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When The Cycle Turns: Rising Interest Rates Will Lift, Not Propel, Western European Banks' Profitability

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Key Takeaways

- We expect revenues for Western European banks to benefit from gradual interest rate hikes starting in the second half of 2019, but after years of low rates weakened revenue generation will limit upside for the ratings.
- Despite decreasing interest rates, net interest margins have been generally resilient over the past five years, thanks to a parallel downward shift of interest income and interest expenses and improving economic conditions.
- We think the strain of low interest rates is starting to show. Flexibility to adjust funding costs is vanishing, assets continue to reprice, competition in mature European markets is only increasing, and banks are adapting their business models to the digital and fintech challenge. In some countries, larger loan origination has helped offset margin compression, but this is unlikely to continue.
- We also expect cost of risk to increase as interest rates start to rise, after years of very low impairment charges that have supported earnings metrics, somewhat counterbalancing the expected slow rise of operating revenues.

After years of low interest rates that have compromised revenue generation, Western European banks are looking forward to a new era with the expectation of interest rate hikes. But S&P Global Ratings believes profitability is unlikely to rebound quickly. Interest rates will rise but from ultralow levels, and still remain historically low for some time. That's why they aren't likely to give banks much relief in the short term. Indeed, we believe low rates are increasingly weighing on profitability indicators as flexibility by banks to adapt is coming to an end. For the moment, we generally do not expect widespread negative rating actions across the sector because economic conditions, albeit less supportive, should continue to help banks maintain sound balance sheets. Furthermore, we believe weakened revenue generation will increasingly become a constraint for positive rating actions. We expect Western European banks will see a normalization in the cost of credit risk and a continuing costly adaptation of business models, not only to address the digital and fintech challenge but also evolving regulatory requirements. For banks that have already strengthened their capital bases, we expect a steady upward rise of dividend payouts. Therefore, we believe the long-awaiting rise in interest rates won't dramatically boost earnings and balance sheet metrics and change our views about the creditworthiness of Western European banks.

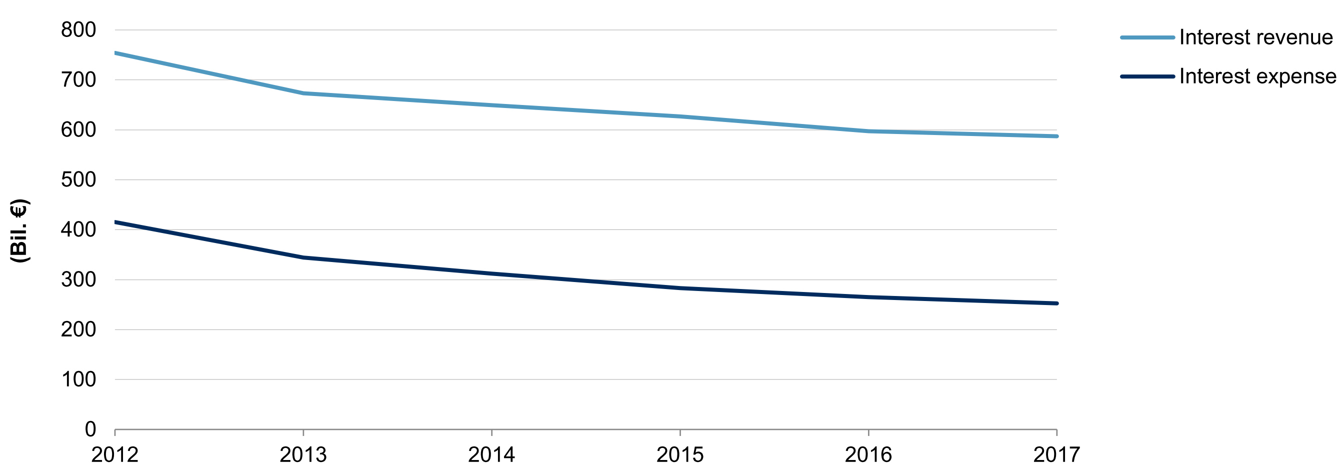
Western European banks have managed to limit downward pressure on interest revenues, but this cannot last

Here, we examine the resilience of interest revenues for the top 50 Western European banks we rate, as listed in the latest "EMEA Financial Institutions Monitor 1Q2019," (published on Jan. 14, 2019; excluding our rated Greek banks and France-based Dexia Credit Local in run-off). We note that the net interest margin (NIM)--the ratio of net interest income to total earning assets--has been generally fairly resilient during the past three years, remaining in the 1.5%-2.0% range on average.

The observed resilience of NIMs seems to run counter to the argument that low interest rates have weakened revenues. Banks have been able to resist the pressure on earnings only because of a parallel downward shift in interest expenses due to active balance sheet management (see chart 1). That's mainly because banks have successfully managed to bring down funding costs to mitigate lower remuneration on the asset side. However, this active and demanding strategy is unlikely to continue producing the same positive results. Moreover, this sample of banks is not representative of all Western European banks. Many of them are among the most diversified banks geographically and by product and client sector, and typically have some pricing power. Smaller, less diversified banks are more exposed to NIM trends.

Chart 1

The Downward Parallel Shift Of Interest Income And Expenses Has Helped Western European Banks Offset Low Interest Rates



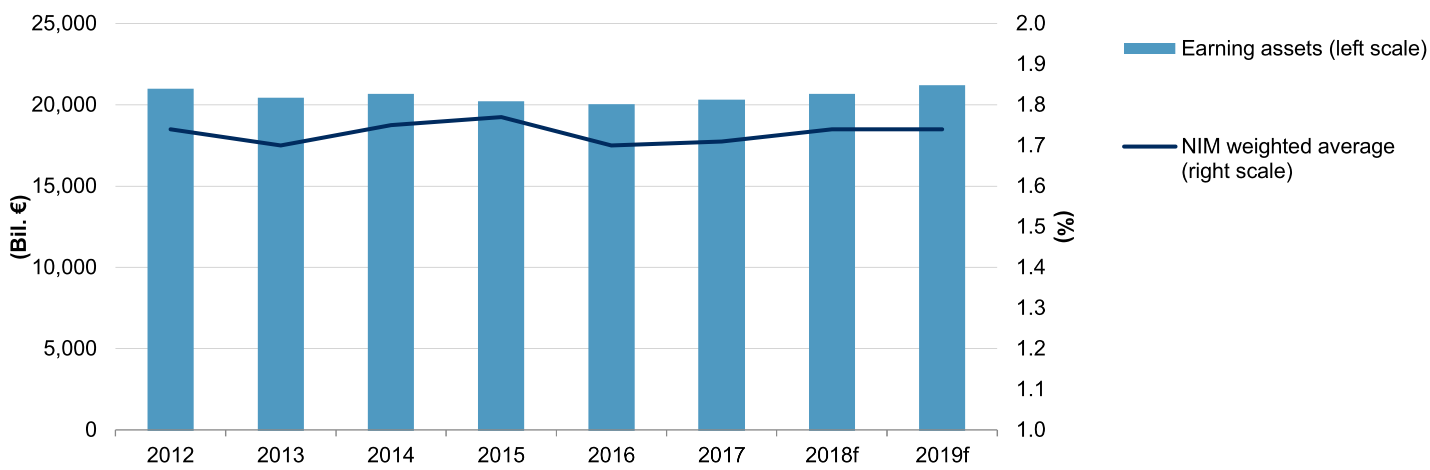
Source: S&P Global Ratings. Data excluding Intesa and Unicredit (as they do not report interest expense separately).

On the funding side, banks have benefited from lower market rates and the shift of retail customers toward less costly current accounts and short-term placements in the absence of alternative attractive investment opportunities for them and, more recently, in anticipation of the rise in interest rates. Cheap money from the ECB's targeted longer-term refinancing operations (TLTROs) has also contributed to that. The remuneration paid on the bulk of customer deposits has been trending down and banks have even passed on negative rates to some corporate or institutional customers.

On the asset side, we note that, in aggregate, the volume of earning assets has not changed meaningfully over the period (see chart 2). This is not only because banks have optimized their asset mix, in particular their liquidity portfolios, or reduced their stock of nonperforming assets, but also because of their search for yield, with appetite for geographic diversification or increasing exposure to better-remunerated products, like consumer loans. Mergers and acquisitions have also helped some banks in the sample to increase their earnings bases.

Chart 2

Margins And Earning Assets Have Remained Fairly Steady For Western European Banks



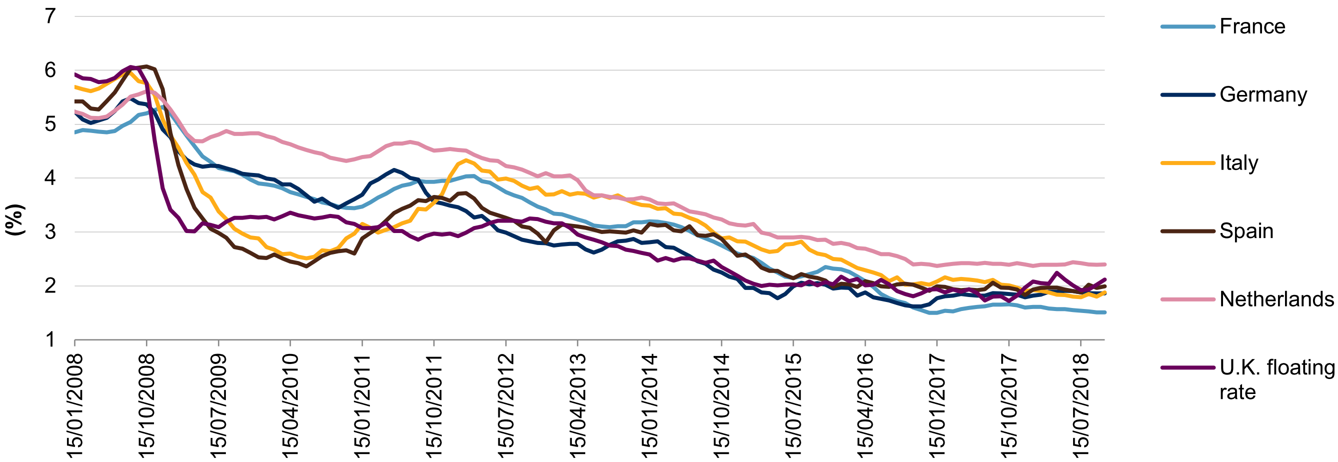
f--S&P Global Ratings forecast. NIM--Net interest margin. Source: S&P Global Ratings.

Contrasting country-specific trajectories, in particular the speed at which countries have recovered from the past downturn, as well as active balance sheet restructuring also explain why the stock of earning assets has been relatively stable, only in aggregate, over the period.

Some banks have retreated from lending activities, while others have seized opportunities, which have partly compensated for low interest rates. In many countries, clients took advantage of lower interest rates to refinance their loans (see chart 3) and banks have used dynamic property markets to compensate lower margins with increasing volumes. Mortgage loans represent a meaningful portion of Western European banks' lending portfolios. In countries that have experienced a more prolonged property market downturn, like Ireland or The Netherlands, banks benefited from higher rates for longer, as they were able to continue pricing for higher risk. We expect mortgage rates to converge toward the EU average as property markets recover and catch up.

Chart 3

Interest Rates On Mortgage Loans Are Converging Downward In Many European Countries



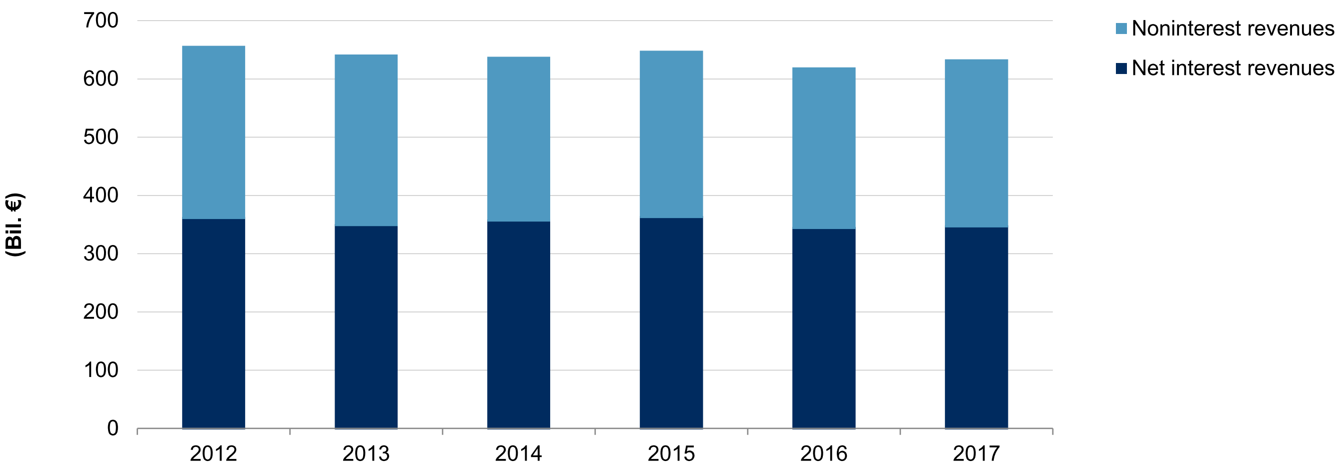
Sources: European Central Bank, Bank of England, S&P Global Ratings.

The resilience of NIMs, at least until recently, combined with fierce banking competition in the mature banking markets of Western European, explains why the structure of revenues--the share of interest income versus fee and commission income--has not changed dramatically. Revenues remain skewed toward interest revenues and, despite the increase of fees and commissions, their marginal positive impact is rather limited due to the base effect.

Meanwhile, strategies to increase commissions earned from insurance activities have proved successful in some markets thanks to increasing efforts to cross-sell insurance products to bank customers, especially non-life products, either through partnerships or in-house insurance companies under the bancassurance business model. It suggests that the universal banking model, properly managed, brings more resilience thanks to its diversity (see chart 4).

Chart 4

The Structure Of Western European Banks' Revenues Has Not Changed Dramatically

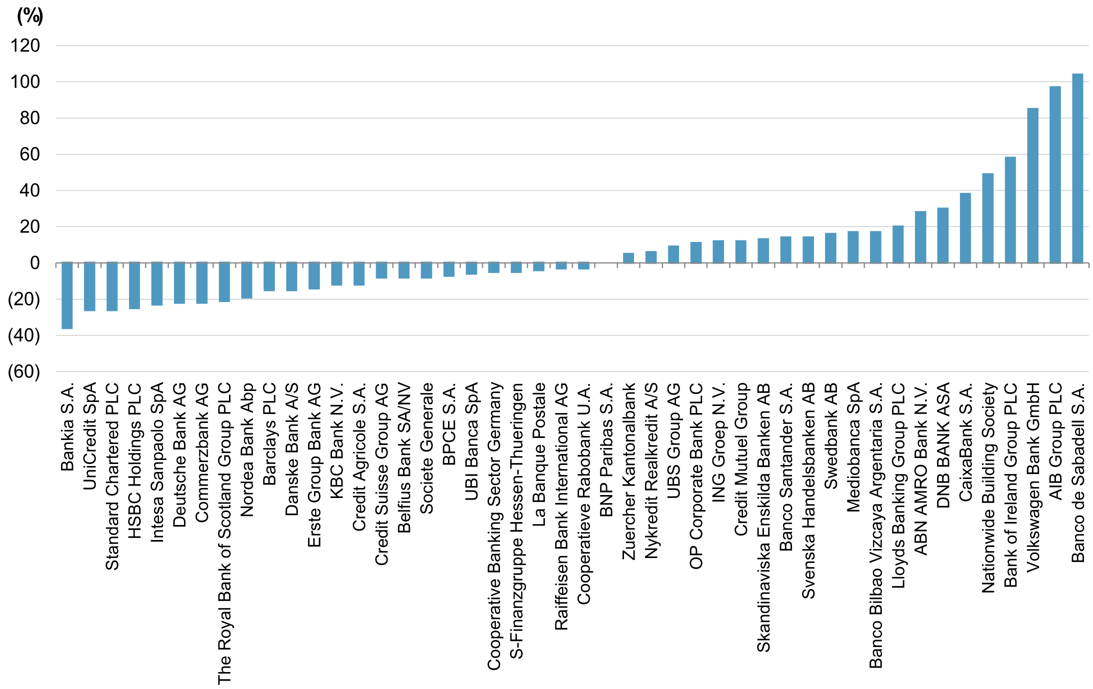


Source: S&P Global Ratings.

We observe that among the largest Western European banks we rate, the number of banks that have managed to increase operating revenue is much larger than those that have raised interest revenue. However, the improvement of operating revenues is only modest, reflecting the gradual economic pickup of Western European countries (see charts 5 and 6). Even though fee and commission income is small compared with net interest income, this somewhat more balanced revenue distribution has softened the impact of low interest rates.

Chart 5

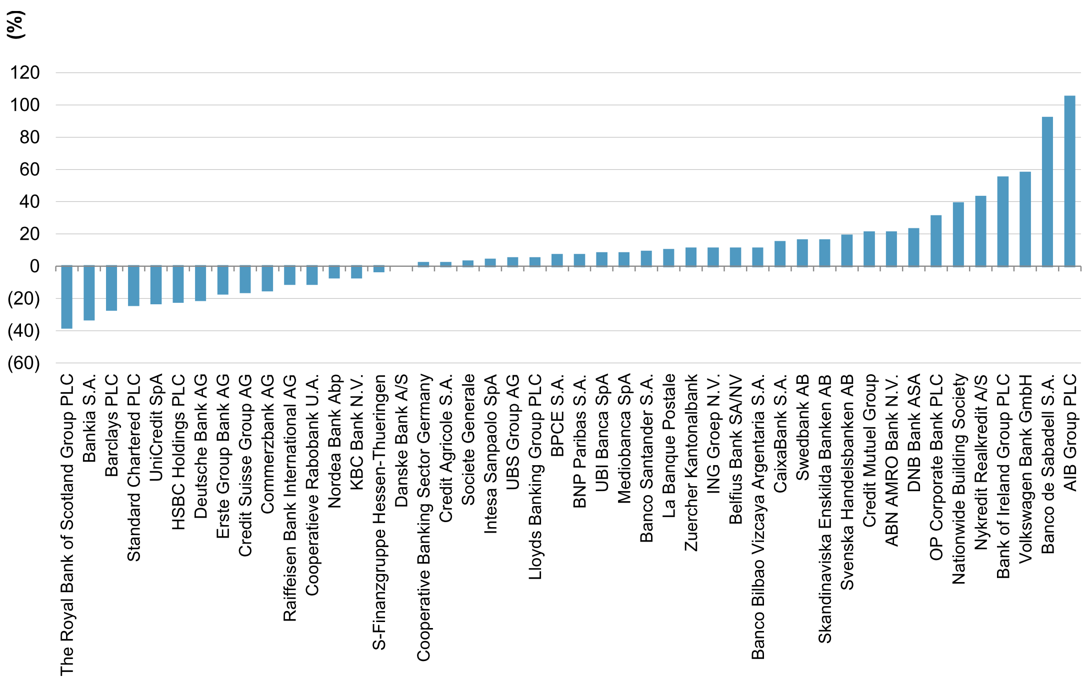
From 2012-2017, The Decline In Net Interest Income Was Widespread, Except Mainly For Banks That Had Restructured After the Last Downturn



Source: S&P Global Ratings.

Chart 6

From 2012-2017, A Larger Share Of Western European Banks Managed To Improve Operating Revenues Thanks To Revenue Diversification



Source: S&P Global Ratings.

We expect pressure on revenue generation to become even more visible when banks start publishing 2018 full-year results

Overall, we believe the decline in interest income has meaningfully weighed on the profitability of Western European banks since 2016. The impact for some banks is even more severe than what reported accounting figures would suggest. In some countries like France and Belgium, commissions paid upfront by clients to renegotiate their mortgages are being amortized over the period of the loan and included in interest income, partly compensating for the decline in interest paid on those mortgages. NIM on investment and liquidity portfolios is also falling, with a clear pattern of reinvestment at ever-decreasing yields.

Moreover, NIM compression can only increase, we believe, because banks are running out of ways to adapt to low interest rates, and the repricing of assets continues to dent revenue generation. Banks' ability to move funding costs downward has largely come to an end. Many deposit rates have reached rock bottom or have lingered in negative territory. But under competitive pressure, banks have limited ability to charge negative interest to clients, especially retail ones. Regulated savings have also constrained the ability of banks to further pass on lower interest rates to clients. The absence of attractive, alternative placements for retail investors has accentuated this issue for banks, which face excess on-demand or short-dated customer deposits.

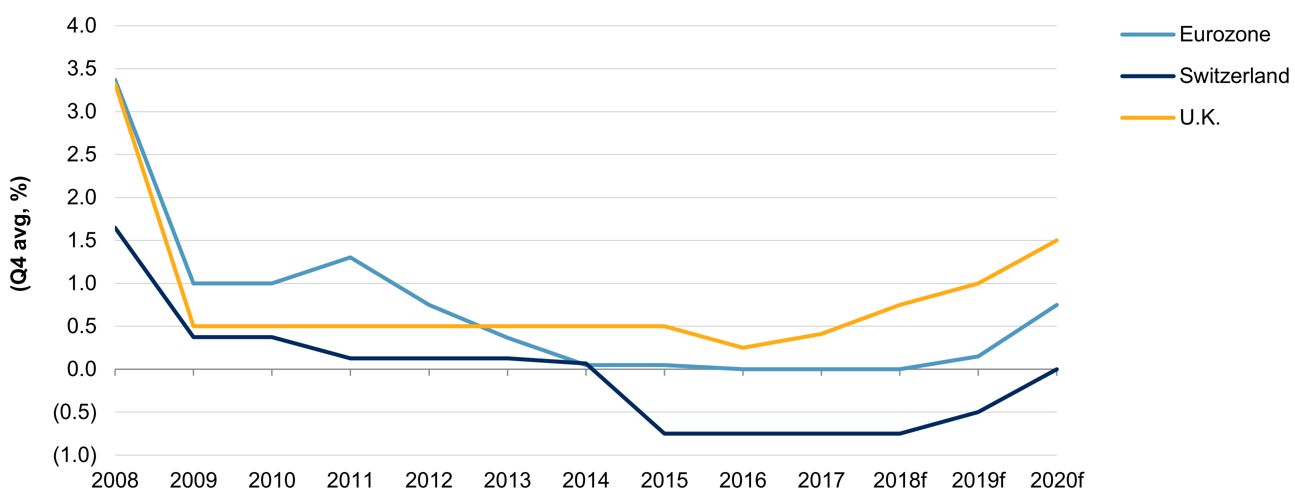
As a result, 2018 and 2019 will likely start a period when we see increasingly visible competitive pressure on NIMs, as well as incentives to relax underwriting criteria. The "lower for longer" interest rate scenario might become a real issue for Western European banks.

We expect interest rates to start rising gradually during the second half of 2019

For the moment, we expect to see the ECB's first hike in interest rates in September 2019. We believe the ECB will start by raising its deposit rate by 15 basis points (pbs). It could then proceed with raising other rates together in 25 bps steps as soon as December 2019, hence exiting negative territories. From there we have penciled in a gradual increase in rates with two rates hikes per year (see "The ECB’s New Normal And How We Might Get There," published on Nov. 29, 2018). The end of the central bank's asset purchase program and interest rate hikes should result in some tightening of financing conditions in the eurozone. Yet, we expect normalization to proceed slowly, preventing an abrupt rise in borrowing costs. Due to the remaining vulnerabilities of some European countries and the rising uncertainties about the economic outlook, we believe that the ECB will implement a very gradual path to tightening monetary policy (see chart 7).

Chart 7

Evolution Of Policy Rates For The Eurozone, The U.K., and Switzerland



f--Forecast. Sources: S&P Global Economics, Oxford Economics.

For these reasons, yields are likely to trend upward softly and gradually, primarily for more risky assets, as investors rebalance their portfolios back to safer assets. In the meantime, given how slowly we expect rates to rise and other revenue pressures on firms, return to meaningfully higher rates might take a long time. Overall, the economy's good yet slowing momentum should help banks in EMEA maintain sound or improving balance sheets, while cost initiatives should somewhat help profitability and offset still weak revenue growth.

Interest rates rise will be beneficial but not a game changer

Western European banks are well positioned to benefit from rising interest rates because we expect a faster repricing of assets than liabilities. This trend is likely to be gradual and not a radical game changer. We believe many factors will constrain banks' ability to gain from this repricing differential.

Gradual reductions in the negative carry of liquidity portfolios will be beneficial and much awaited. Higher revenues on structural hedges will also emerge but slowly in a rising rate environment due to the typically long-term nature of hedge programs. But this repricing will happen in parallel with the rebalancing of funding structures, and depositors will turn again to remunerated products and longer-dated instruments with the fattening of interest rates. Asset and liability management (ALM) strategies rely on assumptions about client behavior. We should question the calibration of models used to predict balance sheet repricing if they depend overly on behavioral patterns of recent years. Any rapid repricing of short-term rates on deposits would counterbalance gains on new loan production, especially if they trigger deposit volatility. The development of digital banking capacities will facilitate deposit transfer much more rapidly than in the past and lead to stronger price competition.

On the asset side, with the recent waves of mortgage loan renegotiations, clients have extended maturities and the portion of loans with fixed interest rates has increased. This will impede banks' ability to benefit from steepening yield curves in case of ALM mismatching or if they haven't swapped their fixed-rate assets into floating-rate assets.

Plus, as yields on riskier assets rise, investors will have a renewed ability to better price risk premiums in wholesale markets, which will increase funding costs for some banks more rapidly than for others. The expected increase of market volatility, due to the more efficient rate differentiation, will affect all banks. We will also monitor how the unwinding of TLTRO II, which banks have used at length, more or less opportunistically, could inflate refinancing cost for banks.

Three years since bank resolution regimes were created in most European countries, banks are continuing to restructure their balance sheets to build up further total loss absorption capacity (TLAC) and, more generally, buffers for minimum requirement for own funds and eligible liabilities (MREL; see "The Resolution Story For Europe's Banks: The Clock Is Ticking, published on April 25, 2018). It remains to be seen if the enlarged hierarchy of debt instruments in liquidation, and for that matter in resolution, from senior preferred to subordinated instruments, will allow for the maintenance of a similar average funding cost, as more risky debt instruments are deemed to protect other layers. Sensitivity to investor confidence could also delay banks' issuance and make it more expensive than initially planned.

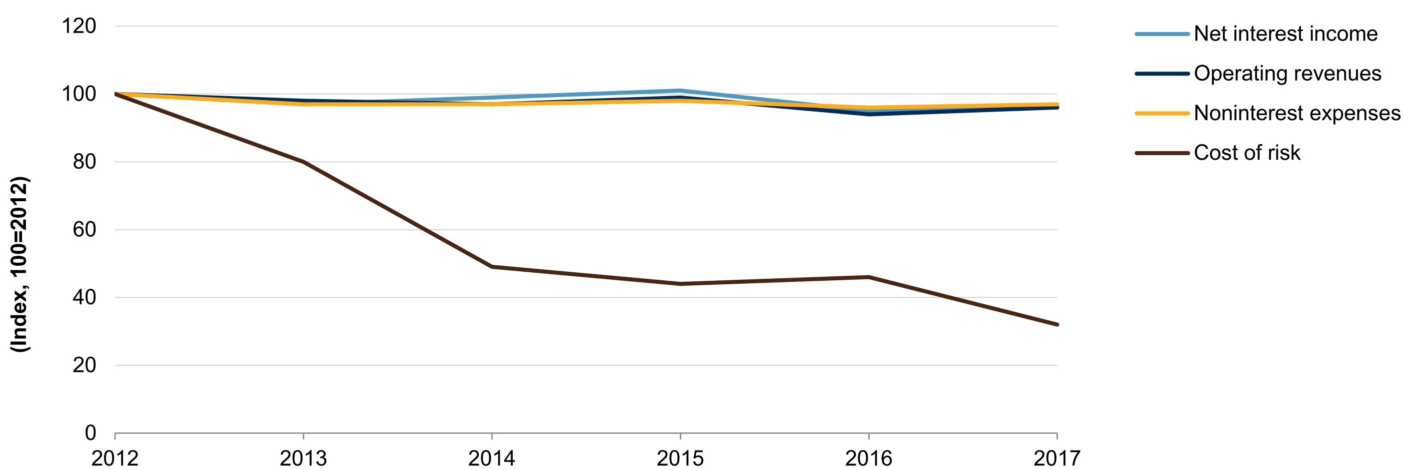
In any case, we expect banks to face more market volatility in 2019 from policy uncertainty and the rollback of monetary easing. In the U.S., the Federal Reserve's actions to raise interest rates since December 2015 have generally benefited banks as the yields they earn on their assets has risen faster than the cost they pay on their deposits. However, we expect the benefits of further Fed rate hikes for banks to begin to diminish with greater differentiation in the interest rate sensitivity of individual banks, particularly in the pace of their deposit repricing (see "U.S. Bank Interest-Rate Sensitivity Tracker: Betas Begin To Climb," published July 12, 2018).

Low cost of risk, so far the most supportive factor for earnings, will normalize

We expect net new lending will remain modest as in many Western European countries affordability, due to rising rates, will likely constrain credit demand. We expect nonperforming loan formation to remain low in the short term, but cost of risk should rise along with interest rates, after years of unexpectedly low levels of impairment charges. With weak revenue growth in recent years, the low cost of risk has been the biggest boost to profitability for Western European banks, partly compensating for needed restructuring costs and adaptation of business models (see chart 8).

Chart 8

Dropping Credit Loss Provisions For Western European Has Been A Critical Factor Supporting Financial Performance So Far

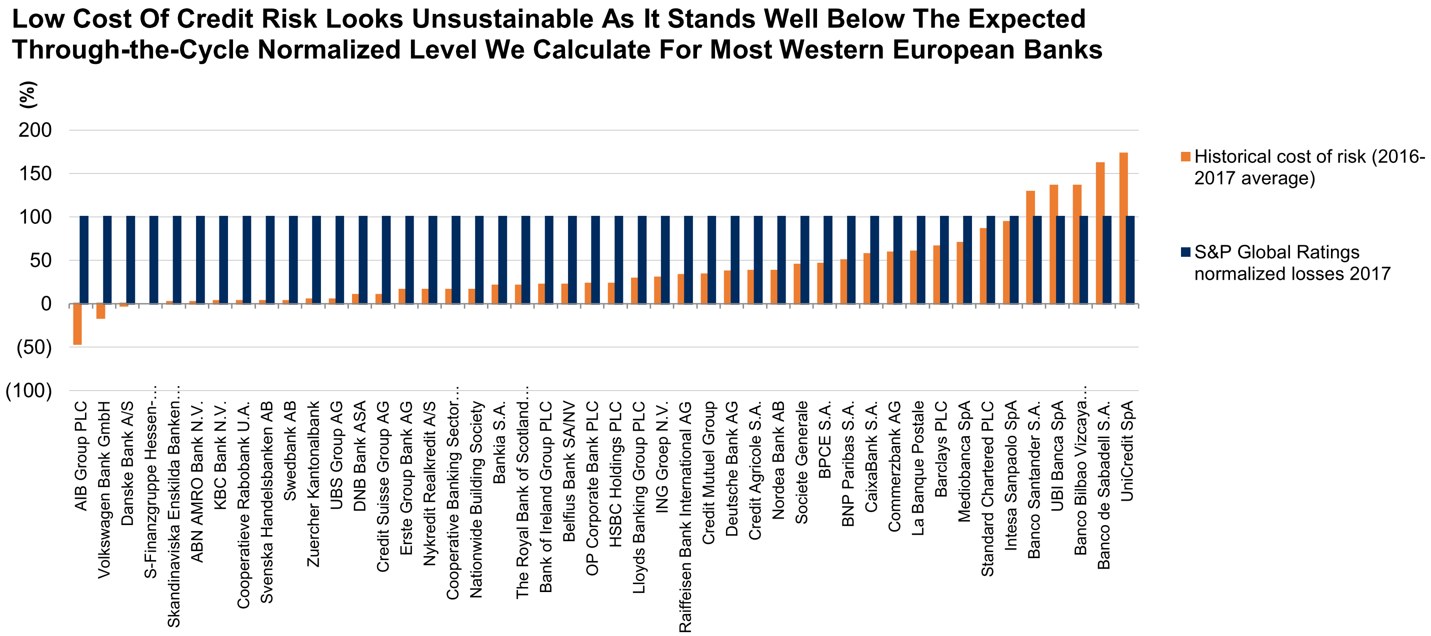


Source: S&P Global Ratings.

We now believe many countries are at their peak in the credit cycle, showing extremely low and unstainable impairment charges, notwithstanding the required efforts to improve coverage of bad loans in some jurisdictions. S&P Global Ratings calculates "normalized credit losses," which are long-term average annualized credit-related losses using an approach based on the average "through the cycle" annual loss rate we expect to occur for a given asset class (see "Banks: Rating Methodology And Assumptions," Nov. 9, 2011). We observe that compared with our measure of normalized credit losses, most banks in our sample reported a cost of risk substantially lower than half of the expected through-the-cycle level (see chart 9).

This expected normalization of the cost of risk, as interest rates start to rise, will inevitably in the long run partly counterbalance the benefit of rising interest revenues. Under this timing of events, and given our current macroeconomic scenario for the region, we believe banks will be able to absorb this increase in the cost of risk.

Chart 9



Related Research

- EMEA Financial Institutions Monitor 1Q2019, Jan. 14, 2019
- Global Banks 2019 Outlook: Bracing For More Volatility, Dec. 3, 2018
- Banking Risk Indicators: December 2018 Update, Jan. 3, 2019
- The ECB's New Normal And How We Might Get There, Nov. 29, 2018
- Europe's Housing Markets Are Staging A Soft Landing, Sept. 3, 2018
- U.S. Bank Interest-Rate Sensitivity Tracker: Betas Begin To Climb, July 12, 2018
- The Resolution Story For Europe's Banks: The Clock Is Ticking, April 25, 2018
- The Future of Banking: How Much Of A Threat Are Tech Titans To Global Banks? Jan. 15, 2018
- The Future Of Banking: How FinTech Could Disrupt Bank Ratings, Dec. 15, 2015

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