weights, testing the possibilities for a reduction, taking into consideration a scenario with a reduction by one third in relation to the current situation, and to review the qualifying thresholds for SMEs. Moreover, the Commission, consulting the EBA, will, within 24 months after the entry into force of the regulation, report on lending to SMEs and natural persons, and will submit this report to the European Parliament and to the Council, together with any appropriate proposals for amendments to the rules.

Some aspects remain open: the treatment of systemically important financial institutions (SIFIs), financial and banking intermediaries operating outside the regulated sector (shadow banking), the uniform application of the Basel III Agreement at global level.

The additional capital requirements for SIFIs which the G20 requested in November will be introduced by the European Union in appropriate legislative measures. The measures will be accompanied by stronger measures to prevent and manage banking crises, to be proposed by the European Commission in line with the FSB recommendations.

Another crucial issue to be addressed is the risk that a stricter regulatory framework for the banks may cause financial activities to be transferred to areas outside the banking system and the scope of the regulations. The problem has been brought to the attention of the Financial Stability Board. On the one hand, supervision must identify the risks to the banks that shadow banking presents and ensure that appropriate steps are taken to deal with them. On the other, the scope of the regulations must be extended, to prevent financial agencies operating in the shadows from generating systemic risks.

Lastly, as regards the implementation of Basel III at global level, the Commission, while stressing that the Union is naturally interested in strengthening the stability of its own banking system, it has, on numerous occasions, shown a firm determination to monitor the effective implementation by the other principal countries and to prevent the risk of regulatory arbitrage to the detriment of European banking institutions.

4. The sovereign debt crisis and the EBA recommendation

The financial crisis entered a new phase in August last year, with growing concern about the sustainability of the enormous volume of public debt in some countries in the euro area. Investors began to assess the capital strength of the European banks, measuring their sovereign exposure against the market value. A vicious circle was created, in which assessment of the banks was increasingly bound up with opinion as to the soundness of the Member State that provided them with a safety net in the event of a crisis.

In this situation, the medium- and long-term banking collection markets were blocked. From the end of June, non-guaranteed issues by European banks could be counted on the fingers of one hand, and, even in the case of issues that were guaranteed, the spread increased dramatically, raising the cost of funding banking activities to prohibitive levels. In the second half of the year, the prospect of difficult and costly medium- and long-term funding was already prompting a process of deleveraging, with the initial emphasis on downsizing some non-essential activities. The criteria for selecting clients began to be tightened up in the first three quarters of 2011, as reported in the Bank Lending Survey published by the European Central Bank. Diminishing supplies of credit had an adverse effect on funding the economy and on the prospects of growth, and this, in turn, made the sovereign debt crisis even worse.

The EBA had begun to express its own concern about the effect on market dynamics in August, telling the Economic and Financial Committee first, and then the Ecofin Board, that the sovereign debt crisis was responsible for the difficulties that the banks were having in collecting funds on the market and warning them that, if policy decisions were not taken, there was a danger of uncontrolled deleveraging that would have an adverse effect on funding the economy. We therefore proposed a package of measures agreed at European level to strengthen the banks' level of capitalisation and encourage a return to normal conditions on the collection market. In particular, the EBA was in favour of introducing European schemes to guarantee the banks' new medium- and long-term liabilities, in order to sever the links between the credit quality of the banks and that of their countries.

We also stressed that these measures must be accompanied by effective and credible policies to solve the problem of sovereign debt, to avoid the risk of the infection spreading to other countries in the euro area. This approach was also supported by the European Systemic Risk Board at the end of September.

These combined measures would have broken the vicious circle linking the banking sector with sovereign risk.

On the capital front, action was taken on the lines proposed. After the European Council's decision of 26 October, the EBA Board – the Authority's decision-making body in which representatives of all the national authorities participate – approved a recommendation that the banks should form a capital buffer that will enable them to reach a capitalisation coefficient of 9%, in terms of highest quality capital (CT1), by the end of June 2012, after careful evaluation of the banks' exposure to Member States of the European Union (sovereign buffer).

I should stress that the EBA has not changed the prudential rules, far less the accounting rules. On the contrary, in view of the tensions on the financial markets, it has asked the banks to form an additional, temporary and exceptional buffer fund to meet the systemic risk arising from the sovereign debt crisis. In order to discourage the disposal of State securities, the buffer on sovereign exposure is defined on the basis of holdings at the end of September 2011 and will not be modified if exposures or the value of securities changes in the next few months. The need to maintain this buffer and the size of the buffer will be reviewed if and when the policy measures to deal with the sovereign debt crisis have an effect on the prices of state securities.

Unfortunately, while measures have been defined to strengthen capital, less progress has been recorded on other fronts. Guarantees on bank collection will be provided by national governments, without any element of mutualisation or aggregation at European level. This does not lessen, but even increases the connection between the banks and their countries of origin. However, the operations to support liquidity approved by the European Central Bank have alleviated the pressure on bank collection. Measures designed to strengthen the European Financial Stability Facility (EFSF) have been agreed but are not yet fully operational.

Before concluding, I should like to address some aspects of the recapitalisation measures that have been the subject of heated debate, particularly in Italy. I think some clarification on these points may help to avoid possible confusion and improve understanding of our action.

In the first place, the buffers requested by the EBA are not intended to cover just one source of risk. Sovereign risk is certainly a cause of deep concern, and we have therefore asked the banks to undertake a careful evaluation of their own exposure, in line with the action suggested by the Monetary Fund in September and with the action analysts and investors have taken since the summer in assessing the banks' soundness. But the recapitalisation exercise is not confined to sovereign risk. All banks have been asked to reach a level of 9% of the Core Tier 1 ratio, with the exception of sovereign exposure holdings; it was also decided that the stricter rules on market risks – introduced in Europe by a directive currently being implemented in the Member States (CRD 3) – should apply immediately, in order to take account of other high risk assets held by the banks in trading portfolios. The facts speak for themselves: according to information collected by the EBA and published on 8 December, one third of the increase in capital requirements called for in the recommendation is due to the higher capitalisation threshold imposed, one third to the CRD3 rules on market risks, and the remaining third to the sovereign buffer. I should also point out that that buffer is calculated on the basis of two mechanisms. The first is removal of the so-called prudential filters relating to securities in the Available for Sale (AFS) portfolio; the second is careful evaluation of securities in the banking book. The first element, which represents approximately two thirds of the total sovereign buffer, is not new to Italy. Before the crisis, the Italian regulations foresaw that potential losses resulting from mark-to-market in the AFS portfolio would have an (adverse) effect on capital, unlike gains. I should also point out that the prudential filters will be removed when Basel III enters into force. In the case of the Italian banks, only 3.9% of the capital shortfall is attributable to the requirement to enter the market value of sovereign exposures in the banking book.

In the second place, the complaints about the unfairness of the measures that we have taken are misplaced, in view of the diversity of current supervisory practices in Europe. Undoubtedly, much still remains to be done in the European Union to ensure that the rules are more homogeneous and, above all, that supervisory practices are more consistent. We were among the first to point this out. But the recapitalisation exercise is not responsible for the lack of convergence. On the contrary, it is an important instrument for the purpose of identifying the most outstanding differences and overcoming them.

A final point concerns the risk of deleveraging. As I have already said, this process began long before the EBA started the debate on recapitalisation, and it is closely bound up with the difficulties banks had in collecting funds on the market at a reasonable cost. Our task is to ensure that the recapitalisation exercise does not cause a further move to reduce credit. To that end, we have laid down guidelines and asked the banks to submit plans for recapitalisation that show the steps that they propose to take in order to reach the required level of capital. Only a limited number of measures to reduce assets will be permitted in order to meet our request: for example, it will be permissible to transfer companies or certain categories of activities to third parties because that does not reduce the leverage of the system as a whole; conversely, reductions in credit granted to clients will not count.

The banking industry had also maintained that it is necessary to delay, or even withdraw, the recapitalisation requirements. It is argued that, at this stage, it would be very difficult for the banks to approach the private market with any hope of success. I think it would be a mistake to comply with those requests. The banks currently need more liquidity and more capital in order to be able to support the economy. The ECB is working on the liquidity front. It is for the supervisory authorities to deal with the problem of capital. The proposed scenario, in which recapitalisation is deferred, would, in my view, be particularly unsatisfactory. If recapitalisation were shelved, it would not solve the banks' problems which arose long before the EBA announced its own measures. Investors would continue to regard the banks as weak, and there would be even more uncertainty about the European banking system. The problems on the collection side, likewise associated with levels of capital that are considered to be insufficient in view of the risks, would remain. The result would be an even higher incidence of deleveraging than we have seen so far. It is therefore essential to recapitalise, preferably with private investments. Governments have also undertaken to provide their own financial support for banks which are denied access to private capital, possibly with the assistance of the EFSF.

5. Conclusions

The first phase of the crisis, caused by the losses arising from structured finance, has led to radical reform of banking regulation: banks must operate in a stable manner, with levels of capital – high quality capital – significantly higher than in the past; they must have sufficient buffers of liquid assets to survive without assistance in situations of stress and they must not continue to provide unlimited long-term funding for non-liquid assets from volatile short-term sources of collection; the requirements for capital market activities have been recalibrated to take better account of the risks; systemically important financial institutions must comply with even stricter requirements and must conduct their operations in a manner that enables them to withdraw from the market in crisis situations without having to call on public funds. It is important that in-depth analyses be conducted before the process of defining all the new rules is completed, in order to avoid any unwelcome effects the stricter rules might have. At the same time, it is essential to avoid a situation where the process of implementing the reforms is so protracted that the rules are watered down and new differences arise in applying them at national level.

We must ensure that the regulatory lever cannot be used again in the future as an instrument to attract business in national financial centres or to favour national standards. The EBA's task of ensuring strict and uniform implementation of the reform throughout the Single Market will be a substantial one.

The second phase of the crisis, associated with sovereign debt, calls for an equally strong response from the public authorities. It is essential that the banks have access to unlimited liquidity, in both the medium and the long term, at reasonable prices: with the wholesale blocking of collecting markets, the banks are, in fact, losing their ability to fund the economy. At the same time, the banks must be asked to strengthen their own capital position, in order to face up to the systemic risk arising from the sovereign debt crisis, convince investors and depositors that they are sound, and avoid uncontrolled deleveraging. We are aware that it will be a difficult process, which may affect assets controlled by the banks and, in some cases, may even require support from the public authorities. But a clear and firm response is needed in the current uncertainties. This course is certainly preferable to more cautious and less timely solutions, which would most probably prolong the crisis and increase the final cost.