GLOBAL COMPETITIVENESS OF THE EU BANKING SECTOR

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The strategic priorities of the Basel Committee

This year will mark the 15th anniversary of the Great Financial Crisis (GFC). Much has happened since then. The Basel III reforms have fundamentally bolstered the global regulatory framework. Banks are now better capitalised and have stronger funding profiles than in 2007. Advances in technology and the growth in non-bank financial intermediation (NBFI) are reshaping the financial system. Covid-19 has accelerated the urgency of addressing medium-term structural trends.

Against that backdrop, what lies ahead for the Basel Committee in 2022 and the medium term? Four broad themes underline our strategic priorities.

First, the Committee will continue its work related to Covid-19, with a view to ensuring that banks remain resilient and contribute to a sustainable recovery. The past few months have reminded us that the transition from pandemic to endemic is likely to be a bumpy one. The outlook continues to be marred by uncertainty and divergences across regions.

While the global banking system has largely weathered the pandemic to date, it is crucial that banks and supervisors remain vigilant to risks and vulnerabilities as Covid-19 continues to unfold. This includes managing risks related to frothy asset valuations and the trajectory of interest rates, and ensuring that banks remain operationally resilient. The unwinding of public support measures – which were critical in shielding banks from losses thus far – will also test banks' resilience.

The Committee is evaluating whether the Basel III reforms implemented thus far have functioned as intended during the pandemic. Our preliminary assessment indicates that the banking system would have faced greater stress during this period had these reforms not been adopted and in the absence of public support measures. We have also identified some areas in the Basel Framework – including the usability of capital and liquidity buffers, the impact of the leverage ratio on financial market intermediation and potential procyclical dynamics in the risk-weighted framework – that we will continue to evaluate.

Second, the Committee will proactively assess emerging risks and structural trends affecting the global banking system. This includes the ongoing digitalisation of finance, which is reshaping the range of financial services on offer, the distribution channels of these services and the suppliers behind them. We are conducting a set of deep-dive thematic analyses to gauge the impact of these drivers on banks and will consider whether any additional supervisory or policy measures are needed at the global level.

A related area of focus for the Committee relates to cryptoassets. The potential for this market to scale up rapidly and the wide range of potential exposures to banks merit close attention. The Committee is cooperating closely with other global bodies to assess the cross-border financial stability risks from cryptoassets and identify any gaps in the global regulatory framework. One such area relates to the prudential treatment of banks' exposures to cryptoassets, which we plan to finalise in 2022.

Another area of focus is climate-related financial risks. The Committee is pursuing a holistic approach to help banks and supervisors adequately measure and mitigate such risks. In 2022, we plan to finalise global principles for the effective management and supervision of such risks. We will also liaise with the International Sustainability Standards Board and other global forums to ensure that banks' Pillar 3 disclosures adequately reflect their climate risk profile. And we are assessing whether there are any potential gaps in the Basel regulatory framework for mitigating such risks.

Third, the Committee will pursue a range of initiatives aimed at strengthening supervisory coordination and practices. This includes ongoing work aimed at safeguarding banks' operational resilience, including with regards to the use of third- and fourth-party service providers and cyber attacks. The Committee is also carefully assessing the supervisory implications of the digitalisation of finance, including with regards to the role of artificial intelligence and big data.

The growth in NBFI raises important supervisory questions for the Committee, given the interconnectedness between banks and non-banks. Events over the past few years, including the March 2020 market turmoil and individual episodes of NBFI distress, have highlighted how these channels of interconnections can pose risks to banks. The Committee will continue to work closely with other global forums to ensure that banks and supervisors adequately manage these channels of risks.

Fourth, the Committee will continue to promote the full, timely and consistent implementation of all aspects of the Basel III framework including the outstanding standards due in January 2023. Doing so will help lock in the benefits of these standards to ensure that banks can withstand future crises.

ELIZABETH MCCAUL

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Strengthening the resilience of the European banking sector

The good news is the euro area banking system has proven resilient in the COVID-19 pandemic: banks remain generally well capitalised, hold ample liquidity and are performing their key role as sustainable lenders. While reassuring for now, this may not be good enough for the future. European banks have been struggling with low profitability for a decade. Low interest rates and excessive risk-taking as investors push for more yield, may make financial markets vulnerable to abrupt asset price corrections and disorderly deleveraging. Achieving higher profitability is important for strengthening resilience, as is transformation towards more sustainable business models, sufficient investment in digitisation and consolidation to remain competitive. All of this in an environment that is fraught with uncertainty and risk, providing significant challenges requiring action from both bankers and policymakers alike.

For a start, the full impact of the pandemic on balance sheets is not yet known. Nor is the impact of supply chain bottlenecks on growth. Underperforming loan classifications are higher than before the pandemic and loans benefiting from COVID-19 support measures appear to have a slightly higher risk profile. Bankers must ensure solid credit risk management is in place to avoid a new surge in non-performing loans and losses.

Bankers need to adapt their strategies to two major structural shifts: first, digital transformation is an opportunity or even a must for banks to reduce costs, gain efficiencies and identify new sources of revenue. Areas that have historically been the domain of the banking sector are seeing new entrants, reinforcing the need to adjust strategically. Exposure to IT and cyber risk both within and outside the supervised banking sector will increase as this profound shift takes place. Policymakers should ensure a level playing field on risk management between banks and bigtech. The Digital Operational Resilience Act and the Regulation on Markets in Crypto-assets are therefore welcomed. The second structural shift is the green transition. The climate crisis is exposing banks to physical and transition risks, and they will need to strengthen and reassess their strategies and risk management frameworks accordingly to safely finance the greening of the European economy.

For European policymakers, the positive role played by the regulatory reforms since the global financial crisis to reinforce our banking system, and the coordinated supervisory response in the Single Supervisory Mechanism to the COVID-19 crisis should be forceful reminders of the importance of completing the reforms agenda. The implementation of the final Basel III standards effectively addresses important issues concerning the reliability and consistency of capital requirements, especially when risk-weighted assets are calculated by the banks themselves via their internal models. The reform package proposed by the European Commission goes beyond the Basel III standards and introduces other desirable changes, such as environmental, social and governance risks and the individual and collective fit and proper criteria and harmonised early approval mechanisms.

Achieving a truly integrated European banking market would put banks in a much better position to reap benefits of scale and scope and to finance the green and digital transitions of the European economy. It would enable a greater degree of private risk-sharing, so that shocks hitting a region of the banking union would be more easily absorbed, without the need to consider public support measures. Differences in local rules and practices for crisis management prevent progress towards cross-border banking, so a revamp of the EU's crisis management rules is welcome.

Challenges and risks abound, there are paths for bankers and policymakers to manage safely ahead.

Meanwhile, bankers can choose existing options such as expanding across borders through branches and the direct cross-border provision of services. Increasing digitalisation makes it easier for banks to offer services competitively across borders, while the framework for single supervision should allow a smoother transition to a branch-based structure for all entities willing to take that route – a solution that has already been adopted by many non-EU banks that have relocated to the euro area after Brexit.

Challenges and risks abound, but there are clear paths for bankers and policymakers to manage safely on the road ahead.

FRÉDÉRIC OUDÉA
Chief Executive Officer
Société Générale

Solving the banking sector competitiveness equation

When comparing the present situation to the pre-GFC years, Europe's competitiveness problem becomes blatant. The market capitalization of the main European banks has not only decreased by a third, but a single American bank is now worth as much as the top 10 EU banks combined. Recently, the same bank announced annual net results significantly superior to the aggregated 9-months net results of the main French banks and a ROE more than twice higher.

There are many factors underlying this competitive underperformance.

First, the pace of recovery: massive public-sector intervention both in 2008 and 2020 boosted the US economy. The US economy outperformed the EU after the GFC, and US GDP surpassed its pre-Covid level as early as Q3 2021, while most EU countries are expected to catch up during 2022. Driven by stronger growth, US stocks have outperformed EU markets: the S&P and Nasdaq have soared 35% and 50% in the last two years, while the DAX and CAC have both gained around 20%.
The GDP gap is expected to widen, although the US faces rising inflation and the risk of a fiscal cliff, and the situation may yet have unknown ramifications. EU banks continue to face a challenging monetary environment, with low or even negative interest rates.

Second, more structurally, the EU banking sector remains fragmented, depriving the industry of economies of scale.

The greater depth of US capital markets also contributes to increased investment bank activity. Thanks to active securitization, which in the case of mortgages relies on vehicles guaranteed by two Federal agencies, US banks can reduce their balance sheets and have greater capital efficiency. By contrast, integration in EU capital markets is only at an early stage and the euro area still lacks a common risk-free asset. The euro needs to play a more prominent role internationally: in a heavily dollarized world, EU banks will always face additional costs compared to US banks. During episodes of financial stress, EU banks faced higher dollar funding costs than their US peers.

This profitability gap is a threat to the future, as it means that US banks are better positioned to invest in particular, but not exclusively, in large-scale digitalization. This situation of a fragmented bank system with low profitability and underdeveloped capital markets comes at a critical time when we require risk-taking capital and strong finance to ensure that the green and digital transitions can deliver jobs and sustainable growth.

The industry landscape is also being reshaped with increasing competition from neo-banks, crypto asset players and new payment institutions. Central bank digital currencies are likely to emerge and drive profound change, and the place of traditional banks in this ecosystem is yet to be defined.

On a positive note, Europe has taken a lead on green finance and can rely on strongly capitalized banks. It is on these sound foundations that the EU should now develop the capacity to create its own banking champions. In response to the domination of US card-payment giants, EU banks are working to develop a home-grown alternative in the European Payment Initiative.

The EU should ensure that its regulation contributes to the competitiveness of its financial players, and to the deepening of EU banks' ability to support its economy, both through their lending and markets activities.

The EU should enable European banking champions to emerge.

The first step is to finalize the implementation of Basel reforms in a way which is sensitive to EU specificities and does not constrain EU banks from fully playing their role in financing economic development. This means also addressing the disproportionate costs supported by large banks in prudential and resolution rules. In the longer term, more structural reforms will be needed to reduce the fragmentation in the EU. This means adopting a different mindset vis a vis the consolidation of banks (and solving the home/host debate) as well as the development of securitization.

In any case, it is essential that policies should never be envisaged in isolation, and that their impact on the attractiveness of EU markets and on the competitiveness of EU players should be a primary criterion in their assessment.

If Europe can successfully address these challenges, I have no doubt that the competitiveness gap can progressively be closed instead of further widening.

DOMINIQUE LABOUREIX
Secretary General - Autorité de Contrôle Prudentiel et de Résolution (ACPR)

A competitive EU banking sector is key for European financial sovereignty

Following the Great Financial Crisis (GFC), despite a significant increase of EU banks' resilience, the profitability of a large number of them has lagged behind their international peers, in particular US banks. Over 2014-2020, US banks were able to maintain a higher ROE than their European peers (US 8.5% vs EU 5%); moreover, EU banks price-to-book ratios have, on aggregate, not yet recovered their pre-GFC level – contrary to US banks as early as 2013.

A well-known cause of this gap in competitiveness is due to the higher fragmentation of the EU banking sector, with no sign of this trend being reversed, as M&A activity in the EU banking sector remains limited compared with the US. This low level of concentration is a source of significant inefficiencies and vulnerabilities, because of lower economies of scale than in a number of non EU jurisdictions and a lower cross-country risk sharing. This in turn is fed by the perception of an insufficient risk sharing at Union level, as in case of difficulties, safety nets remain largely national. Fragmentation also leads to "overbanking", which in the end affects the profitability of the banks in the system – as showed by the higher cost to income ratio, notably linked to the relatively high number of branches within the EU.

A newer source of concern affecting EU bank profitability is the overtaking of EU banks by their US counterparts in their own market as the largest US banks have accounted for more than half of total investment banking revenues in the EMEA region since 2016.

This latest development sharply raises the stakes for further financial integration in the EU, as not only is EU banks' profitability at stake, but also EU sovereignty. Indeed, the increasing market share of non EU investment banks could expose the EU economy to a risk of investment outflows in times of stress. As such the coming years will be crucial to address any systemic risks stemming from excessive reliance on non-EU entities.

The recent CRD6 legislative proposal to harmonise the rules pertaining to the establishment of third country branches and the provision of banking services by third country firms thus goes in the right direction. However, these measures should be calibrated to maintain the liquidity of global markets, particularly with respect to interbank lending, as well as to preserve EU market attractiveness. Autonomy does not mean autarky and we must keep in mind the EU commitment to healthy economic multilateralism.

Securing robust sources of funding at the EU level will also require regaining momentum to overcome banking fragmentation by moving toward the completion of the Banking Union. This would indeed boost the emergence of consolidated pan-European banking groups that would be able to more efficiently allocate savings surplus to investment needs across the EU.

The EU has achieved significant progress on the second pillar of the Banking Union with the introduction of the backstop. The Single Resolution Fund is now well capitalised, but issues remain on the liquidity of banks in resolution and on the harmonisation of bankruptcy laws. As regard the third pillar, let us be clear: the European Deposit Insurance Scheme (EDIS) needs a major overhaul. Alternative avenues should be explored such as the creation of a liquidity support system between national Deposit Guarantee Schemes combined with a renewed approach, in which foreign subsidiaries would be affiliated to the home DGS.

Digitalisation and the Banking Union are essential to increase profitability and market integration.

The priority for banks to bridge their profitability gap is however to rise to the new challenges facing them: digitalization, climate risk, cyber security. All of them need considerable investments, either to avoid potential losses, or to generate future profits. In a world which changes very quickly, they need to follow the path of digitalisation to keep up with their rising Fintech and Bigtech competitors and to properly address consumers' expectations. While the principle of "same activity, same rule" must consistently apply to prevent less regulated actors from draining profitable businesses, we should pay attention that regulation does not hamper innovation that drives long-term growth prospects. For banks, that means they need to be ahead of the curve.

CHRISTIAN EDELMANN
Managing Partner Europe
Oliver Wyman (UK)

How European banks can close the gap

Europe's banks have had a tough ride over the past decade. Their market value is still down by more than two-thirds from the peak before the global financial crisis.

European banks are falling behind on both sides of the ledger. Not only has revenue growth been weak — cost structures also remain a major burden. U.S. banks boasted a cost/income ratio roughly 15 percentage points better than their European counterparts in 2021, according to Oliver Wyman research. About 80% of that gap was attributable to support function costs: U.S. banks are getting more out of their technology than European banks.

Only one-fifth of the gap was due to higher front-office payout ratios last year. But if revenue and cost trends persist, European banks soon will struggle to keep up with Americans on comp as well.

Granted, some of the malaise is due to negative interest rates, which have taken a major toll on European banks.

Regulation and its implementation, or the lack thereof at the European layer, is another important factor. Both the Banking Union and the Capital Markets Union are key ingredients for creating a simpler and ultimately more level playing field across Europe, which also would help foster well-needed consolidation. European banks also have a point when they argue there is no truly holistic view on regulation across the Basel regulatory framework and the full prudential regulatory agenda. This includes all supervisory tools such as the Supervisory Review and Evaluation Process (SREP) and its drivers, as well as the Asset Quality Review and stress testing. Better understanding of how these regulations and tools systematically impact the business model of typical European bank is critical.

But what if that day of "regulatory panacea" never comes? In this moment of political populism, growing nationalism, and fiery polarization, it has been difficult for European leaders to make progress on regulatory initiatives. For example, the CMU was absent in the President of the European Commission's state of the union address, which sets out her top priorities.

If banks want to get out of their malaise, they will likely have to do it for themselves, and swiftly. It requires nothing less than radical transformation.

Most banking CEOs will argue they have been in constant transformation over the last decade. But they have reacted far too slowly and too gradually. They have tried to preserve what made them successful historically, and then tried to layer on new capabilities largely on legacy infrastructure that in most cases dates to the 1970s and '80s.

Banks haven't leveraged the value of the data they have. And most important, they haven't sufficiently appreciated how the process of value creation has shifted. Historically, banks created value by managing pools of risks —and they extracted so much money out of it that they even offered ancillary services such as custody or payments for free or at cost. They didn't realize the value opportunity that specialist providers have tapped into over the last decade.

Banks need to organize business units around data and customer lines — but so far, none has truly done this. The quickest successes would come from simple improvements such as using data to help customers make better spending decisions. In an extreme scenario, one could imagine a ring-fenced setup in which managing the balance sheet stays in a regulated entity while customer-focused platforms that serve all manner of customer needs sit outside it. It might sound farfetched, but radical thinking is required.

If banks want to close the gap in the near term, they will likely have to do it for themselves.

An example of such a customer-focused platform could be related to climate transition. Indeed, this is one area in which the European political and regulatory environment can become an advantage. Europe is further along the political, societal and regulatory journey than the United States. Banks have a chance to finance and advise corporates along this journey and, on the flip side, distribute such assets to institutional investors who are urgently looking to beef up their climate-friendly investment track records.

These aren't quick fixes; they require major transformations that demand leadership courage and investment budgets. Most firms don't have those budgets and may have to think about selling assets to finance this critical transition, painful though that may be. But they need to be bold. Incrementalism will not do the job.

STANISLAS ROGER

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Chief Executive Officer - SMBC Bank EU;
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How international banks can help promote EU competitiveness

The EU has long been attractive to banks which are headquartered outside of the EU. Having been able to carry on business in the EU over many decades, many international banks such as SMBC now view themselves not just as "international" banks but as fundamentally European.

As EU policymakers look ahead to shaping the future of the EU financial markets they will of course consider a wide range of questions, including – "which activities should be encouraged?", "how much activity?", and "should all institutions have the same level of access?". When thinking about these questions it is worth to re-cap some of the policy approaches that will best ensure that international banks are able to offer the greatest benefits to the vibrancy and competitiveness of the EU financial markets.

International banks are best placed to offer benefits to the EU where markets are "open"

EU financial markets should continue their long history of being seen to be "open", which has encouraged a wide diversity of market participants to do business in the EU. Markets which are easy to access are of course more likely to lead to international banks offering a greater range of banking products and services. The benefits are not just to international banks but are reciprocal; customers across the EU are able to access a huge range of services and products which are offered by international banks. Prices are also better where competition is strong.

The EU has long provided an environment in which this has been possible. International banks – including those coming from the other side of the world, such as Japan – have welcomed the flexibility and openness of the EU financial markets which has allowed huge amounts of international capital to be leveraged for the benefit of EU customers.

Markets may be considered to be less open where they are more difficult to access, whether by requiring a physical presence in a particular member state to conduct business, or by requiring licences to conduct business which go beyond the current framework that international banks have long adapted to.

It is important to take the "global view"

The EU has been successful in communicating and sharing ideas with policymakers in other jurisdictions since the financial crisis on a number of global issues. As policy issues are increasingly required to be seen through a "global" lens – whether because of their global impacts, such as environmental issues, or their importance to global banks, such as capital – the EU should continue to take a global view.

International banks are subject to rules and regulations across all of the major jurisdictions. Complexity in the regulatory framework is an important barrier to EU competitiveness, and is reduced where international banks are able to understand and implement rules where it is clear that common objectives are being looked at in concert.

Including banks in the conversations

Banks are willing partners in the policy debate. In recent years banks operating in the EU have enhanced their resource to be able to effectively participate in industry conversations about the direction of EU policy. These people come from a range of private and public backgrounds which combine to provide an additional layer of expertise that policymakers can leverage to produce policy which works. Moreover, banks have an inherent interest in working together with policymakers to share experiences and influence change. The situation is no less the case for international banks operating in the EU. International banks see themselves as "partners" in the European project and accordingly wish to see a stable, competitive, and efficient EU in which they can do business.

Many international banks see themselves as fundamentally "European" with benefits for EU customers.

The important policy questions of which activities should be encouraged, how much, and who should be able to access the EU markets are always important to consider; not forgetting meanwhile the importance of international banks to the competitiveness and vibrancy of the EU financial markets.

BEATRIZ MARTIN JIMENEZ
UK Chief Executive and
Group Treasurer - UBS

EU capital markets need a strong connection to the global financial system

The European Commission recently proposed legislative measures aimed at stepping up efforts to build the Capital Markets Union. These include changes to the MiFID framework to improve the flow of information to investors and reforms to the regulation of long-term investment funds, aimed at making them more attractive to asset managers and investors.

These are steps in the right direction. Harmonising rules and market practices for financial products and improving transparency of investment opportunities can help to unlock capital so that it flows across national borders. In this way, the right regulation can help to integrate markets and improve competitiveness, improving the supply of, and demand for, investment products.

At the same time, creating deeper capital markets requires scale efficiencies. This is particularly important in the post-financial crisis era where firms are, rightly, required to hold higher levels of capital and liquidity to ensure their resilience.

Yet this significant increase in regulation has been accompanied by significant fragmentation risks that have been exacerbated by geopolitical factors. The industry is, for example, already facing increased costs from emerging regulatory divergence as the EU and the UK begin to review what have until now been shared rules such as MiFID. While some divergence may be inevitable, we will all share the benefits of more integrated and deeper capital markets if we seek to minimise the increased costs that accompany financial fragmentation.

In addition to concerns over divergence, Brexit has also led to increased focus on the concentration of EU financial services in London, which arose over time in large part due to the EU single market. Yet history tells us that while the single market was indeed a key driver in London's growth, another critical factor was the opening up of the UK financial sector to more competition, particularly to international players, through the 'Big Bang' reforms of the mid-1980s.

In the same way, global firms such as UBS can play a vital role in connecting the EU to the global financial system, helping to channel funding into EU capital markets and deliver cross-border banking and investment services to support our EU clients.

Yet the proposed EU banking package would restrict non-EU firms' cross-border access to EU clients and markets. This could lead to a number of downsides. EU-based firms, corporates, governmental entities and individuals could find they have reduced access to global products. EU-based corporates could find it more difficult to raise finance or manage risk in some non-EU markets, or to make or receive cross-border payments, potentially putting them at a competitive disadvantage and creating barriers to international trade. EU banks and investment firms could find it more complex to manage their liquidity and funding, as accessing counterparties or financial market infrastructure outside the EU could become more challenging.

Restricting cross-border market access in this way would also represent a major change from the status quo whereby a significant number of EU member states offer a range of cross-border licences and exemptions. Usually these come with conditions, including that the relevant national authority considers the regulation of the non-EU firm's home jurisdiction as equivalent. In some cases, the national regulator will also have agreed on audit procedures to ensure compliance with relevant rules.

Global firms such as UBS can play a vital role in connecting the EU to the global financial system.

It is of course fully understandable that the EU wants to mitigate any risks to financial stability that may arise from cross-border financial activity. But there doesn't need to be a trade-off between growing the EU's capital markets and ensuring its financial stability. The EU, like other major jurisdictions, introduced post-crisis measures to mitigate the risks to stability of cross-border derivatives business, for example, through rules mandating clearing, margining and reporting requirements. And while there may be prudential risks from cross-border activity, these primarily relate to the home jurisdiction where the non-EU firm is based.

Any residual risks can and should be addressed through robust regulatory and supervisory cooperation.