Yves Mersch: Three challenges for the banking sector

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the European Financial Forum dinner, 2015 Cumberland Lodge Financial Services Summit, Cumberland Lodge, Windsor, 12 November 2015.

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Thank you very much for inviting me to speak to you this evening.

I have been asked to give a "central bankers' view" on the various issues being discussed at this conference, so let me lay out upfront the perspective I will be coming from. While I am indifferent to how structural changes affect individual financial institutions, I have a strong interest in how they affect the financial *sector* – and in particular, in a bank-based economy like the euro area, how they affect the ability of banks to finance the real economy. We need to make sure that in an environment of structural change we still have strong and sound banks.

At present, euro area banks continue to struggle with low profitability driven by both cyclical and structural factors. On the cyclical side, the low nominal growth and low interest rate environment makes traditional banking activities such as retail lending using maturity transformation less lucrative. On the structural side, banks' return on equity remains below their cost of equity, which points to a need for further balance sheet adjustment. Non-performing loans (NPLs) in particular remain an important obstacle for banks to provide new credit to the real economy.

These challenges need to be addressed both by raising growth potential and by a concerted effort to complete the clean-up of bank balance sheets. Yet as important as these issues are, they are largely legacies of the recent crisis. What I would like to concentrate on – as you are discussing at this conference – are the *forward-looking* challenges to the banking sector, and how they will affect banks given the already difficult operating environment.

I would like to focus on three that I see as particularly relevant: the payments challenge, the markets challenge, and the regulatory challenge.

1. The payments challenge

One of the key challenges facing banks is the impact of disruptive new technologies on their retail payments business – the so-called "rise of the FinTech".

Such competition from non-banks in retail payments services is of course not new. Western Union and Moneygram, for example, are well-established non-bank providers. But what is different now is that various factors are coinciding which look set to fundamentally change the landscape of the retail payments market, and in ways that threaten banks' dominant market position.

First, regulation is opening up market access. With the revised Payment Services Directive (PSD2), the list of activities that payment institutions can carry out is being expanded to include the initiation of payments. They can also provide account information for accounts held at other payment service providers. This will inevitably – and deliberately – weaken banks' market power.

Second, consumer preferences are changing rapidly. Retail customers now expect to be able to integrate e-commerce, social media and retail payments. They also expect to be able to switch seamlessly across digital platforms. These are not areas of strength for many banks: given their heavier compliance obligations, banks have traditionally invested more in the security and resilience of their systems rather than optimising the user experience.

Third, payments technology is evolving at an unprecedented speed. Contactless cards, online payments, mobile payments, are all becoming more prevalent. Keeping pace with those technologies will require major investment from banks, and they have to contend with the fact that their new competitors – for example PayPal and Apple – already have an edge in digital technology.

The initial effect of this disruption in the payments may well be to reduce the role of cash payments, which will not fundamentally affect banks. But in my view banks should not take this challenge lightly. According to estimates by Deloitte, retail payments will generate around €128 billion in revenues for banks in 2015, or around a quarter of total European retail banking revenues.[1] With profits already depressed on lending activities, banks can scarcely afford to start seeing margins being squeezed and market share lost in other areas.

So banks would be well-advised, to my mind, to face this challenge head on. Whether via joint ventures or higher investment, they need to keep up with technological change if they are to have a long-term business model. Banks accounted, however, for around 20% of the €10 billion euro total investment in FinTech in 2014, and collaborations between banks and non-banks a further 20%. Non-banks accounted for the remaining 60% – a clear gap to close.[2]

But should policymakers also take an interest in how this disruptive process unfolds? Or should they just stand back and let the market work? I would offer a somewhat nuanced view.

In principle, I would always prefer as little interference as possible in the creative destruction process. History shows us that new entrants have brought many benefits to the retail payments market. For example, merchants were the initial drivers of the introduction of payment cards in the US in the 1930s and, just a couple of years ago, it was a mobile network operator in Kenya that succeeded in making mobile payments widespread in that country. PSD2 was introduced precisely because there is no good reason for the regulatory framework to protect the rents of banks.

But policymakers also need to monitor carefully the system-wide impact of these technologies. Innovation should not come at a cost to consumer protection. We do not want a situation where unregulated non-banks create pressure for a race-to-the-bottom among more regulated banks, which might be detrimental consumer security. Nor do we want banks that must comply with higher consumer protection standards to be disadvantaged. So going forward, policymakers must ensure that the regulatory landscape is fair: neither stifling new operators, nor harming establishing ones.

I say this as a central banker not only because one of the ECB's statutory tasks is to ensure the smooth operation of payment systems. I say it because, ultimately, trust in payments means trust in money as a reliable medium of exchange. For a sound currency, consumers must have 100% confidence that their money can be exchanged safely.

2. The markets challenge

Non-banks are not only increasingly entering the retail payments market in the euro area, however; they are also entering the lending business. This brings me to the second challenge for euro area banks: the markets challenge.

For some years now, we have been witnessing a trend towards more capital market-based financing in the euro area, driven by both deleveraging among banks and the very low cost of market finance. Looking forward, the Capital Markets Union (CMU) project promises to

1 Deloitte (2015), "Payments disrupted: the emerging challenge for European retail banks".

2 Ibid.

further deepen market finance in Europe by, among other things, making it easier for young firms to access risk capital and smaller firms to issue bonds, as well as deepening markets for high quality securitisation.

So what will this mean for European banks?

In the long run, deeper capital markets may lead to more competition in the provision of financial services and hence weaken banks' market power. For example, research looking at the pre-crisis period suggests that where banks face limited competition in their domestic markets, they tend to charge higher margins for lending to SMEs, and that effect increases in financial systems which are more bank-based [3] That would change if small firms had more options to diversify, for instance through efficient private placement markets or further growth in crowdfunding.

There are nevertheless good reasons why banks are the primary lender to SMEs in most national markets – they have the client relationships, information database and domestic networks which are necessary for that type of lending – so banks are unlikely to be displaced by non-banks for quite some time. The challenge posed by CMU is therefore not, at least in the medium-term, about surviving. It is rather about *thriving*. CMU presents banks with an opportunity to recover profitability and to find a niche within the emerging market for new financial products in Europe.

Because in the euro area we have a universal banking model, more disintermediated finance will have to involve banks as the primary market makers. With CMU on the horizon, there is now a window for banks to specialise in specific products, become market leaders and bolster their sources on non-interest income. In particular, the development of securitisation markets offers significant possibilities for banks. There is clear demand for a conduit between non-bank investors looking for SME exposure and small firms looking for new sources of financing.

From my viewpoint as a central banker, I hope that banks indeed seize on this opportunity, because I think it would ultimately lead to a more robust banking sector as a whole. For example, European securitisation markets would improve risk-sharing among banks: one can imagine a world where small, local banks originate loans while larger, global banks securitise and market them. And a true CMU would also mean convergence of some parts of insolvency law and deepening of markets for distressed debt, which would help banks work through NPLs more quickly in future and hence increase the resilience of the banking sector to shocks.

Moreover, if bank finance declines in importance over the longer-term, that might also encourage some much needed consolidation in the banking sector, which would in my view be beneficial for the real economy. We see at the moment that overcapacity hinders the recovery of bank profitability, as weaker banks distort competition and make it difficult for other banks to re-price loans.[4]

Whether all this materialises, however, hinges crucially on how far-reaching the CMU project really is. The Commission's Action Plan for CMU has put forward many areas for further work, but each will take years to implement. What type of CMU will ultimately emerge therefore remains to be seen. I am sure Commissioner Hill will give us more guidance on this tomorrow.

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3 Ryan, R., O'Toole, C. and McCann, F. (2014), "Does bank market power affect SME financing constraints?", Journal of Banking and Finance.

4 ECB (2015), Financial Stability Review, May 2015.

3. The regulatory challenge

As I said, however, CMU is for the longer-term. For the medium-term, SME financing in the euro area will still mainly come from banks. So we need to make sure that there are no unnecessary obstacles to that process. And this brings me to the third challenge facing banks – the regulatory challenge.

The regulatory agenda since the crisis has no doubt been essential. Banks had too little capital, too much short-term funding, too high leverage, and created too great a cost for society when they failed. The reforms that have been introduced so far have increased resilience and, in extremis, made banks less costly to resolve. And there is no reason why this should, in principle, diminish the ability of banks to serve the real economy – research suggests, for example, that higher bank capital has no negative impact on lending.[5]

But as new regulation accumulates, we know that it can also come with costs as well. In the economics jargon, policymakers always have to be watchful that, in attempting to internalise externalities, they do not inadvertently create new externalities. The possible risks can be summarised under the headings of *complexity*, *clarity* and *consistency*.

As regulations have built up since 2009, they have tended to introduce more *complexity*, and with that comes an inevitable cost in terms of compliance. For example, a study from a few years ago estimated that to comply with Basel III for a midsize European bank would require up to 200 full-time jobs.[6]

That is not *per se* a problem, but one has to look at it in the context of the current environment facing banks. If banks are simultaneously aiming to cut costs to restore profitability, while raising the resources they dedicate to compliance, there could be a consequence elsewhere: for instance, IT resources may be diverted away from innovation. That would hinder the process of technological adaptation that is key for their long-term viability. So I would argue that regulators should be mindful of the burden they are placing on banks and the potential unintended consequences.

If banks are to adapt effectively to the new regulatory environment, they also need *clarity* on what it will look like. The risk of a prolonged period of regulatory reform – and remember the current phase has been ongoing since 2009 – is that it creates a moving target, which in turn prevents the industry from settling into sustainable new business models.

To give just one example, some banks responded to the crisis by switching to a vision of retail deposit-funded subsidiaries, which was also supported by the initial wave of regulation, for example the Net Stable Funding Ratio. Now, with the introduction of the Total Loss Absorbing Capital rules, they may be forced to reconsider those business models as they will need to issue more unsecured long-term debt. Let me be clear: I am not making a value judgement about these regulations. What I am saying is that, if we want banks to adapt successfully to the post-crisis world, we need to give them sufficient visibility about the future.

Finally, regulation needs to be mutually *consistent*. In particular, if we want banks to be bigger players in a more market-based financing mix, we need to ensure that regulation supports that transition and does not unduly impact banks' ability to transact in capital markets. We know that one side effect of the reform agenda so far has been banks retreating from, or scaling down, certain market making activities.

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5 See for example Buch, C., and Esteben, P. (2014), "Do better capitalized banks lend less? Long-run panel evidence from Germany", International Finance 17:1.

6 Härle, P., Lüders, E., Pepanides, T., Pfetsch, S., Poppensieker, T. and Stegemann, U. (2010), "Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation", *McKinsey Working Papers on Risk*, Number 26.

This is a particular issue for less liquid markets, such as ABS, which depend on market makers that can absorb temporary supply-demand imbalances. It is also one reason why part of the CMU Action Plan is a call for evidence on the cumulative impact of financial services reforms. Going forward, we should be careful to ensure that new regulations, for instance aimed at separating the banking and trading arms of universal banks, do not have negative consequences for market-making activities that are not justified by significant risks. Likewise, we should be mindful about the fallouts of an ill-designed financial transaction law.

Conclusion

Let me draw to a close.

The euro area banking sector is facing challenges on all sides: from new technologies, from new market players, from new rules of the game. Those challenges, insofar as they lead to competition and innovation, are healthy. They are how a well-functioning market economy works.

But we must also recognise that, in the euro area, we need sound banks. A weak banking sector means a weak economy. So I entreat banks to respond to the challenges of the new environment and reinvigorate their business models. And I entreat policymakers to create a fair, clear and consistent level playing field where that can happen.

Thank you for your attention.