WHAT'S NEXT FOR EUROPEAN BANKS

Gikas A. Hardouvelis
University of Piraeus

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DELPHI ECONOMIC FORUM IV

The Challenge of Inclusive Growth

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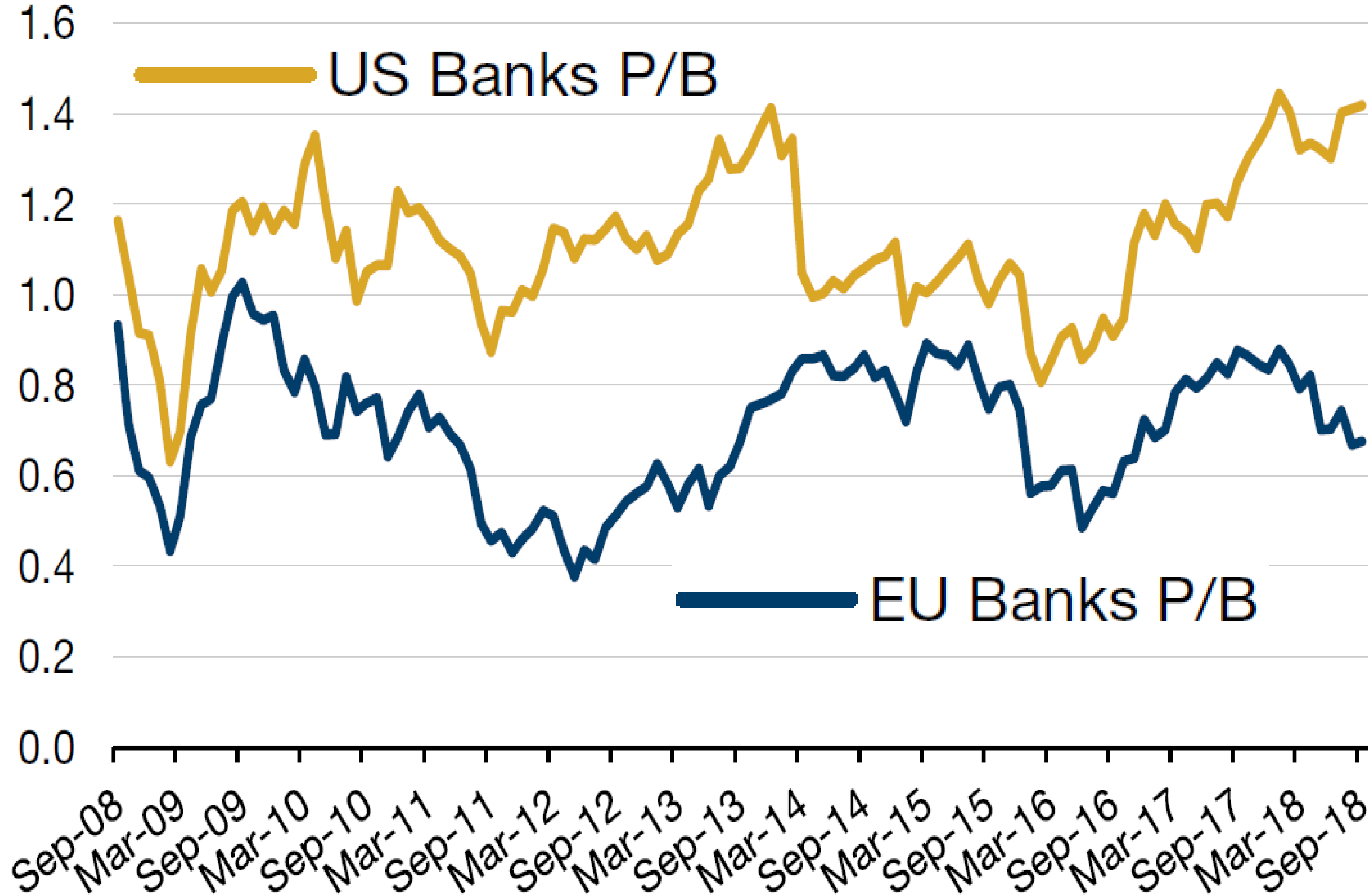
Two opposing forces influence European banks

Summary

1) Low risk – the positive force
2) Low profitability – the negative force
   - Both forces are due to the aftermath of the international financial crisis 2007-2009
     - The negative force of low profitability has dominated European bank valuations up to now
     - Yet the second positive force of low risk may dominate in the future; no one knows for sure
   - Greek banks faced a deeper crisis, losing twice ~100% of their value in February 2012 and November 2015
     - Now for a third time they face demise as their valuation is at 35% the post recapitalization level of 11/ 2015
     - They are pressed to shed their NPEs quickly

European banks lag behind US banks in stock valuation

- Since the Great Financial Crisis of 2007-2009, Price–to–Book (P/B) ratios consistently below the US counterpart P/B ratios



Source: Man-GLG CIO Commentary, Sept 2018

The crisis depresses bank stocks everywhere

- Non-financial stocks in Europe perform a lot better
- Europe went through a second crisis with lower profitability than the US, hence its banks stocks lagged behind US stocks
- Greek bank stock prices close to zero in early 2012 due to PSI

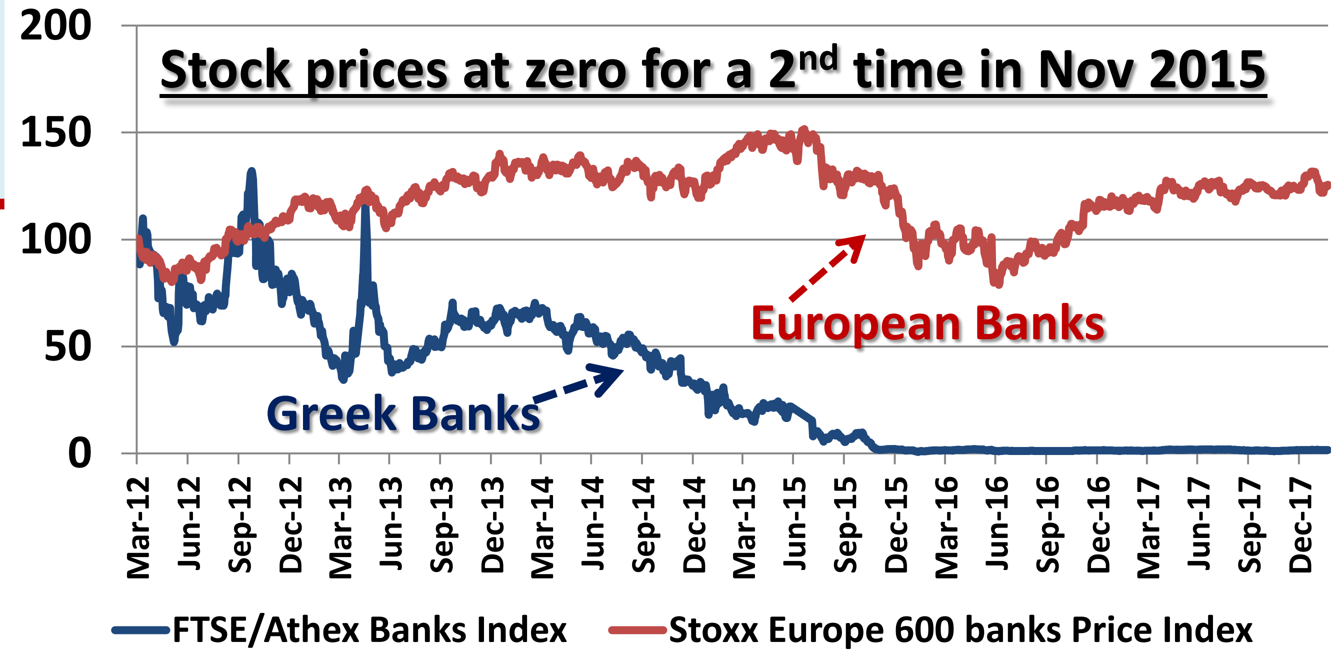
Greek banks do even worse

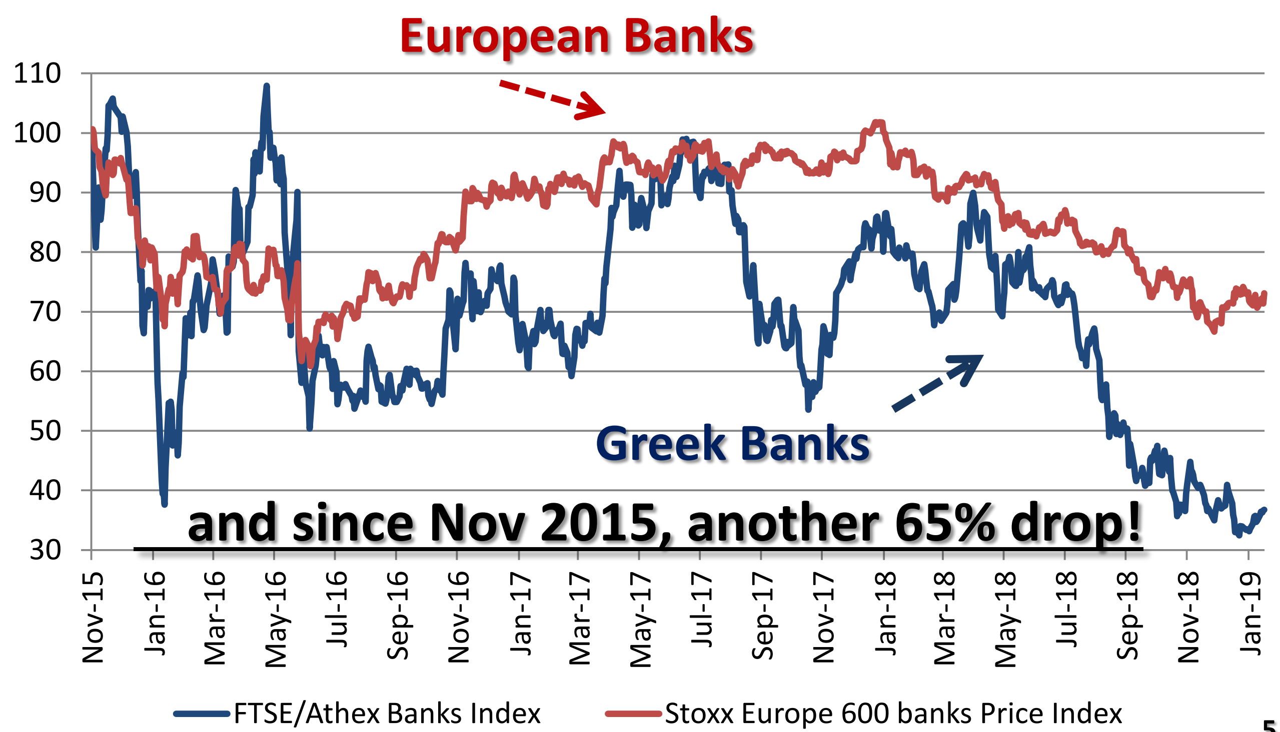
BANK INDICES = 100 at 30/3/2012

- Bank stocks reached zero value for a second time in November 2015

BANK INDICES = 100 at 30/11/2015

- After the third recapitalization, the Greek bank index fluctuated and now is 65% lower!





European banks today relative to 2007

- Balance sheets are now smaller and more robust (safer)
  - Asset size shrinks as credit growth declines and is negative for some time
  - Loans are now a larger fraction of their assets with NPLs down from €1 trillion in 2014 to €600bn in 2018
  - Liability side is stronger as share of deposits & core capital increase
- Regulation is now stricter: Basel III, biennial stress tests & annual SREP
  - Total core capital increased by ~40%
  - Risk weights increase in the denominator of the CAD ratio (although risk-weighted assets decline together with total assets)
  - In the top 20 banks, from approximately 8.2% Tier I CAD ratio in 2007 to ~ 13.8% Core Equity Tier I ratio in 2018, and from 3.6% leverage ratio in 2007 to 5.8% in 2018
- Profitability is lower as banks shy away from speculative trading and rely more on traditional lending activities. In the top 20 banks,
  - Total revenue declined -23% (Fees & commissions -22%, Trading Income -54%, whereas NII increased a bit, 12%)
  - Operating Expenses declined by less, -9%, and Cost-to-Income ratio increased from 55% to 62%
  - Hence Net Income down and ROE declined from above 20% to below 10%

European banks in the future

- Future risks remain contained - BREXIT risks (e.g. CCPs located in London) in the short run cannot reverse this picture
- Yet profitability continues to be under pressure
  - Banks face even stricter regulation which affects profitability negatively
    - Pillar 2 of Basel III bites (P2R & P2G)
    - Basel IV in effect from 2022, fully loaded in 2027, expected impact of additional 5ppts on CAD ratio
    - G-SIBs face 16% CAD ratio & 6% leverage ratio (18% & 6.75% in 2022)
    - EU Banking Union brings stricter provisioning rules on NPLs
  - Technology and new competitors bite on profitability
    - PSD2 puts pressure on fee income
    - Digital transformation brings competition from Fin Tech and need to invest in technology
  - A new environment of normalized (higher) interest rates would follow QE
    - History shows NII is relatively insulated, yet it falls in the first two years after rates go up, and only begins to rise afterwards
    - Loan losses rise, hence bank provisions increase and the cost of risk rises, which feeds into the economy

Greek banks in the future

- Similar to the European challenges on profitability yet with an unusually large extra NPE burden
  - Until recently, target NPE reductions were <u>not</u> ambitious plus government's sluggishness protected strategic defaulters
  - HFSF & BoG SPV schemes promise to reduce NPEs more quickly
- Greek economy cannot recover in a sustainable manner unless banks recover, which means:
  - Cost of risk needs to come down
  - Demand for healthy lending and fees needs to rise
  - A tough stance on costs required
  - Technology to be espoused not only as a cost-reduction tool but for sales enhancement as well

Thank you
for your attention

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