U.S. Banks In Much Better Shape, Credit Demand Yet To Gather Pace In Europe, Japan

Until last year, it was widely believed that the banking industry in most developed countries was finally recovering from a long period of weakness that followed the 2008 financial crisis. However, the negative interest rate policies pursued in Europe and Japan have trimmed their margins further when credit demand remains tepid at best. On the brighter side, large banks in the U.S. are healthier and are now seeing a rebound in earnings, helped by higher trading income. Though mortgage credit demand remains somewhat subdued, U.S. banks are finding enough takers for other forms of consumer credit. In the emerging economies, the recovery in energy and commodity prices, as well as lower interest rates, has reduced bad loan risks for the banking industry.

The extraordinary monetary policy measures, including direct bond purchases by the central banks rolled out in the developed world after the financial crisis, were supposed to keep borrowing costs low and lift credit demand. While the policies did keep interest rates low, credit demand has not yet seen a meaningful, broad recovery across different market segments. Further, the impact of these policies has so far been more favorable in the U.S. where the banking industry underwent a deeper restructuring after the crisis, compared to Europe or Japan. When the central banks in Europe and Japan lowered their benchmark rates to negative, it was seen only as an expansion of their existing policies.

KEY TAKEAWAYS

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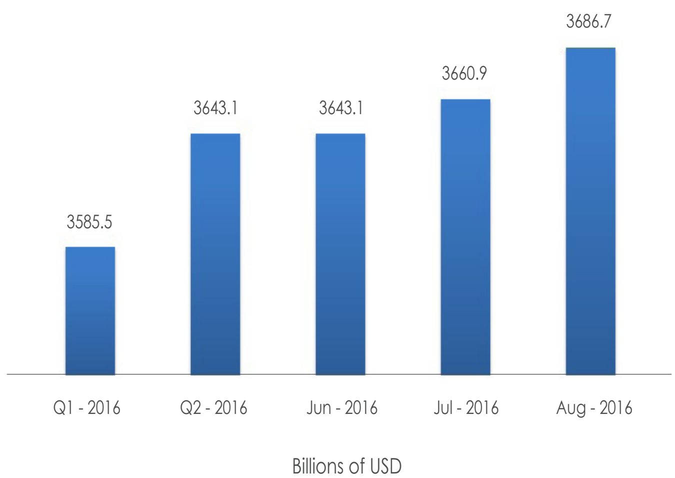
Total consumer credit outstanding in the U.S.



Data source: U.S. Federal Reserve

U.S. banks have fared relatively better, as the pressure on interest margins has been less when compared to Europe and Japan. Demand for consumer credit and mortgages have also been fairly healthy in the U.S., helped by gains in housing prices and financial assets. However, mortgage demand has moderated this year as many potential first time home buyers are discouraged by higher average prices and low inventory in popular markets.

However, investors were not prepared for the unintended adverse impact on the banking sector from the negative rate policy. Banks could no longer park their excess funds with the central banks even for a meager return. At the same time, their lending rates drifted lower and compressed net interest margins even further. In some European countries, floating rate borrowers started receiving interest rate payments on their mortgage loans. Banking stocks in Europe and Japan underperformed during the first half of this year, though they have made a partial recovery recently on expectations that central banks cannot possibly continue this much longer.

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In the emerging markets, the biggest risk for banks has been the possible jump in bad loans among energy and materials sector borrowers. The demand boom and high prices had encouraged oil producers, miners, as well as metal and cement manufacturers to borrow heavily for capacity expansions. As commodity prices tumbled and construction activity slowed, some of these borrowers struggled to meet debt repayments. Until early this year, it was feared that surging loan losses would force governments in several emerging countries to recapitalize their large banks.

Though they are not completely out of the woods, there are signs that the environment is improving in most emerging countries. The rebound in oil and commodity prices should improve the cash flows of leveraged corporations, and reduce the risk of defaults. In addition, lower interest rates have also reduced the outflows for borrowers that are able to refinance their loans. The recovery in stock market valuations is also attracting more buyers to distressed assets, thus offering banks an earlier exit option.

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