Sabine Lautenschläger: The European banking sector - a quick pulse check

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism, at the Euro Finance Week Conference, Frankfurt am Main, 15 November 2016.

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Since the financial crisis of 2008, the health of the banking sector has become one of the hot topics in public debate. And with good reason, because banks are important for all of us – in good times and in bad.

In good times, banks help to finance enterprises which, in turn, drive economic growth and provide employment. In bad times, banks can threaten the financial system and damage the economy – as we have learned during the recent financial crisis.

Against that backdrop, the purpose of my speech today is to do a quick pulse check and see how European banks are doing.

European banks – more resilient and less profitable

Let us begin by talking about the obvious!

First, banks have become much more resilient. Higher capital buffers are helping them to withstand even severe shocks. The recent stress test conducted by the European Banking Authority confirmed the increased resilience of European banks.

However, that rather benign finding seems to be contradicted by the collective pulse check that is conducted by the markets. Since the beginning of the year, the share prices of European banks have fallen by more than 20%, on average. It seems that, in the view of the markets, European banks are not that healthy.

The diagnosis is not a lack of stability but a lack of profitability. And indeed, the return on equity of large banks in the euro area is mostly still below the estimated cost of capital.

Attempts to explain this lack of profitability have focused on low interest rates. It is true, of course, that low interest rates are a challenge for banks. Still, we should not completely ignore their positive effects. They reduce funding costs for banks and support the economy, which also indirectly benefits banks.

But it is not just low interest rates that pose a challenge to banks. Other issues play a role, too: high costs eat into profits; non-performing loans weigh down balance sheets; and fee-generating business has become more difficult. Digitalisation has introduced fintech companies as new competitors, and the banking landscape in general is still characterised by overcapacities. This increases competition and depresses margins.

European banking supervision – a comprehensive treatment plan

Banks have become more resilient, but they do operate in an environment that is characterised by constant change and constant competition. In order to retain their resilience and preserve their profitability, banks have to change as well. Most importantly, they have to rethink their business models.

From our perspective as supervisors, the viability of business models is currently one of the main points of attention. While it is not our role to tell banks how they should operate, we must warn them against the temptation to prop up their profits by taking on too much risk. An excessive search for yield could easily lead to new troubles for the banks themselves and the financial system as a whole.

And against the backdrop of low profitability, abundant liquidity and high competition, this is not a purely hypothetical concern. As a result, we are not only scrutinising business models and profitability drivers, but are also taking a close look at risk management. This is reflected in our supervisory priorities today and for the coming years.

In a nutshell, effective risk management rests on two pillars: sound governance structures and high-quality data. With regard to internal governance, we recently published the results of a thematic review. Its conclusion: many euro area banks need to improve the way they conduct business and manage their risks in order to achieve international best practices. With regard to data quality, the “Principles for effective risk data aggregation and risk reporting” published by the Basel Committee on Banking Supervision in 2013 are a suitable benchmark. We will closely monitor whether banks are applying these principles.

Another important issue in the context of risk management is the internal models that banks use to calculate their risk-weighted assets which, in turn, serve as a basis for determining capital requirements. For the next three years we will conduct a targeted review of these internal models in order to ensure consistent model outputs and restrict unjustified variability in the calculation of risk-weighted assets.

Through our review, we will gain in-depth knowledge of the internal models for credit and market risk used by European banks, as well as of their standards and best practices. We will put this knowledge to use for several objectives.

Our follow-up decisions, in particular when approving models and requesting improvements or add-ons, will contribute to a level playing field regarding the calculation of capital requirements.

We will also use the knowledge we acquire to hone our supervisory expectations and our guidance for banks regarding credit and market risks. And we will base our position in international supervisory and regulatory groups on the knowledge and experience we gain during the project. Our review is certainly a huge project – in 2017 alone, we will be conducting more than 100 assessments, each of them covering three to four models. Nevertheless, the benefits will be equally large.

In addition to business models and risk management, we are currently focusing on a third issue: credit risk. Most prominently, this includes the issue of non-performing loans that I mentioned before. It is the banks themselves that have to tackle this issue as quickly as possible. However, they sometimes face obstacles in the form of inadequate national legislation and national judicial frameworks, as described in the stocktake of national practices we published in September. Here, policymakers can play an important role by reforming relevant legislation.

As supervisors, we can assist the banks by pointing out best practices and ensuring that they are applied. Today, we will close the public consultation on our guidance for banks on dealing with non-performing loans. That guidance takes the form of recommendations to banks and defines a number of best practices that we have identified. It sets out our supervisory expectations and serves as a basis for supervisors to evaluate how banks handle non-performing loans.

Conclusion

Ladies and gentlemen, to sum up: banks are more resilient than they were just a few years ago. However, they still have to improve their fitness. They have to adjust to a new economic environment; they have to adapt to the digital world; and they have to become more efficient and deal with legacy assets. This is no small task, but it has to be done.

Moreover, the banks have to get used to a new regulatory framework. That framework should be finalised by the end of the year, and it should be finalised at the global level. Banking became a global sector years ago, and regulation must follow in order to ensure stability.

Thank you for your attention.