

What Future for the European Banking System?

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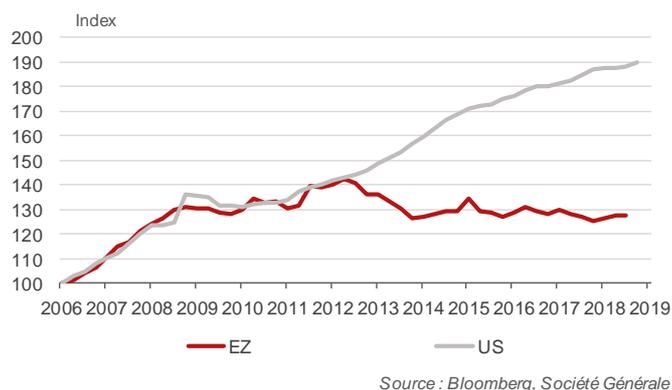
The European banking sector is going through complicated times. Its performance over the last decade diverged widely from that of the US. Between 2007 and 2018, the overall market valuation of the eleven largest US banks² increased from 915 to 1365 billion dollars, with a 50% gain. In the same time span the combined market cap of the 19 largest Eurozone banks dropped from 713 to 438 billion euro, with a 40% loss (Fig. 1). In ten years the market value of the largest US bank, JP Morgan Chase, doubled and is worth more than the ten largest European banks combined. Before the crisis it was worth slightly more than one and a half times the largest European bank, Santander; it is now 5 times larger.

¹ The views expressed in this note reflect only those of the author.

² Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, PNV Fin Serv, State Street, Capital One Financial Corp, BB&T Corp, Wells Fargo, JPMorgan Chase, SunTrust Bank.

Fig.1 Bank Market Cap

This divergence is confirmed by other data. For instance, the combined balance sheet of US banks nearly doubled in the last decade, while that of the Eurozone remained broadly unchanged (Fig. 2). In short, the US banking system has become larger and better valued compared to the pre-crisis situation, while the European one shrank, both in terms of balance sheet and market capitalization.

Fig.2 Banks' Total Assets

This result is somewhat paradoxical. The crisis started on the other side of the Atlantic, as a result of an under-regulated and over-sized US financial system. Regulation has been strengthened since then, and supervision toughened, also with a view to reduce the so-called too-big-to-fail problem. Since the crisis US banks have nevertheless grown even bigger. In Europe, instead, where the crisis erupted as a result of the contagion from the US, the banking system has shrunk. The situation does not seem to have stabilized yet, in spite of the creation of a single supervisory mechanism. The penetration of the US banks in the European market continues to rise, while that of European banks in the US decreased.

This contrasting development raises a series of issues. The first concerns the causes of the divergence across the Atlantic. The second relates to the effects of the continuation of these divergences, in particular concerning the European Economy, and that of its member states.

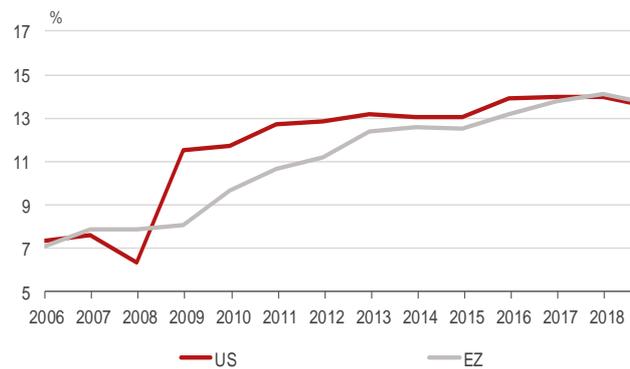
Let's start with the explanation of the divergent performance between the US and European banking systems. The capitalization of both systems has been substantially strengthened after the crisis. At the end of 2007 the average CoreTier1 ratio of US and European banks was around 7%. At the end of 2018 both systems were on average above 13.5%, nearly twice as much as ten years earlier (Fig.3). To be sure, the US system was

recapitalized much more rapidly, as a result of the Tarp package, while in Europe the adjustment differed from country to country. However, since 2015 the US and European systems are broadly aligned.

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

The banking systems have become more robust, both in the US and Europe, and better equipped to absorb shocks arising from the financial system or the real economy.

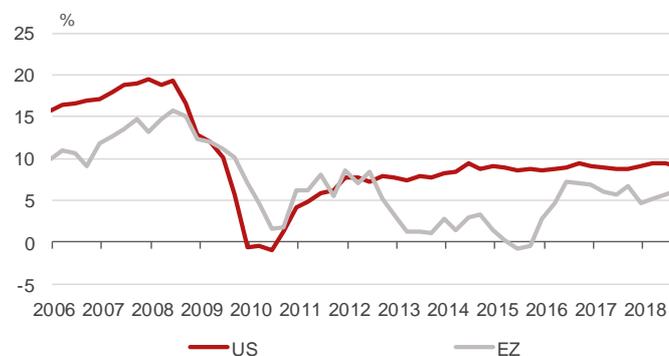
Fig.3 Bank Capitalization (Cet1)



Source : Bloomberg, Société Générale

The main factor of divergence is profitability. Banks' return on capital fell, both in the US and Europe, compared to the early 2000s. US banks' profitability fell to zero in 2009-10, as a result of the crisis and the forced recapitalization, but rose again to close to 10% in the last few years (Fig. 4). In the Eurozone, profitability remained low until 2016, and gradually increased thereafter towards 6%. In countries like Germany and Italy profitability remained negative for several years, as a result of the cyclical downturn and the slow balance sheet restructuring.

Fig.4 Bank profitability (Roe)



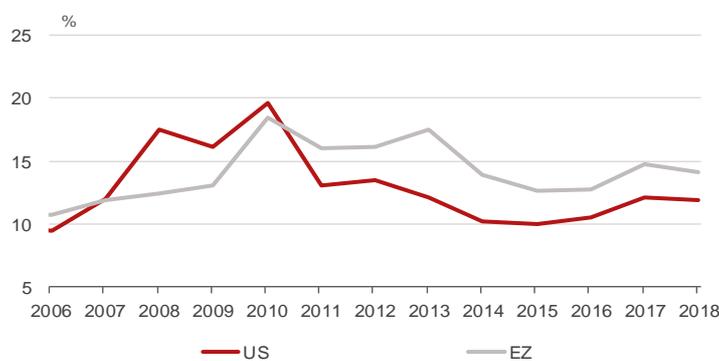
Source : Bloomberg, Société Générale

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

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

In the US, the cost of capital increased after the crisis and gradually came back to slightly above 10%. In Europe instead, the cost of capital remained high, over 15%, for a prolonged period of time (Fig. 5). In Italy the cost has been affected by the rise in Government bond yield in 2011-12 and in the most recent period.

Fig.5 Banks' Cost of Capital



Source : Bloomberg, Société Générale

Contrarily to what some academics like to think, the banking sector can not be assimilated to a utility, characterized by a combination of low rates of return and low volatility. Indeed, banks' profitability is highly correlated with macroeconomic developments, since revenues are not determined by regulated tariffs but subject to strong competition within the sector, and by the level of interest rates.

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

There are six main factors that influence the difference between banks' return and cost of equity across the Atlantic.

The first is the level of interest rates and the yield curve, which basically reflect the different stage of the cycle. The higher the interest rate and the steeper the yield curve, the higher is profitability, especially when banks' liabilities are short term and assets long term. The profitability of the traditional bank business, based on the holding of short-term deposits and the supply of longer terms loans to the private sector, depends on the steepness of the yield curve. The sharp reduction of short-term rates after the crisis, in line with the policy rate cuts, and the fall in long term rates, especially after the implementation of quantitative easing, have compressed the profitability on both sides of the Atlantic. The US have nevertheless benefitted from a quicker exit from the low interest rate policy, which instead persists in Europe. In the Eurozone, the banking system is

also penalized by negative rates (-0.4%) on bank deposits with the central bank, which cannot be passed to the customers.

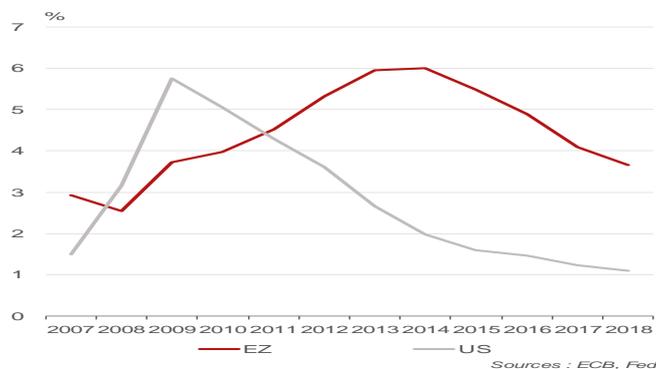
Looking ahead, the difference is likely to persist as the spread between US and European interest rates reflects the more advanced cyclical position of the US economy since the crisis.

The second factor is taxation. In recent years the US banking system has benefitted from the reforms implemented by the Trump administration, which has substantially reduced the fiscal burden. Taxation has instead increased in Europe, with specific measures such as the recent ones implemented in Italy and Spain. In the Eurozone, there is also an implicit taxation deriving from the creation of a 50-billion-euro Single Resolution Fund, which is based on the annual contribution of the largest banks over 8 years. Furthermore, in some countries, banks have also contributed “voluntarily” to the resolution of smaller banks, like for the case of the Atlante Fund in Italy.

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

The third factor is related to the cleaning up of banks' balance sheet after the crisis. The higher is the ratio of non-performing loans, the lower is banks' profitability, especially if the value of the collateral is not adequately accounted for. In the US, after having reached a peak around 6% in 2009, banks' overall NPL ratio fell rapidly, getting back to the pre-crisis level by 2015 (Fig. 6). In the Eurozone the rise in NPL was initially slower but accelerated after the second recession of 2012-13. The reduction was also slower, and the pre-crisis levels have not yet been reached.

Fig.6 Banks' Non-performing Loans



The difference between the US and Europe is due to several factors, including the different bankruptcy legislation and accounting rules. In the US, legislation is more flexible and easier to apply, while the accounting rules are more strict. The ECB has recently adopted measures aimed at aligning the speed of NPL reduction in banks' balance sheets to that of the US.

Overall, US banks have cleaned up their balance sheets much more quickly, also as a result of the forced capitalization implemented in the context of the TARP. In Europe the process has been slower, especially in some countries, due in part to the expectation of a recovery which did not materialize, to the lack of a secondary market for NPLs and to the slow recapitalization by the private sector. The fear to destroy value through an excessively rapid reduction of NPLs produced the opposite result. Banks which did not dispose sufficiently quickly of their NPLs experienced a sharp reduction of profitability and a rise in the cost of capital. The destruction of value has been larger.

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

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

In Europe concentration progressed differently across countries. It has advanced in the Nordic countries, Benelux, France and even Spain, as a result of the crisis. In Germany and Italy, instead, the system remains fragmented, with a strong presence of cooperative banks which are less constrained by the need to remunerate capital above its cost. This presence puts pressure on the profitability of the banks' competitors.

Looking ahead, there will be strong pressure for consolidation within borders, especially in Germany and Italy. At the European level, the pressure for greater concentration should emerge as a consequence of low profitability and the need to compete on a similar scale with US and Asian banks. However, it is unlikely that the existing obstacles to concentration will rapidly fade away. The difference between legal systems across countries make it difficult to extract synergies, especially in retail banking, that would make mergers attractive. Furthermore, national political authorities have become increasingly sensitive to the risk of having their banks merge with or being acquired by others from different countries, in the fear that this would restrict credit to local companies. It is unlikely that the system of exemptions to the EU regulation, which allows national regulators to restrict capital and liquidity mobility within cross border banking groups, will be changed in the near future. The fear, especially in smaller countries, that in case of crisis the bank headquarters would push the burden of adjustment on branches located in other countries, explains the reluctance of some national authorities towards a full implementation of the banking union.

Another obstacle for moving towards a complete banking union, in particular a common deposit insurance scheme, derives from the still high level of Government bonds held by some banking systems, which produces a high correlation between bank and sovereign risk, the so-called doom-loop.

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

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

The European Commission launched a European Capital market union project, but progress has been slow. Time will be needed before legal and tax barriers are removed. Furthermore, in order to function properly, a

capital market requires participants, which are typically banks, that have the size and capability to perform various tasks such as origination, securitization, dealership, advisory, analysis.

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

The sixth factor concerns regulation. New rules have been defined after the crisis, in the context of the cooperative framework imbedded in the Basle Committee. However, the implementation differed between the US, where supervisory authorities enjoy substantial discretion, and Europe where regulation is comprehensive and rule-based. The new US Administration has inverted the regulatory trend of the previous decade. In Europe, instead, the late creation of the single supervisor, in 2014, forced a process of harmonization and standardization of rules and procedures which on the whole have become stricter. There is still a high degree of uncertainty on how some of the new Basel rules will be implemented in the European context. In spite of all the regulatory effort, the uncertainties underlying regulation seems to have contributed to raise the cost of capital.

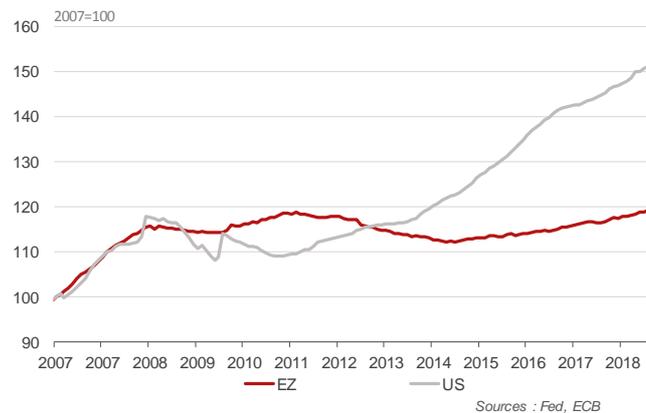
An additional factor, which may be counted as seventh, in explaining the different profitability between the US and European banking system, is played by the different flexibility of the labor markets. The financial crisis and the emergence of new technologies in financial transactions has put pressure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

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

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

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

More importantly, a banking system which is not sufficiently profitable is not able to adequately support economic growth, especially in a bank-centric financial system like the European one. The comparison with the US is also enlightening. At the end of 2018 US bank credit to the private non-financial sector was 40% higher than before the crisis. In the Eurozone bank credit was only 10% higher (Fig. 7). In sum, a fragile banking system is an obstacle for growth and job creation.

Fig.7 Bank Credit to the Private Sector

Furthermore, a capital market union cannot be created in Europe without a strong and profitable banking system. A well-functioning capital market, capable of financing the real economy and absorbing asymmetric shocks within the monetary union, cannot rely on US banks alone. Without a strong banking system there can be no banking union, capable of supporting the growth of European companies in the global competition.

To conclude, the European banking system is going through complicated times. Being insufficiently profitable, it risks being fragile and not being able to contribute to the creation of a true banking and capital market union. Without a full banking union, European banks risk losing market shares and cannot support the European economy as they should.

The reasons for the different profitability of the two systems has been examined above. Some factors are exogenous and depend on conditions that are outside the control of policy authorities. However, what seems to be missing in Europe, both at the Union level and within its member states, is a strategic view of the role that the banking system can and should play in the process of economic development. Ten years after the crisis, the banking system continues to be viewed in Europe as the main cause of the crisis and, at most, as a potential source for higher taxes. In the US and in China, instead, there is a broad support for a strong domestic banking system, based on large international institutions that have the means to support their clients in the global competition.

It may be time for Europe to learn from its own experience and from that of the other major areas of the world and possibly change its approach.