



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

## SSM thematic review on profitability and business models

Report on the outcome of the  
assessment

BANKENTOEZICHT

September 2018

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# 1 Executive summary

## 1.1 SSM priority and objectives

In 2016 European banking supervision launched a thematic review in order to assess in more depth the profitability drivers and business models of the significant institutions (SIs)<sup>1</sup>. This has been a key priority for European banking supervision, especially due to the challenges that banks in the euro area are facing, triggering the need to review their business models. These challenges include, among others, low profitability and pressure on revenues from the economic environment, the low level of interest rates and high competition; elevated levels of non-performing loans (NPLs) and the need to clean up balance sheets; digitalisation and new competitors (fintech and big tech companies); tougher regulation and the need to adapt to it; etc.

This thematic review had the following objectives:

- to provide tools and methodologies to facilitate consistent business model analysis at firm level by the Joint Supervisory Teams (JSTs);
- to assess banks' ability to steer strategically their business models;
- to monitor the consequences of weak profitability for banks' risk-taking behaviour; and
- to enrich horizontal analysis by integrating JSTs' insights in a consistent way across banks.

The thematic review mainly took on a micro perspective, with the bank-specific analysis being the main pillar and adding value to the exercise.

## 1.2 Process

The thematic review timeline extended from 2016 to the first quarter of 2018. During the first year the work focused on preparing a toolkit to assess individual banks' profitability and business models, mainly made up of data sources (e.g. the profitability forecast exercise) and tools that use supervisory regulatory data which are available to JSTs on an ongoing basis. In addition, detailed guidance was developed for the assessment of the quality of a bank's profitability steering process and inherent strengths/weaknesses in business models, ensuring that all JSTs were applying the same criteria and covering the same aspects in their assessments. Moreover, this guidance remains available and can be used by JSTs for further analysis, on-site inspections or deep dives.

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<sup>1</sup> Some SIs were excluded from the scope of the thematic review due to their specific circumstances.

During 2017 the JSTs engaged with the banks and carried out the profitability analysis at firm level which included direct interactions in order to screen different aspects of their business model, ranging from banks' core capacity to generate revenues to their ability to understand and steer their activities and implement their chosen strategy. When the individual assessments were finalised (by the end of September 2017), a horizontal review to ensure the consistency and homogeneity of the applied criteria was performed.

At the beginning of 2018 the JSTs engaged in a supervisory dialogue with banks:

- by the beginning of February, deficiencies in steering processes as well as qualitative observations resulting from the business model and financial plan analysis were brought to the banks' attention via dedicated meetings;
- by the end of April, the key conclusions and recommendations on process deficiencies were communicated to SIs in follow-up letters, including risk-mitigation programmes (RMPs) where appropriate. Regarding the next steps, the results of the thematic review will feed into the 2018 Supervisory Review and Evaluation Process (SREP) and might also trigger on-site missions and deep dives where further analysis is required. In addition, throughout 2018 and 2019 the JSTs will follow up on the RMPs.

## 1.3 Main conclusions

The main conclusions and identified high-level results were as follows.

**Profitability and business models remain under pressure.** Euro area SIs' profits are still lagging behind: SIs' aggregate profitability in terms of the weighted average return on equity (RoE) and return on assets (RoA) was 6.3% and 0.41% respectively in 2017. SIs' profitability is being challenged by high impairments, legacy issues and pressure on revenues from the economic environment, low interest rates and high competition. On the one hand, net interest income, which represents 57% of SIs' operating income, has declined for half the SIs over the last three years, with little room for manoeuvre in terms of reducing the cost of funding going forward. On the other hand, NPL stocks are decreasing in most countries; nevertheless, the current aggregate level of NPLs remains far too high by international standards. Litigation costs have not totally abated and heavy cost structures inherited from the previous expansionary cycle persist despite significant shrinkage: there are still 40 or more branches per 100,000 inhabitants in many countries and more than 400 employees per 100,000 inhabitants in most. Consolidation has taken place within many euro area countries over the last decade, but some markets remain fragmented. Furthermore, with regard to non-bank competition, the impact of fintechs remains to be seen, as for banks they may represent an opportunity (e.g. partnerships to target growth initiatives) or a threat (e.g. increased competition).

It is not expected that the euro area banking system will return to pre-crisis RoE levels due to changes in the environment, risk profile and capitalisation. However, banks still need to earn an appropriate return on their capital to be sustainable.

**The profitability situation differs widely across institutions.** Banks that have outperformed the others over the last years are geographically spread out and have differing business models. For some banks, the key was being more cost-efficient, while others managed to generate significantly higher revenues (relative to their total assets) than their peers. Costs are not a decisive factor alone: while banks that reduced staff have certainly decreased expenses, they seemingly have not been able to maintain income levels.

**Insufficient strategic steering of profitability may exacerbate banks' challenges and is being closely monitored by JSTs.** Strategic steering refers to the management's ability to set a course towards the bank's long-term objectives; it comprises things such as efficient processes and good governance. Banks that performed best over the last years seem to have on average better strategic steering capabilities, while in general SIs need to make improvements in these areas, such as the following:

- **Income:** understanding of the detailed drivers of increases or decreases in income across business lines or geographical areas, and detailed and effective scenario analysis.
- **Cost:** breakdown of costs by business line or distribution channel, allocation of costs to business areas or to the lowest level possible, and quality of cost-reduction programmes.
- **Loan pricing:** a comprehensive pricing framework should be applied consistently across the banking group; this should include an awareness of the minimum level of pricing needed to cover all costs and risks ("pricing floor"), the use of pricing model output as an input in pricing decisions and monitoring of exceptions.
- **Strategy:** involvement of the risk management function in the formulation of the strategy, the interlinkage with the risk appetite framework or the Internal Capital Adequacy Assessment Process (ICAAP), the scope and granularity of the key performance indicators into which the strategy is translated or the development of detailed scenario and sensitivity analysis. These deficiencies may impair the banks' ability to critically evaluate the risk/reward balance of their strategy, to understand the drivers of their profits, to analyse the downside risks and to define mitigating measures should the risk materialise.

**Banks' responses to profitability challenges vary.** Looking across the SI universe, there is no one-size-fits-all approach to profitability as even strategies among the best-performing banks have largely differed with regard to costs and income.

Going forward, banks' overall strategies largely reflect their current state of profitability: weaker banks are trying to reduce their costs and NPLs, while better performers tend to focus on growth.

In practice, this includes a number of different approaches, ranging from increasing lending volumes to focusing on fee and commission-generating businesses and/or

cost optimisation. The international business will be a special focus, as banks plan to grow roughly twice as fast internationally as domestically.

Digitalisation is a stated strategic priority for most banks. They not only need to react to the new environment to satisfy customers' needs, but should also adequately address the transition towards digitalisation in their internal systems and processes. However, the pace of IT development varies. IT budgets have grown by more than 20% over the last five years. However, it is difficult to assess what share of this spending on IT helps banks prepare for the future given the significant issues many banks are facing with their legacy systems. With regard to fintech, a number of banks are investing in or entering into partnerships with these companies. On the other hand, a range of industrial and tech companies are straying into the field of finance. At the moment, this is mostly based on payments, but these companies could go further and start offering loans in order to optimise the customer experience. Given their customer base, technological knowledge and financial capacities, these players could significantly disrupt the world of banking.

**The supervisory focus is tailored to the specific issues each bank faces.** Many banks are now planning to grow and they need to make well-informed decisions about risk-taking and make sure their strategic steering capability is commensurate with the risk of their activities. Banks that are planning to cut costs need to ensure that essential risk management and controls are not affected, that they maintain their franchise and that they keep up the necessary investments (e.g. in IT) to be able to achieve their business goals in the long run. The majority of JSTs have identified certain increases of risk stemming from banks' strategies. JSTs are challenging banks – e.g. where their plans are based on unrealistic assumptions – and paying close attention to the impact of the strategies on the SIs' risk profile or the credibility of their regulatory capital projections, as signs of pressure to reach for yield and changes in funding structure are starting to emerge.

## 2 Background: objectives and outputs of the thematic review

**Due to the challenges posed by a continuing low profitability of significant institutions, in 2016 the SSM launched a thematic review of profitability and business models.** The profitability of SIs as measured by RoE has been relatively low compared with international peers and many SIs may not earn their cost of capital. When considering profitability from an RoA perspective, the trend is similar (see Chart 3). For example, the majority of the stocks of listed SIs trade at a price-to-book ratio below par, showing that current and expected returns do not always meet investors' expectations. The risk of this situation is twofold: on the one hand, banks may not have the ability to generate additional capital; on the other hand, banks may increase their risk exposure in order to generate higher profits. Against this backdrop, the SSM thematic review had four objectives:

- to provide tools and methodologies to facilitate consistent business model analysis at the firm level by the JSTs;
- to assess banks' ability to mitigate weaknesses in their business models;
- to monitor the consequences of weak profitability on banks' risk-taking behaviour; and
- to enrich horizontal analysis by integrating JSTs' insights in a consistent way across banks.

The analysis included the assessment of the following areas:

- sustainability of net income (interest income, fees and commissions, trading income, operational costs and cost of risk);
- banks' framework to steer profitability (including the cost analysis and cost allocation, the loan pricing and the funds transfer pricing framework); and
- banks' strategic aspects, including, among others, the following aspects: governance, process robustness, the feasibility and consistency of the strategy, as well as potential impacts of the strategy on the risk profile.

**During 2017 the JSTs engaged with the banks and carried out the profitability analysis at firm level of the aforementioned areas.**

**At the beginning of 2018 the JSTs engaged in a dialogue with banks, communicating the findings and main conclusions of the thematic review.**

Process deficiencies as well as the challenging of the business plans were brought to the banks' attention via a supervisory dialogue and also follow-up letters on process deficiencies. The findings from the individual firm-level analysis feed into Element 1 of the SREP 2018 cycle.

**This report summarises the findings of the thematic review.** Chapter 3 provides an overview of the profitability situation and challenges of the SIs. Chapter 4 summarises the deficiencies identified in the analysis of individual banks. Chapter 5 discusses how banks are reacting to their profitability challenges and states what the supervisor's view is.



### 3 Profitability and business models remain under pressure

**While US banks managed a faster recovery after the crisis, SSM banks are still adjusting.** After the financial shock in 2007-08 US banks quickly cleaned up their balance sheets and built up capital with support by the state, benefited from relatively strong economic growth, increased assets and managed to achieve pre-crisis profits by 2013 (see Chart 1). By contrast, the recovery of euro area SIs' profits still has some way to go. Since the crisis, SSM SIs have slightly reduced their size and, despite a recent recovery, aggregate profits still only accounted for three-quarters of pre-crisis levels in 2017 (see Chart 1). Although it is not expected that the euro area banking system will return to pre-crisis RoE levels, SIs' aggregate profitability in terms of RoE averaged 6% in 2017, which is less than half of aggregate profitability levels before the crisis in 2006. Similarly, in terms of RoA, profitability averaged 0.4% in 2017, compared with 0.6% in 2006.

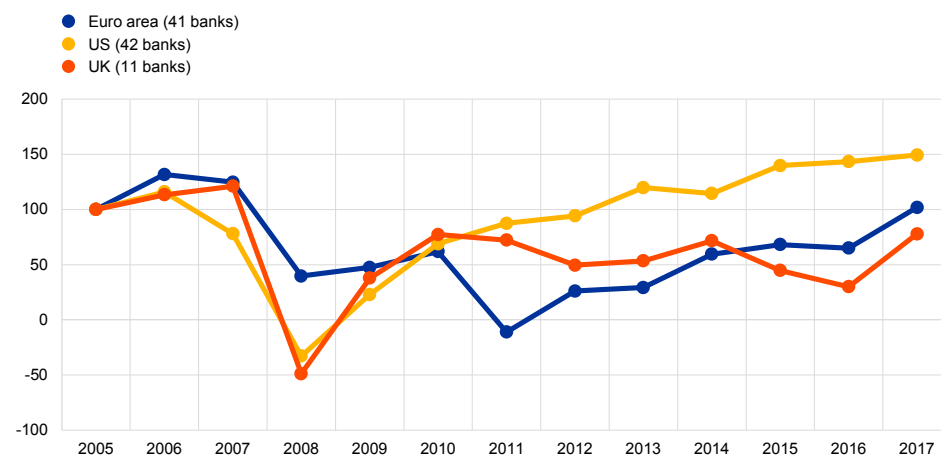
**Euro area banks' profits are still lagging behind: one of the causes is high impairments and legacy issues.** NPL stocks are decreasing in most countries; nevertheless, the current aggregate level of NPLs remains far too high by international standards. Euro area banks' total assets are still below the level of 2008, driven by balance sheet clean-ups and a contraction in total assets. Litigation costs have not totally abated and heavy cost structures inherited from the previous expansionary cycle persist despite significant shrinkage; for instance, there are 40 or more branches per 100,000 inhabitants in many countries and more than 400 employees per 100,000 inhabitants in most.

The macroeconomic environment characterised by low interest rates, highly heterogeneous labour markets in the euro area and an uneven expansion has left its mark on banks' business models. The accommodative monetary policy eased the pressure on the cost of risk and supported loan growth, but also contributed to a squeeze of net interest margins. Net interest income has declined only modestly over the last years for the whole SI universe, as loan growth compensated for most of the margin compression. Loans to households and non-financial corporates have grown by a cumulative 6% between 2014 and 2017 compared with annual GDP growth rates of 1-2%. The aggregate trend however hides a substantial bifurcation: over the last three years net interest income has declined for half the SIs, but has actually increased for the other half. From a business model perspective, retail lenders in particular have suffered significant falls in net interest income over the last three years.

## Chart 1

### Evolution of aggregate profits by jurisdiction

(evolution of aggregate profits before taxes, index: 2005 = 100)



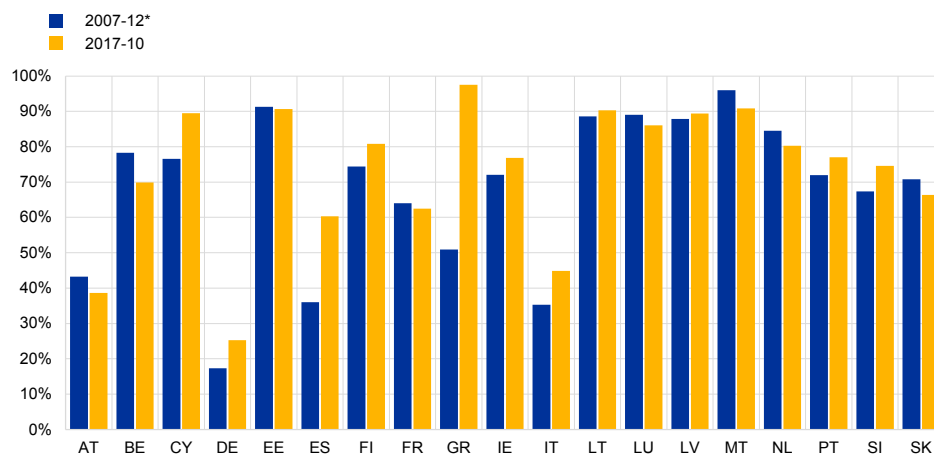
Sources: SNL and ECB calculations.

**The competitive environment is also putting pressure on revenues.** Over the last decade consolidation has taken place within many euro area retail markets, especially in countries more affected by the financial crisis. However, some markets, in particular Austria, Germany and Italy, remain fragmented (see Chart 2). With regard to non-bank competition, the impact of fintechs remains to be seen, and big tech players could enter the market and alter the landscape. Moreover, the revised Payment Services Directive (PSD2) may provide a catalyst for increased competition from fintechs and big tech players. A number of SIs are already actively pursuing partnerships with Fintechs. Here, fintechs represent an opportunity but they could also be a threat if they compete independently. On the other hand, a range of industrial and tech companies are straying into the field of finance. At the moment, this is mostly based on payments, but it is easy to imagine how these service operators could go further and start offering loans in order to optimise the customer experience. Given their customer base, technological knowledge and solvency, these players could significantly disrupt the world of banking.

## Chart 2

### Evolution of deposit market share of the top 5 institutions by country

#### Deposits from households – evolution of top 5 banks' domestic shares



Source: ECB Statistical Data Warehouse.

Notes: The sample includes 91 banks. Please note that the market shares only reflect data submitted on an individual basis to the ECB's Statistical Data Warehouse. In some cases, institutions might therefore be omitted from these charts and they should not be understood as a complete ranking by size. In particular, the market shares do not consider the full group operations of banking associations, but only those of banking subsidiaries within the group on an aggregated basis.

\*Blue bars represent a different year (shown in brackets) for the following countries: CY (2008), EE (2011), FR (2010), LT (2015), LV (2014), MT (2010), SK (2009), NL (2010).

**However, the profitability situation differs widely across institutions and within business models.** Not all SIs are affected to the same extent as the evolution of banks' core banking revenues differs substantially: for instance 27 out of 90 SIs managed to increase both net interest income and net fee and commission income in the last three years, while 6 of the 90 SIs managed to raise core banking revenues by substituting net interest income with fee and commission income. Yet, the remaining majority could not compensate for decreasing income from lending activities with other sources of income. At the business model level, G-SIBs (global systemically important banks) and universal banks raised their profit-generation capacity over the last three years by boosting net fee and commission income, along with significant cost-efficiency improvements. By contrast, diversified and retail lenders' higher revenues from fee and commission business did not suffice to compensate for their large decline in net interest income over the last three years.

**In spite of a challenging business environment, 22 significant institutions from 12 countries have consistently outperformed their peers over the last three years.** These 22 SIs achieved an average RoE of 6-15% over the last three years; weighted by total assets, this sample even achieved an average RoE above 8% over the same time period. Similarly, they overall reached an RoA which was 20-25 basis points higher than the SSM average (see Chart 3). While euro area banks spend on average 65 cents in order to earn one euro, the 22 top-performing banks managed to spend only 58 cents on average. For some this was due to being very cost-efficient, while others managed to generate significantly higher revenues (relative to their total assets) than their peers. These banks are diverse in terms of size, business model and country of origin. This emphasizes that each bank needs to find its optimal trade-off and that it is feasible to be profitable even in challenging macroeconomic conditions regardless of a bank's business model.

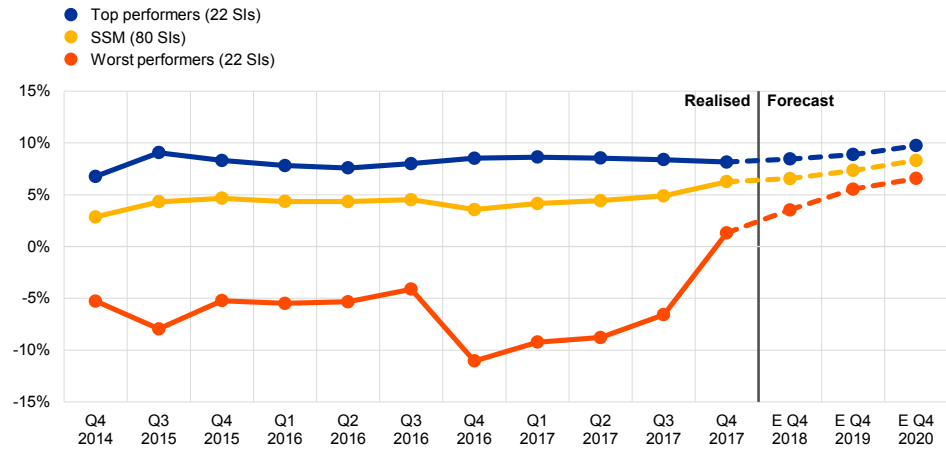
**Costs are not a decisive factor alone: whilst reducing costs, banks need to make sure that they maintain their franchise and keep up the necessary investments (e.g. in IT) to be able to achieve their business goals in the long run.** Cost-cutting could positively impact profitability. However, the cost-to-income ratio seems to be more driven by income than by costs. So while banks that reduced staff have certainly decreased expenses, they seemingly have not been able to maintain income levels. This shows that banks should carefully make changes to their business model rather than engage in hasty cost-cutting.

**It is not expected that the euro Area banking system will return to pre-crisis RoE levels due to changes in the environment, risk profile and capitalisation. However, banks still need to earn** an appropriate return on their capital to be sustainable. RoE levels and targets have in part been pushed down by increased equity, de-risking and regulatory regime change. In addition, a lower general equity risk premium and lower nominal interest rates have probably decreased the banks' cost of equity. Also, pre-crisis RoE levels in some cases may have been inflated by excessive risk-taking and leverage. Going forward, SSM SIs as a whole forecast the current RoE of 6% to increase to 8% by 2020, although in some cases this may include overly optimistic projections. Nonetheless, the average short-term projection for 2017 shown in Chart 3 has been met. Despite the expected recovery, target levels are significantly below pre-crisis profitability. Yet, a factor of the downward revision is an increase in equity, implying an improvement in SIs' resilience. Nonetheless, many banks do not seem to earn their cost of capital yet. For example, the vast majority of listed SIs trade at price-to-book ratios below one, implying that investors are not satisfied with current or expected returns.

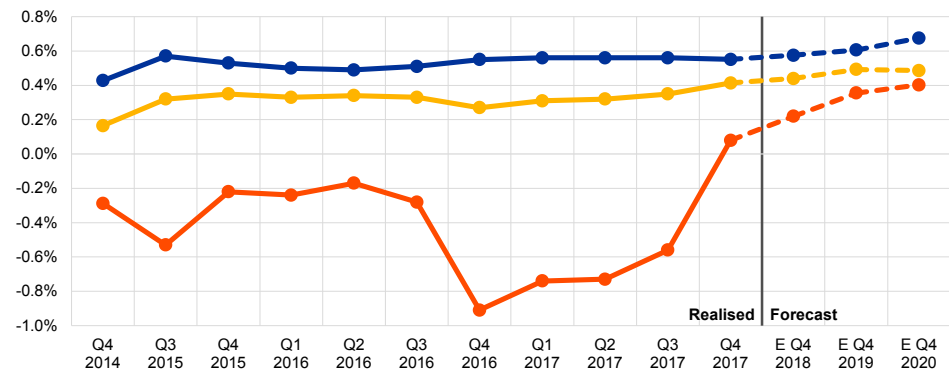
**Chart 3**

Three-year evolution of return on equity and return on assets

**Evolution of RoE**



**Evolution of RoA**



Sources: FINREP and profitability forecast exercise.

Notes: All samples exclude subsidiaries of non-SSM banks; Top performers: 22 SIs with average RoE ≥ 6% over the last 3 years; worst performers: 22 SIs with a negative average RoE over the last three years.

## 4 Insufficient strategic steering of profitability may exacerbate banks' challenges and is being closely monitored by JSTs

### 4.1 The review identified or confirmed various issues related to strategic steering capabilities across institutions

**The firm-level analysis included a comprehensive review of the institutions' internal set-up to steer profitability (“strategic steering capabilities”).** This covers the management's ability to set a course towards the bank's long-term objectives and includes governance and processes around income and cost drivers, loan pricing and strategy. The analysis was structured across several areas: net interest income (NII), net fee and commission income (NFCI), net trading income (NTI), operational costs, loan pricing and strategy. For each area, JSTs analysed and assessed key dimensions of how well a bank understands the details of the particular element, its external drivers and historical and future developments. For example, for net interest income JSTs assessed to what extent a bank can break down its income into volumes and margins, distinguish between commercial and asset/liability management (ALM) income generation and assess the contribution of each business or country. They also covered to what extent best practices are embedded in the organisation holistically and consistently. For example, for loan pricing, JSTs assessed to what extent a bank understands which loans are profitable and how it grants and monitors exceptions.

**For net interest income, net fee and commission income and net trading income, detailed and effective sensitivity and scenario analysis should be implemented at banks.** In addition, the supervisory expectation is that banks should analyse in detail the drivers of net interest income evolution across business lines or geographical areas, e.g. in terms of volumes, margins or products. The assessment took into account the findings from the 2017 IRRBB (interest rate risk in the banking book) sensitivity analysis and confirms that declining funding costs have contributed to almost sustaining net interest income in the recent past, but that there is limited room for manoeuvre going forward. This stresses the need for an appropriate steering of the income sources. Furthermore, many banks on the one hand assess their fee and commission income as mostly stable, but on the other hand plan to grow significantly in this area. These growth plans often lacked a detailed analysis of the external factors that could impact the projections.

**The analysis of the cost structure and operational costs has shown that some banks can improve their understanding of their cost structure, the cost allocation and the implementation of cost-reduction programmes.** This area was assessed by all JSTs and, in general terms, SSM banks have a clear and fairly

granular view of both aspects, with adequate management and control processes around them (budget, monitoring of deviations, corrective actions, etc.). However, three areas have room for improvement: (i) a further breakdown of profitability would be needed, as many banks do not adequately provide cost information per business line or distribution channel; (ii) not all costs are allocated to the business areas or to the lowest level possible and/or there are significant unallocated costs in the corporate centre; and (iii) cost-cutting programmes need to factor in execution risk, the impact on the control environment and income generation. Addressing these areas should result in better-informed decisions at business line level.

**Loan pricing was identified as an area that overall needs enhancement: most banks need to develop a more comprehensive pricing framework and apply it consistently across the organisation; this includes an understanding of minimum floors for pricing decisions.** Specifically, JSTs assessed the pricing process to ensure that all key components were considered in the “minimum pricing threshold”<sup>2</sup> and that exceptions were monitored systematically. Deficiencies in this framework impede the institution’s ability to evaluate the pricing decisions it is taking, its understanding of the impact this has on profitability and whether the expected profitability is in line with its strategic objectives. However, in many institutions the loan pricing framework is not sufficiently well developed or is only applied for certain business lines. For corporate loans, the pricing frameworks are generally more developed as larger loans tend to be priced on a case-by-case basis. Many banks have not defined this minimum threshold or it is not enforced and exceptions are not monitored. Some banks follow the market in their pricing decisions without comprehensive ex-ante profitability analysis.

**Issues related to governance and strategic planning processes have also been identified.** In most of the cases, the strategy is approved by the management body and reviewed for possible changes at least annually, and one-year forecasts submitted to the SSM have so far been broadly met. However, many banks need to reinforce the process involved in challenging the assumptions underlying their strategy and medium-term goals at the board level. For instance, for only half of the banks the risk management function is significantly involved in the formulation of the strategy, while for one-third it is not evident how the strategic targets are calibrated to the risk appetite framework or the ICAAP. Banks would benefit from a more extensive use of sensitivity and scenario analysis, including downturn scenarios, in order to better understand the drivers of their results. Finally, even though the strategy is generally translated into targets for key performance indicators, the scope and granularity of those targets are not sufficient in a number of cases.

**All the issues identified are often exacerbated for banking groups with significant subsidiaries; these can operate independently and need appropriate oversight and control by the group.** As a precondition for this, the group must ensure it receives an adequate level of information on how subsidiaries

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<sup>2</sup> A comprehensive pricing model should include the following components: (i) funding costs; (ii) the credit risk premium; (iii) contribution to loan administration/operational costs d)capital charge.

operate, e.g. how they price loans. JSTs observed some cases where the planning of the subsidiaries was inconsistent with the overarching strategy of the group.

## 4.2 Banks with better strategic steering capabilities have generated higher returns over the last years

**Banks that performed best over the last years seem to have better strategic steering capabilities.** Banks that achieved the highest profitability in terms of RoE and RoA since the launch of the SSM in 2014 were assessed by the JSTs as, on average, having better strategic steering capabilities. For instance, these top-performing banks showed a greater effectiveness of their asset-liability management, their distribution channels, their overall pricing processes, their capacity to measure ex-ante and ex-post profitability individually and their capabilities to break down the cost structure – to name just a few. They also seem to be markedly better at cross-selling, a key area of planned growth for many banks.



## 5 Banks' responses to profitability challenges vary, and supervisory expectations along with them

### 5.1 Higher profitability situations reflect diverse strategies

**Looking across the SI universe, there is no one-size-fits-all approach to profitability as even strategies among the best-performing banks have largely differed with regard to costs and income.** The 22 SIs with the highest RoEs and RoAs follow different approaches to costs and income, enabling them to outperform peers over a horizon of three years. A first sub-group achieved high profitability by following a high-income strategy, which entailed relatively high costs that are more than compensated for by a very strong income-generation capacity. A second sub-group stands out its high cost-efficiency, where low costs make up for relatively meagre income. A third group lies in the middle managing to outperform other SIs by balancing a medium income generation capacity with medium to low operating expenses. This tends to confirm that banks have different levers at their disposal. In any case, given that outperformance could also be a sign of search for yield behaviour, JSTs remain vigilant with regards to the sustainability of profits in these SIs.

**Banks' overall strategies going forward strongly reflect their current state of profitability: weaker banks are trying to reduce their costs and NPLs, while better performers tend to focus on growth.** In the last three years the worst-performing banks' comparative disadvantage has primarily stemmed from significant impairment flows as a result of high levels of NPLs. Accordingly, for the future the currently unprofitable SIs plan to reduce costs and NPLs in order to boost profitability. They also plan to increase their capital in order to decrease their risk profile. On the other hand, many top RoE/RoA banks plan to leverage their currently strong position in order to grow in size and increase capital, while keeping a lid on operating costs. Finally, medium RoE/RoA banks tend to follow a growth and capitalisation strategy with both higher income and higher costs. In addition, numerous medium performers expect lower impairment flows.

**The differences in banks' high-level strategies are reflected in diverse action plans: from increasing lending volumes to focusing on fee-generating businesses and/or cost optimisation.** Roughly half of the top and medium performers plan to increase loan volumes, compared with only one-third of the bottom RoE/RoA banks. A smaller share of banks want to enter new markets, or diversify the sources of income or increase fee income through cross-selling and activities such as asset management, private banking or insurance. The share here is particularly low for the bottom RoE/RoA banks (6%) compared with the top and medium performers (18% and 15%, respectively). The international business will be a special focus for SIs that generally plan to grow, as banks plan to grow roughly

twice as fast internationally as domestically, which is consistent with the higher profitability achieved in those markets in the past. Beyond such customer-centric and income-focused strategies, some SIs are considering cost optimisation in the form of downsizing or digitalisation and outsourcing initiatives as well as improvements in credit risk management and measures to tackle impairments. From the bottom performers, every third bank plans to optimise its funding costs, compared with only 5% of the top RoE/RoA banks.

**Digitalisation is a stated strategic priority for banks – this transition also needs to include their internal systems and processes.** The vast majority of SIs have made digitalisation a strategic priority or are dealing with the topic at the boardroom level. However, the engagement varies widely, with G-SIBs and universal banks being the ones more at the forefront. Whilst almost all banks aim to offer online and app-based distribution channels to their customers, many are also following a more integrated approach and are actively pushing their digital transformation throughout the organisation. This not only pertains to the front-end, i.e. customer interfaces and user experiences, but also to their back-end systems and processes. The aim is to enable them to react more quickly to new developments. To a certain extent, this transformation is attested by IT budgets that have grown by more than 20% over the last five years. However, it is difficult to assess what share of this spending on IT helps banks prepare for the future given the significant issues many banks are addressing regarding their legacy systems.

## 5.2 The supervisory focus is tailored to the specific issues each bank faces

**JSTs are challenging banks if their plans are based on potentially optimistic assumptions that could negatively affect their profitability, capital generation or risk profile if they do not materialise.** JSTs deem execution risks as relevant for one-third of the banks. Of those, many do not seem to sufficiently factor in exogenous developments, such as regulatory changes, macroeconomic developments and competitive pressures. Nonetheless, the capital position of the most optimistic banks would show certain resilience overall if adjusted to the mean profit (and risk-weighted asset) growth. In any case, JSTs are following up by asking for plausible downturn scenarios around banks' baseline projections.

**Banks that are planning to grow need to make well-informed decisions about risk-taking and make sure their strategic steering capability is commensurate with the risk of their activities.** Going forward, banks' strategies imply certain increases in risk in the JSTs' view. Half of those relate to credit risk, in particular loosening credit standards on existing products, offering new products or entering new segments, increasing concentrations or aggressive loan pricing. Apart from that, JSTs cite operational risks from digitalisation, conduct-related vulnerabilities and the impact of cost optimisation on the capabilities of control functions as other relevant sources of risk arising from the banks' strategic decisions. This increase of risk in itself is not necessarily a concern if those banks have very good strategic steering capabilities and can properly assess the risks they are taking in relation to the

potential rewards. In this sense, the recommendations addressed to the banks as a result of the thematic review do not necessarily call into question a given strategy, but focus on ensuring that the necessary improvements in steering or risk management capabilities are put in place.

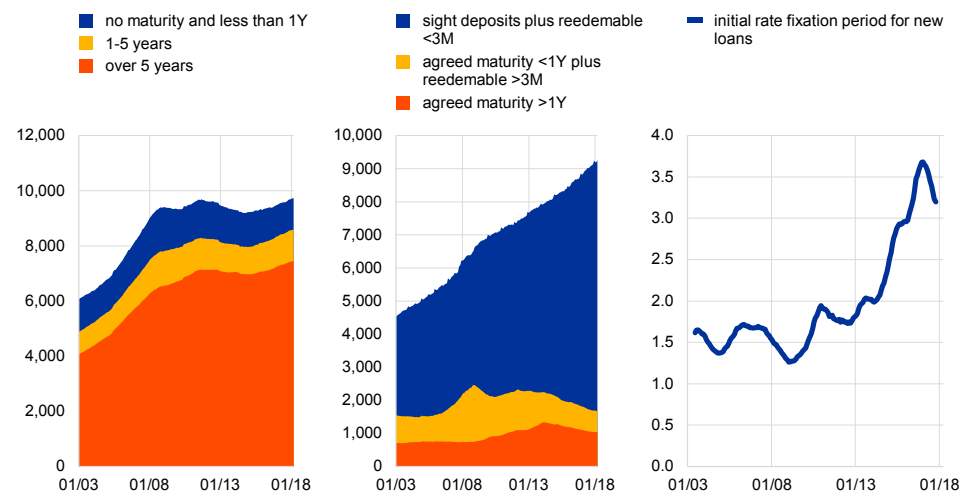
**JSTs are paying close attention to the impact of the strategies on the SIs' risk profile or the credibility of their regulatory capital projections, as signs of pressure to reach for yield and changes in funding structure are starting to emerge.** Due to the increased reliance on sight deposits, the stability of short-term funding could be compromised in a scenario of interest rate normalisation (see Chart 4). On the assets side, the share of loans with long maturities is increasing and rapid growth can be observed in certain products such as covenant-lite loans and consumer loans. JSTs are closely assessing the risk/reward balance in terms of the forward-looking sustainability of the profitability of SIs.

#### Chart 4

##### Composition of loans and deposits by maturity and initial rate fixation period

Evolution of loans by maturity (left panel), deposits by maturity (middle panel) and initial rate fixation period for new loans (right panel)

(EUR billions for the left and middle panels and years for the right panel)



Source: ECB MFI statistics.

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For specific terminology please refer to the [SSM glossary](#).

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