Markus Ronner

Group Chief Compliance and Governance Officer, UBS

A healthy financial ecosystem to strengthen the European recovery

As the world emerges from the initial phase of the COVID-19 pandemic, it is clear that the consequences will be far reaching. The IMF now predicts that global GDP in 2021 will be 6.1% lower than projected prior to the pandemic, while global government debt is predicted to reach a record high of 101% of GDP. In these circumstances, Europe needs to pursue a strong and coherent strategy to recover from the recent – and indeed previous – crises and address long-standing structural issues. An efficient banking and capital market system will be a prerequisite for this strategy to succeed.

Overall, banks performed well in responding to the crisis, with high levels of capital and liquidity as well as operational resilience. However, in order to fulfil their role of supporting the economic recovery, banks must contend with several key challenges. The first is a further prolonged period of negative interest rates as the ECB continues to pursue a very expansive monetary policy. This further aggravates a situation in which most European banks were already struggling pre COVID-19: Eurozone banks' Net Interest Income was 45% lower at the beginning of 2020 compared to 2007. Thus, revenues from traditional banking activities have been significantly squeezed. The second key challenge is the extension of credit by the unregulated non-bank financial system: According to the Financial Stability Board (FSB), non-bank financial, or shadow banking, activities in a narrow sense have grown by almost one-third over the last decade to 59% of GDP. The FSB also finds that almost three-quarters of these investments are held in instruments "with features that make them susceptible to runs". Despite the risks it poses to the financial system the non-bank sector is not subject to the same standards of regulation as the traditional banking sector which also leads to less transparency and an increasingly unlevel playing field.

The pandemic will also lead to substantially higher Non-Performing Loans, an increase in bank funding costs and, over time, additional costs for liquidity buffers. As a consequence, European banks will struggle to return to sustainable profitability and generate attractive returns for investors. The market is already pricing this in: In the first six months of 2020, Eurozone bank valuations had on average deteriorated by one third whereas most broad market indices were only down by single-digit percentage points.

In response to these challenges, policymakers and banks need to take joint action to strengthen the European financial ecosystem. This should involve the following:

- Further integration of the European banking sector by completing the Banking Union, demonstrating that this is a win-win for all EU countries. Removing barriers to cross-border consolidation should therefore be a priority, in particular eliminating regulatory fragmentation across the EU, including different national regimes for many prudential, accounting, insolvency and AML rules, as well as excessive limits on the fungibility of capital and liquidity within a banking group.
- A clear strategy to deepen Europe's capital markets and diversify sources of finance. It is well known that capital markets in the EU are only around one-third as deep as in the US, but even more importantly, while US capital markets have grown relative to GDP over the past decade, they have shrunk in 80% of EU member states. Deepening European capital markets in a transparent manner, with appropriate regulation for non-bank financial services, will provide greater resilience to the economic cycle and to idiosyncratic shocks such as COVID-19.
- A pragmatic and open approach to market access for third country participants. Third country banks can play an important role in deepening the CMU by facilitating global capital flows to the EU. This will allow Europe to benefit from investment from jurisdictions with deeper and more liquid markets, boosting innovation and competition. Equivalence is an important part of this, which should be outcome-focused and take into account relevant international standards.

This strategic approach, alongside an enabling regulatory framework, will support the European banking industry in adopting the new business models that the digital revolution demands. Together with deeper and more vibrant European capital markets this will help to create a healthy financial ecosystem to strengthen the European recovery. ●