STATEMENT FROM DIRECTOR MARIO NAVA

Oireachtas Committee of Inquiry into the Banking Crisis

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I am very pleased and honoured to have been invited to assist this Committee in its Inquiry into the banking crisis. I have been asked to provide the European Commission's perspective on the fitness of the European Union (EU) regulatory framework for banks and the supervisory policies, systems and practices in the run-up to the financial crisis, the lessons learned and improvements made in the last few years.

The regulatory framework for banks in the EU has evolved considerably over the last 15 years. A number of factors have driven this evolution: the needs of the EU's single market, international developments, rapid changes in the banking sector and shortcomings in banks' risk management and the regulatory and supervisory frameworks.

The EU's regulatory framework takes account of the global standards for prudential regulation and supervision set by the Basel Committee on Banking Supervision. These standards have been updated several times since 1988, most recently in 2010, when the Basel III standards were adopted. Each of these updates has been implemented in EU law.

In the 2000s, the EU regulatory framework followed a principles-based approach that was embodied in the principle of minimum harmonisation. Directives were used as the main legislative instrument, setting minimum requirements for prudential supervision. Member States were required to transpose those Directives into their respective national legislation. The use of the Directive as the main legislative instrument and the minimum harmonisation principle gave Member States a degree of flexibility in setting the regulatory framework for banks as long as they did not “go below” the minimum standards required by the EU law. However, in line with the principle-based approach to regulation, Member States typically did not resort to implementing overly prescriptive rules, which would provide specific and detailed guidance to supervisors for exercising their duties. During the same period, national supervisory authorities were responsible for applying and enforcing the prudential requirements set out in the Directives, which empowered each national supervisory authority to take the steps it considered necessary to implement prudential measures to safeguard the resilience of the banks it supervised and the financial stability of the banking sector as a whole. National supervisors had a considerable degree of discretion to apply stricter requirements than the minimum standards set out by the Directives.

In other words, nothing in the Directives prevented Member States and their national supervisors from taking appropriate measures to reduce further the risk of a bank failing or risks to the stability of the financial system as a whole.

The crisis has taught us a lot about the failure of some European banks to manage their risks prudently and of some national regulators and supervisors to exercise their powers with sufficient rigour. Many studies and reports have been produced to analyse the consequences of the principles-based approaches pursued by national regulators and how national supervisors exercised their oversight and enforcement duties in the pre-crisis period.

Reliance on soft and light-touch approaches and low supervisory intensity encouraged by the principles-based approach to regulation, inadequate resources and insufficient attention to banks' corporate governance systems represent the most prominent causes of the various supervisory failures observed in several Member States. Too often, national supervisors took a narrow focus on credit risk and underestimated the importance of concentration, liquidity and funding risks. Too little attention was given to macro-prudential considerations and effective early warning mechanisms, which could have helped national authorities to detect emerging risks early and prevent bubbles from growing.

The EU Capital Requirements Directive (CRD) adopted by the European Parliament and the Council in 2006 required national supervisors to conduct a thorough assessment of the risk management systems and governance of the banks they supervised and to take measures corresponding to the specific risk profile of the bank in question. The Directive also stipulated explicit requirements for management of liquidity and concentration risk as well as risks arising from exposures to real estate markets. If national supervisors had used these powers to the full extent, a number of major difficulties could have been prevented.

Robust risk management and governance structures in banks and effective oversight and control systems represented the two indispensable conditions for the success of principles-based regulation. In the absence of these two preconditions, the regulatory effects intended by the Directive could not be delivered.

These deficiencies also revealed important shortcomings in the governance of the institutional framework for supervision itself and have sparked a period of unprecedented reforms in the EU, backed by an international consensus on the causes of the financial crisis and responses needed to address it. The reforms had two distinctive dimensions: regulatory and institutional.

On the *regulatory* side, there has been, in line with international developments, a pronounced shift to a more *rules-based* approach. Introducing more detailed guidance in the regulatory frameworks for the supervisors to ensure that they step up their supervisory scrutiny was considered essential. As a result, the new regulatory requirements have been

made more prescriptive, the coverage of risks has been expanded and the prudential treatment of those risks has been strengthened.

This reform was carried out in two phases. The first phase (CRD 2 and CRD 3 adopted in 2009 and 2010 respectively) introduced quick fixes for some of the most pressing deficiencies highlighted by the crisis, namely liquidity management, large exposures, remuneration, management of securitisation, trading exposures and supervisory cooperation. For example, banks were required to develop robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of liquidity risk and funding positions. In the inter-bank market, banks were not allowed to lend or place money with other banks beyond a certain amount in order to limit the risk of contagion, which also increased the diversity of borrowing banks' funding sources. National supervisors were required to review banks' remuneration policies and empowered to impose sanctions if these policies did not meet the new requirements.

The second phase (CRD 4 adopted in 2013) represented a more fundamental revision of the regulatory framework, responding in particular to the review of international prudential standards in the Basel III framework. This included new rules increasing the quality and quantity of banks' regulatory capital; more detailed and harmonised rules dealing with liquidity and funding risk and excessive leverage; and measures improving banks' corporate governance, including rules realigning incentives. Supervisors have obtained enhanced sanctioning powers and are required to carry out their duties in a more intrusive, intense and forward-looking manner. Particular attention was given to measures improving supervisors' capacity to take appropriate remedial action at an early stage, by putting more emphasis on macro-prudential considerations.

This latest revision also aims to establish a single rule book to respond to the need for a more harmonised set of rules across the single market, in order to provide a true level playing field on which EU banks can compete. The degree of flexibility previously granted to Member States and national supervisors, as mentioned above, had led to divergent transposition of EU rules in national law. This created opportunities for regulatory arbitrage and hampered legal clarity. In order to achieve greater convergence, various options and discretions have been removed and most provisions have been moved into a Regulation (CRR) and have thus become directly applicable.

In parallel with the new prudential measures to reduce the probability of a bank failure, measures were also needed to minimise the impact of possible failures and to equip resolution authorities with effective tools to deal with those situations. The new harmonised bank resolution regime, embodied in the Bank Recovery and Resolution Directive (BRRD) adopted by the European Parliament and the Council in 2014, was introduced in recognition of the fact that the normal insolvency regimes were not well-suited to deal with bank failures. It was also a response to the need to protect certain critical stakeholders (e.g. deposit holders) and functions of a failing bank and to reduce moral hazard in banks. The

BRRD includes a requirement for banks and resolution authorities to draw up recovery and resolution plans; gives bank supervisors an expanded set of powers to enable them to intervene in cases where an institution faces financial distress; provides the resolution authorities with a credible set of resolution tools (including bail-in); and improves cooperation between the respective resolution authorities.

One more initiative needs to be mentioned in this context, namely the Commission's proposal on banking structural reform dealing with systemic risk of "too-big-to-fail" banks heavily engaged in trading activities. The proposal, still under negotiation, would provide for a ban on proprietary trading and empower supervisors to separate banks' risky trading activities from their retail operations.

On the *institutional* side, the crisis demonstrated the need to adapt the institutional framework for financial regulation and supervision to a fast-moving and interconnected banking industry.

First, the institutional reforms revolved primarily around the creation of the European Banking Authority. Its creation was necessary to promote convergence of supervisory practices in the EU and to improve communication and mutual trust among supervisors. In addition, the European Systemic Risk Board was created to respond to the failure of the national competent supervisory authorities to anticipate adverse macro-prudential developments and to prevent the accumulation of excessive risks within the financial system.

Institutional reforms went a step further at the euro area level and led to the creation of a Banking Union. The crisis clearly showed that, in addition to a common set of reinforced rules for all banks, a single and independent supervisor to enforce those rules was also essential.

Thus the Single Supervision Mechanism was created with a view to breaking the link between banks and sovereigns and ensuring the highest standards of quality and impartiality of supervision. While the European Central Bank (ECB) took over the supervisory responsibility for 120 of the largest banking groups in the euro area in November 2014, day-to-day supervision of smaller banks remain, for reasons of efficiency, the task of the national supervisors under the general guidance of the ECB.

The second equally essential element of the Banking Union is the Single Resolution Mechanism. The Single Resolution Board, the new single resolution body, will ensure that banks participating in the banking union are resolved if necessary in an efficient and centralised way with minimum impact on taxpayers. The costs of any such resolution procedure will be paid for by the private sector and backed by a Single Resolution Fund financed by bank contributions.

Taken together, the above-mentioned reforms represent a significant strengthening of the regulatory and institutional framework underpinning the EU banking sector. It would be presumptuous to claim that these reforms have consigned financial, and in particular banking, crises to history. However, it is undeniable that, if properly enforced, they equip supervisors and the resolution authorities with a more robust set of tools, making future crises less likely and, if nevertheless they were to happen, less costly.

Greater resilience of European banks and robustness of the new regulatory, supervisory and resolution frameworks will foster confidence in European banks, which will in turn encourage sustainable lending to the wider economy and promote growth and jobs.