Euro area banking sector gathers strength

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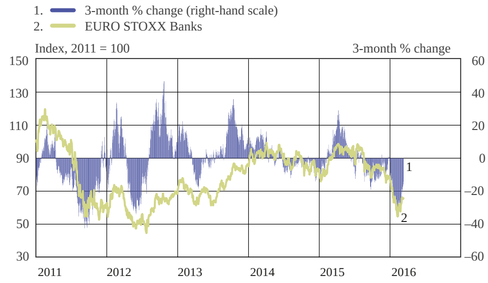
Increasing market uncertainty over the condition of banks in early 2016 was not due solely to concerns about global economic growth but also above all reflected concerns about banks' non-performing loans and declining profitability amid low interest rates and subdued growth. Nonetheless, the condition of the European banking sector is gradually improving, despite major cross-country differences. Notwithstanding the positive developments, banks nevertheless remain vulnerable to deteriorations in the operating environment.

The instability of markets has reflected concerns springing from the global growth outlook. Market fluctuations have been reinforced by mounting credit risks in the energy sector, weak market liquidity, which intensifies price movements, and uncertainty over whether economic growth can be supported by monetary and economic measures.

At the end of January 2016 large falls were witnessed in bank share prices, globally. The lack of confidence in the condition of banks was heightened by concerns about the amount of non-performing loans held by European banks and the profitability outlook for the banks. Market sentiment was also adversely affected by negative earnings shocks from some large banks. The heightened market stress increased doubts over the level of risk resilience of market-sensitive investment banks in adverse market conditions.

Early-year market turbulence hit bank shares



Source: Bloomberg.
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Chart

Although there are many factors underlying market concerns, the euro area banking sector has strengthened in recent years and improved its resilience to deteriorating conditions. Banks' profitability and capital adequacy have improved, on average, and the liquidity position has been strengthened. The condition of European banks remains challenging, however, as the average figures conceal fluctuations across countries and banks. Problems still remain, notably in those countries that were hardest hit by the sovereign debt crisis, with the large amounts of non-performing loans and loan losses eroding the profitability of banks.

The large amount of non-performing loans presents a burden for banks in many respects. Non-performing loans erode banks' profitability, as banks have to make provision for future losses. Banks also do not accrue any earnings from the non-performing assets shown on the balance sheet. Furthermore, the portion of non-performing assets not covered by technical provisions tie up capital because of the higher risk weights applied to bad loans. Such encumbered assets are not available for new lending and, consequently, the banks' ability to provide credit to the real economy has weakened (See Inflation outlook requires accommodative monetary policy -article chart 6).

Several measures have been attempted to solve the problem of banks' non-performing assets. There is no single solution at hand; measures must be extensive, also considering the restrictions imposed by the new resolution legislation and government support.

The current operating environment also creates challenges in respect of banks' profitability outlook, with subdued credit growth and low interest rates weighing on net interest income. Net interest income has been bolstered by the measures of the European Central Bank, which reduced banks’ market-based funding costs. The ECB's measures have also enabled banks to obtain valuation gains on their securities holdings. Improvements in the profitability outlook are also supported by the gradual recovery of European economic conditions, banks' cost-cutting measures and rationalisation of operations, as well as reductions in high-risk balance sheet assets.

There is a strong connection between the condition of the banking sector and the real economy. A deterioration in the real economy would weigh on the banking sector's operating capacity, as loan losses would begin to increase again, while a weak banking sector would impair the recovery of the real economy. On the other hand, it takes a sound banking sector to ensure smooth financial intermediation to satisfy the needs of the real economy. Day-to-day measures contribute to achieving this.

Tags

euro area, market turbulence, banking sector