

European Banks Strategy

Careless talk costs loans

Industry Overview

Banks are upbeat. We are too

Management comments at an industry conference underpin our positive view on the sector, discussed in [Results wrap: all calm](#) (report link). But as laid out in [The stability of a graveyard](#) (report link), challenges remain. One leg of re-rating potential would be a reduction in market concerns over central bank regulatory and monetary policy actions that lower bank earnings or raise capital requirements. We see actual actions set to be small. However, continued discussion by policymakers keeps bank stocks discounted.

Two steps forward

Two issues in focus: ECB mandatory reserves and the US Basel III Endgame (B3E). Both were material overhangs, we think. Raising mandatory reserves was never ECB policy, but some of the 27 on the governing council had talked extensively (Box 2) and linked a potential increase to bank profits being excessive. We see no excess profits, but the potential landing of actual cost based on that perception by the supervisor was naturally a problem for bank shares. This has now been definitively removed, after months of uncertainty. Separately, Governor Powell's comments in Congress that B3E will be diluted or cancelled (Box 1) signifies structural improvement.

New supervisor highlights downside risks

Overhangs remain, central to banks' low multiple (Exhibit 3). One is ECB language: a speech by the supervisory chair emphasised risks and a preference for higher capital (Box 2). We believe the banks are resilient to shocks, but naturally the market worries - rhetoric is expensive - and especially when a separate theme is manifesting. Countercyclical and Systemic Risk buffers were a post-2008 concept, intended for when credit growth is booming, which it clearly is not (Exhibit 2). However, the ECB has discussed *structurally* positive buffers (Box 4), as announced by the Bank of Italy (Box 5). This late-stage addition reminds the market that frameworks are malleable by supervisors at will.

Too little risk, not too much

We believe the European banking system has too little, not too much risk. Europe's challenge is its shortfall in economic growth, to which a lack of finance contributes. We believe that further capital requirements would not be net benefit. And the discussion itself raises the cost of capital - in turn, constraining bank's willingness to lend. While shareholders have a favourable picture, with high distributions from low-risk companies, we see a sub optimal banking environment - a high cost of capital means too little lending, as discussed in [four in a row ahead](#) (report link).

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Timestamp: 15 March 2024 08:38AM EDT

15 March 2024

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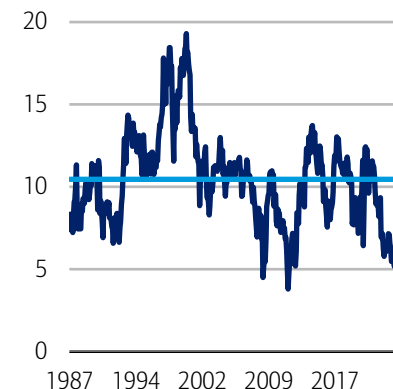
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Exhibit 1: close to a long term PE low

Median 12 month forward PE (x), 1987-2024



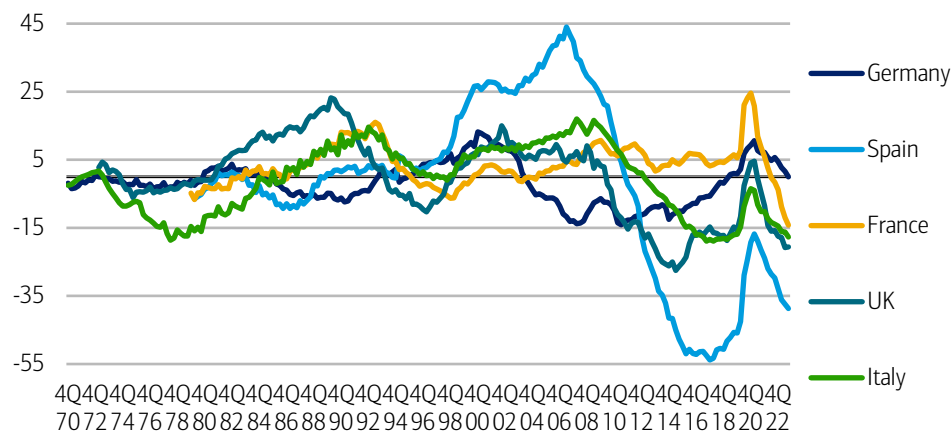
Source: Eikon

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Key charts

Exhibit 2: credit to GDP gaps close to, or at, all-time lows

Credit-to-GDP gap, level, 1970-2023



Source: Basel Committee

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Box 1: Basel III Endgame

"I do expect that there will be broad and material changes to the proposal."

Regulators scrapping the plan proposed last July and proposing a new version is a "very plausible option."

Fed chair Powell, Bloomberg, March 2024

Box 2: downside risks, more capital

One of the key lessons from the impact of the pandemic was the importance of building up adequate releasable capital buffers...

As banks compete more intensively for deposits because they have less excess liquidity, they're likely to offer even higher interest rates to attract and keep customers. This puts downward pressure on interest margins...

As the economy slows down, and as public support recedes, demand for credit may also fall. This posing downside risk to profits and makes it more difficult to pass through higher interest rates to borrowers...

[T]here are early signs of a deterioration in loan portfolios...

Adopting a strategy grounded in radical uncertainty... means building resilience in terms of capital, IT infrastructures, and operational resilience.

Claudia Buch, chair, ECB Single Supervisory Mechanism, March 2024

Box 3: minimum reserve proposals

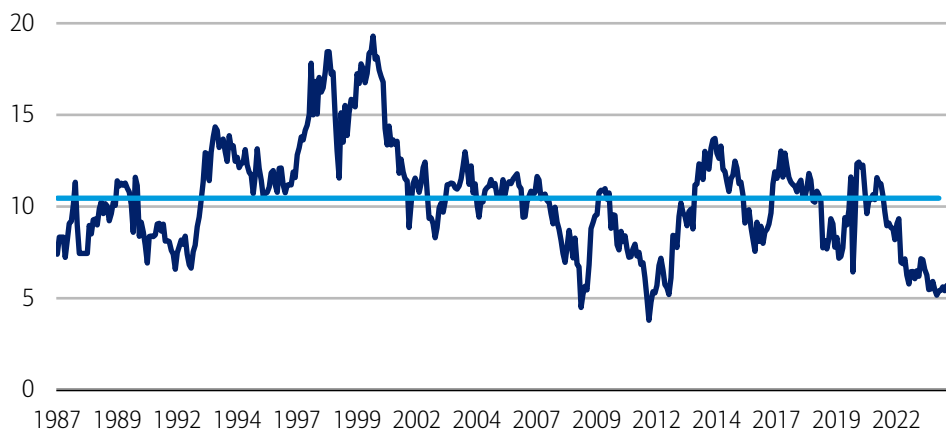
Firms currently need to hold 1% of certain liabilities — mostly customer deposits — at the ECB. In July, officials decided to stop paying interest on those holdings. At the time, some wanted the central bank to also raise the amount required from banks, arguing that 2% had been the rule before 2011.

Holzmann, one of the Governing Council's most hawkish voices, said "I'm thinking about 5%-10%,"

Bloomberg, September 2023

Exhibit 3: banks PE close to a 40 year low, still

Median 12 month forward PE (x), 1987-2024



Source: Eikon

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Box 4: ECB buffer preference

macroprudential authorities should preserve releasable capital buffers to ensure that they are available in the event that conditions in the banking sector deteriorate

Luis de Guindos, ECB, November 2023

Box 5: new Italian buffer

The Bank of Italy has launched a public consultation on a proposal to activate a systemic risk buffer (SyRB) of 1.0 per cent of domestic exposures weighted for credit and counterparty credit risks; the buffer requirement would apply to all Italian banks and banking groups... 0.5 per cent would need to be set aside by 31 December 2024, and the remaining 0.5 per cent by 30 June 2025.

Banca d'Italia, March 2024

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