29 May 2019

SLOVENIAN BANKING SUMMIT

Speech by Gonzalo Gasós, Head of Banking Supervision

SUPERVISION POST-REGULATORY REFORM

Thank you, Stanislava Zadravec Caprirolo, for your invitation to participate in the Banking Conference of the Bank Association of Slovenia. I am pleased to visit Slovenia, also because it is a country with a keen interest in finance. That became obvious in the European Money Quiz, the financial literacy competition that we organise annually in the European Banking Federation with the participation of more than one hundred thousand students from across the EU. Two teenagers from the Slovenian team were placed first in the second edition last month. My deepest congratulations!

The last time I was in Ljubljana was in 2010 when I gave a presentation in the program on home-host cooperation. Rereading my slides, I realise how much the supervisory architecture has changed towards a European model and how little the banking system has moved from its national based model since then. In 2010, the first steps of the European System of Financial Supervisors were being taken. I claimed in my presentation that further bank consolidation would contribute to the Single Market's integration and that we all should encourage the emergence of cross-border banking groups.

- This will be the first topic of my speech, the longstanding cross-border ambition in European banking and supervision;
- Secondly, I will raise some facts about the supervision of banks as businesses in the new regulatory framework;
- Number three, I would like to assess the interaction between regulation and supervision;
- Finally, I will refer to the role of the internal assessment of banks as the place where business and supervision come together, offering an opportunity to conduct business-conscious oversight in the post-regulatory reform era.

The cross-border ambition

I have named my first topic the cross-border ambition because that is one of the oldest dreams in European banking. It all began with the Second Banking

Coordination Directive, which was adopted in 1989 and resulted in the implementation of the Single Banking Licence in 1993. By this directive, credit institutions authorised in any Member State were free to establish branches and to provide cross-border services throughout the European Community under an arrangement reliant on home country supervision. This was a crucial step in European banking integration, making the world's largest banking market free of regulatory barriers. A decade later the euro became the single currency of 11 Member States, therefore, facilitating the offer of banking services across the Euro Area. In the following years, we witnessed many mergers and acquisitions between European banking groups. To recall a few big takeovers, Unicredit entered Germany buying Hypovereinsbank; ING did so with Direktbank, Santander in Portugal with Banco Totta and in the UK with Abbey National, BNP Paribas took over the Italian BNL, Deutsche Bank bought Banco de Madrid, Barclays settled in Italy, and so on. There was indeed an active period of European banking integration.

However, the upsurge of the financial crisis in Summer 2007 put a sudden end to the European banking integration process. As it happened, the largest acquisition in the global banking industry until that time, the purchase of the Dutch giant ABN Amro by RBS, Fortis and Santander, was the last one in the pre-crisis period. The days of banking expansion across European borders ended with the financial crisis, turning a page in the recent history of our European banking sector.

What happened next?

Ten years of bankruptcies, the Euro Area crisis and the regulatory reform swept away the motivation for cross-border banking in Europe, at least for the majority of European banks. However, the public sector is still keeping the old dream alive. Curiously, public institutions have taken the lead, breaking a long-established practice whereby banks came up with new ways of doing business and supervisors kept up with the trend at a later stage.

On the contrary, these days, regulators and supervisors are the advocates of European banking consolidation. Paradoxically, there has been a switch: Before the crisis, banks were becoming increasingly international at a time when most regulations were national, and supervisors were not totally prepared for the demands of cross-border supervision. Since the crisis, regulation has become European, and a single supervisor has taken over responsibility from national authorities, - yet banks have stopped and even retreated from cross-border activity focusing on their domestic markets.

Let me sum this up: we have a Single Market, a new Single Rulebook and a Banking Union underway. Why do we still not see increased appetite by banks for cross border mergers? The answer to that is complex – some important elements will become clear – I hope – in the points I am going to raise in this speech.

The implementation of a Single Rulebook in Europe is a great achievement; it should have paved the way towards the open offer of banking products and services throughout Europe. Yet, there remain significant regulatory impediments that make cross-border banking uneconomical. For instance, the ample discretion granted to Member States to apply systemic buffers on a national basis or the lack of waivers for the transfer of capital and liquidity across European subsidiaries of the same banking group. These examples are barriers to European integration, therefore encumbering the benefits in terms of efficiency and progress that cross-border bank consolidation could otherwise offer to European citizens.

On the side of supervision, we have made huge progress with the implementation of the Single Supervisory Mechanism. These days, a common supervisory culture is in place in 19 countries with hundreds of supervisors from different nationalities working together with the same purpose under the principle of harmonised supervision. In contrast, the reality of the economies where banks operate remains very national. Let’s not forget that national laws and local business environments are not converging as fast as European supervision. No wonder SSM management is a balancing act exercise. Success means striking the right balance. How can that be done legitimately? An opportunity lies in the internal assessment of banks capital and liquidity, known as ICAAP and ILAAP. I will come back to this in my last point.

Supervision of businesses

Now I will move to my second point, the monitoring of banks as businesses. I mentioned previously that European consolidation would not happen if it doesn’t make business sense. This sounds obvious. However, we seem to have forgotten that our banks are businesses that compete amongst themselves and with companies from other industries.

We are still conditioned by the financial crisis and its social repercussions, which still reverberates in the media. Other jurisdictions have been more able than Europe to put the global financial crisis behind and begin looking forward. So I think the EU should do the same.

We have come a long way since the financial crisis. We have created the highly successful Banking Union and completed other necessary post-crisis reforms, which have led to a tremendous increase in the resilience of the banking system.

However, time has revealed an unintended consequence of the European architecture of banking regulation and supervision. The multiplicity of authorities in Europe has resulted in cumulative requirements and overlapping requests. European banking regulation is a mixture of gold-plating decisions taken by co-legislators, where typically the most conservative option on every issue becomes the rule. Each authority has the right to increase the regulatory bar, but none is responsible for the overall result. Likewise, the low profitability of the banking system is everyone’s concern but nobody’s responsibility.

This situation creates an environment of regulatory uncertainty precisely in a moment when banks mostly need predictability in front of investors. Let’s not forget that the total market value of European banks remains roughly the same as ten years ago despite having doubled the regulatory capital. This indicates that the market has not assimilated the increased regulatory resilience.

Fortunately, the international prudential standards leave room for supervisory judgment, mainly in Pillar 2. This represents a significant part of the capital requirements for European banks. The supervisor should be able to assess the bank as a business, not just from a normative perspective.

This brings me to the third point I wanted to make.

The balance between regulation and supervision

Regulation is gradually replacing supervision. Banking regulation is so vast, so deep and so prescriptive that there is very little space for supervisory judgment. This is illustrated by the division between pillar 1 and pillar 2. The more stringent pillar 1 becomes, the less room there is for pillar 2. This is not good in the long term. In my experience, I have seen arguably flawed regulation, but I have never encountered a totally wrong supervisor.

A negative consequence of the excessive prescriptiveness of regulation is that an overwhelming normative perspective inevitably constrains the dialogue between supervisor and bank. We should be able to streamline tedious and cumbersome box-ticking tasks and leave more time for discussion and interpretation of the idiosyncrasy of every bank.

Some say that the regulatory activity is slowing down, but I cannot entirely agree with that. The entry into force of CRR2 and BRRD2 and the NPL backstop, the next battery of 70 mandates given to EBA, the transposition of Basel IV, as well as the Fundamental Review of the Trading Book; all this will keep us busy during at least 4 or 5 years. The pillar 1 regulatory bar will be pushed up, including but not only due to the capital floors, therefore narrowing down pillar 2 and the influence of supervisory judgment.

All in all, the Single Supervisory Mechanism is confronted with a two-fold aim: it has to conduct harmonised supervision, and it should do it with a tailored assessment of every bank. However, harmonisation should not be an excuse to make one-size-fits-all decisions. Conversely, it should only apply to methodologies and procedures but not to individual assessment of banks. Having spoken about this with numerous banks, I arrive at the diagnosis that the purpose of harmonisation prevails over the individual evaluation of banks. The ICAAP and ILAAP offer greater space for individual assessment that has not yet been totally used.

In conclusion, the post-regulatory reform era is featured by a significant transfer of supervisory discretion to automatic ultraconservative regulation. This situation poses two unintended consequences in the economy:

1. First, the regulation significantly constrains the capacity of banks to give credit to viable businesses and households;
2. Second, that the regulation triggers resolution in a bank that could have otherwise continued operating safely.

We need a revaluation of regulation and the matters that should be put back onto the table.

Internal assessment of banks

My last point is about the internal assessment of banks. Supervision is an art and a science. The scientific part is to check regulatory compliance, the box-ticking task. The artistic part is the judgment of the bank in front of you. Not only the numbers but also the circumstances. Paraphrasing, the philosopher Ortega y Gasset: I am myself and my circumstances. Likewise, a bank is itself and its circumstances.

The assessment of a bank cannot be carried out just by running mechanistic benchmarking comparisons. A meaningful assessment requires a broader view of the environment where the bank operates, its choices, its planning, and the way it navigates through its circumstances.

Opportunely, the bank regulatory toolbox provides with the appropriate instrument to conduct enhanced supervision and makes the internal assessment of the bank relevant. I am referring to the Internal Capital Adequacy Assessment Process, the ICAAP, and its counterpart for liquidity, the ILAAP. These are comprehensive tools that enable supervisors to assess every bank entirely from the inside view of the bank like a business, thus enriching the Supervisory Review and Evaluation Process (SREP).

The ECB Guide on ICAAP and ILAAP is a promising starting point, at least conceptually:

- It recognises the internal nature of the assessment; however, it gives more prominence to the normative perspective leaving a secondary role to the economic perspective;
- it foresees the integration of the adequacy assessment with the business strategy and risk appetite that the bank is free to set;
- it contemplates the use of ICAAP-based risk-adjusted performance indicators; it recognises the independence of the bank to set the management buffer, even at zero;
- it links the going concern view of the ICAAP with the gone concern purpose of the recovery plans;
- also interestingly, the ECB guide envisages that the institution is expected to have a strategy for addressing potential deteriorations of the internal
- capital adequacy position. This should serve as the basis for discussion between bank and supervisor.

Having a conceptually solid guide is good, but it does not guarantee a practical implementation. Let me enumerate the five stages that a properly conducted ICAAP should follow:

1. Understanding;
2. Dialogue;
3. Challenge;
4. Conclusion; and
5. Recommendation.

If the supervisor jumps directly to the last stage, making recommendations without having fully understood the bank business nor established a sufficiently productive dialogue, then we wouldn't be harnessing the benefits of a well-rounded and more business-conscious supervisory assessment.

Let me illustrate some situations which are enshrined in the spirit of the ICAAP and ILAAP guidelines:

- First, banks should be managed according to their economic capital models; however, the regulatory capital has taken over as the binding factor for bank management. This is, in my opinion, one of the major causes of the low valuation of banks. The fact is that the business model of a bank is more stable than the regulatory framework. The bank can draw a plan for the next three years in terms of economic capital and truly stick to it, however doing so in terms of regulatory capital is a guessing exercise. MREL and Basel IV make a dangerous combination. The factors involved in regulatory capital planning are moving targets: the risk-weighted assets, the minimum core equity, and the amount of subordinated convertible debt that banks will have to issue cannot be accurately predicted. Even if the business model of a bank is stable, regulatory uncertainty is a significant risk factor.
- Second, the ICAAP foresees that the supervisor should understand the situation of the bank as regards funds raising, including volumes, prices, and investor appetite. In my view, this is a critical bit of information in the coming years with the upcoming MREL issuance. Supervisors should be business-conscious and market-aware and incorporate those circumstances in the assessment.
- Another example is the approach to intra-risk and inter-risk diversification. I have discussed many times the benefits of diversification, and there is broad agreement about it, but only theoretically; in practice, the capital requirement remains equal. However, evidence suggests that well-diversified banks are more able to engage in cross-border mergers. However, what is the incentive for buying a foreign bank in resolution if the benefit of diversification is only apparent in the internal model with no effect on the regulatory capital – and hence on the return on equity?

- Likewise, the ILAAP contemplates the integration of the liquidity cost-benefit allocation model into the measurement of profitability for new asset and liability generation. Here a question arises: what is the right balance in the trade-off between liquidity buffers and profitability? As I mentioned in my speech at the Liquidity conference two years ago, there is a paradox of our regulatory framework: The best bank, in terms of regulatory ratios, would be funded with lots of capital and expensive subordinated debt and be invested in liquid government bonds. Such a bank would be the champion of compliance with all regulatory ratios. Yet sooner rather than later, it will agonise due to a lack of profitability. The trade-off between regulation and profitability raises a question which is addressed nowhere in
- our vast regulatory framework. Here, the only one who can apply a bit of common sense is the supervisor in the scope of the SREP.
- Another puzzling example: The supervisor has to conduct an assessment of the intragroup liquidity flows and funding positions, including any possible legal or regulatory impediments to the transfer of liquidity within the group. Unfortunately, this is happening between Member States and even within the Euro Area.
- Let me give one more example. Stress testing has become a standard regulatory tool. After an intense experience last year, the EBA is thinking about changes for future exercises. Well, let me recall that the most meaningful stress testing is the one that every bank carries out internally within the scope of the SREP. The internal stress testing promotes the
- dialogue and understanding between bank and supervisor because it is all about the plausible scenarios that each bank could face. Anyways, it is overshadowed by the external stress testing, which follows a one-size-fits-all approach which cannot contemplate the specific circumstances of every bank.

In summary, regulators have completed a daunting task with the regulatory reform. However, the business aspects seem to have dropped from the regulatory radar. Supervisors have a more truthful view of those business needs, because they spend much time on the battlefield, sitting next to bankers, talking with them, understanding their business. My plea to supervisors is to take note of the things that are not working well in terms of regulation and give well-informed feedback for a critical review of the law.

Ten years on, we need another De Larosière report, made by a group of bankers and supervisors, that can inspire a well-thought through review of the European prudential regulation.

I will conclude with a reminder. Do not forget that as regulators, supervisors, and banks, we are all in the same boat. Not only do we have to keep it afloat, but we also have to let it sail along with other competitors. Being pro-European is not only about harmonising rules; it is also about taking legitimate decisions to benefit the position and the competitiveness of European businesses.

Thanks for your attention. I look forward to an interesting debate in the panel session.