Scope Scope Insights

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Scope Insights – When the pandemic started to threaten Europe's economies early this year, the market assumed that a new banking crisis was looming. But, so far, the banking sector is holding its ground, which will likely be the case for next year as well. The most recent edition of The Wide Angle[1] suggested that Europe's large banks are on balance at their best and safest in three decades. Prudentially and in terms of balance sheet strength, but also, increasingly, with respect to business models and strategies. Some in the market appeared surprised by what they perceived as a bold statement. Which gives Sam Theodore and Keith Mullin the opportunity to debate it in this new edition of Point and Counterpoint.

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SAM THEODORE

My views about the banking sector are supported by its reassuring prudential metrics and balance-sheet fundamentals, the more straightforward and risk-averse business models and strategies, and the much-improved risk profiles.

A key catalyst for these improvements has been the significantly enhanced prudential regulatory architecture, as well as more effective and proactive supervision – all occurring in the aftermath of the Great Financial Crisis (GFC). Absent these, it is very likely that the European banking industry would have stepped into the pandemic in frighteningly poor shape. The consequences of that would have been quite dramatic, given how crucial the banks' role is in supporting the real economy. Visibly more so in Europe than in the US, given the high degree of credit intermediation by banks.

The counter argument to this view is pointing to structurally weak profitability, for which the 2021 outlook does not look any better. This keeps disappointing not only investors and analysts in the market, but also regulators.

Equity investors lodge the added complaint that EU banks cannot pay dividends or engage in share buybacks, although that will start changing for some banks next year.

[1] https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=a0115536-09d1-4608-955f-5bb4fab0e5d5

Weak profitability is without doubt a millstone for the sector, and banks will need to deal with it, mainly through continuing to concentrate on culling and pruning their legacy structures. Because driving revenues up will remain a tall order in the current environment, and this will be visible in 2021. And credit investors at least, and surely supervisors, would not be reassured if, to achieve higher profits, some banks dived back into some of the high-risk/high-return activities they had exited after the GFC. But before going any further, Keith, what say you?

KEITH MULLIN

There's no disagreeing with the fact that European banks are in sound prudential shape, Sam. The metrics and ratios make that clear. That is clearly the result of regulatory and supervisory scrutiny and vigilance since the global financial crisis. As new iterations of the Basel framework are introduced and rolled out, capital requirements will indeed continue to rise.

But here's where I slightly lose the plot: what exactly is the point of having risk-averse banks acting as zombie utilities armed to the teeth with capital – and running super-high cost-income ratios – that don't make any money on an all-in basis. It just seems like a totally futile exercise.

We are now in the absurd situation where official monetary policy has flooded the system with liquidity via bond purchases, and massive central bank lending programmes to protect banks. A situation where as you mention banks can't pay dividends or buy back shares and are being encouraged to draw on capital buffers – all in the name of making sure they continue lending. These State-directed actions wouldn't be out of place in a Soviet-era centrally planned economy.

ZIRP/NIRP, official lending and asset purchasing have pushed bond yield curves close to or through the zero bound. And they're so flat that no-one gets paid for terming out. This has rendered it nigh on impossible for banks to make any money – even if they did continue lending. (Instead because of the severe recession, they're quite naturally, reasonably and prudently tightening underwriting standards).

You make the point about high-risk high-return business, Sam. Here's where I disagree with you. I don't get risk-averse banking. It's an oxymoron. Banks must be risk-seeking enterprises. I don't mean risk-seeking as per pre-GFC peddling complex derivatives or taking massive speculative punts on the prop desk.

I mean risk-seeking in financing real things and real entrepreneurs – business start-ups, SMEs, new technology, connected Smart infrastructure, renewable energy, innovation, climate-change mitigation. This is high risk stuff, but it is what banks should be financing. Banks as lifeless risk-averse utilities and agents of State earning poor returns is senseless. Doesn't it render them un-investable? No matter that credit investors will fund them cheaply. That's a red herring. Profit-seeking shareholders deserve better.

SAM THEODORE

Fair point. "A boat is always safest in the harbour, but it is not what it was built for" goes the saying. I must say I am puzzled by the insistence of some CEOs to refer to their banks' "fortress" balance sheets as an ultimate achievement. If it wants to play a constructive role in the economy and society, a bank should be an open city rather than a fortress. To be more precise, an open city with solid defence capabilities.

But, Keith, most large banks seem to already be doing some of the stuff you rightly highlight. Such as adopting new technologies; moving, some more clumsily than others, to the digital ecosystem; and starting to make, or at least consider making, ESG-related adjustments. It is just that these strategic and operational shifts, as essential as they are to keep the bank on the right

track for the future, entail additional costs and will not boost ROEs. At least not in the short term, which as it happens remains pretty much the time horizon of choice for far too many in the market.

And regarding lending to the real economy, it is quite evident that more should be done. But if you ask the banks, many will tell you that credit demand from the business side is simply not there. At least not within the underwriting parameters imposed by the post-GFC regulatory framework. And even with cheap funding, lending margins remain underwhelming, especially when the cost of risk is thrown in the pot.

Speaking of which, too many people in the market keep pointing out that it is the high capital requirements for banks which constrain new lending. I disagree and find that the regulators were spot on in imposing them in the post-crisis years. Overall, banks with ample capital cushions are the ones which are more confident in their lending as they have fewer reasons to fear adverse supervisory and market reaction. To me, 2Q 2020 aggregate CET1 ratios of 14.9% for the 100-plus large euro area (EA) banks and 15.7% for the UK banks seem reassuring, not excessive.

Where at this time I find somewhat of an anomaly in the new regulatory architecture is in the liquidity part. It is fully understandable why post-crisis bank regulators were so keen to enforce tough liquidity standards. After all, for banks the GFC started as a funding and liquidity crisis before turning into an asset-quality and capital crisis. But no two crises are the same and the situation is now different.

Through the pandemic the large European banks have been experiencing substantial deposit inflows, in addition to cheap TLTRO and market funding. The latter being the result of market confidence boosted by the unprecedented central bank and government financial support for businesses and households. Which, as it happens, is keeping an economy afloat that could otherwise have collapsed. And taken many banks with it.

Under these circumstances, the 165% liquidity coverage ratio (LCR) that the large EA banks showed on aggregate in Q2 seems excessive, compared to the 100% regulatory floor. Imagine how much more bank lending to the real economy could be occurring if that ratio were 25-30 percent lower, while still affording a reassuring cushion. It is in this area where regulators could perhaps be more constructive, besides allowing banks to dip into their liquidity buffers if needed (clearly there is no need for that under the circumstances).

And I am not talking about shifting down the LCR floor; that would be a dreadful idea. I am thinking more about an adjustment of the categories and weights of High-Quality Liquid Assets, to fit the reality that for the foreseeable future central banks, like the ECB, are going to remain a dominant presence in fixed-income markets.

But I digress. Far from being lifeless utilities, the market should view Europe’s large banks not mainly as profit maximisers for shareholders but as key players in helping the continent’s economies recover and start growing again.

And it is how well and safe they play this role that should be a key criterion for market judgment, rather than primarily ROE. Especially since, in assessing the latter, most market participants and some regulators continue to point to questionable low double-digit cost-of-capital (COC) levels.

With depressed risk-free rates, solid regulation and supervision and enhanced systemic safety, I would assume an aggregate COC level at 5%-7% for Europe’s large banks. Which makes a high single-digit ROE more appealing than it is now.

KEITH MULLIN

Sam, you say most large banks are already doing some of the things I highlighted. I'm not talking about banks moving into the digital ecosystem as providers, I'm talking about banks financing business start-ups, innovation, technology, and projects designed, for example, to mitigate adverse impacts on climate-change. This can be high risk, but banks need to be active here, alongside other sources of capital.

There will always be demand from start-ups and entrepreneurs for financing. I'm not suggesting banks pull back from retail, consumer and business lending and go hell for leather for this type of activity. But banks can provide a vital credit lifeline for entrepreneurs in areas that, incidentally, European governments are very keen on developing, hence playing a key role in the process of new economic transformation. At the same time as generating reasonable returns above those available in business-as-usual lending, where margins are ultra-low and generating decent revenues relies on volume.

Regarding BAU lending, I agree the evidence suggests it's not a lack of financing firepower that's the issue here; it's lack of demand. Having central banks harass banks to continue lending into a recession where demand has evaporated is futile. And it suggests central bankers would make poor commercial bankers.

As to whether it's high capital requirements or liquidity ratios that constrain lending, it's hard to see specifically what impact they have. But maintaining an aggregate 165% LCR is surely ridiculous. I do find it weird that so many banks strive not just to hit regulatory floors on solvency and other metrics but to try and exceed them just to prove to the market that they're somehow better, as per your fortress balance sheet.

This is where bank senior executives may themselves have lost sight of why they're there. Regulators have taken a view on bank solvency, stability and systemic risk since the GFC and set regulatory floors where they are for a reason. Engaging in an arms race to prove you have more capital and liquidity and lower leverage than your peers – and way above where the regulator says you need to be for prudential reasons – while you generate low returns beats me.

Having credit investors in the capital markets punish banks that fall behind their peer group average even if they sport reasonable metrics relative to minimum requirements only compounds the madness.

But let me get to my final point in this segment. When the pandemic hit and the world's economies cratered, I lost count of the number of times I read that governments and central banks had flooded the market with cash and introduced a raft of policy measures including regulatory forbearance to prevent another banking crisis. At the same time as I read – endlessly –that European banks in aggregate were robust and had good levels of capital.

Why, then, are taxpayers footing the bill – again – for measures to protect banks? The last crisis was supposed to have been the end of taxpayer support. Let me make a big distinction here. I fervently believe it was right and proper for people and businesses to be offered State and bank support (the latter in the form of moratoriums and payment holidays) in an environment of government-imposed lockdowns and other restrictions that destroyed jobs and businesses in certain sectors of the economy.

But if banks were so robust, shouldn't governments have let events take their course with the tools they have, including the apparatus of resolution, to ensure proceedings remained orderly? That's what they've spent 10 years preparing and stress-testing for. That'd be one way of reducing over-capacity.

It's that I just don't agree with the idealistic world view that says private banks should become quasi State-directed agencies and that profit-seeking shareholders should be made second-class citizens. Private banks exist to finance economies while making returns for their owners. Shouldn't they be allowed to conduct business at their own pace and in their own way?

Being banned from returning capital to shareholders was, I think, shocking. Not because I necessarily believe it's always the right thing to do at a given point in time. But because how private banks manage excess capital should be their decision within existing regulatory parameters and a matter for their own governance and approach to managing risk.

If they run into solvency issues; again, that's what resolution and other elements of the banking regulatory framework – including sanctions for reckless behaviour – are there for.

So, to your notion of an open city with solid defence capabilities, I'll add, with an effective police force carrying a suite of deterrents but not an army of occupation.

SAM THEODORE

It is here that we disagree, Keith. During the GFC, what the ECB, Bank of England, the Fed and other central banks did was to prevent large bank failures, among other things. This time around, faced with an unprecedented and sudden threat brought by Covid-19, central banks and governments were relatively fast and effective in moving to directly prop up businesses and households through loans, guarantees and moratoriums, with commercial banks being the distribution agents.

The direct support for banks is coming mostly through ultra-cheap ECB funding and some supervisory leeway. But this is mostly to stimulate them going forward, not to prevent failures. So, what banks need to do – and this is where I agree with you – is to step up to the plate more vigorously within their mandate to support economic recovery in the markets they cover.

This entails imagination to do some of the things you highlight. Being averse to unnecessary risk is not the same as lack of imagination and avoidance of facing uncertainty.

In my view, the lasting collateral damage is not so much for taxpayers, as I don't see how in the years ahead tax hikes will work out politically to pay for higher public indebtedness. It is rather for savers, including current and future retirees, who for some years will have to settle for meaningless returns on their deposits and investments.

For you, me and for so many others this may look like sophistry, as most taxpayers are also savers, and the other way around. But that would make for another **Point and Counterpoint** next year.

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