A stress test for the banks

by Michael Heise

Fears of a new banking crisis are haunting financial markets. The market value of Europe’s banks has plummeted by no less than EUR 250bn since the beginning of the year. Britain’s vote to leave the EU added further fuel to the fire, but earnings and the earnings outlook were already under pressure on several fronts: low capital market yields and the ECB’s penalty rates are squeezing profits in the traditional banking business, credit demand has been weak for years and regulation requires the reduction of risk and creates additional costs. Italian banks, at the epicenter of the crisis, are also dogged by a huge pile of non-performing loans, a legacy of a drawn-out recession.

As policymakers see it, it is up to banks themselves to reduce costs and risks, rectify market structures and adapt to new digital competition. But the problem runs deeper. The political framework has also dramatically weakened the banks. Thanks to the ECB’s negative interest rates the banks have to pay interest on their deposits of around EUR 700bn but are unable to simply pass on this interest burden to their customers. Investing in government or corporate bonds is hardly worthwhile because the central bank’s bond purchasing program has squeezed yields and risk premiums dry. In the zero-interest rate world, the banks’ bread-and-butter business, the generation of an interest surplus, is largely obsolete. But without adequate profits the banks are unable to ramp up their capital cushions as required. In the case of the Italian banks, there is again talk of government aid, with the taxpayer ultimately picking up the tab. It will probably boil down to such a solution, since the bail-in of private investors, as envisaged by the EU’s new rules, would clobber lots of small savers in Italy and is therefore strictly rejected by the government.

The ECB should come to the rescue by changing course. Its policy of zero interest rates and bond purchases, pursued since late 2014, has weakened rather than strengthened the banks. The ECB should therefore abandon penalty rates on deposits. It would also help if it were to reduce the volume of its bond purchasing program which is exerting massive downward pressure on market risk premiums. In contrast to the doubtful and unverifiable economic effects of this policy, the impact on bank balance sheets is plain for all to see. If the situation remains as it is, the resilience of banks in stress situations will increasingly diminish. Weak banks represent a major risk to long-term growth in the eurozone. For this reason, too, the ECB should start to rein in its unconventional measures.