Chart Focus: Global Banks

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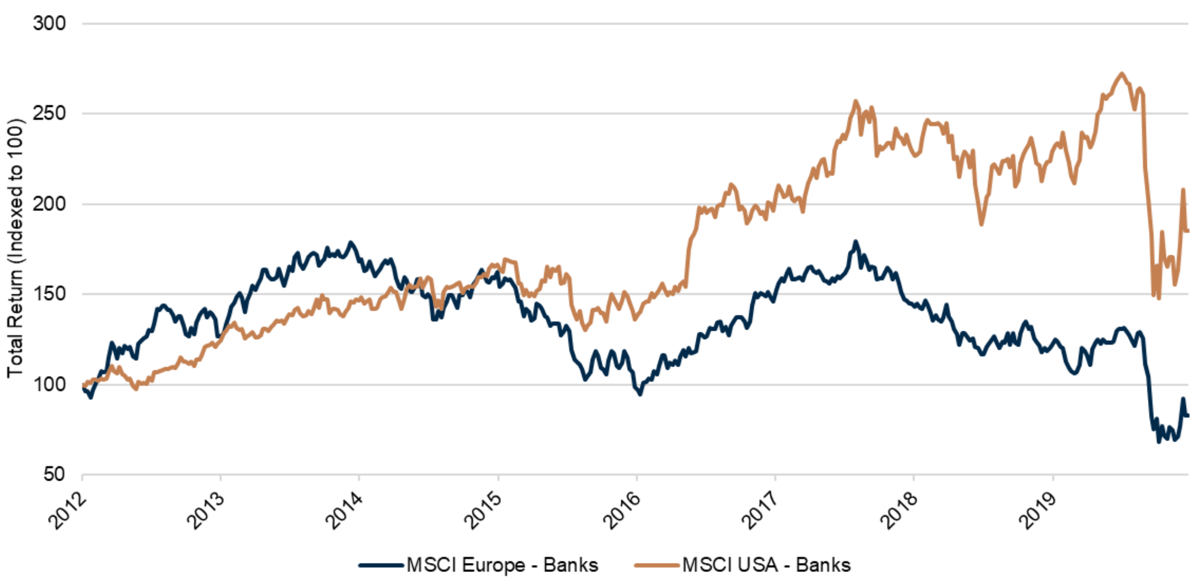
Banks have been some of the worst-affected businesses this year, given moves by Central Banks to cut interest rates in the hope of supporting economies hard-hit by COVID-19 lockdowns. While the effects of quantitative easing have certainly impacted banks, this isn't the only problem. Banks have underperformed the MSCI World by an annualised total return of 4% over the last 20 years, measured in US Dollars. This quarter, we explore some of the reasons for their underperformance.

Figure 1: World Bank Index relative to the MSCI World Index

European banks have worn the last decade the worst. When compared to the US, there has been a marked divergence between the two regions; since 2012, European banks have been losing on average 2% a year, on an annualised basis. This equates to 20% in absolute terms over this time.

Figure 2: European and US Bank Returns



Source: Bloomberg

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A real pressure point for banks is the net interest margin, a key measure of profitability for their core lending business. This is the difference between the interest banks pay on deposits held, and the interest earned on advancing loans. The European Central Bank's sustained effort to stimulate the economy since 2008 has delivered record low policy rates in the monetary union, in turn supressing margins.

Banks are also facing the slow but sure force of demographic aging. The lower level of consumption in these older populations weakens the demand for credit from the banks. This lower uptake on credit extension reduces the scope for banks to earn more from the interest charged on loans while remaining competitive.

Lastly, banking regulations over the last decade have imposed stricter measures to account for the bank's supporting capital, constraining the capacity for global banks to grow into new markets and compete with local firms.

It is difficult to talk about the headwinds banking faces without also mentioning Deutsche Bank, that this year celebrates its 150th anniversary. The German bank is not only tasked with navigating this unfavourable environment but also taking strides in downsizing its operations - the bank most notably announced it would be pruning its total workforce by as much as a fifth in 2019. Rapidly reducing its footprint as the opportunities arising from a globalisation-led expansion are no longer as abundant as they were in the 1990s.

Banks find themselves in a challenging situation that has been exacerbated by the recent coronavirus. Given lender's relationship with every part of the economy, there may only be significant improvements in profitability once most economic sectors begin to show stability again. While banks stay positioned to benefit from this recovery, the symptoms stemming from restrictive regulation and low policy rates show no signs of alleviating anytime soon.