ANALYSIS

Major changes underway in European banking sector

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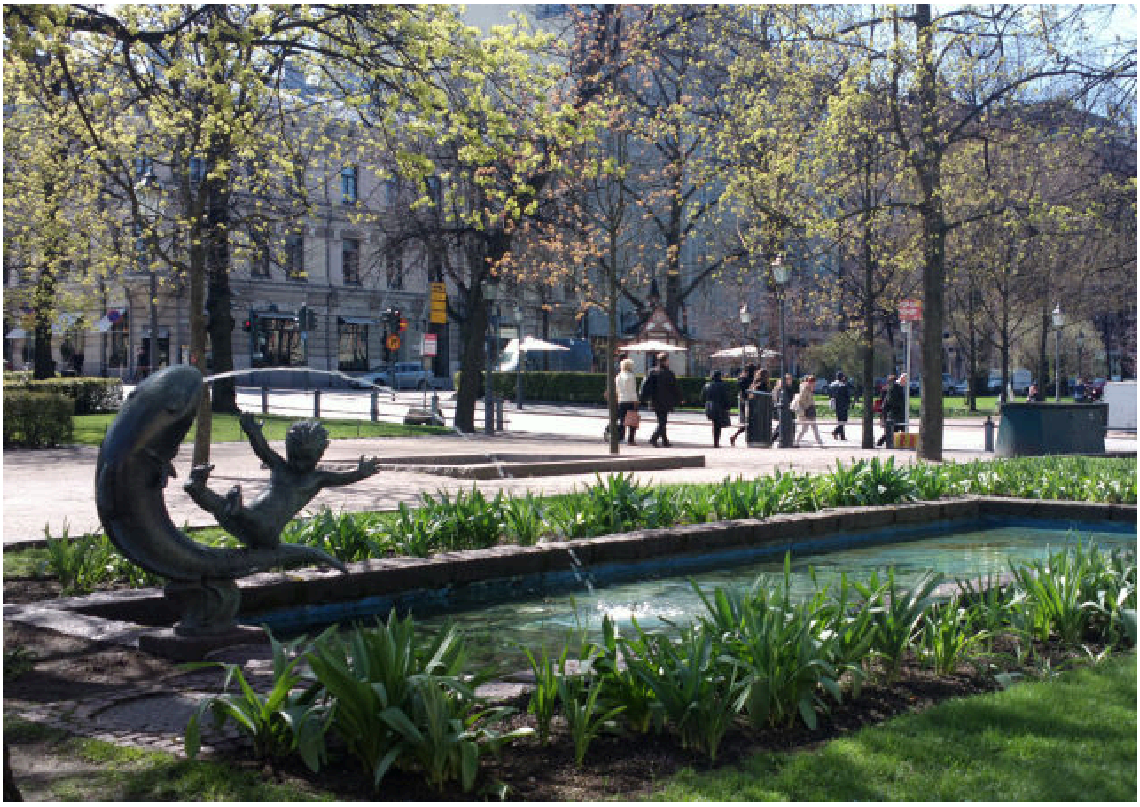
Weak profitability is a major problem for the European banking sector. Particularly in the euro area, a weakly performing economy and related impairment losses, subdued credit dynamics and prolonged low interest rates have weakened banks' profitability. The profitability of major European banks has also been undermined by court costs and sanctions imposed by the authorities. Growing regulation and an influx of new competitors on the market increase the need for balance sheet adjustment. The changes also affect Finnish banks.



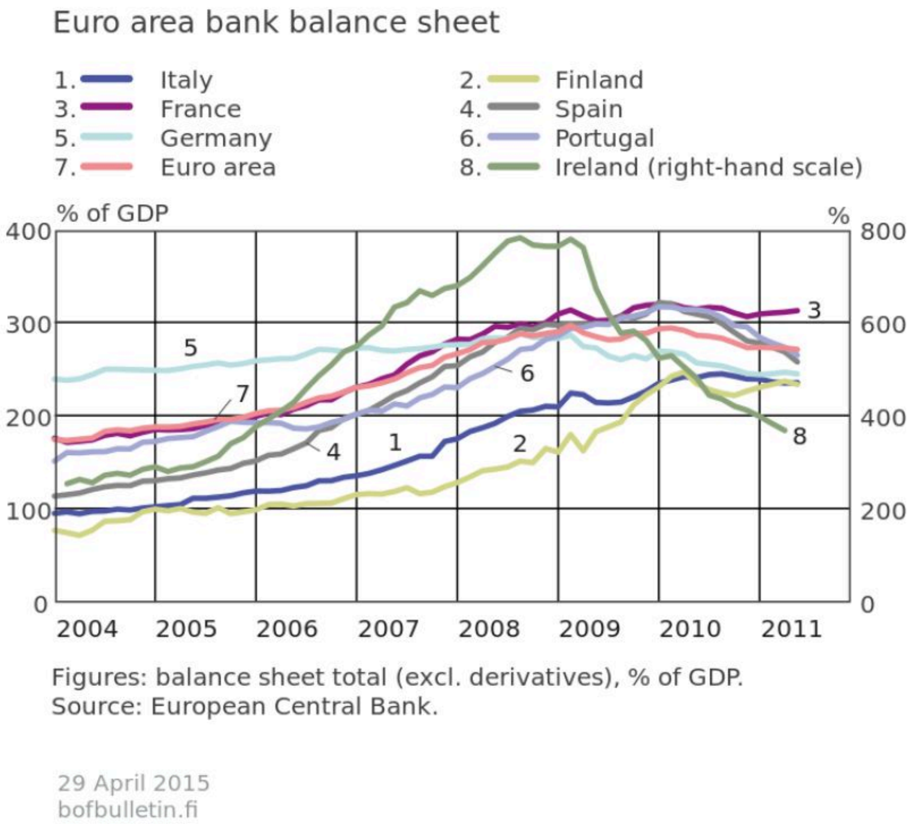
Banks adjust their balance sheets and business models

As a result of the prolonged profitability problems, some banks have had to change their business models and lower their balance sheet risks. According to the European Banking Authority,[1] banks are planning particularly to adjust their investment banking and foreign operations and decrease their high-risk and capital-intensive lending.

In recent years, large European and US banks have announced shrinking investment banking operations due to weak profitability. This is due to challenges in administration and IT systems from large-scale operations, tough competition and tightening regulation for large banks. In the new situation, large banks concentrating on their domestic markets, such as Wells Fargo in the United States and Lloyds in the United Kingdom, are considered to be better off than global actors, such as Citibank and HSBC.

In 2013, in particular, European banks sharply deleveraged (by about EUR 3,400 billion) to prepare for the comprehensive assessment of banking sector balance sheets and EU-wide stress testing that preceded single banking supervision in the euro area. Although banks' average balance sheets and loan stock have begun to grow slightly in Europe in 2014,[2] both banks and market participants still see a need to decrease their balance sheet risks.

Chart 1.



The consulting and auditing company Pricewaterhouse[3] has assessed that sales of banks' loan portfolios to funds and other actors will grow to a record level of EUR 100 billion in Europe in 2015. The adjustment of European banks' balance sheets has paved the way for the advance of new actors (see the article **'Structural changes in banking have paved the way for shadow banks'**). According to information provided by the market intelligence company Preqin,[4] European credit funds in 2014 collected record capital of USD 20 billion on top of USD 40 billion in investment promises. Funds see growth potential particularly in investments in medium-sized enterprises, as banks have decreased their lending and tightened their lending terms as regards higher-risk SMEs.

The crisis has driven banks to consolidate both voluntarily and as a result of steps taken by the authorities. Perhaps the most recent example is the attempts by local banks in Italy to form amalgamations in the wake of a legal reform.

Focus on traditional banking

The crisis has clearly affected banks' operating models. Many banks that participated in the stress test performed by the European Banking Authority were after the escalation of the financial crisis in 2008 compelled to temporarily shift their emphasis to traditional banking. Banks are divided into those focusing on traditional banking, those focusing on other banking activities, such as trading and investment banking, and diversified banks relatively equally involved in traditional and other banking.[5,6] In particular, the balance sheets of banks with weaker profitability have contracted sharply during the euro crisis.

In 2012–2013, shrinking balance sheets occurred both in banks with a diversified and those with a traditional business model. On average, the balance sheet adjustment was a little stronger in banks with a diversified business model, but in 2014 the average trend of balance sheets in the banking sector took a positive turn.

The average risk weight of bank assets has decreased since the start of the crisis. In 2014, only the average risk weights of the assets of banks with diversified business activities decreased. Banks nevertheless succeeded in improving their capital adequacy overall. The cost/income ratio has shrunk since 2012, reflecting improved efficiency. This does not hold true for traditional banks, whose ratio increased in 2013. The profitability of banks had been negative from 2011 and did not return to a positive trend until 2014. Banks with diversified business performed better than traditional banks, as their profitability was negative only in 2012. However, traditional banks have better net interest income.

Regulation affects business models

A report[7] by the European Banking Authority analysed the implications of regulatory measures for banks' business models. On one hand, the report deals with the targeted effects, and on the other hand with unexpected, possibly detrimental influence.

The objective of regulation has been to increase the risk resilience of the banking sector. Banks have to improve their capital adequacy and liquidity buffers as well as increase their funding maturity and transparency of operations. As expected, banks also have to downsize and, due to the lower level of interest rates, be content with a lower return on equity.

However, the report states that some regulatory measures have detrimental effects in certain areas, such as corporate banking, cross-border activities, risk appetite, securitisation and asset encumbrance due to higher collateralisation. Regulatory consolidation and the reporting obligations flowing from increased regulation are encouraging banks to form amalgamations.

Improved operational efficiency also in Finland

The requirements posed by the changing operating environment also concern Finnish banks.[8] As it is difficult to increase net interest income, banks are looking for profits from fee income and revamped pricing. Efficiency programmes have kept cost growth moderate. Cost savings are reflected in lower staff expenses in many banks.

Banks have sought savings and streamlined their operations through reorganisation. OP Financial Group (previously OP-Pohjola Group) rationalised their ownership structure by acquiring the rest of the Pohjola shares. S-Bank Ltd merged with LähiTapiola Bank. The POP Banks are preparing for amalgamation. A group of savings banks that stayed outside the new amalgamation of savings banks merged to form Oma Savings Bank Plc. In addition, some savings banks have merged with Aktia Bank, and among the cooperative banks mergers have also been carried out across group boundaries.

In recent years, Finnish banks have also created new operational models extending outside the traditional financial sector. In 2013, the OP group began providing health services through Omasairaala, thus aiming to utilise synergies with the group's insurance operations. S-Bank Ltd, established in 2007, is in turn challenging traditional banks by providing bank services in connection with, for example, visits to the food store.

Notes

1. Risk assessment of the European Banking System, December 2014, European Banking Authority. See https://www.eba.europa.eu/documents/10180/934862/EBA+2014.6941+RAR+web.pdf/7d2d629a-b212-4b1a-96c2-62db832ea03c. ↑
2. Bank Lending Survey 2015, 14 April 2014, European Central Bank. See https://www.ecb.europa.eu/press/pr/date/2015/html/pr150414.en.html. ↑
3. CoopersSales of European loan portfolios hit €91bn for 2014 – Full year report, 2015, PricewaterhouseCoopers. See http://www.pwc.co.uk/transaction-services/publications/sales-of-european-loan-portfolios-hit-91bn-euros-for-2014.jhtml. ↑
4. The 2015 Preqin Global Private Debt Report, 2015, Preqin. ↑
5. The division is based on an average of two ratios (interest income to total operating income and loans to total earning assets), (Laeven and Levine, 2007). ↑
6. Laeven, L. – Levine, R. (2007) Is there a diversification discount in financial conglomerates? Journal of Monetary Economics 85 (2). See http://dx.doi.org/10.1016/j.jfineco.2005.06.001. ↑
7. Overview of the potential implications of regulatory measures for banks' business

models, 9 February 2015, European Banking Authority. See https://www.eba.europa.eu/documents/10180/974844/Report+-+Overview+of+the+potential+implications+of+regulatory+measures+for+business+models.pdf. ↑

8. Financial position and risks of supervised entities 1/2015, 1 April 2015, Financial Supervisory Authority. See http://www.finanssivalvonta.fi/fi/Tiedotteet/Analyysit_tutkimukset/Documents/Valtari_1_2015.pdf. ↑

Key words

banking regulation, business models, consolidation