Sabine Lautenschläger: Dealing with a globalised banking sector

Statement by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at George Washington University Law School, Washington DC, 16 October 2017.

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Ladies and gentlemen,

Today we can look back on nearly a decade of rule-making. Following the financial crisis of 2008, almost no stone was left unturned – at least in the field of banking regulation.

But this wave of re-regulation didn't just focus on banks; rules were put in place to increase consumer protection and regulate the derivatives business, central counterparties and rating agencies.

In many countries these changes were accompanied by institutional changes – new authorities were set up to deal with financial risks, and they were given new powers and instruments to mitigate these risks.

Authorities gained a whole new set of tools for macroprudential oversight.

The reforms were far-reaching in many countries, and in particular in the major financial centres.

And I am convinced that this overhaul will contribute to future financial stability.

There are two main reasons for this.

First, deregulation and light-touch supervision were a significant cause of the financial crisis in 2008.

In the early 2000s many believed in the self-regulation of the financial market – so restricting the entrepreneurial freedom of financial market participants was not at the top of governments' to-do lists.

This all changed with the financial crisis, which was costly for banks, their investors and the taxpayers in many countries. In addition, the crisis was followed by an economic recession.

Banks, for example, now have to comply with a strict set of rules – they have to hold more and better capital than they did ten years ago. Their capacity to absorb losses has increased significantly. Banks are better prepared for a potential drying-up of liquidity sources, as the quantitative and qualitative requirements regarding liquidity management have risen significantly.

This makes banks more resilient to potential economic downturns or major unexpected events.

And supervision has changed quite dramatically, too. Many supervisors have been given greater powers to act pre-emptively; the set of supervisory tools and resources has expanded considerably. Supervisors are therefore able to pick up on deficiencies in banks, risky trends and misbehaviour earlier and more decisively than before the crisis.

Does this mean that there is no room to improve the current rules?

Definitely not.

There may be some topics which we have not yet addressed or which might need addressing because changes in the regulatory environment are always met with evasive manoeuvres.

One example is the shadow banking sector. When regulation is tightened in one area, incentives are put in place for other intermediaries to step in.

When certain business activities are pushed out of the banking sector, it does not necessarily mean that the risks for financial stability increase, but nor does it mean that these activities will not pose risks if they are handled by other market participants.

So developments in the shadow banking sector warrant our close attention.

Furthermore, we have to regularly assess whether the stated objectives have been fulfilled with the new set of rules. The Financial Stability Board (FSB) is currently evaluating the recent reforms, so this will give us an indication as to whether there have been any unintended consequences and whether we need to adapt some of the rules – although I do not expect a need for huge amendments.

As I mentioned, there is a second reason why I think that the reforms have made financial markets safer.

The standards were set at the global level, by the FSB and the global standard-setting bodies. This addressed one of the lessons learnt from the last crisis – financial markets and financial institutions are much more closely interconnected than most people realised.

There is no such thing as a national banking sector. The banking sector has become global. Many banks operate not just in one country, but in dozens of countries. And almost all banks do at least some business with banks from outside their own country.

Such a global banking sector is a good thing. It facilitates global trade and investment; it unlocks new sources of funding for the economy; and it improves the way capital and risks are allocated across countries.

And because the banking sector is global, the standards need to be global too, to contribute to financial stability in the major financial centres. So I hope that the latest package of global banking standards – Basel III – will be completed this year. And I am still confident that this will be the case.

After finalising Basel III, we need to focus on implementing the standards. I worry that some financial centres might not implement significant parts of the agreed framework.

And that would be a great mistake.

Without consistent implementation, the common standards will remain fragmented, leaving the door wide open to a race to the bottom in regulation, regulatory arbitrage, higher risks and future crises. At the same time, banks would not compete on a level playing field, and that would weigh on efficiency.

Ladies and gentlemen, the reforms that followed the financial crisis of 2008 were far-reaching, and they placed a burden on the financial sector – of that there is no doubt.

Do the reforms offer a full insurance contract to prevent each and every risk to financial stability? Well, no; such rules do not exist.

But there is no doubt that they help to make the global financial sector a safer place. They make it less likely that we will experience a second financial crisis of the same magnitude.

Looking ahead, we should not forget that we live in a globalised world. And any attempt to turn back time, any attempt to isolate one country from the rest of the world is not only a pipe dream; it is a perilous dream.

That is particularly true in the case of finance and banking.

So, instead of building walls, we should come together to discuss how we can deal with a global banking sector, how we can reap the benefits and keep the risks in check. That is the only way forward. Walking backwards will only lead us to where we came from: another global financial crisis.

Thank you for your attention.