Priorities for the banking sector

During this session, the panellists assessed the regulatory and supervisory framework in which banks operate, taking into account new developments related to the implementation of Basel III regulatory requirements (notably in the UK and the US). They also expressed their views on the issues that may hinder or help European banks to improve their global competitiveness.

1. The decline in the global competitiveness of European banks has a number of structural and cyclical causes and has negative consequences for the financing of the European economy and the strategic autonomy of the EU

1.1 Some figures

An industry representative observed that European banks have been experiencing low profitability for 15 years. Figures from the European Central Bank (ECB) and the Federal Reserve show that the return on equity (ROE) of US banks has been at least 200 basis points higher than that of their European counterparts since 2010. The ROE of EU banks improved last year, mainly due to a temporary lag in the adjustment of the cost of funds. ROE declined again in the second quarter of 2024 and remains lower than in the US.

1.2 Weaker growth in the European economy and the absence of a single financial market are factors in the lower profitability of European banks

One policymaker noted that one reason for the slower growth of the European banking sector compared to the US is the slower economic growth, but there are other variables affecting the European market share, such as the organisational structure and the l%

ack of an integrated market. Cooperation is needed to address the latter.

1.3 Other factors behind the decline in the overall competitiveness of European banks

One industry representative suggested that the declining market share of EU banks is affecting their competitiveness. There are also structural causes such as a weak European economy, market fragmentation, over-regulation, excessive capital requirements, over-taxation and fee caps. Lack of profitability makes it harder for EU banks to digitise, invest, develop abroad, reduce costs by scaling up and take risks due to high concentration ratios and the perception that annual profits are the first line of defence.

The chairman countered that it was the bank's choice, not the regulator's edict, to maintain large management buffers. An industry representative explained that banks grow with the economy, which is why US banks have grown faster than EU banks. The US consumer has also been in better shape than the EU consumer, supporting banks' earnings capacity in the US than in Europe; this reflects an issue of consumer confidence.

There are also structural differences between US and EU banks. The EU system is regionally and nationally focused and lacks global scale. It is difficult to compete with larger, global players. EU banks' profitability relies heavily on traditional lending activities, while international competitors focus on investment banking and trading. Market fragmentation in Europe is also a factor. It seems that securitisation could be an easy win that can be achieved in the next 18 months with the necessary political will. As a comparison it was mentioned that the US securitisation volume in 2023 was $500 billion, compared to $200 billion in the EU.

The bank levy, which still exists in nine European countries, hampers banks' ability to generate profits, which is unattractive to investors. The levy needs to be abolished to bring EU banks in line with their Asian and North American counterparts. The US Federal Deposit Insurance Corporation (FDIC) also has a role to play. By comparison, the Spanish government has blocked the acquisition of one bank by another. Win-win cross-border consolidation needs to increase if the profitability of the EU banking sector is to improve. In this respect, the outcome of the talks between an Italian and a German bank will be important for the progress of the Banking Union and for increasing the profitability of European banks. The Chairman noted that the question was whether banks should finance the economy or vice versa.

1.4 Negative consequences for the financing of the European economy and the strategic autonomy of the EU

An industry representative highlighted that a lack of profitability has negative consequences for the financing of the European economy. The monitoring report of the Basel Committee on Banking Supervision (BCBS) shows that the global share of European banks has fallen by 16% by 2011. The share of rest of the world banks has increased and the UK share remains stable. In 2023, business lending by EU banks fell back to levels last seen in 2008.

1.5 Three key steps to stop the decline

An industry representative stated that the first step is to stop developing new regulations and capital requirements. According to the BCBS, EU banks are better capitalised than their US counterparts and have sufficient liquidity reserves. Second, duplicative capital requirements need to be streamlined. The European

Banking Authority (EBA) recently showed that there are 10 such overlapping requirements. Third, regulation needs to be stabilised. Regulatory instability and uncertainty are the main reasons for the high management buffers of EU banks, which are almost 500 basis points higher than in the US.

2. The Prudential Regulation Authority (PRA) has published its near-final policy statement and rules on the implementation of Basel 3.1 standards for credit risk, the output floor and reporting and disclosure requirements

A central bank official stated that the aim of the PRA's rules are to ensure that risk is properly captured in the capital framework and through that help ensure there is no disruption to the sectors' ability to lend. This is consistent with the Bank of England's primary objective of promoting the safety and soundness of firms and its secondary objectives of promoting competition, competitiveness and growth in the UK, subject to alignment with international standards. While certain elements of the package are tailored to the UK, overall it remains aligned with core Basel standards.

The implementation date has been delayed after the original pre-summer publication date was pushed back by the UK general election. The implementation of the package as a whole is delayed until 1 January 2026, in line with the EU's implementation of trading book rules and to allow additional time for preparation. The transitional period for the output floor has been reduced to four years, so the floor will be fully implemented by January 2030.

2.1 No increase in capital market requirements for SME and infrastructure exposures compared to today

A central bank official explained that, following consultation on the removal of support factors for lending to small and medium-sized enterprises (SMEs), the PRA considers it right to remove support factors from Pillar 1 so that risk weights are calibrated to reflect the risk of the loans. However, the PRA recognises that, even though the impact of removing the support factors is small, SME and infrastructure lending matters for growth. So mindful of competitiveness and growth considerations the PRA is implementing a structural adjustment to Pillar 2 to ensure that the removal of the support factors do not result in an overall increase in capital requirements for SME or infrastructure lending.

Where clear evidence was provided through the consultation to support this, lower, more risk-sensitive conversion factors have been introduced, along with more dynamic approaches to property revaluations. The treatment of provisions under the internal ratings-based (IRB) and standardised approaches for the purpose of calculating the output floor has been harmonised and simplified.

2.2 Tier 1 capital requirements for large UK firms will be virtually unchanged, with an overall increase of less than 1% when the transitional arrangements end in January 2030

A central bank official noted that the impact of implementing Basel 3 in the UK by 2030 was expected to increase capital requirements for the major UK banks by less than 1%. This is partly because risks previously captured in the UK under Pillar 2, but not in other jurisdictions, will now be included under Pillar 1. The official noted, as an example, that Pillar 1 risk weights would increase by 5-6% but be largely offset by reductions in Pillar 2 requirements. The UK will be left with a capital stack roughly the same size as the EU. A comparison with the US is more difficult as the full details of the proposed changes in the US have not yet been announced.

2.3 A simpler, more risk-sensitive approach to residential property valuation

A central bank official added that the strong and simple regime currently under consultation will be available to the UK's smallest banks with less than £20 billion in assets and at least 85% exposure to UK borrowers, representing 3% of UK lending. Around 80 banks would be eligible fory this simplified regime. They must not have significant trading books or IRB modelling authorisations, nor provide complex services such as clearing and settlement. This sector is vital to UK economic growth through lending to niche sectors and specific regions. The regime remains robust and, while capital requirements remain broadly unchanged, the calculation and application will be simplified, reducing compliance costs, providing certainty and facilitating future planning. The Pillar 1 and Pillar 2 methodologies have also been simplified. For example, there is no requirement for firms under the strong and simple regimes to calculate market and counterparty credit risk using the Basel approach.

2.4 A single, more constant and predictable capital buffer

A central bank official highlighted that the three existing buffers will be removed and replaced by a single, firm-specific buffer based on a non-cyclical stress test and capped at 3.5% of risk-weighted assets. Pillar 1, Pillar 2 and the buffer framework will be significantly simplified, with corresponding simplifications in the Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP) and reporting and disclosure requirements. However, the level of resilience will remain the same.

The Chairman noted that there is a lot to read from the PRA on this issue. It appears that the US Federal Reserve intends to follow a similar path. The European Commission took the important decision to extend the implementation of the fundamental review of the trading book (FRTB) to January 2026.

3. Implementing the Basel III framework consistently across jurisdictions

3.1 Minimising divergence in the implementation of the Basel framework

One industry representative noted that regulators have taken a pragmatic approach. However, Japan and other jurisdictions have already implemented Basel III and are in compliance. This international framework will be strengthened by consistent implementation, minimising fragmentation and ensuring fair competition and high standards.

Jurisdictions have understandably taken into account the specificities of their markets, but this has led to some inconsistencies. For example, under the standardised approach to credit, different risk weights are applied to unrated corporate exposures, which can have an impact on the financing of corporate customers and the real economy. Similarly, the implementation of private ratings is not fully aligned with Basel. Indeed, some jurisdictions have chosen to apply a lower alpha factor for counterparty credit risk (SA-CCR) than the original Basel proposals, which may create some competitive disadvantage.

It is essential that global systemically important banks (G-SIBs) have a level playing field to do more business with European clients.

3.2 Implementation of the Basel III framework in Europe strikes the right balance between resilience and competitiveness

One policymaker described the implementation of the Basel III framework in Europe as the best possible outcome. The implementation plan has been achieved in a short timeframe and strikes the right balance between resilience and competitiveness. The EU framework applies to all banks, further ensuring resilience and stability. The EBA will play a key role and the Commission will continue to monitor developments, in particular to ensure a level playing field internationally.

It is a positive sign that there is an intention to deliver in the US, but the details remain to be worked out. The developments announced by the Bank of England are welcome, particularly in view of the aim to continue to align with international standards and agreements at European level. It is to be hoped that the postponement of the effective date of the market risk element of the package will be the last necessary adjustment.

The Chairman stated that the EBA is ready to act on the Commission's instructions and hopes that there will be no further changes to provide certainty to the industry. The EBA's implementation roadmap aims to provide predictability and ensure convergence over the next two and a half years. There must be no double counting of risks now addressed under Pillar 1, and Europe must follow the Bank of England's lead in conducting a quantitative impact assessment.

3.3 Taking into account the specificities of the EU in the implementation of Basel III

An official stressed the importance of taking into account European specificities in banking regulation, including the needs of the industry and the specificities of the economy. Europe has achieved a balanced outcome with long transition periods and the UK is taking a similar approach. The postponement of the FRTB is supported by member states. There are areas where the framework can be improved. The Bank of England's strong and simple regime could be analysed and considered to be applied in the EU, where complex rules are a challenge for small banks. The original US proposal to lower the threshold to $100 billion could also be relevant in the EU.

It is difficult for banks to plan for compliance with rules that have not yet been finalised. Perhaps Europe should review its processes in the future to allow banks sufficient planning time. The Chairman described the EBA as a small peon in a larger process that is relevant to all market participants. Basel III needs to be implemented in all banks and at all levels, specifically the European approach.

3.4 European banks need a level playing field to regain their competitiveness

An industry representative pointed out that, according to the BCBS and the EBA, the finalisation of Basel III will increase minimum capital requirements in the EU by 18% for Group 1 banks and by 16% for large international EU banks, but only by 1% for America and the UK and -1% for the rest of the world. It is therefore in the interests of US and Japanese firms to implement Basel III. The EU should follow the UK's example.

In such a context, the implementation of Basel III will reduce the competitiveness of EU banks. The competitiveness gap can be reduced firstly by EU regulators clearly distinguishing Level 1 from Levels 2 and 3 when implementing the banking package, while recalibrating buffer requirements to avoid double counting, as has been done in the UK. Second, the review of the macroprudential framework should be capital neutral and not add to existing buffers or other requirements. Third, it should neutralise the impact of the MREL on the output floor, which is well above the TLAC requirements. Finally, European regulators and supervisors should have competitiveness as a long-term objective.

3.5 What kind of banking regulation is needed to improve the competitiveness of European banks?

An industry representative suggested that regulation is a factor affecting competitiveness. Banks compete in international markets and with a broad range of players, including bigtechs and non-bank financial intermediaries. It is very challenging to ensure minimum consistency with standard regulatory tools – such as capital requirements. Much more would be with price-based tools such as intricate approaches for Value for Money in the Retail Investment Strategy or hard binding caps on interest rates for credit. Regulation should aim to ensure that prices work efficiently, rather than acting on prices themselves.

On the ESG front, lot of progress has been achieved during the last EU legislature. Now appears to be the time to focus on implementation and to ensure an efficient, stable and predictable ESG regulatory framework. Regarding digital regulation – for instance on cyber-risk, cyber-resilience and Artificial Intelligence, there is a need for new and more flexible approaches and tools.

3.6 International convergence beyond Basel III, particularly on sustainability, is essential

An industry representative explained that for internationally operating banks such as SMBC, harmonisation and alignment in terms of regulatory compliance with other jurisdictions is key. This applies to Basel III, the Digital Operational Resilience Act (DORA) and others. Investments in sustainability need to be justified as they impact profitability, especially in Europe. It is hoped that other jurisdictions will follow the EU standards in this area, but some, such as Japan, are creating their own, aligned with the International Sustainability Standards Board (ISSB). Any gap between the ISSB and the Corporate Sustainability Reporting Directive (CSRD) will affect profitability and competitiveness.

4. Towards a period of prudential regulatory stability?

4.1 Ensuring a period of regulatory stability

A policy-maker indicated his intention to recommend a period of regulatory stability to the new EU political leadership. Legislators have intended to do this at the turn of each cycle since 2008 but have been prevented by various crises requiring timely action. It is useful to take a step back and look at the overall functioning and coherence of the framework from a distance. Nevertheless, targeted improvements to the framework are proposed under the umbrella of the Capital Markets Union. Capital markets need to go hand in hand with the banking sector.

A savings and investment union would facilitate the contribution of capital markets, banking and insurance to the financing of the real economy. The European Council is drawing up a list of initiatives for the Commission, and the Eurogroup statement of March 2024 sets out the priorities. Strong political support from Member States will be needed.

4.2 The prudential agenda on digital risks, climate change and operational resilience will prevent a regulatory pause

One central bank official suggested that the regulatory pause mentioned above may not become a reality. The PRA's top banking policy priority is the implementation of Basel III and the strong and simple regime, alongside its agenda on operational resilience and cyber risk. This will involve interaction with DORA and international alignment. The sector continues to learn from the events of March 2023 in the US in relation to Credit Suisse, although the implications for the implementation of Basel III have yet to be finalised. The PRA's will continue to consider whether more targeted changes are needed to support its secondary objective to promote the competition, competitiveness and growth in the UK.

4.3 Improving the EU regulatory and supervisory framework for securitisation

One official reiterated the need for progress on securitisation. EU bureaucracy and complexity need to be reduced, following the UK example. Supervisors should review the Basel III rules relevant to securitisation, as not all jurisdictions have fully implemented the Basel approach. The rules may be too stringent and possible improvements should be considered during the next policy cycle.

4.4 While greater stability and predictability is welcome, climate change and digital risks will require the regulatory and supervisory framework to evolve

One industry representative explained that his main concern relates to the next iteration of the Basel framework and how it will incorporate new risks, which will make regulatory and international convergence more challenging. Bankers find the changes to Basel III difficult to understand, as the marginal benefits are not always clear. It is welcome that the capital framework will remain largely unchanged, but it remains uncertain how Basel intends to address emerging digital and environmental, social and governance (ESG) risks. A more flexible approach will be needed. The right way forward is to improve the existing guidance.

Emerging risks will make consistent oversight of the next Basel framework more challenging. There will be new players to consider, and there is the question of entity versus activity-based regulation. There are improvements to be made to the existing framework as it is implemented, but the main concern is the next framework and how to deal with emerging risks.

4.5 Policy choices are key for the future of the European banking system

One industry representative suggested that the pace of regulatory projects should be improved. It is challenging for large banks but for smaller banks with fewer resources, it is less manageable to simultaneously implement the wide variety of existing regulations. Regulatory harmonisation with a lead regulator could help. More dialogue between regulators is needed, with a formalised agreement on communication and objectives. Securitisation across the EU, which is often a topic of discussion between legislators and regulators, should be addressed as soon as possible.

The Chairman identified implementation as the key issue. The European Commission has responsibilities in this regard. Securitisation, digital risks, sustainability and macroprudential risks must all be taken into account in the future. The pace of regulation and reform must be improved. The implementation of Basel III must be effective, consistent and coordinated.