Sabine Lautenschläger: Banking supervision – what next?

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the Banking Supervision, Resolution and Risk Management Conference during the 20th Euro Finance Week, Frankfurt am Main, 14 November 2017.

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"What next in banking supervision and resolution?" is the title of this panel discussion. Well, before we discuss what comes next, let us take a quick look at what has happened in recent years.

Since 2014, we have built European banking supervision from scratch. We have hired people, devised methods and set up processes. There are certainly still things that need to be improved, but by and large the system runs smoothly.

As that is the case, there will be less construction work to be done in the years ahead. But this doesn't mean that we will sit idly by, quite the opposite. The banking sector is facing a whole range of challenges, as you well know, and we have our part to play.

Let me mention a few points – and it's not a comprehensive list. There is the banks' search for profitability and their need to cut costs and adjust their business models. There is Brexit. There is digitalisation and there are cyber risks. There are the Basel III reforms, which need to be finalised and then implemented. And there are efforts to further strengthen proportionality.

I could go on, but allow me to focus on just one of the core topics which the banks – and we – have to deal with: non-performing loans, NPLs for short. Most NPLs are legacy issues. European banking supervision has, so to speak, inherited them. It's a major problem that we have to tackle – or rather, the affected banks have to.

For them, the non-performing loans weigh on profits; they require provisioning, and they are a constant drain on banks' human resources, which could be put to more profitable use. And NPLs undermine trust – to what extent do markets trust a bank with a balance sheet that is considerably impacted by NPLs? In other words, non-performing loans make the affected banks weaker and keep them from lending to the economy.

Banks which manage to forcefully address this legacy can focus on the future and attract new investors and new business, instead of forever having to look to the past. These banks can do their job: finance the economy.

That makes it imperative to sort out NPLs. And there has been quite some progress on this front. Since 2015, significant banks in the euro area have brought down their non-performing loans by almost €200 billion; from €989 billion to €795 billion. That said, NPLs are still too high in parts of the banking sector.

That is why banks have to act. And times could not be better. We can look back at 18 consecutive quarters of economic growth; this is a robust, broad-based economic recovery.

Now is the time to sort out the issue of non-performing loans. Banks need ambitious yet realistic plans to deal with their stocks of NPLs. And they need the right governance for these plans.

Earlier this year, the ECB published its "Guidance to banks on non-performing loans". Along these lines, and as part of our supervisory dialogue, we take a close look at the banks' ability to manage their NPL stocks. We then scrutinise the plans devised by the banks to reduce those stocks. We will start providing our feedback later this month.

Banks have to carefully consider how they will react should any performing loans happen to become non-performing. So, with the future in mind, we have to ensure that the problem of NPLs does not recur. New NPLs should therefore be conservatively provisioned within a reasonable period of time. This would serve to strengthen the balance sheets of banks, enabling them to focus on their core business.

That's why we have drafted an addendum to our guidance on non-performing loans. It sets out how we expect banks to provision for future NPLs. The main goal is to have timely provisioning, which should prevent new NPLs from becoming a problem with systemic implications.

But let me say that while our expectations are firm, there are no automatic actions attached to them. We will discuss with each affected bank individually why it is not fully provisioning for loans which have been non-performing for several years. Only if the results of this structured dialogue do not convince us will we consider Pillar 2 measures. We have followed this path before, for instance with our **recommendation on dividend distribution policies** and the **Asset Quality Review**.

The addendum to our guidance on non-performing loans explains our methodology and is currently the subject of a public consultation. This consultation will increase transparency for banks, and the public, and it will help to ensure a level playing field. So, while it is ultimately up to the banks to deal with NPLs, we supervisors play a role too. It's our job to address vulnerabilities in the banking sector. NPLs are probably the single biggest challenge – and of course they are a drag on the entire economy.

And while I am convinced that the ECB has led the way with its work on NPLs, we are not the only ones who can and should take action. European finance ministers agreed, in July this year, on an action plan to tackle NPLs. Also, national governments can help to resolve the NPL problem by reforming their legal and judicial systems. In some countries, it can take quite a long time to recover NPLs in court. This is something that can only be addressed at national level by national governments.

NPLs are a joint problem, and we need to make a joint effort to resolve it. Each party has to play a role: banks, supervisors and politicians. In line with our mandate, we supervisors have done and will continue to do what is necessary.

Thank you for your attention.