



European banks' profitability: plus ça change?

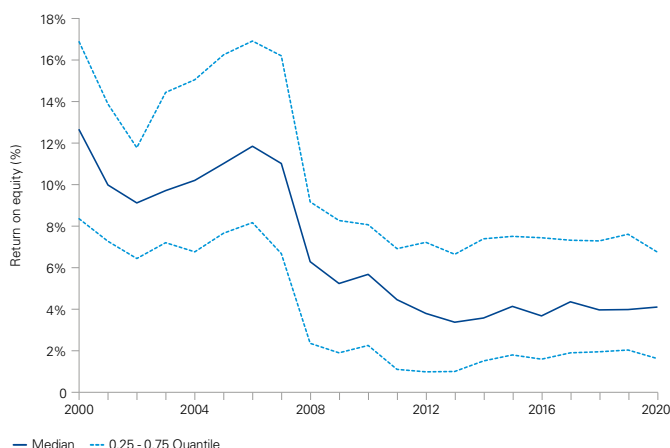
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Profitability of European banks has come under significant pressure since the financial crisis of 2007-08. This could be partly due to the low interest rates environment since then and has wide implications for the economy. Profits are one of the sources used to build up capital, which can then be used as a buffer against unexpected shocks. Capital accumulation also determines the provision of credit to the wider economy and can weaken economic growth prospects if the financing available is insufficient. In addition, weak profitability can increase banks' funding costs if investors demand a premium to reflect a higher credit and/or liquidity risk. Banks suffering from poor profitability may be more prone to taking on excessive risk in order to generate the desired returns, increasing the systemic risk embedded in the financial sector. All this points to the importance of profitability for the resilience of individual banks as well as the health of the financial system and the overall economy.

European banks' profitability was very low even before the COVID-19 pandemic began. Median European banks' return on equity (ROE) fell from around 11% in 2000-07 to just 4% in the past decade (chart 1). The decline has been nearly universal, with median return in most countries lower in 2019 than in the period before the 2007-08 financial crisis (chart 2). ROE has also been below the bank cost of equity (COE) in recent years (chart 3)¹. We estimate the market-implied COE at around 8% in 2020, consistent with the majority of banks' self-assessed value, which ranged between 8% and 10% (chart 4)². This is important because banks with ROE persistently below their COE are deemed to have an insufficient level of profitability.

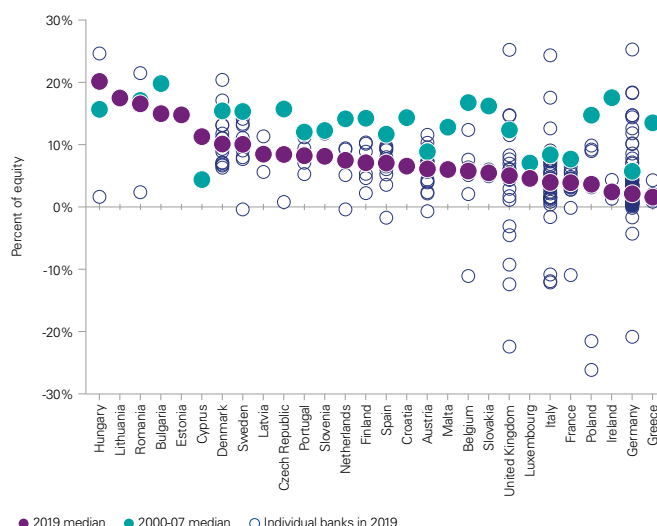
Another interesting picture emerges when comparing profitability of European banks versus their US counterparts. While the gap in earnings between US and EU banks was already in place before 2009, US banks saw a continued improvement in earnings since the financial crisis. That contrasted with a more persistent decline in European profits, particularly in the more vulnerable countries (chart 5). Part of the difference in performance can be attributed to cyclical divergence, including weaker euro area economic growth (prolonged by the sovereign debt crisis). In contrast, US banks benefitted from a more favourable macroeconomic environment, with a big part of the improvement in the US linked to declining loan loss provisions, as well as higher interest rates in recent years. However, there are also structural factors which have been important. The larger size of the US market compared to individual European markets, in the absence of a full European banking union³, provides more scope to gain from economies of scale.

Chart 1: Median European bank's profitability



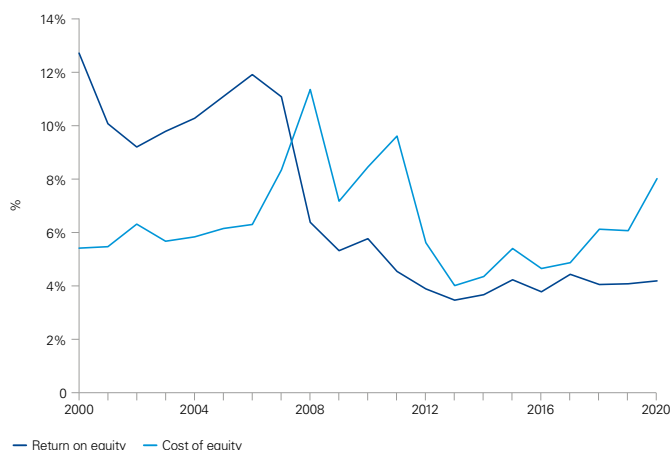
Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis.

Chart 2: European banks' ROE, 2019 vs 2000-07



Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis.

Chart 3: Median European bank's return on equity and market-implied cost of equity



Source: S&P Capital IQ, Refinitiv Datastream, KPMG analysis.

¹ We estimate the market-implied cost of equity as the ratio of banks' ROE to their price-to-book ratio, consistent with the Gordon growth model.

² EBA (2020), 'Risk assessment of the European banking system', December.

³ Although even with a completed Banking Union the EU market would still be less homogeneous than the US one due to the divergence in customs, languages etc.

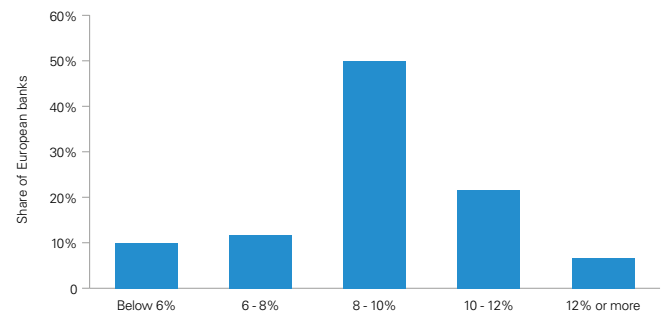
The US also represents a less crowded market, with overcapacity weighing down on European banks' profitability. Raising capital ratios in response to regulatory requirements since 2008 has also been more pronounced in Europe, given the stronger starting position of US banks. The divergence in profitability outcomes has affected banks' valuations, with the price-to-book ratio recovering back above one in the US, whereas in Europe it has flatlined below one, despite reaching the same trough as the US during the 2007-08 crisis (chart 6).⁴

In this report we look in more detail at a number of explanations for European banks' low profitability in recent years:

- Low interest rate environment, resulting from central banks' aggressive monetary easing policies in response to the economic climate that followed the financial crisis of 2007-08;
- Legacy assets issues, stemming from the euro area sovereign debt crisis, with banks struggling with high shares of non-performing loans (NPLs);
- Stricter regulation, requiring a shift away from risky activity, as well as increased level of back and middle office staffing;
- Challenges related to digital transformation and FinTech, such as increased outlays on IT and cybersecurity, while adapting to competitive pressures from FinTechs; and
- Overcapacity in the sector, with the supply of banking infrastructure and services outstripping the demand for it, resulting in a market that is overly competitive with no room to gain critical mass.

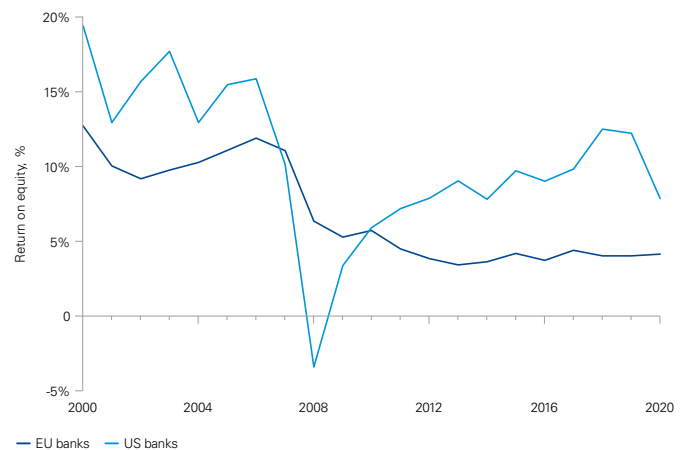
These forces have already been present before the COVID-19 pandemic. The challenges triggered by the latest crisis will put further downward pressure on banks' returns in the coming years. Exactly how European banks' profitability will evolve will depend on a number of factors. Using the dataset of 300 European banks that we constructed, we examined a number of scenarios which we outline further below.⁵

Chart 4: Self-assessed cost of equity for European banks, June 2020



Source: EBA

Chart 5: Return on equity for European & US banks



Source: S&P Capital IQ, Refinitiv Datastream, KPMG analysis.

Chart 6: Price-to-book ratio for European & US banks



Source: Refinitiv Datastream, KPMG analysis.

⁴ The price-to-book ratio, under a standard definition used by market analysts, is the ratio of return on equity to cost of equity (assuming that the long-term earnings growth is approximately zero). In other words, it indicates how difficult it is for banks to raise equity in the market.

⁵ Unless otherwise stated, the data cited in this report refer to a panel of over 300 European banks with assets over £1bn, extracted from the S&P Capital IQ database and Refinitiv Eikon.

Low interest rate environment

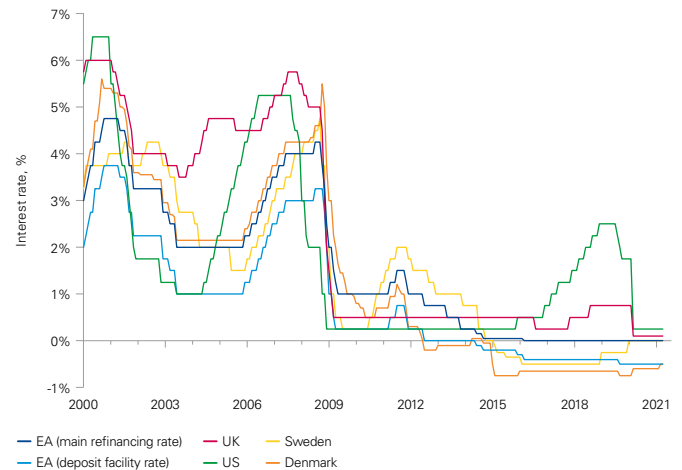
The fall in profitability has occurred alongside the persistent fall in interest rates, with some central banks setting their policy rates below zero in recent years (chart 7). Deposit rates usually move in tandem with rates on loans that the banks issue. Lending and deposit rates are set by the banks' treasury functions as a margin over/under the official policy rate.⁶ But because deposit rates cannot fall significantly below zero, the net interest margin (NIM) becomes squeezed as policy rates set by the central banks approach their zero-lower bound (or 'floor'). Consequently, banks have experienced a gradual fall in net interest income, from just under 2% of assets in 2000-07 to around 1.5% in recent years (chart 8).

The squeeze on interest margins has had a particularly negative impact on banks that rely more on net interest income, although that has not been the only driver of lower profitability in recent years. The contribution from non-interest income (such as fees & commissions and trading income) has also fallen, but by less (from around 1.4% in 2000-08 to 1% in 2019), and is now at a similar level to that during the financial crisis of 2007-08. This is despite the fact that a lower interest rate environment could boost income from non-interest activities such as mergers & acquisitions (M&A) and other intermediation activity (eg trading), and generate higher fees & commissions.

Lower interest rates should also generate gains on banks' securities via higher asset prices. But what matters is not just the level of interest rates but also the slope of the yield curve (i.e. the term structure of interest rates). If banks borrow short and lend long, they can earn returns from engaging in maturity transformation activities. However, if banks hedge interest rate risk through derivatives, then the slope of the yield curve affects net interest income and trading income in opposite directions, meaning that a flatter term structure should boost non-interest income.⁷

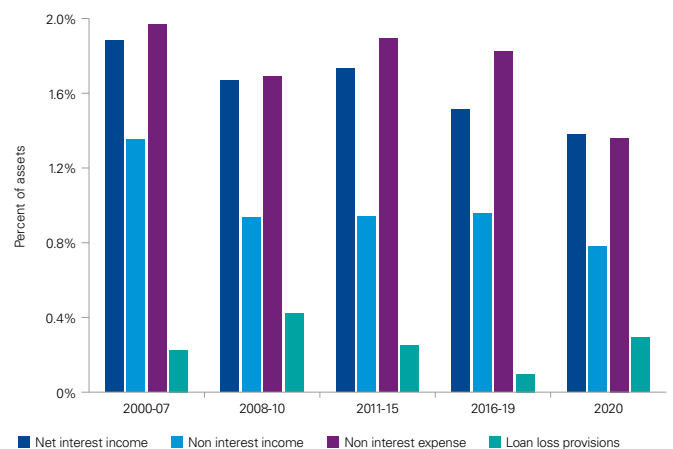
Turning to loan loss provisions, lower interest rates reduce the probability of default on loans at any stage of the economic cycle. But provisions are also highly counter-cyclical, meaning that they tend to increase as economic conditions worsen to insure banks against potential future losses. Thanks to central banks' loose monetary policy since the financial crisis of 2007-08, which has helped stimulate the economy, loan loss provisions fell from a peak of 0.5% of assets in 2009 to just 0.1% in 2019. That trend reversed in 2020, with median bank's provisions rising to 0.3% in Europe during the COVID-19 pandemic.

Chart 7: Central bank policy rates



Source: Refinitiv Datastream, BIS.

Chart 8: European banks' average breakdown of profitability



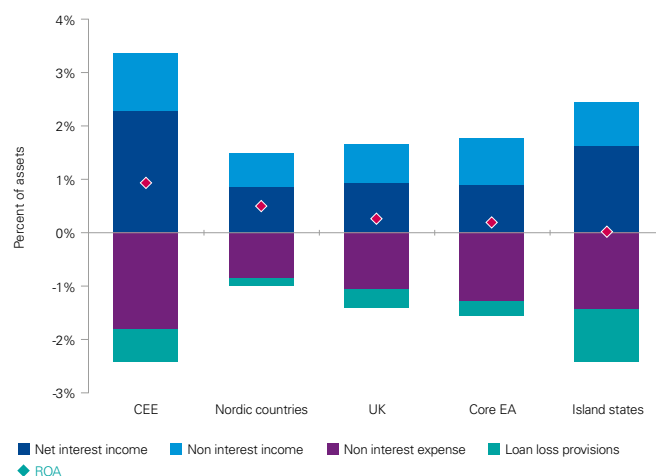
Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis

⁶ See Cadamagnani, Harimohan and Tangri (2015), 'A bank within a bank: how a commercial bank's treasury function affects the interest rates set for loans and deposits', Bank of England Quarterly Bulletin, 2015 Q2

⁷ See Borio, Gambacorta and Hofmann (2015), 'The influence of monetary policy on bank profitability', BIS Working Papers, No 514, and Alessandri and Nelson (2012), 'Simple banking: profitability and the yield curve', Bank of England, Working Paper No 452.

The aggregate position as of 2020 points to a number of distinct country groups (chart 9). Central and Eastern Europe shows elevated levels of profitability (averaging 0.9% ROA), driven by higher interest rates boosting net interest income. The average central bank policy rate in CEE was 0.8% in 2020, with rates averaging 1.8% in Romania and 0.7% in Hungary. By contrast, the policy rate averaged 0.2% in the UK, 0% in Sweden and the euro area, and 0.6% in Denmark. At the other end of the spectrum, the 'Island states' (Greece, Cyprus, Malta and Ireland) had ROA of around zero, mainly on the back of higher provisions. The Nordic countries, which are relatively more advanced in digitalisation, fared better than Core EA (France, Germany and Italy), thanks to relatively low non-interest expenses and loan loss provisions. The UK was in the middle of the pack, though its return structure resembled that of Core EA.

Chart 9: Average return on assets in 2020



Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis.

CEE: Lithuania, Romania, Hungary, Estonia, Poland, Latvia, Slovenia, Czech Republic, Bulgaria, Slovakia.

Nordic: Sweden, Finland, Denmark.

Core EA: France, Italy, Germany.

Island states: Cyprus, Malta, Greece, Ireland.

Legacy asset issues

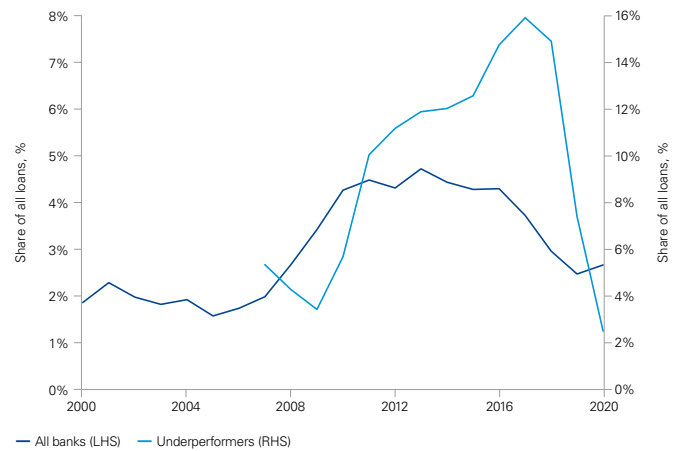
We can look at the expenditure side to identify the key underperformers. Between 2016 and 2020, the median ROE was 4%, but a quarter of banks recorded profitability of 1.9% or less. Taking the institutions which fell in the bottom quartile for at least two years in this period (the 'underperformers') reveals two distinct characteristics: a high share of non-performing loans, and a high cost-to-income ratio.

Following the financial crisis of 2007-08 banks had to adjust their capital structure to comply with the regulatory requirements under the Basel III accords. Specifically, the total regulatory capital ratios have been raised from 8% to 10.5% of risk-weighted assets to account for the capital conservation buffer. Although this has made the sector more resilient to withstand unexpected shocks through de-leveraging and de-risking of banks' balance sheets, it has also limited their capacity to generate returns via riskier activity.

Significant progress has already been made in reducing the burden from non-performing loans across all banks in Europe. Median bank's NPL ratio has halved from a peak of nearly 5% (as a share of all loans) in 2013 to under 3% in 2018-20 (chart 10). But it can take a long time to repair each bank's balance sheet and many European banks still carry a substantial amount of older non-performing legacy assets. For the EU as a whole, as of June 2020 44% of NPLs' value was classified as unlikely to be repaid and over one year past due (chart 11), while 20% were more than five years overdue. Within those, Greece and Cyprus had around 40% of NPLs past due for more than 5 years, and for Italy that figure was around a third. These legacy asset carriers are over-represented among the underperformers, with the median NPL ratio at nearly 10% in that group in 2016-20. Banks with such high shares of NPLs were located in countries such as Cyprus, Greece, and Italy which comes unsurprising given their role in the eurozone debt crisis.

The underperformers have also exhibited high cost-to-income (efficiency) ratio, which stood at 68% since 2016, 8 percentage points above that of the average for all banks. Those banks which have underperformed due to relatively high costs compared to income have been primarily located in Greece, Germany, and the UK. With the latter two exhibiting the lowest level of sector concentration (see chart 17) – this could suggest that a high degree of competition is putting a cap on revenues despite a lean cost structure in those countries.

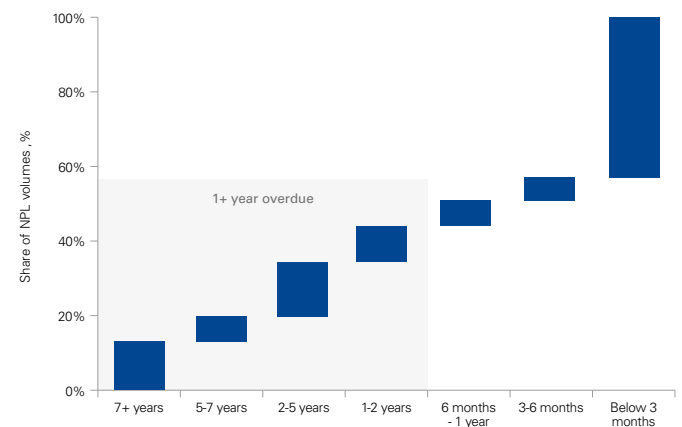
Chart 10: Median European bank's NPL ratio



Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis.

Note: The figure for underperformers is averaged over 2 years.

Chart 11: Distribution of EU banks' NPL volumes by past-due category, June 2020



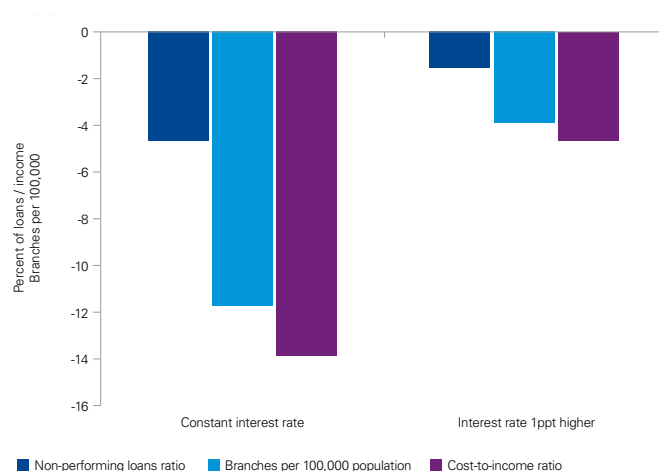
Source: EBA, KPMG analysis.

We carried out a simple econometric exercise in order to assess the scale of change that would be required to lift average profitability of European banks.⁸ The results in chart 12 suggest that, in order to increase ROE by 3 percentage points – that is around a half of the difference in ROE between 2000-07 and now – an average European bank would be required to:

- Reduce its ratio of non-performing loans by 5 percentage points;
- Cut the number of branches by around 12 per 100,000 population;
- Reduce its cost-to-income ratio by 14 percentage points; or
- A combination of the above strategies.

These results assume that interest rates stay unchanged. However, an increase in interest rates would make that task easier to achieve through the boost to net interest income. That would mean that the required reductions would be around two-thirds smaller if interest rates rose by 1% (chart 12).

Chart 12: Improvement needed to achieve a 3ppt increase in ROE



Source: S&P Capital IQ, Refinitiv Eikon, OECD, BIS, KPMG analysis.

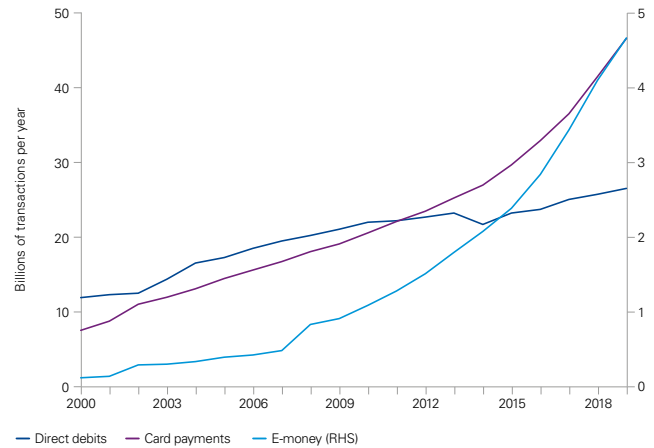
⁸ The results are based on a panel of 153 European banks with assets over £1bn, estimated over 2000-19. The return on equity was regressed on the interest rate, the ratio of non-performing loans to total loans, the cost-to-income ratio, the number of branches as a share of the population, and annual real GDP growth, controlling for bank-specific (fixed) effects.

Challenges related to digital transformation and FinTech

The rise of FinTech has led to a significant change in banks' business environment. The number of transactions in the EU relying on electronic money is now almost 40 times larger than in 2000 (chart 13). The use of technology was facilitated by an increased access to the internet, with over 90% of households in the EU owning internet access. COVID-19 has further accelerated the trend in internet banking, with 66% of all internet users in the EU (83% in the UK) conducting their banking activities online in 2020, up from 51% (55% in the UK) just a decade ago (chart 14). The services offered by digital banks, including low fees and user-friendly infrastructure, will likely continue to attract further demand as customers embrace the technological solutions.

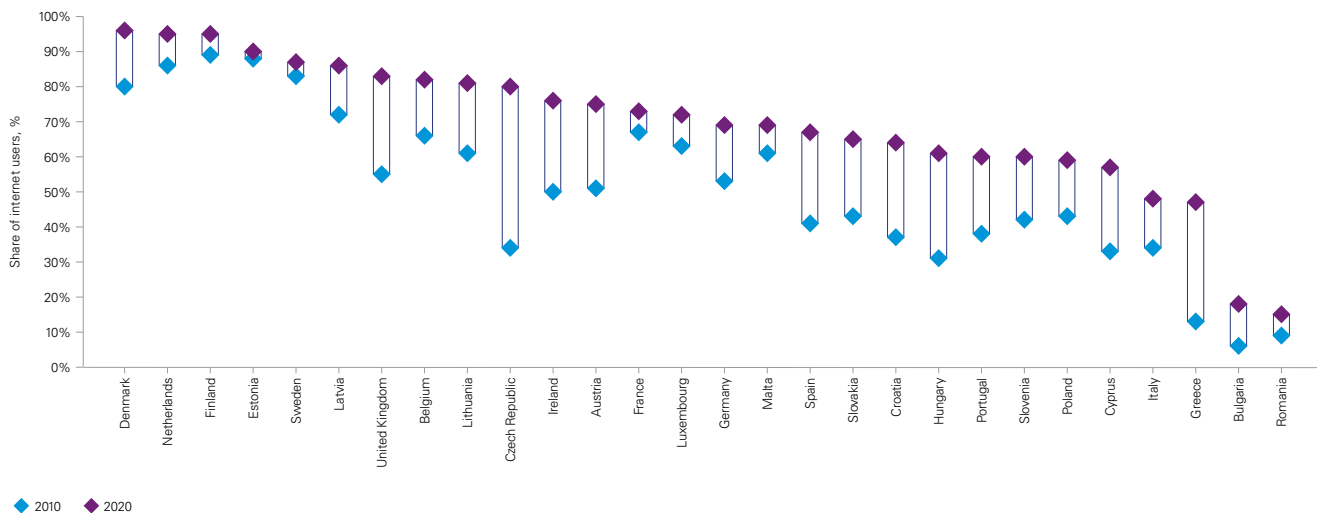
European banks don't perceive unregulated FinTech companies as a direct threat to their business, opting instead to exploit synergies through commercial partnership initiatives. According to the EBA's risk assessment questionnaire, 90% of banks have engaged in commercial partnerships with non-bank FinTech companies to offer new products or services in 2020, and 71% have held direct or indirect investment in FinTech.

Chart 13: Number of transactions per payment system in the EU



Source: ECB, KPMG analysis.

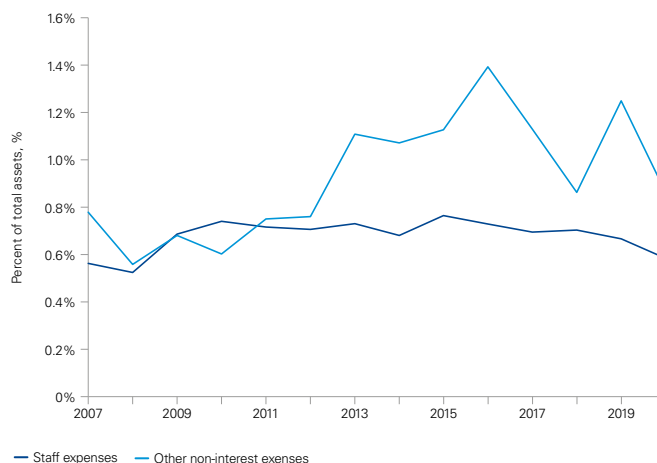
Chart 14: Internet users of online banking



Source: Eurostat.

Nonetheless, the shift to digitalisation has increased the need for IT systems upgrade and maintenance as well as cyber security systems to address online-related threats, which together amount to around one-third of total administrative expenses across EU banks.⁹ Financial technology has also generated demand for improved and more versatile consumer services, with cloud computing and digital wallets used (or piloted) by over 70% of banks, and many other applications in the pipeline. Across the largest UK banks, 'other' non-interest expenses (which include spending on IT and advertisement) have increased from 0.6% as a proportion of assets in 2008-10 to 1.0% in 2011-20, while staff expenses have been broadly flat (chart 15). This suggests that banks will likely adjust their staff levels while this technology induced shift towards automation continues. With less need for high street branches, this will provide an opportunity for banks to further reduce their cost base.

Chart 15: Non-interest expenses across the largest UK banks



Source: Refinitiv Eikon, KPMG analysis.

⁹ EBA (2019), 'Risk assessment of the European banking system', November.

Overcapacities

Overcapacities (or 'overbanking') occur when the supply of banking infrastructure and services outstrips the demand for it. These can create sub-optimal market dynamics where certain banks struggle to stay profitable. While it is difficult to pin-point a specific threshold above which the sector experiences overcapacity, this is usually linked to the overall size of the sector relative to the economy; the concentration of assets among the largest institutions; and the banking infrastructure relative to customer base (e.g. 'over-branching').

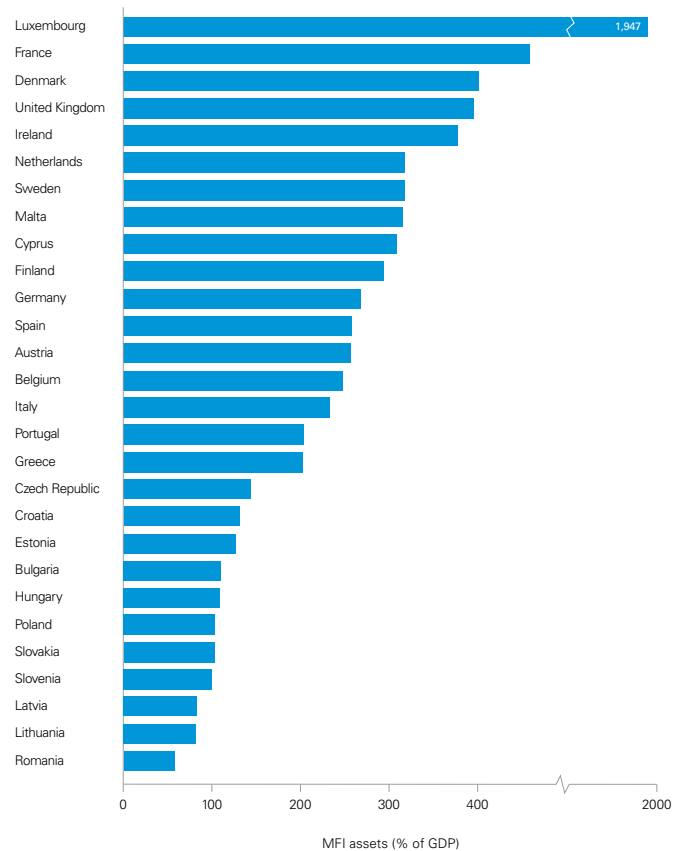
The banking sector has grown significantly in many European countries (chart 16). In France, the size of monetary financial institutions' (MFIs) assets rose from around 250% of GDP in the late-1990s to 460% today. In the UK, the banking sector is equal to 400% of GDP today, compared to 100% in 1975, and the Bank of England predicts that it might grow to over 950% of GDP by 2050.¹⁰ Luxembourg is a clear outlier given the importance of its banking industry relative to the size of its economy.

There are a number of reasons why the banking sector has grown so big in certain countries. These include the benefits of financial hubs which draw more institutions to cluster around a specific region, or comparative advantages related to legal and regulatory environment. And while the size of MFIs' balance sheet has implications for financial stability and fiscal risks, it is not immediately clear that it creates unhealthy competition – especially if, for example, it merely reflects a market with a small number of very big players.

Two metrics are often used to gauge the overall concentration of the sector. The CR5 ratio takes the asset share of the five largest credit institutions expressed in percentage terms. A higher value represents a greater degree of concentration, whereas a small value points to a more dispersed market. The second indicator – the number of bank branches per population – can be used to proxy the overall infrastructure of the sector. The latter has a negative correlation with the CR5, suggesting that sectors with a higher concentration also tend to be less over-branched (chart 17).

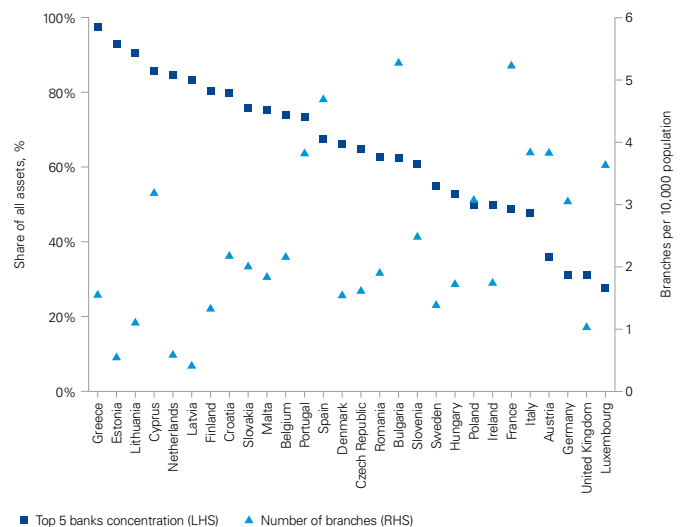
Chart 17 also shows that the countries with the largest banking sectors also tend to be more dispersed. Banking sectors in the UK and Luxembourg display the lowest concentration ratios, and their top five institutions account for less than a third of all assets. Conversely, countries such as Estonia, Lithuania and Latvia have highly concentrated sectors which are also relatively small relative to GDP. That could also highlight how more developed financial markets have room for more financial institutions.

Chart 16: Size of the banking sector in 2020



Source: ECB, OECD, KPMG analysis.

Chart 17: Banking sector concentration measures, 2019



Source: ECB, OECD, KPMG analysis.

¹⁰ Bush, Knott and Peacock (2014), 'Why is the UK banking system so big and is that a problem?', Bank of England Quarterly Bulletin, 2014 Q4.

The fallout from COVID-19 could create an opportunity to remove excess capacity through consolidation. Mergers & acquisitions can offer the benefit of faster technological adoption while streamlining the network of branches. However, the number of M&A deals in Europe has been on a downward trend since the financial crisis of 2007-08, with domestic deals accounting for the great proportion of overall transactions (chart 18). Although domestic mergers can drive up cost efficiency, more cross-border deals would facilitate greater resilience through portfolio diversification. Research has found that poor asset quality has been the main culprit behind the fall in cross-border M&As in Europe.¹¹ This suggests that tackling legacy asset issues will be crucial in paving the way for further consolidation.

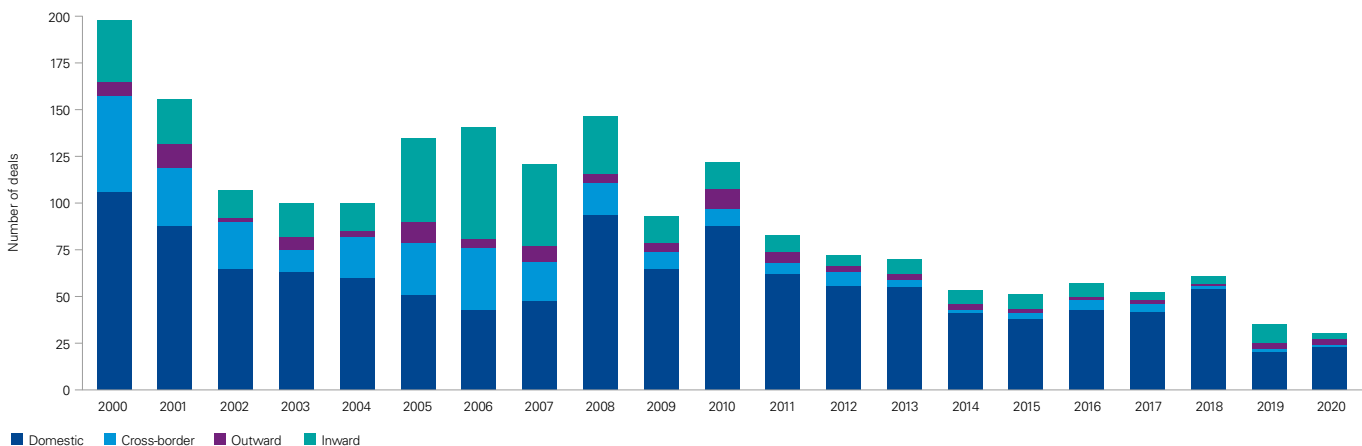
In the long run, however, a more sustainable solution to overcapacity will nonetheless require the completion of the European Banking Union (EBU). The EBU, initiated in 2012 in response to the Eurozone crisis, would ensure the transfer of responsibility for banking policy from the national to the EU level.

There are three pillars of the EBU, consisting of:

- The single supervisory mechanism (SSM), where the European Central Bank (ECB) is the central prudential supervisor of financial institutions in the euro area and other EU countries that choose to join the SSM;
- The single resolution mechanism (SRM), which ensures an orderly restructuring of failing banks, with the single resolution board acting as the central resolution authority within the banking union; and
- The European deposit insurance scheme (EDIS), meant to provide stronger and more uniform insurance cover for all retail depositors in the banking union.

With the first two pillars (the SSM and the SRM) already in place, a common system for deposit protection will be needed to establish the third pillar of the EBU and complete the union.

Chart 18: The number of European banking sector M&As has fallen



Source: Refinitiv Eikon, KPMG analysis.

11 Schmitz and Tirpak (2017), 'Cross-border banking in the euro area since the crisis: what is driving the great retrenchment?', Financial Stability Review, ECB, November 2017, Special Feature B.

The outlook for banks' profitability

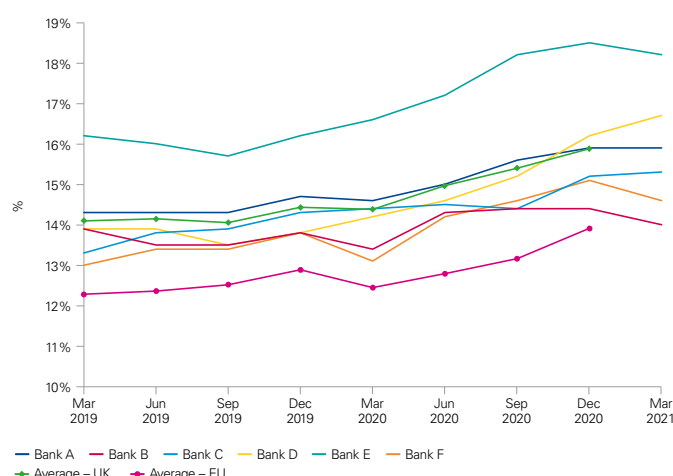
Thanks to the stricter regulatory requirements, banks have entered the COVID-19 pandemic in a much stronger position than before the financial crisis of 2007-08. Despite the effect of the pandemic on profits, capital ratios among UK and EU banks have actually increased in the past year, with an average 150bps improvement in common equity tier 1 (CET1) ratio for the major UK banks (chart 19).¹² The regulatory support, in the form of quick fixes adopted by the EBA and PRA, has been a major contributor to the higher overall capital ratios in 2020.¹³

Nonetheless, the crisis has exacerbated many of the difficulties related to generating returns and we expect the environment to remain challenging for the banking sector. We used our econometric model to conduct simulation analysis of how European banks' profitability could evolve over the next five years.¹⁴ These are illustrative scenarios which represent the possible paths for bank returns given the evolution of GDP growth, interest rates, as well as the progress banks make with their stock of NPLs, cost-cutting and consolidation strategies. We developed three scenarios:

In the **'main' scenario** we assume that GDP growth follows our latest forecasts, and interest rates rise only gradually over time, which limits the scope for banks to benefit from higher net interest income. We assumed that banks' NPL exposure rises by 1.5% (consistent with the existing empirical evidence on the impact of COVID-19),¹⁵ while the trend in declining number of branches observed in recent years continues at the same pace. In that scenario, median profitability recovers only temporarily on the back of the bounce-back in GDP this year and falls back to 5% by 2025 (chart 20).

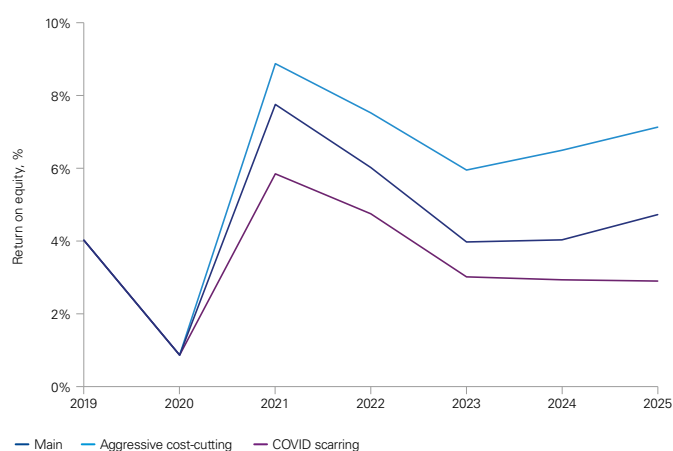
In our **'aggressive cost-cutting' scenario** we model a 3% a year reduction in the efficiency ratio, consistent with the median bank reaching the efficiency levels of a bank in the 25th quantile. COVID-19 crisis has amplified structural changes in customer behaviour related to the use of digital services, including for online banking. We expect this shift to continue, with an increasing share of business conducted online, and requiring less need for high street branches. This will provide an opportunity for banks to further reduce their cost base. Consequently, we assume the number of branches to decline by nearly 4% a year. We also assume in this scenario a slightly stronger recovery in GDP growth. In that scenario, profitability, as measured by ROE, reaches 7% by 2025.

Chart 19: CET1 capital ratio



Source: Financial statements, KPMG analysis.

Chart 20: Median European bank's return on equity



Source: S&P Capital IQ, Refinitiv Eikon, OECD, BIS, IMF, NIESR, KPMG analysis.

¹² For further detail, see KPMG (2021), "COVID-19 economic impact on Expected Credit Losses", May.

¹³ The support included: IFRS 9 transitional arrangements, a non-deduction of certain software assets from CET1 capital, as well as SME and infrastructure supporting factors, which resulted in a more favourable prudential treatment of certain exposures.

¹⁴ See footnote 8 for a summary of the model.

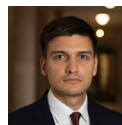
¹⁵ Specifically, we used the OECD estimates of the impact of COVID-19 on NPLs in Europe adjusted for a plausible macroeconomic scenario. See OECD (2021), "The COVID-19 crisis and banking system resilience" for further detail.

On the other hand, in our **'COVID scarring' scenario**, we model a slightly slower economic recovery, coupled with interest rates staying at their current levels as monetary policy remains accommodative. Banks' credit quality starts to deteriorate again as businesses facing liquidity issues become less likely to repay their loans, with the NPL ratio rising by 2.5%, similar to the rise observed during the financial crisis of 2007-08. In addition, banks fail to incorporate branch closures or other major cost-cutting strategies. In this scenario, profitability remains very weak in the coming years, reaching only 3% in 2025.

Despite the strain on profitability as a result of COVID-19, we don't expect the aggregate capital ratios to fall below the regulatory minimums. That's largely thanks to a stronger starting position and government loan guarantees introduced in response to the pandemic. The aggregate picture would nonetheless mask heterogeneity among individual institutions, with more vulnerable banks facing the risk of a more substantial erosion in capital.¹⁶

Overall, our scenarios suggest that pressures resulting from the recent crisis will require banks to be more ingenious in pursuing strategies which cut operating costs and improve their income streams. Successful banks will largely be among those which can embrace the shift to online while keeping a lean cost structure.

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¹⁶ See also [KPMG Peer Bank](#), a benchmarking solution for banks built using over 5 million data points from the EBA transparency exercises, which provide detailed bank-by-bank data on banks' assets and liabilities, capital positions, risk exposure amounts, leverage exposures and sovereign exposures on over 125 banks across 27 countries from the European Union and European Economic Area.

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