Sabine Lautenschläger: Risks to banks – from inside and out

Speech

Ladies and gentlemen,

It is a pleasure to be here today! And not only because it allows me to escape the cold German winter, but also because this meeting allows us to share views from opposite ends of the world – views from Asia and Australia and views from Europe.

The crisis has shown how important it is to do just that. How important it is to be aware of what's going on elsewhere, of how closely markets and market participants are interconnected. After all, a crisis that breaks out on one side of the globe can quickly spread to the other.

So, being aware is one thing. But the crisis forced us to go further; it forced us to join forces – not only in overcoming problems as they arose, but also in revamping the regulatory and supervisory framework afterwards. This happened at the global level – Basel III – and at the regional level.

In Europe, policymakers went further than anywhere else. At the height of the crisis, they decided to set up a banking union. The first step was to take banking supervision from the national to the European level. So, in 2014, the ECB became responsible for supervising banks in the euro area.

Has this worked out? I still remember that, back in 2014, I heard quite a few critical voices. Not everyone believed that European banking supervision would actually work. Four years later, this has changed. European banking supervision has been set up, it is running smoothly, and it contributes to making banks safer and sounder.

But it was quite some job, I can tell you. I remember the early days, when we were just a handful of people sitting in a half-deserted building in Frankfurt.

I remember how we began to hire staff – around 1,000 – for the ECB, and how we began to bring together the supervisors in national authorities, supporting them in adopting the new European supervisory approach.

I remember the comprehensive assessment we carried out on the banks that we would later supervise. We were like a start-up; we still are, in fact. We are constantly innovating, learning and growing together as a European team of supervisors.

And this European aspect is crucial. As European supervisors, we can take a higher vantage point; we can see and act across borders. As a national supervisor at the Federal Financial Supervisory Authority and the Deutsche Bundesbank, I supervised 20 large banks – all from Germany. In the SSM, we supervise around 120 large banks from across the euro area. You can imagine the greater depth of insight that we gain.

We benchmark all these banks against their peers; by comparing them we can more easily spot new trends, new risks and new vulnerabilities. We can clearly distinguish the nodes and links of the European banking sector. And see what works and what doesn't – both on the banking and the supervision side.

Let me give you just one example. It's no secret that European banks have a profitability problem. In analysing this problem, we benefited a great deal from our cross-country perspective. We could identify a number of banks that constantly outperform their peers, and we could assess the factors behind their success. This would not have been possible if we had looked only at a national sample of banks.

But now that I have lavishly praised the concept of European banking supervision, let's turn to the banks and the risks they face.

And there are plenty of risks. Plenty of risks that interact in complicated ways. So, for brevity's sake, I won't address all the risks that exist but will focus on just a few. I will start with one of the issues that has, unfortunately, become a hallmark of the euro area banking sector: non-performing loans, or NPLs.

In early 2015, significant institutions in the euro area held almost €1 trillion worth of bad loans on their balance sheets and the aggregate NPL ratio stood at 7.5% on average. This average, however, masks big differences: NPL ratios ranged from around 1.5% in Luxembourg to more than 45% in Greece.

The banks therefore had a heavy burden to carry. After all, NPLs require special care and so tie up management resources. They also pose a higher risk of losses, require provisions, tie up capital and affect lending. Their effect on lending is what makes NPLs a problem that reaches beyond the banks.

The euro area economy mostly relies on banks as a source of credit – much more so than many other economies. This is particularly true for small and medium-sized enterprises, which form the backbone of the economy. In the EU, SMEs account for more than 50% of value added and more than 60% of employment. Altogether, 99% of all enterprises are small and medium-sized.[1] The three most important sources of financing for SMEs are bank loans, leasing and credit lines.[2] So they do rely heavily on banks.

This makes them somewhat vulnerable. In crises, banks tend to charge higher premiums when lending to SMEs. And, as an ECB study shows, this premium is in turn partly driven by the amount of NPLs on a bank's balance sheet.[3] The more NPLs a bank holds, the less it lends to the economy.

So, it was clear from the start that NPLs were not just a problem for banks and their supervisors. Other national and European authorities had to act as well.

As for us supervisors, dealing with NPLs is a core task! We benefited from our European point of view, from being free of national traditions. We drew, for instance, on the experience of countries such as Ireland which had already successfully dealt with NPLs.

And we were able to compare and draw lessons from the different legal and judicial environments in 19 countries. Building on all these insights, we developed a harmonised European supervisory approach for tackling NPLs. This was not easy, though, as we met with considerable pushback.

But we nevertheless moved ahead. After first taking stock, we pursued a two-pronged approach from 2015 onwards: first, directly addressing legacy NPLs; second, preventing new NPLs from piling up.

On this basis, we devised a harmonised approach that rests on three pillars.

The first pillar is qualitative guidance to banks on how to develop and implement strategies to reduce NPLs. These strategies should contain targets for reducing NPLs at the portfolio level over a three-year horizon. But our guidance simply outlines best practices in devising the strategies and lists tools for implementing them. As no two banks are alike, each bank needs to pursue an individual strategy and meet individual reduction targets. It goes without saying that we diligently monitor their progress.

The second pillar is a quantitative addendum to this guidance, in which we specify our supervisory expectations for the provisioning of new NPLs. These expectations depend on the extent to which NPLs are secured. For fully unsecured exposures and unsecured parts of partially secured exposures, we expect banks to achieve 100% coverage within two years after a loan has been classified as non-performing. For secured NPLs, the limit is seven years.

The third pillar is a framework to address the stock of NPLs. Within this framework, we formulate, for each bank, our expectations regarding the provisioning of legacy NPLs, bearing in mind the general expectations on provisions that I just outlined.

Our assessment of each bank’s implementation of our qualitative and quantitative guidance is part of our bank-specific Supervisory Review and Evaluation Process, or SREP for short.

At the same time, an action plan to tackle NPLs was developed at the political level. This plan set out the need for action in three areas: first, banking supervision; second, insolvency and debt recovery frameworks; and third, secondary markets for distressed debt.

And since 2015, we have made real progress in bringing down the level of NPLs. The volume of NPLs has declined by almost €400 billion since that year. The average NPL ratio now stands at just over 4%, around €600 billion in absolute terms. So things are improving significantly, but there is still some way to go.

NPLs are among the biggest challenges facing banks in the euro area; it is essential that banks complete the clean-up of their balance sheets as long as the sun is shining.

But banks and supervisors cannot focus solely on the past, on legacy assets. We must also look to the future and watch out for the risks that are still beyond the horizon or just appearing on the horizon.

While I have just praised the banking union as a major step towards a united Europe, one country is about to take a step in the opposite direction. Brexit is about to happen – or so it seems. The official date for the United Kingdom to leave the European Union is 29 March 2019. As of today, however, it is still unclear how this will happen – if it happens at all. The worst scenario would be a Brexit without any agreement between the United Kingdom and the EU on their future relationship.

Despite all the uncertainty, one thing is clear: Brexit will change the shape of the European banking sector. In the first place, the large number of banks that are located in the United Kingdom and do business in the EU will have to find new ways of accessing the European market after Brexit.

And this is relevant for us supervisors, of course. Over the past two years, we have clearly set out what we expect from banks relocating to the euro area. We have published information on our website; we have talked about the issue in interviews and speeches; and we have had intense discussions directly with the banks. We have urged and pushed them to prepare for all potential outcomes of the political process. At present, most banks relocating to the euro area have made reasonable progress in preparing their move.

But it’s not just banks located in the United Kingdom that will be hit by Brexit. Euro area banks rely, for instance, very much on central counterparties, or CCPs, in the United Kingdom to clear derivatives. With Brexit, they might lose access to these services, and this might disrupt their business and the markets, and in turn threaten financial stability. The European Commission has acknowledged the problem and plans to take temporary measures to preserve access. While this is certainly good news, it is merely a stopgap. There is no time to relax; there is just a little more time to prepare.

Now, Brexit at least offers an opportunity to think about CCPs and concentration risk in more general terms. The market for clearing is highly concentrated. While I do see the benefits in terms of efficiency, I also see the risks. And this is something we definitely need to discuss.

I have now focused on two challenges that are more or less European: NPLs and Brexit. There are, of course, many more challenges, and these affect banks not only in Europe but worldwide.

There are geopolitical uncertainties, for instance. It seems that nationalism and, thus, protectionism, is on the rise. In the long run this will hurt the economy and everyone will be worse off, including those who appear to benefit from protectionist measures at first glance; the current trade tensions are a case in point.

Then there are financial market risks. Interest rates are low and liquidity is still abundant and cheap, but these conditions will not last forever; there is the risk of a snapback in markets.

At the same time, technological progress might change the business of banking and the structure of the sector. This could be an opportunity; but it may also be a risk if banks fail to adapt.

Ladies and gentlemen, banks have to deal with many risks these days. And while it seems that the risks have grown, it should be clear that risks are an inherent part of a bank’s business. In fact, what distinguishes a good bank from a bad bank is how it deals with risk.

And in this regard, the enemy all too often comes from within. After all, banks are managed by people. And people make mistakes from time to time; they are often biased when taking decisions under uncertainty and some people have skewed ethics. The result can be bad risk management or even outright misconduct. Neither is acceptable and each can damage the reputation of a bank, drive away its customers and diminish its capital. Each can bring down a bank and harm others.

For policymakers, issues of misconduct can bring additional challenges. Money laundering is a good example. Recent cases have shown that it often reaches across borders and requires different authorities to act. In Europe, national authorities are in charge of anti-money laundering, AML for short. The ECB has no AML mandate, but as European banking supervisors we also have to take relevant risks into account. We do so, for instance, when we assess acquisitions of qualifying holdings, or when we assess whether banks’ managers are fit for their jobs.

Prompted by the recent scandals, European policymakers have now taken several initiatives, one of their aims being to strengthen the cooperation between national AML authorities and European banking supervisors.

For instance, new European legislation provides that the ECB and national AML authorities exchange relevant information. To better integrate findings from national AML authorities in prudential supervision, ECB Banking Supervision is setting up an AML coordination function which will have three main roles: to handle interactions with national AML authorities, raise supervisors’ awareness about money laundering risks in banks, and be a centre of expertise on prudential AML topics.

But AML is just one example. More generally, good governance, with the right checks and balances in place, can keep such problems from emerging. Governance has been neglected by regulators and supervisors for far too long. I see it as a crucial topic for the years to come.

For European banking supervision, governance is a key issue – and has been from the very beginning. The quality of a bank’s governance is one of the four pillars of our SREP. How could we judge a bank to be safe and sound without assessing its governance framework?

As part of our SREP, we also assess the banks’ risk appetite frameworks, their RAFs. We look at whether banks are fully integrating the policies, processes, controls, systems and procedures set out in their RAF into their decision-making processes and their risk management. We also assess whether their RAF is aligned with their business plans, strategies, capital planning and remuneration schemes. Easier said than done, as I’m sure you know.

We do not look at banks in isolation. As I just mentioned, benchmarking is a key supervisory tool. We carry out horizontal analyses on a host of issues, including governance, which was the subject of a thematic review we published in 2016.[4]

However, all of this is still work in progress – for supervisors and for banks. That banks are not yet where they should be becomes clear when we look at the recent scandals in the headlines: money laundering, tax evasion, manipulation of rates and prices – you are no doubt familiar with these cases. They are not confined to a single region, nor to a single bank. While good governance can take banks a long way in behaving responsibly, we have to dig deeper.

Ultimately, ethical behaviour is either helped or hindered by a bank’s culture. So we do not want to see a culture that tolerates misconduct or even encourages it. But it is not in a supervisor’s power to shape a bank’s culture. Ultimately, the onus is on the banks and their stakeholders to bring about a cultural shift.

The first step is to understand that staying in business for the long term is more important than ramping up profits in the short term. In that sense, a good reputation is worth more than a dodgy deal – no matter how much profit that deal promises.

Shareholders, too, should focus more on the sustainability of a bank’s business model, and thus their investment, and less on receiving as high a dividend as possible in the short run.

This understanding is only the first step. The culture of a bank is shaped both ways, top-down and bottom-up. The management of a bank plays an important role in setting the tone and defining expected behaviour. But this is not enough. When it comes to culture, action speaks louder than words. Staff will take the behaviour of management as a cue of what is acceptable and what not. Managers have to lead not only by words but by example.

Incentives are another important point. Staff will know which behaviour earns them a bonus or gets them promoted. That’s why European banking supervisors assess remuneration schemes, including the extent to which integrity matters in promotions. More generally, integrity is one of the five criteria we apply when conducting fit and proper assessments of potential bank managers.

And this is key. Culture tends to be self-perpetuating, because people with certain values tend to hire people who hold the same values. Breaking this cycle is difficult, but necessary. But simply hiring people with different values and perspectives will not suffice. They then must be encouraged to speak up – to call foul when necessary. Here, we supervisors can help again. The ECB has set up a breach-reporting mechanism through which whistle-blowers can share information with us. Last year, we received more than 120 reports, an increase of about 40% from 2017.

So, there are things that can be done, but we should not expect miracles. Culture is a sticky thing that tends to change very slowly. I am sure it will keep us busy for some time to come.

Ladies and gentlemen,

This is it; this is how the banking world looks from a European point of view. Banks have become more resilient over the past years, but they still face a number of risks and challenges. Some of these risks and challenges are indeed European, but some are global in scope. And a number of risks are universal in the sense that they emerge from within a bank: weak governance, bad risk management, unethical behaviour. So plenty of work lies ahead for banks and supervisors.

But for now, I am looking forward to listening to you, and to discussing our thoughts and ideas.

Thank you for your attention.