Luis de Guindos: Euro area banking sector – current challenges

Keynote speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Annual General Meeting of the Foreign Bankers' Association, Amsterdam, 15 November 2018.

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Introduction

It is my pleasure to speak to you here in Amsterdam. Today, I will focus my remarks on the state of the euro area banking sector and its current challenges.

I will first look back and take stock of the developments since the financial crisis. Much has been done in the past ten years to enhance the resilience of the euro area banking sector. But as welcome as these developments have been, under many metrics euro area banks are still underperforming relative to their international peers. It is therefore reasonable to discuss the key challenges that the sector is currently facing.

As I will explain, some of these challenges still relate to the legacy of the crisis. Equally importantly, however, some are linked to the fragmentation of the euro area banking sector, which acts as a drag on its operational efficiency and profitability.

While it is up to the banks themselves to address many of the issues surrounding these challenges, I am convinced that policymakers also have an important role to play in reducing fragmentation in Europe. So I will finish with some remarks on the policy action needed to remove obstacles to the further integration of financial markets in Europe.

The euro area banking sector – developments since the financial crisis

Let me start with a brief recap on what has already been done to heal the fault lines that appeared at the outbreak of the global financial crisis. The financial health of euro area banks has improved markedly since the beginning of the crisis. The aggregate core capital (Common Equity Tier 1) ratio of euro area banks stood at around 14% at the end of the second quarter of 2018, the double of what is was in 2007. Regulatory liquidity ratios are at solid levels, with an aggregate liquidity coverage ratio of 141%. European banks are also making progress in fulfilling the minimum requirements for own funds and eligible liabilities (MREL).

One indicator of this is that the volume of Additional Tier 1 bonds and Tier 2 instruments issued by euro area banks and held by investors in the euro area increased by two-thirds between 2013 and 2017. Finally, banks are also making progress in repairing their balance sheets – the aggregate non-performing loan (NPL) ratio has nearly halved from its 2013 peak of around 8%, to its current level of 4.4%.

The recently published results of the 2018 stress tests reflect exactly this. On average, core capital of euro area banks after stress stood at 9.9%, up from 8.8% in the same exercise two years ago. Underlying the results is the strong build-up of capital buffers in recent years resulting in a better condition at the starting point of the exercise (end 2017).

I would however like to note that, while the adverse scenario was generally more adverse for European economies than in the 2016 exercise, it did not capture events which have become prominent through the course of the year, notably developments in emerging markets and sovereign spreads. Taking these into account would add on to overall capital depletion.

While euro area banks are clearly better capitalised and more resilient, this exercise should not hide the fact that areas of vulnerability remain. In particular, banks are still struggling to achieve sustainable profitability. Admittedly, headline profitability figures show that the sector seems to be

improving rapidly – the average return on equity for euro area banks increased from 3.4% in 2016 to 6.9% in the second quarter of 2018. However, more careful analysis reveals that this improvement is mainly due to a reduction in the cost of credit risk. This results, in part, from a cyclical upswing that has stemmed the flow of new NPLs and led to provisioning costs falling to post-crisis lows. At the same time, operating profits have remained modest overall and the average cost-to-income ratio flat at 66% over the same period, reflecting some cyclical and structural challenges.

Through the lens of the stock market, the outlook for bank profitability remains clouded, confirming that these challenges are material. Euro area banks' average price-to-book ratios of 0.8, are still about half of those of their US peers, which stand around 1.6. But these price-to-book ratios vary widely between countries and between individual banks in the euro area. This variation is bound to arise from cyclical factors, but it also stems from differences in the progress made by banks in tackling structural issues.

Challenges to bank profitability

Let us take a closer look at these cyclical and structural challenges to bank profitability.

On the cyclical front, banks are finding it hard to increase their revenue in the low interest rate environment. Although credit growth has increased somewhat with the improving economic conditions, it is not yet sufficient to compensate for the low interest rate margins. The continued economic recovery should, however, reduce the negative impact of cyclical factors over time, as banks' balance sheets adjust.

But most importantly, a number of structural challenges continue to dampen bank profitability. These factors vary across countries and banks and include incomplete business model adjustments, cost inefficiencies and excess capacity. The stock of NPLs also remains high at some banks. Let me elaborate on each of these issues in turn.

Starting with the issue of business model adjustment, our analysis shows that, in the past, diversified banks have been more successful in generating higher revenues from net fees and commissions and trading when faced with pressure on interest income. This is perhaps no surprise, as banks engaging in custodian, asset management or investment banking activities are likely to be better able to gear themselves towards fee-generating activities, whereas commercial banks may not have access to such opportunities for diversification.[1]

At the same time, one has to acknowledge that it is not only the low yield environment and lack of income diversification that is challenging banks' business models. The rapid pace of technological advances and the ensuing change in the competitive landscape are both a key strategic opportunity and a challenge for banks. For example, a shift from branch networks towards digital banking has enabled many banks, notably in the Nordic countries, to reduce costs while maintaining sound customer bases and market shares. But clearly, a successful transformation is likely to hinge on the support of beneficial structural factors such as labour laws, how the market is structured and the digital readiness of the economy. Policy action may thus have a role in supporting these conditions. Incumbent banks also need to be prepared for the increasing competition from the non-bank financial sector and "Fintech", fuelled by the increasing role of technology in financial services. Increased competition in lending, investments and payments is bound to increase pressure on retail banking revenues. It will subject deposits to more intense price competition, and may erode revenues related to overdrafts and payments.

Adjustments to business models are closely linked to the second challenge: the need to improve cost efficiency. I already mentioned that digitalisation can enable substantial cost savings. However, on aggregate, euro area banks have so far been unable to meaningfully reduce operating costs in the aftermath of the financial crisis. In fact, euro area significant institutions' operating expenses have increased by over 5%, on aggregate, since 2010, despite a 3% decline

in total assets over the period and the extensive restructuring efforts that have taken place in many banks.

Third, regarding the legacy of NPLs we first need to acknowledge that significant progress has been made. On average, NPL stocks are being reduced fairly quickly, particularly in countries with the highest levels of NPLs.

Still, the burden remains heavy for a number of banks. Reduction plans for these banks look ambitious for the coming years, but it is how they are implemented that will make the difference. At the same time, the ongoing policy initiatives designed to address this issue and prevent a similar build-up in the future are essential.

If these structural challenges are only resolved slowly, the outlook for the euro area banking sector will hinge on cyclical developments and their impact on banks' operational environment. It is thus interesting to look at the broader financial stability challenges for banks over the next couple of years. Despite some positive recent trends, the risk environment has become more challenging for the euro area financial system in many ways.

On the positive side, the growing economy and the ever more resilient banking sector are supporting financial stability. This is partly why the financial system has recently proved resilient to volatility, and why contagion across countries and markets has remained limited.

But these developments need to be put into the context of the continuing search for yield in the markets, rising trade protectionism, and political and policy uncertainty, which increase risks to financial stability.

Taking these factors together, the euro area financial sector is faced with risks, which can be classified in three categories.

First, the factors that are related to the past, in other words, the legacy of the crisis, include a still-significant private and public debt overhang. And as I just said, the banking sector is still dealing with the challenges posed by the quality of its legacy assets.

Second, the current expansion of the US is now significantly longer than historical norms and the second longest in US modern history. Looking ahead, a down-turn in the US macro-financial cycle could trigger a correction in markets in particular for riskier asset classes. Furthermore, tensions have grown in emerging market economies on the back of a stronger US dollar and increased trade frictions. These developments may undermine global growth prospects and ultimately lead to abrupt increases in risk premia. So far, however, we continue to observe high risk-taking by market participants searching for yield in the low interest rate environment, a symptom of which is increasing asset prices.

Third, in Europe, debt sustainability concerns have risen both in the public and private sector. As regards public finances, Italy is the most prominent case at the moment in light of the overall debt level and the political tensions around the Italian government's budget plans. Contagion to other European sovereigns has however been limited.

Against this background, the risk of an abrupt rebound in risk premia remains high, and could be further exacerbated by low market liquidity if market-making capacity evaporates. Developments in the non-bank financial sector also require monitoring, as the sector continues to become larger, more interconnected and more exposed to risks.[2]

Having said this, I would still like to stress that we currently see no indication of *excessive* credit growth or *broad-based* asset price misalignments, in other words the types of developments that have preceded previous financial crises. However, increasing asset prices in some sectors, such as residential and commercial real estate in some euro area countries, do warrant close

monitoring, also following up on warnings issued by the European Systemic Risk Board (ESRB) and an ECB statement on this topic.[3]

In sum, there is no reason to be complacent about financial stability risks in the banking sector, which could materialise in a number of ways. At the current opportune moment with 22 consecutive quarters of economic growth behind us, minds should be concentrated on tackling structural impediments to sustained profitability in the euro area banking sector.

Financial integration in the euro area banking sector

Let me now turn to financial integration. The economic benefits of an increase in cross-border banking activities are unquestionable. These include higher diversification of risks, which can improve resilience and lead to better risk-sharing across countries. To date, cross-border activity in the banking sector remains fairly limited in the euro area.[4] Banking sector integration also matters for the good functioning of the monetary union, as it fosters the smooth transmission of monetary policy throughout the euro area economy.

Despite these benefits, progress in banking market integration in Europe has been slow, particularly in retail banking. For example, in 2017 cross-border loans amounted to only 8.6% of total loans to firms and a negligible 0.9% of loans to households.[5]

It is true that cultural, legal and language barriers may make it difficult to directly provide cross-border banking services. Increased consolidation across countries may be the more realistic way to make the single banking market more integrated. Banking union will also help address the financial stability concerns surrounding resolvability, moral hazard and cross-border contagion that are related to large cross-border banks.

But so far, banking union has not induced a wave of cross-border mergers. In fact, M&A activity in the euro area banking sector, and especially across borders, has been declining since 2000, especially in the aftermath of the crisis.[6] The overall value of M&A transactions declined from an average of €51 billion in 2000-06 to less than €5 billion in 2017. Of this amount, cross-border euro area transactions accounted for 17% in 2017 compared with 21% in 2000-06.[7]

Given the economic benefits of further consolidation in the euro area banking market, we should pause for a moment to consider what is stopping us from reaping these benefits. There are certain structural challenges that still need tackling. For example, some banks' high levels of NPLs may reduce their attractiveness as potential targets, and therefore also deter consolidation. This is another reason why resolving the NPL problem is of the utmost importance.

But financial integration may also be hampered by regulatory obstacles that hinder the free flow of capital and the liquidity of banking groups. These obstacles often relate to regulatory fragmentation and the ring-fencing of national markets. They could be addressed by further harmonisation, combined with appropriate prudential safeguards to address possible financial stability concerns. Let me give you a few examples.[8]

First, on the free flow of capital. Unfortunately, in the ongoing review of the Capital Requirements Regulation, Member States have not agreed to introduce cross-border capital waivers within the European Union. This is a missed opportunity, as such waivers would be consistent with the establishment of the Single Supervisory Mechanism and the banking union. The potential financial stability concerns raised by their proposed introduction could have been addressed by making the waivers subject to additional prudential safeguards and transition arrangements that would accommodate the planned future development of the banking union.

Second, on the free flow of liquidity. In theory, the existing legal framework already allows for cross-border liquidity waivers within the EU. Unfortunately, the remaining national options and

discretions in the EU regulatory framework hamper the practical application of such waivers. For example, the national large exposure limits on intragroup exposures that are currently in place in several European countries prevent banks from transferring liquidity flexibly within the group. We need further harmonisation to address such practical obstacles, also given that the regulation already contains appropriate prudential safeguards for applying liquidity waivers.

Third, banking union as a single jurisdiction. In coherence with the current common supervision and resolution mechanisms, the international regulatory framework should treat the banking union as a single geographical area for the purpose of calculating capital surcharges of global systemically important banks.

Banking union and the benefits of more integration

The banking union is key to reaping the benefits of cross-border banking activities in the monetary union. But while we have made significant progress, the banking union is not yet complete.

We still need a backstop for the Single Resolution Fund (SRF) to underpin its credibility, and a common fully mutualised European deposit insurance scheme – EDIS. While discussions are progressing on the SRF backstop, the negotiations on EDIS have stalled.

That is unfortunate, as both elements would improve financial stability in the euro area by increasing confidence and reducing the likelihood and cost of a bank failure. With EDIS, this would mainly happen via three channels. First, depositors would trust that their deposits are safe, regardless of the location of the bank in question. This would help break the link between banks and sovereigns. Second, pooling resources at the banking union level would enhance the banking sector's resilience to shocks. Some argue that this would lead to unwarranted systematic transfers between banking sectors. However, banks' contributions to the deposit insurance fund can be designed to reflect their relative riskiness, in terms of NPLs or sovereign exposures, for example.[9] Third, EDIS would remove the current misalignment whereby supervision and resolution have been elevated to the European level, while depositor protection remains a national task.

But it's not all about the banking union. We need to continue making progress with other important initiatives to work towards a more complete financial union. The capital markets union is another element that will foster cross-border financial integration. In the past, banks and capital markets were sometimes seen as competing with each other for limited investment opportunities.[10] Some even went further – seeing capital markets as a threat to traditional banking models. However, banks and capital markets can complement each other in financing the real economy. Seen in this way, the banking union and the capital markets union are not mutually exclusive projects; they are, in fact, mutually reinforcing and can bring the Single Market for financial services to the next level. This is particularly important in the light of the United Kingdom's departure from the EU and the importance of London as a centre for capital market services.

The synergies between the banking union and the capital markets union can be looked at from two angles. On the one hand, the banking union supports the capital markets union by increasing the resilience of banks, which in turn supports the development of capital markets. On the other hand, the synergies also run in the opposite direction, as the capital markets union supports the banking union. More integrated and jointly regulated capital markets would support cross-border activities and the resilience of banks.

Let me be more specific.

In an integrated capital market, banks would no longer need to develop local expertise for each national market. They could exploit economies of scale more easily by offering similar or even

the same products and services in several countries. By operating in a larger, more integrated market, they would likely increase their cross-border holdings of assets and be able to build larger and more diversified collateral pools for securitised products and covered bonds.

Cross-border assets would contribute to reducing the sovereign-bank nexus. And banks could also benefit from a larger investor base for funding.

Conclusion

Let me conclude. Although we can see that the resilience of the euro area banking sector has improved considerably since the financial crisis, the lingering structural challenges and the financial stability outlook mean there is no room for complacency. It is important to tackle the remaining structural issues that are preventing the financial union from reaching its full potential.

First, banks need to adjust their business models to further diversify their income and reduce cost inefficiencies. They should also prepare for the challenges of digitalisation and competition from technology companies. And it is of the utmost importance that the large stocks of NPLs that still remain in some banks are reduced.

And second, policymakers need to maintain the momentum towards completing the financial union. Undue regulatory obstacles to cross-border banking sector consolidation need to be removed. Banking union needs to be completed with a backstop for the SRF and a credible EDIS. Finally, we need to complete the capital markets union and take advantage of the synergies between the two unions.

The work that banks and policymakers need to do will not be easy. But we should not be daunted by the task ahead. We should take things one step at a time, making sure that we are always making progress.

Thank you.

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[1] See European Central Bank (2016), "Adapting bank business models: financial stability implications of greater reliance on fee and commission income", *Financial Stability Review*, November, pp. 147–157.

[2] See de Guindos, L. (2018), "Coming to the forefront: the rising role of the investment fund sector for financial stability in the euro area", Speech at Opening Conference, 21st Euro Finance Week, Frankfurt am Main, 12 November.

[3] See the Governing Council statement on Macroprudential Policies, December 2016, and the ESRB warnings, September 2016.

[4] See ECB (2018), *Financial integration in Europe*, May. For more information on the benefits of cross-border consolidation, see Hartmann, P. et al. (2017), "Cross-border bank consolidation in the euro area", *Financial Integration in Europe*, May, pp. 41–64.

[5] See ECB (2018), op. cit.

[6] See ECB (2017), *Report on financial structures*, October.

[7] See, for example, Chart 2.8 in ECB (2017), ibid., updated with ECB calculations based on Dealogic data.

[8] See also Draghi, M. (2018), "The Benefits of European Supervision", speech at the ACPR Conference on Financial Supervision, Paris, 18 September; and Praet, P. (2018), "Creating an enabling environment for pan-European banks in the Banking Union", remarks at the Eurofi Financial Forum 2018, Vienna, 5 September.

[9] See Carmassi, J., Dobkowitz, S., Evrard, J., Parisi, L., Silva, A. and Wedow, M. (2018), "Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?", *Occasional Paper Series*, No 208, ECB, April.

[10] See Allen, F. and Gale, D. (1997), “Financial Markets, Intermediaries, and Intertemporal Smoothing”, *Journal of Political Economy*, Vol. 105, No 3, pp. 523–46; and Boot, A. and Thakor, A. V. (2000), “Can Relationship Banking Survive Competition?”, *The Journal of Finance*, Vol. 55, No 2, pp. 679–713 .