SCOPE

European banks in 2023: fine financially but multi-pronged digital challenge remains

Sam Theodore | January 2023

2023 will be another bumper year for European banks from the financial perspective. Which is just as well because the sector will continue to face substantial structural challenges: economic, geopolitical, financial risks from outside the banking system (sky-high public and private indebtedness, non-bank disintermediation), and climate-related.

But above everything else is the continuous struggle to hold ground, grow and compete in the digital ecosystem. Specifically, the technology and regulation-driven payments revolution in Europe will require most banks to adjust their business models to preserve and grow their customer base and revenues.

Digital neobanks will not displace incumbents…

Digital transformation remains a top challenge for banks and will be for years to come, as technology advances usually occur faster than banks' ability to incorporate them in operations. This is not about online banking (which everybody has been doing for a while) but more broadly about repositioning banks in the new ecosystem to compete for customers' financial needs and data with other participants, banks and non-banks alike. It's about replacing more traditional delivery and decision-making channels with digital platforms and APIs, and about migrating back offices and data storage to the cloud.

This is a costly exercise and should see banks investing heavily in technology and digitalisation. A painful proposition if not consistently accompanied by a parallel reduction in excess legacy capacity (branches and back offices). But on the evidence thus far, this is easier said than done and 2023 will not be significantly different in this respect. Especially since many banks across Europe continue to see strategic value in large branch networks.

Having said all of that, I do not currently see neobanks as real threats to the large incumbent groups. With few exceptions, primarily in the UK (Starling and possibly Monzo), neobanks remain loss-making. With the disappearance of cheap money, a turnaround to profitability is unlikely. If incumbent banks can adjust their offerings in the digital space to keep and attract financially savvy business and individual customers – an increasing number of banks are in this position – the wiggle room for disruption from outside the sector narrows significantly, especially in Europe's fully banked markets. And based on today's market expectations, fast growth in revenues and assets can no longer supplant actually being profitable.

There was a sharp decline in new funding for neobanks and other fintechs in 2022. That was no surprise. This year should be no different. Banks taking over some of the better managed neobanks or other fintechs can't be ruled out. This could help them improve their own digital delivery infrastructure and neutralise disruptive effects.

… But new payment platforms and structures can (and it may hurt)

In the payments area, the competitive landscape is far more threatening for incumbent banks, especially for the digital laggards. Regulators and policymakers have encouraged the development of open banking through the Second Payment Services Directive (PSD2), adopted in 2018. For the first time, consumers have the legal right to access their accounts with European banks and fintechs through third parties, which has allowed them to see financial data or initiate payments after providing consent.

Current consultations initiated by the European Commission will likely lead to an updated version, PSD3, in years to come, which should encourage the

development of open banking and open finance in line with fast-evolving technology.

A new initiative in this respect is an EU Digital Identity Wallet pilot project (also known as Nordic-Baltic eID Project), set to be launched in March, which will see the EC funding a consortium of banks and technology companies from Denmark, Germany, Iceland, Italy, Latvia and Norway. DSGV, DNB and Intesa are among the banking groups participating. The focus will be on payments and will leverage existing payment infrastructures.

Deriving from the open-banking concept, new related business models such as banking-as-a-service (BaaS) and embedded finance (EmFi) are gradually taking hold. A recent survey of 1,000 SMEs from Benelux and the UK showed that most expect BaaS (using financial services via non-financial brands) to eventually replace traditional banking for consumers (65%) and SMEs (51%).

Revenues from payment flows represent roughly 15%-20% of retail and commercial banking earnings, and the erosion of such a large, stable and reliable income generator would be a clear negative for any institution. It is thus imperative for banks to adjust their business models to offer and rely on payment platforms, open banking, or BaaS/EmFi. This is often done by acquiring or partnering with payment fintechs. Large banks in the UK, Netherlands, the Nordic region and elsewhere have started to do that and it is a trend that will broaden in 2023.

Crypto risks remain marginal for banks

In the midst of the current crypto meltdown, I do not anticipate any material crypto contamination of the European banking sector, which has, on balance, managed to avoid the temptation. Last year saw the adoption of Markets in Crypto Assets (MiCA) –a far-reaching piece of crypto regulation which will place the EU at the forefront of regulated crypto markets.

MiCA and the establishment of retail Central Bank Digital Currencies (CBDCs) should constrain and marginalise the attraction of decentralised finance (DeFi) and stablecoins. I am sceptical about the future of private crypto money when, in the digital age, digital versions of fiat currencies will be accessible to all. Concern about privacy using CBDC are real, however, when compared to using either cash fiat currencies or stablecoins. They will need to be convincingly addressed before CBDCs become live.

Best financial shape in decade

As for the banking sector's financial credentials, I wrote this in *The Wide Angle* report exactly a year ago: "The European banking sector is entering the New Year in its best shape in decades. Having covered the sector for over 35 years, I consider it in a much healthier form not only since the Global Financial Crisis – which is the widely used reference today – but since pre-crisis times."

I stand by those comments for 2023 but this time around, I see the various ifs and buts as being even more marginal than last year.

The sector's structural profitability deficit is much less of a challenge than in the past. Core revenues should strengthen further through the net interest margin endowment effect in a rising rate environment, especially in SME and consumer lending, and variable or resettable-rate mortgages, where repricing is occurring faster than for fixed-rate mortgages. Contrary to the expectations of savers (which I admit I shared), the rise in deposit yields is lagging, largely because of the large share of current-account balances. Savers have been heavily penalised by central banks' ultra-low-rate policies and continue to be so despite the current bout of high inflation

While Europe's economies will likely see a mild recession or at best stagnation this year, it will probably be less severe than anticipated, unless energy prices take a turn for the worse. Net new bank lending should remain positive, as it was through 2022. Loan-loss provisions will rise across the board but from historically low levels and not so aggressively as to clobber profitability and threaten capital levels. Equally, I have no concerns about bank liquidity, which remains reassuringly high despite a gradual decline in deposit liabilities.

I am less positive about investment banking, where in the current difficult markets and the lack of event-driven activity there will be winners but losers too among European banks. The investment-banking capacity of some of the large European players is excessive and will need to be geared down, in some cases significantly, due to lack of profitable opportunities and to heightened competition.

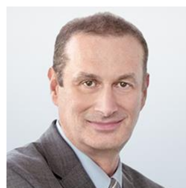
The EBA is launching its 2023 stress-test exercise this month; results are scheduled to be published in July. I expect the results to be encouraging for the sector and not to cause material market concern, as

all prudential metrics on balance remain comfortably stable.

Investors, analysts and rating agencies are generally positive about European banks, despite unsettling geopolitical and market uncertainties. Fears of another banking crisis, which prevailed through the pandemic years, have evaporated. Vigorous debt issuance from European national champions in the first few days of 2023, including in senior non-preferred, Tier 2 and AT1 formats has come at reasonable levels, evidencing positive market sentiment.

References to resolution are absent from the market dialogue. Which is understandable, as I see the sector as remote from a resolution scenario as at any time since the framework came into effect a decade ago.

Analyst



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