Sabine Lautenschläger: The evolution of banking regulation

Panel remarks 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 Financial Stability Institute 20th anniversary conference, Basel, 12 March 2019.

* * *

The crucial challenge with Basel III was to get the balance right between risk sensitivity and simplicity. Overall, I believe we did a good job. I know there are many complaints coming from the industry for a few of the asset classes, but I doubt that it is possible to establish a perfect balance for such a heterogeneous group. A perfect balance cannot be our objective as it would be impossible to deliver.

But let's start from the beginning.

I remember the often passionate discussion in the Basel Committee on Banking Supervision (BCBS) about balancing risk sensitivity and simplicity. Not all of us believed in risk sensitivity as a basis for capital requirements.

So first of all, I am glad that we still have a risk-sensitive capital framework, although restricted by important backstops.

I am convinced that risk sensitivity is the only way to give banks effective incentives. Bigger risks need to be accompanied by higher capital buffers. Lower risks need smaller capital buffers. If we were to de-link capital requirements from risks and, therefore, potential losses, we would have to deal with unhealthy consequences.

In a crisis there would not be sufficient capital to cover increasing risks and losses, as we would incentivise weak banks to take on high risks in pursuit of high returns.

Although I am convinced by the idea of making capital requirements more risk-sensitive, I acknowledge that estimating actual risk weights is very hard. Thus, it was very important to combine greater sensitivity with backstops. So, with Basel III we introduced the input and output floors, which will limit the influence of modelling choices. And we prohibited the most complex model choices for some specific asset classes.

And then there is the leverage ratio, of course, which serves as an additional backstop to the risk-sensitive capital requirements.

Overall, I think we managed to strike a balance by combining a risk-sensitive approach with solid backstops.

But did we manage to keep the framework simple? Well, it is not actually simple; that much I admit. But we must remember that Basel III is targeted at a financial sector that is very complex. It is a grave mistake to believe that there are simple solutions to complex problems.

Think about the leverage ratio, for example, which has been promoted as a simple measure to restrict risks. Designing a leverage ratio compatible with the different banking systems has been anything but simple; at the BCBS it took us several years and I would not call the outcome a simple design either. Often there was no easy answer available to those negotiating Basel III as we had to cater for the heterogeneity of our markets, market participants and banking systems.

As for the future, I believe the basic architecture of Basel III is solid and that it will serve us well for years to come. But it's no secret that the business of banking changes fast. So, it was clear from the start that some parts of any framework might have to be fine-tuned. The same is true with Basel III's complexity. We have to see how the rules work in practice and what impact they have. But still, we can reinforce the framework without introducing new rules or reworking its architecture.

The next step is now to faithfully implement Basel III around the world.

Overall, I agree with the idea that we should not try to come up with a new framework every three years. We should rather focus on implementation.

But I would not want to give the impression that I am in favour of less regulation. Over the decades, we have seen a regulatory and supervisory cycle. The post-crisis phase of this cycle has been characterised by an understandable tendency to strengthen regulation and supervision. This is natural when the memory of the consequences of light-touch regulation is still fresh.

However, as the memory of the crisis fades, the cycle usually enters a phase where regulation and strong supervision are perceived as a hindrance to growth and markets. In this phase, regulation leaves less room for supervisory discretion. The requirements for the supervisor to be allowed to act begin getting more stringent. In this phase of the cycle, it is usually harder for regulators and supervisors to react to new risks.

My impression is that we are now between these two phases of the cycle. Between a phase where strong regulation and supervision are encouraged, and one where there are strong calls for fewer restrictions. This could be risky, and I would strongly advise against weakening rules we have already agreed on.

Besides this general point, there are several issues which should and could be dealt with, or discussed at the BCBS. Work can be done to improve joint understanding of emerging risks in the banking sector, to exchange information on standards and best practices on new or increasingly relevant topics, and to work on a minimum convergence of supervisory practices. And if I am informed correctly, many of the topics I will mention can be found in the 2019 work programme of the BCBS.

- First and foremost, the BCBS should monitor how the new Basel rules are implemented in national laws and ensure it has a thorough overview of how these are then translated into supervisory practices.
- It should also foster an intensive exchange of information about the risks and vulnerabilities we see in today’s and, in particular, tomorrow’s macroeconomic environment. These discussions should also cover the approaches supervisors could use to analyse, assess and react to these upcoming risks via Pillar 2, or other instruments. After all, a US supervisor’s challenge today may be a European supervisor’s concern tomorrow. I believe that supervisors from around the world would benefit from sharing views and experiences. The one thing we have to keep in mind is this: good supervision is a positive-sum game – everyone wins.
- The BCBS could and should be a hub for exchanging supervisory knowledge, tools and approaches regarding cyber risk.
- And finally, the BCBS could be of great help for supervisors regarding operational, legal and reputational risks in banks which are linked to conduct risks or anti-money laundering. The same is true for green finance or climate-related risk. Here, too, a structured exchange of information about different tools and methods would help to strengthen supervision globally.