SCOPE

Loosening regulatory capital requirements would be a dis-service to European banks

Sam Theodore | February 2023

Emboldened by reassuring financial and business fundamentals – about to be confirmed by Q4 results – large European banks are dusting off the old lobbying narrative that post-GFC regulations and supervision have placed them in a less competitive position than their US counterparts. Specifically, by forcing them to operate with lower profitability and needlessly stringent capital requirements.

I disagree with this view, especially considering the crucial role the new regulatory architecture has played and continues to play in restoring and preserving market confidence in the banking sector. Loosening it at this stage is an unnecessary and risky step, liable to make the sector more vulnerable to the ghosts of market uncertainty, distrust, and fear.

In the foreword to a 53-page reference study on the impact of regulations on EU banks published by Oliver Wyman, the European Banking Federation (EBF)[1], which commissioned it, notes that regulations have *"a direct impact on the banking sector's ability to support the real economy … When setting the regulatory agenda, authorities should closely consider the costs for financial institutions and the impact they will have on clients and more broadly on Europe's economic growth"*.

Using an extensive and in-depth comparison of the EU banking sector with its US counterpart, the report concludes that, partly because of constraining regulations and supervision, the profitability of EU banks remains consistently lower than that of US banks, failing to cover the cost of capital. Consequently, EU banks have market values below book values and are at a competitive disadvantage in global funding markets. The report also states that structural obstacles within the EU prevent cross-border bank consolidation and ensuing synergies, unlike the high degree of consolidation in the US banking sector.

Equally highlighted is the little progress so far in achieving an EU Capital Markets Union, which would be helped by the return of a securitisation market; a trigger of higher bank profits like in the US. The report criticises the EU's approach to bank capital requirements as more complex and burdensome and less transparent than the process in the US.

The report's key points are that revisiting EU regulatory capital requirements and supervisory processes could provide an EUR 4trn-EUR 4.5trn in additional bank lending capacity for financing the green and digital transition and generally contributing to the heightened competitiveness of the EU economy. It also believes that 0.8%-1% of the ROE gap between EU and US banks can be explained by the difference in regulatory capital requirements.

This suggests that if regulatory capital requirements in the EU (although the report focuses primarily on the Euro Area) were adjusted to the US model, they would make banks more profitable and create better capacity to provide additional lending, including green finance.

I disagree. My view is that the current regulatory framework in the Euro Area and the wider EU is a factor of strength for the sector, not an impediment.

[1] The EBF unites 33 national banking associations in Europe representing ca. 3,500 banks.

With respect to profitability, the main areas of distinction between large EU and US banks – and for banks in different EU countries for that matter – relate to different market evolution, traditions and structures, different social and political dynamics, and significant variations in business models.

Regarding EU banks' aim to provide more green and digital finance and generally more lending to the real economy, the most straightforward avenue is to adjust lending strategies towards these goals. Bank supervisors already demand this. Most banks, supported by adequate levels of capital, have the necessary capacity to do it. Not operate with reduced capital levels, which would worsen their risk profile and make new lending more problematic. Historically, banks with borderline capital levels have been inherently more hesitant than better capitalised competitors to expand their lending, fearing that even a modest rise in provisions could endanger their capital position.

When presenting the virtues of the US market-based banking system compared to the EU, it is worth remembering that the two major bank-triggered financial crises of the last half-century – the S&L crisis of the late 1980s and the GFC of 2007-2009 – originated in the US, only to spread like wildfire into Europe and beyond through a poorly regulated global financial system.

EU vs US banks: five areas for consideration

1 When comparing EU and US banks in relation to global funding competitiveness, the perimeter of assessment is uneven. Even if the Oliver Wyman report refers to a 34-bank aggregate, the lion's share of bank debt issuance in the US belongs to the three global universal banks (JP Morgan Chase, Bank of America, and Citigroup); one large institution with a more traditional retail and commercial banking franchise (Wells Fargo); and two global investment banks (Goldman Sachs and Morgan Stanley). The latter two have a revenue structure quite different to the universal or retail banks. Most other significant US banks have a mostly domestic focus and issue far less internationally.

For the EU, the report uses a 110-bank aggregate – three times larger than for the US. Importantly, within this aggregate there are 20-25 large EU banks that have a material cross-border presence, and which routinely access funding in international markets. This detail is important when trying to understand like-for-like comparisons.

2 In aggregate, Western European banks have a penetration of the bankable population of more than 95%. By contrast, nearly 25% of households in the US are either unbanked or underbanked, according to the Fed. This means that certain categories of basic bank-account holders do not have access to a normal range of products and services due to high levels of banking fees that keep them at bay.

Banks refer to a Pareto Law-type situation of 80%-90% of retail/SME revenues being generated by the top 10%-20% of retail/SME customers. Under this scenario, broader penetration translates into comparatively lower profitability.

There are categories of low-income bank customers in the EU who may not pass muster with the large banking groups in the US. For decades, analysts have been referring to the relationship culture of many European banks vs. the transactional culture of their large US counterparts. At the risk of simplifying, this cultural difference remains in place.

3 There are significant differences in the balance-sheet mix of EU and US banks – highlighted in the Oliver Wyman report – which contribute to variations in profitability. Most visibly, mortgages originated by banks in the US are largely securitised, primarily via the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac. Low-risk but also low-yield assets are thus flushed out of the originating banks' balance sheets, removing an important component of low profitability.

This is not the case for EU banks, many of which fund their mortgages with covered bonds hence retain both the asset and the liability on the balance sheet. EU securitisation volumes have fallen dramatically in recent years.

The EU covered bond system is quite elaborate and performs its main function of refinancing residential mortgages. Over recent decades, there have been various attempts to establish GSE-like bodies in EU jurisdictions but the conclusion has always been that what was needed is to improve and broaden the existing covered-bond system – the EU Covered Bond Harmonisation Directive is a step in this direction – not replace it.

It is highly unlikely this will materially change, even when an EU Capital Markets Union finally emerges. If anything, more countries outside the EU – even in the Americas – have adopted the covered-bond funding model rather than the GSE-like securitisation system. This means that the low-risk/low-return mortgage component of EU bank assets will remain in place for the foreseeable future.

The Oliver Wyman report notes that the European securitisation market (including the UK) is only 6% of the size of its US counterpart. This low percentage could gradually rise over the years. The financial sector has been lobbying the European Commission hard to soften the more conservative elements of the current EU securitisation law.

Even if they succeed, the EU will not get anywhere near the 50% mortgage-portfolio securitisation hypothesis highlighted in the report. Not with a mature covered-bond market in place. And, again, the US securitisation market would not be nearly as ample as it is without direct government support via the GSEs.

EU banks are the main lenders to regional and municipal governments – another category of relatively lower-risk/low-return credits – whereas the US has a large and diversified market of tax-driven municipal bonds. As for sovereign bonds, they will continue to represent a significant component of EU banks' liquid assets. This also is not likely to change, despite regulators' valiant efforts to delink bank and sovereign risks – especially as the ECB and other central banks will no longer be the main buyers in this segment.

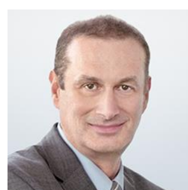
4 The EU market remains heavily bank-intermediated not only on the credit side but also with respect to savings. Directly or through subsidiaries, the large banks continue to have the lion's share of savings, much of it in saving deposits offering customers higher yields than current accounts. This in turn contributes to narrower net interest margins than zero-rate deposits, especially as rates are now rising.

In contrast, the savings market is far more diversified in the US, and significantly more disintermediated from banks. On balance, US bank have a higher base of demand deposits funding part of their assets. This suggests that the so-called endowment effect of rising rates – especially when low-yielding fixed-rate assets like housing loans are flushed out via securitisation – is more favourable for US banks than for EU banks.

5 The report rightly points to banking system fragmentation, much deeper in the EU than in the US. Hence, from a cost perspective, European banks display lower economies of scale and less capacity to invest in digital transformation. But this structural weakness can be more easily addressed through partnerships en route to digitalisation i.e. with other banks, fintechs, and big techs rather than pan-European M&A which is economically problematic (as the Oliver Wyman report admits).

It hardly needs mentioning that Single Market aside, the EU is a community of sovereign States so it is and will remain structurally different from the US – institutionally, legally, socially, and politically. Extreme populism, say, in Florida or Texas, would not threaten legal and institutional cohesiveness in the US the way hypothetical extreme populism in, say, Italy, Spain, or France could potentially hurt the structure and viability of the EU. We should expect national bank champions to continue to exist, rather than pan-European "sea to shining sea" transborder megabanks.

Analyst



Sam Theodore
Senior Consultant
Scope Group
+44 (0)7769 321043
s.theodore@scopeinsights.com

This report is published by Scope Group.
The Content is an independent view not related to Scope's credit ratings.

Scope SE & Co. KGaA

Lennéstraße 5
D-10785 Berlin
scopegroup.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scopegroup.com

Bloomberg: RESP SCOP

Contact Details

scopegroup.com/contact

Disclaimer

© 2023 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, Scope Innovation Lab GmbH, Scope ESG Analysis GmbH and Scope Hamburg GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin.