Luis de Guindos: Euro area banks: the profitability challenge

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Euro area banks’ profitability remains weak

The resilience of the euro area banking sector has continued to improve over the past few years, supported by a sustained economic expansion. Banks’ aggregate Common Equity Tier 1 ratio, a key measure of capital strength, stood at 14.3% at the end of 2018, up from 12.7% in mid-2015. Cyclical factors have also helped banks’ profitability recover from its trough in the wake of the sovereign debt crisis.

That said, banks’ return on equity (ROE), at around 6%, still falls short of their cost of capital, which is estimated at around 8-10% for most banks.[1] Euro area banks’ ROE also remains below that of some of their international peers, for instance US and Nordic banks. Recently, profitability concerns have again come to the fore as the operating environment for banks has become more challenging, with economic growth projected to slow down in 2019. Banks’ profitability prospects could thus be dampened by deteriorating growth expectations, adding to structural weaknesses.

A number of banks continue to have depressed market valuations, with price-to-book ratios well below one, mirroring their weak current and expected profitability. In other words, price-to-book ratios below one indicate that those banks are not earning their corresponding cost of equity (COE). However, it is important to stress that the situation of individual banks across the euro area varies considerably in terms of both ROE and COE. There is still a large gap between overperformers and underperformers; in the past few years around one-quarter of significant banks delivered an ROE of at least 8%, while the ROE of the worst-performing quartile remained below 3%. The COE situation is also very mixed: over 20% of European banks surveyed by the European Banking Authority estimate their COE to be above 10%, while around 10% of them estimate it at below 8%.

Why is low profitability a concern from a financial stability perspective?

So why does low bank profitability matter for financial stability? Perhaps most importantly, persistently low profitability can limit banks' ability to generate capital organically. This makes it harder for them to build up buffers against unexpected shocks and limits their capacity to fund loan growth. At the same time, banks with weak profitability prospects and low market valuations could find it very costly, or even prohibitively expensive, to raise capital from market sources should the need arise.

In addition, banks with limited current earnings power may also be tempted to take on more risk. Higher risk-taking by banks can cause financial imbalances to build up, should risks be correlated. In fact, in the banking sector, profitability which is (too) high may be as much of a problem as profitability which is (too) low, as it may be an indication of excessive risk-taking of the sort observed in the run-up to the global financial crisis.

Against this background, today I will focus my remarks on the main determinants of banks' profitability outlook. I will cover both cyclical and structural factors, as well as possible ways for banks to return to sustainable profitability.

Cyclical factors have helped improve bank profitability in recent years

Bank performance is closely linked to economic activity. In fact, bank profitability has improved in the past few years on the back of continued economic growth, with euro area banks' ROE reaching 6% in 2018, up from 3% two years earlier. Cyclical factors have supported these profitability improvements via three channels. First, the broadening economic expansion, coupled with low interest rates, has made it easier for borrowers to repay their loans, leading to better credit quality and lower bank provisions. Second, increased lending volumes have helped offset the negative impact of shrinking net interest margins. And third, a favourable macroeconomic environment has also supported NPL work-outs and the reduction of risk premia, leading to higher NPL sales, which have contributed to lower provisioning needs.

In this context, it is important to recall that the overall effect of our monetary policy on bank profitability has so far been broadly neutral. Nevertheless, the overall effects of negative rates on the banking sector need to be carefully monitored, particularly because the balance of their effects will depend on how long rates remain in negative territory.

Progress in tackling structural challenges has clearly been insufficient

Notwithstanding the weakening economic prospects, banks' profitability is mainly weighed down by structural factors. Improving cost efficiency is one of their key challenges. Cost efficiency, as measured by cost-to-asset and cost-to-income ratios, has deteriorated since 2010 as cost containment has not offset a marked decline in revenues and total assets. As a result, euro area banks continue to underperform some of their international peers in terms of cost efficiency with an average cost-to-income ratio of 66%, compared with 55-57% at Nordic and US banks. It is important to keep in mind, however, that the picture is extremely varied at the level of individual banks, and the best-performing banks in the euro area have shown evidence of sustained profitability improvements supported by efficiency gains.[2]

Second, despite notable progress in reducing legacy NPL stocks, some banks continue to face earnings headwinds due to low returns on NPLs, which tie up capital, absorb operational capacity and incur legal and administrative costs.

Third, excess capacity has been offered as an explanation for the euro area banking sector's low profitability, as it can reduce cost efficiency and erode banks' pricing power.[3] And based on a composite indicator of overcapacity constructed using various measures of size, competition and efficiency, euro area banks indeed score relatively poorly compared with other advanced economies.

Finally, while market funding conditions remain favourable, the need to issue more bonds that are eligible under the minimum requirement for own funds and eligible liabilities, or MREL, may pose challenges for some banks in the coming years, especially smaller banks[4] and those with lower credit ratings. A possible increase in funding costs might complicate their efforts to build up the necessary loss-absorption capacity and could weigh on their profitability.

Possible ways for banks to return to sustainable profitability

Let me now turn to discussing the possible solutions to the profitability problem. First, there is no "one-size-fits-all" strategy for banks to return to sustainable profitability. Each bank's preferred strategy will likely depend on multiple factors.

Let's start with reducing costs and improving efficiency. These are necessary steps, and potential strategies to achieve them range from more traditional measures, such as downsizing and branch closures, to adopting new, cost-saving technologies aimed at digitalising financial intermediation services, for example increasing reliance on internet-based banking.

It must be remembered, however, that benefits will typically accrue only gradually. Reducing overcapacity entails restructuring costs in the short run, with the benefits materialising later. And for digitalisation, there are typically significant short-run costs involving severance payments and IT investment, while the potential profitability gains may only accrue over the medium to long term.[5]

Digitalisation can be an important and permanent cost-saving strategy for banks, particularly in countries with a dense branch network. But it needs to be underpinned by certain structural requirements. Banks' ability to cut costs will depend on factors such as labour laws, population density and the overall level of digitalisation in society. The Scandinavian (and Benelux) countries provide examples of successful cost optimisation strategies through digitalisation.

In addition to cutting costs, many banks will also need to improve their income-generating capacities. One possible avenue for better income diversification is by enhancing fee and commission-based activities. However, the extent to which banks can diversify into areas generating more fee and commission income is likely to depend on their specific business models. In particular, banks that rely heavily on maturity transformation business to generate income could benefit the most from increasing the amount of their total income accounted for by fee and commission-based activities.

Consolidation can further bolster efficiency through cost-cutting synergies. Evidence suggests that domestic mergers and acquisitions (M&As) tend to focus on achieving cost synergies, while cross-border M&As appear to be driven more by expansion opportunities.[6] This is mainly because banks have greater scope to streamline overlapping distribution networks within their domestic market.

So domestic consolidation is crucial. Domestic M&As can deliver substantial cost savings, particularly in less concentrated banking markets. This can be achieved through economies of scale, for example, lower administrative expenses and branch rationalisation, and through revenue synergies, such as lower funding costs for the merged unit.

However, consolidation across countries is an indispensable complement to domestic M&As. Banks that are more geographically diversified have tended to display stronger revenue performance in recent years.[7] Furthermore, cross-border holdings of deposits and loans can help bolster economic resilience within the euro area by helping to smooth shocks through income-sharing. These private sector risk-sharing channels play an important role in smoothing shocks in the United States but are of a much smaller magnitude in the euro area.

There are still some significant obstacles preventing us from reaping the full benefits of cross-border consolidation. In order to facilitate larger

M&As within the euro area banking sector, we must make further progress towards completing the banking union and the capital markets union, and overcome prevailing regulatory and supervisory obstacles. Truly pan-European banks need to conduct liquidity and capital management at the consolidated level to be efficient. Concrete steps in this direction involve establishing a European deposit insurance scheme and, subsequently, removing national options and discretions, for example regarding capital and liquidity, as well as harmonising insolvency laws and taxation regimes. Discrepancies in insolvency and judicial systems hamper cross-border activity in capital markets. A consistent and efficient framework for pursuing failed contracts is vital to reduce uncertainty for cross-border investors.

Concluding remarks

Let me conclude.

The persistently weak profitability of the euro area banking sector remains a key concern for financial stability, as it constrains banks' ability to build up buffers against negative shocks. While cyclical factors have helped improve bank profitability over the last few years, progress in tackling structural challenges has clearly been insufficient.

Reducing costs and improving efficiency are necessary steps, and digitalisation can be an important and permanent cost-saving strategy for banks, but it needs to be underpinned by the structural requirements I mentioned earlier, such as a general environment that is conducive to digitalisation. Many banks also need to improve their income-generating capacities, for example by enhancing fee and commission-based activities.

In terms of the euro area banking sector as a whole, consolidation, both domestic and cross-border, is vital if we want the sector to become more efficient. We need to facilitate this. And we urgently need to make further progress towards completing the banking union and the capital markets union.

The Single Market is still fragmented along national lines. National options and discretions in the regulatory and supervisory frameworks reduce the economies of scale for banks operating across borders. Decisive steps to overcome these, the establishment of a European deposit insurance scheme as well as the harmonisation of insolvency laws and judicial frameworks are necessary bold steps to allow for the emergence of efficient pan-European banks and greater private risk-sharing in the European Union.