

Cross-border financial services: Europe's Cinderella?

Report on a conference jointly organised by Belgian Financial Forum and SUERF

Brussels, 15 November 2019

Conference Report



Jean Hilgers



Robert Koopman



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Jean Hilgers, President of the Belgian Financial Forum and Member of the Executive Committee of the National Bank of Belgium, and **Ernest Gnan**, Secretary General of SUERF and Head of the Economic Analysis Division of the Oesterreichische Nationalbank, welcomed the participants. **Jean Hilgers** developed in his **opening remarks** the need for a further development of cross-border financial services. They are still underdeveloped. According to the Financial Integration Report of the ECB, the cross-border positions and trade in financial services do no longer converge. The current CMU 2.0 initiative deserves all support and efforts should be targeted on the insolvency regimes and implicit tax-biases granted in national legislations. Furthermore, it is essential to translate the concept of financially integrated markets into very concrete daily operations. Additional interpretative communications are required.

Supervisors have to meet the challenge to fully internalize the cross-border dimension of financial service provision in their policies. The financial sector is facing more disruptive structural challenges such as the digital transformation, which offers a window of opportunity of a global reach to the financial servicing sector with almost unlimited opportunities. But it entails potential risks such as cyber risks and money laundering which could hurt the financial stability. Finally, the geography of the European financial market and services may fundamentally change because of Brexit. Financial protectionism is not the answer.

Keynote speaker was **Robert Koopman**, Chief Economist and Director of Economic Research and Statistics Division of the World Trade Organisation, who focused on “**Who benefits from banks’ cross-border competition?**”. Financial services are the second largest service sector traded globally (18,6 %). Commercial presence is the dominant mode of supply. China, Singapore, Korea, Hong Kong and India are the largest developing exporters of services. But digitalization, e-banking and mobile banking

are reshaping the business model. So the number of affiliates abroad is decreasing (-6% for the European Union in 2017 compared to 2005). The cross-border supply of financial services is gaining importance (for the United States it tripled between 2005 and 2017). Financial services are important inputs into manufacturing exports which makes them critical for the functioning of the entire economy and sustainable development. Trade in financial services can potentially improve the quality and efficiency leading to more competitive production. Imported financial services can partly compensate for a weak domestic financial services sector, improving productivity in the manufacturing sector. The cost of trading financial services across borders has been increasing while the cost for other services declined. Commercial banking has one of the highest trade restrictions index on cross-border supply. Reductions in the cost of face-to-face communication are projected to greatly decrease the cost of trading financial services. Under such scenario and taking into account the digitalization, financial services are projected to be among the fastest growing sectors. Financial services have a relatively high level of commitments in GATS (General Agreement on Trade in Services). Fin Tech has grown rapidly in the past decade, allowing for emergence of mobile payments and peer-to-peer lending. Fin Tech presents many challenges due to regulators' limited technological expertise which makes it difficult to assess innovative business models and practices, and their impact. An increasing number of regulators are responding by introducing innovative regulatory approaches, including so-called innovation offices and regulatory sandboxes.

The **first panel** was dedicated to “**The intra and extra EU cross-border financial services (in) activity: Europe’s Cinderella?**”. The panel was chaired by **Urs Birchler**, Professor Emeritus of Banking of the University of Zurich and Member of the Council of Management of SUERF. **Goetz von Peter**, Principal Economist at the Bank for International Settlements (BIS), identified the specific part European banks played in the deglobalization trend. The contraction seems to be concentrated in banking while foreign direct investment (FDI) and portfolio flows continued to expand. Cross-border assets of banks fell about 20 percentage points from 60 to 40 % of global GDP. This decline is concentrated in the interbank segment, mainly of the euro area, except the Spanish banks due to their large foreign operations in Latin America. This is due to the reaction to the financial crisis. Nationalisation, capital injection, limitation of credit, risk aversion, return to home market are the most important reasons. The importance of the United Kingdom as financial sector cannot be ignored. The dominance is huge in the booking for euro dominated credits, foreign exchange, OTC interest rate derivatives, but also the clearing of interest rate and credit derivatives. Since the beginning of 2019 the share of what is cleared in France is increasing. Transitional arrangements for Brexit may therefore have a serious impact.

Mathias Hoffmann, Professor of International Trade and Finance of the University of Zurich, analysed the cross-border banking flows making a distinction between inside and outside the euro area. While the interbank flows declined, the flows to the real economy did not collapse. When integration started, the cross-border bank-to-bank flows increased mainly between banks from core to periphery countries leading to credit booms in the recipient countries. Interbank integration left the domestic sector fully exposed to local banking shocks while at the same time it removed the benefit of a strong local banking sector. The breakdown in interbank integration during the global financial crisis exacerbated macroeconomic asymmetries particularly for bank dependent sectors with many small and medium sized enterprises countries that relied heavily on this interbank lending. On the lending from domestic banks to the private sector it is clear that the domestic bank dependence got hammered the most. There was also a collapse in cross-border risk sharing. Europe needs a deep bank to real sector integration. An integrated banking system will improve the risk situation. Something similar happened in the US in the 1980ies. In Europe regulatory fragmentation persists, supervision is still not fully at the European level, resolution mechanisms keep a large national fiscal component and on the subject of deposit insurance everything remains to be done as far as integration is concerned.

Jan Van Hove, Chief Economist of KBC Group and Professor of International Economics at the Catholic University of Leuven, pointed out five elements to explain why the dream of financial consolidation in Europe has not yet been realised and why it may not happen in the short or medium run either. First, the international trade in services is limited in general and the home bias dominates. In an advanced economy about 70% of the economy consists of services, but in terms of trade, cross-border activities account for only 30% in the European Union. Second, the (bank) profitability is too low to have a strong M&A activity. Even while capital ratios may be strengthening, the risks are still quite substantial. Third, regulatory divergence and lack of regulatory level playing field are major barriers. There are a lot of inconsistencies between European and national regulations. While traditional banks face lots of regulations, new and innovative players are not subject to the same kind of regulations. Fourth, the domestic clean-up in the sector should come first. There are too many banks. Buying a bank is not a simple matter due to legal and political hurdles. Monetary policy probably has a perverse effect on consolidation, as it helps shore up weaker banks. Fifth, there is no business case for cross-European consolidation in the financial sector. Profitability is driven by service diversifications. Banks focussing on core markets are doing better than banks with a European network. Innovative banks are in a better shape than traditional banks. Banks focussing on cost management are doing better because profitability isn't determined by scale and size but rather by internal management decisions and strategies.

Carey Evans, Director of the Public Policy Group at BlackRock, brought a positive, even success story. Asset Management is already mainly European and helps a wide range of end users over a very wide range of different investment approaches and the ability to provide service on a cross-border level. Efficiency and scale are realised. Regional centers as Luxemburg and Ireland are powerful. Brexit forces the EU to develop a robust third country framework for the UK. Obviously, the liquidity is centered in London. The European commission proposed legislation to increase the efficiency of marketing and distributing funds on a cross-border basis will increase operational efficiency. Barriers such as the insolvency law and withholding tax should be removed.



Mathias Hoffmann



Jan Van Hove



Carey Evans

Panel 2 was dedicated to “**New developments in European financial regulation: what implications for cross-border financial services?**” and was chaired by **Isabelle Vaillant**, Director of Prudential Regulation and Supervisory Policy of the European Banking Authority (EBA).

Gonzalo Gasos, Head of Prudential Policy and Supervision of the European Banking Federation (EBF), focussed on cross-border consolidation in Europe. He recapped the history of the banking consolidation in the EU with the Second Banking Coordination Directive in 1989, the single banking licence and the home country supervision in 1993, the launching of the Eurosystem in 1999. All these

steps stimulated the mergers and acquisitions. The financial crisis of 2008 ended this trend of European banking integration process. Since 12 years regulatory reform has been at the top of the agenda. Cross-border asset reallocation is observed. There are many disincentives: ring-fencing of liquidity, capital buffers at national discretion, G-SIB added cost of capital, internal MREL, disparate insolvency regimes, divergent national laws. Before taking further steps to consolidation, existing regulation must be reviewed. The transformation of the banking sector will be quite different than what we have seen in the past 20 years.

Philipp Härle, Senior Partner of McKinsey & Company, started from the current state of regulation, which is pretty positive and by now relatively harmonised across Europe. Only a few banks have a sizeable position in another market and some banks (UniCredit, Santander) have wholesale ambitions in some other countries (ING, BNPParibas, HSBC). There are different reasons not to decide a cross-border consolidation. First, domestic consolidation creates more value through size and market share in a country. Doing digital banking in different countries is a nightmare. Second, banking profitability is structurally very low. Most banks are treated below book value. Third, some banks have a lot of homework to do, such as cleaning up balance sheet and cost reduction. Fourth, there are numerous regulatory and political barriers. To solve this problem European authorities should remove the regulatory barriers and create an environment to strengthen the profitability of the banking system.

Jean-Paul Servais, Chairman of the Financial Services and Markets Authority (FSMA), started by saying that the regulation was positive for the development of the cross-border financial services. But new steps are necessary. CMU must be developed to broaden access to finance for companies and increase investment opportunities, certainly once the Brexit is a reality. The EC High-Level Forum on CMU will focus on building an ecosystem for capital raising with special focus on SMEs, including a private-public fund specialising in initial Public Offerings of SMEs. Furthermore, we need a European capital market architecture which includes how new financial technologies can support this process. A renewed focus is needed on the demand side so that citizens can reap the benefits of the CMU, via an increase of retail investor participation and the diversification of the investor base, including on a cross-border basis. Key issues include strengthening investor trust, enhancing financial literacy, supporting more suitable retail investment products, adequate investor protection standards, more efficient distribution of products. This new holistic approach to the CMU should be combined with a new EU Fin Tech plan and a strong sustainable Finance Agenda. But the CMU is not the same as Banking Union. In terms of supervisory architecture, the aim is to ensure the appropriate level of supervision at the right level, avoiding inefficient centralization. The supervisory model should recognize the differences between retail markets, consisting of less integrated national ecosystems, and more unified professional markets. A consistent application of the single rulebook is needed.

A more integrated regulatory framework together with innovative online services and the digitalization of traditional financial services have driven progress towards a more integrated market. This evolution has made it easier for financial institutions to provide services across borders and has given European consumers more choice and better access to financial services across the EU. This has resulted in the need to enhance the home-host cooperation among national CAs and to strengthen supervisory convergence. The distribution of responsibilities between home and host NCAs is not always clear. Further there is the risk that home NCAs prioritise financial institutions that represent a higher risk in their own territories, with less attention paid to the activities of those institutions carried out in other member states. Possible remedies are considered by the European Supervisory authorities in their Joint Committee Report, such as reinforcing the harmonisation of Level 1 provisions governing the marketing and sale, providing more clarity on when activities carried out through digital means fall under pass porting, addressing the topic of jurisdiction shopping, considering requiring a pass porting regime to include the proportionate provision of information, ensuring an effective collaboration and exchange of information between NCAs. Supervisory

convergence is needed because it enables fair competition and ensures the same level of consumer protection regardless of the type and location of the service provider. It is also in the interest of the investors. The ESAs have to deploy a range of tools to promote that convergence, such as guidelines, Q&As and peer reviews.

The **afternoon session**, started with the second keynote speech of the conference, given by **Almoro Rubin de Cervin**, Head of Unit for international Affairs in Dg FISMA. First, he looked backwards underlying three major achievements since 30 years for the Italian financial system because the internationalisation of the Italian banking sector was the theme of his dissertation at Bocconi University. The evolution is spectacular from a very national and less sophisticated system towards a more complex and diversified international oriented system. Ownership changed, new instruments are used, asset management and insurance are now more global industries. A similar change took place within the EU. We do have a very open system with European players which are also active worldwide with a very diversified offer of financial services. This openness is even greater if we include London. It is good for the economy as a whole. A lot of foreign non-European financial institutions are active in the EU.

This bright picture is facing a huge number of risks such as the lack of a level playing field leading to regulatory arbitrage, the fall-out of the financial crisis after a kind of Ponzi scheme in some activities such as the subprime in the US with its impact on the European banking industry and the fund management business, the integrity of ratings and blind focus on benchmarks, money laundering, the lack of transparency, tax competition, the weak coordination of resolution actions, etc. All the risks are covered by regulation in one or another way. The risks are manageable. The international standards are the reference. The EU has also put in place a lot of tools to manage those risks. There is also the equivalence recognition for prudential control, financial instruments, ratings, benchmarks, audit, access to the market. Furthermore, you have also the trade agreements with a chapter on financial services, covering the establishment and eventual cooperation concerning laundering, taxation, listing process, international sanctions (strongly used by the US).

The prospects are to maintain and develop further an open system, to strengthen the banking union, to increase cooperation within the banking sector, to fine tune the Basle requirements, to activate CMU 2.0 which is prepared by the High Level Forum. But new more global challenges are ahead such as digitalization, the launching of new currencies such as Libra, cyber risk, green finance. We need to preserve the integrity of the financial system. We need to work on the protection of the EU players from sanctions coming from abroad. Another challenge is the goal to increase the international role of the euro compared to the USD which became more a tool for policy since some 10 years. The complexity linked to the Brexit must be solved in a global context. All those elements are not neutral for the maintenance of the financial stability.



Isabelle Vaillant



Gonzalo Gasos



Philipp Härle



Jean-Paul Servais



Alvaro Rubín de Cervin



Panel 3 - The future geography of financial services: views of the financial industry

The topic of the **third panel** was “**The future geography of financial services: views of the financial industry**”, which was chaired by **Michala Marcussen**, Chief Economist Société Générale and Vice-President of SUERF.

Tim Clausen, Head of International Regulatory Policy and Strategy at HSBC Holdings, started his intervention by saying that HSBC is a fragmented organisation with multiple balance sheets for branches and subsidiaries. It reflects the ongoing fragmentation in the global financial system. The fragmentation is observable in banking structures, in market structures, in prudential and conduct regulations and in data and operations. Fragmentation may generally be seen as damaging global financial flows and stability, but, on occasion, there will be good reasons for countries to ring-fence their national financial system and/or deviate from globally agreed standards. Underlying this is a trade-off between integration, which can improve efficiency in the financial system with better productivity in the underlying economy and fragmentation which can act as a brake on contagion in the event of a crisis.

According to Brexit, the uncertainty is still huge. The City of London is developing a global financial partnership strategy with financial centers such as Switzerland, Hong Kong, Singapore, Tokyo and Sydney. So the US are not necessarily the target. To what extent can affinity lead to mutual trust? There is a need of an integrated vision.

Frank Wulms, Executive Director, Public Policy International at Bank Julius Bär & Co, developed the Swiss vision. Switzerland occupies a unique position because it is surrounded by the internal market. Since 1992 it has signed 120 bilateral agreements. Wealth management is a real cross-border business. It intervenes for two thirds of the revenues. We have to focus on the competitiveness of Europe compared with the US and China. How strong is Europe as a continent? The Brexit, the low profitability and the huge volume of regulations are the big challenges for the EU, knowing that the two largest financial centers are outside the EU. There is a necessity for collaboration between financial centers to ban protectionism. What kind of market access can a Swiss bank have in the EU? The international standards are the same, but the EU third country framework is a real handicap to develop cross-border business. Europe has ambitious goals such as the increase of the international role of the euro, be nr 1 in sustainable finance. But the needed capital for that sustainable programme has to come from mainly private investors who are not in the EU. Therefore a global financial partnership is needed. Financial centers are on the one hand competitors among themselves but there is already also a pronounced specialisation: the UK is leader in the bond market, Switzerland is leader in private wealth management, Luxemburg and Ireland are strong in fund and asset management, Germany is leader in corporate finance. Complementarity must be stressed. Of course, trust is a crucial factor to decrease the national protectionism and vested interests.



Tim Clausen



Frank Wulm



Peter Hahn



François Benaroya

Peter Hahn, Henry Grunfeld Professor of Banking and Dean of the London Institute of Banking and Finance, started with the observation that fast growing technology, which is expensive, and the booming regulation, which is costly, are serious sources of increased costs, while the slow economic growth and the competitors are pushing down the revenues. So banks are squeezed. A similar evolution is observed in asset management with the success of passive management, in the insurance industry with increased focus on data analysis, in investment banking with automated tradings. Financial institutions have to become more service providers. The management of data is crucial but also expensive due to the storage, the protection, the treatment of those data. Payments, health, credit, purchases ... data are numerous: how to monetize those data? Nevertheless it is an opportunity for the financial institutions to set up a brighter future.

François Benaroya, Head of CEE and Turkey at BNPParibas, underlined that there are no fully fledged EU wide banks, but a lot of specialised banks. Most traditional network banks are still domestic. The scale within a country is crucial. The sector is facing a lot of uncertainties: what is the future of banking? Quid the value of the network in 5 years? Quid the underestimation of costs linked to regulation? Quid the controversial attitude of the politicians? The bigger the bank, the greater the penalization by regulation. The political agenda is driven by risk fear and not by the search of growth. The EU is in favour of freedom of capital but has a ring-fencing view on liquidity. Regulation is very complex and not harmonised throughout the countries. According to the climate change banks like to be a part of the solution but the risks linked to that business is directly converted into new regulation. So the need for harmonization is increasing. The challenges are not the capital ratios, but the profitability of on average 7% and the technology asking for huge investments. The prudential treatment of ICT investments is very different in the EU compared to the US: 1 euro invested in ICT leads to the deductibility of 1 euro of the revenue. In the US the investment is considered as intangible 100% risk weighted asset and so 1 euro is converted into 12 euro.

The growth opportunity outside the EU is Eastern Europe or Africa is huge, but the volatility is also important. It is necessary to combine economic cycles and geographical diversification in order to limit that volatility. The EU regulation has a great influence on those markets, who import that regulation into their national rules. The negative aspect is that we export our knowledge, but also our unsolved problems. Globally Europe is squeezed between the US and China. European share is declining. To be relevant, Europe has to decrease its fragmentation.

About the authors



Frank Lierman is the former Chief Economist of Belfius Bank, having formerly held the role at Dexia Bank Belgium. Previously he worked at the Artesia Banking Corporation and its predecessor Paribas Bank Belgium in a number of capacities: Economic Research, Marketing, Organisation, Asset Management, Euro-Project. He is a member of the Council of Management of *SUERF – the European Money and Finance Forum*, serving on its Editorial Board and has been the Association's Vice President. He is also co-president of the Coordination Committee of the Belgian Financial Forum (BFF) and serves as head of the BFF's *Revue bancaire et financière*. He has authored numerous publications on the solvency and profitability of Belgian financial institutions, and on various financial and macroeconomic topics. He holds a degree in Economic Sciences from the Catholic University of Leuven.



Carlos Bourgeois is the former CEO of Holding Communal after having worked at Dexia and previously Gemeentekrediet in the Study Department, Audit and Marketing. He holds a master of Economic Sciences from the State University of Gent. Currently he is member of the Editorial Committee of *Revue Bancaire et Financière*.



Jan Vermaut is the former Head of the Economics Department of the BACOB Savings Bank and a long-standing member of the Editorial Committee of *La Revue Bancaire & Financière*. He currently works as a product manager at Belfius, probably Belgium's most innovative Bancassurance group. He holds a master's degree in Commercial Engineering and in Econometrics, both from the University of Antwerp.