Investors show more optimism for financial services in Europe

European Attractiveness Survey 2017: financial services view
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Foreword

Investors in financial services (FS investors) say they are bullish on the prospects of the sector’s European market, despite a variety of political, regulatory and economic uncertainties. In a recent EY survey, global FS investors ranked financial services as the second-most important driver of growth in the region, after information technology. For now, however, a gap remains between the optimism they express and their level of actual investment.

In our first European Attractiveness Survey specifically focused on the financial services sector, we learned that:

► Global financial services investors believe Europe is still the most attractive region in the world in which to invest in financial services: 44% ranked Europe as their top choice.

► However, although FS investors express more optimism about Europe than global investors in other sectors, the growth of financial services projects did not keep pace with the general growth of FDI across Europe.

► Total financial services investment projects in Europe by global financial services investors in 2016 rose 6% above 2015 (up to 295 from 277).

► FDI projects are more likely to be expansions than new ventures than in 2015, 24% versus 17%.

► The combination of improving macroeconomic fundamentals and technological advances offers a rare opportunity for financial services executives and policymakers to create a robust, sustainable future for the industry.

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1 Respondents to the survey were individuals in FS companies in investment decision-making positions, referred to in our analysis as “FS investors”. A total of 80 decision-makers were interviewed by telephone for the Europe Attractiveness Survey 2017 Focus on Financial Sector and supplemented by 28 FS investors from the main European Attractiveness Survey 2017. Seventy of these senior executives were interviewed in Europe; 38 outside of Europe. Interviews were conducted in English, French, German, and Spanish. Most represented financial services companies (86%), but 14% identified their companies as FinTech firms.
Confidence soars, investment crawls

As we near the tenth anniversary of the first tremors of the financial crisis, optimism about the sector has begun to return. FDI in financial services is finally regaining its pre-crisis levels, and FS investors have expressed confidence in Europe’s ability to return to dynamic growth in the near future (61%) and that their own industry to do the same (77%).

Their confidence appears to be warranted. Europe remains attractive and growth prospects look better than they have in years. The continent is well positioned to attract the forms of talent FS firms will need. Innovation programmes may be on the verge of generating not just greater efficiency but more growth.

Enthusiasm for populism appears to be on the wane. Even the United Kingdom’s decision to leave the European Union now seems less concerning than feared last autumn, particularly for non-UK firms. Perhaps most importantly, though FS firms are still occupied with the implementation of regulation, it seems that the pace of new regulations is finally beginning to slow.

Yet although their enthusiasm is back, FS investors haven’t necessarily hit the buy button yet. True, the number of investments is up 6% over last year, but a larger percentage of those investments were for expansions of earlier projects than new ones (24% in 2016 versus 17% in 2015), suggesting some risk aversion remains.
Although 21% of FS investors said they planned to invest in Europe this year, none of them represented companies not already established here. FS investors from outside Europe in particular, expressed a desire for more reassurance that today’s growth will continue.

Interest in particular markets is fragmented, however. While FS investors still rate London as the most attractive market, followed by Paris and Frankfurt, FDI in financial services is growing faster in France and Germany than in the UK. The number of projects in the UK grew by 5% compared to 2015, while in France and Germany the number of projects rose 20% and 18% respectively.

2 We define FinTechs as high-growth organisations combining innovative business models and technology to enable, enhance and disrupt FS. This definition is not restricted to start-ups or new entrants, but includes scale-ups, maturing companies and even non-FS companies, such as telecommunication providers and e-retailers.

The story is slightly different when it comes to FinTechs, the innovative startups that 72% of FS investors see as a key reason for Europe’s attractiveness. Half of the interviewed FS investors’ favourite FinTech hubs are in Europe, with London topping their list and Berlin in fourth place. Such initiatives as online banking portals, discount services for simple transactions, and car insurance based on direct monitoring are proving popular with customers, but few financial institutions have seen a major return on investment yet.

Industry executives tend to take one of two views about the state of their business. Many operating managers remain focused on fire-fighting, coping at a tactical level with regulators’ demands, emerging competitive threats, and nonperforming loans. The latter factor remains a particularly serious and stubborn problem in many markets: as of the end of the third quarter of 2016, more than a third of European countries have an NPL level above 10%.

Other executives, meanwhile, have taken a longer, more strategic perspective. Having been forced to take stock of their firm’s prospects following the United Kingdom’s decision to leave the European Union (and amid the current uncertainty about how the exit will unfold), these financial services executives see their company’s strengths and weaknesses more clearly, and have greater confidence about their strategy.

Neither group sees the outcome of Brexit as synonymous with the future of European financial services. Whether lunch two years from now is fish and chips, steak-frites, or bratwurst and kartoffelsalat, the work will go on.
Of deeper concern to many observers is how well financial services firms will make their transition into the digital era. As firms become ever leaner and more digitized, many executives are asking themselves tough questions:

► Do we have the right back-end technologies and analytics to support and execute our customer-facing innovations?

► Are we agile enough to move quickly if a disruptive new entrant begins to gain traction?

► Do we have the right talent, not only to develop new services and technologies but also to effectively manage a digital organization?

► Do we have what it takes to attract that talent?

This last point is particularly important. A number of polls have found that to recruit the best of this generation, companies must offer more than competitive compensation and a good work-life balance. They need to have a well-defined purpose that will make a real, sustainable difference in their customers’ lives.

Other challenges depend on the age of the company. Established financial service companies face stubbornly high structural costs, heavy capital charges, stagnant revenues and disappointing returns on equity.

Part of firms’ underperformance is due to the fact that their response to regulation has swallowed much of their resources, including talent, that might otherwise have been put towards innovation projects and expansion in new markets. They also face potentially disruptive competition from FinTech firms, a fear that seems to have encouraged them to adopt more customer-pleasing technical innovations, such as biometrics for banking security, despite the fact that these new services have not yielded more revenue.

At the same time, FinTechs and other disruptors face the classic challenge of companies in a young, consolidating industry. The ecosystem as a whole may be healthy, but most of these start-ups face long odds in achieving scale.

In the long run, the major firms and the FinTechs are likely to resolve their respective difficulties through more collaboration. FinTech will help the large financial services, becoming the engine-room of growth by providing the solutions FS firms need to cut costs, drive greater efficiencies, and delight customers in a crowded market. At the same time, the big firms will offer the startups life-sustaining scale, either as a vendor or as a future business unit.

Our data shows that this may already be happening. The shrinking ratio between FDI and number of jobs suggests that total employment created by FDI fell by 3% since 2015, even as investment grew.

### Innovation and technology will play a big role in driving future growth in the financial service sector

![Chart showing the percentage of total investments in Europe FS where growth would come from: 33% Innovation models, 30% New business models, 28% New market models, 25% Mergers & acquisitions, 24% Organizational re-design: new ways of working, 20% Partnerships with FinTech organizations, 19% Cost reduction programs, 12% Strategic alliances, 4% Regional economic power and demand.](chart)

Where do you think the growth of your company for the next 12 months will come from?

N = 295 total investments in Europe FS
Although the return on investment in innovation in the form of growth, as opposed to efficiency, remains elusive, FS investors still believe the future depends on innovation. Thirty-three percent of FS investors surveyed said they believe their growth will come from innovation; 30% from new business models; and 28% from new market entries. Only 2% see organic growth as the way forward.

The slowing pace of new regulations may mean that in the future more capital and management attention can finally be dedicated to innovation programmes. However, these initiatives raise their own regulatory concerns. As they look to data analytics and management systems as levers of innovation, FS firms must address issues related to data privacy and incorporate new legal frameworks such as the General Data Protection Regulation.

Other regulatory concerns stem from political uncertainty. As European financial services look toward a post-Brexit world, they see that many important regulatory issues have yet to be resolved. For instance, will Euro-clearing stay in London or will it move to the Continent? If the European Union does push for the switch, can it enforce the move without undermining confidence in the market?

Uncertainty around Brexit may also lead to more competition between markets. After all, policymakers on both sides of the Channel have noted that one reason London became the world leader in FinTech has been its fast-track licensing procedures.

Despite the many questions, FS investors’ concern about Britain’s departure from the EU seems surprisingly muted, at least thus far. In theory, there is no reason the UK financial services industry can’t continue to prosper outside the EU.

However, our research suggests that a lot will depend on the terms of the UK’s new relationship with Europe and the country’s new role on the larger world stage. How the major firms respond to any final deal will have a big influence, with any signs of major relocations of talent and operations by big banks liable to create a snowball effect for the rest of the industry.

European financial services strategists should also consider how differently insiders and outsiders perceive the region. FS investors already in financial services in Europe believe that conditions are good and getting better. Investors we surveyed who don’t do business here, however, believe that regulations have become complex to the point of stifling innovation. Particularly in Europe’s younger central and eastern markets, more needs to be done to open up new opportunities for growth.

Whether the concerns are Brexit or Basel IV, financial services firms and policymakers shouldn’t let intra-European sparring distract them from two more important but distant opportunities.

First, they should encourage policymakers to use this historic opportunity to create a friendly environment for innovative financial services. Government initiatives that support small business, innovation, and education while reducing regulatory complexity could help ensure that Europe retains its place at the forefront of financial services development.

Second, they should take advantage of the rare chance that the continued digitalization of financial services offers for strategic alignment. This will be especially important as the sector overall continues to be disrupted and competitors from outside the industry try to take market share from the traditional giants.

For financial services companies large and small, 2017 is likely to be a crucial year, a time to reflect both on where you are and where you’re going.
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