21 May 2016

# Patrimoni

Class/CNBN interviews

## Light and dark in the banking sector

*In Europe (and even more so in Italy) the situation is difficult. The fall in earnings is structural and non-performing loans are a burden. But while it's best to be prudent as regards shares, there are some good opportunities in bonds.*

by Aldo Bolognini Cobianchi

The banking sector has cast light on some serious problems and share prices have suffered, especially in Italy. But there are some good opportunities out there, especially in bonds. **Francesco Castelli** (in the photo), investment manager at Banor Capital and manager of the Banor SICAV Euro Bond Absolute Return fund, sums up the situation.

**Investing in banks, whether bonds or shares: is that an opportunity or a risk, in view not least of the negative rates?**

The disastrous start of the year for shares and the debt issued by banks is the effect of a widespread malaise in the financial sector. The banks, and the insurance companies too, are struggling to make money in a world where economic growth is fragile, rates are low or negative and the opportunities for fixed income investment continue to be scarce. We feel that these difficulties are only temporary for the USA. But for European banks, the leaner profits are a structural problem: the tighter legislation introduced in recent years has increased costs to a notable degree, while the economic slowdown and negative rates have led to a fall in earnings. The difficulties are being felt keenly in Italy, where non-performing loans are having double the impact compared with the European average. Our country now seems to be on course for modest but positive growth; however, the long period of stagnation that hit us between 2007 and 2014 has left its mark and has had a crippling effect on a significant proportion of our banks.

**How big an impact do central bank decisions have on the sector?**

In our opinion, we've entered a period where interventions by the central banks are, again, struggling to help the sector. Negative rates, not just on deposits but also on many short-term government bonds, mean that liquidity is becoming a cost for banks (while in the past it was a source of income). However, we don't expect any more significant rate cuts: both the European Central Bank (ECB) and the Bank of Japan will probably be aiming for alternative monetary policies to avoid any more damage to the banking system.

The important thing will be to understand how the ECB will behave in its supervisory role, as supervisor of the banking sector. It seems that the hard line is winning the day: the inflexible application of the banking rules laid down by the European Union. In Italy we can see it clearly, with the pressure to speed up the sale of non-performing loans (NPLs). An acceleration that could also penalise the banks, if sales were to turn into a sell-off.

**Better Europe or the USA?**

From the point of view of shares, we feel that American banks' fundamentals are sounder. The regulatory climate is more favourable, rates are low but positive, and tending to rise. The US banking giants have made an enormous effort to get their accounts back in shape and the economy, apart from the occasional, and natural, temporary slow-down, is much healthier than is the case in Europe.

**In Europe, what type of bank should people be placing their bets on?**

Given the greater uncertainty, in Europe it's a good idea to stick to the safe options: sound banks that have shown they can make profits even in difficult situations. Banks with low profitability, and exposed to the risk of recapitalisation, should on the other hand be treated with caution and left to the professional investors. Low as prices might seem, we know that a capital increase nearly always requires a discount on the current price, and that penalises investors.

In Italy, consolidation will not necessarily be a good thing for stock market prices. Many possible mergers will be "paper for paper" operations, where the banks that have been acquired receive a very low valuation premium.

And then, as happened with the Banco Popolare-Popolare di Milano operation, there's a risk that the ECB will approve only with reservations, and make onerous recapitalisation demands.

**Could bank bonds be a good investment opportunity for investors' portfolios?**

We're viewing bonds in a more constructive light: there are some good opportunities, more so in Europe than in America. European banks in general (and Italian ones in particular) offer considerably higher yields and spreads, which can be explained by the weaker credit profile. While we can understand the market's fears, in our opinion it's unlikely that episodes like the one we saw last November [2015], with the resolution of four Italian banks (and the bail-in of subordinated bonds) will be repeated.

There's been a lot of criticism of the new law on the resolution of failing banks: it's an instrument that solves very few problems, creates a lot of new ones and reduces confidence in the financial system.

Our feeling is that in future the authorities will use this instrument to only a minimum degree, making credit risk possible but improbable. That's why investment in bonds is an excellent opportunity, as long as investors ensure that their portfolio is adequately diversified, both by country and by issuer.

In general, our view is that senior bonds are more suitable for private investors, while subordinated bonds, which are more complex, are best left to the professional investors.

**Hybrid bonds: are there more risks or more potential advantages right now?**

Hybrid bonds are perpetual subordinated bonds, characterised by uncertain coupon payments (a characteristic that makes these securities, for all that they are bonds, similar to shares, hence the name "hybrid").

In our opinion, they make an excellent investment opportunity, especially in Europe, where they offer yields that are often 2-3% higher than for bank stocks.

However, these securities are highly complex (which is why their distribution to private clients is prohibited or restricted). Investors need to study complex variables (distance to trigger, capital buffers, coupon language, conversion mechanism) and prepare to buy securities for which the minimum amount is set at over 100,000 euro.

As with the rest of the high yield market, it's often worthwhile entrusting your investment to a specialised fund.

**What's the best recipe to follow to kick-start Italy's banks?**

We think the country's moving slowly, but in the right direction. The banks are responding to the government's invitation to consolidate, albeit with a certain time lag. Even when there's a capital shortfall, the system is managing to mobilise and avoid the worst. The recovery will be achieved, we think, by following two main courses of action: a balance sheet clean-up, with a drastic reduction in the stock of impaired loans and a rationalisation of cost structures. On the first point, we’re optimistic: at present there’s a very broad spectrum of buyers, the only problem is that prices are too low.

The legislative provisions taken forward by the government to reduce the time needed to recover impaired loans will help (at present, the average recovery time is 7 years, which is 3 or 4 times worse than the rest of Europe). And then we must hope that the ECB doesn’t rush sellers: selling off at bargain basement prices would end up simply enriching the buyers of NPLs and causing even more damage to banks. The cost review will, as Minister Padoan [translator’s note: Italy’s economy and finance minister] has pointed out, include a reduction of the number of branches and a process, sometimes painful, of staff cuts and re-training. Italy holds the unenviable European record for the number of branches per inhabitant: a network that, in the internet era, is a heavy burden on the sector and is holding back the growth of the entire country.