Danièle Nouy: Regulation and supervision in Europe – can many cooks make a good broth?

Speech by Danièle Nouy, Chair of the Supervisory Board of the ECB, at an ILF Conference, Frankfurt, 15 May 2017

Ladies and gentlemen,

In 2005 the French cook Paul Bocuse had to undergo heart surgery. Lying on the operating table, he said to the surgeon: "If an architect makes a mistake, he covers it with ivy. If a cook makes a mistake, he covers it with sauce. If a doctor makes a mistake, he covers it with earth." It turned out that the doctor didn't make a mistake: Paul Bocuse is alive and well.

But we are not here to talk about cooks or doctors, of course. We are here to talk about banks. So what might Bocuse have said about banks? Maybe he would have said that if banks make mistakes, they tend to cover it with taxpayers' money. At least, that is the impression many people got from the financial crisis.

And this impression is not entirely wrong. The crisis did put a huge burden on taxpayers – and on everyone else for that matter. It hurt the economy, it destroyed jobs and it shook many wisdoms and beliefs about how financial markets work.

The crisis should have changed the way bankers think and act. And it definitely has changed the way regulators and supervisors think and act. They seized upon the crisis to tackle shortcomings and mistakes in regulation and supervision. And just to reassure you: they did not just cover them with sauce.

Together, regulators and supervisors from around the world came up with truly new recipes for safe and sound banks. They added new ingredients and introduced new techniques. And despite the fact that many cooks were involved, the broth is good. But is it good enough? Let us take a look.

Regulation – more than just a national task

It all began in the autumn of 2008. Lehman Brothers had just collapsed and set off the financial crisis. It quickly became clear that this crisis had to be fought at the global level. And so the leaders of the G20 met in Washington to discuss the way forward. Among other things, they agreed to reform regulation in order to avoid future crises.

Two things were crucial in my view: first, the reforms themselves, and second, the fact that they took place at the global level.

The crisis had laid bare gaps and weak spots in the regulatory framework. So the aim was clear: mend the regulatory framework to prevent future crises. And that's what we did.

Now, there are some who think we went too far in mending the framework – that it has become too tight and that it is choking the economy. There are politicians who would like to reverse some of the reforms to help the banks and spur the economy.

In my view that is not the way forward. The reforms are crucial to make banks safe and sound – all around the world. And only safe and sound banks can reliably serve the economy. Walking back on the reforms would just lead us to where we came from: a major crisis.

We need strong rules for banks, and we need them at the global level. The financial system reaches across national borders, and no wall, no fence can keep crises from spreading around the globe. A fragmented system of national rules cannot protect us.

It is thus crucial that everyone sits at the table when rules are made – first of all those countries that have very large financial sectors. The Basel Committee on Banking Supervision has become the forum for this. It brings together 28 jurisdictions to ensure a truly global approach to rule-making.

So a lot of countries have worked together on regulatory reform. And each of them has its own banking system with individual risks and needs. Still, the collaboration has not led to a weak compromise. Rather, it has resulted in strong global standards.

But we are not quite done yet. There are some open issues, which are still being discussed. Here, the Basel Committee must strike an agreement as quickly as possible. The reforms have been going on for almost a decade now, and the banks need a stable set of rules to plan ahead.

Of course, the Basel Committee just issues global standards that are not binding. They still have to be transposed into actual law. In Europe, such law is either issued at the European or at the national level.

Thus, there are a lot of junctions on the way from global standards to actual law. And at each junction, countries might choose slightly diverging paths. These diverging paths lead to a fragmented set of rules. That is not ideal.

Europe is no exception in that regard. The European Commission is currently working on integrating some global standards including the leverage ratio into European law. This is in the spirit of a global approach. Still, the Commission has also suggested deviating from the global standards here and there. And this deserves a closer look.

In some cases, there might indeed be room to deviate from global standards. Here I am thinking of deviations that address special circumstances in Europe and that do not make banks less safe and less sound. One example is deviations that aim at making the rules for smaller banks a bit simpler. But other deviations need to be thoroughly assessed. We must ensure that they do not make banks less safe and less sound. And we must ensure that they do not compromise our ability to compare banks from different countries; otherwise deviations will come at a cost for European banks.

But rules for banks not only diverge between Europe and other jurisdictions: they also diverge within Europe. True, the aim is to create a harmonised set of rules for all banks in Europe – to write a single rulebook. This would ensure that all banks have a level playing field on which to do business and it would pave the way towards a truly European banking sector.

But we are not quite there yet. The single rulebook is not so single, and the level playing field is not so level. It still has some uneven patches, and these are caused by three things.

First, the single rulebook is made up of two different types of law: EU regulations and EU directives. EU regulations are binding laws that can be applied directly in all Member States. EU directives, on the other hand, have to be transposed into national law. The resulting law in Germany might then look different from the resulting law in France or Spain. So relying more on EU regulations would take us one step closer towards a level playing field for banks and a truly European banking market.

Second, the single rulebook contains what are known as options and national discretions, or ONDs. These ONDs give supervisors and governments some leeway in how they apply the rules. This too has the potential to create uneven patches on the playing field.

The good news is that the SSM was able to remove some of these patches. Together with the national supervisors, we have agreed to exercise a large number of ONDs in a harmonised manner across the entire euro area. Still, some discrepancies remain. This is due to the fact that some ONDs are not within the remit of supervisors but of governments.

And the current proposals to reform the CRR/CRD4 are disappointing in this respect. More could have doneto harmonise them. But there is still a chance to do so. Why not put the remaining ONDs in the hands of supervisors? Then we could harmonise these ONDs as well and take another step towards a level playing field for banks and a truly European banking market.

Third, there is the issue of national powers. As the European supervisor, the ECB has to apply all relevant European law. But then there are some supervisory powers which are only provided in national law and do not derive directly from European law. So is it just the national supervisors who can exercise these powers. In our view, the ECB should also be enabled to directly exercise them. This would take us still another step towards a level playing field and a truly European banking market.

To sum up: in Europe, we have 19 versions of the single rulebook, and each one is slightly different from the others. Such a fragmented set of rules is a problem. It increases risks, and it makes European banking supervision more complex and costly for banks.

If policymakers are serious about the banking union and a truly European banking market, they should take the steps I have just laid out. They should rely more on EU regulations, they should harmonise the remaining ONDs, and they should resolve the issue of national powers.

If they took these steps they would bring us closer to a European banking market where banks can more easily operate across borders. That is why we support the European Commission proposal of granting capital waivers within a banking group on an EU cross-border basis, and not just locally, as is the case now. This would give banks an incentive to become more European.

Supervision – more than just ticking boxes

So, strong and harmonised rules are the basis for safe and sound banks. Still, more is needed. And that is supervision, of course. But what do supervisors actually do? Do they just make sure that banks follow the rules? Well, supervising banks is much more than that; it is much more than just ticking boxes.

We make sure that banks have a realistic view of their risks. Supervisors assess the risk profile of each bank. They do so in a forward-looking manner, not just taking into account today's risks but also tomorrow's. And they do so in a holistic manner. All the risks of a bank are interrelated, so it is crucial to see the whole picture. And finally, they do so in a neutral manner. They have no stakes in the bank and SSM supervisors have no national interests.

Based on the risk profile of a bank, we can then take measures that go beyond the minimum requirements laid out in the rules. We can, for instance, impose capital add-ons or demand additional reporting from the bank.

In my view, combining rules with the judgement of supervisors is a very good approach. Rules are static and not very flexible. They cannot foresee all potential situations, and they cannot keep pace with an industry that is constantly evolving and creating new types of risk.

We must therefore supplement the rules with supervisory flexibility. Only then can we ensure safe and sound banks. That's why I am worried about some legislative proposals that are being discussed. By framing too tightly supervisors' assessment of pillar 2 risks through a regulatory technical standard and restricting their ability to collect ad hoc reporting, the proposals risk creating a one-size-fits-all approach where supervisors can no longer adequately differentiate risks. This would hurt the safest banks rather than the most risky ones.

Banks – more than just business as usual

Despite some impediments that I have just mentioned, we have made good progress. The rules for banks have been made stronger and supervision has been taken to the European level.

But the banks have to act as well. The world around them has changed in many ways, and they have to adjust. If they don't, they will be in trouble. So what is going on?

First of all, European banks are not very profitable, to put it mildly. And in 2016, things did not really get better. The return on equity of large euro area banks fell further, to about 3.2% in the fourth quarter. This is far below the estimated cost of capital. At the same time, net interest income fell to its lowest level since 2014, while costs went up for most large banks.

There are many reasons for this dire situation: very low interest rates, overbanking, digitalisation and new competitors such as fintech companies. So, is there any hope? Well, it seems there is. There are about two dozen banks that consistently outperform their peers. Over the past three years they have had an average return on equity of more than 6%. So, it seems that it is possible to thrive, even in these circumstances.

Banks have to adapt to a new world. They have to adjust their business models and unlock new sources of income. At the same time, there is a need for consolidation. This could happen through mergers, including cross-border mergers. And finally, the banks have to get rid of legacy assets.

The latter point takes us directly to non-performing loans, or NPLs. In some parts of the euro area, banks still have quite a lot of NPLs on their books. These are an echo of the economic crisis, as many companies are still struggling to pay back their loans. In the first place, this is a problem for the companies, of course.

But it is also a problem for the banks. As the saying goes: if you owe the bank €100, that's your problem; if you owe the bank €100 million, that's the bank's problem. And in the euro area, we are not talking about €100 million. We are talking about more than €900 billion worth of NPLs as of end 2016..

However, resolving NPLs is easier said than done. And it takes time. In March, we published our guidance for banks on how to deal with NPLs. Now they have to act and to set realistic, but also ambitious reduction plans; they have to establish the relevant governance and put in place the needed operational structures.

And it is not just the banks that have to act. In some countries legal and judicial systems hinder the speedy resolution of NPLs. Policymakers should reform these systems to help resolve the issue.

Banks do not just struggle with the past and the present, however. They also struggle with the future. The entire sector is looking ahead to Brexit, which will lead to huge changes. The central concern is that UK banks will lose access to the EU's single market should there be a "hard Brexit".

So the question is, how can UK banks maintain access? Basically, they have three options.

The first option is to set up a subsidiary in an EU country. This requires a banking licence. In the euro area, it is the ECB that grants these licences. And rest assured that we will stick to our high standards. Any bank that wants to open a business in the euro area will have to meet those standards.

But banks might also set up what are known as third-country branches. These would not be supervised at the European level, but at the national level. This would be another source of fragmentation. And as national legislations differ and countries might compete for banks, that could easily lead to a race to the bottom in terms of standards. But there is a chance to adapt the rules: third-country branches might be attached to intermediate parent undertakings. That would bring them under European banking supervision.

And finally, banks might choose to set up broker-dealers. Again, these would not be supervised at the European level. So, we are worried about the risks of such a fragmented approach. We are also concerned about supervisory gaps. In the UK, large and systemic broker-dealers are supervised exactly like banks. This is what we need in the euro area as well.Overall Brexit forces us to re-design the framework for third-country banks, with a view to preventing supervisory fragmentation, supervisory gaps, and the resulting unlevel-playing field. Those areimportant issues for legislators to address.

Conclusion

Ladies and gentlemen,

The financial crisis set off a major reform: the rules for banks have been made tougher. That was needed. And it was important to do it at the global level.

Granted, devising global standards involves many cooks. But contrary to popular wisdom, they did not spoil the broth. All in all, it has turned out to be pretty good. But it still needs to be finished – a few ingredients still have to be added to the recipe.

Another thing is that each country adds some local flavour to that recipe. In some cases that might be warranted, while in others it goes against the idea of a global approach – and a European approach. In Europe, we are aiming for a banking union and a truly European banking sector. Against that backdrop, we need a harmonised set of rules. Here, some additional work is needed. Otherwise, we will have a hard time reaching our goal.

Thank you for your attention.