Improving the global competitiveness of the EU banking sector

The panel focused on the global competitiveness of the larger European banks on the global stage. First the panel considered the question of the causes and consequences of this potential competitiveness gap. Then there was a move to the policy responses that may be required or appropriate if that competitiveness gap is to be closed.

1. Major European banks remain generally less profitable compared to global counterparts

All speakers agree that the major European banks remain generally less profitable and undervalued compared to their global counterparts. Cyclical and structural reasons explain this gap. Achieving higher profitability is important for strengthening resilience, as is transformation towards more sustainable business models, sufficient investment in digitisation and consolidation to remain competitive.

1.1 Strength of the European banking sector through the pandemic

An industry representative noted that the European banking sector has been extremely strong through the pandemic and has come out of it with stronger liquidity and capital ratios. Europe should play the resilience of its banking sector to its advantage.

A supervisor agreed that the euro area banking system has proven resilient in the COVID-19 pandemic: banks remain generally well capitalised, hold ample liquidity and are performing their key role as sustainable lenders. While reassuring for now, this may not be good enough for the future. European banks have been struggling with low profitability for a decade.

1.2 Profitability has lagged behind international peers

1.2.1 Facts and figures

A supervisor stated that following the great financial crisis (GFC), despite a significant increase of EU banks' resilience, their profitability has lagged behind their international peers, in particular US banks. Over 2014-2020, US banks were able to maintain a higher ROE than their European peers (US 8.5% vs EU 5%); moreover, EU banks price-to-book ratios have, on aggregate, not yet recovered their pre-GFC level – contrary to US banks as early as 2013.

Another supervisor confirmed that there is a gap in profitability between the US and the euro-area banks, meaning there is a difference in competitiveness. The US return on equity (ROE) is five to six percentage points above the one of the Single Supervisory Mechanism (SSM) banks, which comes from three drivers: the net fee and commission income, the net trading increases and differences in the impairments and provision.

1.2.2 European banks are falling behind on both sides of the ledger.

An industry representative stated that European banks are falling behind on both sides of the ledger. Revenue growth has been weak and cost structures remain a major burden. US banks boasted a cost/income ratio roughly 15 percentage points better than their European counterparts in 2021. About 80% of that gap was attributable to support function costs. U.S. banks are getting more out of their technology than European banks due to the scale advantage of the American markets.

1.2.3 The EU has long been attractive to banks which are headquartered outside of the EU

An industry representative confirmed that their bank, headquartered outside of Europe, looks at the whole world and opportunities, and the Americas, Asia and Europe are all always assessed as the regions to deploy capital. International banks have welcomed the flexibility and openness of the EU financial markets which has allowed huge amounts of international capital to be leveraged for the benefit of EU customers. International banks see themselves as "partners" in the European project and accordingly wish to see a stable, competitive, and efficient EU in which they can do business. However, Europe is often seen as being more complex, more fragmented. The cost to income ratio for a global bank is generally higher in Europe than in the US and Asia.

1.2.4 Non-EU Investment banks are gaining market share in Europe

An industry representative stated that if you look at the role of Global Systemically Important Financial Institutions (G-SIFI) in the European Union, Americans are 2.5-times Europe in fixed income; in equities it is 3-times and in Investment Banking Department it is 4-times. That gap has been growing every year. European banks have more of a compliance mindset than American banks, which have a growth mindset.

He provided two examples related to the climate and digital transition. On climate, the first thing the European institutions ask is what they need to stop financing, whereas the first things the American institutions ask is where the financing opportunity is, how they can finance the transition and get ultra-high-net-worth money into financing start-ups. Concerning digital assets, the work on digital asset strategies for American institutions probably peaked 12 months ago and it is only starting in Europe.

Much of the value creation has actually happened outside the banking system, through payment providers like Square. The big tech firms are key with how they

leverage data and turn that into customer-ready value propositions.

1.3 Cyclical causes

Four cyclical reasons contributing to the competitiveness gap between large EU banks and their American and Asian peers were underlined during the session.

1.3.1 The yield curve and interest rate differential between the US and the eurozone

A supervisor stated that there has long been a real difference in the yield curve. More than 50% of EU banks' net operating income comes from the net interest income. Therefore, the interest level matters. Since 2014 the ECB deposit facility rate has also been negative, unlike US rates. Combining all of these conditions on the interest side, there is a large difference, and it is a long-lasting difference.

1.3.2 The US's more favourable macroeconomic environment

A supervisor noted that the macroeconomic situation has been less favourable in Europe than in the US since the great financial crisis.

1.3.3 The legacy of the Global Financial Crisis

A supervisor added that there is also the problem of the treatment of the legacy of the financial crisis, and in particular the treatment of non-performing loans (NPL). In Europe, there is a lack of a genuine securitisation market, for instance for NPLs, so the initiative taken by the Commission recently is welcome.

1.3.4 The corporate taxation rate

A supervisor noted that in the US there was a reduction to 21% in 2018 which is much lower than what the top 10 SSM banks are required to pay.

1.4 Structural factors

The European financial market remains small and most of the financing in Europe is provided by the banking sector. The situation is the opposite in the US.

1.4.1 The fragmentation of the EU banking sector

A supervisor highlighted the low level of concentration and the higher fragmentation of the EU banking sector, which is a source of inefficiencies and vulnerabilities. This situation leads to insufficient risk sharing at the EU level, since in case of difficulties, safety nets remain largely national. Fragmentation also leads to "overbanking", which in the end affects the profitability of the banks in the system – as showed by the higher cost to income ratio, notably linked to the relatively high number of branches within the EU.

Additionally, there are new competitors. This new paradigm between banking activities and new actors, fintech, big tech, etc, is a challenge in terms of profitability for banks, which are obliged to invest a great deal to be able to compete with these new actors and properly address consumers 'expectations.

The underlying risk requirements can also be very different depending on the US or the EU market. With the French banking system there is a long historical period of lower and less volatile cost of risk. That is fact. When there is a lower and less volatile cost of risk year after year, that reflects a low risk profile on the domestic market, and in particular on residential real estate. With lower risk there are lower interest margins, because there is no need to cover the risks. This can explain a part of a difference in terms of profitability.

Another supervisor stated that the competitive structure differs between the euro area and the US banks, because the euro area banking landscape remains more fragmented. There is a much more diverse nature to the national markets in Europe, and that is due to different attitudes toward credit, the different legal frameworks and the different structures. The most pertinent goal for the euro-area banks is to aim to generate healthy levels of profitability, which function as a buffer against losses. The goal is not for euro-area banks to be compared directly to US banks but to look at how to address the profitability questions. An industry representative agreed that cross border fragmentation and the different regimes in Europe are reasons for the cost/income ratio of European banks being so high.

1.4.2 US banks benefit from a large domestic base

An industry representative highlighted that, when looking at this US market, the consolidation which has taken place and the scale in terms of market share means a very different pricing power. For initial public offerings (IPO), structurally the pricing is different. Even the public guaranteed loans that were put in place were typically much more profitable for the US banks. Cultural differences are also present, and the two major European banking markets are dominated by mutual banks or their equivalent.

1.4.3 The European financial market remains small

A supervisor stated that the capital markets play a very different and much more significant role in the US, and therefore the banks earn more fees from intermediation between the corporates and the capital markets. Even for loans to households, US banks are functioning much more as originators and distributors, while the euro-area banks are holding the loans on their balance sheets.

1.4.4 The absence of a securitisation and a single capital market in Europe

An industry representative noted there are banks that have large balance sheets in Europe, but unlike those in the US they are not able to originate and distribute as much. Therefore, a euro of capital is, by definition, not as productive depending on the side of the Atlantic where the bank is located. Thanks to active securitization, US banks can reduce their balance sheets and have greater capital efficiency. By contrast, integration in EU capital markets is only at an early stage and the euro area still lacks a common risk-free asset. It is an impediment, in particular in light of the Basel IV framework where holding a loan in the balance sheet will be even more expensive than it is currently and knowing that Europe does not have public agencies like Fannie Mae and Freddie Mac in the US, which are like gigantic vacuum cleaners of major amounts of

mortgage loans that European banks have to keep on the balance sheet.

Following the Global Financial crisis, the initial purpose of the new EU framework was to say there needs to effectively be a financing of the economy, which would be better balanced between banks' balance sheets and capital markets, with more origination to distribute capacities, but it has not been possible to move forward on the second leg while progress on the first is at about the halfway mark.

One other non-structural element is that the construction of the European banking resolution system is also paid by banks, and the amounts for French banks have become an impediment in terms of profitability. The hope is that it will stop in 2024.

An industry representative agreed that US banks operate on more of an originate to distribute model and that this has delivered a stronger secondary capital market. It also allows a stronger primary market and a funding market for corporates and banks. The competitiveness gap between the main European banks and their American and Asian competitors also exists because of factors like interest rates, the fragmentation of the market, particularly post-Brexit, excess capacity and the fact that the composition of the financial sector in Europe is different from the US. Having deep pools of liquidity that reduce funding costs and allow for cross-border global flows into the European market is something on which the European Union needs to continue to be focused.

1.5 The profitability gap is a threat to the future

An industry representative suggested it is fair to say that the main challenge in term of competition and capacity to compete is on international businesses such as wholesale and investment banking. US banks that have a strong market share in their large domestic market (e.g., the US still represent 50% of the market, with the capitalisation of a company like Apple being $3 trillion, the equivalent of CAC 40), have an extraordinary advantage and a greater capacity to develop internationally.

They are active in Europe and take market share from local competitors. At this stage on retail, it may be seen by authorities as a remote issue, but we should not underestimate their competition in the future. They might try to look at the most attractive part of the retail and wealth management business in Europe. Retail activities might not be immune from that competition forever.

The focus of public authorities was very much on security, which is understandable after the financial crisis. There has not been enough attention put to the competitiveness of the sector, which is also an important feature of a sound banking market.

A supervisor added that a newer source of concern affecting EU bank profitability is the overtaking of EU banks by their US counterparts in their own market as the largest US banks have accounted for more than half of total investment banking revenues in the EMEA region since 2016.

This latest development sharply raises the stakes for further financial integration in the EU, as not only is EU banks' profitability at stake, but also EU sovereignty. Indeed, the increasing market share of non-EU investment banks could expose the EU economy to a risk of investment outflows in times of stress. As such the coming years will be crucial to address any systemic risks stemming from excessive reliance on non-EU entities.

2. The priority for banks to bridge their profitability gap

2.1 Facing the reshaped industry landscape

An industry representative stated that there is a need to push ahead with the Capital Markets Union (CMU). The last milestone in terms of the prudential regulation should be adopted in a less naive way. The European Commission has started to understand what is at stake in terms of competitiveness, but there is a need to remain vigilant.

One of the major issues for banks to compete is the limited capacity to develop start-ups in a regulated banking environment. There is a need to be able to remunerate the entrepreneurs like other start-ups, which is difficult in the current regulatory framework. Exceptions should be granted on this matter.

Banks should try to move as quickly as possible in terms of digital technology, while focusing on areas where they can have a competition edge. Environment, social and governance (ESG) could be an opportunity, but it could be a further burden, if there is not enough pragmatism in this matter.

2.2 Achieving a genuine Banking and Capital Markets Union

A supervisor emphasised that the CMU and Banking Union are strategic imperatives. They are about security, diversification of risk, being prepared for the upcoming digital revolution and being prepared for the climate transition. Achieving a truly integrated European banking market would put banks in a much better position to reap the benefits of scale and scope and to finance the green and digital transitions. It would enable a greater degree of private risk-sharing, so that shocks hitting a region of the Banking Union would be more easily absorbed, without the need to consider public support measures. Differences in local rules and practices for crisis management prevent progress towards cross-border banking, so a revamp of the EU's crisis management rules is welcome.

An industry representative stated that the Banking Union and the CMU are key ingredients for creating a simpler and more level playing field across Europe, which would also help foster well-needed consolidation. But what if the day of "regulatory panacea" never comes? In this moment of political populism, growing nationalism, and fiery polarization, it has been difficult for European leaders to make progress on regulatory initiatives. If banks want to get out of their malaise,

they will likely have to do it for themselves, and swiftly. It requires nothing less than radical transformation

2.3 EU bankers need to adapt their strategies to digital transformation and the green transition

A supervisor remarked that Europe has a citizenry that believes in the need for transformation of the economy and to protect the earth, so there is an understanding and a buy-in that there is a need to completely move from preserving the economy to completely transforming it. That means the banking sector needs to be able to finance it. The amount of financial investment that has to take place as estimated by the Commission is around 2% of gross domestic product (GDP) every year until 2050. There is an enormous opportunity for European banks to be enabled, if they have the capital markets capacity. In the US there is not remotely the same level of buy-in, which means the European banks will be competitively positioned to be the global financiers of this activity.

Digitalisation is another strategic imperative. There is a need to move into this technology component and understand that a revolution is occurring. Paradoxically, US banks are at a competitive disadvantage. They have been investing in technology for at least 10 years, but they are facing a different level of competition from big tech. It is not quite the same dynamic in Europe.

European institutions must not only invest in entrepreneurs and embrace the next generation's concept of what banking means; they must also deal with the operational components, the processing which means security. It is management of risk. Tough decisions have to be taken about not continuing to just buttress legacy systems and questions of whether to invest in online banking. What is needed is deeply transformational change in the technology area. The regulatory framework at the European level needs to enable both of these issues.

2.4 Winning banking models will be platforms-oriented around data

Banks have not leveraged the value of the data they have. And most important, they haven't sufficiently appreciated how the process of value creation has shifted. They did not realize the value opportunity that specialist providers have tapped into over the last decade. Banks need to organize business units around data and customer lines — but so far, none has truly done this. The quickest successes would come from simple improvements such as using data to help customers make better spending decisions.

An industry representative highlighted data as a way to close the global competitiveness gap. There has to be reciprocity, as increasingly many institutions are tapping into banking-like services. For banks it means changing the business model organisation, because banks are still vertically integrated institutions that are organised along product lines, and many of the other institutions, like the big techs, have overcome this by creating joint ventures. Data is a more regulated component in a banking world than it used to be in other institutions. The demand for reciprocity creates a huge opportunity. This sounds difficult but that is exactly what an institution like Microsoft did. Microsoft was in a tricky situation. It was a product factory, with the likes of Windows, and it has changed towards a customer-centric organisation. That was a tricky transformation but thinking through what really closes the gap or creates value, data services usually come with a P/E multiple of about 30 to 40, whereas traditional banking services are perhaps 10 to 15. With the way things are reported to investors and the associated organisational shift there could be a value lever.

2.5 More consolidation is needed

A supervisor noted that to build more scale advantage within the European landscape, in addition to consideration of all that has been said in preparing for the future, more consolidation is needed. The European banking system is made of a series of national assistance. The French case is a good one: the six big groups amount to about 80% of the French banking system, so the work is done. This is not the case in some other European countries, but there have been some big changes. There is the movement of concentration within the jurisdiction and there is a need to go beyond that because there is a Banking union and a European Union. Regulation can help and supervision can assist in implementing the regulations.

A supervisor stated that there has been a great deal of progress. The Eurofi conference 10 years ago was before the single rule book, before the creation of a single supervisor and before the creation of a single resolution authority. It is costly, but it is much better than having 27 supervisory authorities, 27 resolution authorities and 27 rule books. That work is largely done. The Banking Union is not yet entirely in place, but for big players the two first pillars (supervision and resolution) are largely sufficient. The third pillar (EDIS) is not essentially meant for the big players.

Among the small steps that can be taken is the implementation of the waivers by supervisors. They exist in the level 1 text. They should be implemented by supervisors under scrutiny, under control and under conditions. The management of liquidity can be made on a cross-border basis, meaning between two jurisdictions, but within the same area, which is called Banking Union. This is an example about which there can be collective effort.

Going beyond in terms of capital waivers and having minimum requirement for own funds and eligible liabilities (MREL) can then be considered. The debate on home hosts should be moved beyond because the question of the competitiveness of banks is true for all banks. Being a host or a home does not change anything. These are very small steps to be implemented very easily and, it is hoped, quickly as well.

The Chair remarked that much revolved around the question of how to get the advantages of market scale found in the US. Much has been created and much has been harmonised, but it is incomplete. Consolidation can help and can produce institutions with a different level of scale and competitiveness, but the answer to competitiveness cannot just be to become larger and

then reduce to oligopolistic structures which then do not benefit the consumer.

2.6 Ensuring competitive funding costs is critical for the competitiveness of global banks

An industry representative stated that their organisation tries to constantly optimise its operations. It needs to be very careful about being efficient and making sure it constantly rationalises its network. In Europe, it has a number of operations, including subsidiaries and branches.

It also needs to be able to distribute funding throughout the group, because it is not in retail in Europe so funding comes either from corporate clients and depositors, or directly from the international headquarters. That requires flexibility. It is important for the organisation to ensure that it has some form of flexibility; that is a policy matter it has been discussing with the regulators, to make sure that it can continue to access the necessary funding at the right cost. Competitiveness for the organisation is also about making sure that, when it comes to access to capital, it is not at a disadvantage compared to EU banks.

2.7 Dialogue between the industry and supervisors on the future of the EU banking sector is required

An industry representative wanted to see more dialogue between the industry and supervisors on what the banking system will be in 10 years' time. There are technology changes, central digital currency, possibly crypto-assets and ESG. This is just the start of a major industrial revolution for the banking sector.