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Reinventing the European Banking Sector

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Paris, November 25, 2021 - Since the 2008 financial crisis, the European banking sector has lost in competitiveness: having seen their profitability fall by 3 to 5 percentage points lower than that of American banks since 2013, abandoned by investors and poorly valued by financial markets, European banks may no longer have the means to invest in their future.

In the face of such challenges, Institut Montaigne releases today its new report *Reinventing the European Banking Sector.* Based on more than sixty interviews with leading bank executives and European regulators, this work calls on European stakeholders from the banking ecosystem to reaffirm the strategic nature of this sector, critical to European sovereignty.

Co-chaired by François Pérol, Managing Partner and Co-Chairman of the Group Executive Committee of Rothschild & Co, and Natacha Valla, economist and dean of the School of Management and Innovation at Sciences Po, Institut Montaigne's task force plead for industrial and public sector decision-makers to collaborate to revitalize the banking sector by relaunching the European project of 2010 - that is, the emergence of a stable and profitable banking sector in the service of the euro area. Addressing this challenge entails:

- **building a strategic vision for the European banking sector, supported by the main countries holding banking assets (France, Germany, Spain, Italy and the Netherlands), with a focus on stability, profitability and on enabling cross-border activity;**
- **committing to complete the European Banking Union by 2030, with the implementation of a European deposit guarantee scheme;**
- **moving forward with the establishment of the Capital Markets Union, to avoid being further penalized by international prudential rules compared to American banks.**

"The loss of competitiveness of the European banking sector is a problem not only for financial institutions, but also for Europe's economic and political standing. The European banking industry plays a major role in financing the European economy, in the transformation of its savings, in the circulation of capital within the euro area and, more generally, in the service of the sovereignty of Europe and the States that make it up", **explains François Pérol, Managing Partner and Co-Chairman of the Group Executive Committee of Rothschild & Co, and Co-Chairman of Institut Montaigne's task force.**

"A fragmented European 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. This fragmentation of the European market is worsened by the preservation of national regulations, the divergent applications of European directives and the differences in tax regimes. For instance, Europe's crisis resolution system is not widely used", **claims Natacha Valla, economist, dean of the School of Management and Innovation at Sciences Po, and Co-Chairman of Institut Montaigne's task force.**

"Already strained by the macroeconomic environment and increased Basel regulations, European banks are facing additional competition from new emerging players specializing in specific segments of the value chain: on the one hand, new technological players such as "neobanks", Fintech and BigTech, and on the other hand, institutions of the so-called "parallel" banking system (debt funds, hedge funds, etc.)..." **Jean-Werner de T'Serclaes, Managing Director & Senior Partner at the Boston Consulting Group, general *rapporteur* of this publication, explains.**

Since the financial crisis of 2008, European banks are stronger but less profitable...

Although the industry was deeply destabilized by the successive 2008 financial and 2013 sovereign debt crises, European banks have since cleaned up their balance sheets. Overall, European banks saw a 65% increase in equity between 2008 and 2020, a 7 percentage point increase in their solvency ratio, as well as short-term and long-term liquidity ratios growing above regulatory minimums. They are now better capitalized, more solvent and have stronger liquidity, as demonstrated by their ability to withstand a major economic shock in 2020.

Still, European banks face declining profitability: the return on equity of the 30 largest European banks has fallen from 20% before 2008 to 8% in 2019. It remains lower than that of American banks, which have been outperforming Europe by 4 to 5 percentage points. European banks' return on equity has been lower than their cost of capital, which has not fallen since the financial crisis: the persistence of these low stock market valuations suggests that it has to do with doubt concerning the relevance of banks' current business model.

European banks' low performance is linked to a difficult macroeconomic and monetary environment: a weak annual GDP growth over the 2010-2019 period - the average annual growth was 1.2% in the euro area, compared with over 2% in the US - and persistent negative interest rates, a situation that banks in no other advanced market other than Japan have faced.

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

- a **fragmented European market** (the top three banks hold 10-15% of the euro area's assets compared with 35% in the United States) and a **limited access to capital markets**;
- **prudential regulatory requirements** that 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;
- the **unprecedented 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) that is raising standards of expertise and quality to levels often difficult for banks to match.

....as a result, the efficiency of this strategic industry for Europe is jeopardized

A strong banking sector is critical to European sovereignty and to allowing **the financial system to allocate savings efficiently**:

- a **sound banking sector provides essential inputs to all other sectors which support economic growth**;
- **banks are a powerful conduit of government support** (transmission of monetary policy, allocation of savings, financing of states, support of macroeconomic stability and diffusion of fiscal policies in case of crisis);
- only **strong banks can finance the green transition** and set decarbonization targets at a global level;
- 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).

Institut Montaigne's 14 objectives to reinvent the European banking sector

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.

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About Institut Montaigne: ***Founded in 2000 and based in Paris, Institut Montaigne is an independent think tank dedicated to public policy in France and Europe. Its work is the result of a rigorous, critical and open method of analysis based on international comparisons. This pioneering non-profit think tank brings together business leaders, senior civil servants, academics, civil society and personalities from a wide range of backgrounds. It is run exclusively through private contributions, each representing less than 1,5% of its annual budget, which amounts to € 6.5 million. Through its various actions - proposals, evaluations of public policies, citizen participations and experimentations - Institut Montaigne aims to fully play a key role in the democratic debate.***