Business model analysis
European banking sector model in question

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The sluggishness of the profitability of the European banking sector should push a deep market transformation under the scrutiny of the Business Model Analysis (BMA) performed by European Competent Authorities, and especially by the European Central Bank (ECB) for banks supervised under the Single Supervisory Mechanism (SSM).

Since the financial crisis emerged eight years ago, the banking industry has been facing major disruptions shaped by several dynamics, resulting in a shift of the bank's playing field. One of those dynamics is driven by EU Supervisors, who are willing to create a more stable banking sector through harmonized rules at the EU level and stricter risk and capital requirements. A second dynamic distorting the bank's playing field is the low interest rate environment resulting from the state of the economy. Finally, the digital revolution has fundamentally changed the way people think and the way the world conducts economics and business practices, opening the door to competitors in a mature industry. Taking individually, those dynamics should have a positive impact on the banking industry—combined together, those forces are sources of disruption that requires financial institutions to reconsider their business model.

In this article, we are exploring the impact of those dynamics on the bank's playing field and explain why banks must reconsider their business models in order to remain viable and sustainable, especially with the introduction of regulatory oversight over EU banks' profitability (Business Model Analysis).

Business Model Analysis: risk appetite alignment, adequate funding mix, and sufficient profitability

In its Q2 2016 risk dashboard, and dating back to when it started to produce a risk dashboard to monitor the risk level of the EU banking sector, the European Banking Authority (EBA) has classified the Return on Equity indicator (ROE) in the red level (i.e., high risk). This red flag on EU banks' profitability results from harsh market and economic conditions, in which more than 44 percent of EBA's sample of banks generate a ROE per annum below 6 percent.

The poor performance of the EU banking sector stresses the need for the sector to adapt its business model to cope with a new financial environment of low interest rates, as well as to optimize its net profit generation capacity under stricter regulatory requirements.

In this respect, the introduction of regulatory oversight over EU banks' profitability with the launch of the Business Model Analysis (BMA) in 2016 may incentivize banks to compete on innovation and implement profitability enhancement projects.

The BMA performed under the Supervisory Review and Evaluation Process (SREP) by European Competent Authorities, and especially the ECB for banks supervised under the SSM, aims at assessing whether a bank's business plan ensures its viability and sustainability, respectively over a one-year and a three-year horizon.

The one-year viability will be assessed with a main focus on three elements: first, the relative level of risk allowed by a bank in its risk appetite as compared to its peer group in the pursuit of its business model or strategy; second, the acceptability of the level of profitability that is expected to be generated in the business plan; and third, the adequacy of the funding mix with respect to the business model or strategy.

The three-year sustainability will also be assessed with a main focus on three elements: first, the plausibility of the projected financial performance as compared to the current and foreseen business environment; second, a revision of the projected financial performance by the Competent Authority relying on its own business environment assumptions; and third, the likelihood of success of the bank's future strategy.

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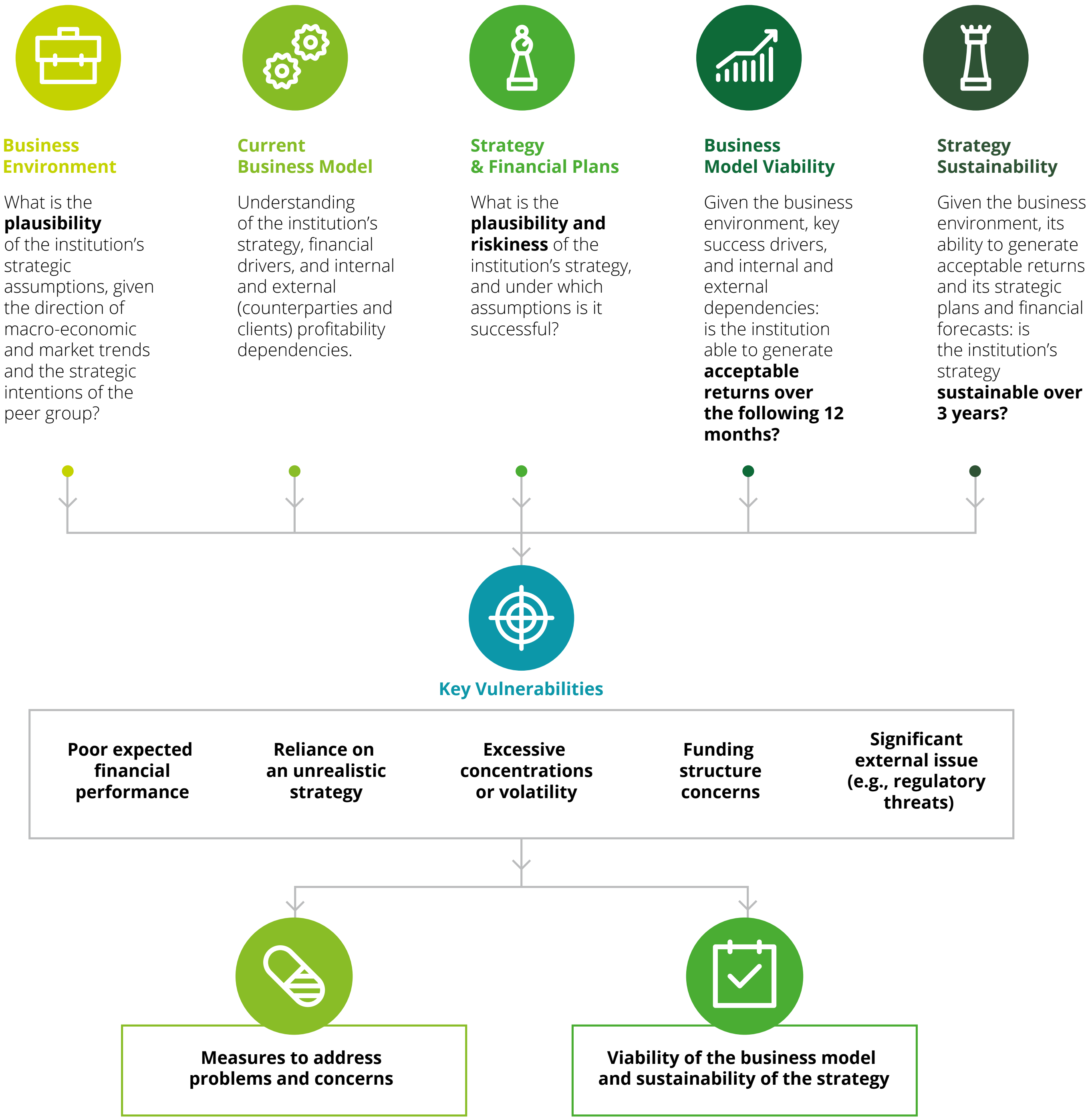
The BMA will therefore require banks to develop robust strategic planning processes that are aligned with the current and prospective business environment within adequate acceptable risk appetite boundaries.



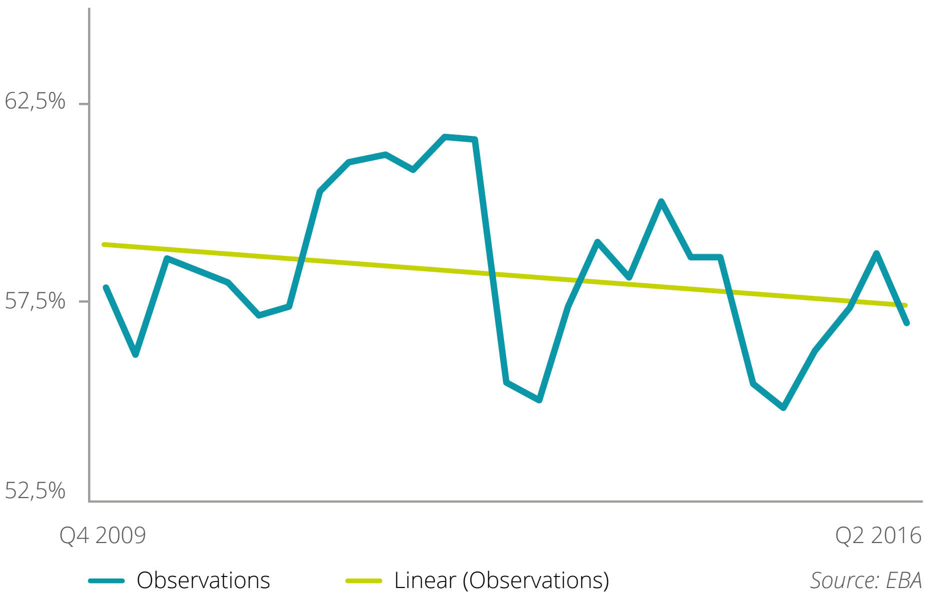
Interest rate dynamic

The net interest margin depression is one of the main elements explaining the persistent drag weighing on the profitability of the EU banking sector that will have to be addressed under the BMA. This depression of the banking net interest margin is resulting from a combination of low interest rate monetary policies and a shift of fundamental economic factors requiring banks to sustainably diversify their profit structure.

The European economic environment and especially the current low interest rate market configuration casts a new banking era in the EU. Within this new era, the industry's challenge is to evolve toward a profit model less reliant on the net interest margin. This profit diversification strategy is particularly important for Europe, where a significant share of the financing of the economy is achieved through the banking sector, which, as a result, relies heavily on interest rate revenues for raising the bottom line of its profit and loss statement.

A diversification strategy of profit sources should be a long-term strategy to preserve the profitability of the EU banking sector in response to multiple intertwined factors. First, the level of nominal interest rates is expected to remain low under the monetary policy of the ECB as uncertainty prevails around the re-ignition of growth and inflation in the Union. Second, demographic and world economic shifts have durably pushed back real interest rates. Finally, the decline of the contribution of the net interest margin in the profitability of the EU banking sector is projected to accelerate as the existing pool of high yielding assets is progressively prepaid or reaching maturity.

EU banks decreasing share of net interest income in the total operating income
(weitghted average Q4 2009 - Q2 2016)



At the European level, demographics, and especially the rise of life expectancy, is the main driver explaining the increase of savings supply, driving real interest rates down.

Central banks' monetary policies

The first factor leading to the erosion of net interest margins is the low/ negative interest rate environment driven by expansionary monetary policies of central banks. Those monetary policies are meant to support economic growth, but banks active in the Eurozone especially suffer from negative interest rates, since they are reluctant to pass negative interests born on their liquidity placements through to their clients' deposits. A contraction of the bank's net interest margin is resulting from this situation, as interest incomes decrease while interest expenses remain stable given banks generally floor their deposit rates to zero.

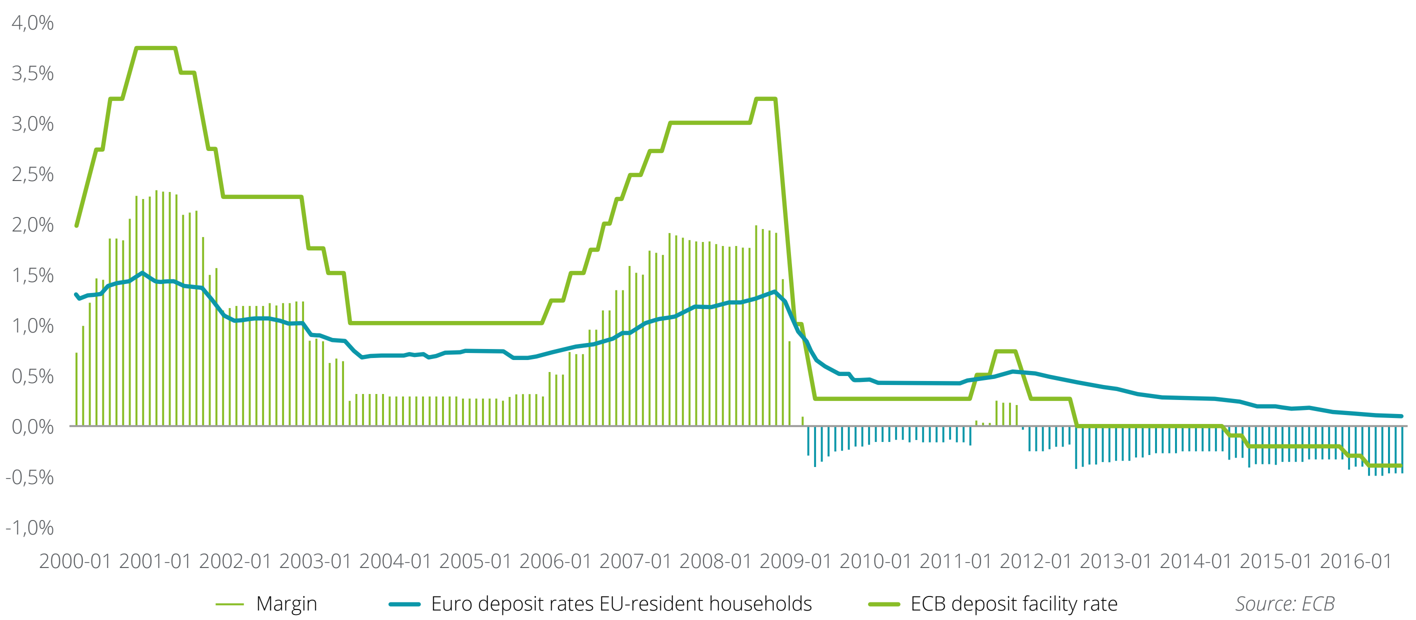
Real interest rate decline

A second factor leading to the erosion of net interest margins is the fall in real interest rates driven by an increase in the supply of savings at both the European and global levels. These macroeconomic factors limit the rise of the nominal interest rate, compromising the potential of a net interest margin recovery.

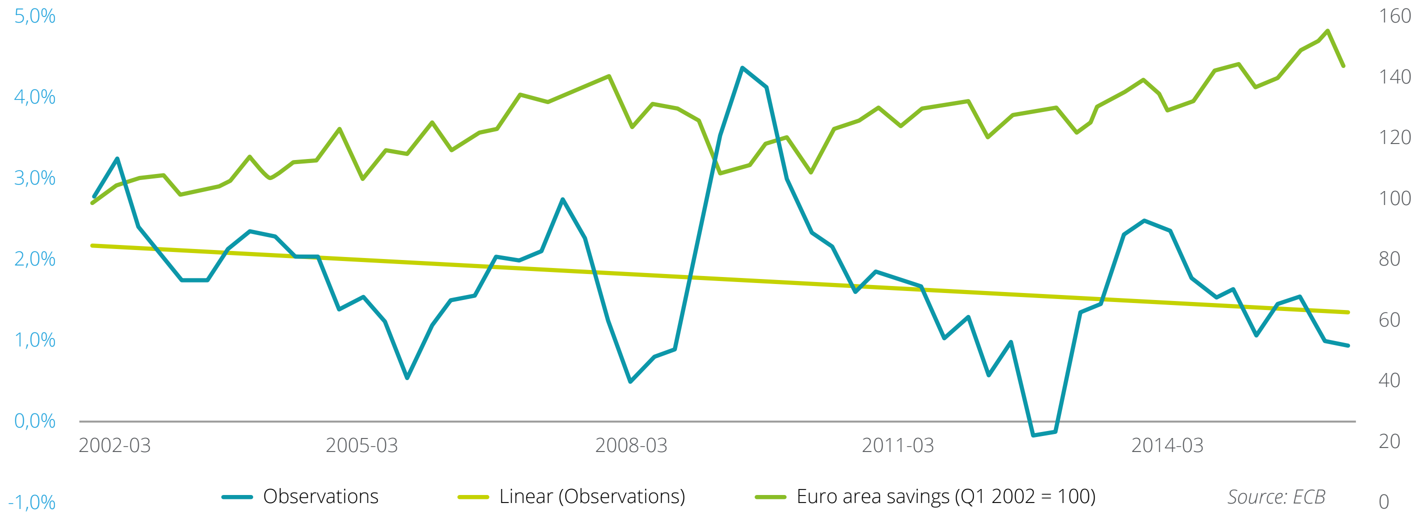
At the European level, demographics, and especially the rise of life expectancy, is the main driver explaining the increase of savings supply, driving real interest rates down. This increase in savings supply is mainly explained by the faster pace of rise of the average life expectancy compared to the average age of retirement, implying a longer average period of retirement. Higher savings rates are therefore required today in order to support longer retirement times of tomorrow, which mechanically drives the yield of low risk assets downward to reach an equilibrium in capital and debt markets.

At the global level, the integration of emerging economies in the global economy that took place in past years, and especially countries without an organized pension scheme that encourage people to save even more, increasing the supply of savings and the downward pressure on assets yields.

Euro deposit margin in negative territory since 2009



Euro area exeperiencing a decrease of its real interest rate while total economy savings is surging
(per annum, ECB euro 10Y government bond yield benchmark minus HCPI YoY % change 1997 - 2016)



The regulation dynamic

In the search for sustainable profitability enhancing strategies, the introduction of stricter regulatory capital and liquidity requirements in the EU does not favor volume-driven profit reinforcement strategies, nor alternative business model evolutions that significantly affect banks' balance sheets and commitments.

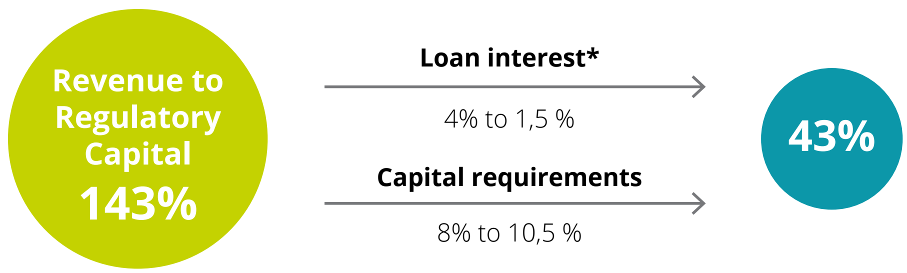
The implementation of the Capital Requirements Directive IV package (CRD IV) since 2014, and notably, the introduction of stricter capital and liquidity requirements must drive banks to seek to provide additional services to generate profit without increasing their balance sheet size and commitments.

Regulatory capital requirements

The increase of regulatory capital requirements under CRD IV through stricter capital definitions, increase of Risk Weighted Assets (RWA), and introduction of capital buffers limit the room for improving profitability through the origination of higher volumes of transactions or asset shifting from lower to higher yielding products.

The following illustration points out the combined negative effects of low interest rates and stricter capital requirements on banks' profitability. In this example, the ratio of "revenue to regulatory capital" on a loan risk weighted at 35 percent, such as a residential mortgage loan under the regulatory standardized approach, is decreasing by 70 percent from 143 percent (4 percent interest revenue to 8 percent of capital requirements on RWA) to 43 percent (1.5 percent interest revenue to 10.5 percent of capital requirements on RWA). In other words, where in the past a bank could generate 1 euro of revenue per unit of capital, in the current regulatory and interest environment, a bank is now able to generate only 0.3 euro per the same unit of capital.

The combined effect of interest rate decrease and capital requirements increase on the ratio "interest revenue on regulatory capital"



*Example of a loan with 35% regulatory risk weight

Liquidity requirements

The introduction of regulatory liquidity requirements by CRD IV must provide two incentives for banks to limit the generation of profit through transactions affecting the size of their balance sheet and commitments.

On one hand, increasing the size of regulatory High Quality Liquid Assets (HQLA) by acquiring debt securities represents a high interest rate risk, given the price inflation that low risk debt securities have experienced since the financial crisis. Should nominal interest rates rise in the medium term, the value of such debt securities will suffer from a significant loss of value.

On the other hand, constituting HQLA by increasing reserves at the central bank constitutes a threat for a bank's net interest margin as long as ECB interest rates are below zero.

ROE and market consolidation

In the current economic and regulatory environment, pursuing an acquisition strategy targeting medium-sized players to foster profitability may prove to be a winning strategy thanks to potential efficiency gains. However, ultimately, succeeding a fee-driven strategy of profit diversification shall be supported by a fundamental business model review aiming to provide the utmost level of flexibility to clients with full digital support.

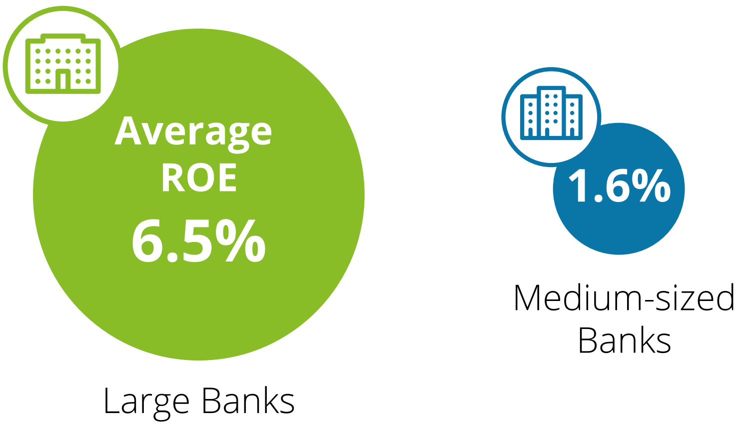
Since the financial crisis, the concentration of the EU banking sector has increased as a result of mergers and acquisitions (M&A) transactions, which helped to achieve overall efficiency gains in the sector. Banking statistics suggest however that in some regions the Euro area, the concentration of the banking sector remains low with high-branch penetration rates (see ECB Financial Stability Review, May 2016), pointing out that further efficiency and cost-cutting gains are achievable through mergers.

In this market configuration, banks able to allocate resources to M&A operations under their business development strategic plan may develop a long-term strategic competitive advantage in their market, notably through efficiency gains. Under this perspective, EU statistics suggest that medium-sized banks (EBA Risk Dashboard sample) may prove to be attractive targets. First, medium-sized EU banks are relatively inexpensive acquisition targets, since they appear to structurally lack profitability momentum in the current market and financial environment, experiencing persistently lower ROE relative to large-sized banks—respectively 1.6 percent versus 6.5 percent on average between 2014 and 2016.[1] Second, besides overall efficiency gains, integrating the acquired clientele of medium-sized banks into larger banks may prove to be a winning strategy in terms of profitability development, due to the fact that larger banks are able to offer their clients a wider range of financial services at a low marginal cost.

1. This trend will not be in the interest of consumers who will lose the advantage of competitive markets.

Gap in ROE between large and medium EU Banks underlines potential efficiency gains from market consolidation

(EBA Risk Dashboard sample of EU Banks ROE, Dec. 2014 - Jun . 2016) - *Source: EBA*



The digitalization dynamic: fees instead of penalties

The pursuit of the digitalization of banking is key toward a widening financial services offering and cross-selling under a strategy of profit diversification through the generation of fee income. Furthermore, market players able to increase the accessibility of their services to their customers by providing reactive and complete online and mobile banking platforms will develop strong competitive advantages over traditional banks and increase their resistance to external competitive threats, such as FinTechs.

The digitalization of banking, and its democratization to medium-sized banks, provides banks with key abilities to support the successful implementation of ambitious business and strategic plans:

- The dilution of branch networks leading to the reduction of branch and staffing costs
- Increased responsiveness to client requests and higher quality services
- Enhanced data analysis capabilities and behavioral understanding
- Increased funding management reactivity and accuracy
- Offering additional and complementary on-demand fee-based services

Finally, to be successful, the implementation of a fee-based profit diversification strategy through digital transformation must be coupled with a fundamental philosophy shift toward flexibility. Such strategy must indeed provide clients with the highest degree of flexibility with respect to the management of their personal finances, supported by the offering of a wide range of services and options as standard, such as the option to choose and modify loan conditions at any time in exchange of fees instead of penalties.

The pursuit of the digitalization of banking is key toward a widening financial services offering and cross-selling under a strategy of profit diversification through the generation of fee income.

This article illustrates the impact of several dynamics on banks' playing field and highlights the importance for the banking industry to reconsider their business model in order to remain viable and sustainable. Some banks have opted for a cost-cutting strategy or increase in management fees to support their performance, but they also need to reduce their dependence on interest income and integrate the ongoing digital revolution. Fee income is considered an alternative source of revenue, but the market appetite for complex products is decreasing, pushing market players toward simpler products that are protected by stricter consumer rules and characterized by lower fees.

Under the Business Model Analysis regulatory stream, EU Supervisors should spark initiatives to support banks' profitability but will at the same time control that the change does not bring systemic instability nor jeopardize the economy. To meet those requirements, banks will have to undertake a tremendous balancing act.