Stock Market Review

BOV's return on equity drops

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BOV chairman John Cassar White. *Photo: Stefan Abela*

The semi-annual publication of the financial statements of Malta's two largest banks is always a defining moment for the local equity market. The widespread debate which escalated in recent weeks on the rates of interest being charged by local banks and, as some commentators argued, the "extraordinary profits" being generated by these institutions, placed added importance on last Friday's announcement of Bank of Valletta plc's March 2014 interim results.

Apart from referring to the debate on whether interest rates by local banks should be reduced further, the presentation to financial analysts also provided the ideal forum for BOV's chairman and top management to discuss the impact of the more onerous regulations being faced by banks across the eurozone.

As expected, BOV's chairman, John Cassar White, dedicated part of his presentation to explain in a somewhat structured manner how the rate of interest on loans is established by banks in order to shed more light on some of the conclusions reached by the various commentators.

Mr Cassar White explained that the strategy of most of the local banks was to fund their balance sheet through retail deposits as opposed to wholesale funding from other banks or via the European Central Bank.

BOV's chairman correctly indicated that the international financial crisis clearly showed the merits of this decision although it increases the costs of funds for local banks. Mr Cassar White explained that the pricing of a loan was not only based on the cost of funds but it was also dependent on the risk of the company or individual seeking to borrow. He argued that borrowers of a good financial standing are naturally charged a lower rate of interest.

Although Mr Cassar White also indicated that the dynamics of the exact lending rate is a complex issue which is too technical for many observers to understand, BOV's chairman made reference to some statistics published in some leading international journals which indicated the high level of local private lending as a percentage of GDP.

Mr Cassar White explained that these statistics indicate the under-capitalisation of many local companies which are way too dependent on banks not only to finance specific projects, but also for working capital requirements. The chairman claimed that this increased the risk for banks which is a key element for the determination of interest rates.

Although the arguments put forward were clearly used to defend the current status quo, Mr Cassar White however fell short of disclosing BOV's official position or his personal views on this delicate subject matter. The discussion as to whether local banks ought to reduce interest rates escalated in recent weeks with interventions by the governor of the Central Bank of Malta, a former BOV chairman, an ex-governor of the Central Bank of Malta, a regular columnist on financial and political matters as well as the Prime Minister.

In my view, the return on equity being generated is a benchmark that should be used as a comparison between local banks and their European counterparts to judge whether the local financial institutions are indeed generating such "extraordinary profits" as some commentators concluded from the "high interest rates" being charged.

BOV's ROE (calculated using after-tax profits) during the first six months of the 2013/14 financial year, dropped from 17 per cent to 12 per cent – the lowest level since 2009. The other local banks have also experienced a declining trend in returns when compared to the significantly higher levels achieved prior to 2008.

Across the eurozone, the trend has also been in decline and currently the average ROE is of 10 per cent. Although local banks are generating higher returns, this does not imply that they are generating "extraordinary profits". A 12 per cent ROE is by no means extraordinary and shareholders generally require double-digit returns to justify the risks being taken by the business.

Furthermore, last week's suggestion by a columnist that a one-off additional tax on bank profits could be imposed is potentially a dangerous policy given Malta's success in recent years in attracting a number of international companies (including banks) to Malta, providing important benefits to the wider economy.

Moreover, this would also not achieve the objective of the recent debate, i.e. to stimulate increased lending to local businesses. Such a measure would solely benefit the public coffers through a one-time boost to government revenues.

With a clearly positive path towards achieving a reduction in the budget deficit and the expected significant inflow of funds should the citizenship scheme reach the desired numbers, the government could do without the revenue from a one-time tax on bank profits given the adverse repercussions that this could bring along if introduced.

> **"It is surprising that the drop in the dividend… reflects the exact decline in the bank's profits"**

Notwithstanding the recent discussion on this delicate subject, naturally the major part of last week's meeting was dedicated to an analysis of BOV's financial results for the first half of their current financial year.

The BOV Group reported that it registered pre-tax profits of €50.7 million during the six months ended March 31. Although this represents a decline of 21 per cent over the comparative period last year, it is important to highlight that last year the profitability achieved by BOV was greatly influenced by the very positive conditions of the financial markets during that period which led to large positive fair value movements and also a significant increase in contributions from the insurance companies.

BOV's chairman explained that although core profits decreased by 5 per cent during the first six months of the current financial year, the main reason for the profitability decline was the lower level of fair value movements and the contribution of insurance activities. The impact of these two non-core items was of €12 million as financial market conditions were not as positive as those in the comparable period.

BOV's CEO Charles Borg gave an overview of the movements in assets and liabilities during the first half of the year. The overall loan book only increased marginally to €3.7 billion. Although Mr Borg acknowledged that business lending was generally slow, he argued that the net effect must be seen in the context of the repayment of some very large accounts, which distorts the true amount of new lending conducted during the period.

Moreover, the CEO and also the chairman indicated that in recent months, BOV sanctioned a number of large loans but these are not showing up as yet since they were not yet drawn down by the companies in question. When answering questions, BOV's chairman indicated that these new facilities run into "hundreds of millions of euros" and are expected to translate into an increase in the loan book in the near future.

While the overall loan portfolio registered weak growth due to the amount of repaid loans, the deposit base continued to expand with an increase of a further 7 per cent equivalent to €362 million in only six months. The consistent increase in deposits at a time of generally weak loan demand coupled with sizeable loan repayments, presents a very challenging scenario for the banks. This is exacerbated by the lower rates of interest that are earned on the excess liquidity which is invested in the local and international bond markets. In fact, the loan to deposit ratio of BOV at 58.7 per cent is far too low indeed and this needs to rise to improve returns to shareholders.

The other item discussed at length during last week's meeting was the asset quality review (AQR) currently being conducted by external independent professionals engaged by the MFSA on behalf of the European Banking Authority.

The review involves an independent assessment of the credit quality of the loan book. Mr Cassar White indicated that this review would be completed by the end of June. Afterwards, the European Banking Authority will conduct a stress test based on the AQR results which will be concluded by the end of October.

The bank will be incurring a significant cost to enable the external professionals to conduct these in-depth reviews. BOV's CEO claimed that although he is hopeful on the final outcome, the concern is that the 'one-size-fits-all' approach for such reviews being conducted across all selected banks in the eurozone may not be suitable for BOV due to the inherent characteristics of the local economy and many local businesses.

In the next few months, the market will be eagerly awaiting the results of BOV's AQR and the stress tests since these could instigate further impairment provisions. As such, they could also impact on the level of dividends recommended for distribution to shareholders.

In fact, in a statement accompanying the interim results, BOV's board explained that the final dividend for the 2013/14 financial year normally recommended at the end of October will take into account not only the financial performance achieved during the current financial year to September 30, 2014, but also the results of the AQR and stress test.

In this respect, it is surprising that the drop in the dividend declared with last week's interim results reflects the exact decline in the bank's profits. This implies that BOV's dividend declaration was not adversely impacted by the new Banking Rule 09 unlike the recent final dividend recommendations made by HSBC Bank Malta plc and Lombard Bank Malta plc.

This was not highlighted during last Friday's analyst meeting and further clarification from BOV would seem warranted. Possibly, BOV had already set aside sufficient reserves in the past. In fact, article 38 of Banking Rule 09 states that the capital allocation "may be satisfied by surplus Common Equity Tier 1 capital already held by the credit institution which is not utilised to cover any other risks to which the credit institution is exposed". Should this be confirmed, BOV ought to have highlighted this in the announcement and in the analyst meeting since it may help the bank to continue to maintain its present dividend payout policy unless the results of the AQR and the stress tests dictate otherwise in the next few months.

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