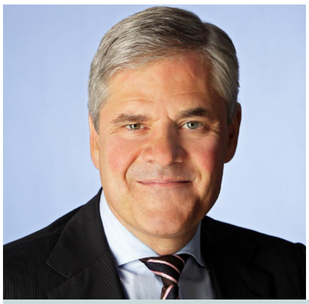
EXCHANGES OF VIEWS



Is normalising EU monetary policy feasible? If so, how and when?

Jacques de Larosière - Honorary President, Eurofi

Andreas Dombret - Global Senior Advisor, Oliver Wyman

Andreas Dombret (Chair)

The Chair introduced himself, welcomed everyone to the discussion and wished Portugal a fruitful, productive and successful Presidency.

He noted that, as a former governor and former managing director of the International Monetary Fund (IMF), and as a founder of Eurofi, Jacques de Larosière needs no introduction, so they could jump into the first question. Despite 10 years of accommodative monetary policy, which has led to low-to-negative interest rates, growth in the eurozone is still subdued and investment is declining. He asked why this is the case.

Jacques de Larosière

Jacques de Larosière considered that today's world is made up of paradoxes. Global demand is weak, investment needs are enormous and not being realised, at least in Europe, and interest rates have been low for a number of years, although non-residential productive investment has been declining. Monetary policy has been particularly accommodative for more than 10 years, and interest rates have converged to zero or negative rates.

Looking at M0 – banknotes in circulation and bank reserves held at the central bank – shows that in advanced economies, during the last 10 years, the money base has grown almost four times more quickly than the nominal economy. This policy has been so accommodative because monetary policy has been geared to an overriding objective in terms of consumer price index (CPI) and to keep inflation at a level close to 2%. This objective poses a major problem, because structural factors have been at play for the last 10 to 15 years: ageing; opening of international trade and globalisation, which has allowed western countries to import massive amounts of goods and services that are made on low wages (approximatively 1/10th of those of industrialized countries); and consequences on prices stemming from technological innovation. These factors have put inflation at a lower rate than in the old days.

This moderation of inflation has to be understood not as the result of a weakness in demand but of structural changes. Monetary policy has made a serious mistake because policymakers seemed to believe that low inflation – and lower than the arbitrary target of 2% – was the manifestation of insufficient global demand. The Keynesian recipe of monetary stimulus was therefore justified, in their eyes, and so they decided to increase monetary creation, as long as inflation was lower than 2%. More analysis should have been required on the precise nature and causes of these disinflationary forces. To the extent that these forces are structural and therefore unavoidable, attempts should not be made to redress them by more money expansion.

Money creation, in fact did not create more demand nor more inflation but translated in less velocity. If monetary policy over the last 15 years or so had been geared to a more realistic inflation target of around 1.5% or 1%, instead of 2%, the world would have avoided the unnecessary expansionary monetary stance, as well as deflation.

This systematically loose monetary policy contributed to building the enormous credit bubble that nearly broke the financial system in 2008. All financial indicators were flashing, but, as the CPI was low, central banks were not worried. However, they should have been, because a financial bubble is the present manifestation of inflation in an environment of technological disinflation.

Strange as it can seem, the extreme magnitude of the excess leverage that was appearing in the financial cycle, did not attract the attention of Central Bankers, simply because CPI was stable. The financial house was burning, but no alarm bell was ringing; complacency was the name of the game and the fire became threatening.

Andreas Dombret

The Chair noted that the COVID-19 pandemic has clearly not made the situation better but worse in the past year or so. However, that is by no means able to explain by itself low growth and receding investment in the eurozone. He asked what have been the effects on growth of monetary policy over the last 10 years.

Jacques de Larosière

Jacques de Larosière stated that the question is at the heart of the problem. If aggregate demand remains weak, it is mainly due to structural factors such as ageing, etc, leading to an overall saving surplus. A common opinion is that, in the face of relatively sluggish global demand and excessive savings, fiscal and monetary policies are required to stimulate demand, so it is worth pausing to analyse this apparent obviousness.

In spite of the explosion of debt over the last 20 years and of very low interest rates, the stock of non-residential productive investment – not including intangibles – has fallen from 14.4% to 12% of gross domestic product (GDP) in advanced economies, which has been only partially offset by the rise in intangible investments which have risen from 4,3% to 4,9 % of GDP. This is a staggering figure. In a normal situation, the capital base should not fall but expand. It is surprising that this statistic, which is one of the most significant in terms of global demand, is not highlighted more. The collapse of productive investment has occurred despite historically low interest rates.

Jacques de Larosière stated that a strange hypothesis eventually emerged to him: is it possible that very low or negative interest rates contributed to lower investment? The answer would be that that is absurd. If the financial conditions are easy and inexpensive, it is not clear how investment could be penalised. This is where the liquidity trap comes in. Once again, Keynes was right. He was in favour of low interest rates, but he specified not too low interest rates. Indeed, when they are too low, they deter savers from investing in long-term bonds and encourage them to either keep their savings in liquid forms, which they are doing, or in assets remunerated only because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no growth emanating from zero interest rates for a long time, are turning away from productive investment in favour of things like share buybacks and speculative opportunities.

This is not an invention; it is based on a study from the prior year that showed over the last 10 years a massive and spectacular increase in the purely liquid part of household savings – notably, in overnight bank deposits – even before the Covid crisis. This research is European and may be less verifiable in the US, where investors are less risk-averse than they are in Europe, and more interested in the opportunities offered by Wall Street. This interpretation is not universal, but, if it is correct in Europe, serious thought should be given to the problems posed by monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States. The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

Andreas Dombret

The Chair proposed going from the analysis to the recipes. He asked whether a zero-to-negative-interest-rate policy on the one hand, and fiscal domination on the other, are the right recipes for reviving eurozone economies, as it is not possible to be satisfied with the paradigm of low growth going forward.

Jacques de Larosière

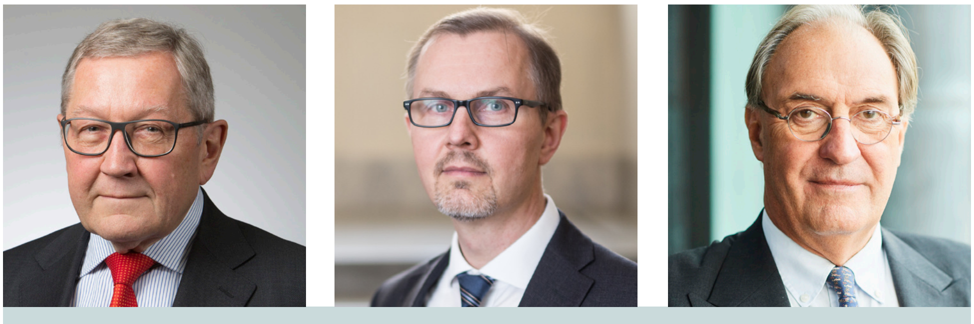
Jacques de Larosière stated that not only is he not convinced that a negative-interest-rate policy and fiscal domination are the right recipes, but he is convinced that they are the wrong recipes. Zero interest rates alone do not foster economic growth. They shift savings to liquidity holdings, discourage long-term and riskier investment, as they have no remuneration. They trigger financial bubbles and pave the way to the next crisis.

Andreas Dombret

The Chair noted that it would be possible to talk about this for much longer and asked for the three most important takeaways for the audience.

Jacques de Larosière

Jacques de Larosière considered that the time has come to start getting out of the present monetary trap, gradually and with the benefit of international consultation. He proposed three simple orientations: first, to allow long-term financial markets to express their inflationary expectations through higher yields. This would provide investors with a more normal remuneration and foster long-term investment. Adequate remuneration for risk is of the essence. Second is to have a more realistic view on price developments. A price slightly less than 2% is not one of instability; it is the contrary. Third, if yields tend to get somewhat higher, central banks should not consider that they should redress their tendency and provide member states with the unconditional benefit of a zero-rate guarantee. Fiscal domination, which is presently a fact of life, should not become the rule for the future.



The reform of the EU fiscal framework and the transition for its re-implementation

Klaus Regling - Managing Director, European Stability Mechanism (ESM)

Tuomas Saarenheimo - President of the Eurogroup Working Group and the Economic and Financial Committee, Council of the European Union

David Wright - President, Eurofi

David Wright (Chair)

The Chair welcomed participants to a debate on the reform of the EU fiscal framework and the transition for reimplementation and introduced the speakers. The discussion would consider the reform of the fiscal framework.

There are a few initial assumptions to consider: first, this is not in the context of treaty change, nor, hopefully, in a context of perpetual monetisation of public debt, and some form of coordination framework is needed. These are basic principles. He asked Tuomas to look at the outlook and how to move towards a firmer and more stable situation.

Tuomas Saarenheimo

Tuomas Saarenheimo considered that there is a recognition that something needs to be fixed and that colleagues are unanimous on this. Moving on from there gets more complicated. An issue is the increasing complexities that have been introduced into the rules over the years, much of which came with the Two Pack and, particularly, Six Pack reforms around 10 years ago. That has already started and there are all kinds of unmeasurable variables that the assessments are based on.

Behind this complexity lies the fact that fiscal policy is complicated, and situations vary. Rules set up sensibly in one set of circumstances might be completely nonsensical in another set. Over the years, attempts to pre-programme for all eventualities has led to complexity. There has not been the willingness to provide the Commission the discretionary powers to adapt its assessment to various situations, but rather member states have wanted to have clear rules for every situation. That has led to the current situation.

It is not about providing the EU tools to discipline misbehaving countries. The idea of creating a framework that forces fiscal discipline on countries through the use of sanctions is a fallacy. Rather, better ways have to be found to work with countries and to engrain the European fiscal framework in national budgetary practices, in a manner that facilitates intelligent discussion, increases transparency and honesty of budgetary policy and communication at the member-state level, and creates support for responsible fiscal policies. This is the challenge faced.

Klaus Regling

Klaus Regling noted that this is a clear explanation of why the framework that has been developed over the years needs to be reformed. It is clear from the introduction that there is an assumption that fiscal coordination is needed in a monetary union, which makes sense. In the end, monetary union is still unique in the sense that it centralises monetary policy completely, while fiscal responsibilities continue to be with national governments and parliaments, so it requires coordination.

First, it is important to be clear about the aim of fiscal surveillance, framework or governance, because there are many good reasons to have it. There are many objectives that people try to reach. One is debt sustainability, but also many want to use it to promote growth or the green economy. Some want to prevent divergences in the monetary union, and some want to create space for cyclical stabilisation. These are all good objectives, and it is difficult to disagree with them.

At the same time, it is not feasible to reach five objectives with one rule, so the discussion must be broadened, remembering that other instruments exist, like the EU budget. The EU budget provides permanent, continuous transfers from richer to poorer countries and can be used to prevent divergences among countries and to promote convergence. It can also be used to promote greening of the economy. The annual country specific recommendations could also be used. There are many instruments – not only the Stability and Growth Pact – to reach several objectives linked to budgetary and fiscal policies.

To make it even more complex, it is important to remember that assessing the value of a fiscal framework is a question not only of debt levels or deficits but also of quality of expenditures, of revenues, which can be growth-friendly or less so, and of the size of the public sector. Jacques noted in an article in the Eurofi magazine that the size of the public sector – if, say, expenditure to gross domestic product (GDP) is 10 percentage points higher in one country than in others – is more important than higher debt. It is a complex issue to find a system that ensures that the entire public finance is good and, in this broad sense, achieves all these objectives.

There is no silver bullet to achieve all of that and no model ready in the drawer that can be adopted and fix all the problems. It will not be that simple, but something is needed. Tuomas mentioned some principles that could be subscribed to, such as simpler rules and using observable variables. Expenditure rules should be used, as others such as the European Fiscal Board have proposed. The primary balance should maybe be used as an anchor for countries that have particularly high debt levels.

Then there is the difficult question of what debt target to aim for. The current world is different from when the Maastricht Treaty was negotiated. At that point, the 60% debt-to-GDP level was a reasonable target. It happened to be the average of the member states at that time and was also consistent with a nominal growth rate of around 5%. Interest rates were also much higher than today. In the future, interest rates will be lower than in the past. They will not remain as low as they are now, but on average they will be lower than 20 or 30 years ago. That indicates that higher debt-to-GDP ratios can be accepted as something to aim for. The 60% should be raised. This will be a controversial issue but there are good economic arguments for that.

In addition, a fiscal-stabilisation facility should be added to this new framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

That is one reason, but there is a second reason for thinking about a transition period. The general escape clause in the current year will also apply in the next. In 2023, when it will probably no longer apply, there will not be many countries with a deficit below 3%. Several will have deficits close to 10% and will need and should have a number of years, for economic reasons, to reduce them. A recent proposal from Jean Pisani-Ferry and his colleagues is to look at plans country by country for how to manage public finances in the future.

For the steady state it is preferable to have a new set of rules, but they cannot apply immediately, because the situation in 2022 23 will make that impossible. A transition period could be envisaged, where something like Jean Pisani-Ferry's recommendations is used: country-specific adjustment or consolidation plans proposed by the Commission, discussed in the Eurogroup and agreed in the Council, in order to bridge the time until a new common framework is reached, perhaps after three or four years, where some of the principles mentioned are reflected.

David Wright

The Chair noted that that is quite a long timeframe before any new rules would start to apply. It is a long transition period. He asked Jacques de Larosière to outline some of the thoughts mentioned in his paper on the elements that could be useful in the future fiscal framework in order to improve discipline.

Jacques de Larosière, Honorary President, Eurofi

Jacques de Larosière felt in harmony with the previous speakers' comments. First, the accepted rules of the stability pact are now so far away that it may be tempting to 'throw the baby out with the bathwater'. That would be a major mistake. It is precisely because of the turmoil of enormous deficits and massive debt ratios that rules to help countries normalise and better their position have been conceived. It is indispensable to work on this subject and not wait for the future to happen.

A second idea, which is close to what Klaus said, is that the situation is more complicated than it was 20 years ago. This complexity must be considered, as mentioned by the first speaker, who carefully explained the importance of this complexity. This is right.

It is vital to be intelligent and not get percentages and rules out of the blue. To work on this complexity, first it is critical to understand what could be called the legitimate heterogeneity. If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because of a 3% rule or a 60% rule. It is important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and abnormal heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working marginally on that element.

The third idea is that the amount and quality of public expenditure is probably more important than the level of debt to GDP. In many cases – and in the case of France, for instance – the abnormality of public expenditure related to GDP compared to other countries is such that it is practically impossible to regain, with that abnormality, a path of gradual normalisation and of industrial competitiveness. Proposals have been made in France to reduce a little more sharply this abnormality in order to be able to regain something more reasonable.

Public expenditure has to be worked on, both on the quality and whether it is to pay for the end of the month of current expenditures or to increase the capital base of the country through valuable investments. Attempts have to be made to move it towards valuable investments and to reduce the part of those public expenditures that are related to current expenditure, while acting on the quantity or the size.

It is possible to be agnostic on the number of years. Each country will probably have its own views on the duration of the process that will lead it towards an acceptable, reasonable path. This period has to be discussed as an essential part of the framework. Klaus is right that a specific, tailormade process must be done, especially in the first years, and then, when some normality in the primary budget has been regained, it will be time to think of a common framework for everybody. It is too early now, and it has to be done country by country. Jean Pisani-Ferry's study has made that point.

First, this is a necessary process that has to start quickly. There is no time to waste. Second, the complexities of nations have to be delved into. Third, that has to be done collectively. It cannot be a state-by-state or member-by-member thing. An element of agreement on the direction of movement and on the timeframe must be instilled in that nationally based process. These are not original ideas but are in line with what the two previous speakers have said. It is difficult work that needs a great deal of attention and dialogue with the country. It is not only the photograph of the country's views; it has to be negotiated.

David Wright

The Chair asked Tuomas Saarenheimo for comments about a transitional period, without being precise about timing, and whether peer pressure could be ratcheted up, with the Commission playing a bigger role.

Tuomas Saarenheimo

Tuomas Saarenheimo believed that rules are needed, although it would be more precise to say that a framework is needed. The framework is more important than the precise rules, if 'rules' means a set of numbers. A set of numbers is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems.

Regardless of the criticism that the framework has received, in general, quite a number of good examples have also been received. The best examples come precisely from countries where the European fiscal framework is an integral part of the domestic budgetary process and is present from the first domestic discussion. A situation where the European framework comes into play only when the draft budgetary plan is presented and then either accepted or rejected is too late. It has to be part of the domestic discussion.

The spirit of what Klaus and Jacques said is, essentially, the same. Jacques spoke about legitimate heterogeneity, which links to not focusing on rules and numbers but on frameworks, targets and goals. The question is one of where Europe wants to move towards and then of considering the situation in a country. It is vital to consider expenditure needs, the structure of the economy and ways to improve competitiveness. The most important thing is to get an honest, visible discussion on each country and then have the courage, if a country puts forward a set of bad policies, to 'call a spade a spade' and to say that these are bad policies, and to try to affect the domestic discussion. There are many ways to get there, but this is key.

David Wright

The Chair asked whether this could include public statements.

Tuomas Saarenheimo

Tuomas Saarenheimo agreed. The European framework primarily works through publicity and media attention, while hesitating to call it naming and shaming, but it ultimately is that. No country or government wants it known that it has bad budgetary policies. No country wants to read it in the Financial Times or domestic newspapers. Media and publicity are a key part of this. An important part of this endeavour is to find ways to open up the discussion. There is no need to be cagey or to soften blows so as not to trigger an escalation. Honesty must be a big call of this exercise.

David Wright

The Chair asked Klaus Regling for comment on Jacques' idea of some form of early warning mechanism.

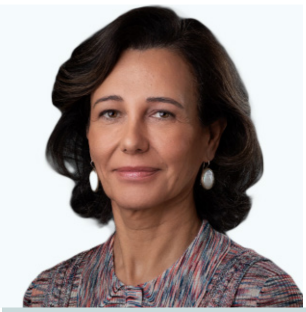
Klaus Regling

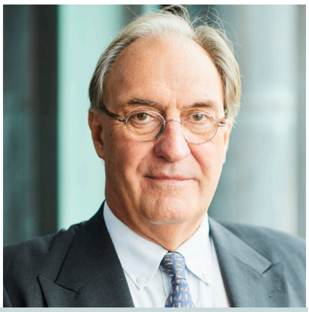
Klaus Regling recalled the idea of the transition period. 2022 will start with a situation that is heterogeneous and difficult, and which will require time to adjust and return to a more common framework. That is unavoidable and can be done only country by country. Tuomas is right that disagreements should be discussed in the Eurogroup – that is the kind of peer pressure that leads to results – but it should also become public. The Commission has also done that in the past. There were sometimes statements at press conferences about the budgetary plans in certain countries. The European Semester provides a framework to talk early and before final decisions are taken in a country and the Commission can indicate early whether policies are good or need to be improved.

The European Fiscal Board has not been mentioned, but it has played a positive role and can also be helpful in giving input into the process, together with national, independent councils. In principle, every country should have one, and maybe they can be better used. From experience, when there is negative publicity, markets react. It is true that governments then react, as they see that it can be costly to ignore the advice or comments coming from the European Commission or the Eurogroup.

David Wright

The Chair thanked all the speakers for their interesting input into the discussion.





Exchange of views

Ana Botín - Executive Chair, Banco Santander

David Wright - President, Eurofi

David Wright (Chair)

David Wright welcomed and introduced Ana Botín, giving thanks for Banco Santander's support. Ana Botín has immense experience and knowledge of the challenges facing European banks, and as Chair of Banco Santander serves about 150 million customers worldwide. David Wright asked about the crucial role the banks have played in bridging the disruption of the pandemic and why it has been so different from the previous crisis.

Ana Botín

Ana Botín stated that this is a very different type of crisis. This is a health crisis which has created an economic shock; that is very different from 2008, which was a financial crisis. Back then banks were in large part the source of the instability but, this time, they have been a source of stability. If banks have been part of the solution this time, it is because they learned the lessons of that crisis. They now have strong balance sheets and are able to support people and business. For example, Santander lent €1 billion euros a day during 2020, and its peers did likewise.

The nature of the public health response created an urgent need for liquidity support for otherwise generally viable businesses, which is a very important point. This was a gap that banks could step into with state backing. Emergency lending has played a much bigger part in this crisis than in the 2008 crisis, in part because banks were deleveraging in 2009.

The third point, which is crucial, is that financial regulators and governments moved together, working with the banks, very quickly to support economies. From the point of view of the banks, the biggest difference compared to 2008 is the speed and scale of the response from authorities. Given that the last crisis was a financial crisis, in some cases authorities were reluctant to be seen to be rescuing banks and creating morale hazard, and they intervened only when there was no alternative. This time the response was almost immediate, with monetary and fiscal measures in Europe coming into place within days. The response was ahead of the problems, and banks were there to help, because they had strong balance sheets and were agile.

David Wright

David Wright asked whether Ana Botín is worried about corporate insolvencies and non-performing loans as there is now a transition to a more normal economy.

Ana Botín

Ana Botín believed the lesson is that when governments, regulators and banks work together at speed they can actually make a huge difference, and a once-in-a-century shock has been withstood. These plans require trade-offs. Loan moratorium programmes, for example, require banks and governments to work together. Commercial banks were used as a route for state-backed lending, and so, looking to the future, it is critically important that any consequent bad debt be dealt with constructively and in partnership, that contracts should be respected and that if direct aid is desired that it is not at the expense of changing the conditions of the loans that were given. This is really important, because it is going to be an issue in many countries.

There is still a health crisis. The best economic policy, the best thing for citizens, companies, banks, the economy and society is to deal with what is still here: a very severe health crisis that has not finished. Vaccination is the best economic policy for 2021.

Looking ahead in terms of how best to handle a rise in insolvencies, there is substantial capital and substantial loan reserves. Losses have not yet materialised, but this is a risk to profitability and not to solvency. For example, Santander's pre-provision profit, even after increasing its loan reserves by 50% last year, could still increase again by that same amount without getting to zero profit. Others doubtless have similar, albeit slightly different, numbers. Losses will come in 2021 and 2022, but there are provisions. If more provisions are eventually needed, it has to be added at a lower cost of risk. It is a risk to profitability, but not to solvency.

Where solvency rules have been temporarily relaxed, it is crucial that companies still need help, and that depends on the depth and the quality, as well as the speed, of the recovery. The vital message is that growth matters. Clear action on NPLs is needed, probably with a gradual approach, and a gradual approach to returning to prudential standards. Regulators must be worked with to ensure that the regulatory framework is not focusing on stability at the expense of growth, and that there is a capital framework which is not procyclical.

David Wright

David Wright queried whether there is concern about the implementation of Basel. Europeans are apparently concerned about the output floor and capital for non-rated SMEs, for example.

Ana Botín

Ana Botín confirmed that there are concerns. The biggest challenge is making sure that a cliff-edge effect is avoided, not just on the fiscal side but also on the banking side, and so banks need to be able to lend more to business. Banks need to be able to deploy more of the capital they have built up, which means being able to attract investors. That is a starting point. Without a good, profitable model it is going to be very difficult. Basel matters and their implementation is a very immediate challenge. There is a risk that the Basel implementation will restrain banks much further at a time when they need to be able to support recovery. Rules need to be simplified and properly calibrated to take into account European specificities.

Strong economies are powered by strong banks. In Europe, SMEs depend on banks for 70% of their external financing. There was a €400 billion financing gap for eurozone SMEs in 2019. That is 3% of gross domestic product (GDP). There is a need to calibrate capital to remain prudent and strong, but also to be able to support the economy and use balance sheets responsibly. Then there is the whole issue of the digital transformation and how to compete.

David Wright

David Wright noted that Ana Botín has been positioning Santander for the new digital and green world. Both trends are irreversible. David Wright asked whether Ana Botín is worried about the level playing field.

Ana Botín

Ana Botín stated that due to COVID-19 everyone has to become digital. Car companies are now saying that they have to be software companies. The financial sector is essentially dealing in a digital currency anyway. 80% of all Santander UK sales in 2020 were digital. Competition and innovation are positive, but it has to be fair competition. This has to be addressed, especially regarding data and payments. If data is opened up to other companies, those other companies should do the same, but that is not happening. The Revised Payment Services Directive (PSD2) is focused on banks opening up data on customers, but it is not reciprocal. A much better service and a much better price on risk can be offered if banks get data from other companies that are willing to share. In the European Banking Federation (EBF) and other fora, the principle of same services, same risks, same rules and same supervision is defended. Data access is crucial, but there are many other issues. For example, this relates to both the green and the digital issues.

Recently everything became software, and this is very good news. Previously, software was not treated as capital. Software is one of the biggest assets companies can have. American banks were able to treat it as capital. When European banks invested in software, it was deducted one-to-one immediately, so this is a major progress. More rules like this that are adapted to the reality of today are needed, and the reality is that most things are becoming digital. This is interesting for Europe, for the consumer, for the banks, and for growth; on green issues it is the same. Basel is looking at this. There should be awareness of the optimal level of capital. There are questions on how to calculate risk ratings on assets helping to green the economy and how to agree on a common set of data taxonomy standards. There is an alphabet soup of different standards and rules; common and hopefully global agreements must be reached.

David Wright

David Wright asked whether Europe has carved out intellectual leadership, particularly on green issues and on some of the digital issues, but with too slow decision-making.

Ana Botín

Ana Botín stated that Europe has a huge opportunity to become the standard setter for green, digital and data issues. The Digital Markets Act, and several other initiatives in the Commission, are very encouraging. Banks and companies should provide input for the Commission when they ask for consultation. Sometimes they are too shy. Specific cases should be chosen and evidence given to the Commission. There is a need to move faster, but it is also important to do it the right way, and it is not easy. Getting input, as the Commission is trying to from the private sector, is hugely important. To the broader question of Europe and the US, Europe is at a disadvantage. A common question asked is what the gap is between regulation, or why the financial market in Europe is so different from the US.

David Wright

David Wright asked why the valuations of European banks' profitability are much lower than those of the US. Many excuses have been given, such as securitisation, no banking union and no capital markets union.

Ana Botín

Ana Botín confirmed that the short answer is that it is the sum of all of those. There is not one answer. Santander was worth the same as JP Morgan 10 years ago, and today JP Morgan is eight times larger. Santander was the largest bank in the eurozone; it is still number one or two depending on the month or year. JP Morgan is 10 times more, and Santander has done well in terms of growth. One important factor is the macro context. The US rebounded very quickly after 2011, whereas Europe entered the euro crisis in 2011-12, with three years of very poor growth, ultra-loose monetary policy and negative growth. There is much debate about negative rates, but this is very important. The commodity is interest rates, so a small difference there has a huge impact on profitability.

It is not just a difference in interest rate. It is the construction of the financial system itself, the Fannie and the Freddie. Mortgages need to be kept in a balance sheet in Europe; in the US, they sell them off. Americans have enough space to support the economy much more. The regulatory regime is also much more constructive. There are fewer intrusive business limitations. In the US, there is a single market. There are economies of scale, which are hugely important on digital. In Europe, the capital markets union has been discussed for years. There is also the question of innovation. There is a long list that should be understood, because stronger banks are needed for a stronger economy.

David Wright

David Wright agreed and noted that the projected growth rate for the United States is at 6.5% according to the governor of the Fed, while Europe is at 3.5% or maybe 3.7%. Some think that the US growth rate could even be in double digits. David Wright asked what the position will be in 10 years' time.

Ana Botín

Ana Botín noted that the consequences of Covid-19 will only be seen after a couple of years but these will accelerate change, and in a direction that might not have happened without Covid-19. It is going to have a huge impact on the political side. Government intervention means that there is more debt. That is going to cause a great deal of rethinking of public policies, which is right. A new social contract is needed, and this is aligned with the green and digital issues. It also has huge implications for taxes, competition and many aspects of political, public and business life.

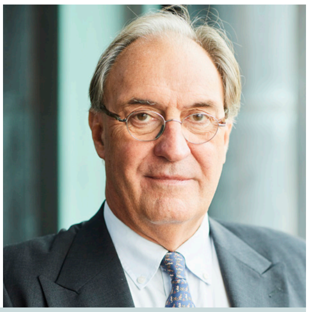
For Santander as a business, change is driven by consumers. Behaviour is going to be very different. There will be 5G. The Internet of Things (IoT) means people will be connected in a way unimaginable today. Again, speed is very important.

Europe is excellent on the economic and public sides. It has done a fantastic job on the monetary side through the European Central Bank (ECB), and also on the fiscal side. It could do better on health. It now has to shape its future correctly to allow businesses to be agile.

To create new jobs, we need to be agile. How SMEs are financed has to be reinvented, because they do not have a factory or a bar; they have talent and brains. There are questions of how to finance start-ups and incentivise banks. Different business models are needed. Santander calls it 'one Europe, one Santander'. The question is how to create a global platform, and how to do that at the European level for all industries. The future driven by the consumer is much more digital, with the likes of payments. Payments will not be measured; it is going to happen, so there will be a need to learn how to provide more value added for clients, and more help for succeeding on a personal basis or as a small company entrepreneur.

David Wright

David Wright thanked Ana Botín.



Exchange of views

Bernie Mensah - President of International, Bank of America

David Wright - President, Eurofi

David Wright (Chair)

The Chair welcomed everyone to the session and introduced Bernie Mensah, the President of International for Bank of America, a member of Bank of America's executive management team and CEO of Merrill Lynch International in London, to give us a broad account of how banking is evolving and what important issues are. The Chair began by asking how Bank of America as a major global institution sees the global situation and the basic trends for where banking will be in five or 10-years' time.

Bernie Mensah

Bernie Mensah said that he sees the present trends as similar to others. Fragmentation is one. Sustainable finance, environmental, social and governance (ESG) and green financing concerns is another, where there is a need to get a grip on the topic, and make sure that it is set up in the right way as it evolves and become more important. The management and handling of data and its impact on financial services and clients is something that everyone is having to 'get their arms around,' if possible. Perhaps one further area is Asia, with China having driven growth in many other sectors over recent years. Asia has always been a large exporter of savings and perhaps putting to use those savings within Asia itself, with initial public offerings (IPOs) etc, is something to come.

David Wright

The Chair agreed it is interesting and asked whether there is a level playing field with the new digital competitors that are entering, such as new fintechs, or whether that is a worry. He asked if regulation is sufficiently evenly balanced across the globe.

Bernie Mensah

Bernie Mensah said that it does not always feel like a level playing field, and in some areas regulation may be a little behind and in some areas ahead - although this is perhaps not intentional. In a way, it is right to let 1,000 flowers bloom and see what innovation comes. However digital competitors are playing in a space that is traditionally very highly regulated, and big banks might say that, as they are regulated, so everybody else should be. It is about getting that balance right. It is interesting that China recently released a set of regulations, driven by a large IPO there, which seemed intended to regulate some fintechs in the context of these financial institutions. That is not necessarily what would happen, but regulators are looking at that example, as they probably should.

David Wright

The Chair noted that Bank of America implements over time all the Basel standards. He asked whether the Basel process works well and if the standards are implemented in a consistent way across the globe.

Bernie Mensah

Bernie Mensah observed that looking back over 10 or 12 years they have been good on the whole. The standards certainly played a part in the response to the pandemic crisis of 2020. For the industry it was not a financial crisis; there were no systemic issues concerning banking and that is great. There are always unintended consequences and some adjustment is needed around that, mainly regarding the extension of deadlines and timing, etc. As a banker, one likes a little more flexibility, while expecting regulators to want to insist on making sure some of these things do come through. Interestingly, one of the things on the horizon is the Fundamental Review of the Trading Book (FRTB), which has been quite rightly kept back a couple of times. That highlights some of the flexibility that has been needed. What it is trying to achieve cannot be faulted, but some elements of cost benefits have been necessary when postponing the deadlines around that.

David Wright

The Chair asked Bernie Mensah for his views on Brexit, as an institution with large interests in the UK and across many European member states. He asked whether things are unfolding as expected or if there are surprises, and what he would like to see in the future.

Bernie Mensah

Bernie Mensah observed that Brexit has dominated attention for a while. The bank's reaction was set early on to deal with it as positively as possible and to take advantage as much as possible of the new dispensation. Like others, entities have been established on the continent, in Ireland and in France. This allows for as much full-service support of clients as possible, and we have senior people in place making that happen. The upside with that and the upside with Brexit, insofar as anyone is looking for one, is that it has brought the bank closer to clients on the continent, which has been positive in terms of the level of dialogue with clients in France, Germany and across the EU.

It allows for closer working with regulators across the region to understand the direction of travel on topics. Liquidity, however, remains a concern. There is a great deal of liquidity in London and a great deal of liquidity on the continent, and one concern would be where that liquidity would shift to, because that drives capital flows, capital allocation, profitability and it also drives finding the right solutions to existing market issues. As expected, it is a little bifurcated at the moment, so that will have to be kept under review.

Finally, on the horizon are discussions about clearing and where that ends up. There are probably not too many surprises in terms of the opportunities and challenges that are expected to emerge.

David Wright

The Chair asked if these are early days and whether the business that has moved is the beginning of major changes in structure between the EU and the UK, or if a steady state is being moved towards quite quickly.

Bernie Mensah

Bernie Mensah stated that there are different angles to that, and investments have been made. It is not necessarily a steady state, because things always evolve. Even in London and New York they are evolving.

Likewise, the relationship between the EU and the UK is clearly evolving. The recently-agreed memorandum of understanding (MOU) is part of that evolution. It is important for both centres to figure out what the new dispensation means, and that is just as applicable to the UK as it is the to EU. The EU would probably agree that their financial centre was in London and so the EU is in the process of building, investing in, coalescing – whatever word might be used – a financial centre within the EU. There are many thoughtful, smart people who are figuring out what that should look like. The UK, having dissolved its relationship with the EU, will also have to figure out the direction of travel for the City of London.

David Wright

The Chair asked whether Bernie Mensah would agree that if Europe can deliver a Banking Union and drive forward on a Capital Markets Union, sustainability and digital, the potential for growth for financial institutions, including large ones such as Bank of America, is quite important.

Bernie Mensah

Bernie Mensah agreed absolutely. It has often been quoted that if the EU is compared to the US, for example, a large amount of corporate funding in the US is done through the capital markets, more than 50% or 60%. In the EU, that similar percentage is on bank balance sheets. Senior EU policymakers have said that the balance is not right. It might not be desirable to get to 60% or 70%, but capital markets are an incredibly powerful and useful tool for driving economies, funding high yield investments, and providing an alternative source of capital. A thriving high-yield capital market can fund growth companies in an efficient way, with the losses borne by those prepared to take the risk, in a way that allows capital to be driven to where it needs to be. Perhaps with negative rates in the EU, a little more of that would be useful. That is perhaps the angle bankers would be expected to take, but it might be a benefit for institutions that were always in the EU, but who now have more people on the ground and are spending more time there, to add to that dialogue.

David Wright

The Chair thanked Bernie Mensah very much for his thoughts and much-needed optimism.