Banking Union: how to break the deadlock?

Introduction

Beyond financial stability considerations, a genuine banking union is necessary because banks remain fundamentally unable to leverage the single market to the benefit of their clients. This has negative consequences for the economy: competition for savings remains largely national, opportunities to deploy capital where it can create the most growth are constraint, and lack of scale means European banks cannot compete in all aspects of global finance.

The Chair outlined that the banking union is in a deadlock situation, with numerous constraints and practices in the supervisory field that do not help progress. The session considered what measures could be taken to make progress and to overcome the lack of trust between supervisory and other authorities. The panel also considered the impact of digitalisation and other market developments.

1. A great deal of progress has been made but loopholes remain that make the Banking Union fragmented

1.1 Main achievements of the banking union to date

An official emphasised that banking union has been a successful story so far. It has provided economic benefits. The European banking sector is more resilient than in other parts of the world. This was demonstrated during the US mini-banking crisis in March 2023, when the EU regulatory framework and stringent Basel requirements proved to be the difference. However, the banking union is a long way from fulfilling its potential. Economically, the banking sector remains fragmented, and the expected consolidation has not happened Politically, the banking union has not yet attracted enough countries outside the eurozone. There are challenges relating to geopolitics and the transition, so the cost of inaction is high.

A Central Bank official observed that trust has been built in the system over the past 10 years. There is a sense of cooperation between the single supervisory mechanism (SSM) and the single resolution mechanism (SRM). This is particularly important at times of stress when it is necessary to act quickly.

1.2 The same risk carries a different capital requirement depending on where a bank is domiciled, due to the lack of harmonisation of macro prudential requirements

An industry representative stated that, in many cases, banks do not need new incentives; they just need to have the existing framework working. The purpose of the banking union is to have a transparent, unified, and safe environment for banks. A great deal of time has been spent on safety, but now that the economic environment has changed, more attention should be paid to transparency and unified rules.

Minimising political and regulatory uncertainties is key. Diverging macroprudential requirements across different jurisdictions is an issue faced by cross-border banks operating under a branch structure. National authorities can use a lot of discretion, leading to a scattered landscape with little predictability and an often-insufficient analysis of the overlaps between various requirements. On the microprudential side, there are many differences in interpretation. This is even more complex when banks operate both inside and outside the banking union. Even within the banking union, interpretations vary and there are additional local rules around privacy and conduct.

There should be further alignment between supervisors' division of responsibilities per CRD/CRR and the supervisors' practical say in banks' operations. Banks with operations in many member states face supervisory expectations to align practices at group level, while host supervisors may also prefer to extend a large proportion of their expectations to those entities. This makes operating cross-border banks increasingly complex.

1.3 Ad hoc taxes to the banking sector are a significant source of undue fragmentation

An industry representative emphasized that taxation is a very well-known source of fragmentation. The problem of ad hoc taxes has existed from the beginning. Currently, six European countries have windfall taxes; in four countries, a windfall tax is going through a legislative process; and five countries have made an announcement of some kind. Therefore, this is a material issue in about 15 out of 27 countries. Taxes vary in their design and scope. Some try to target extraordinary profits while also making contributions to specific goals. Some are a surcharge on new taxes, while some are completely new taxes. This is a clear source of fragmentation and contributes to the lack of banking union. The ECB has warned of the negative consequences for resilient capital, credit provision and market competition.

Finally, banks and the financial sector are subject to headwinds as well as tailwinds. The pandemic and future uncertainty is a reminder of this. All considered, there is a need for a fundamental rethinking of policy regarding windfall taxes to banks.

1.4 European institutions are tiny and much less competitive compared to their American counterparts

An industry representative commented that European banks have smoothly navigated crisis situations such as

Covid and the invasion of Ukraine. However, the market value of European banks has not traded above book value since 2014. European institutions are tiny compared to their American peers. The top 10 European banks combined do not match the market cap of the single largest American bank. In the long term, the industry needs diversification and scale to invest in order to compete with non-EU banks.

The Chair noted that the world outside the European Union is moving quickly. There are longstanding perceptions of a competitive disadvantage with US banks.

An industry representative observed that direct comparisons between the EU and US markets can be difficult. A recent ECB paper quantified the difference in return on equity (ROE) at 5% to 6%. One of the drivers of this is structural differences in the market. In the EU, there are challenges involving excess capacity. Differences in profitability also feed into the stock valuations, impacting capital retention capacity and financial stability. In sectors where there is truly global competition, there seem to be increasing economies of scale with strong US banks. An immediate action that the EU can take is to ensure that we do not shoot ourselves in implementing the fundamental review of the trading book ahead of global competitors. Overall, EU regulators should consider how emerging regulation will affect the global competitiveness of pan European banks.

1.5 The CMDI review is a step in the right direction, but more is needed

A Central Bank official stated that two-thirds of the architecture of the banking union are in place, but the last pillar - the European Deposit Insurance Scheme (EDIS) - is still needed. The proposal of crisis management and deposit insurance (CMDI) is a step in the right direction. There is reason to believe that the third pillar will be achieved, but even then, the banking market will continue to be fragmented. Countries have different macro contexts, bankruptcy laws, regimes and fiscal budgets. There is excessive complexity in the European regulatory framework, with multiple levels of capital. Uncertainty about regulatory evolution and messages from supervisors can lead to too much capital being held above the requirements. Supervisors do not like excess capital, which leads to suboptimal capital structures, lower profitability, low remuneration of investors and a lack of competitiveness in the banking sector.

The Chair stressed that, after the great financial crisis, it has taken 17 years to approve the Basel III standards. There are now 140 EBA mandates to further implement the rules. The challenge is to strike the right balance between waiting for regulations to be fully implemented while also needing to take actions to constrain undesirable business development and to preserve the safety and soundness of banks, in aforward-looking perspective.

On CMDI, combining all the available resources in national deposit guarantee schemes (DGS) and the single resolution fund (SRF) will provide the same available amount as in the US. It is not only an issue of funding needs. The problem is that these amounts cannot be used and result to be 'frozen' at the current stage. Some might argue that these funds can only be used for large banks, but there is no incentive for banks to continue to provide funding. This is where the CMDI could be beneficial.

2. Digitalisation will not be the gamechanger to break the deadlock

2.1 Digitalisation and technological innovation must be part of the bank's DNA in the way it does business

A Central Bank official stated that digitalisation is a priority within the SSM. A few years ago, the growth ambitions of retail banks were built on expanding branch networks and headcount. Thankfully, this is no longer the case. Digitalisation is part of how banks deal with their clients. There is the potential to scale up businesses when banks have good ideas, service propositions and platforms.

Digitalisation and technological innovation should also be part of how banks deal with information and risk management. Banks need to have good internal control functions dealing with third-party providers. This is an integral part of the assessment of the business model of banks in the supervisory review and evaluation process (SREP) carried out by the SSM. Senior management should have the skills and knowledge to deal with technological innovation and digitalisation. This is part of the fit and proper assessment for senior management.

2.2 All banks need to become digital, but regulation and differences in customer behaviour across member states make it more complicated

An industry representative commented that all banks will need to become digital in the medium to long term. In the short term, there is a distinction between cloud-native banks and other banks with more legacy items to digitise. For cloud-native banks, while it is relatively easy to provide basic banking services, more complicated products such as mortgages present a challenge. In theory, it should be easy to expand a digital business model across the EU, but regulation and differences in customer behaviour make it more complicated. Scale and profitability are needed in order to invest, especially in the current environment. It may not be as easy for neobanks to get funding for investments. If it is not possible to invest, there is the risk of a vicious circle.

An important issue to raise is the macroprudential element. The Commission's initiative to explore expanding the framework to fintechs and other entities is welcome, as instability in the non-bank sector has also impacted banking in the last few years.

2.3 Retail markets are different in EU countries. The more that compliance and GDPR rules are harmonised, the less optimisation banks will need to do

An industry representative stated that the distinction between a digital bank and a bric-and mortar bank does not exist anymore. Classical branch banks will no longer exist in Europe within five years. The market has moved quickly. But mortgages in some markets have their own characteristic client behaviour and taxation, so fragmentation will not be easily solved. However, banks can scale in areas such as operations and IT if policy, regulatory and supervisory harmonisation is achieved. The more that compliance and GDPR rules are harmonised, the less optimisation banks will need to do. Fragmentation sometimes gives large banks a competitive advantage. Digital banks, fintechs and neobanks need to have scale across the eurozone, as they will not have millions of clients in a particular market. Harmonisation needs to work so that newcomers can succeed.

3. Possible ways forward

3.1 Top five to-do list for policymakers

An official outlined five key principles to achieve progress on banking union. Firstly, the political significance of banking union should be highlighted. Secondly, it is important to overcome the home bias or national concept. Thirdly, it is necessary to overcome the 'prisoner's dilemma'. Instead of competing within the banking union, with a lack of trust between member states, banks, regulators and EU institutions, banks and institutions need to be Europeanised. Fourthly, it is important to make use of the linkage between banking union and the development of the capital markets union (CMU). Lastly, a holistic approach should be followed. Progress is needed on the European deposit insurance scheme (EDIS), the Regulatory Treatment of Sovereign Exposures (RTSE), and on crisis management. Overall, there is a need for more speed, less resistance, and more honesty in discussions.

An industry representative agreed that a holistic approach is needed. Without a comprehensive solution, consolidation will not be triggered in Europe. There are small aspects that can be optimised in the short term, such as free flow of capital and liquidity among the banking subsidiaries of European banks. A single macroprudential policy across all European banks would also help. A European DGS system would be hugely beneficial, as this is one of the major components that makes M&A risky for banks. Banks should also diversify and limit concentration risk to sovereign bonds and, consequently, put an end to the sovereign bank doom loop risk. Lastly, it is important to ensure a credible liquidity backstop for resolvable banks.

3.2 There is a need for a rethinking of policy regarding windfall taxes to banks

An industry representative stated that windfall taxes are a pseudo-solution generating a real problem. One solution is to remove them. A second solution is to generate common criteria, guidance and coordination at the European level. Uncertainty and fragmentation affect investment decisions. Taxation impacts the possibility of obtaining the necessary scale to innovate and compete at the European and international levels. Clear rethinking on windfall taxes is needed, as this is already affecting some investment decisions connected to digital transformation and innovation.

3.3 National governments need to be neutral about how banks prefer to operate within the banking union (branch or subsidiary)

An industry representative commented that, when a bank is contemplating operating either as a subsidiary or branch model across the EU, the complexity of the landscape increases difficulty and unpredictability. There is no need for new regulation; the rules and the intent to have a unified setup are already there. National governments need to respect that spirit and to be agnostic about how banks prefer to operate within the banking union. This will lead to consolidation.

3.4 Improving the securitisation market in Europe remains challenging

An industry representative stated that securitisation is an area where further integration is needed. There is a need for end-to-end optimisation instead of regulating components separately. This is a very important component of the CMU. There are divergences regarding on-balance sheet securitisations; this is an area where more alignment within the EU would be welcome.

The Chair added that the US market for securitisation benefits from a public guarantee with government sponsored enterprises (GSEs). While there are some margins for improvement in regulation, it would not be appropriate to look for a perfect match with US securitisation. Regulation can attract investments and this is why it can be considered a competitive factor, in particular on innovative areas (such as AI).

Home and host bias is another issue to consider. The solo approach is still applied within the European Union. One question to consider is whether the solo approach can be considered from a different perspective, given all the improvements made on supervision and on resolution.

3.5 Competitiveness and modernisation of the single market should be the top priority for the new institutional cycle

An official commented that it is very likely that competitiveness and modernisation of the single market will be the top priority for the new institutional cycle. Europe has the largest single market, but benefits for banks and citizens are limited. The opportunity should be taken to fulfil this potential. The strategic discussions on the CMU are progressing significantly. The reporting burden is important to address, as it is interlinked with competitiveness. Europe cannot rely on crisis mode this time, as the cost of inaction could be very high.

On the home-host issue, more Europeanisation of institutions and banks is needed, including governance. This also includes the Single Resolution Board (SRB). There are possibilities to improve the setting of the SSM. It is also valid for banks. In the portfolios of banks, there are home buys but no host buys. Diversification of the portfolio is needed.

3.6 Continuing to wait for someone to make the first move is not the right approach

The Chair noted that there is a long list of interlinked issues, including the lack of coordinated macroprudential policy. Indeed, macroprudential in Europe is now associated with fragmentation, as it is an additional tool that national authorities can use to ring-fence capital, which was not the original intention of the Basel discussion. Everyone is aware of the issues, but nobody wants to take the first step. Within the public sector, there is talk of the home-host issue and a lack of mutual trust between supervisors and resolution authorities. The problem is that the world is moving quickly. In Europe, there is self-confidence that the period of crisis has been dealt with, and wariness about addressing sensitive problems.

The only way to cope with this is to have a stronger Europe. A stronger Europe starts with the recognition that there are available resources to address a crisis of the banks. There should be allowances made for transfer strategies, the possibility for the investors to step in, a lack of preferential treatment for DGSs, and host authorities trusting the home. Europe cannot wait for the next great financial crisis, because then it will be too late.

An official stated that progress should be made on all elements of the banking union, as they are interlinked. The project should not be built at the cost to some, but to the benefit of all. It is not a question of whether the home or the host will make the first step. A holistic view is needed, with more clarity about the goal. Currently, even among the home member states, there is no shared goal for the banking union project.