Sabine Lautenschläger: The European banking sector – growing together and growing apart

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism,at the LSE German Symposium, London, 2 March 2017.

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Two major events provide the frame for my speech today. Both of them took place in June – one in 2012, the other in 2016. One of them took place in Brussels, the other here in the United Kingdom. One of them made Europe grow together; the other made Europe grow apart.

On 28 June 2012 in Brussels, the leaders of the EU decided to take banking supervision to the European level and explore the idea of a fully fledged banking union. They took a decisive step towards a more united Europe. On 23 June 2016, the people of this country voted to leave the European Union. They took a decisive step away from a united Europe.

Both events – while very different in nature – will fundamentally change Europe. From the perspective of banks and their supervisors, both events have had and will have a huge impact. Let us take a closer look.

Growing together – European banking supervision

In June 2012, the euro area was a bad place to be – if you were an investor, a bank or a country that had lost the trust of the markets.

On 1 June that year, the Financial Times wrote "Spain suffers €100 billion exodus". In the days thereafter, its front-page stories focused on ailing Portuguese and Spanish banks. In mid-June, its headline was "Fears rise over EU handling of debt crisis".

By then the markets had driven the bond yields of some euro area countries to new heights. In other words, if the governments of those countries wanted to sell bonds to finance their debt they would have to pay much more. The media started speculating about a break-up of the euro area, as did some politicians.

Two weeks later though, something had obviously changed. On the last day of June, the Financial Times, on its front page, said "Markets rebound following EU deal".

What had happened?

What had happened was that an EU summit had taken place in Brussels. There, the leaders of the EU agreed on a package of measures to stabilise the euro area. They decided on a €120 billion pact for growth; they decided that the rescue funds, the European Financial Stability Facility and the European Stability Mechanism, could directly recapitalise banks under certain conditions; and they pledged to use the instruments of the rescue funds flexibly and efficiently.

Another important element of the package was to create a "Single Supervisory Mechanism", as it was called. Banking supervision was to be taken from the national to the European level.

Just two years later, European banking supervision became reality. In November 2014, the ECB began to supervise banks in the euro area. But how does the new European system work? And why is it better than the old national ones?

Some people think that the ECB has become the sole supervisor of all banks in the euro area. Well, it is true that European banking supervision has put an end to the patchwork of national supervision. But in essence, it is a common European undertaking.

In the euro area, we divide banks into two groups: large ones and small ones. And it is the 126 largest banking groups which are directly supervised by the ECB – they are called "significant institutions" and account for 82% of the euro area's banking assets. For each of these large banks, we have set up a "Joint Supervisory Team", or JST. These JSTs are headed by ECB staff and comprise supervisors from both the national authorities and the ECB. It is these teams that actually supervise the banks. They are at the heart of European banking supervision.

Alongside the 126 largest banking groups, there are around 3,300 smaller ones, the "less significant" institutions. These banks are still directly supervised by the national authorities. Nevertheless, the ECB plays a role, too. Together with the national authorities, it develops and implements supervisory standards for the smaller banks, and it ensures that supervisors apply these standards across the euro area.

And not only is the day-to-day supervision of banks a joint task. Decisions are also jointly prepared and adopted. The main bodies in this regard are the Supervisory Board and the Governing Council of the ECB. The Supervisory Board is chaired by the ECB and includes representatives from all the national supervisory authorities. The Governing Council of the ECB in turn comprises the governors of all the euro area central banks and the Executive Board members of the ECB.

It is true to say that national authorities are no longer responsible for supervising their largest banks. But they share their knowledge and experience with the ECB, which directly supervises the largest banks and oversees the entire system of European banking supervision. We have joined forces to make the banking sector safe and sound.

In my view, this was the right thing to do. Over the past decades, the financial system has turned into a global village. As a result, a crisis, say, affecting a single bank can quickly spread around the entire globe – as happened in 2008. This is particularly true for monetary unions such as the euro area. Here, problems can spread even faster and may threaten the financial stability of the entire union.

Therefore, European banking supervision brings real benefits. It allows us to look beyond national borders and national interests. When we supervise banks and take decisions, we take a truly European view.

At the same time, we can compare banks across the euro area and gain many more insights than national supervisors could. We can draw on a huge pool of expertise as our analyses are based on the knowledge and experience not only from the ECB but from across Europe and beyond. All in all, the ECB itself brings together staff from 28 different countries. So not only do we have lots of data and information but we also have the resources to analyse it. All this helps to spot potential problems early on and thoroughly assess their impact.

We can combine the best approaches to banking supervision from 19 different countries. We can ensure that high standards are uniformly applied in the entire euro area. This creates a stable and predictable business environment for banks that operate across borders. Wherever they go in the euro area, they are supervised to the same standards and methods.

The idea of harmonisation goes beyond supervision; it is the theme of the entire European banking union. In January 2016, a European resolution mechanism for banks was introduced. It ensures that banks across the euro area can be resolved according to the same rules. A European deposit guarantee has not yet been agreed upon – but even without one we have made good progress. Altogether, the banking union helps to create a level playing field for banks.

This is the ground on which a truly European banking sector can emerge. And contrary to what some people say, a large common market is better than isolated national ones. A common market creates more jobs, more income and more wealth. On that note, let us move to the second part of my speech.

Growing apart – Brexit and the banks

It seems that by now we have got used to political events that defy all expectations. Last June, however, it was still a new thing. So when a majority of the people of the UK voted to leave the EU, it sent a shockwave not only through Europe, but around the world.

Indeed, on 23 June 2016, the future changed – or to quote Yogi Berra: "The future ain't what it used to be". But what exactly the future will be is still unclear. Official negotiations on Brexit have not even started, and they will take years to conclude.

Meanwhile, a cloud of uncertainty is now hanging over everyone, including the banks. Despite this uncertainty, the banks need to act now to be well prepared for any outcome. But what does Brexit mean for the banks? Well, let us for a moment assume that there will be a 'hard Brexit' in the sense that the UK would turn into a third country from the perspective of the EU. As a result, the UK and its banks would lose their access to the single EU market. Why is that?

Currently there are around 40 banking groups in the UK that operate in the EU market. Some of them are British, of course; others are global investment banks, for instance, from the US. And there are some smaller groups with roots in Asia and the Middle East.

How do these banks currently access the EU market? Many of them use the EU passport, which was introduced in 1993. The passport was actually one of the first major steps towards a truly European banking market. When a bank is licensed in one Member State of the EU, it can conduct business in any other Member State – no additional licensing is required.

In the event of a hard Brexit, these banks would lose the passport. Those banks that fully rely on it would have to seek another point of entry. Most obviously, they would have to obtain a licence in an EU country.

And this is where European banking supervision comes in: it is the ECB that grants banking licences throughout the euro area – for large and small banks alike. Moreover, we have no stake in whether UK banks set up shop in Paris, Dublin, Frankfurt or any other euro area city. We are neutral.

However, there is one issue on which I have strong views.

Our objective is to make the banking system safe and sound. I therefore expect banks which are seeking a licence in the euro area to meet our standards. There will be no race to the bottom in banking supervision.

In particular, I do not see the ECB issuing banking licences to empty shell companies. Banks which plan to permanently book all exposures back-to-back with another entity in London might be in for a disappointment. This is not about a full ban of back-to-back booking. We rather aim at ensuring both an adequate local management of all material risks and the resolvability of the euro area entity.

Needless to say that I would certainly not accept banks' booking all exposures with the euro area entity while having their risk management and internal control systems outside the euro area.

As we expect many banks to apply, I urge them to make up their minds and contact us early on. We will then decide on an appropriate path for them to meet our expectations. But one thing has to be clear: eventually, all banks will have to fulfil the high standards of European banking supervision.

We are talking to the banks, of course. And what we hear is that some of them are thinking about taking other paths into the EU market. They are considering complementing or even replacing licensed subsidiaries with other entities – investment firms or branches, for instance. Such entities, however, would not come within the scope of European banking supervision. They would continue to be supervised at the national level.

Still, investment firms can be quite large and might conduct bank-like business. In countries such as the UK or the US, the largest investment firms are supervised by banking supervisors. To achieve greater consistency, regulation in the EU might be adapted – the intermediate holding company might be a part of a potential solution. The current review of the European banking rules might provide an opportunity to do so. For those banks we directly supervise we will in any case keep a close eye on the risks that result from different group structures and from relations between different entities of the same group.

Securing continuous market access will be the most pressing issue for UK banks – there's no doubt about that. We know that some of them have already started to address this issue. And yes, time is of the essence.

Market access is just the first step. Related to it are hundreds of other even more technical questions. How to treat financial and risk relations between existing and new entities in the euro area and related UK entities? How to deal with the internal models that UK banks might want to use in their newly established EU entities? How best to continue the fruitful cooperation with our colleagues from the Prudential Regulation Authority? After all, our banking systems will remain closely connected.

Brexit might cut through a sector that is deeply connected. Keeping the sector together will be a complex task – legally, operationally, organisationally. From whichever angle you look at it, it will be difficult. I have only scratched the surface here, but that much should have become clear.

Still, I can assure you that we are prepared for any scenario. Whatever the UK and the remaining 27 EU members agree upon, European banking supervision stands ready to contribute to a safe and sound banking sector.

Ladies and gentlemen, I have talked a lot about UK-based banks that operate in the EU. What about banks on the Continent that operate in the UK? Well, they face the same uncertainty and the same challenges. I therefore urge these banks as well to prepare for the new future.

Brexit will shake up the banking sector; there's no doubt about that. But how will it affect London as a financial centre?

Just two Tube stations away from here is Mansion House. It was there, on 10 November 1986, that the then Prime Minister, Margaret Thatcher, was invited to speak at the Lord Mayor's banquet. In her speech, she said that "the City serves not only the City, but the nation as a whole". This was two weeks after the government had established a new legal framework which deregulated the stock exchange. The "Big Bang", as it was called, attracted banks from around the world and turned London into a global financial centre.

It became a magnet for banks. And the resulting scale effects have made it even more attractive. Today, it offers liquid markets, specialist services, solid market infrastructures and a huge pool of talent. More than a million people work in the financial sector and another million work in related services. Altogether, the sector generates about 11% of Britain's GDP.

And there's no doubt either that the Single Market increased London's appeal. Because of EU passporting, banks enjoy unlimited access to the European market, as I said just now. And they make the most of that opportunity. Their business in the other 27 EU countries accounts for about one-quarter of revenues of the UK's financial services.

Take, as an example, the clearing of derivatives that are denominated in euro. A large number of these deals take place in London – more than 75% in some asset classes. The ECB is involved in the oversight of UK central counterparties through supervisory colleges and a Memorandum of Understanding with the UK authorities. This framework enables us to monitor risks to the euro – also due to good cooperation with our British colleagues and legal certainty afforded by the European Court of Justice.

In view of Brexit, some might now ask whether it would make sense in the future for the majority of euro clearing to take place outside the EU. Well, that depends on whether the new framework will offer us the same level of involvement as we have today. And it depends on whether the new framework will be strong enough to ensure financial stability in the euro area.

To sum up: access to the European market is important for the financial sector. And the financial sector is important for the British economy. Losing that access would therefore have an impact – not only on the banking sector itself but also on the UK's economy. We are talking about jobs, income and prosperity.

The question therefore is: will London remain a global financial centre? Yes, it will. But at the same time, it might lose part of the business, while Europe might attract some of it. The race is on, and many cities are competing for the banks – either to keep them, in the case of London, or to attract them, in the case of other cities in Europe. In the end, there probably won't be a winner-takes-it-all scenario. Some banks might go to Dublin, some to Paris, others to Frankfurt or elsewhere in Europe.

As I said, the ECB is neutral. Still, the competition must not result in a race to the bottom with regard to regulation, supervision or taxation – neither in the UK nor in the rest of Europe. Such a lowering of standards might work in the short term, but in the long term it would do more harm than good. That is why European banking supervision will not change its policies in the wake of Brexit.

In fact, strong rules and strong supervision should attract banks – they boost the reputation of banks, increase people's trust, and that's good for business. And above all, strong rules serve a purpose: they help to prevent future crises – not only at a national but also at a global level. And financial crises can be very costly.

The financial sector will always test the boundaries of regulation; it will always look for the best deal – globally. We therefore need global rules to make the financial sector a safe place. Countries which believe that they can secure national financial stability without global rules may actually endanger the financial sector – everywhere.

So Sam Woods, head of the Prudential Regulation Authority, was quite right to say in his Mansion House speech last year: "The UK financial system must be robustly regulated and supervised whatever the outcome of the government's negotiations with the European Union". The same is true for the European banks, of course. This approach makes for a safe and sound banking sector and should not change.

Conclusion

The euro area has grown closer together. The single currency has been complemented by a single banking supervisor and a single resolution authority. This was a major step towards safe and sound banks as well as towards a stronger economy. To be sure, the euro area faces some serious challenges, but I am convinced that they are better tackled jointly rather than individually.

Still, the UK is charting a course away from the shores of Europe and into a vast and empty ocean. That makes me think of Antoine de Saint-Exupéry, who said: "If you want to build a ship, don't drum up people to collect wood and don't assign them tasks and work, but rather teach them to long for the endless immensity of the sea". It seems that many people in the UK indeed long for the endless immensity of the sea. To them it stands for independence from the EU and for freedom.

However, building a ship and sailing the seven seas still requires collecting wood and assigning tasks and work. These may seem to be small details, but in the real world, the devil is in the detail. Today I have touched on some of the details that will affect the banks – and these are very intricate and difficult to handle. Now just imagine that there are many other sectors where Brexit will trigger equally complex issues.

The goal should be to find a workable solution that is in the interests of both the British people and the people of the EU. We all have an interest in strong banking supervision and mutual cooperation. And that is a strong foundation.

Thank you for your attention.