Finance Watch
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European Parliament
Committee on Economic and Monetary Affairs (ECON)
ECON Public Hearing on the new banking legislation package
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These speaker's notes were prepared ahead of the ECON public hearing detailed above. A full summary of Finance Watch's position on the Banking Package will be published in due course and made available to members of the public on our website (www.finance-watch.org)

1. General remarks

The European Commission's legislative proposal incorporates important new international standards into European law. The introduction, at long last, of the Leverage Ratio and the adoption of the TLAC framework are significant regulatory milestones.

We caution, however, against a tendency towards deviating from internationally agreed standards to accommodate demands by the European banking industry. To deviate materially from internationally agreed standards would only reduce their usefulness, 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.

The current package seems to be based on a number assumptions:

- regulatory reforms to strengthen the financial system are now largely completed;
- capital ratios have been restored to (more than) satisfactory levels;
- excessive regulation is holding back European banks' capacity to lend to the real economy, slowing down the recovery.

but

- European banks, notably larger institutions, continue to be less well capitalised than most of their overseas peers;
- The European banking sector still has ca. EUR 1 trn of non-performing loans to absorb;
- Nearly all capital raised by European G-SIIs between 2010 and 2014 has been, or is expected to be, absorbed by fines for misconduct;
- Between 2007 and 2014 large Eurozone banks paid out some 40% of net profits as dividends, not counting other discretionary distributions, such as coupons on AT1 instruments and variable remuneration to staff;
- Current data, e.g. from recent ECB reports and surveys, do not point towards a shortage of bank credit holding back economic growth. In fact, the availability of bank credit ranks as the lowest-priority concern of European SMEs. 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;
- We note that, to the contrary, household debt levels in several Member States are already at elevated levels. Both the ESRB and the OECD have pointed out that several EU Member State economies could be at risk of a correction in their overheating residential property markets.

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2. Putting financial stability first

Finance Watch supports the Commission's agenda for jobs and growth. But sustainable growth and financial stability are by no means opposites. Recent experience shows that the problem of banks being "too big to fail" has not been resolved yet. To do so, we need to

a. Ensure that resolution is applied as intended:

BRRD has stumbled at the first hurdle: taxpayers are still being called upon to bail out failing banks;

- The statutory review of the "precautionary recapitalisation" clause (), included in the current text of Art. 32/4 BRRD, is overdue and should be implemented as part of this package.

b. Ensure that banks, in particular "systemically important" (G-SIIs and O-SIIs) and "significant" institutions, are resolvable:

- TLAC needs to be implemented fully and without deviations from the FSB Term Sheet;
- Binding minimum levels of TLAC ("Pillar 1 MREL") should be introduced for O-SIIs, in analogy to the TLAC requirement for G-SIIs;
- MREL should be aligned with TLAC, in particular with respect to subordination;
- Structural impediments to resolvability must be removed. Resolution authorities should be encouraged to set tight deadlines for banks, e.g. to implement structural measures, if necessary.

c. Ensure that European banking sector becomes healthy and profitable again without losing diversity and competitiveness:

- Weak banks must be allowed to exit the market;
- Banks need to focus once again on competing on the strength of their assets (better products, better service, better lending decisions), not on optimising capital;

d. Financial stability and strong credit markets are not mutually exclusive. To the contrary,

- Well capitalised banks will, in the long run, fund themselves on more favourable terms than weak ones;
- Well capitalised banks are more likely to lend to the real economy.

3. Proportionality

Finance Watch is aware of the burden of compliance for smaller participants in the banking market. We believe that this issue could best be addressed by improving the effectiveness of regulatory reporting and welcome the proposed introduction by EBA of a harmonised "compliance tool".

There is currently a multiplicity of statutory reporting formats and channels at various levels, within the Banking Union and the EU at large. To fully reap the benefits of harmonisation, which will benefit smaller institutions the most, we would like to see a more ambitious approach leading towards a "single point of contact" for regulatory reporting, operating under the "once-only" principle. In addition we would like to see a mandate for EBA to develop a set of mandatory, unified European templates for statutory accounts, regulatory and financial markets reporting.

The objective should be, in our view, not to obtain fewer data but to have fewer and simpler reporting processes with unified formats. Reducing the regulatory burden for smaller institutions should not result in a loss of transparency, however.

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We believe that the proposed definition of "small institutions" (new Art. 430a/4 CRR) should be more differentiated and comprise a combination of qualitative and quantitative criteria, mirroring the SII regime, e.g. a combination of absolute and relative size criteria, as well as criteria related to the institution's business model and risk profile.

4. Specific observations

a. Pillar 2 and guidance

There needs a more informed discussion of the proposed review of the **Pillar 2 regime**, including Pillar 2 guidance. We understand, and share, the desire to harmonise supervisory practice across Member States to safeguard financial stability and maintain a level playing field.

So far this has been primarily a technical discussion between regulators (EBA, ECB), but facts have already been created. If the Parliament is expected to do more than rubber-stamp a *fait accompli* it must be provided with the necessary factual basis. We would recommend an in-depth review of the recently adopted regulatory practice, including a detailed assessment of its expected quantitative and qualitative impact, and potential alternative approaches, before adopting the proposed, sweeping changes into law.

b. Macroprudential regime

We consider it problematic to introduce fairly momentous high-level changes to the prudential regime (such as the deletion of Art. 103 CRD IV) without having completed the pending review of the Macro-prudential Policy Framework. Harmonisation of the macro- and micro-prudential framework, which we strongly support, should go hand in hand to avoid discontinuities and regulatory "blind spots". We would therefore urge the legislators to postpone the proposed amendments to Section IV of Title VII of the CRD IV until a comprehensive proposal for the harmonisation of both micro- and macro-prudential tools has been developed and discussed.

c. Leverage ratio

Finance Watch welcomes the introduction, at long last, of a binding Leverage Ratio (LR). The Leverage Ratio has been identified as a significantly more reliable indicator of a bank's distance to default than risk-based capital measures and as a more neutral regulatory benchmark, e.g. for evaluating stress test results. It is also simple for banks to implement and more transparent for regulators to monitor and review.

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. The Commission does not currently propose a Leverage Ratio surcharge for G-SIIs and O-SIIs on the grounds that international discussions on this point are still ongoing. Switzerland and the U.S., which together account for ten of the 30 G SIIs, have both already implemented higher LR requirements (at 5% to 6%). A 5% Leverage Ratio requirement for European G SIIs would level the playing field with their Swiss and U.S. peers and effectively set a harmonised standard for 75% of the total G SII population.

The Commission's proposal remains silent on the possibility of setting a higher LR requirement for O-SIIs. We believe that the prudential framework for O-SIIs in the EU should be harmonised and O-SIIs, which are already subject to buffer requirements under the risk-weighted capital regime, should also comply with a Leverage Ratio that is higher than the base level of 3%.

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Finally, the Commission's proposal (Art. 429a/1/d-f and 429c/4 CRR) contains a number of exceptions which would exclude certain categories of exposures from the Leverage Ratio denominator ('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 removed.

d. Resolution

The introduction of the TLAC framework is an important step forward in making resolution feasible for G-SIIs. We have some observations, notably on aligning TLAC and the existing MREL framework. In the interest of time I am not going to enter into these details today.

We would reiterate, however, that even the most elaborate resolution framework is useless if it is not implemented when the need arises. We would therefore advocate, once again, a review of the existing "precautionary recapitalisation" rule which we believe is a major hindrance in putting the BRRD into practice.

We would also like to take issue with the concept of "MREL guidance", which is being proposed as an equivalent of "Pillar 2 guidance" (new Art. 45e BRRD). We are sceptical about placing narrow limits on the resolution authority's ability to set and enforce loss-absorbing and recapitalisation capacity. It is the resolution authority's primary responsibility to assess MREL level in line with the institution's resolution plan. As with "Pillar 2 guidance" we have great reservations about any measures that result in a material net reduction of loss-absorbing capacity in the financial system, bearing in mind that we have yet to see a real-life precedent of a successful resolution process under the BRRD framework.

5. Preliminary conclusions

We would caution against sacrificing international co-operation on banking regulation – as well as the strength of the EU's position in future negotiations – for the sake of short-term gains for the European banking industry which, by the way, are likely to even prove counter-productive in the longer run in terms of its resilience and competitiveness. We would therefore strongly suggest to reconsider proposed deviations from the FSB and Basel Committee standards.

We also believe that the European banking sector is not yet in a condition that would permit significant concessions in terms of capital adequacy and would therefore strongly advise to reconsider the proposed introduction of "guidance" as a way of effectively reducing the capital and loss-absorbing capacity requirements.

Finally, we would strongly urge the legislator to review obstacles in the BRRD resolution regime and ensure that it can be applied, safely and consistently, to facilitate the recovery of the European banking system.

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