What ambitions for the EU banking sector and related policy priorities?

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The Chair introduced the broad discussion on ambitions for the EU banking sector and related policy priorities that reflect a situation which no European can be satisfied with. Profitability is an issue, there are legacy issues of all kinds and there is an obvious profitability gap to US competitors.

1. The profitability malady: an overview from an EU supervisor

1.1. Banks are much more resilient, but their profitability remains disappointing

A Central Bank official gave a snapshot of the European banking sector. The post-crisis repair process is almost complete, and banks are in a satisfactory place on credit and liquidity. Capital requirements and buffers are now fairly similar across the euro area, UK and US banks. The boxes are ticked.

Asset quality in internal models and risk weighted assets is close to the end of the process. The European Central Bank's (ECB) targeted review of internal models (TRIM) process will soon be complete. Policies on non-performing loans (NPLs) are in place and significant progress has been achieved in cleaning up banks' balance sheets. There is still an issue of execution and completion of the process in banks where issues are still relevant. European Banking Authority (EBA) policies on internal models are close to implementation. The Basel package is coming.

The sector is more robust and resilient, but the major issue is that it is now widely considered almost un-investable. Low current and expected profitability is reflected in low market valuation price and books often well below one. This profitability malady is a problem for supervisors because they like banks to generate capital organically and to be able to raise capital in the market if needs be. Banks are not in a comfortable place now.

1.2. The remedy does not lie in watering down key prudential regulatory reforms

The banking sector and the industry argue that the remedies to this situation lie with public policies. They propose putting pressure on central bank regulators to focus on higher interest rates and ideally lower regulation and lower capital regulation, especially a relaxation in the implementation of the Basel standard. This is not the way forward. It is not the appropriate policy response to these problems. It is important to complete the post-crisis adjustment and make clear that the process is finished. A clear signal is crucial. There is a perception sometimes, also from investors, that in Europe the bar for capital is going higher and higher. This must be clearly shown to be the last bit. On Basel, an effort was made to repair internal models and maintain a risk-sensitive approach to supervision. It is vital to finish the job. Almost all the Basel standards come from EBA analysis or from findings that have been confirmed by the ECB's on-site analysis.

These points have been made in these forums in the past. The output floor has never been a strong point and has never convinced that it is a good way forward. More reliance was placed on the bottom-up repair done at the ECB and the EBA for internal models, while acknowledging that it was part of an international deal. Negotiation started with a window on the output floor of between 70% and 90% and ended at 72.5%. That was as much as could be achieved in the international negotiations. It is now crucial to get this done.

1.3. Banks should concentrate efforts on cost efficiency, refocusing business models and digitalisation to restore profitability

If deregulation is not the right response to the low profitability issue, the question is what the policy focus should be. Banks control levers that need to be used. The ECB's work shows that cost efficiency, business model viability, strategic steering and investment in new technologies are features of banks that have recovered profitability. Banks raise the point that compliance costs and the Banking Union machinery can be heavy handed and demanding. There is a need to listen and respond positively if that can be lowered.

1.4. Restarting the securitisation market on a more viable basis should remain a high priority for public policies in the euro area in the EU

Another area of focus is securitisation. Five years ago, the discussion was around securitisation as the low hanging fruit of the Capital Markets Union (CMU). It is sad that the market still does not have a tool for a liquid and standardised securitisation market. This would help banks to have leaner balance sheets and to deploy capital for better purposes. Complex securitisation products still exist. Restarting the securitisation market on a more viable basis should remain a high priority for public policies in the euro area in the EU.

1.5. Authorities should deploy a multi-pronged strategy to address the structural issues that are preventing excess capacity in the sector from being addressed and hampering efforts to move towards a truly integrated, single domestic market in the Banking Union

The structural problems that are impeding banks from recovering profitability must be acknowledged. These can be classified under two headings. The first is excess capacity and lack of consolidation, and the second is backward steps in financial integration and the lack of a truly domestic single jurisdiction for European banks in the Banking Union. Public policy should focus on these structural issues as a matter of urgency. The ink is barely dry on the recent legislative package and legislative constraints will not go away quickly.

Exit from the market should be made smoother and easier. This is an issue that qualifies the European post-crisis experience in a negative way compared to the US. The US had more exits from the market and more consolidation immediately after the crisis, which helped to mop up excess capacity much faster than Europe could. The Bank Recovery and Resolution Directive (BRRD) would have brought Europe closer to these objectives. It must be acknowledged that even relatively small banks still do not have good enough technology to pull the plug and exit the market in a smooth way. Common tools are needed. There are various approaches, ranging from voluntary liquidation to corporate-like liquidation, to administrative liquidation, to administrative liquidation with liquidation aid. It is messy.

The second point is to review the obstacles to consolidation, especially to cross border consolidation and integration to find a better way of allowing banks to pool capital and liquidity across the Banking Union. The work on the European deposit insurance scheme (EDIS) under the euro working group is anticipated. It is important to make progress, but it will be difficult. Progress must also be made with the current legislative environment. An interesting proposal was made by Jacques de Larosière and François Villeroy de Galhau to rely more on intragroup guarantees. These avenues should be explored. Recovery and resolution plans could give greater strength to these tools and ensure that they provide sufficient safeguards to both home and host authorities and to have greater progress in these areas.

The Chair finds the options interesting. Compressed risk premia and a severe low interest environment have existed for some time. It is not known how long it will last but the industry is increasingly feeling the impact.

2. The root causes of the profitability malady

There are both temporary and permanent factors behind this drag on profitability.

2.1. The conjunctural causes: lasting very low interest rates and low growth deteriorate the profitability of the banking sector in Europe

Low interest rates reduce euro-zone banks' intermediation margins and the return on their excess reserves, leading to low bank profitability.

An official advised that this is another perfect storm. Several elements are putting pressure on the banking industry. One is the impact of interest rates on margins, which will exist for some time. Latest signals from both the ECB and the FED suggest that low policy rates are here to stay for the foreseeable future. This highlights the difficulties for monetary policy in having an impact on inflation and the traditional channels of monetary policy. Monetary policy cannot solve structural economic issues. Increasing growth in the euro area will have to come from other instruments and fiscal policy is the obvious choice, particularly for countries that benefit from room for manoeuvre. The current decelerating macro environment also worsens banks' prospects for making revenue. Structural factors impact profitability. The regulatory burden is associated with additional requirements for solvency.

An industry representative advised that a recent investor roadshow delivered the message that progress is being made and should continue, along with cost reduction and digitalisation. Supervisor recommendations are followed because they come from the supervisor and match those from shareholders. European banks are committed and are obliged to go this route as there is no other route.

Despite that, the message is that banks are not investible due to extended periods of very low interest rates. Commenting on monetary policy goes far beyond what bankers can do. That is the reality. It must be coped with and it would be foolish to imagine that revenues can increase massively in this environment.

An official stressed that the current unconventional monetary policy has allowed banks without a viable business model to stay in the market. In addition, this lack of exit means that non-viable banks can be aggressive in their pricing and make life more complicated for other banks.

2.2. Structural factors

2.2.1. Banks face mounting competition from new FinTech providers

A public decision-maker raised external factors such as digitalisation. Banks' P&L show strong pressure on specific business lines that are influenced by new FinTech providers. This will only increase in the future. The challenge is whether the banking industry, which is well suited to benefit from this technological solution and innovation, can benefit from it or be a victim of innovation. So far, banks have weathered the fintech environment reasonably well. With more investment and creativity, they should end up benefitting from it.

2.2.2. Ring-fencing policies fragment markets, impede consolidation and impact European banks' profitability

When comparing European banks with their American peers which benefit from a single financial market, EU banks do not benefit from the expected opportunities that a single banking market and effective Banking Union could deliver for market participants. Some progress was made but there is more to do.

An official stated that analysis must go deeper into the structural issues to set out an appropriate policy response. Banks are too small and have too many branches because there is fragmentation across the jurisdiction. The structural reasons for this outcome are closely interlinked. There is no effective and smooth crisis management in Europe. This creates a lack of trust between supervisors and therefore ring-fencing policies. The EU resolution framework is indeed incomplete. There are notably two different layers of banks and frameworks for crisis management. One is dedicated to 30 banks of public interest that need to be resolved if likely to fail. The second layer is for the others except the 30, which are left with liquidation. That is unrealistic and must be addressed. This discussion has been long and requires innovative solutions or lateral thinking, otherwise it becomes like the chicken and egg and leads nowhere.

An industry representative advised that profitability issues cannot be overcome without the political will in Europe to address the lack of consolidation or excess banking capacities in Europe. Banking Union is a tremendous success and there is a strong supervisor and a respected resolution authority. Yet the capacity to invest in another country has not changed on the ground, even within the eurozone. The SSM cannot be reproached for that as they have made efforts. More should be done as there is little progress.

While cross borders can generate synergy revenues and partly resolve access capacity problems, they do not reduce the cost base significantly due to the heterogeneity of retail markets in Europe. However, market fragmentation is adverse as it obliges banks to locate capital and liquidity in different eurozone countries, which is suboptimal in the management of the balance sheet.

2.2.3. Insufficient development of European financial markets contributes to EU banks' low profits

An official agreed with the factors behind low profitability outlined in the presentation. The relatively low development of capital markets is an issue as they are a potential source of revenue for banks and can at least partially offset decreased revenues from slowing economic growth or negative interest rates.

The answer cannot be to backtrack on regulatory decisions that have been achieved, while acknowledging that a more stringent approach has been adopted for these decisions than in the US, such as minimum requirement for own funds and eligible liabilities (MREL) requirements that exceed the global arrangement.

3. Solutions for improving bank profitability

3.1. Settling the home-host dilemma is the right way-forward

An effective Banking Union requires going beyond the 'risk reduction, risk sharing' debate and to address the root causes of ring-fencing policies.

3.1.1. Addressing the root causes of ring-fencing policies

An official noted that it is vital to define the Banking Union reboot, which goes beyond EDIS. It goes into significant issues around fragmentation. Recent legislation has not helped in this respect and has probably gone in the other direction. The home-host balance is indeed not favourable for consolidation across the eurozone. Consequently, addressing fragmentation requires the home-host balance to be reassessed. Moreover, the Banking Union's first two pillars must also be assessed. There is room to improve and have a more efficient and well organised exit strategy for banks.

A clear roadmap is essential and must be delivered at the end of the year or early next year, including significant and enforceable targets. Deposit insurance is one, market fragmentation is another and a clear exit strategy should be the third. The fourth would be risk reduction, where a great deal has been done. Most of the targets set a few years ago have been achieved but there is more to do.

A Central Bank official noted that the issues of fragmentation and requirements that force banks to keep capital and liquidity segmented in different jurisdictions have been raised. Insufficient progress has been made, which jeopardises the movement of capital and liquidity.

An official responded that regulators can improve the situation. Having the Banking Union as a single marketplace for banks in at least the euro area would be a game changer. This has been a struggle for the last few years. In the early stages of the Banking Union and in the first attempt, there was a clear roadmap with three pillars and three key ambitious targets. Then came the pressure of the crisis and the need for urgent delivery. There was success on single supervision and single resolution, which only a few years before would have seemed impossible. There was a failure not to deliver on EDIS, which would give depositors, investors, managers and shareholders across the euro area certainty that the guarantees are the same regardless of the location of the bank they put their money into. But EDIS is not the only missing part of an effective Banking Union. A single marketplace must be dealt with as should other issues like the bank sovereign 'doom loop', which is only partly addressed by the single deposit system for Europe.

3.1.2. Addressing ring fencing policies would also encourage cross-border consolidation

The EU legislative framework does not recognise trans-national groups at the consolidated level but only as a sum of separate subsidiaries ('national or solo approach') due to member states' insufficient trust in the Banking Union's institutions. Ring-fencing practices such as increased capital buffers or Pillar 2 requirements for subsidiaries, application at the local level of specific capital, liquidity and MREL requirements are an obstacle to the emergence of truly transnational banking groups within the Banking Union as they hinder effective allocation of capital and liquidity within banking groups and reduce economies of scale.

An industry representative gave the example of a company's subsidiary in another country, where both countries are in the eurozone. There are MREL requirements for the subsidiary, but a waiver is not possible. It is possible for the parent's subsidiaries in the same country but not possible because of regulation on the foreign subsidiary. The political will is that each country is still considered totally independent, even though they are members of the eurozone under the same reliable supervision and managed by the same resolution authority in the event of crisis.

There is a lack of will to resolve this and put all euro area bank subsidiaries on the same footing. Such measures would not resolve the problem but would encourage cross border. The consolidation process is less attractive if a cross border acquisition traps liquidity and capital in other countries.

3.2. Completing the Banking Union and addressing the sovereign bank nexus are also required

3.2.1. Achieving an agreement on EDIS

An official stated that the first layer on consolidation is large. The Banking Union's first and second pillars exist but the third one, EDIS, is missing. It is like the chicken and the egg. More risk reduction is needed for EDIS to become a reality, but that risk reduction is only made possible by establishing Banking Union. The SRM, as the second pillar of the Banking Union, exists in a form that does not seem to be useful, due to the lack of a harmonised liquidation regime.

This is a risky discussion as there is a danger that markets perceive policymakers as concentrating on ring fencing rather than breaking down fences. If market perception is that consolidation will not happen, cross-border activity will remain expensive because expectation plays a key role.

A Central Bank official noted that without the third leg of the Banking Union, there is an argument that the bill lands on the national table if something goes wrong. This cannot be let go. There have been positive experiences and cases where banks were allowed to pay extraordinary dividends to the parent with the parent's commitment to intervene with subscriptions of additional tier one, tier two or capital in the subsidiary if something goes wrong. These techniques should be further developed to address these issues.

The Chair noted that much has been done to deleverage NPLs, but not enough to move towards EDIS.

3.2.2. Addressing the sovereign-bank nexus and harmonising EU liquidation procedures

A new proposal on the regulatory framework and the implementation of the next round of Basel is imminent. This review should acknowledge the prudential advantages of diversification of sovereign bonds holdings. If concentration charges can be considered, so can diversification advantages. It meets European specificities that aim for a single jurisdiction, recognising the issue of asymmetric shocks in different eurozone countries.

M&A is not a target for others per se and is beneficial in facilitating concentration. Regulators and policymakers should not target M&A so that market operators are free to choose between organic growth and other tools. But removing excessive costs must be an objective of policymakers and regulators.

Leaving banks with national liquidation regimes is inconsistent with a well-functioning Banking Union. Something beyond liquidation is needed and the Federal Deposit Insurance Corporation's (FDIC) crisis management provides an example to European public decisionmakers for addressing small banking crises.

3.3. A question of political awareness and method

The Chair noted the lack of political will on consolidation and asked what could be done to promote it if the political will is available. An industry representative paid tribute to the SSM for doing what is possible within its mandate's limits to reinforce the eurozone's strengths and the fluidity of capital among member states. The question is the present limits set by regulation. There is an issue of priority and a question of political awareness and method. Eurozone savings are not circulating normally from the north to the south, from countries with excess savings, such as Germany or the Netherlands, to those with a need of investment financings such as Portugal or Greece. Saving surpluses are not recycled within the eurozone but outside it. This is not corrected by a capital union nor by a redistribution and transfer mechanism as there is no federal budget at the eurozone or EU level.

Few banks are present simultaneously in many eurozone countries, which reflects the eurozone's weakness. Those banks cannot channel savings from one part of the eurozone to another. The key political question is whether the eurozone is ready to accept this financial fragmentation. Answer it and the technical details can be discussed. If the political priorities are not at the top of the eurozone's agenda, the same debate will happen again without any solution. It is a concern that that point has been reached.

The second message is not about measures, but procedures. Banks are heavily regulated. They have clients and they have shareholders. How policy is aimed at banks should be tested and discussed with investors because losing their confidence will not make things easier, but worse.

A public decision maker started from a pessimistic assumption of how the Banking Union's functioning can be improved with a mandate of four and a half years if political debates do not progress. Positive surprises are hoped for, but it is vital to improve the functioning of the existing infrastructure and that is where to focus attention. Intragroup guarantees will be key to working within the current setting.

Investors sometimes consider the ECB an obstacle. Bankers' body language shows that they do not think the ECB puts its money where its mouth is. A first objective would be to convince markets that the ECB is not an obstacle to consolidation. It would be enough to focus on these points during a limited mandate.

3.4. The lack of success on securitisation is disappointing and cannot be a solution at this stage

An industry representative advised that securitisation's lack of success is disappointing. First, the passed legislation is stricter than the precedent. The hope that securitisation will be a solution is doubtful. Second, targeted longer-term refinancing operations (TLTRO) and lasting very low interest rates make securitisation less attractive because TLTRO supposes that loans are kept on the balance sheet. That is unfortunately not a solution. Securitisation exists in countries with more developed financial markets, such as the US, where it is massive and publicly managed by Fannie Mae and Freddie Mac. Europe does not have that. The difficulty for the EU is not a lack of support from supervisors, nor is the solution to relax the banks' efforts. The banks will do their utmost. It is not good banking if the price to book is lower than one, but if all the European banks' price to book are below one, it is not because bankers are not efficient. There is a collective problem.

3.5. The Basel IV reform would penalise the competitiveness of the EU banking sector

An industry representative stated that the level of capital in European banks is adequate. That raises the question of why the EBA says that global systemically important banks (G-SIBs) should raise 28%, which is more than significant. It is an adverse environment which always asks for more capital. The prospect of more capital to be invested is not interesting for investors. The price to book is lower than one for all these reasons and there are difficulties in arguing that.

As reassurance, no one talks about backtracking regulation. No one says that supervisors' and regulators' past actions were inappropriate, but the EBA's message is that the solution to the problem is to not distribute dividends. Investors do not like that. Maybe the EBA is misunderstood but that is what is passed on.

A Central Bank official commented on the EBA report on the impact of the Basel agreement. Much of the adjustment requested by the Basel package is underway thanks to the EBA action for repairing internal models and the impact that the TRIM is having on banks. The final effect of the Basel package on the banks will be much lower. The EBA report looks at the complete Basel implementation without considering any deviation from Basel that European legislators have already decided to take and which they will not revert to. There is also an issue of distribution. Repairing internal models aims to ensure a right, reliable distribution of capital and so this model and approach must be pursued.

3.6. Revamping the CMU agenda

An official noted that developing capital markets is important for profitability because it provides additional revenues. Revamping the CMU agenda is important and is being explored by a group of experts. The Commission will present ideas. Remaining as ambitious as possible is key. The CMU is often perceived as technically complex, but less controversial politically than the Banking Union. The CMU is complex both from technical and political perspectives. Issues like insolvency legislation include property rights, which is a highly politically sensitive issue and is why justice ministries have difficulties in finding agreements.

The Chair noted that having savers' money circulate freely within the EU is important. The policy question is around the structures that the EU would have to offer to make that work. Expressing the wish is one thing, offering policy structures to make it work is something else.

One free wish for the new EU Commission would be to complete the Banking Union. The impact on European banking market profitability will be marginal but it must be done for policy reasons. The big game changer which could happen if the political will exist, is to put it at the top of the agenda the CMU project. The most impactful lever would be unlocking EU pension savings as a homegrown strengthening of the buy side, where the EU is weak. Not to downgrade the importance of Banking Union, but there is almost an obsession with completing it but this will not be a game changer. A CMU would be. Unfortunately, it is a huge challenge both technically and politically, but not tackling it is not an option. ■