Competitiveness of the EU banking sector

Introduction

The Chair stated that the question of the competitiveness of the EU banking sector is crucial and connects to a range of other issues, including how best to finance European needs, whether to have a single or multiple European banking systems, and how open European banking systems should be and to whom. This is also linked to the question of the profitability of European banks.

1. A diversity of bank business models is needed to finance the various needs of EU economies

1.1 Taking advantage of bank diversity in Europe

A regulator commented that there is still no single financial market in Europe. Looking at the banking market, there is still a need to distinguish between more bank based countries and mode market based financial systems and there is no definite answer to which system is performing better. Market dynamics have so far failed to equalise the banking across EU Member States structure because of underlying structural economic and social factors (e.g. differences in pensions systems, housing policies…), that have far reaching consequences and are very difficult to address.

Against this backdrop, it is not easy to say which type of bank is the best. Europe has to accept a diversity in the European banking landscape that reflects these differences. The question of whether a universal banking model with diversity united under the roof of a single bank is the right model for Europe needs to be answered from three perspectives: whether the economy benefits from it, what the impact on stability is and whether it is efficient.

The European economy, compared to the US, is very diverse and is dominated by small and medium sized enterprises. Diversified banks can offer tailored solutions for all of their customers' needs under one roof, and this is an advantage. A universal banking system also has benefits for financial stability because it is less dependent on the business and lending cycle and their lower return on equity can improve their shock absorption capacity. However, a universal banking system is more complex to manage, which risks subsidising unprofitable business lines and delaying identifying the erosion of business models.

1.2 A clear need for healthy competition and efficiency of diverse business models to protect customers and serve domestic needs

An official explained that Europe remains the sum of different social and economic systems, cultures and institutional set ups. As a result, competitiveness of large players in the international arena needs to be balanced with healthy competition to protect customers and serve diverse customer needs.

For assessing competitiveness of EU banks, it is necessary to look at all parts of the equation: cost, revenues and risk. Banks' ownership structure, return on equity, business models and where they operate, which affects their risk profile, should be looked at to assess their viability as well as risk adjusted return over a long period of time to gauge success.

A number of high performing banks have reported increasing customer satisfaction after the crisis without meeting the 10% threshold for return on equity. It is difficult to measure economies of scale when moving from large banks to very large banks, of scale when moving from large banks to very large banks, whereas it is quite easy to find a pattern of overperformance when looking at banks that have been able to react to changes in market conditions in a very agile manner, with innovation, automation and digital transformation.

All the efforts made by banks in Europe to restructure and revisit their business processes after the global financial crisis are paying off. Euro area banks' cost to income ratio by the end of 2021 was 60%, well below the average of US banks.

1.3 The optimal size of a bank is a market issue and not a supervisory one; the key issue for supervisors is the efficiency of banks' business models

A regulator explained that determining the optimal size of a bank is a question for the market, not for supervisors. Supervisors have to offer a clear and stable regulatory environment and adequate supervision that does not prefer anybody. Supervisors also need to consider where problems can arise, and in particular whether banks' business models are viable for the near of medium term future in order to intervene very early. This generation of supervisors believes that the drive for bigger sizes has much to do with becoming too big to fail, which is a very dangerous issue because government support should be a thing of the past, and exercising market power, which reduces social benefits. Questions of development, size and competition should be decided according to efficiency and investment in technology. Digitalisation is the issue where success and failure will be determined in the future.

The Chair observed that banks needed to be profitable to be able to make such investments.

1.4 We do need European champions for investment banking services

A regulator stated that climate change and the transition to a green economy is one of the many challenges Europe is currently confronted with and requires an enormous amount of long term investment. These funds will need to be mobilised globally and channelled to those projects bringing the most value added to both the environment and investors. If this intermediary role is not filled by EU banks, Europe will become completely dependent on foreign funds provided by foreign banks to finance its transition.

2. Economic, monetary and structural factors explaining the competitiveness gap between EU banks and their American and Asian peers

An industry representative explained that Europe continues to be a laggard compared to other large banking markets and there were cyclical and structural differences notably between European and American banks.

2.1 Cyclical causes

Weak economic growth has proved to be a hindrance for the competitiveness of banks in Europe. Over the past decade, average annual US GDP growth was 2.1% compared with 0.9% in the euro area, as the US recovered after the financial crisis more quickly than Europe. Secondly, the divergence of monetary policy over this period has also played its part. The Federal Reserve started to increase rates in 2015 while the ECB has just started to do so, meaning European banks' net interest margins have contracted. European banks' ability to extract value from liquidity has also been limited for longer.

Two additional structural factors explain the competitiveness gap between EU banks and their international peers: banking fragmentation issues in the EU and the absence of Capital Markets Union (CMU).

2.2 There is no Banking Union, and it appears that the EU is far away from it

The last 15 years have not been the most profitable period in the history of the European banking system. European banks are trading at six times earnings and only half tangible book value, which provides an indication of what investors think. Profitable banks are needed in order to be able to invest in platforms and infrastructure in order to serve clients.

The lack of deposit insurance in Europe is unfortunate. The fragmented domestic banking market continues to hold back European banks from realising economies of scale, resulting in higher average cost to income ratios and insufficient scale to compete effectively. Despite laudable recent harmonisation efforts, the economic rationale for retail banking integration in Europe faces natural barriers from different legal and tax frameworks, capital or liquidity ring fencing due to the incomplete Banking Union, and obvious language issues. Chronic over capacity due to national authorities' reluctance to countenance market exits by failing banks has exacerbated the problem. Retail banking in Europe has, in other words, remained stubbornly national in nature.

2.3 Europe is held back by relatively shallow capital markets; there has been insufficient progress notably on increasing the use of securitisation within the EU

Some progress has been made on CMU, but it is not enough, so it is good that there has been a lot of focus during the conference on the acceleration of CMU. US capital markets are much deeper than in Europe and US banks take advantage this by using securitisation to recycle less profitable assets, which European banks tend to keep on their balance sheet. In Eurofi's Santiago de Compostela agenda next year, there should be more focus on securitisation to help European banks increase velocity in recycling their assets.

The good news is that rising rates means the profitability and earnings capacity of European banks will increase, enabling them to invest more in digitalisation and the green transition. This is an opportunity for banks to comply with regulatory requirements but also to make money.

The Chair commented that although it is incomplete and could be improved, there is a Banking Union. There was a first pillar with unified supervision and a second pillar with a unified resolution framework, although it is correct that there is still no CMU. There is a gap in competitiveness between American and European banks with consequences on market shares and valuations. There are also questions regarding strategic autonomy and the composition of the future European banking system.

3. Some priorities to bridge the gap

3.1 Implementing economic and financial structural reforms to create a stable macro-economic environment for economic agents and banks in particular

A regulator observed that there is agreement that EU banks are weaker than they ought to be. Ideally, the banking sector would be stable, innovative, cost effective, profitable and able to provide credit and services to the real economy in good and bad times. Profitability was basically the same between the eurozone and the US until the global financial crisis (2008) and then things have diverged quite radically.

Sweden and many of the Nordic countries had a significant banking crisis 30 years ago that forced them to undertake a number of structural reforms in different areas. This created a macroeconomic background that has been extremely stable and has helped the banks in those countries to remain profitable through the period since then, even though they operate in quite small markets. Macroeconomics and structural reforms beat scale.

3.2 For an open strategic autonomy in the financial area

The EU needs to deepen and integrate its capital markets in general, but the EU cannot come near the US situation in the foreseeable future. Openness to the rest of the world would allow the European financial system to benefit from economies of scale and enhanced competition. The importance of transatlantic cooperation has been illustrated during the previous six months and a general principle of friend shoring is better than strategic economy.

Being closed to the rest of the world is very costly, so it is necessary to pick the reasonable risks and earn benefits from them.

The Chair stated that defining friends is not exactly compatible with the free provision of services and friends could become less friendly than before. The first solution is not to close the market or to expect to close the gap in a few years, but rather to take a selective approach. Other elements are needed to have a stable, robust and innovative banking system.

3.3 Addressing banking fragmentation

A regulator commented that an issue paper published by Didier Cahen makes clear that Banking Union is not complete and there is much to be done. This is very important, but it is not the core of the problem. Before the financial crisis, there was an impetus towards mergers and acquisitions (M&A) in Europe. It is possible to foster this from a regulatory perspective, but the animal spirits of the European banking industry are missing, and they remain passive and concentrated on the national level.

Digitalisation could be the turning point because digital challenger banks are operating on a European level and in some areas are very successful. Big institutions need to be challenged to move towards European banks that are not limited to national borders. The preconditions for banks to use Europe as one room do exist, but they should be used. This is an issue for market participants. Finally a great deal of banking regulatory issues can be overcome if subsidiaries are converted into branches.

The Chair stated that he has noted completion of the Banking Union, the question of animal spirits and digitalisation as key issues.

3.4 Completing the Banking Union; EDIS would be a gamechanger

An official explained that policymakers' goal is to design conditions for banks to thrive, to support growth and to preserve financial stability. Their final objective is the integration of the market for banking services. The lack of a truly integrated single market is a clear disadvantage for banks in Europe that makes the comparison with other jurisdictions impossible. European banks seem to have reduced their international activities in a permanent manner and the European banking sector remains segmented along national lines. The regulatory framework is conducive to this fragmentation and inconsistencies need to be fixed.

However, the full removal of obstacles to optimal resource allocation will only be possible once the safety net in the Banking Union is established and reinforced. There is a need for a European Deposit Insurance Scheme (EDIS) and the introduction of the backstop to the Single Resolution Fund (SRF) to ensure the resolution of all banks in the euro area can be carried out without tapping into taxpayers' money. EDIS is the only way to ensure that all savers in the European Union can be protected in the same manner and to ensure the credibility of the Banking Union project.

Banking integration does not mean consolidated or bigger banks. There is a need to make progress on Banking Union to deepen the discussion regarding the optimal size of EU champions competing in the international arena. At this stage, it is impossible to say that the 'too big to fail' problem has been solved and the fact that the orderly resolution of global banks is still an open issue casts doubt on their superiority in terms of financial stability. There is a need to move forward step by step on the integration of the market, through harmonisation of insolvency law, standardised disclosures, equal depositor protection and a common supervisory approach. This will enable European banks to better serve domestic clients and international competitors.

The Chair commented that a number of Eurofi conferences would be needed to bring this to completion.

3.5 Simplifying and improving EU banking regulation

An industry representative stated that after 10 years of successful implementation of regulations around the Single Supervisor Mechanism (SSM), the next 10 years of regulation should focus on simplifying and improving regulation in Europe. The emphasis should be on focus and quality, rather than quantity. Edouard Fernandez Bollo has stated that the European Central Bank (ECB) is doing a self assessment with an independent body to look back over the last 10 years on what regulation has accomplished and what the next 10 years will be. There is reason to be optimistic that this consolidation is on the right path, but there is a lot of work to be done.

A regulator noted that the rule book is not as single as it seems. Due to the national implementation of EU Directives, national discretion in the application of common rules is still widely possible, hampering the formation of a true single market. Fragmentation in the European banking market is promoted not least by obstacles that do not come directly from banking regulation. All these factors put together put EU banks in a disadvantageous position towards their US peers when it comes to competitiveness, especially in the investment banking business.

A regulator observed that it is necessary to learn the lessons from the global financial crisis and the eurozone sovereign crisis. Basel III needs to be finalised to provide a level playing field in international markets and Banking Union should be completed. Other issues below the surface are even more important. Europe is over banked and there is a need for consolidation and the introduction of innovative players. That means that some other banks need to be removed. European policymakers need to understand that structural change in the financial sector is necessary to reap full benefits of Banking Union. Although there are short term costs, this will have will be long term benefits. Lessons also need to be learned from the pandemic. In Sweden, it became clear that capital market funding was too weak as corporate bond markets froze up. Deepening the CMU to provide capital to the real economy is therefore crucial also for Sweden.

Simplifying regulation without watering it down is a key issue because there is general agreement that the system is complicated. Sam Wood' writings from the Prudential Regulation Authority (PRA) on the 'Bufferati' is a good starting point, as simplifying regulation and focusing on buffer usability should be the main principles going forward.

The Chair questioned whether the need for simplification is the real explanation for the gap in competitiveness because the level of complexity is extreme in the US. An industry representative commented that there is plenty of room for harmonisation and simplification, which would make things easier for banks and clients. An EU wide AML approach would bring down transactional costs and make banks' provision of services more efficient, faster and more reliable.

The other aspect is that capital is global. It is banks' job to bring together people who need money and people who have surplus money. London is a huge pool of liquidity that needs to flow within Europe to allow the efficiency of capital movements to help banks' customers. It is therefore time to rethink the lessons learned from Brexit. Many banks now have a strong footing within the European Union, but they still need to leverage access to capital in Europe, the US and Asia for the benefit of European customers.

Conclusion: The key priority to move forward

The Chair asked each participant to choose which of their ideas would be the first priority to improve competitiveness of the European banking sector and achieve their stated goals. An official stated that their priority is the digital transformation. A regulator commented that all of the European banking system's problems will be overcome if it is possible for a foreign bank to buy the biggest French, German or Italian bank. An industry representative stated that his priority is the completion of the CMU and securitisation. A regulator commented that their priority was to fix the real economy and complete the CMU. The Chair summarised that there is consensus on completing the CMU and that the next Eurofi financial forum will work on that.