Sabine Lautenschläger: How can prudential regulation foster growth?

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 Frankfurt Finance Summit, Frankfurt am Main, 16 March 2015.

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Supervisors can contribute to sustainable economic growth by ensuring that supervised entities are resilient to plausible shocks, properly managed, adequately capitalised and subject to an efficient risk management and the right incentives. The European Single Supervisory Mechanism takes a medium to long-term perspective on this, resisting those who argue for short-term relief. The SSM ensures that banks can deliver in their tasks in all phases of the economic cycle and thus are able to provide the economy with the financial services that corporations, smaller firms and citizens need.

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It is my pleasure to open this dinner with a question that may seem quite straightforward, but whose answer is far from intuitive, especially from the perspective of a supervisor: “How can prudential regulation foster growth?”

I must admit that when I first saw the topic of this short speech I was tempted to turn this into a brainstorming session. I am sure that many of you have innovative ideas on how to foster growth by means of prudential regulation and supervisory action. Some might suggest restraint on the side of regulators and supervisors as a way of fostering growth – and they may be right regarding some of the many topics that were regulated over the last seven years. But if you now expect me to provide comfort with a regulatory break or even promise supervisory leniency, I am afraid you are in for a disappointment.

The financial crisis has shown that there is little more damaging for sustainable growth than a malfunctioning banking sector. That is why – after a long period of deregulation – governments around the world decided to strengthen regulation and supervision. The ultimate objective of these reforms has been the same since the 1930s: regulators and supervisors have to ensure that the banking sector is resilient and provides the economy and society at large with its key services, even under severe stress.

As a supervisor, our most valuable contribution to economic growth is to do our job – by implementing regulation consistently, by closely monitoring supervised institutions in a forward-looking, risk-based and proportionate way and by taking timely and determined action when needed. The SSM has the responsibility and privilege to go a step further. By harmonising supervisory practices, we will contribute to a level-playing field which will eventually also foster growth.

To be more concrete, I would like to draw your attention to two important issues with implications for growth which both also reflect the unique features of the SSM.

The first one is the Supervisory Review and Evaluation Process (SREP), which gives us the instrument to tailor supervisory requirements beyond the minimum capital requirements set by the Basel Accord. We take into account the banks specific business risks, but also include governance and internal controls.

The second one is the harmonisation of supervisory practices to the highest standards, through the consistent and rigorous exercise of options and discretions formally left to national supervisors.

Both topics, SREP and options and discretions, relate, among other things, to “more capital with higher quality”. Let me first respond to concerns about some of our SREP decisions. Some critics argue that setting capital requirements above the regulatory minimum hampers the economic recovery in Europe. You will not be surprised that I do not share these

concerns. On the contrary, I am of the firm view that the time for muddling through is over. Generally setting capital requirements at the minimum might have an effect on short-term growth (though this is highly questionable), but it would come at the expense of more problems in the future if the bank concerned has a specific need for capital. I think we can all agree that we need banks that are able to permanently fulfil their role in good times as well as bad. That is why we have to start working towards that now by using the SREP to set capital requirements as appropriate for the individual banks' risk profile and governance.

I appear to be in good company with this view: there seems to be a consensus in the academic literature that an increase in regulatory capital requirements has a positive impact on lending to the real economy in the long term, while loan reduction can occur in the short term. For a start, the vast majority of banks have capital buffers above the thresholds implied by the SREP decisions, which in those cases means that an increase in capital requirements would actually have little or no effect on the banks' credit supply. In the event of an actual deleveraging by a bank as a result of a SREP decision, lending activities would often not be hit as it would be logical for the bank to first reduce its non-core business. And even if there were a reduction in credit supply by specific banks, this could only have a consequence on the real economy if no off-set happened elsewhere in the financial system. Finally, there would need to be an assumption that no relief in the banks' funding costs would occur as a result of the improvement of the capital ratio imposed by the SREP decisions. Therefore, I would call for caution when making a direct link between SREP decisions and consequences on the real economy.

But the SREP is not only about capital, it is much more. The overall efficiency in operations and in credit allocation, as well as the stability and resilience of the banking sector do not depend solely on the level and quality of capital. Capital should actually be a bank's last line of defence, and the supervisory approach we believe in implies that we are not engaged in a simple box-ticking exercise, whereby internal processes and conduct features can be ignored as long as a bank holds enough capital. On the contrary, we have decided to use the SREP exercise to perform an acute forward-looking review and challenge top managers in all aspects of the banks' operations. This goes beyond the assessment of traditional risks. The SREP allows supervisors to draw conclusions on the banks' internal governance, risk management practices, incentive systems, effective data aggregation, as well as the general risk appetite of the institution and how it matches its business model. This can result in the supervisor potentially requiring the bank to hold additional capital, but this outcome is only one of the supervisory tools available.

As the European banking system faces a challenging mix of low growth, high volumes of non-performing loans, a low interest rate environment and intense competition, the comprehensive SREP process is of paramount importance. Banks might embark on dangerous business strategies or reduce costs by reducing staff for risk management. Only by taking a holistic view of the bank can the supervisor counter the build-up of risks on all levels and weaknesses in governance and internal controls with adequate capital surcharges.

Being able to apply these principles and actions in a single and consistent manner for all SREP decisions is a major benefit of the SSM, both for supervisors and for banks themselves, which are treated on an equal footing based on the single methodology applied across the board.

This approach, consisting in identifying best practices and then harmonising the performance of supervision accordingly, is also reflected in the work we are currently undertaking at the SSM on regulatory options and national discretions.

Up until now, Member States in the euro area, banks and supervisors have to work with more than 150 different options and national discretions in the single rulebook. These options and national discretions are often a legacy resulting from different market structures and legal environments. Many of them have material effects on the level of prudence of the

framework and on the comparability of capital ratios; they also add an additional layer of complexity as well as a source of regulatory arbitrage, of risk to the financial sector and of competitive disadvantage for banks established in Member States that have chosen the most virtuous standard.

Let me take one example related to the transitional arrangements in the definition of capital. The various phase-in arrangements of the CRR capital definitions within the SSM account for an overall €126 billion gain compared to the "fully-fledged" definition. This amount is unequally shared across national banking systems as clearly shown in the comprehensive assessment report published last year.

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It is up to the SSM to use its power for exercising options and national discretion wisely. We aim to improve the comparability of capital ratios and create transparency by providing reliable information to citizens and market participants. In the medium to long run, this will permanently increase the resilience and service capacity of banks.

Of course, harmonisation cannot be a goal in its own right. Exactly the same is true for national specificities: if national specificities contribute to a more stable banking system, the SSM will be eager to preserve or even promote them. But if national characteristics are only the reflection of unquestioned traditions and regulatory capture, they should be eradicated. As with the SREP decisions, we expect positive outcomes in terms of prudence, consistency and stability of the framework to outweigh by far the adjustment costs that each national banking system will face by converging to the high standards.

Let me conclude, as dinner is awaiting us.

While banking is a complex business, and as such it cannot be naively regulated or supervised, there is of course always room for improvement. Therefore, you will be pleased to hear that simplicity and comparability of prudential standards have become a top priority for the Basel Committee on Banking Supervision, and that regulators are now giving greater attention to formerly disregarded parts of EBA standards called "impact assessments". As member of the Basel Committee, I very much welcome this development.

That being said, I am convinced that supervisors can contribute to sustainable growth by ensuring that supervised entities are resilient to plausible shocks, properly managed, adequately capitalised and subject to an efficient risk management and the right incentives. We as the SSM take a medium to long-term perspective on this, while resisting those who argue for short-term relief. Our role, in short, is to ensure that banks can deliver in their tasks in all phases of the economic cycle and thus are able to provide the economy with the financial services that corporations, smaller firms and citizens need. Achieving this ambitious objective will certainly contribute to the economic growth that Europe is craving for.