Keynote speech by Gonzalo Gasos at the International Bankers Forum

9th European SSM Round Table: "Progress in SSM Regulation"

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Full speech

Setting sail from resilience towards efficiency

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A very good morning to you all,

I would like to thank Professor Maleki for inviting me to speak at this long-established event, the 9th European SSM Roundtable; it is an honour to give a speech at the Central Bank of Luxembourg, an institution symbolically of the same age as the European Central Bank and a result of the unique endeavour of the European Economic and Monetary Union.

I would like to open this keynote speech with an historical remark about another great European endeavour. We are approaching the 500th anniversary of a remarkable achievement, the first circumnavigation of the Earth led by Ferdinand Magellan with a fleet of 5 vessels and 270 sailors. Following the course of the sun, they crossed the Atlantic Ocean, the eponymous Magellan strait, the Pacific

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and the Indian oceans; they arrived in Europe three years later with only one ship and 17 survivors. It was a daunting task that required an unimaginable degree of determination.

Resilience

The banking regulatory reform is also a big undertaking. Especially in the Euro Area as it coincides with the transfer of supervisory responsibilities to the European Central Bank. The Single Supervisory Mechanism has been consolidated thanks to the strong determination of its management in finding a new path, a new supervisory culture, its ability to navigate storms and overcome difficulties. The achievement of the regulatory reform has also been possible thanks to the continued commitment of banks. The current prudential metrics of the European banking system speak for themselves: the core equity capital ratio is up to 14%, double that of the pre-crisis level; the leverage ratio has been raised from less than 3% to above 5%; the short-term liquidity ratio, one of the weakest features of European banks in the crisis, has gone up from 70% to 145%. This is hard evidence.

Looking at the global picture, the Basel Committee recognised that in 2016 all large internationally active banks met the Basel III minimum and core equity tier 1 target capital requirements. But Europe seems to be going beyond because the so called "Finalisation of Basel III" will, reportedly, increase the capital requirements of global European banks with a percentage between 18% and 25%.

Modigliani-Miller Theorem

This brings us to the question of the optimal level of capital. At the beginning of the regulatory reform it was argued that more capital would make banks safer and equally profitable. This concept is enshrined in the Modigliani-Miller theorem, whereby a shift from debt to equity in the funding structure of a company would keep its return to equity at the same level under the assumption that the increased safety would be assimilated by the market. I am a strong believer in academic theorems which have stood the test of time. In our case, we need to test it with three questions: the first is whether higher safety has been adequately reflected in banks' market valuations; the second, which factors explain the gap; the third and most important question, what can be done to improve the current situation?

To broach the first question, we need to distinguish between the regulatory value of equity and the market value of equity. The regulatory bar has become so stringent that the level of equity is no longer a choice for the bank, but rather a threat to its going concern status in case of regulatory breach. As a precaution, during the last decade banks have raised a massive amount of regulatory capital which has become the driving factor in their financial decisions. However, as regulatory capital went up, its relative market value dropped in about the same proportion.

As a result, the market valuation of the European banking system as a whole is below its book value since the beginning of the regulatory reform, currently showing a deficit of 30%. Since the crisis, our banking system has almost doubled its equity but its market capitalisation remains the same. More regulatory capital, same market value. In the past, the market appraised banks above their book value. Today, the price-to-book ratio of EU banks is 0.7 while the same ratio for the EuroStoxx General Index is 1.6. So, there is something not quite right about the banking system.

This widening gap between book value and market value is no doubt affected by the low profitability of the sector and is the result of two conflicting objectives:

Regulation continues to increase regulatory equity which is measured at book value, whereas bank managers also seek to increase the value of equity which is measured at market price. The objective of resilience has been largely achieved by raising regulatory capital, but we are still lagging behind in the objective of transmitting the value of increased resilience to the market. The broad gap between book value and market value reflects the uncertainty surrounding the banking system at large.

We can conclude that the old Modigliani-Miller theorem does not seem to work well in the European banking system as profitability has declined at the same pace as regulatory capital has increased. The profitability of the European banking system is too low to remain competitive with other industries in a global market and with new competitors in the financial arena. The recent stress test exercise showed that European banks can withstand a major adverse economic scenario, which is good news, but it also laid bare that only 3 out of 48 banks show a return-on-equity above their cost-of-equity under the baseline scenario. This protracted situation is not conducive to a sustainable banking system.

The second question is how to explain the gap. Profitability in the European banking system remains subdued mainly due to three concurrent factors: first, the low interest rate environment; second, the high level of legacy non-performing loans (NPL); and, third, the higher regulatory cost. There is a fundamental difference between these three factors: the first two, low interest rates and high NPL ratio, are temporary but the third one, costly regulation, is there to stay. Low interest rates might go up one day. The European NPL ratio has been reduced from the peak of 7.5% to the current 3.7%; if this trend continues, it will be at business-as-usual levels in a couple of years. But the tougher regulatory framework is permanent.

It is no wonder that the return on equity of European banks has halved in the last decade, from 11% to around 5% on average, because the volume of business is similar and the capital is double. This is for a good reason, heightened resilience, which was absolutely necessary after the crisis. But let us not forget that there is no free lunch in the market. Sectors which do not deliver enough yield are doomed to shrink, unless we take decisive action. And let me underscore the word we, meaning all of us: bankers, supervisors, regulators and authorities.

Efficiency

What can be done to increase profitability and push up the market value of our banking system without giving up the high level of resilience achieved? The answer is efficiency. To be more precise: efficiency in bank management, efficiency in regulation and efficient coordination between authorities. I would like to outline some areas which could lead to greater efficiency:

On the side of banks' management, the challenge is to reduce the cost-to-income. Easy to say, but hard to do. More competent banks are more resilient and more profitable. Some have put in place long-term goals to become more efficient, typically as part of wider programmes to embrace the opportunities of digital transformation. This said, banking regulation is impeding the modernisation of banks' IT systems. Software development is becoming a strategic area for banks and non-banks, and yet it is penalised by banking regulation which requires the deduction of software investments from regulatory capital; in other words, the EU prudential regulation attaches 12 times more value to lifeless furniture than to vital software in the books of a bank; meanwhile, the same software can stay in the books of a technology company without any capital requirement at all. In a world where the borders between technology and banking are blurred, this difference is a major impediment to the efficiency of banks. Another opportunity for banks is the migration to cloud solutions which should bring down IT maintenance costs significantly; if today this presents itself as an opportunity, very soon it will become a necessity. Another notable trend is specialisation in more profitable products at the expense of others which are less profitable; some bank products and services are costlier than others, not least due to diverse regulatory requirements, therefore a reallocation process will take place and is already doing so.

On the side of regulatory efficiency, the aim should be to scrutinise every requirement and to reconsider those which cost more than what they contribute to financial stability. The volume and complexity of regulations affecting the banking system are enormous. The Capital Requirements Regulation and Directive is so intricate that banks need legions of experts simply to understand how to comply with it. Banks also dedicate huge resources to a long list of regulations, including EMIR, BRRD, MAD, MiFID, Prospectus, etc. The Commission should investigate, alongside banks, the cost of compliance with banking prudential regulations, and it should run a cost-benefit analysis in order to redress the balance.

Substantial efficiency gains lie in store if a critical review of the banking regulatory framework is carried out. The review should be complemented with a serious examination of the level playing field with non-bank competitors which are not subject to the same regulation. As a matter of principle, the same activity should be subject to the same rules irrespective of the sectoral classification of the company. Otherwise, the most profitable parts of the banking business will move, and already do so, to less regulated environments.

Apart from reviewing the banking regulation currently in force, we should care about efficiency in the Risk Reduction Measures package currently under negotiation. One of the key decisions pending will determine the efficiency of the European banking system: the acceptance of waivers to capital and liquidity requirements in the EU subsidiaries of EU banking groups. The EU Single Market and the Banking Union should be recognised in the regulation for the sake of a competitive and efficient European banking system which will ultimately benefit European citizens.

Last but not least, efficient coordination between authorities is necessary. Undoubtedly, reporting is the prudential area that requires further improved coordination. Banks have significantly increased their reporting budgets. Nonetheless, there is a general belief in the banking and supervisory community that reporting should be organised in a more efficient way. More than the amount of reporting requirements, the issue is actually the lack of efficiency in the design and transfer of data from banks to supervisors and regulators. This is due to various circumstances: first, there are new prudential requirements, like liquidity ratios or recovery plans, that need to be reported; second, the multiplicity of European authorities and supervisors whose actions are not always very well coordinated; third, we still lack a common and comprehensive reporting taxonomy.

The solution to the current problem of redundancies in reporting should apply these principles: define once, report once and share information. "Define once" requires setting up a single data dictionary for all purposes: supervision, resolution, statistics and other uses. "Report once" means that each data point and each template should be reported only once. "Share information" implies that European and national authorities should have protocols for data sharing to avoid requesting more than once the same data in different forms and for different purposes.

The Bank Integrated Reporting Dictionary (BIRD) is an initiative of the European Central Bank, with the support of banks, aimed at unifying supervisory and statistical data reducing the reporting burden for banks. It is a step in the right direction. It can alleviate the reporting burden, improve data quality, enhance comparability and foster collaboration between regulators, supervisors and banks. All in all, the BIRD paves the way to the use of technological solutions, RegTech, which can offer an opportunity for big gains in efficiency. With a harmonised data model, there would be machine-readable requirements and clear transformation rules from IT to regulatory figures. Banks could harness the use of the cloud for the common process of regulatory and statistical data from many banks under the joint governance of authorities and supervisors, national and European.

In conclusion, efficiency is the key to recovering the market value of the European banking system without compromising its resilience.

The measures I have mentioned today will, if adhered to, sufficiently increase the efficiency of banks, the efficiency of regulation and the efficient coordination between authorities.

History relates that after two years of navigation, the sixteenth century expedition had lost four of its five vessels as well as the motivation of its crew. Juan Sebastian Elcano brought the remaining crew back to Europe in the last surviving ship, thereby completing the heroic exploit. Likewise, European bankers, supervisors, regulators and authorities, are too all in the same boat, the European banking system; not only do we have to keep it afloat, we have to let it sail along with other competitors. It is time to take decisive action and to do it jointly.

Thanks for your attention. I will be happy to take questions.