Box I.2: The shape of the euro-area banking sector and implications for the economic outlook

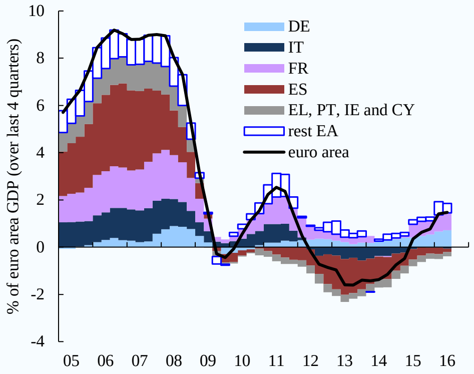
Credit plays a crucial role for the allocation of capital in an economy, especially in the euro area where the bulk of it is provided by the banking system. Empirical research confirms the importance of credit not only as a driver of the business cycle and inflation, but also for long-term growth. [1] Credit flows have a leading and causal impact on investment, growth and growth multipliers (even if the causality sometimes runs both ways).

Credit in the euro area started recovering only recently. Lending decreased during 2012-14, partly due to a further episode of tightening in credit standards which took place in the broader context of the prolonged period of unprecedented tightening which followed the 2008 financial crisis. But since early 2015, overall credit standards have been easing noticeably promoting loan expansion in the Member States less affected by the crisis, and reducing credit pressure in the majority of the most affected Member States (Graph 1a). The easing in lending conditions may have helped to halt the decline of investment as a share of GDP (an increase to 20% of GDP is projected for 2016).

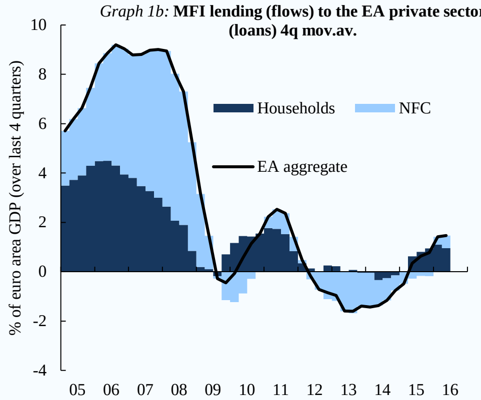
The recovery of euro area lending has mostly rested on expanding mortgages, while lending to the non-financial corporate sector (NFCs) remains weak (Graph 1b).

New loans to households are expanding and are matching their 2011 growth rates, partly due to mortgage growth in Germany. In contrast, lending to NFCs remains weak despite some improvement. After averaging minus 1% of GDP p.a. during 2012-14, new NFC loans amount to 0.5% of GDP since mid-2015. While flows have returned to 2011 levels in most Member States, some countries defy that trend. For instance, credit contraction in Italy remains particularly severe. Monetary policy has helped to halve nominal interest rates on new loans to Italian NFCs since 2012, and stabilize household loans. But NFC loans continue to decline, and remain 12% below their 2011 level. As a result, private investment has fallen to a low of 14.2% of GDP in 2015, 4.5 percentage points below its (already sub-par) 2007 level.

Graph 1a: **MFI lending (flows) to the EA private sector (loans) 4q mov.av.**



Graph 1b: **MFI lending (flows) to the EA private sector (loans) 4q mov.av.**



Source: ECB, own calculations

Going forward, the prospects for more dynamic bank lending will be determined inter alia by the banking sectors' health and in particular its current and prospective capital position. Thanks to years of monetary accommodation, the availability of liquidity is unlikely to pose a constraint in the foreseeable future. However, the capital position of the euro area banking system faces a set of challenges which warrant close monitoring. Its capacity to weather shocks has greatly improved and continues to do so, making stability risks less of a concern for policy makers. But the system's capacity and readiness to support credit and growth going forward will critically depend on the extent to which banks expect their capital buffers to comfortably cover the risk related to new lending. [2]

(1) Much of this research is based on the seminal work by Levine, Loayza and Beck (2000) *Financial intermediation and growth: Causality and causes.* While it is financial development, not credit *per se*, which is the focus of the analysis, the former is usually measured by credit to the private sector as a share of GDP.

(2) Concerning the link between bank capital and lending, see *inter alia* Gambacorta and Shin (2016): *Why bank capital matters for monetary policy.* BIS Working Papers No 558 as well as Cohen and Scatigna (2014): *Banks and capital requirements: channels of adjustment.* BIS Working Papers No 443.

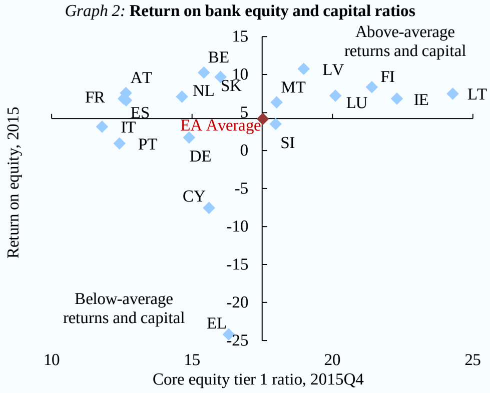
(Continued on the next page)

Box (continued)

Since retaining earnings is the easiest way to strengthen capital positions, profitability remains under scrutiny in this context. In 2015, bank profitability in the euro area improved. This was due to receding losses from non-performing exposures in some banking systems as well as increasing asset prices also thanks to the effects of financial asset purchases from monetary authorities. However, going forward bank profitability is likely to get under pressure.

Importantly, these nuanced dynamics take place against the backdrop of persistently low *levels* of profitability as highlighted by many observers (ECB, OECD, IMF). Low profitability levels and subdued prospects are mainly driven by three factors, which apply to the different Member States in different degrees (see Graph 2). First, legacy issues from previous stages of the cycle such as high levels of non-performing exposures and/or provisioning needs for legal costs; second, a fractionalized sector with high overhead and operational costs; and third, business models that are challenged by the low yield environment, technological change and competition from non-banks. Given the outlook described above, already low profitability in combination with a relatively weak capital position (SW quadrant in Graph *2*) constitutes an important concern.

Graph 2: **Return on bank equity and capital ratios**

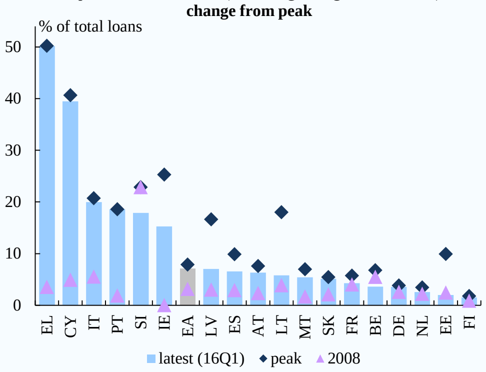


Source: ECB

In addition to directly limiting bank's sources of capital, low profitability also makes alternative sources of capital less accessible. In combination with the unfavourable prospects indicated above, it already translated into a noticeable stock market underperformance when compared with the broader economy, accentuated since late 2015. From beginning of 2016 until August, when the results of the EBA stress tests were revealed, the market capitalisation of euro area banks declined by close to a quarter of their total value. When compared with US peers, European banks continue to trade at a significantly smaller fraction of their book value. As a consequence, banks have little incentive to issue new shares for capital-raising purposes.

As for the underlying causes of low profitability, the prevalence of non-performing loans in Italy has lately received much attention in the media. However, the issue is of importance for a number of banking systems (Graph 3).

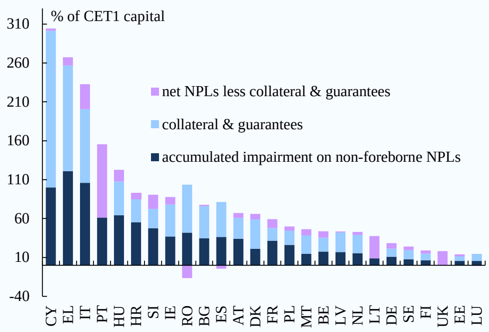
Graph 3: **NPLs of banks (including foreign-owned subs), change from peak**



Source: ECB, own calculations

While the level of NPLs has fallen from its post-crisis peak in nearly all of them, it still remains exceptionally elevated in several countries when compared with pre-crisis levels. The degree to which NPLs are covered by provisions and collateral also varies across banking systems (see Graph 4).

Graph 4: **Coverage of non-performing loans**



Source: ECB, own calculations. Note: No data available for SK. No information on collateral and guarantees is available for PT.

Situations where the amount of NPLs is neither covered by sufficient provisioning nor by a realistic assessment of the value of the underlying collateral are of particular concern. In these cases, banks need to be particularly wary to ensure that their NPL portfolio does not further impinge on their capital positions. Thus, they can be expected to be particularly cautious concerning new lending.

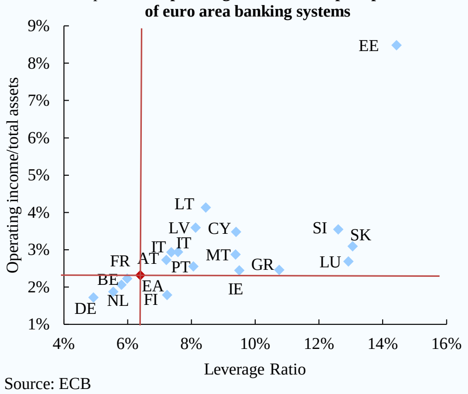
(Continued on the next page)

Box (continued)

In addition, the European banking sector is still characterised by national specificities and different degrees of competition in different segments of the market (e.g. financial institutions of different client base and/or size). In some segments and Member States, banks still carry particularly high overhead and operational costs which is coming under increasing pressure with a view to make better use of synergies and economies of scale.

Finally, the shift away from trading activities, growing competition from alternative advisory service providers (i.e. putting pressure on fee income), the increasing need for technology investment (including adressing competition from fintechs) and costs of safeguarding against higher operational risks are limiting banks' capability of exploiting alternative sources of income in a situation where the low yield environment is starting to eat into profits from traditional maturity transformation. Operating profits are already very low in a number of banking systems (Graph 5).

Graph 5: **Net operating income and capital position of euro area banking systems**



Source: ECB

Interestingly, those systems where deposit funding is relatively important, fare particularly bad in this respect. This could be because banks are reluctant to reduce deposit rates too significantly [3] either as they account for a large part of funding (Germany, Belgium) or, conversely, they are relatively scarce entailing upward price competition (Netherlands, France). High market fragmentation and high costs further add to the pressure in some banking systems.

These developments may not have an immediate visible impact on the capital position, but given the underlying problems, persistence of low yields will increase their severity over time. As low operating income margins are observed to be associated with low regulatory capital relative to assets (leverage ratio), capital constraints could quickly become binding in some banking systems, especially if hitherto unaccounted risks for the solidity of balance sheets materialise.

While required for ensuring financial stability at all times, new regulatory requirements will need to be managed going forward. The upcoming review of Regulation (EU) No 575/2013 (CRR) and of Directive 2013/36/EU (CRD IV) will introduce some regulatory innovations. While these are the outcome of international and European discussions and as such already mostly anticipated, those banks that have not already adjusted their balance sheets will be required to do so over the coming years. Most importantly, this is expected to include implementation of limits to banks' leverage as well as strengthened loss absorption capacity through the internationally agreed to "Total Loss Absorption Capacity" (TLAC) requirement and the minimum requirement for bail-in-able liabilities ("MREL") required by Directive 2014/59/EU (BRRD). Moreover, transitory regimes for regulatory capital requirements, in particular concerning the gradual build-up of a capital conservation buffer of 2.5% of risk weighted assets, will completely fade out by 2018.

All of these observations are supportive of a nuanced picture concerning the capital position of banks in the euro area and their capacity to support or even promote economic growth by means of new lending. Subdued profitability appears to result from a number of factors and is a relatively widespread phenomenon, and the low-yield environment makes it less sustainable biting ever more the longer it persists. Member States where banks already suffer from low profitability given structural features, may hence relatively soon add to those facing difficulties today. As NFC loans in particular bear higher capital and surveillance costs than investment-grade bond purchases or household loans, such difficulties have the potential to mutate into an important bottleneck for wider economic developments relatively soon. Also for this reason, efforts to create a European Capital Markets Union as priority are geared towards opening up more diverse sources of funding to the economy.

(3) Cœuré (2016): *Assessing the implications of negative interest rates*. Speech at the Yale Financial Crisis Forum, Yale School of Management, New Haven, 28 July 2016