EBA European Banking Authority

European System of Financial Supervision

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Committee on Economic and Monetary Affairs

Public Hearing
Basel III and CRD IV: A European Supervisor's Perspective

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Initial Statement by Andrea Enria
Chairman of the European Banking Authority

The crisis that the global economy is facing since the summer of 2007 has revealed major weaknesses in the banking and financial system. The lessons drawn so far show a wide consensus and firm convergence at the international level on the kind of regulatory repair that is now needed.

In 2009, in its recommendations for reforming European financial supervision and regulation, the High Level Group chaired by Jacques De Larosière emphasized the need for moving to a single rulebook, with truly uniform rules throughout the Single Market, while strengthening the requirements on the quantity and quality of bank capital, reducing pro-cyclicality by requiring that buffers are built up in good times to be used in bad ones, tightening the rules on liquidity risk.

The same emphasis on a stronger and internationally consistent framework for capital and liquidity requirements was shared by the G20 Leaders at their Pittsburgh summit in September 2009, and confirmed when the new international framework agreed on by the Basel Committee in September 2010 was endorsed by the G20 Seoul Summit in November 2010.

The Commission's proposal of July 2011 (CRD IV/CRR) is in line with this path, and makes of the EU the first jurisdiction in the world that brings these major reforms onto the legislative stage. It also responds to the key concerns raised in the Report coordinated by Othmar Karas and approved by the European Parliament one year ago.

In the building up of this new EU framework, the EBA is called on to play a very significant role, through the drafting of regulatory and implementing technical standards making up the EU Single Rule Book, and steering the convergence of supervisory practices to the highest standards. As a young authority, we are honoured of the responsibilities that the Commission proposes to assign to us and look forward to the final decision of the European Parliament and Council. Of course, we are concerned of the huge amount of delicate technical work that will have to be completed in a very short span of time, following the due process of informal dialogue with interested stakeholders, impact assessments and public consultation. But I am confident we can succeed provided we have access to an appropriate amount of resources and we can rely on effective working methods, also drawing on the expertise available at national supervisory authorities.

The EBA's technical standard should avoid the significant divergences in national implementation of EU rules that has caused serious harm in the run up to the crisis, leading to legal uncertainty, opening the floor to regulatory competition to favour national champions and market places, enabling institutions to exploit regulatory loopholes, distorting competition, and making it burdensome for firms to operate across the Single Market.

As to the substance of the Commission's proposal, the first important objective, maybe the most important, is strengthening the quality of capital. One of the key lessons of the crisis is that the relaxation of the regulatory criteria and competition in laxity on the definition of capital is extremely damaging to financial stability. It is the EBA's view that only instruments of the highest quality are to be included in the Common Equity Tier 1 of EU institutions and that compliance with this strict requirement should be continuously monitored on an on-going basis, in order to avoid that a new bout of financial innovation leads again to a watering down of the quality of EU banks' capital.

The EBA has already taken this approach when elaborating and enforcing the definition of capital used for the last EU-wide stress test exercise. The EBA trusts that the eligibility criteria put forward by the draft Regulation will not leave room for financial engineering and national interpretations and that only a consistent set of instruments of the highest quality across Europe will meet these eligibility criteria, which have been crafted to reflect the basic features of common equity in terms of permanence, loss absorbency and flexibility of payments.

The Commission's proposal favours an approach that privileges substance over form, as we don't have an EU-wide definition of common equity. If this approach is chosen, as suggested also in the Karas report, it is essential that strong mechanisms are put in place to make sure that there is no room to water down the requirement in national application. The "substance" needs to be checked and has to be the same across the Single Market. Article 24.4 of the draft Regulation) require the EBA to establish and publish the list of forms of capital instruments that qualify as Common Equity Tier 1. It would be important that the legislation clarifies that only the instruments included in the EBA will be eligible as Common Equity Tier 1.

The second key point is increasing capital requirements and reducing leverage. The increase in the level of capital required will be significant, especially for Systemically Important Financial Institutions (SIFIs). The industry has argued that such tightening of the standards will significantly affect the ability of banks to support the real economy, thus adversely affecting growth and employment prospects. This is not confirmed by the empirical analysis conducted by the supervisory authorities. A higher level of capital will reduce the probability of default of the banks and their funding costs. We are witnessing in these very days that if banks are not perceived to be sufficiently capitalised they are likely to face major difficulties in funding their activities, which can indeed trigger a fast deleveraging process that would have serious negative repercussions on growth.

The risk weighted ratio will also be coupled with a leverage ratio, to provide a backstop to model risk and to avoid that the degree of leverage is unduly increased by exploiting pitfalls in the ability of risk weights to effectively capture risks. Some argue that the leverage ratio should be the only instrument to be relied upon by supervisors, due to the lack of reliability of the methodologies for calculating risk weights. I believe that the two ratios should complement each other and supervisors need to maintain a tool to exercise their scrutiny on the models used by banks measure and manage their risks.

Third, the introduction of macro-prudential instruments: I believe this is one of the most significant innovations in response to the crisis. The new framework introduces a countercyclical buffer to lean against the wind and pre-emptively limit the build-up of risks in the upper parts of the credit cycle. National supervisory authorities must have flexibility in operating these buffers based on the risks in domestic financial markets, but a framework of constrained discretion should apply. To ensure consistency across countries, the European Systemic Risk Board (ESRB) should provide ex ante guidance and organise ex post reviews. Let me also concede that supervisors should further consider a point frequently raised by the industry that the release of the buffers during a crisis will be difficult due to the pressure exercised by the market.

Fourth, the CRDIV/CRR proposal would also bring in a new framework for liquidity risk management and supervision. The proposal implements the Basel III liquidity provisions, whilst allowing for flexibility regarding

the final calibration of the ratios, which is envisaged by 2015 for the liquidity coverage ratio (LCR) and 2018 for the net stable funding ratio (NSFR), after observation periods.

I am aware that the banking industry is very concerned about the implementation of the new requirements. While I believe that we must make sure that we properly assess any potential unintended consequences during the observation periods, I am also convinced that the basic principles underlying the two requirements are sound: banks need to set aside sufficient high quality liquidity buffers to withstand periods of stress, and constraints need to be set as to their engagement in maturity transformation.

The EBA will start monitoring the two requirements in 2013 and report annually to the European Commission on their potential impact on the business and risk profile of credit institutions, on the economy as a whole and on bank lending, with a particular focus on lending to small and medium enterprises (SMEs).

Regulatory repair is essential, but we should not lose sight of the enforcement aspect of supervision. As underlined also in the resolution of the European Parliament of 6 July 2011 on the financial, economic and social crisis (the CRIS report), the creation of the ESRB and the three ESAs is a fundamental step in the direction of a single set of rules. But further progress is desirable, in particular to ensure the uniform enforcement of these rules.

In the last two decades we have adopted an approach to supervision 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 rather variable degree of supervisory scrutiny. The EBA is strongly committed to ensuring greater consistency across the various national supervisory approaches, which should converge towards the highest standards. To this end, robust methodologies would need to be agreed for the supervisory review and evaluation process (SREP), and peer review mechanisms should be designed to make sure that such methodologies are applied consistently across all EU countries. This is a difficult challenge and the EBA's efforts will not deliver results in the short term. However, we need to see steady progress and the implementation of the new regulatory framework will provide us with a window of opportunity to promote convergence in supervisory practices.

Consistency in regulation and supervision is a global issue that goes well beyond the EU, and to this end it is essential that the Basel III Agreement is consistently implemented at the global level as well. The Basel Committee has already announced that it will undertake a rigorous monitoring of the implementation of the new framework in all the G20 countries.

The proposal put forward by the Commission adapts the global standards to account for some EU specificities. The bancassurance business model is one example, where some coordination between the Basel Committee's standards and the EU legislation on financial conglomerates is called for. In doing so, we need to make sure that we do not offer banks easy routes to circumvent the strict rules on bank capital. We also have to recall that differently from other jurisdictions, the legislative proposal will not only apply to internationally active banks, but will also cover all banks and investment firms licensed in the EU. This wide scope of application requires that appropriate emphasis is given to the concept of proportionality, in order to take into account the banks' specific risk profiles and the diversity of the European banking sector. I would like to stress that the Commission's proposal, by building on the guidelines on core capital published by CEBS in June 2010, envisages an appropriate approach for cooperative banks in the EU.

The EU has interest per se in implementing the new standards in order to increase the resilience of its banking system. However, the effectiveness of the new standards as a whole would be seriously undermined if unequal and unsynchronised implementation persisted at global level. The regulatory dialogue the Commission and the three European Supervisory Authorities are conducting with other key jurisdictions and the strong commitment made by the Basel Committee and the Financial Stability Board should ensure that the degree of consistency achieved is much greater than in the past.