BANKS – STILL FAR FROM NORMAL

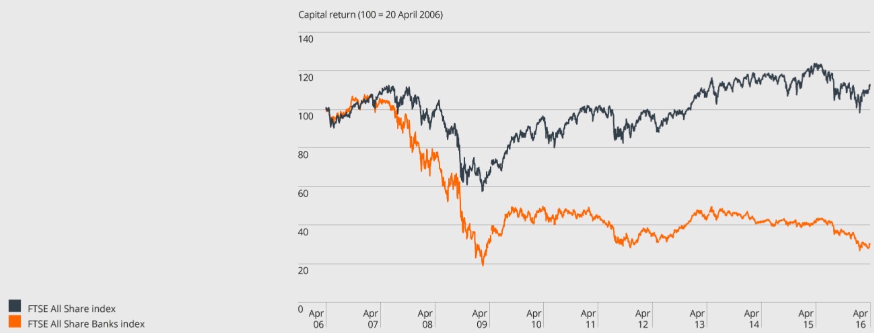
Mitchell Fraser-Jones, 22 April 2016

Following up on Paul Lamacraft's piece on fintech last week, we thought it would be worthwhile revisiting one of the core, widely-held sectors in the UK stock market – the banks. Here, we look at some of the problems that still blight banking systems across much of the developed world and why they lend themselves to a consistently cautious view on the medium-term economic outlook.

Neil used to be a significant investor in the banks, with almost a third of his portfolios invested in the sector in the late 1990s. Since then however, with the exception of HSBC, which was a constituent of the Woodford Equity Income Fund when it first launched, banks have barely featured in his funds. The only bank in the portfolios currently is Atom Bank, which as a recently authorised 'challenger bank' with no legacy assets, is clearly a very different and, in our view, attractive proposition compared to the traditional banks.

There are many reasons why we have not invested in the banking sector, some of which we touched upon in our fintech piece. They have been weak this year – indeed, they have been weak for almost the entire period since the global financial crisis commenced.

Banks have substantially underperformed since the financial crisis
Source: Woodford, Bloomberg



Recently, this weakness has been attributed at least in part to the ultra-low interest rate environment that we are living in. Banks struggle to make money in this sort of environment. Net interest margins (the difference between the rate at which they borrow and lend) are currently very slim and could narrow further if we head towards negative rates. Paradoxically, extraordinary monetary policy depresses bank margins and, in so doing, undermines the banks' ability to recover from the crisis that erupted in the financial system nearly 10 years ago.

And so the aftermath of the crisis continues to reverberate through the global financial system. Economic growth rates remain sub-par worldwide, debt levels have increased in many economies and, although many of the global fragilities that contributed to the crisis have been at least partially resolved, banks continue to raise capital in an ever-evolving & ever-tightening regulatory environment.

This is typical of a post-crisis resolution period. In any recession, banks incur losses – loans made in the good times simply cannot be paid back in tougher times. A recession can trigger a financial crisis if the extent of these losses exceeds the amount of capital in the banking system, resulting in insolvency. This may be a product of higher loan losses or a lack of capital in the banking system but, more often than not, it is a combination of the two. Either way, the process of loss recognition is necessarily delayed. Instead, the banks hide the losses and engage in 'extend and pretend' activities, whereby the creditor extends the maturity of a loan rather than accept its impairment, in the hope that time will increase the probability of its ultimate repayment – *a rolling loan gathers no loss*!

Policymakers are initially complicit in this behaviour, through their 'regulatory forbearance' where, in acknowledging that immediate loss recognition would result in insolvency, the regulators turn a blind eye and allow the banks time to 'earn their way out of trouble', slowly rebuilding the capital they need to realise losses through retained earnings.

This process takes years to complete and, as the chart below demonstrates, in a 'typical' single-country financial crisis, approximately 10% of peak loan assets are written-off. Sometimes, it's worse than that – in the early 1990s 'synchronous' Nordic financial crisis, 15% of peak assets became impaired whilst in Japan's increasingly poorly-monikered 'lost decade' over 20% of peak loan assets have been written-off and that number continues to rise.

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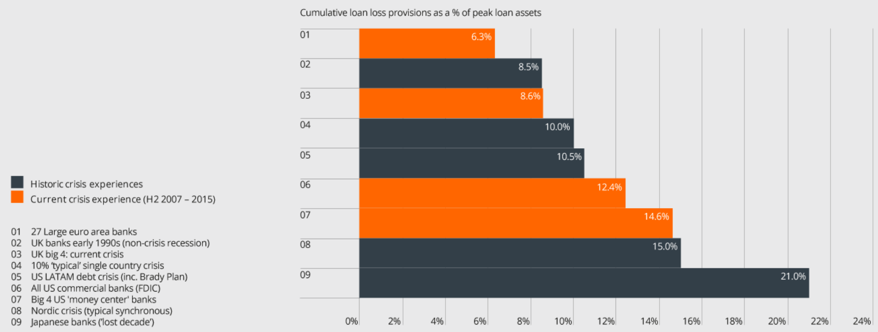
After a financial crisis, the process of loss recognition takes years to complete
Source: The MacroStrategy Partnership, Woodford



In the meantime, economies tend to exhibit very similar characteristics as they slowly emerge from their crisis:

- Banks do not engage in their normal business of lending
- The transmission mechanism that links monetary policy to the real economy via the banking system, money supply and inflation, is therefore broken
- Instead, the withdrawal of credit from the financial system represents a powerful deflationary force
- Overall economic performance remains lacklustre with short, shallow business cycles.

Sound familiar?

The speed at which crisis resolution takes place can be influenced by the immediate response of policymakers to the crisis. If they act with urgency and determination, they can kick-start the healing process by forcibly injecting capital back into the banking system and by providing mechanisms through which loan losses can be effectively crystallised without exacerbating the threat of insolvency.

In the case of the US, that is exactly what happened and, as the chart above demonstrates, the US banking system looks like it has largely completed the process of loss recognition. This in turn explains the behaviour of US banks, which have commenced the normal activity of lending again, and that of the Federal Reserve which raised interest rates in December for the first time in nearly 10 years, believing that the normal monetary transmission mechanisms linking the banking system, money supply and inflation, are now beginning to function again.

The Chinese know the great financial crisis as 'The American Crisis' but it was of course a synchronous event, afflicting much of the western world. In the UK, the incumbent banks have come some way in the process of loss recognition, with the big 4 (HSBC, Lloyds, Barclays and RBS) having loan loss provisions representing 8.6% of peak loan assets. This, however, is only slightly more than the 8.5% experienced in the early-1990s, non-crisis recession, which looks slightly odd as losses in a crisis are normally higher, especially in a synchronous one.

One explanation for this is that UK house prices never fully adjusted in the crisis, which has meant that the banks' mortgage books didn't come under as much pressure as they had in the early-1990s. However, if UK house prices were to just start the process of normalisation towards average (and affordable) valuations, this would create a massive new problem for the UK banks. Another reason, therefore, not to expect UK interest rates to rise any time soon and, in our view, evidence that the UK banks are not as strong as they first appear.

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Perhaps even more worrying than the position of the UK banks though, is that of the European banks. In Europe, the process of loss recognition has barely commenced – recent discussions over the Italian bank bail-out provide ample evidence of this. Perhaps European authorities believed the Chinese line about the provenance of the crisis but the process of acknowledging bank losses in Europe didn't really start in earnest until the euro crisis forced policymakers' hands in 2012, with a raft of new measures announced to give the banks the opportunity and incentive to start cleaning up their balance sheets. In short, banks in the eurozone remain way behind the curve when it comes to the process of crystallising legacy non-performing loans. In our view, this is a better explanation for the most recent slump in their share prices than negative interest rates.

While the process of loss recognition continues, we believe that bank shares across Europe are likely to remain under pressure and prone to steep losses when market sentiment is at a low ebb. Perhaps more important, however, is what this predicament says about the broader economic outlook.

European banks still aren't lending and without lending it would be wrong to expect growth in broad money. Expecting a recovery in the eurozone economy without broad money growth would be like Waiting for Godot – it just isn't going to turn up! Our expectation is that there won't be a recovery in the eurozone until the bank loss recognition process nears completion – at the current pace of progress, that suggest another four to five years.

At the same time, we need to keep an eye on the development of the next financial crisis. The 'American crisis' will be followed by a 'Chinese crisis' – it isn't a question of 'if?', the relevant questions are 'when?' and 'how big?'. Given the scale of China's financial system and the speed at which debt has accumulated over the last six years, this is a story that we are likely to hear a lot more about over the next couple of years, and the global economic ramifications could be significant.

More reasons for caution, therefore, but this doesn't undermine our investment strategy or our confidence in our long-term return expectations from the portfolios. Indeed, we'll finish with a reminder from one of the financial world's most-respected, original thinkers about some of the things that can differentiate a great fund manager from the pack. Here's Nassim Nicholas Taleb from Kilkenomics last year, on why investment isn't just about what you're invested in – *what you're not invested in, matters too*!

What are the risks?

- The value of the fund and any income from it may go down as well as up, so you may get back less than you invested
- Past performance cannot be relied upon as a guide to future performance
- The ongoing charges figure is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded
- The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits – some of these security types could increase the fund's volatility and increase the level of indirect charges to which the fund is exposed
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling – as a result, exchange rate movements may cause the sterling value of investments to decrease or increase
- The fund may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value

Important information

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