European Banks' Struggles Will Continue
By: STRATFOR

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Forecast

- *Many of the factors limiting the profitability of European banks (low interest rates, high levels of bad debt and insufficient economic growth) will continue to present challenges for the sector.*
- *The Brexit referendum has added political risk to the list of threats European banks face; uncertainty about the future of the European Union will lead to uncertainty about the future of banks.*
- *Though stress tests are never fully reliable, they confirmed that banks in countries such as Italy, Ireland, Germany and the United Kingdom will continue to face challenges in the future.*

Analysis

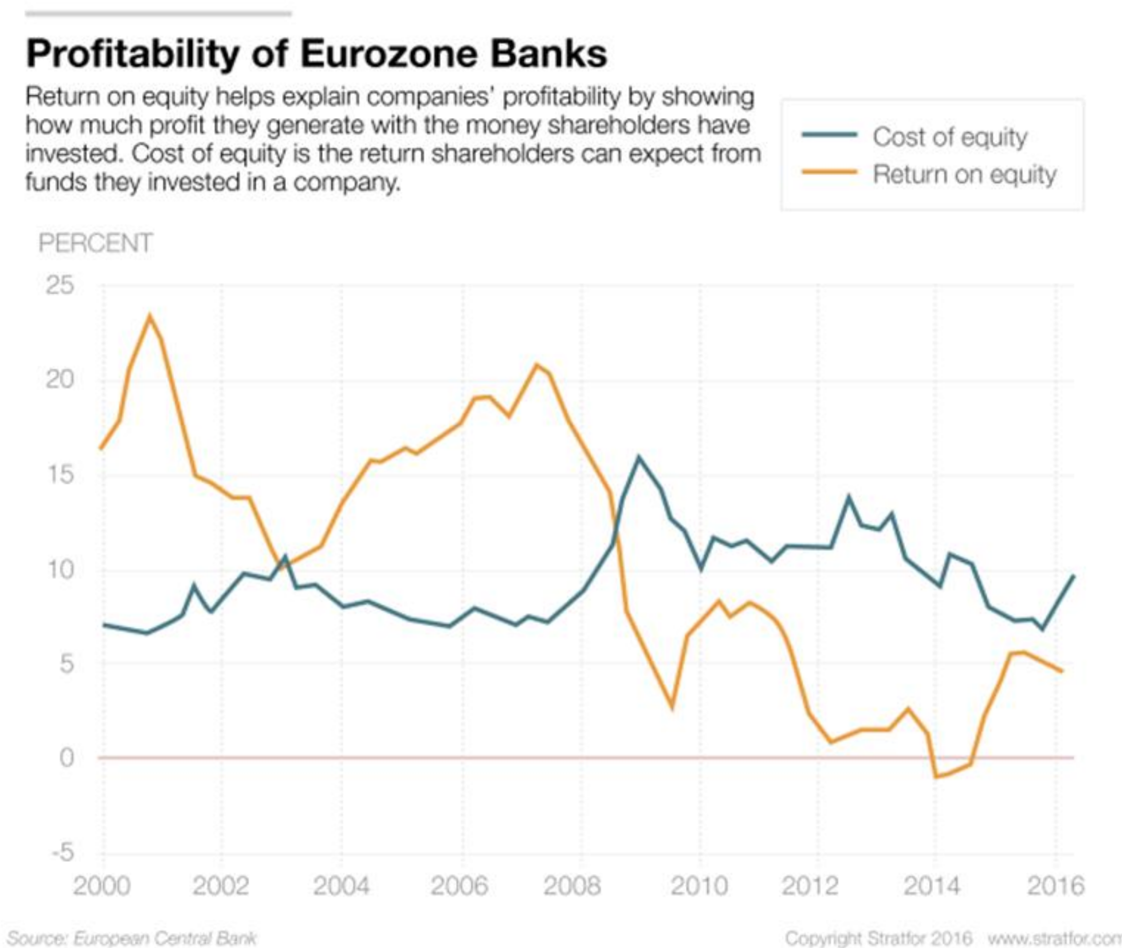
European regulators officially consider most banks in the eurozone stable, despite the timid economic growth and low interest rates in the currency area. Most banks in the eurozone have enough capital to face a new economic crisis, according to stress tests by the European Banking Authority (EBA) on July 29. But not all the banks are in good health. The weakest of all the large banks in the currency area according to the EBA was Monte dei Paschi di Siena, Italy's third-largest lender — a widely expected result considering that Monte dei Paschi has been fragile for years. The EBA also warned of a significant deterioration in the key capital ratio of the Irish lender Allied Irish Bank. Austria's Raiffeisen, Spain's Banco Popular, the British Barclays, and the Bank of Ireland were also among the weakest performers in the tests.

The stress tests involved 51 European banks each with a minimum of 30 billion euros ($33.3 billion) in assets, representing roughly 70 percent of total EU bank assets. Small banks, which in some cases are more vulnerable to failure, were excluded. The tests assessed the banks' reaction to a scenario depicting modest economic growth in Europe and to one assuming a prolonged recession. Unlike previous editions, this time the tests did not include a threshold to determine whether banks passed or failed. After the results, the EBA will issue specific guidance for the banks that are considered to be under greater risk.

The EBA's stress tests come as the banking sectors of several EU members are dealing with multiple sources of vulnerability. In recent weeks, Italian banks have come under intense scrutiny from investors, analysts and politicians. Most of the attention has focused on Monte dei Paschi, which has required two state bailouts in recent years. Other institutions, including Italy's largest bank, UniCredit, have seen their share prices decline sharply in recent weeks. Since the beginning of the year, the shares of Germany's Deutsche Bank, weighed down by low earnings and multiple lawsuits, have dropped by half. Spanish banks are probably stronger than they were during the height of the financial crisis, but large lenders such as Santander have also struggled with low profits. The fallout over the United Kingdom's decision to leave the European Union has helped accelerate their decline, as the uncertainty created by the Brexit has raised questions about the health of European banks. But there are also structural issues at play.

Struggling to Remain Profitable

One of the main challenges for European banks is their low profitability. In the eurozone, banks have somewhat improved their profitability recently after a long period of low returns, but their recovery is still weak. The average return on equity (which basically measures how much profit banks generate with the money their shareholders have invested) for European banks was at around 5.8 percent in the first quarter of 2016. This was slightly better than the fourth quarter of 2015 (4.7 percent) but below the first quarter of 2015 (6.9 percent). In addition, European banks' return on equity remains below their cost of equity (the return shareholders can expect from their investment), which is estimated to be around 9 percent. This gap has persisted since the financial crisis started in 2008.



The weak profitability of banks is the result of several factors. The European Central Bank (ECB) has progressively reduced interest rates, hoping to encourage economic growth in the eurozone. In March, the ECB introduced a deposit rate of minus 0.4 percent, which means it is charging commercial banks for holding their excess cash. Other central banks, such as the Bank of England, are also pursuing a policy of low interest rates to generate economic growth.

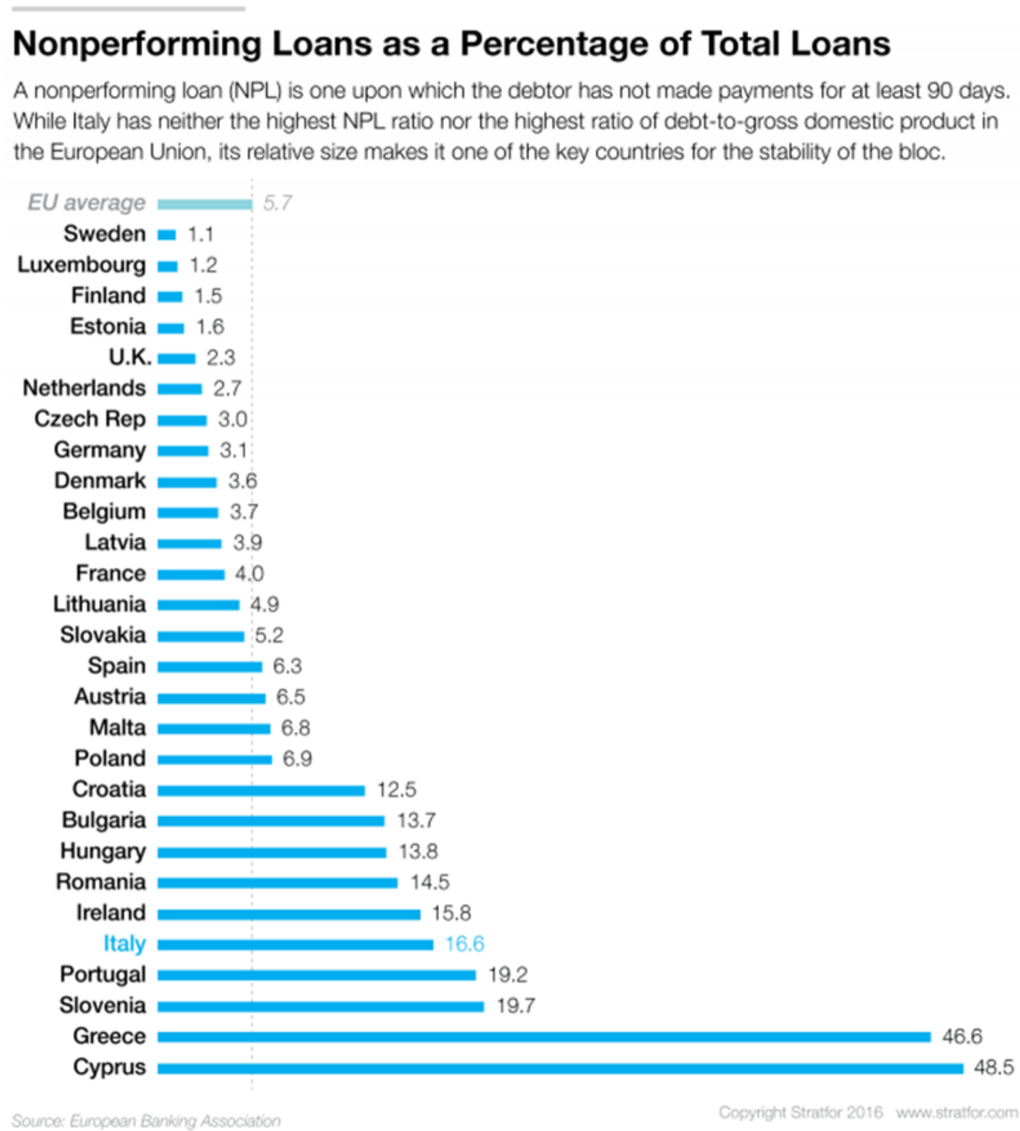
Both institutions have signaled that rates will remain at least at current levels, or possibly lower, for a long period to encourage an economic recovery after the Brexit referendum.

This is risky for commercial banks because it narrows the gap between what they pay for funding and what they charge for lending. By introducing negative interest rates, the ECB wants to pressure commercial banks to lend more money to businesses and households. But this puts banks in a dilemma: If they pass their costs on to customers (that is, if they charge customers for holding their savings), customers could withdraw their money. But if the banks absorb the costs, their profits take a hit. A prolonged environment of low interest rates could actually make banks even less willing to lend.

The German government has been particularly vocal in its criticism of ECB policies because low interest rates, known as "penalty rates" in the country, have hurt the business model of smaller financial institutions, such as local savings banks and life insurers. When these institutions deposit their surplus cash at the ECB, they lose money. Larger institutions also do not like the ECB policies: Germany's Commerzbank recently threatened to store cash in deposit boxes instead of keeping it with the ECB. According to the Bundesbank, ECB policies cost German banks 248 million euros in 2015.

Too Many Bad Debts, Too Little Economic Growth

In certain countries, a large pool of nonperforming loans (ones where scheduled payments have not been made for at least 90 days) are limiting bank profitability. According to the ECB, the largest banks in the eurozone hold some 950 billion euros worth of such loans, equivalent to around 9 percent of the gross domestic product of the currency area. This is a legacy of the financial crisis: The ratios of nonperforming loans to total loans are particularly high in the eurozone periphery, reaching between 15 and 20 percent of total loans in places such as Italy, Portugal and Ireland. Countries outside the eurozone such as Romania, Hungary and Bulgaria also present ratios well above the EU average of 5.7 percent.



Recent changes in regulations also explain weak profits, as many banks are rethinking their business model. Before the financial crisis, some banks based their profitability on high leverage and elevated risk-taking. But changes during the past decade (including tighter regulations and higher capital standards) are in theory making banks safer but less profitable. During the height of the crisis, banking sectors in some eurozone countries went through a process of consolidation. In Spain, for example, more than 30 banks have disappeared since the country's property bubble burst in 2008. But in other nations such as Italy and Germany, many smaller banks are still operating independently. Consolidation comes with its own problems. In the coming years, falling earnings, high costs and competition entities such as hedge funds or financial technology companies will force some banks to merge to become more profitable. Consolidation could, however, lead to the creation of banks that are "too big to fail" and therefore force governments to use public money to rescue them in case they run into trouble.

Naturally, the health of banks is also connected to the health of the economies in which they operate. During the height of the economic crisis, demand for credit decreased as companies and households felt the effect of contracting activity and rising unemployment. Credit supply also contracted as banks became more cautious in their lending policies. But credit supply and demand have improved recently. On July 19, the ECB announced a generalized improvement in loan supply conditions for enterprises and households during the second quarter. The institution revealed that demand for loans also increased across all categories. But as the British referendum creates political uncertainty across the Continent, economic growth in the United Kingdom and Europe will probably slow down. This would, in turn, hurt banking activities.

Political Disputes

Political considerations also affect the atmosphere in which European banks operate, since current EU rules to deal with failing banks have yet to be tested. During the height of the eurozone crisis, several governments, notably Ireland and Spain, used taxpayer money to rescue collapsing banks. This forced the governments to issue massive amounts of public debt, which deepened their fiscal deficits and led to their accepting financing programs from the European Union and the International Monetary Fund that came with the condition of introducing austerity measures. These events convinced EU leaders of the need to shift the burden of bank rescues from taxpayers to bank investors. In January, the European Union introduced rules that, in the case of a bank failure, would force shareholders and large customers to absorb losses before any public funds could be used.This process is commonly known as a "bail-in."

But bail-ins could be politically explosive. In Italy, for example, roughly half the bonds that would be first affected if a bank got in trouble are owned by retail investors. In late 2015, the Italian government forced the bondholders of four small banks to take losses during a state rescue. This led to protests and criticism by opposition parties, and one pensioner even hanged himself after his investment of 100,000 euros was wiped out. In the aftermath, the government in Rome has argued that, under special circumstances (such as the uncertainty that followed Brexit), public funds should be used to rescue banks without bondholder responsibility.

The stress tests confirmed that Europe's banking sector is still vulnerable in many ways. Many of these vulnerabilities, such as weak profitability and high rates of nonperforming loans, are a legacy of the financial crisis. Others, such as market volatility and pressure on certain banks, are connected to the new phase of uncertainty opened by the Brexit referendum. In the coming months, political risk and slowing economic activity will probably continue to create problems for banks in the European Union, regardless of what the stress tests say.