Banks | Have Lessons Been Learnt?

Gavin Gunning
Melbourne
gavin.gunning@spglobal.com
+61-3-9631-2092

Even though most banks have built stronger balance sheets since the global financial crisis, the pandemic has highlighted the ongoing importance of government support in a systemic shock.

How this will shape 2022

In our base case, we anticipate relatively stable ratings, although risks are more prevalent than upside potential. Our net outlook bias for the global banking sector improved significantly, to about positive 1% in October 2021 from about negative 31% in October 2020.

Banks' balance sheets should stay in reasonably good shape. Most banking sectors emerged from the global financial crisis better capitalized (see chart 35) and more liquid than before, with significantly improved asset quality (see chart 36). Stronger capitalization progressively built up over the past 10 years has helped banks cope with weaker operating conditions amid COVID-19.

High credit losses and tight interest margins will continue. We expect banks' credit losses to total about $1.6 trillion in 2021 and 2022, still significantly higher than before the pandemic (see chart 37). Profitability will remain constrained in some jurisdictions--especially in Japan and Western Europe--where low interest rates are hampering revenue growth (see chart 38).

The timing of governments' withdrawal of support hinges on the strength of economic recovery. Intervention by public authorities has assisted banks both directly and indirectly. Households and corporations benefited from extensive fiscal support, which saw global sovereign borrowings reach about $16 trillion; and monetary policy shifts, leading to ultra-low interest rates. Markets received massive liquidity support from central banks, including the U.S. Federal Reserve's $2.3 trillion lending programs, and the European Central Bank's facilities totaling over €2 trillion. These initiatives by public authorities reduced asset quality, funding, and liquidity risks for banks. Banks will cope with the eventual withdrawal of intervention by public authorities, but the way forward will be bumpy for some.

What we think and why

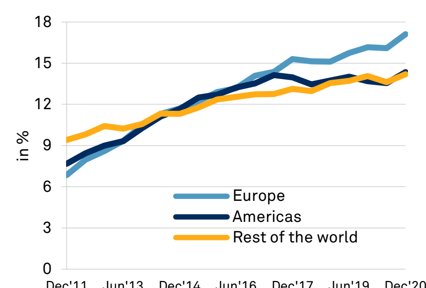
The pandemic highlights the enduring role of public support in banks' business models. However, because COVID-19 is an unusual shock, it does not represent a reliable blueprint about how public authorities will handle future stress scenarios. Regulation isn't a substitute for financial aid, if needed occasionally to address a systemic issue that could affect banks, or potentially to assist individual banking groups. To support the economies where they operate, banks take on risk--borrowing money for short timeframes to lend out for longer timeframes--and operate with a smaller proportion of equity than most nonfinancial corporates. Regulations can only influence the extent to which banks can play these maturity transformation and credit creation roles, balancing the economic benefit against the likelihood of banks needing support in certain stress scenarios.

Bank ratings have scope to solidify at current levels. Noting the significant turnaround in the net rating outlook bias to +1% from -31%, most banks' credit profiles look set to stay at current levels. The net outlook bias is unlikely to improve much, however, and could regress. By comparison, the global corporate sector showed a net negative outlook bias of about 6% in November 2021. The gap versus banks is mainly due to government support for households and corporates ultimately benefiting banks, as well as banks' diversified loan books, while certain corporate sectors (e.g. aviation and hotels) are still hampered by COVID-19.

Without support from the authorities during the pandemic, banks would have fared worse

Chart 35

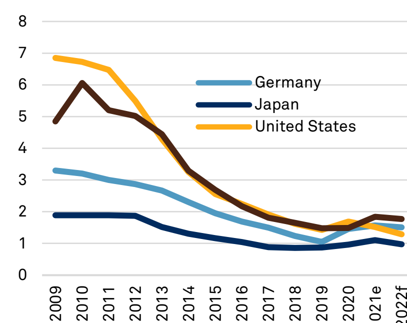
Tier 1 Ratios By Region - Group 1 Banks



Source: Basel Committee on Banking Supervision, Bank of International Settlements. Note: Group 1 banks are those that have Tier 1 capital of more than €3 billion and are internationally active

Chart 36

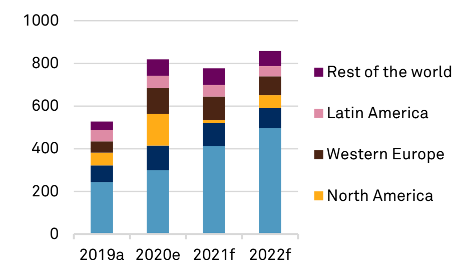
Nonperforming Assets - Selected G20 Jurisdictions.



Source: S&P Global Ratings.
e--Estimate. f--Forecast. Nonperforming assets as a % of systemwide loans.

Chart 37

Estimated Bank Credit Losses of US$1.6 Trillion Over 2021-2022.



Source: S&P Global Ratings.
a--Actual. e--Estimate. f--Forecast.

Recovery will be uneven. For about half of the top 20 banking jurisdictions, we estimate that a return to pre-COVID-19 financial strength will occur by year-end 2022; and for the rest, not until 2023 or later (see chart 39). Some banks in emerging markets face additional risks, including reliance on external funding, concentration in economies, or lack of government capacity to provide support.

What could go wrong

Risks could intensify. Key risks for banks include (i) the economic recovery stalling, (ii) high debt leverage in the corporate and government sectors resulting in higher corporate insolvencies than we expect, and less government support; (iii) disorderly reflation; and (iv) property sector challenges that vary by jurisdiction, noting current stress in China and spiking house prices in many markets. Potential positive rating changes are likely to be constrained. Currently, across developed markets, we see positive economic risk trends giving a boost to banks in only two jurisdictions (Ireland and Italy), and positive industry risk trends in three jurisdictions (the U.S., Korea, and Australia).

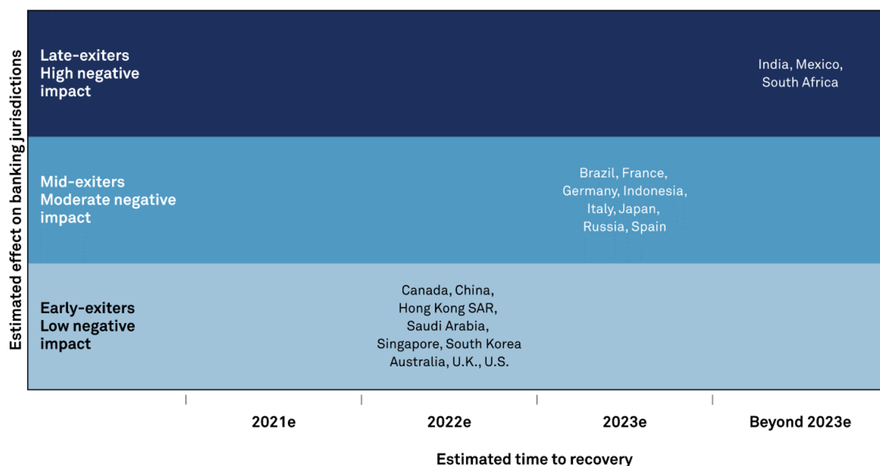
Authorities may mistime their actions. Should monetary, fiscal, and liquidity support diminish too early, then market disruption or a drawn-out recovery is likely. This could result in more damage to households and corporates. Public authorities have to perform a delicate balancing act, however, since measures in place for too long could also have adverse consequences for banks.

Nonbank sectors could command a larger share of the financial market. As bank regulations have tightened over the past decade, new unregulated or less-regulated, nonbank financial institutions (NBFIs) have gained market share. NBFIs now account for almost half of global financial assets according to the Financial Stability Board, compared with 42% in 2008. Financial risks posed by nonbank entities are on supervisors' radar, and regulations may well change to cover their activities.

The lessons of the past may not help banks cope with new risks. Disruption from new technologies as digitalization of the financial ecosystem evolves, cyber risks, and markets' clear focus on ESG factors present risks and opportunities. Yet we expect the Basel Committee will have limited appetite for another hike in capital requirements in the next two years, given concerns about banks' business model sustainability amid low rates, and a shift in focus to different emerging risks (e.g. technology and climate related). The importance of risk management culture is an enduring lesson that banks can take forward.

Chart 39

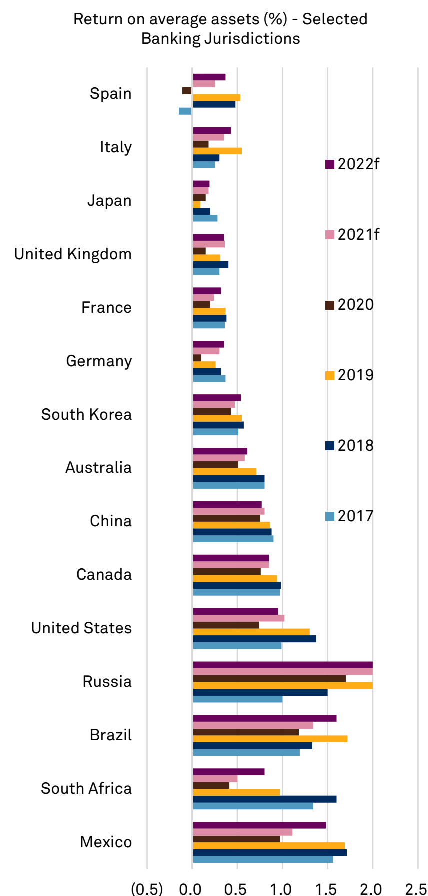
Banking Recovery Prospects Vary Across Geographies



Source: S&P Global Ratings

Chart 38

COVID-19 Is Dampening Prospective Returns



Source: S&P Global Ratings.
e--Estimate. f--Forecast.

Read More

The Basel Capital Compromise For Banks: Better Buffers, Elusive Comparability, June 3, 2021

Digitalization Of Markets: Framing The Emerging Ecosystem, Sep. 16, 2021

This report is an extract from "Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions", Dec. 1, 2021.

Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.capitaliq.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Australia: S&P Global Ratings Australia Pty Ltd holds Australian financial services license number 337565 under the Corporations Act 2001. S&P Global Ratings' credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.

spglobal.com/ratings