Q&A

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Current challenges for the European banking sector

HOW TO ADDRESS THE DEEPENING OF THE FRAGMENTATION OF THE EU BANKING MARKET OBSERVED DURING THE PAST FEW YEARS DESPITE THE IMPLEMENTATION OF THE BANKING UNION? WHAT ARE THE MAIN ROOT CAUSES OF THIS FRAGMENTATION?

With the banking union we have taken a big step towards a more integrated market. Banks are now supervised in the same way across 19 EU countries and are resolved through European procedures where necessary in the public interest. However, the banking market remains fragmented along national lines. Banks are not in a position to consider the whole euro area as their domestic market. There are many reasons for this, but two stand out. First, notwithstanding major progress in creating a single rulebook, many chapters are still leaving ample room for national discretion. Second, in the absence of common crisis management tools, countries resorted to ring-fencing measures during the crisis. The obstacles they put up still hinder the free flow of capital and liquidity within cross-border banking groups.

So as far as integration is concerned, the banking union remains unfinished business. For one, banks cannot reap the efficiency gains from becoming more European, making it harder for them to overcome their profitability issues. Moreover, in a fragmented market the banking sector tends to amplify local shocks, rather than helping to absorb them as would an integrated market. So, by moving ahead on integration, we could help to solve two pressing issues: we could help banks to become more profitable, and the market to become more stable.

But how can we move ahead? At the moment I am afraid that the lack of trust between Member States is giving rise to a classic prisoner's dilemma: everybody would benefit from completing the banking union with a proper safety net – including a European deposit insurance scheme. Likewise, everyone would benefit from removing national regulatory barriers and ring-fencing measures. At the same time, however, everyone is concerned about being made liable for losses generated in other Member States. Even the development of a step-by-step roadmap to finalise the banking union is proving difficult.

In the meantime, I think European authorities, like the ECB, need to do their utmost to improve the practical functioning of the current system. Jacques de Larosière, former Managing Director of the IMF, and François Villeroy de Galhau, Governor of the Banque de France, recently proposed the use of intragroup guarantees to allow for greater pooling of capital and liquidity within cross-border banking groups. Their suggestion should be carefully considered, also in the recovery and resolution planning process.

WHY ARE EU BANKS LESS PROFITABLE THAN EQUIVALENT US ONES? WHAT IS THE ROLE OF DIFFERENT UNDERLYING FACTORS E.G. MARKET STRUCTURE, REGULATION, MACROECONOMIC CONTEXT ...? WHAT IS THE ROOM FOR MANOEUVRE IN SOLVING THESE DIFFERENT ISSUES?

European banks are indeed struggling to remain profitable. For a number of them, return on equity is still below the cost of equity, and price-to-book ratios are stuck well below one. And compared with their counterparts in the United States, European banks are clearly lagging behind.

Low profits are not solely a concern for shareholders; they mean less capacity to build up capital buffers and attract new investors. Banks might also feel the need to embark on a search for yield, which will ramp up risks and undermine sustainability. These are sources of concern for supervisors.

I believe it is wrong to single out regulatory reforms, and in particular the toughening of capital requirements, as a main driver of low profitability. The Basel reforms have been rolled out across the world – including in the United States – and have not hindered a significant recovery in profitability, especially in those countries that have frontloaded the adjustment to the new required capital levels. Hence, addressing the low profitability issue by deregulation, as some argue, would be a mistake. Such an approach would merely undermine stability.

European banks' profitability is instead significantly constrained by some structural factors, excess capacity being one of them. In Europe, fewer banks exited the market than in other jurisdictions and the necessary restructuring has often been delayed for too long, as shown by the difficult discussion on policies to address the significant legacy of non-performing loans. Also, owing to some extent to the existing obstacles to market integration, the scale of the restructuring process was sub-optimal. The limited consolidation that did take place fell mainly within national borders. At the same time, banks with non-viable business models have been able to stay in the market and exercise downward pressure on interest margins.

But there is also room for action by bank managers. Looking beneath the aggregate, we do see diversity: some banks are doing well, others are not. Each company is the master of its own fate – as a general rule at least. First and foremost, let's not forget that banks need to finish cleaning up their balance sheets as poor asset quality has been a major drag on profitability. Next, it is crucial that banks enable themselves to steer their profitability by knowing exactly what drives their revenues and how their cost-efficiency could be improved. And they must not only be able to take sound strategic decisions; they must also be able to execute them. And here, we still see some shortcomings – loan pricing is just one example.

IS THE LACK OF CONSOLIDATION OF THE EU BANKING SECTOR A MAJOR ISSUE AND HOW TO EXPLAIN IT? IS FURTHER CONSOLIDATION POSSIBLE IN THE SHORT OR MEDIUM TERM?

The debate on overbanking is not new, but it is still relevant. The European banking sector is indeed quite large and has excess capacity. Competition is intense and margins are low. A large banking sector also means that less use is made of other sources of funding – such as capital markets. This, in turn, makes the economy less able to absorb shocks.

Consolidation is necessary to absorb the excess capacity created in the run-up to the crisis. The banking sector must become leaner. The only question is how this can be achieved. Of course, cross-border mergers would have the benefit of contributing to greater risk diversification and better integration in the banking market. But domestic mergers could be important too, as efficiency gains could be relevant in the context of overlapping distribution networks. This is not a decision for policymakers: the ball is in the banks' court. I acknowledge that there could be some regulatory impediments, especially in the case of cross-border mergers. However, as a supervisory authority, the ECB stands ready to accompany consolidation. I often hear that supervisors are part of the problem; I am keen to prove that this is not the case.

CONCERNING AML/TF IN THE EUROZONE, WHAT ROLE SHOULD BANKING SUPERVISORS AND NOTABLY THE SSM PLAY AND WHICH ADDITIONAL POLICY ACTIONS ARE NEEDED?

Money laundering has drawn considerable attention recently in the wake of a number of high-profile cases. And it is indeed an issue we urgently have to deal with for many reasons. From our point of view, money laundering damages the reputation of banks, destroys public trust in the sector and may even lead to bank runs and failures. We take this very seriously.

The SSM is responsible for prudential supervision while national anti-money laundering authorities are in charge of assessing how vulnerable banks are to financial crime and illicit money flows. Still, there is some overlap, of course, and that's why cooperation is key. We have now signed an agreement to exchange information with anti-money laundering authorities from across the euro area.

So we take money laundering and terrorist financing risks into account when controlling access to the banking sector and assessing internal governance and controls at individual banks. And next year, new legislation will come into force that strengthens the requirements for prudential supervisors to incorporate relevant concerns into the supervisory review and evaluation process.

Greater prudential focus on money laundering and terrorist financing risks as well as close cooperation between banking supervisors and anti-money laundering authorities can help to drive progress. Still, in order to properly address the issues confronting us, we need a more European approach. As money laundering is often a cross-border business, weak rules or poor enforcement in one Member State can have negative effects across the Single Market. And in my view, the latest review of the relevant European directive might not be sufficient. Also in this area, we need to move to maximum harmonisation and stronger institutional arrangements at the European level. This, however, is a task for European legislators not us banking supervisors. ●