Erkki Liikanen: Europe without banks? The future of financial sector

Keynote speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Alpbach Financial Market Symposium, Alpbach, Austria, 28 August 2014.

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Introduction

I thank the organizers for assigning me such a thought-provoking title. For a start, to me it is clear that we continue to need banks also in the future – especially in Europe, where the role of banks in financing households and SMEs is crucial and important also for other enterprises.

However, we have needed and we need a change. We have just experienced and are still recovering from the biggest financial crisis of our generation. The social costs of the financial crisis have been enormous: the losses in the GDP and the increases in unemployment have been very high. If policymakers, in central banks and in governments, had not learned from the policy mistakes made during the Depression in the 1930s, the crisis could have been even more destructive.

To avoid such crises in the future, we need a more stable and resilient banking and financial system in Europe. To that end, we need better regulation and supervision of banks and other financial institutions. Well-designed regulation would provide banks with the right incentives to choose their business model, scope, and size efficiently to best serve the society.

Before the crisis, financial regulation was too lax and the supervision of financial institutions too fragmented. Many important steps have been taken or are being discussed to repair the regulatory and supervisory framework, some of which I shortly discuss in my remarks.

Some observers have argued that the new regulation has gone too far. I disagree. It is a key responsibility of our generation to make the financial system much safer than it has been. To be sure, we do not need to return to the repressive regulation of the post-war period. But we do need to find a better balance between rules and flexibility in regulation than we have had.

The rest of this speech is organised as follows. First, I discuss what the European financial system looked like before the crisis. Then I discuss what it should look like in the future. Finally, I provide some suggestions on how we can get there.

What the European financial system looked like?

As convincingly argued in the recent report by the Advisory Scientific Committee of the European Systemic Risk Board, over the past 20–25 years banking systems in Europe have become, too leveraged, too concentrated, and sometimes also too big. Hence they created a major risk for the stability of the European financial system.

Let me present some evidence provided by the ESRB. First, consider the amount of lending. In the 1950´s, bank loans to the domestic private sector as a proportion to the domestic GDP were almost equal in Europe, US and Japan, at about 25 per cent. In 2010, the figure for Europe was well over 100 per cent of the GDP, while that in Japan was about 90% and in the US only close to 50%.[1]

[1] In some European countries, the size of the banking sector more than doubled in a mere 20 years between 1990's and 2010. Among the countries that recorded the biggest increases were Cyprus, Iceland, Ireland, Spain, Portugal and Greece.

Second, European banks' balance sheets have ballooned. The total assets of the EU banking sector were over three times the EU GDP in 2013. In several EU countries, the ratio is much bigger. The Japanese banking sector is more than half of the relative size of the European banking sector, but the US banking sector is only a quarter of the size of its European counterpart.

Third, the European banking system has also become more concentrated. Since 2000, the share of the three largest domestic banks of the national banking system total assets – the so-called C3 ratio – has increased in all major EU countries except Italy. (In Finland, of which I am the most familiar with, the C3 ratio is close to 90%, one of the highest figures in the EU.)

Fourth, European banks dramatically increased their leverage before the crisis. For example, as documented by the ESRB, in the late 1990's the median equity to assets ratio of the largest 20 listed banks in the EU was around 6%. By 2008, this median level was only just over 3%. Because of the deficiencies of the Basel II capital rules, banks were able to halve their equity ratios without any increase in their risk-weighted regulatory capital requirements.

The increases in bank sizes and bank lending have not been matched by an equivalent increase in market-based funding. For example, the ratios of stock market capitalisation to bank credit have decreased considerably in the 2000s in the biggest EU countries, much more so than in the US. As a result, the European financial structure has become even more bank-based than before.

The large reliance of European firms – especially the SMEs – on bank finance has recently been a drag on the recovery of the European economy as banks´ ability to lend has been weak in many EU countries in the aftermath of the crises.

It is now obvious that many of the developments in the European banking since the 1990's sew the seeds of the banking and sovereign debt crisis:

- Too-big-to-fail and too-big-to-save problems became more severe;
- Banks misallocated too much funds in asset markets fostering unsustainable bubbles;
- Weakly capitalised banks´ resilience to shocks became poorer;
- Increased concentration of the banking system made banks more interdependent and vulnerable to contagion.

Some recent research suggests that a banking sector beyond size may also be harmful to a long-term economic growth. There are several potential reasons for that:

- An overexpansion of banking may lead to a misallocation of financial capital towards housing loans and away from corporate lending.
- The overexpansion may also lead to a misallocation of human capital as an excessive share of talented individuals is employed in the financial industry rather than elsewhere in the economy. Financial sector needs talent individuals, so do the other sectors.
- Larger banking systems tend to experience more severe financial crisis.

What the European financial system should look like?

Given the developments in the European banking and financial markets over past 20 years and given the legacy of the crisis, the policymakers face both short and longer-term challenges in financial market policies.

In the short-term, we must find ways to boost bank lending especially to SMEs to invigorate economic growth in Europe. The most recent results of the ECB´s quarterly euro area Bank Lending Survey are encouraging in that respect: for the first time in seven years, euro area

banks reported a net easing in credit standards in loans to enterprises in the second quarter of 2014. Despite that, banks´ credit supply is clearly insufficient in many European countries.

Another short-term concern is the sorry state of the European securitisation markets: public issuances in the European ABS markets remain low, trading is thin in some market segments and the whole market carries a stigma in spite of the fact that most European structured finance products performed well throughout the crisis.

In the short-term, we need to stimulate ABS markets to stimulate credit creation. In the longer-term the revitalisation of ABS markets would, among things, (i) allow better risk sharing among investors (ii) help banks to diversify their funding structure thus increasing their resilience, and (iii) make firms less reliant on bank finance.

In the longer term, we need to reverse the unwelcome trends in banking documented by the ESRB. We need a banking system that is better capitalised, less concentrated, less procyclical, and relatively smaller than it is today. Thus, we need a financial structure in which financial markets play a larger role than today in allocating funds to final customers.

How to get there?

As you are well aware, we are in the process of implementing a comprehensive supervisory and regulatory reform to make the European financial system safer. We are likely to discuss many of these reforms in this panel.

In these remarks, let me focus only on some of the most recent policy developments and initiatives.

Concerning short-term challenges, the Governing Council of the ECB decided in June to carry out targeted longer-term refinancing operations (TLTROs) in the coming months. The aim of these operations is to enhance the functioning of the monetary policy transmission by supporting lending to the euro area non-financial private sector, excluding loans to households for house purchase. The Governing Council has also intensified preparatory work related to outright purchases of asset-backed securities.

The ECB, together with the Bank of England, also published a short issues paper in April and a longer Discussion Paper in June to foster discussion on how to build a better functioning securitisation market in the European Union. In particular, these two central banks suggest that authorities should create standards for the so-called high-quality securitisations to identify low-risk ABS products that are simple, robust and transparent.

Concerning regulatory reforms, let me have a few words on the state of the reform of banking structures.

The Expert Group that I chaired saw the need to simplify the structure of large and complex banks to shield the deposit-taking bank from an excessive risk-taking in trading activity, to facilitate monitoring and supervision of these banks and to make the recovery and resolution measures easier to impose. At the same time, we wanted to preserve the universal banking model that, by and large, has well served the European economy.

Given these starting points, we proposed a mandatory separation of a deposit entity and a trading entity within a banking group. Based on this recommendation, the European Commission presented its proposal for the Regulation on structural measures January this year. The objectives of the Commission´s proposal are similar to ours. However, the Commission´s proposal leaves more discretion to the authorities concerning the separation process. In addition, the Commission´s proposal includes an outright ban on organised proprietary trading as in the Volcker reform.

I welcome the Commission´s proposal and I am pleased that the Council working group has been negotiating of the proposal throughout the summer. Of course, more progress will be made in the autumn, when the new Commission and Parliament start their work.

Concluding remarks

Banks play an important role in the economy as the key financiers of households and companies, among other tasks. Banks´ role is especially important in Europe, as they are by far the most important source of finance for small and medium-sized enterprises.

One of the principal aims of the ongoing regulatory reforms and other policy actions is to enhance the ability of the financial sector to provide loans and other financial services efficiently and without compromising financial stability. Being successful in these aims would improve the long-term growth prospects of the European economy and thus the welfare of European citizens.

Banks´ reputation and the public confidence towards banks have suffered badly since the financial crisis. That has harmed not only banks but also the wider economy. We must rebuild the confidence on financial institutions and financial markets. The regulatory reforms advance that aim. I strongly believe that the ongoing reforms will benefit us all – the citizens, the wider economy, but also the financial institutions.