

# Digitalisation and Negative Interest Rates – Two Drivers for Change in the Financial Industry

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## What is the current state of European banks?

European banks have been in crisis mode since the global financial meltdown in 2007/2008. The price-to-book ratio serves as a good indicator of this. If the ratio is below 1, investors are not willing to pay a price that exceeds the available equity of a company. This is always the case when there is a broad consensus that the cost of equity cannot be earned permanently in the future.

Since 2008, European banks have been valued at a price-to-book ratio of less than 1. This crisis has been going on for 153 months and is thus by far the longest that any major industry has ever experienced. It has now lasted almost twice as long as the crisis in the mechanical engineering industry from 1982 to 1989, due to the recession in Europe and North America; and longer than the crises faced by the aerospace and defence industry from 1987 to 1993, or by the oil producers from 1980 to 1985. In addition, there have been two developments in recent years that have made it extremely difficult for banks to generate income: the ongoing problem of negative interest rates, and digital transformation.

## How do prolonged negative interest rates affect the traditional business models of banks?

Basically, this depends on the bank's strategic focus. There is no general answer to this question – not even for a specific business model. Let's look at retail banking for example. The consequences depend greatly on the preferences of a bank's customers. In Germany, for instance, low interest rates have an extremely delayed effect on traditional regional banks.

The reason for this is that long-term loans usually have a fixed interest rate and therefore provide an income and profit buffer. The very low customer interest rates only gradually replace the bank's existing business while refinancing, because of the short duration of liabilities, reacts very quickly and is getting cheaper. On the other hand, the low lending rates are also locked in for a very long period of time. Moreover, when there is a rise in interest rates, for instance, the interest on assets hardly changes, whereas refinancing becomes more expensive and net interest income declines. In Austria, where customers tend to prefer variable-rate loans,



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this lack of synchrony does not arise or is much less pronounced.

The current state – with negative interest rates across almost all maturity bands of the yield curve – is making the income situation of retail banks even worse compared with the low-interest phase outlined above. Strictly speaking, the banks should pass on the negative interest rates to their customers and charge custody fees on deposits. This is not happening to the full extent at the moment due to (business) policy and legal constraints. Thus, a floor has been established at a zero-interest rate on the liability side, while interest rates on the asset side are increasingly coming under pressure.

We have simulated the impact of the current interest rate situation on the profits of German regional banks.

**If there is no serious change in the interest rate situation in the next few years, the cumulative annual net profit of savings banks and cooperative banks, which is currently still around EUR 15 bn, will drop to zero by 2025 – unless measures are taken to prevent this development.**

But, in order to implement measures to close the profit gap, one or several parties have to make a sacrifice: either the competitors by losing market shares; the customers by paying higher prices (fees, custody charges, interest on loans) and having to travel longer distances to get to the next branch; the employees when jobs are cut; and/or the owners who receive lower distributions.

## **How does digital transformation tie in with these trends?**

Customer behaviour is changing: the most important aspect is that customers are carrying out their banking activities independently via apps. However, many of them are unwilling to do this completely without services and competent advice in their branch. In addition, every bank has to decide how to react to tech giants such as Amazon or Google or new innovative fintech companies. Ultimately, the company that wins the customer will be the winner in the inevitable digital transformation race.

For traditional (regional) banks the risks associated with digital transformation may seem to outweigh the benefits.

**However, especially when considering the challenges caused by prolonged negative interest rates, as outlined earlier, we are convinced that – with the right concept and consistent implementation – digitalisation can increase banks' income significantly and reduce costs at the same time.**

This also holds true for regional business models – and should therefore be seen as an opportunity by banks. To this end, it is crucial to put the focus clearly on the customer. This entails that banks consistently design their processes with the customer in mind and optimise existing procedures “end to end” – from the first contact with the customer in a business process to its conclusion. In addition, robotics and artificial intelligence can improve efficiency in many areas, while big data can

open new sources of income – as personal contact with the customer is getting less and less important.

Customer focus also entails that banks aim to increase the share of wallet considerably. Regardless of the customer segment, the majority of banks currently have a limited offer that only meets a fraction of their customers' needs. On average, traditional banks are able to capture only 40% of the potential total income, which is earned by all financial service providers with a certain customer - their competitors are the ones who generate the remaining income.

Another difficulty is that a significant portion of the current income is derived from the deposit business, in which regional banks traditionally have a strong basis. Considering the current interest rate situation, deposit margins will sooner or later become negative (if they aren't already) and therefore a burden – unless custody charges are introduced. Consequently, without additional sales efforts, share of wallet will decline in the coming years. Especially in regards to insurance brokerage, regional banks are only generating ~10% of the potential revenue from their customers. But there is also a considerable need to catch up in the securities business and in consumer loans.

## About zeb

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