

Luis de Guindos: Opportunities and challenges for the euro area financial sector



SPEECH

Opening speech by Luis de Guindos, Vice-President of the ECB, at the 22nd Euro Finance Week

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I am honoured to open the 22nd Euro Finance Week. We gather here every year to discuss the recent financial and economic developments in the euro area and beyond. As we are going to publish our Financial Stability Review in two days' time, today I will focus on the health of euro area financial institutions and the opportunities and challenges they face in the current environment. I will also offer some policy considerations.

Opportunities and challenges for euro area banks

Let me start with euro area banks, which have been reporting persistently low profitability in recent years. The aggregate return on equity of the sector slightly declined to less than 6% in the 12 months to June 2019. This weak performance is broad-based, with around 75% of significant banks generating returns below the 8% benchmark return demanded by investors for holding bank equity.

Poor profitability of course reflects both cyclical and structural factors.

The current macro-financial environment in the euro area is challenging for euro area banks. The recent softening of the macroeconomic growth outlook and the associated low-for-longer interest rate environment are likely to weigh further on their profitability prospects. Many market analysts are concerned about the drag on bank profitability that could result from the negative impact of monetary policy accommodation on net interest margins. And net interest margins are indeed under pressure.

Just focusing on this one aspect is misleading, however. Importantly, it neglects the first-order effect of monetary policy in supporting economic activity. Without this, 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. In addition, the introduction of the two-tier system for reserve remuneration will help mitigate the cost of negative interest rates for banks.

Structural factors are at the heart of weak bank profitability, however. In particular, euro area banks face challenges linked to the sector's overcapacity. There are too many banks. Many of them have low market shares and so are under high competitive pressures, also from outside the sector, for example from fintech companies. Another important dimension of overcapacity in the euro area is persistent cost inefficiencies. Banks are not fully benefiting from economies of scale and are relying on overlapping physical distribution networks. As a result, their cost-to-income ratios – currently at 66% – are high when compared with those of their peers in the United States and the Nordic countries.

So, how can euro area banks return to sustainable profitability? And how can they make more decisive progress in tackling structural challenges and cost inefficiencies? Let me mention two avenues which would support an increase in bank profitability.

First, there is room for banks to adjust their business models. In fact, ECB analysis has found that the best performing banks have diversified their income sources, improved their cost efficiency and invested in digital technologies to a greater extent than their peers.^[1]

Second, consolidation via mergers and acquisitions may allow banks to exploit economies of scale and scope, which should bring about improved performance. Cross-border mergers, while less likely to produce cost savings or economies of scale, would have an additional benefit of improved risk diversification and would thus result in more resilient profitability. To this end, policy-makers may need to remove obstacles to cross-border mergers and acquisitions, promote further integration and pursue the banking union agenda.

It is also worth recalling the good news. Banks have noticeably improved their resilience over the past few years. This largely reflects the new regulatory framework. They now need to hold more and higher-quality regulatory capital and they must maintain liquidity buffers. They also need to finance themselves through stable funding sources. And they have to plan for their potential resolution and issue debt instruments that can be bailed

in. While these adjustments can be challenging in the short term, in the long term they increase the banking sector's resilience to adverse shocks, reducing the likelihood of costly financial crises.

In fact, the euro area banking system already complies with the new requirements for high-quality capital and liquidity buffers. But even though banks have improved their capital positions in recent years, only a small fraction of bank capital requirements are in the form of the countercyclical capital buffer (CCyB), 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 CCyB a more prominent role.

Opportunities and challenges for euro area non-bank financial institutions

I will now turn to the euro area non-bank financial sector, which has grown rapidly since the global financial crisis. Its total assets have almost doubled over the last ten years, growing from €23 trillion in 2008 to almost €46 trillion in June 2019.

Euro area non-banks are playing an increasingly important role in financing the euro area economy, especially through their 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, as opposed to 7% held by euro area banks. The greater role of non-banks can be positive from a financial stability perspective 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.

But, similar to banks, non-banks also face several challenges in the current environment, with profitability being one of the major concerns. As bond yields have fallen, non-bank financial intermediaries are holding a growing share of low-yielding bonds, which decreases their investment income in the medium term.

Many non-banks tend to compensate this 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, it contributes to rising risks and vulnerabilities in non-banks' balance sheets.

Liquidity risk is a particular source of concern, as illiquid funds can face severe difficulties in dealing with large-scale outflows. Over the past one and a half years there have been several cases of UCITS funds under such stress. All these funds had large liquidity mismatches on their balance sheets as they invested in illiquid assets but offered daily redemptions.

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. Moreover, 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.

Against this background, we need to think about potential gaps in the current regulatory framework. In particular, we should embark on developing a macroprudential framework for the non-bank financial sector, which is still in its infancy. Additional 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 procyclical risk taking and excessive leverage, liquidity and maturity transformation. One could consider macroprudential restrictions on fund leverage and additional liquidity management tools that align redemption terms more closely with the liquidity of funds' assets, for example. The policy tools should also provide incentives for non-banks to internalise the impact that their actions have on the rest of the financial system and the real economy. In particular, such policy tools could mitigate non-banks' potential to amplify exuberance in upturns and adversely affect financial and economic conditions in downturns.

Of course we cannot have a one size fits all approach for non-banks and we need to account for differences in balance sheet structures and business models when designing any macroprudential policy framework. But the growing size of non-bank financial institutions, their greater importance to the financing of the real economy and their interconnectedness with the rest of the system highlight the importance of developing a sound macroprudential framework for this sector.

Conclusion

Let me conclude.

Currently, one of the most significant vulnerabilities of euro area banks relates to their weak profitability prospects. The lacklustre outlook reflects both structural and cyclical factors. The banking system is operating with significant overcapacity resulting in persistent cost inefficiencies and competitive pressures. At the same time, the weaker cyclical momentum and associated low interest rates are weighing on bank profitability, although monetary policy accommodation has supported lending volumes. However, we need to acknowledge that banks have made significant progress in repairing balance sheets since the outbreak of the financial crisis. Nevertheless, a rebalancing of the current composition of capital requirements towards a more prominent role for the CCyB could help mitigate costly economic deleveraging in downturns.

Non-bank financial intermediaries have grown rapidly over recent years in the euro area, which is a welcome development. But similar to banks, they are

also facing profitability headwinds in the current environment. As a consequence, they are searching for yield in riskier assets. Given their increasing importance in financing the real economy, their increased risks and vulnerabilities highlight the need for the development of a macroprudential framework for this sector.