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Recent developments and open questions in the European banking industry

Speech by Governor of the Bank of Italy

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Ladies and Gentlemen,

It is an honour and a privilege to address this assembly. I would like to express my gratitude to Governor Linde and President Prados del Amo for the kind invitation to be here today. I will take this opportunity to share with you some reflections on the state of the European banking industry, of which Spanish banks are a fundamental part.

I will start with some considerations on the evolving structure of the sector; I will then move on to the issue of profitability; and I will conclude with my take on the main open questions we need to address over the coming months.

The long journey: evolving structure of the European banking industry since the financial crisis

Since the global financial crisis, the European banking industry has undergone a considerable structural transformation, along three closely intertwined dimensions.

The first one concerns the profound changes in both regulation and institutional set-ups. Capital requirements have been raised, leverage has been limited, and stringent liquidity requirements have been established. The institutional set-up has also been completely modified. In a very short time frame, the Banking Union has been launched, with the introduction of the Single Supervisory and Single Resolution Mechanisms (SSM, SRM). A new framework for managing banking crises has been adopted. Although the third pillar of the Banking Union – the European Deposit Insurance Scheme – is still lacking and in other dimensions advancement is slow, the overall progress has been remarkable. It would perhaps have been unimaginable only a few years ago and testifies to the strong determination to continue along the path to European integration.

The second dimension of structural change relates to the contracting size of the European banking sector, which not only reflects the tightening of regulation but also other factors, such as the need for banks to clean up their balance sheets, the impact of technology, as well as the increased role of non-bank financing. In the aftermath of the crisis, the total assets of the euro area banking sector declined significantly both in absolute terms, by 15 per cent between 2008 and 2016, and relative to GDP; leverage has been reduced across the board, and especially in countries where it was higher.

The downsizing of the European banking sector is also the result of important changes in its industrial organisation, which represent the third dimension of structural transformation. Between 2008 and 2016 the number of euro area banks declined by around 25 per cent, with Spain being one of the countries where the reduction was greatest. The number of branches is also decreasing and the use of resources is generally becoming more efficient.

Overall, this set of structural changes is delivering positive results. The European banking system is enhancing its resilience and all actors involved are contributing: regulators, banks, and supervisors. There is, however, no room for complacency. As I will discuss next, legacies from the crisis still linger and remaining vulnerabilities call for continued vigilance and unwavering determination on all sides.

Out of the woods? Not yet: some crisis legacies are still with us

The issue that epitomises the problems left on the table is low profitability. On the aggregate, the return on equity of euro area banks has not yet recovered since the financial and sovereign crises, and remains low by historical and international standards. There are, however, important heterogeneities: small and medium-sized banks are still suffering, while larger intermediaries are recovering. In 2017, net interest income improved for some intermediaries, while fee income, supported by the asset management business, increased more broadly.

Profitability is also well below estimates of the cost of equity for most banks. Despite the differences across banks and jurisdictions – in Spain, for example, the gap is relatively smaller than elsewhere – the problem extends across Europe. The causes of the phenomenon can be traced back to both transitory factors – such as the legacy assets from the adverse cyclical developments – and structural elements, including the need to adjust the business model to technological change and to the new regulatory environment.

The ongoing recovery of the global and the euro area economies contributes to addressing the transitory impediments. However, analyses and simulations from various sources seem to suggest that for a non-negligible part of the European banking sector this may not suffice to recover adequate levels of profitability.

Going forward, the target for banks' profitability may actually prove to be lower than the one deemed appropriate by some international institutions, such as the IMF. Indeed, once the transition to the new regulatory regime is completed, and a safer banking system has emerged from the reforms, investors might reduce the returns that they expect to receive from banks. In other words, in future months the "reform dividend" may translate into a lower cost of equity. Indeed, estimates of the cost of capital for European banks show that it has declined significantly since the beginning of the year, although it remains higher than the average in countries, like Italy and Spain, that have been hit particularly hard by the financial crisis. This is a key issue that deserves further analysis and that we have to keep monitoring closely.

A contribution to closing the gap must also come from banks' efforts to increase profitability in a structural way. This is something that concerns most banks, those facing difficulties as well as those that currently show healthy conditions. Against this backdrop, while there is no single winning business model, the experience of the most profitable banks provides useful guidance for both costs and revenues. On the revenue side, a greater diversification of the sources of income in favour of high quality financial services can help compensate for the prolonged compression of interest margins. A progress in this direction is already visible, but international comparisons suggest that there is ample room for improvement.

The expansion of non-bank financing and technology-based intermediation, despite increasing competition, also offers banks opportunities for broadening their revenues by focusing on the provision of related and complementary services, for example in the areas of corporate finance and asset management. Benefits for income generation can also come from mergers and acquisitions geared towards exploiting economies of scope and scale, and facilitating investment and access to capital markets. Those of a cross-border nature can also foster financial integration.

On the cost side, there is a broad consensus that operational efficiency needs to be improved resolutely. Since the beginning of the crisis, the banks' cost-to-income ratio has deteriorated in the majority of countries. In many cases this has reflected the reduction in revenues per unit of assets, while the cost-to-asset ratio has often improved. In Spain there has been a major effort in streamlining branch networks; the number of branches has dropped by almost 40 per cent since 2008. In Italy the figure is less impressive, 15 per cent, but progress has been made nonetheless.

As in other countries, there is room for further streamlining – not only as regards branch networks but also operational costs, including, where appropriate, labour costs and managers' remunerations. Cost savings coming from further rationalisation can be used to redirect spending towards investment in technology and innovation, which can go a long way to enhancing productivity.

Needless to say, further progress in the clean-up of balance sheets is also necessary to increase profitability. Encouraging signals are emerging: as the economic recovery consolidates, credit quality is improving. In Italy, which is one of the countries where the problem of non-performing loans (NPL) is most acute, the flow of new NPLs relative to total outstanding loans has fallen to the levels prevailing before the crisis. The stock of NPLs is also falling quite significantly, and disposals currently under way will lead to a further drop over the coming months. It is important that such disposals are implemented in an orderly fashion, in order to avoid fire sales and keep the market price of NPLs at levels consistent with their recovery rates. Indeed, sales at very low market prices, which reflect high returns required by the buyers, would put undue pressure on banks' balance sheets and, ultimately, lead to a contraction in the supply of credit to the real economy.

This clean-up of banks' balance sheets must continue, both in Italy and elsewhere. For this to happen, European banks must strengthen their strategies for NPL management. In this respect, the guidelines published last March by the SSM are an important point of reference and indicate several possible options, from the creation of separate and specialised management units, to the recourse to external managers, and to the sale of portfolios on the market. The stock of NPLs in banks' balance sheets depends crucially on the length of the recovery procedures which in turn depends on the protection granted to the creditors by the law in the event of insolvency of the debtors and on the time that courts take to enforce the law.

In Italy the stock of NPLs is high also because the outflows are small, due to the very lengthy judicial recovery procedures. Reforms recently introduced to significantly speed up the credit recovery process are already positively affecting the market price of NPLs; such effect will continue in the coming years. In Spain, as a legacy of the crisis, banks have taken large stocks of foreclosed assets onto their balance sheets. In other countries, other vulnerabilities, such as for instance the large concentration on banks' balance sheets of complex and illiquid activities – those classified as Level 2 and Level 3 assets, need to be closely monitored.

A public consultation has recently been launched on a draft addendum to the ECB guidelines considering the introduction of mechanisms that set compulsory minimum write-downs, increasing over time, on loans that will be classified as non-performing. It is important to recall that, in the current context, any policy action needs to strike a delicate balance between the goal of speeding up the resolution of the NPL problem and the goal of preserving financial stability.

In particular, supervisors should refrain from imposing measures that de facto imply blanket sales of NPLs on banks, which in the current circumstances would lead to a fall in the market price of NPLs and thus to a transfer of resources from the banks to a handful of specialised investors operating in an oligopolistic environment. This type of policy would erode banks' own funds at a time when raising capital can still be difficult, thereby putting the ongoing recovery at risk. While there is no question that, especially because of the positive effects of the recovery, banks should make clear progress in the management of NPLs, I would dare to evoke the great nineteenth century Italian writer Alessandro Manzoni, who in his masterpiece "I promessi sposi" had the Spanish Gran Canciller de Milán Antonio Ferrer say to his coachman during a famous riot in 1629: "Pedro, adelante con juicio".

Looking forward: expectations for a safer and sounder industry, and open questions

The financial crisis has spurred a global regulatory response influencing almost every aspect of the banking industry: lending, securities and derivatives trading, funding, bank supervision and resolvability. Such reforms have led to more demanding capital and liquidity requirements, less room for banks to exploit leverage, stronger constraints on their organisational structure to ensure resolvability. Further adjustments will come as single pieces of the reform package, such as the requirements regarding loss-absorbing liabilities (TLAC and MREL), are implemented. Moreover, the adoption of the new accounting standard IFRS9 in 2018 will change loan valuations: banks will have to make provisions for expected losses and no longer only in the event of a default. The new standard will force banks to improve the allocation and assessment of loans and to adopt new criteria to measure credit risk and calculate loan loss provisions.

A key priority now is to rapidly reach – after a too long negotiation period – an agreement on the finalisation of the Basel 3 reform package aimed at reducing the ample variability of risk-weighted assets as calculated by internal models. Following that, a period of regulatory stability – free from further rule-changing – would be opportune, not only to allow banks to fully adapt to the new system, but also to avoid the incessant production of rules becoming in itself a source of uncertainty, and thus a hindrance to banking activity.

Looking ahead, there is reason to be confident. Expectations are for a sounder and gradually more profitable European banking industry. This is also borne out by the market's assessment of the outlook for banks. The completion of the regulatory reforms will dispel the uncertainty that is still preventing the market from fully perceiving the benefits of the reduction of excessive risks in banks' balance sheets. But we know that the stakes are high. For those banks that will not be able to withstand the increased pressure, it is important to prepare measures in advance that will make it possible for them to exit the market in an orderly fashion.

Should new crisis situations emerge, preserving financial stability will hinge critically upon the availability of an effective crisis management framework, one characterised by prompt and decisive action, close cooperation among all the parties involved, and a clear definition of responsibilities and priorities. This is how in the past even severe strains were overcome without damage to savers or the overall economy.

The experience gathered thus far within the new European framework for bank recovery and resolution can teach us important lessons on whether the new set-up also meets such criteria. In particular, besides the resolution of Banco Popular in Spain, earlier this summer three crisis situations were tackled in Italy, leading to the precautionary recapitalisation of Banca Monte dei Paschi di Siena, and to the orderly liquidations of Veneto Banca and Banca Popolare di Vicenza.

All these decisions complied fully, albeit in different ways, with European legislation and procedures. To the extent permitted by these rules, efforts were made to find the solution that best protected the interests of all parties involved; the recourse to public funds represented only a small fraction compared to the taxpayer money employed just a few years ago by other countries in overhauling their own banking systems. The measures adopted have been successful in eliminating the tail risks weighing on both individual banks and the sector as a whole. In fact, over the last six months, stock prices of major Italian banks rose by 25 per cent, against the 11 per cent on average for major European banks.

However, these initial experiences have also highlighted some inadequacies and pitfalls in the new resolution framework. In the Italian cases, the final decisions were adopted only following a lengthy and complex process due to the fact that in some instances (e.g. the precautionary recapitalization foreseen by the BRRD) the new framework entrusts the management of banking crises to numerous mutually independent authorities and institutions, both national and supranational. Such a framework is hardly compatible with rapid intervention and lacks an effective coordination mechanism for setting priorities and establishing guidelines on the margins of discretion afforded by the law. Moreover, no specific procedures are in place to account for the decisions taken.

A further lesson that can be drawn from the recent cases is that it is important to preserve margins of flexibility in the framework, as even relatively small banks' failures, if not properly managed, may have extensive and, at times, systemic consequences. Even the resolution of a middle-sized bank could have been problematic, had the overall economic and financial conditions made it difficult to identify possible buyers and the bail-in of senior bond and relatively large deposit holders become inevitable.

Overall, these experiences can be taken to support the view – which I have voiced in several occasions in the past – that the new resolution framework does not fully take into consideration the risks associated with its own implementation and thus needs further fine tuning. The new rules were rightly designed with the goal of contrasting opportunistic behaviour by banks, but their application must also take into account the broader objective of safeguarding financial stability. I believe that the transitional period foreseen in the implementation of the new framework has been too short for all parties involved to adequately adjust to the new regime. This has been especially important in light of the fact that some of the crucial elements for the overall balance of the framework – such as the availability of adequate loss absorbing liabilities in banks' balance sheets, just to mention one among several others – were not yet in place.

Furthermore, in my opinion the interpretation of the new rules on the management of banking crises and on state aid in some cases has been overly restrictive, denying recourse to some tools used in the past to effectively manage crisis situations without causing undue disruption. For example, recourse to the preventive intervention by domestic deposit protection funds is now treated as equivalent to state aid, and thus not permitted, even though these funds are entirely private and their utilisation is guided by entrepreneurial considerations, and not by the authorities' decisions. In addition, the use of public funds to address banking problems, even in specific circumstances where it may be economically and financially advantageous, is now subject to very stringent limits even after shareholders and subordinated creditors have been bailed-in and the old management completely replaced.

The interpretation of state aid rules as put forward in the EU legislation in 2013 has severely limited the possibility to establish a publicly supported asset management company (AMC) to deal with banks' NPLs. I strongly believe that protecting taxpayers' money must be a priority in managing banking crises. But I also think that the seriousness of macroeconomic shocks, the negative externalities that come from the dismal performance of the real economy, the market failures that result from the lack of a robust secondary market for NPLs are important conditions that may justify the recourse to public funds. This recourse might have been excessive in Europe in the years following the global financial crisis, but the reaction to such an excess may have also been somewhat extreme.

It is important to carefully evaluate the costs directly and immediately borne by the State in each single intervention. However, those that may arise from a mismanagement of the crisis should also be carefully considered. To some extent this consideration may explain why the AMC hypothesis has recently returned to the spotlight. Under some proposals, an AMC should be established at the national level but in accordance with a common European framework. This implies that the conditions under which it would comply with the EU regulatory set-up, including the BRRD and the rules on state aid, should be properly spelled out.

In order to address the NPL problem successfully, such a company would need to attract a relatively large number of banks. Banks' participation in the scheme should be voluntary, and subject to standard restructuring plans defined ex ante. Most importantly, NPL transfer prices should be determined so to make the AMC profitable, but without making them excessively detached from their real economic values (i.e., the values that could be reasonably recovered over time).

All this leads me to suggest that the opportunity to improve upon the new regime of bank crisis resolution should not be missed. This can be accomplished through the review of the BRRD scheduled for 2018, as well as via the ongoing negotiations on issues related to the implementation of the MREL requirement and the completion of the Banking Union. In particular, the framework should envisage adequate tools to address banking crises of a systemic nature. Ways to limit contagion externalities should be considered, possibly allowing for the recourse to state aid in situations of serious market turbulence, and devising mechanisms to properly address liquidity crises.

Some shortfalls can be addressed along the road towards the completion of the Banking Union. Indeed, the Banking Union is still missing two very important pieces: the availability of common public funds to support resolution procedures in the case of ailing banks – the Single Resolution Fund's fiscal backstop – and a common bank deposit insurance scheme, again supported by a common public backstop. These are key ingredients for the overall balance of the new system: in their absence, it would not be easy to counter the views of those who claim that the fiscal backstop should remain a national prerogative and that, therefore, the national authorities should have the final say in all interventions aimed at minimising the overall costs of the distress. Furthermore, we should also reflect on how to deal with possible crises of banks for which the existence of public interest, necessary for the initiation of a resolution procedure, is denied. This is the case for the smaller banks, but it may also apply, as it has been recently the case, to banks considered significant within the SSM. Indeed, it would be difficult to object to the observation that the current framework calls on these banks to pay into a crisis management system from which they cannot benefit.

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To conclude, progress on all these fronts – and, more generally, toward a deeper European integration – can be achieved only if we overcome the mutual distrust and prejudice among member countries that have developed in recent years. In doing this, we should strive to give sound and fair application to the principles underpinning the new European rules, preserving the value of banking activity, to the benefit of savers and borrower households and firms.

Thank you for your attention.

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