Analysis

Banks concerned about profitability and the sustainability of their operating models

Financial stability | 07 June 2016 | Kimmo Koskinen

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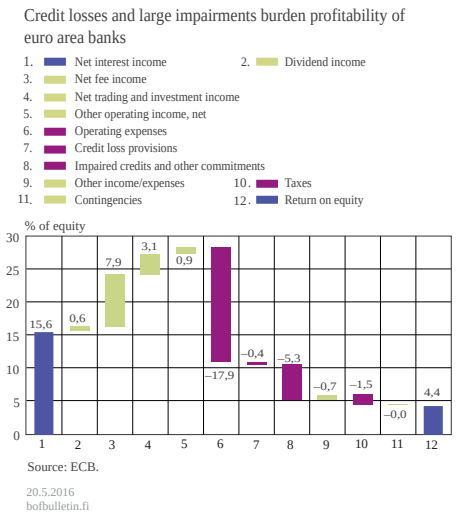
The year got off to an uncertain start for the European banking sector, and market turbulence was strong in the first half of 2016. The uncertainty has reflected increased concerns about the growth prospects for the global economy. Rising credit risks in the energy sector, weak market liquidity and uncertainty about monetary and economic policies' ability to support economic growth have increased market volatility. Uncertainty over global growth prospects has also focused strongly on the banking and financial sector, which is particularly sensitive to changes in the economic outlook. Although the profitability and liquidity position of the European banking sector has improved on average in recent years and capital adequacy has advanced, the banking business is facing numerous risks both in the short and the long term. Banks' long-term profitability and the sustainability of their operating models have been singled out as special causes for concern.



Market uncertainty has weakened short-term prospects for large banks

The financial market uncertainty has particularly weakened large investment banks' profitability in the short term. Although the effects of the market uncertainty in early 2016 on, for example, banks' funding costs seem to have been short-term and focused mostly on the highest-risk instruments, the uncertainty has been reflected in lower commission, fee and trading income. For this reason, shares of the more closely market-related investment banks have lately been exposed to higher price reduction pressures than shares of other banks. At an annual level, fee income has decreased in the first quarter of 2016 by almost 30% from the previous year.[1] Although the situation has stabilised since the end of February, the financial markets remain very vulnerable to significant market fluctuations and sudden changes in market sentiment.

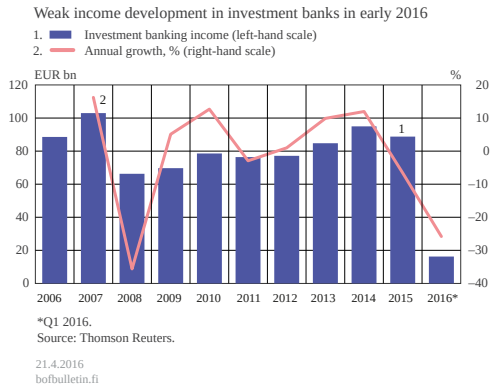
Chart 1.



Financial and debt crisis inheritance burdens profitability

In addition to market risks, the profitability of European banks is also eroded by the inheritance of the financial and debt crisis. In particular, the environment of low interest rates and the considerable number of non-performing loans and credit losses are regarded as the greatest challenges. The low interest rates due to weak economic growth and accommodative monetary policy and the small difference between short- and long-term interest rates have reduced the interest income of European banks. Interest income is an important item in banking business, as the difference between interest income and interest expenses, i.e. net interest income, represents an average 55% of income in the business of European banks.[2] For some small European cooperative and savings banks, the interest margin is actually even more important than this, up to 70–80%. In addition, the low interest rates reduce banks' ability to increase their interest margin through new lending, as the margin between banks' funding and lending shrinks with the decreased difference between short- and long-term interest rates.

Chart 2.



However, the effects of low interest rates on bank profitability varies significantly between banks and countries. The effects depend on banks' ability to transfer costs to customers and the structure of banks' funding and income. Country-specific traditions, such as proportions of fixed and floating rate loans, are also very important to the profitability effects of low interest rates. On the other hand, the extraordinary monetary policy measures by central banks support banks' profitability by reducing their funding costs, and in the short term they have also increased the gains from securities sales. The gradual economic recovery in some European countries as well as the cost trimming and streamlining of operations by banks also improve the profitability outlook for banks.

In addition to the environment of low interest rates, non-performing loans also undermine European banking profitability and lending capacity. Non-performing loans easily turn into a self-fuelling vicious circle, which it has been found hard to escape from. Non-performing loans undermine banking profitability, because banks have to prepare for future losses by accumulating provisions, thereby reducing business income. Furthermore, non-performing loans on the balance sheet generate no income, such as the income on normal claims. In addition, the share of non-performing loans not covered by provisions binds a lot of capital, because bad loans often carry higher risk weights. Bad loans also weaken banks' balance sheets, increasing their funding costs, as investors require a higher return on higher-risk investments.

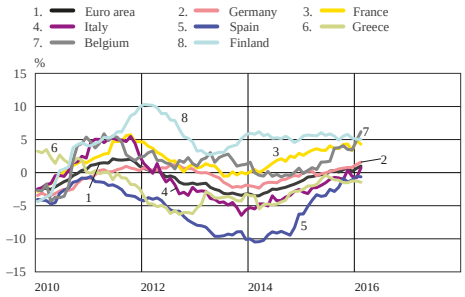
European banks still have EUR 1,000 billion of non-performing loans on their balance sheets. However, the problem is primarily significant in the countries that suffered most from the debt crisis, where the volume of non-performing loans has remained high in spite of a gradual economic recovery. In these countries, banks' capacity for lending to the real economy has been disrupted and the net flows of lending are still clearly negative. In addition, the private and public sector debt level in many countries is still quite high and companies' loan servicing ability is weak. Especially the corporate sector, and particularly the SME sector that is so important in southern Europe, is

still suffering from a large number of non-performing loans.[3] Increased higher-risk lending requires additional capital in the banks, and finding new funding has not been problem-free in times of weak profitability, as the banking sector has been valued at a very low level in the wake of the market turbulence, which makes it more difficult to obtain funding or makes additional funding through share issues too expensive. Banks have also had to consolidate their balance sheets to meet the requirements of stricter regulation.

Due to the large number of non-performing loans, strengthened capital adequacy in the banks is particularly important, because it reduces market uncertainty over the banking sector, strengthens banks' funding and improves their future lending capacity. Necessary measures to solve the problem of non-performing loans have been commenced, but this will take time, as there is no single solution that would fit all. The measures should also be comprehensive and include i.e. legislative changes, development of secondary markets for non-performing loans, banking sector consolidation measures and different measures in the public sector. New limitations due to Europe-wide recovery and resolution regulation must also increasingly be taken into account.

Chart 3.

Growth in euro area corporate loans still weak, particularly in countries suffering most from debt crisis



Corporate loans: annual growth; not seasonally adjusted; adjusted for effects of securitisation.
Source: ECB.

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New players and operating models challenge traditional banking

Due to the protracted profitability problems, more than 30% of the banks reporting to the European Banking Authority (EBA) indicate that they will still make revisions to their operating models. According to the EBA, banks are planning particularly to adjust their investment banking and foreign operations and decrease their high-risk lending. In addition to profitability problems,

banks report that they are planning this mostly because of tightening regulation and the entry of new players and operating models onto the market. Those new players and operating models will begin to challenge traditional banks in the next few years.

As a rule, the new players and operating models can be divided into two groups. Firstly, the increased use of financial innovations (Fintech) and digitalisation in recent years and the tightening regulation of the traditional banking sector have changed the competitive situation on the financial markets and in payments. Particularly in the USA, the United Kingdom and emerging economies, such as China, various players utilising digitalisation and social media, such as peer-to-peer lending and group borrowers, have rapidly gained market shares in e.g. consumer loans, student loans and SME lending. Although the success of players using new technology is hard to assess, they may have significant effects on bank profitability. Citibank assesses that banks will lose about 17% of their income to new players by 2023. How radical the change will be will, however, also depend on banks' own ability to adopt new innovations and operating models.

In addition to the players utilising cutting-edge technology, various more traditional operators are also competing for banking business, such as venture capital companies, investment companies and asset managers. Their entry onto the market has been particularly driven by their less stringent regulation compared with the banks. As banks tone down their activities, different property, hedge and debt funds are extending the focus of their investments from securities to lending. In Europe, new types of credit funds grant loans mainly to medium-sized high-risk companies, where the return is higher than in loans to large companies and where the need for alternative funding channels has increased as banks have reduced their high-risk lending. According to the data and intelligence house Preqin, different debt funds globally collected about USD 85 billion in new equity in 2015, and the amount of managed assets increased to about USD 520 billion.

If the significance of new players on the credit market increases at the present rate, they will in future play an important role in lending to the private sector. However, there is a risk that the channelling of funds is shifting to players characterised by weak supervision, little experience of banking and the effects of economic cycles on credit losses, inadequate risk management and less transparent operations than the banks. In addition, there are almost no risk-reducing macroprudential tools in the sector and they could prove difficult to introduce.

Notes

1. Thomson Reuters Global investment Banking Review (I/2016). ↑
2. EBA (2015) Risk Assessment of European Banking System. ↑
3. EBA (December 2015) Risk Assessment of the European Banking System. ↑

Keywords

banking sector, profitability, risks