EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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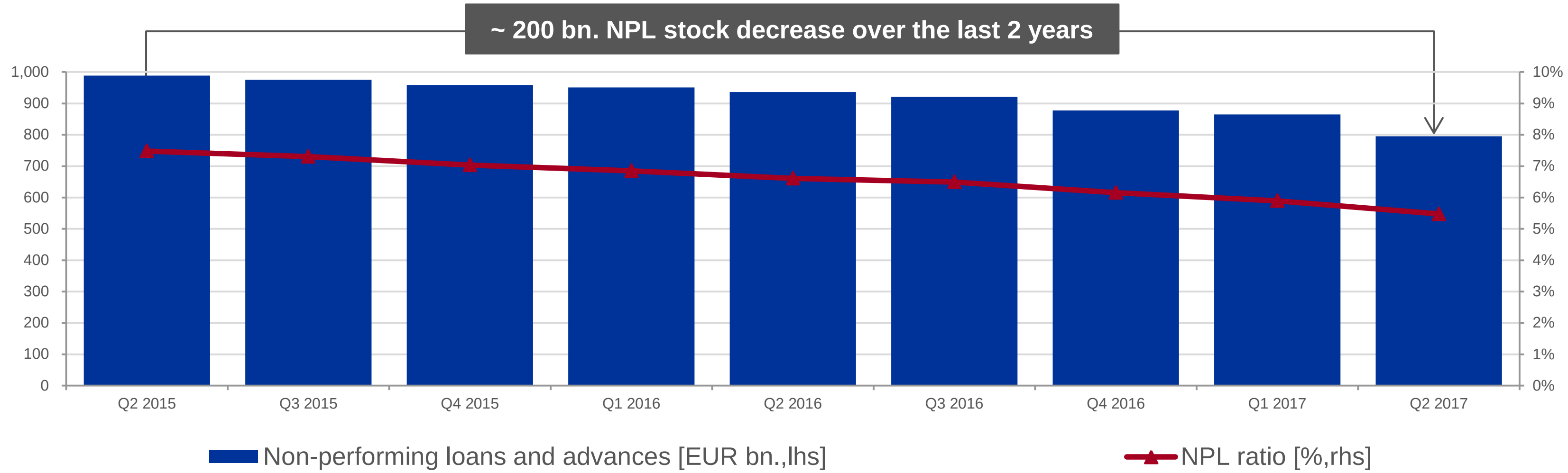
Next steps for the Completion of Banking Union and the reduction of non-performing loans

Conference on Completing the Banking Union, Ljubljana,14th February 2018

Part 1: Non – performing loans (NPLs)

Supervisory efforts to address NPLs has started to bear fruit – however still high levels of NPLs compared to other jurisdictions

NPL stock and ratio evolution of significant institutions (Q2 2015 - Q2 2017)

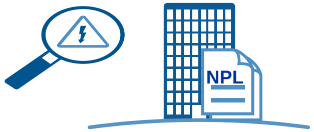


Source: ECB Supervisory Banking Statistics
Note: Significant institutions at the highest level of consolidation for which common reporting on capital adequacy (COREP) and financial reporting (FINREP) are available. The number of entities per reference period reflects changes resulting from amendments to the list of SIs following assessments by ECB Banking Supervision, which generally occur on an annual basis, and mergers and acquisitions.

Comprehensive strategy to address NPLs requires action from all stakeholders including EU and national public authorities

I.

Supervisory actions



ECB has clearly and transparently set supervisory expectations

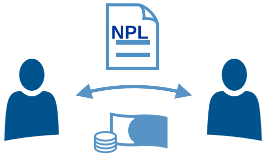
II.

Legal and judicial reforms

Reform to legal, judicial and extra-judicial frameworks necessary to create a more favourable environment for NPL workout

III.

Secondary markets

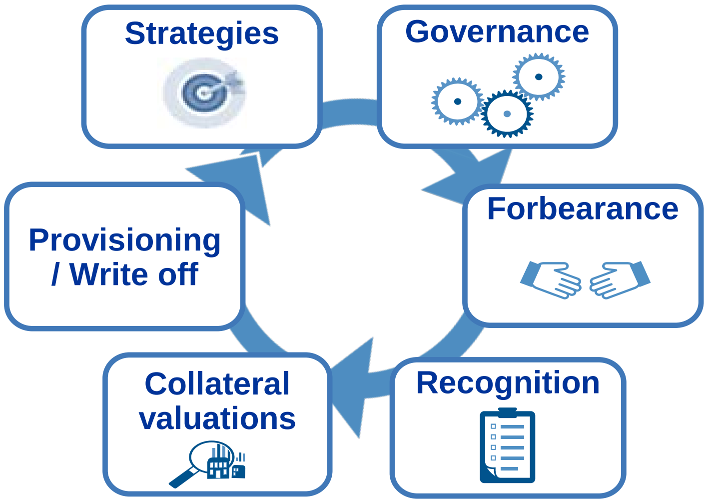


Development of the secondary markets and possibly creation of national AMCs

ECB has clearly and transparently set supervisory expectations by publishing NPL main guidance on 20 March 2017

Overview of ECB guidance to banks on NPLs

(final version published in March 2017)

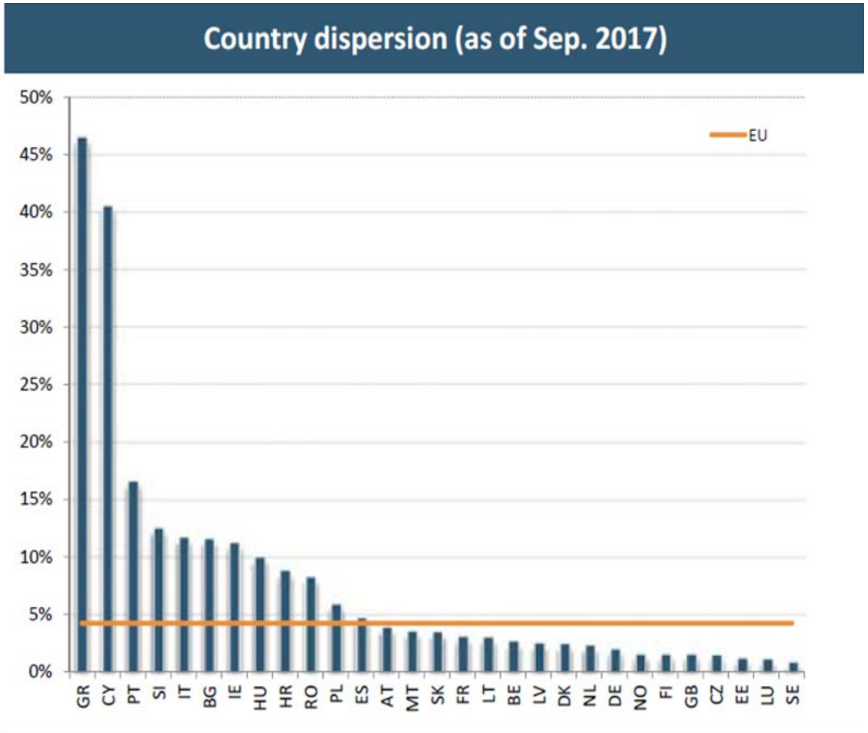


- NPL Guidance outlines **measures, processes and best practices** for banks to address, manage and reduce NPLs.
- NPL Guidance based on EBA ITS common definition of non performing.
- **Deliberate and determined action** by banks is required, and the banks themselves are responsible for implementing ambitious and credible strategies to reduce their NPL & foreclosed asset portfolios
- **“Wait and see” approaches** often observed in the past are **not acceptable**.

Guidance to serve as basis for ongoing supervisory dialogue with banks

What is expected of banks with higher levels of NPL’s

- Banks with high levels are expected to establish their own ambitious and credible **portfolio level quantitative targets**.
- Banks are expected to reduce high levels of NPL’s and foreclosed assets in a timely manner using a diversified range of strategy reduction options – forbearance, write offs, sales etc.
- SSM expects a **proactive approach** to the implementation of the NPL Guidance via early arrears management and dedicated teams to manage the NPL’s in an effective manner.
- Banks must ensure that the **governance structures and frameworks** supports the execution of the strategy via performance objectives for workout managers and a responsibility at the management body level to drive through the execution of the strategy.



Weighted Averages by country.

Source: EBA Quarterly Risk Dashboard – NPL Country dispersion as at Q3 2017

Supervisory engagement on NPL Guidance & NPL Strategies

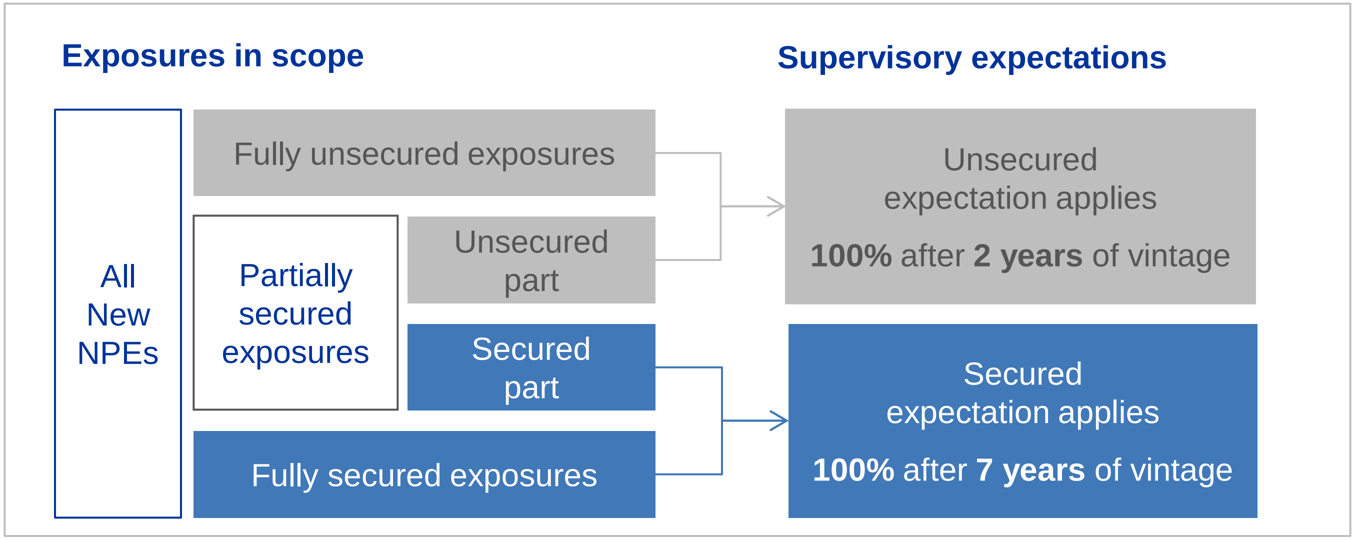
- Joint Supervisory Teams (JSTs) are engaging with banks and are following up on the implementation of the guidance in the context of day to day supervisory interaction.

- **Bank strategies** are subject to detailed review, benchmarking and on-going performance monitoring by the JST's. Bank by bank quantitative analysis and **horizontal analysis is performed** to promote a level playing field and **identify outliers.**

- Detailed **feedback has been sent to affected banks in the form of NPL letters and Strategy feedback letters** detailing the areas of required remediation .

- We expect banks to comply with the Guidance, we will follow up in the event of non-compliance through on-going supervisory activity using the available supervisory tools.

Overview of key features of draft NPL addendum



- The SSM aims to **determine whether accounting allowances are adequately cover expected credit risk losses** at individual banks.
- **Expected to be considered by banks for all new NPEs** classified as such from 2018 (including unlikely to pay). **Different expectations** for unsecured and secured exposures
- Secured expectations rely on the prudential principle that **credit risk protection must be enforceable in a timely manner**
- **Deviations from supervisory expectations** do not trigger automatic actions but **form starting point of an institution-specific supervisory dialogue**
- ECB is assessing the outcomes of the recent consultation with final policy outcomes to be announced over the coming months

Next steps

The JST's will continue to work very closely with banks who present high levels of NPLs.

- JST's will monitor progress made by the banks on implementing the NPL guidance and the outcomes will be part of SREP assessment of Credit risk.
- Bank strategies will be reviewed and challenged in great detail to monitor banks performance against targets.

Banks with high levels of NPLs will be subject to regular onsite inspections and JST deep dives on this topic.

- OSI's represent a detailed method of assessing how effectively banks manage NPL's and foreclosed assets
- Even though the guidance is currently non-binding in nature, banks is expected to follow the NPL guidance and deviations will need to be explained and assessed.

Dedicated NPL reporting templates have been implemented and are on-going.

- High NPL banks are subject to detailed quarterly NPL reporting with the aim to increase transparency and ensure comparability to monitor banks progress.
- High NPL banks have been required to complete dedicated NPL Strategy templates detailing portfolio level targets.

Part 2: Completing the Banking Union

Completing the Banking Union

As per President Junker:

*"Banking Union must be completed if it is to deliver **its full potential as part of a strong Economic and Monetary Union** (EMU). Together with the Capital Markets Union (CMU), a complete Banking Union will promote a **stable and integrated financial system** in the European Union. It will **increase the resilience of the Economic and Monetary Union towards adverse shocks** …"*

Key benefits & aspects of the Banking Union so far:

- Common supervision, crisis management and deposit insurance will allow for deeper financial integration underpinned by a stable financial system.
- Single Rulebook provides a single set of harmonized prudential rules
- All banks in the European Union are supervised according to the same standards, with SI's in the euro area being centrally supervised by the European Central Bank (ECB) via (SSM).
- In the case of failure, banks can be resolved centrally and according to the same standards within the Single Resolution Mechanism (SRM), which is backed by a Single Resolution Fund (SRF).

Key actions needed under Banking Union relating to NPL's

- **Legislative proposals for minimum harmonisation of insolvency law:**
  - Weak insolvency frameworks can hamper the reduction of non-performing loans, discourage new lending and ultimately result a drag on the health of the banking sector.
  - ECB supports the work on-going across numerous stakeholders to introduce legislative proposals for harmonisation of insolvency laws.

- **Implementation of the 2017 Council Action plan on non performing loans:**
  - Comprehensive package of measures to tackle NPL's including:
    - AMC blueprint
    - Measures to enhance secondary market & protection of secured creditors.
    - The ECB welcomes such initiatives and agrees a co-ordinated approach to resolving NPL's in Europe is essential.

- **Moving forward on the European Deposit Insurance Scheme:**
  - Why is it essential? Banks are supervised and resolved at European level, but in the event of a failure, the negative consequences are felt mainly at national level.
  - The ECB welcomes initiatives to fully implement the third pillar of the banking union.

Finalizing the Banking Union will pave the way toward a truly European banking sector

The second pillar of Banking Union:

- The fruitful cooperation between the SRB and the ECB in bank resolution will continue

The third pillar of Banking Union:

- The European Deposit Insurance Scheme (EDIS) will gradually help sharing risks more efficiently across the euro area, after a parallel risk reduction
- It will also align liability and control between the national and the European level
- The EU Commission's proposal for EDIS foresees an asset quality review, when moving from re-insurance to co-insurance

A truly European banking sector:

- Once the Banking Union is complete, the euro area will become even more of a single jurisdiction
- This will make it easier for banks to reach across borders, and for the sector to consolidate

Bridge Financing for the Single Resolution Fund (SRF)

The SRF became operational in 2016 and its target level (around €55 billion) will be gradually built-up until 1 January 2024

Bridge financing ensures that enough money is available if a bank needs to be unwound before 2024

In February 2017, the SRB concluded Loan Facility Agreements through which each Member State provides a bridge financing during the transitional period, until the SRF is fully mutualised by 1 January 2024

Public common backstop for the SRF

Member States should put in place the common backstop at the latest by the end of the transitional period (i.e. 2024)

General principles for the common backstop:

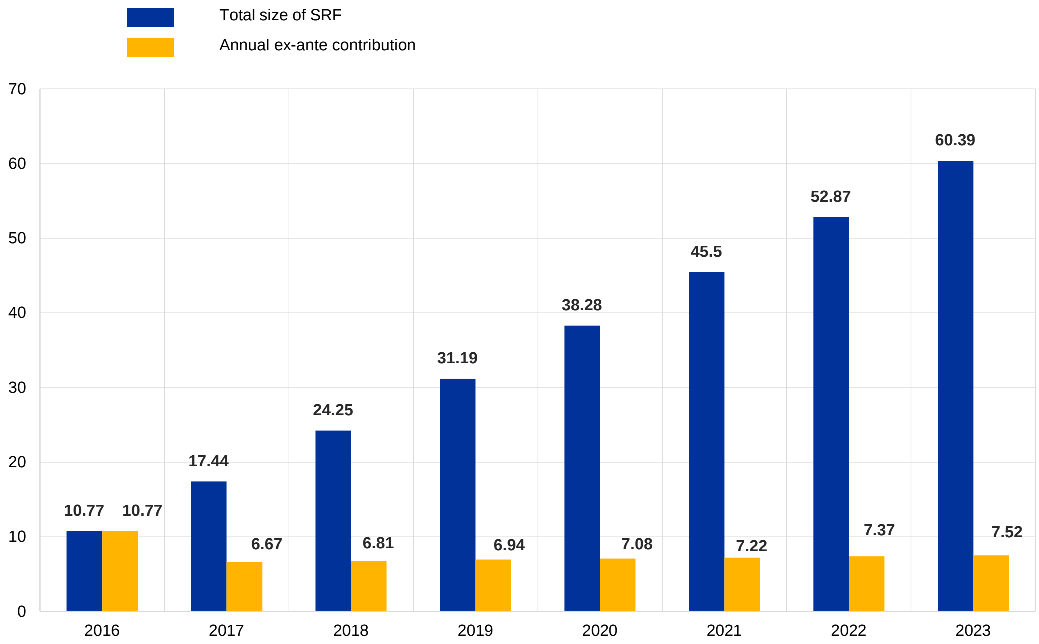
- Fiscal neutrality over the medium-term (*ie*. contributions to be recouped from the banking sector)
- Equivalent treatment across all participating Member States
- No costs for Member States not participating in the Banking Union

ECB Position:

- effective financing of the SRF is crucial for the credibility of the Banking Union
- ESM is the most logical provider of the common backstop to the SRF

The Single Resolution Fund (SRF)

- The SRF is being built up over a period of eight years (2016-2023)
- The target size is intended to be at least 1% of covered deposits by end 2023
- In total the SRF held an amount of €17.4 billion as of end of 2017
- In 2018 an overall amount of € 6.81 billion is expected to be collected via ex-ante contributions



Build-up of SRF until 2024*

* Assuming an annual growth of covered deposits of 2%

Forging a single European banking sector – The 3rd pillar of the Banking Union

EU Commission's proposal on EDIS

Phase 1: Re-insurance

Starts in 2019

Only liquidity coverage, but no loss coverage

Transition conditions

Including a targeted AQR to address NPLs and Level III assets followed by the solutions of the problems identified

Phase 2: Co-insurance

Starts in 2022 at the earliest and only if the transition conditions are fulfilled Loss coverage starting from 30% and gradually increasing

The ECB's view

- The Commission's proposal to introduce EDIS in a more gradual manner could help to foster a political compromise, …
- … But it must be clear that we strive for a fully-fledged EDIS in the steady state
- Timeline for full liquidity and losses coverage remains open. But this should not result in indefinite postponement of a fully-fledged EDIS

A functioning market for cross border mergers can:

- Deepen financial integration within the Euro area
- Give savers and borrowers more options
- Improve risk-sharing
- Help reduce banks' excess capacity

Two ways the banking sector can consolidate

"Comfortable" way

- Cross-border mergers
- National mergers

"Uncomfortable" way

- Failures

The role of the Banking Union:

European banking supervision
to ensure that the mergers are sound

Single Resolution Mechanism
to ensure that banks can fail without breaking the financial system

Thank you for your attention!

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