



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Margarita Delgado

Deputy Director General at the SSM
(DGMS1), European Central Bank

Business model sustainability and viability

10 November 2016

XV Jornada Anual de Riesgos

Overview

1 Profitability: key risk for the banking sector

2 Overall profitability of SSM banks

3 SSM BMA Methodology

4 SSM supervisory actions

1. Profitability: key risk for the banking sector

SSM institutions are affected by the developments in macro-financial, economic, competitive and regulatory landscape



ECB Banking Supervision: SSM priorities 2016

- **Weak operating profitability remains by far the most important risk, magnified by the ultra-low / negative interest rate environment, as well as overcapacity, high competition and in many cases high levels of NPLs.**
- **Followed by credit risk, which is driven by lacklustre economic growth in the EU and high unemployment levels in some countries**
- **SSM supervisory priorities 2017 are expected to be published at the end of the year**

1. Profitability: key risk for the banking sector

Banks face a very demanding environment...

Competitive landscape

- High competition in many EU countries / overbanking
- Market entry of non-bank firms and shadow banking system
 - FinTech / BigTech
- Related risks: search for yield, loosening credit standards, operational, reputational & cyber risks

Structural changes

- Challenging demographics
- Regulatory environment: New set of binding constraints targeted to:
 - **Reduce probability of failure**: RWAs, new minimums and buffers, leverage ratio, LCR, NSFR, etc.
 - **Reduce severity of failure**: resolution plans, TLAC/MREL, OTC derivatives in CCPs, etc.
- Related risks: RWAs optimisation

Risks to banks' profitability and business model

Macroeconomic environment

- Ultra-low / negative interest rates
- Uneven and anaemic growth
- High unemployment in some countries
- Geopolitical / country risk
- Related risks: search for yield, loosening credit standards, cost cutting affecting control functions

Legacy issues

- High level of NPLs in some countries
- Misconduct cases
- Related risks: vulnerability to shifts in market sentiment

1. Profitability: key risk for the banking sector

...and survival requires not only adaptability but also rethinking of business

Banks' actions and business model change

React

Adapt

Rethink

Transform

Short term viability

Long term sustainability

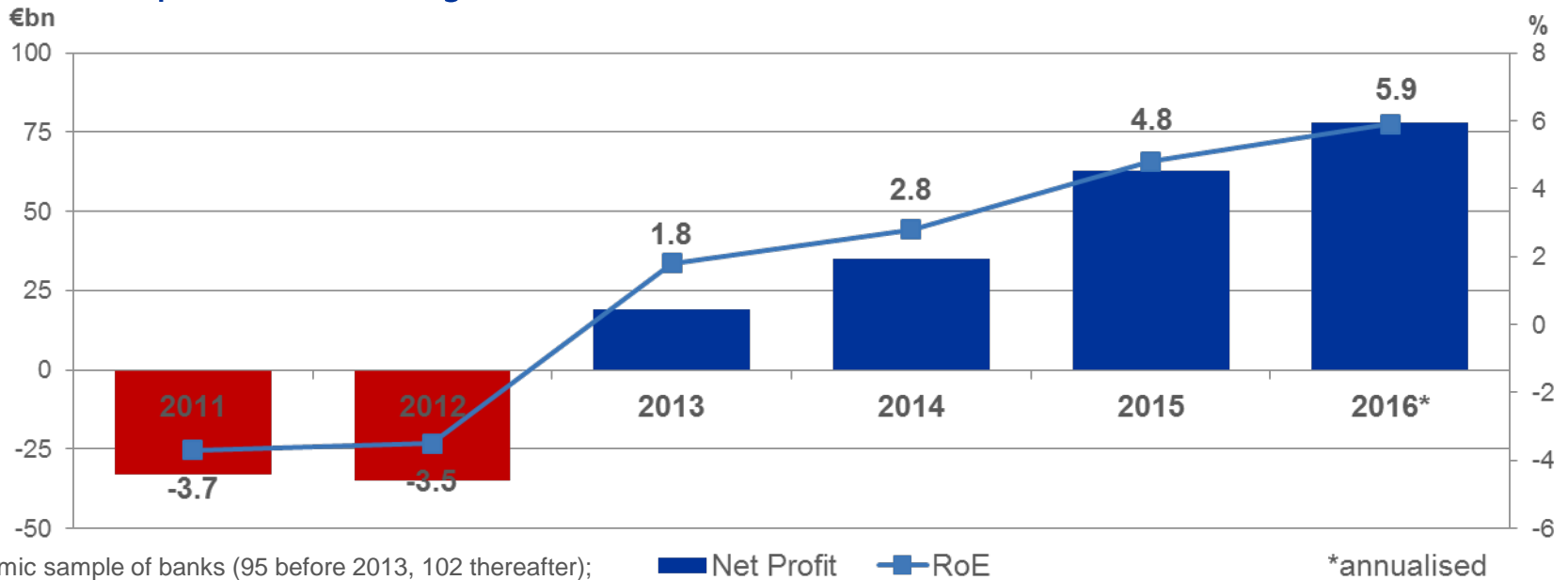
Increase in capital and provisions, more liquidity and higher capital ratios, cut costs, more transparency: recognise losses and disposal of legacy assets

Forward looking strategy focused on **sustainability through the cycle** in terms of profitability, capital generation, and stable funding base.

- Some banks need to **scale back** (cost structure, business lines / regions)
- **Differences in BMs are essential** for an efficient and resilient financial ecosystem, but sustainable BMs will require:
 - **Very good governance, risk management**, products, services and pricing
 - **Profitable** (risk adjusted, with realistic ROE goals) **business lines, products, and geographies**; winding down the others

2. Overall profitability of SSM banks

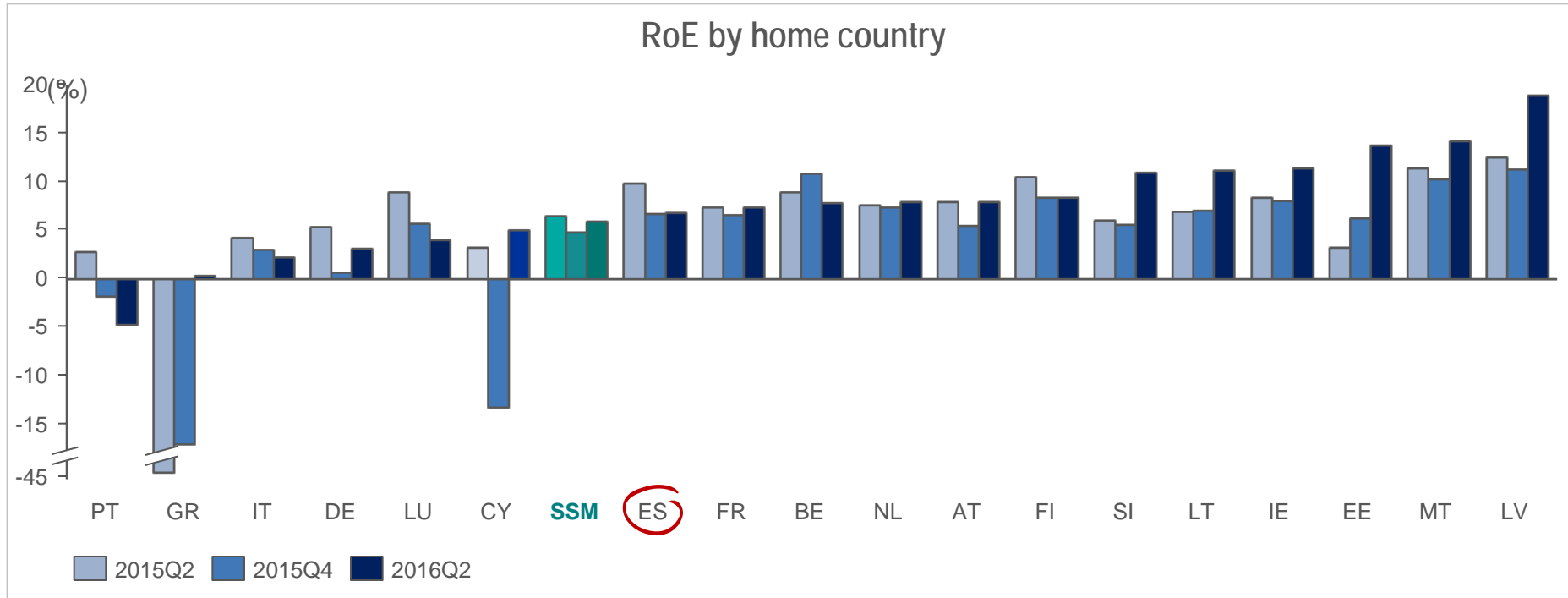
Current profitability levels of SSM banks



- RoE remains below the cost of equity.
- Recurring banking revenues remain under pressure: both NII and NFCI decreased year on year.
- Reduction of impairment flows seems to have lost momentum, although the cost of risk still decreased year on year.

2. Overall profitability of SSM banks

RoE positive on aggregate in almost all jurisdictions

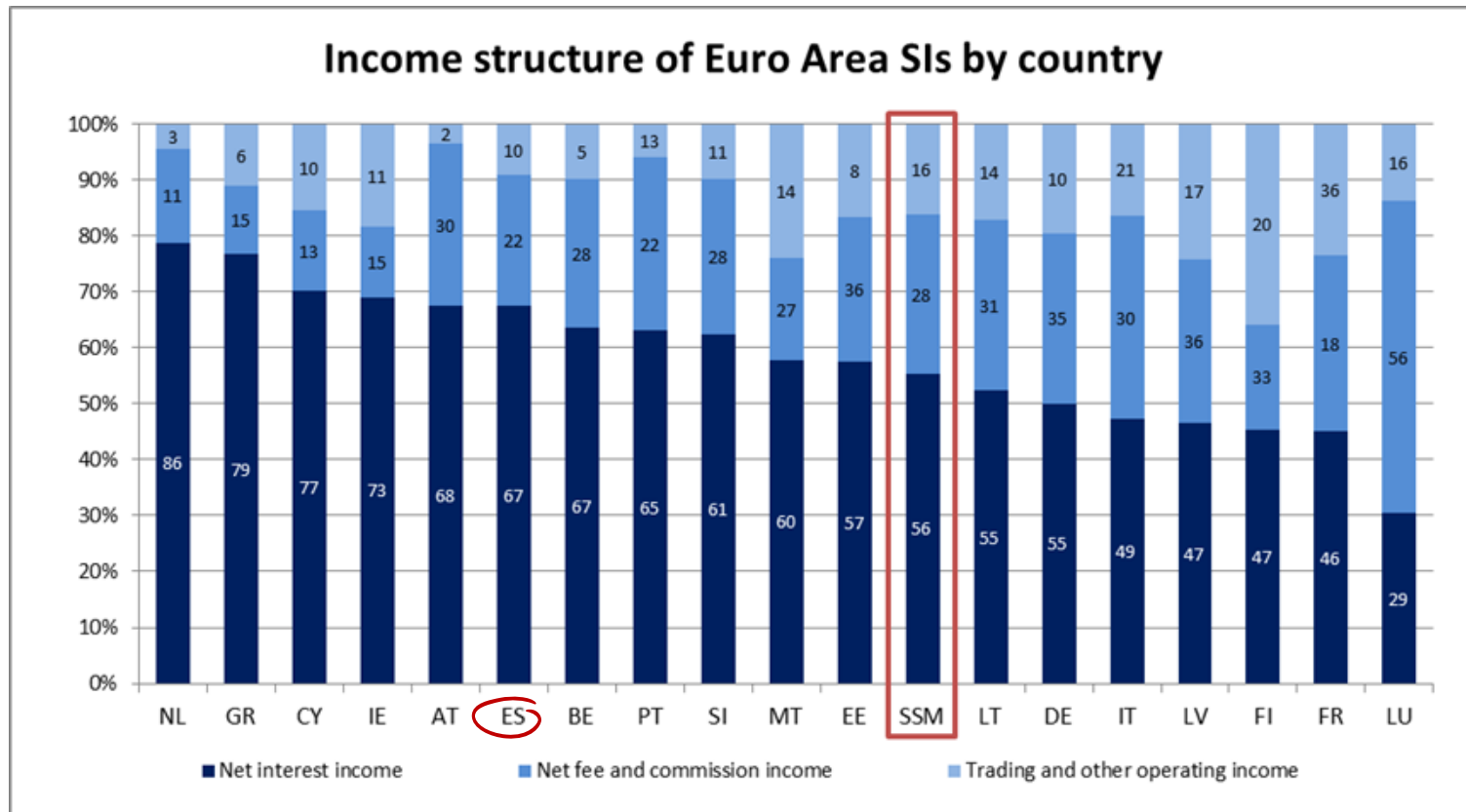


Sample: 102 SIs; Source: SSM Risk Analysis Division

- Spanish banks' RoE just above SSM average and similar to 2015Q4
- Evolution of recurring revenues for Spanish banks similar to SSM average
- Spanish banks remain more cost-efficient than the euro-area average

2. Overall profitability of SSM banks

Interest income is the main source of revenues

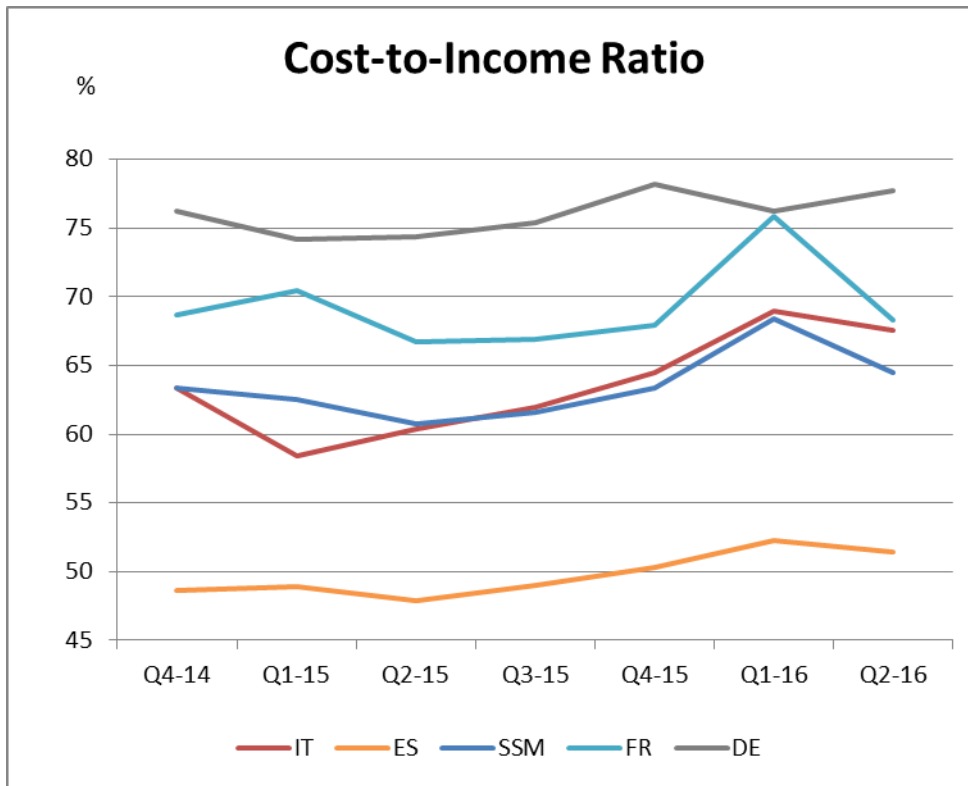


Sample: 103 SIs; Source: SSM Risk Analysis Division

- Trading income more volatile nature impacts income distribution
- Spanish SIs display a higher reliance on interest income compared to the SSM average

2. Overall profitability of SSM banks

Not clear trend in the SSM average cost to income ratio

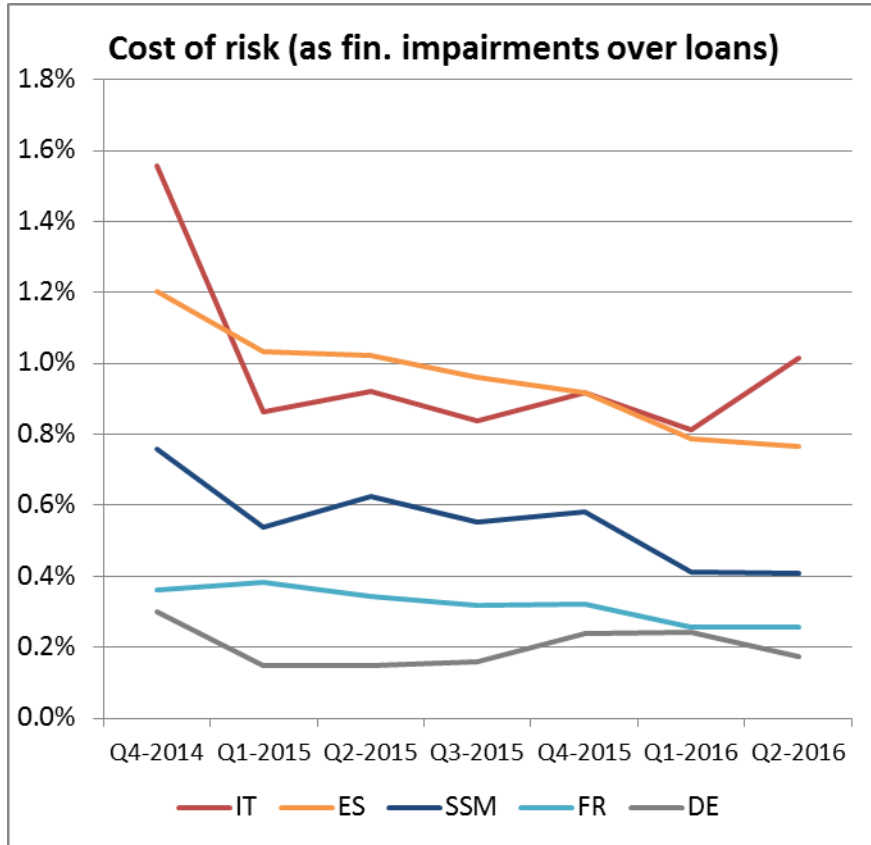


- SSM average cost to income ratio level indicates there could be room for efficiency gains
- Spanish SIs display the lowest cost to income ratio of the biggest SSM countries

Source: FINREP

2. Overall profitability of SSM banks

Cost of risk is on a downward trend in the last few quarters

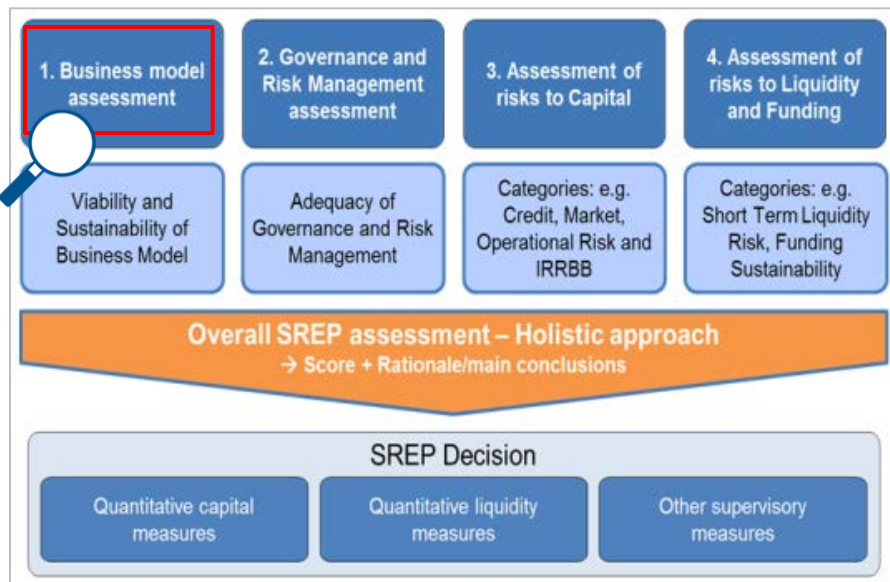


Source: FINREP

- Spanish banks keep experiencing cost of risk levels twice as large as the SSM average
- Cost of risk remains on a downward path for Spanish SIs
- SSM average also shows year-on-year drop but stabilization quarter-on-quarter.

3. SSM BMA Methodology

Assessment of Global Business Model as part of SREP

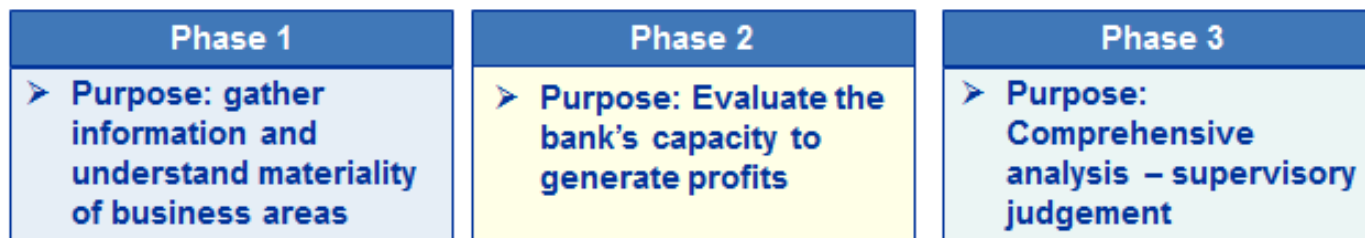


→ In line with EBA SREP Guidelines

→ Examples of identified business models

Custodian, diversified lender, small domestic bank, universal bank.

3-phase approach



4. SSM supervisory actions

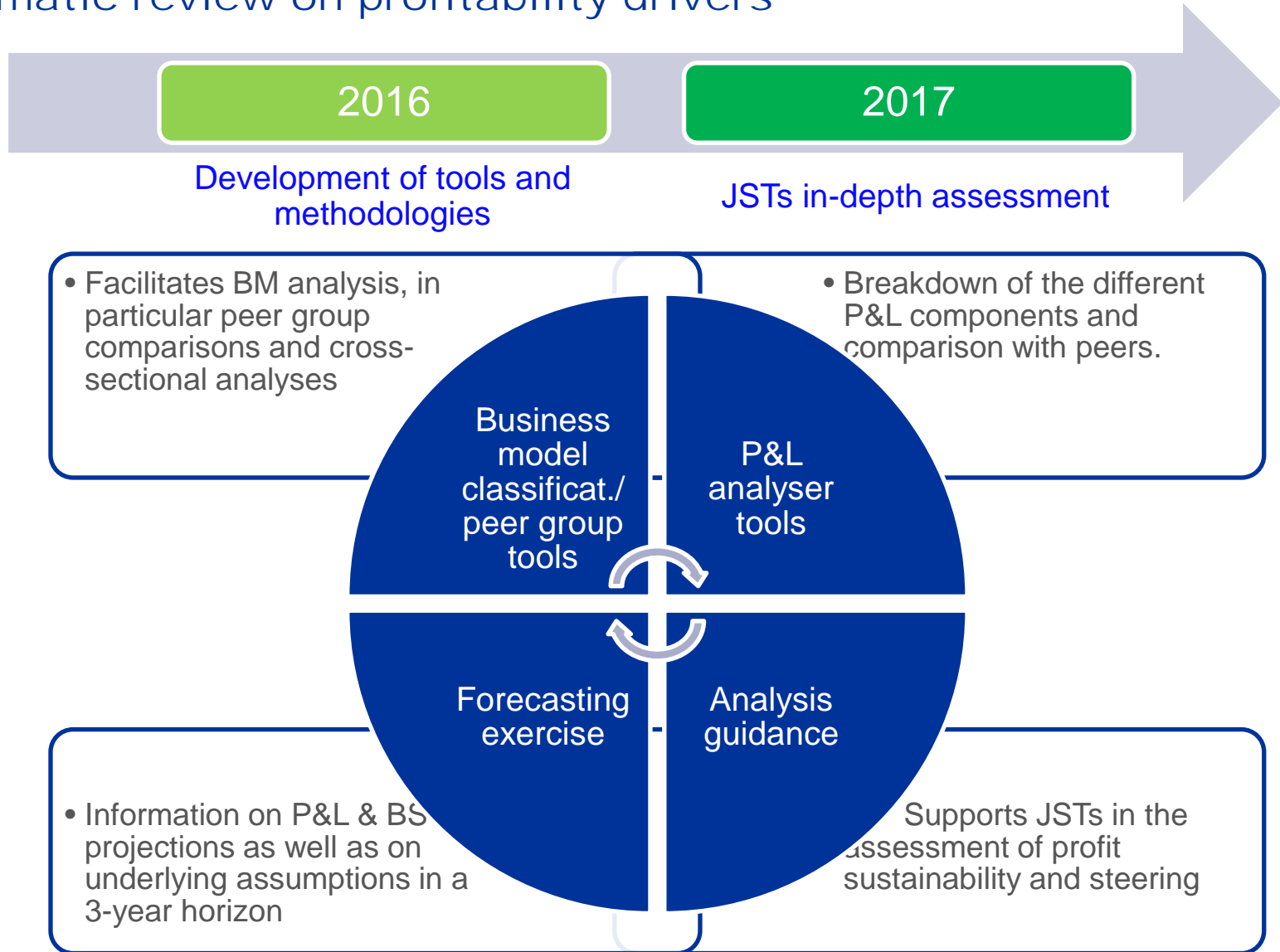
The SSM's 2016 priorities included initiatives focused on business models and profitability drivers which will be carried into 2017



- **Thematic review of banks' profitability drivers at firm level and across business models**
- Will facilitate the assessment of banks' ability to mitigate weaknesses in their business models
- An area of supervisory focus will be examining whether profitability is achieved through, among other things, a weakening of credit standards, greater reliance on short-term funding, or an increase in risk exposures not commensurate with the bank's stated risk appetite.

4. SSM supervisory actions

Thematic review on profitability drivers



Thank you

