4. BANKING REGULATION

Forthcoming banking regulations: what potential impacts and issues for the EU banking sector?

KEY ISSUES | *The session tried to assess the magnitude of the forthcoming global regulatory evolutions in the context of an already unprecedented regulatory overhaul initiated in the wake of the financial crisis. The rationale and the main consequences and issues related to these additional significant initiatives were also outlined.*

Basel IV: reducing risk weight variability

Many consultations were underway on issues such as changes to leverage ratio and operational risk. A 3% Basel global minimum for leverage ratio had been confirmed, although some countries had adopted a higher standard. Current challenges included specifying the capital baseline and ensuring that all regions reached it. Conversely, there were instances where regions had adopted more robust standards than the Basel minimum.

One critical intention was to reduce risk weighted asset variability. Some risk weights had been revealed to be unfathomably low, which proposals had been introduced to fix. The governors and heads of supervision had announced a yearend deadline for completion of reforms.

Indeed, Several CEOs in 2011 had said at the time that the recapitalisation exercise had been launched by the EBA, that they would comply by risk weighting optimisation, which everybody had read as tweaking the models to circumvent the requirement. The investors had been concerned seeing banks with similar portfolios coming out with very different calculations of risk weighted assets.

The EBA had since produced five reports to understand the issue, and Basel had also completed useful work. The industry understood that the issue needed to be addressed and they had to accept that a lot of those differences had been driven by supervisors applying different rules. They needed to repair those issues and provide clarity and consistency to the market.

A prominent issue arose from what was considered 'significant'. In the finalisation of Basel IV the main restriction had been on not 'significantly' increasing capital requirements. However 'not significantly increasing capital' was a vague term. One way of viewing significantly increasing capital was its impact on outliers. Outliers were likely to have to increase their capital. A concern was that there were a number of outliers banks in the EU, which actually needed to have 20% more capital.

Housing Finance and Real Estate

A public authority representative noted that the issue that received the most attention regarding risk weighting was housing finance and real estate. It had been suggested that all housing and real estate markets were special. It was also highlighted that differences between markets were never as significant as people thought. Finally, the panellist from the industry concluded by saying that a number of distortions had been introduced by creating something floor based on the basis that those markets were the same.

Low-default portfolios had been given high risk weight in the latest proposals. Though they could not ignore that low risk weights did not indicated that Probability of Defaults (PD) were low, but also reduced Loss Given Default (LGD). Indeed, they often had low default portfolios either because not many defaults happened or because the transactions that they did with those clients were self liquidating. The desire to be conservative was understood, but it was stated that the combination of the PD and LGD could not lead to the risk weights that they were seeing, which was a concern.

To move forward they had to look at the structure of those markets in greater depth. Indeed, >>>

>>> European systems under Insolvency legislation featured personal liability and there were therefore fewer losses in those systems than in the US'. In addition, although one would have thought that large banks adding up to the majority of the population in a given country would have to have the same risk profile, however, their risk weights were very different.

The differences in the investor perceptions between the EU and US banking sectors might had to do with the different respective supervisory practices, which were also illustrated by the respective stress testing approaches that had happened.

Regulatory Uncertainty

Another important concern of bankers, investors and analysts was the regulatory uncertainty arising from decisions yet to be made, and reforms yet to be closed. It was becoming increasingly urgent to complete processes and move to a different stage.

The specific issues of regulatory uncertainty needed clarification. The calibration of already agreed requirements was an area with no uncertainty. However, there was uncertainty in the repair of internal models, and providing clarity and consistency in the application of completed reforms. Both areas required rapid regulatory responses.

If organisations needed more capital, they would endeavour to find it; however, the uncertainty was over the amount of capital that was required, which then needed to be communicated outwards.

Pillar II was an additional challenge due to fragmented application; however, there was commitment to eliminating differences. Resolving the issues in definitions would also reduce the difference in risk weighted asset calculations.

A Risk Weighted Approach to Banking Regulation

Further reduction in the differences of risk weighted asset calculations required improving the standard and internal models, and implementing the leverage ratio as a complement to capital requirements. Stress testing was also important.

Getting the capital level right had become less accurate in the current proposals. However, there were reasons to think that some portfolios could not be individually modelled. Input and output floors needed to be considered, and they also had to define how they implemented leverage ratio.

Models tended to be more effective in practice if used for both regulatory and business purposes. Consequently, the more regulators desensitised models for risk, the bigger the problem would become as whenever risk weights were defined according to a floor higher than the actual risk, the incentive to provide more careless lending would be there.

On the risk weighted approach towards banking regulation; first, they were not afraid of well capitalised banks releasing capital requirements. Second, it was concerning that the industry increasingly sought shortcuts to push for better capitalised banks rather than working on plain capital requirements based on risk weights.

There were also points that undermined the risk based approach. First was on incentives; if they insisted that risk weights were defined according to a floor higher than the actual risk, the incentive to provide more careless lending would have been there. Second was on complexity; they had many ways of accounting for capital requirements, which made some people uncomfortable. Third was that risk weights were not perfect.

There were some firm believers in stress testing and the virtues of the leverage ratio. However, Insolvency legislation was identified as a problem which made life different across jurisdictions.

One element of the 24 March proposals that had gained attention was the prospect of an output floor. Some thought that capital floors were a problem. If they wanted to calibrate their capital levels, it had to be done through a portfolio of floors.

Supervision

The framework for the prudential regulation of the banking sector was essentially a three legged stool with risk based metrics, leverage ratio and stress tests. There was a danger in the extent to which they were turning the risk based leg into a non-risk based measure.

It would also be important to discuss the role of supervision. The Basel Committee had completed a lot of work which had seemed to be setting the stage for more intrusive work as supervisors. It was worth inserting that as a much more significant part of the Basel agenda. It was noted by some that they were moving back towards supervision, and that they also had to consider the importance of risk management governance culture in banks.

The work over the course of the year had largely been taking the risk based leg of the stool and turning it into a second non risk based leg. Further work in that area was recommended.

There was a critical role for supervision. The regulatory phase was concluding and >>>

>>> they were seeing a clear move towards implementation and supervision.

Remaining Issues

On the lack of analyses of the cumulative effects of all measures completed by separate bodies, there was a discrepancy highlighted between the ambition levels of the organisations driving it, and the realities at the level of a real bank considering the consequences.

There was also uncertainty on who would reduce risk if the banking sector shifted them into the markets. There was also lingering uncertainty as to whether that would benefit taxpayers or if Europe was prepared to intervene and absorb some of the risks through the Central Bank balance sheet.

Package reforms had consistently strengthened the treatment of the trading book, reinforcing capital requirements, introducing a non risk weighted metric, and repairing the problems identified in the internal model.

Conclusion

Since the beginning of the crisis, the intention had been to make something coherent, but the results had not always been so. Directives were thought to no longer be the correct instruments for a 28-member union. They perhaps needed to make fewer regulations, but also had to reduce creativity in implementation at a national level.

Second, the importance of supervision was emphasised. They needed strong supervisors with tough powers.

Finally, the industry was advised to relax. They concluded that they had to believe that progress was possible and, although they wanted to keep the UK on board, they would carry on. ●

Banking Union: what are the priorities of the SSM to achieve trust in the banking system?

KEY ISSUES | *This session discussed whether the expectations related to the SSM had been met so far. The objective of this session was also to review the priorities of the SSM and the significant challenges of how to achieve trust in the banking system of the Eurozone and make banks' business models sustainable in the current monetary, economic and regulatory environment.*

Benefits of a Single Supervisor

Since 2014, the Single supervisory mechanism (SSM) has been responsible for supervising the most significant banks in the Eurozone, with the aim of ensuring consistent supervisory practices and increasing the soundness and stability of the banking system. In order to treat equally all supervised banks showing the same characteristics, the ECB needs homogeneous rules and homogeneous ways of applying them. Some benefits had arisen from the moves towards an integrated framework that had taken place over the course of the past year and a half. The SSM has achieved a lot in the areas of common approaches, common supervision, and levelling differences. There had been in particular an integration of practices, and willingness to borrow from best practices that were already present across Europe.

As the SSM operational units, joint supervisory teams (JSTs) are composed of ECB and national competent authorities (NCAs)' staff. The SSM draws therefore on the expertise and resources of 19 NCAs in performing its supervisory tasks, while also benefiting from centralised processes and procedures. This set-up allows for a cross-border perspective while retaining a national perspective. The SSM is a major step towards a level playing field in banking supervision in Europe. In the future it will continue its endeavours towards full comparability and harmonisation.

The EBA's deliberations had included the important issue of how to ensure the existence of a common rulebook and practices across the European Union, beyond the boundaries of the monetary union and the SSM. The concept of dealing with a single supervisor was a very attractive one to >>>

>>> international banks, and now that regulators in the Eurozone were gathered together, it was easier to identify the differences between regulatory approaches across Europe: for example, the differing approaches to the supervisory review and the evaluation process (SREP). Indeed there had been 19 different approaches to Supervisory Review and evaluation Process (SREP), but these were now being organised in a much more consistent and integrated way. It took some time to fully realise all those benefits in an operational sense, but there had still been some 'major game changers' and steps forward .

In addition, having a single representative body able to conduct meetings with the Federal Reserve or the Prudential Regulation Authority (PRA), as an equal partner in a trilateral context, had also been helpful.

Predictability, consistency and Coordination Issues

SSM was a major investment, and the result of a major crisis; it had been in place for 16 months, and had achieved some of its goals, but a lot more work needed to be done. There needed to be both operational and regulatory improvements to improve the performance of the SSM. Firstly, it would be necessary to plan the SSM's actions better, with involved parties receiving the agendas of meetings sufficiently early to prepare for them; more transparency and feedback in relation to things like the SREP methodology and internal model validation; and clarification on how the ECB intended to integrate the stress-test results in the SREP analysis in 2016. The calendar of the SREP needed to be reformed, to reduce the amount of activity that was front loaded into the first half of the year.

Increased visibility would also be necessary in relation to the Basel Committee, SSM and EU Commission regulatory agendas. There should be clarification regarding reporting requirements, to reduce duplicated requests. Although the concept of having a single approach was being widely debated, there had been multiple perspectives prevalent during the discussion at the end of 2015 on Pillar II and MDA; there needed to be a more coherent and consistent view on these crucial issues, as this had led to instability in the market and higher volatility. More precisely, the EU legislation created notably an inconsistent treatment of AT1 instruments across Europe. Firstly, these instruments were paid, not based on group results, but on solo accounts of the company. In his institution's case, their holding company is based in Germany, and subject to German GAAP. In order to avoid confusion of investors, the payment on AT1 instruments should be based on IFRS. Secondly, many investors do not understand that in Germany AT1 payments were not based on the Group level but on the GAAP solo account of the company. This should be based on the consolidated accounts of the group, as is the case in the US. Thirdly, uncertainty is created due to the different interpretations of the interaction between the Pillar II requirement and MDA (e.g. CRD IV vs. EBA/ECB and European Commission).

There was no more volume in the market: banks were keeping liquidity for themselves, which made banks safer but weakened the market. As such, adjustments were based on price, which created huge volatility, and made the market susceptible to shocks such as the one that had happened over Chinese New Year 2016. Inconsistency in legislation, uncertainty about supervision, and huge volatility added up to cause accidents.

The question of MREL and TLAC, and the respective role of SRM and SSM, needed to be considered, along with the problem of Basel IV and the consequences for the IRB. There also ought to be more guidance and transparency in the area of internal models. Although the direction of Basel on this issue was not necessarily welcomed by the industry, banks would still want to know what was impending.

Banks needed to become accustomed to the fact that the macro environment, technology and regulation were the three key factors that were structuring and lowering prospective profitability, and the enhanced perspective of organic capital generation. The SSM should also become familiar with these issues, in the sense that capital needed to increase generally, and would also need to develop a fruitful relationship with other supervisors. It would be helpful, as well, for the SSM to unify its practices and to be seen as banks' main interlocutor, rather than just another partner; to become better known outside of the Eurozone; and to build up its relationship with US regulators.

International groups were calling for the banking union to be treated as in a single jurisdiction and not face local requirements (capital, liquidity); some progress had been made towards this goal, such as having waivers for solo rules in individual countries, but these moves had been too cautious. Best practices from individual countries were currently being brought to bear in the supervisory approach of the SSM; Dutch bankers had introduced a bankers' oath, and the SSM had also taken an interest in countries that paid more attention to details, file reviews, and data analysis. These two approaches were complementary and enriching.

A lot more could be done in relation to the SRB and the SRM. Regarding the former, the focus was always on when a bank was failing or likely to fail, and when control moved over to the resolution authorities: it had become clear that it was usually not difficult to determine that a bank was failing, but it was >>>

>>> more difficult to determine what form the bank should take after the resolution weekend, and what supervisory requirements would need to be imposed on it. This topic needed to further looked at.

Progress on conduct had been slower. Conduct regulation and supervision had been kept within the scope of national authorities; this was a very important issue, and now that prudential aspects had been dealt with, it was the next thing to look at.

SSM Evolution in Countries with Large Foreign Banking Sectors

Representatives of national banks in countries where large percentages of the banks were foreign banks differed regarding the impact that SSM had had. One stated that the SSM environment meant that co-ordination had to take place at the higher SSM banking union level, or Eurozone level, which had significant impacts on their regulatory and supervision cultures. The other stated that national organisations had worked well with their counterparts in different countries in the past; they had had joint memoranda of understanding, and he did not perceive a significant difference between the pre SSM and post SSM situation. Improvements could be made: the supervisory review process timelines could be better aligned, and there should be a clearer policy stance on stress testing approaches for subsidiaries, although the panel member acknowledged that more time was needed.

Achieving Trust, Reforming Banks' Business Models and improving profitability

One banking representative stated that profitability would inevitably be lower in the future taking into account the monetary, economic, technological and regulatory environment; to manage this, it was vital to have notably clarity and guidance on the forthcoming regulations. The instability of legislation has not helped to restore confidence in the EU banking sector and had had major consequences for the profitability of banks. For instance, specialised lending could lead to a threefold or fourfold increase in capital requirements. Investors wanted opportunities to discuss Basel with European banks, and when they did so, it was important for banks to be able to speak about them in detail. Due to the uncertainty on the forthcoming global (Basel IV) regulations, banks had not been in a position to do so and this could create volatility in European financial stocks, which was something that definitely needed to be avoided in the current, already volatile context.

Non-performing loans in the banking system in Europe, and levels of certainty business models, also needed to be considered. Non performing loans having recurred as a source of concern was surprising, because a very comprehensive assessment had taken place at the end of 2014, with provisions increasing to the necessary level. However, investors did not accept this when banks had non performing loan percentages of 20% or higher; this would need to be addressed via the SSM.

Regarding NPL, this was an important indicator, but from a supervisory capital and equities calculation perspective, prudent and concrete asset value was more important. Ultimately, capital adequacy was the most important ratio, and if the value of assets was correct, differences in NPL ratios did not distort the analysis and comparability of the banks.

According to a central banker, with the present low interest rates they had not yet significantly damaged the interest income of banks but, eventually, they would do so, and there was also concern about how banks would develop their business models. To address these kinds of concerns, it would be necessary to enhance synergies, and to produce more realistic assessments at both the local and group levels and at the SSM level. Risk assessment methodology was vital: uniform terminology, uniform assessment of scoring indicators, and uniform reporting needed to be in place; otherwise, different requirements would be in place for the same risk level in different banks and groups, which would cause competitive disadvantages. A panel member from a smaller European country noted that there was a need to consider the pressure that all of these demands placed on administrative capacities and on staff.

In such a context, for stable profits to be achievable in the future, regulatory stability was essential. The finalisation of Basel III needed to be completed within a reasonable timeframe and calibration for stability's sake, although there were good reasons why time had been taken over this. Other challenges to banks' business models included competition, technological innovation and market developments; instability was not only arising from regulatory concerns.

A Central Banker summarised the job of supervisors as containing three aspects: promoting a stable regulatory environment while completing the banking union project in the appropriate way; promoting consistency and a level playing field, both within the SSM and globally with peers; and to militate against the huge amount of pressure that was placed on institutions to be profitable, which created a risk of them acting in ill advised ways. Supervisors should identify weak practices reaching for yield, inappropriate risk return, and short term type behaviour. ●

EDIS: what prospects for an EU Deposit Insurance Scheme?

KEY ISSUES | *The "Five Presidents' report" highlighted common deposit insurance as a desirable and realistic objective for the financial sector. The aim of this session was to discuss the key success factors needed for the adoption of the legislative proposal of the EU Commission for a common deposit insurance scheme.*

Speakers were also be invited to assess the improvements brought about by the EDIS proposal to the Banking Union and the added value of tackling at the same time the risk reduction measures in the banking system (notably bank exposure to sovereign risk).

The Commission's Proposal on EDIS

The key objective of the EDIS is to enhance the effective deposit guarantee framework with a view to protecting depositors, in the banking union, against the consequences of deposits becoming unavailable.

According to the European Commission's legislative proposal the European Deposit Insurance Scheme would be established in three successive stages. During the reinsurance period of three years, the national DGSs would have to be exhausted first before EDIS could be used, providing with national schemes an additional source of funding. This reinsurance phase would be followed by a progressive mutualisation of deposit insurance over a period of four years. To reduce moral hazard, the EDIS proposal contains some safeguards. For instance, in the first two phases, the national scheme has to comply with the obligations of the DGS Directive (adopted in June 2014), in particular with regard to the required annual target levels, before receiving any extra support by EDIS. The full insurance of depositors would fall under EDIS from 2024 onwards

Everybody had an opinion on EDIS, many of which differed. However, a majority of those opinions were in favour of EDIS, and there was agreement that it would be a good thing for a lot of European citizens.

7.2 trillion of the 15 trillion of deposits in the EU were protected by deposit schemes. The current average of DGSs in Europe was 0.62% of covered deposits. From that they could conclude that EDIS would initially need to provide liquidity support; it needed to be designed to avoid unfair disadvantages to less funded schemes; it had to be cost neutral compared to current schemes for participating banks; and it had to take into account risk based contributions. The first stage of EDIS that the Commission had proposed helped because it accounted for those legacy issues.

For full coverage, they also needed to consider bank structures because those under joint liability schemes or IPS would never trigger EDIS. Furthermore, they needed to discuss the alternative use of DGSs in other countries, and the safeguards in the Commission's proposal.

The legal basis could be discussed, but they were confident that it was correct.

Some felt that the discussion was actually about the singleness of money, and not EDIS, and that questioning EDIS was questioning the single currency.

The Commission had said that they needed to work in parallel on risk reduction measures. It was agreed that they needed to do so, and they had worked on many over the past few years. In terms of risk sharing, the SRF would not be mutualised until 2024. They therefore had to work on risk education and risk sharing in parallel. If they did so, they could create stability and protection for savers anywhere in Europe.

Some had already established teams to deal with EDIS, anticipating that it would be both important and difficult. The real question on EDIS was not whether it should be implemented, but on the timing of the sequencing, and various tasks needed to reach completion before EDIS could progress.

Scepticism

Some contended that, on EDIS, it was inadequate to consider phase II and III of the EU Commission's legislative proposal and that they should consider renaming the regulation to EDRIS (European Deposit Reinsurance Scheme), because reinsurance was an effective long term solution. A second reason for caution was that the EU needed to translate TLAC in the EU legislation and precise the interaction between TLAC and MREL. Third, priority needed to be >>>

>>> given to transposing and implementing DGSD II in all Member States. Fourth, it was common sense to check risks before sharing them.

An argument against EDIS was that there were already common standards for a DGS, including mandatory pre financing. If the DGSD were fully implemented by all Member States, there would be equal protection across Europe. The EDIS proposal was therefore unnecessary.

It was suggested that there could be interesting relationships between the DGSD and EDIS. The DGSD proposal had a voluntary mutual assistance mechanism and they could consider how to implement the EDIS proposal into the DGSD. However, that was disputed, as an attempt to put mandatory lending between DGSs had faced unanimous rejection in the past.

It was thought that EDRIS would establish a good operational sharing of responsibilities between national funds and the reinsurance entity. Second, it would ensure better cost neutrality and a more centralised system. Third, it would increase operational certainty when it came to the breakdown of contributions between banks. Fourth, it would reduce moral hazard. It would also send the right message and create two interlinked capsules: the national DGS and the European mechanism. Finally, citizens would know that they were protected at two levels.

A reinsurance system appeared pragmatic, efficient, and a good compromise between eurozone members, which would respect the principle of subsidiarity. Others were advised to consider it.

However a public decision maker reminded the audience that EDRIS was the first half of the journey. The second half was building on reinsurance and moving towards co insurance. They had to complete both parts.

The ECB 's support to EDIS

The ECB saw EDIS as a logical and necessary third pillar. They had said that a well performing banking union required further steps beyond the establishment of the EDIS, and that progress on other risk reducing measures had to be achieved in parallel with the establishment of the EDIS. They had also said that delays could be caused by a solution that made transition from one phase of EDIS to another dependent on progress, and that if conditional phase in of EDIS was supported, any milestones on risk reduction had to be precisely defined ex ante.

The ECB had considered that an impact assessment could have been warranted on the most important elements of the proposal; it was recommended that they did so.

The treatment of sovereign exposures was something to be discussed at Basel level. It would have been problematic to have a single European solution to it. Europe should have had a decisive role in Basel, but there was also the key question of what Europe's strategy in Basel was.

Sovereign risk was typically at the forefront of discussions on risk reduction. Not all sovereigns were alike, so they had to find ways to limit the exposures of local banks to local sovereigns. Europe could use the opportunity to foster diversification at the level of local banks. There were ways of entering hybrid approaches with long phase in periods that could produce a diversified market for sovereigns in Europe. They therefore warned against rushing ahead of the international process.

Building a compromise

EDIS was a topic of growing political pressure. There were two consequences to avoid: first, was that they should not forget the progress they had made with the Banking Union; second, was that they could not pour all resources into the debate, as they also had to make progress elsewhere (e.g. fostering investment through the Juncker plan, progress on economic coordination).

One way forward was to build a compromise, comprised of three elements. The first step was the Commission's proposal on reinsurance; second was a fiscal common backstop on resolution; and a third was added on governance of EDIS because of the proposed different bodies and voting mechanisms which made it too complex. Instead a weighted voting system like in other European institutions should be contemplated.

Conclusion

There were three phases of EDIS, and it was suggested that support would decrease as they progressed along the scale. On the first phase, EDRIS would solve the problems of citizens to a large extent, but they had to consider how markets would react to them sticking to the first half. The only way to reach the final stage of EDIS, with support decreasing as they progressed, was to have risk reduction increasing.

Singularity of money as the necessary third pillar and the need for a legal debate about text were key takeaways from the debate. They all saw EDIS as a necessary component of a Banking Union. However their job was to determine which pillars, beyond sovereign risk, were required to support EDIS. ●

Cross-border bank resolution: how to make it workable?

KEY ISSUES | *Banks need to issue significant amounts of TLAC/MREL instruments and investors require a clear understanding of these products and under what conditions they will assume losses.*

In such a context, the objective of this session was to discuss the remaining challenges regarding the EU resolution framework taking into account the global context. Speakers were also invited to assess the obstacles to the smooth resolution of a global bank.

EU Resolution Framework

The rationale for the discussion was to ensure that the right instruments were available to let taxpayers 'off the hook' following the financial crisis, and de risking the banking system. For the single currency's purposes, it might be necessary to have a single decision making body. For cross-border groups and those under the single supervisor, there was now a single resolution authority in the form of the banking union, although some areas needed to be clarified further.

Differences between MREL and TLAC

A number of representatives of resolution authorities agreed that TLAC and MREL were 'two sides of the same coin'. One explained that TLAC, as the international standard, was required to be 18% of risk-weighted assets and 6.75% of leverage ratio as from 1 January 2022 (16% of RWA and 6% of leverage ratio as from 1 January 2019). It was relatively easy to implement the main features of TLAC within the MREL framework; however, for this to take place, a change in legislation would be necessary, for which a proposal was currently being mooted. To reconcile MREL and TLAC in relation to G SIBs, the best approach would be to begin with a standard MREL requirement for G-SIBs that was entirely consistent with the TLAC term sheet, before building the Pillar II aspect on top. Another panel member noted that Europe was trying to guarantee stability in the market by addressing systemic institutions, but was disregarding the systemic impact of bailing in certain asset classes, such as senior debt or deposits. Attention would need to be paid to this issue, especially as the stability elements of the package had not been addressed.

The UK's proposal regarding MREL had had a constructive intent behind it: MREL and TLAC needed to be aligned in order to implement them beyond the borders of the EU, and this proposal demonstrated that this synthesis could be achieved. Banks and regulators had previously been looking at different aspects of this question, but Europe needed to start considering what the unintended consequences might be in five years' time, and identify whether anything that had been introduced might have a destabilising impact. One bank had considered how it could meet its TLAC requirements in five years' time, and had concluded that it could not: these needed to be met on an on-going basis. One risk was the risk of liquidity not being forthcoming to refinance TLAC or the MREL liabilities, which added an element of instability during the interim period.

Who would invest in these bail-in instruments?

Investors also needed clarity regarding the creditor hierarchy, which meant having consistency across countries. They also needed clarity in relation to the precise definition of the MREL targets; as of the third quarter, investors still did not know the liabilities accepted, or anything about calibration and compatibility with business models, which was key to institutions' financial planning and capital planning of institutions.

It was important to preserve neutrality of design in relation to business models when designing resolution approaches. In order to fulfil the requirements of MREL and TLAC, an institution should not need to change anything particularly substantial about its business model; this was especially true regarding the SPE/MPE organisation of a bank. If an MPE group were treated as a consolidated group in relation to resolution, it was not clear what would be done about bail-in-able instruments in small jurisdictions where it was very difficult to issue subordinated debt.

For a common framework for subordination

Having a common European approach to the different types of debt that could be eligible >>>

>>> for MREL requirements would be desirable, but would take a long time to put in place; in the meantime, effective tools for resolution would need to be implemented. The Italians and the French had put in place reforms, with the French approach similar to that of Germany eventually.

However, it was not only subordination that needed to be considered, but also the counter-factual analysis and how to implement the framework in the context of different legal frameworks. More harmonisation on the insolvency law front and a more harmonised approach to creditor hierarchy would be desirable, although this would not be easy to achieve. A representative of a resolution authority reminded the audience that in any resolution, we have the counterfactual analysis and we have to prove that the creditor is not worse off than in insolvency. Therefore clarity and transparency were vital: investors should know that somebody who had invested in a deeply subordinated tool would hopefully never be called upon, but would be called upon before someone who had invested in a senior investment, and that only investors in guaranteed deposits would never be called.

The 8% issue was a controversial topic

BRRD and the SRM regulation had come into full effect on 1 January 2016, and there was now a mandatory bail in scheme, with bail-in decided by creditor hierarchy and not by credit name or wealth. European legislation made clear that MREL was a Pillar II requirement; it needed to be set entity by entity and was entirely risk specific. Resolution authorities would want to have all possible tools available, part of which was respecting that the SRB would need to bail-in de minimis 8% of total liability before it had access to the Single Resolution Fund. For these 120 systemically important institutions, and only these institutions, MREL of potentially 8% of total liability would be the norm.

There was a controversial discussion of this 8% rule: one banking representative stated that there needed to be increased clarity regarding what this 8% referred to, as BRRD made it very clear that this was an entry hurdle to the resolution fund, expressed as the amount of bail-in that had to occur: there was no direct link to MREL. It was also not clear how small institutions with a lot of NPLs could be asked to raise 8% of bail-in-able assets in the context of a non-performing economy and a low rate of interest, or how this was compatible with the European projects on capital markets union.

It was a common-sense conclusion that a minimum MREL would need to be established for all of the banks, but this might give rise to very serious consequences if the minimum MREL were to be set at 8%, notably as a substantive part of bail-in-able debt was not included in the current MREL definition. Additionally, this should not mean that every resolution case should require use of the resolution fund.

Global Crisis Management Framework

Living Wills

US authorities had recently issued results, including deficiencies and/or shortcomings, for eight of the firms subject to US living will requirements, providing this feedback in a transparent manner with two joint public documents having been issued. The firms involved had been asked to deal with a number of issues in their next submissions, including sorting out the capital and liquidity necessary in resolution; establishing a methodology for determining what that might be, and ensuring that these resources could get to where they were needed; a governance process to promote confidence that resolution would be entered into at the appropriate time; and dealing with some of the operational continuity issues that would arise during resolution, while dealing with derivatives in a way that did not engender disruption. Legal entity rationalisation would also need to be tackled.

Cooperation between Home/Host Supervisors and Resolution Authorities

There had recently been a US proposal for TLAC, which would require the US subsidiary a European G-SIB to issue internal TLAC to its parent bank, even if even if an MPE resolution strategy is contemplated for the foreign firm. MPE firms have raised concerns regarding the proposed requirement that foreign banking operations operating in the US issue internal TLAC to the parent; these MPE firms had been used to issuing debt externally in the local jurisdiction, and this proposed requirement would cause an adjustment to that. These firms would also like to be viewed in the same way as some of the US regional banks that were of their size and more closely resembled them, and to be allowed to compete on that basis. This raised some difficult issues, and discussions were underway.

Meanwhile there was not yet sufficient confidence from the firm perspective in the home/host discussion to accept pre-positioning of internal TLAC that might be outside of cash instruments, or that the legal context would allow for such contractual arrangements to take precedence over a statutory approach. This ties to the viability of large institutions' cross-border resolvability. With one bank's assets located in a different country, subject to different law, supervisors tended to ring fence and take precautions, which was reflected in the rules and in other ways. >>>

>>> It was also important to note that, in small markets, it was inconceivable that the complex instruments that were issued in developed markets would be replicated, and SPE models had not yet been put to the test. Collaboration between home or host via MOUs could be helpful.

According to a leader of the industry, It was not yet clear whether enough had been done to reduce the amount of ring fencing that had been seen in the past; this could still be dealt with, because the rules were not in place yet and it was not yet clear how internal MREL or internal TLAC would need to be distributed within Europe. Europe needed to be careful to preserve the many different 'level playing fields' that it was host to: the trans Atlantic field, where G SIBs from one continent adhered to the same rules as those from another, and the domestic 'playing fields' within individual European jurisdictions.

Many G-SIB groups had quite varied balance sheets, containing tranches of debt that would qualify for TLAC and be ideal for bail in, but many of their subsidiaries were straightforward retail deposit-funded banks in a particular jurisdiction. From the industry perspective, whatever was done in relation to internal TLAC should not interfere with those business models, and to ensure that this was the case, it would be necessary to find forms of non-cash and non-rigidifying MREL and TLAC, i.e. 'soft' MREL and TLAC in the form of guarantees. Such guarantees did not need to be collateralised: loss absorbency or recapitalisation should flow within a group, with due attention being paid to the need not to ring fence liquidity and capital, and thereby create problems with 'brittleness'.

Legal Backing for Effective Cross Border Resolution

Effective resolution of a cross-border bank requires a high degree of trust between supervisors before, during and after resolution. But some countries do not yet have a full resolution regime in place and of those that do, there are questions over whether they contain avenues for giving effect to the resolution actions of a foreign authority. This is the reason why the question is whether mutual confidence between supervisors needs to be supplemented by additional arrangements and what could be envisaged to favour such arrangements. The FSB has work in progress in this regard.

A representative of a bank stated that his institution's approach to meeting the TLAC requirements had been to do so via holding company issuance. This meant having a surplus of long dated funds at the centre; therefore, you were 'damned if you did, and damned if you did not'. Having these centrally while not needing them created a drag on the business, but these were not needed out in the group, either. The question was what kinds of arrangements his bank needed to implement – not only to meet the expectations of CMG countries, but also, and importantly, those of non-CMG countries as well – to find a good balance. His institution would not want to be over-deploying TLAC within the group, where there was a direct cost of holding it centrally. ●

Retail banking: what priorities for building a single retail financial market?

KEY ISSUES | *The session was dedicated to identifying how the EU Digital Single Market Strategy (DSMS) was unfolding in the financial services area. It notably tried to clarify the challenges specific to existing and incoming players, assess actual achievements in the EU and the difficulties posed to the DSMS by cybercriminality. The session finally outlined the possibly relevant regulatory initiatives and financial infrastructures required.*

The demand for, and the current state of the EU single market for Retail Financial Services

There was no single retail market in Europe: many consumers did not know what a cross-border opportunity was, and those who did were not sure that they would profit from this kind of opportunity. Only 3% of consumers had purchased credit cards, current accounts or a mortgage from another EU state, and only 5% had bought a consumer loan abroad. Most consumers did not want these services, or did not have a need for them, but it was also possible that those who would have bought them had not been able to overcome the obstacles that existed, which included fixed cost regulatory obstacles, reporting requirements, and tax >>>

>>> impediments. Consumers also exhibited different behaviours in different countries, and people's ages also affected their behaviours: some citizens still wanted to speak to people in person at a physical bank branch, but there was also an increasing number of 'digital natives'. As such, the needs of these different types of consumers would have to be taken into account.

The European Commission's Green Paper on retail financial services, adopted by the European Commission in December 2015, had received 428 replies and between 180 and 200 had been from individual citizens. Citizens expected that they should be able to buy financial services cross border, but, they faced a number of issues such as lack of information about products available in other Member States, or data protection concerns. that made cross border buying and selling harder. Favouring competition was also vital, and passporting was critical to the development of a retail single market. The barriers to a single European market tended to be the result of domestic-specific consumer protection regulations. Customers' concerns were primarily convenience, trust and cost; any system to unify the market would need to address each of those issues.

These expectations came in a context where customers were becoming more and more demanding, wanting 24-hour service and immediate answers to any of their demands, as well as the opportunity to have a face-to-face relationship. European banks needed to move towards digitalisation for the sake of their own citizens and customers, but should not lose sight of the need not to impair confidence, which was has been based on face-to-face relationships. Finally, customers wanted more digital interaction, but were not explicitly demanding cross border banking.

Main Impediments and risk of a Single Market for Retail Financial Financial Services

Predominant domestic bias

Digital exclusion was a potential impediment to a single retail financial market. Inefficiency in the home/host environment was also an important impediment as it required to devise multiple IT systems to address for example the Anti Money Laundering (AML) requirements of each individual country impeded innovation and increased costs to the consumer.

Some elements of supervision needed to become a little broader and more holistic. There it might be helpful to look at the status of apps as a way of determining whether a bank needed additional liquidity: if banking was done more digitally, and if users did not have efficient and appropriate apps on their smartphones, then banks would have liquidity problems when their customers took their business elsewhere.

One representative of a bank felt that the biggest major obstacle on the demand side was the lack of a single deposit guarantee fund; the lack of a European Deposit Insurance Scheme created fragmentation as witnessed by the crisis during which deposits moved in search of stronger banks in strong Member States. The harmonisation achieved via the Directive had been a step in the right direction, but had not been sufficient. On the supply side, although passporting and common frameworks were in place, local AML and KYC demands varied, and more coordination would be welcome. Data protection was another key issue.

Limited demand and difficult access to domestic customers from abroad

There were also demand side issues relating to consumer protection, where clear rules were required, and in the area of contracts: consumers still had doubts around the applicable jurisdiction, for instance. Furthermore, customers did not engage much with financial services, and were not very vocal about the need for a single European market. People from younger generations were difficult to contact; they would not read generic letters, and to contact these people, you needed a primary account. Accessing to account information, a bank could then send meaningful and relevant information to a client.

Initiatives to Encourage Further Integration

Key possible Policy Initiatives

The single market was premised on the idea that more open economies generated more competition, which in turn created more productivity and better outcomes for consumers. The area of payments was one where the benefits of competition could be demonstrated: consumers wanted to be able to make payments when they went on holiday, when they lived abroad, and when they worked abroad.

The work that had already taken place across Europe regarding financial stability had been very valuable, and what had been done on the Single Rulebook, CRR, CRD4 and Bank Recovery and Resolution Directive was done also to rebuild trust of EU citizens. The question of redress would also need to be considered; this could be addressed through encouraging the national ombudsmen that existed in different countries to work closer together. A EU regulation relating to data protection had now been adopted, and would come into force in 2018. >>>

>>> Investment in IT needed to be encouraged within banks, as the accounting framework did not help them to meet the goal of creating a single retail financial market, indeed software has been identified as an intangible asset, and this is very costly for us in terms of capital. All players in the market needed to contribute to digitalisation, and banks – given the additional regulation that they worked under – would need particular help to digitalise effectively.

The European Commission had already created a palette of tools containing a number of ideas and initiatives, in order to address the issue of retail. Indeed, the issue of retail was a multifaceted one: payments, for instance, lent themselves to harmonisation well, but others did not.

In some areas, such as motor vehicle insurance, the problem of compensation at different levels had already been seen, and further harmonisation work would need to take place in this space. Increasing the portability of pension schemes was necessary, and this would not work without a common legislative framework. Harmonisation was more difficult in other sectors, such as mortgages.

European Commission regulations could also contribute more in a number of spaces, including digital onboarding. A European Deposit Guarantee Scheme would help make customers feel more comfortable about putting deposits in banks.

There needed to be more interconnection between DGs to make sure that the agenda of building a single retail financial market could be pursued, and also to preserve the added value of each banking model, which might have something to offer in relation to these new retail financial services.

The challenge was how to strike the right balance between legitimate differences between national markets and producing value for consumers by doing things at a more consistent level across the whole EU. Very different answers to these questions arose depending on which aspect of retail financial services was being considered. One should be open to other ways by which best practices could be shared and innovation at the national level towards a common goal could be encouraged. Europe should be able to employ not only regulation, but also best practices, guidelines, various groups' initiatives, and so on. However, creating exceptions increased costs, reduced advantages and decreased competition, and consumers suffered as a result.

The Role of Digitalisation

Payments was the first field in which cross-border selling and digitalisation could go together. One European institution was about to launch a payments system based on voice-biometric technology, but there were trust issues surrounding this that would need to be addressed at the EU level.

Representative of various banks agreed that eID would been very useful for their institutions' purposes, with one noting that common rules needed to be created that everyone agreed to, and that applied to everybody. eID and trust services was one of the areas in which the European Commission could provide 'building blocks'.

It was now possible to look at where transactions were crossing borders and sectors 'more or less automatically', and as criminals did not respect borders, cyber criminality was another reason for having a European Directive.

Expected Contribution of EU Digital Market Strategy and PSD2

The European Commission's package on trust services would come into force on 1 July, so people could identify themselves via eID; the Network and Information Security Directive would also be adopted soon. A contractual public-private partnership would soon be in place to help prevent criminals from gaining access, and the Commission was also beginning an evidence-gathering procedure in relation to bad algorithms. It had created a palette of measures containing a number of ideas and initiatives in order to address this issue.

PSD2 had been a good development in the sense that it made it easier for new players to enter the market, but it also created burdens on the traditional players. The problems that existed could be managed, but consideration needed to be given to the question of what might go wrong if all payments were opened up and clients gave their identification to a new payment provider. Banks might be required to automatically compensate the client, and to start chasing all of the parties who provided new payment services. More balance was needed in this space to promote fair competition. Ways would need to be found for innovative banks to operate, with some regulatory exemptions that would make them less subject to constraints and more capable of contributing well and quickly to innovation and digitalisation. ●