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Banking in Europe

The Quest for Profitability after the Great Financial Crisis

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Introduction

Profitability is a crucial goal for a firm; it is very likely to be the most important one. This statement holds for several kinds of enterprises, operating in different sectors. Although it can be criticized, for example, with reference to specific institutions operating under a mutualistic approach to the market, it is widely accepted within modern economies. Making a profit means that a firm is able to generate a stream of revenue that is greater than its operating costs, and in a broad sense, it signals the success of the firm within the market. Not surprisingly, this leads to the commonly held belief that states that a profitable firm is usually also a sound enterprise.

Over time, several elements contribute to the shape of profitability of a specific business: the level of interest rates, inflation, general economic growth, competition within the sector and so forth. Profitability is usually pro-cyclical, in that during economic downturns, the level of profits falls sharply, and some firms default, exiting the market for ever. The knock-on effects of these events influence the whole economy and are typically stronger when the defaulting institution is systemically important due to its dimension or function. In this respect, the banking sector plays a crucial role within the economy of a country, and it is not surprising that its profitability is a strong indicator of the health of a specific economic and financial system.

In many ways banks represent a fundamental pillar sustaining modern economies, and they are active both in direct and in indirect finance. Deterioration of the surrounding environment leads to a worse asset quality and lower revenues for the banking system. The main problem here is that banks are at the same time the target and the promoters of the dynamics of the economic cycle; they are—as it is usually expressed—'systemically important'. While in recent times, this notion has assumed a specific regulatory meaning (as we will see later in more detail), more informally we agree with the idea that a bank default can exert a strong negative impact on a specific territory (be this large or small, it does not matter). Given that banks represent a transmission channel for transferring purchasing power within the economy, their default can be at the same time the effect of defaulting firms and the cause of economic downturns; they can transform a crisis at a microeconomic level into one at a macroeconomic level. This is the reason why the health of the banking system is a key issue for policymakers and regulators and, at the same time, it explains the enormous output of prudential regulation over time.

The severe crisis that started in the US in mid-2007 has had intense and long-lasting effects on the banking sector; one of the most important—and easily observed—results of this troubled period has been a dramatic fall in bank profitability. This outcome is particularly dangerous for the financial industry and so for the whole economy, in that the resilience of a bank depends on its level of regulatory capital, and its ability to increase this aggregate is strongly linked to the remuneration offered to its shareholders. Moreover, recent prudential regulation has strengthened the importance of self-financing as a measure for reinforcing the level of capital ratio. Hence, reestablishing a sound level of profitability has become a key point on the agendas of bankers, regulators and policymakers; in this area, some elements need to be managed and clarified.

On the one hand, from a technical point of view, it is necessary to define what we mean by profitability and which indicators we can use to measure it. In effect, over the years, different ratios have been used to define the profitability level of a specific firm; this has been particularly true for the banking system, which has peculiar features in terms of financial statements and business lines. These ratios can involve measures of profitability, profit volatility, risk-adjusted performance measures and others linked to financial market data; moreover, attention can be focused on the revenues of a specific business, as in the case of the interest margin. The possible combinations in this field are almost infinite.

On the other hand, from a strategic and managerial point of view, it is necessary to clarify how the profitability of a specific bank can be enhanced. This involves the ability of a firm to understand and anticipate the changes in the surrounding environment, choosing between the alternatives available at specific times. Internal development or outsourcing? Focusing or diversification? Innovation: friend or foe? These are a few of the questions that each year a bank's decision-makers need to face. Their ability to create a stable stream of profits is strongly correlated to their ability to find the right answers to these issues. The same holds for regulators and policy-makers, who can reshape the regulatory framework in which banks operate, promoting or reducing profit opportunities.

This book aims at providing a comprehensive overview of the preceding issues, examining the dynamics that have been affecting the profitability of European banks since the recent crisis period. More specifically, we shed light on the most crucial changes in profit generation and on the changes in banking strategies deriving from fiercer competition, reduced margins and changing regulation. The scope of the book is to provide a straightforward interpretative system for understanding and managing the continuous changes in the financial environment. The work is divided in four main parts. In the first one, we provide an overview of the changes in the technological, competitive, regulatory and macroeconomic context that affected the banking sector over the years of the great international financial crisis. In the second, we review the literature on bank profitability and outline the main determinants of profit generation. In the third, we provide a cross-country analysis of profitability for a wide sample of European banks; this includes panel regressions and cluster analysis both on profitability and risk-adjusted performance measures. In the last section of the book, we discuss the results of this quantitative analysis in the light of the new regulatory and competitive framework (Banking Union, fintech, Basel regulation, etc.) that is progressively affecting the banking sector.

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