Credit investors take heed: a different landscape will emerge for European banks

The pandemic is fast pushing the European banking sector into a new and different stage; one that none of us could have anticipated. At this time there is no reason for credit investors to fear outright bank failures since this is not a copycat of the last financial crisis. (Even so and rather surprisingly, the risk of default for European banks is high in several credit-strategy models.)

There is, however, a clear need to reassess some of the underpinning rationales for investing in the debt of European banks. The dynamics of the landscape are changing and a return to the past is not likely any time soon.

The themes highlighted below suggest a framework for this new landscape. Future "The Wide Angle" reports will go into more detail about these themes as they become clearer.

Banks asked to step into a new helping-hand role; profits on the back burner

National governments, the European Commission, the ECB, Bank of England, and other central banks are putting in place unprecedented pandemic-related rescue programmes for businesses and households. Bank regulators have provided clear indications of temporary forbearance and supervisory leniency – in capital buffers, NPL recognition, and loan-loss provisioning.

In exchange, banks are expected to engage heavily in the effort to prevent a total collapse of entire sectors of the economy facing unprecedented threat – through repayment moratoria, forbearance, removing interest from overdrafts; in general, keeping the engines of lending to businesses and households running. When the pandemic crisis subsides, banks will likely be asked to participate all-hands-on-deck in the reconstruction process.

This is exactly what banks were asked to do in the decades after World War II; many of them as state-owned entities. Now, with a more comprehensive regulatory architecture in place, there should be no need for taxpayer-subsidised re-nationalisations. If a large bank proves unable or unwilling to fulfil its changing mission, early intervention or even resolution could be initiated to force its repositioning – mostly through replacing senior management, adjusting the business model, and discontinuing unnecessarily risky activities.

Large banks' debt and capital instruments should be safe

There will be no need for debt bail-ins if the bank is not failing or likely to fail. Which in general should not be the case as European banks' prudential metrics on balance remain relatively strong, with ample excess capital and liquidity cushions.

As for smaller banks no longer able to carry on under difficult market conditions, they would plausibly be strong-armed by their regulators to merge into financially healthier peers. The avenue of insolvency proceedings is not likely to be pursued -- unless the bank is in a critical state due to its own mistakes -- as doing so would unnecessarily create market panic which could ripple over the entire sector.

One particular area of investor concern is the safety of AT1 coupon payments. In all likelihood, a bank will always choose to keep coupon payments going. The cost of temporary non-payment would be too prohibitive for the respective bank in terms of future market access compared to the relatively modest financial boost. An AT1coupon payment is typically in the EUR 40m-50m range, far lower

Author

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

Editing and Media

Keith Mullin
k.mullin@scopegroup.com

Scope Insights

Suite 204
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Scope Group

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

www.scopegroup.com

Bloomberg: SCOP

than dividend payments. The only plausible scenario for AT1 coupon non-payment is that of the supervisors prohibiting the bank from paying. Which, again, is not likely to be the case for the foreseeable future and with bank capital levels being where they are.

Bank priorities changing tack

In this new landscape, going all-out to maximise shareholder value can no longer be a top goal in bank strategies. Not if banks want to earn the image of a helping hand rather than be stuck with that of an unreformed spoiler. Based on their current communications, some banks appear not to have internalised the new dynamics. But this will change.

Prodded by their supervisors, or (more positively) in a minority of cases at their own initiative, many large banks have announced that during the pandemic they will skip dividend payments, forego stock buybacks, reduce or cancel management bonuses, and avoid staff layoffs. This is a good start.

But things won't get any easier for the banks. They will have to operate in an environment likely afflicted by materially higher levels of business and personal financial hardship, bankruptcies, and a sharp spike in unemployment. The social welfare layers prevailing across most of Europe, to which the new unprecedented public-sector financial support will be added, should attenuate the impact of the economic meltdown. At least for a while. But in this new frightening world, banks will be expected to keep tagging along with their new role for some time. Bailing out in mid-course to resume unnecessary risk-taking to boost returns will not land well with the world around them, least of it their supervisors.

Blow on revenues likely

In this new landscape, European bank revenues (which were not high to begin with) will be substantially affected. This will transpire very soon. Q1 results will offer a partial glimpse, followed by a more depressing Q2, several quarters before the impact of deteriorating asset quality also hits.

The new situation will probably be most visible in wholesale/investment banking and in asset management. In a depressed and profoundly worried market, investment banking activities will have to take a back seat, at least for some time. Besides, banks may wisely decide to steer away from re-engaging in high-risk high-return transactions and other such activities. These will not sit well with the general expectation that banks need to focus on helping businesses to survive and preserve jobs and help households make ends meet. For a while at least, investment bankers may have to lay low. Expected higher volumes of distressed-credit trading may not sufficiently replenish the bucket.

As for asset management, in the current market it is very likely that the downward pressure on volumes, new net money flows, yields and fees will intensify, convincing more squeezed players to exit the field. The pandemic crisis will entail massive investment losses globally – unlike the situation during the last financial crisis. On the other hand, banks are likely to book fees from governments for disbursing and monitoring state-guaranteed or subsidised loans. Some of the larger fintechs and neobanks are also trying to get a foothold in this business.

Worsening asset quality – with a lag

Despite supervisory forbearance for asset quality, credit losses will ultimately have to be provisioned for, and at that time the impact on the bottom line will be felt. The level of pre-provision earnings is likely to be insufficient to provide a reassuring cushion. Entire industries will be hurt – airlines and transportation, tourism, hospitality, entertainment, fossil fuels, and key manufacturing sectors (cars, aircraft, ships). A large number of SMEs will fold, not being able to come back when the pandemic is over.

The V-shaped expectation of many in the market may not be realistic. First, the mandatory lockdowns are likely to be kept in place for longer than the few weeks people assumed at the beginning. Second, it is certain that when the lockdowns are eased the world will not revert quickly to the pre-pandemic lifestyle. Not as long as a successful coronavirus vaccine is unavailable to all. By the looks of it, this will be a 2021 story at best.

The move to cyberspace: higher cyber risk and a further blow to physical legacy

The viral corona pathogen has locked the majority of the world population at home and has entirely shifted commercial, business, financial, educational, social, and cultural contacts into cyberspace. Unthinkably, another type of powerful virus, potentially crippling segments of the internet, could bring our civilisation to a temporary standstill. The importance of cyberspace safety and security is more critical than ever. With mutually hostile states and powerful criminal organisations around, and with international relations dangerously shifting to a post-globalisation mode, this is not science fiction.

Within this broader context, banks have largely moved their activities and operations into cyberspace. The unsung heroes in banks these days are their IT workers, who have been steering the unprecedented migration of most employees from their offices to remote home locations, as well as supporting the organisation's business contingency plans. For many of these bank employees, working online from home is a first-time experience, and so the challenge of replicating a familiar IT environment for them is enormous.

Heightened cyber risk

But the massive online migration considerably heightens cyber risk. This is undoubtedly the top risk in banking (it was important before the pandemic, but now it is far more so). It is also the least understood and probably most opaque risk for outsiders. It is rare for analysts or investors to drill the banks in detail about their cybersecurity parameters. And if they do, the answers may not be very detailed, for obvious security reasons.

In recent years, banks have been able to minimise their network protection vulnerabilities (out-dated software, data in cleartext, lack of security on remote access etc.), so their external networks should be more difficult to penetrate. The soft underbelly remains the banks' internal networks, which can be accessed by cybercriminals through phishing, credential stuffing, ransomware, or targeted social engineering. The increased reliance on a few cloud providers for data storage, while reducing some risks, adds new ones (e.g., hackers accessing data in the cloud).

It is plausible to assume that as they are now working from home rather than in an office traditionally protected by firewalls (again, maybe for the first time in their professional life), bank employees could be more vulnerable to malicious phishing by increasingly motivated cybercriminals. In the age of the pandemic, cyber risk for banks is more threatening than ever. And a massive successful cyberattack can have grave consequences for the bank, as there are currently few physical-space alternatives.

Migration online may be irreversible

Another important consequence of the massive online migration is related to customer behaviour. Banks always assumed that while more clients opted for dealing with them online (through apps and websites), a segment would continue to rely on physical branches and interact with real people. With the pandemic locking bank customers into their homes, they have been left only with the online option.

Assuming that parts of that customer segment will find bank apps and websites convenient and easy to access, and bearing in mind that even after the end of lockdowns many people (especially older people; precisely those who were traditionally more reluctant to abandon their branches) will continue to practice some form of social distancing, it is possible that branch usage will become much more sporadic than before the virus struck.

By the same token, banks may realise that, if work can be done from employees' remote locations as efficiently and safely as from the office, the modus operandi for back and middle offices should be more permanently adjusted.

It is thus very likely that the pandemic-related switchover will make it even more evident to banks that the infrastructure of their activities needs to change. What was very evident before coronavirus will become even more so after.

While banks will do everything possible to avoid staff layoffs during the pandemic, it is almost unavoidable that massive restructurings will have to start occurring afterwards, especially as competition in the digital space intensifies. This is likely to add new areas of stress for banks, at a time of heightened economic and social hardship.

Scope Insights GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

Managing Director: Florian Schoeller
Commercial Register: District Court Berlin-Charlottenburg HRB 202433 B