Yves Mersch: From Basel III to European banking regulation

Dinner speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the IIF 6th Annual European Banking Union Colloquium, Frankfurt am Main, 25 November 2019.

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Introduction

Free markets are the best way of organising an economy – on the whole. And the ECB is constitutionally committed to this principle. But public goods generally require some degree of regulation to protect the interests of society. Financial stability is one of these public goods, embedded in the price stability goal. The ECB contributes to the smooth conduct of policies pursued by the competent authorities to preserve financial stability, and in the pursuit of its microprudential mandate, it has also been assigned some responsibility for macroprudential interventions.

Can the ECB use its regulatory power of monetary policy, which integrates financial stability concerns under its two-pillar strategy, to operationalise and expand its macroprudential powers which are defined in the microprudential mandate? Would that not be considered a self-referral of additional competence and a violation of the separation decision explicitly requested by the legislator when it conferred the microprudential competence on the ECB?

The question is not whether banks need to be regulated. The question is by whom they need to be regulated. We have to strike a balance between enabling banks to perform their role in the monetary policy transmission mechanism and, at the same time, avoiding undue risks. What are the ideal levels of capital and liquidity for striking that balance? Is the ECB trying to sidestep the legislator by invoking its monetary policy powers, as its microprudential powers are limited to only implementing the legislator’s will?

Implementing Basel III benefits the euro area economy

I will begin by discussing the scope of existing regulation and what is in the pipeline. Some argue that regulatory reforms have gone too far. They claim that the final Basel III package will place too much of a burden on European banks, putting them at a disadvantage to their US peers. They also claim that it will curb profits and make banks less able to support the economy.

The European Banking Authority, the EBA, estimates that capital demand for EU banks will increase by around 24% under Basel III. And yes, this figure is lower for US banks, at least according to the latest Basel estimates. But there are two things that we should keep in mind. First, the EBA’s estimate for EU banks is based on fairly conservative assumptions – the actual impact is expected to be somewhat lower than 24%. And second, only some banks will face significant increases in capital requirements. For some banks the requirements will even decrease.

We should not forget the rationale behind Basel III. The aim is to preserve risk-sensitive regulation and, at the same time, reduce excessive variability of risk-weighted assets. This is reflected in the design of Basel III. Take the output floor. It sets a lower limit for the risk-weighted assets that banks calculate with their internal models, giving them the freedom to use internal models while at the same time introducing a safeguard.

The very same idea appears in other parts of the Basel III framework – the operational risk framework has been simplified, for instance. Internal models can no longer be used to assess operational risks; it had become clear that they were too complex and led to excessive variability in risk-weighted assets and insufficient levels of capital for some banks. In their place, a new

standardised approach has been introduced, which combines simplicity and risk sensitivity. We agree with the Basel Committee on Banking Supervision and the EBA on the design of this approach – we recognise the benefit of including past losses in the new standardised approach to make it risk sensitive. This feature also helps to maintain a direct link between risk measurement and risk management – good risk management will keep losses at bay and thus result in lower capital requirements.

To sum up: Basel III will change capital requirements, making crises less likely and thus supporting the euro area economy. So we think that the benefits of a faithful, consistent and timely implementation of Basel III will outweigh the costs. And we also think that banks will be able to manage its full impact.

I know that some would like to reopen the Basel package before implementing it. In my view, this would not serve anyone's needs; it would just prolong the period of regulatory uncertainty. The only sensible next step is to implement Basel III in all jurisdictions, including the European Union.

By sticking to what was agreed we underline that we continue to feel committed to a multilateral framework of standard-setting, which is superior to bilateral agreements and clearly preferable to any kind of trade war. That said, I am aware that Basel III comprises a vast and complex set of standards. We will need to continue evaluating these standards – once they have been implemented. To this end, we contribute to a number of working groups in both the Financial Stability Board and the Basel Committee on Banking Supervision. We should not renege on the commitment to implement internationally agreed reforms. Instead, we should focus on how regulators and banks can have a constructive dialogue within a Basel-compliant framework. This dialogue has been ongoing for many years and will continue. And overall, we can see that capital requirements and buffers are levelling off, while supervisors are increasing their focus on specific risk areas in individual banks. Stabilising the capital requirements is a reasonable objective asked for by banks, but we need to finalise the Basel III package first.

From micro to macro

Ladies and gentlemen, so far I have focused on the microprudential side. Is there a macroprudential side here, too?

In the euro area the relevant authorities apply various microprudential measures to address institution-specific risks, as well as various macroprudential capital buffers or borrower-based measures to address systemic risks. The institutional setup and the distribution of competences are different from one country to another. The Treaty does, however, not set out macroprudential supervision as a basic task of the ECB or the ESCB, nor does it establish financial stability as one of their specific goals[1]. With both the pooling of monetary sovereignty and the exclusive competence for prudential supervision at the ECB, how can Member States steer the cycle at national level beyond fiscal and structural policies? Furthermore, the costs of financial crises are mostly born at the national level and much less so at the European level. This seems to have been the rationale behind attributing macroprudential tools to the national level. That said, the SSM Regulation stipulates that, if deemed necessary, the ECB may apply higher requirements for measures taken by national authorities, provided that these measures are set out in EU law and are intended to address systemic or macroprudential risk. In other words, the ECB can top up national measures under certain conditions.

A case in point is the countercyclical capital buffer, or CCyB, which can be released in periods of stress, although this has never actually occurred.

And here, some basic questions need to be asked. What and who trigger this release? The turning point in the financial cycle or the stress in the banking system? Are we adding a new layer of authorities responsible for forecasting the cycle on the basis of yet new models, while the former ones have repeatedly failed in the past? Or are we tasking supervisors with becoming

better at guessing when the cycle will turn by deducing future patterns from observations of the past? Do we need yet more authorities attempting to further smoothen the business and financial cycles? What experience do we have with the financial cycle, which is different from the business cycle? And how well do we understand the interaction between the two? Research has undoubtedly made progress in this respect and I understand that those working in this area are keen to prove their beliefs in real time. The issue for policymakers, however, is that the input is biased towards action. They thereby underplay the risk of adding an additional layer of policymaking between monetary policy and prudential supervision that might affect our reputation and accountability from both angles, especially when we concentrate on instruments with no clear governance framework in place.

Current discussion on additional macroprudential tools are based on a simplistic belief that recessions can only be addressed with additional credit, with no thought given to the distribution of credit, and on the idea that all crises can be solved with supply-side measures. We need to better understand what determines the financial cycle; and we need to better understand macroprudential transmission mechanisms and the effects of policy instruments. This reinforces the need to fully take into account all possible interactions when considering whether to introduce new macroprudential measures or adjust the calibration of existing ones.

Finally, with the introduction of Basel III, there is general agreement that the capital requirements are adequate. To avoid increasing the burden on banks, some people are proposing creating macroprudential space within the current microprudential stack of capital buffers. One idea is to use the reduction in demand for banks to maintain the highest quality capital for some requirements, resulting from the changes of the latest banking package.

However, there are three crucial points in this debate that must not be overlooked. First, for significant institutions, the microprudential stack of buffers falls under the remit of the ECB. I would question whether it is appropriate to change the distribution of powers between the EU and national levels, particularly in the current weak economic environment, and to once again give national authorities a greater say on capital buffers overall. Second, the interactions between prudential measures need to be thoroughly assessed. In other words, we must ensure to safeguard integrity of microprudential tools and that we do not limit supervisors' ability to tackle risks. Third, any proposal would need to be accompanied by proper governance arrangements within the ECB, respecting the separation principle between monetary policy and banking supervision and ensuring an adequate distribution of powers between the national and EU levels.

As I just said, given that the cycle is maturing, I fear that now is not the time for an operationalised standalone macroprudential approach that implies new capital requirements not foreseen in EU law.

Conclusion

Ladies and gentlemen,

A strong regulatory framework is vital if we want to have safe and sound banks; this is an important lesson from the crisis. Basel III provides such a framework. And it is equally important that the regulatory framework is sufficiently harmonised across borders. This is relevant at the global level, but it is even more relevant in the euro area, as a foundation for the banking union.

This calls for the Basel standards to be implemented faithfully, including in the EU. Fully implementing Basel III will have a positive effect on the economy in the long run. At the same time, we should not breach our promise of no further capital requirements on aggregate. Doing so would undermine our efforts to implement Basel III.

Monetary policy incorporates financial stability, and microprudential supervision follows its own objective. Macroprudential supervision should continue to contribute to deepening the analysis in

line with Article 127(5) of the Treaty. Rushing to operationalise it could be seen as a solution that is desperately looking for a problem.

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[1] The ESCB has a contributory role in the field of financial stability. See Mersch, Y. (2018), "Financial stability and the ECB", speech at the ESCB Legal Conference, Frankfurt, 6 September.