Diverse, green, and agile: an investment-friendly banking landscape for Europe - article by Nicoletta Mascher

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"Diverse, green, and agile: an investment-friendly banking landscape for Europe "
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Performance metrics show the euro area banking sector does not compare favourably with other major jurisdictions. Profitability is the weakest spot with return on equity being close to half that of US and Chinese competitors. The cause of such disparity is not easily traceable; efficiency metrics are a case in point. Rationalisation of business structures and digitalisation of processes have already brought about significant efficiency gains; however, operating expenses remain relatively high, as the production cycle cannot generate adequate return on assets.

The industry size and concentration indices do not fully explain the underperformance of euro area banks either. While bank assets are nearly three times GDP figures in China, they are approximately twice the size of the euro area economy and close to the level of economic output in the US. Some national markets in the euro area are more concentrated than in the US or China, but there

are considerable disparities across big countries.
The question is whether performance and concentration are the right metrics for competitiveness. A finer analysis should look at the value banks can offer to customers and the constraints they face (e.g., regulatory).

One clear disadvantage is weak market integration. The global financial crisis has scarred cross-border activities. While peers in other jurisdictions rebuilt their cross-border positions a few years after the crisis, euro area banks permanently reduced their international activities.

Despite efforts towards establishing banking union, the European banking sector remains segmented along national lines. Regulatory requirements for liquidity and capital at solo level limit banks' possibilities to optimise resource allocation, preventing banks from exploiting economies of scale and the benefits of risk diversification.
Banks could also better compete in a more integrated European capital market with wider opportunities to serve a diversified demand. In such an investment-friendly market environment, banks could better serve the needs of firms with little or no alternatives to bank financing, while other corporates could tap into a wider range of funding sources and a larger investor base. To this end, a deeper market for securitisations can help. While US banks continue to actively manage balance sheets via securitisations, asset portfolio choices for European banks are quite limited. Deepening this market with the right incentives and safeguards would open opportunities to improve efficiency and free up capital for lending.

Euro area banks are well placed to support the twin transition

There is one aspect where Europe has recently advanced faster: the green transition. European banks have been actively incorporating climate-related risk considerations into their mandates, thanks in part to strong supervision. In contrast, US banks seems to have taken a more passive stance. Europe's more conscious approach may deepen differences in the short term, while ensuring a longer-term advantage for European banks over foreign banks and their growing EU branches.
To accelerate progress, European banks can also scale up their digitalisation efforts and adapt business models more decisively to serve a growing new type of demand. Compared with the US, euro area banks have invested less than half into information technology in 2020. Euro area banks must anyhow speed up digital transformation to achieve sustainable cost efficiency in the long term.

For Europe to be able to effectively compete with peers, playing fields need to be levelled. To achieve this, the completion of banking union and progress on capital markets union are essential conditions. However, the full removal of obstacles to optimal resource allocation will only be possible once the European safety net is complete and capital markets are integrated. The introduction of the ESM backstop to the Single Resolution Fund and the establishment of the European Deposit Insurance Scheme are essential steps to that end. The revival of securitisation activity, by streamlining the related regulations and harmonising national insolvency laws, would help banks in a more effective capital management.

Europe probably does not need many global megabanks. Although they seem to perform better by standard measurements, the fact that orderly resolution for global banks remains an unsolved issue casts doubt on the superiority of their financial stability. Moreover, there is a clear need for healthy competition and diversity in the banking sector to protect customers and serve domestic needs, something quite versatile in Europe.

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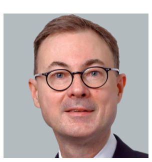

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