Retail or not retail

Have European banks become more retail on the wake of the crisis?

Javier Villar Burke / Cristina T Plata García[1]

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Executive summary

- **Retail deposits represent about 30% of total European banking assets.** The bulk of the balance sheet of banks (about 70%) comprise non-retail loans and deposits (e.g. interbank loans and deposits, loans and deposits from insurance corporations and pension funds and loans and deposits from non-residents) and other wholesale and investment activities (e.g. holdings of securities, hedging services, issuance of bonds).

- At country level, **there is a clear divide between emerging European countries**, where retail loans and deposits represent more than 50% of total assets, **and Western European countries**, where retail loans and deposits represent less than 30% of total assets.

- Within this context of a preponderance of wholesale assets and liabilities, **a significant evolution towards a more retail orientation of banks is observed since the outbreak of the crisis**. This was mainly achieved through a sustained increase in retail deposits, while the evolution of retail loans was more mixed.

- This increase in retail deposits implies **a substantial shift in the sources of funding** used by banks and, therefore, **in the own nature of EU banks**.

- **Market forces** (including changes in investors' preferences) **and new regulation have been the main drivers of such shifts.**

1. Introduction

Depending on the relative importance of retail and trading activities the business models of banks are usually classified from the extreme of pure **commercial banking** to the extreme of pure **investment banking** with a spectrum of different degrees of universal banking in between.

Commercial banking activities are regarded as particularly important for the real economy because they encompass functions such as maturity and liquidity transformation, risk assessment, asset allocation and support of the payment system. These critical functions are the rationale for a series of layers of safety nets protecting banking activities including supervision, regulation, deposit guarantees or the lender-of-last-resort function of the central bank. The recent financial crisis revealed that the existing safety net was not sufficient or not properly calibrated. Public

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authorities had to intervene to avoid a collapse of these critical functions for the economy, to fix some flaws in the system and to reinforce the protective layers so that financial stability could be ensured.

On top of financial services provided to households and non-financial corporations, **commercial banking activities need the support of a series of "wholesale" activities** (e.g. liquidity management); banks also provide services to other parts of the economy (e.g. governments or pension funds). The outbreak of an unprecedented financial crisis seems to have revealed that, over time, **many large universal banks shifted too many resources to trading books**, supported by cheap funding.[2]

Moreover, the outbreak of the financial crisis, and the heavy burden imposed on taxpayers, triggered **a reassessment of risks**. In particular, the costs and benefits of proprietary trading and other securities markets activities were put under scrutiny as the complexity of many banks weakened market discipline and their interconnectedness increased systemic risk.[3] Besides some proposals to separate commercial and investment activities,[4] **market forces and some regulatory reforms have encouraged a shift towards more retail activities.** Market forces are reflected in the lack of confidence and the dysfunctionalities of interbank markets; new regulation such as new liquidity requirements embedded, for instance, in the Basel reform put pressure to a wider use of customer deposits as a source of funding. However, interactions are more complex. The BRRD requires a certain amount of bail-inable debt, and therefore, penalizes retail deposits. Moreover, although Basel III foresaw a transition period of almost 10 years for the new capital requirements, markets required them to be met almost immediately, also influenced by a more regular and binding use of stress tests by supervisors. Furthermore, some evidence indicates a lower performance of securities markets activities compared to commercial activities[5] and therefore the former may require higher leverage.

This note reviews **whether the significant restructuring and resizing effort** triggered on the wake of the financial crisis **has affected the business models of the banking systems across the EU.** For instance, it has been argued that banks retrenched to their core geographies[6] and refocused on more traditional banking activities by reducing the use of wholesale funding[7].

2. Euro area aggregates

Data indicate that today **the bulk of banks' balance sheet** (about 70%) **comprises non-retail loans and non-retail deposits** (e.g. interbank loans and deposits, loans and deposits from insurance corporations and pension funds and loans and deposits from non-residents) **and other wholesale and investment activities** (e.g. holdings of securities, hedging services, issuance of bonds) (Table 1).

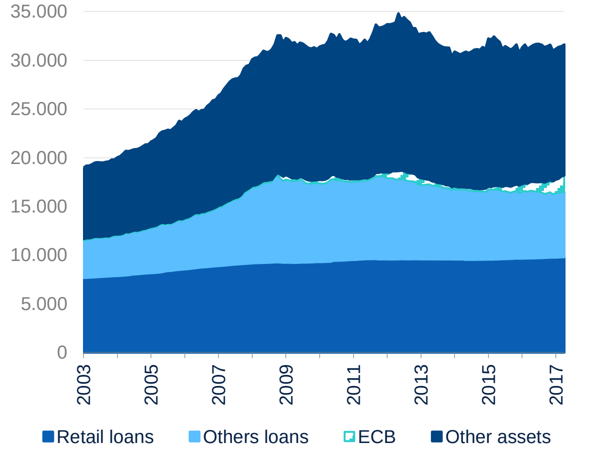
2: See, for instance, Gambacorta and van Rixtel (2013).
3: See, for instance, Gambacorta and van Rixtel (2013).
4: Those include the Vickers reform in the UK, the Volker rule in the US and the Liikanen report in the EU. Similar initiatives were also proposed in Germany, France and other countries.
5: See, for instance, Gambacorta and van Rixtel (2013), Kok, Moré and Pancaro (2015 and 2016) and van Ewijk and Arnold (2014). See also Figure A1 in the Annex.
6: See, for instance ECB (2017): *Financial integration in Europe.*
7: See, for instance, Gambacorta et al. (2017).

Table 1. Overview of retail activities, euro area banks

	2008	2012	2016	2008	2012	2016	2008	2012	2016
€ billion		**Total**			**Retail**			**Other**	
Loans	18,100	18,000	17,600	9,200	9,600	9,800	8,900	8,400	7,800
Deposits	16,700	17,200	17,000	6,900	7,900	9,100	9,800	9,300	7,900
% of total assets		**Total**			**Retail**			**Other**	
Loans	56.9%	55.1%	56.8%	28.9%	29.4%	31.6%	28.0%	25.7%	25.2%
Deposits	52.5%	52.7%	54.9%	21.7%	24.2%	29.4%	30.8%	28.5%	25.5%

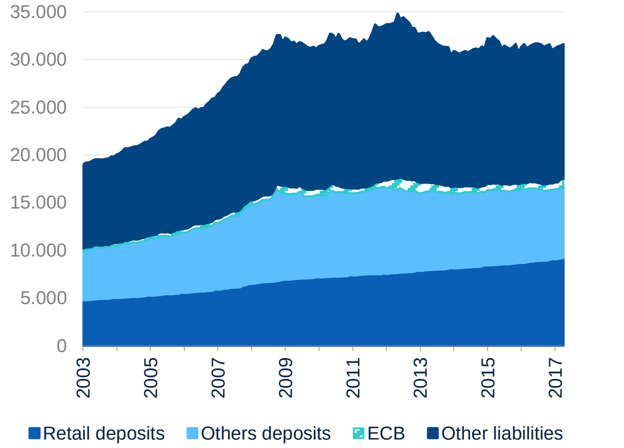
Notes: Analysis based on domestic, non-consolidated assets. For details about total assets, see Figure A4 in the Annex.
Source: ECB and BBVA Research.

Figure 1a Evolution of retail and non-retail activities. Euro area banks – Assets (€ billion)



Note: retail loans are calculated as the sum of NFC loans and households loans. ECB: deposits at the central bank.
Source: ECB and BBVA Research.

Figure 1b Evolution of retail and non-retail activities. Euro area banks – Liabilities (€ billion)



Note: Retail deposits are calculated as the sum of NFC deposits and households deposits. ECB; loans from the central bank.
Source: ECB and BBVA Research.

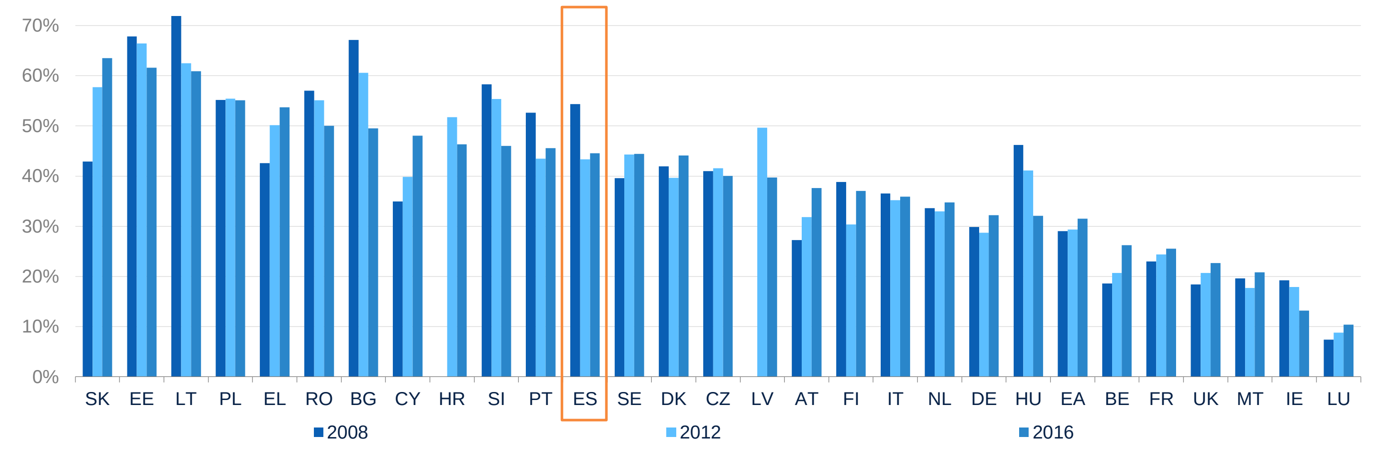
This being said, **retail deposits**[8] **have substantially increased** since the outbreak of the crisis by over 30% (e.g. from €6,900 billion to €9,100 billion in the euro area). As a consequence, retail deposits, which represented only 22% of total assets in 2008, now represent almost 30% of the funding sources used by euro area banks. **On the other hand, retail loans have only marginally increased** both in absolute terms (from €9,200 billion to €9,800 billion) and relative to total assets (Table 1 and Figure 1).

3. Country breakdown

Aggregate data conceal great heterogeneity in the mix of activities across countries. In most Eastern and Central European countries, the banking system has a clear retail orientation, with retail loans and deposits representing more than 50% of total assets. In other countries, with a long tradition of investment banking and wholesale financial services (e.g. Belgium, France, Malta, Ireland and Luxembourg), retail loans and deposits represent less than 30% of total assets (Figures 2 and 3; see also Figures A2 and A3 in the Annex).

8: For the purpose of this note, we consider retail activities as the loans and deposits to/from households and non-financial corporations.

Figure 2 Retail loans to total assets, percentage



Note: Analysis based on domestic assets (non-consolidated); for euro area countries, it refers to exposures to the euro area as a whole. Retail loans are calculated as the sum of non-financial institutions and households. Data for Latvia and Croatia are not available in 2008.
Source: ECB and BBVA Research.

In terms of evolution, the proportion of retail loans has remained rather stable in a majority of countries. However, important shifts are observed in a few countries, although without a clear trend. For instance, in Slovakia, Cyprus, Greece and Austria, the proportion of retail loans expanded by more than 10 percentage points between 2008 and 2016; while in Spain, Latvia, Lithuania, Slovenia, Hungary and Bulgaria, it decreased by more than 10 percentage points (Figure 2).

These trends can be split into their two components (i.e. loans in the numerator and total assets in the denominator). In the countries more severely affected by the crisis (i.e. Greece, Ireland, Portugal, Cyprus, Spain and Hungary), we can observe a significant expansion in the volume of retail loans in the run up to the crisis, followed by a continuous contraction in loans. In core countries (e.g. Austria, France, Germany and Luxembourg) as well as in Belgium, pre-crisis growth of retail loans was much more moderate. In these countries, after being hit by the initial shock, retail loans stagnated; in the recent years, the volume of retail loans has regained some dynamism (Figure A5 in the Annex). Poland appears as a particular case because, on the one hand, it has been one of the few countries not entering into recession during the financial crisis and, on the other, it has a still developing banking system. In this context, one should take into account that one of the main drivers of the volume of loans is general economic activity.[9] With respect to total assets, we can observe a significant contraction of total assets in most peripheral countries as a consequence of the restructuring measures, and a stagnation in most core countries (Figure A4 in the Annex).

The low interest environment have made financial markets more affordable for corporations, which may have substituted some bank loans for the issuance of bonds in the markets and other sources of funding.

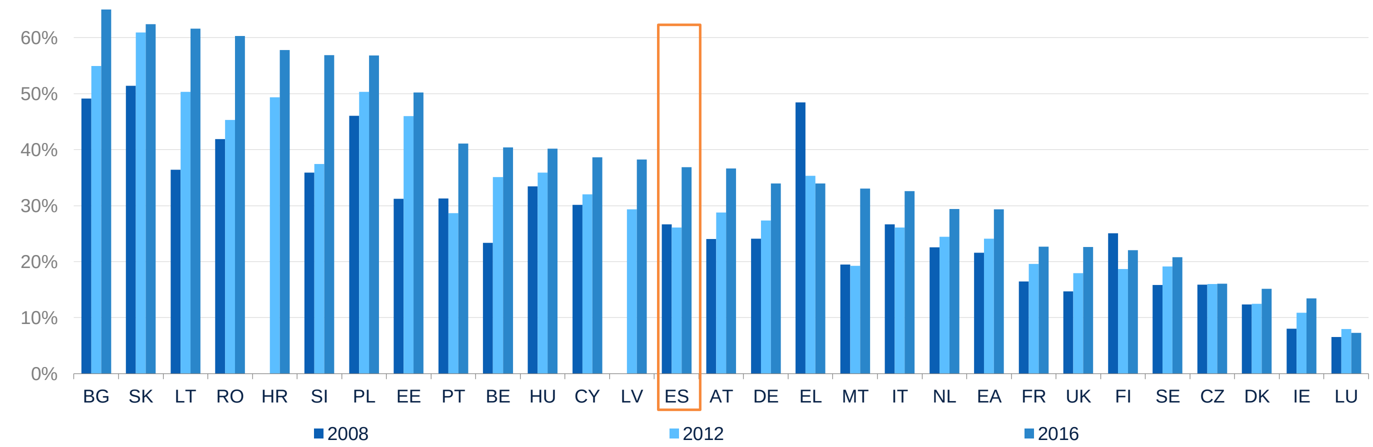
9: See, for instance, Izquierdo de la Cruz (2017).

On the liabilities side, **a broad increase in the share of retail deposits on total assets can be observed** (Figure 3). This was driven by a sustained expansion in the volume of deposits (Figure A6 in the Annex) which have replaced other sources of funding on the wake of the financial crisis.

The largest increases are observed in Eastern and Central European countries, which have a rather small and still developing banking system. However, these dynamics were also possible thanks to the *Vienna Initiative*. In general, the bulk of the banking systems in Emerging Europe consist of subsidiaries and branches of banking groups from Western countries. To safeguard the financial stability in these countries, the European Bank Coordination “Vienna” Initiative was launched in 2009. The initiative was conceived as an emergency response to the threat of an exodus from emerging Europe by Western banks.

A remarkable exception is Greece, where the proportion of deposits in total assets declined by almost 15 percentage points. This is explained by a deposit flight during the height of its financial turmoil[10]. In Cyprus, non-insured deposits were charged with a levy as part of the macroeconomic support program, but they recovered subsequently (and total assets declined in a similar proportion).

Figure 3 Retail deposits to total assets, percentage



Note: Analysis based on domestic assets (non-consolidated); for euro area countries, it refers to exposures to the euro area as a whole. Retail deposits are calculated as the sum of non-financial institutions and households. Data for Latvia and Croatia are not available in 2008.
Source: ECB and BBVA Research

The need to increase retail deposits was driven, largely, by the squeeze in other funding sources experienced by banks. Indeed, wholesale funding (e.g. interbank lending, securitisation and the issuance of bonds) froze during the crisis because of the retrenchment in international activities with funding sources further eroded by mounting losses[11]. This was only partially contained by the massive support implemented by public authorities (from guarantees on bank liabilities and liquidity injections by the central bank to direct capital injections by governments[12]).

10: Capital controls contained the deposits flight, but they were introduced only in June 2015, when significant amounts of deposits had already fled the country.
11: See, for instance, Cœuré (2013), Krugman (2013), Gorton and Metrick (2012), Varoufakis (2011), Abbassi and Schnabel (2009) and Cochrane (2014).
12: For further details, see Villar Burke (2017): *Weathering the Storm. The financial crisis and the EU response*. Business Expert Press.

It is important to remember that retail deposits are very different from wholesale (interbank) deposits. Interbank deposits need to be repaid at maturity (usually one or two days) and, subsequently, a new contract needs to be formalised if the banks still needs the funding. At any time, the lending bank may decide not to renew. On the other hand, overnight retail deposits are implicitly renewed every day without issuing a new contract and therefore retail deposits are considered as a stable source of funding. They can potentially be withdrawn on a bank run following a panic, but this risk is mitigated through deposit insurance.

Given the longer maturity of banking assets than their liabilities, banks had recourse to (stable) retail deposits to replace fleeing wholesale funding. This prompted a sort of “deposit war” in a few countries on the height of the crisis. This being said, other factors may have played a role, among others, the low interest rate environment, changes in investor’s preferences (given financial uncertainty, the low yield environment and increased unemployment, some households may have converted some of their investment into deposits) and prudential regulation[13].

The evolution of retail deposits implies **a substantial shift in the sources of funding** used by banks and, therefore, **in the own nature of EU banks**. As indicated by Gambacorta et al. (2017), the financial crisis interrupted the globalisation of banking by prompting an important retrenchment in bank’s international activities and exposures, in particular in cross-border funding markets. Conditions in global credit markets and regulation may trigger some breaks in bank funding models and influence the leverage cycle.

4. Conclusions

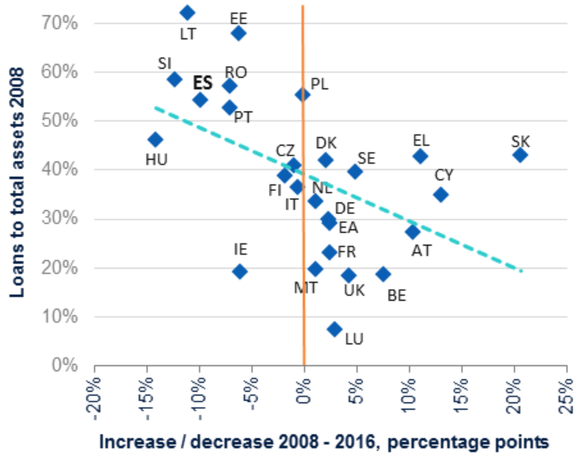
On the wake of the financial crisis, we observe a shift towards a more retail orientation of banks, particularly from the funding side (deposits) (Figure 4). These trends are reflected in a declining loan-to-deposit ratio, which got closer or even below 100% in most EU countries (Figure A8 in the Annex). In other words, banks have tended to go back to traditional banking activities.

The squeeze in interbank lending and other wholesale sources of funding, new regulation requiring liquidity buffers and changes in investors’ preferences pushed banks to increase retail deposits as a source of funding for their activities. Indeed, banks in virtually all countries increased their retail deposits, with the banking system with an already important retail orientation becoming even more retail (Figure 4b).

A slowdown in economic activity and the pressure on banks, households and non-financial corporations to deleverage limited the demand for new loans. This pressure to deleverage was stronger in the banks with proportionally larger retail loans, which declined over the crisis. In banking systems with the smallest proportion of retail loans, retail loans tended to expand over the crisis (Figure 4a).

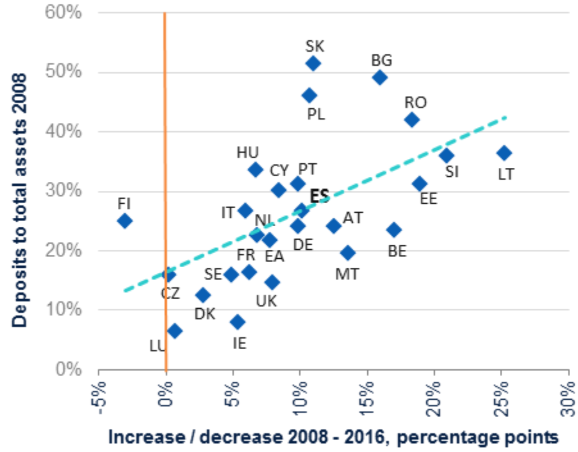
13: Although the impact can be complex. For instance, liquidity requirements in Basel III promote retail deposits while the BRRD requires a certain amount of bail-inable debt, and therefore, penalizes retail deposits.

Figure 4a Retail loans in 2008 and evolution up to 2016



Note: Analysis based on domestic assets (non-consolidated). Retail loans include all loans to households and non-financial corporations.
Source: ECB and BBVA Research

Figure 4b Retail deposits in 2008 and evolution up to 2016



Note: Analysis based on domestic assets (non-consolidated). Retail deposits include all deposits from households and non-financial corporations
Source: ECB and BBVA Research

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