What future for the European banking system?

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Summary: The paper assesses the main factors underlying the decreasing profitability in the European banking sector, in comparison with the US. It underscores in particular the role of low interest rates, lower concentration, tighter regulation and the absence of a deep and liquid capital market. A stronger European banking system requires true pan-European banks and a true capital market union.

Zusammenfassung: Das Papier beleuchtet die Hauptgründe, die der sinkenden Rentabilität des europäischen Bankensektors im Vergleich zum US-amerikanischen zugrunde liegen. Sie unterstreicht insbesondere die Rolle niedriger Zinsen, geringerer Konzentration, strengerer Regulierung und des Fehlens eines tiefen und liquiden Kapitalmarktes. Ein stärkeres europäisches Bankensystem erfordert echte gesamteuropäische Banken und eine echte Kapitalmarktunion.

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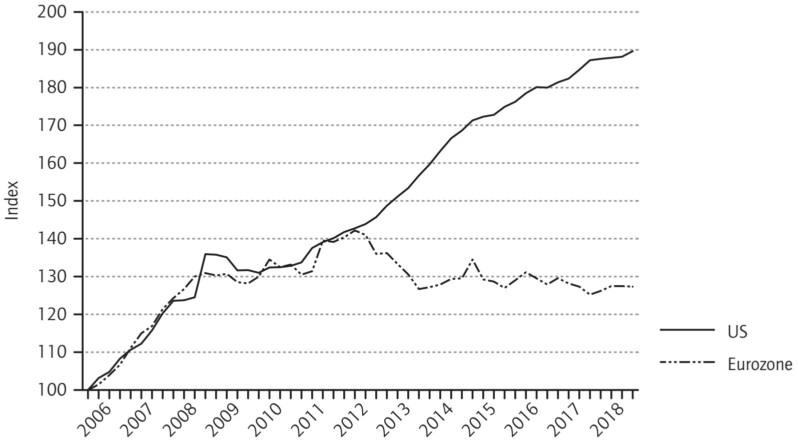
* The views expressed in this note reflect only those of the author.

The evolution of the banking sector since the collapse of Lehman brothers, ten years ago, seems quite paradoxical. Although the crisis started on the other side of the Atlantic, as a result of an under-regulated and over-sized US financial system, and although regulation and supervision have been tightened since then, with a view to reduce the so-called too-big-to-fail problem, US banks have grown even bigger. In Europe, instead, the baking system has shrunk. Just to take a simple indicator, the combined balance sheet of US banks nearly doubled in the last decade, while that of the Eurozone remained broadly unchanged (Figure 1).

Figure 1

Banks' total assets



Source: Bloomberg, Société Générale.

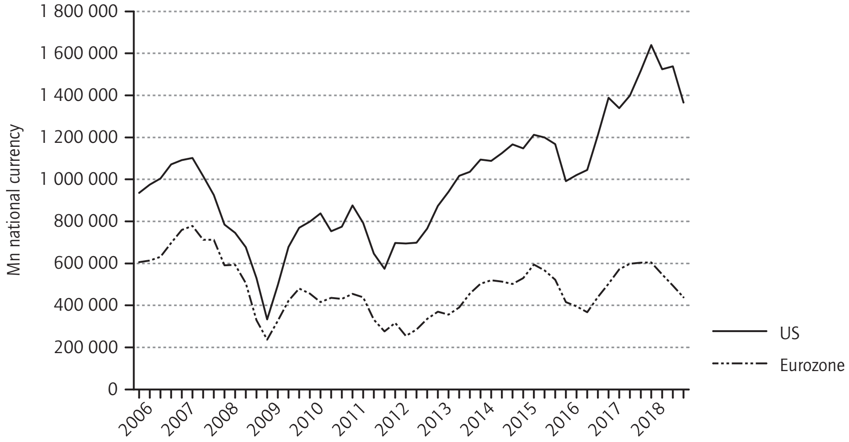
This has been reflected in market valuation. Between 2007 and 2018, the overall market cap of the eleven largest US banks[1] increased from 915 to 1365 billion dollars, with a 50 percent gain. In the same time span the combined market cap of the 19 largest Eurozone banks dropped from 713 to 438 billion euro, with a 40 percent loss (Figure 2). In ten years, the market value of the largest US bank, JP Morgan Chase, doubled and is now worth more than the ten largest European banks combined. Before the crisis it capitalized slightly more than one and a half times the largest European bank, Santander; it is now 5 times larger.

The divergence is reflected in the different support that the two systems have provided to the economy. Over the last ten years bank credit to the private non-financial sector increased by 40 percent in the US, against only 10 percent in the Eurozone (Figure 3). Given the importance of bank credit in the European economy, the slower pace in Europe represents an obstacle to growth and job creation.

1 Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, PNV Fin Serv, State Street, Capital One Financial Corp, BB&T Corp, Wells Fargo, JPMorgan Chase, SunTrust Bank.

Figure 2

Banks' market cap

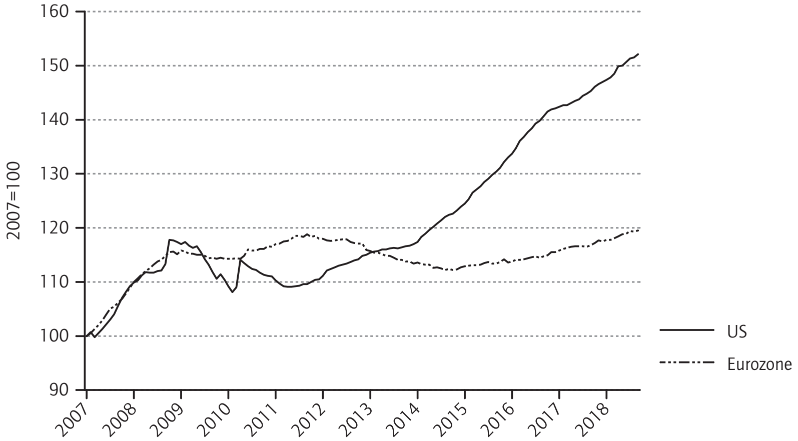


Source: Bloomberg, Société Générale.

The slower pace of bank credit in the Eurozone might be due either to a weakness in supply, determined by a fragility of the banking system, or in the demand for credit, due to a less buoyant economic activity resulting from the double recession experienced in Europe. Disentangling the demand and supply effects is not easy. However, the issuance of market debt by the non-financial private sector increased strongly both in the US and Europe after the crisis (Figure 4). This sug-

Figure 3

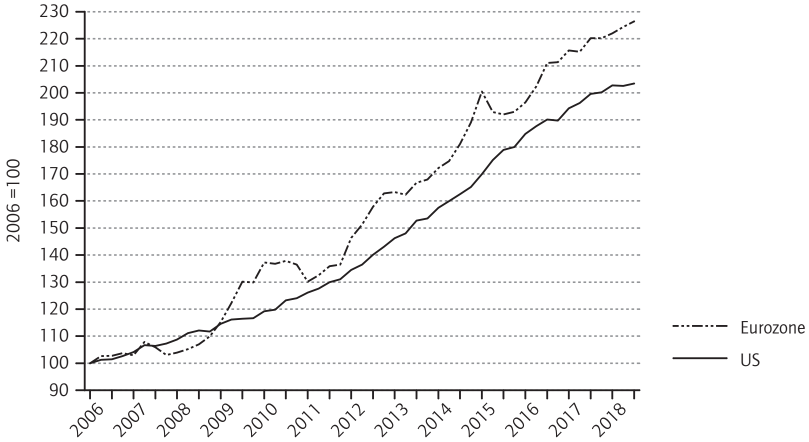
Bank credit to the private sector



Source: Fed, ECB.

Figure 4

Private sector market financing



Source: ECB, Fed, Société Générale.

gests that the slow pace of bank credit experienced in Europe is due mainly to the supply side, i.e. the state of the banking system.

It is thus key to understand what might explain the different performance of the US and European banking system over the last decade, and how it can evolve with a view to support economic growth.

Considering first the capital position of the two banking systems, it has substantially strengthened after the crisis. The average CoreTier1 ratio of US and European banks, which was around 7 percent at the end of 2007, raised above 13.5 percent, nearly twice as much, ten years later (Figure 5). The US system was recapitalized much more rapidly, as a result of the TARP package, while in Europe the adjustment differed across countries. However, as from 2015 the two systems are broadly aligned.

This is the result of the regulatory measures implemented after the crisis and the tougher stance taken by supervisory authorities, and by banks themselves, towards risk management. This has pushed the system towards higher and better-quality capital buffers. The same applies to liquidity.

Overall, the banking system has become more robust and better equipped to absorb shocks arising from the financial system or the real economy. The increased stability does not explain however the very different performance across the two areas.

A factor that may explain the different bank performance, both in terms of valuation and credit growth, is profitability. Banks that are more profitable are better valued by the markets and are better positioned to generate new capital and thus provide credit to the real economy. This has been a major discriminating factor between the US and Europe.

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Figure 5

Bank capitalization (Cet1)

Source: Bloomberg, Société Générale.

Banks' return on capital fell in both areas to close to zero in 2009–2010, as a result of the crisis. However, it rose back towards 10 percent in the US, as the economy recovered, but remained low in Europe until 2016 (Figure 6). In countries like Germany and Italy profitability was negative for several years, as a result of the cyclical downturn and the slow pace in balance-sheet restructuring.

Banks' profitability depends not only on the return but also on the cost of capital, which is generally estimated on the basis of capital asset pricing models. Estimates are based on several parameters, such as the risk-free rate of return, the cost of debt, the risk premium and price volatility. If the return is higher than the cost, investors will be led to increase the holding of the asset, with respect to other alternatives, and valuations will tend to rise, and vice versa.

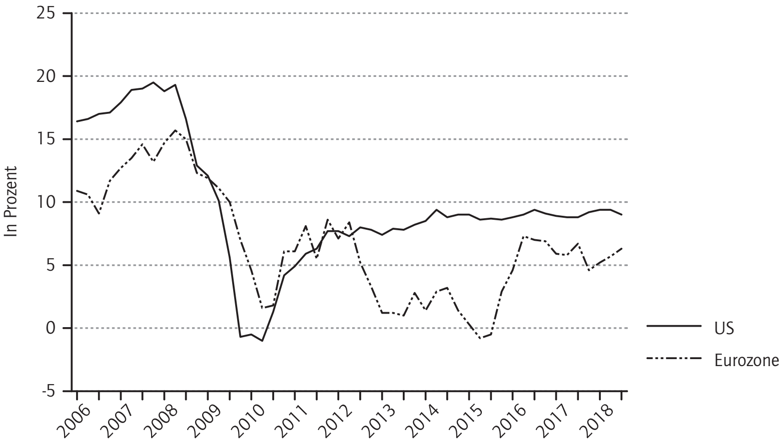
It is interesting to note that both in the US and Europe the cost of capital has benefitted neither from the reduction of interest rates on risk-free assets nor the strengthening of regulation and banks' capital position. Although yields on both US Treasuries and German bunds fell sharply, especially after the implementation of quantitative easing by the Federal reserve and the ECB and the above-mentioned strengthening of banks' capital position, the cost of capital has remained elevated, higher than pre-crisis levels.

In the US, the cost of capital increased after the crisis but gradually came back to slightly above 10 percent. In Europe instead, the cost of capital remained high, over 15 percent, for a prolonged period of time (Figure 7). In Italy the cost has been affected by the rise in Government bond yield in 2011–2012 and in the most recent period.

What is the reason for such a high cost? Contrarily to what some academics like to think, the banking sector cannot be simply assimilated to a utility, which is highly regulated activity characterized by a combination of low rates of return and low volatility. Banks' profitability is correlated with macroeconomic developments, since revenues are not determined by regulated tariffs but rather

Figure 6

Banks' return on capital



Source: Bloomberg, Société Générale.

subject to strong competition within the sector. The increase in capital requirements have not reduced the perceived cost of capital but have compressed profitability.

Comparing the cost and the return on capital helps explaining the different performance of US and European banks. For the former, the return on capital has basically caught up with costs, while in Europe there is still a substantial gap, with costs remaining higher than returns, especially in Germany and Italy.

There are seven factors that explain the difference between US and European banks' profitability.

The first is the level of interest rates and the yield curve, which basically reflect the different stage of the cycle across the Atlantic. The higher the interest rate and the steeper the yield curve, the higher is profitability, especially when banks' assets have longer maturities than liabilities. The profitability of the traditional banking business, based on the holding of short-term deposits and the supply of longer terms loans to the private sector, depends on the steepness of the yield curve. The sharp reduction of short-term rates after the crisis, in line with the policy rate cuts, and the fall in long term rates, especially after the implementation of quantitative easing, compressed the profitability on both sides of the Atlantic. The US have nevertheless benefitted from a quicker exit from the low interest rate policy, which instead persists in Europe. In the Eurozone, the banking system is also penalized by negative rates (–0.4 percent) on bank deposits with the central bank, which cannot be easily passed to the customers. This represents a tax on the amounts of deposits banks hold with the central bank, while in the US banks are remunerated at positive rates on their excess reserves.

Looking ahead, the difference is likely to last for some time if the European cyclical position continues to lag behind that of the US. Any new announcement by the ECB to prolong the zero

Figure 7

Banks' cost of capital

Source: Bloomberg, Société Générale.

interest rates forward guidance contributes to depress bank valuation. The ECB may at some stage consider alleviating the burden created by negative interest rates on deposits, adopting for instance a tiered system like in Japan, exempting certain deposits from the penalty. This could in fact have a positive impact on credit conditions, by providing banks with greater room for maneuver in their capital position.

The second factor influencing bank profitability is taxation. In recent years the US banking system benefitted from the reforms implemented by the Trump administration, which has substantially reduced the fiscal burden. Taxation has instead increased in Europe, with specific measures such as the recent ones implemented in Italy and Spain. In the Eurozone, banks must also contribute to the creation of the 50 billion euro Single Resolution Fund, which represents an implicit taxation. In some countries banks also contributed "voluntarily" to the resolution of smaller banks, like in the case of the Atlante Fund in Italy.

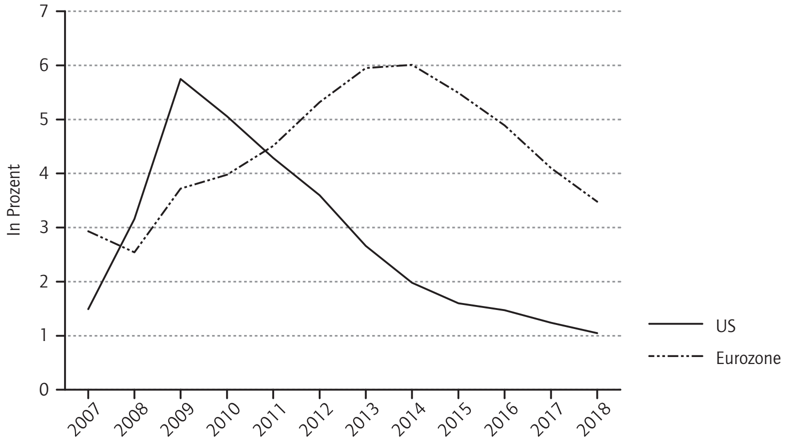
Looking forward, it doesn't seem that the more favorable fiscal position for US banks will change over the coming years.

The third factor is related to the cleaning up of banks' balance sheet after the crisis. Indeed, the higher is the ratio of non-performing loans, the lower is banks' profitability, especially if the value of the collateral is not adequately accounted for. In the US, the overall NPL ratio reached a peak around 6 percent in 2009, but fell rapidly thereafter, getting back to the pre-crisis level by 2015 (Figure 8). In the Eurozone the rise in NPL was initially slower but accelerated after the second recession of 2012–2013. The reduction was also slower, and the pre-crisis levels have not yet been reached.

The difference between the US and Europe is due to several factors, including the different bankruptcy legislation and accounting rules. The US legislation is more flexible and easier to apply,

Figure 8

Banks' Non-performing Loans



Source: ECB, Fed.

while accounting rules are stricter. The US capital market is also deeper and better equipped to absorb securitized NPLs, while it took some time in Europe to develop a market for this type of asset. The ECB recently adopted measures aimed at aligning the speed of NPL reduction in banks' balance sheets to that of the US.

Overall, US banks have cleaned up their balance sheets much more quickly, also as a result of the forced capitalization implemented in the context of the TARP. In Europe the fear to destroy value through an excessively rapid reduction of NPLs in banks' balance sheets produced the opposite result. Banks which did not dispose sufficiently quickly of their NPLs experienced a sharp reduction of profitability and a rise in the cost of capital. The destruction of value has been even larger.

Going forward the situation is expected to improve in the Eurozone. The reduction of NPLs should continue in the coming years, bringing the ratio back to pre-crisis levels. Profitability should thus rise again, unless the economy slows down sharply, producing a new jump in NPLs.

The fourth factor which explains the higher profitability of the US banking sector is its degree of market concentration. The Gini coefficient of the US system is around 50 percent, higher than in European countries and in the Eurozone as a whole. The five largest banks cover over 50 percent of the market. Concentration is even higher in the capital market. This means that US banks have greater pricing power and more degrees of freedom in setting rates and commissions. They can benefit from economies of scale, due to their larger size, and have the critical mass to produce services in-house that they then sell to their customers, rather than having to distribute other banks' products, which obviously lowers profitability. The larger size better enables them to face the challenge of new entrants and eventually buy them out.

In Europe concentration progressed differently across countries. It has advanced in Nordic countries, Benelux, France and even Spain, as a result of the crisis. In Germany and Italy, instead, the system remains fragmented. In several countries the strong presence of cooperative institutions, which have a much lower cost of equity and thus lower requirements in terms of return on equity, puts pressure on the profitability of listed banks.

Looking ahead, there will be strong pressure for consolidation within borders, especially in Germany and Italy. However, the fear of having banks that are too big tends to discourage aggregations, even between weak banks, under the false assumption that the sum of weaknesses does not create a strength. This ignores the fact that synergies and efficiencies can be generated through mergers between institutions that have a strong overlapping business. Aggregations are also discouraged by conflicts of powers within and between boards, where political considerations may play a substantial role. In the US, bank mergers continue to take place, as the issue of being too-big-to-fail seems to have been reconsidered.

At the European level, the pressure for greater cross-border concentration should emerge as a consequence of low profitability and the need to compete on a similar scale with US and Asian banks. However, it is unlikely that the existing obstacles to concentration will rapidly fade away. The difference between legal systems make it difficult to extract synergies, especially in retail banking, that would make mergers attractive. Furthermore, national political authorities have become increasingly sensitive to the risk of having their banks merge with or being acquired by banks from different countries. The system of exemptions to the EU regulation, which allows national regulators to restrict capital and liquidity mobility within cross border banking groups, is unlikely to be changed in the near future. The fear, especially in smaller countries where branches are located, that the burden of adjustment would be borne by the latter, explains the reluctance of some national authorities to move towards a full implementation of the banking union.

Another obstacle for progressing towards a complete banking union, in particular a common deposit insurance scheme, derives from the still high level of Government bonds held by some banking systems, which produces a high correlation between bank and sovereign risk, the so-called doom-loop. This issue is however not easy to solve, as Europe would be penalized if it was the only area in the world to adopt a system which would limit the extent to which banks can hold Government bonds in their balance sheets. Ideally, the Eurozone should adopt a safe asset, that banks can easily invest in, especially to satisfy their liquidity ratios, but this solution appears politically premature.

The fifth factor, which is linked to the previous one, concerns the different state of development of the capital market in the US and Europe. The US capital market has developed over the last 30 years in line with the process of bank concentration that took place after the Savings and loan crisis and the removal of the prohibition of inter-state banking. Major US banks are active in the capital market, as originators, market makers and advisors. They can extract fees and commissions on a broad range of products, both on the buy and sell side. The strong degree of market concentration ensures high profitability of the so-called universal bank model, which combines retail and capital market activities. The crisis accelerated such a development. The largest banks strengthened their market position, contributing to bail out smaller or more specialized banks, such as Bear Sterns or Washington Mutual.

In Europe the capital market is smaller and fragmented. Bank financing represents still around 70 percent of the total financing to the economy, against less than 30 percent in the US. This means that a large part of the loans provided by banks remains on their balance sheet and cannot be securitized and sold in the capital market. One of the major obstacles is the different nature of national markets and banking practices in different European countries. Since a French mortgage is different from an Italian or Dutch mortgage, they cannot be bundled together and traded and is the case of the US. There is no such a thing as a Fanny May or Freddie Mac in Europe.

The European Commission launched a European Capital market union project, but progress has been slow. Time will be needed before legal and tax barriers are removed. Furthermore, in order to function properly, a capital market requires participants, which are typically banks, that have the size and capability to perform various tasks such as origination, securitization, dealership, advisory, analysis. As European banks shrink their investment banking activity, the likelihood of a capital market diminishes.

In principle, all countries are in favor of creating a capital market union, especially after Brexit. The new European Commission is expected to launch an initiative with new concrete proposals. In practice, there is still strong national resistance, in particular with respect to giving stronger regulatory powers to ESMA, the European market supervisory authority.

The sixth factor concerns regulation. New rules have been defined after the crisis, in the context of the cooperative framework underlying the Basle Committee. However, these rules tend to penalize the European banking system in several respects. In particular, the desired incentive for standardization, in particular in the use of models to assess risk, can be fully captured only in the presence of a deep and liquid capital market. In the fragmented banco-centric European system the benefits of standardization cannot be fully reaped. As a result, the new rules tend to discourage credit, and make it more expensive. Another example is the additional capital buffer which is charged on large banks, which is based on the absolute value of the balance sheet, which tends to penalize a banco-centric financial system like the European one.

Furthermore, the implementation of the new regulation differs between the US, where supervisory authorities enjoy substantial discretion, and Europe where regulation is comprehensive and rule-based. The new US Administration has clearly inverted the regulatory trend of the previous decade. In Europe, instead, the late creation of the single supervisor, in 2014, forced a process of harmonization and standardization of rules and procedures which on the whole have become stricter. There is still some degree of uncertainty on how some of the new Basel rules will be implemented in the European context. In spite of all the regulatory effort, the remaining uncertainties have contributed to raise the cost of capital.

The last factor explaining the different profitability between the US and European banking system is played by the different flexibility of the labor markets. The financial crisis and the emergence of new technologies in financial transactions has put pressure on the traditional banking models, especially in the simpler activities like deposit taking, credit and payment. There is less need for an intensive interaction between customers and bank employees and for a diffused network of bank branches. Data has become the key resource for financial institutions. The higher the number of clients, and the more information banks have on their clients, the greater the ability to design efficient products and services at the desired price. Having more clients is less costly and more profitable than in the past. In short, size matters.

The change in the business model requires strong investments in new technologies and a high flexibility of labor, both to attract new talent and to ease the exit of excess labor. The US have certainly benefitted from a more favorable environment to implement these changes, compared to European countries, where the reduction in costs has been slower and more complex.

To sum up, the combination of the above-mentioned factors explains the divergence between the profitability of the US and European banking systems, and within Europe between that of different countries. Over the last decade, US banks have grown in terms of size and activity, while European banks have reduced the scope of their activities. US banks have taken the lead in capital markets, including the European ones, leveraging on their stronger and more profitable domestic market. Even in the non-banking sector, such as wealth management, US players count amongst the largest.

European supervisory authorities understood, with some delay, that a banking system that is not sufficiently profitable can become a source of fragility over time. One of the potential problems is the ability to generate sufficient resources to continue investing, especially in technology, including for cyber-security, which is key to increase revenues and safeguard profitability. Furthermore, a system that is not sufficiently profitable is not able to attract investors, which may be needed especially at times of crisis.

More important, a banking system which is not sufficiently profitable is not able to adequately support economic growth, especially in a banco-centric financial system like the European one. Furthermore, a capital market union cannot be created in Europe without a strong and profitable banking system. A well-functioning capital market, capable of financing the real economy and absorbing asymmetric shocks within the monetary union, cannot rely on US investment banks alone. Without a strong European banking system there can be no banking union, capable of supporting the growth of European companies in the global competition.

While the problem may start to be understood, no concrete solution is being foreseen. Regulation continues to be tightened; negative interest rates continue to prevail; no euro safe asset is being developed; cross-border capital and liquidity mobility continues to be restricted by national regulators; taxes on banks continue to be raised; the willingness to move towards banking union is still constrained by national political considerations and mutual distrust. The result is that the profitability of the banking system remains impaired. European banks are losing grounds in the global competition, in particular to US banks. As a consequence, banks' ability to grow and to support economic growth in Europe is much more limited than in the US.

What ultimately seems to be missing in Europe, both at the Union level and within its member states, is a strategic view of the role that the banking system can and should play in the process of economic development. Ten years after the crisis, the banking system continues to be viewed in Europe as the main cause of the crisis and, at most, as a potential source for raising taxes. In the US and in China, instead, there is a shared awareness among policy-circles that a strong and profitable banking system, based on large international institutions that have the means of supporting their clients in the global competition, is a strategic priority.

It may be time for Europe to learn from experience. And possibly change its policy.