Boosting investor appeal in euro area banks

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Market participants often point to the euro area's more stringent regulations for the persistent valuation gap between United States (US) and euro area banks, believing they limit profitability and growth. However, this explanation overlooks regional disparities in economic growth, monetary policy, and market fragmentation. US banks benefit from a more dynamic and integrated economic environment, allowing greater economies of scale, whereas euro area banks face fragmented markets.

Higher interest rates temporarily improved euro area banks' profitability but are insufficient to reduce the valuation gap sustainably. Completing banking union and capital markets union will help remedy this disadvantage: it will create an environment that incentives the removal of remaining obstacles to cross-border consolidation, thus allowing banks to modernise their business models.This evolution would make euro area banks more efficient and sustainably profitable while maintaining the standards set within the rigorous regulatory framework. Ultimately, these changes could boost investor appeal in euro area banks and thereby reduce the valuation gap.

Market valuation is about more than regulation

A significant valuation gap has persisted for decades between US and euro area banks, which only narrows during times of global crises (see Figure 1). [1] Most market participants attribute this disparity to the more stringent regulatory environment in the euro area, believing it limits profitability and stifles prospects for growth.[2]

Figure 1: Euro area banks persistently traded at a discount to US banks, except during times of global crisis

Price to book-value (in multiples)

Note: SX7E and BKX indices contain the top banking entities in the euro area and US, respectively, by size. These entities are on consolidated basis i.e. may contain non-banking operations.

Source: ESM calculations based on Bloomberg data

While we believe that there is a need for targeted regulatory fixes, this alone will not suffice.[3] The valuation gap is influenced by a complex interplay of factors, including broader regional economic disparities. We find that leveraging upon ongoing pan-European Union (EU) initiatives to modernise their business models could help euro area banks reduce the valuation gap.

Broader regional differences contribute to the valuation gap

Economic growth, monetary policy, and the degree of economic and financial integration are key drivers of companies' valuations. These elements have been on divergent paths for the US and euro area. The US gross domestic product (GDP) growth has outpaced that of the euro area since the second quarter of 2002, reflecting a more dynamic economic environment. This, coupled with relatively higher monetary policy rates, has supported higher US bank valuations to date (see Figure 2). More generally, the economic underperformance of the euro area is at the heart of the competitiveness debate, taking centre stage in policy discussions. [4]

Figure 2: US bank valuations have benefitted from relatively higher economic growth and higher monetary policy rates

Notes: The excess real GDP growth rate represents the difference between the cumulative quarterly real GDP growth rate of the US and the euro area. The larger the number on the y-axis, the larger the gap in favour of US growth versus euro area growth. As business cycles in the US do not move in lockstep with the euro area, the corresponding raises and reductions in policy rates occur with a lag or lead, respectively. Hence, we look at the policy rate at the peak of the respective business cycle and find that the US exceeds the euro area. Assuming comparable trajectories of monetary policy easing and tightening, the average policy rate level is higher in the US. Thus, this offers another explanation for banks' higher profitability and subsequent valuations.

Source: ESM calculations based on Organisation for Economic Co-operation and Development and Bank for International Settlements data

Additionally, euro area market fragmentation exacerbates the valuation gap. The EU market remains primarily divided along national lines, with varying market practices and competitive conditions across member states, not to mention different tax systems and corporate insolvency laws .[5] This contrasts sharply with the more integrated and cohesive US market, where companies can achieve greater economies of scale and efficiency, which results in higher valuations for US companies.[6] This is showcased by the overall valuation differences persisting across different industries, illustrated by the valuation gap between the general market indexes, the S&P 500 and the STOXX 600 (see Figure 3).

Figure 3: Broader regional differences have contributed to a valuation gap for listed companies

Price to earnings (in multiples)

Source: ESM calculations based on Bloomberg data

Cyclical profitability does not compensate for structural differences

Cyclical profitability supports higher bank valuations but is insufficient to reduce the valuation gap given the gains are short-lived. Higher interest rates have boosted euro area banks' profitability. Many banks with variable-rate loan books reported the most significant improvements in net interest margins, which, amidst sustained asset quality, contributed towards rising valuations closer to 1x price-to-book value ratios (see Figure 4).

Figure 4: Euro area banks with mostly variable rate mortgage books have historically traded at a premium to their peers with mostly fixed rate mortgage books

Price to book-value (in multiples)

Note: Majority fixed rate mortgages and majority variable rate mortgages represent the breakdown of euro area banks that are part of SX7E Index based on whether the majority of the bank's mortgage book is at a variable or fixed rate.

Source: ESM calculations based on Fitch data

However, higher interest rates may also lead to market perceptions that banks' earnings will eventually decline due to rising costs, such as funding costs (wholesale and deposits), higher staff wages, and additional provisions against deteriorating asset quality. As these profitability gains are only cyclical and unsustainable, euro area banks' market valuations still lag behind their US counterparts due to the less positive earnings outlook (see Figure 5).

Figure 5: Profitability gains are cyclical and do not indicate a sustainable growth trajectory

Return on equity (in %)

Source: ESM calculations based on Fitch data

Aiming for efficiency to support banks' competitiveness

Scale and consolidation are prominent factors in increasing banks' efficiency and, therefore, growth potential. In contrast to US banks, euro area banks are constrained by a fragmented market across national lines, limiting their ability to scale and diversify geographically and across financial services.[7], [8]

The largest US banks have a greater market share than the largest euro area banks, though that of the euro area is more evenly distributed. Historically, US asset consolidation was driven by larger US banks absorbing numerous smaller savings and loans associations over time.[9] For the euro area, bank consolidation occurred within national borders, leading to the ten largest euro area banks being based in five countries (see Figure 6).

In a single integrated market within the euro area, such national lines should not play a role in the provision of banking services. Still, the valuation discrepancy we observe indicates that investors do not value the cohesiveness of the current setup of the single market to the same extent they do in the US.

Figure 6: Large US banks hold more market share compared to their euro area peers

Notes: Market share is calculated as the percentage of each bank's total assets divided by the total assets of the whole banking system. Data for US banks is from Federal Deposit Insurance Corporation, and US system-wide total assets are calculated as a sum of the total assets of all Federal Deposit Insurance Corporation-insured banks. For the euro area, the individual bank's total assets are sourced at the highest level of consolidation from Fitch, and the euro area system-wide figure is based on European Central Bank consolidated banking data. Therefore, by considering the highest level of consolidation for euro area banks, we overestimate their total euro area market share by including non-euro area exposures. Nonetheless, they still lag behind their US peers.

Source: ESM calculations based on Fitch, Federal Deposit Insurance Corporation, and European Central Bank data

Advancing banking union and capital markets union is essential for equipping the EU financial system with the necessary tools to support growth and tackle global challenges, including the green and digital transitions. [10] The completion of capital markets union could pave the way for a pan-EU securitisation platform to provide a mechanism for banks to offload loans from their balance sheets, boost sustainable profitability, and reduce domestic exposures. [11] Ultimately, this could help create the environment to incentivise the removal of obstacles to cross-border consolidation. [12], [13]

By reducing market fragmentation and encouraging the expansion of cross-border activities, banking union and capital markets union would help modernise euro area banks' business models. This would enable banks to better leverage economies of scale, accelerate their adoption of innovative technologies, and enhance their global competitiveness.

Existing EU initiatives can reduce the valuation gap

Boosting investor appeal in euro area banks requires a multifaceted approach. While regulatory adjustments could bring some efficiency gains, they would not suffice because the impediments to sustained profitability are more profound and thus require structural reforms enabled by the completion of banking union and capital markets union. In doing so, the euro area can leverage its rigorous regulatory environment while also fostering a more dynamic, competitive, and financially stable banking sector through innovative financial structures and cross-border diversification.

Promoting larger EU banks that are operational across countries rather than national champions will enhance banks' ability to service the euro area economy and boost their appeal to investors. By addressing structural challenges and fostering greater market integration, the euro area can maintain the resilience driven by its regulatory environment and improve its growth prospects.

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Footnotes

[1] There are many ways to value a company. We measure a bank's valuation by price to book value (in multiples). For a non-bank company, we measure valuation by price to earnings (in multiples). A valuation gap is the difference between the valuation metrics of one index and those of another index.

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