

How should the market view European banks in the post pandemic age?



Point and Counterpoint: How should the market view European banks in the post pandemic age?

Scope Insights – Are Europe’s banks entering a new age that will see them more closely aligned with social and economic public priorities in the countries in which they operate? Will they move away from the “markets first” “shareholders first” and “bonuses first” of recent decades where the priorities were profit maximisation, driving up market share and beating competitors?

This is the topic of Scope Insights’ first ‘Point and Counterpoint’, summarising a dialogue between Sam Theodore and Keith Mullin. Sam is a bank credit analyst; Keith is a banking and financial market commentator and journalist. They have both looked at the banking sector and the market through several cycles in recent decades.

Sam believes banks will in future resemble a hybrid of private-sector institutions with quasi-public roles and priorities and that they will have to adjust their strategies accordingly. With so much support coming from governments and central banks to help businesses get through the pandemic and keep people employed, it is difficult to support the argument that governments should stay out of the market economy. Banks have no choice but go along with their countries’ public priorities: first safeguard businesses and jobs, second rebuild economies when the pandemic impact has subsided.

Keith doubts that transforming banks into socially minded political operatives is sustainable, and that creeping politicisation of access to finance is unhealthy. Once the Covid-19 crisis is over, we should see a drift back to the former status quo. The role of profit-seeking private banks in capitalist economies is not to do the bidding of governments. If governments play a more central role in directing credit provision – and lending into a recession will lead to a spike in defaults – will governments then nationalise bad debt? Non-profit-maximising society-friendly non-dividend-paying banks will be wholly un-investable.

Sam Theodore:

Market participants continue to assess banks using the tools, concepts and priorities that have existed for decades – albeit with a marked readjustment after the last financial crisis to take more account of prudential metrics and regulatory expectations. Banks are still expected to generate earnings to cover and exceed a rather theoretical cost of capital, and to reassure both equity and credit investors that they are not going to become vulnerable to supervisory intervention, which could create threats to investment.

However, it seems to me that in the future banks will resemble a hybrid of private-sector institutions with quasi-public roles and priorities.

In dialogue:

Sam Theodore
(Credit analyst)
+44 (0)776 932 1043
s.theodore@scopeinsights.com

Keith Mullin
(Financial market commentator)
k.mullin@scopegroup.com


Scope Insights

111 Buckingham Palace Road
London SW1W 0SR

Scope Group

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
www.scopegroup.com

 Bloomberg: SCOP

It will be quite clumsy for banks to define their fiduciary responsibilities as being mostly about maximising shareholder value – even with the by-now obligatory sustainability proviso. Their strategies will have to be readjusted through more alignment with public priorities in the countries in which they operate (domestic markets and key foreign markets).

This is not what the market currently takes account of when assessing bank creditworthiness. At least, not yet. And, by the look of most analyst focus during the Q1 results reporting season and the angles presented during investor calls by the banks' CEOs, CFOs and Investor Relations representatives, these new angles have not really surfaced.

Will that change?

Keith Mullin:

It's an interesting thought. There has certainly been a lot of chatter about banks re-creating their image along new society-friendly lines during the Covid-19 crisis and redeeming themselves in the minds of a lot of people who still hold that caricature of wealthy avaricious bankers committing nefarious acts that led to the global financial crisis and the deep recession that followed.

But transforming banks into altruistically minded government-directed administrators, or, even worse, political operatives? Hmm... I don't see it becoming a sustainable shift. Nor, actually, do I believe what sounds like a creeping politicisation of access to finance is healthy. While it's certainly true today that banks are being thrust forward as government-appointed agents to smooth the sharply negative economic impacts of the pandemic, I believe for governments it's merely expedient to rent the bank's networks and technology – for free – to convey cash from fiscal support programmes to end-users in need.

My sense is that once the most serious impacts of the Covid-19 crisis are over, once government support programmes have expired and the effects of the (short-lived?) recession are behind us, we'll see a drift back to the status quo (far from perfect though it might be). Co-opting banks to work for the public good works in countries that have predominantly government-owned banking sectors or where government-directed lending is the norm (as in certain emerging markets).

Elsewhere, maybe there is a balance to be struck – not just in crisis but at all times. But it seems to me that the role of profit-seeking private banks in capitalist economies is not and nor should it be to do the bidding of governments. Doesn't that simply demand that they become riskless utilities? On that basis, with little to no latitude for competitive differentiation, won't transformation along these lines – taken to its conclusion – undermine the current structure of Europe's banking sector? And if government plays a more central role, will government nationalise bad debt resulting from government-directed lending?

Sam Theodore:

Government administrators or political operatives, Europe's banks will most probably not be. Unlike the post-World War II decades of European

reconstruction, when financial sector regulation was top heavy, lending was largely government-directed and State ownership or control of banks was prevalent.

Present-day European governments do not have the financial capacity or political mood to re-nationalise any of Europe's large banks. Besides, there is no need for that. Let's not forget that on balance the banking sector has walked into the Covid-19 crisis in a relatively robust prudential and financial shape, albeit with structurally weak profitability. This is due not least to a sustained, and in the main successful, push by regulators to de-risk and strengthen the sector across Europe.

And now the same regulators, to help banks play their primary role of lending to the real economy – and for that purpose only – are encouraging them to use liquidity and capital buffers and are providing relief in the implementation of expected-loss IFRS 9 for loan-loss provisions and in NPL recognition. These are definitely regulatory steps that would not have been taken were it not for Covid-19.

With the trillions of euros, dollars, pounds, or yen thrown by governments and central banks to help businesses get through the pandemic crisis and keep people employed, it is difficult to support the argument that governments should stay out of the market economy. I know it goes against the grain for so many of us who have participated and observed the market.

But the reality is that for the second time in as many decades, the market economy has proven itself unable to ride a major crisis unaided. And in each instance the “adult in the room” has been the public sector – governments and central banks. So, I guess banks have no choice but go along with their countries' public priorities: first safeguard businesses and jobs, second rebuild economies when the pandemic impact has subsided.

This second stage of economic rebuild will likely be more evident from Q3, and it is at this stage that banks – private and public – will have to take a leading role. To provide loans and guarantees, to keep some debt-repayment moratoria in place for pandemic-affected businesses and individuals. And, also, in the case of those institutions that can do it, to bring businesses to the primary markets to raise new debt and equity.

Against this background, it will be important to see where the market thinking goes for the near future. For example, can a bank with solid financial metrics but sub-par performance in helping the local economy, or viewed as excessively aggressive in the market, or relatively oblivious to ESG criteria, be an investor favourite as it might perhaps have been in the past?

Keith Mullin:

I'm not arguing against the principle of having banks play a role in keeping viable businesses needing temporary support going and generally helping re-build economies during this crisis and in its immediate and medium-term aftermath. Especially as you point out, as government has stood on the front line to lessen the economic impacts. Banks should be motivated to assist.

If this new-found relationship is a function of crisis-mitigation only, I think that's fine but I re-iterate my sense that banks will eventually drift back to the former status quo. Even assuming bank-government partnerships are a medium-term arrangement, where does or where should the ultimate burden of responsibility lie for lending decisions? With bank management or with civil servants? Will governments ultimately create lending quotas and use this as a punitive tool? And who takes the hit if loans go bad? Taxpayers or shareholders?

Let's face it: for all the talk of casino banking, highly leveraged trading, or engaging in risky ventures, lending – retail, consumer, SME—is among the riskiest things a bank can do. Lending into a recession – as governments are exhorting [forcing] banks to do – is typically a bad idea and will lead to a spike in bad loans. I don't think there's any doubt about that. You surely can't have a situation where banks fall into line with government influence and continue lending but then bank shareholders take the hit when defaults rise.

Government and banks will have different perspectives on credit and where need is greatest. Or more pointedly for banks, where profit is greatest. You can't just dismiss profit-seeking behaviour by banks and shareholders and say: 'OK now it's not important for banks to make profits as they've upgraded their *raison d'être*.'

You bring up the very relevant point about where market thinking goes in the near future. You ask if a bank with solid financial metrics but sub-par performance in helping the local economy etc can be an investor favourite as it might have been in the past.

This gets to the heart of the whether banks are investable. Under the non-profit-maximising society-friendly model, I suggest this makes the banks wholly un-investable. Why would an institutional investor invest in a bank engaging in low-return government-influenced lending that can't pay dividends? For retail clients, good intentions are good intentions but they don't pay pensions. Investors will seek better returns elsewhere.

This narrative has been very topical in the realm of ESG. Environmental activists would like to see companies and banks that pay scant or no attention to ESG factors starved of capital and forced out of business. That hasn't happened. In the bond market, credit investors don't accept a lower return when it comes to pricing on companies that have solid ESG credentials relative to those that don't. I don't see how investors can favour society-friendly low-profit banks over banks seeking to responsibly maximise profits.

Do you agree? More broadly, Sam, how do you see competition evolving in this putative new banking paradigm? And how do you see regulation evolving? Regulators have already shown banks a lot of forbearance around NPL recognition, capital buffers etc. You've previously written that resolution is highly unlikely in the present environment. So will the regulatory paradigm need to shift for good and will regulatory tolerance gain more latitude? Isn't that just storing up future problems?

Sam Theodore:

First, I agree that, from an equity perspective, banks are probably less attractive investments. But then the height of their attractiveness was in the decade before the last crisis, in hindsight obviously for many wrong reasons. My understanding is that during the last decade the main attraction of bank equity was the payment of dividends, which of course is temporarily no longer the case. And many look at investing in large banks with dominant domestic market positions as a proxy for investing in the local economy. That will probably not change at all.

On competition, Keith, I actually see no alternative to sustained in-market consolidation among second-tier banks. The national champions in each European country will remain well entrenched, and probably build up more market dominance. But the second fiddles will have no other choice but to throw in the towel and get merged either among themselves or taken over by bigger competitors. This is actually the route that bank supervisors would surely prefer, as they have said time and again, even before the pandemic.

Speaking of regulation, just a couple of points. First, the regulatory framework put in place after the global financial crisis has been working pretty well, by the look of the sector at present. Let's just remember the dreadful state of capital, funding or liquidity, the inadequate risk profiles and management of so many banks as the last financial crisis was entering the stage, almost 13 years ago.

Second, bank supervisors have been seen as the town sheriffs (which of course they are) and credit and equity investors alike dreaded how they might react to banks with underwhelming prudential metrics and behaviour. But now the sheriff is in a different mood. The town economy needs to be stimulated and its people need to work, so the toughness is manifestly subdued. At least there is far less tough talking. And you are right, the Damocles Sword of resolution is becoming more of a theoretical threat, as at no time since the last crisis is it less likely to be foisted on a bank. That said, resolution planning remains a valuable exercise.

The current regulatory architecture was built after the last crisis and with that crisis in mind. The pandemic crisis is forcing some readjustments and a very pragmatic softening in implementation. It remains to be seen if this degree of flexibility will be positive for the health of the banking sector. In my opinion it is.



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Scope Insights GmbH

Lennéstraße 5

D-10785 Berlin

Phone +49 30 27891 0

Fax +49 30 27891 100

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Managing Director: Florian Schoeller

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