19 March 2021


Just before the first lockdowns in Europe were emerging last March, I published an edition of The Wide Angle entitled "Covid-19 and European banks: stress is back but no crisis"[1]. The market thought the opposite and banks' equity and bond prices abruptly collapsed. They have eventually recovered; bonds faster than equities (the latter affected by non-payment of dividends). But unease about the sector's asset quality and creditworthiness persisted through the year, albeit in gradually decreasing circles.

Fourth quarter results further attenuated asset-quality fears. The market view on European banks is becoming visibly less negative. Some analysts believe the situation might turn out to be better than their year-end outlooks anticipated. The overall message in banks' presentations at an investor conference this week[2] is one of cautious optimism and increased confidence in what lies ahead. In a speech at the conference, Andrea Enria, the ECB's top bank supervisor, while predictably showing professional sternness, sounded more confident than in the past[3]. Doom and gloom are no longer at the top of the menu.

## Banks in solid prudential and financial position with improved public image

In aggregate, I continue to see Europe's large banks as being in their best prudential and financial shape in the past three decades (since EU bank deregulation). Profitability remains lower than in pre-GFC years but business, financial and risk profiles are substantially stronger.

There are no striking outliers among the large banking groups; not even Deutsche Bank these days. Business models differ but to a lesser extent than in the past and they are driven much less by adventurous strategies or transactions. Importantly, all banks, prodded by their supervisors, have taken positive steps to reduce complexity and improve transparency. As a consequence, Europe's large banks are as remote from a resolution scenario as they have been in the last decade, even though the resolution framework keeps strengthening.

Banks also have a more positive image today than a decade ago. Bankers quote the "banks are no longer the culprits but part of the solution" mantra with gusto. And who can blame them?

[1] "Coronavirus-related market fears are piling punishing stress on European banks. But they are unlikely to re-plunge the sector into crisis" https://bit.ly/3eRed0a
[2] Morgan Stanley – Banks and Diversified Financials Conference (16-18 March 2021)
[3] https://bit.ly/30XLX41

One area where banks can still get a black eye is misconduct, notably money laundering and gross operational carelessness. The UK FCA's prosecution of NatWest Group, launched on 16 March for a past money-laundering scheme (now addressed), is the latest case in point. But even here, efforts by banks and supervisors to curb money laundering are on the right track. The EBA has published detailed guidelines on risk-based anti-money laundering and combatting terrorism finance (AML/CFT) supervision in the EU[4] and will launch a public consultation.

### Low net interest margins for the greater good…

By the look of it, the ECB will keep its current policies in place for some time. Which means that rates in the euro area (EA) are not going to shift much from where they are now in the immediate future. First, because inflation-related sentiment seems to be lower in the EU than in the US, given the more modest growth expectations. Second, because safeguarding and stimulating EA economies appears to be a priority carved in stone for the leaders of the ECB – with Member States' stamp of approval, including Germany.

ZIRP/NIRP[5] are of course a central reason for banks' underwhelming net interest margins. Banks and investors remain deeply unhappy about this. But in the broader scheme of things, ECB monetary policy – in addition to the various forms of financial support for businesses and households – saved EA economies. Economies did fall into deep recession but stayed afloat.

Which implicitly means fewer asset-quality and revenue troubles for banks. In fact, banks' "keep calm and carry on" approach during the first year of the pandemic (less by design and more from fear of the unknown) has been a factor of relative stability for the industry. The cases of glaring asset-quality mishaps, earnings collapses, reckless strategic moves, or major self-triggered operational incidents were few and far between.

In the main, the same low interest rates that are affecting banks' margins are helping borrowers keep up loan repayments. And allowing governments and other public bodies to borrow more cheaply to support businesses through lockdowns. Growth in public borrowing – and in debt servicing costs when rates do go up – should be an important element for the ECB and the Bank of England in future rate-setting decisions.

### … but it is depressed loan growth that currently impacts revenues

The main culprit for low bank revenues at this stage of the cycle is not low net interest margins, however. Margins will not move up significantly even when the rate landscape changes. The main culprit is low and flat new lending volumes. New lending has historically compensated for the negative effect of thinning spreads (in line with risk reduction). But even as pandemic effects subside in line with mass vaccination and new therapeutics, steep loan growth will not be forthcoming this year. Businesses are holding significant amounts of excess cash and will deploy this in the first stages of the re-launch.

A more aggressive pace of post-pandemic growth may lead to materially more business lending in 2022 and beyond. But even then, I see that only as Plan B, below Plan A: more moderate loan growth, such as that which prevailed after the GFC. Besides, over time, further bank disintermediation is likely to occur, especially if the Capital Markets Union belatedly takes shape.

One thing to watch out for is the extent to which vaccinated households step up spending and investments. This could save the day for banks with strong and well-supported retail lending

[4] https://bit.ly/3vGovWX

[5] Zero-interest rate policies/negative-interest rate policies.

franchises. On the other hand, investors and supervisors will need to watch out for post-pandemic exuberance, which could push banks towards reckless lending and activities in general.

### The real game changes for the sector will the pace of digitalisation

Despite their entrenched market position, reinforced during the pandemic, banks will be on shakier ground as their landscape turns increasingly digital. Especially with the pandemic-induced changes in the way we live and work. Banks not moving fast and convincingly enough in the digital arena will leave them in a losing position from which there is no return.

Analysts and investors do not seem to consider this challenge as key for the banking industry. The topic of fintechs and digital strategies is treated in general as a fringe aspect; something that is happening in the banks' backyard but not where "classic" banking takes place.

This is the wrong approach. Banks are no longer the only players in the low-risk/high-volume business of payment transfers which has been their exclusive business domain for so long.

Stripe, the Irish-American fintech specialising in online payments processing – and which is considering expansion into Europe – has recently been valued at USD 95bn, which is significantly higher than the EU's largest bank by market capitalisation, BNP Paribas, at USD 77bn[6]. PayPal's market cap is above USD 300bn. Klarna, the Swedish buy-now/pay-later fintech, is valued at USD 31bn, making it the most valuable European fintech at this time with a market cap on a par with Credit Suisse and above Deutsche Bank, SEB, Svenska Handelsbanken, or Société Générale. (Mind you, I do see risks in Klarna's business model: a fast-growing short-term credit institution not regulated as a bank.)

Digitalisation does heighten and broaden the range of cyber risks, for which few reliable analytical metrics exist, and which in general are not yet on investors' radar screens. Increasingly, what needs to be recognised is that money laundering and other misconduct are becoming a sub-set of cyber risk, since financial misbehaviour is now mostly digital.

[6] The largest Europe-based banking group by market cap is HSBC, at USD 122bn.

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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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