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EUROZONE BANKS AND PROFITABILITY

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PROFITABILITY MATTERS

Profitability is a key factor in every business, but it is even more crucial with reference to the banking system. Indeed, an adequate level of profitability ensures financial stability in two different ways:

- First, profits allow the coverage of impairment losses on the credit portfolio;
- Then, if retained, profits constitute an additional capital buffer to face adverse scenarios.

The theme is particularly relevant in the Eurozone where banks' profitability widely fell after the 2008 financial crisis and the following European sovereign debt crisis and has not recovered yet. European Central Bank (ECB) stated in 2019 that Euro area banks' average return on equity (ROE) stands at around 6%, a considerably lower value than their cost of equity (COE), which oscillates between 8% and 10% for most banks. During the past years just one-quarter of significant banks reported a ROE of at least 8%, while the ROE of the worst-performing quartile remained below 3%. This last one is mainly composed by institutions from the countries more affected by the crisis (PIIGS).

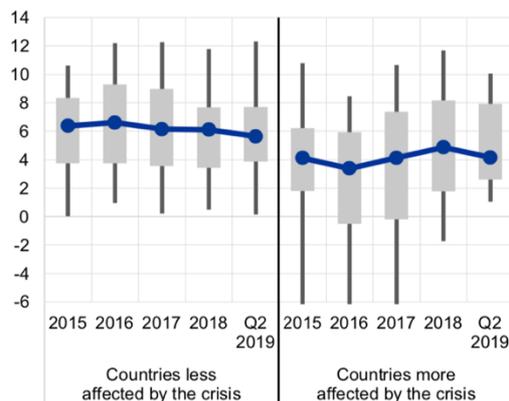


Figure 1 – Distribution of significant institutions' ROE(%) by country group.
Source: ECB

Before 2008 European bank's profitability was almost aligned with the one of US' institutions and they both declined with the crisis. However, while the ROE of American banks has shown a significant recovery reaching again levels above the COE, the

European banking system followed a pattern of stagnation. As a result, the major part of European banks still receive market valuations notably lower than their book values. As an evidence, in the last decade, while the S&P 500 Banks Index has tripled its value, the correspondent Stoxx 600 Bank Index fell by 35%.



Figure 2 – Stoxx Europe 600 Bank Index vs S&P 500 Bank Index.

Source: Bloomberg

ECONOMIC CYCLE AND LOW RATES

Banks' profitability strictly depends on the economic cycle and expansion phases favor the loans' repayment and the credit portfolio's growth. The Eurozone has experimented a positive growth since 2014, however the economy slowed down in 2019. According to Eurostat, the GDP growth rate for the single currency area fell to 1.2% from the 1.9% reported in 2018. In this context of positive growth the stock of non-performing loans (NPLs) has been reduced and the aggregate ratio dropped to 3.8% in 2018, from 7% at the end of 2015. The reduction has certainly a positive effect on profitability as there is a lower amount of provisions to be made. However, the NPL to total loans ratio remains above the pre-crisis level and, in Southern Europe countries, significantly higher than the Eurozone average.

The net interest income, which accounts for nearly 60% of significant institutions' total operating income, grew by just 1% as the first half of 2019 on a 12-months basis. The weak growth is due to the spread reduction between deposits and loans rates, opposing to the positive effect on the margin of the increased lending activity. In particular, the customer loan-deposit margin (on outstanding amounts) continued its decline since 2015 and the

net interest margin also decreased in 2019 after two years of stability.

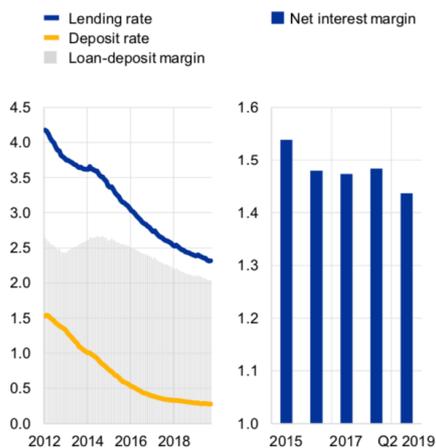


Figure 3 – Euro area loan-deposit margin (%) and significant banks' net interest margin (%).

Source: ECB

In addition Eurozone banks have been charged for their reserves since June 2014, when the ECB fixed a negative deposit facility rate. The policy clearly has a negative effect on profitability, particularly on institutions having wide amounts of excess reserves. In the same period US banks received a positive remuneration on their reserves up to 2.40% in 2019. At first sight the policy adopted by the ECB might seem one of the key factor to explain the different levels of profitability. However, it should be noted that also Norway, Sweden and Denmark have adopted a negative interest rate policy and, in terms of profitability, Nordic banks are much closer to US institutions than to Eurozone ones.

Nevertheless the loan-deposit spread shrinking, banks are reluctant to apply negative rates to costumers deposits. One of the first steps towards this direction was made by the Unicredit Group in October 2019, however the decision was not welcomed by the consumer associations. The bank had to clarify that the measure would have been applied only to costumers deposits of more than 1 million euros, less than 0.1% of the bank's clients.

In addition, as of 2019 second-quarter, Eurozone banks registered a decrease of nearly 2% for the net fee and commission income, which constitutes the second main source of incomes. The reduction is due to a slight drop in asset management fees and to

the persistent negative growth of commission on securities and structured finance products.

COSTS AND FINTECH COMPETITION

High operating costs represent another main factor affecting the profitability. A possible solution is to take advantage of technology opportunities, promoting a banking model based primarily on digital channels rather than physical ones. This is actually happening and it is accompanied with divisions mergers, management rationalizations and employees' reduction in the long term. Nevertheless those measures, the cost-to-income ratio reached the 66% in both 2018 and 2019 (Q2) for Eurozone banks and it is significantly higher than the 55-57% of Nordic and US banks. ECB top figures repeatedly claimed that further consolidations between existing institutions, both at domestic and cross-border level, are needed to improve efficiency, as the number of Eurozone banking institutions remains too high.

Regulation also has a negative impact on profitability due to implementations costs. Differently from the US, European institutions adopted a strict regulatory approach applying the new Basel standards through the CRD IV to all Eurozone banks, and not only to internationally active ones. However, the regulation cannot be seen as one of the main sources of higher cost because Nordic banks are subjected to the same regulatory framework. Additional measures, as the Single Supervisory and Single Resolution Mechanisms, have been implemented although the Banking Union remains uncompleted leading to uncertainty.

Further concerns over profitability come from the increased competition of Fintech companies, which put under pressure the current banks' business model. In 2018 the European Banking Authority (EBA) identified that the payment and settlement business lines are the most affected with a negative effect on future fee and commission incomes. Fintech firms are specializing also in cross-border transfers, micro-payments or card payments with possible negative consequences on the retail banking segment.

POSSIBLE COVID-19 EFFECTS

The slowdown of Eurozone economy in 2019 led the market to adjust, by the end of the last year, its expectations about banks' profitability. The ROE, initially expected to grow in the upcoming years, was then forecasted stable between 6% and 6.5% in both 2020 and 2021 for listed institutions. Three months later these estimated values seem to be already outdated as the COVID-19 disease is spreading around Europe and the rest of the world. The surge in number of cases is forcing the Western countries to adopt lockdown measures, leading inevitably to negative effects on the economic growth. JP Morgan and several other institutions have called for a new recession affecting both the US and Europe by July. In particular, the American bank expects the Eurozone GDP to contract by 1.8% in the first quarter of 2020 and 3.3% in the second.

ECB assessed in 2019 the solvency and profitability of euro area credit institutions under an adverse scenario, in which the Eurozone GDP declines of 0.5% in 2020 and 1.5% in 2021. The scenario is based on such hypothesis which clearly cannot capture the current situation, however ECB projections help to understand what could happen to banks' balance sheets in case of an economic downturn.

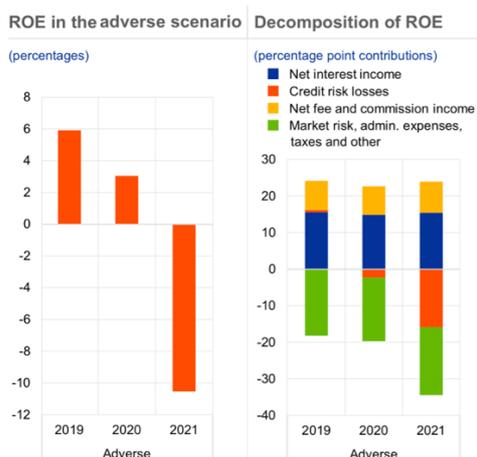


Figure 4 – ROE and credit risk losses in the adverse scenario
Source: ECB

In particular, as the GDP decreases for an extended period, ROE becomes negative, driven by the credit

risk losses which imply provisions and capital write-off without providing returns.

The expectations of credit risk losses due to the COVID-19 impact on the European economies have already been incorporated in the prices. Indeed, the Stoxx 600 Bank Index has fallen by 40% in the last month.

The disease outbreak in Europe and Western Countries is still at the beginning and it is difficult to estimate, as of today, the entity of the impact on economy. In fact, it depends on how long the restrictive measures will last and on the policies adopted by political and monetary institutions.

Looking at the Eurozone banking system it is reasonable to expect a further decrease in the already depressed profitability. In case of a violent and extended recession it is also reasonable to expect negative ROEs for banking institutions. The net banking income might not be enough to cover operating costs and increased credit risk losses, resulting in net losses to be covered with capital. In addition, the upcoming period will allow to understand the effectiveness of the newly implemented capital and liquidity requirements to ensure stability and prevent systemic shocks.

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