Sabine Lautenschläger: Caught in the middle? Small and medium-sized banks and European banking supervision

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 Banking Evening of the Deutsche Bundesbank Regional Office in Baden-Württemberg, Stuttgart, 22 February 2016.

*   *   *

Ladies and gentlemen,

I am delighted to be here in Stuttgart this evening. On the one hand, because I can honour the promise I gave to the President of the Bundesbank's Regional Office, Mr Sibold, when I was still Vice-President of the Bundesbank.

On the other hand, because I am looking forward to the opportunity of a discussion with you after I have given my speech. I hope it will be a lively discussion of what you expect from European banking supervision.

I also hope to be able to answer some questions and clear up misunderstandings – regarding, for example, which tasks European banking supervision, the SSM, does perform and does not perform in supervising small and medium-sized institutions, as well as those tasks it does not wish to perform.

Let me start by clearing up one misunderstanding.

Yes, the SSM supervises small and medium-sized institutions only indirectly – and we have absolutely no desire to directly supervise these institutions. If an individual small or medium-sized institution fails, it does not generally jeopardise the stability of either the national or the European financial market; so it does not need to be subject to European banking supervision.

Let me briefly put the role of small and medium-sized institutions in the euro area into perspective, before I deal with the greatest challenges facing this group of institutions.

There are roughly 3,300 banking groups in the euro area, 129 of which are directly supervised by the ECB. We will leave these few banks out of the picture this evening and devote our time to the remaining 3,200 or so groups of institutions instead.

And let me start by going straight to the trickiest part: the correct description of these institutions. The official term for them is "less significant institutions".

This is because, although they are clearly in the majority, their balance sheet total is comparatively small. If we look at the overall balance sheet total of the euro area banking system, scarcely 18% can be attributed to the "less significant institutions".

Does this mean that small and medium-sized institutions and their services are completely unimportant and so do not require good supervision? Not at all!

This 18% of the balance sheet total for the entire euro area banking system is not evenly spread across all countries, but is essentially concentrated in three: Germany, Austria and Italy.

These three countries alone are home to four-fifths of all the supposedly "less significant" institutions, whose balance sheet total amounts to 80% of annual economic output in Austria and Germany.

And in Germany, it is precisely these institutions that provide funding to small and medium-sized enterprises, which, in turn, form the bedrock of the economy. All in all, the "less significant" institutions in Germany finance 70% of the regional economy.

I'm therefore not going to discuss at this point whether or not these institutions are important for the real economy – everyone knows that they are.

And everyone knows that the "less significant" institutions can indeed be significant for the stability of the banking system – not individually, but collectively as associations of savings banks and cooperative banks.

That is particularly true when you consider that many small and medium-sized institutions in the euro area belong to institutional protection schemes and are hence closely interlinked – and often they are also in protection schemes with large, systemically relevant banks. I'll come back to this topic later on.

Ladies and gentlemen, at this point, I'm going to have to disappoint one or two of you: I do not think it is a good idea to leave the "less significant" banks to regulate themselves or to encourage a form of supervision that is more akin to gravedigging than supervising, focusing solely on resolvability.

And, the type of supervision being advocated by some, whereby supervision is exercised over the association rather than over the individual institution, is also no solution as long as there is no legal basis or tools for the appropriate, effective and efficient supervision of associations.

For all the reasons I have just mentioned, and I could give many more, the supervision of "less significant" institutions, which tend to have a regional focus, needs to take into account national particularities on the one hand and meet high quality standards on the other hand.

After all, the aim is to have a functioning banking sector over the medium and long term, providing the real economy with the services that it requires – and it is precisely small and medium-sized institutions that make for a functioning banking sector, as clearly highlighted by the financial crisis.

Given the experience of the past year, I believe that indirect supervision, as is being carried out by the ECB, can be of great benefit – to banks, to their customers, to the stability of national financial centres and to the real economy. But I will come back to that later too.

Now, going back to finding a name for the "less significant" institutions. How should we refer to these 3,200 banks?

As you've probably noticed by now, I've opted for the term "small and medium-sized institutions" – and this decision was preceded by a lengthy discussion.

For those of you who represent a small or medium-sized bank, I hope that you are happy with this description; it will see us through the rest of the evening.

Having now resolved the naming problem, we can turn our attention to some slightly more straightforward issues. I will address two topics this evening.

- First, the challenges now facing small and medium-sized banks; and
- Second, the cooperation between the ECB and the national authorities in supervising small and medium-sized banks.

The challenges – weak profitability and low interest rates

Whether national or European, supervisors are always interested in banks' stability. And the most important components of a stable bank are capital, liquidity and profitability.

Capital serves as a buffer for losses – the higher it is, the more losses a bank can absorb before it collapses. If we want to assess a bank's stability, we should first look at its capital.

The capital ratios of small and medium-sized institutions in the euro area are gratifying. The average Tier 1 capital ratio is 15.2%.

In Germany, the Tier 1 capital ratio of this group of institutions is slightly below average at 14%, but is still significantly above the regulatory requirements, which, as a supervisor, I find reassuring!

And if we now look at how Tier 1 capital ratios have developed recently, we can see another welcome development. They are stable.

In the first instance, that is somewhat surprising, given that the balance sheet total of small and medium-sized banks has increased slightly, while capital has marginally declined. In fact, Tier 1 capital ratios could reasonably have been expected to fall too.

The fact that they remained stable can be explained by the reduction in the riskiness of banks' balance sheets – because this is the basis for calculating Tier 1 capital ratios. That is also something I like to see as a supervisor.

As far as the liquidity of small and medium-sized institutions in Germany is concerned, there isn't really a lot I can say. Instead of there being too little liquidity, there is too much liquidity in Germany. And this liquidity is searching for yield.

First and foremost, high capital and liquidity ratios are sound preconditions for the stability of small and medium-sized institutions. They are good preconditions for the banking system being able to withstand unfavourable market conditions or unexpected shocks – even over a prolonged period.

It is important that these preconditions are met, because small and medium-sized institutions are facing a series of risks and challenges.

The greatest of these challenges is the banks' business models and earnings performance.

It's nothing new that some banks in the euro area are suffering from weak profitability. And that's not just since the period of low interest rates began. It was also the case before that – including for some small and medium-sized institutions.

In some countries, competition among banks for customers is rife – and it is an unhealthy form of competition if risks and collateral are not priced in correctly. In 2014 banks' return on equity was just over 3%, considerably lower than what market participants would deem sustainable.

However, it is not just a question, for example, of whether there is sufficient business among small and medium-sized enterprises and retail customers for the roughly 1,650 banking groups in Germany.

It goes without saying that the prolonged period of very low interest rates is not helping to remedy this weak profitability – on the contrary. The vast majority of small and medium-sized institutions operate a traditional business model that is heavily reliant on interest rates – and consequently they are often harder hit than larger banks.

At the same time, those institutions that mainly extend credit to retail customers are more severely affected by low interest rates. It should come as no surprise that banks that primarily issue fixed-rate loans have thus far coped with the low interest rates comparatively well.

However, I don't need to tell you that, as soon as loans and investments with high and fixed interest rates expire and have to be replaced with lower-yielding assets, these banks incur burdens. Moreover, these banks will suffer from the effects of the low interest rates for longer than banks that mainly grant variable-rate loans – the latter see the benefits more quickly when interest rates go up again.

In order to safeguard earnings performance, small and medium-sized institutions need to assess the efficiency of their business model – and better sooner than later.

I will not give any detailed advice on business policy here – supervisors are not the better bankers. Fundamentally, though, banks have two options: they either raise their earnings or lower their costs.

Let's look at the earnings side first. It makes sense to create new sources of earnings that are less dependent on interest rates – such as fees and commissions.

A survey of German institutions conducted by the German Federal Financial Supervisory Authority (BaFin) and the Bundesbank has indeed revealed that more than half of the respondents have already expanded the share of fees and commissions income in their earnings.

On the costs side, precisely German institutions have potential for savings. By European standards, their cost efficiency is relatively low. For every euro of earnings, they bear costs of almost 70 cent – compared with just 50 cent in other countries.

However, the solution does not necessarily lie in merging small institutions to ultimately create a large, systemically relevant institution.

On the contrary: "small is beautiful" is a good, if not better, alternative – provided that "small" is sustainable in the long term.

In order to realise scale effects, banks could also centralise certain areas – such as reporting, transaction settlement or some elements of risk management. The German savings banks and cooperative banks in particular already have experience in this regard.

Whatever way the institutions choose, it's crucial that they keep proper control of the risks they have taken on.

Banks are obviously not having an easy time right now. They are obliged to increase earnings in times of low interest rates and tough competition, but at the same time must not take any excessive risks when doing so.

Many would liken this to trying to square the circle. I think it's more like a system of mathematical equations with many unknowns – complicated, but nevertheless resolvable.

There are always ways to revive your own business – even without incurring excessive risks. Digitalisation, for example, is opening new paths, which some alert managers are already exploring – be it to develop new sources of income or distribution channels, or to reduce costs.

Cases in point are online banking through smartphones or advisory services for customers by video conference. Digitalisation also offers opportunities for small and medium-sized institutions. For these institutions, the trick will be to innovate, without losing sight of their roots.

Ladies and gentlemen, business models and earnings performance are currently the biggest challenges facing the banking sector – but they are not the only ones.

For example, the activities of small and medium-sized institutions are often very concentrated – on certain sectors or regions. While that is in the nature of small and medium-sized institutions with a regional focus, it also creates a dependency which makes them vulnerable.

So it is all the more important to take this concentration risk into consideration in risk management – particularly with regard to its qualitative elements. If there is no way to avoid concentration risks, the principle of "know your customer" gradually becomes more critical.

And that is exactly where the strength of small and medium-sized institutions lies. They know the risk profile of the individual borrowers as well as the value of their collateral. And they know the regional markets and their potential.

All this needs to be used by banks in the context of their risk management and must continuously be taken into account in their decision-making in order to ensure their success and survival.

It will come as no surprise to you that for me, as a representative of the SSM, it is not just about business models, earnings performance and the concentration of risks when it comes to small and medium-sized institutions. As the SSM, we are always having to ask ourselves how we can support our colleagues at the national supervisors.

Supervision – division of roles between the ECB and national supervisors

Now let's move on to the division of roles that has been in place since November 2014 for the supervision of small and medium-sized institutions in the euro area.

As you know, within European banking supervision, the national supervisors are responsible for supervising small and medium-sized institutions – so in Germany, it's BaFin and the Bundesbank.

The ECB only plays an indirect role in respect of supervising small and medium-sized banks – the point of contact is not the institutions themselves, but rather the national supervisors. Direct contact between the ECB and the institutions only occurs in exceptional cases – for example with regard to the granting or withdrawal of banking licences.

This indirect approach reflects two major principles underlying European banking supervision: subsidiarity and proportionality. Most small and medium-sized institutions have relatively low-risk business models that are tailored to their region – direct European supervision is generally not required here.

But what is the SSM's contribution, what is the contribution of European banking supervision? It is up to the SSM to give background support to the national supervisors.

Together with the national supervisors, we are developing high quality, flexible standards and tools for risk-oriented supervision, which can take into account regional aspects such as the size, business and risk profile of the institution.

This indirect supervisory approach involves, for example, agreeing with the national supervisors on the key components of a recovery plan for small and medium-sized institutions.

It also involves obtaining an overview of whether on-site inspections and discussions are also taking place at these institutions; of whether the level of supervision is tailored to the risk profile of the individual bank; and of whether the national supervisors take macroeconomic developments into account when conducting their risk analyses.

Let me make one thing clear, however: it is not our intention to remove all particularities and replace national supervisory approaches with a European approach. Instead, we are trying to ensure that the key elements of supervision meet certain minimum requirements.

This will enable national particularities to be taken into account – only, however, if these particularities are justifiable in terms of risk. Something we all agree on, I'm sure.

Taking this approach for the indirect supervision of small and medium-sized institutions also ensures two things.

- First, it ensures that the principle of the supervision being tailored to the risk profile and size of the institution is safeguarded.
- Second, it ensures that the principle of proportionality is fully upheld, as it is up to each individual supervisor to use the supervisory tools in a risk-oriented and proportional manner.

Small and medium-sized institutions fall indirectly under European banking supervision. But they benefit directly from it nonetheless.

After all, the objective of indirect supervision is to contribute to the stability of national financial markets and in so doing reflect the importance and particularities of small and medium-sized institutions.

European banking supervision has a much wider overview than national supervisors. The ECB can look at all countries in the euro area and it shares its insights with the national supervisors.

It may well be that a number of national supervisors have already decided to intensify their supervision of certain institutions owing to the increase in information.

Conversely, the ECB gains important insights into small and medium-sized enterprises from the national supervisors. The past few months, in particular, have shown that considerable contagion effects can arise within a banking system.

Against this background, it is very important that the ECB covers and understands a banking system as a whole. This is also of benefit to the supervision of large, directly supervised institutions.

For those exact reasons, European banking supervision can better prevent future crises and that also helps small and medium-sized institutions.

After all, financial crises always damage the real economy too – and the real economy is crucial for small and medium-sized institutions.

For the reasons I have mentioned, European banking supervision will also boost the trust that customers and investors have in the banking sector.

And that too is of benefit to small and medium-sized institutions. After all, trust is the foundation of banking – whatever the size of the bank.

The future – open issues relating to the supervision of small and medium-sized institutions

Ladies and gentlemen, European banking supervision is barely one-and-a-half years' old. In that time, we have also made some headway with regard to small and medium-sized institutions.

In close collaboration with the national supervisors, we have established a set of common standards and methods – and, in many cases, the national supervisors have at their disposal a range of methods and standards that they can choose from.

We have therefore come a lot closer to achieving our goal of creating a more stable banking system. Nevertheless, there are still a number of open issues.

One of those is reporting requirements that provide a minimum amount of data. In general, reporting is a controversial topic right now – and not just because of AnaCredit. There are still a number of misunderstandings that could be cleared up in this regard.

In the wake of the financial crisis, the information needs of banking supervisors have increased significantly – that's for sure. The crisis quite clearly highlighted that the German reporting system did not even fulfil the necessary minimum.

For example, the reports that had to be submitted on a regular basis did not contain any information on country risks – for example to what extent the institutions depended on what was happening in Greece or the United States.

Subsequent ad hoc requests then had to be made, which were expensive – for the banks and for the supervisors.

Sound risk analysis and effective supervision are only possible if the appropriate data are available. The increasing need for data obviously also affects small and medium-sized institutions.

Of course, it's important to weigh up the costs and benefits when collecting data. That is required under the principle of proportionality.

In order to analyse the risks of a small or medium-sized bank, supervisors need and ask for less data; in order to analyse the risks of a large, international bank, they need and ask for more.

Accordingly, the reporting requirements are tailored to, among other things, the size of the institutions.

For example, in anticipation of future reporting requirements, we asked the national supervisors last year, for the first time ever, to provide us with supervisory data on all small and medium-sized banks. They were asked to submit 37 separate data points, including the balance sheet total, the level of customer deposits or the trading book portfolio – so nothing complex at all.

By contrast, the banks that are directly supervised by the ECB are asked to give more than 8,000 data points – and these have to be submitted not annually but quarterly.

Our requests for information of course comply with the guidelines of the European Banking Authority.

For indirect supervision, however, it is not a question of more reports. It is much more about using the experience collected within the SSM for the supervision of small and medium-sized banks.

For example, we are currently working on a concept for the Supervisory Review and Evaluation Process, or SREP. The SREP is the most important tool of banking supervision. The supervisors analyse each institution's business model and governance, as well as its capital and liquidity risks. On this basis, national supervisors determine how much capital each individual institution is required to hold.

Last year, for the first time ever, the SREP for the large banks in the euro area was conducted in accordance with a common methodology – an important step towards genuine European banking supervision. From 2018 it is likely that, for small and medium-sized institutions, the national supervisors will use a simplified methodology that covers the key aspects.

Another thing that also plays an important role for small and medium-sized institutions is the system of institutional protection schemes. More than half of all euro area banks belong to an institutional protection scheme – large banks along with small and medium-sized institutions.

In Germany, four out of five institutions belong to such a protection scheme – measured by balance sheet size, that represents 40% of the German banking system. Institutional protection schemes are therefore highly relevant for the stability of the banking system.

But they are also important to supervisors for another reason. Under European law, more specifically the Capital Requirements Regulation (CRR), banks may be granted certain privileges if they belong to a protection scheme.

For example, institutions need not necessarily hold capital against exposures to members of the same protection scheme. The decision whether to grant such a privilege is taken by the competent supervisor – for small and medium-sized institutions, the national supervisors; for large banks, the ECB.

There is therefore much to be said for granting these privileges in accordance with uniform criteria – both across countries and across institutions.

I'd like to be clear about one thing, however: the aim is not to call into question the protection schemes in general. The objective is to harmonise the supervisory treatment of the systems. We have therefore defined the relevant criteria and are currently conducting a public consultation that will run until the middle of April.

Concluding remarks

Ladies and gentlemen,

I began my speech with the conclusion that the term "less significant" institutions is not justified for the group of small and medium-sized banks.

In view of the importance and particularities of this banking sector, I believe indirect European banking supervision to be necessary and appropriate. I also believe that the division of roles that has been in place since November 2014 is clear and unambiguous.

Small and medium-sized institutions basically fulfil the ideal function of the financial system: they finance the real economy. However, this traditional business model is being challenged – at the moment also by sluggish economic growth, weak investment and the prolonged period of low interest rates.

In some countries, many banks have also for a long time been plagued by relentless competition for too few customers for a large number of banks.

The German institutions, in particular, indeed have considerable reserves, their customers are generally solvent and liquid, and the ratio of non-performing loans is accordingly low. Therefore, as a supervisor, I'm not immediately concerned.

Nonetheless, even these institutions should not try to just hold their breath until they surface from the low interest rate phase. They could rapidly run out of air.

The small and medium-sized institutions will not be able to avoid assessing (in detail) the efficiency of their business model – and better sooner than later.

Small and medium-sized institutions are subject to national supervision. Nonetheless, European supervision still plays an important part, but indirectly through cooperation with the national authorities.

These institutions benefit directly from European supervision, however; trust in the banking sector is increasing, the information base for supervision is becoming wider, the likelihood of crises is decreasing and competition is becoming fairer.

After one-and-a-half years of European supervision, much has changed for small and medium-sized institutions too. Reporting requirements are higher, the SREP is being harmonised and the supervisory treatment of institutional protection schemes is being standardised.

The ECB and the national supervisors are working together on implementing these changes.

The objective is to exercise the best possible supervision, which follows the principle of proportionality, takes appropriate account of national particularities and reflects the particular importance of this banking sector for the stability of national financial markets.

Thank you for your attention.