European Foundation for the Improvement of Living and Working Conditions

Financial services: challenges and prospects

Executive summary

Introduction

The recent financial crisis has brought to light the serious challenges that the European financial services sector is facing. What are the prospects that a viable, more resilient financial industry will emerge from the crisis? This report reviews the economic trends in the banking and insurance industries and the debate on the regulation of financial markets. It looks in detail at the business models that are applied in the different segments of the financial sector as a response to the crisis. Finally, it develops scenarios for the potential adaptation process of the European financial services sector. The research was conducted by means of case studies of a range of companies in the sector, an online survey and interviews with experts from companies, social partners, research institutions and public authorities and a detailed analysis of company statements and financial data.

Policy context

It is unlikely that the series of shocks arising from the vulnerability of banks has come to an end. Rising default risks in real estate markets, product markets and among banks in Europe and the US will have a negative effect on banking assets and on economic growth. As a result, the exit scenarios developed by the European Commission all point to a transition phase with low or even negative growth. On the positive side, regulatory reforms have begun and the uncertainty about their scope and direction has been reduced by the US Senate's recent approval of the 'Wall Street Reform Bill', and the decision taken on regulating hedge funds, and on other issues, in the European Union. However, the global debate on a worldwide regulatory framework, as envisaged by the G20 governments, continues.

Key findings

As a response to the crisis, financial companies have adapted their business models, concentrating on the strengths of their core business. A significant deleveraging process (paying off of debt) can be observed in private banking in particular. A number of private banks have tried to expand their retail and commercial activities, but returned to investment banking when capital markets opened up promising opportunities. State-owned banks, which are part of the public rescue programmes, have been restructured by selling off peripheral and risky activities. Risk-assessment tools have been improved and equity ratios have increased. Balance sheets have been repaired by substantial writedowns and profitability has returned to large parts of the business.

However, this return to profitability was at the expense of considerable job cuts. In 2009, roughly 10% of jobs in the state-owned banks examined were cut (around 5% in the surveyed private banks). In the cooperative banks examined, employment was reduced by 1%. Only in one insurance company and a so-called 'ethical' bank did the number of jobs actually increase. Though the case studies do not give a complete picture of employment developments in the sector, they do show how restructuring in the sector impacted on the number of jobs.

A majority of companies have revised their remuneration systems for managers and investment brokers, linking income to business performance over a number of years. In general, the size of bonuses – in relation to fixed salaries – has been reduced and payments have been deferred by between three and four years. A substantial proportion of bonuses is now awarded in the form of company shares. The effect of these changes on investment behaviour and risk appetite is still to be observed.

Despite sharing some general trends, the business models of financial companies show significant differences. They can be classed according to three different approaches.

One group of 'liberal' banks, investment funds and other intermediaries draws high profits from trading books and proprietary trade. While adapting their business operations to the new market conditions, they still try to continue their profit-oriented strategy, pressing for only minor changes in the regulatory framework.

A second group of 'state-owned banks', which came under state control during the crisis, now face severe restructuring. They have to adapt to substantial losses in trading books as well as the reorientation of business strategies towards the core retail and commercial business. Public supervision strongly affects the restructuring process but also provides important advantages in the form of state guarantees.

A third group is described as 'sustainable', since these institutions follow long-term business strategies with less leverage and less ambitious profit targets. This group was not greatly engaged in new financial markets and thus experienced only minor losses from asset writedowns. Parts of the saving banks and cooperative banks belong to this group, as well as the newly emerging 'ethical' banks and most of the insurance companies.

Scenarios for the future

Based on the above findings, three potential adaptation scenarios for the European financial sector were developed.

The past is the future

This scenario assumes that the big players are strong enough to ensure that no major reform of the financial system takes place. The crisis is generally interpreted as the accumulation of unfavorable circumstances rather than a systemic default. This allows 'liberal' banks to continue their profit-oriented strategies while the 'sustainable' segment will succeed in holding its position, albeit without expanding substantially. Faced with the growing strength of 'liberal' banks, 'state-owned' banks will be under stress and governments will try to reduce their involvement in such institutions. The scenario assumes that a further financial crisis can be avoided with only minor regulatory adjustments and that retail and commercial banking will provide sufficient stability.

A new world order for financial markets

This scenario sees the G20 governments agreeing a fundamental reform of the world financial system in December 2010. The reform includes higher and risk-based equity ratios, the separation of investment banking from retail and commercial banking, the submitting of resolution plans ('living wills') – at least by the big players – and efficient monitoring. Implementing these rules will reduce the competitive advantages of liberal banks and put the sustainable and state-owned companies into a much better position. Higher equity ratios will be the key to this type of adaptation, which will require a long and difficult transition period.

Divided economies

This scenario assumes that the financial crisis cannot be kept under control. Rising default rates and overburdened public budgets will force some governments in the euro area to cut liabilities by between 20% and 30% and to resolve – close or nationalise – a series of banks. Austerity programmes in European countries will be an additional burden on real economies and rising inflation in the US and the UK will create further imbalances. The scenario foresees the international regulation of financial markets failing, hence a strongly profit-oriented and growth-oriented group of managers and professionals will continue to engage in short-term speculation and arbitrage, supported by some countries offering liberal financial markets. This approach will be opposed by some sections of society, which will start developing local network-based economies. A fundamental critique of globalised economies will lead to new approaches based on 'micro-organisms' rather than macro-institutions.

All scenarios see a further reduction of employment in the financial sector. This will be most severe in the third scenario. However, the pressure to achieve cost savings will be strong in all scenarios, while information and communication technologies will provide scope for continuous productivity increases. Social dialogue, in all the three scenarios, is best developed according to the assumptions of the second ('a new world order').

Further information

The report *Financial services: challenges and prospects* – is available at http://www.eurofound.europa.eu/emcc/content/source/eu10001a.htm

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