Sabine Lautenschläger: European banking supervision – much achieved, but still much to do

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 Bundesbanksymposium "Dialogue on banking supervision", Frankfurt am Main, 1 June 2016.

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Ladies and gentlemen,

In 1863 the Freemasons' Tavern in London was the scene of a lively discussion. It concerned the adoption of a set of rules which was initially only valid in England and a good 20 years later was to become very important for the whole world. The rules I'm referring to govern the world's nicest trivial pursuit – and for once I'm not talking about banking – I'm talking about football. Football is played the world over according to the same set of rules. Whether in South America or Europe, whether it's the World Cup or at regional league level, the rules are the same worldwide.

Incidentally, at the outset it was the players themselves who policed the game. Referees, as we know them today, didn't appear until the end of the 19th century – the players' self-regulation didn't work out particularly well.

Banking is perhaps not the world's nicest trivial pursuit, but in some respects it is not unlike football. Banks also compete with each other and have to stick to certain rules. And these rules, too, are now largely harmonised. The Basel framework takes care of that at global level and the single rulebook at European level.

And, of course, also in the banking sector there has to be someone who makes sure that everyone follows the rules – banks need a supervisor just as footballers need a referee, for self-regulation is a sub-optimal solution here too. We have had single European banking supervision in the euro area for over one-and-a-half years – here too there's been a harmonisation.

This process aims to regulate and supervise banks across the euro area according to uniformly high standards – and to prevent regulatory and supervisory arbitrage. That, in turn, is an essential basis for a stable banking sector that promotes growth and prosperity in the monetary union.

Much achieved...

It was in this context that European banking supervision was established. Since November 2014 the ECB has supervised the now 129 biggest banking groups in the euro area. However, this does not mean that there is only one referee.

European banking supervision consists not only of the ECB, but also of a total of 26 national central banks and supervisory authorities. And the national supervisors play an essential role in day-to-day supervision. They make up the majority of the members of the teams supervising the large banks. Decisions are then taken by the Supervisory Board and the ECB's Governing Council, in which the national supervisors are also represented.

European banking supervision thus means cooperation – a stable European banking system is a joint endeavour. It's about supervising banks from a European perspective; it's about combining experience and knowledge to spot risks at an earlier stage and to respond to them more rapidly. It's about preventing regulatory and supervisory arbitrage, and it's about supervising in the same way, throughout the euro area, the same business and the same risks. By focusing on all these goals we have already achieved quite a lot.

We have, for example, harmonised large parts of the supervisory cycle. Together with the national supervisors we identify the main risks to the banking sector. Building on this, we specify our supervisory priorities and transfer them to the supervisory programme for each bank, taking a uniform approach that is forward-looking, risk-oriented and proportionate.

Above all, we have harmonised the annual SREP – the Supervisory Review and Evaluation Process, the centrepiece of any form of banking supervision. In the SREP we analyse the business model, governance, the capital and liquidity risks for each institution, as well as the respective risk management. Using this as a basis, we then specify the capital and liquidity requirements for each institution. Our advantage is not only that we can assess banks across the euro area on the basis of uniform criteria, but also that we are now in a position to compare banks with similar business models and to draw conclusions not only for individual banks, but also for whole banking systems.

Another example of harmonisation concerns the "options and discretions". The European regulatory framework contains a series of provisions which allow the respective supervisor to decide on their practical implementation. Together with the national supervisory authorities we have agreed to exercise these options and discretions in a uniform way throughout the euro area.

... but still much to do

So, in the last one-and-a-half years, we have notched up some achievements. But there's still a lot to do.

One of our roles is to further develop the SREP. We are working on improving our analysis of liquidity risks, risk management and liquidity adequacy. We will harmonise our idea of how banks internally review their capital adequacy –ICAAP (internal capital adequacy assessment process) is the key word.

This year, however, we still need to decide on other components of the SREP concept.

One question is whether, with regard to a bank's capital position, we as supervisor should restrict ourselves solely to the formal and binding supervisory capital surcharge.

Or would it make sense to express the supervisor's expectation for a bank's capital level as requirements on the one hand and as guidance on the other?

The requirement could then represent the formal, binding part of the supervisory expectations for capital. The supervisor could use the instrument of the requirement if immediate risks were not, or not adequately, covered or if there were serious shortcomings in a bank's internal risk management. These capital requirements would then serve as the variable for the distribution of dividends, and so for the calculation of the maximum distributable amount.

By contrast, the supervisor could mainly use the instrument of guidance when processing insights from hypothetical scenarios.

To this end, we would need, among other things, to transfer to the calculation of the supervisory guidance on capital those scenarios that we, in the last year SREP exercise, took into account in the binding capital surcharge. This adjustment to the SREP concept would not change the total capital level; it would just be divided differently between requirements and guidance.

If a bank observed the binding capital requirements, but not the guidance, this should not automatically lead to a formal supervisory measure.

But that is enough about potential changes to the concept – as I said, the work is still ongoing.

Let's consider the small and medium-sized institutions: for them, the system of institutional protection schemes, for instance, plays an important role. In Germany, for instance, four out of five institutions belong to such a protection scheme – measured by balance sheet size, that's around 40% of the German banking system.

Under European law, banks gain privileges if they belong to a protection scheme. For example, institutions do not necessarily have to hold capital against exposures to members of the same protection scheme. The decision on whether to grant such a privilege is taken by the competent supervisor – in the case of small and medium-sized institutions, the national supervisors; in the case of large banks, the ECB.

So there is much to be said for harmonising supervisory expectations here too and for granting the privileges according to 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.

Ultimately, European banking supervision can only apply the principle of equal treatment as far as national banking regulation permits. As for national banking regulation, there are still a number of differences, some of them major, among the countries of the euro area.

Let's compare it with football for a moment. For the referee it would be difficult if he were in charge of a game in which each player played by different rules and in which there were some parts of the pitch, scattered around, where the rules were different.

But this is exactly the situation European banking supervision is contending with at the moment. One source of the regulatory differences is the CRD IV Directive which, as a European directive, has to be transposed into national law in the individual countries. And it wasn't and won't be as uniformly implemented as would be sensible for single supervision.

Let me mention just one example to give you an idea of these differences, which are often hard to understand. The supervisor assesses whether candidates for the governing bodies of banks are professionally competent and reliable. However, the corresponding rules are implemented in very different ways at national level. In some countries, for instance, it's not only the candidates for the governing bodies who are evaluated but also those for key positions at the levels below. Some countries use questionnaires for the assessment and a range of detailed evaluation criteria, others don't. Some countries interview the candidates, in part with the support of psychologists, others don't. Some countries don't allow candidates to occupy their new post until the supervisory body has given its approval. In other countries candidates can take up their new post even if the documents required for the assessment are not yet available.

These differences create serious complications for European banking supervision and are an obstacle on the way to a single financial market. How can it be that the executive board members of a globally active bank in one particular country have to have different skills, knowledge and experience from their counterparts in another country? Here too, further harmonisation of the relevant rules would be useful.

National rules which are not expressly mentioned in the CRD IV are a further cause of regulatory fragmentation. They include rules governing the acquisition of shareholdings. Some countries require major transactions to be supervised in advance by the national authorities, other countries don't. Here too, it would make sense to further harmonise the regulation.

We can thus conclude European banking supervision has helped to further harmonise the supervisory framework in the past 18 months. Much has been achieved, but there is still much to do.

Limits of harmonisation

Ladies and gentlemen, harmonisation is not an end in itself but important for financial stability and sustainable economic growth. But how far must harmonisation go?

Let's consider football again. Yes, the rules are largely harmonised, but that doesn't mean the referee punishes every misdemeanour straightaway. In the penalty area a serious foul results in a penalty kick, and outside that area a free kick. The reason: a foul in the penalty area, i.e. near the goal, has a greater effect on the game than a foul in midfield. At the same time, the rules in professional leagues and in major competitions are stricter – consider the fourth official or goal-line technology.

The rules and the refereeing of football thus follow the principle of proportionality. And in the banking sector the proportionality of regulation and supervision may be even more relevant than in football.

First and foremost, the rules of football should allow fair and orderly play; in the banking sector, it is also and above all about stability – the stability of the banking system and ultimately of the whole economy.

And here the fact that multiple and diverse players are on the pitch is important: large banks, small banks, regional institutions and cross-border ones, banks with risky business models and banks with low-risk models. As all these banks are relevant to the stability of the system in different ways, the benefits of strict regulation and supervision also differ widely.

The costs incurred by individual banks as a result of regulation and supervision also vary, particularly the operational costs. For smaller banks, these costs, relatively speaking, are higher – unlike larger banks they cannot benefit from economies of scale. At the same time, disproportionately high regulatory and supervisory costs represent a barrier for new competitors entering the market.

So there is something to be said for regulating and supervising banks according to the proportionality principle. Here, harmonisation comes up against a boundary which is both reasonable and necessary.

In public discussions proportionality is often tied to the size of the institutions. This makes the discussion easier, but it can also lead in the wrong direction. The decisive factor should be the bank's systemic importance. And at the latest since the savings and loans crisis in the United States in the 1980s, we know that even small banks may still be systemically relevant – "too many to fail" is as big a problem as "too big to fail".

The wording of the legal basis of European banking supervision with regard to proportionality is correspondingly broad. It reads as follows: "When carrying out the tasks conferred on it, and without prejudice to the objective to ensure the safety and soundness of credit institutions, the ECB should have full regard to the diversity of credit institutions and their size and business models".

In European banking supervision, proportionality is clear to see: while the 129 biggest banks in the euro area are directly supervised by the ECB, the smaller institutions, some 3,200 of them, are overseen by the national supervisors.

Only in specific cases and under certain conditions does the ECB directly supervise smaller institutions – and in such cases the question may be asked whether that is appropriate at all.

Normally, the ECB only plays a secondary role in the supervision of smaller institutions – its task is to be in the background supporting national supervisors. So we are developing, together with national supervisors, high-quality standards which take account of regional factors, size, business and risk of the individual institutions, and are correspondingly adaptable.

This kind of harmonisation does not aim to be a levelling-down. It is not a question of replacing national supervisory approaches by a European one. On the contrary, we ensure that the key elements of the supervision attain certain minimum standards. Then national specificities can be taken into account, but only if they are justified from a risk perspective.

The principle of proportionality also takes us into areas which go beyond the general supervisory standards. And I would like to take the opportunity to clear up a widespread misunderstanding. Again and again, people tell me that the ECB is imposing who knows how many reporting obligations on small and medium-sized institutions. Let me give just two examples that show that when it comes to reporting we certainly work in line with the principle of proportionality.

Under the European regulation, supervisors may require the banks to use the International Financial Reporting Standards for supervisory reporting. We have chosen not to exercise this option. It would have imposed a disproportionate burden on those banks that draw up their balance sheets according to national standards. Banks may therefore continue to use national standards for their supervisory reporting.

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

And one last example: the supervisory fees are also based on the principle of proportionality, rightly taking into account the significance, the size and riskiness of the respective institution. Of this year's fees, around 88% are allotted to the 129 institutions directly supervised by the ECB, 12% to 3,200 smaller banks.

Conclusion

Ladies and gentlemen, harmonising banking regulation and supervision in Europe plays a key role in ensuring the stability of the banking sector and in providing the basis for prosperity and growth in the euro area. With regard to the banking sector, we have in the last year-and-a-half come a long way, but there is still much to do.

In view of the increasing harmonisation of regulation and supervision their proportionality is a recurring issue, not least because the complexity of regulation has increased. Again, it's always being said that smaller banks above all are bearing a disproportionate burden; and again, a reduction of these burdens is always being called for.

This discussion is important, but it must be conducted in a discerning way. First, regulation and supervision already follow the principle of proportionality – I have given some examples. Second, the complexity of regulation and supervision is not least due to the increasing complexity of the banking business. And third, the principle of proportionality must not be used as a pretext for generally weakening regulation and supervision. The basis of the discussion must always be the cost-effectiveness of regulation and supervision – proportionality must not come at the expense of stability.

As I said earlier, there was a heated discussion in the Freemasons' Tavern too about an important set of rules. What started in 1863 in London will again be in the spotlight as of 10 June, for that's when the Euro 2016 championship starts. As a professional European I naturally have no favourites. I look forward to a fair competition, and may the best team win. But if it happens to be Germany, I wouldn't complain.