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

SPEECH

Speech by Luis de Guindos, Vice-President of the ECB, at the XXVI Santander Iberian Conference

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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.

EIB backs EUR 4.9 billion clean energy, sustainable transport, agriculture and housing investment

- **116 civil society representatives discuss climate and development priorities with EIB board**
- **First EIB board meeting without UK**
- **EUR 1.7 billion for private sector, industrial energy efficiency and corporate innovation**
- **EUR 2 billion for clean energy and sustainable transport**

The EIB approved new investment across Europe and around the world to improve clean energy, sustainable transport, high-speed communications and social housing, as well as health and education infrastructure.

Meeting in Luxembourg today the Board of the European Investment Bank (EIB) agreed to support EUR 4.9 billion of financing. This included EUR 1.7 billion of new support for corporate innovation, industrial energy efficiency and business investment through direct financing and credit lines with local financial partners.

Building on largest ever stakeholder engagement

Ahead of the first board meeting of the year the EIB hosted a day of discussions covering climate action, development impact, transparency and anti-corruption with representatives of 116 civil society, stakeholder and NGO groups.

This follows EIB’s largest ever stakeholder consultation last year, an eight month discussion, with 149 written contributions and petitions signed by over 30,000 people, ahead of adoption of a new lending policy in the field of energy.

Helping companies to cut energy use and innovate

The EIB agreed EUR 1.7 billion of new financing for private sector investment. This includes projects to reduce industrial energy use, develop medical devices and accelerate digitalisation of postal services.

New targeted credit lines will support climate action by companies in Bulgaria, Italy, Romania and Spain, improve access to finance by energy, tourism and education companies in Serbia, help agriculture firms in Romania to expand and encourage circular economy investment in Spain.

Harnessing renewable energy and improving energy efficiency

EUR 1 billion of financing will go to clean energy investment across Europe and Central Asia. This includes support for 18 new photovoltaic projects in central Spain, renewable energy projects in Austria and Italy, as well as new transmission infrastructure in the Netherlands to distribute electricity generated by windfarms in the North Sea.

The EIB will also support a new investment programme intended to cut energy use by district heating systems in Uzbekistan.

Expanding rail and maritime transport

EUR 983 million of new investment will go to sustainable transport projects. This includes upgrading urban and regional rail links in Denmark, Germany, Italy and Poland, and expanding maritime and rail freight transport capacity on routes across Europe.

Addressing the shortage of social housing

Two new projects will expand the availability of social and affordable housing in Paris and Berlin. The two projects will encourage a greater social mix and support construction of new housing for low and middle-income households.

Improving education and medical facilities

Research and development at the Universities of Santiago de Compostela and Vigo in northern Spain, primary schools and sports training facilities in Hungary and a regional medical centre in Estonia will all benefit from new EIB financing approved today.

EUR 1.4 billion of investment backed by the Investment Plan for Europe

Five projects approved by the EIB board, a total financing amount of EUR 445 million today, will be guaranteed by the European Fund for Strategic Investments (EFSI), the financial pillar of the Juncker plan. This will mobilise an estimated EUR 1.4 billion of new transport, energy, agriculture and small business investment.

Safe and clean drinking water: Council approves provisional deal which updates quality standards

Drinking tap water in Europe is perfectly safe, and the EU is making it even safer

The EU is ensuring that tap water across the EU is safe to drink. Today, member states' ambassadors meeting in the Council's Permanent Representatives Committee (Coreper) confirmed the provisional agreement that was reached with the European Parliament on 18 December 2019 on a proposal to revise the drinking water directive. Today's endorsement clears the way for final adoption.

> Our message to citizens is clear: Drinking tap water is perfectly safe everywhere in the EU. Today's agreement will result in a further improvement in the quality of tap water. This is very good news for all Europeans. I am pleased that member states have endorsed this agreement today.
>
> *Tomislav Ćorić, Minister of Environment and Energy of Croatia*

Under the new rules, the quality standards that drinking water must meet are brought up to date, and a cost-effective risk-based approach to the monitoring of water quality is introduced. The updated rules also set out minimum hygienic requirements for materials in contact with drinking water, such as pipes. The aim is to improve the quality of such materials to ensure that human health is protected and no contamination takes place.

The updated directive addresses growing concerns about the effects of endocrine disruptors, pharmaceuticals and microplastics on human health by introducing a watch list mechanism. The watch list will allow the EU to follow up, in a dynamic and flexible way, on new knowledge about these substances and their relevance for human health. Beta-estradiol and Nonylphenol will be included in the first watch list in view of their endocrine disrupting properties. The first watch list will be adopted by 1 year after the entry into force of the directive. The endocrine disruptor Bisphenol A is directly added to this directive, with a health-based parametric value of 2,5 µg/l.

Member states currently undertake considerable efforts to improve access to drinking water. In order to promote the use of tap water, member states will ensure that outdoor and indoor equipment, such as taps or water fountains, are set up in public spaces, where technically feasible and taking into

account specific local conditions, such as climate and geography. In addition, member states may voluntarily choose to take further measures to promote the use of tap water, such as launching information campaigns for citizens or encouraging the provision of tap water for free or for a low service fee in restaurants, canteens, and catering services.

In addition, member states will have to ensure that consumers can access information on the quality of their drinking water. Member states will also take measures that they consider necessary and appropriate to improve or maintain access to water for all citizens.

Background and next steps

The overarching objective of the recast proposal is to ensure a high level of protection of the environment and of human health from the adverse effects of contaminated drinking water. The revision is also a direct result of the first-ever successful European citizens' initiative 'Right2Water'. The Commission adopted its recast proposal for the drinking water directive on 1 February 2018. The Council adopted a general approach on the proposal on 5 March 2019. Negotiations between the co-legislators followed. On 18 December 2019, a provisional agreement was reached between the Council and the European Parliament. Today's confirmation of the agreement by the EU ambassadors of the member states paves the way for the final adoption.

The European Parliament's Committee on Environment, Public Health and Food Safety (ENVI) is expected to vote on the compromise agreement on 18 February 2020. The ENVI Chair is then expected to address a letter to the Presidency confirming that, should the Council approve this text in first reading, after legal-linguistic revision, the Parliament would approve the Council's position in its second reading.

Prior to that, the confirmation of the political agreement will be submitted to the Environment Council meeting on 5 March 2020, after translation of the text in all official languages.

This directive will enter into force 20 days after its publication in the Official Journal of the European Union.

Spain: EIB to finance pioneering project to imrove CEPSA's energy efficiency and reduce the

environmental impact of its chemicals operations

- **The EU bank is providing €60 million in financing to enable the company to develop and implement more sustainable and efficient technologies in its production process**
- **The San Roque (Cádiz) chemicals plant will become the first operational plant in the world to install the Detal system, cutting its emissions and water and electricity use and improving safety**
- **Promoting employment in Andalusia: the project will create 250 jobs during the implementation phase**
- **The agreement is supported by the Investment Plan for Europe**

The European Investment Bank (EIB) is to support CEPSA's commitment to reduce the environmental impact of its activities by financing a globally pioneering R&D project to increase the sustainability of its petrochemicals operations. To this end, the EU bank has granted a €60 million Investment Plan for Europe loan to the company on favourable terms. The agreement was signed in Madrid by EIB Vice-President Emma Navarro and CEPSA CEO Philippe Boisseau.

The EIB-financed investment will be used to install the Detal system, a state-of-the-art technology created by CEPSA and specialised technology company UOP (Universal Oil Products) to produce linear alkylbenzene (LAB), the most commonly used raw material for the production of biodegradable detergents internationally. This technology improves the efficiency of the

manufacturing process and cuts CO_2 emissions and water and electricity use. It also optimises the production process as it both reduces waste and enables much of it to be reused. Lastly, this technology delivers major safety improvements.

The EIB will monitor the implementation of this project, which CEPSA plans to complete in mid-2020, as part of its goal to move towards a more efficient and sustainable productive model.

The agreement was made possible by the Investment Plan for Europe, which enables the EIB to support investments fostering innovation, economic growth and employment. During the implementation phase, CEPSA estimates that this project will create around 250 (mostly local) jobs, peaking at 400 jobs, and will help to safeguard CEPSA's 3 600 direct and 2 600 indirect positions in Andalusia.

At the signing ceremony in Madrid, **EIB Vice-President Emma Navarro** highlighted the fact that this project "*will help a Spanish multinational to lead the petrochemical industry towards a more environmentally friendly model. With this agreement, the EIB is contributing to the achievement of the EU's climate and environmental objectives by supporting investments enabling CEPSA to develop new innovative and resource-efficient production processes. We are pleased that these cutting-edge technologies are being installed at a factory in Andalusia, helping to create jobs and foster social and territorial cohesion."*

Paolo Gentiloni, **European Commissioner for the Economy**, said: *"A central message of the European Green Deal Investment Plan I presented in January is that all actors must play their part to make the climate transition a success. This agreement signed with CEPSA is a tangible example of how Europe can support companies' efforts to become greener and more energy efficient – while leading the way in innovation."*

CEPSA CEO Philippe Boisseau added: "*We are grateful for all of the EIB's support and for its interest in moving towards safer and more sustainable industrial processes. This project will not only enable us to reduce the impact of our operations (a priority for CEPSA), but also to improve the quality of our output and increase the versatility of the San Roque plant, adapting to the specific requirements of each customer and strengthening international competitiveness. Without a doubt, it is our experience and capacity for innovation in this sector that has enabled us to tackle such a unique project.*

ESMA launches a Common Supervisory

Action with NCAs on MiFID II suitability rules

The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, is launching a common supervisory action (CSA) with national competent authorities (NCAs) on the application of MiFID II suitability rules across the European Union (EU). The CSA will be conducted during 2020.

The CSA will focus on the application of the MiFID II requirements on the assessment of suitability. This action will allow ESMA and the NCAs to gauge the progress made by intermediaries in the application of this key requirement. It will also help in the analysis of whether, and how, the costs of investment products are taken into account by firms when recommending an investment product to a client. ESMA has updated its guidelines on the topic in 2018 and has also recently published a supervisory briefing on suitability, both of which will be considered for this 2020 CSA.

ESMA believes this initiative, and the related sharing of practices across NCAs, will help ensure consistent implementation and application of EU rules and enhance the protection of investors as well as improve NCA's understanding of supervisory approaches in line with ESMA objectives.

The CSA contributes to fulfilling ESMA's mandate on building a common supervisory culture among NCAs to promote sound, efficient, and consistent supervision throughout the EU. ESMA's promotion of supervisory convergence is done in close cooperation with NCAs.