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Research, Strategy and Analysis

20 October 2016

Banks: the weak link in the European recovery

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Investors' scepticism on the outlook for European banks has caused the sector to starkly underperform the broader financial markets. The Stoxx Europe 50 Banks has lost more than 25% on the year to date. Financial issuers have also underperformed in IG universe. So what's going on? Mario Draghi came right out and said it: "Banks' problems are not just a matter of low interest rates". Let's face it: it's hard to imagine a central bank chairman saying anything different. Remember that the official message is to restart inflation by restoring credit channels to promote investment and, ultimately, an economic recovery. In this article, we review the fundamentals of the European banking system and the repercussions of ultra-accommodating monetary policy.

Abstract

Investors' scepticism on the outlook for European banks has caused the sector to starkly underperform the broader financial markets. So why are they so sceptical? There's no point in looking for parallels with 2008: banks have now shored up their solvency, liquidity and capital structures considerably to comply with new regulatory restrictions. Banks are now suffering from a generalised dearth of profitability, due in part to an environment of low/negative rates. The ECB denies that its ultra-accommodating monetary policy has ultimately undermined the euro zone's banking system. Mario Draghi has blamed "overcapacities in the European banking sector". The IMF came to a similar conclusion in its latest GFSR. It should be noted that this strategy takes time and is hard to implement in the current environment.

1 An enhancement in solvency and liquidity ratios since the sovereign debt crisis

The financial sector has, on the whole, become healthier since the 2007 crisis, thanks to: (1) stricter regulatory restrictions; and (2) unprecedented support from the ECB.

The period after the 2007 crisis featured a reinforcement and transformation of financial institutions' regulatory framework.

- **The Basel III reform is part of this approach and aims to reinforce (short- and medium-term) liquidity standards and the shoring up of equity**. Remember that a bank's solvency is measured by its Common Equity Tier 1 (CET1) ratio, which is equal to the amount of equity deemed solid divided by risk-weighted assets (RWA) The Basel III agreements redefined the eligibility criteria of equity and raised the minimum required CET1 to 8%. To comply with this new regulation, euro zone banks have shored up their balance sheets considerably. The CET1 ratios of the euro zone's largest financial institutions averaged 13% at the end of 2015 vs. just 7% in 2008 (source: ECB).
- **The largest banks will also have to comply with a new solvency ratio, the Total Loss Absorbing Capital (TLAC).** Thirty banks worldwide fall into this category, including 16 European banks. This new regulatory ratio was established by the Financial Stability Board (FSB), a body set up by the G20. The goal is for systemically important banks to possess a total capacity for absorbing losses in the event of default, in order (1) not to generate systemic risk; and (2) to avoid recourse to public funds for massive recapitalisation. TLAC instruments must be potentially liquid, priceable, and be subject to no risk of legal contestation. The FBS chose: hard equity (CET1), subordinated debt instruments (AT1, Tier2) and some senior debt. The TLAC will require that banks, effective 2019, carry a cushion of equity and similar instruments amounting to 16% to 18% of their total risk-weighted assets (RWAs).

"Banks have shored up their equity considerably since 2008"

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- **Another major change in the regulatory framework is the "bail-in". This principle was formally adopted in January 2016 by European bodies as part of the Banking Union.** Remember that the Banking Union was set up in Europe to address insufficiencies in the European financial system and excessive interdependence between banks and governments. The goal is to put an end to the "bail-out" that was predominant during the crisis and that allowed credit establishments to call on public savings in the event of default. The "bail-in" agreements provide that, in the event of a capital shortfall after losses, shareholders and holders of regulatory capital will be called on first, followed by holders of subordinated debt, and then holders of non-guaranteed deposits.

The ECB's unprecedented measures have boosted bank liquidity significantly. The unlimited volume of refinancing operations and longer-term have allowed banks to weather the crises of late 2011 and early 2012. In addition, the ECB has significantly expanded the spectrum of guarantees demanded in return for its loans to ensure access to its funds to banks in difficulty. Peripheral banks are still very dependent on ECB funding. In contrast, excess reserves that euro zone banks deposit with the ECB (mainly core country banks) even crossed the €1000bn threshold! This record level is due mainly to the outcome of the ECB's asset purchase policy. The liquidity injected remains on the bank accounts of economic agents and is ultimately deposited by the banks with the ECB.

All in all, banks have shored up their solvency, liquidity and capital structures considerably to comply with new regulatory restrictions. There is no point in drawing parallels with 2008: the European banking sector is suffering from no solvency/ liquidity problems but does face a generalised problem of profitability. Note that some specific banks remain undercapitalised in peripheral countries.

No bad surprises in the findings of the stress tests conducted under the supervision of the European Banking Authority (EBA)

The stress tests aimed to ensure that major banking groups will remain solvent in the event of losses caused by a deep economic recession. The adverse scenario covered a three-year period and included a 1.2% recession in the European Union in 2016 and a 1.3% one in 2017.

The stress tests showed that banking establishments are, on the whole, able to absorb a shock over a period of three years, even if their balance sheets could be better. Under the adverse scenario, CET1 ratios would fall, on average, to 9.4%, which is above the minimum 5.5% required in the 2014 test. It is noteworthy that this time the tests did not include a failure or success threshold. Credit risk losses would account for the biggest decline in solvency.

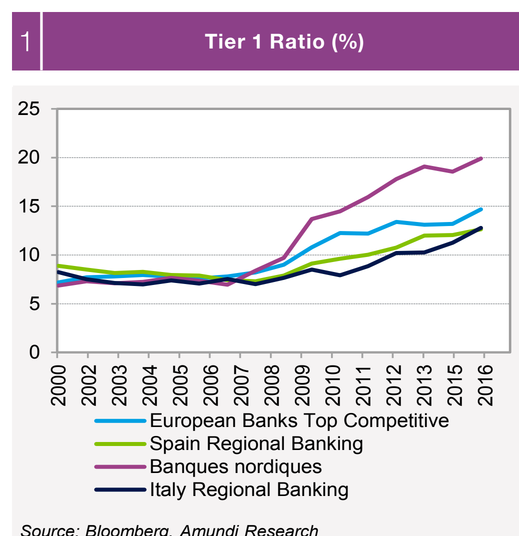
The impact of the adverse scenario on solvency varies widely from one bank to another. Monte dei Paschi and Allied Irish Banks fared poorly (with their respective CET1 ratios hitting -2.4% and 4.3% in 2018), as did Bank of Ireland (6.1%) and Raiffeisen Holding (6.1%). The national giants Deutsche Bank, Barclays, Unicredit, Commerzbank and Société Générale are also showing signs of weakness (between 7 and 8%).

2 A generalised problem of profitability

The low-interest-rate environment is undermining profitability from lending and deposit. The net interest margin (i.e., the difference between interest received and funding costs) has been hit by historically low interest rates. The very slight slope in the yield curve is depriving banks of transformation profits between the various maturities. This is the very foundation of the banking business. However, not all euro zone banks are as sensitive to low interest rates. This sensitivity depends on:

- **Deposit volumes compared to loans.** After the 2008 crisis, banks reduced their dependence on the markets by raising their share of funding from deposits. Otherwise, holding deposits costs banks money, as liquidity deposited at the ECB is charged a negative rate (-0.40%). German institutions are right to be unhappy. They have heavy surplus reserves.

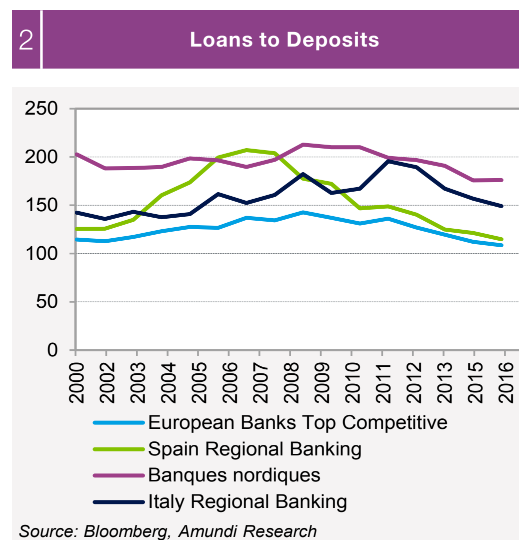
1 Tier 1 Ratio (%)



Source: Bloomberg, Amundi Research

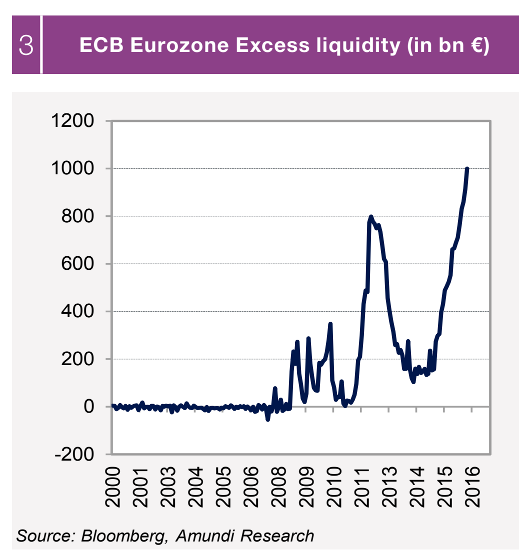
> *Bail-in: the end of "too big to fail"*

2 Loans to Deposits



Source: Bloomberg, Amundi Research

3 ECB Eurozone Excess liquidity (in bn €)



Source: Bloomberg, Amundi Research

The Bundesbank estimates that the ECB's policy cost German banks €248 million in 2015 and that it will cost them about €1 billion in 2016.

- **The type of loans (floating-rate or fixed-rate).** Italian, Spanish, and Portuguese banks finance most home purchases through floating-rate loans indexed to Euribor. But the steady slide in interest rates is forcing the banks to reduce clients' monthly instalments.

The ECB denies that its ultra-accommodating monetary policy has ultimately undermined the euro zone's banking system.

Mario Draghi pointed out the positive impacts of low interest rates for banks: (1) capital gains in bond portfolios; (2) enhanced borrower solvency; and (3) increased lending volumes. What are we to make of all this?

1. A large portion of domestic public debt is held by banks – as much as 22% in the case of Italy. Falling interest rates has allowed them to realise substantial capital gains in recent years. With a Bund at 0%, these benefits are mostly a thing of the past!
2. Low interest rates have also reduced borrowers' debt-servicing costs, improving *de facto* their solvency and allowing banks to lower their provisions on the risks of non-repayment of loans.
3. Bank lending remains anaemic in the euro zone. Its banks cannot get in a race for volumes to offset the decline profitability, as this would ultimately end in an explosion in credit risk. The margin on loan distribution must remain sufficient to cover the cost of risk borne by the banks.

More importantly, the ECB chairman also pointed the finger "overcapacities in the European banking sector". In its new report on financial stability, the IMF also called for in-depth reforms of the European banking sector to "to adapt to this new era of low growth and low interest rates, as well as to changes in the markets and regulations" (GFSR, October 2016). However, this strategy takes time and is hard to implement in the current environment.

These squeezes on profitability on top of increasingly strict capital requirements have contributed to the sharp drop in return on equity. Most major euro zone banks' return on equity now hovers around 5-10%, vs. 15-20% from 2000 to 2006. Many banks earn less than their cost of equity. If this goes on, the banks will have a hard time raising capital on the equity markets.

What about Basel IV? A further squeeze on profitability?

Basel III simultaneously targeted the definition of the numerator (eligible equity) and the minimum ratio. Basel IV is now taking aim at the denominator of the solvency ratio, i.e., the method of calculating assets as weighted by balance sheet risks. These new rules are due to be finalised by yearend and enter into force in 2018-2019. We see two major reforms under Basel IV:

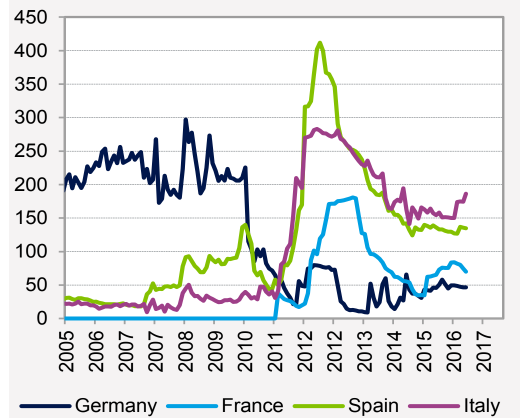
- **The introduction of interest-rate risk.** The weight of long-term, fixed-rate loans on bank balance sheets continues to grow. Banks lend for the long term but fund themselves constantly on the money market and would thus take a direct hit from an increase in interbank rates.
- **The standardisation of calculation methods for assessing banks' RWA,** as some major banks use "in-house" models, which makes comparisons hard between banks.

3 What are the risks for bond investors?

No wonder financial stocks are taking a beating on the markets. Banks' lack of profitability is affecting shareholders directly (with a dim outlook for profits and dividends). But to what extent can bond investors also be affected?

- Investors are concerned about the heavy amount of non-performing loans held by European financial institutions – €950bn at the end of 2015, or 7.1%

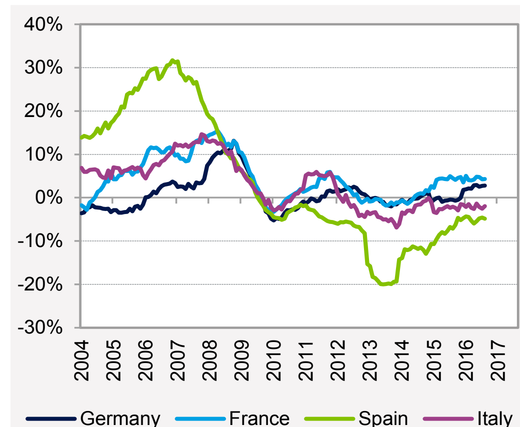
4 ECB Balance Sheet lending to Euro Area credit Institutions (LTRO and MRO) (in € bn)



Source: Bloomberg, Amundi Research

> *Regulatory constraints and the interest-rate environment have undermined banks' profitability*

5 Loans to Euro Residents NFCs (change in %)



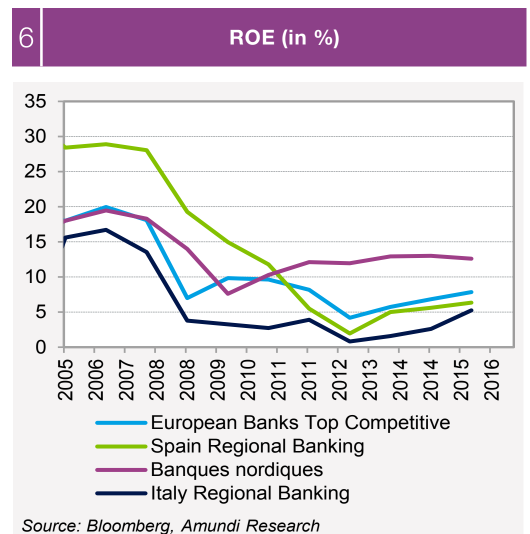
Source: Bloomberg, Amundi Research

> *ROE is below the cost of equity at many banks*

of total outstanding loans. This is high by international standards and higher than in the US and UK (source: ECB). Non-performing loans are concentrated in peripheral countries: Greece (34% of total loans), Italy (18%), Ireland (15%) and Portugal (12.8%).

- This is a particular point of concern for these banks, which may have an increasingly hard time shoring up their equity by: (1) setting aside income as reserves (lower profits); or (2) raising new capital (little appetite on the equity market).
- In the event that market recapitalisation fails, since 1 January 2016 bond investors must help shoulder the burden of recapitalising distressed banks. Subordinated debt holders are first in line.

6 **ROE (in %)**



Source: Bloomberg, Amundi Research

Conclusion

The level of solvency is an important, but far from sufficient, indicator for bond investors. Bond investors must pay careful attention to a bank's ability to generate profits to reconstitute its equity in the event of a shock. The best source of equity is internal production of capital.

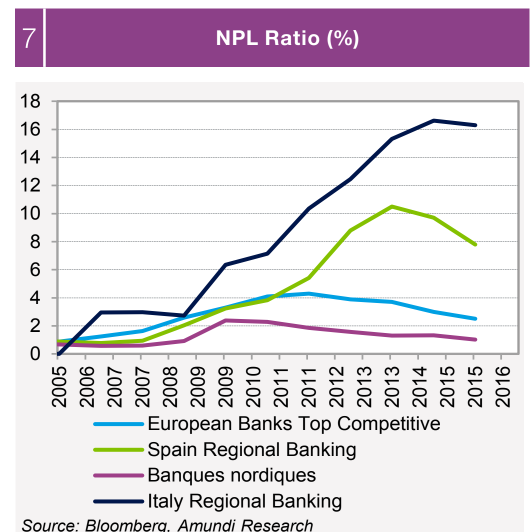
Banking securities (both shares and bonds) are currently trading at a discount on the financial markets. What events would help improve the market performance of banking securities?

1. A shift in the ECB's monetary policy that would promote a (slight) steepening in the yield curve.
2. An easing in regulatory constraints. A way around the "bail-in" rule (in Italy) would be cheered by holders of subordinated debt.
3. And, in the longer term, a significant improvement in the economy to boost incomes and facilitate the sector's restructuring.

On the macroeconomic front, banks' ability to generate enough resources to finance the economy must not be undermined by the interest-rate environment and increasingly stringent regulatory constraints. Accumulating equity must not be not an end in itself.

"The ECB's responses: concentration, restructuration and a new direction in activities"

7 **NPL Ratio (%)**



Source: Bloomberg, Amundi Research

"Accumulating equity is not an end in itself"

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