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Among all risks facing the financial sector, profitability is the most critical

Plenty of risks surround the European financial sector:

- While Europe has largely been spared higher tariffs so far, the U.S. administration's focus on cars imports could mark a turning point;
- Market volatility amid the normalization of monetary policy could turn a mature credit cycle;
- China's attempts to control its own indebtedness have been hurting European exports;
- Lasting political uncertainties are dampening business investment in Europe; and
- Cybersecurity and disruptive technologies are externalities that the financial sector needs to internalize.

While most of these external risks are manageable or can dissipate at some point in time, this is not the case for low interest rates. So, it is certainly no understatement to say that low interest rates remain the key issue for the European financial sector.

Ten years after the Great Recession, one can argue that the European financial sector is more resilient than before, bank's balance sheets are in best shape they've been in decades. Banks have enhanced their capital bases, liquidity buffers have been built, stress tests are run regularly to identify possible pockets of losses in bank portfolios. Cheap central bank liquidity is plentiful and a palliative to an increase in external funding costs. Nevertheless, the profitability of many European banks is once again at historical lows. While European companies in the Euro Stoxx 50 Index are priced at 1.5x their book value, many Europeans banks are priced at less than 0.6x. Such low valuations correspond to previous episodes of severe economic downturns in 2008, 2012, and 2015.

Low interest rates and a flat yield curve are among the root causes of this low profitability. They simply make the transformation of short-term savings and deposits into long-term lending less lucrative for banks. The banking sector is not the only victim. Low interest rates in the current regulatory framework compel insurance companies, as well as nonfinancial corporations with pension liabilities, to set aside considerable amounts of funds to secure future payments. The consequences are higher retained earnings and therefore less investment. The situation for banks is particularly worrying because low profitability could overtime undermine bank's lending capacity and reduce loan supply to the economy.

A rapid increase in interest rates is certainly not desirable. But can they gradually return to the levels seen before the Great Recession? There is room for doubt.

Low productivity and demographic change are making their singular mark on this economic expansion, both of which point to slow growth and subdued inflation. Central banks will find it difficult to exit their accommodative monetary policies, independently of whether they change their mandate or not.

Moreover, the demand for safe assets like U.S. Treasuries or German Bunds seems to exceed supply, despite the widening in the U.S. budget deficit on one side and the shrinkage of the Fed's balance sheet on the other.

Banking will therefore remain a low-margin business for a long time to come, which may bring consolidation and restructuring. As the European economy is still mostly financed by banks, a retrenching banking sector could have implications for employment and prosperity on the Continent. ●