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HOW EUROPEAN WHOLESALE BANKS CAN SEIZE THE MOMENT

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The future is looking bright for European wholesale banks for the first time in 15 years. A positive interest rate environment is creating new opportunities for European firms to increase earnings and deliver sustainable returns. At the same time, divergence in new capital rules, if implemented as proposed, would raise capital requirements for US banks and could create advantage for Europeans.

After a decade of intensive restructuring, European wholesale banks are poised to seize these opportunities. They are leaner, more focused, and higher returning than a decade ago. With disciplined participation choices, as well as cost and balance sheet control, they now have the platform they need to create durable returns well above the cost of capital.

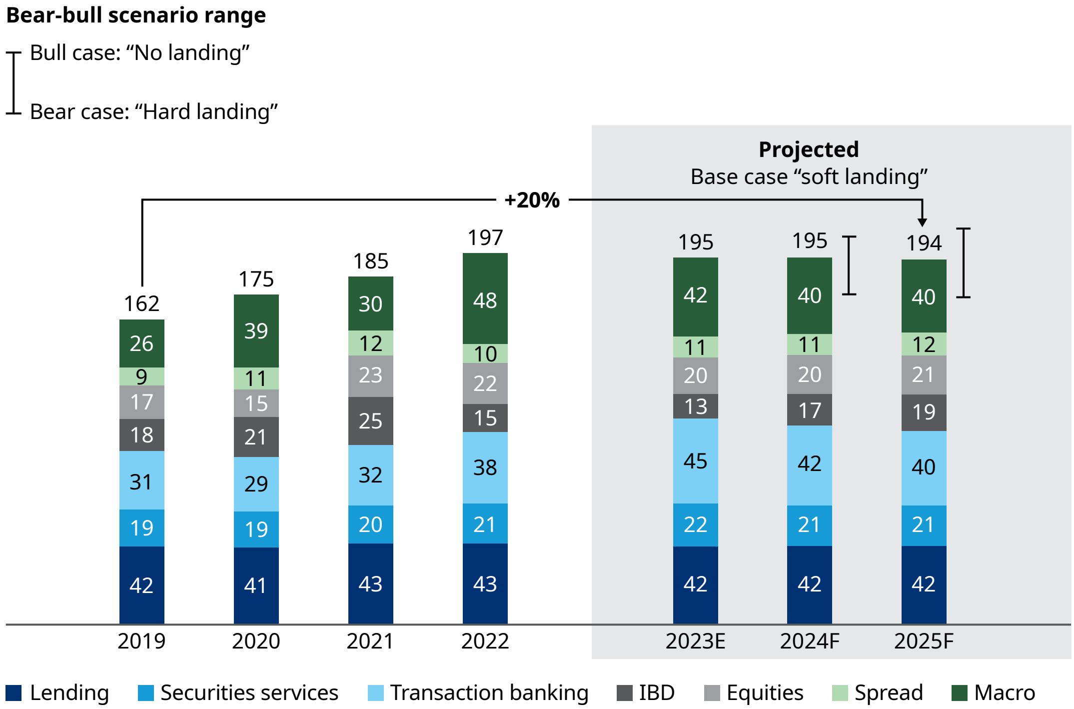
THE NEW MONETARY ORDER IS DRIVING CHANGE

European wholesale banking revenue pools have grown by 20% since 2019, reaching $195 billion in 2023. We expect these gains, with a structurally larger and more profitable pool, to be sustained. Growth has come from volatility-driven trading and interest income that benefited from rising rates. European policy rates have increased by 450 basis points in the past two years, after a decade below zero. Deposit betas — or how much of the change in market interest rates banks have to pass onto their customers — have been lower in the Eurozone than in the United States, allowing transaction banking and securities services businesses to add $16 billion in revenue.

Investment banking and equities revenue has been weaker, but European banks have benefited from a greater presence in these growth businesses. As the cycle has turned many have realized the benefits of a diversified and stable universal banking model.

Exhibit 1: European wholesale banking has grown 20% since before the pandemic and is expected to protect those gains in a soft-landing scenario

EMEA revenue pool outlook, US$ billion



Note: Forecasts do not include credit losses.

Source: Coalition-Greenwich, Oliver Wyman analysis

Assuming an economic soft landing and gradual tapering of monetary policy from 2024, the outlook for revenues over 2024–25 is stable, sustaining a revenue pool 20% larger than the pre-COVID-19 era (notwithstanding obvious macroeconomic and geopolitical risks).

THE BASEL 3 ENDGAME COULD SPUR VALUE SHIFTS

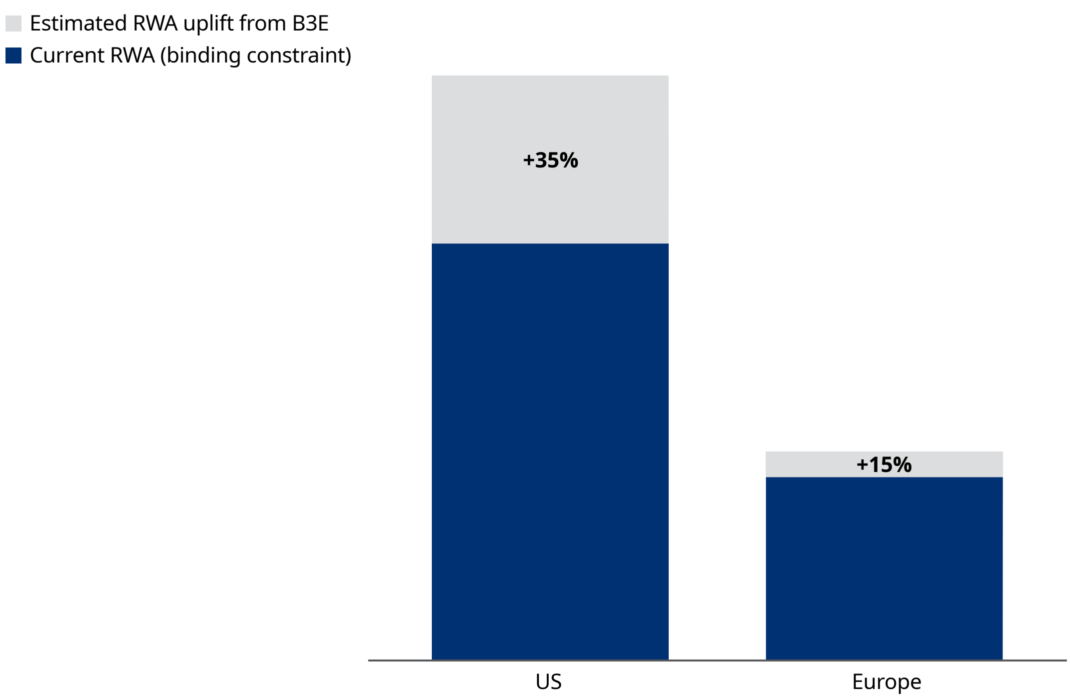
New capital rules known as the Basel 3 endgame could structurally change the competitive landscape and returns of global wholesale banking. This creates both opportunity and challenge for European banks. Current US proposals, if implemented, would result in a 35% increase in risk-weighted assets (RWA) for US banks globally and international banks' US subsidiaries, compared with just 15% for European banks under European proposals.

The proposed US rules are more punitive than European proposals in how market, credit, and operational risk capital are calculated, compounded by potential double counting across capital requirements. The RWA effect would vary substantially by business, with the greatest uplift in macro and spread businesses and significant hotspots at more granular levels, such as holding inventory in any single-name exposures, financing unlisted corporates, structuring long-dated or complex derivatives, and financing the climate transition. (For a deeper analysis of the proposed rules and their potential impact, see our Outlook for Wholesale Banking report 2023.)

We expect some changes to the final rules, but even so, the proposals could lead to a 2–3 percentage point drag on returns for US wholesale banks, compared with 0–1 percentage points for European banks. These changes could largely close the return gap between US and European banks, relevelling the playing field for Europeans.

Europeans will still need to adapt their business model in light of Basel 3 — including pricing for increased capital and reviewing businesses that deliver marginal returns — but the headwinds should be largely manageable. Many European banks are already adapting their business to anticipate Basel 3 endgame impacts, including in capital allocation decisions.

Exhibit 2: Basel 3 endgame could drive significant increase in capital for US banks
Estimated RWA Uplift under B3E proposals versus current binding constraint



	US	Europe
2022 ROE	14.3%	11.7%
Expected B3E impact on ROE[1]	-2 to -3 pp	+0 to 1 pp

1. Assumes bank adaptation and rules implemented as proposed.

Source: US banking regulators, Bank for International Settlements; European Banking Authority, Bank disclosures, Coalition-Greenwich, Oliver Wyman analysis

US banks won't stand still, of course. We expect to see repricing, technical adaptation, and capacity reductions in places. US banks might also reconsider their capital allocation to international entities, many of which deliver returns at or below the cost of capital. The asset classes most impacted by the rules will be the focus, as well as those that already have marginal economics today: equity derivatives, cash equities, lending, fixed income, and commodities.

There is a potential for $35 billion in US bank revenues to be captured by other providers — a sum equal to 15% of the combined Americas wholesale banking revenue pool and US wholesale banks' overseas revenues. We expect about half would go to non-US banks, particularly European banks given their existing scale and capabilities. The other half of the value migration will accrue to non-bank financial institutions (NBFIs) such as private credit funds and non-bank liquidity providers.

Exhibit 3: Up to $35 billion of revenue could flow from US banks to non-US banks and non-banks

Revenue outflow from US banks by asset class, US$ billion 2025F

Asset class	Revenue flow out of US banks (US$ billion)	Key opportunities for Europeans CIBs
Fixed income	14-16 / 13-15 / 27-30	• Emerging market Rates and FX • Commodities • G10 FX
Equities	1-2 / 4-5 / 5-6	• Equity derivatives • Cash equities
Lending and investment banking	<1 / 1-2 / 1-2	• Leveraged lending • Project finance
Transaction banking and securities services	~0	• Not applicable — limited value shift anticipated

■ To non-US banks ■ To non banks

Source: Oliver Wyman analysis

After a decade of market share loss to US banks, European wholesale banks now have an opportunity to recover some of the lost share; in all, we estimate that European investment banks could claw back about 10 percentage points. Morgan Stanley estimates this could add up to 0.8 percentage points of return on tangible common equity for the most advantaged European corporate and investment banks.[1] While the final rules — and therefore the size of opportunity for European banks — remain uncertain, the opportunity could be meaningful.

1 Oliver Wyman and Morgan Stanley Blue Paper, Into the Great Unknown (2023).

GETTING ONTO THE FRONT FOOT

The market backdrop is more favourable for European wholesale banks than it has been since the financial crisis. The industry is building on firm foundations after a decade of restructuring, allowing it to deliver solid returns. The market revenue outlook is constructive, and the regulatory landscape could create more opportunities to gain share and bolster returns.

While profitability has improved recently, valuations have not. European banks still trade well below book value. Autonomous research shows that European banks are close to all-time lows in terms of price-earnings multiple relative to US banks: European banks are valued 36% lower than US banks on this measure.[2]

Winning in this environment will require decisiveness and discipline. We highlight four actions for European wholesale banks.

1. FOCUS ON AREAS OF ADVANTAGE

With cost and capital constrained, European banks' focus should be on deploying scarce resources where they can deliver superior returns.

Over the past decade, European banks have undergone profound restructuring. In 2016, European banks had around two-thirds of the cost base of US peers, yet only half the revenue.[3] As a result, cost-efficiency ratios were 15 percentage points higher. Over the past decade they have taken out $7 billion of cost and held leverage exposure flat as US banks grew by almost 20%. Many banks have exited sub-scale and low-returning business lines and markets.

European banks these days are leaner, more focused, and higher returning, delivering returns above the cost of capital and only about 3 percentage points shy of US banks. To deliver sustainable returns above the cost of capital in the future, they must remain focused on resource allocation and returns and maintain a stable earnings profile through the economic cycle.

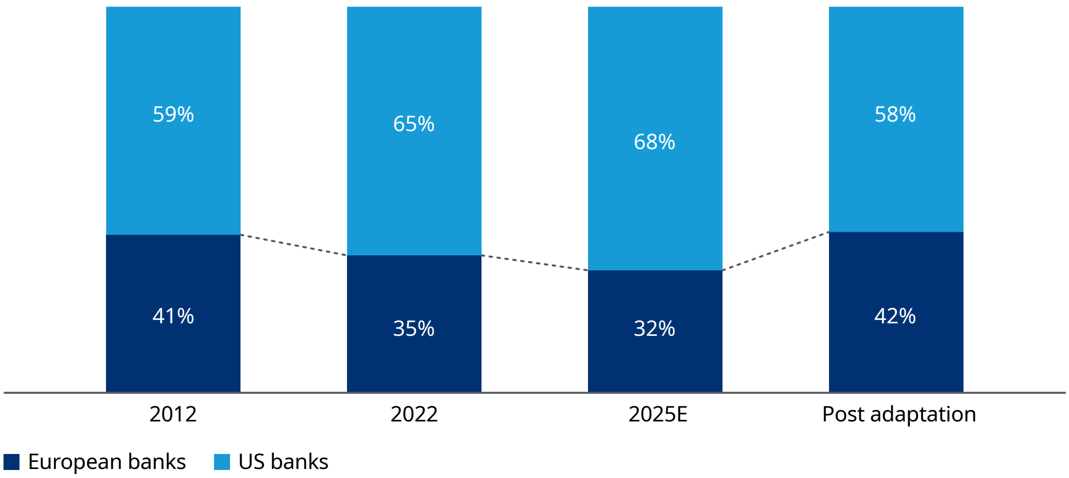
To the extent that Basel 3 endgame spurs value shifts in the industry, European banks will need to balance opportunism with discipline. There may be opportunities to gain market share if US banks cede ground, but additional capital should be deployed only in areas of strategic advantage, where banks have scale and can expand at low marginal cost. Fixed income represents the largest opportunity. Management teams will need to make the case to investors for why the wholesale bank is a better place to deploy more capital compared with other divisions or distributions to shareholders. The bar is high.

2 Autonomous report, European Banks Roadmap — 2024: Re-Rating Can Trump Downgrades.

3 Coalition Greenwich, Oliver Wyman analysis. All numbers refer to Coalition Index banks: Bank of America, Citi, Goldman Sachs, JP Morgan, Morgan Stanley, Barclays, BNP Paribas, Deutsche Bank.

Exhibit 4: European wholesale banks have an opportunity to claw back up to 10 percentage points of market share after a decade of retreat

Capital Markets, % revenues within peer set shown



Note: US banks are JP Morgan, Citi, GS, Bank of America; European banks are Deutsche Bank, HSBC, Barclays, BNP Paribas, Societe Generale, UBS.

Source: Morgan Stanley research, Coalition, Oliver Wyman analysis

2. SCALE-UP PARTNERSHIPS AND BALANCE-SHEET-LIGHT STRUCTURES

The structural shift to private credit presents a key strategic challenge for many European corporate and investment banks. Private credit is a $1.4 trillion industry today, having grown at roughly a 10% compound annual rate over the past 10 years.[4] In Europe, bank balance sheets have barely grown since the financial crisis, as private credit has exploded, with NBFIs now making up nearly half of total lending to non-financials.[5] Continued ratcheting of bank capital requirements since the global financial crisis is widening the competitiveness gap between banks and non-banks. If the trend persists, banks over time could turn into mere utility providers while non-bank lenders pick up higher-margin — and higher-risk — assets.

While this value migration to non-banks presents a challenge to banks, there is opportunity in embracing the market structure change and partnering with non-banks. We see significant opportunity to scale-up or create new partnerships with NBFIs to jointly deliver client services, while avoiding the worst of the capital headwinds. Partnerships could be with private credit funds to originate-to-distribute or co-originate high-yielding credit onto non-bank balance sheets, or with non-bank liquidity providers to provide deeper trading capabilities and inventory, enabling a full-service client proposition without the capital or cost outlay of owning the entire business.

4 Morgan Stanley.

5 BIS. Euro area credit to Private non-financial sector from Banks vs. NBFIs, 2008-2023.

There will remain a natural tension between banks and private credit funds as the latter focus on expanding direct origination, yet we still see banks as playing an important role in covering clients, structuring solutions, and funnelling private capital. Capturing the opportunity will require a reset of the strategy, adjustment of risk appetite, and a build-out of distribution infrastructure.

3. DEEPEN LINKAGES WITH HIGH-RETURNING GROUP BUSINESSES

Wholesale banking divisions over the past three years have delivered returns above group returns.[6] Yet many banks still limit the capital deployed to wholesale banking divisions, often capping out at one-third of group capital or RWA. Earnings volatility is one reason. Investors tend to favour more stable retail banking and wealth management businesses. While there is a case to be made to investors that today's wholesale banking businesses are higher quality, lower risk, and lower volatility than in the past, there is also merit in deepening linkages with the rest of the group.

Leading players have sought to demonstrate that wholesale banking businesses are not standalone franchises but rather are deeply connected to, and create value across, the wider bank. Key areas to drive deeper collaboration include wealth and asset management, commercial banking, and payments. In each of these areas, leaders are looking to drive cross-selling and referrals, create new group-wide organizations to create cost and revenue synergies, and show their value to the market.

For example, banks are focusing on deepening linkages between the markets business and private banking to provide high-net-worth clients with access to the full capabilities of the trading business. Others are creating group payments organizations, pooling infrastructure across retail and wholesale payments and merchant acquiring. The investor value of these linkages is clear: Morgan Stanley has estimated that if investors fully baked in the value of transaction banking franchises, group stock value would increase by 8% on average.[7]

4. TAKE STRUCTURAL ACTION ON COST

Cost will be a critical lever to defend and improve economics, particularly in a weak revenue environment. Our 2023 Outlook for Wholesale Banking report argues that the industry needs to move from episodic belt-tightening to a forward-looking view of sustainable cost efficiency.

6 Bank disclosures, Oliver Wyman analysis of top seven European wholesale banks.

7 Morgan Stanley Blue Paper, Striving to Sustain Returns (2021).

Sustainable cost management requires action on multiple fronts.

- **Workforce management:** Aligning supply versus demand. Building a clear understanding of the work required and aligning the workforce to deliver, considering skills, capacity, reporting lines, and locations.
- **Digital infrastructure:** Building (and maintaining) a modern and efficient infrastructure to deliver critical data and services across the organization.
- **Next-generation process management:** Designing critical processes in a modular automated manner, with artificial intelligence embedded to deliver resilient, timely, accurate, and traceable actions.
- **Organization:** Structuring the organization and business set-up to deliver as effectively and efficiently as possible, reducing unnecessary complexity and activities that outweigh any potential optionality.

The right actions for each bank will vary considerably based on business model. European global firms have a broad footprint across products and regions, but often lack revenue scale. Beyond strategic focus on areas of strength (action 1), European global firms should focus on technology modernization and automation to provide a lower cost and scalable platform to support the business. AI, in particular, presents new opportunities to transform key processes, such as loan underwriting and know-your-customer practices.

European regional banks face even greater challenges of scale, and lack the resources to develop custom solutions. Simplification and standardization are key. Banks should focus on a core product set that is central to their clients' needs (typically focused on lending, transaction banking, and FX/rates), and rely on third-party technology providers to deliver standardized platforms. Mutualization also offers a new route to scale: sharing infrastructure with other banks, or white-labelling solutions from third parties.

Now is the time for Europe's wholesale banks to be bold. These actions can help protect the gains made over the last decade, deliver good returns, whatever the outlook — and demonstrate as much to investors.

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