EUROPEAN CENTRAL BANK

EUROSYSTEM

DIRECTORATE GENERAL -MACROPRUDENTIAL POLICY AND FINANCIAL STABILITY
FINANCIAL STABILITY SURVEILLANCE DIVISION

MACROPRUDENTIAL POLICIES AND FINANCIAL STABILITY CONTACT GROUP

FRANKFURT AM MAIN, MONDAY 19 SEPTEMBER 2016, 10:00-13.30 CET

MEETING SUMMARY

1. Market sentiment towards euro area banks

Introductory presentations were given on:

i. "European banks: value or value trap?" (Deutsche Bank)
ii. "Lessons learnt from past bad banks and workouts of legacy portfolios – what works, what doesn't?" (Bank of America Merrill Lynch)

Most MFCG members regarded depressed euro area bank equity valuations as reflecting subdued return-on-equity expectations, while capital, funding, and liquidity positions had all improved. Some members also saw regulatory uncertainty weighing on market sentiment towards euro area banks. Members largely agreed that capital constraints – resulting both from reduced internal capital generation and difficulties in raising capital externally – weigh on banks' lending activity. Apart from cyclical factors, many members also saw structural issues impeding the recovery of banks' profitability, especially overcapacity in parts of the euro area banking sector.

Members were concerned about the high stock of non-performing loans (NPLs) in some major banking sectors. They thought the most efficient way of tackling the issue was to improve insolvency frameworks, followed by imposing supervisory time limits for writing off NPLs and, to a lesser extent, facilitating the development of the NPL servicing industry and establishing secondary markets for distressed debt, as well as strengthening banks' internal workout capabilities.

Drawing on lessons from previous debt workouts, members felt that, per se, bad banks can work well but are essentially unfeasible without public sector support. In addition, no matter how well constructed a bad bank is, successfully managing a financial crisis would also require the creation of "good" banks; that is banks that are sufficiently capitalised, profitable and able to lend. Overall, members were of the view that if NPLs were correctly provisioned, there would be no problem in selling them. However, they saw too much discretion between countries: whereas US Generally Accepted Accounting Principles (GAAP) provided clear rules on provisioning, International Financial Reporting Standards (IFRS) did not until IFRS9 enters into force in 2018.

2. Key developments since the UK referendum on EU membership

Introductory presentations were given on:

i. "Financial market developments – was Brexit just a storm in a teacup?" (Citi)
ii. "Consequences for the organisation of the financial sector in Europe" (BNP Paribas)

Only a few members were concerned about Brexit having financial stability implications for the euro area over the medium term. However, some members expressed concern that the quick

normalisation of initial market reactions might be deceptive: the real impact of Brexit would be rather long term.

Most participants agreed that Brexit is likely to lead to the relocation of some activities from the City of London to the euro area. Brexit would have a sizeable impact on banks while also affecting Central Counterparty Clearing Houses (CCPs) and the asset management sector. There was a difference of opinion as to whether the insurance and pension fund sectors would be impacted as a whole or rather just their asset management arms. The main issue for banks was considered to be the likely loss of passporting. Members thought CCPs could be affected if negotiations with various countries caused disruption to clearing services.

3. Technological innovation in the financial sector – implications for financial stability?

An introductory presentation was given on:

i. Fintech: disruptive threat or tool? (Morgan Stanley)

Followed by short remarks on the role of FinTech on:

ii. insurers (AXA)
iii. asset managers (BlackRock)

Largely, members were of the view that FinTech developments had great potential for reducing banks' operational costs if banks took the opportunity to partner with FinTech companies. They thus saw FinTech developments as an opportunity for banks to become more efficient. For this to work, some hurdles would need to be overcome though: for one, institutions would need to actually want to collaborate. Furthermore, regulation (e.g. as regards data sharing) would need to be appropriate.

Rather than as an opportunity, a few members regarded FinTech developments as a threat to bank profitability with FinTech companies competing in traditional banking activities. Members agreed that the implications of FinTech developments were of an evolutionary rather than a revolutionary nature.