Matthew Elderfield: European banking regulation and the Eurozone crisis

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland and Alternate Chairman of the European Banking Authority, to the 4th CDU/CSU Congress in the Bundestag, Berlin, 26 March 2012.

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These remarks are the authors personal views and do not necessarily reflect those of the EBA or of the ESRB, of which Mr Elderfield is a member of the General Council.

Thank you for the invitation to join you today to discuss European banking regulation. In my brief time for opening remarks I would like to do three things: explain the actions the European Banking Authority (EBA) has taken to address the eurozone financial crisis; discuss the limits of regulatory action due to the feedback loop characteristics of the crisis and suggest two or three areas to explore to improve the current policy response to the crisis.

The formation of the EBA at the start of 2011 was a very significant milestone in the development of European regulation and the single market in banking. The EBA is different from its predecessors in three important ways. First, its actions as policy-maker will mean that a single European rule book will become a reality and be directly binding on all EU banks. Second, its remit for supervisory convergence and direct operational responsibilities – such as its role in colleges of supervisors – will make it increasingly influential in how supervision works on the ground in national authorities. And third, its responsibilities for crisis management mean that it will be at the forefront of the most important regulatory challenges of the day.

This has, of course, been the case with the current Eurozone financial crisis, first through a series of stress tests and, more recently, with its recommendation to create a temporary capital buffer to strengthen the European banking system. It is important to remember that the EBA's actions on capital were taken in response to not only market concerns but also calls for strengthening of capital from leading international and European policy makers. Last autumn both the new Managing Director of the IMF and the European Systemic Risk Board, comprising the EU's central banks and regulators, made strong calls for increased capital levels at Europe's banks. EBA's Chairman, Andrea Enria, showed strong leadership to respond to those concerns by crafting a new initiative on capital which was adopted by the EBA's members.

Constructing correctly calibrated regulatory measures involving bank capital is extremely challenging in the current financial crisis. This is principally because of the negative feedback loop between the banking sector, sovereign debt and the real economy. There are two dimensions to this feedback loop problem: procyclicality – or the interaction between bank lending and the real economy – and backstop burdens – or the interaction between bank recapitalisation and sovereign debt sustainability.

Procyclicality is the phenomenon by which banking capital rules exacerbate the business cycle by encouraging lending at a time of growth or contracting it in a time of recession. Basel 3 aims to build up a countercyclical buffer to lean against the wind in good times and be eased to help growth in bad times. We are evidently in bad times now, so intriguingly this has prompted some to consider whether you should in fact be starting to release the buffer. Indeed, you could probably run the Basel countercyclical buffer methodology with some plausible assumptions and get to the conclusion that for many countries we are well past the point where the buffer would be released. The problem, of course, is that the buffer is not in place to be eased and, indeed, that there is still a further strengthening of capital required under Basel 3. In addition, market expectations are for more capital faster. Where they can, banks are responding by racing to meet the new Basel standard well ahead of the five year transitional period. In this respect, what the regulator has given – a transitional period to ease the impact of the new rules – the market has taken away. A fair minded regulator should acknowledge that was a concern identified by industry some time ago.

All these considerations led the EBA to be very careful in design of the buffer in two respects. We made it clear that in calculating the capital buffer the determination of sovereign debt exposure would be fixed at one point in time, so there was no advantage and therefore incentive to dispose of sovereign debt holdings. And we provided tight guidelines limiting the capacity of banks to meet the capital requirement through deleveraging activity – reducing lending – that would hurt the real economy.

We have now seen the banks' plans to meet the EBA's aggregate €115 billion requirement. The assessment is encouraging, with banks' providing a margin for error, with very limited deleveraging planned and with overwhelmingly most of the required minimum met by new capital rather than reduced assets. However, EBA will of course monitor developments very closely.

Where should we go next in terms of policy responses? The European banking regulators' room for manoeuvre is in fact very constrained by the two dimensions of the negative feedback loop problem. The central dilemma is that for microprudential regulators more capital is a good thing – but that from a macroprudential perspective there is a concern about how fast to get that and at what cost. Perhaps the safest course of action, then, is for a breathing space in terms of further initiatives on the capital front. The EBA's decision to postpone its next stress test exercise into 2013 is therefore a sensible development.

There is also an argument for breathing space to let the political decisions on the sovereign debt crisis be fully implemented, both with respect to fiscal discipline and to building a firewall with adequate resources and sufficient operational flexibility. Indeed, if this does happen, and has a sustained positive impact, it could eventually give scope to the EBA to revisit the necessity for the full scale of the current capital buffer.

I would like to see that we use this breathing space wisely to consider the future design of stress tests and the operational flexibility of firewall structures. It seems that the role of the stress test as a diagnostic tool needs to be reasserted. Recent EU stress tests have evolved into what might be described as a "capital shortfall" calculation: setting a single scenario and a specially created threshold to effectively prescribe additional capital even where not required by EU law or Basel rules. Interestingly, the US stress tests are now focused on dividend and share repurchase approval rather than closing a capital gap in a prescribed timeline. The EU stress test approach therefore is in addition to – and potentially cuts across – the new Basel 3 minimum capital requirements which are coming in anyway. Also, I fear that trying to satisfy insatiable market expectations of conservatism in a stress test risks being very procyclical.

Stress tests were originally conceived as diagnostic tools, considering a range of scenarios and providing the basis for management and supervisory judgement, rather than as an automatic capital formula. Given that the introduction of Basel 3 already requires increased capital and in light of the changing balance of risks of procyclical regulatory action, it would be sensible to recalibrate the European approach to stress testing in the next period.

What about the second negative feedback problem that I mentioned, which might be described as "backstop burdens". The problem here is if countries with sovereign debt concerns need to borrow more to recapitalise their banks, which harms their debt sustainability and therefore exacerbates the euro crisis, impacting the real economy and feeding back to the banks. A former US Treasury Secretary colourfully spoke of the need for a bazooka – a big gun – to sort out the crisis, by which he meant using a vast amount of money to convince markets the problem has been solved. But for countries with debt problems, they need to borrow more to afford the ammunition for the bazooka and their debt sustainability position gets worse. The room for manoeuver for ever tougher capital standards is therefore constrained. In this respect, the feedback loop will only be broken by investment, rather than borrowing, from outside the loop.

Thus, while the debate around firewall structures is normally about the sensitive issue of size, I would suggest that having sufficient operational flexibility in any new mechanism is an equally important objective. Finding mechanisms for investment in banking systems without adding to sovereign debt must surely be a desirable policy goal to be considered carefully. This might be done through European firewall mechanisms or other structures. I was interested in the reported comments of Hans-Peter Keitel, president of the Federation of German Industries, about the benefits of investment in (rather than more loans to) debtor countries such as Greece. This seems a sensible initiative to be developed. Investment in stressed banking systems would help break the feedback loop and provide commercial opportunities at the same time.

Let me conclude by once again acknowledging the good work done by the European Banking Authority in the current crisis. But let us also recognise the limits of further action on regulatory capital to address the crisis. We should use a breathing space to refine the policy instruments at hand in a way that can help break the feedback loop that is doing so much damage to all the member states of the Eurozone.