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The European banking sector is entering 2022 in its best shape in decades, at least since the current long-run phase of deregulation began in the late 1980s. Having covered the sector for a long three and a half decades, I find it in much healthier form not only since the Global Financial Crisis of 2007-2009 -- which is the widely used reference point today – but since pre-crisis times.

Contrary to popular belief at the time, the banking sector did not enter a new crisis when the pandemic started almost two years ago. Thanks to the robust regulatory framework and pro-active supervision instituted after the GFC. And due also to a visible adjustment in most banks' management strategies and the de-risking of their business models and balance sheets. As well, crucially, to the massive and prompt lifeline to the economy provided by governments and central banks.

The pandemic changed banks' image for the better – and for the right reasons. Cases of banks glaringly 'jumping the shark' in their activities, while not absent, were few and far between.

As another first and unlike in the past, I do not currently see any Top 35 European bank being an obvious negative outlier in terms of credit risk. Not even among groups with sizeable investment banking activities (as Deutsche Bank and to a lesser extent Credit Suisse were in the recent past). At least not from what the top of the iceberg is showing.

But the sector does face formidable structural challenges, first and foremost the struggle to hold its ground, prosper and compete in the digital world. The task at hand is not to migrate products and services to the digital space. That is something that pretty much all banks are doing already – some with more success than others. The task is rather to adjust or reinvent their business models for the digital world. The road for an incumbent bank to moving and breathing like a digital native is a difficult and challenging one.

Because to get there, the laborious and thankless process of reducing structural legacy costs – branches and back offices – must intensify. Despite heightened market expectations – fuelled by the boost in fees and commissions during the pandemic – further revenue growth is going to remain an uncertain process for most banks. Profitability, however, can be more convincingly and effectively improved through cost reductions, which still have a long way to go.

Regulators are finally more positive…

In its quarterly Risk Dashboard Report published this week[1], the EBA notes that, on aggregate, at the end of Q3 2021 EU banks' CET1 ratio stood at a healthy 15.4% (inter-quartile ranges between 14.1% and 20%), the NPL ratio stood at 2.1% (5% QoQ NPL drop) and return on equity reached 7.7% (higher than pre-pandemic levels). I believe that forthcoming Q4 numbers are likely to show slight further improvements.

And in a recent interview[2], Andrea Enria, Chair of the Supervisory Board of the ECB, shows relative optimism about the sector, noting that "we are no longer expecting the tsunami of non-performing loans that we feared in 2020". Using the cautious phraseology expected from a top supervisor, he also warns banks not to dilute the risk-aversion standards that have helped them in recent years, promising vigilance on the part of the ECB.

… as are market analysts and rating agencies

As for the market perspective, having gone over several banking outlooks for this year – from sell-side houses and rating agencies – I notice, for the first time since the GFC, relative optimism and reassurance about the European sector's health. Not a moment too soon.

Not surprisingly, sell-side reports alert to the potential volatility brought about by central bank tapering and the forthcoming widening gap between US rates (US Treasuries likely at 2.1% in late 2022) and zero-bound euro area rates which are not expected to move up before the end of 2023. But what is of relevance to me is that most of these reports are no longer showing gloom and doom about banks' credit dynamics – notably asset quality.

In these outlooks, equity analysts look at dividends and share buybacks as a key differentiator for bank stocks. The current aggregate price-to-book for the sector is ca. 68%, against a post-GFC average of 53% (with the highest pre-Covid indicator at 62% in January 2020). Sell-side credit analysts, expressing confidence in banks' prudential metrics and their sustainability, focus primarily on the attractiveness of AT1 instruments on the risk-return spectrum.

As for the rating agencies, their views remain more cautious and with the usual "on the other hand" hedging but following the same direction of travel: things are improving. Importantly – and positively in my view – there were no significant rating downgrades during the pandemic and there are no grounds to do so now. On the contrary, rating upgrades would, in my opinion, be justified for some of the better positioned European groups.

Largely absent from the market dialogue are references to resolution scenarios. And rightly so, as I see the European banking sector as remote from a resolution scenario since the framework came into effect nearly a decade ago.

Where negative surprises, if any, could come from

I continue to discount new asset-quality stress this year. Also very are a noticeable capital depletion or a structural funding bottleneck that could pose a heightened challenge to any of Europe's large banks. Equally, fintechs, neobanks of big techs are not going to significantly dent any large bank's footprint.

1 https://www.eba.europa.eu/asset-quality-has-further-improved-cyber-risk-remains-source-concern-eu-banks

2 https://www.bankingsupervision.europa.eu/press/interviews/date/2022/html/ssm.in220110~9fa0e44b60.en.html

Equally, expected market volatility this year due to growing rate differentials, while definitely creating uncertainty, could in fact be another income opportunity for some banks – as was the case during the pandemic.

In my view, a negative surprise about a large European bank that catches the market unaware and scares investors could come primarily from the sudden unveiling of a misconduct event (e.g. money laundering) or the self-inflicted wound of an investment-banking mishap.

A major cyber incident for a bank can also create instant panic in the market, but if this is not the consequence of an internal fault (i.e if it is the result of a massive external hack), it is unlikely this will scar the bank's reputation. That said, regulators increasingly consider cyber threats as a major risk for the banking industry. Both the EBA report and the Enria interview mentioned above specifically highlight this risk. Unfortunately, this is also a risk on which the market has very little visibility because banks, understandably, do not want any transparency on their protection systems to avoid helping hackers and other criminals.

Competition in the digital space vs. legacy banking consolidation

As I mentioned above, banks and other financial institutions will have to compete increasingly in the digital space. This competition is already on. This is the reason why, in my view, acquisitions of, or mergers with legacy banks (heavy on physical branch networks and back-office capacity) make little sense unless clear value can be extracted.

This would be mostly the case, first, with in-market transactions, like CaixaBank-Bankia last year, or BPER's announced intention to acquire Carige. Or other yet unannounced but much-needed in-market consolidation, especially of second-tier banks with challenged revenue potential and franchises on their own (e.g. in Germany, Italy).

Second, it could also be the case with targeted acquisitions in a non-domestic market in which the acquiring group already has a material presence, such as last year's Credit Agricole-Creval transaction. The just-announced intention of UniCredit to bid for Otkritie Bank, a Top 10 bank in Russia (bailed out by the country's central bank four years ago) could fit this case, but much more as an outlier.

Third, the acquisition of a non-bank business which would broaden and diversify activities, like the recently announced ALD-LeasePlan transaction likely to help Société Générale's business diversification and revenues.

In this respect, what we are likely to continue to see is large banks acquiring fintechs and digital platforms already in the market that could help to fill important gaps in their digital strategies. Again, not so much to digitise existing products but to support and ease their overall digital transformation.

"Gradually, then suddenly"

"The Wide Angle" has in the past pointed out that due to the incumbent banks' very high level of market penetration (95%-100% in Western Europe), a significant denting of their position by neobanks and other fintechs is not very likely in Europe. Especially since most of these entities are not yet profitable and their business models are not always totally convincing – e.g. BNPL ("buy now pay later"), a consumer lending activity which has not yet passed the test of fire of a consumer crisis.

Increasingly, however, significant segments of traditional bank activities, like payments, are being taken over by native digital platforms, which then can build other products and services on top to sell to households and small businesses. As PayPal has been successfully doing worldwide, including in Europe. Through PSD2, European regulators have pushed the new reality that, with the need to create open APIs, the incumbent banks' lock on their clients may one day be a thing of the past.

In the UK, the Financial Conduct Authority recently removed the three-month re-authentication obligation for clients who access financial information through TPPs (third-party providers). In this way, an important barrier to entry in open banking is being removed, which will represent a new challenge for the major incumbent banks.

Many in the market remain sceptical about the slow rate of success of the new digital companies and business models. For example, using TPPs, open banking, or banking-as-a-service (BaaS) platforms may excite fintech experts and early adopters, but are largely unknown to most bank clients – households and businesses.

But kicking the fast-moving developments emerging in the digital world into the long grass is not a smart strategy for any bank. Digital transition can happen, to borrow from Hemingway, "gradually, then suddenly"[3]. After which it may be too late for the laggards.

[3] "How did you go bankrupt?" "Two ways: gradually, then suddenly" (Ernest Hemingway, "The Sun Also Rises").

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