S&P Global Ratings

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European Banks Count The Cost Of Inefficiency

October 22, 2019

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Key Takeaways

- Revenue pressures are pushing European banks to address their structural cost problem.
- Firms are prioritizing "run-the-bank" efficiency savings to create capacity for "change-the-bank" technology investments that support leaner operating models.
- Efficiency improvements will be slow and we expect that the sector's profitability will remain subdued.
- We could lower the ratings on banks that fail to adapt to the weaker revenue environment and the industry's digital revolution.

Many European banks have a longstanding cost problem. The weak revenue environment is making their position more obvious, and acting as a catalyst for banks to tackle it more decisively. However, progress will not be quick or easy, not least because the sector faces near-term cost inflation from technology investments and increased compliance spending, among other items. The inevitable consequence is continued mediocre earnings, while weaker performers implement efficiency measures and hope for more supportive economic and monetary conditions. Some banks may look to downsize marginally profitable business units, and shareholders may look more favorably at in-market consolidation to realize cost synergies.

European banks' subdued earnings prospects constrain S&P Global Ratings' view of the sector. We see minimal ratings upside potential and we could lower the ratings on banks that struggle to adapt their operating models and embrace digitalization. Banks with limited ability to make structural changes will suffer more. That is why, for example, we have negative outlooks on nine German banking groups (see "Outlooks On Various German Banks Revised To Negative On Rising Banking Sector Risks; Ratings Affirmed," published on Sept. 18, 2019).

Structural Inefficiencies And Revenue Pressures Weigh On Profitability

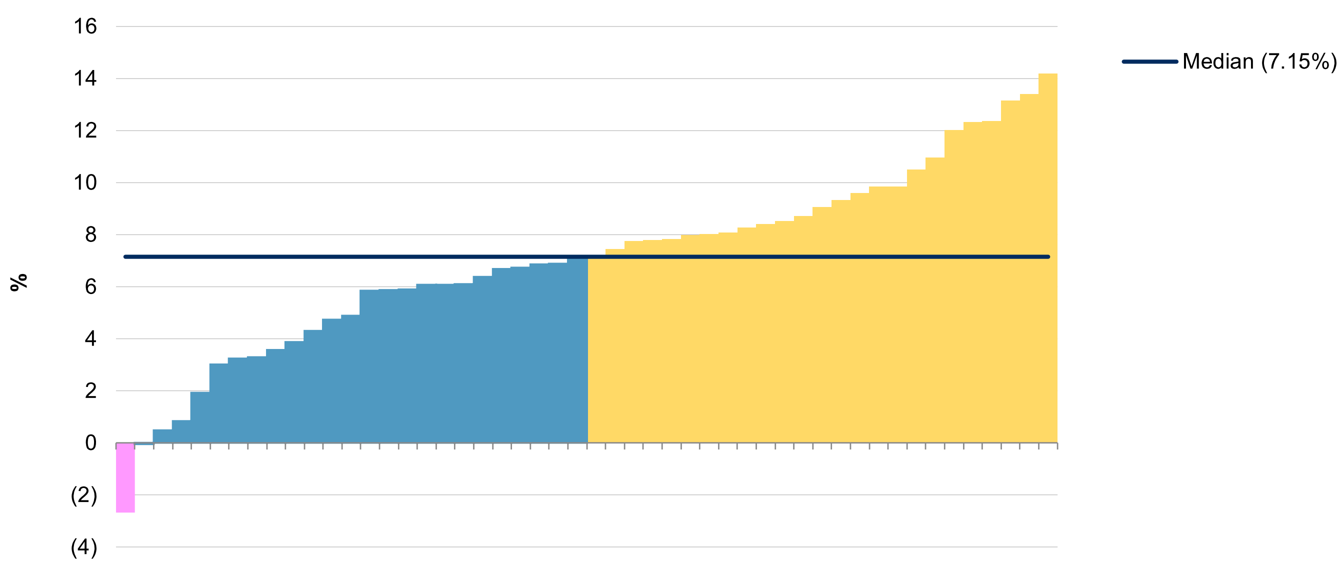
The economic slowdown and lower-for-even-longer interest rates are challenging European banks' efforts to strengthen profitability. The reasons for the sector's mediocre performance are well known: squeezed margins, subdued customer demand, cost inefficiencies, and industry overcapacity. Meanwhile, financial technology companies (fintechs) and other new entrants are aiming to take a larger bite out of incumbents' most profitable products and customers. These factors have led several banks to lower their medium-term earnings guidance recently, and others look likely to follow.

Profitability varies significantly across Europe. Led by Nordic banks, the best performers already achieve CEOs' holy grail of double-digit returns on equity and material payouts to shareholders. These banks typically have entrenched market positions, meaningful pricing power, strong cost discipline, and consistently low credit losses. The weakest cohort of banks lags far behind, but their earnings have benefited from the steady reduction in charges for legacy nonperforming loans. As a result, European banks' average earnings have shown gradual improvement over recent years, but we question whether they can maintain this trend.

A large number of listed European commercial banks fail to achieve returns in excess of their estimated 8%-10% cost of equity, which is the minimum that institutional shareholders would typically expect over the medium term (see chart 1). Lower returns also mean smaller buffers to absorb losses ahead of debt investors in a stress scenario. A return on equity exceeding 8%-10% is inherently challenging to achieve in competitive markets with negative risk-free rates and essentially flat yield curves. Still, most banks have ample scope to make progress on areas within their control, particularly cost management.

Chart 1

Projected Return On Average Common Equity In 2020
Data for the top 50 rated European banks

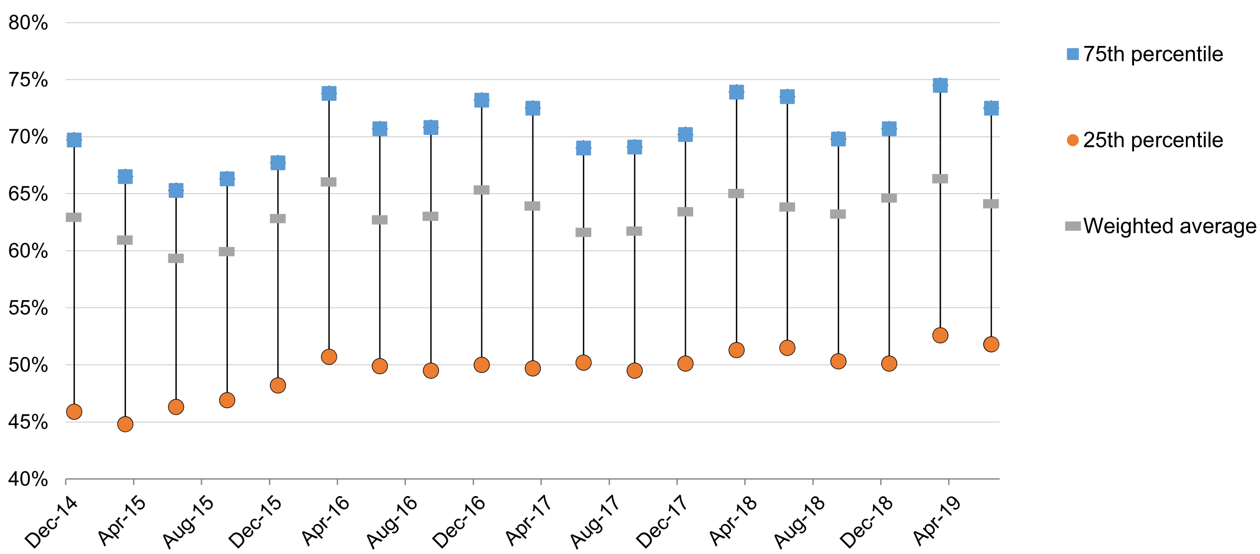


Source: S&P Global Ratings.

European banks' costs have proved stubbornly high, both in absolute terms and as a proportion of revenues (see chart 2). We expect efficiency initiatives to become more visible in earnings as time goes on, but the sector faces various sources of unavoidable cost inflation in the meantime. These include restructuring charges associated with efficiency programs; technology investments; legacy conduct and litigation settlements; and increased expenditure on regulatory compliance, including anti-money laundering controls and data management.

Chart 2

Costs Remain Stubbornly High
Quarterly cost-to-income ratios for European banks

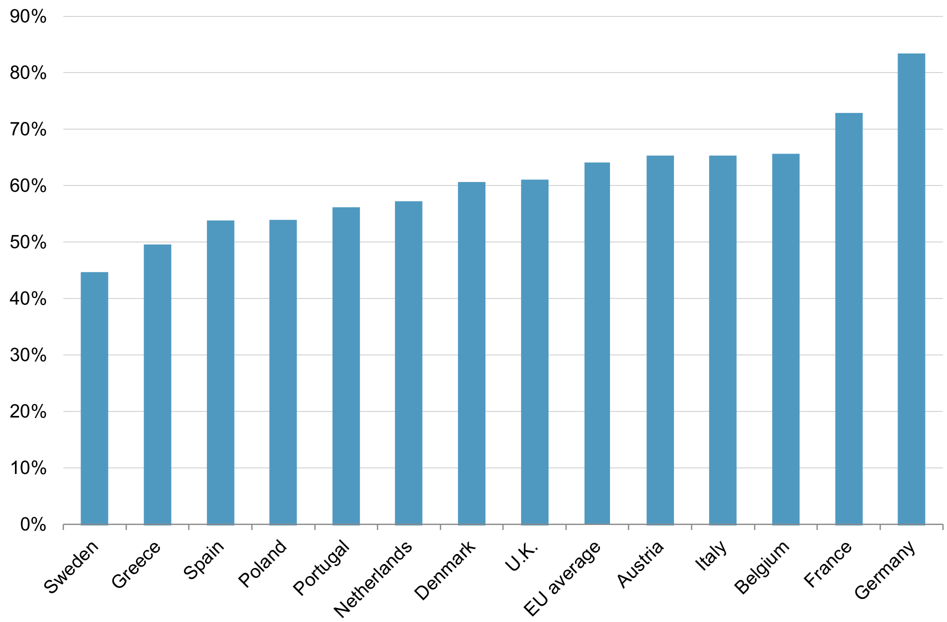


Source: European Banking Authority Risk Dashboard.

Banks' efficiency ratios vary materially across the region (see charts 3 and 4). This partly reflects differences in market characteristics, including market competitiveness, labor laws, population densities, and the speed of digital banking adoption. Institutions' chosen business models are also an important factor affecting cost ratios. For example, private banks are inherently cost-intensive, but also capital-efficient, which enables them to generate respectable returns on equity even in today's environment of low interest rates. While such nuances are important and reflected in our analysis of each rated entity, the overall picture is a sector with a structurally high cost burden that is unsuited to digitalized markets.

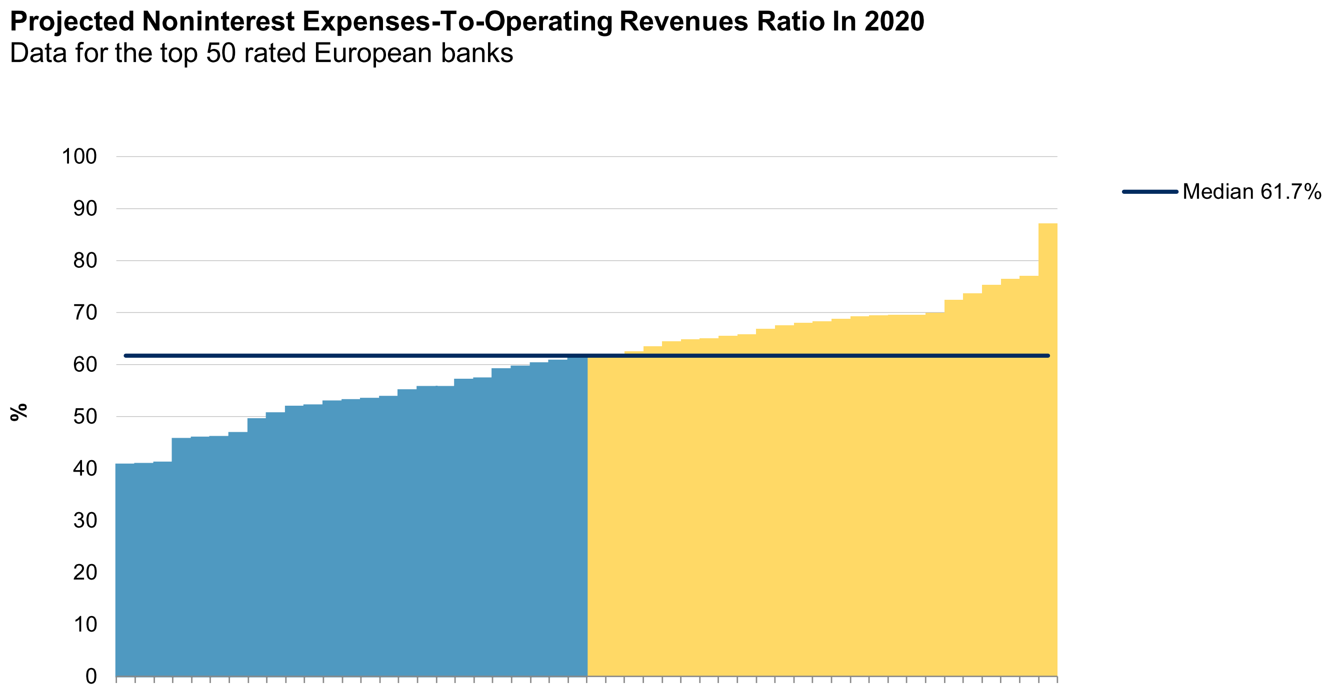
Chart 3

Efficiency Ratios Vary Significantly Across The Region
Cost-to-income ratios in selected EU countries in Q2 2019



Source: European Banking Authority Risk Dashboard. Data include both consolidated groups headquartered in each country and local subsidiaries of foreign groups.

Chart 4



Source: S&P Global Ratings.

Mutual and state-owned banks often report weaker earnings and efficiency metrics than listed competitors but there are notable exceptions, such as Finland's OP Group. Mutuals are typically better capitalized than listed peers and their cost of capital tends to be lower. They do not focus on return on equity targets, and they prioritize customer service and competitive pricing ahead of minimizing costs and maximizing revenues. Private sector competitors may be forced to respond through finer product pricing or by focusing on specific customer segments.

Traditional Sources Of Cost Savings Come To The Fore

Revenue pressures are the trigger for many European banks to tackle their structurally high operating expenses more decisively. This is the profit and loss line over which they have most unilateral control at present. In particular, we see increased focus on lowering "run-the-bank" costs, including staff and property. However, this is a gradual process, and early progress is often masked by associated restructuring charges and "change-the-bank" technology investments. As it is rolled out, this technology holds the key to fundamental re-engineering of banks' cost bases, delivering productivity and customer service improvements that increasingly benefit earnings, or at least mitigate lower revenues.

People and premises represent a large share of banks' costs and are therefore a prime target of efficiency initiatives. Addressing these traditional costs is essential to create headroom for technology investments without overly compromising bottom-line profitability. A common target is positive "jaws", which means improving efficiency by growing revenues faster than costs. With revenues likely to remain under pressure, many banks must cut costs in absolute terms if they are to report positive jaws. The best performers already achieve this, but it is a demanding target for the overall sector.

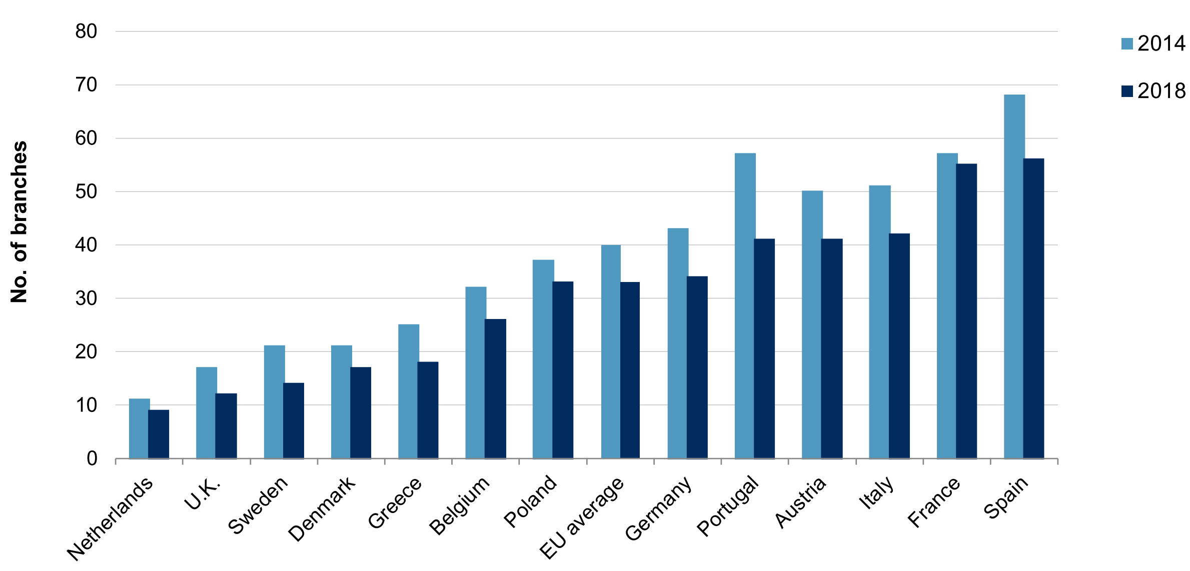
The European banking sector has shrunk since the financial crisis as banks exited peripheral businesses and refocused on core activities with stronger franchises and better earnings prospects. This approach simplified operating models and released capital to other activities. Revenues inevitably fall faster than costs in the initial stages of this strategy, particularly when cost bases are largely fixed. Many banks have struggled to boost revenues from their redeployed capital, and therefore continue to downsize their expenses to match their smaller footprints. This is particularly true of investment bank businesses, where European players have been hit by a double whammy of a declining global revenue pool and a sustained loss of market share to U.S. peers. Deutsche Bank is the prime example of this trend (see "Deutsche Bank 'BBB+/A-2' Ratings Affirmed On Restructuring Announcement; Outlook Stable," published on July 15, 2019).

Banks are attacking their traditional running costs in a number of ways:

Cutting property costs as new technologies reduce the need for physical infrastructure. This includes smaller branch networks and fewer data centers, with associated savings in staffing. Branch numbers vary significantly across the region and the most branch-heavy banks have scope to reduce the size of their networks further as digital adoption grows (see chart 5). Banks have also sought to reduce head office costs by moving non-customer-facing roles to cheaper onshore, nearshore, and/or offshore locations, and by embracing flexible working practices to reduce required floor space.

Chart 5

Branch Densities Vary But Numbers Are Falling Across The Region
Number of bank branches per 100,000 inhabitants in selected EU countries

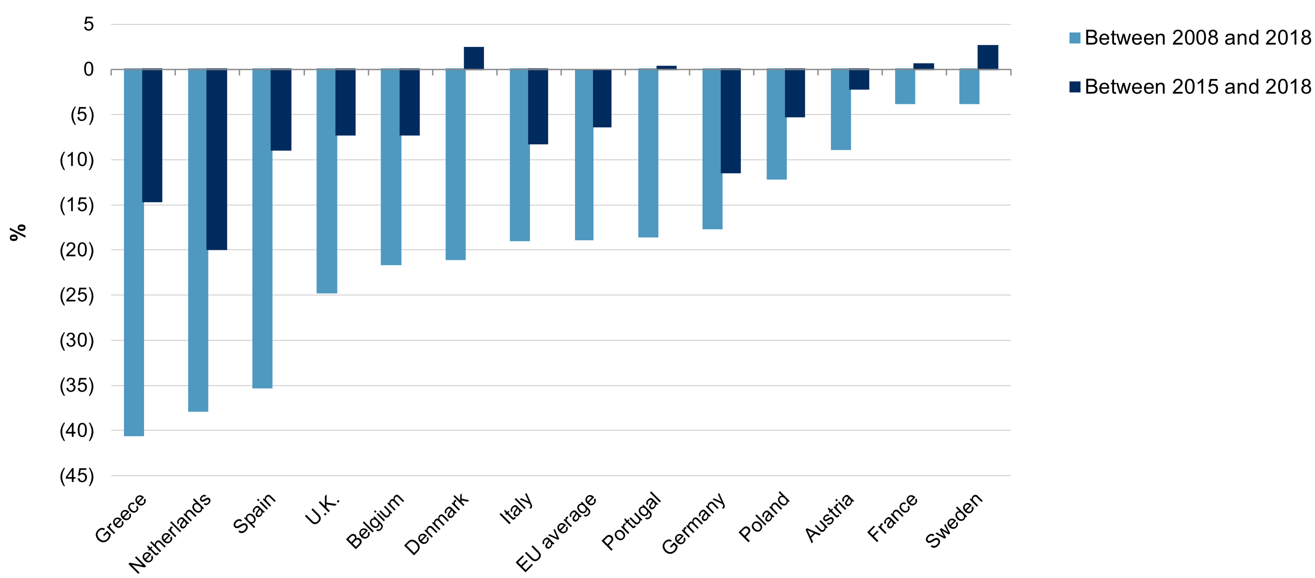


Source: European Central Bank, S&P Global Ratings' estimates and calculations.

Reducing headcount. Aggregate employee numbers are in long-term decline across the European banking sector, mostly due to branch closures (see chart 6). Other restructuring measures aimed at reducing headcount include merging divisions, consolidating duplicated functions, rationalizing middle management layers, and implementing hiring freezes. For example, several investment banks have combined the traditionally separate equity and fixed income fiefdoms with the aim of achieving cost synergies and providing more integrated client propositions.

Chart 6

Reducing Employment In European Banking
Change in the number of employees of domestic credit institutions in selected EU countries



Source: European Central Bank.

Curbing fees paid to contractors and consultants. For example, some banks have brought outsourced functions, particularly technology operations, back in-house to manage costs and improve control.

Centralizing procurement to maximize economies of scale. This includes using platforms such as e-auctions to obtain better prices from suppliers.

Restricting travel, entertainment, and marketing. For overheads such as these, some banks have adopted zero-based budgeting methods, in which all expenses must be justified in each accounting period. This is an established approach among corporates, but a more recent innovation in the banking sector.

Cooperation on back office infrastructure. We see more examples of banks joining together to reduce the cost of infrastructure and technology. They include shared procurement, data centers, and payment platforms. There is potential for the scope of back office collaborations to expand further, subject to meeting regulatory, competition, and data protection requirements.

Effective cost management is notoriously difficult in large organizations. Success requires relentless focus and strong oversight from senior leadership. Banks often establish executive sub-committees to set the tone from the top on cost control, monitor progress against targets, and approve material expenditure items. Insufficient cost discipline can result in failure to achieve planned reductions. Equally, over-zealous cuts can flatter short-term performance at the expense of longer-term customer satisfaction, employee morale, and franchise strength.

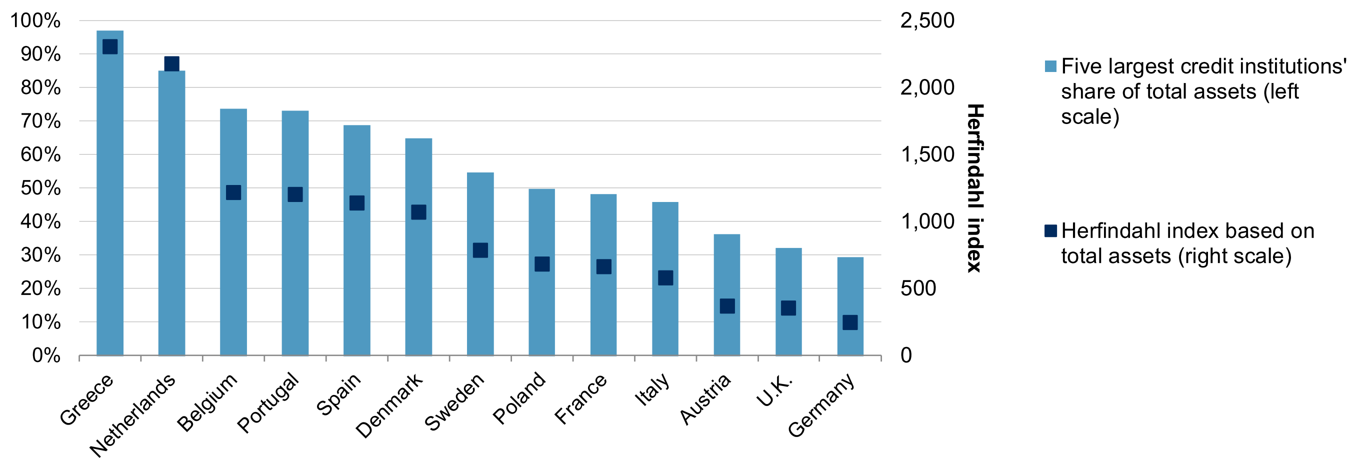
Mergers And Acquisitions Are Not A Silver Bullet

Consolidation has been a rich source of cost savings for European banks in previous cycles, and remains so in other sectors. Cross-border bank mergers are a hot topic in European banking, but we believe they are not supported by regulatory and market conditions (see "European Bank M&A: More Talk Than Action," published on Aug. 6, 2018). Furthermore, cross-border transactions generate fewer cost-saving opportunities than in-market deals due to material structural differences between Europe's national banking markets.

Several European countries are clearly overbanked and look ripe for in-market consolidation (see chart 7). Nevertheless, transactions have been sporadic since the financial crisis, with a few exceptions, such as in Spain, where there has been an orchestrated consolidation process, and in Germany, where cooperative and savings bank networks have rationalized their legal entities. We think there may be a pick-up in deal-making, but not a surge. Bigger banks are often less efficient than smaller rivals that have narrower, less complex business models. Realizing cost synergies from mergers and acquisitions requires concerted effort over a long period, which can cause senior management to become very internally focused. Combining two banks' legacy technology infrastructures could also delay migration to digital platforms. Indeed, some large banks operate duplicated systems today because they failed to fully integrate acquisitions completed many years ago.

Chart 7

Scope For In-Market Consolidation In Many Countries



Source: European Central Bank. Data for 2018. The Herfindahl index is a measure of concentration derived from the market shares of all credit institutions in a country. Figures can understate concentration, particularly in financial centers, where wholesale banking subsidiaries of foreign groups inflate total system assets.

Technology Opens The Door To New Efficiency Opportunities

Digitalization is moving banks toward technology companies, with far-reaching implications for their business models. New technology threatens incumbent banks' revenues by facilitating new competitors and potentially commoditizing key product lines. However, it also provides an unrivaled opportunity to reconfigure costs and realize savings.

Most banks are in the investment phase of their technological development, which raises costs immediately if the outlay is expensed, and increases depreciation in future if it is capitalized. Achieving run-the-bank efficiencies is particularly important during this phase to mitigate the impact of the elevated spending on bottom-line earnings. Unlike their U.S. peers, EU banks are required to deduct capitalized technology investments from regulatory capital alongside other intangibles, but this is set to change under proposed new rules.

Technology As A Source Of Cost Savings

We identify four broad technology types under our technology, regulation, industry, and preferences framework, which assesses the potential for market disruption in banking industries (see "The Future Of Banking: Will Retail Banks Trip Over Tech Disruption?," published on May 14, 2019). All four types are set to become increasingly important sources of cost efficiencies:

Mobile banking. Customer self-service through digital apps is now the norm and banks also originate growing proportions of new product sales through this channel. This trend enables branch networks and call centers to be slimmed down and refocused on delivering more complex client needs. Application program interface-enabled platforms modernize banks' technology architecture, increase their agility and efficiency, and meet the requirements of the EU's second Payment Services Directive (PSD2). However, achieving cost savings and service improvements through digitalization requires much more than eye-catching customer apps. In particular, automating front-to-back customer journeys is a prerequisite to realize efficiencies and accelerate standard processes such as account opening, customer authentication, and funding new loans.

Cloud computing. Banks are steadily migrating technology applications to private and public cloud hosting. This enables the decommissioning of physical infrastructure such as mainframes and data centers, with meaningful cost savings. Cloud computing also supports speed to market and scalability. It forms part of a modular approach to system architecture that reduces reliance on incumbent banks' legacy core banking systems by replacing and upgrading individual components. These include improved data warehouses and analytic tools that can together yield more insight into customer behaviors to produce personalized pricing and propositions, for example.

Artificial intelligence (AI), machine learning, automation, and robotics. Automation is entering several aspects of banks' activities to improve efficiency and customer satisfaction. For example, AI-enabled chatbots handle routine customer queries and pass more complex matters to human advisers. In addition, robo-advice facilitates low-cost investment solutions for customers who would not qualify for a traditional wealth management service. Behind the scenes, banks are deploying machine learning technology in a variety of ways, such as more efficient sifting of large transaction volumes in search of fraud, money laundering, and rogue trading.

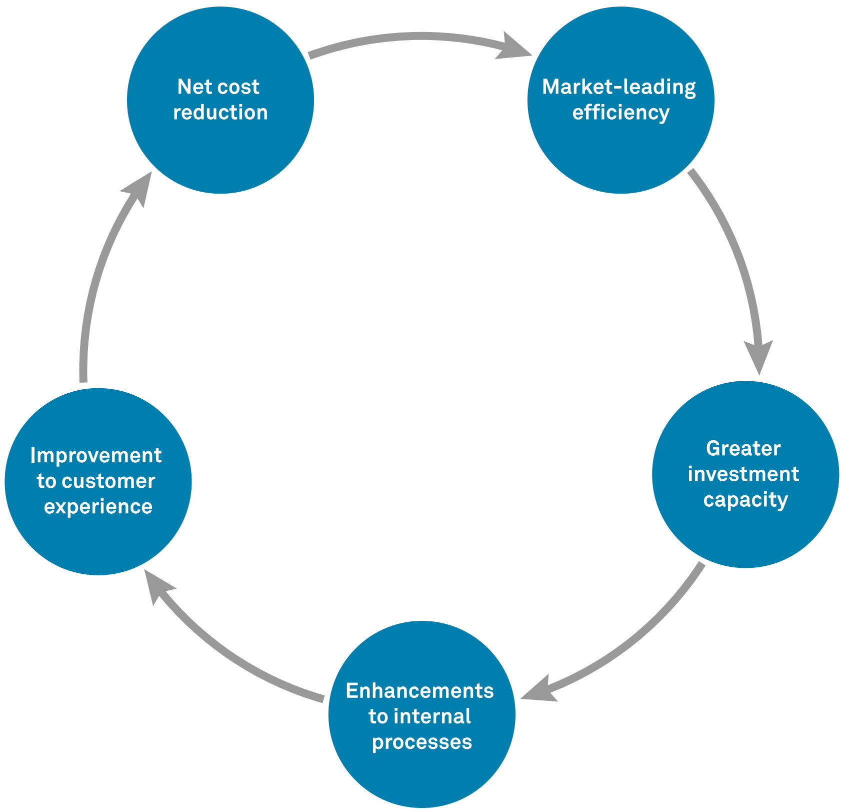
Distributed ledger technologies and blockchain. Blockchain is at an earlier stage than other technologies in its take-up across commercial banking. Still, there are various initiatives in fields such as payment services that have the potential to lower costs, reduce errors, and accelerate processing times (see "The Future Of Banking: Blockchain Can Reshape The Financial System," published on Oct. 26, 2016). Blockchain initiatives compete for members and successful advancement of this technology will likely require the industry to coalesce around common platforms.

Many banks do not disclose how much they spend on technology maintenance and development, but we understand it typically amounts to 10%-20% of total costs. Those proactively investing in digital investment operate toward the top of that range.

The technology cycle should become more self-sustaining as growing efficiency gains create capacity to invest in further process and customer service enhancements (see chart 8). Technology is constantly evolving and banks' platforms will require constant development, but the ramp-up of investment programs should eventually evolve into a more stable phase focused on maintenance. Among incumbent banks, there will inevitably be winners and losers from the technological revolution, and not all money will be invested wisely.

Chart 8

New Technology Unlocks Improved Processing And Service



Source: Lloyds Banking Group PLC.

Amid the current revenue pressures, banks may be tempted to skimp on technology spending to support short-term earnings. It is normal for companies to prioritize and adjust the pace of investment in response to changes in the operating environment. For example, banks could postpone certain technology projects if a sharp economic downturn slows the expected pay-off. However, we think a sustained delay in investment would ultimately prove a false economy that could ultimately damage banks' franchises.

Banks' technological transformations massively increase the importance of operational resilience, particularly service availability and cyber risk management (see "Credit FAQ: How Ready Are Banks For The Rapidly Rising Threat Of Cyberattack?," published on Sept. 28, 2015). Platform upgrades and migrations are inherently complex, and TSB Banking Group plc's 2018 system failure highlighted the franchise risks from a mismanaged process. Innovations such as cloud computing also bring new information security challenges. It is therefore essential that banks devote appropriate resources to these areas as part of their technology programs.

Banks Step Up Their Cost-Saving Efforts

European banks' revenue challenges have encouraged more decisive action to tackle their structurally high cost bases. Efficiency programs are an integral part of banks' strategic plans, and many have set material cost-saving targets for the next two-to-three years (see table 1).

Table 1

10 Largest European Banks' Cost-Saving Plans

Cooperative Banking Sector Germany	Realize efficiency gains by selectively merging legal entities (such as DZ BANK and the former WGZ Bank in 2018), and digitalizing processes to meet customer expectations and adapt the cost structure.
HSBC	Positive jaws (revenue growth minus cost growth) in each financial year in 2018-2020, partly to create capacity for a $15 billion-$17 billion aggregate investment in growth and technology.
Crédit Agricole	Lower Crédit Agricole S.A.'s cost-to-income ratio to below 60% in 2022 from 62.1% in 2018, with lower running costs invested in business development and IT transformation, including over €15 billion of group-wide technology investments over four years.
BNP Paribas	€3.3 billion of cumulative recurring cost savings by 2020, with €2.7 billion of aggregate one-off transformation costs. €1.5 billion of the targeted savings had been achieved as at June 30, 2019.
Santander	€1.2 billion of incremental annual cost savings to lower the cost-to-income ratio to 43%-45%, partly to create capacity for over €20 billion of aggregate investments in digital and technology over four years.
BPCE	€1 billion of group cost synergies by 2020 and a cost-to-income ratio of about 64% in the retail banking and insurance segment.
Barclays	Guidance of less than £13.6 billion in costs for 2019, excluding litigation and conduct, down from £13.9 billion in 2018, through flexibility in compensation costs and adjusting the pace of investment spending.
Deutsche Bank	A €6 billion reduction in gross adjusted annual costs by 2022 through an overhaul of front-to-back processes and infrastructure.
UniCredit	Initial targets under the Transform 2019 program were €10.6 billion in total operating costs and a 52% cost-to-income ratio in 2019. The cost target was subsequently improved to €10.1 billion.
Société Générale	€1.6 billion of cumulative cost savings by 2020 (revised up from an original €1.1 billion target), of which €0.6 billion had been achieved as at June 30, 2019.

Source: Banks' published reports and presentations. Ranking based on total adjusted capital plus participation in insurance subsidiaries as at year-end 2018.

Europe's banks may need to become much more ambitious in their efficiency plans if fintechs fundamentally disrupt incumbents' business models. Fintechs are efficient and agile, partly because they are not burdened by legacy infrastructure, and are leveraging these advantages in an effort to win customers. PSD2 presents a unique growth opportunity to new entrants, but we see large banks' established market positions, scale, and intense regulation as strong defenses against material customer attrition (see "The Future Of Banking: Is PSD2 Yet Another Threat To Revenues In Europe?," published on May 16, 2017). Banks' relationships with fintechs are not entirely adversarial because banks often partner with them on growth initiatives and technology projects. Still, new entrants have designs on an increased share of the revenue pool, and, if they succeed, banks will be forced to take tougher decisions on costs and redouble their efficiency efforts to remain competitive.

Profitability And Cost Efficiency Shape Ratings

Earnings matter to our view of banks' creditworthiness because they are the first line of defense against credit losses, and the primary source of capital generation. European banks have been able to cope with an extended period of modest profitability because credit impairments are at a cyclical low and the sector is adequately positioned relative to current regulatory capital requirements. However, this picture could change as the economy slows and banks are required to accumulate capital to meet the final Basel III reforms. Waiting for help from interest rate increases is not an option because they are an ever more distant prospect.

Persistent failure to meet the performance expectations of shareholders and other stakeholders can destabilize banks through management changes and strategic upheaval. This also weakens banks' equity valuations and therefore reduces their capacity to raise capital if needed. In extreme cases, institutions might increase their risk appetites in a bid to boost short-term performance, though we see few signs at present.

Our ratings assume that European banks' profitability will remain subdued over our two-year outlook horizon. We see little upside potential in stand-alone credit profiles (SACPs), and the main source of any rating improvements is likely to be further strengthening of bail-in buffers. We could lower SACPs on banks that fail to adapt their operating models and cost efficiency to the digital era, resulting in a steady deterioration in their competitiveness and performance prospects.

Related Research

- Outlooks On Various German Banks Revised To Negative On Rising Banking Sector Risks; Ratings Affirmed, Sept. 18, 2019
- The Future Of Banking: Will Retail Banks Trip Over Tech Disruption?, May 14, 2019
- When The Cycle Turns: Rising Interest Rates Will Lift, Not Propel, Western European Banks' Profitability, Jan. 14, 2019
- European Bank M&A: More Talk Than Action, Aug. 6, 2018
- Chasing Shadows Or Rainbows? Sustainable Profitability Still Eludes Some Major European Banks, March 15, 2018
- The Future Of Banking: Is PSD2 Yet Another Threat To Revenues In Europe?, May 16, 2017
- The Future Of Banking: Blockchain Can Reshape The Financial System, Oct. 26, 2016
- Credit FAQ: How Ready Are Banks For The Rapidly Rising Threat Of Cyberattack?, Sept. 28, 2015

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