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ECB's Fresh Stimulus Spotlights Rising Risks For European Banks

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Key Takeaways

- The ECB's latest measures to support the softening eurozone economy are a net negative signal for bank ratings.
- Low for longer interest rates will limit upside to bank earnings and profitability this year at least, while asset quality will likely gradually weaken.
- A new series of TLTROs could alleviate refinancing risks for weaker eurozone banks, especially second and third tier Italian banks.

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Yesterday's monetary policy decisions by the European Central Bank (ECB) are net negative for our ratings on European banks. Although the decisions by themselves are not material enough to have immediate rating implications, the reasons behind the ECB's move cast a spotlight on the rising risks for banks from a softening macroeconomic environment. It confirms our expectation of a far more balanced pattern of rating actions, which could be skewed to the downside for European banks in 2019 (see "The Top Trends Shaping European Bank Ratings In 2019," published Feb. 28, 2019).

The ECB's guidance of a delay in rate hikes will likely further impede bank revenue growth. It means a continued squeeze on the margin between the interest rates that banks have to pay on deposits and are able to charge on loans. As a result, banks may need to make additional cost cuts to achieve their earnings' targets. Probably more important than the decisions themselves are the ECB's significantly lower annual projections for real GDP and inflation. Although the environment will likely remain supportive in 2019, lower growth could mean lower demand for loans. Moreover, it shows that downside risks are increasing. If these risks materialize, they could result in higher credit losses for banks. Furthermore, the continued slowdown might lead to further delays in interest rate hikes and additional earnings' headwind. On a positive note, the ECB's decisions are helpful for European banks from a funding perspective, in particular as it grants more time to weaker eurozone banks, particularly in Italy, to adjust their funding profiles.

Low For Longer

Yesterday's communication by the ECB means a continued accommodative monetary policy in the eurozone. It reflects a delay in the expected gradual, orderly normalization in interest rates owing to easing inflation expectations linked to weaker European economic prospects. Specifically:

- The ECB kept key interest rates unchanged and indicated it will postpone the first hike to 2020. This is one quarter later than the previous guidance, but earlier than the late 2020 implied by market prices ahead of the ECB meeting.
- It announced that it intends to continue reinvesting, in full, the principal payments from maturing securities under its asset purchase program for the extended period at least until it starts raising interest rates.
- It further announced a new series of long-term refinancing operations (TLTRO-III) from September 2019 until March 2021. The maturity of these operations will be limited to two years compared with four years under the previous program. Likewise, while details are still missing, the ECB will index borrowing cost under the operations to the rate for main refinancing operations (0.00%) compared with the possibility to borrow as low as the deposit facility rate (-0.40%) under the previous program.
- It confirmed that it will continue to provide full allotment under its normal lending operations for as long as necessary, and at least until March 2021.

Negative For Bank Earnings

Low for longer interest rates mean that any upside to bank earnings from a normalization of interest rates is unlikely to materialize before 2020. Yesterday's postponement in the ECB guidance is relatively short, but the softening environment could lead to further delays, as even the ECB recognizes that risks to growth are tilted to the downside. Mitigating against any impact on our bank ratings, however, is that we did not project a boost for European banks' profitability from a potential first rate hike in 2019. Even before today's decision, we anticipated that profitability would likely remain below cost of equity for many banks in 2019 and that rising interest rates (if they were to happen) would gradually lift, but not propel, bank profitability. More importantly, we expect banks to redouble their efforts on improving costs in light of the gloomier macroeconomic outlook. It could also act as a further catalyst to the in-market consolidation that is already under way in systems like Italy and Spain.

Nevertheless, yesterday's decisions underpin our view that it remains possible that we will see economic expansion translate into only very limited growth in bank profitability this year.

Bank Asset Quality Can Hardly Get Stronger

Underlying the ECB's decisions are its weaker projections on key macroeconomic variables. That said, the revised projections confirm that the macroeconomic environment for European banks should remain supportive in 2019, with gradually rising inflation, although at a lower pace than previously projected. Strong asset quality, and associated low impairments, have been a blessing for many European banks and might remain so. Yet, the ECB's projections highlight that slack in the economy has diminished substantially and the external environment remains cloudy. If Europe does face a trickier economic climate, we cannot overlook that it does so while still trying to remedy the ill effects of the last downturn, aided by unconventional monetary policy that risks asset bubbles in the stronger economies, government-backing for failed banks, and a heavy regulatory push on certain banks to dramatically reduce their nonperforming exposures (NPEs). But aside from those eurozone banks that continue to make strides to cut bad loans, European asset quality can only get worse despite continued central bank stimulus. We expect gradual weakening trend at least, with some one-off event risk (such as on single-name exposures).

TLTRO III Will Allow A Gradual Funding Adjustment, But Most Banks Do Not Need It

At the same time, the decision to launch another series of TLTROs and continue full allotment under normal lending operations extends the ECB's funding support for the banking sector, if needed. The new TLTROs alleviate the refinancing risks for weaker eurozone banks, in particular from having to redeem drawdowns under the previous operations (TLTRO II), for which banks are due to make their first major repayments in mid-2020. Extending the funding support benefits in particular the second and third tier Italian banks. In our view, these banks are significant borrowers under TLTRO II, they derive competitive benefit from the associated cheap funding, and in some cases have constrained access to wholesale investors. Conversely, we expect the rest of the eurozone banks to be well prepared to pay down their ECB borrowings at maturity regardless of their participation in the ECB's new program. However, we are also mindful that the publication of binding MREL (minimum requirement for own funds and eligible liabilities) for additional systemic European banks will likely spur a further wave of issuance of senior nonpreferred (or nonoperating holding company senior) debt by banks.

The potentially higher borrowing cost and shorter duration of the new operations could mean less favorable conditions for banks than TLTRO II. This should remind banks that the period of cheap central bank funding is finite despite the extended accommodative stance of the ECB. It also might remove partly the competitive distortions between weaker and stronger banks created by these operations. The ECB is still due to announce the precise terms of TLTRO III, leaving some uncertainty about the potential effects.

We understand that banks have started to prepare for the end of TLTRO before yesterday's announcement, including through repricing of loans or stronger use of other long-term instruments, such as covered bonds or securitizations. It remains unclear to what extent banks will participate in the program TLTRO III. In any event, the TLTRO III could function as a "backstop" in case funding conditions in the markets were to deteriorate again, for example through external shocks, such that they could undermine the transmission of monetary policy decisions. Given the latest operation will be in March 2021, the ECB's funding support for banks would stretch into 2023. In line with previous TLTROs but subject to review of the precise terms and conditions of the program, we generally would consider drawdowns under TLTRO III as long-term funding when assessing banks' funding and liquidity position, but only until 12 months before maturity.

Related Research

- The Top Trends Shaping European Bank Ratings In 2019, Feb 28, 2019
- Global Financial Institutions Analyst Survey 2019, Feb. 26, 2019
- When The Cycle Turns: Rising Interest Rates Will Lift, Not Propel, Western European Banks' Profitability, Jan. 14, 2019

This report does not constitute a rating action.