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## Post-crisis repair and the profitability malady

Presentation at the Forum Analysis, Milan 17 September 2019

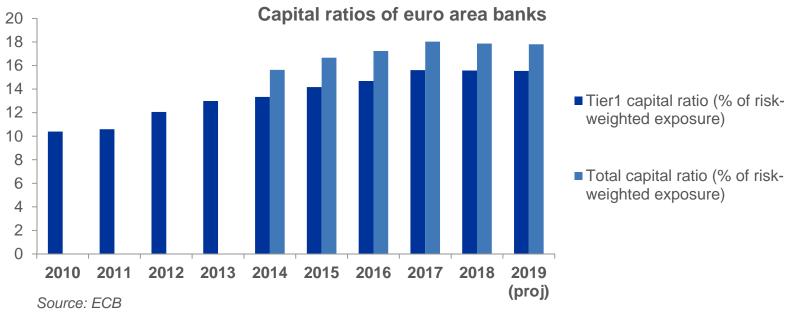
#### **Overview**

- 1 Progress in post-crisis repair
- The profitability malady
- 3 Conclusion

#### 1. Progress in post-crisis repair – raising capital

### Post-crisis treatment worked: banks have become more resilient

- Regulatory reforms ensure that banks hold more and better-quality capital and more liquidity
- European banking supervision levelled the supervisory playing field for all euro area banks – the same high standards are applied everywhere
- Capital requirements and buffers now fairly similar across the euro area, UK and US banks



#### 1. Progress in post-crisis repair – reviewing internal models

### The last step in regulatory reforms: repairing internal models

- The need to restore the credibility and consistency of risk-weighted assets: the EBA's regulatory repair agenda
- Supervising the quality of internal models and the consistency of their outcomes: the ECB's TRIM
- International standards: why we should pursue a faithful implementation of the Basel package
  - Standards are in line with findings of the EBA and the ECB and in most cases reflect European proposals
  - Focus on overall impact may lead to misleading conclusions
  - The output floor: a controversial element of the package
- This is the last step, no further increases in capital requirements

#### Supervisors and regulators have taken big steps

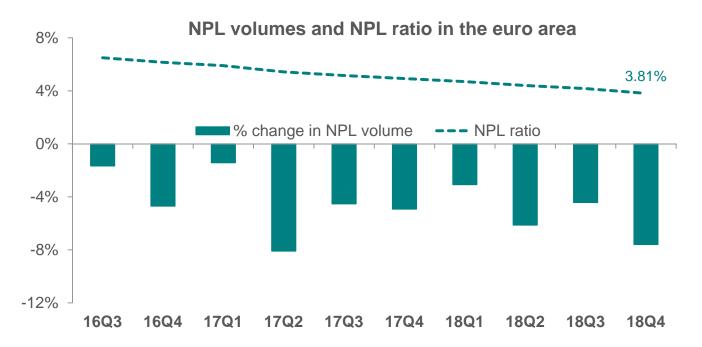
- 1. March 2017: ECB's Guidance to banks on non-performing loans (NPLs) strategies for banks to address stocks of NPLs
- 2. March 2018: Addendum to the ECB's Guidance to banks on NPLs supervisory expectations for the provisioning of new NPLs
- 3. July 2018: ECB's expectations for the provisioning of the stock of non-performing exposures (NPEs)
- **4. April 2019**: The Capital Requirements Regulation (CRR2) introduced a Pillar 1 minimum loss coverage requirement for new NPLs
- **5. August 2019**: Since the revised legislation partially overlapped with the scope of the ECB's expectations for the provisioning of the stock of NPEs, the ECB adjusted its supervisory expectations

## The ECB is also reviewing banks' credit underwriting standards

 While the new EU regulation should prevent the build-up of unprovisioned assets, upholding the highest quality standards when deciding whether to extend credit and how to price it is an essential first step in the process

### Significant progress has been achieved in cleaning up banks' balance sheets

- The supervisory approach developed by the ECB has driven a significant acceleration in the reduction of NPLs
- A liquid and efficient secondary market has been established: sales and securitisations peaked in 2018
- Banks in line with targets, with many overachieving



## There is some evidence that the markets welcome NPL disposals...

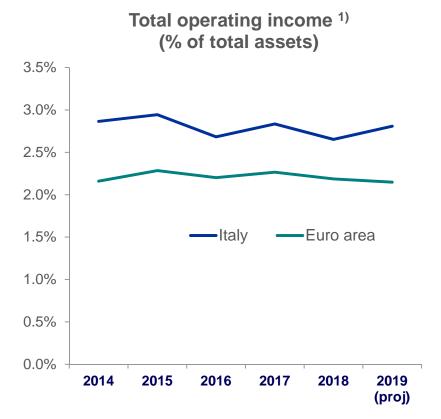
- Banks' share prices react positively to announcements of NPL disposals in some countries with high levels of NPLs\*
  - In particular, market reaction is significantly positive for announcements of NPL disposals under the Italian GACS scheme\*\*
  - The maturity of the national NPL markets and the characteristics of the domestic legal frameworks affect stock prices differently across jurisdictions

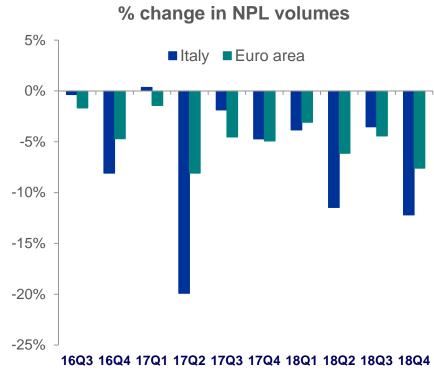
# ...which should help banks transition to higher capital levels and make them better prepared for when the next recession hits

<sup>\*</sup> Source: ECB internal analysis and La Torre, M. et al. (2019), "NPL sales and market reactions: who is left empty-handed?", Bancaria, No 3. \*\* The GACS scheme is a state guarantee that secures the payment obligations of Italian securitisation vehicles (SPVs) in relation to senior translation transactions of NPLs).

## While Italy has already made substantial progress in NPL deleveraging...

Italian banks' profits weathered the NPL disposals fairly well

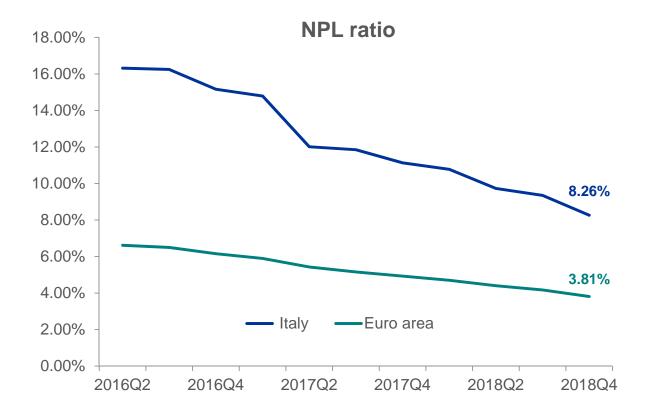




<sup>1)</sup> Before administrative expenses, depreciation and impairments

Source: ECB Banking Supervision - Supervisory data

# ...the problem has not been solved - and we must avoid complacency, as the macroeconomic outlook is deteriorating



Source: ECB Banking Supervision - Supervisory data

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#### 2. The profitability malady – the facts

### Banks are much more resilient, but their profitability remains disappointing: although their profits increased in 2018...

- Core banking revenue (net interest income and net fees and commissions income) at its highest level since 2014, due to an increase in the volume of interest-bearing assets
- Lower impairment flows due to NPL reduction and a favourable economy
- Return on equity (ROE) expected to stabilise after a slight dip in 2019 (banks' projections)

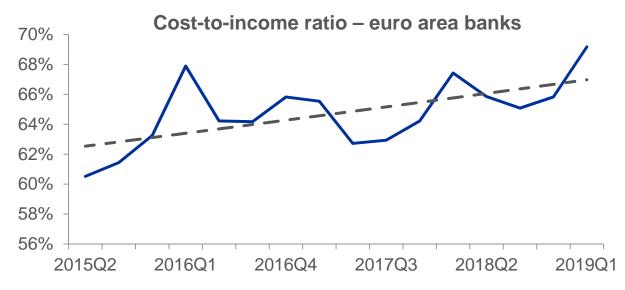
#### Return on equity of euro area banks



#### 2. The profitability malady – the facts

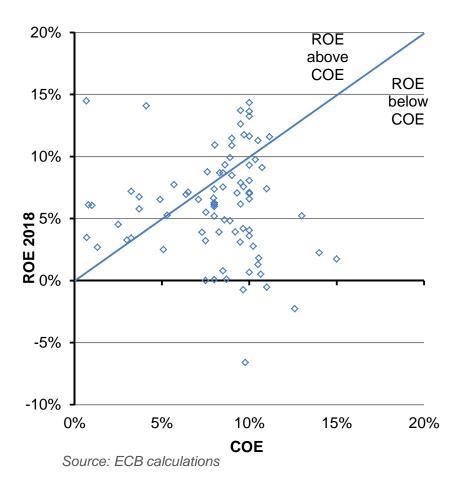
#### ...drivers of profitability reveal a gloomier diagnosis

- Lower impairments were the main driver of higher profits in 2018, but impairments are not expected to decrease much further
- Operating profits decreased
- Trading income and operating income decreased
- Operating costs slightly increased



#### 2. The profitability malady – the facts

#### EU banking sector profitability remains low overall



- Relative to peers:
  - profitability of euro area banks is still lower than that of US or Nordic banks
- Relative to investors' expectations for many banks:
  - ROE < cost of equity (COE)</li>
  - price-to-book ratios < 1</li>

## Are low interest rates and capital requirements the culprits?

- Low interest rates indeed exercise downward pressure on margins, but the positive effect on the macroeconomic outlook helps banks to:
  - keep impairments low
  - dispose of and restructure NPLs
  - increase lending volumes
- International standards are also applied sometimes in a more stringent fashion – in countries where banks have more satisfactory profitability levels
  - if anything, the fact that Europe opted for a long phasing-in period for new requirements is to blame

#### Structural impediments are playing a relevant role

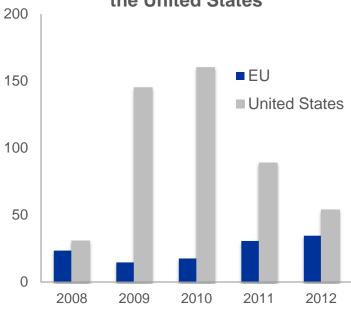
### 1. The market remains fragmented along national lines

- Countries are still ring-fencing liquidity and capital at the national level, preventing cross-border banks from reaping the efficiency benefits of the banking union
- Despite the Single Rulebook, the regulatory framework remains fragmented along national lines

## 2. Excess capacity has not been eliminated since the crisis and consolidation is not taking off

- Compared with other jurisdictions, only a small number of banks exited the market in the euro area
- Mergers and acquisitions (M&As) have not recovered since the crisis, especially crossborder M&As

### Banks resolved in the EU and the United States

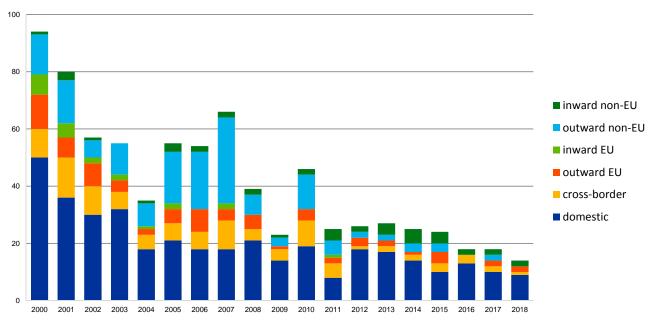


Source: FDIC and Open Economics. Pagano, Marco, et al. *Is Europe Overbanked?*, No. 4. Reports of the Advisory Scientific Committee, European Systemic Risk Board, 2014.

#### Few M&As, almost none cross-border

- The few deals we see are mostly domestic (which is already a step in the right direction) and among smaller institutions
- Differences in retail banking markets and investment banking structures between countries discourage banks from making cross-border deals

#### Bank M&As in the euro area – number of transactions



Source: Dealogic and ECB calculations

#### So what are the remedies?

- 1. Banks should pull the levers under their control:
  - fast restructuring/disposal of NPLs
  - cost efficiency
  - business model viability/strategic steering
  - investment in technology/digitalisation

#### So what are the remedies?

- Legislators and authorities should focus their efforts on removing structural impediments:
  - harmonised administrative liquidation framework should facilitate smooth exits from the market – FDIC model
  - the completion of the banking union, with a European deposit insurance scheme (EDIS), would lessen the need for ring-fencing
  - guarantees and commitments for intragroup support could be incorporated into recovery and resolution plans, thereby creating room for more groupwide management of capital and liquidity within the banking union
  - identify and remove obstacles to cross-border M&As
  - complete the efforts to establish a liquid and efficient market for securitisation, with standard contractual features

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- 1 The profitability malady a history
- 2 Potential remedies the role of NPLs
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#### 3. Conclusion

#### Conclusion

- The EU banking sector has become stronger and post-crisis repairs are now in the final stages, but banks are still suffering from a profitability malady
- The remedy does not lie in slowing down the cleaning up of banks' balance sheets or in watering down key regulatory reforms – this would just make EU banks weaker when the next recession hits
- To restore their profitability, banks should instead concentrate their efforts on cost efficiency, refocusing their business models and digitalisation
- Authorities should deploy a multi-pronged strategy to address the structural issues that are preventing excess capacity in the sector from being addressed and hampering efforts to move towards a truly integrated, single domestic market in the banking union