ECONOMICS

HOW CAN RETAIL BANKING MAKE A FUTURE FOR ITSELF?

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PERSPECTIVES

Retail banking has been experiencing a decline in its profitability for the past ten years

Retail banking has been under pressure for several years now. Its profitability has significantly declined: standing at 17% on average for French banks in 2000, it virtually halved after 2008 to stabilise at around 8–9% in recent years. Its price-to-book ratio is in line with this trend, with values around 0.5 on average, and a range from 0.3 to 0.7 in Europe.

This decline has made the banking sector much less attractive than others. Its ROE is currently below that of sectors like telecoms or consumer goods, not to mention health, the new *El Dorado* for investors. As for price-to-book ratios, the banking sector has one of the worst of all after having been in front for some time.

One of the causes of the sector's deterioration lies in its lacklustre net interest margin. For all French banks combined, the net interest margin has fallen by 10% since 2009, whilst outstanding amounts have increased by 10% over the same period. However, the race for volumes and outstanding amounts is now more difficult to run due to the cost in RWA and, therefore, in equity.

In this context, French banks' results remained relatively stable in 2018. When looking at the market's six major banks, the NBI of their retail banking divisions was stable compared with 2017 at around €60 billion. The net income of the same divisions also remained stable at around €18 billion, despite slight variations from one bank to another.

Notwithstanding, this stability cannot hide the scale of the challenges facing the sector in the coming years, after ten lean years already. At least five such challenges can be found, with four in the financial and regulatory sphere and one in the commercial sphere, which will likely be the most dangerous in the long term. Combined, these challenges could reduce ROE by an additional 2.5 points by 2025.

Four challenges affect the financial and regulatory sphere

The first challenge relates to a fundamental aspect of the business: the level of interest rates. Retail banking plays a major role in the economy by ensuring the essential function of transforming short-term resources – deposits – into long-term resources – mortgages and business loans, in particular. ALM is at the heart of this transformation, which requires an increasing yield curve, ideally with a slope of 2%.

However, the monetary policy put in place after the Lehman Brothers crisis led to a double decrease in rates: first, in the short term, through the decrease of the reference rates, and second, in the long term, through the quantitative easing programmes. The yield curve slope in Europe gradually fell to almost nil. Yet earning money with no slope flies in the face of the fundamental laws of retail banking, which finds itself in an unprecedented and dangerous situation.

The second challenge relates to equity. Between 2005 and 2018, French banks more than doubled their equity under Basel 3. At the end of 2018, this equity amounted to almost €300 billion against €130 billion in 2005. But after Basel 3, Basel 4 is now coming into play. The impact will certainly be much less significant than previously indicated, but this increase could further reduce ROE by a few precious tenths of a point.

The third challenge is cyclical: the cost of risk. Overall, the cost of risk for all business lines grew from 0.1% of outstanding amounts in 2005 to almost 1.3% in 2009, before gradually returning to the levels in place before the crisis, at around 0.3% in 2018. However, if the cycle were due to deteriorate, the curve could invert again. Each additional tenth of a point in the cost of risk represents €2 billion for French banks; it is not negligible.

The last challenge in the financial and regulatory sphere – in theory random, but ultimately more structural in the past ten years – relates to fines. Since 2007, European and American regulators have imposed USD 230 billion in fines on international banks, of which subprime cases represented almost 70%. Many may well think that the worst has passed, but fraud and money laundering could take over from the subprime crisis, leading to continued damaging penalties in case of breaches.

Ultimately, these four challenges could deduct almost two additional points of ROE from French banks, taking the sector down to extremely low levels within five years. Beyond pure performance effects, these challenges may also handicap banks at a time when they need to invest massively to face the following challenge, that of business and development.

The commercial challenge is the primary threat in the long term

The commercial sphere is not exempt from difficulties. Indeed, the commercial challenge represents the primary threat to retail banking in the long term, with the growth in intensity of the competitive landscape relating to three factors: a reduction in barriers to entry, the transformation of the use of retail banking and the technological revolution in progress. New players – neobanks – are making the most of it, and threatening traditional banks in the process.

If we summarise the history of neobanks over the past 30 years, we can consider that there have been two phases. The first saw players in the supermarket and hypermarket sector, like Carrefour and Casino, and players in the insurance sector, like Axa and Allianz, extend their offers to include banking services, with the aim of making clients more loyal. In response, traditional banks most often created online banks to retain clients.

The second phase saw the context change. Since 2010, new categories of players have attempted to penetrate the market with relatively different models. One such category includes players like Revolut or N26, which are trying to create low-cost banks with full service offers from scratch, particularly by creating partnerships. These players are in a race to reach critical mass. Another category relates to new-technology players, which enter the market through specific services – payments, in particular – but are not looking to provide a full range of services from the outset. By way of example, we could cite Apple Card or Apple Pay, or Amazon providing insurance services. These players tend to eat away at traditional banks' revenues.

This effect is growing, as neobanks are gaining 300,000 clients each year. Initially, their NBI per client is much lower than that of traditional banks, with the client often only opening a secondary account. But, with time, and the gradual development of the range of products, the service offer grows and these secondary accounts can turn into main accounts.

Neobanks are also imposing new quality standards in two ways: first, through high levels of client satisfaction on digital applications (some traditional banks have already reacted by significantly upgrading their applications) and second, through immediate account opening. A client may set up an account with a neobank in just a few minutes, far from traditional standards.

Nevertheless, despite their sometimes undeniable commercial success, no neobank has managed to find its way to profitability – their aggressive welcome offers are often an obstacle to it.

Traditional bank models appear to be partially protected in the short term

Usually, retail banking is presented under two complementary environments: the first covers items that have no impact on a bank's balance sheet ("non-BS environment") and includes services related to payments and everyday banking; the second covers items that do have an impact on the balance sheet ("BS environment") and includes savings, credit, and insurance products. For some years now, a third environment has emerged for certain players:

complementary proximity services, such as telephony or smart-home products.

Barriers to entry for the two main environments have decreased in recent years, but not homogeneously. For the non-BS environment, they have been the subject of a double diminution, both regulatory (DSP2, open banking, GDPR, etc.) and technological (digital progress, artificial intelligence). The BS environment is better protected, via numerous regulations on equity and liquidity, but unfortunately suffers from the lack of slope linked to the flattening of the yield curve.

In this context, the risk for traditional banks is to become simply the balance sheet for other players that capture the client relationship. Traditional banks have the advantages of expertise and existing distribution networks, but they are in general further behind on client experience and technology compared with online banks and especially fintechs.

Nevertheless, their physical networks create a real advantage and a strong differentiating factor for at least three reasons: they provide, first and foremost, a degree of proximity where, in recent years, the city centre is being rediscovered; they facilitate human contact, enabling real dialogue with the client and making it possible to provide bespoke advice; finally, they make it possible to transition to a physical presence, which makes real sense in the digital age. Moreover, digital services do not currently provide 100% of the financial services needed.

The most threatened environment is, of course, that of everyday banking and payments, which is very sensitive to speed and price, two factors well served by digital technology. By contrast, the BS environment is less vulnerable, and the opportunity for a client to meet an adviser remains an advantage when seeking a mortgage or advice on savings.

Traditional banks must continue to accelerate their commercial and organisational transformation

To resist the rise of new players, traditional banks must upgrade their non-BS environments to the level of best practices in the digital sphere, and They must differentiate their tariffs based on their clients. As for the BS environment, they must capitalise on the existence of their physical networks, often in excellent locations; they must improve the quality of advice offered; and they must put in place better-segmented loyalty programmes.

These observations could constitute a three-part action plan, based on diversification, ubiquity and respectful use of data.

Diversification is vital to allow traditional banks to escape the impossible equation of a non-BS environment open to new, more agile players and a BS environment suffering from suffocating yields. Creating new proximity services would make it possible to develop revenues, whilst strengthening the link between banks and their clients.

These services must first be defined in relation to the current core business, around major events in the relationship. Housing – the acquisition of property, in particular – lends itself naturally to this very well. But it is possible to go further, towards services related to travel or even certain hobbies. These successive expansions will allow banks to become key players in the everyday lives of their clients.

Ubiquity is the second axis, which is very complementary to the first. Physical networks, whilst expensive, constitute a major advantage for traditional banks. All that remains is to transform them into living spaces capable of attracting a large number of clients back. But this physical network must also be combined with a flawless digital service, developed internally or via partnerships with fintechs.

However, banks will only be able to capitalise on the advantage of their physical networks if they are able to deliver the quality of advice expected by their clients. To do so, they will have to meet three major needs: maintain stability in the client relationship/adviser, pay special attention in key lifemoments (unemployment, retirement, divorce, etc.), and provide personalised advice for certain products (life assurance and mortgages, in particular).

Finally, traditional banks have a major role to play in the use of data, by becoming a trusted partner of their clients and, in so doing, taking the opposing position to GAFA. If they succeed, they can win back points in the corporate image battle. This is especially the case given that clients seem ready to share their data if it means that they will receive better quality advice.

These three axes could constitute the core of a five-year plan aiming to win back all or some of the ROE points that will be lost. Nevertheless, these actions will not be enough on their own and will only serve to complement the savings and process-simplification plans already implemented in all banks, and which will have to be accelerated further.

In such a tense context on all sides, retail banking is almost at a crossroads, required to reinvent itself to take into account changes in use and the arrival of new players, all whilst being deprived of some of its financial means to invest through the absence of slope in the yield curve. The players facing these challenges are not all equal, and banks are not likely to follow the same trajectory.