Patrick Montagner: Learning from the past, preparing for the future

Keynote speech by Mr Patrick Montagner, Member of the Supervisory Board of the European Central Bank, at the 11th Institute of International Finance (IIF) Colloquium on European Banking Regulation and Supervision, Frankfurt am Main, 5 December 2024.

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Thank you for inviting me to speak here in my new capacity as a member of the ECB's Supervisory Board. I've been asked to give you the ECB's view on the preparedness and competitiveness of the EU's banking system, and on how the regulatory and supervisory framework can foster conditions that help to balance growth and resilience.

Above all, a resilient banking sector is a precondition for economic growth. That's why the Basel Committee on Banking Supervision has just publicly reaffirmed its expectation concerning the Basel III framework being implemented in full, consistently and as soon as possible.

Let me first recall some facts about the recent past. The aim of prudential supervision is not to avoid all risks, but to have sufficient confidence in the preparedness of each individual bank to face all its risks. A cornerstone of what we do is assessing whether all material risks are being properly managed by the banks. If we look back on the great financial crisis, we can see that there were a lot of imbalances within the global economy. On top of that, the banking sector was not prepared to face these shocks and had taken a lot of risks which had either not been assessed properly or, in some cases, not assessed at all. This was mainly due to the race to the bottom in financial regulation that started in the 1990s, driven by the belief that light regulation and supervision could act as a catalyst for economic growth. Up until 2014, we were faced with huge fragmentation within the EU, with different adaptations of the Capital Requirements Directive[1], different supervisory practices and different requirements. And the banking sector itself was complaining about this situation, with each bank thinking its competitors were benefiting from a friendlier regime. The result was the worst depletion of wealth since the Great Depression of the 1930s, including a huge bailout by taxpayers and the failure of several major banks – unable to survive due to their poor governance and risk culture.

Turning to the current situation, we can all be satisfied with how far we have come in the last ten years. Over the past decade the overall profitability of European banks has increased. In 2024 banks under European banking supervision reported a return on equity of around 10%, compared with 6% in 2015. Banks' return on assets rose from 0.4% to 0.7% over the same period. During the years of low interest rates and low inflation profitability was much lower and it only recovered when interest rates increased. The non-performing loans ratio has decreased dramatically, from 7% in 2015 to below 2% today. Meanwhile, all banks under European banking supervision, whether significant or less significant, are now subject to the same supervisory standards – applied in the same way across all 21 countries. And harmonisation with practices in the rest of the EU has also greatly improved.

So, clearly, good regulation and good supervision have been essential to create a safe and harmonised level playing field and to allow the EU banking system to play its role in the economy without compromising banks' lending capacity. They have also helped banks withstand some unexpected turmoil in recent years: Russia's war of aggression in Ukraine and the energy supply shock, as well as the banking turmoil of March 2023 in some other countries. Weakening banking regulation and supervision would not boost the competitiveness of the EU economy. The issue of competitiveness should be addressed in a different way and the recent report by Mario Draghi has delivered some key messages, notably the need to encourage innovation and productivity in the European Union.

We all know that there are still significant discrepancies between countries that could create market distortions, in particular discrepancies in tax and corporate insolvency laws. Achieving a harmonised single market also requires structural reform in all countries. I won't repeat here the rationale behind the need to create a truly single market for capital, but I would nevertheless like to emphasise that we need to complete the banking union. This requires, first, a fully-fledged European deposit insurance scheme and, second, a stronger European framework for crisis management (and here I am referring to the crisis management and deposit insurance, or CMDI, framework). Both will promote integration and reduce national fragmentation. A more integrated European banking sector will be more efficient and competitive.

Of course, the ECB remains open to discussing possible simplifications and streamlining of its approach to banking supervision. The reform of our Supervisory Review and Evaluation Process (SREP) is one key element. Changes will be implemented gradually, starting in the second half of 2024, and will be finalised for the 2026 SREP cycle. The SREP reform will enable us to be more efficient, more comprehensive, and more effective – and will enhance our communication with banks.

Allow me to elaborate further on my point by taking climate and nature-related risks as an example. The EU legislator did not invent climate risk or the burden of ensuring an orderly transition. The risk has been around for a long time. The Intergovernmental Panel on Climate Change (IPCC) was created in 1988 to provide scientific assessments and recommendations related to the current state of knowledge about climate change. The Paris Agreement was adopted in 2015 at the UN Climate Change Conference COP21[2] after the Fifth Assessment Report of the IPCC. So clearly, all the facts have been on the table for decades. The latest tragedy in Spain has shown that the financial cost can severely hit the economy, not just at the regional but also at the national level. And we have many other recent examples showing the macro-financial relevance of climate and nature-related risks. On the one hand, the cost of the transition will be high. On the other hand, analysis consistently confirms that the costs of doing too little too late are much higher. The ECB supervisory stress test in 2022 confirmed this analysis for the banking sector. The reinsurance sector, which is exposed to natural catastrophes more routinely than the banking sector, has clearly understood this and shown that, without rapid adaptation, insurance could become unaffordable in some regions. Regrettably, the prevailing consensus in climate science tells us that we are far from on track to meet the goal of limiting global heating to two degrees Celsius, as set out in the Paris Agreement. Diluting regulation, supervisory intensity and effectiveness will do nothing to change the scale and magnitude of these risks, either in the very near future or in the medium and long term. Instead, we need to renew our efforts and banks

need to demonstrate their ability to correctly assess and properly manage these risks – risks which will undoubtedly have a negative impact on their profitability and resilience.

Digitalisation is another important factor that will drive bank profitability in the future. And once again, the facts leave no room for doubt. Customers expect the same from their banks as they do from any other business: they want to be able to easily access all of the services associated with their bank account. Banks also now face competition from newcomers that are not held back by legacy IT systems. They will therefore need to implement efficient digital solutions for their customers, find economies of scale and ensure the highest levels of IT security. At the same time, digitalisation doesn't mean the end of face-to-face interactions between banks and their customers: some people still want to go into their local branch in person, especially older people and those carrying out more complex financial transactions. The ability to respond to customers' evolving needs will be crucial for the future of established banks. They are facing competition from new financial service providers that are trying to attract business in the most profitable segment of banking operations: payments.

In addition, banks need to make major investments in their cyber and IT resilience to stay at the forefront of technological developments and prevent disruptions or breaches. Investment in IT will be key to ensuring the banking sector remains sound and competitive in the future. Economies of scale and a more integrated EU market are likely to be needed in order to absorb the cost and boost profitability. That's a key point: IT investment needs to be strengthened to maintain competitiveness vis-à-vis US peers. A study last year[3] observed that the annual IT budget for US global systemically important banks (G-SIBs) in 2021 was around 0.36% of total assets, compared with 0.19% for euro area G-SIBs.

Therefore, one of our supervisory priorities at the ECB is assessing how banks formulate, implement and monitor their digitalisation strategies, and how they manage the related risks. Building on our findings and surveys, we recently published criteria and best practices for banks' digital activities.[4]

But some questions related to technology are far from being solved. Generative artificial intelligence (AI) tools have the potential to transform some parts of the banking business, although as yet there is no clear evidence that they have been fully incorporated into banks' digitalisation strategies. Crucially, consumer rights and privacy must also be respected when issues related to AI are being addressed. And without good IT systems, AI tools won't be correctly fed by banks' data.

Let me conclude. The ECB's mandate to keep banks safe and sound makes a critical contribution to the overall competitiveness of the banking sector. And this works both ways, as the resilience of the banking sector is also about its competitiveness. We are therefore looking closely at the sustainability of banks' business models and their future profitability. Moreover, by establishing a harmonised framework for its supervisory activities through the Single Rulebook, the ECB has reduced the fragmentation that existed previously. And the SREP reform is another important milestone in our efforts to better assess risks while stabilising the methodologies we use. However, much of the work that still needs to be done falls outside of the ECB's remit. A strong supervisory framework plays a key role in supporting the growth and competitiveness of the economy but will never replace the need for structural reforms to boost productivity.

Other factors will also play a major role, such as changing demographics, including ageing societies, and geopolitical risks.

Overall, the profitability of European banks has increased significantly in recent years, but they need to continue adapting to a changing environment presenting a cluster of challenges. Long-term investment and a strong capital base will be crucial for banks to meet these challenges. From the ECB's perspective, there is no room for complacency.

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[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[2] Conference of the Parties (or "COP") to the United Nations Framework Convention on Climate Change (UNFCCC).

[3] Di Vito, L., Martín Fuentes, N. and Matos Leite, J. (2023), "Understanding the profitability gap between euro area and US global systemically important banks", *Occasional Paper Series*, No 327, ECB, August.

[4] ECB (2024), Digitalisation: key assessment criteria and collection of sound practices, 11 July.