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# From crisis to financial reform: The outlook for U.S. and European banks

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## Key takeaways

- U.S. banks have recovered from the 2008 credit crisis following a process of recapitalization.
- Stocks of U.S. banks are becoming attractive investments with different features than they had before the crisis, including more stable cash flows and earnings.
- European banks are vulnerable to the European sovereign debt crisis and the possibilities of either a default or a change in the structure of the eurozone.

### The financials sector is in the midst of historic changes

Since the U.S. housing market collapsed five years ago, risk and volatility have alienated investors from financial stocks. Well into a long-term reform of the sector, now is an opportune time to address its future prospects. The travails of the banking industry, in particular, contributed to a global recession in 2008 and 2009, and its ongoing challenges and uncertainties continue to be a major source of global macroeconomic risk. Despite recent challenges, financials remain the largest global sector, averaging about 20% of the MSCI World Index over the past five years. The next largest sector, technology, constituted only about 12% of that index at the end of 2011 (Source: MSCI).

This paper provides an investment update on banks and related industries in the U.S. and European financials sectors, such as diversified financial institutions with investment banking and capital market operations, as well as securities exchanges. These are the areas of the sector primarily influenced by the 2008 financial crisis and the ensuing processes of reform and re-regulation. Other industries within the sector, such as insurance and credit card companies, have been less affected.

Regarding Europe, our view is that the structural flaws of the banks continue to pose a significant risk to the global banking industry. However, bank stocks in the United States, while not free from contagion risk, are poised to become more attractive investment opportunities, having rebuilt most of the capital base damaged by the 2008 crisis.

### U.S. banks have recapitalized

The 2008 financial crisis originated in the U.S. mortgage market. After a decade-long housing boom, billions in mortgage-related debt went sour. Many banks faced insolvency, and the loss of liquidity disrupted the normal flow of credit to the economy, contributing to a severe recession. The International Monetary Fund has estimated the tally of crisis-related bank writedowns worldwide at \$2.3 trillion, though some estimates have ranged higher.\*

\* Source: April 2010 Global Financial Stability Report.

**Not FDIC insured  
May lose value  
No bank guarantee**

The process of rebuilding bank capital began during the crisis. U.S. policymakers in the Federal Reserve and the Treasury facilitated the acquisition of Bear Stearns by JPMorgan, placed Fannie Mae and Freddie Mac into conservatorship, and rescued AIG within days of allowing Lehman Brothers to fail. Since the AIG rescue, the Fed and Treasury have followed a policy to recapitalize the banks, with the ultimate goal of restoring more rapid economic growth. Government policy resulted in a massive transfer of debt from the private sector to the public sector.

**Figure 1. Politically unpopular federal funds fueled recapitalization**

Total U.S. government bailout spending	\$603.8B
Banks and other financial institutions (TARP)	\$245.2B
Fannie Mae and Freddie Mac (non-TARP)	\$187.5B

Source: Propublica.org. Data last updated 9/14/12.

The policy of providing capital to the banking industry facilitated early and rapid recognition of the problematic assets on the banks’ balance sheets. U.S. banks were supported in the effort to clean up their balance sheets through the often criticized but arguably successful Troubled Asset Relief Program, which furnished funding to stabilize the sector. TARP was expensive and effective. Through August 2012, the government had recovered \$266 billion from TARP bank programs, \$21 billion more than had been disbursed (Source: U.S. Treasury, TARP Monthly Report to Congress, August 2012).

Government support helped put the sector on a more stable foundation. Many banks have increased capital by issuing new equity and retaining more of their earnings. Nevertheless, the use of taxpayer money to save the banks was unpopular, prompting a political controversy that remains with us. Congress and regulatory authorities responded by developing new rules with the goal of preventing future government involvement in protecting banks.

**New regulations focus on raising capital and reforming industry practices**

In 2010, Congress passed the Wall Street Reform and Consumer Protection Act, popularly known as Dodd-Frank, with the purpose of regulating behavior of banks and financial institutions, capital markets, trading in derivatives, and treatment of retail customers. Since then, regulatory authorities have been gradually implementing some provisions while writing rules for others with a process that incorporates feedback from the industry and the public.

Outside the United States, regulatory reform has been undertaken by the Basel Committee on Banking Supervision, a group comprising central bank policymakers from the Group of Ten countries (which, in truth, has 11 members: Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, the United States, Germany, Sweden, and Switzerland). The consensus view is that the previous global rules significantly underestimated risk and capital needs for investment banks, in particular. The new set of rules, called Basel III, is now in the hands of each national regulator to customize for its own banking system.

While the ultimate impact of new regulations cannot be forecast with precision, we can provide this overview.

**Capital requirements.** One of the key components of new regulations, both in the United States and globally, is higher capital requirements. A larger capital base in theory makes banks better able to withstand losses during a crisis such as in 2008. Under Basel III’s new capital requirements, banks must raise their Tier 1 capital ratio — or core capital, consisting largely of stock and cash reserves — from the previous minimum of 4.5% to 6%. A bank’s total capital ratio must be at least 8%. Also, a special capital conservation buffer of 2.5% must be phased in by 2019 (Source: Bank of International Settlements). In practice, most banks are aiming to achieve a minimum capital ratio of 9%, or twice the level of the previous minimum, consisting primarily of common equity and retained earnings, by 2013.

Capital requirements have a couple of effects. Lifting capital requirements changes the economics of banking, for investment banks in particular. Compared with retail banks, investment banks require significantly more capital for operations — in some cases, three times as much. The Basel III requirement to retain more capital will likely increase costs and put downward pressure on bank returns on equity (ROEs). Before the crisis, ROEs of investment banks were generally in the range of 15%–20%, twice as high as those of retail banks. The new capital requirements could reduce ROEs to much lower levels.

In Putnam’s view, with banks now much better capitalized, they are better prepared to survive an increase in credit risk, which they were unprepared for in 2008. Leverage ratios at many institutions before Lehman’s collapse were much higher, at 30–50 times equity, in some cases. Today, these ratios are generally closer to 10–12 times equity (Figure 2). The funding structure has changed significantly, in that even investment banks rely less on overnight lending, which can evaporate suddenly. New forms of funding, such as equity and long-term debt, are more stable.

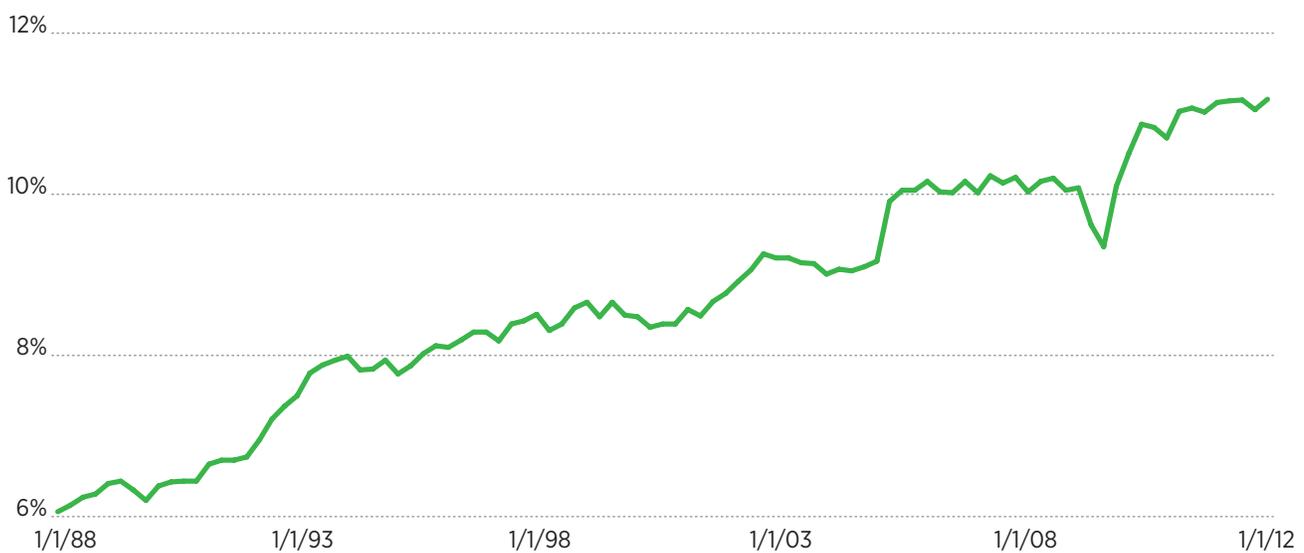
**Limits on proprietary trading.** A section of the Dodd-Frank law called the Volcker Rule is intended to limit the ability of banks to engage in proprietary trades that could jeopardize the financial stability of an institution and therefore risk a taxpayer-funded bailout. Institutions would still be permitted to engage in client-facilitating market-making activities, but regulators are attempting to squeeze out proprietary trading that is disguised as market making.

However it is ultimately formulated, the Volcker Rule will be complicated and difficult to enforce. Differentiating between proprietary trading and market making, and trying to enforce the rule in the U.S. operations of global banks, are tremendous challenges. Proprietary trading is now prohibited, and banks are faced with deciding the level of resources that they will commit to market-making operations. Their decisions will be influenced in part by how the restrictions are written into the rules and how they are enforced. Federal authorities plan to complete work on the Volcker Rule by the end of 2012.

Putnam’s view is that, though the Volcker Rule is significant, the impact is likely to be less meaningful than the

**Figure 2. Bank equity-asset ratio has risen to the highest level in nearly 25 years**

Total equity divided by total assets of U.S. banks, 1/1/1988–1/1/2012



Source: Federal Reserve Bank of St. Louis. Data last updated 6/24/12.

change in capital requirements. The scale of proprietary trading, and its importance to the business models of banks, were often exaggerated in past media coverage. In addition, it has already begun changing. Investment banks have de-emphasized speculative activity and have emphasized transactions where they act as agents and facilitators. This trend helps to enhance the stability of the financial system.

**Derivatives regulation.** The Dodd-Frank law strives to increase transparency in derivatives trading by moving over-the-counter trading to exchanges, where prices and counterparty risk are easier to track. This provision has pluses and minuses for financial institutions. On one hand, funding the over-the-counter trading was expensive, so less of this sort of trading actually helps to free up capital. On the other hand, this business generated large revenues.

Putnam’s view is that many of the past problems with derivatives now targeted by regulators are less significant today. For example, exotic trading instruments like collateralized debt obligations (CDOs), which were at the center of the storm in 2008, no longer exist. Banks generally stopped creating these instruments in the immediate aftermath of the crisis. The market had effectively punished and all but eliminated certain products and practices that led to large and systemic losses. Banks’ derivatives exposure has ceased growing at the pre-crisis

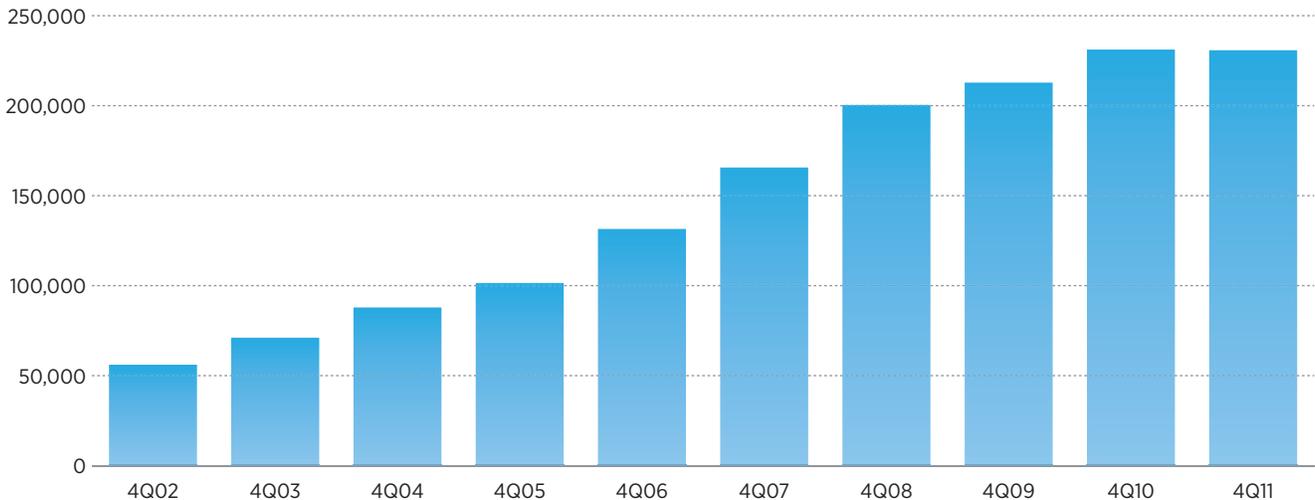
pace (Figure 3). A significant portion of the new regulations thus involve issues that pose little threat today.

**New oversight.** Beyond the Volcker Rule, the launch of the Consumer Financial Protection Bureau (CFPB) authorized by Dodd-Frank also creates uncertainty. The CFPB has broad responsibilities and authority for regulating consumer financial products, including mortgages, foreclosures, credit cards, and student loans. It has a role in writing and enforcing regulatory rules, and it will study consumer behavior in order to further refine its regulations. As an example, the CFPB plays a role in overseeing the clarity and transparency of mortgage-related documents to help ensure that borrowers better understand the responsibilities and risks they are undertaking with a mortgage.

Putnam’s view is that the intent of the CFPB is worthwhile, but it remains to be seen how effectively the CFPB can perform its stated function. Given its extensive mandate, it will take time to measure the CFPB’s impact. It could have a beneficial effect by restoring trust damaged by abusive practices in the past, though critics fear that it could have a dampening effect on lending. In the housing market, for example, there is negative potential in that the CFPB could place costly requirements on banks, making mortgage lending a less attractive business, and slow new mortgage originations that would give the housing market greater vigor.

**Figure 3. Banks’ derivatives exposure has plateaued**

**Derivatives in \$billions**



Source: Comptroller of the Currency, OCC’s Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2011.

### Evaluating U.S. banks as investments

Our overall view of the financials sector is that it will offer investors a more attractive range of investments in coming years than has been the case since the housing bust began in 2005. Most banks now have — or are close to having — the capital they need to meet the new requirements, but those that continue extensive investment banking operations will need to increase capital. From this point forward, we anticipate little in the way of new equity issuance.

Those banks that need additional capital are likely to attain it by generating and retaining earnings, either as cash or in the form of “safe” securities. While the ultimate impact of new regulations will be unknown for some time, the risk and volatility of bank earnings and, by extension, bank stocks, should be lower in the future.

Banks have been responding and will continue to respond to the new environment and seek ways to attract investors (Figure 4). As new regulations are implemented, the banks will also explore new ways to protect and increase their profit margins. They are likely to adjust their mix of businesses and develop new ways to work within regulations in order to achieve higher ROEs.

Given that higher capital requirements are likely to lower the profit margins for investment banking, the leaders of each institution will need to decide whether it makes sense to continue operating these units. We anticipate that many

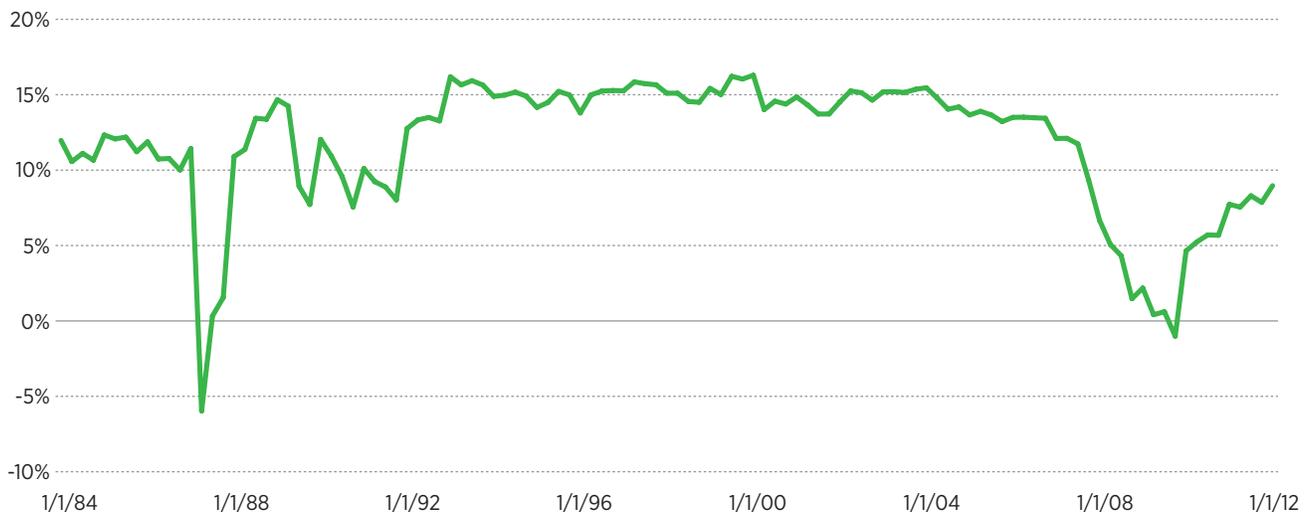
### The outlook for U.S. banks

- Banks will generally have higher capital ratios and lower ROE ratios.
- Bank securities are likely to have less solvency risk and less vulnerability to a liquidity crisis than in the years preceding 2008.
- Corporate cash flows and earnings are likely to be more stable and less volatile.
- The investment banking industry will be radically different from that of the past. It will rest on a larger capital base but operate with lower risk, lower volatility, and lower profitability. New capital requirements and regulation will make much of the past business model either uneconomical or prohibited. Each institution will determine which specific businesses to terminate or de-emphasize.
- The movement of derivatives trading away from the over-the-counter market is neutral or slightly negative for banks, but positive for exchanges.
- Future implementation of the Volcker Rule and CFPB may have significant impact on bank business models.

institutions will decide to scale back investment banking operations.

**Figure 4. U.S. banks have worked to improve ROEs to pre-recession levels**

Average return on equity for all U.S. banks, 1/1/1984-1/1/2012



Source: Federal Reserve Bank of St. Louis. Data last updated 6/4/12.

Regulations will also have spillover effects on capital markets. Historically, investment banks have played a significant role in trading fixed-income securities, currencies, and commodities. Trading in these areas has represented about 60% of the revenues of investment banks. As a number of institutions retreat from these markets, there is likely to be less liquidity. This could have the effect of widening bid-ask trading spreads and could contribute to a higher level of volatility.

### **European banks remain exposed to structural flaws**

Europe's banks have faced deteriorating business conditions since the 2009 recession, when GDP in advanced economies fell 3.6% (Source: IMF). For over two years, these problems have been a source of financial market volatility, yet no comprehensive solution has been implemented.

European banks in general have relied heavily upon wholesale funding via both short- and long-term financing. Both sources of funding have become increasingly expensive, or in some cases, have completely dried up as concerns about the health of both the banks and European economies have increased. For short-term funding, European banks have relied less on customer deposits, a relatively stable source of funding, than have U.S. banks.

The banks' exposure to sovereign bonds has increased in recent years. These large exposures were partly encouraged by the regulatory environment. Prior to Basel III, capital rules assumed sovereign bond holdings in developed countries were more or less risk free, and hence required no capital backing. In theory, therefore, owning sovereign bonds was a very profitable investment decision for the banks prior to the sovereign debt crisis. In addition, European regulators, in the wake of the Lehman Brothers collapse, urged banks to increase their holdings of liquid and low-risk securities, as sovereign bonds had been classified.

Meanwhile, the short-term funding system in Europe became paralyzed in 2011, resulting in a liquidity crisis.

For many months, the loss of liquidity in short-term money markets, and a near disappearance of U.S. dollar funding, threatened many institutions with insolvency. Although the European Central Bank had long resisted calls to intervene, it ultimately introduced a new program, the Long-Term Refinancing Operation (LTRO), to relieve the short-term funding pressure on European banks. The LTRO allowed banks to exchange their short-term debt for three-year funding.

The majority of European banks now have adequate liquidity to fund their operations into 2013. In the first operation during December 2011, the ECB allotted €489 billion to 523 banks, and in a second operation during February, the ECB loaned €530 billion to 800 banks. The LTRO significantly reduced borrowing costs, giving banks time to address their structural funding issues by developing new, more stable long-term funding sources.

### **Risk of capital flight caused by possibility of default or currency dissolution**

The burdens on government finances in recent years have resulted in greater credit risk in sovereign bonds that had been regarded as low risk. Since 2010, the ECB along with the 27 European Union member nations and the 17-member eurozone have undertaken efforts to restore confidence in sovereign bonds of highly indebted countries. The EU's European Financial Stabilisation Mechanism (EFSM) and the eurozone's European Financial Stability Facility provide lending for indebted states, as the region has gradually revised treaty arrangements to establish a permanent European Stability Mechanism (ESM), which is expected to become effective in late 2012. For its part, the ECB launched the Securities Market Program (SMP) to make limited purchases of sovereign bonds.

While the announcement of each initiative calmed markets temporarily, investors quickly perceived that each effort fell short of the scale of the problem, and anxiety resumed. For most European nations outside Germany and Scandinavia, bond prices have fallen and interest-servicing costs have risen, further weakening bank balance sheets and government finances.

As the crisis has continued, it has created the possibility that nations currently in the eurozone, particularly Greece, might consider exiting. Greece is among several eurozone economies suffering from high unemployment and falling incomes because of international uncompetitiveness. An exit would allow these economies to set new, more competitive currency exchange rates. This possibility, however, would reduce the value of savings and other assets currently denominated in euros.

Talk of an exit has prompted some individuals and businesses to begin moving their savings from banks in peripheral markets to banks in economically stronger countries. This flight to safety adds further pressure on banks in peripheral markets struggling to improve the capital strength of their balance sheets.

The ECB is facing the challenge that almost €3 trillion in bank deposits may be vulnerable to capital flight (Figure 5). Italy and Spain account for more than €1 trillion each of this amount. A massive tide of deposits leaving the banking system would reignite liquidity fears and could prompt a run on deposits. Bank runs, once begun, are difficult to stop.

### The outcome hinges on Spain and Italy

A default or debt restructuring by Spain or Italy has emerged as the greatest threat to the European financial system. Such an event would have a significant and almost unquantifiable negative impact on virtually all European banks. Spanish and Italian government bonds are widespread holdings on bank balance sheets that have been losing value, and they may continue to suffer. Many banks would simply not survive, and others would require either significant capital injections or nationalization.

Spain and Italy face daunting problems. Spain's debt-GDP ratio is lower than Italy's, but its current short-term funding needs are greater. In addition, Spain's banks were in weaker condition because of bad mortgage-related loans. In June 2012, European authorities agreed to supply €100 billion to backstop Spain's banks and reduce the chance of capital flight out of Spain. The European Commission also agreed in principle that these funds would go directly to the banks rather than adding to Spain's government debt burden. Italy's current budget deficit is more manageable than Spain's, but it must reduce its outstanding debt with a credible long-term plan.

**Figure 5. ECB funding to cover bank deposits that are vulnerable to capital flight (€ billions)**

	Italy	Spain	Portugal	Ireland
<b>Domestic deposits</b>	€1,376	€1,652	€188	€164
<b>of which retail + corporate</b>	1,019	908	164	121
<b>Estimated covered deposits</b>	460	777	80	113
<b>Implied uncovered deposits (a)</b>	917	876	109	51
<b>International deposits and international interbank (b)</b>	236	248	105	289
<b>Estimated "hot" deposits (a) + (b)</b>	1,153	1,124	214	340
<b>as % ECB balance sheet (€2.96 trillion)</b>	<b>39%</b>	<b>38%</b>	<b>7%</b>	<b>11%</b>

Sources: ECB, national central banks, FSB, European Commission, and autonomous research estimates. Data as of February 2012.

Action by the ECB in September 2012 further reduced the near-term default risk in Spain and Italy. Acting to preserve the euro, the ECB instituted a new bond-buying program, the Outright Monetary Transactions (OMT), to purchase unlimited amounts of sovereign bonds of nations that meet its conditions for reforming government finances. This facility eases near-term funding pressure on Spain and Italy. In turn, this moderates the risk that banks would take capital losses on their sovereign bond holdings, which remains the greatest threat to the financial system.

These major changes mean that much of the risk of capital losses for banks has been removed, or at least delayed, by the ECB intervention. Unlimited bond purchases improve upon previous ECB efforts. The ECB has also stated that it will be equal in priority with existing bondholders rather than ranking ahead of others as it had in the past, which carried the self-defeating consequence of exacerbating the risk that other institutions might take capital losses. Germany, meanwhile, resolved a major question about its contribution of €190 billion to the ESM when the German Constitutional Court confirmed the constitutionality of these arrangements. The ESM will function alongside the OMT.

At this point, the responsibility now falls on Spain, Italy, and other indebted nations to institute credible reforms while steering their economies clear of any worsening economic fortunes. The ECB will not be able to help nations that do not deliver on reforms, and the whole situation remains vulnerable to macroeconomic deterioration.

The situation in Greece remains distinct. In theory, at least, the threat of a Greek default is manageable. Under the debt restructuring agreements reached with private-sector involvement during February 2012, the majority of exposures of European banks to Greek bonds has been written down, and other direct exposures are fairly

limited. However, Greece continues to pose a risk should it withdraw from these agreements or exit the euro. While Greece's June election installed a coalition ostensibly in favor of working within the agreements and remaining within the eurozone, other outcomes remain possible. Another scenario is that markets could cut off funding to Greece, effectively forcing an exit. Either a default or a eurozone exit by Greece would pose a contagion threat that is difficult to forecast and potentially quite dangerous, particularly for other peripheral countries such as Portugal, Spain, and Italy. In such an event, European political leaders and ECB policy leaders would need to act quickly to create a firewall around Greece and make it appear an exceptional case rather than a model for other less-competitive economies.

### **Evaluating European banks as investments**

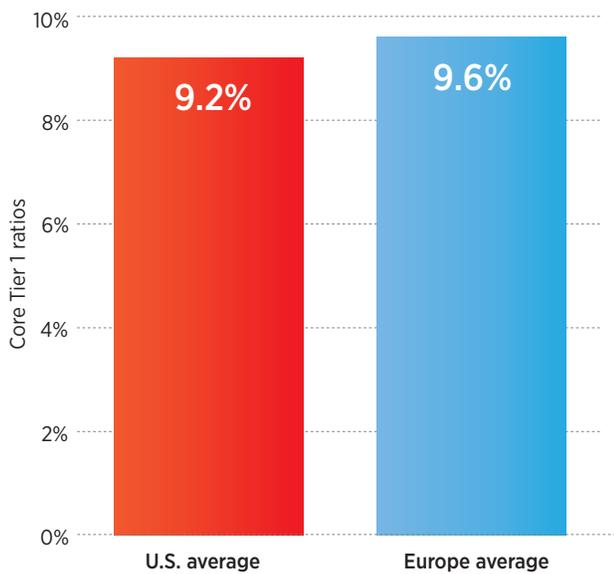
European banks face several structural challenges. They will need to have smaller balance sheets that are more stably funded and less at risk from periodic times of liquidity stress and lower leverage. The funding of balance sheets will be more highly geared to deposits, a more stable source, rather than to the volatile and less predictable wholesale funding markets. Banks would then have much higher capital ratios, making them less risky, but also giving them lower profitability as measured by ROE.

The banks can also improve overall efficiency by reducing costs that are still too bloated for the challenging revenue environment of a weak economy. This will involve reducing or selling businesses or assets that are the most capital intensive. In turn, this would allow the banks to reduce their reliance on wholesale funding, reduce leverage, reduce complexity, and improve capital.

**Leverage ratios.** According to Basel III accounting methods, the capital ratios of European and U.S. banks are similar (Figure 6). However, it is important to note that there are doubts as to the consistency of the underlying assumptions. Under Basel’s accounting methods, sovereign debt holdings require virtually no capital backing, despite the obvious credit risks of the sovereigns’ current environment.

**Figure 6. European bank capital ratios match those of the U.S. only if sovereign bonds avoid default**

**European and U.S. banks — fully loaded Core Tier 1 ratios**



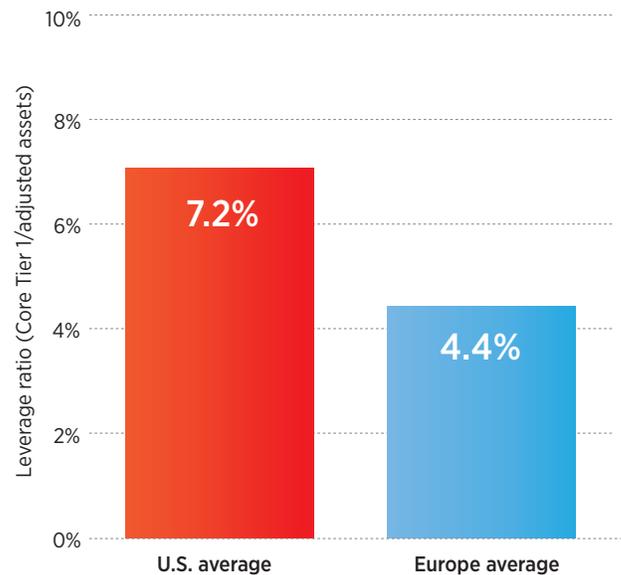
Source: Barclays research, based on estimated 2013 earnings under Basel III rules.

While, as measured by Basel III, European and U.S. banks have similar capital ratios, European banks are much more highly levered (Figure 7). In theory, this implies that European banks hold lower-risk assets relative to U.S. banks, a difference that can be partly explained by retaining lower-risk mortgage assets. U.S. banks typically sell these assets to government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. However, the magnitude of the differential is difficult to justify from this evidence.

In our view, while U.S. banks have similar capital ratios, they have much lower leverage. U.S. banks have more capital backing the assets on their balance sheets, making U.S. banking stocks less leveraged than European banks.

**Figure 7. European banks have higher leverage than U.S. counterparts, reflected in lower equity-asset ratios**

**European and U.S. banks — tangible equity-asset\* ratios**



Source: Barclays Research, based on estimated 2013 earnings.

\* Assets ex-derivatives.

**Stock valuations have become more attractive because of deleveraging**

While the relatively high leverage of European banks remains an issue, the market’s fears have created attractive valuation opportunities. Prices of European stocks have fallen to levels not seen since the early 1990s. Of course, these price levels reflect limited growth potential. European economies, like much of the developed world, are in the early stages of a long-term debt deleveraging cycle. Deleveraging reduces demand for loans that would fuel earnings growth for banks.

**Figure 8. Deleveraging cycles have lasted an average of five years****Major national deleveraging events, 1981–2007**

Country	Crisis year	Credit buildup (years)	Deleveraging (years)	Increase in credit/GDP*	Decrease in credit/GDP*
Argentina	2001	6	3	28%	-30%
Chile	1981	N/A	1	N/A	-10%
Colombia	1998	6	7	17%	-16%
Dominican Republic	2003	8	4	29%	-26%
Finland	1991	6	6	51%	-44%
Indonesia	1997	5	4	83%	-104%
Ivory Coast	1988	4	6	14%	-27%
Japan	1997	5	9	N/A	-26%
Malaysia	1997	5	3	72%	-33%
Mexico	1994	7	1	24%	-16%
Nicaragua	2000	4	2	19%	-15%
Norway	1991	5	6	66%	-38%
Philippines	1997	6	10	60%	-50%
Russia	1998	3	2	29%	-27%
Sweden	1991	5	6	46%	-35%
Thailand	1997	5	4	N/A	-78%
Uruguay	2002	7	5	70%	-64%
<b>Average</b>		<b>5</b>	<b>5</b>	<b>44%</b>	<b>-38%</b>

Source: Bank of International Settlements.

\* Percentage points.

To estimate the expected length of the current deleveraging cycle, we can look at past precedents. History shows that the average length is five years (Figure 8).

In Europe, deleveraging took hold in 2010, and today structural debt levels remain high. In Ireland, Portugal, and Spain, for example, private sector debt as a percentage of GDP is higher than it was in Japan prior to its 1990s banking crisis. The deleveraging process, we believe, is likely to last until 2015, or perhaps longer.

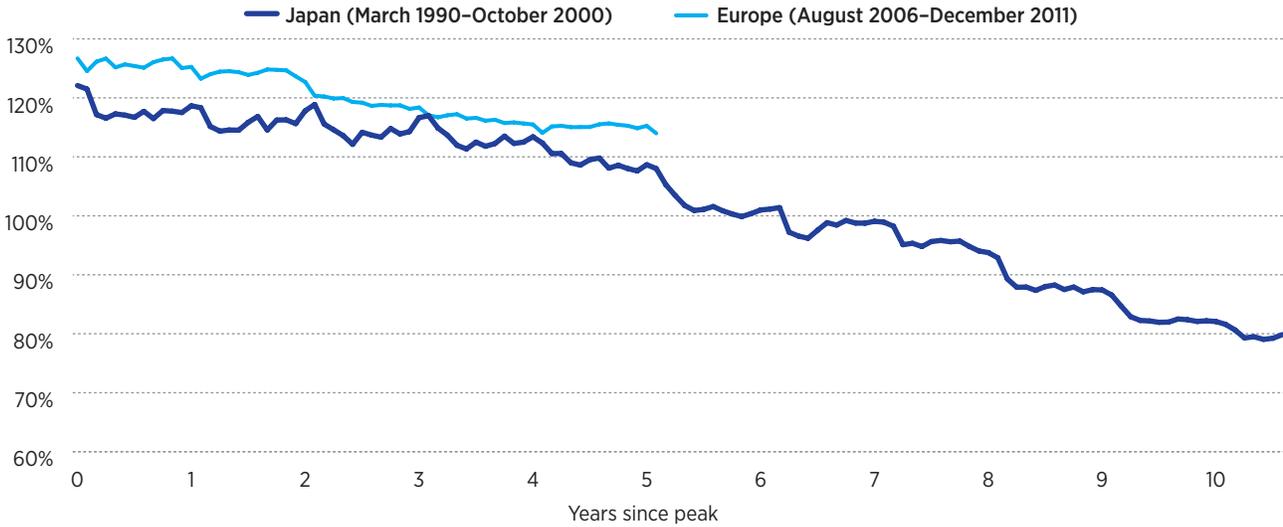
In addition to the duration of deleveraging, it is important to consider its magnitude. Deleveraging cycles in the past have, on average, achieved a 38% reduction in debt-to-GDP ratios. No nation in the current cycle has yet approached that threshold. Ireland and the United Kingdom, which have made the greatest progress, have each reduced debt-to-GDP by less than 20%. Spain,

prior to its June 2012 bank bailout, which increased sovereign debt, had reduced debt-to-GDP by less than 10%, and Italy has achieved only a 1% reduction. (Source: ECB, U.S. Federal Reserve, and IMF).

### **The long road to recovery: Will Europe follow Japan?**

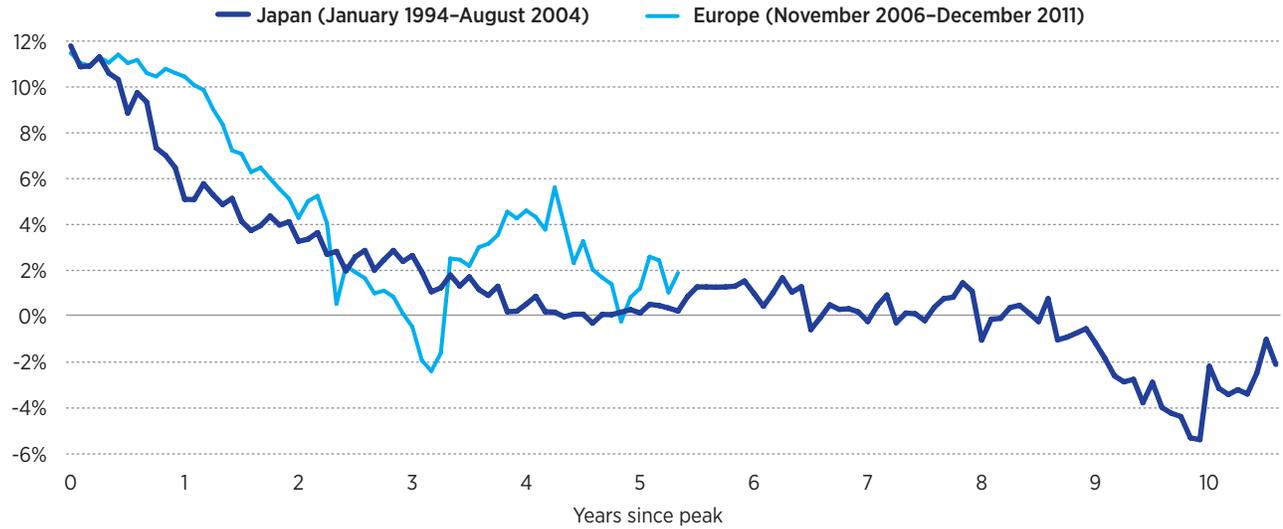
The leading recent example of a developed market deleveraging cycle involved Japan during the 1990s. It is possible that European banks may follow the path of Japanese banks and experience a shrinkage in lending over many years, accompanied by very low interest rates for an extended period. Figures 9 and 10 provide an overview of Japan's banking crisis and parallels to Europe's crisis today. For Japan's banking system, the impact of this sustained deleveraging cycle was long-term subpar profitability.

**Figure 9. European loan-to-deposit ratios continue to decline**



Sources: Bank of Japan, national central banks, and Barclays research. Data as of December 2011.

**Figure 10. Europe has followed Japan’s path in falling loan growth**



Sources: Bank of Japan, national central banks, and Barclays research. Data as of December 2011.

## The outlook for European banks

Barring a major sovereign default or currency dissolution, the majority of European banks now have adequate liquidity to fund their operations through the next two years, granting them time to reform their balance sheets, and improve capital structures and business models. We believe European banks will focus on the following strategies:

**Improving efficiency** by developing appropriate cost structures. Currently, the cost basis for most banks is still bloated and inappropriate for a more challenging revenue environment.

**Reducing non-core businesses or assets**, including capital-intensive operations that are too expensive to fund. The goal of these measures is to help improve the current structural weaknesses of the balance sheets — that is, reduce reliance upon wholesale funding, reduce leverage, reduce complexity, and improve capital ratios.

**Shoring up balance sheets** with funding from more stable sources, which will reduce risks proceeding from periods of liquidity stress and lower leverage. The funding of balance sheets ought to be geared to more stable deposits, rather than wholesale funding markets.

**Increasing capital ratios**, which will reduce business and operational risk. The downside effect is that profitability will be lower on a return-on-equity basis.

**Reducing business-model risk** with “bail-in” concepts to suit regulators who want to escape the “too big to fail” risk. In the future, long-term wholesale funding will compel investors to bear the losses when banks get into trouble, rather than to transfer these losses to the public. These concepts, however, permanently increase the cost of wholesale funding for banks.

**Reforming investment banking.** This industry will change dramatically, as it will rest on a larger capital base but operate with lower risk, lower volatility, and lower profitability. New capital requirements and regulations will make much of the past business model either uneconomical or prohibited.

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