Ambrosetti Club

The European House Ambrosetti

Towards Better Regulation for the European Banking and Financial System by Balancing Security and Stability Objectives with the Need for Competitiveness and Growth

Executive Summary

Banking and financial sector is crucial for economic growth, job creation and competitiveness of economic systems as a whole, also giving pivotal support to innovation and relaunch of productive investments.

This is particularly true considering the European Union. Here, on average, banking system accounts for **over 70% of lending to the economy** (a percentage more than double compared to the United States)[1].

In this context, we believe that regulation of banking and financial sector plays a central role in allowing the achievement of **growth and competitiveness objectives** by the European Union.

Despite this, current banking regulation framework in Europe - largely the result regulators' response to 2008 crisis – has as stability and security main objectives, leaving growth and competitiveness in the background. This because European decision-makers have focused on breaking and avoiding a recurring of the **vicious cycle triggered by the crisis**, that linked credit institutions and national budgets with important effects on the real economy[2].

Towards these objectives, European banking regulation has followed three lines of action::

- Implementation of the **prudential and liquidity requirements** established at supranational level by the Third Basel Accord (Basel III), applied directly to all banks operating within the European Union, independently of size.

1 See, in this regard: European Commission, "A European Framework for Simple and Transparent Securitization", Brussels, September, 30, 2015, and BNP Paribas, "Economic Conjoncture Research", Céline Choulet and Yelena Shulyatyeva, "History and Major Causes of US Banking Disintermediation", January 2016.

2 Since 2008, bailout procedures borne by EU Member States (total amount of over €4,600 bn. between 2008-2014) placed significant stress on national budgets. Repercussions on government bonds, held in large measure by the credit institutions themselves, put further pressure on European banking system, leading to a credit crunch with negative effects on business environment and leading to an increase of non-performing loans (once again hindering financial sector itself).

- Shifting of supervision, control and support responsibilities at supranational level, through direct implementation of the so-called European System of Financial Supervision and the Single Supervisory Mechanism.
- Adoption, under the Bank Recovery and Resolution Directive (BRRD), of the principle by which the cost of resolution of bank crises has to be borne by shareholders – through the so-called bail-in procedure – without weighing on public aid.

The same needs seem to be reflected by the **European Banking Union** project, looking focused more on priorities of stability and security and far from pre-crisis target: create a single market for financial services capable of sustaining access to credit and growth within the European Union.

Agreeing with the need for stability and security of the financial system, we believe that a Better Regulation of the European banking and financial system should pursue a right balance between security and stability and support to the **virtuous cycle that the banking sector can fuel** within the European economy.

One of the biggest criticalities associated with current regulatory set-up of the financial sector concerns the **high proliferation of laws, regulations and standards at the operational and detailed level** and their frequent changes. These modifications occur with near-daily frequency (in 2015, at global level, number of regulatory changes alerts averaged 190 per business day, double that of 2013 and six times higher if compared with 2008 levels).

The direct consequence is an **increase in complexity together with costs related to adaptation and management of these obligations borne by credit institutions**. This is true also considering the increase in human resources and time dedicated to compliance, risk management and regulatory activities within a bank.

Increase of capital requirements, necessity of greater high-quality liquidity reserves, risk moderation instruments and growth in cost of financing (due to BRRD) are negatively affecting not only the profitability levels in the sector, but also the possibility to operate in highly competitive international market. This is true especially for smaller players, because European regulation applies **to all banking players, independently of their size**.

Possible risks include a decrease in the level of service provided, an increase in costs transferred to customers, and the renounce to manage specific activities made too expensive or scarcely profitable due to regulation and disruption from new technological players. Finally, provision of credit to real economy and SMEs is at risk.

In this context, **smallest credit institutions are suffering the most**, not having adequate size and scale to cushion high fixed costs coming from compliance and regulation. They are also characterized by traditional business models, currently penalized by risk weighting models.

Current European banking regulation also affects **competitive dynamics within financial sector**. It influences the capability of European players to compete within the international context, for instance against **U.S. operators** (in part because of different implementation of international regulation overseas, European banks' market share in EMEA area fell by 8.6 p.p. between 2005 and 2015, while U.S. banks gained 7.4 p.p. in the same period).

Moreover, an increasingly stringent regulation could lead to a migration of activities and risk from traditional banking sector toward less regulated markets. This would feeding the phenomenon of **Shadow Banking** (a dynamic already seen before 2008 and now widespread in less or differently regulated markets, such as Chinese one).

Regulation also risks to hinder new entrants and traditional bank operators, while **innovative technological players**, exploiting asymmetries in regulation and more flexible structures, can progressively disintermediate activities within banking value chain. As of today 10.3% of ICT expenditures of Italian banks is related to compliance requirement, consuming resources that otherwise could be used to improve digital services for services and customers.

We therefore believe in the importance to provide the current debate and policy-makers with a set of **concrete proposals, characterized by a high degree of feasibility**.

For this reason, we have decided to focus on two regulatory topics currently under reform or revision:

- Banking resolution procedures, decided at European level in the BRRD, introducing the so-called MREL requirement (Minimum Requirement for Own Funds and Eligible Liabilities)[3]. Its objective is to assure to market that banks are resolvable and therefore that the amount of liabilities admissible in resolution procedures is enough to ensure an orderly resolution process. MREL requirement are not fixed in the same way for all European banks, but are defined case by case, on an individual basis, by relevant resolution authorities.
    - A central theme in the current debate related to subordination criteria for liabilities admissible in case of bail-in. The European Commission proposed the introduction of a new type of bond, i.e. Senior Unsecured Bonds, which would be placed, in the hierarchy of bank liabilities, between other Senior Bonds and subordinate bonds. Concretely, it is a solution managed in an inhomogeneous way among each European country, with particular cases in Germany, France and Spain.

3 It imposes a minimum ratio between liabilities claimable in the case of resolution of a banking institution (bail-in) and total liabilities.

- A second theme is the revision of Basel III supranational accords. Main issue is related to the way banks calculate their Risk Weighted Assets (RWA), which underlies the definition of the capital requirements. The current proposals involve a limitation of internal models usage in the calculation of RWAs in order to reduce the arbitrariness and the risk of distortions in the computation.

The formulation of our proposals wants to balance on one hand the **need of concrete and feasible actions**, **capable to effectively impact on current regulation,** addressing most relevant themes in the current debate. On the other hand, we pursue the **realization of one long-term objective**: bring growth, competitiveness and support for innovation at the core of European decision-makers' Agenda, rebalancing the regulation of European banking sector.

Finally, we have formulated a **specific proposal for Italy (Proposal 4)**, believing that the country is particularly hindered from current regulation. Indeed, although European regulation goes in the direction of ever-greater uniformity and uniform supervision functions at supranational level, the adoption and implementation of these rules leaves some room for country-specific implementation.

Proposal 1

Start up a **process of standardization and rationalization** of the current European banking sector regulatory framework, addressing objectives of growth and competitiveness as priorities, also in the wake of the **Better Regulation** initiative[4].

4 The initiative dubbed "Better Regulation" has been launched by the European Commission in May 2015 and is aimed at reducing the number of legislative proposals, in all areas, also improving the quality of regulation and boosting consultation with stakeholders.

Proposal 2

Finalize European banking resolution regulatory framework following principle of proportionality and objectives of growth and competitiveness. In the definition of MREL requirements principles of **reduction of discretionary power, increase of transparency and attention to cross-country uniformity** have to be followed.

Proposal 3

Review the use and application of internal models, solving the problem of divergences and distortions, avoiding the introduction of minimum input floors and introducing **output floors raised to a level not greater than 70%**.

Proposal 4

Set up a **coordinated, systemic action** of the whole Italian country, involving major national stakeholders in order to effectively influence the formulation of European and international banking sector regulation. As of today this coordination and systemic action has lacked, or at least has not been effective as definition of risk weighting criteria for RWA calculation show. It is particularly important because these criteria condition equity requirements and, as a result, the level of lending available to real economy.

In this sense, we have estimated that, a risk weighting model more aligned with respect to the needs and to the structure of the Italian banking system[5] would have led to an improvement of average CET1 ratio of Italian credit institutions by up to 3.15 points. This would have brought a €38bn improvement in the regulatory capital of Italian banks, making over **€480 bn. (9.8% of current total credit provided to non-financial sector)** available for lending without worsening prudential solidity.

5 By way of example we hypothesize a RWA/assets ratio equal to the average of the six leading European countries. By way of example, the RWA/assets ratio of the Italian banking system would be equal to the average of the six leading European countries (Italy, France, Germany, Spain, Belgium and the Netherlands): 33.9.

Italy

» MILAN
The European House - Ambrosetti
Via F. Albani, 21
20149 Milan
Tel. +39 02 46753 1
Fax +39 02 46753 333
ambrosetti@ambrosetti.eu

The European House - Ambrosetti
Via Durini, 27
20122 Milan
Tel. +39 02 878416
Fax +39 02 86460876

» ROME
The European House - Ambrosetti
Via Po, 22
00198 Rome
Tel. +39 06 8550951
Fax +39 06 8554858

» BOLOGNA
The European House - Ambrosetti
Via Persicetana Vecchia, 26
40132 Bologna
Tel. +39 051 268078
Fax +39 051 268392

Europe

» GERMANY
GLC Glücksburg Consulting AG
Bülowstraße 9
22763 Hamburg
Tel. +49 40 8540 060
Fax +49 40 8540 0638

GLC Glücksburg Consulting AG
Albrechtstraße 14 b
10117 Berlin
Tel. +49 30 8803 320
Fax +49 30 8803 3299
berlino@ambrosetti.eu

» UNITED KINGDOM
Ambrosetti Group Ltd.
1 Fore Street, Ground Flr
London EC2Y 5EJ
Tel. +44 (0)7588199988
london@ambrosetti.eu

» SPAIN
Ambrosetti Consultores
Castelló nº 19 Madrid, 28001
Tel. +34 91 575 1954
Fax +34 91 575 1950
madrid@ambrosetti.eu

» TURKEY
Consulta
Kore Şehitleri Caddesi Üsteğmen
Mehmet Gönenç Sorak No. 3 34394
Zincirlikuyu-ŞiŞli-Istanbul
Tel. +90 212 3473400
Fax +90 212 3479270
istanbul@ambrosetti.eu

World

» ASEAN COUNTRIES
The European House - Ambrosetti
(Singapore) Consulting Pte. Ltd.
19 Keppel Road #03-05
Jit Poh Building
Singapore 089058
Tel. +65 6407 1203
Fax +65 6407 1001
singapore@ambrosetti.eu

» CHINA
Ambrosetti (Beijing) Consulting Ltd.
No.762, 6th Floor, Block 15
Xinzhaojiayuan, Chaoyang District
Beijing, 100024
Tel. +86 10 5757 2521
beijing@ambrosetti.eu

Ambrosetti (Beijing) Consulting Ltd.
No. 1102 Suhe Mansion,
No.638 Hengfeng Road, Zhabei District
Shanghai, 200070
Tel. +86 21 5237 7151
Fax +86 21 5237 7152
shanghai@ambrosetti.eu

» KOREA
HebronStar Strategy Consultants
4F, Ilsin bldg.,
Teheraro37gil 27,
Gangnam-gu, Seoul
Tel. +82 2 417 9322
Fax +82 2 417 9333
seoul@ambrosetti.eu

» JAPAN
Corporate Directions, Inc. (CDI)
Tennoz First Tower 23F
2-2-4 Higashi Shinagawa,
Shinagawa-ku
Tokyo, 140-0002
Tel. +81 3 5783 4640
Fax +81 3 5783 4630
tokyo@ambrosetti.eu

» IRAN
KDD Group
Unit No. 4, No. 11 Africa Ave.
After Hemmat Highway Bridge
Corner of Zagros Alley
Tehran-Iran
Tel: (9821) 88654451-6 & 8873 4267
Fax:(9821) 8865 4460 & 8850 1176
teheran@ambrosetti.eu

» SOUTH AFRICA
Grow To The Power of n Consulting
Suite F9, Building 27
Thornhill Office Park – Bekker Road
Vorna Valley, Midrand
South Africa 1685
Tel. 0861 102 182 (local)
Tel. +27(0)11 805 0491 (international)
Fax 086 501 2969
johannesburg@ambrosetti.eu

» K FINANCE
Via Durini, 27
20122 Milan
Tel. +39 02 76394888
Fax +39 02 76310967
kfinance@kfinance.com

» BAI SHI BARBATELLI & PARTNERS COMMERCIAL CONSULTING SHANGHAI COMPANY LTD.
No. 517 Suhe Mansion,
No.638 Hengfeng Road, Zhabei District
Shanghai, 200070
Tel. +86 21 62719197
Fax +86 21 62719070
info@barbatelli.net