

Speech at Deutsche Bundesbank Conference  
Bank business models - Structural changes and their  
systemic implications

---

20/02/2018

---

## Speech at the Deutsche Bundesbank Conference - *Bank business models - Structural changes and their systemic implications*

Frankfurt, 20 February 2018

---

Check Against Delivery  
Seul le texte prononcé fait foi  
Es gilt das gesprochene Wort

### *EU banks' business models – Adapt to thrive*

Dear Colleagues, Ladies and Gentlemen,

It is my honour and great pleasure to be able to address you tonight during the dinner following the first day of your discussions on bank business models. I did not submit a paper to the conference organisers, instead I was asked to share some thoughts with you on the practical regulatory and supervisory aspects of the evolution of bank business models in Europe. I would like to thank our colleagues at the Bundesbank for giving me this opportunity to participate and speak at this event.

---

Since we are at dinner, let me start my remarks with a short personal recount of some key events in the evolution of the EBA's assessment of bank business models. In 2014, the EBA developed an approach to business model analysis (BMA) making it one of the key elements of the common supervisory review and evaluation process (SREP) framework. It was introduced in our Guidelines on common procedures and methodologies for SREP.

A couple of weeks after publishing the guidelines, I had the opportunity of giving a speech at a banking industry conference, presenting the overall SREP process and its aim. The feedback that I received was not that surprising in its substance, but more so in its intensity. Bank representatives argued very strongly that regulators and supervisors should not dictate or decide how banks do business.

It was not surprising because during the process of designing the guidelines we had lively discussions on what the role of supervisors should be. Where is the boundary between assessing business models and prescribing one? Should the supervisors intervene in the process of setting the strategy and business model of a bank?

Clearly, it was not our objective to suggest that supervisors are empowered to decide on banks' strategies.

The role of supervisors, in our view, is to assess and challenge business models, but not to control banks' development of their strategies and the corresponding business model. To be a bit more specific, the main objective of business model analysis is to allow competent authorities to develop a view on two main areas. Firstly, they should have a view of the current business model of the supervised institution, and its viability. Secondly, they should understand how the business model may evolve as a result of strategic choices made by the institution and/or the impact of changes to the business environment in which it operates and, therefore, its risks and sustainability. Both views should bring benefits in the form of improved supervisory practices, which in turn should ensure the health of the EU banking system.

But I do not want to expand my remarks on business model analysis and supervisory processes. I would rather like to focus on why banks need to adapt their business models according to the results of our analysis. It is not a new topic of interest, but no simple answers have been found.

Around a year ago, I was chairing a discussion on exactly the same topic at the Eurofi conference in Tallinn. The panel had colleagues from the official sector as well as from the industry. Even if we did have different perspectives, we agreed that the main challenges for banks going forward were low profitability, high non-performing loans and overreliance on the central bank funding. These were all symptoms of weaknesses in business models. We also agreed that for addressing those weaknesses, banks had to consider several factors, including the macroeconomic developments, regulatory changes, structural adjustments in the financial markets and advance in technology, but that they could respond by revising and changing their business models.

While the relative weight of these factors have somewhat changed over the past years, they remain relevant and most challenges in business model adaptation seem to be broadly the same.

Therefore, to reach a more thorough understanding, I suggest that we have a look at the developments in the EU banking sector in the recent years.

## Banks' challenges

More than eight years after the beginning of the financial crisis, the repair of the EU banking sector is progressing and a number of vulnerabilities have been addressed. EU banks have significantly strengthened their capital positions and are perceived by market participants as more stable and resilient.

Capital positions are strong, possibly the strongest in decades. The Common Equity Tier 1 ratio increased from 9.0% in 2009 to 14.6% as of Q3 2017. In the years following the crisis, improvement in capitalisation was driven by deleveraging and de-risking, but also through capital increases. However, deleveraging has receded in the past year together with some signs of asset and loan growth. On the other hand, there has been a decrease in capital issuance. Most of the capital increases have recently resulted from retained earnings. This is mainly due to capital issuance being either too expensive or not needed, because there is no ability to expand.

Nonetheless, challenges still remain. One of the easiest way of detecting a problem EU banks have is by looking at their valuation metrics. Average price-to-book of European banks is still below 1 and with relatively low prospects of balance sheet growth. In other words, there are either low earning prospects or there are some balance sheet characteristics that produce uncertainty compared to global peers or both.

After the crisis, profitability decreased substantially, especially during the two sovereign crisis. It seems, however, that banks took the right path in 2017. The EU average RoE increased notably in the past few quarters. In Q3 2017, for a third consecutive quarter (YoY basis), it reached 7.1%, which is much higher than the 3.3% in 2016. The dispersion across banks and jurisdictions remains and is actually widening. Despite this positive trend, the average RoE remains well below the average CoE estimated to be at 10-11% for the EU.

Asset quality is the other major perceived vulnerability for EU banks, especially in the countries that were most affected by the euro area sovereign crisis. After the outburst of the financial crisis, NPL volumes started picking up quickly and reached almost EUR 1.5 trillion. The highest NPL ratio for the sample of EU banks that the EBA is monitoring was recorded at 6.8% in 2013. NPLs remained high and stable for a long period and started gradually decreasing after the comprehensive assessment in 2014. There was a gradual decrease, thereafter, with volumes falling by a third in three years. The recent data shows that in September 2017 the EU weighted average NPL ratio decreased to 4.2%. At the same time, all of the sectors (Large corporates, SMEs and households) have decreased NPL ratios, with large corporates having the highest decrease in volumes since 2014 (-35%). Geographically speaking, the highest decrease of the average NPL ratio was recorded in Cyprus, Portugal and Italy. If the past year trend continues, the average NPL ratio for the EU banks will fall below 4% in the 2017 year-end figures.

It seems that after a coordinated and more decisive action from the official sector, especially through supervisory pressure and focused commitments to address other problems - such as structural and secondary market issues - banks have picked up the pace in resolving NPLs. Although the trend is clear and promising, on a global level, the non-performing loan ratio in the EU is still the highest among its peers (i.e. US and Japan). Profitability remains the main concern in terms of banks' ability to deal with legacy poor performing assets. Our analysis shows a negative correlation between NPL ratios and profitability and shows that banks unable to cope with their non-performing loans will probably struggle to return to profitability.

The challenges posed by remaining asset quality issues are, therefore, clear and they have implications on profitability. While the risk costs of lingering legacy assets directly and negatively impact profitability, the link between banks' management capability to react and adapt and constant changes in their operational environment due to the efforts required to resolve NPLs has indirect, but also negative effect on banks' profit generating capacity..

## **Business model adaptation and exogenous factors**

As I mentioned before, there are exogenous conditions affecting banks' ability to adapt their business models and it seems that some of them have moved into the right direction since the meeting in Tallinn, making banks' transition slightly easier. For instance, over the past year, the endorsement of the outstanding components of the Basel III reform package brings more regulatory clarity and helps banks in planning, and possibly adjusting their model of business. In addition, the macroeconomic outlook have improved. Still, to find the adequate business model, banks will have to take into account a number of exogenous factors. Let us now look at the list of the most important ones.

### **Macroeconomic developments, structural changes and banks' focus.**

The first step in the process of banks' business model adaptation should be fixing their strategy. Banks' future strategy needs to take into account the potential prolongation of the current low interest rate environment, the pace of cleaning up of their balance sheets, the implementation of Basel prudential rules and the new resolution framework, as well as the possible future developments of the Capital Market Union (CMU). In the context of this strategy, banks should also re-assess their risk appetite. The most successful banks need to develop a risk strategy beyond regulatory compliance focusing on the overall business risk management. Besides their risk culture, banks also need to develop their business culture, addressing both their customers as well as their employees.

What have we seen in this context until now? Net interest margins (NIM) have been decreasing since 2014 reaching 1.47 % in Q3 2017, their lowest level, but might be bottoming out soon. Many banks enjoyed a strong support for profitability from falling liability costs. This has been a key element of the resilience in bank spreads in the past couple of years. However, as the downward repricing of the back-book will continue, banks will have to concentrate on repricing credit rather than hoping for further decrease in funding costs. The latest developments have supported the

latter assertion, as loans are picking up but net interest income is falling. Pressure on margins is not only seen in the euro area, but also in the Nordic countries despite their quicker return to growth after the crisis.

There are little signs of increasing fees and commissions, less than banks expected. Fee and commission income increased in Q3 2017 YoY but stayed stable compared to 2014. The latest improving signs of profitability were mainly driven by higher trading income and lower cost of risk. Net trading income to operating income stood at 9-10% in 2017, significantly above the average of previous years. The cost of risk (Impairment for loan losses/ gross loans) decreased further and it is now at record low levels (0.24% in Q3 2017 compared to 0.6% 3 years ago).

### **Rationalisation and improving efficiency**

EU banking sector efficiency indicators show a significant diversity across jurisdictions. Operational expenses seem to be sticky and looking at the latest data, there are no major improvements in efficiency (Cost-to-income ratio is still above 60%). The same applies to measures of overcapacity, such as branch density. Even though EU banks' activities have become less branch-based and asset intensive, they are still lagging behind their US peers. For example, if we look at total asset to GDP, the EU with 1.84 is more than double the US ratio at 0.74. Similarly, though less pronounced, when looking at the number of branches per inhabitant in 2016, the EU is still 30 % above the US. While this likely reflects different factors, such as social, cultural and geographical heterogeneity, it also suggests that in some EU banking systems there is room for efficiency gains. This seems to be the case for banks in some of the larger countries like Germany, France, Italy and Spain, but also in smaller countries like Slovenia, Portugal, Cyprus and Malta. Market concentration indexes provide a similar read-across. Against this backdrop, reducing overcapacity stands out as a necessary means to an end that can be accomplished in a number of ways, such as mergers and acquisitions, or resolutions. However, one should bear in mind that mergers should in principle be conducive to the establishment of sound and viable players, endowed with adequate capital bases, reasonably proportionate to risks. On the other hand, alternative solutions, such as resolving or liquidating weak banks, must be carefully weighed against the possible macro dislocations that such measures may entail, if not appropriately thought through and carried out. In these cases, supervisors should always be mindful of the possible unintended side-effects that pure micro-prudential decisions might have on financial stability as striking the right balance is no easy task.

In general, both cross-border and domestic mergers can pursue the objective of cost reduction, economies of scale (at least up to a certain extent) and risk diversification. In particular, cost reduction and efficiency gains can be brought about by a more efficient infrastructure management. Coupled with mergers, NPL disposals can also positively benefit from economies of scale, in particular for smaller banks. In addition to that, in the current very low interest rate context, the objective of revenue diversification is as important as operational efficiency. The possibility to fill gaps in the product proposition and to diversify revenue sources, including from fee-generating products, allow banks to enter new markets, to be more resilient to shocks and more able to deal with an unconventional environment like the one we are currently experiencing.

Nonetheless, total M&A activity in the EU banking sector has declined since the high values recorded in 2007 in terms of the value of transactions. In terms of the number of transactions, M&A activity in the euro area banking sector has been falling almost continuously since 2000. The number of M&A transactions in 2016 was still much lower than the number observed before the crisis and well below the peak of 2001. Cross-border transactions within the euro area and outward transactions (with euro area banks as acquirers) were those most affected by this decline.

The decrease in the volume and number of M&As is likely explained by the macroeconomic cycle (less M&As in a downturn) and the obstacles that are restricting them. As the economy is picking up slowly, the focus is more on the obstacles. These range from legal and regulatory constraints such as tax treatment, civil laws, prudential liquidity and capital requirements, and cultural and governance differences to political and supervisory practices, especially for cross border M&As. Let me give you a few specific examples. When systemic risks are addressed in the EU, macro prudential policies remain in the national domain and, therefore, if they are not better harmonised across Member States, they can lead to ring fencing of capital and liquidity. Another example is connected with the movement of deposits. The EU has not yet set up a common European deposit guarantee scheme, which would guarantee customer deposits at EU level and, therefore, enable the movement of cross-border funds. Deepening the Banking Union would definitely benefit banking consolidation and help reduce fragmentation across the EU banking system. Having said that, a combined effort from banks, supervisors as well as governments is needed for establishing an environment where banks' decisions on an M&A would be solely based only on the identified synergies.

## **Technology**

With a fast growing financial technology industry, the way banks conduct business is changing significantly. Technological trends such as big data, block chain, cloud services, open banking and machine learning are not only automating some processes, like banking services, trading and underwriting, but they might also change the underlying methodologies, especially for risk underwriting. On the other hand, with generational shifts and rapid adoption of new technologies by consumers, financial technology is shaping the pallet of financial products and services banks offer to their customers and also changing the way their clients are approached. To compete with non-bank competitors, banks need to get closer to their customers by creating a completely virtual experience, potentially modifying the role of primary account providers. Improving technology could be a tail-wind to the banks' non-interest income potential for increasing revenues and with it profitability.

Based on the last EBA risk assessment report, most banks admit the rapid growth of FinTech firms markedly impacting their business especially in retail banking and payment and settlement. The EBA mapping exercise also showed that (i) FinTech firms target a wide range of end-users, with consumers being identified as the main target of end-users and (ii) all business lines across banks seem to be affected, albeit with no immediate threat. The most disrupted business line is payments and settlement which is perceived as an opportunity for banks to either increase revenues or

reduce costs. This is also supported by the EBA mapping exercise which indicates that FinTech firms appear to be particularly dominant in the provision of payments, clearing and settlement services. Retail banking is probably the second most disrupted business line while the EBA mapping exercise indicates disruption also in other financial-related activities (e.g. credit reference services, compliance services etc.).

We expect pressure on banks' market share from competing FinTech companies to intensify, as their numbers grow. In Q1 2017, investments in European venture capital-backed FinTech companies spiked to 73 investments worth USD 667m. At the current pace, total funding dollars to FinTech companies based in Europe might surpass USD 2.6bn in 2017. The numbers are still relatively low, but they are growing exponentially.

### **Operationalisation and risks**

Finally, the way potential synergies are captured depends on the operationalisation of the adaptation to the three factors mentioned above. Moreover, one should bear in mind that some of the opportunities may bring additional risks. This is especially the case when cost rationalisation and implementation of new technologies are carried out at the same time. Therefore, when revising their business models, banks need to find a balance between mandatory (regulatory) changes, changes to stay competitive also with the non-bank competitors and changes that banks are able to implement without taking on excessive additional risks. On the other hand, it is for supervisors to remind banks about potential risks and assess if adequate mitigation measures are in place.

## **Conclusions**

To summarise, adapting banks' business models is essential for establishing an efficient and, above all, sustainable EU banking sector. To ensure the process does not have negative systemic implications and consequences to depositors, the most vulnerable stakeholders, supervisors will conduct business model analysis in their regular supervisory process. Nonetheless, in adapting business models not all the burden falls on the shoulders of banks. As technology advances and traditional banking models becomes less viable, further efforts are also needed from the official sector. The deepening of the Banking Union is one of these as through further harmonisation of rules, macroprudential policies and supervisory practices, it will enable cross border movement of funds and capital, and leverage on potential efficiency gains. Another one is the further development of the CMU that has a potential to reduce the burden on banks in terms of capital charges and servicing costs. Banks, on the other hand, have to factor these changes in their business model revisions. Even though one can only assume how this evolution in business models will actually take place across the current EU banking sector, the ultimate result is expected to be a reduction of number of banks, yet a more efficient, stable and competitive banking sector.