Monthly analysis – May/June

# György Pálfi: European bank sector: back in the doldrums

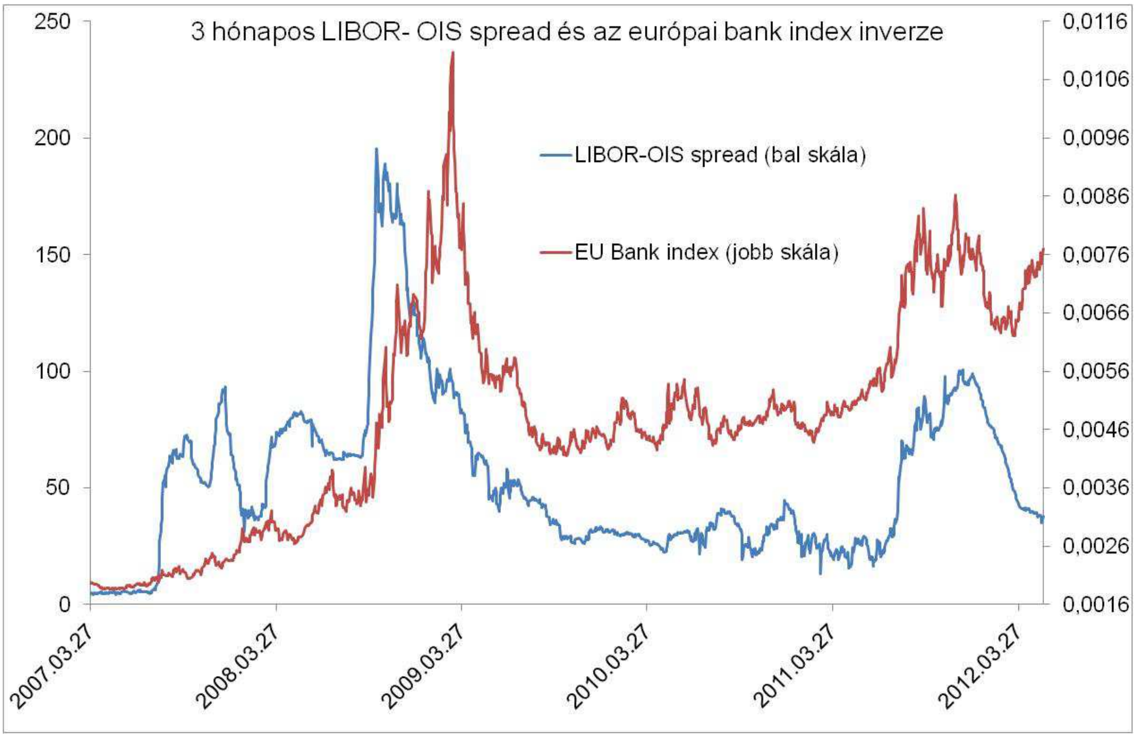
Although the European Central Bank says we just need to give it some more time, the market is increasingly sceptical about the impacts of the LTRO (Long-Term Refinancing Operation), the ECB's three-year credit program. While in the first quarter it seemed as if the ECB's miracle cure could bring about a solution to the European bank sector's problems, the market respite has proved to be temporary. The bank sector slumped back to last November's levels, with its capitalisation dropping to EUR 800 billion, which although much higher than the trough of March 2008 still represents a three-year low in comparison to the capitalisation of the overall European market. The sector's stock value has also plunged to levels last seen in the spring of 2008, and with shares changing hands at 40% of their book value it's clear that investors expect to see further substantial asset write-offs and bank losses. The pricing for the bank sector as a whole – although there are significant differences within the sector – once again reflects serious risks, similar to those of last autumn.

**European banking sector capitalization vs. total European equity market capitalization**


Source: Bloomberg, AEGON Fund Management

But the situation is by no means as alarming as it was last November. Back then, the bank sector was close to a relatively major collapse, similar to 2008, the interbank markets had dried up, and for many banks procuring funds had become considerably more difficult. The somewhat late but nonetheless assertive intervention by the central bank succeeded in averting a more serious liquidity crisis, which is clearly shown by the notable decrease in that barometer of interbank lending activity – or put more bluntly, the banks' "mistrust" of each other – the LIBOR-OIS spread.

Note: The LIBOR-OIS spread is the interest premium applied by banks in their dealings with each other.




Source: Bloomberg, AEGON Fund Management

At the same time it appears that the central bank's measures, beyond avoiding a sudden meltdown, have not for the time being achieved all that was expected of them. One of the ECB's objectives was to improve the lending situation while the other, albeit covert, aim was to generate additional demand in the peripheral bond markets. In March it appeared that the latter ploy might just work; the Spanish and Italian short yields halved, and the portfolio of state bonds held by banks in these countries rose by EUR 150 billion. But now these sources have dried up and the Spanish and Italian banks, which used nearly half of the EUR 1000 billion available under the LTRO, have vanished from the government securities market as buyers; and what's more the banks of other countries – the signs indicate – failed to even set foot in the markets of the more problematic countries. This is because in the present circumstances the banks, as they work to downsize their risky assets, would for the sake of security prefer to park their additional liquidity in German state bonds, which keep on breaking records, or simply in an ECB deposit. (Money deposited in the ECB's overnight facility rose by EUR 300 billion in March, and hasn't decreased since then.)

Although the impact of the central bank's measures on the real economy and lending activity may still be felt in the long term, the market is sceptical about this too. This is because market funding sources remain pretty expensive for most banks, and the return on lending activity is highly uncertain given the current outlook. It would be hard to expect a European bank to significantly step up its lending activity in European markets that are teetering on the brink of a recession, struggling with rising unemployment and a concomitant jump in non-performing loans. At the moment the bank sector is far more preoccupied with the clean-up of the credit portfolio and management of bad loans. Just take the Spanish banking system, which came into the focus of attention in recent weeks, where the new provisioning requirements represent a burden running into the hundreds of billions for the bank sector. In an environment such as this, growth seems next to impossible.

What's more, in their efforts to reduce the vulnerability of the bank sector the authorities are also shepherding the banking system towards a gradual downsizing of balance sheets. In order to fulfil the ever stricter capital requirements, the banks are continuously performing balance sheet adjustments. And although the bulk of this can be covered through the sale of non-operating assets and subsidiary banks, the remainder can only be achieved by downsizing the loan portfolio.

It seems, therefore, that the ECB's credit program has only managed to temporarily reassure the markets. The peripheral bond markets still don't represent an attractive target for non-local investors, and the fragility of market sentiment only serves to further heighten the bank sector's risk aversion. As a result of this, getting liquidity to the peripheral government bond markets becomes difficult, and channelling it into the real economy even more so. Reversing this process will probably take further decisive steps by the central bank and the eurozone.

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