Outlook for financial stability and business prospects in the European banking sector

EU banks have significantly improved their profitability post crisis. However, a challenging regulatory and monetary climate will put renewed pressures on bank profitability in the coming year.

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Abstract: Europe's banks are approaching year-end offering the highest returns in a decade, albeit still below pre-crisis levels. In 2018, EU financial institutions will face changes, both in the level of regulatory burden, as well as in the monetary policy environment, and will therefore be under renewed pressure to boost their profitability by increasing cost to efficiency ratios, in part by accelerating technological change. On the regulatory front, completion of Banking Union is running up against a set of challenges. And on the monetary front, quantitative easing is set to be gradually rolled back, albeit over an uncertain time horizon. There is also downside risk, particularly in the form of heightened political tensions in some countries (*i.e.,* the situation in Catalonia in Spain). In Spain, the six largest banks by asset volumes reported aggregate net profits of 11.78 billion in the first

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nine months of 2017, year-on-year growth of 11.6%. The return on equity (RoE) offered by Spanish banks is above the Eurozone average and their cost-to-income ratio is among the lowest in the region. As for the risks posed by the situation in Catalonia, it is worth noting that the measures taken by the financial institutions affected have proven an efficient backstop to mitigate risks that were reduced from the onset.

Introduction

The European banking sector is at a crossroads between recovery in the wake of the financial crisis and specification of its business model post-crisis. The strategic approach to the banking business in the years to come will be significantly affected by three factors:

- The regulatory burden implied by the universe of new banking regulations passed since the crisis and which must be largely in place by 2019, according to the schedule agreed in Basel III.
- The possible (but not totally certain) end of the great monetary policy experiment known as quantitative easing.
- A shifting competitive environment marked by a reduced physical presence via branch representation relative to online channels.

Banking union and regulatory pressure

This paper addresses recent relevant changes in the regulatory framework governing European banks. Specifically, those that relate to the architecture of the Banking Union project. Whereas the single supervisory and resolution mechanisms are being cemented, with varying degrees of difficulty, the creation of a single deposit insurance scheme would appear not only not to be advancing but to be falling behind.

The European Commission, European Parliament, European Council and European Central Bank issued a joint statement on October 11th on completing the Banking Union. Their document highlights the importance of the pillars already in place and, above all, stresses how the single resolution mechanism has injected stability and reduced uncertainty in episodes of bank stress. However, it acknowledges that one of the challenges that remains is to decisively continue the recent trend of reducing the high levels of non-performing loans (NPLs). As for the single deposit insurance scheme, the European authorities state that it remains “one of the missing pieces”. In fact, they report that the greatest achievement to date came about as a result of the stress and fear of bank runs in 2008 and 2009, which prompted an increase in the minimum balance protected per holder and account to 100,000 euros all across the EU. Significantly, the report alludes to the lack of a single deposit insurance scheme as an important part of the evidence that there is no ‘common backstop’ and notes that its absence also potentially undermines the role to be played by the single resolution mechanism. In practical terms, the report maintains that risk reduction will only work “if risk reduction and risk sharing go hand in hand.”

The timeline contemplated in 2016 called for having the single European deposit insurance scheme in place by 2024. However, now that that deadline has been eliminated, this risk sharing has been left in limbo, which poses two problems. Firstly, genuine aggregate protection of bank exposures in the EU has been set aside *sine die*. Secondly, elimination of the deadline implies a new risk insofar as the market’s interpretation may be that the banks face a less onerous protection regime and that there is no intent to remedy the situation.

As shown in Table 1, although the timeline for completing banking union approved

Table 1 **Roadmap for reducing risk through Banking Union**

2016 Council Roadmap	Current status	Next steps
a. Propose amendments to the legislative framework in view of implementing the Total Loss Absorbing Capacity (TLAC) standard and reviewing the minimum requirement for own funds and eligible liabilities. The Council will seek to ensure consistent rules and adequate amounts for the bail-inable buffers that contribute to an efficient and orderly resolution process in line with the Bank Recovery and Resolution Directive (BRRD) for all credit institutions for which bail-in would be the validated resolution strategy. b. Put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution. c. Propose amendments to the Capital Requirements Regulation/Capital Requirements Directive IV as part of an overall review exercise, which would result in: i. Harmonisation or further specification of options and national discretions granted to Member States, which could also contribute to the objective of reducing financial fragmentation; and, ii. Implementing and finalising remaining Basel reforms including the introduction of a leverage ratio, possibly set higher than 3% for systemic banks, and the introduction of a net stable funding ratio.	Legislative proposals, including all measures indicated by the 2016 Council Roadmap, are under negotiation. On options and national discretions in the Capital Requirements Directive/Capital Requirements Regulation, in addition to the legislative proposal, the European Central Bank has undertaken a comprehensive exercise to harmonise them.	Agreement among co-legislators on the legislative proposal by mid-2018 at the latest.

Source: European Council and authors' own elaboration.

by the European Council in 2016 (the first column) remains the benchmark, the current difficulties (second column) raise new issues (third column).

Another regulatory issue set to have an important impact on the scope of the banking business is the looming implementation of the Markets in Financial Instruments Directive (known as MiFID II). The business issue posed by this directive is the need to standardise a broad number of sales and marketing, as well as advisory procedures. In fact, the enacting regulations in Spain have been drafted in

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phases and have taken the form of standards stretching hundreds of pages which are not easy to put into practice. Adoption of MiFID II was initially set for January 3rd, 2018. In the end, however, gradual adoption over the course of 2018 is going to be permitted in the EU. In fact, the Spanish government is still working on its legal enactment, which it expects to complete and put before parliament for approval by the end of the year.

Monetary policy: A complex normalisation

The ECB's Governing Council held one of its most important meetings in years on October 26th, 2017. It decided to reduce the monthly pace of net purchases under the asset purchase programme (APP) from 60 billion euros to 30 billion euros from January 2018 until the end of September 2018 "or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim." This decision implies an adjustment to the money supply which is expected to nudge interbank interest rates higher because, although the ECB's key rate has not changed, monetary policy will become somewhat less lax, foreshadowing more pronounced tightening in the long term.

At any rate, these changes will be gradual as quantitative easing cannot be taken away overnight. Against this backdrop, the Governing Council decided that the Eurosystem will reinvest the principal payments from maturing securities purchased under the APP "for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary".

For banking business purposes, official liquidity remains abundant. Indeed, the ECB said it would continue to conduct the main refinancing operations and three-month longer-term refinancing operations (LTRO) as fixed rate tender procedures with full allotment for "as long as necessary, and at least until the end of the last reserve maintenance period of 2019".

The outlook resulting from these monetary measures, while still expansionary, may prompt a gradual tightening in interbank rates, which remain in negative territory across a broad spectrum of terms. The relationship between the banking business and real interest rates has been anomalous in recent years with situations such as inverted yield curves (where short-term rates are higher than long-term rates) which have made it harder for the banks to pursue their traditional business of securing short-term deposits and making longer-term loans. In much of the Eurozone, the rates earned by deposits have fallen by less than borrowing rates (the banks themselves veering away from offering negative savings rates) despite which the drop in net interest margins has been relatively small due to the 'volume' effect (bigger movement in deposits than loans). It is estimated that the average rate earned on deposits in the Eurozone contracted by 0.2% between 2014 and 2016, while borrowing

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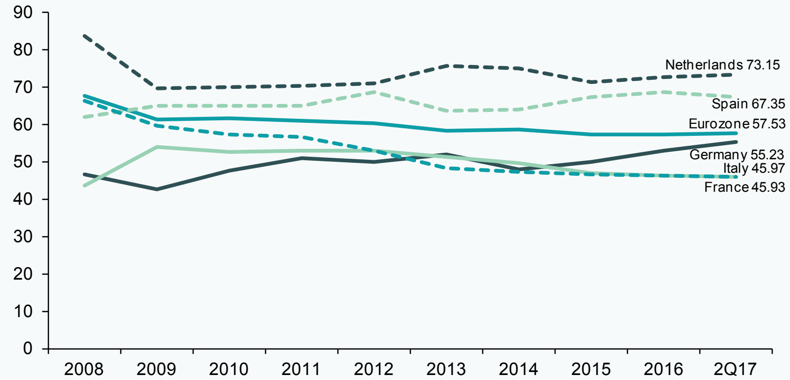
Exhibit 1

Ratio of net interest income-to-total income across the Eurozone (2008-2Q17)

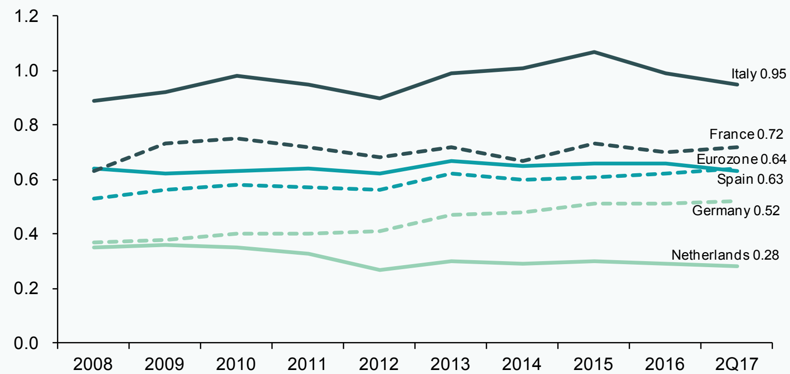


Source: ECB and authors' own elaboration.

costs fell by 0.8%. The ECB asset purchases have had the effect of distorting rates such that they do not tally with the equilibrium between private supply and demand. This 'artificial' equilibrium in the price of money also has the effect of masking the price of risk implicit in demand for credit and therefore prevents credit from flowing to the extent desirable. The existence of negative real rates has also given rise to technical issues, substantially affecting the banks' IT systems and market operations.

Exhibit 2

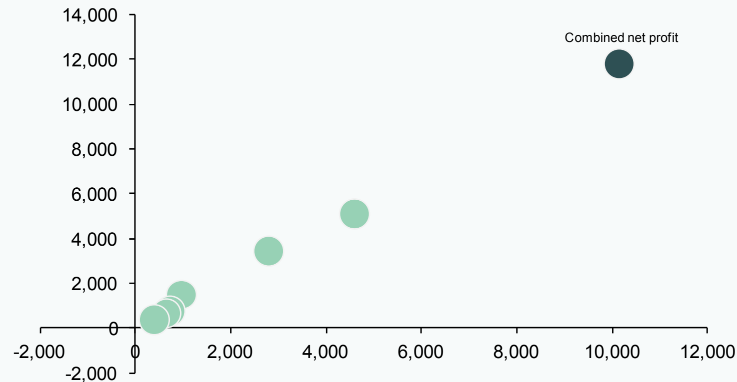
Net fees and commissions income over total assets in the Eurozone (2008-2Q17)



Source: ECB and authors' own elaboration.

Exhibit 3

Net profit at Spain's top six banks in 2016 (x-axis) and 2017 (y-axis) (9M)



Note: The six banks are Santander, BBVA, Caixabank, Bankia, Sabadell and Bankinter.
Source: ECB and authors' own elaboration.

It is hard to tell to what extent the gradual shift in the monetary environment will foster an improvement in bank margins. Although the relationship between asset and liability rates may enter more natural territory, there is also risk implicit in the increase in the cost of debt, both for the banks' funding costs and on the lending side of the business, with the impact on non-performance hard to predict.

As shown in Exhibit 1, the impact of negative rates on margins is significant given that net interest income accounted for 57.53% of total bank income in the Eurozone in Q217. This contribution level has barely moved since the start of the crisis. In Spain, the percentage is a little higher (67.35%), albeit lower than in the Netherlands (73.15%).

The contraction in net interest income has only been partially mitigated by fees and commissions income. As shown in Exhibit 2, net fees and commissions income as a percentage of total assets has been steady within a range of 0.6-0.7% in the Eurozone since 2008, standing at 0.64% in Q217. Italy (0.95%) and the Netherlands (0.28%) stand out at the two extremes.

Third quarter earnings in the Spanish banking system

In a propitious macroeconomic and financial environment, the earnings reported by the Eurozone's banks for the first nine months of the year generally reveal two trends: (i) an improvement in their RoEs; and, (ii) a drop in interest margins. As we will show in this section, most of the improvement in the banks' returns is attributable to their efforts to improve their cost-to-income ratios (although this is not the case across all the Eurozone countries).

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Spain’s six largest banks by asset volumes reported aggregate net profit of 11.78 billion in the first nine months of 2017, year-on-year growth of 11.6%. As depicted in Exhibit 3, the earnings momentum was widespread.

The Spanish banking sector stands out among its European counterparts in terms of returns. The ECB, in its capacity as single supervisor, published complementary statistics on the performances of the Eurozone’s banks in October. These figures enable an interesting comparison from 2008 until Q217. The trend in the banks’ returns on equity (RoE) between 2008 and 2017 (Exhibit 4) corroborates the fact that of the two recessions sustained during the crisis, it was the sovereign debt crisis of 2011 and 2012 that had the biggest adverse impact, due to the sizeable losses reported, especially in 2012. That year, the sector’s RoE plummeted to -25.6% in Spain, albeit going on to recover quickly in subsequent years. The most erratic trend is observed in Italy, where bank resolution efforts have been intermittent and uncertainty remains. In Q217, the Spanish banks’ RoE stood at 8.3%, which is above the Eurozone average (7.1%), higher than that of Germany (3%) but lower than that of the Netherlands (10.2%).

In light of the difficulties faced in lifting their RoE, it is worth investigating what role efforts to become more cost-efficient can play in boosting bank earnings. In 2008, the cost-to-income ratio (CIR) in the Eurozone was 74.46%; by Q217, it had fallen to 62.72%. However, the trend is uneven across the various countries and may well

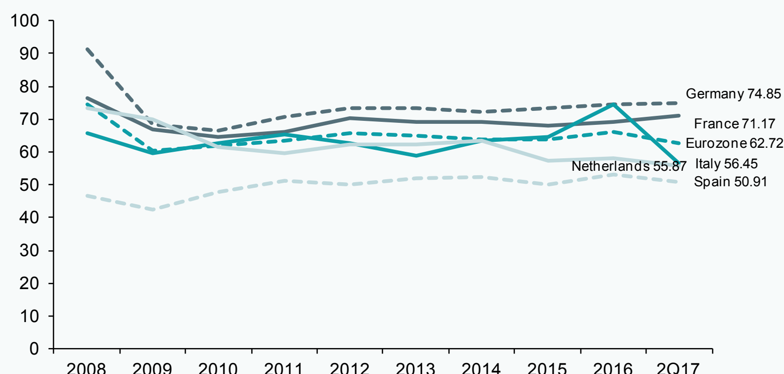
Exhibit 4

Banking sector return on equity (RoE) in the Eurozone (2008-2Q17)

Source: ECB and authors’ own elaboration.

Exhibit 5

Cost-to-income ratio (operating expenses/operating income) in the Eurozone (2008-2Q17)



Source: ECB and authors' own elaboration.

largely explain the differences in returns. Germany presents the highest CIR among the countries analysed (74.85%) and Spain, the lowest (50.91%). Several agents from the market and supervisory arenas continue to call on Europe's banks to make additional efforts to contain costs, aware that the shift in distribution channels, with the role of the branches waning and that of the online channels on the rise, will be key.

Conclusions: Outlook for Europe's banks in 2018

As we near the end of 2017, the European banking sector appears to be entering a new phase marked by a shift in monetary conditions, materialisation of significant elements of the regulatory tightening effort and a more pressing search for returns and cost-efficiency driven by technological change.

As far as regulations are concerned, the Eurozone would appear to be handicapped to a degree by relative stagnation on the road towards true banking union, particularly the elimination of the 2024 deadline for articulating a single deposit insurance scheme. Looking towards 2018, materialisation of the last pillars of the Basel III regulations and effective implementation of the Markets in Financial Instruments Directive (MiFID II) will also be important; both will consume significant amounts of human and business resources in compliance activities and the impact will be difficult to quantify – albeit surely adverse in the short term – on business.

Elsewhere, the relative tightening of monetary policy marks a first step along the much anticipated but always tricky return to financial 'normality'. The trends in interest rates and yield curves under quantitative easing have hindered the banks' core leveraging activities. With the foreseeable rise in market interest rates and the desirable coexistence of private and official liquidity, it is possible we will see a slight recovery in interest margins, albeit punctuated by new risks such as pressure on loan performance on the asset side of the business and on funding costs on the liability side.

Lastly, it is worth stressing that 2017 looks likely to be the year of the highest returns in a decade, albeit still well below the RoE levels recorded prior to the crisis. The figures provided in this paper show that Spain enjoys a privileged position in this respect, in large part

thanks to a more pronounced effort to boost cost-efficiency relative to its European peers.

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Box: Financial stability and the situation in Catalonia

The political events affecting Catalonia in recent months, particularly since September 2017, are significantly impacting the economic and financial panorama. As far as the banking sector is concerned, the most relevant developments took place in early October, when, in the wake of the illegal referendum and the resultant institutional uncertainty, the main banks with registered offices and tax domiciles in Catalonia decided to move them to other regions of Spain. From the point of view of bank strategy and financial stability, at least four conclusions can be drawn:

1. The stress generated was limited to the liquidity aspect and the entities affected had contingency plans to deal with this. Specifically, they had abundant levels of collateral to monetise vis-a-vis the European Central Bank. Moreover, in all instances, the entities affected boasted strong capitalisation ratios and, especially in the case of the two most prominent institutions (Caixabank and Sabadell), substantial and solid internal funding and capital-generating circuits across the entire national market.

2. The entities affected have moved their registered offices and tax domiciles outside of Catalonia. In the process, they have reinforced their reputations, needed not so much from a financial perspective as from the standpoint of the peace of mind the decision creates for the business (removing it from the source of the conflict) and in terms of the message it sends to their customers.

3. Much of these banks' structures remain in Catalonia, among other things because a large part of their businesses and corporate roots are located in the region. In tandem, there has been a parallel – and significant in economic terms – movement by non-financial corporates (moving both registered offices and entire corporate structures away), which is very likely to have an adverse effect on the macroeconomic environment in Catalonia and Spain as a whole.

4. Financial stability in Catalonia and Spain has not been and is not at risk because the private sector's pre-emptive moves have prevented tension from spiralling further. At present, this source of political tension is a problem that threatens the Spanish economy as a whole and warrants the attention of EU authorities given its potential risks for the European economy.