Euro area financial regulation: where do we stand?

Benoît Cœuré
Member of the Executive Board
European Central Bank

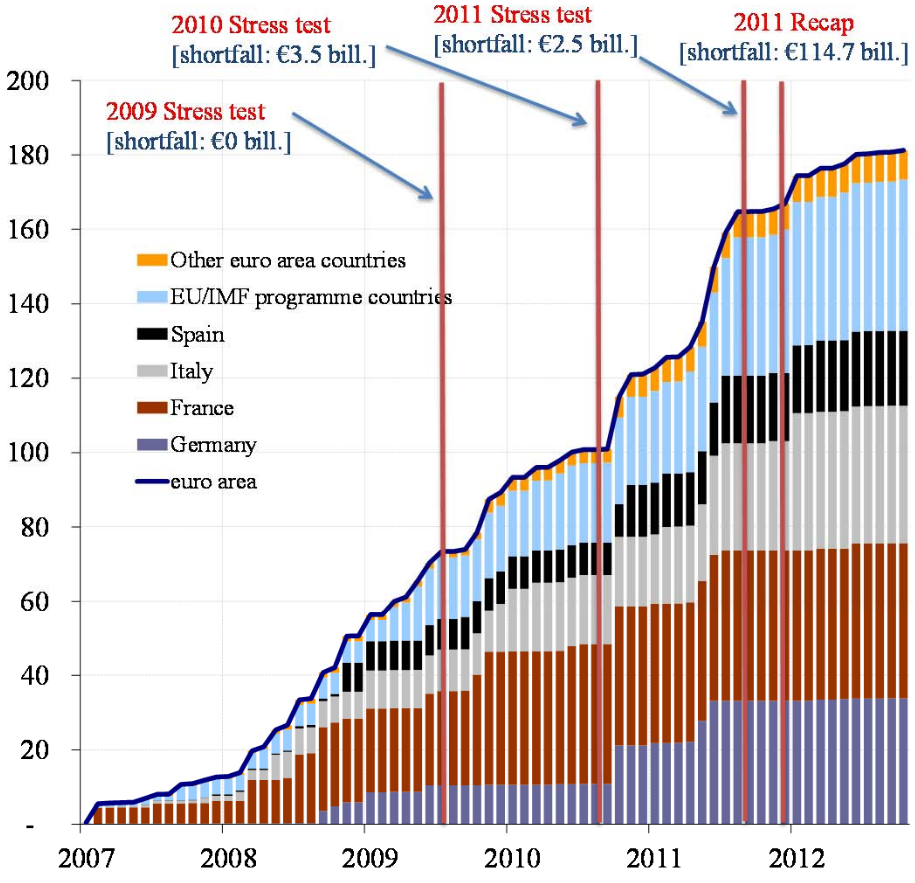
Paris, 18 January 2013

Euro area banking sector

- What has been done?

Large amounts of new capital have been raised since the crisis erupted and disorderly deleveraging has been avoided

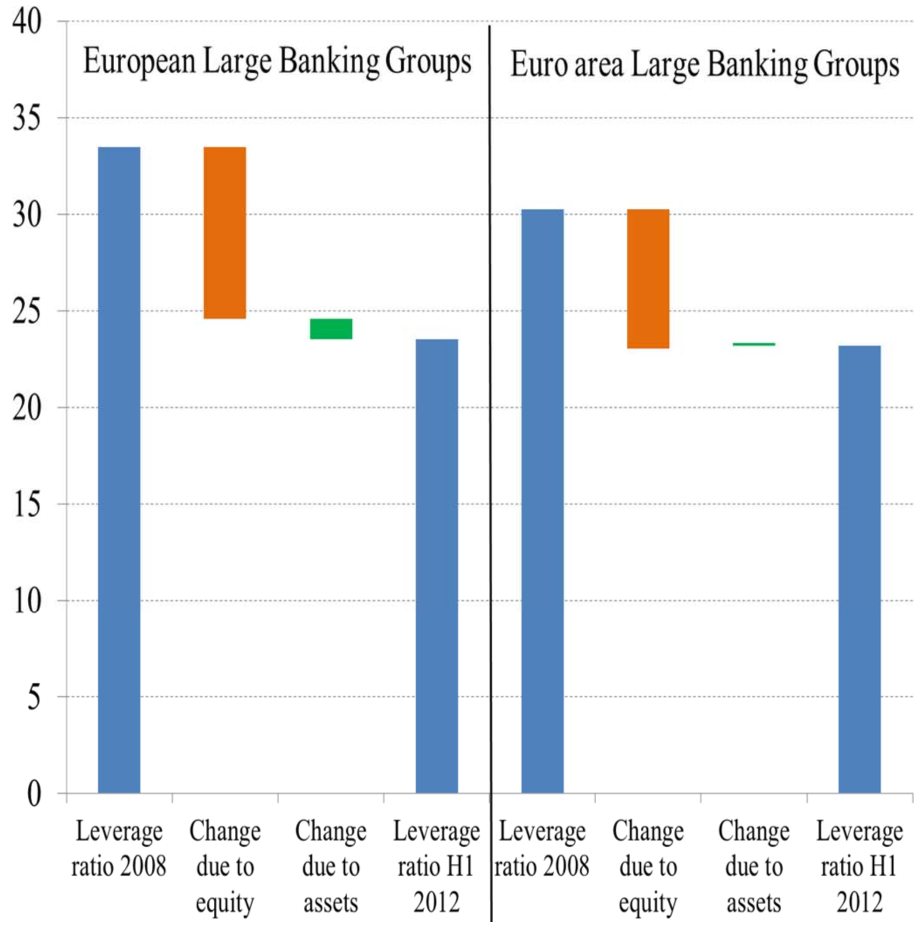
Equity issuance by euro area banks
(in € billion; Jan07-Oct12)



Source: ECB.

Note: In addition to the private equity issuance shown in the chart, government capital injections into euro area banks have amounted to around €225 bn since 2008.

Change of leverage ratio of large EU and euro area banking sectors *(ratio)*



Sources: Financial reports and ECB calculations.

But compliance with Basel III would still require further adjustments to capital positions

- **Recent EBA CRD IV monitoring report points to a total EU bank capital shortfall of around €380 bn**

Table 3

Estimated overall capital shortfall, Group 1 and Group 2 banks, in € bn

	Group 1 banks	**Group 2 banks**
Number of banks	41	110
Minimum		
CET1 shortfall – 4.5%	3.7	5.3
Tier 1 shortfall – 6.0%	13.4	7.5
Total capital shortfall – 8.0%	50.0	12.4
Minimum plus capital conservation buffer*		
CET1 shortfall – 7.0%	112.4	17.9
Tier 1 shortfall – 8.5%	223.8	24.8
Total capital shortfall – 10.5%	348.4	35.2

* Including the capital surcharge for global systemically important banks (G-SIBs).

Sources: EBA, CRD IV monitoring report based on end-June 2012 data.

Basel III

main design elements and implementation in Europe

Regulatory reform - Basel III

Main elements of the Basel III framework

- **Capital requirements**
  - Enhancing the quality (i.e. loss absorbency) of the capital base, focus on core elements of capital (common equity)
  - Increasing the quantity of capital (minimum + buffers)
  - Ensuring harmonisation and consistent application of requirements
- **Leverage ratio**
  - Supplementary, non-risk-based measure
  - Calibration subject to observation and revision
- **Liquidity ratios**
  - Liquidity Coverage Ratio (LCR) establishes a minimum level of high-quality liquid assets to withstand an acute stress scenario lasting one month
  - Net Stable Funding Ratio (NSFR) aims to ensure a closer alignment of the funding of longer-term assets or activities

Regulatory reform - Basel III

Implementation timeline and assessment

Capital

- Gradual implementation globally, starting from 1 January 2013
- Full implementation by 2019

Liquidity

- GHOS agreement in 2013: Revised LCR framework
- amendments to the definition of high-quality liquid assets (HQLA) and net cash outflows
- gradual implementation starting from 60% in 2015, reaching 100% in 2019
- the stock of liquid assets could be be used in times of stress (i.e. liquidity buffers)

Implementation review

- Carried out by the Basel Committee
- Aim is to ensure full and consistent implementation across jurisdictions
- First assessments for EU, US, JP already published on the BIS website

Implementation of Basel III in Europe

Key issues of implementation in Europe

- Implementation through a Directive (CRD IV) and a Regulation (CRR)
  - Discussions between European Council, Commission and Parliament are ongoing
  - Political agreement expected to be reached under the Irish Presidency
  - Implementation (probably) from 2014
- Aim to establish a single rulebook for credit institutions in the EU
  - Ensure level playing field
  - Mitigate regulatory arbitrage opportunities
  - Reduce compliance costs
  - Support financial integration
  - Enhance the single market for financial services

Implementation of Basel III in Europe

Single rulebook vs. national discretion

- Single rulebook designed for <u>micro</u>-prudential supervision should be complemented by discretionary measures for <u>macro</u>-prudential purposes
- Need for national discretion stems primarily from
  - Differences between countries in economic and financial cycles
  - Differences in structural features of the respective financial sectors
- A balance can be struck between the two objectives (single rulebook and national discretion)
  - Ex ante coordination at EU level for macro-prudential measures
  - Deviation from single rulebook only temporary
  - Only calibrations may change at national level, while concepts and definitions remain intact
  - Full transparency of measures

Macroeconomic impact of Basel III

Macroeconomic impact assessments

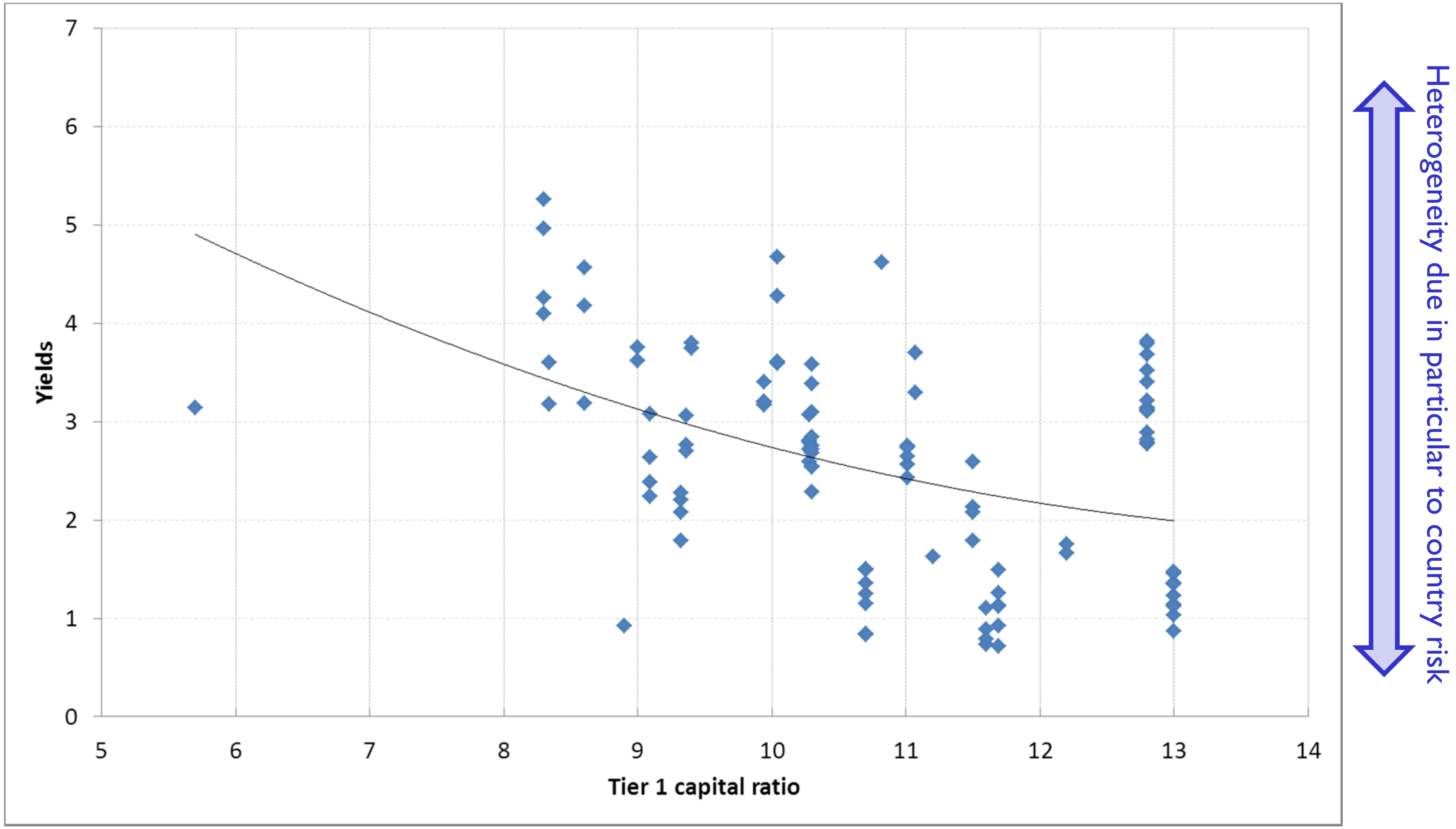
Costs and benefits of Basel III

- Impact assessments carried out at the initiative of the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS)
- Macroeconomic Assessment Group (MAG) evaluated the transitional costs of introducing higher capital and liquidity requirements
- Long-term Economic Impact group (LEI) assessed the long-term benefits of Basel III
- Main conclusion: manageable transitional costs against substantial long-term benefits
- Caveat: Assumed gradual implementation of Basel III, while a more frontloaded adoption could lead to more pronounced transitional macroeconomic costs

The markets' view (1)

Covered bond yields and Tier 1 capital ratio of euro area banks

(16 Jan. 2013, three to seven years' maturity, percentages)

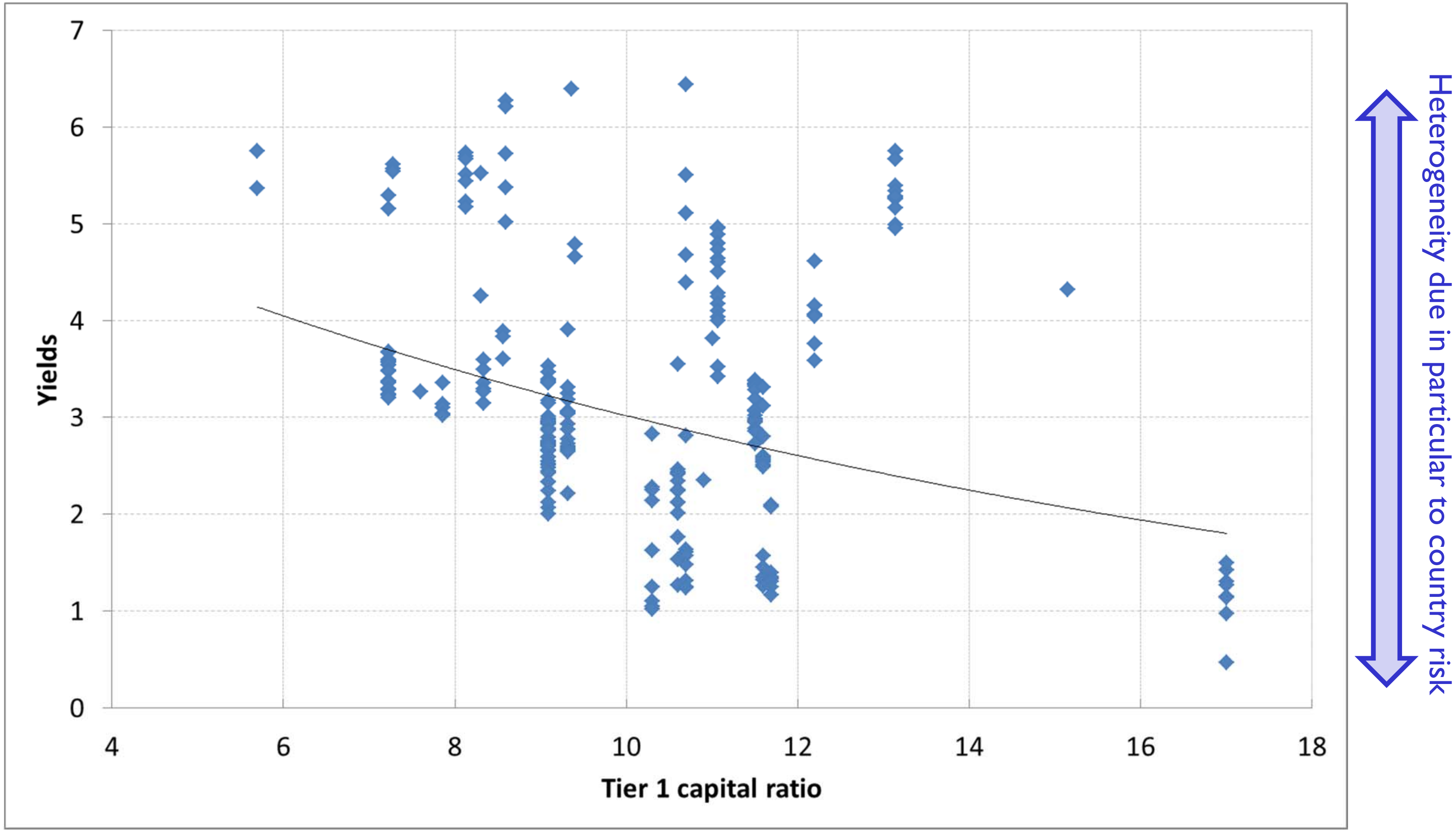


Source: Bloomberg.

The markets' view (2)

Senior unsecured bond yields and Tier 1 capital ratio of euro area banks

(16 Jan. 2013, three to five years' maturity, percentages)



Source: Bloomberg.

The Single Supervisory Mechanism

The Single Supervisory Mechanism (SSM)

Establishment of the SSM

- Need to speed up strengthening of Economic and Monetary Union because of:
  - Sovereign debt crisis
  - Contagion in the banking sector
- Milestones of the process in 2012
  - 29 June: Euro area Summit – Request to set up a single supervisory mechanism (SSM)
  - 12 September: European Commission proposal for a Council Regulation
  - 18 October: European Council conclusions on completing EMU. Objective to agree on legislative framework for SSM by 1 January 2013
  - 13 December: European Council agreement

The Single Supervisory Mechanism (SSM)

Two main advantages and goals of establishing the SSM

- Will address the so-called “financial trilemma”
  - Impossibility of achieving financial stability, financial integration and maintaining national financial policies in a globalised financial market
- Together with a single resolution mechanism, will help to break the negative feedback loops between sovereigns and banks
  - Increasing debt levels of sovereigns that provided financial support to struggling banks
  - Losses for banks from exposures to sovereigns under stress
  - Break the correlation between the cost of funding of euro area banks and that of their respective sovereigns
  - Need for a common resolution mechanism

The Single Supervisory Mechanism (SSM)

Main features of the SSM

- Single system of supervision
- The ECB will take all decisions regarding the banks, banking groups and respective components categorised as “significant” (around 150 banks in the euro area countries)
    - Banks with more than €30 billion in total assets
    - Banks representing more than 20% of domestic GDP (unless <€5 billion in assets)
    - 3 most significant banks in each country (unless justified by particular circumstances)
    - Banks receiving direct assistance from the EFSF/ESM
- The ECB can decide to exercise direct supervision of other banks

The Single Supervisory Mechanism (SSM)

Main features of the SSM (cont.)

- The national supervisors will take the decisions regarding “non-significant” banks subject to regulations, guidelines or general instructions
- Close cooperation with non-euro area Member States
    - The ECB can conduct supervision in a non-euro area EU Member State, following a request for close cooperation
- Transition
    - The SSM will start supervision on 1 March 2014 or one year after the entry into force of the regulation, whichever is later
    - ECB may choose to postpone the start if it deems that it is not ready

The Single Supervisory Mechanism (SSM)

ECB's guiding principles for establishing the SSM

- Comprehensiveness and strong institutional framework
- Independence
- Clear separation of monetary policy and supervisory responsibilities
- Decentralisation
- Consistency with the single market
- Accountability

The Single Supervisory Mechanism (SSM)

Establishment of a banking union

- "Towards a genuine Economic and Monetary Union"
  Final Report by the President of the European Council (December 2012)
- Core elements of a banking union:
  - A Single Supervisory Mechanism (SSM) consisting of the ECB and national supervisors
  - A single bank resolution mechanism, including an independent resolution authority and a European resolution fund
  - More harmonised and sufficiently robust deposit-guarantee mechanisms in the EU

Other regulatory initiatives

Other regulatory initiatives in banking

Crisis management and resolution framework in Europe

- Proposal of the European Commission published in June 2012
- Overriding policy objective: setting a harmonised EU framework which would enable national authorities to prevent systemic damage caused by disorderly failure of banks, without exposing taxpayers to risk of loss and causing wider economic damage.
- Approach:
  - emphasis on crisis preparation and prevention first;
  - stronger and more effective toolbox for early interventions;
  - harmonised procedures and tools for resolution
- ECB Opinion published on 29 November 2012
  - full support for the development of a recovery and resolution framework
  - ECB calls on the Commission to urgently present a separate proposal for an independent European Resolution Mechanism, including elements of a common European Resolution Fund.

Other regulatory initiatives in banking

Financial structures (Liikanen report)

- Report by the High-level Expert Group on reforming the structure of the EU banking sector published in October 2012
- Actions recommended in five areas:
    - Mandatory separation of proprietary trading and other high-risk trading activities
    - Possible additional separation of activities conditional on the recovery and resolution plan
    - Possible amendments to the use of bail-in instruments as a resolution tool
    - A review of capital requirements relating to trading assets and real estate-related loans
    - Strengthening the governance and control of banks
- Next steps:
    - Commission carries out an impact assessment in 2013
    - Regulatory initiative possibly in 2013 or 2014

Other regulatory initiatives in banking

Financial structures (Liikanen report), cont.

- Eurosystem stance is currently being prepared (to be published soon)
- Preliminary views:
  - The proposals in the Liikanen report are broadly supported
  - A legislative proposal ensuring a consistent framework for the EU should be put forward by the Commission as a matter of priority
    - some Member States are unilaterally going forward with national initiatives
    - piecemeal approach based on similar but divergent national approaches should be avoided
  - Attention should be paid to carrying out a comprehensive impact assessment
    - structural differences in banking sectors may lead to different consequences for the real economies of Member States

Other regulatory initiatives in banking

Systemically Important Financial Institutions (SIFIs)

- Address the negative externalities and moral hazard issues linked to the ‘too-big-to-fail’ problem
- The Financial Stability Board (FSB) focuses on developing a comprehensive policy approach to SIFIs.
- In November 2011 specific measures were announced for global systemically important banks (G-SIBs), including a common equity capital surcharge.
- The BCBS and the FSB completed the framework in 2012 by extending it to domestic systemically important banks (D-SIBs).
- Substantive work was done in 2012 to enhance both the data quality and the robustness of the methodology underlying the G-SIB identification and calibration.
- An updated set of G-SIBs based on the most recently available data was published in November 2012

Other regulatory initiatives in banking

Shadow banking

- Work coordinated by the Financial Stability Board (FSB), in cooperation with the Basel Committee and IOSCO
- Five work streams have been launched to develop proposed policy recommendations:
  - Banks’ interactions with shadow banking entities
  - Money market funds
  - Other shadow banking entities
  - Securitisation
  - Securities financing and repos
- Consultative Document on policy recommendations published in Nov. 2012
- In the EU context, the Commission published a Green Paper on shadow banking
  - Focus on the need to increase monitoring and regulation thereof

Other regulatory initiatives in banking

Benchmark rate reform

- Suspicion of LIBOR manipulation triggered various initiatives by the European Commission (public consultation on the regulation of indices), the EBA-ESMA (public consultation on the principles for benchmark setting in EU), Wheatley report in UK, and the BIS (central bank perspective)
- General purpose of work streams: restore public confidence in benchmark setting, prevent further abuse, enhance governance and assess possible changes in benchmark definition and calculation methodology
- While reference rates should remain private market initiatives, the ECB supports initiatives because:
  - of the role reference rates, such as EURIBOR and EONIA, play in the transmission of monetary policy
  - of the systemic importance of reference rates in the financial system
  - credible and reliable reference rates are a public good

Other regulatory initiatives in banking

Benchmark rate reform, cont.

- The ECB's response is driven by a few key principles:
  - Differentiate between short-term measures aimed at restoring confidence in integrity of benchmarks and longer-term changes;
  - In the short term, governance reform can enhance and restore credibility of rate setting;
  - Governance and regulatory reform should balance the need for enhanced controls and safeguards with the cost efficiency of banks' contribution process;
  - Regulation should be uniformly applied and enforced across euro area to prevent risk of market fragmentation;
  - Need for continuity in rate setting;
  - Continuity of contracts is a key requirement to be assessed for any change to be introduced;

Other regulatory initiatives in banking

Benchmark rate reform, cont.

- In the longer term, more far-reaching changes in the reference rate definition and calculation methodology can be considered. For example, transaction-based EURIBOR calculation following thorough testing, broadening of panel;
- In the longer term, the current reference rates based on unsecured lending might be complemented by others based on secured lending, given the increasing weight of the latter, or based on a risk-free rate such the OIS; however, reference rates based on bank unsecured lending rates are probably still needed;
- Given the uncertainty about how financial markets will emerge from the crisis, it may be however premature to elaborate at this juncture these long-term solutions; this process should be primarily driven by the market, based on the needs of end-users, while being supported by the public sector;
- In the short term, restoring public faith in the credibility of these reference rates and ensuring their continuous viability are urgent matters. We welcome EBA and national supervisors encouraging banks to remain panel members;

Regulatory initiatives in financial infrastructures

International level

- **G20 mandate for OTC derivatives reform (Pittsburgh Summit, 2009):**
  - ✓ Implementation of mandatory central clearing, reporting and electronic trading obligations for OTC derivatives by end-2012
  - ✓ Implementation delayed and need to resolve cross-border differences, but significant progress expected in 2013
- **CPSS-IOSCO Principles for Financial Market Infrastructures (April 2012)**:
  - ✓ Update and strengthen existing supervisory and oversight requirements for CCPs, (I)CSDs, systemically important payment systems and trade repositories
  - ✓ Take into account lessons for infrastructures from financial crisis as well as specific risk management challenges in OTC derivatives markets
  - ✓ Currently being implemented
- **CPSS-IOSCO consultative report on recovery and resolution of financial market infrastructures (July 2012)**
  - ✓ Promote infrastructure resilience also in exceptional market conditions
  - ✓ Reduce moral hazard risk relating to infrastructures considered "too big to fail"

Regulatory initiatives in financial infrastructures

EU level

- **European Market Infrastructure Regulation (EMIR)**
  - ✓ Establishes single passport regime for EU CCPs and trade repositories in line with CPSS-IOSCO principles
  - ✓ Implements mandatory central clearing and reporting obligations for OTC derivatives
  - ✓ Adopted in July 2012; expected to fully apply as of Q2 2013
- **Central Securities Depository Regulation (CSDR)**
  - ✓ Establishes single EU passport regime for EU (I)CSDs in line with CPSS-IOSCO principles
  - ✓ Commission proposal issued in March 2012; still under negotiation
  - ✓ Adoption expected prior to launch of T2S in June 2015
- **Markets in Financial Instruments Directive (MiFiD)**
  - ✓ Updates EU rules for securities and derivatives trading
  - ✓ Will implement electronic trading obligation for OTC derivatives
- **Proposal for EU framework for recovery and resolution of non-banks**
  - ✓ Issued in October 2012

Thank you for your attention