

## A contrarian view: further ECB easing won't be that bad for banks



The ECB's announcement of easier monetary conditions isn't all bad news for banks. Nonetheless, analysts, other market participants, financial media and many of the banks themselves have been depicting the move as a further blow to already weak bank profitability in the euro area (EA).

It's true that low-to-negative rates will continue to hurt EA banks' net interest margins, which have been uncomfortably thin for some time. In fact, one reason why US banks' profits have been richer than their European counterparts lies into the higher US rates helping bank spreads.

But several factors argue against commiserating too much with banks over the ECB's easing and its impact on bank profits. They start with the very reason why easing has been adopted.

### Easing-induced loan growth is good for banks

The latest ECB bank lending survey (July 2019)<sup>1</sup> shows new credit demand still at acceptable levels, but with a softening trend compared to previous years. Against the margin-depressing backdrop of low-to-negative rates, loan volume growth has been an essential driver of bank revenue growth in the post-crisis decade. ECB stimulus aims to mitigate the softening economic trends across the EA. Banks should be able to benefit from higher credit volumes for both businesses and individuals.

This aspect is not one to be sneered at – as long as it mirrors actual economic trends rather than result from banks just loosening loan underwriting criteria. For the time being, the latter does not seem to be the case as the same ECB survey shows a slight tightening in credit standards for SME and consumer loans.

The ECB anticipates very low rates at least through the first half of next year, but the reality is we are not likely to see higher rates for a longer period of time. First, because of the EA economies' growing softness, likely to be further affected by a no-deal Brexit. Second, because the Fed easing makes the US-EA rate gap marginally more tolerable.

The ECB's announced move could mean that consumer confidence in the EA picks up further, which would translate into more mortgages and consumer credit. This could also be true for business confidence, although the evidence shows that it would take more than very low rates to entice businesses to grow more sharply through bank borrowing.

The policy rate move deeper into negative territory also means that investment risk-free rates in the EA shift even further down, closer to zero. That strengthens the argument that banks' cost-of-equity (COE), against which the market benchmarks ROE, should be adjusted down further. My comment last month

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<sup>1</sup> [https://www.ecb.europa.eu/stats/ecb\\_surveys/bank\\_lending\\_survey/html/index.en.html](https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/index.en.html)

concluded that persisting questionable assumptions unnecessarily make European bank profitability indicators look worse than they actually are<sup>2</sup>.

### **More market funding across banks' capital structure**

Savings rates will remain stubbornly depressed, though, as savers remain the hapless collateral damage of the crisis a decade ago. The near-certainty of underwhelming savings rates for a longer period of time should lead to further diversification of savings away from bank balance sheets, searching for better yields. On balance, EA banks' loan-to-deposit ratios (currently averaging 118%) are likely to gradually move south.

Future loan growth should be funded mostly from market sources, right across banks' capital structure. In addition to filling MREL buckets – mostly non-preferred senior and Tier 2 – more issuance of covered bonds and senior preferred can be expected later this year and the next. The details and appetite of the ECB's renewed asset purchase programme (APP) will be an important factor for future bank funding, especially for its crowding-out effect (for covered bonds) and the fact that the ECB is inherently less fussy about yields than private investors.

### **The hidden danger of chasing higher profits**

Low profitability has been viewed by investors, analysts, financial media, and supervisors alike as a persisting weakness of the European banking industry, so there have been plenty of suggested avenues to bring it back to a mythical "normal" over the years. They range from the self-evident – boosting revenues and cutting costs – to the more counter-intuitive – cross-border consolidation across Europe.

The relatively sharp cost reduction in recent years – both credit risk-related and structural/operational – cannot be expected to be replicated on the same scale in future years. In fact, the cost-income ratio of ECB-supervised banks rose in aggregate to 69% in Q1 2019, from 65% last year (partly also because of pressure on revenues). More than ever, banks need to invest in new digital capacity, which is extremely costly and with benefits that do not show up the day after. Capacity that also needs to be delivered on a fast schedule, given the unforgiving pace of technology changes.

At the same time, banks continue to operate their 20<sup>th</sup>-century structures (physical branches and back offices), large chunks of which are increasingly idle going expenses. Excess capacity reduction remains frustratingly slow.

As for boosting revenues, nobody is pointing to embracing a higher risk appetite as a solution. But it is difficult to assume that in today's market -- faced with the growing risk of digital disruption, major constraints to diversification, and changed customer behaviour -- banks will be able to find new sources of revenue growth without taking more risk. And herein lies a key hidden danger of the new ECB easing.

Easing credit and new business-activity standards is a constant threat: it leads to higher revenues tomorrow at the expense of higher risk costs the day after. Faced with an outlook of low-to-negative rates for longer, some of the existing rail guards could be moved further away, especially if over time some supervisors yield to populist politicians.

This is not very likely to happen for now, notably because the post-crisis supervisory tools and processes remain in place (e.g. SREP rules, stress tests). Also, because the supervisory structure and culture in the EA are visibly more de-linked from national political pressures than in the years before the Banking Union. But it is a risk which should not be off investors' radar screens.

Credit investors have been coming to terms with this reality; less so equity investors and analysts.

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<sup>2</sup> <https://www.scoperatings.com/#search/research/detail/160249EN>



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