BANCO DE ESPAÑA
Eurosistema

22.02.2019

Banking Union: the challenge of going digital and being regulated

Presentation of the PwC report

Pablo Hernandez de Cos
Governor

Let me begin by thanking PwC for their kind invitation to participate in this presentation of the Sixth Report on Banking Union.

In recent years these reports have provided us with a detailed analysis of the challenges facing the Spanish financial sector as a result of having to adapt to regulatory changes and to the new institutional arrangements of Banking Union.

And this against a background of far-reaching technological change, which has seen the emergence of new players (such as the fintech and the technological giants, the so-called bigtech*)*. These agents are altering the competitive framework in some of the traditional business segments of banks.

As on previous occasions, this year's report is very complete and analyses key questions on new issues relating to regulation, to banking activity and to the environment banks face.

Allow me to focus on two specific issues: the tasks outstanding regarding Banking Union and the technological challenge from a regulatory standpoint.

These two issues are, moreover, interrelated. To successfully address the transformation imposed by the new competitive environment resulting from technological changes will probably require harnessing the opportunities of scale and specialisation that the integration of European financial markets offers. But to enable this process of integration it will be necessary first to remove the obstacles that continue today to block the way to the creation of Banking Union and the full Capital Markets Union.

The (scant) risk-sharing channels in the Economic and Monetary Union

Completing Banking Union and developing the European Capital Markets Union are, moreover, key objectives for securing the appropriate and stable functioning of the European Economic and Monetary Union (EMU). Comparing the workings of EMU and of the United States, in terms of the mechanisms each have in place to cushion the impact of shocks affecting a single country or State, illustrates clearly how far we still have to go.

Indeed, the empirical evidence suggests that, in the United States, around 70-80% of the impact of shocks affecting a particular State is distributed among the other States.

In this case the main risk-diversification channel is through the workings of the capital markets. Hence, the cross-border ownership of capital allows around 40% of the asymmetric shocks within the United States to be shared.

The credit channel, which operates through the granting of credit by non-resident institutions to resident agents, enables around a further 20% of asymmetric shocks in the United States to be shared.

Conversely, in the euro area, around 70% of the financing received by households and firms is mediated by the banking sector, while only the remaining 30% is obtained on capital markets. This is practically the opposite of the United States, and reveals how the financing of the economy depends on the banking sector in Europe. As a result, capital markets in the euro area absorb 10% of shocks, and the credit channel around 34%.

Yet irrespective of the different composition of the risk-diversification channels, what needs highlighting is that in the euro area the combined power of all the private risk-sharing channels is much more limited than in more stable monetary unions. Given that the role of the public sector is also virtually non-existent in Europe's case, the outcome is that more than 56% of the effect of shocks – as opposed to 28% in the United States – is not shared.

Moreover, it is important to note that during the most acute phase of the last financial crisis, the main risk-sharing channel in the euro area – the credit channel – virtually disappeared, owing to the process of renationalisation of bank loans. This was due to the climate of mistrust about banks' financial health, and to the existence of negative feedback loops between public finances and banking solvency.

To sum up, in the euro area our risk-sharing channels are weaker and, what is more, they tend to contract precisely when they are most needed.

The limited strength of private risk-sharing channels in the euro area reflects both the underdevelopment of capital markets and a highly segmented banking system at the national level.

There are practically no banks with a pan-European strategy, and there is little progress in cross-border lending, especially in the retail markets, or in other words, in lending to households and firms.

Today, the euro area's banks continue to grant more than 90% of credit to firms resident in the same country, with only 5% going to firms in other euro area countries. In the case of loans to households, the bias is even greater.

Expanding this foreign activity is essential for the sound working of the euro area. In this respect, there is still a long way to go before we achieve a pan-European banking system and a more complete Banking Union.

The need to complete Banking Union

Since Banking Union was launched in 2012, substantial institutional progress has been made towards the creation of a new common supervisory and resolution framework. The aim has been to restore lost confidence and ensure protection for depositors, irrespective of their nationality. The first pillar of Banking Union – the Single Supervisory Mechanism (SSM) – has indeed been completed. Today, the European Central Bank (ECB) directly supervises significant credit institutions, which account for almost 82% of all banking assets in the euro area.

Progress has also been made in the case of the second pillar, with the creation of the Single Resolution Mechanism (SRM). The SRM establishes uniform resolution criteria according to the principle of the lowest possible cost to the taxpayer.

However, for completion of the Banking Union important institutional challenges remain. First, the **creation of a common financial backstop for the Single Resolution Fund** (SRF), to ensure that it has sufficient resources to withstand future banking crises without destabilising the public finances of the countries concerned.

In this respect, an agreement was reached at the Euro Summit in December 2018 to establish a common financial backstop for the SRF. This took the form of a credit line provided by the European Stability Mechanism, to be repaid by the banking system itself through its future contributions. The launch of this financial backstop, currently scheduled for 2024, could be brought forward to 2020 if it is considered that sufficient progress has been made to reduce banking risk.

Here it is important to note that the percentage of bad loans on euro area banks' balance sheets has fallen notably in recent years, down to close to 4% of all loans, albeit still somewhat above the pre-crisis level. Likewise, banks' capitalisation levels have improved substantially; the total capital ratio for euro area banks overall now stands at 18%.

A further key aspect for completion of the design of the euro area is the **creation of the common European Deposit Insurance Scheme**; this would be the third pillar of Banking Union.

In my view, it is difficult to believe that, without this third pillar, the first two will be able to guarantee in a credible manner the same level of protection for all depositors across the euro area, irrespective of where they are located. Sufficient confidence to mitigate the risk of large-scale bank runs and the consequent financial fragmentation in severe crisis situations would thus fail to be generated.

A recent paper published by the ECB shows that a relatively small common deposit insurance fund – 0.8% of deposits covered – could suffice to withstand severe crisis situations such as that experienced between 2007 and 2009.

Moreover, the existence of contributions – tailored to the risk profile of each bank – to a European common deposit insurance fund could ensure that there was no systematic cross-subsidisation between countries. They could, at the same time, guarantee that appropriate treatment was given to risks associated with sovereign debt holdings on banks' balance sheets.

In short, this third pillar would contribute to financial stability and would solve the problem of asymmetry that common supervision entails compared with the national banking systems' ultimate responsibility for deposit insurance.

None of the above necessarily means that any losses stemming from decisions taken prior to the launch of the SSM in 2014 will have to be shared. But if there is to be mutual trust, Europe's leaders should decide to take joint responsibility for the banking risks assumed since single supervision came into force. Hence the importance of the measures taken by credit institutions to reduce their impaired asset volume, in addition to the direct positive impact of such measures on their profitability and efficiency.

Towards pan-European banking

It is essential that the public and institutional aspects of Banking Union are completed. However, to secure more stability for the euro area, it is also necessary to strengthen the private risk-mitigation and risk-sharing mechanisms I mentioned earlier. To do this, on the banking side, it is important to **eliminate national barriers to European banking integration**.

Despite the challenges faced in recent years, with the emergence of new competitors and low levels of profitability, many European countries' banking systems remain oversized and still have surplus capacity. In addition, international consolidation processes have been few and far between, and this pattern has not changed since the launch of Banking Union.

This situation contrasts, once again, with the consolidation process in the United States following the removal of certain regulatory hurdles that restricted mergers and acquisitions between banks from different US States. In comparison, here in Europe barriers preventing a truly pan-European bank persist, especially in the retail business segment.

These barriers are both explicit – different national regulations – and implicit. Thus, the use of directives that provide for national exceptions and specificities have not been sufficient to harmonise and standardise European banking regulations.

Moreover, these regulations do not fully acknowledge the advantages of geographical diversification of banking activity.

Also, in some European countries, there are still broad segments of the banking industry that are either fully State-owned or are sheltered from competition by means of specific regulatory treatment. They thus have fewer incentives to search for more profitable business options.

Removing all these obstacles is essential to achieve greater risk diversification through the creation of cross-border banks. That would increase the capacity for stabilisation in the face of turmoil and would, at the same time, weaken the link between sovereign and banking risk.

Regulatory challenges in the new technology environment

Following these thoughts on the recent development of and future prospects for Banking Union, and its consequences for the financial system and financial stability, I shall devote the last part of my address to highlighting a number of regulatory challenges emerging in the financial sector's new technology environment, in which new players, technologies and services have appeared.

The digital transformation process is characterised by its high technology component, with applications that are accessible to society at large, and by the speed at which innovations are introduced.

In this setting, it is no surprise that banking intermediation, which largely depends on exploiting information asymmetries, has viewed this revolution with a mixture of concern and interest. Concern because of the difficulties involved in adapting to the new environment and competing with the new market players (especially bigtech*,* which I mentioned earlier). Interest, because of the possibilities it offers to achieve synergies, improve the range of services on offer and secure efficiency gains in numerous internal processes.

First, digital transformation offers significant potential advantages to companies, be it thanks to efficiency gains, progress in financial inclusion levels or the possibility for different intermediaries to better meet each customer's needs.

However, as in any other transformation process, there are also new and important challenges to be addressed. Accordingly, the regulator should review and adapt the rules already in place; the aim must be to remove obstacles limiting the advantages to be had and, at the same time, to mitigate any risks that the new environment may generate.

From the regulator's standpoint, it is important, first, to **maintain a level playing field**, which basically entails putting into practice the well-known maxim: "same risks, same requirements".

However, this has not proved easy, as a great many of the regulations in place have a sectorial approach. In addition, certain activities are subject to special regulations, because of the possible implications, for instance, for financial stability. This is the case of deposit-taking, which leads to banks being subject to strict criteria that shape their activity overall, while other intermediaries that offer similar services, but not deposit-taking, are free from such requirements.

Turning to the **promotion of innovation**, in such a global, competitive and dynamic environment some flexibility in the stages at which ideas are tried out is required. Here, the proportionate application of regulations, within the permitted margins, or the creation of controlled test spaces, known as sandboxes, appear to be suitable measures for promoting innovative projects that seek to harness the potential of new technologies in the financial sector.

Further, it is worth paying attention to how this transition process unfolds. As I stated earlier, our starting point in Spain – and largely in the rest of Europe – is that of a heavily banked society. But, further to digital transformation, significant changes are afoot in the business models of traditional institutions, and in the role that other agents from different sectors play, in relation to the provision of financial services.

As regulators, we should **seek to ensure this transition is orderly,** maintaining at least the existing levels of stability and the safeguards set in place following the financial crisis.

In this respect, if anything characterises the new scenario, it is the growing importance of data as the source of a competitive edge. Technological development has given rise to an unprecedented transformation in the capacity to capture, store, process and analyse information.

Unquestionably, this is one of the basic reasons it was decided to liberalise the exchange of certain pieces of financial information in Europe. And it is also why other jurisdictions (Australia, for example) appear to be following the example.

It is in this new competitive context, where data on payment transactions circulate more readily, that it is important for banks to take the necessary steps to **ensure the security and privacy of the information** that is shared.

Also, aspects such as data governance, differentiated treatment in terms of their nature and defining where individual data end and where those processed by banks begin are all issues that need to be resolved. Indeed, a far-reaching debate looks likely.

In any event, in the European Union this debate should not be tackled in a fragmented fashion, with national-based differences. It should be one of the issues at the heart of the agenda for the forthcoming European Commission meeting.

It would be remiss of me not to discuss, albeit briefly, the importance of cybersecurity in this new digital environment. Ultimate responsibility for managing this increasingly significant risk should fall on financial sector participants themselves, including central banks, who play a key role in the management of many market infrastructures. Yet in such an interconnected and interdependent sector, the authorities must develop an appropriate framework geared both to reducing the incidence of cybernetic attacks and to increasing resilience in the face of such attacks. Here, moreover, the principles of proportionality and graduality applied when managing other types of risks do not prevail; any link in the chain, no matter how small it is, may act as a gateway for a cybernetic attack that compromises the security of the entire system.

Lastly, I should like to discuss an aspect which, I believe, will be pivotal in future discussions among financial authorities: **coordination among the different regulators**.

As I mentioned, one of the strategic elements of digital transformation is the management of information. But the discussion goes beyond financial data and may also affect other sectors. Moreover, digital transformation enables the supply of financial services to be extended, accommodating them to the individual needs of consumers, who see their choices and decision-making capacity increase.

This means that aspects such as the privacy or protection of information, transparency towards consumers (so they may take informed decisions) and the effective level of competition between providers of specific technological services (take, for example, the use of the cloud) all gain in importance.

However, these matters lie outside the typical remit of financial supervisors and thus make it necessary to promote a collaborative climate and more intense cross-disciplinary dialogue.

Conclusions

By way of conclusion, I would assert that twenty years after the creation of the euro, major headway has been made in equipping EMU with greater stability.

However, the architecture of EMU remains incomplete: there is a pressing need to complete Banking Union and make headway on the Capital Markets Union. To do this, we must push through key aspects such as the common European deposit insurance scheme, and deepen financial integration. The internationalisation of the banking business would help bring about greater diversification, weakening thereby the link between sovereign and banking risk.

Further, harnessing synergies and economies of scale may contribute to improving profitability. That would provide for the investment needed to enable the ongoing adaptation to the change wrought by the digitalisation of the banking business. Digitalisation promises major benefits, both for consumers (in the form of better and tailored services) and for those financial institutions able to seize this opportunity. Our role as supervisors lies in ensuring a safe and stable transition for the good of all citizens.

Thank you.