Regulatory Reform Developments in Europe

Banking Challenges and Opportunities in an Era of Global Crisis

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Section 1

General Remarks

- The drying-up of interbank markets was the worst possible crisis for the Eurozone (an imperfect monetary union with no fiscal union)

- The European legislative process is quite complex: the European Commission, the Members States (represented in the European Council) and the European Parliament are involved in the so-called “trialogue”

- It is important to distinguish between the EU-28 and the EU-17. The Banking Union is a project with a Eurozone scope (EU-17)

- The EU has adopted most of the regulatory reforms agreed within the G20 and the FSB since the beginning of the crisis

- The reform has 3 main objectives: (i) reinforcing bank’s balance sheet resilience, (ii) addressing systemic risk and (iii) protecting taxpayers

- Global regulatory consistency must be reinforced
European regulatory reform and banking union

- New European Systemic Risk Board
- OTC derivatives, Infrastructures, Credit Rating Agencies
- Separation of retail and investment banking activities
- Macroprudential
- Financial markets
- Structural reforms
- Bank Resolution
- Capital/Leverage
- Transposition of Basel III rules
- Liquidity
- Supervision
- Harmonization of Resolution & DGS regulation
- Single Supervision (SSM)
- Single Resolution (SRM)
- Three new Authorities:
  - Banking (EBA)
  - Markets (ESMA)
  - Pensions & Insurance (EIOPA)

BANKING UNION (EUROZONE)
Section 2
Transposition of Basel III in the EU

Capital
- In line with Basel III: 4.5% CET1 + 2.5% conservation buffer
- Countercyclical buffer: up to 2.5% (national discretion)

Systemic risk
- National discretionary powers:
  - Systemic risk buffer (financial sector): 1 – 3%
  - SIFI Buffer (institutions): G-SIFI (1-3.5%); Other-SIFI (0-2%)

Leverage
- 3% minimum (binding since 01/2018)

Liquidity
- Pending calibration of LCR
- 100% target in 2018 (BIS: 2019). Earlier implementation possible at national level

Remuneration
- From 2015 bonuses capped to fixed salary (1:1) (2:1 with shareholders approval)

Implementation date: 01/01/2014
Bank resolution: a revolutionary change

**Objective**
- Orderly resolution while minimizing cost for taxpayers
- Based on FSB Key Attributes (but went much further in tying the hands of the authorities)
- European approach: not only about Too Big To Fail

**Tools**
- Sale of business
- Asset separation
- Bridge institution
- **Bail-in** (main loss-absorbing tool)

**Main aspects under discussion by legislators**
- **Bail-in**
  - Harmonized hierarchy of creditors
  - Minimum internal loss-absorption
  - Depositor's protection
  - Discretionary exclusion of certain liabilities

- **State aid rules**
  - Partial bail-in in since July 2013
  - Government stabilization tools / Role of European funds under discussion (ESM)

- **Resolution fund**
  - Funded by the industry
  - Resolution fund/deposit guarantee schemes: joint or separate
  - Eurozone: Single Resolution Fund under discussion
Section 3

Resolution: bail-in and use of Resolution Fund

**8% internal loss absorption**

8% of total liabilities to be absorbed by shareholders & creditors before use of Fund. Depo preference and constrained discretion for bail-in exemptions

**Use of Fund**

Loss absorption or capital injection up to a limit of 5% of total liabilities

**Financing of Fund**

Banks: ex-ante, ex-post and, exceptionally, alternative financing sources (private/public)

**Alternative financing sources**

Only after 5% Fund cap has been reached and all unsecured and non-preferred liabilities other than eligible deposits have been bailed in

**HIERARCHY**

- Depo preference
- DGS (covered deposits)
- Households & SME Eligible deposits (>EUR 100,000)
- Corporate deposits >EUR 100,000
- Subordinated debt
- AT1 and AT2
- CET1

**LOSS ABSORPTION**

Resolution Fund 5% liabilities

More bail-in or eventually alternative financing sources (private, public/ESM)

Internal absorption 8% liabilities (hierarchy order)

Fund could absorb losses

More bail-in or eventually alternative financing sources (private, public/ESM)

Resolution Fund 5% liabilities

Internal absorption 8% liabilities (hierarchy order)
Section 4

The Eurozone needs a banking union

To stop fragmentation and separate sovereign and banking risk

European Banks: Average exposures to banks located in other EU members USD (dollars).

Source: BIS

Use of cross-border collateral in Eurosystem monetary policy operations (% total)

Source: ECB

Re-nationalization of the financial systems fuelled by (i) market-driven segmentation, (ii) rating agencies and (iii) regulation (mostly moral suasion)
Section 4

The banking union project

- Single Supervisory Mechanism:
  1. European Central Bank
  2. National supervisory authorities
- Precondition: comprehensive asset review (AQR+ Stress test)

Single Resolution Mechanism:
- Single Resolution Authority
- Single Resolution Fund
- Not in the mid term roadmap
- Treaty reform required

Single Rulebook
- Capital Requirements Directive (CRD IV)

Single Supervision
- Under implementation

Single Resolution
- Under implementation

Single Deposit Guarantee Scheme
- Under negotiation
- To be negotiated
Banking union: the way forward

1. The EZ needs a fully fledged banking union. This includes single supervision, single resolution and some elements of debt mutualization and fiscal union.

2. Dealing with legacy problems is key: comprehensive assessment of banks by the ECB, Asset Quality Review (AQR) and Stress Test with EBA.


4. Bail in will contribute to separate the sovereign and banking risk: hydrids already in force, senior debt in 2018 (may be 2015).

5. Negotiations on Single Resolution Mechanism are at a stalemate but time runs out. Fiscal union by the backdoor? Reform of the Treaty?
Global regulatory consistency is needed

New trends in regulation puts at risk the efficiency of the reform

- Extraterritoriality
- Excessive regulatory activism
- Procyclicality
- Ring-fencing
- Overlapping

- Fragmentation of financial markets
- Pro-cyclicality // Delay in economic recovery
- Regulatory arbitrage
- Shadow banking
- Increase in cost of financial intermediation

Ensuring international cooperation and global consistency

- Promoting mutual recognition of standards
- Ensuring a careful calibration and coordinated implementation of new rules. Supervision is key
- Intensifying the transatlantic dialogue between US and EU, leading towards convergence
- Acknowledging different realities beyond US/EU. Emerging countries: focus on financial inclusion
Thanks!

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Annex

Single Supervision

Already in force. Fully operational in November 2014

**A** Main goal: Restoring confidence in the Euro by stopping financial market fragmentation

**B** Institutional setup
- Mandate: Eurozone-wide financial stability
- Authority: European Central Bank (ECB) is the ultimate responsible but:
  - Direct supervision of top 130 banks
  - Indirect supervision (through national supervisors) of the rest (6,000 banks)
- Scope: Eurozone + open for no euro countries willing to join
- Governance: Separate Board inside the ECB

→ Why the ECB? Prestige, independence, know-how + legally suitable
→ Risk: Necessary separation between supervision and monetary policy

**C** Prior to full operation: legacy issue → Asset Quality Review + Stress tests (Nov‘13-Oct‘14)
The need for an SRM

The SRM: main objectives

- Provide a **credible counterparty** to the SSM on the resolution side
- Ensure a **uniform implementation** of the EU bank resolution rules
- Guarantee a **level playing field** across the Eurozone
- Provide the EU with a satisfactory solution to **cross-border resolution**
- Provide **greater clarity** in the relationship between CMGs and resolution colleges
Fixing the Legacy Issue

A robust comprehensive assessment

- Sound methodology
- High transparency
- Sound loss absorption

Enough backstops: sequence

1. Tapping the markets
2. Banks’ balance sheet management
3. Implementing partial bail-in
4. Fiscal backstops at national level
5. European backstop

To ensure credible results