Matthew Elderfield: Micro-macro schizophrenia – Banking Union and the European capital dilemma

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland and Alternate Chairman of the European Banking Authority, to Bloomberg, Dublin, 26 November 2012.

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European regulators face a dilemma – a bad case of policy schizophrenia – in deciding the pace of the next steps of bank recapitalisation. With the fiscal policy break full on, and the monetary policy throttle full back, what is the right calibration for prudential capital policy? From the micro-prudential perspective, the answer is more and faster. From the macro prudential perspective, fear of pro-cyclicality and debt sustainability might suggest: take care. This has been a central dilemma for policymakers in the Eurozone in many countries. As I would like to discuss today, this will be a key policy choice for the European Central Bank under a banking union.

The European summit conclusions of 29 June gave official birth to the concept of a banking union and the single supervisory mechanism. These steps arose out of the pressing need to break the debilitating link between weak banking systems and constrained sovereign finances. While there is a continuing debate on the details, this is to be done by facilitating the direct recapitalisation of banks, from pooled European resources following the successful introduction of a common European banking supervisor, for Eurozone countries.

Banking union also holds out the prospect of strengthening the framework for European banking supervision, if implemented successfully. Creating some distance between supervisors and the banks they regulate (and, indeed, from the political systems of the banks they regulate) can help improve the capacity for challenge and ensure a broader, more detached, perspective on problems. Bringing in a foreigner to do your supervision is not, alas, the magic solution to all the woes of a banking system. But the single supervisory mechanism holds open the prospect of an institutional framework, a broader skill set and more diversity of experience that should help insulate supervisors from the pressures – subtle and direct, cultural and political – that come from long-time and close proximity to their regulatory charges and their champions.

In addition to strengthening banking supervision and breaking the link between banks and sovereigns, the banking union also may allow the development of a deeper single market, although here there are considerable uncertainties and potential risks due to the fact that only a subset of the European Union will be taking the steps towards banking union. The proposed way to square the circle between the single market and the banking union is to provide for a bifurcation between regulation and supervision. Banking supervision for the Eurozone (and opt-in countries) will be undertaken by the single supervisory mechanism operated by the ECB. But regulation, that is to say the process of agreeing policy on rules, will remain with the EBA.

However, matters are not quite so straightforward and concerns have been raised in a number of quarters. For example, the distinction between supervisory standards or practices on the one hand and regulations on the other is easier in the abstract and becomes blurred in some areas. In the space left for national discretion under current EU directives and regulations, should the EBA seek to develop a common single market rulebook – or should the ECB do its own thing? I would think that where issues arise from divergent interpretations of existing EU law or of differences in definitions and standards, the EBA and all 27 supervisors should have an opportunity to discuss and consider efforts at further convergence before the ECB sets off on its own. However, in areas of supervisory practices (such as SREP, risk assessment, inspection methodologies and the like) I would think it makes sense to preserve some flexibility for national discretion at the level of the 27, but that it will be essential for the ECB to move forward with plans to develop a common supervisory model.

What would, however, be more worrying is if the different principal supervisors in the single market, now including the ECB, were to take measures that sought to ring fence or discourage cross-border banking structures or activities that spanned their respective domains. In this respect, my personal view is that the ECB's stance towards Euro clearing by LCH is an unfortunate precedent and it is important that this philosophy does not spill over into banking supervision. But equally, it is important that the FSA's approach to incoming branches and to liquidity and capital support from banking groups based elsewhere in the EU does not undermine the single market.

This issue underlines another important role that the EBA plays, beyond that of policy and rule maker: its mediation mandate to resolve disputes between supervisors and ensure the application of EU law. This is a crucial role which has yet to be tested in earnest. And it could be of increasing importance as a tool to tackle supervisory actions which undermine the operation of the single market for banks.

Both the policy-making and mediation roles of the EBA raise what has become a key issue in the political negotiations on the banking union, namely the voting arrangements that will apply in the future. It is clear that the concerns of the UK and other "out" countries will need to be addressed. I think it would be unfortunate if the "ins caucus" sought to agree a common position on matters before engaging in debate around the EBA table, so as to benefit from the views of other countries – and indeed I would not see the caucus leading to a block vote, as individual supervisors will still retain their responsibility for policy-making. But, as I said, the governance and voting arrangements for the EBA clearly need to change.

Another key point of discussion relates to the scope of the ECB's responsibilities in terms of the number of banks it is responsible for, and the speed with which its new mandate is implemented. It is clear that at the outset, a core group of systemically important banks will be subject to direct ECB supervision, albeit with some supervisory tasks delegated to national supervisory authorities. However, an open question subject of considerable debate relates to the timing of any subsequent assumption of responsibility for banks from programme countries and/or smaller banks. Broadly casting the ECB's mandate to cover all banks will avoid any disruptive capital flows between institutions subject to the two different regimes, and will also acknowledge the fact that severe problems have arisen from clusters of banks that sit below any obvious systemic threshold, but which nevertheless have imperilled the finances of governments. Ireland and Spain are, of course, examples of this.

This approach was considered at the October EU summit. There is, however, a practical question regarding the speed with which the ECB can reasonably assume responsibility – and potential reputational risk – for such a large universe of credit institutions, even with a model involving significant delegation of tasks to national authorities. This points to the need to articulate some transitional arrangements. One approach might be a transitional phase of supplemental, but not direct ECB supervision, for the wider set of small banks. In this interim period, the ECB would issue its supervisory manual for use by national supervisory authorities for the smaller banks too. And, crucially, the ECB could be given the power to step in to inspect the financial soundness of any particular bank or subset of banks outside of the systemic group but which are flashing red on its radar. A small supervisory SWAT team could be sent in to kick the tires alongside the national supervisor that retains direct supervisory responsibility. And, if necessary, the ECB could elect to bring particular banks under its direct supervisory power. This would allow it to gradually expand its remit during the transitional period and have the absolute right to troubleshoot problems beyond the systemic group, which is surely what recent experience has proved necessary.

Another key challenge will be to develop the operating model of the ECB's new supervisory responsibilities. I have two thoughts here. First, while the high-level governance framework of the ECB's supervisory responsibilities (as distinct from its monetary policy ones), remains under negotiation, it seems likely that there will be some sort of high-level supervisory board put in place. At the other end of the spectrum, will be the national supervisory authorities conducting decentralised tasks. The exact design of the arrangements for escalation and decision making between the two are of crucial importance. While there will necessarily be a framework of committees and panels for certain types of decisions and policy-making, it is vital that there is clear accountability and the capacity for decisive executive decision-making, particularly in times of crisis. In moments of crisis or market disruption, supervisors are required to take dozens of decisions in short periods of time. It is important that the organisational design of the single supervisory mechanism recognises this reality. Indeed, this is the negative flipside that distance between supervisor and bank can bring. So, one reasonable design principle – both for the regulated bank in search of a speedy answer and for the depositor in need of decisive supervisory action – one such principle must be that of efficiency and effectiveness in the escalation and decision making process of the new supervisor.

My second thought on the ECB's new operating model relates to supervisory culture. A clearly articulated supervisory culture and philosophy will be important for guiding front-line supervisors and for ensuring consistency in practice. It is important that supervisors who engage day-to-day with banks understand the risk appetite of senior management and their willingness to tackle problems. Tone and culture, as well as the underlying supervisory model, will be key in setting expectations.

Seventeen national supervisors (at least) will be converging into a new pan-European structure, uniting diverse cultures rooted in different market structures, as well as reflecting a range of different supervisory practices. Should the focus be on rule breaches or risks? Business models or audit reports? Should supervisors talk more to the CEO or to the compliance officer? How central a role should enforcement play for prudential breaches? And how should senior management distil down the essence of the new supervisory model and approach, so that it can be communicated and understood easily by both firms and front-line staff? For example, in Ireland, our new approach is one of "assertive, risk based supervision underpinned by a credible threat of enforcement." That is designed to put a few concepts front and centre: that we operate a risk-based approach, differentiating based on impact and probability; that there are consequences and accountability for non-compliance; and that our supervisors are empowered to insist upon actions to mitigate risk where we are not satisfied by the explanation from a firm's management.

The best driver for creating this common supervisory culture and model is through the development – jointly by the supervisors that will use it – of a risk assessment framework. This will provide a common vocabulary across the banking union for the description and identification of risk, and set out clear rules of the game for supervisors regarding risk appetite and how problems are to be mitigated. It will therefore be an early, important task, for the ECB to develop a common risk assessment framework and a protocol for on and off-site inspections.

Stepping back from this long to-do list, it must be pretty obvious what the central challenge is for the new single supervisory mechanism. The key first call to be made is around the "European capital question": is there enough capital in the European banks, in light of asset quality problems and the requirements of CRD IV, and, if not, how quickly should you remedy the deficit?

This raises the policymaking dilemma, which one might call Micro–Macro Schizophrenia: the tension between the micro-prudential imperative to require more capital, more quickly, and macro-prudential concerns over the implications for pro-cyclicality and sovereign debt sustainability. It's most obvious form may be found in peripheral Eurozone countries but the condition is, of course, widely observed!

The micro-prudential supervisor's concern for more capital, faster, is rooted in scepticism over the asset quality of the European banks' balance sheets, due to practices of forbearance and failure to recognise embedded losses. It is compounded by the concern that the use of bank internal models, creating risk weights from historical losses, is masking or understating problems. And it is heightened by the imminent challenge facing the European banks as they start on the foothills of CRD IV/Basel 3 implementation, with the five-year transition to higher capital requirements just beginning and the banks collectively facing a staggering capital gap of €349.3billion.[1]

The micro-prudential supervisor who argues for tougher, faster bank capital standards might also pray in aid of a macro-prudential argument: that a lengthy transition incentivises banks to hoard capital and avoid lending, so get it over with! However, there are two other competing macro-prudential concerns. One is pro-cyclicality. The Basel 3 framework addressed the pro-cyclicality problem, but perhaps like a general fighting the last war it sets out the case for a countercyclical buffer to be built up to provide a drag on frothy, imprudent lending in good times. But times are now certainly not good, so is there a case for the release of capital – or the deferral of new requirements? The argument here is that increasing capital requirements inhibit lending and encouraged deleveraging, therefore harming growth. In a speech prior to his exposition on the Dog and Frisbee, the Bank of England's Andy Haldane hinted that there might be a case to be made for some such adjustment.[2] Adair Turner shortly after tackled the question of the design of countercyclical buffers, but dismissed the case for any relaxation in Basel 3 implantation on the grounds that the Basel Committee's analysis showed that the long-term benefits of sticking to the plan outweighed the costs. However, he acknowledged risks to SME lending.[3] And perhaps the Basel analysis might have a different colour if it was conducted now in the depths of the sovereign debt crisis?

The other macro-prudential concern is around debt sustainability and the linkage between weak banking systems and stressed sovereign finances. The problem here, of course, is that if countries with sovereign debt concerns need to borrow more to recapitalise their banks, then this harms their debt sustainability requires more austerity, which in turn impacts on the real economy and feeds back into the banks. This is a highly damaging feedback loop that needs to be broken. The former US Treasury Secretary Hank Paulson famously spoke about the need for a bazooka to sort out the crisis, by which he meant using a vast amount of money to convince the markets that the problem has been solved. But for countries with debt problems, they need to borrow more to afford the ammunition for the bazooka, so their debt sustainability gets worse. The room for manoeuver for ever tougher capital requirements brought forward faster and faster is therefore severely constrained. In this respect, the feedback loop will only be broken by investment, rather than borrowing, from outside of the loop. This, of course, is where the banking union is supposed to come in, but back to that in a minute.

This micro-macro dilemma has more than faint echoes of the debate on fiscal policy. Is more austerity needed or is there a case for stimulus? Do you stick to Plan A or move to Plan B. The recent IMF analysis on the fiscal multiplier – whereby it contended that fiscal corrections in certain countries have a larger than previously considered drag on growth – casts new light, indirectly, on the dynamic of the bank-sovereign debt negative feedback loop.[4] If you want to embrace the micro-prudential instinct for ever more capital but need to cut spending

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1 In order to achieve a tier 1 ratio of 8.5% based on year end 2011 data: http://eba.europa.eu/cebs/media/Publications/Other%20Publications/QIS/EBA-BS-2012-xxx--Public-ISG-Report-Basel-III-Monitoring-.pdf; http://www.bis.org/press/p120920.htm.

2 "Risk Off," Andrew G Haldane, 18 August 2011 (see page 9).

3 "Credit Creation and Social Optimality" Adair turner 29 September 2011.

4 IMF Report: World Economic Outlook October 2012: Coping with High Debt and sluggish Growth. Article by Olivier Blanchard and Daniel Leigh entitled *High fiscal multipliers undermine austerity programmes*.

to get there, be wary of the multiplier impact back into the economy and on the business prospects of the banks you are trying to strengthen in the first place.

So, is there a cure for the Micro-Macro Schizophrenia condition? Well, there are perhaps three competing schools of thought regarding treatment: what we might call the St Augustine, Schwarzenegger and Dell cures.

The St Augustine approach proposes: "make me very, very capital virtuous, but not yet." The policymaker is advised to adopt even tougher capital rules in the future, but to push back their start date and in the meantime use relaxation and/or deferral of prudential capital standards as a countercyclical stimulus to the economy, perhaps like the Roosevelt administration apparently did in the New Deal.

The St Augustine solution seems to suffer a number of defects, however. It creates an even bigger eventual capital ascent for the banks. Doesn't the yet bigger capital mountain ahead cast a long shadow and still encourages hoarding? Indeed, it seems that one lesson from the Basel implementation process is that transition periods have only limited value as markets anticipate their end point and put pressure on banks to be early adopters: to be fair to the industry, this was a point they made at the time. But most fundamentally, the St Augustine approach suffers from the fact that the compelling logic of Basel 3 has not really changed and that there is every possibility the banks need more capital to get through their current travails, not just some future ones.

The contrasting treatment is the Schwarzenegger cure, to be specific the approach which involves a muscular saviour arriving from the future to protect the present day. The answer here is to fast forward Basel 3 implementation and immediately bring forward the full future requirements of 2018 to the present day of 2013. The argument here[5] is to get it all over with quickly and avoid a half-decade of anaemic growth caused by constrained lending as banks slowly meet Basel 3, hoarding capital and deleveraging along the way.

This prudent, conservative approach has a lot going for it and is appealing to a micro-prudential regulator. In Ireland we have sought to put the loan losses in the banks behind them by rigorously capitalising for future projected losses. Our tool has been the stress test, in its capital shortfall variant: you project forward losses over a three year period under a severe stress scenario, calculate the shortfall that arises against a prescribed hurdle rate and, crucially, require that to be filled *now*.

In Ireland we went a step further and used an outside party, to come up with a wholly independent calculation of projected loan losses. This lead to a capital requirement that was €8 billion higher than that projected by the banks themselves. That is the equivalent to 4.9% of Irish GDP. In UK GDP terms, the amount would have been £76 billion. This is clearly a significant number no matter which way you look at it. And then as a further measure we required an additional buffer of capital for projected losses beyond the stress test period, to a value of €5.3bn.

Should Ireland or other EU member states adopt the Schwarzenegger school and fast forward all the way to Basel 3 as soon as possible? As I say, that has strong attractions for a micro-prudential supervisor. But there are two absolutely necessary conditions for this to make sense. First, it would have to be absolutely clear that the tougher capital requirement cannot be met by deleveraging, as that would defeat the purpose and exacerbate the macro-prudential problem.[6] Second, we have the sovereign debt negative feedback loop to worry about. Accelerated Basel implementation shouldn't come at the cost of worse debt

5 Philip Hildebrand and Lee Sachs Financial Times OpEd 24 September2012.

6 The EBA's recapitalisation exercise did a good job of managing this by the way. http://www.eba.europa.eu/capitalexercise2012/finalreportrecapitalisationexercise.pdf.

sustainability. So, this approach also only makes sense if there is European direct capital support to make this happen.

In the absence of these essential conditions, we then have the third approach, the Dell school. This is, of course, named after Michael Dell, one of the innovators of just-in-time manufacturing. This involves making sure that banks stay above their *current* minimum capital requirements,[7] and living with that just up until the point of need of recapitalisation and public support, to meet Basel 3 or stress losses. Call this a just-in-time approach to backstops, if you like. Banks therefore make their slow progress towards full Basel 3 compliance step-by-step. This may involve a protracted period of uncertainty, but you are not adding fuel to the sovereign debt crisis fire by trying to accelerate the implementation process through more sovereign borrowing.

Which school of thought would I adopt to resolve the micro-macro dilemma?[8] In a nod to the St Augustine school, it certainly makes sense to take off the table any thought about attempting to impose an additional counter-cyclical buffer for the foreseeable future. With the end point of CRDIV clear, supervisors should require European banks to set out their capital plans for achieving their trajectory to full compliance with CRD IV. Banks should start reporting on a full end point CRDIV basis to their supervisors, so the size of the task is very transparent to us. And they should build on the EBA recapitalisation process, maintaining the quantum of capital that meets the EBA requirements as a platform for further progress to CRDIV.

It will be informative to see the banks' projections regarding loan losses and future profitability in assessing the realism of their plans. And it will be necessary to stress test them, which should be done in a coordinated way at an EU level orchestrated by the EBA. This will allow supervisors to assess the realism and resilience of the plans. I think some fine-tuning of the stress test approach makes sense. Trying to satisfy insatiable market expectations of conservatism in a stress test risks being very pro-cyclical. Rather than calculating a capital shortfall for immediate remedy, the recent US stress tests have moved to using the stress test as a tool for restricting dividends and share repurchases. This would seem to be a useful refinement that Europe could follow too. Stress tests were originally conceived as diagnostic tools, considering a range of scenarios and providing a basis for management and supervisory judgement, rather than as automatic capital formulae. However, if the stress tests show a bank's plans to be hopelessly implausible, then it may indeed be better to bite the bullet and look to an early capital injection or explicit backstop.

There is, however, also a need for a rigorous examination of asset quality. Apparently higher capital ratios provide illusory comfort if they are based on avoidance of embedded loan losses. Ireland has taken a very stringent approach to asset quality reviews. We have used third parties to assess the quality of legal security and loan file data integrity, as well as conducting detailed loan file reviews and independently modelling loan losses. We have also pressed the Irish banks to re-underwrite their mortgage and SME portfolios that are in arrears to establish a more granular view of embedded losses. And we have required more rigorous provisioning practices and disclosure of impairment.[9]

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7 After taking prudent impairments for future loans.

8 The FSA's recent fine tuning of its capital approach for the new small business lending facility and its reported focus on preserving the stock of capital rather than maintaining a tougher ratio at all costs is an innovative approach to address the dilemma at a UK level.

9 The Financial Measures Programme Report, March 2011: http://www.centralbank.ie/regulation/industry-sectors/credit-institutions/Documents/The%20Financial%20Measures%20Programme%20Report.pdf.

Impairment Provisioning and Disclosure Guidelines, December 2011: http://www.centralbank.ie/press-area/press-releases/Documents/Impairment%20Provisioning%20Guidelines-%20Central%20Bank%20of%20Ireland%20-%20Decemeber%202011.pdf

However, it is clear that Ireland is not the only jurisdiction where significant questions have been raised over the asset quality underlying banks' actual balance sheet strength. It makes sense to undertake a pan-European asset quality review exercise of some sort.

Capital plans, diagnostic stress tests and rigorous asset quality reviews would seem a reasonable course of action to underpin and strengthen a Dell-style just-in-time approach to the capital problem. But there is another crucial element that needs to be in place, in case the need for capital injections does in fact arise. This raises the last subject I want to mention: the appropriate sequencing of the introduction of the single supervisory mechanism with a new European resolution mechanism. And related to this is the question of the role of the ESM concerning direct bank recapitalisation.

The sequencing debate goes something like this: if the single supervisory mechanism is implemented in the course of 2013 - and a pan-European Deposit Guarantee Scheme is a distant prospect – when should you introduce new resolution powers, ESM direct recapitalisation and/or a pan European resolution Authority and Fund?

There is an Irish-orientated debate on retrospective ESM recapitalisation, but I want to put that to one side and argue that for the banking union to be a success for Europe as a whole it is important that the sequencing debate is concluded sensibly. You do not want the ECB to start its new mandate without the full toolkit of European resolution and recapitalisation arrangements operational and at hand. To do otherwise places the new single supervisory mechanism in a precarious position at the moment of its inception.

What, for example, of the question of accountability for triggering the use of taxpayer funds? One of the mantras behind banking union from creditor countries is that liability means the need for responsibility. In other words, mutualisation of risk through direct recapitalisation requires joint supervisory control and responsibility. But I would suggest the reverse applies too and creates an awkward scenario for the ECB. The ECB may wish to exercise its supervisory discretion and require more capital even when minimum pillar 1 requirements are met, such as through Pillar 2 charges, stress test results or maybe even accelerated CRDIV implementation. But these actions could trigger the use of national taxpayer funds and therefore a vicious cycle of further sovereign debt, more austerity for particular taxpayers (to which it has no accountability) and a negative feedback into the bank it is trying to sort out. If a European institution is taking on the responsibility of such an important call then surely some European arrangements need to be in place to deal with the consequences?

This is an invidious position to impose on the new supervisor right at its birth. To switch from analogies bazooka-like, it is a distinctly unpleasant situation to be asked to put out a fire, but to find your fire extinguisher is half full – and that the only way to get a re-load is to increase debt and austerity.

So, this then, is my overriding and final conclusion. To be a success, the new single supervisory mechanism of the banking union needs to have a well-considered relationship with the EBA and a strong commitment to the single market. It needs to have a best practice supervisory toolkit, effective and efficient decision-making procedures, a top-notch risk assessment framework and a robust, jointly shared, supervisory culture. But above all, the European political process needs to ensure that the new resolution rules and ESM direct recapitalisation tools are fully operational for the new supervisor when it takes on its onerous responsibilities. If not, the ECB itself is at risk of succumbing to a very nasty case of micro-macro schizophrenia.