

## **Steven Maijor: Strong like a castle? Challenges for banking in a post-Covid world**

Speech by Mr Steven Maijor, Executive Director of Supervision of the Netherlands Bank, at the Cumberland Lodge Financial Services Summit, Windsor, 4 November 2021.

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I must say: it's very brave of you to invite me to entertain you during dinner. As a Dutchman and supervisor, I will need to avoid the impression of speaking from a pulpit, but rather give a speech in the same spirit as today's open discussions.

The beautiful place we are today, with Windsor Castle only a few miles down the road, inspired me to do a little thought experiment about castles. The British isles are full of them, one even more majestic and impressive than the next. But as you know, castles are not a British invention. They were imported from France. The success of the Norman conquest was not only due to William beating Harold in the battle of Hastings in 1066. It was also because as soon as the Normans landed, they put up castles all over the place. And once these stone fortifications were erected, they were impossible to tear down. It was a formidable military innovation that changed the course of history. Castles remained a crucial instrument of warfare for ages. Until the introduction of gunpowder changed their role forever.

With some imagination, you can see a fair few similarities between banks and castles. Invented in the 15th century, banks were a major financial innovation that changed the course of economic history. They have performed a crucial role in our economies for centuries. And they too had to adapt in the face of change and disruption.

Indeed, life for banks in Europe hasn't been easy lately, on both sides of the Channel. Their business models and profitability are under pressure. As a central banker and financial supervisor, I care about this, because banks' profitability is an important driver of their capital strength and financial stability.

In the short term, the economic exit out of the Covid pandemic poses a real challenge to the asset quality of banks. I have always been intrigued by the term 'non-performing loan'. It has a subtle British understatement to it. This is especially refreshing to someone like me coming from a Calvinist country where the word for debt – schuld – is the same as the word for guilt. But still, we are talking about a situation where someone may not pay back your loan. For a bank, that's potentially life-threatening, because it can erode your capital.

Since the beginning of the Covid crisis, European banks haven't pulled up their drawbridges, but instead continued lending to firms and households. At the same time, they increased provisions, in expectation of a surge in non-performing loans.

But so far, the impact of Covid on asset quality was not as bad as expected. So now, banks have started to release provisions again, reflecting the brightening outlook for the economy.

But isn't that a bit too soon?

True, the economic recovery in Europe looks strong. But let's not forget the unprecedented nature of what happened. One of the reasons why we haven't seen lots of firms go belly-up during the pandemic, is the unprecedented scale of government support. Support that has kept many firms afloat that might otherwise have gone bankrupt. Competition, and the process of creative destruction that goes with it, has been suppressed for the past 1.5 years. To give you an idea, at the height of the pandemic, bankruptcies in the EU had fallen by half compared to pre-pandemic levels. In spring this year they were still only at three-quarters of these levels.

And in the meantime some very significant changes to economic activity and customer preferences have taken place that are likely to be structural. Think of the rise of the online economy, think of the shift away from inner cities to the suburbs or rural areas.

We simply haven't been here before.

With the wind-down of government support measures, the true picture of the health of firms will gradually emerge. How many firms might still go under? We simply don't know. But bankruptcies are creeping up again. So banks should be careful and not release provisioning too soon.

The Covid-legacy also means banks need to take a close look at another part of their defences: risk management. The pandemic presents unique challenges for managing credit risk. Assessment of bank practices by supervisors, at least in the eurozone, shows that not all the banks have sufficiently strong credit risk practices in place. Too many banks have insufficient high quality data and early warning systems. They are continuing to drag their feet when it comes to classifying problem loans, and are applying inadequate practices for provisioning, valuing collateral and making financial forecasts. So a broader adoption of good credit risk management practices is needed.

All in all, my message to the banks is this: be careful, don't release your provisions too soon, and strengthen your guards.

The business model of a castle was for the lord to tax the peasants in his estate, in exchange for protection. But if harvests were bad, that reduced the lord's ability to levy taxes. His income fell, and he had to look for other sources to cover costs.

That basically describes the challenge low interest rates pose to bank profitability. For some time the impact on banks of falling interest rates seems to have been ambiguous. On the one hand banks' interest margins have been compressed. On the other hand, lower rates may simultaneously have had a positive effect by supporting banks' lending volumes and trading book valuations.

But evidence shows that since 2020, the already slim bank interest margins have been squeezed further. Lending growth has not been able to compensate that, and this resulted in a drop in net interest income. For European banks, the decline was 5% year-on-year in 2020.

Banks will likely have to operate in a low interest rate environment for some time to come. One important way for banks to tackle the challenge of lower interest rate margins is to enhance cost efficiency and to refocus their business models towards non-interest income.

Encouragingly, several banks have recently taken the route of doing just that. We have seen banks strengthen their position in the fee and commission income-generating business. For instance, by acquiring asset management, custody or securities services business lines, or by merging their businesses with competitors. By doing so, banks further diversify their business and increase the scale of their operations, which is a very important condition for success in these areas.

Think of what the lord of a castle would do if his tax income dropped. He would start raising tolls on passing ships, look to conquer other lands, perhaps compete for the hand of the king's daughter.

So my message here is: don't wait for interest rates to return to higher levels but look for other ways to create value.

The biggest challenge castles had to face was the invention of gun powder. The arrival of gunpowder shifted the function of castles. Their role evolved from a purely defensive one to a more residential one. Other defensive structures came up, like forts. They were more suitable for firing off canons themselves, thus adopting the new technology. So too the arrival of new technology and new players will change the role of banks.

Our gunpowder challenge is FinTech, and especially BigTech. The influence of BigTech firms in banking is growing rapidly. I am sure at least some of you are already using Apple Pay or Google Pay. Banks are increasingly outsourcing to the Cloud. And banks and BigTechs are joining forces in SME lending. For example, a bank starting to offer loans to merchants active on a web-based platform, using transaction information from that platform.

The entry of BigTechs makes banking an industry ripe for disruption. I think we should not fear this new challenge. I am not one of those who believes BigTech will tear down the banks. But I am convinced that BigTech will change the rules of the game.

How exactly will partly be determined by the strategy of BigTechs. Will they choose cooperation or disruption? But it will also depend on the innovative power of financial institutions: on their vision and strategy, their capacity for change, their ability to attract talent. Financial institutions have already innovated successfully in some cases, and they have to continue doing so in the future.

So my message to banks is: innovate. If you succeed, you will be able to shape innovation in financial services. If you fail, you may find yourselves in a dependent position.

The rise of BigTechs in the financial sector also has implications for regulators. First of all, we will have to seriously challenge banks on the sustainability of their business model. And what does the rise of BigTechs in the financial sector mean for

concentration risk and systemic risk? We have worked for years to solve the problem that many banks are too-big-to-fail, and now BigTechs are entering the scene, raising similar issues. The recent outage of WhatsApp offers a stark reminder of what could happen if crucial technological infrastructure fails. Existing regulation may need to be adjusted to address these risks.

Supervisors at European level and beyond will have to team up to prevent gaps, conflicts and overlap in regulation. Not only across borders, but also across areas of competence and expertise, such as cybersecurity, data protection, competition and financial supervision.

One of the great things about the Norman conquest of 1066 is that after that Britain was never invaded again. Some see Brexit in that historical context. As is clear from the topics of the panel discussions earlier today, the future relationship between the EU and the UK is still subject to lively debate. But what is clear is that cooperation is more important than ever. Many challenges the banking industry faces today are relevant on both sides of the Channel. In order to overcome them, we need to work together. To stay strong and dependable. Like Windsor Castle.