Benoît Cœuré: From challenges to opportunities – rebooting the European financial sector

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the SZ (Süddeutsche Zeitung) Finance Day 2016, Frankfurt am Main, 2 March 2016.

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Ladies and gentlemen,

For those of you here who work in the financial sector, your job depends on your ability to assess and manage risk. What allows you to do this is the fact that many risks are tangible – they can be identified through analysis, measured through models and hedged using financial instruments. Risk is not *per se* an obstacle to decision-making; it simply frames the parameters of those decisions.

The situation is different, however, when risk morphs into uncertainty[1]. Uncertainty, by definition, cannot be predicted or quantified. It is therefore much more of an impediment to decision-making. And that brings with it economic costs: firms postponing investment, households postponing consumption and increasing savings.

In the European economy today we face several sources of uncertainty. We face uncertainty about the outlook for the global economy. We face uncertainty about the direction of Europe and its resilience to new shocks – the UK referendum, the next wave of migration. And germane to this conference, we face uncertainty about the way forward for the European financial sector.

A significant amount of this uncertainty stems from the fact that, eight years after the crisis, we are still in a transition phase. Financial institutions are considerably stronger than in 2008 but they are still adjusting their business models to a post-crisis world. We have a new regulatory regime, whose contours are not yet fully defined. And the new regime is being overlaid on a financial sector that, in some cases, still has substantial legacy issues to address. That creates unavoidable frictions.

But uncertainty can also be self-imposed, and policy decisions can play a role in that. In the still fragile environment we face today, what is essential is that policy works to reduce uncertainty – and does not become a source of uncertainty itself.

At the same time, policy cannot be an excuse for financial firms to put off revising their business models and updating their technologies. To build confidence in the European financial sector, all actors need to play their part. The post-crisis environment is a challenge, but it is also an opportunity: for the financial sector to become more profitable, more efficient and more stable.

What I would like to do in my remarks today is look more closely at the sources of uncertainty we face today, and at what policymakers and private players can do to address them. There are three areas in particular I would like to focus on: the business environment, the regulatory environment, and the technological environment.

Business environment

The *business environment* confronting the European financial sector today is evidently challenging.

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1 See F. Knight (1921). Risk, Uncertainty and Profit, Boston: Hart, Schaffner and Marx.

Earnings among euro area banks continue to be weak, with their average return on equity – although markedly improved since the crisis[2] – remaining below their cost of equity. Cost cutting and rationalisation has been ongoing since 2008, making further cost savings harder to achieve. Low profitability constrains the capacity of banks to generate capital internally. And new challenges have arisen in the face of an uncertain economic outlook, especially given the weakness in emerging markets and in commodity-producing sectors.

So are there ways that policymakers can reduce this uncertainty?

One topical issue is, of course, whether monetary policy is contributing to weak profitability. In particular, a concern has built up that, as central banks lower interest rates into negative territory, the impact of monetary policy on banks is becoming increasingly adverse. That is because bank lending rates fall linearly but their funding costs are non-linear – as interest rates on retail deposits are sticky – which puts a squeeze on net interest margins.

Let me underline that we are well aware of this issue. We are monitoring it on a regular basis and we are studying carefully the schemes used in other jurisdictions to mitigate possible adverse consequences for the bank lending channel. But I also think we need to qualify the narrative that banks' challenges flow largely from our monetary policy.

So far, many banks have been able to more than offset declining interest revenues with higher lending volumes, lower interest expenses, lower risk provisioning and capital gains. Last year, for example, euro area banks' aggregate net interest income increased, especially as crisis-hit banks refinanced expiring high-yield liabilities. And negative interest rates are complementary to our asset purchase programme, which has had clearly positive effects on asset prices, credit risk and intermediation volumes. This has to be set against the direct costs from our measures to net interest margins.

Moreover, in an environment of rising global uncertainty, what would be the costs for the financial sector if monetary policy had *not* responded? We have seen from the recent sharp fall in bank equity prices that the sector is highly sensitive to a weaker-than-expected economic outlook. In that context, our commitment to our price stability mandate is vital to anchor expectations of nominal growth. Those who call for a less accommodative monetary policy have to ask themselves what would be the impact on banks' lending volumes and loan-loss provisions if output were stagnant and prices falling.

More generally, market jitters have particularly focused on banks perceived to have residual weaknesses – in particular those with high stocks of non-performing loans (NPL) and those perceived to lack sustainable business models. These are challenges that have little to do with the central bank. Reducing uncertainty from these sources requires other policymakers and private players to act.

Two priorities stand out. The first is moving more decisively to deal with legacy assets. Progress in NPL resolution is still slow when compared with the volume of problem loans. In countries most affected by the crisis[3], the ratio of non-performing exposures to tangible equity and loan loss provisions – the so-called "Texas ratio" – currently stands at around 100% for many banks. That undermines confidence in their ability to absorb further losses, creating volatility in the event of economic bad news, as well as hampering loan growth to the real economy.

All the preconditions are now there to accelerate NPL resolution: NPL levels and provisioning have been reviewed by the supervisory arm of the ECB as part of the Asset Quality Review.

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2 For the euro area banking sector, the annualised return on equity for the first three quarters of 2015 was 5.7% in 2015 compared with 3.4% in 2010.

3 See ECB Financial Stability Review, November 2015. The analysis is based on publicly available data for a sample of 60 significant banking groups. Countries most affected by the crisis include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

The challenge now is to speed up the process of writing off and/or disposal. There are various policy measures that can facilitate this process.

One is improving insolvency regimes, which help separate viable from non-viable borrowers and enable the valuation of assets to be sold off. Another is increasing the efficiency of judicial systems, which allows faster foreclosure of collateral underlying NPL portfolios. And in my view there are also merits in facilitating the carve-out of substantial portions of bank balance sheets. But this assumes, of course, that workable solutions exist for the transfer of legacy assets at sensible prices to investors able and willing to manage them. It also assumes decisive action to kick-start the market for loans in those jurisdictions where NPL ratios are the highest – that is, in Cyprus and in Greece.

Second, banks with perceived business model risks need to do more to mitigate uncertainty by reshaping their business mix and their operational models. Asset carve-outs could be catalytic here as well: streamlining their balance sheets by disposing of assets can allow banks to concentrate on developing new business, as opposed to managing legacy assets – in other words, it can save them from "zombification". Beyond that, banks with weak profitability need to find ways to increase non-interest income and, where possible, to reduce further their operating costs. There appears to be scope for this too.[4]

On the earnings side, for example, we have already observed a trend among banks to compensate for lower interest income by increasing fees and commissions. There is some evidence that banks are offering fee-based products to clients as substitutes for interest-based products. On the cost side savings are more challenging given the extensive rationalisation efforts of recent years, but there is still one obvious "low hanging fruit" to be picked: consolidation within the sector.

Indicators of market concentration suggest some over-capacity in the European banking sector, especially in countries with more fragmented banking systems. For example, the Herfindahl-Hirschman Index for the euro area, though rising in recent years, still stands below 750. As a general rule, a figure below 1000 signals low concentration.[5] Cost-income ratios in some banking sectors also remain high. That implies there would be efficiency gains from consolidation without exacerbating "too-big-to-fail" problems.

The fact that we now have a European supervisory and resolution regime presents the ideal conditions for banks to capitalise on new cross-border M&A opportunities. What our economy needs is European banks operating in a European market: large enough to operate across borders and diversify risks, but small enough to be resolved with the resources of the Single Resolution Fund. This would reap the full benefits of banking union and improve the terms of the trade-off between financial stability and economic efficiency.[6]

For that to happen, however, we need to remove any remnants of the regulatory framework that implicitly support home bias. For example, how much national discretion is allowed in implementing rules; how fungible are liquidity and capital across borders; how regulations affect the choice of subsidiaries versus branches – all these issues will crucially shape the incentives of banks to become European. And if we do not get them right, the risk is that consolidation ultimately happens through the more painful route of resolution.

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4 See D. Nouy (2016), "Risks and resilience – the European banking sector in 2016", speech at the Deutsche Bank – Bank Capital Forum, London, 23 February 2016.

5 See ECB Report on financial structures, October 2015. The Herfindahl-Hirschman Index (HHI) is defined as the sum of the squares of the market shares of all firms within the industry, where the market shares are expressed as fractions. 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. The range of the index lies between 0 and 10 000.

6 See B. Cœuré (2014), "On the optimal size of the financial sector", speech at the ECB conference on the optimal size of the financial sector, Frankfurt, 2 September.

Regulatory environment

This brings me to the second part of my remarks: the *regulatory environment*. Clearly, the European financial sector is facing a profoundly changed regulatory environment after the crisis. That applies to quantity and quality of capital, to leverage, to funding profiles, to bail-in-able debt, to risk management practices. Derivatives markets and market infrastructures have also been subject to a comprehensive reform agenda.

Is this regulation a source of uncertainty? Taking a longer-term view, I find it difficult to believe so. Thanks to regulatory initiatives, capital ratios for euro area banks have risen from around 8% in 2008 to close to 14% today. Leverage ratios have improved in most countries. And funding has become more stable: median loan-to-deposit ratios have fallen from more than 140% in 2008 to around 110% now. Forcing over-the-counter (OTC) derivatives onto central clearing has also netted out counterparty risk and reduced uncertainty over who owns what in a crisis.

All this contributes to a more robust financial sector that is better able to absorb shocks. And though there are always costs to regulation, most studies suggest that, in the steady state, the macroeconomic benefits outweigh them. For example, Commission simulations find that the new regulatory framework will deliver macroeconomic benefits of around 0.6–1.1% of EU GDP per year, compared with long-term costs of about 0.3% of EU GDP per year.[7]

Where regulation can create uncertainty, however, is in two areas. The first is if there is a lack of visibility on what the future regulatory regime will look like. And the second is if there is uncertainty about how new regulation will be applied.

The volume of new regulation coming in has created uncertainty in the financial sector in recent years. But I think the contours of the new regime are now clearer than before. The key unfinished parts of the Basel III agenda, such as the leverage ratio, reductions in the variability in risk-weighted assets, total loss absorbing capacity (TLAC) and the fundamental review of the trading book, look set to be finalised in Europe by the end of this year. That should help provide clarity on the post-crisis steady state. As confirmed by G20 Finance Ministers and Governors at their meeting in Shanghai, the aim is now to focus on making Basel III effective without further increasing regulatory capital requirements.[8]

But there are still some areas where, I think, more visibility would be beneficial. One is the timeline for the Directive on Markets in Financial Instruments, which was recently postponed. Regulators no doubt face a difficult trade-off between the urgency of reform and the need for such a fundamental change in regulation to meet technical and logistical reality. But it is also important that the process does not lose momentum, not least as this legislation will be the backbone of a future Capital Markets Union.

Another area is the resilience, recovery and resolution of clearing houses, on which the Commission will make a proposal later this year when the global framework has been clarified. The CPMI, IOSCO and the FSB are making good progress in this area and will deliver guidance ahead of the G20 Hangzhou summit.[9]

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7 See European Commission (2014), Economic Review of the Financial Regulation Agenda, May.

8 See Communiqué G20 Finance Ministers and Central Bank Governors Meeting, Shanghai, February 27, 2016.

9 Still another area is how pension funds will be impacted by the move towards central clearing for OTC derivatives. Central counterparties generally only accept cash as margin, while pension funds typically hold few liquid assets. That is why, in June last year, the Commission agreed a two year exemption for pension funds to find a technical solution to this issue. Until it is resolved, however, there may be uncertainty among investors about how pension funds will be able to meet their clearing requirements without shedding profitable assets.

In terms of the application of regulation, we have also seen – perhaps inevitably – a degree of uncertainty as the new regime beds in. For example, some of the recent volatility we saw in bank shares seems to have coincided with uncertainty around how pillar 2 capital requirements would be applied. But recent clarifications by the European Banking Authority (EBA)[10] and additional communication by the Single Supervisory Mechanism (SSM)[11] have now, I think, gone a long way towards allaying concerns. All things being equal, supervisory requirements will also not be increased further.

What perhaps remains to be clarified is exactly how the new resolution framework will work. The resolution cases in Portugal and Italy last year have sparked concerns about equal treatment, but it is important to underline that this was not an application of the bail-in tool in the Bank Recovery and Resolution Directive, but rather of the EU state aid rules. What is key now is that creditors have certainty about where they stand in the new resolution hierarchy.

That would be enhanced, in my view, by ensuring that MREL (the minimum requirement for own funds and eligible liabilities) is consistently implemented across the EU, including a common EU framework on the degree of subordination of senior unsecured bank bonds[12]. It would also benefit from clarifying the interaction between MREL and TLAC (total loss-absorbing-capacity), in particular the differences in subordination and the treatment of additional capital buffers. The ongoing MREL review, which will also implement TLAC, will need to address any remaining inconsistencies and uncertainties, as banks need clarity to start issuing the bail-in-able debt that will make the new resolution regime fully effective.

I trust many of these issues will be addressed and finalised in the course of 2016.

Technological environment

Finally, let me say a word about the third and in my view the most important area of potential uncertainty in the financial sector: the evolving *technological environment*. What I am referring to here is the emergence of disruptive new technologies – so-called "FinTech" – which look set to profoundly reshape the structure of financial intermediation.

FinTech now spreads across financial market segments and along the value chain. It is present, albeit still at an early stage, in payments, credit provision, investment and financial advice, insurance. It runs from front office to back office. And FinTech innovations are increasingly cascading into new areas. For example, the development of instant payments infrastructures has helped develop new markets for mobile P2P, e-commerce or point-of-sale payment solutions, which may become a new standard of payments in some areas.

On the face of it, I have no doubt that this is a positive development for the financial sector. It leads to greater efficiency, better products and lower prices for consumers. It also has the potential to support financial inclusion. In short, FinTech can be part of the answer to the fundamental questions facing our economies: lack of productivity and rising inequalities.

That is why regulation is generally supporting opening up market access by introducing legal certainty to previously unregulated services. For example, the revised Payment Services Directive is expanding the list of activities that payment service providers can carry out to include the initiation of payments and account information services. Where the uncertainty comes in, however, is how this will affect incumbents.

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[10] See Opinion of the European Banking Authority on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions.

[11] See SSM SREP Methodology Booklet.

[12] See ECB (2015). Opinion of the European Central Bank of 2 September 2015 on bank resolution (Con/2015/31).

FinTech presents an opportunity for new start-ups to compete with established financial institutions in specific financial services, but without the costs of legacy IT systems and a compliance-oriented business culture. FinTech also opens the market for “BigTech” firms such as Apple, Google and Amazon, which have an in-built advantage in digital technology. This threatens to take business away from banks which traditionally offered a package of services, potentially weakening their business models.

What is more, over the longer-term technological innovations, such as distributed ledger technologies (DLTs), could have profound impacts on financial intermediation. DLTs have the potential to substantially reduce reconciliation costs for market participants, to disintermediate incumbents in the financial value chain, and to allow for a more efficient use of collateral. Through decentralised update and validation of records, they may even challenge the basic business models of intermediaries or central market infrastructures.

So should policymakers be concerned about this?

Generally speaking, it is up to market incumbents to rise to this challenge. In particular, banks facing questions about their business models should see the new wave of innovation as an opportunity – to reach out to new customers, to increase efficiency, to revamp their business models. After all, they still retain economies of scale unavailable to small start-ups and intellectual capital unavailable to outsiders. FinTech may be exactly the shock the sector needs to restructure after the crisis.

But policymakers also need to monitor developments closely. As more firms enter the market it will be important to ensure a level playing field between entities providing similar financial services. Moreover, market fragmentation might create challenges for a single European market, as market innovators have a tendency to build closed-loop solutions or “silos”, and challenge the existing approaches towards containing systemic risk. For example, the emergence of popular retail payment platforms in one country could undermine the market integration already achieved in the context of SEPA.

We will have to see how the market evolves before assessing whether regulation should provide a steer in one direction or another, whether the new approaches will provide full legal certainty to market participants, and whether regulatory space can be provided to let innovation develop without hindering financial stability. But we have started moving along a steep learning curve. For example, the CPMI has launched work in partnership with IOSCO and other standard-setting bodies on the impact of the distributed ledger technology and related digital innovations on payments and market infrastructures.

Conclusion

Let me conclude.

The euro area is still recovering from a once-in-a-generation economic and financial crisis that has left deep scars on the economy. It urgently needs higher growth to bring down high unemployment, to deleverage the economy and to raise inflation back to our price stability objective. Uncertainty in the financial sector only blocks that path.

To reduce uncertainty, both policymakers and financial institutions need to play their part. They need to ensure that the financial system is fit for purpose and able to finance the recovery. And they need to do so today, not tomorrow.

But we should keep in mind that the challenges facing the financial sector also present an opportunity. A tough business environment can push banks to be more efficient. A new, stable regulatory environment will make the financial system safer. And a disruptive technological environment can lead to new business models and better financial services.

It is in all our interests to rise to this challenge.