Kick the can no more: six talking points for European banking in 2020

The slow but unmistakeable decline of Europe's banking industry will continue in 2020, and the process is probably irreversible. This does not mean that most banks will need external support any time soon, despite the persistence of weak profitability metrics. In fact, the opposite is true: post-crisis de-risking and vigorous prudential re-regulation have moved the needle away from the failure zone, save for a small and shrinking contingent of outliers. Taking sizzle out of the banking industry should reassure credit investors.

Investors can start worrying less about how resolution will work for banks that are safely removed from any hint of needing resolution. And they can be less panicky about an otherwise healthy bank with capital levels modestly below peer averages but still safely above regulatory norms.

But the banking sector is not resting on a bed of flowers: there are genuine causes for investor concern elsewhere. In addition to an increasingly unattractive macro environment, the headwinds of structurally weak profitability, stubbornly high excess capacity (made worse by systemic fragmentation), increasingly out-dated business models, and new risks which are less modellable (digital disruption, cyber, misconduct, climate change) will intensify in 2020.

Below are six talking points for 2020.

1 Excess analog capacity: kick the can no more

For European banks, stubbornly high excess capacity is the elephant in the room. Not Basel IV, not the ECB's negative rates, nor the lack of pan-European deposit insurance. The debate on whether or how fast and comprehensively banks should transition from analog to digital goes on. A large number of institutions still resist, claiming that customers prefer to use physical branches (the faster-horse paradigm when the first cars arrived).

Mobile-embracing customer behaviour and competition from fintech/big tech will likely be spurred in 2020 by the new open-banking regulations. This makes banks' massive legacy infrastructures – branches and back offices – both costly and unnecessary. There is no way back on this path, and technology advances, especially in mobile communications, will increasingly force the banks to switch from walking to running on it.

Embracing digital cannot be successful if banks remain chained for too long to their legacy analog burdens. The main advantage of fintechs and neobanks may not be that they are digitally sharper than the banks; many of the latter have been embracing digital for some time, and successfully so. Rather, it is that they don't have costly analog legacy to carry in the way the banks do.

With constrained and more disrupted demand for financial services and with revenues under constant negative pressure, banks will no longer be able to keep kicking the excess-capacity can down the road. In 2020, more substantial legacy cutting will have to take place across the entire field: fewer banks, fewer

Author

Sam Theodore
+44 (0)776 932 1043
s.theodore@scopeinsights.com

Media

André Fischer
+49 30 27891 147
a.fischer@scopegroup.com

Scope Insights

Suite 204
2 Angel Square
UK-London EC1V 1NY

Phone +44 20 3457 0444

Scope Group

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

www.scopegroup.com

Bloomberg: SCOP

This report is published by Scope Insights, a Scope Group subsidiary which is separate from Scope Ratings. The content is an independent view not related to Scope's credit ratings.

branches, smaller back offices.

At the end of 2018, there were 174,000 domestic branches for the ca. 6,000 EU-based banks (incl. the UK), according to the European Banking Federation. By the end of 2020, the equivalent number will likely be 140,000-145,000, with more drastic cuts in the following years.

It is also likely that banks will restructure their surviving branch networks, to make them targeted and competitive. As an example, some banks are contemplating keeping a smaller number of cashless branches (no deposits or withdrawals at manned counters), focused mostly on providing financial advice and complex account opening and/or personal loans/mortgages, thus lowering the overhead.

2 Fintech/big tech disruption: a banks' market to lose

Like in the rest of the world, Europe's financial sector is witnessing the disruptive challenge of the new digital-only players – fintechs and neobanks. Not inconsequential, but to a lesser extent so far than in other regions, GAFA companies[1] are assessing their future positioning as chief disruptors as well.

The main entry gate into financial services has been via payments, for which full banking licenses are not necessary. Very wide gaps in financial inclusion in emerging markets (and to a certain extent in the US market as well) has offered new entrants (some created by e-commerce companies or telecoms) the opportunity to capture large segments of the unbanked and under-banked population, both households and small businesses. It starts with payments, then moves into other vanilla products – current and savings accounts, credit cards, mortgages, consumer and business loans, financial management services, etc.

This has been the case in China (Ant Financial and Tencent), in sub-Saharan Africa (M-Pesa), and in Latin America with Nubank (mostly in Brazil) and Mercado Libre. Recent surveys reveal that ca. 30% of the US population has opened or plans to open accounts with neobanks, citing convenience.

Europe has been a more difficult nut to crack so far for the digital disruptors, mainly because of the dominant hold of the incumbent banks on the banked population and the substantially higher degree of financial inclusion (in Western Europe). However, neobanks like Revolut, N26, Monzo, etc. are becoming household names, and their recognition will probably strengthen in 2020. But they are not profitable. And it is symptomatic that as they grow, European neobanks look to a broader international expansion – including in emerging markets and the US – to become profitable.

New open-banking regulations, primarily the Revised Payment Services Directive (PSD2), are opening up competition for financial services. Those banks with advanced digital strategies are already taking advantage, creating open APIs and offering Banking-as-a-Service (Baas) opportunities to fintechs and other third parties. Thus, the sooner incumbent banks switch business models to open banking, transparency, and sharing platforms with competitors, the better for them.

It is very likely that next year more banks will start devising, communicating and implementing open-banking strategies, and thus that investors and analysts will focus to a higher degree on these aspects. A bank claiming it can cross-sell a large number of its own proprietary products to on-the-hook clients will sound less convincing in the new ecosystem than another bank which will build and use open platforms and proposed BaaS partnerships to third parties, such as fintechs.

[1] Google, Amazon, Facebook, Apple.

3 Bank revenues will remain underwhelming

Against a relatively gloomy macro picture, European bank revenues will probably not do much better in 2020 than they will do in 2019. On the contrary. In the euro area and most of the Nordic region, negative rates will probably start hurting banks' net interest margins more than they did this year, thanks to loan repricing and structural hedges. Increasingly, banks can be expected to start passing negative rates on to larger business and individual depositors, to try to avoid further clobbering their own margins. This will not earn them brownie points with clients, but choices are limited.

The negative margin effect may not be properly compensated by a positive volume effect, as unattractive economic growth trends – slowdowns or even recessions – will not be conducive to credit growth on a sufficient scale. Besides that, banks, closely watched by their supervisors and still on probation vis-à-vis public opinion, will continue to avoid building up material pockets of credit and investment risk to boost returns. And rightly so, as there won't be any supervisory and market tolerance for risk-on outliers.

Banks' opportunities to diversify into fee-generating services are also increasingly constrained, again thanks to the disintermediating impact of technology. Large banks with a well-diversified revenue stream consisting of large flows of fees and commissions from asset management, bancassurance, or wholesale activities (such as some of the large French groups) may be less impacted by this trend, especially if they will play their open-banking digital cards wisely.

On the other hand, banks with less diversified revenue streams and generating most of their profits from spread income will face significant hurdles should they wish to diversify into new activities. This is the case with numerous second-tier banks spread across Europe, primarily in Germany, Austria, Italy, Switzerland, Norway, or Spain. Short of sector consolidation to absorb the weaker players, their future in the digital age is clouded.

4 Cutting costs will not be that obvious: massive IT investments needed

Reducing legacy excess capacity is definitely a *sine qua non* for more efficiency, but a lower cost base is not necessarily a given. The IT budgets of the large European banks are in general only a fraction of their large US counterparts' (ca. USD 10 billion/year for the latter on average). The situation is dire for second-tier incumbent banks.

Massive investments in digital capacity – platforms, products and processes – are urgently needed, so 2020 will witness a greater effort from many banks (if not, investors should demand answers). Investments are required in cybersecurity systems, cloud storage, artificial intelligence, blockchain, and open APIs.

Importantly, the European banking industry is short of state-of-the-art expertise on sufficient scale in these areas. Acquiring appropriate intellectual capital for the digital age does not come cheap. In fact, this is one strategic rationale for some forward-looking banks to acquire fintechs and the expertise attached to them. One example among many is the acquisition of regtechs to help banks' compliance and regulatory affairs process.

Again, this challenge underlines the more precarious position many second-tier banks with old-fashioned business models find themselves in. For some, banking in the digital age could become out of their reach as soon as 2020.

5 Domestic consolidation unavoidable for second-tier banks; cross-border mergers unwise

It has been evident for some time that, in its analog form, Europe's banking sector is in dire need of restructuring. While the large groups have the capacity to meet the digital challenges (some better than others), the smaller and less well diversified banks do not. It is unrealistic to expect or hope that, on its own, a branch-based traditional retail bank with a narrow range of products can remain economically viable by successfully migrating to the digital ecosystem as a winner.

For some time, European supervisors have pushed for more in-market consolidation among smaller banks. Faced with the inevitable, it is likely that in 2020 this process will intensify. And not a moment too soon. In Germany, savings banks will continue to merge, and it would be ideal if a similar trend took place in the Landesbanken segment as well. Alternatively, and probably as an equally wise route, Landesbanken could evolve into more integrated wholesale arms of their regions' savings banks, and less independent banks on their own. Regarding the German co-ops, after DGZ became the single central organisation of the group, intra-group consolidation has been taking place as well.

Similar trends should be seen in Austria and Switzerland, where there are still too many regional and local banks, some of whose business models are showing signs of obsolescence.

Italy is another market where too many second-tier banks keep treading water, even though unnecessary systemic fragmentation is appearing increasingly as a barrier to a more dynamic transformation of the sector. Overall, second-tier Italian banks are somewhat behind the industry's digital advances.

Despite the obvious economics, the urge of supervisors, and market expectations, consolidation among second-tier banks remains a painful process in which the banks are only reluctantly engaging. Local social and political hurdles related to ownership, legal status, business missions, and funding are still standing in the way of a smoother evolution along this path. Often, there is also the thorny issue of top management and board teams with a short-term vision on the future, unwilling to embark on a longer-term strategy which may not favour them personally. The very short-term market focus gives them temporary breathing space if they can somehow show quarterly results which do not look too disappointing.

At the same time and more than ever, cross-border bank mergers do not look like a realistic route in the digital age. As banks struggle to reinvent themselves digitally, buying or merging with a legacy bank in a different country (even if still in the euro area) is likely to slow the process without any clear advantages.

Most of a bank's products are fully commoditised and replicable so an acquisition will not add much in terms of product expertise. As for distribution, the future belongs to open platforms through which digitally minded banks will set up partnerships with fintechs and other financial services providers, in line with PSD2 and other present and future open-banking regulations.

In this new landscape, large cross-border mergers would do more harm than good, unnecessarily postponing digital transformation while spending precious years on a forward-to-the-past integration process of the two legacy banks. While these banks' competitors could jump ahead in the digital space through open BaaS platforms and partnerships.

6 Risks (old and new), capital and resolution

As banks' tolerance to risk remains constrained, 2020 will likely not register a significant spike in new asset-quality problems. In the post-crisis years, loan growth has been relatively subdued and there are no obvious large-scale pockets of credit risk ready to implode, short of a more severe and prolonged economic recession in Europe (which could affect commercial real estate and business loans). The near certainty of very low rates will not add significant loan-repayment burdens to individual and business borrowers in 2020

Also, in a first stage at least, a post-Brexit dynamic is not likely to hurt the asset quality of the large UK banks, which remains solid and well watched over by the supervisors. A prolonged period of economic funk will of course start eroding UK banks' loan quality, but such a scenario is more nebulous at this stage.

On the other hand, European banks are increasingly exposed to different, less modellable risks, as "The Wide Angle" has highlighted several times before. Among them are cyber risk, digital disruption risk, misconduct risk (including money laundering), and climate-change risk. There is little doubt that in 2020 the focus of supervisors and investors will increasingly be on these risk categories. The trend is already present.

It would help to see these risks reflected more in forthcoming supervisory stress test scenarios and taken into account for regulatory capital assessments. There is more to risk-based capital calculation than credit and market risk; and operational risk is a generic category which may not capture all new risks. But it is not likely that 2020 will see too many dramatic changes in this respect, as regulatory fatigue has followed the wave of massive post-crisis re0-regulation.

By the same token, as new risks permeate into the banking industry, resolution scenarios may become less transparent and predictable. At the very moment when more regulatory clarity has emerged regarding MREL standards and resolution scenarios. One example is cyber risk. Would a bank be placed coldly into resolution if its capital were depleted through a massive cyberattack initiated, say, by a hostile power or through mega-criminal activity?

Such scenarios will bring questions which will need to start being considered more actively by supervisors, analysts and investors, ideally as soon as next year.

Scope Insights GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

Disclaimer

Managing Director: Florian Schoeller
Commercial Register: District Court Berlin-Charlottenburg HRB 202433 B