

Priorities for the EU banking sector

Three topics were discussed, the first being how the banking sector is addressing and confronting the current geopolitical risks and volatility.

The second important theme was European-specific and structural priorities for the next five years. It is vital to stress the importance of aligning banking priorities with EU objectives, in particular in the context of improving the overall competitive position of the EU banking sector and the need to create a robust Savings and Investment Union (SIU) as part of a broader EU initiative aimed at promoting savings flows and facilitating investment across the region.

The third area of focus was how the sector is dealing with ongoing regulation. It is also important to effectively implement global regulatory frameworks such as Basel III while addressing the challenges associated with consistency of implementation across the EU's diverse financial landscape. Achieving a harmonised regulatory framework is crucial to maintaining the stability of financial markets, given their international interconnectedness

1. The European banking sector is showing remarkable resilience in the face of an uncertain external environment and a broader risk landscape

1.1 The European banking sector is resilient enough to cope with the uncertain external environment

An industry representative stated that capital is needed to withstand a crisis. Banks supervised by the Single Supervisory Mechanism (SSM) have maintained strong capital and liquidity positions. At the end of 2024, banks directly supervised by the SSM reported an aggregate common equity tier 1 (CET 1) ratio of 15.86%, compared with the requirement of 11.3%, up from 12.72% in the second quarter of 2015. The liquidity coverage ratio (LCR) of SSM banks is 158%, while the net stable funding ratio (NSFR) is 126.85%. Market movements are currently very volatile. Macroprudential buffers can be released, as seen during Covid. The earnings capacity of European banks remains very strong.

Challenges remain in the technological infrastructure of European banks. On average, US banks invest three times more in IT than their European counterparts. This investment gap is strongly correlated with medium-term operational efficiency and the overall security of banking institutions. Modernising outdated technology is a necessity to improve competitiveness and operational capabilities.

European banks are also facing increasingly fierce competition, not only from each other but also from non-

bank entities that are rapidly developing their service offerings. There is a need to redirect technology budgets from maintenance to innovation and expansion, particularly in light of accelerating technological advances and evolving consumer expectations. European banks are well positioned from a financial perspective, but there is a need to guard against complacency. Continuous assessment of current conditions and emerging risks is required.

An industry representative appreciated the remarks on the strengths of European banks in terms of capital, liquidity and profitability. European banks are entering this situation from a position of strength, but uncharted territory lies ahead. There is a need for collective thinking to address these emerging challenges. The ECB's initiative to promote discussions with industry representatives and regulators is welcome.

1.2 Addressing a broader risk landscape: geopolitical and cyber risk

1.2.1 Dealing with geopolitical risks and macro-economic uncertainty

A Central Bank official emphasised that geopolitical risks have been a concern in recent years and need to be integrated into regular risk assessments across the banking landscape. There is a historical context to the perception of these risks, as there was little discussion of them following the Russian occupation of Crimea. The need to address these risks only gained momentum after the unjustified invasion of Ukraine, which was a wake-up call for the financial sector and forced stakeholders to fundamentally reassess their risk frameworks. Exposure to regions of geopolitical uncertainty, such as Russia, has become a very tangible risk for many financial institutions.

Geopolitical risk is now considered a mainstream concern, requiring careful assessment in the areas of credit, liquidity and operational risk. Operational risk has increasingly attracted the attention of regulators and bank executives, given the frequency and impact of cyber-attacks that the banking sector has faced in recent years. The Digital Operational Resilience Act (DORA) aims to strengthen the operational resilience of financial institutions.

Both the public and private sectors need to join forces to address operational challenges more effectively. Despite the strong capital and liquidity positions of European banks, significant operational risks remain, especially those arising from cyber threats or other state-sponsored activities. It is an undeniable fact that operational risks are significantly more complex than traditional banking risks, which underlines the need for banks to develop comprehensive plans to mitigate the impact of these emerging threats.

A Central Bank official added that banks need to be encouraged to incorporate geopolitical risks into their

scenario planning and to make contingency arrangements for their risk management and governance. Coupled with maintaining strong operational resilience frameworks, the best defence against geopolitical risks is the robust capitalisation of banks.

The Chair agreed that geopolitical risks permeate through all risks, but there is a particular emphasis on operational risks and operational resilience.

1.2.2 There is a need for collective intelligence, humility, and proactive crisis preparedness in the banking sector to address emerging geopolitical and technological risks

An industry representative stated that geopolitical risks are horizontal drivers of various banking risks, including credit, market, liquidity and operational risks. Scenario planning and preparedness are important; effective planning is crucial, but it should also focus on how banks respond during an actual crisis. It is vital for the banking sector to be able to react quickly in times of need, and for a culture of collective intelligence and humility to prevail among industry players in meeting the challenges posed by geopolitical volatility.

There is a difference between traditional risks and those arising from advanced technological disruption. The banking industry needs to be proactive in responding to the growing cyber threat, as conflicts in the modern world extend into cyberspace. The banking industry must adopt robust cybersecurity measures to counter vulnerabilities that could arise from service disruptions. It is important to be more open, humble and clear about the unknowns and, as a result, find the right responses, especially in a world where paradigms have shifted significantly in recent months.

1.2.3 Overcoming Europe's financial fragmentation, boosting investment in defence and innovation, and adopting more agile regulation are essential to strengthen resilience against geopolitical and technological challenges

The Chair observed that banks have a great deal of capital, good liquidity and good non-performing loan (NPL) ratios, but that does not necessarily make them robust to cyber-attacks. Dependencies on infrastructure also need to be addressed.

An industry representative emphasised that maintaining a continuous dialogue between the public and private sectors is crucial to successfully navigate the unpredictable landscape that currently surrounds Europe. There are concerns about the fragmented state of European financial markets. The greatest risk facing Europe is the failure to coordinate effectively in response to potential threats. Significant investment is needed to strengthen defence infrastructure; moving to a 2.5% investment level will require around \$360 billion of additional investment; conversely, moving to 3.5% would require around \$1,100 billion of additional investment.

Europe's energy infrastructure is aging, and immediate upgrades are needed to support a sustainable transition. While the US may be scaling back its global commitments, Europe cannot afford to abandon its focus on innovation, especially in key sectors such as AI, which play an important role in modernising the financial services

landscape. Because of its fragmentation, Europe is lagging behind the US in both AI and financial markets. Europe's fragmented financial market structure needs to be overcome, as the existence of 26 central securities depositories (CSDs) and 14 central counterparties (CCPs) across the region hinders the creation of an integrated, efficient financial infrastructure.

The final challenge is the banking sector itself and how it deals with all the challenges, especially cyber risk. US banks have invested three times more in software IT development, but that is because they are much more profitable and have a deeper capital market to tap into. US companies do not have to deduct investment in software, as European companies do. More agile regulatory frameworks are essential to respond effectively to the multiple challenges posed by geopolitical risks and rapid changes in the operational landscape.

Large defence companies are well capitalised and do not need further support from the financial sector. Their supply chain is fairly dependent on SME funding, but if it is raised to 3.5%, they will struggle to get the funding they need because they are not tapping the capital markets. The banks are still very strong and have good, solid CET1 ratios, but they are also constrained in terms of being able to provide more support to defence companies.

2. Priorities for EU regulation and supervision

2.1 Europe's true obstacle to unlock its competitive potential is not over-regulation, but the urgent need for greater harmonisation and standardisation

An industry speaker explained that intra-European competitiveness is not as negative as has been expressed, as the EU is the largest single market. It has its competitive potential, as it has 450 million customers, most of whom have money. If energy is taken out of the equation, the EU is still a major manufacturing centre and has large trade. The EU is significantly diversified, with countries and regions whose economies are based on different economic foundations. The EU also has talents that should not be underestimated.

While there is a persistent criticism of over-regulation in the EU, there are legitimate concerns about excessive regulatory burdens. However, it is important not to focus only on extreme examples. Despite some absurdities in the regulatory framework, simple and harmonised rules could act as a catalyst to improve market competitiveness and stability. This can be seen in the example of the European railway system; although each country has developed its robust railway system independently, the lack of standardisation ultimately leads to inefficiencies. The same idea can be applied to the financial market. There are well-developed banking systems in each EU country, but there is insufficient harmonisation and standardisation in the regulatory framework, particularly in the area of investment, which undermines optimal performance. Some European countries require a licence

for mergers and acquisitions (M&A), while others do not.

The problem of over-regulation is secondary; the real problem is the lack of harmonisation and standardisation. Deregulation is a very good concept as it temporarily boosts the credit and lending market, but President Reagan's deregulation ended in a mass bailout and cost the taxpayer some \$124 billion. There is a need to improve intra-European competitiveness in the financial market. There must be standardisation and harmonisation of rules and regulations, but there must be an end to gold-plating in all areas of regulatory activity, which the EU does far more than it needs to.

The Chair agreed that affecting the frictions of the single market is a core issue. When talking about trade wars, the equivalent internal tariffs within the EU will potentially be about 100% when compared to an effective single market.

2.2 To implement, or not to implement: geopolitics and Basel III

A Central Bank official stated that the introduction of extensive tariffs would lead to an economic downturn. Recently, the biggest threat to financial stability is a global tariff spiral. Markets are currently volatile, but there are no signs indicating an uncontrolled crisis. Financial and capital buffers are thus important. There is a debate about whether Europe needs to focus on financial deregulation. The idea that came out of the financial crisis was to have global standards. It is important not to question the Basel regulation, but the call for simplification by the central bank governors of Spain, France, Italy and Germany was positive. Detailed work needs to be done on how to streamline regulation, but it should not end in a race to the bottom.

The US has a differentiated system. Global systemically important banks (G-SIBs) are treated differently from small and medium-sized banks. Proportionality is key. The implementation of the Fundamental Review of the Trading Book (FRTB) needs to be reviewed once it is clear what the US will do. US G-SIBs do not have the same capital buffers as EU G-SIBs. The US already has a Collins floor.

An industry representative underlined that the EBA is looking at Level 2 mandates, as this will be an important aspect of the simplification process. Global standards are needed, both on the financial markets side and on the Basel side. The world is becoming more and more digital, so it is important what is done at a global level. Climate change cannot be ignored.

FRTB is a clear example where the process of setting global standards is flawed, because it was designed and agreed around 2017. It took time to test, to run the numbers and to look at the trading desk to see what would happen in practice. There are flaws in the standard, even if what the US and UK are going to do is ignored. The ideal scenario would be to fix FRTB at a global level, but it has to be done at a regional level because there are no procedures or processes to do this quickly at a global level. If FRTB is not fixed then European banks will be less able to support the government bond market, which is already dominated by their US counterparts. The global standards need to be maintained, but the feedback

process needs to be changed.

The Chair observed that regulators have been pushing the standards for the last decade and it has taken the industry a decade to accept them, but the regulators are now being asked to quickly revise them.

2.3 EU regulation and supervision should focus more on horizontal risks in a world where paradigms are rapidly shifting

An industry representative noted that the increased capital liquidity seen after the financial crisis is positive and makes the system much better. The challenge is whether the right things are being talked about in terms of regulation and supervision. If two-thirds of a bank's time and effort is spent on insignificant micro adjustments to internal credit risk models, then that is not the right focus. What should be discussed are horizontal risks and how banks respond to them, but a risk-based debate is needed on what is important and what is not. There needs to be a discussion about what the game changers are, because the world today is one of paradigm shifts.

It is important to ensure that what needs to be funded can be funded. Five years ago, it was green transformation, and today it is defence. Everyone agrees that a defensible Europe is a necessity, so people need to think about their role as supervisors, regulators and banks to help finance that, respecting all the difficulties and constraints.

2.4 Mobilise savings through swift EU reforms

2.4.1 Complementing the Savings and Investment Union

An industry representative noted that there are some quick wins to be had. Before the next Eurofi it would be beneficial to have the securitisation framework in a place where significant new liquidity can be unleashed. The second quick win is the review of the prudential framework with a view to harmonising capital requirements. National buffers should be harmonised because they are punitive for certain structural products, for mortgages and for other complicated issues.

Europe has €13.5 trillion of savings, but €2 trillion of that is in the US. European savers go to the US because they have higher return expectations over a longer period of time. Higher annualised returns in the US have created a self-perpetuating cycle; higher returns attract more capital and greater market depth, widening the performance gap. Banks welcome the EU's initiative to provide more information on financial products, so that savers who park their money in low-yielding deposits can put it into higher yielding products that are injected into the economy to stimulate faster growth. Secondary liquidity is needed through market making, which is the responsibility of both banks and non-banks.

An industry speaker explained that rapid implementation of the issues previously discussed is essential. The SIU is also part of harmonisation. A rethink is needed on how success is measured. It is not just about the volume of assets involved, it is about inclusivity and whether SMEs are getting money from outside the big cities. It encourages the regulator and supervisor to see banks as partners in what needs to be done, rather than as the source of the next crisis.

There are four points for success that need to be addressed in terms of investment: education, standardisation for a true pan-European market, how the future of the EU is funded, and the fact that the Markets in Financial Instruments Directive (MiFID) should be seen as a warning to educated investors, rather than something to scare them.

2.4.2 There is a need for more efficient and harmonised regulation whilst streamlining securitisation processes and supervisory practices, and also reassessing burdensome reporting requirements

A Central Bank official said that promoting the competitiveness of banks is essential for effective financing of the economy. The discussions on the capital markets union (CMU) and SIU are critical components of a regulatory dialogue. Significant progress is overdue, given the historical context of the last decade. Success requires a focus on regulatory efficiency. There is a need for regulatory harmonisation that does not lower capital standards. Completing projects such as the Banking Union (BU) and addressing areas such as crisis management and deposit insurance (CMDI) are necessary to avoid repeating the mistakes of the past, while moving towards more robust financial outcomes for the industry.

There have been improvements in the supervisory approach, such as the introduction of more risk based assessments under the Supervisory Review and Evaluation Process (SREP). It is also important to streamline securitisation processes, as such developments are essential to maintain the overall efficiency of market operations. There are concerns about the extensive reporting requirements, which have been heavily criticised by banks. This underlines the need to assess whether the plethora of data points required are really necessary for effective risk management.

The current momentum within the EU provides a unique opportunity to strengthen the banking sector. There is a need for stakeholders to work together to enhance the resilience and adaptability of the financial landscape to ensure that it can meet emerging challenges while taking advantage of growth opportunities. Further work is needed on levels two and three. It is also important to harmonise the use of macroprudential buffers across Europe.

2.4.3 Benefitting from the significant opportunities presented by the new German government

A Central Bank official highlighted the significant opportunities presented by the new German government's initiatives, particularly in financing sectors such as defence and infrastructure. The announcements of new tax deductions and investment incentives to stimulate economic growth are welcome, as they reflect a proactive government. There is a need for decisive action on the pending legislative proposals on CMDI, reinforcing the essential cooperation needed to achieve tangible progress in these areas.

There is also a need to review the competitive landscape within the banking sector. European G-SIBs have indicated that returns on similar transactions in the European market are nine to ten times lower than in the US market. This discrepancy is a critical issue. A close

examination of the factors affecting the profitability of European banks is needed, especially with ongoing discussions on the SIU and CMU.

There is an urgent need to mobilise available capital and to raise public awareness of the importance of risk-taking and investment strategies. Effective cooperation between financial institutions, government representatives and legislators is essential to create a regulatory framework that supports mobility and economic innovation, while addressing key risk factors that affect growth. Citizens need to understand the need to mobilise capital within the EU, as there will be no high-tech development without risk taking.

The Chair acknowledged the consensus that has emerged surrounding significant issues, particularly the complexities presented by geopolitical and cyber risks, which have been identified as pressing priorities for EU banks. Despite the banking sector's solid positioning concerning capital and liquidity, ongoing efforts are crucial to enhance resilience and effectively respond to the challenges posed by both geopolitical and operational risks. There is a pressing need for coordinated action aimed at reinforcing integration within the EU banking sector, ensuring that it remains equipped to effectively confront both current and future challenges. There is a perception that risks are being faced by the industry relatively well, but more needs to be done at the margin to make sure that those challenges are able to be addressed.