SCOPE

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Large banks are likely to remain islands of relative stability amid the deepening energy crisis, high inflation and threats of recession, and should be able to avoid the dramatic meltdowns of the global financial crisis (GFC). Stresses will inherently develop in the form of higher loan-loss provisions and more challenged business lines (like commercial real estate lending) and some banks will perform better than others. But the large-bank sector will remain safely outside the boundaries of a banking crisis.

The Wide Angle made a similar no-crisis call in March 2020, just when the pandemic was taking hold and when many market participants – with the memories of the GFC in mind – were warning the exact opposite. In the end, the European banking sector held up quite well during the pandemic years, in the process also regaining an image of respectability it had lost more than a decade earlier.

The current crisis is different but only to a degree; the main difference being that during the pandemic, central banks kept a highly accommodative stance through ultra-low rates and massive purchases of domestic or (for the ECB) Euro Area debt.

This time around, central banks have had to return to their more traditional role of fighting inflation, tapering their purchase programmes and hiking interest rates; a process that is not likely to stop any time soon.

Five reasons why a new banking crisis is unlikely

1 Unlike central banks, governments remain increasingly supportive of households and businesses. Governments in Germany, France, Sweden, the Czech Republic and other countries are putting together costly measures to enable their economies and citizens to face the energy crisis. In addition to financial relief packages, other steps are being implemented or at least contemplated, such as caps on energy prices. Price caps are also being proposed by the European Commission for all Member States.

Except for Hungary, all EU Member States are determined not to yield to Russia’s energy blackmail – which would be a lose-lose situation – but at the same time they are aware that unsustainable rises in the cost of living will lead to social turmoil and to unsavoury political choices in future elections.

The uncertainties of this month's election in Italy or the capacity of the two political extremes to create blockages in the French Parliament are just two examples.

In a paper just published, the IMF is calling for a new approach to managing public finances on a more permanent basis, underpinned by common debt issuance and new income streams – not that different from the pandemic-related NextGenerationEU recovery fund. Of course, it remains to be seen how this proposal will become reality.

The long and short of all this is that, faced with steep increases in the cost of living and in the cost of doing business, households and companies are not likely to be left solely to their own devices. Therefore, large-scale loan defaults are unlikely. Again, a situation not dissimilar from the pandemic period, which suggests that a large-scale asset-quality meltdown will not occur.

Over the next several quarters, loan-loss provisions will move up but in most cases to controllable levels.

2 On balance, Europe's large banks have preserved strong prudential liquidity and capital metrics, which held up well during the pandemic crisis. According to the EBA's latest risk dashboard, on a fully-loaded basis at the end of Q1 2022 the average CET1 ratio stood at 15% (down from 15.5% a quarter earlier), the leverage ratio at 5.6%, and the LCR at 168%. The NPL ratio stood at a very low 1.9%. These are all very reassuring metrics and will not budge considerably.

Expected asset-quality deterioration will not shake the credit fundamentals of most large banks. Besides, collateral values – mainly housing – remain stable. Importantly, the cohort of post-GFC loans to households and businesses was underwritten using far safer criteria than pre-GFC credits – not least because of tougher new regulations. Accordingly, the number and amount of highly risky loans which would be much more likely to turn sour when problems appear will be far less significant than those of the previous generation of credits.

ECB supervisors point to commercial real estate (CRE) lending as an area that banks should pay particular attention to, noting that approximately 30% of aggregate NPLs (for a group of 40 banks under targeted examination) are CRE-related. The ECB's latest supervisory newsletter warns that while banks make efforts to manage CRE risks, processes and data remain sub-optimal. This is thus an area that analysts and investors should watch out for.

3 Throughout the pandemic, banks managed to hold and even improve their earnings – especially large groups with more diversified activities (wholesale/investment banking, bancassurance etc.) and diversified geographies. The rise in interest rates currently underway should strengthen net interest margins, which for the last few years were affected by low-to-negative rates. Not as significantly as is the case with US banks but to better levels nonetheless.

This means that barring the unexpected, large European banks will preserve their internal capital generation capacity and their dividend flows.

4 The large European banks are increasingly alike, with management strategies and business models converging toward the safer, no-drama end of the spectrum. A few years ago, the one outlier of this trend was Deutsche Bank, which has subsequently managed to reshape and de-risk its activities and balance sheet. The one European outlier now within the large-bank peer group is Credit Suisse, specifically its investment banking franchise. The results of the group's comprehensive strategic review, undertaken

under new management, will be unveiled with the release of Q3 earnings. Any reboot will take time.

At sector level, the element of negative surprise, so present in the pre-GFC decade, is almost non-existent. Banks are at the opposite end of adventurous these days, even shunning transactions hinted at by the supervisors, such as cross-border M&A, which is inherently risky and riddled with strategic and execution problems. Which is just as well.

5 Last, but not least, bank supervisors are firmly in charge. Tighter regulations and more effective supervision, including by the ECB through the Single Supervisory Mechanism, are a key factor leading to a consistently stronger sector. In recent years, one stress test after another has revealed that the sector remains well capitalised and well provisioned.

Banks will be able to face more difficult times without falling below their supervisory metrics.

To help banks during the pandemic, supervisors agreed to a certain level of forbearance so as not to discourage new lending and other activities. This supervisory strategy ended up being successful and steered the sector through uncertain times.

There is no reason to believe that, faced with the energy crisis and inflation, European supervisors will change tack and become excessively severe with their banks. So-called regulatory risk, much feared by banks and investors in the post-GFC decade, will not be more threatening during the emerging crisis than it proved to be during the pandemic. If banks do not make light of regulatory norms, notably on conduct, supervisors will see no reason to unnecessarily rock the boat.

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