“The new world of banking – charting the territory”

Speech by Danièle Nouy, Chair of the ECB’s Supervisory Board, at a joint conference of tvi24 and the Associação Portuguesa de Bancos, Lisbon, 17 May 2016

Ladies and gentlemen,

Thank you very much for the invitation to speak at today’s conference on the present and the future of the banking sector. It is a pleasure to be here in Lisbon.

For a long time, Portugal was the edge of the known world. The Romans, for instance, thought that beyond the coast of Portugal, the sun sank into the ocean marking the end of the world. The Portuguese obviously thought otherwise. When they looked at the sea, they wondered what lay behind it.

In the 15th century, they finally set off to explore what were then uncharted waters – the great age of discoveries had begun. Thanks to state-of-the-art tools and techniques, explorers such as Vasco da Gama and Ferdinand Magellan discovered much of Africa, Southeast Asia and South America. Back then, these were whole new worlds; today, they are familiar territory.

Turning to the financial sector, we are in a similar situation. To many it seems as if the storm of the financial crisis blew them across a vast sea and onto the shores of a new world – a new world with new rules, new actors and new challenges. And some may wonder whether this new world is better than the one they came from.

Let me map out the new world and highlight a few features of the landscape; let me explain why the new world looks as it does and, most importantly, why it is indeed better than the old one.

Preventing emergencies – regulation and supervision

In creating the new world of banking, policymakers were driven by two main objectives: first, to make banks more resilient and crises less likely; second, to realign incentives for banks and investors and to protect taxpayers. Towards these ends, the supervisory and regulatory landscape has been transformed.

In the euro area, the supervisory landscape changed dramatically on 4 November 2014 when the ECB began directly supervising the at the time 120 largest banks in the euro area. Taking banking supervision to the

European level was the biggest step towards financial integration since the introduction of the euro – and it was a necessary step.

European banking supervision offers at least three advantages:

- First, European banking supervision allows for banks in the entire euro area to be supervised according to the same high standards.
- Second, European banking supervision does not stop at national borders but takes a European perspective. It can therefore compare and benchmark banks across borders in order to identify problems early on.
- Third, European banking supervision is less prone to national interests getting in the way of necessary measures. It can therefore act when action is called for.

Does European banking supervision push national supervisors to the sidelines? No, it certainly does not. First, national supervisors are still responsible for directly supervising the smaller banks – and these constitute the overwhelming majority. In Portugal, for instance, just four banks are directly supervised by the ECB, while around 120 banks are directly supervised by the Banco de Portugal. Second, with regard to the large banks, the ECB naturally relies on the expertise and experience of national supervisors, who are in the majority on the relevant supervisory teams, and the national competent authorities are represented as members in the Supervisory Board.

European banking supervision is founded on cooperation. Supervisors from across the euro area work together for a stable banking sector. It will of course take time to adjust to this new world, to grow closer together and to establish a common supervisory culture. And yes, we might encounter conflicts along the way which will have to be resolved in a constructive manner.

Nevertheless, we have made good progress since November 2014, and eventually a European supervisory culture will emerge. At the end of the day, we all share a common goal: a more stable banking sector.

European banking supervision has been a decisive step towards that objective. Nevertheless, it has not been the only one: banking regulation, too, has been overhauled.

The most prominent new feature of the regulatory landscape is higher capital requirements. Capital is a bank's most universal buffer – no matter from which direction the storm blows, a well-capitalised bank will be able to withstand it. Consequently, capital requirements have been increased in both quantity and quality – banks have to hold more and better capital than ever before.

Nevertheless, there are some who contend that higher capital requirements have side-effects. They argue that capital is costly to banks and might force them to increase lending rates. That in turn would choke credit growth and damage the economy. So, are higher capital requirements really bad for the economy?

Empirical evidence suggests otherwise. In a recent study, for instance, Leonardo Gambacorta and Hyun Song Shin concluded that “both the macro objective of unlocking bank lending and the supervisory objective of sound banks are better served when bank equity is high.”[1]

Moreover, we should not look solely at the costs of higher capital requirements but also at the benefits. For one, higher capital requirements reduce the likelihood of crises, which would otherwise be very costly to the economy. Comparative studies of the costs and benefits of higher capital requirements conclude that, in the end, benefits exceed costs.[2]

Handling emergencies – resolution and risk-sharing

With European banking supervision and higher capital requirements, we have made a leap forward towards a stable banking sector. Nevertheless, individual banks may still fail. After all, the market economy thrives on creative destruction: unsustainable enterprises exit the market and make room for better ones. Chance and circumstance might push banks over the edge, even if they are strictly regulated, closely supervised and prudently managed.

However, many banks are woven so deeply into the fabric of the financial system that their failure might trigger a systemic crisis – particularly when the failing bank is a very large one. This “too-big-to-fail” problem was a major issue during the recent financial crisis. In order to prevent the worst, governments around the world were prompted to save failing banks.

Such bail-outs first and foremost hurt public finances. Take Ireland as an example: in 2010, the Irish public deficit soared to more than 30% of GDP – a direct result of bailing out large banks.

And there is an additional effect: public bail-outs increased the likelihood of future crises because they set the wrong incentives for banks. They enabled banks to operate with an implicit and cost-free public insurance. For the banks, little could go wrong: either their investments paid off or the government would step in and save them. It was a case of heads, the banks win; tails, the taxpayers lose. So they had an incentive to engage in risky activities, reap the returns and pass potential losses on to others. Such a system is obviously not sustainable.

---

[1] Gambacorta, L. and Shin H.S. (2016), “Why bank capital matters for monetary policy”, *BIS Working Paper*, No 558.

[2] For an overview, see Basel Committee on Banking Supervision (2016), “Literature review on integration of regulatory capital and liquidity instruments”, *Working Paper*, No 30.

Consequently, another prominent feature of the new regulatory landscape is mechanisms that allow for an orderly failure of banks. A crucial feature in that regard is the bail-in tool. In Europe, that tool was introduced at the beginning of the year through the Bank Recovery and Resolution Directive. According to these new rules, shareholders and creditors are first in line when it comes to bearing the costs of bank failures. They earn the returns, but also have to take the risks; heads, they win; tails, they lose.

Will the existence of bail-in discourage investors from putting their money into banks? Well, in the world of business that is a matter of price. Now that the implicit public insurance has been removed, investors might demand higher risk premia, thereby pushing up funding costs for riskier banks and forcing them to rethink their business models. And that of course is perfectly in line with the objective of increasing market discipline and realigning incentives for banks and investors.

However, two other factors are also at play: transparency and certainty. First, investors need to know the rules of the game – transparency is essential. Second, investors need to be certain that the game will be played according to those rules. Without transparency and certainty, investors might indeed be discouraged from putting their money into banks.

Managing transition – the banking sector

Ladies and gentlemen, the banking sector has entered a new world – the rules have become tougher and a new supervisor has entered the scene. I do not deny that huge efforts are required in adapting to this new world.

Burdened by the legacy of the crisis, banks have to raise capital in an environment where markets price in the true risk of losses. Despite these headwinds, banks in Europe managed to significantly increase capital. Since 2012, the CET1 ratio of significant institutions in the euro area has risen, on average, from 9% to around 13%.

This is a welcome development as it puts banks in a better position to cope with those challenges that go beyond regulatory and supervisory reform.

The most prominent of such challenges relate to the sustainability of the business models and the profitability of banks across the euro area, both of which are under pressure from the prolonged period of very low interest rates.

For now, the effects remain somewhat elusive, however. Looking at the large banks in the euro area, we observe that, on aggregate, profitability increased significantly over the course of 2015. The average return on equity rose from 2.8% in 2014 to 4.5% in 2015 – despite a significant rise in equity itself. At the same time, aggregate net interest income remained stable.

However, while profitability improved last year, it did so from a very low level. Moreover, the observed increase in profits was partly driven by non-recurring revenues, and the aggregate figures conceal rather diverse developments across institutions.

Going forward, low interest rates may eventually take their toll: high yielding assets will either mature or be prepaid, while at the same time, a decrease in interest expenses is limited by the zero lower bound on deposits. So banks need to prepare for tomorrow by reviewing their business models today.

And, looking at individual countries, low interest rates are not the only challenge. Banks also have to deal with low asset quality, including high levels of non-performing loans, governance issues, large exposures to national sovereigns, a lack of cost-efficiency, potential overbanking and headwinds from problems in emerging markets.

Against that backdrop, structural changes are called for in order to put the banking sector on a sound footing. Regulation and supervision provide the necessary framework – within that framework, market forces can now do their job and foster necessary changes.

Nevertheless, the banking sector is not an isolated island. Rather, it is closely intertwined with the real economy. Banks always mirror the state of the economy – cyclically as well as structurally. A sound and healthy economy is a prerequisite for a sound and healthy banking sector. Consequently, there is a need for structural reforms that go beyond the banking sector, particularly in those countries that were hit hardest by the recent crisis. Much has been achieved in that regard, now it is essential to finalise the necessary reforms – backtracking is not an option.

Conclusion

Ladies and gentlemen, the banking sector has entered a new world. I am convinced that this new world is better than the one we came from. But still, it will take time to adjust to the new regulatory and supervisory landscape, to overcome the legacy of the financial crisis and to finalise the necessary structural change. I am optimistic, though, that what is now a new world will eventually become familiar territory and the home of a stable banking sector.

Woodrow Wilson once said: “You cannot, in human experience, rush into the light. You have to go through the twilight into the broadening day before the noon comes and the full sun is upon the landscape.” Coming from the night that was the financial crisis, we have made good progress on our way, and the sun has appeared beyond the horizon.

Thank you for your attention.

***