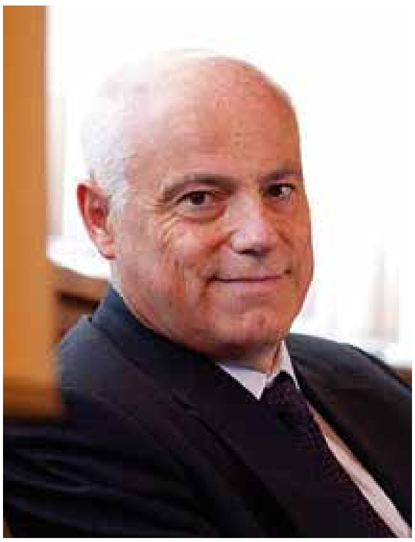
Improving the global competitiveness of the EU financial sector



José Manuel Campa Fernández

Chairperson, European Banking Authority (EBA)

Shakeout: a way out of the profitability trap?

EU banks' profitability has lagged behind that of US banks for years. Whereas the return on equity (RoE) stood at 6.5% for EU banks in 2018, it was 11.9% for their US peers (EBA Risk Dashboard, US Fed). This difference cannot be attributed to a single reason. It is striking that in the US the consolidation of the banking sector has moved much faster than in the EU. Also, the number of exiting institutions has been bigger in the US compared to the EU. This higher rate of restructuring occurs both between large and small institutions. As a result, in the US the number of credit institutions has fallen by 30% since 2008, while the decrease in the EU was just 20% (ECB, US Fed).

Furthermore, comparing EU banks with their US peers, the cost to income ratio (CIR) for the former is on average 66.3% versus 62.8% for the latter. These similar ratios underscore however different underlying trends. US banks have decreased their CIR from 71.8% in 2014 whereas it has increased for EU banks since then from 62.9% (EBA Risk Dashboard, US Fed). The poor peformance of the CIR is mostly explained by the difficulty of banks to adjust operating expenses in line with the negative evolution of their income in a challenging environment.

> *"Shakeout through consolidation, exit and orderly restructuring might improve banks' profitability."*
>
> \- JOSÉ MANUEL CAMPA FERNÁNDEZ

The EBA's risk assessment questionnaire (RAQ) shows that banks are aware of this challenge. Many of the respondents pointed out that they plan to reduce overhead and staff costs and to invest in automatisation and digitisation. Differences in profitability and cost structures between EU and US banks are similarly reflected in investor perceptions of them. More than 80% of US banks were trading at a price to book multiple (PtB) above 1 in July this year, compared to less than 30% of EU/EEA banks. At the beginning of 2008, the PtB was above 1 for around 90% of the banks in both jurisdictions.

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>>> One should not conclude that consolidation is a goal in itself nor that consolidation as such drives profitability up. However, through creative destruction, an active process by which more efficient institutions continue to gain market share, while weaker, less efficient institutions exit the market will be one contribution to improve profitability. At the same time such consolidation could potentially benefit from operating synergies allowing the remaining firms to provide better services while enhancing their profitability.

Consolidation along national borders appears more appealing than cross-border consolidation within the EU. Overlaps in staff and branch networks of banks operating in different countries are more limited and so would be the reduction of operating expenses from cross-border vs. domestic mergers. Differences in tax and insolvency regimes also make cross-border transactions more complex. Additionally, different supervisory practices and national application of macroprudential measures as well as the ring-fencing of capital and liquidity of subsidiaries are perceived as an obstacle to cross-border M&As, according to a stocktake run by the EBA.

Regulation should not pose additional undue obstacles but should ensure that the basis for healthy competition exists. This should include adequate exits from weak banks with unsustainable business models, effective competition, and the ability for incumbents and newcomers to adopt new technologies that provide better services while ensuring financial stability.

The EU regulatory framework can help in this area by finalizing the effective implementation of the resolution framework to ensure orderly exits from banks happen. Effective supervision and harmonisation around the setting of capital buffers, like the systemic risk buffer and the buffer for other systemically important institutions, need to assure that no unnecessary burdens exist. The setting up of a fully-fledged European Deposit Insurance Scheme in the Banking Union would also reduce the reluctance of regulators to exercise national waivers on liquidity and capital. Finally, regulation needs to be put in place to allow for the introduction of new technologies and new players in the industry that foster competition while preserving financial stability. ●

Elke König

Chair, Single Resolution Board (SRB)

European banking – there is strength in diversity

If the European Union's motto is 'United in Diversity', then perhaps the Banking Union's motto should be something along the lines of 'Strength in Diversity'.

The Banking Union is a diverse mosaic of small and complex financial institutions. In some states, the banking market is dominated by foreign operators. In others it is small banks that have the lion's share of the market. And in others still, the market is largely made up of just a few large banks. The structure of individual markets within the Banking Union varies hugely reflecting not least different traditional development. This diversity in structures is not necessarily a bad thing. For example, a large bank poses a serious risk to financial stability if it cannot be made resolvable; smaller banks may not have the economies of scale to be viable in the long-term. There are pros and cons to each model – the important thing from a financial stability point of view is that small banks and big banks have sustainable business models. Regulation and supervision have to cope with the variety of business models. Just to name two points: Regulation has to be proportionate, there is no "one size fits all" and in a single market the diversity in national rules has to be overcome to facilitate mergers and acquisitions.

A good regulatory framework can facilitate this, but of course, the role of the regulator is not to ensure every bank can make a profit. Every bank, big and small, must be in >>>

>>> a position to comply with regulatory standards and bear the cost that is inherent in the safety net that regulation provides to society. That said, the regulatory landscape should facilitate as much as possible the natural behavior of a free market in the European banking sector. The challenge for regulation has always been to recognize that one size does not fit all, while also balancing the need for a level-playing field.

However, it is not just about regulation for the financial industry. A fully functioning Capital Markets Union, which allowed for investment to flow easily across the euro area, is much needed and would do much to ensure that banks have an enlarged "home market for capitalization and investment". A proper, fully functioning capital markets union in Europe would allow for greater integration of investment, allowing for the possibility of more consolidation, creating banks ready to operate right across the 19 Eurozone countries. This would introduce competition for the consumer, but it would also diversify the banking market within many member states, which would be a good thing. Unlike the Banking Union however, the Capital Markets Union is more of a concept, and idea or a notion, rather than a concrete legislative framework.

"Diversity in structures is not necessarily a bad thing."

- ELKE KÖNIG

There is also work to be done in harmonising insolvency procedures. In the Banking Union itself we have 19 different insolvency procedures, so banks and their investors will have to contend with and learn about many different legal systems just to invest in a market that is outside their home member state. The single market has still a way to go.

It is also true that completing the Banking Union and having all European deposits protected at EU level, in a harmonized way, would promote stability and confidence if and when the next crisis strikes.

There probably is a need for consolidation in the European banking market in order to remove overcapacity and ensure greater profitability overall. Some banks will simply have to exit the market; mergers and acquisitions can play a significant role in consolidation. In any case, a completed Banking Union and a full Capital Markets Union would be a solid framework so that the markets can be left to play their part, strengthening the sector going forward and thus helping to promote financial stability. ●

Michael West

Managing Director, Global Ratings & Research, Moody's Investors Service

EU financial sector held back by low growth, interest rates and fragmented markets

The scale and profitability of many EU financial institutions falls short of that of US counterparts. Lower interest rates and slower economic growth in the EU contribute to this shortfall. Between 2010 and 2018, US GDP growth exceeded EU growth by 0.7% annually, on average. In the EU, interest rates remain close to zero, while in the US they hover between 2.25% and 2.5%. Lower growth and interest rates, along with the bloc's fragmented markets, will hold back profitability and scale for banks and asset managers.

There is no true single market for the EU: instead, it is segmented along national lines and cost inefficiencies plague some domestic banking systems. On the positive side, banks' stocks of non-performing loans are falling, longer term assets are building, and capital buffers are wider. Still, weaker growth and low interest rates will constrain bank profitability and improving cost efficiency remains a key challenge. Large EU banks still lack the necessary scale to compete with global banks, and they will soon face significant challenges from big tech and fintech firms. While bank digital strategies provide revenue and pricing >>>

>>> opportunities, benefits have yet to fully materialize.

EU asset managers similarly lack scale compared with their US counterparts. The 10 largest US asset management firms manage €22.1 trillion or 30% of global assets under management (AUM), while their 10-largest EU peers manage only €7.9 trillion or around 10% of global AUM. Smaller EU firms are struggling to sustain high margins amid long-term trends towards lower fees and higher costs.

The fragmented EU fund market – which will be exacerbated by Brexit – also hampers competitiveness against US peers, which benefit from the large single market in the US. US asset managers are leveraging their global positions and scale (notably those in the "trillion-dollar club") to compete in the European markets. Consolidation is under way in the EU, and EU-wide rules allow funds to conduct business across EU borders. Nevertheless, legal and political obstacles to a single EU market have yet to be fully addressed.

"Large EU banks still lack the necessary scale to compete with global banks."

\- MICHAEL WEST

National boundaries that divide the EU market are less of an issue for insurers. The entire insurance industry is fragmented globally. EU firms are largely focused on the EU despite the EU having a few global players in reinsurance, and in commercial, property and casualty. Prudential rules are also fragmented; Solvency II rules apply only in the EU. Profitability levels have been similar for European and US property and casualty insurers for the last 10 years, although the EU's much lower interest rates have curtailed the profits of EU life insurers.

A true single market for the EU across product lines – from retail banking and asset management, to debt and equity issuance and advisory services – is key to addressing many industry headwinds and crucial in our view to improving credit quality. ●

Philippe Heim

Deputy Chief Executive Officer, Société Générale

A wake-up call for improving EU Banks' competitiveness

Banks are undoubtedly better equipped to face adverse shocks today than they were at the eve of the last financial crisis. Euro area banks kept providing credit to the real economy while implementing a broad set of new regulatory requirements. They have accumulated €175.6bn of CET1 capital since Q4.2014 and accelerated the clean-up of their balance sheets through a significant NPL decrease. Yet, Euro area banks' profitability remains persistently low, especially when compared to their US counterparts. Euro area banks' return on equity stood at 8.7% in 2018, lower than the level observed in 2007, while US banks reached 11.2% in 2018, recovering their 2007 level.

Since the crisis, the euro area took almost a full decade to return to its pre-crisis GDP per capita, while the US recovered in near half that time. The US economy's competitiveness was further boosted by the 2017 tax reform. Aging demographic trends are also a driver of lower European growth, and negative central bank deposit rates combined with high excess reserves cost euro area banks around €7.5bn per year.

"Europe needs competition between a smaller number of strong banks, not a larger number of weak banks."

\- PHILIPPE HEIM

In this context, it is challenging for Euro area banks to absorb the high costs stemming from digital transformation and regulatory compliance burdens. The diverging regulatory approach between the EU and the US - in particular MiFID and GDPR - and the difficult ramp-up of the Banking Union, represent key differentiating factors which favour US banks.

In reaction, several challenges must be considered to strengthen EU banks' competitiveness:

- European policy-makers should recognize the key role of banks in financing growth and prosperity but also in supporting energy transition investments. Banks are instrumental in the fight against financial crime and money laundering. The resilience and profitability of EU banks are both prerequisite to allow them to properly accomplish their missions.
- A fair and pragmatic transposition of the Basel III agreement is key to ensure EU banks' competitiveness. Otherwise, it could jeopardize EU banks' business models, notably by widening the EU/US gap over market activities. This is at odds with calls made for speeding up the CMU.
- Finalizing the EU's Capital Markets, Banking and Monetary Union is vital, especially in the context of Brexit. A more concentrated EU banking system would ease cross borders operations. Strengthening the Euro as an international currency would also ensure a greater financing autonomy by making EU banks less vulnerable to external shocks.
- It is now time to reap the benefits from the Banking Union. Completing its third pillar, an EU-wide deposit insurance system, would be decisive. But it makes no sense to have a EDIS if liquidity and capital persistently remain fragmented along domestic lines. Hence, we should first finalize its two first pillars.

Once all these issues are addressed, pan-European groups can emerge, thus reaching the necessary critical mass to improve European banks' position in the international competition.

Europe needs competition between a smaller number of strong banks, not a larger number of weak banks. ●

Luigi Federico Signorini

Deputy Governor, Banca d'Italia

Weak bank profitability in Europe: one problem, but no single solution

European banks are still recovering from the consequences of the global financial crisis and the sovereign debt crisis. Legacy problems are less of a concern today, as banks in countries that were hit harder by the crisis have come a long way in cleaning their balance sheets. But bank profitability is still far from pre-crisis levels: in 2018 the average return on equity (ROE) of EU banks was 6 per cent, well below the level of 2007 (10 per cent), and will likely remain so for some time.

Although the low interest rate environment is commonly blamed as the main factor preventing banks from returning to a double-digit ROE, there is no convincing evidence that low interest rates per se are the culprit of weak profitability. The significant heterogeneity in performance observed across EU countries and banks suggests that there is no single explanation.

"Understanding heterogeneities of weak profitability is key for devising improvement strategies."

\- LUIGI FEDERICO SIGNORINI

Cyclical conditions within Europe are not uniform and banks, with few exceptions, concentrate most of their business in one or few economies; some of the heterogeneity is therefore the result of different national output dynamics, real estate and financial cycles. For Italian banks we estimate that in 2018 roughly one third of the gap between realized ROE and a 10 per cent target – a level that analysts and banks themselves deem necessary to cover the cost of equity – depended on the weak macroeconomic environment.

Second, European banks' business models differ in their sensitiveness to macroeconomic conditions, and face somewhat different structural challenges. For example, banks engaging primarily in lending are more sensitive to the domestic business cycle than those that are more involved in investment banking and trading activities. With respect to vulnerability to structural changes, institutions that focus on serving retail clients and on traditional credit intermediation face challenges due to the developments in technology that threaten their comparative advantage in exploiting soft information and physical proximity to clients. Complex universal banks are instead struggling mainly because of the fundamental changes in capital and liquidity requirements and in the global financial industry (e.g. margins squeeze on exchange traded products previously traded OTC).

Specific external conditions also influence the pace at which banks are adjusting their business models to the new competitive landscape. Many banks have downsized their physical networks and increased cost efficiency, but opportunities for fully exploiting technology are constrained by the unequal diffusion across countries of digital services among consumers and firms. In some countries legacy problems have absorbed resources at the expense of business innovation.

Consolidation can be a path to achieve greater overall efficiency but retail markets in Europe are not integrated yet, thus most benefits would be generated by the absorption of excess capacity at the domestic level rather than by the exploitation of returns from scaling up to a larger market. Achieving sustainable profitability requires not only cost cutting but adopting innovative business strategies, and further adjustments in the way banks perform their intermediation functions, leveraging on their ability to bundle credit provision with other products and services. ●