COMPETITIVENESS OF THE EU BANKING SECTOR

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The profitability challenge of the European banking sector

Since the Great Financial Crisis, the EU banking sector has been going through considerable changes. One of those has been the sizeable increase in capital and liquidity reserves, which have made banking institutions stronger and safer as illustrated during the COVID crisis, where they were able to service the real economy in times of stress. However, the profitability of EU banks has stalled at a depleted level, especially in comparison to US banks which consistently generate larger returns on equity.

The reasons behind this gap are manifold and before delving into the details, it is necessary to mention that if banking institutions on both sides of the Atlantic share the same economic mission, they do not share identical market and institutional settings, which reflect into different business models. Helped by a deep and integrated capital market, that provides with 71% of corporate funding (vs 35% in the Euro area)[1], US banks follow an originate-to-distribute design, where less risky assets are sold on the markets while the riskiest are kept on the balance sheet to generate revenue. By contrast, EU banks retain most of the assets they originate on their balance sheet. Moreover, this originate-to-distribute model benefits from a large investor pool given the capitalization retirement system, whereas EU banks operate mostly in countries with defined benefits schemes. Those differences in dynamism, risk profile and market depth are not a problem in themselves as the revenue generation divergence fades off when adjusted for risk, but it explains a part of the profitability gap when coupled with the larger cost base of EU banks.

Another structural cause behind the EU banking sector' low profitability indeed lies in its fragmentation and overcapacity: the top 5 EU banking groups concentrate 23% of the continent's total assets, while that figure is 43% for the US top 5[2]. Despite the progress made on the Banking Union and having a few large banks being active across European borders and internationally, most EU banks remain active in their only domestic markets and cannot benefit from large economies of scale. Capital markets also remain confined within borders and are not deep enough to allow EU banks to compete on global markets or to manage their balance sheet more dynamically.

While more resilient since 2008, EU banks still have to find their way to stronger profitability.

Cyclical causes add to these structural features. The first one relates to the gap in economic dynamism between the US and EU economies: banking profits strongly correlate with economic growth and US GDP figures quickly rebounded after the GFC while the Eurozone crisis hamstrung prevented a quick economic rebound in the EU. Second, while the accommodative monetary policy followed by the ECB since 2014 had positive impacts on banks (i.e. lower cost of risk, marked-to-market gains or economic growth), it has depleted their net interest margins, which represent around half of their source of revenues. On the contrary US banks never faced negatives nominal interest rates and rather have benefited from rates' increases between 2014 and 2018 (even if they returned to 0% during the pandemic).

The profitability issues constitute a risk for the European financial stability and sovereignty. Indeed, banking profits are key for the capital trajectory, being a key generator of capital reserves, and banks failing to generate a return above their cost of capital might struggle to tap the markets when in need of capital. This is especially true at a time where a significant amount of financing is needed for the adaptation of the European economy landscape to, among other, the ecological transition and digitalization. Having efficient local corporate and investment banking services such as debt & capital issuance or structures finance is also important considering the risk of overseas banks shutting down their European activities in case of market turmoil and thus threatening corporate access to vital resources.

To mitigate the risk posed by weak EU banks' profits, several levers are usable. As fragmentation and the lack of economies of scale stand as a key cause, the removal of obstacles to cross border activities and mergers should be a priority for public policy. This includes the finalization of the Banking Union through the creation of a European wide deposit insurance framework and, where possible, the closure of national discretions and home bias. Moreover, given its complementarity with the Banking Union and its spillovers on banking profitability, the new impetus given to the Capital Markets Union by the 2020 European commission's action plan is a welcome development.

Once consolidation initiated, EU banks will be able to close the profitability gap arising from their high-cost base through cost reduction and digitalization programs they are engaged into.

[1] https://www.institutmontaigne.org/en/publications/reinventing-european-banking-sector#
[2] https://publications.banque-france.fr/sites/default/files/medias/documents/821129_bdf235-2_en_consolidation_vfinale.pdf

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Mind the gap: the competitiveness of European banking

Creating a more globally competitive economy has, rightly, been one of the long-standing political priorities of the EU, in recognition that enhanced competitiveness drives gains in productivity and growth, thereby improving the lives of citizens across the Union. The development of more efficient financial markets and competitive institutions is one part of that equation, helping to ensure the smooth flow of finance from investors to businesses seeking capital and contributing to a more dynamic economic environment. In this regard Europe however continues to be a laggard compared to other large banking markets. The reasons for this competitiveness gap can be attributed to both cyclical and structural factors.

Considering cyclical factors first, relatively weak economic growth has proved to be a hindrance for the competitiveness of banks in Europe, manifesting in lower profitability. Over the past decade average annual GDP growth was 0.9% in the euro area, compared with 2.1% in the US[1]. This led to stronger organic business growth opportunities for banks in the US, indirectly supported by borrowers' improved creditworthiness and lower impairments. Conversely European financial institutions suffered from the double-dip recession caused by the 2010-12 sovereign debt crisis.

The divergence of monetary policy over this period has also played its part. While the ECB and Federal Reserve both pursued expansionary monetary policies after the 2008-09 global financial crisis, the US started hiking rates from 2015. The ECB's main policy rate has remained close to zero since 2016, combined with negative deposit facility rates. While this has supported banks' funding costs, and indirectly helped to address non-performing loan ratios, low rates in the euro area have led to a significant contraction in the net interest margins of banks – which is critical to profitability.

Perhaps more interesting from a financial services policy-maker's perspective is the impact of structural factors on bank competitiveness. While aggregate non-performing loan ratios have declined in Europe, the US moved faster and more effectively to clean up its banking system in the wake of the global financial crisis. The lack of a coordinated European approach to government-backed 'bad banks' proved to be a particular missed opportunity.

Achieving a single market would allow Europe to seize the chance to finance the transition to net zero.

A fragmented domestic banking market continues to hold back European banks from realising economies of scale, resulting in higher average cost-to-income ratios and insufficient scale to compete effectively. An incomplete Banking Union means there are still barriers to cross-border consolidation in the form of capital or liquidity ring-fencing. National supervisors, for example, retain the power to stop banks branching into their territory and can require capital add-ons, such as systemic risk or counter-cyclical buffers, which make cross-border activity a less appealing prospect.

Despite laudable recent harmonisation efforts, the economic rationale for retail banking integration in Europe faces natural barriers from different legal and tax frameworks, in addition to obvious language issues, which hinders much cross-border activity and meaningful synergies. Chronic over-capacity, despite reductions in the number of high-street branches as banks have responded to consumers' preference for online services, has exacerbated the problem with little appetite from national authorities to countenance market exits by failing banks. Retail banking in Europe has, in other words, remained stubbornly national in nature.

Finally, Europe is held back by relatively shallow capital markets, thereby missing out on the benefits of greater liquidity. Various Capital Markets Union initiatives have helped to make in-roads, but there has been insufficient progress on increasing the use of securitisation. As such, European financial institutions tend to keep less profitable assets, such as mortgages, on their balance sheet rather than distribute such assets through credit transfers. The latter is a common feature of the US market, where banks can leverage both the depth of the capital markets as well as the implicit government guarantee mechanisms from US federal agencies, which are largely unparalleled in Europe.

Facing into these twin challenges, cyclical and structural, Europe has a choice. It can continue to allow the fragmentation – which, it should be acknowledged, has its benefits in the shape of retail banks exclusively focused on and attuned to local communities and their needs – or it can double-down on existing efforts (like the Banking Union) to address the causes of market fragmentation.

Achieving a single, coherent market would allow Europe to seize fully the opportunity presented by its early leadership on financing the transition to net zero and to channel international investments into the European economy. That, surely, is a prize worth grasping?

[1] World Bank, 2012-2021 https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2020&locations=XC-US&start=2010

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Mind the gap! Ways of active transition for the EU banking market

Arising from the financial crisis in 2008 the supervisory focus was clearly set on strengthening the crisis resilience of the EU banking market. This is probably best seen through the creation of the Banking Union, encompassing the Single Supervisory Mechanism and the Single Resolution Mechanism. In addition, European supervisors managed to steadily increase the capitalisation in the Euro Area to up to 19.5% in Q4-2021 for significant institutions; well above for example the US banking market with 15.2% in Q4-2021. However, in other areas, EU banks are still lacking behind its US and Asian peers. This concerns in particular the stake of European banks in the corporate investment banking area.

On a global level, but also in Europe itself this segment is dominated by US banks, which outperform their European peers in terms of pricing, technology and economies of scale. This discrepancy is sometimes referred to as one reason for the differences in profitability observable between US and EU banks. While the cost income ratio in the Euro Area averages 66%, US and Asian competitors with a CIR of 61.8% and 40.9% respectively are on average more profitable. This holds true even though personnel expenses are on average higher in the US than in the EU. Here, one may ask several questions: First, what drives these differences and second is there a need for "European champions" in the investment banking area?

Focusing on the first one, here the crucial differences in capital markets and banking sectors between the EU and the US come into play. US companies rely much more on capital market financing than EU companies, which naturally drives up the demand for investment banking services. In addition, securitisation in the US is by far more important in terms of volume than in the EU, not least because of Fannie Mae and Freddie Mac, two government-sponsored enterprises dominating the US securitisation market. EU banks in turn focus more on traditional lending business and finance themselves via deposits. These fundamental market differences are, however, only part of the answer. Another crucial aspect is a European banking sector still fragmented along national borders.

In light of pressures towards cost efficiency, an evolving risk landscape and competition pressure from global competitors, it could be argued that there is not enough consolidation taking place in the EU banking market. One reason to this is a still incomplete Banking Union, where the common deposit guarantee scheme constitutes the last missing corner stone.

European investment banking is needed to fund the transition to a green and digital economy.

Another crucial aspect is a rule book, which is not as single as it seems. Due to the national implementation of EU Directives, national discretion in the application of common rules is still widely possible, hampering thus the formation of a true single market. Fraqgmentation in European banking market is promoted not least by obstacles that do not come directly from banking regulation. All these factors put together put EU banks in a disadvantageous position towards their US peers when it comes to competitiveness, especially in the investment banking business.

Let me now turn to the second question, i.e. do we actually need European champions for investment banking services? Let me answer this question with a full-hearted yes. Climate change and the transition to a green economy as one of the many challenges Europe is currently confronted with requires an enormous amount of long term investment. These funds will need to be mobilised globally and channelled to those projects (like for example dedicated green tech industrial complexes) bringing the most value added to both the environment and investors. If this intermediary role is not filled by EU banks, Europe will become completely depended of foreign funds provided by foreign banks to finance its transition.

The final and crucial question thus would be how do we foster the role of EU banks in investment banking? First, further harmonisation of financial regulation, and most prominently the completion of the Banking Union, is needed in order to support European cross-border banking as well as M&A's, leading in turn to increased efficiency. Further to that, banks require a digitalisation strategy, permitting them to address existing cost inefficiencies, scale up their business and support the adaptability of their business model in light of changing customer and investor behaviour. Finally, further initiatives to boost European capital markets are needed in order to allow for more market-based finance.

All in all there is still considerable way ahead of us until the European banking sector can compete with its US and Asian counterparts on equal terms. I am, however, confident that a transition towards a truly integrated European banking sector is doable; Europe definitely needs one to cope with the challenges of the future.

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Diverse, green, and agile: an investment-friendly banking landscape for Europe

Performance metrics show the euro area banking sector does not compare favourably with other major jurisdictions. Profitability is the weakest spot with return on equity being close to half that of US and Chinese competitors. The cause of such disparity is not easily traceable; efficiency metrics are a case in point. Rationalisation of business structures and digitalisation of processes have already brought about significant efficiency gains; however, operating expenses remain relatively high, as the production cycle cannot generate adequate return on assets.

The industry size and concentration indices do not fully explain the underperformance of euro area banks either. While bank assets are nearly three times GDP figures in China, they are approximately twice the size of the euro area economy and close to the level of economic output in the US. Some national markets in the euro area are more concentrated than in the US or China, but there are considerable disparities across big countries.

The question is whether performance and concentration are the right metrics for competitiveness. A finer analysis should look at the value banks can offer to customers and the constraints they face (e.g., regulatory).

One clear disadvantage is weak market integration. The global financial crisis has scarred cross-border activities. While peers in other jurisdictions rebuilt their cross-border positions a few years after the crisis, euro area banks permanently reduced their international activities.

Despite efforts towards establishing banking union, the European banking sector remains segmented along national lines. Regulatory requirements for liquidity and capital at solo level limit banks' possibilities to optimise resource allocation, preventing banks from exploiting economies of scale and the benefits of risk diversification.

Euro area banks are well placed to support the twin transition.

Banks could also better compete in a more integrated European capital market with wider opportunities to serve a diversified demand. In such an investment-friendly market environment, banks could better serve the needs of firms with little or no alternatives to bank financing, while other corporates could tap into a wider range of funding sources and a larger investor base. To this end, a deeper market for securitisations can help. While US banks continue to actively manage balance sheets via securitisations, asset portfolio choices for European banks are quite limited. Deepening this market with the right incentives and safeguards would open opportunities to improve efficiency and free up capital for lending.

Euro area banks are well placed to support the twin transition

There is one aspect where Europe has recently advanced faster: the green transition. European banks have been actively incorporating climate-related risk considerations into their mandates, thanks in part to strong supervision. In contrast, US banks seems to have taken a more passive stance. Europe's more conscious approach may deepen differences in the short term, while ensuring a longer-term advantage for European banks over foreign banks and their growing EU branches.

To accelerate progress, European banks can also scale up their digitalisation efforts and adapt business models more decisively to serve a growing new type of demand. Compared with the US, euro area banks have invested less than half into information technology in 2020. Euro area banks must anyhow speed up digital transformation to achieve sustainable cost efficiency in the long term.

For Europe to be able to effectively compete with peers, playing fields need to be levelled. To achieve this, the completion of banking union and progress on capital markets union are essential conditions. However, the full removal of obstacles to optimal resource allocation will only be possible once the European safety net is complete and capital markets are integrated. The introduction of the ESM backstop to the Single Resolution Fund and the establishment of the European Deposit Insurance Scheme are essential steps to that end. The revival of securitisation activity, by streamlining the related regulations and harmonising national insolvency laws, would help banks in a more effective capital management.

Europe probably does not need many global megabanks. Although they seem to perform better by standard measurements, the fact that orderly resolution for global banks remains an unsolved issue casts doubt on the superiority of their financial stability. Moreover, there is a clear need for healthy competition and diversity in the banking sector to protect customers and serve domestic needs, something quite versatile in Europe.