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Reinventing the European Banking Sector



REPORT NOVEMBER 2021

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Reinventing the European Banking Sector

REPORT – NOVEMBER 2021

INTRODUCTION

*There is no desire more natural
than the desire for knowledge*

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Since the financial crisis and the sovereign debt crisis, European banks have grown stronger but are now less profitable. Stronger, because their solvency and liquidity ratios have improved thanks to the major adjustment efforts carried out from 2009 onwards to comply with, and exceed, the new prudential rules. Their resilience was put to the test during the COVID-19 crisis, with positive results, even though the economic support measures taken by governments have clearly greatly eased their balance sheets. Less profitable, because European banks have generated, on average, a rate of return below their cost of capital. To put it bluntly, European banks have destroyed shareholder value. This situation is specific to Europe, and is not occurring in the big American or Asian banks. A company or industry, which finds itself in this situation on a long-term basis, is put in jeopardy. It runs the risk of not attracting sufficient capital to finance the investments needed to guarantee its competitiveness, and therefore its future is at stake – precisely at a time when the technological revolution underway requires a profound transformation of the banking sector. It risks losing ground in the markets in which it operates and where it sometimes competes with other global players. It risks no longer being able to play its part in financing the economy under the right conditions, including the transmission of monetary policy, nor being able to contribute to Europe's strategic independence. Yet Europeans would be wrong to neglect the future and the sovereign nature of the banking sector – in which we believe – solely based on its current poor reputation. How should we view a situation in which the head of a major European bank has said half in jest: “The future of the European banking sector? Outside Europe, or perhaps even outside banking.” A situation in which the subsidiary of a major European bank, once a flagship of its country's banking industry, is sold at a very negative price? A situation in which the financial markets are telling us, through their average valuation of European banks, that their continued operations are constantly destroying value?

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This report thus starts with a clinical assessment of the banking sector's situation, based on the way in which capital providers view European banks. We will rely on indicators of solvency, liquidity, profitability, return on invested capital, and market value in relation to equity, and will draw comparisons with American and Asian banks. Of course, we are aware that not all European banks are listed, not even as joint stock companies. The cooperative and mutual banking sector, which has a strong presence in Europe, with contrasting developments in different countries, does not necessarily meet the same management criteria. Nevertheless, we believe that the market provides useful indications about the future of the sector that cannot be ignored.

We will then endeavor to explain the reasons for this underperformance, while aiming to distinguish between cyclical causes (i.e., macroeconomic situation, monetary policy) and structural causes (i.e., market structure, regulation, new competition).

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This paper will also consider whether, beyond the obvious problems it raises for the banking industry itself, this situation presents disadvantages for Europe as an economic and political power. We believe this to be the case because positive externalities from the financial sector – with the banking sector at the heart of it – benefit the rest of the economy, as banks play a major role in financing the European economy, in the transformation of its savings, in the circulation of capital within the euro zone and, more generally, in the service of the sovereignty of Europe and the States that make it up.

Finally, potential means of remedying this situation will be assessed. Our proposals will be clarified by mapping out possible scenarios for the evolution of the banking industry in Europe. We will also consider what banks can do for themselves. Lastly, public policy choices, at national or European level, will be analyzed to consider what might prevent the attrition of the European banking industry as a consequence of its loss of competitiveness.

Methodological notes

The observations in this report should be applied to the banking sector as a whole, i.e., to all regulated institutions engaged in retail or wholesale banking. Depending on the information available, the geographical scope of the study is, by order of priority: the euro area (~4,500 banking institutions) with identical currency and a single supervisor, then, the European Union (~6,000 banking institutions), and finally continental Europe.

When possible, market trends and sector performances are compared with the US market, which has comparable economic maturity, regulations and consumer habits. To a lesser extent, the Asian market, including the Chinese, Japanese, South Korean, Hong Kong and Singaporean banking sectors, may also allow for an interesting point of comparison as an alternative model.

The analyses are primarily based on national aggregates provided by central banks and banking associations. However, as this data's level of granularity is limited, most of the findings are based on a sample of banks which represent the dynamics of the regions in which they operate. The 30 largest European listed banks have therefore been selected by balance sheet size, as a representative sample of trends in their regions, as well as the 20 largest US listed banks and the 30 largest Asian listed banks, following the same criteria. In addition, certain comparative analyses were carried out on 900 or so European banks and on 400 US banks with balance sheet sizes of over \$1 billion.

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SINCE THE FINANCIAL CRISIS, THE EUROPEAN BANKING SECTOR IS STRONGER BUT LESS PROFITABLE

1. As pillars of economic financing, European banks have learned the lessons of the financial crisis and cleaned up their balance sheets – despite certain persistent weaknesses

1.1. In Europe, banks remain essential for financing the economy

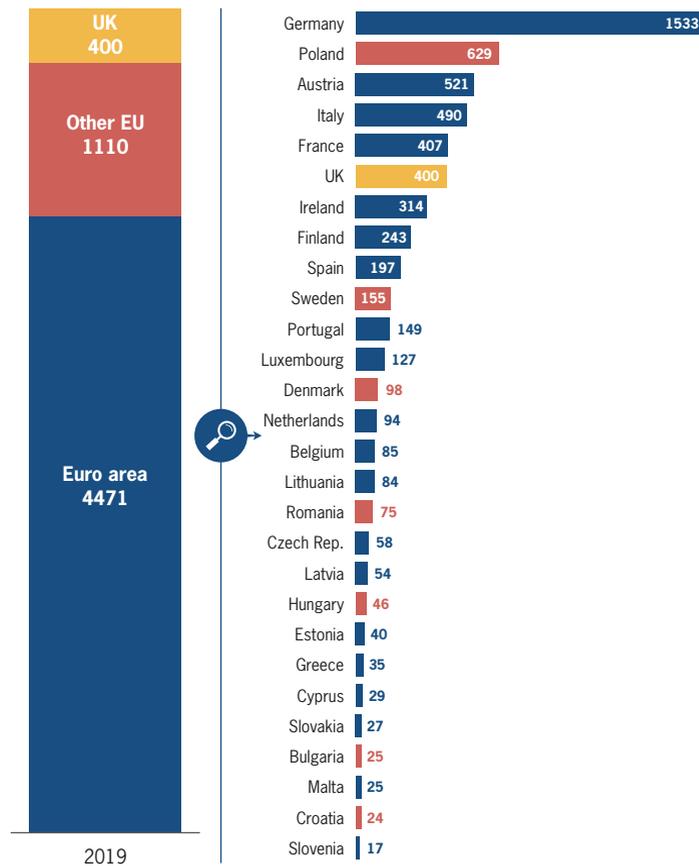
There are around 6,000 banks in the European Union, including just under 4,500 in the euro area (see figure on page 13) – which is almost as many as in the United States, where nearly 5,200 institutions are registered with the Federal Deposit Insurance Corporation. This tally, made on an “individual” basis – each institution, even a subsidiary or an affiliate, counts as one bank – suggests that the sector is not highly concentrated. In actual fact, the banking industry is much more concentrated. For example, in the euro area, 115 banking groups, which also happen to be the largest ones (see box on page 14), are directly supervised by the European Central Bank and account

¹ Federal deposit insurance corporation (FDIC), 2020. <https://www.fdic.gov/news/press-releases/2020/pr20018.html>

for 80% of the sector's total assets. In this respect, the French example is very telling: there are 425 credit institutions on an individual basis, but 300 of them belong to 11 banking groups, which account for 85% of the sector's assets. Among them, the 6 main ones (BNPP, BPCE, Crédit Agricole, Crédit Mutuel, La Banque Postale and Société Générale) account for 90% of the total. However, not all European countries have France's level of concentration. The European banking sector is actually less concentrated than the American banking sector, where the top three banks account for 35% of assets, compared with less than 15% for the top three European banks.

Number of credit institutions in the European Union

(2019)



Source: European Central Bank, analyses BCG.

European banks are very different from each other. It would be impossible to give an example of a “typical” European bank (see box: “The diversity of the European banking landscape”). Indeed, not only do they vary significantly in size, but they can also be distinguished by their different governance systems and their various business models. The only shared aspect is of a regulatory nature: because they all receive deposits from the public, these companies are subject to specific regulations that define them as banks, or credit institutions (see box: “What is a bank?”).

The diversity of the European banking landscape

In Europe, local branches coexist with global banks, sometimes on a continental scale or beyond. 115 banking groups are directly supervised by the European Central Bank (ECB) because of their size and interconnection with other credit institutions.² Of these banks, 13 are of global systemic importance (G-SIBs³), and 8 of the 13 are from a euro area country (see figure on the following page). Alongside these giants, the European banking landscape also includes a multitude of local or regional players, such as the cooperative credit unions in Germany (*Raiffeisenbanken* or *Volksbanken*).

.../...

2 A banking group gets placed under the direct supervision of the European Central Bank if it meets at least one of the following four criteria: (i) its total assets are over €30 billion; (ii) its economic importance in the country in which it operates or in the European Union more generally; (iii) its total cross-border assets are over €5 billion and its ratio of “total assets in a member country” to “total assets” is over 20%; or (iv) if it has received funds from the European Stability Mechanism. These 115 banking groups hold approximately 82% of the total banking assets of the European Union countries participating in European banking supervision.

3 “Global Systemically Important Banks”: defined by the Basel Committee and implemented by the Financial Stability Board, this category includes 30 banks worldwide. This prompts additional prudential requirements compared to the ordinary rule of law, notably a capital cushion, the value of which (from 1 to 3.5% of risk-weighted commitments) is determined by the level of systemic importance (from 1 to 5).

Global Systemically Important Banks (G-SIBs) in Europe in 2020

Establishment	Country	Category
HSBC	UK	3
Barclays	UK	2
BNP Paribas	France	2
Deutsche Bank	Germany	2
Credit Suisse	Switzerland	1
Groupe BPCE	France	1
Groupe Cr�dit Agricole	France	1
ING Bank	Netherlands	1
Santander	Spain	1
Soci�t� G�n�rale	France	1
Standard Chartered	UK	1
UBS	Switzerland	1
Unicredit	Italy	1

■ Euro area banks

Source: Financial Stability Board.

The diversity of the European banking landscape can also be measured by the different governance models that coexist within the continent, between capitalist, cooperative and public banks:

- **The first group encompasses banks established as joint stock companies.** Typically, the largest of them operate using a public listing of their securities, as this method of financing supports high yield bonds while at the same time ensuring a low concentration of ownership rights in the company.
- **The second group is made up of banks referred to as “cooperatives”,** inheriting from the mutualist movement. These institutions appeared in the Rhineland in the middle of the 19th century under

.../...

the impetus of Frédéric-Guillaume Raiffeisen, and were intended to provide access to credit for the most modest individuals and the smallest companies – e.g., in agriculture or the craft industry, by means of a joint guarantee system (the equivalent of *Crédit Agricole* and *Banques Populaires* in France, for example). They are not owned by shareholders but by their members, who are responsible for the commitments contracted by the cooperative within the limit of their shares. The share is unlisted, at a fixed nominal value and with an interest rate level fixed each year, after setting aside retained earnings. In France, for example, the law caps the remuneration of cooperative bank shares at the average one-year return on private company bonds, plus 2%. This payment is generally lower than the dividend paid by “share” banks, allowing these cooperative banks to amass reserves faster and more significantly, especially in times of very low interest rates such as now. The cooperative model plays an important role in Europe, with its banks accounting for between 25% and 45% of loans issued in the largest countries.

Some countries have supported the development of these institutions, notably Germany and France,⁴ where they now play a very important role, mainly in retail banking. Conversely, the cooperative model has been receding since the financial crisis in other countries such as Italy, whose banks have faced serious management difficulties.

- **The third group covers publicly owned banks.** In some European countries, the banking sector has undergone phases of nationalization, particularly France in 1945, then again in 1981, before being privatized from 1986 onwards. This public banking sector has been considerably streamlined since the 1990s, except in Germany

.../...

where, even though the *Landesbanken* have been deeply affected by the financial crisis, savings banks still maintain a strong presence. However, in France, they were turned into cooperative banks by law in 1999; in Spain, they did not withstand the financial crisis, which led to their disappearance or their regrouping into larger entities.

The German banking system provides an evocative illustration of the coexistence of these three banking models. Three pillars are traditionally distinguished. The first pillar is made up of the large listed banks such as *Deutsche Bank* and *Commerzbank*. The second pillar encompasses the 400 public banks operating at regional and local levels, whether they are owned by the federal state (*Landesbanken*) or by the municipalities (*Sparkassen*). The third pillar consists of the cooperative banks, many of which are grouped within federal structures.

Lastly, the diversity of European banks can be seen in the business lines in which they operate and in their combination of different business models.

Retail banks, which focus on individuals, the self-employed and small and medium-sized enterprises (SMEs), operate mainly in domestic markets, governed by specific tax and legal rules and local consumer habits. By contrast, wholesale banks, which focus on financing larger companies and accessing international financial markets, face global competition governed by common rules. According to BCG, retail banking revenues will account for slightly less than two-thirds of banking sector revenues in the euro area in 2020, compared with more than one-third for wholesale banking. Ancillary services, especially third-party asset management, insurance and financial advisory services, account for less than 5% of revenues. Universal banks base their business model on the exercise of all these activities, whereas specialist banks limit themselves to a specific business segment or customer base.

⁴ See in particular the law of November 5, 1894, allowing for the creation of local agricultural credit banks or the 2009 State-backed creation of the *Banque Populaire Caisse d'Épargne* group (BPCE).

Business lines and business models of European banks

Business lines

Description

Retail Banking	and/or	Wholesale banking	and (optional)	Ancillary services (non-banking activities)
The retail bank accepts deposits and grants loans to individuals and small businesses.		The wholesale bank offers financing solutions to companies (loans, bonds...) and gives access to financial markets.		The ancillary services to diversify the banking offer, including: <ul style="list-style-type: none"> • Asset management; • Wealth management; • Insurance; • Remote monitoring...

Banking income % estimate in the euro area

57% – 62%	37% – 42%	< 5%
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Example

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Scope

Universal bank	Specialized bank
Usually large banks that have several banking activities (retail and wholesale) and non-banking activities.	Usually niche banks that focus on one type of banking activity or serve only one type of customer.

Source: BCG Banking Pool.

What is a bank?

A bank is defined by its monopoly on receiving deposits and its right to grant loans. These activities, which are crucial for financing the economy, are regulated and are reserved for licensed companies. In Europe, these companies are legally classified as “credit institutions”⁵ and are subject to a set of prudential and customer protection rules.

A bank, qualifying as a “credit institution”, is a company whose business is to receive deposits from the public and to grant loans:

- The exclusivity in receiving deposits and other repayable funds from the public is regulated by EU law⁶ and therefore applies to all European countries;
- The ability to grant loans on a regular basis can be reserved for banks or opened to other institutions, depending on the rules which differ from one European country to another.⁷ In France, transactions in loans fall under the purview of credit institutions, with some exceptions. Spain and Italy also generally restrict lending to banks. Conversely, the British system boasts greater freedom.

Banks also offer transaction and payment services – one of their core activities – however, these activities are not exclusive to them as credit institutions. Finally, banking groups may also develop other related activities through dedicated affiliates, such as insurance services or investment and market intermediation services. .../...

5 Capital Requirements Regulation (CRR): Regulation (EU) No. 575/2013 of the European Parliament and of the Council of June 26, 2013, regarding prudential requirements for credit institutions and investment firms.

6 “CRD IV” for “Capital Requirements Directive IV”: Directive 2013/36/EU on accessing the business of credit institutions and the prudential supervision of credit institutions and investment firms.

7 Haut comité juridique de la place financière de Paris, Report on the banking monopoly, March 14, 2016.

By receiving deposits and granting loans, banks play a central role in the financing of the economy. The development of banks has accompanied the emergence of modern economies. Academic literature⁸ distinguishes essential roles played by banks:

- **A maturity transformation role:** demand or short-term deposits and short-term market financing are transformed into medium and long-term financing. Asset-liability management within a bank aims to continuously adjust these resources and uses in order to guarantee the institution's liquidity and solvency;
- **An information role:** by being an intermediary in the relationship between lenders and borrowers, banks reduce the information asymmetry that necessarily develops between these two agents. Banks implement means of information and in-depth control of borrowers, based on a long-term relationship that makes it possible to assess their risk profile;
- **A risk management and sharing role:** by pooling financing needs and capacities, banks, like financial markets, play a risk diversification role. They also allow for risks that cannot be diversified at a given time to be smoothed over a longer period. Academic research⁹ shows that banks, as long-term institutions, are able to accumulate reserves in periods of expansion and to draw on these reserves in periods of decline; this mechanism makes it possible to protect themselves over time against global risks such as macroeconomic risks;
- **A monetary policy transmitting role:** as the only entities with access to the central bank's balance sheet, they are the "monetary policy counterparties" and, as such, are one of the most direct channels for transmitting monetary policy. In the euro area, only

.../...

credit institutions have access to the standing deposit and lending facilities and to the refinancing operations "conducted at market conditions"¹⁰ organized by the Eurosystem¹¹. From this access to the central bank's balance sheet, banks act as money multipliers by creating money to meet the demand for credit.¹²

Given the intrinsic vulnerabilities of the changes they make and the importance of their activity for financing the economy, banks are closely regulated players. The maturity mismatch between banks' resources and uses exposes them to the risk of a bank run. Given its

critical role in financing the economy, the banking system cannot be left to fail by governments, which are then forced to recapitalize struggling banks. The latter are then placed in a situation of moral hazard ("too big to fail") which also argues for their *ex ante* regulation.

Moreover, the credit institution status – a prerequisite for banking activities – is subject to a prior authorization procedure, to a prudential framework and to supervision by a supervisory authority. The development of international banking activities has made it necessary to establish a minimum prudential framework. These common prudential rules are drawn up at the global level by the Basel Committee and incorporated into European law before being transposed into national law in Member States¹³ (see graph on the next page).

.../...

10 Open market operations.

11 Banks also play a key role in the implementation of unconventional measures: exclusive access to Targeted Long Term Refinancing Operations (TLTROs) and the role of market intermediaries in support of asset purchase programs.

12 See in particular Banque de France, "Who creates the money?", *L'éco en bref*, January 2019.

13 The CRR regulation, the CRDIV directive and other legislative texts are brought together in a single rule book. In order to clarify these requirements, the European Banking Authority (EBA) publishes binding technical standards, but also guidelines, recommendations and opinions.

8 See in particular F. Allen, E. Carletti and X. Gu, "The roles of banks in financial systems", in *The Oxford Handbook of Banking* (3rd edition), 2018.

9 F. Allen and Gale D., *Comparing Financial Systems*, MIT Press, 2000.

Summary of the requirements for obtaining a banking license in the euro area

<p>3 types of applicants</p>	<p>The ECB assesses the bank based on 5 stability criteria, according to the terms defined by CRD IV and their implementation by the local national competent authorities (NCA)</p>		
 <p>New business (e.g. neobank)</p>	<p>1 Equity requirement</p> <ul style="list-style-type: none"> Initial capital requirement > €5M Equity quality Expected capital amounts, in line with capital adequacy ratios 	<p>2 Corporate operational plan risks</p> <ul style="list-style-type: none"> Activity risk profiles Consistency of market approach (products/services, customer segments, distribution channels...) 	<p>3 Soundness of financial projections</p> <ul style="list-style-type: none"> Consistency of financial projects based on different internal performance assumptions and the economic environment Internal capital adequacy based on these assumptions
 <p>Bank resulting from a merger</p>	<p>4 Appropriate organizational structure</p> <ul style="list-style-type: none"> Management structure, governance arrangements, role and task distribution Internal control and risk management framework, qualitative and quantitative composition of related functions 	<p>5 Manager and shareholder competence</p> <ul style="list-style-type: none"> Integrity and competence of the members of the management board Evaluation of the shareholders in terms of reputation, financial soundness, and AML compliance 	<p>+ Compliance with the regulatory requirements related to the activities carried out</p> <ul style="list-style-type: none"> e.g., CRR, BRRD, IFRS, MIFID...
<p style="text-align: center;">↓</p> <p>ECB sole competent body to approve credit institutions established in Member States participating in the Single Supervisory Mechanism (SSM)</p>			

Source: European Central Bank, BCG analysis.

Since 2014, the euro area has implemented these rules under a single supervisory mechanism (SSM).¹⁴ A single supervisor, backed by the European Central Bank and placed under the authority of a Supervisory Board, ensures the homogeneity of the supervision of all banks in the euro area, grants and withdraws the authorization of credit institutions and takes charge of the direct supervision of the 115 largest banking groups, with teams (Joint Supervisory Teams) associating the ECB with the national competent authorities (NCAs).¹⁵ The NCAs are responsible for the direct supervision of small and medium-sized banks, although some decisions are taken by the Supervisory Board.

In Europe in particular, the banking sector plays a key economic role.

Despite globalization, the major balances in economic financing remain specific to each major zone. Historically, the United Kingdom and Japan have had a relatively balanced financial structure between bank financing and market financing of stocks and bonds. The United States is the perfect example of a market-based financial system, while the euro zone and emerging Asian countries rely more on the banking system. Across the European Union, banks hold €43 trillion in assets, of which almost two-thirds are loans (to companies, individuals and public institutions).¹⁶

Banks are therefore more important than the market in terms of financing for European companies

(see figure below), although there are significant differences between Member States – France, for example, has a level of disintermediation close to that of the United Kingdom. Market or disintermediated financing accounts for twice as much of the total in the United States as in the euro area (86% versus 43%). Conversely, the share

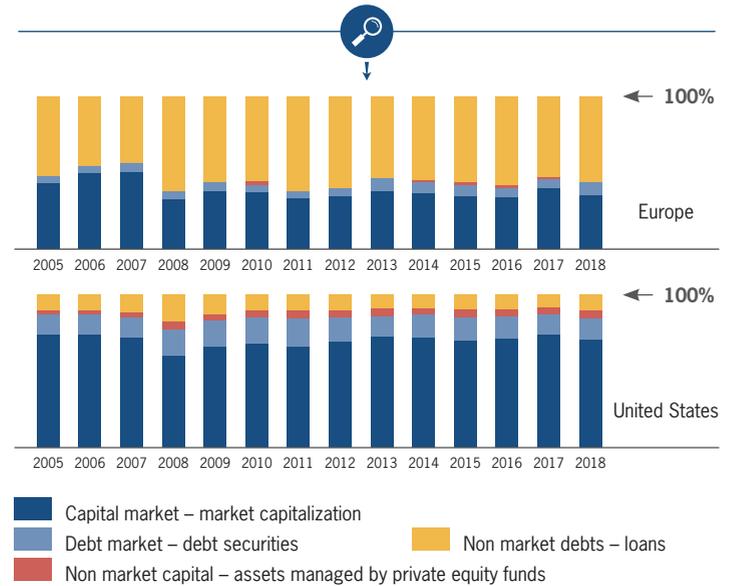
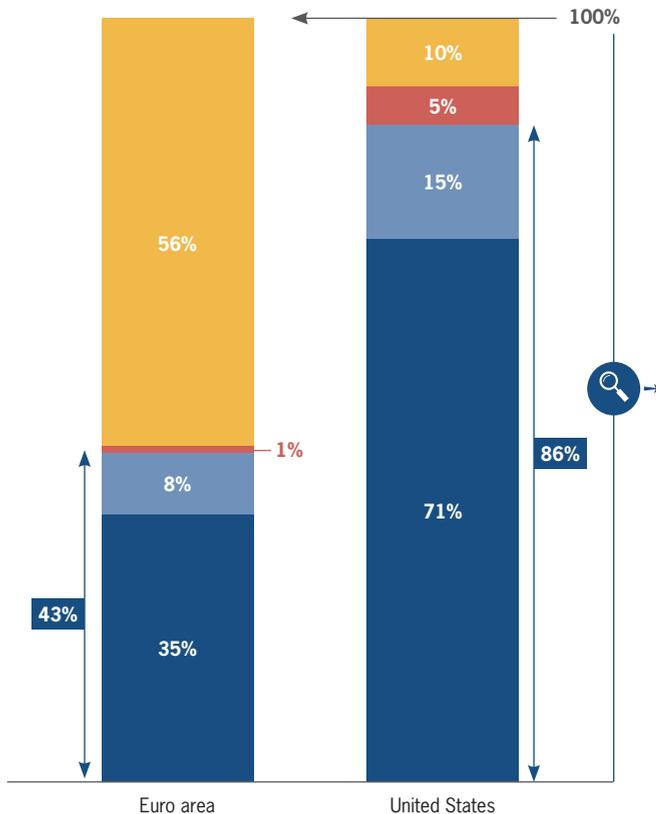
¹⁴ Council Regulation (EU) No 1024/2013, of 15 October 2013, entrusting the ECB with specific tasks for policies relating to the prudential supervision of credit institutions.

¹⁵ Such as the *Autorité de contrôle prudentiel et de résolution* (ACPR) in France.

¹⁶ Source: European Central Bank, 2019.

of non-market debt, essentially bank financing, finances 56% of the balance sheet of companies in the euro area, compared with 10% in the United States.

Distribution of financing of private non-financial companies as a percentage of total financing volumes
(2018 estimate)



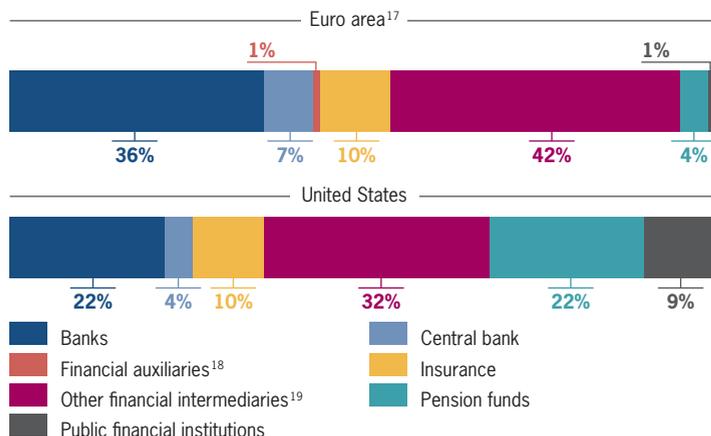
Source: World Bank, IMF, Preqin, Pitchbook, BCG Analysis.

Similarly, in 2019, the bank shares in asset ownership are significantly higher in Europe (36%) than in the United States (21%) (see figure below). The financing of the European economy has admittedly been rebalancing in favor of the markets for several years. The bank shares in financial holding assets were 55% in 2006, 49% in 2010 and then stabilized at 36% between 2017 and 2019. But this phenomenon should not obscure the prominent role of banks in the financing of the European continent's economy until today, nor should it conceal the fact that banks indeed contribute to the organization of this market financing, either on the primary markets or on the secondary markets. Many long-standing factors explain this disparity. Among them, the pension financing model appears to be a determining factor: the accrual system, which is more

prevalent in the United States than in Europe, is reflected in the creation of pension funds, which account for 21% of total assets and feed the financial markets.

Share of different financial intermediaries in the holding of total financial assets in the euro area and the United States

(2019)



Note: Financial assets are the total productive assets recorded on the balance sheets of financial institutions, and are considered as financing sources for businesses and individuals (loans, bonds, etc.)

Source: Financial Stability Board, BCG analysis.

¹⁷ Calculation based on eight representative countries in the euro area (France, Germany, Spain, Italy, Ireland, Netherlands, Belgium and Luxembourg), representing 85% to 90% of total assets in the euro area.

¹⁸ These are investment funds (equity, fixed income, money market funds), brokers, structured investment vehicles (SIVs), captive financial institutions, lending companies (including credit FinTechs).

¹⁹ Firms that provide assets but are not intended to hold them, such as insurance brokers, financial investment advisors...

Beyond its role in financing the economy, the European banking sector also contributes economically in terms of value creation and employment. Although it has been in decline since 2008, the clout of European banks remains significant. According to the European Banking Federation,²⁰ between 3 and 4% of the value added created in the European economy was created in the banking sector. At the end of 2019, banks employed over 2.6 million people in the European Union (i.e., around 1% of total employment). Across the continent, the sector’s workforce remains concentrated in the largest financial centers: 68% in Germany, France, the UK, Italy and Spain. In the euro area, banks employed 1.9 million people in 2019.

1.2. European banks have largely cleaned up their balance sheets since the financial crisis

The two successive financial and sovereign debt crises have profoundly destabilized Europe and the European banking sector. European banks were directly or indirectly affected by the global subprime crisis, before finding themselves at the heart of a specifically European crisis prompted by banking risks polluting sovereign risks (see box: “The two European banking crises (2008-2013)”).

²⁰ Annual report 2020. <https://www.ebf.eu/facts-and-figures/structure-of-the-banking-sector/>

The two European banking crises (2008-2013)

In the summer of 2007, the uncertainties surrounding a possible spread of the American subprime mortgage crisis to Europe led to the evaporation of liquidity on the interbank market. The ECB and the other central banks of the advanced economies intervened on a massive scale by offering broad refinancing to compensate for the disappearance of interbank refinancing. The tensions in the banking system did not disappear and reached a climax in the early autumn of 2008 after the collapse of Lehman Brothers and several bailouts for banks and insurance companies in the United States. The widespread nature of the crisis forced governments to provide fairly extensive support to the banking sector (recapitalizations, refinancing guarantees), especially since some banking systems were facing a rapid deterioration in the quality of their assets, particularly in the context of bursting real estate bubbles (notably in Ireland and Spain). Between the beginning of 2007 and October 2008, the main European banks reported credit losses and asset write-downs amounting to \$252 billion.

The banking crisis of 2007-2008 then extended into a sovereign debt crisis, as part of a feedback mechanism. To avoid the bankruptcy of their banking sector and, more generally, to deal with the crisis, several European States agreed to unprecedented emergency recapitalization measures and announced large-scale fiscal stimulus plans, at a very high cost to public finances. According to European Commission data, €642 billion of public funds (i.e., 4.6% of the Union's GDP) were committed to support banks between October 2008 and December 2014. The largest rescue plans were implemented in Germany (€144 billion), the UK (€140 billion), Spain (€95 billion), Ireland (€65 billion), Belgium (€43 billion) and Greece (€41 billion).

.../...

The impact on public finances of supporting the financial sector, combined with the impact resulting from automatic stabilizers and stimulus plans, undermined investor confidence in the solvency of certain States. The crisis revealed the partial and fragile nature of financial integration in the euro area. The gap between sovereign rates is widening, particularly for Greece, Italy, Spain, Ireland and Portugal. Banks in these countries are the first to be affected and the risk of recapitalization is increasing investors' distrust of sovereign debt: this phenomenon is referred to as the "sovereign-bank loop" (or "doom loop"). Only the unconditional intervention of the ECB (Mario Draghi's famous "whatever it takes") combined with solidarity measures between European States enabled the financial system to stabilize from 2013-2014.

After a decade of restructuring, European banks are now better capitalized, more liquid and less exposed to non-performing loans.²¹ This makes the banking sector more stable and resilient.

First, European banks have significantly increased their capital (see figure below).²² Since 2008, their capital has increased by nearly 60%, from 4% to over 7% of their balance sheet total. Most of this capital (83%) is the highest quality capital (CET1, Common Equity Tier 1, sometimes referred to as "hard" capital, as opposed to hybrid capital instruments, which share some characteristics with debt securities).

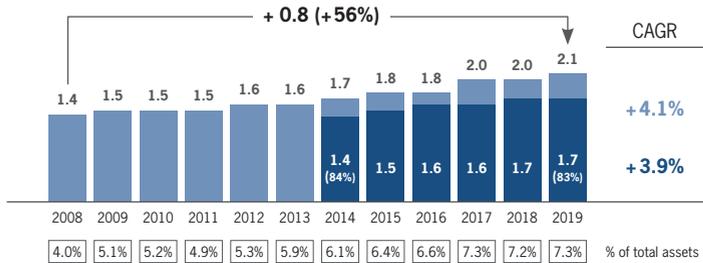
²¹ "Non-Performing Loans" – NPLs.

²² Unless otherwise indicated, the term "capital" refers to book capital, not just "hard" capital (CET 1), throughout the report.

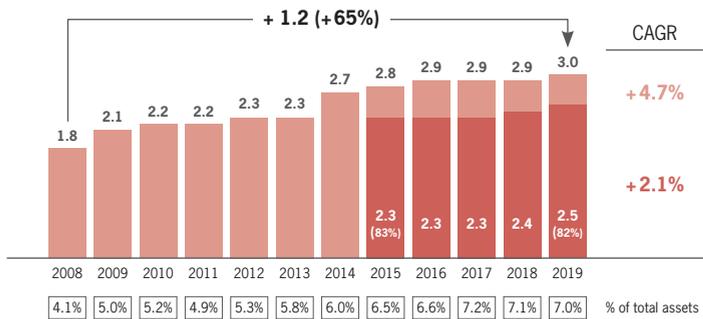
Banks' equity capital growth, by region

(in € trillions)

Euro area



European Union²³



■ Total equity ■ Of which CET 1

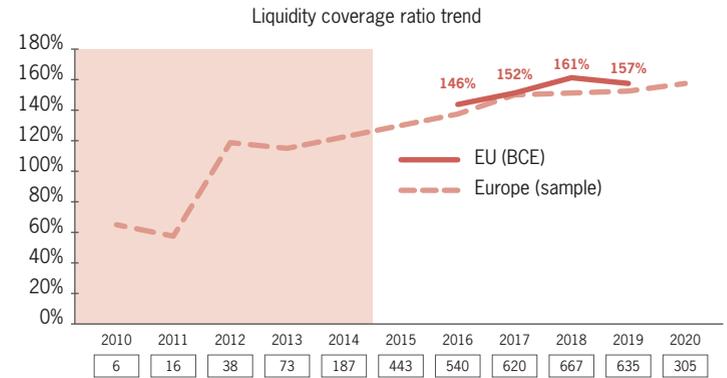
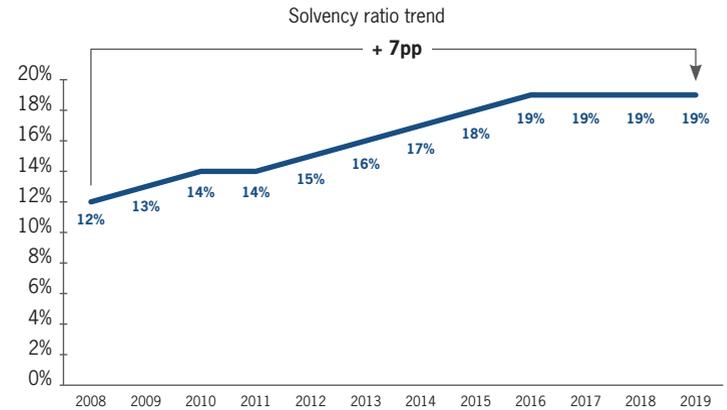
Source: European Central Bank, BCG analysis.

The solvency ratios of European banks increased over the period mainly due to retained net surplus. At the end of 2019, the total solvency ratio of European banks stood at 19%, up 7 percentage points since 2008 (see figure below).

23 Including the United Kingdom.

Average solvency and liquidity ratios of European banks

(2008-2019)



Limited sample before 2015:
few banks publish their LCR before this date

Banks in sample

Source: European Central Bank, S&P SNL, BCG Analysis.

The average CET1 solvency ratio of European banks is 14.8%, for a prudential minimum including systemic and countercyclical buffers of 11.7%.²⁴ Of the 109 European banks under the ECB's direct supervision in 2019, only six had CET1 ratios below the requirements.²⁵

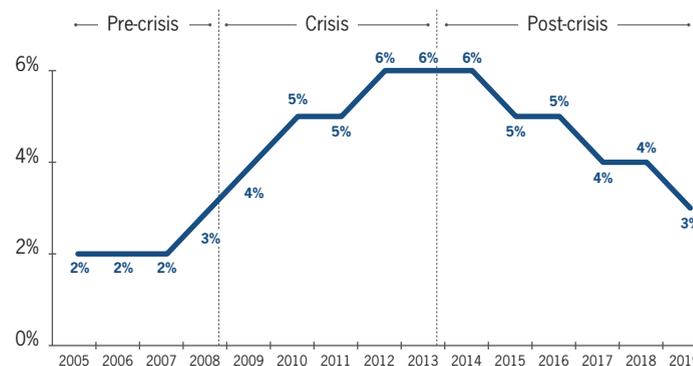
This high level of capital is also reflected in controlled leverage ratios. In June 2020, the average leverage ratio in the European Union stood at 5.3%, well above the minimum requirement of 3%.²⁶

Liquidity ratios (the short-term ratio in particular) also increased by rebalancing liabilities in favor of deposits and the gradual accumulation of liquid assets (see figure above). The short-term liquidity coverage ratio thus stood at 157% in 2019, following a steady upward trend since the beginning of the decade.²⁷

Beyond prudential ratios, the consolidation of bank balance sheets can be measured by the attrition of the share of NPLs (see figure on the next page). After rising sharply during the two financial and sovereign debt crises (+4 percentage points), the share of these assets in total loans has returned to its 2008 level (3%).

Average NPL ratio trend of European banks

(2005-2019)



NPL ratio = non-performing loans / total loans to customers.

Note: Sample of 895 European banks with total assets over \$1 billion.

Source: S&P SNL, BCG analysis.

This increased resilience in the European banking sector should not gloss over persistent disparities between countries. Solvency levels are higher on average for banks in the north of the continent, while the countries most affected by the two past crises still have lower ratios, especially Portugal, Spain, Greece and Italy (see figure below).

²⁴ ECB, *Aggregate Supervisory Review and Evaluation Process (SREP) outcome for 2019*, January 2020 (<https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200128-20e2703d8e.en.html>); 10.6% excluding systemic and countercyclical buffers.

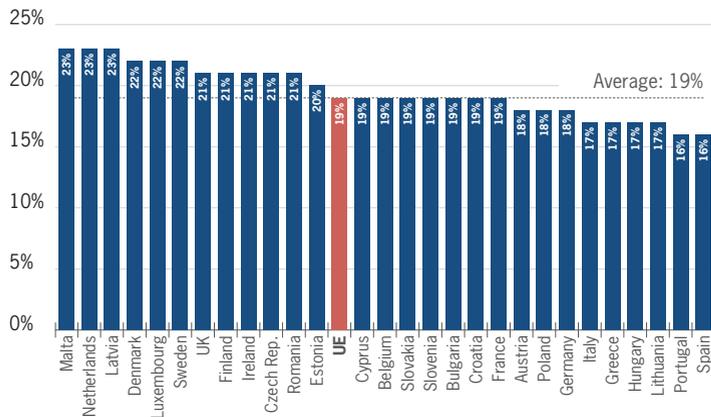
²⁵ *Ibid.*

²⁶ EBA, *Risk assessment of the European banking system*, December 2020.

²⁷ "Liquidity Coverage Ratio" – LCR.

Average total solvency ratios by country

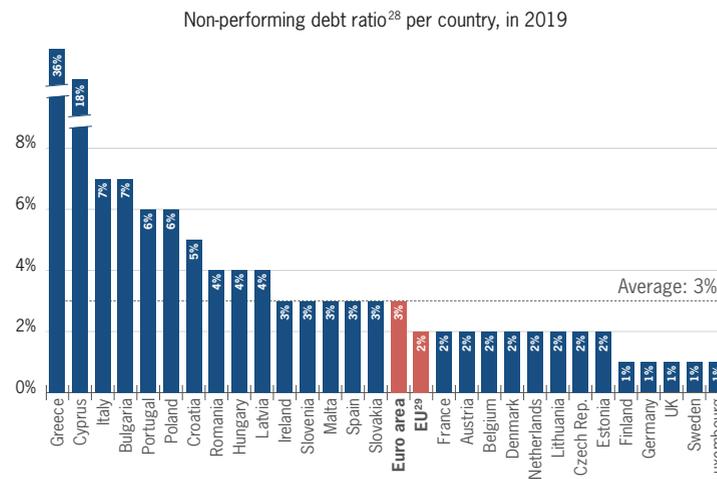
(% – 2019)



Source: European Central Bank.

Ratio of NPLs and advances by country and institution

(% – 2019)



% of total NPLs

of EU		8	20	0	2	3	0	1	0	2	0	0	12	0	82	18	2	2	2	5	0	1	0	1	8	10	2	0
of euro area		10	24	3	0	2	0	0	14	0	22	3	3	6	0	0	1	10	1									

% of total loans

of euro area		1	10	1	0	2	0	0	13	0	25	4	4	10	0	0	3	23	3
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Source: European Central Bank, SNP S&L, BCG analysis.



²⁸ NPL ratio = Non-performing loans / total loans and advances.

²⁹ Includes UK.



Selection of European banks (with income > € 1bn) having the highest rates
 of non-performing loans

Bank	Country	NPL ratio ³⁰ 2019
Alpha Bank	Greece	33.7%
National Bank of Greece	Greece	31.0%
Eurobank EFG	Greece	29.1%
Alior Bank	Poland	12.6%
Banca Monte dei Paschi di Siena	Italy	11.7%
Banca Popolare di Sondrio	Italy	10.6%
BPER Banca	Italy	9.5%
TCS Group Holding	Cyprus	8.8%
Banco BPM	Italy	8.1%
Intesa Sanpaolo	Italy	7.6%
Banca Transilvania	Romania	7.1%
Banco Montepio	Portugal	6.3%
OTP Bank	Hungary	6.2%
Bank Polska Kasa Opieki (Pekao)	Poland	5.5%
Caixa Geral de Despósito	Portugal	5.4%
AIB Group	Ireland	5.4%
UniCredit	Italy	5.0%

Source: European Central Bank, SNP S&L, BCG analysis.

However, the situation in these countries has steadily improved since the crisis, thanks to the proactive approach of national and European supervisors. The Italian situation is a telling example of this dynamic: in 2015, the Italian ratio was 16.8% (a drop of nearly 10 points in four years). The sale of assets to

specialized investors, in particular to US investment funds, has helped to clean up the balance sheets of Italian banks. In February 2016, the government introduced a guarantee mechanism to facilitate transfers of NPLs (*Garanzia sulla Cartolarizzazione delle Sofferenze* – GACS). In July 2017, ECOFIN adopted an “Action Plan to Tackle NPLs in Europe” at the European level. In its fourth progress report on the implementation of these measures,³¹ the European Commission noted significant progress: the trend is towards an attrition of the share of NPLs in all the most exposed countries. However, this trend will have to be maintained over time if all European banking systems are to converge on the lowest possible level of exposure, which will ensure their ability to withstand future shocks.

Overall, however, European banks are now much safer than they were before the financial crisis, as their resilience towards the economic shock of COVID-19 has demonstrated – albeit in a context of unprecedented joint public support from central banks and governments. Overall, European banks faced this pandemic with sound fundamentals, which enabled them to withstand the ensuing financial and economic shocks. In a July 2020 study, the European supervisor estimated that the continent’s banking sector was sufficiently capitalized to absorb the impact of a transitory recession without downwards adjustments in credit supply.³² Even in a so-called “severe” scenario, characterized by a slower economic recovery, the impact on the financing of the economy was contained.

31 COM (2019) 278 final, “Fourth progress report on reducing NPLs and further reducing risks in the Banking Union”, June 2019.

32 ECB banking supervision, “COVID-19 vulnerability analysis, results overview”, 28 July 2020. https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_annex-d36d893ca2.en.pdf?731039993a2a10392e3b7679d1669fb5

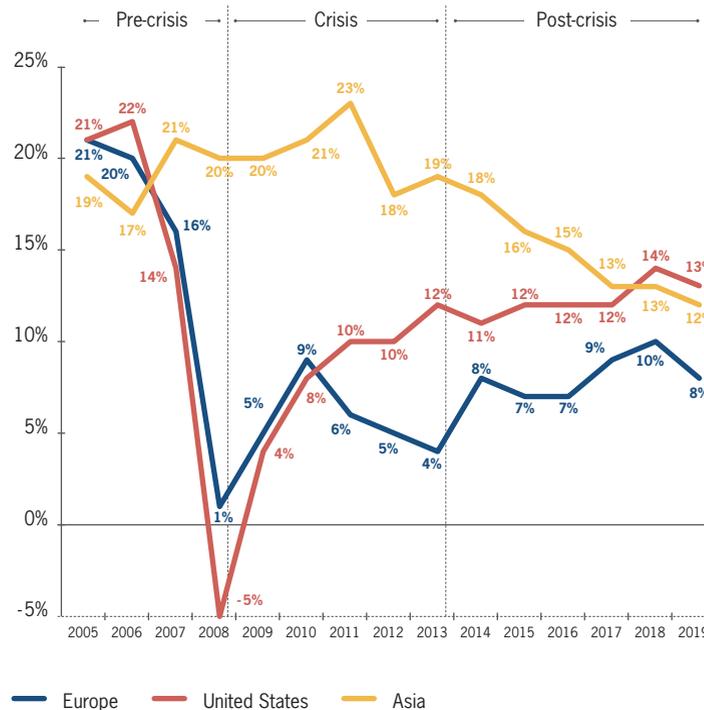
30 NPL ratio = Non-performing loans / total loans and advances.

2. The low profitability of European banks since the financial crisis puts them in a precarious situation

2.1. European banks' profitability has fallen since the financial crisis

Since the financial crisis, European banks have had lower profitability than their Asian and American competitors (see figure on the next page). In 2006, the pre-tax return on equity was 22% for US banks, 20% for European banks and 17% for Asian banks – although these levels were perhaps excessive. More than a decade later, profitability levels have fallen in all three regions, but this common trend is compounded by a specific decline in European banks. In the short term, the financial crisis affected US banks more, with a negative return in 2008. However, from 2010 onwards, the performance of US banks caught up with that of European banks (between 8 and 9%), before clearly outperforming them when Europe experienced a new recession in 2011. In 2013, the profitability gap reached a high point (8 points). Since then, it has narrowed without disappearing: the differential was still 5 points in 2019. Asian banks, which were less affected by the 2008 financial crisis, saw their profitability decline steadily over the period, though without reaching European levels.

Pre-tax return on equity for European, Asian and American banks (2005-2019)



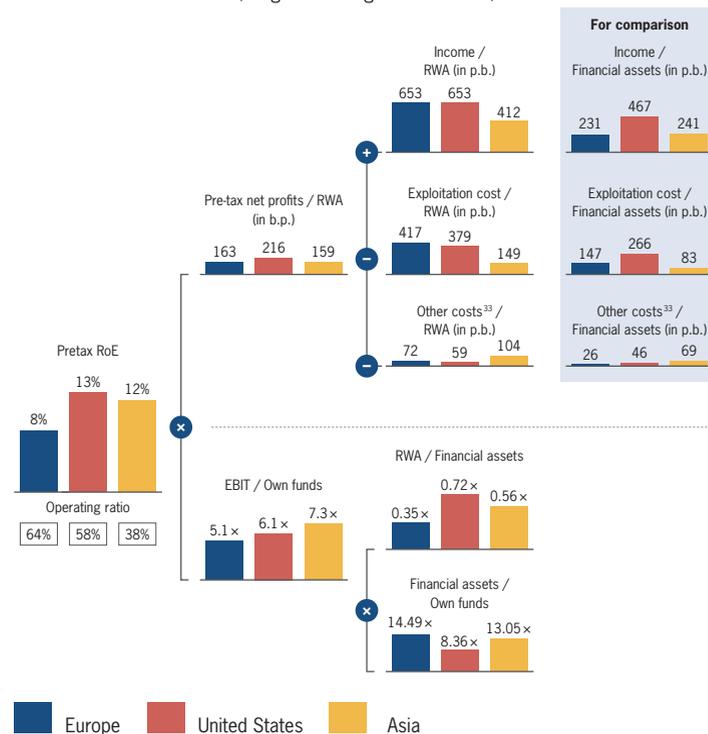
Note: Representative sample of the 30, 20 and 30 largest European, American and Asian banks, by balance sheet size.

Source: S&P SNL, BCG analysis.

Why are European banks less profitable? To try to understand this, we have broken down return on equity into factors relating to the business or income statements (revenue and costs) and those relating to the financing or balance sheet structure (the level of equity on the liabilities side and risk-weighted commitments on the assets side). The graph below shows said breakdown. Several lessons emerge, particularly if we compare European banks with their American competitors: the balance sheet of European banks has less risky assets than American banks, and are thus less profitable and generate less income; the costs incurred in originating and managing these assets are lower in European banks than in American banks, but still too high compared to the income generated. There is therefore a contradiction between capital that has increased a lot due to regulation, revenue generation that is limited by a less risky balance sheet and a cost structure that is too high. Let us now delve into the details of each of the terms of the equation.

Breakdown of pre-tax return on equity for European, American and Asian banks in 2019

(Weighted average data in 2019)



Note: representative sample of the 30, 20 and 30 largest European, American and Asian banks by size of their balance sheet.

Source: S&P SNL, BCG analysis.

³³ Other costs include the cost of risk.

First, European banks stand out for the low level of income generated from financial assets on their balance sheets. In Europe, financial assets generate an average income that is half of what it generates in the United States (231 basis points versus 467). This is due in part to the different risk profiles of institutions in the two regions – and also to higher pricing in the US, both in retail and wholesale banking.

In fact, the balance sheet of European banks is on average half as risky when compared to its American counterparts – based on the regulatory measure of the risk level of assets, which assigns a risk coefficient to each asset on the balance sheet to calculate the figure for risk-weighted assets (“RWA”), the higher the risk of the asset, the higher the coefficient. For European banks, RWAs represent 35% of total financial assets, compared with 71% for US banks. This significant difference in risk profile is fundamentally explained by the role of capital markets in the US.

Indeed, the balance sheets of US banks “turn over” faster than they do in European banks, thanks to much deeper capital markets and much more active securitization. Balance sheet assets are renewed more quickly – this is called “balance sheet velocity”. Unlike European banks, which keep the vast majority of the assets they originate on their balance sheets, US banks are able to sell the least risky assets they issue, such as mortgages, on the market. These are securitized in vehicles that are guaranteed by federal agencies. We will circle back to this mechanism, which allows them to reduce the volume of financial assets on their balance sheet while keeping the riskiest assets, which also generate the most income. Finally, total revenue is increased by retaining part of the fees for originating primary assets and structuring securitization vehicles.

The second reason which may also come into play, but to a lesser extent, is that European banks are more exposed to sovereign debt, which has a risk weight of zero or close to zero. In 2019, sovereign debt accounted for 28% of total assets held by banks in the euro area, compared with 17% for US banks.³⁴

While the impact on the level of risk is positive, the holding of these low-margin assets nevertheless weighs on the ability to generate income per financial asset for European banks.

Details of the comparative analysis of the profitability of European and American banks

Fifteen years on, a comparison of US and European performance confirms the diagnosis: the less risky nature of European banks' balance sheets, combined with higher costs, limits their ability to generate profits. The graph below shows how the profitability factors of banks in Europe and the United States have changed since 2005.

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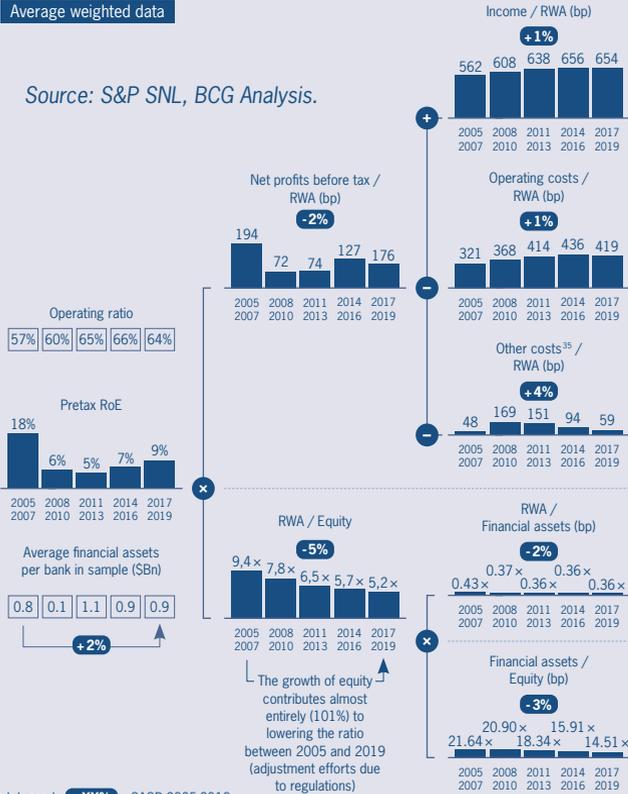
³⁴ Sources: ECB, Fed, SNL S&P.

Breakdown of the pre-tax return on equity of European and American banks (2005-2019)

Zoom on Europe | Breakdown of historic performance

Average weighted data

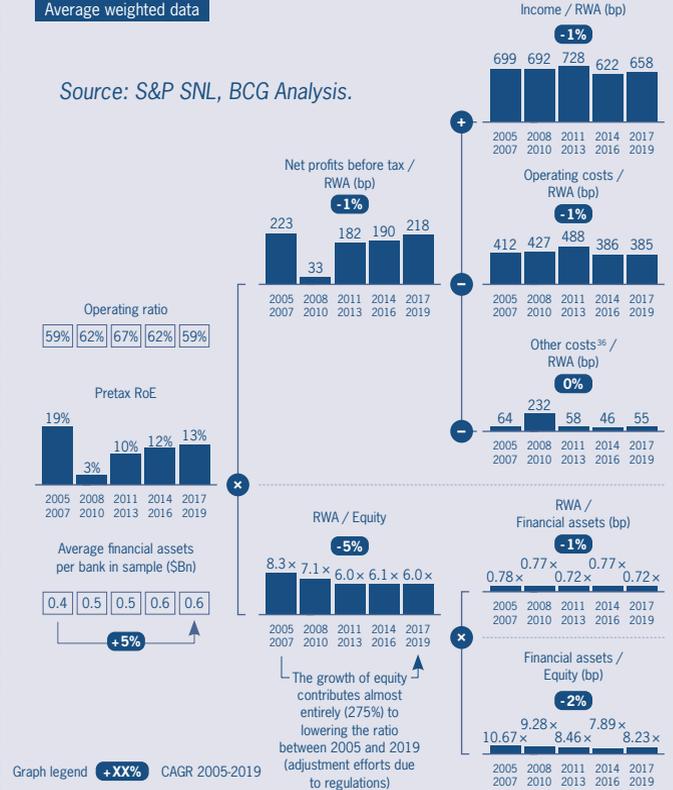
Source: S&P SNL, BCG Analysis.



Zoom on the United States | Breakdown of historic performance

Average weighted data

Source: S&P SNL, BCG Analysis.



Graph legend +XX% CAGR 2005-2019

Note: Representative sample of the 30 largest European banks and the 20 largest US banks by balance sheet size.

... / ...

35 Other costs include the cost of risk.

36 Other costs include the cost of risk.

In Europe, the level of asset risk measured by the ratio of RWAs to financial assets declined by 2% per year. The revenue-generating capacity of European banks increased by 1% per year over the same period, confirming the diagnosis of inadequate risk exposure in the balance sheet, rather than a difficulty in generating revenue for a given level of risk. However, costs have increased significantly, particularly non-operating costs (+4% per annum). The operating ratio, which has been rising steadily since the beginning of the decade, has not fallen significantly since 2013 (-1 point) and remains well above its pre-crisis level (+7 points).

In the United States, banks also reduced the risk level of their assets, but at a slower pace than their European peers (-1% per year compared with -2%). Their capacity to generate income deteriorated slightly proportionally to risk-weighted assets (-1% per year). But, above all, the evolution of costs has been better controlled: operating costs have decreased (-1% per year) and other costs, including the cost of risk, have remained stable. In 2017-2019, the operating ratio had returned to its 2005-2007 level (59%), wiping out the entire increase following the financial crisis (+8 points).

Asian banks have low revenues and costs. Unlike Europe, Asia has a high level of operating performance, made possible by very low labor costs and extensive use of digital technology. However, this operating performance does not compensate for the low level of revenues generated, which is particularly noticeable when compared with risk-weighted assets. The robust profitability of Asian banks stems mainly from their balance sheet structure: they are more thinly capitalized proportionally to their risk-weighted assets, which enables them to offer a higher return on equity than European banks, despite comparable earnings.

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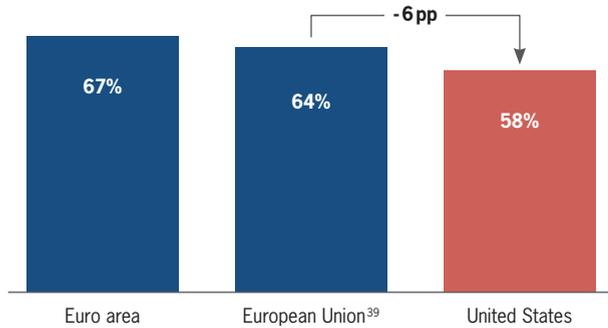
A less risky and less swift balance sheet is not in itself an insurmountable obstacle to profitability. However, when combined with high costs, it explains the low profitability of European banks. Indeed, the income generation gap completely disappears when the level of risk of balance sheet assets is taken into account: US and EU banks have identical income generation capacity per risk-weighted asset (653 basis points). But European banks have higher costs than US banks. Expressed as a proportion of RWAs, they are 51 basis points higher than those of US banks (38 basis points for operating costs, 13 basis points for other costs, including risk-related costs). Moreover, they have grown at a higher rate than revenue growth between 2005 and 2019, justifying the erosion of the pre-tax net income margin over said period.

The operational underperformance of European banks is very clear when costs are compared along revenues (see figure below). In Europe, the operating ratio is 6 points higher than in the United States, with the gap widening to 9 points in the euro area alone. However, there is considerable heterogeneity between European countries. The German banking sector stands out as the least efficient, with an operating ratio of 84%. At the other end of the spectrum, Spanish banks stand out for their greater efficiency (53% operating ratio).

37 In addition to operational underperformance, regulations may occasionally weigh on the operating ratio of European banks, as in the case of contributions to the Single Resolution Fund (SRF). This mechanism, created within the framework of the Banking Union, aims to collect 1% of guaranteed deposits in the euro zone by 2023 (i.e., approximately €75 billion). The fund is endowed by increasing annual contributions, the majority of which are borne by the largest banks in the zone. In 2020, contributions to the SRF represented €9.2 billion, which is nearly 2% of the cost base of European banks and more than 3% for certain large institutions (source: SRB, EBA, ECB, annual reports, press, BCG analysis).

Costs to income ratio (operating ratio) of European and American banks³⁸

(2019)

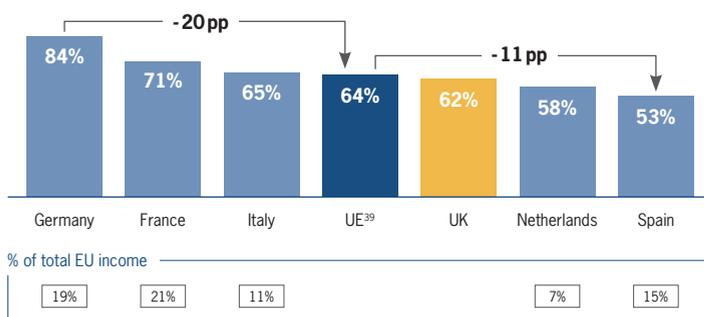


In any case, for the same level of risk-weighted income, the levels of operational efficiency and risk pricing of European banks do not allow them to generate a similar level of profit as US banks. With better operational efficiency and more effective risk pricing, **US banks manage to generate one-third more pre-tax net income (as a proportion of risk-weighted assets) than their European counterparts.**

US banks are thus deploying a coherent strategy based on high value added and supported by a favorable market structure. Conversely, European banks are in a difficult situation, with a lower value-added business and a larger, less risky and less profitable balance sheet, combined with a relatively higher operating cost structure.

2.2. Too unprofitable, European banks do not pay their cost of capital, making them less attractive to investors

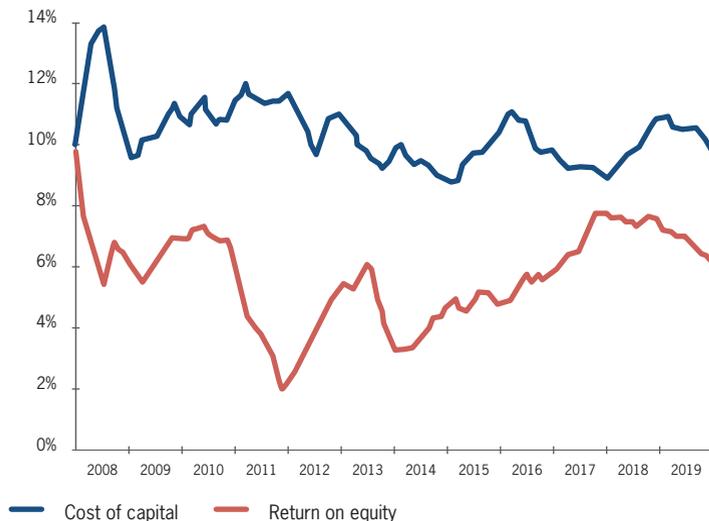
Since 2008, European banks' return on equity has been lower than their cost of capital, with an average difference of around 5 points, or 45% (see figure below). If profitability is higher than the cost of capital, value is being created. Otherwise there is value destruction – which has been the case for European banks since the financial crisis.



Source: FDIC, EBA, European Central Bank, BCG analysis.

³⁸ Selection of countries each representing more than 5% of EU banking revenues.
³⁹ Excluding the UK, weighted by total banking revenue for each country.

Evolution in the cost of capital and return on equity of European banks (2008-2019)



Source: European Central Bank (based on Bloomberg, Refinitiv, Kenneth French's data library, S&P market intelligence).

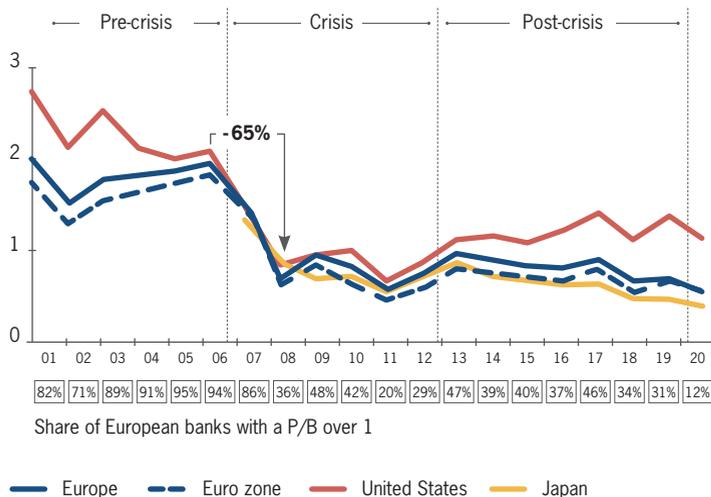
The first reason for this is obviously insufficient profitability, as described above. But we also need to look at the other side of the equation: the cost of capital for European banks has not fallen since the financial crisis. Thanks to regulation, European banks have more equity and have largely cleaned up their balance sheets. But this has not been enough to bring down their cost of capital. On the one hand, prudential rules make shareholders bear a larger share of the costs associated with a possible bail-in. Moreover, since the financial crisis, the environment has been generally unfavorable to financial institutions, which are now perceived as yielding values

but carrying risks due to their high sensitivity to the economic situation and to changes in regulations that are difficult to anticipate, resulting in a volatility of income that is higher than that of the market as a whole (the beta of financial stocks is traditionally higher than 1, ranging from 1.2 to 1.4 over the past five years). Lastly, the cost of capital is also a function of investors' trade-offs, attracted by new players and sectors, especially technology, with attractive growth prospects, some of which are also challenging the banking value chain.

Investors' distrust is reflected in stock market valuations that are persistently lower than equity. In 2019, the market capitalization of European banks was on average 0.7 times their book value (price-to-book of 0.7) (see figure below). Since the financial crisis, this indicator has been in constant decline: after peaking in 2006, it has never been above 1 in Europe since 2008. By comparison, it has been slightly above 1 in the United States since 2013. While the price-to-book ratio of less than 1 could initially be interpreted as a lack of confidence in the quality of balance sheet assets (existence of unrecognized, unrealized or probable losses), the asset review exercise conducted prior to the implementation of the Single Supervisory Mechanism and the persistence of these low valuations suggests **that it is more to do with doubt concerning the relevance of banks' current business model, and therefore with poorly secured future results.**

Market capitalization of European banks in relation to their book value since 2001

(Price to Book, P/B)



Share of European banks with a P/B over 1

— Europe — Euro zone — United States — Japan

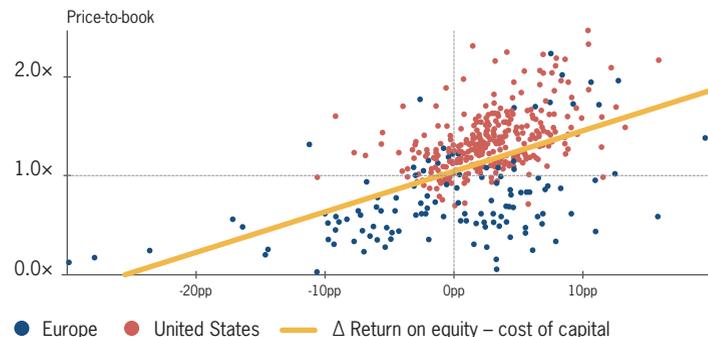
Note: ratio calculated on December 31 of each year on a sample of 60 European banks, 19 American banks and 7 Japanese banks (limited data before 2007). China is not included due to the strong correlation between valuation and the country's economic outlook.

Source: BCG FDP, CIQ, BCG analysis.

Hence, investors have deep doubts about the ability of European banks to return to profitability above their cost of capital. Based on a sample of European and US banks, a 2019 comparison of the difference between return on equity and cost of capital on the one hand, and price-to-book ratios on the other, shows a strong correlation between these two variables (see figure on the following page).

Recent developments show a direct causal link: in the United States, banks' market capitalization has only been worth more than the book value of their equity on a sustained basis since they have had a return in excess of their cost of capital (see figure on the following page).

Correlation between the price-to-book ratio, and the spread between return on equity and cost of capital for selected European and American banks in 2019

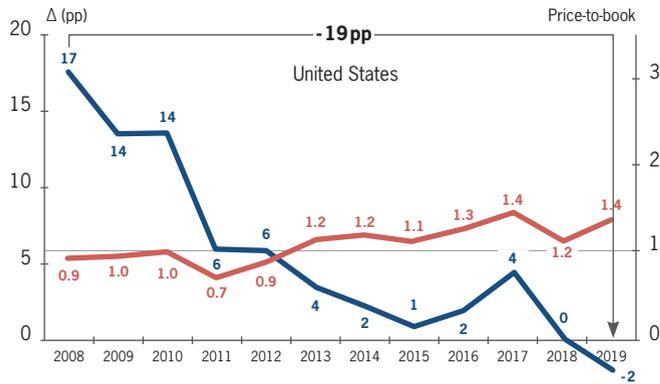
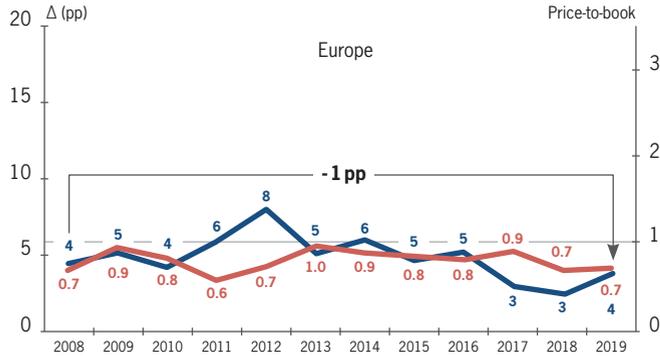


Note: Cost of capital and return on equity based on a sample of 203 European and 344 US banks.

Source: S&P SNL, Bloomberg, BCG analysis.

Comparative trends in the price-to-book ratio, and in the gap between return on equity and cost of capital in Europe and the United States

(2008-2019)



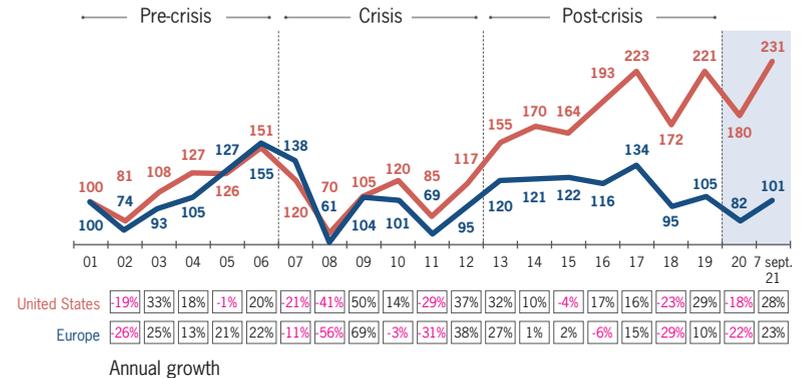
Note: Cost of capital and return on equity calculated on a sample of 203 European and 344 US banks.

Source: European Central Bank (based on Bloomberg, Refinitiv, Kenneth French's data library, S&P market intelligence), S&P SNL, Bloomberg, BCG analysis.

Since 2008, investors have not believed in the future of European banks, whose market capitalization has never returned to its pre-crisis level (see figure below). In September 2021, the value of banks listed in Europe was just above its 2001 level (+1%). 2006 was a high point, which has never been equalled since. It should be noted that the COVID-19 crisis wiped out 22% of banks' market capitalization, but the months that followed saw a return to levels close to those of 2019. Since 2010, the share of so-called "growth" institutional investors in the capital of European banks has fallen by 17 points, to the benefit of so-called "value" and "yield" investors, who held 55% in 2019.⁴⁰

Market capitalization of European banks from 2001 to 2021

(base 100 in 2001)



Note : December 20XX for all dates. Currency conversion based on annual average. Analysis based on a sample of 60 European banks (European Union, United Kingdom, Norway, Switzerland) with a market capitalization in 2020 of more than 500 million euros.

Source : CIQ, Analyse BCG

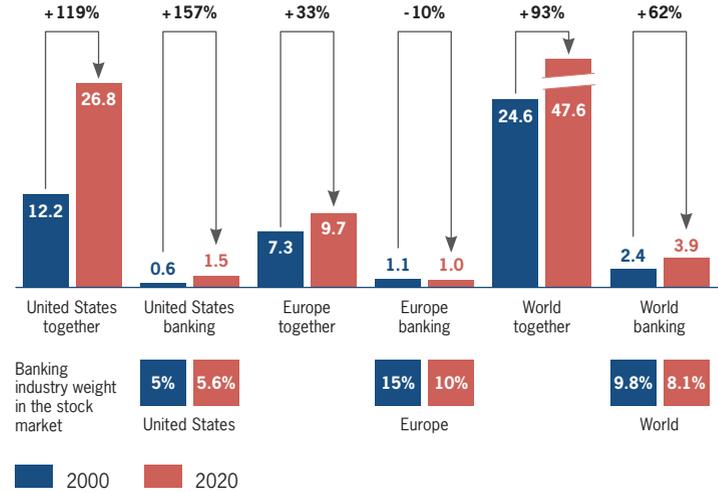
⁴⁰ Source: Thomson Reuters, BCG analysis. Does not include passive investors such as index investors, specialist investors, hedge funds, etc. Based on a sample of 24 European banks.

This stock market withdrawal is even more notable when compared to the dynamics observed in other regions and sectors. While European banks saw their capitalization decline between 2000 and 2020, US banks appreciated rapidly (+157%), while global banking indexes also rose significantly (+62%, see figure on the next page). In absolute value and at the level of individual institutions, this results in significant differences. For instance, at the end of 2020, the market capitalization of the leading US bank, JP Morgan, was €317 billion, six times that of BNP Paribas, which is one of the leading European banks. Finally, since the beginning of the century, the European banking index has fallen by 10% while the European and world stock market indexes have risen by 33% and 93% over the same period.

Trend in market capitalization of the main American, European and global banking indexes

(in trillions of dollars and as a percentage, 2000 – 2020)

Indicative estimate based on a series of indexes, compositions may vary



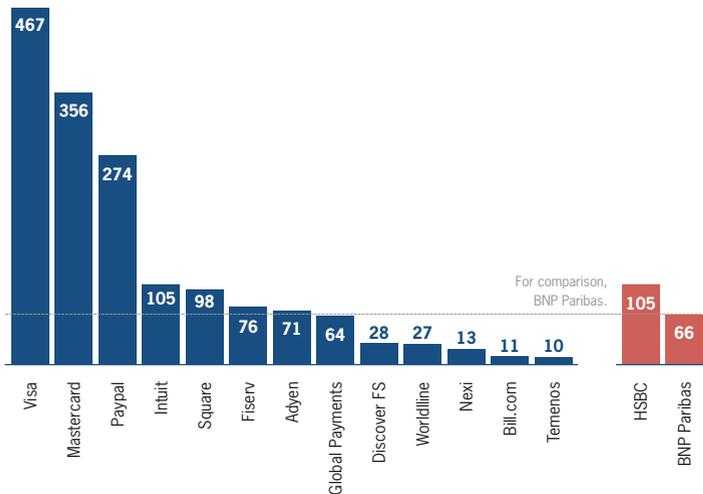
Methodological note: Market capitalization calculated from the sum of the capitalizations of the companies included in the S&P 500 composite and S&P 500 Banks indexes for the United States, FTSE Europe and FTSE Europe Banks for Europe, and FTSE World and FTSE World Banks for the world.

Source: Datastream, BCG analysis.

At the end of 2020, only 7 European banks were still in the top 100 European stocks, for 5% of total capitalization. Over the decade 2000-2010, there were 18 or 19 European banks in this top 100, for 17% of total capitalization.⁴¹ European banks are now being replaced by new financial players, more digital and more specialized, particularly in the payments sector (see figure below).

Market capitalization of new financial players and the top two European banks (for comparison)

(in billions of dollars, as at 31 December 2020)



Source: Capital IQ.

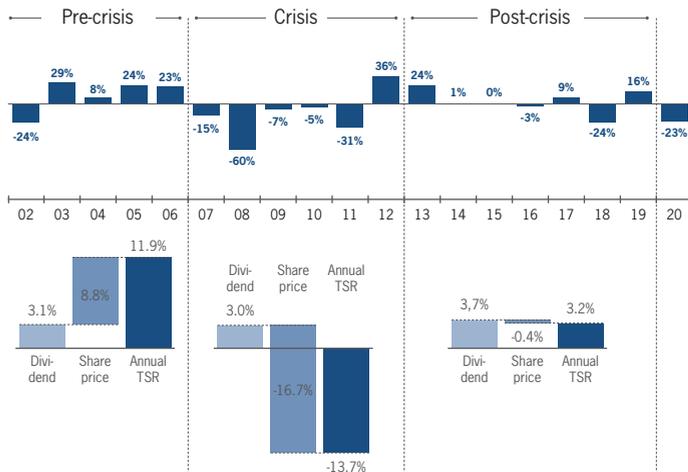
Lastly, the decline in valuations has led to greater pressure on dividends, which has increased the cost of capital thus fueling a vicious cycle. Investors tend to view banks more as yielding stocks, which puts greater pressure on dividends. Dividend yields have risen by 4.2 percentage points in Europe between 2000 and 2019, compared with 0.9 percentage points in the United States, with diverging dynamics since the financial crisis.⁴²

However, this focus on dividends is still not enough to offset the decline in valuations (see figure on the next page). The total return to shareholders, calculated as the sum of the increase in valuations and dividends paid, fell by 8 points between 2002-2006 and 2013-2019. During the crisis, the return to shareholders of European banks was negative (-13.7%), despite a 3% dividend. Since the end of the euro area crisis, the total return has been close to the dividend, given a slight drop in valuation (3.2% versus 3.7%, with a 0.4% drop in valuation).

41 Sources: Capital IQ, BCG analysis.

42 CIQ, BCG analysis. Calculation based on a sample of 24 European banks (including 14 from the euro area), and 18 American banks.

Total return trends for shareholders of European banks from 2002 to 2020



Note: Total return for my shareholders calculated on the stock market price at 12/31.

Source: Capital IQ, BCG analysis.

2.3. This situation could jeopardize the future of European banks

In a way, the market is pushing European banks to realize that, without adapting their business model or the conditions in which they operate, it would be best for them to stop doing business altogether rather than continue, since this line of business is constantly destroying value. This is obviously a theoretical point of view: stock market valuations do not accurately

reflect the price of a public buyout, just as book values do not necessarily reflect the price of asset sales. The fact remains that this sends a very strong message to the managers of European banks, as managing a business that investors view as having destroyed value for the past twelve years makes conducting said business all the more arduous.

To improve returns for their shareholders, banks are seeking to increase the dividends they pay out, which is detrimental to their self-financing capacity and, consequently, to investment in their own transformation. How can they attract capital when their stock market valuation is lower than their book value? European banks are therefore being called into question, and there truly is a strong and concrete threat to their future.

The impact of this vicious cycle can be seen in the difficulty banks have in investing in their human capital. Between 2009 and 2019, European banks lost 15% of their workforce. Some of these job losses are certainly the result of productivity gains. But over the long term, this phenomenon, if accompanied by a hiring freeze, prevents the renewal and strengthening of skills and thus maintains a weakening of innovation and performance.

Thus, in just a few years, we have been witnessing the downgrading of banking networks that were once considered to be the sector's flagships. One example, among many others, is quite symptomatic: in 2000, HSBC acquired Crédit Commercial de France and its network of branches for €11 billion. After the sale of its regional banks and successive restructuring operations, the sale of the network to an investment fund was being negotiated in April 2021, at a negative purchase price, which will affect the accounts of the selling bank to the tune of over €1.6 billion.

43 European Banking Federation, Annual Report 2020. <https://www.ebf.eu/facts-and-figures/structure-of-the-banking-sector/>



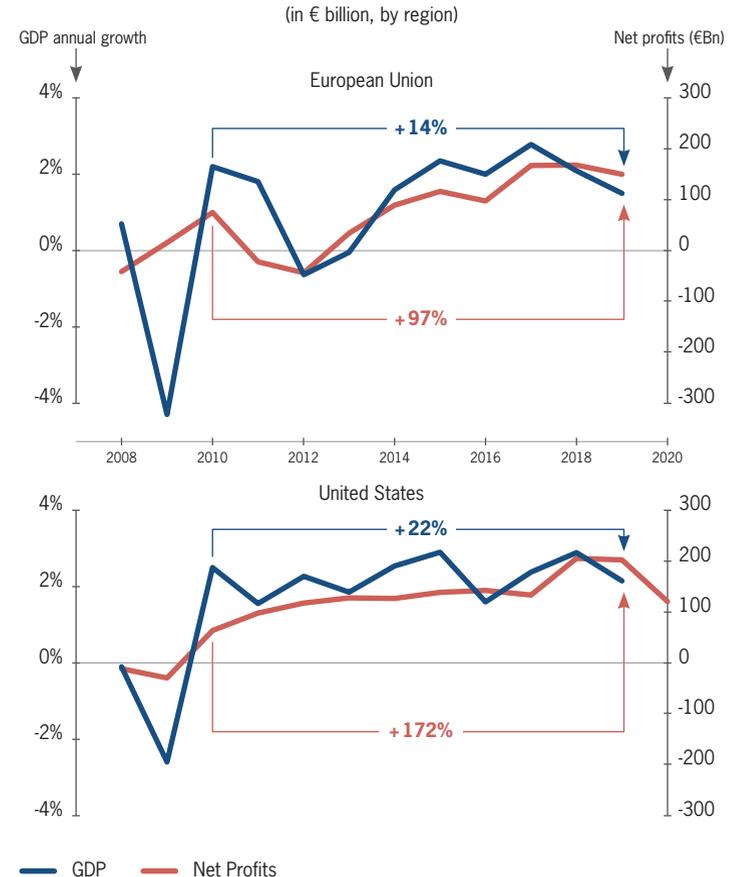
SEVERAL REASONS ACCOUNT FOR THIS SITUATION

1. Cyclical causes: the macroeconomic and monetary environment is putting European banks under pressure

1.1. The economic situation, which has been less favorable in Europe than in the United States since the financial crisis, has weighed on bank performance

Bank performance is linked to the soundness of the economies in which they operate. Since 2008, the macroeconomic situation in Europe has been less favorable than in the US and other regions. European banks have been through two crises: the global financial crisis of 2008-2009 was followed by a euro area crisis between 2010 and 2012. Even after 2013, the European recovery has been sluggish. Over the 2010-2019 period, average annual growth was 1.2% in the euro area, compared with over 2% in the US. As a result, banks' net profits, which are highly correlated with growth, have increased less in Europe than in the United States (see figure on the next page).

Comparing annual GDP growth (in %) and annual growth in banks' net profits



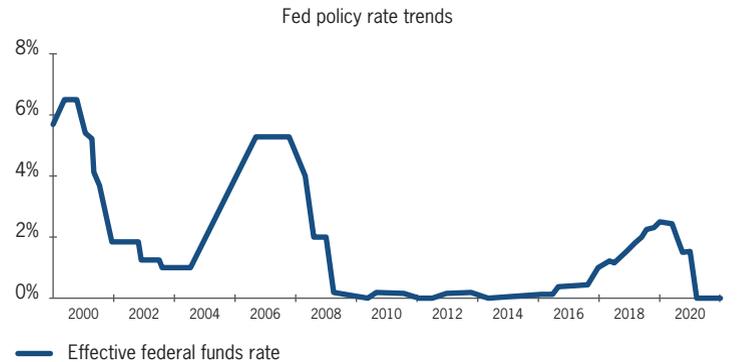
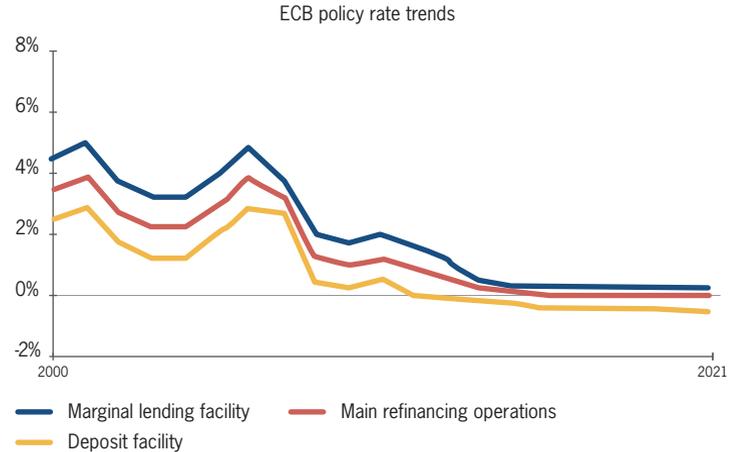
Note: EUR/\$ = 1.1222 at 2019.

Source: European Central Bank, FDIC, World Bank, BCG analysis.

1.2. The accommodative monetary policy has had a greater impact on European banks

Both the US Federal Reserve and the ECB pursued policies to support the economy after the financial crisis. They lowered their policy rates, in order to push down short-term rates. They also implemented unconventional policies, such as the quantitative easing programs launched in 2008 in the United States and in 2015 in Europe, which reduced long-term rates. The ECB's response came later,⁴⁴ and in reaction to persistent low inflation in the euro area, **the ECB had to pursue a more accommodative monetary policy over a longer period.** While the US was able to initiate a rise in the federal funds rate as early as late 2015, the ECB's main policy rate has been zero since March 2016 (see figure below). Moreover, since 2014, the ECB has applied negative rates to the deposit facility granted to European commercial banks, in contrast to the US.

Comparing central banks' policy rates, by region



44 By the end of 2008, US Federal Reserve rates (effective federal funds rate) were close to 0%. In the euro area, the main refinancing rate did not reach 0% until 2014.

Source: European Central Bank, Fed Note: Annual key rates calculated from the average daily rates

What has been the impact of this policy on European banks? It is widely accepted that the central bank's mandate is price stability, and not protecting banks' operating accounts. The accommodative monetary policies have likely had positive effects on economic growth, which would have been lower without them, although the magnitude of the gain is sometimes disputed.⁴⁵ By promoting growth, monetary policy may have limited business failures and thus, via the cost of risk, protected the operating accounts of banks. A "holistic" approach is therefore needed to assess the impact of recent monetary policies on bank profitability.

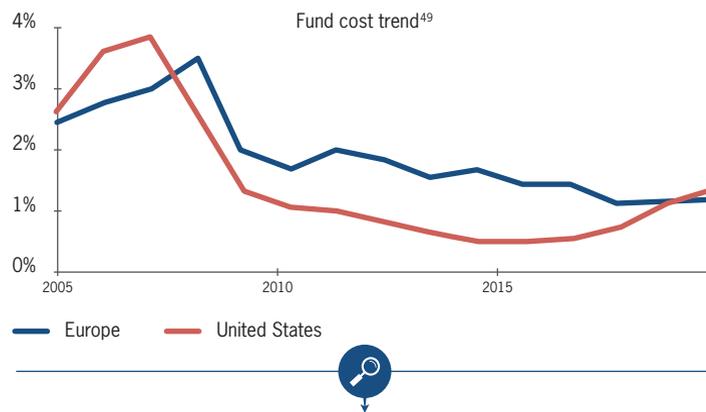
However, it is indisputable that low and then negative interest rates – which have never occurred in the United States – and the flattening of the yield curve have led to a sharp decline in the net interest margin of European banks, which represents a little more than half of net banking income. Thus, in 2019, the net interest margin of European banks was almost 30% lower than that of US banks.

The mechanisms at work are well known: on the one hand, a flat yield curve reduces the profit that banks derive from their transformation business line, which consists in financing long-term loans with demand or short-term deposits; on the other hand, euro area banks have generally chosen not to pass the negative rates that they have to pay to the ECB on to their customers, or have not been able to do so. Since 2017, this asymmetry has led to an increase in their overall cost of financing (see figure on the next page). This last phenomenon is exacerbated by the obligation imposed on banks, for prudential reasons,⁴⁶ to hold large amounts of liquid assets, consisting mainly of government bonds or reserves with the central bank, whose yield is negative.

The ECB is well aware of this phenomenon, and has sought to mitigate the negative consequences of its monetary policy on banks' profitability. In 2019, the remuneration mechanism for liquidity deposited by banks with the ECB was modified to introduce several levels of remuneration ("tiering"⁴⁷). This mechanism is more favorable for the banking system, having made it possible to reduce banks' negative rates costs by 45%, which would have been reduced to €4.7 billion in 2019,⁴⁸ representing 4% to 5% of the banks' profits.

Furthermore, the ECB's long-term refinancing operations, known as "TLTROs", contain an element of support for the banks' operating accounts, which in turn depend on the rise in outstanding loans to the economy. However, compensation given to credit institutions only partially offset their losses.

Comparative trends in banks' financing costs and central bank policy rates, by region



45 Fabo, B., Jančoková, M., Kempf, E., & Pástor, L. (2021). Fifty Shades of QE: Comparing Findings of Central Bankers and Academics. *Journal of Monetary Economics*.

46 Compliance with the short-term liquidity coverage ratio ("LCR"), in particular.

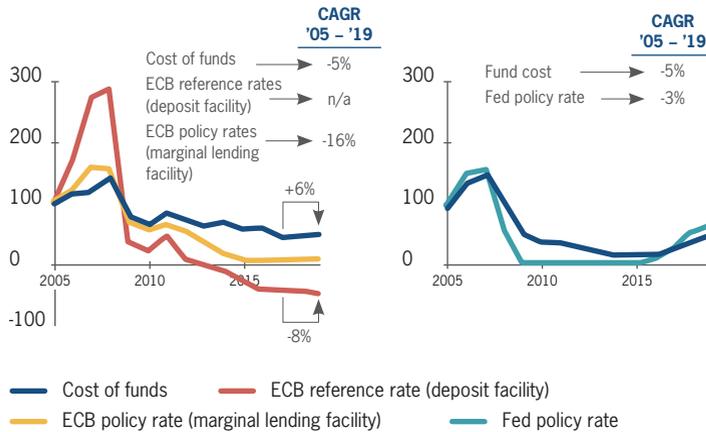
47 Tiering: exemption from negative interest rates for part of the liquid assets (beyond the reserve requirements).

48 Source: BNP Paribas Economic Research (based on BC E, national central banks).

49 Estimation.



Fund cost trend⁵⁰ vs central bank interest rate – base 100 in 2005



Source: S&P SNL, European Central Bank, FRED, BCG analysis.

Thus, since rates became negative, European banks have grown even more dependent on the ECB for their operating results, as in the old days of credit regulation in France, since much of what goes to their profits is no longer determined by the market, but by administered mechanisms. This may also be the reason why the market is shying away from banking stocks, as it seems to believe that the future profits of these companies are no longer really in the hands of their managers.

2. Structural causes

There are also structural reasons for the underperformance of European banks: the fragmentation of the European market; international regulation that is unsuited to the European system of financing the economy based on credit, as opposed to market-based financing; and finally, a technological revolution, based on data and digitization, which holds the potential for a fourth industrial revolution. Since the Great Financial Crisis (GFC), these three phenomena combined have put the business model of European banks in difficulty, and caused it to lose ground to American banks:

- A fragmented domestic market, combined with capital markets that are too shallow, prevent European banks from benefiting from the same economies of scale and the same flexibility in managing their balance sheets as their American competitors. In addition, Europe's crisis resolution system is not very mature and is therefore not widely used, leaving banks facing difficulties to exist at the mercy of national governments, thus maintaining market overcapacity;
- Regulations which are unfavorable to European banks, not because they are more demanding than those that apply to American banks, as is often said, but because they were designed for the American, rather than European, banking environment, and therefore required, and still require, a greater effort to adapt on the part of European banks;
- Finally, as in all regions of the world and in all economic sectors, the acceleration of technological change and customer behavior is leading to an increase in the number of competitors in all segments of the value chain, and raising standards of expertise and quality to levels that are more difficult for banks to achieve.

⁵⁰ Estimate.

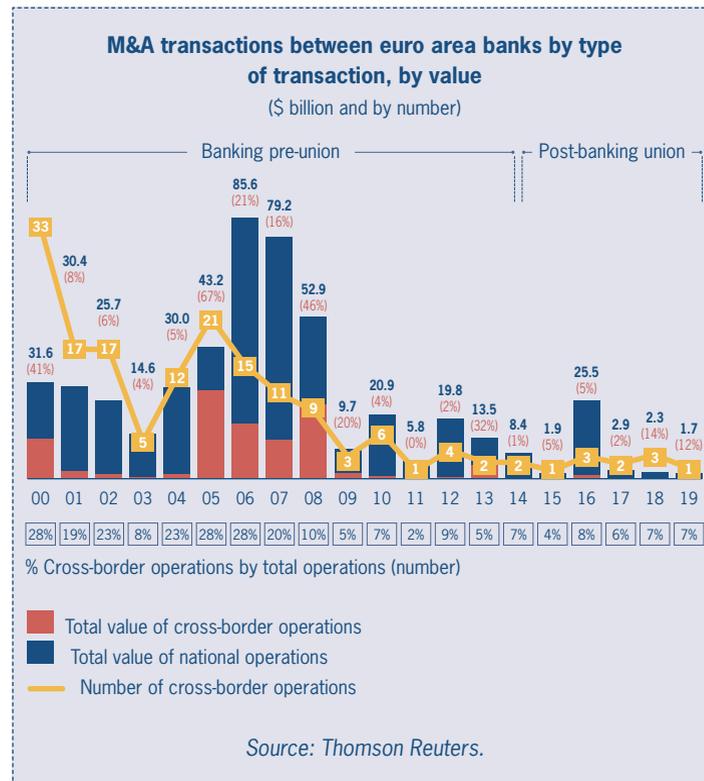
2.1. Market fragmentation puts European banks at a disadvantage compared to their American competitors

The European banking market remains more fragmented than in the United States, despite the proposed Banking Union. The European Union is currently composed of a small number of pan-European banking players, and the few cross-border European banks are located in only a handful of Member States.⁵¹ As we have already seen, the level of concentration in the sector is lower than in the United States: for example, the top 3 European banks account for only 10-15% of total European banking assets, compared with 35% in the United States.

History of consolidation in the euro area

The pace and scale of cross-border bank consolidation has slowed significantly since 2009 and the implementation of the Banking Union in 2014 has not led to a recovery. Whereas just over 15 cross-border M&A deals (for an average amount of \$11.5 billion) were recorded each year on average between 2000 and 2008, cross-border consolidation has now reached a low point: since 2014 there have been fewer than two deals per year, for an average amount of \$0.2 billion (see figure below). The decline in cross-border bank consolidation post-2014 is more pronounced than that of domestic consolidation, and runs counter to the movements expected at this stage of the financial cycle (there should theoretically be a greater number of acquisitions during a recovery).

.../...



The incomplete Banking Union has yet to succeed in encouraging cross-border consolidation. In particular, the regulatory management of capital and liquidity between subsidiaries penalizes cross-border banks, as it is still largely in the hands of national supervisors who wish to protect their domestic market. Currently, supervision of cross-border banking groups is carried out both on a consolidated basis and on an individual

51 These are either banks with a regional presence, such as some Nordic banks, or large global banks with a European presence limited to a few Member States.

basis⁵² (i.e., at the level of the supervisor of each subsidiary). Supervisors in Member States hosting subsidiaries of foreign banking groups (host countries) have tended to apply the level of capital and liquidity requirements expected at the consolidated level to each subsidiary of foreign banking groups. This aims to limit the distribution of profits, and to restrict cross-border asset transfers in order to better protect local stakeholders,⁵³ in a context where the European resolution framework is not considered sufficiently credible, and where there is no pan-European deposit guarantee. **This limits the free flow of such liquidity and increases capital requirements.** Provisions in the current framework to mitigate this – such as the granting of cross-border waivers for liquidity requirements – are too infrequently used in practice because of the binding guidelines of the single supervisor. Other features of the regulatory framework, such as the fact that additional capital requirements increase with bank size, also contribute to discouraging consolidation.

A fragmented domestic market, coupled with thin capital markets, prevent European banks from benefiting from the same economies of scale and balance sheet management flexibility as their US competitors. Pan-European banks would provide a channel for the dissemination of financial product and service innovation through their expansion across jurisdictions, thereby contributing to convergence towards more efficient and less costly banking practices. With greater economies of scale, cross-border banks could enhance their profitability and thus be able to compete more robustly with large US banks. Moreover, greater banking integration and deeper capital markets could also make the euro area more resilient facing crises by acting as a private risk-sharing mechanism, and preserve financial

stability by breaking the sovereign-bank loop. Despite these benefits, banking integration and market deepening face the following obstacles.

First, the lack of clear cross-border economic synergies contributes to the continued fragmentation of retail banking in Europe – because there seems to be little economic rationale for cross-border consolidation in this segment. Most product lines, such as savings products, are primarily adapted to the legislative, regulatory or fiscal demands of Member States, which are often similar but never identical. The corporate credit business would benefit from a greater coordination of security and bankruptcy law. The possible synergies between information systems, which are generally different from one country to another, are also considered difficult to implement. Their cost and execution duration are discouraging, at a time when banks must also invest heavily in modernizing their infrastructures. In an era of digital transformation, there is an opportunity for fundamental improvement of information systems. The process of building systems capable of operating in the same way in several European countries is however attempted by some new players, who are not burdened by existing systems.

The fragmentation of the European market is thus worsened by the preservation of national regulations, the divergent applications of European directives and the differences in tax regimes. Similarly, the cross-border sale of products remains complex, which prevents many synergies.

52 The June 2019 banking package (CRD-V/CRR-II) opened up the possibility of waivers from supervision on an individual basis, based on the provision of collateral by the parent company, recognizing that this practice by national supervisors could prevent cross-border banking groups from managing their resources efficiently. However, this override mechanism, which is still relatively rare, does not close the gap with the United States, where a consolidated regulatory approach and the organization of branches rather than subsidiaries prevail.

53 These may be shareholders, creditors, host country depositors, the national guarantee fund or taxpayers.

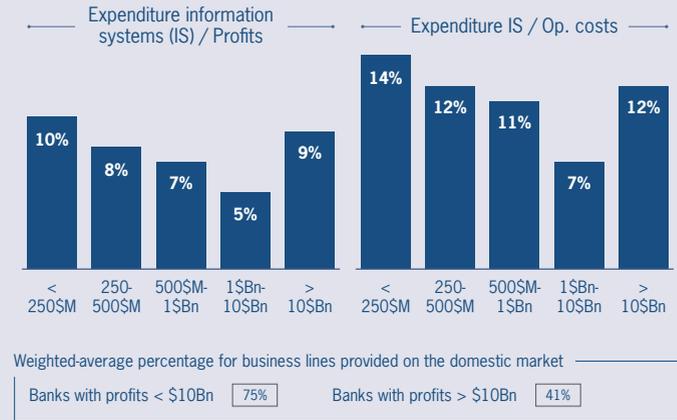
Economies of scale on information systems expenditure

By way of example, economies of scale in the field of IT systems appear to be less feasible at pan-European level, whereas they are possible at national level. The fact that expenditure on information and telecommunications systems rises sharply for banks operating in several Member States, whereas it decreases with size for banks operating in a single domestic market, seems to corroborate this (see figure on the next page). More generally, operating costs as a proportion of revenue are higher (67%) for European banks with a majority of operations in several Member States and with revenues of more than \$10 billion, whereas they decrease with revenue (from 65% to 63%) for banks that are based in their domestic market and have annual revenues of less than \$10 billion.

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Information and telecommunication systems expenditures

(average as a percentage of total revenues and operating costs, by bank size in total revenues generated)



Source: Gartner, Annual Reports, BCG Analysis.

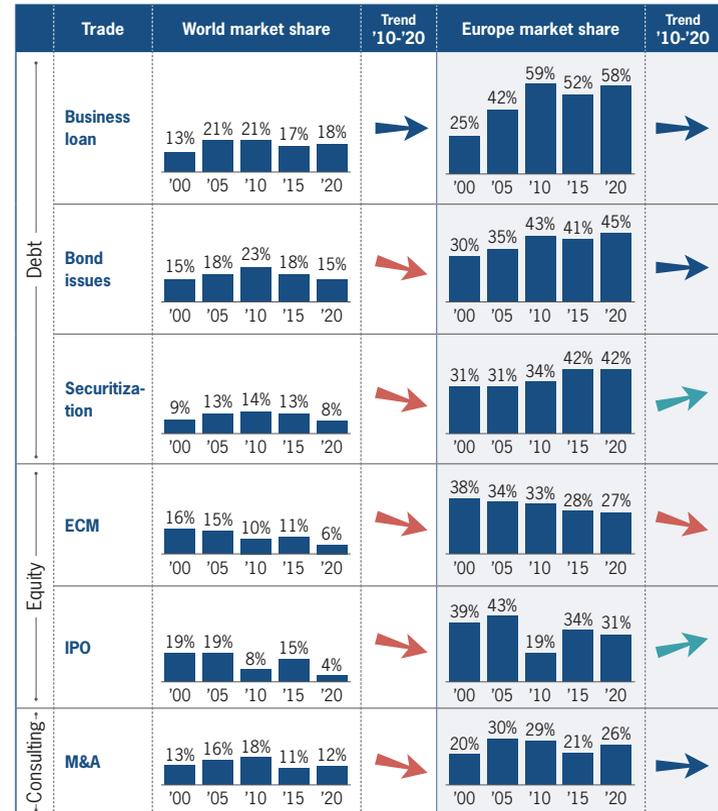
Second, US capital markets being deeper and more difficult to access have led to the emergence of a few large players that now dominate corporate and investment banking internationally, something that Europe has not been able to replicate. Capital markets have historically accounted for a larger share of the financing of the economy in the United States than in Europe (as discussed in Part 1). Capitalizing on the depth of these markets, US corporate and investment banking players have developed and have increasingly replaced European players on a global scale since 2000.

The corporate and investment banking market in Europe remains comparatively less consolidated, despite more natural cross-border synergies, since large international clients with global needs can more readily bypass specific national measures.⁵⁴ It is as if European banks, when they do not have critical mass in these business lines, still find it difficult to give them up, either for reasons of prestige, or because they are difficult to sell to another player.

To this extent, even in Europe, where the market is relatively open, the largest European banks are not able to fully compete with their American competitors as leaders in corporate and investment banking. EU corporate and investment banks had significantly strengthened their presence in Europe before 2010, accounting at that time for around 30% of the M&A market, almost a third of the securitization and equity market, over 40% of the bond business and 60% of the corporate lending business. Between 2010 and 2020, their market shares in Europe stagnated in corporate lending, bond activity, equity transactions and mergers and acquisitions (but they did strengthen their position in securitization and IPOs) (see graph below). While their US competitors, who lost market shares in Europe between 2000 and 2010, have been gaining ground in corporate lending, bond activities, equity transactions and M&As over the past decade. It seems that the European market shares of the main EU banks remains dependent on whether US banks expand into the European market.

Evolution of EU banks' market shares by trade, worldwide and in Europe

(2000-2020)



Source: Thomson Reuters, BCG analysis.

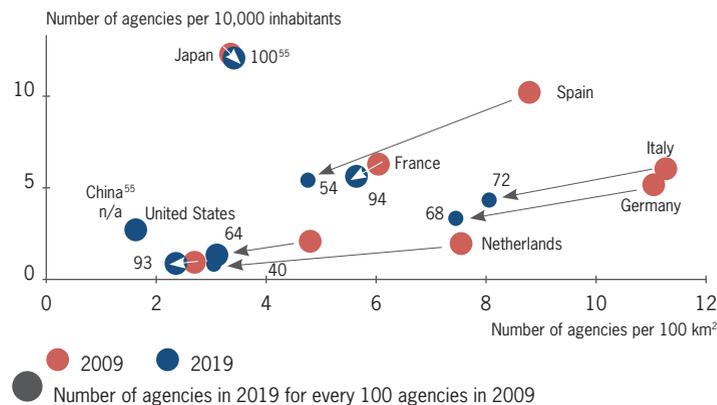
54 CIB covers bond issues, securitization, equity management, IPOs, corporate lending and financial advisory services (mergers and acquisitions).

The fragmentation of the European market is also due to overcapacity.

For example, the continent has the highest number of branches proportional to population (see figure on the next page), with disparities between Member States: Germany and Italy have the densest networks, while the Netherlands' branch network is similar to the US makeup. Since 2009, the trend in Europe has been towards reducing the number of branches in the networks (with a decrease of 60% in the Netherlands, 50% in Spain, and around 30% in Germany and Italy), although they still remain denser than in the US.

Another example of this overcapacity is that more banks in Europe than in the United States remain active despite very low returns on investment, or despite high costs relative to revenues. This last point can also be linked to a stronger presence in Europe of banking models that are less sensitive to the profitability of their activity – either because return on capital is not a management criterion, or because of the presence of local elected officials in their governance structures (mutual banks, public banks).

Evolution in the number of agencies per inhabitant and per area, in a selection of countries



Source: World Bank, S&P SNL, FRED, China Banking Association, BCG analysis.

What is the Banking Union?

The Banking Union is a European Union initiative launched in 2012. It aims to **create a banking market that is more transparent** (through the application of common rules and standards for banking supervision and resolution), **more unified** (by ensuring a level playing field between domestic and cross-border operations, and by decoupling the financial health of banks from the countries in which they are located), **and safer** within participating Member States.

.../...

⁵⁵ China data from 2018, Japan from 2017.

First of all, the Banking Union consists of a **single rule book**, which provides a set of integrated rules that institutions throughout the European Union must follow. This unified regulatory framework for the EU financial sector **ensures a uniform application of the international Basel III regulations** in all Member States.

It is then based on **two pillars**, which reflect the priorities set out above and aim at closer integration of the banking system in the euro area, as well as among the non-euro area countries that have chosen to participate (Bulgaria and Croatia since October 2020):

- A **Single Supervisory Mechanism (SSM)**, established in 2013, which relies on the ECB and the national supervisory authorities of the participating countries to ensure that banks comply with EU prudential rules⁵⁶. The SSM is responsible for supervisory reviews, on-site inspections and investigations, granting or withdrawing banking licenses, examining acquisitions and disposals of shareholdings by banks, and setting capital requirements in the light of each bank's situation.
- A **Single Resolution Mechanism (SRM)**, introduced in 2014⁵⁶, which organizes the orderly restructuring of a bank when it fails or is likely to fail, in order to limit the cost to taxpayers and to the economy. It is based on a single resolution board and a single resolution fund (SRF). €55 billion is financed by contributions from the banking sector in proportion to banks' liabilities. It is used to wind up troubled banks (e.g., by guaranteeing their assets during resolution), once other options, such as a takeover by another bank, or a bail-out, have been exhausted.

.../...

The Banking Union has yet to establish a common deposit guarantee scheme, and reduce risks within the banking sector (in particular, those linked to NPLs, or initiatives to encourage banks to diversify their investments in sovereign bonds).

What is the Capital Markets Union?

The Capital Markets Union (CMU) is an **EU initiative launched in 2014 to create a single capital market** ensuring that financial resources – investments and savings – flow across the EU to benefit consumers, investors and businesses, wherever they are. It will offer businesses a wider choice of cheaper funding options, beyond the bank financing that is still dominant in Europe, and increase cross-border sharing of financial risks.

Since the implementation of **the CMU Action Plan launched in 2015 by the European Commission**, legislative progress has been made to fill the gaps in the area of securitization (to make it simpler, more transparent and more standardized in order to extend investment opportunities and foster lending to households and businesses), investment funds (to promote venture capital and social investment in the EU and facilitate cross-border distribution of collective investment funds), investment firms, covered bonds, pension products and restructuring legislation. However, for some of these legislative proposals, the initial ambitions had to be scaled down considerably in order to reach an agreement between the co-legislators (Council and European Parliament). European capital markets remain fragmented to this day.

.../...

⁵⁶ Defined by CRR-II (Regulation (EU) 2019/876 amending Regulation (EU) No 575/2013), CRD-V (Directive (EU) 2019/878 amending Directive 2013/36/EU).

⁵⁷ By the SRM Regulation (EU) No 806/2014, supplemented by the BRRD Directive 2014/59/EU.

Therefore, in September 2020, the European Commission adopted a new action plan to complete the CMU, meant to lead to a new legislative package. The purpose is to make it **easier for businesses to access finance to support a green, digital and inclusive recovery** (including making businesses more visible to cross-border investors, encouraging institutional investors to increase their long-term and equity financing and helping banks to lend more to the real economy), **promoting long-term investment and the smooth flow of savings in the EU** (e.g., through financial education) and **integrating national capital markets** (e.g., by enhancing the predictability of insolvency procedures, or developing cross-border settlement services).

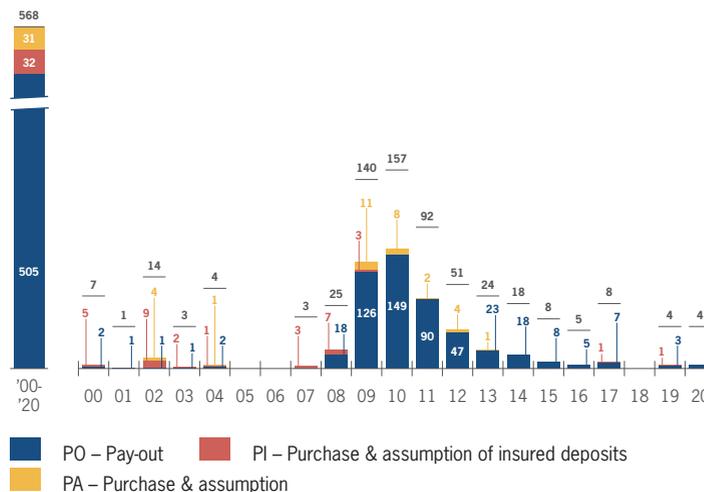
FDIC \$70 billion. More than 70 acquisitions of failed banks took place in the United States between 2008 and 2013, more than half of which happened in 2010-2011.⁶⁰ Comparatively, only five acquisitions of failed banks took place in Europe, although some restructuring did take place outside of bankruptcy proceedings (e.g. mergers of savings banks or regional cooperative banks in Germany).

2.2. The United States successfully cleaned up its banking system after the financial crisis, thanks to a proven resolution system which has not worked in Europe

The resolution of the consequences of the financial crisis has been faster and more effective in the United States thanks to a proven resolution framework that has allowed failed banks to be backed by sound banks at lower costs. Since 1933, the United States has had the Federal Deposit Insurance Corporation (FDIC), an independent agency whose mandate includes deposit insurance,⁵⁸ primary supervision of certain banks that would not be covered by the Federal Reserve, and finally the management of bank resolutions. Between 2008 and 2013, the FDIC assisted nearly 500 banks in their bankruptcy proceedings (see figure on the next page),⁵⁹ costing the

Number of banks in FDIC bankruptcy proceedings
(per year, by type of proceeding)

Almost 581 banks guided by the FDIC in their bankruptcy proceedings since 2000



Source: FDIC.

⁶⁰ The savings and loan associations and mortgage lenders, for example, were absorbed by the large, healthy banks after the crisis (JP Morgan's acquisition of Washington Mutual and Bank of America's acquisition of Countrywide Financial).

⁵⁸ The *Deposit Insurance Fund*, which is primarily funded by bank contributions for deposit insurance purposes, has nearly \$118 billion (according to its quarterly financial statement as of December 2020).

⁵⁹ Primarily in the following manner: after the right to bank is terminated, deposits (insured and uninsured) and certain other liabilities are transferred in an organized manner to another institution. The difference between the value of the liabilities transferred in liquidation and the actual value of those same liabilities is borne by the FDIC: this is the cost that amounted from 2000 to 2020 to \$70 billion.

Conversely, the European Union has only recently adopted a unified resolution framework, which has yet to prove its usefulness. This bank resolution framework was unified at the European level in the spring of 2014,⁶¹ and is managed by the Single Resolution Mechanism (see box below).⁶² Yet, this framework has been used only once in the euro area (in 2017, for the resolution of Banco Popular Español S.Á., which resulted in an acquisition by Santander). It is already being circumvented, even for medium-sized banks,⁶³ which may call its credibility into question.⁶⁴ Moreover, although progress in standardizing characteristics has been made at the European level,⁶⁵ deposit guarantee funds remain national: based on contributions from the domestic banking sectors, they are still financed in a heterogeneous manner,⁶⁶ depending largely on their history of use, and their amounts remain modest compared to those of the FDIC. The national deposit guarantee funds in the euro area covered around 0.5% of the total guaranteed deposits in the area in 2020,⁶⁷ compared with 1.3% for the FDIC fund.

The European resolution framework has so far failed to counter the notion that “global banks die domestically” and has therefore not enabled a cross-border reconfiguration of the European banking sector post financial crisis. Despite the European resolution framework, national supervisors in Member States hosting subsidiaries of foreign banking

groups have maintained a supervisory practice focused on protecting their domestic markets, which has discouraged cross-border consolidation. The absence of pan-European deposit guarantees has certainly also contributed to this. **Almost all bankruptcies have been managed outside the resolution framework,⁶⁸ through winding-up procedures that have remained national, with strong disparities** between Member States. This state of affairs has not made it possible to break the “sovereign-bank loop”, and neither has it been able to counter the idea that the cost of national bankruptcies will continue to be borne largely by public finances of the Member State in which the bank is located.

Early recapitalization of American banks through equity issuance

Unlike Europe, the United States encouraged early and significant recapitalization of its banking sector after the financial crisis (see figure below). In the United States, banks were forced to rebuild their capital base by issuing new shares as early as 2008, in the midst of the financial crisis. In the euro area, banks were required to improve their capital to risk-weighted assets ratios, but they were left to decide how to proceed. This may have encouraged alternative strategies where banks would have shifted from lending to companies to acquiring low-risk assets, such as sovereign debt.

.../...

61 A bank resolution occurs when the authorities determine that a failing bank cannot follow the normal insolvency procedure without harming public interest and causing financial instability.

62 In particular, the Bank Recovery and Resolution Directive (BRRD).

63 An example would be the case of the German bank NordLB, which in December 2019 received €3.6 billion of public support processed outside the single resolution mechanism.

64 Pancotto L et al (2019). The European Bank Recovery and Resolution Directive: A market assessment, *Journal of Financial Stability* Vol.44. <https://www.sciencedirect.com/science/article/abs/pii/S1572308917308720>

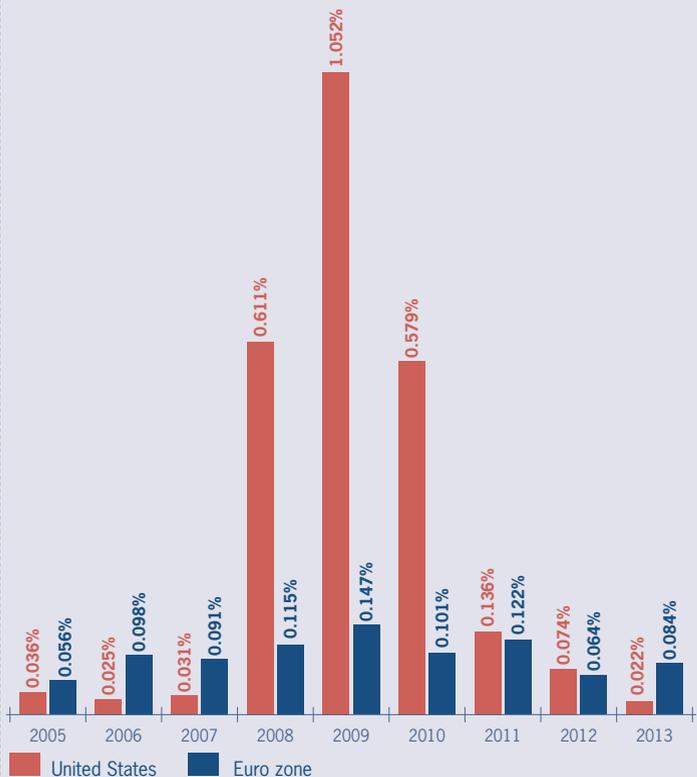
65 By Directive 2014/49/EU, amending Directive 94/19/EC.

66 By way of example, at the end of 2020, Germany has four separate guarantee funds (for different categories of banks) for a total of more than €10 billion, the French *Fonds de Garantie des Dépôts et de Résolution* totals just over €5 billion, the two Italian guarantee funds account for just under €2 billion, and the Spanish fund has a contribution of €4 billion.

67 To these national funds should be added the Single Resolution Fund of the euro area, whose role is to financially support the resolution mechanisms of failed banks – whose size in 2020 was €38 billion or 0.6% of the guaranteed deposits of the area.

68 Examples include Veneto Banca and Banca Popolare di Vicenza.

Bank equity issuance trends as a percentage of consolidated balance sheets, by region



Source : Homar T. et Van Wijnbergen J.G. (2017). Bank recapitalization and economic recovery after financial crises, *Journal of Financial Intermediation* Vol. 32.

Different bad bank systems and structures have been put in place by national governments in European countries to allow for the clearance of “legacy assets” after resolution⁶⁹

In some European countries, resolution mechanisms have been supplemented with public structures for clearing “legacy assets” (mainly NPLs) (see graph on the following page). The purpose of these structures is to restore balance sheet solvency for banks undergoing resolution procedures, so that they can regain their ability to raise capital and finance themselves on the market in order to restart their operational activity.

.../...

69 “Legacy” assets.

Main national clearance systems and structures in Europe

(not exhaustive)



Post-crisis, three main systems have been set up by European national governments:

- Support for the securitization of NPLs to remove them from banks' balance sheets by providing a **state guarantee** on the least risky segments of these securitized assets, as allowed by the Greek Hercules and Italian *Garanzia sulla Cartolarizzazione delle Sofferenze* (GACS) schemes.
- Establishment of **national coordination platforms** that, on behalf of several creditor banks exposed to common borrowers, negotiate with other creditors as a single voice to improve the prospects of loan repayment in the event of the borrower's liquidation.
- Creation of **asset management companies financed mainly by public funds**, whose objective is to buy NPLs from banks undergoing resolution procedures and then sell them on the secondary market. This system makes it possible to isolate the latent losses of NPLs within a single financial structure and thus limit the risk of bankruptcy for the rest of the banking sector. On the other hand, this system remains difficult to accept politically, as it means transferring private sector risk-taking to public finances, and therefore to taxpayers. Such asset management companies have been created with varying degrees of success in Ireland (*National Asset Management Agency*, NAMA), Spain (*Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria*, SAREB⁷⁰), and Slovenia (DUTB).

With regards to the latter system, the potential creation of a European asset management company convinces a number of European decision-makers who stress (i) the potential to improve the institutional framework for crisis prevention, both by reassuring local authorities

... / ...

70 Of which 55% of the shareholding is private, but since March 2021 has been counted as part of the government's purview.

who have pan-European but non-domestic banks operating in their country and by allowing for a greater overall stability of the European banking sector, and (ii) the improvement of the economic viability of a system that would be financed at the rate of European versus national sovereign bonds.

However, this project still comes up against national political differences, as most governments do not wish to take the risk of pooling losses and thus burdening their local taxpayers with the risk-taking of foreign private institutions.

2.3. Increased regulations have generated additional costs, and international agreements, particularly the Basel Accords, are in fact more challenging for European banks

In the wake of the 2008 financial crisis, the global regulatory framework has been strengthened to ensure the stability of the financial system.

For instance, the number of regulatory changes applied to financial institutions increased by 35% cumulatively between 2011 and 2015, and has since reached more than 50,000 per year.⁷¹ Among these new regulations, what is known as Basel III Accords (see box: “What is Basel III?”) has established new common standards for internationally active banks since 2010.

What is Basel III?

Basel III is a set of internationally agreed measures developed by the Basel Committee on Banking Supervision (under the aegis of the Bank for International Settlements, bringing together 28 partner countries), mainly announced in 2010 in response to the financial crisis of 2007-2009. These measures follow the Basel II framework negotiated at the turn of the century, which came into effect just as the financial crisis unfolded. They aim to **strengthen the regulation, supervision and risk management of banks.**

As with all previous Basel Committee standards, the Basel III standards are **minimum requirements that apply to internationally active banks.** Members are committed to implementing and enforcing these standards in their jurisdictions while respecting the deadlines set by the Committee.

The initial phase of the Basel III reforms (2010-2017) focused on strengthening the following components of the regulatory framework:

- Improve the quality of banks' regulatory capital by placing greater emphasis on higher quality, loss-absorbing Tier 1 capital (CET1);
- Increase the level of capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress;
- Improve risk capture by revising standards within the risk weighted framework that have proven to be poorly calibrated, including the determination of market risk, counterparty credit risk and securitization;
- Add macro-prudential elements to the regulatory framework: (i) introducing capital “cushions” that are built up in prosperous times and can be used in hard times to limit procyclicality; (ii) establishing a large exposures regime that mitigates systemic risks arising from

.../...

⁷¹ Source: Thomson Reuters cost of compliance study.

linkages between financial institutions via the largest exposures; and (iii) introducing a capital buffer to address externalities created by systemically important banks;

- Specify a minimum leverage ratio requirement to limit excess leverage in the banking system;
- Introduce an international framework to mitigate excessive liquidity risk and maturity transformation, through the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

A package of new reforms, announced in 2017 and referred to by European banks as Basel IV, completes aspects of Basel III left unresolved. Their application could begin on 1 January 2023 and be fully implemented by 2028. The revisions aim to further improve the **calculation of risk-weighted assets** and enhance the **comparability of banks' capital** ratios by:

- Enhancing the robustness and risk sensitivity of standardized approaches for credit risk, credit value adjustment (CVA) risk and operational risk;
- Restricting the use of internal model approaches in the calculation of risk-weighted assets by imposing limits on certain inputs used to calculate capital requirements under the Internal Ratings Based approach (IRB) for credit risk and by removing the use of internal model approaches for CVA risk and for operational risk;
- Raising the leverage ratio for global systemically important banks (G-SIBs) to further limit leverage;
- Making the current Basel II output floor, which limits the deviation of the valuation of risk-weighted assets obtained by internal models from the standard model, more binding.

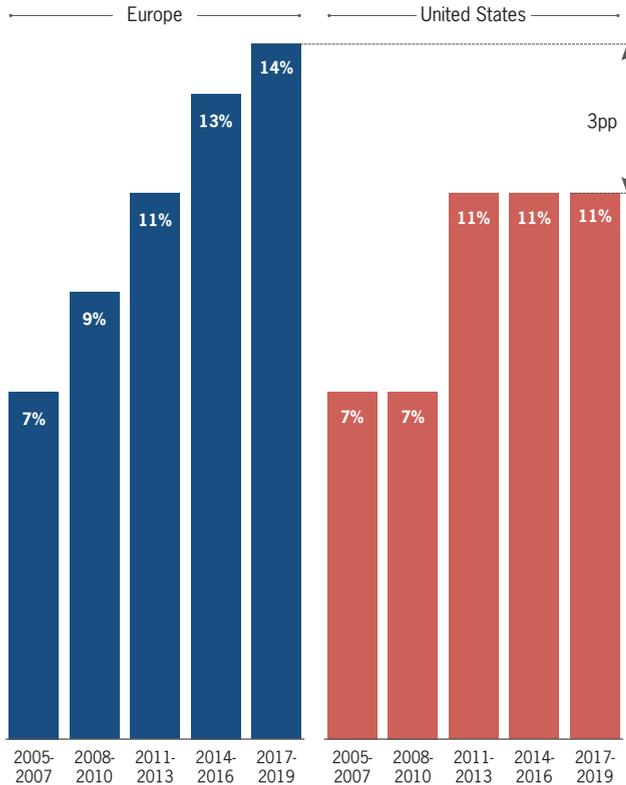
Source: BIS

Compliance with the new regulatory requirements has generated additional costs for banks:

- **Operational** costs: the largest banks have doubled or even tripled the proportion of their staff dedicated to compliance and risk functions between 2009 and 2019.
- **Additional capital** costs: compliance with the new liquidity ratios also required adaptation, through the creation of liquid asset reserves, whose low return weighs on profitability, and through the extension of the average maturity of balance sheet financing. Lastly, the new regulatory framework led to additional capital costs which were offset by the improved resilience of the banking sector.

A comparison of the prudential ratios of the largest European and US banks is interesting (see figure below): European banks' most demanding capital ratio (CET1) grew continuously between 2005 and 2019 (from 7 to 14%). Conversely, the CET1 ratio for US banks increased from 7 to 11% between 2005 and 2013, but then stabilized. This increase is consistent with the whole sample of banks considered, and remains valid within each bank size category (e.g., between G-SIBs on both sides of the Atlantic). It is as if the capital markets demand more hard capital from European banks than from US banks.

CET1 capital ratio trends, by region



Max.	10%	15%	19%	25%	25%	13%	19%	19%	15%	13%
3 rd quartile	7%	10%	13%	15%	16%	8%	10%	13%	12%	12%
1 st quartile	6%	8%	11%	12%	13%	6%	7%	10%	10%	10%
Min.	4%	5%	8%	8%	11%	5%	2%	7%	9%	9%

Source: S&P SNL, BCG analysis.

Although the framework for large banks is similar in Europe and the United States,⁷² in practice the regulatory requirements have a greater impact for the European banking sector:

- i. whose banks have a larger average balance sheet and less “velocity”, not benefiting from fluid securitization mechanisms,
- ii. which has the same level of regulatory requirements for all its banks (small, medium and large, local subsidiaries and parent companies),
- iii. and, is likely to be further penalized by future Basel regulations. Thus, the finalization of Basel III, which aims to limit the favorable effects of the use of internal risk-weighting models by European banks, will eliminate an instrument that allowed the continent’s major institutions to balance their regulatory treatment compared to American banks.⁷³

First, regulatory capital requirements increase with the size of the balance sheet.⁷⁴ This penalizes European banks proportionally more, which, resorting significantly less to securitization than their American competitors, have a heavier and less swift balance sheet on average. They therefore keep certain less profitable assets on their balance sheets, such as real estate loans, whereas US banks remove this type of asset from their balance sheets through securitization, thus not tying up regulatory capital.

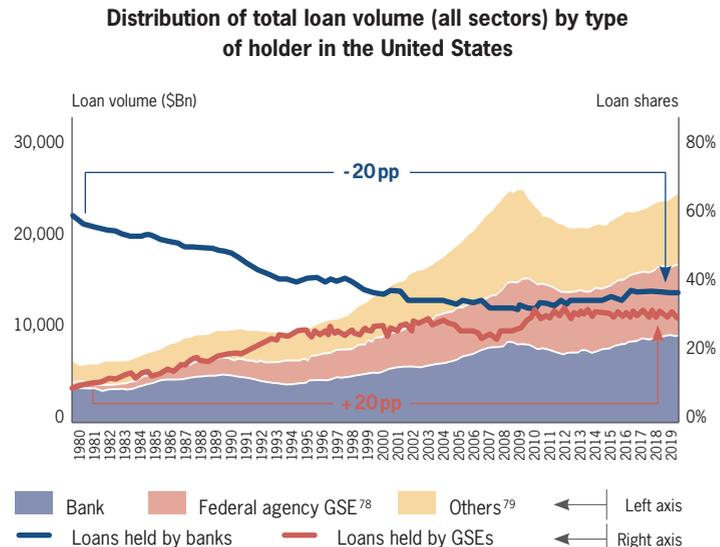
This credit transfer mechanism, which enables US banks to lighten their balance sheets and optimize their use (underpinning the US “originate-to-distribute” business model), is made possible not only by the depth of the capital market, driven by institutional investors whose importance stems from that of the funded pension system, but also

72 Since 2010, Basel III has imposed a capital adequacy ratio on US banks, with minimum requirements and capital reserves similar to those of CRD IV/ CRR, in effect since 2013 in the European Union. The “Dodd Frank” regulation imposes similar, if not stricter, capital, clearing and reporting requirements for OTC derivatives on US banks than the European standards.

73 The US banks use the standard model but apply it to a balance sheet structure that is faster and more optimized because of the depth of their financial markets.

74 For example, the level of the systemic buffer for global systemically important banks (G-SIBs) which is a component of the CET1 capital ratio.

by government guarantee mechanisms. It is estimated that US banks could account for more than half of the world's proprietary securitization business.⁷⁵ The implicit guarantee of the US federal agencies Freddie Mac and Fannie Mae,⁷⁶ two government-sponsored private financial institutions, has contributed to the establishment and deepening of a secondary market for mortgage loans by significantly increasing their holdings of these assets, which has been accompanied by a symmetrical decline in holdings by US banks. These two institutions now hold around \$7.8 trillion in loans (see figure on the next page).⁷⁷



Source: FDIC, BCG analysis.

Secondly, it should be noted that the choice was made in Europe to apply the Basel III regulations to all banks, regardless of their size (large, medium, small) and their legal status (parent company and subsidiary),⁸⁰ whereas in the United States this framework applies only to internationally active banks.⁸¹ The entire European banking sector is

75 Source: Estimate based on Thomson Reuters Refinitiv data.

76 Forty years ago, Congress created Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) as Government Sponsored Entities. These private financial institutions have a public mission to provide a stable source of funding for residential mortgages throughout the country. They do this by intervening in the secondary mortgage market, purchasing mortgages that meet certain standards from banks. They then package these loans into securities backed by Freddie Mac and Fannie Mae that are guaranteed against losses due to defaults on the underlying mortgages. These securities are then sold to investors in a process called securitization.

77 Compare this, for example, with the combined balance sheet of the 10 largest European banks (over €17 trillion) or the US (over €11 trillion).

78 Government Sponsored Enterprise.

79 Includes credit unions, ABS issuers, non financial institutions, other financial institutions.

80 It should be noted that the regulatory requirements do not apply to local entities under "branch" status if the parent company is in compliance, whereas they do apply to local subsidiaries. The branch model is still not very developed in Europe at the moment and is often discouraged by local national authorities.

81 This difference does not appear to have translated into regulatory largesse for small and medium-sized US banks: their CET1 ratios are in line with those of the largest US banks, and the difference in CET1 ratios between small banks on either side of the Atlantic is equivalent to that between large banks.

therefore in compliance with the regulatory constraints formulated in Basel for very large banks only. Unlike the United States, which only applies the Basel prudential requirements to its largest banks, the ECB applies them to all banks under its supervision (115 banks holding 82% of the area's banking assets). Moreover, the majority of banks under national supervision in Europe are also held to this same level of requirement by the national authorities of the countries where they operate. The United States seems to have differentiated and simplified the requirements for smaller banks. This difference also stems from a greater trust in the US in the crisis management framework for smaller banks.

To this extent, the additional costs associated with the strictly European MREL⁸² standard, which applies to all credit institutions, compared with the international TLAC standard applied to systemically important banks, may have weighed more heavily on European banks than on their US competitors.

Lastly, the finalization of the Basel III reforms (see box: "What is Basel III?"), which should come into force gradually between 2023 and 2028, would, as they stand, have a greater impact on European banks than on American ones. It will be transposed into European law in the coming months on the basis of an initial proposal from the European Commission, expected soon.

According to the European Banking Agency, the finalization of Basel III would require European banks to increase their capital by more than €50 billion, the bulk of which (€30 billion) in the most demanding form of capital (CET1).

82 At the G20 level, a new minimum requirement for total loss-absorbing capacity (TLAC) came into effect in 2019 for global systemically important banks (G-SIBs). As transposed into EU law, the TLAC standard will set out binding requirements governing issues such as the amount and eligibility of liabilities as well as other aspects (e.g., allocation of loss-absorbing capacity within groups, rules on other banks' investments in TLAC). In parallel, the EU has already introduced a minimum requirement for eligible capital and liabilities (MREL) under the Bank Recovery and Resolution Directive (BRRD). The MREL will be set by the resolution authorities on a firm-specific basis and according to certain rules, making it a more flexible tool in terms of the amount and eligibility of instruments to be held.

For the largest European banks, the minimum required ratio of Tier 1 capital to risk-weighted assets would increase by more than 20% compared to other global systemically important banks.

The main causes of this need for additional capital for European banks are the **review of market risk**⁸³ and the **reform of the capital floor**,⁸⁴ which will limit the benefits that banks can derive from the use of internal models (particularly in terms of risk assessment of exposures to unlisted companies)⁸⁵ to calculate minimum capital requirements. The large US banks, which already use a majority of standard risk models as opposed to internal models, and which have already implemented a form of capital floor, won't be particularly affected, especially since the United States has already **taken a public position in favor of transposing the finalization of Basel III without increasing the capital level of the US banking sector**.⁸⁶

France, like the European authorities, also believes the finalization of Basel III should not have an excessive impact on the capital requirements of banks in the area. However, a consensus has yet to be reached.

83 "Fundamental review of the trading book".

84 The revised output floor limits the amount of capital benefit that a bank can derive from its use of internal models, compared to the use of standardized approaches. The computation of the RWAs of banks generated by internal models, at the end of the finalization of Basel III and in a progressive way, cannot be lower than 72.5% of the RWAs calculated by the standard approaches (as opposed to 50% today). RWAs are, as a reminder, the frequent denominator of the Basel III prudential ratios, and their underestimation therefore mechanically increases these ratios.

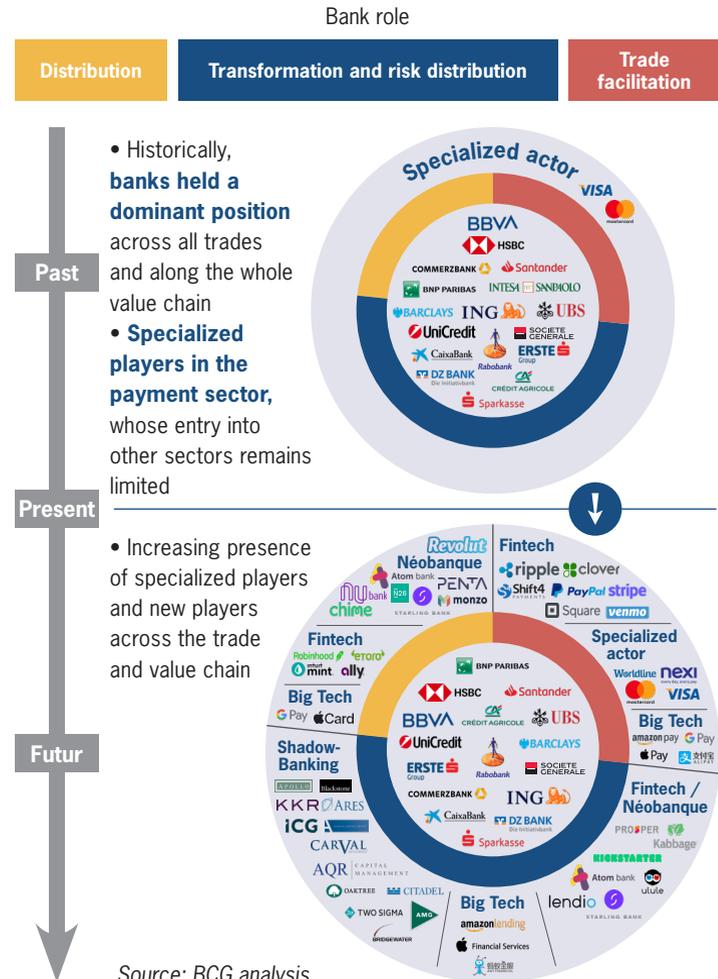
85 Basel III requires the application of a 100% risk weighting for exposures to corporate borrowers (excluding SMEs) that are not rated by agencies but which, according to internal models, are investment grade (i.e., at least BBB). The regulations are unfavorable to European banks given the small number of rated companies in Europe, unlike the United States where the majority of large companies are rated. (sources: EBA, FBF, expert interview).

86 See speeches by Federal Reserve Vice Chairman for Supervision R. Quarles, including in September 2020 at the Institute of International Bankers. <https://www.youtube.com/watch?v=0KIVx6Jbuo>

2.4. Banks are faced with an increasing number of competitors in all segments of the value chain, with standards of expertise and technology that are difficult to achieve

European banks are facing increased competition. In recent years, banks have moved from a quasi-monopolistic position in all their businesses (processing, payment, risk sharing, service distribution, etc.) to an intense competitive environment with the emergence of new players specializing in specific segments of the value chain (see graph on the next page).

Evolution of the ecosystem for core banking activities



The players who represent the greatest potential for market share capture today can be separated into two categories: **on the one hand, new technological players such as “neobanks”** (Revolut, N26, etc.), **Fintech** (Square, Stripe, etc.) **and BigTech** (Google, Amazon, Ant, etc.), and **on the other hand, institutions of the so-called “parallel” banking system** (debt funds, hedge funds, etc.).⁸⁷

1. The technological evolutions of the last decade have favored the emergence of new players

The emergence of these new players is a direct consequence of the technological revolution, which has accelerated customer expectations faster than many traditional banks have been able to keep up.

This may have caused them to lose ground in terms of customer satisfaction. Indeed, the confidence of under 45 year olds in digital banking is now on par with their confidence in traditional banks.⁸⁸ The challenge of building a quality customer relationship in the digital age is vital, as 40% of European customers' interactions with their banks are now through online platforms, as is the case in the US.

The momentum behind neobanks has accelerated significantly in the last 5 years. Neobanks are new players and financial intermediaries offering online banking or banking 100% accessible through mobile applications, and may or may not hold a banking license.⁸⁹ Although their market share is still low at this stage, with less than 5% of total banking customers in the European and US markets considered here, the growth of their customer base is now substantial (in France, for example, between 30 and 50% of new accounts opened between 2017 and 2019 were in neobanks and digital banks). Moreover, the customer base of the leading “digital native” neobanks has more than

doubled in the space of 4-5 years.⁹⁰ The large traditional European banks have developed their own digital banks, enjoying a certain legal and operational autonomy while still remaining tied to them.⁹¹ However, the performance of digital native banks is still perceived as better, **which begs the question of whether traditional banks can truly develop attractive digital offers.** This can be explained by a less specialized targeting of the digital banks' offer than by the native neobanks, or by more expensive offers due to a less favorable initial cost structure. The sustainability of the business model of digital neobanks should not be taken for granted either, as winning new customers happens, at least in the first few years, at the expense of profitability, and only a handful of neobanks have managed to attract a broader customer base (see figure below). For these new players, scale is crucial and it will be interesting to study their ability, or inability, to expand their skills and offerings in the coming years, as well as to attract a core customer base (who do not have previous accounts with other banks). However, whether or not they succeed in scaling up and sustaining their model does not preclude the fact that in the meantime these new players will have significantly changed the competitive landscape.

⁸⁷ Also known as “Shadow Banking” – the term “Shadow Banking” will be used for the rest of the report.

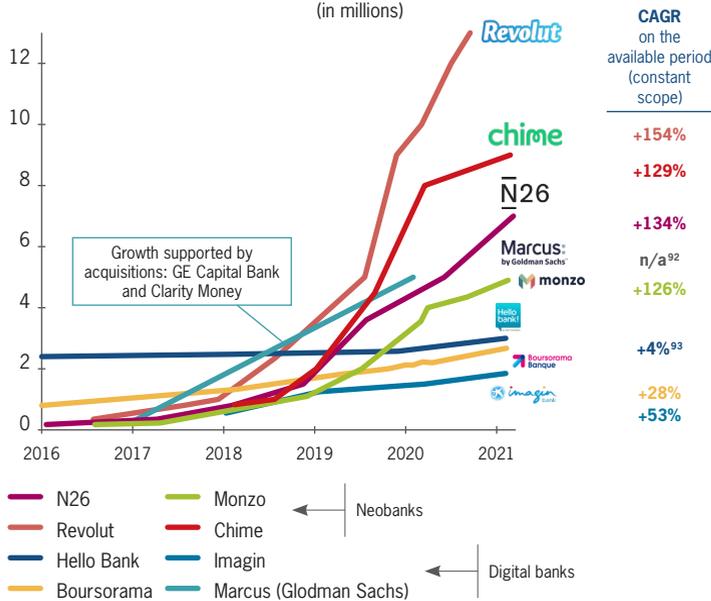
⁸⁸ Sources: Retail banking excellence benchmark (REBEX) 2020 (16 countries, n=12,000), BCG analysis.

⁸⁹ ACPR definition, in ACPR. (2020). Neobanks in search of profitability.

⁹⁰ That is, pure new entrants, launched directly as a digital business.

⁹¹ For example, these digital banks in France would be Boursorama (Société Générale Group), EKO (Crédit Agricole Group), Hello Bank (BNP Paribas Group), ING Direct (ING Group), Monabanq (CM11-CIC Group), Orange Bank (Orange Group), Ma French Bank (La Banque Postale Group).

Evolution of the number of customers for selected neobanks and digital banks



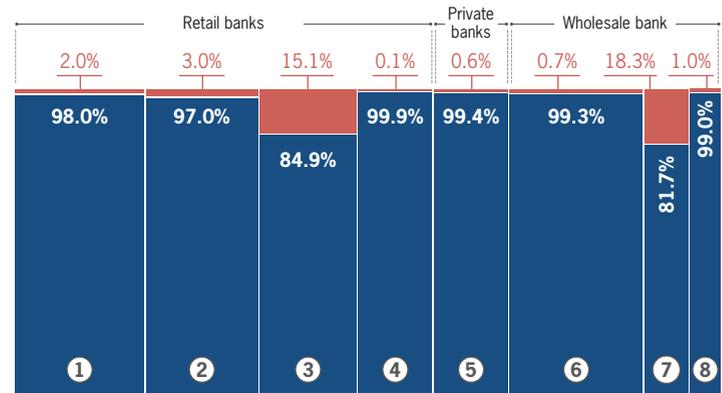
Source: Rapport annuel, Présentation investisseur, Presse.

Fintechs, which rely on the use of technological innovation to support or provide financial services, have been growing dynamically for the past decade in the euro area – which now has more than a fifth of the world’s FinTechs with 2,800 entities. They are highly concentrated in a handful of Member States (France, the Netherlands, Germany), and in payment, clearing and settlement

92 Past pro-forma acquisition data not available.
 93 Excluding Italy.

activities, as well as in credit, collecting deposits and raising capital.⁹⁴ **It is in the area of payments that FinTechs are currently competing most fiercely with banks: they now account for 15-20% of the market share for retail and wholesale payments respectively** (see figure below).⁹⁵

Revenue split between traditional banks and FinTechs on selected banking activities
 (worldwide, estimated in 2018)



- ① Bank account ② Consumer credit ③ Payment (individual)
- ④ Mortgage loan ⑤ Asset management ⑥ Business loan
- ⑦ Payment (wholesale) ⑧ Capital market

■ Revenue shares held by traditional banks
 ■ Revenue shares held by Fintechs

Source: BCG Banking Pools 2019, BCG Fintech Control Tower.

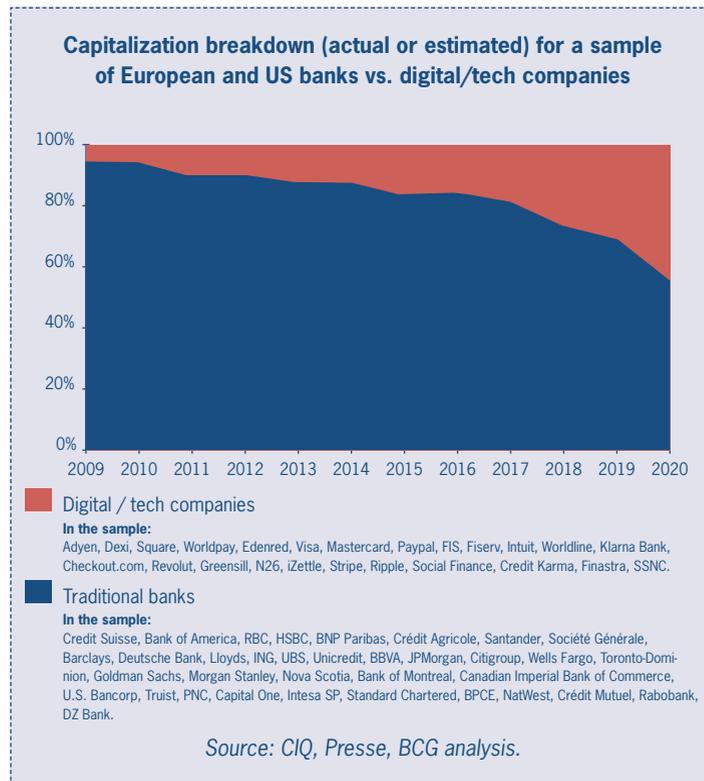
94 European Central Bank. (2020). Report on “Financial integration and structure” in the euro area. <https://www.ecb.europa.eu/pub/fin/html/ecb.fie202003~197074785e.en.html#toc19>
 95 Especially in the acquiring segment, with a gradual diversification towards processing.

At this stage, financial markets and investors seem to trust FinTechs more than banks when it comes to seizing opportunities linked to the digital revolution, as illustrated by the differentiated evolution of capitalizations. These capitalizations reflect the future revenue streams expected by investors. The market caps of many FinTechs specializing in payments are now higher than those of the largest European banks (e.g., Stripe and Square are valued at between \$90-100 billion each). Moreover, there has been a marked growth in fundraising for FinTechs worldwide since 2014.

Market penetration of new players as evidenced by their increasing valuations

As a symptom of the penetration of these new technology players, traditional banks are seeing their valuation decline in favor of these new competitors (see figure on the next page). In a constant sample of 35 banks and 25 tech players, the observation is clear: in 2009, the valuation of banks represented 95% of the total valuation of the sample; it only represents ~55% in 2020. The lower attractiveness of banks for investors raises the question of the ability of banks to finance the investments necessary for their digital transformation. The valuation logic of traditional banks and FinTechs may differ (the latter are more optimistic), but this does not call into question the findings.

.../...



Finally, the BigTechs (GAFAM, but also the Asian digital giants such as Ant Group) **have gradually developed their offer in the field of payments, credit and distribution, by playing on their comparative advantage.** They capitalize on their large customer base. They have significant clout given their technological advantage, in customer data management for example, which allows them to target their offers more effectively and also to better

price customer risk. For the time being, they are strategically positioning themselves in traditional banking activities that are among the least regulated (payments, certain segments of the lending business) by developing proprietary solutions or in partnership with specialized FinTechs (see graph below). Lastly, they may support unprofitable models subsidized by their other business lines, with the commercial aim of developing their activities (e.g., consumer credit from their core market place business).

Overview of segments and offers developed in-house or in partnership with Fintechs, for a selection of BigTechs

	# of Fintech partnerships 2015 vs 2021		Key segments of partnerships	Own solutions developed and major investment in partners
	56	88	Fintechs (26), Loans (19), Payment (17)	
	12	23	Payment (7), Fintechs (7)	
	1	1	Loans (1)	
	2	5	Fintechs (1), Payment (1)	
	10	58	Loans (12), Payment (11), Fintechs (9)	
	12	35	Payment (10), Fintechs (7), Loans (7)	

Note: in brackets, number of partnerships by key segment in 2021.

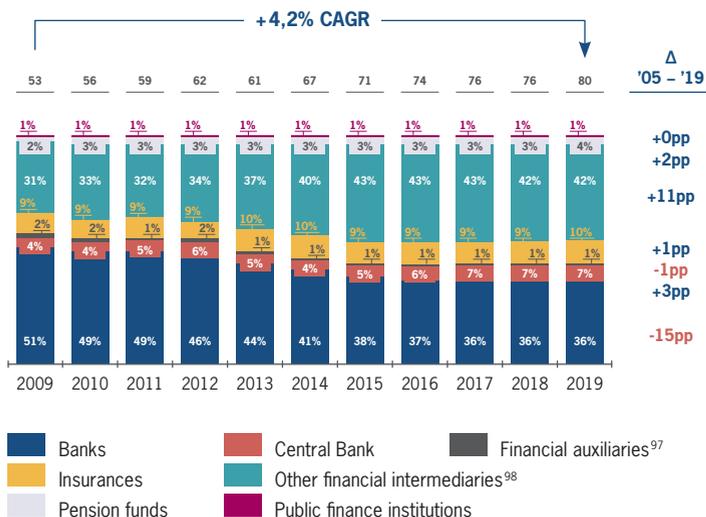
Source: Crunchbase, BCG Fintech Control Tower (April 2021).

2. There is a fundamental trend towards disintermediation by nonbank financial companies

European banks have lost their leading role in financial intermediation. While European banks held more than half of the financial assets of companies and households in 2009, by 2019 they held just over one-third (see figure below). This erosion has almost exclusively benefited private financial intermediaries (excluding insurance and pension funds) such as investment funds, structured finance vehicles and specialized FinTechs. This is not correlated to a decline in the size of banks' balance sheets, but rather to the fact that these new entrants have captured the growth in financial assets over the past decade. Conversely, the US financial intermediation model has been relatively stable over the same period, with banks still accounting for just over 20% of total financial assets.

Changes in holdings of total financial assets for businesses and households in eight major euro area economies, by type of intermediary in € trillions

(Estimate based on 8 countries⁹⁶ in the euro area)



Note: Financial assets represent the total productive assets recorded on the balance sheets of the financial institutions mentioned, and are considered as a source of financing for companies and individuals (loans, bonds...).

Source: Financial Stability Board, BCG analysis.

96 Total figure for 8 countries representative of the euro area (France, Germany, Spain, Italy, Ireland, Netherlands, Belgium, Luxembourg) representing 85-90% of total assets.

97 Investment funds (equity, fixed income, money market funds), brokers, structured finance vehicles, financial captives, lending companies (including credit FinTechs)...

98 Firms that provide assets but do not hold them (insurance brokers, financial investment advisors...).

Technological developments linked to the increasing digitalization of our economy alone cannot explain this phenomenon of growing disintermediation. Shadow banking institutions,⁹⁹ which include entities that collect and manage funds from the public but are not credit institutions, such as money market funds, investment funds and securitization vehicles, do not wield substantial comparative advantages over traditional banks in the digital arena. However, shadow banking has been providing a growing share of financing to the real economy over the past ten years, in debt or equity, reflecting the underlying trend of disintermediation by banking players.

Although European banks still play a dominant role, **private debt funds are increasingly investing in corporate debt financing in Europe.** Although this trend has had only a moderate impact on outstanding debt over the past decade, it is quite noticeable in terms of flows: private debt funds have accounted for between 10% and 15% of corporate debt issuance in recent years, peaking at 25% in 2019, compared with just 1% in 2000 (see figure below). These funds, which often began developing alongside private equity activities,¹⁰⁰ have gradually expanded their portfolio of activities to include private debt. There are several explanations for this: private debt funds have been able to gain a foothold in niche markets that have been abandoned by traditional banks (often because of regulatory constraints); they are subject to fewer regulatory requirements; and they can benefit from the dynamic fundraising that is made possible due to the abundant liquidity currently circulating in the economy.¹⁰¹

99 The list of shadow banking entities is long and varies according to the definition. The sector is identified by the nature of its operations, particularly its credit intermediation activity. Shadow banking entities finance themselves on the financial markets (by issuing, selling or lending securities) in order to lend to the economy (by buying or borrowing securities). (Source: Banque de France).

100 Private Equity.

101 Abundant liquidity that allowed funds to accumulate a lot of dry powder.

Weight of private debt funds in outstanding amounts and flows of corporate debt financing, by region



2.5. Towards a new disintermediation: would a central bank digital currency be a threat or an opportunity for banks?

What is a central bank digital currency?

Money¹⁰³, which plays the triple role of account unity, intermediary in exchanges and store of value, is being **questioned in its current form by major underlying trends: digitization, the decline in the use of cash and banknotes** accelerated by the COVID-19 pandemic, **and lastly the development of means of payment issued privately by non-banking players, as well as central banks' digital currencies.** More than 60% of central banks declare that they are engaging in work and experimentation on the subject. China is currently experimenting with the use of a digital yuan accessible to consumers directly in certain districts of Shanghai. In addition, there is the very dynamic development of cryptoassets, which, although they are primarily based on speculation, sometimes perform some of the same functions as money.

A central bank digital currency (CBDC) would be the equivalent of banknotes, but in an electronic form: it would thus be a direct obligation of the holder to the Central Bank. It would complement the range of payment options already available: Central Bank money in the form of cash, commercial bank money (for example, digital bank .../...

103 In the study of the money supply, four distinct aggregates are taken into consideration: (i) M0, also known as the monetary base, or central bank money, represents all the monetary commitments of a central bank (i.e., coins and banknotes in circulation, holdings of non-cash money recorded by the central bank), (ii) M1, which also includes demand deposits with commercial banks, (iii) M2, which supplements M1 with deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months, and finally (iv) M3, which includes repo agreements, money market fund shares and debt securities with a maturity of up to two years. M0 is thus included in M1, which is itself included in M2, etc.

Note: Europe = European Continent. Debt = Total debt to non-financial corporations.

Source: Preqin, FRED, BRI, BCG analysis.

102 Net issuance defined as the difference between N and N-1 stocks.

deposits), and nonbank digital money (such as payment cards). For the European Central Bank, a digital euro would allow **the sovereign currency to remain at the heart of the European payment system** even in a situation of rapid digitization in the world of payments, and at a time when international card systems, payment wallets and applications developed by the major technology companies are developing. It would contribute to the development of new payment and settlement/delivery infrastructures, based on blockchain technology already well understood by many private players. It would provide a continuous link between the European citizen and the European Central Bank at a time when the use of cash is becoming increasingly rare. Some may even see it as an additional channel for the transmission of monetary policy, or as an opportunity for greater inclusion of people with little access to banking services.

Europe, under the impetus of the European Central Bank, has announced that it is examining the possibility of launching a digital euro project by mid-2021, but its outline has yet to be decided. The European Central Bank, together with the Commission, would like to analyze the modalities for integrating the digital euro into the payments ecosystem (in particular to position the digital euro as a complement to, rather than a competitor of, the European Payments Initiative),¹⁰⁴ as well as to examine its impact on financial stability in order to take into account the risks of a shift of deposits to the digital euro. It is also examining its technical feasibility (in particular access arrangements and the issue of data protection and anonymization).

¹⁰⁴ This correlates to an initiative launched in July 2020 by 16 European banks, and with the support of the European Central Bank, which aims to create a unified payment solution for consumers and merchants in Europe, including a payment card and a digital wallet and covering in-store, online and person-to-person payments as well as cash withdrawals. Despite the establishment of pan-European infrastructures in the Single Euro Payments Area (SEPA), fragmentation in the payments area persists, and this initiative addresses this need. Indeed, several European countries still have national card schemes that do not accept cards from other EU Member States, and many mobile wallets are only offered at the national level.

The impact of a digital euro on European banks will crucially depend on its design and calibration. First and foremost, the distribution pattern of the digital euro will be consequential. Banks are currently the only financial intermediary with direct access to the central bank's balance sheet, which allows them to create money and have access to liquidity "as a last resort".¹⁰⁵ This makes them special financial players with increased resilience. Any change in this area, for example if access to the digital euro were opened to payment service providers, would alter this balance and could impact the banking sector. The question then arises as to whether the **market is wholesale or retail**.¹⁰⁶ European banks have expressed strong concerns about the introduction of the digital euro on the retail market. The risk that large amounts of bank deposits would quickly be shifted to a digital euro would be an existential threat to banks. Several solutions are being considered by central bankers to remedy this problem, such as the introduction of a holding limit, a usage limit or a zero interest rate for the digital euro. Greater deposit volatility would have consequences for the supply of credit by banks because of asset-liability management requirements, and for their ability to offer fixed rates on the credit distributed. This would lead banks to make greater use of more expensive and less stable market sources of funding, which would increase the rate of lending they provide.

¹⁰⁵ Commercial banks currently have access to central bank money, mainly through refinancing operations. By granting credit, they participate in money creation. This is known as the money multiplier, which relates the money supply to the Central Bank money MO actually in the hands of the Central Bank.

¹⁰⁶ The arrival of a digital euro on the interbank market already seems a given, according to most of the qualified people interviewed. The market infrastructures capable of supporting this development could be put in place quickly, cf. Deutsche Börse's announcement of a central clearing for crypto-currency trading.



IN EUROPE, NOT ONLY DO BANKING DIFFICULTIES COMPROMISE THE EFFICIENCY OF ITS FINANCIAL SYSTEM, THEY ALSO JEOPARDIZE EUROPEAN SOVEREIGNTY

1. Difficulties in the banking sector have consequences for the stability and, above all, the efficiency of the European financial system

1.1. The decline of banks in favor of new players could lead to the emergence of new risks that should not be overestimated or ignored

Of course, recent developments have seen a decline in the risks to financial stability, as banks' balance sheets and practices have become more secure. As mentioned earlier, European banks have significantly strengthened their capital base and cleaned up their exposures. The banking sector is generally safer than it was at the time of the 2008 crisis. The current difficulties of banks, which relate to their profitability, do not as such represent a risk to financial stability. Their high level of capitalization, which is the result of regulatory requirements, allows low profitability without the risk of failure for the institutions in question.

However, the attrition of banks from the financing of the economy could fuel the emergence of new risks. Although the current difficulties of European banks do not, as such, represent a risk to financial stability, they often lead to a reorganization of the financial system that raises questions.

The financial crisis had already highlighted the risks associated with shadow banking. In the United States, the emergence of new players in place of banks, with little or no regulation, was widely considered to be a major factor of financial contagion in 2007-2008, particularly via money markets and repo transactions.¹⁰⁷ Traditional regulation, focused on the banking sector, was ill-equipped to detect and limit these risks. Under the leadership of the G20, new regulatory tools were introduced at the international and national levels: the supervision of the financial system was extended to these players and new rules were introduced to govern their activities and their interconnection with the banking system. In 2017, the Financial Stability Board noted that the regulatory framework for managing these risks was well adapted.¹⁰⁸ However, the effective implementation of these rules remained a challenge in some areas, particularly asset management, and the regulatory framework had to keep pace with financial innovation.

Two recent cases illustrate the need for continued vigilance, given the strong interconnections between these entities and traditional banks (see box: "New players and financial risks: the cases of Greensill and Archegos Capital Management"). In March 2021, two nonbanks, one specializing in factoring (Greensill) and the other in asset management (Archegos), experienced serious financial difficulties, resulting in cumulative net losses for Credit Suisse of nearly €8 billion.¹⁰⁹ These losses are in addition to the direct losses of the creditors of these entities: companies, individuals and municipalities.

¹⁰⁷ Respectively "money market funds" and "repurchase agreement".

¹⁰⁸ FSB, *Assessment of shadow banking activities, risks and the adequacy of post-crisis policy tools to address financial stability concerns*, 3 July 2017

¹⁰⁹ These losses have a direct impact on Credit Suisse's profits of \$4.84Bn (\$4.7Bn for the liquidation of Archegos' positions and \$140M of loans not repaid by Greensill) and an indirect impact on the performance of the supply chain funds managed by Credit Suisse of \$3Bn (linked to the write-off of Greensill exposures).

New players and financial risks: the cases of Greensill and Archegos Capital Management

Greensill, a British financial company specializing in factoring and supply chain finance, filed for bankruptcy on 8 March 2021 following the termination of its insurance policies and the freezing of funds provided by its banking partner Credit Suisse. The withdrawal of Greensill's partners was motivated by doubts about the risks of certain loans granted by the company, in particular the speculative "future accounts receivable financing". The failure of Greensill has resulted in significant losses for Credit Suisse and its clients: \$140 million of loans will not be repaid while investors in the supply chain funds managed by Credit Suisse are expected to incur losses of around \$3 billion. Greensill's failure also jeopardizes the financing of the operational activity of the companies dependent on its factoring service. Around €700 million of uninsured deposits, largely held by German municipalities, are also affected.

Archegos Capital Management was a hedge fund that had accumulated large exposures financed through high leverage. The level of risk in its business had been masked by the use of a "prime brokerage" mechanism in which Archegos relied on banking partners to borrow liquidity and execute transactions. In March 2021, Archegos' inability to meet margin calls forced the banks to liquidate the underlying securities, resulting in a loss for Archegos (estimated at between \$8 billion and \$20 billion) and for the provider banks (estimated at around \$10 billion, including \$4.7 billion for Credit Suisse and \$2 billion for the Japanese bank Nomura).

March 2020 demonstrated the importance of the associated risks. It has also highlighted blind spots in current supervisory methods, with the detection of certain vulnerabilities proving to be deficient. In sum, the attrition of banks' role poses new risks that require continuous adaptation of the regulatory framework.

1.2. Above all, a large, robust and efficient banking sector is significant for determining the ability of the financial system to efficiently allocate savings within the continent

The allocation of capital and liquidity within the European continent is a major issue, especially in times of crisis. Heterogeneous financing needs and capacities are typical in euro area countries. In theory, these disparities should be reflected in different levels of return on capital and cross-border funding flows that allow savings to be allocated where they are most efficient. In practice, however, restrictions on the mobility of capital across countries impede these adjustment mechanisms.

These restrictions are particularly detrimental to the resilience of the euro area when facing the asymmetric shocks that its member countries may experience in a crisis. The common currency deprives each country of the monetary instrument to deal with its own shocks. In this context, risk-sharing mechanisms of a public (tax transfers) and private (movement of capital and labor) nature play a fundamental role. In terms of fiscal integration, progress has certainly been made recently with the European recovery plan "Next Generation EU". However, the size of this tool remains below what is considered necessary for the completion of the Economic and Monetary Union (EMU).¹¹¹ Labor mobility, which can also play an important role in cushioning localized shocks, is also constrained by a combination of factors relating to the integration of social systems and cultural and linguistic differences. Gaps in these two risk-sharing

More generally, in its latest report on nonbank financial risks, the Financial Stability Board concludes that there is a continuing need for periodic supervision of this sector.¹¹⁰ The market turmoil that followed the spread of COVID-19 in

110 FSB, *Global Monitoring Report on Non-Bank Financial Intermediation*, 16 December 2020.

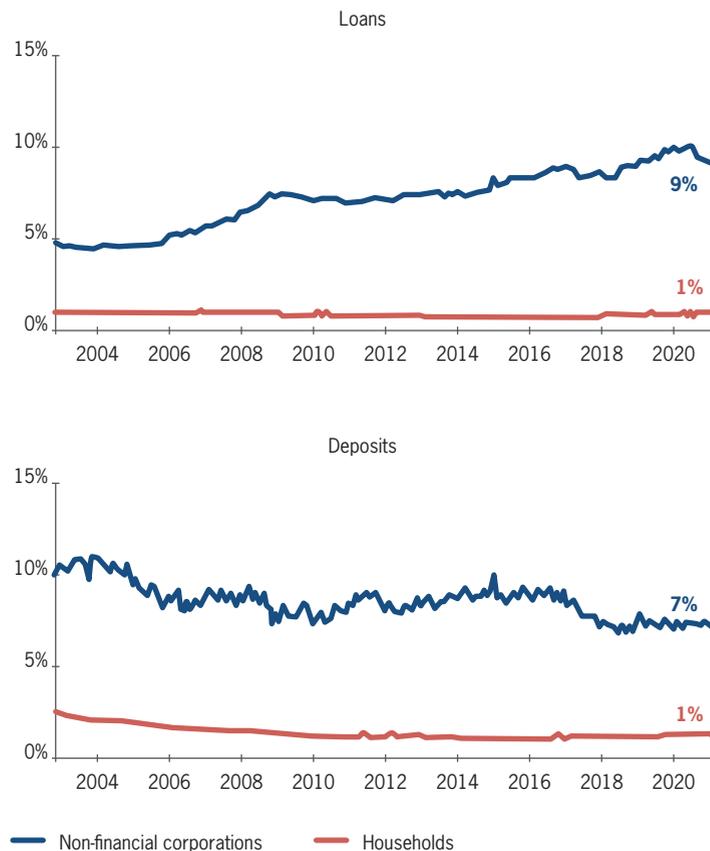
111 Note Trésor-éco, "Contribution to the reflection on the strengthening of the euro area", February 2017.

mechanisms make financial integration even more important. In a 2016 study, the European Commission estimated that the existing risk-sharing mechanisms in the euro area smooth out only 24.3% of asymmetric shocks, compared with 82.4% in the United States.¹¹² In the euro area, financial integration accounted for 75% of total cushioning.

A more efficient, pan-European banking sector could significantly contribute to a more efficient allocation of capital in Europe. Deepening financial integration in the euro area is largely a matter of capital markets unity, a strong priority of the European Commission since 2015.¹¹³ But banks also have a role to play in building a system for the efficient allocation of savings within the continent. It is therefore necessary to deepen both the Capital Markets Union and the Banking Union.

Scale is essential for the efficient allocation of savings on the European continent. As a corollary to these incomplete unions – banking and capital markets – the potential of large European banks remains untapped (see figure on the next page). Cross-border loans and deposits remain underdeveloped, with shares of 9% and 7% respectively for companies and around 1% for households. The current difficulties of the European banking sector and, in particular, the halt in cross-border mergers are weighing on the allocation of capital in Europe and the continent's resilience against asymmetric shocks. According to the aforementioned Commission study,¹¹⁴ the US financial system is able to absorb 26.7% of asymmetric shocks, i.e., 8.5 percentage points more than Europe, primarily because of a more robust and integrated banking sector at the national level. While the COVID-19 crisis exit trajectories could be very disparate across euro area countries, the banking integration instrument cannot be left aside.

Share of cross-border loans and deposits in the euro area for non-financial corporations and households



Source: European Central Bank.

112 European Commission (2016), "Cross-border risk sharing after asymmetric shocks: evidence from the euro area and the United States", *Quarterly Report on the Euro Area*. https://ec.europa.eu/info/sites/default/files/ip030_en_1.pdf

113 Commission Action Plan of 30 September 2015 for the establishment of a Capital Markets Union.

114 European Commission (2016), "Cross-border risk sharing after asymmetric shocks: evidence from the euro area and the United States".

2. More broadly, European sovereignty depends on a healthy and strong banking sector

Banks provide essential inputs to all other sectors of the economy. The fact that European banks are losing ground to their American and Asian competitors and to new specialized players raises the question of substitution between the services provided by these different players. Particularly in the event of a crisis, there is a great risk that foreign players will take refuge in their domestic markets, which would be detrimental to the ability of European companies and governments to access financing.

Banks play a crucial role in transmitting public policy and financing the entire economy. Therefore, in order to meet the major challenges ahead, especially environmental ones, and to compete with other powers, Europe must be able to rely on a robust and dynamic banking sector, capable of ensuring the effective transmission of monetary policy, of allocating domestic savings efficiently according to regulatory constraints, and of contributing to the stability of financing for the Member States of the Monetary Union.

2.1. Banks have long been a powerful tool for public decision-making, as they demonstrated again during the pandemic

Banks play a decisive role in the transmission of monetary policy. As mentioned above, banks are the “monetary policy counterparties”: as such, banks are currently the only ones with access to the central bank’s balance sheet to refinance themselves.

Banks, as deposit-taking institutions, are an essential cog in the monetary machine of the euro area. Firstly, they are directly involved in the creation of money, and thus in the legitimacy of the euro as a reference currency. Secondly, they carry what is known as the “credit channel” – on which the transmission of monetary policy to the supply of financing and thus, to investment, is based.

However, the ability of banks to ease the supply of credit when macroeconomic circumstances require it depends very much on their financial situation, in particular on the quality of their assets. A balance sheet burdened with bad loans or a low level of capital can lead to persistent credit rationing, even under an expansionary monetary policy.

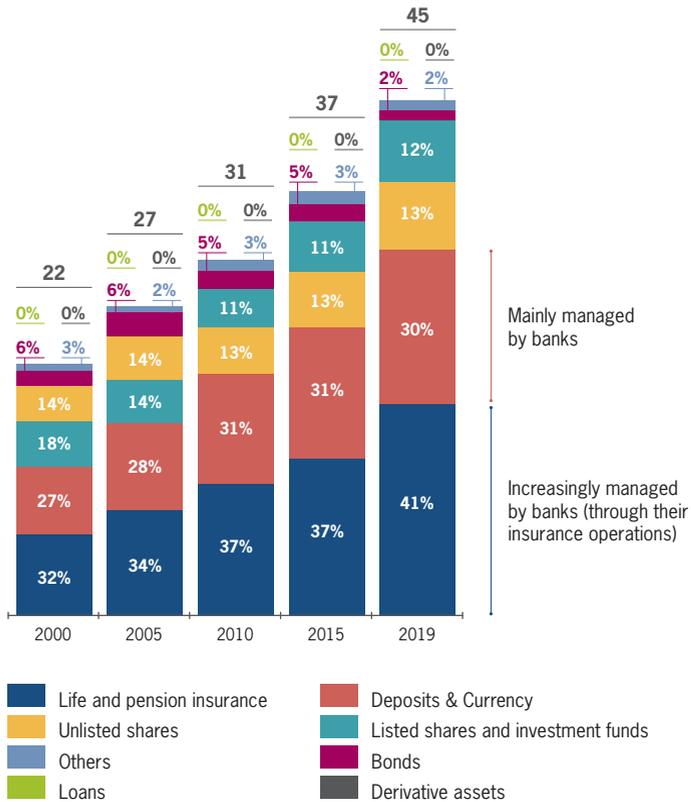
As mentioned, European banks have made significant progress in reducing their outstanding NPLs. However, the uncertainties linked to possible corporate bankruptcies in the context of a normalization of fiscal policy may affect this momentum and obliterate the quality of bank loan portfolios. To this could be added the long-standing problem of information asymmetry, which could lead to credit rationing if and when key interest rates normalize, not only for reasons of anti-selection but also because of constraints on the availability of their own balance sheets.¹¹⁵

Banks are also a key channel for the allocation of savings and related policies, especially in France. Banks manage a large and growing share of Europeans’ savings (see figure on the next page): 30% are bank deposits and 41% are in retirement savings and life insurance schemes, in which banks play an important management role, particularly through their insurance subsidiaries (see figure page 125). In most European countries, governments encourage the development of these savings and their use to finance the economy through tax exemption schemes.¹¹⁶

¹¹⁵ Joseph E. Stiglitz and Andrew Weiss, “Credit Rationing in Markets with Imperfect Information”, *The American Economic Review*, Jun. 1981, Vol. 71, No. 3 (Jun., 1981), pp. 393-410.

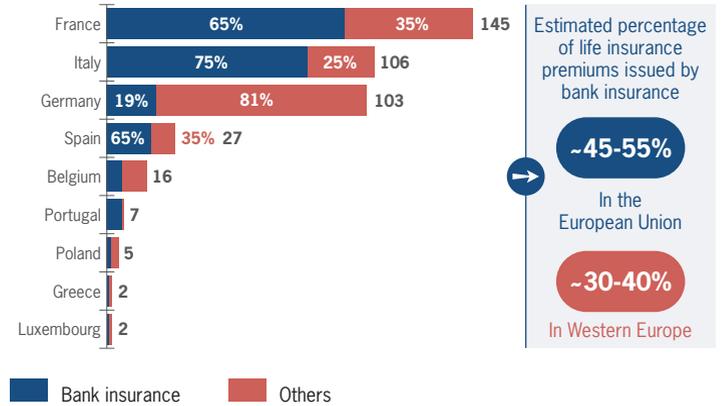
¹¹⁶ Systems are specific to each country: for example, individual savings accounts (ISAs) in the United Kingdom and pension savings accounts in Belgium.

Breakdown of Western European retail savings¹¹⁷, by asset class¹¹⁸
(in € trillion)



Bank shares in the life insurance market

Distribution of life insurance premiums per distribution channel, for a selection of countries in the EU, in €Bn, in 2019



Life insurance ranking, by share of premium received

	#1	#2	#3	#4	#5
France	Crédit Agricole	CNP Assurances	BNP Paribas Cardif	Crédit Mutuel	AXA
Italy	Intesa San Paolo	Generali	Poste Vita	Allianz	Aviva
Germany	Allianz	Generali	R+V Versicherung	Talanx	Debeka
Spain	Vidacaixa	Zurich	Mapfre	Santander	Santa Lucia

Insurer owned by a bank

Source: BCG Global Wealth Market Sizing 2020, BCG analysis.

Source: Insurance Europe, BCG analysis.

117 Of which United Kingdom.
118 Real estate not included.

In France in particular, **regulated savings** give banks a key role in implementing the government’s financing priorities (see box: “Regulated savings in France”). Regulated savings play a significant role in the deposit-taking activities of French banks. Half of the savings collected by banks in France are allocated to public interest purposes (see figure on the next page). Since the Law on the Modernization of the Economy in 2008, the distribution of “Livret A” savings accounts has been liberalized, allowing all banks established in France to participate in this scheme.¹¹⁹

- The remainder of the deposits, known as “non-centralized”, is mobilized by the banks for priorities recently reviewed within the framework of the “PACTE” law¹²¹: SMEs (for 80%), projects contributing to the energy transition and the fight against climate change (10%), and the social and solidarity economy (5%).

Regulated savings in France

Regulated savings in France cover seven savings products for which, in addition to a special tax regime, the State guarantees a level of remuneration and sets a limit on the uses to which they may be put. At the end of 2019, these products accounted for €772 billion, or 14% of household financial savings. The main vehicles are the “Livret A” (€282.1 billion), the Housing Savings Plan (PEL, €282.5 billion), the Livret de Développement Durable et Solidaire (LDDS, €111.9 billion) and the Livret d’Epargne Populaire (LEP, €39.4 billion). Under the terms of the Monetary and Financial Code¹²⁰, funds placed in regulated savings accounts may only be used for a limited number of purposes.

This allocation of regulated savings to national priorities follows two distinct paths:

- A share of the deposits collected, set by regulation, is centralized within the savings fund (€264 billion at the end of 2019). Backed by the Caisse des Dépôts et Consignations, this fund finances projects mainly in the social housing and urban policy sectors;

.../...

119 Law No. 2008-776 of 4 August 2008, on the modernization of the economy.
120 Article L. 221-5.

Breakdown of bank deposits
(2019)



Note: The figures indicate the share of each type of bank deposit in the financial assets of households. In total, bank deposits account for 30% of households’ financial assets.

- Currency and sight deposits
- Livrets A / LDDS
- Ordinary passbooks and CATs
- PELs
- Other regulated savings

Source: BCG Banking Pools 2019, BCG Fintech Control Tower.

Banks are also a central link in the financing and stability of governments. In Europe, banks play a key role in the primary and secondary markets for sovereign debt. In France, for example, the responsibility for participating in auctions, placing Treasury securities and ensuring the liquidity of the

121 Law no. 2019-486 of May 22, 2019, on the growth and transformation of businesses.

secondary market, is assigned to a group of fifteen banks, labelled by the State as primary dealers (SVT, *spécialistes en valeurs du Trésor*). Each year, these institutions are ranked according to their level of performance in fulfilling their missions: in 2019, four of the top five banks in this ranking were European.

Beyond this observation, it is certainly difficult to be normative *ex ante* on the need to entrust the management of primary sovereign debt markets to indigenous banks. On the other hand, the issue of sovereign financing is threefold: it reflects the argument of sovereignty (can a State put its financing in the hands of non-resident entities or those subject to minimalist regulatory treatment?); the efficiency of the debt market, the control and predictability of its financing costs; and finally, the regulatory issues related to what has been called the “feedback loop” between banks and their sovereign, in particular with regards to the weighted treatment of the sovereign risk that sovereign debt imposes on the balance sheet of banks that have acquired it for their own account. It should be noted that the question of weighted-risk applicable to sovereign securities between euro zone member countries is, for the time being, an ongoing source of tension in Europe.

During the pandemic, banks were an indispensable tool for macroeconomic stability and the dissemination of supportive fiscal policies.

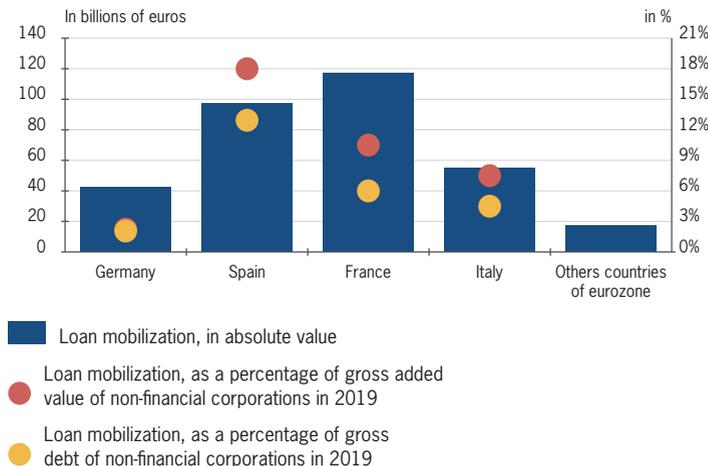
The travel restrictions and business closures required by the pandemic significantly increased the liquidity needs of European companies. To meet these needs, most euro area countries implemented government-guaranteed loan schemes distributed by commercial banks. The government guarantee was partial in principle (between 70 and 90%) to encourage banks to check the solvency of borrowers. However, full guarantees have also been decided upon, particularly in Germany and Italy to the benefit of SMEs and the self-employed. The compatibility of this type of scheme with the rules on State aid has been confirmed by the European Commission.¹²² On this basis, Germany, France,

Italy and Spain have implemented the largest schemes in terms of volume – with maximum amounts of €757 billion, €300 billion (for both France and Italy) and €140 billion respectively.

These schemes were rapidly implemented by European banking networks (see figure below). By August 2020, around 5% of the total gross debt of French non-financial companies had been distributed as government-backed loans. In Spain, the figure was 11%. It was also significant in Italy (4%) and Germany (2.5%). This mobilization of the European banking sector attests to its importance as a relay for economic policies, particularly in times of crisis.

Mobilization of government-guaranteed loans to non-financial corporations in euro area countries

(over the period April-August 2020)



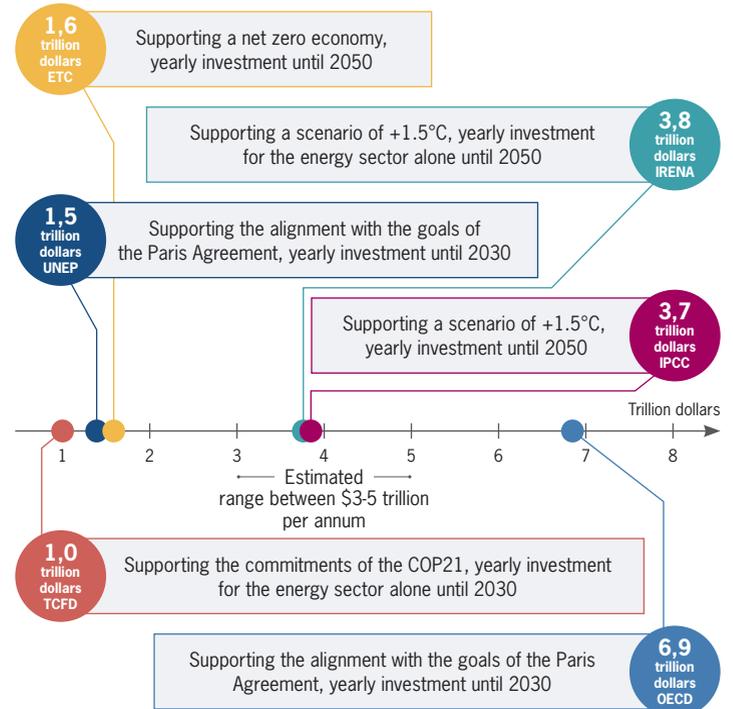
¹²² Commission Communication 2020/C 91 I/01 “Temporary framework for State aid measures to support the economy in the context of the current COVID-19 outbreak”, section 3.2.

Source: “Public loan guarantees and bank lending in the COVID-19 period”, ECB economic bulletin, Issue 6/2020.

2.2. A healthy and solid European banking sector is absolutely necessary in order to face the challenge of financing the ecological transition and other future transformations in the European economy

The ecological transition requires unprecedented financing. At the global level, estimates of the financing needs associated with achieving the objectives of the Paris Agreement vary significantly but on average range between \$3-5 trillion per year (see graph on the next page). According to a study by BCG and the Global Financial Markets Association (GFMA), the financing needs associated with respecting an emission trajectory limiting global warming to +1.5°C would be \$121.7 trillion by 2050. For the European continent alone, the financing needs amount to \$20.7 trillion.

Estimates of financing needs associated with meeting the Paris Agreement targets according to various sources



ETC - Energy Transitions Commission. **IRENA** - International Renewable Energy Agency. **UNEP** - United Nations Environment Program. **IPCC** - Intergovernmental Panel on Climate Change. **TCFD** - Task-Force on Climate-related Financial Disclosures. **OECD** - Organization for Economic Cooperation and Development.

Source: BCG, GFMA, "Climate finance markets and the real economy: sizing the global need and defining the market structure to mobilize capital", December 2020.

Contributions from a dynamic banking sector will be crucial to meet the financing challenges on a European scale. Reaching these investment targets is not possible without the mobilization of private capital. In this context, many initiatives aim to stimulate the development of “responsible” or “sustainable” finance, based on the integration of environmental, social and governance (ESG) criteria into financial decision-making.

Historically, responsible finance first developed in the field of asset management, around the six principles for responsible investments (PRI) proposed by the United Nations in partnership with a group of managers: \$90,000 billion in assets were managed according to these principles in 2020.¹²³

The banking sector is called upon to play a pivotal role in financing the fight against global warming. For example, on 2 July 2019, the main players in Paris (banks, asset managers and insurers) committed to ending their funding of coal-related activities. The first report on the implementation of this commitment,¹²⁴ drawn up by the regulators, shows a positive trend. According to the BCG and GFMA study mentioned above, 44% of the \$121.7 trillion financing requirement will have to be met through loans. For Europe alone, this proportion is close (45%). However, almost half of Europeans’ savings are managed by banks. Therefore, the mobilization of the banking sector is essential to massively increase the flow of funds for the transition.

A resilient and flexible banking sector will also be needed to address the new financial risks associated with climate change. These are twofold. Changing weather patterns create physical risks, such as natural disasters, which can have significant financial consequences. But the efforts undertaken to limit climate change also create a transition risk: the objective of carbon neutrality implies a complete reorganization of the production apparatus, which will result in asset devaluations, which ultimately may be brutal.¹²⁵

123 PRI, Principles for Responsible Investment: an initiative launched by investors in partnership with the UNEP Finance Initiative and the UN Global Compact, brochure 2020.

124 AMF/ACPR, “Coal” policies of the Paris financial market players: first monitoring and evaluation report, November 2020.

125 Also referred to as “stranded assets”.

In a recent publication, the Bank for International Settlements (BIS) describes these risks as “green swans” in reference to the concept of “black swans” developed by Nassim Nicholas Taleb to describe unpredictable risks with extreme repercussions.¹²⁶ Banks, like the entire financial system, are highly exposed to these risks. Managing them will require fundamental changes in the way banks view risk and allocate their resources. The supervisory authorities have taken the measure of the challenge since December 2017, and addressed it by setting up a Network of Central Banks and Supervisors for Greening the Financial System (NGFS) to share best practices and support the financial system in this transition.

Finally, it is critical for Europe to have robust and dynamic banks in order to have an influence on the setting of international standards for sustainable finance. Europe is a pioneer in this field, with the emblematic project of a Taxonomy of environmentally sustainable activities.¹²⁷ Other standard-setting initiatives are being developed at the global level, in particular the Task Force on Climate-Related Financial Disclosure (TCFD), under the aegis of the Financial Stability Board. Fundamentally, the rules applicable to sustainable finance stem from a political vision which consists in categorizing economic activities according to their compatibility with a desired model of society. Europe has already seen its main non-financial rating agencies bought up by Anglo-Saxon financial information players.¹²⁸ It is therefore necessary to preserve a healthy and dynamic banking sector, capable of carrying Europe's values towards the financing of the ecological transition.

Beyond the green transition, banks will also be an essential link in the financing of other economic transformations to come. Digitalization can be considered as one of its key challenges. It is the source of a massive need for funding from all economic players. The mobilization of banks, through their networks and the long-term relationships they maintain with companies of all sizes and in all sectors, will be essential to meet this challenge.

126 Patrick Bolton, Morgan Despres, Luiz Awazu Pereira Da Silva, Frédéric Samama, Romain Svartzman, *The Green Swan: central banking and financial stability in the age of climate change*, January 2020.

127 Regulation (EU) 2020/852 of 18 June 2020 on establishing a framework to promote sustainable investment.

128 See in particular, the acquisition of Vigéo-Eiris by Moody's in 2019.

FOR A STABLE AND PROFITABLE EUROPEAN BANKING SECTOR

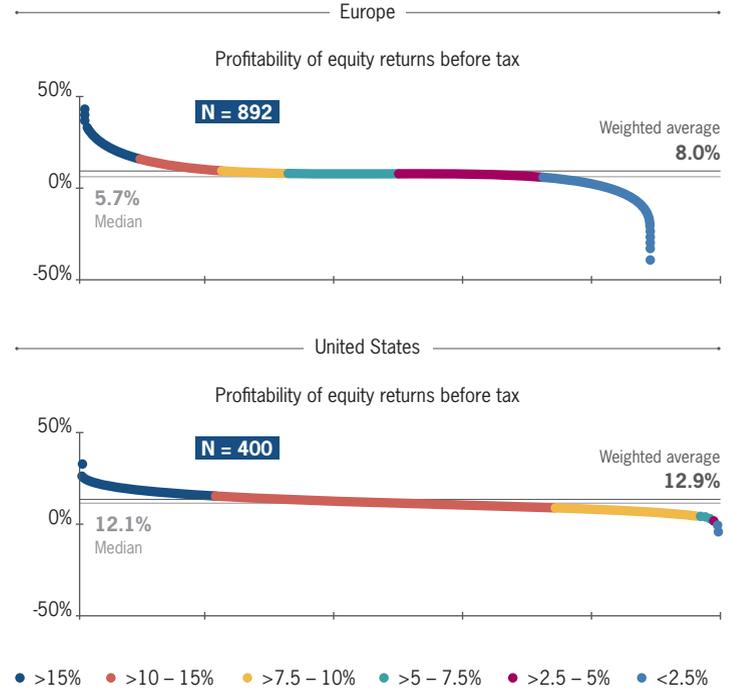
1. What future scenarios for European banks?

1.1. In search of the most profitable European banks

Despite the overall difficulties of the sector, some European banks have managed to restore or maintain high profitability. For example, according to BCG, 60 EU institutions from 19 different countries generated equity returns before tax above 15% on average between 2017 and 2018.

As shown in the figure below, the median profitability of US banks is higher than that of European banks: 12.1% versus 5.7%. European bank performances are also more heterogeneous, with more extreme values and a more dispersed distribution.

Distribution of European and US banks by equity returns before tax



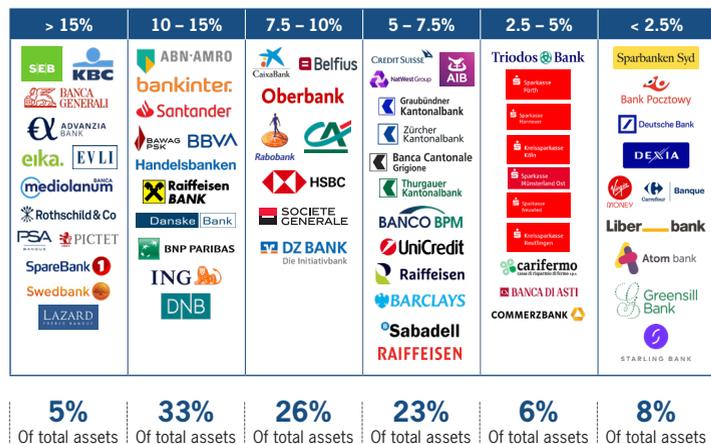
Note: Sample of banks with total assets over \$1 billion.

Source: S&P SNL, CIQ, BCG analysis.

We considered the banks that had the highest profitability in 2017 and 2018 (see graph below), trying to understand the reasons for their outstanding performance. Some cases are very specific: for example, the high profitability

of a Lazard or a Rothschild & Co can be explained by the relative weight of non-banking business lines in their business portfolio, and financial advice in particular; others are single-product institutions, such as Pictet (private banking), or PSA Banque (car loans).

Selected European banks by equity returns before tax



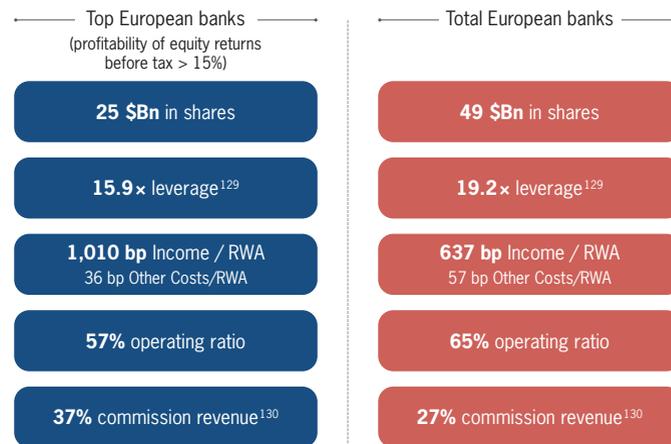
Source: S&P SNL, Capital IQ.

However, these banks have one or more of the following five characteristics, allowing us to paint a picture of the “typical” value-creating European bank (see graph on the next page):

- **This bank often specializes in few business lines** based on confident strategic choices, and therefore has a smaller volume of assets;
- **Its balance sheet is rigorously managed** with significant efforts dedicated to limiting the conservation of unprofitable assets, resulting in lower leverage ratios;

- **It generates more revenue** as a proportion of risk-weighted assets, but manages to keep its cost of risk low through good asset selection and accurate pricing of risk;
- **It has better operational efficiency**, with lower average operating coefficients;
- **It favors activities that generate fees and commissions** when allocating its capital.

Balance sheet and operating characteristics of the best-performing European banks



Note: Sample of banks with total assets over \$1 billion.

Source: S&P SNL, CIQ, BCG analysis.

¹²⁹ Assets / CET1.

¹³⁰ Net fee and commission income / Operating income.

Finally, European and US banks do not all share the same performance factors. While they share operational excellence, the most profitable European banks stand out by their ability to generate income, while US banks benefit from their greater balance sheet velocity.

1.2. What future scenarios for European banks?

In short, both the “external” and “internal” dimensions must be taken into account in order to map out possible scenarios for change. The “external” dimension is that of the regulatory environment: banks are regulated and particularly sensitive to regulatory changes. We will come back to the desirable changes in public policy at greater length at the end of the report. The “internal” dimension is that of banking strategies (i.e., banks’ choice of business model).

Of course, a “business-as-usual” scenario, in which banks do not change their business model in an unchanged regulatory environment, would spell the end of European banks since they would be unprofitable. This scenario is purely theoretical: even if regulations did not change, or changed too slowly, banks are businesses capable of adjusting their business models to their environment.

Many European banks are “universal” banks, offering a comprehensive range of services across a wide variety of trades. This is notably the case for the continent’s largest banks, which are present, to varying degrees, in most retail and wholesale banking businesses, as well as in nonbank businesses, such as asset management and insurance. It seems to us that the sustainability of the universal model requires major efforts by the banks, combined with regulatory changes:

- A greater effort to reduce costs, notably through digitalization, as well as better pricing of risk when it comes to revenue;
- A greater consolidation of the sector, both within each domestic market and across borders. This would help to reduce costs and allow the necessary technological investments to be amortized on a broader basis;

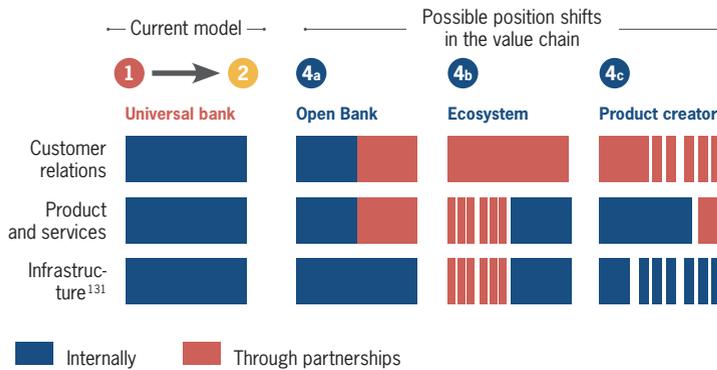
- Support from public authorities and especially regulators: adapting the prudential framework; speeding up the development of capital markets to give universal banks new capabilities to manage their balance sheets and thus help them manage prudential requirements; removing regulatory and political obstacles to consolidation operations.

If these regulatory changes were not to occur, or were to occur too slowly, then many universal banks would have to review their business model, seeking greater specialization, which would mean abandoning certain business lines, and/or limiting their offer to intervene only in certain segments of the value chain in the business lines that they would retain:

- **In terms of business lines, the universal logic** would be weighed against the potential gains of specializing in one of the business lines traditionally carried out by banks. Some banks could thus choose to reposition themselves in sectors in which they have strong expertise or any other differentiating characteristic. Their other activities would either be sold to players capable of carrying them out effectively, or simply reduced in terms of allocation of the institution’s resources.
- **In terms of their position in the value chain, the choice of maintaining a complete offer** would be weighed against the benefits of a broader use of partnerships. There are three segments in the banking value chain: infrastructure management, product creation and product distribution. Each of these segments has value, which explains the emergence of increasing competition from specialized players. In this context, several alternative models could be considered (see graph below), depending on the level of openness at the different stages of the value chain:
 - The “open bank” model would consist of broadening the scope and diversity of the offer via external partners backed by a common infrastructure within the bank;
 - The “ecosystem” model would instead consist of keeping customer relationship management in-house while partially outsourcing operational infrastructure and balance sheet management, as well as product and service creation;

- Finally, the “product creator” model would consist in a specialization in the upstream part of the value chain and the delegation of customer relations to partners.

Value chain positioning opportunities for European banks



Source: BCG.

The graph on the next page illustrates the possible scenarios, depending on the degree of specialization and positioning in the value chain chosen by the bank:

- 1. The business-as-usual**, mentioned for the record, is more than unlikely.
- 2. The overhaul of the current model**, which will require a threefold effort on the part of the banks in terms of costs, revenues and competitive environment, combined with proactive support from governments.
- 3. Specialization in one or a few businesses** to capitalize on differentiating expertise.

4. A new positioning in the value chain, the use of external partners, allowing some banks to expand their capabilities and refocus on their differentiating assets. The third and fourth scenarios would naturally be combined within a new strategic guidance.

Scenarios for the evolution of the European banking model



Source: BCG.

131 Operational (processes, tools, information systems) and balance sheet (asset aggregation).

2. “God helps those who help themselves”

The future of European banks therefore depends primarily on the banking companies themselves, which can use several levers to improve their profitability. Here is a brief description of these levers – though it is by no means an attempt to give management or strategy lessons to the directors of European banks... Simply to remind them that European banks are not mere spectators of their industry’s developments, and are thus not doomed to a deteriorating situation or to inaction. Possible courses of action are:

- **Operational**, meaning deployable throughout the bank to restore its profitability;
- **Strategic**, aimed at repositioning it on business lines, customers and links in the value chain with high added value;
- **Partnerships with the Fintech ecosystem** would serve to deepen and strengthen these actions;
- Finally, **green finance** can be a real growth opportunity for European banks.

2.1. Operational levers

Revenue growth

In addition to the cost-cutting objectives described below, which are rarely welcomed by employees, **European banks must focus their efforts on revenue generation.**

In particular, **the use of AI solutions can provide growth drivers for banks:** the large-scale use of external databases to support prospecting efforts; the systematic review of portfolios to optimize penetration and cross-selling; the coordinated approach to pricing policies; the identification of weak signals to prevent attrition of the least committed customers; are all opportunities that can enable banks to offset the often sluggish revenue growth in the most mature markets. For institutions that manage to implement such programs to bolster revenue growth, analysis suggests revenue growth of more than 10%,

well above the average annual growth rate of the broader European economic environment.¹³²

Cost reduction

Even if many operational efficiency programs have already been implemented, **cost reduction remains a real opportunity for European banks** – as we have seen, their operating ratios are currently higher on average than those of their American or Asian competitors – provided that it is seen as a thorough transformation of business models.

Redesigning customer coverage models must be a priority. With the impact of the COVID-19 pandemic, the shift in customer relations from physical to digital channels has accelerated. Already a minority in many retail and SME markets, interactions with branch-based account managers or business managers are likely to be further eroded in favor of self-service options via digital platforms that often respond much better to consumers’ expectations of flexibility and simplicity. The acceleration of the digitalization of the banking relationship – which is not synonymous with the disappearance of the human component – offers **the opportunity to rationalize and optimize the territorial coverage of bank branches, which represent a major part of the operational cost base.** This trend is nothing new, as the number of bank branches in Europe has already fallen by 31% between 2008 and 2019.¹³³ But it is true that, here again, situations vary from country to country and that the rigidity of certain labor markets tends to make restructuring more difficult, for example in terms of branch closures.

Operational processes also need to be reviewed. Euro area banks are still poorly digitized, compared to their Nordic peers for example, who have asset and deposit ratios per employee that are on average 3 times higher.¹³⁴

¹³² Source: BCG.

¹³³ Source: European Central Bank.

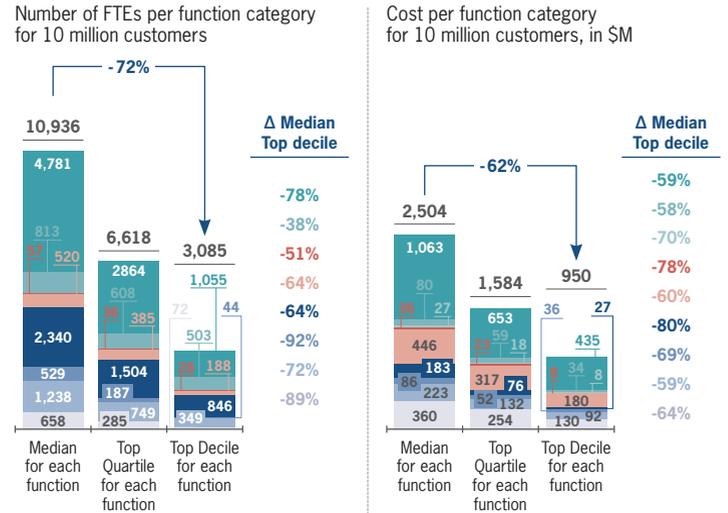
¹³⁴ Benchmark of 51 European retail banks; Source: Annual reports, Capital IQ, BCG analysis.

Even within homogeneous geographies and activities, there are major variations: compared to the top 10% of retail banks, banks in the median require 4 times more employees per customer (see figure on the next page).

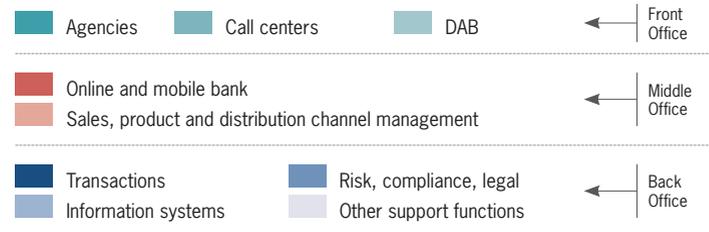
What are these processes? For retail banking, they include account opening, home loan applications and selling investment and savings products; for corporate banking, they include finding and integrating new customers, estimating and monitoring credit levels, and executing unusual individual transfers; for investment banking, they may include cash management, risk monitoring, or the processing of certain complex products such as Forex. These processes are **still largely done manually, with little automation. The use of digital and automated solutions would contribute to a significant reduction in operational costs.**

We should also note the positive, albeit slow, evolution of traditional players in terms of technology: despite having less flexible information systems than neobanks and native digital players, they continue to evolve at a rapid pace, by grafting innovative solutions and programming interfaces (“APIs”) onto the periphery of their core systems.

Benchmark of FTEs and associated costs per function category for 10 million customers



Benchmark



Note: Retail banking perimeter; benchmark components are global tier 1 banks, each with significant retail banking market shares.

Source: BCG REBEX benchmark.

It may also involve **reducing the cost of risk**. The use of new risk models – which add models using AI, based on transactional data, to the existing traditional financial analysis – can reduce provisions and losses during the course of the credit, as well as capital consumption, thus optimizing both the income statement and bank capital. On these topics, analyses suggest reductions in credit loss provisions in the range of 10% to 15% and a correlated reduction in capital requirements.¹³⁵

Finally, the transformation of banks will also involve reorganizing the way they work. **An obvious target is the rationalization of the considerable information systems costs:** these costs represent up to 50% of banks' annual modernization budgets.¹³⁶ This is all the more true since the information systems expenses of European banks are comparatively higher than those of their competitors: 11% of revenues in Europe compared with 8% for the rest of the world; 19% of total operational expenses in Europe compared with 10% for the rest of the world.¹³⁷ Reorganizing budgets, methodically monitoring modernization investments, as well as operating expenses, and the large-scale use of Agile methodologies can lead to substantial cost optimization.

Human resources

Lastly, **banks must continue to update their human resources strategy.** This is all the more critical as the profiles needed for the success of their digital transformation are changing and banks are no longer the first choice employers they were 20 years ago. **In 2020, no bank appeared in the top 10 preferred employers of French, German or Dutch graduates** (see example on the next page). Instead, new graduates' ranking of preferred companies are dominated by both established and startup technology companies. Even experienced graduates show their disaffection with the banking sector, with financial services only holding up thanks to the attractiveness of shadow-banking players (investment funds specializing in private equity, private debt, infrastructure, etc.) and, in some cases, market finance.

135 Source: OCG.

136 Source: BCG Beethoven, Schubert, and Bank Technology Modernization.

137 Source: Gartner, BCG European IT Banking Benchmark.

Limited attractiveness of banks for graduates in major European banking centers

	Business schools		Engineering schools	
	% tech in the top 10 and ranking	% of banks in the top 10 and ranking	% tech in the top 10 and ranking	% of banks in the top 10 and ranking
France	20% #3-Google #5-Apple	0%	30% #2-Google #6-Apple #7-Microsoft	0%
Germany	20% #3-Google #4-Apple	0%	10% #10-Google	0%
Netherlands	10% #7-Google	0%	20% #2-Google #5-Apple	0%
Italy	30% #1-Google #2-Apple #5-Amazon	20% #6-Intesa #8-Unicredit	50% #1-Google #2-Apple #4-Microsoft #6-Amazon #9-Samsung	0%
Spain	30% #1-Google #2-Apple #5-Amazon	20% #8-BBVA #9-Santander	50% #1-Google #2-Apple #3-Microsoft #4-Amazon #6-Samsung	0%
United States	30% #1-Google #2-Apple #4-Amazon	20% #6-JP Morgan #9-Goldman Sachs	4-Google #7-Apple #8-Microsoft #10-Amazon	0%

Source: Universum's "most attractive employers" ranking 2020.

For banks, recruiting and retaining the talent needed for technological transformation is no longer a given, but all the more essential now that changes are accelerating and require attracting new profiles. This difficulty is coupled with the challenge of training existing staff in digital technology

and AI. For European banks, the priority must therefore be to resize teams and bring employees up to speed by setting upskilling and reskilling programs; and, to a lesser extent, to redeploy and relocate part of their resources and provide career transition support for redundant positions.¹³⁹

2.2. Strategic levers

The first strategic lever for European banks is to make **a controlled effort to refocus on a limited number of key businesses** in which they already have, or want to acquire, key success factors.

This new positioning may be in higher value-added business lines and/or activities in which the bank already has strong expertise (retail banking, wholesale banking, wealth management, etc.). At the same time, other business lines, whether historical or recent, could be scaled back or abandoned, either through voluntary attrition or through disposal. **This strategy can create a virtuous circle** by redeploying resources and energy to the most dynamic businesses. Conversely, **a bank whose resources are deployed across a wide range of products or businesses rarely has the capacity to achieve the full potential of each activity.** A targeting strategy that is consistent and coherent over time can recreate a differentiating competitive advantage and generate a higher level of profitability.

Some of today's best-valued European banks are successful examples of refocusing that demonstrate the relevance of these strategies. For example, the Belgian bank KBC has successfully refocused on retail banking and insurance in its domestic markets. The Swiss bank UBS, while retaining a strong international dimension, cut back on corporate and investment banking in the wake of the financial crisis and successfully focused on wealth management.

On a more granular level, refocusing may involve the choice of customer targets, **products and geographical areas.** The aim is to take a more

systematic approach to the range of products and services offered, so as to retain only those business lines that benefit from a high level of industrial expertise, a sustained operating margin and a risk profile in line with the announced strategy. This is why some market banks have recently abandoned certain lines of business (for example, Deutsche Bank, in equity sales and trading, for lack of critical mass).

The second strategic lever may also involve **positioning the bank at other levels of the financial services industry's value chain.**

This strategic option, which is still relatively recent and underdeveloped, is part of the "open banking" dynamic driven by technological change, and depends on two features. First, the ability to fragment the value chain into its three constituent elements which are now autonomous (i.e., customer relationship, product creation and banking infrastructure) without interruption. Second, a flexible, high-performance technological environment that enables the creation of a complete ecosystem of partnerships between suppliers in order to meet all customer needs.

In practice, **"open banking" allows them to refocus on a limited portion of the value chain, where they perceive they have – or wish to develop – a major competitive advantage, while outsourcing the parts of the value chain they do not cover to external partners** (which can be incumbent banking players, BigTechs or Fintechs).

We can thus imagine an open bank whose mission would be focused on customer relations: it would capitalize on distribution channels that are among the best in the market, but would have ceased creating its own products, positioning itself as a distributor of products and solutions designed and operated by its partners. The Italian bank Banca Sella is a good example of a pioneering bank, since it decided in 1999 to shift its IT systems towards an open banking solution, thus enabling it to offer its customers services and products from third parties.

¹³⁹ Better known as "off-shoring".

Alternatively, a bank may choose to reposition itself in the creation of banking products, while having abandoned customer relations management, deemed too costly to maintain in an environment of high banking network costs. The role of this bank in the financial ecosystem would then be the design and operation of key products for white label distribution by its network of partners. Far from being an exception, these business models are already common in the payments segment where credit cards are often distributed by banks based on a pre-existing product. Similarly in capital markets, more and more regional corporate and investment banks, perceiving their inability to compete with the market leaders capturing the majority of flows, have decided to act as distributors to retain their clients.

Finally, there is the possibility of creating “banking infrastructure providers” that would build a balance sheet offer (asset carrying) or technologies (operating processes) through non-held distribution channels, in partnership with other players focused on customer relations and product offers. Far from being a futuristic idea, the examples of nCino and Salesforce, which respectively offer turnkey credit infrastructure platforms (from inception to monitoring) or CRM systems (allowing the monitoring of customer relationships across multiple customer segments, geographies and products), demonstrate that the disruption of the banking value chain is still far from having reached its peak.

2.3. Partnerships with Fintechs

Both operational efficiency and open banking dynamics can benefit from developing partnerships with FinTechs.

Not all FinTechs are in direct competition with banks. **A growing proportion of FinTechs have a collaborative business model and their customers are more often the banks themselves than end consumers (see figure on the next page).**

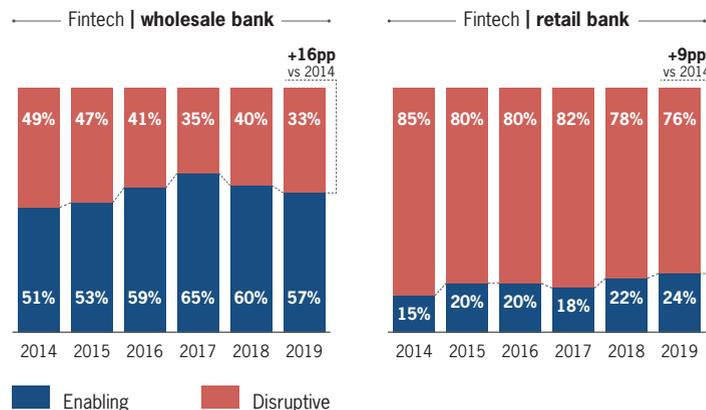
For example, these “facilitating” FinTechs allow for the development and provision of new tools (such as platforms or simplified processes) to generate operational

efficiencies for banks through digitalization, automation, technological expertise (including data analysis), and infrastructure and organizational flexibility.

In retail banking, the proportion of “facilitating” FinTechs has almost doubled in 5 years to ~25% today, while in wholesale banking, the proportion is now over 65%.

Enabling vs. Disruptive Fintechs

(as a percentage of Fintechs created between 2014 and 2019 worldwide)



Source: BCG Fintech Control Tower.

Lastly, partnerships with “disruptive” FinTechs (offering products that compete directly with traditional banks) are also possible and can be used to create **growth drivers**. This option is now widely pursued, particularly in the retail or very small, small or medium-sized business markets, where web banking portals provide access to a considerable number of customers who are also seeking new value-added services.

For example, in the UK, Barclays' program for very small businesses, "MyBusiness Works", provides accounting and business plan creation, payroll and withholding tax management services to customers whose small size is often a barrier. These services are usually provided by third-party FinTechs and not by the bank directly, but the bank finds a growth driver here and a real competitive edge for its customers.

2.4. Green finance can be a real growth opportunity for European banks

Europe has a significant lead in certain key areas of the green transition. There is a strong and stable consensus between States, businesses and civil society players in favor of respecting the commitments made under the Paris Agreement. The project for a Taxonomy of green activities suggests the articulation in the short term of a clear and stabilized vision of what a sustainable European economy should be. A dynamic ecosystem is also developing in Europe in the field of responsible finance. Banks are included, but their participation in this movement is in large part through their asset management subsidiaries, which are already very advanced in the development of responsible investment strategies and in the construction of savings vehicles offering both a financial return and a non-financial impact.

European banks must seize this opportunity and commit themselves more resolutely to green finance, across all their business lines. The construction of green bank savings vehicles would open up considerable opportunities for differentiation. In a context of financial returns constrained by monetary policy, offering savers a non-financial return offers new prospects. Banks would have to guarantee to individual depositors that their funds are allocated to sustainable activities or activities in transition. Unlike asset managers operating in public markets, banks can distinguish themselves through a closer relationship with the companies they finance and a perhaps greater capacity to guide their strategic decisions. This offers banks the opportunity to report to investors on the concrete impact of their investment. The development of such a service will require a major operational transformation in

order to collect the necessary data from companies to be able to assess their non-financial impact and to share this intelligibly with investors.

For financing decisions, banks will necessarily have to develop their tools and methods in order to be able to assess the financial and non-financial situation of companies. This extension of the scope of analysis will give banks that are able to implement it the opportunity to position themselves in the most resilient sectors with the strongest growth over the long term. It will also allow them to protect themselves against the risks associated with the transition. The construction of a low-carbon economy will reshuffle the deck and generate very significant competitive movements between sectors and geographies. Banks must put themselves in a position to advise their clients and to help them on the path of this green transition. This is also a matter of reputation: banks must be able to attract foreign capital which is focused on the sustainability of investments.

3. Public authorities should promote the following measures

While the future of European banks depends primarily on the financial players themselves, it is also clear that European and national policymakers (political entities, monetary institutions, supervisory authorities) have a major stake in the evolution of the sector.

Here again, it will be a matter of expressing the main desirable conditions, while avoiding being too prescriptive regarding decisions that are part of a government's purview and regarding details of the implementation methods, in order to meet 4 main objectives, namely:

- 1) Reaffirming the strategic nature of the banking sector;
- 2) Developing a new industrial policy for the sector in the digital age;
- 3) Deepening the integration of financial stability into monetary policy, and;
- 4) Overhauling European banking regulations in a global framework.

For the sake of clarity, each of these objectives is broken down into specific proposals, focusing first on the diagnosis of the problems, and subsequently on the levers and concrete actions on which public players could capitalize in order to implement their vision for the future of the European banking sector.

3.1. Objective #1: Reaffirm the strategic nature of the banking sector, seek the completion of the Banking Union and make effective progress in establishing the Capital Markets Union.

PROPOSAL 1

Make the stability and competitiveness of the banking sector a strategic priority for the European Union. The banking sector has proven resilient to crises, but it today lacks the financial flexibility to fund its future development. The challenge is to maintain its position in the medium term in the face of international competition and new players.

Policy makers must address the problem of European banks' decreasing profitability as it affects their ability to pay their cost of capital and thus jeopardizes their future. The ability of European banks to embrace and invest in technological and digital innovations depends on it. This is an existential issue for banks insofar as they have been competing with new nonbank players and foreign players throughout their value chain for some years now. In 2009, the political impetus of the G20 led to considerable progress in making the global banking sector more resilient in the wake of the Great Financial Crisis, through reforms to the global regulatory framework (Basel III). Now that resilience has been improved, the attention of European policymakers must focus on the structural weakness of the European banking sector's profitability and on its investment capacities and incentives. In the post-Covid-19 period, this issue is

all the more critical as banks are the intermediaries for many public policies, and the expected normalization of monetary and fiscal policies in Europe will directly impact the quality of their balance sheet and those of their customers.

In order for banks to have better structural profitability, public decision-makers can complete the ambitious work of the Banking Union, pursue the development and integration of European capital markets within the framework of the Capital Markets Union, and use the rapid progress of digital files in the areas of payments and money. Although rebalancing the financing of the European economy towards greater involvement from nonbank and/or foreign players is an inevitable and to some extent desirable development, excessive disintermediation would sow the seeds of future financial imbalances and crises that would be problematic for growth and macroeconomic and financial stability. Moreover, political decision-makers will have to measure all the implications of this choice in terms of European sovereignty and strategic autonomy on the one hand, and in terms of financing the Union's priorities, such as the green and digital transition, on the other.

PROPOSAL 2

Promote the integration of the European banking sector and enable cross-border activities.

European banking integration will be a prerequisite for building resilience and increasing profitability in the sector. In an industry that benefits from undeniable economies of scale, this progress in integration will enable European banks to optimize their cost base and unlock new growth drivers in a more consolidated market, following the example of the US. Cross-border consolidation, often feared or even blocked by political authorities, will be a powerful vector for restructuring the European landscape. This requires a long-term political vision that goes beyond local differences and interests.

Finally, though perhaps more prospectively, closer fiscal and legal integration (e.g., on company taxation or certain financial products) would enhance the economic benefits expected from such cross-border consolidations.

PROPOSAL 3

Commit to advancing the Banking Union project – with the primary objective of getting member states to take a clear stance on the banking sector they want to see in the European Union within 10 years. If there is a shared vision, draw up a new credible roadmap to serve this vision, with firm commitments to finalize it, particularly in terms of resolution and deposit insurance.

Restarting the work on completing the Banking Union is necessary for the resilience and integration of the European banking sector. Although European leaders have been calling for a Banking Union since 2012, the European political drive seems to have dried up since the significant progress made on supervision and on single resolution in 2014.¹⁴⁰ A consensus is yet to be reached on some pillars of the Banking Union, such as the European resolution, which has only been mobilized once and which has also been circumvented many times. Others are simply struggling to get off the ground, such as the European deposit insurance.

The completion of the Banking Union remains hampered by deep divisions between Member States, as illustrated by their inability to reach a consensus on a progressive and time-bound work plan on all outstanding issues at the June 2021 Eurogroup.¹⁴¹ Member States' red lines are clashing and they are

¹⁴⁰ See the report by the 4 Presidents (of the European Council, the Commission, the European Central Bank and the Eurogroup) "Towards a genuine economic and monetary union" of December 2012.

¹⁴¹ Meeting of Finance Ministers, here in an inclusive format, i.e., bringing together the 27 Member States.

getting bogged down on issues relating to the crisis management framework, further integration, a European deposit guarantee scheme, and the regulatory treatment of sovereign exposures. For example, some are making the hard-line reform of the prudential treatment of sovereign exposures and risk reduction a prerequisite for any progress on a European deposit guarantee; while others are insisting on the need to first give credibility to the current crisis management framework, notably the European resolution. Deep fault lines persist, for example between the home countries of the major European banks, or between the latter and the half-dozen or so Member States that host subsidiaries (who tend to raise the capital and liquidity requirements of subsidiaries to protect their domestic markets), or concerning the prudential treatment of sovereign exposures and the scope of the European resolution.

In order to overcome these deep divisions and to make real progress on the unfinished business of the Banking Union, Member States should first agree on a shared vision of the European banking sector model they wish to have in 10 years' time, and then translate this into a new credible roadmap with firm commitments.

PROPOSAL 4

Prioritize the integration of European capital markets to strengthen them and boost securitization development.

The development of European capital markets is also one of the preconditions for the largest European banks to achieve profitability once more in the current regulatory framework. Policymakers must be fully aware that the global banking regulation (Basel III), whose post-financial crisis developments were not designed to accommodate the specificities of the European universal banking model, penalizes European banks more heavily because of their larger and slower balance sheet models, compared to their US competitors.

The finalization of Basel III will only reinforce this additional cost borne by European banks. In order to achieve the levels of profitability necessary for their proper development, the largest European banks must follow the example of US banks and lighten their balance sheets and optimize them through securitization. Public support is needed to develop deeper and more efficient capital markets in the EU, consistent with the European banking regulation choices of the last decade. Europe has created a framework to promote simple, transparent and standardized securitization, but this may have increased the regulatory capital cost of securitization.¹⁴² Recalibrating the capital charge applied to senior segments, recognizing senior segments as high-quality liquid assets in the calculation of liquidity ratios, and simplifying and increasing the predictability of the risk transfer assessment process for securitization are promising options. Having a reliable, recognized and sufficiently simple reporting framework for these securities will make secondary markets more fluid. In any case, this requires political awareness and agreement, for example, to overcome the negative connotation of securitization in some governing bodies since the 2008 financial crisis.

3.2. Objective #2: Develop an industrial policy for the European banking sector in the digital age.

The European Union is in the process of relaunching its industrial policy strategy.¹⁴³ However, despite its strategic nature, the new technological challenges and the increased competition it faces, a common vision for the European banking sector and its role in financing the economy and future growth has yet to emerge. While banks are faced with the need to better master technological levers and to rely on new growth drivers, many public players' perception of the banking sector is still very much influenced by the 2008 financial crisis. The focus is on the sector's resilience tied to more stringent prudential rules, rather than on an in-depth review of the conditions

for its future development and profitability. An assessment focused on an industrial policy for the banking sector must now be undertaken. One of the potential answers could lie in the targeted structuring of a legislative and regulatory framework so that the European banking sector (re)invests in strategic activities such as payments and sustainable finance, which are dealt with in the following two proposals.

PROPOSAL 5

Actively support the European Payments Initiative for better pan-European integration.

The European Payments Initiative (EPI) is one of the last chances for European banks to develop pan-European payment solutions (instant payments, single cards or digital wallets) capable of competing with the major American schemes.¹⁴⁴ The development of a unified European payment system is a crucial issue of sovereignty and general interest in order to avoid dependence of such a strategic activity on foreign players. Public interventions in favor of it are therefore largely justified. It is also crucial for the business model of European banks: retail banks generate a significant part of their revenues by providing payment services, although they are facing increased competition in this area. The European Central Bank and the European Commission for the EPI must be supported, with a goal of rapid ramp-up and implementation from 2022. Indeed, scale and networks are decisive in the payments field, and any slowdown in the EPI will only strengthen the dominant position of the few historical American players on the European market. Success will be largely determined by the ability of stakeholders to design the EPI as a new commercial and profitable operator.

¹⁴² High-Level Forum on Capital Markets Union. (2020). "A new vision for Europe's capital markets".

¹⁴³ For example, by the European Commission's Communication in May 2021.

¹⁴⁴ 31 credit institutions and 2 third-party buyers to date.

PROPOSAL 6

Support the European Taxonomy as the international reference standard for the definition of green and sustainable investments and develop non-financial reporting obligations for companies.

Europe's ambition is to spearhead a responsible form of capitalism, committed to the fight against global warming with a goal of climate neutrality by 2050. This ambition will lead to considerable opportunities for European banks. For example, this could help them to better manage their balance sheet exposure to climate risk, or to better identify sustainable projects in need of funding by reducing information asymmetry, and finally to better value the virtuous nature of their exposures to investors, if necessary. This presupposes that Europe makes rapid progress on the dual front of the EU Taxonomy and on non-financial reporting by companies.

The European Union is now a pioneer in creating a reference framework for sustainable investments to guide the decisions of market players, thanks to the adoption of the EU Taxonomy.¹⁴⁵ The possibility of competition between several international standards, as is currently the case with accounting standards, would place large companies such as international banks in a delicate situation – hardly compatible with an effective energy transition. A global standard, recognized in all major economic areas, is therefore essential. European public decision-makers must capitalize on the lead taken with the European Taxonomy to make this the starting point for a global reference framework in the supranational bodies that set dedicated standards. Thus, Member States need to overcome their latest disagreements on the subject.

The transitional challenges relating to the EU Taxonomy and development strategy of sustainable finance will have to be constantly monitored by public policymakers. An orderly withdrawal of the banking sector from unsustainable activities will necessarily be gradual, or else risk causing damage to the sector (e.g., by considering that too much of their banking assets are not aligned with the requirements of the EU Taxonomy). European policymakers will need to maintain a constant focus on the further development of the sustainable finance framework (including the EU Taxonomy), and on defining a clear and balanced transition path, to enable banks to determine whether the companies they intend to finance or the beneficiaries of their investments are on the right transition path.

Public decision-makers will also have to ensure consistency between obligations for banks and non-financial reporting obligations for companies. An overhaul of the non-financial reporting obligations for companies was launched in April 2021 by the European Commission.¹⁴⁶ Member States, in their capacity as co-legislators, should seek to refocus the debate on the real issues of this overhaul, namely inviting companies to publish quality information on the sustainability of their activities and to set up a common and operational framework for measuring the impact of these activities, all with the aim of saving resources for the companies in question.

PROPOSAL 7

Ensure the legal and regulatory framework provides a level playing field for all participants, with equivalent data sharing obligations for banks and nonbank players alike.

¹⁴⁵ Regulation (EU) 2020/852, supplemented by delegated acts of the European Commission. A first delegated act of April 2021 defines the criteria and activities contributing substantially to climate change mitigation or adaptation.

¹⁴⁶ With a draft directive on corporate sustainability reporting (CSRD), which is intended to replace the Non-Financial Reporting Directive (Directive 2014/95).

It is crucial for banks to foster the emergence of an ecosystem that will enable them to master the new technological levers and opportunities associated with digital technology. Public authorities have a role to play in this respect by ensuring that the regulatory and legal environment is conducive to the establishment of such an ecosystem, and by ensuring a level playing field between banks and nonbank players with equivalent activities. The current regulatory framework sometimes leads to asymmetry and lack of reciprocity between banks and nonbank players. For example, banks' payment information is accessible to nonbank players, however, nonbanks do not face similar requirements to share their own customer data (which is usually different from payment data) with third parties, including banks.¹⁴⁷ If policymakers do not work to restore the conditions for fair competition within these ecosystems, there would be a great risk of data concentration. Future growth opportunities would thus be in the hands of a few large tech players, and banks would be greatly penalized.¹⁴⁸

3.3. Objective #3: Integrate financial stability considerations more explicitly within monetary policy normalization.

PROPOSAL 8

Operationalize the integration of financial stability into the European Central Bank's monetary policy, following its strategic review in July 2021.

With a mandate focused primarily on price stability, the Governing Council of the European Central Bank has always based its monetary policy decisions on an assessment of macroeconomic conditions and inflation developments.¹⁴⁹

¹⁴⁷ Under the Payment Services Directive (EU) 2015/2366 (PSD2).

¹⁴⁸ Institute for international finance. (2018). Reciprocity in customer data sharing frameworks, brief.

¹⁴⁹ Article 127 of the Treaty on the Functioning of the European Union.

With the COVID-19 crisis, developments in financing conditions have become more important in the definition of monetary policy, through a holistic analysis of a set of "indicators spanning the entire transmission chain of monetary policy from risk-free interest rates and sovereign yields to corporate bond yields and bank credit conditions".¹⁵⁰ This step forward deserves to be maintained by the ECB, as financial stability underpins price developments over the medium term. The ECB's new monetary policy strategy published on 8 July 2021 should be welcomed, as it puts forward the explicit principle of taking financial stability into account in the determination of future monetary policy – as a necessary condition for price stability on the one hand, and as contributing to the general EU objectives covered by the ECB's secondary mandate on the other. It will be necessary to ensure that this principle is reflected in the actual consideration of financial stability indicators for the determination of monetary policy.

PROPOSAL 9

Maintain the dynamic use of liquidity steering instruments.

The European Central Bank has made major changes to the way it provides liquidity support to the banking sector since the financial crisis.¹⁵¹ These changes are a real progress, and their principle has been maintained during the ECB's strategic review in July 2021. For example, the European Central Bank has introduced long-term bank refinancing tools (TLTROs), which are targeted in that they explicitly link the pricing of bank refinancing to their lending policy. These instruments were supplemented and recalibrated during

¹⁵⁰ Christine Lagarde, President of the European Central Bank, 11 March 2021.

¹⁵¹ For example, the switch in 2008 to fixed-rate offers in the main refinancing operations, or the introduction in 2009 of long-term refinancing loans for banks with a maturity of more than one year the first time, and up to three years in 2012 (Long-term refinancing operations or LTRO).

the COVID-19 crisis, with more favorable pricing and an extension of the total amount that banks are allowed to borrow. This has helped to preserve the supply of credit and ensure the smooth transmission of monetary policy. It will be important, in the modus operandi for the implementation of monetary policy in “normal times”, to maintain a flexible use of these instruments, particularly in circumstances where the evolution of financial constraints on bank balance sheets is not aligned with the need to adjust the general stance of monetary policy on the basis of the macroeconomic analysis.

PROPOSAL 10

Continue to enable the use of flexible ECB collateral arrangements and allow these to become an active instrument in monetary policy within appropriate risk boundaries.

The European Central Bank will also have to ensure that its collateral policy remains in line with the composition of bank assets to date (while respecting the risk aversion of any central bank). The ECB accepts financial assets as collateral in its market operations and credit operations for the benefit of banks, among others. The adequacy between the assets held by banks and the ECB’s collateral framework will therefore be a condition for the effective participation of banks in ECB operations such as the Eurosystem’s targeted refinancing operations. This position will need to be supported in the context of the Governing Council’s reassessment by June 2022 of the collateral framework relaxation measures launched in April 2020.

PROPOSAL 11

Encourage the development of a central bank digital currency (a digital euro), while ensuring that (i) its implementation is geared towards synergy with European banking intermediation, and consider relying on banks as an exclusive distribution intermediary, and (ii) its implementation preserves financial stability and the role of banks in the transmission of monetary policy.

The development of a digital euro is becoming more and more of a pressing issue as digital currency projects from foreign central banks and crypto-currencies from private players flourish (e.g., Facebook’s Diem/Libra “stable coin”), and are now capable of competing with physical currencies. It would seem appropriate for the ECB to take up this issue in order to preserve the common-good aspect of money and to avoid any risk of disintermediation by private players – which would call into question European sovereignty and could destabilize the banking and finance sectors, and the economy, making many economic agents more vulnerable by depriving them of a stable currency whose value is guaranteed by a sovereign lender of last resort.

In addition to this “protective” development, the European Central Bank, in agreement with the other relevant European institutions and the Member States, will have to develop a digital euro. The calibration of this digital euro should capitalize on the strengths of the “banking system – Central Bank” tandem, on which are based the strength and effectiveness of the transmission of monetary policy to the rest of the economy and the financial sphere. European banks already have solid experience in distributing commercial digital currency, and in particular they have the infrastructures that allow for the right level of confidentiality and protection of holders’ data, which should be put forward. From the point of view of the banking system, the digital euro could be a new source of growth rather than a threat. Conversely, a poorly calibrated digital euro would pose a major risk to the European banking sector

– for instance, a massive shift from bank deposits to digital euros – and this would in any case degrade the quality of the credit supply of European banks. However, this currently seems to be a highly unlikely scenario.

3.4. Objective #4: Integrate European banking supervision and regulation in a global view of the sector's upcoming challenges.

PROPOSAL 12

Finalize the European framework for banking crisis management, easing some restrictive criteria based on lessons from past crises.

Strengthening, finalizing and giving credibility to the European crisis management framework is a precondition to the integration of the European banking market. Only a fully operational framework will make it possible to counter the idea that banks are “dying domestically” and to prevent the national market protection reflexes that are harmful to European banking integration. Political impetus will be necessary, but regulators will also have to take up the issue. Strengthening the current European resolution framework and giving it credibility will necessarily require new practices in this area. Relaxing the conditions of the general interest test that determines whether a failing bank should be placed in resolution would make it possible to broaden the scope of application of the European resolution (even if it also means rethinking conditions for financing the resolution). The possibilities of circumventing the European resolution framework, in particular through the use of precautionary recapitalizations, or through administrative liquidations permitted in certain Member States, or through public recapitalizations framed as being on market terms in a very broad sense, should be restricted. Work on the state aid framework applied to banks could eventually be considered.

PROPOSAL 13

Facilitate cross-border banking activity by reducing barriers between home and host countries, particularly in the context of capital and liquidity management.

Beyond strengthening the crisis management framework, other regulatory and supervisory levers would facilitate a genuine cross-border management of banking groups. First, regulatory and supervisory practice by the relevant authorities (ECB and national supervisors, Single Resolution Mechanism) should make it possible both to avoid increasing the burden of prudential requirements for banks in host countries and to ensure better circulation of liquidity in the European Union. Since the 2019 banking package, the current framework opens up the possibility of waivers to apply liquidity requirements at the consolidated level. In practice, supervisory authorities should be granting these waivers extensively, much more so than observed to date. This implies relaxing the eligibility conditions at the individual level to grant these waivers for a banking group. The Single Resolution Board should also promote a consolidated management of the minimum requirements for own funds and eligible liabilities (MREs) mobilized in the event of an internal bail-in during a resolution.

If this is not possible, and in the absence of changes to the current regulatory framework, new legal and organizational practices could be adopted by banks with the support of the relevant authorities. For example, cross-border banking groups could favor branches over subsidiaries wherever possible, as branches are not subject to the requirements of host country supervisors.

PROPOSAL 14

Promote a European version of the final Basel III reforms to minimize or offset the additional capital costs that European banks incur; and explore other measures that can help European banks gain better competitive balance with foreign institutions, especially US banks.

The finalization of the Basel III global regulatory framework is a challenge for European banks and a crucial moment for European regulators to highlight European specificities. The first Basel reforms from 2010 had already relatively penalized the European banking sector because they do not take its specificities into account – such as the broader and slower velocity balance sheet structure. The challenge for the European transposition of the Basel III finalization will be even greater: the new reforms launched in 2017 relate to practices that are central to European banks' model (internal models and output floor in particular), while they are more peripheral for their American and international competitors. This is happening in a context in which the US supervisory authorities have already announced their desire for a US transposition of Basel III that does not increase the capital requirements for the banking sector as a whole. In order to achieve the stated objective of respecting European specificities and competing fairly with foreign jurisdictions, Europeans will have to work together to find solutions to reduce or even offset the additional capital costs incurred by the reform of the output floor. This must be done as soon as the European Commission publishes its proposal for transposing the finalization of Basel III into European law.¹⁵²

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Chairs of the taskforce

- **François Pérol**, Managing Partner and Co-Chairman of the Group Executive Committee, Rothschild & Co
- **Natacha Valla**, Dean of the School of Management and Innovation, Sciences Po

General Rapporteur

- **Jean-Werner de T'Serclaes**, Managing Director & Senior Partner, Boston Consulting Group

Rapporteurs

- **Paul Chablet**, Civil servant
- **Clément Gandolfo**, Senior Associate, Boston Consulting Group
- **Marie-Baïanne Khder**, Civil servant
- **Antonin Linares**, Project Leader, Boston Consulting Group
- **François Orain**, Director, Boston Consulting Group

As well as

- **Lucas Cherfils**, Assistant policy officer
- **Milo Rignell**, Innovation officer

¹⁵² "Parallel stack" proposal.

Interviewees

- **Paul Achleitner**, Chairman of the Supervisory Board, Deutsche Bank
- **Jean-Luc Allavena**, Chairman, Atlantys Investors
- **Benoît d'Angelin**, CEO & Founder, d'Angelin & Co.
- **Maya Atig**, CEO, French Banking Federation (FBF)
- **Luiz Awazu Pereira da Silva**, Deputy General Manager, Bank for International Settlements (BIS)
- **Étienne Barel**, Deputy CEO, French Banking Federation (FBF)
- **Corso Bavagnoli**, Managing Partner, Lazard
- **Nicolas Baverez**, Lawyer, Gibson, Dunn & Crutcher
- **Lionel Benatia**, Head of Public Policy, Amazon Web Services France
- **Jesper Berg**, Director General, Danish Financial Supervisory Authority (FSA)
- **Jean Beunardeau**, Chairman of the Board of Directors, HSBC Continental Europe
- **Lorenzo Bini Smaghi**, Chairman of the Board of Directors, Société Générale
- **Philippe Brassac**, Chief Executive Officer, Crédit Agricole SA
- **Sir George Bridges**, Senior Adviser to the Group Executive Chairman, Banco Santander
- **Henri De Castries**, Chairman, Institut Montaigne
- **Éric Chaney**, Economic Advisor, Institut Montaigne
- **Laurent Clerc**, Director for Research and Risk Analysis, Autorité de Contrôle Prudentiel et de Résolution (ACPR)
- **Benoît Coeuré**, Head of the BIS Innovation Hub, Bank for International Settlements (BIS)
- **Thomas Courtois**, Chairman, Nickel
- **Koenraad Debackere**, Chairman, KBC Group
- **Meriem Echcherfi**, Head of Group Strategy, Crédit Agricole SA
- **Andrea Enria**, Chair of the Supervisory Board, European Central Bank (ECB)
- **Gregorio De Felice**, Chief Economist, Intesa Sanpaolo
- **José Garcia**, Chief Financial Officer, Banco Santander

- **Antonio Garcia Pascual**, Deputy Chief for Global Market Analysis Division, International Monetary Fund (IMF)
- **Gilles Grapinet**, Chairman and CEO, Worldline
- **Philippe Heim**, Chairman of the Management Board, La Banque Postale
- **Stéphane Honig**, Head of Strategy, Natixis
- **Alejandra Kindelan**, Head of Research and Public Policy, Banco Santander
- **Kinner Lakhani**, Head of Group Strategy & Development, Credit Suisse
- **Jean Lemierre**, Chairman of the Board of Directors, BNP Paribas
- **Jean-Frédéric de Leusse**, Chief Executive Officer & Country Head, UBS France
- **Paul de Leusse**, Deputy CEO, Mobile Finance, Orange
- **Thomas Leysen**, Honorary Chairman, KBC Group
- **Éric Litvack**, Group Director of Public Affairs, Société Générale
- **Martin Merlin**, Director DG FISMA, European Commission
- **Sofia Merlo**, Head of Group Human Resources, BNP Paribas
- **François-Louis Michaud**, Executive Director, European Banking Authority (EBA)
- **Laurent Mignon**, Chairman of the Management Board, BPCE
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- **Marco Morelli**, Executive Chairman, AXA Investment Managers
- **Xavier Musca**, Deputy CEO, Crédit Agricole SA
- **Jean-Pierre Mustier**, Former CEO, Unicredit
- **Nicolas Namias**, Chief Executive Officer, Natixis
- **Emmanuel Nusimovici**, Business Development Manager - Financial Services, Amazon Web Services
- **Philippe Oddo**, General Partner, ODDO BHF
- **Jernej Omahen**, Head – European Financials Research, Goldman Sachs
- **Frederic Oudéa**, Chief Executive Officer, Société Générale
- **Michel Péretié**, Partner & CEO, RiverRock European Capital Partners
- **Guillaume Plantin**, Professor of Economics, Sciences Po
- **Stanislas Pottier**, Senior Advisor to the General Management, Amundi
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Institut Montaigne

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