



Weekly Insight

European banks: Rising risks but not a repeat of 2011/12

European bank share prices have been under significant pressure this year, giving back 2015's strong performance. Weak investor sentiment has been accentuated by the Bank of Japan's decision to apply negative interest rates on excess reserves, which follows moves already taken by the European Central Bank, Sweden and Denmark. Concerns are increasing that in a climate of negative interest rates and prolonged dovish monetary policy banks' profitability will be squeezed.

Renewed concerns about Italy's banks

Europe probably carries more banking sector risk than most other regions, since banks are the predominant source of funds for companies. In particular, there are renewed concerns about the health of the Italian banking sector. Italy's banks have the largest share of non-performing loans (NPLs) – loans considered to be near or in default – versus their European peers. As a share of total loans, NPLs are 16.7% in Italy versus 5.6% for the European average. The big disappointment is that NPLs in Italy continue to rise at a 10% annual growth rate, countering the trend seen in other countries such as Spain, where NPLs have been declining since mid-2014 [Source: JP Morgan].

Why does this matter?

A high level of unprofitable loans on banks' balance sheets impacts the broader economy by stifling both domestic demand and bank lending growth. This in part explains why Italy's economy has not recovered as quickly as other countries, such as Spain and Ireland. The Italian government has recently taken steps to address

NPLs, allowing banks to voluntarily sell NPLs to private investors with a government guarantee. However, in many ways these measures have fallen short of expectations, compared with Spain and Ireland where banks were forced to dispose of NPLs. We may also see more consolidation within the Italian banking industry, since the main stresses appear to be among smaller Italian banks where NPLs have risen significantly in the last few years. In contrast, NPLs for larger names, such as Intesa Sanpaolo and Unicredit, have remained stable.

Domestic demand recovery cycle remains intact

Crucially, though, the broader macro backdrop remains supportive for domestic demand in Europe. Compared with 2011/2012, the height of the euro sovereign funding crisis, capital ratios have improved and continue to grow. Europe's banking system has ample liquidity, including Italy, and banks have access to the ECB's emergency funding facility if needed. Moreover, policy is aimed at stimulating bank lending across the eurozone. So while further negative interest rates are likely to be detrimental to bank net interest margins, some of this impact should be offset by the ECB's ongoing bond buying programme, which should keep borrowing costs low for both sovereign and bank issuers. While current concerns around the banks will add to market volatility, we continue to believe that the domestic demand recovery cycle in Europe remains intact; we are therefore maintaining our current overweight in European equities.

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Risk Warnings:

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