Sabine Lautenschläger: Walled off? Banking regulation after the crisis

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 Institute of International and European Affairs, Dublin, 13 March 2017.

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Walls have their place in human history. Just think of the Great Wall of China or Hadrian's Wall or the Berlin Wall. And then there are the more abstract walls: paywalls or Chinese walls, for instance.

In my speech today, I would like to discuss banking regulation – which some see as a massive wall of rules. If you asked bankers, some would certainly claim that they have been imprisoned by that wall and would even like to tear it down – some politicians might feel the same way.

However, to paraphrase the American poet Robert Frost: "Don't ever take a wall down until you know why it was put up". You will understand that I, as a German, cannot fully support this statement but with regard to regulation this advice is appropriate. Following that advice, let us have a look at why the regulatory wall was put up.

Why banks need rules

Why do we need rules at all? Rules confine us; they limit our freedom. Take the rules of the road as an example. You can't drive as fast as you want; you have to wear a seat belt and you have to stop at red lights. These rules exist to make our lives safer. They help to prevent accidents; they protect drivers, passengers and pedestrians.

And that also applies to banking rules. Banks take on risks – that is part of their job. These risks, however, can lead to huge losses – not only for the banks and their investors, but for the entire economy and all of us.

In the euro area, it is mostly banks that finance the economy. They also take in deposits and provide other essential services, in payments, for instance. It is therefore crucial that banks work well – not only in the short run but in the long run. So it makes sense not to give them absolute freedom, but to wall them off from the biggest risks.

After all, bankers are people. Like the rest of us, they sometimes tend to overestimate potential profits and underestimate risks. Markets can get carried away, as Alan Greenspan said, by irrational exuberance. Expecting eternal growth, banks might make huge investments. But at some point reality hits, and it might hit hard. If it does, those who took on too much risk might fail. And the crisis taught us that the failure of a single bank can damage the entire financial system and the economy.

In a nutshell, that's why banks need rules. That's why the regulatory wall was put up in the first place. And following the financial crisis, we have repaired and modified it.

Not all banks, of course, are happy with the new wall. While they seem to agree with regulation in principle, they usually think it is too strict. They say that the sheer number and complexity of the new rules increase the costs of doing business. They also say that this limits their ability to finance the economy. In short, the banks claim that regulation hurts them, the economy and, thus, all of us.

Unsurprisingly, I disagree. It is true, of course, that there are many rules; and it is true that the rulebook is very complex. But then again, banking has become very complex. Over the past

decades, banks have come up with ever more sophisticated innovations – all of them have added to the complexity of banking but not always to its value. The rules just mirror this complexity.

Let me give you an example. Banks favour what is known as "internal models". Using these models, they calculate how risky their assets are. The risk-weighted assets then form the basis for calculating capital requirements. So banks are clearly in favour of risk sensitivity when it comes to determining the adequate level of capital. And I too see merits in that approach.

But internal models are complex, and to keep them in check, we need complex rules. These rules, for instance, require banks to comply with certain conditions before they are allowed to use their models. Without these rules we would quickly experience a race to the bottom in capital and an uneven playing field.

It is true that rules impose a burden on those who have to comply. And the pressure on banks has increased quite a lot since the crisis; I won't deny that. Still, there are two points I would like to make.

First, we seek to ensure that the burden is reasonable. Take reporting, which banks often describe as a major burden. However, to do our job, we need data from banks – not just on internal models but on all sorts of things. And this data needs to be comparable across the euro area; we must be able to compare banks with their peers, be they Irish, French, German, whatever. We therefore need a European approach to reporting. In this regard, it would lighten the load on banks if national regulators and supervisors were to adjust their own reporting requirements and processes to the new European reality.

My second point is that rules may not only put a burden on banks but also offer them benefits. Strong rules foster trust. Would you get into a taxi if you knew the driver was not bound by traffic rules? Would you do business with a bank that was not regulated?

Banks with a low level of capital and inadequate internal controls are viewed with suspicion: investors ask for higher risk premia and the banks thus face higher funding costs. Banks need people's trust to do business, but as a result of the crisis they have lost a lot of trust. They should bear this in mind when complaining about regulation.

Now, do bank rules harm the economy? This question mainly, but not only, focuses on capital requirements. Usually, the argument goes like this: capital is expensive for banks and might prompt them to increase lending rates. And even worse, it might cause them to stop lending altogether for fear of not meeting their capital requirements. That in turn would choke credit growth and damage the economy.

But consider the benefits. Banks which are well capitalised are well prepared to withstand shocks. It is these banks that keep credit flowing to the economy even when the going gets tough. These banks can finance the economy throughout the entire business cycle.

Banks with low levels of capital, on the other hand, are more likely to face a crisis, and banking crises are costly. They inflict damage on the economy by hurting growth, destroying jobs and putting a burden on taxpayers. As a matter of fact, recessions that accompany a banking crisis are much more severe than "normal" recessions.[1]

So, strong rules put a burden on banks. But at the same time, they do help the economy. Only well-capitalised, well-managed banks do a good job of lending to the real economy over the short, medium and long term. The net benefit should be positive. Empirical studies indicate that the benefits of higher capital are indeed greater than the costs.[2] To me, higher capital and strong rules in general seem to be a small price to pay for a more stable and prosperous economy. And the banks themselves also benefit from more stability, of course.

Against that backdrop, I favour a strong regulatory wall. But, work on that wall seems to follow a pattern. After a crisis, the wall is usually reinforced. Then, after some time, as the crisis fades into the background and tends to be forgotten, someone starts chipping away at it. The risks start penetrating the cracks in the wall, eventually leading to a crisis, and the cycle begins again.

I'm afraid that a change of direction lies just ahead. There are more and more voices calling for an easing of the rules – not just banks, of course, but also some politicians. My advice to them is: don't weaken regulation just for a short-lived increase in growth prospects.

Instead, we should finalise the reforms as quickly as possible. We have been repairing and modifying the regulatory wall for eight years now. It's been a long time, and I understand that the reforms have created uncertainty for the banks. It's time to finish the job. It's time to finish the job and to focus on implementing the rules.

Writing the rules

However, the job can only be finished at the global level. We must not build walls that separate nations; we must build a global regulatory wall. The financial system knows no national borders, and regulation must be equally global.

It is the Basel Committee on Banking Supervision that is in charge here. Founded more than 40 years ago, it has become the main forum for discussing and drafting global rules for banks.

The Basel Committee comprises central bankers and supervisors from 28 countries. Since the crisis, it has devised an improved set of global rules, known as Basel III. While much of Basel III has already been agreed upon, some final issues remain open. These are still being debated by the Basel Committee. In my view, it is time to conclude that debate and bring the reforms to an end.

With regard to the reforms, I sometimes hear people complain that the Basel Committee lacks democratic legitimacy. They say it's an opaque body that imposes its rules on banks all over the world. The answer, of course, is that the Basel Committee does not impose anything on anyone; it does not set binding laws. It defines global standards. These standards are mere proposals submitted to lawmakers. It is they who decide whether the proposals are to be transposed into actual laws.

In the EU, it is the European Commission that proposes such laws. The European Parliament and the Council of the EU then decide on whether to pass the laws. The key decisions are thus taken by elected national and EU representatives. It is they who decide on European banking law.

European law comes in two forms. First, there are regulations. These are directly applicable in all EU countries and provide a truly level playing field for banks. Second, there are directives. These still need to be transposed into national law. And this often leads to differences – the outcome in Ireland might be different from the outcome in Germany or Spain.

This is not a problem in itself as long as the differences are rooted in country-specific risks. But there are still some unjustified differences; there are some uneven patches on the playing field.

Such patches run counter to the idea of a European banking union. They prevent the European banking sector from growing together, and they make European banking supervision less efficient. They require us to apply 19 different national rules instead of a single European one. That is bureaucratic, and it is expensive, first and foremost for banks. If policymakers are serious about European financial integration, they must further harmonise the relevant rules.

And there is another source of fragmentation. EU banking law contains some provisions that are known as options and discretions. Some of them give supervisors leeway in applying the rules. It

was therefore one of our first major projects to tackle the issue of options and discretions. Together with the national supervisors, we have agreed to exercise them in a uniform way across the euro area. We have made the playing field a bit more even. But there are also options and discretion which fall within the competence of the Member States. And here harmonisation based on the "same business, same risks, same rules" principle is paramount, too.

Rules carved in stone?

To sum up: I am very much in favour of a strong regulatory wall, and I am convinced that it has to be global. I am also in favour of harmonised rules in Europe.

Still, rules must not be carved in stone, of course. Driven by innovation, the banking sector constantly evolves – new instruments are devised, new risks emerge. The rules must reflect such change. After all, the financial crisis was partly caused by financial innovations that took place outside the regulatory wall.

To be sure: eight years of regulatory reform have led to a comprehensive renovation of the regulatory wall. Now it may be time to check whether all the pieces, all the bricks, fit together. And it may be time to make sure the new rules have no unintended consequences. But I don't expect any major revisions, just some minor adjustments.

In any case, I welcome the fact that the European rules are now being reviewed. In November, the European Commission made proposals on how to adapt and amend the relevant laws.

And there are a lot of good things in these proposals.

- First, they support the idea of the global regulatory wall. They seek to transpose a series of global standards into European law – the leverage ratio is one example.
- Second, they support the goal of creating a truly European banking sector. They allow for capital and liquidity waivers to be granted for intragroup exposures – not just within a single country as before, but on an EU cross-border basis. This would make life easier for banking groups that span the entire EU.
- And third, they support the principle of proportionality. They seek to ease the regulatory burden on smaller banks. And that's good: smaller banks generally represent a smaller risk and therefore do not need to be as strongly regulated as large banks.

But there are also items in the proposals that should be further discussed.

- First, supervisors need to be able to act quickly and flexibly, based on their judgement and expertise. A few proposals, however, seek to put a tighter frame around supervisory actions. That would limit our ability to adapt our actions to the ever-changing financial industry – an industry that is always looking for the best deal, that is always testing the boundaries of regulation and that seizes any opportunity to arbitrage the rules.
- Second, in some cases, the proposals deviate from global standards – for instance, with regard to liquidity rules. Sometimes, these deviations just reflect EU specificities and do not run counter to the goals of regulation. In other cases, we would need to ensure that the deviations do not increase risks.
- And third, I still hope for more harmonised rules – I have already touched upon that issue. There are, for instance, still some unwarranted options and discretions that lie within the competence of Member States. These uneven patches in the playing field should be repaired.

Conclusion

I have argued that banks need rules, and that these rules need to be global. I have therefore warned against leaving the global regulatory wall unfinished or even tearing it down. It protects us all: taxpayers who had to bail out failing banks during the crisis; savers and investors who lost money; business owners who could not get loans; and, yes, it also protects the banks themselves.

Still, the history of finance seems to follow an eternal cycle. A crisis happens and the rules are tightened. After a while, people forget the crisis, and the rules are loosened. This leads to the next crisis, which takes everyone by surprise. The rules are tightened.

Listening to some politicians, I am worried that we are about to enter the next stage of the cycle: a new wave of deregulation. As George Bernard Shaw said: "If history repeats itself, and the unexpected always happens, how incapable must man be of learning from experience!". Isn't it time to prove that we are capable of learning from experience?

Thank you for your attention.

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1 Reinhart, C. and Rogoff, K. (2009), "This Time is Different", Princeton, NJ. Jorda, O., Shularick, M., Taylor, A.M. (2011), "When Credit Bites Back: Leverage, Business Cycles, and Crisis", NBER Working Paper No. 17621.

2 Fender, I. and Lewrick, U. (2016), "Adding it all up: the macroeconomic impact of Basel III and outstanding reform issues", *BIS Working Paper*, No 591; De-Ramon, S., Iscenko, Z., Osborne, M., Straughan, M., Andrews, P. (2012), "Measuring the impact of prudential policy on the macroeconomy: a practical application to Basel III and other responses to the financial crisis", *FSA Occasional Paper*, No 42. Yan, M., Hall, M.J.B., Turner, P. (2012), "A cost-benefit analysis of Basel III: Some evidence from the UK", *International Review of Financial Analysis*, Vol 25, pp 73-82.