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Regulatory reforms and financial integration

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Introductory remarks

Financial integration has contributed significantly to the development of EU economies and the progress of the Single Market. It incentivised cross-border banking and supported the availability of finance for households and businesses, also reducing the spreads in the cost of funding across jurisdictions. Financial integration has been, however, one of the main casualties of the crisis, both in Europe and at the global level.

The fragmentation of the Single Market was in particular associated with the financial and sovereign debt crises and was very much determined by an institutional setting in which crisis management was left to country-specific solutions and national policy measures. When the crisis hit Europe, the political decision was taken that national governments should bear the exclusive responsibility and costs of rescuing their banks. Market participants started assessing intermediaries on the basis of the credit standing of the countries providing them with the safety net. A vicious circle developed between the banks and their sovereigns which led bank funding markets to a halt, with negative repercussion on cross-border lending and a generalised weakening of the Single Market.

Following resolute policy actions on various fronts, financial integration has recovered over the last years, although at a moderate pace and unevenly. On the regulatory side, the global regulatory reforms endorsed by the G20 Leaders strengthened the international prudential standards and established for the first time common criteria for crisis management and resolution, addressing the "too big to fail" issue. Tighter prudential criteria and clear *ex ante* arrangements for managing cross-border crisis are essential to re-establish trust amongst authorities in different jurisdictions and reverse ring fencing measures introduced in the heat of the crisis. In the EU, the reforms represented a unique opportunity for developing the Single Rulebook: truly common rules for EU banks, applied consistently across jurisdictions on a going-concern basis and providing for a collective response in the case of a crisis, are a precondition for a smooth functioning of the Single Market.

The balance sheet repair has been also instrumental to restore the trust in the EU banking sector and amongst national authorities, and laid the foundations for the recovery of cross-border banking. The EBA has coordinated a joint effort by European supervisors to significantly increase the quantity and improve the quality of capital at EU banks. Common equity tier 1 (CET1) capital ratios, rose from around 9% in 2011 to over 13.5% in 2016.

The establishment of the Banking Union has been explicitly targeted to break the vicious link between banks and their sovereigns, through single supervision and the fast integration of the mechanisms for resolution funding – although the construction of a fully integrated safety net is still lacking some crucial components, such as a common deposit guarantee scheme.

In the euro area, unconventional monetary policy interventions – particularly the Outright Monetary Transactions (OMT) in 2012 – have triggered a "reintegration trend"[1]. Additional monetary policy measures and the start of the Banking Union further stimulated this trend.

Tonight, I would like to describe the developments in financial integration following the policy measures adopted over the past years, track the progress in the institutional setting as well as the areas where additional work is needed, discuss the impact of the pending regulatory reforms on the functioning of global financial markets.

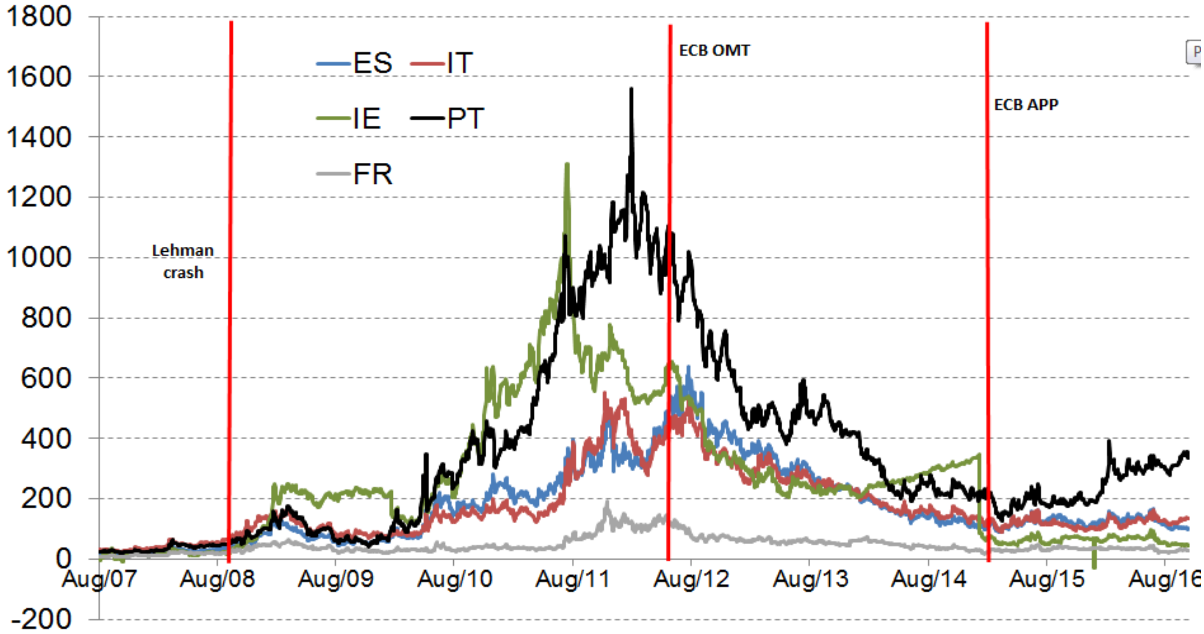
[1] ECB (2016), Financial integration in Europe.

Tracking the fragmentation in the Single Market

After the default of Lehman Brothers in 2008 and the start of the euro area debt crisis in 2010, the European financial system has shown evident signs of financial fragmentation. This has materialised through higher sovereign and corporate credit spreads (charts 1 and 2) but mainly by a drop in cross border lending. At the end of 2011, the spread of Italian and Spanish 10y government bonds with the German Bund were six times higher than at the beginning of 2010, increasing respectively by 450 and 350 bps.

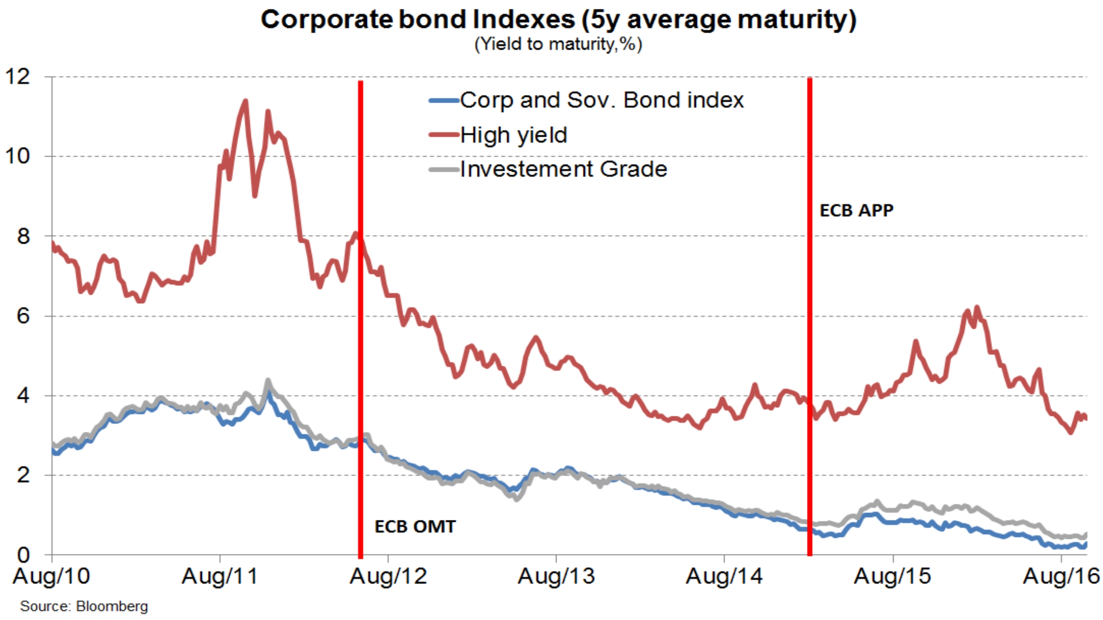
Chart 1

10 Government bond spread with Germany for selected countries (bps)



Source: Bloomberg

Chart 2

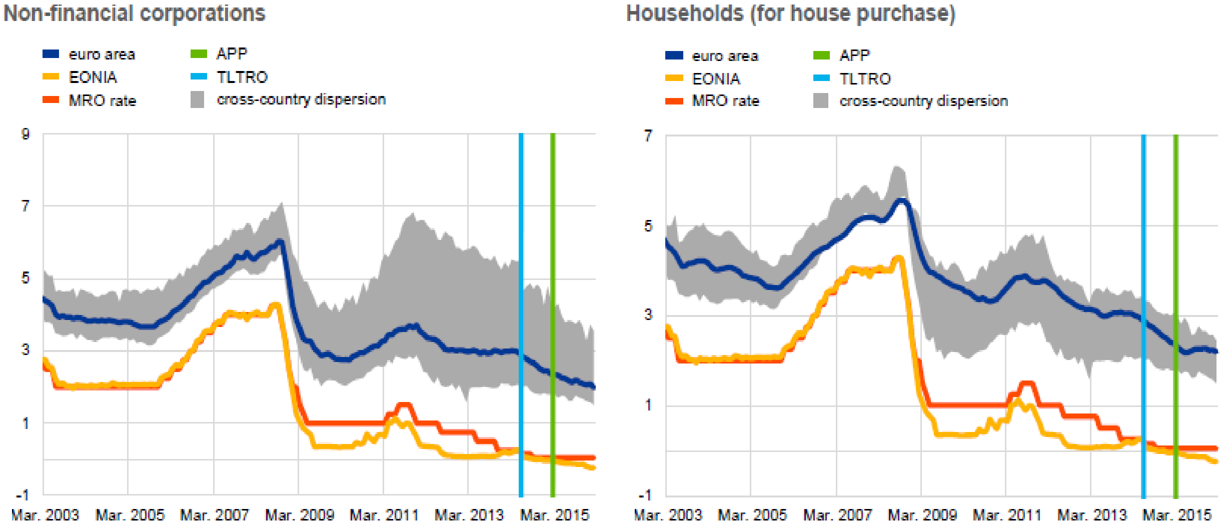


While borrowers benefited from historically low interest rates on average, financial fragmentation led to high interest rate dispersion for firms and households across the euro area countries (chart 3). At the same time, investors revised their risk appetite and started searching for yield, potentially distorting the valuation of assets. The combination of these forces, in turn, affected the effectiveness of the monetary policy transmission.

Chart 3

Composite bank lending rates for NFCs and households

(percentages per annum)



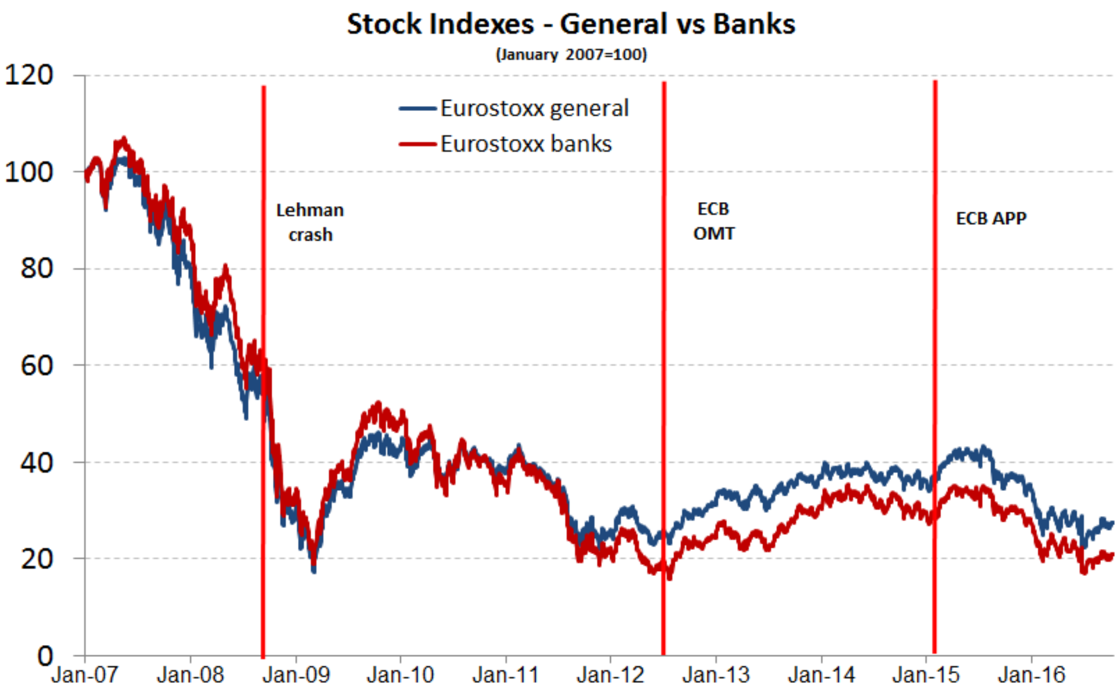
Sources: ECB and ECB calculations.
Notes: The indicator is computed by aggregating short and long-term rates, using a 24-month moving average of new business volumes. The cross-country dispersion displays the min-max range after trimming off extreme values.

More importantly, the retrenchment of banks within the borders of their home country and the pressure from many national supervisors to ring-fence capital and liquidity contributed to the fragmentation of the Single Market. The progress in financial integration achieved as a result of a long standing, patient and difficult effort in regulatory harmonisation and common institution building was reversed in just a few months.

The decision to let national authorities manage the crisis, even in cases in which European programmes were deployed, implied that the restructuring process has occurred within a predominantly national dimension. As documented in the report of the ECB on financial structures, mergers and acquisitions activity has been on a declining trend, particularly evident for cross-border transactions.

The dynamics of the stock exchange reflects also the destruction in value generated by these trends: main equity indexes – especially the European banking sector one – have slumped to levels 70% lower than in 2007 and since then they have only showed a timid sign of recovery in the first four months of 2015 (chart 4).

Chart 4



Source: Bloomberg

Addressing fragmentation to restore a well-functioning financial system in the EU has been one of the key objectives of the banking regulators and central banks. Immediate emergency responses to ensure banks' access to liquidity were followed by more structural measures, aiming at strengthening the institutional setting for banking supervision in Europe. The long term refinancing operation (LTRO) and especially the Outright Monetary Transactions (OMT) have been real game changers.

Central banks have guaranteed the functioning of the liquidity market, first by announcing in 2011 two LTROs and then starting the OMT in 2012 to cool down tensions on the sovereign bond market. Two years later, additional unconventional monetary policy instruments were also implemented, namely the Asset Purchase program (APP) and the targeted LTROs (TLTROs). In March 2015, the APP was extended to a broader range of securities and the amount of the monthly asset purchases increased. The announcement of the Banking Union in 2012, followed by the quick start of the Single Supervisory Mechanism (SSM) and the establishment of the Single Resolution Mechanism (SRM), has put the basis for the supranational supervision of a large part of the Single Market.

All these policy initiatives contributed significantly to restore funding conditions and support lending at European banks, with interbank liquidity gradually picking up over the past five years. In the last two years, also government spreads have considerably narrowed and stabilized after the OMT was implemented, going down to the 2010 pre-sovereign crisis levels. Risk premia on corporate and sovereign bonds have receded and the dispersion on the bond market has further decreased. At the same time, the interbank lending rates dropped substantially as a result of the increase in liquidity provided via the TLTROs, while money market activity reduced as banks held a larger amount of excess liquidity. Retail interest rates paid by banks' customers have also become less dispersed across countries.

This trend is confirmed by the latest "price" indicators compiled by the ECB, which show that the average degree of financial integration across money, bond, equity and banking markets increased moderately in 2015 compared with 2014, even though dispersion remains. On the other hand – and I am still quoting the ECB data for the euro area – cross-border holdings of equities and bonds suggest that the fragmentation remain high in terms of capital flows across borders.

In fact, bank lending growth has only stabilized recently, remaining still subdued. Cross-border lending stays at low levels as also confirmed by BIS data on banks' cross border claims (charts 6 and 7). Since Q3 2008, European banks have reduced significantly their cross-border exposures to both banks and the real sector. In particular, inter-bank lending decreased by more than 40%.

While lending rates to firms and households have started to pick up over the recent years, and prices show some degree of convergence across borders, cross-border loans to firms and households showed only a very mild increase for the first time in Q1 2016, also in connection with the gradual economic recovery.

Chart 6

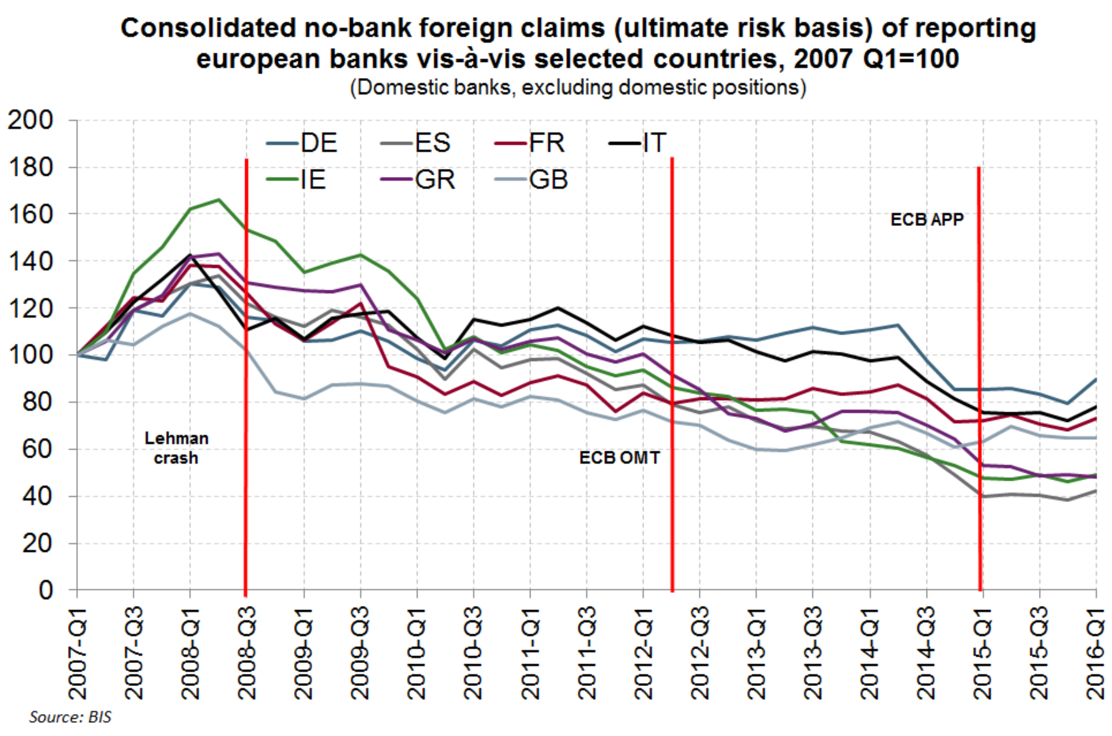
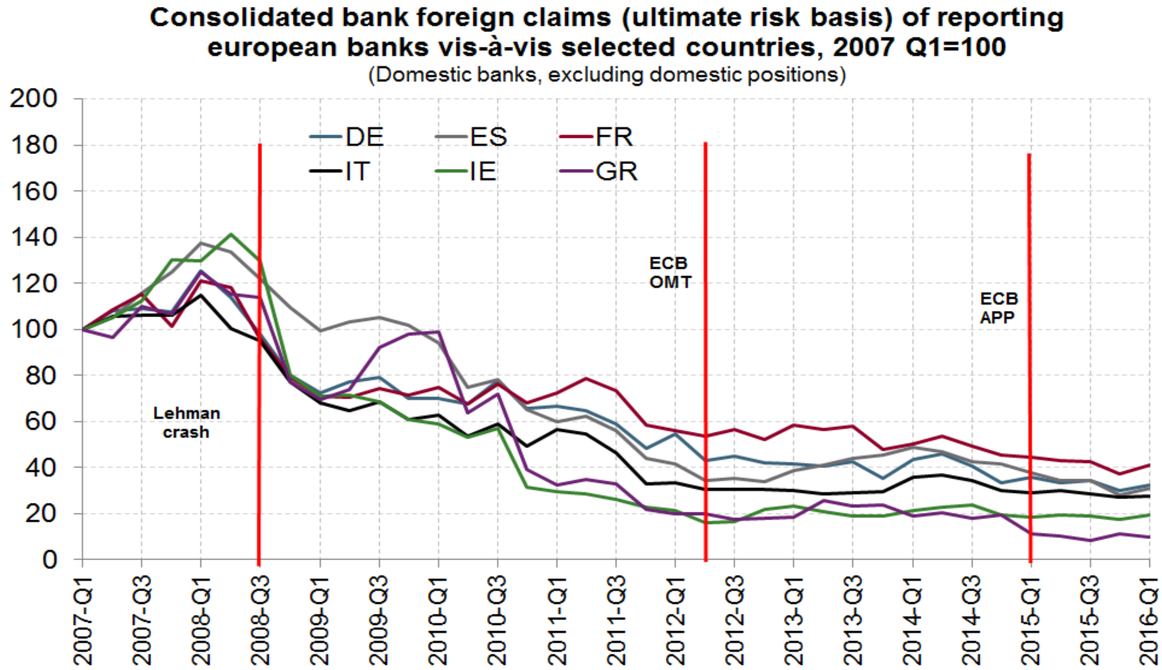


Chart 7



Source: BIS

It is too early to assess whether the re-integration trend in the European financial system is tailing off or not. My main concern is that, while there seems to be a positive trend in the price indicators, there is still much to be desired in terms of recovery of cross-border flows and lending, while banking structures have been refocused mainly on core home markets. This calls for further actions for returning to a well-functioning Single Market.

Which preconditions for financial integration in the EU?

A level playing field is the principle that underpins the effective and smooth functioning of the Single Market. It is not surprising that the development of a common set of rules was at the heart of the EBA mandate. However, as our day-by-day experience shows, having the same rules is not sufficient for achieving a true level playing field across the EU.

First, while the regulatory framework should be as comprehensive and clear as possible, it cannot include all possible technical details: banking supervision requires room for judgment and case-by-case assessment. This is essential to avoid a drift towards a 'one size fits all' model, where supervision ends up being merely a 'tick box' compliance exercise. In addition, there are always emerging issues – new risks or innovative banks practices – that are not covered by the rules and need to be dealt with quickly adapting supervisory responses.

This brings me to focus on the convergence of supervisory practices, the second essential ingredient for ensuring the level playing field. The goal here is to achieve comparable supervisory approaches and consistent supervisory outcomes across the EU, which means simply that – given the common regulation and allowing for the necessary judgment – institutions running broadly similar business models and with broadly similar risk profiles should be subject to broadly similar supervisory responses, regardless of the jurisdiction in which they operate.

Having achieved significant progress over the last years in the development of the Single Rulebook, it is crucial to focus more on harmonising supervisory practices, which are still considered as very diverse across Europe, not fully transparent and a material obstacle to cross-border banking. The actions of supervisory authorities have been perceived as a factor trapping capital and liquidity resources within jurisdictions, at the expense of their efficient allocation within a cross-border group and with a subsequent impact on pricing.

The EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) have significantly contributed to a common understanding and more consistent use of Pillar 2. Based on our assessment of the convergence of supervisory practices, most authorities established processes that – while cognisant of the specificities of local markets – are broadly in line with our guidance[2].

There are, however, areas where authorities still face challenges to converge, for instance with regard to the setting of institution-specific capital requirements. Divergences in supervisory approaches towards the nature and level of capital requirements, as well as in the application of automatic restrictions on distributable amounts – partly due to the lack of clarity in the relevant regulation – generated uncertainty among institutions and investors and, in some cases, temporarily affected capital planning and investment decisions. In fact, in the first half of 2016, the market for additional Tier 1 instruments (AT1) came to an almost complete halt, following the widespread uncertainty on supervisory approaches adopted by different competent authorities for the automatic restrictions to distribution and AT1 payments, known as maximum distributable amount (MDA).

This is a good example of a topic that – despite being addressed in the common legislation – might be subject to interpretation and different supervisory practices. It also shows how differences in supervisory practices may have far-reaching effects, not only for banks subject to different supervisory treatment, but also for other stakeholders, including the investor community. Different

[2] EBA (2016), Report on the convergence of supervisory practices.

supervisory practices may negatively affect allocation of capital within a banking groups and in the system as well as create advantages or disadvantages for banks with no other reason that the inconsistent application of common rules.

For this reason, in 2016, we have put significant emphasis on Pillar 2 topics and on the implementation of our SREP Guidelines. Our opinion on MDA addressed some of most urgent concerns related to the stacking order and the role of Pillar 2 capital requirements in the MDA framework, but we have also urged the Commission to clarify this point in the incoming revision of the CRD. We are currently working on finding a consistent approach to incorporating outcomes of supervisory stress testing in the SREP framework, by means of introducing non-legally binding Pillar 2 capital guidance sitting on top of the binding capital requirements.

The challenges we face in the SREP process are being replicated in the assessment of recovery and of resolution planning, in resolvability assessments and in the setting of total loss absorbing capacity (TLAC) and minimum requirement of own funds and eligible liabilities (MREL). To some extent, I would argue that success in establishing consistent practices in this area is even more essential for restoring financial integration. As a matter of fact, ring fencing measures come as a natural response when authorities are concerned that a crisis at a branch or subsidiary of a foreign institution would impact the local safety net. Joint decisions in supervisory and resolution colleges, within a clear and legally binding framework, are the only way to restore trust in collegial, coordinated solutions, as opposed to the fragmented national responses we have seen in recent years.

Of course, the Banking Union is a powerful driver for change. In 19 Member States, supervision is now conducted according to completely integrated methodologies and fully centralised at the ECB for significant institutions. But it remains vital to keep the development of supervisory practices in the Banking Union well connected with the EU-wide convergence agenda, for two reasons: first, the ability of the Single Supervisory Mechanism (SSM) to follow completely unified processes and deliver fully consistent outcomes in its own jurisdiction is constrained by the level of harmonisation achieved with the Single Rulebook - if common EU rules leave room for discretion in national implementation, the SSM will be obliged to apply different rules to otherwise identical banks, just because they are headquartered in different Member States; second, if the harmonisation of practices were pursued only within the euro area, and different approaches were to prevail in Member States not participating in the Banking Union, we would risk crystallising a new segmentation within the Single Market, between "ins" and "outs".

The role of global standards

Lastly, I would like to draw your attention on the particularly important role that global standards can play in the context of fragmented banking and financial markets. Indeed, market fragmentation goes well beyond the European boundaries and the current divide across markets and regions seems to challenge the business model of the 'global bank' – as we have come to know it.

Internationally active banks have historically served the fundamental purpose of allocating financial resources from regions with excess savings to regions with excess investments. With the global financial turmoil, interconnections across global banks proved to be one of the channels of contagion and international banking experienced significant disruptions. Since then, global banks have reviewed their business strategy and implemented radical restructuring plans. Global regulators have taken important steps towards ensuring the safety and resilience of these entities. We have ensured that banks hold higher amounts of capital as well as capital of higher loss-absorbency capacity; we have introduced countercyclical buffers and buffers that are specific to systemically important institutions; we have agreed on new requirements to ensure stability of institutions' funding and liquidity; also, we have set out criteria to ensure that authorities can orderly resolve banks, irrespective of their size and systemic relevance.

As part of the post-crisis agenda, the Basel Committee has also initiated a review of the consistency in the calculation of risk-weighted assets (RWAs), which shed light on the excessive variability in the outcomes of banks' internal models and resulted in an ambitious plan of additional regulatory adjustments. The policy options currently under discussion include (i) introducing constraints on the internal modelling of credit risk to address the 'unwarranted' RWA variability stemming from model error and arbitrage; (ii) improving the risk-sensitivity of the standardised approach to credit risk; (iii) reviewing the operational risk framework, where internal models have in several instances performed poorly.

Addressing the issue of RWA variability is essential to restore the reliability and consistency of international standards. If the use of internal models by banks and the supervisory guidance and approval practices of authorities are driving to significantly different results for similar exposures to risk, the legitimacy of international standards and their ability to support cross-border banking is compromised.

The debate on this last chapter of the Basel Committee's reforms is focused almost exclusively on the impact of the proposals. To some extent, this is understandable, as the proposals submitted to consultation do not seem compatible with the objective set by the Governors and Heads of

Supervision (GHoS) and the G20 Leaders not to generate a significant increase in capital requirements. Still, this is an excessively limited perspective. In my view, what is essential is delivering a framework that is fair and risk-based. Any increase in capital requirements need to be justified on the basis of the underlying risks. Increases in capital requirements may be warranted, if they target portfolios where internal models performed badly; they are not justified if they hit hard banks and areas of business that have not proven particularly risky.

Throughout the design and calibration of the Basel Committee's package, the EBA's position has been guided by four clear principles: (i) risk-sensitive internal models should remain the first driver of capital requirements in the EU, whereas the combined constraint of non-model based metrics – such as the leverage ratio or the output floors – should act as a backstop; (ii) the RWA variability stemming from IRB models should be addressed looking at its main drivers, for instance lack of data for LGD estimation in low-default portfolios; (iii) standardised portfolios, which are immune from the RWA variability problem should not see an increase in capital requirements; (iv) lastly, a more reliable solution to compute operational risk capital requirements is highly warranted, due to the failure of the advanced measurement approach (AMA) to quantify risks in a sufficiently prudent and comparable fashion.

Both industry and regulatory evidence are clear that the reform will have a divergent impact on different regions of the world. Designing global standards for structurally different financial markets has always been a challenge. I won't have to remind you that different jurisdictions within the Basel Committee's remit are characterised by a different degree of corporates' reliance on bank lending; a different concentration of mortgage lending on bank's balance sheets; different approaches to the use of external ratings and internal models in the calculation of capital requirements; different legal approaches to conduct and operational events. Also, we are aware that the implementation of different accounting standards may not always provide a consistent and truly comparable picture of banks' regulatory positions across the globe.

From a European perspective, some of the proposed constraints to the use of internal models, such as output floors, would have a significant adverse impact on low risk business - for instance, residential mortgages.

Despite all these differences, the standards laid out by the Basel Committee are an essential common yardstick if we want to support safe and sound cross-border banking on a global scale. We have a duty to do our utmost to achieve an agreement and restore an international level playing field. All parties have to make an effort to understand the specificities of other models of financial intermediation and avoid triggering unwarranted disruptions. An agreement is particularly important at the current global juncture, characterised by fragile trade and growth prospects and high vulnerability to shocks.

Conclusions

The efforts made by policy makers at the international and European level have been effective in enhancing the resilience of banks, but signals are still mixed as to the progress made in re-establishing an environment supportive of financial integration. Walls and ditches have been built to prevent the crisis from spreading and protect local savers and taxpayers, and they are not easily dismantled.

Cross-border banking groups, which had been the main drivers of financial integration in the 2000s, have been subject to a sort of “soft break-up”, reflecting the segmentation in markets for banking services.

I believe it is our duty to strive to find institutional solutions, cooperation arrangements and practical mechanisms which foster trust and mutual reliance between home and host authorities, so that cross-border banking business could flourish again, purged of the excesses that led to the crisis. Strong international standards, a far reaching Single Rulebook in the EU, progressive convergence in supervisory practices are fundamental elements of this strategy. The EBA is committed to moving forward and expects a positive engagement with the banking industry on this agenda.