Policy priorities for the banking sector

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European financial markets have become more stable

The sociologist Max Weber likened politics to the arduous task of boring through hard boards of wood – an activity that requires both passion and perspective. In my view, this description can also be applied to financial regulation. At present, the community of European financial regulators has some rather tough materials to work through – and against the backdrop of somewhat unfavourable conditions. With that I am referring, among other things, to interest rates, which have been historically low for some time now. The persistently high levels of non-performing loans in some EU member states is another relevant topic.

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>
> \- FELIX HUFELD

In spite of this, the past few years have seen the launch of some innovative projects that have succeeded in increasing financial stability in Europe. The European Banking Union comes to mind – with two out of three pillars in place, we have already crossed two key milestones in this regard. In November, we will be able to celebrate the fifth anniversary of the first Pillar, the Single Supervisory Mechanism (SSM) under the umbrella of the European Central Bank (ECB). As a member in the Supervisory Board of the SSM, I have seen first-hand how processes have become increasingly established and cooperation between the ECB and national supervisory authorities has become routine practice. The high degree of professionalism that has come to characterise the SSM is not just visible in the day-to-day supervision of institutions, but also in the implementation of strategically important projects.

Our success can also be seen in the second pillar of the banking union, the Single Resolution Mechanism (SRM), with the central resolution authority, the Single Resolution Board (SRB). The SRM aims to ensure the orderly resolution of systemically important banks with minimum impact on the real economy, the financial system, and public finances. That is of value in itself. But when we look beyond the big picture at the hard work on the ground, the positive development in the SRM

>>> becomes clear, for example in coordinated resolution planning for significant institutions operating on a cross-border basis, and in the formulation of complex capital requirements, such as for own funds and eligible liabilities (MREL).

The situation is a little more complicated when it comes to the third pillar of the banking union, the possible introduction of a common European Deposit Insurance Scheme (EDIS). I expressly share the opinion of the German Federal Government that the introduction of an EDIS must be tied to certain conditions. These conditions have not yet been met. Before we launch a common deposit guarantee scheme, we must first sufficiently reduce the various existing risks in the financial sectors of the member states.

One consideration that is becoming increasingly important at the European level is consumer protection. The cornerstones of Europe-wide regulation are the Markets in Financial Instruments Directive (MiFID II), the Insurance Distribution Directive (IDD) and the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPS Regulation). Supervisory convergence is now also gaining in importance; this describes efforts to create a common supervisory culture, ensure coherence in supervisory practices and guarantee the use of consistent procedures.

The three European Supervisory Authorities (ESAs), which have recently been bolstered by the compromise reached as part of the ESA review, particularly with regard to consumer protection, have an important role to play here. International cooperation between national supervisory authorities will also gain in importance – a trend which is amongst others fostered by digitalisation. Cybercriminals as well as money laundering activities will not be stopped by national boundaries, which is why supervisors and regulators need to find the ways and means to work together more closely and more effectively across national borders.

Another key European project is the creation of a Capital Markets Union (CMU), or the further integration of financial markets within the European Union. If the right conditions are created, the CMU will contribute to making the European capital market and banking market more efficient, competitive and diverse, and to broadening the possibilities on offer for both private and corporate customers. ●

Xavier Musca

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Basel IV: the one reform too many for European banks competitiveness

The new European legislature will be tasked with the transposition of the Basel Committee December 2017 recommendations into EU law. As a reminder, only those Basel recommendations that are transposed into national or European law have legal force. It is therefore up to the legislators to take their responsibilities.

We call that reform "Basel IV" because it implies a radical shift away from the 2005 Basel doctrine which Basel III then confirmed: a move from a risk-based capital requirements approach to a flat-rate approach that does not suit low risk balance sheets. This would particularly penalise large EU banks whose balance sheets' risk density is lower than US banks'. The Basel Committee estimated in March 2019 that capital requirements would decrease in Asia, increase in the US by 1.5% but >>>

>>> increase in the EU by more than 20%. This would create a competitive disadvantage for EU banks, particularly vis-à-vis US corporate and investment banks that already enjoy a 50% EU market share.

This would also penalise the financing of the European economy and its competitiveness as the capital requirements increase would be particularly high for the financing of unrated corporates, real estate or specialised lending (infrastructures, aviation, rail etc.) for which the increase could be well over 100%.

Within a rationale of standardisation, comparability of models and strengthening of solvency, the Basel recommendations have thus considerably deviated from the 2016 G20 statement, the 2016 ECOFIN conclusions and the 2017 European Parliament resolution. There should be no significant increase in the overall capital requirements for the banking sector and no significant differences across regions of the world. We are very far from these objectives.

Last July EBA aggravated impact estimates for EU banks, with an average increase in capital requirements of 24.4% for all EU banks and of 28.6% for GSIBs, which is more than significant. Besides, EBA recommends tightening certain aspects of the Basel approach, for instance applying the output floor at entity level. Furthermore, EBA has not assessed the impact of Basel IV on capital requirements under the MREL. Worse still, EBA downplays the impacts of that reform on banks by assuming on the one hand that banks' capital surpluses beyond the regulatory minimum will allow partially addressing the impact and, on the other hand, that banks' retained earnings will absorb the rest.

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For investors, however, what matters is not the absolute level of banks' own funds but the excess of own funds compared to the regulatory requirements. Dedicating the accumulation of future earnings to these new regulatory requirements would lower profitability, which is an important soundness indicator for debt and equity investors. Furthermore, this would reduce the capacity to fund the European economy at a time when important investments in technology and ecological transition are called for.

Let us recall that in response to the 2008 financial crisis, regulators already greatly increased own funds requirements. For the past ten years, the level of capitalisation of European banks has more than doubled: it now reaches 14.4% of CET1 on average and thus includes a substantial amount of capital reserves.

Last, constant regulatory instability has become a source of concern rather than comfort: despite the Banking Union and all the prudential measures already adopted, equity investors have been shifting away from the European banking sector.

Let us make no mistake. We are not questioning what has been implemented to strengthen the safety of the financial system. This is by no means to argue for any deregulation. A sound banking system is not a system investors would turn away from.

Let us be cautious not to create Malthusian banks unable to finance economic development, by looking at financial stability only through the lens of capital level.

The European Union has set the political conditions that must govern the conclusions of a Basel agreement. That political will must not abdicate. ●

Carlos San Basilio

Secretary General of the Treasury and International Financing,
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Addressing the challenge of bank profitability

The Banking Union can support bank profitability by both reducing and sharing risks as well as by fostering cross-border flows, broadening the customer base and incentivising cross-border mergers.

Although with certain ups and downs, return on equity in the EU has been on a general upward trend over the last years, increasing according to the EBA from 4.8% in 4Q2013 to 6.8% in 1Q2019. Nevertheless, these figures are well below the situation before the recent crisis.

Behind this drag on profitability there are both temporary and permanent factors. From a conjunctural perspective, low interest rates can stimulate the flow of credit but at the same make it difficult for banks to get financial revenue, with latest signals from both the ECB and the Fed hinting at the possibility that low policy rates are here to stay for the foreseeable future. Additionally, the currently decelerating macro environment is also worsening the prospects of banks making revenue. From a structural perspective, banks have been facing a wave of new regulatory requirements, while at the same time being faced with mounting competition from new FinTech providers.

In this context, what can we do as policymakers to help the banking system keep its capacity to fund the real economy? First, we must incentivise banks to do away with the legacies from the crisis, by adequately valuing and provisioning assets and selling those that are distressed. The reforms of the Spanish banking system is a case in point, encompassing a domestic asset quality review and stress test, ambitious provisioning requirements and stricter criteria on forbearance. From a European perspective, ongoing work by the European Commission, the EBA and the ECB to catalise the set-up of a market for NPLs in the EU could greatly contribute to cleansing bank balance sheets. Second, we must make sure there are no regulatory obstacles to bank restructuring, namely by streamlining insolvency procedures.

Efforts by the European Commission to harmonise insolvency procedures in the EU are very positive in this regard, contributing also to cross-border restructuring. Third, we must guarantee a level playing field between banks and new FinTech providers under the principle that a given activity must always be subject to the same regulatory requirements, regardless of the nature of the provider. All that being said, it is key to bear in mind that policymakers should only complement and never substitute for private market adjustment.

Within an increasing interconnected world, the cross-border perspective is also relevant to bank profitability. In this regard, the Banking Union can support bank profitability by both reducing and sharing risks as well as by fostering cross-border flows, broadening the customer base and incentivising cross-border mergers. While it is true that cross-border banking mergers and acquisitions are still rare even after the inception of the SSM and the SRB, it is to be expected that the ongoing efforts to finalise the Banking Union, most prominently through the set-up of an EDIS, will give depositors, investors, managers and shareholders across the euro area certainty that the guarantees are exactly the same regardless the location of the bank they put their money into.

Finally, there is also a positive note on this profitability challenge, which will make banks adapt their business models to become more efficient. Profitability challenges are an issue that should be dealt with by banks themselves, with financial authorities playing a role to facilitate the adjustment and making sure investors' and financial consumers' rights are adequately catered for along the process. ●