The European Banking Union: Challenges Ahead

by Howard Davies[22]

"This time the banks are not part of the problem, as was the case in the financial crisis of 2008, but part of the solution"(1). Such was the verdict of Felix Hufeld, then the President of the Bafin, the German financial regulator, in June 2020.

Hufeld himself has since moved on, a casualty of the Wirecard scandal, but his sentiment has been echoed by many regulators, commentators, and even some politicians who have been sparing in their praise of the banking sector in the past. It has even become something of a cliché, beloved of bankers themselves, who have enjoyed basking in the warmth of unaccustomed praise.

Bankers are human too (at least they like to think they are), so congratulations are always welcome, but some have been uncomfortably aware that these golden opinions may have come at a hefty price. Banks have been strongly encouraged, even required, to keep their branches open through the Covid lockdowns even when the footfall has been very light. They have given extended mortgage holidays to personal borrowers on demand. And they have extended loans to distressed companies, to help them through dips in demand, or even enforced closures. Some of those loans have been fully or partly guaranteed by governments, but it would be unrealistic to assume that the banks will not incur major losses on that and other lending. Some have been pushed into loss for 2020. And these losses come at a time when bank profitability is under serious threat from very low, or even negative interest

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rates. With yields on low risk assets almost flat as far as the analyst's eye can see, the usual attractive and rewarding banking business of maturity transformation on an upwardly sloping curve has not been available.

That banks have survived this very difficult period can largely be attributed to the strong capital ratios they displayed when the crisis hit. Regulators have therefore taken some credit for the banks' success. The aggressive re-regulation of the sector since 2008, led by the Basel Committee, has paid off. In spite of the sharpest recession for a century in the largest European economies, no significant bank has fallen over, or needed to be rescued by the state. And banks demonstrated remarkable operational resilience. The ECB acknowledges that there was no noticeable rise in operational losses due to business disruption or system failures. That is as remarkable as the strong capital position.

But in spite of this robust performance at a very challenging time the market has drawn the unsurprising conclusion that future profitability is uncertain and that bank stocks are to be treated with great care. Most large European banks have continued to trade at a significant discount to book value, well below 100% and systematically below their US counterparts in most cases, even though there was something of a rally in early 2021 (1).

Some might be tempted to think that if this is what it means to be a solution, maybe being a problem was not such a bad thing after all.

As we emerge from what we must hope to have been the worst of the pandemic, it is time to ask whether, from the banks' perspective, anything has changed. Will politicians and regulators conclude that large banks, which many saw as dinosaurs, ready to be wiped out by agile digital fintech newcomers, or by the BigTech monoliths, have their social uses after all, and should not be allowed to vanish into the primeval swamp along with diesel engine plants and high street fashion retailers? Or will the Covid crisis be seen merely as a temporary respite in a process of secular decline?

To attempt an answer to that question we need to parse it a little, and address four sub-questions:

1. Can we expect the regulatory environment to change as a result, in ways that might benefit traditional banks?
2. Might the experience of the crisis, and the solidity the banks displayed, affect customer behaviour, and create a kind of 'flight to safety'?

3. Has the crisis weakened some new competitors and demonstrated weaknesses in their business models?
4. Are banks therefore now in a stronger competitive position, or is their predicament fundamentally unchanged?

1. Regulation

The European regulators' initial response to the Covid crisis was not encouraging from a bank perspective. In March 2020 both the European Central Bank and the Bank of England imposed restrictions on bank dividends, indeed they effectively banned any capital distributions during the whole of the year, to retain as much capital as possible within the banking system. The Federal Reserve did not take the same line, allowing normal dividends, typically accrued quarterly in the US, to continue, but did impose a moratorium on share buybacks, which in recent years have dominated US bank distributions.

The banks reacted negatively, arguing that their capital positions were strong enough to sustain normal dividends, and that preventing them from rewarding their shareholders would adversely affect investors' views of the investability of bank stocks, thereby raising their cost of capital in the longer term. They pointed out that the ban was also inconsistent with the capital framework put in place since the crisis, with its higher ratios, buffers and rigorous stress tests.

By early 2021 there were signs that the regulators were beginning to soften their position, and allowing modest distributions to go ahead. The Bank of England revised its guidelines. The ECB allowed stronger banks to resume dividends within strict limits, noting that the average tier 1 capital ratio for the banks it supervised had risen from 14.4% at the start of 2020 to 15.2% at the end (2). The revised rule was that dividends in 2021 should not exceed 15% of 2019-20 profits, or 20 bps of CET1 capital. Though the secretary of the Basel Committee, Carolyn Rogers, alarmed bankers (and some regulators alike) in November 2020 by arguing that the dividend ban should continue until the full extent of the covid hit to the economy was clear (3). That may take some time, as the pandemic rumbles on for longer than expected.

In other respects, however, the regulators were somewhat more helpful to the banks. The ECB implemented a series of relief measures, which were broadly paralleled by the Bank of England and others. They allowed, indeed encouraged banks to dip into their capital conservation buffers, and allowed some capital instruments which would not normally be counted towards pillar 2 requirements to be incorporated. The ECB revealed in January 2021 that nine banks, which would otherwise have fallen below its CET1 guidance, had taken advantage of that flexibility, though most have not needed to do so. The regulators also allowed the use of transitional IFRS 9 provisions, which somewhat reduced the procyclicality of the expected loss calculations. Banks could operate below the 100% liquidity coverage ratio until the end of 2021, and that may be extended. Furthermore, a series of other supervisory interventions were deferred or abandoned, notably the deadline for meeting the 2019 qualitative guidance.

But these transitional relief measures are specifically related to the crisis period, and there has been no suggestion from the ECB, or the Bank of England, that capital requirements will be relaxed in the longer term. Indeed the full implementation of Basel 3, to which the regulators are committed, would increase minimum capital for a number of institutions, putting further pressure on profitability, which is already challenged. As the ECB itself concludes: "Banks profitability and business model sustainability remain under pressure from the economic environment, low interest rates, excess capacity, low cost efficiency, and competition from banks and non-banks"(4). They do not include high capital and liquidity requirements in that list of obstacles. While in the US there have been some signs of willingness to lighten capital requirements on small institutions in particular, there is no sign yet of a similar move in Europe.

The banks, while not requesting a major relaxation of the rules, have asked the ECB to rethink the remainder of the Basel 3 reforms, and invited the Commission to use its discretion to reduce the scale of the levy paid to the Single Resolution Fund. Both requests have so far been declined.

A recent report by the independent banking analyst at Autonomous has argued the capital rules for banks in the UK, and the same could certainly be said of banks in the Eurozone, are now arcane and in some respects dysfunctional. "The UK capital framework is creaking under the weight of its

own complexity", the author Christopher Cant maintains, and "the level of complexity is a deterrent for investors" (5). The stress testing arrangements are opaque, and there is still no clarity on the transitional arrangements for IFRS 9. There is uncertainty over the MREL and liquidity requirements. Overall, they conclude, "the scenario doesn't exactly bode well for a rapid normalisation of dividends".

There is another dimension of regulation, however, where change might be in prospect. For some time the banks have maintained that new digital competitors, whether small fintech start-ups or Bigtech giants, have benefited from lighter regulation in areas such as data usage and anti-money laundering, where banks seem to be held to higher standards. And there has been a bias towards promoting new competition, through forcing the opening up of banking relationships (open banking) and regulatory sandboxes, in which the regulators help new entrants to develop compliant business systems.

The response from regulators to date has been that the same activity is subject to the same regulation, and that most of these new entrants have chosen not to be banks, which brings obligations as well as rights.

There are signs that this line may be in the process of being rethought. A February 2021 paper (6) by Fernando Restoy, of the Financial Stability Institute, a think tank linked to the Bank for International Settlements in Basel, questioned the current approach. Restoy notes that the 'same activity, same regulation' mantra is not accurate, and that incumbent banks have specific entity-based prudential and other obligations which do not facilitate a level playing field. He argues that 'the growth potential of fintech and big tech companies could be, in part, the consequence of lighter regulatory requirements'. He goes on 'regulation specific to banks entails higher compliance costs and can therefore put them at a competitive disadvantage'.

The policy implications of his analysis are intriguing. His main point is that while banks have argued that regulation should be activity-based to promote a level playing field, that may well not be the consequence, and that fintechs may 'generate concrete threats to relevant policy objectives such as market integrity or stability or fair competition'. Those threats may create a case for entity-based regulation of these new entrants, which would achieve a better balance of policy objectives, and would in practice level what is now a very bumpy playing field.

It is too early to say whether this argument will influence key decision-makers in the European Commission, or elsewhere in the Tower of Basel for example, but the implications could be far-reaching.

It is possible, too, that payments initiatives led by central banks themselves will alter the competitive landscape. The most recent survey by the BIS shows that 86% of the central banks surveyed are working on their own digital currencies (7). The gauntlet thrown down by Facebook's Libra initiative, now dubbed Diem, has stung the central banks into a response. Depending on the nature of the response CBDCs could disintermediate commercial banks or strengthen them. The ECB has (8) suggested in a consultation paper that individuals should hold digital euros through their accounts at private sector banks. If they maintain that view commercial banks could find their position in the payments landscape reinforced.

So the incumbent banks robustness and resilience in the Covid crisis has pleased regulators, and there are signs that the nature of desirable competition may be under review. But in the long run customer preferences will be decisive. Has their performance paid dividends with customers?

2. Flight to Safety

The key lending support schemes for businesses affected by the covid crisis were backed by governments in various ways. But while that was true, lenders still needed the balance sheet strength to participate in the schemes. For the most part they took the view that, at least in the early stages, they would lend only to existing clients. Performing new 'know your customer' checks was almost impossible in the timescales involved. So businesses which had moved their business to challenger banks or peer to peer lenders faced a problem if those lenders could not extend their facilities rapidly.

Some of the new lenders – Tide is an example in the UK – were able to participate fully in the government schemes, but others had less balance sheet flexibility. There are no reliable data on how many companies were affected by the inability of their principal bank to extend further credit, but there is some anecdotal evidence. Alan McIntyre, head of Accenture's global banking practice, commented, "Part of the fintech challenge is that in times of

uncertainty and stress, traditional banks are seen as a safe haven. This partly reflects a flight to safety, as people hew closer to institutions with long track records that they judge more likely to survive an economic downturn"(9).

How significant has this factor become? Have new competitors in the banking sector in fact lost share to the larger incumbents. The answer is not clearcut. A research note by Jeffries in July 2020 entitled "Will Corona kill the Digital-Only Challenger? (10)", focussing on the UK market, argued that "digital engagement has inflected back into the hands of large incumbents in the era of coronavirus". Their evidence to back this claim showed that the rates at which customers were installing apps from large and small banks had begun to change in 2020. For some time the app share of challenger banks had been rising, but the trend changed in early 2020. The significance of this change of trend is disputed. Starling, a strong digital challenger, said "we simply do not recognise the picture outlined in this report". It may also simply reflect an improvement in the digital offerings of the larger banks, rather than a lack of confidence in the stability of new entrants.

3. Competition

There are signs, however, that the competitive environment for the big banks may have become a little less intense. Some fintechs have struggled in the new landscape. While finance has remained available to fund the growth of the most promising and competitive, the implied equity valuations have fallen when new money has been raised. Some have withdrawn from markets in which they are marginal players. N 26 pulled out of the UK, for example, but the cost advantages of the new entrants which focus on payment services, with up to date technology and without the cost drag of large branch networks, remain strong. Both Monzo and Revolut have continued to grow their customer base, though profitability remains elusive.

And the societal and behavioural changes driven by lockdown restrictions may work to their advantage. Deloitte point out that "as social distancing has taken hold worldwide, there has been tremendous growth in the use of digital services and e-commerce (11)". The footfall in traditional bank branches has necessarily fallen, which may have the effect of reducing brand loyalty in the

medium term. The number of bank branches in the EU fell by over 6% in 2019: the fall is likely to have been sharper in 2020. Deloitte's conclusion, which is plausible, is that "an important outcome of COVID-19 for fintechs may well be the continued acceleration of partnerships with financial institutions, which can offer the benefits of capital, distribution access, and compliance infrastructure, but often lack highly sought-after digital solutions".

Different considerations apply to the Bigtech companies, Apple, Google, Amazon and Facebook in particular. They can hardly be described as financially challenged. Their balance sheets are stronger than those of any major bank, and their market valuations are of a different order. Amazon's market capitalisation in early February 2021 was around $1.7 trillion, compared to JP Morgan's $420 billion.

The challengers and peer to peer lenders who offer credit face a different challenge. They will almost certainly experience a credit environment which will be far more hostile than they have encountered hitherto. I suspect some may be crushed under the wheels of an unforgiving credit cycle. There will be an element of chance in who survives and who does not. Those which had completed a funding round shortly before the crisis hit may well have the resources to ride out the storm. Others, who need more capital to grow (and many are still loss-making) will find new money harder to raise except on terms which may constrain their growth ambitions. Investors in peer to peer lenders have found it difficult to access their cash, with waits of several months at some providers (12). That is likely to constrain growth in the future as investors will be far more reluctant to fund them if they fear their money is locked up. Some have sought wholesale funding to replace the retail funds, which may guarantee short-term survival but will put pressure on margins in the longer run.

A continued shake-out in the challenger bank and peer to peer sectors seems very likely. But will that be enough to alter the competitive dynamics of the European banking sector, and return it to acceptable levels of profitability, with share prices at or above book value?

Are banks now stronger?

Generalisations about the prospects for European banks are hazardous. Some large banks, especially those in Scandinavia, have remained acceptably profitable throughout the last difficult decade. They have achieved low cost-income ratios, maintained strong market positions and innovated successfully and repeatedly. Their reputations have remained strong, too, though in some cases tarnished through money-laundering problems. But, on average, large European banks have found it difficult to earn their cost of capital.

Looking forward, the most decisive influence will be the level and shape of the yield curve. That in turn will be influenced ultimately by the supply of and demand for investment funds. The central banks will not raise rates to rescue the profitability of the banking sector. Negative interest rates will make the problem more severe for banks, as it is both technically and presentationally difficult to charge negative rates to retail customers who have the opportunity to switch money holdings into cash. The ECB has tried to mitigate the impact of very low rates on the banks, with mixed success. They may continue to do so, as may the Bank of England if it also imposes negative rates. In February 2021 they asked the banks to prepare for that eventuality.

When challenged about the viability of the banking sector the ECB typically points to a lack of concentration, and high costs, suggesting that many of the remedies lie in the hands of the banks themselves. In 2016, for example, Mario Draghi said: “Overcapacity in some national banking sectors, and the ensuing intensity of competition, exacerbates this squeeze on margins (13)”. How valid is this argument, and what scope is there for further bank consolidation in Europe?

On a conventional definition, concentration in EU banking seems quite high. On average the top 5 banks per country have 65% of the market as defined by balance sheet size, with the range running from 28 to 97% (14). But the ECB have attempted a more sophisticated analysis to try to determine what we mean by overcapacity in the banking sector, and where it is present.

The research (15) identifies three overlapping definitions of overcapacity. The first is size, measured by bank assets as a percentage of GDP, and as a percentage of the whole financial sector. The second is the intensity of competition. As proxies they use the number of banks per 100,000 inhabitants,

the concentration ratio and also measures of Net Interest Margin and Return on Assets. The third dimension they call "Infrastructure/efficiency" which includes a basket of measures such as the number of people per bank branch, customer deposits per branch and total assets per bank employee. From these three components they construct a composite indicator of overcapacity.

The methodology may be open to criticism, and the composite measure involves a degree of subjective judgement on the weights to be attached to individual factors. But the results are intuitively reasonable. They show that those Scandinavian countries where returns on equity, and price to book ratios, are healthy, show low volumes of overcapacity. At the other end of the European scale Germany, Austria, France and Italy have relatively more overcapacity. As the authors point out, 'the banking systems of these countries are often characterised by the traditionally strong role of savings and cooperative banks, and, thus, a high number of banks, lower degree of concentration and an extensive physical infrastructure".

Where that is the principal reason for overcapacity it is not easy for private sector banks to solve the problem Draghi identified. There are countries where consolidation is possible, and there has been some recent activity in Spain and Italy, but the analysis suggests that different approaches are needed in different countries. In some cases progress can be made through conventional efficiency improvements, such as branch closures. In others exit of some players may be needed. These are controversial and time-consuming changes.

Pre-crisis, the ECB's solution was threefold: reductions in Non-Performing Loans, for those still with high stocks of such loans, in-market consolidation by weak-performing small banks and a combination of bank-level restructuring and cross-border M&A activity for poor performers among the large banks (16). The first option now looks harder to achieve. In-market consolidation is difficult but not impossible and the crisis may give those efforts a boost, as we have seen in some cases. But significant cross-border consolidation looks as far off as ever, for cultural, political and regulatory reasons. In 2018 bank M&A activity in Europe was lower than at any time this century (17). Andrea Enria, the Chairman of the ECB's Supervisory Board, has acknowledged that countries are still ringfencing liquidity and capital at the national level, which means that limited benefits emerge from operating across borders.

Conclusions

One conclusion from this review might be that nothing fundamental has changed.

Banks with high costs and weak positions in slow-growing markets remain as challenged as before. Indeed the likely resurgence of NPLs, which had been declining for several years, will make their dilemma sharper.

The interest rate prospect, from a bank's perspective at least, has become even more pessimistic. The prospect of strongly positive real interest rates has retreated further into the future.

The attractiveness of new digital competitors in the payments arena, unburdened by the legacy costs of unwieldy technology stacks, remains strong.

But that conclusion does require some qualification. Politicians and regulators have seen that the financial re-regulation they oversaw since 2008 has indeed delivered a banking sector which is robust, even in a sudden and unparalleled economic crisis delivered by the pandemic. Over time, that will reduce the pressure for ever higher capital ratios, which were in prospect before the crisis hit. They have seen that strong bank balance sheets are a highly valuable asset at times when the private sector needs credit and liquidity support on a massive scale, and that bank systems can deliver sharply higher volumes of activity very quickly. As a result, the reputation of banks, and trust in bankers, have risen, after a long period in which the latter were languishing near the bottom of the trust league, along with politicians and journalists. That reputational benefit does not translate into an enhanced return on equity in the short term but it will have a value over time.

We have also seen that non-bank credit provision can have fragile foundations, causing some business customers to appreciate the value of a solid banking relationship more. That may also translate into business opportunities in the longer run.

But the pressures on banks to reduce cost income ratios, to focus on business areas where they have a defensible market position, to control NPLs and to upgrade their technology to compete effectively with new competitors will remain intense. Covid is not going to offer the banks a 'get out of gaol card' but some of the more fanciful predictions of the death of banking may

need to be revised. In 1997 Bill Gates said "We need banking. We don't need banks any more"(19). It is fortunate for the global economy that this is one of his predictions which did not come true.

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