European banks through 2030: more vigorous with digital; more rigorous with risk

Sam Theodore | March 2024

The future for European banks looks unmistakably digital and AI-driven. Platform economies are emerging and the blurring of cyberspace borders between financial and non-financial businesses is set to further disrupt incumbent banks' legacy silo structures.

Technology-driven banking and financial services are shifting from being product-centric to becoming customer-centric. Banks will need to adjust their business models because just digitalising legacy business models will not do.

This also means that cyber risk will continue to grow. AI should help detect and defend against it, but the same AI can be used for nefarious purposes by cyber criminals and fraudsters, as well as other rogue actors like hostile states.

On a different front, I do not believe transformational cross-border mergers among legacy banks will take place, even within the euro area (EA), as the economics will not support such transactions. The emergence of a European cross-border megabank "to rule them all" is not in the cards. Nor does it need to be. In fact, using open banking and finance digital platforms may be a better way to succeed in pan-European banking and financial services.

I also believe that with the development of AI and other technology tools to estimate and manage credit risk – complemented by effective supervision – the likelihood of material asset-quality shocks like previous ones is decreasing for banks.

More advanced risk-control technologies, past institutional memories, and more vigorous supervision are convincing banks' top managers and directors that in the end high risk does not pay.

However, an overall threat to the system can exist, as private credit outside of the heavily supervised banking system is growing in aggregate (although European aggregates are massively dwarfed by US aggregates). To increase leverage and thus boost profitability, private credit funds often use bank financing, which can create material contingent risk overall.

This report highlights the following key themes:

- The good and bad of digitalisation and AI as dominant change drivers for the sector
- High bank intermediation will persist through the rest of the decade
- How pan-European banking and finance will be achieved: not via cross-border M&A
- Material bank asset-quality shocks less likely

The new banking paradigm in the digital age

I believe that the digitalisation/AI paradigm shift will have to be the dominant driver of change for the rest of the decade. Thanks to the tech revolution capturing the financial landscape but also to forward-looking European regulations aiming to ease financial actors into the new ecosystem for the benefit of households and businesses, and to preserve financial stability.

From a regulatory angle even if not necessarily from a technological angle, Europe looks better equipped for the financial sector's digital transition than other regions. The danger, of course, is that excessive regulation putting the cart before the horses can kill the golden goose.

The Revised Payments Directive (PSD2), launched in 2015 and in effect since 2018 has made open banking possible for the first time. Its successor, PSD3, will adapt the framework to the digital age and will include open finance. For the first time, banks and non-banks alike, licensed and supervised as payment service providers (PSPs), can provide payment services to households and businesses and, with the customers' agreement, access their financial information to enable the provision of competitive products and services.

It is a new world for banks and bank customers and one that will increasingly define bank relationships. Open banking is more advanced in the UK, where regulators have chosen early on a standardised approach that creates less uncertainty. But it will increasingly take hold elsewhere in Europe as rules become clearer and technology allows better integration of payments and financial-services digital platforms, such as the case of open-banking application programming interfaces (APIs).

The payments business is in most cases the entry point for fintechs looking to penetrate the financial sector. Large payment platforms have been operating successfully for more than a decade in some instances and have been able to take a significant share of the segment – and the attached revenues – from banks.

New EU regulations like mandating low-cost instant payments for all (SCT Inst) should make the sector more competitive, while pressuring related revenues. In such circumstances, having reliable and scalable technology that makes a bank a low-cost operator for the long run can be a crucial competitive factor.

Many banks are busy building partnerships with payment platforms to stay in the game and keep the customer relationship. There are multiple examples. On 20 March, Credit Agricole announced a 50-50 joint venture with Worldline, the large French payment processing company. The latter is also involved in the European Payments Initiative (EPI), together with 15 large European banks.

EPI plans to launch a digital wallet in the summer to compete with non-European providers like ApplePay, GooglePay, and SamsungPay. The extent to which this initiative will ultimately be successful is not clear to me at this time. Top technological reliability and customer trust rule cyberspace, whether the system happens to be genuinely European or not.

Tokenisation of payments is another trend that will very likely catch on in Europe, as blockchain technology evolves and is adopted on a more industrial scale. This is something welcome by both consumers and merchants (as some surveys show), as it will provide enhanced security – a perennial topic of concern for everybody. Indeed, through tokenisation, sensitive data related to the customer and to the transaction is converted into non-sensitive tokens (a randomly generated set of numbers and letters) that can be used in place of the original data.

The growth of embedded finance (EmFi) – the ability to integrate financial products into non-financial environments – and banking-as-a-service (BaaS) are equally important developments. In fact, both terms define roughly the same concept; the former with a broader scope than the latter. EmFi and BaaS can establish more direct and stable links between banks and commerce than open banking. No bank in Europe will be able to ignore that, lest it risks seeing customers walk. Being an attractive partner for EmFi and BaaS should grow as a major competitive factor for banks.

Many banks are not ready for it on their own, lacking the right infrastructure and know-how so are partnering with, or buying specialised fintechs, to get themselves into shape.

One critical area for banks is the future of deposit funding. Concerns have been expressed about central bank digital currencies unfairly competing with bank deposits. In my previous The Wide Angle report, I explained why this should not be the case. If anything, the existence of digital fiat money like CBDC should crowd out the more worrying (at least for banks) inflows of stablecoins – US-originated private crypto money used not only as store of value but also as means of exchange.

Besides, it is possible that at some point banks will be able to start using deposit tokens –transferable tokens issued on a blockchain by a bank which count as a deposit claim against it. Deposit tokens would be covered by deposit insurance schemes with conditions like offline deposits. A banking system in which CBDCs and deposit tokens coexist, supported by strict regulations of crypto assets via the recent Markets in Crypto Assets Regulation (MiCAR), will make it more difficult for less regulated decentralised finance (DeFi) activities to be successful in Europe the way they might be in the US.

An earlier The Wide Angle report highlighted some of the advantages for banks of using AI for both front-end operations – customer chatbots, advisory etc. – and back-office processes. An AI-driven increase in productivity will be a *sine qua non* in retail and SME banking, as the interest-rate peak is passing and increased competition and market pressure to lower fees will make non-interest income more difficult to generate. This will put pressure on top-line revenues, which leaves increased productivity as a key driver for bottom line strength. A sub-optimal approach to AI usage might push a bank out of the game.

For all actors participating in the financial sector, AI is now a must, not a nice-to-have.

High degree of bank intermediation to continue

Unlike in the US, the high degree of bank intermediation will not materially diminish in European credit markets through the end of the decade. On balance, the large banking groups, each in its own national market, will be able to satisfy the financing needs of businesses and individuals. The strategic importance of large banks in European countries cannot thus be over-emphasised, given the lack of a solid capital markets alternative.

This does not preclude more active consolidation among the smaller banks – including through incorporation into larger and more diversified counterparts. In fact it should stimulate it. I anticipate such consolidation will continue more vigorously through the decade, driven by revenue-generation challenges and the need to reduce costs.

Like it or not, large banks will continue to sit in the space between public utilities and profit-seeking private-sector institutions. In view of reassuring prudential metrics (capital, leverage, liquidity) and stable funding sources, there is sufficient 'dry powder' for loan growth should credit demand pick up further, even though banks like to complain about the severity of capital rules or other perceived threats like CBDC. The shareholder-pleasing share buybacks currently occurring across the sector also suggest unutilised spare capacity for growth, including in lending.

In part, I see banks remaining the main port of call for financing Europe's economies because a viable Capital Markets Union (CMU) is not about to kick in any time soon, despite the European Commission's increasingly targeted messages and despite a generally more optimistic tone in some top policymakers' public discourse (most recently by the French President). The forthcoming European Parliament elections this coming June will be an indicator. If populist-nationalist parties make visible headway – a distinct possibility – the direction of travel toward genuine pan-EU market integration could be more difficult to achieve at pace.

A recent report commissioned by the European Parliament suggests the adoption of a "twin peak" integrated supervisory architecture across the EU as an entry point for CMU. I remember such an approach was successfully adopted some 15 years ago in the UK (the Bank of England's Prudential Regulation Authority and the Financial Services Authority). This, however, could be a much higher mountain to climb in a union of 27 countries and with widely different levels of financial strength, political priorities, or financial-centre rivalries (e.g. Paris vs. Frankfurt), not to mention different legal and tax environments or cultures.

Securitisation in Europe is likely to remain substantially behind the volumes and diversity seen in the US. A more restrictive regulatory view in Europe, scarred by the bitter memory of the Global Financial Crisis partially imported from the US, is one reason. Another one is that in Europe, mortgages (the largest asset class for securitisation) will continue to be funded through banks' balance sheets and refinanced largely via covered bonds – the opposite of the large off-balance-sheet mortgage-securitisation market in the US. The different approach also holds true for sub-sovereign financing: in Europe bank lending is an important source for this, unlike the broad and deep tax-advantaged municipal bond market that exists in the US.

Achieving true pan-European banking (not via cross-border M&A)

I anticipate that 'national champions', the large banking groups dominating today's European scene, will continue to yield financial power, albeit, as suggested above, in a decidedly more digitised form. And most probably sharing it more with non-bank players from the ranks of fintech and plausibly big tech (assuming European regulators' doubts about the role of US big techs are not growing).

In a digital world, the economics of cross-border transformational mergers between groups with vast legacy structures will not work. Some regulators are openly encouraging this, hoping to see the emergence of mega-groups competing in size and global market power with US giants. But going ahead with massive transactions having a high degree of execution risk will take more than regulatory handwringing.

Large incumbent banks typically come with heavy baggage of IT system silos, often the result of prior mergers, and with potentially cumbersome operational legacy layers. Efficiency and economy of scale will be difficult to achieve at a time when competition is based on nimbleness, speed of service, and an optimally attractive quality-price mix.

The reality is that true cross-border banking in Europe, including the EA, hardly exists. Retail and SME banking remain mostly a national affair. Those banks that in the past (mostly before the GFC) engaged in transformational cross-border M&A realised this long ago.

But in the digital age there is another, more achievable way to pursue cross-border banking and finance, and I anticipate that this route will be increasingly taken. Open banking, being active on digital platforms with payments and other financial services and products can in time drive banks – but also non-bank competitors – to access customers beyond their national borders.

The more open banking and the embedding of finance and commerce adopts common standards (in APIs for example) the better this process can expand and be successful. Naturally, this is a process that can work both ways for banks – there are new customers to gain but also old customers to lose – but the overall pan-European market can gradually build up.

In other words, a smart incumbent bank can have the best of both worlds – operating in a platform economy to broaden its footprint and, for as long as necessary, accompany its own customers via its own online and offline channels. In this respect, I do not believe that branch banking will totally disappear anytime soon, if at all. The role of branches is changing, however, from aiding with routine operations to providing value-added services. Again, with increased productivity and customer quality helped by AI.

Material asset-quality shocks less likely

Banks have increasingly used machine learning and more recently AI to assess the credit risk of loan and investment portfolios and to detect negative trends at an earlier stage. This process will undoubtedly improve substantially as AI becomes more widely utilised and as it performs better. The result is that unexpected and supposedly unpredictable asset-quality shocks will be less likely.

Those who lived through the major European bank asset-quality crisis of more than 30 years ago, at the onset of deregulation (on the heels of the US S&L meltdown in the late 1980s) will remember that loan portfolios imploded with very little prior visibility. That was to some extent because the technology to anticipate negative trends hardly existed.

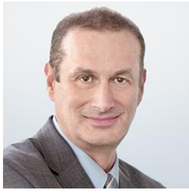
Poor supervision did not help, and neither did the opaque accounting rules of that period. Fifteen years later, the asset-quality deterioration during and after the GFC was less of a surprise, and in fact some banks using more performing credit-risk assessment frameworks (with the technology of the time) were able to protect themselves better than others.

Since then, the technology and the science of credit-risk anticipation have evolved substantially, including in the Basel 3 framework. New enhanced regulations have forced banks to tighten their credit underwriting criteria. The loan cohorts entering banks' balance sheets in the saner post-GFC period are on balance more diversified, better collateralised, and not least monitored more accurately.

This does not mean that bank asset-quality shocks will not exist in the future; it only means that their likelihood, amplitude, and systemic ripple effects will be less devastating. A case in point is European banks' commercial real estate exposures, many of which are deteriorating, especially in office space. For sure, some specialised real-estate lenders are under pressure, partly due to lack of diversification, and their viability as independent entities may be debatable. But CRE is far from triggering anything resembling a true crisis for the larger and more diversified European banking groups.

On the other hand, the growth of the private credit segment outside the boundaries of the heavily supervised banking sector can keep credit in play as a significant risk. To be sure, private credit aggregates in Europe – estimated at the equivalent of ca. EUR 460bn – are dwarfed massively by the USD 17trn aggregate in the US (which exceeds both the leveraged loan and the high-yield bond aggregates). To increase leverage and thus profitability, many large private credit funds use bank financing, which can indirectly pass some risk back to the banking sector. This is an aspect bank supervisors should and hopefully will be focusing on more forcefully.

Analyst



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