The silver lining of negative rates: real restructuring opportunities for banks

Banks and bank analysts continually highlight the fact that the ECB's negative rates are affecting performance now more than ever. This is a prevailing theme in the current results season, and likely to remain so into next year. Somehow, the real underlying purpose of ECB action – to stimulate economic growth in Europe (which should implicitly help credit demand) – seems to have got lost in the shuffle.

Low profitability for the European banking sector is here to stay for the foreseeable future. But banks should do more than just "blame, complain and explain". They can use negative rates as a strategic opportunity, not a moment too soon, to undertake truly transformational restructuring: vigorously shedding branch and excess back-office capacity and accepting in-market consolidation. Their efforts in this regard should be far more sustained than the steps taken so far.

However, at a time when the European banking industry is eager to show increased social responsibility and present a positive image, massive restructuring could be viewed as ruthless; the opposite of an enriching experience. But when all the chips are down, it cannot be avoided if banks wish to preserve their market positions and maintain viable financial conditions in the digital age. Which they all say they do.

The accelerated move into the digital space puts banks in the situation of movie actors in the late 1920s during the transition from silent film to talkies. Some converted successfully to talking-movie actors, others did not make it and faded away.

Seven structural factors behind poor profitability

Seven structural factors are pressuring European bank profitability. The add-on of negative rates is just the icing on the cake.

1 The low rate environment has been around for more than a decade, depressing net interest margins since the crisis years.

2 Loan growth has been relatively unconvincing, even in the years of more positive economic growth. Much of Europe's post-crisis economic recovery has relied somewhat less on bank lending than in preceding decades: more capital market borrowing for larger corporates, more self-sufficiency for SMEs (due also to banks' more severe underwriting standards).

3 Toughened prudential standards (e.g. on capital) have irrevocably altered the denominator-numerator relationship in banks' returns on equity. Single digit to low double-digit ROEs will most likely remain the norm.

4 Financial inclusion (the percentage of the banked population) is much higher in Europe than in the US, where banks were able to avoid or price out tens of millions of low-income households; even more so than in emerging markets. But this comes with a cost tag, translated into comparatively lower profitability.

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5 In the absence of Freddie Mac/Fannie Mae-like government-sponsored agencies, European banks keep most low-yield residential mortgages on their books.

6 The evolution of banking culture inherently has to adjust to priorities. For example, even with the prospect of juicy margins, there is at least an expectation that European banks (perhaps unlike counterparts elsewhere in the world) will be reluctant to lend on a material scale to segments like weapons manufacturers, tobacco, as well as fossil fuels or other carbon-heavy sectors. Or to countries with dubious social or political realities.

7 Probably most importantly, digital disruption for traditional banking institutions is real and very likely to turn ever more threatening in years to come. Disruption is coming from new actors – fintechs, neobanks, open platforms – but also from other banks that have positioned themselves better for the digital age. It leads to a continuous erosion of traditional banking revenues – a trend which will only worsen going forward. A comeback of the industry to its earlier self will not happen. There is no recipe for unscrambling eggs.

Transformational restructuring is not optional; the time is now

The real burden for European banks is not insufficiently reassuring prudential metrics. Or problematic asset quality. Or aggressive expansion into new markets and geographies (which is very timid). Or even low profitability.

The real elephant in the room is the sector's substantial excess capacity in all of the Western European developed markets, bar none. This was evident immediately after the crisis, but has been made much worse with digital transformation, especially mobile-based applications. Banks like to show their progress in digitalising products, platforms and processes, and some have made impressive progress in open platforms and banking-as-a-service (banks like BBVA, ING and DNB come to mind). This progress entails significant investments in IT, although these are dwarfed by the massive IT outlays by the largest US groups – roughly USD 10bn per bank.

The main upset factor, however, is less the sub-optimal pace of digitalisation. Even if for too many banks it is too slow. The main upset is the insufficient reduction in parallel legacy costs – mostly related to physical branches and back offices. So far in 2019, European banks have announced nearly 50,000 job cuts (over 40% of them in Germany)[1] and more are likely by the end of the year. The equivalent number was 72,000 in 2017[2].

But these numbers combined amount to no more than 4.5% of the 2.7 million bank employees in the EU-28 at the end of last year. In 2018 the number of EU bank branches dropped by 10,000, to 174,000. During the 2008-2018 decade the total number of bank branches shrunk by slightly more than a quarter. These are necessary restructuring steps, but by no means are they transformational. A growing number of bank customers use mobile channels as the primary interaction venues with their banks; although there are differences between countries; the Nordic/Baltic region, the Netherlands and the UK being at the forefront of mobile usage.

A far more serious effort will be needed for transformational restructuring away from the physical bank in countries like France or Italy. Segments of the banking industry where this restructuring will probably go more slowly are among savings and co-operative banks, for which shareholder and market pressure is less acute. The claim of some banks that "our customers prefer us to keep our physical branches" cannot offer a full justification to preserve extensive branch networks. After all, if asked, many customers would also prefer interest-free loans.

Various independent reports estimate that within the next five years, over 20% of existing bank jobs will go away in the US (and over 50% within the next 10 years). It is implausible to believe that, even with a delay of a few years, Europe will not undergo a similar change.

At the same time, numerous new jobs will be created by the digitally restructured banks, but these will mostly be in IT or IT-related areas. At this time, there is a very significant shortage in too many European countries of experts in cybersecurity, digital product design, creative digital thinking, AI, marketing digital services, etc.

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[1] Source: S&P Global Market Intelligence.
[2] Source: European Banking Federation.

This is why a specific exogenous driver such as the ECB’s pushdown of negative rates should drive banks to bite the restructuring bullet more decisively and more rapidly.

Investors and analysts should be specifically focusing on this aspect from both qualitative and quantitative angles, rather than merely benchmarking cost-income ratios (which are driven by revenue variations as well).

In-market consolidation among second-tier banks is a sine qua non

Not all banks will achieve successful digital transformation and remain competitive in the new ecosystem. Especially those with revenues mostly dependent on traditional intermediation activities such as retail and SME lending. The banking sector’s soft underbelly for disruption by fintechs, open platforms, other banks, possibly big tech are commoditised activities, starting with payments.

This is why such banks –the majority of the ca. 6,000 EU-based banks – will need to undergo more significant in-market consolidation in the next few years. Choosing to go solo cannot be a long-term option for the majority of these banks. There is significant scope for more vigorous consolidation in Germany, Austria, Italy, and to a lesser extent in Spain (where the bulk of in-market consolidation has already occurred under duress during the crisis). Outside of the EU, there is need for further second-tier bank consolidation in Norway and Switzerland.

Meanwhile the focus of the market remains pegged to some hypothetical M&A among Europe’s larger banking groups, especially cross-border. This is also on the wish list of ECB supervisors. But cross-border M&A is less economically justified in the digital age. Even within a large cross-border group, the bulk of retail and small-business banking is undertaken at a national, not cross-border, level. And it will be much more efficient for a large bank to offer services to new customers in a different country via open platforms and other digital channels, rather than through a top-heavy combination with a legacy bank.

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