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# EUROPEAN BANKS ARE VERY SOLID, BUT IS THIS ENOUGH?



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► The rise in interest rates is above all a godsend for European banks. Since the financial crisis they have battled to avoid destroying value, in other words to make sure that their profits exceed the cost of capital. This problem was instantly resolved by the return of positive rates.



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Firstly, the liquidity pool accumulated during the Covid period went from being extremely costly to highly profitable. Secondly, European banks' earnings show that the profitability of assets is readjusting much faster than the cost of liabilities. This is all the more true for countries with a tradition of variable rate loans, such as the UK or peripheral European countries. At the same time, the increase in the cost of liabilities is readjusting much more slowly than during previous cycles, for several reasons. The first, and most important, is the slowness with which banks are passing on the rise in interest rates to the interest paid on their deposits (known as the deposit beta). In the space of a year, almost to the day, eurozone key rates have increased by 3.75%. The average interest paid on European deposits has risen by barely 0.4% over the same period.

So why has so little been passed on? First of all because, as mentioned previously, European banks, which have only just emerged from the Covid era, still have an abundance of cash (deposits grew by more than 8% in 2020, then 4% in 2021) and there is therefore very little reason to fight to attract more. Next, because the depositor base is less sophisticated in Europe than in the US, and therefore less focused on optimisation at all costs. Young people are used to not receiving interest on their current accounts, and pay much closer attention to fees. Finally, against a backdrop of economic uncertainty, European companies, which are not in the habit of investing their cash in the money markets, are also reluctant to tie up their funds in time deposits that may pay a higher return but are less flexible.

Another structural issue is the gradual lengthening of market financing, driven by the regulations. The creation of new prudential ratios has forced banks to increase their longer maturity market financing, which will necessarily slow the rise in costs through refinancing. All of these factors, combined with (temporarily?) resilient default rates, have quickly put European banks in an ideal position to return to profitability levels not seen since 2008.

## WHAT'S HARDEST IS NOT THE ASCENT... BUT THE LANDING

Numerous risks could emerge due to the ultra fast and uncontrolled nature of this upwards cycle. If so they should start to materialise once rates have plateaued.

This interest rate cycle has not been triggered by economies overheating, but by rampant and difficult to control inflation. Squeezed risk premiums on the financial markets, low interest rate debt, the increased importance of the parallel banking system and crypto-assets, poor asset/liability management policies and the overheating of real estate markets are all anomalies generated by a very long period of negative interest rates and are likely to disappear in the wake of this sudden draining of liquidity.

Given the fundamentals currently reported by European banks (high liquidity, record high capital adequacy ratios, non-performing loans at a low and prudent levels of provisioning), it is difficult to imagine one of these risks undermining the European financial system on their own. It is the unfavourable alignment of the planets that is the regulator's focus, however. Political pressure and fear of the

stigma of too rapid a fall in deposits will gradually force banks to increase the return on deposits at the same time as interest rates stabilise. Banks will therefore have to abandon some of the margins generated during the period of interest rate hikes. The economic slowdown combined with the increase in refinancing costs will probably result in higher default rates in the real estate sector and business loans, which will oblige banks to recognise larger provisions.

Lastly, the interconnection between banks and non-bank financial operators could produce both high losses (defaults on loans or derivative exposures) and deposit flight (the share of deposits from non-bank financial operators having greatly increased in recent years, to nearly 10% of total bank deposits). After the Credit Suisse, SVB and First Republic Bank episodes, deposits are being scrutinised by the markets more than ever, and it is better to stay in the centre than to occupy the extremes.

**To conclude, although European banks are better equipped than ever to cope with these risks, their status as the lungs of the economy unavoidably exposes them, directly or indirectly, to a liquidity shock of this kind.**

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