Scope Insights

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Scope Insights – The pandemic-triggered economic slump has not hurt Europe's large banks in any substantial way despite intense "here we go again" market fears. No banking crisis is likely in 2021 either.

The severe economic slump triggered by the pandemic has not substantially hurt Europe's large banks thus far, despite intense market fears fuelled by the "here we go again" memory of the last crisis. There has been no banking crisis in 2020 and no banking crisis is likely in in 2021, especially as vaccines are in clear sight.

For sure, equity investors are not overly happy, although a resumption of bank dividends next year and the potential for share buybacks will change their mood. But for credit investors, despite much hand wringing, the sector is on balance holding its ground, as third-quarter results and fourth quarter expectations show.

The best prudential and financial shape in decades

From the vantage point of a credit analyst who has followed the banking sector through its ups and downs over many years, Europe's large banks on aggregate appear to be in their best prudential and financial shape, certainly since the EU kicked in the new era of banking deregulation[1]. A bold statement perhaps, but one supported by European banks' reassuring prudential metrics and balance-sheet fundamentals; by their more straightforward and risk-averse business models and strategies; and by much improved risk profiles – all underpinned by enhanced and more effective supervision.

At the end of the first half of 2020, the aggregate CET1 ratio of the euro area's top 100 banks was 14.9% and the liquidity coverage ratio (LCR) reached 165%. For UK banks, the aggregate CET1 was 15.7%. These ratios hardly portray systemic weakness from a prudential standpoint.

Importantly, there has also been a gradual but unmistakeable narrowing of the ranges of prudential and balance-sheet metrics across large European banks, with no notable outliers in sight. This is significant and has never been as visible over the last three decades. This goes for business models and strategies as well. Each

[1] The EC's Second Banking Directive was adopted on 15 December 1989 and became effective three years later.

large bank may claim it is different, but the main strategic directions are not that different, as all banks face a common bucket of challenges: reducing costs, shunning new risks on a material scale, shrinking their physical presence, streamlining operations, and investing in digital.

Differences between large banks are more a function of their business and geographic mix rather than distinctly different approaches and degrees of success in the same segment of financial services, which has been the case in the past. For example, the domestic retail banking franchises of the top four French banks look relatively similar and with comparable results.

This would suggest that credit spread differentials across the large-bank sector in Europe should narrow further in 2021. And that the relative de-linking of credit spreads from their equity-price equivalents should continue.

Resolution has been the ultimate bugbear of investors and analysts since the EU adopted the Bank Resolution and Recovery Directive in 2014. The likelihood of a large European bank ending up in resolution is more remote now than at any time since the crisis. This should remain true post-pandemic when banks will be expected to play a central role in the economic rebuild.

There is a heightened sense of uncertainty in the air at this moment, but some of the main elements of the evolving banking landscape are already in place. Below is ***The Wide Angle***'s appraisal of the key issues facing banks next year.

Excess capacity will remain the elephant in the room

The main struggle for European banks is not so much the adoption of digital routes; all banks are moving down this track (some doing it far better than others). It is shedding excessive legacy infrastructures – branches and back offices that are both costly and increasingly unnecessary. Especially with the impact of the pandemic.

In this, there are leaders and laggards. Nordic banks are among the former. German, French, Italian, Belgian, Austrian or Spanish banks are among the latter, although most are progressing well on the digital front.

Large banks have more resources and know-how to invest in digital infrastructures than smaller, more marginal banks whose future may be more clouded. But a large bank with national reach cannot easily fold its legacy infrastructure and start anew as a digital alter ego while keeping hold of its clients. There are political and social pressures not to turn too radical. And with the difficult realities of pandemic-stricken economies and the need to preserve an acceptable public image, the banks need to balance their priorities. But the trend is there and will not revert.

One way to take excess capacity out of the system is through in-market consolidation, especially among second-tier banks with more clouded outlooks in the face of digital competition. This is a clear opportunity for large players to broaden their market footprints through domestic M&A. It is very likely that next year we will see further steps in the Italian and Spanish systems, and the savings-bank and co-operative network in Germany will continue, each separately, with their ongoing intra-system consolidation. More consolidation within the savings groups in Norway is possible, and indeed desirable.

At the same time, cross-border M&A continues not to look like a realistic route, despite senior euro area (EA) supervisors' urging and analysts' and wishes and support from the financial media. As banks strive to reinvent themselves digitally, buying or merging with a legacy bank in a different country (even if still in the EA) is likely to slow the process without any clear advantages. Especially given the outlook for more reliance on open-banking platforms and partnerships with/acquisitions of fintechs.

Large banks can win the digital disruption contest

A year ago, ***The Wide Angle***[2] noted that Europe's banking sector was undertaking a slow but probably irreversible decline due to its inability to shed excess capacity decisively in the face of the disruptive challenge of digital-only players.

That statement probably needs to be revisited, because the pandemic has been reshuffling the deck – so far to the banks' advantage. First, the public image of banks has been improving – a visible turnaround from the last crisis – as they are being counted on to actively support the economies they operate in, rather than being blamed as troublemakers.

Second, fintechs and big tech are being forced to move at a slower clip into disrupting the banks' traditional segments. For fintechs, financing growth has slowed considerably during the pandemic. And customers seem to be less keen to leave their banks to migrate to new entrants in such challenging times. Especially in Europe, where customer bank relationships are in general stickier. The fact that fintechs remain less regulated than banks is not helping confidence either, especially after the Wirecard debacle.

As for the big tech players, the more negative image problem they now have seems to be making them more hesitant to compete head-on with banks – unless they are being asked to. Besides, growing public scrutiny of their speedy growth and massive power – and the potential for them becoming more controlled – inherently reduces the appeal to make more inroads into the heavily regulated financial services sector.

This does not mean that digital disruption is less of a threat for banks; far from it. But, with an improving public image and slightly more breathing space in the competitive landscape, large incumbent banks now stand a better chance of going where they need to be in the digital space without being disrupted on the way. Provided they make good progress along that path. Some banks are moving faster than others but the entire sector is broadly moving in the same direction.

Where banks are positioned on the road to digitalisation may emerge as a central consideration in assessing their long-term credit quality. Rather than today's financial ratios alone. Sooner or later all banks will need to get there, so will invest and refocus on the digital space.

Especially since, with lockdowns and social distancing, more bank customers have been moving online, many for the first time. If the experience is positive, physical branches will see even less traffic than before the pandemic. Notably from more elderly customers, traditionally more reliant on branches and on interfacing with real people.

Asset quality: less of a critical concern due to public-sector support for borrowers

Asset quality will likely not worsen to anywhere near the levels reached during the last crisis. Europe's central banks and governments are supporting businesses and households survive the pandemic crisis on an unprecedented scale. There is no plausible scenario for a sudden drop in this support when, sometime next year, the pandemic crisis will hopefully have subsided. Rather, support will see a gradual downward adjustment, most probably in line with economic recovery rates.

This, alongside supervisory leeway in recognising and provisioning for NPLs and urging the use of capital buffers if needed, should keep the banks fully engaged in maintaining their

2 https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=dff50081-c242-47db-93bf-310096a713f0

lending. If there are asset-quality spikes next year, these will stem from the impact of the pandemic rather than from the banks' own recklessness and mismanagement, as was the case last time around. This is a big difference, which suggests that the regulators' response will also be different. In fact, the regulators have been messaging this since early spring, when the pandemic started.

It is interesting to note that, based on gathered market intelligence, the just-published US Fed's Financial Stability Report lists bank asset quality and profitability as only the 10th most cited potential shock in the US for the medium term [3]. Not surprisingly, US political uncertainty is at the top. Second is the fear of corporate/SME defaults. But because the US market is more bank-disintermediated than Europe's, this will not impact the banking system to the same extent.

The rise and rise of non-financial risks: ignore them at your peril

What is increasingly relevant, and will become more so in 2021, is the centrality of non-financial risks for banks: misconduct (notably money laundering); climate-change and other environmental risks; and cyber risk (still very opaque to market observers). Investors and analysts gloss over these risks at their peril. Just because a full range of suitable metrics does not yet exist for these risks is not justification for ignoring them.

Over the last few years, it has become evident that what reflects negatively on banks is not primarily asset quality, reckless risk-taking, excessive reliance on market funds, or capital weakness. These are more things of the past in the current cycle. It is the revelation – mostly by whistle-blowers or investigative reporters rather than supervisors or the banks themselves – of money laundering (ML)/terrorist financing (TF) or other misconduct, including outright fraud.

In 2021, it is very likely that new concrete steps will be taken to strengthen the supervisory framework for ML. The EBA recently published an opinion on how to include ML/TF risks in SREP[4]. The document recommends that prudential supervisors focus on business model analysis (looking for changes that could give rise to ML risks), specific indicators (if a large segment of non-resident deposits cannot be explained by the business model), and governance and internal controls. Establishing a ML/TF/conduct supervisory body for the entire euro area (EA) – within or outside the Single Supervisory Mechanism – will boost market confidence.

Regarding climate change and other ESG risks, 2021 will likely see a significant improvement in bank disclosure, as well as more supervisory initiatives. Stress-testing for climate change is already being pursued by UK, French and Dutch supervisors. A discussion paper recently published by the EBA[5] refers in detail to the relevance of ESG risks for the financial sector. The EBA aims to collect stakeholder feedback to deliver a full report next June. The paper identifies three methods for assessing ESG risk: portfolio alignment, risk framework, and exposure; and examines each in detail. The goal is ultimately to incorporate ESG risks into SREP. It is not going too far to think that including ML/TF

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[3] https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf

[4] https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Opinions/2020/935606/Opinion%20on%20how%20to%20take%20into%20account%20MLTF%20risks%20in%20SREP.pdf

[5] https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Discussions/2021/Discussion%20Paper%20on%20management%20and%20supervision%20of%20ESG%20risks%20for%20credit%20institutions%20and%20investment%20firms/935496/2020-11-02%20%20ESG%20Discussion%20Paper.pdf

and ESG risks in SREP will substantially improve the depth and quality of supervision in Europe.

The UK Treasury's green roadmap will lead to mandatory climate-related disclosures by 2025, based on the framework of the Task Force on Climate-related Financial Disclosures (TCFD)[6]. As for the US, there is much more concern about climate risk than the Trump administration's wilful marginalisation of it might suggest. The Fed report cited above considers climate change as a near-term risk for the financial system. Among other things, climate-change risks could affect financial stability through real-estate exposures.

Protifability to remain sub-par; not that dramatic for credit investors

The weak link remains stubbornly low profitability, even though this is less striking on a risk-adjusted basis. Which should be more important to credit investors than higher but volatile and potentially less sustainable ROEs.

The outlook for bank revenues is not soaring; in fact they will remain on a negative trajectory. Net interest margins will stay depressed for some years, and it is unlikely that loan volume growth will compensate for the margin deficiency. Recent quarters have been beneficial for banks engaged in trading and primary-market activities, taking advantage of the market's volatility and lack of predictability. This may not be the case next year, when the heightened uncertainty of the pandemic subsides. Fees and commissions will remain under the same tight pressure as in the past, as active asset management continues to contract.

In the post-pandemic world, a high single-digit ROE should be considered reasonable. With their roles more clearly defined, banks are no longer in the business of just maximising profits. They are moving in a new direction, in-between market dynamics and a quasi-public mission based on an unwritten but increasingly evident new social contract.

There is a widespread perception that high single-digit ROE levels do not cover banks' cost of capital. Supervisors seem to have bought into this view when they (strangely) urge banks to merge cross-border to boost profits. But the assumption that the cost of capital of large European banks is in the low double-digits does not reflect today's reality: a highly and effectively regulated industry, strong balance sheets and prudential metrics, and risk-free rates at the zero bound or lower.

[6] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf

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