Andrea Enria, Chairman

European Banking Authority

Challenges for the future of EU banking

Speech by Andrea Enria, Chairman EBA

After a number of years in which all our concerns have been directed to the day-to-day issues raised by the unfolding of the financial crisis, it is time to look ahead and start asking ourselves which are the medium to long term challenges facing the banking sector in Europe. At the same time, we are all aware that the pathway out of the crisis – including both the gradual structural adjustment of banks' balance sheets and the regulatory reforms driving that process – will, to a large extent, affect the future shape of EU banking markets.

I will therefore organize my remarks in two parts. In the first part, I will focus on the progress made in the repair of the EU banking sector – both regulatory reforms and adjustment in banks' balance sheets. My main point is that we have already moved to a radically different landscape for banking activity, but we need to keep up momentum to complete the reform package endorsed by the G20 Leaders according to the agreed timeline and aiming at the maximum possible level of consistency at the international level and, especially, within the EU Single Market. In the second part, I will cover some of the challenges ahead and focus my attention on three remaining open issues that will determine the shape of the EU banking sector going forward, namely: (i) the pathways to eliminate excess capacity in banking and exit from debt overhang that still affects private and public borrowers – two issues that are each the mirror image of the other; (ii) the need to improve the functioning of banks' internal risk models so as to restore confidence in their use for regulatory purposes; and, finally, (iii) the ways to address major shortcomings in bank conduct and re-establish on a sound basis the role of banks in our societies. I would like to stress that on none of these issues I am arguing for additional rules besides what has been already agreed at the international and European tables: what is needed in my view are effective and coordinated policies, and a thorough enforcement of the Single Rulebook we have just put in place.

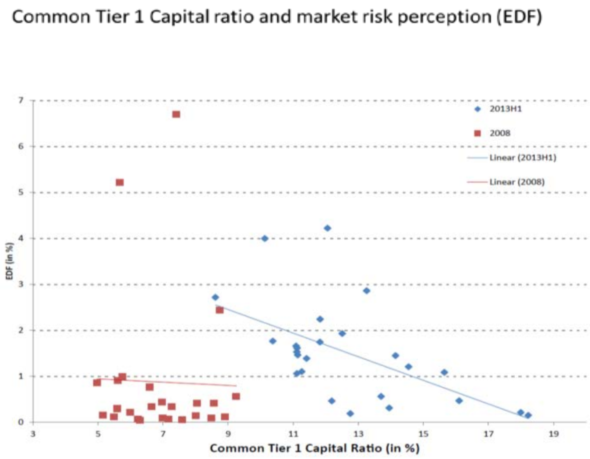
1. Progress in the repair of the EU banking sector

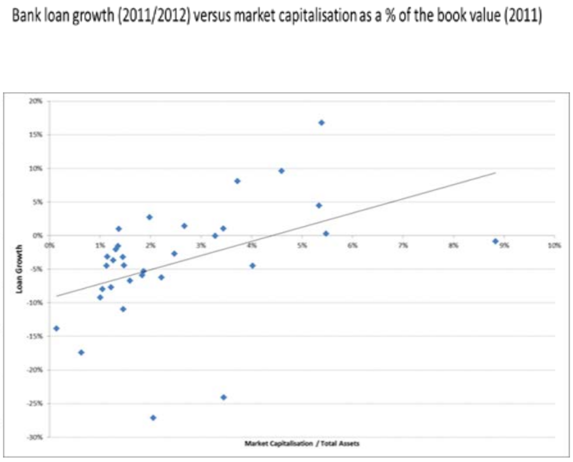
a. Regulatory repair

The G20 package and roadmap has defined the substance and the timeline of the regulatory reforms in banking. The first line of action focused on strengthening banks' capital and liquidity: higher risk-weighted capital requirements and buffers, based on a stronger definition of capital, to be gradually phased in by 2019; stressed and structural liquidity requirements to be introduced sequentially; and a non-risk-weighted leverage ratio, to act as backstop to risk sensitive requirements, as the last element of the framework. The second strand of reforms aimed at addressing the "too big to fail" issue, ensuring that also large and complex banking organisations can be resolved without the need to deploying taxpayers' money. The main drivers here are: the key attributes of resolution regimes; recovery and resolution plans; requirements on bail-in and loss absorbing capacity.

There has been a wide and open debate on these reforms. The long time it took to finalise the technical details of these packages is also a sign of the great attention and care that has been devoted to their specification and calibration, through impact assessments and engagement with all stakeholders. I cannot support, or even understand, the renewed calls from industry representatives to re-open a discussion on the calibration of these requirements, usually accompanied with the claim that this would be needed to support growth. Looking at the EU, the jurisdictions that have decided to frontload the new Basel 3 requirements are amongst those that have a stronger growth. More generally, there is plenty of evidence that banks that have been faster in complying with the new requirements are those that have experienced a greater growth in lending volumes, gaining market shares and attracting cheaper funding. Looking at bank capital, the negative relation with expected default frequency has significantly become steeper after 2008, showing the increasing importance of capital to better differentiate creditworthy banks (Chart 1). Also at the micro-level, a positive correlation between the level of bank capital and loan growth is well established at the EU level, as well as in each Member State. Indeed, it is the group of banks with proper and credible capital buffers that has been able to maintain lending levels during the most difficult periods of the crisis (Chart 2).

Chart 1 and 2: Common tier 1 ratio and market risk perception (expected default frequency); and Bank loan growth (2011/2012) versus market capitalisation as a % of the book value (2011)





Source: EBA Risk Assessment of the European Banking System.

I would argue that we need to be serious and complete the implementation of the international reforms in line with the agreed calendar and move on.

At the EU level, a lot of the regulatory repair has already been finalised. In a sense, for us it has been a double challenge, as we also aimed at implementing the bulk of the new international standards into a Single Rulebook, i.e. a set of truly homogeneous rules legally binding in all 28 Member States of the Union. The core provisions of Basel 3 have been adopted through the Capital Requirements Regulation (CRR), which is directly applicable throughout the Single Market. So far, we have issued 90 technical standards, and other 50 are in the pipeline, to be finalised by end 2015. The progress in harmonisation is truly impressive: EU banks of all types and sizes are now facing truly uniform definitions of key supervisory aggregates, for instance a common definition of non-performing loans and forbearance, common definitions of capital and of high quality liquid assets and a single framework for supervisory reporting – to mention but a few. We developed user-friendly tools to raise questions to the EBA and the European Commission, so that implementation issues find a common response valid for all European banks. On our website, we have developed an interactive tool, which gives concrete visibility to the Single Rulebook, by bringing together the primary legislation, the delegated acts of the Commission, the EBA's standards and guidelines, as well as the relevant questions and answers.

Of course, the transition to the new system is far from being completed. I would like to draw your attention to two areas, where the legislation has left room for national discretions and options: the definition of capital and the framework for recovery and resolution.

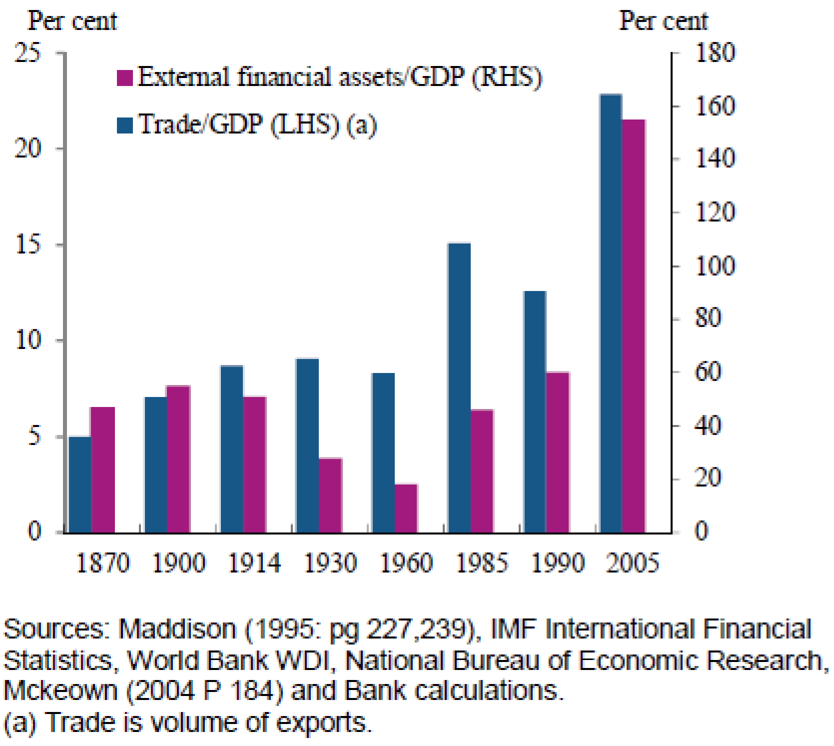
The EBA, and I personally, have always argued that we should have aimed to a fully harmonised definition of capital, completely aligned with the Basel standards. However, a number of national discretions and options have been inserted in the legislative texts, which still hamper the comparability of capital ratios across EU banks. Luckily enough, most of these discretions are linked to the pace of phasing-in of the new requirements and will gradually fade away. But some will be in place for up to ten years, and some do not have a clear expiration date. We are talking about deductions from common equity – e.g., goodwill, deferred tax assets, prudential filters on AFS gains and losses – and other technical details – e.g., the calculation of Basel 1 floors. They can have a sizeable, and often unnoticed, impact on capital levels and their comparability. The issue emerged with great clarity in the conduct of the 2014 EU-wide stress test. The ECB immediately realised that as they are taking up supervisory responsibilities they cannot rely on such a diverse implementation of common rules. As a number of the national discretions are in the remit of competent authorities, the ECB will now be in a position to iron them out. But others remain in the hands of Member States. The EBA has done all possible efforts to minimise the impact of such differences, for instance by providing very detailed disclosure of the capital components and publishing, for the first time, the results of the stress test also with reference to the fully loaded capital ratio, which is much less affected by national discretions. Still, going forward, we have to make a stronger commitment to truly common rules, especially when we define these common yardsticks for supervision. The EBA has recently published detailed information on the implementation of national discretions under CRD/CRR in each member state. This transparency exercise provides a better picture of where differences in implementation remain, and will be followed by peer review analyses to monitor their impact.

The EU has also now implemented the other major pillar of the international reform effort – the Financial Stability Board’s Key Attributes of Effective Resolution regimes, through the Bank Recovery and Resolution Directive (BRRD) and the creation of the Single Resolution Board (SRB). But in this area the issue of consistent implementation across the Single Market is even more complex and important.

Let me stress that this is a crucial step to re-establish the integrity of the Single Market. If regulators, governments, banks, and investors believe that capital and liquidity will be trapped in individual member states when a bank fails, they will be reluctant to let it circulate freely within the Single Market in good times. National authorities at the peak of the crisis took understandable decisions to ring-fence and focus on national, rather than Europe-wide, banking sector restructuring – in part, because they were aware that most member states did not have resolution regimes which could be relied upon to look after the interests of depositors and other stakeholders across the EU, and in part because they wanted support from domestic taxpayers to be channeled into their domestic economies. We can see this dynamic at work, for example, in the significant decrease of cross-border banking business within the EU; in the fall in the assets of branches of EU credit institutions in other member states; or in the complete absence of cross-border bank mergers as EU banking sectors restructured during the crisis.

Unless we act to change these underlying incentives and define a framework that gives sufficient reassurance to all authorities, home and hosts, that in case of difficulties a cooperative approach will prevail, the expectation that similar actions would be taken again might last for a very long time. When the outbreak of World War I brought an abrupt end to the financial integration of Europe, as wartime sanctions separated borrowers in much of the continent from their lenders in London's financial centre, few of those involved lived to see the restoration of a genuinely international financial system (Chart 3).

Chart 3 Flows of capital, goods and services



Taken from Haldane (2013), 'Why institutions matter (more than ever)':
http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech676.pdf

The harmonised resolution regimes introduced by the BRRD aim to tackle the fear that the interests of parties in home and host member states will be treated differently in resolution. Each resolution authority now has similar legal powers, which are effective throughout the EU, and an obligation to use these in consultation with the authorities of all affected member states, taking into account the interests of depositors and financial stability in those jurisdictions. This is major progress.

But the BRRD leaves a number of areas for national decisions, which may still have an adverse impact on cross-border resolution. For instance, it does not make it mandatory to reach a joint decision on the resolution plans for cross-border groups. Therefore, resolution authorities can decide to follow a non-coordinated approach. The same applies to measures to ensure resolvability, and the setting of the minimum required eligible liabilities (MREL, i.e. the type and amount of liabilities that can be promptly written down or converted into equity in case of a crisis). There is a concrete risk that the toolkit introduced with the purpose of establishing an EU-wide 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, leading to ring-fencing. While we expect that the Single Resolution Board (SRB), working with the Single Supervisory Mechanism (SSM), will aim at achieving full fungibility of capital and liquidity within the euro area and across participating countries, if this does not extend also to non-participating countries, we might face a risk of barriers remaining within the Single Market, dividing “ins” from “outs” and crystallising a two tier system.

That is why the EBA has been extremely busy since last summer filling out the BRRD framework with technical standards and guidelines, working with supervisors and resolution authorities to issue close to 30 consultation papers. With these, our aim is to ensure that resolution authorities – and, even more importantly, other stakeholders such as investors in banks – have a clear and common understanding of how the powers in the BRRD should be applied. Resolution is a collective action problem, to make it work all the various stakeholders (banks, investors, depositors, analysts, market gatekeepers, supervisors, resolution authorities, governments) need to have ex ante clarity and confidence on the rules of the game. Enhanced legal and factual certainty will not only keep trust in a moment of crisis, even more importantly it restores market discipline and proper pricing in “normal times” banking.

I would like to give three examples of how we are pursuing this goal. One group of EBA regulatory products fleshes out the triggers for the various actions in the BRRD and how these are linked to the normal assessments of the banking supervisors. This is particularly important to minimise the potential for duplication of work or conflicting assessment of prudential supervisors and resolution authorities. A second group explains the principles on which a valuation of a failing bank should be based, and how this valuation should inform the terms on which a bail-in is conducted. And a third sets out minimum standards for resolution planning and how the resolution authority’s broad powers to require changes to how banks are run in order to remove impediments to resolution should be used. In each of these three areas, inconsistent national approaches would sooner or later lead to conflicts affecting the free flow of funds within EU banking groups. These technical standards and guidelines will provide a basis for consistent decisions, and the EBA will be vigilant to ensure that coordinated and cooperative approaches prevail. We know from experience that this is an area where agreements are likely not to be adhered to in a situation of crisis, unless there is a strong legal basis and clear tools for European authorities to enforce cooperative solutions, e.g. via mediation.

A key question is whether the reform will be effective in breaking the sovereign-banks loop that has been so central in the recent phase of the crisis. Some argued that the loop will remain important even in the Banking Union because national arrangements remain in place for deposit guarantee schemes and, during an extended transitional period, for resolution funds. I do not intend here to go in depth into the case for or against a single deposit guarantee scheme, but rather to make the point that these funds are in any case only intended as backstops. Under the new resolution regimes, authorities should plan to be able to deal with failing banks without providing solvency support from any outside source – as would be the case for any failing non-bank company. The primary mechanism for weakening the sovereign-bank loop is not to have mutualised mechanisms for public solvency support, but rather to avoid such support in the first place. And if this loop can be broken, cross-border cooperation should be significantly easier. Importantly, this mechanism also works for the whole Single Market, not just for the Banking Union. Adequate backstops are of course important, but we must remember their secondary role.

The credibility of the commitment not to bail out a failing bank depends crucially on the liability structure of the institutions, which need to have sufficient instruments that can be fully and promptly written down or converted to recapitalise the bank. Some liabilities deemed essential to the financial system fulfilling its critical economic role can be protected in resolution – for example, through the introduction of depositor preference and the exclusion of some liabilities from the scope of the bail-in power. In order to avoid that institutions finance themselves exclusively with instruments exempted from bail in, the BRRD requires that they to maintain a minimum amount of own funds and other instruments that can be written down or converted into equity in resolution – the minimum requirement for own funds and eligible liabilities (MREL).

But the MREL requirement is set on a case-by-case basis, not as a fixed figure, and so again needs to be implemented in a way which does not further fragment the Single Market. Large differences in the requirement for similar banks in different Member States would jeopardise the trust between authorities that is the most important ingredient to re-establish cross-border banking on a sound basis. The EBA is consulting on standards mandated by the BRRD to flesh out common criteria for setting the amount of MREL needed to absorb losses – which should be closely linked to the capital requirements – and to recapitalise the bank, with changes from the current capital requirements carefully justified by a credible resolution plan.

The crucial judgement that resolution authorities will need to make is which liabilities it is more feasible and credible to bail in given their resolution plan. And we will need to consider how best to ensure consistent approaches to these decisions, and also the transparency which investors in bank liabilities will need.

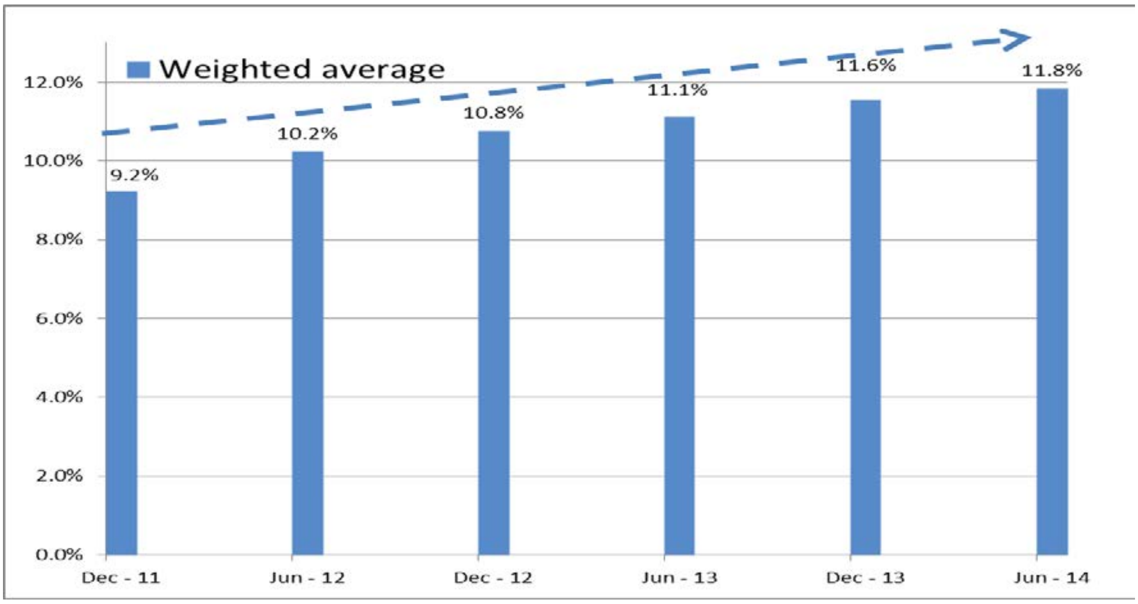
Lastly, on how all this fits into the global policy framework, we expect that the rules on MREL will allow the largest, globally-systemic banks to meet at the same time the requirements on Total Loss Absorbing Capacity (TLAC) that arer being defined by the Financial Stability Board. One important difference is that the MREL applies – in a proportionate way – to all banks, not just the 30 G-SIBs. This wider scope of application means that the MREL has to be calibrated to the different characteristics and systemic relevance of the bank, and further that it avoids the cliff effect of having no, or sharply lower, requirements for banks just below a particular cut-off. A more fundamental difference is that at the global level it is difficult for nations to make binding agreements about how they will act in a crisis – a major reason why, in the words of Ragnar Nurske, the Estonian economist whose work at the League of Nations was at the forefront of attempts to reconstruct finance between the wars, international credit was like a borrowed umbrella you had to return if it started to rain, only there when it was least needed. Within Europe this is still challenging, but we have an institutional set up allowing us to go much further in giving certainty to all interested stakehiolders.

The Banking Union will give great impulse to the Single Rulebook, as the SSM and the SRM cannot properly work without a truly homogeneous regulatory framework. A harmonious balance between the Banking Union and the Single Market will require that these efforts to strengthen the Single Rulebook maintain an EU-28 dimension.

b. Banks' balance sheet repair

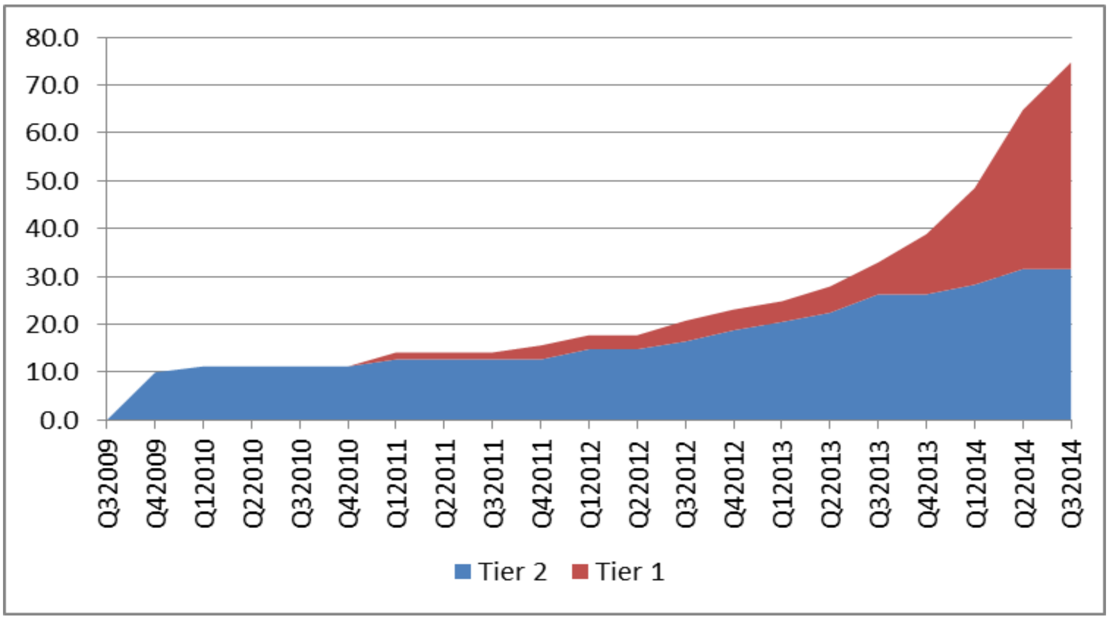
Let me now move to the progress in banks' balance sheet repair. The 2014 EU-wide stress test has been a further, very important milestone in the process of strengthening EU banks' capital position. Following the 2011 stress test and the successive recapitalisation exercise, EU banks had already significantly increased their capital ratios (from 9.2% at end-2011 to 11.8% in June 2014), reaching levels comparable with the largest US banks (Chart 4). In 2013, for example, the euro area banks raised over EUR 80 billion in capital and between January and September 2014 alone, they raised an additional EUR 54 billion of equity (EUR 39 billion net of repayments and buybacks) and 39 billion of contingent convertible instruments (Chart 5, both additional Tier 1 and Tier 2). This reflects the peculiar nature of EU stress tests, which, differently from those carried out by the Federal Reserve in the US, are "bottom up", i.e. rely on calculations done by the banks themselves, using their internal models and subject to quality assurance by their supervisors. As a result, banks are made aware of (and consulted upon) the methodology and the stress scenarios well in advance and can take pre-emptive actions to avoid being found wanting in the exercise. Hence, in the EU, the bulk of the adjustment actually precedes, rather than follows, the conduct of the stress test exercise.

Chart 4: Common equity tier 1 ratio (till December 2013: Tier 1 ratio excluding hybrid instruments) — weighted average



Source: EBA Risk Assessment of the European Banking System.

Chart 5: Total issuance of AT1 and Contingent Convertibles by EU banks (billion EUR)



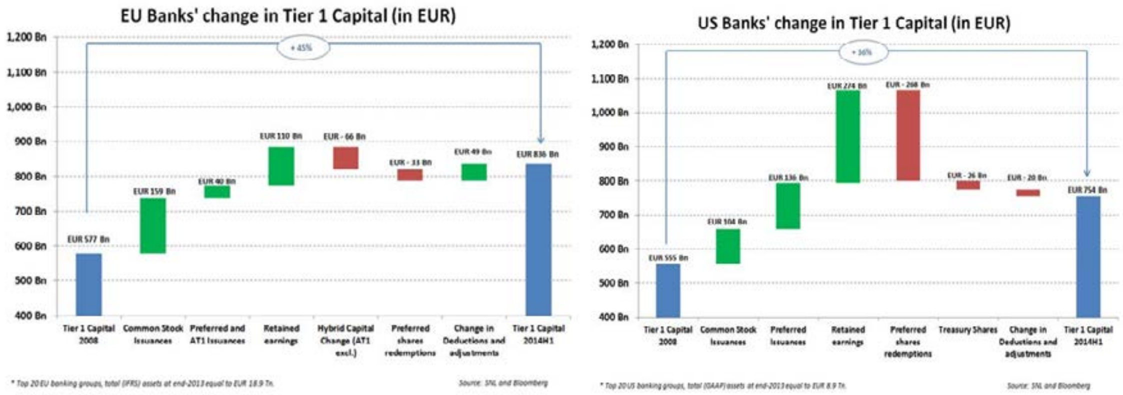
Source: EBA Risk Assessment of the European Banking System

The strengthening in capital position has also allowed for bringing forward the cleaning of the balance sheets. Banks tried to adjust to the new, more rigorous definitions of asset quality (non-performing loans and forbearance) ahead of the exercise – which has driven a greater recognition of the deterioration of their loan portfolios. The greater capital strength has also allowed a relevant increase in provisions (+EUR 120 bn in the year ending in June 2014). The asset quality review (AQR) conducted by the ECB has put further pressure on this adjustment process: non-performing loans were corrected upwards by EUR 136 bn (+18.4%).

Let me take this opportunity to dispel a misleading narrative that is usually referred to when comparing the adjustment process between EU and US banks. According to this rather common line of argument, US banks would have strengthened their balance sheets through real capital issuances, while EU banks would have enhanced their capital ratios mainly by reducing the denominator, risk weighted assets (RWAs). An adjustment via RWAs is often seen as particularly troublesome, as it could be the result of tweaking of internal models to minimise capital requirements (i.e., the adjustment would not be for real); or it could happen through a reduction in lending to customers attracting higher capital charges, which might in turn reduce the ability of the banking sector to contribute to the recovery.

Now, it is interesting to notice that the absolute amount of Tier 1 capital of the top 20 banks in the US and in the EU was approximately the same at the end of 2008 (EUR 577 bn for the EU banks, EUR 555bn for the US banks), and the EU banks have increased capital more than their transatlantic competitors (+45%, against +36%). US banks have issued more capital (especially preferred stocks), but they also conducted significantly more buy-backs. This means that the net increase of capital since the Lehman crisis has been more substantial for EU banks. However, it is also fair to admit that the frontloaded capital increase pushed by the Fed at US banks in 2009, based on the use of the federal funds available under the TARP programme, has allowed a more rapid strengthening of the US banks, which in turn might have accelerated the recovery in lending dynamics in that country (Chart 6 and 7).

Chart 6 and 7: EU and US Banks' change in Tier 1 Capital (in EUR)



Source: EBA Risk Assessment of the European Banking System.

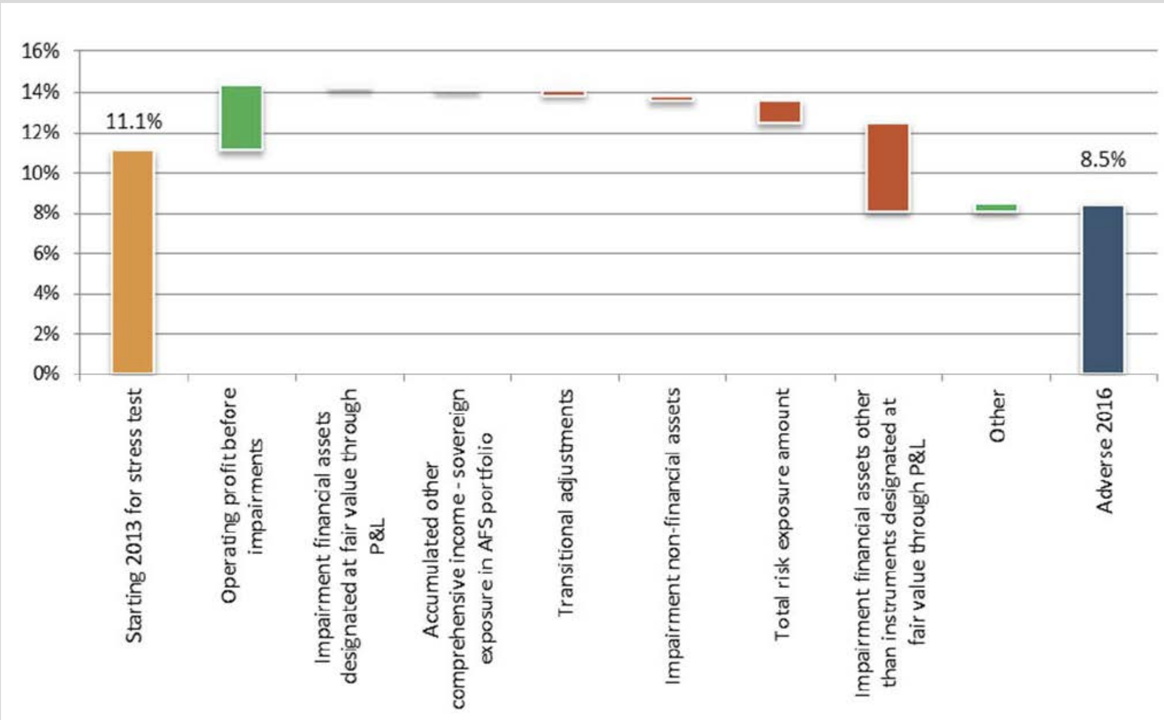
Let me briefly touch upon the results of the EBA stress test exercise. It has been a massive effort, covering 123 banking groups. On average, EU banks' common equity ratio (CET1) dropped by 260 basis points, from 11.1% at the start of the exercise to 8.5% after the stress. The joint effect of the AQR and the stress test was 300 basis points. Over the three-year horizon of the exercise, 24 banks would fall below the 5.5% CET1 threshold and the overall shortfall would total EUR 24.6 bn. The number of banks that showed a shortfall went down from 24 to 9 institutions, and the shortfall from EUR 24.2 billion to EUR 9.5 billion, when considering the capital injections and conversions performed in 2014.

It is interesting to notice that 16 out of the 24 banks with a shortfall at the end of the exercise were already falling below the minimum threshold after the AQR. This means that initial values are an important driver of the results. Or, to put it differently, it has been those banks that resisted the pressure to strengthen capital levels, or didn't manage to take pre-emptive actions, that performed particularly weakly in the exercise.

The main drivers for this impact are credit risk losses, which account for a 440 basis points decrease in the CET1 ratio, and the increase in total risk exposure (Chart 8, 110 basis points decline in the CET1 ratio).

The banks whose capital position fell below the minimum threshold have submitted their capital plans to remedy the deficiencies highlighted in the exercise. For the others, the stress test results will provide input to the risk assessments and joint decisions by competent authorities. It is important to point out that although the attention of observers has focused on capital actions requested of the weaker banks, this has been a very extensive supervisory exercise, which has allowed the ECB, in particular to gather a wealth of information. As a result, there might be also other types of more qualitative assessments, for instance on the internal governance of banks, on their data integrity framework, etc., which might call for supervisory actions.

Chart 8: Contribution of different drivers to the change in Common Equity Tier 1 Capital ratio from 2013 to 2016 in the adverse scenario



Source: EBA Results of 2014 EU-wide stress test.

2. Challenges for the future

a. Bank restructuring and debt overhang

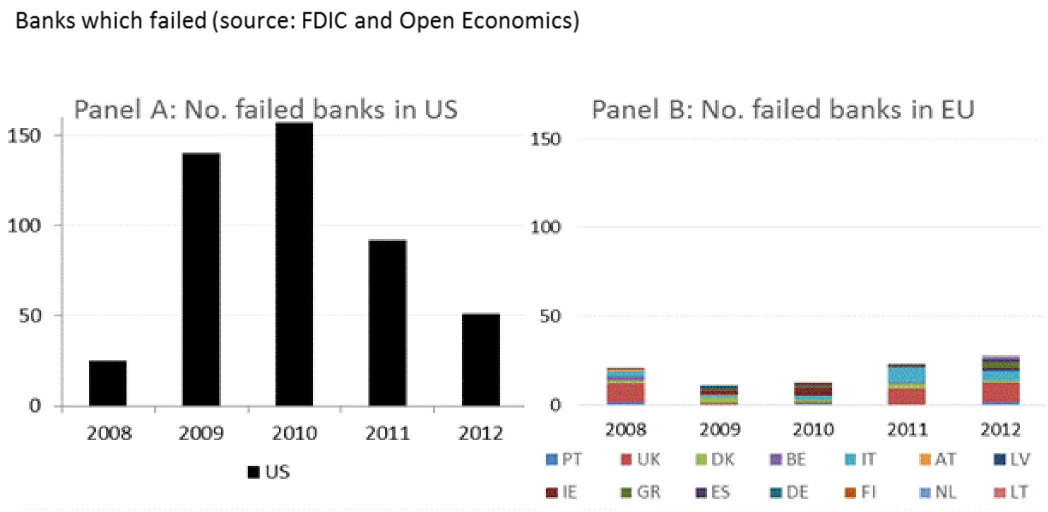
Since the inception of the financial crisis in 2008, the EU banking sector has been going through a rationalisation process. Pressure on banks to contain cost, deleverage and restructure has been very high in the countries most affected by the financial crisis. I do not want to downplay the relevance of the restructuring process. I would argue though that in the EU there has been a widespread preference for bank bail-outs and the restructuring has been driven mainly by the Commission's enforcement of the State aid rules. Compared with the US, where the process has been led by a federal resolution agency, the Federal Deposit Insurance Corporation (FDIC), the European institutional set up has led to a lower number of banks in the EU exiting the market – i.e. lower outright liquidations and reduction in the number of banks via mergers and acquisitions.

The excess capacity created in the run up to the crisis has not been rapidly reduced. The European Systemic Risk Board (ESRB) has recently published[1] an analysis of its Advisory Scientific Committee on the "oversize" European banking sector, arguing that the excessive expansion has been driven by (i) government support and inadequate prudential supervision, exacerbating banks' moral hazard problems; (ii) political encouragement to bank expansion, for instance to promote "national champions" or to stimulate employment growth for electoral reasons; and (iii) the cost mix of European banks, with high fixed costs and negligible marginal costs encouraging excessive entry in the market.

The aggregate balance sheet of euro area banks is around 270% of GDP, whereas in the US, where capital markets are deeper, it is only around 70% of GDP. The US banking sector has undergone a steady process of consolidation during the past decade, with the number of banks declining from over 8,000 in the early 2000s to just over 6,000 in 2012. The decline in the euro area during the same period was more modest and the number of banks even increased in 2008 before resuming a downward trend. In the EU, a much lower number of banks have been put into resolution (Chart 9). European banks are still deleveraging while US banks are now taking on board more risk.

[1] [1] ESRB, 2014. Is Europe Overbanked? No. 4/June 2014.

Chart 9: Banks which failed in US and EU



Source: FDIC and Open Economics.

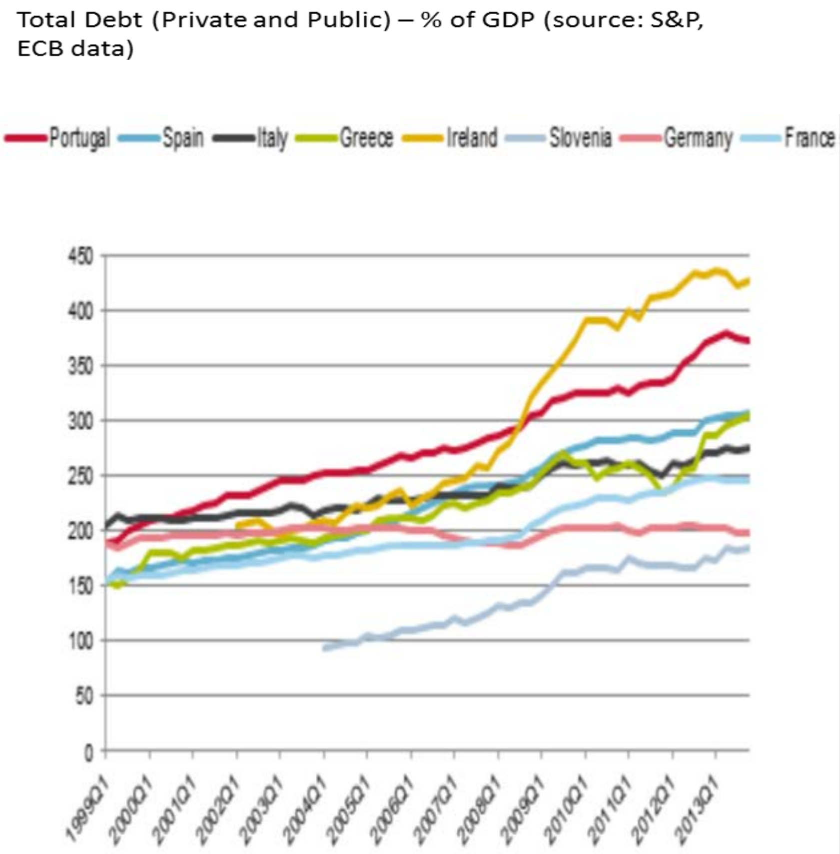
Excess capacity is accompanied by persistently low and still deteriorating bank profitability. In the first half of 2014 bank profits decreased by 24%; the average return on equity (ROE) was 5.7%, with 76% of the banks below 8%, and 14% below 3%. To some extent, the deterioration of bank profitability could be read positively, as a one-off effect linked to the recognition of losses and cleaning of banks' balance sheets driven by the asset quality review and the stress test. However, it could also signal a continued reluctance of banks to recognise the structural weaknesses that may prejudice the longer term viability of their business models and the need to pursue more radical restructuring strategies.

Too much leverage - the debt overhang persists

Debt overhang in the private sector is the other side of the coin of excess capacity in the banking industry. When banks delay recognition of their asset quality problems and resist the pressure to restore appropriate levels of capital, they cannot engage in the needed efforts to reschedule and restructure their customers' debt. Both lenders and borrowers live in the hope that an exogenous improvement in the economic outlook would cure the problems.

Overall private and public sector debt remains near record highs, both in absolute value and in percentage of GDP (Chart 10). The extremely low inflation is making continuous deleveraging more difficult.

Chart 10: Total debt (Private and Public) - % of GDP



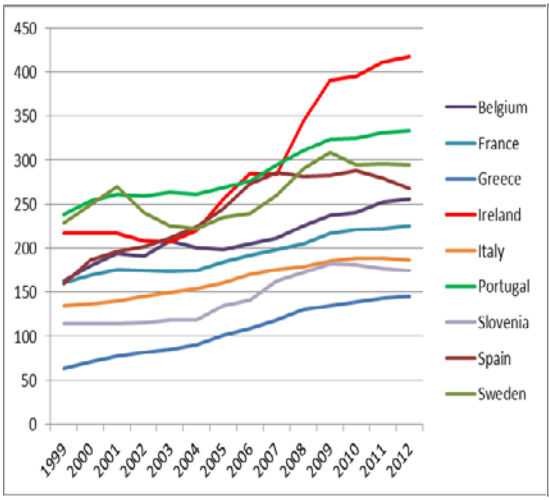
Source: S&P, ECB data.

Debt financing continues to dominate equity financing. The high and still increasing leverage of the corporate sector is an element of financial fragility and a drag on growth. In some Member States the corporate sector faces high debt servicing pressures, even in the current low interest rate environment. In Portugal, Spain and Italy more than 50% of corporate debt is concentrated in firms whose interest payment absorbs more than half of their earnings before interest and taxes. An interest rate shock could prove particularly damaging for such companies (Chart 11 and 12). Moreover, the high level of debt implies that firms remain focused on rebuilding equity and tend to postpone investment projects, with adverse effects on growth and employment (Chart 13 and 14).

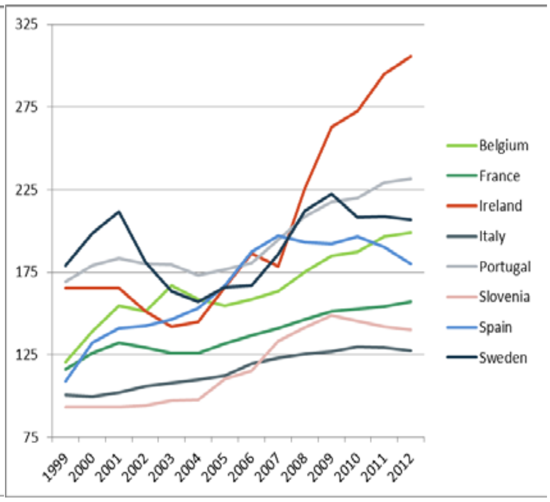
Initiatives have been developed by several EU banks, often in cooperation with specialised investors, to transfer bad quality assets into ad hoc funds, which then engage into extensive restructuring actions, including conversion of debt into equity. The scarce anecdotal evidence shows that such actions encounter a number of obstacles, especially in terms of demanding legal requirements in local insolvency laws and creditors' protection regimes. This is an area where it would be extremely difficult to develop coordinated EU-wide initiatives, due to the limited harmonisation of the relevant legal frameworks. But it is probably the most promising field to support more restructuring, which could lead, at the same time, to mopping up excess capacity in the banking sector and rebalancing the liability structure of the private sector. In the absence of progress in this direction, the exit from the crisis is likely to continue at a very subdued pace.

Chart 11 and 12: Debt (Private sector) - % of GDP; and Debt of non-financial corporations - % of GDP from 1999 to 2012

Debt (Private Sector) – % of GDP (source: EBA calculations, OECD data)



Debt of non-financial corporations - % of GDP from 1999 to 2012. Source: OECD data, EBA calculations



Source: OECD data, EBA calculations.

Chart 13: Share of debt at firms with various interest coverage ratios

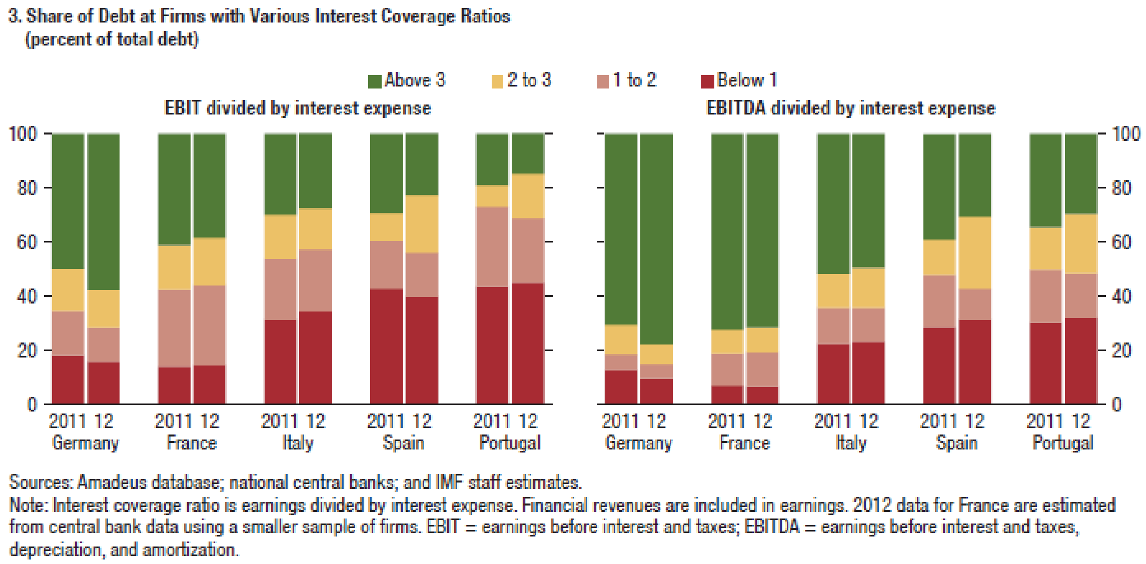
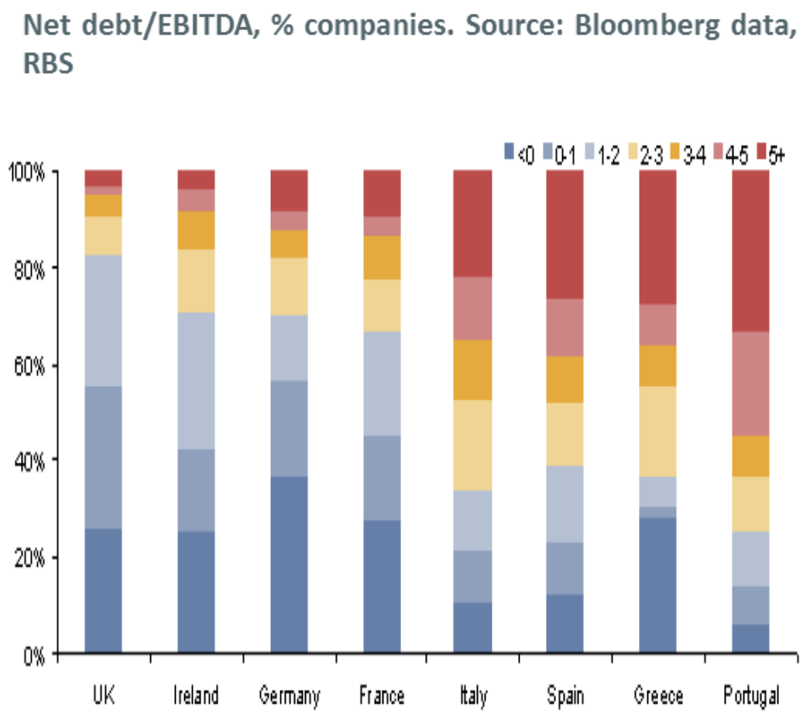


Chart 14: Net debt/EBITDA - % companies



Source: Bloomberg data, RBS.

b. Banks' internal models and risk weighted assets

Another relevant challenge, which could trigger significant change in the measurement and management of risks going forward, is the functioning of banks' internal models and the reliability and consistency of their regulatory outcomes, risk weighted assets (RWAs). The policy choice made in the second half of the 1990s to rely on banks' internal models for the calculation of key regulatory requirements moved from the awareness that blunt, risk insensitive regulatory approaches were being massively circumvented and could also lead to the undesirable result of favouring excessive risk taking, especially at banks under stress. It was at the same time a humble recognition of the limits of public regulation in front of global financial markets and financial and technological innovation, and an act of faith in the functioning of private markets. The basic idea is that in order to recover its effectiveness public regulation had to rely on the internal safeguards of the regulated firms and foster best industry practices in risk measurement and management, thus going with the grain of the market. The poor performance of these models during the crisis, and the perception of unfairness and gaming of the rules that accompanied reports of wild differences in risk weighted assets at banks with supposedly similar portfolios have seriously dented the credibility of current regulatory approaches. Some rating agencies and bank analysts started substituting traditional risk-based metrics with alternative estimates of risk-based capital ratios or focusing attention exclusively on non risk-based indicators, such as the leverage ratio. The banking industry contributed to the loss of confidence in the current system: for instance, in 2011 when the EBA issued a recommendation to banks aimed at raising their capital ratios above 9%, several bankers replied that they would have complied via "RWAs optimisation", which most observers interpreted as outright manipulation of capital ratios via adjustments to the internal models. A debate started also in the regulatory community. Daniel Tarullo, the member of the Board of the Federal Reserve responsible for supervisory matters, recently argued that regulators should stop relying on banks' internal models to calculate capital ratios, focusing instead on standardised methods defined by the authorities, coupled with top down stress tests also conducted by supervisors.

The EBA has done extensive work in this area, publishing several analytical reports. Our analysis has shown that approximately 50% of the variability of RWAs could actually be explained, if structured information were made publicly available – for instance, on the break-down of assets by portfolios and countries, or on the share of defaulted assets. The significant dispersion of results that cannot be explained by risk-based drivers stems from the excessive degree of flexibility in the regulation, which led to significant differences both in supervisory approaches in the approval and monitoring of banks' internal models, and in banks' own modelling choices.

In line with the mandate received in the Capital Requirements regulation (CRR), the EBA is setting in place a repair strategy based on three lines of action:

i. *enhanced transparency*: current disclosure by banks under Pillar 3 of the capital framework has proved insufficient, inadequate or in any case unable to allow for the necessary comparisons across banks. The EBA intends to significantly enhance the availability and comparability of the information provided under Pillar 3. Important steps in this direction have already been taken: in the 2013 transparency exercise and in the publication of the results of the 2014 stress test, a significant amount of information has been uploaded on the EBA website - e.g. breakdown of exposures values, RWAs and value adjustments by regulatory approach, for each exposure class and separately for defaulted and non-defaulted exposures, at the consolidated bank level and by jurisdiction – for a large sample of banks.

ii. *higher convergence in supervisory practices*: different supervisory approaches and inconsistencies in key regulatory definitions are an important driver of inconsistencies in RWAs across Member States. We have a duty to iron out these differences and promote rigorous and convergent supervisory practices. The legislation assigns to the EBA the task of harmonising key concepts (e.g. the definition of default, the criteria for permanent partial use of the standardised approach for selected portfolios, LGD estimation, etc). The Basel Committee is also discussing the possible use of the capital ratio calculated according to the standardised approach as a floor for internal ratings-based (IRB) results. Moreover, there is clearly a variety of approaches in assessing and challenging the robustness of internal models, both during the approval process and on an on-going basis. The Banking Union will provide great impetus to this work, as the Single Supervisory Mechanism (SSM) will have to move to completely unified supervisory practices for the euro area.

iii. *regular benchmarking of bank practices*: divergent views on risks stemming from internal models are to be expected and up to a certain point may also increase the overall resilience of the banking system, as they prevent herding behaviour. At the same time, there needs to be a structured process to identify those banks that exhibit systematically lower evaluation of risks compared to their peers – of course, with reference to the same portfolio and jurisdictions. And if the conclusion of this supervisory analysis is that a bank modelling choices are not robust and conservative enough, supervisory action needs to be taken. This is the whole purpose of the EU benchmarking exercise that the EBA is requested to conduct regularly under the CRR. In performing such exercises it will be important to find the right balance, ensuing greater consistency across banks while at the same time avoiding to impose preferred methods or leading to a standardisation of models' outcomes.

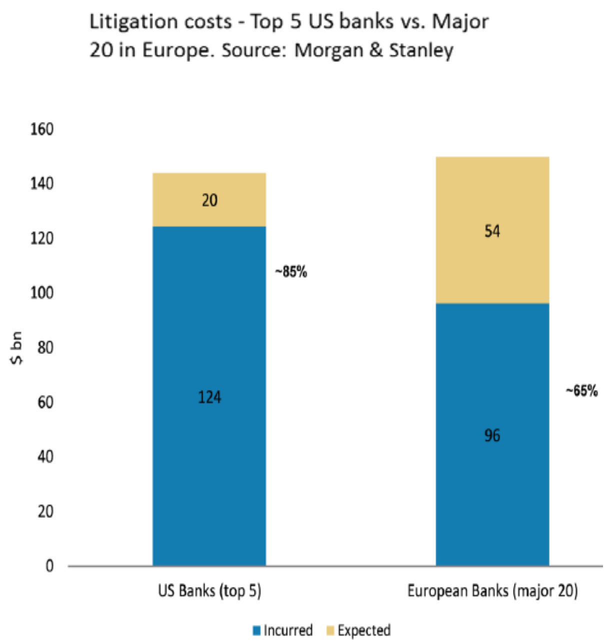
Restoring credibility and comparability of RWAs will be an extremely challenging task: if successful, it will enable banks and regulators to restore confidence in the methodologies for measuring and managing risks; if not successful, it will probably lead to more radical changes in the regulatory framework.

c. Conduct issues

Finally, I would like to address the third major challenge confronting banks and regulators: making sure that episodes of the conduct failure such as those experienced in recent years are effectively eradicated from bank practices.

We have seen cases of manipulation of market benchmarks, mis-selling of financial products to consumers, circumvention of anti-money laundering and counter terrorist financing regulation, and support to tax evasion on an unprecedented scale. The first and most relevant adverse effect has been on the reputation of the banks involved and of the banking sector as a whole. The confidence of consumers and users of banking services in the integrity of bank behaviour has been seriously compromised. It will take time and effort to gain it back. The banking sector used to be perceived as the “intelligent plumbing” of our economies, facilitating commercial transactions, ensuring that financial resources could flow efficiently to the best investment opportunities, protecting today’s savings for tomorrow’s needs. Now, it is more frequently considered a bloated sector, distracting resources from other parts of the economy, often in pursuance of the individual interests of the bankers themselves. The second adverse effect is on financial stability, as the scale of conduct failure is such that very material sanctions have been applied or onerous settlements have been achieved, which had a relevant impact on banks – according to some estimates, the costs of conduct failure accruing to a small sample of major EU and US major banks alone since the beginning of the financial crisis in 2007 have exceeded EUR 200 bn, with additional EUR 70 bn expected in the near future (Chart 15). The costs tend to arise as a result of compensation paid out by banks, regulatory fines as well as litigation payments.

Chart 15: Litigation costs – Top 5 US banks versus Top 20 European banks



Source: Morgan &Stanley.

I believe that the relevant primary legislation to deal with conduct issues is in place in the EU. The key issue is effective application and enforcement. Most importantly, we need to dispel the impression that competent authorities across the Single Market attach different priorities to addressing conduct issues, sometimes also as a consequence of divergences in sanctioning powers attributed to them. More convergent approaches are essential also in this area. This is why the EBA is working to a number of standards and, especially, guidelines to ensure coordinated and consistent action by the competent national authorities.

There are three levers that should be activated to achieve more effective and consistent application and enforcement of the common rules. First, there is a need to strengthen internal governance and controls at all levels – functioning of boards, selection of staff, the governance of bringing products to the market, incentives to both risk-takers and sales staff, monitoring through active use of customer complaints, punishments for misconduct. This is essential to prevent misconduct and send clear messages throughout the organisation, thus affecting its culture. The EBA has in the pipeline a number of guidelines on internal governance, remuneration, product oversight and governance, which should ensure tighter and more convergent approaches by competent authorities. Second, we need to seriously review the approaches used so far to quantify and mitigate operational risk, also considering the possibility of setting specific requirements for conduct risk. Also, efforts should be made to develop methodologies to incorporate conduct risk in stress test exercises – we didn't manage to do so in time for the 2014 test, but we will hopefully make progress in time for the next exercise. Third, there is a need to set out a more harmonised and predictable framework for sanctions, that ensures fairness of treatment across cases and across borders. This is particularly difficult also in light of different legal settings at the national level, sometimes involving different authorities or even prosecutors. But sanctions cannot have the desired deterrent effect unless it is common knowledge that breaches of the common rules will be met with severe punishment in all cases.