Sabine Lautenschläger: The banking sector - where did we end up after all the reforms?

Opening 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, to panel 1 "After all the reforms: Where did we end up?" at the 6th Frankfurt Conference on Financial Market Policy: "European Financial Markets – Too Much Variety?", Frankfurt am Main, 14 December 2018.

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It’s often said that in every crisis there is an opportunity. And in the case of the financial crisis, I think that regulators have seized that opportunity.

The crisis prompted an overhaul of banking regulation. And it did so not just at the national or European level. Through the G20 and the Basel Committee on Banking Supervision, the reforms became a common project at the global level.

So what was the general idea behind these reforms?

The primary aim was to address specific issues that had been laid bare by the crisis. This was the first step. But regulators knew, of course, that the latest crisis is never a blueprint for the next one. The next crisis might come in a completely different form.

So the second step was to enhance the general resilience of banks, to make them strong enough to withstand any type of storm. This idea underpins the three main building blocks of the reforms: Capital, liquidity and governance.

And much has been done on all three fronts. Banks not only have to hold more capital than they did before the crisis; their capital also needs to be of higher quality. Banks can therefore suffer more losses before they actually fail.

At the same time, banks have to fulfill much stricter liquidity standards than before, providing them with a cushion in case trust evaporates and funding dries up. This allows banks to survive such a situation for longer than in the past.

Reforms to improve governance and risk management have also come about, but these have received less attention. For too long, governance and risk management have taken a backseat in public or academic debates.

But they are just as important as capital and liquidity – if not more important. After all, good governance and sound risk management help to prevent a bank from getting into trouble in the first place. Capital and liquidity are merely backstops for bad management – or bad luck.

New rules help banks to set up appropriate processes and integrate them into their organisational structures. In this context, one of the standards developed by the Basel Committee is somewhat underappreciated in my view.

I am referring to the BCBS 239 principles for effective risk data aggregation and risk reporting, which play a significant role in adequately managing the risks of a bank. In order to make sound decisions, top management needs sound data.

These are the basics. Where do we stand in turning them into actual policy?

Well, it has taken some time to work through the long list of individual reforms. Some of them are already in place; others are now being implemented – with some delays here and there.
The final part of Basel III was agreed a year ago, in December 2017. So, this is the major set of reforms that still needs to be implemented. And while speed plays a role here, substance is also important.

The reforms need to be turned into actual law, and this law has to reflect what was agreed in Basel. It is important that this happens in all of the relevant financial markets. And I fear that this might not be the case.

Not least in Europe, it seems that some of the Basel standards might not be implemented faithfully. This affects important things such as the leverage ratio, the net stable funding ratio and the fundamental review of the trading book.

Other parts of the rulebook have also come under pressure.

Pillar 2 capital is a recent example. Supervisors set the level of Pillar 2 capital to account for risks which are not, or are only partially, covered by regulatory capital requirements; it is thus an important additional tool for making banks more resilient.

So far, significant banks in the euro area have had to cover their Pillar 2 requirements with Common Equity Tier 1, the highest quality of capital. This, however, might change. In the future, banks might generally be allowed to use lower-quality capital to build up their Pillar 2 buffers.

Such a change will encourage banks and markets to come up with financial innovations with regard to additional tier 1 capital, or AT1 for short. And this is something we supervisors are not very keen on, not least because we have already seen significant market volatility.

On top of that, the playing field for large and small banks might become uneven. Unlike large banks, smaller banks are often unable to access AT1 markets. So the opportunity to use AT1 in order to meet Pillar 2 requirements would be of little benefit to them. Large banks, by contrast, would have an advantage, not least because AT1 coupons are tax-deductible in most Member States.

To sum up: banks would become less resilient and the playing field less even.

But let me come back to Basel.

The reforms we agreed on in Basel do make sense, and they strengthen the resilience of banks. A key feature of the reforms is their global nature. They are designed to ensure not only safer and sounder banks but also a level playing field.

So if reforms are not implemented as agreed, the playing field will become uneven, opening the door to regulatory arbitrage.

But regulation is not the only game in town, of course. Supervision counts too. And although supervisors need rules to guide their work, they see that not everything can be or should be captured by rules. Global reforms such as those devised in Basel and their transposition into European law cannot be perfectly tailored to each and every business model that banks pursue.

At best, rules can cover the average case. This is particularly true in a sector that is changing as quickly as banking.

So it is up to the supervisor to adapt the capital requirements to a bank’s specific risk profile in order to cater for deviations from the average case. To this end, the rules should be principle-based and leave sufficient discretion to the supervisors.

In the European context, this need is even greater, as nowadays, we often have to deal with 19 slightly different national rules applying to the same case.
Common principle-based regulation, applied to all 19 countries, would allow supervisors to cater for bank-specific risks in their national environment, thus ensuring a level playing field.

So, let me conclude.

The overarching question is: have the reforms so far helped to make the banking sector a safer place? My answer is: yes they have, but they still need to be finalised. The key point is to implement the reforms, to turn them into actual law.

So, we cannot stand still; we have to move on. And under no circumstances should we move backwards.

Thank you for your attention.