COLUMBIA THREADNEEDLE INVESTMENTS

Mark Burgess
Deputy Global CIO and CIO, EMEA

BACK TO THE FUTURE: A DECADE OF BANK BAILOUTS

The U.S. and U.K. moved fast to clean up bank balance sheets – Europe delayed and could face the next downturn from a weak position

A decade on, banks in some major economies have largely recovered from the global financial crisis (GFC). In others, legacies of bad assets still clog the banking system, stalling economic growth. This divergence is largely due to the differing approaches governments took to recapitalizing their countries' banks after the crisis—especially their willingness to confront problems comprehensively and quickly.

The history

The U.S. acknowledged the scale of the banking crisis quickly and responded with the Troubled Asset Relief Program in October 2008. The entire banking sector was obliged to accept injections of capital from the Federal Reserve. This quickly underpinned market confidence and allowed banks to rapidly absorb big impairments in their portfolios of sub-prime mortgage securities, as well as hits to their loan books as the U.S. economy deteriorated. Over the course of 2007-8, the Federal Reserve (Fed) lowered interest rates from over 5% to effectively zero in an effort to bolster a rapidly spiraling economy

The U.K. took a similar approach. The government injected equity into the most troubled institutions, notably RBS and Lloyds, and created a state-backed asset protection scheme. The failed mortgage lenders Northern Rock and Bradford & Bingley were split into a good bank/bad bank structure, with the bad assets passing to the state-controlled U.K. Asset Resolution. At the same time, the Bank of England provided unlimited liquidity to address solvency concerns.

However, there was no consistent approach to recapitalizations across Europe. Institutions such as UBS, ING and KBC were restructured on an ad hoc basis, but governments, central banks and regulators on the continent were generally slower to confront systemic weaknesses in their banking systems. (Still focused on inflation risks, in July 2008 the European Central Bank raised rates by 25 basis points (bps) after the

U.S. had already lowered rates by 225 bps that year.) Many banks remained paralyzed by their burdens of doubtful and non-performing loans, and lending to the real economy shrank.

Ireland was forced to confront its banking crisis early on and through a painful process of state support, nursed its banks back to health. By 2012, Spain began to acknowledge its problems and created a bad bank, Sareb, to receive more than €50 billion of the toxic real estate assets weighing down its commercial lenders. Having shifted bad assets to a bad bank, the Spanish banking sector consolidated, and balance sheets were recapitalized, signaling the start of Spain's return to health.

The picture in Italy is very different because the problems in its banks have never been fully addressed. There have been ad hoc solutions for institutions such as Monte di Paschi and the Venetian banks, but no comprehensive recapitalization.

Germany experienced major problems in its Landesbanken—the country's network of government-owned wholesale banks—which had invested heavily in toxic U.S. real estate assets. As their problems emerged, several Landesbanken failed and had to be recapitalized by the government. The biggest problems in Germany's private banking sector were at Commerzbank, which was also bailed out by the state.

Where we are now

A decade on, the health of these countries' banks largely reflects the differing approaches governments had taken to recapitalize following the GFC. U.S. banks returned to health quickly, buoyed by the country's strong economic performance. Today their capital positions are strong, as demonstrated by the Fed's regular stress tests, and they have payout ratios of more than 100%, returning surplus capital to shareholders.

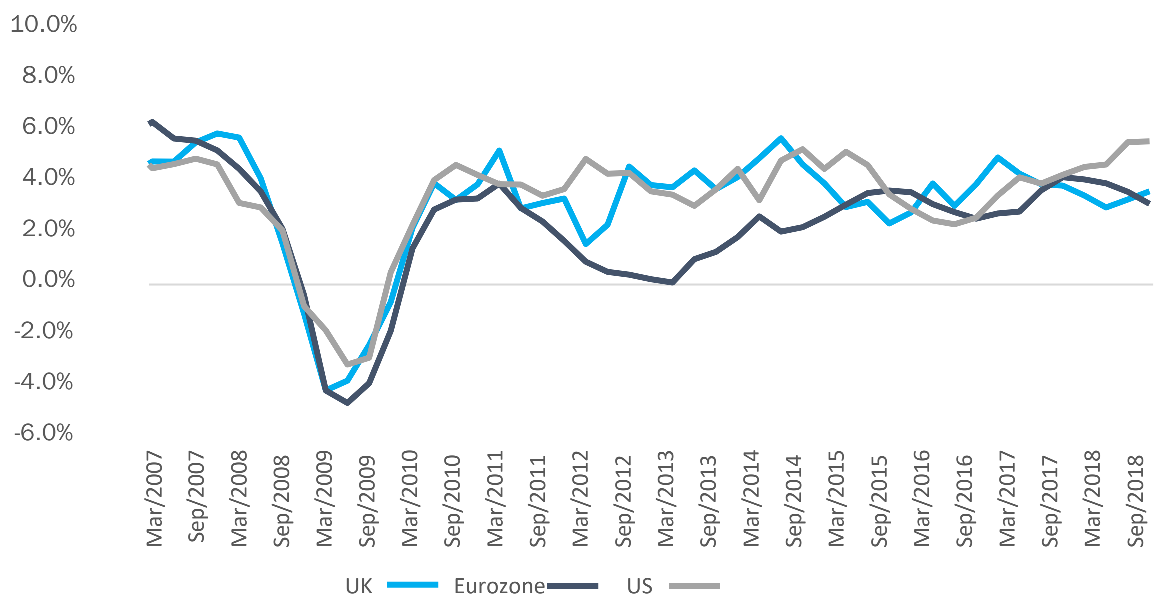
U.K. bank balance sheets are strong and capable of surviving a disorderly Brexit, according to the BoE's recent stress tests. The banks are carrying excess capital that could be returned to shareholders, but their earnings recovery since the crisis has been badly hit by fines, mainly related to mis-selling of loan repayment insurance. However, this factor will soon recede since the final deadline for claims is August 2019.

The picture across continental Europe is far more mixed. The major institutions that received bespoke bail-outs, including ING, UBS and KBC, recovered relatively quickly. Similarly, Spain's banks are now in good health following the government's decision to move toxic assets into Sareb and restructure the sector.

However, the German banking system has yet to recover fully, while Italy has not addressed its banks' bad asset problem. As a result, they are unable to support economic growth: the eurozone economy is two-thirds bank-funded, and small and medium-sized enterprises (SMEs) account for two-thirds of the Italian economy. Yet the stock of bank lending to Italian SMEs has been shrinking for 10 years.

Clearly, the way the U.S. recapitalized its banking system after the GFC allowed it to absorb losses and continue lending into the real economy, boosting corporate growth and GDP in the years following the crisis. But in Europe this was not the case, and with the knock-on effects of banks failing to support SMEs, overall GDP growth lagged the U.S. and the U.K. for much of the post-GFC period (see Figure 1).

Figure 1: Nominal annualized GDP growth



Source: Bloomberg, December 31, 2018.

Ready to face the storm?

As developed economies approach a turn in the cycle, U.S. and U.K. banks are much better placed: they face any downturn with the highest levels of capital, the strongest liquidity and the most robust regulatory framework that has existed for many decades. Equity valuations could be badly hit in a recession, but their balance sheets can seemingly withstand a downturn. On a traffic light system, the U.S. and U.K. are green.

In Europe, we give Spain an amber light, although we regard its banks as investable. But in both Italy and Germany the light is red. Italy faces the biggest challenge. If it enters recession its banking system will need recapitalizing, but the government will struggle due to its large debts and budget deficit. This could shift the burden to the European Union.

The major risk is that Italy's weak banking system sparks a sovereign crisis. This risk is compounded in Italy's case by the fact that the EU's bank resolution framework now obliges governments to wipe out shareholders and senior bondholders as a condition of any state-funded rescue.

In Italy, this would be politically dangerous because approximately a third of senior Italian bank debt is held by domestic retail investors. The potential electoral difficulties are obvious, which is why an Italian banking crisis is one of the key event risks we identify, alongside a disorderly Brexit. However, we believe the risk Italy poses is potentially more serious, and yet gets little attention.