# Tech Disruption In Retail Banking: France's Universal Banking Model Presents A Risk

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(***Editor's Note:*** *This article is part of a series of commentaries on retail banking sectors, illustrating how technology disruption forms part of S&P Global Ratings' analysis of banks.)*

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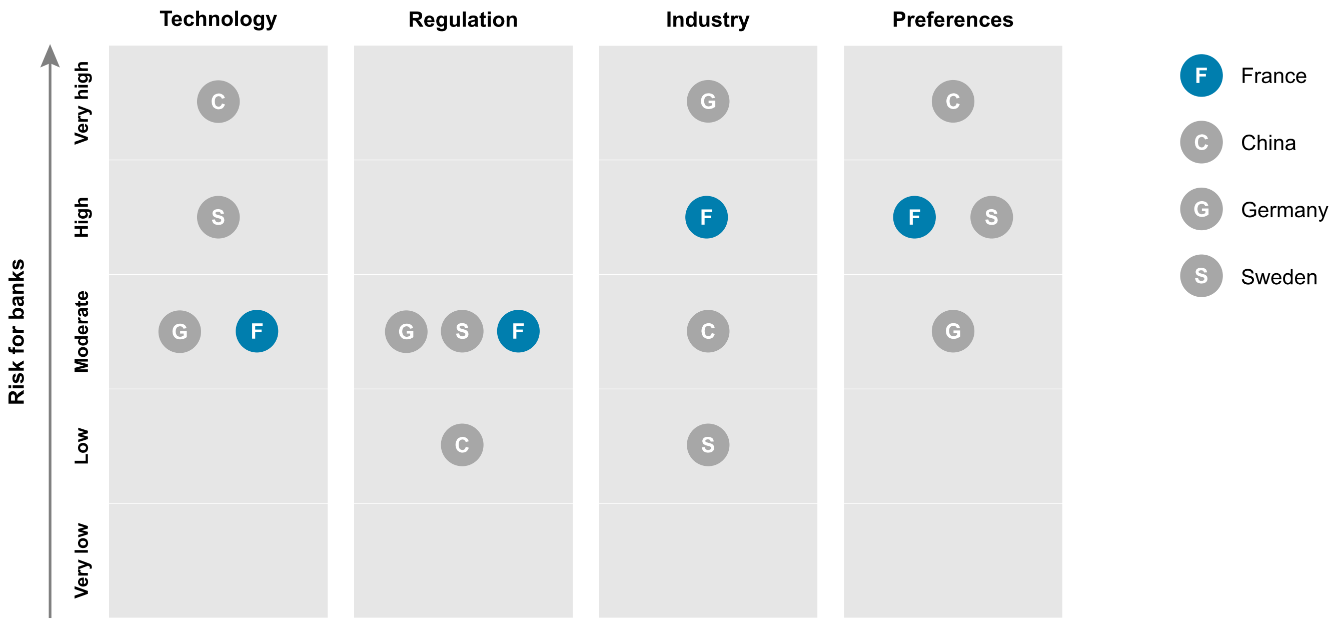
## Key Takeaways

- The universal model for traditional French banks and their revenue structure create some protection against disruption in their lending business but adds additional risk for disruption in remaining retail segments.
- The way that customers interact with their financial providers will evolve faster over the next 10 years as millennials embrace new digital solutions.
- The key to adapting to the new digital reality for French banks will be trimming cost structures and replacing outdated core banking systems.
- That said, French banks don't seem alarmed by the move to digital; incumbents are moving to adapt to regulation and to new customer preferences for digital products and services.
- Although our French bank ratings aren't threatened by these trends in the short term, they weigh on profitability; we estimate 15%-25% of banks' consolidated revenues could be attacked by fintechs and later on perhaps by the Big Techs.

S&P Global Ratings believes French incumbent banks have to boost their digital capabilities to prevent disruption in their retail segments, particularly because of increasing competition from fintechs and eventually from Big Techs.

Applying our four-factor analysis of a banking system's technology, regulation, industry, and preferences (TRIP), we think the prevailing universal banking model and evolving customer preferences may diverge, and as such are the main tech disruption risks for French retail banks (see chart 1). We believe French consumers will increasingly swerve toward digital banking services in next 10 years because of demographic trends, creating opportunities for new and simpler services, and ultimately threatening retail banking's integrated value chain. So far, the regulatory framework neither favors fintechs nor incumbent banks, but remains a barrier to entry given the high costs in complying with regulations. Still, we expect more rules to apply to nonbank fintechs as their presence increases in the market.

**Tech Disruption Risks: French Banks**
Growing digital appetite and universal banking model are key risks




Our view of digital disruption risk is the outcome of a point-in-time analysis of four factors of a country's banking industry relative to peers. There is no explicit quantitative analysis behind the scoring; the assessment is the view of S&P Global Ratings' analysts that includes their discussions with market participants. 1--Bank's technological capabilities. 2--Protectiveness of regulation for the banks' market position. 3--Structure of the banking system and its ability to adapt and invest. 4--Customer's preferences for emerging technologies and digital banking, and perceived likelihood to switch to nonbank competitors.
Source: S&P Global Ratings.


## Industry: Disruption Risk | High

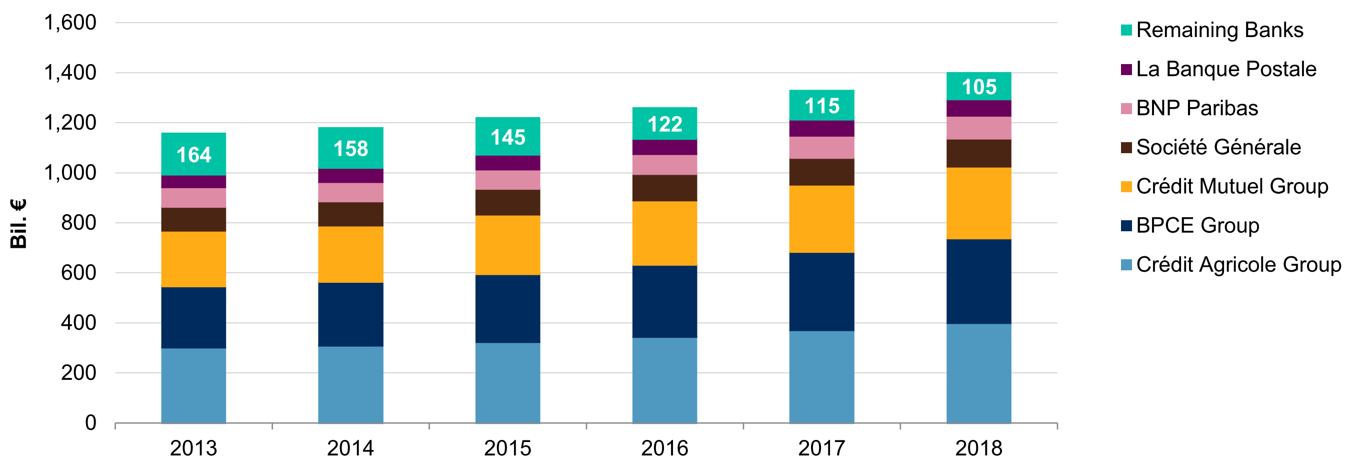
### The universal model leaves many flanks vulnerable to attack

The French universal banking model, with its one-stop shopping strategy, including consumer finance, insurance, and asset management, explains why banks need to swiftly adapt to digital banking. To be successful, such a model implies that customers remain loyal and satisfied with the quality of service and depth of products and services on offer. If so, clients won't seriously look at alternatives, preventing disruption. Large incumbents, especially cooperative groups, benefit from generally well-entrenched retail franchises, acquired after decades of presence throughout the country. The strategy of most of them continues to be rapidly growing credit volume and attracting new customers to offset margin pressure from very low interest rates and cross-selling to sustain revenues with noninterest-sensitive fees and commissions. Such strategies leave the door open to disruption if banks are less able to cross-sell other banking or insurance products, particularly if their proximity with or perceived quality of services for clients weakens. Another risk, under the upcoming open-banking framework, is if it appears that incumbents are failing to offer competitive products.

The strength of the large incumbents might become their weakness. Large universal players with omnichannel distribution strategies dominate the French banking panorama, with household debt increasingly concentrated in the hands of top six groups: Crédit Mutuel, Crédit Agricole, BPCE, Société Générale, BNP Paribas, and La Banque Postale (see chart 2). They have created a highly competitive market for housing loans that is formidable against new players. Indeed, low margin for longer-than-ever loan maturities represent about 80% of retail lending volumes. This is intentional because banks use home loans as the hook or, in other words, the primary product to sell add-on products to clients such as consumer credit, savings schemes, funds, insurance, and payments services. This type of consolidation has been largely beneficial for large groups over the past few decades. They have managed to leverage higher lending volumes into a rise in cross-selling, with, for example, a gain in market share in consumer finance to 80% from 75% in the past five years and increased diversity of revenue streams, thanks to insurance and asset management.

Chart 2

**French Banks Loans To Domestic Households**
Household's financial debt is increasingly in the hands of top six banks

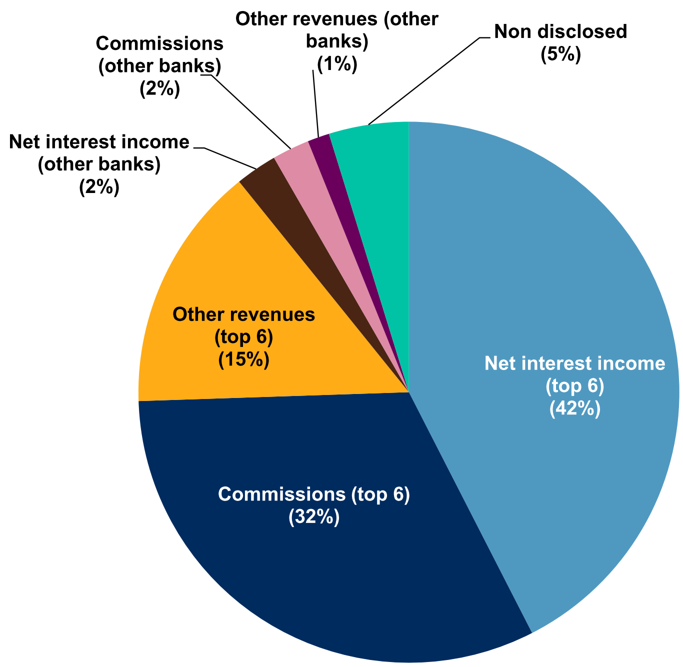



Sources: Banque de France, banks' financial reporting, S&P Global Ratings estimates.


We believe these market dynamics make it difficult for new players to compete in housing loans, but create disruption opportunities in nonlending retail segments. For housing loans, and increasingly in consumer lending, returns are too low to compensate new players for their costs of entering the market. To offset low margins on housing loans, all banks are looking to stabilize their revenues with greater lending volumes, as well as a higher share of consumer loans, insurance diversification, and fee-related income streams. If we believe disruption will remain limited for lending, we estimate this will leave an estimated 45% of French retail revenues potentially at risk over time.

Chart 3

**Consolidated French Banks Net Banking Income Breakdown**
A large 55% of NBI stems from non-interest revenues




NBI--Net banking income. Source: ACPR, based on banks consolidated accounts, including foreign revenues.


Where new entrants manage to come to market, we observe that the cost of attracting new clients is high, and it remains to be seen if they can develop a profitable model. A good example is Orange Bank, which posted a cumulative net loss of €260 million since its launch in 2017, and management estimates another cumulative €250 million-€350 million loss in the next four years before reaching breakeven. In a time of low for longer interest rates where it becomes unprofitable to sit on large deposits, some existing licensed banks with enough funding resources and international players leveraging existing platforms are trying a full digital offering in the domestic lending segment. Boursorama (a Société Générale subsidiary) and ING's French subsidiary--the two largest pure digital banks by clients--have taken this approach. Still, given the tight pricing on this segment and their lack of scale, we do not anticipate that they will be highly profitable if they do not diversify their revenue streams, even if they are a commercial success.

Most bank-like fintech entrants offer current accounts and payment solutions with an enhanced customer experience, which we view as enough to lure some clients from traditional banks and dent payment revenues, but not threaten other retail segments. Over the past few years, we have seen many actors emerging in France. To attract new clients, most of these online banks usually offer a monetary welcome reward upon the opening an account, provided that it remains active for a certain period of time. Although this strategy works in creating a client base, it raises questions of profitability. However, they create the perception, in particular among the younger clientele, that banking services should be cheap, a trend that incumbents have to embrace as well. If incumbent banks want to retain customers, they face a difficult task: reduce prices and at the same time increase IT and infrastructure investments. This will obviously put a drag on profitability and favor banks that are highly cost efficient in retail activities.

The remaining French fintech space is increasingly crowded, with most actors trying to capture value in payment services, personal finance management (aggregators), and savings advisory including fund placements. We also note an increasing number of players in cryptocurrency exchange and crowdfunding, but volumes remain limited. The Big Techs are also targeting this piece of the pie with their own mobile payments solutions--but aren't touching the lending and savings part of the business because of the regulatory burden. In general, new players are positioning themselves to seize parts of the integrated value chain the incumbents currently hold.

To counter retail disruption, banking groups have adopted a few strategies. First, most groups have launched or are launching their own digital banks or brands, either through acquisitions of self-innovation: Boursorama (Société Générale), Hello Bank! (BNP Paribas), BforBank (Credit Agricole), Monabank (Crédit Mutuel), Fortuneo (Crédit Mutuel Arkea), and the forthcoming My French bank (La Banque Postale). Second, they are trying to accelerate the digital offerings of their traditional brands to be truly omnichannel; we have seen online and mobile distribution increase exponentially in latest quarters, but we think it will take banks time to complete their full digital journey.

## Preferences: Disruption Risk | High

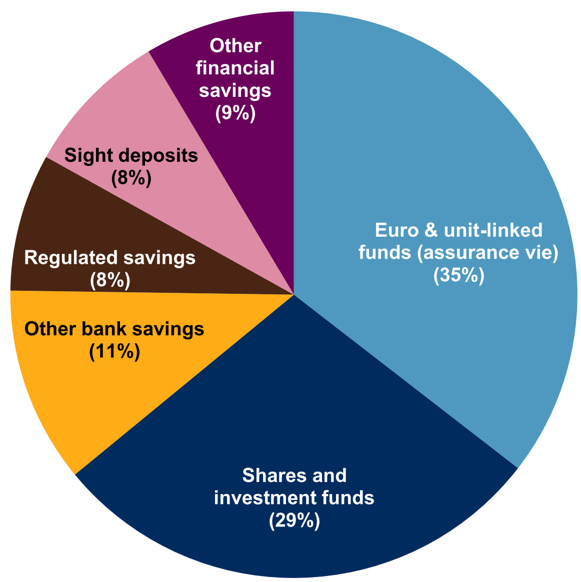
### High adoption of digital banking is around the corner

We believe that traditional players need to adapt mainly in three areas: client interaction with financial advisers for savings, lending, and payments.

As for savings, most people still rely on traditional banks for their deposits, which we believe indicates a mindset that generally places their trust in banks. Most people are still reluctant to use fintech for liquid deposits because they view them as more prone to data privacy issues and not necessarily financially attractive compared to regulated savings. Moreover, online banking is well established in this savings segment. The same applies to other savings schemes (investment funds, securities, and "assurance vie," see chart 4) where traditional banks and insurers still have the upper hand in the market thanks to their brand reputation and ability to cross-sell. We do not expect fintechs to radically change this picture in the next few years, but it may in the longer run as customer preferences shift and as technology advances. While traditional banks' funding profile will continue to rest on liquid deposits, intermediaries could manage customers' other financial allocations like shares and funds. Such intermediaries, or independent financial advisers, already exist but represent a mere 5% of the French market in household assets. With the progress in technology, financial allocations will be increasingly automatized and offer simpler reporting through digital channels or mobile apps, and customers will logically turn to the cheapest and most convenient solution. When this happens, traditional banks would not lose all of their retail revenue because they would still be able to compete through the insurance or funds products they create. However, losing their integrated distribution model will reduce their margins.

Chart 4

**French Households €5.5 Trillion Financial Savings Breakup**
Most nonbank savings could be disintermediated




Sources: National financial accounts, Banque de France, S&P Global Ratings.


When discussing lending trends, there's a big difference between housing and consumer loans. When it comes to housing loans, the traditional banking groups remain the first choice for French customers. They take out housing loans where their deposits are. They are not likely to move accounts even though new banking regulation has allowed for greater competition by making it easier for customers to transfer accounts from one bank to another. Aside from customer preferences, we believe the country's complex regulation of housing loans and their low profitability for banks will protect the market share of traditional banks and block new entrants. However, consumer loans are more profitable products, with shorter maturities and higher margins. We think fintechs could challenge the current players in this segment by offering competitive rates and betting on volumes to generate their margins. Overall, we estimate French clients still prefer their traditional banks for housing loans, but less so for consumer credit. The risk is modest that banks will lose interest income revenue to nonbank fintechs.

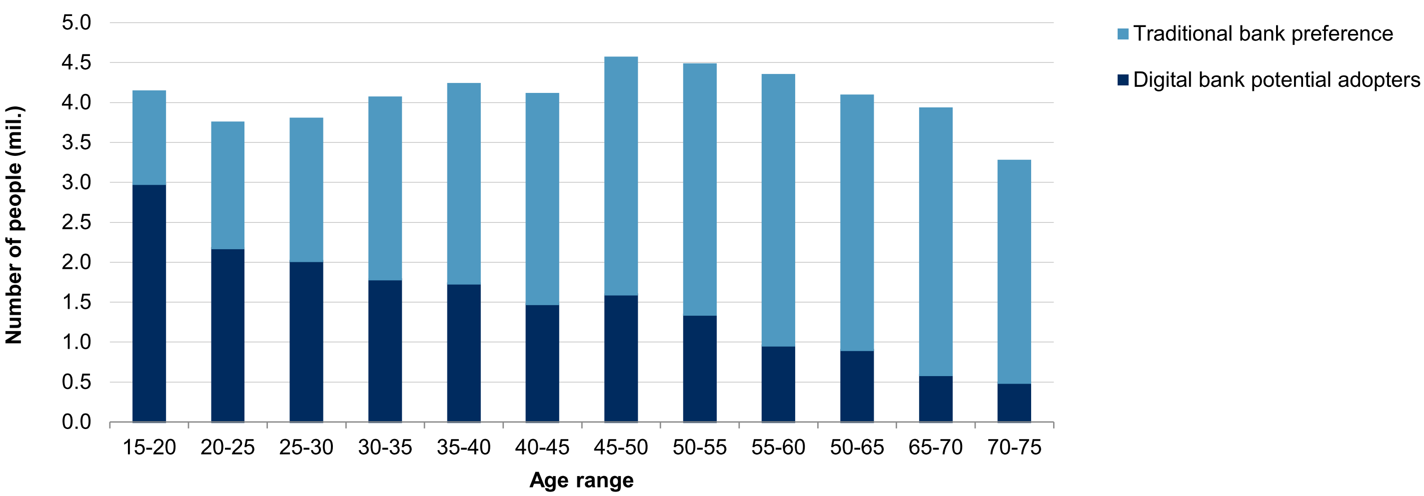
The payment area is the one that presents the most risk for traditional banks. According to data from the European Central Bank (ECB), cash still represents the dominant share of payments at points of sale (POS) in France, but their volume represents less than 30% of total payments and is on a downward trend. This figure is broadly in line with that for Benelux countries but far below that of Germany, Italy, Portugal, or Spain, where cash payments range between 50% and 70% of total volume. The reason for France's low share is mainly due to the long-standing Carte Bleue card payment system created in the 1960s and acquired by Visa in 2010. We expect cash to continue to fall out of favor as noncash payments for POS continue to climb and e-commerce takes stronger hold. We estimate payment-related revenues in France to be 4%-6% of all revenues for banks, and believe these to be at risk given the potential for a cheaper and better customer experience. New competition in this area are fintechs that are on the verge of offering direct payments that bypass cards systems or potentially Big Techs that charge banks for their intermediation of mobile payments. Mobile payments were still marginal in 2018 with volume of only €10 million versus €2 billion in transactions by contactless cards and about €12 billion of total card payments. However, mobile payment services are on the rise, through systems such as Apple Pay or Samsung Pay, and so is client knowledge, which is a risk for traditional banks. They are trying to find a common front with their own solution, Paylib, but they are up against companies that already know how to win over clients on mobile.

We believe security and data protection concerns are the main reasons why not more of the French population hasn't yet shifted to cashless payments. However, we think this is about to change because of demographics. The new generation of digital natives is likely to gravitate toward digital payments. In 2025, we estimate that the millennial generation (born between 1980 and 2000) will represent around 75% of the active French population. What's more, this generation's propensity to adopt digital banking is 2x-3x that of generation X (born between 1965 and 1980). In other words, future core users of banking services will expect a full, digital experience, and a premium service, as they will be able to switch financial providers easily.

Chart 5

**French Demographics Will Change The Picture**

The digital savvy millenial generation will represent 75% of the labour force in 2025.




Source: S&P Global Ratings.

## Regulation: Disruption Risk | Moderate

### The legal environment has improved for new players, but barriers to entry remain high

The French legal framework and European regulations are pushing banks to open their systems, allow for more competition, and better inform and protect customers. Nevertheless, not everything is negative for incumbents, as increasing regulation also heightens the barriers to entry. Banks have therefore no choice but to adapt, keeping in mind that they are at a competitive disadvantage with other global peers when it comes to their workforce flexibility.

The risk and opportunities of open banking will become apparent with the implementation of the EU Payment Services Directive 2 (PSD2). Incumbent banks have to open their gates to third-party providers through Application Programming Interfaces (APIs) such that digital banking services to clients can be offered from third-party companies. Fintechs will likely benefit from this opening and try to limit customers' interactions with their banks, which is the first step to breaking down French banks' highly integrated distribution model. The next round of regulation is likely to address ownership of personal data, which will probably grant access to third parties upon client consent. This will undermine the existing universal banking model, unless banks develop platforms providing the best customer experience.

More specific to France, successive governments have undertaken a number of reforms in the past decade to enhance consumer protection and increase competitiveness between banks through a banking mobility act. Switching between banks is now much easier and cheaper for clients, as the acquiring bank handles all of administrative steps. The impact has been negligible so far in terms of current account market share, but it gives neobanks a chance to become a customer's main bank. Other measures include better protection of customers from high consumer finance interest rates (capped rates; mandatory amortizing loan offer when principle exceeds €1,000 instead of only an expensive revolving credit, for example), and more flexibility to switch insurance contracts. All these measures can be detrimental to banks' revenues and to client retention, but it makes the French market less attractive to new competitors in the consumer finance space. In addition, many operations are required to be free such as closing a deposit account. It is therefore free of cost to the customer to switch banks, which however charge very little for basic accounts.

Adapting to regulation and digital trends also means investing large amounts in IT infrastructure, processes, and personnel. Smart technologies and automatized services can reduce headcount and lower wage expenses. However, we think French banks to be at a disadvantage compared with peers in countries with more flexible labor laws, in particular because incumbents already have higher cost-to-income ratios than the European average. Consequently, it could take more time and be more expensive to adapt the large French retail network to the new norms.

## Technology: Disruption Risk | Moderate

### Banks try to keep up with the increasing available digital solutions

New technology is the root of innovative product solutions. However, we do not think it's the main risk for French banks because new technologies are generally available to all banks, but the speed of implementation differs and creates a divide between adopters and laggards.

France ranks in the top tier of countries in the ability of individuals in a country to access and use new information and communication technology, as demonstrated by UN's Digital Access Index. Looking more closely at domestic banks, we believe the availability of technology is not an issue, but implementing it as fast as fintechs and Big Techs is the challenge because of their legacy IT systems. New competition will have a competitive edge for years to come thanks to much lighter and agile systems, in our view. In this panorama, legacy IT systems and already high cost-to-income ratios, compared with peers', will take a toll on incumbents' ability to innovate rapidly.

Open banking, mobile, and instant payment will be the key technologies in the French customer relationship race. Incumbent banks are actively creating their own platforms to take full advantage of the open banking era and add new services in their mobile apps, including nonbanking products. This is a crucial strategy to retain customer contact, in our view; banks still have the lead compared to new entrants, thanks to their longstanding relationship with clients, but we cannot exclude disintermediation risk in the medium term if better nonbank platforms become clients' preferred solution. This is particularly relevant since exponential use of smartphones, increasing device capabilities, and less time for customers to spend at branches are the perfect combination for a shift on how customers consume daily banking services.

## French Banks Are Among The Highest Rated Financial Institutions Globally

French banks ratings remain strong in a global context, supported by a wealthy and resilient economy, a favorable momentum for low credit losses, and very diversified revenue streams thanks to their universal model. We do not see any immediate impact from the tech disruption on large incumbents' ratings in the near-term because we believe bank management teams clearly identified the risks and opportunities, and are implementing well-defined strategies to address them.

Still, the medium-term picture in not that clear for their domestic retail business lines, and the failure to satisfy evolving customer way of daily banking would put additional pressure on an already below par efficiency. Incumbents are on the move to digitize their processes and offering, investing large amounts to adapt systems, and trying to adapt their branch structure. This does not mitigate the risks for French banks, due to the low profitability of core lending. We consider that the other retail activities, on which French banks make more money, to be more at risk. Therefore, digitalization could eventually question the overall pricing structure of French retail banking if banks lose part of their non-lending revenues.

## Related Research

- The Future Of Banking: Will Retail Banks Trip Over Tech Disruption?, May 14, 2019
- Tech Disruption In Retail Banking: German Banks Have Little Time For Digital Catch-Up, May 14, 2019
- Tech Disruption In Retail Banking: Swedish Consumers Dig Digital--And Banks Deliver, May 14, 2019
- The Future Of Banking: Research By S&P Global Ratings, May 14, 2019 [Contains links to all tech disruption articles]

- Banking Industry Country Risk Assessment: France, July 11, 2018

This report does not constitute a rating action.