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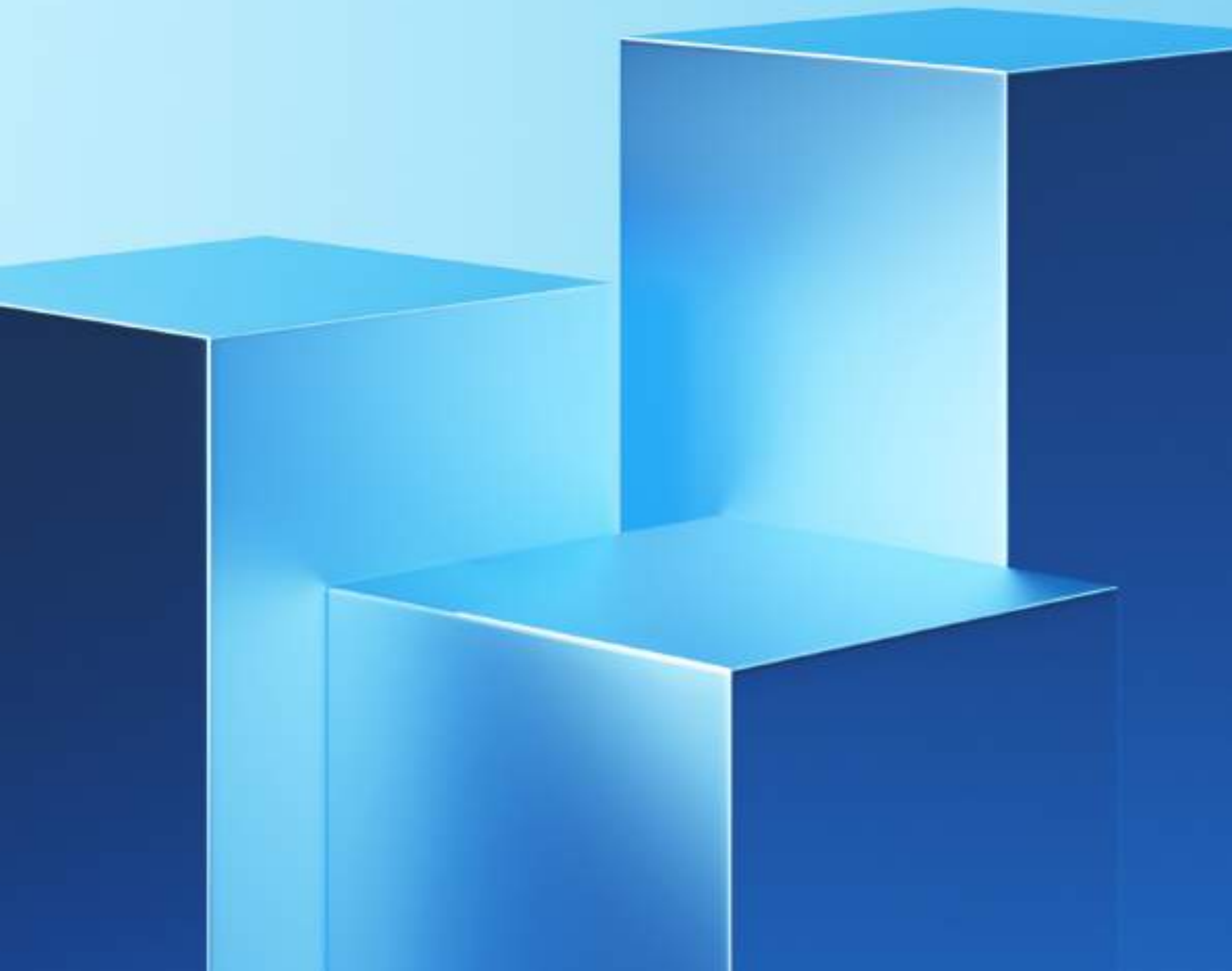
THE FINANCIAL CENTRE DEVELOPMENT AGENCY

Competitiveness of European financial services



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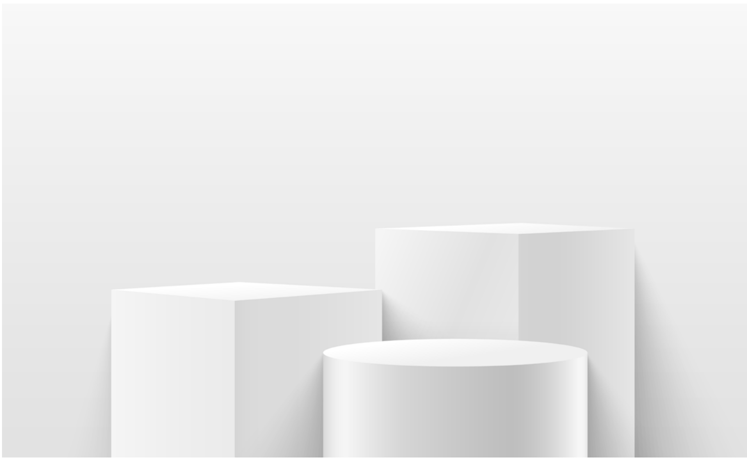

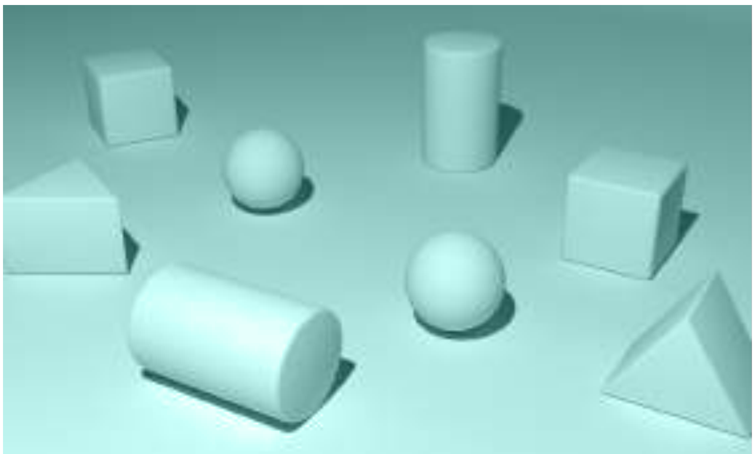

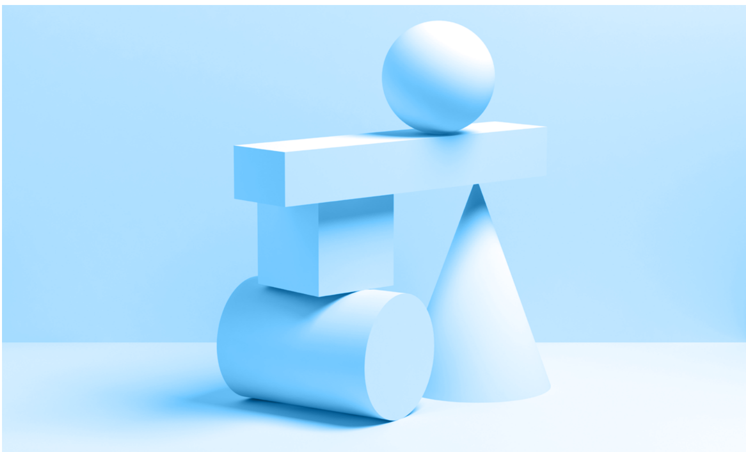

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ABOUT OMFIF

With a presence in London, Washington and New York, OMFIF is an independent forum for central banking, economic policy and public investment – a neutral platform for best practice in worldwide public-private sector exchanges.

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ABOUT LUXEMBOURG FOR FINANCE

Luxembourg for Finance is the Agency for the Development of the Financial Centre. It is a public-private partnership between the Luxembourg Government and the Luxembourg Financial Industry Federation (PROFIL). Founded in 2008, its objective is to develop Luxembourg's financial services industry and identify new business opportunities.

LFF connects international investors to the range of financial services provided in Luxembourg, such as investment funds, wealth management, capital market operations or advisory services. In addition to being the first port of call for foreign journalists, LFF cooperates with the various professional associations and monitors global trends in finance, providing the necessary material on products and services available in Luxembourg. Furthermore, LFF manages multiple communication channels, organises seminars in international business locations, and takes part in selected world-class trade fairs and congresses.

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How Europe can take the lead in financial services

Deep and well-functioning capital markets are critical to a competitive real economy, one that fosters innovation and creates jobs, writes Nicolas Mackel, chief executive officer, Luxembourg for Finance.

THE YEARS following the 2008 financial crisis could rightly be termed a 'decennium horribilis' for European financial services, which saw it drastically lose ground to US and Asian financial institutions. The effects of a succession of crises are clear. Beginning with the 2008 financial crisis and the ensuing regulatory tsunami, the European sovereign debt crisis and, most recently, the Covid-19 pandemic, Europe's financial services ecosystem has continued to lose its competitive edge compared to North America and Asia. The numbers you will discover in this report make this unquestionable.

Several factors account for this loss of competitiveness, the most critical of which has been overcoming the inherent fragmentation of European financial services in the fight to regain competitiveness. With different expectations in different countries in Europe, be it from a regulatory or an investor perspective, it is increasingly difficult to overcome the splintered nature of Europe's financial services ecosystem. It is therefore crucial that we continue to work towards completing the capital markets union and banking union as we are stronger when working together. The recent work on the European Union taxonomy and Sustainable Finance Disclosure Regulation only further reinforces how Europe can take the lead in financial services when we eliminate fragmentation.

The interplay between financial services and the real economy makes this issue all the more pertinent. Deep and well-functioning capital markets are critical to a competitive real economy, one that fosters innovation and creates jobs. Therefore, we must ensure that the cycle linking financial services and the real economy remains virtuous and that we are competitive enough on the global stage to finance the real economy and boost growth in the region.

Decision-makers have understood the urgency of the issue, with both former Italian Prime Ministers Mario Draghi and Enrico Letta having been tasked to produce reports on the topic. They have not been simple tasks for either, with Draghi examining EU competitiveness and how to better it, while Letta's report will explore the future of the single market. Draghi's recent warning on the matter is dire: 'Either Europe acts together and becomes a deeper union, a union capable of expressing a foreign policy and a defence policy, aside from all the economic policies… or the EU will not survive other than being a single market.'

Allow me to take this opportunity to thank our partner OMFIF for its work in producing this valuable report outlining the competitiveness of European financial services. I am sure it will serve as a useful reference point, providing an overview and outlining next steps.

'It is therefore crucial that we continue to work towards completing the capital markets union and banking union as we are stronger when working together.'

Rebuilding the competitiveness of Europe's financial sector

There are encouraging signs of recovery after a lost decade and a huge opportunity to build and benefit from sustainable and technological transformations. By Clive Horwood, managing editor and deputy chief executive officer, OMFIF.

HOW does one define competitiveness? It is not a simple task. In business terms, it might refer to the ability of an organisation to deliver better-value prospects to its customers. A competitive economy may be classed as one whose rate of productivity is able to drive growth, and subsequently income and welfare. More holistically, competitiveness can be viewed as the characteristics or abilities of any organisation to achieve its mission more successfully than other organisations.

Defining competitiveness in financial services is harder still. The aim of this report, published in conjunction with our partners at Luxembourg for Finance, is to consider the relative competitiveness of the European financial services industry against their peers in the US and Asia. As such, we have looked closely at factors such as scale, diversification, profitability, pricing power and valuation.

In these terms, Europe has fallen far behind the US since the 2008 financial crisis. Perhaps that is not surprising given relative economic performance: in dollar terms, the European Union's economy is now worth 65% of the US economy. In 2013, its combined gross domestic product was 91% of the US's.

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Losing ground

The decline of the European banking industry has been even more dramatic. In 2007, the total market capitalisation of European banks was $2.7tn. By 2021, it was valued at just $1.4tn. Europe's regression has been almost exactly matched by the growth of US banks, whose combined market cap was $1.6bn in 2007 and stood at $2.6tn 14 years later.

Europe's asset management sector has suffered an arguably even steeper decline. Looking at the share of assets of the world's top 100 investment institutions, in 2007 European firms accounted for 47% of funds and the US 51%. By 2022, Europe's

share of the fund management wallet had declined to just 22%, while US funds' global dominance had become entrenched at more than 70%.

This is reflected in a list of the leading global asset managers today. The top seven firms are all headquartered in the US. Europe's biggest fund manager, Amundi, ranks eighth, and its assets under management are just a quarter of the size of the global leader, BlackRock. Only one other EU-based asset manager ranks in the top 20 globally, Natixis. Its AuM is roughly half of Amundi's.

There's a similar story to tell in banking. Europe's most valuable bank, BNP Paribas, has a market cap of around $70bn. JPMorgan Chase, the US leader, is worth more than $400bn.

Scale is not everything of course – China has the biggest banks in the world in terms of balance sheet – but these state-owned enterprises have relatively low valuations compared to their size. Profitability and efficiency are also vital considerations.

But for-profit scale gives the biggest banks a huge competitive advantage. Take the issue of technology – arguably the battleground of the future of financial services. Bank of America spends more than $10bn a year on maintaining and building its technology. That's almost double the profits made in 2022 by one of Europe's biggest banks, Societe Generale.

Reconsidering regulation

How does Europe reverse this trend? There are no easy answers. Europe's financial markets remain deeply fragmented and, its leading financial institutions would argue, regulated in a way that harms their ability to compete.

A new way of looking at current and future financial regulation is urgently needed. Regulations should be viewed through a lens of what impact they have on the ability of banks to compete and provide the finance the European economy needs.

Equally, Europe's financial service providers need to be realistic about which battles to pick. Many complain about the burden of paying for the build-up of the Single Resolution Fund, a much-needed system for funding an orderly resolution of European banks that run into liquidation. But this backstop is important for global investors in terms of rebuilding trust in the European banking industry. That trust might enable many European banks to reduce the so-called 'management buffer' – the excess levels of capital they choose to carry, above and beyond regulatory requirements – and deploy that freed-up balance sheet to more profitable purposes. At the same time, EU regulators need to reinforce their resolution frameworks, not least by positioning the European Central Bank as a provider of extra liquidity for banks that run into trouble.

22% ↓

In 2007 European firms accounted for 47% of the top 100 global investment funds and the US 51%. By 2022, Europe's share had declined to just 22%, while US funds' global dominance had become entrenched at more than 70%.

The good news on the regulatory front is that, after years of being penalised by Europe's early adoption of the Basel III guidelines, US banks face being forced to raise their capital levels. But European banks could still learn a thing or two about lobbying – the concerted and vociferous criticism of Basel III by US financial services chief executives is a lesson in harnessing the power and influence of the banking system, and could still see the Federal Reserve water down some of its proposals.

Focus on competitiveness

Europe's financial system will remain fragmented on national lines unless or until there is a change in political will at both EU and domestic levels. Fundamental change – in the form of banking and capital markets unions, which provide an EU-wide, cross-border, frictionless financial services regime that matches the US for size and scale – can only come with consensus from the political classes.

There is some hope here. EU President Ursula von der Leyen has made competitiveness a priority of her presidency, appointing Mario Draghi, former ECB chief and Italian prime minister to lead efforts to improve Europe's competitiveness in its economy and financial services. The incoming Belgian presidency of the Council of the European Union, which runs through the first half of 2024, has commissioned another former Italian prime minister, Enrico Letta, to prepare a report on reinforcing the competitiveness of Europe's internal market.

But politicians must also stop viewing financial services as an industry to mistrust, or one to milk. For every step forward, there is still often a step back. Europe needs to transition from a vicious cycle in financial services to a virtuous one. It can be done.

Europe's banks and asset managers will play a crucial role in financing the digital and environmental transformation over the coming years. That opportunity – if grasped by the political and financial sectors – could provide the economic growth that the EU desperately needs.

The current state of play

The last 15 years have seen Europe lose its place among the top ranks of financial services globally.

Key findings

1. European financial services have lost market share in the past 15 years. Among the largest 100 asset managers globally, the share of funds from Europe has dropped to 21.9% in 2022 from 47.1% in 2007.
2. Of the top 50 largest banks by Tier 1 capital, the total market capitalisation of European banks was the highest of any region globally in 2007. It is now approximately half of the value of those in North America and Asia Pacific.
3. Europe is the home of just three of the top 20 largest asset managers globally and three of the largest 20 banks by market capitalisation.

EUROPEAN financial services suffered greatly in the decade that followed the 2008 financial crisis. The industry has been on a surer footing in recent years – despite the challenges that emerged from the pandemic, Russia-Ukraine war and the sharp rise in interest rates. While weathering the storm relatively well, asset managers and banks in Europe have underperformed compared to those in North America and Asia over the past 15 years when considering their relative size in global markets.

For the purposes of this report, we have included European institutions from outside the European Union, such as Switzerland and the UK, in our overall data analysis, but we focus on opportunities and challenges for banks and asset managers within the EU in our written assessments.

Asset management

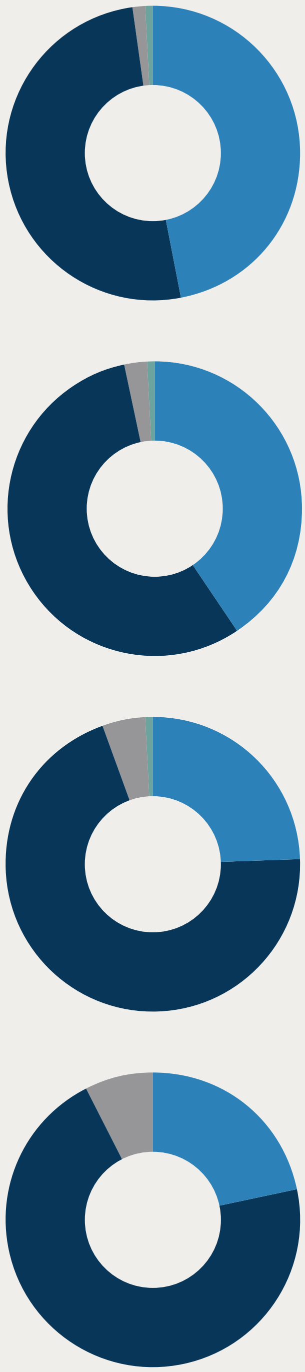
In 2007, there was almost an even split among the largest 100 asset managers in the world between those managed by North American funds (50.9%) and European funds (47.1%). Four of the top 10 were based in Europe at the time: Barclays Global Investors, Allianz Global Investors, Natixis Investment Managers and Deutsche Asset Management.

In 2012, the share for Europe fell to 40.6%. This fell further in 2017 to just 24.5% as the continent was embroiled in the sovereign debt crisis. As of 2022, this share has edged even lower to 21.9%. North American funds have dominated over the past five years and have managed just over 70% of assets of the top 100 managers (Figure 1.1). The share among Asia Pacific fund managers has gradually increased in the past 15 years, though remains below 8%.

The difference in outcomes over this time is stark in nominal terms. The assets managed by European funds within the top 100 was €18.5tn in 2022 – 29% higher than it was in 2007. By contrast the latest data show it is close to €60tn for North America, more than a 300% rise from its level in 2007. →

Figure 1.1. European funds have lost significant market share

Share of top 100 asset managers' AuM by company's region (%)



2007

Europe	47.1%
North America	50.9%
Asia Pacific	1.2%
Other	0.8%

2012

Europe	40.6%
North America	56.1%
Asia Pacific	2.5%
Other	0.8%

2017

Europe	24.5%
North America	70.1%
Asia Pacific	4.7%
Other	0.6%

2022

Europe	21.9%
North America	70.6%
Asia Pacific	7.5%
Other	0%

Source: Investments & Pensions Europe, OMFIF analysis

US investment giants BlackRock and Vanguard are the biggest drivers of the surge in assets managed by North American funds. They are the two largest asset managers globally and have experienced almost a tenfold increase in their AuM since 2007 to approximately €7tn-€9tn each, having taken advantage of the sectoral shift towards low-fee passive investing.

The chief executive officer of an asset management firm we interviewed criticised this approach: 'Is the US market competitive and open? Maybe. Does it come out with the right outcomes? Not really. A push towards cheap market indexation without engagement is detrimental to long-term, sustainable wealth creation.' Nonetheless, this trend has boosted the assets of US managers, especially given the bias towards its domestic market, which has seen significant outperformance since the 2008 financial crisis.

The MSCI USA Index (which covers 85% of the free-float market capitalisation of US equities) has jumped by close to 300% since the start of 2007. The equivalent figures for the MSCI All Country Europe and MSCI All Country Asia indices are less than 30% (Figure 1.2). It's notable that these figures are in the same ballpark as the growth in overall AuM among the largest funds in these regions. The factors behind this period of US exceptionalism include the surge in large-cap tech companies, the favourable regulatory environment and its stronger economic growth, which has fed into higher corporate earnings.

The underperformance of Europe's economy (in nominal terms) is shown in Figure 1.3. While output was close to $14tn in both the EU and US in 2006, it is projected to reach $18tn in the former this year compared to almost $27tn in the latter. In the meantime, the GDP of emerging and developing Asia has surged from $5tn to $25tn. The faster-growing US and Asian economies not only

While output was close to $14tn in both the EU and US in 2006, it is projected to reach $18tn in the former this year compared to almost $27tn in the latter. In the meantime, the GDP of emerging and developing Asia has surged from $5tn to $25tn.

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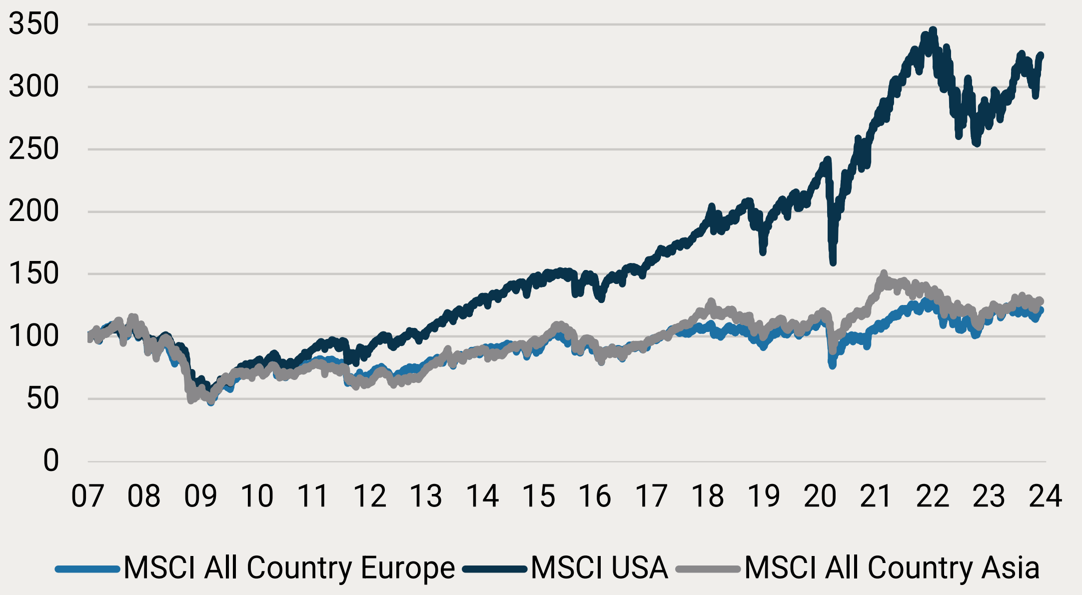
Chief executive officer of an asset management firm

Figure 1.2. US equity exceptionalism

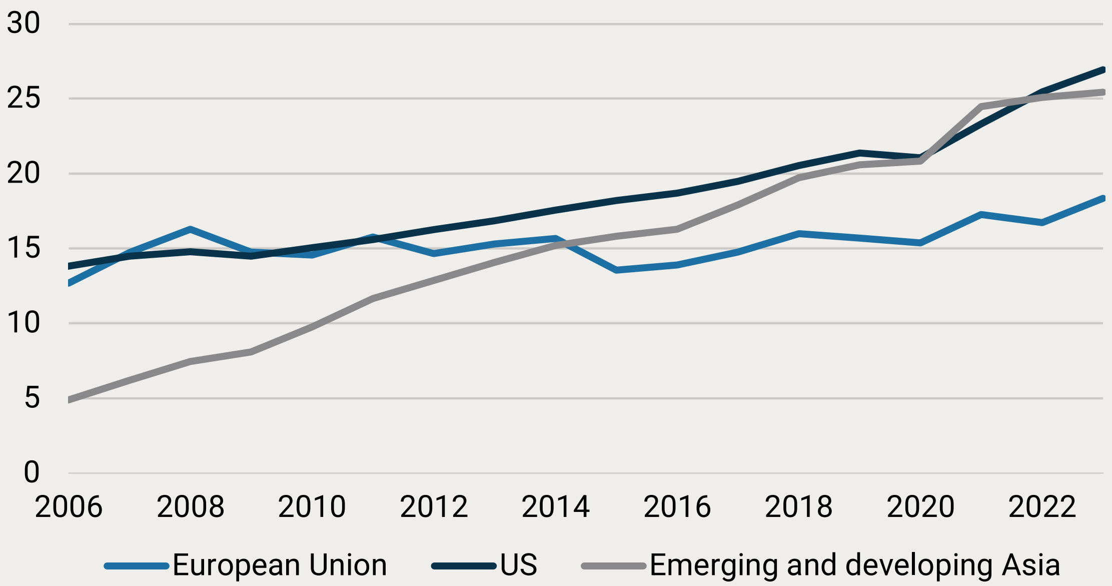
MSCI indices, 1 January 2007 = 100



Source: LSEG Datastream, OMFIF analysis

Figure 1.3. EU has underperformed since 2008

Nominal GDP, $tn



Source: International Monetary Fund, OMFIF analysis

Europe's share of the largest 100 asset managers in the world:

2007:
47.1%

2012:
40.6%

2017:
24.5%

2022:
21.9%

300%

Rise in North American share of assets in top 100 asset managers since 2007

70%

North American funds' share of the largest 100 asset managers globally by 2022

underpinned better performance of corporates and financial markets, they also provided the foundations to generate higher savings and pools of capital for their asset management sectors.

The upshot of this is that Amundi is now the only Europe-based asset manager in the top 10. Only three more – Legal and General, Natixis and UBS – are within the top 20. All other funds in the top 20 are US asset managers (Figure 1.4). As we explain in Chapter 2, the outperformance

Figure 1.4. US funds dominate globally

Largest 20 asset managers by AuM

	Company	Country	Total AuM 2022 (€m)
1	BlackRock	US	8,802,447
2	Vanguard Asset Management	US	7,272,747
3	Fidelity Investments	US	3,973,275
4	State Street Global Advisors	US	3,638,913
5	JP Morgan Asset Management	US	2,410,484
6	Capital Group	US	2,387,599
7	BNY Mellon Investment Management	US	2,140,000
8	Amundi	France	2,063,753
9	Goldman Sachs Asset Management International	US	1,950,032
10	PIMCO	US	1,932,285
11	Legal and General Investment Management	UK	1,690,135
12	PGIM	US	1,532,119
13	T Rowe Price	US	1,442,930
14	Invesco	US	1,416,500
15	Franklin Templeton	US	1,387,060
16	Wellington Management International	US	1,253,497
17	Natixis Investment Managers	France	1,245,459
18	Northern Trust Asset Management	US	1,184,737
19	Nuveen	US	1,117,205
20	UBS Asset Management	Switzerland	1,068,876

Source: Investments & Pensions Europe

of US markets and the growth of low-fee passive investing explain part of the story. Other structural factors have held back European funds including its fragmentation and smaller retail investor base.

Banking sector

Similar to asset managers, European banks have lost ground to their counterparts in North America and Asia since the 2008 financial crisis. The emergence of Chinese megabanks that service the growing domestic economy means that the size of European banks' balance sheets looks much smaller at a global level.

Based on a sample of the top 50 global banks by tier 1 capital, Chinese banks now contribute 49% of the total, up from 15% in 2007. The share among European banks has effectively halved in this time to 22%, from 43% (Figure 1.4). Five Chinese banks are in the top 10: Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China and Bank of Communications. HSBC is the only European bank in the top 10, linked to its relatively strong presence in China.

This trend is mirrored by the evolution of total assets held by banks in the same sample. Those accounted for by European banks have held steady at $25tn over the past 15 years. Those in Asia Pacific surged to above $40tn, but much of this is held in Chinese banks. It's worth noting that both tier 1 capital and total assets are higher in Europe than North America. Interviewees mentioned that European corporates are much more reliant on banks for financing, which makes up around 80% of financing. For the US this share is closer to 30% with capital markets the more common point of access to financing.

While their loan books are larger, European banks have been much less profitable than those across the Atlantic Ocean. The average return on equity of the 11 North American banks in the sample has been close to, or above, 10% since the 2008 financial crisis. It is similar for banks in Asia Pacific, though their RoE has been gradually trending lower since 2011. But the average for European banks has been consistently below 10% throughout this period (Figure 1.5).

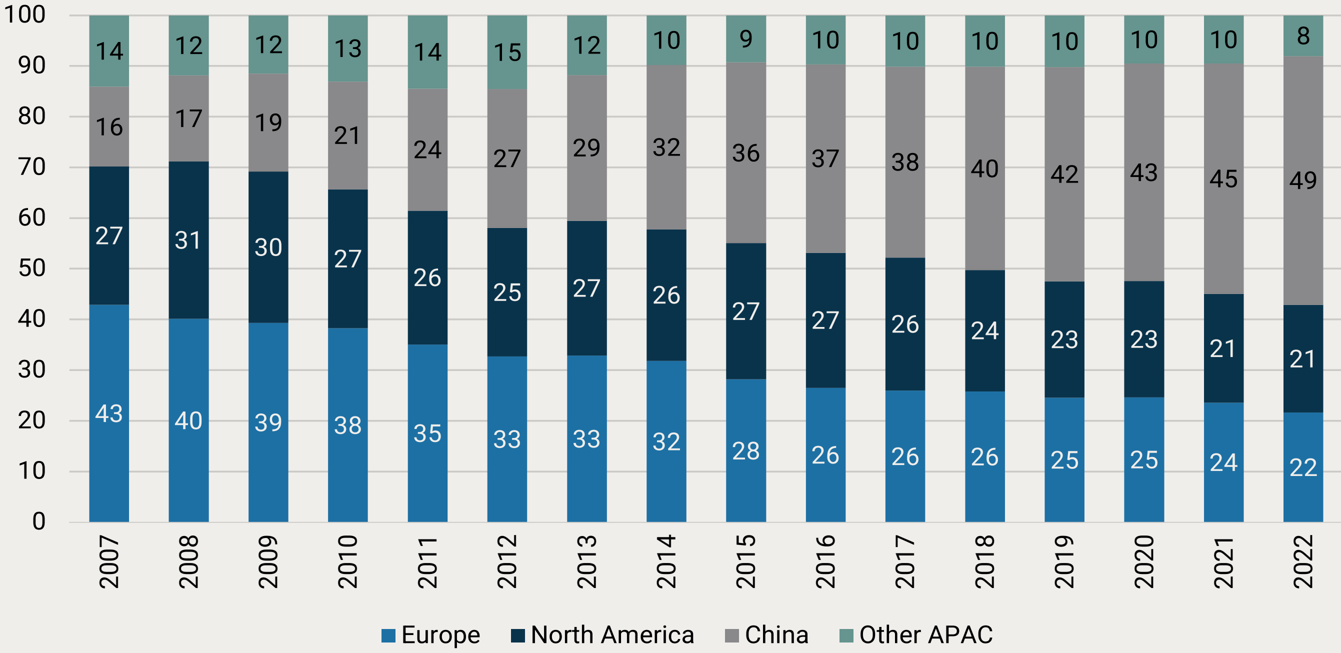
Various factors have held back those in Europe. Until the post-pandemic monetary tightening cycle, ultra-low interest rates had squeezed margins. The weaker macroeconomic performance also contributed to a higher share of non-performing loans. Data from the International Monetary Fund show that the ratio of non-performing loans to gross loans was less than 1% in the US and Canada in 2022, compared to above 1% in Germany and France and close to 3% in Italy and Spain. →

49%

Share of Chinese banks of the top 50 global banks by tier 1 capital, up from 15% in 2007

Figure 1.5. Rise of Chinese megabanks

Share of tier 1 capital by region, %

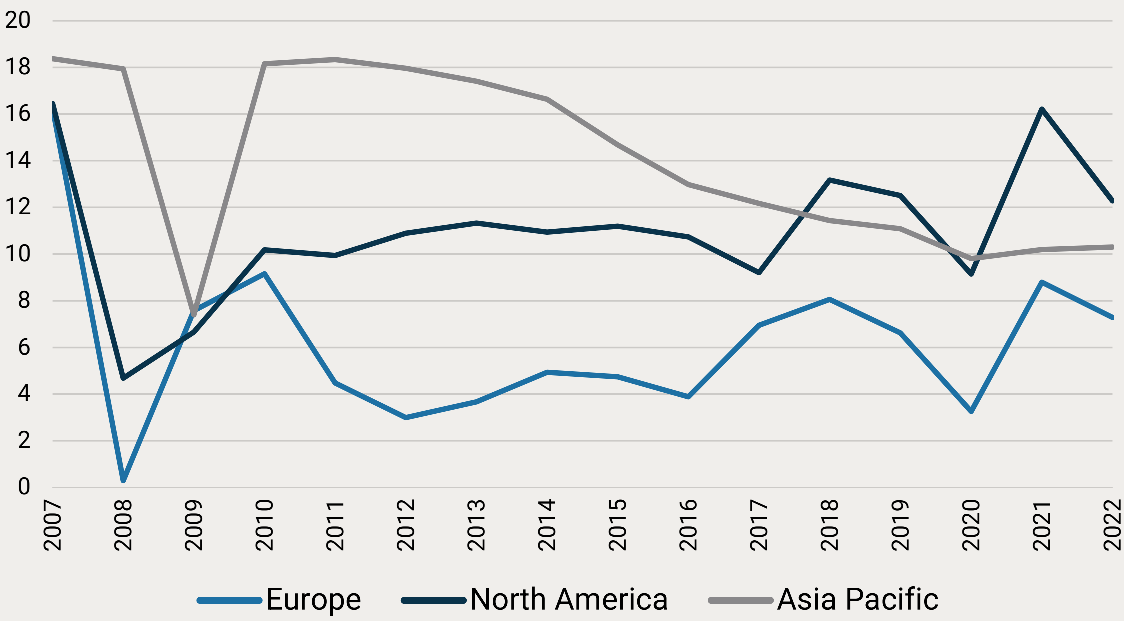


Source: LSEG Datastream, OMFIF analysis
Note: Based on sample of largest 50 global banks by tier 1 capital

European corporates are much more reliant on banks for financing, which makes up around 70% of financing. For the US this share is closer to 30% with capital markets the more common point of access to financing.

Figure 1.6. Weaker profitability of European banks

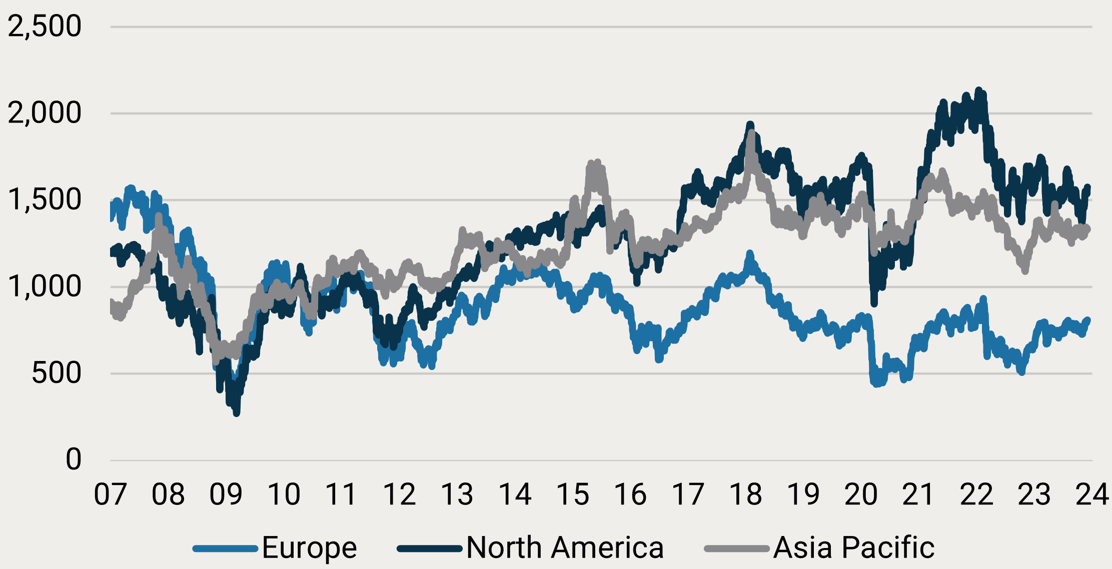
Average RoE of banks by region, %



Source: LSEG Datastream, OMFIF analysis
Note: Based on sample of largest 50 global banks by tier 1 capital

Figure 1.7. European market cap falls behind

Total market capitalisation of banks by region, $bn



Source: LSEG Datastream, OMFIF analysis
Note: Based on sample of largest 50 global banks by tier 1 capital

The higher profitability and relative optimism in North America's banking sector are reflected in higher market valuations there. The average price-to-book ratio for North American banks in the sample has been consistently above 1, compared to below 1 in Europe since 2009. The ratio for banks in Asia Pacific has also dipped below 1 since 2016.

As a result, despite having larger assets and tier 1 capital, the market capitalisation of European banks is significantly lower than in North America. As of 30 November 2023, the value of the European banks in the sample was $811bn. It is almost double that at $1,577bn for North America and $1,334bn for Asia Pacific. It is notable that, prior to the 2008 financial crisis, the value of European banks was higher than in other regions, but it has lagged since the sovereign debt crisis a decade ago (Figure 1.7).

Digging deeper, only four European banks now feature in the top 20 banks ranked by market capitalisation – HSBC, UBS, BNP Paribas and Banco Santander. These four together are worth $385bn, 15% lower than the market capitalisation of JP Morgan alone (Figure 1.8). This underlines that European banks are a far cry from the market leaders they were 15 years ago.

Figure 1.8. European banks are trailing US market capitalisation

Largest 20 banks by market capitalisation

	Company	Country	Market capitalisation ($bn)
1	JP Morgan	US	451.2
2	Bank of America	US	241.3
3	ICBC	China	181.9
4	Agricultural Bank of China	China	163.9
5	Wells Fargo	US	161.9
6	HSBC Holdings	UK	147.5
7	China Construction Bank	China	139.1
8	Morgan Stanley	US	130.2
9	Royal Bank of Canada	Canada	126.7
10	Bank of China	China	117.9
11	Commonwealth Bank Group	Australia	116.3
12	Goldman Sachs	US	111.4
13	Toronto Dominion Bank	Canada	110.6
14	Mitsubishi UFJ Financial Group	Japan	104.7
15	UBS	Switzerland	98.1
16	Citigroup	US	88.2
17	China Merchants Bank	China	83.3
18	BNP Paribas	France	72.3
19	Banco Santander	Spain	67.1
20	Sberbank	Russia	66.8

Source: LSEG Datastream, OMFIF analysis

US leads a fragmented Europe

Structural, cultural and regulatory challenges mean Europe is playing catch up to a much stronger US and a dynamic Asia.

Key findings

1. Since the 2008 financial crisis, weak gross domestic product growth, fragmentation, regulatory burden and an underdeveloped retail investor base have contributed to the loss of Europe's global market share of the asset management industry.

2. Global leadership in sustainable finance standards offer a comparative advantage for European asset managers.

3. Achieving a capital markets union would help to address European fragmentation but it would not overcome the cultural factors that lead to a home bias among investors.

4. A more diversified and sophisticated retail investor base, through financial education and pension reform, could boost demand for European asset managers.

THE weaker macroeconomic and financial market performance of Europe relative to the US explains much of the story for the loss of global market share among European asset managers. But more long-standing structural issues have also contributed to this decline – namely fragmentation and a relatively unsophisticated retail base.

Splintered capital markets hold back Europe

Fragmentation in capital markets was mentioned by several interviewees as a hurdle to cross-border investment and building scale. That's particularly the case as investors have to navigate divergent regulations in different European jurisdictions.

Different rules persist in European Union member states regarding initial public offering processes, disclosure requirements for publicly listed companies, prudential rules for securitisation, tax, insolvency procedures, custody, clearing and other elements. As noted by one interviewee from Europe, 'In terms of anti-money laundering and compliance, there are still many national rules. If you want to employ staff, labour rules are very national.' They added that 'Brexit didn't help… Europe was less fragmented when London was a major financial hub within the single market.'

That said, there have been rules introduced to improve cross-border investments in the EU. The Undertaking for Collective Investment in Transferable Securities was introduced in 1985 and updated in 2011. It allows for the harmonisation of collective investment schemes (in liquid assets) among EU member states. A similar framework has been introduced for alternative assets. The net assets of UCITS and alternative investment funds stand close to €20tn according to data from the European Fund and Asset Management Association, reflecting their popularity among investors in Europe.

Even so, there are other barriers that have splintered EU markets. Cultural and national boundaries often lead to home bias among investors. This is where investors favour domestic investments and opt to manage their assets with domestic asset management firms. For example, the 2022 annual report of Amundi (Europe's largest asset manager) showed that 46% of its assets under management are in France – where the company is domiciled. These preferences are linked to longstanding commercial relationships within and between countries with similar histories, cultures and languages. In some cases, home bias may be exacerbated by national authorities tacitly condoning it for domestic economic development purposes.

Home bias can also be understood as a risk-mitigation strategy. One interviewee from a European asset manager reflected, 'Home bias – you see it everywhere. And it is not very rational with regards to basic diversification rules of asset allocation. But everywhere – Latin America, the US, Europe – you have the feeling that in uncertain times, you can always have a better settlement than with peers and counterparts in a home country than with peers in another country.'

While the home bias phenomenon is not unique to Europe, the EU's configuration of individual nation states means that European markets are naturally more splintered than the US. 'Investors don't see the EU as a union when there are different expectations in Germany, Italy and France,' one interviewee from the asset management industry explained.

Whether due to policy or culture, there is a more unified domestic capital market in the US. An interviewee from an American asset management firm operating in Europe mentioned that 'The US uses the same everything [custodians, asset servicers, venues], which is partly why it is efficient and why capital moves much more freely.' This has enabled Wall Street to benefit from agglomeration effects and build scale as there is 'concentration, knowledge sharing and healthy competition' among financial institutions in the US. One roundtable participant from a European financial markets body mentioned that this allowed US firms to benefit from economies of scale, which provided a springboard to expand globally. By comparison, European players face a smaller and more fragmented home market, which makes it hard to scale up both domestically and globally.

It has been especially difficult for European firms to penetrate the US market. Because the US market boasts 'long-time established players', one European asset manager explained, 'it is impossible to compete with US asset managers on US clients from the outside, you need to be inside and located there'. Moreover, 'there is a premium in terms of market share for those with a long track record of →

'Brexit didn't help… Europe was less fragmented when London was a major financial hub within the single market.'

An interviewee from Europe

20-40 years; there is a lower premium for those with a 10-year track record', which is the case for many European asset managers operating in the US.

Though much more fragmented than the US market, European asset managers have built more scale than in Asian markets. Even Japan, a country with relatively large and deep financial markets, has struggled to achieve scale. An interviewee from a European asset management firm operating in Asia Pacific observed that 'Most of the asset management companies in Japan are affiliates of large global firms,' and a lack of scale of capital markets persists within markets throughout the region. This is linked to historical and organisational factors as big financial institutions did not previously consider asset management as a standalone industry but a service alongside loans and mutual funds (which have a narrower investment focus).

13% vs 38%

In 2022, just 13% of US household financial assets were held in currency and deposits, versus an average of 38% for EU households.

Unsophisticated retail base

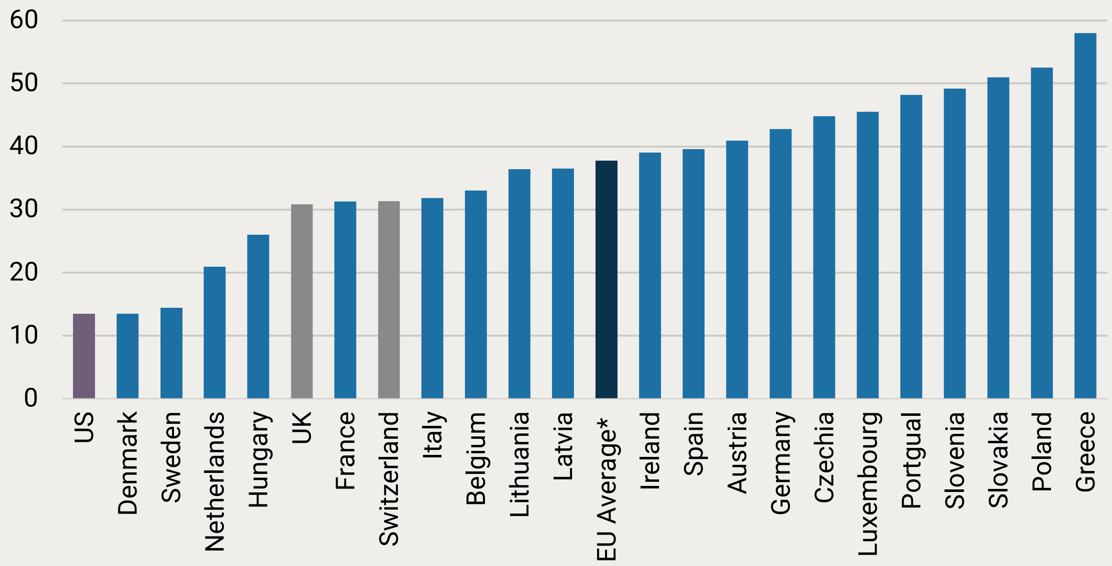
The comparatively small and less sophisticated retail investor base in Europe has also contributed to the relatively stunted trajectory of the European asset management industry. Retail investors in Europe are less sophisticated than their US counterparts. Data from the Organisation for Economic Co-operation and Development show that, in 2022, just 13% of US household financial assets were held in currency and deposits, versus an average of 38% for EU households (Figure 2.1). Correspondingly, data from the European Capital Markets Institute show that households' financial assets in investment funds or equities (listed and unlisted) total 30% in the EU, compared to 47% in the US. This entails less retail demand for asset managers in the EU.

Cultural factors explain part of this disparity. The US is seen as having a more entrepreneurial and risk-seeking culture than Europe, which leads to more diversified investments. Similarly, in many Asian markets, interviewees suggested there is more risk-taking although the culture of long-term investing has yet to be embedded. An interviewee from the Asia Pacific asset management industry stated 'European markets are more mature. Asia is still very young in terms of investments and the sophistication is still not there. It takes longer to get people to invest and stay invested, despite the growth of the population and wealth.' The pool of those investing and remaining invested long term is smaller compared to Europe.

Digitalisation creates growing potential for Asian investors to become more advanced, and potentially leapfrog Europe. The same interviewee noted that, in Asia, 'We see a new generation of investors coming in, who are looking into exchange-traded funds, digital currencies, cryptocurrencies.' Digital innovation is helping reduce fees and barriers to entry for clients, which is especially helpful in Asian markets with less mature investor bases, making fintech innovation a key area of interest for

Figure 2.1. EU retail investors less diversified than in US

Share of total household financial assets held as currency or bank deposits, %



Source: OECD, OMFIF analysis
Note: No data available for Bulgaria, Croatia, Cyprus, Malta or Romania

regulators and market participants to develop.

Policy has historically helped to inform an investment culture. One interviewee said the US has fostered a capital markets culture since the 1930s, which was 'explicitly supported by government schemes like 401k savings programmes'. This was echoed by another interviewee based in Asia Pacific, who stated 'The 401k is a great example of encouraging retail investment. In Hong Kong and Singapore they have something similar. This builds discipline, and the governments have great programmes to help manage that.'

The risk-seeking cultural differences across regions is underpinned by institutional frameworks. 'The US has always been more entrepreneurial than Europe, partly because European citizens have more demand towards governments to provide safety… whereas in the US, there is a deep societal preference towards the option to make money,' explained an interviewee from Europe. Another interviewee from the asset management industry went further: 'In the US, savings are built and managed over a long period of time because you don't have long-term plans for health, education and retirement, which are more intermediated by the government.'

These societal and cultural differences also impact the scope of capital markets activity and the growth of the asset management industry. As an interviewee from a European asset management firm explained, 'Regarding the balance sheet, the AuM we have in Europe reflects the allocation of household savings, and we see the difference in asset allocation with other parts of the world. Clearly in Asia and in the US, you see much more appetite for riskier assets from retail investors than in Europe, because you need to save and manage plans over the long term, so you take risk. This is not just because they like to "play", it is due to economic institutions and a different setup of social safety net and collective political choices.'

Leadership in sustainability

Though Europe faces a series of structural, institutional and cultural factors that have hindered the growth of the asset management industry since 2008, one area where European funds have a comparative advantage is in sustainable finance.

The frameworks and standards in sustainable finance developed by the EU were seen as an advantage for Europe –to varying extents – by nearly everyone we interviewed. One interviewee from the asset management industry stated, 'Europe is more advanced because the regulation is in place, it is clearer and there is more political agreement around it.' European domiciled funds are able to include environmental considerations as material to investment decisions, while US fiduciary law means funds cannot do so where the explicit focus is on returns above all else. A representative from a European asset manager noted, 'European regulation allows for sustainability to be included as a factor as a material risk into investment decisions, ipso facto allowing for long-term considerations.' Taking this long-term approach and incorporating environmental, social and governance factors should confer higher returns, in their view.

Europe's leadership in ESG standards and regulation gives the European asset management industry an edge to introduce new innovations and build scale globally. An interviewee from the asset management industry said European asset managers can try to 'differentiate' themselves. 'What we can bring is an extra financial angle, like climate ETFs and products that are more advanced and innovative than in other geographies.'

Asian asset management firms are also becoming more interested in ESG investing and are looking to Europe for knowledge acquisition. The interviewee continued, 'In Asia there is more and more appetite for ESG, so it can be seen as an advantage to European asset managers. Europe is more advanced in terms of methodology on what added value to provide besides pure financial performance.' Another interviewee based in Japan mentioned 'Japanese firms can learn from European companies on how they do sustainable investment.' They added that European frameworks 'are state of the art. Our task is importing knowledge transfer for sustainable finance.'

Despite Europe's leadership in sustainable finance, there are some factors that may constrain its advantage. One factor is fiscal support for the energy transition. More specifically, the US Inflation Reduction Act – a package of subsidies and tax incentives designed to mobilise private investment into domestic renewable energy production – is likely to prop up sustainable sectors in the US. There is less fiscal support in Europe, demonstrated most notably by the rigid enforcement of the debt brake by Germany's constitutional court, which constrains public funding for green industries. This could hamper relative returns for sustainability-focused investments in Europe, with implications for the asset management sector.

Another drawback is that the EU's sustainability regulation adds a layer of friction for asset managers. One interviewee stated that, 'We go to a lot of Network for Greening the Financial System events and we hear consensus that the European Commission's approach to environmental regulation to be enforced by financial firms is "heavy". How many pages can an asset manager read before investing? As an investor, why would you voluntarily adopt the EU standards if you weren't mandated to?'

This feeds into a broader point that asset management regulation could be seen as overly →

'These [ESG] standards are not global, so they will not apply to all equally, but progress on this front will protect the industry and our clients from greenwashing and all in all will make sustainable finance progress.'

An interviewee from a European asset manager burdensome in Europe. The Markets in Financial Instruments Directive II, implemented in 2015 to harmonise regulation and supervision throughout European financial markets, has added to reporting and disclosure requirements. These regulations were determined by the European Securities and Markets Authority to be overly costly for financial institutions in a consultation paper published in 2022.

That said, the general consensus is that the EU's regulation is a net positive. 'The IRA is a huge subsidy allowing American industry to grow, but on the investment side, you cannot create a fund within the current 40 ACT structure that says "we will only invest in new sources of low carbon" unless you state that we think it will make money, because American regulation does not allow it,' explained the chief executive officer of an asset management firm. 'European funds are the only ones who can invest sustainably, US funds cannot. Asian funds can go into sustainability, but they are also focused on the short term.'

The EU taxonomy can help to address greenwashing concerns. 'These standards are not global, so they will not apply to all equally, but progress on this front will protect the industry and our clients from greenwashing and all in all will make sustainable finance progress,' explained an interviewee from a European asset manager. 'With regards to competition, players who miss this change will lose advantages.' Accordingly, the credible and consistent regulation in Europe not only offers protection, but a chance for the asset management industry to evolve.

'Europe is fundamentally always going to be more fragmented. They all speak different languages.'

An interviewee from a US asset management firm operating in Europe

Need for capital markets union

While leading in sustainability offers certain advantages to Europe, more can be done to unlock the potential of the asset management industry on the continent. Conducive policies and better mobilisation of existing capital will be crucial, especially since it's unlikely that the sector can rely on a turnaround in economic fortunes to bolster its performance.

Establishing a capital markets union to boost the asset management sector was mentioned in various conversations with industry experts. Since the CMU agenda was introduced in 2015, little substantive progress has been made. What have been the barriers? 'The usual suspects of all financial services regulation: supervision, tax, company law, accounting and insolvency,' explained one interviewee from a European regulatory body. 'This is what we understand, from speaking with the industry, has been hindering progress.'

Political will for a CMU may be catching up with industry interest. Fiscal policy is becoming restrictive in much of Europe following years of pandemic-era stimulus and energy spending, which leaves little room for public financing of major investment projects. 'Fiscal space is shrinking in most member states – or it was never there. So, the reach for public investment is limited. At the same time, we want to be successful in the green and digital investment opportunity. We need to find the funding for these agendas,' explained an interviewee from a European regulatory body.

The emphasis on building capital markets was echoed by a representative from a central bank in the EU. 'If corporates don't consider issuing corporate bonds but go straight to banks, that is not sufficient to fund the greening of the economy. The amount of capital needed is way too large to be handled only by banks. And banks are not the optimal financiers of that project, which is high risk-high return, with a lot of technological uncertainty. This is typically not financed by bank loans but by debt financing.'

As a result, the need for greater capital to finance the digital and sustainable transformation in Europe seems to be paving the way for deeper and more harmonised capital markets. Following on from the 2021 CMU package, the EU Council and European Parliament reached a provisional agreement in mid-2023 to update regulatory framework for AIFMD and UCITS to enhance integration of asset management markets. Otherwise, Next Generation EU has enabled the issuance of a significant volume of debt at the European level. Beyond providing a much-needed safe asset denominated in the euro, the NGEU facilities provide crucial funding for members states' digital and sustainable transformations. The success of the joint European debt instrument is helping to lay the groundwork for the deepening and further integration of European capital markets.

That said, a CMU would not be a silver bullet. The home bias phenomenon with societal differences makes it hard for financial institutions to operate across a more heterogeneous economic area than in the US. 'Europe is fundamentally always going to be more fragmented. They all speak different languages,' declared one interviewee from a US asset management firm operating in Europe. The limitations of the more fully formed banking union highlight the barriers to full integration of the European capital market that go beyond regulation. While not the ultimate solution, a CMU would still be a step forward.

Mobilising European savings

Given Europe's weak demographic trends and growth outlook, finding ways to better use existing savings and demand for asset managers will be key to boost the industry. Growing capital markets in Europe will also require a larger demand base. 'We need to think about how to create these products and make them easily available for potential issuers, on supply side – but we also need demand, who should buy these instruments?' reflected an interviewee from a central bank in Europe.

There are three possible avenues for broadening the retail investor base to diversify and deepen the European market. The first is financial literacy campaigns, such as the Netherlands' Money Wise Platform. Programmes here include financial education in schools, pension awareness campaigns and workshops and support for employers to prevent financial problems among their employees. But such initiatives could take many years to have a meaningful impact. One interviewee from a European regulatory body noted that, while initiatives like the Dutch platform are positive, 'building financial literacy takes a while… some policies would have a direct impact, while some have to be built and would take longer to deliver.'

Second, diversifying pension schemes offers another opportunity to increase demand for actively managed assets. Though savings rates in Europe are high, a significant proportion of pensions are under a defined benefit scheme, which is strictly regulated in many EU member states, leading to a relatively high concentration of fixed income assets. A representative from a major US asset manager pointed out there are 'big pools of capital in Europe but they are fragmented. They are largely held with pensioners, but there are restrictions on whether they can be invested in risky assets.'

Moving to a defined contribution pension system would mobilise investments in a broader range of assets. Accordingly, as mentioned in the European Central Bank's May 2021 bulletin, 'a shift towards DC products could increase the demand for equities' and 'support further growth of the investment fund sector'. Progress on this front varies by country. The process of shifting to DC pension schemes is currently underway in the Netherlands. 'The UK is far ahead of most of Europe but still more defined benefit than defined contribution assets than in the US,' noted an interviewee from a major asset management firm.

Another initiative to mobilise pension investments is the Pan-European Personal Pension Product. Formally introduced in 2022, this vehicle is available to all EU citizens to provide greater investment choice and products outside of national boundaries. This aims to complement national pension schemes while providing the start of a unified European pension market. This scheme is still in its infancy. The central register of the European Insurance and Occupational Pensions Authority shows only eight PEPPs have been set up, all from Slovak firm Finax, to serve the central and eastern Europe market. While there is a long way to go, these pension reforms offer a chance to mobilise European pensions and boost demand for asset managers.

Third, products can be better targeted to mobilise retail investors. There are positive signs on this front with recent amendments to the legislation for European long-term investment funds. ELTIFs were introduced almost a decade ago to offer new investment vehicles for institutional and retail investors to finance long-term projects across the EU, including renewable projects. However, as noted by the EU Council in late 2022, 'since the adoption of the regulation in 2015 only a few ELTIFs have been launched due to significant constraints in the distribution process (demand-side) and stringent rules on portfolio composition (supply-side)'.

'Asia is still very young in terms of investments and the sophistication is still not there. It takes longer to get people to invest and stay invested, despite the growth of the population and wealth.'

An interviewee from the Asia Pacific asset management industry

The legal amendments to ELTIFs published in the Official Journal of the European Union, due to take place in early 2024, aim 'to enhance the flexibility of asset managers to invest in broad categories of real assets'. These include changes to widen the net of retail investors that can buy ELTIFs. Previously they had to invest a minimum of €10,000 and they could invest up to 10% of their total portfolios in ELTIFs. These rules created 'a significant obstacle to investments in ELTIFs for retail investors' so have been removed. Similarly, restrictions have been eased on the assets that can be incorporated within ELTIFs. Previously eligible real assets had to exceed €10m but this requirement has been removed. These changes could kickstart greater investment flows in ELTIFs, allowing more investors to diversify their portfolios with long-term products and increase the scope for asset managers.

There could be other innovations to mobilise investors. Government bond issuance could specifically target retail investors, for example. Several European debt management offices have ramped up the issuance of retail government bonds. Belgium, Portugal and Italy are channelling more of their funding towards retail investors, while Hungary leads the EU with retail investors accounting for 20% of its funding. Market standardisation across the EU would help to attract cross-border retail investment. 'Diversification is a cultural issue that goes hand in hand with financial literacy. These are deep structural issues, and not something you can solve with regulation,' said an interviewee from a European central bank. 'But a kind of market standardisation could help by reducing complexity for the consumer on the retail side.'

A reversal of fortunes

Europe's banks have fallen far behind the biggest US competitors, but there are signs the gap can be narrowed.

Key findings

1. European banks now have stable capital bases and are returning to improved profitability, but a lost decade has seen them fall far behind leading US banks in terms of scale and global diversity of business.
2. The lack of a proper single market for banking in the European Union makes it hard to build scale on a similar level.
3. Regulators need to consider the impact of new directives on banks' ability to compete both throughout Europe and internationally. US banks are less likely to benefit from a more benign regulatory playing field as they are forced to adopt the 'Basel endgame'.
4. A change in political will is essential to giving banks a platform to help Europe through the green and technology transitions.

BANKING is often described as the world's most competitive industry. In that competition, JP Morgan is almost certainly the current global champion. JP Morgan's market capitalisation at the end of October 2023 stood at $410bn, making it the 17th most valuable company in the world.

Compare that to the biggest banks in the four largest economies of the European Union. France's BNP Paribas has a valuation of $70bn; Spain's Santander is valued at $58bn; Italy's Intesa SanPaolo at $46bn; and Germany's Deutsche Bank at $22bn (Figure 3.1). At $196bn, the combined valuation of these four banks is less than half of JP Morgan's. BNP Paribas ranks as the world's 188th most valuable company.

In terms of profitability, the comparison is a little brighter. JP Morgan returned net profits of $37.6bn in 2022. BNP Paribas made €10.7bn, Santander €9.6bn, Intesa SanPaolo €4.4bn and Deutsche Bank €5.7bn – a combined profit of $32.7bn. This suggests that, in investment terms, global fund managers ascribe less value to the profits of European banks compared to their biggest American peers.

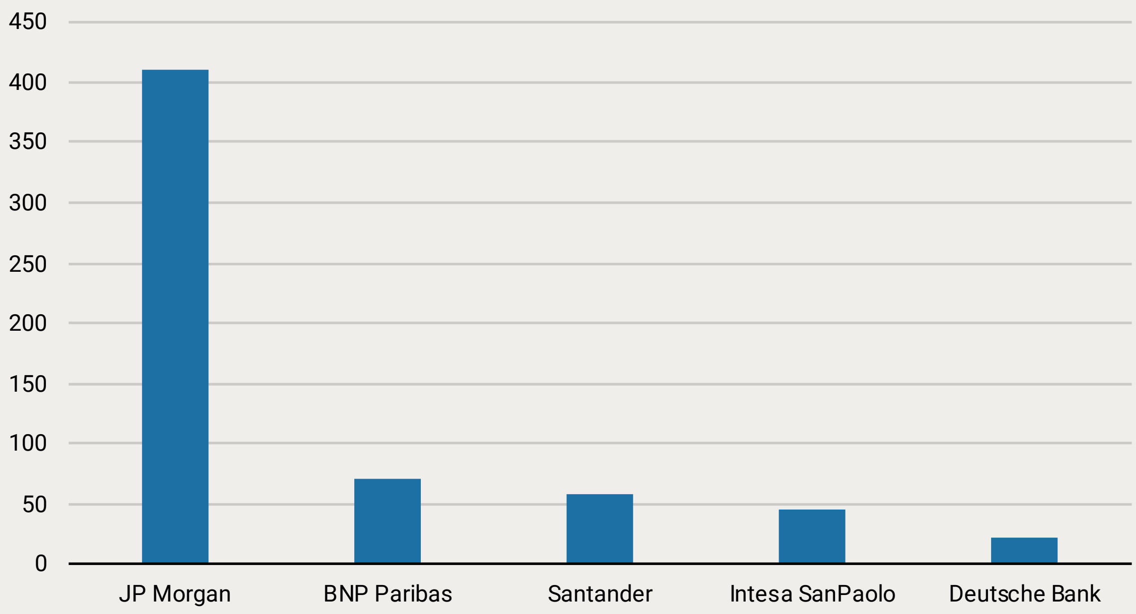
Another key indicator of competitiveness is scale, measured by size of assets. Bank of America, the second biggest US bank, had an asset base of $3.15tn at the end of Q3 2023. The combined balance sheet for these four European banks was $6.75tn, more than double that of BofA.

At the end of Q1 2023, there were 11 banks headquartered in the US with a balance sheet greater than $500bn, according to S&P Global Market Intelligence. There were 17 banks headquartered in the EU with an asset base of at least that size (plus another five headquartered in the UK and one in Switzerland). While there are plenty of European banks that have the scale to compete with their US counterparts, there are very few that can be counted as competitive on a global scale.

According to Christian Sewing, chief executive officer of Deutsche Bank, 'Europe needs a more efficient and globally competitive financial system – including much deeper capital markets and banks that have the capacity and expertise to provide their clients with access to these markets.' The trend has been going in the opposite direction for years, he said. 'There are not even a handful of European banks that are globally competitive. →

Figure 3.1. Europe's leading banks fall way short of JP Morgan

Market capitalisation, $bn



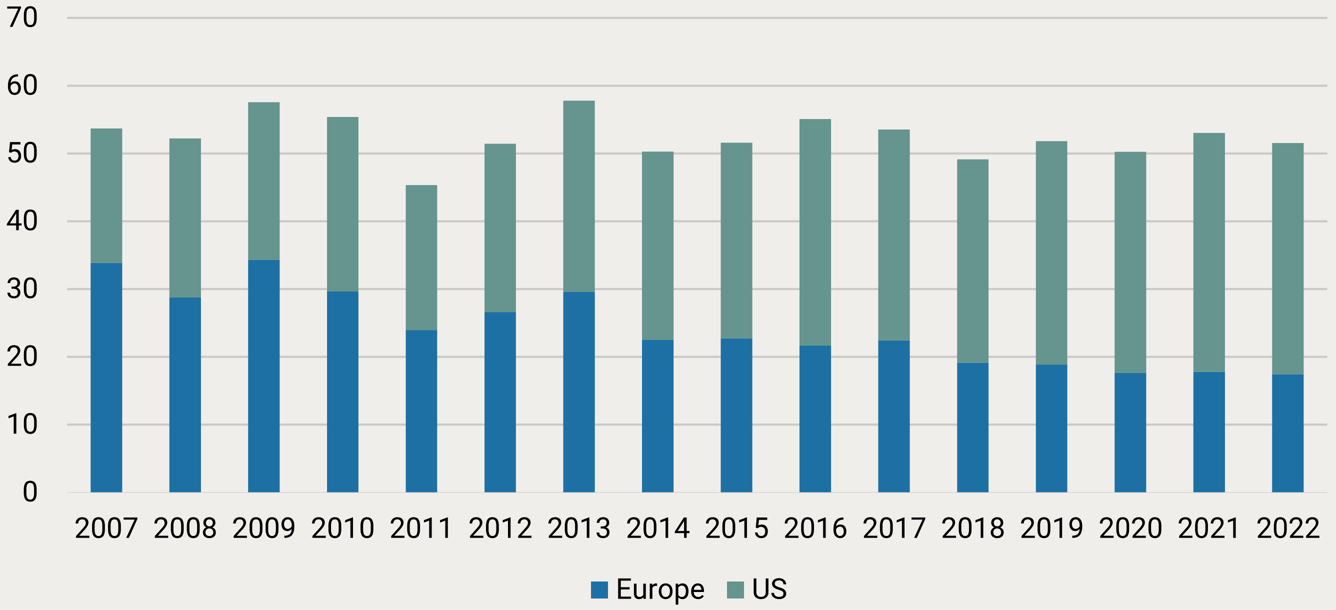
Source: Bloomberg, OMFIF analysis

$196bn

the combined valuation of the biggest banks in Europe's four largest economies is less than half of JP Morgan's.

Figure 3.2. European banks' steady decline

Share of global market cap, %



Source: LSEG, OMFIF analysis

And these banks are falling further behind the global market leaders. We need regulation that does not restrict banks further but also keeps an eye on their competitiveness.'

A lost decade and more

The aftermath of the 2008 financial crisis hit US banks first, but it hurt European banks harder and for longer. Three main issues have held European banks back for the past 15 years: the impact of regulatory frameworks; low or negative interest rates in a protracted period of quantitative easing and anaemic economic growth; and the fragmentation of the European banking system.

From the 1980s to 2008, European banks ran models that did not properly take into account funding, liquidity and gross leverage. They boosted their balance sheets on the modelled assumption that default rates and non-performing loans would remain low. The asset side of their businesses swelled, while their risk capital remained low. In the 1990s there was a long list of European banks that were globally significant financial institutions. The impact of the 2008 financial crisis and the impact of what became known as Basel 2.5 completely changed that and forced European banks to recalibrate their risk models and exposures.

The impact of subsequent crises on the global heft of European banks can be seen clearly over the last 15 years. According to data from Bloomberg, in 2004, European and US banks each represented about 41% of the global banking industry in terms of market capitalisation. By 2009, US banks accounted for just 23.2% of global banking value, while European banks were holding steady at 34.3%. But by 2014, US banks were on the path to recovery and then dominance at 27.8%. This share reached 34.1% in 2022. Meanwhile, European banks, fully immersed in a low-growth euro area economy and struggling to adapt their business models to the new reality, represented just 22.5% of the global market cap by 2014, which fell to 17.5% in 2022 (Figure 3.2).

Around the same time, European banks had to deal with two new hurdles to profitability: the introduction of a leverage ratio and the collapse in net interest margins – a core driver of revenues.

The impact of low interest rates was particularly hard on European banks. At the start of 2014, 10-year interest rates in the US and Europe were comparable at around 2.7%. Since then, long-term rates in Europe have typically lagged US rates by at least one percentage point. US long-term rates never dipped into negative territory, but QE saw European banks contend with a period of negative rates. Their decision not to pass on those negative rates to customers hit profitability.

So did the nature of a European banking market that typically retains loans on its balance sheet. According to the European Central Bank, mortgage loans in Europe account for 44% of aggregated bank balance sheets, whereas the vast majority of mortgage loans in the US are securitised. Overall, around 90% of household financing in Europe is funded by bank loans, whereas 73% is funded by the capital markets in the US, according to data from Eurostat. For corporate loans, 30% are funded in the capital markets in Europe, versus nearly 80% in the US. Therefore a reduction in NIMs has a proportionately detrimental impact on European bank profitability versus their US peers.

US banks had been forced to comply with a leverage ratio since the early 1980s, set at a national level of 4%. For European banks this became a reality only in 2013 where, under the provisions of Basel III, a minimum leverage ratio requirement of 3% was established. In contrast to risk-based capital requirements, the leverage ratio is based on gross exposure levels, rather than risk weights.

Both the EU and the US have since brought in supplementary leverage requirements. For global systemically important banks in the US, this is set at 5%; in Europe, the supplement applies to all banks supervised by the ECB. In 2012, the average European bank leverage ratio was around 2.5%, compared to 4.2% in the US. By 2022, European banks stood at 5.3% compared to 5.9% in the US.

This matters because the leverage ratio can limit the usability of capital-based buffers. According to a 2021 European Systemic Risk Board analysis, remaining in compliance with the leverage ratio implies a drop of about 2.2% of risk-adjusted capital requirements.

Capital imbalances

As recently as 2013, European and US banks had almost identical common equity tier 1 ratios, according to data from the Basel Committee. In response to the 2008 financial crisis and Basel III requirements, banks in both regions steadily increased capital from averages of just 5% in 2011. Material divergence began in 2018, when European averages rose by a percentage point and US averages fell by a similar amount. Since then, the gap between European and US CET1 ratios has continued to grow, and now averages around three percentage points.

The much hoped-for regulatory level playing field remains elusive. Banks in the EU have different capital requirements to their US counterparts. While both have minimum Pillar 1 capital requirements under Basel III standards (set at 4.5%), and both have countercyclical capital buffers, other requirements vary.

European banks have a capital conservation buffer, set at 2.5% according to Basel III, designed to avoid breaches of minimum capital requirements during periods of stress. They also have additional capital requirements based on individual risk levels. US banks have a single stress buffer requirement, also set at 2.5%. European banks have been faced with a G-SIB or O-SIF buffer based on systemic importance, as well as a systemic risk buffer determined at a sector or institutional level. US banks simply face a G-SIB surcharge. EU supervisors are much more likely to use their discretion to penalise poor governance practices or other business risks through higher capital charges.

In addition to capital requirements, European banks are more likely than their US counterparts to voluntarily introduce additional levels of capital to offset potential risks such as changes to regulatory requirements or the potential difficulty or cost of raising capital – the so-called management buffer. According to the ECB, from 2017-22 EU banks held an additional 4.1% on average, compared to just 1.9% for US banks. This also reflects the lower levels of transparency on capital requirements for individual banks in the EU.

However, there are encouraging signs that these regulatory headwinds are receding – not because of any relaxation of standards in Europe, but because of a stricter approach from US supervisors following the collapse of Silicon Valley Bank and the forced takeover of First Republic Bank in 2023. US bank leaders have been quick to complain about the potential implications of what has become →

'There are not even a handful of European banks that are globally competitive. And these banks are falling further behind the global market leaders. We need regulation that does not restrict banks further but also keeps an eye on their competitiveness.'

Christian Sewing, chief executive officer, Deutsche Bank

Figure 3.3 European financing dominated by bank lending

Share of total financing, %

	Bank loans	Capital markets financing
US households	17%	73%
European households	90%	10%
US corporates	20%	80%
European corporates	70%	30%

Source: Eurostat

'You tend to focus on your best businesses because the cost of banking goes up every day, whether it's from technology or regulation. There is no room to be in businesses where you lack critical mass or profitability. All European banks came to the same conclusion in their own way.'

Jean-Laurent Bonnafé, chief executive, BNP Paribas

known as the 'Basel III endgame'.

B3E will fundamentally alter the regulatory capital regime for US banks by the proposed compliance date of 2028, and apply to banks with $100bn or more in assets. It is expected to end banks' ability to use their own internal risk models to determine how much capital should be held against lending activities. It will also add new requirements for determining how much capital banks should hold for their trading activities to mitigate market risk, and incorporate standardised approaches to operational risk, based on banks' business activities and historical operational losses. This could particularly impact institutions with higher exposure to non-interest fee income such as investment banking or credit cards.

Randal Quarles, former senior regulator at the Federal Reserve, has estimated that full implementation of B3E could raise capital requirements by 20% for some large US banks. This would dramatically reduce the long-term gap with European banks. Jamie Dimon, chairman and CEO of JP Morgan Chase, has argued that a fully-implemented B3E would make US banks 'uninvestible'. He said that 'operational risk capital is based on a model that makes no sense', and posited that the US plan as written would mean JP Morgan having to hold 30% more capital than a leading G-SIB European bank due to the repurposing of what constitutes risk-weighted assets.

EU-supervised banks are generally more advanced in their readiness for Basel III. According to a report published by the European Banking Authority in September 2023, based on a monitoring exercise of 157 banks at the end of 2022, European banks would need only €600m of extra capital to meet requirements by the 2028 deadline.

A chance to close the gap?

Large European banks are entering a more benign period. Throughout 2023, their profitability has been rising, driven in large part by the rise in euro area interest rates and helped by a stable capital base.

In its third-quarter earnings statement for 2023, Deutsche Bank reported a rise in net interest margins in its corporate bank to 3.94%, compared to 2.64% in Q3 2022; and a rise from 1.91% to 2.28% over the same period in its retail bank. Deutsche Bank was on track to record its best full-year revenue results for seven years.

For the third quarter of 2023, Santander posted strong results driven by a year-on-year rise in net income interest of 16%. On average, leading European banks are now posting returns on equity in the double digits for the first time in more than a decade, according to research from Bank of America.

But how will these European banks deploy their regained profitability? Santander announced in October a 39% increase in its dividend and plans for a further share buyback that will mean the Spanish lender has bought back 9% of its shares since 2021. This will surely benefit the bank's share price and close the valuation gap between its price-to-book value compared to US-based peers. But it also suggests it sees limited opportunities to grow, either organically or via acquisition.

UniCredit, until recently Italy's only G-SIB, has gone even further. It will have returned €5.75bn to shareholders through dividends and buybacks in 2023, on the back of expected profits of €6.5bn, having returned €5.25bn in 2022. In other words, its management is telling the markets: we don't see many areas to deploy our profits for growth, so instead we will boost our share price.

It's a similar story at BNP Paribas. The biggest bank in the euro area posted a 12.7% return on tangible equity for the third quarter. But it is close to completing a €5bn share buyback programme for 2023, which is equivalent to roughly 7% of its market capitalisation, paid for by the sale of its biggest non-European asset. BNP Paribas remains one of the most globally diversified European banks, but in 2023 sold its US-based operation Bank of the West for $16.3bn. It followed other European banks out of the US market, such as BBVA and HSBC which exited in 2020 and 2021, respectively.

Jean-Laurent Bonnafé, chief executive of BNP Paribas, said in an interview in the summer of 2023 that 'the past cycle has been much more about organic growth than the previous one. You tend to focus on your best businesses because the cost of banking goes up every day, whether it's from technology or regulation. There is no room to be in businesses where you lack critical mass or profitability. All European banks came to the same conclusion in their own way.'

That conclusion increasingly looks like platforms that can be stretched throughout the European banking area – such as investment banking, trade finance, cash management and possibly wealth management – which could be built into global platforms with a strong European foundation.

The gap between European and Asian banks is harder to quantify. The balance sheets of the biggest Chinese state-owned banks dwarfs that of even the largest US banks (see Chapter 1). But Chinese banks face particular headwinds: slower economic growth in the domestic market that dominates their business, exposure to NPLs from the real estate sector in particular and declining net interest margins, which make up the majority of their revenues. This is one of the reasons they trade at a paltry price/earnings ratio of 4, despite posting returns on equity in the high single digits for the past couple of years.

Elsewhere in Asia, the banking system looks remarkably similar to Europe's. Few banks in the region have operations of any substance outside their home markets. China's biggest banks are an exception, with well-established operations in European financial centres, including Luxembourg and London. The largest Japanese banks have a long-standing and substantial presence in Europe, primarily to support their domestic interests. But you are unlikely to find an Asian bank for whom building a business in Europe is a strategic priority.

Most countries in Asia Pacific have a handful of leading domestic banks and have large domestic market shares and ample pricing power. Many of these are more profitable than their European counterparts. Singapore has three leading domestic banks – DBS, OCBC and UOB. They boast healthy net interest margins (a little over 2% in 2023), and post high returns on equity (DBS at 18% in Q3 2023, UOB at 14%). Unencumbered by large legacy businesses, these banks have typically invested heavily in their digital banking operations and are considered market leaders in the fintech space.

Fragmentation remains a sore point

Absent a meaningful banking union, the European financial system remains highly fragmented and there seems little reason for its banks to engage in cross-border consolidation. In 2017, UniCredit went to shareholders to shore up its capital base, raising €13bn at a time of stress for the Italian banking sector. At the time, the group had excess capital sitting in its German banking operations under the HVB brand: German regulators were reluctant to allow the bank to transfer any of that excess to the group level.

Liquidity transfers between different countries remain difficult and costly. EU banks with subsidiaries in different member states must satisfy liquidity and capital requirements at the level of both the subsidiary and the consolidated balance sheet. Banks operating in multiple European countries remain bound to the will of national regulators.

The scale of European banks remains limited. In the US, JP Morgan has a fast-growing share of deposits of around 14%. In Europe, the biggest bank deposit holder is Crédit Agricole. It accounts for 27% of deposits in France, but just 4% of all deposits in the EU.

Europe's competitiveness in financial services is also hampered by the prevalence of smaller banks, often tied to the public sector or not otherwise listed, such as savings banks, regional banks and co-operative banks. In some cases, such banks have an outsized proportion of deposits or lending because their not-for-profit status means they can offer more attractive rates to customers, which are at uneconomic levels for commercial banks.

With a few exceptions (such as BNP Paribas, which owns the top five banks in Benelux and Italy), Europe remains essentially a collection of national banking sectors. The continent desperately needs a European Deposit Insurance Scheme, which would create a safety net at the European level.

As Adrian Enria, chair of the supervisory board of the ECB, said in October 2023: 'Without EDIS, national authorities are more reluctant to support cross-border integration, fearing that, in a crisis, their national safety net would have to support banks failing because of strategic decisions taken elsewhere. On the other hand, without more integration, crises are more likely to occur because of the limits to private risk sharing, and resolving them is more challenging due to the segmented nature of the market.'

While waiting for developments in banking union, what other options do ambitious European banks have? Nordea is the only large EU banking group to change its legal structure from cross-border subsidiaries to branches. The bank says there are clear benefits from being able to operate a 'one bank' model, such as clearer governance and accountabilities, a simpler and more effective balance sheet and liquidity management, avoidance of duplicated requirements on subsidiaries, ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability and reduced reporting burden. But it is not a model easily applied to banks trying to operate at a nationally important level in multiple countries.

The safety net: costs and consequences

According to the European Banking Authority, European banks face contributions to the safety net infrastructure that are twice as high as US banks, and requirements on bail-in capacity that are 3.6 percentage points higher than in the US. The debate about this aspect of the safety net goes to the heart of issues that are proving hard to solve between the region's banks and their regulators.

The biggest banks in both the US and Europe must comply with Total Loss Absorbing Capacity of 18%. This is designed by the Financial Stability Board to facilitate an orderly winding of failing banks that minimises the impact on financial stability. In the EU, all banks under supervision by the Single Resolution Board must meet a Minimum Requirement for own funds and Eligible Liabilities. Total MREL requirements are 3.9 percentage points higher than US TLAC requirements, and are subject to a highly complex and supervisor-led process, according to the European Banking Federation.

EU banks currently have to contribute to two distinct resolution structures. At the EU level, there is the Single Resolution Fund, which aims to cover at least 1% of deposits, but with current target contributions set at 1.6%. There are also national deposit guarantee schemes and the target →

90%

of household financing in Europe is funded by bank loans, whereas 73% is funded by the capital markets in the US.

'President Von Der Leyen's commitment to put competitiveness back at the top of the EU agenda is vitally important. We have long lagged behind our global competitors. With greater coordination, we can create a more unified and prosperous Europe and the financial sector is fundamental to this.'

Andrea Orcel, chief executive officer, UniCredit

coverage ratios range from 0.5% to 0.8% of deposits. In the US, via the longstanding Federal Deposit Insurance Fund, banks must meet a single regulatory minimum target of 1.35%.

The SRF scheme is in its relative infancy, having been set up after the 2008 financial crisis to shore up banks' resources in a crisis. It is due to reach €75bn by 2024. Many other national deposit schemes are also nascent, and therefore European banks have had to make outsized, one-off contributions to build the guarantee schemes rather than just maintain them, as is now the case in the US. The schemes are mostly hitting the European banks that are most likely able to compete on a global scale: the top 20 European banking groups in Europe make up nearly two-thirds of contributions.

While banks push back on the size and nature of the SRF, the EU organisation that oversees it, the Single Resolution Board, doesn't think it is big enough in the case of a large bank failing, with its head Dominique Laboureix calling for the ECB to agree to fund banks in resolution. And while many of Europe's banks may complain about the presence of MREL and SRF, both are important aspects of maintaining global trust in the European banking sector, especially among investors.

Europe needs political will

Perhaps what European banking needs most of all, however, is a change in the political climate. For nearly two decades, Europe's banks have been regarded in most political arenas as a problem, rather than a solution. But there are encouraging signs that the political tide is shifting, and Europe's leaders are considering how to meet the challenges of the green transition, energy self-sufficiency and digitalisation.

In September, a joint letter to the Financial Times from the finance ministers of France and Germany, Bruno Le Maire and Christian Lindner, called for Europe to enable businesses to raise the private capital necessary to achieve these transitions, which they estimated at €500bn a year. They said it was 'high time' Europe picked up its efforts on capital markets union. 'We must make market-based financing more attractive to EU businesses,' they wrote, and they called for an effort to 'revitalise the EU's sluggish market for securitisation.'

Deutsche Bank's Sewing commented that 'the joint initiative of Finance Ministers Lindner and Le Maire on this is a strong signal that I highly appreciate. We need regulation that does not restrict banks further but also keeps an eye on their competitiveness.'

Celebrating the 30th anniversary of the European single market in March 2023, EU President Ursula von Der Leyen called for a renewed emphasis on improving the relative competitiveness of the EU, including in financial services.

This was welcomed by leading European bankers. Andrea Orcel, CEO of UniCredit, said that 'President Von Der Leyen's commitment to put competitiveness back at the top of the EU agenda is vitally important. We have long lagged behind our global competitors. With greater coordination, we can create a more unified and prosperous Europe and the financial sector is fundamental to this. However, the EU single market is not fully integrated, especially for services, including finance, and establishing a functioning banking union would be an important step forward. Without this, the road to a stronger finance bloc is a narrow one.'

But that political will does not extend across Europe. As banks returned to better levels of profitability in 2023, a number of national leaders sought to introduce windfall taxes on their profits. In August, Italian Prime Minister Giorgia Meloni announced a plan to impose a 40% tax on profits derived from the surge in banks' net interest margins, sending Italian bank stocks plummeting. After an intervention by the ECB, the proposal was watered down and allowed banks to use the 'windfall' to bolster their reserves.

Some policies could have negative consequences for European banks. Politicians, regulators and other supervisors talk about the need to ensure that Europe has a financial sector capable of supporting the sustainable and digital transition. According to the European Commission, the continent requires €620bn of investments annually to meet the Green Deal objectives and €125bn annually to close the investment gaps for the digital transformation. The vast majority of this funding will need to be provided by European capital markets. Banks and governments can only provide part of it.

According to Olivier Vigneron, chief risk officer at Deutsche Bank, there are two areas where current regulation could harm the ability of European banks to help deliver these transitions. First, a digital euro may extract deposits from banks' balance sheets that banks consequently cannot turn into lending for the economy. Second, the Payment Services Directive 3, following on from the huge cost of implementation of PSD2, 'will further increase these operational costs and continue to assist third parties in competing with banks at zero costs of their own. These costs prevent investments in making EU banks themselves more efficient,' said Vigneron. He calls on the European Commission to 'reverse this direction of travel and take a more holistic and future-orientated approach, which allows the European banking sector to contribute to the strategic priorities of the EU.'

However, proponents of PSD3 would argue that its implementation will be crucial to the modernisation and competitiveness of the European banking system. Its stated aim is to improve competition in the financial industry, transforming the efficiency and security of electronic and digital payments.

Where next for European banking?

A report published by the European Banking Federation and Oliver Wyman in January 2023 argued that a review of capital requirements and supervisory processes in the EU could, 'in a hypothetical scenario', provide capacity for €4tn-€5tn in additional bank lending. It called on policy-makers to redouble their efforts to complete banking and capital markets union, and simplify the complex and costly resolution regime. It also called on banks to improve operational efficiency and digitalisation, and position themselves for 'the long-expected process of consolidation in the eurozone that will also foster better allocation of resources across EU borders.'

Ana Botín, chair of Santander group, said 'In recent years, European banks have built up more capital than our US counterparts – more than €250bn since 2014 in a period when CET1 ratios remained stable in the US. Europe's banks are in a strong position to help our economies not just weather the storm, but power the growth we need. Transition plans require large amounts of capital to be invested and new technologies to be developed. The banks are the institutions best suited to this role. Billions are already flowing into the transition, but there is an enormous appetite to do more.'

Europe remains over-banked and over-regulated. That is clearly reflected in a stark reversal of fortunes between European and US banks. According to S&P Capital IQ, in 2007 the total market capitalisation of European banks was $2.7tn, compared to $1.6tn for US banks. By 2021, the picture was rather different: $1.4tn and $2.6tn respectively.

Over the past two years, the outlook for European banks has substantially improved. They have refined their business models, built their capital bases and seen net interest margins return them to better levels of profitability. Now, they need to put their profits to work (rather than just return them to shareholders), build their lending books, increase the velocity of their capital and benefit from better capital markets. They need the capacity to finance the net-zero and digital transitions, and apply their financial power and expertise across Europe, not just in the country in which they are headquartered. They need to benefit from an efficient and competitive European banking system and grow accordingly.

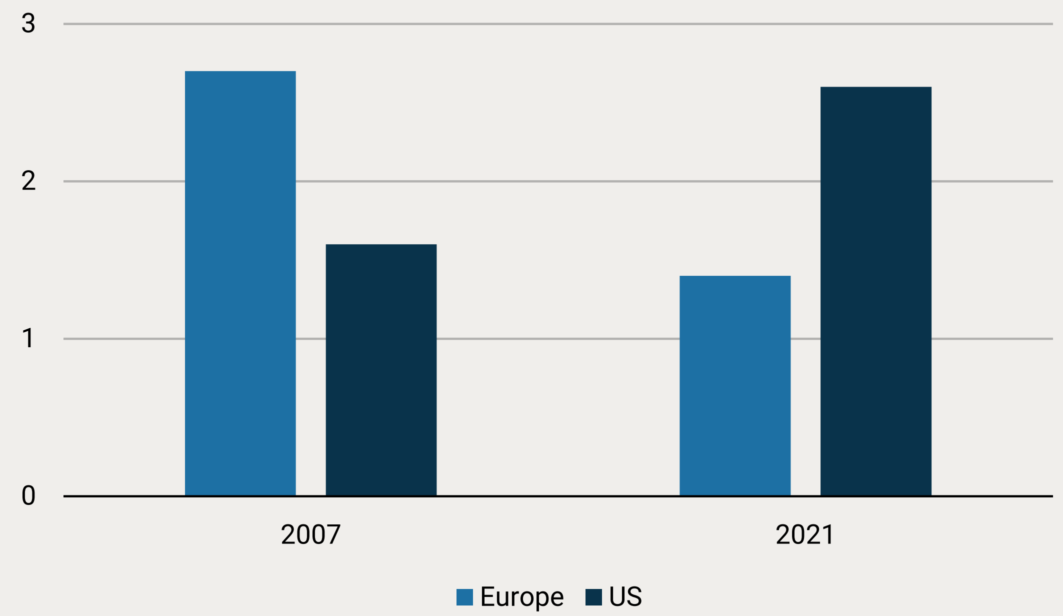
And they need to consider where and how they can realistically compete outside the EU's borders. It may seem a long and unlikely road to challenge the dominance of US banks. But history tells us that banking dominance does not always endure, however entrenched it seems to be. Botín sends out a clear signal: 'The message from us to our governments and regulators is clear: we are ready to do more, we are on your side. Let's work together to get through the challenges ahead, to make Europe more resilient and to get our economies going again.'

'In recent years, European banks have built up more capital than our US counterparts – more than €250bn since 2014 in a period when CET1 ratios remained stable in the US. Europe's banks are in a strong position to help our economies not just weather the storm, but power the growth we need.'

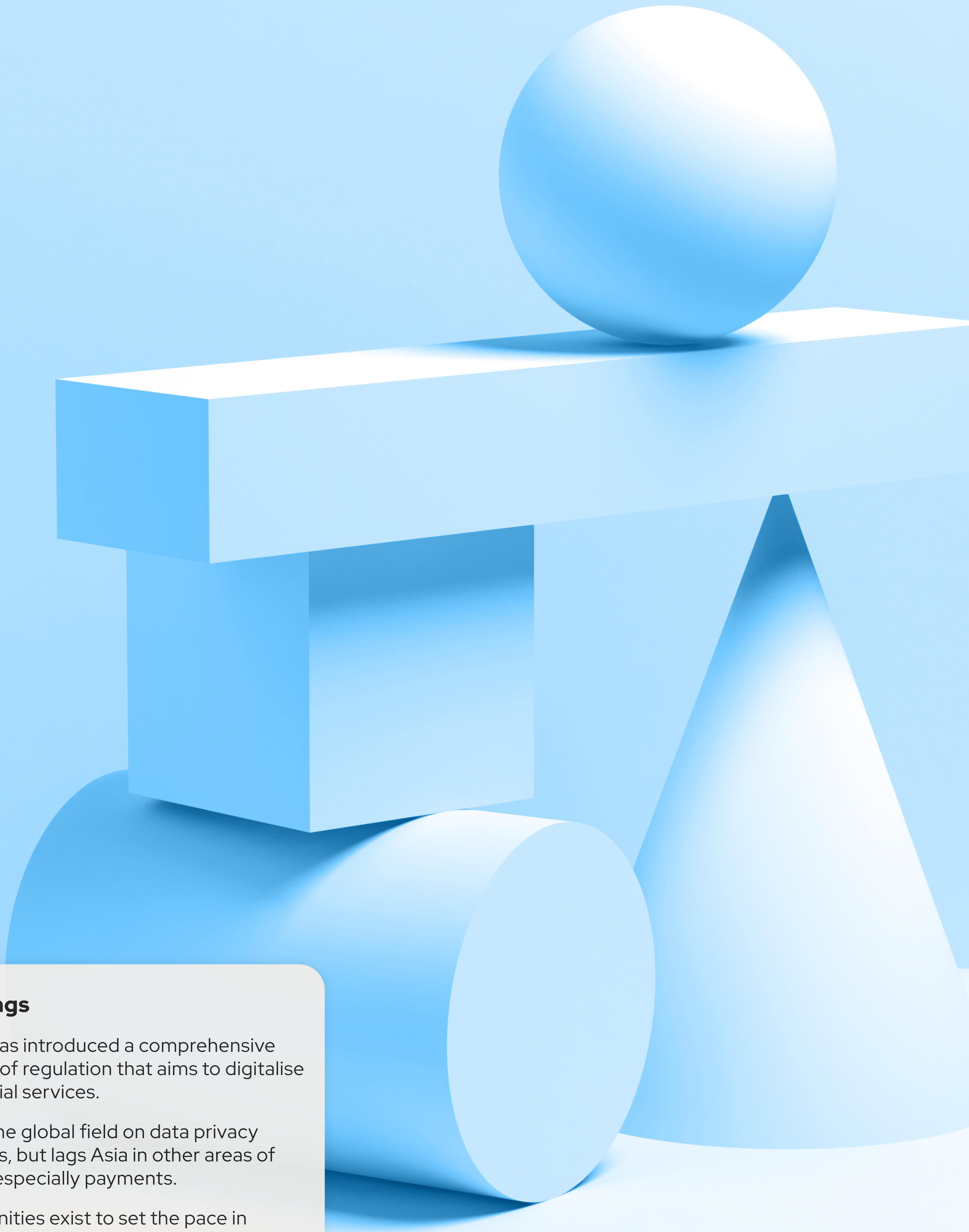
Ana Botín, chair, Santander group

Figure 3.4. Stark reversal of fortunes

Total market capitalisation, $tn



Source: S&P Capital IQ



Key findings

1. Europe has introduced a comprehensive package of regulation that aims to digitalise its financial services.
2. It leads the global field on data privacy standards, but lags Asia in other areas of finance, especially payments.
3. Opportunities exist to set the pace in central bank digital currencies, distributed ledger technology and artificial intelligence.

Finding a careful balance

Europe has become a leader in standard-setting, but with digital finance, markets must tread carefully between deploying effective regulation and stifling innovation.

IN 2020, the European Union announced its Digital Finance Package, which revealed four priorities. The first was tackling fragmentation in the digital single market to enable European cross-border consumer access and help financial institutions scale up their digital operations. Second was adapting the EU regulatory framework to facilitate digital innovation. Third, promoting data-driven innovation by establishing a common financial data space. And fourth, addressing the challenges and risks associated with the digital transformation and boosting the digital operating resilience of the financial system.

It was a stark recognition that Europe needs to play catch-up on the digital transition within its real economy. 'Europe is not as fast at taking up technologies, and innovations have been driven by US companies,' noted one interviewee from a European central bank. 'The Googles of the world are not in Europe. More slowly developing digital growth – this problem has been identified by everybody, the question is how to solve it.' This also applies to fintech innovation.

In some Asian jurisdictions, regulators have been nimbler than their counterparts in Europe to embrace digital finance. The fast growth of this sector in Singapore, for example, was attributed by one asset manager from Asia Pacific to the proactive and fast-moving efforts of the government and Monetary Authority of Singapore to facilitate fintech innovation. 'Through the government and MAS… we have seen rapid growth in terms of how to bring innovation in fintechs to Singapore.'

Other policy-makers in the region have been working to develop fintech innovations. India's interoperable stack of digital public infrastructure – with biometric identity, digital payments and document storage – has increased access →

'There is a huge new wave of regulation coming out on AI. This is far too soon for my taste, because I'm not sure we fully understand it.'

Christopher Smart, managing partner, Arbroath Group

€240tn

Europe has taken a bold and comprehensive approach to modernising its payments systems and recognising the growth of electronic payments, which climbed from €184tn in 2017 to €240tn in 2021.

to formal financial services. More than 300m consumers are using digital payments and over 450m have low-cost bank accounts, which could be used to mobilise future savings and investments. It's similar story in China, with the People's Bank of China reporting more than Rmb100bn has been used in digital renminbi tractions across 360m transactions.

There are various structural and institutional factors that have led to the concentration of fast-growing technology companies in US and parts of Asia. But one aspect that could help to drive growth in digital finance in Europe is offering regulatory clarity, which – as with the sustainable taxonomy and regulations – can promote innovation and investor confidence.

A comprehensive package of reforms

Policy-makers in the EU are working to promote digitalisation in financial markets. The EU has been a leader in regulating data privacy and protection within the European economic area with the 2018 General Data Protection Regulation.

Europe has taken a bold and comprehensive approach to modernising its payments systems and recognising the growth of electronic payments, which climbed from €184tn in 2017 to €240tn in 2021. The Payments Services Directive 2 regulates electronic payments services to make payments within the EU more integrated and secure, boosting innovation and helping banking services adapt to new technologies. PSD2 will be supplemented by PSD3, announced in June 2023 by the European Commission, which aims to further improve consumer protection and competition, and empower consumers to share their data in a secure way so that they can get a wider range of better and cheaper financial products and services.

The EU has also proposed a new Financial Data Access framework, a flagship initiative of the EU Digital Finance Strategy, which is crucial to the EU-wide implementation of open finance. FIDA grants consumers and small and medium-sized enterprises the right to authorise third parties to access their data held by financial institutions. The 24-month proposed implementation timeline of FIDA is ambitious and signals the EU's commitment to the use of data in an open finance architecture.

The Markets in Crypto-Assets regulation is providing much needed regulation of cryptocurrencies where other jurisdictions have fallen short. MiCA sets out transparency and disclosure requirements for cryptoasset issuance and trading, as well as regulations for the authorisation and supervision of issuers and service providers of cryptoassets. The first phase of the regulation came into force in June of this year, with the remaining provisions to be implemented in stages until 2025. One interviewee from a European central bank hoped that 'MiCA is the framework which is needed and that we can learn, over time, how to be more growth friendly' in the digital space.

The broader Digital Finance Strategy provides a framework in other areas to foster market activity. The EU's distributed ledger technology pilot regime, which began in March this year and runs until 2026, is a first step in exploring the opportunities for the trading and settlement of tokenised financial products. This pilot allows some exemptions from certain components of the Markets in Financial Instruments Directive 2014 and the Central Securities Depositories Regulation, which gives scope for the private sector to experiment and innovate.

Embracing new technologies

To support the digital asset infrastructure more generally, the ECB is also considering a central bank digital currency. As explained by one interviewee from a European regulatory body: 'With the digital euro, we are… seeking to provide a level playing field and an infrastructure more than just regulation. Businesses add value and →

Rmb100

The People's Bank of China reports that more than Rmb100bn has been used in digital renminbi tractions across 360m transactions.

300m

In India, more than 300m consumers are using digital payments and over 450m have low-cost bank accounts, which could be used to mobilise future savings and investments.

services, but this is a new area where it is worth having the public sector taking the lead and leaving space for the private sector to innovate.'

There is an opportunity for Europe to be a leader in artificial intelligence regulation too. 'It is a part of European identity: regulatory frameworks, protecting consumers. This can be the same approach on AI and privacy,' explained one interviewee from a European regulatory body. 'We will try to be standard-setting in certain aspects, not only for the protection of citizens but also to create harmonisation that is helpful for business to know how it works across the single market.'

The proposed EU AI Act, a first attempt at regulating the new technology, would use a risk classification system to introduce various disclosure requirements related to intellectual property and personal data. EU lawmakers agreed on the terms of the Act in December 2023. Once the regulation comes into force, it will comprise the world's first rules on AI.

But many of the interviewees, particularly outside of the EU, see the precautionary approach to AI regulation as overly burdensome as it would introduce high compliance costs and administrative burdens for companies. As a result, some fear that the EU AI act would stifle innovation. 'I have the sense that Europe is still riding high on the GDPR euphoria wave. The EU is finally leading the world in setting a standard for something, on data privacy standards. This has raised the bar and now the US is now working to meet that… But there is a huge new wave of regulation coming out on AI. This is far too soon for my taste, because I'm not sure we fully understand it,' noted Christopher Smart, managing partner of Arbroath Group.

'Regulation is making leaps and bounds on AI. Here, the EU is taking a similar approach to environmental sustainability: "If we get there first, we can propose something that becomes a global standard", like with the extraterritorial data regulation,' explained one interviewee from the financial services industry. 'But, from what I've seen, this regulatory burden will not drive innovation and will make the EU less competitive.'

Treading a difficult line

Ultimately, European policy-makers are looking to build an holistic and clear market framework for digital finance while collaborating with the private sector. This could prove to be a fruitful approach to provide regulatory clarity while allowing new technologies. Boosting European financial market activity in this way would have positive spillovers for asset managers. The challenge will be to tread the difficult line between promoting security and resilience without stifling innovation. The consensus is that European policy-makers are taking the right steps for sustainability on this front, so a similar approach would help to achieve this regulatory balance when considering digitalisation of finance.

'Europe is not as fast at taking up technologies, and innovations have been driven by US companies.'

An interviewee from a European central bank