Comment: Getting used to single-digit bank ROEs. They're here to stay.

Europe's largest banks produced fairly consistent levels of core profitability in 2017. Cutting through the adjustments banks made for one-off, extraordinary or non-material items, returns on equity were clustered in the mid to high single digits.

That is not going to change much any time soon, says Sam Theodore, managing director and head of financial institutions ratings at Scope Ratings. More to the point: given what's happened to the risk profile of the European banking industry since the financial crisis, it's a reasonable proposition so we should all get comfortable with it.

"My expectation is that bank profitability won't rise significantly; returns will likely remain in the high single digits," Theodore says. "But as an investor, it is perfectly legitimate to live with banks earning high single-digit ROEs when there is a reduced likelihood of unpleasant surprises bearing mind business models and risk and prudential metrics are more sustainable and predictable."

"Generating significantly higher returns on capital bases that are multiples of what they were before the crisis, during a long period of extremely low rates, in an environment of intense competition at the same time as banks have de-risked their balance sheets and their business models is just unrealistic," Theodore adds.

If that's the case, investors and market participants looking to position ahead of expected linear progression in profitability to a point where returns are consistently and sustainably above 10% are likely to have their hopes dashed, certainly in Europe. If anything, they should be wary of ROE jumping too high, as this may suggest the bank is starting to take bigger risks.

Accepting high single-digit returns is certainly easier if you consider that banks' cost of equity is no longer in the double digits. Continuing to impute a cost of equity in the 10%-12% area is effectively mispricing banks for the realities of today. The risk-free rate is basically zero, the bank premium is low given high levels of regulation and, as bank balance sheets start to look similar, betas should converge too.

Theodore believes earlier expectations that returns would revert to the high teens to mid-20s have given way to a greater sense of equanimity. "Some analysts' models may say the banking sector is un-investible but if the evolution of bank equity prices tell you anything, it's that demand for bank equity remains strong," he said.

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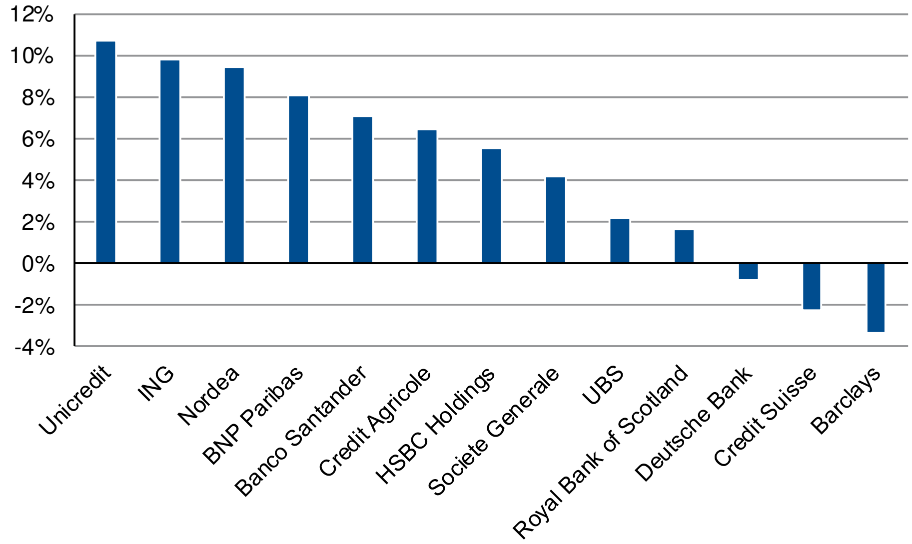
Figure 1: Major European banks' FY 2017 Returns on Equity



Source: Bloomberg

Why the status quo will be sustained

Maybe it's a combination of historical reference, wishful thinking and blind hope but the universally received wisdom is that better prospects for the global economy and the looming cycle of rising interest rates and higher bond yields will drive top-line growth and push up profitability as banks benefit from wider interest margins at the same time as trading profits improve on the back of institutional clients' preparedness to exploit heightened market volatility, and as banks make progress on cost optimisation.

But at least six factors undermine this thesis.

Political pressure to compensate savers

1. Savings rates

It's true that rising interest-rate cycles have historically led to wider interest margins. Banks have found it relatively easy to reprice loans; the higher the market rate, the better the outcome. But the situation, certainly in Europe, is different now. Large masses of savers in Germany, France, and elsewhere in Europe sitting on large pools of savings have been battered by low rates for years.

"Savers are collateral damage from the crisis," Theodore said. "They didn't trigger it in the first place, but they've been stuck in a limbo of low, zero or even negative interest rates even though the crisis has long passed. As rates start inching up, there's going to be huge political pressure on banks to increase savings rates. Savers are also voters. That's going to crimp their interest margins."

2. Fixed rates

The biggest chunk of European bank balance sheets consists of residential mortgages. These are predominantly fixed-rate or with multi-year resettable rates. Current growth in European mortgage markets suggests that customers, sensing that the historically low interest-rate cycle won't last forever, have been actively refinancing to lock in long-term fixed rates.

Higher interest rates will create drag effect

3. Highly leveraged borrowers

Higher rates will create a drag effect as highly-leveraged borrowers fall into difficulty or distress even in the event of a gradual hike cycle. "I include certain eurozone sovereigns in that category, for whom financial conditions haven't materially improved since the crisis but which have been assisted in their debt service by ultra-low rates," Theodore said. "When rates go up, some sovereigns will breathe less easily."

Sovereign-bank debt loop won't disappear

4. Bank-sovereign nexus

Debt-challenged sovereigns will create an uncomfortable reality for banks in certain eurozone jurisdictions – despite policy efforts to dismantle the sovereign-bank nexus. The debt loop will remain in place, not least because of contradictory regulation.

It's not just that sovereigns will continue to count on their large domestic banks for funding; it's that sovereign debt is a core component of the High-Quality Liquid Assets banks have to hold to meet their Liquidity Coverage Ratios. Banks will continue to be among the largest category of investors in sovereign debt, particularly debt of their own sovereigns.

There may well be a pan-eurozone supervisory framework in the form of the Single Supervisory Mechanism but when it comes to banks in deep distress – witness Banco Popular in Spain, and Monte dei Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca in Italy – the interests of domestic governments come into play and issues turn domestic. That's when the regulatory rubber meets the political road. The link between sovereigns and their banks will thus remain.

Consolidation not the point; it's about taking out excess capacity

5. Over-capacity

There has been a lot of focus on consolidation in an over-banked Europe. Consolidation will happen – mainly at the level of second and third-tier banks rather than the region's large banks. But reducing the number of banks is not everything. France, for example, has a highly consolidated banking sector – the top five banking groups have nearly 90% market share. But it's visibly inefficient with a high cost-income ratio (70%-75% and above) and thus more reduced financial flexibility.

"It's not only about reducing the number of banks, it's first and foremost taking out capacity. Banks will only achieve that by continuing to close branches and obsolescent back offices," said Theodore. "It's all well and good for banks to establish digital labs, fintech incubators and the like but at the same time they need to severely reduce their legacy overhang. The problem there, of course, is massively reducing staff at home will do nothing for their already battered public image."

Digital and fintech players pose competitive threat

6. Non-traditional competition

In the medium term, banks' earnings ability is likely to be constrained by more secular issues, which will see bank and financial markets becoming less intermediated by banks. "More competition for lending will emerge from non-traditional players, from direct lending by non-banks and other sources but more pointedly from digital platforms and fintech solutions. It won't be that easy for banks to maintain market share let alone recoup lost ground and reprice loans," Theodore said.

There is a difficult balancing act here. Banks' preparedness to extend new loans will help drive their future profitability but the picture is clouded. At the same time as policymakers, regulators and supervisors have required banks to de-risk their business models, maintain hefty capital and liquidity buffers, deal with legacy NPLs and frontload provisions for future loan losses, they are putting pressure on banks to extend new loans in order to propel growth in the real economy.

"Banks will continue to lend but it's undeniable that their underwriting criteria will be much more onerous. That's the result both of the lower-risk strategies they've adopted as well as supervisory endeavour that's forcing banks to become more conservative. I don't think that's going to disappear," said Theodore.

Digital platforms will be encouraged by new regulations such as the Revised Payment Services Directive (PSD2), which is forcing banks to create secure open APIs. "If prudential regulation creates high barriers to entry, non-prudential regulation such as PSD2 is lowering those barriers and creating opportunities for new entrants to build relationships with a bank's clients by offering potentially better or cheaper products. Banks will henceforth have much less facility to cross-sell their products at high price points and expect clients to stay with them," Theodore said.

To maintain market share, banks will need to be less proprietary and think about shared or co-mingled solutions. "Building a single-name platform at the same time as you're forced to provide visibility around what you're doing could be a risky strategy for a bank. If clients feel they're not getting value for money, they will move," Theodore said.

"And not necessarily to another bank but to new incumbents that are moving into financial services, such as Google, Amazon, Facebook, Apple, Microsoft and other major tech players with high-visibility brands."

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