Bank performance in the US and Europe
An ocean apart

Large differences in bank profitability. Whereas before the financial crisis, both US and European banks reported record profit levels, only US banks are beating those nowadays, while their European peers are struggling to sustainably stay above the zero line at all.

Three main drivers: Diverging trends in revenues, lending and provisions. On the one hand, US banks are benefiting from stable revenues that are significantly above pre-crisis levels, on the other, EU banks have never seen them recover from the slump in 2008 and again decline during the European debt crisis. In addition, loan growth has returned in the US, particularly in corporate lending, which remains the weakest spot in Europe. Finally, loan loss provisions have fallen to 2007 lows in America, but stay elevated in the EU.

Three main underlying causes: Macroeconomics, banks’ own decisions, institutional differences. The US economy has been growing relatively steadily since 2010 already; output in Europe, by contrast, suffered a double-dip recession from which it is just about emerging. Furthermore, EU banks’ greater need to raise capital ratios to more prudent levels and their stronger deleveraging and shrinking has put them at a competitive disadvantage against their American competitors, not least in fast-growing emerging markets. Doubts by some market participants over the very survival of the European Monetary Union, weak domestic governments, an emerging patchwork of rules in the European financial market, and much more aggressive market interventions by the US Fed have also affected the Europeans and helped US banks to regain strength.

Outlook: Improvements ahead for both, but the "ocean" will turn into a "sea" only. With the US recovery now well established and Europe probably having turned the corner, banks may see this tailwind translate into better operating results, though much remains to do especially for European financial institutions. Given substantial catch-up potential, they may be able to narrow but probably will not close the gap to their US peers in the coming years. A gradual exit from the extremely loose monetary policy on both sides of the Atlantic does not seem to represent a major risk for the two banking systems.
Introduction

European and US banks are looking like two unequal siblings these days. On the one hand, US banks are back at pre-crisis record profitability levels – indeed, in Q2 this year they reported their highest quarterly net income ever (USD 42 bn). On the other, European institutions are struggling to find new ground in a profoundly changed, politically and economically more challenging operating environment – indeed, the largest banks which cover about half of the overall European market posted a combined net profit of only EUR 16 bn for the entire year 2012 (the unweighted-average ROE was even slightly negative), before returning to modest profitability in the seasonally strong first half of this year. To explore why the two largest and most advanced banking systems in the world are diverging so widely, we first contrast the development of the most important performance indicators and provide an analysis of the underlying reasons afterwards.¹

US financial institutions (and financial markets in general) were at the core and origin of the financial crisis of 2007-09. Unsurprisingly, therefore, they suffered larger losses than anybody else; in fact overall writedowns amounted to more than USD 1.1 tr (see chart 1).² With writedowns of more than USD 0.5 tr, Europe’s financial institutions were also hit hard, though not as dramatically as their American peers. From the onset of the crisis, the market capitalisation of banks from both continents plummeted rapidly. In less than two years, both the DJ US Banks Index and its European equivalent, the DJ Stoxx 600 Banks Index, lost roughly 80% of their market value. Both indices reached their lowest level in March 2009. Thanks to extensive government and central bank help, confidence and liquidity then slowly returned to the markets. Consequently, the market capitalisation of European as well as American banks saw a solid rise until late 2009. Up to that point, developments in the overall market value of European and US institutions were closely correlated (see chart 2), entering into a sideward movement.³ But from summer 2011 on, they started to diverge strongly with shares experiencing only a temporary setback in the US but a fall without recovery in Europe due to the European sovereign debt crisis.

US banks’ outperformance of their European peers

Market value: US banks more valuable than their European peers

Over the past two years alone, the DJ US Banks Index has climbed by almost 80%, nearly twice as much as its European counterpart. The average price-to-book ratio of major US banks stands at 1.2, compared with only 0.8 for the leading European institutions. Similar results can be derived from an analysis of the market cap of the world’s 25 largest banks, where Europe’s banks have dramatically lost ground recently. Before the start of the financial crisis, European banks accounted for nearly half of the aggregated market cap of the

¹ Due to a lack of data on aggregated banking activity, we generally limit our analysis in Europe to the 22 largest banks on the continent, unless mentioned otherwise. Speaking of “European” banks in the following thus refers to this largely representative set rather than all of the about 9,000 banks in Europe. Despite our sample covering every major institution and all of the bigger geographic markets, hence offering timely insights into recent trends, a structural bias cannot be ruled out completely as small to mid-sized retail banks may not be adequately represented.

² This includes losses recorded by the government-sponsored enterprises (GSEs).

³ For more information on the extent and effects of the financial crisis on banks in Europe and the US, see Schildbach (2009).
Bank performance in the US and Europe

25 largest institutions worldwide (see chart 3). This share has fallen to currently only 17.5%. On the other hand, US institutions initially also suffered but were able to enlarge their share again from a low of 22% in 2009 to 31% today (which is higher than in 2007!), while banks from emerging markets as well as other developed countries gained enormously in importance. At USD 2.8 tr, the total market cap of the top 25 global banks has seen a remarkable rebound from its trough during the crisis and is not far off the all-time peak of USD 3.1 tr any more, yet the market cap of the list’s European “members” has plunged to USD 492 bn (2009: USD 640 bn).

Net income: Gap between banks in Europe and US widens

The troubles the European banks are having in the stock markets are to a large extent due to weak profitability. For a long time, net income figures evolved relatively similarly on both sides of the Atlantic – including the downturn in 2008 (see chart 4). The recovery from the meltdown in Q4 2008, however, initially laid bare differences between quicker Europeans and slower Americans.\(^4\) Unfortunately for the early-movers, their momentum soon faded and net profits tumbled again from mid-2011, having stayed moderate throughout the previous two years. By contrast, in the US the recovery in banks’ net income came later but proved more sustainable and prolonged, culminating in a record (absolute) figure in the most recent quarter. Hence, net income trends somewhat resemble both economic growth and stock market developments: on one side, a V-shaped recovery in the US and, on the opposite, a double dip in Europe. For instance, net income in 2012 (USD 141 bn) was up by 20% year-over-year in America, but down another 43% in Europe (to EUR 16 bn), from an already terrible prior-year result.\(^5\) And while EU banks recovered some ground in a favourable environment in the first half of this year – which in the past often did not last – US banks remained out of sight.

Return on equity: Moderate but steady rise in the US

As should be expected, the ROE picture is very similar to the one presented by net income figures. Return rates of recent years thus also indicate that US banks have been performing much better than their peers in Europe. Average (after-tax) ROE of American banks has steadily trended upwards since 2009 (see chart 5). By contrast, European banks’ ROE initially recovered faster from the financial crisis but in 2011 fell back into depressed levels of close to zero, creating a widening gap between European and US banks. In H1 2013, in benign conditions, the European banking industry achieved at least a moderate 6%, yet US institutions reported another increase to exceed 10% for the first time since 2007 (Q2 2007, the last quarter before the beginning of the financial crisis, had also been the last with a double-digit ROE, now succeeded by Q2 2013). In addition, this masks the fact that European banks are usually (substantially) less profitable in the second half of a year – US banks, however, more. Clearly, this lack of profitability in the European sector is unsustainable in the long term as banks are nowhere near to earning their cost of capital, i.e. a decent return for investors in their shares which, in addition, have shown high volatility over more than the past decade.

\(^4\) Indeed, already the slump of 2008 had indicated an (emerging) structural earnings gap and differences in the resilience of banks’ business models: EU banks suffered a greater drop, despite writedowns in the US being considerably larger.

\(^5\) In fact, European banks’ poor results are due to both large and small institutions. The major banks suffered more during the financial crisis in 2008, while regional and specialist institutions on aggregate recorded substantial losses over the past two years, when the large banks stayed at least somewhat above the zero line.
Why does this matter? The role of banks in the economy

If banks were just a “normal” industry with ups and downs not affecting the broader health of the entire economy, a weaker or stronger banking system would hardly be a matter of concern. However, providing finance is a cross-sectional industry that is highly relevant for all other parts of society – companies, households and governments. That alone would make the different shape US and European banks are in crucial for the well-being of these economies. What aggravates this, however, is the enormous difference in the size and importance of the banking sector defined narrowly (relative to the overall financial sector). In the US, financial firms other than banks have been growing much more quickly in past decades, resulting in the so-called shadow banking system overtaking the traditional banking system in size in the 1990s (see chart 6; the ranking reversed again only recently, in the aftermath of the financial crisis). In Europe, by contrast, most financing is still being done by traditional credit institutions. As a consequence, despite their economies being roughly comparable in size, the EU boasts a banking sector that is more than four times as large as total bank assets in the US (see chart 7). In more tangible terms, this has important repercussions e.g. for the way enterprises fund themselves externally. Whereas in the euro area the share of bank loans in total liabilities remains high at around 70%, this figure is less than one-sixth in America (see chart 8). In the US, much more capital is raised directly in debt markets, through the issuance of bonds and other securities, rather than via conventional bank loans that stay on banks’ balance sheets until maturity. Hence, banks’ capacity (or lack thereof) to provide credit to the private and public sectors much more determines the economy’s overall financial strength in Europe than in the US where players other than banks are at least as relevant.

Reasons and drivers of the performance differences

Bright outlook for US economy, Europe trapped in crises

Back in autumn 2008, the then German Finance Minister claimed the financial crisis was an event confined to the US that would not affect the European financial system. Days afterwards, Europe was right in the middle of the financial meltdown, side by side with the US. And since 2011, it has been looking as if the global crisis had been primarily a European one, given the bleak situation of banks on this side of the Atlantic and the strength which the US institutions have regained. What caused this tremendous shift in fortunes – why did the US banks recover more decisively and why have their European competitors been struggling ever since?

It is quite obvious that macroeconomic developments have been one crucial driver of the recent divergence. Quarterly GDP growth in the US has been persistently positive for the past 2.5 years (see chart 9). With few exceptions, growth rates of real GDP have broadly been hovering around 2-3% p.a. since 2010. Unemployment, a lagging indicator of economic progress, has also been coming down significantly over the past 24 months. Policymakers even agreed on some form of fiscal consolidation, one of the thorniest political issues, which has also been helped by the recovery. Therefore, growth prospects for the US remain comparatively bright, possibly allowing the Fed soon to scale down (though not end) its quantitative easing programme (QE) and extremely loose monetary policy.
Europe’s economy, on the other hand, has been trapped by its crises. In spite of financial markets calming over the past year, the euro area has just about emerged from recession and at year-end, some countries will have seen their GDP decline in four out of the past six years. The outlook is somewhat better; however, the extent of initially demand-dampening structural reforms and the fact that they coincide in so many countries implies that economic growth may remain suppressed for some more time yet. This makes for a decisive difference from earlier recoveries from national financial crises in the past three decades (e.g. in the Nordic countries in the 1990s). Then, the adjustment process in crisis countries was eased by a favourable external environment which allowed for an export-led rebound of the economy. This is much harder now that many of European nations’ trading partners (i.e. other Europeans) are embarking on a similar strategy for revival. The other factor missing compared to earlier periods of weakness, of course, is an independent currency which may depreciate and thereby enables exporters to regain lost (price) competitiveness. With the euro, most European countries instead have to pursue a more painful real devaluation.

But what makes the US fundamentally different from those post-bubble European economies? True, America had to digest its own real estate bust, yet apart from that, it benefited (and still does) from a number of institutional and political factors setting it apart from the situation in the euro area:

— an aggressive central bank which has a much broader mandate than the ECB and which to this date intervenes heavily in financial markets as well as government bond markets, driving down risk-free interest rates as well as risk premiums on a broad range of financial assets (see the more detailed analysis below).

— an undoubted currency – whereas the very existence of the euro had been called into question in 2012, triggering excessive risk spreads on those European assets susceptible to be converted into a weaker currency in case of a breakup of the Monetary Union. The US economy, in turn, benefited from traditional safe haven flows, despite potentially inflationary pressures induced by the strong growth in the money supply.

— an undoubted sovereign. For all the talk about the fiscal cliff, the debt ceiling and the reluctance of both political parties to seriously tackle fiscal problems, financial markets around the world never really questioned the solvency of the US government, allowing it to postpone a gradual fiscal adjustment until the recovery was well under way.

— a more flexible labour market which led to a spike in unemployment as early as summer 2009 but helped creating lots of new jobs once the recovery gained momentum in 2011, whereas rigid labour rules initially protected many Europeans from being laid off only to prevent them later on from finding new work as employers remained (and still are) reluctant to hire.

— an economy less dependent on weak European trade partners. Foreign trade intensity of the US is much lower than that of the relatively small European nations which are closely interlinked with each other, resulting in a drag on growth if all economies are hit by the same shock.

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6 For the particular case of the UK, see text box 10.

7 Whether the US labour market itself has become structurally less flexible after the crisis or whether the still elevated level of unemployment is only of temporary, cyclical nature, is a matter of ongoing debate. See e.g. Lazear and Spletzer (2012).
UK versus US banks

The UK is a somewhat special case. The country exhibits many parallels with the US – a post-real estate boom economy, a trusted sovereign and an aggressive central bank pursuing large-scale QE (which also helped to depreciate the currency substantially). Despite that, as regards their post-crisis performance, British banks are firmly in the European “camp”. This may be primarily due to two reasons: i) macroeconomic weakness has been more pronounced in the UK and ii) the British banking sector was more vulnerable than its US equivalent.

Economic weakness has been driven in part by a larger housing bubble in the UK, whose bursting affected a relatively bigger construction sector (though this did not shrink more than in the US). Possibly with support from lower energy prices thanks to the shale gas boom, manufacturing also recovered substantially in America whereas industrial output remains depressed in Britain.

With respect to the second factor, apart from the fact that the banking sector in the UK is large even by European standards, it is crucial to note differences in the nature and focus of the two global financial centres New York and London and their respective banking systems: New York and the US financial industry first and foremost caters to its huge domestic market. US banks are much less international than their European and especially British peers. London, by contrast, is a centre for international, cross-border banking and home to many foreign institutions that conduct much of their wholesale business from this European hub. In addition, many British banks have a strong international business themselves, with a large presence in other European markets (as well as the US and Asia). Both these features, however, became a burden rather than a boon for British banks in the aftermath of the financial crisis: foreign banks, especially from Europe, shrank their investment banking operations, not least as a consequence of much higher capital requirements, and British banks reduced their widespread international network, but also suffered from their greater exposure to troubled continental Europe (compared with their US competitors). Finally, the regulatory environment in the UK has seen one of the most dramatic shifts of any major banking market, from being very lax (based on “light-touch” supervision and self-regulation) to quite tough and sometimes hostile (the Vickers Commission’s structural reforms are among the most far-reaching globally). Overall, this has hurt the financial centre London much more than New York (see also chart 11) and may explain why British banks are indeed distinctly “European” in the context of this study.

Total revenues: Trending down in Europe, stable in the US

In light of the challenging macroeconomic environment in Europe, revenue figures of European banks have also been trending down and remain well below pre-crisis levels (see chart 12). In 2011, all major components of total revenue declined at the same time for the first time in at least a decade. In 2012, this weakness became more pronounced and entrenched: net interest income accelerated its decline (which continued in the first half of this year); fee and commission income stagnated and only the volatile trading income managed a slight increase. For an industry used to double-digit growth rates prior to the crisis – sector-wide revenues rose by 13% p.a. on average during 2003-2007 – this is close to a revolution. By contrast, US banks’ revenues – though lacking meaningful growth – have constantly been above pre-crisis levels in recent years. Despite suffering from a decline in the interest margin of late, net interest income is still substantially higher than before the onset of the crisis, thanks to lower funding costs and, more recently, increased portfolios of debt securities and an uptick in lending volumes (see below). Non-interest income, in turn, was hit harder by the crisis yet has been growing again over the past two years (accordingly, total revenues of US banks are now up by almost 20% compared with Q1 2006).

The big difference: Lending to companies

One of the main reasons for the different revenue performance has been cross-continental differences in banks’ lending business. With economic activity picking up in the US, growth rates of loans to the private sector have turned positive as well, though volumes have not reached their pre-crisis peak again, and deleveraging among firms and households has been substantial (partly continuing to this date). Lending activity in Europe, on the other hand, is far from
Bank performance in the US and Europe

Housing market in the US recovering, price bubbles in Europe not yet corrected

Even for lending to households, which so far looks relatively similar in both markets, the outlook for the US is much more benign than for Europe: in the former case, the housing market has undergone a sizeable price correction – a fall of more than 20% from the bubble’s peak in early 2007 (by some measures earlier, followed by a larger decline) to the trough in summer 2011 (see chart 16) – which has brought down affordability ratios, while years of low building activity have helped considerably reducing the oversupply of homes. With a large part of past excesses now digested, the outlook for a moderate housing recovery, and a corresponding expansion of mortgage lending, has now cleared. In fact, several indicators show just such a recovery is already underway: real estate prices are climbing fast, led by increases in the largest cities which bodes well for a broader upswing also in more rural areas (see chart 17). In a country where most mortgages are sold on to investors as residential mortgage–backed securities (RMBS) or similar securities, it is also encouraging to note that issuance levels of mortgage–related securities have risen strongly over the past year rates below US levels for the past 1.5 years (see chart 13).

Tellingly, overall figures for lending to the private sector are masking remarkable divergences between borrower types. Loans to households, in fact, remain largely flat in both markets – but loans to non-financial corporations are worlds apart: they are currently growing at rates of more than 5% in the US, but shrinking at an equal pace in the euro area. Corporate lending is more of a bellwether for the health of the economy than household lending which may depend more on lagging indicators such as the state of the residential real estate market and the employment situation (as well as on personal perceptions of individual well-being) rather than on economic growth prospects. The observed differences in corporate lending growth therefore fit neatly into the quite gloomy European picture, in contrast to the brighter mood in the US.

In general, macroeconomic factors (i.e. the demand side) may exert substantial influence on banks’ performance rather than the other way round. In recent years in some euro-area countries, admittedly, supply-side restrictions may have aggravated an already bad shape of the economy by constraining the flow of credit more than would have happened anyway, even with a fundamentally sound banking sector. However, this may have been only a temporary phenomenon as, still in the middle of the euro debt crisis, the usual nexus between banks as the “recipients” of signals sent out by the overall economy was re-established: since early 2012, lending seems to be held back more by a lack of credit demand than by restrictive behaviour by banks (see chart 14). Quarter by quarter, on average about a quarter of all banks have been reporting a decline in loan demand, compared with the preceding quarter, according to the ECB’s Bank lending survey (BLS). Yet only about 10% of banks still tightened their credit standards. In the US, on the other hand, for most of the past 3.5 and 2.5 years, respectively, a relative majority of banks in fact relaxed their lending standards and saw an increase in the demand for commercial & industrial loans (see chart 15).

Housing market in the US recovering, price bubbles in Europe not yet corrected

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8 Private- and financial-sector deleveraging has also been less pronounced in many European countries than in the US (see e.g. McKinsey (2012)).
Bank performance in the US and Europe

Source: S&P, OECD, SIFMA, DB Research

Nominal residential property prices

Q1 1995 = 100

Sources: OECD, DB Research

US housing market is recovering

 Nominate residential property prices

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Sources: OECD, DB Research

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US housing market is recovering

Households' total mortgage debt

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Residential mortgages on banks' balance sheets

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Residential mortgage-related securities

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* includes self-employed

Source: Fed, FDIC, SIFMA, DB Research

mortality securitisations outstanding are growing – in fact, they have not even stabilised but continue to fall (see chart 18). There are several reasons for this, at first glance, puzzling disconnect:

- Households are still deleveraging and reducing their indebtedness, while banks remain equally eager to run down particularly risky mortgage portfolios, i.e. those with high loan-to-value (LTV) ratios, and apply tighter credit standards than during the subprime and Alt-A era.

- Real estate prices and absolute transaction numbers are still considerably below their peak levels, holding down the overall deal volume of new house purchases.

- Most importantly, a large part – reportedly between a third and more than half – of all transactions are nowadays cash-only, i.e. not financed including any mortgage. This proportion was only about 20% before the crisis. Many of these acquisitions are made not by residents, but by investors who find current valuation levels attractive and expect house prices to rise further. A smaller part of the drop in mortgage lending relative to the total volume of housing transactions may also be due to lower LTV ratios for those deals that are still financed with a mortgage.\(^9\)

All of this, however, underlines the strength of the US housing market rather than being a sign of weakness.

The level of debt households are taking on is much healthier now than prior to the crisis; banks are more prudent in whom they lend to (and how much); and many potential buyers have so far stayed on the sidelines, leaving considerable potential for a further positive development of the housing market. They may well be encouraged sooner or later to jump on the trend by property prices (as well as the overall economy) continuing to recover from their recent lows. In that case, at the latest, an increase in mortgage lending and therefore business for banks becomes highly likely.

Property markets in Europe, in turn, have clearly not hit the bottom yet. In addition, in many countries the bubble size has been substantially larger than in the US (indeed, the only major European economy which did not experience a housing boom was Germany). Price indices for Ireland and Spain, where real estate markets once were strong engines of lending growth, are now reflecting a substantial but still unfinished adjustment. Houses in France, Sweden or the UK still look overvalued. Prices in these countries have not even started to realign with fundamentals and are stagnating at high levels. Unsurprisingly, this inherent risk of a potentially significant depreciation of housing values has had a rather dampening effect on retail lending in Europe and may continue to inform borrowers’ but also lenders’ cautious navigation in the coming months and years.

Lower loan loss provisions boost US banks’ profitability

Mortgage loans, of course, are a major part of banks’ lending business and thus also an important component of the industry’s credit losses. Therefore, trends on the housing market have significant repercussions not only for revenues but also bottom-line profitability of the banking sector. Prior to the outbreak of the crisis, banks on both continents benefited from low credit losses and proportionately low provisions for loan losses. During the crisis, allowances for expected loan losses surged, but then trends started to diverge. In line with the stronger correction in the US real estate market, US institutions provisioned much more aggressively than their European peers (see chart 19). Due to this

\(^{9}\) See e.g. Goldman Sachs (2013).
Bank performance in the US and Europe

“front-loading” of the burden – provisioning levels in 2009 were almost nine times as high as in 2006, an increase twice as strong as at the European banks – US banks have since been able to return to remarkable profitability: asset quality improved across the board from 2010 on, house prices stabilised, but also the corporate sector recovered strongly, and non-performing loans (NPLs) dropped (see chart 20). In fact, in Q2 2013, loan loss provisions at US banks sank for the 15th consecutive quarter (compared with the prior-year period) and have now fallen by close to 90% from their crisis peak.

Provisioning in Europe has been more timid, initially due to the fact that many European countries did not face an “own”, original banking crisis, but increasingly probably also driven by their lower earnings power (measured e.g. by the return on assets) and weaker capital ratios compared to US competitors. Neither did it help that NPLs, the fundamental driver of provisions, rose instead of declining as in the US. Loss provisions at European banks, thus, still remain relatively high, at about half their peak level, and have not come down meaningfully over the past 3.5 years. With provisions substantial in absolute terms and feeding through directly into the P&L, this has had an immediate, significant effect on the earnings profile of European as well as US banks (note the almost perfectly inverse development of net income as shown in charts 21 and 22). Given the different state of the two economies today, including the prevailing trends on housing markets, major changes to this broader picture are unlikely any time soon, even though the upside left in the US should be limited, while credit losses in Europe could finally decrease in the eventual case of the economy returning to more robust growth. Considering only loans made post-crisis, both banking industries may benefit from lower loan losses due to much tighter credit standards. However, the drag from older commitments whose lower quality they have not yet recognised may continue to burden EU banks for longer: compared to the US’ return to growth in summer 2009, the macro-economic cycle on this side of the Atlantic is about four years behind (or even more, given the European debt crisis has often strained households as well as corporations to the limits – more than the deep but shorter Great Recession stretched the resources of their American counterparts).

Stronger underlying margins at US banks

Due to their structural nature, differences in “normalised”, operating profitability cannot be the drivers for the recent performance discrepancies between US and European banks. Yet these differences become much more evident and relevant in the current environment of low growth in revenues and assets, and low interest rates. Before the financial crisis, EU banks achieved relatively similar returns on equity as their US peers. However, they did so on the back of a generally weaker capital base (see below) which masked their lower returns on assets (see chart 23). Efficiency levels and interest margins were – and are – also lower on the European side (see charts 24 and 25). In the “good times”, this hardly mattered as investors focused on ROE figures and were mainly concerned with growth dynamics and absolute size. Currently, though, when capital is scarce, banks deleverage and profits at most institutions are meagre, the underlying weakness in European banks’ P&L numbers is remarkable – and, apparently, disconcerting for investors. Discussing reasons for this in detail would be beyond the scope of this paper, but it might partly be due to poorer cost management and possibly more intense competition among the Europeans compared to their US counterparts.\footnote{See also Deutsche Bank (2013).}

\footnote{See e.g. Sun (2011).}
Bank performance in the US and Europe

One thing can easily be noted on banks’ cost-income ratios, though: while the transatlantic gap seems to have closed somewhat since 2009, the impression is misleading. US banks may have dealt more aggressively and earlier on than the Europeans with the legal repercussions from misbehaviour before and during the crisis, settling a large number of disputes and setting aside substantial sums for further litigation costs. These outlays increased non-interest expenses and thus the cost-income ratio, concealing progress on the “fundamental”, underlying level. With these extraordinary charges likely to fall in the US (in fact, the cost-income ratio was down to below 60% in the first half of 2013) but probably remaining a material burden on many European players, the continental efficiency divide may well widen soon again.\(^{12}\)

Similarly, the net interest margin in America continues to be a multiple of that in Europe. Granted, European (i.e. ECB) banking statistics do not disclose the most sensible measure, i.e. net interest income relative to interest-earning assets, whereas it is published in the US. We therefore use the “second-best” ratio which divides net interest income by total assets. This distorts the picture somewhat to the detriment of European banks which are not allowed under the IFRS accounting standard to net most of their derivative positions and hence, ceteris paribus, have larger balance sheet totals than US banks reporting under US GAAP. However, the conclusion – European banks run on much lower interest margins – is robust and holds even under far-fetched, completely overdrawn assumptions: derivative positions account for some 30-40% of total assets (or liabilities) at some of Europe’s largest banks with big investment banking operations. Even assuming that i) all European banks would have such a high proportion of derivatives on their balance sheets (as a matter of simplicity, we base our calculation on a share of one-third) and ii) they could net all of them under US GAAP (again too strong a simplification), then the ratio of interest income to total assets rises by half. Still, in this hypothetical and too benign scenario, the net interest margin in Europe would not have been higher than 1.8% in 2008 and 1.6% last year, compared with 2.7% and 3% in the US. It is only characteristic for European banks and adds to their troubles that they have not been able to fully capitalise on the vast decline in funding costs in 2009/10 on the back of loose monetary policies by the world’s central banks, while afterwards all Western banks have been suffering from slow margin erosion.

Deleveraging more a drag for European banks

Finally, banks’ own strategic decisions may also have played a significant role in the divergent performance of financial institutions in Europe and the US since the financial crisis. One of the central pillars of the current comprehensive overhaul of the regulatory framework for banks is a massive strengthening of capital (and liquidity) buffers to allow banks to absorb more of their own losses before bailing in creditors or, in extreme cases, taxpayers. Basel III provides the internationally agreed standard, although a number of national authorities meanwhile have opted for even stricter rules. In any case, since 2007/08 there has been (and partly still is) intense pressure on banks on both sides of the Atlantic to raise capital levels to the new requirements – and deleveraging is one way for banks to achieve that. Raising capital ratios has been, however, more of a burden for European institutions, due to three reasons:

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\(^{12}\) Bloomberg (2013) calculates that legal expenses since 2008 have exceeded USD 100 bn at the six largest US banks alone. This is significant: it is a sum equivalent to about one quarter’s total non-interest expenses of the entire US banking industry (and represents almost 5% of all operating costs since 2008).
Traditionally measured capital ratios have usually been higher to start with at US than at European banks.

As just described, banks’ underlying earnings power is often stronger in the US than in Europe, facilitating organic capital generation.

When regulators’ and investors’ focus shifted towards the stricter new ratios in 2011, Europe was already on the verge of plunging back into a structural recession from which it is just about emerging now, making progress on the front of (both via an internal build-up of capital and by tapping equity capital markets) much more difficult to achieve than for the Americans.

With regard to traditional measures of capital strength, European banks initially were lagging behind their US peers. At the end of 2008, after the collapse of Lehman Brothers, they posted an average Tier 1 ratio of 8.7%, compared to 10% for US banks (see chart 26). This is a substantial difference in itself, yet in reality it was probably even bigger: the European figure is calculated according to Basel II requirements, whereas the US number follows Basel I rules. When EU banks switched from Basel I to Basel II reporting in 2007, however, many banks saw their capital ratios increase due to some more generous provisions under Basel II’s internal models-based approach versus the older Basel I standard approach. Hence, on a like-for-like basis, US banks’ Tier 1 ratios would probably be even higher (or European ones lower) than shown in the chart. From 2008 on, banks both in America and Europe strongly strengthened their capital positions, in a relatively similar way. But pressure to do so was clearly higher for European institutions.

The differences were even worse with respect to another traditional measure of capitalisation levels, the nominal equity – or leverage – ratio (the latter is often calculated as the reciprocal of the former, i.e. it gives total assets as a multiple of the equity base). It had remained a regulatory tool in the US under the original Basel accord which introduced risk-weighted capital ratios and is now making a “comeback” as part of the new Basel III regime. In Europe, under Basel I and II, however, little attention was paid to this risk-insensitive, non-sophisticated measure, also in light of a high share of low-weighted interbank business. Consequently, in 2008, US banks’ equity ratio came to an impressive 9.3%, while it amounted to only 5.7% in Europe (see chart 27). Part of this is due to European banks’ traditionally lower ratio of risk-weighted assets (RWA) to total assets than at their US peers (which in itself may be partly the result of differences between Basel I and II) which allows the former to run larger balance sheets with the same amount of capital (see chart 28). In contrast to the Tier 1 ratio, however, the difference between the US and the European leverage ratio is admittedly somewhat exaggerated. US banks’ reporting is based on US GAAP which allows a rather generous netting of equivalent derivative positions on the asset and liability side of the balance sheet. European banks, on the other hand, report under IFRS which is considerably stricter on derivatives netting, leading EU banks to show higher nominal balance-sheet figures for their derivatives business. European nominal capital ratios are therefore somewhat lower than they would be under a similar accounting standard as used in the US. Nonetheless, given investment banking’s limited overall role in the European financial system, the general conclusion stays the same: using simple balance sheet figures, European banks were much more “leveraged” than their US peers before and during the crisis and had to work harder to adjust, i.e. reduce their assets-to-equity ratio. (They are still far from closing the gap but at least both European and US banks have raised their equity capital ratio by about 2 pp over the course of the past four-and-a-half years.)

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13 Apart from the Basel concepts (and accounting standards, as discussed below), other methodological differences such as those stemming from the national implementation and application of internationally agreed rules also significantly influence the measurement of risk and capital. See also BIS (2013).
In 2008-10, hence, European banks looked much weaker on the two most important capital ratios used at the time than their main international competitors. Pressure to accumulate capital (or de-risk and shrink business volumes) was considerably higher than elsewhere, leading many banks to make painful cuts (foregoing attractive business opportunities in the process) – or postponing a clean-up of their balance sheets (“ever-greening”) as they could not afford to take the corresponding hits to their capital ratios.

In a second stage, since the first publication of the new Basel III rules by the Basel Committee on Banking Supervision in December 2010, the focus of banks, regulators and investors then shifted ever more from the traditional Tier 1 ratio, which was seen as too soft, towards the new standard measure, the Core Tier 1 (CT1) or Tier 1 common capital ratio which puts more emphasis on pure common shareholders’ equity. On that basis, (large) European banks had actually looked stronger than the (largest) US institutions at the height of the financial crisis, with an average CT1 ratio of 7.3% versus only 4.8%, respectively, in Q1 2009, the first quarter with comparable data (see chart 29). However, these figures were somewhat distorted as capital injected into the large US banks through the federal government’s TARP programme in the form of preferred stock did count as Tier 1 but not Tier 1 common capital under the regulatory requirements. As a consequence, with the large US banks raising fresh equity in the market and repaying the government, their CT1 ratio rose quickly and by the summer of 2010, US and European banks were de facto at eye level, at about 9%. Ever since the CT1 ratio became the new benchmark for capital adequacy in industrialised countries in 2011, banks from both Europe and the US have essentially walked up the stairs side by side (with the Europeans being slightly faster), temporary hits from the application of Basel 2.5 notwithstanding.14

How, in which concrete way, did the banks then raise their capital buffers and how did this affect their business outlook and contribute to their differing fortunes in terms of performance? There are three main channels to increase a (risk-weighted) capital measure: retain earnings from ongoing operations, raise fresh capital from outside investors, or reduce the scale of the bank’s business activities and particularly their inherent risk.15 US and European banks have employed these options rather distinctly: growing the capital base organically by retaining earnings has only really been possible for the US banks in recent years, whereas EU banks were hardly profitable at all (see the development of net income above). In the US, as shown in chart 30, cash calls on shareholders were concentrated on the crisis period 2008/09 when US banks also made much heavier losses than EU banks, though (see above). In the EU, capital increases remained an important feature throughout the years until the summer of 2011 when investors shied away from the continent due to its intensifying debt crisis (see chart 31). Overall, EU banks have raised more capital since 2007 than their US peers (EUR 248 bn versus EUR 190 bn). In light of the much larger size of the EU banking system, however, the European figure has not been that impressive.16 The large share price discount EU banks had to offer

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14 Many European banks still do not yet publish figures assuming the full, immediate application of the Basel III rules, making such a comparison with the US impossible.

15 There are other ways to strengthen capital ratios which have been used by European banks to some extent but may not have played a decisive role overall (and are also harder to quantify): e.g., i) reducing RWAs by applying a different methodology to measure risk, by shifting from a standardised to an internal ratings-based approach; ii) converting certain securities which did not count as equity (any more) into core capital; or iii) repurchasing debt securities at a discount, bagging in a profit.

16 Politics may have contributed to this outcome: in the US, policymakers urged banks first to take government funds to shore up their capital base, but also encouraged them to repay the money by issuing new shares soon afterwards. In Europe, on the other hand, politicians and supervisors have been reluctant to force banks to request money from taxpayers (not least because they could hardly afford large handouts, both financially and politically) and they also did not push banks to raise new capital – instead overseeing a “hunger march” of banks shrinking ever more.
Bank performance in the US and Europe

(37% on a weighted-average basis from 2008 to summer 2011, compared with only 6% in the US) to convince shareholders to stump up new money further underlines the Europeans’ difficulties in accessing markets even before they were effectively shut out of them in the course of the sovereign debt crisis. One factor behind this may have been investors’ impression that EU banks had not dealt with legacy assets, restructured and hit the cost brake as aggressively as their US competitors, implying a drawn-out process to get to grips with the new, rougher environment.

Hence, with limited support from earnings and capital raisings, European institutions had to rely much more on the capital ratio’s denominator, i.e. on de-risking and shrinking their business – following a first phase during the financial crisis when they had already cut RWAs much more forcefully than their American peers (see chart 32) and despite regulatory changes (viz. Basel 2.5) which substantially increased RWAs at larger institutions at the end of 2011. As a result, RWAs today are in fact higher in the US than before the financial crisis, but about 20% below that level in Europe. Taken together, this suggests that in the US, retained earnings and, only in the acute phase of crisis, also de-risking may have been the major drivers behind the strengthening of capital ratios; in Europe, by contrast, it may have been primarily de-risking followed by capital measures.

In particular, de-risking and shedding assets have come at a real price for the (European) banks: they have exited higher-yielding business segments (e.g. proprietary trading, securitisations), cut back exposures to certain clients and overall have become much more restrained in making new, capital-intensive commitments. This also meant banks were less focused than before on investing in new business and on generating revenues. The risk adjustment has taken place mainly in Europe; here, however, it has of course been all the harder to achieve as banks in 2011/12 suffered strong headwinds from the debt crisis with all its negative effects – higher funding costs, losses on Greek government bonds, risk aversion among investors leading to a drop in capital markets activity, and weak demand and higher credit losses in their core commercial banking businesses as the European economies relapsed into recession. Meanwhile, growth in the US, on the other hand, picked up gradually and financial markets recovered by and large steadily.

De-globalisation and re-fragmentation: a nightmare for Europeans

Moreover, banks in Europe show a clear tendency to shrink their activities by re-focusing on domestic markets. This is partly driven by business considerations such as a re-think of the broad, undifferentiated expansionist strategy many banks had been pursuing in the era of unlimited, cheap credit without major capital constraints. In the new environment, where “capital is king”, banks concentrate much more on markets in which they have sufficient scale, which fit into their overall portfolio and where they exert full control over their franchise.

The other main reason for banks to retreat to their home market(s) are regulatory changes. Regulation has increasingly shifted towards requiring banks to run separately capitalised, independent subsidiaries with own liquidity holdings in host countries. Regulation across Europe and beyond has dramatically splintered, despite attempts to maintain the EU’s single market for financial services, as national authorities nearly everywhere have come up with distinct demands in an effort to protect the domestic financial system from potential instability and to reduce risks for their taxpayers thereby. Some countries have moved to limit the extent banks are allowed to conduct certain activities, some have introduced (or are about to do so) mandatory

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17 See e.g. Schidbach (2011).
organisational separations within banking groups. Furthermore, the lack of coordination on a supranational level is striking and has already led to a patchwork of rules even within the supposedly harmonised EU financial market. All in all, of course, this raises banks’ cost of business and acts as a significant barrier to cross-border finance.

Apart from banks’ “voluntary” shedding of non-core assets and a common regulatory basis which is breaking apart, two other factors have led European banks to cut back on their intra-European and other international exposures, increasing the share of their domestic operations at the same time: stakeholder pressure to care more for domestic clients (who sometimes suffer as a consequence of this very behaviour by other, foreign banks), and EU state aid provisions which force banks bailed out in the financial crisis to become substantially smaller.

The ensuing market re-fragmentation has been particularly pronounced within the euro area. Government bond yields had diverged vastly in 2012 prior to the ECB’s announcement of potential, unlimited purchases of debt securities; equally, rates for lending to the private sector went in opposite directions in core and peripheral countries and spreads have stayed wide ever since (see chart 33). True, this was driven to a large extent by domestic banks’ (more restrictive) behaviour, but foreign banks pulling out also played a role.

European institutions reduced their involvement outside Western Europe, too. Two broad geographic trends can be identified, the first relating to developed markets outside Europe, the other to the emerging markets. With respect to the former, a retreat has taken place (and still continues) whose scale can only be called “dramatic”. European banks’ single largest foreign market, the US, had seen them accumulating gross claims of more than USD 5 tr outstanding in the run-up to the crisis (see chart 34). Since then, however, this figure has dropped by 38%, and by more than USD 550 bn in the past 18 months alone. Similarly, European banks’ exposure to the other three large industrialised countries Australia, Canada and Japan has de facto halved from its peak in March 2008 and remains on a steep downward trend.

Nor have European banks been able to grow their activities in the fast-growing emerging markets (let alone compensate for the huge loss in business volume in the developed world). A brief, short-lived recovery in 2010/11 notwithstanding, their total claims on the emerging world are lower today than in early 2008 and by and large stagnating (see chart 35). Overall, commitments to Asia and Latin America are currently moderately higher than five years ago, but the opposite is true for Eastern Europe and the offshore centres.

As a result of shrinking global ambitions, European banks are missing out on some of the most important growth trends, not only on a cyclical but also on a structural basis. Particularly in the emerging markets, but also in the US, medium-term forecasts for economic growth are far higher than in Europe, not least due to demographic and – partly – catch-up effects. In addition, other benefits of internationalisation are eluding European banks: a better allocation of capital between countries with savings surpluses and deficits, an improved risk profile for banks thanks to reduced asset concentrations etc., to the detriment of banks as well as their customers. Finally, deleveraging under pressure does not facilitate achieving reasonable prices for assets sold, hence European banks may not only be suffering from a “volume effect” of reduced business activity, but also from a “price effect”.

US banks, in turn, are hardly affected by fragmentation, as their home market maintains a uniform (though unconsolidated) regulatory setup, and are also under much less pressure to retreat from foreign markets (US banks generally have never been even remotely as active across borders as their European counterparts). Instead, since the crisis on their home turf, they have consistently...
Bank performance in the US and Europe

US banks* claims on...

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<th>2008</th>
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* Q1 2009 break in series due to inclusion of former investment banks in reporting population.

Source: BIS

More comprehensive central bank action in the US

As mentioned above, beyond macroeconomic and banking sector-related factors, there has been one more important driver of a speedy recovery of the US financial industry which has not been present to the same extent in Europe: the central bank.

While it is hard to quantify the impact Fed and ECB actions have had on the banking systems in their respective countries, a couple of facts and figures provide some clues. First, the Fed has overall been more aggressive in intervening directly in financial markets to reduce volatility and stabilise prices. The size of the Fed's balance sheet has grown to currently more than 400% of its summer-2007 level (and it continues to expand). By contrast, total assets of the ECB today are only about double the pre-crisis amount (and shrinking).

Second, the Fed has been much more involved in crucial market segments, whenever it deemed action necessary. That was true for the provision of liquidity to banks in the aftermath of the Lehman collapse, when the Fed not only supplied USD 1.6 tr in short-term loans to banks but also used more than USD 400 bn to prop up liquidity markets such as the asset-backed securities (ABS) market for student, auto and credit card loans (see chart 39). As soon as bank funding markets had largely recovered – also the result of a public stress test commonly regarded as transparent and credible – quantitative easing (programme 1) to support a broader recovery of the US economy became the main target, with the Fed injecting up to USD 1.3 tr into the mortgage market (via purchases of MBS) and in addition buying USD 300 bn of US Treasuries. Both programme components were enlarged later, to see the Fed now holding USD 1.7 tr in Treasuries and USD 1.4 tr in MBS (whose volume temporarily had shrunk significantly as debt matured “naturally”).

Irrespective of the question whether these initiatives indeed proved successful in their bid to kick-start the US economy or whether the recovery was the result of the private sector starting to invest and borrow again after a sizeable...
Bank performance in the US and Europe

deleveraging, the Fed intervention in any case had two effects: first, it sent a strong signal to financial market participants that it would act as a buyer of last resort in all kinds of market segments, and not just narrowly support banks; and second, it provided the bridge needed for the public sector to postpone its fiscal adjustment until the recovery was well established – guaranteeing low funding costs for the government and in turn the entire economy.

In the euro area, by contrast, the ECB’s response to the financial crisis and its aftermath, the sovereign debt crisis, has been much more limited. In line with its narrower mandate, it confined itself to helping banks and reluctantly also backed pressured governments, yet without large-scale intervention in the markets. Its strongest move, the announcement to do “whatever it takes” to preserve the euro, came only after successive assistance packages had been agreed with troubled countries that had tight fiscal targets attached to them. Refinancing rates for banks, though at record lows, remained higher in Europe than in the US throughout the post-2008 years, and in 2011 the ECB even attempted a (short-lived) exit from its exceptionally loose monetary policy (see chart 40). In terms of “hard money”, the central bank by and large only stepped in to replace retreating customers and investors as a source of funding for banks, i.e. central bank liquidity became a substitute for deposits, money-market fund investments as well as longer-term bond issuance. On the other hand, as chart 41 shows, the ECB in total has bought less than EUR 300 bn of euro-area government bonds and covered bonds since the height of the crisis (with the outstanding volume shrinking in the past few months due to redemptions). Hence, compared to the Fed’s interventions, the maximum amount of direct purchases of financial instruments in public markets – in effect new funds injected into the system – remained small: they were equivalent to less than a quarter of the ECB’s balance sheet size in June 2007; the corresponding figure for the US has reached 350% by now, and continues to rise. This enormous difference was compounded by the fact that global capital flows continued into the US, whereas the European debt crisis at times led to a flight of US and emerging-market investors from the continent.

With a number of vulnerable countries and banks struggling to preserve access to funding markets (for bank equity capital markets, see above; for debt capital markets, see chart 42), several economies in 2011 tumbling back into recession, negative feedback loops setting in between weak banks and weak sovereigns, the very survival of the Monetary Union at times in doubt, and a central bank much more constrained in its ability to (counter)act than its US counterpart, market pressure finally, last year, convinced European banks to seriously embark on a process of restructuring and shrinking. This reduced banks’ funding needs (they later regained access to capital markets which eased constraints, too) and made it possible for the ECB to subsequently downscale its liquidity support. US banks, on the other hand, were able to tap capital markets again in the course of 2009 already, allowing them a much smoother transition to the new normal environment of higher capital and liquidity ratios, low interest rates and low revenue growth, while at the same time remaining open for new business with their clients.

In sum, both the absolute size of its effectual market intervention and the tailwind the central bank provided (and was allowed to provide) more generally to governments and the economy as a whole proved much more overwhelming in the US than in the euro area, thus contributing to banks on the Western shores of the Atlantic emerging faster and stronger from the ashes than their peers from the Eastern coasts.

What do the Fed’s announcements about a possible tapering of QE then imply for the banking sector? Given that US banks as well as the entire economy seem to be on a fundamentally relatively sound path, probably not too much.
Banks’ funding costs may rise, initially pushing the net interest margin further to the downside, yet afterwards it may rise again as banks are able to charge their clients more, too. The consequences for European banks should also be manageable. Funding costs for them have been substantially higher than in the US for longer, driven by the debt crisis, and many foreign investors had pulled away from them anyway. Hence, even with international capital flowing back to higher yields in America, Europe may be affected relatively little. Even more, the end of the recession and the start of a – timid – recovery may well bring about a return of confidence in European financial institutions that leads to a decline in banks’ funding costs. Overall, thus, tapering may not pose a major risk and threaten neither US nor EU banks.

Conclusion

US and European banks nowadays are literally and virtually an ocean apart. This has not always been the case – in fact, before the financial crisis, they looked rather more like twins (despite some significant differences). Today, however, US banks are among the most profitable, most valuable and strongest ones in the world, and growing their business again, whereas European banks on average report poor profitability, are shrinking their business activities including a pull-back from overseas markets, restructure their operations and are “rewarded” with low share prices.

There is a triad of major reasons underlying these huge differences:

— macroeconomic factors such as a quicker adjustment and deleveraging of the real economy in America, while Europe (its corporate sector, labour markets, the housing market etc.) had more problems to achieve a turnaround

— internal banking sector drivers such as US banks’ more rapid dealing with legacy assets from the pre-crisis boom period and European banks’ initially weaker capital position which forced them to shrink more and still remain preoccupied with the past for longer

— institutional differences such as a cohesive US market, with a powerful central government, an undoubted currency and an interventionist central bank compared with, on the other hand, a European market suffering from a lack of common action and suspected of falling apart because of diverging national interests and weak central institutions

Ranking these three main channels of American banks’ “return to glory” and European banks’ “perennial struggle” is difficult as they all played into each other, compounding their effect. It may be clear, however, that quick and decisive, sometimes radical action by decisionmakers – especially politicians, supervisors and financial-industry executives – has been crucial. To be fair, in some respects, e.g. fiscal matters, Europe has done more than the US, thereby adding to the pressure the economy – and the banks – were facing anyway. More generally, it is an open issue whether the more aggressive central bank policy in the US will have damaging effects in the long term which would then burden the financial industry and the real economy alike. America has also been more reluctant and postponed the implementation of necessary structural reforms e.g. with regard to the housing giants Fannie Mae and Freddie Mac, while its extremely loose monetary policy stands just at the very start of a long tightening process. These changes would and will most certainly dampen the economic recovery and thus also blur the comparatively promising outlook for US banks. Equally, many of the factors currently acting as a drag on European banks may slowly subside sooner or later. Hence, while a narrowing of the currently enormous (performance) gap between European and US banks
Bank performance in the US and Europe

depends on many factors, economic as well as political and regulatory, this vast virtual “ocean” is more likely to turn into a “sea” rather than becoming even larger over the next few quarters and years. The gap as such will probably remain, though.

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Bank performance in the US and Europe

Literature


