KEY POINTS

- Since the Global Financial Crisis (GFC), significant steps have been undertaken to strengthen the EU's banking regulatory framework. The strength of the EU banking system has allowed banks to weather the cataclysmic impact of the COVID-19 crisis relatively undamaged. Banks helped backstop the economy, leveraging fiscal support measures of unprecedented scale and the accommodative monetary policy regime of the last decade.
- Despite its strength, the EU banking sector today is not earning its cost of capital, while US competitors have returned to pre-crisis profitability levels. This has been driven by an economic environment of comparably poor growth in the Eurozone, late policy responses to the Eurozone debt crisis, high fragmentation, lack of scale in a context of rising minimum cost of doing business, and a long period of negative interest rates that depressed banks' earnings in a period where they had to strengthen capital buffers.
- Today, there are still structural obstacles to bank consolidation across the Eurozone, preventing banks from realising synergies across markets. The Banking Union will remain incomplete for the foreseeable future. Political and regulatory restrictions remain that prevent the emergence of universal bank business models spanning across borders, in particular requirements that impede liquidity transfers within the Banking Union.
- Furthermore, the EU's capital market union remains underdeveloped, preventing the creation of a securitisation market. Persisting market fragmentation, due to the lack of convergence of insolvency rules among other issues, hampers cross-border investment within the EU and dampens funding from outside. This happens at a time when more financing, including equity, is needed to overcome geopolitical, environmental, and digitalisation challenges.
- Despite a globally coordinated "level playing field," differences remain across economies in how rules effectively work and how they are implemented. The incremental difference in regulatory-induced cost at EU banks compared to US peers can explain 0.8-1.0 percentage points of the return on equity (RoE) gap.
- The EU's approach to determine capital requirements is more complex, gives regulators wider discretion and might be perceived as being less transparent. The resulting uncertainty is one of the reasons that EU banks tend, on average, to hold surplus capital. Additionally, on average and considering that samples are not directly comparable given differences in business models and market structure, EU banks face higher capital requirements than US peers: 10.6% versus 9.9% for Common Equity Tier 1. In addition, future requirements related to the full implementation of Basel III and climate-related capital surcharges are expected to penalise EU to a larger extent than US banks.
- Further, EU banks face almost twice as high contributions to deposit and resolution funds at EU and member-state level compared to US peers, while requirements on bail in capacity are 3.9 percentage points higher than in the US. Despite a gradually mutualised safety net, cross-border access to the European market remains limited for EU banking players.
- A review of current capital requirements and supervisory processes could, in a hypothetical scenario, provide capacity for EUR 4-4.5 trillion additional bank lending, provided that policies and measures are put in place to ensure that viable borrowers have growth opportunities that support additional borrowing demand. Additional lending could also support the financing of the green and digital transitions, and more generally investments in strengthening the competitiveness of the EU economy. Further, this would create additional opportunities for investment in areas such as consolidation and digitisation.

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CALL TO ACTION

- Policymakers should redouble their efforts to complete the banking and capital markets unions. They should also simplify the current complex and costly resolution regime.
- Supervisors should place greater emphasis on streamlining and making more efficient key processes (such as the Supervisory Review and Evaluation Process or stress testing) and be more vigilant on breaches of the level playing field in EU countries. As Basel III is fully implemented, authorities must ensure that EU banks do not have a disadvantage on the global playing field.
- For their part, banks should sustain their focus on improving operational efficiency and digitisation. They should position themselves for a long-expected process of consolidation in the Eurozone that will also foster better allocation of resources across EU borders. They also must recognize that a level playing field is a legal requirement in the EU.

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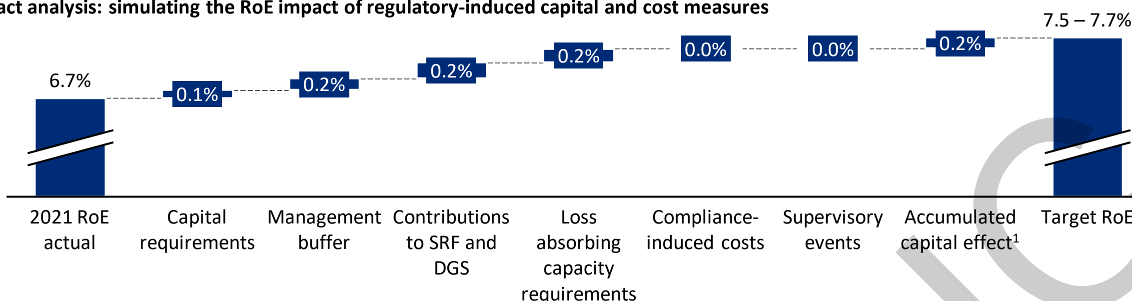
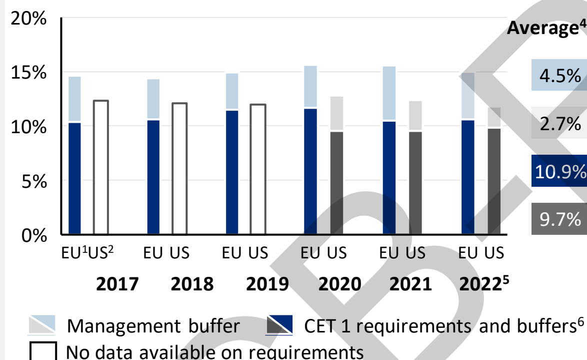
SELECTED EXHIBITS

The difference in regulatory-induced cost at EU banks explains 0.8-1.0 p.p. of RoE gap compared to US peers



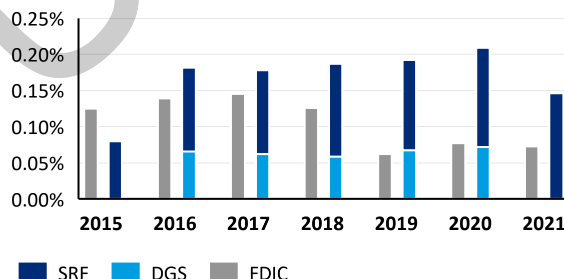
1. Refers to the effect of incorporating all capital impacts jointly
Source: Oliver Wyman Analysis, ECB, Fedc

EU banks engage in more restrictive capital management due to supervisory restrictions and expectations, uncertainty regarding capital requirements, and limited ability to raise capital



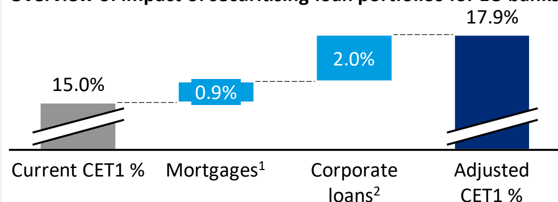
Notes: 1. Banks participating in SREP; 2. US large banks participating in DFA Stress Test; 4. Average over the period 2020-2022; 5. Latest available (2022 Q1); 6. SREP results reported as a simple average
Source: ECB, DFA Stress Test Results, SREP

EU banks face twice as high contributions to safety net infrastructure and requirements on bail-in capacity are 3.6 p.p. higher than in the US



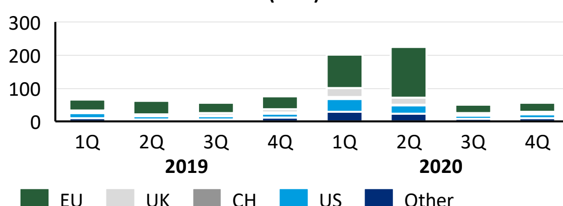
Note: Data on DGS contributions not available for 2015 and 2021. DGS contributions calculated as difference in fund assets
Source: EBA; SRM ex-ante contribution calculation; Annual reports SRF and FDIC, ECB Supervisory Banking statistics

Leveraging securitization would have a significant impact on EU bank's balance sheet and on the economy



Source: ECB, Supervisory banking statistics, 2022Q1
Note: assumes no tranches are retained and 50% of the mortgage and corporate book (RWA density of 20% and of 45%) is securitised

For broader economic policy and resiliency considerations, it is critical for the EU to have a strong banking sector focused on the region



Source: Dealogic

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