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European banking sector: situation and challenges*

Speech based on the address delivered at the UIMP seminar "¿Qué hemos aprendido de la crisis?" ("What have we learned from the crisis?") / APIE

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*Translation of the original in Spanish

Thank you, Miguel Ángel, for your introduction. As you know, it is a pleasure to be here once again in Santander, participating in the closure of the seminar organised by the APIE (Association of Economics Journalists) at the Menéndez Pelayo International University (UIMP). As always, I greatly appreciate having been invited to what has become a traditional event on the calendar.

Some days back in the course of a meeting, a renowned economics practitioner told me how complex it can be for interested citizens to obtain a well-founded view of the situation of the Spanish banking system. This struck me as a very appropriate remark. Despite the extensive work by the Banco de España and other public and private agencies to compile and disseminate information and analysis on banks, it is not always easy to gain proper insight into the sector as a whole.

That is why I would like to take the opportunity today to offer an in-depth analysis of the situation and outlook for Spanish and European financial institutions in the context of the Single Supervisory Mechanism (SSM). In this connection, I shall first briefly review the situation of the banking sector, focusing thereafter on the challenges banks will have to face in the short and medium term. I shall conclude with some brief thoughts on the ECB's new supervisory framework.

1 Recent developments in the banking sector

In recent years, and in response to the financial crisis, banks have substantially improved their solvency levels, largely as a result of the new regulatory and supervisory requirements. At SSM-supervised banks, in the last year alone their highest-quality (i.e. CET1) capital increased on average by 70 bp, from 12.7% in 2014 to 13.4% in 2015[1]. In the case of Spanish banks, whose starting levels were somewhat lower, the increase exceeded 80 bp, making for an average of 12.5% of CET1 at end-2015.

The profitability of the banking business, however, remains at low levels and, in any event, far off the double-digit figures seen before the crisis. Among SSM banks as a whole, the return on equity (ROE) in 2015 was slightly below 5%, whereas in Spain, in consolidated terms, it was scarcely 5.6%.

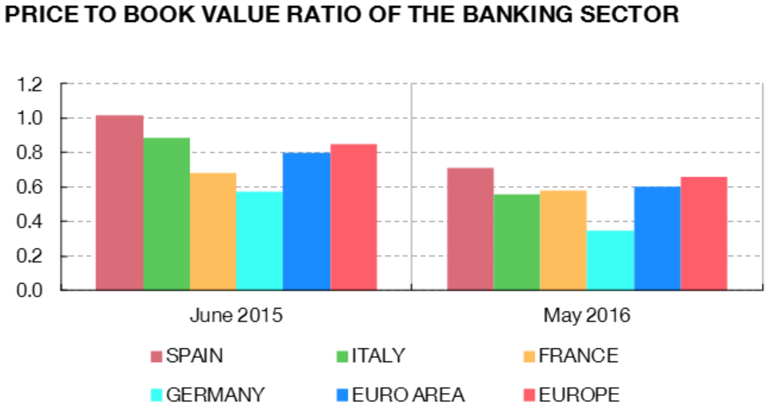
Admittedly, it is unusual for the return on capital to stand in most euro area countries at levels below the average cost of capital, on estimates made by the Banco de España. In the case of Spanish banks, estimates of the cost of capital stood at 6.8% in December 2015, drawing close to levels of 8% in early 2016, as a result of the period of instability observed in financial markets.

We are thus in an environment in which the return demanded by investors is, in general, lower than that obtained by banks at present. And this despite the fact that the risk that the acquisition of bank shares entails should have lessened as a consequence of the reduction in banks' leverage.

[1] Average of SSM institutions according to Banco de España calculations.

Naturally, the disappointing performance of bank profits is one of the factors behind the decline in banks' share prices in recent months which, across the board, stand significantly below their book value, as can be seen in Chart 1. This decline has been somewhat greater in the case of Spanish banks, although these continue to evidence a higher ratio than that of the main euro area banking systems.

Chart 1



SOURCE: Datastream.

2 Challenges for the banking sector

Several factors account for the low profitability of the banking business in Europe.

2.1 Low interest rates

One of the main factors is the maintenance of interest rates at low levels which, along with the low level of economic activity, exerts downward pressure on banks' net interest income.

The pressure exerted by low interest rates does not only affect Spanish banks but is common to most European entities, albeit with differing intensity depending on balance sheet structure and the predominant type of banking business.

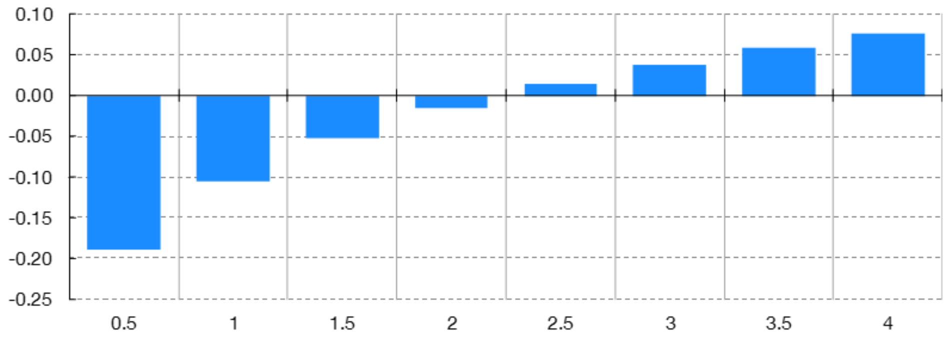
Hence, the adverse effect on profitability of interest rates holding at low levels is all the greater the higher the percentage of loans extended at a floating interest rate, the lower the percentage of assets recorded at fair value or the greater the proportion accounted for by deposits in the bank's financing structure. That is to say, the current environment of low rates particularly affects the traditional banking business of financial intermediation, namely that which prevails in Spain.

Additionally, it should be borne in mind that the impact of changes in interest rates on bank profitability is not linear. Any reduction in interest rates, in what is an environment with already very low levels, affects bank margins with particular intensity. Indeed, the work performed at the Banco de España shows (see Chart 2) that, for high levels of interest rates, a moderate reduction in the Euribor exerts a positive impact on net interest income, since the stimulus effect (quantity effect) exerted by lower rates on the demand for credit offsets the reduction in the unit return on the loans (price effect). However, when interest rates are already very low, a decline in the Euribor is associated with a reduction in the interest margin (the price effect exceeds the quantity effect) as banks have less capacity to pass through the reduction in interest rates to retail deposits owing to their proximity to the zero-rate level. It is possible that these non-linearities may be exacerbated when interest rates move into negative territory.

Chart 2

IMPACT OF A 100 bp REDUCTION IN THE 12-MONTH EURIBOR ON NET INTEREST INCOME (a)

Business in Spain, ID



SOURCE: Financial Stability Report, May 2016, Banco de España.

a. The Y axis in the chart shows the impact of a 100 bp cut in the 12-month Euribor on net interest income for different levels of the 12-month Euribor in the range [0.5-4], which are indicated in the X axis of the chart. The impact is defined as the rate of relative change in net interest income given a 100 bp reduction in the 12-month EURIBOR .

That said, there are also factors that mitigate the impact of low interest rates on results. In particular, low interest rate levels contribute to reducing loan loss provisions, insofar as they are conducive to a decline in non-performing loans. This mitigating effect is particularly significant in Spain, owing to the prevalence of assets with floating rates on bank balance sheets.

2.2 Non-performing loans

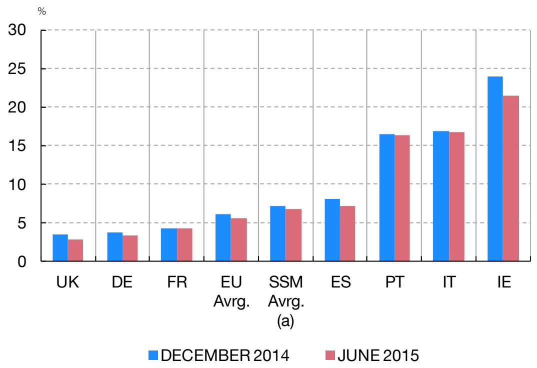
The second factor weighing down on bank profitability is the still-high level of non-productive assets on the balance sheets of banks located in specific countries, despite the continuing downtrend we have observed for some time. As can be seen in Chart 3, in some instances the NPL ratio exceeded levels of 15% in mid-2015. With its ratio at approximately 7%[2], Spain stands only slightly above the euro area average, thanks to the reduction witnessed in the past two years.

[2]According to data for Spain from the EBA 2015 transparency exercise (consolidated data, significant institutions). With data for business in Spain, drawn from individual financial statements, the related ratio for the resident private sector in Spain stood at 10.4% in December 2015.

Nonetheless, the NPL ratio can be an imperfect indicator of the effect that non-productive or problem assets may have on a bank's solvency, since it does not take into account the asset collateral or the provisions set aside. The so-called Texas ratio, an approximation to which is illustrated in Chart 4, offers a much broader view in that it also includes in its calculation the provisions and capital available to the bank.

Chart 3

NPL RATIO

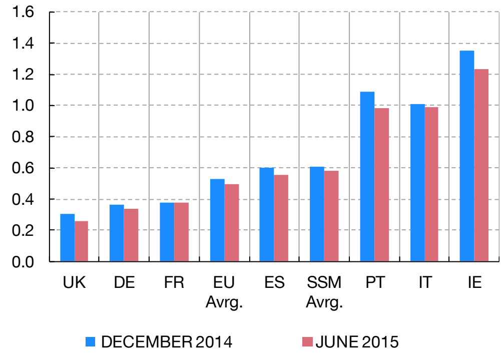


SOURCE: European Banking Authority. Transparency Exercise 2015 (104 institutions).

a. The SSM average includes data on 15 of the 19 euro area countries. No data for Greece, Slovakia, Estonia or Lithuania.

Chart 4

TEXAS RATIO PROXY (a)



SOURCE: European Banking Authority. Transparency Exercise 2015 (104 institutions).

a. The ratio has been calculated dividing NPL by the sum of provisions and capital (including equity instruments eligible as CET1 and reserves).

In any event, ensuring a suitable level of provisioning for problem assets is key to properly identifying impairments and correctly measuring the bank's solvency. Moreover, a rigorous provisioning review policy provides banks with the right incentives for the management of their non-productive assets, since it reduces the book losses that the disposal of such assets may generate. This is only achieved with stringent accounting regulations and strict supervision of asset valuation on the bank's balance sheet which, as you are aware, has been a key element in the Banco de España's supervisory strategy. Indeed, we have recently amended the accounting Circular to which banks must conform in order, among other purposes, to fine-tune the accounting criteria in respect of provisioning credit risk losses. Further, for some time we have been actively contributing within the SSM to developing a common methodology in this field encompassing best practices and ensuring their uniform application across all countries.

2.3 Regulatory reform

The ongoing and still incomplete reform of the regulatory framework is another factor of uncertainty that has affected banks' share prices.

With regard to the Basel Committee's agenda, major headway has been made in reforming prudential standards and, in particular, in the treatment of credit, market and operational risks. One of the most relevant areas of work under way seeks to correct the excessive variability of risk-weighted assets (the denominator of the capital ratio) prompted by the use of insufficiently homogeneous internal models. Such heterogeneity leads to inadequate risk measurement and generates competitive distortions, harming those institutions subject to more demanding regimes of model supervision.

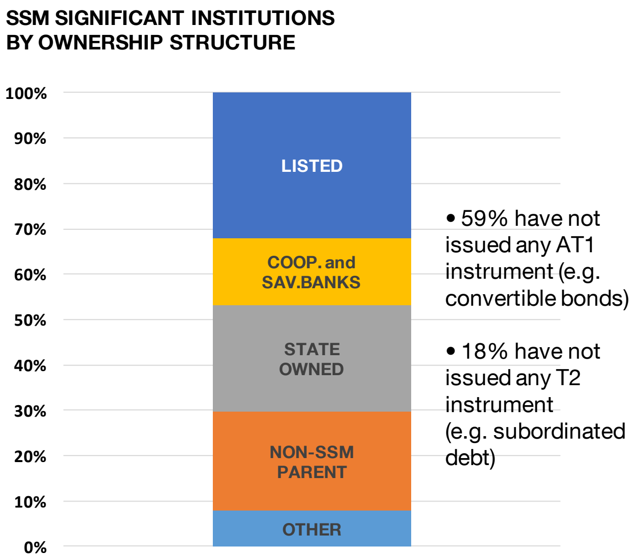
The current challenge is to come up with a parameterisation of the new requirements that enables risk measurement to be enhanced without significantly increasing capital requirements for the system as a whole, as this is one of the commitments announced by global supervisory authorities, in order to hold prudential requirements at levels compatible with the pursuit of banking activity on a proper footing.

Banks must also meet the requirements stemming from the new resolution regulations, which seek to minimise the need to use public funds to manage bank crises. In particular, under the Bank Recovery and Resolution Directive (BRRD), significant institutions shall, in addition to meeting the established capital requirements, have a minimum volume of liabilities enabling losses to be absorbed should it be necessary. That is to say, they shall have debt instruments at hand that may be converted into capital if they experience problems of viability.

These requirements will likely prove a binding restriction for some financial institutions. The issuance of these instruments may pose a challenge, especially for unlisted banks with little experience in the issuance of convertible instruments or of subordinated debt. This concerns a quite substantial segment of the European banking sector. Consider that almost 70% of banks supervised by the SSM have not issued listed shares, 59% have not issued convertible bonds and 18% do not have subordinated debt on their balance sheets (see Chart 5).

Many of these banks will foreseeably have to make adjustments to their business model, to align it to the change in size and composition of bank balance sheets required under the new regulations.

Chart 5



SOURCE: Banco de España

3 Possible responses by the banking sector

Macroeconomic and regulatory developments support the increasingly widespread perception that there is excess capacity in the European banking industry that will heighten competition and jeopardise the viability of those institutions least able to adapt to the new environment.

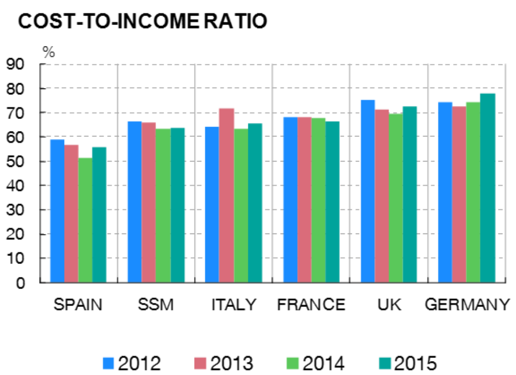
3.1 Efficiency

Naturally, credit institutions' first line of defence is to gain in efficiency. In recent years, as observed in Chart 6, cost-to-income ratios across the European industry have not appreciably improved in the different banking systems and they remain significantly heterogeneous. That suggests there is considerable room for improvement.

Spanish banks, for their part, are in a relatively good position compared with their European counterparts, with a relatively high and growing degree of efficiency. In any event, it is also true that office density, despite falling in recent years, remains high, especially when compared with that of other European countries (see Chart 7).

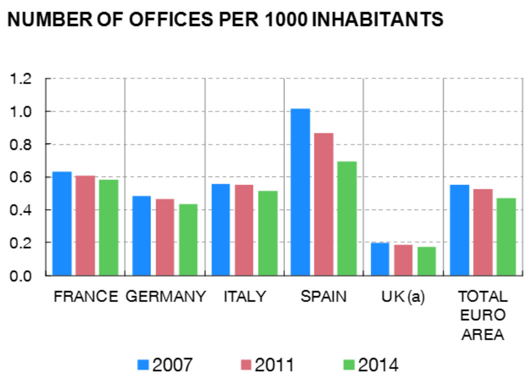
In this area, new technological developments should allow further gains in efficiency by providing for proximity to customers and for the marketing of products via means other than face-to-face contact.

Chart 6



SOURCE: SNL (significant institutions on which data are available each year; In the case of UK, the 5 biggest banks, in terms of total assets).

Chart 7



SOURCES: ECB (*Structural Indicators*) and World Bank.

a. Latest figures: 2013.

3.2 New products and services

The second foreseeable response by the industry to the narrowing of financial margins is the search for income supplementing that from the traditional commercial banking business.

Net fee income relating to services (management or transactional), as a proportion of total operating income, has been on a slightly rising trend in most countries. In the current setting, it appears this trend is reflecting a lesser propensity of banks to subsidise certain transactional services with a charge to net interest income.

That said, fee-generating business is subject to growing competition owing to the emergence of new unlicensed bank competitors, which have demonstrated ample ability to harness the new technologies (the so-called fintech companies). These new competitors specialise in specific segments of the services value chain, services that in the past were exclusively provided by banks, without being subject to banking regulation requirements.

Unquestionably, this scenario of new technologies and new emerging competitors poses a challenge to the traditional banking business. However, technical progress is also an opportunity for the more dynamic banks to generate efficiency and to extend the services provided to their customers.

For instance, banks are proving very adept at developing instant payment services. And some of them might be well-positioned to develop direct lending facilities (P2P) competing with the new non-bank operators (e.g. crowdfunding). Banks retain advantages in terms of experience, market roots and the ability to offer a full range of transactional and intermediation services which should help them face competition which, nonetheless, will be increasingly intense.

In our capacity as regulators and supervisors, we should seek to strike a balance between facilitating technical progress, supporting the development of new products and services, and properly safeguarding customers and financial stability.

3.3 Consolidation

Finally, orderly correction of the excess capacity in the banking industry will foreseeably require greater consolidation in the sector. I spoke to you about this exactly a year ago in this same forum and I believe that since then the view that such a process is becoming increasingly likely has become widespread.

Ideally, consolidation should take place at the European level, in order to overcome the strictly domestic vocation of the overwhelming majority of banks. The existence of more banks with a pan-European outlook would amount to a private national risk pooling mechanism that would help weaken the link between the macroeconomic risks existing in each country and the stability of its banking system, adding robustness to the monetary and banking union.

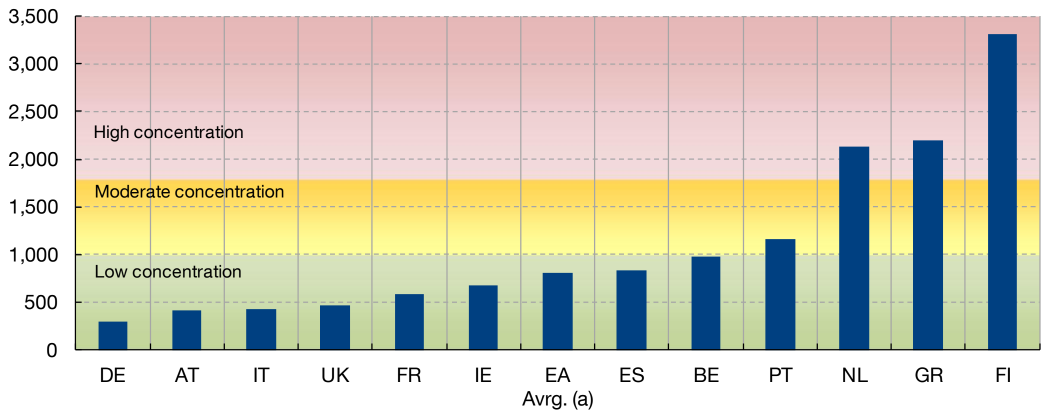
It is therefore important to identify and attempt to eliminate those obstacles that continue to hinder such banking consolidation in Europe, in spite of the establishment of the banking union. In particular, we must consider whether regulation and supervisory practices tend to unduly penalise geographical diversification of a bank’s business.

It would also be desirable to ascertain whether the current structure of the industry in various countries, characterised by the existence of numerous banks that are not listed public companies and that maintain strong links with national business sectors, hampers the participation of foreign competitors, whether directly or through acquisitions.

All told, in the short or medium term it is likely that the need to continue reducing costs will encourage bank mergers and acquisitions within each country in order to harness potential economies of scale. In the largest European countries, there would seem to be room for more consolidation. In fact, in many countries the level of concentration in the industry, as measured by the Herfindahl-Hirschman index, is below that which might be considered to pose a possible threat to competition (see Chart 8).

Chart 8

CONCENTRATION INDEX
December 2014



SOURCE: ECB (*Structural Indicators*).

a. The euro area average is calculated as the average of the Herfindahl-Hirschman indices for each of the euro area countries, weighted by their total assets.

Accordingly, the European banking industry is facing important challenges arising from the new macroeconomic environment, which is not conducive to income generation, and from regulatory reform which, in order to protect financial stability, is introducing new rules and safeguards that restrict the risk transformation business.

As a result, there is a need for banks to adapt their business models and corporate strategies, and this will undoubtedly affect the structure of the sector.

The role of the supervisor is not, generally, to impose specific strategic action, which should be determined by the banks themselves. Rather it is a matter of facilitating the process maintaining the required supervisory standards and, thereby, offering incentives so that the right decisions are made at the right time and in an orderly fashion, always for the benefit of the shareholders, which almost always contributes to the sector's stability.

Allow me to conclude by briefly mentioning the banking union.

4 The Single Supervisory Mechanism

The supervisory framework in Europe has been significantly strengthened by the setting up of the Single Supervisory Mechanism (SSM). Barely a year and a half after it started to function, it has succeeded in putting into operation a supervisory model consistent with the most demanding standards. As the result of the action taken following the analysis of the banking sector conducted in 2014, the SSM has led to an appreciable increase in the sector's capital and has prompted the most vulnerable banks to start cleaning up their balance sheets.

The SSM has also shown itself capable of participating effectively in the resolution of crisis episodes, like the one involving Greek banks.

Moreover, the SSM has managed to eliminate many of the national regulatory particularities, has created a common methodology for the supervisory review of all banks and has made significant progress in harmonising inspection practices by drafting and developing a manual of common procedures.

At the operational level, in record time, joint supervisory teams have been put in place for each significant institution and an ambitious programme of on-site inspections has been developed. All these actions have been carried out within a framework of cooperation between national authorities and the European Central Bank which is, generally, functioning appropriately. Naturally, the fact that almost 100 employees of the Banco de España have been recruited to the ECB's supervisory arm, making it the national authority that the ECB has most relied on to cover its supervisory staff requirements, is something to be proud of, although it is also an organisational challenge.

Given the complexity of the project, which includes coordinating the staff of 19 national supervisors plus the ECB, and the short time that the SSM has existed, there is obviously still room for improvement. That said, there is also palpable determination on the part of those responsible for the SSM and its Supervisory Board (on which we participate) to continuously review the arrangements and processes used in order to promote its improvement when needed, counting on the conscientious contribution of all supervisory staff.

In sum, as a national supervisory authority, we can only congratulate ourselves on the impetus the banking union is giving to the institutional strengthening of the euro area and on its role in preserving financial stability. We also positively value our contribution (through our staff and experience) to the effective operation of the SSM and ongoing improvement in its procedures and supervisory arrangements.