



Adjusting to new realities – banking regulation and supervision in Europe

Speech by Danièle Nouy, Chair of the ECB's Supervisory Board,
at the European Banking Federation's SSM Forum,
Frankfurt, 6 April 2016

Introduction

Ladies and gentlemen,

Thank you for the invitation to speak at the European Banking Federation's SSM Forum. It is a pleasure to be here today.

Less than six months ago, the European Banking Federation opened an office here in Frankfurt. That office is a symbol of the Federation's faith in the new European banking supervision. And, equally important, it is a platform for the exchange of ideas, facilitating the dialogue between the supervisor and the banks.

Dialogue is particularly important in times of change. And since the financial crisis broke out, change seems to have been the only constant in the world of banking. The regulatory and supervisory landscape, for instance, has been transformed by a number of reforms. That change has certainly put a burden of adjustment on the banks.

However, continuing with business as usual was never an option. During the crisis, it had become obvious that banks did not manage their risks properly, that the regulatory framework had weak spots and that, in the euro area, the architecture of banking supervision did not fully reflect the reality of a monetary union. Change had become a necessity.

Policymakers therefore chose to follow John F. Kennedy's dictum: "There are costs and risks to a program of action. But they are far less than the long-range risks and costs of comfortable inaction." So yes, regulatory and supervisory reforms place a burden of adjustment on the banks. But they were necessary to put the banking system on a more solid foundation and to ensure its stability.

Let us take a look at how regulatory and supervisory reforms have contributed to that objective.

Banking regulation – increasing resilience

Regulatory reform drew on an insight gained not only from the recent crisis, but from many crises before it.

That insight is: we know that the next crisis will come, but we don't know from which direction. Against that backdrop, the sensible thing to do is to increase the resilience of banks. From whichever direction the storm blows, a resilient bank should be able to withstand it.

And that is exactly the objective of regulatory reform. Among many other things, it aimed at increasing the most universal shock absorber available: capital. Banks are now required to hold more capital, and better capital, than ever before.

Consequently, banks have significantly improved their capital positions in recent years. Since 2012, the CET1 ratio of significant institutions in the euro area has risen, on average, from 9% to around 13%. Banks have undoubtedly become more resilient.

Does the recent market volatility prove otherwise? In my view it does not. The markets seem to worry less about capital, and more about profitability. Supervisors share the concerns about profitability: banks urgently need to adapt their business models.

Nevertheless, the increase in capital ratios is a remarkable achievement in terms of adjusting to the new regulatory reality. But some still focus on the costs of higher capital ratios – both for the banks and for the economy. And yes, in line with the quote from John F. Kennedy, there are short-term costs to a programme of action – no one denies that.

But there are benefits, too. Well-capitalised banks reduce both the likelihood and the costs of crises – they are able to finance the economy throughout the entire business cycle. By contrast, poorly capitalised banks increase both the likelihood and the costs of crises – they are exuberant during good times, and cut back their lending in bad times.

All of the existing studies that compare the costs and benefits of higher capital requirements conclude that, in the end, benefits exceed costs.

And Basel III, the centrepiece of regulatory reform, is about to be finalised in 2016. There will be no significant further increases in capital requirements, and we are not discussing Basel IV. Regulatory reform is coming to an end. Yes, it brought about significant change, but at the same time, it paved the way towards a more stable banking system.

Banking supervision – harmonising standards

Turning to the euro area, there has been another source of change: supervisory reform. About one-and-a-half years ago, banking supervision was brought from the national to the European level. The ECB now directly supervises the 129 largest banking groups in the euro area – or, measured in terms of assets, about 82% of the banking sector.

The idea of European banking supervision was not an entirely new one. In fact, it had already been discussed in the late 1980s by the Delors Commission, and one of those in favour of European banking supervision was former ECB president Wim Duisenberg. At that time, however, it was decided to leave banking supervision at the national level.

Ultimately, it was the euro that drove the integration of financial markets to a point where national banking supervision was dangerously at odds with the realities of a monetary union. In 2012, at the height of the crisis, policymakers leapt into action and decided to finally set up European banking supervision.

That was the biggest step in European financial integration since the introduction of the euro itself. European banking supervision adequately reflects the realities of an integrated banking system and a single currency.

First, European banking supervision does not have a national focus, but takes a European perspective, allowing it to compare and benchmark banks across borders and identify problems early on. Second, European banking supervision combines the experience and expertise of 19 national supervisors and the ECB, enabling it to draw on a huge pool of analytical power. Third, European banking supervision is less prone to national interests getting in the way of necessary measures, leaving it free to act when action is called for.

Ultimately, European banking supervision aims to ensure that banks across the entire euro area are supervised according to the same high standards.

And we have already taken important steps in that direction. For instance, we have agreed on a common framework for exercising options and national discretions. These refer to a large number of provisions in European regulation, which give supervisors some leeway in deciding on their concrete implementation.

Let me highlight just one of these discretions as an example. According to European regulation, supervisors might require banks to use the international reporting standard IFRS for the purpose of supervisory reporting. Nevertheless, following a thorough analysis, the Supervisory Board decided not to exercise that discretion. It would put an additional burden on those banks that currently report according to national standards – they would need to keep parallel accounting for supervisory and financial purposes. Weighing that burden against the potential benefits indicated a net-cost of exercising the discretion. Banks can therefore continue reporting to the supervisor according to the national accounting standards.

More generally, it has now been agreed to apply all the identified options and national discretions to be exercised by supervisors in a harmonised manner across the entire euro area; a guide is already operational while relevant ECB Regulation will enter into force in October 2016.

Another important step we took in 2015 relates to the main instrument of banking supervision, the Supervisory Review and Evaluation Process, or SREP for short. In 2015, the SREP was, for the first time ever, conducted according to a harmonised methodology. Banks across the euro area were measured against a common yardstick. Consequently, we are now seeing a stronger correlation between the risk profile of institutions and the relevant supervisory capital requirements. Banks with higher risks must hold more capital.

In 2016, the SREP will be supplemented by two stress tests: an EU-wide stress test conducted by the European Banking Authority, the EBA, and a euro area-wide stress test conducted by the ECB, which covers the significant institutions that are not included in the EBA's stress test. Consequently, almost all of the 129 largest banking groups in the euro area are undergoing a stress test this year.

The results of both the EBA's and the ECB's stress test will feed into the 2016 SREP; not only the actual results, but also, for those institutions concerned, any data quality and quality assurance issues experienced during the exercise.

At a more general level, our supervisory work in 2016 is guided by five supervisory priorities.

- › First, we will look at the business models and the profitability drivers of banks. Both are challenged by the prolonged period of very low interest rates.
- › Second, we will look at credit risk, given that levels of non-performing loans are still elevated in some countries. In order to address this issue, we established a dedicated working group last year. That working group has been tasked with developing and implementing a consistent supervisory approach, aimed at supporting a reduction in the stocks of non-performing loans.
- › Third, we will look at capital adequacy – for instance with regard to the new standards such as total loss-absorbing capacity, or TLAC, and the minimum requirement for own funds and eligible liabilities, or MREL.

- › Fourth, we will look at risk management and governance. Given the current environment of very low interest rates and abundant liquidity, it is increasingly important that banks manage their risks in an appropriate manner.
- › And fifth, we will look at liquidity – for instance with regard to the Internal Liquidity Adequacy Assessment Processes of banks.

So, European banking supervision is up and running. We are still refining our methods, but we have come much closer to the objective of supervising banks in the euro area according to the same high standards.

Bank resolution – sharing risks

There have been many changes in banking regulation and supervision, and adjusting to these changes requires efforts. Nevertheless, the long-term benefits of regulatory and supervisory reform outweigh the short-term costs. The financial system has become a safer place.

But after all, the financial system is still a market. And to quote the economist Allan Meltzer: “capitalism without failure is like religion without sin. It doesn’t work”. The core characteristic of a well-functioning market is the possibility of failure. Unsustainable business models will not survive the competition, and creative destruction will enhance growth and prosperity. Individual banks can fail and they will fail. There is no doubt about that.

And in that regard, there is one question that has been widely discussed over the past years: who bears the costs of bank failures? In theory, the answer has always been easy: the costs should be borne by those who took the risk in the first place, by those who earned the returns. That is, the shareholders and creditors of the bank. In practice, however, the answer has too often been: the taxpayers.

Setting aside their impact on government finances, such bail-outs set all the wrong incentives for banks and markets alike. Who has an incentive to invest and act prudently if they can be sure that someone else will foot the bill? Obviously, there was a need for further change, a need for setting up a framework that would allow for resolving failed banks, without endangering the stability of the financial system and without putting the burden on the taxpayers.

In Europe, such a framework has been established through the Bank Recovery and Resolution Directive, BRRD for short. In the euro area, the BRRD has been implemented through the Single Resolution Mechanism. Another key milestone was reached on 1 January 2016 when the Single Resolution Board became fully operational. The banking union now rests on two pillars.

The BRRD and the Single Resolution Mechanism have changed the rules of the game. The BRRD, in particular, ensures that shareholders and creditors are first in line when it comes to bearing the costs of bank failures, while taxpayers have moved to the very end of the line. This will not only protect taxpayers, it will also align incentives for banks and markets.

Moreover, bringing bank resolution to the European level should liberate it from the influence of national interests – it should become easier to take uncomfortable action, instead of choosing the path of comfortable inaction that often has led to calamity.

Establishing the BRRD and the Single Resolution Mechanism has been another necessary change, and it too requires adjustment on the part of banks and investors alike. From now on, every creditor of a bank must understand that their money is at stake. At a more technical level, every creditor must know where they stand in the pecking order of loss sharing. In the euro area, that would be facilitated not only by increasing transparency, but also by further harmonising the creditor hierarchy.

But, again: the important message is that every bank creditor might have to bear losses should the bank fail. This is as true for professional investors as it is for retail investors – depositors are of course protected

by deposit insurance schemes up to an amount of €100,000.

Particularly with regard to the retail investors, it is the banks that have to make their customers aware of the risks associated with certain financial products. There is no question about that.

Ultimately, however, the new system requires what could be termed responsible financial citizens. Anyone who participates in the financial system by investing money should have at least a rudimentary knowledge of finance. At the very least, every investor should know two things: first, higher return always goes hand in hand with higher risk; second, never put all your eggs in one basket.

And with regard to such basic financial education, there indeed seems to be room for improvement in the euro area. According to a recent study by Standard & Poor's, only about half of all adults in the euro area are financially literate^[1] – ranging from 26% of adults to 66% depending on the countries. This should change, and it is welcome that institutions such as the European Banking Federation are promoting financial education.

Conclusion

Ladies and gentlemen,

Over the past eight years, the world of banking has been subject to constant change. And adjusting to this change still requires huge efforts. Nevertheless, change was necessary, and it was change for the better.

The new regulatory and supervisory frameworks protect the stability of the financial system. First, they make crises less likely by making banks more resilient. And second, they reduce the costs of crises for society by protecting the taxpayers.

Nevertheless, regulation and supervision simply provide a framework for the financial system. Within that framework, everyone can contribute to the stability of the financial system by acting prudently. Every banker, every investor affects the stability of the financial system, and is affected by it. Whoever takes imprudent decisions will have to bear the costs. That is the new reality.

So, to close with a variation on another quote from John F. Kennedy: ask not what the financial system can do for you; ask what you can do for the financial system.

Thank you for your attention.

[1]The candidates were asked multiple-choice questions, testing the concepts of risk diversification, inflation, numeracy and compound interest. Persons were defined as financially literate if they answered three out of the four concepts correctly.

European Central Bank Directorate General Communications

Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany

Tel.: +49 69 1344 7455, e-mail: media@ecb.europa.eu, website: www.bankingsupervision.europa.eu

Reproduction is permitted provided that the source is acknowledged.

> **Media contacts**