José Manuel González-Páramo: The banking sector towards the "new normal" – some considerations

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the "Jornada de la Banca" organised by PricewaterhouseCoopers (PwC) and IE (Instituto de Empresa) Business School, Madrid, 27 January 2011.

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Ladies and gentlemen:

I. Introduction

It is a privilege for me to participate in this conference, dedicated to the very important topic of the challenges and opportunities that the banking sector will face when its ongoing restructuring process comes to an end and the new regulatory and supervisory framework is implemented. The organisers may be asking themselves (and also asking us): "and now, what?" Well, we may reply that now it is time for the "new normal". This is a simple answer that entails a number of complex demands. This is why it is useful as a starting point to recall the recent past.

The protracted financial crisis that we have experienced since 2007 has unveiled important sources of vulnerability in the financial system. These include weaknesses of the regulatory and supervisory framework of the banking sector, which failed to ensure the safety and soundness of financial institutions both individually and as a system. This has prompted the relevant authorities to pursue a number of reforms of the microprudential supervisory and regulatory framework, while also assigning central banks all over the world macroprudential tasks in recognition of the importance of the systemic component of financial stability.

In addition, the crisis has shown that the relationship between financial development and economic growth is not really linear and that, when financial sectors become "too large" relative to their home economies, risks to financial stability and macroeconomic stability may arise. Moreover, the crisis has undermined the sustainability of some business models that were rather widespread among large international banks, while also exposing the shortcomings of corporate governance and of the evaluation and management of the different sources of risk within financial institutions.

There are of course many other lessons that we can draw from the crisis, but given the time constraints, the rest of my intervention will focus only on some key aspects of the regulatory reform, on issues related to the size of the banking sector, on the business models of banks and on their corporate governance. I will conclude with a short reference to the new role of central banks in macroprudential supervision. Let me first say a few words to explain how the crisis has affected the macroeconomic and financial environment in which banks operate.

II. Towards a new economic and financial paradigm: the "new normal"

In the aftermath of the crisis, it is very likely that many fundamental elements of our economies and financial systems work differently than in the past in a number of aspects, reflecting processes of adjustment in the behaviour of agents and policy-related reforms that are currently under way. More generally, empirical evidence shows that systemic banking crises typically affect the structure and dynamics of economic systems over very protracted periods.[1]

Before venturing into the future, let me recall the main elements of the ***pre-crisis economic and financial paradigm, i.e. the "old normal"***.

- *Reduced macroeconomic volatility.* Prior to the deterioration of the crisis in October 2008, our economies experienced two decades of significantly reduced macroeconomic volatility. A number of empirical studies documented a significant decline in the variability of both economic growth and inflation in almost all major industrialised economies. Most of the debate among monetary economists focused at the time on the predominant source of "the Great Moderation" among three main candidates: (1) better macroeconomic policies, (2) structural changes in the economies, and (3) less disruptive distributions of shocks ("good luck"). While the alternative explanations could in theory have different implications for the sustainability of the decline in macroeconomic volatility, in general few doubts were expressed about the steadiness of this new state of the world: the "Great Moderation" was here to stay.

- *Sustained economic growth*. The decline in macroeconomic volatility was also accompanied by a significant improvement in economic performance as agents were able to extract the dividends of sustained price stability and reduced uncertainty about macroeconomic activity. Potential growth in most developed economies rose, enabling their citizens to benefit from protracted periods of economic expansion, only infrequently interrupted by relatively moderate recessions.

- *Strong dynamics of house prices*. Sustained economic growth, supported by low and stable interest rates, contributed to improving expectations about asset prices, particularly about house prices. Optimistic expectations about housing markets at a time of: (a) increasing deregulation and liberalisation of the banking and financial sectors, (b) fast financial innovation, and (c) progressive globalisation of financial markets, led to rapid appreciation of house prices, which was supported by excessive indebtedness of households in some countries. The rise in household indebtedness and house price inflation was particularly significant in those countries in which the decline in nominal interest rates as a result of the shift to price stability had been more pronounced.

- *Increased profitability of the financial sector at a time of historically low risk premia*. In the years preceding the crisis, the profitability of banks and other financial institutions significantly improved as a result of generally favourable economic and financial conditions. At the same time, it was pointed out that the improvement in profitability had taken place against a background of: (1) unusually subdued volatility in financial markets, (2) credit risk premia at historically low levels, (3) very high valuations of asset prices, and (4) relatively light regulation and supervision in some countries. Moreover, the improvement in the financial positions of banks had taken place in an environment characterised by ample market liquidity across a number of global financial markets, which led to almost no liquidity risk premia being priced in.

As the crisis is still unfolding, we cannot tell with certainly how our economic and financial systems will function in the future. However, we can safely predict that many of the elements of the old paradigm will no longer be valid. This will give rise to an ***economic and financial "new normal"*** in the post-crisis period. Some of the its main elements, that can be sketched out based on previous experiences of systemic banking crises, are as follows:

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[1] Reinhart, C.M. and K.S. Rogoff (2008), "The aftermath of financial crises", NBER WP 14656.

- Somewhat higher macroeconomic volatility and lower potential growth
- Protracted periods of adjustment in housing markets and in the construction sector
- An upward shift in the pricing of credit and liquidity risk
- Stricter regulation in order to strengthen the resilience of the financial sector, though probably at the cost of making financial intermediation somewhat more expensive
- Evolving role of central banks (stronger inclination towards “leaning against the wind” policies and the assignment of macroprudential objectives)

Changes in the macroeconomic environment, regulatory and supervisory framework as well as industry structure may have very significant implications in the way the financial sector operates in the future. Let me briefly elaborate on some of those implications.

III. The banking sector after the crisis

An important consequence of the financial crisis is the significant transformation which is taking place in the EU banking sector. The global overhaul of banking regulation and supervision resulting from the crisis, the demanding macroeconomic environment and the ongoing deleveraging and banking restructuring in some European countries are key factors which are shaping the future of the banking industry both in the short- and medium-term.

In the context of the lessons learnt from the crisis and of the regulatory reform, the rest of my speech will focus on the main aspects of this reform and the developments in the size of banking sectors, banking business models and corporate governance. I will conclude by discussing the role of central banks in the new macro-prudential supervisory framework.

III.1 Regulatory and supervisory framework

The crisis has revealed serious gaps in the regulatory and supervisory framework for financial institutions, both with regard to the prudential rules on capital and those on liquidity. Several systemically important institutions that seemed to have a solid financial position before the crisis proved not to be sufficiently resilient to withstand the shocks that have hit the financial system in the past three years and a half. Consequently, governments and central banks had to provide an unprecedented amount of support, and in parallel with this process, several initiatives have also been launched that resulted in a major overhaul of the regulatory and supervisory framework.

A core element of the regulatory reform was the complete revision of the Basel II framework (now commonly referred to as Basel III) that has been recently agreed by the members of the Basel Committee and endorsed by the Group of Central Bank Governors and Heads of Supervision. The key elements of the new framework include:

(1) *a new definition of regulatory capital* that will improve both the quality and consistency of the capital base,

(2) the introduction of *capital conservation buffer requirements* that would constitute an additional layer of protection for banks, especially in periods of excessive credit growth,

(3) the strengthening of the *risk coverage of the capital framework* that would represent a revision of the prudential rules on securitisation and trading book activities as well as the counterparty credit risk framework,

(4) the planned introduction of a *non-risk based leverage ratio* that would serve as a supplementary measure to the risk-based requirements to contain the build-up of excessive leverage and address model risks associated with the risk-based capital framework, and

(5) the development of a *liquidity risk framework* that would aim at improving the resilience to liquidity shocks of the banks.

The new measures will be introduced over a transition period of 8 years, and have been calibrated with the aim of avoiding severe implications for the national banking system, while supporting economic recovery[2].

III.2 "Too large" financial sectors?

Turning to the developments in the banking sector, let me recall that the size of the financial systems dramatically increased during the past few decades both in Europe and in the US.[3] To judge whether the financial sector has grown "too large", it is crucial to answer the question of whether or not the expansion of finance before the crisis was driven by fundamentals.

On the one hand, it is clear that this process was fuelled by fast economic growth and a rapid accumulation of savings in emerging markets. On the other hand, developed countries engaged in rapid innovation in the field of financial products, which allowed the more efficient channelling of domestic and global savings towards productive investments. The most striking developments in this respect occurred with credit default swaps (CDSs) and securitised products. This increase in financial innovation may, in turn, have led to an inefficient allocation of resources, excessive risk-taking and over-leveraging of the system. Examples of such resource misallocation include the expansion of the US subprime mortgage market and of the shadow banking system.

Similarly, while we have always known that financial innovation can contribute to enhancing risk diversification, it is clear that innovative financial instruments also have the potential to undermine financial stability. For example, the complexity of new instruments might lead to a misallocation of capital and risk among market participants. In this respect, the crisis has exposed the fragilities of the securitisation process, including the misalignment of incentives among agents participating in the origination and in the distribution, lack of transparency with regard to the risks underlying securitised products and the inadequate management of the risks associated with the securitisation business. It is by now evident to everybody that weaknesses in the business model based on "originate-to-distribute" contributed to the worsening of loan quality.[4]

The experience of the crisis also suggests that most investors hugely underestimated the risks of the most complex financial instruments. This is precisely why there is an increasing demand for transparency about both the degree of risk of individual instruments and the exposures of institutions to different instruments, markets and counterparties. The EU-wide stress test exercise proved to be an important step toward a more transparent assessment of the exposures of individual institutions to different instruments and countries. The

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[2] The impact assessments carried out by the Basel Committee and the Financial Stability Board with relation to the transitory and long-term effects of the Basel reform package revealed that the costs of financial intermediation may temporarily rise during the implementation phase (e.g. in terms of increasing spreads, lower credit volumes and a more moderate GDP growth). However, in the long run, the net positive benefits are expected to dominate as a result of lower probability of crises to occur.

[3] In the euro area, the expansion of banks' balance sheets has been around 400% between 1992 and 2007 (just before the crisis) whereas nominal GDP has increased only 130%. As a result, the ratio of banking sector total assets to GDP, a measure of the depth of bank intermediation, increased from 145% in 1992 to 331% in 2007. It should be also noted that the reported assets understate the growth of bank activity in that period, as a lot of it took place off-balance sheet.

[4] See, among others, G. Dell'Ariccia, D. Igan and L. Laevan, *"Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market"*, IMF Working Paper, No 08/106, IMF, 2008; and A. Maddaloni and J.-L. Peydro, *"Bank Risk-Taking, Securitization, Supervision, and Low Interest Rates: Evidence from Lending Standards"*, ECB Working Paper No. 1248, October 2010.

forthcoming EU-wide stress test will be more comprehensive and detailed than the previous exercise, thereby playing an even more important role in supporting banks' access to medium- and long-term funding.

Going back to the ongoing regulatory reforms, while the overall impact in terms of the size of the banking sector is expected to be moderate on average, some business lines or institutions may be relatively more severely affected. Overall, credit institutions that are smaller and focused on the traditional retail banking business are not expected to be severely affected by the new prudential rules. However, some large universal banks (especially those with significant investments in other financial institutions and in insurance companies, often across borders) will face new challenges, mainly resulting from the new definition of capital and from the introduction of the leverage ratio.

These large institutions are typically more leveraged than their smaller counterparts and, as a result of the introduction of certain adjustments in the calculation of the regulatory capital, their capital bases may need in some cases to be strengthened further in order to include only high quality resources with true loss absorbing capacity. Given that the structure of the financial system is rather heterogeneous across EU countries, the national banking sectors will have to face different challenges in the years ahead.

It is important to emphasise in this context that several policy initiatives have been launched recently to address the specific risks associated with systemically important financial institutions (SIFIs). In particular, the Group of Governors and Heads of Supervision agreed in September 2010 that SIFIs should comply with additional capital requirements over and above the Basel III minimum requirements. Extensive work is currently being carried out under the aegis of the Financial Stability Board to develop a framework for the regulation of global and national SIFIs and also to enhance the banks resolution regimes so as to be able to handle systemic crises in an effective and efficient way.

At the same time, in the short- to medium-term it will be inevitable to improve the cost efficiency of banks as well as to make changes in the ownership structure and in the business activities of certain institutional models, while also restructuring some segments of the national banking sectors. To live under the "new normal", banks must first get there. This may require consolidation as well as changes in corporate governance, transparency and business models.

III.3 Business strategies and corporate governance

Business models

The crisis has shown the vulnerabilities of some ***business models***. In particular, it has exposed the fragilities of those models based, on the one hand, on "originate-to-distribute" activities and securitisation techniques, and, on the other hand, on excessive dependence on wholesale and capital markets for funding. Although no business model outperformed the others during the crisis, there is evidence that banking models based on higher diversification of activities and funding proved to be the most resilient. This explains why such models are becoming increasingly attractive within the European banking landscape[5].

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[5] The Banking Supervision Committee (BSC) of the ESCB conducted a study based on structured interviews of selected market participants and academics in London, Frankfurt and Paris during the winter 2009–2010. The questions focused on market participants' expectations in the medium term, i.e. during the coming 3 to 5 years, as regards the bank business models, consolidation and integration processes, and bank funding structures in the EU. The main results of this exercise were published in the ECB report "EU Banking Structures" in September 2010. According to the results, market participants expect the diversified banking model to increase in importance at the cost of specialised banking models, although with more concentration on core businesses within the banks.

Indeed, diversified business models act as better shock absorbers in times of stress, and their ability to perform well under stressed conditions represents an additional incentive to adopting them. In the aftermath of the financial crisis, rating agencies, investors and counterparties have significantly reduced their tolerance to leverage and now discriminate more between firms with different risk profiles.

In this regard, the main priority of EU banks in terms of their business strategies in the post-crisis period is currently to focus on their balance sheet structure (e.g. the composition of lending and of their funding sources), with a view to making it more robust and transparent.

Furthermore, some banks still remain too dependent on central bank facilities for their funding, which is not sustainable in the long run. This requires efforts to adjust business strategies towards more sustainable models. There is some evidence that point to an increasing recourse to retail deposits among large EU banks. After experiencing a reduction during the years prior to the crisis, retail deposits started on an upward trend in late 2008, and such trend has continued into 2009 and 2010. A remaining challenge is though the fact that at present banks are often competing for the same deposits, which makes it difficult to achieve substantial increases in their deposit bases and may also erode their margins.

At the same time banks have reviewed the geographical location of their assets. The increasing internationalisation of important European groups reveals the preference among large EU banks for regional diversification.

Reforms of the regulatory framework that aim to render bank business models more resilient are a key factor that will contribute to moving funding structures away from volatile short-term sources towards more stable long-term ones, such as capital and deposits. As a consequence of the substantial strengthening of the regulatory requirements on trading book exposures and on securitisation, the relative attractiveness of traditional investment banking activities is expected to decline. Similarly, with the envisaged introduction of the non-risk based leverage ratio, certain institutions specialised in business lines that are traditionally considered as relatively low-risk (e.g. mortgage lending) may need to reconsider their activities and look for alternative sources of revenue.

Risk management

Apart from the regulatory initiatives, the banks' internal ***risk management*** represents a first line of defence against increasing risks. The need for improved risk measurement and management practices with regard to the main risks institutions are exposed to (e.g. credit, liquidity and market risks) has also been recognised in a number of industry studies that have identified areas in need of improvement[6].

Supervisory authorities have issued guidelines on required improvements in corporate governance and risk management (in areas such as liquidity and stress testing) and have also issued supplemental guidance under Pillar 2 (the supervisory review process) of Basel II that addresses the flaws in risk management practices revealed by the crisis. Although progress has been made in improving internal risk management systems, considerable work must yet be done.[7]

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[6] The industry has published reports highlighting the need for improved risk measurement and management, including the provision of information to and involvement of senior management with regard to the risk profile of the institution. See for example publications by the Institute of International Finance: *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System* (Dec. 2009), *Principles of conduct and best practice recommendations, Financial services industry response to the market turmoil of 2007–2008* (Jul. 2008), report by the Counterparty Risk Management Policy Group entitled *Containing Systemic Risk: The Road to Reform* (Aug. 2008).

[7] Conclusion reached in a recent report by the Senior Supervisors Group entitled, *Observations on developments in risk appetite frameworks and IT infrastructure*, December 23, 2010.

Looking forward, the re-shaped banking strategies need to reflect a better balance between risk and returns. An important challenge for the EU banking sectors in the next few years will be to find the optimal level of return that preserves long-run profitability, without incurring in unknown risks.

III.4 Central banks and the new macro-prudential supervisory framework

Let me conclude my speech by providing a brief reference to the new macro-prudential supervisory framework in Europe.

The financial crisis has provided a vivid illustration of the importance of having in place an effective framework of macro-prudential surveillance that can complement micro-prudential supervision both at the national level and in a cross-border context. Thus, in order to enhance their abilities to assess and address potential systemic risks, over the past few years significant work has been undertaken by authorities at country, regional and global levels with the aim of setting up a macro-prudential policy framework. In this respect, a major achievement at the European level has been the establishment of the European Systemic Risk Board (ESRB), entrusted with the responsibility of macro-prudential oversight at the EU-level. The ECB plays a key role by providing the ESRB with a Secretariat, and thereby logistical, administrative and analytical support.

A key objective of the ESRB is to link systemic risk analysis with appropriate policy responses. The analytical work will focus on identifying, measuring and assessing the potential sources of systemic risks on the basis of broad and deep information, and on applying a wide range of analytical tools to process the relevant data. The work will entail the assessment of the potential impact of the risks identified and of the ability of the financial system to withstand the related shocks. On the basis of the outcome of its risk analysis and assessment, the ESRB may issue concrete and well targeted risk warnings or policy recommendations.

There is no doubt that the establishment of the ESRB introduces a new function at the EU level that will enhance the ability of European and national authorities to promote the stability of the EU financial system as a whole.

IV. Conclusions

Let me now conclude. This conference has provided many interesting contributions about the future of the banking sector in the post-crisis macroeconomic and financial environment. This is an issue of crucial importance for our economic welfare, given the fundamental role played by banks in most European countries. This is why it is important to stress that there is still much work to be done before we can exit from the crisis.

In an economic and financial context which is still fragile, the adjustment towards a “new normal” continues posing important challenges and needs. It is essential that we continue making progress in reforming both the microprudential and macroprudential regulatory and supervisory framework. At the same time, the banking sector must continue addressing with perseverance, rapidity and determination the vulnerabilities in strategies and business practices of individual institutions revealed by the crisis. This is the only way in which the banking sector will become part of the solution to the problems that still represent obstacles to economic growth and employment creation.