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# Current developments in banking and some prospects for the future

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36. Finančna konferenca

Portorož, 7. maj 2019

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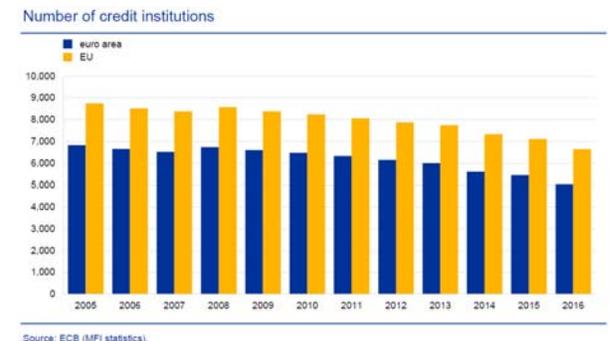
# Outline

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- Banking sector in euro area and Slovenia
- What is a sustainable profitability of banks?
- Return on equity and cost of equity
- Cost efficiency
- Revenue diversification
- Asset quality
- Low interest rates
- Digitalisation / FinTech challenges
- Prospects for the future

# Size of the banking sector - euro area

- Banking sector in the euro area is shrinking:
  - Number of banks / credit instit. has been reduced
    - EA 2008 => 6768
    - EA 2015 => 5474
    - EA 2016 => 5073
- Volume of financial intermediation through banks is decreasing
- Some indicators of the banking sector capacity (euro area, ECB, FSR):
  - Population per credit institution (↑): EA 2008 = 47898 ; EA 2016 = 67341
  - population per local branch (↑): EA 2008 = 1731 ; EA 2016 = 2278
  - population per bank employee (↑): EA 2008 = 141 ; EA 2016 = 174
- Concentration ratios in banking markets (CR5, HHI)
  - tendency to increased concentration after GFC (EA, peak in 2014)



# Bank and Non-bank financial intermediation (FSB)

Macro-mapping of the financial system

21+EA-Group

Exhibit 2-1

	Total global financial assets	MUNFI						
		Central banks	Banks	Public financial institutions	Insurance corporations <sup>1</sup>	Pension funds	OFls	Financial auxiliaries
<b>Size at end-2017</b> (USD trillion)	382.3	30.1	150.8	17.0	32.8	33.7	116.6	1.2
<b>Share of total global financial assets (%)</b>	100.0	7.9	39.4	4.5	8.6	8.8	30.5	0.3
<b>Growth in 2017</b> (year-over-year, %)	5.3	8.8	2.8	4.9	4.8	6.8	7.6	22.6
<b>Growth 2011-16</b> (annualised growth, %)	5.9	8.9	3.6	4.2	6.0	6.1	8.9	7.0

Some exchange rate effects have been netted out by using a constant exchange rate (from 2017). <sup>1</sup> For some jurisdictions, data on insurance corporations include separate accounts.

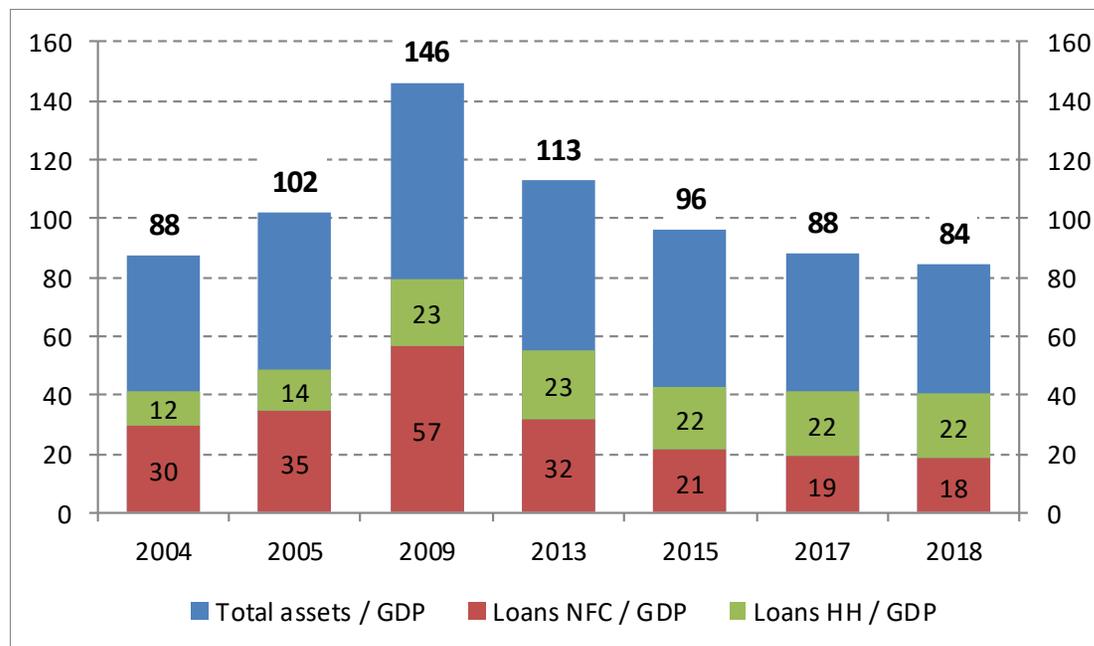
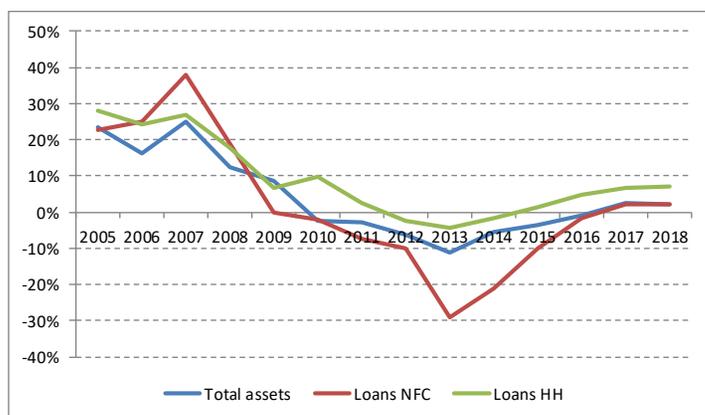
Sources: Jurisdictions' 2018 submissions (national sectoral balance sheet and other data); FSB calculations.

Source\_FSB, Global Monitoring Report on Non-Bank Financial Intermediation 2018, Feb 2019

# Size of the banking sector - Slovenia

## • Size of the banking sector over 2004 – 2018 period

- Total assets to GDP in %
- Loans NFC to GDP in %
- Loans HH to GDP in %



Growth rates  
of Total assets, Loans to NFCs and Loans to HHs

# Responses in the post-crisis period

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- New institutional settings (e.g. banking union, SSM, SRM, (EDIS),...)
- Regulatory rules - modifications and innovations
- Capitalization of banks (elevated requirements)
- Changes in the reporting standards (IFRS)
- Quality of the credit portfolios
- Increased liquidity (regulation, EA monetary policy)

# What is a sustainable profitability of banks?

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- *“On aggregate, bank profitability in the euro area has improved in recent quarters along with the cyclical recovery. However, the level of earnings for many banks is still below that required by investors and bank profitability is still vulnerable to a possible turnaround in the business cycle.” (low cost-efficiency, limited revenue diversification and high stocks of legacy assets)*
  - M. Andersson, C. Kok, H. Mirza, C. M3r3 and J. Mosthaf (2018): “How can euro area banks reach sustainable profitability in the future?”, published in ECB, Financial Stability Review, Nov. 2018
- *“Today, the profitability of European banks is relentlessly being pushed down by three forces.”, “...negative central bank deposit rates...”, “...burden of non-performing loans...” (EA peripheral countries), “...implementation of a brand new, strongly pro-cyclical, regulatory and supervisory rulebook.”*
  - D. Folkerts-Landau, A. Singh, I. Ulargui, P. Sabbione, M. Jezek, A. Hanamante, C. O-Toole (2019): “How to fix European banking ... and why it matters”, Thematic Research, Deutsche Bank Research, Mar 2019
- *“The Europeans underperform on whatever measure you care to choose...”*
  - The Economist – European banks. Reaching for elusive 10%, 6. Apr. 2019

# What is a sustainable profitability of banks?

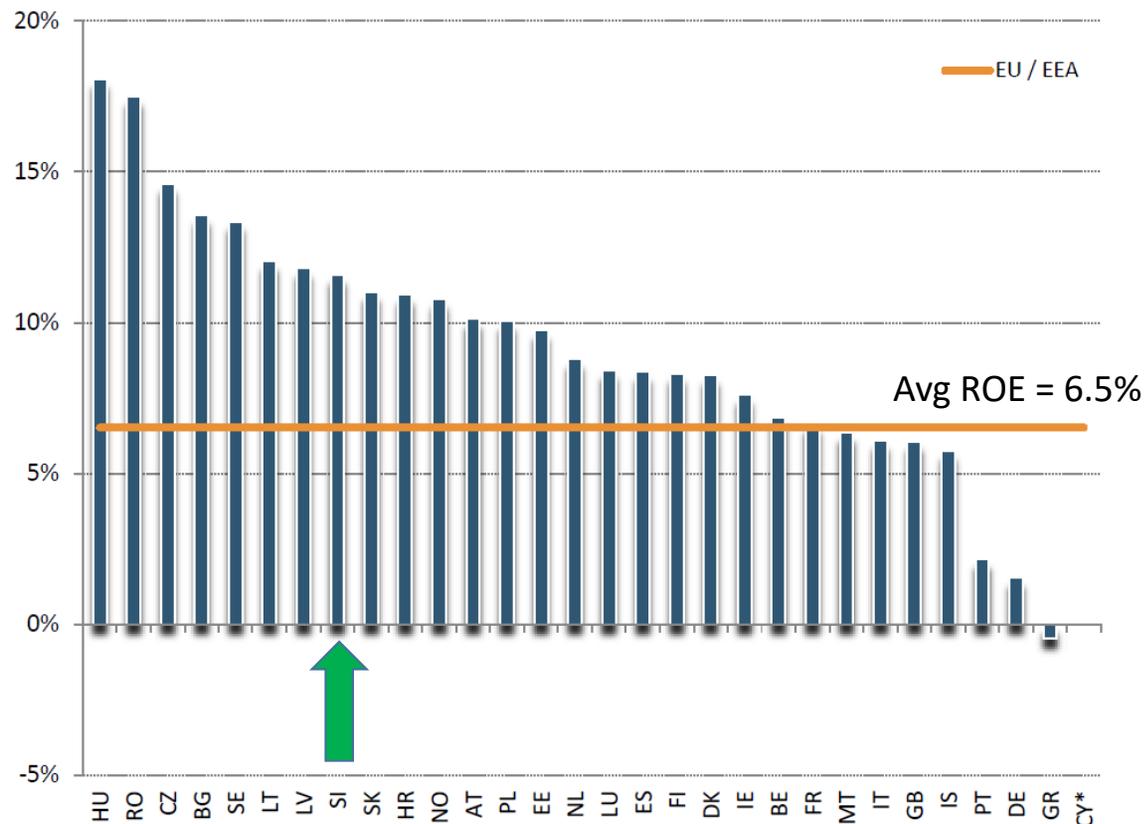
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- Return on equity and cost of equity
- Cost efficiency
- Revenue diversification
- Asset quality
- Low interest rates
- Digitalisation / FinTech challenges

# Profitability of european banks

- Profitability measured by ROE, European banks as of Dec. 2018
  - Source EBA Risk Dashboard
  - sample of 190 European banks

- Profitability of banks in Slovenia (BS, Monthly report on bank performance )

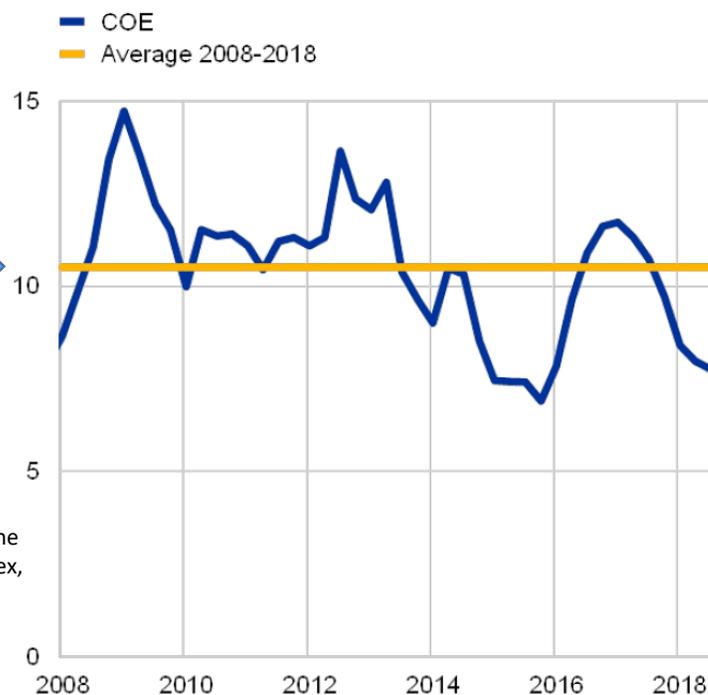


in %	2014	2015	2016	2017	2018
ROE	-2.69	3.63	7.96	9.58	11.09
ROA	-0.27	0.42	0.99	1.19	1.39

Note: The EBA risk dashboard is based on a sample of Risk Indicators (RI) from 190 European banks (unconsolidated number of banks, including 36 subsidiaries)

# Sustainable profitability and cost of capital

- **COE (cost of equity), EA listed banks** - shareholders' required returns



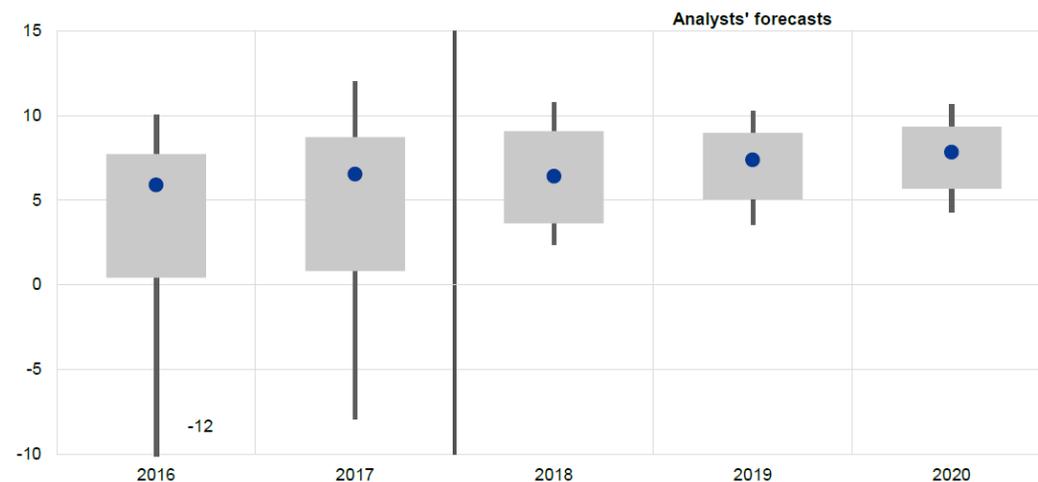
Note:  
 expected return on the Euro Stoxx Banks index, estimated by CAPM

Source: ECB, FSR, Nov 2018

- **ROE, profitability**

- EA – gradual improvement expected, but still ROE < COE
- The median ROE for listed euro area banks (based on a sample of 41 SIs)

Actual ROE for 2016-17 and mean ROE estimates for 2018-20 for euro area banks  
 (2016-20, percentages; median (blue dot), interquartile range and 10th-90th percentile range)



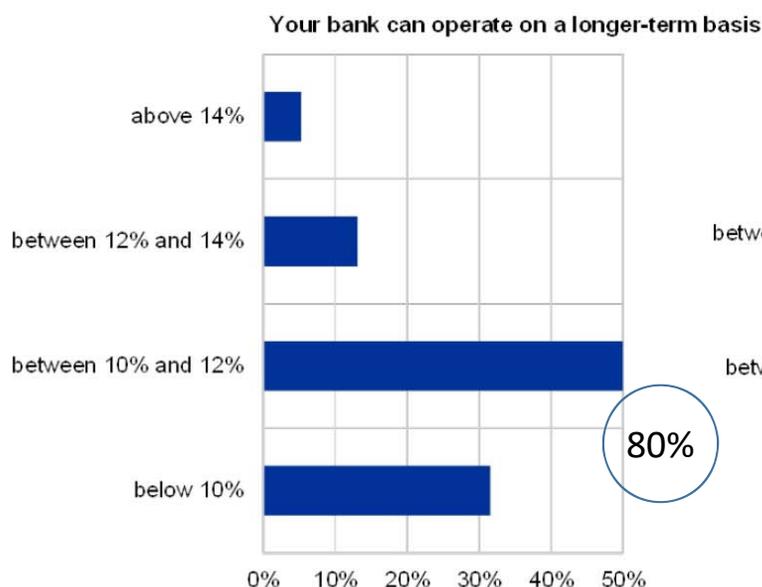
Source: ECB, FSR, May 2018

# Sustainable profitability and cost of capital

## Survey-based evidence on banks' future profitability targets

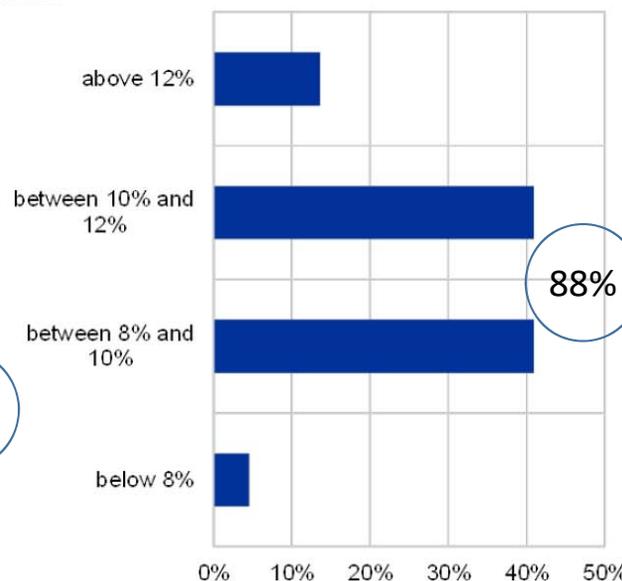
European banks' long-term sustainable profitability targets

(EBA quarterly basis by NCAs, sample of 187 banks from 25 EEA countries, 80% of the EU banking sector)



ROE targets for large euro area banks

(21 large euro area banks)



Source: ECB, FSR, Nov 2018

Notes: In the left panel, the results are taken from the EBA's Risk Assessment Questionnaire, which reports the responses from banks and market analysts. The right panel is based on 21 large euro area banks. The targets have been collected from banks' business and strategic plans.

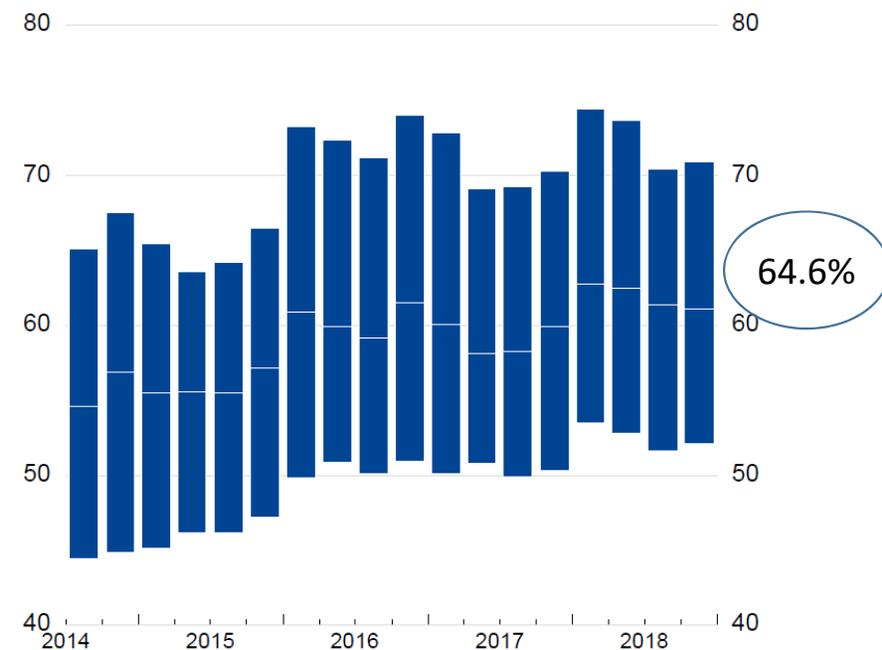
# Sustainable profitability – Cost efficiency

## • Cost efficiency

- Euro area banks cost-to-income (CIR)  
62% in 2010  
65% in 2017
- Comparison to Nordic banks CIR 2016
  - Sweden 52%, Finland 51%,  
Danemark 54%, Estonia 48% (ECB, DWH)
- EA banks – long term structural factors more important than cyclical
- Improvement of (structural) efficiency
  - shrinkage of physical banch networks
  - further digitalisation (one off costs!)
  - Cost cutting synergies (consolidation / M&As )

## • Cost-to-income ratio

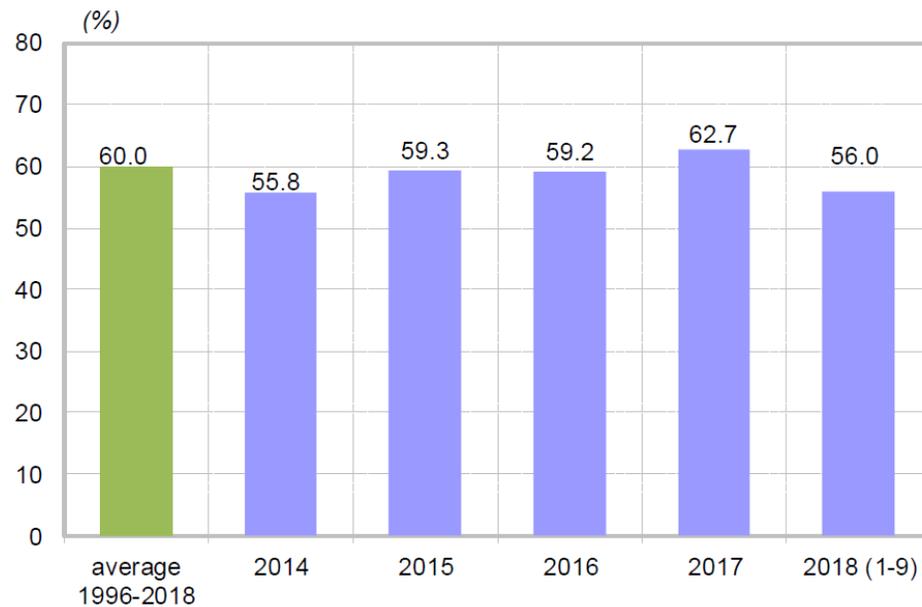
(EU; percentages; interquartile range and median; last observation: Q4 2018; 190 european banks)



Source: ESRB, Risk dashboard, Mar 2019

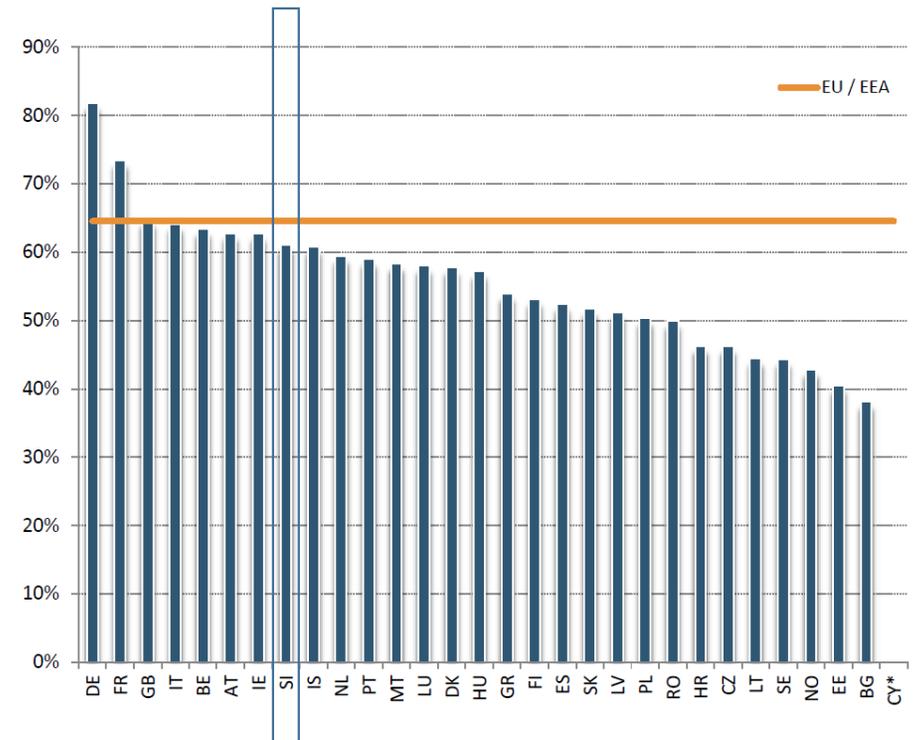
# Sustainable profitability – Cost efficiency

- Cost-to-income (Slo)



Source: BS, FSR, Dec 2018

- Cost-to-income (EU/EEA)



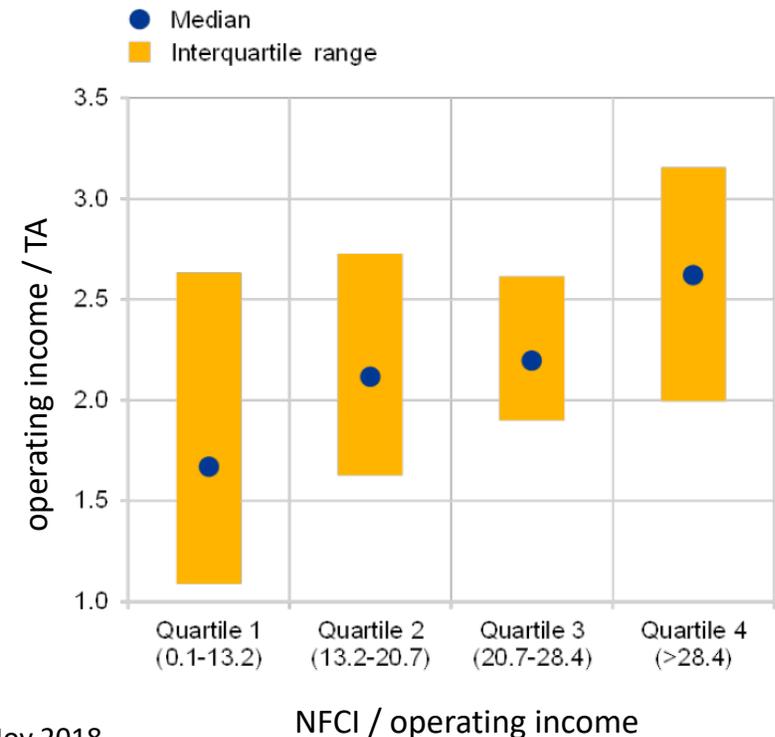
Source: EBA, Risk dashboard, Q4/2018

# Sustainable profitability – Revenues

## • Revenue diversification

- Enhancement of revenue generating capacities
  - Adjustments to business models
  - Fee and commission based activities
  - Retail banking (limitations)
- Competition from non-bank financial intermediaries (incl. FinTech)
- Increased market based finance (corp.)
- Geographical diversification of banks => stronger revenue performance
  - higher margins, better growth opportunities

- Operating income to total assets compared to NFCI/operating income (by quartiles) - averages over the period 2014-2017 (EA, 39 SIFI)

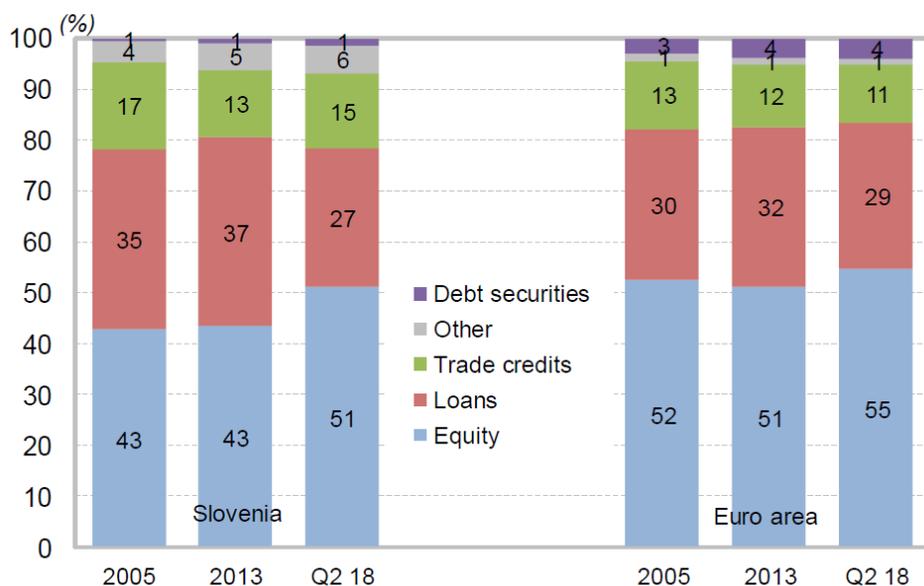


Source: Source: ECB, FSR, Nov 2018

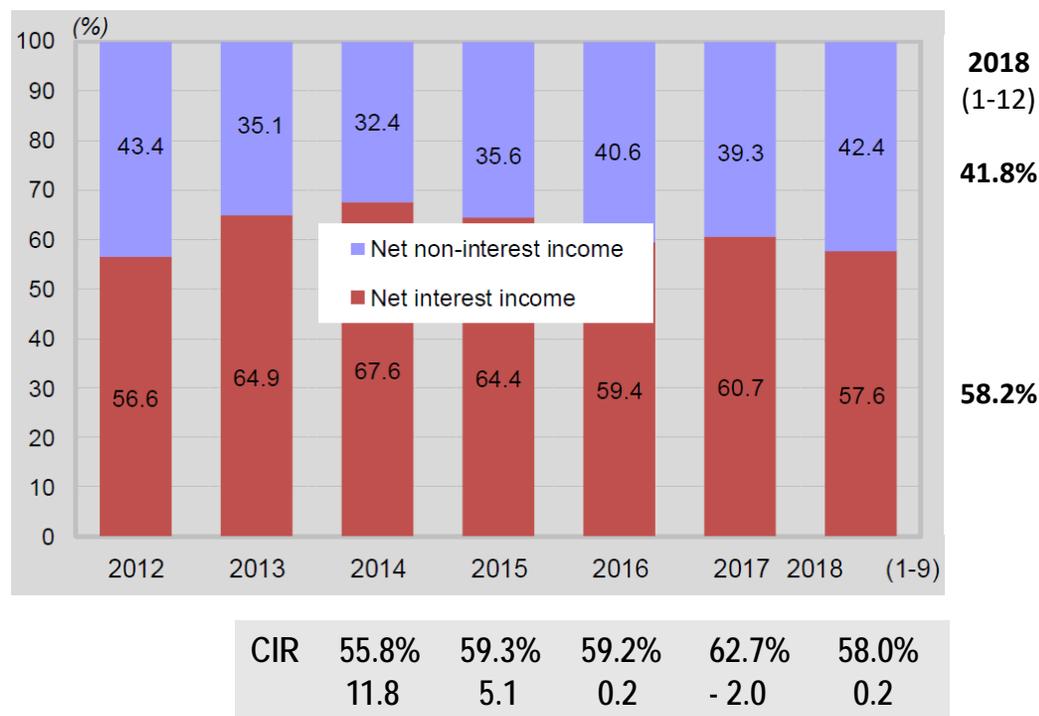
NFCI / operating income

# Sustainable profitability – Revenues

- Breakdown of NFCs financial liabilities in Slovenia and in the euro area overall



- Breakdown of the banks' gross income into net interest income and net non-interest income



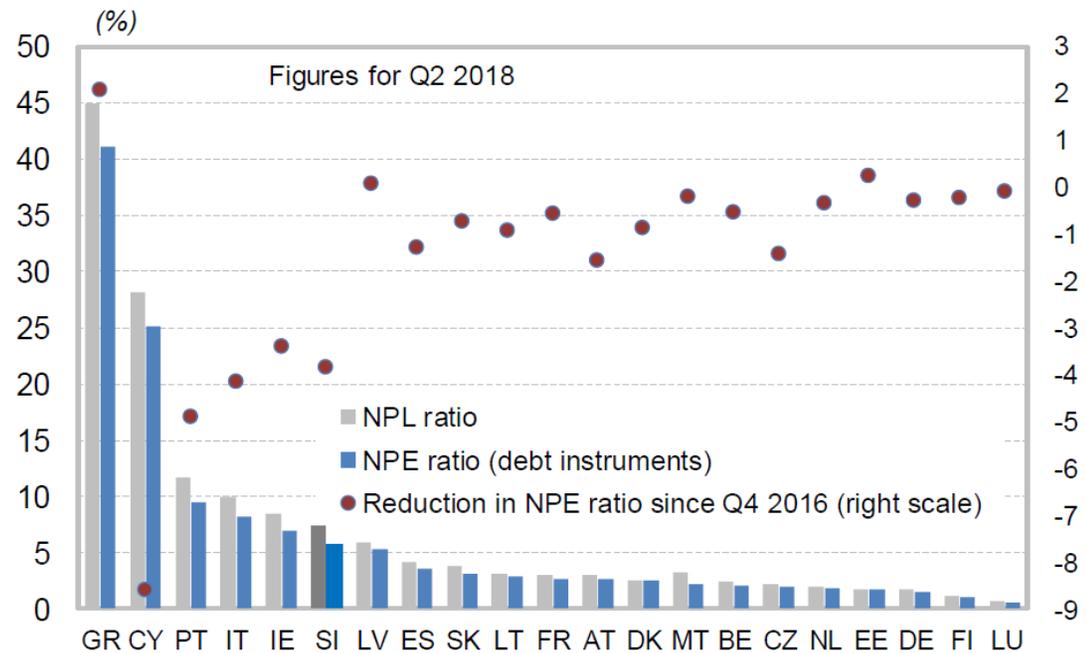
Source: BS, FSR, Dec 2018

# Sustainable profitability – Asset quality

- **Asset quality** (differences in EA!)

- Large variation in NPL levels across EA countries ( LU < 1%, GR ≈ 45%)
- Loan impairment costs important driver of low profitability

- NPE and NPL ratios in euro area countries (Q2 2018)



NPL = 6.3% (1.8 bn Eur)  
 NPE = 4.5% (1.96 bn Eur)  
 Sept 2018

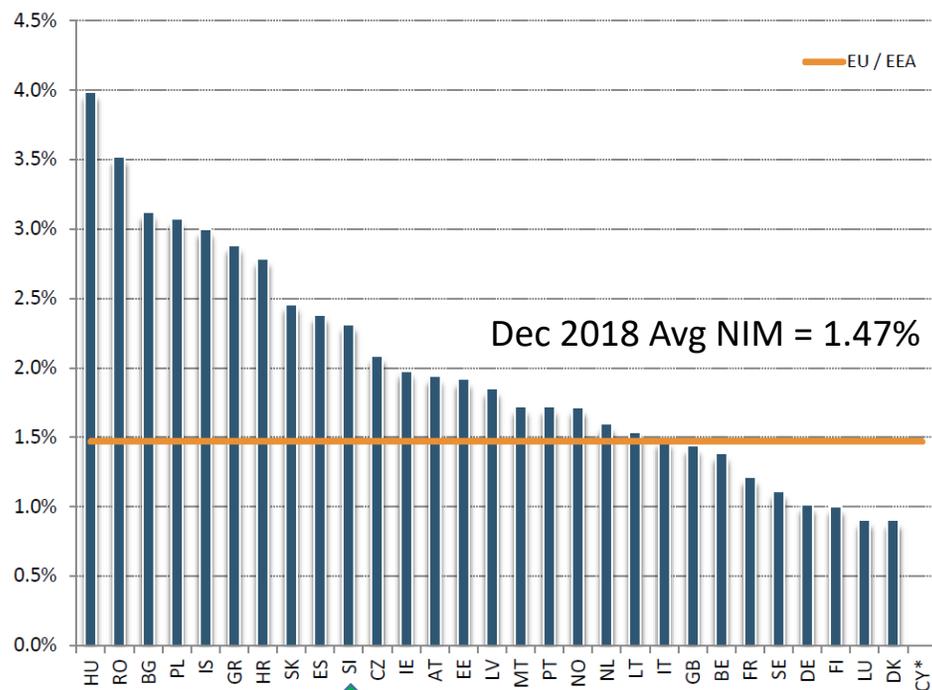
Source: BS, FSR, Dec 2018

# Sustainable profitability – Low interest rates

- **Low interest rates**

- ECB policy rates (-0.4% deposit rate, 0% refinancing rate)
- general trend of decreasing rates
- Unsustainability of banking returns
- Compression of net interest margins (NIM)
- Net interest margins (US banks)
  - Q4/2008 = 3.15%
  - Q4/2014 = 3.11%
  - Q4/2018 = 3.35%
- Net interest margins (Japan)
  - 2000 = 1.5%
  - 2018 = 0.9%

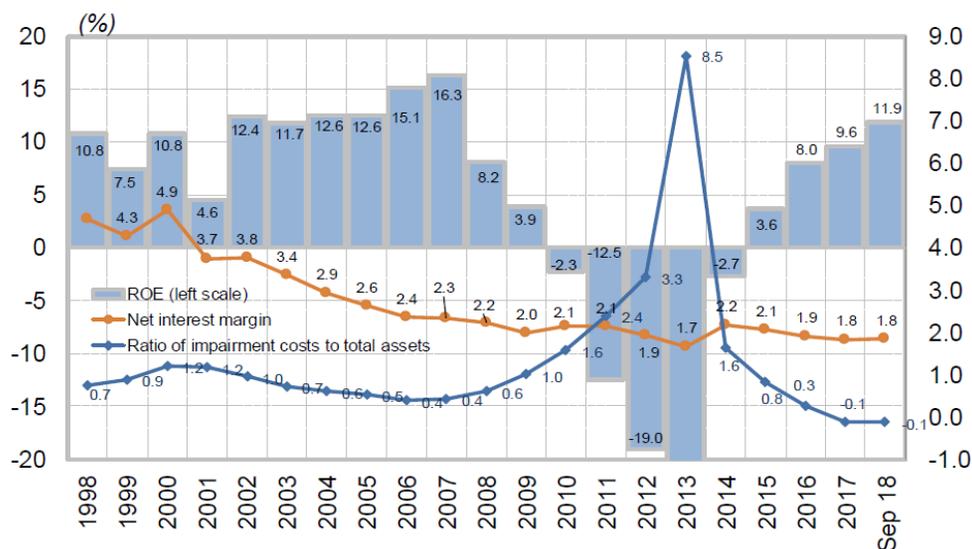
- Net interest margin (EBA sample dec 2018)



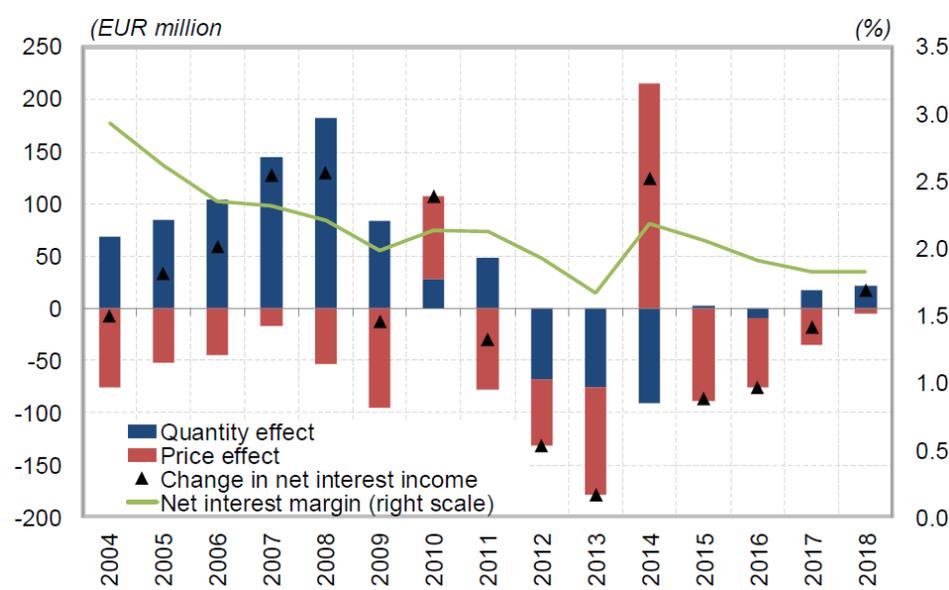
Source: EBA, Risk dashboard, Q4/2018

# Sustainable profitability – Low interest rates

- Banking sector in Slovenia:
  - ROE, NIM, and ratio of impairment and provisioning costs to total assets



- Contribution made by quantity effects and price effects to the change in net interest income, and net interest margin



Source: BS, FSR, Dec 2018

# Sustainable profitability – FinTech challenges

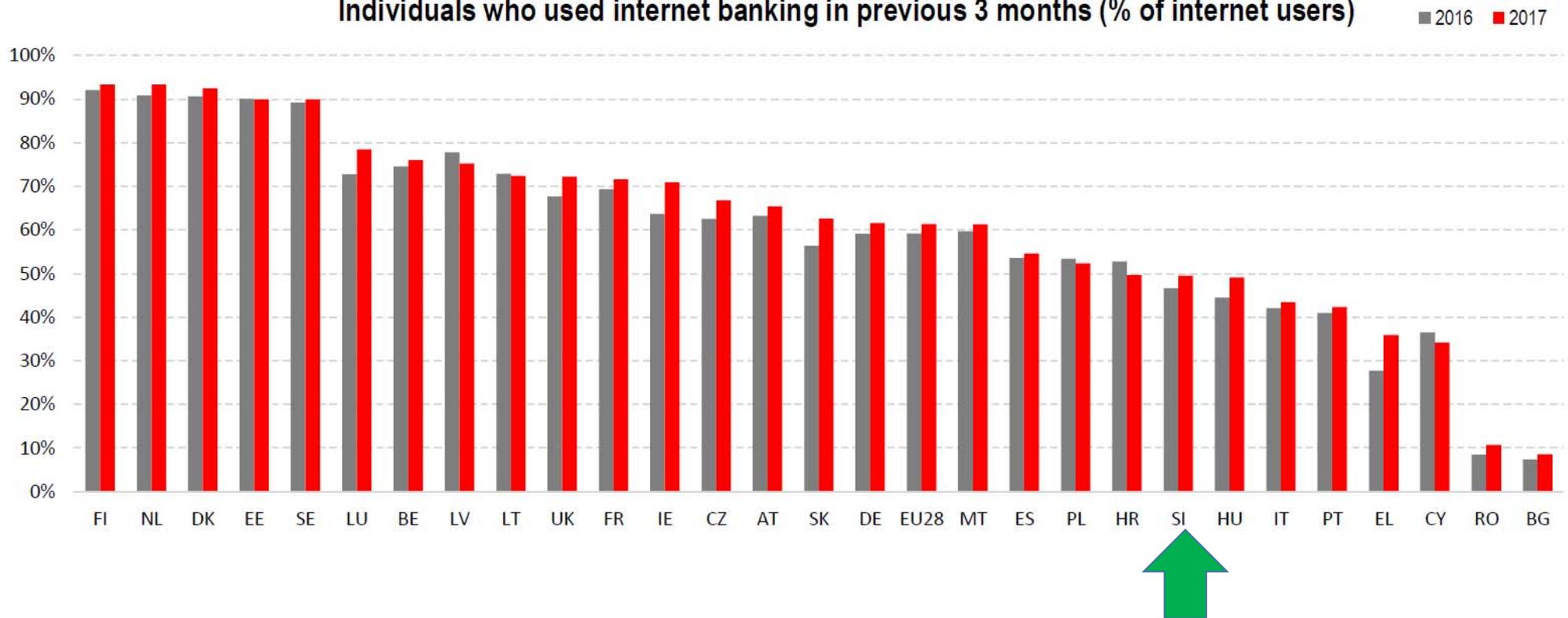
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## • **FinTech – challenges for banks**

- FinTech - one of the drivers that forces banks to rethink their business strategies and models – digital disruptors
- Strategies
  - partnerships with non-bank FinTech firms
  - internal developments of technology-based products/services using new technologies
  - digital branches/subsidiaries (Santander => Openbank; RBS => Bó, ING => DiBa)
- EU banks developing digital channels
  - **61%** of EU internet users performed their banking activities online in 2017 (**52%** in 2010)
- Expansion of mobile banking
  - “neobanks” – mobile only platforms
  - Fintechs and neobanks acting as marketplaces for non-banking services (e.g. payment apps bundled with e-commerce)
- Pros / Cons of digital change

# Sustainable profitability – FinTech challenges

Individuals who used internet banking in previous 3 months (% of internet users)

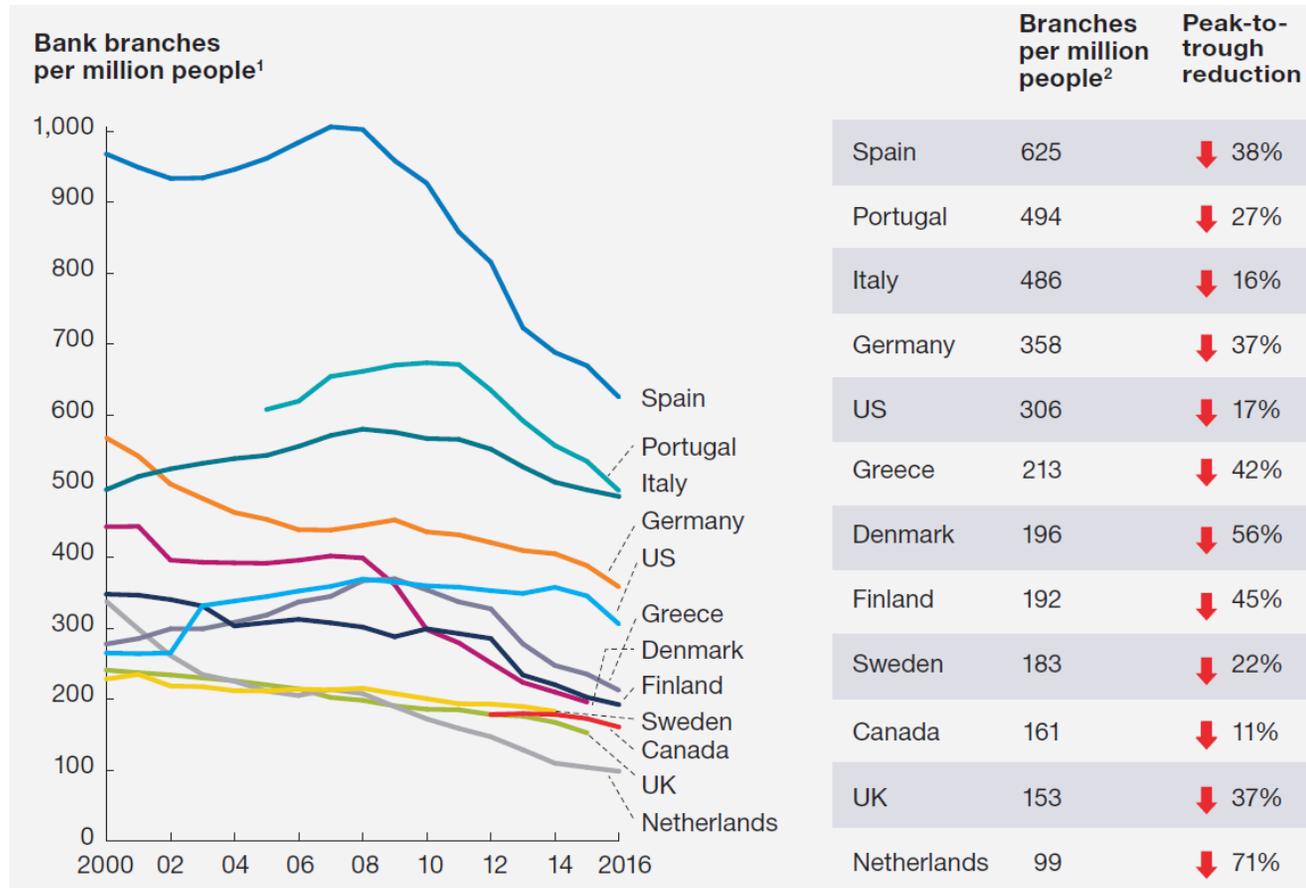


Source: EC, Digital Economy and Society Index Report 2018

# Sustainable profitability – FinTech challenges

- Declining number of bank branches in North America, the UK and Europe

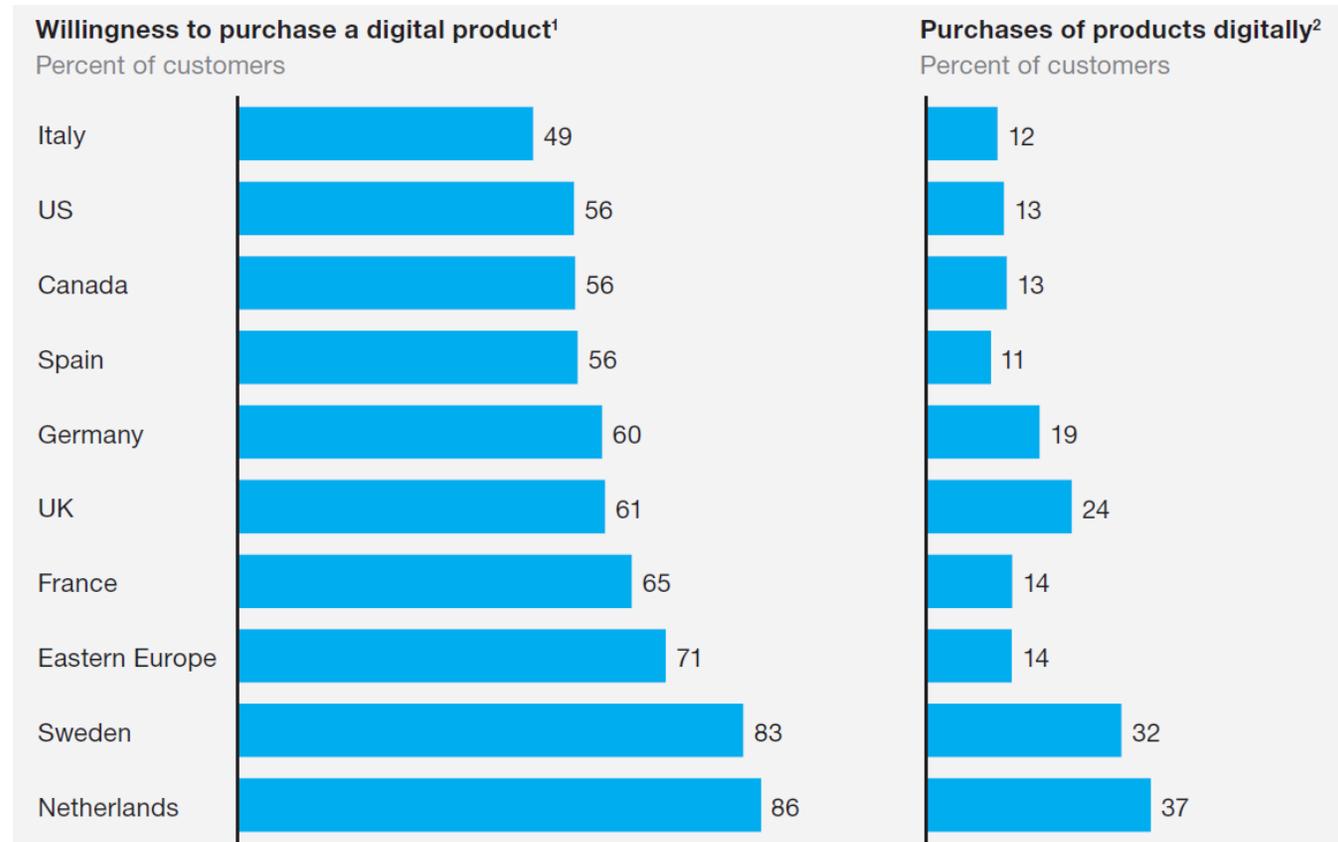
Slovenia 2016 (ECB): 282  
Euro area 2016 (ECB): 439



Source: McKinsey, Feb 2019

# Sustainable profitability – FinTech challenges

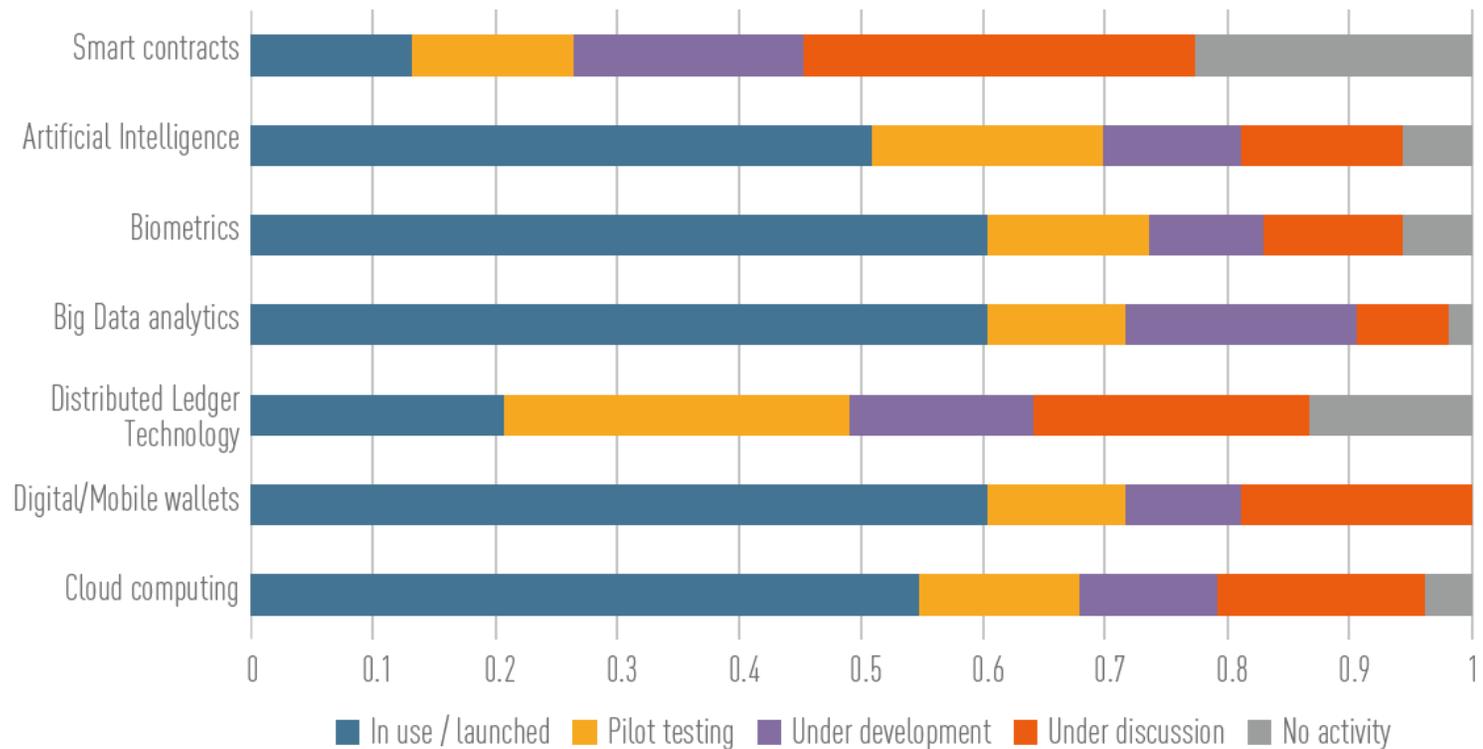
- Digital preferences of banking customers



Source: McKinsey Consumer Multichannel Survey (n=12,000)

# Sustainable profitability – FinTech challenges

- Status of adoption of financial technologies by EU banks — December 2018



Source: EBA, Risk Assessment of the European Banking System, Dec. 2018

# Prospects for the future

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- Consolidation in the banking sector
  - Finalising the privatisation and new players in the market
  - M&As and changes in the market structure (smaller number of banks, market concentration)
- Growth potential for all banks in the market
  - general economic picture (growth slowing down)
  - Are scale economies achievable?
- Adjustments in business models
  - Digital banking for digital economy
  - Keeping pace with digital disruptors: “Neobanks” (Revolut, Monzo, N26), Bigtech
  - Level playing field (regulation, financial stability, AML)
  - Cyber security issues

# Prospects for the future

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- **New retail banking landscape (McKinsey)**
  - reducing branches and growing digital sales
  - customer experience
  - scale economies and cost advantage
  - unbundling and “rebundling” retail banking services (digitalisation, regulation)
- **Green banking**
  - **Network for Greening the Financial System / NGFS**
    - supervising of climate and environmental risks
    - analysing the macrofinancial impact of climate change
    - scaling up green finance
  - **Joint EBA & EBF Workshop on Sustainable Finance (Apr 2019)**
    - integrating climate risk into financial risk management frameworks
    - climate risk should be considered as financial risk and falls into the mandate of central banks & supervisors

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**Hvala za pozornost!**