Ladies and gentlemen,

Good afternoon and thank you for inviting me to deliver a keynote speech at this conference on "The Future of Bank Capital Reform in Europe".

At the time you sent out your kind invitation, you probably hoped that I might be able to tell you something about the agreement that the Basel Committee had wanted to reach in January on what they call the "finalisation of Basel III". I had hoped so, too.

But as you know, no agreement has been reached so far. Instead, the crucial meeting of the Basel Committee's oversight body (the GHOS, Group of Central Bank Governors and Heads of Supervision), which was planned for the 8th of January and which I was looking forward to attend was postponed until further notice.

So how did we get to this point? The Basel Committee initiated the current discussions in order to improve the balance between three objectives: risk sensitivity, simplicity and comparability of capital ratios.
However, there was consensus that Basel III had already strengthened the quantity and quality of capital sufficiently. And that further reform must therefore not lead to a significant increase in capital requirements.

At the heart of these discussions is the role of internal models. No doubt internal models can result in unjustified variability of risk weights. Unjustified variability results from differing practices by banks or supervisors. It has to be distinguished from variability that is justified by differences in the underlying risks. In fact, analyses showed that roughly 3/4 of all variability was justified, but the remainder was not, hindering comparability of capital ratios and also impacting the level playing field among banks.

Against this background, I think most people can agree that simpler and more comparable capital requirements are very laudable objectives – in particular if they do not significantly increase capital requirements. The Commission has certainly always supported these objectives.

So much for the theory.

In practice, what the Basel Committee proposed was to put in place constraints on internal modelling, which limit unjustified variability, but also risk sensitivity.
This trade-off is to some extent unavoidable. Unfortunately, banks and supervisors must have different views about this trade-off.

For instance, banks with a lot of low-risk mortgages on their books – as is often the case in Europe – will find risk sensitivity very important. At the same time, other banks – for example because they remove low-risk mortgages from their balance sheets – may put less emphasis on risk-sensitive rules.

The key factor in the trade-off is the so-called output floor proposed by the Basel Committee. It backstops risk weights under internal approaches at a certain percentage of the risk weights calculated under the standardised approaches. It was this output floor that became the main point of contention during the negotiations.

As the Commission has repeatedly said, we do not believe that such a floor is an essential part of the framework. We do not share the view that such a floor is needed as a backstop – after all, we already have the leverage ratio for that, but I will come back to that later. Moreover, an output floor that is too high will limit risk sensitivity too much. In the extreme, too high a floor could make a low risk and a high risk portfolio look just the same. This way, it makes capital ratios less comparable, not more comparable.
Let me also emphasise that in Europe we have already taken decisive steps to address the issue of unjustified variations in capital requirements: we have created a single rule book with technical standards to harmonise risk measurement. In the Banking Union, the Single Supervisory Mechanism will approve regulatory capital models in a coherent way. The EBA is taking benchmarking exercises forward. Finally, more work is being done by the EBA to achieve bottom-up model repair, and I suspect Andrea [Enria] may tell you more about this later this morning.

And we have also taken very significant measures over the past years to make banks safer: They now have much more and better quality capital and better liquidity. We are now at a point where we find that the current capital requirements overall are at a sufficient level. The Commission therefore believes that the increase in requirements potentially caused by a high output floor would be unwarranted, with potentially a negative impact on bank lending to the European economy.

But let me be clear: Despite our concerns regarding the output floor, the Commission does want to reach an agreement, as long as it is properly designed and calibrated.

I also do not believe that the failure to reach an agreement in January results from a categorical lack of willingness of the European Committee members to agree to such a
measure. By contrast, my impression is rather that certain other members may have to give more thinking about what level of floor could be reconciled with the objectives of safeguarding risk sensitivity and avoiding a significant increase in capital requirements.

The question has been asked what impact the American elections may have in this context. In response, I think it suffices to say that an international agreement is only good if all major jurisdictions are able to adhere to it. And if that means that more time is needed for the US administration to explain what their priorities are going forward, then we may have to wait.

Now let me turn to the Banking Reform Package that the Commission tabled last November, as you hopefully noticed.

We proposed to introduce into EU legislation a number of important standards that had been agreed internationally by the Financial Stability Board and by the Basel Committee.

These include a binding leverage ratio of 3%, which is meant as a backstop to banks' risk-based capital requirements.

We proposed to introduce a Net Stable Funding Ratio, which would ensure that banks finance their long-term
exposures with stable sources of funding, and therefore can weather periods of market stress better.

We proposed more risk-sensitive and arbitrage-safe capital requirements in a number of areas, such as market risk, counterparty credit risk and exposures to central counterparties.

And we also proposed that global and systemically important banks should have a minimum amount of Total Loss-Absorbing Capacity, integrating the international agreement into our European MREL standard.

We also proposed some targeted adjustments to certain elements of the international standards. We have done this where we felt that these standards do not sufficiently factor in the specificities of the EU or where we see uncertainties about the impact on banks [for example in the trading book].

In particular, the Commission conducted the Call for Evidence, a consultation on potentially undesired effect of the regulatory framework, for example in terms of inconsistencies and unnecessary regulatory burdens, and ultimately the ability of the European economy to finance itself. Some of our proposals are a result of this consultation, for example aiming at improving financing of SMEs and infrastructure projects.
These adjustments are either limited in scope, or of limited duration to allow for monitoring the impact of the new rules. All in all, I think it is fair to say that nobody implements international standards as comprehensively as we do in Europe.

So the Commission's message is clear: We believe in the importance of international cooperation in financial regulation, and we put our money where our mouth is.

Global banks need global standards, which limit regulatory arbitrage and underpin a level playing field and stability in world markets. This is why Europe champions the work in the G20 to further international agreements in response to the financial crisis. And this is also why we continue engaging constructively in the Basel Committee.

At this stage, I remain optimistic that the Basel Committee will reach an agreement on the "finalisation of Basel III" eventually. Not coming to an agreement would be a severe blow for the credibility of the entire Basel process. And it would send a fatal signal in the current environment of post-truth politics and rising protectionism.

At the same time, we should remember that this agreement will shape aspects of banking regulation for years to come. So we now need to concentrate on getting it right, not on reaching an agreement quickly, to ensure that we find a good agreement that works for everyone.
Thank you for your attention.