SPEECH

# Hearing at the European Parliament’s Economic and Monetary Affairs Committee

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

Frankfurt am Main, 23 March 2021

Madam Chair,

Honourable members of the Economic and Monetary Affairs Committee,

Ladies and gentlemen,

I am delighted to be with you again this morning and to present to you the 2020 ECB Annual Report on supervisory activities.

## The response to the COVID-19 crisis

A year has passed since the coronavirus (COVID-19) pandemic started in Europe. The pandemic has had an unprecedented impact on the global economy over the course of 2020 and this has continued into 2021.

Credit risk is the key priority for ECB Banking Supervision. Although public support measures mitigate the risk, the deep recession caused by the pandemic is expected to lead to a deterioration in bank asset quality. This deterioration is likely to be more prominent in sectors most affected by the pandemic and the subsequent lockdown measures and to reflect differences in the strength and speed of the recovery across areas of business.

An important lesson we learned from the great financial crisis is that early recognition and management of credit risk are essential to avoid a pile-up of bad loans, which would amplify the depth of the shock and hamper the ability of banks to support the economic recovery. In July and December of last year, the ECB sent letters to CEOs of significant institutions setting out clear supervisory expectations for appropriate operational preparations for the increase in non-performing loans (NPLs) and for robust credit risk identification, measurement and management practices. Accordingly, we formulated a dedicated and targeted COVID-19 credit risk strategy that sets out concrete and focused areas of work.

The first priority area is to closely investigate and monitor potential cliff-edge effects in asset quality that could occur once public support measures related to COVID-19 are withdrawn.

Our work here focuses on three elements, namely: i) classification of exposures and measurement of credit risk, with a view to assess banks’ compliance with our supervisory expectations; ii) targeted risk analytics using all available data sources to generate COVID-19 key risk indicators and benchmarking to drive supervisory engagement; and iii) tools to support Joint Supervisory Teams (JSTs) in their ongoing bank-by-bank credit analysis, with a specific focus on assessing banks’ credit risk management practices with respect to vulnerable sectors.

The second priority area is ensuring that banks adequately prepare for the upcoming increase in NPLs and is centred on two elements: first, the operational capacity to deal with the expected increase in the number of distressed debtors; second, banks’ compliance with the applicable prudential rules and supervisory guidance on NPLs, which will be essential to support a pro-active management of distressed customers and faster clean-up of bank balance sheets.

These two priority areas are fully complementary: they focus on ensuring that banks are adequately and effectively addressing credit risk deterioration due to COVID-19 in a timely manner; this, in turn, helps mitigate both the increase in NPLs and the associated damage to the real economy.

Over the coming months, the ECB will communicate the specific outcomes of these work areas to ensure transparency regarding our findings and supervisory follow-up actions.

## The need to improve profitability

The COVID-19 pandemic has also made it more urgent than ever that banks address the structural weaknesses driving their low profitability and depressed market valuations. Even before the pandemic, return on equity was lower than the estimated cost of equity for most of the banks under our supervision. Banks need to adjust their business models to ensure they are sustainable in an environment where revenues are affected by the low interest rate environment and credit losses are rising.

There is no one-size-fits-all structural solution that euro area banks need to target. Effective bank strategies include rigorous cost-saving measures as well as measures to diversify income sources. But whatever the features of the markets in which banks operate, a key ingredient is the effectiveness of banks' strategic steering, for example in terms of loan pricing, planning and control, cost allocation and oversight of business functions. Banks that have performed better in recent years are on average also better at strategic steering.

Digitalisation is becoming an integral part of banks' business models, changing their internal operations and business practices. While it can be an important and permanent cost-saving strategy for banks, it can also generate revenues by enhancing their fee- and commission-based activities, and by enabling banks to develop new products and provide better services to satisfy customers' needs, also in view of new competitors entering the banking market.

Digital transformation comes with corresponding up-front costs in IT infrastructures and new skills, but in the medium term it provides clear opportunities for a much needed increase in cost efficiency.

Finally, banking sector consolidation can be an important factor to help address the overcapacities and fragmentation of the banking sector, potentially leading to synergies and greater efficiency. At the beginning of this year we published a Guide setting out our prudential approach to consolidation. This was intended to provide clarity as to how we assess the prudential aspects of consolidation projects and to dispel concerns that credible integration plans could be hindered by the supervisory actions of the ECB.

## Fit and proper assessments

Internal governance is a key factor of banks' ability to overcome the challenges ahead. It is also the area in which our Supervisory Review and Evaluation Process (SREP) identified most findings, while remediation is proceeding at slow pace, also due to current circumstances. We have announced our intention to clarify our supervisory expectations regarding the suitability of board members. Three key improvements could be made in this area. First, we will encourage early engagement with the supervisory teams, recommending all banks to provide us with their suitability assessments before making appointments, even if they are currently subject to national regulation that allows for ex post assessments only. Second, when assessing the suitability of candidates for appointment or reappointment to a bank's board, we are going to give greater consideration to any supervisory findings related to positions previously held by the candidates, as well the specific needs of the banks. Third, as fit and proper criteria are to be respected through time, not only at the time of the first appointment, we want to further clarify the way in which we reassess sitting board members, if new relevant facts emerge which could affect their suitability.

## Enhanced management of climate-related risks

The supervisory actions we take to ensure that banks address climate-related and environmental risks are becoming more concrete. We published our supervisory expectations in November last year in the form of an ECB Guide. The banks under our supervision will be required to carry out a self-assessment of their climate risk management strategy, which will provide the basis for a supervisory dialogue on credit risk management. We also provided guidance on banks' climate-related and environmental risk disclosures, as well as an assessment of the level of disclosure of climate-related and environmental risks. In 2022 we will carry out a climate risk stress test, which will allow us to review banks' practices in this area and take concrete follow-up measures where needed. Meanwhile, we are setting up a climate change centre at the ECB. It is bringing together staff with data and climate expertise in workstreams that cover both the banking supervision and the monetary policy functions of the ECB. They will shape the ECB's climate agenda, both internally and externally. We have the ambition to continue playing a leading role in European and international fora to drive progress in this field.

Lastly, we continue to engage with banks to ensure that in the post-Brexit world they allocate enough staff and assets to institutions inside the banking union. This is necessary to ensure adequate management of risks both in and from Europe.

## The importance of completing the banking union

The lack of a fully integrated safety net in the banking union preserves segmentations across national markets, which adversely affect the efficiency of the European banking sector and the pursuit of our supervisory priorities. Following the conclusions of the Euro Summit last December, we welcome the ongoing discussions on a roadmap for implementing the European Deposit Insurance Scheme (EDIS). It is important to put EDIS in place and complete the banking union, to ensure that depositors across participating Member States enjoy the same level of protection of their savings and to support the seamless deployment of capital and liquidity within banking groups, especially at times of stress.

We also welcome the European Commission's review of the crisis management and deposit insurance framework and stand ready to contribute to the discussion with the experience of the first years of the banking union. The main improvement that can be made in this area is to ensure that crisis management works for all banks – not just the larger banks with cross-border operations, but also the banks that are smaller and largely deposit-funded. Here we can take inspiration from existing best practice examples, most notably the functioning of the Federal Deposit Insurance Corporation in the United States.

## Conclusion

Together with the newly appointed Vice-Chair Frank Elderson and my other colleagues on the Supervisory Board, I can assure you that we will remain proactive in inducing banks to effectively manage the risk of the COVID-19 pandemic, with a view to supporting sustainable credit provision and economic growth. At the same time, we will continue our work in other risk areas to ensure that the banking sector is also prepared to mitigate risks that will become relevant in the future. We hope that the co-legislators can reach an agreement on measures to complete and further strengthen the banking union in the near term, as this would be to the benefit of all EU citizens. I look forward to continuing our exchanges of views in 2021.

Thank you for your time and attention. I now look forward to your questions.

Related topics

Coronavirus

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