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1 Transparency in Banking[1]

According to economic theory, perfect knowledge and transparency are preconditions for competitive markets. For this reason, all large corporates are subject to some kind of disclosure requirements. The purpose is to make those enterprises accountable towards different stakeholders but also to allow investors to price risk and assess what assets are worth. The rationale for more stringent disclosure requirements for banks is that the business they carry out is more opaque and, thus, the actual quality of assets is hard to assess for outsiders. Indeed, banks' assets are largely illiquid so that financial markets cannot provide a price that can be used as a reference[2].

The financial crisis is a clear example of the consequences of banks' opacity on financial stability. When the crisis broke out in 2007, subprime losses started materialising and a series of reports began conjecturing possible consequences for banks. However, there was no certainty on the scale of the problem, the accuracy of loss estimates, the intermediaries involved. Anecdotal evidence suggests that market participants, missing any clear information, feared that the banks were downplaying their losses and exposure[3]. The panic which followed the default of Lehman Brothers was also due to the limited information available on banks' exposures, the uncertainty on capital levels, and the mistrust on the loss absorbency capacity of capital instruments issued by banks. The sudden illiquidity of the financial markets that followed had, in turn, an adverse effect on the level of transparency that asset pricing provides.

The second wave of the crisis, started in 2009 and centred on the euro area, was largely the result of the institutional foundation of the single currency. With the introduction of the euro, banks were encouraged to look at the currency area, and at the Single Market, as their domestic market. At the same time, as the crisis hit, no EU-wide safety net was made available and bail-outs were conducted under the responsibility of national governments. Moreover, the composition of the banks' sovereign portfolio had remained

[1] *Based on the OMFIF City Lecture «Ensuring Transparency in the European Financial System», London, 4th May 2016.*

[2] For a survey see Boutant R., Crnogorac D. and Resti A. (2015). 'Transparency and Market Discipline', in M. Quagliariello (2015), *Europe's New Supervisory Toolkit*, London: RiskBooks.

[3] Laux C. and Leuz C. (2010) 'Did Fair-Value Accounting Contribute to the Financial Crisis?', *Journal of Economic Perspectives*, 24 (1).

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significantly biased towards bonds issued by their home country's governments. As a result, banks started to be assessed by market participants on the basis of the credit standing of the sovereign providing them with the safety net and of the amount and quality of their sovereign exposures. However, at that time, there was virtually no public information available on banks' sovereign exposures. Funding pressure started to mount as the result of actual problems as well as investors' concerns due to poor disclosure, leading to the freezing of the area-wide money market.

The response of the central banks and the supervisory community, both at the global level and in Europe, has been decisive for addressing the roots of the crisis. The mix of unconventional monetary policy measures, stricter and more harmonised rules on banks' operations and capital levels, as well as increased disclosure on bank's exposures contributed to overcome the deepest stages of the sovereign crisis. In particular, the capital strengthening of European banks, which started in 2011, has reassured market participants and allowed banks to move a long way in the right direction. Areas of uncertainty on asset quality, valuations of EU banks' balance sheets as well as on the reliability of the outcome of internal models for determining own fund requirements called for further *ad hoc* actions and extensive EU-wide asset quality reviews.

2 The EBA's Efforts in Restoring Confidence in the EU Banking Sector

Since its establishment, the EBA has consistently pushed for additional disclosure and transparency in the EU banking sector. Despite lacking an explicit mandate, we considered the dissemination of banks' data as an integral part of our responsibility of monitoring risks and vulnerabilities and preserving financial stability in the Single Market. Indeed, we have been conducting transparency exercises at an EU-wide level on an annual basis since 2011.

Transparency brings along several tangible benefits in terms of restoring confidence, stabilising market developments and allowing investors to allocate resources efficiently. It also provides a positive signal to investors and calms down panic particularly when markets are turbulent: more problematic banks will be disciplined by investors and other stakeholders, while stronger institutions will be rewarded through better access to financial markets or lower cost of funding[4]. This is necessary to avoid that key banking functions are impaired: if investors are unable to assess the distribution of exposures and risks across institutions, the whole funding market may well go into shutdown, as it happened during the crisis, thus disrupting the provision of key services also by banks less affected by the market turmoil.

Back to 2011, the first EU-wide stress test carried out by the EBA was crucial in providing the market with the ability to discriminate among different levels of risk for financial institutions, providing detailed information on capital composition, geographical breakdown of exposures as well as sovereign holdings. We filled an informational gap and provided comparable data on banks' solvency ratios, front-loading – with some

[4] Petrella G. and Resti A. (2016) 'The Interplay between Banks and Markets: Supervisory Stress Test Results and Investor Reactions', mimeo.

simplifications – the global definition of Common Equity Tier 1 then under discussion at the Basel Committee.

Progress between 2011 and 2016 is noticeable: we moved from a major shortage of publicly available data on EU banks in 2011 to a regular and consistent disclosure of comparable figures afterwards. The EBA has established a tradition of disseminating detailed bank-by-bank data designed to improve the understanding of the EU banking sector and foster market discipline in the Single Market.

In parallel, we have also worked on building our own capacity to collect, quality assure, explore and disseminate granular bank data. In this context, the 2015 EU-wide transparency exercise represented a milestone since it mostly relied on the information reported to the EBA on a regular basis through the supervisory reporting framework. For the first time, data templates were filled directly by the EBA and only sent for verification to banks. This approach reduced the burden on banks and showed our commitment to significantly trim down *ad hoc* data collection now that common supervisory reporting standards are available.

3 Comparability as a Prerequisite for Effective Disclosures

Disclosure of financial information is certainly important, but it does not come without challenges. Disclosure works properly only if the underlying data is consistent, of high quality, and reliable. Only *disclosure* of well-understood and comparable data really delivers *transparency*.

In 2014, the EBA finalised and rolled out a single set of supervisory reporting standards in the form of Common Reporting Requirements (COREP) and Financial Reporting Requirements (FINREP). The EU reporting standards provide fully harmonised information on banks' own funds and balance sheet data. In practice, all banks are subject to the same standards for supervisory reporting, to ensure adequate information and coverage for both micro- and macro-prudential purposes.

The development of EU-wide reporting went hand in hand with the identification of common definitions, with the objective of bringing together supervisory, accounting and prudential aspects. This is the case, for instance, for our standards on the definitions of non-performing exposure and asset encumbrance. Indeed, before the crisis, supervisory reporting based on national requirements resulted in large sunk costs for cross-border banks, challenges in comparing bank data across the border and poor data sharing among supervisors.

This was true in general, but particularly for the assessment of credit risk, where the identification of non-performing and forborne loans followed very country-specific and hardly comparable definitions. Our technical standards on non-performing exposures (NPE) and debt forbearance, finalised in 2014, ensured uniformity across the Single Market, at least for supervisory reporting. They have been a precondition for carrying out the asset quality review on a consistent basis in 2014, thus also supporting a smooth start of the Banking Union. In 2015, as part of the EU-wide transparency exercise, we have published bank-by-bank data on NPE and forbearance providing, for the first time, fully comparable information on asset quality for a large sample of major EU banks.

The awareness that comparability is essential also for banks' own disclosures gave impulse to greater standardisation of the information released to markets. Disclosure requirements were introduced by the Basel Committee as a tool for market discipline back in 2004 – the so-called Pillar 3, complementing minimum requirements (Pillar 1) and the supervisory review process (Pillar 2). More recently, the Pillar 3 framework has been enhanced following the crisis storyline, with a view to both improving the information available to investors and mirroring the regulatory changes in Pillar 1 requirements. In order to improve comparability, disclosure requirements were accompanied by specific templates and definitions.

The introduction of standardised formats has increased the consistency of the information disclosed. On the other hand, lack of consistency and poor comparability remain a challenge where standardised formats do not exist. There is, therefore, a long way to go for both banks and regulators. A further harmonisation of Pillar 3 requirements is one of our priorities for the next years. With our transparency exercises we have already established a hub where data on EU banks can be easily accessed, explored and downloaded through scalable and user-friendly interfaces. Organising and coordinating this kind of exercises remains a rather complex process, but transparency should ideally become more frequent and wider in scope. Our ultimate goal is to have Pillar 3 requirements as aligned as possible with supervisory reporting definitions and templates so as to achieve greater integration of different data sources and reduce the burden for banks and data-users.

4 Transparency of Authorities' Action

There are two pieces of the new regulatory framework that, in my view, introduce a new dimension in the discussion on transparency in banking. First, one of the main implications of the crisis on banking regulation is that the cost of bank failures should be borne first and foremost by its shareholders and creditors. Support with taxpayers' money should be used only as a last resort, when there is a proven concern for systemic stability. Second, the new macroprudential framework has introduced the principle of «capital conservation» which requires banks to restrict payouts – in terms of dividends, coupons and bonuses – to a «maximum distributable amount» (MDA) if they are unable to meet the cumulative macroprudential buffers (the «combined buffer») above Pillar 1 and Pillar 2 requirements.

The shift from bail-out to bail-in and the MDA concept have important implications for market dynamics, since the decisions of the supervisory authorities directly affect the payoff of several banks' stakeholders. The question is, therefore, whether supervisory decisions on, for instance, Pillar 2 requirements and actions possibly triggering the suspension of payments to stakeholders should be transparent.

Unquestionably, increased transparency reduces the magnitude and frequency of bank problems, as it allows market participants to impose market discipline at an early stage and more effectively. However, the traditional view on the disclosure of supervisory decisions is that it may generate instability and possibly lead to a bank run. The disclosure of sensitive information concerning supervisory assessments – such as, for instance, additional capital requirements under Pillar 2 – may indeed trigger self-fulfilling processes. Indeed, most jurisdictions have traditionally disclosed little, if any, of their supervisory assessment of banks.

But under the new regulatory setting, what happens if relevant information is not disclosed and investors bear losses due to measures they were not aware of when taking decisions? And how can certain instruments be priced if key information such as conversion triggers is not known to investors?

I believe that an open debate on pros and cons of unveiling supervisory decisions is necessary and cannot be delayed. Indeed, uncertainty on how supervisors operate and make decisions may affect market valuations on banks. We have witnessed this in early 2016, when the European markets for additional tier 1 (AT1) instruments have been significantly disrupted, with primary issuance volumes falling and secondary market yields and spreads rising sharply. For this reason, the EBA recommended supervisors to disclose their decisions to request additional capital under the supervisory review and evaluation assessment (SREP). The push for increased transparency reflects our belief that market participants should be aware of Pillar 2 requirements since these affect the risk/return profile of their investments.

My call for transparency is particularly topical for the marketing of subordinated or long term debt to retail investors. The mis-selling of risky instruments to retail clients, unaware of the underlying risks, has created challenges in resolution both during the crisis and more recently. Some have suggested a complete ban for the distribution of instruments subject to write-down or conversion into equity to retail customers. I think that as retail investors may buy shares, they should be allowed also to buy subordinated debt instruments. However, it is essential that they are fully aware of the risks that they assume.

5 Conclusions

The financial crisis has significantly affected my thinking about transparency. If market participants are unable to compare and contrast the situation of banks vis-à-vis a specific risk, they are naturally inclined to think the worst of each and every bank. The whole market grinds to a halt. If authorities act in an unpredictable way, for instance by taking different courses of action in apparently similar cases or by concealing the information that is at the basis of their decisions, volatility is likely to increase and any shock can easily destabilise the system.

This is why the EBA has consistently focused its efforts in increasing the quantity and quality of bank disclosures, enhancing the comparability and accessibility of bank data, and recommending greater disclosure of authorities' assessments.

The transparency of bank data is particularly important in the EU, where the lack of comparability of key bank information across countries has been a major hindrance to the functioning of the Single Market, and even to supervisory cooperation.

I am confident that we will soon move to a new setting, in which any interested party can easily access all relevant bank information, drawn from supervisory reporting (*i.e.*, without any additional burden for banks), on a regular basis – ideally quarterly –, and in a single place – the EBA website. This is what is already happening in the United States, and we should aim at achieving at least the same results in the Single Market. Ideally we should exploit all the possible synergies between Pillar 3 disclosures and supervisory reporting, thus achieving an integrated set of information, easily available and consistent across banks.

I am also convinced that, in the new regulatory setting, supervisors have to become more and more transparent about their own decisions, especially when these may affect the payments to investors or even the value and nature of the financial instruments they hold. If the buck is going to stop with shareholders and creditors of a bank, it will be the duty of authorities to put them in a position to exercise their role in an effective way, correctly pricing capital and debt instruments and imposing an adequate level of discipline on bank management.