Financial integration and stability in Europe:

the role of the European Banking Authority

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15th China Beijing International High Tech Expo

China Financial Summit 2012

Beijing

23 May 2012

Dear CHITEC host, Ladies and Gentlemen,

It is a pleasure to have been invited to address you this morning at the China Financial Summit 2012.

Given the very difficult environment we are facing in the financial markets, and especially in the European banking sector, this conference provides an excellent opportunity to give this international gathering some insight into the recently established European Banking Authority, the EBA, including the role it plays in tackling the crisis, and in strengthening the regulatory framework for European banks. While the immediate challenges are dominating our thoughts at present, it is also important that we continue to develop the structural changes necessary to deliver a more secure and stable banking environment for the long term.

The extent of the problems which have beset the global financial system over the last five years are unprecedented in modern times and have exposed serious weaknesses in financial regulation and supervision. In his February 2009 report, Jacques de Larosière pointed to the belief that in the run up to the commencement of the crisis in 2007, financial regulation and supervision had been too weak and provided the wrong incentives. Lack of adequate macro-prudential supervision, ineffective early warning mechanisms, lack of frankness and cooperation between supervisors and lack of common decision making process were among the key lessons learned from the crisis. We had a Single Market, closely integrated especially after the introduction of the euro, but the regulatory and supervisory environment has remained very diverse, notwithstanding the efforts for harmonisation.

A key component of the European response to addressing these deficiencies was the establishment of the European System of Financial Supervision on 1 January 2011. This includes the European Systemic Risk Board (ESRB), in charge of macroprudential supervision, and the three European supervisory authorities, the EBA for banking, ESMA for securities and markets and EIOPA for insurance and occupational pensions.

The EBA has been given a wide-ranging mandate. In the field of supervision, while the day-to-day oversight of banks' safety and soundness remains a responsibility of national authorities, the EBA has been entrusted with key responsibilities. These include the regular conduct of risk assessments, which should also lead to the establishment of a risk dashboard, and of area-wide stress tests, aimed at ensuring the resilience of European banks in front of adverse shocks. The EBA also fosters cooperation between home and host authorities and actively participates in and oversees the work of supervisory colleges for cross-border groups. Additional tasks are envisaged in the area of crisis management where the EBA is in charge of coordinating recovery and resolution plans for the major European banking groups. In the area of rule making, the EBA plays a major role in the establishment of the so-called Single Rulebook – i.e. technical rules truly uniform throughout the European Union, adopted through legal instruments that are directly binding in all the 27 Member States of the Union. Last but not least, we have been entrusted with the responsibility for monitoring and tackling consumer issues.

Let me first give you an overview of the EBA’s role and activities in relation to micro prudential supervision, and namely to the Authority’s efforts in tackling the financial crisis.

The EBA’s efforts in tackling the crisis

The EBA’s initial priorities were centered on the challenges raised by the deterioration of the financial market environment. In the first part of 2011, we conducted a stress test exercise, aimed at assessing the capital adequacy of the largest European banks in front of adverse macroeconomic developments. The exercise focused on credit and market risks and also, in recognition of the risks that subsequently crystallised, incorporated sensitivity to movements in funding costs. Banks were required also to assess the credit risk in their sovereign portfolios. In many respects, I believe the exercise was successful: in order to achieve the tougher capital threshold, anticipating many aspects of the new Basel standards, banks raised €50bn in fresh capital in the first four months of the year; we set up a comprehensive peer review exercise, which ensured consistency of the results across the European Single Market, notwithstanding the many differences in national regulatory frameworks; the exercise included an unprecedented disclosure of data (more than 3200 data points for each bank), including, amongst other things, detailed information on sovereign holdings.

However, the progress of the stress test was tracked by a significant further deterioration in the external environment. The main objective of restoring confidence in the European banking sector was not achieved, as the sovereign debt crisis extended to more countries, thus reinforcing the pernicious linkage between sovereigns and banks. Soon after the completion of the stress test, most EU banks, especially in countries under stress, experienced significant funding challenges.

In this context, the IMF and the European Systemic Risk Board (ESRB), called for coordinated supervisory actions to strengthen the EU banks' capital positions. The EBA assessment was that without policy responses, the freeze in bank funding would have led to an abrupt deleveraging process, which would have hurt growth prospects and fuelled further concerns on the fiscal position of some sovereigns, in a negative feedback loop. We then called for coordinated action on both the funding and the capitalisation side. While advising the establishment of an EU-wide funding guarantee scheme, the EBA focused its own efforts on those areas where it had control, primarily bank capitalisation.

To this end, the EBA's Board of Supervisors, comprising the heads of all 27 national supervisory authorities, discussed and agreed that a further recapitalisation effort was required as part of a suite of coordinated EU policy measures. This resulted in the EBA issuing a Recommendation that identified a temporary buffer to address potential concerns over EU sovereign debt holdings and required banks to reach 9% Core Tier 1. The total shortfall identified was €115 bn. The measure, agreed in October 2011 and enacted in December 2011, seeks that Supervisory Authorities should require those banks covered by its Recommendation to strengthen their capital positions by end of June 2012. The Recommendation was swiftly followed by the ECB's long term refinancing operations (LTROs), arguably the key "game changer" in this context. The LTROs allowed banks to satisfy their funding needs in front of a significant amount of liabilities to roll over in 2012, thus preventing a massive credit crunch. The recapitalisation was a necessary complementary measure: while banks needed unlimited liquidity support, to keep supporting the real economy, they had to be asked to accelerate their action to repair balance sheets and strengthen capital positions. When the process is completed, European banks will be in a much stronger position, also vis-à-vis their main peers at the global level.

The EBA is, in general, satisfied with the progress made in the fulfilment of this Recommendation and notes that the actions taken by the bulk of banks include capital strengthening and adequate recognition of losses. In addition, three banks identified as having weaknesses have subsequently undergone restructuring processes and will no longer exist in the same form as at the moment of the stress test. We have put a lot of efforts to avoid that banks reached the target ratio by cutting asset levels instead of raising capital, thus reducing credit availability for corporates, especially small and medium enterprises and households.

However, a deleveraging process is needed in the banking sector. It has already started, with a different pace in different areas of the global financial system and needs to be accomplished in an ordered fashion.

The first step has been the increase in capital levels, long overdue and one of the cornerstones of the regulatory reforms endorsed by the G20 Leaders. The second step requires a reduction in size of balance sheets, especially by addressing non-performing assets and de-risking in areas such as capital market activities and real estate lending, which grew too much in the run-up to the crisis. The third step entails a refocusing of business models, especially towards more stable funding structures and the gradual exit from the extraordinary support measures put in place by central banks.

I am convinced that without an ordered deleveraging process, through a significant strengthening of capital and a selective downsizing of asset levels, we would fail addressing the fragilities that are preventing banks from performing their fundamental functions.

Supervisory Colleges

The misalignment between the international nature of the major banking groups and a national system of supervision has been a contentious subject for many years. In the years preceding the crisis and in an effort to improve supervision, colleges of supervisors were established, to varying extents, for major banking groups. However, as the financial stresses developed in 2008, these structures did not work effectively in a large number of cases. The already difficult situation was compounded by the lack of dialogue and information exchange between supervisory authorities, as national priorities took precedence in the decision making process.

Given the problems which this lack of cooperation presented, there was a clear need to radically overhaul the voluntary structures which existed. This need has manifested itself in legislative changes to the Capital Requirements Directive (CRD), the primary European legislation that implements the Basel accord for banking in the EU, and in specific provisions incorporated into the mandate of the EBA. Supervisory colleges are now required for all cross border banking groups operating in the European Economic Area and the EBA has been granted full participation rights as a competent authority. The EBA staff are attending supervisory colleges of the major systemically important groups in Europe and go to these meetings with a clearly defined goal of promoting and monitoring the efficient, effective and consistent functioning of colleges as well as fostering the coherent application of the EU law by supervisors. Also, since 2011, European colleges are the forum in which the consolidating supervisor and the competent authorities responsible for the supervision of subsidiaries are required to reach a joint decision on the capital of the group and the relevant subsidiaries. The formal system of joint risk assessments, which underpins this process, and the drive to make the core supervisory decision on capital, represents a major step forward in the coordination of cross border supervisory processes.

I am glad to say that in many of these meetings for banking groups which have operations outside the European Union, consolidating supervisors will often invite supervisors from countries outside the EU so that they can give a firsthand account of the risks being run in the entities they oversee.

The EBA strongly believes the work to implement these arrangements has to be strengthened in order to improve the effectiveness of supervision for cross-border groups. Good progress has been made in many quarters. For instance, national authorities are coming to their joint decisions on the capital of a banking group using the common structures and templates set out in guidelines issued by the EBA. However, there is still a long way to go to enhance consistency in supervisory outcomes and to achieve adequate levels of information exchange and cooperation.

Crisis Management

It is at these times of intense challenge, that structures and relationships are most tested, and we actually see how well coordination of supervision works at an international level- and see most clearly where fault lines continue to exist.

Before I give you some views on what is happening within the EU regulatory community, I need to forcefully make the point that primary responsibility to enhance preparedness for a crisis situation lies with the banks themselves. Banks must learn the lessons of the crisis and materially improve their risk management processes. They must embed into their processes the capacity to perform real stress tests and make sure they are well equipped to withstand severe adverse market developments. Part of this process will involve the development of effective Recovery and Resolution Plans (RRPs) and the identification of the steps to be taken when the viability of the firm is at risk. The guidance of the Financial Stability Board is a key benchmark in this area.

For cross-border groups in the European Union, colleges of supervisors will develop plans for the coordination of supervisory action in emergency situations. Colleges are supplemented by the Cross-Border Stability Groups (or "crisis colleges"), which bring together fiscal authorities, central banks and supervisors. But the lesson of the crisis is that voluntary cooperation arrangements are not enough. Stronger legal and institutional underpinnings are needed to enforce effective crisis management and resolution tools in the European Single Market.

An important step has already been taken to strengthen the European institutional setting with the provisions set out in our founding Regulation, which gives the EBA responsibilities in areas such as the monitoring of colleges, the development of Recovery and Resolution Plans and the conduct of EU-wide stress tests. In addition, when an emergency situation is declared by the European Council, the EBA has been given the power to address specific recommendations to national supervisory authorities with a view to coordinating their actions and, if necessary, apply European decisions directly to individual institutions in case of inaction by national authorities.

Nonetheless, the structures are not complete and a more formal role for the EBA in crisis management will depend on the outcome of the European Commission's work on new legislation for bank recovery and resolution, due out soon. The legal underpinning for crisis resolution needs to be fully harmonised in order to allow for an integrated process, with close cooperation between the authorities involved. This should allow interconnecting national resolution procedures so as to ensure an integrated approach for cross-border firms, ensuring an equitable treatment of creditors in all jurisdictions. At the same time, mechanisms should be in place to constrain the actions of national authorities and drive towards coordinated, firm-wide solutions. Over time, the EBA's role in this area is likely to grow substantially, including its role in mediating between conflicting interests of national authorities as serious problems emerge.

Rule Making and the Single Rulebook

As proposed by de Larosière in his report, the EBA now has the capacity to draft directly applicable rules, by means of regulatory and implementing standards that will then be adopted by the European Commission as EU Regulations and thereby become directly binding in the whole EU, without the need for national implementation.

This process will help eliminate many of the inconsistencies which have arisen from options, national discretions, and the different interpretations adopted when previous rules were transposed into national legislation by the 27 EU Member States. Materially reducing the fragmentation in the EU regulatory regime will provide greater certainty to market participants and stronger foundations for convergence in supervisory practices.

Based upon the current legislative proposals for the implementation of Basel 3, about 200 deliverables will be expected from the EBA, including proposals for around 100 Technical Standards such as on the definition of capital, capital buffers, liquidity, remuneration, and the leverage ratio. This will be essential to ensure level playing field and avoid in the future that the regulatory lever is used to attract business in national market places or to favour national champions, a process that has played a great role in the relaxation of regulatory standards in the run up to the crisis.

The EBA can also issue Guidelines and Recommendations which are not legally binding, albeit the EU national supervisory authorities need to indicate publicly whether they intend to comply, and if this is not the case they will need to publicly explain the reasons. The EBA can also conduct peer reviews in order to make sure that the common standards and guidelines are effectively applied in a consistent and effective fashion.

Conclusions

Ladies and gentlemen,

Today I tried to convey to you an overview on the difficult challenges the EBA is facing. In our first 16 months of activity, we have already done a huge effort to strengthen the capital position of EU banks and to restore confidence in their resilience. The work is not over in this area. The liquidity support provided by the

ECB avoided an abrupt deleveraging process, but banks are still in the process of repairing and downsizing their balance sheets and of refocusing their core business. We, as supervisors, need to accompany this process and do our utmost to ensure that it occurs in an ordered fashion, without adverse consequences on the financing of the real economy.

In the coming months we have to complete the preparation for the implementation of the reforms agreed by the G20 Leaders, in particular Basel 3. It is a major challenge for regulators across the world and the EBA is establishing close contacts with fellow supervisors in other countries, including China, to ensure that there is always an open dialogue and a common commitment to strengthening the safety and soundness of banks. In the EU, this challenge is compounded with our resolve to set up a much more uniform regulatory setting for all the banks operating in the Single Market, with the so called Single Rulebook.

Strengthening regulation is not enough if it is not coupled with more effective supervision, especially for those large and complex groups that are active on a cross-border basis and may generate systemic risks across jurisdictions. This requires identifying best supervisory practices and ensuring convergence towards these benchmarks, as well as strengthening cooperation within colleges of supervisors. This has surely a strong European dimension, due to the relevance of cross-border business within the Single Market, but requires also close cooperation with supervisors in other regions. We are surely committed to bringing our contribution to the success of this endeavour.

Thank you for your attention.