# Luis de Guindos: Building the financial system of the 21st century

Speech (via videoconference) by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 18th annual symposium on "Building the Financial System of the 21st Century: an Agenda for Europe and the United States", organised by the Program on International Financial Systems and Harvard Law School, Frankfurt am Main, 22 July 2020.

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In my remarks today, I will highlight the impact that the coronavirus (COVID-19) shock has had on the banking sector and market-based sources of finance. In both the euro area and the United States, the pandemic and the related lockdown measures have led to stark economic contractions. These contractions have been shaped by key structural differences between the two financial sectors, requiring differentiated policy responses. Irrespective of these differences, a powerful trio of monetary, prudential and fiscal policy responses on both sides of the Atlantic provided critical support that prevented the financial system from immediately seizing up, which would have had severe consequences for financial stability in the near term. Looking ahead, the pandemic shock may accelerate ongoing transformations in the financial sector landscape. Moreover, the shock is highlighting the importance of macroprudential policy in both the bank and non-bank financial sectors to safeguard a stable financial system.

## The financial sector in the wake of the pandemic crisis and the policy response

Differences between the financial systems on each side of the Atlantic are well documented. The financial system in the euro area is predominantly bank-based compared with the more market-based system in the United States. In fact, more than half of funding to non-financial firms in the euro area is channelled through banks. By contrast, bank financing accounted for only 25% of firms' total financing in the United States in 2016, although this share has increased slightly in recent years.[1]

At the same time, the euro area financial sector has increasingly begun to resemble its US counterpart over the past decade. The non-bank financial sector has seen exceptional growth: total assets of the sector doubled from €24 trillion in 2009 to €48 trillion in 2019.

In considering how these secular changes affect real economy financing, composition matters. Market-based financing is primarily accessed by large enterprises, while for small and medium-sized enterprises – which are the backbone of the euro area economy – bank credit remains the main source of financing.

Thanks to the Basel III regulatory framework, banks entered this crisis with stronger capital and liquidity positions than they had before the global financial crisis. Their improved resilience has been central in enabling banks to weather the initial strain of the pandemic shock and continue funding the real economy.

The same cannot be said for the non-bank financial sector or the investment fund sector in particular, which experienced a severe episode of liquidity stress and reportedly contributed to market dislocations and price volatility. Euro area financial markets saw an unprecedented sell-off in late February and March 2020, with the EURO STOXX 50 index losing almost 40% of its value. During this period, investment funds experienced exceptionally large outflows, similar in magnitude to those seen during the global financial crisis. The combination of high redemptions and low liquidity buffers prompted funds to sell both risky and less risky assets. This amplified liquidity stress in an environment of rapidly increasing demand for cash and high market volatility. Liquidity fell sharply – not only for riskier assets, but also briefly in high-quality markets such as the US Treasury and money markets – as both financial and non-financial sectors sought cash. Increased market volatility, in turn, forced non-banks to post higher margins on their derivatives

positions, thereby adding to the demand for cash and exacerbating liquidity stress.

The economic consequences of these developments could have been far worse had it not been for the timely accommodative monetary and fiscal policies on both sides of the Atlantic. Announced fiscal relief measures – which represent up to 20% of GDP in the United States and in some euro area countries – are rightly acting as the first line of defence.

Actions taken by central banks were no less impressive and were essential to stabilise financial markets and improve liquidity conditions across a broad range of assets. The Federal Reserve System launched a range of measures addressing the main market segments and also benefited from some form of credit protection from the US Treasury. Liquidity stress was alleviated and margin calls declined, with renewed inflows being seen across all asset classes.

In the euro area, support provided by the ECB has reflected the importance of banks for corporate financing – we have expanded and eased existing measures to support our price stability objective. Our measures have provided a backstop against liquidity shortages, as well as incentives for banks to keep credit flowing to the real economy. Sizeable increases in asset purchases aimed to prevent a tightening of financing conditions which would have amplified the downturn. Measures providing liquidity to banks at very favourable terms were complemented by a collateral easing package and ensured the continued flow of credit.

These monetary policy initiatives were complemented by a range of actions by micro- and macroprudential authorities to sustain lending during the downturn. A number of relief measures were adopted to allow banks to temporarily operate below the level of supervisory capital defined by the Pillar 2 Guidance. Supervisory flexibility was introduced on the treatment of non-performing loans and banks were encouraged to avoid excessive procyclical effects when applying accounting standards. ECB Banking Supervision also asked banks to limit capital distribution by refraining from paying dividends or buying back shares. Furthermore, the ECB endorsed all macroprudential policy decisions proposed by national authorities in relation to reductions in the countercyclical capital buffer and other macroprudential buffers. We also encouraged banks to make full use of all releasable buffers.[2]

Timely monetary, prudential and fiscal policy supported near-term financial stability, but could not prevent the pandemic crisis from exacerbating medium-term risks to financial stability, to which I will turn next.

### Looking ahead: challenges for the euro area banking sector

The banking sector has proven to be resilient in the initial phase of the pandemic stress. But this is not to say that the sector will not face headwinds in the future. Market valuations were hit hard at the height of the crisis and analyst forecasts of bank profitability for 2020 have recently undergone large downward revisions amid concerns that banks will need to increase their provisions for future credit losses.

Such a sharp deterioration in profitability adds to the structural challenges already facing the euro area banking sector. As the ECB has repeatedly highlighted in its twice-yearly Financial Stability Review, low bank profitability is being driven by both low cost-efficiency and weak income-generation capacity. Overcapacity, legacy assets and a perhaps insufficiently diversified structure of revenues are some of the issues underlying these trends.[3]

Bank consolidation (exploiting economies of scale and scope), further bank management actions on resolving non-performing loans, and diversification of the revenue structure towards more fee and commission income (depending on the specific business model) could be some of the ways forward.

To enhance structural profitability over the long term, banks need to thoughtfully invest and

support digitalisation and the transition towards a low-carbon economy. The coronavirus pandemic could in fact represent an opportunity for the financial sector to adapt to this new environment more swiftly.

### Looking ahead: challenges for the non-bank financial sector

Turning to the non-bank financial sector, the early stages of the pandemic shock have shown how investment funds in particular can contribute to amplifying adverse market dynamics by increasing market volatility and price dislocations. A number of funds facing severe liquidity bottlenecks resorted to exceptional measures to cope with large outflows, such as applying swing pricing and redemption fees or even suspending redemptions.[4]

In my view, the increasing importance of the non-bank financial sector in the financing of the euro area economy calls for a stronger macroprudential framework for the sector. Such a framework is still in its infancy. To date, the prudential policy framework for investment funds has primarily relied on ex-post liquidity management tools under asset managers. These tools are, however, of limited use in preventing liquidity stress at the system level. I would therefore argue in favour of extending the current macroprudential toolkit by including ex ante liquidity management tools (such as minimum liquidity buffers and redemption notice periods). Closer monitoring of intermediaries' leverage and how it interacts with factors such as fund illiquidity is essential. Leverage may also amplify procyclicality in the investment fund sector as it is an important factor in investors' redemption decisions.[5]

We should thus reconsider existing leverage regulation on investment funds.

### Conclusion

Let me conclude. The coronavirus pandemic and the associated lockdown measures have caused an unparalleled shock to the global economy. Swift actions undertaken by monetary, fiscal and prudential authorities in the United States and in Europe have been crucial in stabilising investor sentiment and ensuring that the financial sector continues to support the recovery, thereby mitigating the economic costs of the pandemic.

Although not at the epicentre of the crisis, the financial system has been under strain during the coronavirus pandemic. Banks' market valuations were hit hard and a number of investment funds faced severe liquidity difficulties. The pandemic crisis has increased the pressure on the already low prospects for bank profitability in Europe, thereby underscoring the need for consolidation and structural change in the sector. Digitalisation and the transition to a low-carbon economy are particularly important elements of the ongoing structural transformation of the financial system.

The pandemic crisis has also drawn further attention to the role of the new macroprudential policy area in safeguarding the stability of the financial system.

Looking ahead, while the overall level of bank capital is broadly adequate, its composition may be limiting the full potential of releasable buffers as a macro-financial stabilisation tool. Reviving the debate about the appropriate balance between structural and cyclical releasable buffers is welcome, facilitating a reallocation of capital requirements towards releasable buffers in a capital-neutral manner.

Developments in credit intermediation outside the banking system, coupled with vulnerabilities highlighted by the pandemic crisis, have shone a light on the need to strengthen the macroprudential framework for non-banks. This is a truly global matter: action on one side of the Atlantic has tangible effects on the other. A holistic framework and effective coordination at the global level are therefore needed.

[1] See “Trends in the external financing structure of euro area non-financial corporations”, ECB Economic Bulletin, Issue 5, ECB, 2016.

[2] See “Macroeconomic impact of financial policy measures and synergies with other policy responses”, Financial Stability Review, ECB, May 2020.

[3] See “Euro area bank profitability: where can consolidation help?”, Financial Stability Review, ECB, November 2019.

[4] See Financial Stability Review, ECB, May 2020, sections 4.2 and 5.3.

[5] See “Is leverage driving procyclical investor flows? Assessing investor behaviour in UCITS bond funds”, Macroprudential Bulletin, ECB, October 2019.