The new market economy and the coming of a third European banking age

Under a blue summer sky, children are happily swimming in the relaxing waters of the backyard pool. They organise races; some swim fast, others less so but all are having a good time.

All of a sudden, dark clouds gather and cold heavy rain starts pouring down. The games come to a frightened halt. Worried adults emerge quickly from the house carrying large umbrellas and rush the children indoors. Straight into a hot bath and warm towels.

The kids will keep talking about their unfinished swimming race and how it will have to be resumed later on. But for the time being the adults are in charge, the children are protected, and everybody is reassured.

For the second time in as many decades, the market economy has proven itself unable to ride a major crisis unaided. Central banks are again "leaning against the wind" (rather against a hurricane), with a multiple of the force used during the last crisis. This time around, they have been massively doubled up by governments, offering financial guarantees, subsidies, moratoria, and direct credit on an unprecedented scale.

Only a couple months ago, the very idea of Western economies being kept afloat by massive government support would have been considered a joke in financial markets. But "I'm from the government, and I'm here to help" are no longer "the nine most terrifying words in the English language" – market capitalism's mantra famously uttered more than three decades ago by Ronald Reagan.

The market economy is now surviving through public support

Financial market transactions will continue to allow businesses, individuals, and the public sector to fund their activities, to preserve economic stability and spur growth and innovation. And equally to create private and public wealth.

But when push comes to shove – whether through the self-inflicted blow of more than a decade ago or through the deadly pandemic now – it is evident that, left to their own devices, financial markets quickly have to throw in the towel. Economies, and implicitly the social contract they underpin, would simply collapse without prompt and massive public-sector intervention from central banks and governments.

This is one of the 'new normal' realities likely to take hold in the future. Following the global financial crisis, the role of central banks has remained critically important for economies and financial markets. In the euro area, the ECB was able to stimulate economic activity through radical rate cuts and substantial debt-purchase programmes. But all along, the expectation, albeit increasingly fainter as years went by, had been that one day it would eventually pull out, leaving the markets again in full charge.

With the pandemic-induced blow to the global economy, and the massive public-sector financial effort required to avoid a total collapse, the scenario of the markets regaining full independence and high public confidence in a pre-2008 fashion is, more than ever, a thing of the past. Not only in Europe, but in the US as well.

Given the lack of viable alternatives but also given their globally positive track record, European market economies will most likely survive and won't morph into state socialism, despite the socio-political turmoil to which the prolonged

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hardships coming out of the Covid-19 crisis will possibly lead. But the role of governments in setting and financing socially-useful economic priorities – healthcare, social services, environmental projects – will become markedly more dominant in the post-pandemic period. Which is just as well.

Investors' value perception is being altered

From a credit investor's perspective, a private company engaged in an activity fully supported by government priorities – e.g. providing healthcare infrastructure or being a key part of the circular economy – stands a plausible chance of being bailed out if its severe financial difficulties are not of its own making. The plausibility threshold would not need to be as high as another pandemic or an event of similar amplitude.

In fact, any tentative return of market confidence is almost entirely pegged on the belief that state bailouts and direct intervention are here to stay and will bear fruit. Not on the hope that Adam Smith's "invisible hand of the market" will win the day.

As for central banks, their prominent financing role will probably shrink gradually in the post-pandemic years as economies stabilise. But that reduced role will most certainly still be far from the position where they had been in before 2008. More specifically, the ECB's current role in preventing massive-scale economic collapse through its policies will be able to preserve a financial market with active investors and issuers.

Accordingly, a European new normal could be that capital market issuance, investment, and trading decisions remain influenced by the knowledge that powerful central banks are willing and able to support issuers and the market by purchasing debt securities on a large scale, even approaching monopsony. Which in fact could be as relevant as a government bailout of the issuer.

Against this potential backdrop, there are hints that Europe's banking sector may enter a new age, the third in its post-war history. Not overnight, not without overcoming an understandable rear-guard struggle by incumbents, and not without going against some commoditised market thinking.

European banks may be entering a new age

The new catchphrase used by bankers, regulators and analysts is that as the banks this time around are not part of the problem, they are part of the solution. But how and whose solution?

The history of European banks being relevant for the market's "animal spirits" (to use Keynes' formula) is actually not that long. Shorter in fact than the half-century one for US banks.

The first age

For nearly 40 years after World War II, Europe's reborn banking systems were rigidly regulated and directly or indirectly controlled by their respective states. Their main mission was to finance reconstruction (e.g. in Germany, Austria and Italy) and provide safety for individual and business savings through thick and thin – the industrial-boom decades and the stagflation years, respectively. The banks of that time had to be specialised – commercial banks, savings and mortgage institutions, long-term business lenders, or investment banks. Crossovers were not possible. Considered mostly as financial utilities, there was no overwhelming market interest in bank debt, which remained limited to begin with. To top it all, financial disclosure was poor and unreliable.

The second age

A new age for European banks emerged more than three decades ago, notably from 1989 when the European Commission's Second Banking Directive led to the deregulation of banking and financial services. This led to the creation of universal banks encompassing a wide range of commercial and investment banking activities – e.g. in France, the UK, Benelux, and later Italy and Germany. It also led to aggressive financial innovation which challenged supervisors' ability to oversee it, to boundless and reckless lending, to privatisations, and to a wave of ensuing M&A. This triggered a major banking crisis in the early 1990s, whose depth in some countries (the Nordics, France, or Germany) exceeded that of the 2008 crisis.

During this second age and before the 2008 crisis hit, most European banks focused on profit maximisation to deliver high returns to equity investors on the back of sub-par supervision and unbridled market appetite for more. The post-crisis decade saw European banks rebuild their prudential and financial strength and risk down their business models and balance sheets. But investor expectations, especially on the equity side, were still that banks needed to deliver better profits – a theme supported by supervisors as they became more comfortable with the banks' strengthened prudential metrics.

The third age?

Barring an excessively optimistic V-shaped scenario which would limit damage to the short term, the pandemic crisis and its aftermath could shift Europe's banking sector in a new direction. Not back to the post-war years of rigid regulation, national and functional fragmentation, credit controls, and public-sector ownership. But equally not to the trigger-happy 1990s and 2000s.

It is likely that this new age for European banks will see them first being drawn – by governments, regulators, client expectations, and peer pressure – into helping businesses and households stay afloat financially for as long as possible during the pandemic and its aftermath. For that purpose, and for that purpose only, supervisors are encouraging banks to use liquidity and capital buffers, providing relief also in implementation of IFRS 9 for loan-loss provisioning and NPL recognition.

In this first critical stage of the pandemic crisis, the role of the banks is still secondary to that of governments, central banks and public-sector development institutions, which provide the bulk of financing and guarantees. What the banks are being asked to do now is to distribute public-sector financing, provide temporary financial relief to their clients who need it while continuing to stand on their feet.

This last aspect is essential because in a second stage after the pandemic, it is almost certain that the banks –notably the systemically-important groups that inherently display more financial muscle –will be expected to take a leading role in financing Europe's economic rebuild. By providing new credit (alongside public-sector development banks) and, for those which are equipped to do it, by bringing businesses to the primary capital markets to raise debt and equity.

To be able to perform that role without glitches, the banks will need to be in adequate prudential and financial shape and not force supervisors to consider intervening. This, despite the expected drop in top-line revenues and, in a second stage, a sharp rise in loan-loss provisions to catch up with the new asset-quality realities on the ground. Currently most large European banks display sufficient capacity in terms of excess capital and liquidity as well as in regulatory buffers. They will need to keep it this way.

The market's assessment lens will have to be adjusted in time

The European banking sector moving into this new direction, in-between market dynamics and a quasi-public mission, will probably require investors and analysts to adjust their assessment lenses. This is evidently not going to happen overnight. In fact, it may not happen for a while, as often the market's commoditised thinking is to fight the last war's battles.

But the new reality will eventually have to take hold. Like all market-listed firms, banks need to generate profits to be able to service their capital structure – including paying dividends to shareholders when possible. However, by pegging their activities to the broader economic goals that the societies they operate in need to achieve – increasingly including ESG goals – the banks will need to re-balance their strategic priorities away from first and foremost meeting bottom line-related shareholder expectations.

It is in this multi-dimensional context that the markets will have to consider assessing banks, rather than just through a profit generation-capacity lens.

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