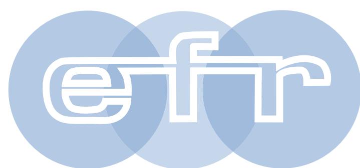
European Financial Services Round Table

April 2022

EFR PAPER: ENSURING COMPETITIVENESS OF THE EUROPEAN FINANCIAL SECTOR

Background

When it was first launched in 2015, the Capital Markets Union (CMU) initiative was grounded on the need to change the European economy's financing model by giving financial markets a bigger role, taking into account the increasing restrictions that the reinforcement of the prudential framework was imposing on bank lending. This objective to build deeper and more integrated EU financial markets remains all the more valid at a time when the Union faces ever growing financing needs to ensure the decarbonisation and digital transformation of its economy. The European Commission (EC) recently evaluated the additional investments needed to reach the EU's 2030 climate and environmental policy goals at EUR 470 bn per year, and the EU's needs to pursue the digital transformation of its economy at EUR 125 bn.

Still, two major shocks have renewed the importance of fostering the development of the EU's financial markets:

- following the departure of the UK from the EU, the most significant European pool of financial market expertise and resources now sits outside it. The financial services ecosystem remains vital to the functioning of the European economy, and policymakers must consider the way their markets operate with external locations as well as building capacity within the single market,
- the Covid-19 crisis has deeply affected EU-27 economies and caused a surge of the indebtedness of companies and states, further confirming the need for the EU to develop its market-based financing capacity. More than anything, it has revealed the need for the EU to regain autonomy in strategic areas, finance undoubtedly being one of these.

With this in mind, EFR strongly supports the EU's ambition to pursue a model of open strategic autonomy for the development of its financial markets. "Open", as excessive fragmentation would isolate EU financial markets and limit their ability to serve the needs of EU economies. "Strategic", as the ability of the EU to reach its green transition, digital transformation and social justice objectives are conditional on the availability of sufficient financing resources. "Autonomy", as the EU must control enough of such resources independently to preserve its sovereignty.

EFR Members strongly believe that the achievement of such open strategic autonomy in the area of financial markets requires ensuring the attractiveness of EU financial markets and the competitiveness of EU financial market participants remains a cornerstone of the EU's financial strategy. It should also be underlined that these attractiveness and competitiveness considerations need to be integrated into every aspect of the legislative work of the Union in relation to financial markets to account for the diverse needs of EU investors and corporate companies, to raise capital (equity listing, private equity, bonds, etc.), invest (funds, structured products) and hedge risks (OTC derivatives). These concepts have not always been given sufficient weight in the design of regulation adopted in recent years.

Competitiveness in the digital space

As the EFR has stated over the last few years, the economy is becoming more digital than ever, and Europe needs the right public policies to catalyse innovation and build on them so that its economy remains competitive and ready for the critical challenges ahead.

The European Commission is already building the required foundation with its Digital Finance package, as well as with the initiatives stemming from the cross-sectoral Digital Strategy, such as the Data Governance Act (DGA), the Digital Markets Act (DMA), the Artificial Intelligence Act and the upcoming Data Act. All these initiatives are intended to make markets more competitive, empower users and open up more opportunities for European firms on a global scale.

In this context, and as fundamental pillars of the economy and key actors in the European strategic autonomy, financial institutions must also be able to digitise themselves and compete fairly in digital markets. Both objectives require a regulatory framework that:

- is consistent at international level: as the EU financial sector is part of a globally interconnected market, this is critical for maintaining financial stability and protecting end users, as well as for addressing gaps in supervision across jurisdictions that could create systemic vulnerabilities.
- ensures fair competition among financial institutions as well as with new players: in particular, we support the EC´s work to address the imbalances in the digital economy that arise with the gatekeeper role of the big online platforms.
- reduces the burden for the non-core business of regulated entities: the regulatory framework should consider how to limit the negative implications of prudential consolidation, advancing towards more activity and risk-based regulation – consistently applying the principle of "same activities, same risks, same rules".
- adequately regulate new entrants: including new players in the regulatory and supervisory perimeter is an important step towards enforcing the above-mentioned principle, applying, for example, the same AML / CFT[1] supervision to BigTech and FinTechs that offer financial services or considering a holistic entity-based regulation for non-banks, such as BigTechs, entering financial services.

Going forward, the competitiveness of the financial sector will also significantly depend on being able to:

- fully reap the benefits of valuable data exchanges and flows amongst all actors within a clearly articulated framework. This is already an important part of the EC EU´s strategic digital and data agenda, although they might fall short of the ideal end goal. For that reason, the EC needs to address the challenges ahead by putting an ambitious horizontal framework in place to facilitate cross-sectoral data sharing with specific sectoral add-ons where needed.
- facilitate the uptake of technologies and digital innovation. The use of cloud or AI and of the different digital infrastructures like payments or Distributed Ledger Technology (DLT) and being at the forefront of initiatives like digital identity are at the core of the evolving business models of financial institutions.
- ensure that crypto-assets don't disturb financial markets. There needs to be clear and consistent rules for crypto-asset services so as to enable banks to be part of the development of these markets and contribute to a level playing field among different players. This would also require a prudential treatment of bank exposures to crypto assets that is proportional to their risks and enables banks which want to be involved to compete in these new markets.

This has to be done in a way that guarantees that the entire digital financial ecosystem is resilient, secure and trustworthy. This applies to all actors in the financial services value chain, including third-party providers that should be equally committed to existing obligations and be supervised. In this regard, the EFR strongly supports the development of a robust EU digital operational resilience framework by the EC and particularly welcomes the initiatives around cyber security (i.e. through the Digital Operational Resilience Act for financial services).

EU Competitiveness and sustainable finance

The development of a robust sustainable finance framework is critical to finance the massive public and private investments[2] needed to re-orient the economy onto a sustainable and competitive pathway. Europe leads other jurisdictions in this effort and the EFR strongly supports EU leadership in the development of internationally-designed standards. The EFR also welcomes the objectives set by the EC in its Renewed Sustainable Finance Strategy, in particular the enhanced emphasis on better recognising transition financing in the EU Taxonomy and its ambition for international coordination.

The EU Taxonomy is a building block of the EU sustainable finance framework. It provides very detailed, scientific based definitions for sustainable economic activities, protects private investors against greenwashing, and supports companies as they plan their green transition. The Taxonomy, however, is still very much a work in progress and there is a risk, in our view, that the current design of the Taxonomy could be construed as a binary tool, one that market participants may use to steer financing away from non-taxonomy aligned economic activities. However, not-yet green activities constitute most of the economy today and are most in need of financing to enable their transition to carbon neutrality. For this reason, the EFR welcomes the EC's intention to consider options to extend the Taxonomy to recognise transition efforts. Besides, regulations can help, but the transition to a sustainable economy requires much more: green investments and projects are crucial and far from sufficient today.

[1] Anti-Money Laundering / Combating the Financing of Terrorism

[2] The EC estimates that Europe will need EUR 470 bn in additional investment annually over this decade to meet its 2030 environmental goals and, globally, a GFMA report has estimated the funding need at USD 100 tn - USD 150 tn over the next three decades to support the decarbonisation of ten sectors representing 75% of global carbon emissions.

As global financial firms, EFR members are keenly aware that achieving global convergence among taxonomies and sustainability reporting standards under development in different jurisdictions will be essential to maintaining Europe's leadership and competitiveness in sustainable finance. Although the EU Taxonomy disclosure requirements have a role in reaching the Paris climate objectives, greater consistency at the global level will be necessary to define what is sustainable across various jurisdictions. While Europe has taken the lead in developing a sustainable finance framework, climate change is a global challenge and financial markets are also global, so it will be essential to achieve common ground and convergence of taxonomies and disclosure regimes at international level in order to enable global capital flows and ensure a level playing field for European companies. We appreciate the EU's leading role at international level and urge the EU to work closely with international authorities and standard setters in defining the sustainable finance framework and thereby encourage global alignment and co-creation of sustainable finance standards to avoid market fragmentation.

Unlevel playing field with respect to Solvency II

Solvency II is globally the most modern and risk-sensitive framework for insurance supervision and has worked well, particularly through the pandemic crisis. However, past crises have shown that the current framework can also bring undue market volatility for the solvency measurement of EU insurers, particularly with respect to long-term insurance business. The framework needs further adaptation to better reflect the economics and specific risks of a long-term business model. Artificial volatility of available capital forces insurers to hold artificially increased levels of capital in order to comply with regulatory capital requirements at all times. Since long-term business is particularly sensitive to artificial volatility, getting it wrong has the potential to reduce the contribution of insurers to long-term financing of a green recovery of the EU.

Any increase in regulatory capital requirements would further raise capital costs for EU headquartered groups, impeding their external growth capacity to compete with non-EU players. This relates both to direct impact from artificial volatility, increasing actual capital requirements, as well as new proposals for potential supervisory intervention before a breach of the SCR. Both effects would result in an ineffective use of available capital and a decline in relative attractiveness of the EU insurance sector for global investors and, as such, may cause difficulties in providing the resources that would help the EU's goals in terms of the capital markets union, green recovery and wellbeing of people in general.

Unlevel playing field with respect to European Banks

One of the key messages of the EFR has always been that internationally operating financial groups based in the EU benefit from global standards that provide added value to their customers through efficiency gains and increased competition as a result of an international level playing field. It is furthermore important that the EU should ensure that measures taken in the EU do not create global competitive disadvantages for the European financial sector.

At the presentation of the Banking Package 2021 on 27 October 2021, both EVP Dombrovskis and Commissioner McGuinness stressed that *Europe needs a strong banking sector to keep lending to the economy as we recover from the COVID-19 pandemic and that banks have an essential role to play in the recovery.* In the proposals of the Banking package, it is stated that, *thanks to the globally adopted rules in the aftermath of the financial crisis, EU banks remained resilient during the COVID-19 crisis, as evidenced by the fact that they continued lending. The proposed reforms aim to complete the post-financial crisis agenda with a view to substantially boosting the competitiveness and sustainability of the EU's banking sector.*

The EFR welcomes the aim to boost the competitiveness of the EU banking sector, since the current reality is a different one. The global market share of EU banks has been declining over the years, which is also due to regulatory and policy measures taken by EU institutions. While the financial crisis rightfully prompted structural reform and new regulatory measures, the financial regulation was heavily focused on risk and less so on growth.

The graphs in the Annex show how the competitiveness of European banks has been under stress over the last few years.

They notably illustrate how:

- The "fully phased-in" level of the Basel III framework clearly induces a significant distortion between European and US banks, to the detriment of the former;
- EU banks face continuing pressure on interest margins, as eurozone banks continue to suffer from the negative rates environment. Additionally, EU banks face an increasing competition from US CIBs, that can rely on a deeper, more profitable and more concentrated domestic market;
- The development and current supremacy of US banks in market activities was enabled by the fact that - contrary to Europe - the US constitutes a unified legal, regulatory, fiscal and, in some areas, infrastructure framework. Critical US reforms undertaken in the 70s and the 80s have enabled the consolidation of banks and the emergence of champions in the Corporate & Investment Banking (CIB) area;
- In relative terms, US banks have seen their European business grow very quickly.

EFR recommendations

- It is crucial that the recent European reform proposals ensure level playing fields (in the implementation of Basel III as well as in the on-going review of Solvency II for instance), foster the deepening of EU financial markets (CMU initiative, securitisation market, etc.) and enable to keep significant European players that need to be enhanced rather than weakened by an excessive regulation and an efficient deployment of the available capital in the markets. In particular, the Solvency II review can support the latter while improving the global competitiveness of European insurers. The Banking Union should also be completed in order to allow banks greater freedom to utilise their capital and liquidity more efficiently and optimise their ability to use their balance sheets to support their customers across EU markets.
- European authorities should effectively take the elements of attractiveness and competitiveness into account in their regulatory and supervisory work. This would for instance imply:
  - ensuring that, for each envisaged evolution of the regulatory framework, the impact on the attractiveness of EU capital markets and on the competitiveness of EU market participants is systematically assessed, alongside the current assessments of the impact on investor protection, financial stability and market integrity. To ensure that competing priorities are managed properly, a Do Not Significantly Harm (DNSH) principle could be applied, by reference to the principle applied for the green transition. It should be recalled that the European Economic and Social Committee proposed such a test in its answer to the CMU action plan.
  - adding the consideration of attractiveness and competitiveness as a secondary statutory objective for selected European authorities (first and foremost the European Supervisory Authorities). It is noted that this approach is currently being proposed in the UK, for the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), in the consultation on the Regulatory Framework Reform.
- In order to enable the Digital Transformation of the financial services industry, the EU authorities need to ensure that the regulatory framework for EU financial services is consistent at international level, ensures fair competition, reduces the prudential burden for the non-core business of regulated entities and adequately regulates new entrants.
- Additionally, in the wider digital context, the EU should enable its financial sector to reap the benefits of a horizontal data sharing framework and easily take up new technologies and develop digital innovations (AI, cloud, DLT, crypto assets). This should be done through a robust EU digital operational resilience framework (DORA).

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

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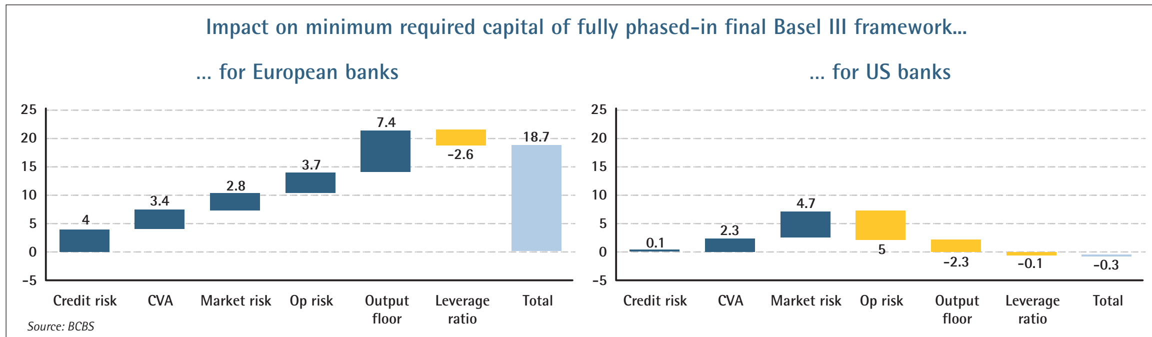
ANNEX

1. Basel III

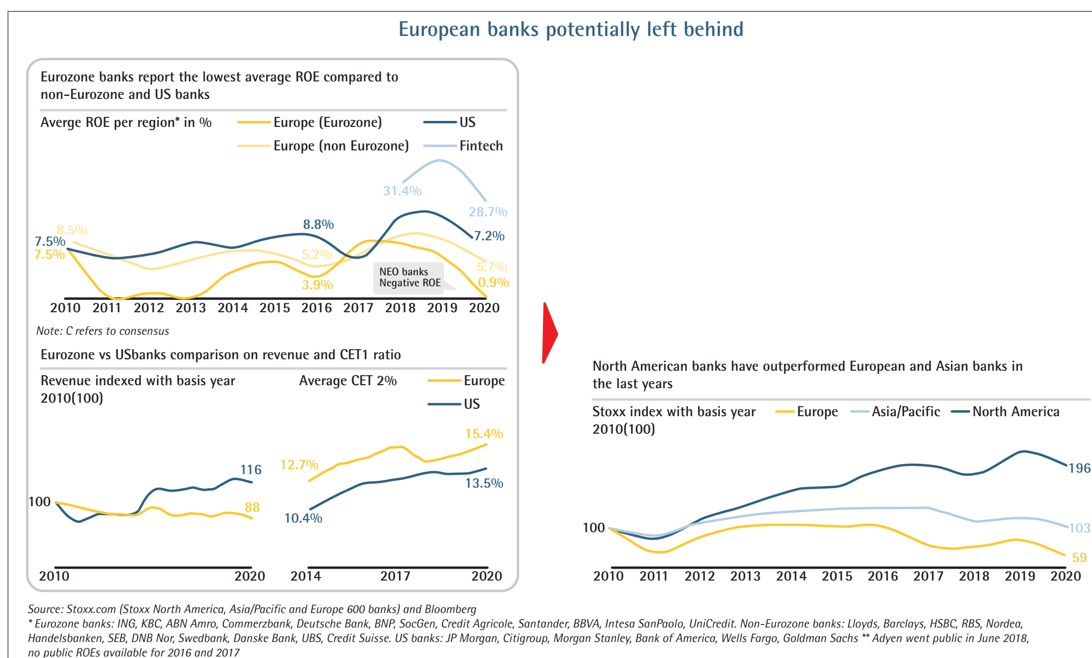
The “fully phased-in” level of the Basel III framework clearly induces a significant distortion between European and US banks, to the detriment of the former.



It is noticeable that the stronger requirements imposed on European banks are not linked to lower levels of capital that would need to be corrected (see for instance BCBS Basel III Monitoring Report, December 2020, page 26), but rather to the difference in the structure of balance sheets: compared to US banks, which benefit from a deep (and government-supported) securitisation market. European banks keep large pools of low-risk assets in their balance sheet, which are penalised under the “fully phased-in” Basel rules. It should also be noted that FRTB (Fundamental Review of the Trading Book) rules favour more developed capital markets, and hence thwart the ambition to develop the market activities of European banks.

2. Revenues & market share

European banking profits have been under significant and increasing pressure since the global financial crisis. Negative interest rates and muted lending demand have a material impact on the Net Interest Income of European banks. EU banks face continuing pressure on interest margins, as eurozone banks continue to suffer from the negative rates environment. TLTRO and Tiering provide some relief but do only offset the negative consequences of the low and negative rate environment to a limited extent. Additionally, EU banks face an increasing competition from US CIBs, that can rely on a deeper and more concentrated domestic market. In that context, the weighted average RoE of European banks over the last decade did not surpass the 5% hurdle. The graphs below show how the EU banking sector falls behind on aggregate compared to US peers.



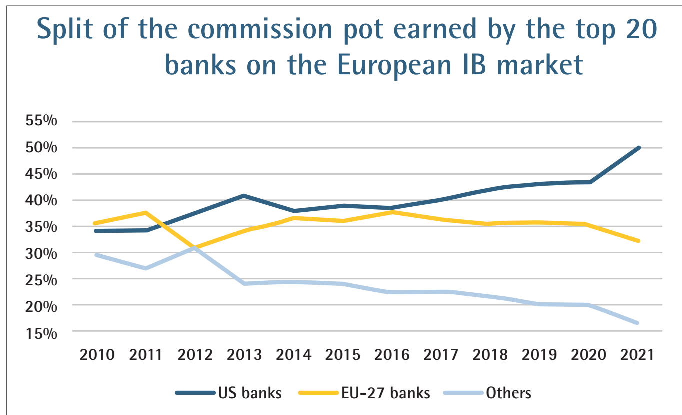
Source: Stoxx.com (Stoxx North America, Asia/Pacific and Europe 600 banks) and Bloomberg
** Eurozone banks: ING, KBC, ABN Amro, Commerzbank, Deutsche Bank, BNP, SocGen, Credit Agricole, Santander, BBVA, Intesa SanPaolo, UniCredit. Non-Eurozone banks: Lloyds, Barclays, HSBC, RBS, Nordea, Handelsbanken, SEB, DNB Nor, Swedbank, Danske Bank, UBS, Credit Suisse. US banks: JP Morgan, Citigroup, Morgan Stanley, Bank of America, Wells Fargo, Goldman Sachs ** Adyen went public in June 2018, no public ROEs available for 2016 and 2017*

Furthermore, with regard to revenues and market shares, it is important to understand the conditions that have enabled the development and current supremacy of US banks in market activities. Contrary to Europe, the US constitutes a unified legal, regulatory, fiscal and, in some areas, infrastructure framework. Critical US reforms undertaken in the 70s and the 80s have enabled the consolidation of banks and the emergence of champions in the Corporate & Investment Banking (CIB) area, that was also supported by a strong public involvement in selected domains (securitisation and lending to SMEs), the depth of the securitisation market and the consistency of the pension funds ecosystem.

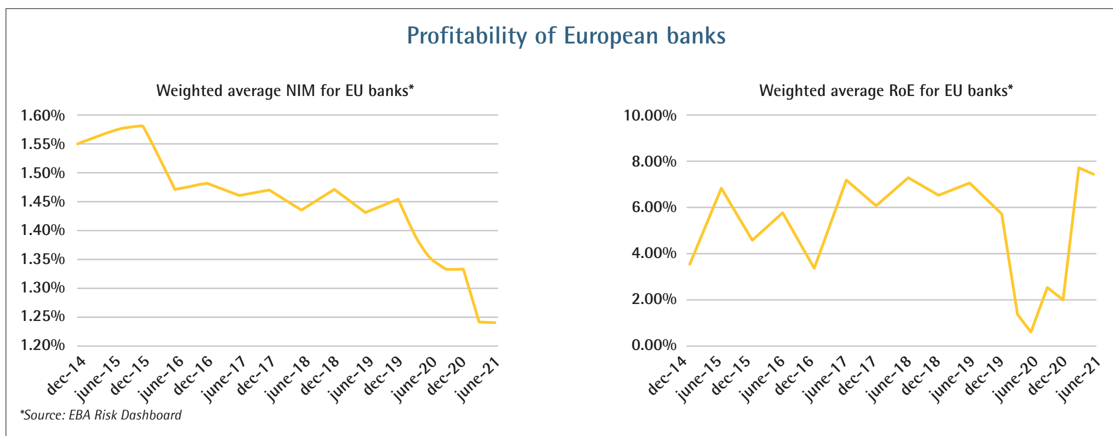
- **The market share of the different banks in the Investment Banking market in Europe have followed diverging paths** (in the geographical sense EMEA: EU-27 + UK + Switzerland + Middle East and Africa, IB market being DCM, ECM, M&As and syndicated loans)

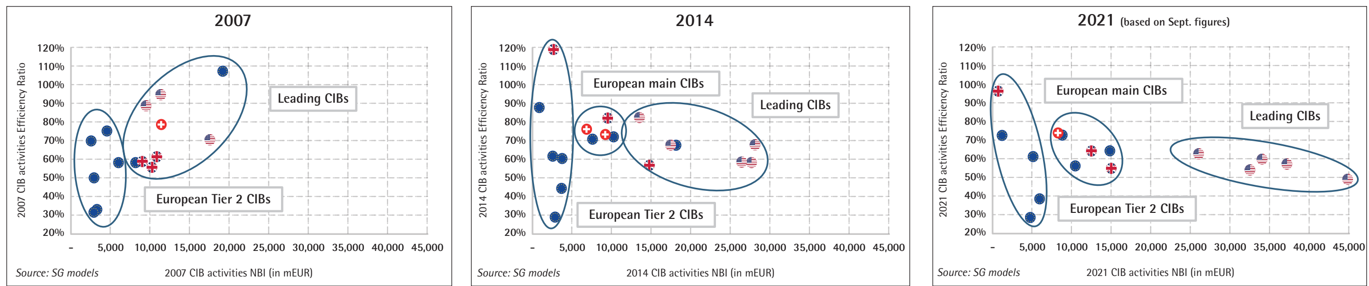
According to the Refinitiv league tables, the market share of US banks has grown very significantly since 2010, first on the back of the weakening of other non-EU-27 banks, and more recently to the detriment of EU-27 banks.

It is notable that this market share gain accelerated in 2021. The return to better fortunes of European institutions hides the fact that, in relative terms, US banks have seen their European business grow very quickly.



- **The profitability indicators of European and US banks, both globally and limited to the CIB activities, clearly show the stall of the former.**





The vision here is global, not limited to the scope of European activities. This graph shows the stalling of European banks compared to US banks quite well.

This is due to a narrower, less profitable and highly competitive "domestic" market, a US market organised to the benefit of US banks, and an unfavourable prudential development for European banks compared to US banks, following a more brutal impact of the 2008 crisis for the latter.