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U.S. and European Banks: Two Sides of the Same Story?

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Will the size differences between American and European banks impact their ability to rebound from the financial crisis?

Does internationalization of banking play a role in the success or failture of U.S. and European banks?

What trends are likely to emerge in the banking industry as new regulations are implemented?

American and European banks take center stage in the current global financial crisis—but are they really as similar as current developments seem to suggest? How do the fundamentals of banking markets on both sides of the Atlantic compare?

While financial institutions in the U.S. are at the heart of the storm, European banks have faced strikingly similar problems, proving how deeply interconnected national financial systems have become. European banks have been hit nearly as much as their American peers by losses from subprime mortgage investments, leveraged loans, and failed financial hedges. They have taken even more of a beating in the stock markets (the respective European sub-index fell by 68 percent since the onset of the crisis on August 9, 2007; the American counterpart by “only” 57 percent), with embarrassing failures of national bank icons and bank runs thought an unpleasant memory of the distant past.

Prior to the crisis already a remarkable long-run convergence of banks’ profitability levels occurred: whereas U.S. banks have been highly profitable rather consistently throughout the 1990s and up until 2006, European banks initially still struggled with greater inefficiencies and recovered only slowly from the economic downturn at the beginning of the 1990s. Since then, however, they have made impressive progress and have steadily improved profitability and efficiency—only shortly interrupted by the burst of the “New Economy” bubble after 2000—and have closed in on American banks, even overtaking them with regard to return-on-equity (ROE) levels in 2005. Now both American and European banks’ profitability levels are sinking in unison.

This suggests that there has been strong convergence of banking markets in the U.S. and Europe over the past decade and that American and European banks may (now) be two sides of the same story. To evaluate such a statement, three dimensions in particular seem worth considering: 1) the development of market structures, especially consolidation; 2) changes on the revenue side—especially diversification both at the geographic level and with respect to business segments; and 3) the regulatory environment with particular focus on the substantial adjustments it will undergo as a result of the current crisis.

To begin, the number of banks has been decreasing continuously in Europe (negative 29 percent from 1997 to 2007 in the EU-15) and America (negative 22 percent), which resulted in the average bank roughly tripling in size. Huge differences, however, remain between the EU banks' average of $8.6 billion in total assets and U.S. banks' $1.5 billion. (Even Germany with its infamously fragmented banking sector reaches an average bank size of $5.5 billion.) With roughly the same number of banks, this indicates that European banking markets are much larger as compared to the U.S., which in turn is a result of a different evolution of the financial system: the U.S. has always had a much more market-based system, with the capital market providing a large share of funding for corporations and investment opportunities for private households. Conversely, in (especially continental) Europe, banks have traditionally played a much more important role as financial intermediaries.

A second indicator that points toward at least some convergence between U.S. and European banks can be found in branching trends. Whereas the total number of branches in the "old" EU countries has declined slightly since 1997 (mainly due to a strong reduction in Germany), in the U.S. it has been growing fairly steadily—but still hardly reaches half of the European level. For better comparison, branches per inhabitant are an often-used measure and here, again, the U.S. has caught up and closed some of the gap with Europe. Nonetheless, the branch density remains considerably higher in European countries.

Banking markets both in the U.S. and the EU-15 have also become more concentrated in fewer hands. While the American market has traditionally been rather fragmented, consolidation since the 1990s had already left its stamp in Europe and given the top five banks on average more than 50 percent of the market at the beginning of the twenty-first century. Since then, the share has continued to rise, but at a relatively modest pace. (Germany remains the clearest laggard, and progress has also been slow until recently, when significant changes within the private pillar of the banking system got under way.) By comparison, the increase in market concentration in the U.S. has been greater than in the EU-15 even before taking into account recent mergers among some of America's largest banks. Including these mergers, the market share of the five largest banks (the so-called CR-5 ratio) has surged by an extraordinary 14 percentage points (ppt) since 2001.

This shift, however, has not primarily come from change at the regional level: there is a much lower increase (if any at all) in market concentration in individual states than at the national level (see Chart 1).

What is probably the more important reason for the shift is an exceptional move toward interstate branching—and therefore belongs to the second dimension when comparing European and American banks: the development of revenues. The breakthrough for interstate branching and thus a big boost to the integration of the inner-American (retail) banking market came in 1994 with the adoption of the Riegle-Neal Act. Interstate branching increased

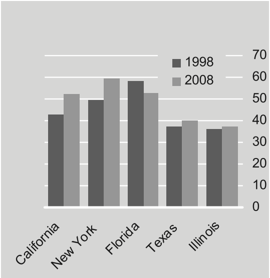


Chart 1: Market Share of the Five Largest Banks, as Percent of Total Assets (left) / Percent of Deposits, Five Largest States by Deposit Volume (right)*

* USA: as of June 30, 2008 and incl. JPMorgan-WaMu and Wells Fargo-Wachovia transaction; EU: unweighted average

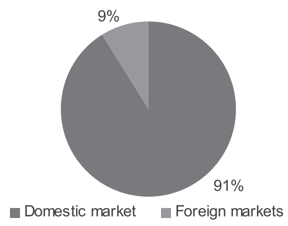
Sources: Federal Reserve, ECB, DB Research

the most after Riegle-Neal came into full effect in 1997, after which the number of interstate branches surged to about 40,000 today—nineteen times the level in 1994. Similarly, the share in total branches rose several fold to now more than 40 percent.

One of the most important drivers of this shift has been the emergence of a few large banks that have become increasingly active on a national scale. Two of the most outstanding examples are the rise of Bank of America and of Wells Fargo. Bank of America was established in 1998 by the acquisition of BankAmerica by NationsBank which afterwards changed its name to Bank of America. The geographic fit was excellent as both banks had an overlap of branches in only four states, with NationsBank being present in seventeen states and BankAmerica in twelve. Later, Bank of America expanded into another ten states and pulled out of only two. Thus, as of summer 2008, Bank of America operates branches in thirty-three states—still falling considerably short of covering the whole country but operating the largest banking network by far in the U.S.

Wells Fargo and Wachovia, on the other hand, were still mid-sized banks back in 1998 with a presence in ten and six states, respectively. Both then expanded at a similar pace, with the former extending its branch reach to twenty-three states until summer 2008, the latter to currently twenty-one states. Following their recently announced merger, which again involves limited geographic overlap (both banks compete with each other in six states only), the combined institution will even supersede Bank of America as the institution with the broadest presence in the U.S. of any bank, covering thirty-eight states.

Focusing strongly on domestic expansion, U.S. banks, however, had fewer resources to devote to increasing their international footprint. This is in sharp contrast to European banks which have made great efforts to become less dependent on their respective domestic markets in recent years. In fact, for the twenty largest European banks, the national market already accounts for less than half of total revenues today, down from 53 percent in 2001, whereas the share of revenues from other European countries has risen substantially. In contrast, foreign operations hardly play a



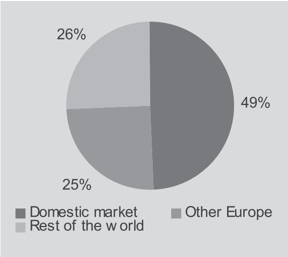


Chart 2: Geographic Distribution of U.S. and European Banks' Business; Left: Assets of the 20 Largest U.S. Banks by Region; Right: Revenues of the 20 Largest European Banks by Region***

* 30 June 2008, unweighted average; Incl. JPMorgan-WaMu and Wells Fargo-Wachovia transaction

Sources: Federal Reserve, DB Research

** 2007, unweighted average

Sources: Federal Reserve, DB Research

significant role for most U.S. banks. While there is no comparable data to the European breakdown of revenues, the fact that 91 percent of total assets of the top twenty U.S. banks are located in the U.S. clearly underlines the difference (see Chart 2). Major changes to this picture seem unlikely for the coming years as the U.S. market remains relatively attractive for U.S. banks, while European banks are set to continue their internationalization rather steadily.

Whereas large differences exist—and are set to persist—between Europe and the U.S. with regard to the geographic diversification of banks' business, developments in the structure of revenues with respect to the mix of business segments reveal greater similarities. Europe has moved from a primarily bank- and balance sheet-based financial system closer to the American model of an integrated financial system based both on banks and capital markets. Even though a partial reversal seems likely as a result of the current financial crisis, banks will nonetheless continue to actively manage risk by using securitizations and credit derivatives. There will be no return to the risky (considering concentration risk) and inflexible balance sheet-based banking of the old times.

This trend, the so-called convergence of traditional on-balance-sheet banking and capital markets, is most clearly reflected in the share of non-interest income—i.e., mostly fees and commissions but also trading income—in total bank revenues: in the U.S., the share has been growing from 34 percent to 42 percent over the last decade for commercial banks alone (i.e., the investment banks with their primarily fee- and trading-based business are not included here). In some of the largest European banking markets, the increase was even stronger, e.g., in Germany (+31 ppt to 52 percent), France (+16 ppt to 63 percent), or Italy (+24 ppt to 48 percent). The United Kingdom was a notable exception with a modest 3 ppt decline from a relatively high starting level of 39 percent. For the time being and for the next few years, the general shift has probably come to a halt, but considering the long-run trend, a further increase in the importance of non-interest income seems in the pipeline not least as growth in interest income may be moderate due to global interest rates remaining at relatively low levels.

The third area to compare U.S. with European banks, the regulatory framework, will be reshaped to a large extent as a result of the current crisis. With the scope of the discussion continuing to widen, currently five main topics emerge:

1) Requiring higher capital buffers for banks: in a longer-term analysis, it is hard to find evidence for a general increase in (commercial) banks' leverage in the U.S. and the largest European banking markets (though investment banks had indeed become more leveraged in recent years). At the same time, banks in Europe used to be much less well capitalized than their American counterparts. As Basel II minimum capital requirements have come under criticism for allegedly not capturing systemic risks adequately, some authorities have proposed the alternative measure of a leverage ratio which essentially puts a cap on the ratio of total assets to total equity. However, focusing on a nominal figure such as the leverage ratio does not improve transparency on risk levels exactly because it is completely risk insensitive. It might even provide wrong incentives and lead to an increase in banks' risk levels: to comply with a leverage ratio, a bank could, for example, sell government bills and buy fewer high-yield bonds instead, thereby reducing its total asset volume—but obviously not the incorporated risk. Hence, refining capital requirements within the risk-based Basel II framework would surely be preferable to a simplistic leverage ratio.

2) Holding securitization issuers more accountable: securitizations have triggered a lot of discussions recently. Banks are facing demands to retain some part of the credit risk they want to transfer to investors (e.g., the EU Commission is proposing a 5 percent mandatory retention). Granted, the securitization of increasingly low-quality loans with subsequent sharp rises in default rates has raised questions about banks' judgment, not without reason. But still, there are better instruments than a mandatory retention for securitizations to regain investors' trust, most importantly greater transparency on underlyings and the distribution of risk.

3) Accounting rules: modifications to reclassification rules under International Financial Reporting Standards (IFRS) have doubtless alleviated some pressure on banks and helped them in exceptional market circumstances. Yet this will not be the solution to the underlying problem of uncertainty about the quality of assets. The core principle of fair-value accounting must remain central to banks' reporting. Otherwise, it would be hard to re-establish confidence among investors—and indeed, among banks themselves. Irrespective of the kind of changes that are being made, there is a strong need for internationally consistent rules.

4) Reducing the role of ratings in the risk management process: some consensus also seems to have been reached that too favorable ratings and a lack of discipline on the part of investors contributed to overinvestment in many structured products. Rating agencies have been blamed for acting not in the interest of investors but of the issuers who paid them. While other reasons may have played a role as well, this apparent conflict of interest will induce

some changes, e.g., rating agencies will probably become subject to some supervisory oversight and will have to provide more information on their rating models to investors. The use of ratings for regulatory purposes will also be curtailed.

5) Aligning employee compensation with long-term rather than short-term goals: lawmakers are discussing limits to senior management compensation. But a more fundamental shift in compensation policies is coming from within the industry itself: banks have recognized that too strong a focus on short-term goals can in fact induce behavior that is detrimental to the bank's interest in the long run. By introducing some kind of a bonus-malus system that relates bonuses to profits achieved over a period of several years and delays the effective payout to employees, compensation can be better aligned with a bank's long-term sustainable profitability.

Overall, while many concrete changes are still unclear, close coordination between America and Europe (but also on a global scale) is in sight and hence further convergence of banking regulation on both sides of the Atlantic can be expected. This will ensure that the relative competitiveness of neither side is seriously affected and will even improve the chances of further integration of global financial markets.

To conclude: in many ways, there is remarkable convergence between banking markets in the U.S. and Europe. They have seen a closing of the profitability gap in recent years and now face an abrupt decline side by side. Both have made considerable progress with consolidation even though the U.S. market remains more fragmented than most national markets in the EU. There is also convergence as European banks tend to move in the direction of the American, more market-based banking model, and with regard to new regulatory rules as a consequence of the financial crisis.

Differences between U.S. and European banks are likely to persist, however, with respect to the share of international operations—American financial institutions will remain much more focused on their domestic market than their European peers.

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