

Margarita Delgado: Keynote address – 4th Annual European Financial Integration Conference

Keynote address by Ms Margarita Delgado, Deputy Governor of the Bank of Spain, at the 4th Annual European Financial Integration Conference, organised by the Association for Financial Markets in Europe (AFME) and the Official Monetary and Financial Institutions Forum (OMFIF), Frankfurt am Main, 28 May 2024.

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First of all, I would like to thank the Association for Financial Markets in Europe (AFME) and the Official Monetary and Financial Institutions Forum (OMFIF) for inviting me to the 4th Annual European Financial Integration Conference. I am sure that in today's agenda will hear very interesting ideas regarding European Financial integration from different perspectives, including technology, innovation, the capital markets union, sustainability and so on. All these thoughts will need to be set in the context of the current uncertain macroeconomic and geopolitical environment.

I will start with an overview of the European macroeconomic situation, followed by an analysis of the current state of the banking sector, as well as the main challenges it faces in the medium term. Additionally, I will discuss the bold decisions that European policymakers must make during this legislative cycle to promote greater market integration.

Global economic activity was more buoyant than expected in late 2023 and in the early stages of this year, compared with the figures envisaged in the ECB's latest macroeconomic projections exercise of March 2024.¹ At the same time, economic activity has evolved differently across geographical areas, with a clear contrast between the improvement observed in the United States and China and the relative weakness observed in the euro area. In this context, the global disinflationary process has continued amid declining energy prices, a reduction in supply disturbances and the ongoing impact of restrictive monetary policy in the main advanced economies. Finally, international financial markets are being shaped by the recent delay in the expected path of interest rate cuts by the Fed.

In this context, economic activity in the euro area has remained weak since mid-2023 and only more recently has it shown signs of improvement. The ECB's most recent projection exercise predicted an average annual GDP growth rate of 0.6% in 2024, 0.2 pp higher than the figure observed in 2023. However, in early 2024 the euro area has shown signs of a stronger recovery than initially expected. Indeed, according to Eurostat's flash estimate, quarterly GDP growth stood at 0.3% in the first quarter of 2024, clearly above the figure of 0.1% envisaged in the ECB's March projections.

Moreover, in the medium term GDP growth is expected to strengthen gradually, with private consumption as the main driver supported by growth in household disposable income. Declining inflation and robust wage growth are two additional factors to consider. Meanwhile, the ECB's monetary policy will exert less drag on the economy as

monetary conditions gradually normalise over the projection period. As a result, the ECB's March projection exercise envisages moderate growth rates of 1.5% in 2025 and 1.6% in 2026, slightly above the average annual growth of the last two decades (1.4%).

As for inflation, in recent months it has performed largely as expected in the ECB's latest projection exercise, declining by a cumulative 8.2 percentage points (pp) from its peak in October 2022 (and by 3.0 pp since March 2023 in the case of underlying inflation), in a context in which the ECB's monetary policy continued to be transmitted robustly to financial conditions. However, according to the flash indicator, HICP² inflation held at 2.4% in April, 0.2 pp above the March forecast.

Going forward, inflation is expected to decline further in the coming quarters, albeit with a somewhat bumpy profile in the short term. Indeed, energy base effects, the unwinding of crisis-related fiscal measures and the relatively slow moderation of services inflation will cause inflation rates to fluctuate during 2024. Overall, the projections envisage a moderation in inflation to 2.3% on average in 2024 (compared with 5.4% in 2023) and to around 2% in 2025 and 2026.

This progressive reduction in inflation would be compatible with robust – although more moderate – wage growth, against the backdrop of a recovery in labour productivity and the containment of business margins. These are expected to act as a cushion for wage pressures in the face of weak demand and the unwinding of supply bottlenecks.

As for productivity, it is important to highlight the role of labour hoarding³ by firms to explain the positive performance of employment in recent quarters. Despite weak demand, employers prefer to retain workers as they perceive labour shortages to be high and expect existing shocks to be temporary. Therefore, the ongoing recovery in activity is expected to be less intensive in employment, thus boosting productivity.

In my opinion, the risks surrounding these inflation projections are balanced. On the one hand, as I have explained, the gradual downward trajectory towards the 2% inflation target is conditional on the moderation of wage inflation, a recovery in productivity and profit margins continuing to act as buffers to inflationary pressures. If these assumptions do not materialise, inflation would be higher than expected in the baseline scenario. On the contrary, if the effects of monetary policy on activity and inflation are stronger than expected, we could observe a negative deviation of inflation from the target.

Despite this uncertain geopolitical environment and unequal macroeconomic landscape, European entities have continued to operate robustly. Over the last ten years, the banking union was rather unique in terms of risk reduction. Despite a series of shocks hitting European economies in recent years, macroeconomic volatility has remained low with the exception of a couple of episodes. First the pandemic (March 2020), then Russia's war against Ukraine, the energy crisis and, last year, the March 2023 banking turmoil. Banks went into these episodes well capitalised, with plenty of liquidity and hence resilient.

According to the latest data published by the Single Supervisory Mechanism for the last quarter of 2023, banks have further strengthened their solvency. The average CET1 ratio reached 15.7%, 30 basis points (bps) higher than the previous year. Additionally,

the significant increase in ECB reference interest rates has had a very positive impact on banks' financial results, achieving an average return on equity of 9.3%, significantly higher than the previous year (7.7%) and well above the historical range of 5% to 6%. Furthermore, this interest rate hike has not yet significantly affected the non-performing loan (NPL) ratio, which has only experienced a slight increase of 3 bps in the last year, reaching 2.30%. On the other hand, liquidity remains robust, maintaining a liquidity coverage ratio of above 160% and a net stable funding ratio of over 125%, well above the regulatory requirements.

Of course, these positive overall figures conceal a much more heterogeneous reality among entities, countries and business models that needs deeper analysis.

For instance, we should note that the sharp increase in interest rates has been partially cushioned by households due to the robustness of the euro area labour market, which reached historically low unemployment levels (6.5% in March). However, as I mentioned before, according to the ECB the economy remains weak, especially in the manufacturing sector and particularly in energy –intensive industries. Over the coming quarters a gradual economic recovery is expected, led by the services sector and exports growth, in line with the global economic rebound. But we must remain prudent.

The geopolitical situation is still a factor to consider and could generate uncertainty that affects the economy. For this reason, caution is necessary, and monitoring should be reinforced in specific sectors within certain regions, such as the commercial real estate sector, which is already coming under scrutiny by supervisors.

Additionally, other pockets of NPLs could emerge in more vulnerable sectors that have been heavily impacted by prolonged higher interest rates. Highly targeted portfolio monitoring is essential to spot any early warning signs that might trigger targeted supervisory actions.

Under these circumstances, entities should capitalise on their current positive results to strengthen their solvency and ready themselves to face the upcoming challenges in the coming years.

The first challenge is digitalisation. Financial institutions will need to continue making significant investments in new technologies to adapt their business models to the evolving digital landscape. Like other sectors, the banking industry is putting customers and their expectations at the core of its strategy. These expectations are unquestionably evolving in step with technology and banks will have to keep pace if they wish to remain the predominant players. Responding fully to the needs of customers will be crucial for the future of banking, given the threats and challenges looming over the financial system. Digitalisation opens doors to expanding the range of clients that an institution can reach and increasing the number of channels for product distribution, while also laying the foundations for enhanced financial services.

However, it also requires substantial investments to reinforce operational resilience. There is no such thing as zero risk, and it is evident that expanding the technological ecosystem in which banks operate will significantly increase the attack surface and the risk of system failures. Banks will need to have strong operational frameworks to mitigate these risks and to be able to respond to incidents quickly. Supervisors remain

vigilant of this risk due to the severe negative consequences that system failures or cyberattacks could have not only on trust in the specific institution, but also on trust in the entire system.

Additionally, the use of technologies such as cloud services often involves having to depend on external providers. Although these services have clear advantages in terms of improving firewalls or back-up systems, they also entail concentration risk and the relinquishment of control. The industry's reliance on a limited number of providers, and the total inability to switch providers as and when required, may generate vulnerabilities. This is another aspect that is on the supervisory agenda.

Moreover, digitalisation is closely tied to data aggregation and management, which are essential for a robust decision-making process and good governance. Investment in this field is necessary and profitable because the benefits of having high-quality, well-structured data in easily processable formats contribute to reducing operational, technological information and reporting costs in the medium term.

The second major challenge faced by financial entities is adapting to the real economy's new environmental requirements. This extends beyond climate change adaptation and mitigation processes to include aspects like biodiversity loss and social considerations.

Europe has committed to transforming its economy to align with these elements, necessitating substantial investment. Banks cannot remain on the sidelines of this transformation; they must also design realistic, transparent, and credible transition plans with intermediate milestones. Achieving this will require significant effort in terms of developing key performance indicators and obtaining relevant information, which will also require a significant amount of investment. The financial sector must decide where it wants to be 10-15 years from now and monitor exposures and compliance with the milestones established in the transition plans.

As I mentioned, the green transformation of our economy will require enormous resources, making a capital markets union urgently necessary. This will be one of the key points to be addressed in today's conference; in my view, it is essential to make the final push and implement the project outlined in the 2020 action plan. During the last European Council meeting on April 17 and 18, emphasis was once again placed on the critical aspects needed for further progress.

These include, among other aspects, harmonising corporate insolvency systems, promoting the European securitisation market, enhancing convergence and efficiency in capital markets supervision and designing simple and effective cross-border investment and savings products for retail clients. Ideally, the European economy would mobilise the savings currently held in bank deposits towards more productive investment forms. In other words, building confidence among European savers to invest in products that offer better long-term returns would benefit both savers and companies, which could access alternative forms of financing. Therefore, progress towards a capital markets union should be accelerated. Undoubtedly, a first step towards integration is to work on the convergence of regulatory and supervisory frameworks and towards a single financial culture.

Turning back to the banking sector, another aspect to consider is cross-border mergers.

Not forgetting the neutrality that authorities must maintain, we must also recognise that the absence of notable examples of cross-border mergers in the European Monetary Union is an anomaly. Such operations would bring benefits such as greater diversification and potential efficiency gains related to larger size.

So why haven't they occurred before now? I believe that the conditions for banks – which are the ones that need to propose and analyse the potential business case – have not yet been met. There are still certain regulatory divergences in Europe: different insolvency regimes, transaction costs and banking product cultures that have prevented any notable examples of cross-border operations to date. Having large Pan-European banks on an international scale would probably make it easier for our large companies to raise finance more competitively for their international activities. But this point also leads me to raise another question: Do we want "Pan-European banking champions" at any cost? The answer is 'no'. Bigger isn't always better. Every operation must be based on careful analysis of the specific benefits it would entail, which in any case should outweigh the associated costs and risks. The resulting business model must be profitable and sustainable as a result of the synergies that the current regulatory framework does not provide to our institutions to grow beyond the national borders. Therefore, I would like to emphasise, once more, the importance of continue building the foundation of a truly common regulatory framework in Europe for the shake of our own interest. Our financial system, our companies and economy need to be stronger to compete at international level.

Finally, in relation to supervision, I'd like to stress that improving the governance and functioning of the Economic and Monetary Union would significantly reduce the vulnerability of the European financial system. Specifically, creating a fully mutualised European deposit insurance scheme would boost citizens' and markets' confidence and contribute to greater risk-sharing within the euro area, thereby reducing the potential for fragmentation episodes. In the meantime, the crisis management and deposit insurance package improves the current rules to better protect taxpayers from the costs of bank failures.

In conclusion, the European banking system is well positioned. We can consider it robust, solvent and profitable. The 2023 turmoil involving some medium-sized banks in the United States and Credit Suisse proved that a sound risk management and governance structure and a strong and clear regulatory and supervisory framework are key for the stability of our financial system.

Nevertheless, we must still pay close attention to the consequences that this uncertain macroeconomic and geopolitical scenario might have for the credit quality of specific portfolios. Additionally, the new monetary policy scenario also requires our banks to develop robust, diversified and credible funding plans easily to be operationalised. Banks should also set effective contingency plans to be able to withstand short-term liquidity shocks and also ensure the adequate management of their interest rate risk positions.

I firmly believe that institutions should take advantage of the current profits to make all necessary investments to ready themselves to address the new digital and environmental risks.

The world today is much more complex than 30 years ago. Competition across sectors and geopolitical blocks are even more intense and of a global scale.

Meanwhile, the capital markets union should urgently and definitively gain political momentum in the next legislative cycle to strengthen and galvanise European investment and, consequently, the economy. Additionally, completing the third pillar of the banking union is another priority that must be addressed in order to achieve the full integration of our banking system.

¹ According to the ECB's March 2024 macroeconomic projections, world GDP would have slowed slightly in 2023 to 3.5%.

² Harmonised Index of Consumer Prices.

³ Labour hoarding can be defined as that part of labour input which is not fully utilised by a company during its production process at any given point in time. https://www.ecb.europa.eu/pub/pdf/other/mb200307_focus04.en.pdf