Yves Mersch: Banks adapting to the new normal – striking a balance between prudence and pragmatism

Dinner speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Mandarine Gestion Investment Conference, Munich, 19 September 2016.

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Introduction

Eight years ago, almost to the day, US investment bank Lehman Brothers went bankrupt. Its default unleashed a global financial crisis we still haven't fully recovered from.

Regulators worldwide responded to the crisis by imposing stricter rules to make the financial system more resilient.

Addressing financial sector weaknesses is an important step. When addressing these we need to keep in mind the challenges banks are facing as they adapt to a new operating environment. They face challenges to their business models and to their profitability, they face increasing competition from the non-bank sector and have to contend with new technologies in the payments field as well as new regulations.[1]

Today I want to focus on two of these in greater detail. First, I will consider how the economic environment has made it more difficult for banks in some countries to lend. I will then take a look at the financial regulation and the changes that are still being implemented.

Adapting to the new operating environment has not been easy. Banks have been very vocal critics of tighter regulation and low interest rates, particularly here in Germany.

The ECB is aware of this criticism, and of the crucial role banks play in transmitting our accommodative monetary policy stance to the real economy. At the same time, the financial crisis has taught us that banks' capital and risk buffers were too low and regulation of certain markets needed to be tightened.

Striking the right balance between prudence and pragmatism

We need to learn from the past, which saw the biggest bailout in history, costing European taxpayers almost €2 trillion.[2] Germany's government, by the way, was one of those in Europe that spent the most to support the country's financial institutions.

This experience has led to a paradigm shift: from "bailout" to "bail-in". In other words, banks' shareholders and creditors, rather than taxpayers, will be called on first to bear any losses arising from a bank's failure. Stronger and more harmonised regulation is necessary, no doubt, but we should not go too far and keep in mind that banks need some leeway to operate effectively.

Implications of the low growth and low interest rate environment

Let's take a closer look at the economic environment banks are operating in today.

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1 Y. Mersch, Grasping the new normal of the banking industry – a view from a European Central Banker, June 2016.

2 Around €5 trillion of aid (including State guarantees) were approved by the Commission between 2008 and 2014, of which €1.9 trillion were used at the height of the crisis. EU Commission, State Aid Scoreboard 2015, Aid in the context of the financial and economic crisis.

Low growth and low inflation are not only European phenomena, but are prevalent in many mature economies around the globe. They are driven by factors such ageing populations, shrinking workforces, rapid technological progress and the aftermath of severe economic downturns.

In the euro area, a mood of uncertainty and a weak economic recovery are holding back investment and bank lending. This mood is informed by geopolitical uncertainties, subdued growth prospects in emerging markets, necessary balance sheet adjustments in a number of sectors, the slow implementation of structural reforms in general,[3] as well as Brexit and the refugee crisis.

Economic downturns following the financial crisis have, in some euro area countries, exacerbated the problem of non-performing loans (NPLs) for banks. This legacy issue has seriously handicapped their lending to companies and households. The 2014 comprehensive assessment, which for the first time evaluated euro area banks' assets according to the same standards, identified an upward revision of the estimated non-performing exposures amounting to €136 billion, or 18%. Banks stepped up their provisions accordingly, but the NPL problem cannot be solved with capital alone. The ECB is fully aware of this and is developing guidelines for banks, asking them for example to create operational structures and draw up strategies to manage and ultimately reduce their NPL stock in a timely manner. National authorities need to play their part as well and take the necessary steps to resolve the issue, for instance by making changes to the judicial system.[4]

We cannot afford to waste too much time. High levels of NPLs are paralysing banks, preventing them from passing on the ECB's monetary stimulus to companies and households, and effectively holding back the recovery in the euro area.

The comprehensive assessment was a starting point and a milestone: it gave us a better idea of the size and the nature of the problem we are facing. We have to be realistic though; improvements will not happen overnight. It will take years. We have to be patient – and determined. The economic environment plays a key role in overcoming the issue. Recessions tend to increase the dimension of NPLs. It is not surprising that the problem is most pronounced in countries with the weakest growth dynamics. Therefore, structural reforms that aim to spur growth are an indispensable precondition to remove the millstone that weighs heavily on the banking sector.

Consistent implementation of bail-in tools

Another challenge banks face today is tougher financial regulation. A number of new rules are already in place, while some, for example on bank resolution, have yet to be fully implemented. The global framework for an orderly resolution of failing banks that includes a new standard on total loss absorbing capacity (TLAC) will come into force from 2019 for global systemically important banks.

On a European level, the resolution authorities still need to set the minimum requirement for own funds and eligible liabilities (MREL) as part of the Bank Recovery and Resolution Directive (BRRD) for individual banks.

The transposition of the BRRD into national law has also triggered some changes to national insolvency regimes,[5] which will lead to the reclassifications of some assets in some countries and to the creation of new asset classes in others.

3 Introductory statement to the press conference, 21 July 2016.

4 Guidance to banks on non-performing loans.

5 Bundesbank Monthly Report July 2016.

These changes, which generally aim to protect taxpayers from bank failures in future, may have further implications for banks as they may affect the eligibility of certain assets as collateral for central bank refinancing operations. This in turn could impact on liquidity conditions and the spreads of the respective assets, affecting banks' refinancing costs.

The statutory subordination of certain senior unsecured bank bonds to other senior debt, as proposed in the adaptation of the German national banking resolution law, for instance, is expected to facilitate resolution and the implementation of the TLAC standards. But it also means that these kinds of bond would no longer be eligible as collateral for Eurosystem credit operations, according to ECB guidelines.[6] Clearly, any implementation of the BRRD in different ways combined with other upcoming requirements may lead to a re-fragmentation.

We are closely monitoring the ongoing regulatory changes in this field. It remains to be seen how they correspond to our rules and, as a result, how they may affect our pool of eligible collateral and ultimately our monetary policy stance.

Although we will have to make sure that our operating framework helps to strike the right balance – allowing the banking system to breathe and at the same time avoiding an excessive reliance on the central bank[7] – any coordination of our decisions with regulators would hardly be compatible with central bank independence.

A European perspective will be crucial when working out the final steps in the implementation process. The Commission will need? to define a harmonised European approach to reforming national insolvency laws so as to avoid creating new problems while trying to solve old ones.

Conclusion

Let me conclude. Eight years after the collapse of Lehman Brothers sparked the global financial crisis, banks are still adapting to the "new normal" – an environment defined by low growth, low interest rates and stricter financial regulation worldwide.

While it is important to be prudent and learn from past experience, we must apply the lessons we learn in a measured way.[8] The regulatory requirements need to be properly calibrated.

Amid all the regulatory changes that seek to strengthen our financial system we must remember to leave banks room for manoeuvre. Banks are crucial: they ensure that our accommodative monetary policy reaches the real economy as they translate lower refinancing costs into more favourable lending conditions for euro area households and companies.

As much as possible, we should aim for European standards rather than national solutions. That way, we can avoid returning to a fragmented set-up prone to arbitrage that provided fertile ground for the financial crisis.

We need to be prudent when learning from the past yet pragmatic when applying such lessons if we are to shape the future in a judicious way.

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6 Opinion of the European Central Bank on bank resolution (CON/2015/31).

7 U. Bindseil, Evaluating monetary policy operational frameworks August 2016 (p. 15).

8 Y. Mersch, Grasping the new normal of the banking industry – a view from a European Central Banker, June 2016