EUROPEAN CENTRAL BANK

BANKING SUPERVISION

INTERVIEW

Interview with *Handelsblatt*

Interview with Andrea Enria, Chair of the Supervisory Board of the ECB, by Yasmin Osman and Kathrin Jones, conducted on 5 October 2020 and published on 12 October 2020

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Mr Enria, we spontaneously decided to meet face to face for this interview. That is still quite a rare occurrence these days. Have you generally gone back to working from the office instead of at home?

No. Until the start of next year we at ECB Banking Supervision will, in principle, continue to work from home. But in the meantime staff members who wish to work in the office again are allowed to do so, as long as they follow the distancing rules. I go to the office three or four days a week – last week I was actually there every day. It's great to see colleagues in person again.

What was the working from home phase like for you?

Well I did find the shutdown tough, especially as my wife was in Italy during that time and I was on my own at home. But work carried on surprisingly efficiently and effectively – a lot of people experienced the same thing, including at the banks.

As a supervisor don't you catch more, especially informal things, when you inspect banks on site?

It is indeed quite different when you can talk to people directly. Detailed on-site inspections are very important to our supervisory philosophy. In that sense the pandemic has had a major impact on us. But the banks have been able to provide us digitally with a lot of the information that we would otherwise ask for on site. In some cases they have even provided laptops with direct access to their data.

Isn't that something you could also continue after the coronavirus crisis?

Perhaps in future we will integrate these experiences into our supervisory approach. Before the coronavirus this kind of on-site inspection took twelve weeks. If we prepare more intensively in future using digital methods, we might be able to reduce the time it takes. That would be good for our budget and for the environment.

On the other hand, in the spring you must have felt helpless sitting in your office at home looking at all the projections about the bad loans that were going to hit Europe's banks, right?

If a huge wave of non-performing loans is coming towards you, it doesn't matter whether you are in the office, working at home, or at the beach. It's never a good feeling. However, our top priority in the spring was initially to prevent the banks from tightening their lending standards too much. Excessive caution could have led to a massive credit crunch, which could also have wiped out a lot of companies that are actually viable.

You allowed banks to reduce their capital buffers significantly during the pandemic.

Yes, but since July we have been urging banks to analyse in more detail what effects the extraordinary recession triggered by the pandemic is having on their asset values. The banks should take a long hard look at their loan books and work out which of their clients are really going to survive the crisis. The banks need to make a start on this now, so that the wave of bad loans doesn't have a chance to get too big.

Are banks already doing this?

I'd say there are three groups. A few banks have already started reassessing their clients' bankruptcy risk. Other banks, while not reassessing individual loans, are nonetheless building up a general risk provision for their loan portfolio as a precaution. I consider that a prudent approach as well. And then there are still the optimists who prefer not to do anything until there's a clear-cut indication that one of their clients is going to go bust.

How many optimists are there among the banks?

I can't say, but our supervisory teams are analysing these banks very thoroughly and are discussing things with them in great detail. It is not wise for a bank to put off such a step until the last moment and wait for moratoriums to expire. If many clients subsequently fail to pay, everything will unravel at once. We think it's important that banks also start now to build up their organisational capacity to process bad loans. This also applies to those banks that, up to now, haven't had many problems with bad loans.

How significant could the volume of bad loans be following a wave of insolvencies in the economy?

If the economy evolves in line with our baseline scenario, the banks should be able to handle the expected increase in non-performing loans. But there is a lot of uncertainty as to what could happen next. Under a severe scenario with a second wave of contagion and containment measures we have calculated that there could be up to €1.4 trillion in bad loans, which is more than after the last financial crisis. And it's still too early to rule out this severe scenario. That would have material consequences for the banks' capital positions.

So relaxing the rules on bad loans to enable banks to issue more loans isn't an option, is it?

I'm absolutely convinced that it's better for the banks and their clients if bank balance sheets are cleaned up as fast as possible. If that doesn't happen, the bank is dysfunctional. Instead of taking care of new clients, it uses lots of capital and human resources to service clients that are presumably never going to be able to pay back their loans. I'm very glad that we introduced rules and supervisory practices after the last crisis to force banks to recognise and work off bad loans sooner. In the current crisis this is more important than ever.

What do you mean by that?

I don't see this crisis as a typical recession, where economic activity first declines and then picks up again. My impression is that this crisis will lead to structural changes, which will transform our economies. Certain sectors will not recover from this downturn to reach the same levels of activity as in the past. Other areas of our economies, linked to the development of digitalisation and to green and sustainable businesses, will be increasing in importance. If the banks remain focused on servicing non-viable customers in declining industries, they won't be able to give their full support to these future-oriented sectors.

Do we need a bad bank to speed up the clean-up work?

I think that asset management companies, as I prefer to call them, can be useful tools, and they fulfilled a useful role in some countries after the last crisis. If they are set up right, they don't have to cost the taxpayer anything either. That's the kind of tool we should develop.

At the national or European level?

I believe there are strong arguments for a European initiative. But a network of national asset management companies can work well too. There is one mistake that we shouldn't repeat, though.

What's that?

After the last crisis we pumped a lot of taxpayer money into the European banking sector, but we didn't decisively restructure it at the same time. Despite receiving stimulus equal to 13 per cent of European GDP, the banking market came out of the crisis with significant structural weaknesses: excess capacity, limited profitability, excessive costs and in many cases institutions without sustainable business models.

What exactly was the mistake?

Unfortunately, the restructuring last time was entirely in the hands of the Member States. So any consolidation was solely at the national level. That was a mistake. This time, the restructuring should follow European principles and lead to a more integrated European market.

Will the coronavirus drive consolidation among European banks?

Consolidation can be part of the solution, for example to reduce excess capacity. The pandemic could accelerate this process. By the way, I'm not at all surprised that we have primarily seen domestic mergers. When it comes to cutting costs, you'll find that the biggest overlaps in the branch networks, and therefore opportunities for cost saving, are usually at the national level. But I think it would be great if the diversification of sources of income and risks was also considered. And the best way to do that is with cross-border mergers. That would make banks more stable.

Why does that almost never happen?

There are a few obstacles that would need to be dealt with via legislation. They make it very hard for a pan-European bank to move capital and liquidity around freely. Until this changes, cross-border mergers are much less attractive. Of course I understand that in the absence of a pan-European deposit protection system individual countries prefer to maintain capital and liquidity at the national level, to protect local depositors. This is why a European deposit guarantee scheme is so important. In fact, progress in integrating European banking could and should be a matter of urgency. Last week I floated a proposal (Link to: http://www.ecb.europa.eu/press/blog/2020/html/ssm.blog201009~bc7ef4e6f8.en.html) to rely on intragroup guarantees, approved by the European supervisor, to alleviate member state concerns and enable a greater pooling of capital and liquidity at group level.

Isn't the lack of that deposit protection system just another reason to stick to national mergers?

If European governments want the European banking market to remain national and inefficient, sure. But if we want stronger banks able to better serve Europe's households and corporates, then we have to think bigger.

Aren't you worried about banks getting too big to fail?

Too big for whom? A big bank might be too big for a given Member State, but if you think of it as a European market, then relative to European GDP these institutions are not that big, and in any case not bigger than their American competitors. Some lines of business, i.e. capital market activities, are only worth it if banks can achieve economies of scale. That's why European banks have been losing market share in the capital market business for years.

The end of the year will also be the end of the transition phase for Brexit and there is still no sign of a trade agreement. How dangerous is this for banks?

Of course Brexit is an additional element of tension in an already tense situation. But banks have had a lot of time to prepare. We have been encouraging them since the beginning to prepare for a hard Brexit.

Are you pleased with the result?

There has been a lot of progress, even though there are still banks that must do more. And of course our supervisors are putting a lot of pressure on those banks. We do understand that the pandemic is making it harder to move employees around. So we are trying to be a bit flexible about that. But of course essentially we need to ensure that the banks in the European Union have sufficient local capacity to ensure a clear strategy and adequate risk management. This is what we are focussed on.

Banks are complaining that the de facto ban on dividends is making them unattractive to investors. Can you understand that?

Well, the European banking sector wasn't particularly attractive even before our dividend recommendation. That was due to low profitability, high costs, the lack of sustainable business models at certain banks and insufficient investment in new technologies. Of course I admit that the ban on dividends has not helped. But it was necessary to avoid capital flowing out of the sector during the worst recession on record.

Will it be lifted at the end of the year?

I will be as happy as everyone else when we can go back to our standard practice, which is to only intervene and limit the distribution of dividends for weaker banks. But before we lift our ban on dividends, we need to be clearer about where the economy is heading. We will also need to be able to determine how reliable and robust banks' capital planning is again.

That's a very long horizon for a measure that was intended as an exceptional one-off.

The ban on dividends is an exceptional measure. We do not intend to make it a regular supervisory tool. It was introduced when governments, the ECB and ECB Banking Supervision announced a major support

package to deal with the fallout of the pandemic. The ECB has calculated that the full use of government guarantee schemes might reduce banks' loan losses by between 15 to 20 per cent in the euro area. The package was intended to allow banks to grant loans to households and companies, not to compensate shareholders. The pandemic led to factory and school closures, and some of us were locked down for months. Why should dividends, of all things, be the only sacrosanct element in our societies?

While we're talking about lockdowns: how much have you allowed yourself to get back to normal in the meantime? Are you only going to the office, or also going out to eat again?

My wife went through the lockdown in Italy, and that affected her greatly. We go out to eat much less frequently than before, especially at the moment, since the weather makes it harder to sit outside.

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