EUROPEAN CENTRAL BANK
EUROSYSTEM

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Summary of Banking Industry Dialogue on 8 November 2017 in Frankfurt am Main

Participants

- Members of the Governing Council of the ECB or their alternates.
- Representatives of Banco Sabadell, Bankia, Bayerische Landesbank, BBVA, BNP Paribas, Caixa Geral de Depósitos, Danske Bank, de Volksbank NV, DekaBank, DZ Bank, HSBC, Mediobanca, Norddeutsche Landesbank Girozentrale, Permanent tsb Bank, Piraeus Bank, Societé Générale and Unicredit.
- Senior ECB officials from the Directorate General Macroprudential Policy and Financial Stability, Directorate General Communications and Directorate General Secretariat, and the ECB's Chief Compliance and Governance Officer.

Outlook and challenges for banks

The discussion focused on; i) challenges and opportunities for banks from financial technology (Fintech) related developments, ii) the need to improve profitability in the banking sector, for example by enhancing efficiency, reducing costs , and addressing high stocks of non-performing loans (NPLs), and iii) regulatory issues.

Various trends in the technological landscape affecting the banking sector were discussed, including; i) changing customer behaviour and expectations vis-à-vis digital provision of financial services, including increased mobile device usage, ii) greater automatisation in various production processes, and iii) lower data storage costs and increased computing power.

Fintech was, in general, seen by bank participants as an opportunity, as banks can take advantage of technological advancements. Banks could, for example, acquire or enter into strategic partnerships with Fintech companies, or develop own solutions based on ideas from the Fintech industry. It was, however, acknowledged that smaller banks have fewer possibilities in this area given the large-scale investments often needed.

The possibility that big technology companies incorporate financial services into their platforms was seen as a potential competition challenge for the banking sector. It was noted that some of these companies have already developed payment schemes, albeit normally in cooperation with banks, and are in some cases also providing lending services.

Bank participants discussed the need for further cost cutting and business model adjustment in the banking sector. While further cost cutting was seen as needed in parts of the banking sector, it was noted that banks also need to invest, particularly in IT, to remain competitive in an environment of higher digitalisation of financial services. This will lead to higher costs in the short term but should reduce costs in the medium term due to efficiency gains. One way to reduce costs in the banking sector could be consolidation but impediments to consolidation, especially across borders, were seen by bank participants as being large due to issues such as limited scope for cost synergies in cross-border transactions owing to limited network overlaps as well as regulatory uncertainties and developments. Regarding business model adjustments, participants acknowledged that while adjustments are in many cases needed, there is not one business model that suits all banks and adjustments therefore need to take into account bank-specific characteristics and different market needs.

Regarding the high stocks of NPLs, bank participants acknowledged that further actions are needed, but noted the differentiation between NPLs where remedial actions had already been taken to effectively resolve them and those for which action is still needed.

On the subject of the finalisation of Basel III, bank participants stressed the need for a balanced and appropriate calibration to be agreed as soon as possible, in order to ensure a proper and stable framework for banks. The final rules should not lead to a significant overall increase in capital requirements but should provide the right incentives for banks to improve their risk management systems.

Participants also noted that it was essential to maintain international cooperation and convergence of regulatory standards, in order to preserve a level playing field at the global level. In this respect, some concerns were expressed on recent developments in the debate on financial regulation in the US.

Another level-playing field issue at the global level where bank participants voiced concerns was related to the Revised Payment Services Directive (PSD 2) in the EU. The concerns centred around the fact that the directive will allow some third parties to access bank customer information in the EU but that such information is not available in other jurisdictions globally.

The need to ensure a level playing field between banks and other financial services providers was also highlighted, whereby it was stressed that the same type of business should be subject to the same type of rules. At the same time, a right balance between encouraging innovation and restricting business via regulation was seen as needed.

The importance of reforms in benchmark overnight interest rates for financial markets and monetary policy implementation was highlighted by participants. The ECB recalled its communication on the topic on 21 September 2017, where it was announced that; i) the ECB will develop a transactions-based euro unsecured overnight interest rate by 2020, which will complement existing benchmark rates produced by the private sector and serve as a backstop reference rate, and ii) that the Financial Services and Markets Authority in Belgium, the European Securities and Markets Authority, the European Commission and the ECB have set up a new working group tasked with the identification and adoption of a "risk-free overnight rate" which can serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area.

Financial stability risks in banks' operating environment

The discussion focused on: i) risks related to compressed risk premia amid low levels of volatility in financial markets, ii) the growth of the non-bank financial sector, and iii) cybersecurity risks.

The reasons behind compressed risk premia and low levels of volatility were discussed, including fundamental factors, such as a low level of economic surprises, low earnings volatility and low levels of default rates. Quantitative easing policies by key global central banks were also seen as impacting price discovery mechanisms, with volatility-dampening effects. Concerns were however raised that current levels of risk premia and financial market volatility did not reflect the elevated levels of geopolitical uncertainty across the globe. The materialisation of geopolitical risks was therefore seen as a potential trigger for higher financial market volatility and a concomitant increase in risk premia.

In an environment of low yields, bank participants noted that significant margin pressure could lately be observed in some competitive lending markets. While there were few signs of broad-based increases in risk taking in lending markets by banks, credit standards were seen as weakening in some segments (e.g. leverage finance and acquisition finance), with some riskier lending segments moving to the non-bank financial sector.

The rapid growth of the non-bank financial sector and especially the investment fund sector was highlighted. Concerns were raised that liquidity mismatches in open-ended and exchange traded investment funds could lead to large sell-offs by such investors during a market correction which could aggravate it. In this respect it was acknowledged that while the regulatory response in the banking sector had been decisive after the financial crisis, the regulation of non-bank financial activities was lagging in some areas.

Cybersecurity and IT risks were also highlighted by some bank participants, with some considering them to be the biggest risks for banks at the moment.