



Bank business models: time to act*

By Rudi Vander Venet
Ghent University

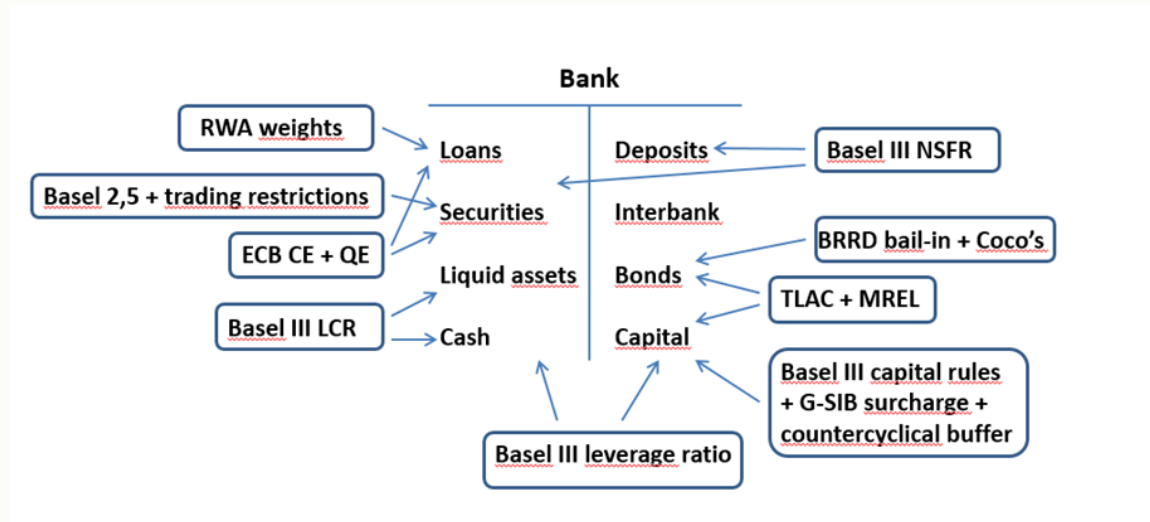
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Banks are operating in a new environment. The regulatory framework has been firmly updated. The higher capital requirements of Basel 3 are the cornerstone, but also the new liquidity requirements (LCR and NSFR) and the rules about bail-in capacity (TLAC/MREL) impose important constraints on what banks can do. On top of that banks are confronted with a challenging macroeconomic environment characterized by very accommodative monetary policy (the ECB combines low rates, asset purchases and forward guidance) causing a low for long interest rate environment. Chart 1 illustrates that this environment fundamentally affects the balance sheet of banks.

* This is a summary of an intervention given by the author at the SUERF/Belgian Financial Forum Conference „Ten years after the crisis: Contours of a new normal“ on 14 September 2018 at the National Bank of Belgium, Brussels.

Chart 1: Impact of regulation and macroeconomic conditions on banks



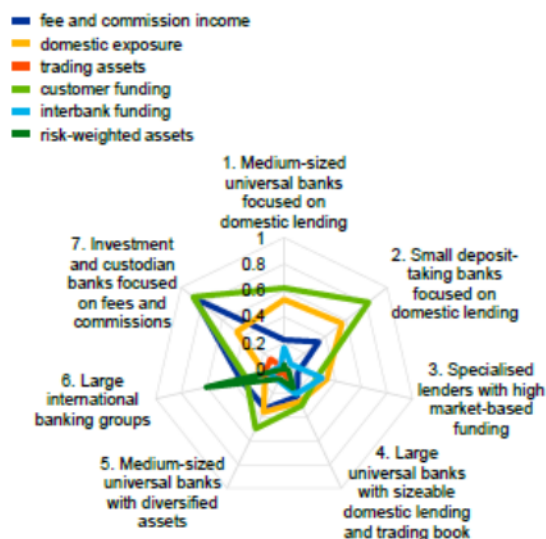
Faced with these challenges, the expectation is that banks will fundamentally restructure their business models in terms of asset and funding structure, revenue mix, and geographical scope. However, in reality business model shifts have been slow and modest, at best. The following chart is taken from the ECB 2016 Financial Stability Review. On the left hand side it shows seven business model types that ECB researchers distinguish based on bank characteristics. On the left hand side, it is shown that although some banks have switched to a different business model the overall picture is that the majority of banks have remained within the same business model cluster.

Chart 2

Business model classification driven by size, internationalisation and funding profile

Balance sheet structure of different business models

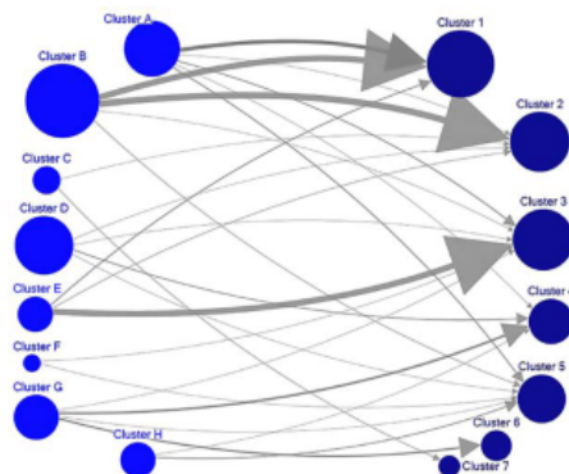
(2014; ratios and percentage shares)



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

Evolution of business model clusters between 2007 and 2014

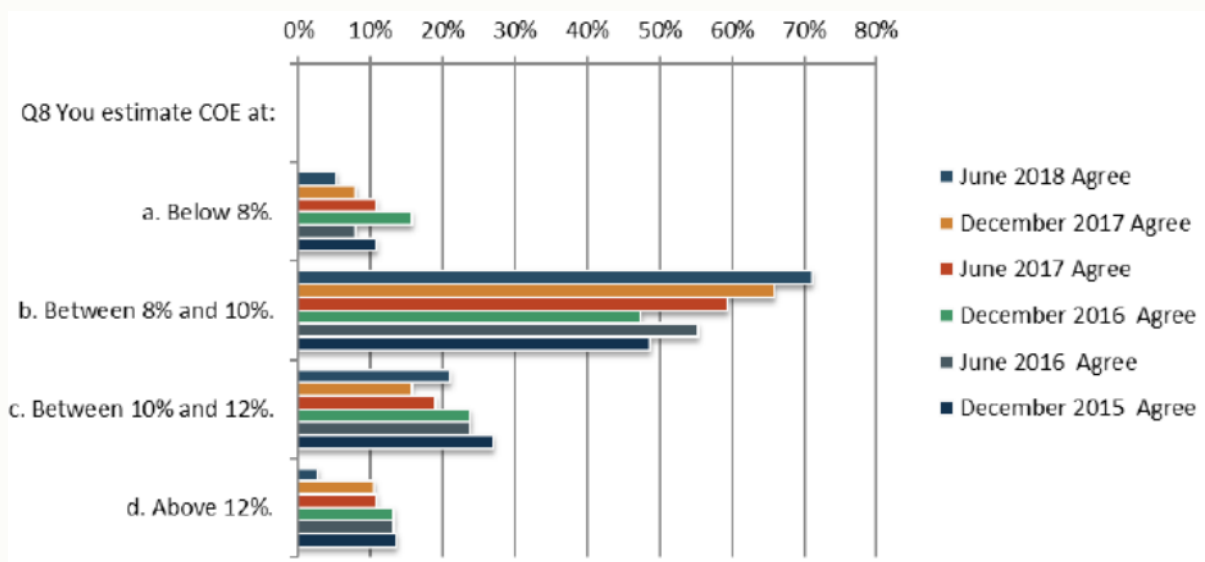
(left-hand side: 2007; right-hand side: 2014; percentage of total equity)



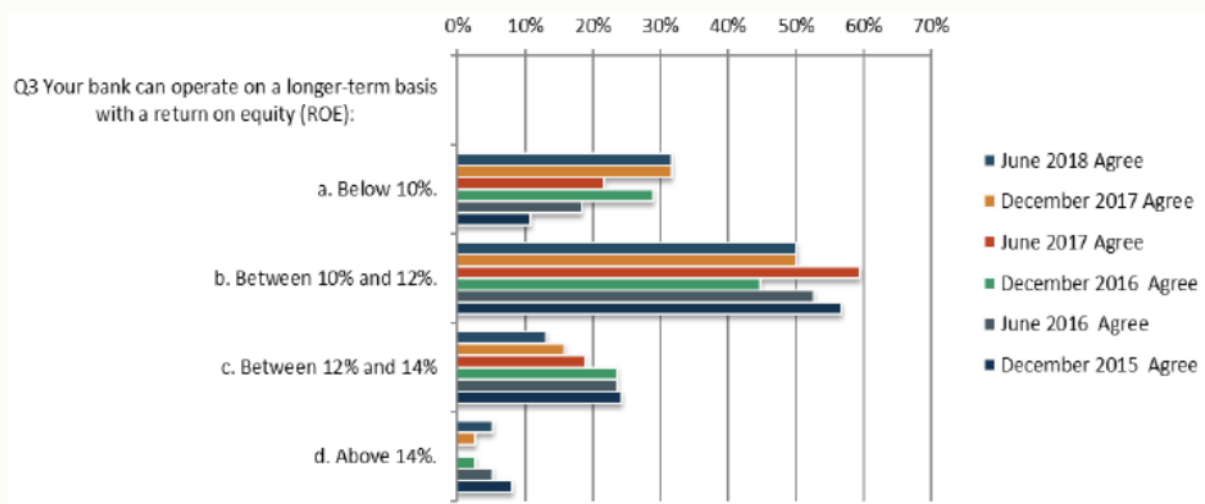
Source: ECB FSR 2016, Trends in bank business models

Yet, the pressure for European banks is clearly mounting. A substantial number among them remain characterized by weak profitability since their average return on equity (ROE) is lower than the cost of equity (COE), whereas long-term viability requires that ROE exceeds the COE. To illustrate this trade-off, the EBA runs a regular Bank Risk Assessment and in the 2018 questionnaire the banks' answer to the question what they think their COE is, the majority puts the number in the 8-10% range.

Chart 3: EBA bank risk assessment questionnaire 2018



When the banks are asked what they consider to be their longer term ROE, the vast majority of the banks indicate that levels above 10% should be achievable, as can be seen in the next graph.



While these answers seem to indicate that banks think they are able to achieve viability (ROE>COE), the actual ROE numbers offer little comfort in the short run. As can be seen from the next table, again taken from the EBA bank risk assessment exercise, only a small fraction of European banks actually operates with an ROE above 10%. Hence, some modesty seems to be warranted.

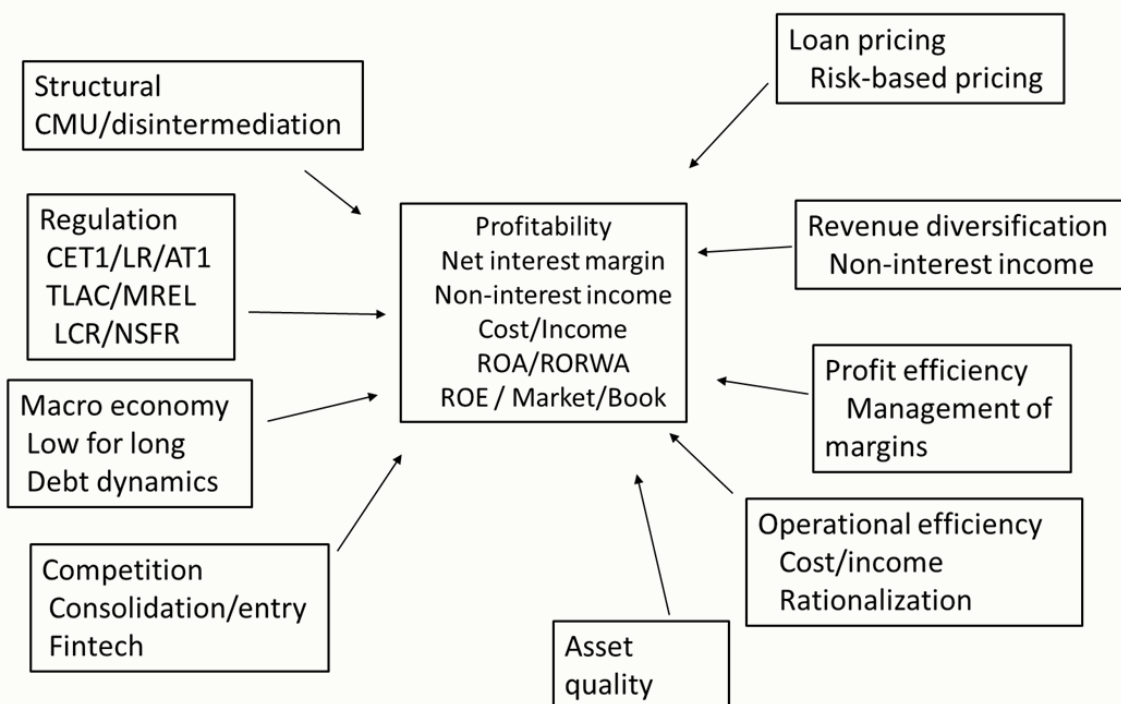
Table 1

| RI | Threshold | Current vs previous quarters for the worst bucket | 201412 | 201503 | 201506 | 201509 | 201512 | 201603 | 201606 | 201609 | 201612 | 201703 | 201706 | 201709 | 201712 | 201803 |
|----|------------|---|------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| | | | Return on equity | >10% | | 5.0% | 18.7% | 25.2% | 23.9% | 6.4% | 3.1% | 6.0% | 6.6% | 5.3% | 11.6% | 11.9% |
| | [6% - 10%] | ● | 29.1% | 33.1% | 45.6% | 34.9% | 44.5% | 42.3% | 49.5% | 36.9% | 40.5% | 45.4% | 47.7% | 48.1% | 34.3% | 50.7% |
| | < 6% | | 65.9% | 48.3% | 29.2% | 41.2% | 49.1% | 54.7% | 44.5% | 56.5% | 54.2% | 43.0% | 40.5% | 36.8% | 53.3% | 36.7% |

Source: EBA Risk Dashboard 2018

Going forward, next to being confronted with new regulation and challenging interest rate conditions, banks will feel the impact of structural tendencies (shift towards market-based financing) and competitive issues (consolidation, competition from new entrants due to e.g. PSD2, fintech). Chart 4 summarizes (on the left hand side) the effects that might negatively affect their profitability. On the right hand side is a series of potential actions that banks can undertake to mitigate some of the negative consequences and drivers to restore sustainable profitability.

Chart 4: Challenges and mitigating actions



Source: Mergaerts and Vander Vennet, Journal of Financial Stability 2016.

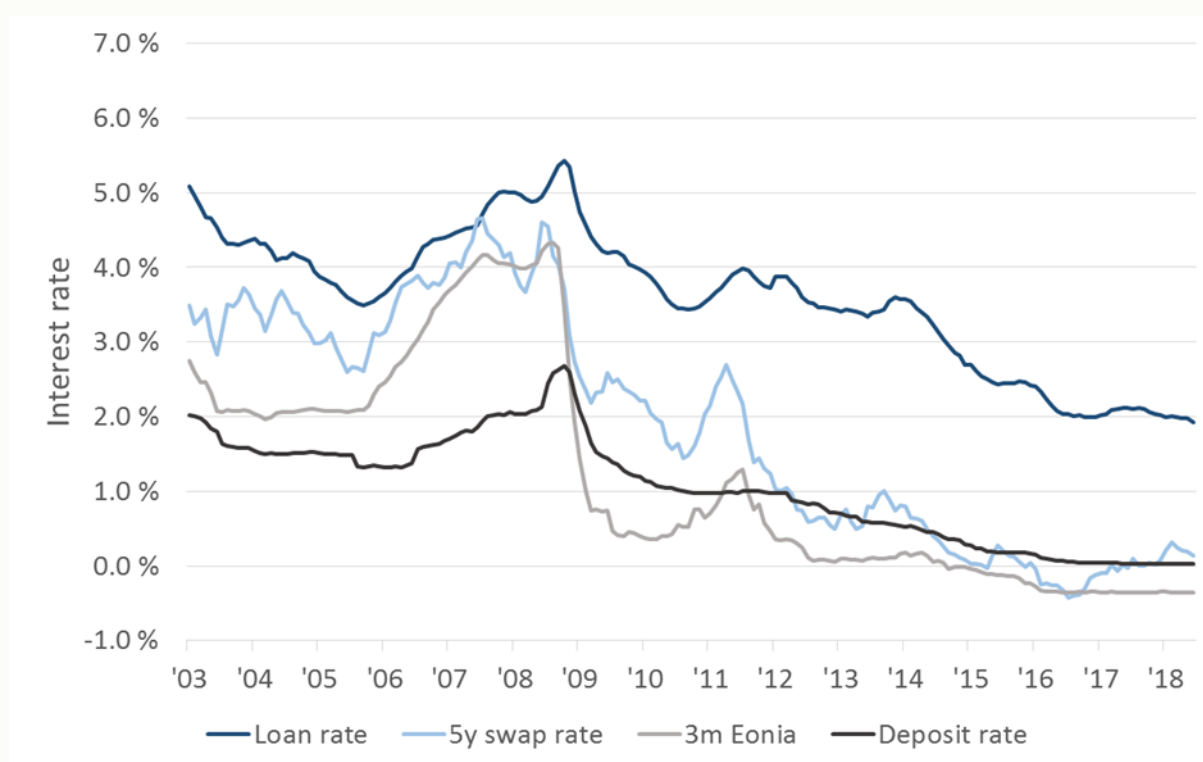
Summarizing the main mitigating actions for bank business models:

- Risk-based pricing. Banks need to apply adequate margins in their lending portfolios, covering not only credit risk, but also interest rate risk and liquidity risk.
- Operational efficiency. Banks will have to invest heavily in upgrading their cost efficiency and productivity. They will have to integrate technological solutions and artificial intelligence in the core of their business models.

- Diversification. Banks will need to diversify their sources of revenues, both functionally (non-traditional financial activities) as well as geographically. The likely evolution will be towards offering integrated banking services and not necessarily through established distribution channels.
- Asset composition and asset quality. Banks need to use their comparative advantage in terms of intermediation and origination and apply rigorous credit standards.

In terms of the bank's net interest margin, the post-crisis period has witnessed a shift from deposit margin to lending margin, as illustrated in the next graph for the Belgian banks. Due to monetary policy actions and the zero lower bound on retail deposit rates, the deposit margin (between the deposit rate and the interbank rate, here 3m eonia) has even become negative. Banks have compensated that evolution by increasing their lending margin (compared to the swap rate). The crucial question is how banks will adjust the deposit margins when policy rates increase. One hypothesis is that banks will be forced by competitive conditions to follow short-term interest rate increases much faster and more complete than was the case in the past. If that should happen, will banks compromise their lending margins by lowering the risk spreads, as they have done in the pre-crisis era? Hence, sound risk-based loan pricing will be of prime importance to maintain viable margins.

Chart 5: Lending and deposit margins for Belgian banks



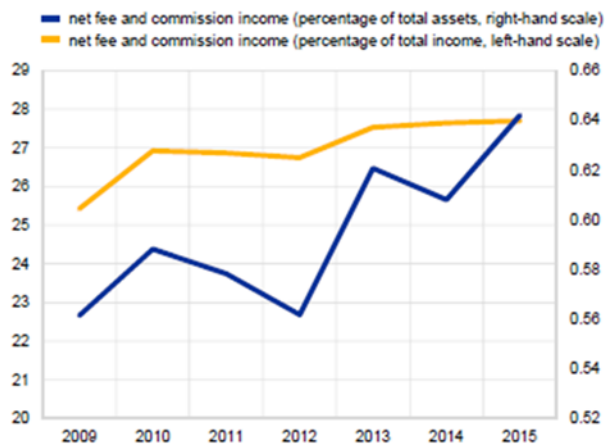
Source: ECB SDW

Another type of action to support bank profitability is to diversify their revenues and increase non-interest income. As the following chart from the ECB 2016 FSR illustrates, banks are pursuing this avenue, but it is equally clear that the increase in fee and commission income has been modest. There is no unlimited pool of fees available for all banks. Banks will have to focus on what their comparative advantages are in terms of non-interest income and adapt their business model accordingly. This should hopefully lead to a more diverse banking landscape. If all banks diversify in exactly the same activities, this would only increase systemic vulnerability. Society needs diversity in banking models.

Chart 6

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

Euro area banks' net fee and commission income as a percentage of total assets and of total operating income (2009-15, percentage share)



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

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

SSM significant institutions' net fee and commission income as a share of total income broken down by business model (2015, percentage share)



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.

It is also clear that banks have no other option than to improve their operational efficiency in a substantial way. There is no absolute benchmark, but as the next table shows, many banks still operate with relatively high cost/income ratios (source: EBA Bank Risk Assessment report). Simply cutting staff or branches will not do the trick. It will involve a fundamental redesign of bank intermediation.

Table 2

| RI | Threshold | Current vs previous quarters for the worst bucket | | | | | | | | | | | | | | |
|----------------------|-------------|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--|
| | | 201412 | 201503 | 201506 | 201509 | 201512 | 201603 | 201606 | 201609 | 201612 | 201703 | 201706 | 201709 | 201712 | 201803 | |
| Cost to income ratio | <50% | 10.2% | 10.6% | 13.0% | 13.8% | 11.8% | 12.1% | 9.9% | 9.4% | 10.7% | 13.8% | 14.6% | 13.6% | 10.2% | 9.5% | |
| | [50% - 60%] | 13.5% | 33.7% | 34.1% | 35.5% | 17.6% | 16.9% | 26.3% | 23.9% | 13.6% | 9.1% | 17.0% | 18.5% | 16.9% | 18.0% | |
| | >60% | 76.3% | 55.7% | 52.9% | 50.7% | 70.5% | 70.9% | 63.9% | 66.8% | 75.7% | 77.2% | 68.4% | 67.9% | 72.9% | 72.4% | |

Source: EBA Risk Dashboard 2018

As a conclusion, the actions needed to restore viable bank profitability going forward can be summarized as follows:

- Restoring viable profitability requires *adequate pricing of loans and funding sources*, thereby restoring decent interest rate margins. *Lending margins* are key drivers due to the zero lower bound on deposit rates. Banks will have to avoid the trap of excessive risk taking caused by a generalized search for yield.

- Banks will need to *diversify* to non-interest income sources. However, the pool of available fees and commissions is limited. And also in this respect, risk implications need consideration.
- Cost *efficiency is a key driver*. Fintech might help to increase efficiency of processes and offer commoditized products and services. Branch network rationalizations are unavoidable. The required consolidation of banking via M&A will hopefully be enacted at a European scale and create viable European banks.
- The cyclical recovery may lower loan impairments and provisions. Although there remains lots of cleaning-up in the Eurozone periphery.
- Banks will have to elaborate on their *comparative advantages*, e.g. relationship banking, cross-selling, product design, operational excellence.

The impression remains that Eurozone bank sector restructuring is progressing in slow motion. In terms of business model adaptation, the regulation overhaul is done so banks should adapt swiftly to the new regime. In the near future, technology and customer experience will drive the pace of innovation. And we will have to seek a new equilibrium between banks, non-banks and financial markets (capital markets union should accelerate the transition). In terms of bank sector restructuring, it can be noticed that the pace of entry as well as M&A remains slow. The question is whether these forces will lead to more diversity instead of simply increasing the size of banks. Some remaining issues loom large over the future of banks, notably the necessary completion of the banking union, the treatment of sovereign exposures, and the increasing levels of indebtedness (both private and public).

About the author

Rudi Vander Vennet serves as full professor of financial economics and banking at Ghent University, Belgium. He is chairman of the department of financial economics and program director of the advanced master in banking and finance. He also teaches in the advanced financial management program at Solvay Business School, Brussels. His research is published in international journals and he has been involved in several European research projects.

Mr. Vander Vennet has professional experience as current or previous board member in financial institutions (e.g. ASLK/CGER Bank, CBHK/OCCH, Credibe, OBK-Bank and Belfius Bank and Insurance). He was a member of the bank stakeholder group at the European Banking Authority.

Rudi Vander Vennet obtained his master in economics (1987) and advanced master in finance (1988) at Ghent University before becoming a Ph.D. student (1992-93) at the William E. Simon Graduate School of Business Administration, University of Rochester, New York (with a graduate fellowship awarded by the Belgian American Educational Forum). He obtained his Ph.D. in economics at Ghent University in 1994.

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at