

TEN YEARS AFTER

The 2017 Banking Package: One Step Forward, Two Steps Back

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Executive Summary

Ten years after the onset of the most serious financial crisis in recent history the EU is preparing to put the finishing touches on the centrepiece of its post-crisis regulatory project. The Banking Package incorporates the last batch of key international standards into EU law, albeit in a curiously reluctant and unambitious way. At the same time it also begins to unpick significant elements of the existing prudential framework. Given that many of the root causes of the last crisis remain unresolved, while governments and central banks resort to monetary stimulus at an unprecedented scale to compensate for the continuing fragility of the financial system, there are in our view no grounds for complacency, let alone a return to “business as usual”. The economic recovery in Europe is still fragile. The EU in general, and some Member States in particular, would be hard-pressed to absorb another systemic crisis. Further reforms to improve the resilience of the banking sector are still needed to turn the current cyclical recovery into a sustainable structural recovery.

Finance Watch welcomes the European Commission’s legislative proposal, which incorporates important new international standards into European law. We do not share the view, however, that the regulatory effort prompted by the last financial crisis is nearly complete and may even have gone too far. There is, in our view, no convincing case for reversing the regulatory progress of recent years.

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Key points and recommendations

There is no compelling evidence of the argument that post-crisis regulation of the banking sector is stifling the **provision of credit and economic growth**. To the contrary, credit is plentiful and, in some Member States, once again driving asset prices to dangerous heights.

Recent analysis of the Basel III framework by the Bank for International Settlements indicates that the **gains from financial stability** outweigh the cost of post-crisis regulation and could even contribute materially to economic growth.

The **problem of “too-big-to-fail” financial institutions**, the single biggest risk for financial stability highlighted by the last financial crisis, remains unresolved. Global and domestic systemically important banks still tower over the industry, their size and complexity barely changed.

Large banks are still viewed as “national treasures” by many policymakers who are showing a troubling inclination towards bailing out failing institutions with taxpayers’ money. Unless revoked, the “**precautionary recapitalisation**” clause could end up consigning the EU’s bank resolution framework to irrelevance.

Suggestions to radically dilute existing **prudential standards**, by turning binding prudential requirements into “guidance”, and to severely restrict supervisors’ ability to impose stricter requirements on individual banks are counter-productive and should be rejected.

There is **no consistency in the application of macroprudential tools**, such as capital surcharges for systemically important institutions, across EU Member States. It is unacceptable that national supervisors should be prevented from imposing Pillar 2 requirements to address macroprudential risk as long as the consistent and effective implementation of these dedicated tools is not guaranteed at the EU level.

The **introduction of the Basel III Leverage Ratio** is a welcome step in the right direction, although we note that the current definition proposed by the Basel Committee comprises, once again, too many elements of the risk-sensitive framework, in particular for derivative exposures (SA-CCR).

The **implementation of the Basel III Leverage Ratio** in the current proposal does not go farther than the bare minimum of 3%, however. In analogy to the risk-weighted capital framework – and in line with Swiss and US precedent – G-SIBs and D-SIBs should be subject to higher minimum requirements.

To restore the **level playing field** and reduce the burden on **smaller banks**, which are disproportionately affected by the inefficiency of current regulatory reporting systems and processes, we would strongly support the EU-wide introduction of unified reporting formats and interfaces via a single point of contact.

B. General observations

1. European particularism: A questionable narrative

The European Commission's legislative proposal incorporates important new international standards into European law. In a number of instances, however, the proposed drafting either deviates from the international standard or contains material carve-outs. The Commission proposes, for instance, adjustments to the scope, calculation and calibration of the Leverage Ratio, the Net Stable Funding Ratio and the market risk rules, arguing that these are needed to account for the specificities of EU institutions and the EU economy. The stated aim of those adjustments is *"to support greater lending to the economy and mitigate potential disincentives related to the efficient functioning of capital markets"*.¹ This is, of course, the line that has been put forward forcefully by the banking industry in recent months but it does not stand up very well to the facts:

- Firstly, there appears to be little empirical evidence, e.g. from the ECB's own reports and surveys,² of a shortage of bank credit holding back economic growth. In fact, the Survey on the Access to Finance for Enterprises (SAFE)³ has indicated consistently for the last two years⁴ that **availability of bank credit ranks as the lowest-priority concern** of European SMEs. Moreover, where credit shortages exist they appear to be largely of a structural nature, e.g. due to high levels of non-performing loans (NPLs), rather than a result of a lack of lending capacity brought on by regulation. To the contrary, household debt levels in several Member States are already at elevated levels. Both the ESRB⁵ and the OECD⁶ have pointed out in recent publications that several EU Member State economies could be at risk of a correction in their overheating residential property markets triggering a potential mortgage debt crisis.
- Secondly, we are sceptical about the connection made here between the efficient functioning of capital markets in Europe and the prudential regulation of banks. Most studies and reviews into this topic have found no evidence of a significant impact of bank regulation on capital markets activity.⁷ Instead, a recent report by the Commission⁸ provides a list of some of the numerous barriers to capital flows between EU Member States, including withholding taxes, residence requirements, home bias and

insolvency regimes. Addressing these issues by way of further harmonisation would, in our view, go a long way towards encouraging cross-border investment and improving the functioning and integration of EU capital markets without weakening prudential standards for EU banks.

- Finally, recent studies, e.g. by the BIS, indicate that, rather to the contrary of the banking industry's preferred narrative, **prudential reforms under Basel III are generating net economic growth** to the order of 0.5% to 2.0% of GDP.⁹ This corroborates the intuition that a better regulated and more stable banking sector should also contribute to a better allocation of credit and more growth.

Already today the EU is the only jurisdiction that has been found "materially non compliant" with international standards by the Basel Committee.¹⁰ To deviate from, and water down internationally agreed standards would only cast more doubt on the actual condition and resilience of the financial sector in Europe and weaken the EU's hand in current and forthcoming multi-lateral negotiations. EU legislators should resist the pressure to backtrack on international commitments for the sake of questionable short-term advantages.

Finance Watch shares the Commission's goal to promote jobs, growth and investment. But **short-term growth cannot, and should not, come at the expense of long-term financial stability**. In its recent report on global financial stability, the IMF warns that only a strong international framework *"will sustain financial stability and ensure that the financial system can support the real economy in bad times and good Failure to complete the global reform agenda could erode the consensus already achieved. And that could encourage a short-sighted rollback and competition to ease regulation as growth continues to elude many advanced economies."*¹¹

2. The bigger picture:

“Too big to fail” still unresolved

(Inter)National Treasures: G-SIBs

The EU is home to ca. 3,200 credit institutions with a total of EUR 34 trn in assets,¹² equivalent to ca. twice the aggregate GDP of the EU-28. Despite a decrease of ca. 12% since 2008 the EU banking sector is still significantly larger relative to GDP than the U.S. or Japan's.¹³ At the same time, EU banks continue to suffer from a structural lack of profitability and weak capitalisation, both of which have been extensively documented and discussed in recent times.¹⁴ They have also amassed a staggering **EUR 1 trn of non-performing loans (NPLs)**. Nearly ten years after the onset of the financial crisis these three factors combined continue to pose serious challenges to financial stability in Europe.

As of year-end 2015, thirteen “global systemically important” institutions (G-SIBs) accounted for nearly half of all banking assets in the EU. Together with ca. 200 “other systemically important” institutions (D-SIBs),¹⁵ which include ca. 125 “significant” banking groups domiciled in the Eurozone and supervised by the ECB,¹⁶ they make up **only 7% of the total number of EU credit institutions but ca. 75% of all banking assets**.¹⁷

In the immediate aftermath of the financial crisis there appeared to be a broad political consensus that these largest banks, considered “too big to fail”, should no longer benefit from an unconditional guarantee underwritten by the public. And because it had become obvious during the crisis that “too big to fail” was only one part of the problem much thought was given also to the question of how to tackle the related issues of “too complex to fail” and “too interconnected to fail”. From today's perspective, and in view of recent events, it seems fair to say that these problems have remained largely unresolved:

Size

The total sum of balance sheet assets of the thirteen G-SIBs domiciled in the EU still equals **ca. 110% of the aggregate GDP of the EU-28**.¹⁸ A state-sponsored rescue, similar to what was done during the last financial crisis, would likely test Member States' economic and political capacities to breaking point. Most, if not all, of the European G-SIBs are “universal banks” but only a small number of them have adopted structural reforms turning these large, monolithic groups into smaller units

under a joint holding company. If more European G-SIBs were to adopt a holding company structure in this way, it would not only reduce their sheer size but also offer an opportunity to legally separate banking from capital markets operations, a measure that could significantly improve the resilience and, if necessary, resolvability of the group and its constituent parts in times of crisis, as well as reducing their implicit guarantee underwritten by the public.¹⁹

Complexity

Whereas some progress has been made, G-SIBs (and some D-SIBs) still comprise hundreds of subsidiaries dotted across the globe and linked by myriad legal, financial and operational interdependencies. In 2012, the seven largest U.S. banking groups together had ca. 14,600 subsidiaries, i.e. ca. 2,000 legal entities per group on average, and approximately three quarters of all the legal entities controlled by the 4,660 groups that make up the U.S. banking sector. European G-SIBs are structured in very similar ways.

TOO COMPLEX TO FAIL:
WHEN IN DOUBT, BLAME REGULATION



These structures, which have grown over decades, often through numerous mergers and acquisitions, make the task of creating a workable resolution plan – which relies on the identification and structural separation of core business lines and critical functions – extremely difficult. Technology, in the form of shared IT services, adds another layer of complexity: major banks operate a vast array of systems that have evolved over decades, frequently by layering new technologies on top of ancient, often sparsely documented legacy systems.

Interconnectedness

There are few indications that G-SIBs today are any less interconnected, and hence prone to systemic contagion, than in the immediate aftermath of the last financial crisis when the problem was articulated.²⁰ Thirteen European G-SIBs still account for more than one quarter of all cross holdings of assets between banks globally and one-third of global OTC derivatives exposures.²¹ Within the Eurozone one-third of unsecured debt securities, which would be susceptible to being bailed-in, are thought to be held within the banking sector²². The contagion risk among European banks, as well as between banking and other parts of the financial sector, is still very high.²³

Significant Others: D-SIBs

Large “second-tier” banks that are not G-SIBs but systemically important in one or several Member States pose at least as much of a threat to financial stability as the G-SIBs themselves. They attract only a fraction of the attention that is being accorded to the G-SIBs, however. So far, the focus of the EU legislative has been on transposing, with some modifications, the Financial Stability Board’s G-SIB regime while the regulation of D-SIBs was left mostly to national authorities. This has produced numerous inconsistencies, for instance in the designation of D SIBs: in some instances banking groups that were identified as **“significant” at the European level** by the ECB and therefore placed under the supervision of the SSM, were **not deemed “systemically important” at the national level** by their home-country supervisor and are therefore not subject to D-SIB buffer requirements.

Similar discrepancies can be observed in Member States’ approaches to the application and calibration of D-SIB buffer rates as well as the length of phasing-in periods: several designated authorities have not defined any D-SIB buffer rates yet, or kept them at zero, whereas others have uniformly imposed buffer rates at the maximum level of 2% for all D-SIBs under their jurisdiction.²⁴ It appears somewhat counter-intuitive that macro-prudential tools, such as the setting of systemic buffers, should remain the prerogative of national authorities. We feel strongly that macro-prudential measures should be co-ordinated and, as much as possible, centralised at the EU level to ensure that macro-prudential policy is applied in a consistent manner. Within the SSM the ECB already has a subsidiary right to impose higher buffer rates than those set by national authorities to cover systemic or macro prudential risks (Art. 5/2 SSM Regulation). In order to co-ordinate and further harmonise macro-prudential policy throughout the EU, including Member States that are

not SSM participants, the role of the ESRB needs to be substantially strengthened.²⁵

“Moral hazard” (continued)

Moral hazard, which lies at the heart of the “too big to fail” problem, still runs deep:

A study published by the ESRB in June 2015 found that the **total cost of misconduct for EU banks** for the five-year period from 2010 to 2014, including regulatory fines and settlement payments, stood at **ca. EUR 50 bn** and goes on to say that *“past fines and ones in the near future erase virtually all of the fresh capital raised by European G SIBs over the previous five years”*. The report also found that fines were *“concentrated among the major players – the so-called global systemically important banks (G-SIBs). By 2013, some 85% of these fines had been made against ten banks in the top three “buckets” of the G-SIB classification. Both this concentration and the industry-wide phenomenon emphasise the systemic relevance of the issue.”*²⁶

Moreover, many European banks have maintained high levels of pay-outs, by way of dividends, coupons and variable staff remuneration, even throughout periods of severe losses, instead of re-building their capital bases. Calculations by the BIS show that a group of 90 large Eurozone banks **paid out more than 70% of their cumulative net profits as dividends** between 2008 and 2015, not counting other discretionary distributions, such as coupons on AT1 instruments and share buy backs.²⁷ It is not surprising therefore that European G SIBs still lag behind their overseas peers in terms of capitalisation.²⁸

Even the current NPL crisis in certain EU Member States cannot be separated entirely from the issue of governance. Although macroeconomic factors may have contributed substantially to the particularly high concentration of NPLs in these countries it is ultimately the lending practices and risk management of individual financial institutions that cause NPLs to accumulate. And they will continue to do so as long as banks can expect to be bailed-out regardless of their lending record.

Ultimately, the moral hazard problem also short-circuits the underlying logic of the Basel II/III capital regime based on risk weighted assets (RWA). The principal argument for allowing banks to hold varying amounts of capital depending on the risk of the asset is based on the assumption that, all other things being equal, bank management would naturally tend to allocate the bank’s

limited capital towards the highest yielding and hence, as a general rule, riskiest assets. To compensate, and to incentivise banks to engage in what are perceived to be low-risk / low-yielding activities, the Basel II/III framework introduced the concept of calculating banks' capital requirements against risk weighted assets (RWA). The RWA regime, in particular its internal model-based approach (IRB) has added huge complexity to regulation and encouraged a veritable arms race among market participants to devise internal risk models that would 'optimise', i.e. minimise, the amount of capital required to support their balance sheets. Thirteen years – and one global financial crisis – later, even a cursory look at the results speaks volumes about the success of this approach: the average risk weights of G-SIBs – officially, and by definition, the riskiest banks – are, rather counter-intuitively, among the lowest of all.²⁹ The underlying fallacy of the entire construction, however, has remained unresolved: as long as bank management and investors are shielded from the single most powerful corrective factor to risk-taking provided by the market itself – bankruptcy risk – by the expectation of government support in the shape of bail outs, no amount of tinkering with market-based mechanisms and incentives is likely to remove the problem of moral hazard. Arguably, much of the hugely complicated, intrusive and potentially distorting micro-management contained in current and proposed legislation, including exemptions, classifications, support factors etc., could become redundant, without any major loss of stability and diversity of the financial system, if policy makers and regulators could summon the resolve to treat banks like normal commercial companies – and let them fail.

Solving “Too Big To Fail”

There are essentially three categories of measures that still need to be properly implemented:

➔ Resolution must become a credible option for dealing with a large, failing bank. Recent experience has shown, unfortunately, that political decision-makers and regulators are still hesitant to put the new resolution framework into practice.³⁰ Continued state support for the banking sector encourages management to delay remedial action, increases moral hazard and slows down the process of restoring the EU banking sector to health and profitability. In order to improve legal certainty and to render the BRRD framework credible we would recommend removing the “precautionary recapitalisation” clause in Art. 32/4 BRRD.

- ➔ In order to put resolution into practice and increase confidence among policy makers and regulators that banks are resolvable without triggering systemic contagion resolution, authorities must be encouraged to make use of their powers, already available under the BRRD (Art. 17), to impose structural changes upon banks, if necessary to ensure their resolvability. Core banking operations and critical functions must be structurally separated and placed into independently capitalised entities.
- ➔ Macro-prudential policies must be harmonised and tightened. The ESRB's recent report³¹ confirms that the macro-prudential regime in Europe lacks rigour and consistency. Responsibility for the designation and categorisation of G-SIBs and D-SIBs, as well as for the application of macro-prudential tools, including the calibration of the “combined buffer” regime, should be centralised at the EU level. The competencies and resources of the ESRB may need to be upgraded accordingly.

3. Proportionality

In the previous section we have discussed in some detail how the odds are presently stacked in favour of (very) large banks. The benefits of size include the implicit SIFI subsidy, the advantage of using IRB over Standardised Approach (SA) risk modelling, cross subsidisation, e.g. between investment and commercial banking, and genuine economies of scale, e.g. on fixed assets, such as IT infrastructure and on other fixed costs. The plight of smaller banks is, viewed this way, merely the flip side of the G-SIB/D-SIB problem – a competitive distortion brought about by policies that, by and large, favour national champions. Proportionality is about levelling the playing field.

It is important to remind ourselves, however, why we should care about levelling the playing field. As with any other eco-system, diversity – in this case of bank sizes and business models – improves the stability of the system and its resilience in times of crisis.³² In fact, the large majority of Europe's 6,500 credit institutions³³ are unlikely, individually, to ever pose a serious risk to financial stability.

They are, however, closely interconnected with the financial system and still susceptible to contagion. This is why the search for proportionality should not lead to a loosening of prudential standards.

A more promising approach is to look at the actual factors that are blamed for smaller banks' troubles. Much of this discussion revolves around the cost of regulatory reporting and compliance.³⁴ It is certainly true that banks face more intense regulatory scrutiny than before the crisis – for good reason. The quality of prudential supervision relies to a large extent on the timely availability and quality of data. We would therefore support an approach that maintains or improves the efficiency of reporting processes for all banks and takes a more differentiated look at the reporting requirements for smaller banks with traditional, non-complex business models:

- ➔ Banks currently have to supply data in multiple formats to a number of different authorities for different purposes (e.g. regulatory reporting to the national supervisor and ESAs, monetary policy and statistical data to the central bank, national and European statistical offices, resolution-related data to the resolution authority, etc.) There is frequently significant overlap in terms of content but differences in terms of format, presentation or delivery, which cause duplication and inefficiencies.
- ➔ Smaller banks with traditional business models that do not engage, in any material way, in complex activities, are sometimes obliged to report on these activities, which are for them *de minimis* but absorb significant amounts of management time and resources nevertheless.

To address duplication we would suggest the development of standardised, pan-European reporting formats, which comprise all regulatory and statistical information and can be submitted electronically, at given intervals, once only, to one single point of contact which is then responsible for managing the sharing of data between the relevant national and European authorities. Authorities would, in turn, be both authorised and obliged to share relevant data, if appropriate. The EBA should be mandated to design appropriate templates and processes (new Art. 99 CRR, to be amended accordingly). We note, however, that the efficiency of reporting processes also depends, to a large extent, on the quality of the bank's internal processes and controls and the deployment of up-to-date IT infrastructure. The efficiency of a bank's reporting systems, as well as their effectiveness, should be reviewed regularly as part of the Supervisory Review and Evaluation Process (SREP).

The option to be exempted from reporting requirements on businesses in which a bank has no material involvement, should be limited to banks that conform to the definition of a "small institution" (new Art. 430a/4 CRR), which needs to be calibrated accordingly. In analogy to the D-SIB regime (Art. 430a/1 CRR) a "small institution" should be defined by size, using a combination of absolute and relative criteria (total assets max. EUR 1.5 bn or less than 0.1% of GDP of the Member State where it is established) and, in addition, by its business model. A non-complex business model could be defined, for instance as not having significant cross-border activities, not using the internal model-based approach (IRB) for managing risk-weighted assets and not operating a trading and/or derivatives book that exceeds 5% of the bank's leverage exposure measure.

C. Comments on selected individual measures

1. Capital Requirements Regulation (CRR II)

The Leverage Ratio

Finance Watch welcomes the introduction, at long last, of a binding Leverage Ratio (LR).³⁵ The build-up of excessive leverage has proven to be one of the main threats to financial stability in 2007/08 crisis and many of the crises before. The Leverage Ratio is widely seen as a significantly more reliable indicator of a bank's distance to default than risk-based capital measures³⁶ and as a more appropriate regulatory benchmark, e.g. for evaluating stress test results.³⁷ It is also simple for banks to implement and more transparent for regulators to monitor and review.

That said, it is worth pointing out that the definition of the Leverage Ratio, by now on its third iteration since 2010,³⁸ is moving away fast from its original design, and its intended simplicity and transparency is diluted with every new revision. The principal problem, differences in the treatment of derivatives under IFRS and US GAAP accounting rules, has still not been resolved.³⁹ To overcome the impasse, the Basel Committee has resorted to including elements of its risk-sensitive modelling framework instead, turning the Leverage Ratio into a hybrid of accounting and supervisory approaches. This development is unfortunate – it would be preferable, in our view, to revert to a purely accounting-based measure and require international banks, which are already reporting under IFRS or US GAAP, respectively, to provide notes with IFRS – US GAAP reconciliation as part of their financial statements.

Regarding the calibration of the Leverage Ratio it is important to bear in mind that an LR of 3% corresponds, only just, to the minimum risk-weighted Tier 1 capital requirement under Basel III.⁴⁰ According to the EBA's findings, the largest and most complex credit institutions, in particular those that operate the business model of a 'cross-border universal bank' and are at the same time G-SIBs, are significantly more prone to excessive leverage.⁴¹ The Commission does not currently propose an LR surcharge for G-SIBs and D-SIBs on the grounds that international discussions on this point are still ongoing. By way of comparison, Switzerland⁴² and the US,⁴³ which together account for ten of the 30 G-SIBs, have both already implemented higher LR requirements at 5% (6% for U.S. institutions holding FDIC-insured deposits):

A **5% Leverage Ratio requirement for European G-SIBs** would level the playing field with their Swiss and U.S. peers and effectively set a harmonised standard for 75% of the total G-SIB population. Based on the EBA's analysis it would currently place an effective balance sheet constraint on all of the thirteen EU G-SIBs,⁴⁴ which would be in keeping with its role as a counter-cyclical measure designed to dampen the rate of balance sheet expansion in an upturn.

The Commission's proposal remains silent on the possibility of setting a higher LR requirement for D-SIBs. As mentioned previously, we strongly believe that the prudential framework for D-SIBs in the EU must be expanded and harmonised as a matter of urgency. In the same way that D-SIBs are subject to buffer requirements under the risk-weighted capital regime they should equally be bound by a LR that is higher than the base level of 3%.

Finally, the Commission's proposal (new Art. 429a/1/d-f and 429c/4 CRR) contains a number of exceptions which would exclude certain categories of exposures from the LR denominator (the LR 'exposure measure'). These exceptions, e.g. the deduction of initial margin payments for centrally-cleared derivatives trades (Art. 429c/4 CRR), are not compliant with the Basel Committee's definition and should be rejected as they would affect comparability across jurisdictions and thus frustrate the primary purpose of the LR, which is to create a risk-neutral benchmark that bridges differences in accounting standards, notably between IFRS and US GAAP.

Net Stable Funding Ratio

The proposed implementation of the Net Stable Funding Ratio (NSFR) comprises a number of exceptions (new Art. 428f CRR) which mirror similar adjustments made in the EU incorporation of the Liquidity Coverage Ratio (LCR). In its treatment of derivative transactions, of short-term transactions with financial institutions and of High Quality Liquid Assets (HQLA), the Commission's proposal also deviates from the Basel Committee's definitions in several respects (new Art. 428r – 428ag CRR). This could result in overstating the funding position of EU banks, both in absolute terms and relative to their overseas peers. As set out previously we are sceptical of the wisdom of diluting international standards by being overly accommodating to European specificities. Not only does it diminish the comparability across jurisdictions, it also increases the risk of concealing systemic vulnerabilities.

IFRS 9 and Fundamental Review of the Trading Book

Finance Watch is generally supportive of the stated objectives of the Fundamental Review of the Trading Book (FRTB), which are to improve the accuracy and reliability of calibrating capital requirements for market risk, limit the potential regulatory arbitrage between banking and trading book and reduce the scope for subjectivity. We have commented on the advances and shortcomings of the Basel Committee's standards in our recent policy brief, "Curbing Subjectivity".⁴⁵

In the context of the proposed implementation of the FRTB framework, we would therefore concentrate on the proposed adjustments. These concern, in particular, securitisation, covered bonds and sovereign exposures:

- ➔ Finance Watch has commented extensively on the Commission's proposal for a Capital Markets Union (CMU)⁴⁶ and, specifically, the Simple, Transparent and Standardised (STS) Securitisation initiative.⁴⁷ We remain sceptical about STS, which includes, once again, many of the features that were instrumental in precipitating the last financial crisis, such as tranching, synthetics and insufficient retention requirements. We would therefore advise strongly against affording these securities the same favourable treatment as, for instance, high-quality covered bonds.
- ➔ We are mindful of the specificities and inherent challenges of sovereign bond markets in the EU in general and within the Eurozone, in particular. These provisions are reflective of the fact that European economic, monetary and financial integration is still incomplete and supporting measures may therefore be necessary and justified. We caution, however, that such measures are prone to producing unintended and undesirable side effects and may introduce distortions that affect the orderly functioning of the capital markets. We would therefore recommend mandating the EBA to conduct a review of the capital adequacy regime for sovereign exposures under the CRR within three years after the adoption of the current legislative proposals.
- ➔ IFRS 9, in its current form, penalises banks that use the Standardised Approach (SA) to calculate their risk-weighted assets (RWA) vis à vis competitors using the Internal-Model Based Approach (IRB): only the latter are able to count general provisions towards Tier 2 capital. Since IRB is in use primarily at larger banks

this is yet another instance where smaller banks are disadvantaged by the current Basel III framework with its unjust, unnecessary and wasteful parallelism of three concurrent risk-weighting regimes.⁴⁸

The transitional rules set out in the proposal are, in our views, overly generous:

- ➔ Contrary to the European Parliament's resolution on the adoption of IFRS 9, which called for a transition period of three years,⁴⁹ and the EBA's recommendation of four years,⁵⁰ the proposed transition period is now five years (new Art. 473a/3/lit. a CRR). Bearing in mind that the transitional arrangements do not foresee any phase-in impact on capital requirements for the first year – because this impact can be off-set by the banks at 100% for the purposes of calculating CET1 capital – there will be no incentive for banks to adopt the new rules during the first 12 months at all, i.e. the net effect is a simple postponement of the introduction of IFRS 9 by one year.
- ➔ It is unclear why such a long transition period would be needed given that most of the impact is likely to relate to traded securities, not illiquid long-term assets such as loans, and the introduction of IFRS 9 has been anticipated ever since the publication of its first instalment in late 2009.⁵¹ According to the international standard-setting body, the IASB, the standard is due to come into force as of 01 January 2018.
- ➔ The transitional arrangements open up the possibility for institutions to claim CET1 capital relief for certain provisions ("incurred but not reported" losses, IBNR) which have been booked already under the predecessor standard to IFRS 9, IAS 39, and which are therefore not even linked at all to the introduction of the new standard.
- ➔ We would endorse the EBA's recommendation of changing the approach to phasing in IFRS 9 from a "dynamic" method, where the differential between IFRS 9 and its precursor, IAS 39, is calculated periodically throughout the transitional period and the impact on CET1 capital compensated accordingly, to a "static" approach, where the impact of transitioning from IAS 39 to IFRS 9 is calculated, once and for all, on the date when the law enters into force and the differential is amortised over the (three-year) transitional period.

→ We believe that the objective of the proposed transitional arrangements is to accelerate the adoption of IFRS 9 while mitigating one-off effects. The primary objective of IFRS 9, in our view, is to better capture changes in asset quality and to encourage earlier provisioning. This would support the argument that the impact of IFRS 9 should be measured once only and on the same set of assets and the new standard should be applied fully from that point onwards. All subsequent changes in assets composition would therefore be reported under IFRS 9 while the initial impact would be amortised and hence mitigated.

2. Capital Requirements Directive (CRD V)

Pillar 2

Finance Watch agrees, in principle, with the Commission's stated aim of harmonising competent authorities' practice regarding the application of Pillar 2 capital add-ons across Member States. The proposed amendments to the provisions (Art. 102 – 107 CRD IV) are so extensive, however, that they amount to a wholesale re writing of the Pillar 2 prudential framework.

The proposed new rules governing Pillar 2 capital requirements (new Art. 104 – 104c CRD) place numerous qualitative and quantitative constraints on the ability of supervisory authorities to adjust capital requirements for individual institutions or groups of institutions to account for risks that have been identified by the supervisor but are not adequately covered by the generic provisions set out elsewhere in the CRR and the CRD.⁵² We believe that these constraints are far too restrictive and are likely to impinge severely on the ability of supervisors to adequately exercise their mandate. In particular, authorities should be allowed to take account of stress tests, including adverse scenarios, in binding P2, not P2G, in accordance with the stated objective of the original provision.

The proposed new rules explicitly bar competent authorities from imposing Pillar 2 capital requirements to cover macro-prudential or systemic risks (deletion of Art. 103 and insertion of new Art. 104a CRD). We agree that this would be consistent, from a purely methodological point of view, with the conceptual separation of micro- and macro-prudential responsibilities and supervisory powers. But considering the current state of development of macro-prudential supervision on the EU the effort, well-intentioned as it may be, looks distinctly unrealistic. The initiative also appears oddly mistimed: following the

consultation launched by the Commission in October 2016⁵³ on a review of the macro-prudential policy framework and the ESRB's recent report on macro-prudential policy in the EU, which highlighted still significant institutional and structural deficiencies and material divergences in the implementation of macro-prudential instruments. It would be advisable in our view, to await the outcome of the proposed reforms of macro-prudential co-ordination and decision making processes at the European level which should, one would hope, result in a more uniform and effective application of the macro-prudential toolset, in particular the buffer regime,⁵⁴ by designated authorities under the guidance of the ESRB.

Pillar 2 guidance

The Commission's proposal incorporates the concept of "Pillar 2 guidance" (P2G, also known as "soft Pillar 2") into the CRD (new Art. 104b CRD). This requires supervisors to formulate certain capital measures, in particular those needed to compensate shortfalls exposed by the adverse scenario of a stress test, as a non binding recommendation ("guidance") instead of being able to impose binding capital requirements immediately. P2G has been introduced into supervisory practice by the EBA and ECB already in 2016 with dramatic results: at the stroke of a pen, binding CET 1 **capital requirements for 'significant' Eurozone banks in the SSM were reduced by 23%, on average!**⁵⁵ This move materially weakens the existing Pillar 2 regime and further compromises the already much-doubted effectiveness of stress tests.



BY THE TIME THE FLAWS IN HIS "SOFT PILLAR 2" DESIGN BECAME APPARENT, THE ARCHITECT HAD ALREADY LEFT TOWN

There is little evidence so far to suggest that regulatory forbearance towards banks that failed in stress tests has had any effect other than to delay the implementation, eventually, of the necessary remedial measures.⁵⁶ Moreover, because P2G is non binding, non-compliant banks are able to continue making discretionary distributions to shareholders and holders of AT1 securities (contingent convertible or CoCo bonds) as well as bonus payments to management and staff, effectively without restrictions. This is particularly troubling given that European banks have been harshly criticised by the BIS and leading academics for maintaining generous dividend pay-outs in times of severe losses, even at the cost of eroding their capital bases.⁵⁷ We are concerned that the adoption of P2G may herald a return to the 1990s notion of ‘light touch’ regulation, which we thought had been utterly discredited by the last financial crisis. There is, in our view, no compelling reason for this tool: it is difficult to conceive of a regulatory outcome that could not be achieved with equal, if not greater, certainty by setting a clear, binding Pillar 2 requirement that could be made subject to phase-in periods, where appropriate.

It is surprising that the Commission should be proposing such fundamental changes to the capital adequacy regime without having produced, to our knowledge, any detailed empirical analysis of the divergences in Member States’ practice regarding, in particular, the structure and calibration of micro- and macro prudential Pillar 2 add ons and / or a quantitative impact assessment that would enable EU legislators to properly evaluate the proposed measures. In view of the importance of this matter for the effectiveness of prudential supervision and the preservation of financial stability we would urge the Commission to postpone the proposed changes to this section until a) the ongoing review of the macro prudential framework has been completed and b) a suitable quantitative impact assessment of the proposed new Pillar 2 regime has been made available for public consultation. In particular, legislators should be given adequate time and information to consider the proposed incorporation of the P2G regime into Level 1 legislation if the legislative process should amount to anything more than rubber-stamping of a regulatory *fait accompli*.

There are already numerous mechanisms in place, such as EBA guidelines,⁵⁸ supervisory colleges and joint supervisory teams (within the SSM), to promote regulatory convergence. This proposal appears to be more concerned with restricting, rather than aligning, the competent authorities’ powers. We very much support the Commission’s objective to work towards harmonisation of

supervisory practice in the Member States and towards a level playing field for financial institutions in the EU. But putting a padlock on the regulators’ toolbox is not the way to do it.

3. TLAC/MREL and other modifications of the Recovery and Resolution regime

TLAC and MREL calibration

The Commission proposes to introduce a minimum harmonised MREL requirement (also referred to as a “Pillar 1 MREL” requirement) applicable to G-SIBs only, in line with the scope of application of the TLAC standard agreed by the G20. Under TLAC a minimum level of capital and liabilities – 16% of RWA or 6% of total exposure initially, rising to 18% and 6.75% in 2022 – must be available for resolving and recapitalising a bank in a crisis. All other banks, including D-SIBs, remain under the existing (“Pillar 2”) MREL regime, which is not subject to a binding minimum level.⁵⁹ As for the going-concern capital regime, this leaves the calibration of MREL for D-SIBs largely in the hands of the relevant authorities, in this case the SRB or national resolution authority. Finance Watch believes that D-SIBs should also be subject to a minimum harmonised “Pillar 1 MREL” requirement.

Creditor hierarchy, insolvency harmonisation

We are concerned about the lack of progress in harmonising creditor hierarchies across EU Member States. This is a critical step towards rendering the bail-in tool credible and fit for purpose. We note that much of the current discussion around bail-in, ‘burden sharing’ and MREL is overshadowed by misconceptions about the resolution process and the legal and financial mechanics of the bail in tool.

Firstly, the political discussion does not seem to differentiate between the concepts of eligibility for bail in and eligibility for MREL (or TLAC). The intention of the BRRD, and of the FSB’s “TLAC Principles and Term Sheet”,⁶⁰ is to define and quantify distinct categories of liabilities that are not only suitable for bail in but can be bailed with a high degree of confidence without interfering with the claims of other senior unsecured creditors. Because senior unsecured creditors rank *pari passu*, i.e. have the same rank and rights in an insolvency, it is very risky to assume that some

of them may be bailed in in an insolvency while others are spared. Art. 75 BRRD states explicitly that creditors are entitled to compensation if they suffer a higher loss under resolution than under a conventional insolvency and liquidation. The risk of a successful legal challenge against the resolution plan by unsecured creditors is quite high under these circumstances and likely to discourage resolution authorities from pursuing bail-in as a resolution option at all. This reasoning is also reflected in Sections 10-11 of the “TLAC Principles and Term Sheet”, which explicitly disqualify from TLAC *“any liabilities that, under the laws governing the issuing entity, are excluded from bail-in or cannot be written down or converted into equity by the relevant resolution authority without giving rise to material risk of successful legal challenge or valid compensation claims.”*

Secondly, the discussion is undermined by a misconception of what constitutes “market discipline”. “Market discipline” is not tantamount to exposing as many creditors as possible to the risk of being bailed in, in the hope that putting them at risk would increase the level of scrutiny and, possibly, pressure on bank management. As the term indicates, “market discipline” is exercised by the (capital) markets, i.e. by investors. Suppliers of everyday goods and services, critical or not, are not agents of “market discipline”. Unlike investors in bank equity or debt they are not providing capital to the bank’s business in exchange for a financial return. Theirs is a different relationship and, in contrast to investors in tradeable securities, they are not able to end it at a moment’s notice by selling their stake. It is therefore not only prudent, to avoid disruption to the bank’s critical operations, but also equitable to draw a very clear distinction between financial and commercial senior creditors. Any subordination regime, or new class of securities, should therefore ensure that financial creditors’ claims are separated from, and rank junior to commercial creditors, irrespective of whether the latter qualify as “excluded liabilities” or not.

For the bail-in tool to be credible and practicable, TLAC/MREL-eligible liabilities must be limited to claims that can be bailed in safely without triggering massive litigation risks. It cannot be the resolution authorities’ responsibility to take risks on the legal status of individual claims, or category of claims, under Member State insolvency laws. It is, rather, the legislator’s responsibility to create a reliable legal framework at the European level.

A general depositor preference is a step in the right direction as it contributes towards separating depositors

from investors and towards channelling losses towards institutional investors, who are better placed to evaluate risks, correctly price debt instruments and, if necessary, absorb these losses. It is not sufficient, however, as it does not comprehensively address the issue of *pari passu* claims.

Accordingly, liabilities eligible for TLAC / MREL need to be subordinated to senior unsecured (*pari passu*) creditors. The proposed definition of eligible instruments (new Art. 72b/2 / lit. d CRR) should therefore be rephrased and all senior unsecured (*pari passu*) claims should be excluded from eligibility for TLAC and MREL (new Art. 72a/2 CRR) – not, for the avoidance of doubt, from the eligibility to be bailed in altogether, which is defined in Art. 44/2 BRRD. The exemptions from the subordination requirement (new Art. 72b Abs. 3-6 CRR), which are based on Section 11 of the “TLAC Principles and Term Sheet”, should be reconsidered as well: it is difficult to see how including claims that may give rise to *“material risk of successful legal challenge or valid compensation claims”* if bailed in would not also *“have a material adverse impact on the resolvability of the institution”* (new Art. 72b/3 / lit. c CRR).

MREL guidance and restrictions on discretions

In analogy to the proposed strict limits on the ability of supervisors to impose additional capital requirements (Pillar 2, see above) the proposal aims at placing similar restrictions on the resolution authorities’ calibration of MREL (new Art. 45c/3 BRRD). The proposed wording imposes a cap on MREL (*“shall not exceed”*) and ties the resolution authority’s assessment of the loss absorption and recapitalisation amounts firmly to the supervisory authority’s calibration of Pillar 2 (new Art. 104a CRD). In addition, EBA should be mandated to draft regulatory technical standards to further narrow down the general criteria that govern the resolution authority’s assessment of MREL (new Art. 45c/7 BRRD).

In line with the proposed introduction of P2G for going-concern capital requirements, the proposal introduces analogous provisions for MREL (Art. 45e BRRD). As with the calibration of binding MREL the resolution authority would be effectively bound by the supervisory authority’s judgment (new Art. 104b CRD).

The proposed rules are likely to create an institutional hierarchy where the resolution authority is effectively subordinated to the supervisory authority. This is,

in our view, neither compatible with the FSB's "Key Attributes"⁶¹ nor desirable from a practical point of view. The resolution authority's analysis is necessarily different from the supervisory authority's as it has to work on the assumption that an institution that ends up in its care will be failing or have failed already, i.e. it will have breached the safety nets that were put in place by the supervisory authority. The resolution authority's outlook is different, too, and predicated primarily on the institution's new, post-resolution shape, which is based on the resolution plan and likely to be very different from its pre-resolution shape. The two perspectives are not conflicting but complementary and it would be very unwise therefore to give one precedence over the other.

Precautionary recapitalisation

Intentionally or not, the continuing drama around the proposed state-funded rescue of a number of failing Italian banks,⁶² could have a lasting, and potentially huge negative signalling effect. It demonstrates to what lengths governments are still prepared to go to in order to bail out banks if that is seen as the politically expeditious thing to do. Bank executives and investors will take this episode as conclusive evidence that they can still count on governments, i.e. the taxpayer, to ride to the rescue. "Too big to fail" is still alive and well, at least in Europe. To remove, once and for all, the temptation for policymakers to off-load the wreckage of failed banks onto taxpayers' shoulders, Finance Watch therefore strongly recommends deleting the "precautionary recapitalisation" clause (Art 32/4 BRRD) from the current legislative package.

Additional Tier 1 (AT1) instruments / Contingent convertible (CoCo) bonds

We have argued previously that instruments eligible for bail-in should be held by professional investors as they are best positioned to evaluate, price and, in necessary absorb, their risk. Where even professional investors continue to struggle, however, are AT1 instruments. These instruments are poorly designed, poorly understood⁶³ and, at present, very optimistically priced. The episode in February 2016, when some AT1 issues suffered has

shed light on the fragility of this market. The decision to prioritise AT1 coupons over other Tier 1 distributions (new Art. 141/3 CRD), which was not part of the original design of these instruments, may alleviate some of the concerns of investors but will not solve the underlying problems. The flawed design of the instrument, in particular the poor alignment of incentives between AT1 investors and other stakeholders, continues to draw criticism from both academics and practitioners.⁶⁴

There is a risk that this market has by now attracted large numbers of investors looking for relatively high yields, arguably without a full appreciation of the risk-return characteristics of these complex instruments. It is, in our view, very likely that these instruments will not perform their intended role in the event of a crisis, not least as a result of the misguided prioritisation of AT1 coupons. Any investor reaction, i.e. "market discipline", has been pushed out to the point when the bank triggers the "failing or likely to fail" threshold, i.e. entering resolution. The value of the instrument as an early-warning system transmitting signals from the market has largely been lost in the process. Whereas ESMA issued a warning note to institutional investors in July 2014,⁶⁵ the UK FCA intervened more decisively to prohibit the sale of these securities to retail investors.⁶⁶ In view of the attendant risks, Finance Watch would strongly recommend a similar ban on a pan-European basis.

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org



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