



# Are European banks investable?

**European Central Banks report on financial structures  
with a perspective on Belgium**

KPMG Belgium

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# What are the long term prospects of the European banking sector, in the light of the ECB's report on financial structures?

**Banks and financial institutions have moved on from the financial crisis, but still urgently need to address the challenges of the current economic and technological environment.**

With their profitability under scrutiny (see our article on the profitability of EU-banks)<sup>1</sup>, the ECB identified this as one of its key supervisory priorities for 2017, because of the close link between profitability and capital adequacy (see our article on ECB's supervisory priorities 2017).<sup>2</sup>

From a creditor's perspective, profitability is a major issue, as it indicates whether a bank is able to satisfy its liabilities. For regulators, meanwhile, profitability is a main indicator of the viability of the bank. Both creditors and regulators closely monitor banks' profitability – and banks should be ready to address any concerns on this front. However, they should also consider the bigger picture. How promising are they as an investment prospect from a shareholder perspective? Do they offer sufficient upside potential?

1. <https://home.kpmg.com/xx/en/home/insights/2016/10/the-profitability-of-eu-banks-fs.html>

2. <https://home.kpmg.com/xx/en/home/insights/2017/04/what-lies-behind-what-lies-ahead-of-ecbs-banking-supervision-fs.html>

"I think there is also a lot of doubt – fundamental doubt – about whether there is a viable business model that covers the cost of equity. [...] That's the big, big, big question [that] makes banks not really investable as a sector."

Tidjane Thiam (CEO of Credit Suisse), September 2016



Banks need to offer a viable and sustainable business model, with a persuasive growth story and upside potential, in order to gain access to capital. This allows (non-state-owned) banks to operate with sound capital levels and fulfill their role as financial intermediaries.

Below, we consider the four overriding factors that determine whether a bank is investable: the real economy, the quality of its balance sheets, operating income and costs.

**Status of the real economy:**

Those banks which fully reflect the status of the real economy in their portfolio decisions and their management of concentration risks significantly improve their level of investability. By taking those steps, they are effectively

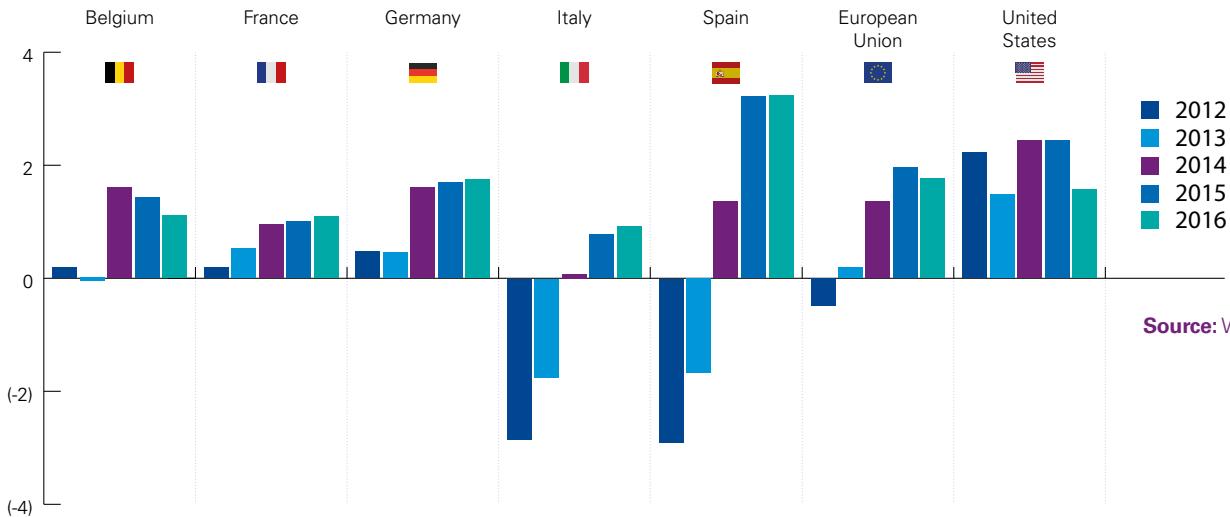
limiting unexpected losses for shareholders and ensuring the soundness of their balance sheet.

As figure 1 demonstrates, recent GDP growth rates indicate an improving economic environment, which is also mirrored, to some extent, in the balance sheet of European banks. Banks focusing on their investability – and particularly those acting in a highly competitive environment – therefore need to be disciplined in their risk allocations, avoid concentrations of risk and closely monitor the status of the real economy.

*Focus on Belgium:*

The Belgian economic environment shows a modest but steady growth over the last 2 years (even if more limited in 2016), consistent with the growth rate observed in its European neighbors.

**Figure 1: Development of gross domestic product at country level**



Source: Worldbank

### Health of banks' balance sheet:

One key indication of the health of a bank's balance sheet is a low level of non-performing loans. High NPLs absorb capital, liquidity and talent: resources which would be much better focused on new business and growth.<sup>3</sup> It is encouraging that, for the first time since 2008, there has been a decline in the median NPL ratio in the Euro Area as mentioned in ECB's report on financial structures.

Yet there are still considerable variations between NPL-ratios across different banks and countries.

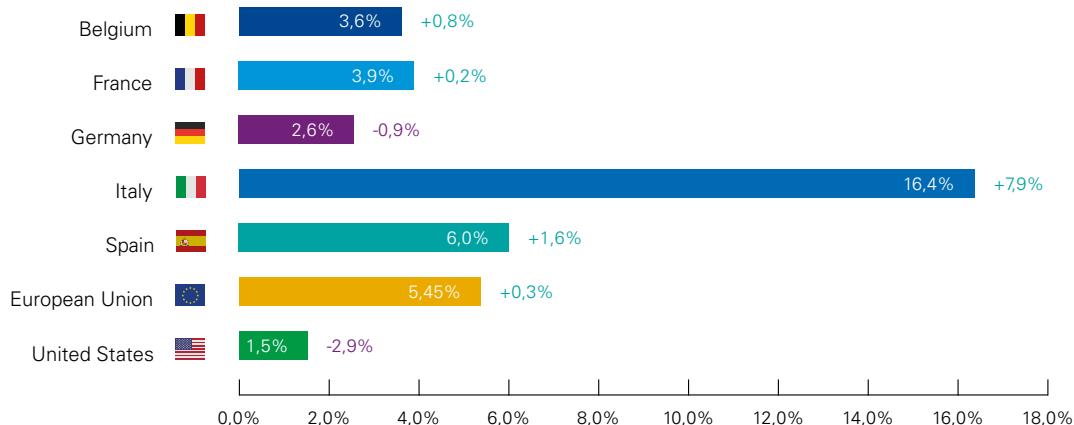
The average European NPL-ratio range is still more than three times higher than in the US (see figure 1). Analysis from the wind down of banks shows that investors are unwilling to invest in NPL portfolios, given their current valuations – indications of unhealthy balance sheets.

The ECB has repeatedly emphasized that banks need to do more to address their high stocks of NPLs, including devising a convincing NPL strategy in compliance with the final NPL guidance for significant banks. This should also attribute to how attractive and investable the European banking sector is for shareholders of banks as less capital, liquidity and talent will be absorbed by NPLs.

#### *Focus on Belgium:*

The NPL-ratio is low (even if it slightly increased over the last few years) – suggesting that the profitability of Belgian banks is less affected than its European peers by non-performing loan. Compared with US levels however, there is still room for improvement

**Figure 2: Selected NPL-ratios**



%: 2015 vs. 2010 stats

Source: EBA, Worldbank

3. Other factors include e.g. the level of forborne exposures, provisions and impairments or the soundness of the funding structure.

### Operating income structure:

Generally, those banks which are investable are marked out by having an operating income structure able to withstand a period of low interest rates or changes in market or customer behaviour trends, due to, say, technological innovation.

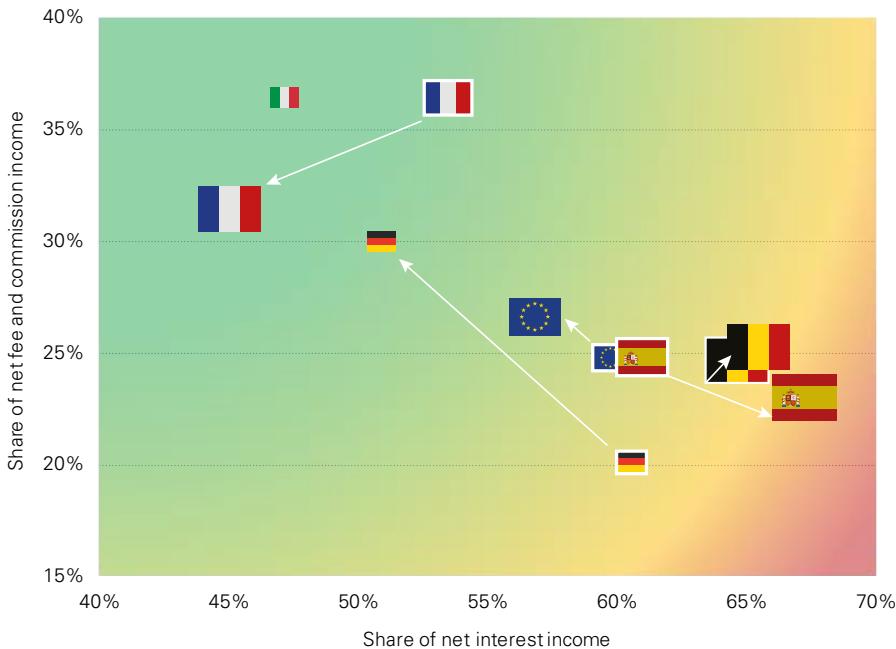
While the ECB report highlights differences between the operating income structures of national banking sectors, recent EBA-data also demonstrates that banks' operating income structure is changing. As figure 3 indicates, the European average bank has lowered its share of net-interest income and increased (although to a lesser extent) its share of net fee and commission income since 2013. This can, of

course, be explained by low interest rates, but also partly by active business model changes and the use of new technologies (see our article on PSD2 and the power APIs).

#### Focus on Belgium:

The high dependence of the total income on interest-income might create risks in the future, in a context of persistent low interest rates. A continued low-rates environment might erode the interest margins in the future and so on the profitability of Belgian banks, which still have work to do in terms of their business model diversification.

**Figure 3: Share of net interest income vs. net fee and commission income on operating income**



**Notes:** Heat map, June 2016 values are shown (December 2013 values are highlighted with a white outline). The flag size indicates return on equity. Also note that EBA figures consider large banking groups only, which may differ from country averages that consider all banking groups, such as 75 percent NII share for all German banking groups. Not shown here is the average value for Italy in 2013 due to negative RoE.

**Source:** EBA,



### Cost efficiency:

Cost efficiency within banks can either be a driving force for sector consolidation or the reason for low average return on equity (RoE), as depicted in Figure 4. In terms of consolidation, it is interesting to review cost-income ratios vis-à-vis some sector capacity indicators from the ECB's report, such as bank density. As figure 2 shows, there has been a slight improvement in the EU-average cost-income ratio between 2013 and 2015, from 63.1 to 62.8 percent, combined with a reduction in the number of credit institutions per capita.<sup>4</sup>

However, there are considerable differences between countries and banking sectors: while, for some national banking sectors, we see a continuous decrease in both the number of banks and average cost-income-ratio (CIR) – as is the case in Spain – banking sectors of other countries struggle to improve their cost-efficiency. Furthermore, it seems evident that highly fragmented markets occur together with high CIR and low RoE – and vice versa.

Looking at the slow improvement of the CIR over the last years for the average European banks, it appears unlikely that cost efficiencies will present a strong buy argument for shareholders over the next couple of years. What is more likely is that national sector consolidation – in other words, a decrease in bank density – will contribute more to banks RoE than improvements in cost efficiency. More generally and positively phrased, we believe that digitalisation has the potential to boost the whole value chain of banking. Banks that effectively under-invested in IT-systems in the past now face a greater challenge operating with legacy IT and suboptimal organisational structures. In our view, this explains the slow CIR improvements observed to date – and most likely also in the following years.

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4. For comparison, US banks' average cost-income ratio is close to 60 percent per end of 2015, while the number of credit institutions per 100k people is close to around 1.9 (FDIC-insured institutions only).

**Sources:** OECD, FDIC.

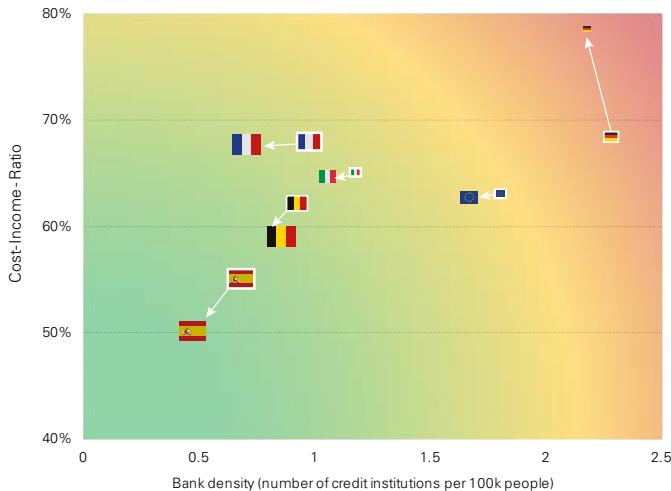
*Focus on Belgium:*

Belgian banks have put a lot of effort into managing their cost structure (through cost-cutting measures and improvement of the operational chain), which is reflected in a strong reduction of the cost-income ratio. These efforts, however, are non-homogeneous across Belgian banks, with high degrees of diversity in the cost-income ratio levels. A key element of the bank “investability” will be to transform these cost-cutting measures into long-term efficiencies (which will trigger important investments in the future, in particular in IT infrastructure).

**Conclusion: where does Belgium stand compared to European peers?**

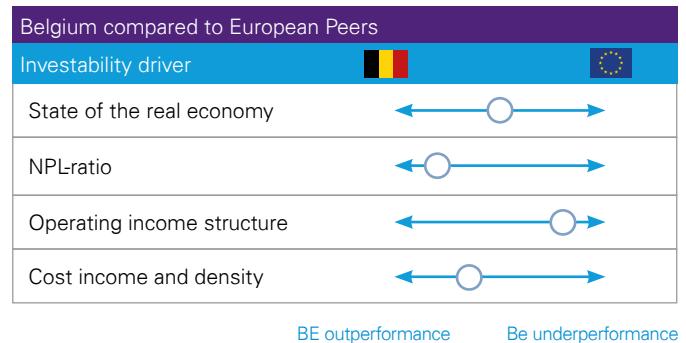
When assessing the positioning of Belgium compared to its European peers, we observed that overall, Belgian banks are among the best students in the European class, in particular in terms of increase in Return on Equity. As a result, Belgian banks are interesting in terms of “investability”. A major pitfall remains the dependence of the business model on interest income – this might impede the future profitability of Belgian banks should low interest rates persist.

**Figure 4: Cost income ratio vs. bank density**



**Notes:** Heat map, the flag sizes indicate return on equity for 2015 (white outlined flags indicate 2013 values). For bank density, 2015 (2012) values are shown.

**Sources:** ECB, EBA



## What will drive banks' investability over the next few years?

As we've seen, there are currently a number of factors dampening the attractiveness of the European banking sector from a shareholder's point of view.

In KPMG's view, the future drivers for banks' investability are likely to be:

- **Banks** positively differentiating themselves through, for example, balance sheet optimisation, business model reengineering, cost optimisation measures or investments in the digitalisation of their value chain;
- **Regulators** ensuring a high level of risk transparency for shareholders, so encouraging financial innovation which creates upside potential and minimises costs from regulatory burdens; and
- **Governments** removing existing impediments for solving Europe's NPL-problem, national sector consolidation and cross-border mergers.

For banks, the vital question now is: which of these key drivers will contribute to their investability in the short and long term? Some will clearly involve a significant investment in terms of time, money and effort.

For the EU banking sector as a whole, however, they add up to a powerful combination of changes to improve the future investability of European banks.

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