FINANSSIVALVONTA
FINANSINSPEKTIONEN
FINANCIAL SUPERVISORY AUTHORITY

# Regulatory Reform and Progress Towards Implementing Best Practices: A Nordic and EU Perspective

IIF – SEB Seminar, 11 November 2010, Stockholm

Jukka Vesala, Deputy Director General

# Major lessons from the global financial crisis

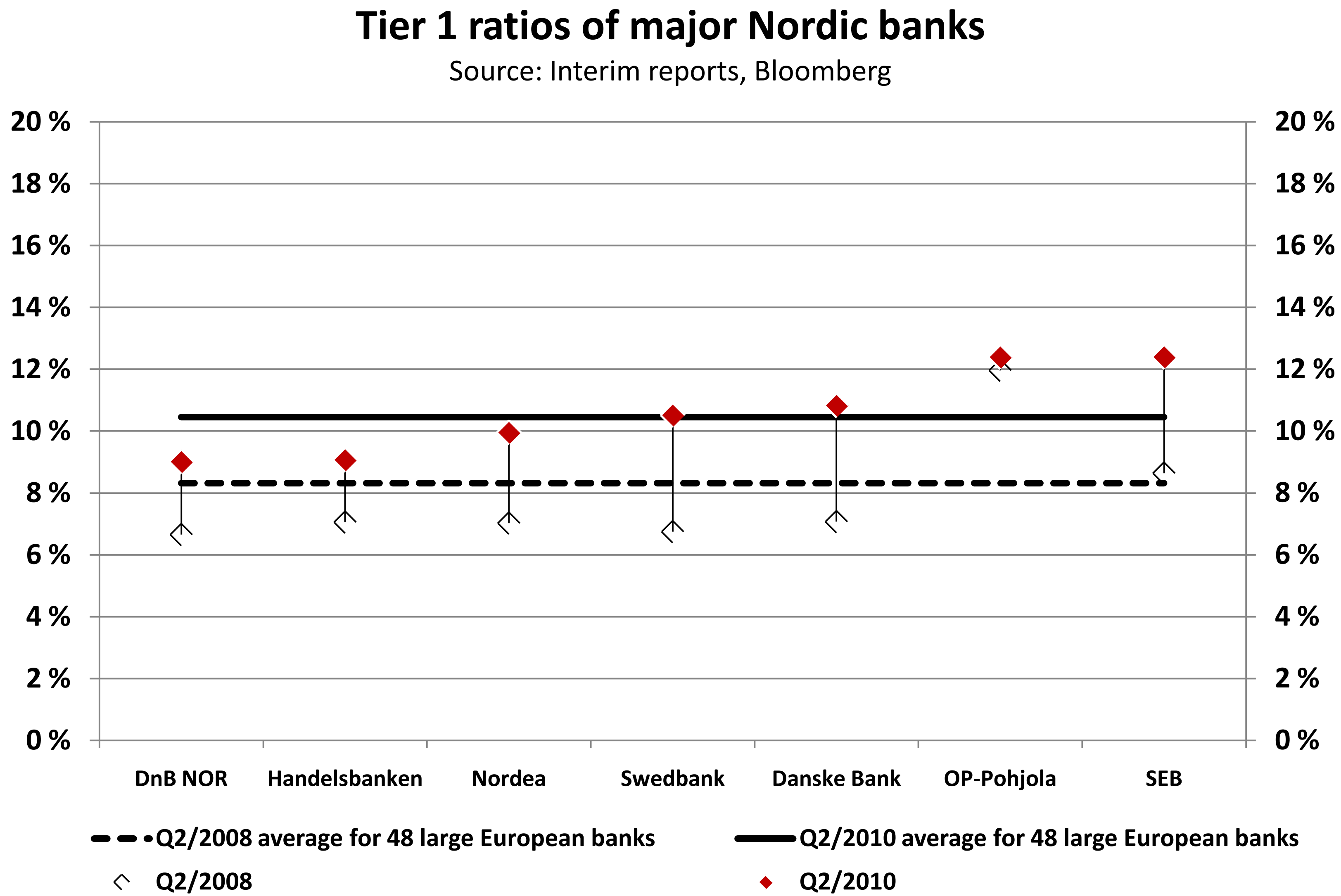
- Bank capital base too weak to absorb losses
- Pro-cyclical capital adequacy and accounting regulation
- Limited attention to liquidity risks
- Too little attention to systemic risks (e.g. interconnectedness)
- Failures in risk management and internal governance

# Strengthening the size and quality of capital buffers in Basel III

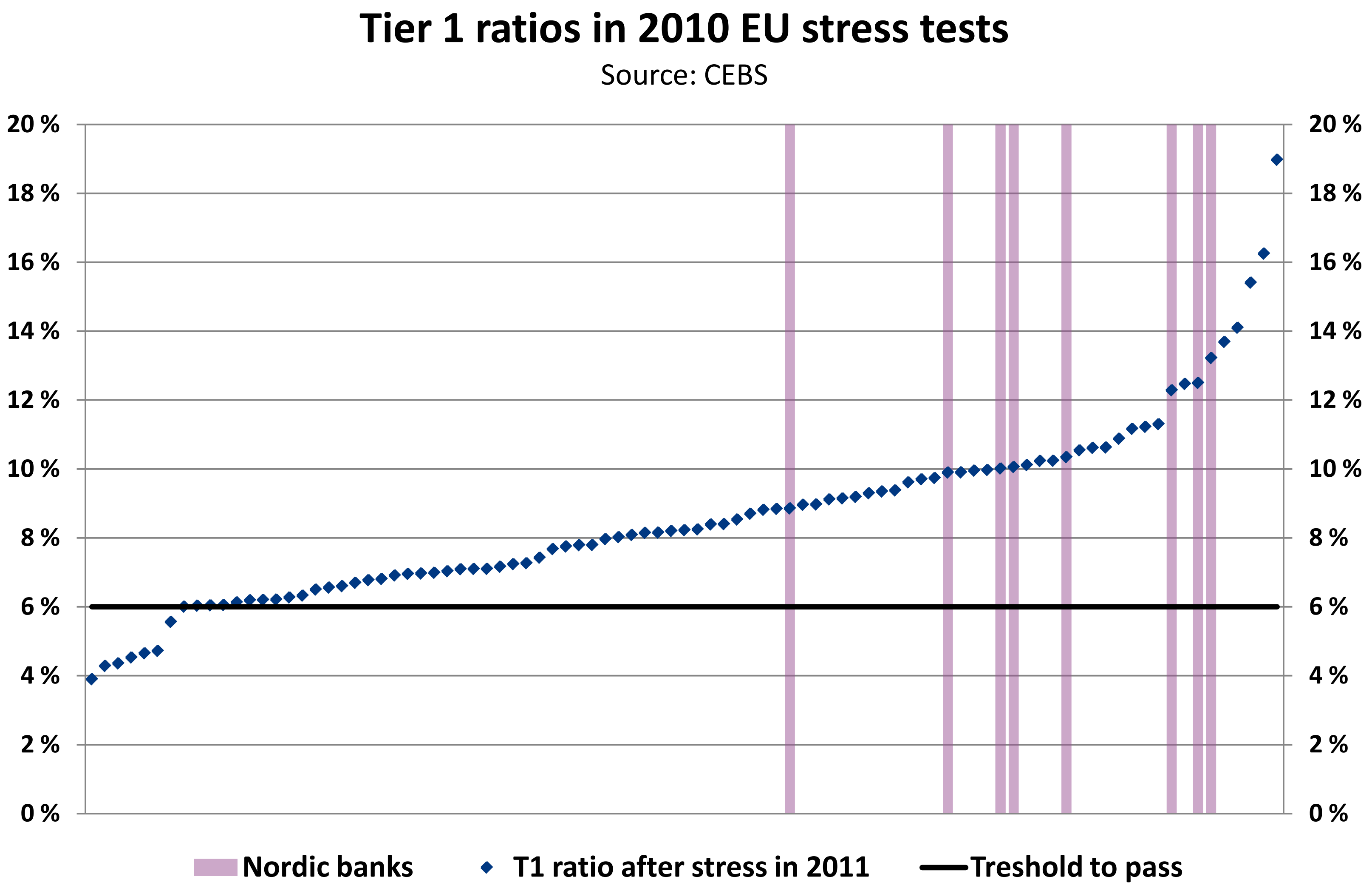
- Higher and stricter Core Tier 1 (Common Equity) requirements:
  - Stronger ability to withstand losses while going concern
- Higher trading book and counterparty risk capital requirements:
  - Limits on regulatory arbitrage
  - Reduced leverage and systemic risks
  - ➢ **Incentives to shift activity in the "shadow banking sector"?**
- New capital buffer requirements above minimum capital levels:
  - Reduced impact of modeling failures in Pillar 1 calculations
  - Limits to pro-cyclicality
  - ➢ **But can buffers be effectively used in bad times?**

➢ **Nordic banks are in a relatively good position to meet the new capital adequacy requirements**

# Major Nordic banks have strong to average Tier 1 ratios in European comparison…



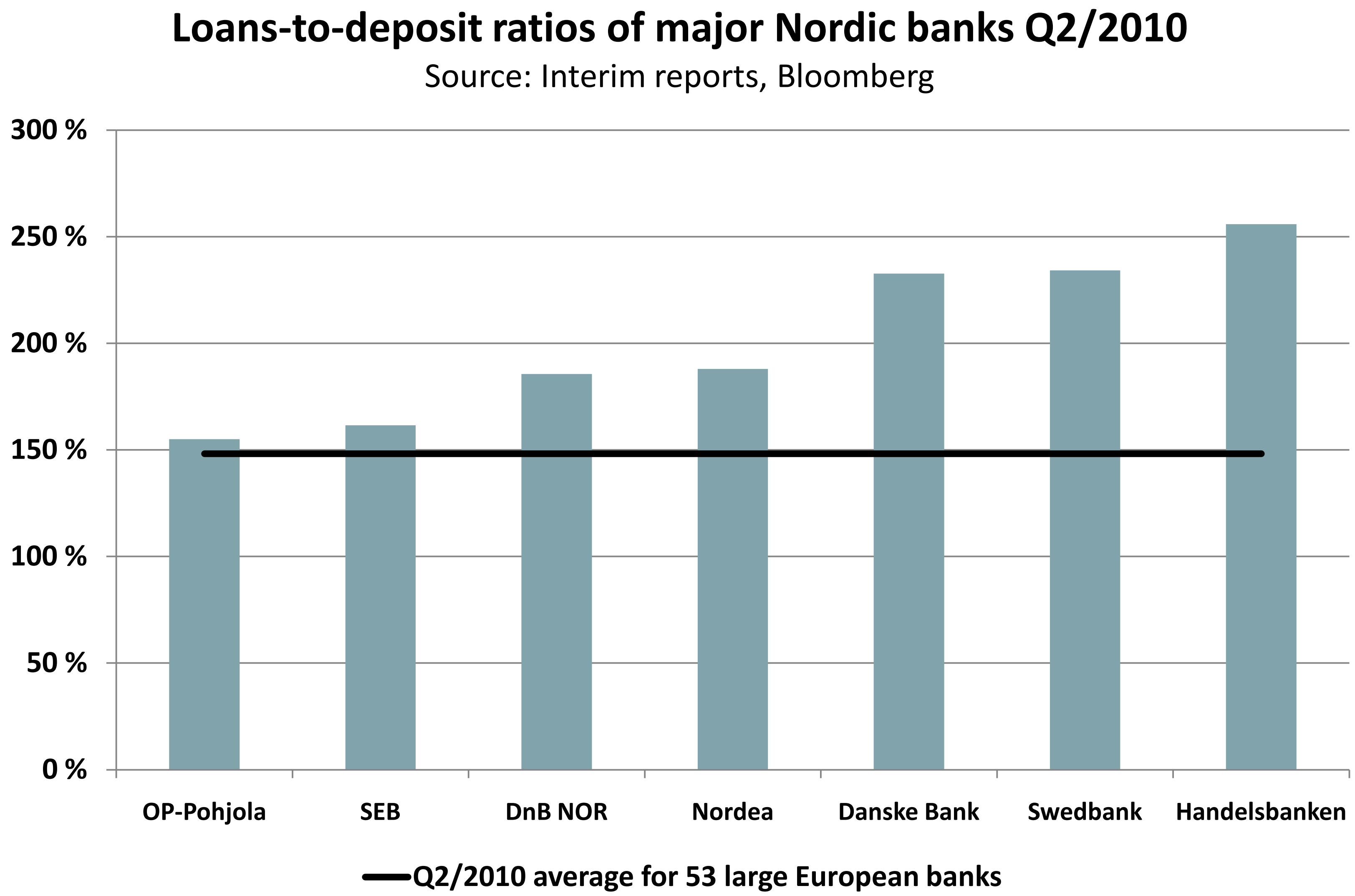
# … and have strong capital buffers according to the EU-wide stress test



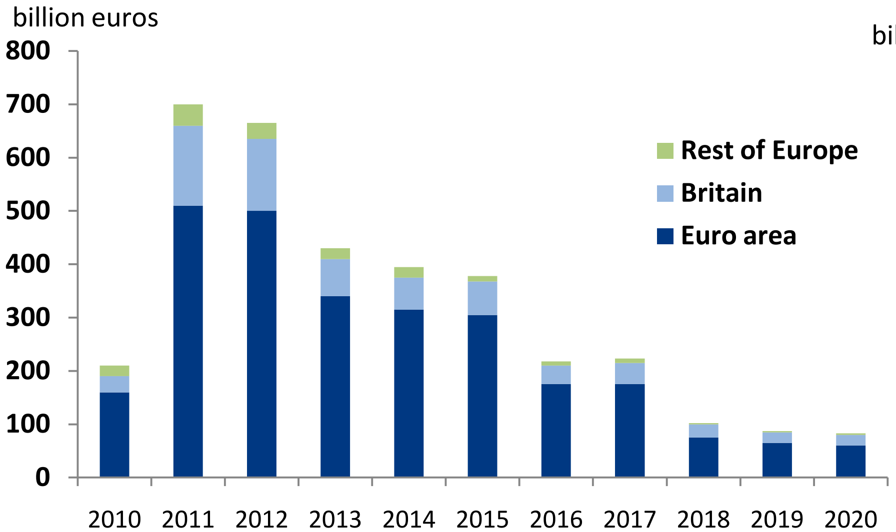
# New quantitative liquidity requirements in Basel III

- Appropriate to ensure adequate liquidity buffers (LCR) and to limit excessive reliance on short-term funding (NSFR)
- However, a significant negative impact on bank profitability
  - ➢ **Nordic banks face slightly higher liquidity shortfalls and clearly higher long-term debt issuance needs relative to other EU banks**
- EU banks have substantial long-term refinancing needs in the coming years:
  - – Regulatory driven long-term funding needs on top of roll-over needs
  - – Basel III and Solvency II: Reduced incentives for banks and insurance companies to hold bank debt
  - ➢ **Banks' funding costs could increase**
  - ➢ **Need to revisit the details of especially NSFR regulation in order to have appropriate calibration (transitional period to 2018)**

# Relatively low share of deposits could explain the larger impact of NSFR on Nordic banks

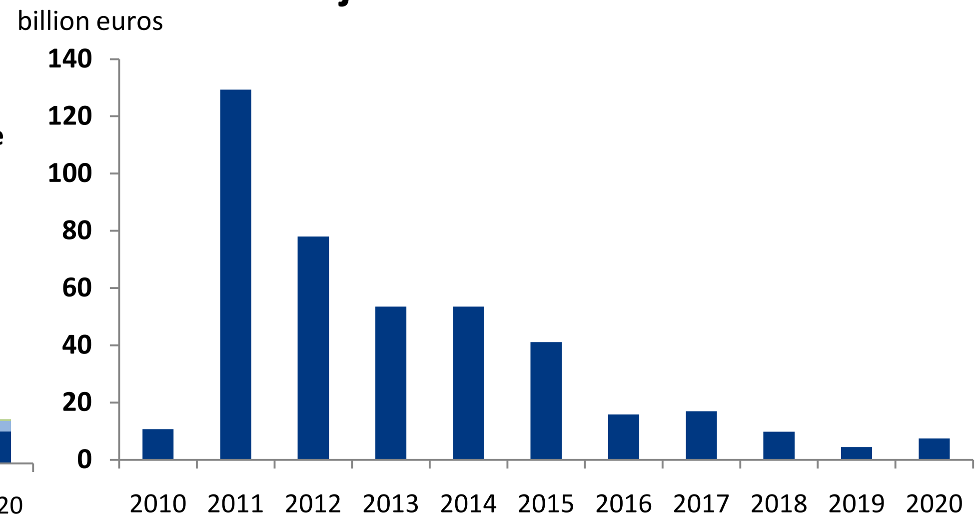


# Large refinancing needs in the European banking sector in 2011 – 2012




Source: ECB

## Major Nordic banks*




Source: Bloomberg

- The maturing long-term debt in 2011-12 in the European banking sector amounts to roughly EUR 1350 billion
- And in the major Nordic banks to roughly EUR 200 billion

***Nordea, Swedbank, Handelsbanken, SEB, Danske Bank, DnB NOR, OP-Pohjola**

# Macroeconomic impact of Basel III

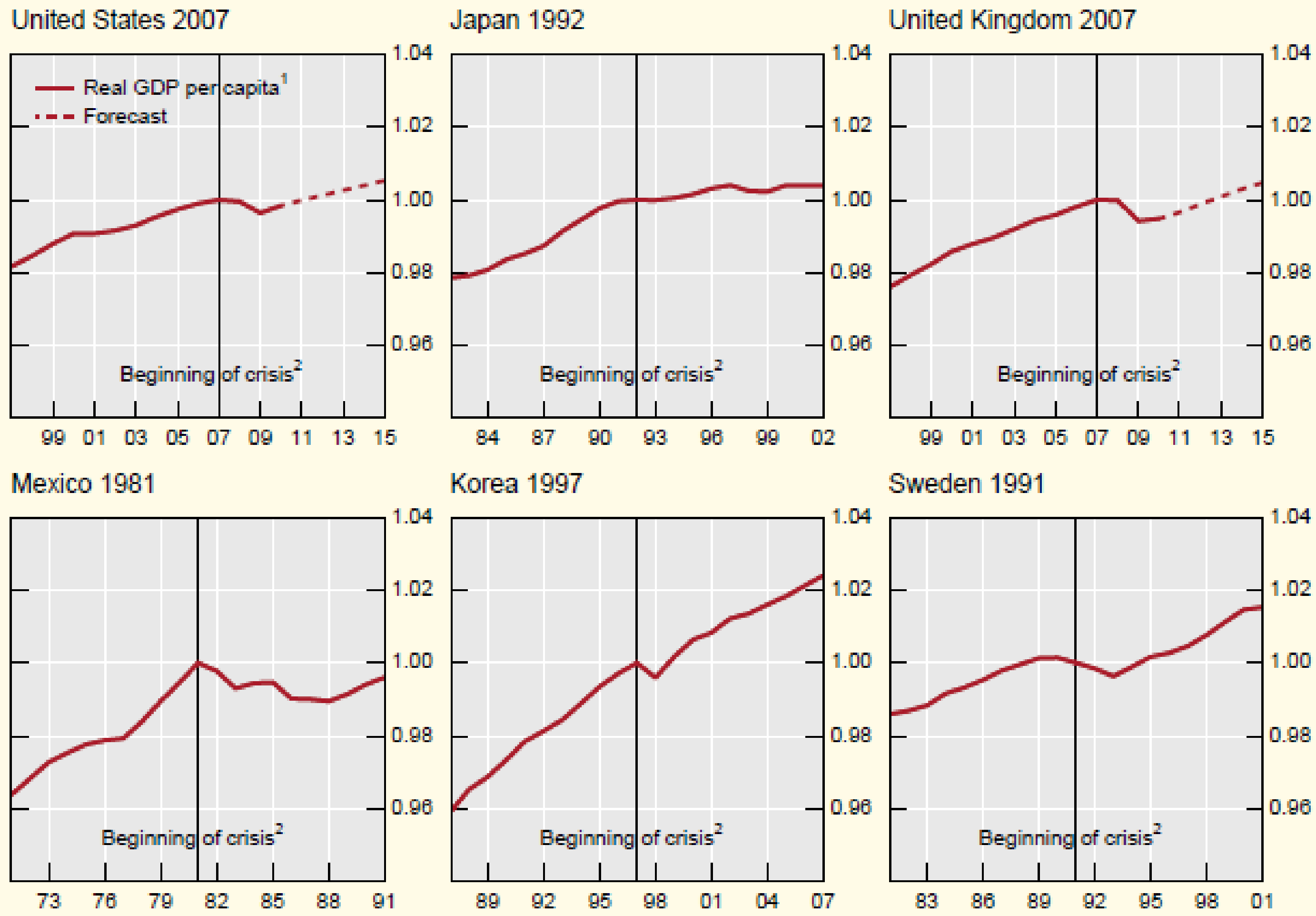
- Macroeconomic costs of the transition to stricter rules uncertain
  - BIS: 1-percentage point tightening in capital requirements lowers output by 0.16% in four years (below trend)
  - Model outcomes vary significantly
- New liquidity requirements could have a significant impact on bank lending
  - **Banks' margins could widen significantly**
  - **Negative impact on especially retail and SME-lending**
- Macroeconomic benefits of the reduced likelihood of financial crises are substantial and undisputed:
  - **Reduced risk of global financial turmoil of key importance also for the Nordic economies**
  - **Impact of the lower risk level on banks' cost of equity capital?**

# Impact of Basel III likely stronger in bank-based financial systems

| | Bank assets / GDP |
|---|---|
| United States | 100 % |
| Euro Area | 334 % |
| Japan | 169 % |
| Nordic Region | 221 % |

Source: OECD, ECB

# Banking crises have a substantial negative effect on macroeconomic performance




[1] GDP per capita is the logarithm of real GDP per capita, normalised to 1 at the beginning of the crisis. [2] The starting years for each crisis are based on Laeven and Valencia (2008) and Reinhart and Rogoff (2008).

Source: IMF (2009).

# Effective risk management is of crucial importance

- Effective group-wide risk management and control
- Contingency planning for stressful market conditions
  - **Critical evaluation of model assumptions / appropriate role of models**
  - **Enhanced role for stress testing (CEBS Guideline)**
- Strong and independent risk control functions
- Remuneration practices in line with effective long-term risk management
- Identification and mitigation of <u>all</u> relevant risks; adequacy of Pillar 2 capital buffers

- **Effective supervision at least as important as adequate regulatory standards**

# CEBS' work to improve cross-border supervision: Supervisory Colleges

- Scope of the CEBS College Guidelines:
  - Colleges to be set up for EEA headquartered cross-border groups; also in case of significant branches
  - Comprehensive guidance: 64 Guidelines + Explanatory Texts + Annexes
- Objectives:
  - Enhanced consolidated and solo supervision of cross-border groups (highly operational colleges)
  - Convergent practices <u>across</u> colleges
- CEBS has set up targets for the establishment and practical operation of colleges (2008→) and conducted a Peer Review (2010)

➢ **Nordic cooperation has been used as a model of well-established and operational supervisory cooperation**

# CEBS’ work to improve cross-border supervision: Joint Assessment and Decision on the Risk-based Capital

Authority A

Authority B

Authority C

Authority D

...

Consolidating supervisor

National SERP results (i.e. assessment of risk and control factors, assessment of ICAAP and assessment of compliance with minimum standards set in the CRD) based on national approaches and methodologies with reference to CEBS existing guidance (GL03)

**Translation**

Common templates and common scoring tables to summarise individual entities’ SRP results:

-Common templates and common scale to summarise individual assessments of risk and control factors

-Common templates and common scale to summarise individual assessments of ICAAP

-Common templates and common scale to summarise individual assessments of compliance with minimum standards set in Directive

Authority A

Authority B

Authority C

Authority D

.....

**Consolidating supervisor**

Consolidating supervisor to produce the risk assessment report of the group taking into account the input provided by host supervisors. Individual templates to be annexed to the report.

College discussion - facilitated by the use of convergence tools - in order to reach a joint understanding of the SREP of the group and its entities as a basis for the joint decision.

Discussion led by the consolidating supervisor, focused on the SREP of the group, of the significant or relevant entities, on the significant risks born at the group and solo level, as well as on risk management issues in a cross-border context

**Outcome of the process**

- Joint assessment of elements covered by the SRP
- Joint decision on the risk-based capital adequacy
- If appropriate, joint decision on the application on the application of Article 136.2
- Where agreed on a voluntary basis, decision on the application of other prudential measures under 136.1
- Communication of the fully reasoned joint decision

Joint decision to be reached within 4 months* after the distribution by the consolidated supervisor of the risk assessment report of the group.

* 6 months until 31 December 2012

# Other regulatory measures currently under consideration

- Stricter regulatory requirements for SIFIs:
  - Difficult to measure systemic risk contribution
  - A public SIFI-list would worsen moral hazard
  - ➢ **Instead, focus on effective crisis resolution and other means to limit systemic risks (e.g. central counterparty clearing of OTC derivatives)**
- “Bail-in requirements” to have creditors participating in losses while going concern:
  - Debt instruments in regulatory capital should be loss-absorbing
  - Conversion into Core Equity rather than a Haircut
  - <u>Conversion Trigger</u>: When private Core Equity no more available to avoid falling under regulatory limits
  - ➢ **Availability of investors? Possibilities for investor education?**

# Thank you!

jukka.vesala@fiva.fi