Sabine Lautenschläger: Two years and three days of European banking supervision – what has changed?

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 and Corporate Evening of the Deutsche Bundesbank's Regional Office in Bavaria, Munich, 7 November 2016.

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Ladies and gentlemen,

Do you remember 28 June 2012?

On that day – which was a Thursday, by the way – a new parliament was elected in Mongolia, while, in Berlin, the Bundestag approved a draft law on the taxation of sports betting. Forest fires were raging in the United States and the United Kingdom was being battered by storms. Here in Munich it was close to 26°C with intermittent clouds.

You probably don't remember any of that. But perhaps you do remember what happened in Brussels on 28 June 2012. There, the EU Heads of State or Government were meeting to discuss the crisis in the euro area, which had then reached a new climax. This meeting resulted in a decision to create a European supervisory authority – a "single supervisory mechanism" as it was called in the summit statement.

Things moved quickly after that. Barely two years later, on 4 November 2014, the ECB officially assumed responsibility for banking supervision in the euro area. Today, it is therefore two years and three days since European banking supervision was established.

And the question this evening is: what has changed since then?

European banking supervision has arrived

What has fundamentally changed is that banks in the whole of the euro area are now supervised based on the same high standards – as objectively as possible, not through national lenses, and following the principle of "same business, same risk, same supervision".

That increases the stability of the banking sector over the long term, helps rebuild trust in European banks and contributes to fair competition.

Have we already achieved everything that European supervision was supposed to achieve? I think we've come a long way in the last two years and three days, but we have not yet reached our goal.

I'd like to go into two important topics in more detail, since here in Munich, the capital of Bavaria, it's also okay to blow your own trumpet sometimes.

First, we have developed a common methodology for the most important banking supervision tool: the Supervisory Review and Evaluation Process, referred to by the experts as the SREP.

We currently carry out the SREP for the 129 biggest banking groups in the euro area. These are the banks that are directly supervised by the ECB. We scrutinise each and every one of these banks and determine their risk profile. We are extremely thorough and comprehensive: we look not only at the amount and quality of capital and liquidity, but also at the corresponding risk management, as well as the business model and governance.

Based on this, we determine how much supervisory capital the bank should hold – this is in addition to the regulatory capital already required. We also set the bank's supervisory liquidity requirement. And if necessary, we can take additional, specially tailored measures.

Bank supervisors across the whole euro area are therefore now working using the same methodology – a methodology which combines the knowledge and experience of the supervisor with the analysis of hard data.

This is where we benefit from the fact that, as European supervisors, we are supervising more banks and therefore have access to a wider set of data than the national supervisors had for their national banking sector.

For example, we can create groups of comparative institutions for almost all banks and lines of business, across the whole euro area. This makes it possible to conduct comparative analyses, which help us to assess business activities, such as leveraged finance, and the related internal bank management more quickly and accurately as well as to identify risks early on. We made great progress in this last year.

And we have not only developed a single SREP methodology. We have also harmonised the way in which euro area supervisors exercise the national options and discretions provided for in the banking regulation. We have agreed to use this room for manoeuvre in a uniform way. Anything else would be unthinkable for a European supervisory body which has the principle of equal treatment in its mandate.

That was an important step, but we still need to do more. In many cases, banking regulation continues to be very nationally focused. This is partly because quite a number of European rules still need to be transposed into national law and the way in which this is done can look quite different in France compared with Germany or Spain, for instance.

Differences in the regulation applicable to systemically important banks, such as differences in risk management requirements for investment banks depending on their home country, don't make sense. It only makes sense to have different rules if national specificities create risks that need to be assessed differently. Because the principle of "the same supervision for the same business and the same risk" does not mean taking a "one size fits all" approach just for the sake of it.

By way of illustration, let me give you an example of differences that do not make sense and that make our lives as European supervisors very difficult. Banking supervisors assess whether candidates for banks' governing bodies are "fit and proper". This is an important task, but the rules underpinning it vary considerably across countries.

In some countries, for example, it's not only candidates for the governing bodies that are assessed, but also those for key positions at the levels below.

In some countries, a candidate is not considered fit and proper if he or she has been convicted in the court of first instance of offences against property; in other countries this only applies to convictions for specific offences against property and only if it is a judgement from the court of last resort.

In some countries, the candidate is not allowed to take up the new position until the supervisor has approved it; in other countries, the candidate can take up the position even before the documents needed for the assessment have been provided.

These regulatory differences are an obstacle to a common market. Not only that, it also means we are obliged to take into account 19 different procedures instead of one common one. That is bureaucratic and expensive. If politicians are serious about the banking union and the single banking market, they must commit to removing these "unjustified" differences in banking regulation.

So much for regulation, let's come back to supervision. Of course, European banking supervision first and foremost affects the 129 large banking groups that are directly supervised by the ECB – for them, quite a few things have changed.

For the roughly 3,200 smaller banking groups, at first glance it would seem that not so much has changed; they continue to be supervised by the national supervisors.

If you look again, though, you'll see that progress has been made in the supervision of smaller banks as well. Together with the national supervisors, we have developed a range of common standards that provide a kind of tool set that all supervisors can use and which are intended to help them in their daily work.

We are currently working with the national supervisors on developing a SREP methodology for smaller banks. We are building on some of the experiences gained and solutions found during the harmonised SREP for the large, internationally active banks, though of course this will be a much slimmed-down version that takes the features of smaller banks into account.

Of course, national supervision can also benefit from the additional knowledge provided by European supervision. This ranges from the exchange of information on acute risks, through to the question of how smaller banks in other countries have developed structurally and what that could potentially mean for the domestic banking sector.

There are two things about the supervision of small and medium-sized institutions I'd like to clarify, though.

First: we are not trying to make one size fit all by replacing national supervisory approaches with a European one. We are more interested in making sure that there are minimum standards in place for the core elements of supervision.

Second: we are also not trying to make one size fit all by making national supervisors treat small banks in the same way as large ones. The principle of proportionality is absolutely sound; smaller banks generally represent a smaller risk and therefore do not need to be as strongly regulated or intensively supervised as large banks.

So European banking supervision has changed a few things for banks – a bit more for the large ones and a little less for the smaller ones. But what about the bank supervisors? The world has also changed for them. They have been thrown into an international environment; they have to bring together different supervisory cultures and become familiar with new processes and ways of working.

This is a challenge and a lot of work, but it is also a wonderful opportunity. We are seeing a European supervisory culture gradually form, supported by a community of European supervisors. In my view, banking supervision is already a good example of how cooperation in Europe can work.

Without question, we can and must improve our methods and processes even further, and we are currently working on doing that. But if you consider the fact that European banking supervision has only just celebrated its second anniversary, it has already made quite some progress in its early years and has had to grow up quickly. As part of the banking union, it contributes to creating a level playing field for banks. These are the foundations on which a European banking market can be built. That's our vision.

The European banking sector – still in the making

In a European banking market, banks would offer their products and services across borders and enjoy the benefits of a large marketplace. At the same time, borrowers and savers could choose from banks across the entire euro area and be sure that all of these banks are supervised according to the same high standards. Risks would be spread more widely, making the banking sector more stable. It would also be better at allocating capital to where it is of the most benefit, which would in turn help the economy.

In any case, we're not there yet. During the crisis, the banking markets in the euro area drifted apart somewhat and have not really come back together since then. That being said, they appear to have started moving closer together again since the end of 2012. But we can't yet speak of a single banking market in the euro area.

One indication of this is, for example, the fact that interest rates on savings still vary across countries – even if they are gradually adjusting. We see a similar picture if we look at quantity rather than prices. Only a small part of all loans are extended across borders, and savings are rarely deposited across borders.

The banking union is laying the groundwork for a European banking sector, but in order for it to flourish, more needs to be done. Think about all the other areas of legislation that are important for the banking business – insolvency law, for example, or tax law. Here, there are still many differences that stand in the way of a European banking market. And even if all of these obstacles are eliminated at some point, a European banking market won't be created overnight.

So, currently there is no truly European banking market and it looks set to stay that way for the foreseeable future. There is European banking supervision, however; and that is already a substantial achievement.

The situation in the banking sector – challenges...

Prior to November 2014, bank supervisors for the most part only looked at their respective national banking sector. Now we look across national borders at the entire euro area. We see the whole picture – we can compare banks and their business activities and identify common problems.

But what is the current state of the banking sector? Let's look first at the positive developments. In the past few years, euro area banks have become more resilient. The most important safety buffer for institutions – namely, equity capital – has increased significantly in recent years. The core capital ratio of the large European banks has increased by half in just four years – from 9% in 2012 to 13.5% today.

Banks therefore have a bigger and better buffer to protect themselves against losses. The most recent stress test confirmed again that European banks would be able to withstand even a severe economic crisis.

But that doesn't mean that bankers and supervisors can put their feet up and close their eyes. Then they would lose sight of all the challenges banks must face.

And this is where it is clear how fragmented the European banking market still is. Some of the imminent challenges affect all banks, others affect banks with certain business models or mainly affect banks in certain countries.

What many euro area institutions are suffering from is an almost chronic weakness in earnings.

The average return on equity of the large euro area banks is just under 6%, while the estimated cost of equity is above 8%. This barely sustainable ratio of returns to costs is the reality in most euro area countries, including Germany – here, returns are even below the European average.

These weak earnings are not only a cause for concern for bankers, but for us supervisors, too, because only profitable banks can conclude enough new business, build up sufficient buffers for the risks they take on and still be attractive to investors.

So why is it that banks' returns are so low? Many in this country – bankers as well as some politicians – would answer "because of strict regulation and low interest rates". Let me say immediately that anyone who is satisfied with this answer is overlooking a few things – intentionally or not.

Let's start with regulation. It is indeed true that regulation has become stricter since the crisis. And it's true that banks have to put in a lot of effort to adapt to the new rules.

And yet: as a supervisor I look at the new regulatory framework in a rather favourable light – as do taxpayers and all those who suffered during the recent crisis. Because if we talk about the cost of regulation for banks, we also have to speak about the cost of crises for others.

That throws a different light on the discussion and even gives reason to believe that the banks themselves ought to look a bit more favourably on the regulation. Because they, too, suffered as a result of the crisis. In addition, better regulation helps them to rebuild the trust that was lost in the crisis.

But one thing is clear: the regulatory framework cannot be so tight that banks suffocate. What we need are rules that provide stability without making it impossible to finance the real economy at prices that take adequate account of the risk. That is a key criterion – especially in a country like Germany, where so many companies rely on bank loans for funding.

We have been working on this regulatory framework, referred to at the global level as Basel III, for several years now. In order to give banks certainty about the future rules, we should complete this work now.

And we must complete it at the global level. Markets and market participants are interconnected. The resulting risks do not stop at national borders. That's why we need to agree on minimum standards at global level, at least for systemically important banks. Moreover, investors in European banks are guided by compliance with global rules. The banking system is global and needs a global regulatory framework – anything else would be a step backwards.

So much for regulation. Let's turn now to the low interest rates.

The discussion around the low level of interest rates has been particularly loud and emotional in Germany. There are two reasons for this.

First of all, Germany has a particularly large number of banks whose business models are very dependent on interest rates. For the smaller institutions, net interest income makes up almost 60% of their operating result – though the figure for large banks is not much lower.

Second, German savers usually put their money in bank accounts and rarely invest in the capital market – meaning that savers' business model is also very dependent on the interest rate.

That being said, in my opinion, the debate in Germany has been rather one-sided. The prevailing view here seems to be that the ECB is wilfully implementing a monetary policy the only effect of which is to harm banks and savers – especially German banks and savers.

I'm not really known to be particularly doveish; quite the opposite, in fact. However, when it comes to "low interest rates", I need to clarify three things that have been neglected in the German debate.

First, the ECB does not set interest rates arbitrarily. The rates always reflect the economic situation, which is influenced by things outside the scope of monetary policy, such as tax policies, fiscal policy and structural reforms, which secure the future sustainability of the national economy. It is therefore short-sighted to hold the ECB alone responsible for the low interest rates. That's a bit like blaming the dentist because he has to give you another root canal.

Second, what would happen if interest rates were to go up now? The recovery would be stifled, unemployment would increase and inflation would fall. Would that help savers, most of whom are also employees? Would that help banks, whose returns and impairment losses depend on how well the economy performs? I don't think so.

Third, low interest rates are only partly a cyclical, or temporary, phenomenon. In fact, interest rates have been falling for several decades now, worldwide. This is the result of structural, or long-term, developments. One example is demographics: ageing societies save more, the supply of savings increases, the interest rate falls.

In summary, the phenomenon of low interest rates is more complex than the debate in Germany would suggest.

But that doesn't change the fact that I'm very sceptical as far as further interest rate cuts or additional expansionary monetary policy measures are concerned – over time, the benefits of these measures decrease, while the risks increase.

And of course it doesn't change the fact that low interest rates, just like stricter regulation, represent a challenge and a strain for the banks.

But – and this is the next important point – they are not the only challenges. The weak earnings of several European banks are down to more than just stricter regulation and low interest rates.

In addition to interest income, fee income is the most important source of income for most banks. And this part of earnings, which is not dependent on interest rates, is also coming under pressure – since last year the net fee income of large euro area banks has fallen by almost 7%.

Structural developments are playing a role here, too. One example is the capital market business: institutional investors are becoming increasingly interested in simple, passive investment strategies. From the banks' perspective, this is of course a problem, since the simpler the product requested by the customers, the lower the commission for the bank.

And while we're on the subject of banks' earnings, we must also speak about their costs. As every businessman or woman knows, a company's profits don't depend only on turnover, but also on costs. And costs for European banks are still comparatively high. For each euro they earn, they must spend almost 65 cent – for German banks, it is as much as 72 cent.

Banks' earnings are therefore relatively low, while their costs are relatively high.

At the same time, some banks in Europe are still encumbered with legacy assets – non-performing loans, for instance. Non-performing loans not only weigh on banks' earnings, they also limit their ability to extend new loans. So in some parts of the European banking sector, such loans are contributing to the weakness in earnings as well as limiting investment and economic growth.

If we look beyond individual banks, we can identify another cause of the weakness in earnings. European banks have to survive in a market characterised by overcapacity – there is often talk of "overbanking". That doesn't necessarily mean there are too many banks or that banks are too big. What it means in general is that there is an oversupply of banking products. Competition is therefore tough, which puts pressure on earnings.

This is clearly not sustainable – especially if banks' earnings are coming under pressure from other directions. In a functioning market, overcapacity should disappear over time – either because weaker banks exit the market, or because banks merge.

We can thus expect the market to consolidate. We are already seeing some initial, sometimes tentative, signs of this, especially in countries whose banking systems are still very fragmented, namely Germany, Austria and Italy.

But the market is also changing for other reasons. Digitalisation has set off a technological transformation that could fundamentally change the banking business and the banking market.

The former chairman of the US central bank, Paul Volcker, once said the last meaningful invention in the financial sector was the ATM. In some ways, digitalisation is now taking the principle of ATMs a step further. Thanks to ATMs, we have access to cash around the clock. Thanks to new digital products, we now have access to almost all banking services, from all over the world, around the clock.

Digitalisation is therefore changing customers' behaviour and expectations, just like ATMs did. Today, would you open an account with a bank from which you could only get cash during its opening hours and only from the counter? Now, like then, banks do well to adapt to their customers' expectations.

And the competition doesn't sleep. With digitalisation, new providers, referred to as "fintechs", are making advances in the banking market. They have the technical knowledge and the necessary IT systems to both take advantage of and drive forward the digitalisation trend.

A Chinese proverb says: "when the winds of change blow, some people build walls, others build windmills". The fintechs are clearly building windmills; perhaps the banks should too.

Ladies and gentlemen, European banks are suffering from weak earnings, the causes of which go far beyond stricter regulation and low interest rates. Banks must clear their balance sheets of legacy assets and get their costs under control. But most of all, they need to adjust their business models.

Only then will they be able to restore their profitability, which is in their own interests, in the interests of their customers and in the interests of the economy.

... and risks

Banks' business models continue to be one of the most important topics for us as supervisors. We are also of the view that some institutions urgently need to adjust their business models.

And when I talk about "adjustment", I mean sustainable adjustment. Banks could of course embark on a search for yield by taking ever greater risks, but this type of adjustment would lead straight to new problems – for the bank itself and quite possibly for the banking system as a whole.

Against this backdrop, we take a close look not just at the banks' business models, but also at their risk management. Good risk management is crucial and it only works if, first, the decision-making process is properly structured and, second, the decision-makers have the right information at their disposal. Governance therefore has to be right, and so does data quality.

We carried out an assessment of the governance of the large euro area banks, the results of which were published in June. The banks have already made some improvements, but most of them are still a long way from international best practice, so there is some catching-up to be done.

On the issue of data quality, guidance is provided by the principles of the Basel Committee on Banking Supervision. We are also taking a close look at this area to assess the extent to which banks are following these principles.

In addition to business models and risk management, there is a third topic that concerns us as supervisors, and that is credit risk. I have already mentioned the issue of non-performing loans in some euro area countries. This issue urgently needs to be resolved, not only in the interests of the banks themselves, but also in the interests of the economy.

However, non-performing loans cannot be disposed of overnight. It is clear that some banks need to clean up their balance sheets, but the speed at which they can do so depends on a number of factors. Things like national insolvency law, national rules on realising collateral and the effectiveness and efficiency of the judicial system all play a significant role, and they do not always foster the speedy reduction of non-performing loans. Such a reduction can also be hampered by a lack of mature markets for non-performing loans.

For our part, in September we launched a public consultation on guidance for dealing with non-performing loans. This guidance brings together recommendations for banks and a number of best practices, and will constitute our supervisory expectations in the future.

Conclusion

Ladies and gentlemen, I started my remarks by asking what has changed in the two years and three days since European banking supervision began. In answering this question, I went far beyond the topic of European banking supervision, as you no doubt will have noticed.

The world of banking has indeed changed fundamentally since the crisis, and is still changing now. Banks have to adapt to these changes: to European banking supervision, stricter regulation, lower interest rates and digitalisation.

That is not easy, but there is no way around it. As Charles Darwin discovered, it is not necessarily the strongest or the most intelligent that survive, but those who are most prepared to adapt.

Thank you for your attention.