Competitiveness of the EU banking sector

Introduction: The European banking sector is lagging behind the United States banking sector in terms of competitiveness

The chair introduced the session by reminded the audience that the European banking sector is lacking behind the United States banking sector in terms of competitiveness. More interestingly, we could consider questions such as why this competitiveness gap exists. Are there historical reasons? Are there geographical reasons related to the fragmentation of the general landscape? Are they regulatory? To what extent is it a problem beyond the shareholders of the banks? What are the broader ramifications to the society of this competitiveness gap, and whether the ongoing trends, and perhaps the recent turmoil, brings anything new into the picture. Finally, what should we do about it? Are there any low-hanging fruits that we have not identified, or should we go all in and do something drastic to address the issue?

This session highlighted the reasons for this competitive gap and outlined several avenues of progress to bridge it.

1. There are several reasons explaining this gap in competitiveness

1.1 The state of play

A supervisor noted that Single Supervisory Mechanism (SSM) banks suffer from structurally lower profitability in comparison with the US banks. SSM banks' return on equity in the third quarter 2022 stood at 7.6%[1], compared to 13.1% in the US. This weaker performance has been reflected in their valuations, with price-to-book ratios and market capitalisation of SSM banks well behind US peers.

A regulator stated that the word 'competitiveness' acts as a reminder of a debate and a famous article by Paul Krugman, in which it was said, 'Countries do not compete; companies compete.' The real key issue to think about is whether Europe has a banking and financial system that can provide the adequate allocations and roles that is supposed to be provided to the European citizens. That is basically to provide adequate financing and to allocate savings and investments in an effective way across the Union, and then beyond that hopefully also able to export that model and provide those services to other countries.

Competitiveness is a combination of two things that sometimes get mixed. One is the obvious loss of market share of large European banks in the global financial markets. The global European banks have been losing market share relative to American banks in global financial markets. That is not a good sign, but that is not as relevant.

The real concern or the real difficult parameter is the valuation and the fact that banks might not be able to get an adequate return on capital to compensate investors. Operating in a sector in which investors are now satisfied is a necessary condition for sustainability over the medium and long term. That is the key issue. That not only affects large banks, but it affects the banking sector in Europe. It affects the smaller banks, medium banks and large banks. Average profitability is probably too low, or has been low, and the question is why that is the case and how it can be answered. It is banks that need to be able to put this forward. There are always references to the macro environment in which Europe operates not being prone to profitability. In fact, profitability has risen over the last year. The effectiveness of the European market has been the ability to develop a single market. That is an area in which Europe needs to work for the policymakers to put that forward.

It has also been said the complexity of the regulation, or the perception of the regulation within the European Union, is more burdensome than others. Differences in implementing the global standards are putting differential pressure on the banks. The single market can be effective and bring economies of scale there. Those are the issues. As part of ensuring a banking sector that is sustainable over time, there needs to be an adequate return on capital.

A third argument is whether the cost of equity is too high after all the reforms put forward. That is for the markets to provide us input on this issue.

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

A supervisor highlighted five cyclical and structural differences between EU and American banks that explain this competitiveness gap:

- Euro area growth has been slower than the US over the past decade. This was also reflected in monetary policy, with the ECB that kept rates down longer than the US Federal Reserve, putting pressures on banks' interest margins.

  A leader of the industry (F. Vicario) agreed that cyclical factors, such as weak economic growth and a

1. Banks' return on equity increased to 7.68% in 2022 from 6.70% in 2021. It reached the highest reported value since 2015 as net interest income rose to €298 billion from €260.7 billion in 2021. The net interest margin stood at 1.36% in 2022, up from 1.21% one year earlier.

double-dip recession at the beginning of the last decade, have proved to be a constant headwind for the profitability of EU banks. Monetary policy has also played its part, sustaining a long run low interest rate environment, which only now is changing. While this has supported banks' funding costs and indirectly helped to address non-performing exposures, low rates in the euro area have led to a significant contraction in the net interest margins of banks, which is critical to profitability.

- The prevailing bank business model in Europe implies, in principle, the retention of loans on the balance sheet until full repayment, given also less developed capital markets. In contrast, US banks can leverage on large and developed capital markets for their lending business, employing the originate-to-distribute model, where loans are securitised and transferred to the financial market.
- The European banking sector is less concentrated than the US one. SSM banks have generally shown less appetite for cross-border M&A operations. This means that banks in Europe face higher competitive pressures than its US peers, with an additional impact on pricing. Despite efforts towards establishing a banking union, the SSM banking sector remains segmented along national lines and barriers to cross-border consolidation with capital or liquidity ring-fencing still exist. Therefore, SSM banks cannot fully exploit economies of scale and risk diversification.
- SSM banks show larger management buffers above capital requirements than US peers. In particular, European banks are typically concerned with market stigma. Therefore, they usually decide to hold significant management buffers, which are expensive.
- Regulatory pressures and supervisory intrusiveness are perceived to be very high for SSM banks. Despite the application of the proportionality principle, actual differences between large and small banks are not perceived very material from the regulatory and supervisory standpoints.

A supervisor stated that, when looking at recent events, there is a need to look at how risks are governed, controlled and how the regulations and supervision can help tackle this issue. Europe has a different scope of application or regulation supervision. A great deal of work has already been done at Basel and at the European level regarding the interest rate risk in the banking book. This is already part of the Pillar II. Looking at different jurisdictions, some supervisors have already used it to a significant extent in order to tackle the expected increase in this risk.

One issue that has not been tackled on both sides of the Atlantic is opacity in the CDS market. After 15 years, it is still not understood where the interconnection in that market lies. The other topic that has not been tackled is crisis management.

1.2.1 Banking remains a fragmented industry in Europe

A supervisor agreed that Europe still has an issue about fragmentation and overcapacity. 5% of the top EU banking groups hold 20% of total assets, while 5% of the top US banking groups hold 40% of assets. There is a significant gap between the two sides of the Atlantic, and one of the reasons for this is fragmentation and overcapacity there still is in Europe. Another reason is that Europe still has domestic markets and not a fully unified market. That makes it more difficult for banks to expand properly to design products that could be sold all across the EU. That is despite of the banking union, but it is also because the banking union is not yet completed.

Securitisation is something which is missing at this stage in Europe. On top of that, there are several cyclical factors linked to the level of interest rate, the slope of the yield curve, and the level of growth, but the main structural factors are to be found in the first one I mentioned.

A leader of the industry agreed that overcapacity and fragmented domestic banking markets continue to hold back EU banks from realising economies of scale, resulting in higher average cost-to-income ratios and insufficient size to compete effectively with international non-European peers. While we have already seen considerable progress in banking consolidation within single Member States, particularly in those markets that were historically less concentrated, such as Italy or Spain, there are still several barriers to cross border consolidation. With cyclical factors turning the tide (or arguably remaining outside of direct control of legislators), the EU should focus on addressing these structural factors, doubling down on existing initiatives to address the causes of fragmentation and overcapacity in its banking sector.

1.2.2 EU appears more like a conglomerate of 27 different markets and is not prepared for a new banking crisis

An expert stated that banking is all about size. UBS just got a lot bigger, due to a well-rehearsed takeover. A Swiss bank could easily complain about the size of the home market because it is a small market. With a small home market, it is necessary to be a lot more international, and being very international means banking all the markets in the world.

There will be more financial stress. European regulators and banks have a complete sense of complacency about where Europe stands in the credit and business cycle and what the risks are ahead. It is the same complacency and finger pointing witnessed 15 years ago. Europe points at the US, saying US banks are in trouble. This time, it is not the big US banks. It is the second league of US banks. But I would be more cautious and recommend humbleness rather than complacency. The crisis might well return and then be haunting European banks.

The title of this session is about competitiveness of European banking. But Europe did not want competitive banks. The whole regulation has been about making banking a commodity and bringing down the cost of financial services, rather than having globally competitive banks. With new financial stress, Europe is again standing at a crossroads.

If stress emerges, acting quickly is key. The UBS takeover of Credit Suisse was well-rehearsed. The banks and the regulators were ready to act on a weekend. If an EU bank were to run into trouble, the other European bank would not be ready for a major acquisition of a competitor. Boards and managements of these banks would be quite reluctant to adopt such risky takeover on a weekend without a proper due diligence process, since without it they could end up in court down the road. Europe is not prepared for a new financial crisis. Prudent risk management is not about hoping that risk will not materialise. It is about being prepared when risks materialise, being ready to manage these risks. In 1860, the US created with the Federal Banking Act a US federally chartered league of banks that could offer banking services across the US. They are supervised by the Office of the Comptroller of the Currency (OCC), and deposits are insured by the Federal Deposit Insurance Corporation (FDIC).

A federal European insurance deposit agency with similar powers does not exist. A similar size balance sheet, and the ability to tap markets and raise funds and have the other banks pay into the federal deposit insurance scheme, is not there at a similar scale in Europe. Europe afforded he luxury of waiting 10 years to discuss this, but 10 years of action to implement this would have been preferable because during this time Europe could have built a European deposit insurance scheme that is worthwhile having.

Europe must create a federal European crisis management mechanism in order to deal with pan-European banking problems. The current system consists of 27 national regulators, and to make things even more complicated, a European 28th regulator on top. Complexity in managing financial stress in Europe multiplies by 28. Even smaller banks in Europe operate cross border instead of only nationally, but there is no truly European league of pan-European banks.

1.2.3 Insufficient scale or synergies across markets

An industry representative stated that there is now competition among countries and regions. Without a scale, it is very difficult as a company to compete with other companies that are global and have that scale, and it is very difficult to compete among countries.

With the current fragmentation, SMEs cannot grow in Europe. SMEs benefit when they can export and when they can get global. It is difficult to attract foreign investment. It is very difficult for big companies to get global and to have efficiencies there. Europe's strengths are related to sectors. The finance sector is at the front and centre of Europe's strengths, but Europe have other sectors on which it can lead and be an example, such as the energy sector and the outer sector.

A weakness of Europe is that it is not one single country. We have seen in the past, and are seeing now, how regulation has the capacity to really scale and grow sectors very fast and very efficiently. Fintech is a good example of growing a successful sector. We are seeing, and have seen, how regulation is able to destroy sectors, to really kill innovation and not allow companies to grow. The European finance sector should be front and centre of growth and competitiveness.

1.2.4 A competitive banking sector in the EU an objective to pursue

An industry representative stated that the root causes of the competitiveness gap between EU and Is banks are well known as to why European banks are less profitable than US and Asian banks. The starting point here is SSM banks have a good capital base and are very illiquid.

In 2012, the stress test focused also on sovereign risks included in the balance sheets of these SSM banks across Europe. Europe has a problem of scalability and national barriers, but there are early steps to go into a banking union and capital markets union which just require accelerated implementation. It is also difficult to compare American banks with European banks, as European banks tend to have more internal models with a lower risk-weighted asset density.

Europe distributes more in the US, and less in Europe. There is a wealth of securitisation activity happening in the US that is not quite happening yet in Europe. There are a few important steps that could get the European SSM banks to accelerate some degree of consolidation. That does not mean it will be at the cost of a weaker client service, but better profitability with a lower cost base.

2. Some priorities to bridge the gap

2.1 Some nonperforming banks should exit the market

A regulator stated that the European Union consists of 27 member states and has to consider a 28th country. In the area of supervisory and bank supervision, the relative wait between the one and the 27 has shifted the most, and the most progress has been attained. There are problems moving liquidity and capital across the European Union and this has to be worked on.

The parameter by which large banks in Europe are less different from large banks around the world is on their balance sheet. The question is how to explain the benefits of size. That has much to do with synergies for a rotation of assets. We have to question the benefit of having in Europe an even larger bank just purely in terms of balance sheet without a different business model that makes it more profitable, that is capable of providing an adequate return on equity. The question is why Europe has such large banks that seem to be so unable to be profitable, or to be adequately profitable. It could be because there are many small banks that do not have a goal to be profitable and Europe has a domestic market that is not capable of being really competitive and constructive. It is also important to clean up some of the non-performing banks. Europe needs to address how big the market is for corporate governance in the banking sector and how many poorly run banks can be taken over, run and changed.

2.2 Facilitating the consolidation of the market

A supervisor stated that the issue is not that Europe should avoid failing banks exiting the market, but banks should exit the market in a proper and smooth way without creating additional tension in the market.

It is true that scale and size has always been the proxy for sustainability of a business model, but it is also fair to say now that digitalization helps even second-tier banks to survive because they can also be part of a bigger platform. Banks sometimes are a by-product of platforms, and these non-banking and non-financial firms can survive because they have the possibility to crunch, manage and aggregate massive amounts of data. One additional key driver for success might be data aggregation and data management. One of the priorities for the EU could also be to go deeper into the regulation of digitalization of the governance of DeFi. This might be an additional field where competitiveness can increase at the global level.

2.3 Europe needs more funding through capital markets to improve competitiveness

An industry representative explained that Europe faces the need for a great deal of investment (digital and green transition, defence...). For facilitating these investments, debt and equity capital markets and hedging activities for foreign exchange or interest rates are activities that need to be developed in a deeper way in Europe[2]. The first defence is to have a strong franchise with customers and recognised resiliency. The reason the scalability that was mentioned was, when you have a deeper market like the US, they are able to expand and start from a strong base. The strong base for European banks should be in Europe.

Perhaps short-term measures, like securitisation, is a way diversify funding sources and to make progress in the CMU. In the short term, we need to be careful in the EU clearing framework not to penalise global EU banks that need to have some of their non-EU clients to access clearing houses that sit outside of Europe, even though we should support more clearing on the Continent Certain protective measures, such as an inducements ban in the retail investment strategy, would hurt our franchise for our retail customers and would away them from capital markets as well as not giving the ability for European asset managers perhaps to get some of these assets.

Regarding long-term changes, regulation has been effective, but Europe really needs to reflect on the business model, and sustainability of business models. The Prudential Regulation Authority of the Bank of England and the Monetary Authority of Singapore have a prudential mode at first, but they definitely have a mandate to also make sure that banks thrive.

Lastly is consolidation of market infrastructures. In Europe there is a great deal of fragmentation across central clearing counterparties and exchanges across 27 national markets. EU equity capital markets are only 25% the size of the US. Moreover, the EU has 3 times as many exchange groups, 18 central counterparties (CCPs) and 22 central securities depositories (CSDs), as opposed to 1 each in the U.S. Further consolidation would create deeper liquidity pools, making it more attractive for investors to invest in Europe.

These policies would permit Europe to build on its strengths while adapting its weaknesses, leading to higher living standards, a a better climate and long-term growth.

2.4 Further harmonising local tax, insolvency and anti-money laundering frameworks and addressing ring fencing issued would help increase commercial synergies

An industry representative stated that a great deal of money could be saved if insolvency and anti money laundering frameworks were equal across Europe. Some of these issues will admittedly require several years to get resolved. However, authorities should further build on initiatives such as the Capital Markets Union or the EU strategy for retail investors.

The other aspect that matters is intra-group capital and liquidity ringfencing by country within cross-border banking groups. This makes life very inefficient. Good intentions are being discussed in Brussels. The current CRR3/CRD6 package offers a great opportunity to tackle the problem, for instance with regard to the level of application of the output floor in the 2017 Basel agreement and the potential extension of capital/liquidity waivers within the Banking Union. Concerns from host countries could be addressed by expanding group-wide resolution requirements and increasing supervisory cooperation. Designing a regulatory environment that could favour the establishment of branches instead of more complex subsidiaries would also play an important role.

Once a better place has been reached it frees up capacity to continue to invest in technology. Banks are technology departments with an attached banking service provision that makes banks safe.

2.5 Thinking European rather than national

An industry representative suggested that countries will think of themselves first before thinking about Europe. Unless that is changed, this debate about the finance sector, and any other sector, will happen again and again.

An industry representative stated that there are certain jurisdictions, in the US in particular, where there are some requirements for having an independent holding company or a different setup. It is quite efficient for fungibility of capital and liquidity operating through branches.

2.6 European Banking Union needs a regulatory big bang for a fully-fledged EU banking framework for cross border banking groups

An expert highlighted the need for a European league for EU-based international banking groups in order to

2. 70% of funding in Europe is provided by banks. In the U.S., this is reversed. Bank lending capacity is determined by capital requirements, which constrain banks' capacity to fund the necessary investments. Recent bank failures have also demonstrated the need to reduce the economy's reliance on bank funding, as this creates risk concentration. European governments are also constrained by high debt. In parallel, the EU capital market is still smaller than in the U.S. with 14% versus 42% of global market share. Europe is fragmented along 27 national markets.

compete with U.S. banks at the level and degree of sophistication that the US banks display. Some European banks can compete, but Europe simply does not have an integrated home-market of the size and depth that would foster such a pan-European set of sophisticated financial services. Should there be banking problems not just in the US or Switzerland, but in the eurozone, there is a question whether Europe would be prepared and able to manage these risks.

15 years ago, financial crisis management in Germany was largely improvised. Looking at, in particular, the Benelux countries, preserving national banking systems mattered a lot in how rescue operations and how crisis-related mergers and acquisitions were done. A crisis will never come from where the last one was.

There is not much time. Europe should not discuss Basel IV and Basel V ad infinitum. Europe should basically implement a pan-European banking union. It needs to happen fast, not just at the spend of the lowest common denominator. There has to be some tough decisions at this point in order to create such forward momentum. If the hope is the next crisis will create that momentum and that acceptance, it is likely there will be another crisis before moving to the next level.

The chair noted that it was said that Europe needs a lot more European agencies, operators. But when you look at these heroic banking mergers, or banking interventions, be that Credit Suisse or the actions in United States, in the great financial crisis, what is common there is that, behind all these different private banks and regulatory agencies, there is a unified political will that is directing things.

An expert answered that it is necessary for Europe to allow banking mergers, or banking takeovers, without there being a completed banking union or a politically legitimated European to supervisor or regulators. If the aim is to get to European banking union by taking everyone along and creating something that has organically grown, it will take a long time because there are 27 members, and it will happen ot the speed of the slowest members. The takeover of Credit Suisse by UBS shows that even if resolution works, it is likely to be more risky and can be much more painful than a takeover by a competitor. If you look at that example, Swiss banking consolidation has come at a lower cost, less financial distress and was a much smarter solution as opposed to letting the distressed bank drive into the wall, picking up the pieces and then selling the pieces. Pieces of a bank are not worth a lot. The bank as a whole can be worth a lot.

Europe needs to have a single European banking licence. UBS, as a Swiss bank, needed 27 national licences in Europe, 27 platforms, and 27 management teams. If UBS could be run its entire European business out of Frankfurt centrally with a single banking licence, supervised by a single supervisor, subject to a single resolution regime, subject to a single deposit insurance scheme, it would have been a profitable market. It could have achieved a level of profitability of French clients, German clients or Italian clients that was unachievable based on a fragmented business, and it would have increased competition pressures in the home markets French, German, Italian and any other European banks. More competition based on lower cost would have reduced the cost of financial services for clients, and based on lower cost, an increasing number of clients could have benefited.

Secondly, there is a big misperception when talking about scalability. In banking, it is often argued that the number of branches and the number of clients matter. That is what Europeans call scale. However, branches have moved from being an asset to being a liability for banks. Scalability is not about banking more clients. It is about banking the same clients multiple times with different products. Scalability in Europe is not about becoming bigger. It is about becoming more universal financial service providers.

It is hard to understand the creation of a European banking union was designed as a journey that would take all banks onboard and therefore required national savings banks and corporate banks to move along. They are only purely national financial service providers. They are the second tier of European banks. Why not let them do their job and let them bank their clients nationally? Why do they need a European licence and all the complexity of European supervision and regulation if they run only local banking businesses? Europe needs global banks and pan-European banks to be regulated at the European level, because that is where competition will be the most intensive and benefit clients most.

Europe has chosen to travel at the speed of the lowest common denominator to European banking union. At the moment that speed is strongly influenced by German savings and corporate banks. They do not want European regulation; they have German business and regulating them nationally would absolutely suffice. None of them operate beyond the borders of Germany. The concern of European Banking supervisors should be about the top 15 international and pan European banks, because if they have a problem, it will require cross-border collaboration to rescue them. Supervising the top 50% of each member-countries banking institutions was how the Single Supervisory Mechanism was set-up. Supervising the top 50% of the Euro area banks would have been a smarter way to start it. The real challenge now is not to worry about the smallest 50% of Euro area banks, the puerly domestic local banks. It is not a key risk for Germany, nor for any other country. Could Germany afford to rescue its saving banks and its corporate banking sector? Of course, it could, but they will organize the rescue within the groups because they allow competition to take over and consolidate the system within the group. But can Germany afford to rescue its big banks? I'm sure it can, but it would have to happen within a European framework, which has key elements still under construction to date.

In the other 26 countries Europe, ask yourself the same question. The risk is that if financial stress continues, the market may test whether the regulators and a country 's government can afford to save their banking system. This is where contagion risks become very dangerous for Europe. Whether a bank has a fundamental problem is then largely irrelevant. If speculative market pressure and short selling increases for a bank by enough to cause deposits to flow out, if the stock price falls enough to add to the perception of instability, that will organize be the moment where the regulator and the home-country may have to step in and save that bank. It is not about whether European banks are safe or not safe. It is a question of whether a European bank in trouble can receive sufficient support and access a backstop, a deposit insurance and other recovery mechanisms to stabilise the bank, as the U.S. did.

The U.S. supervisory authorities have far-reaching emergency authorities. Europe needs 27 authorities with little power each around the table to agree to move on European supervisory issues. The European public would not forgive the supervisors and regulators if there were another round of banking problems in Europe and they are not dealt better and much quicker than last time around. Europe needs to be prepared for this. There is a sense of complacency that is not addressing the fundamental issues.

The Chair concluded the session by noting that the banking sector in Europe has a competitiveness issue. To fix that, we need to do a bunch of things. We need to create scalability in whatever definition of that word. We need to create standards and efficient technologies. We need a European banking licence. We need European deposit insurance, European agencies, and European spirit. We need a big bang, and we need time. That is the plan. Thank you for your attention.