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FEDERATION OF INTERNATIONAL BANKS IN IRELAND

Keynote of the Chairperson of the European Banking Authority

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Fragmentation of financial markets in the EU and policy responses

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

Introduction

Let me first of all thank the Federation of International Banks in Ireland (FIBI) for inviting me here today and for giving me the opportunity of addressing such a distinguished audience.

The completion of the Financial Services Action Plan in the early 2000s and the introduction of the euro led to a wave of cross-border banking business in the EU. This process was brought to a halt and then significantly reversed during the financial crisis. Ireland and other Member States have bitterly experienced the consequences of this boom-bust development in cross-border banking. The key question confronting us is whether the institutional changes and the policies that we have put in place in the last years will be successful in providing a more solid underpinning for cross-border banking in the Single Market and contrasting the re-emergence of financial markets fragmentation in the EU.

I will give you a brief overview of three main areas of policy response: first of all the **institutional repair**, i.e. single supervision, single resolution mechanism and pooled resources to directly support banks under stress; secondly, the **regulatory repair**, i.e. the work to make sure European banks operate under a *Single Rulebook* and are subject to consistent and coordinated supervisory approaches; lastly the **banking sector repair**, i.e. the actions to improve the resilience of the European banking sector. These are major, far reaching changes, which should go a long way in creating a more unified regulatory and supervisory framework, centred on cooperation and trust rather than on ring-fencing to protect local establishments.

I will then focus on one specific aspect of the policy armoury, namely the new **macro-prudential framework.** This is the tool that should assist in pre-empting the build-up of those financial imbalances that in Ireland, as in other jurisdictions, had at the time been the premise of the bank-sovereign loop and the resulting fragmentation of the EU financial market. My key point is that close coordination at the European level is necessary in order to re-establish the integrity of the Single Market.

Lastly, I will draw your attention to the work that the EBA is currently carrying out to identify, at the regulatory level, a **simple standard and transparent securitisation funding tool,** as one of the steps which may contribute to improving firms' access to finance in those jurisdictions that were particularly hit by financial market segmentation.

Financial markets fragmentation

In the first decade of this century the EU, following the establishment of the Single Market and the introduction of the single currency in the Euro-zone area, has witnessed a substantial increase in the level of integration of banking and financial markets: an unprecedented expansion in cross-border banking business has taken place, with banks taking more and more a European dimension and engaging in long series of merger and acquisition operations. Along with the integration of the wholesale banking markets, mergers and acquisitions have realised some degree of 'indirect' retail integration, via the internal capital markets of cross-border institutions.

In an integrated financial market resources move smoothly between regions where they are in excess supply to regions where they are in excess demand. Resource imbalances auto-correct and prices of comparable assets converge. All this has to a large extent taken place in the EU, bringing about a series of benefits: more efficient allocation of capital, higher investment and growth and enhanced risk-sharing. However, we have also observed the gradual build-up of imbalances within national banking markets. In specific jurisdictions, including Ireland, lending to the real estate sector has drifted away from fundamentals, feeding a financial bubble that eventually burst.

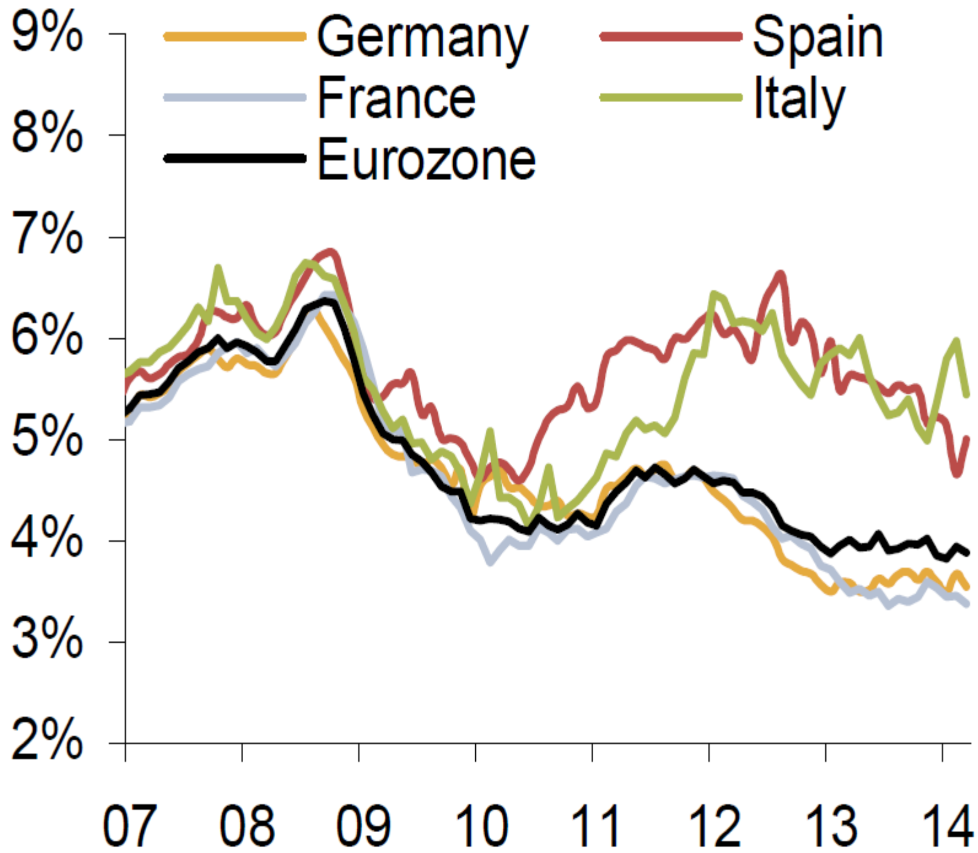
As financial institutions started being hit by the crisis, proposals to pool resources to support distressed institutions were rejected: the political decision was that each Member State was exclusively responsible for its banks. This decision exposed a major contradiction in the European institutional framework: banks had been encouraged to consider the EU as their domestic market, and took up a dimension commensurate with the new size of their market, but by doing so they had become too big for the fiscal capacity of their home country - the largest 10 European banks' assets are all above 50% of their home country GDP, with 5 of them above 100%.

This triggered a very hard-to-break bank-sovereign loop, as financial markets started assessing the creditworthiness of institutions on the basis of the strength of the domestic safety net and, even more so, as institutions were heavily exposed to the debt of the domestic sovereign. Funding markets and national authorities pushed banks to a much closer matching of assets and liabilities in each jurisdiction, driving the Single Market towards a painful segmentation along national lines.

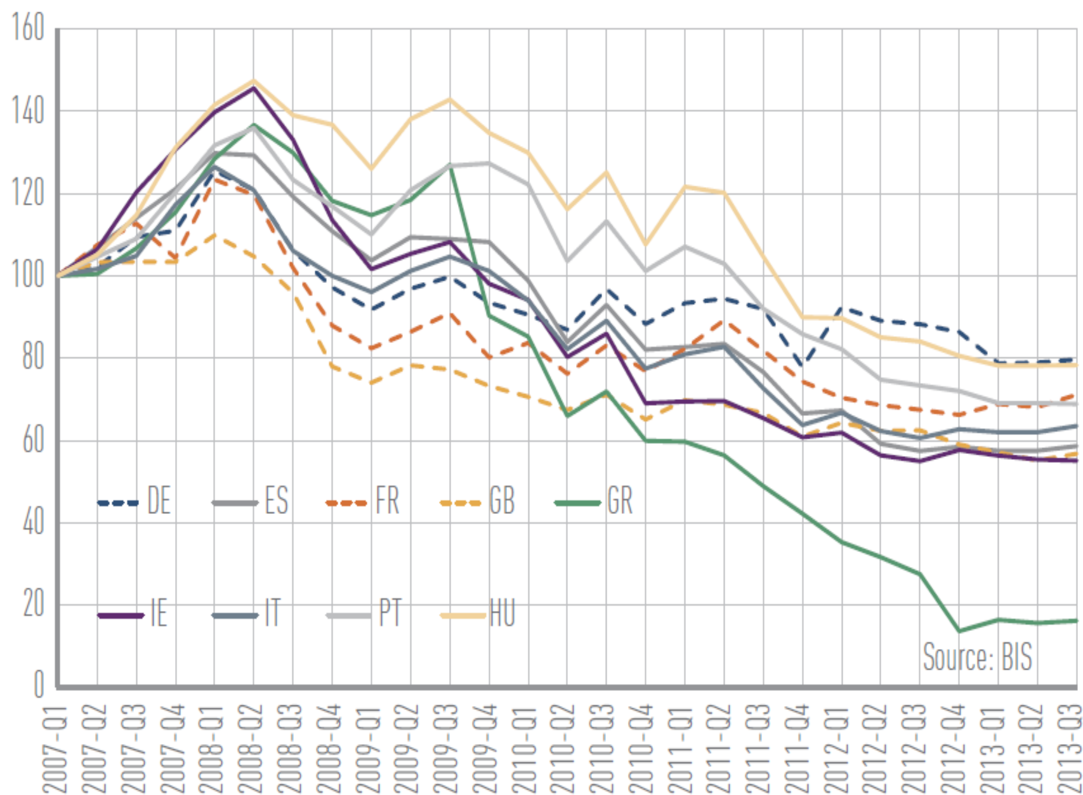
Well established measures of financial integration confirm that, since the crisis, segmentation is back on the scene. We see for instance – from a recent series of research papers - that the levels of convergence of government bond yields, money market rates and the cost of funding for firms is diverged in peripheral jurisdictions and back to levels only seen in the 1990s. The same research shows that the share of cross-border Euro-zone area interbank assets as a percentage of total interbank assets had by mid-2013 reverted to levels similar to those at the start of stage three of EMU over a decade earlier.[1]

[1] It is the case of PT and ES, as documented in L.V. de Souza and M. Tudela: Comparative Economic Studies, 2014, 56, (337–350).

SME loan rates, % (source: RBS, ECB)



Consolidated total foreign claims (ultimate risk basis) of reporting European banks vis-à-vis selected countries, 2007 Q1 = 100 (source: EBA Risk Assessment of the European Banking System, BIS data)



The fact that the drop in cross-border banking was driven mainly by interbank flows also signals the increasing difficulties cross-border groups have faced to freely move capital and assets across jurisdictions, thus significantly hampering their role in the integration of retail markets.

It is fair to say that public authorities and public choices have played a crucial role in this context. The political decision to fully rely on national safety nets and backstops was followed by a certain degree of 'home bias' in the design of restructuring processes: I am thinking here of de-leveraging and de-risking processes focused on foreign jurisdictions, as well as ring-fencing implemented by host authorities via capital and liquidity add-ons. The EBA deployed all its tools to address these developments: we opened two breach of law investigations, we exercised our pressures towards truly joint European-minded decisions in Colleges of supervisors, and we brought eight mediation cases to a positive conclusion, with satisfaction from both home and host authorities. But we have to acknowledge that without a more profound repair of the institutional set up these actions would have fallen well short of reversing the massive move toward national segmentation of banking markets.

Institutional repair

The Banking Union is certainly the turning point in the overall process of repair undertaken since the financial crisis and the major step in the direction of breaking the bank-sovereign loop.

In a few weeks from now the European Central Bank (ECB) will take responsibility for the supervision of banks established in the Eurozone and in those jurisdictions that voluntarily decide to join the Single Supervisory Mechanism (SSM), the first pillar of the Banking Union. In addition, the Regulation enacting the Single Resolution Mechanism (SRM) has entered into force, paving the way for a unified approach to managing the restructuring of troubled banks and the winding-down of non-viable banks.

Back in 2012, Daniel Gros put forward a very interesting natural experiment comparing Ireland with the US State of Nevada: broadly similar jurisdictions under several respects (size, population etc.) they have both experienced an extraordinary boom-bust cycle of the real estate sector. While the federal institutions of the 'US banking union' (i.e. the FDIC) have provided Nevada with a shock absorber approximately equal to 10% of the GDP, the Irish bail-out experience could not rely on any European homologue. If one takes into account the additional losses internally absorbed by fully integrated US banks, operating in Nevada as well as many other US States, the shock absorbency capacity extended possibly up to 20% of Nevada's GDP. The relative fall in GDP in the 2007-2010 period in Ireland was three times larger than the one in Nevada.

The courageous step that this institutional change represents has to be acknowledged. However, let me remind you the challenges that, looking forward, we will undoubtedly have to face in the implementation of this ground-breaking reform. First of all, we will have to make sure that the room left to national discretion in the transposition of relevant chapters of the Bank Recovery and Resolution Directive (BRRD) will not hamper the effectiveness of what can be considered the major regulatory tool in the hands of the SRM. To this I will come back later when touching upon the regulatory repair. Secondly we will have to ensure that the legal framework and the governance of the decision making process can provide effective and timely resolution actions at EU level, in case of financial turmoil, particularly when distress involves cross-border groups.

Also, since we speak today of market fragmentation, we will have to make sure that a new fragmentation does not arise in the space of recovery and resolution matters, due to the fact that Eurozone Member States automatically adhere to the SRM while other Members in the EU may choose not to do so.

Regulatory repair

Reverting the fragmentation of the Single Market also goes through ensuring that the rulebook applicable to banks across EU Member States is genuinely and entirely a Single Rulebook. This is now even more important in light of the fact that a single supervisory mechanism can only operate effectively if all supervised entities are subject to the same rules.

The EBA has already achieved a lot in this area and plans to do more. Let me remind you that we have already finalised 76 technical standards and we have additional 70 in the pipeline to be finalised by the end of next year. Banks in the EU are now subject to harmonised key definitions, for instance around non-performing loans and forbearance, as well as to a single framework for supervisory reporting.

What we have achieved so far is as relevant as what we need to work on going forward. The crucial challenge is that primary legislation still leaves significant margins for national flexibility in a number of areas. Most often, these are very technical details of the rules and the impact of such differences is not easily grasped by external observers. The effects are sometimes very substantial. In addressing questions received from the industry in our Q&A tool and in the conduct of the stress test we realised that there are a number of differences that still impair meaningful comparisons of capital ratios, especially in the transition to the full implementation of the new requirements. The EBA is very supportive of efforts to reduce the distance between national implementation of the common rules. Where this is not entirely possible, we are relying on disclosure of common benchmarks, in order to ensure that bank data are as comparable as possible. For instance, the results of the stress test will also provide disclosure of the fully loaded Common Equity Tier 1 ratio, so as to sterilise differences stemming from national approaches in the phasing-in of the new requirements.

As I already mentioned, this issue is particularly delicate in the space of the BRRD. We will have to make sure that elements of national discretion related for instance to determining which instruments are subject to write down or conversion into equity do not translate into the possibility that a given instrument is treated differently across jurisdictions. In particular, there may be a risk that a toolkit introduced with the purpose of establishing an EU-wide recovery and resolution framework may actually be used to engineer a certain degree of ‘home bias’ in recovery and resolution decisions, thus leading to resolution procedures that move along national borders and aim at ring-fencing. Establishing common approaches to resolution and strong agreements between home and host authorities on how they would interact in a crisis is a necessary condition for an effective and durable removal of obstacles to cross-border banking.

The EBA also works to enhance convergence in supervisory practices in the EU. The common guidelines on the Supervisory Review and Evaluation Process (SREP) aim at providing a common framework for the work of supervisors in their assessment of risks to banks' business models, their solvency and liquidity. The role of the EBA in joint decision processes within supervisory colleges and in mediation is particularly relevant. I mentioned earlier that as the crisis struck, financial market segmentation was driven by home bias in the design of restructuring processes and by lack of cooperation and trust between home and host supervisory authorities. The Banking Union will provide a fully unified supervisory framework for banks headquartered in the Euro-zone area and other participating countries, so to expand the common elements in the supervisory handbooks of all competent authorities in the EU is an important element to maintain the integrity of the Single Market and to avoid a polarisation between practices in “in” and “out” countries.

Banking sector repair

It has to be acknowledged that the freeze in interbank lending that brought about the collapse in cross-border banking has also been driven by lack of trust and by the perceived fragility of EU banks’ balance sheets. Since 2011, the EBA has been pushing for significant recapitalisation of EU banks and has been monitoring the smooth and timely transition to the CRR/CRD4 framework.

With the EU-wide stress test exercise and the recapitalisation exercise in 2011-12, the EBA managed to bring EU banks' capital ratios to levels comparable to the US. These initiatives reduced the uncertainty surrounding banks' vulnerabilities, putting markets in a position to better price the risk premium demanded for investment and expeditiously moving capital and credit more efficiently.

Despite these efforts, discrepancies remain between regulatory yardsticks on the one hand and market perception on the other. Fully restoring markets' confidence requires a strong focus on banks' asset quality, in order to dispel remaining concerns and reassure potential investors on the robustness of EU banks. Our Recommendation to supervisors to undertake asset quality reviews issued in October 2013 went exactly in this direction, as it called on all competent authorities to use, to the extent possible, our new common definitions of non-performing exposures and debt forbearance in their asset quality reviews. Asset quality reviews are a real game changer in the new round of EU-wide stress tests that supervisors have undertaken in 2014, of which the results are going to be published at the end of this month.

Results can already be seen. Between June 2013 and June 2014, in preparation to the asset quality review and the stress test EU banks in the sample raised more than €120 bn of total capital (€55 bn of CET1), allowing extra provisioning for about €120 bn.

The asset quality review and the stress test are key, as only banks that have a strong capital position and have completed the cleaning of their balance sheet are in a position to support normal lending to corporates, especially small and medium enterprises, and households.

The macroprudential toolkit

The CRR/CRD4 regulatory package provides public policy with a set of macro-prudential tools: here I am in particular thinking of measures such as the capital conservation buffer, the countercyclical capital buffer, the buffers for globally systemically important institutions and other systemically important institutions, the systemic risk buffer, the measures aimed at increasing risk-weights or LGD floors for certain exposures secured by real estate mortgages and the so called 'flexibility package' (Article 458 of the CRR), under which Member States can take a variety of macroprudential measures to address systemic risks and pillar 2, which can also be taken with a macroprudential objective.

The toolkit is at the same time comprehensive and complex: some of the tools affect usually only one or a few banks on the basis of their idiosyncratic characteristics, others impact the system as a whole as they apply to all institutions or at least a subset of those. In addition, the tools are in part of a structural nature and in part of a countercyclical and forward looking nature.

The macroprudential tools, and particularly those characterised by a countercyclical/forward looking nature, represent a precious armoury in the hands of those jurisdictions that experience the insurgence of local/regional financial imbalances, like those that triggered the bank-sovereign loop observed in some peripheral Member States during the financial crisis. The crucial financial stability objective of these tools is fully acknowledged by the EBA: last June we issued an opinion

addressed to the European Commission where we assessed these tools against, among others, the objectives of addressing externalities across institutions, as well as risks and the time-series dimension of the build-up of imbalances, both for mitigating the credit cycle and for building up in good times capital buffers that are to be depleted in bad times.

As one would expect, these policy tools are designed in a way that enables the national authorities to tackle the specific features of the build-up of risks in their jurisdictions. Some degree of flexibility in the use of the tools is also needed in light of the fact that macroprudential instruments are broadly untested.

At the same time, it is the EBA's view that we should remain focussed on protecting the unity of the EU market, not only through microprudential rules, but also through the macroprudential toolkit. More specifically, the macroprudential tools should be designed in such way that they cannot be used for ring-fencing purposes and regulatory arbitrage in general should be avoided.

Since the CRR/CRD4 came into force, several EU Member States have started applying macroprudential instruments, and some divergence of approaches can already be noticed. In particular, in order to address concerns stemming from the local real estate market, some countries have used the 'flexibility package', whereas others (like Ireland) have increased risk weights for real estate exposures, and the systemic risk buffers are being used. It is important to underscore that Member States should be able to act in a timely manner, but it is also important to maintain consistency in the rules, as the EU level playing field may otherwise be well hampered.

In this regard, the recognition of measures, the so-called 'reciprocation', is extremely important, as it ensures that institutions set aside the same level of capital requirements for the same type of exposures: when one authority increases risk weights for real estate exposures, then authorities in other Member States should also apply higher capital requirements for real estate exposures located in that country.

Secondly, the crucial issues of incentives and coordination in the governance of the toolkit need to be considered. The power of activating macroprudential measures lies with Member States. Some of the measures I mentioned are the responsibility of Competent Authorities (i.e., microprudential supervisors), some are the responsibility of Designated Authorities (i.e., macroprudential bodies). Designated Authorities are 'appointed' by each Member State, and these may be the central bank, the financial authority, a committee, or the ministry. There is currently no requirement for the Competent Authority and the Designated Authority to coordinate their actions, which may be problematic as conflicts of interest may exist between micro-and macroprudential authorities.

Lastly, there may be cases and times in which a national authority does not have the correct incentives to the activation of a measure. For instance, actions to counteract a real estate imbalance could be delayed by the effects that such imbalance has on the fiscal position of a Member State. As a relevant example here, according to data published by the Commission right

before the collapse of the real estate bubble, in 2006-2007, the property related tax revenue of the Irish government represented almost 5% of GDP.

A pan-EU level of coordination is therefore of paramount importance, and this will benefit both microprudential and macroprudential supervision.

Fragmentation in financing costs: an EU simple standard and transparent securitisation tool is (only one) part of the response

Before concluding my intervention today let me go back to one of the symptoms of financial market segmentation we discussed earlier, namely a price measure of financial segmentation: the dispersion in the cost of bank funding for non-financial companies. The increased dispersion of this variable between “peripheral” and “core” Member States is hampering investments and growth opportunities in “peripheral” Member States, and in particular to the detriment of SME borrowers, a very important portion of the production sector in the countries involved.

The EBA is currently investigating whether the conditions exist to identify, from a regulatory perspective, a segment of the securitisation market that may function as a simple, standard and transparent funding tool. I believe we are all aware, by now, that the stigma received by the securitisation market following the crisis was mostly determined by the very negative performance of specific products and asset classes within the securitisation market. Following a call for advice from the Commission, the EBA is now working to identify criteria to address the major drawbacks of the securitisation process observed during the crisis, such as the excessive leverage, the misalignment of interests between originators and investors, the maturity transformation and the lack of transparency vis-à-vis investors.

A robust and well-functioning securitisation market, which is free from the shortcomings we have observed during the crisis and which can regain the confidence of a broad investor base, will contribute to unlocking funds for the financing of the real economy, including SMEs. If the risks associated to the identified segment of the securitisation market warrant it, the prudential regulator may also design a differentiated regulatory capital treatment. The regulatory recognition of contained risks may positively affect the decisions of market participants to issue/invest in securitisations. In theory, through securitisation institutions tap the capital markets on the basis of the quality of the underlying loans rather than on their own name and on the strength of the sovereign supporting them. For this reason a securitisation instrument structured according to EU-wide principles of simplicity, transparency and standardisation and backed by robust underlying exposures may free up bank capital resources and alleviate financing constraints.

While developing this policy line, we have to be mindful of its challenges and limitations.

A regulatory recognition to a segment of the securitisation market is only one of the steps that are necessary to alleviate the financing constraint. When it comes to firms’ access to financing, and in particular SMEs, there are parallel and equally necessary discussions that should be tabled at EU level.

I am first of all thinking of the lack of harmonized and enhanced indicators for tracking SMEs credit performance and credit quality, such as EU-wide credit registers and credit scoring systems. Benchmarking and comparing is crucial against the current levels of opaqueness in the quality of relatively risky exposures, such as those to SMEs.

I am also thinking of the role of external ratings and rating agencies. Partly due to the lack of reliable and comparable performance data on SMEs, partly due to their approach to addressing sovereign risks and other risk factors, rating agencies can impose levels of collateralisation in securitisation transactions that make the economics of the transaction almost not sustainable. Also due to this aspect, we have recently seen a growing role for public/international guarantees and similar forms of support towards securitisation transactions.

Last but not least, we have to pay attention to the high level of indebtedness of the private sector, including SME borrowers. A healthy flow of credit to the SME sector will only be revived if the current levels of private debt are adjusted to a more sustainable steady-state.

Conclusions

In conclusion, the EU policy toolbox deployed against fragmentation of financial markets is wide and complex.

The foundations of a new and to some extent revolutionary institutional set-up have now been laid down. Substantial work is being carried out and has already been accomplished in order to ensure that banks are adequately capitalised and resilient, that they operate in a single rulebook environment and that they are supervised according to harmonised standards and practices. In addition, the macro-prudential toolkit is available to Member States to ensure that, among other objectives, the build-up of local financial imbalances is properly addressed. Regulators are also working to identify the conditions under which a simple standard and transparent securitisation funding tool can be defined at EU level.

There are some indications that the fragmentation of banking in Europe is starting to recede. But I believe it is important to keep in mind that we are dealing with the consequences of overextension of credit on a massive scale. Private and public sector debt remains near record-highs, both in absolute value and in percentage of GDP, particularly in the countries that were most hardly hit by the crisis. The Bank for International Settlements (BIS) recently warned over the risks of a debt trap, as policies seeking to stimulate the economy by encouraging more and easier debt financing could ultimately add to the problem they intend to solve. Hence, the most important step is to complete the process of cleaning banks' balance sheets and providing the right incentives for write-downs and restructuring of private debt, also through debt-to-equity swaps. Several initiatives have been put in place at national levels to facilitate this process. We have to learn from these experiences and promote best practices. More generally, restoring a well-functioning, integrated EU financial market will also call for a rebalancing between debt and equity financing. This, I believe, should be the core focus of the project for a Capital Market Union.