Yves Mersch: Europe in transformation - structural, regulatory and technological challenges for the markets of tomorrow

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Slovenian Banking Days conference, Brdo pri Kranju, Slovenia, 6 November 2017.

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Banks play a vital role in the economy, matching surplus funds from savers to those wishing to invest in profitable projects – a process that contributes to the growth in productivity and overall welfare.

It is also a process that plays an important role in the transmission of monetary policy, which means that monetary policymakers, such as myself, take great interest in the structure and performance of the banking sector. From this point of view too, it is important that the sector operates in an **efficient** and **smooth** fashion. During the crisis, banks in the euro area did not operate in this way, and their failure to do so exacerbated the impact of the crisis on people and on the economy.

This will be the focus of my talk today. Banks face a number of challenges, visible in the weak financial performance of the sector, with low price-to-book ratios and meagre profitability. Compared with the pre-crisis status quo, profound changes in the sector in terms of structure and business models will be needed to tackle those challenges. Broadly speaking, the challenges are threefold: structural, regulatory and technological.

Structural challenges

We are now a decade after the onset of the crisis. Yet despite the ongoing broad-based recovery in the euro area economy, bank profitability remains low. In part, the roots of that continued poor performance lie before the crisis, which served to expose structural issues within the European banking sector. Chronic overcapacity had resulted in poor profitability and too much lending to marginal projects which eventually turned sour.

That stock of non-performing loans (NPLs) remains high in some countries and continues to depress bank profitability today. At the end of 2016, the stock of gross NPLs in the EU banking sector was around €1 trillion. This NPL overhang is tying up bank capital in failed or failing ventures and preventing the efficient flow of new lending to profitable projects.

How should banks react to this challenge? First, we should recognise that Europe remains overbanked. Although progress has been made on this front, with 25% fewer credit institutions in the euro area now than in 2008,[1] there is considerable scope for consolidation within some countries and across borders. The creation of Europe-wide banking groups would help break the bank-sovereign nexus and the consequent fragmentation of bank lending along national lines and through national interference that so marked the crisis. Credit provision should then be able to continue in a smooth fashion in future downturns, mitigating, rather than exacerbating, asymmetric shocks.

Greater efforts should be made to resolve the overhang of NPLs. I see a number of avenues that are worth exploring. Banks themselves should make efforts to fully provision the true expected loss from NPLs. Countries where NPLs are higher are often those where weak institutions make it difficult for banks to seek insolvencies and seize collateral from non-payers. Structural reforms to boost judicial efficiency will aid banks in the process of NPL recovery. Finally, setting up an effective Europe-wide securitisation market for distressed debt should help banks to shift NPLs from their balance sheets and free up capital for new lending. Too much remains on bank balance sheets at uncertain values by comparison with other continents, where securitisation makes assets tradable, thereby allowing the markets to clear banks' balance sheets.

Zombie banks supported by official interventions prevent new lending to the economy. And the low growth environment fostered by such behaviour in turn sours more assets on the banks' balance sheets.

To break this vicious circle, determined action on NPLs is required.

Regulatory challenges

The second challenge faced by banks is the stricter regulatory and prudential framework imposed on the sector following the crisis. These measures aim to create a banking sector that works efficiently and smoothly, as I mentioned earlier.

Banks are now required to have more – and better quality – capital. The incoming rules on liquidity and leverage are already forcing banks to make some tough decisions on asset allocation and business lines. New regulations on resolution provide supervisors and the resolution authority with a toolkit to intervene early to require banks in difficulty to take necessary actions to bring about recovery.

In the case of an actual resolution, the new regulations aim to minimise the impact of a failed bank on overall financial stability – i.e. to ensure the system as a whole runs smoothly and to better protect taxpayers' money at large, rather than the invested money of the few directly involved.

There is evidence that these new regulations are helping to create a stronger banking sector in the euro area. Common Equity Tier 1 capital ratios of significant institutions rose on average from 7% in 2007 to 13.5% by end-2016. I recognise that tighter regulations do come at a higher cost to banks, but this should be set against the costs incurred by society over the past decade as a result of regulation that was too lax. Nonetheless, regulators should quickly agree on appropriate international standards to give banks certainty over long-term planning around business models.

Technological challenges

The final challenge for banks comes from the impact of technology, which is leading to increased competition from non-banks in domains traditionally considered to be the core business of banks: lending and payment services. I wish to focus my remarks on this particular challenge today.

With regard to lending, technological advances have permitted the growth of internet and mobile banking, opening up the sector to newcomers and exposing incumbents with large branch networks to greater competition. Moreover, there is a shift to more market-based finance in the euro area, a trend that is likely to continue under the Capital Markets Union initiative. While still small in overall terms, there is a growing role for so-called shadow banking – asset managers, pension funds, money market funds and the like – in providing financing to the real economy.

But there is also increased competition in the provision of retail payment services, made possible through new technology, which is disrupting banks' traditional business models.

Traditionally, banks have offered payment services as an extension of a customer account – debit and credit cards, direct debits and the like. There has of course always been some limited competition between banks – customers could obtain a credit card from another bank, and even change banks, although they seldom did.

Yet the growth of e-commerce has created a demand for payment services outside the traditional channels. The banking sector overall was slow to respond to consumer demand, permitting companies such as PayPal to enter the market. Initially, they used the existing infrastructure and instruments, such as credit cards.

More recently, a new type of provider which directly uses the online banking services of the respective bank has emerged. Such services operated in the past in a legal and regulatory grey area, and often in contravention of the terms of service of banks' online platforms.

Regulation has started to catch up with the new technology. The Second Payment Services Directive (PSD2) has codified these services, requiring companies to be authorised as a payment service providers, to identify themselves to the bank and to communicate with the bank using a common and secure method. The Directive mandated the European Banking Authority to develop technical legal requirements, which are now being finalised.

The main aim of the legislation is to provide a Europe-wide common framework for payments, and a standardised interface for such payments. Without that standardisation, there was a risk that new providers would face different sets of connection protocols and data requirements from each of the 4,000 retail payment banks.

By providing a standardised system that operates across the EU, PSD2 offers the basis for a new generation of financial services. For example, it will become easier for consumers to track all their accounts at different institutions using a single app and to analyse expenditure by type, and it will further open up mobile and internet payments. The benefits of this digitally integrated market for consumers should be welcomed.

The Eurosystem has been involved throughout this process in several roles: as an operator to provide the right services for settlement and payments; as a catalyst to facilitate standardisation, reachability and interoperability, and as overseer and regulator to ensure a smooth functioning of payment systems and to ensure a level playing field.

Our aim, as with the provision of banking services generally, is to have a payment system that functions smoothly and efficiently, while still providing the necessary legal safeguards for data and privacy. We are striving for a regulatory framework that is consistent and neutral – neither stifling new competitors, nor protecting the incumbents.

Much work remains to be done by both banks and the providers of these payment services to ensure we have a robust framework. Despite the disruptive nature of this technology, banks have plenty of opportunities to take a leading role. Consumers clearly value the service provided by the new entrants. Rather than seeking to obstruct the new payment systems (an ultimately fruitless endeavour), banks should seize the chance to provide an extra service that their customers value. For all that technology has changed the methods of delivery, one of the constants in securing long-term viability for a service provider is keeping its customers happy.

Technology and central banking

Of course, commercial banks are not the only ones facing challenges from technology and consequent changes in the economic environment. Technology also affects how central banks carry out their operations. As I said in a recent speech,[2] technological progress can affect the dynamics and measurement of inflation, which can in turn influence the monetary policy settings that are needed to fulfil our price stability mandate. The unconventional monetary policy measures we have put in place over the past decade reflected the particular circumstances at the time, when our traditional tool of influencing short-term interest rates was insufficient by itself to achieve price stability.

In other areas, too, central banks are analysing the potential impact of technology. The advent of Distributed Ledger Technology (DLT) has the potential to change how central banks issue base money[3] and operate payment systems. We are currently carrying out research to improve our understanding of this technology. It remains to be seen whether DLT can genuinely provide more efficient central banking services, while still operating smoothly and offering the necessary legal safeguards. Only through detailed research and testing can we determine if, and how, we should use DLT. This is different from the steady upgrading of our platforms to meet the demand for real-time services, as in the case of instant payments for instant purchases.

But despite the changes in the institutional and economic environment, one of the constants in the field of central banking is that of central bank independence What is of essence in this concept is the freedom from the political instruction of the government or its influence. But while the institutional and economic environment is in flux, one concept in the field of central banking is an enduring one: independence. The idea is to shield monetary policy from political interference and electoral considerations. Therefore, it is clear that any reforms implemented via national legislation that specifically target the central bank, as we have seen in some recent legislative initiatives in Slovenia, must not undermine its independence either directly or indirectly by exposing the institution to political pressure.

The most recent ECB opinion approved by the Governing Council concerning the Slovenian Act on judicial relief together with the draft law amending the Banka Slovenije Act (relating to the audit of its operations) underlines the risk of inducing this undesired effect. First, the combination of the two acts creates uncertainty with regard to the standard against which Banka Slovenije's past practices are to be audited by the Court of Audit. Let me just point out that the Slovenian Act on judicial relief was triggered by the need to remedy the unconstitutionality of certain provisions of the Slovenian Banking Act which authorised Banka Slovenije to adopt measures to write-down or convert qualified liabilities during the reorganisation of banks. Second, the Slovenian Act on judicial relief alone puts the central bank in a precarious position. Banka Slovenije is essentially obliged to file a claim against the State even though the central bank has nothing to claim but rather has to defend itself, and what is more, to defend the diligence it has exercised against an implicit presumption of wrongdoing and an ambiguous standard of assessment.

Conclusion

Let me conclude.

A well-functioning financial system is of vital importance for long-term, sustainable economic growth. The crisis laid bare elements of the financial system that were not functioning in the smooth and efficient manner required.

The new regulatory regime put in place since the crisis provides the right framework for the banking system to function better in the future. But work remains to clear up the legacy of the crisis, particularly in terms of the overhang of NPLs. Regulation alone is insufficient, and further effort is required of banks, in terms of both consolidation and refining business models, to return the sector to sustainable rates of profitability. But efforts are also required at national level to make national institutions function in line with European legislation.

Payment services is a further area where regulatory advances are of themselves insufficient to provide a working system that operates in a smooth and efficient way, that is still safe and respects European privacy provisions. Banks now have a great opportunity to embrace the new technology and serve their customers in a new fashion. Agreeing and implementing technical standards in a timely fashion will help foster the right conditions for a payment system that benefits everyone.

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[1] European Central Bank (2017), *2017 Report on Financial Structures*.

[2] Mersch, Y. (2017), "Central banking in times of technological progress", speech at the Bank Negara Malaysia

Monetary Policy Conference, Kuala Lumpur, 24 July.

3 Mersch, Y. (2017), "Digital Base Money: an assessment from the ECB's perspective", speech at the Farewell ceremony for Pentti Hakkarainen, Deputy Governor of Suomen Pankki – Finlands Bank, Helsinki, 16 January.