Q&A

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The banking sector remains vulnerable to potential sudden adjustments

What are the key financial stability risks and the main vulnerabilities in the financial sector at the EU level in the context of persistently very low interest rates, the deterioration of credit risk, inflationary pressures and very accommodative fiscal policies?

European banks have shown good resilience to the pandemic shock. Backed by strong national and European public support measures, they managed to avoid the flow of credit to the economy becoming clogged up throughout the most severe stages of this crisis. But looking ahead, they need to remain mindful of certain risks building up in the financial sector.

First, there are signs that the asset quality deterioration caused by the pandemic may not yet have peaked, as it has been somewhat masked and certainly delayed by the extraordinary pandemic-related public support measures. Euro area banks' non-performing loans (NPLs) increased slightly in the first quarter of 2021, but NPL ratios have otherwise fallen throughout the pandemic, driven by an uninterrupted effort to reduce legacy risk. Crucially, credit risk controls at some banks have not been sufficiently tailored to the specificities of this shock, meaning that they do not allow for a timely and proactive assessment of credit risk developments by looking past the public support measures. As this support is phased out, we can expect non-financial corporate defaults to increase, notably in the sectors hit hardest by the crisis. Taken together, these developments make it all the more important for banks to remain prudent and proactive. Delaying the recognition of loan losses can damage both banks' balance sheets and borrowers' recovery prospects, thus deepening the shock and hampering the economic recovery.

There are also growing signs of complacency on the part of market participants, which is leading to higher levels of leverage, financial complexity and opaqueness. Within the growing market for leveraged finance, banks have gradually loosened their underwriting standards and allowed for increasing levels of corporate leverage. In the market for equity instruments, where some banks provide prime brokerage services and structure complex derivative products, idiosyncratic accidents have shown the disruptive potential of leverage and opaqueness.

In an environment where banks and the shadow banking sector remain interconnected in numerous ways, the banking sector remains vulnerable to potential sudden adjustments, such as asset price corrections that may stem from changes in investors' expectations regarding inflation and the path of monetary policy.

Why has the banking union failed to provide the degree of financial integration that was expected? How to overcome the fragmentation of the EU banking sector going forward?

In many ways, the banking union has delivered a significantly more integrated and resilient European banking market.

Against the backdrop of the reforms that were implemented after the financial crisis, the banking union helped equip banks with higher capital and liquidity buffers. And when the pandemic broke out, the banking union enabled a swift and fully unified supervisory response that was in stark contrast with the "go-it-alone" responses to the previous crisis. That such a response was fully coordinated with the monetary and fiscal stimulus provided at European and national level is another sign that there has been a paradigm shift.

But we have not yet reached the finish line as far as financial integration in the banking union is concerned. First, we should introduce the European deposit insurance scheme. The great financial crisis left profound scars and, in the absence of a safety net that is fully integrated at the European level, Member States will continue to take measures that prevent cross-border groups from operating seamlessly in the euro area as a unified market. National options and discretions should be further reduced, as they undermine the single rulebook and can at times serve as a ring-fencing toolkit.

Second, we should strive to harmonise the crisis management framework across the banking union to ensure that there are consistent outcomes in resolution and liquidation. The efficiency of cross-border banking is also affected by whether or not there is a level playing field when banks exit the market. Finally, while we wait for concrete legislative progress, I believe that the industry could do more to make the market better integrated under the institutional setup and legislative framework that is currently in place. For example, banking groups could reorganise their structures and rely more widely on branches, rather than subsidiaries, thus fully exploiting the opportunities provided by the single passport. In the context of Brexit, we have seen a number of banks relocating their business from outside the EU by adopting a branch structure for their euro area operations, through the use of the legal form of a European Company, or Societas Europaea. We are currently looking at the banks under our direct supervision that have adopted a similar structure to understand what lessons can be learnt from them, and we intend to share these lessons with the industry to stimulate progress on this front.

How to foster further supervisory convergence in the EU? How to improve regulatory and supervisory practices for transnational banking groups in the EU?

We now have single supervisory and resolution authorities that are European by their very nature, and that are therefore committed to protecting the interests of all European citizens. However, there is still the fear that, in times of crisis, parent companies will protect their own interests, and home authorities will prioritise the fulfilment of their national aims, which is exactly what happened in the wake of the great financial crisis.

We should ensure that a cooperative and coordinated approach prevails when the situation of a cross-border group starts to deteriorate, and also when this develops into an outright crisis. One way we can do this is by strengthening the role of group recovery and resolution plans, as well as their practical implementation. Subsidiaries and their parent companies could enter into a formal agreement to provide each other with liquidity support, and this could be embedded in their group recovery plans. To foster solid forms of integration, the ECB could make the granting of cross-border liquidity waivers conditional on the use of such intragroup support agreements. In addition to this, bail-in tools will become easier to use once all banks have reached the final target for their minimum requirements for own funds and eligible liabilities. These tools will support the long-term viability, stability and efficiency of the financial system by promoting transparency, accountability and the better pricing of risk.

A truly integrated banking market can act as a powerful shock absorber in crisis times. When the banking sector is segmented along national lines, a shock that hits one country will have to be absorbed within that country, putting a huge burden on its economy. But if the European banking sector is more integrated, local losses can be smoothly offset with profits from other countries and the risk can thus be privately shared across borders. And in the event of a shock hitting the entire banking sector of a single Member State, the assets and liabilities of failing banks can be sold to banks from other Member States, thus limiting disruptions for local depositors and borrowers. Capital and liquidity are still excessively segmented into local pools in individual Member States, and the banking union is not fully delivering on its private risk-sharing potential. More work is needed in this area if we want to reap the full benefits of financial integration.

How to further support the development of an internal market for financial products and services particularly in the retail area? How can the development of cross-border banking in the euro area be encouraged?

First of all, introducing a European deposit insurance scheme will be a crucial milestone for integrating European financial markets, encouraging banks to expand across borders and providing a guarantee to European citizens that each euro on deposit carries the same value, irrespective of where the bank and the customer are located within the banking union.

We have also stated several times that a certain degree of sustainable consolidation would be useful in addressing the profitability challenges that European banks are currently facing, including by allowing them to achieve economies of scale, become more cost-efficient and improve their capacity to face a future that is increasingly digital and definitely global. For this reason, we have made it one of our priorities to streamline and clarify our supervisory expectations for the consolidation process as much as possible.

The coronavirus (COVID-19) pandemic caused a significant jump in bank customers' demand for digital products and showed that services can be offered even with no physical presence. In my view, this is likely to remain part of the new normal for the banking sector, meaning that banks will need to have competitive digital products on offer if they are to survive. The sustainability of banks' business models will depend much more on their digital growth and effectiveness and less on the need for them to set up local structures, including across borders. Indeed, banks should take advantage of the digital momentum created by the pandemic to revise their cost structures, channel their investments towards becoming more digitalised and optimise how they are structured. At the same time, we are aware that this transition into a more digital realm also implies that areas such as cyber risk, IT risk and operational resilience will demand greater supervisory attention from us, in the broader context of the EU's planned reforms in the area of digital operational resilience.