The Case *for* European Banks

Danièle Nouy, *Chair of the Supervisory Board of the European Central Bank.*

TIE *Founder and Editor David Smick interviews Danièle Nouy, the chief supervisor responsible for supervising the 120 largest banking groups in the euro area.*

David Smick: Tell us about the state of the European banking system.

Danièle Nouy: Well, the European banking system has seriously improved since the crisis. Banks have more and better-quality capital. For example, their common equity Tier 1 capital is now 13.7 percent, rising from 9 percent in 2012. This is a strong, solid development.

But there are challenges as well. European banks need to fully complete their business model adjustment, and for many of them their operational costs—and their cost-to-income ratios—are too high. Also, the low level of interest rates is hurting retail banks that earn profits through their interest rate margins. There is strong competition from non-banks such as fintechs, for example, and other banks, because we have an overcapacity of banking in Europe. Certain banks have high levels of non-performing loans which are dragging down their profits. They don't earn the returns they need, and they have to make provisions or take losses when they are selling those non-performing exposures.

That's an issue, obviously. But these problems will continue to be addressed in the coming months and years. And looking only at the overall averages for the sector doesn't make much sense. Some banks are doing very well, but other banks are doing less well and are responsible for the not-high-enough average for the return on equity and the too-high average of cost-to-income ratios. But a number of banks are doing better, and the larger ones in general are in much better shape.

Smick: Many people at the IMF/World Bank meetings this fall were deeply interested in the effect of the recent German elections on the potential for a European banking union and the potential for pro-European reforms in general. The saying is, "Macron's visions are running into Merkel's realities." Given the political coalition German Chancellor Merkel is trying to put together, are pro-Europe reforms such as banking union and the appointment of an EU finance minister now on hold? The Social Democrats, who were always

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pro-Europe, are now on the sideline, replaced by the Euroskeptic AfD party.

Nouy: I don't want to comment on political events because it's not my territory and it's always delicate. But I have the feeling that the prospects for completing banking union and developing the euro area further are much better than they were a few months ago. There are anti-Europe populists in all countries, but they have not gained power. I think the outlook for further banking union is good. The ambition of the European Commission is well placed. I'm pretty sure we will see further developments.

Smick: Even still, after the interesting and surprising French election, the assumption in global financial circles was that the populists were on the run. In Germany instead they won the third-highest number of seats in the Bundestag. Have the populists disrupted the pro-Europe momentum?

Nouy: Frankly, I don't think so. And I don't think there is uncertainty on issues for the European banks. I think we need to be very cautious when interpreting political developments. Personally, I see the environment as quite favorable for the time being.

What is important for the European banks is to be safe and sound themselves. Most of the big ones, the significant institutions that we supervise, are internationally active banks. They need to be well capitalized. They need to be fit for challenges such as digitalization. They need to finish adjusting their business models.

But I don't see significant problems coming from political developments. Rather, the opposite—the European Commission wants to move forward with banking union, in particular the third pillar, the deposit guarantee scheme. This may not happen immediately, but will steadily move forward, first one step and then a second step. That's the way it works in Europe.

I think the outlook is good. Even when unforeseen events can cause disruption, banks are now doing much better regarding contingency planning. They are much better prepared for all kinds of events. For example, two large banks in Catalonia decided at one point to move their registered head offices to another part of Spain and they only needed a few days to be able to do so because they were very well prepared. So, I don't think banks will be negatively affected if progress on banking union is slower than we would like. Personally, I believe we will make progress faster rather than slower.

Smick: Many Germans have recently commented that while their economy was once called the "sick man" of Europe, the real sick man now is Italy. In capital markets, the conventional wisdom (which is usually wrong) insists that populist groups such as the Five Star Movement in Italy can't get traction. But then they do, and if they do well in upcoming elections, they could become a disruptive factor. Are you worried about the Italian banks becoming the soft underbelly of the European banking system at a time when the Italian populists could be on the rise? That's not a great combination for success.

Nouy: First of all, in Frankfurt we are more interested in banks than in national banking systems. We try to forget the nationality of the bank in order to focus on the bank itself, and treat them all equally.

As a matter of fact, like in many countries, we find all kinds of banks in Italy. There are some very good banks in Italy; let me remind you that Intesa is the European bank that did the best in the 2016 European Banking Authority stress test.

The outlook for further banking union is good.

Like in other countries, there are Italian banks doing their best to improve their situation, and they do it very seriously. For example, Unicredit undertook a large equity issuance plus sales of non-core assets in order to clean its balance sheet. Its actions have been very ambitious and very well-executed, and now it's a different bank.

Some other banks are not ambitious enough or remain to some degree in denial of the problems they face, and the job of supervisors is to make sure that they do what they need to do. Otherwise, if they don't make good decisions, they may be wound down. This is what happened to two Italian banks in the summer: Veneto Banca and Banca Popolare di Vicenza.

Smick: For years, there was concern about whether Italian bank balance sheets can even be trusted.

Nouy: Well, the Single Supervisory Mechanism (SSM) has now been supervising euro area banks for three years. We are doing our job in Frankfurt. We are independent. We treat the banks based on what we see. We're not interested in the nationality of the bank. For us, it's all about supervising individual banks.

In 2014, we started with the comprehensive assessment. We had an asset quality review which looked at 60 percent of banking assets. Then, for the rest, we did on-site inspections. Sometimes we find situations where a valuation made by a bank is not correct and there's a need for more provisions; or a capital shortfall appears in the adverse scenario of the stress tests. That is why Monte dei Paschi di Siena was recapitalized with public money with the authorization of the European Commission.

We do what we have to do. We are also revalidating the risk models used by the banks. We make sure that the risk-weighted assets produced by the models are adequate so that the models produce the right capital requirements. This is still a work in progress. We do as much as we believe we should do, and as much as we can do, and we will not stop.

Smick: Let me ask you one other question about the German banks. The German banks, as well as the German auto industry, have had a lot of exposure to China. Are you worried about the Chinese situation? There's talk that in coming months there could be defaults on dollar-denominated debt by private Chinese corporations. Wouldn't that be a problem for German banks, and possibly some French banks as well? How does China fit into the European banking equation?

Nouy: Supervisors are concerned about everything. That's a feature of how we think. When you have been doing supervision for decades, you are concerned by every move that doesn't look positive or brilliant.

So yes, we are following these developments, but they are just some of the many possible risks. We are also monitoring developments in leveraged finance because when the return on equity is not good enough for example because of the interest rates, there is a tendency to seek out profits elsewhere. There is no reason to focus particularly for the time being on these sorts of risks. But they are monitored, like any source of risk.

Smick: So when you look at the risks out there, which ones concern you the most?

Nouy: For us, it's profitability. A number of banks in Europe are not earning the cost of their capital. That's not sustainable in the longer run. In order to address profitability, these banks have to tackle non-performing exposures. They also need to address overcapacity—there is a need for some consolidation of banks in the euro area. They have to address the lack of cost efficiency and high cost-to-income ratios. Many of them have too many branches, and they probably have too much staff for an environment that is more and more digitalized. They need to have efficient, well-performing information technology systems because some banks are offering digital services to customers that look nice on the surface but are not based on a strong digital infrastructure.

Obviously, the world is changing. Certain countries and regions of the world are doing better than others. But we monitor risks from all regions. Risk may also come from things that were not expected, like the situation in Catalonia.

Smick: In a perfect world, what kind of reforms would you institute?

Nouy: I have some ideas for the euro area. For example, I would like fully harmonized regulation. When we took over supervision, we had 167 options and national discretions permitting the nineteen countries of the SSM to treat banks they supervised differently. We had to spend time deciding on a single way of supervising. We did that for the options and national discretions that were in the hands of the supervisors, but almost forty additional ones are in the hands of the legislators. I would like the European Commission to address this: either to suppress them or to give the national competent authority, which is the SSM for the nineteen countries in the euro area, the power to harmonize them just like we did with the others. That would be much more efficient.

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I would like also to have an efficient delegation framework for the SSM. There was no delegation foreseen in the SSM regulation, which means that very minor decisions were taken at the level of the supervisory board, which is not efficient. It took almost three years for our lawyers to recognize that it would be safe allowing our middle management to take some of the small, everyday, supervisory decisions, in particular on assessing the suitability of

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proposed candidates for positions of responsibility in the banks. There can be thousands of these decisions.

We also need more European-wide regulation and fewer directives. European regulations are implementable directly by us without any transposition in the national countries. Directives, unlike resolutions, need to be implemented through national laws, which means that we can end up with nineteen different ways of doing something.

Smick: It looks like Brexit is going to be a hard landing. How will that impact what you do?

Nouy: Well, nobody knows what will happen. But it's certainly the case that Brexit has not started well. The negotiations are a bit delayed. The British government seems to be asking for a transition period, which may be accepted by the European Commission. A transition period will make the Brexit process smoother, while we prepare for whatever could happen.

Personally as a European-minded person, I think having a country leave Europe is very sad. But that's the desire of the UK voters. Some London-based banks that will not be able to use London as a passport for the rest of Europe will be relocating to the continent or to Ireland.

Smick: Are you worried about the prospect of an international race to the bottom involving the United Kingdom, the United States, and Europe to offer the fewest regulatory controls, not just on banking but on financial markets in general? Capital could end up moving to the area with the least control, but the risk goes up for the entire interconnected global financial system.

Nouy: I would make a distinction between two things. With regard to European countries trying to attract the jobs and activities leaving London as part of Brexit, we should remember we are barely just out of the last financial crisis. For some years into the future, people should be prudent in starting this kind of race to the bottom. The damage they could do to themselves could be significant. That is why I feel people will be cautious. And certainly, our colleagues in the United Kingdom are not engaged in a race to the bottom.

Smick: But look at the Dodd-Frank financial reform legislation passed in the United States in response to the 2007–2008 crisis. The big surprise under the Trump Administration has been that Dodd-Frank has not yet been repealed. Some say the secret is that about four years ago, the banks figured out the loopholes in Dodd-Frank, and the larger banks therefore haven't been as constrained. They therefore are not as aggressive in pushing for the regulation's elimination.

Nouy: This is a policy decision for the United States. But though I am not as familiar with the U.S. situation as with the situation in Europe, I see the desire here in the United States as one for more simplicity in regulation. I don't see that as a desire to be less tough, or require less capital in the banks. As for the situation in the United Kingdom, I don't see a desire for less-strict regulation there either for the time being.

What could have been an issue for us is that, within the banking union, we supervise the banks, but not investment firms or branches of banks headquartered in third countries, which for us includes the United States and will include the United Kingdom after Brexit. Branches of UK banks will become third-country branches in the future. Perhaps certain members of the euro area could have considered attracting investment firms or bank branches, but the European Commission is addressing this issue, in particular for systemic investment firms.

Smick: In the trading world, crises don't seem to matter in affecting long-term investor confidence. Looking back over the last several decades, every time a Latin American country would default, the conventional wisdom would maintain that one thing we know for certain is that in our lifetimes, they'll never be allowed back into the credit markets. Then five years later, that same country would again be successfully selling its sovereign bonds.

Nouy: That's a different situation. Countries are not supervisors. I think supervisors learn more lasting lessons.

As for the investment firms, investment firm status is not as closely regulated in Europe as banking status. In general, investment firms are smaller in Europe

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except in the United Kingdom. The United Kingdom has fixed the issue by deciding that its Prudential Regulation Authority can supervise those investment firms like banks. The European Commission is also working on a similar policy for Europe.

Smick: There is concern in London that the City, as a result of Brexit, could lose considerable economic clout as a global financial center. Will London in response push to see the City become a sort of offshore financial haven like Singapore?

Nouy: Perhaps. There may be a moment they will be tempted. I think personally that London will stay important. It will be important for the SSM banks, including the banks that relocated on the continent. A number of American banks or banks from other countries will continue having relationships and activities in the United Kingdom. I don't think a decline in its importance would happen so fast and so significantly that they would need to find something to compensate immediately. But maybe I'm too optimistic.

I think personally that London will stay important.

Also, the future outlook for offshore centers is not exactly the same after the crisis as it was before the crisis. The opportunities are not what they were before. There will still be opportunities, but it's not exactly a glamorous business model.

Smick: Thank you very much. ◆