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BLOG POST **26 JUNE 2015**

Hermes: 16 European banks in 16 days

Filippo Alloatti, Senior Credit Analyst, Hermes Credit, recently met with 16 major European lenders over 16 days. He found that capital adequacy, revenue generation and interest rates were the key themes in his recent discussions.

Capital, revenue and bad legacy loans

European banks continue to accumulate capital while reducing leverage. Such progress, combined with the growth of deposit bases, should help compress spreads on their debt. However, banks are finding it difficult to generate revenue through traditional lending practices to compensate for declining net interest margins, forcing management teams to pay close attention to the overheads of their extensive branch networks and higher compliance and consumer protection costs. In an environment where generating revenues is still tough, cost control is also necessary.

The large stock of non-performing loans (NPLs) – Italian banks hold €350bn and Spanish lenders have €211bn, for instance – remains problematic but could become less worrisome amid a strengthening cyclical recovery and higher GDP growth in real and nominal terms – as long as deflation is kept at bay. It is important that banks work faster to resolve these bad loans, as these assets require large capital backstops and, for this reason, partially explain the absence of new lending in the economic recovery.

The banks' need to hold capital against NPLs and the difficulty of generating revenue also makes it challenging for them to match the cost of equity, even though it has declined slightly.

Interest rates and proposed regulation

The movement of interest rates is clearly another important consideration. Higher rates, coupled with a steeper yield curve, could in time translate into better net interest margins for banks. On the flipside, persistently low rates would put pressure on banks to re-think their business models and consider other lines of business, such as asset management, as revenues from loans remain subdued.

More broadly, three consequences of the global financial crisis will continue to influence the environment in which banks do business: overhanging public and private debt, low levels of investment by companies and high unemployment in peripheral European Union countries.

While the jury is still out on the impact of the European Central Bank's quantitative easing programme, the cost of equity, as mentioned previously, is declining. Proposed regulations from the Basel Committee on Banking Supervisions (BCBS), dubbed Basel IV, seems to support the use of simple standardised models instead of banks' internal methods to calculate capital requirements. A consequence of this may be an increase in risk-weighted assets. The Fundamental Review of the Trading Book, another BCBS consultation, could have a similar impact on investment banks.

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Notes to Editors:

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