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Tech Disruption In Retail Banking: Italian Banks Not Adapting To The Digital World Quickly Will Be Left Behind

February 17, 2020

(***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.)*

PRIMARY CREDIT ANALYST

Mirko Sanna

Milan

(39) 02-72111-275

mirko.sanna@spglobal.com

SECONDARY CONTACT

Alessandro Ulliana

Milan

(39) 02-72111-228

alessandro.ulliana@spglobal.com

Key Takeaways

- We believe new technologies are increasingly available for Italian customers, while regulation on open banking is kicking in and will likely favor transparency and new entrants to the markets
- Most Italian banks are adapting to the digital world, enhancing their internal processes, offering multichannel solutions to their customers, and joining forces with fintechs; however, mass adoption of open banking might take longer, given customers' conservative behavior in approaching financial services and stickiness to traditional financial services providers.
- We see lower near-term risks because banks retain a strong advantage in terms of customer relationship, but disruption risk might be high overall, particularly for entities unable to keep abreast of innovation and evolving competitive environment.
- Our ratings on Italian financial institutions are lower than those on most peers in Western Europe because they already face greater economic risks and because of the uncertainties about the sovereign's creditworthiness and government; on top of that, some banks' business models are at risk.

S&P Global Ratings believes that the tech race and increasing competition in Italy could fuel more structural industrial changes in the domestic banking sector. Traditional banks will have to continue to improve their internal processes, foster innovation, and focus more on value added services. Furthermore, some core banking products might become increasingly commoditized, in our view. This is likely to happen amid sluggish economic growth, persistently low interest rates, and highly constrained profitability.

For this reason, we expect to see growing divergence in the Italian banking sector. Large banks with bigger economies of scale have strong capacity to invest in digital innovation and enhance

their efficiency while diversifying their revenues stream, in our view. At the same time, some smaller entities with an agile, cost-light business model might quickly adapt to evolving consumers' preferences, leveraging the opportunities that open banking offers or filling the gaps in some market segments. However, we see a number of other institutions, namely weaker small-to-midsize banks still dealing with legacy issues, that will be more exposed to this disruption risk because they might not have the capacity to cope with increasing competitive pressures the digitalization will inevitably lead to.

While we believe these risks are on the rise, we don't anticipate they will substantially materialize in the near term. This is mainly because mass adoption of digital banking might take longer in Italy than in other countries given clients' conservatism and cultural constraints. Banks still have some time to react, but more effective actions need to come sooner rather than later.

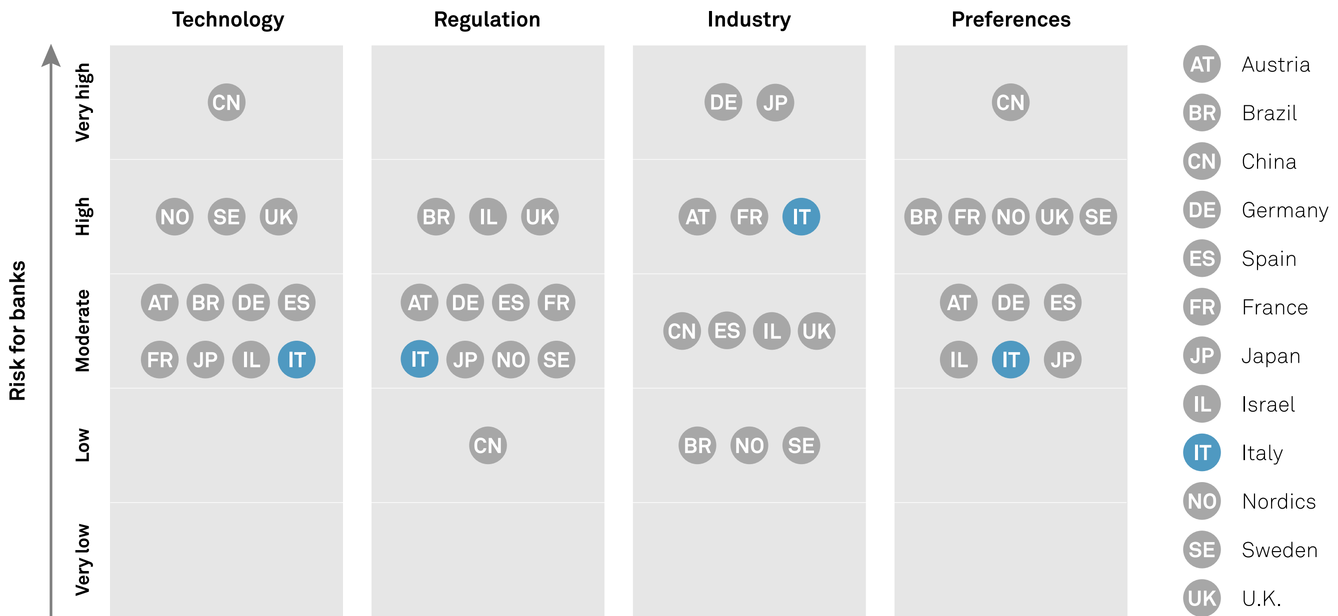
TRIP Analysis Shows High Risks For Weaker Banks

We are applying our four-factor analysis of a banking system's technology, regulation, industry, and preferences (TRIP) to the Italian banking sector. We conclude that, while new technology is already available to most customers, they are still not using it on a large scale for banking transactions. In addition, banks are mostly relying on digitalization as a tool to improve efficiency and productivity and to enhance their internal processes, more than a value proposition to customers. For this reason, among others, retail consumer preferences largely remain tied to traditional brick-and-mortar banking. This will give some time to the laggard banks to take action, although modest earnings prospects and legacy asset quality issues could undermine their investment capacity and ability to cope with innovation.

So far, a large number of banks have responded to the tech challenge by enhancing their IT processes and, for some of the largest players, internalizing fintechs' offerings and innovative services through acquisitions or imitation. Digitalization investments have been primarily aimed at enhancing operating efficiency, and improving product offering and customer experience. On the other hand, smaller traditional banks with lower investment capacity have been more "followers" on the digital innovation front, copying solutions implemented by more innovative players, launching initiatives to foster cooperation among themselves, and cross-sharing of technological capabilities. As a result, we believe digitalization could bring some benefits to banks in the near term, due to the productivity gains it can generate. Beyond then, as customer preference evolves and get used to real time advanced digital banking solutions, the effect of tech disruption might become apparent for the laggard banks (see chart 1).

Chart 1

Tech Disruption Risks: Italian Banks



Our view of digital disruption risk is the outcome of a point-in-time analysis of four factors of a country's banking industry. There is no explicit quantitative analysis behind the scoring; the assessment is derived from discussions with market participants and S&P Global Ratings' analysis. Technology--Banks' technological capabilities relative to nonbank competitors. Regulation--Degree to which regulations protect banks' market positions. Industry--Structure of the banking system and its ability to adapt and invest. Preferences--Consumer preference for emerging technologies and digital banking, and perceived likelihood of customers switching to nonbank competitors. Source: S&P Global Ratings. Source: S&P Global Ratings.

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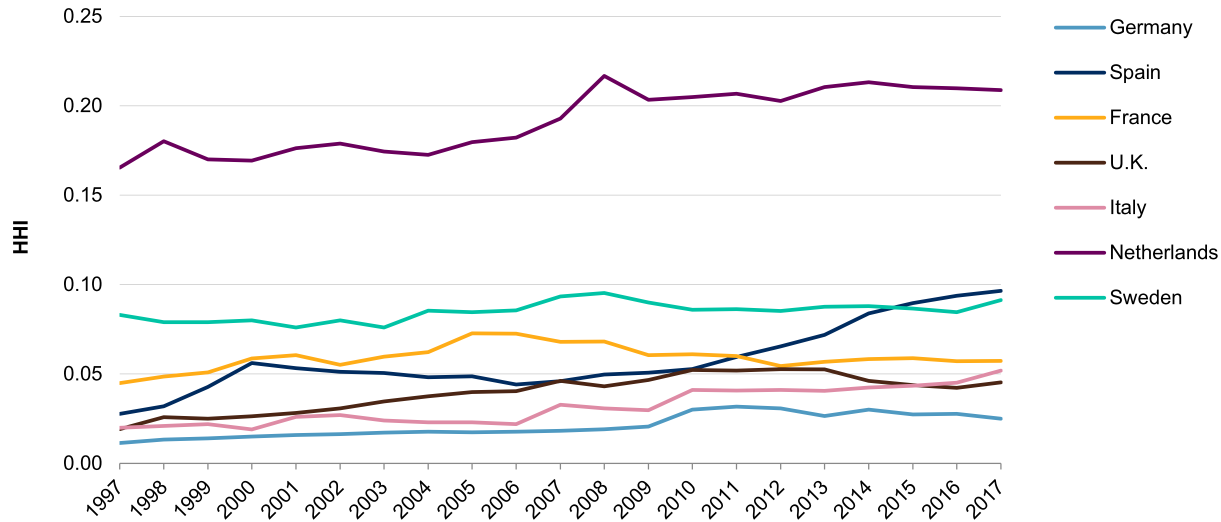
Industry: Disruption Risk | High

A fragmented system with modest earnings prospects, which might challenge several banks' business models

The Italian banking sector remains dominated by the traditional banks that continue to benefit from long-standing relationships with their customers. The sector experienced significant changes and restructuring to deal with the consequences of the double-dip recession. As a result, we observed increasing concentration, with 12 banking groups now controlling about 80% of assets (see chart 2). Still, this was not sufficient to solve most of the issues the sector faces.

Chart 2

Italy Did Not Experience The Same Consolidation Of Countries That Suffered From Deep Corrections Phases
Measured by the Herfindahl-Hirschman Index (HHI)*



*The HHI measures the degree of competition in a marketplace. It is the sum of squares of the banks' percentage market shares (of total assets) in a country. It ranges from a minimum of '0' (low concentration and therefore high competitive dynamics) to a maximum '1' (high concentration and therefore low competitive dynamics). Source: European Central Bank.
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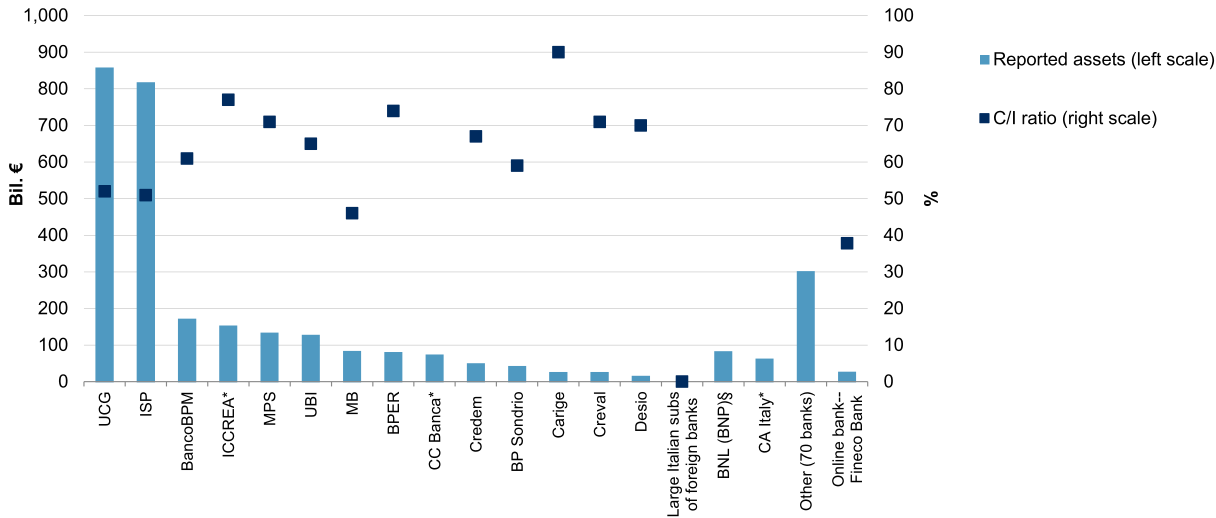
Most Italian banks are unlikely to reach satisfactory return in the near future. This stems from high margin pressure due to some overcapacity in the system and persistently low interest rates. Despite cost-cutting measures, banks have been just able to cushion the loss of revenue. Finally, a few players are still dealing with legacy nonperforming exposures from the past recession. As a result, although declining, credit losses continue to absorb a higher proportion of their operating income than stronger domestic banks and most peers in Europe. In this context, performance among banks vary significantly (see charts 3-5).

Chart 3

Scale Or Agile Models Characterize Most Efficient Banks
Structure of the Italian banking sector (bil. € in assets)



*As of June 2019. §As of December 2018. Source: S&P Global Ratings on latest company figures.
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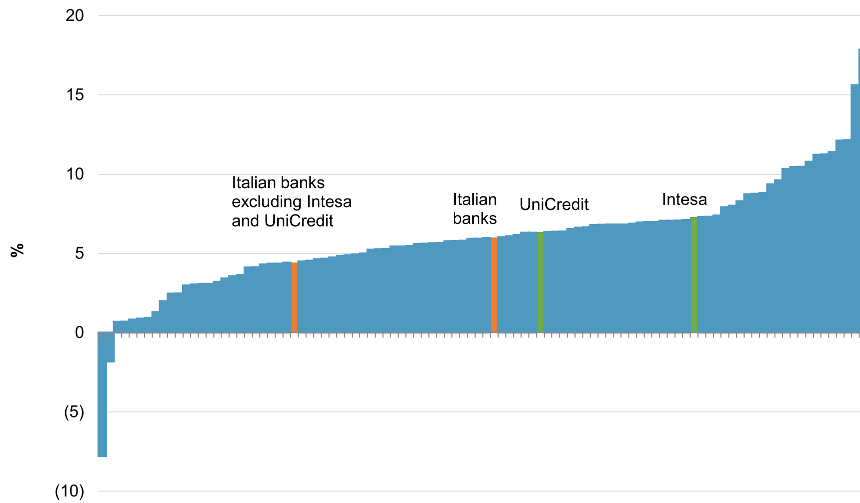
Chart 4

Subdued Profitability Prospects For Most Banks
Top 100 European banks return on average equity, 2020 forecast



Source: S&P Global Ratings.
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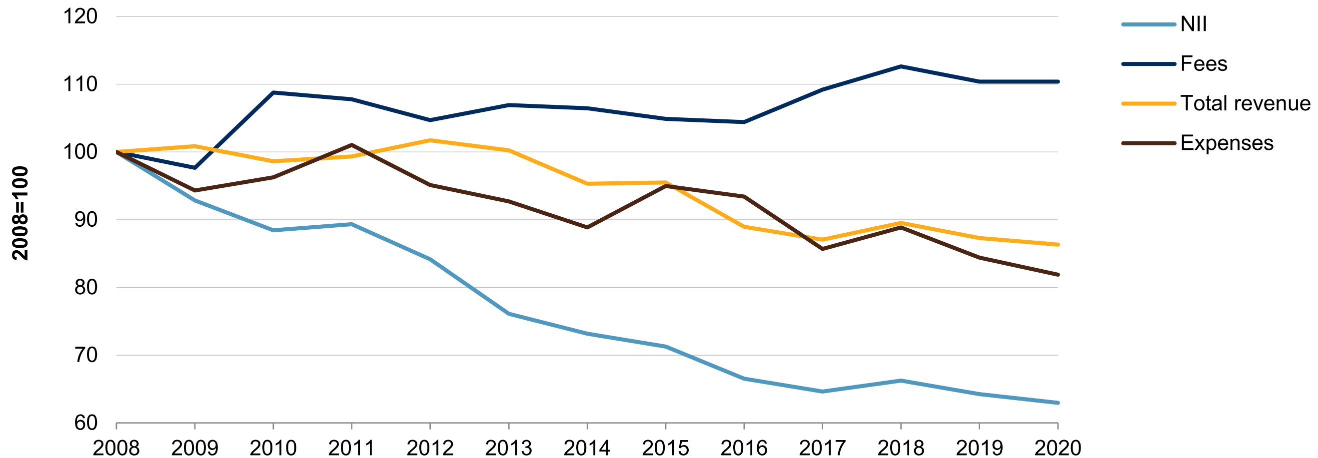
This could result in several players not having enough earning capacity and modest capability to continuously invest in innovation.

Chart 5

Pressures On Commercial Bank Revenue Persist

Trend of operating performance



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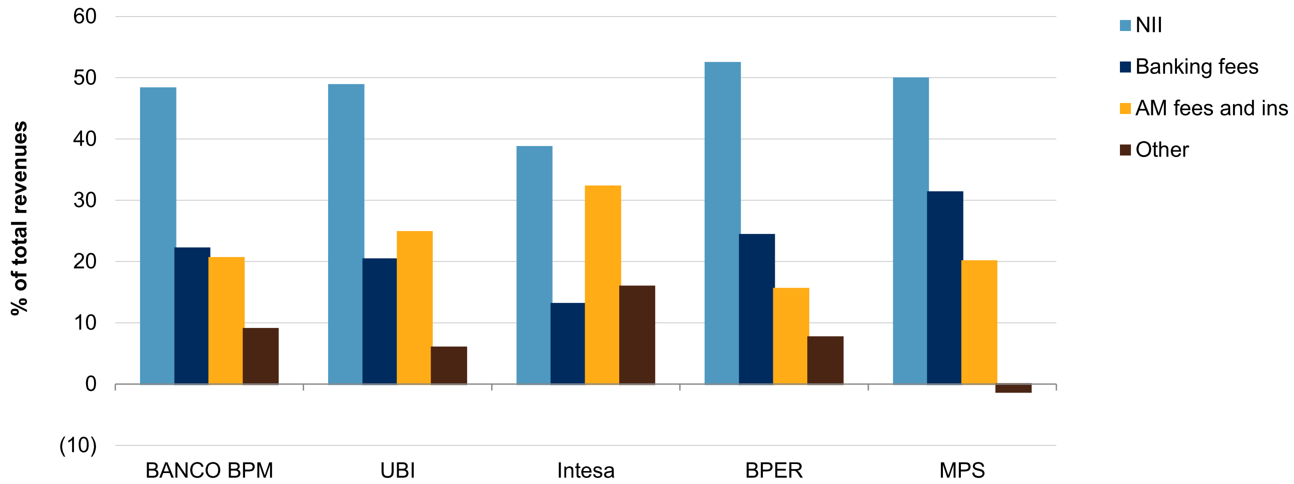
In this context, new digital entrants (and the more digital ready institutions) in the market could spoil those weaknesses to gain market share and potentially disrupt the already vulnerable business model of those weaker institutions in the medium term. We observe that in Italy there are already well established institutions in retail banking and asset gathering that combine digital platforms with network of financial advisors. The most notable is Fineco Bank (BBB/Negative/A-2), now operating for more than 20 years. Despite its success and constant growth, overall market share remains limited, and most of these banks' focus is on generating commission from wealth management and no-lending activities. Lending is just an ancillary business and their success largely stems from the face to face interaction and approach of the financial advisors combined with advanced digital platforms.

Payment and consumer finance could also be segments upon which fintechs are already particularly focused. This could include digital payment providers like Satispay, or more established foreign players entering the market such as N26 or Revolut. Those players have rapidly attracted hundreds of thousands of new customers. As for the more established, nontraditional players, the question is whether the new entrants will catch on outside the more sophisticated (a minority of the total customers) or very young generations, where traditional banks with multichannel offerings continue to dominate.

Overall, the revenue structure of the Italian traditional banks could be subject to further compression if the effect of the tech race becomes more apparent, in our opinion. Examining the revenue of some of the large Italian banks holds clues to where the switch to digital could hit the most.

Chart 6



Source: Bank reports.

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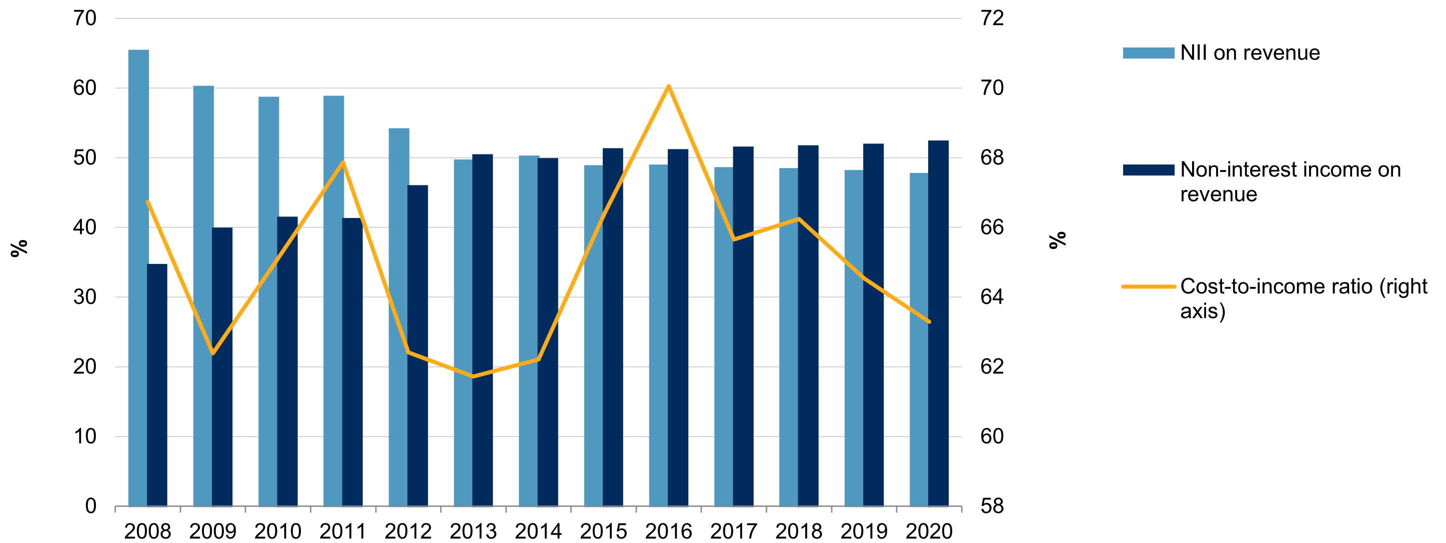
Although more difficult to predict, commercial banking fees might be the first to erode (see chart 6), as transactional banking, payments, current accounts is where we see new entrants already very active as it is usually the easiest point of contact with potential customers. Not only will banks have to adapt their products and services, they will most likely give up margins to keep customers, in our opinion. Related to this, we expect that consumer finance and personal loans will also be segments with more imminent treats from new entrants.

Banks remain the main channel for distribution of funds, insurance products (about 70% of total insurance products), and advisory services through their networks of financial advisors and branches. We expect revenue on wealth management could also come under pressure (see chart 7) once customers become more aware of the cheaper options that digital platforms could offer, also accounting for the challenges asset managers face with persistently low interest rates environment and difficulty in finding yields in many asset classes. This could take longer considering that trust and face-to-face established interaction still favor existing players. Furthermore, wealth management commissions are rising in Italy as banks continue to benefit from positive inflows.

Chart 7



NII-Net interest income. Source: S&P Global Ratings.

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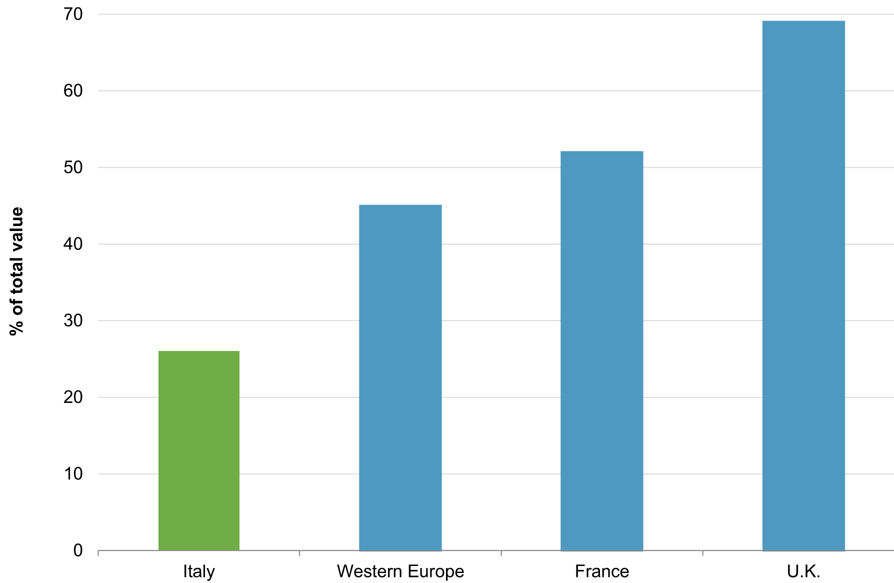
Preferences: Disruption Risk | Moderate

Expanding digital banking from a very low starting point

Italian clients are yet to move to digital banking compared with other major countries in Western Europe. Cash payments are still predominant, representing about 60% of total value, with credit card transactions representing less than 30% of total value and just 12% of transactions (see chart 8). Cashless transactions are comparably lower than other mature economies in Western Europe.

Chart 8



Source: S&P on Euromonitor International.

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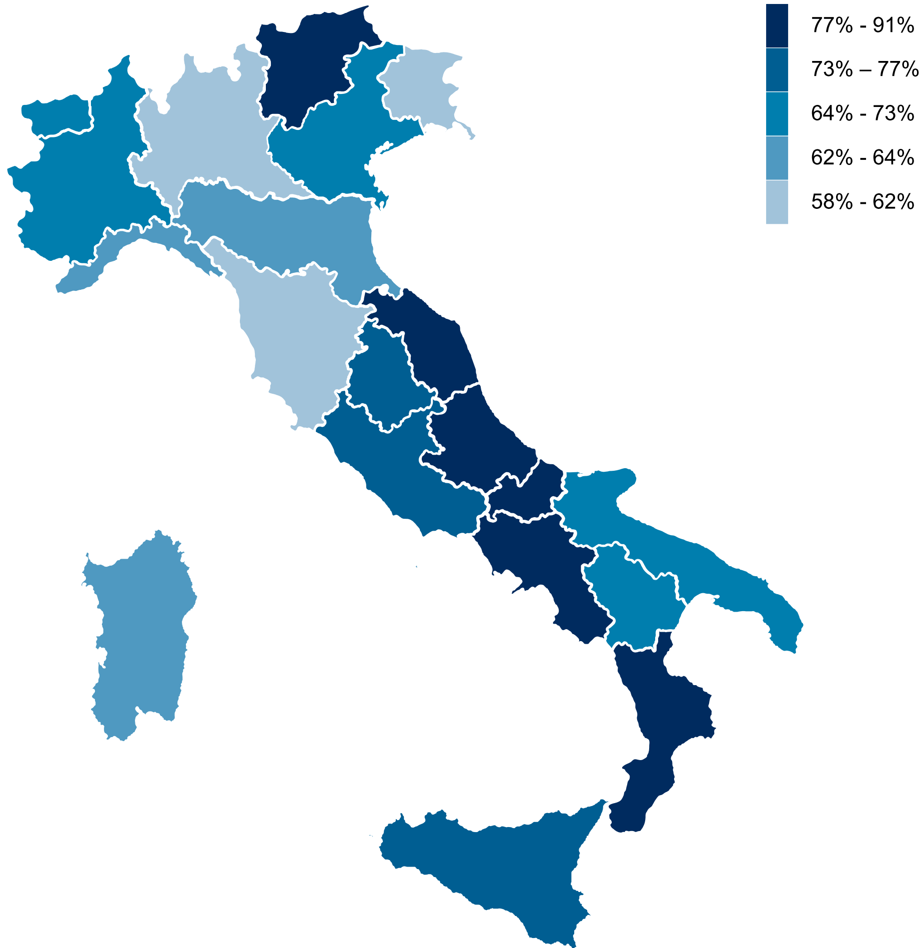
This preference for cash primarily stems from security and privacy concerns, wider acceptance of cash for transactions than cards and some other specific factors including one of highest level of tax evasion in Europe, in our opinion. Regional difference across the country play a role as well (see chart 9).

Chart 9

We Continue To See Wide Regional Difference In The Use Of Cash For Payments

Cash transaction in % to total transactions value



Source:Bank of Italy

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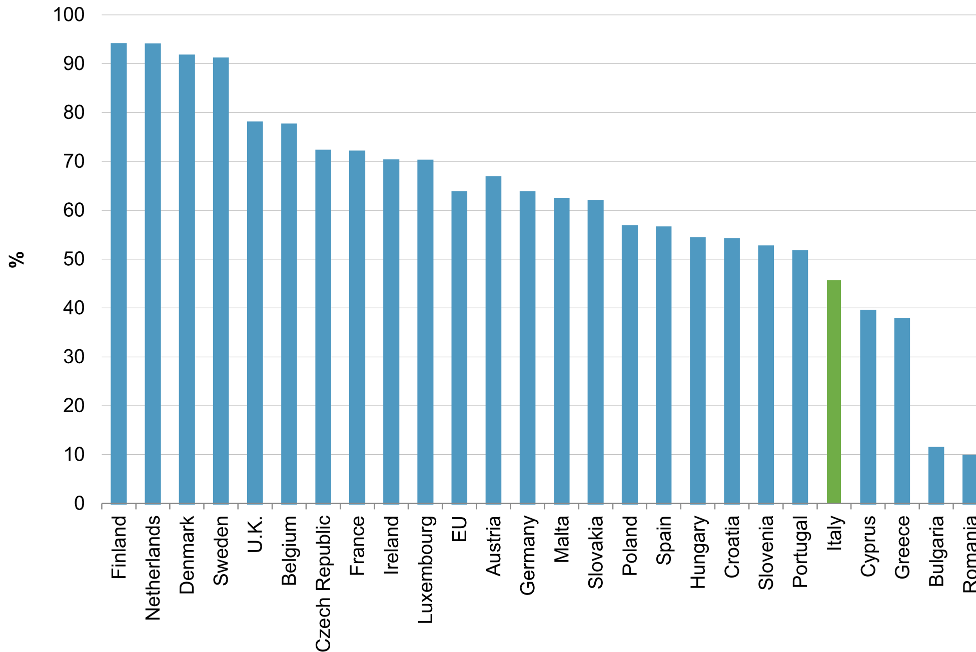
Similarly, Italian customers appear to still lag in terms of usage of online banking compared with most Western European countries (see chart 10).

Chart 10

Italians Use Online Banking Less Than Most Larger European Economies

Online banking prenetration in Europe (analysis year: December 2019)



Source: EU Digital Economy and Society Index 2019.

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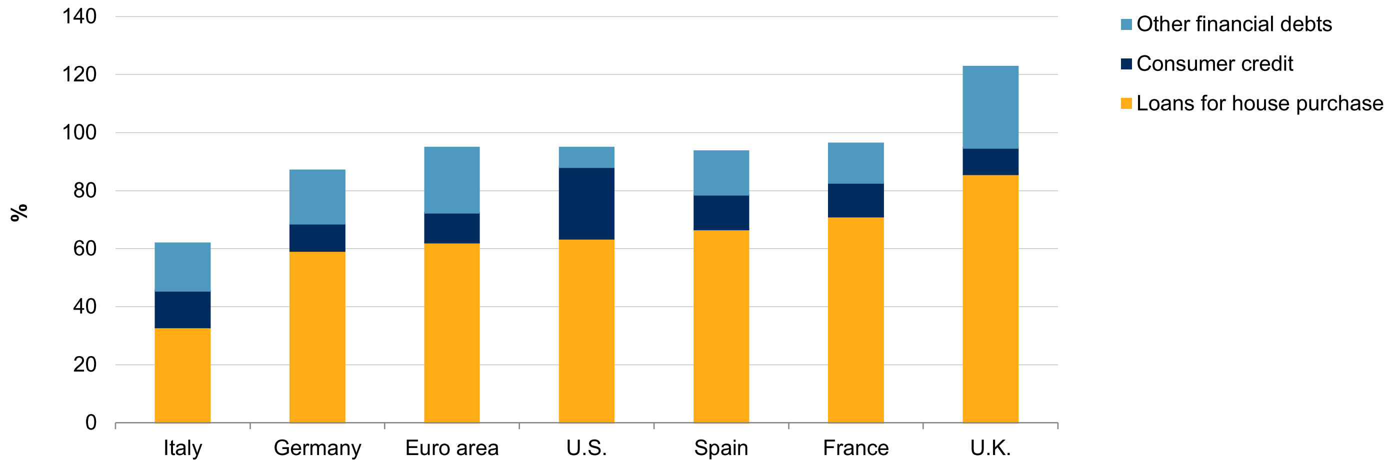
This will gradually change, driven by banks giving customers incentives to switch to digital, and with regulatory requirements. As proximity becomes increasingly less relevant, banks will have the opportunities to further accelerate their plans to trim branches, reduce staff, or allocate people to more advisory front office and commercial activities while not suffering from consequential losses of business. The open banking platform will allow more digital customers to have real-time options to compare products and services and switch providers, particularly if mobile banking develop at a fast pace. Whatever the pace of the customer shift toward digitalization, this trend would stress margins for basic product and services.

Demographic and other structural factors will also play a role in the evolution of customer preference and the potential repercussions for banks. Household net wealth remains relatively high, reflecting both historically high levels of savings and low debt (see chart 11).

Chart 11



Source: Financial stability report.

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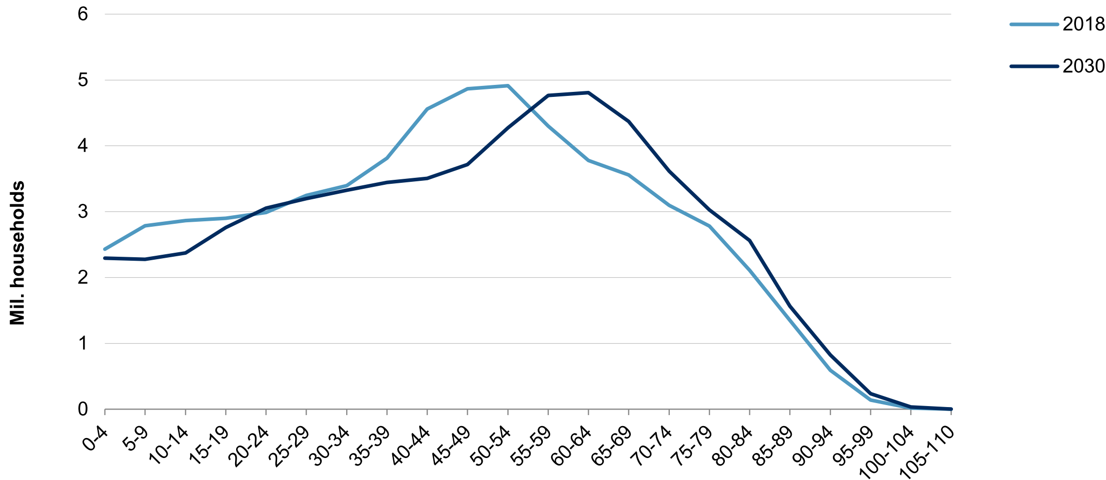
Most of the wealth is concentrated with the over-50 group (see chart 12 for a demographics breakdown). The youngest generation will be significantly more inclined to embrace the new digital offering and are unlikely to be as loyal to their traditional (often local) brand as their parents did. We believe this is already evident with payments, where the young generations embrace newcomers.

Chart 12



Source: Istat.

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We believe the disruption risk is likely to increase once the younger population ages and gets access to a wider range of banking products. We expect this shift to start from payment services and consumer credit, two segments where customers typically have commercial interests from an earlier age, then move to savings and investment. However, given the relative concentration of wealth in the older segment of the population, we believe this will be a very gradual process. Cultural attitudes could make some difference as well. For instance, IntesaSanpaolo signed a joint-venture agreement with Sisal Group to exploit the concept of proximity banking, because IntesaSanpaolo can offer basic banking services through a network of thousands of tobacconists, where millions of people shop every day. This combines physical presence with digital capabilities.

We expect the older population to prove more reluctant to embrace these new methods. Still, a minority of sophisticated customers is already attracted by new offerings and are more sensitive to higher commissions charged by the traditional providers. New entrants could use their cheaper and more effective product and advisory services to attract those sophisticated customers.

Lending and ancillary services to small and midsize enterprises remain core activities for most Italian banks in retail banking, particularly for the smaller banks. We believe that entrepreneurs might be attracted to innovative and cheaper solution from fintechs. Clearly, the historical strong link with traditional banks and their ability to provide fully comprehensive set of product and services might more difficult to unfold for scattered fintechs. Furthermore, by joining forces with fintechs, traditional banks are widening their product range and offering.

Technology: Disruption Risk | Moderate

Technologies are within reach for both banks and customers

In terms of innovation capability and speed at which countries can adapt new ideas and methods, Italy compared relatively well globally (22nd overall, according to the 2019 World Economic Competiveness Report). We consequently do not see any particular technological obstacles for Italian banks in continuing to digitize their business models.

Conversely, the Italian population remains less tech savvy than in most developed countries, ranking 25th out of the 27 countries in the EU in terms of digital knowledge and usage of internet, according to a European Commission report from 2019. This also stems from some infrastructural constraints, such as the lower penetration of fast broadband, at 22% of households compared with 44% on average in EU and over 70% in the Northern countries. Still, the penetration of smartphones among the Italian population is one of the highest in the world and most banks and fintechs offer easy-to-use applications.

Comprehensive 4G coverage in Italy is aligned with the EU average. The switch to 5G is underway but it might take a few years. Nevertheless, consumers have already good access to easy-to-use mobile banking product and services, and we do not see any particular constraints in terms of access to technology. Specifically, mobile banking is where we believe more Italian customers could rapidly switch to.

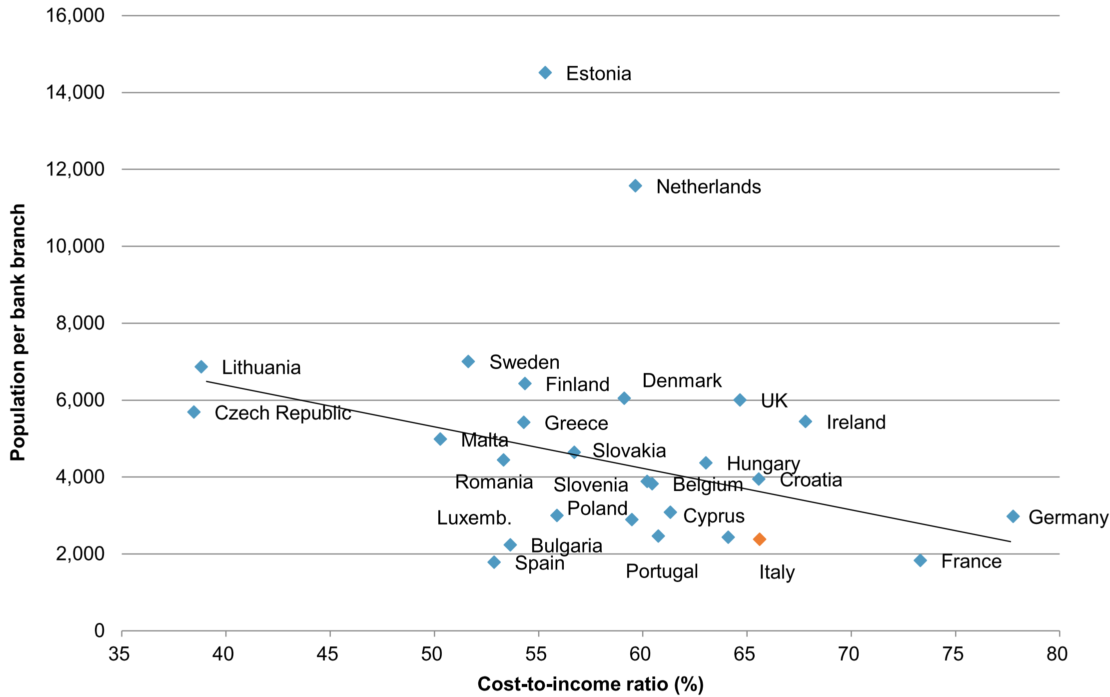
In this context, the introduction of PSD2 and open banking present new challenges for the incumbent banks because it could threaten the main assets Italian banks have, in our view: the knowledge and the data of their customer base. Third-party fintech operators can now have access to customer data (with permission) and provide enterprises and individuals with cheaper and fancier tailor-made services, without also having the same structural costs and constraints that banks have and face. For instance, customers could keep money in their traditional bank accounts or under administration because they might still feel safer, but feel free to use third-party providers to get other banking services they currently get from their own banks.

This challenge has forced Italian banks to react, first to fulfill the technical and compliance requirement, second to anticipate potential future increasingly competitive pressure from new players. The larger banks opted for in-house solutions and joined force with fintechs to replicate their innovation. The smaller traditional players, on the other hand, move more through co-sharing of external solutions that clearly reaffirm their lower capacity to innovate.

Banks are increasingly using new technology to enhance the middle and back office processes and risk management tools. Clearly, investment capacity is different among institutions and in most cases constrained by other urgent priorities such as getting rid of legacy nonperforming exposures and strengthening capital. For some, switching from legacy and often-outdated IT systems is a clear disadvantage compare to new or more agile operators in the market. Larger players are also using artificial intelligence or analytics to better understand customer needs and provide more tailor-made solutions.

Increasingly, digitalization is an opportunity to accelerate plans to further rationalize their expensive branch networks still weighing on efficiency (see chart 13).

Chart 13



Data relates to 2018. Source: S&P Global Ratings. ECB. World Bank Group.

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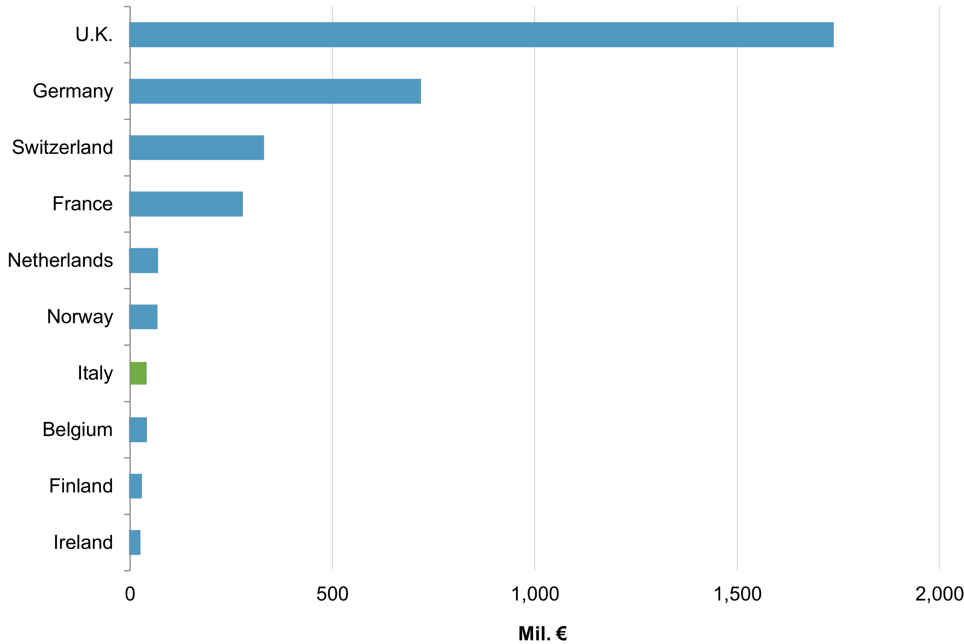
The fintech world in Italy is still in early development and quite scattered (see chart 14). According to recent data, there are more than 250 fintechs operating in Italy, primarily focused on payment, factoring, crowdfunding, mobile banking, digital lending, and credit risk management. This also includes some relatively established international players now entering the country (N26, Revolut). Not surprisingly, given their limited size and the primarily start-up models, most fintechs aim to partner with existing banks.

Chart 14

The U.K. Attracted More Investment Than The Rest Of Europe Combined In 2018



Source: "2018 FinTech VC Investment Landscape," report by Innovate Finance.

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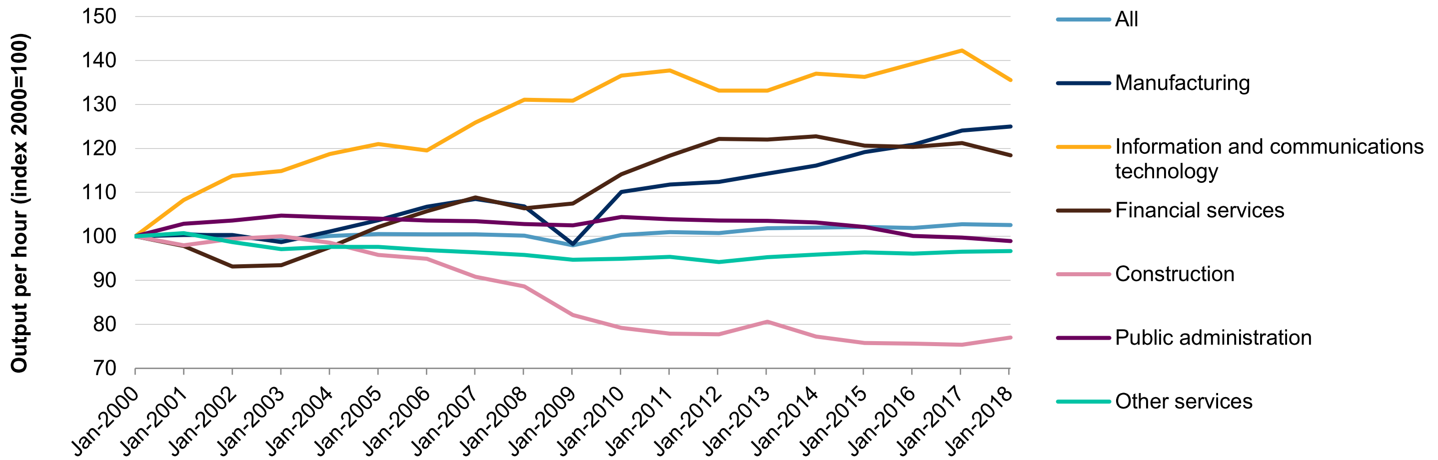
Compared to fintechs, big tech companies could be a bigger threat for traditional banks given their brand, superior financial capability, and knowledge of their customers. As is the case in other countries, it is unclear whether big tech will try to enter highly regulated banking segments such as lending and deposits. Currently, Apple Pay is available via many large institutions in Italy.

As revenue for traditional banks might face further pressure, Italian banks might have to run their operations more effectively, and at a lower cost, while complying with more demanding compliance and data security requirements and challenges. On this front, digitalization could drive further productivity gains (see chart 15).

Chart 15

Italian Banking Sector Outperformed On Productivity Most Of The Remaining Domestic Sectors



Source: Eurostat, Datastream, S&P Global Ratings.

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Regulation: Disruption Risk | Moderate

Broadly aligned with rest of the eurozone

Italian legislators introduced several measures in recent years with a clear aim to provide a relative supportive framework for innovative small business and starts-up, including fintechs. The recently approved Decreto Crescita, for instance, launched the concept of regulator sandbox, a controlled place where fintechs can operate for up to 18 months with simplified regulatory requirements and test their business, potentially favoring investor interest. An effective sandbox supported a rapid development of the fintech sector in several countries, such as Denmark. Furthermore the government had introduced tax incentives, namely tax deductions for the amount invested and tax credit on R&D expenses, the hyper-depreciation of investments in high-tech tangible assets.

Equally important, in our view, have been measures to support electronic payments to contrast tax evasion often connected with the large use of cash in transactions, clearly more difficult to track. Based on current legislation, as of July 2020, individual cash transactions cannot exceed €2,000, decreasing to €1,000 in 2022. This is not new in Italy and this limit has fluctuated in recent years. We believe those measures align Italy with that most countries in the EU, although remaining well behind outliers such as the U.K. Still, fintechs in Italy have not yet attracted significant investments.

Two pieces of legislation appear as most affecting incumbents in the near-to-medium term. Italy is aligned with European regulation on data protection and data access, and since September 2019, the PSD2 is operating in Italy, along with most countries in the eurozone. PSD2 requires

banks to set up specific interfaces with third-party providers allowing fast and secure interactions among software. This clearly reflects European authorities' attempts to push banks to open their systems and client data and increase competition while informing and protecting customers. Open banking clearly will require banks to adapt their systems to the new requirement. While larger banks are managing this internally, smaller banks tend to share some required platforms such as the API gateways.

While new regulations offer opportunities to new entrants, regulation provides barriers to entry that clearly reduce the risk from disruptions. First and foremost, third-party providers are required to get a financial licence to access to customer bank account data and offer payment initiation services and account information services.

The Tech Race Could Stress The Creditworthiness Of Laggard Banks

Compared with those on most banks in Western Europe, the lower ratings on Italian banks reflect their exposure to higher economic risk in Italy, as well as uncertainties about the sovereign's creditworthiness and government policy. They also reflect our view that the banking sector has overcapacity that hampers the profitability of several institutions. Legacy asset quality issues still burden the profitability and limit the investment capacity for "change-the-bank" innovations. Digitalization is unlikely to add further disruption over the next couple of years but it will definitely continue to accelerate the required changes in the banking sector's structure

In the near term, we believe the digitalization gives banks opportunities to enhance their efficiency and better withstand the revenue erosion from margin pressure and subdued business activity. As consumer preferences evolve, we see high risk of disruptions for those players unable to take today the necessary actions. Digital banks will eventually lead to lower revenue for traditional banks, especially those more exposed to basic, easy to commoditize services. Most likely, small and midsize banks will be unable to either have economies of scale and value products or agile, cost-light models. While those structural changes are almost certain, the timing is not.

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