EBA EUROPEAN BANKING AUTHORITY

7th FMA Supervisory Conference - Vienna, 5th October 2016

Financial Markets 2.0 – R (evolution): Rebooting the European banking sector

Andrea Enria, Chairperson of the EBA

The title chosen by the organisers for today's conference - Financial Markets 2.0 - R(evolution) - captures the challenge facing the financial sector both in the European Union and globally. The financial system has still to finish a complete reboot after the crisis. Business models and market structures have to change in order to respond to unprecedented challenges generated by far-reaching regulatory reforms, a protracted low interest rate environment and rapid technological changes. Will this be an evolutionary process or more of a revolutionary break? Let me give you my response upfront. If the incumbents - in the EU, in particular, the banking sector - show their willingness and ability to embrace change, to see it as an opportunity to generate value for their shareholders and customers, we will face a manageable evolutionary process. If, on the contrary, banks drag their heels and resist change, we will likely witness disruptions of the present order and the emergence of new players.

At the moment, signals are mixed. Many banks have taken courageous steps to revise their business models, deal with legacy assets, invest in new technologies and recover efficiency and profitability. But many are still delaying the adjustment, lobbying for a relaxation of the new rules, criticising central banks for the low interest rate environment, and calling for regulatory protections from new entrants in the market.

This is not a challenge only for the financial industry. Policy makers will have to take side as well. Fostering change or protecting the status quo. And I see hesitation also in our camp, in the European supervisory community. There are concerns that tough regulatory reforms and high pressure on the banking sector to strengthen its balance sheet and deal with legacy assets could adversely affect lending activity, while alternative channels for financing corporates and households are far from being fully developed. Also, there is a tension between the European and the national dimension, as common responses are needed to foster a truly integrated financial market, but the problems we are facing today are affecting national industries in a very different way.

In my remarks today I will focus mainly on the issue of legacy assets, the very large amount of non-performing loans that still clog the bank lending channel and hamper banks' profitability. This is because I think that we won't be able to build the financial sector of the future until we have effectively dealt with the problems we inherited from the past. But I will also focus on the related issue of low profitability and excess capacity in the EU banking sector, which are major forces for change. Finally, I will provide some reflections on the challenges coming from new technologies and potential entrants in the provision of payments and financial services.

Repairing bank balance sheets: an unfinished business

The process of bank balance sheet repair has been long and protracted in the EU. Too long and too protracted. We are moving in the right direction, but the job is not finished yet.

The first step in repairing banks' balance sheets after a crisis is strengthening their capital position. This is a precondition for tackling legacy assets. This step is broadly accomplished. The EBA has coordinated a successful effort by European supervisors to significantly increase the quantity and improve the quality of capital at EU banks. Common equity tier 1 (CET1) capital ratios have risen from around 9%, when the EBA started working in 2011, to over 13.5% today. The levels achieved are in line with those in other major jurisdictions and although the average may mask areas where more efforts are needed, we are broadly satisfied with the progress made.

The second step is an in-depth assessment of the quality of bank assets. A wide ranging asset quality review was conducted in 2014, when the Banking Union started in 19 Member States of the Union. Other country specific exercises have been put forward since then and, more generally, the review of asset quality has been a key focus of regular supervisory assessments in recent years. A common definition of non performing and forborne loans developed by the EBA was an essential ingredient in this process.

The third, final step is balance sheet cleaning. This step entails enhanced provisioning for non-performing loans, which enables banks to write them off or sell them at market prices. Although also in this area progress has been made, the improvements are still slow and uneven across banks and countries. The average ratio of non-performing to total loans (NPL ratio) is 5.5% in the EU, down from more than 7% three years ago. Still, according to the IMF the ratio remains three times higher than in other major jurisdictions, such as the United States. Also, average figures hide a significant dispersion. For large EU banks, the NPL ratio is below 4%; for smaller banks it is almost 25%. The problem is also unevenly distributed across countries, with 10 Member States showing an average ratio above 10%. This notwithstanding, the problem is European in scale: we have more than 1 trillion euros of gross non-performing loans in the system; even considering provisions, the stock of uncovered non-performing loans is at almost 600 billion - more than all the capital banks raised since 2011, more than six times the annual profits of the EU banking sector, more than twice the flow of new loans. This implies that the lending channel is impaired and monetary policy is forced to move into uncharted territories to ensure that the additional liquidity effectively stimulates economic activity.

Why does it matter?

Some might argue that the problem is not that relevant, as the EBA stress test showed that even under a severe adverse shock European banks would still be able to absorb a significant amount of losses and respect minimum capital requirements. But this neglects the close link between asset quality and profitability, and between asset quality and lending. All our analyses, supported by similar research conducted by the IMF and other international organisations, show that a high level of non-performing loans is strongly correlated with low profitability and feeble lending growth.

For supervisors, this casts serious doubts on the long term viability of significant segments of the banking system. The same concern is shared by investors and is reflected in the low valuations registered in stock markets.

At a more general level, non-performing loans trap capital that could - and should - be used to support new initiatives with a higher net present value. It means that financial resources are not being put to their most efficient use, with an adverse effect on growth and job creation.

Finally, there is an element of potential detriment for consumers of financial services, as borrowers strive to pay interest and fees to retain assets they may eventually end up losing.

In search of a solution

There is no easy shortcut to asset quality problems. It is sometimes suggested that supervisors should force banks to write off or dispose non-performing loans in a very short period of time. This neglects the lack of a deep and liquid secondary market for impaired assets and the remaining structural impediments that widen the gap between bid and ask prices. In such conditions, a forced resolution of non-performing loans would risk being disruptive, especially in the absence of a public safety net.

In order to facilitate an orderly approach to addressing the asset quality problem we need policy action along three lines:

- first, supervisory pressure to an active management and disposal of non-performing loans has to be stepped up; banks must raise provisioning coverage, improve their arrears management systems, and accept the short term pain that is unavoidably linked with the removal of non-performing loans from the balance sheet;

- second, overburdened and slow legal systems and judiciary procedures need to be reformed to ensure faster and more efficient recovery processes, or alternatives should be sought such as greater reliance on out-of-court procedures;

- third, initiatives have to be put in place to support the development of a deep, well-functioning and transparent secondary market for impaired assets.

While significant steps forward have been made in the first area, progress is more uneven in addressing structural impediments to the recovery process and much more limited improvements can be registered in the establishment of well functioning secondary markets. At the current juncture, and just when we are pursuing the ideal of a capital markets union, it worries me that secondary markets for impaired assets are fragmented, often small, heterogeneous and opaque.

If we look at success stories in the disposal of non-performing assets, the official sector has often taken a leading role. In several cases, this has involved governments or special purpose entities sponsored by public authorities directly taking over impaired assets or supporting, with guarantees, their sale to private investors. But an official involvement has been indispensable also to facilitate the price discovery process in private solutions.

There are a number of initiatives that should be considered. A first step is simply improving the quality and quantity of data available to investors, possibly also developing a common approach to collateral valuation. An additional, important contribution would address issues around servicing: banks' "in house" servicing standards leave a lot to be desired and significant improvements could be achieved by having high quality, efficient third party servicers available. To truly address the fragmentation and opaqueness of the NPL market we should also consider establishing either a single EU platform or a EU network of national platforms where banks and investors can market non-performing loans, based on consistent data and harmonised standards for sellers and buyers. Some thinking should be devoted also to greater standardisation of instruments and contracts, overcoming the plethora of different national restrictions on purchasers which today make it very expensive for new entrants to understand local markets.

The most difficult question is whether to attain the necessary momentum in the secondary markets for non-performing loans we should consider public sponsored asset management companies acting as direct intermediaries. This is difficult terrain since such solutions often entail some elements of government support in the determination of prices for the transfer of impaired assets. In an underdeveloped and illiquid market, prices are not necessarily informative and can possibly be misleading: as the market takes off and the number of transactions increases, prices improve and better reflect underlying value. Some form of public support could be justified to address a first mover disadvantage - i.e., no bank will want to sell first if prices only improve later - and an inter-temporal clearing problem. For instance, government capital could be leveraged to kick start this process, paying a fair price accompanied by claw backs to recoup any money from banks if eventually the expected price improvement does not materialise. Still, any form of government support would have to respect the rules set out in the Bank Recovery and Resolution Directive (BRRD) and in the EU framework for State Aid. The rules entail that in case extraordinary public support is required, banks are deemed to be failing or likely to fail and have to be liquidated or resolved, while shareholders and creditors bear a significant reduction in the value of their claims. The BRRD also introduces some exceptions to this general principle in case of serious disturbances to the economy. Developing common European blueprints for the use of government guarantees in securitisation on non-performing loans or of government sponsored asset management companies could provide a significant contribution to accelerating the process of repair in banks' balance sheets.

Low profitability and the challenge to existing business models

While addressing asset quality issues is a key priority, it is by no means the only challenge facing the European banking sector. The scale of the task ahead is well captured by the low current profitability, as reflected in the low level of the return on equity (ROE), and in the negative expectations on future profitability, captured by the low equity market valuations.

The average ROE of the largest EU banks was at 6.7% in June 2016. At the same date, the average cost of equity, calculated with the capital asset pricing model (CAPM), was at 9.7%. While profitability has steadily improved since the peak of the crisis, the European banking sector is still far from recovering its ability to generate positive risk adjusted yields for investors and sustain organic capital growth. The price-to-book ratio for listed European banks is on average around 82%, with several banks below 50%, testifying the lack of confidence in a prompt recovery amongst investors.

Also in this case, average data conceal a wide dispersion. In 14 Member States, predominantly in Central and Eastern Europe and in Nordic countries, the average RoE is above 10%. This shows that even if it is fair to acknowledge that regulatory reforms and the low interest rate environment are putting pressure on banks' profits, it is possible to achieve decent returns even under the present adverse conditions.

From a structural, long term perspective, these data raise important questions. Are current business models sustainable in the long term? If not, what should be done by banks and regulators? Is there excess capacity in the system? If so, what can be done to eliminate it?

First, I would like to stress that dealing with the legacy of the crisis and being able to turn the page should remain the most important priority. Non-performing assets and remaining litigations arising from cases of misconduct are casting a shadow on several banks' ability to recover adequate profitability in the near future. I have already discussed the issue of non-performing loans at length. Recent analysts' estimates put the potential incremental litigation risk for EU banks at almost $ 80 bln, in excess of existing reserves. In the EBA stress tests, loan losses and operational losses from conduct events were major drivers of the impact on participating banks' capital. I note that the ranking of banks in the stress test has an almost one-to-one matching with the ranking of banks in terms of price-to-book ratios. This shows that dealing decisively with the legacy of the crisis is a necessary element in re-establishing a viable business, also in the eyes of investors.

More generally, business models have to be reviewed and adjusted to the new market realities. Banks that have been more proactive in refocusing their business, selling non-core activities and recovering cost efficiency, have been rewarded by investors. As net interest income and trading income have entered a steadily declining trend, costs have not shown a similar downward flexibility: the cost-to-income ratio increased from 55.2% at the start of the crisis to 62.7% today. Also, while some banks have anticipated the adjustments requested by regulatory reforms, developing plans and taking action already at the time of official announcements, other have waited for the actual implementation of the new rules, in the hope that there would have been some reconsideration by regulators. This also has generated some delays in the adjustment of business models. Supervisors are now putting more and more attention to the analysis of business model viability, which features as a key component of Pillar 2 assessments in the EBA's Guidelines on the Supervisory Review and Evaluation Process (SREP).

From the point of view of market structures, the banking sector has not experienced a major downsizing as a result of the crisis. If we consider the typical trajectory of other industries affected by major global crises, the adjustment always entails the elimination of the excess capacity built in the run up to the crisis via exit from the market of the weakest players, in-depth restructuring and reduction of balance sheet size, plants and jobs by the survivors, often accompanied by some consolidation. In the European banking sector there has been a fairly limited number of exits from the market compared to other jurisdictions such as the United States; the aggregate balance sheet has only marginally contracted; consolidation has occurred only at the national level, as even in cases in which the restructuring of the banking sector has been financed by European programmes under the European Financial Stability Fund (EFSF) – now the European Stability Mechanism (ESM) – the bank restructuring process has been managed by national authorities. Instead, a massive move has occurred towards the repatriation of business and the curtailing of cross-border banking, which has led to a fragmentation of the Single Market – not what I would define as an efficiency-enhancing change. Looking forward, the Banking Union and the new legislative framework for managing bank crises should lead to a more integrated approach, less prone to bail-outs. But during the transition, we still have to address the delays in the restructuring process in some segments of the European banking sector.

Technological change: new opportunities, and new risks

Another major driver for change is technology. New players, often technology firms with little or no previous experience in financial services, are investing massively in new channels for the provision of traditional banking products, such as payments services or lending activities. “FinTech” firms are potential agents of a new disruption of banks’ business models, as they can erode rents and unbundle cross-subsidies in banks’ balance sheets. Enhanced competition is widely expected to benefit consumers of financial services.

The banks’ franchise has been based, to a large extent, on their ability to borrow cheaply, which mainly relied on the explicit and implicit government guarantees, and on their access to private hard data (e.g., payment transaction data) and soft information (e.g., business plans) on a wide range of customers; both elements granted them privileged access to a stable customer base, whom could be sold a wide range of products. The withdrawal of implicit government guarantees, the broader availability of personal data from a variety of external sources (“big data”), the regulatory constraints aimed at limiting the banks’ ability to exploit their powers vis-à-vis captive retail customers, are all developments eroding the competitive advantages of banks. Even the informational advantage coming from exclusive access to customers’ payments accounts will soon be challenged, as starting in January 2018 the revised Payments Services Directive (PSD2) will allow non-bank, third party providers (Payment Initiation Services and Account Information Services Providers) to access customer data directly in bank accounts.

Banks are trying to fend off the competition from FinTechs, sometimes also invoking an extension of regulatory requirements to new entrants. It is often argued that regulation should shift its focus from institutions to functions, so as to allow a true level playing field between different institutions competing for the same customers.

But several banks have also developed commercial links with the new players, seeing technological changes as opportunities to review their legacy IT systems, reduce production and distribution costs, enhance their screening and monitoring of customers and provide a new range of services. Others have gone a step further and developed FinTech solutions in house, or are buying external FinTech providers, clearly challenging the view that FinTech is to be seen as a negative disruption on banks’ business.

As regulators, we need to keep a balanced, evidence-based approach, defining our risk appetite in such a way that we safeguard the system without stifling innovation or protecting incumbents. At the EBA we have published a number of Opinions and Discussion Papers that reviewed market developments, identifying possible risks, especially for the consumers, and suggested possible remedies, when we saw a need for public policies. We covered issues such as virtual currencies, crowd funding, innovative uses of consumer data and – together with ESMA and EIOPA – automation in financial advice. The mandates contained in PSD2 are allowing us to further develop the framework on the specific interaction between banks and third party providers in the payments area, for instance in defining standards for strong customer authentication and secure and common communication. IT and cyber-risk are also featuring with high prominence in our work programme.

More generally, I believe we will need to start a debate on the definition of banking. We are still relying to a large extent on the regulatory concepts developed in the Second Banking Co-ordination Directive of 1988, which defined banks as the only entities allowed to combine deposit taking with lending business, and enabled to conduct any other financial activity contained in a fairly broad list. Lighter rules applied to entities not engaged in deposit taking and conducting only one or few activities from the list. This approach had a fairly diverse implementation across the Union, also in terms of the perimeter for consolidated supervision, and requires a thorough review in light of technological and financial innovation.

Conclusions

When I took up my responsibilities as Chairman of the EBA in early 2011, I certainly underestimated the scale of the challenge ahead of me and my newly established authority. It is likely that many bank managers that took the helm at their firms in recent years share the same feeling. We are busy building our new house, while a storm is still raging. And I understand that sometimes we could be tempted to stop our work and wait for sunnier days. But this would not be the right attitude, I believe.

I focused my attention in particular on the issue of legacy assets and changes in business models, as I believe that part of the problems we face today are to be ascribed to resistance to change and to the natural tendency to postpone painful but necessary actions. I would, therefore, like to conclude with a famous quote by Albert Einstein:

"Let's not pretend that things will change if we keep doing the same things. A crisis can be a real blessing to any person, to any nation. For all crises bring progress. Creativity is born from anguish, just like the day is born from the dark night. ... He who overcomes crisis, overcomes himself, without getting overcome. He who blames his failure onto a crisis neglects his own talent and is more interested in problems than in solutions. ... Let us work hard instead. Let us stop, once and for all, the menacing crisis that represents the tragedy of not being willing to overcome it."