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Working Paper How have European banks developed along different dimensions of international competitiveness?

SAFE White Paper, No. 112

Provided in Cooperation with: Leibniz Institute for Financial Research SAFE

Suggested Citation: Heider, Florian; Krahnen, Jan Pieter; Schlegel, Jonas; Pelizzon, Loriana (2025) : How have European banks developed along different dimensions of international competitiveness?, SAFE White Paper, No. 112, ISBN 978-92-848-2676-6, Leibniz Institute for Financial Research SAFE, Frankfurt a. M.

This Version is available at: https://hdl.handle.net/10419/319625

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How have European banks developed along different dimensions of international competitiveness?





Economic Governance and EMU Scrutiny Unit (EGOV) Directorate-General for Economy, Transformation and Industry PE 764.378 - April 2025

How have European banks developed along different dimensions of international competitiveness?

Abstract

This study analyses why European banks, despite improved cost efficiency, continue to trade at lower valuations than their United States (US) counterparts. The gap stems from limited growth potential due to market fragmentation and underdeveloped capital markets. To close this competitiveness divide, the study calls for accelerating the Savings and Investment Union (SIU), expanding investment banking capacity, and implementing smart banking regulation and supervision that reinforces market discipline while enabling risk-taking within a stable, integrated European financial system.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the ECON Committee.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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Manuscript completed in April 2025 © European Union, 2025

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LIST OF ABBREVIATIONS

CIR	Cost-to-Income Ratio
ECB	European Central Bank
EU	European Union
GFC	Global Financial Crisis
G-SIBs	Globally Systemically Important Banks
IB	Investment Banking
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
M&A	Mergers and Acquisitions
NIM	Net Interest Margin
NPL	Non-Performing Loans
ОТН	Originate-to-Hold
OTD	Originate-to-Distribute
P/B	Price-to-Book Ratio
P/E	Price-to-Earnings Ratio
ROE	Return on Equity
SIU	Savings and Investment Union
SMEs	Small and medium-sized enterprises
US	United States

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EXECUTIVE SUMMARY

European banks have made substantial progress in improving operational efficiency over the past decade. Their cost-to-income ratios (CIR) have declined steadily and are now comparable to those of foreign banks operating under similar conditions within Europe. This suggests that, from a current-efficiency standpoint, European banks are competitive. Operational improvements—such as digitalisation, workforce reductions, and restructuring of physical networks—have contributed to a leaner and more responsive banking model. However, this internal progress has not translated into stronger investor confidence. **Despite improved efficiency, European banks continue to trade at significantly lower price-to-book (P/B) ratios than their United States (US) counterparts.** While efficiency improvements should, in principle, lead to higher valuations, the persistent discount on European banks indicates a deeper, structural issue—one that goes beyond current performance and reflects broader market expectations about the future of banking in Europe.

A significant difference between European and US banks in P/B at every level of CIR indicates different expectations about future growth and profitability. US banks operate on a higher P/B-CIR schedule than European banks. While CIR in Europe has improved due to cost reduction measurements and higher interest rates, the difference in schedules appears both in 2018, a low-rate environment, and in 2023, a high-rate environment. This indicates persistent, structural differences that go beyond the current interest rate environment.

US banks operate in a large, integrated, and high-growth market that enables them to scale more easily, generate higher returns, and attract greater capital inflows. In contrast, **European banks remain constrained by fragmented national markets, regulatory inconsistencies, and limited cross-border consolidation.** These structural constraints limit growth opportunities and discourage investment, even when banks demonstrate sound fundamentals. Growth potential is especially critical in today's financial sector, where profitability increasingly depends on scalable, capital-light business models such as investment banking and digital financial services – an area of banking where Europeis not competitive. These business models reward institutions that can serve wide markets efficiently and repeatedly leverage expertise across transactions. US banks have seized this opportunity—benefiting from deep, liquid capital markets and cross-state integration—while European banks struggle to achieve similar reach within a patchwork of national jurisdictions. Without credible prospects for future expansion, European banks are valued as mature, slow-growth entities, limiting their ability to attract capital and remain internationally competitive.

To close this competitiveness gap, **the study recommends three coordinated policy actions**. First, accelerating the Savings and Investment Union (SIU) is essential to **create a truly integrated European financial market**, allowing banks to scale operations and compete at a continental level. Bank cross-border mergers provide all the benefits for the bank's competitiveness and economic growth without the cost of less national competition for customers. Second, enhancing the depth and efficiency of capital markets would enable European banks to **expand into high-value services such as investment banking**. Third, **implement smart banking regulation and supervision** that strengthen market discipline by focusing on banks' liabilities rather than micromanaging their assets. This approach should prioritize robust equity buffers, credible bail-in mechanisms, and transparent leverage ratios to ensure banks have the capacity to absorb losses. By setting clear, consistent rules and emphasizing liability quality, regulators can enable banks to take necessary risks within a stable and transparent framework.

1. INTRODUCTION

The competitiveness of the European banking sector has become an increasingly relevant issue in the context of global financial markets. As Europe continues to lag behind the US in economic growth and financial innovation, concerns over the ability of its banks to remain internationally competitive have grown. Policymakers, including Enrico Letta (2024) and Mario Draghi (2024), have highlighted the need to evaluate the structural and regulatory conditions that shape the banking sector's capacity to support economic growth and withstand external competition. The question of how European banks have developed in terms of international competitiveness is central to understanding the long-term sustainability and effectiveness of the sector in serving businesses and consumers alike.

Competitiveness and competition, though related, are distinct concepts in this debate. Banking competitiveness refers to a bank's ability to perform well in a given market compared to its peers. It's a firm-level concept that measures a bank's strength in attracting customers, growing market share, and maintaining efficiency. In contrast, competition describes the broader dynamics of the banking system. It refers to the degree of rivalry among banks in a market. It measures how intensely banks compete in areas like pricing (interest rates on loans and deposits), services, innovation, and customer acquisition. While a competitive banking system is crucial for economic health, it does not necessarily guarantee that European banks, as individual entities, will be internationally competitive.

The takeover plans by UniCredit for Commerzbank bring this distinction into sharp focus. At first glance, such a merger raises concerns about a reduction in national competition, particularly within the German banking market. The consolidation of two major players could narrow the field, potentially limiting choices for customers and reducing pricing pressure, while on the other hand, it could enhance the merged bank's competitiveness due to economies of scale.

However, within the euro area, competition cannot be assessed solely at the national level. The crossborder nature of the deal—linking an Italian and a German bank—adds another layer of complexity to the assessment. Because UniCredit is headquartered outside Germany, the merger does not represent a purely domestic consolidation. Instead, it reflects a broader European integration that may actually foster national competition, especially if other strong domestic and foreign players remain active. Moreover, the creation of a more competitive European banking champion could enhance the region's ability to contend with global financial giants, suggesting that some reduction in local rivalry might be a necessary step toward greater international competitiveness.¹

The European banking sector faces multiple challenges that affect its international competitiveness. Structural differences between EU member states, the lack of a fully integrated financial market, and regulatory constraints have limited banks' ability to compete with their global counterparts. Additionally, European banks have historically struggled with lower profitability, higher cost structures, and a slower adoption of digital transformation compared to their American and Asian peers. These issues raise concerns about whether European banks can sustain their role in financing businesses and investment, particularly in a rapidly changing financial landscape. Competitiveness of European banks goes beyond the comparison to non-EU banks. Digitalization has intensified pressure by allowing new entrants, such as fintech firms and non-bank financial institutions, to carve out profitable segments of the banking business, such as payment services and lending.

The key question of this study is how European banks have evolved along different dimensions of international competitiveness. Factors such as financial performance, regulatory alignment, market

¹For a detailed discussion on why the Commerzbank takeover by UniCredit will benefit the European banking sector, see SAFE Finance Blog <u>UniCredit and Commerzbank: A pan-European banking revolution in the making?</u>.

integration, and technological adaptation all play a role in shaping the sector's ability to compete globally. However, as we will see, international competitiveness is not determined by a single metric but rather by a combination of internal and external forces. Furthermore, understanding the evolution of European banks' international competitiveness requires an examination of both their financial performance and structural constraints.

2. DETERMINANTS OF BANK COMPETITIVENESS IN A CHANGING FINANCIAL LANDSCAPE

In this section, we discuss the key concept underlying the report: bank competitiveness. On a general level, a bank is competitive if, relative to its actual and potential competitors, it is able to thrive in terms of standard performance indicators, like market share, profitability, cost efficiency, innovation, productivity, and so on. Competitiveness is thus related to a bank's business model, and to its franchise value. Competitiveness is a characteristic of individual firms, rather than entire markets.

A bank is competitive if it can compete successfully with other incumbent banks in its home market. Moreover, a competitive bank is able to withstand competition from banks that have not yet entered the market, like foreign banks, and newly founded financial and non-bank financial institutions.

The different aspects of competitiveness – relative to banks and non-banks—relate to the production function of banking services. We start by looking at a bank's production process that generates its level of competitiveness.

The functional, or textbook, banking model assumes an intermediation circuit, in which banks, with the help of equity and risk management strategies, transform risky, illiquid, information-sensitive loans into liquid, information-free, safe deposits. A common, related way to describe bank business models emphasizes its role in financial allocation, mobilizing deposits in order to lend these funds to firms and households (Freixas & Rochet, 2008; Dewatripont & Tirole, 1994; Admati & Hellwig, 2013).

Banks perform these transformation services by using specialized monitoring techniques to contain loan risk, and by using equity capital to absorb potential losses from the loan book. Private information from long-lasting client relationships, not available to other players in the market, help the bank to carry out superior and value enhancing project selection and project monitoring services.

The value added of these transformation services derives from, among other things, long-term relationships with clients, allowing banks to reduce asymmetric information that otherwise, i.e. in the absence of these relationships, would render the credit market more opaque, more risk-prone, more costly, and last not least: smaller.

This process, largely based on the traditional originate -to-hold (OTH) approach, where loans remain on bank balance sheets throughout their life, is sometimes substituted by a more market-oriented, originate-to-distribute (OTD) model of securitised credit intermediation. In the OTD model, a tailoring of risk distribution among investors, and a broader access to market funding is possible (see e.g., Acharya et al., 2008).

Technological advances in data processing and in the infrastructure of markets facilitates the development of new products and processes – of which securitization is only one example. Regulatory arbitrage and international competition are further drives of change.

Digital developments have made it much easier to single out individual bits and pieces from the universal banking model, and to set up institutions that focus on one or just a few such services, using standardization and scale economies to simultaneously decrease production costs, and increase profitability. Moreover, it favors the market-based credit intermediation process by network of non-bank financial institutions.

The leading example relates to payment services (think of Paypal, Apple Pay) that direct cash flows away from relationship banks (see e.g., Parlour et al., 2022). An important side-effect of these singlingouts is the loss of client-specific information embedded in daily transaction data. Without this data, banks risk losing their comparative advantage with respect to relationship-specific information. In fact, the break-away of specialization services diminishes the value of relationships which, typically, had been based on the combination of client -specific information with transaction data. As the digitalization of bank production function increases, and clients start to source specific transaction services from different providers, the benefits of relationships tend to decrease, and so does presumably its franchise value.

The decomposing of complex financial products into separate transactions, possibly provided by different producers, allows providers to compete via economies to scale, i.e. via decreasing average costs. As more and more clients rely on digital channels for financial products, the trend intensifies. For traditional universal banks, the competition from new, typically digital-only entrants thus gets more serious over time.

The resulting process of profit erosion for these traditional institutions is even stronger if we consider the development of platform technology in banking, which allows to aggregate private information in markets, thereby providing the basis for low-cost loan allocation and a corresponding mobilization of deposits. Here too, cost functions tend to slope down with the number of clients.

Thus, universal banks are under heavy pressure today to reduce their costs in order to stay competitive. In the process, the value of relationship lending tends to shrink, while the ability to exploit economies of scale becomes increasingly important.

One avenue for achieving such scale involves building stronger links to capital markets — for example, through securitization transactions, which allow banks to transfer risk from their loan books into the portfolios of investors. Nowadays, following regulatory constraints imposed by post-GFC regulation, securitization is not anymore about a pure transfer of risk. In order to preserve a certain minimum level of skin-in-the-game, issuers have to retain some level of expected loss. Nevertheless, securitisation allows to leverage the relationship and banking expertise banks possess, by applying their expertise in the loan market (screening, pricing, monitoring) essentially more than one time to a given amount of loanable funds.

Using the same technique, securitization, can also help to separate out parts of a given loan portfolio requiring special expertise or special treatment, like non-performing loans. This, too, is an example of scope economies that have an impact on the profitability of classical universal banks.

The discussion of bank business models will be echoed in the following sections when looking at the relationship between a measure of efficiency, the cost-income-ratio (CIR), and the franchise value of banks, as signaled by the ratio of current market value of a bank's equity to its book value (P/B).

Thus, when in the next section we compare cost-to-income and market-to-book ratios, we relate the current cash-flows of a bank (cost-to-income) to the present value of its future cash flows (price-to-book). The evidence informs about the relationship between these two variables, although the expectation is that, assuming stationarity and rational expectations, high cash flows today (low CIR) should go hand in hand with high cash-flows tomorrow for any level of book values (high P/B). In other words, we want to test the intuition that the relationship between price-to-book and cost-to-income is negative.

Yet, while the negative relationship between CIR and P/B holds broadly, we find suggestive evidence of systematic differences across regions, particularly between European and US banks. Specifically, US banks appear to operate along a similar negative relationship but shifted upward—achieving higher valuations (higher P/B) for comparable levels of operational efficiency (similar CIR). This shift suggests current operational efficiency is not the major concern for the lack of competitiveness of European banks. Instead, limited growth prospects are the key problem.

3. KEY COMPETITIVENESS INDICATORS

3.1. The Price to Book Ratio (Tobin's q)

An often-cited metric for the competitiveness of European banks is the price-to-book (P/B) ratio (see e.g., Bogdanova et al., 2018; Eurofi, 2023; Martinez et al., 2024). The ratio measures the outlook for owners of a bank (or a company). The ratio is calculated as the market price of bank equity divided by the book value of bank equity:

$$\frac{P}{E} = \frac{E^M}{E^B} \tag{1}$$

The book value of equity E^B is an accounting measure of the difference between a bank's assets and its liabilities, i.e., the net-worth of the bank's owners, as shown in a bank's balance sheet. The market value of equity E^M is the market's assessment of this net-worth. It is also called a bank's market capitalization. If the bank is publicly traded, E^M is given the number of shares in the bank times their price.

If the P/B ratio is larger than one, the investors are willing to pay more for owning a share in the bank than the share is worth now according to its accounting numbers. If the P/B ratio is smaller than one, then the outlook is not favorable. Investors are willing to pay less than what the accounting numbers say.

The P/B ratio is closely linked to Tobin's q, which is a classic measure in economics to describe the efficiency of investment decisions. Tobin's q is measured as the market value of assets divided by the replacement cost of assets. The market value of assets is equal to the market value of debt plus the market value of equity. The replacement cost of assets is the cost today of rebuilding the company or bank from scratch at current market prices.

Tobin's *q* larger than one indicates that a company or bank adds value. The market values the firm more than the cost of the sum of its assets. The company should grow, and outside investors should invest in the company as it is creating value. Conversely, a company with a Tobin's *q* less than one should be dismantled or downsized because, as seen by the market, its assets are worth more outside the firm than inside. Outside investors should not invest new capital as the company is destroying value.

In practice, the replacement cost is not directly observable and is often approximated by the book value of assets. The idea is that accounting numbers should ideally reflect the correct value of all assets in place (e.g., via appropriate depreciation). The book value of assets in turn is the sum of the book value of debt plus the book value of equity. Finally, one often equates the market value of debt with the book value of debt because a debt claim is not sensitive to the upside potential of a company.² Hence,

$$q \approx \frac{E^M + D}{E^B + D} \tag{2}$$

where *D* represents the value of liabilities (debt). The relationship between the price-to-book ratio and Tobin's q is,

$$q \approx \frac{D}{E^B + D} + \frac{E^B}{E^B + D} * P/B$$
(3)

Tobin's q is a linear function of the price-to-book ratio where the slope is given by the equity to asset ratio, $\frac{E^B}{E^B+D}$, and the intercept is given by the debt to asset ratio, $\frac{D}{E^B+D}$.

 $^{^{2}}$ For banks, this assumption in the approximation of q ignores the value of the deposit franchise.

Importantly, Tobin's *q* is larger than one if and only if the price-to-book ratio is larger than one, and vice versa. The logic of a threshold at one from Tobin's *q* carries over to the price to book ratio. A price to book ratio above one indicates that a bank is adding value while a ratio below one indicates that a bank is destroying value. Moreover, the price to book ratio is a useful measure for banks because banks

operate with considerable leverage. Banks' equity-to-assets ratio, $\frac{E^B}{E^B+D'}$ is low so that banks with similar Tobin's q can have markedly different price to book ratios. The price to book ratio acts like a magnifying glass for whether a bank is creating or destroying value.

The price to book ratio identifies a prominent gap in the competitiveness of European versus US. banks. Since the 2007-2009 financial crisis, euro area Globally Systemically Important Banks (G-SIBs) have a price to book ratio of less than one. US. G-SIB banks instead have a price to book ratio of above one (Figure 1).



Figure 1: Price-to-Book ratio of G-SIBs

Note: Collected G-SIBs defined by the Financial Stability Board as of November 2024 in the euro area are Deutsche Bank, Banco Santander, BNP Paribas, Societe Generale, ING, Credit Agricole. Collected G-SIBs in the US are JP Morgan Chase, Bank of America, Wells Fargo, Citigroup, State Street, Morgan Stanley, Goldman Sachs, Bank of New York Mellon. Source: Refinitiv, authors' calculations

3.2. Cost to income ratio

Another useful and widely used measure of bank competitiveness is the CIR. The CIR measures a bank's efficiency by comparing its operating costs to its operating income. It is calculated as:

$$CIR = \frac{Operating \ Cost}{Operating \ Income}$$

where the operating cost includes staff costs, administrative expenses, and other overheads, while operating income mainly consists of net interest income and fee-based revenues. A lower CIR indicates higher efficiency, meaning the bank generates more income relative to its costs. The CIR does not, however, consider risk or financing expenses. Moreover, it is a current snapshot a bank's operations with little information about how a bank is going to perform in the future.

The CIR cannot explain why European banks appear to be less competitive than US banks. Before we examine the relationship between the price-to-book ratio in more detail in Chapter 4, it is instructive to compare the cost-to-income ratio of European banks to the subsidiaries of US banks operating in

Europe (Figure 2). Those subsidiaries offer a suitable benchmark as they operate in the same market and under the same regulatory framework as European banks.



Figure 2: Cost-to-Income ratios in the euro area, in %

Source: ECB

Figure 2 presents the average cost-to-income ratio of euro area banks (blue line) and subsidiaries of worldwide non-euro area banks operating in the euro area (orange line; with changing composition of euro area member states over time). After a jump during the financial crisis, one can see that euro area banks faced a steady increase in the CIR until 2018. Since then, we see a constant improvement with current figures below 55% and therefore at an all-time low since the establishment of the database in 2007. Even though subsidiaries of e.g. US investment banks may fulfil different roles in the euro area than domestic ones, they provide a useful first benchmark as they operate under the same set of rules and in the same geographic markets. Based on this comparison, euro-area banks do not have worse CIR than the subsidiaries of US banks since 2018.

3.3. Structural features of the European banking industry

Structural financial indicators offer a big-picture view of the euro area's banking sector, revealing trends in its size, structure, and resilience. They help assess competition, competitiveness, and integration. While they don't capture short-term risks, these indicators are essential for understanding the long-term evolution of the European banking system.





Source: ECB

Figure 3 presents two key structural indicators, namely the number of branches (blue) and employees (grey). For the first ten years after the introduction of the euro, branches increased. This trend stopped between the financial crisis and the euro sovereign debt crisis and reversed afterwards. From its peak in 2011, branches decreased by 12% and employees by 18% showing a clear effort of euro area banks to cut costs.

Combined with the structural improvements of euro area banks compared to non-euro subsidiaries discussed in Chapter 3.2, there is strong evidence that euro area banks have successfully reduced their costs, thereby enhancing their overall competitiveness in recent years. This leads to the key question: which factors can explain the persistent differences in price-to-book ratios between euro area and US banks?

3.4. Other commonly used indicators

While the Cost-to-Income Ratio (CIR) remains a central measure of banking efficiency, other indicators such as Non-Performing Loans (NPLs), Return on Equity (ROE), and Net Interest Margin (NIM) are frequently used in banking analysis but offer limited *additional* insights. NPL ratios provide a measure of asset quality and risk but can be misleading, as non-performing loans can be offloaded through securitization or restructuring, making them an inconsistent gauge of long-term competitiveness. ROE reflects profitability but is heavily influenced by leverage, meaning high returns are caused by taking financial risk rather than genuine operational efficiency. Similarly, NIM, which measures the spread between lending and deposit rates, is shaped by external factors such as interest rate environments and monetary policy, making cross-border comparisons difficult. Hence, the NIM says little about the competitiveness of an individual bank, especially one that has significant fee business or finances itself using debt rather than deposits. While these indicators provide useful perspectives, they do not necessarily offer a deeper or more comprehensive assessment of European banks' competitiveness than CIR, especially when considering structural limitations such as market fragmentation and regulatory constraints and different bank business models.

4. FROM INDICATORS TO INTERPRETATION

4.1. Relationship between cost-to-income and price to book ratios

In section 3, the measures of the competitiveness of European banks provide a mixed picture. According to the price-to-book ratio, European banks are less competitive than US banks. In fact, the P/B is less than one for European banks and hence, they seem to destroy value. The cost-to-income ratio (CIR) shows, however, that European banks have a similar operating efficiency as the subsidiaries of US banks operating in Europe. (Further below, we will also show that the range of CIRs of European banks is comparable to that of US banks).

Noting that the P/B ratio and the CIR measure competitiveness differently, but should nevertheless be somehow related, we propose to examine the link between these two measures in more detail. It is intuitive to expect a negative relationship between these two measures. A bank with a lower operating efficiency (high CIR) should create less value for investors (low P/B).

A formal argument can be made because the price of an asset, e.g., a share in a bank, can be expressed as discounted sum of obtained cash-flows:

$$P = C_0 + \frac{C_1}{1+r} + \frac{C_2}{(1+r)^2} + \cdots$$
(4)

One minus the cost-to-income ratio, i.e., the difference between operating income minus operating cost (scaled by operating income), can be seen as a reasonable proxy for the current cash-flow C_0 but not for the discounted future cash flows.³ The P/B ratio then becomes

$$\frac{P}{B} \approx \frac{Operating \, Income}{B} \left(1 - CIR\right) + \frac{1}{B} \left[\frac{C_1}{1+r} + \frac{C_2}{(1+r)^2} + \cdots\right]$$
(5)

This expression illustrates the expected negative relationship between the CIR and the P/B.⁴

The data confirms a negative relationship between the CIR and the P/B ratios in the European Union (EU) (Figure 4). Of course, the expression above is somewhat simplistic and, importantly, describes the relationship for a single bank across time, while Figure 3 shows the relationship across banks at a single point in time (end 2023). Nevertheless, a higher CIR is associated with a lower P/B on average across banks.

³ Of course, the current cash-flow to equity holders is not exactly the same as one minus the cost-to-income ratio. For example, the CIR ignores financing costs. Also, a bank could be paying dividends. But as a first approximation, it is a reasonable proxy for the purposes of the analysis in this study.

⁴ The slope of the negative relationship is given by the ratio of operating income to book equity.





Note: Figure 4 presents 92 publicly listed banks headquartered in the EU with deposits to total assets above 5% cleaned for outliers (5% of the population). The Price-to-Book ratio on the y-axis is calculated as market capitalization/book equity. The Cost-to-Income (CIR) on the x-axis is calculated as Operating Income/Operating Expenses. Both figures are as of 31.12.2023. Every dot expresses one EU bank.

Source: Orbis, authors' calculations

4.2. The transatlantic divide

Armed with the negative relationship between our two measures of competitiveness, the price-tobook (P/B) and the cost-to-income (CIR) ratio, we revisit the comparison of European banks to US banks. Recall that European banks have on average a P/B ratio below one while US banks' P/B ratios are on average above one but that there is no obvious difference between European and US banks in terms of their CIRs.

One could have expected that all banks share the same negative relationship between efficiency (CIR) and value creation as seen by the market (P/B). A difference in competitiveness then could have meant that European banks have high CIR and hence, lower P/B along this relationship while US bank have lower CIR and hence, a higher P/B.

While the negative relationship between P/B and CIR holds both for European and US banks, this relationship is shifted upwards for the US (Figure 5). At every level of CIR, US banks have a higher P/B ratio than the corresponding European banks. Moreover, the shift upward is approximately parallel. Interestingly, the line indicating the P/B-CIR relationship for European banks lies below one. For all observed levels of operational efficiency, the market views European banks as destroying value. For the US, value destruction is seen to begin only with CIRs above 0.7.

Using the expression above, Figure 5 indicates that the difference in competitiveness between US and European banks lies in the intercept of the P/B - CIR relationship, i.e., differences in the discounted *future* cash-flows relative to current book equity. There does not appear to be a significant difference in the slopes of the P/B - CIR relationship, i.e., the ratio of operating income to book equity across banks is roughly the same in the US and in Europe.



Figure 5: P/B vs. CIR:EU and US headquartered banks

Note: Figure 5 presents publicly listed banks headquartered in the EU (92; grey) and US (271; blue) with deposits to total assets above 5% cleaned for outliers (5% of the population). The Price-to-Book ratio on the y-axis is calculated as market capitalization/book equity. The Cost-to-Income (CIR) on the x-axis is calculated as Operating Income/Operating Expenses. Both indicators are as of 31.12.2023. Every dot expresses one bank. Source: Orbis, authors' calculations

4.3. Robustness

Before we interpret our findings, we want to give some more robustness. Figures 3 and 4 are based on cross-sectional data in 2023. It could be that the difference in the level of the relationship between value creation (P/B) and operational efficiency (CIR) is simply a coincidence. To address this argument, Figure 6 shows the relationship between P/B and CIR in Europe and the US in 2018. The pattern is the same as in 2023. There is a parallel shift in the relationship between the P/B ratio and the CIR ratio. Again, US banks appear to have a higher value of discounted future cash-flows relative to current book equity.

An interesting conclusion from the stability of the P/B-CIR relationship difference in the US and Europe arises from the stark difference in the interest rate environments in 2018 and 2023. In 2018, central bank policy rates were ultra-low (though slightly higher in the US), while the post-pandemic surge in inflation forced both the Federal Reserve and the ECB to increase policy rates drastically. Hence, despite significantly different current interest rate environment in 2018 and 2023, the parallel shift in the P/B-CIR schedules persists. Potentially different interest rate environments cannot explain the difference in growth expectations between US and European banks.⁵

⁵ A possible counter-argument would be that markets expect US banks to operate in an interest-rate environment that structurally allows them to generate higher future cash-flows permanently. While theoretically possible, the robustness of the difference in P/B-CIR schedules pre- and post-Covid, i.e., two very different states of the economy and different economic outlooks, makes it unlikely that the counter-argument can fully explain this difference.



Figure 6: P/B vs. CIR: EU and US headquartered banks in 2018

Note: Figure 6 presents publicly listed banks headquartered in the EU (96; grey) and US (254; blue) with deposits to total assets above 5% cleaned for outliers (5% of the population). The Price-to-Book ratio on the y-axis is calculated as market capitalization/book equity. The Cost-to-Income (CIR) on the x-axis is calculated as Operating Income/Operating Expenses. Both indicators are as of 31.12.2018. Every dot expresses one bank. Source: Orbis, authors' calculations

A second robustness check is to consider only the largest banks. In the US, many small banks are publicly listed, while this is not the case in Europe (e.g. German savings banks). To make the sample more comparable in size, Figure 7 only presents data for banks with total assets above USD 100 bn (i.e., US regulatory category IV or higher). The shift in the negative relationship P/B-CIR relationship between US banks and European banks is still present. Because of the smaller sample size, the estimation of this linear relationship is, however, less precise.



Figure 7: P/B vs. CIR: EU and US headquartered banks with total assets above USD 100 bn

Note: Figure 7 presents publicly listed banks headquartered in the EU (29; grey) and US (19; blue) with deposits to total assets above 5% cleaned for outliers (5% of the population) with total assets above 100 bn USD. The Price-to-Book ratio on the y-axis is calculated as market capitalization/book equity. The Cost-to-Income (CIR) on the x-axis is calculated as Operating Income/Operating Expenses. Both indicators are as of 31.12.2023. Every dot expresses one bank. Source: Orbis, authors' calculations

As another robustness test, we present the relationship between value creation (as seen by the market) and efficiency differently. Instead of varying the CIR in the expression above, while holding constant (across banks) the ratio of operating income to book equity, one can also vary this ratio while holding constant (across banks) the CIR. Moreover, the operating income to book equity ratio should be closely related to the return on equity (ROE) because the ROE is measured as earnings over book equity. According to the expression above, we should expect a positive linear relationship. Importantly, as before, this positive relationship is shifted upwards if the discounted future cash flows relative to book equity are larger, which we expect to be the case for US banks.

Figure 8 confirms the positive relationship between the P/B ratio and the ROE. Moreover, there is once again a noticeable shift, indicating that discounted future cash flows relative to book equity are larger for US banks. Again, as before, the shift is parallel. The average CIR across banks, which determines the slope, is the same in the US. and Europe.



Figure 8: P/B vs. RoE: EU and US headquartered banks

Note: Figure 8 presents publicly listed banks headquartered in the EU (99; grey) and US (285; blue) with deposits to total assets above 5% cleaned for outliers (5% of the population). The Price-to-Book ratio on the y-axis is calculated as market capitalization/book equity. The return on equity (RoE) on the x-axis is calculated as Net Income/Equity. Both indicators are as of 31.12.2023. Every dot expresses one bank. Source: Orbis

4.4. What drives the difference in discounted future cash flows?

According to our analysis, investors think that US banks have better growth options. We have shown that European banks are not less efficient than US banks (Figure 2). The differences in valuations (at every level of operating efficiency) (Figure 4) indicate differences in discounted future cash flows relative to book equity.

But why exactly do investors expect higher growth options for US banks when current measures of operating efficiency are the same (on average)? We explore possible answers next.⁶

⁶ An exhaustive and detailed analysis to answer this question is beyond the scope of this study. We believe, however, that this will be a fruitful avenue for future research.

4.4.1. Growth expectations

Banks in US operate in a larger, more unified, and higher-growth market compared to their European counterparts, making it easier to achieve organic growth. The US economy has consistently outpaced the euro area in terms of GDP growth, offering banks more opportunities to expand revenues. The future market size plays a crucial role: in a growing economy, banks benefit from decreasing marginal costs due to scalability and can achieve constant or even increasing returns. This scalability is especially vital in banking, where fixed costs are high, and network effects can amplify returns.

It is true that higher economic growth per se allows banks to grow independently of issues such as European banking fragmentation. Fostering economic growth at the national level, however, lies beyond the scope of this study. Nevertheless, it must be emphasized that national growth within Europe is not isolated from the effects of banking and capital markets fragmentation.

Start-ups depend on access to venture capital, international financial networks, and efficient crossborder financing options to scale. Likewise, small and medium-sized enterprises (SMEs) require reliable access to financing as well as opportunities to export their products. A well-integrated and less fragmented banking system is also crucial for supporting mergers and acquisitions (M&A) activity. Larger, cross-border-capable banks are necessary to finance and advise on complex transactions, which are vital for driving consolidation, innovation, and international competitiveness among European firms. Without such institutions, M&A processes are slower, costlier, and less accessible particularly for mid-sized firms seeking to expand their footprint across the EU.

While the European single market for goods is incomplete in some areas (e.g. taxation and regulatory harmonization), compared to the fragmentation of the financial sector its integration is an order of magnitude more developed. Therefore, a reduction in fragmentation of the financial sector raises much more potentials for European economic growth.

Besides general growth considerations, bank concentration plays an important role because lower concentration today gives more room for decreasing marginal costs in the future (see e.g., Demirgüç-Kunt & Levine, 2002). Figure 9 presents the share of assets held by the five largest banks in the US. and the euro area. The graph suggests that the US banking sector is more concentrated than the euro area banking sector. This would indicate paradoxically that there is more room for growth in Europe.



Figure 9: Share of assets held by the five largest banks, in %

Note: The US data series is constructed by FED's database FRED. A comparable official series does not exist for the Euro area. The five euro area banks are Deutsche Bank, Banco Santander, BNP Paribas, Societe Generale, Credit Agricole. Source: FRED, ECB, Refinitiv, authors' calculations This picture, however, changes completely when examining the euro area at the country level. Figure 10 shows that the current median and mean (across countries) share of assets held by the five largest banks within a country are around 70% and therefore well above the US levels. Moreover, this share has steadily increased between 2017 and 2023.



Figure 10: Share of assets held by the five largest banks by euro area country, in %

Notes: Interquartile ranges and medians are calculated across average country values. Data for each Member State are available from 1999 or from the year of EU accession.

Source: ECB Press Release "EU structural financial indicators: end of 2023", Chart 2

Putting figure 9 and 10 together, we can summarize that euro area banks are highly concentrated at the national but not the euro area level. How to interpret this difference? If the euro area banking sector was highly integrated, concentration at the euro level is what matters. Then European banks should have better growth options. Our previous analysis shows that the market sees it differently. European banking is not integrated and hence, concentration at the individual country level matters, which is much higher and the option to grow is much smaller.

Indeed, it is the market that gets it right. Figure 11 presents a measure of market integration in European banking. The results are disillusioning. Cross-border loans to corporates and households are only a small fraction of banks' total assets and by far lower than domestic lending. Other statistics like deposits and securities holdings lead to the same conclusion.

Figure 11: Loans to households and corporates in the euro area as % of total assets: domestic vs. cross border loans



Source: ECB, authors' calculations

If an integrated European banking market is almost inexistent, we need to refer to national concentration indicators (Figure 10) instead of a European one (Figure 9). As noted by Vives (2016), in industries where entry requires a significant sunk cost—such as investments in branch networks—market concentration tends to decline as these sunk costs become smaller relative to the overall market size. This aligns with the observed pattern that smaller markets generally exhibit higher concentration. Consequently, expanding the market size through integration (from national to true European banking markets) is likely to reduce concentration. To be clear, we are in favour of less concentrated markets by widening the operating scale of banks. Less concentration on the national level would mean that banks need to become even smaller, which will further dampen its international competitiveness. By creating a fully integrated European banking market, banks are able to grow organically or via M&As. This allows for bigger and therefore more competitive European banks without further increasing the concentration on the national level. Unfortunately, we often see the complete opposite: M&As on the national level, which further elevates national concentration indicators and therefore dampens welfare-enhancing competition for customers and on the other hand a reluctance against cross-border mergers.

A simple example can help illustrate the benefits more clearly. Imagine two countries—Country A and Country B—each with five banks and no cross-border banking activity. If two banks merge within Country A, and two within Country B, the total number of banks drops to eight. The merged banks can operate at a larger scale and benefit from economies of scale as banking has become more technology driven. However, this comes at the cost of reduced competition within each country, as national market concentration increases.

Now consider a different scenario involving cross-border mergers: a bank from Country A acquires a bank in Country B, and vice versa. The total number of banks is still reduced to eight, but each country still has five banks operating within its borders. In this case, the benefits of economies of scale remain, but national competition is not negatively affected—domestic market concentration stays the same.

Moreover, cross-border mergers offer additional advantages. The merged banks, now active in both countries, are more likely to support clients looking to expand abroad. This facilitates international growth for businesses and creates new revenue opportunities for banks. As a result, both the national

economies and the merged banks stand to benefit even more than they would from purely domestic consolidations.

Coming back to the initial question, bank's future growth expectations are low on a national level given the high levels of concentration. Furthermore, European banks are more constrained by national borders, which limits cross-border scaling and reduces the potential to capitalize on a pan-European market in the same way US banks can across states. The policy idea where every euro area country tries to increase bank returns to scale by supporting further concentration on a national level and protecting its national champion has evolved into a zero-sum game, where the national banking sector will not be able to show increasing future returns anymore (see e.g., Rajan & Zingales, 1998). Without future growth, which also has become more and more important for banks to compete due to innovations in technology, euro area banks will not be able to compete with US banks in the future.

4.4.2. Investment banking

Besides low growth perspectives, European banks have fallen behind in Investment Banking. Investment banking refers to a specialized area within banking that deals with capital markets, securities issuance, mergers and acquisitions (M&A), and advisory services for corporations, governments, and other large institutions. Unlike traditional commercial banking, which focuses on deposit-taking and lending, investment banking is less capital-intensive and significantly more scalable. It relies on fee-based income from high-value transactions, rather than interest income from loans. This scalability allows investment banks to leverage expertise and infrastructure across multiple deals and geographies, making the business highly profitable—*but only* if the bank operates on a sufficiently large scale. In addition, investment banking thrives in deep, liquid, and integrated capital markets, where the volume of transactions and investor demand make distribution of bonds, equities, and structured products more efficient. Entry barriers are high, due to the importance of reputation, client relationships, and informational advantages—making size and global reach essential for success.

In global comparison, the EU has fallen far behind the United States in terms of investment banking competitiveness and market presence (see Figure 12). As of 2021, euro area global systemically important banks (EA G-SIBs) earned only about EUR 6.5 billion in Investment Banking fees, representing a meager 6.3% global market share. Meanwhile, US G-SIBs earned over EUR 44 billion, controlling more than 40% of the global market—particularly in the most lucrative segments like M&A and equity capital markets (Di Vito et al., 2023). This disparity is largely structural. The US benefits from a single, integrated, and vast domestic market, with significantly more active deal-making, higher market capitalization (nearly six times that of the euro area), and deeper pools of capital. These conditions create scale advantages for US banks, facilitating more profitable underwriting, easier bond and equity placement, and greater fee income. In contrast, the EU's capital markets remain fragmented along national lines, with limited cross-border M&A and smaller transaction volumes. As a result, EU companies often turn to the US for large-scale funding needs, and even EU-based banks serve their clients through US subsidiaries to access deeper capital markets and investor bases.



Figure 12: Revenues and market share of investment banking activities

Sources: Coalition Greenwich and ECB calculations. Note: The sample comprises EA (excluding BPCE Group due to data availability) and US G-SIBs (excluding Bank of New York Mellon Corporation and State Street corporation due to data availability).

Source: ECB Occasional Paper: Understanding the profitability gap between euro area and US global systemically important banks, p. 28, Chart 15.

Moreover, while US banks have aggressively expanded their global footprint since the global financial crisis, European banks have retreated. Regulatory pressures, lower profitability, and the lack of a unified European capital market have pushed many EU banks to refocus on regional lending and lower-margin debt capital markets. This strategic withdrawal has further eroded their competitive position. Today, US banks dominate not just their domestic market, but also a growing share of capital market activity within Europe—especially in high-yield and equity segments. Their global dominance is now self-reinforcing: success in their large domestic market has enabled them to develop stronger franchises, better distribution, and unmatched expertise, which in turn makes them the preferred partner for major deals globally. Without deeper integration of European capital markets and more aggressive scaling strategies, EU investment banks will likely remain "second-tier" players—outcompeted by their US peers in both volume and value.

To close the investment banking gap with the US, the EU must focus on fostering a more integrated and scalable capital market ecosystem. A true European Saving and Investment Union (SIU) would be a critical step—reducing legal, regulatory, and tax fragmentation across member states to enable seamless cross-border financing, investment, and deal-making. This would increase transaction volumes, attract more institutional investors, and provide the scale needed for European banks to compete effectively. Additionally, strengthening equity and venture capital markets within the EU would help retain high-growth firms that currently migrate to the US for funding. EU banks also need to invest in building stronger global franchises, enhancing digital infrastructure, and developing specialized expertise in higher-margin investment banking segments such as M&A and equity capital markets. Coordinated regulatory support - combined with strategic ambition from the banking sector itself - will be essential to turn European banks into global leaders, rather than regional followers, in the investment banking landscape.

5. CONCLUSIONS ON COMPETITIVENESS OF EUROPEAN BANKS

5.1. Conclusion

The findings from this analysis highlight critical dimensions of European banks' international competitiveness, particularly in comparison to their US counterparts. Chapter 3 examined key financial indicators, such as the Price-to-Book Ratio (P/B) and Cost-to-Income Ratio (CIR), which provide insight into European banks' efficiency, profitability, and market valuation. While CIR has decreased in recent years, suggesting improved cost efficiency, persistently low P/B ratios indicate that investor profit growth perspectives in European banks remains weak.

Chapter 4 explored the trade-offs between CIR and P/B, emphasising the structural disadvantages that prevent European banks from achieving higher valuations. The comparison with US banks illustrated how differences in financial market integration and scale impact competitiveness. Despite structural improvements post-financial crisis (e.g., reductions in branches and staff, improving the Cost-to-Income Ratio), the market has doubts about the future long-term profitability and growth prospects for European banks.

Unlike their American counterparts, European banks operate in a highly fragmented market, limiting their ability to scale operations, generate higher fee-based revenues, and attract investors. Additionally, the transatlantic divide in market structures underscores the competitive gap: while US banks benefit from deep, unified capital markets and robust investment banking activity, European banks remain constrained by national regulatory frameworks and smaller domestic markets.

The analysis clearly demonstrates that European banks exhibit significant structural disadvantages compared to their US counterparts. Due primarily to the fragmented nature of national markets, European banks have faced challenges in achieving sufficient economies of scale, limiting their competitiveness internationally. This fragmentation has impeded their ability to expand in key high-value areas, notably investment banking (IB), which relies heavily on deep, integrated capital markets and scalable business models. European banks thus remain constrained by national borders, creating a competitive disadvantage versus US banks that operate seamlessly in a larger, unified market. Consequently, US banks are able to exploit larger markets, realize economies of scale, and benefit from higher, more stable fee-based revenues.

5.2. Policy Recommendations

Our analysis reveals a clear negative empirical relationship between the cost-to-income ratio (CIR) and the price-to-book (P/B) ratio, indicating that operational efficiency significantly influences bank valuations. Importantly, however, US banks operate on a systematically higher valuation level, even when controlling for CIR, suggesting that their stronger market valuations reflect investor expectations of superior future discounted cash flows.

We see a major reason for this difference in future discounted cash flows between US and European banks in the size of the relevant market. The relevant market in the US is the entire nation, whereas in Europe, the relevant market is the individual member state.

Policy efforts aimed solely at improving operational efficiency or measures at the national level, while important, may be insufficient to close the valuation gap; policies fostering structural reform, regulatory clarity, market integration, and improved growth prospects could be essential to strengthening European banks' competitiveness. In particular, we recommend:

1. Extend the relevant market by allowing for more cross-border banking and a more credible capital market integration

The long-awaited completion of the Banking Union as well as the Savings and Investment Union (SIU) are key to improve the competitiveness of European banks. Achieving this aim requires several regulatory adjustments. As was argued at some length in a recent SAFE study (Heider et al., 2024), the overlapping responsibility of national and European banking supervision is one of the starkest obstacles of a closer internal market. Highest priority should be given to a true unification of supervisory powers, and a compliant streamlining of administrative structures in Europe, notably the abolition of dual reporting lines within the so-called single market. A unified regulatory and supervisory approach to financial markets, i.e. banking and securities markets, is critical to reducing market fragmentation, allowing European banks to reach much larger economies of scale, and to compete more effectively with larger US financial institutions.

2. Support enhancing banks' business models: embrace investment banking and new technologies as sources of growth

A more integrated capital market allows fixed-cost heavy industries, like investment banking, to transfer its expertise into other, formerly foreign markets. The overall market size is likely to rise, and with it the role of cross-border M&A and advisory services. Larger and deeper European capital markets would support the growth of investment banking within Europe, reducing dependency on the US market, retaining talent, and preventing long-term welfare losses due to capital and deal-making flight. European banks should strengthen their competitiveness by proactively embracing digital innovation and integrating complementary fintech solutions to boost efficiency, expand market reach, and effectively counter competitive pressures.

3. Smart banking regulation and supervision

To strengthen the resilience and competitiveness of European banks, regulation and supervision should evolve toward a "smart" approach. *Smart banking regulation and supervision* is defined by four key principles: (a) doing less, but doing it right—making regulation more focused and effective; (b) relying more on market mechanisms to enforce discipline; (c) shifting regulatory emphasis toward the liability side of banks' balance sheets and d) making it homogenous among Europe.

Rather than intensively micromanaging asset-side risks or imposing overly complex and burdensome reporting requirements, smart regulation enables banks to take risks—within clear and transparent boundaries—provided they are adequately backed by robust liability structures such as equity capital and bail-inable debt. This implies a reduced focus on asset-side controls beyond core requirements like risk-weighted assets (RWAs), and a stronger emphasis on credible risk-bearing capacity through transparent leverage ratios, sufficient equity buffers, and market-assessed bail-in mechanisms.

A further essential feature of smart regulation is consistency. Today, only banks under the Single Supervisory Mechanism (SSM) are regulated and supervised centrally, while all other institutions remain subject to national frameworks. Even within the SSM perimeter, implementation diverges significantly across member states—examples include variations in the application of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL). Smart regulation must therefore also strive for a more homogenous supervisory landscape, with consistent rules and supervisory practices across jurisdictions, to ensure a level playing field and regulatory clarity for cross-border banking activities.

By focusing on the quality and transparency of banks' liabilities—particularly instruments traded in capital markets and thus visible to outside investors—regulators can reduce complexity, foster market-based discipline, and empower banks to adapt more flexibly and competitively in an increasingly digital and globally integrated financial environment.

The challenges faced by European banks in terms of competitiveness are not new, but they have become more pressing in light of global financial and technological shifts. The Draghi (2024) and Letta (2024) reports underscore many of the same concerns identified in this analysis, particularly the need to reduce fragmentation, enhance financial integration, and modernise banking and non-banks regulation to create a more competitive banking sector. These reports emphasize that without major structural reforms, European banks will continue to lag behind their US and Chinese counterparts, leaving Europe dependent on foreign financial institutions and capital markets, which we fully subscribe.

What cannot be stressed enough in this context is that there cannot be any improvements as long as national politicians and institutions are not willing to give up power and commit to genuine financial integration. Without a willingness to prioritize the European financial system over national interests, the existing inefficiencies will persist, preventing banks from realizing the full potential of economies of scale, cross-border consolidation, and digital transformation.

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This study analyses why European banks, despite improved cost efficiency, continue to trade at lower valuations than their United States (US) counterparts. The gap stems from limited growth potential due to market fragmentation and underdeveloped capital markets. To close this competitiveness divide, the study calls for accelerating the Savings and Investment Union (SIU), expanding investment banking capacity, and implementing smart banking regulation and supervision that reinforces market discipline while enabling risk-taking within a stable, integrated European financial system.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the ECON Committee.