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BANKING SUPERVISION

SPEECH

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Introductory statement by Andrea Enria, Chair of the Supervisory Board of the ECB

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Introduction

I am delighted to be with you this morning.

The banking union is sometimes compared to a house – albeit one which is still unfinished. If I were to use this metaphor myself, I would say that so far our house seems to have weathered the coronavirus (COVID-19) storm rather well. But we need to make sure there is no damage hiding beneath the surface.

During the 18 months after the start of the pandemic banks proved resilient and capable of supporting our economy, largely because they were better capitalised, less leveraged and had more liquidity than a decade ago. This was a serious test of the framework we set up following the 2008 financial crisis, and we can be fairly pleased with the results so far. This positive outlook owes a lot to the public support provided at European and Member State level and the actions taken by supervisors.

However, we still have to complete our common house and ensure it is fit to withstand future storms. Banks need to prepare themselves for the fundamental challenges posed by digitalisation and climate change. We also need to remain vigilant about the impact of the pandemic on asset quality, as well as other emerging risks, such as increasing leverage and complexity in financial markets. And, of course, we need to make further progress on the missing elements of the banking union, without which our house will not be complete.

Bank resilience and risk outlook

We are gradually moving out of the pandemic phase along what looks like a swift process of economic recovery. The risk outlook still warrants some caution, though. It is too early to declare victory.

Real GDP in the euro area will exceed pre-pandemic levels by the end of this year. The recent stress tests conducted by the European Banking Authority (EBA) and the ECB showed that, following an adverse three-year scenario, the average CET1 ratio of euro area banks would remain very close to 10%. Against the backdrop of improving macroeconomic conditions and decreased uncertainty, we lifted our dividend recommendation last month, but we are sticking to the capital flexibility initially announced. Those banks that have used buffers to cope with the impact of the pandemic will have until at least the end of 2022 to replenish them. Our timelines remain unchanged and ample room for loss absorption remains available for banks under our supervision.

Allow me to say a few more words on how we will follow up on this year's stress test exercise. Following a two-step approach, each bank will first be assigned to one of four Pillar 2 Guidance buckets based on its stress test outcome. Supervisors will then exercise discretion when they adjust the Pillar 2 Guidance to the individual profile of the bank. They can make adjustments within the ranges of the corresponding bucket, and can only go beyond those ranges in exceptional circumstances. This process will ensure a level playing field, reinforce consistency when setting capital guidance and provide more clarity and transparency to banks and the market about the supervisory implications of the stress test. We are setting this guidance now, but we will only expect banks to concretely follow it once the pandemic-related flexibility in capital buffers I mentioned earlier has been phased out.

We are keeping a very close eye on the build-up of risks on bank balance sheets. Banks expect their ratio of non-performing loans (NPLs) to total loans to continue decreasing this year and in 2022. While NPL numbers still appear favourable, asset quality seems to be deteriorating, as suggested by several faster-moving metrics, such as the share of forborne loans and problematic Stage 2 loans[1]. We are also seeing a build-up of residential real estate vulnerabilities in some countries. Moreover, during the first quarter of 2021, bankruptcies started to increase in some sectors, although they generally remained below their pre-pandemic levels. All in all, banks' NPL projections may be overly optimistic and banks should remain cautious with releasing provisions and ensure that they have adequate credit risk controls in place.

Given the difficulty in reliably estimating the trajectory of asset quality, our supervisory focus continues to be on banks' credit risk controls. We are also performing deep dives into vulnerable sectors, such as food and accommodation services and commercial real estate.

Finally, the focus on asset quality should not blind us to other sources of risk that may be building up below the surface. We are increasingly looking at the risks posed by banks' excessive search for yield, which is feeding the growing appetite for leverage, observed in the risky segments of the equity and credit markets, as well as the increased complexity and opaqueness in financial markets. The Archegos case showed that bank exposures to non-bank financial institutions could be a source of concern, especially when the counterparts are not regulated or are lightly regulated, and when they show unsatisfactory levels of transparency on the leverage and concentration of their portfolios. A sudden adjustment in yields, triggered for instance by changing investor expectations about inflation and interest rates, could in this context cause asset price corrections and direct as well as indirect losses for banks. We carefully monitor banks' governance and risk controls in order to promote responsible behaviour and make sure that the growing signs of market exuberance do not end up reviving threats to financial stability.

Digitalisation and climate change

The challenges for our banks go beyond asset quality and financial exuberance. In particular, we are pushing banks to improve their management of the risks posed by climate change and digitalisation, while also being able to benefit from the associated opportunities. Banks need to transform their business models to address these challenges.

The pandemic has accelerated the use of digital banking services, and we have seen a growing number of customers taking advantage of digital and online offerings. This provides avenues for further cost optimisation and revenue growth. However, it also brings with it greater competition from non-banks. Moreover, the benefits of reduced costs and higher revenues will accrue only gradually, while in the short run the associated investments and upfront costs may further weigh on profitability. A more digitalised banking landscape will also inevitably have a direct impact on banks' risk profiles, notably in the form of IT and cyber risk. So digital transformation needs to be part of a holistic strategy spanning the overall business model, internal organisation and governance, as well as risk management.

Turning to climate and environmental risks, we see a somewhat similar picture. Banks need to adapt their strategies and enhance their risk management capabilities to ensure their business models are resilient in the short, medium and long term. They also need to be transparent about their environmental footprint to mitigate reputational damage. The outcome of our assessment of banks' current practices has shown that few banks had developed sound climate and environmental risk management processes, or even integrated these risks clearly into their existing strategies or risk mitigation processes. However, banks also assessed that these risks have or will have a material impact on their risk profile. Therefore, they need to make further progress in understanding how their business models and risk profiles are affected by climate-related and environmental risks.

Our forthcoming supervisory stress test on climate risk, which will take place in 2022, will shed greater light on banks' progress here and will underpin the development of our supervisory approaches. We are aware that collecting the data will be challenging, but this should also increase banks' awareness of the data gaps they need to fill to effectively manage climate risk. This will be a learning exercise, for both banks and supervisors.

These structural challenges allow banks to more decisively tackle the issue of the long-term sustainability of their business models, in particular their low cost efficiency and depressed profitability. Recently we have seen some positive signs, such as more decisive cuts to branch networks, refocusing of business models via targeted acquisitions or disposals of business lines, even across borders, and a rebound in bank consolidation in 2020. But there is still lots of work to be done.

The European regulatory framework and the banking union

Finally, we will continue to contribute to the work on completing the banking union and strengthening the regulatory framework. Our common house will indeed remain vulnerable as long as some elements remain missing.

The first element to be accomplished is the single rulebook, where, with the outstanding Basel III reforms, we are just one mile from the finish line. We are very much looking forward to the legislative proposals from the European Commission. We consider it of paramount importance that the outstanding Basel III standards are implemented in full, and in a timely and faithful manner. We should heed the lesson from the COVID-19 crisis, which is that a strong banking sector acts as a shock absorber rather than a shock amplifier. Indeed, ECB and EBA analysis confirms that the short-term transitory costs pale in comparison with the long-term benefits of strengthening the resilience of the financial system.[2] The ultimate goal of this exercise is not, per se, one of raising the capital bar. Some banks, though, will need to make adjustments, as their use of internal models to compute capital requirements has so far placed them on the low end of the distribution, contributing to excessive variability and a lack of comparability in the system.

We also strongly welcome the Commission's legislative proposals to establish both a single rulebook for anti-money laundering (AML) and combating the financing of terrorism (CFT) and an EU-level AML authority. Effective AML/CFT supervision at the European level is important to enhance the credibility of the EU financial sector, and we look forward to cooperating with the new authority to make our respective supervisory functions more efficient and effective.

As regards the completion of the banking union, we are pushing for a more integrated banking market, relying on the tools we have within the current framework. For example, we have advocated for banks to rely more extensively on branches and the free provision of services, rather than on subsidiaries. This would help them develop cross-border businesses within the banking union by making it easier for them to move capital and liquidity within the group and to optimise the synergies that exist within their banking group. However, there are limits to what we can achieve without legislative change, and we need the support of the co-legislators to achieve real progress towards completing a fully fledged banking union. As an immediate priority, we need to move forwards in the area of crisis management. Ultimately, a European deposit insurance scheme needs to be part of this framework, as it provides funding support to facilitate the orderly management of failing banks and addresses host jurisdictions' concerns over local financial stability and the use of taxpayers' money.

Conclusion

Even though the economic outlook has improved, caution remains of the essence. We will continue to apply the utmost vigilance in our approach to monitoring the build-up of risks. And we will not lose sight of our end goal, which is to play our part in building a fully fledged banking union.

I am pleased to be here today to discuss these matters with you. I now look forward to your questions.

[1] These are loans which have experienced a significant increase in credit risk.

[2] European Central Bank (2021), " Macroeconomic impact of Basel III finalisation on the euro area (Link to: http://www.ecb.europa.euhttps://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202107_1~3292170452.en.html)"; European Banking Authority (2021), EBA Report on Basel III Monitoring (data as of 31 December 2020) (Link to: http://www.ecb.europa.euhttps://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20Basel%20III%20Monitoring%20%28data%20as%20of%2031%20December%202020%29.pdf).

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