# Sabine Lautenschläger: Interview in Expansión

Interview with 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, in *Expansión*, conducted by Ms Alicia Crespo on 7 July 2016, and published on 18 July 2016.

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***How will Brexit affect the Spanish and EU banking sectors?***

The good news is: there have been no funding, liquidity or operational problems in SSM banks since the referendum. Operationally, financial markets have been functioning well. There is of course the risk that a prolonged period of uncertainty about the future relationship of the UK with the EU creates a wait-and-see mood, including increased risk aversion of investors and markets. With all due respect to the political process, it would be good to settle the situation in due course; in fact this is very important.

However, we are witnessing a new wave of risk aversion affecting share prices of banks not exclusively linked to banks with relevant exposure or operations in UK. This risk aversion might partly be linked to concerns about the future profitability of some banks.

***Where should the City relocate to? Frankfurt? Paris...?***

It's too soon to be talking about this. Whether financial activities relocate away from London, and how they do so, depends to a large extent on the negotiations between the EU and the United Kingdom, and on the type of relationship they arrive at.

***Brexit has exacerbated the problems in the Italian banking sector. Should the government inject public money?***

As the banking supervisor for the euro area, we ensure that banks face up to their problems, have a strategy regarding the risks in their balance sheets and do their homework. In a best-case bad scenario, private money supports banks which are struggling. In a worst-case scenario, the euro area is fundamentally better prepared than in 2008. We now have a whole set of instruments which allows the European Commission, national governments, the Single Supervisory Mechanism, the Single Resolution Board, and other stakeholders to deal with difficult situations.

***But all of the post-crisis legal architecture is seeking to avoid taxpayers having to pay for bank failures. Don't Rome's plans go against the banking union?***

The responsibilities for state aid and resolution rest with the European Commission and the Single Resolution Board, in cooperation with the respective Member State. I trust that any solution will fully respect the principles of the banking union. The supervisor has to ensure that the banking system is sound and can fulfil its function. If individual banks fail to do so, the supervisor alerts the above-mentioned authorities and works towards a sustainable solution.

***Is Italy currently the most serious risk to financial stability in Europe?***

It must be recognised that the resilience of banks and financial systems has improved significantly in recent years. We are far too quick to forget this. The European banking sector holds significantly more capital than in 2008, and this capital is of higher quality. There are of course unresolved issues and we might be seeing a contagion effect on banks' share prices, which could be an overreaction. Ultimately, a combination of different factors is at play. It's not just Brexit; it's also a question of the outlook for growth as well as geopolitical risks.

***The profitability problem is getting worse. A Spanish banker has said that the banking sector is being killed by such low rates.***

Low profitability is not only due to the low interest rates. Fierce competition and unresolved legacy issues such as non-performing loans weigh on the profitability of banks. Also, the extremely accommodative monetary policy also entails advantages for banks over the medium and long term. It drives economic growth to the benefit of citizens and companies, and ultimately the banks themselves. The banks must acknowledge and conduct their business within the prevailing macroeconomic environment. Their challenge and their job is to make their business models less dependent on interest margins by increasing fees and other sources of income. Efficiency, sales channels and cost-cutting also play important roles.

***How is the Spanish banking sector doing? What advice would you give?***

Its profitability and efficiency are better than the European average. In terms of efficiency, it's among the best in the euro area. These are the strengths. As for the weaknesses, many European banks – and not just Spanish banks – must do their homework, and think about how to cut costs to deal with the challenges of 2016 and beyond. Spanish banks are dependent on interest margins and need to increase other sources of income, such as fee income. They also need to think about new sales channels and opportunities and challenges around digitalisation.

***Will all the banks under your supervision survive the next two years?***

The objective of the supervisor is to ensure the functioning of the banking system. It is not our responsibility to protect individual banks from market forces. In fact, there may be too many banks in the euro area and it is not our job or inclination to block orderly processes of consolidation.

***You say that mergers are a solution to the low profitability, but no mergers are taking place. Do we need to encourage hostile takeover bids?***

Supervisors don't do industrial policy but rather call on banks to challenge the viability of their business models, strategy and risk profile. You set expectations and requirements, and banks have to find ways to achieve them. We don't have the tools to directly promote mergers and acquisitions and I don't think the market should be subject to this sort of bureaucratic intervention. The soundest and most sustainable solutions are tough but reasonable supervisory standards and market solutions.

***The banking sector is reducing the cost of credit by lowering rates. Should they also charge savers for their deposits?***

This is a matter for the banks, bearing in mind the potential reaction of customers. They have to take into account the advantages and disadvantages in terms of costs and revenues.

***What improvements would you suggest to management boards in Spain?***

We hope that our recent review on governance and risk appetite will help banks to get to know both themselves and the industry standard better. We have seen major improvements in banks' governance, but we are far from having international best practice throughout the euro area banking system. We have, for example, spotted weaknesses in the skillsets and independence of some board members. The boards of all banks must have a broad mix of skills and different, independent viewpoints to contribute to the debate and reflect all aspects of a problem. That's good for the continued success of an institution. And some banks must do more in respect of their risk appetite framework.

***Banks are complaining that the SSM is interfering too much in their governance.***

Good governance is decisive for economic success and the stability of banks. Therefore, the relevant regulation gives us the task to push for sound governance structures in banks.

***The ECB will distinguish between capital requirements and capital guidance in 2016. How will it ensure that banks comply with the part which is not binding?***

The capital demand set by the supervisor (SREP) is split in two, with a requirement linked to the overall risk profile and a guidance related to the results of the adverse scenario of the stress tests, among other factors. The latter would not be binding in the sense of triggering automatic supervisory decisions, such as a cap on dividends, but we expect that banks will comply with it. In severe cases, we can also transform the guidance into the requirement or call for additional measures to mitigate or reduce risks, such as the sale of assets.

***The capital requirements are being eased to help the banking sector pay dividends, CoCo bonds and bonuses.***

Capital demands are not being eased. The level of capital will stay broadly the same, all things being equal.

***The profitability of the banking industry has fallen but bankers' pay has risen.***

As prudential supervisors, we are mainly concerned if too high pay endangers the solvency of a supervised entity. To this end, we analyse the yearly remuneration packages in relation to the bank's existing capital and the capital it may need in order to comply with the progressive demands of Basel III. If the remuneration is too high and the bank cannot retain profits and use them to increase its capital to meet those demands, we impose restrictions.

***How can the market be convinced that the stress tests are useful if each bank's results are not published and capital is not required?***

Stress tests were created to provide supervisors and the public at large with information about the resilience of banks in certain hypothetical scenarios and are very useful in identifying vulnerabilities in banks. The solution to these weaknesses is sometimes but not always more capital. For example, one solution could be changing the composition of a portfolio of loans in order to avoid excessive risk concentration. But the results will also be one important input factor into our capital guidance. Let me also remind you that for the upcoming EBA stress test, the results will be published for banks that represent 70% of the assets of the euro area.

***Brussels and certain sections of the ECB want to ease capital requirements to boost growth. How does the SSM deal with such pressures?***

Only strong banks that are adequately capitalised can offer loans through the cycle and play their part in the economy. Lowering capital requirements will not create sustainable growth.

***You are examining the internal risk models which banks use to calculate their capital. Do you think they are playing games with the supervisor in order to circumvent solvency requirements?***

We have come from a system with 19 different supervisors and countless ways of authorising and applying internal models. We are working on a process and joint criteria to ensure a true level playing field. The objective is to define supervisory expectations and issue recommendations which ensure that internal models yield consistent results across institutions.

***You want to penalise the holding of government debt by the banking sector. Might that not be a major problem for countries and banks?***

The financial crisis has shown that there is no risk-free asset. This includes government bonds. The incentives set by the regulatory framework have to be aligned with this insight. Obviously, this is not only a European issue. The solution has to be global. We have to discuss this important issue in the Basel Committee, recognise that there are no risk-free assets and calibrate the rules properly. Sensible rules and adequate transition periods can help mitigate all related risks.