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Equity returns in the banking sector in the wake of the Great Recession and the European sovereign debt crisis

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ABSTRACT

This study finds that equity returns in the banking sector in the wake of the Great Recession and the European sovereign debt crisis have been driven mainly by weak growth prospects and heightened sovereign risk; and to a lesser extent by deteriorating funding conditions and investor sentiment. While the equity return performance in the banking sector has been dismal in general, there is some evidence that better capitalized and less leveraged banks have outperformed their peers in times of stress.

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1. Introduction

The Great Recession of 2008 and the ongoing euro area sovereign debt crisis, which started in early 2010, have led to elevated strains in financial markets. Despite massive support programs conducted by central banks in advanced economies, banks still face a challenging operating environment, which has been reflected in repeated ratings downgrades, widening funding spreads, and declining equity prices (Fig. 1).[1]

This study focuses on the drivers of equity returns in the banking sector of advanced economies. The drivers analyzed include sovereign risk, economic growth prospects, funding conditions, and investor sentiment or risk aversion. This study finds that, after 2008, equity returns have reacted mainly to changes in the growth outlook and in sovereign risk. The finding is consistent with the existence of strong linkages between sovereigns and banks giving rise to a feedback loop. Banks have been a cornerstone of the European sovereign bond investor base, holding sizable bond portfolios. A deterioration of the economic outlook hurts a country's repayment capacity, raising sovereign risk. Losses in bond holdings decrease banks' ability to provide credit and continue buying sovereign debt, further damaging the growth outlook and leading to higher sovereign spreads that affect the country's ability to serve its debt.

This study also finds some evidence that higher capitalization and lower leverage may make banks' equity returns more resilient to adverse economic and sovereign risk shocks. The equity-to-asset ratio has a positive impact on equity returns. However, the statistical significance of this impact disappears when panel estimates are adjusted for cross-sectional dependence. Annual cross-sectional regressions suggest that the outperformance of banks with higher equity to assets was limited to 2008. The tier 1 capital to risk-weighted assets also has the expected positive sign in the second half of the sample period, 2009–2011, albeit statistically insignificant. These findings suggest that capital plays an important role in shielding banks in times of extreme stress (Lehman bankruptcy), although higher capitalization may not be rewarded by the market in less turbulent times.

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[1] Examples of such support programs include central bank liquidity swap agreements in 2008 and 2011, the Troubled Assets Relief Program (TARP) in the United States, and several refinancing option programs in the euro area.

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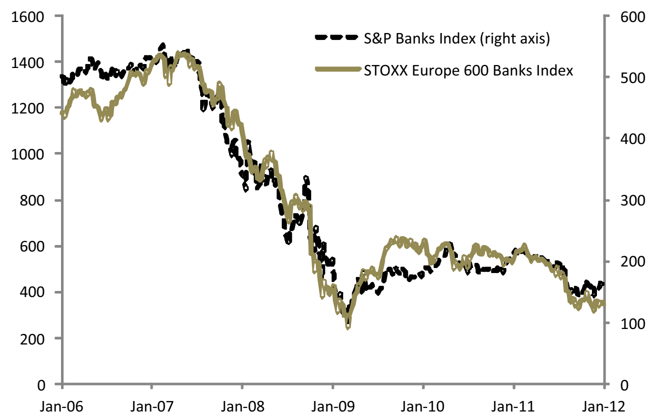

Fig. 1. U.S. and European bank equity price indices.
Source: Bloomberg.

We also find some evidence that the equity returns of banks less reliant on wholesale funding, as approximated by the loan to deposit ratio, tend to outperform after controlling for other variables. Higher reliance on wholesale funding, which is generally short-term, makes banks more vulnerable to funding shortages during periods of extreme market uncertainty, as pointed by Duffie (2010) and Gorton and Metrick (2011) among others. In contrast, deposits tend to be a more stable funding source.

2. Bank equity performance during the recent crisis

Since late 2007, pressure has been building up on both sides of banks' balance sheets. Asset values and earnings expectations have been impaired as the weakening of economic conditions in the euro area offset hopes for a sustained recovery hinted by improved economic data in the United States and major emerging market countries. Non-performing loans will likely remain a problem given the sluggish growth outlook, further eroding profitability in the banking sector.

In particular, banks' holdings of peripheral European government bonds, long regarded as risk-free assets, have experienced large decline in value as markets recently priced in increased sovereign default risk on debt sustainability concerns. Even banks without substantial exposures to peripheral European government securities have been affected, as they are major counterparties in derivatives markets referencing these securities, stand on the other side of large interest rate swaps with sovereigns, and/or have claims on banks highly exposed to peripheral sovereigns. To further compound problems, the restructuring of Greek sovereign debt, which yielded a 70 percent net present value loss for bondholders, has resulted in increased market uncertainty on the effectiveness of hedging instruments and strategies such as credit default swaps (CDS) and short-selling, impacting the investor base negatively and driving sovereign bond prices downwards. Unsurprisingly, equity price declines have been the most pronounced for European banks, which are far more exposed to peripheral European government securities, and could be the most impacted by a potential recession in the euro area. Indeed, banks domiciled in peripheral European countries have performed the worst since 2007 (Fig. 2).

Increased investor attention on the exposure to peripheral European countries has led to a tightening of funding conditions for banks, especially those in Europe and those perceived strongly connected to the latter. Funding tenors have shortened significantly and some financial institutions have been able to access term funding market only by pledging prime assets as guarantees. In particular, European banks have faced U.S. dollar funding shortages, forcing them to retreat from global operations such as trade finance in Asia and municipal finance in the United States. In response to a drying up of liquidity conditions, the European Central Bank

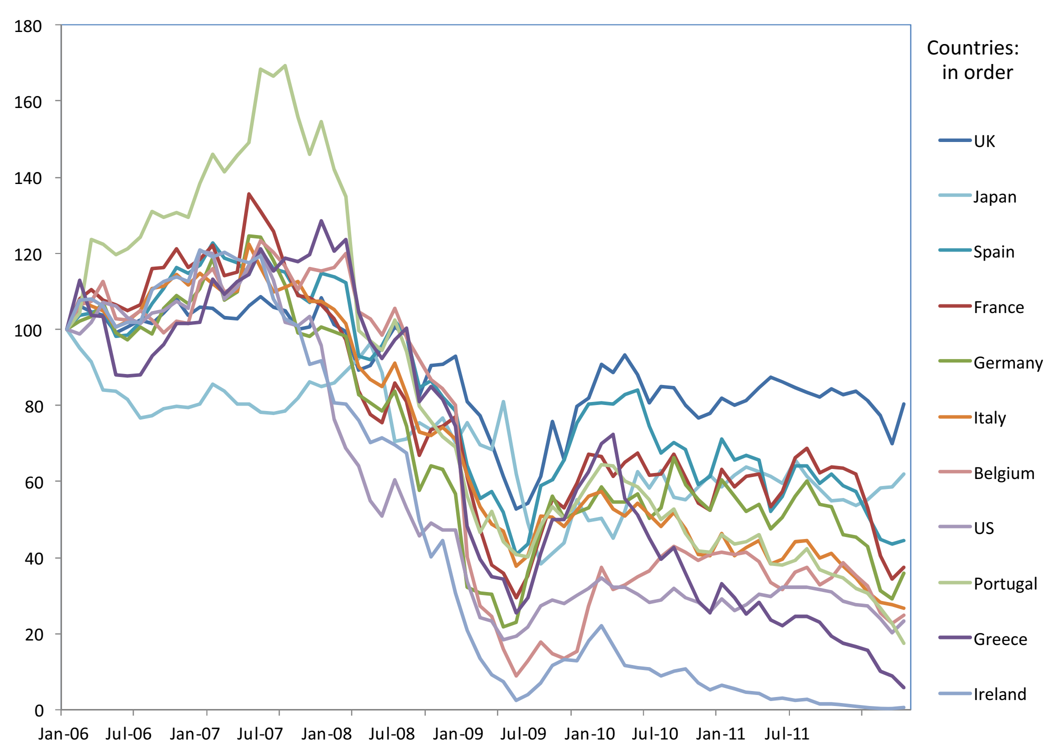

Fig. 2. European banking sector equity price indices, January 2006 = 100.
Sources: Bloomberg and authors' calculations.

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