Sabine Lautenschläger: Ten years after the crisis – risks, rules and supervision

Speech 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 the 13th ASBA-BCBS-FSI High-Level Meeting on Global and Regional Supervisory Priorities in Nassau, Bahamas, 30 October 2018.

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Ten years have passed since the financial crisis erupted – an entire decade. But it is still very present in our minds, and no one wants to go through it all again. So, the key question is: how can we prevent such crises in the future? To answer that question, we need an intimate knowledge of the things that led to the crisis in the first place.

As you are probably only too familiar with these things, I will spare you the long version of events. The short version is that risks were too high, rules were too soft, and supervision was too lax. Ten years on, this has changed – or has it? Are banks now better regulated and supervised? Are risks under control?

Let's take a look at whether we have really succeeded in making the banking sector a safer place.

Tougher rules – but implementation is key

Over the past ten years, a lot of brainpower has gone into untangling the complex web of factors which led to the crisis. But analysis is just the first step, of course; the second step is action. And action was and is still needed to ensure the resilience of the financial system.

We all know that it's this second step where one can easily stumble. Moving from analysis to action always requires a lot of political will and consensus. And this time, it was even more difficult. The financial crisis had revealed how interconnected the financial system had become. So any action to make the system more resilient had to be taken at the global level too. This added another layer of complexity.

But with memories of the crisis still fresh, countries from around the world managed to agree on a large set of reforms, with Basel III being the cornerstone. It took some time to finalise these reforms, but it is still a remarkable achievement.

A remarkable achievement, for sure. But let us not forget that the proof is in the pudding, as they say. Basel III needs to be implemented. And since the banking system is global in scope, Basel III needs to be implemented on a global scale.

Banking might have become a bit more national here and there, ring-fencing a bit more en vogue and the idea of withdrawing from the global stage a bit fashionable. But banks are so closely connected across borders that no national approach will ever be able to deal with the risks involved.

Against this backdrop, I am a bit worried that we are losing momentum on this front. There seems to be less and less drive to follow through on the reforms that were agreed in Basel.

Europe is no exception here, by the way. Lawmakers are reviewing the related legislation, and we are seeing some proposals which would mean that European rules deviate from the standards agreed upon in Basel. This would affect the net stable funding ratio and the leverage ratio, for instance.

It would also affect the way in which we deal with market risk. The fundamental review of the trading book is important here. It is meant to address the shortcomings of the previous market risk framework and is thus an important part of the reform package. However, it seems that we might get caught in a global cycle of postponing its implementation. This would not be good: market risk in particular is global in nature and requires global rules.

We seem to be seeing an old story unfolding before our eyes. In times of crisis, everyone agrees that tougher rules are needed. But as soon as things start to get better, rules are suddenly seen as preventing banks from doing good business and the economy from growing.

Consequently, rules are softened, banks are "freed", the economy grows, and the seeds for the next crisis are sown – because such growth cannot be sustained in the long run. Sustainable growth needs to be financed by stable banks that price risks correctly and cover them with adequate capital. It's a simple lesson, but it seems to be quite a hard one to learn.

Failing to implement the rules is a clear risk. But given the global scale of the banking sector, another risk is that the rules will be implemented unevenly. This would enable banks to go wherever the rules are softest. In the worst case, some countries might try to turn this into a business model. But let me assure you: light-touch regulation is not a viable business model. We have seen it before, and we know what comes next.

The only way to go is to implement Basel III and to do so faithfully. We need to fight the misguided attempt to sacrifice global stability in order to make national banking sectors more competitive. The risks involved outweigh the returns. And what's more, those who reap the returns are often not those who bear the risks.

But even if the rules were faithfully implemented everywhere, that would not be the end of the story. Banks still need to adjust to the new rulebook, and they might do so in the wrong way.

It is a fact of life that banks will look for room to manoeuvre, and experience tells us that they will find it. It might take some time as the framework is still new, but it will happen. And this will undermine the purpose of the rules and increase risks.

That's why we keep an eye on regulatory arbitrage. And here we quite often see something that could be termed regulatory maturity "optimisation". For example, some banks exploit the fact that prudential requirements are tied to the timing and maturity of transactions. This kind of arbitrage happens around the world and can take many forms.

One prominent example is window dressing around quarter-end dates. This affects the leverage ratio in cases where it needs to be disclosed on a quarterly basis. Banks might thus "dress up" their balance sheets just four times a year. So, it might well be a good idea to switch to daily average reporting, at least for some components of the leverage ratio.

In other cases, banks artificially reduce the regulatory maturities of transactions through the use, or restructuring, of derivatives. This allows them to exploit loopholes in the capital and liquidity standards. We keep a close eye on these trends, including the growth of the settlement-to-market model.

In order to deal with arbitrage, we need to cooperate across borders; the loopholes should be closed everywhere. Only then can we ensure the sustained effectiveness of the post-crisis reforms.

Better supervision – a new approach

Ladies and gentlemen, rules are important and they need to be implemented. But rules alone are not enough. You also need people to check whether banks are following the rules. You need supervisors.

And this leads us directly to the first “supervisory” issue. Before the crisis, supervisors often did just that: they checked whether banks were complying with the rules. This compliance-based approach proved to be too limited, though. It didn’t require supervisors to truly understand the risk profiles of banks, and it didn’t require them to think ahead and look out for new risks.

So supervisors needed to change their approach. Dealing with a global banking sector that is constantly evolving requires supervisors who know when it’s time to act, who are willing to act and who are able to act. From this, everything else follows.

First of all, supervisors must take a risk-based and forward-looking approach. The days of mere box-ticking are over.

Supervisors must understand the business models of banks and the economic environment in which they operate. They must understand banks’ internal control systems and their governance structures. And in all of this, they need to have an eye on the future: it’s not just today’s risks that count; it’s also those of tomorrow.

Next, supervisors must be adaptive. The banking sector is steadily evolving. It evolves quickly and not always in a straight line. Supervisors need to keep pace and be aware of any new risks that might emerge along the way.

In addition, supervisors must be intrusive. They must dig deep to obtain an intimate knowledge of their banks. This knowledge then allows them to be sceptical. They do not have to rely on what the banks tell them. Instead, they can form their own opinion and challenge the banks’ views.

But it’s not just about digging deep. It’s also about broadening the perspective and using all the available tools to spot trends and anomalies in the behaviour of banks as well as to identify best practices.

The ECB, for instance, benchmarks banks that pursue the same line of business. Supervising the 118 largest banking groups from across the euro area means that we benefit from a deep quantitative and qualitative analysis. This allows us to challenge banks in a more credible manner.

And speaking of credibility brings me to a very important point. Supervisors must be independent! They must be able to take their own decisions. They must be free from pressure from banks or other stakeholders – and they must be free from political trends. But it’s not just about formal independence. Supervisors must also be independent of mind. They must avoid groupthink and other biases.

And finally, supervisors must acknowledge that they are dealing with a banking system that is global in scope. This means they must reach out to others; international cooperation has become crucial for good supervision.And here the Financial Stability Institute plays an important role; it helps to bring together supervisors at all levels from around the world.

Ladies and gentlemen, I have now listed a few of the traits that help supervisors to do a good job. But there is one trait that I have left out so far. It is probably one of the most important traits, but it is also one that makes us a bit less likeable.

We supervisors must be the spoilsports. We must be the ones who force banks to prepare for a storm when the sun is shining brightly. Do the banks like that? Probably not – at least in my experience. Should we care? No. As you recently put it, Agustín: “…we have come to appreciate how unrewarding it can be to flag risks when markets are running hot”. And we cannot help it: it is our job to look out for clouds on the horizon and draw attention to them.

So, let's do just that. Let's try to spot the clouds; let's take a look at some of the risks that are out there.

Risks – what's looming on the horizon?

Of course, not all risks are relevant for all people and in all places. But the crisis taught us that we cannot turn a blind eye to the risks of others because they might quickly become our own.

Looking at the risks we currently face, there are some well-known ones, of course: geopolitical uncertainties related to trade tensions and Brexit, for example, and legacy assets such as non-performing loans. But there's more – unfortunately.

There are many things that banks have to adjust to. And the risk is that some will either fail to adjust at all, or they will go about it the wrong way.

For quite some time now, banks have operated in an environment that is kind of special. There has been a long period of loose monetary policy, low interest rates, abundant liquidity and solid economic growth. All this may have come to feel normal, but it isn't. There are many things that could trigger a sudden change.

When that happens, risk and term premia in financial markets will snap back and emerging markets might be affected. And all this could cause trouble for banks. The value of mark-to-market assets might go down, costs of funding might go up, interest income would go down, and so on.

We supervisors must ask whether banks are prepared for such change. Are they pricing risks correctly? Are they mindful of the fact that historical data now include a long period of special circumstances? Have they cleaned up their balance sheets? I think I already mentioned that these preparations should be made as long as the sun is shining.

Another source of change is technological, and it's already happening: digitalisation. In itself this is both a risk and an opportunity. Which of the two will become more relevant in the end depends on how banks adjust to the new digital world. Are they investing in their IT systems, stepping up their protection against cybercrime and finding ways to hold their own against new competitors?

If they do these things, digitalisation offers great opportunities to unlock new business and cut costs. If they don't, others will take over: small and agile fintech start-ups or the big and powerful tech giants, for instance. And if that happens, it would add to one of the problems some banks already have: profitability.

It has become more difficult for banks to make money – not least due to low interest rates. In Europe, a number of banks struggle to earn their cost of capital. And again, there is the danger of adjusting in the wrong way.

Banks might embark on a search for yield and take on too much risk. Some observers have recently identified leveraged loans as an area of potential concern in this context. In 2017, the issuance of leveraged loans indeed reached a new high. The worrying thing is that investors seem to be ready to accept lower protection. They have become more lenient in their credit policies – the share of covenant-lite loans has become quite high.

Against this backdrop, the ECB issued guidance on such loans which entered into force at the end of 2017. This was followed by relatively low volumes of leveraged loans being issued in the first few months of 2018. But this doesn't mean that we can relax just yet. Non-banks might step in and become more active in the market.

And this brings me to another risk: shadow banking. This part of the financial system has grown quite big in recent years. In the EU alone, it accounts for 40% of assets in the financial system.

However, we do not have a clear picture of the shadow banking sector. In the EU, almost half of all assets in the shadow banking sector are held by institutions for which we lack a detailed statistical breakdown.

But why should we, as banking supervisors, care about non-banks in the first place? Well, we should care because there are close links between banks and non-banks. And close links mean mutual exposures. Take funding as an example. In 2017, wholesale funding to euro area banks from entities in the shadow banking sector reached a staggering €2.2 trillion. So, there is another source of risk.

To be able to monitor this risk, we need to close the data gaps. We need more data to bring shadow banking out of the shadows. We need more data to examine and understand this large part of the financial system more thoroughly. Otherwise, we might overlook risks that could spill over to banks and threaten their stability.

So, supervisors need to have a broad perspective and they need to look ahead. And if they want to be truly forward-looking, they have to step out of their comfort zone. They need to monitor risks which are not fully clear today, but may become an issue in the future. Risks related to climate change are a perfect example.

I am aware that some see climate change as a matter just for scientists and politicians. And in a way, they are right. But then again, we all share this one planet. And a changing climate affects us not only as inhabitants of this planet, but also as bankers and supervisors. Fortunately, many authorities have realised we need to do more in this field, but work is still in the early stages.

I see three challenges for banks. First, there are physical risks. More frequent and more severe storms, floods, droughts, heatwaves and rising sea levels have already caused losses for businesses. When these risks were uninsured, they had very direct effects on banks' credit risk, for example through damaged collateral.

Second, "green finance" is a growing area of business. As all supervisors know well, financial innovation can bring a lot of good – but it can also spin out of control. So, we must monitor green finance just as we would monitor any other type of financial innovation.

Third, there is the transition to a low-carbon economy. Policies to encourage a more sustainable way of doing business will have far-reaching consequences. For one, they could impact the banks' customers. Think of car manufacturers or energy suppliers. And they could affect commodity and energy prices. This in turn could change market risks for banks. I know this is an apparent paradox. The policies required to shift to a more sustainable economy could at the same time upset financial stability. But this should not scare us into inaction. Because again, the true risk is that banks do not adjust or adjust in the wrong way.

As supervisors, we should keep on doing what we have learned to do since the crisis: expand our horizons. In practice, this could mean encouraging banks to recognise the potential impact of climate risk on their exposures. I am well aware that longer-term trends are hard to incorporate into risk analyses. But ignoring them is not the answer at all.

Conclusion

Ladies and gentlemen,

Let us return to the initial question: has the banking sector become a safer place? Yes, it has. However, we are talking about a moving target; the business of banking constantly evolves and changes. What is safe today might not be tomorrow.

Thus, we must keep a close eye on new developments and the risks that might accompany them. And we need to exchange views. We need to meet; we need to discuss; we need to learn from each other's experiences; and we need to sharpen our analysis. As I said before, other countries' risks can quickly become our own.

That's why I'm happy to be here. I am sure that we will have very interesting debates, and that we can all learn from each other.

Thank you for your attention.