COVID-19

A Catalyst for Change in the Banking Industry?

JOHNSTON CARMICHAEL

Current Environment

COVID-19 & Central Bank Rate Cuts

On 19th March, at a special meeting of the Bank of England (BoE), the members of the Monetary Policy Committee reduced the UK central bank rate from 0.25% to 0.1%, the second rate cut in the space of a month. This is the lowest ever rate in the history of the Bank and is designed to support families and businesses in the wake of the COVID-19 outbreak. It also aligns the UK more closely with many European central banks who have slashed their rates – some even into negative territory.

This rate cut and the impacts of COVID-19 will no doubt have far reaching consequences for many industries, including the banking sector, whose last fundamental change to their business model came from the last financial crisis and the plethora of regulation that followed in its wake (particularly the Retail Distribution Review (2012), the Mortgage Market Review (2014) and the ring-fencing regulations).

It is our belief that the implications of COVID-19 will have a similar effect in changing bank business models to ensure they are even more resilient and viable in the future.

Evolution of Bank Business Models Post Financial Crisis

During the financial crisis, a number of fundamental issues in the UK banking market were uncovered. Firstly, there was an over-reliance on the volatile wholesale funding markets to support lending books – this over-reliance took down Northern Rock who relied on the wholesale market for 75%[1] of their funding. Secondly, the securitisation of sub-prime mortgages led to significant bad debt impairments and revealed a capital base that was too thin to prop up the banks.

After the financial crisis was over, the need to build sustainable 'back to basics' banking business models was front and centre for the Boards of banks as well as the regulator. These changes, which proceeded the financial crisis, give us the bank business models that we see today and they are characterised by:

- A lower reliance on wholesale funding
- Increased reliance on Net Interest Income (and corresponding simplification of offerings to core savings and lending products)
- Increased liquidity (particularly driven by ring-fencing which has increased liquidity for large retail banks)
- Higher capital buffers
- Advice propositions being curtailed or strictly controlled

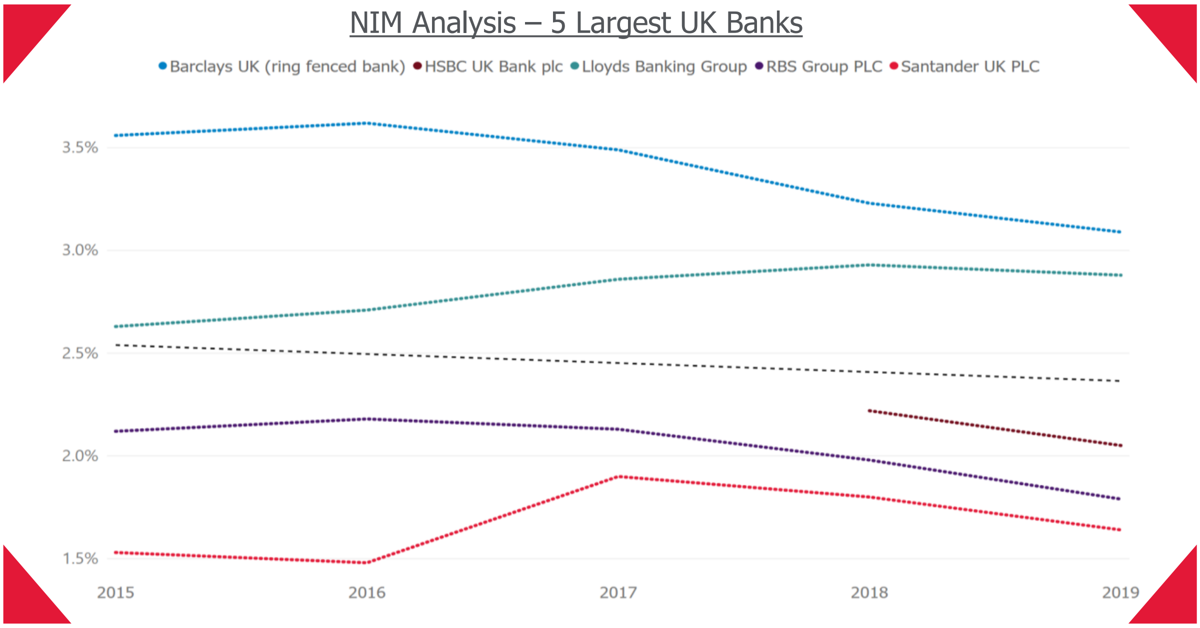
This returned the UK banking sector to their more prudent and conservative beginnings – earning a solid income from taking in deposits, lending them out and making a percentage mark-up on the difference (the Net Interest Margin). However, the recent rate cut has raised an important question: are interest income focused banking models sustainable or desirable when central bank rates reach 0% or less?

[1] Ray Perman (2019): The Rise and Fall of the City of Money

COVID-19 - A Catalyst for Change?

Net Interest Margin (NIM)

The 'low interest environment' has been with us for a number of years now and has had an impact on levels of return on equity (ROE) – the top 5 UK banks over the past 5 years have generated, on average, an ROE below 10%[2] - a level which is certainly well behind historic returns.



NIM is not the only contributor to this reduction in ROE but it is part of the equation. As we can see above, NIM has been declining over the past 5 years and we expect this to continue for the foreseeable future. Indeed, there are a number of catalysts which should cause banks to think about re-orientating and diversifying their business models away from NIM in order to protect returns:

1. Ring-fencing has already significantly increased liquidity in the mortgage market which has driven rates to extremely low levels, putting pressure on NIM.
2. Responding to COVID-19, BoE rate cuts have reduced the potential spreads between lending and savings rates, depressing NIM further.
3. Suspension of the housing market due to COVID-19, meaning new mortgage business has melted away. Further increases in unemployment and higher deposit requirements (due to lower LTVs required by banks) will negatively impact first time buyer (FTB) demand for some time (FTBs represent c. 25%[3] of new mortgage lending).
4. Equity markets are currently depressed but at some point savings may be converted to investments as investors take advantage of the downward adjustment or correction in equity markets.

[2] Johnston Carmichael ROE Analysis

[3] Johnston Carmichael Future of Mortgages Analysis

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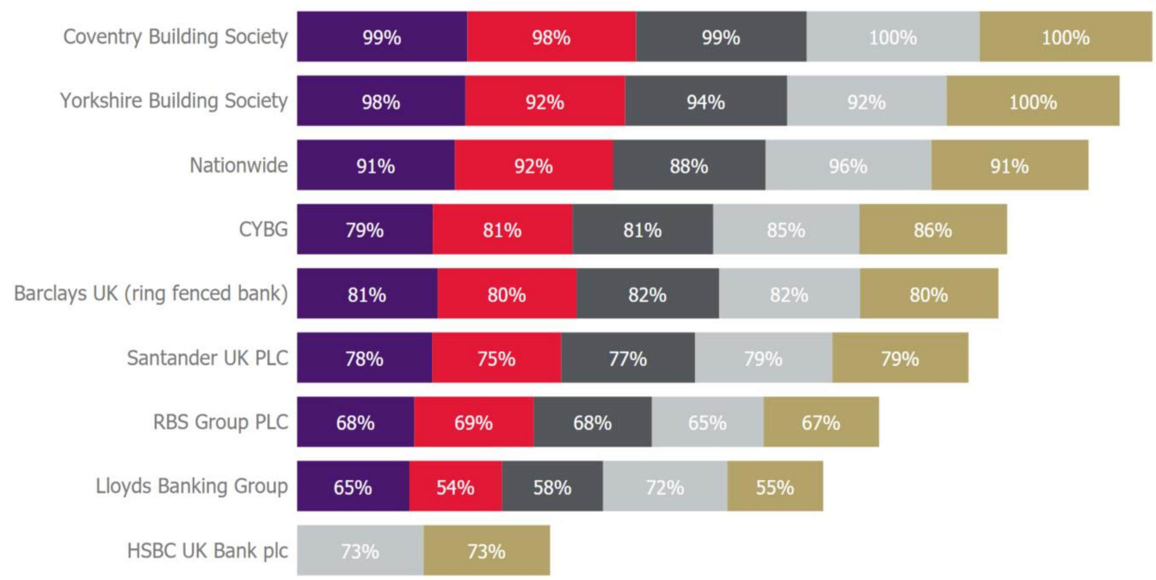
Net Interest Income (NII)

This pressure on margin is particularly important as UK bank / building society models are dependent on Net Interest Income when compared to other sources of income. This lack of diversification may make the banks more vulnerable to their institutional investors if ROE drops further due to NIM pressures. Building societies may also find it difficult to invest in transformation initiatives or member services if they subsidise savings rates to keep pace with their banking competitors, thereby lowering retained profit levels.

Our analysis below highlights the percentage of total income that is derived from Interest Income for some of the leading players in the UK banking market:

Interest Income as a % of Total Income[4]



*Where possible, UK income data is taken at Group level. Barclays data excludes Barclays International as UK figures not provided. RBS Group PLC includes international business as immaterial at c.4% of 'other' income but excludes a £2.2bn strategic disposal in 2019. Santander excludes Banco Santander Group figures. HSBC data includes only the ring-fenced entity and is only available on a comparable basis for 2018 & 2019.

This analysis shows that some banks / building societies are placing more of their eggs in one basket than others. The building societies are almost wholly reliant on Net Interest Income as their main revenue source. Barclays UK (even including Barclaycard) and Santander UK Plc too rely on Net Interest Income to make up c. 80% of their revenue. On the other side of the coin, Lloyds Banking Group (LBG), with perhaps the most diversified product set in the UK market (including a large insurance division), only rely on Net Interest Income for 55% of their revenues.

[4] Johnston Carmichael Interest Income Analysis

A Comparison with European Banks

Case Study: Nordic Banking

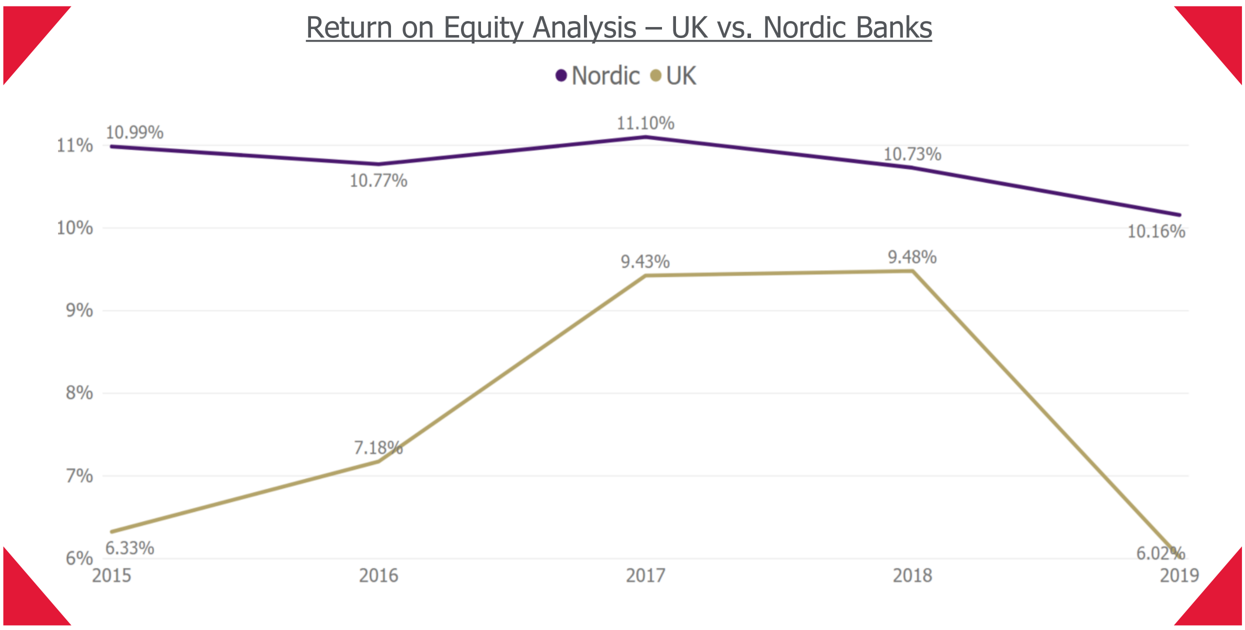
At face value, the situation in the Nordic states, where central bank rates are either 0% or in negative territory, should be far worse than in the UK. In Finland and Denmark, for example, banking providers are having to pay to lodge their deposits with their central banks at rates of -0.5% and -0.6% respectively. This has had a significant impact on the Nordic NIM which currently sits at an average of 1.2%[5] - well behind the current UK rate of c.2.4%. However, there are two fundamental differences between Nordic and UK banking providers – Nordic banks have:

1. Diversified their income stream away from Net Interest Income

2. Reduced Costs – average Cost:Income ratio in the Nordics is 45%[6]

Nordea, for example, one of the biggest banks in the Nordics, has a Net Interest Margin of 0.8% - massively below the UK average. However, Nordea have reduced their reliance on interest income by focusing their efforts on improving income from fees and commissions from Wealth & Asset Management activities. This means that, though rates and interest margins are very low, they have a degree of stability even as the central bank rates fluctuate.

The analysis below demonstrates this point starkly – when we compare the average ROE of the largest 8 Nordic banks vs. the ROE of the UK's 5 biggest banks, we see consistently higher returns over the past 5 years in the Nordic banking sector. This could present a window of opportunity for UK banks if they also focus their efforts on cost reduction and income diversification.



[5] Nordic Credit Rating

[6] Deloitte

Bank Business Models Beyond COVID-19

Income Diversification

Banks should take heed of some of the lessons learnt by Nordic banks and look to diversify their product portfolio in order to reduce their reliance on traditional interest-bearing products. This should reduce the impact of the historic low central bank rate and could include exploring the following products:

Fee & commission products

- Insurance (personal & commercial)
- Financial advice
- Simple investment solutions / robo advice
- Asset management
- Monthly fee accounts

Higher interest-bearing products

- Credit card products & unsecured personal lending*
- Small business deposits & lending
- Corporate deposits & lending

*Caution should be taken on unsecured lending if we do, as expected, hit a deep financial recession. The FCA will also be paying close attention to the treatment of credit card and UPL borrowers, especially interest rates charged and treatment of arrears/ persistent debt post COVID-19 furloughing, redundancies and reduced working hour/ remuneration.

Indeed, even ahead of the COVID-19 crisis, we saw LBG launch their joint venture with Schroders ('Schroders Personal Wealth'):

"We launched Schroders Personal Wealth, with the ambition of becoming a top three financial planning business by the end of 2023" [7].

We expect many more banks to implement income diversification strategies over the next year.

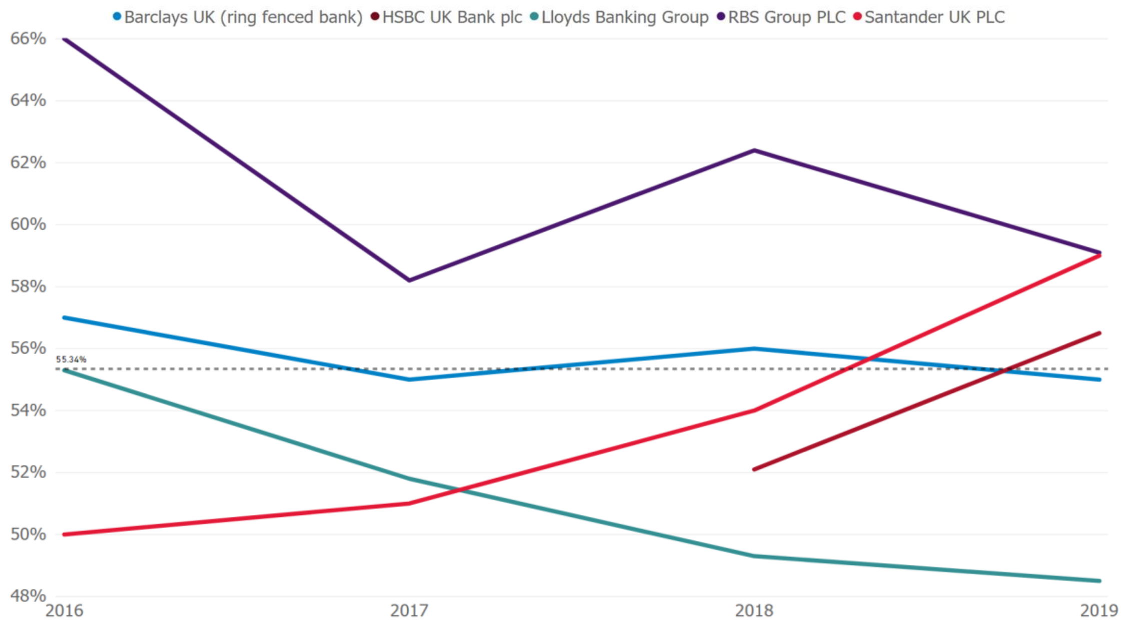
[7] LBG Annual Report 2019

Bank Business Models Beyond COVID-19

Cost Optimisation

In order to make greater returns whilst NIM shrinks, we expect many banks to launch cost optimisation programmes in order to reduce Cost:Income (C:I) levels similar to those achieved in the Nordics (c.45%). As we can see from the chart below, the UK banks have a way to go to achieve this level – the average rate over the past four years being c. 55%.

UK Big 5 Banks – Cost:Income Ratio Analysis[8]



*Cost:Income data excludes litigation and conduct costs – this is done manually where the figures are not provided.

A note of caution should be added to those banks looking at 'cost optimisation' as a purely 'cost reduction' exercise. There are two aspects to the C:I equation – cost and income. Any cost optimisation programme needs to balance the reduction in cost in the short-term with the potential loss of revenue in the medium to long-term.

At Johnston Carmichael, we view costs in two ways: good costs and bad costs. Good costs should be maintained or expanded and include investments in experiences that 'wow' customers and will deepen the customer relationship and the banks' ownership of the value chain. Bad costs include over-investment in functionality that customers expect as standard yet do not overly value, unnecessary steps or choices in the customer journey and cost misaligned to the strategic purpose of the business unit.

In particular, as banks increasingly turn to digital to support efficiency initiatives, they also need to consider how human escalation points interact with the digital experience to improve customer outcomes, maintain compliance and keep costs low. Only by effectively doing this will they boost both sides of the Cost:Income equation.

[8] Johnston Carmichael Cost:Income Analysis

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