European Banks Respond to Pressures at the Margin

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ECB policy is challenging European banks' traditional business models. Could this force a radical shake-up of regional banking? And, if so, will some banks flourish, while others flounder?

Europe's banks are seeing their profit margins firmly squeezed as European Central Bank (ECB) policy exacerbates the pain inflicted by sluggish demand, intense competition and higher regulatory costs.

Life is likely to get more uncomfortable still following the UK's vote to Brexit. On the one hand, ECB policy is likely to favor lower interest rates for longer. And, on the other, European banks will be navigating a more difficult economic environment in which it's harder than ever for them to grow earnings.

As interest rates have moved further south, regional banks have been earning less from lending. At the same time, they're now paying for the privilege of parking money with the central bank as the ECB's deposit rate has dipped well below zero.

So far, banks have been reluctant to pass the cost of negative deposit rates on to customers and have taken almost all the hit. But banks with large retail deposit bases will eventually hit a tipping-point when they're no longer able to absorb deposit rate costs.

Will Tweaking Do the Trick?

Some banks will look to stop passing any further declines in interest rates on to borrowers. And, eventually, some may start to up the cost of borrowing—indeed, this is already happening in Switzerland and Denmark.

Banks might also start to impose charges for services long assumed as mainstays of high-street banking, like free current accounts. But European banking is a crowded marketplace, with competitive pressures rising as new entrants, like technology start-ups and "challenger" banks, join the fray. This means more well-established banks have limited scope to increase the cost of standard banking products and services.

And they've got little room for manoeuver by trying to bolster profit margins by lending more. Regional loan growth is lackluster—and skewed toward lower margin lending, like mortgages.

All this suggests that tinkering around the edges won't rescue European banks' profits— particularly since customers are starting to change their banking behavior as they feel the pinch from ultra-low interest rates.

As savers earn less for depositing money at banks long term, more will move over to instant access accounts. And those with mortgages will look to lock in lower, fixed-rate deals. These trends risk eroding bank profitability still further as banks' better-earning assets gradually melt away.

Or Is Bolder Best?

This suggests that the banks likely to flourish may need to embrace a bold overhaul of their traditional business models. This might involve coaxing customers out of interest-earning deposit accounts and into higher-yielding products—like mutual and pension funds.

This might help banks to cement long-term customer relationships (and hence promote further cross-selling opportunities), while also enabling them to earn attractive fees on this off-balance-sheet business.

Banks with large, well-developed fund distribution platforms are clearly particularly well placed to sharpen their focus on fee-earning savings and retirement products. Their smaller counterparts may find themselves needing to take more circuitous routes towards fee-earning opportunities—perhaps through joint ventures with bigger banks.

Where Might Banking Change Most?

Europe's banking customers are a diverse bunch. Big differences in savings behavior and in how Europeans choose to store their wealth mean that a banking sector shake-up will have greater impact in some countries than others.

Germans are keen savers and keep more of their net worth in deposit accounts than their peers in other large euro-area countries. Dutch households have a much higher skew to pension fund assets and a lower skew to non-financial assets (like housing) than, for example, Spanish consumers, who hold nearly 80% of their net worth in housing.

This suggests that German and Dutch households are more vulnerable to interest-rate dynamics than their counterparts in Spain, Italy and France. As a result, banks in Germany and the Netherlands may have most scope to lure customers out of traditional deposits and into, for example, fee-generating investment funds.

There are regional variations in how much interest banks pay on deposit accounts. In some countries, these accounts offer special benefits that could tempt savers to stay put. For example, French customers can save tax free in Livret A accounts.

German and Spanish banks offer the lowest deposit rates. Some Spanish banks have proactively moved depositors into off-balance-sheet products. This hasn't happened as much in Germany—further underlining the untapped potential on offer in Europe's biggest banking market.

That said, banking customer behavior is likely to change at a measured pace. This suggests that a European banking shake-up is most likely to take the form of a gradual evolution—not an overnight revolution.

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