PRIORITIES FOR THE BANKING SECTOR

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Common EU policy action to the benefit of EU banks, corporates and citizens

The EU has set out its ambition to foster a prosperous and competitive Europe in the 2024-29 strategic agenda: deepening the single market for financial services, mobilising both public and private funding and pursuing the green and digital transition. In all this, European banks will need to play a crucial role going forward.

Resilient banks are competitive banks

Banking crises throughout history have evidenced that healthy and strong banks are to withstand shocks and continue to lend in times of stress. Financial stability is the precondition for banks to help the real economy prosper.

Despite turbulent macro headwinds in 2023, EU banks have performed well. Profitability has increased further, albeit at slower pace, liquidity and capital headroom above requirements remain at comfortable levels. Loan growth, however, has been subdued, due to increased banks' risk perceptions as well as lower demand. The EBA's latest risk assessment report shows that banks aim to increase lending again.[1] Still, the uncertain outlook around economic growth and rate trends may lead to higher credit risks and challenge the sustainability of profit generation.

EU Banks have been challenged by structurally low profitability levels. Only last year, EU banks reached similar profitability levels to their US peers, even slightly overperforming them. Looking forward, EU banks will need to proof that their business model will allow them to maintain profitability levels in a sustainable manner. This implies ensuring a good business model, enhancing competition in the single market as well as a robust, predictable regulatory and supervisory environment.

To remain globally competitive, EU banks need to accelerate their effort to transform their business model. Higher profitability should be an opportunity to increase investment in digitalisation, improving efficiency, revenue capacity and resilience. Investments are also needed to enhance risk management and capabilities to finance the transition to a more sustainable economy. These are important, as EU banks continue to face elevated uncertainty going forward due to geopolitical and cyber risks looming.

At the same time, structural adjustments in the industry are needed. High ratios of bank assets to GDP ratios indicate that banks are essential to finance EU economic growth. They are also a reflection of the need for more financial market intermediation in the EU. They also point to overcapacity in some national banking systems, despite past efforts to consolidate and streamline the sector. Further restructuring is needed not only at domestic level, but also through cross-border consolidation. Deepening the single market with cross-border banking activity will be fundamental to ensure the adequate allocation of saving to investment opportunities across the Union.

Finally, a stable regulatory and supervisory framework should provide the context for addressing financing needs while preserving financial stability. The next years will bring the finalisation of the implementation of the Basel III framework in the EU. The EBA will contribute with level 2 mandates and the fine tuning of the Single Rulebook. This work will run in parallel to the implementation by all other member jurisdictions. Supervisors will need to ensure the implementation of the new framework across all institutions.

EU banks' robustness enhances EU competitiveness and supports integration of the single market.

As we implement this framework, we will continue pursuing analytical work to monitor it is functioning properly. A recent EBA report, provided a comprehensive analysis on the granular system of stacks and buffers in the EU, including a high-level comparison with the UK and US, and a detailed description of what management buffers EU banks aim to hold against the backdrop of regulatory requirements and why.[2] The publication reflects the key idea that regulatory clarity, but also transparency, ensures that respective regulation is well understood and interpreted – and potentially further developed.

1. *Risk Assessment Report of the EBA EBA/REP/2024/12 – July 2024*
2. *Stacking orders and capital buffers. Reflections on management buffer practices in the EU - 15 July 2024*

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Allowing European banks to boost their competitiveness is an essential factor to achieve Europe's strategic resilience

According to the letter report, the EU economy has lost ground and is falling behind the US. At the time of the Great financial crisis, the size of the EU's economy was larger than that of the US[1]. In 2024, the stark reality is that the US economy is 50% larger than the EU's. And specifically in the financial sector, in the years since the crisis, American investment banks have taken more than a 50% share of the European market. Similarly, in the asset management sector, at the time of the crisis European actors had a 47% share of the global market versus 51% for US asset managers. By 2022, the European share had fallen to 22% while the US share had increased to 70%[2].

The European Commission has mandated Mario Draghi to make proposals on how the EU can tackle the erosion of its competitiveness and he has already referred to the need for radical change in the policy agenda to boost European competitiveness. The main political groups in the new European Parliament have also called for measures to support a European competitiveness strategy, and this is indeed to be welcomed.

Being mainly bank-financed, the EU economy is critically dependent on the competitiveness of its banks. If the EU wants to achieve strategic autonomy in the financial sector, it must ensure a level playing field with other jurisdictions regarding prudential regulation of banks, as it is indeed a key element impacting their competitiveness. This is all the more imperative given the massive financing of € 750 bn[3] needed annually for the green and digital transitions, which will require a larger share of private sector financing as the public sector has limited fiscal resources and will continue to lack them in the foreseeable future.

The CET1 ratios of European banks have more than doubled since the crisis, reaching 16.4% at the end of 2023[4]. Europe's banks are now strong and resilient, allowing for adjustments in capital requirements and targeted policy reforms that can create the conditions for more dynamic and robust capital and lending markets, while ensuring financial stability. In a bank-financed economy such as Europe's, banks must indeed be incentivized to lend and support investment.

What needs to be done? Three key priorities have to be addressed:

Avoid gold-plating capital requirements. An Oliver Wyman study[5] has highlighted that the higher capital requirements of European banks is an important reason of their lower profitability. It also underlines that MREL requirements as well as the various buffers translate into significant further barriers to achieving a level playing field that would allow European banks to regain in competitiveness. Furthermore, future climate-related capital regulations will have their own impact.

In light of this, European authorities should carefully calibrate capital frameworks and avoid the excessive capture of risks, notably double counting between the implementation of Basel 3 and the application of Pillar 2. The recent UK Prudential Regulation Authority's statement is a useful policy to avoid this and make sure that risks are properly captured.

Revitalize and recalibrate securitization. Over the last decade, the European securitization market has declined and become but a small fraction of the size of the US market. Relaunching securitization will enable European banks to securitise the loans they originate, allowing them to rotate their balance sheets and increase their lending to the economy while also allowing insurers and pension funds to support the economy's transition and future growth.

Complete the Capital Market Union. As underlined by the French and German Roadmap for CMU, economies with deeper capital markets foster more innovation and achieve higher rates of growth. While Europe has a vast pool of long-term savings (25% of EU GDP vs 18% in the US), it is critical that this pool remains in Europe and is mobilized to fund the huge investments needed for the green and digital transitions, in addition to those needed to the financing of the EU economy. To meet these priorities, in addition to relaunching the securitization market, there is a need to remove the barriers that currently limit access to the equity markets for European companies, in particular for the technology sector, and the free flow of capital in the Union.

In conclusion, Europe needs a radical departure in the policy agenda to regain its global economic competitiveness and that of its financial system to promote economic growth and meet the immense challenges ahead.

1. *IMF datamapper: $14.77 vs $16.29 TR for the EU in 2008 compared to $27.36 for the US vs $18.35 TR for the EU) at the end of 2023)*
2. *Source: Official Monetary and Financial Institutions Forum / Luxembourg for Finance Report*
3. *Source: European Commission 2023 Strategic Foresight Report*
4. *ECB data portal*
5. *Oliver Wyman / EBF: The EU Banking Regulatory Framework and its Impact on Banks and the Economy January 2023*

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

Over the past decade, European banks have struggled to keep pace with the financial performance of their global peers, especially in Corporate and Investment Banking. While this situation stems from both cyclical and structural reasons, policy choices can significantly help the sector and the EU economies.

First, European economies have been hit by successive crises from the pandemic to the war in Ukraine, which resulted in the energy crisis. Consequently, growth for European banks has also been negatively affected. The sudden and sharp increase in ECB rates didn't help either, leading to anaemic growth.

Second, more structurally, the majority of European banks lack global scale. The European banking system is centred on regional banks and national champions. Few of these are pan-European and even fewer are global. This makes it difficult to compete against larger global players. In addition, European banks' profitability relies more on traditional lending activities that are usually kept on the balance sheet, while their international peers are often more active in investment banking and trading.

Fixing the scale issue could prove difficult; M&A is often cited as the solution. Some consolidation has occurred but mostly domestically, in highly fragmented banking markets. Some vertical M&A across the value chain has also picked up in products such as insurance or asset management. However, neither approach has been enough to build large players and close the gap with global peers.

Cross-border M&A has the potential to be transformational. However, the absence of a common European framework, starting with the Capital Market Union (CMU) and the Banking Union (BU), is a hinderance, as two merging banks would not be able to fully crystallise revenues and extract cost synergies.

Larger banks could arguably better withstand periods of economic stress and volatility, decrease the risk of financial disruption, and better support European corporates in their expansions. Finally, stronger banks with scale could also better contribute to the mobilisation of private resources needed for the EU green transition.

Europe has nonetheless come a long way since the Global Financial Crisis (GFC) in 2008. Policymakers, regulators and banks took significant measures to strengthen banks' business models, cut costs and clean up balance sheets. Yet profitability and valuations have been trailing behind their US and international peers since the GFC.

The lack of progress in CMU and BU remains a key hurdle for EU banks to crystallise synergies and achieve scale across markets. The completion of the BU, in particular the establishment of a European Deposit Insurance Scheme and the removal of barriers to cross-border consolidation would help to address the chronic fragmentation in the European banking sector.

Further harmonisation in the national legal and tax frameworks can also improve the economic rationale for EU retail banking integration. A more effective resolution framework for small and middle-sized banks may also facilitate market exits and reduce overcapacity. Greater integration, with a permanent borrowing facility backed by a common fiscal capacity would also be needed to reduce protectionist tendencies.

Finally, SSM banks are currently involved in transformational projects such as DORA, CSRD and the AI Act, among others, which require substantial investments in human and technology resources. Smaller banks will struggle to change at the same pace as large institutions, and this may lead to unintended consequences. Efforts to make regulation more proportionate are welcome.

More generally, the EU needs deeper European capital markets, with more private capital financing and greater banking disintermediation, combined with a larger use of securitisation and other forms of risk transfers.

The lack of progress in CMU and BU remains a key hurdle for EU banks.

The EU securitisation market is not performing to its full potential and is not contributing sufficiently to the development of the EU capital markets. Securitisation can offer: risk transfer out of banks' balance sheets through investments with different risk profile; more lending without the need for increasingly more expensive bank capital; smooth transformation of bank balance sheets from 'brown' to 'green'; simultaneous financing for a large number of EU SMEs; and support for the ECB monetary policy, corporates and sovereigns in times of economic duress.

Therefore, strengthening the CMU should be one of the key policy priorities for the next European Commission. Also in this context, a common safe asset, which could serve as the ultimate risk-free benchmark, would be instrumental in the development of a truly integrated European financial market.

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European banks need a level playing field to regain their competitiveness

Despite a resilient and highly regulated financial system, the EU banking sector has globally shrunk. Between 2009 and 2022, EU banks' share of global market capitalisation fell from 34% to 17.5%. The market share of US corporate and investment banks (CIBs) in Europe is close to 50%, while the market share of European CIBs in their own market is only 35%.

This decline is mainly due to a number of structural causes at both national and European level. These include market fragmentation, the burden of over-regulation and strict supervision, excessive capital requirements, over-taxation and other practices that hinder competitiveness, such as fee caps and regulated pricing.

The EBA estimates that the finalisation of Basel III will increase the RWAs of EU banks by 16% but with a capital shortfall of a mere EUR 600 million. This has the air of a bad joke, since it means that management buffers will be absorbed by new capital requirements. It is like telling somebody that we are going to increase your income tax by 16%, but you will not be affected because you have enough savings to cover the extra burden!

EU banks have a hefty management buffer of 500 bps above capital requirements. This buffer is necessary since two things really matter to the markets: the distance to Maximal Distributable Amount and the distance to the resolution threshold (SREP requirement). For investors, these are key to receiving dividends, and the major threat facing them is losing their capital. According to *The EU banking regulatory framework and its impact on banks and the economy* report produced by Oliver Wyman, EU banks had a management buffer of 440 bps in 2022 vs 190 bps for US banks. This difference is explained by supervisory pressure, both through formal restrictions and informal requirements, uncertainty regarding capital requirements, supervisor discretion, and less transparency and predictability in the EU.

Usually, supervisors play down the consequence of capital requirements on the economy, saying that banks will adapt. However, they often do so by constraining their lending capacity. The ECB figures clearly show that, after Basel III, loans to corporates significantly fell in the Eurozone, only recently returning, in nominal terms, to their 2007 levels. And since there is no Capital Markets Union, no viable alternative yet exists. Another incorrect theory is that the better capitalised a bank is, the more it lends. If that were correct, the capital requirement should be set at 100%! In fact, there is a balance to be struck between financial stability and growth. According to the *EU implementation of the final Basel III framework* report by Copenhagen Economics, the optimum point is around 12-13% of CET1, with any further broad-brush increase in capitalisation resulting in a net cost to society. No risk means no reward.

The rules of the game now need to be changed to give European financial and non-financial companies the room for manoeuvre they need to reduce the competitiveness gap.

In concrete terms, the official mandate of all regulatory and supervisory bodies should be altered to include objectives in relation to competitiveness and long-term growth, as is the case in the US and in the UK. Credible independent competitiveness tests should be carried out ahead of any new regulatory proposals, and gold-plating should be discouraged via the European Commission more frequently exercising its existing powers on level 2 or 3 initiatives that are inconsistent with level 1.

In implementing CRR3/CRD6, EU regulators and supervisors should uphold their objective of "avoiding a significant increase in overall capital requirements for the EU banking system", by recalibrating buffer requirements to avoid double counting (eg. P2), as envisaged in the UK.

The macroprudential framework should also be reviewed to avoid any future possible increases in capital requirements (including via the countercyclical buffer or the systemic risk buffer) on top of the already significant increases brought about by CRR3, as such increases would further harm the position of EU banks.

The European banking sector is resilient and well capitalised, the priority is now competitiveness.

The impact of the output floor on the MREL, already significantly above international TLAC requirements, should also be neutralised.

Over the next parliamentary term, the European Union will have to deal with unprecedented geopolitical, environmental, digital and demographic challenges. These multifaceted issues will force the European authorities to take urgent stock of the situation and come up with bold responses. The European banking sector is resilient and well capitalised, the priority is now competitiveness. This does not contradict the objective of financial stability - quite the reverse.

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The case for greater international alignment: a perspective on CRR III

This upcoming EuroFi conference in Budapest is timely because it not only follows important elections in the EU and its Member States, but comes after the much anticipated publication of the CRR III/CRD VI Banking Package into the Official Journal in June this year, confirming the EU's progress towards implementing Basel III. This marks an important milestone in the post-GFC reforms to banking regulation and will significantly strengthen the prudential framework in the EU.

Recent events such as the 2023 Banking Turmoil, have reminded us of the importance of a sound regulatory framework that accounts for the interconnected nature of the banking system. As a Japanese headquartered G-SIB operating across 135 offices in 38 countries and regions, at Sumitomo Mitsui Banking Corporation (SMBC) we are aware of the impact we have across many different markets globally and the importance of consistent high regulatory standards.

The Basel Committee on Banking Supervision (BCBS) includes within its mandate a commitment for member countries to promote financial stability across the globe and work together to fulfil its mandate. The Basel III standards released in 2017 were originally intended to be implemented by January 2023; the delay in adoption and implementation across many major jurisdictions creates a misalignment of application dates presenting challenges for global banks operating and competing across different markets.

Japan has been leading major jurisdictions with implementation from March of this year; other jurisdictions including Australia and Canada have likewise implemented. However, in the EU, CRR III will not come in to force until January 2025 and in the UK, the implementation date is still to be confirmed but it will be July 2025 at the earliest. The whole sector will of course be watching developments in the US closely, where timely and full implementation of Basel III is important to ensure a level-playing field. Different timelines not only bring complications for banking groups operating across different jurisdictions, but will have implications for capital allocation through the misalignment of the phased introduction of the output floor requirement. Although the decision to delay FRTB implementation in the EU seeks to address competition implications, it is important that other aspects of the package are not delayed, which may further exacerbate these concerns.

The strength of the Basel framework is that it is largely implemented consistently, which helps to minimise fragmentation and ensure fair competition along with high standards. It is understandable that jurisdictions will want to take into account the specificities of their markets when applying the rules; however, this has created several areas of misalignment. Different rules have emerged across major jurisdictions under the Standardised Approach for Credit Risk, where different Risk Weights (RW) are applied to unrated corporates, which may have an impact on the financing of large corporate customers and knock-on effects for the real economy.

Another example of divergence is the attitude towards the use of private ratings, which is an important risk management tool for banks, but implementation is not universally aligned with Basel in this area. Furthermore, recognising the importance of derivatives in allowing parties to hedge specific risks, some jurisdictions have chosen to apply a lower alpha factor for Counterparty Risk (SA-CCR) than the original Basel proposals for certain exposures, which may in turn provide a competitive disadvantage to some derivatives business in other markets.

The focus must now be on the timely implementation by banks and effective supervision by regulators.

As EU regulators have pointed out, the finalisation of CRR III is only the first step of implementing these important regulations. The focus must now be on the timely implementation by banks and effective supervision by regulators. It is vital that the regulatory community continues to look for ways to minimise divergences in the implementation of the Basel framework and where gaps are identified by the BCBS, these are tackled appropriately. Furthermore, as regulators and policymakers examine future changes to the framework, for example, possible revisions to the rules on Interest Rate Risk in the Banking Book and the Liquidity Coverage Ratio following the events of 2023, it will be important to learn from the experience of Basel III and work to ensure that any future changes to the framework are introduced in close partnership across the banking sector.

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Banking regulation and banks' competitiveness

The beginning of the new legislative term in the EU marks an appropriate time to reflect on the roadmap for the upcoming political cycle.

Looking back, we certainly come from a period of intense regulatory activity, involving prudential policy, ESG, digital issues, AML/FT, and horizontal legislation such as due diligence in corporate sustainability and eIDAS, among several others. Looking ahead, while precise policy initiatives have yet to be defined, some broad themes can already be observed. The list is not that short. But looking at the Commission's Strategic Agenda for 2024-2029 and related speeches, there is one salient overarching theme, which is also central to financial activity and regulation: the quest to bolster competitiveness.

Though the relationship between competitiveness and regulation is not straightforward, the following three questions may be useful to reflect on it.

First question: following the premise "First do no harm", what type of regulation would be better to avoid?

The EU banking sector competes on international markets on a broad range of financial products and services, as well as on funding. Banks also compete with a broad range of players, including non-bank financial intermediaries, bigtechs and a growing variety of companies. In this scenario, it is already challenging to ensure minimum regulatory consistency across players with the usual 'standard tools' – such as capital and liquidity requirements, reporting/disclosures standards, and rules, guidelines and restrictions on conduct, AML/FT and corporate governance, to name just a few. Yet, doing so would be even much more challenging and potentially hazardous if price-based regulatory tools are used instead.

Regulation should aim to ensure that prices work efficiently, rather than acting on prices themselves. Depending on markets' characteristics, direct (eg: binding caps) or indirect price regulation (overly intricate approaches on Value for Money) can seriously lessen EU banks' competitiveness. Also, it can hinder innovation and may end up limiting the provision of financial services to different types of clients.

Second question: How can regulation support the digital and sustainable transition in the EU?

European authorities are committed to deliver the digital and sustainable transformation. This will need vast resources and substantial efforts. The banking sector, in turn, is fundamental to the financing of the real economy in Europe, particularly to SMEs and households. As such, more efficient, stable and predictable regulation will help EU banks to do their part in supporting the twin digital and sustainable transition. Predictability also means to allow a time to develop new regulation and a time to implement it. On ESG, it seems now the time to focus on implementation, reduce undue burden and keep assessing the international landscape on this field.

Formal regulatory frameworks for new risks usually evolve from best practices and interactions between entities and regulators/supervisors. Given the novel and dynamic features of those risks associated to ESG and digital technology, a continuous and transparent supervisory dialogue can be the seed of future regulatory frameworks. In the meantime, more flexible and qualitative approaches – less 'capital centric' for instance – are likely to work more efficiently. Cyber-risk, cyber-resilience and AI are clear examples.

Third question: What other policies (close to regulation) may also affect EU banks' competitiveness?

There are several, but taxation policy is surely a major one. Since 2022, nine EU Member States have introduced windfall taxes on the banking sector. This is in addition to existing specific levies on the sector in eight members. The motivation, design and duration of all these levies vary significantly. They go from levies targeting 'extraordinary' profits, to purpose-specific contributions. In addition, their design (eg: the tax base; temporary or permanent), scope (eg: all banks, some banks) and discretions (eg: deductibility regimes) are significantly heterogeneous. This is a key source of financial fragmentation and potential stigmatisation, thus affecting competitiveness of EU banks.

This is time to help bolster the competitiveness of the EU banking sector.

Spain is one of the countries where a windfall tax was introduced. The IMF has commented in its Art IV on the levy, indicating that the current design has several important limitations. The ECB has also warned about its effects on banks' resilience, capital and credit provision as well as on market competition and level playing field. It is worth noting that a less competitive EU banking sector is also less able to work as a driver of full economic growth.