# Luis de Guindos: Challenges for bank profitability

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the OMFIF City Lecture, London, 1 May 2019.

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## Introduction

Sustained economic expansion over the past six years and greater banking sector resilience have supported financial stability within the euro area.

But the recent softening of growth prospects heightens risks. The financial stability environment has become more challenging than it was a year ago. The risks that have been with us for some time now – a possible disorderly increase in risk premia, debt sustainability concerns, low bank profitability and imbalances in the non-bank financial sector – are still present. But they are no longer being mitigated by an improving macroeconomic outlook.

Indeed, the deteriorating macro outlook renders some of these risks more acute. In particular, it may reawaken concerns over debt sustainability and worsen the outlook for bank profitability. Debt sustainability concerns could drive up sovereign bond spreads. In turn higher spreads generate losses on bond portfolios and higher market-based funding costs for financial institutions.

Bank profitability tends to go hand-in-hand with economic activity. Slower growth prospects may dent bank profitability through a reduction in lending activity and a possible increase in credit impairments.

Moreover, the ongoing political uncertainties – including trade disputes – and the softer economic momentum may trigger volatility in asset prices. And if a sudden, disorderly increase in risk premia were to materialise, it could further elevate banks' funding costs.

Against this backdrop, I am going to focus my remarks today on bank profitability. Returning banks to sustainable rates of profitability is a key step towards ensuring that the sector remains resilient, particularly in the face of slowing economic momentum and the potential for market distress.

Euro area banks have certainly improved their profitability in recent years. Their return on equity reached 6% at the end of 2018, up from 3% two years earlier. But their profitability remains below their long-run cost of capital, which most banks estimate to be in the range of 8-10%.[1] Low profitability prospects translate into low bank valuations, as observed in price-to-book ratios well below one, hindering the ability to raise capital, where needed.

European bank profitability has been structurally weak since well before unconventional monetary policy measures were introduced. Broadly speaking, the sources of that weakness can be divided into **cyclical factors**, **cost inefficiencies** and **competitive challenges** arising from outside the sector. Before discussing these sources, let me begin by reminding you why bank profitability is important.

## Why bank profitability matters

Clearly, bank profitability matters for financial stability. Profits are the first line of defence against losses from credit impairment. Retained earnings are an important source of capital, enabling banks to build strong buffers to absorb additional losses. Those buffers ensure that banks are able to provide financial services to euro area households and businesses, even in the face of adverse developments, thereby smoothing rather than amplifying the impact of negative shocks

on the real economy.

Banks with poor structural profitability can face higher funding costs and may be tempted to take on more risk.[2] Within the euro area, weak banks are more likely than healthy banks to be connected to unprofitable firms.[3] This reduces the flow of lending to profitable firms that need funding to invest and grow. The resultant misallocation of capital[4] towards unproductive businesses weighs on long-run economic growth.[5]

Low bank profitability can also matter for monetary policy by impairing the accumulation of bank capital over time. Thinly capitalised banks stymie the ability of monetary policy to stimulate economic activity in downturns. Their capacity to lower the interest rates they charge their customers and increase the volume of lending to the real economy is constrained.[6] This limits the effectiveness of an important transmission channel of monetary accommodation in the euro area, which relies on bank lending supporting consumption and investment.

As the crisis showed, dislocations in the banking sector can deepen recessions and seriously impair the smooth transmission of monetary policy across the euro area. That risk remains today. We recently carried out what we call a macroprudential stress test, which assesses this amplification of shocks using a micro-macro model that feeds back individual bank reactions into macroeconomic outcomes. On the basis of the 2018 European-wide stress test data, we estimate that the banks' behavioural reaction to the adverse scenario exacerbates the fall in GDP by a further 1.6% with respect to the initial shock, which itself further depletes banks' capital.[7]

## Cyclical factors

Given that important link between bank behaviour and the cycle, let me turn to the cyclical factors affecting bank profitability in the euro area.

The economic expansion continued through 2018, although with a sizeable reduction in the pace of growth relative to the previous year. Since the trough, the number of people in employment has increased by over 10 million. While the data since the end of 2018 have been weak – notably in manufacturing and the external sector – the economic fundamentals remain in place to support continued expansion.

The economic expansion and employment growth have supported bank profitability. Loan growth has been robust in recent years, with higher volumes helping to mitigate margin compression.[8]

The stock of non-performing loans (NPLs) has been substantially reduced. Outstanding NPLs fell by €142 billion in 2018 and the aggregate ratio dropped to 3.8% of significant banks' loans at the end of 2018, from 7% at the end of 2015.

NPLs represent a double drag on bank profitability. First, NPLs have to be recognised and provisioned for, reducing current profitability. Indeed, the major driver of the increase in bank profitability over the past two years has been the smaller flow of new impairments. But even when fully provisioned, NPLs hamper profitability by tying up scarce capital without providing returns, absorbing operational capacity and incurring legal and administrative costs.

While NPL ratios have improved over the course of the expansion, overall revenue growth remains subdued across the banking sector. Aggregate net interest income as a share of equity fell marginally between 2015 and 2018, although it is still higher than in countries such as the United Kingdom that have not had negative policy rates.

Yet a number of euro area banks have successfully delivered robust earnings in recent years. A recent study by the ECB highlighted the differences between this group and the remainder of significant euro area banks.[9] The median of these best performers managed to lift its return on

equity by 3.6 percentage points in 2014–17 relative to 2009–13. By contrast, the median profitability for other significant banks was essentially unchanged.

Between those periods, the best performers managed to keep net interest income growing roughly in line with costs, whereas the other banks generally witnessed cost growth outpacing growth in net interest income. Moreover, the best performers managed to increase net fee and commission income by more than half between 2009 and 2017, relative to the less than 10% growth managed by the remainder.

Developing sustainable revenue streams beyond net interest income – such as fee and commission income – remains vital in order to buttress profitability in the coming years. The low interest rate environment is with us for the foreseeable future and is caused in large part by durable structural factors.[10] The interest rate below which monetary policy is accommodative has fallen in the euro area, as is the case in much of the developed world.[11] Even once monetary policy normalises, interest rates are likely to remain below levels that were common in previous decades.

## Cost inefficiencies

The second source of low profitability for euro area banks is enduring cost inefficiencies. Cost-to-income ratios remain high in the euro area relative to international peers. The euro area has too many banks, too many branches and too many bankers. The aggregate cost-to-income ratio of euro area banks reached 66% in 2018, up from 62% in 2010, as the dip in revenues was not offset by cost containment. While similar to that of peers in Japan and the United Kingdom, it is above the ratio typical for US banks, and substantially above the ratio of roughly 50% for Nordic banks.

Reducing costs requires grasping the opportunities offered by technology. Banks have been able to make greater reductions in the density of the branch network in countries where the take-up of online banking is higher. The number of branches in the Netherlands and the Baltic states has halved since 2008, but progress in other countries has been much more limited. Technology can also help enhance operational efficiency by improving processes for loan origination and servicing and enable workloads to be shared better across employees in multiple locations.

That requires substantial investment in information technology (IT). The best performing euro area banks I mentioned earlier increased their IT spending by around 60% between 2009 and 2017, whereas the remaining banks increased theirs by just 10%. Such investment is expensive, but has proven worthwhile. The cost-to-income ratio for the median of the best performers fell by 5.5 percentage points, whereas that for the median of the other banks increased by 3.1 percentage points.[12]

The other source of higher costs for euro area banks is the adjustment to a suite of post-crisis regulation. This includes holding greater amounts of high-quality capital and debt instruments that can be “bailed in” should resolution become necessary. It is also more difficult now to increase measured profitability by increasing leverage. And whilst international requirements on loss absorption only apply to the most systemic banks – so-called G-SIBs – and the Basel standards typically apply to internationally active banks, in the euro area such requirements are applied to all banks. Of course, such regulations have been put in place in recognition of the significant public costs borne throughout the banking crisis. And regulation cannot be seen as the main driver of costs – Nordic banks operate under the same regulatory framework and have been able to attain a high rate of profitability.

But one key element in regulation worth noting is the lack of waivers for liquidity and capital in the euro area. As a result, euro area cross-border banking groups potentially face higher costs than interstate banking groups in the United States.

This recourse to ring fencing takes a narrow national perspective. At present, national deposit insurance schemes will be drawn upon should depositors need to be compensated during bank resolution. Hence the desire of national authorities to ensure that each national subsidiary is sufficiently capitalised and has adequate liquidity. Completing banking union, including the introduction of a European deposit insurance scheme and the removal of the remaining national options and discretions, would help ensure that the costs of resolution are equitably shared. Meanwhile, it would enable banks to use liquidity and capital efficiently at the euro area level.

## Competition from outside the sector

The final challenge for bank profitability comes from increasing competition from outside the sector, in particular from financial technology companies (fintech) and non-bank financial companies.

Lightly regulated fintech companies have begun to encroach into the realm of payment and settlement systems. More than 60% of incumbents view fintechs as a threat to their income from these activities.[13] Given the greater desire by consumers for instant payments and the use of mobile payments, investment in IT is vital to secure future revenue streams.

Banks also face increasing competition in the provision of credit. Total assets of non-bank financial intermediaries doubled in the euro area between 2008 and 2017, whereas total banking sector assets remained broadly unchanged. The growth is particularly marked in the investment fund sector. Around 28% of euro area non-financial company debt issuances are held by euro area investment funds, compared with 18% pre-crisis.

The greater provision of market-based credit is welcome, and indeed the capital markets union agenda has been put in place with this aim in mind. But banks will need to carefully consider how to adjust their business models to accommodate this greater degree of competition. It certainly increases the urgency to improve efficiency in credit provision.

## Conclusion

Let me conclude.

The structurally low profitability of the euro area banking sector remains a concern for financial stability and for monetary policy.

Return on equity below the cost of capital is unsustainable in the long run. The causes of low profitability are for the most part structural and hence require structural solutions. Successful implementation of long-run profitable business plans is essential.

Consolidation remains necessary.

There are a number of benefits arising from cross-border consolidation. Cross-border holdings of deposits and loans can help bolster economic resilience within the euro area by helping to smooth shocks through income sharing. Such private sector risk-sharing channels play an important role in smoothing shocks in the United States, but currently smooth a much smaller share in the euro area.[14]

Moreover, it can provide benefits for the banks themselves. In general, more geographically diversified banks have displayed stronger revenue performance in recent years.[15]

But there are a number of national banking sectors that would also benefit from consolidation within national borders, allowing for greater cost synergies and rationalisation of branch networks. Such consolidation would permit small and medium-sized banks to attain sufficient scale to undertake the IT investment necessary to meet the challenges of the digital era.

While both national and cross-border consolidation options are potentially viable, the key consideration for financial stability is that the combined entity should be able to successfully execute the merger, resulting in a bank that can sustain profitability in the long run.

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1 See European Banking Authority (2018), *Risk Assessment Questionnaire – Summary of Results*, December. 70% of banks view their cost of equity in this range, with a further 15% of banks estimating that it lies in the range of 10–12%.

2 See, for example, Babihuga, R. and Spaltro, M. (2014), "Bank Funding Costs for International Banks," *IMF Working Papers* 14/71, International Monetary Fund; Keeley, M. (1990), "Deposit Insurance, Risk, and Market Power in Banking," *American Economic Review*, 80(5): 1183–1200.

3 See Andrews, D. and Petroulakis, F. (2019), "Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe," *Working Paper Series*, No. 2240, ECB, Frankfurt am Main.

4 See Gopinath, G., Kalemli-Ozcan, S., Karabarbounis, L. and Villegas-Sanchez, C. (2017), "Capital Allocationand Productivity in South Europe", *Quarterly Journal of Economics*, 132(4): 1915–1967.

5 See Adalet McGowan, M., Andrews D. and Millot, V. (2018), "The walking dead? Zombie firms and productivity performance in OECD countries," *Economic Policy*, 33(96): 685–736.

6 See Altavilla, C., Canova, F. and Ciccarelli, M. (2019), "Mending the Broken Link: Heterogeneous Bank Lending and Monetary Policy Pass-Through", *Journal of Monetary Economics* (forthcoming) and Kayshap, A. and Stein J. (1994), "Monetary Policy and Bank Lending", in Mankiw, G. (ed.) , *Monetary Policy, Studies in Business Cycles*, 29: 221–56, Chicago, University of Chicago Press; van den Heuvel, S. (2002), "Does bank capital matter for monetary transmission?", *Economic Policy Review*, Federal Reserve Bank of New York, May, 259–265.

7 See Budnik, K. (2019), "Abird's-eye view of the resilience of the European banking system: results from the new macroprudential stress test framework", *Macroprudential Bulletin*, 7 (March), European Central Bank.

8 See Altavilla C., Boucinha, M. and Peydró, J-L. (2018), "Monetary policy and bank profitability in a low interest rate environment," *Economic Policy*, 33(96): 531–586.

9 See Andersson, M., Kok, C., Mirza, H., Móré, C. and Mosthaf, J. (2018), "How can euro area banks reach sustainable profitability in the future?", Special Feature, *Financial Stability Review*, November, European Central Bank.

10 See Brand, C., Bielecki, M. and Penalver, A. (eds.) (2018), "The natural rate of interest: estimates, drivers, and challenges to monetary policy", *Occasional Paper Series*, No. 217, ECB, Frankfurt am Main, December.

11 See, for example, Holston, K., Laubach, T. and Williams, J. (2017), "Measuring the Natural Rate of Interest: International Trends and Determinants", *Journal of International Economics*, 108 (Supplement 1, May): S59–75.

12 Andersson et al. (2018), op. cit.

13 European Banking Authority (2018), *EBA report on the impact of FinTech on incumbent credit institutions' business models,* EBA, London.

14 See Nikolov, P. (2016), "Cross-border risk sharing after asymmetric shocks: evidence from the euro area and the United States", *Quarterly Report on the Euro Area*, 15(2): 7-18, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission, Brussels.

15 Andersson et al. (2018), op. cit.