



Banking between two crises



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ABSTRACT

The pandemic may prove to have the same effect on the financial sector as on the EU as a whole – it will accelerate integration. As the EU is proposing to double its budget, so may the crisis help to create a truly European financial market. The EU’s reaction will create spill-overs in other fields and allow the EU to take centre stage in financial markets, ensuring that many well-known obstacles will finally be tackled. But the crisis has also revealed that further competition is coming to one very crucial function of banks: payments.

Banks never switched from their defensive mode after the financial crisis. A huge and seemingly never-ending wave of financial sector regulation was rolled out over the last decade, with key implementation deadlines each year. The final element, the famous ‘output floors’ for the use of internal models, was ready for proposal in March but delayed due to the outbreak of Covid-19. A new supervisory structure was created with the ECB in charge, although important levers at the regulatory level remain with the member states, such as the decision on capital buffers.

Banks entered the crisis in a much better position than in 2008. According to the EBA data, the level of capital on a risk-weighted basis has doubled, under a much tighter definition of capital. There are interesting differences in the EU between banks from richer and poorer countries (in GDP terms), with the former having lower levels of capital on average. This shows that the sovereign bank nexus is still in place. But the profitability of banks and the



levels of market capitalisation are low and a reason for concern, as they condition banks' capacity to raise capital. And with a low interest rate environment here to stay for even longer, this situation is not expected to change soon.

The ECB's response

The ECB, as banking supervisor, reacted rapidly to the crisis, through the alleviation of capital and liquidity buffers, as the SSM announced on March 12th at the start of the lockdown in most EU countries. It has introduced supervisory flexibility regarding the treatment of non-performing loans (NPLs), in particular to allow banks to fully benefit from guarantees and moratoria put in place by governments. On March 27th the ECB also recommended that banks should not pay out dividends, which is still a bone of contention as it further reduced the attractiveness of bank shares for investors. This was followed up by a formal recommendation of the ESRB on June 8th.

The ECB as monetary policy actor also reacted rapidly, with additional huge liquidity provisioning to the banks to keep the economy going. On March 18th the ECB announced the Pandemic Emergency Purchase Programme (PEPP) of €750 bn. The ECB expanded eligible assets to non-financial commercial paper as collateral for these operations, easing the liquidity constraints of banks. This was boosted with €600 bn on June 4th. The problem here is that European firms rely much less on market finance than in the US, which makes it more difficult for the ECB to directly facilitate financing. The euro-denominated corporate commercial paper market stands at about €75 bn (ECB data), which is a fraction of the about \$300 bn equivalent in the US.

Another element of the crisis response is the swap lines between central banks to maintain liquidity in local currency market and reduce currency volatility. The immense market sell-off in early March led to an enormous demand for dollars, or other hard currencies, and swap lines between central banks. In Europe, this is important between the eurozone and other EU member states. Not having a swap line with a hard currency central bank in such circumstances relegates a country to second tier.

Compared to 2008, the existence of an extensive financial oversight sector at EU level, employing about 2,100 people full-time in the ESAs, ESRB, SRB and SSM, allowed a rapid reaction.¹ The combination of monetary and bank supervisory functions under the roof of one single entity has facilitated information sharing, communication and coordination, and thus the quick response of the ECB in the interest of the EU economy as a whole. The

¹ See for more <https://www.ecmi.eu/publications/research-reports/complex-european-financial-architecture-10-years>.



massive institution-building after the 2008 financial crisis has thus paid off. The argument in favour of giving the central bank supervisory responsibility, rather than completely separating both functions, has thus clearly won out.

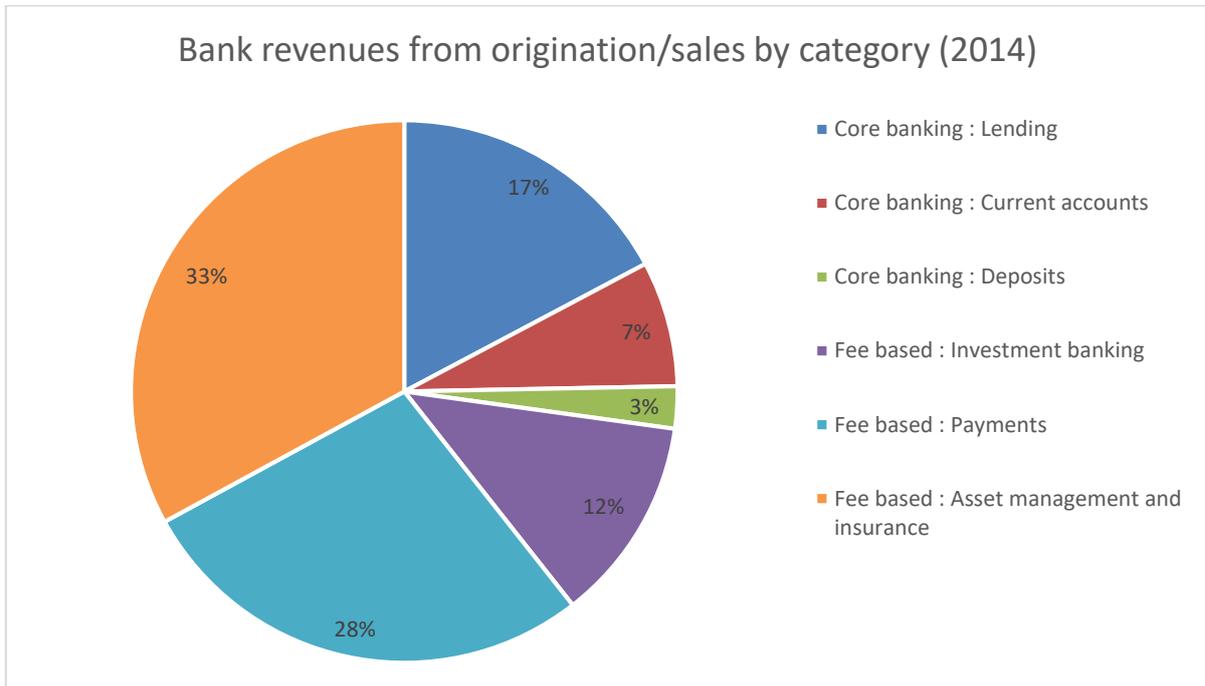
The market still needs to follow through with the Europeanisation of oversight. European banking markets remain fragmented, and consolidation has not advanced. This is reflected in limited competition and marked differences in the price of banking products, certainly at the retail end of the market.² Banks are seen to have outdated business models, in a market where much has changed recently. Most European banks are universal banks, which provide a broad range of services to retail and wholesale clients; basic banking, payment, asset management, but also insurance, brokerage and investment banking services. Newcomers have targeted one of these activities, benefiting from technological advances but undercutting bank pricing in these different activities, and thus undermining the universal bank business model. This has been most pronounced so far in the retail payment services sector.

More competition in payment services

Payment services have become one of the core sources of revenue in banking, together with fees (on savings and investment products) – accounting for about one-third (see graph below). The traditional interest-based revenues have become much less important and will remain so for some time to come in the current monetary policy environment. But overall, payment services are expensive for small businesses and retail clients, which is what these newcomers have noticed. And there is the growth of online payments related to the growth of e-commerce. On the one hand, there are the local payments markets, which are fragmented along national lines and systems. On the other, there are the international payment providers, dominated by a few large credit card companies.

The Covid-19 crisis has been an enormous accelerator of e-commerce and its related payments. Specialised payment providers have targeted the e-commerce market and continued to benefit from the recent surge in e-commerce. It is expected that e-commerce will continue to grow after the crisis, and also the competition from specialised payment firms or other providers, with the biggest threat to banks possibly coming from Big Tech.

² The ECB publishes a financial integration monitor, which measures market integration on the basis of price and quantity indicators. It demonstrates that EU is only halfway towards a fully integrated financial market, and still well below the levels seen before the financial crisis. The latest can be found [here](#) (Chart 20).



Source: "Cutting through the FinTech noise", McKinsey, 2015.

Related to the emergence of newcomers are new technologies such as blockchain, which is used for cryptocurrencies. Cryptocurrencies function outside the official payment system and are a storage of value, depending on their use. Cryptocurrencies have seen huge market volatility, which led to the emergence of stablecoins and central bank digital currencies (CBDC). Stablecoins are linked to fixed proportions of hard currencies, as is proposed for Facebook's Libra. More recently this led to the initiative by central banks to allow retail payments to be settled directly on their books. Both developments are still in the experimental phase but will certainly mean enormous further competition to banks in payment services.

Core to the attraction of the payment providers is access to users' data, notably their payment and consumption habits. The emergence of payment providers is impacted by the Payment Services directive (PSD), which in its second version (PSD II) came into force in 2019. It forces banks to share their clients' data with the non-bank financial services providers licensed under the PSD, which was heavily contested by banks but passed by policymakers to create more competition to banks in one of their areas of activity.

The other biggest single source of revenue on investment and savings products will also come under further pressure, as a result of regulatory actions. The high fees on funds are



already an issue of concern for supervisors, as was highlighted in several ESMA reports.³ The Commission is expected to further address the fragmentation and cost of fund markets in phase II of the Capital Markets Union project. But market developments will also play a role here, as competition from the large US fund managers through fund platforms and/or robo-advice will bring the high fees under pressure.

Interest income, the 3rd source of revenues, will be heavily affected, primarily because of the big decline in GDP, and the payment problems affecting mostly SMEs and households. But it will also be impacted by a third factor, which will be accelerated by the crisis, the "decarbonation" of bank lending and the transition to a low-carbon economy. European rules and market pressure will restrain lending to greenhouse gas-intensive sectors (petroleum product refining, air transport, metallurgy, agriculture, non-metallic mineral production such as glass and cement). SMEs may be less concerned, given their scale, but also as a result of the lack of reporting on the matter, but it will gradually impact them as well.

Hence the strain on banks to further rationalise their business model. Supervisors, which are now well organised as a result of the previous crisis, have been insisting for some time that further consolidation is needed to deal with market dynamics. But consolidation has barely advanced in recent years and, when it does happen, it is mostly at national level.

Covid is a further step forward

A more European approach can therefore be expected as a result of the Covid crisis, also at other levels. Through Next Generation EU, the EU Commission will borrow directly on capital markets, which will be a big push towards the further integration of EU government bonds markets. The proposals also include initiatives to help SMEs strengthen their balance sheets with equity instruments and channel guarantees from the EU budget – areas that have largely been left to the member states so far. This will furthermore only apply if part of the Green transition.

So, although we are only three months since the start of the lockdown, the Covid-crisis means a further step in the integration process of European financial markets, thanks also to the lessons and the structure put in place as a result of the previous crisis. But the competitive environment for banks will not be easing, on the contrary, they will need to further adjust their business models. Banks may have regained their primacy in the financial system as channels of government support for firms, but the vigorous growth of e-commerce should remind them that in retail markets, other evolutions take precedence.

³ Average fees on funds in the EU are 1.5%, see the most recent report:
https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf.