Summary

Since the great financial and the sovereign debt crises, European banks have faced a paradoxical situation. Despite having much stronger balance sheets, they face declining profitability and low market valuations; and without the support of investors, they may no longer be able to transform themselves. Such investment is more crucial than ever to compete with top American banks and with the growing number of tech players that are becoming more active across the value chain. Because banking is a unique industry, this paradox presents a problem not only for financial institutions, but also for Europe's economic and political standing. Addressing this challenge and carving a sustainable path to growth will take reinvention on the part of banks and committed action on the part of policymakers.

I. Since the financial crisis of 2008, European banks are stronger but less profitable, and remain poorly valued by financial markets

European banks are **remarkably heterogeneous:** they vary in size, business lines and governance models. This heterogeneity complicates analysis, which is why we have focused mainly on the large banks since they represent the bulk of the sector's assets. In 2019, the 115 banks under the direct supervision of the ECB held 82% of banking assets. We also analyzed how capital markets view European banks, because while not all European banks are publicly listed, those that are generate market signals that pertain to the future of the sector.

Although the industry was deeply destabilized by the financial and sovereign debt crises, European banks have since **cleaned up their balance sheets**–spurred by new international prudential rules adopted in Basel. They are now better capitalized, more solvent and have stronger liquidity. Overall, European banks in our study saw a 65% increase in equity between 2008 and 2020 and a 7 percentage point increase in their solvency ratio. Short-term and long-term liquidity ratios are also well above regulatory minimums, and most banks reduced the weight of non-performing loans (NPLs) on their balance sheets. The exceptions are some bank balance sheets in countries hit hardest by the two consecutive crises: more than a third of euro area NPLs are concentrated in the Italian and Greek banking systems.

But even though most European banks proved nimble in responding to the COVID-19 pandemic, **profitability has not recovered** from earlier crises and continues to trail that of American banks. On average, the return on equity generated by European banks has been 3 to 5 percentage points lower than that produced by American banks since 2013. Lower-yielding balance sheet assets–as a result of lower pricing and risk–are one reason for the relative underperformance. US bank balance sheets also have a faster asset turnover, thanks to more developed and better resourced capital markets and active securitization. And although it is cheaper for European banks to originate and manage assets, cost structures are still too high compared to the revenues generated. The average cost-to-income ratio of European banks is 6 percentage points higher than that of US banks.

Investor enthusiasm has also waned. American banks have seen their market capitalizations grow by 80% since 2001, while the valuation for European banks remains the same in 2019 as it was in 2001. In 2000, there were 19 banks among the top 100 European capitalizations, for 17% of total market capitalization. Today there are only 7 at 5%. In fact, the average European bank's market valuation is now lower than its average equity capital. This imbalance makes it harder for banks to attract the investment needed to fund transformation.

II. European banks suffer from persistent cyclical and structural challenges

Europe's difficult macroeconomic and monetary environment continues to weigh down bank performance. Between 2010 and 2019, average annual GDP growth was 1.2% in Europe, compared with 2% in the United States. European banks have also been impacted by persistent **negative interest rates,** a situation that banks in no other advanced market other than Japan has faced.

Several structural factors have also made it difficult for banks to optimize growth:

- European banks **operate in a fragmented market.** The top three banks hold 10-15% of the euro area's assets compared with 35% in the United States. The dispersion of assets makes it harder for European banks to gain economies of scale. European banks also lack the balance sheet management flexibility that American banks have thanks to their access to extensive **capital markets.** The European Banking Union is not proving an effective remedy in its current incomplete state, despite its aims of increasing cross-border activity and economies of scale among banks.
- Since 2008, European banks have been facing increasing prudential **regulatory requirements.** Although these rules apply to all

banks globally, they have a significantly heavier impact on European banks because the requirements were not designed for the environment in which the European economy and European financial institutions operate–where credit financing is more important than capital markets financing.
- Their **competitive environment is undergoing unprecedented changes.** A proliferation of new competitors (neobanks, FinTechs, BigTechs, and shadow banking) active across the value chain (retail banking, corporate and investment banking, payment solutions, and specialized products) is raising standards of expertise and quality to levels that are often difficult for banks to match.

III. The banking industry is a strategic industry for Europe

A strong banking sector is critical to **European sovereignty** and to allowing **the financial system to allocate savings efficiently.**
- A sound banking sector engenders confidence: savers trust that their assets are protected and borrowers have faith that resources are available to finance projects, **all of which supports economic growth;**
- Moreover, banks have long been a **powerful conduit of government support,** a fact proven once again during this health crisis, particularly through granting state-guaranteed loans;
- Only **strong banks can finance the green transition.** Without leveraging private capital, it will be close to impossible for communities and organizations to meet their decarbonization targets;
- Finally, banks are a lever of **influence and economic intelligence,** in particular thanks to their advisory business lines and role in managing state and government debt.

IV. Banks and policymakers must make significant changes to maintain their viability and improve the strength and vitality of Europe's financial systems

European banks must take three actions to **reinvent their business models:**
- **Employ operational levers to improve core profitability:** Banks need to redesign their internal processes and customer interactions to boost revenue generation and reduce costs;
- **Refocus strategic levers to prioritize customers and value-added activities:** Banks need to determine where and how they wish to play within the wider value chain and identify those areas in which they can deliver strong customer value and differentiating expertise;
- **Establish partnerships with FinTechs or with other players in the financial system:** Strategic collaborations with the right ecosystem players can help banks meet their dual objective of increasing operational efficiency and expanding avenues of revenue growth.

Public sector decision-makers must also play **their part to revitalize the banking sector by relaunching the European project** of 2010 and by **building a strategic vision for the European banking industry,** with a focus on stability, profitability and on enabling cross-border activity.
- There seems to be a push-pull in pacing and prioritization between the lingering, unfinished Banking Union and Capital Markets Union, and the pressure to complete Basel regulations. Since the latter are poorly adapted to the structure of the European economy or of European banks, the slow pace of the former presents further challenges;
- The strategic vision for the sector must go beyond financial stability alone and consider the threats posed by continued digital disruption and climate transition requirements.

We recommend four priority objectives:

- **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.

PROPOSAL 2

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

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.

PROPOSAL 4

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

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

PROPOSAL 5

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

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.

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.

- **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.

PROPOSAL 9

Maintain the dynamic use of liquidity steering instruments.

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.

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.

- **Objective #4 : Integrate European banking supervision and regulation in a global vision for 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.

PROPOSAL 13

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

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.