Elizabeth McCaul: Fading crises, shifting priorities - a supervisory perspective on the regulatory cycle

Keynote speech by Ms Elizabeth McCaul, Member of the Supervisory Board of the European Central Bank, at the conference "EU banking regulation at a turning point", Rome, 25 October 2024.

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Introduction

Thank you very much for inviting me to today's conference.

I regret that I am not able to join you in person but I am sure that you are having very productive and insightful discussions.

The title of the conference, "EU banking regulation at a turning point", indicates that the regulatory environment seems to be undergoing a fundamental shift. While the years following the global financial crisis have been devoted to reinforcing the regulatory framework to prevent a recurrence of similar failures, the public debate seems to have shifted away from focusing on safety and stability towards placing greater emphasis on competitiveness.

Shifts in public opinion on regulation are nothing new. There is a natural ebb and flow of regulatory intensity driven by crises, economic conditions and political priorities. After a crisis, there is often strong public support for stricter regulation, which tends to weaken over time as the crisis recedes.

In today's remarks, I want to give you a supervisory perspective on the regulatory cycle and its shifting priorities.

I would like to make three main points.

First, it is a fundamental misconception to frame safety and competitiveness as opposing forces. A stable and secure financial system forms the bedrock of long-term competitiveness.

Second, the post-crisis reform agenda in Europe is not yet complete. Notably, the banking union is still unfinished and the capital markets union requires more ambition. For me, there is a clear link here between these important policy objectives and buttressing the competitiveness of the sector.

Third, we need to tackle emerging risks, such as the growth of the non-bank financial intermediation (NBFI) sector, and the rising geopolitical risk, which manifests itself in a number of ways, including in concerns about cyberattacks. Tackling these risks will contribute towards ensuring the continued resilience of the financial system.

Heeding the lessons from the past

As the great financial crisis fades into the rearview mirror, it seems that competitiveness considerations have taken the wheel. However, just as guardrails on a motorway do not impede drivers but ensure they stay on the road, a robust regulatory framework sets safe boundaries for banks, enabling them to fulfil their role of lending to the real economy.

Let me take this traffic metaphor even further. There are countless studies showing that speed limits not only reduce danger but also minimise congestion, thereby reducing the overall travel time. It's a fallacy to think that higher speed limits mean faster travel, just as laxer regulation does not lead to more sustainable growth. Similarly, regulatory competition between jurisdictions is more likely to lead to a race to the bottom than to a robust regulatory framework.

Research consistently shows that well-capitalised banks are better positioned to support the real economy thanks to their enhanced capacity to absorb losses and maintain stability, even under financial stress. Specifically, impact assessments for the Basel reforms have demonstrated that while there may be short-term economic costs, these are far outweighed by the long-term benefits, most notably increased economic resilience.

As for concerns over competitive advantages or disadvantages, I am not convinced that EU banks are at a disadvantage. In fact, the notion that regulatory requirements are more stringent in the EU than in the United States does not hold up to scrutiny. Evidence shows that global systemically important banks (G-SIBs) in the United States face slightly higher capital requirements than their EU counterparts.

Furthermore, when we account for differences in how banks calculate risk-weighted assets, it becomes clear that average capital requirements for significant institutions in the banking union would be somewhat higher under US rules. This directly challenges some of the industry reports that suggest otherwise.[1]

Completing the banking union and the capital markets union

Let me now move to my second point: the need to complete the banking union and the capital markets union.

In recent years, Europe's banking sector has demonstrated resilience amid unforeseen challenges, including the coronavirus pandemic, the energy supply shock following Russia's invasion of Ukraine and high inflation.

This resilience is reflected in the numbers: in 2015 the average ratio of non-performing loans (NPLs) for significant banks in the banking union was 7.5%, at a time when some banking systems had ratios close to 50%. At the end of the second quarter of this year, this ratio had decreased to 2.3%, driven mainly by the reduction of NPLs in high-NPL banks.

Similarly, the Common Equity Tier 1 ratio for significant banks has risen from 12.7% in 2015 to 15.8% today. Bank profitability has increased considerably in recent quarters, benefiting from higher interest rates, and return on equity now stands at 10.1%.

This resilience is also a result of the strengthened supervisory and regulatory framework after the global financial crisis, including the creation of European banking supervision. The limited repercussions from the March 2023 banking sector turmoil stand as a testament to the robustness of our banking union.

However, while we have made significant strides to build a more resilient banking union, the journey is far from complete. Without a European deposit insurance scheme, there cannot be a truly single banking system. Depositors across the banking union should have a uniform level of confidence that their deposits are safeguarded during crises, irrespective of their Member State or the location of their bank.

We must also enhance the crisis management and deposit insurance (CMDI) framework to effectively manage the failures of small and medium-sized banks. It is crucial that authorities have the flexibility to act and that adequate funding is available for a diverse range of scenarios.

Losses from bank failures should primarily be borne by the bank's shareholders and creditors. Nonetheless, the framework should also allow for the use of industry-funded safety nets when necessary to protect financial stability.

In particular, deposit guarantee schemes should be equipped to support the use of crisis management tools, for example by contributing to meeting the bail-in conditions for gaining access to the Single Resolution Fund. Smaller banks, which often rely heavily on deposits as a funding source, may face challenges in issuing financial instruments that could be bailed in if the bank fails.

This issue can be mitigated by clarifying and broadening the least cost test and introducing a general depositor preference based on an equal ranking of all deposits.

The current review of the CMDI framework is an opportunity to bring durable fixes to the flaws I have just described. We hope the co-legislators will reach an ambitious agreement and not settle for small-scale tweaks that would largely preserve the current – and less than satisfactory – status quo.

Liquidity in resolution is another important aspect of crisis management where progress is needed. A resolved bank should primarily rely on market funding for liquidity, but a public liquidity backstop can be critical to maintain confidence in the resolution process, as demonstrated by recent crises in other jurisdictions.

Unlike other jurisdictions, however, the banking union lacks an effective public sector backstop mechanism to provide this temporary liquidity funding. We therefore encourage all EU stakeholders to resume discussions on setting up a European-level public backstop to ensure liquidity is provided to banks facing resolution in a timely and effective manner.

The incompleteness of the banking union is a significant impediment to creating a truly integrated banking sector in Europe and optimising its competitiveness. Achieving this goal means removing unnecessary barriers to cross-border banking and enabling cross-border groups to manage liquidity and capital at the group level. A fully integrated, cross-border European banking landscape would not only make banks more efficient but also more resilient to domestic shocks, by enabling them to diversify their risks and revenue streams. This would contribute to private risk sharing and enhance the overall economy's robustness and efficiency, benefiting European citizens.

Let me now turn to the second element of what is missing in Europe's financial architecture: the capital markets union.

The capital markets union and the banking union are complementary projects. Progress on the capital markets union provides opportunities for banks and vice versa. And deepening the capital markets union is vital for the European economy to attract the necessary private investments to support innovation and the digital and green transitions, thus bolstering EU competitiveness.

For banks, this means more cross-border activities, which would make them more competitive compared with their international counterparts. In a more integrated pan-European capital market, banks could fully exploit economies of scale by offering similar products and services across multiple countries.

Targeted harmonisations across Member States could facilitate such cross-border lending, enabling banks to better assess risks and opportunities from borrowers in other Member States. Completing the banking union would significantly accelerate the push towards a truly integrated European banking landscape.

Securitisation is another measure to advance the capital markets union where banks play a key role. Given the constraints on banks' balance sheets, capital markets can complement bank lending and increase the financing available to the private sector while transferring risks to other intermediaries. Securitisation is crucial as it provides a diversified funding base for banks, a tool to transfer credit risks and new assets for investors. This can also create space for additional lending to the economy.

Tackling emerging risks – non-bank financial institutions and rising geopolitical risks

While non-banks may help in financing the significant needs of the twin green and digital transition, they also necessitate adequate regulation and close monitoring.

The growth in the NBFI sector is staggering. In the euro area the sector has more than doubled in size, from €15 trillion in 2008 to €32 trillion in 2024. Globally, the numbers are even more worrying, with the sector growing from €87 trillion in 2008 to €200 trillion in 2022.

The private credit market is a particular concern. It accounts for €1.6 trillion of the global market and has also seen significant growth recently. The European private credit market growth is accelerating by 29% in the last three years, but the market is still much smaller than the market in the United States, which is where investors and asset managers are often based. The end investors are pension funds, sovereign wealth funds and insurance firms, but banks play a significant role in leveraging and providing bridge loans at various levels to credit funds. We recently completed a deep dive on the topic and found that banks are not able to fully identify the myriad ways they have exposure to private credit funds. Therefore, concentration risk could be significant.

We know that risk from the NBFI sector can materialise through various channels. One such channel is the correlation of exposures, especially given the growth in private credit and equity markets. We supervisors do not have a full picture of the level of exposure and correlations between NBFI balance sheets and bank lending arrangements, lines of credit or derivatives to and from NBFIs.

To make the market less opaque, we should further harmonise, enhance and expand reporting requirements and make information-sharing between authorities easier at the global level.

The growth in the NBFI market is not the only concern we have about the current risk environment. There is ample evidence in our constant media feeds of rising risks. We need only switch on our news channels to see frightening images of human tragedy, Russia's invasion of Ukraine, the widening conflagration in the Middle East, and even what may be the most significant military exercise yet conducted by Chinese armed forces encircling Taiwan. There are many reasons to be concerned about rising geopolitical risk, such as supply chain disruptions, energy disruptions and inflationary pressures. They all pose threats to resilience. I'd like to highlight one resulting risk – the increased risk of cyberattacks, in particular the increased threat from nation state actors. Our IT risk questionnaire shows a significant uptick year after year. In 2022, 50% of our supervised entities were subject to at least one successful cyber attack, rising to 68% percent in 2023 as the upcoming publication of our annual horizontal analysis will show. On an absolute basis the number of reports has also risen significantly. The number of cyber incident reports that we have received in 2023 was 77% higher than in 2022, and we expect the total number of incident reports in 2024 to be similar to 2023. The IMF also reports that the number of attacks has doubled since the pandemic.

Conclusion

Let me conclude.

While the public debate on banking regulation may have shifted, we need to continue to uphold robust regulatory frameworks that balance safety with competitiveness. Completing the banking union and the capital markets union remains a critical priority and one that can enhance the overall competitiveness of the sector. In addition, we must remain vigilant in addressing the emerging risks posed by the growing NBFI sector and rising geopolitical risks that threaten resilience.

By staying committed to these priorities, we can build a stronger, more integrated European financial system that supports innovation, protects consumers and enhances the overall resilience of our economy for all Europe's citizens. Crises fading in the rearview mirror should not be a harbinger of shifting supervisory and regulatory priorities such that a weaker, less competitive and less resilient sector is the result.

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[1] Enria, A. (2023), "Banking supervision beyond capital", speech at the EUROFI 2023 Financial Forum organised in association with the Spanish Presidency of the Council of the EU, Santiago de Compostela, 14 September.