Sabine Lautenschläger: Banks business models - keeping pace?

Statement by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism, at the Seventeenth Annual Conference on Policy Challenges for the Financial Sector, Washington DC, 1 June 2017.

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Ladies and gentlemen,

There are 19 countries in the euro area. They all share one currency, but differ in many other respects. Their economic structures, tax codes and legal frameworks differ. Their macroeconomic characteristics, such as growth, inflation and employment, also differ.

This mix of economies requires a mix of banks. And in the euro area, banks are indeed varied. There are large banks that operate on the global stage and small ones that focus on domestic business; there are banks which are profitable and there are banks which have not earned their cost of capital for several years now.

All these banks face similar challenges.

- First, they have to deal with geopolitical risks, that is, with higher uncertainty.
- Second, they have to deal with a challenging macroeconomic environment; and that includes low interest rates. Hence, banks have to adjust. They have to become more cost-efficient and diversify their revenues.
- Third, they have to deal with overcapacities in the European banking market; many banks compete for the same customers.
- Fourth, they have to deal with technological change, such as digitalisation. That change attracts new competitors to the market, the famous fintechs. This makes the market even more competitive.
- And fifth, they have to deal with tougher rules. That includes higher capital requirements, more reporting and higher demands with regard to the scope and quality of risk management – just think of the BCBS 239.

So banks are important, and they face challenges. That’s why we take a very close look at how banks in the euro area make profits and how their business models work. That is a core element of our annual Supervisory Review and Evaluation Process, or SREP as we call it.

When we assess business models, we combine two things: an analysis of hard data and the judgement of experienced supervisors. This helps us to be unbiased, holistic and forward-looking.

And we benefit from our European viewpoint, of course. Unlike national supervisors, we can compare and benchmark 125 banking groups across the entire euro area. That is a big advantage.

Altogether, we have defined nine different categories of business model, ranging from large universal banks and domestic lenders to specialised asset managers. We then place each bank in one of these categories and can thus compare it to its European peers.

Like all supervisors, we ask one very general question: can a bank generate sufficient returns within a framework of suitable risk appetite and on the basis of a clear and sustainable funding structure?

For us, a business model is viable if it can generate such returns over the year ahead. And it is sustainable if it can generate such returns over a three-year period and through a full business and economic cycle.

The first step we take when we analyse a business model is to map out the general strategy of the bank. We try to understand its main sources of profit and how they might be affected by economic developments. We then refine the map by comparing the bank with its peers across the euro area. As I just mentioned, this is one of the main benefits of European banking supervision.

The next step is then to derive an automated score. This score is based on indicators such as the return on assets and the cost-to-income-ratio. And as I already said, we then complement the scoring with expert judgement.

In doing so, we take a forward-looking approach. And what we look for are key vulnerabilities. We assess how profits might evolve over time. We analyse the bank's strategic plan; we take into account its financial forecasts and assess how it might be affected by internal and external factors.

In the light of this assessment, we might adjust the score. The final result then feeds into the SREP and guides us when we determine supervisory capital add-ons and other measures.

As the ECB is still a young supervisor, we still need to learn more and dig deeper. That's why, in 2016, we launched a thematic review of banks' profitability drivers at firm level and across business models. That review is still ongoing and will provide some more tools to support us when we analyse business models and monitor profitability. It will strengthen our ability to identify banks with structurally low profits; and it will examine in depth how banks respond to weak profits – now and in the future. The thematic review will conclude at the end of this year.

Are we satisfied with the business models of banks in the euro area? Are we satisfied with the progress banks have made by learning the lessons of the crisis? In all honesty, have you ever met a supervisor who was satisfied with anything? I haven't – that is just not in our DNA.

It is true, of course, that many European banks have made a lot of progress. They have significantly raised their capital and liquidity buffers, they have got rid of a lot of bad assets, they have refocused their business, and they have streamlined their cross-border activities. So far so good!

But even though banks have started doing their homework, they haven't finished yet. There are some banks that still have a long to-do list. And a few banks even have to improve the contents of their list. So again, the banks in the euro area paint a very mixed picture.

The good news is that there are about two dozen larger banks that have successfully navigated the choppy waters. These banks come from many different countries and have different business models. What sets them apart is that they generate more income than their peers. Many of them outperform in terms of interest income, but other factors also play a role.

To sum up: banks in the euro area differ in terms of size, business model, legacy issues and their preparedness for whatever the future may hold. Quite a few banks still have homework to do or need to implement what they have already decided to do in order to cope with the new challenges. This variety makes life a bit more difficult for investors and supervisors.

But as diverse as the banks might be, they all play an important role – and by and large, they are the ones, and not so much the capital markets, who keep the European economy running and growing. Thus, we need performing and stable banks in Europe to provide loans and other services. We need banks that are not held back by the mistakes of the past, but which have been cleaned up and are able to do business.

We also need tough rules and tough supervisors who challenge banks' business models. In the long run, only banks that make profits can be stable. And only stable banks can handle uncertainty, deal with a changing environment and reliably serve the economy.

Thank you for your attention.