Yves Mersch: The future of banking – a central banker's view

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Economist Future of Banking Summit, Paris, 10 March 2015.

* * *

Ladies and gentlemen,

It is a pleasure to be here this morning to open this conference on the "The Future of Banking". What I would like to discuss in my remarks is the challenges facing the European banking sector and the right policy responses. The main point I would like to make is that we need a balanced approach – supporting the healthy forces of creative destruction, while at the same time protecting consumers and the essential functions of banks in servicing the economy.

The future for the European banking sector is currently clouded in uncertainty. European banks are coming out of the crisis facing disruptive forces from all sides. They confront three main challenges to their business models.

The first is dealing with the legacy effects of the crisis on their balance sheets.

Since 2009 banks have been going through an arduous process of restructuring and deleveraging: shedding non-core business lines, writing down impaired assets and increasing provisions. This process has been costly both in terms of lower profits and diverted management time. Many banks also still have to work through their large stock of non-performing loans (NPLs), which further weighs on earnings prospects. Sufficient recovery from NPL resolution is hindered by slow national insolvency procedures for firms and an underdeveloped European distressed debt market.

The second challenge is adapting to the new wave of regulation since the crisis.

Banks have been required to improve both the quantity and quality of their capital, which has, in the short-term at least, led to a de-risking of banks' balance sheets to improve risk-weighted assets. The incoming leverage ratio, which will put a cap on balance sheet size, is also obliging banks to make difficult decisions over how to allocate assets and which business lines to maintain. And reform proposals are on the horizon that will limit cross-subsidisation between banking and trading activities, which will require some adaptation in the business models of Europe's universal banks.

Third, banks are faced with profound structural changes.

As evolving customer preferences interact with new technology, for instance in the growth of internet and mobile banking, barriers to entry into banking are falling. Banks with large branch networks are being exposed to competition from lower cost and less regulated operators. We see this already in the emergence of peer-to-peer lenders and technology firms offering banking services. There is also increasing competition in banking services more generally, as firms like Paypal become well-established in markets like retail payments that were previously the preserve of high street banks.

On top of this, the trend towards more capital market-based financing in Europe – supported by the new initiative on Capital Markets Union – will inevitably weaken banks' market power, especially for firms that can easily substitute bank and market finance. And though still relatively small in quantitative terms, we are also seeing a greater role of "shadow banks" in direct lending – asset managers, pension funds, private debt funds – that heralds a shift towards a less bank-dominated financing mix.

Taken together, this represents a uniquely challenging environment for European banks, and this is visible in their generally weak financial performance: price-to-book ratios are low and profitability is meagre. Many banks have a cost of equity exceeding their return on equity.

Moreover, there is little chance of the economy coming to the rescue or of interest rates rising any time soon. Banks will have to return to profitability in the context of a slow recovery with depressed net interest margins.

So, should we be concerned about how banks will fare in this difficult climate? As I already intimated, in my view we need to take a nuanced stance here that balances principle and practice.

In principle, the developments in the banking sector should be largely positive for society at large. Many banks grew too quickly before the crisis and developed unsustainable business models, so a period of consolidation is both desirable and inevitable. The aim of the regulatory agenda, which is to make banks more resilient and reduce the burden of bank failure on society, is also fully justified.

And the ongoing structural changes are welcome. If we believe in the benefits of creative destruction for normal firms, then we must also believe in it for financial firms. Innovation that raises competition in retail lending, and leads to better and cheaper services for customers, is a net gain for the economy. So, a priori, I do not see any role for regulators in protecting banks from new operators – on the contrary, innovation should be nurtured and encouraged.

Equally, the objective of a Capital Markets Union is clearly in the public interest. It would benefit, in various ways, financial stability, access to finance and entrepreneurship. In particular for equity risk capital, which is critical for innovative young firms, market fragmentation in Europe creates a self-fulfilling brake on progress. Venture capital firms do not have a large enough deal flow to cover the majority of investments that will fail, meaning fewer investments are made.[1] So we need to work towards a genuine single market for all forms of financing – for loans, bonds and equity.

Still, despite all these positive aspects, we must also recognise that, in practice, the process of adaptation and structural change in the financial sector could have unwelcome consequences. As such, we cannot be completely agnostic about how that process evolves. Indeed, there are at least two possible outcomes from this changing environment that we need to be particularly careful to avoid.

The first is that innovation comes at a cost to consumer protection.

We have already seen in some European countries the risks posed by the emergence of new actors with little official oversight – internet payday lenders, for example. And such activities by unregulated non-banks can create pressure for a race-to-the-bottom among more regulated banks, which would also be detrimental consumer security. We therefore need to ensure the right balance between innovation and regulation. The regulatory landscape should not stifle new operators or protect the rents of banks, but it also needs to be consistent and fair.

The second outcome we need to avoid is that the pressures of the new environment cause bank lending to fall too much and then stay too low.

I say this not because there is any ex ante preference for bank lending over other forms of credit. I say it because, whether we like it or not, banks have a vital social function in Europe in taking the credit risk to lend to small- and medium-sized enterprises (SMEs). And even with a more diversified financing mix in Europe, this function is essentially irreplaceable by non-banks.

It is only really banks – and in particular larger banks – that have large enough balance sheets to effectively diversify the idiosyncratic risks from SME lending, by lending to a broad enough range of firms. And it is only banks that have the relationship networks and screening

---

[1] Veugelers, R. (2011), "Mind Europe's early-stage equity gap", Bruegel Policy Contribution 2011/18, December 2011.

and monitoring processes to manage the information asymmetries associated with smaller firms. For non-banks obtaining adequate information is simply too costly and resource intensive.

Thus, were banks to respond to regulatory and structural changes and weak profitability by taking less credit risk vis-à-vis SMEs, or shifting their asset allocation to mortgages or securities, non-banks could not easily fill the gap. And as SMEs account for around 85% of total employment growth in the EU, and have a much higher employment growth rate (1% annually) than large enterprises (0.5% a year), the costs for the European economy would be very high.

So how can we avoid this scenario?

First of all, a large body of research suggests that banks need to be strong to lend: to give just one example, the BIS finds that European banks with higher capital levels and stronger profitability have lent more during the crisis than others.[2] So, banks themselves need to face the challenge; they need to reinvent themselves and reinvigorate their business models.

Many banks have already begun this process, for example by shifting focus from trading and wholesale banking to retail banking and asset management. They have also worked hard to reduce costs. All this is an important part of adapting to the new environment.

But I think banks must be careful that responding to short-term pressures does not come at the expense of longer-term viability. Specifically, if they elect to cut costs and boost profits through underinvestment, over time they will not be able to keep up with technological change and evolving customer demands – and in the end they will not have a business model.

Most importantly, retail customers now expect to be able to move seamlessly across digital channels such as online and mobile banking, which requires adequate investment in digital platforms. And if these expectations not met, they are also now increasingly prepared to switch accounts, causing banks to lose a cheap source of funding. In short, more than ever banks need to innovate to keep their customers loyal.

One way for banks to raise profits without shirking on investment is through genuine efficiency gains. And in this context I see a large "low hanging fruit" in Europe that is ripe to be picked – consolidation within the sector. According to most indicators there are too many banks in Europe relative to the size of the market.[3] This implies that there is significant scope to benefit from rationalisation, and without exacerbating the problem of "too big to fail". Moreover, these benefits have become easier to realise now that we have a Banking Union and an end to supervisory divergence.

To give some examples, research suggests that the economies of scale from within and cross-country banking M&A could be sizeable in terms of, among other things, information technology and corporate overhead costs.[4] Banks that implement a pan-European balance sheet strategy could also access a more diversified customer base and, under the Single Supervisory Mechanism, optimise their use of capital and liquidity. And being European provides a platform for banks to launch new products on a European scale, thus increasing the returns to investment and innovation.

---

[2] Cohen, B.H. and M. Scatigna (2014), "Banks and capital requirements: channels of adjustment", BIS Working Papers No. 443, March.

[3] For example, the Herfindahl-Hirschman concentration index (HHI) for the euro area currently stands at around 700. As a general rule, an HHI below 1,000 signals low concentration, while an index above 1,800 signals high concentration. For values between 1,000 and 1,800, an industry is considered to be moderately concentrated. See ECB Banking Structures Report, October 2014.

[4] Kovner, A., J. Vickery, and L. Zhou, "Do Big Banks Have Lower Operating Costs?," Federal Reserve Bank of New York Economic Policy Review, Volume 20, No. 2, forthcoming.

In short, there is every reason for banks to capitalise on the opportunity provided by Banking Union and turn themselves into genuinely European players. And this would go a long way towards creating a banking sector with the resilience and capacity to maintain the essential social function of lending to Europe's smaller firms.

But addressing the SME issue is not only about banks adapting; it is also about policymakers in various fields setting the right incentives for banks. That means, first of all, ensuring that Banking Union delivers on its promise – that the era of national champions is really over. But it also means making a rigorous assessment of the wider policy environment confronting banks – and the various ways in which it might be holding back bank lending.

In my view there are three areas in particular where we could make improvements.

The first is by accelerating efforts to put the legacy of the crisis behind us.

For example, there is a great deal more that could be done at the national level to make NPL workouts more efficient, like improving intercreditor mediation or in- and out-of-court restructuring frameworks. To complete insolvency proceedings in Italy takes 1.8 years, while in Ireland it takes just 0.4 years.[5] Pan-European initiatives could also play a role in reducing the legacy stock of NPLs, for example by adopting a centralised approach to speed up the pace of NPL write-offs.

The second area is advancing with the agenda to revive high quality securitisation in Europe.

Securitisation is where banks and capital markets meet – a well-functioning asset-backed security (ABS) market means more bank lending. There are many issues involved in reiving the market, which I have discussed at length elsewhere,[6] but one of the most important is improving information for investors. The ECB is playing its part here through its loan-level initiative, and various credit scoring initiatives by national authorities are helpful. But over the medium-term I am convinced we need to work towards a pan-European central credit database. This would facilitate multiple country SME ABS, which in turn would reduce both the risk and price of issuance.

Third, I think it is now key to provide more regulatory clarity.

Regulators have put a large burden on banks and it has probably come at a cost. If banks are simultaneously having to lower costs while raising the resources they dedicate to regulatory compliance, there must be a consequence elsewhere. For instance, IT resources may be diverted away from innovation. We also still hear reports from market participants that regulatory uncertainty is constraining bank lending. It is therefore time to make clear how the future regulatory landscape will look.

Let me conclude.

What I have tried to show today is that the European banking sector is facing profound challenges that are reshaping financial intermediation in Europe. These are in principle positive forces and we should not stand in their way. It is banks that need respond and face the challenge.

But we should also not be naïve: we need strong banks in Europe to support our economy, and policy has a role to play to achieving that. This does not mean helping individual banks or promoting national champions, it means creating an environment with better capitalised banks, better information and better regulation. Then, banking will have a solid future in the emerging European financial landscape.

---

[5] World Bank (2013), Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises.

[6] See speech by Y. Mersch, "Next steps for European securitisation markets", Barcelona, 11 June 2014.