BlueBay
Asset Management

How three policy responses impact bank balance sheets

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The Covid-19 pandemic triggered a wave of support to keeps banks functioning efficiently and economies ticking over through lockdowns. We look at what action has been taken and its impact on the health of the banking sector.

1. Central bank monetary policies – low rates

Central banks around the world have been cutting interest rates, with the UK flirting close to zero at +0.1% and a number of banks taking the plunge into negative territory.

This negative rate policy action is designed to lower the overall cost of credit to the global economy. In turn, this helps to maintain the asset quality of banks.

How?

By lowering the interest cost of loans to the economy, the cost of borrowing charged to companies and individuals also reduces, improving the probability of these loans being repaid. The higher the probability of loan repayment, the higher the quality of a bank's assets.

The European Central Bank is allowing banks to borrow from it at rates lower than its headline negative interest rate policy with very lenient conditions. This means a bank gets paid to borrow money from the central bank and can then lend out that money into the real economy. This improves the profitability of both the individual loans and the overall bank, while encouraging the provision of credit into the economy to help keep things moving through lockdown.

Even if a bank lends money to a company or individual without charging them interest, it can make money by borrowing that same money from the central bank due to the negative borrowing rate.

The European Central Bank asset purchase scheme, which focuses on corporate and government bonds, is helping to lower the cost of funding for banks by maintaining funding spreads at very low levels.

Additionally, banks are typically large holders of government bonds for liquidity purposes. As the central bank is buying these bonds as part of its purchase programme, this inflates the price of these securities, further supporting bank balance sheets.

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2. Government fiscal policies – loan & income guarantees

Companies	Individuals
Governments around the world have introduced guarantee schemes for corporate lending in response to the crisis. The rationale for this is to ensure businesses can continue to trade when the lockdown measures are lifted, aiding a strong economic recovery. These schemes help to ensure companies can remain operational through this period, which in turn allows them to service their loans and maintains the asset quality of the banks that are providing these loans.	Governments in Europe have provided a variety of schemes that are intended to help individuals, such as the furlough scheme in the UK. The UK scheme is designed to ensure individuals retain an income during the lockdown that they can use to support their financial position, such as by paying their mortgage. In turn, this protects the balance sheet of the mortgage lender.

3. Regulatory policies – building buffers

Bank regulation has increased stringently since the financial crisis of 2008/2009, which has vastly improved the financial strength of banks coming into the coronavirus crisis.

These policies have created vast capital buffers that regulators have been relaxing in response to the current situation, as they recognise that for banks to continue carrying out their role in the monetary transmission mechanism, they must have comfort in their financial strength.

The regulatory action to increase the capital buffers banks hold has given bank management teams more comfort in their relative capital strength, encouraging them to keep lending to the real economy.

Investment outlook

Multiple steps are being taken by policymakers, central banks and regulators to support banks, underlining our view that banks are an important part of the solution to the current crisis.

The obvious risk to this view is that the virus peak and related impacts last much longer than anyone expects, but we are growing in confidence that policymakers are providing all the support required for banks and that their capital buffers should be robust enough to withstand what we believe will be a sharp contraction and slow recovery over the next two-to-three years. Certainly, owning AT1 securities from national champion banks seems much more appealing to us than extending loans to cruise-ship operators in the current environment.

In the near-term, we feel that investment discipline through robust sector and issuer selection will be paramount in delivering performance over the coming quarters.

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