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Towards Deeper European Financial Integration:

An Assessment of Recent European Financial Regulatory Novelties and their Implications for the Swiss Banking Sector

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Executive summary

Single Supervisory Mechanism, the first pillar of the Banking Union, operates in line with core principles for effective banking supervision. Most notably, Single Supervisory Mechanism has tightened the supervision, improved the supervisory cooperation and harmonised the supervisory procedures across the Member States. Differences between Member States in the way rules are interpreted still exist – which can also be seen in different non-performing-loan ratios between countries. Moreover, Single Supervisory Mechanism suffers from legitimacy and independence issue. Single Resolution Mechanism, the second pillar, brings new tools for dealing with a failing bank and follows theory on optimal resolution procedure. Banco Popular showcased that the new regime works in practice. At the same time, it revealed how difficult it is to execute a bail-in in practice, even for smaller banks. The case of two small Italian banks further undermines the credibility of the new institutions and reveals potential institutional flaws. The Single Resolution Fund ought to be adequate, just in case a crisis similar to the one from the year 2007-2009 occurs. Nevertheless, estimations are based on some strong premises. Therefore, Single Resolution Fund' capacity is questionable. Talks on additional backstops have not been successful so far. European Deposit Insurance Scheme, the third pillar of the Banking Union is considered as uncontested by EU officials. However, it does not function yet, and as it looks like right now, it will not be set up in the near future. Overall, the Banking Union significantly strengthened the resilience of the European Banking sector. Though, without the third pillar and with many open issues, the Banking Union remains uncompleted and has many possibilities for improvement.

The revised Markets in Financial Instruments Directive is largely oriented towards consumer protection, which has been exploited especially during the recent financial crisis. The directive aims to establish a safer, sounder, and more transparent financial system. The directive pays special attention to the investor-adviser relationship and covers every stage of that relationship. The revised Markets in Financial Instruments Directive not only limits the opportunistic investment advisory but also adjusts advisory services to the needs of the client. Client categorisation, best execution aspect, and disclosure requirements, all reduce the information asymmetry between the two parties and strengthen the consumer protection. Concerns with regard to the new directive mostly arise from the contradictory nature of some rules. Questionable is also the implementation progress. The size of the novelty, implementation costs and the lack of clarity of some rules namely make the date of full compliance uncertain.

The Second Payment Services Directive looks to re-establish the balance between convenience, security and competition on the European payments market. One of the two main novelties of the directive is a strong customer identification requirement. This requirement significantly reduces the probability of frauds, thus increasing consumer' protection. The other main novelty is the open banking concept. Open banking should further increase competition, re-ignite the race to innovate and contribute to the greater efficiency and transparency of the European payments market. In addition to that, the Second Payment Services directive improves regulatory surveillance. On the other hand, the directive might not necessarily lead to a better level playing field. Technological giants can freely access bank's customer information, while they are not entitled to grant own customer information to banks. Additional concerns arise from customer' security, unclear liability in case of fraudulent events and the fact is that some of the directive' objectives are conflicting and competing with each other. So far the directive has not been consistently implemented across EU. Besides that, there are compliance delays as the majority of banks took the "wait-and-see" posture.

Basel III accord increases the minimum regulatory capital by introducing three additional capital buffers. The new set of capital buffers addresses the too-big-too-fail issue, provides an additional layer of protection and in theory, reduces the inherent procyclicality that has been present within the Basel II accord rules. Empirical findings on procyclicality of Basel III are not consistent. Though observations on European banks reveal that an increase in common equity tier one ratios can be mainly explained by an increase in common equity tier one capital and to a lesser extent by a reduction in risk-weighted-assets, which means Basel III might have reduced procyclicality. Majority of the European banks try to meet the regulatory expectations well in advance and have capital ratios above the current regulatory minimum requirements. Overall, the quantity of regulatory capital is much higher, compared to the pre-crisis period, but still lower as academics suggest would be optimal. Basel III improves the quality of capital by placing a greater focus on the going-concern loss-absorbing capital. Enhanced risk assessment, leverage ratio and revised output floor all look to reduce the degree of variability in risk-weighted-assets calculation. While the leverage ratio is already largely fulfilled by European banks, output floor will not be fully realised before 2027. If the new rules are properly implemented, they should concretely reduce risk-weighted-assets variability. Empirical studies on liquidity coverage ratio and net stable funding ratio lead to different conclusions – some academics suggest that the new liquidity standards reduce the probability of a bank default while others argue that they only put constraints on the asset side of the bank's balance sheet. European Banks are fully compliant with liquidity coverage ratio. Net stable funding ratio lags behind with the implementation. Overall, it can be said that better-capitalised banks and better quality of capital contribute to greater resilience of the European banking sector. With the new rules, variability in the calculation of the risk-weighted-assets should be reduced. If this will be the case, only time will tell. Prudential liquidity regulation is supposed to limit contagions and probabilities of banks' default. It is still too early to say whether the positives of liquidity requirements outweigh the negatives.

The Automatic exchange of information has been pushed in motion to tackle tax revenues losses, inflicted by tax evasion and tax avoidance. The global standard is also supposed to bring a level playing field, fairness and transparency to the financial market and combat financing of terrorism and money laundering. The global standard' success can be observed by 85 billion EUR of additional tax revenues, collected through the voluntary compliance so far. Although, Organization for Economic Co-operation and Development still has a lot of room for optimisation of the standard. Standard has visible loopholes that must be addressed. Despite many countries signing the Automatic exchange of information, there are non-compliant countries among them. Organization for Economic Co-operation and Development must encourage and support both, the non-compliant members as well as the potential new members who lack the technology to realise the implementation. Special attention should be given to non-cooperative countries, with the US at the forefront, who endanger the level playing field that is claimed to have been created. Besides that, confidentiality is one of the implementation aspects that questions the credibility of the Automatic exchange of information. On top of that, global standard might not be fully utilised at the moment – collected information could have been shared with many other law-enforcement authorities.

The Banking Union increases the resilience of the European Banking sector. Therefore, the stability of the Swiss banking sector is indirectly increased due to the high interconnectedness between the two banking sectors. Internationally active Swiss banks are also influenced directly – they are more strictly supervised and might have to apply the Single Resolution Mechanism's resolution procedure in case of insolvency. From a perspective of an international Swiss bank, the regulatory harmonisation within the Banking Union leads to cost savings. Swiss banks could also be affected by the Banking Union if Switzerland decides to follow the European regulatory developments and implements the regulatory novelties into the Swiss law. However, many of the regulatory novelties that the Banking Union brought had already been incorporated into the Swiss law prior.

The Swiss equivalent of the revised Markets in Financial Instruments Directive – Financial Services Act - is on par with the EU regulations. Financial Services Act reinforces the legal certainty for Swiss banks and their customers. In addition, it increases Swiss banks' competitiveness and the client's trust in Swiss banks as well as the reputation of Switzerland as the financial centre. From the perspective of an individual entity, the majority of Swiss banks regard Financial Services Act as an act of over-regulation that will lead mostly to a more restricted product range, cost-increase, and a lesser degree, up to the actual enhancement of customer protection. Financial Services Act will be easier to implement for large, internationally active Swiss banks in comparison to smaller, domestically focused Swiss banks. For the Swiss banks with no prior experience with the rules on investor protection, Financial Services Act might be an opportunity to modernise their advisory processes.

The Swiss perspective on the Second Payment Services directive is that the equivalent regulation is not needed in Switzerland. A well-functioning payments services market that Switzerland has implies that the regulatory interference might only cause competitive distortions and harm Swiss banks. Examples of cooperation between third-party providers and Swiss banks confirm that the Swiss payment services industry already is "innovation-led" and therefore, does not need a Second Payment Services directive-type of reform. Ratification of such an act could lead to unnecessary additional efforts and costs arising from Swiss bank' infrastructure and compliance requirements. Besides that, gaps could arise in the bank-specific security principles.

Switzerland has followed the global capital standards. Swiss regulators have gone further than these requirements and introduced additional obligations. Swiss banks must, on average, hold 4-5% more capital than most countries adopting Basel III accord. The domestically-focused banks already hold substantial capital surpluses measured against the minimum regulatory requirements. Both systemically important banks are on the right track to fully meet regulatory requirements by 2019 - the Swiss too big to fail regime has been significantly strengthened. Additional capital requirements cause costs that are harmful to the competitiveness of the Swiss banking industry on the international stage. Nevertheless, the restored safety reputation of the Swiss banking sector is supposed to outweigh the negative effects. An abolishment of Swiss finish should be considered, as laying down too many additional restrictions on the Swiss banks could scale up the negative effects.

The Swiss commitment to the Automatic exchange of information brings three major consequences for the Swiss banking sector. Firstly, it caused an outflow of foreign assets from

Swiss banks. Secondly, it caused considerable costs related to the implementation of the standard. Thirdly, it caused a fiercer competitive environment in which Swiss banks operate. Non-cooperative countries like the US undermine the level playing field and pose an additional threat to Swiss banks' export business. On the positive side, Swiss banks might be able to use collected data to optimise the products, services and offer clients solutions of even higher quality. At the same time, acceptance of the Automatic exchange of information increases the reputation of Switzerland as a global wealth management centre.