Sabine Lautenschläger: Monitoring, regulation and self-regulation in the European banking sector

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 evening reception at the Deutsche Aktieninstitut, Frankfurt am Main, 21 April 2015.

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1. Introduction

Dear Mr Baumann, dear Mr Engels, ladies and gentlemen,

My topic today, "Monitoring, regulation and self-regulation in the European banking sector", cannot currently be discussed without asking ourselves the following questions.

Do we need to do more to make sure that we never have to experience another financial market and banking crisis like that in 2008–09, or have we done too much and thus prevented the European banking industry from being able to offer financial services to the real economy?

After a long phase of deregulation, a comprehensive re-regulation has been in vogue since 2009. At the global, European and national level, we have tackled almost everything that can limit, reduce or prevent risks to and risks caused by banks. The general public, politicians, academics, supervisors and even bankers – simply everyone – called for comprehensive and tough rules for banks and for their close supervision. But the mood seems to have changed over the past year. In Germany and Europe, more and more people are complaining of overregulation. In the rest of Europe, a connection is being made between the words "credit crunch" and "regulation".

Many people yearn for a pause in regulation, would perhaps rather leave the market to regulate itself – rely on self-regulation.

At the moment in Europe, we are a long way off from self-regulation. And I hope that it will stay like this, even if people like to quickly forget bad memories. I do not believe in self-regulation, at least not in financial markets. You cannot have stable and functional banks without comprehensive regulation and energetic supervision. A sustainably stable banking sector demands a set of regulations which can keep up with the innovativeness of the financial sector and progress in banking, but which sets adequate limits in order to uncover and correct abnormal trends and excessive risks in their business activities. To this end, the rules have to be adaptable and both leave room for discretion and provide leeway for a clever supervisor with good judgement skills.

2. A retrospective

The past speaks for itself. A light touch in regulation and supervision, or even self-regulation, has not proven to be a convincing solution. Over the last two decades, global financial markets have been characterised by a high level of volatility, a series of rapid booms, major upheavals and severe slumps. The Asian financial crisis of 1997, the dotcom bubble of 1997–2000, the US subprime crisis as from 2007 and the European debt crisis are merely the most prominent examples. Looking at all these events, there is a recurrent pattern: innovation in the real or financial economy and deregulation measures are followed by accelerated growth, which is accompanied by a very expansive lending policy on the part of banks.

Sooner or later, the boom comes to an end and price corrections take place that often end in a recession. As a rule, the stronger the boom is at the start of the cycle, the larger is the subsequent harm to the economy and to society.

This pattern is often complemented by another factor. Particularly, but not exclusively, in the financial sector – a sector with fierce competition between regulated and non-regulated financial market participants – regulatory loopholes are actively exploited in order to gain competitive or other advantages. This is particularly well illustrated by the example of asset-backed securities (ABSs). From the middle of the 1990s, the originate-to-distribute model, i.e. the securitisation and resale of loans, was seen by many as the financing model of the future, not just in the United States, but also in Europe and Germany. Many saw it as a solution to economic and socio-political problems and took measures in favour of ABS financing in terms of regulatory requirements. Accordingly, banks were able, for example, to finance their ABS-based special-purpose vehicles solely through short-term credit lines, credit lines that are in place "until further notice". The "loans" to the special-purpose vehicle did not have to be backed by equity as long as the maturity of the loan commitments remained under one year. So it soon became standard practice among banks to limit the maturity of such credit lines to 364 days and to prolong them accordingly at maturity. The consequences of this practice became clear at the start of the subprime crisis in 2007 when German banks were among the first to run into difficulties because of these credit lines.

- The past thus shows that financial markets do not always behave rationally. In fact, markets tend towards exaggerations even more than individuals; crowd psychology plays a significant role in pricing.
- Given the potential for damage as a result of undesirable developments and the incentives to which participants are exposed, it is obvious that self-regulation alone is not sufficient in financial markets.

3. Requirements to be met by regulation and supervision

Against this background, the question is which regulatory or supervisory approach is the right one for a modern financial system. Should financial markets be subject to all-encompassing regulation in which every single activity is regulated down to the smallest detail? My answer is "no" – because this would not have a satisfactory outcome, either. Depending on its design, such a rule book would either be permanently outdated and incomplete, because legislators cannot keep up with the rapid pace of innovation within the financial sector with meticulous regulation, or would have to regulate so rigidly that it would impose excessive restrictions on the functioning of the financial system. As is often the case, the most sensible option is in the middle. We need regulation based on principles which adapts to changes in banking and we need a supervisory authority that is capable taking action. Allow me to elaborate.

- Good regulations must be adaptable. They must be just as applicable to different business models as they are to different sizes of institution – they must fit large and small institutions alike. Good regulations must adapt to changing circumstances without legislators having continually to improve on them. Accordingly, the rules must provide room for discretion in individual cases.
- Good regulations must, however, also ensure a minimum level of planning and legal certainty for banks; that is the only way in which banks operate properly and provide their financial services over the long term. This holds particularly true of Europe, where banks play a greater role in financing the real economy than the capital markets. At the same time, there has to be a global understanding of what regulation means, since regulations could otherwise, given the global interconnectedness of financial markets, be easily leveraged and since fair competition can only be assured when the rules of the game are the same.
- I remain convinced that regulation and supervision must be sensitive to risks. This means that the bank that takes greater risks and poses a greater threat to financial stability must also be subject to stricter rules and/or limitations on its business

activities. If our set of rules was to treat different risk profiles in the same way, then we would subject conservative, low-risk banking business with low yields to the same requirements as high-risk business activities, thereby making the former uneconomical. In my view, that would be creating the wrong incentive.

- We need a shrewd supervisory authority that monitors compliance with the rules and supervises banks in a consistent and tough but fair way. It needs to be shrewd because it must be able to use its discretionary powers correctly when regulating matters and weigh different arguments on a case-by-case basis. In this role, supervision must be able to act across national borders, because that is the only way to ensure that large, internationally active institutions, too, are subject to consistent and comprehensive control.
- These are stringent requirements which we can only honour with a consistent focus on the ultimate goal of regulation and supervision, namely a stable financial system. I would therefore like to end my list of requirements with a warning. Under no circumstances should regulation be misused to support economic development. That would blur responsibilities and shift tasks from the political domain to supervision. New rules for the banking industry go hand in hand with burdens. With a multitude of new rules, the sum of those burdens can impair the banking industry's ability to function properly. This must be taken into account and solutions must be found, but this cannot be done by ignoring risks. The past has shown us far too often that there is no point in ignoring risks to banks – in the medium and long term, they always come back like a boomerang.

4. Current status and further need for improvement

Where do we currently stand in Europe in this respect? Do we need more regulation, or do we need less? Since 2009, the regulatory framework has undergone further extensive development and has been decisively improved upon at both the international and the European level. Let me mention just a few elements by way of a reminder:

- considerably more and higher-quality capital for banks;
- new standards for liquidity reserves and indebtedness in banks;
- considerably stricter risk management and governance requirements;
- the Bank Recovery and Resolution Directive (BRRD) that marks significant progress in dealing with distressed institutions.

Thanks to these reforms, the regulatory network within Europe has become considerably tighter and more balanced in recent years. It has developed from a purely capital-based system into a set of diversified standards. This has made it more difficult to circumvent individual regulations. It requires banks to give due consideration to a broad range of relevant factors (capital, liquidity, leverage, interconnectedness/systemic significance and structure) when designing their business models.

Despite this progress, there is still work to be done here and there.

- We must convincingly weaken the connections between a country and its banks in the long run. Government bonds continue to be considered by regulators as largely risk-free: there is neither an obligation to have capital available that is commensurate with the risks, nor are there rules that address concentration risks. This cannot be allowed.
- We must also improve the calculation of equity in individual banks. A great deal of confidence has been lost in this respect over recent years. Internal bank models are today seen by many to be a means for risky capital optimisation and not as a useful tool for bank management and risk-based supervision. To restore confidence, we

need less complexity and more transparency. Not every portfolio or risk can be modelled. For these portfolios, we must use simple, standardised approaches. We must reduce the complexity of the model-based approaches to a level which allows both the banks' supervisory bodies and the supervisory authorities to understand and review them within a reasonable period of time. Standard approaches should also be used here as a control variable and indicator for capital savings.

- Given the great number of regulatory measures, it is important not to lose sight of the bigger picture. We will therefore carry out a comprehensive analysis of the overall effect of regulatory measures. This project is already being planned and prepared by the Basel Committee. Such an exercise will do us good and will also be beneficial to the general debate on regulation, helping objectify it. I hope that this work will not only result a list of overlaps, duplication and other inefficiencies which we would subsequently clear up. I also expect that we will address unintended consequences of the new rules.

In supervision, too, much needs to be changed. The crises of recent years did not come about solely because there were weaknesses in the regulatory framework. The supervision of banks did not function optimally, either. The consequence of the crisis is therefore not only that the supervision of banks has shifted from the national level in the euro area to a European level, but also that supervision has changed in its basic approach and in what is expected of it and the supervised entities.

- The SSM has allowed us to start afresh in our relationship with banks. It has broken with traditions and customs that were often no longer being questioned. Supervisory teams from different countries see the banks with fresh eyes and on the basis of their common experience. This creates the necessary critical distance for sensible supervision.
- Banking supervision in Europe should take tough but fair action (the emphasis being on "action"). European supervision, the SSM, sees itself as a supervisor which identifies and addresses risks at an early stage, and thus contributes to ensuring that the banking system is able to function properly. A light touch and reactive supervision should belong to the past.
- European supervision should create a level playing field. That is why the first thing that we developed in the SSM was a consistent supervisory approach with a consistent methodology for assessing banks' risks and governance structures, as well as their equity capital and liquidity positions.
- For the supervision of systemically relevant and large, internationally active banks in particular, the SSM represents a quantum leap forward. The SSM allows us to compare and adapt supervision across 19 countries, to identify best practices and to ensure that they are implemented consistently through effective quality assurance. There are now completely new possibilities for comparative and cross-sectoral analysis than were available at the national level. For our tasks, we can use information and insights from banks with very different business models. This enables us to identify risks and undesirable developments more clearly and at an earlier stage, and to take suitable countermeasures. We can also put work on banks' internal models, which have a significant influence on a bank's capital requirements, on a new footing. We will use the opportunity, given the improved level of data and insight, to implement strict rules for the approval and ongoing supervision of internal models.

Despite this progress, there is still a lot to do in the further development of supervision. The effectiveness and efficiency of supervision is dependent on the legal framework it applies, although this is not the sole determinant. Soft European standards or diverging national rules impair the SSM's ability to take action and its effectiveness. And this does not just concern

national rules that affect the quality of banks' equity. The SSM applies 19 different national legal frameworks and not only when, for example, we examine the professional suitability of managers in large, internationally active banks. Detailed rules on governance in banks and deliberations on transposing extensive rules on banks' internal control systems into national law complicate or even prevent the desired level playing field of consistent supervision – they increase fragmentation. Moreover, European supervisory legislation provides more than 150 options to choose from, options which have so far been exercised along highly different lines at the national level. Some are justified by local features – in this respect, the principle is that similar things should be treated similarly and dissimilar things should be treated dissimilarly. Many of the options are based rather more on tradition, and are in conflict with the principle of "same business, same risk, same rules". The smaller proportion of these options remains national in character. Competence for the majority of the options – for over 100 – has been vested in the SSM since 4 November 2014. The ECB, together with the national supervisory authorities, has now begun to arrange for their consistent application.

This process and the resulting adaptations will not always be simple or convenient, but the benefits of the outcome should outweigh the cost of adaption – not just in terms of financial stability, but also through more balanced competition and lower transaction costs. In some respects, we are still at the beginning of the road, but I am confident that the SSM has put us are on the right path towards achieving these objectives.

5. Conclusions

I don't think that you were much surprised by my saying that I don't think much of lax regulation. Given the obvious tendency towards exaggeration and erroneous developments in financial markets, and the potential damage for the economy and society, good regulations are an indispensable prerequisite for ensuring that the financial sector is able to function properly in the long term. This does not mean that the consequences of regulation and supervision for the banking industry's ability to function should not be considered. The desire of some to make up for the rigour of the rules with less stringent supervision is something I reject. That would be the wrong approach.

But what are required are not only good regulations, but also a well-functioning supervisor that exercises tough but fair control to help ensure a stable banking system and a level cross-border playing field. A decisive factor for the success of the SSM will not just rest on banks in the euro area being subject to a consistent supervisory approach. Rather, both supervisory legislation and the powers of European supervision must take further steps in the direction of harmonisation.

Finally, it is not possible for every conceivable situation to be covered by regulations, nor can every crisis be anticipated from a supervisory point of view. Although regulation and supervision can ensure a certain measure of protection, or build a line of defence, as it were, they cannot and should not eliminate every risk. In this respect, banks and financial market participants that act independently, and take responsibility for their actions, remain a prerequisite for a stable and secure system, even if it is well-regulated and supervised.

Thank you for your attention.