Hans Jörg Schelling
Austrian Federal Minister of Finance

The banking sector – fit for the future?

Looking back to 2016, the European banking industry suffered a significant setback. Revenues declined across the board, cost reductions were unable to keep pace and low interest margins kept away the industry from increasing interest income. As a result, net income fell by almost half. Banks resorted to aggressive de-risking, but a shrinking equity base meant that capital and leverage ratios stagnated for the first time since the financial crisis. By contrast, U.S. banks continued to grow and set a new record in terms of nominal profits, widening the gap to their European peers.

All in all 2016 was not a good year for European banks. Though the economy picked up speed in most countries, banks suffered a setback caused mainly by market turmoil at the beginning of the year, high litigation expenses and large write downs on loans and goodwill in the final quarter. But cost levels also remained stubbornly high.

On the revenue side European banks faced the same challenges as American banks.

This would not have been such a problem if banks had been able to reduce costs to the same extent, or if the cost of risk had continued to decline. Yet administrative expenses fell less than revenues. In addition, loan loss provisions, which had provided tailwind in the past three years, increased by 27%. Having reached the lowest level since 2007 in 2015, this pickup, which burdened specific European countries, was hardly a surprise given the modest improvement in loan growth.

With profitability that much under pressure, banks again resorted to de-risking, deleveraging and shrinking. Total assets fell by another 2%, and total equity declined by 3%.

The impact on risk-weighted assets (RWA) was even more pronounced. They were cut by 7% to EUR 6.600 billion, the lowest level since 2008, despite large-scale inflation from tighter regulation (Basel 2.5 and Basel III). Over this period, banks have slashed *more than EUR 1,000 billion in RWA, or 14%* – an impressive achievement.

The most spectacular figure, however, came neither from balance sheets nor the profit and loss statement: for the first time since the financial crisis, European banks on aggregate did not manage to strengthen their capital levels in the past 12 months, in spite of de-risking. The fully loaded *CET1 ratio remained flat at 12.7%*. Admittedly, capital ratios have risen enormously since 2008.

Still, many banks are not yet comfortably above levels for both measures which would provide them with substantial flexibility and freedom to either invest in business growth or return much of future earnings to their owners.

This also shows that the European banking industry is far from a position where it could easily absorb a significant further tightening in capital requirements. In this regard, the *effective standstill of the Basel IV discussions* following the U.S. election has provided some relief to European banks.

How does the situation of European banks compare with the performance of their peers in Austria?

Austrian banks' profits increased in 2016, but this rise was to a large extent attributable to lower risk provisioning.

Income from core business lines, such as interest and commissions income, was down on the previous year.

More precisely, all major components declined year-over-year. Interest income was under pressure due to the ECB-policy. Modest loan growth could not compensate the contraction of interest margins.

Banks seem to be unable to compensate for this even in part through a shift towards a more strongly fee- and commission-based business model. Despite efforts to increase income from accounts, cards, transactions and asset management, fees and overall commissions dropped due to reduced client activity in volatile capital markets over the course of the year. Similarly, trading income slumped.

Over the past few years, restructuring at individual banks has been a key driver of improvements in the Austrian banking sector's credit quality. That said, the amount of nonperforming loans, which are to a large part in the books of Austrian banks' CESEE subsidiaries, remains a burden for some banks that should be addressed proactively in order to support new lending.

But let us be clear: it should not be addressed at the expense of the public sector! It is definitely not the task of the Government to rescue the financial sector again and again.

The costs for stabilising the banking sector in and after the crisis have been tremendous and as a consequence we have agreed on a resolution framework to ensure that bail-out by taxpayer's money is not on the agenda anymore. And we are continuously strengthening the regulatory framework to reduce the likelihood of failures in the banking sector.

Now it's up to supervisory and resolution authorities to apply the new or improved tool. And it is the task of DG COMP to assess whether the measures are in line with state aid rules or not.

If a bank is in deep, deep troubles, the authorities have to decide on the consequences. But it can't be the case that the bank asks for public support. It can't be the case either that authorities and institutions try to avoid decisions and try to pass the responsibility for actions to the next.

If it happens this way, ailing banks are being kept alive – and they will continue struggling for the rest of their life until severe measures will be taken. Alternatively the public sector has to step in again, but that's what I want to avoid for sure.

We need banks that are fit for the future and we need authorities that support the development of the sector.

One crucial element here is certainly the decision by the authorities on the capital provisions. A carful balance has to be reached between caring for risks and supporting the real economy, but I know that this trade-off is not easy to manage.

Taking a look at the Austrian sector, the *capitalisation of the Austrian banking sector has improved significantly* since the onset of the financial crisis. This trend continued 2016. However, domestic banks' capital ratios were still below the European average and its European peers.

The decline in operating profits accelerated banks' restructuring and adjustment measures as deemed necessary by the authorities but a lot of work is still waiting. For example, according to Eurostat the *population size per branch average* for all euro area countries was *2,170 people* in 2016. In *Austria* it was *2,100,* near this average. But in Belgium the population size per local branch reached 3,200, in *Finland 5,600* and in the *Netherlands 9,600*.

But let me also mention some positive developments, as we were able to find a solution on the *Heta issue*. Looking at the individual figures the resolution seems to be successful: The *recovery ratio* increases from *46% to 64.4%*. But I have to emphasize, a significant winner is also the Austrian banking industry, getting back its market presence especially in Germany.

But all in all, it seems that the *banks haven't done all their* homework yet and I really urge them to do so since they might see themselves confronted with more and more *growing competition* from other areas such as *FinTechs*.

Considering figures and the fact that FinTech start-ups and mobile banking are changing consumers' use of banking products the traditional banking model is threatened.

This is to say, the banks must prepare themselves for a changing environment. For this to be successful, they need to question their business models and make adjustments.

Some of them might be painful – but if these adjustments are postponed all the time, the day will be coming, when it will be too late to manage the turn around.

And please, *don't expect me then to step in and pay for the bank's inability to read the signals of time* and act accordingly.