Clara Raposo: Do we still need banks?

Speech (virtual) by Ms Clara Raposo, Vice-Governor of the Banco de Portugal, at the Webinar "Do we still need banks?", organised by The European Money and Finance Forum (SUERF), in cooperation with BAFFI, Bocconi University, 5 September 2024.

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Presentation accompanying the speech

First, let me thank you for the invitation to participate in this important event, with such a provocative title.

My panel colleagues have already added quite a few insightful and thought-provoking – and provocative – remarks. Given my current job, I'll try to refrain myself from getting into too much trouble-

I guess that, as a central bank vice-governor, no one expects me to say that we no longer need banks.

Indeed, I will not. But I also don't believe that anyone here would dismissively agree that we no longer need banks.

The issue is then: WHY do we need banks? WHAT for? And where are banks currently not fully delivering on their role?

To address such a pinnacular question this panel was asked to answer, we probably need to go back to basics. What is a bank? How does it work? What does it deliver? Is this **still** necessary? And can it be improved?

When we think about a bank, we immediately consider a wide array of products and services being oered.

At their core, the role of banks is to operate as nancial intermediaries, channeling funds from savers to borrowers. Firms and households can "safely" deposit their savings in banks, who will then use them to lend to those who need to borrow in order to consume and invest.

I emphasize the "safely" because this requires a stable banking system, protected with backstops – notably, with deposit insurance.

Through this core nancial intermediation role, banks also play a key role in maturity transformation: depositors often prefer liquidity and shorter maturities; whereas borrowers need longer horizons to make investments.

So, Banks create liquidity with this maturity transformation, then generating growth in the economy.

Now, Regulation puts a break in this maturity transformation. Both the Liquidity Coverage Ratio and the Net Stable Funding Ratio – that were introduced in Basel III as

a response to the shocks faced during the global nancial crisis – although not perfect in assessing banks' resilience to liquidity shocks, do impose limits on banks' ability to borrow short-term (from depositors and from the market) and to lend long-term.

After the 2023 U.S. banking turmoil, no one disputes that having these breaks is helpful to preserve nancial stability. But of course, by limiting one of banks' core functions, regulation limits their protability.

Actually, one of the (often alleged) reasons for the weakest market performance of European banks when compared to their U.S. peers is that tighter regulation may be hindering their protability.

We could have a long discussion on this, and perhaps more research is needed, but the truth is that we might be missing the crux of the problem. Going back to simple things in our basic training in nance, we should remind ourselves that there **is** a tradeo between risk and return.

So, if it is the case that regulation decreases the level of risk, then we cannot expect returns to remain the same.

Setting up ROE targets based on the levels that were seen 15 years ago, before the global nancial crisis, would then be an absurd demand, as the banking system has profoundly changed, both due to regulation and to a change in risk management culture.

The upside of this change? A stronger, more resilient banking system, better able to withstand shocks and to nance the economy, and that way fostering growth.

That said, and coming back to banks' core functions, taking risk is certainly one of them.

Banks make decisions about who to lend to. To maximize prots, they are expected to grant loans to borrowers with positive net present value projects.

But this prot maximization objective is not an unconstrained problem.

Banks need to strike a balance between the need to take risks to maximize prots (and contribute to economic growth) and the need to protect the funds lent by trustful depositors.

Regulation and supervision are there to push for this balance and limit risks. Of course, we can ask if we have gone too far? Is banking still an interesting investment? Well, it is certainly a dierent one from that seen 15 years ago, appealing to an investor base with a dierent prole.

Consequences of this change?

By putting a tight leash on banks, that are operating within the regulatory perimeter, there are incentives for competitor non-banks to grab low hanging fruits and oer competitive nancial products and services.

The importance of non-banks has increased signicantly, both in the U.S and in Europe. This boosts competition and should increase eciency and consumer welfare.

But there are, of course, risks.

Deposits and other investments in non-banks are not protected by deposit insurance, making them much more vulnerable to panic runs.

The fragility of their funding also creates uncertainty on their ability to lend, possibly amplifying market distress.

Perhaps more worryingly, there is convincing evidence that non-banks are deeply connected to banks. A shock to the non-regulated part of the nancial system may pose destructive risks on the regulated part.

An obvious solution would be to regulate (and supervise) nancial institutions based on their activities rather than by name, i.e., based on their legal form. Of course, if that was as easy to do as it is easy for me to say it, we would not be discussing it here today.

Let me bring to the discussion something related which we do not discuss as often: proportionality.

Banks undoubtedly face a heavier burden than non-banks, in exchange for an increased charter value. How? By oering a more diverse and complete set of products and services than what any non-bank is allowed to do, and by beneting from deposit insurance and access to the lender of last resort.

These benets accrue to all banks, but perhaps more so to the larger ones, which can exert more market power over their charter value and are often too big to fail (despite all the regulatory eorts to put an end to this market failure). But the regulatory and supervisory costs are proportionally much stronger for the small and medium-sized banks.

If we add to this the management of cyber risks and the need to invest in technology to keep up with competition, the overburden is clear. Small and medium-sized banks are forced to dedicate a disproportionate volume of resources to these requirements and challenges, being left with little room for strategic decisions that allow for a solid growth strategy.

Should we worry? Well, there are trade-os.

On the one hand, larger banks are supposedly more diversied, more ecient and better able to take and manage risks.

On the other hand, smaller banks may be more willing to nance smaller businesses that are uninteresting to the larger banks due to their scale. These smaller, often innovative, businesses, if successful, may have a strong growth potential and large spillover eects

in the economy. Furthermore, less competition may hurt consumer welfare and even nancial stability.

Let me leave capital markets aside, for later.

Coming back to the list of critical roles played by banks, we cannot forget about their role in payments. This is perhaps one of the areas where banks' market power has become more eroded.

Both traditional players, like Visa and Mastercard, and newer ones, such as Paypal or Revolut, have taken away a lot of the role played by banks in facilitating payments. Even central banks actively oer innovative payments solutions. As an example: Banco de Portugal has recently launched a secure and innovative instant transfer system, named SPIN.

But banks are not out of this game, and they continue to play a key role, sometimes partnering up with technological disrupters, other times preserving unique roles, such as those in cross-border payments.

And Payments are also often the entrance door to nancial inclusion, and traditional banks may be more willing to oer these services. Or at least they can be subject to regulation that requires them to do so, as is the case in Portugal with basic deposit accounts, which are designed to oer a low-cost payment and deposit service to individuals that may be otherwise excluded.

Related with this role, banks also play another important one, in helping to ght nancial crime and money laundering.

Last but not least, I would like to highlight another critical reason for the existence of banks: their role in the transmission of monetary policy.

For central banks to be able to deliver on price stability, a stable and functioning banking system is critical. This was, actually, actively discussed only a few weeks ago at Jackson Hole.

Non-banks also play a role in the transmission of monetary policy, but it appears to be a much weaker one.

If banks are not operating as expected, central banks would have more diculty in achieving price stability, which inevitably would lead to less investment and growth.

I have already talked about challenges to bank protability coming from regulation. Monetary policy also aects banks' protability, itself a transmission mechanism.

During the previous easing cycle, unconventional monetary policy tools boosted banks' prots, but a low interest rate environment created pressures on protability.

In contrast, as we see during the recent cycle, quantitative tightening creates pressures on the protability of banks with sizeable maturity mismatches, but boosts prots of banks with traditional intermediation proles, at least in the short run or for as long as liquidity is abundant.

Let me conclude by coming back to the question we are addressing in this panel.

Do we still need banks? We, denitely, do.

We need banks to intermediate funds in the economy, to make the nancial system work, to help us achieve price stability, to allow us to make payments, and many other functions.

We need banks to make choices about the ecient allocation of funds in the economy, taking informed risks that will allow the economy to grow.

Should the nancial system be entirely bank-based? Absolutely not.

Non-banks oer innovative and competitive solutions. Perhaps more importantly, even though in Europe we now have a working (though incomplete) Banking Union, there is still a lot to be done in terms of achieving a similar level of development and integration in capital markets.

Banks have the skills to monitor and screen viable projects, but they should not carry on their shoulders the entire responsibility of nancing the economy. A more diverse nancial system, with dierent levels of risk preferences, should allow for a more diversied set of investment opportunities, necessary to foster growth.

Especially if you want growth coming from riskier, more innovative, projects and industries, then you probably want that to be funded outside the banking system – and equity should play a huge role in this. Of course, that would mean higher risk taking outside the banking industry and an overall "general equilibrium" allocation of nance to dierent risk classes, in and out of banks.

But that is also the "beauty" of it: to reach a level of nancial literacy and maturity that sustains a new responsible (but *diverse*) risk culture.

So, do we still needs banks?

A nal word to those that are more skeptical: Imagine not having them. And all intermediation being Non-Bank Financial Intermediation (NBFI) as we know it.

Imagine that society and that economy. Guess what? In a few years time, after leaving the central bank and after my cooling o period, I would put in my best eorts to innovate and- create a bank! An institution that takes deposits, with deposit insurance, with access to the lender of last resort, that's regulated and supervised. "Wow!" I'm pretty sure I would attract a decent number of customers.