Ten years after the crisis: Contours of a new normal
Banks: business models in flux

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Rudi Vander Vennet, UGent
The new regulatory framework (especially Basel 3) and the macroeconomic environment (ECB unconventional monetary policy) affect bank business models.
Expectation: banks will fundamentally review their post-crisis business models

• Banks should make strategic choices:
  – Asset structure and loan quality
  – Funding mix (more deposits, more capital)
  – Revenues: lending margins, fees
  – Geographic and functional scope
• To achieve sustainable profitability
• Question: which business model works best?
• Surge of research on bank business models, both academic and from bank supervisors (BIS, ECB, EBA)
  – Business model migration is slow
  – And weak post-crisis operational performance persists in all business models
No surprise, focus on more retail is a popular option

BIS, Bank business models: popularity and performance (Roengpitya et al. 2017)
But: a ‘great convergence’ towards lower ROE 5% - 10% is the ‘new normal’ across bank types
ECB analysis: Business models are sticky

**Business model classification driven by size, internationalisation and funding profile**

**Balance sheet structure of different business models**

<table>
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<th>(2014: ratios and percentage shares)</th>
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<tbody>
<tr>
<td>fee and commission income</td>
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<tr>
<td>domestic exposure</td>
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<td>trading assets</td>
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<td>customer funding</td>
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<td>interbank funding</td>
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<td>risk-weighted assets</td>
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### 1. Medium-sized universal banks focused on domestic lending

### 2. Small deposit-taking banks focused on domestic lending

### 3. Specialised lenders with high market-based funding

### 4. Large universal banks with diversified assets

### 5. Medium-sized universal banks with sizeable domestic lending and trading book

### 6. Large international banking groups

### 7. Investment and custodian banks focused on fees and commissions

**Banks have mostly remained within the same business model clusters over time**

**Evolution of business model clusters between 2007 and 2014**

(left-hand side: 2007; right-hand side: 2014; percentage of total equity)

ECB FSR 2016, Trends in bank business models
Bank business model migration: modest shifts

- Retail banks domestic
- Universal banks domestic
- Large universal banks with diversified assets
- International banking groups
- Specialized lenders, market funded
- Investment/custodian banks
Yet, the pressure is on

- Profit indicators and market assessment demonstrate that not all banks are viable
- Sustainable profitability requires ROE > COE
  - Cost of equity is what shareholders demand
  - Return on equity is what banks deliver for their shareholders
  - For many European banks: ROE < COE
- For listed banks an indicator of soundness and viability is Market Value > Book Value
  - However, M/B is below 1 for many European banks (not all)
EBA bank risk assessment questionnaire 2018
Banks estimate their cost of equity below 10%
Banks claim they can achieve ROE above 10%
Actual European banks’ ROE: Caution required

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<td>&gt; 10%</td>
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<td>5.0%</td>
<td>18.7%</td>
<td>25.2%</td>
<td>23.9%</td>
<td>6.4%</td>
<td>3.1%</td>
<td>6.0%</td>
<td>6.6%</td>
<td>5.3%</td>
<td>11.6%</td>
<td>11.9%</td>
<td>15.1%</td>
<td>12.4%</td>
<td>12.6%</td>
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<td>[8% - 10%]</td>
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<td>29.1%</td>
<td>33.1%</td>
<td>45.6%</td>
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<td>&lt; 8%</td>
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<td>40.5%</td>
<td>36.8%</td>
<td>53.3%</td>
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Market/book of selected European banks
Some have recovered to level >1, many not
How can banks react?

Structural
- Capital markets union
- Disintermediation

Regulation
- CET1/LR/AT1
- TLAC/MREL
- LCR/NSFR

Macroeconomy
- Low for long QE exit

Competition
- Consolidation/entry
- Technology / Fintech

Profitability
- Net interest margin
- Non-interest income
- Cost/Income
- ROA/ROE
- Market/Book

Revenue diversification
- Non-interest income

Profit efficiency
- Management of margins

Operational efficiency
- Cost/income ratio
- Consolidation

Asset quality

Loan pricing
- Risk-based pricing

Mergaerts and Vander Vennet (Journal of Financial Stability, 2016)
Bank business models

• Risk-based pricing
  – Adequate margins are key to sustainable profitability, not volume

• Operational efficiency
  – No compromises on cost efficiency and productivity

• Revenue diversification (fees, geographic, up-to-date services, client segments, distribution channels)
  – ‘Banking instead of banks’
Post-crisis shift from deposit margin to lending margin
Here: Belgian bank margins
Post-crisis Belgian banks:
higher lending margins, but negative deposit margins
Bank net interest margins at a crossroads

• How will banks manage their loan margins?
  – Risk-based pricing or loosening of lending standards?
  – Default risk, interest rate risk, liquidity risk, capital coverage must be covered
  – Margins are key, not volumes

• How will deposit margins evolve when policy rates increase?
  – Return to pre-crisis deposit margins may be illusory
  – Sensitivity of bank deposit rates to ECB policy rates may be higher and hence pass-through of policy rates faster than captured by standard models
Most deposit models have been calibrated on a period of decreasing interest rates only

- The majority of deposit models has been calibrated over a period of decreasing interest rates only.
- Only 7% out of 4.3 trillion of modelled deposits take into account the possibility that deposit stability may decrease with an increase in IR.
- A wrongly modelled stability of deposits – and NII projections as a result – might lead to extensive losses in an increasing rate environment also in relation to lower transaction costs than in the past (online banking).

Evolution of short-term interest rates (3M Euribor, %)

(*) Figures do not include 76 models for which banks did not report no reference to time series information.
Diversification to non-interest income is important but no panacea. There is no unlimited pool of fees.

Fees and commissions have become an increasingly important income source since the financial crisis.

The share of fee and commission income in total income differs across bank business models.

Source: ECB consolidated banking data.
Note: The sample covers most of the euro area banking sector.

Sources: ECB and SNL.
Notes: The sample covers 94 SSM significant institutions. "Universal banks" also include global systemically important banks (G-SIBs) that are universal banks, while "G-SIBs" exclude those banks.
Operational efficiency must be improved (substantially)
Simply cutting branches and/or personnel will not do the trick
It is about fundamental redesign of bank intermediation
Bank business models going forward

• Restauration of viable profitability requires **adequate pricing of loans and funding sources**, thereby restoring economically justified interest rate margins.
• **Lending margins** are key drivers due to zero lower bound on deposit rates. Search for asset yield may cause excessive risk-taking,
• Banks will need to **diversify** to non-interest income sources. However, the pool of available fees and commissions is limited. And risk implications need consideration.
• **Cost efficiency is a key driver.** Fintech might help to increase efficiency of processes and offer commoditized products. Branch network rationalizations are unavoidable. Restructuring of personnel composition is inevitable. Consolidation hopefully in a European framework.
• Cyclical recovery may lower loan impairments and provisions. Although lots of cleaning-up necessary in Eurozone periphery.
• Bank will have to elaborate on their **comparative advantages**, e.g. relationship banking, cross-selling, product design, operational excellence.
Eurozone bank sector restructuring is happening, but in (too) slow motion

• Business models under pressure
  – Regulatory overhaul is done
  – Technology drives the pace of innovation
  – New equilibrium banks / non-banks / financial markets

• Bank sector restructuring must accelerate in Europe
  – Consolidation will accelerate, M&A especially cross-border
  – Banking Union must be completed, true single banking market
  – Diversity instead of size. Diverse banking ecosystem should counter systemic risk