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Banks go from pariah to protected species

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The unprecedented fiscal response to the Covid-19 pandemic, combined with concerted action by global central banks, ensured the banking sector kept vital credit flowing to the wider economy. Now, while the cost of risk is falling, the outlook for banks globally is mixed

The global financial crisis (GFC) could almost have been a dry run for the Covid-19 pandemic. The causes may have been totally different, but the crises bore striking similarities: one was a financial crisis that impacted the real economy, the other a crisis in the real economy that impacted financial markets.

Indeed, some policy measures that were successfully implemented in the financial crisis – most notably extensive quantitative easing – were quickly reignited by central banks around the globe as economies faltered under pandemic-induced lockdowns.

Valuable lessons were learnt this second time around. In particular, the fiscal response amid the Covid-19 pandemic was both swift and unprecedented. Governments offered sizeable job retention schemes and tax breaks for small and medium-sized enterprises (SMEs). Guarantees of lending through initiatives such as the Paycheck Protection Program in the US ensured credit continued to be pumped into the corporate sector just as many businesses needed it.

Credit for the wider economy

Fiscal stimulus has had the desirable secondary effect of shoring up bank balance sheets. In its Financial Stability Review, the European Central Bank estimates that such policy measures will shield bank capital ratios in Europe's major economies by around 300 basis points by the end of this year[1], contributing to a significant improvement in their capital buffers and giving them the confidence to lend.

[1] European Central Bank, https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202011~b7be9ae1f1.en.pdf, November 2020

Indeed, in sharp contrast to the GFC, corporates have had good access to liquidity during the pandemic as banks have pumped credit into the wider economy: throughout 2020, corporate loan growth was up an impressive 6% in Europe and 10% in the US.[2] Furthermore, in countries such as Italy and Spain which are most at risk of non-performing loans (NPLs), a lot of this financial help has been directed at SMEs. This should reduce the number of NPLs, which in turn should further underpin the financial stability of many European banks.

We also shouldn't forget that, with global bond market issuance hitting fresh records in 2020[3], capital markets have played an equally vital role in getting credit to the corporate sector. This increased borrowing has not only provided vital liquidity to companies at a very challenging time, but also provided a powerful countercyclical earnings stream to banks with investment banking business.

But there are risks. Improved credit availability and falling corporate earnings led to a sharp increase in corporate debt relative to GDP in 2020 – both in the US and Europe.[4] We do, however, expect these levels to decline in 2021 as economic growth rebounds.

A financial crisis has been averted with governments, in effect, distributing losses away from bank balance sheets to sovereign ones. The consequence has been sharp rises in government debt. Given some of the biggest holders of sovereign bonds are banks, rising sovereign bond yields weaken bank balance sheets. Sovereign debt loop risks have declined somewhat as central banks are helping to keep borrowing costs low through extensive sovereign bond purchase programs, but with debt-to-GDP potentially topping 160% in Italy and 120% in Spain this year[5], there are warning signs for the financial sector.

Cost of risk set to normalise

While we have seen few corporate bankruptcies so far, the global banking sector took forward-looking provisions against potential defaults throughout 2020. That "cost of risk" is now falling sharply. This is quite an achievement given the significant damage that lockdowns have imposed on national economies. What is more, we expect these crucial cost-of-risk numbers to normalise far more quickly post the Covid-19 pandemic than they did in the wake of the GFC.

Looking at aggregate numbers for more than 50 large banks we cover globally, cost of risk peaked at around 150 basis points during the GFC. It then took another five years to return to normalised levels of around 45 basis points. This time, amid the pandemic, cost of risk peaked around 90 basis points and we expect it to drop back down to around 45 basis points in just two years.[6] In short, given widespread central bank stimulus and unprecedented fiscal support, the solvency concerns that many investors had around banks in the middle of 2020 have all but dissipated. Instead we now predict bank capital ratios to remain strong in 2021 and 2022.

The outlook globally

With cost of risk falling and central bank balance sheets growing, the global banking sector is sitting on excess capital and liquidity. This is great for bondholders and bank credit spreads are back to pre-crisis levels. Hopes of reflation and of returning some of that capital to shareholders through bumper dividends in the coming quarters have also helped share prices to recover.

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[2] ECB Statistical Data Warehouse, Federal Reserve Financial Accounts z.1, March 2021
[3] The Financial Times, Corporate debt sales to shrivel in 2021 after record boom, December 2020
[4] BIS/Bloomberg, January 2021
[5] Citi Global Economic Outlook & Strategy, January 2021
[6] Columbia Threadneedle analysis, April 2021

However, interest rate cuts and an influx of deposits continue to weigh on margins. Investments in technology to improve efficiency are helping. In addition, banks in Spain and Italy are already embarking on an ambitious wave of consolidation to take out costs. We expect that to continue both in Europe and at the smaller and mid-sized US banks. Overall, profitability pressures are more severe in Europe where we continue to expect aggregate returns to be well below the cost of equity. In the US, the profitability outlook is much better. This is reflected in our global investment grade fundamental rankings where the US banks are among our highest ranked globally.

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