European banks' profitability: plus ça change?

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Causes of low banks' profitability in recent years

Low interest rate environment, resulting from central banks' aggressive monetary easing policies in response to the economic climate that followed the financial crisis of 2007-08;

Legacy assets issues, stemming from the euro area sovereign debt crisis, with banks struggling with high shares of non-performing loans (NPLs);

Stricter regulation, requiring an adjustment away from risky activity, or increased staffing;

Challenges related to digital transformation and FinTech, such as increased outlays on IT and cyber-security, while adapting to competitive pressures from FinTechs; and

Overcapacities in the sector, where the supply of banking infrastructure and services outstrips the demand for it, resulting in a market that is overly competitive and often unprofitable.

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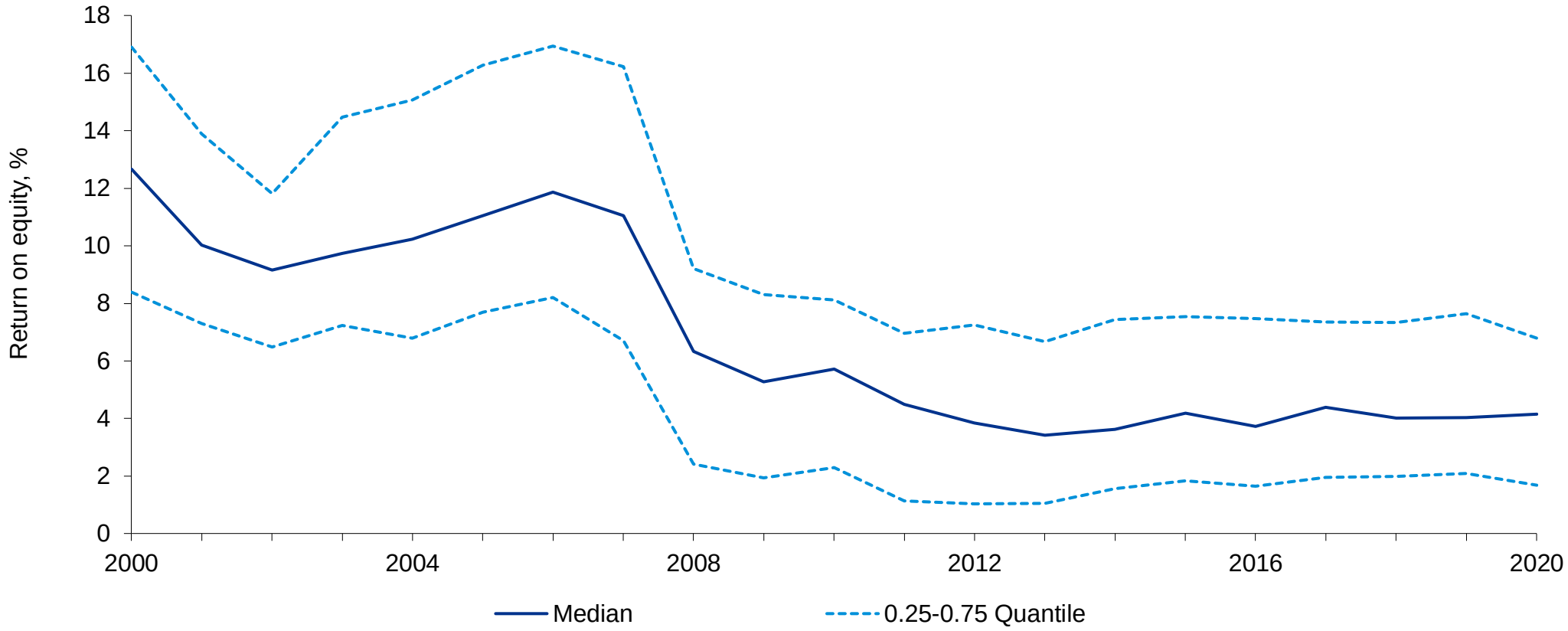
Median European bank's profitability has been weak



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

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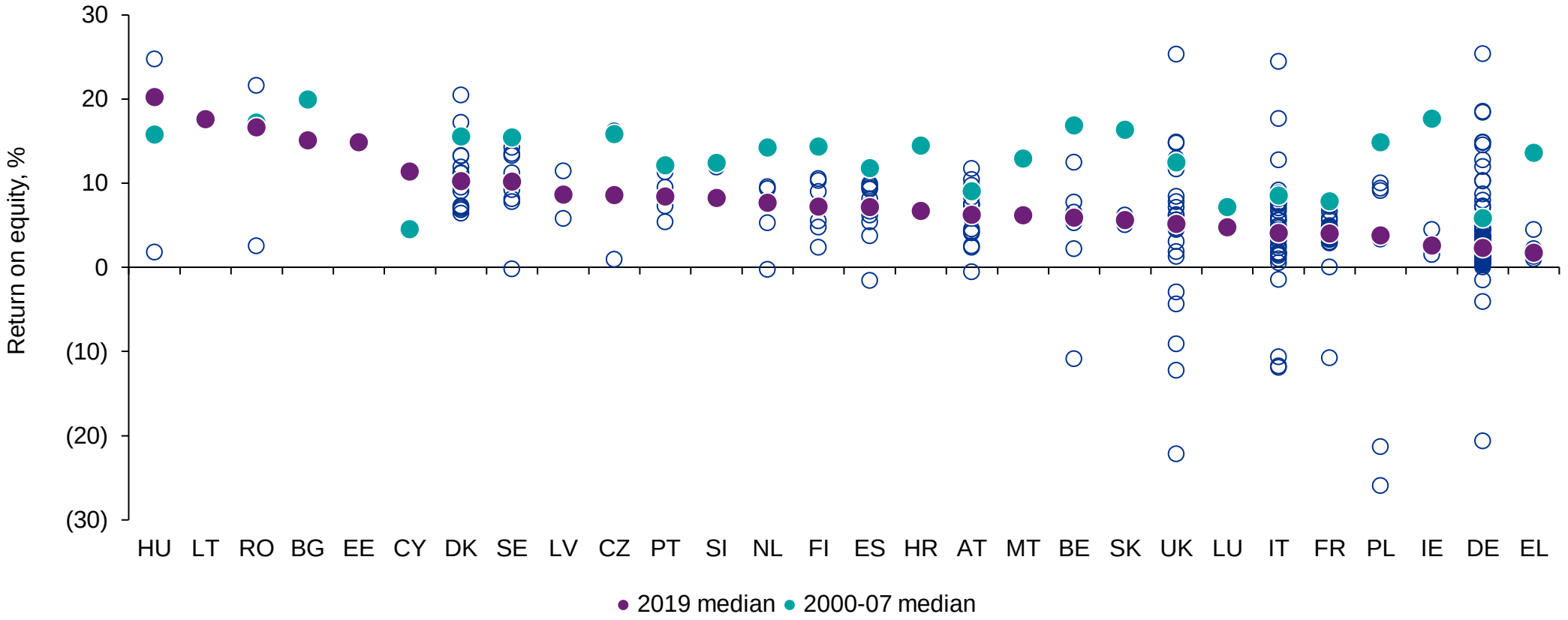
European banks' ROE, 2019 vs 2000-07



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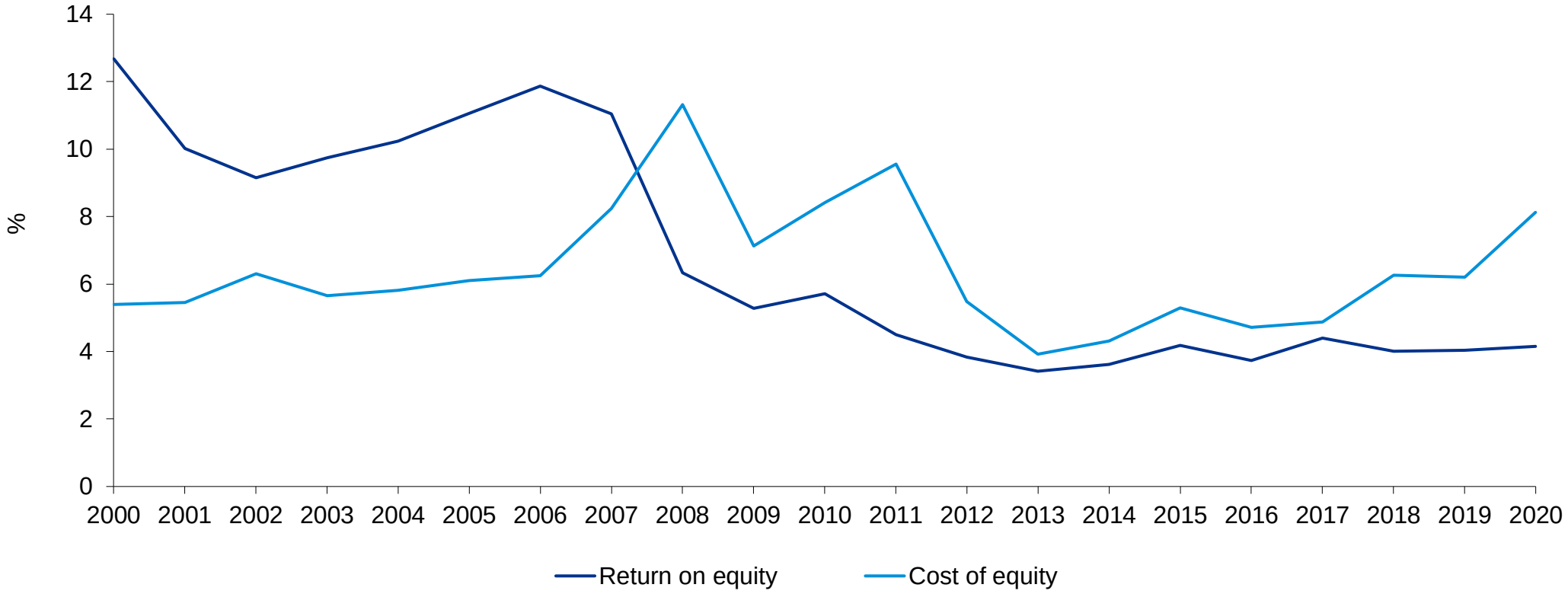
Return on equity has been below the bank cost of equity

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



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

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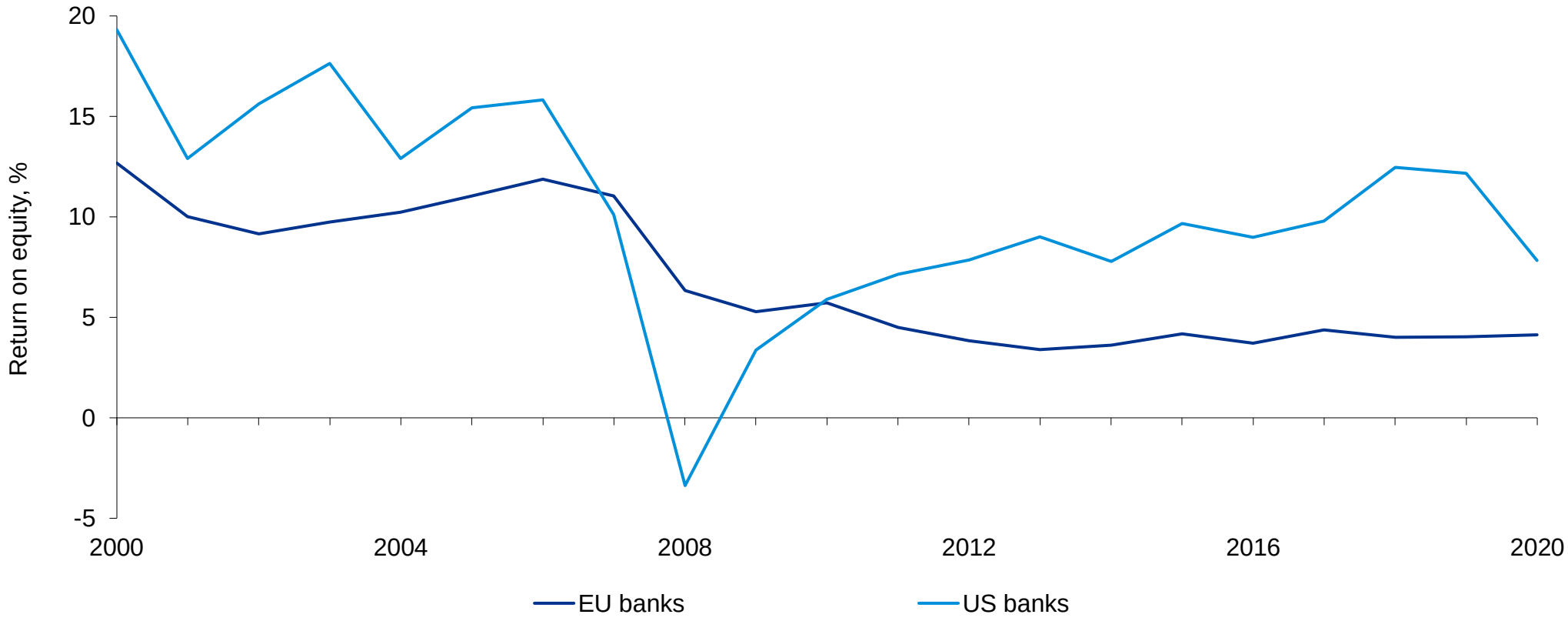
European banks lagging behind US counterparts in ROE...



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

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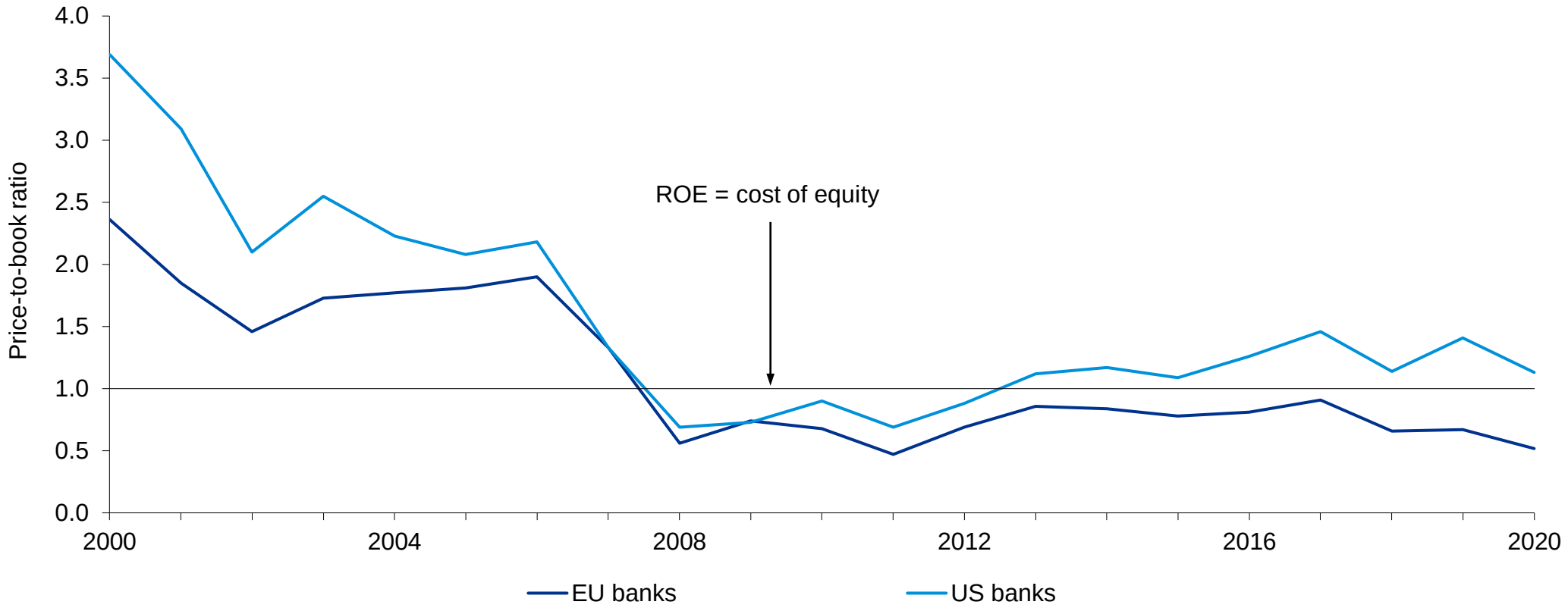
...and price-to-book ratio



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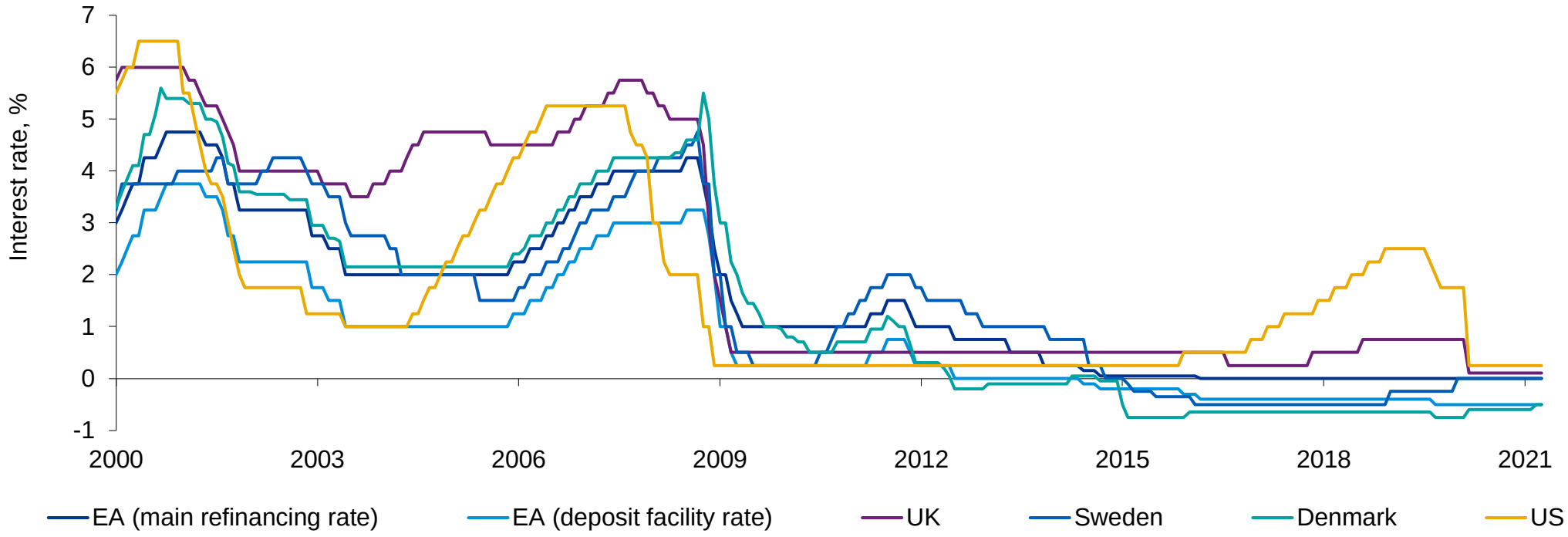
The fall in profitability has occurred alongside the persistent fall in interest rates

Central bank policy rates



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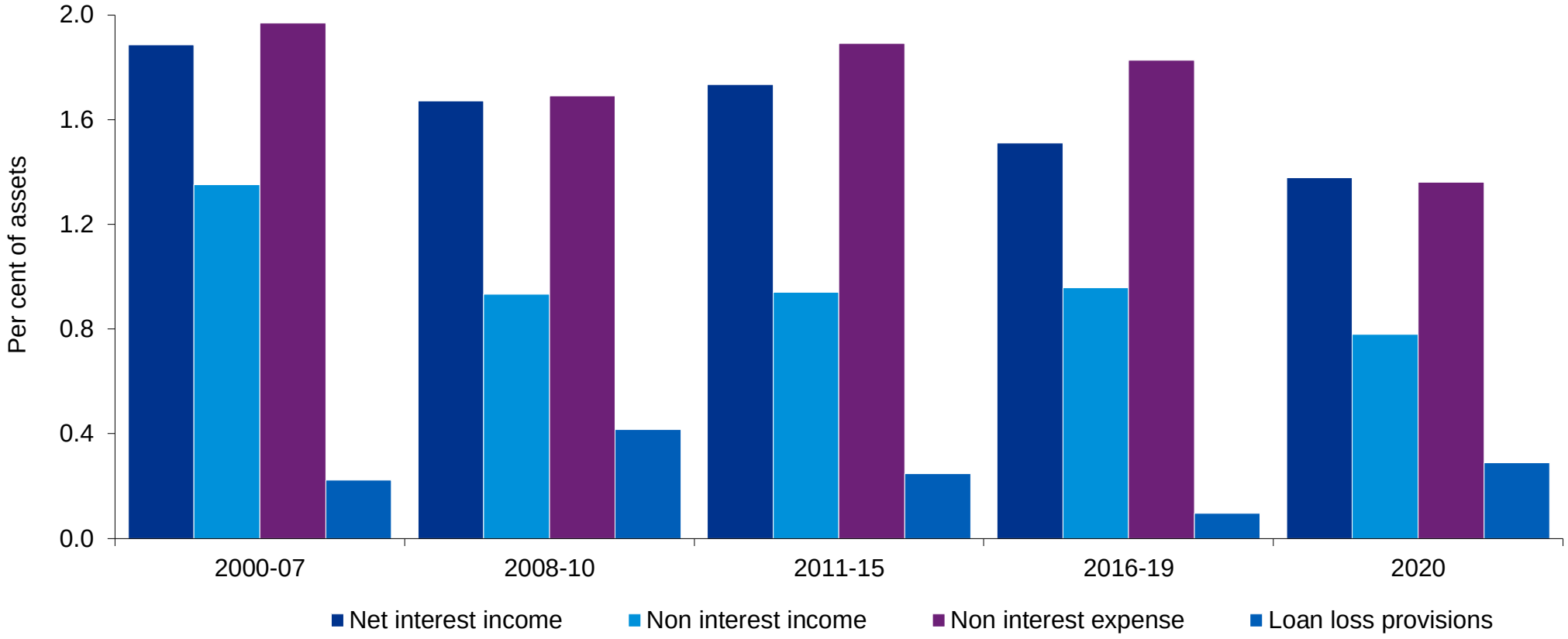
European banks' average breakdown of profitability



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

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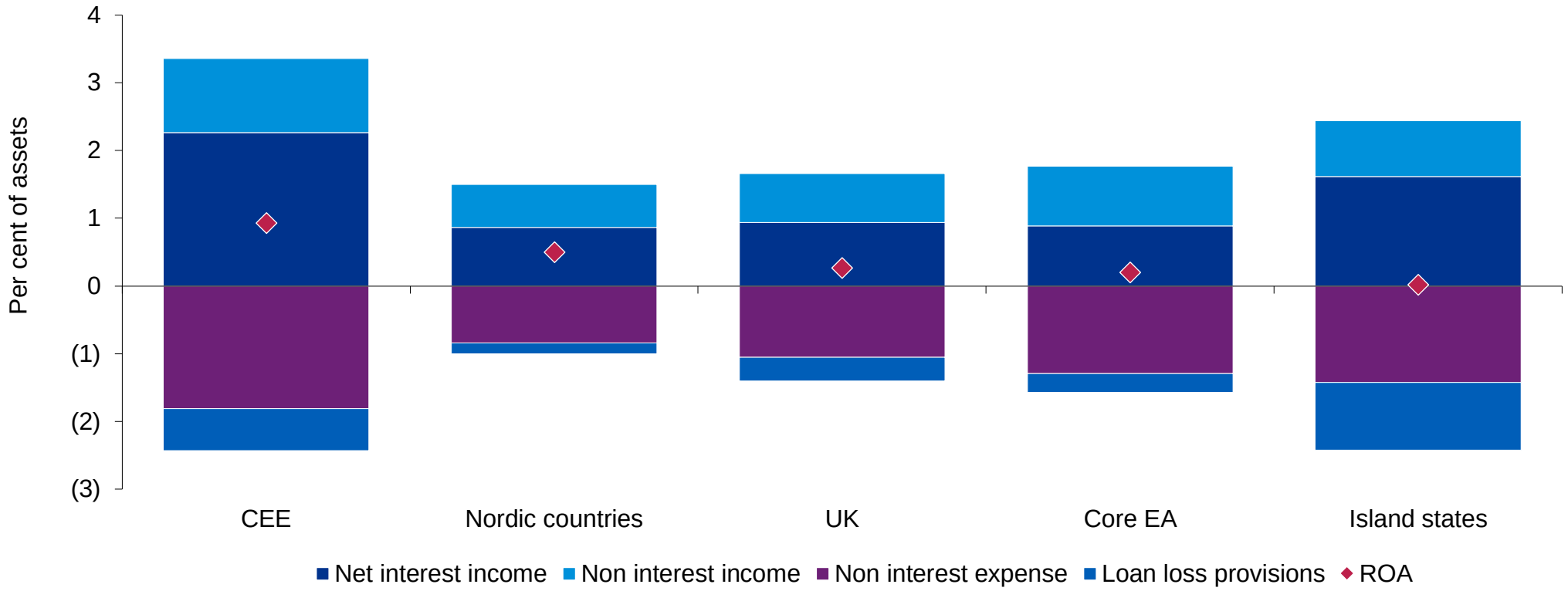
Return on assets in 2020



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

CEE: Lithuania, Romania, Hungary, Estonia, Poland, Latvia, Slovenia, Czech Republic, Bulgaria, Slovakia. Nordic: Sweden, Finland, Denmark. Core EA: France, Italy, Germany. Island states: Cyprus, Malta, Greece, Ireland.

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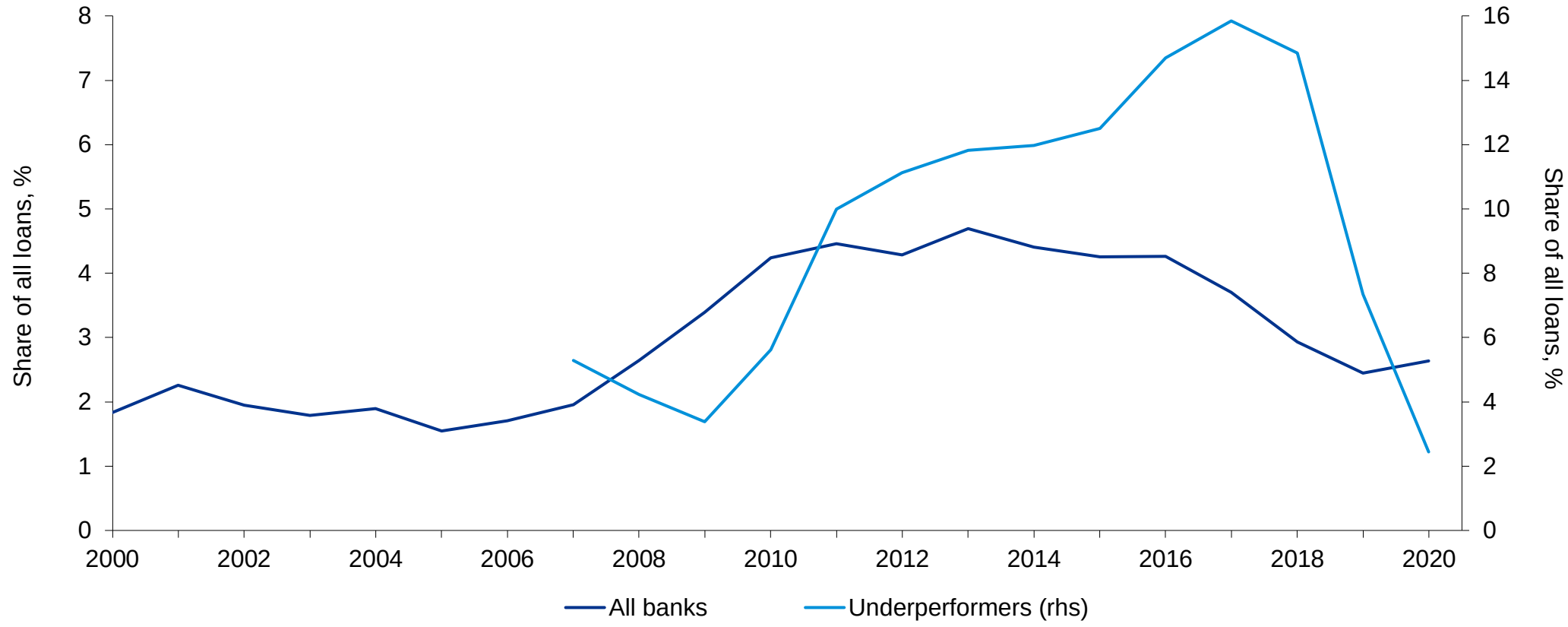
Median European bank's NPL ratio



Source: S&P Capital IQ, Refinitiv Eikon, KPMG analysis.
Note: The figure for underperformers is averaged over 2 years.

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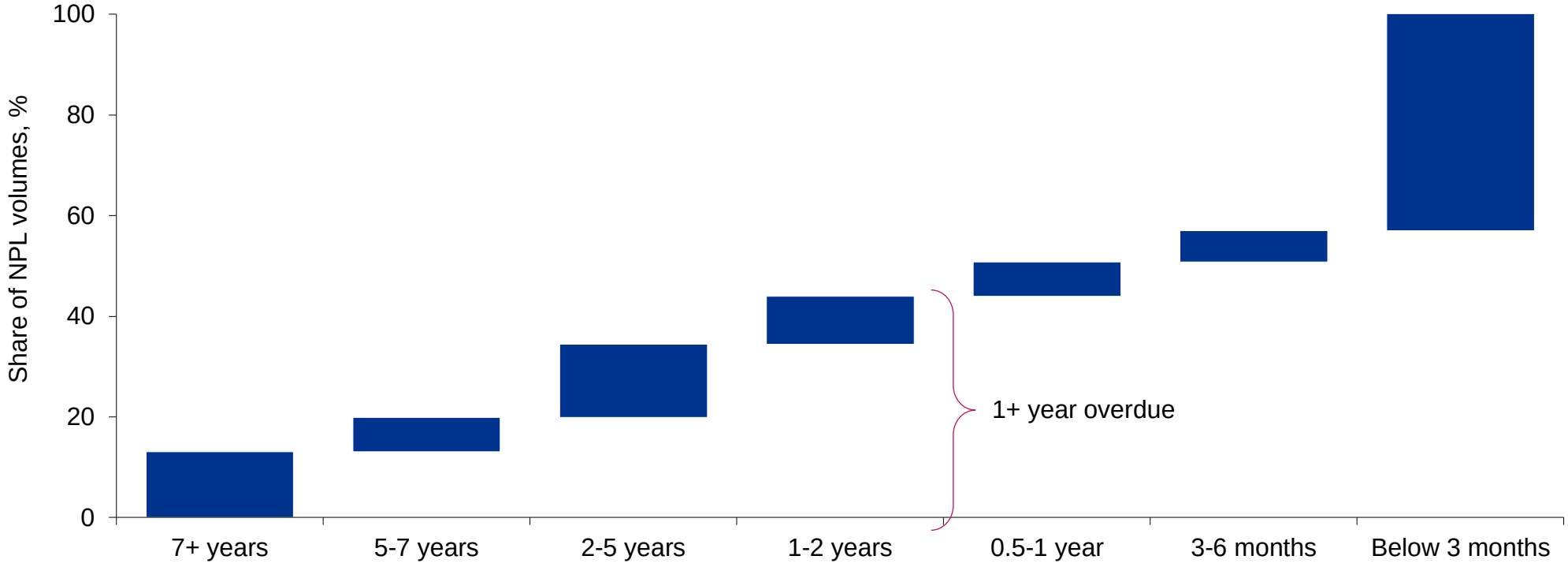
Distribution of EU banks' NPL volumes by past-due category, June 2020



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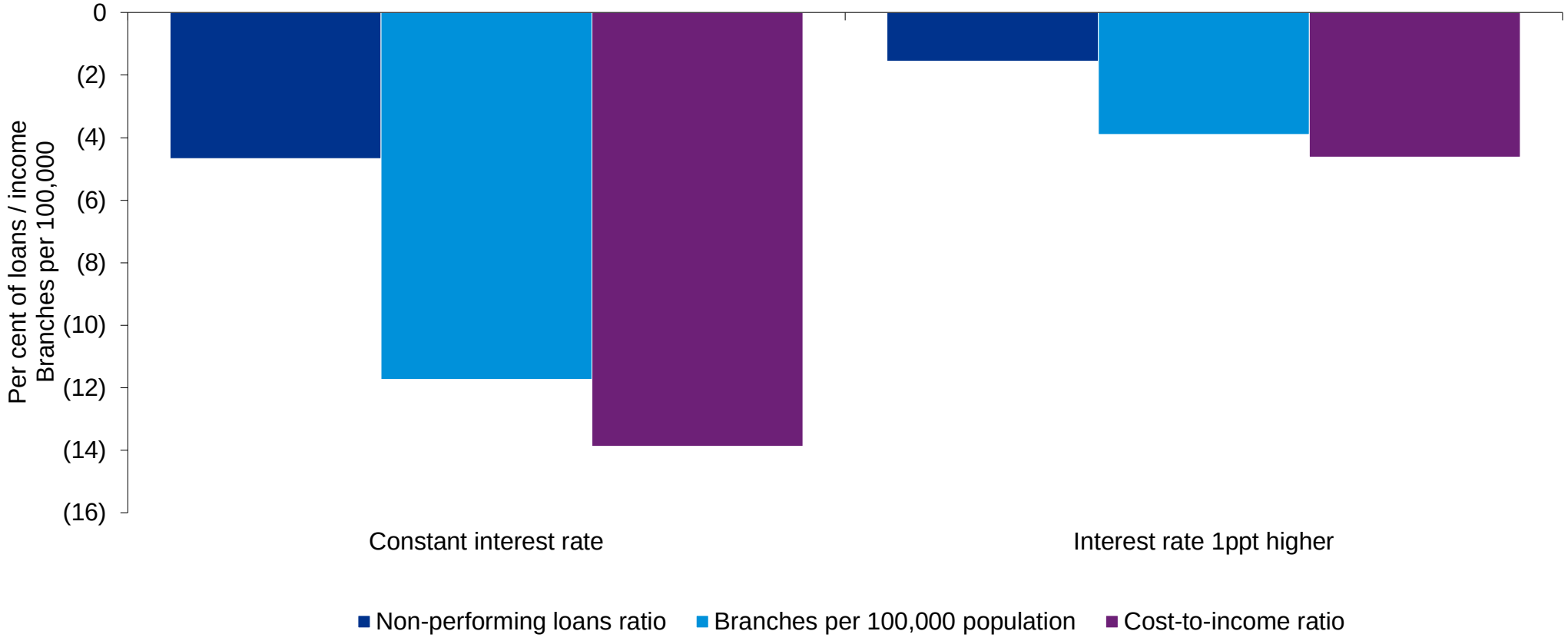
Improvements needed to achieve a 3ppt increase in ROE



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

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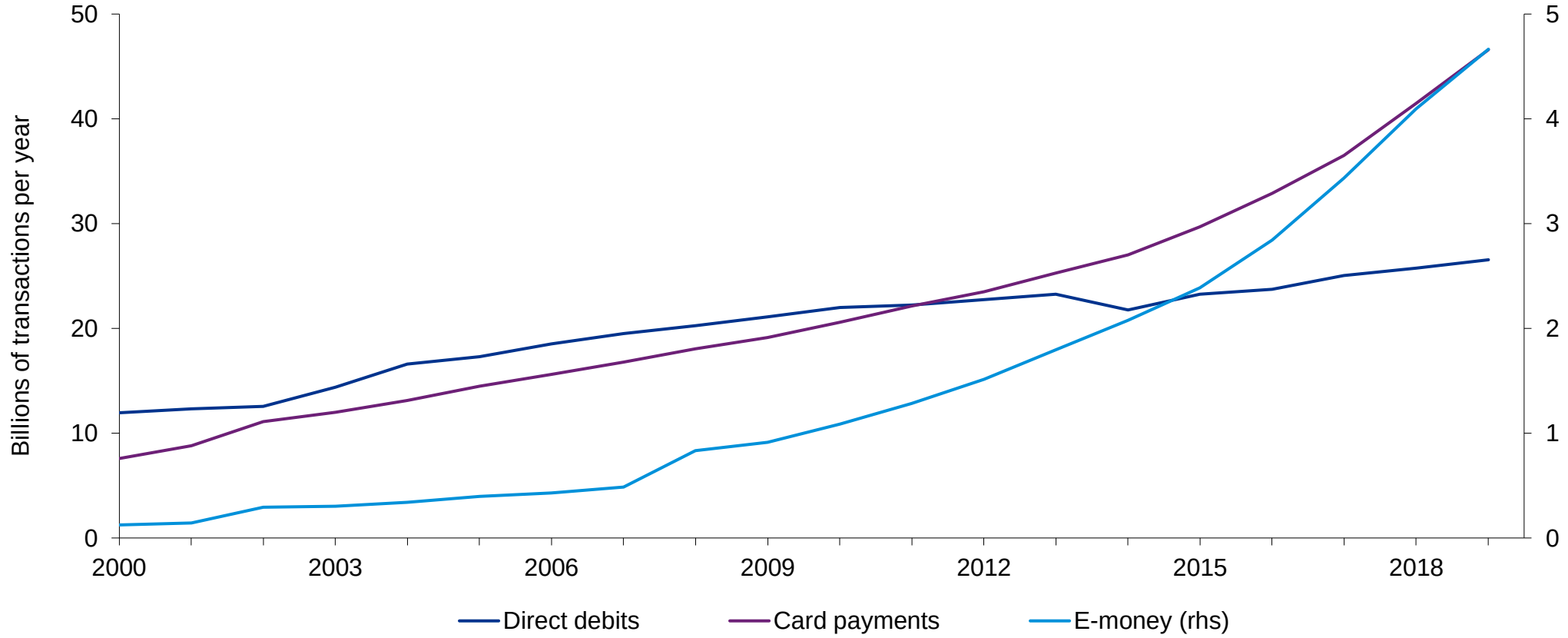
Number of transactions per payment system in the EU



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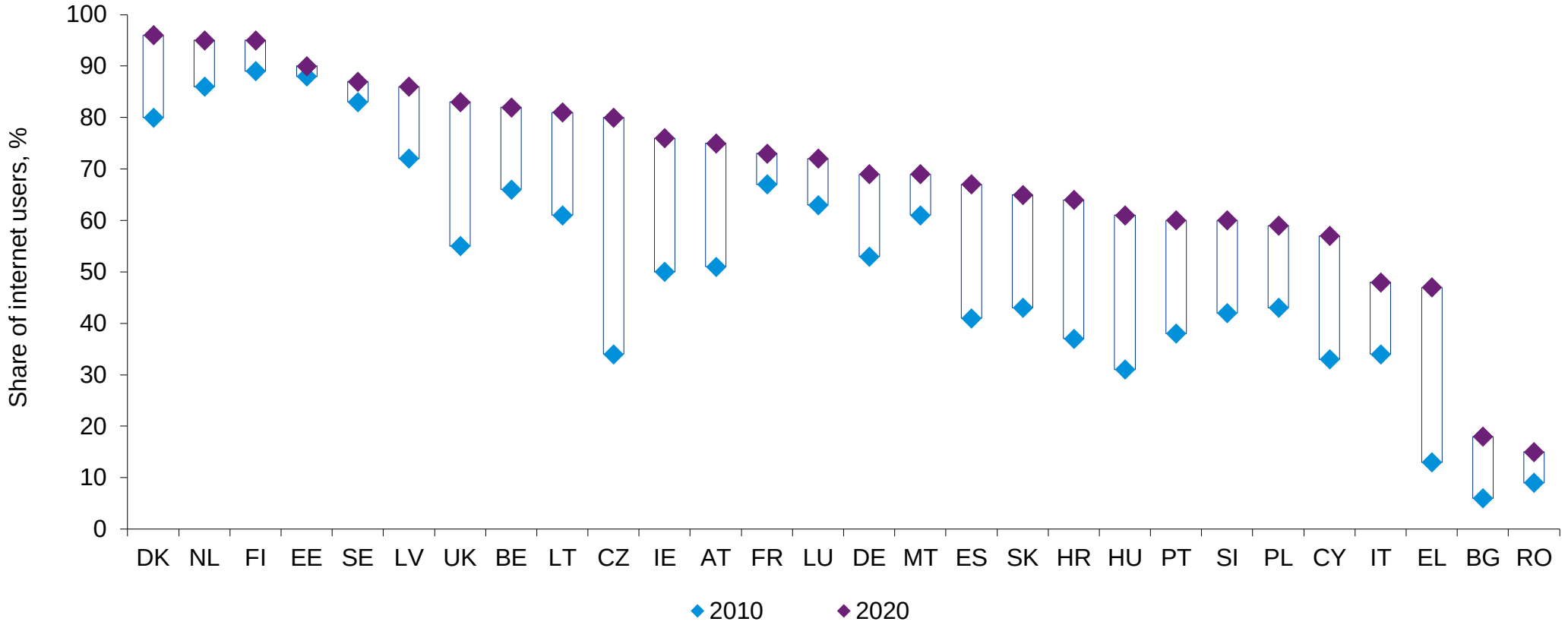
Internet users of online banking



Source: Eurostat.

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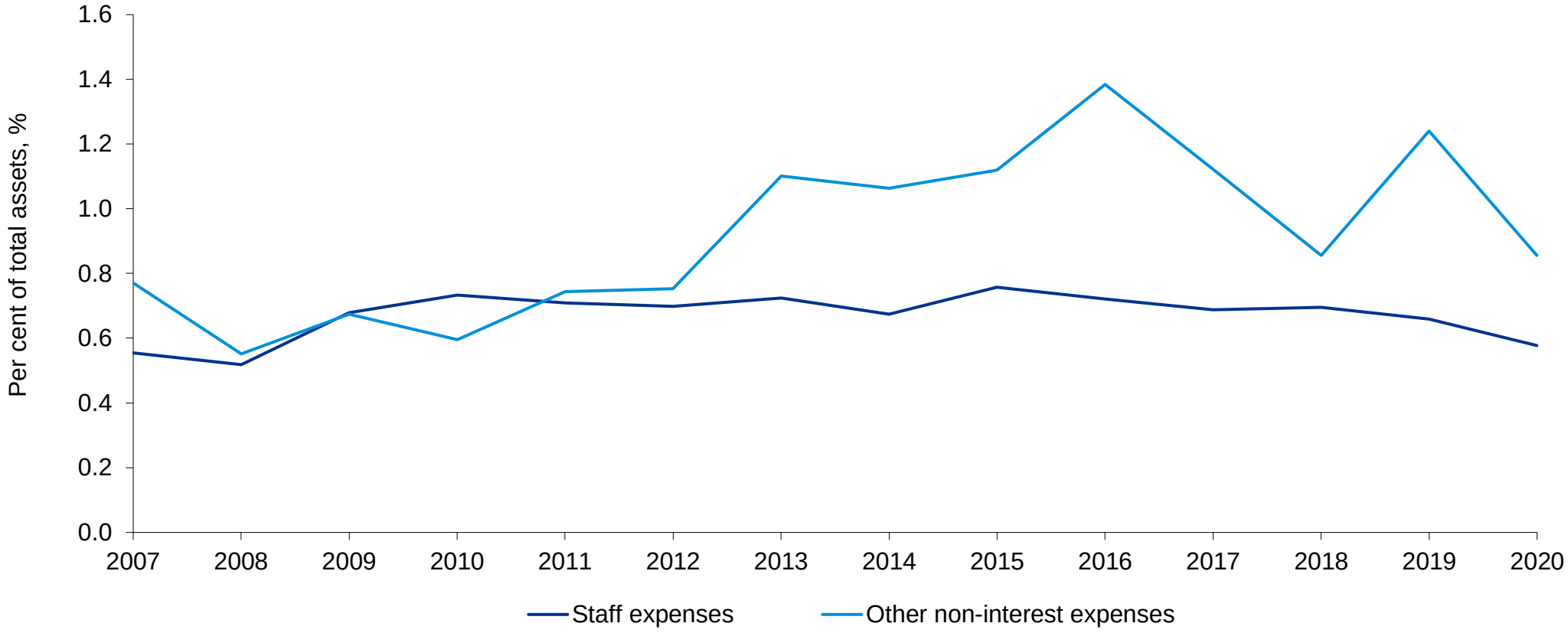
Non-interest expenses across the largest UK banks



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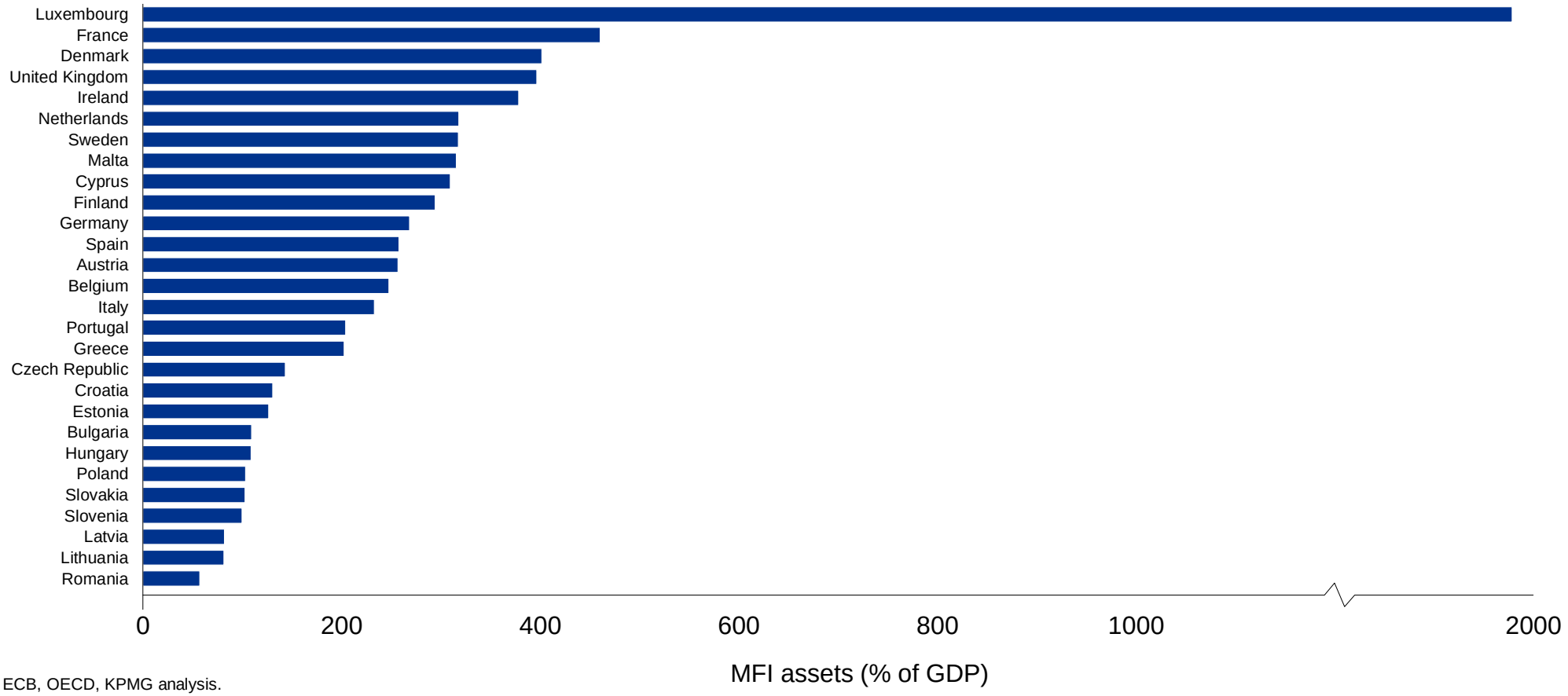
Size of the banking sector in 2020



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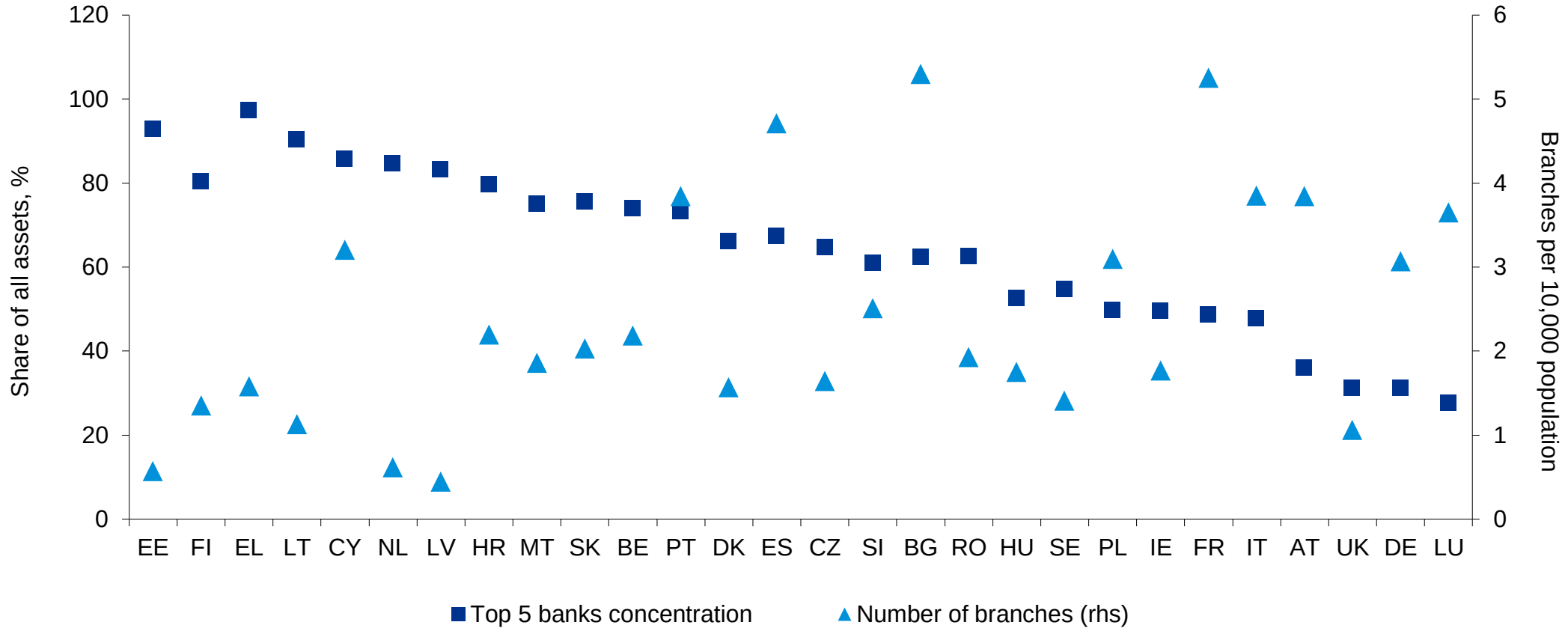
Banking sector concentration measures, 2019



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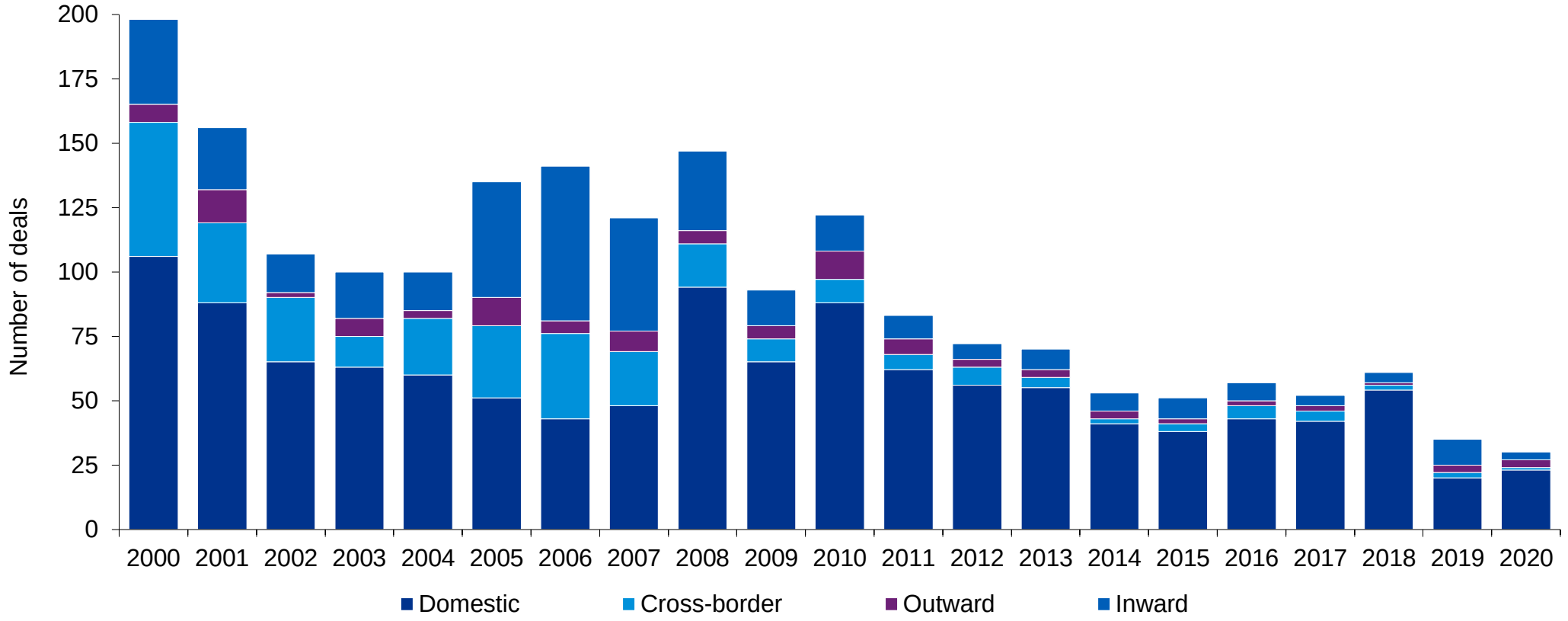
The number of European banking sector M&As has fallen



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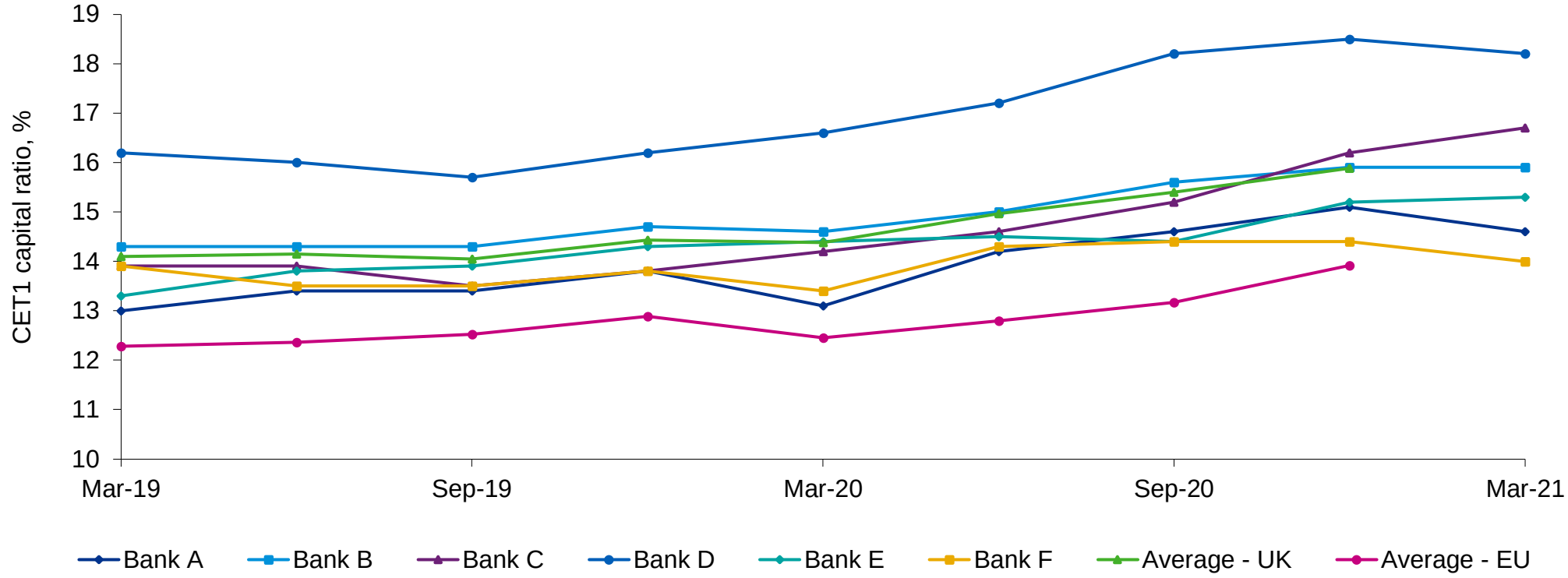
European banks' capitalisation remained strong during COVID-19



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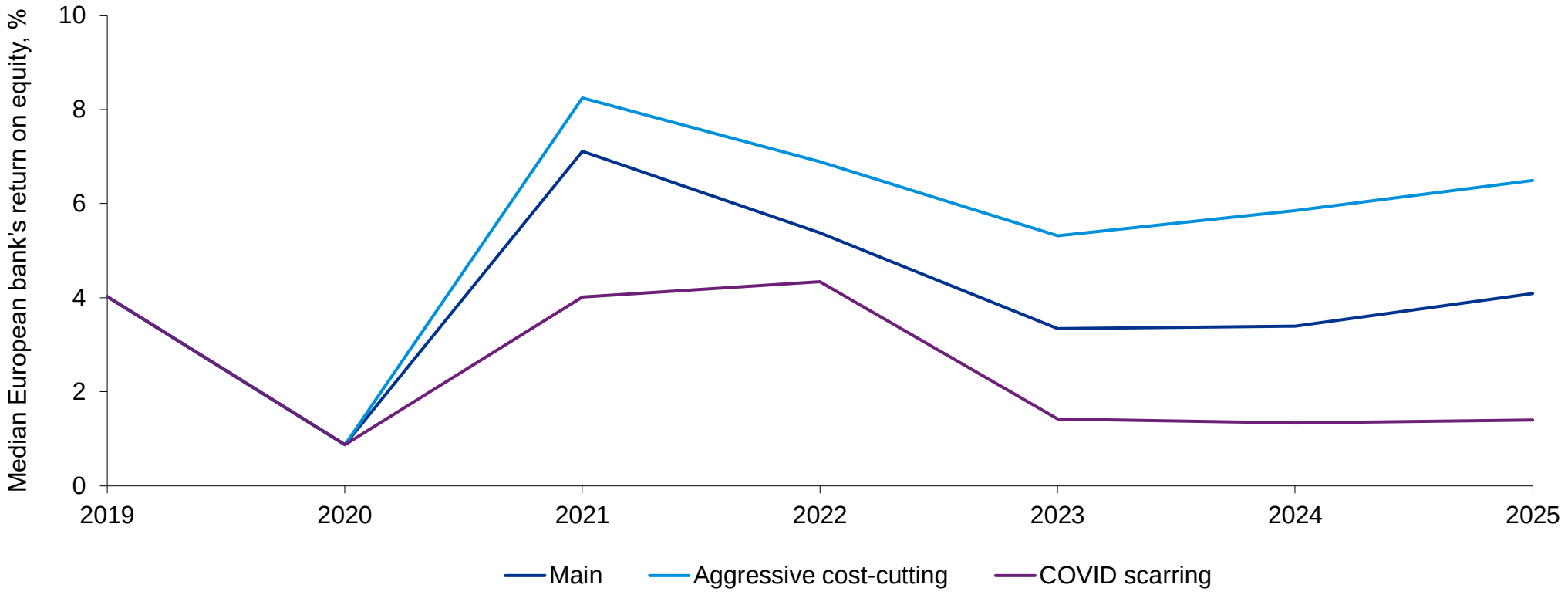
Our scenarios point to different possible paths for profitability by 2025



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

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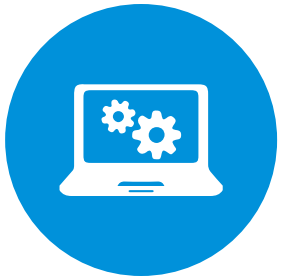
The outlook for profitability

Interest rates will likely remain very low in the near-term, linked to central banks' accommodative monetary policy. That will mean limited scope for relying on banks' net interest income to generate higher returns;



Banks' credit quality may well start to deteriorate again as businesses facing liquidity issues become less likely to repay their loans. The trend in declining loan-loss provisions has already started to reverse last year;

On the other hand, COVID-19 crisis has amplified structural changes in customer behaviour related to the use of digital services, including for online banking. We expect this shift to continue, with an increasing share of business conducted online, and requiring less need for high street branches;

Overall, pressures resulting from the recent crisis will require banks to be more ingenious in pursuing strategies which cut operating costs and diversify their income stream. **Successful banks will be those which can embrace the shift to online while keeping a lean cost structure.**

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