Luis de Guindos: The euro area financial sector - opportunities and challenges

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the XXV Santander Iberian Conference, Madrid, 6 February 2020.

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It is a pleasure to be here today and share my thoughts – and some policy considerations – on the opportunities and challenges facing euro area financial institutions in the current environment.

Opportunities and challenges for euro area banks

The profitability of euro area banks has been lacklustre for several years. Their weak profitability can not only be attributed to the weak macro-financial environment but, more importantly, to structural factors. Significant banks' return on equity was less than 6% in the 12 months to September 2019, falling short of their cost of capital, which is estimated at around 8% to 10% for the majority of banks.[1] Euro area banks' market valuations remain depressed, with an average price-to-book ratio of around 0.6, mirroring concerns about weak current and expected profitability.

From a financial stability perspective, persistently low profitability is a concern as it hampers banks' ability to generate capital organically and to raise capital from market sources. This makes it harder for them to build up buffers against unexpected shocks. Let me also stress, however, that there are significant differences among individual banks. Some banks – across different jurisdictions and business models – have managed to consistently outperform their peers and to be profitable in recent years.

As mentioned, weak bank profitability reflects both cyclical and structural factors. By contrast with the period from 2014 to 2018, when cyclical factors helped improve profitability, the macro-financial environment since then has clearly been more challenging for euro area banks. Given the weaker growth momentum and the associated low interest rate environment, banks are unable to rely on cyclical factors to boost their profitability to the same extent as in previous years.

With respect to monetary policy, and the policy of negative interest rates in particular, market analysts are concerned that its negative impact on net interest margins could result in a drag on bank profitability. Such side effects of monetary policy, which are becoming more tangible, are being monitored carefully.

At the same time, monetary policy has been behind the good performance and recovery of the euro area economy. Without this support, bank lending volumes would have been significantly lower and provisioning costs substantially higher. These factors, together with the increase in asset values, have broadly offset the negative impact of low rates on net interest margins. Against the backdrop of continued loan growth, net interest income increased by about 4% in the first three quarters of 2019, compared with the same period in the previous year. But margins slightly tightened in 2019 as a whole and are expected to remain under pressure. In addition, increasing provisioning needs and persistently high costs will continue to weigh on banks' return on equity.

Structural factors are at the heart of weak bank profitability, however. Euro area banks face challenges linked to the sector's overcapacity, with two important implications for profitability. First, banks are not fully benefiting from economies of scale and are relying on overlapping physical distribution networks, leading to persistent cost inefficiencies. Indeed, euro area banks' cost-to-income ratio – at 66% in the 12 months to September 2019 – is high when compared with their global peers. Second, many banks have low market shares and face high competitive pressures which, in turn, have an impact on their pricing behaviour.

On the positive side, banks have greatly improved the quality of their balance sheets and their resilience over the past few years. There has been a steady improvement in their asset quality: the ratio of non-performing loans more than halved over four years, reaching 3.4% in the third quarter of 2019. Banks now hold significantly more and higher-quality regulatory capital than before the crisis, largely reflecting the impact of the new regulatory framework. Significant banks' aggregate Common Equity Tier 1 ratio, a key measure of capital strength, stood at 14.4% in the third quarter of 2019, up from 12.7% in mid-2015. Regulatory liquidity ratios are also at solid levels, with an aggregate liquidity coverage ratio of 145%. Furthermore, banks also made progress in building loss-absorbency capacity by issuing more debt instruments that can be bailed in. Some market analysts think this has been facilitated by reduced risk aversion among fixed income investors who, unlike equity investors, are less concerned about the overall bank profitability outlook.

But although banks have improved their capital positions in recent years, they hold only a small fraction of their capital requirements in the form of the countercyclical capital buffer, which authorities can release in the event of systemic stress to help avoid costly economic deleveraging. This suggests that the current composition of capital requirements may need to be rebalanced to give the countercyclical capital buffer a more prominent role, without affecting the overall level of capital requirements.

Resilience is a key reason why bank profitability matters for financial stability. Bank profits serve as a first line of defence against losses and are the main source of bank capital growth. But how can euro area banks return to sustainable profitability? I see room for banks to further diversify income sources and improve cost inefficiency. This would include investing in digital technologies, even if this would initially push up their costs. The prudential treatment of software assets in the capital framework should be consistent with fostering digital investment, and an alignment on both sides of the Atlantic would be welcome to ensure a level playing field.

In the light of the overcapacity in the banking system, efficiency gains can also be reaped through both domestic and cross-border mergers and acquisitions (M&A). In practice, incipient M&A activity has mainly taken the form of domestic mergers as cross-border consolidation poses more challenges. Policymakers should remove obstacles to cross-border M&A and to pursue the completion of the banking union.

Opportunities and challenges for euro area non-bank financial institutions

Turning to the non-bank financial sector, its rapid growth since the global financial crisis is impressive: total assets doubled from €24 to €48 trillion between September 2009 and September 2019.

Euro area non-banks have also increased their share of credit to the real economy, especially through sizeable investments in bonds issued by euro area non-financial corporations. Euro area investment funds, insurers and pension funds jointly hold half of these bonds, whereas euro area banks hold less than 10%.

From a financial stability point of view, the greater role played by non-banks can be perceived as clearly positive as it helps diversify the sources of financing provided to the real economy. Moreover, life insurers and pension funds typically provide one of the most stable sources of long-term financing. They are well-placed to invest in infrastructure which can help in reducing asset-liability duration mismatches, for example.

But, similar to banks, non-banks also face several challenges in the current environment, with profitability being one of the major concerns, especially for life insurers and pension funds. As bond yields have fallen, they are holding a growing share of low-yielding bonds, which decreases their investment income in the medium term.

Many non-banks tend to compensate by searching for yield in riskier, more illiquid and higher duration assets. This can be a welcome and intended outcome of monetary policy accommodation as it may help to ease financing conditions for non-financial corporations. But this trend also has a flip side, as it contributes to rising risks and vulnerabilities in non-banks' balance sheets, with potential negative repercussions for the stability of the whole financial system.

Liquidity risk is a particular source of concern, especially for funds that invest in illiquid assets but offer daily redemptions. We have recently witnessed cases in which funds holding considerable amounts of illiquid assets faced severe difficulties in dealing with large-scale outflows. Nevertheless, these cases had no systemic repercussions: because the outflows were triggered by idiosyncratic factors and, most importantly, because the financial market environment was benign. But this does not always need to be the case.

Another source of concern is the elevated exposure of non-banks to highly indebted segments of the corporate sector. Excessive risk-taking may adversely affect the ability of non-banks to absorb shocks, especially if economic conditions deteriorate. Downgrades of corporates to sub-investment grade ratings may force non-banks to sell assets to fulfil their investment mandates. This could amplify price movements in credit markets in times of low market liquidity. It could also generate spill-overs to the wider financial system and the real economy, as funding flows might recede and the cost of corporate financing might increase.

Developing a macroprudential framework for the non-bank financial sector should thus be treated as a priority. New policy instruments should ensure that non-banks can sustain their financing of the real economy under different economic conditions. They should aim to mitigate risks related to pro-cyclical risk taking, excessive leverage, liquidity and maturity transformation by increasing transparency on fund leverage and aligning redemption terms more closely with the liquidity of funds' assets, for example. By internalising the impact that non-banks' actions might have on the rest of the financial system and the real economy, such policy tools might curb non-banks' potential to amplify exuberance in upturns and adversely affect financial and economic conditions in downturns.

Conclusions

Let me conclude. At present, the weaker cyclical momentum and the low interest rate environment are weighing on bank profitability. These weak profitability prospects represent a significant vulnerability for the euro area banking system, which is operating with significant overcapacity. At the same time, monetary policy accommodation continues to support lending volumes and banks have made significant progress in repairing their balance sheets. Nevertheless, a rebalancing of the current composition of capital requirements towards a more prominent role for the countercyclical capital buffer, keeping the overall level of capital requirements unchanged, could help mitigate costly economic deleveraging during downturns.

Non-bank financial intermediaries in the euro area have grown rapidly over recent years, which is a welcome development. But they are also facing profitability headwinds and are therefore, searching for yield in riskier assets. Their increasing importance in financing the real economy and elevated vulnerabilities highlight the need for the development of a macroprudential framework for this sector.

Finally, let me mention a new dimension of risk that affects both banks and non-banks: the risks related to climate change, which have the potential to become systemic.[2] The ECB monitors the physical and transition risks faced by financial institutions. [3] But improved disclosure is essential to pursue this effort in earnest. Disclosure by firms and financial institutions tends to be incomplete and not always consistent. Mandatory and harmonised firm-level reporting of carbon emissions would be a step in the right direction as it would enable better pricing and monitoring of financial firms' exposures to climate-related risks.

On the analytical front, the ECB is contributing to the development of a framework for climate risk assessment and developing methods to gauge financial institutions' exposures to climate-related risks. The framework aims at integrating climate-related risks into regular financial stability monitoring and assessment, including climate risks stress-test analysis. We trust that banks and non-banks are also doing their part to bridge data gaps and are preparing to address risks in the transition to a low-carbon economy.

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1 European Banking Authority, (2019), Risk Assessment questionnaire – Autumn.

2 See De Guindos, L. (2019), "Implications of the transition to a low-carbon economy for the euro area financial system", speech at the European Savings and Retail Banking Group Conference, Brussels, 21 November.

3 See Giuzio M. et al. (2019), "Climate change and financial stability", Financial Stability Review, ECB, May.