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Profitability and competitiveness of EU banks: main challenges

[Full transcript](#)

DAVID WRIGHT:

I have the pleasure of continuing this excellent Forum with a short discussion with the Chief Operating Officer of BNP Paribas, Monsieur Bordenave, well known to you all, I know.

We decided we want to talk about the pressures on the bank, but particularly looking at this from perhaps, a more commercial point of view: the huge regulatory change, the massive digitalisation agenda, common supervision, capital markets union. What does this mean for BNP Paribas? Is this affecting profitability, core activities, how is it reshaping your bank?

PHILIPPE BORDENAVE:

Well, over the last years, banks have had to face a kind of tsunami of new regulations following the G20 package agreed in 2009; as a result, it is obvious that the capital reserves of the banks have been considerably strengthened. The recent figures show an increase of 40% between March 2008 and March 2015, from 1.7 trillion to 2.4 trillion, according to the ECB data.

And though this increase of 40% is really huge, much bigger than over the previous 20 or 30 years, at the same time the liquidity regulation has obliged banks to increase high quality liquid assets at a very high proportion as well, currently reaching 2,300 billion against 1.7 trillion in June '11. So again, a considerable increase.

On top of this, the compliance, control resources and procedures have been considerably strengthened and the reporting has also been considerably increased: it is more granular, you have to report more often, quicker, and so on and so forth.

So, it is a huge amount of work, a huge amount of challenges that have been faced by banks

and they have tackled that appropriately. Banks have not forgotten their clients during this period and this is a remarkable achievement because banks have not only to comply, they are also here to take care of clients. The other side of the coin is that the banking system is much, much more secure than before the crisis. I mean, the result has been achieved.

DAVID WRIGHT:

But do you think, Philippe, there has been a cost to all of this regulation? For example, SME lending. One hears a lot about the pressures on banks who are sometimes...

PHILIPPE BORDENAVE:

In order to meet the regulatory ratios, you can adjust the numerator or the denominator of the ratios. So if you reach the limit of what you can do on the numerator, you just have to shrink the denominator.

So, on top of what banks have made regarding the capital, on the equity side, they also were obliged to clearly shrink their balance sheets. And, if I take the example of BNP Paribas, which is a little bit maybe extreme, it is very dramatic: when we bought Fortis, our balance sheet went up from 2.1 trillion to 2.6 trillion and then, over the following years, we were obliged to go back to below 2 trillion in order to comply with the prudential regulation.

So, in a nutshell we destroyed assets that were of the same magnitude as the total balance sheet of Fortis. We have reduced the balance sheet in every type of items; among others, we have been obliged to crunch the lending and when you look at the banking sector as a whole the statistics are pointing to a reduction of around 10% of the lending in the Euro area over the period 2011 to 2014.

At the beginning of the process, banks tried to protect lending, because it is our business. It is our main source of revenue as well. But after a while, it was necessary to reduce it and the lending contraction accelerated between '11 – '14.

Recently, due to the TLTRO of the ECB which helped a little bit to water down the liquidity constraints, the lending activity recovered somewhat. But still, if you compare the current total amount of loans to non-financial companies and individuals in the Euro area, to what it was in '11, it's still 5% below. So it is a significant contraction.

DAVID WRIGHT:

Let me ask you a very unfair question, I mean, when you look at the threat or the great challenges to BNP Paribas or the banking system in general, and I asked the same question to Jean Lemierre yesterday, what is it, of all the factors? Is it digitalisation which we have just been talking about, is it low interest rates, is it the pressure from regulation, is it a leverage ratio or is it everything?

PHILIPPE BORDENAVE:

Clearly, it is regulation taken as a whole.

DAVID WRIGHT:

More than digitalisation?

PHILIPPE BORDENAVE:

Digitalisation is just the latest form of innovation. I mean we are used to coping with such challenges.

DAVID WRIGHT:

You're comfortable with that?

PHILIPPE BORDENAVE:

Yes, we have already gone through a lot of innovations. I remind you the development of the credit cards, multi-channel banking, and internet banking and so on. So, the banking industry is constantly adapting to new technologies; it is always stimulating, sometimes challenging but this is our business and so it is not a problem in itself. Low interest rates are very challenging as well but it is a matter of asset and liability management, it is also a question of adaptation, we are used to that.

The regulation is really the big challenge. It has clearly reduced, not only the banking offer, with some impact on the real economy, but also, as a consequence, the banking profitability.

The profitability of banks, which used to be an excessive 15, 20% before the crisis, is today in the region of 5% in the Euro area, on average. The non-financial companies are still yielding a return on equity of around 10%, which is what the market is asking for. Therefore this low level of profitability is a real challenge for banks: the pressure is very high to focus more on the most profitable parts, and hence to further crunch the business and the activities.

A very good example is General Electric, which was running a very good, very brilliant financial subsidiary General Electric Capital Corporation. They decided to stop and to sell, and to become pure industrialists back then, because it's too difficult today to be a banker.

DAVID WRIGHT:

But, when you are looking at what is coming down the tube here, TLAC leverage ratios, my sense is that France, for example, is not comfortable with some of the ways these technical rules are being developed, is that right ?

PHILIPPE BORDENAVE:

Europe as a whole is afraid. We feel it when we speak with our banking colleagues from all over Europe.

DAVID WRIGHT:

Why is that Philippe?

PHILIPPE BORDENAVE:

Because after the first wave, which is now almost digested with the help of the TLTRO, as I just said, we see a second wave coming (TLAC/MREL, review of the standard approach for credit, market and operational risks etc.). We are already well capitalised. The level of safety of the banking system has already been increased quite a lot. This new wave of regulation is maybe going to add another layer of safety, but only marginally. It's the law of the declining yields.

But on the other hand, this new wave of restrictions is going to create a new wave of deleveraging, because we are going to be obliged to further focus on the most profitable part of the business and we are probably going to be obliged to focus also on the most domestic part of the business because it is where the profitability lies the most by nature, with more cross selling, with more market shares and so on. There is a significant danger to see, at

least the big European banks, with cross border activities, becoming more focused on their domestic market. And maybe it's a pity, well, it depends on what the Euro zone wants to have as a banking system, but if they want to have a few banks with a global reach, maybe it should think twice before adding new layers of constraints

DAVID WRIGHT:

So, you see a refocusing on core activities, the profitable activities which means what in terms of shedding business lines, or...?

PHILIPPE BORDENAVE:

Exactly. We have already observed examples of this refocusing on core activities. We have seen UBS deciding to exit most of the fixed income business, Credit Suisse poised to do the same, Barclays also deciding to reduce or to almost exit Asia in order to focus on Europe and the US.

So, all banks in front of this new wave of regulation are thinking of how they should focus on their strong points and so it gives smaller banks, which is probably what the regulation is aiming for, smaller banks, simpler banks, but also maybe more fragile, because they are going to be less diversified.

DAVID WRIGHT:

Retrenchment?

PHILIPPE BORDENAVE:

Yes retrenchment and certainly the ability of European banks to accompany big corporate clients outside Europe is going to be hampered.

DAVID WRIGHT:

So, when you think about how to restore return on equity to average industrial levels that

you were referring to, it's through that, it's by doing that, it's by...

PHILIPPE BORDENAVE:

Yes, by improving the cost income ratios, so focusing on the financial places where you are the strongest, and cutting costs, cutting probably entire parts of your business, selecting the ones, of course, that are the more profitable. These adaptations are quite normal industrial reactions in front of new regulatory constraints.

DAVID WRIGHT:

Just two questions to finish, capital markets union. This is going to be a big subject that we'll discuss throughout today, do you see that as a threat or as an opportunity for BNP Paribas?

PHILIPPE BORDENAVE:

It is an opportunity of course; it is an opportunity notably for universal banks. We can accompany clients on the capital markets if we are lending less. We can help them tapping the market. So, for us it is a way to keep working with them and what we are losing on the one hand, we are gaining on the other hand. So, it is an opportunity for big universal banks and an opportunity for big US banks in Europe as well.

But paradoxically at the same time, the same constraints are limiting the ability of European banks to be market makers. Look at the recent PwC study about trading inventories. This study is in particular measuring the daily volumes of turnover on sovereign bond markets. They declined by 20% over the last 3 years. It is largely due to the liquidity ratios and increased risk weighted assets, as measured by the new Basel III rules, and this is going to be worsened by the fundamental review of the trading books, which is upcoming.

The ECB studies, the stress test survey reports, have recently highlighted the reduced confidence among larger banks in their ability to act as market maker in periods of stress.

So, this same reduction of balance sheet has also reduced trading inventories and the banks' ability to be market maker. This is part of the inconsistencies that we are seeing in the regulation.

DAVID WRIGHT:

Last question now. Do you see, and we talked a lot about confidence and trust on the previous panel, what the surveys tell you in France about trust in the banking system, are they showing good results?

PHILIPPE BORDENAVE:

France is maybe in a specific situation, because we had no big banks posting huge losses and banks have not been a drag on public finance at all. It is even quite the opposite: taxes on banks have been increased and so on. Banks are proud to have helped fiscal balances in many ways over the last few years in France. So, the state of mind is not exactly the same, probably as elsewhere. I don't think that in France there is a crisis of trust in banks at all.

DAVID WRIGHT:

Philippe Bordenave, thank you so much.