Banking 2.0: investors will have to adjust the angle in the post-pandemic world

"The real voyage of discovery consists not in seeking new landscapes but in having new eyes." (Marcel Proust)

The Q1 reporting season for European banks is in full swing. The bank-vs-analyst interaction is following the usual script so far: which bank is better placed in terms of loan-loss provisions, net interest margins and fees, expenses, returns, capital position, liquidity and growth (or lack thereof)? The main area of concern seems to be the growing asset-quality troubles stemming from the pandemic crisis, and the extent to which some banks are front-loading expected losses through new provisions while others are kicking the ball into the long grass (IFRS 9 forbearance permitting). Somewhat oddly, the severe drying out of top-line revenue sources which is happening is not yet at the top of the list (presumably because only the second half of Q1 was impacted by the Covid-19 crisis).

Having absorbed the last decade's main risk lesson, that supervisors can take action against prudential outliers, credit investors and analysts are still anxious about this scenario. The market (i.e. analysts, investors, financial media) has seen the signs that the regulatory rules of the game are adjusting but has not yet internalised them and is still focusing on the battles of the last war. Equity investors are concerned about the temporary disappearance of dividends, in addition to a collapse in valuations (and a world in which analysts' forecasting models are less relevant).

Credit investors' fears of AT1 coupon non-payment scenarios are unlikely to materialise. Investors also fear that they could go further underwater in case of a bank entering resolution. But the latter, as the emerging pandemic-era supervisory practices seem to imply, is even more unlikely.

The post-pandemic age: banks as hybrids of private-sector institutions with quasi-public roles and priorities

In the pandemic and post-pandemic age, Europe's banks are entering a new age, as the last "The Wide Angle" report highlighted, framing it in a historical context[1]. In this new age, they would be more closely aligned with the socioeconomic public priorities in the countries in which they operate – unlike the preceding "markets first and foremost" age -- but without being directly state-controlled and top-heavily constrained (like in the post-war decades).

In brief, banks will resemble a hybrid of private-sector institutions with quasi-public roles and priorities. It will be increasingly difficult for banks to define their fiduciary responsibilities as mostly about maximising shareholder value – even with a sustainability proviso. Strategies will need to be redefined accordingly, not by tossing out the existing rulebook but by re-drafting several chapters.

There will likely be two stages of this age: the salvage and the rebuild. In the salvage stage, governments, regulators, public expectations, peer pressure, and not least their own convictions are drawing banks into helping businesses and households stay afloat financially for as long as possible during the pandemic and its aftermath.

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[1] https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=3617a290-4344-4831-a9aa-04aa420044f3

In a landscape defined by maximum stress, the role of the banks will still be secondary to that of governments, central banks and public-sector development institutions, which will be responsible for unleashing the bulk of direct financing, subsidies and guarantees.

However, in the rebuild stage succeeding the acute phase of the pandemic, perhaps from Q3 onwards, the banks, primarily the large European groups, will be expected to take the lead in financing the re-launch of European economies. More so than their counterparts in the United States, as Europe remains much more of a bank-intermediated credit market and will be so for the foreseeable future. This will mean providing new credit, sometimes alongside public-sector development banks, in the countries in which they are active.

For those equipped to do it, it also means bringing clients to the primary capital markets to raise equity and debt. In other words, going back to Investment Banking 101 and moving further away from the excesses and toxicities of the post-deregulation period – even in their lobotomised form after the last financial crisis.

Credit investors sitting pretty…

On balance, this should be reassuring news for credit investors; less so for short-term equity investors. The evolving position of banks means that they will be less likely to take unbridled risks and launch into risky ventures. Again, if banks aim to be part of the solution not the problem, they will be expected to play their part in the reconstruction of European economies. It is for this purpose and for this purpose only that supervisors are encouraging banks to dip into their liquidity and capital buffers and are also providing relief in the implementation of IFRS 9 rules for loan-loss provisioning, as well as on NPL recognition. Not to see banks taking unnecessary risks by engaging in activities and transactions designed to maximise shareholder value and bonus pools through ruthless competition.

In the post-financial-crisis decade, the main fear of credit investors was that regulators would target banks in sub-optimal prudential condition via early supervisory intervention, resolution, or liquidation, threatening both their ability to operate in competitive markets and their debt-repayment capacity – primarily of bail-in-able debt, starting with AT1 coupons, and continuing with coupon and principal on all capital instruments up to non-preferred senior unsecured debt. And, in more extreme situations, in accordance with BRRD, having all long-term unsecured liabilities being threatened if the MREL/TLAC cushion turns out to be insufficient.

Consequently, investors and analysts kept the sharpest eye on any perceived deterioration in banks' prudential metrics. Not only in absolute terms – against regulatory floors – but also through peer comparison. Banks with capital ratios below peer averages, even though safely above regulatory floors, would be penalised with discounts in their debt and equity market valuations. Less so for liquidity, as the large European banks hold very ample cushions of high-quality liquid assets.

However, in the coronavirus age, with the all-hands-on-deck messages from European supervisors – ECB, FINMA, Bank of England, Nordic FSAs -- credit investors' fears of regulatory clampdowns are less justifiable. In this salvage stage, there is not much danger of regulatory intervention for a bank that uses its excess capital and then dips into the regulatory buffers to provide credit to the real economy. This will most likely remain the case in the rebuild stage, when the banks will have to play a central role.

But there is every chance the supervisors will frown upon capital or liquidity buffers being used to engage in risky, equity value-enhancing transactions or ventures not visibly and directly related to the economic reconstruction effort. Or to the strengthening of the bank's own competitive position in a changing market (e.g. enhancing digital channels and platforms, or cybersecurity) which will remain a must.

… But the angle needs to change

This does not mean that credit investors and analysts should give up on thoroughly and methodically assessing the banks; quite the contrary. It does mean, however, that in due course and sooner rather than later, their analytical focus may have to be adjusted. Specifically, prioritising a more institution- and market-specific assessment of how focused, effective and risk-averse a bank is in pursuing its post-pandemic strategy, rather than merely a "horse race" peer-group comparison of prudential metrics and financial ratios. This would relate to the mix of the bank's activities and geographies, the composition and dynamics of its loan portfolio (including ESG criteria), or the growth of its digital presence and effectiveness of its cyber risk mitigation.

To illustrate with a simple example, a negative move in a key metric should not automatically raise a red flag, as long as it doesn't place the bank into a prudentially pernicious position. Understanding why it occurred, though, will be critical. Is a material hike in loan-loss provisions due to a severe deterioration of a previously stable credit sector (e.g. hospitality in the pandemic age)? Or is it due to the reckless entry into a risky new geography or credit sector seeking higher returns, or to losses in an industry which had a clouded outlook to begin with (e.g. coal)?

It may take time, effort and imagination, but the analytical community will need to adopt a new set of appropriate and credible metrics to support these new angles for assessing banks.

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