BANK FOR INTERNATIONAL SETTLEMENTS

The banking industry: struggling to move on

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Theme and takeaways

- Ask 3 questions
- 1. Is the banking industry stronger than pre-crisis?
  - Yes in some important respects, but troubling questions remain
    - Including widespread market scepticism
- 2. Why such scepticism?
  - Mix of legacy problems and an unfavourable economic environment
    - Including prolonged ultra-low interest rates
- 3. What could be done about it?
  - Banks
    - Pursue sustainable profitability and cut costs
  - Prudential authorities:
    - Complete the regulatory reforms (Basel III) and do not dilute standards
    - Encourage the clean up of balance sheets
  - Policymakers generally
    - Facilitate adjustment, including reduction of excess capacity (orderly exit)
- Review some recent BIS research and highlight key questions

1. Stronger? The good news

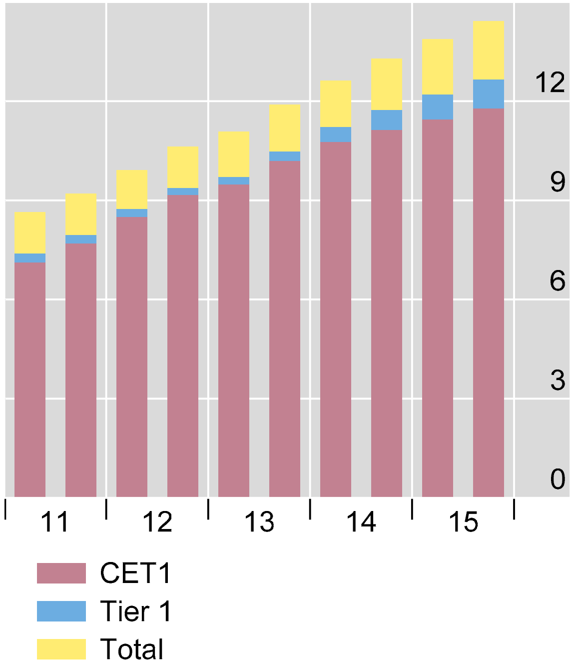
- In crisis-hit economies, profits have recovered albeit at an uneven pace…
  - Recent losses have in part reflected the cleaning up of loan portfolios.

- … And banks have been rebuilding their capital at a brisk pace (G 1)
  - CET 1 capital up from 7 to 12% between 2011-2015
  - Capital shortfall effectively eliminated
  - Mainly through retained earnings and little impact on credit

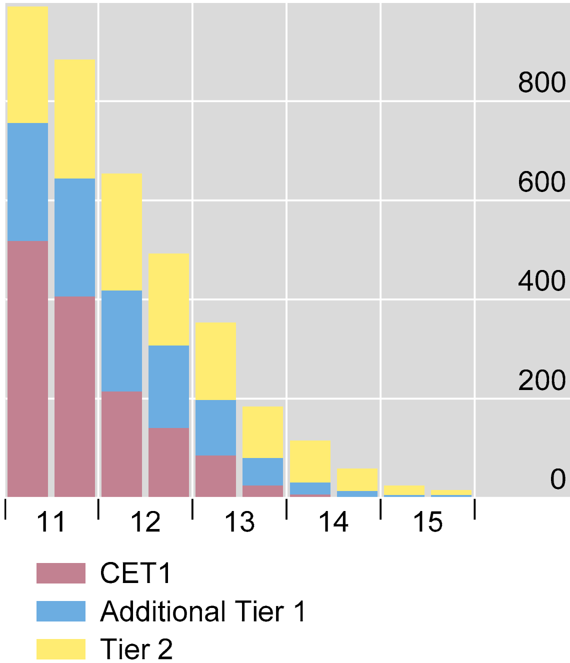
- In non-crisis-hit economies, profits and balance-sheet strength look generally good (G 2)
  - High profits and rising equity to asset ratios
  - Exceptions where financial cycles have turned
    - But no full-blown crisis

Graph 1: Banks have strengthened their balance sheets

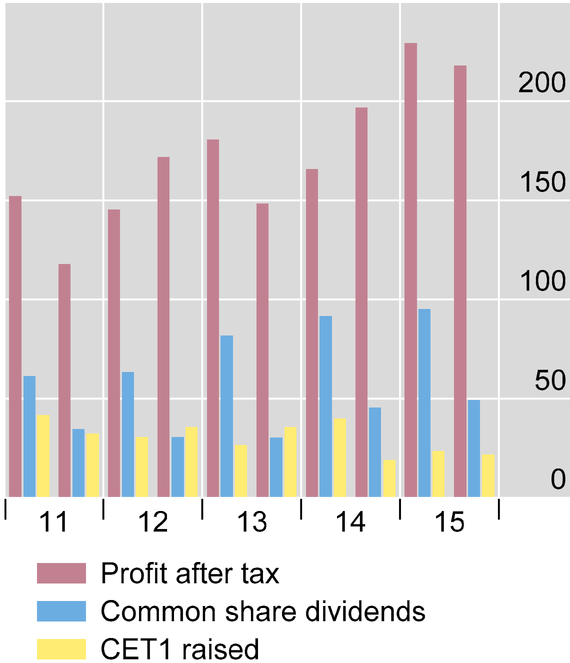
Bank capital ratios on the rise[1]



Capital shortfalls have been met[2, 3]



Profits support capital increases

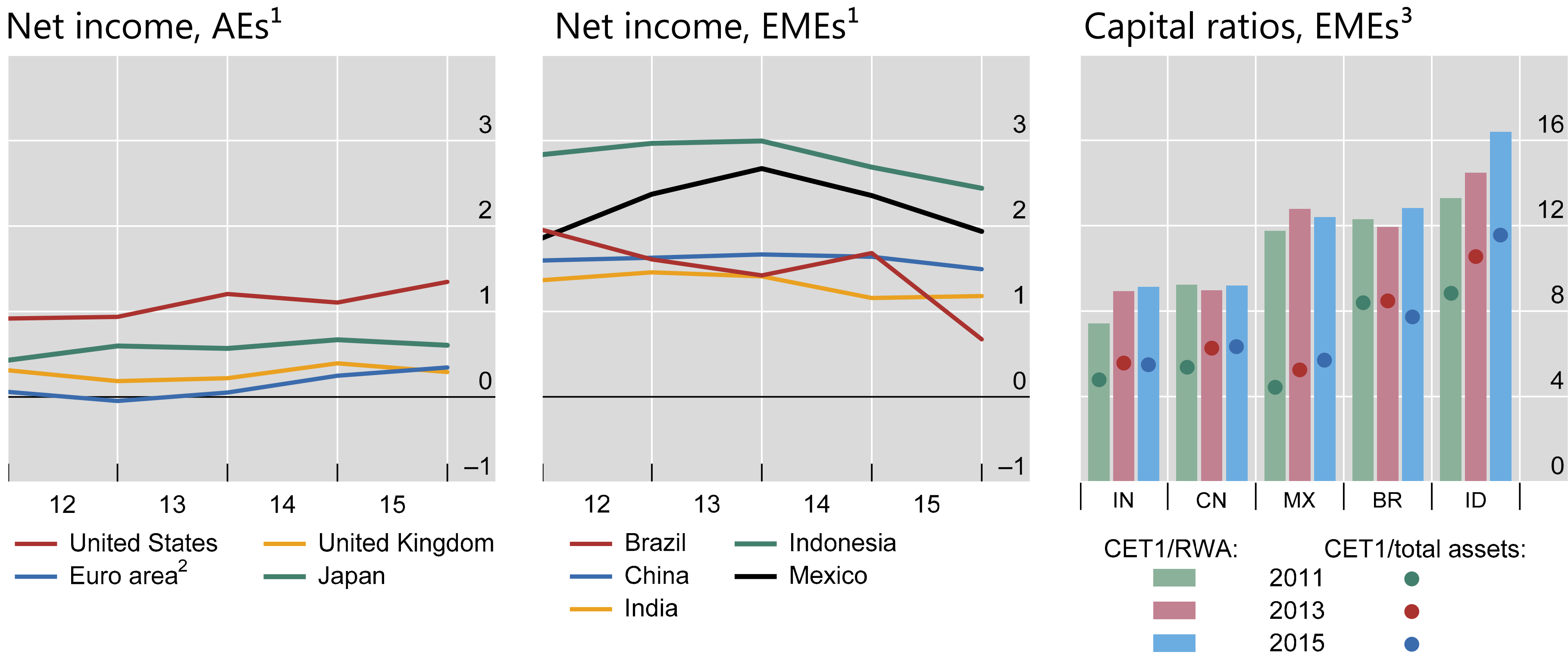


[1] Group 1 banks. [2] Group 1 and Group 2 banks. [3] The height of each bar shows the aggregated capital shortfall considering requirements for each tier (ie CET1, Tier 1 and total) of capital.

Sources: Basel Committee on Banking Supervision; BIS calculations.

Graph 2: Profits and capitalisation: EME banks outperform their advanced economy peers

In per cent



[1] Net income as a percentage of total assets. The calculation of total assets may differ across banks due to different accounting rules (eg on netting of derivative positions). [2] France, Germany, Italy and Spain. [3] Median ratios.

Sources: SNL; BIS calculations.

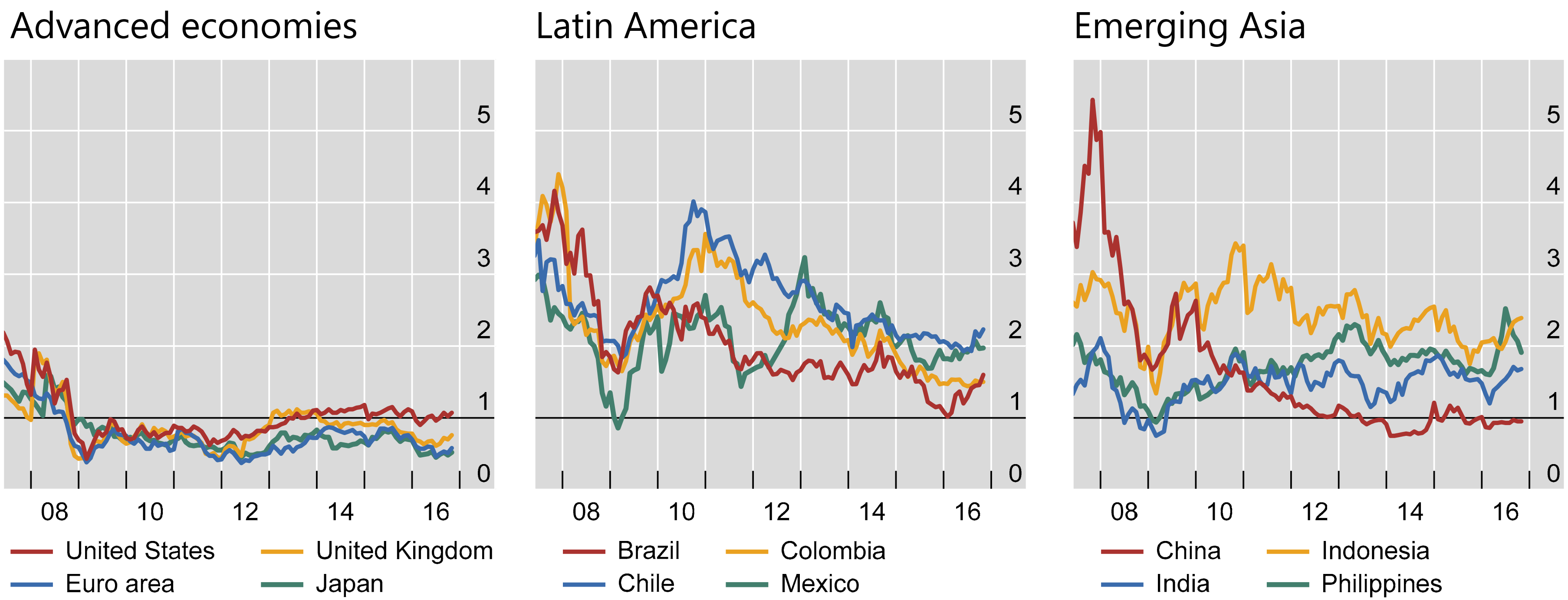
1. Stronger? The bad news

- Widespread scepticism
  - Price-to-book ratios below 1 in many advanced economies, esp. crisis-hit ones (G 3)
    - Shares have underperformed market
  - Credit ratings tell a similar story (G 4)
    - For euro area banks stand alone ratings are lower than at end-2010
    - Not much better for UK and US banks
  - Loss of competitiveness vis-à-vis market-based finance (G 5)
    - All-in ratings have deteriorated relative to corporates
    - Increase in market borrowing costs even for similar ratings
      - Boost banks' disintermediation

- Where optimism present, need not be always well founded
  - Questions about rosy financial statements in countries with strong financial booms
    - Statements are lagging indicators of trouble
    - Pre-crisis refrain «banks have never been as well capitalised»
  - Only time will tell

Graph 3: Bank price-to-book ratios struggle to recover[1]

Ratio

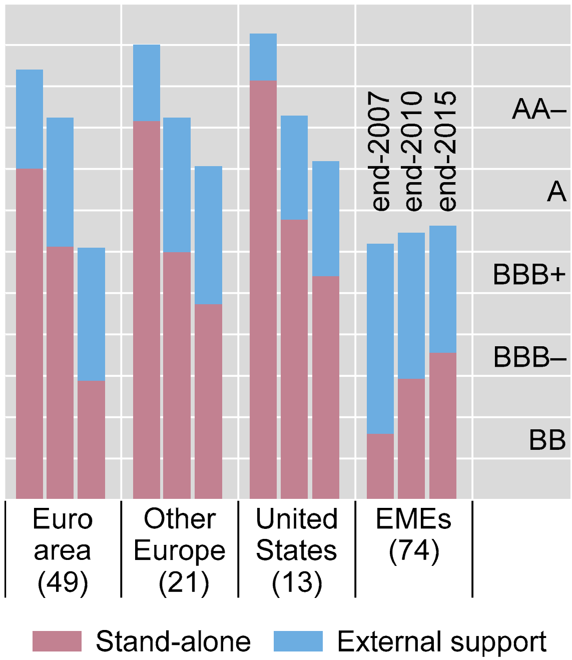


[1] End-of-month data.

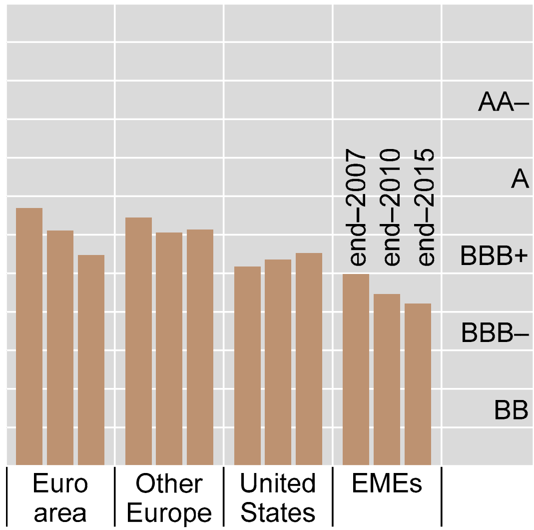
Sources: Datastream; S&P Capital IQ; BIS calculations.

Graph 4: Weak ratings erode bank's funding advantage

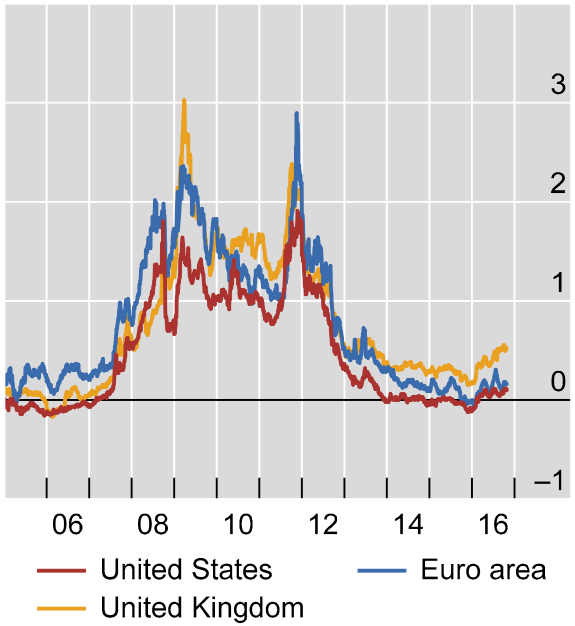
Bank ratings[1, 2]



Non-financial corporate ratings[1]



Relative funding costs: A-rated banks vs A-rated NFCs[3]



[1] Asset-weighted averages. [2] Numbers of banks in parentheses. [3] Option-adjusted spread on a bank sub-index minus that on a non-financial corporate sub-index, divided by the spread on the non-financial corporate sub-index. Sub-indices comprise local currency assets.

Sources: Bank of America Merrill Lynch; Moody's; BIS calculations.

2. Why such scepticism?

- Two types of reason
  - Stock problem
    - Asset quality and mistrust (miscounduct and risk-weight optimisation)
  - Flow problem
    - Profit prospects
      - In addition to Fintech challenge and regulatory concerns…
      - … persistent ultra-low (nominal) interest rates
- Why persistent asset quality issues?
  - A morphing crisis (from GFC to sovereign strains in the euro area)
  - Protracted post-financial boom economic weakness
  - Uneven policy response
    - Lessons of early-1990s financial busts not fully learnt
      - Nordic countries vs Japan
    - Why?
      - Initial mis-diagnosis (liquidity vs solvency)
      - Harder to resolve: securitisation and international dimension
      - Main reason: thought could afford to wait

2. Why such scepticism?

- Why concerns with persistent ultra-low <u>nominal</u> interest rates?
  - Unprecedently low
    - Even negative out the yield curve in some jurisdictions
  - Low rates may temporarily raise profits
    - Capital gains and higher activity
  - But if persistent enough hurt net interest margins
    - Impact of low rates and flat yield curves
    - Empirical evidence confirms this
      - Non-linear relationship at work
    - Evidence that this may also hurt lending (G 5)

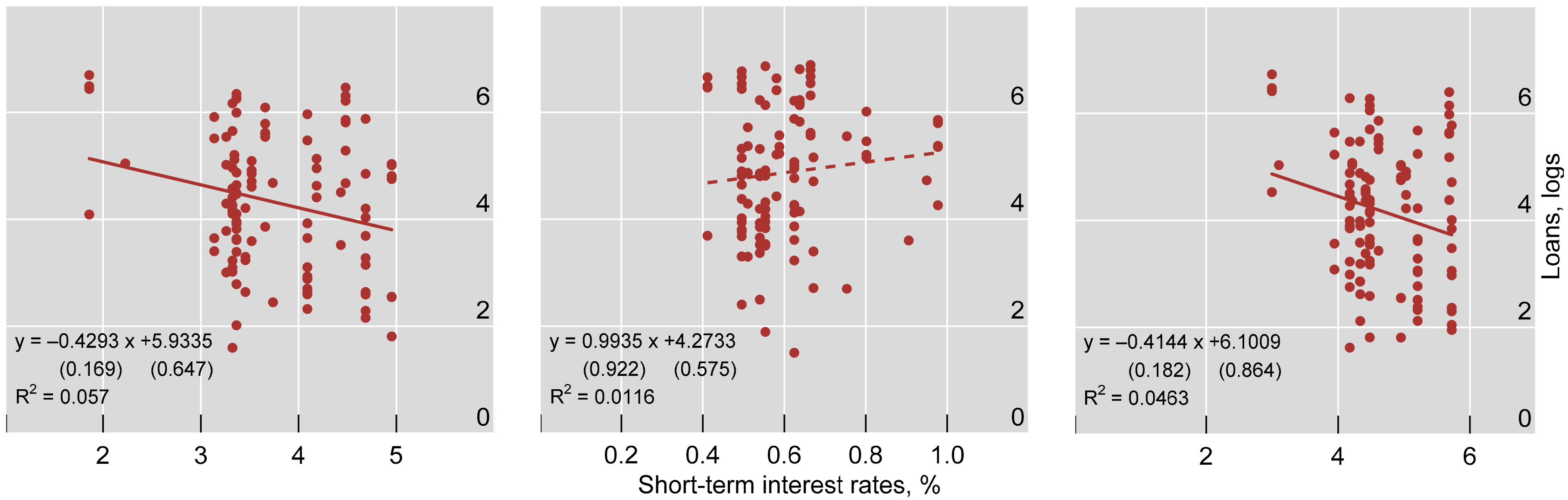
- Such rates raise a business model conundrum
  - Retail business model had performed best through crisis…
    - Increasingly popular post-crisis (T 1)
  - …But it is the model most vulnerable to ultra-low rates
    - Large retail deposit base

Graph 5: At very low rates easing loses effectiveness in boosting lending

(A) Whole sample

(B) Low-interest-rate sub-sample

(C) Remaining sample



Sources: Borio and Gambacorta (2016).

Table 1: Business models: traditional banking regains popularity[1]

Number of banks

		Business model in 2007			
		Retail-funded	Wholesale-funded	Trading	*Total*
Business model in 2005	Retail-funded	53	10	0	*63*
	Wholesale-funded	3	25	2	*30*
	Trading	2	0	13	*15*
	Total	*58*	*35*	*15*	*108*
		Business model in 2013			
		Retail-funded	Wholesale-funded	Trading	*Total*
Business model in 2007	Retail-funded	57	1	0	*58*
	Wholesale-funded	16	16	3	*35*
	Trading	3	1	11	*15*
	Total	*76*	*18*	*14*	*108*

[1] Based on a sample of 108 banks from advanced and emerging market economies.

Sources: Roengpitya, et al (2014).

2. What can be done? Banks

- Get the strategic choices right
  - Sustainable profits, a strong capital base and top-notch risk management

- This was not the case pre-crisis
  - Compared to other sectors, banks had lower but more volatile equity returns
  - Higher return on equity or less Tier 1 pre-crisis....
  - ....meant more emergency official support during the crisis
    - Tell-tale signs of too high leverage and unsustainable returns

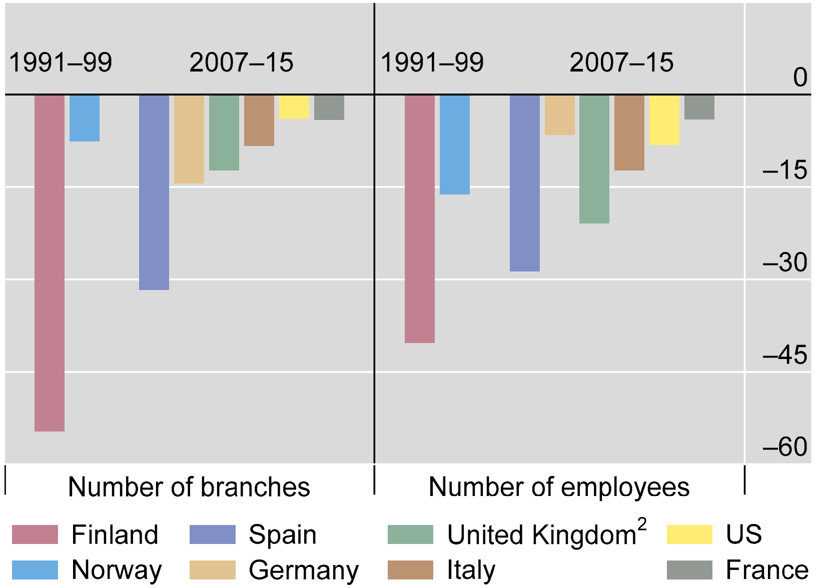
- The business model challenge
  - Tough given the unfavourable environment
  - One key: cost cutting (G 6)
    - Uneven and disappointing progress relative to post-Nordic crisis experience

Graph 6: Uneven progress in bank's costs adjustments

In per cent

Cost-to-income remains stubbornly high for G-SIBs[1]

Cost savings vary 8 years after the onset of the crisis



[1] Based on 2015 list of G-SIBs for which cost-to-income ratios were available. [2] For the change in the number of branches, 2007–14.

Sources: OECD; SNL; national data; BIS calculations.

2. What can be done? Prudential authorities

- Complete the regulatory reforms and do not water down prudential standards
  - Strong base on which to build
  - Benefits of higher capital have, if anything, been underestimated

- Criticism 1: Higher capital requirements, on net, hurt growth
  - Why? Reduce the supply of lending

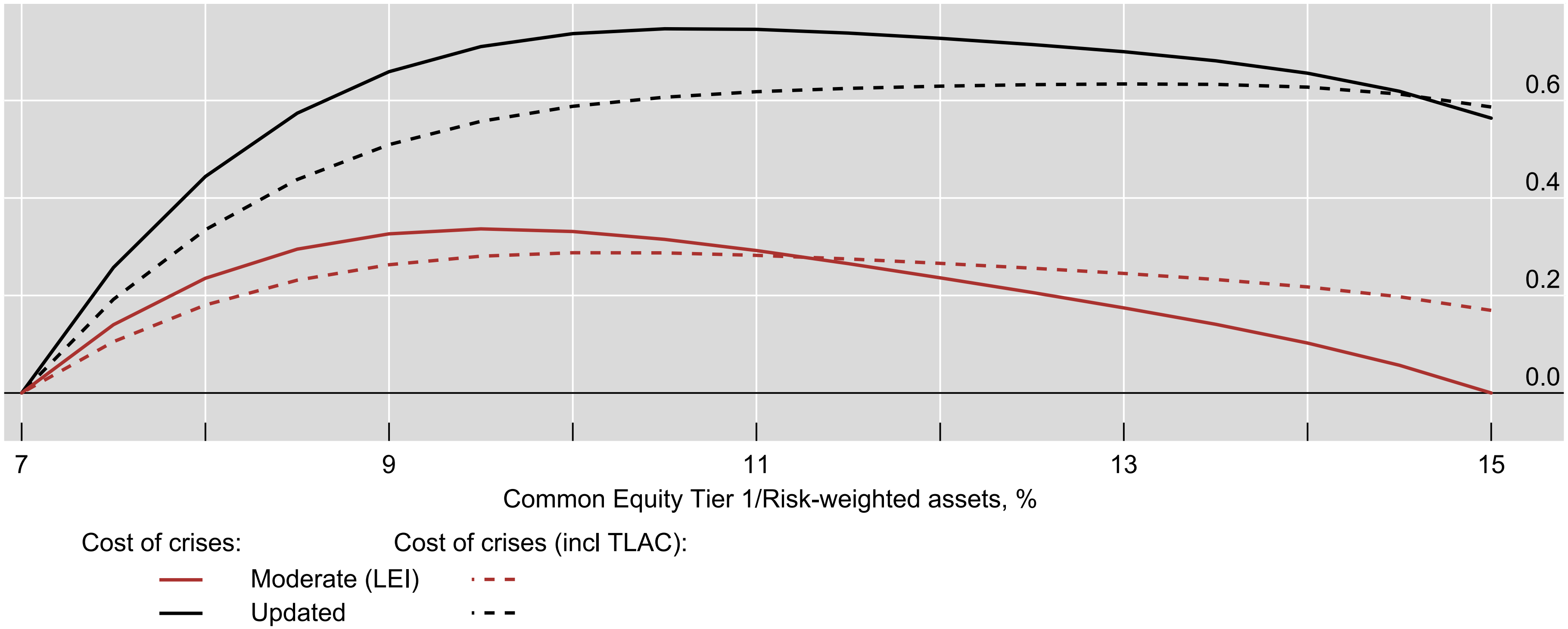
- Answer 1: Long-run – update of cost/benefit analysis points to higher net benefits (G 7)
  - Not least owing to higher crisis-cost estimates and even once include TLAC
  - And original analysis was deliberately very conservative!

- Answer 2: Transition – Banks have adjusted quite well so far
  - Mainly via higher retained earnings; smaller role of lower RWAs and credit (G 8)
  - Banks with higher capital post-crisis lent more thereafter

- Answer 3: Capital is the basis for lending
  - Evidence: higher capital coincides with lower borrowing costs and more credit

Graph 7: Capital regulation is expected to yield sizeable economic benefits

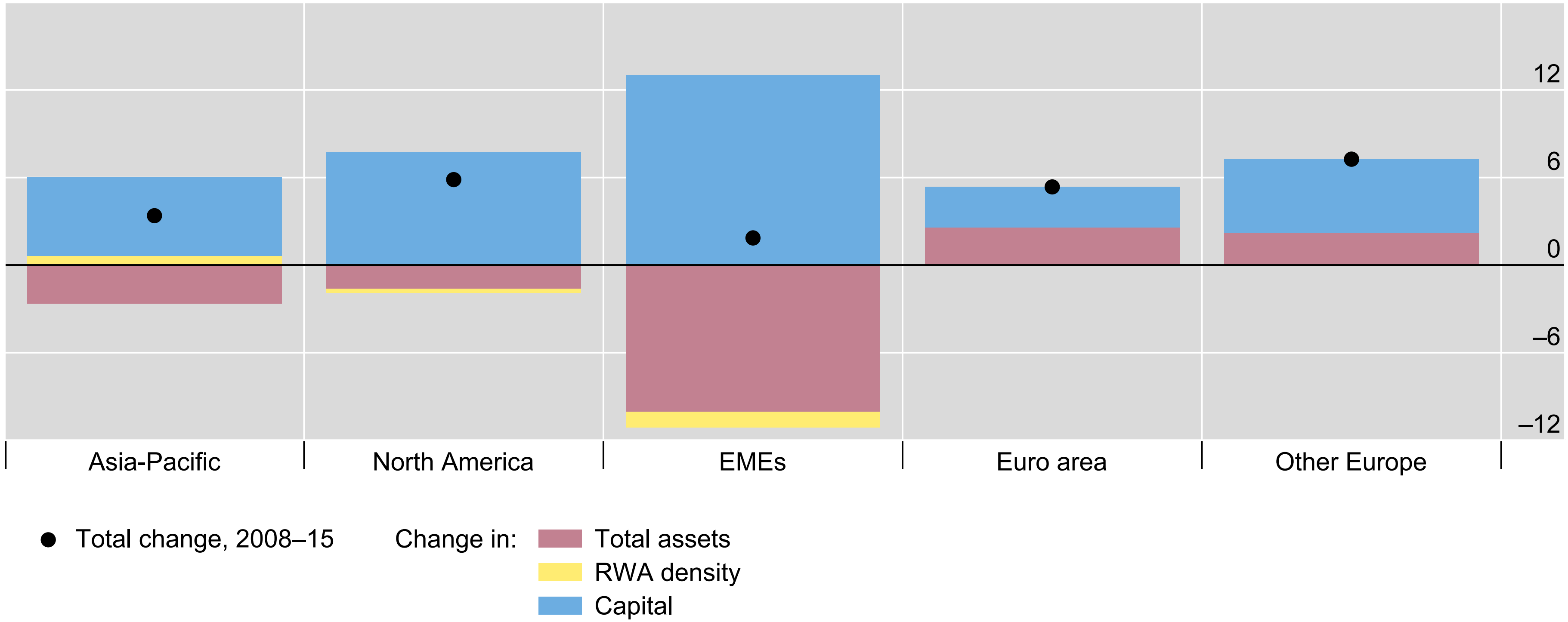
Expected marginal net benefits (per cent of GDP)



Source: BIS (2016a), partly based on Fender and Lewrick (2015) and BCBS (2010).

Graph 8: Sources of changes in bank capital ratios, end-2008 to end-2015

Normalised to percentage points of end-2008 risk-weighted assets



Sources: updated based on B Cohen and M Scatigna (2014).

2. What can be done? Prudential authorities

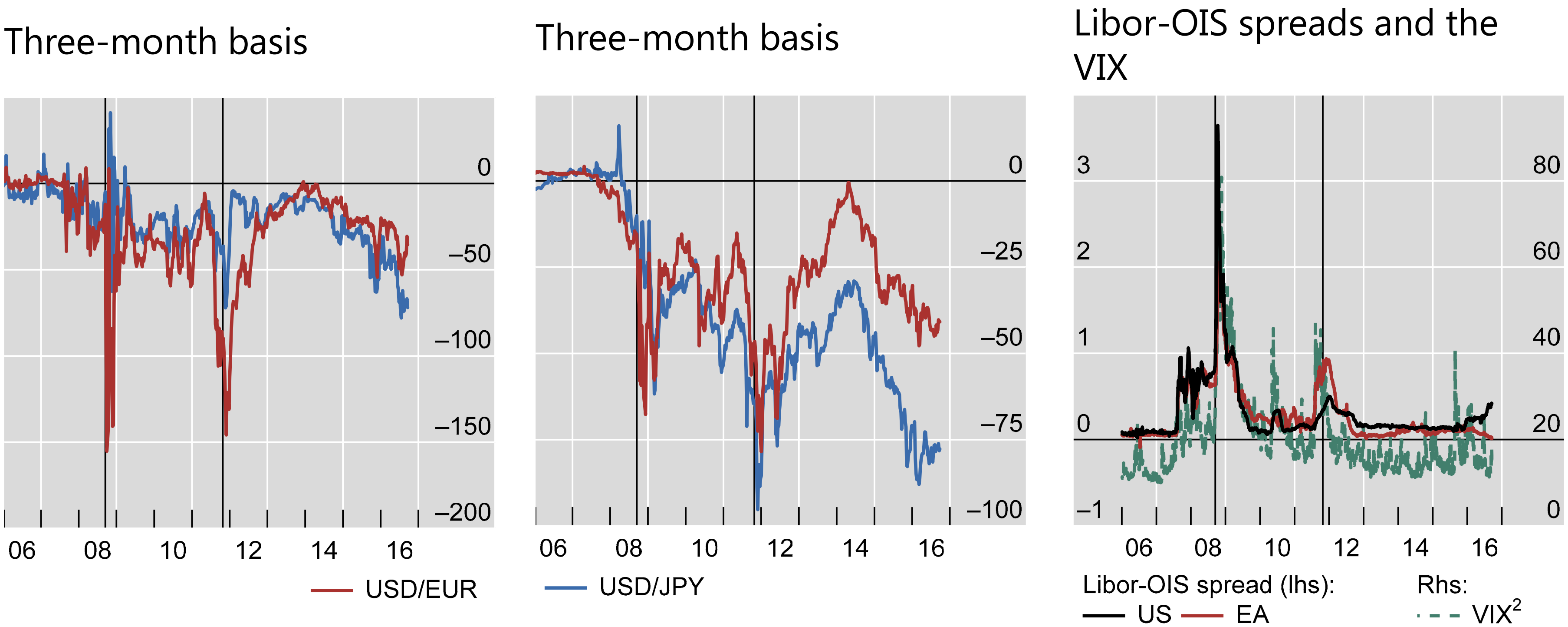
- Criticism 2: Higher capital requirements, on net, hurt market liquidity
  - Why? Reduce the supply of market-making services

- Answer 1: Evidence on post-crisis reduction in market liquidity is mixed…
  - Depends on indicator and is mainly confined to specific segments (eg, corporate bonds)
  - But clearer signs of market anomalies
    - Breakdown of covered interest parity (CIP) (G 9)

- Answer 2: Regulation is at best just one factor
  - Market liquidity: spread of electronic trading
  - CIP: hedging demand combined with tighter management of balance sheets (G 10)

- Answer 3: Impact of regulation is intended
  - When it results in tighter management of risks and balance sheets
    - Avoid pre-crisis underpicing of liquidity and liquidity illusion

Graph 9: Cross-currency basis against the US dollar, interbank credit risk and market risk[1]

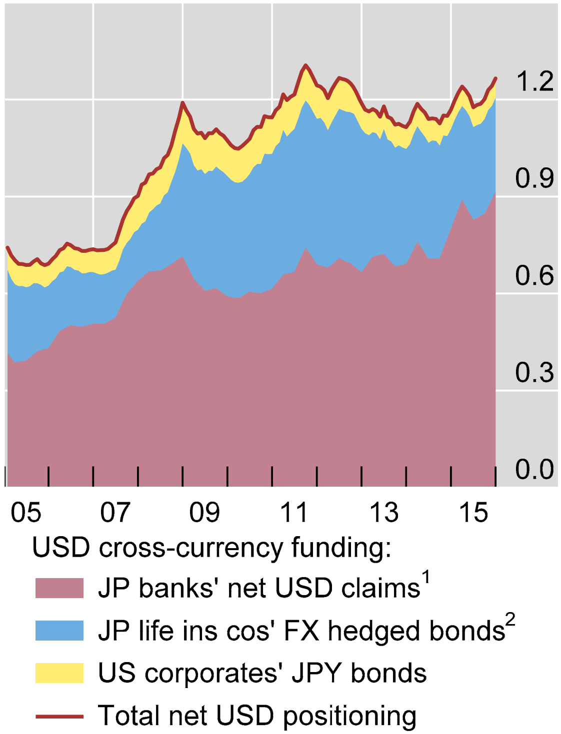


[1] The vertical lines indicate 15 September 2008 (Lehman Brothers file for Chapter 11 bankruptcy protection) and 26 October 2011 (euro area authorities agree on debt relief for Greece, leveraging of the European Financial Stability Facility and the recapitalisation of banks). [2] Chicago Board Options Exchange S&P 500 implied volatility index; standard deviation, in percentage points per annum.

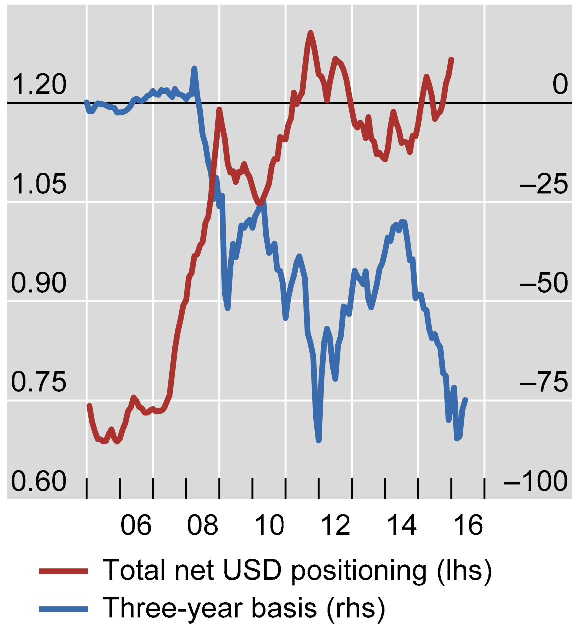
Sources: Bloomberg; author's calculations.

Graph 10: Sources of currency hedging demand and the JPY/USD basis

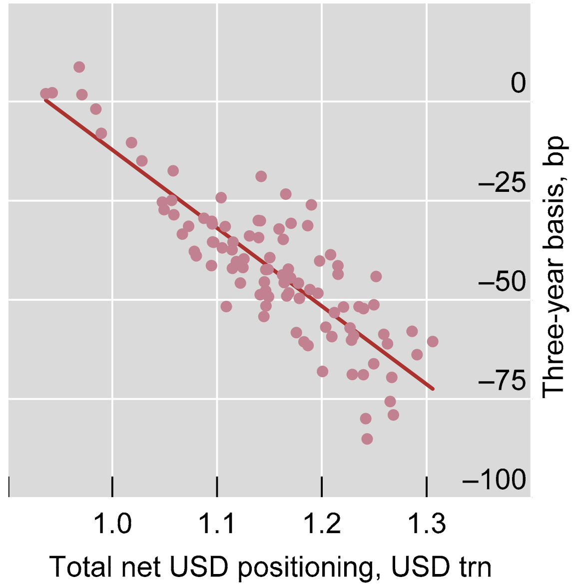
FX hedging demand by sector



FX hedging demand and the basis



FX hedging demand and the basis (Jan 08-Dec 15)



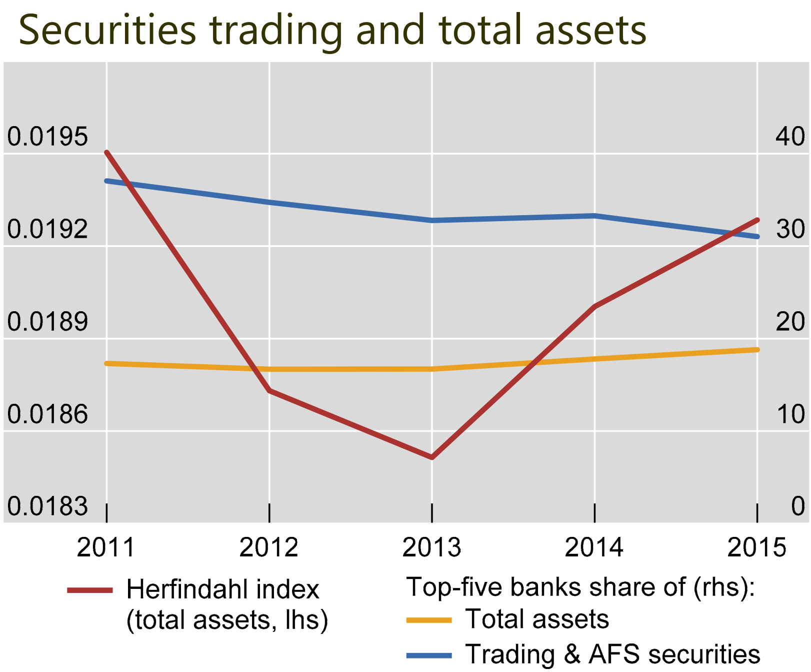
[1] Difference between gross US dollar assets and liabilities of Japanese banks; quarterly data linear-interpolated to monthly frequency. [2] Japan life insurance companies' currency-hedged US dollar bond holdings estimated by multiplying the stock of the insurance companies' FX bond holdings by their time-varying currency hedge ratios; monthly frequency.

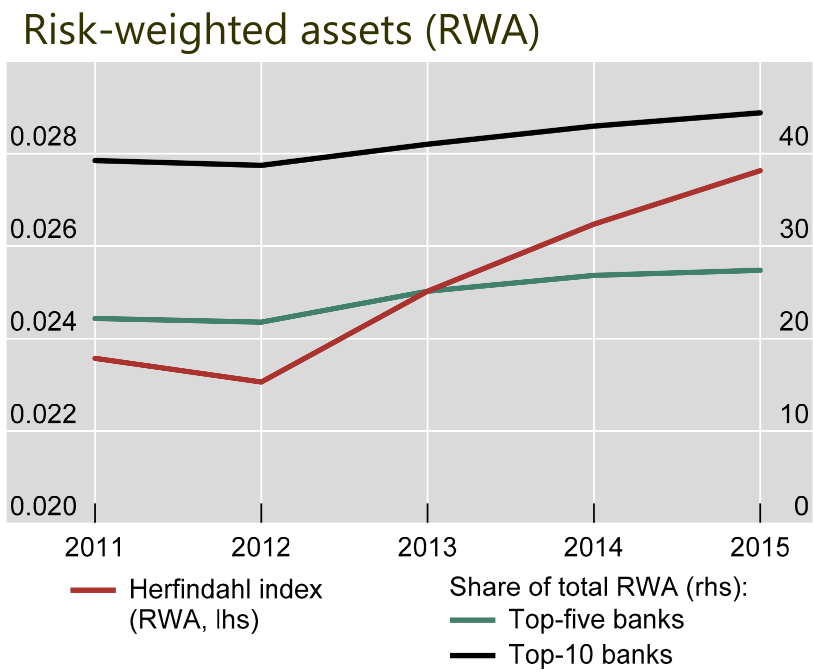
Sources: Borio et al (2016).

2. What can be done? Prudential and other authorities

- Facilitate the necessary adjustment of the sector
  - Tackle poor asset quality and structural excess capacity
  - Exit problem in the industry is key
    - Exit is harder than in other sectors because of costs for rest of the economy
    - Associated safety nets induce over-expansion by reducing market discipline
- Mechanism 1: Improve resolution schemes for orderly exit
  - Work done or under way nationally and internationally
  - Credible schemes are critical to underpin cleaning up of balance sheets
- Mechanism 2: Broader policies to facilitate exit and cost-cutting
  - Better legal frameworks (eg, length of work outs)
  - Less public ownership and fewer barriers to cross-border mergers
  - More flexible labour markets
- Challenges loom large
  - Jury still out on whether the too-big-to-fail problem has been solved
  - Option of public sector support is impotant in case of systemic crises
  - Tricky balance: reducing excess capacity and encouraging concentration (G 11)

Graph 11: Concentration in global banking activity persists[1]





[1] Sample of major internationally active banks that are included in the G-SIB calculation exercises.

Sources: SNL; BIS calculations.

Conclusion

- In some important respects, the banking industry is stronger than pre-crisis…
  - … But troubling questions remain, including widespread market scepticism

- Scepticism reflects a poisonous mix of…
  - …Legacy problems and an unfavourable economic environment

- Addressing this challenge calls for
  - Banks to pursue sustainable profitability and cut costs
  - Prudential authorities to complete the reforms without diluting standards and to encourage clean up
  - Policymakers generally to facilitate adjustment (excess capacity, exit)

- Plenty of question for researchers!
  - Implications of persistent ultra-low interest rates for profits and business models
  - The nexus between exit barriers/excess capacity/risk-taking
  - The nexus between regulation/internal capital allocation/pricing decisions