POLICY PRIORITIES FOR THE EU BANKING SECTOR

European banks have shown resilience during the pandemic but suffer from a persistent low level of profitability. Pre existing vulnerabilities, such as banking overcapacity, lingering cost inefficiencies and increased competition from non banks, particularly fintech and big tech firms, are forcing banks to adjust their business models and make themselves more sustainable in order to continue to support the post Covid recovery. The solutions to the profitability challenge are well known but often difficult to implement. Digitalisation enables banks to improve cost efficiency and offer better products to customers while facilitating the integration of the European banking sector, but these innovations raise new regulatory challenges around level playing field and consumer protection.

1. Improving the competitiveness and profitability of the EU banking sector remains challenging

The EU banking system faces a lack of competitiveness and structural under profitability, which disrupts on bank valuations. The low profitability in European banks is caused by a range of factors, including lasting low interest rates, excess capacity, low cost efficiency, the high cost of regulation and a lack of scale.

1.1 The European banking industry is not profitable

An industry representative mentioned several key factors concerning competitiveness, highlighting the importance of overcapacity. There is still overcapacity in some areas of banking. The cost income ratio is an important subject, but in the last seven or eight years the European banking sector has demonstrated its ability to tackle costs. The European banking sector – whether in wholesale banking, retail banking or asset management – is a broadly a low margin environment compared to the US, which benefits from a large domestic base. There are many parts of the US banking sector where margins are simply higher than in Europe. Lastly, the cost of regulation is very important here. It is clear that the US banking sector and US regulators are more sensitive to the cost and effectiveness of regulation, whereas Europe is only now starting to consider this.

1.1.2 Low profits and high costs remain a key challenge

A regulator agreed that the first challenge for the EU banking sector is profitability. For many years, the banking sector has been unable to obtain a return on equity commensurate with the expected cost of equity. Last year, return on equity was around 2%. Given the macroeconomic environment, the European Banking Authority (EBA) considers cost to be the key component of profitability which could be adjusted going forward. An industry representative agreed on the need to tackle low profitability in the banking industry. The main reasons for low returns are: low interest rates; non bank competition, especially new digital entrants; the cost of regulatory compliance; and the expected increase in non performing loans (NPLs) resulting from the pandemic. There may or may not be overcapacity in the industry, but there is a lack of scale in some areas. Low profitability becomes a prudential issue, however, because the industry cannot grow and support economies.

1.1.3 The weak prospects for profitability continue to weigh on valuations

An official considered that it is extremely challenging to have such a low ratio of average valuation compared to book value. Average valuation compared to book value is approximately 0.6 compared to the US, where it is perhaps more than double. The challenge of bank profitability incorporates a number of issues. First, there is the technological challenge concerning how people buy financial services and execute payments. There is also a challenge concerning scale. Those who are technologically better prepared will 'win the race'. There is also a discrepancy between the profitability of the sector and the risk perceived by stock market investors.

1.1.4 A comparison between the EU and US: profitability, capital and the cost of equity

An industry representative described how the European banking sector has been very resilient throughout the pandemic. There are three interesting comparisons to make between the EU and US banking sectors, based on profitability, capital and the cost of equity. In 2019, the US large banks' return on equity was 14.2%; the European Union banks' return on equity was only 7.4%. One reason is a larger net interest margin (NIM), but the other principal reason is more scale and greater efficiency. US banks have a cost income ratio of around 60%; in the large European banks it is around 70%. In terms of capital, US and EU banks have exactly the same Common Equity Tier 1 (CET1), but the US banks have a much better leverage ratio. In terms of the cost of equity, the US banks have a more attractive revenue mix, better efficiencies, and more sustainable and higher margins. This clearly leads to a lower average implied cost of equity for large US banks of 9% to 11% versus 11% to 13% for the large European banks.

1.1.5 A monetary profitability loop in Europe

An industry speaker noted the loop between the European monetary context and the constraint on profitability. Indeed, interest rates and bank profitability are connected. Lasting negative interest rates in Europe are pressurising net interest margins and weakening the profitability of EU banks. The monetary situation is very different in the US, where interest rates are higher, which helps explain why the European banking sector is less profitable than its US counterpart.

1.1.6 Persistent low bank profitability is accompanied by excess capacity

A regulator noted that excess capacity is another important challenge. The sector will need to restructure in order to enhance efficiency. It is important for banks to favour sustainable business models in the future. The authorities must take action to allow this restructuring to happen in the smoothest and most efficiency enhancing way possible. An industry representative stressed that there is no consensus on the concept of overall capacity. In France, for example, there is an ongoing debate about banks' ability to maintain a network of branches and ATMs. Indeed, the availability of cash was one issue which contributed to the famous 'yellow vests' movement in France. There is a well known conundrum around maintaining profitability without a physical presence. The usual suggestion is that a bank can cut costs by adapting its footprint, but there is a clear link between the amount of physical infrastructure owned by a bank and the profitability of its client base. Without a physical presence, it is difficult to serve clients. Cutting costs by adapting a bank's footprint will never be the whole solution.

2. Solutions for addressing the profitability challenge are well known but difficult to implement

There are established ways for EU banks to return to sustainable profitability. Banks must continue to make efficiency gains by cutting costs and making more intensive use of new technologies. Improving the EU crisis management framework and increasing consolidation in the sector would help address excess capacity. Banks should be able to consider the Banking Union as their domestic market. Completing the Banking Union is therefore vital; it would notably favour the emergence of effective transnational banking groups. But this is difficult to achieve: solving the home host dilemma and achieving agreement on a common deposit insurance framework remain controversial issues.

2.1 Policymakers need to avoid cliff edge risks

An official highlighted the extraordinary role that the banking system has played in handling the crisis in coordination with central banks and public authorities. It will be crucial to see what happens to the unprecedented public guarantee schemes, which are a shared responsibility between states and banks. There will have to be restructuring in some of the most affected sectors, and it is important not to create a cliff edge in the economy by not supporting these sectors and the viable companies that were particularly affected by the crisis.

2.2 Making efficiency gains by further cutting costs

2.2.1 There is further progress to be made on cost reduction in Europe

A regulator agreed that overcapacity is an important issue in European banks. While there has been some progress, cost income ratios in EU banks remain broadly higher than those of their global peers. Additionally, performance on cost income ratio remains extremely uneven across Europe. Even banks with the same business models have very different cost income ratios. From a supervisory point of view, revenues are also concerning. Banks have very few sources of revenue and the cost of risk has been very low lately, which means that margins in Europe remain very weak. At these low levels of revenue, one of the key issues is diversification. National consolidation creates more synergies, but cross border consolidation provides more diversification.

2.2.2 Reducing cost and exploiting synergies in a cross border banking group

An industry speaker described how their institution, a cross border banking group, has the benefit of both in country scale and scale across Europe, with 25 million active customers and around 70,000 employees. Even without consolidation, it is possible to find cost savings on a pan European and cross border basis, even in retail banking. The institution is seeking to develop a common operating model and has announced €1 billion of cost savings, which is roughly 13% of their cost base. Additionally, this institution also has scale in country. Increasing profitability cannot only be about shutting down branches and reducing its physical footprint. Instead, there must be a proper transformation of the banking model in Europe.

2.3 Improving the EU crisis management framework to address overcapacity

A public representative stressed the importance of crisis management. Europe needs a credible system and reliable system for banks to exit the market, while the current bailout intensive system (e.g., NordLB, Veneto Banca, Banca Tercas…) does not encourage them, and instead keeps many banks in and out of the 'bailout hospital' for many years. The precautionary capitalisations (e.g., Monte Paschi) cannot continue. In the US, the Federal Deposit Insurance Corporation (FDIC) is a well-funded and independent body, which has managed the consolidation of thousands of banks and hundreds of billions in assets. The FDIC's resolution process has been a massive success, and Europe does not yet have anything like this. To promote banking consolidation, we must also solve the home host issue and deposit insurance is critical for this endeavour. Europe needs a commitment not just to consolidation but to forcing bank exits if a bank is unable to compete. A regulator agreed that EU institutions should improve the process of an orderly exit for players without a sustainable model, thus helping to reduce overcapacity and unhealthy competition and promote thus financial stability.

2.4 Completing banking union is of the essence

2.4.1 Addressing the issues around ring fencing

An industry representative suggested that there is a need for the regulatory toolbox to be amended to avoid trapping liquidity and capital inside national barriers. This goes against the principles of the single market and does not help to foster economic growth in all member states. A deposit insurance programme is only one element of this; Europe also needs a harmonised set of rules to enable large European banks to compete.

2.4.2 Settling the home host dilemma

An industry speaker outlined the significance of the home host dilemma. This explicitly adds a substantial amount of cost to European regulation in terms of liquidity requirements and capital allocation. Everybody agrees that there is a problem, but now there is a need to develop solutions to ease the mistrust between home and host states. The industry should seek to tackle the European Deposit Insurance Scheme (EDIS) over the next few quarters; progress on EDIS could unblock much of this mistrust.

2.4.3 Achieving consensus on a Banking Union remains difficult

An official agreed on the importance of achieving a genuine Banking Union. Hopefully, by the end of the first half of 2021 there will be a roadmap for a Banking Union, though this will not be an easy task. It is important for the industry to reflect on the schedule for a Banking Union and determine the appropriate milestones. Banking union compromises many different elements – such as EDIS, cross border integration and the management of sovereign risk exposures in different geographies – which makes it extremely difficult to find consensus between member states. The industry and the public authorities should consider how valuable it would be to make a Banking Union happen in one go. This would create value and employment for the whole economy, not merely the banking sector. An industry speaker welcomed the suggestion that a Banking Union could be achieved in one step but is sceptical that this can be achieved in light of the progress made over the last few years.

2.4.4 There is a window of opportunity on EDIS after the elections in Germany and France

An industry speaker described how their institution is already engaging on EDIS schemes with member states, the Commission, national governments, and national banking associations and banking sectors in EU member states. There will be a window of opportunity next after the elections in Germany and France to try out EDIS and hopefully to unblock some of the issues around the home host dilemma.

2.4.5 Breaking the deadlock on the Banking Union

A regulator suggested that benefits of a Banking Union have not yet been realised, especially in the eurozone, where there is no longer a division between home and host but a single supervisor. It could be a game changer merely to send the signal that the issue of a Banking Union is unblocked, even if not everything is resolved. There might not be a complete upheaval of the market, but it is important for the industry to explore all of the possibilities here, including consolidation, branchification and the free provision of services, building on digitalisation.

2.5 Banking consolidation

2.5.1 Banking consolidation requires progress on a Banking Union and the home host dilemma

A public representative noted that the European Central Bank (ECB) has been trying to encourage consolidation with its new guide on the supervisory approach to mergers, cross border liquidity management and intragroup financial support agreements. These measures are welcome, but there will not be further cross border mergers and consolidation until there is progress on banking union. Some issues in the banking sector could be addressed regulatorily, such as the home host issue. This discussion often focuses on liquidity waivers and so on, but fundamentally the issue is about the fact that regulators force banks to have duplicated capital at the consolidated and subsidiary levels.

2.5.2 Completing the Banking Union would lead to more consolidation

An industry speaker agreed on the need to complete the Banking Union. Europe must align policies, remove additional barriers, and create a single rulebook and a single deposit insurance scheme. That will naturally lead to more consolidation, including across borders.

2.5.3 Consolidation is only a solution for wholesale banks

An industry representative distinguished the situations of retail banks and wholesale banks in relation to consolidation. There is no clear evidence on building cross border synergies in retail activities due to the specificities of different banks. In addition, there are specific tax regimes, cultures, and savings habits in different countries, all of which reduces the prospects for eliminating overcapacity in EU retail banking.

A regulator highlighted the specific need to increase efficiency across the EU. Technology and digitalisation might be able to assist the process of a Banking Union. There are difficult questions here such as the home host issue, but there are also interesting mechanisms such as the provision of services via branches, the cross border provision of services and digitalisation. In the area of payments, there is a broad degree of cross border provision. As this technology is introduced to a wider set of services in the banking sector, it could enhance these services and realise some of the cross border benefits of the single market by making banks more effective and profitable.

3. A harmonised legal and regulatory environment for a digital banking sector

Digitalisation is becoming an integral part of banks' business models. Of course, digital transformation has important upfront costs in IT infrastructures and new skills, but in the medium term it provides clear opportunities to increase cost efficiency. Regulation and supervision should be technology neutral, and tackling fragmentation is critical. Europe will not be able to compete globally with a fragmented legal and regulatory environment that stifles innovation or allows regulatory arbitrage. Above all, Europe must harmonise protection rules and Know Your Customer (KYC) standards and promote a level playing field around innovative technologies, ensuring that the principle of 'same activity, same risks, same rules' remains the norm throughout the digital transition.

3.1 Digitalisation can facilitate the integration of the EU banking system

An industry representative agreed that technology will enable the industry to make greater progress in the future. For example, anti-money laundering (AML) laws are an excellent example of an area where greater harmonisation could be realised through technology. The efficiency of technology could be leveraged to a far greater extent if there were the same rules in all EU jurisdictions with combined supervision to ensure that the application and interpretation of the rules was aligned. A regulator stressed that the ECB is seeking to invest in digitalisation. It will not happen immediately, but there is potential to optimise the interactions between supervisors and banks.

3.1.1 Open finance responds to consumer needs

An official highlighted the importance of open banking, which was introduced by Payment Services Directive 2 (PSD2). This enabled the entry of players that were able to innovate in the market and exploit their superior technological 'know how'. EBA observations suggest that this was positive for the development of market participants' business models. The Commission will propose legislation on a broader open finance framework by mid 2022.

3.1.2 EU regulation should promote innovative technologies in financial services

An official stressed that regulation should focus on what is substantial. It is important not to hinder innovation and to accept that the technological revolution is about demolishing the borders between sectors. It is important for the public authorities to keep pace with innovation, not to prevent innovation and not to try to regulate everything. This should be achievable, for instance, with the Regulation of Markets in Crypto-assets (MiCA) regulation. Additionally, the Consumer Credit Directive (CCD) review, which was postponed until the third quarter of 2021, will be important in addressing the consumer protection issues which arise from the emergence of new operators and new forms of consumer credit.

3.1.3 The EU regulatory regime for crypto assets could be adopted quickly

An official noted that Portugal is somewhat positive about the MiCA regulation. This process will hopefully be concluded during the first half of the year. This is very important, because there is currently no legal certainty for crypto assets. Considering the trends in this space, this is very necessary. This work should progress in the first half of the year, but it involves complex technical issues.

3.1.4 Digitalisation is becoming an integral part of banks' business models

An industry representative welcomed the European Commission's drive to foster innovation and a more competitive and diverse ecosystem for finance, particularly digital finance. Parts of the digital revolution have happened already, and this process was accelerated by Covid. It is very positive to see regulators encourage digitalisation. The same rules and the same supervision must apply to the same activity. An industry speaker agreed that it is essential for the industry to keep pace with innovation. There is increased competitive pressure from new entrants and Google, Apple, Facebook and Amazon (GAFA), who are building amazing customer experiences.

3.2 Key success factors for increasing the digitalisation of the banking sector in Europe

3.2.1 Harmonising consumer protection rules and KYC standards

An industry representative reiterated his belief that scale matters. Given the size of the challenge facing Europe, it is extremely important to ensure that there is less overcapacity, more consolidation and bigger scale. The industry representative's institution is able to achieve this because of its scale. Even if a bank creates one app for all of its markets in Europe, there are still many barriers around consumer protection and KYC standards. Removing these barriers would have substantial benefits in terms of overall scale, technology and the investments necessary to better serve customers.

3.2.2 Developing EU solutions to ensure data protection and increase European data sovereignty

An industry speaker explained how data is an important matter for the European sovereignty. Some actors are extremely predominant in areas such as the cloud. If Europe wishes to move towards open banking and banking as a service, the use of public cloud infrastructure is almost compulsory, but there is no credible alternative in Europe. If Europe wishes to keep pace with its competition, there is a clear need to develop practical solutions while protecting client data.

3.2.3 A level playing field for incumbents and new entrants concerning innovation and access to data

An industry speaker highlighted the importance of the level playing field. If operators are in the same industry, using the same kinds of models with the same kind of risk, they should apply the same rules and the same supervision. Some new entrants may be seen as 'free riders' in the system.

3.2.4 Europe should aim to be a single prudential and regulatory jurisdiction

An industry representative observed that the consolidation of the US banking industry did not happen overnight; rather, it started 30 years ago. Frankly, it is not realistic to expect that Europe will be able to replicate what happened over 30 years in a short period of time. Clearly, there is a need for greater support from the regulators. There should be one supervisory body, the ECB, and much greater harmonisation. In the US, there is one counterparty that looks over the industry, which makes the banks more efficient. Efficiency comes not only from the banking system but also from the regulators and central bankers with oversight of these banks, who can accelerate change and transformation.