The Future of Financial Services

The Future of Commercial/Universal Banks in Europe
## CONTENTS

1  Introduction

3  Executive Summary

5  Chapter 1: Framing the Discussion

11 Chapter 2: Three Different Scenarios

14 Chapter 3: Common Themes – “Givens” and “Uncertainties”

15 Chapter 4: So, What’s The Future for Europe’s Universal Banks?

19 Appendix: List of Participants
On September 30th the University of Chicago Booth School of Business (Chicago Booth) convened our second Future of Financial Services Initiative (FoFS) forum at our campus in London. In a group comprised of 40 senior bankers, leaders of newly established disrupter firms, regulators, academics and other thought leaders, we shared perspectives presented by the Bank of England and Chicago Booth on the Future of European universal banks.

The discussion was led by Randall S. Kroszner, Norman Bobins Professor of Economics at Chicago Booth and ex-governor of the US Federal Reserve System. Our partner was Andrew Haldane, Chief Economist of the Bank of England.

This second forum reinforced many of the views of the first with some interesting new views. The first forum examined the future of marketplace lending, the dominant part of the alternative finance industry. It was held in June 2016 after three years of rapid growth in transaction volumes, which in the main markets of the US, Asia-Pacific and the UK reached a total of $144bn in 2015. While the banking market varies from country to country, typically the biggest banks remain the dominant lenders.
The consensus view at the first forum – with support of 10:1 in a vote on different scenarios – was that alternative lenders would develop in parallel with the traditional banks. The two models would play complementary roles in the financial system, including sometimes working in partnership. Some challengers might be taken over by big banks and some might grow to become forces in their own right. You can access the first forum report on our website: https://www.chicagobooth.edu/future-of-financial-services.

The second forum echoed the view that the two models would be complementary. This would mean a diminished role for the universal banks in that they would no longer be THE single central players in the financial system. In their efforts to restore returns on equity, deal with onerous regulation and respond to the challenges from new entrants, they would refocus on their strongest lines of business. As legacy problems – fines, compensation, information technology – receded, the outlook for these more streamlined institutions would improve.

The Future of Financial Services Initiative is based in London, the world’s foremost international financial centre, and led by Chicago Booth, the world-renowned leader in research and business education. In a series of private and open forums, we investigate what the future might hold for the financial services industry and how market participants can prepare themselves to compete and add value. We offer new perspectives and generate thought leadership that we hope will have a broad impact on the future of finance and business. With the involvement of a range of influential partners and participants, we aim to play our part in improving their ability to compete and to improve the sector’s impact on society.

This is a critical time for financial services – the shock waves from the credit and debt crises of the last decade are still reverberating across the world’s financial centres – and London, in particular. The last 10 years and even the last few months have brought huge changes, sometimes seismic, in many factors affecting the industry, including:

- Attitudes of the Public
- Competition Dynamics
- Demand Demographics
- Disintermediation
- External Dislocations
- New Entrants
- Profitability and Volatility
- Regulation
- Technology
- Wealth Distribution

In future forums we aim to address questions such as how can financial services firms of the future hire, motivate and retain the best and brightest graduates in an increasingly competitive market for talent?

Renu Kulkarni  
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Chicago Booth

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Director  
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The first forum in Chicago Booth’s Future of Financial Services Initiative examined the future of marketplace lending, the dominant part of the alternative finance industry. It was held in June 2016 against a background of rapid growth in transaction volumes, which in the main markets of the US, Asia-Pacific and the UK reached a total of $144bn in 2015. However, this total is a fraction of the loan assets found on the balance sheet of any one of Europe’s large commercial – or universal – banks. Banks remain the largest source of corporate credit in the EU and are particularly important for small and medium-sized businesses, which have very limited access to bond markets. In 2015, when the EU launched its Capital Markets Union (CMU) project, it was estimated that 80% of corporate debt in Europe was in the form of bank lending, with just 20% coming from the corporate bond markets – almost the inverse of the proportions in the US. While the banking market varies from country to country, typically the biggest banks are the dominant lenders (See chart: "The Existing Architecture of Lending").

The consensus view at the first forum – with support of 10:1 in a vote on different scenarios – was that alternative lenders would develop in parallel with the traditional banks. The two models would play complementary roles in the financial system, including sometimes working in partnership. Some challengers might be taken over by big banks, some might grow to become forces in their own right. Thinking beyond “fintech”, the innovative approaches to analysing customer data of companies such as Google and Alibaba could lead them to become serious challengers.

The second forum, held on 30 September 2016, focused on the other end of the banking market: Europe’s big commercial banks, which encompass retail, corporate and investment banking. As these banks often have insurance and asset management arms as well, a more common term for this model is universal banking. The largest are classed by regulators as “systemically important financial institutions” (SIFIs) and those with global impact as G-SIFIs.

**Tough time for universal banks**

The discussion took place against a difficult background for Europe’s universal banks, as returns on equity (RoE) lagged behind cost of capital. Legacy issues such as fines, compensation and the need to overhaul IT systems were part of the problem. Another issue was the negative impact of low – or negative – interest rates. It was assumed that regulation would remain tougher for SIFIs than for alternative finance providers.

Universal banks were expected to respond to these issues, and to the fintech challenge, by refocusing on stronger lines of business. These more streamlined institutions would retain – for a while at least – some advantages gained through “sticky” insured deposits, soft information gleaned from customer relationships, and links to central banks in liquidity provision and
the transmission of monetary policy. Legacy issues would recede, helping to improve returns, and they would share in technological advances rather than lose their role because of them. But as alternative providers – and Europe’s capital markets – developed, these competitors would provide a “second engine” of growth and dilute the dominant role of banks.

**Challenge posed by alternative providers**

Some believe a revolution is under way through the democratisation of access to services, advances in data analytics and decentralisation. This is feeding the disintermediation of banking, for instance through marketplace lending and non-bank payment systems. Others point out that non-banks remain well short of critical mass in both traditional lending and disruptive technologies. For instance, developments in data collection and analytics face questions of privacy and quality, while distributed ledgers (the blockchain) will require common standards and protocols to gain traction.

Trust remains key and some challengers have suffered high-profile setbacks in 2016. Meanwhile, established banks have been investing heavily in information technology, although much of this has been absorbed by overhauls of legacy systems and separation of business units. Yet it is by no means a foregone conclusion that big banks cannot innovate.

**Regulation adds to the problems**

Since the financial crisis, Basel III (and now the so-called “Basel IV”) have multiplied capital requirements. This means that equity levels are much higher at a time when returns – especially in Europe – remain under pressure. Regulators have also had an impact on returns through fines and compensation payments, and central bank action has contributed to suppressed interest rates along the yield curve.

Regulators’ attitudes to competition have varied between countries because of risks to financial stability and consumer safety. However, UK regulators are expected to encourage competition, and those across Europe want enhanced access to capital markets to provide a “second engine of growth”.

**Business models streamlined**

The diversification premium enjoyed by universal banks pre-crisis has been reversed. This is related to a backlash against globalisation, a reassertion of national political interests and the regulatory response to the “too big to fail” criticism of banks. Many universal banks have already shed some business lines and reduced their geographic spread. The questions facing bank boards include: what is the optimum degree of bundling services together? And what economies of scale and scope still persist? With RoE never likely to return to pre-crisis levels, the key question is: what level will investors be content with?

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A vote was held after round-table discussions on three scenarios for the future of European universal banks:

- They remain THE central players in roughly their current form.
- They remain universal, and central to the system along with new entrants, but become more focused.
- They unbundle, under pressure from new competitors and regulators, and no longer remain THE central players.

Assuming a timeframe of 5-10 years, no-one believed that they would remain the central players to the exclusion of others. Nearly 30% voted for the other end of the spectrum – that they would be superseded. However, the most popular view was that they would remain universal, albeit more focused, and that they would share a central role in the financial system with others. This is aligned with the vote for parallel development and complementarity that emerged from the first forum. A significant minority saw a more radical unbundling of universal banks that would diminish their role more quickly.

The “parallel and complementary” view of developments in financial services also echoes a view in Europe that the financial system needs a “second engine”. Whether it be the EU’s plans for capital markets via the CMU or UK regulators’ mandate to encourage competition, relying on banks for the bulk of lending is not seen as sustainable or desirable.

**The future for Europe’s universal banks**

Europe’s universal banks have been at a low point in 2016. Capital requirements have continued to rise while returns remain under pressure. An optimistic view would see legacy regulatory costs receding, rationalisation benefits flowing through and economic growth providing a better business environment.

Nevertheless, banks have some way to go to match the nimbleness and customer friendliness of fintech companies, which benefit from lighter regulation. The parallel and complementary development of banks and their tech-based peers, as envisaged by the first two FoFS forums, suggests a blurring of the divide between conventional finance and new technology.
CHAPTER 1
Framing the Questions

Tough time for EU’s universal banks

The forum took place at the end of September 2016 amid a gloomy backdrop for European banks, with concerns about the balance sheet strength and poor profit performance of many universal banks. Returns were typically not covering the cost of equity, and market values remained below net asset (book) values, less than 50% for some in October 2016, according to YCharts, the financial data research platform. Legacy costs, in the form of fines, compensation and the need to overhaul information technology, remained high. The US Department of Justice’s demand for redress of $14bn from Deutsche Bank, for mis-selling of mortgage-backed securities, had recently been announced. Globally, about $300bn has been levied in fines and compensation since the financial crisis.

Several European banks were continuing to take losses as they wound down “non core” activities. The Basel Committee on Banking Supervision’s proposed revisions to risk-weightings, unofficially dubbed “Basel IV”, had caused dismay among banks using internal risk models to reduce the weightings. Greater use of the standardised approach, as proposed, could significantly increase capital requirements for large banks – prompting protests from EU finance ministers. And concern about the impact of a “lower for longer” interest rate environment had been intensified by negative interest rates, or charges for deposits, at some central banks.

Ways in which they remain special

Yet it was also pointed out that incumbent banks remained special in the following ways:

- Provision of liquidity, especially by deposit-taking banks in a stressed economic situation;
- The stability of “sticky” insured deposits, which may reduce credit losses in a crisis;
- Soft information about customers through account activity and branch networks: the distance between lender and borrower still matters;
- Some deposits lead to more lending, especially to opaque borrowers;
- Monetary policy: banks are still at the heart of the movement of credit through the system and the gathering of information by central banks; they are effectively central bank partners in money creation;
- “Big data” – collection, analytics – has not eliminated the “special” role of banks.
The evidence shows that banks’ role as lenders and deposit-takers is far from dead. Since 1950, bank loans have continued to rise as a percentage of GDP, especially in Europe (See chart: “Bank Loans Rising Relative to GDP Globally”). Since the financial crisis, the liabilities of traditional banks have grown, while those in the shadow banking sector have shrunk (See chart: “Since the Crisis, Shadow Banking Liabilities Down and Traditional Bank Liabilities Up”).

**Bank Loans Rising Relative to GDP Globally**

![Graph showing bank loans rising relative to GDP globally.](image)

*From Pagano et al (2014). Is Europe Overbanked? Reports of the Advisory Scientific Committee, ESRB. Source: Schularick and Taylor (2012). Notes: Bank loans refers to the resident banks’ loans to the domestic private sector (households and non-financial corporations). The data therefore exclude foreign (and foreign currency) loans and loans to the financial and public sectors. Europe represents an average (weighted by GDP) of DK, DE, ES, FR, IT, NL, SE and the UK.*

**Since the Crisis, Shadow Banking Liabilities Down and Traditional Bank Liabilities Up**

![Chart showing shadow banking liabilities compared to traditional bank liabilities.](image)

The challenge posed by alternative finance providers

Whereas the first forum focused on alternative finance providers, a wider perspective was provided in this forum on the future of universal banks. The viewpoints might be characterised as “revolution” and “over-hyped”.

The first one of these views runs as follows: the broader technological revolution, which democratises access to services and decentralises provision, has clearly reached banking. The disintermediation of credit, with its “peer-to-peer” element, is one example of a decentralised model. Developments in data collection and analytics (e.g. using social media and shopping habits) could provide credit-relevant data to match banks’ access to information via customer accounts.

Payments have considerable scope for disintermediation, with banks enjoying revenues of more than $2 trillion annually from this source (See chart: “Payments as a Source of Profit”).

Payments as a Source of Profit

Payments Revenue to Banks

<table>
<thead>
<tr>
<th>Region</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2019F</th>
</tr>
</thead>
<tbody>
<tr>
<td>APAC</td>
<td>0.5</td>
<td>0.6</td>
<td>0.7</td>
<td>0.7</td>
<td>0.5</td>
</tr>
<tr>
<td>EMEA</td>
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<td>0.1</td>
<td>0.4</td>
<td>0.5</td>
<td>0.3</td>
</tr>
<tr>
<td>LatAm</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>North America</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Share of total banking Percent

<table>
<thead>
<tr>
<th>Year</th>
<th>APAC</th>
<th>EMEA</th>
<th>LatAm</th>
<th>North America</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>37</td>
<td>38</td>
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<tr>
<td>2019F</td>
<td>37</td>
<td>38</td>
<td>38</td>
<td>40</td>
<td>40</td>
</tr>
</tbody>
</table>


Real-time gross settlement (RTGS) and the use of application programming interfaces (APIs) to gain access to banking infrastructure will multiply opportunities for non-bank payment system providers. Blockchain technology, creating distributed ledgers, could remove the need for a centralised body to monitor and verify transactions.

The second view takes note of the use of the future tense in describing many of the opportunities. In brief, non-banks remain short of critical mass. For distributed ledgers to gain traction, common standards and protocols are needed to underpin “smart contracts”. Privacy questions include whether access to data is permitted or not – and even whether there is clarity over who owns the data. Trust remains key. It is possible that banks will retain a better reputation for guarding personal data than technology companies. The limitations of data have often been demonstrated:
relevant information does not start when data collection starts, and the quality of information remains crucial (garbage in, garbage out will always apply). A more sober view of alternative finance providers has emerged in 2016, a year when the phenomenal growth rates have been tempered, even in China. The first FoFS forum recognised that the sector has yet to weather a full economic cycle and that its reputation had taken a few knocks. By summer 2016, Lending Club, the US platform, had lost about 80% of its market value since peaking at nearly $9bn in December 2014. Early this year it was found to have fabricated some loan details in a securitisation, and its CEO departed after a related-party transaction. More recently it has tightened credit policies and raised rates after higher than expected loan losses. Meanwhile, banks have continued to provide not just conventional business loans but also access to capital markets via securitisation.

Established banks have been investing in technology, spending more on IT than most other sectors. (See chart: “Cost of Bank IT Systems”. The trend has been confirmed by recent US data from Forrester Research, showing that tech budgets in the banking sector have continued to be three times the national sectoral average.)

But much of it has been absorbed by an overhaul of legacy systems and by implementing regulatory requirements to separate out certain businesses. It is estimated, for instance, that it cost Lloyds Banking Group almost £2.5bn to separate out TSB, while RBS has spent £1.5bn carving out Williams & Glyn – disentangling IT systems is a key part of these bills. This “legacy” problem, along with cultural issues to do with siloed activities and inhibited innovation, has underpinned the assumption that new, nimble, tech-savvy companies are more likely to have an innovative edge. This, in turn, may make these new entrants more attractive to young talent, or “digital natives”. Yet it is by no means a foregone conclusion that big banks cannot innovate – or at least adopt innovations that make them more efficient and serve customers better. It was noted that in Japan in the 1970s innovation came from the big firms, not the small ones.

Cost of Bank IT Systems

![Bar chart showing IT costs as % of revenues for European Banks from 2006 to 2010.](source: Deutshe Bank (2012), “IT in Banks: What does it cost?”, Boston Consulting Group; Forrester Research Inc.)
Regulation adds to the problems of depressed returns on equity

No discussion of the issues facing big banks gets far without examining the role of the great re-regulation that has occurred since the financial crisis. Basel III has multiplied the equity capital requirement relative to risk-weighted assets (RWAs) by about six times; broader capital and liquidity requirements have been ratcheted up; risk weights have been raised substantially on trading books; supervision has become much more intensive, including much more stringent stress tests, and intrusive via scrutiny of pay, governance and senior appointments. The bigger the bank, the bigger the compliance costs (See chart: “Overview total capital requirements and capital buffers”). However, Europe has not followed the US in limiting imposition of Basel III-style requirements to SIFIs. Both FoFS forums took it as a given that regulation would remain tougher for banks (deposit-takers) compared with non-banks.

Overview total capital requirements and capital buffers

Capital requirements in % of RWA

While return on equity (RoE) remains the most closely watched performance metric, the bottom line is that equity levels are much higher at a time when returns – especially in Europe – remain under pressure. One reason for subdued returns is the direct regulatory cost of fines and related compensation payments. Another is the indirect effect of low, or even negative, interest rates set by central banks. At best this has deprived banks of a safe source of revenue through interest earned on their short-term placing of deposits; at worst it has created a charge that banks are unwilling to pass on to their depositors – although even that has begun to change. Central bank bond buying, through quantitative easing, has also suppressed longer-term interest rates and flattened the yield curve (alongside external factors such as very low inflation expectations). This has constrained the profits available to banks from maturity transformation. It was, however, pointed out that the aim of central banks in exerting downward pressure on yields from safer assets was to encourage risk-taking to aid economic recovery.
Regulators’ attitudes to competition have been more equivocal. One of the causes of the crisis was a race to the bottom by lenders on risk pricing. In any sector where incumbents face little competition, they will be more profitable – and profitable banks are more stable. So some tension exists between competition and financial stability. But central banks also realise that a “monocultural model”, which is over-reliant on banks, is not stable, and that a sector with little entry and exit is not healthy. So the UK’s financial regulators are expected to encourage competition. Indeed, when it comes to the impact of monetary easing on credit creation, transmission – or pass-through to the wider economy – is viewed as more likely with new entrants. Regulators more generally in Europe are keen to see enhanced access to capital markets to provide a “second engine of growth”.

However, in 2016 some of the market headwinds have reversed. Global banks have rationalised their investment banking activities leading some weaker players to withdraw. This more favourable environment showed through in third-quarter results. Groups with strong investment banking arms reported an uptick in profits from FICC (fixed-income, currency and commodity trading), helped by previous cost-cutting. Fees from advisory work, although volatile because of variable M&A and IPO activity, have recovered from a nadir in 2009. It is worth noting the extent to which litigation and conduct costs and restructuring charges have weighed on profits at European banks. Management’s “adjusted” profits tend to exclude these losses, implying that once these burdens recede profitability will recover, and these special costs will not be reincurred.

Business models are becoming more streamlined

Before the financial crisis, diversification via a broad portfolio of activities was regarded as a means to reduce risk and universal banks effectively had a “diversification” premium. Since the crisis, that premium has reversed. At the macro level this is related to a backlash against globalisation and a re-assertion of national – or regional in the case of the EU – political interest and regulatory power. The impact on the banking industry has been amplified by the regulatory response to criticism that some banks were “too big to fail” (TBTF). Regulators such as Neel Kashkari, head of the Minneapolis Federal Reserve, have also asked whether they are “too big to manage”. In November 2016 he unveiled the “Minneapolis Plan to end TBTF”. It entails a dramatic increase in the amount of common equity as a percentage of risk-weighted assets that a large bank must hold. This goes further than Basel III, which includes long-term debt in the capital requirements for systemically important institutions.

At a structural level, some post-crisis measures have encouraged both spin-offs and internal separation. The US’s Volcker Rule has led to the spin-off of proprietary trading; the UK’s Independent Commission on Banking called for the ring-fencing of domestic retail banking from investment banking. The “recovery and resolution” plans demanded of SIFIs means that they must be able to sell units to raise money and that more capital is held in subsidiaries. This “subsidiarisation” process has diminished the ability of group management to switch capital between countries and lines of business in search of the best returns. Not only has this limited previous economies of scale, it has added costs that may amount to a diseconomy of scale.

The discount now being applied by equity markets to diversified banks can be seen in the discount to net asset value at which many European banks trade (also reflecting longstanding concern about asset quality). This has led to streamlining, notably the retreat of universal banks from countries and trading activities in which they have a sub-optimal market share.

This leaves a series of questions for bank boards:

- What is the optimum degree of bundling services together?
- What economies of scale and scope still persist?
- Is the endgame that banks become public utilities?

As they become less risky, will the hurdle rate for RoE fall back towards 7% (similar to other sectors) from a pre-crisis level of up to three times that? A return even to the mid-teens is now regarded as “delusional” by regulators such as the Bank of England. Most bank managements have tempered their targets – but not to single digits. The question that has yet to be answered is: what level will investors be content with?
CHAPTER 2
Three Different Scenarios

The forum broke into groups to discuss the likelihood of three different scenarios that might emerge for universal banks in Europe over the next 5-10 years and the conditions that will have to occur for each scenario to happen.

SCENARIO I
They remain THE central players in the European financial system in roughly their current form, perhaps integrating some innovative activities and/or competitors into their operations.

SCENARIO II
They remain “universal” but become more focused by product and market segment, as well as, perhaps, regionally, due to regulation, technology and other constraints and opportunities; they remain central, along with new entrants, to the European financial system.

SCENARIO III
Pressure from innovative competitors forces them to “unbundle” and narrow their functions and/or reduce their relative size to such an extent that they no longer remain the central players in the European financial system.

1 Still THE central players
Even if European banks’ share of financial risk is halved to about 40%, they will still be the “central” players in the financial system.

Banks can help themselves by cutting costs and their efforts to de-risk will result in a lower cost of capital, restoring the investment case. Regulatory costs will at least cease to rise – perhaps under political pressure, as is now being exerted against “Basel IV”. The stance may even soften in recognition of the role of banks in credit provision for smaller businesses, and amid nervousness about the exposure of retail investors to fintech providers. The latter may be aggravated by a loss of trust through business failures or fraud.

The future of universal banks was considered under two economic scenarios:

The yield curve stays relatively flat:

- Banks raise their relevance to corporate and retail clients, including by adopting some of the alternative providers’ innovations.

- They get better at monetising their customer data and at cross-selling products and services. They raise their income from fees and commissions. Shareholders accept a lower RoE.

The yield curve normalises:

- It becomes easier to make money as a deposit-taker and through the net interest margin.

- The private banking model, serving wealthy and “mass affluent” individuals, continues to show good returns.

- Technology allows banks to retool and reduce costs, as they continue to rationalise. This improves returns.

- Big data: data sharing is limited and the protection of personal information is emphasised. The answer to the question ‘whose data is it?’ is neither that it is public nor that it belongs to Google or Facebook or some other service firm.

Banks are seen as beneficiaries of the EU’s CMU project. They facilitate corporate access to capital markets, eg through securitisation, and provide stability at the heart of the system. Regulators recognise the importance of (insured) deposit-takers and become more “helpful”, while levelling up requirements for alternative finance platforms. Customer trust in banks is restored and they – and their deposits – remain “sticky”.

None of the participants believed this scenario was likely.

2 Banks refocus and share centrality
This was the most popular scenario. The proponents shared some of the views expressed in scenario I in pointing out how the universal banks can help themselves, while alternative providers develop in parallel.

- Focus: universal banks develop a clear strategic focus in terms of product, client and region. The “lower for longer” interest rate environment prompts them to expand origination and fee income.

- Streamlining: performance improves as they regroup around their core strengths, disposing of peripheral low-return activities.
trusted brands; brand recognition matters for certain products, e.g. saving for retirement, and for fee-based services. The amounts being spent on compliance may even engender trust.

- Data opportunity: banks have a mass of data about their customers and will get better at using it, both to serve those customers and in careful monetisation of the data (careful so as not to sacrifice trust in privacy).

- Regulation: held at current levels, with a focus on stability that may be helpful to incumbents. This includes a softening of the regulatory approach to capital requirements and internal ring-fencing.

- Regulators working across borders may find big banks easier to deal with than the fragmented alternative sector.

- Balance sheets: the stronger capital position of banks is recognised, which attracts clients and eases regulatory scrutiny.

- Diversification: the benefits will again be appreciated as a source of stability in a volatile environment.

- Has the implicit government guarantee really gone away? If not, this benefits the universal banks.

Proponents of this scenario believe that economies of scale will persist in banks’ structure and in political backing based on their continuing economic importance. This is in addition to the value clients place on broad relationship banking. Refocusing will make them stronger: coupled with cost-cutting and better use of data, it will improve returns. A side effect of retaining some diversity of activity and geography is that careers in big banks will remain attractive to talented people, who will help those banks adapt and innovate.

The other side of the coin is a less rosy future for non-bank challengers than some expect in 2016:

- The challengers will be tested as they go through a full credit cycle.

- Too much competition, leading to under-pricing of risk, and abuses of data privacy will scare regulators and temper their encouragement of fintech providers.

- As the disruptors get bigger, they will attract more regulatory attention (under the proportionate approach to systemic and conduct risk), which will level the regulatory playing field.

- Millennials will not automatically be attracted to new entrants. Banks will remain more trusted on privacy of data.

- The big technology groups and e-tailers, such as Google, Facebook, Alibaba and Tencent, will stay away? If not, this benefits the universal banks.

Under this scenario new entrants fill gaps, rather than grabbing market share from banks. There is also a time element. The EU’s capital markets remain fragmented and immature, so small and mid-sized companies will continue to rely on banks for the next 5-10 years.

22 votes – about two thirds of attendees – were recorded for this scenario.

Looking beyond ten years, there was less conviction in the persistence of universal banks’ advantages, which leads into scenario 3.

3 Unbundling diminishes central role

Assuming a low-interest-rate environment, customers will be looking for low-cost alternatives to banks in payments and remittances, robo-advice and lending. If banks rethink the ‘free to client if they are in credit’ current account model, they will charge for more basic services and invite further competition. Regulation will continue to encourage and enable new entrants, including the EU’s new payment services directive (PSD2), open access to bank infrastructure and a benign view of the potential for distributed ledgers. Even if customers care about capital strength (and deposit insurance negates that for any challenger with a banking licence), the technology companies also have “fortress balance sheets”. Characteristics of this scenario may include:

- Open data facilitates the entry of non-bank competitors, including the giant technology-based companies.

- The demographic shift will bring in new decision-makers with more of a DIY approach and less brand loyalty. They are willing to try different providers and have an open mind on sources of information and exchange of data.

- Other incumbents in financial services, such as asset managers and insurers, will expand their funding activities, encouraged by CMU measures to prompt deployment of savings into infrastructure and growing companies.

- Incumbent banks fail to adapt. They are overwhelmed by legacy IT and compliance costs and so have little to invest in new IT. They fail to change their siloed, bureaucratic culture.

- The regulatory framework is deliberately more painful for bigger banks – and will remain so.

This less palatable view of the future envisages banks remaining unpopular with the public and politicians. There is a danger they will be left with the less-profitable business lines and customers, while the good parts are cherry-picked by challengers. They will be expected to remain public utilities: vehicles for public policy on universal access to bank accounts and payments, and on lending to SMEs. Some of their activities will face caps on charges. Thanks to stringent capital requirements and implicit government backing, they will be investible (just about) as
low-risk/low-return 'public good like' institutions.

As one participant put it: they "will survive but be miserable". A parallel was drawn with the German model where three-quarters of equity is state owned and banking is subsidised. Banks support the family-controlled manufacturing businesses that are regarded as the backbone of the economy. In other words, the strongest economy in Europe has the weakest banking sector.

Nine participants, or just under one-third, voted for this scenario.
CHAPTER 3
Givens and Uncertainties—How Scenarios Play Out

To draw out common themes from all three scenarios, the context in which they would play out was separated into “givens” – the conditions that all assume will pertain – and “uncertainties” – the ones that will make a difference as to which scenario will actually occur.

The Givens

- Bank RoEs are trending lower as a result of regulation, technology and competition.
- Low interest rates and a relatively flat yield curve will persist; bigger companies can borrow cheaply in capital markets.
- The regulatory burden on the largest banks will remain much higher than in the past and than for smaller firms.
- Deposit insurance stays. This is an advantage for challenger banks but big banks pay for it.

Critical Uncertainties

- Cost of capital: what is the ultimate impact on hurdle rates of the increased amount of equity capital a bank must hold?
- To what extent will banks rotate towards fee-based income, bearing in mind concern about conduct risk?
- Demographics: are millennials different in their financial purchasing choices and, if so, in what way?
- Will regulation increase for non-banks, placing a limit on competition?
- Trust: to what extent can small players build it?
- Data: who owns it? Who has access to it?
- Geopolitical risk: what is the impact on universal banks of the retreat from globalisation?
CHAPTER 4
So, What’s the Future for Europe’s Universal Banks?

Recovery from 2016 low
It is worth noting – from the first two forums in the FoFS series – that 2015, running into the first part of 2016, represented a high point in the growth rate and popularity of fintech. Conversely, Europe’s universal banks entered 2016 at a low point. The burdens of additional capital requirements, litigation and conduct charges, and restructuring costs continued to hit returns in both absolute terms and in the RoE metric. Returns were also being squeezed by low, or negative, central bank rates, by weak economic growth in many EU countries and by the losing battle that European investment banks had fought with their US counterparts in some lines of trading.

Leaving aside any wounds that the fintech sector might inflict on itself, a more optimistic view of the resilience of Europe’s financial institutions emerged from the second forum (and showed signs of being borne out in third quarter results). This view runs as follows.

Returns on equity improve
Returns will rise as legacy costs dwindle and banks earn more fees, partly through changes to their business models and partly as the economy improves. Retail banking margins in the UK have already returned to their long-run average. On the cost side, banks have further to go in savings on labour costs and investing in IT to increase efficiency (See chart: “Efficiency of the Financial System”).

As their strategies become clear, after dropping non-core units and poorly performing assets, they will become more attractive to investors. They may even shrink to a size where the regulatory requirements are less onerous. Coupled with their increased safety and soundness, after all the prudential reforms, the hurdle rates demanded by investors will fall – think of 7% as being reasonable in the context of a low risk-free rate and a reduced beta for bank risks.

The yield curve may normalise
Central banks do not control the yield curve, and long-term rates have been falling for 40 years, influenced by demographics, savings gluts, etc. Nevertheless, there is hope (via economic recovery and inflation expectations) of a return to more “normal” base rates and an upwardly sloping yield curve, which will help bank earnings via maturity transformation.
The value of soft information

Something special does remain in customer relationships and in a bank’s ability to sustain trust in the safety of deposits (helped by insurance schemes) and in privacy. Value remains in some face-to-face encounters with customers when they are seeking advice on important financial decisions. Proximity and an established relationship also count when assessing and managing borrowers (See chart: “Number of Bank Organisations and Offices”).

A vision of parallel and complementary development

The popularity, at both the 2016 FoFS forums, of scenarios suggesting parallel and complementary development of refocused banks and their market-based competitors is positive for both banks and the financial system. Banks are far from dead but they will cease to carry the bulk of Europe’s financial risks. The emergence of a “second engine” of growth, via expanded capital markets and alternative finance platforms, is what policymakers and regulators want. It is in line with a spreading of risk away from SIFIs and, by implication, the taxpayer.

There were concerns in the group that while a second engine would benefit the economy, it would be dangerous to move to a scenario 3 environment where large universal banks were no longer central. In that environment, the regulator would no longer be able to influence the financial sector via its impact on those large universal banks. In a world of decentralised payments, it would also struggle to see what was going on in the financial system, threatening its ability to maintain financial stability.

The consensus view was that an open environment without large important banks would be a problem for central banks and other regulators as they would not have a few large players through which to transmit monetary and other policies.

The blurred economy

It is, in any case, no longer clear that a divide exists between conventional finance and new technology. There is a blurring of businesses providing financial services, as access to credit-relevant and other customer information increases and data analytics advance. These innovations are changing the fabric of customer relationships.

What business models will succeed in the next decade? The evidence suggests banks are still “special”, but it is not clear for how long they will remain so. The future of universal banks is tied up with the policies and actions of regulators, but they must take account of the risks inherent in technological advances. Central banks’ own digital capacity needs to expand to keep abreast of developments that include digital currencies and decentralised payment systems.

We may be at a “defining moment” for both universal banks and central banks, both of which must adapt to technological challenges. As Randal S. Kroszner points out in his 2016 paper “The Future of Banks: Will Commercial Banks Remain Central to the Financial System?”, banks may come to be seen as IT and data companies.
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