Banks should fear Trump, Johnson, Salvini. Not the ECB or the EBA

Faced with underwhelming profitability– most recently displayed in Q2 results – European banks and other market participants have been pointing fingers at the ECB and the EBA. The former for announcing renewed monetary easing to stimulate inflation and by extension economic growth across the euro area (EA), thereby depressing further banks' net interest margins. The latter for recommending to the European Commission (EC) the full implementation of Basel III standards, which would force EU banks to boost their minimum regulatory capital by 24.4% on average (mostly accruing in the large globally-active banks).

Neither initiative is, in actuality, aiming to weaken Europe's banks, as unwelcome as they have been among analysts, some investors and the financial media. What can be truly harmful for the sector, however, is the fast-souring political climate trending towards national populism, – with Messrs Trump, Johnson and Salvini as current front-stage protagonists.

The ECB's easing aims to mitigate softening economic trends

Earlier this month, "The Wide Angle" suggested that the forthcoming additional monetary easing announced by the ECB may help EA banks to benefit from higher credit volumes for both businesses and individuals[1]. This would be important, as in recent years growth in loan volumes, even if modest and uneven, has been able to partially mitigate the negative impact of depressed interest margins on bank earnings.

This is positive as long as it mirrors actual economic trends rather than results from banks just loosening loan underwriting criteria. And for now, the latter does not seem to be the case, despite a Q2 uptick in credit costs for some banks (from very low levels though).

The EBA's Basel III adoption recommendation was to be expected

As part of the wide bank supervisory structure built after the crisis, the EBA's main role is to help preserve financial stability across the EU and protect bank depositors. It is not to help institutional investors obtain higher returns from bank earnings, let alone protect dividend distribution.

From this perspective, and as a country-neutral EU expert public body, it was to be expected that the EBA would recommend that the EC adopt the final Basel III standards for banks' minimum capital requirements, including imposing constraints on banks' internal credit modelling to address what it calls "undue variability of model outcomes". No surprise there.

That said, it is likely that intense pressure will be brought to bear by some large banks and potentially their national authorities before the EC's final decision on this matter be reached. The large French banks in particular (three of them being G-SIBs) feel that the new rules – impacting mostly the large players –

[1] file:///Users/samtheodore/Downloads/Scope-Insights-Wide-Angle-01-August-2019.pdf

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would unduly penalise them for both SME loans and mortgages. Because of the importance of these groups in the country's highly consolidated banking system, and the high degree of bank intermediation for both individual and SME credits, it is highly plausible that the French national authorities will be actively involved. Not totally unjustified, one might add, as it was neither domestic residential mortgages nor SME loans that upset the large French banks during the past crisis.

Growing fear and uneasiness stemming from Donald Trump's acts and intentions

At different levels, most large European banks are on the global financial circuit, many of them actively so. An increasingly unsettled and threatening macro environment whimsically driven by US presidential acts, tweets and remarks remains disruptive for global banks aiming to carry out their role as key contributors to economic growth and stability. Aside from the fact that, unlike the previous US presidents, Trump is no friend of the EU or the political and economic concept it represents, there are three aspects of particular concern in this respect.

First, aggressive tariffs, or threats of new tariffs, are hurting global trade and implicitly global banks' business activities. As shown by the contraction of Q2 industrial production in Germany, the US-China trade war has effects far beyond the bilateral trade of these two economic superpowers. Aside from the actual impact of applied tariffs, the US president's threats of additional tariffs (e.g. on German cars) – even when off the cuff – add fuel to the fire.

Second, Trump's overt and aggressive pressure on the US Federal Reserve to cut rates more deeply, thus going against the Fed's own mission and strategy, can be seriously unsettling. So far, the Fed has resisted the pressure – despite the recent 25bp rate cut – but all bets will be off in a high-stakes election year when this president will wish to show growth at whatever cost later on.

Third, and so far, more marginally, presidential tweets about the need to devalue the US dollar in order to unilaterally stimulate US exports and limit imports represent another element of harmful incertitude. Especially when one assumption behind this suggestion is that the euro's value is deliberately kept low by the Europeans. Again, with a deeply unsettling election year coming up, marginally disruptive tweets can lead to massively disruptive acts.

Potentially harmful consequences of a Boris Johnson no-deal Brexit

The large UK banks continue to display strong prudential and financial metrics and in general remain anchored to more conservative strategies[2]. On the other hand, growing fears of a no-deal Brexit led in Q2 to the first economic contraction in the UK since 2012. Market observers, and the banks themselves, are becoming increasingly worried about the noxious impact of this situation on the economy under the newly-installed leadership of Boris Johnson. This cannot be good news for the country's banking system.

Furthermore, should the current Conservative government turn more national-populist after a no-deal Brexit is consummated, to counteract any ensuing economic contraction and to keep political power away from Labour, it could initiate more free-wheeling public spending, well beyond the relative financial prudence of the post-crisis decade. In fact, such post-Brexit intentions are already on record.

On the other hand, if it came to that, a potential post-Brexit Labour government would not think twice before launching itself into big public spending initiatives.

Under such scenarios, it is not too farfetched to think that the large UK banks could be gradually roped in and pressured into laxer lending to prop up a weakening economy, with unforeseen consequences. The current dual regulatory structure of the Bank of England (prudential) and the FCA (conduct) is reassuring for the banking system's stability. However, history has shown that no bank regulator can remain totally immune to heavy and persistent political pressure over a longer period of time.

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[2] Please see Pauline Lambert's research on UK banks at www.scoperatings.com.

More generally, a no-deal Brexit will also inherently affect EU economic activities – even though to a lesser degree than in the UK. This could cloud the outlook for those banks more actively financing EU-UK trade circuits or with a larger direct presence in the UK.

A Matteo Salvini government could muddy the waters for Italian and other European banks

In recent years a majority of Italian banks (notably the top two) have gradually shed the legacy asset-quality burden, strengthened their balance sheets and prudential metrics, and improved earnings[3]. However, they remain vulnerable to negative market sentiment on the Italian sovereign for both funding costs and asset valuation (specific to investment in Italian government debt).

A national-populist Matteo Salvini government resulting from a possible snap election in the near future is not likely to be reassuring for the Italian banking sector, as well as for other European banks with a material presence in Italy. Salvini has stated that an EA exit is not on the cards should he form a government, so EA break-up risk is minimal.

However, shaking the tent from the inside can be also very traumatic. Persistent and disruptive dissent within the EU, challenging financial laws, structures and priorities and promoting a national-populist agenda – likely to be mimicked by some CEE governments – will not help financial integration, most importantly across the EA.

Negative market reaction, at least in the short run – until more clarity of a Salvini government's intentions exists – will likely impact sovereign spreads, and by extension bank funding costs. A ripple effect on foreign banks with a large Italian presence may also emerge, at least temporarily – particularly in a potentially discordant political situation.

Under such a scenario, the challenge for the large Italian banks will be to keep their eyes firmly on the ball: further cleaning up their balance sheets, adjusting cost structures, strengthening prudential metrics and shoring up earnings. Being supervised by the ECB within the European Banking Union is definitely helping them remain more insulated against domestic political pressure. At least for now.

[3] Please see Marco Troiano's Italian bank research at www.scoperatings.com.

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