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BANKING SUPERVISION

Risks and resilience – the European banking sector in 2016

Speech by Danièle Nouy, Chair of the ECB's Supervisory Board,
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Ladies and gentlemen,

Thank you for inviting me to speak at the Bank Capital Forum 2016. It is a great pleasure to be here today.

The financial market is a mysterious place where an investor can make a fortune within minutes – or lose it all. Many ambitious people have therefore attempted to decipher the secret of the financial market in order to attain fame and wealth.

In their quest, many of them have sought the council of those who they saw as the wizards of finance. One of those wizards was John Pierpont Morgan. And the legend goes that, one day, a young man approached him and asked about the secret of the stock market. J. P. Morgan looked at the young man and replied: "it fluctuates".

Well, recently, we have certainly seen some proof of that. Since the beginning of the year, share prices of European banks have been extremely volatile. On some days, we have seen prices rise or fall in double digits. This development seems to be driven by a number of worries relating both to macroeconomic factors and idiosyncratic issues.

The question for me is: how should we, as supervisors, interpret the current market environment?

Resilience and risks – the European banking sector

From a supervisor's point of view, there is one thing that should be emphasised: over the past few years, European banks have raised their resilience to an unprecedented level. Since 2012, the CET1 ratio of significant institutions in the euro area has risen, on average, from 9% to around 13%. These institutions have made huge progress in meeting the fully phased-in capital requirements that will be in effect from 2019 onwards. In fact, the vast majority of banks meet these requirements already today. Measured in terms of capital, the European banking sector rests on a solid foundation.

This is certainly good news, given that strong winds have set in – winds that make some observers wonder whether banks might be thrown off balance – a worry that is reflected in recent market developments. What has caused these winds are weak economic growth and a prolonged period of very low interest rates. As a result, many banks are challenged to remain profitable.

On the asset side of their balance sheets, nominal yields are on a downward trend. First, because earnings on a significant portion of their assets are correlated to market rates; and second, because yields on newly acquired assets are usually well below those of expiring assets. At the same time, banks cannot fully reap the benefits from decreasing funding costs because they tend to avoid paying negative interest on their customer deposits.

Against that backdrop, we still see indications that the large banks in the euro area, on average, increased their profits in 2015. Consequently, they were able to pursue appropriate distribution policies, while still meeting regulatory and supervisory capital requirements.

Nevertheless, the return on equity realised by banks in the euro area is still well below their costs of equity. Low profitability is obviously a major concern for the stockholders of banks. And it is also a concern for supervisors. Over the long term, low profitability threatens the ability of banks to generate capital and access financial markets. Ultimately, a lack of profitability affects the stability of banks.

So, how can banks brace themselves against the wind and strengthen their balance? A natural impulse might be to lean against the wind. But if they lean too far in, they might lose balance when the wind stops. Banks should therefore refrain from taking on excessive risks in order to increase profits.

Still, the impulse to do just that is certainly strong. Weak profitability might push banks into a hazardous search for yield. And we do observe a trend towards higher risk-taking by banks. Certain banks in the euro area have, for instance, invested in leveraged finance such as high-yield bonds.

In its search for yield, the financial sector has apparently ventured into riskier territories, driving risk premia to historic lows. This situation harbours the potential for an abrupt reversal that could be exacerbated by illiquidity in some segments of fixed-income markets. Such a reversal in the search for yield can affect banks in several ways. First, they might have to revalue their security holdings – particularly those assets measured at fair value might then cause losses. Second, lower asset prices may lead to increased collateral requirements – affecting, in particular, those banks with a large proportion of secured funding. Third, banks with a high reliance on wholesale funding might experience higher funding costs when risk premia increase.

So, how can banks brace themselves against the wind without leaning too far against it? How can they preserve their profitability without taking on too much risk?

Instead of leaning against the wind, banks could try to become more aerodynamic in order to reduce the drag from the wind. More specifically, banks could expand their non-interest business operations. And we indeed observe that banks compensate for lower interest income by increasing their fees. There is at least some evidence that banks tend to offer fee-based products to clients as substitutes for interest-based products. While the revenue structure of euro area banks has been stable for a long time, it has recently begun to change. The role of interest income seems to be slowly decreasing.

Another option for banks would be to cut their costs and increase their efficiency. Cost-income ratios might not be the perfect metric, but for some banks in the euro area, high cost-income ratios indicate that there is some room for improvement in terms of efficiency. Nevertheless, banks might also be tempted to cut costs where they should not. Inappropriate cost-cutting might, for instance, affect IT-systems, putting their soundness at risk and exposing the banks to cybercrime or preventing them from coping with the challenges of digitalisation. The consequences could be operational losses, reputational damage and a disruption of business.

To sum up, the need to increase profitability and potentially adapt business models is a challenge facing all banks in the euro area. All of them feel the strong winds from low economic growth and low interest rates. And all of them have to find ways of dealing with these circumstances.

Still, there are more risks out there – although their relevance varies across the euro area. This variance reflects the different structures of the banking sector and different business models of banks. The additional risks include credit risk and heightened levels of non-performing loans, conduct and governance risk, sovereign risk, geopolitical risk and growing vulnerabilities in emerging economies, as well as IT and cybercrime risks.

Regulation and supervision – priorities for 2016

Ladies and gentlemen, European banks are certainly facing a number of challenges. Nevertheless, they rest on a solid foundation of capital. Compared with 2008, the financial system has become a much safer place – not least thanks to an improved regulatory framework.

Over the past few years, capital requirements for banks have increased. Banks now have to fulfil higher regulatory requirements and stricter supervisory requirements. Admittedly, that sounds like a lot of additional capital to be held by banks. However, regulators and supervisors are not acting without purpose. Their objective has been to increase the resilience of banks and to establish a universal buffer against any shock; that universal buffer is capital.

Nevertheless, regulation cannot entirely prevent individual banks from failing. The risk of failure is inherent in a well-functioning market economy, and we should not try to change that. What we have to do is ensure that the failure of an individual bank does not destabilise the entire financial system. And also ensure that the costs of failure are borne by those who willingly took the risk in the first place – namely the shareholders and the creditors. We must leave "too big to fail" and public bail-outs behind.

To this end, new standards are essential, such as those for total loss-absorbing capacity, TLAC for short, and minimum requirement for own funds and eligible liabilities, or MREL. Altogether, the new bail-in regime is an incentive for investors to exert market discipline on banks – which is indeed one of its desired effects. Nevertheless, the recent increase in spreads does not appear to reflect the fact that banks hold an amount of capital that by far exceeds the minimum requirements.

Yes, we have added some spice to the alphabet soup of regulation, and we have done so to increase financial stability and protect the taxpayers who have had to support failing banks far too often. Nevertheless, it is not the intention to increase capital requirements indefinitely. With regard to supervisory capital requirements, we have clearly stated the levels of Pillar 2 capital we expect the banks to hold in steady state. All things being equal, supervisory requirements will not be increased further.

From the regulator's point of view, it is also not the intention to tighten rules and requirements up to a point where all risks would be eliminated. Reaching that point would simultaneously eliminate the market economy – something we should definitely not try to do. Within the regulatory framework, the financial system needs breathing space and that, inevitably, entails taking risks. Therefore, it is important that not only banks but also banking supervisors keep track of these risks and address them early on.

Against that backdrop, we have conducted a thorough analysis of risks in the banking sector, and we have defined five priorities that will guide European banking supervision in 2016.

The top priority relates to a challenge which all banks in the euro area face and which I already discussed: business models and profitability. European banking supervision will closely follow each step the banks take in their attempt to tackle this challenge. More specifically, a thematic review has been started on bank's profitability drivers at firm level and across business models. In this context, we will examine whether banks try to increase profitability by leaning too far against the wind – through weaker credit standards, greater reliance on short-term funding or increased risk exposures.

Another key priority for 2016 is credit risk. We still see elevated levels of non-performing loans in some segments of the banking sector. These non-performing loans were identified in the 2014 comprehensive

assessment and they are reasonably well provisioned for. European banking supervision now aims to develop a consistent approach for reducing the level of non-performing loans in an orderly manner over the next few years.

To this end, a task force on non-performing loans is currently reviewing the situation of those institutions affected and will propose follow-up actions. European banking supervisors will also investigate excessive risk concentrations in areas such as real estate. Another issue is the implementation of the new accounting standard "IFRS 9 – Financial Instruments", as this standard will change the way credit impairments are measured. A relevant thematic review will be launched in the course of 2016.

Another supervisory priority for 2016 concerns risk governance and data quality. Both are particularly important given that low profitability of banks coincides with the availability of cheap and ample funding – a mixture that might easily lead to a search for yield and excessive risk-taking. In this context, sound governance and effective risk management are essential to keep risks in check.

Nevertheless, the financial crisis revealed that the governing boards of banks may lack the information necessary for good decision-making. European banking supervision will therefore clearly articulate its expectations vis-à-vis banks in that respect. Furthermore, a thematic review will assess to what degree banks comply with the principles for effective risk data aggregation and risk reporting issued by the Basel Committee on Banking Supervision. This review will also reinforce the follow-up actions to the 2015 thematic review of risk governance and risk appetite.

Capital adequacy remains another key priority for 2016 – I have already mentioned the importance of capital as a universal buffer against shocks. In 2016, European banking supervision will mainly focus on the consistency and quality of banks' internal capital adequacy assessment processes, ICAAP for short. We will also examine the internal stress testing capabilities of banks and conduct regulatory stress tests – the 2016 Europe-wide stress test coordinated by the European Banking Authority and the stress test performed by European banking supervision as part of the Supervisory Review and Evaluation Process, or SREP.

Finally, liquidity was also added as supervisory priority for 2016. Experience from the financial crisis has shown how dangerous liquidity shortages can become. In addition, the experience of our 2015 SREP has shown that a number of banks do not yet fully meet supervisory expectations regarding sound management of liquidity risks. Consequently, we will further develop the SREP methodology on liquidity risk. This includes understanding the reliability of liquidity risk management in banks as expressed through the internal liquidity adequacy assessment process – the ILAAP.

Conclusion

Ladies and gentlemen,

while John Pierpont Morgan may not have revealed the secret of the stock market, he at least revealed an eternal truth: the stock market fluctuates. And it may well be that we will never fully understand what fears and hopes drive these short-term fluctuations.

Therefore, it is essential for banks to take a longer-term view and tackle the structural challenges. That is the only way to regain trust and ensure sustainability. Bankers, supervisors and regulators have to work together in order to preserve the profitability and stability of the banking system. And to quote J. P. Morgan once again: "When I have business on hand I think it is better to have it done quickly".

Thank you for your attention.

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