Yves Mersch: Grasping the new normal of the banking industry – a view from a European central banker

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the European Financial Congress, Sopot, Poland, 14 June 2016.

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Europe's banking sector faces many challenges: challenges to its business models and to its profitability; competition from the non-bank sector; disruptions provoked by new technologies in the payments field; and challenges related to implementing the requirements of new regulation.

Some national banking sectors have further and more idiosyncratic challenges. For example in Poland, the banking sector faces risks related to Swiss franc-denominated mortgages, the introduction of a new tax for certain financial institutions (on which the European Central Bank (ECB) has issued an opinion)[1] and additional ex-post contributions to the recently used Polish Bank Guarantee Fund.

The central message of my remarks today is that we need both change *and* stability to secure the future of Europe's banking sector. On the one hand, we should support the healthy forces of creative destruction resulting from competition and technological advances. On the other hand, we need certainty and stability so that banks can make long-term business plans and do their job of financing productive investment. Sustainable economic growth requires a strong, profitable and resilient financial sector.

Let me explain in a little more detail what I have in mind. I will first elaborate on the challenges facing banks under what has come to be known as the "new normal". I will then focus on the new regulatory and supervisory framework and the importance of it being completed with a solid architecture for managing financial crises. I will conclude with some reflections on the need for policy-makers to provide certainty and stability to underpin the process of change that banks are currently going through.

From the "old normal" to the "new normal" – drivers of change

In the aftermath of the financial crisis and the global recession, Europe's banks face an environment that previously would have been considered abnormal but which nowadays has become so commonplace as to be perceived as the "new normal". Yet at the same time, the fundamental role of banks in the economy has not changed: the banking sector is there to channel savings towards productive investment and thus to serve the real economy.

The "old normal" was characterised by a long period of low macroeconomic volatility, sustained economic growth, historically low credit and liquidity premia, and rising asset prices. All this came against a background of light-touch regulation. The financial crisis has led to much-needed and far-reaching reform of the regulatory framework and a redesign of the supervisory architecture.

But while we may have left the 'old normal' behind us, the "new normal" is still surrounded by substantial uncertainty.

I see three challenges or drivers of change in the banking sector that will ultimately influence the shape of the "new normal".

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1 Opinion of the European Central Bank of 12 January 2016 on a tax for certain financial institutions (CON/2016/1).

First, the current economic environment poses a challenge to banks' business models and their profitability. Abundant savings are not sufficiently absorbed due to timid investment activities of cash rich corporates. At the same time households and governments still need to repair their debt-contaminated balance sheets. Moreover, although very low to negative interest rates aim at stimulating investment and consumption, a Ricardian reaction cannot be excluded, i.e. households are hoarding even more as they need higher saving ratios to build up the same amount of wealth over the same time span.

For some banks, a particular challenge is compounded by a legacy issue, namely non-performing loans (NPLs), which remain a serious obstacle for these banks to provide new credit to the real economy, and a more general impediment for some banking sectors.

Second, banks face increasing competition from other actors in the market for financial intermediation. These actors include peer-to-peer lenders and technology firms offering financial services, but also to some extent insurance companies or investment funds.

While more competition is surely welcome, market funding should complement, not replace, the role of banks in financing the economy. But further consolidation in the banking sector could improve its overall profitability by increasing cost and revenue synergies, thus make banking more competitive again.

Third, banks are confronted with potentially disruptive technologies such as distributed ledger technology (DLT) in the payments field. A distributed ledger is essentially a database that is shared across a network to record and validate transactions in different locations.

As with all innovations, this new technology brings both challenges and opportunities. While it could increase pressure on some bank activities, DLT also has the potential to lower back-office costs significantly and make market infrastructures more resilient and efficient.

As I highlighted in a speech in Frankfurt in April[2], I see three main roles for the Eurosystem in this regard: first, as an operator, to ensure that we provide the right services for the settlement of payments and securities; second, as a catalyst, to facilitate standardisation and interoperability; and third, as an overseer and supervisor, to safeguard financial stability and ensure a level playing field.

Some of you may say that there is another challenge, namely the need to cope with the many changes in the regulatory framework. While I fully agree that we should provide stable framing conditions in terms of regulatory certainty, we should not forget where we have come from: the transition from the "old normal" to the "new normal" was accompanied by the biggest bail-out in history, costing European taxpayers almost two trillion euros.[3]

In response, the European Union (EU) has strengthened and harmonised the regulatory framework with the Single Rulebook and by introducing a paradigm shift from "bail-out" to "bail-in". In the euro area, we went even further with the establishment of the Banking Union.

The Banking Union was a game-changer in the crisis as a way to weaken the bank-sovereign nexus. It was also an unprecedented step towards deeper integration of Europe's banking sector. The Single Supervisory Mechanism (SSM) is the basis for independent, tough but appropriate supervision across the Banking Union. It is also an open project where non-euro area Member States can join through close cooperation.

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2 Speech by Yves Mersch: Distributed ledger technology – panacea or flash in the pan?, 25 April 2016.

3 Around 5 trillion euros of aid (including State guarantees) have been approved by the Commission between 2007 and 2015 of which 1.7 trillion were used at the peak of the crisis. State Aid Scoreboard 2015 > Aid in the context of the financial and economic crisis.

Deposit insurance and effective resolution tools

It is important in the "new normal" not only to strengthen regulation and supervision but also to establish a framework in which it is possible for banks to fail without challenging the stability of the whole financial sector. Here the frameworks for resolution and deposit insurance are central.

At the EU level, beyond the establishment of the Single Resolution Mechanism, the Directive on Deposit Guarantee Schemes has already harmonised important provisions in deposit insurance, such as the coverage level and the payout period, and thus strengthened depositor protection.

But ultimately we have to go further in the Banking Union to ensure that depositors across the euro area are afforded a uniform level of protection wherever they are located. At the same time, legacy issues will need to be addressed to ensure a level playing field and to mitigate moral hazard. Tackling these legacy issues should proceed in parallel with the establishment of an European Deposit Insurance Scheme (EDIS).

Deposit insurance kicks in only at the very end of a bank's lifetime, once it is already undergoing insolvency proceedings or is in the process of being resolved. Recent events, including in the Polish banking sector, have reminded us of the importance of having an effective toolkit to deal with failing banks, including at the early intervention stage.[4]

The Bank Recovery and Resolution Directive (BRRD) – which has yet to be transposed into Polish law – provides just such a toolkit, giving the supervisor the necessary tools, for example, to require a bank in difficulty to take the necessary recovery action.

If early intervention proves unsuccessful, a bank may need to be resolved, without disrupting financial stability and the real economy but also without taking recourse to taxpayers' money. In this respect, the BRRD provides for the necessary resolution powers and tools, as well as for substantial loss-sharing procedures with the stakeholders of the failing bank.

Going forward, it will be essential for both investors and banks to have certainty on the overall level of capital requirements and the application of the new resolution framework.

In this respect, consistent implementation of the minimum requirement for own funds and eligible liabilities (MREL) across the EU and implementation of total loss absorbing capacity (TLAC) in the common EU framework will both be of great importance.

Regulatory certainty

Strengthening the regulatory framework through the Single Rulebook and establishment of the Banking Union have made Europe's banking sector and the financial system as a whole more stable and resilient. Banks' capital positions have been strengthened; leverage has been reduced; and business models and funding models are continuing to be adjusted. We should not undo this achievement.

Now is the time to finalise the regulatory reform agenda and implement the remaining measures. This includes TLAC but also the Net Stable Funding Ratio and the Leverage Ratio. Banks need regulatory certainty.

Let me remind you of the message from central bank governors and heads of supervision that they would not significantly increase overall capital requirements across the banking sector in finalising international regulatory reforms. It is fully recognised by all public authorities that proper calibration of the regulatory burden needs to be ensured.

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4 See NBP FSR of February 2016 (Financial Stability Report): 'The experience from attempts to rescue SK bank confirmed the necessity of prompt introduction into the Polish legal system the provisions of the Bank Recovery and Resolution Directive – BRRD' (p.52).

In this respect, we have to be mindful of banks' concerns about compliance costs, the complexity of the new framework and its cumulative impact. Inconsistencies between the different levels of legislation should be avoided. At the same time, more clarity about the interaction between the various acts and measures would be welcome.

We agree on the need to standardise and streamline data reporting initiatives to reduce unnecessary burdens for banks. Proportionality must guide action in the reporting area if we want to be consistent with the objective of preserving diversity of business models within the EU. And if there are concrete cases to improve the overall consistency of the post-crisis framework by avoiding overlaps and gaps in the regulation, these should certainly be addressed.

Conclusion

Let me draw to a close. A stable financial system is an absolute prerequisite for sustainable economic growth, but stability alone is not enough: as has been said before, *we all want stability, but we should not want the stability of the graveyard*.

It also has to be profitable for banks to provide credit to the real economy. For that, we need a more favourable business environment in Europe but we also need less uncertainty, including in the realm of regulation. The cost of equity cannot stay above the return on equity forever.

Put differently, regulatory reform is necessary but it should lead to regulatory reliability. We should aim for regulatory completion yet still strive for a new dynamic equilibrium to provide the solid foundation that banks need in order to operate effectively.

I am convinced that the transformation of Europe's banking landscape currently in progress can lead to a stronger, more competitive and more resilient banking system if we succeed in balancing change and stability.