IMPROVING THE GLOBAL COMPETITIVENESS OF THE EU FINANCIAL SECTOR

A regulator noted that the objective for the session was to discuss the challenges faced by the EU financial sector. The sector should be able to address the transformation of the industrial sector while also securing the appropriate financing of the economy. The persistent low profitability in the European banking sector is somewhat shocking compared with international competitors, particularly in the US. Unprofitable banks cannot support economic growth, and this issue makes it difficult to build up capital buffers.

1. The EU financial sector continues to suffer from low profitability

Banks in Europe are more resilient, but their profitability remains disappointing. Beyond cyclical factors, Europe's fragmented banking markets play a negative role, hampering cost-efficiency and technology investment. The fragmented EU fund market also hampers competitiveness against US peers. Profitability levels have been similar for European and US property and casualty insurers for the last 10 years. As in the US, the EU insurance market is predominantly domestic.

1.1. EU banks' profitability remains weak, particularly in comparison with banks in the US

An industry representative outlined the position in terms of profitability among EU banks. Comparing the top 20 banks in the EU and US, the industry representative noted that average return on assets over the last five years for EU banks is around 40 basis points versus around 110 basis points in the US. Overall return on equity for EU banks was in 2018 6.3% versus 9.2% in the US. A leader of the industry stressed that profitability is weighted at around 15% in the assessment scorecard, and there is a three notch difference in the profitability score between the top 20 EU and US banks. Europe's profitability factor is one notch above non investment grade. Another industry speaker highlighted the increasing amount of EU capital requirements. Overall, trade tensions between US and China and the perception of political risk in Europe affect the way we do business.

1.2. There is very little difference in the overall profitability between the EU insurance industry and the US industry, but EU asset managers lack scale compared with their US counterparts

An industry representative noted that there is very little difference in the overall profitability between the EU and USas both insurance industries are fragmented; the EU industry is dominant in the few business segments which are global (e.g.; reinsurance) . However, EU asset managers lack scale compared with their US counterparts in a context where the asset management industry is experiencing pressure on fees, which makes size even more important. The top 10 asset managers in the US, which benefit from the single market in the US, manage around 22.1 trillion of assets, 33% of the global total, while in Europe the corresponding figure is 7.9 trillion (12% of the global total). Smaller EU firms are struggling to sustain high margins amid long-term trends towards lower fees and higher costs. Furthermore, for asset managers, the profitability of European players has also lagged behind US counterparts due to a smaller and less diverse capital market. Lastly EU asset managers are largely owned by large banking and insurance groups and are impeded by the same obstacles as their owners.

2. The EU banking sector is held back by low growth, interest rates, fragmented markets and regulatory and supervisory issues

The scale and profitability of many EU banks falls short of their US counterparts. Lower interest rates and slower economic growth in the EU contribute to this shortfall. Moreover, there is no true single banking market for the EU; instead, it is segmented along national lines and cost inefficiencies plague some domestic banking systems. Large EU banks still lack the necessary scale to compete with global banks, and they will soon face significant challenges from bigtech and fintech firms. Furthermore, specific EU regulatory issues also impact the competitiveness of EU banks.

2.1. The negative consequences of lasting zero and even negative interest rates and low growth

Monetary policy is one source of the non level playing field between EU and US banks. An industry representative described how interest rates in the EU have been virtually zero or negative compared to 2.25% or 2.5% in the US. Likewise, growth prospects in the EU have lagged behind the US by approximately 70 basis points. An industry speaker suggested that low profitability emerges from the profile of the curve. At the short end, the impact of transfers of excess cash to the ECB is around 40 basis points, which is equivalent to a transfer of roughly €7 billion. On the long end, banks must hold liquidity reserves to constitute their liquidity ratios, and these portfolios produce poor or negative yields. European banks hold €1.3 trillion of excess reserve, which is affected by negative interest rates. In the US, the systemic banks hold $0.9 trillion, which is remunerated at the Fed's current overnight rate. Another industry representative highlighted the contraction revenue from interest margin in France, noting that in the Czech Republic or Romania, for example, revenues from interest margin are up 10 15%, with a normalised curve.

A Central Bank official highlighted that conjuncture is currently worse in Europe than in the United States. Interest rates are important, but their impact must be qualified. Low interest rates have a negative impact on the net interest income of banks, but this is a partial equilibrium. A recent Banca d'Italia study concluded that monetary policy has a negative impact on net interest income but a positive one on loan provisions and loans more generally.

2.2. The fragmentation of banking markets along national lines holds back profitability

An industry representative described how Europe remains relatively fragmented both across the EU and within individual countries. Within Germany the top five banks only represent 43% of total assets, compared to 58% in Italy and 80% in France.

Another industry speaker offered their condolences for UniCredit's Chairman, Fabrizio Saccomanni, who recently passed away. Returning to the subject of the panel, the industry speaker acknowledged that there are manifold reasons for low profitability but highlighted in particular the

role of regulation. The European banking system is under higher regulatory pressure than the US banking system, and there have also been stronger tax incentives in the US. There is also fragmentation in Europe caused by obstacles to the free flow of liquidity and capital within cross border banking groups, which is impairing the efficient running of cross border banks and the consolidation of the sector.

2.3. The impacts of the EU resolution framework on the global competitiveness of EU banks

2.3.1. A source of concern

Considering resolution, an industry speaker explained that total loss absorbing capacity (TLAC) is required only for Global Systematically Important Institutions (G-SIIs) in the US, while the European framework requires all banks to comply with minimum requirements. There is a non level playing field here also because the EU's TLAC requirements for subsidiary banks go beyond the requirements of international standards. More is required from subsidiaries of European banks than from third country subsidiary banks, which is a contradiction. This should be addressed in the new third capital requirements regulation (CRR 3). Additionally, European banks are paying significantly higher risk premiums than US banks for minimum requirement for own funds and eligible liabilities (MREL).

2.3.2. 'Stop mourning and do your homework'

A regulator quoted Felix Hufeld's recent remark, 'Stop mourning and do your homework.' The financial crisis had a substantial cost to societies and taxpayers, and the Banking Union was a reaction to it. The US and Europe responded to the crisis at different speeds. Additionally, Europe had a double dip crisis, and its regulation was a reaction to that. However, the regulator sympathised with the comments made about MREL. For regulators, it is important to implement the EU legislation that has been passed and to avoid starting the next reform before the last one has been implemented. Resolution is only for a few significant institutions, not for the many smaller ones. When smaller institutions fail, insolvency should be the rule. There is also a need for further consolidation in order to remove overcapacity and ensure profitability overall. Clean up consolidation can work between neighbours or within a country, but it can be very difficult to create synergies between vastly different member states.

The regulator also highlighted the relevance of the Single Resolution Fund (SRF). A political decision was taken to have a last resort fund to avoid relying on the taxpayer. The SRF is paid for by all institutions, but it is important to have proportionality here. It is essential not to 'change the gears every time' regarding regulation, but regulation is not the root cause of Europe's lagging profitability. Cost income ratios do not emerge from regulation. Regulation might be 'the icing on the cake', but it is no more than that.

2.4. Software treatment: EU banks are at a competitive disadvantage versus US banks

An industry representative described how US banks do not have to deduct their investment in software from capital, while currently every euro invested by an EU bank in IT must be backed by one euro of CET1 funding. This disincentivises investment in innovation. In the banking package, the European Banking Authority (EBA) has been entrusted with the task of establishing what should be deducted and what should not.

Another industry representative highlighted two important imperatives: First, non performing loans (NPLs) are a drag on profitability in the EU, whereas the US tackled NPLs very swiftly after the crisis. Second, there is a need for greater digitalisation and overall investment in both front end and back end technologies.

3. The way forward: both market participants and regulators must 'do their homework'

There is no single solution to improve bank profitability in Europe. Several avenues for progress were discussed: There is an urgent need to complete both Banking Union and Capital Markets Union. Regulators must ensure that regulation is properly implemented, particularly Basel III. Digitalisation remains a key focus for market participants, and there must be a level playing field for traditional institutions to compete with bigtechs. Excess capacity has not been eliminated since the crisis and consolidation is not taking off. Consolidation could be a path to greater overall efficiency, but the retail markets in Europe are not yet integrated, which reduces synergies from cross-border mergers. In addition, achieving sustainable profitability requires not only cost cutting but the adoption of innovative business strategies and further adjustments to the way banks perform intermediation by leveraging their ability to bundle credit provision with other products and services.

3.1. Achieving a true single market: there is an urgent need to complete both Banking Union and CMU

An industry speaker considered that a true single market 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 to improving credit quality.

3.1.1. Finalising the Banking Union

A regulator suggested that the EBA's 'homework' is now about implementing the recent major regulatory changes. The EBA's main focus is secondary legislation. The EBA has over 100 mandates to develop over the next few years. It is essential to ensure that the high level regulatory framework works effectively. The EBA's goal is an effective Banking Union and integrated single banking market. An industry representative agreed on the need to complete Banking Union and the CMU, observing however that there are some practices which should be avoided. At present, some member states still introduce national profit damaging measures such as taxes on assets and the forced convection of mortgages in foreign currency with retroactive application. The Commission must play a stronger role in ensuring the free circulation of capital, which is a freedom enshrined by the Treaty.

A regulator noted the need to finalise the Banking Union, which will entail finalising the backstop to the Single Resolution Fund and liquidity in resolution. There must also be a harmonised liquidation framework for banks. For the moment, the insolvency of banks with a negative public interest test is administered according to national procedures; some of these procedures function better than others. Furthermore, Europe must have a solid answer for depositor protection in its liquidation rules. A Central Bank official agreed on the need to consider the agenda for authorities, noting that many of the stumbling blocks on the path to Banking Union are political rather than technical.

Additionally, according to an industry representative changes to the prudential treatment of sovereigns would negatively impact banks' profitability. Another industry representative considered the construction of the Banking Union the key priority. Europe must continue to work on ensuring the free circulation of capital and liquidity within EU transnational banking groups, which requires solving the "home-host dilemena".

3.1.2. Completing the Capital Markets Union

A regulator stressed the importance of completing the CMU which would notably ensure that banks benefit from an enlarged home market for capitalization and investment. To fund the financial industry, it is necessary to fund the banking industry. CMU is essential to create a fungible financial market. The progress on CMU has been restricted mainly to 'peripheral cleaning'; Europe has not tackled the behaviour of investors. Investors demonstrate an inevitable home bias because they know the 'rules of the game' in their home country. To overcome this, there must be changes to insolvency rules, company rules and resolution procedures. Investors always need to understand how they will be protected if something goes wrong.

An industry representative felt that proposals such as the financial transaction tax could not be implemented alongside CMU. If certain transitions are taxed in only a limited number of member states, these transactions will simply move to different jurisdictions.

3.2. Reducing the overcapacity: the expected benefits and challenges of banking consolidation in Europe

A public decision maker stated that consolidation does not drive profitability by itself. However, creative destruction will contribute to profitability: more efficient institutions will gain market share while less efficient institutions exit the market. At the same time, consolidation enables operating synergies which allow firms to provide better services while enhancing profitability. Cross border consolidation is less appealing because there are fewer overlaps in staff and branch networks between banks operating in different countries and hence fewer opportunities for cost reduction. According to a stock take by the EBA, market participants also worry about differences in supervision, national applications of macroprudential measures and the ring fencing of capital and liquidity. Regulation should not create unnecessary obstacles but ensure a basis for healthy competition. A Central Bank official noted the importance of well functioning cross border groups, along with mergers and acquisitions in individual countries. If the problem is cost efficiency, however, cross border consolidation is generally not a solution. The problems concerning fragmentation and banking overcapacity will not be solved by creating more European mega banks; consolidation at a lower level will be important. An industry representative added that consolidation is more challenging in retail banking due to the complexity of mobilising cross border synergies.

3.3. The Basel III agreements must be implemented fairly and pragmatically to ensure EU banks' competitiveness

3.3.1. The full implementation of Basel III, under conservative assumptions, will increase the average minimum capital requirement (MRC) by 24.4% but would contribute to ensuring a well functioning global banking market

Turning to Basel III, a regulator emphasised the importance of terminology. Europe is implementing the existing regulations, not developing new ones. This process is the finalisation of Basel III, not 'Basel IV'. Some of these outstanding issues are substantial, but this is not a new change to the system. The EBA's overall message on the call for advice was about adhering to the Basel rules as much as possible. Over the medium to long term, this will help maintain global standards and a global banking sector. There can be European specificities, however, if they are well identified, well explained and well justified using a risk based approach. A question from the audience suggested that the participants in the Basel Committee had not had enough leeway in their discussions, but the regulator reminded them that Basel III covered some of the 'idiosyncrasies' of the European industry, particularly regarding the risk sensitivity of the models for small and medium sized enterprises. The supporting factors will be less effective after the implementation of Basel III and hence the marginal value added is small, which is why the EBA has suggested eliminating them.

The regulator encouraged all participants to read the EBA's publication on the subject. The headline is the average increase of 24% in risk weighted assets (RWAs) in the system. This increase in capital requirements implies an aggregate shortfall in total capital of €135.1 billion (€91.1 billion in CET1). The regulator noted that this calculation was somewhat conservative as it was static or ceteris paribus. Basel III uses pillar 2 measures to compensate for the weaknesses identified in risk management, and these are already being put in place. Banks will adjust to new measures and authorities will adjust to the new environment. Therefore, it is misleading to think that these figures reflect the actual impact of Basel III; it is likely to be significantly smaller. Additionally, the impact on banks will not be homogenous. The majority of the capital impact occurs in large globally active banks.

3.3.2. However, the transposition of Basel III could jeopardise EU banks' business models

An industry representative emphasised the importance of a simple, pragmatic and fair transposition of the 'Basel IV' package. There must be a level playing field and a common regulatory rulebook between Europe, the US and Asia. While this fair transposition of the Basel rules is essential, it is also necessary to consider the specificities of the European market. Because the EU is a largely intermediated economy, the impact of the package is very specific. The implementation of output floors will have a significant effect on mortgage books in Europe, for example. It will be important to ensure that the financing of corporates is not penalised, because in Europe 90% of financing to non financial corporations comes from banks; in the US, 50% of this comes from the debt market. Another industry speaker agreed with these comments, adding however that regulation is not 'the icing on the cake' as another panellist had described it. The EBA's impact assessment calculated an increase of 24% to MRC, which not everyone may consider is 'icing'. The industry speaker called on the Commission to conduct an overall impact assessment of the regulations which have so far been enacted.

3.4. Digitalisation: a key challenge for markets participants

The pace of technological advances in the competitive landscape represents a key strategic challenge, especially for banks. A Central Bank official suggested that banks should continue to focus on digitalisation. There are still large differences between the cost income ratios of banks in Europe. The shift from a brick and mortar network to a digitally orientated supply is a key challenge here. It is important to note that the prevalence of digital banking varies hugely across Europe. The adoption of digital banking correlates very strongly with education and infrastructure, which suggests that there is also a role for supervisors alongside banks. The challenge from bigtechs poses an existential threat to the banking system. While a bank offers a bundle of services, new competitors can offer unbundled services at potentially lower costs than traditional banks. However, banks exist because there are synergies between their activities. Banks must think strategically about their ability to exploit the advantages of bundling banking services in a 21st century environment. An industry representative also highlighted the importance of digitalisation. Cybersecurity has significant cost requirements, and digitalisation requires upfront costs before any cost benefit can be realised.

A regulator noted that one comment from the audience queried the integration of products across different banking or financial groups. Aggressive bundling or cross selling can lead to substantial problems in terms of mis selling, inadequate customer management and customer protection. A Central Bank official clarified that they do not advocate bundling in that sense, citing these serious consumer protection issues. There should be tough regulation and enforcement on consumer protection. There are synergies in banking because banks collect information about their clients, which allows them to create products with value for clients on both sides of the balance sheet. The Central Bank official suggested that this is part of competitiveness in the banking system. Banks cannot be competitive if they are not trusted.

A regulator invited the panellists from the industry to comment on the European data framework. An industry representative observed that GDPR embraces all possible sectors in Europe. However, there is no consistency between the second Payment Services Directive (PSD2) and GDPR: there is a duty to ensure data protection, but banks must also open their data to third parties.

Another industry speaker agreed, noting that competition from bigtechs necessitates a regulatory level playing field in respect of GDPR. The industry speaker stressed the importance of ensuring that competition between bigtechs and financial institutions takes place on an equal basis. A regulator confirmed this need for a level playing field. Ultimately, there is nothing more important than transparency and appropriate market regulation, but there must also be proportionality. 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.