BofA SECURITIES

European Banks Strategy

Peak nothing

Industry Overview

It takes time, by design

We don't see the end to interest rate hikes, should there be one, presaging the end of bank revenue growth. European bank balance sheets are built for interest rate changes to flow through over a typical five years. Less than two years into this cycle (Exhibit 2), with most hikes recent and central banks' moving to a "higher for longer" narrative, we see continued upgrades at the banks (Exhibit 42) and €53bn+ hedging revenues ahead (Exhibit 22).

Nil paid, 5 year duration money factories back in business

A serious de-rating (Exhibit 46) has consumed much of the 43% 2023E earnings upgrades the banks delivered over the last two years (Exhibit 45). For a traditionally cyclical sector, de-rating peak earnings would be nothing new. But for us, the opportunity is that we do not see these as peak earnings. And the restoration of liability income should in our view have supported a *re*-rating of the system: the combination of normalised pre-impairment profit (Exhibit 33) up by a half on the zero rate years, meeting structurally lower impairments (Exhibit 35) leaves bank earnings higher and less cyclical than for decades.

We know a lot more more about deposits

For a while in the Spring, it was fair to ask whether banks' deposit stability assumptions would hold. The combination of failures in US regional banks and the pace of rate hikes from zero was unprecedented. But with rates now stabilising, the chances of abrupt changes in depositor behaviours falls away quickly. And deposits have been remarkably stable, in the face of €1.4 trillion reduction in the ECB's balance sheet (Exhibit 6) and continued low rates paid (Exhibit 19. The income engine is back (Exhibit 20).

Better profits than America

2023 is set to be the first year in many (Exhibit 41) where European bank profits best American. This reflects low credit risk in European banks (Exhibit 27) and much lower bond portfolio challenges (Exhibit 11).

Normal profits and growth meet peculiar multiples

We see continued revenue growth beyond 2023E, in line with nominal GDP at 3% (Exhibit 44). This restores a normal situation for banks, after the negative rate years when revenues underperformed by 25% points (Exhibit 43). Again, normality restored, not peak anything. Cash distributions are sustainable at today's robust €102bn annual levels, we think (Exhibit 39). The only outlier really then is the multiple: a 6x 2024E PE and an 11% running cash distribution yield (Exhibit 38). We reiterate our positive view.

01 September 2023

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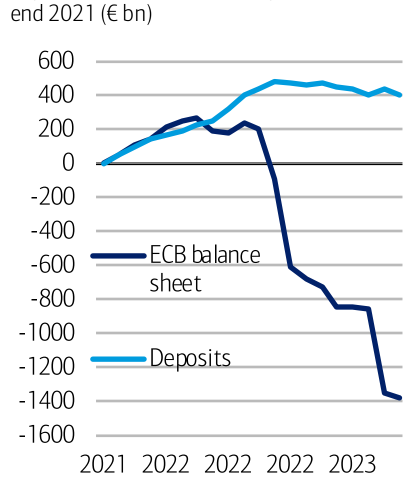
Exhibit 1: household and corporate deposits stable even as the ECB balance sheet has declined €1.4 trillion

Change in ECB balance sheet and euro area deposits, households and corporate, since end 2021 (€ bn)



Source: BofA Global Research estimates, ECB

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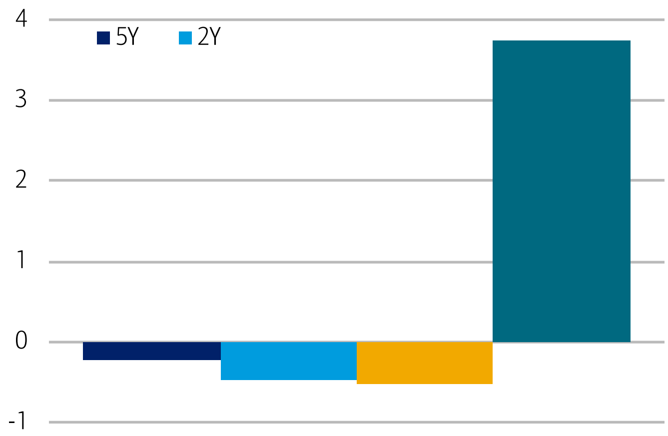
After the interest rate shock

That was the greatest interest rate cycle of forty years. There isn't going to be another like that for many years to come. This is not to suggest that interest rates will not rise another 5%. Further sharp hikes are not our expectation, but they certainly can happen. But to rise from negative levels this quickly (Exhibit 2) with the bond price collapses associated (Exhibit 3) just isn't likely from today's starting point.

Exhibit 2: two years ago, ECB rates were to be anchored to minus 0.5% for 5 years to come
Market Implied ECB Deposit rates as of September 2021 and realized (%)



Source: BofA Global Research, Bloomberg

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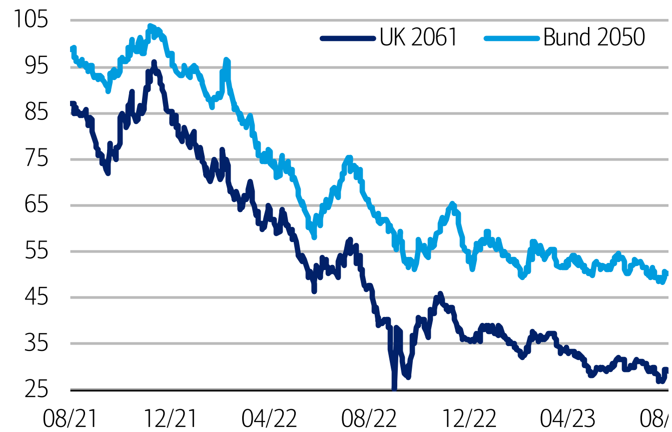
Exhibit 3: long bond prices down as much as 65 points
Long-dated UK and German bonds, price (c/ p) 2021-23



Source: Bloomberg

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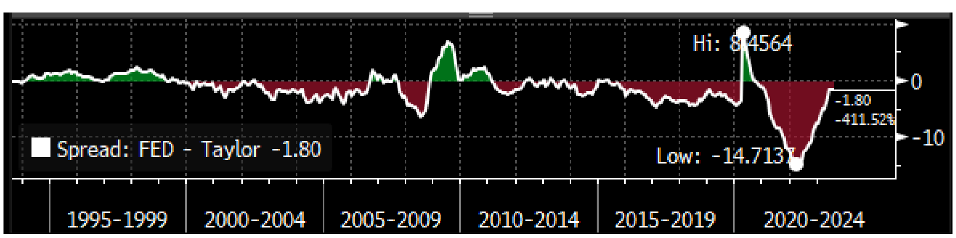
Certainly, the shock central banks experienced when it proved quite possible to create inflation through a combination of massive monetary expansion and fiscal stimulus will not be repeated for some years to come. Monetary policy is likely to be somewhat more symmetrical, now that rates have somewhat reconnected with historical precedents (Exhibit 4). Interest rates can fall as well as rise; the two are now relatively balanced for the banks.

Exhibit 4: spread between Fed Funds and Consumer Price Inflation now closer to historical levels
Taylor Rule and Fed Funds, spot CPI, last 30 years (%)



Source: Bloomberg

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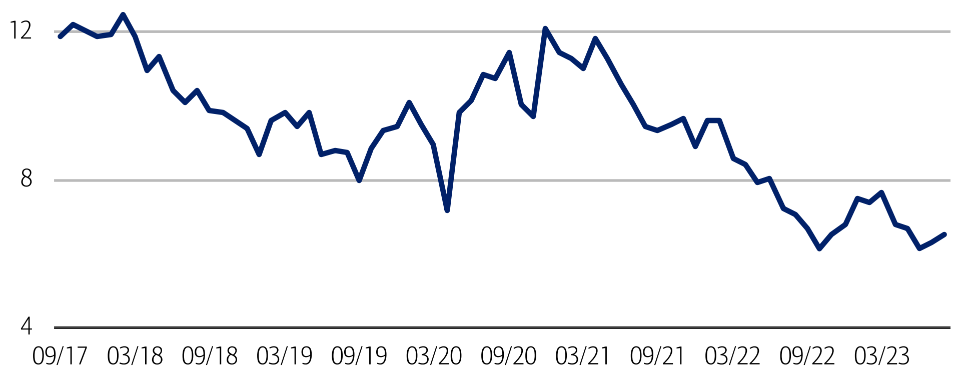
What did banks in Europe learn through this? Most important, that their deposit bases are valuable again – and stable.

Deposit assumptions de-risked

We're looking to explain to ourselves how the banks de-rated so much in the last couple of years (Exhibit 5), to historically exceptional levels.

Exhibit 5: European bank 12 month forward PE (x)
PE (x) 2017-23



Source: BofA Global Research estimates, company report

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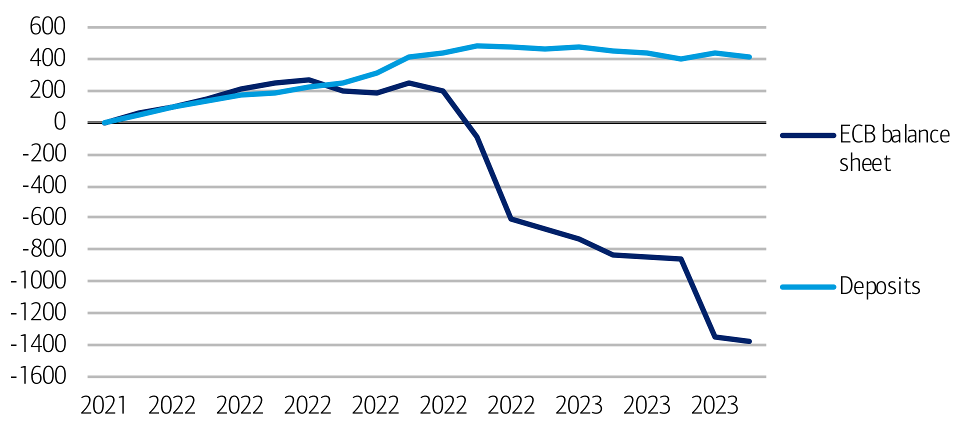
Our opening expectation would be that return of interest rates to historically recognisable levels restores bank earnings power, without any additional capital need. This is what has happened. The de-rating in part then must reflect market concern that deposit stability assumptions embedded in banks' business models may prove wrong. The events around Silicon Valley bank demonstrate the ruinous practical outcome of those assumptions being wrong. But if the interest-rate environment now is one of stability, it follows, we think, that predicting deposit behaviour becomes less risky. And actual deposit experience has been very favourable so far.

European deposit assumptions have been robust.

Exhibit 6 shows that deposit levels have remained close to their peak, even as the ECB has shrunk its balance sheet by €1.4 trillion.

Exhibit 6: household and corporate deposits stable even as the ECB balance sheet has declined €1.4 trillion
Change in ECB balance sheet and euro area deposits, households and corporate, since end 2021 (€ bn)



Source: BofA Global Research estimates, ECB

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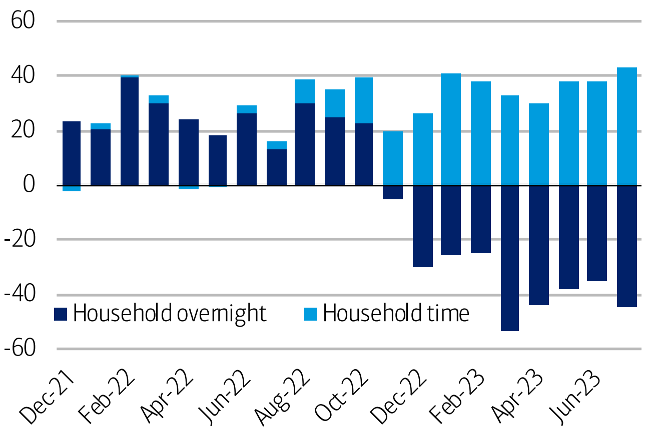
There has of course been deposit migration to higher-yielding term deposits, shown in Exhibit 7 and Exhibit 8.

Exhibit 7: euro area household deposit flows have been between mainly between types of deposits, rather than out of banks
Monthly net flows in euro area household deposits (€ bn) 2021-23



Source: BofA Global Research estimates, ECB

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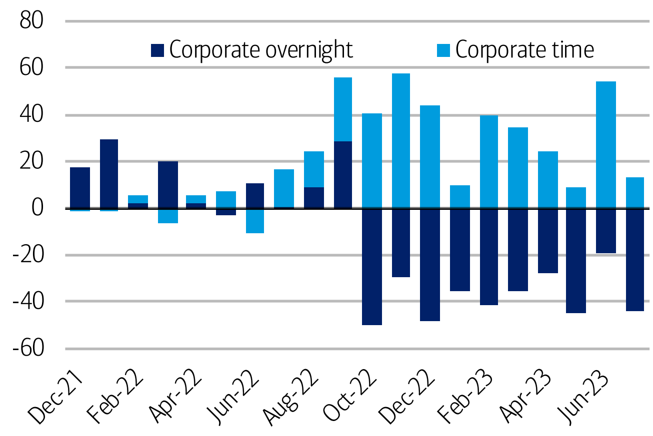
Exhibit 8: euro area corporate deposit flows have been between mainly between types of deposits, rather than out of banks
Monthly net flows in euro area corporate deposits (€ bn) 2021-23



Source: BofA Global Research estimates, ECB

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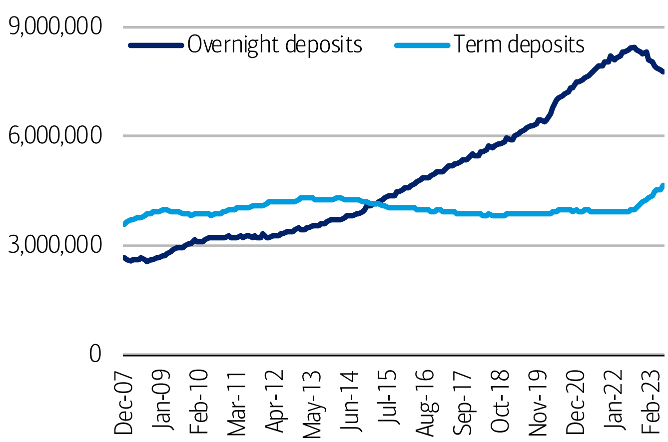
But as highlighted in Exhibit 9 and Exhibit 10, the radical improvement in the deposit mix and the loan to deposit ratio since the global financial crisis have been sustained. European banks need incremental deposits much less than historically, so can focus on optimising profitability on both sides of their balance sheet.

Exhibit 9: deposit mix: overnight deposits 67% greater than term, from 25% smaller
Euro area household and corporate deposits, 2007-2023 (€ mn)



Source: BofA Global Research estimates, ECB

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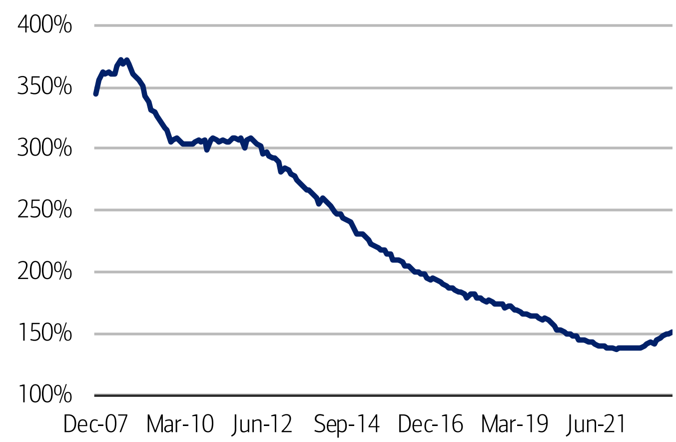
Exhibit 10: loans now 1.5x overnight deposits from almost 4x in 2007
Euro area household and corporate loans, % overnight deposits, 2007-2023 (€ mn)



Source: BofA Global Research estimates, ECB

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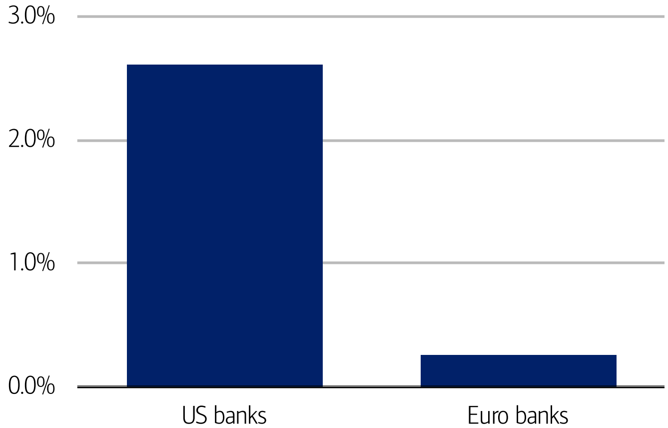
Robust experience in hedging

European banks have proven robust in their deposit assumptions and prudent in their interest-rate hedging. Exhibit 11 and Exhibit 12 compare the experience of the US and European banks in this context.

Exhibit 11: US bond losses much greater than those in Europe, through the asset lens

Held to Maturity and Available for Sale marks not realised through regulatory capital, % assets, March 2023



Source: BofA Global Research estimates, FDIC, ECB, Gruenberg speech, 6 March 2023

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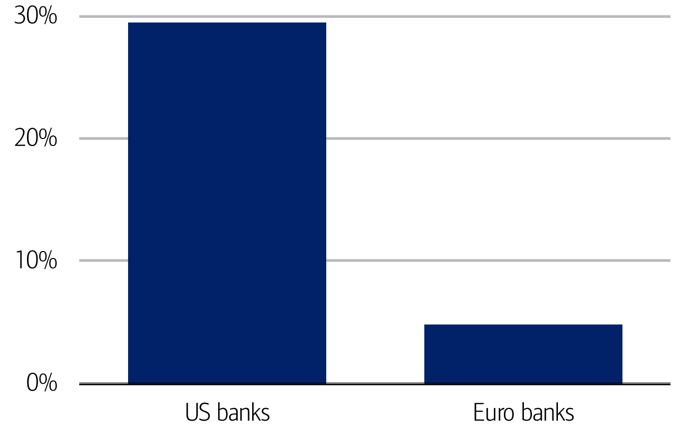
Exhibit 12: US Held to maturity losses much greater than those in Europe, through the Tier 1 lens

Held to Maturity and Available for Sale marks not realised through regulatory capital, % Tier 1 capital, March 2023



Source: BofA Global Research estimates, FDIC, ECB, Gruenberg speech, 6 March 2023

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Two major wins

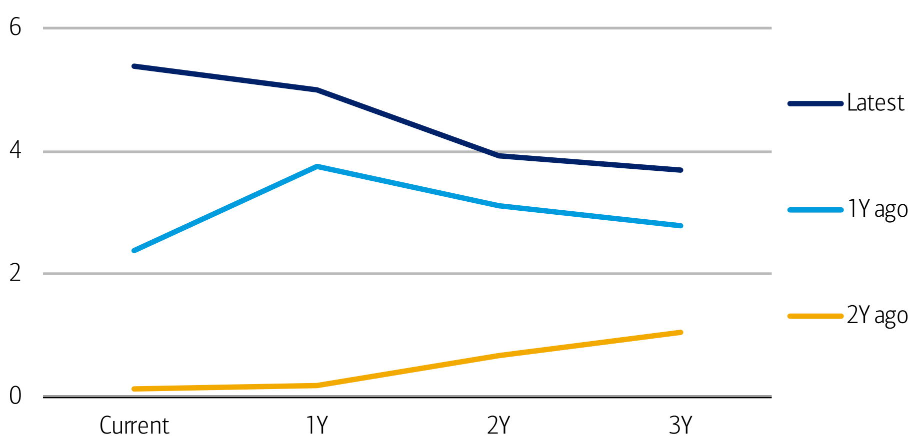
These are two major wins for European banks. Their deposit profitability has returned; and they did not have excess duration on their balance sheets. Either could have sustained a multiple re-rating for the industry; the combination of both really should have, we think. The opportunity is therefore we think for a re-connection of bank stocks with historical average multiples.

Of course there will be higher Betas

We do see rising deposit betas and some banks may see margins decline. But the risk of the banks' business model being exposed is rapidly receding. Into this, we arrive at central banks higher for longer (Exhibit 13). This is earnings accretive to banks, through cash yields remaining elevated longer than we had expected, and reinvestment yields on hedges being higher than embedded in our forecasts.

Exhibit 13: US$ Fed Funds set to remain higher for longer

Market Implied Fed Funds rate (%) out to 3 years, latest and a year and two years ago (%)



Source: Bloomberg

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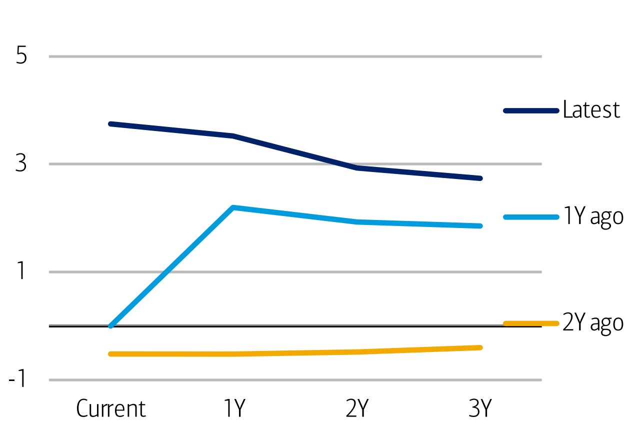
The other way up: peak rates followed by sharp declines

In addition to the fear of rising rates causing bank deposit or held to maturity loss issues, European banks have also struggled in the market's perception with the endless debate about peak rates. In this version of bank risk, somehow the opposite of the other, policy rates fall quickly. The story of the last 12 months has been a constant lifting of the level to which rates are going, but because futures curves have always pointed down within a few months, this worry has remained alive (Exhibit 14, Exhibit 15).

Exhibit 14: euro rates set to fade but to above where they were expected to peak a year ago
Market Implied ECB deposit rate (%) out to 3 years, latest and a year and two years ago (%)



Source: Bloomberg

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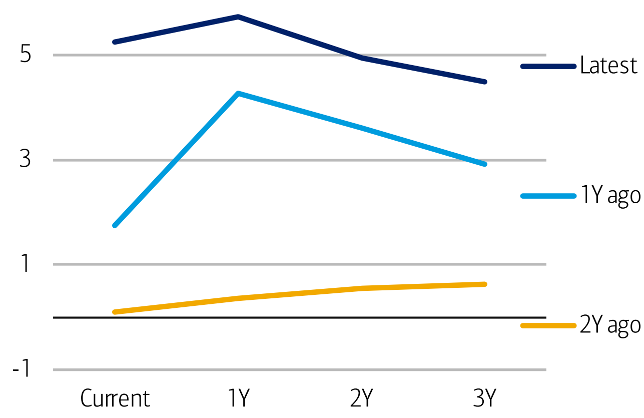
Exhibit 15: sterling rates set to fade but only to where they were expected to peak a year ago
Market Implied Bank of England Bank Rate (%) out to 3 years, latest and a year and two years ago (%)



Source: Bloomberg

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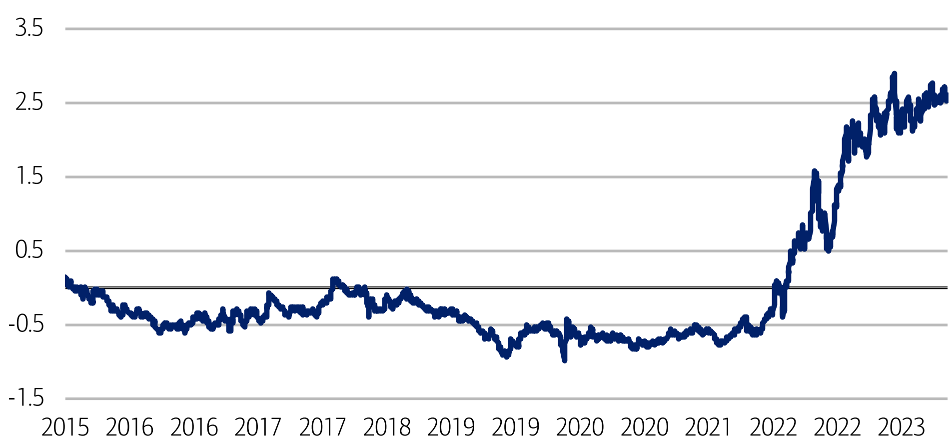
Nil paid, five-year money factories

For us, the risk of an outcome where rates return to zero has faded sharply. Today's yield curves and rates forwards are still in the same broad 'hill' shape as those of a year or two ago, but the substance is completely different.

Banks Achilles' heel is their inability to make money from deposits when rates are zero and yield curves similarly close to nothing. In short, banks are factories that produce nil paid, five-year money. When central banks made have nil-paid, five-year money widely available, banks were challenged. A return to zero is now not foreseen at any point in forward curves. Those bank money factories were unprofitable for 15 years and are now back in business.

Exhibit 16: five year money was free from 2015-22. Now it's expensive again
Euro area generic 5 year sovereign yield (%) 2015-23



Source: Bloomberg

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A bit lower? Absolutely fine

Rates falling somewhat from here is absolutely fine for banks. We are now far enough from zero that the point at which rates become problematic is beyond our investment horizon. Indeed, now that it has been proven to central banks that monetary and fiscal stimulus can indeed always create inflation, the underlying driver of zero rates – a fear of deflation – may have been removed for decades to come.

A new narrative: Dales, not mountains

Central banks themselves seem to have changed their narrative from peak rates to, well, something else. They are clearly not sure: Box 1 is a stark contrast in ECB rhetoric from the 2014-21 era of seeking to dominate the entire yield curve.

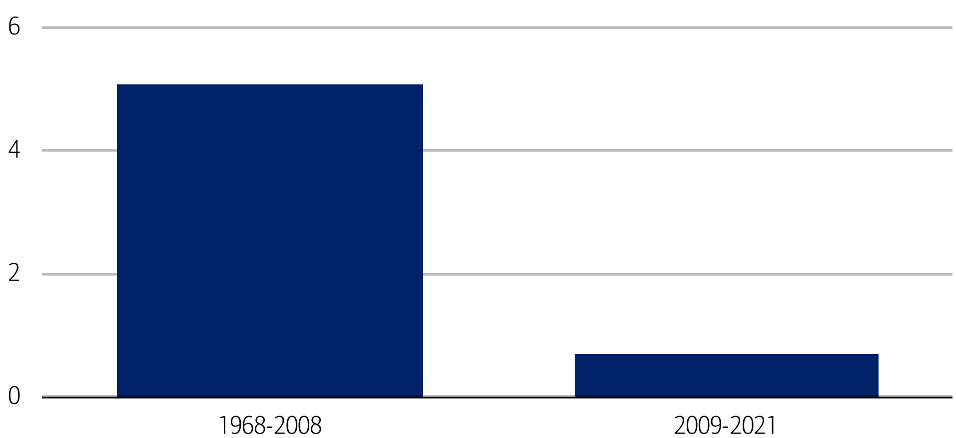
Box 1

> To my mind there are three key elements: clarity, flexibility and humility.
> First, we need to provide clarity on our objective, and on unwavering commitment to deliver on it. But in order to achieve our goals, we need flexibility in our analysis…
> The third element that is crucial in this new environment is humility… we should be clear about the limits of what we currently know and what our policy can achieve… Research suggests that households trust central bank forecasts less if their recent performance has been poor
> *Christine Lagarde, president, ECB, Jackson Hole August 2023*

We think the shift itself is important. If there were a single rise in rates, followed by a peak and a sharp decline, that would have had one set of outcomes for bank margins. Something more like the Dales, in Yorkshire and Cumbria in northern England, where there are plenty of peaks and valleys, but at a generally high level, and in no particular order, may be more useful for thinking now.

For banks, rates generally between 2- 3% and 5-6% are very happy places. Given the hedging of their books, as discussed next in this report, rates coming down would not be strongly associated with margin declines, as hedges mature. And rates may then be going up again relatively quickly. Changes in rates are also very good for banks' heart rate. Many changes provide many gapping opportunities, shown in Exhibit 17.

Exhibit 17: 7x as many rate changes in the era of inflation vs the era of perceived deflation risk
Bank of England annual average number of rate changes, 1968-2021



Source: BofA Global Research estimates, Bank of England

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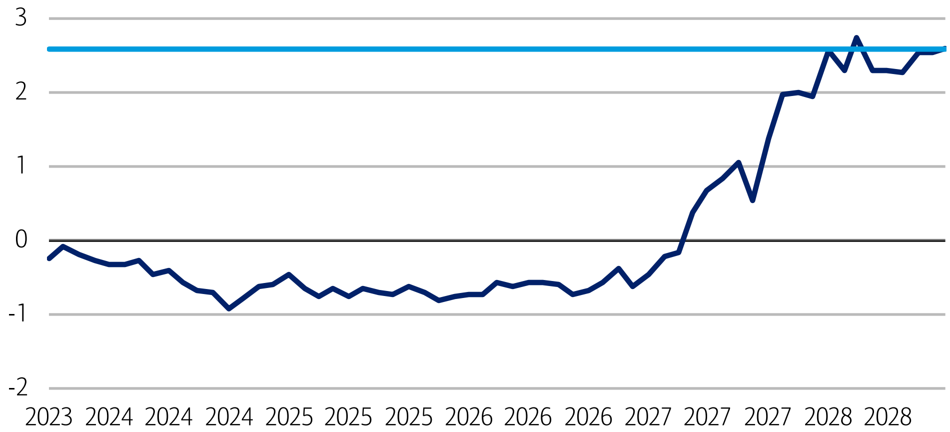
A year and a bit into the five

Bank balance sheets in Europe are designed to take perhaps five years for a change in interest rates to be fully reflected. We see the idea that rates rise a lot in a short time as they have, and then a peak in rates equals a peak in bank margins and revenues is not likely. Other things being equal, bank margins continue to rise for another three or four years as the changed interest-rate environment flows through. Exhibit 18 illustrates.

Exhibit 18: it's the end of 2027 before 5 year bond maturities reach today's yield – and the lowest-yielding bonds are maturing in the next 18 months
Euro 5 year bond yield (%), lagged five years and compared with current yield (%)



Source: BofA Global Research, Bloomberg

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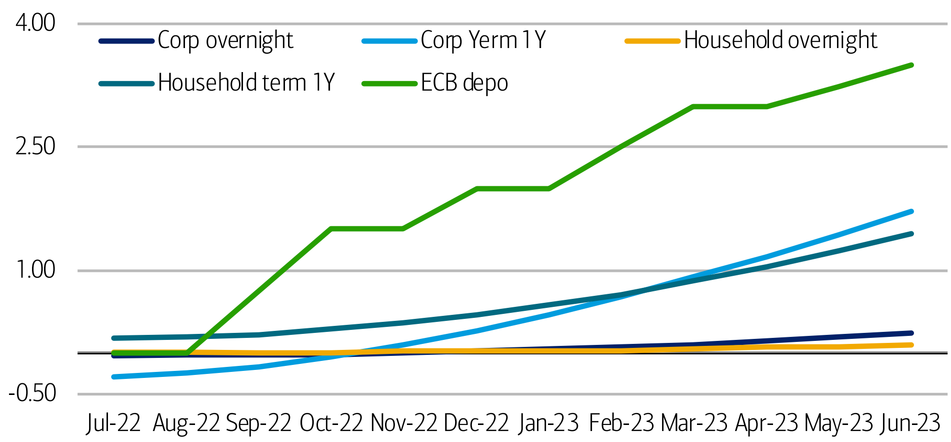
Banks hedge differently. Some in swaps; some in government bonds; others through a portion of their fixed rate mortgage books. The language banks use to express their duration is also highly idiosyncratic. And there is a wide spread of duration appetite within the average of five years or so. But the essential point is banks now have multiple drivers to income:

- Deposit spreads are likely compress (Exhibit 19), but with their strong deposit positions, banks are well positioned to allow some deposit outflows in order to protect what is now good profitability

Exhibit 19: banks have weathered the interest rate storm and restored deposit spreads
Overnight and term deposit rates, compared with ECB deposit rate (%) 2022-23



Source: BofA Global Research estimates, ECB

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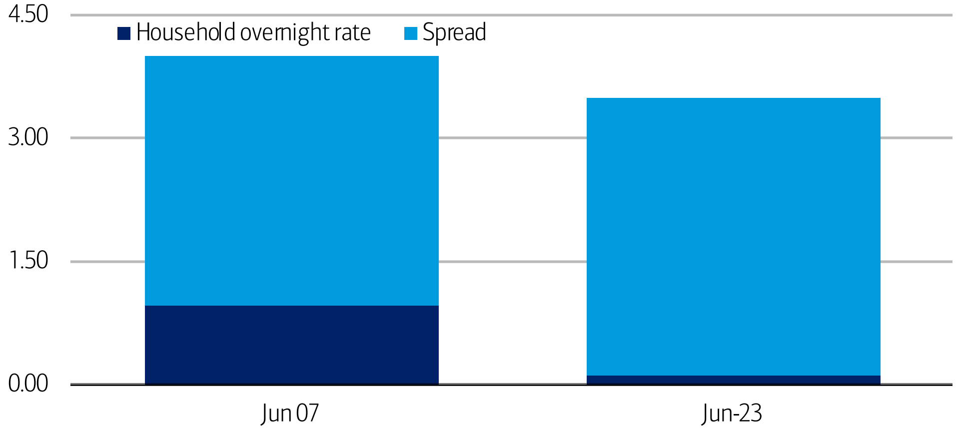
- We see banks able to justify their household deposit spread, now modestly above the level immediately before the financial crisis (Exhibit 20).

Exhibit 20: euro area bank overnight deposit spreads modestly above those of 2007
ECB policy rate decomposed into rate paid to overnight household deposits and bank spread, 2007 and 2023



Source: BofA Global Research estimates, ECB

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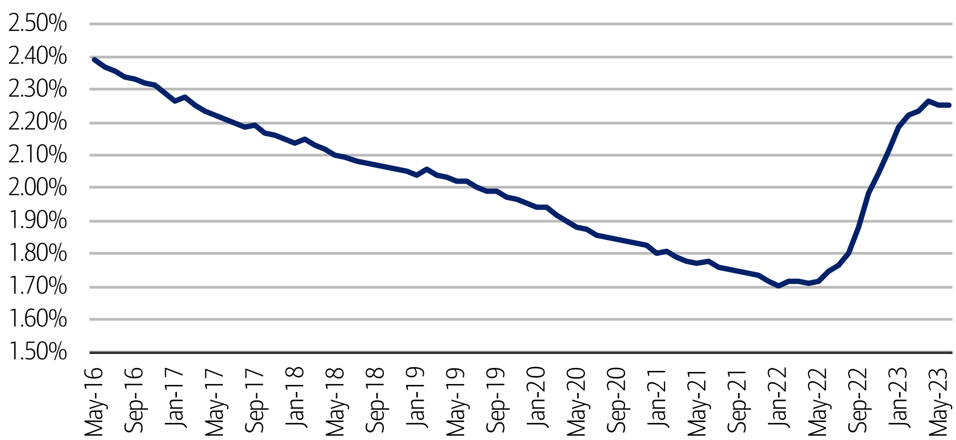
- We show in Exhibit 21 that there is no sign of excess return in the European banks spreads – rather, an unwind of the compression of the negative rates era

Exhibit 21: euro area loan and deposit customer spread has recovered most of its negative rate era losses
Yield on loans less rate paid on deposits (%) 2016-2023, euro area banks



Source: BofA Global Research estimates, ECB

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- Hedges roll onto higher yields for some years to come. European banks we cover hold around €6 trillion in Current and Savings Accounts (demand deposits). Assuming a modest 25% hedge, the reinvestment revenue ahead could be €53bn (Exhibit 22). This represents 8% on 2023E industry revenues

Exhibit 22: €53bn potential hedge revenues ahead
European banks Current and Savings Accounts and hedging (€ bn)

CASA	6,000
Hedged	25%
Reinvestment pickup	3.50%
Additional revenue	52.5

Source: BofA Global Research estimates

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- Banks may be able to grow volumes in the higher nominal-GDP environment

- Capital markets revenues are depressed and could recover

- Asset management revenues are depressed and could recover

In short, banks have enjoyed one thing returning – deposit spreads. Many of the other income streams have been weak through this recovery, while hedge revenues are designed to lie ahead. To assume that the deposit income fades and nothing else recovers is a pessimistic approach. It would need, we think, new regulatory headwinds. We now turn to why we think these are not likely to materialise in Europe.

Not the LCR

The finalisation of Basel III currently underway is the end of the global regulatory agenda (see Box 2).

Box 2

The implemented Basel III reforms have greatly enhanced the resilience of the global banking system, with total leverage in the banking system halving from about 30x to 15x since 2011. Banks' holdings of liquid assets have more than doubled during this period and now stand at €12.5 trillion. These reforms have helped contain the fallout of the recent banking stress events.
But these events have also highlighted areas of "unfinished business", including as it pertains to the robustness and credibility of banks' reported risk-weighted capital ratios. The Basel III reforms finalised in 2017 seek to address these and other fault lines, which remain as material today as they did six years ago. Therefore, implementing the outstanding Basel III standards in a full and consistent manner in all jurisdictions is a critical step towards safeguarding the resilience of our banking system.
Pablo Hernández de Cos, Chair of the Basel Committee on Banking Supervision, April 2023

Europe is implementing the Basel III finalisation over the next several years and the capital drag on the banks is included in our forecasts. Yet, we believe that the market continues to worry about further regulation could still emerge. Two areas are in focus: proposed higher capital requirements in the US; and the experience of liquidity for some banks earlier in 2023. We start with liquidity:

1. LCR was a key focus

We think 2023 has shown the Liquidity Coverage Ratio (LCR) to be a poor guide to judging a bank's liquidity. In perhaps a classic regulatory cycle, banks in 2008 were found to be illiquid – some with terminal results (Exhibit 23).

Exhibit 23: Northern Rock in 2006 had £1bn cash and £61bn debt outstanding
Key balance sheet items, Northern Rock, 2006 (£ bn)

Cash	1	Debt	61
Loans	87	Deposits	27
		Equity	2

Source: company

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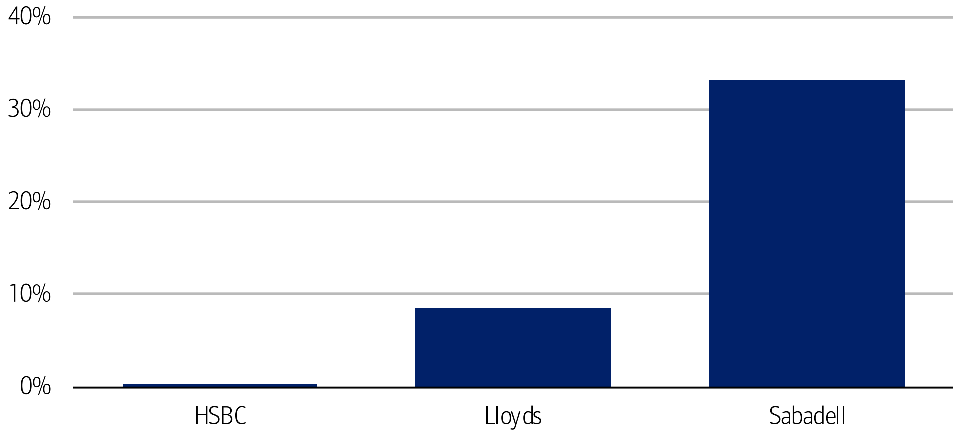
A period of discussion after 2008 resulted in a fixed table to calculate liquidity, which banks fill in to deliver the LCR. Building liquidity to meet LCR demands became a key focus over 2013-18. According to the Basel committee, this has sucked up US$7 trillion of cash, now unavailable for use elsewhere – see European Banks Strategy: Earnings upgrades, dividend increases, more buybacks - meet depressed multiples 15 May 2023 (report link).

However, when banks fail with a 150% LCR, such as was the case with Credit Suisse, it is clear that other liquidity metrics may also be important. In particular, the LCR does not take eligibility of collateral for central bank refinancing into account. We understand why - because central banks may not wish their own eligibility rules to determine banks' liquidity planning. However, looking through this alternative and relevant lens, some banks have a great deal more potential liquidity access than others. Exhibit 24 illustrates.

Exhibit 24: encumbered loans, % deposits 2022
HSBC has not encumbered almost any of its loans



Source: BofA Global Research estimates, company report

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Less LCR, not more

We believe that far from banks being expected to hold higher levels of LCR, as seemed possible immediately after Silicon Valley, a de-emphasising of LCR by the market and supervisors is likely. This will introduce complexity into bank analysis, but may not require banks to hold more liquid assets. Overall, the dramatic build in deposits relative to loans at European banks since 2008 shown in Exhibit 10 has transformed the system's liquidity position.

New liquidity conditions

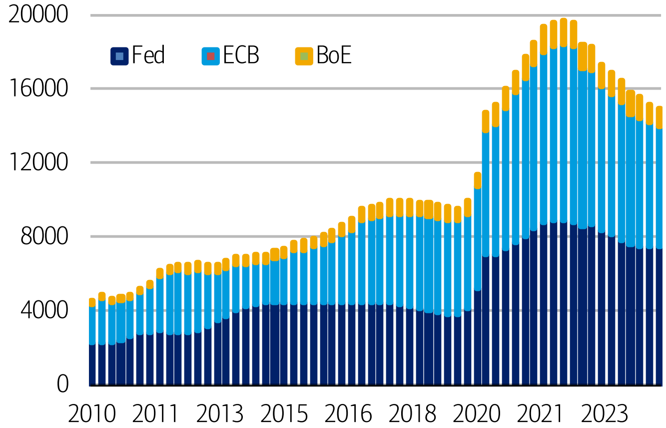
What could change this? The next 12 months is set to see continued central bank balance sheet run down ("Quantitative Tightening", or QT, Exhibit 26). Having begun the process without specific problems associated with the sale itself, central banks are increasingly confident they can run smaller balance sheets (Box 3).

Box 3

> To give my conclusion up front, I see potential to increase slightly the pace of gilt stock reduction…
> The empirical evidence we have so far supports the theory: the overall impact of QT on gilt yields appears to have been small.
> *Bank of England, July 2023*

Indeed, the debate has been opened by central banks on whether to move from monetary policy based on abundant reserves to one based on reserve scarcity, as prevailed in many countries before the financial crisis. Banks had no problem operating in such a pre-crisis low cash environment. However, the interaction between liquidity and funding demands and central bank balance sheets has not been tested. If banks are generally not able to consider collateral eligibility in the regulatory calculations, we could see strains emerging as the monetary policy of central banks drags in one direction, while the supervisory arm continues to haul in the other. This may be a distant issue, but is one we have a keen eye on.

Exhibit 25: central bank balance sheet contraction to remain rapid
Fed, ECB and Bank of England total assets, US$ bn, 2010-24E



Source: BofA Global Research estimates, central banks

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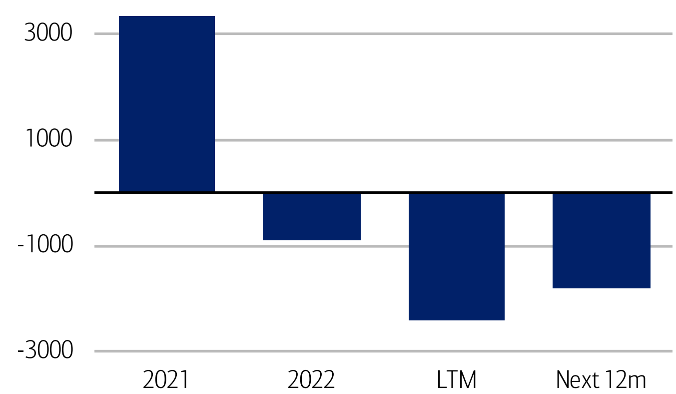
Exhibit 26: pace of Quantitative Tightening to slow modestly
Change in Fed, ECB and Bank of England total assets, US$ bn, 2021-24E



Source: BofA Global Research estimates, central banks

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2. Regulation: neutral is a positive

We also intend to return to regulation in subsequent work, as the Fed progresses with its Notice of Proposed Rulemaking (NPR). We think that there are two essential regulatory conclusions for European banks at present.

- First, the European structures are committed to fully implementing the Basel rules, as laid out some years ago. We include in our forecasts the assumed increases in risk-weighted assets that result. But there is no further agenda in Europe, the banks having performed well through a period of intense interest rate and economic change.

- Second, the Fed proposes to limit or remove models for American banks (see Box 4). One implication would we think potentially to leave certain low risk assets requiring more capital at US banks than at those European banks with relevant models. Basel does not seek to remove models, although the rollout of output floors does limit the overall benefit models can deliver on a consolidated basis. Should the NPR become policy as currently proposed, this may be a structural change to the benefit of the internationally active European investment and wholesale banks who have persisted through a difficult 15 years.

Box 4

> In particular, the proposal would standardize aspects of the capital framework related to credit risk, market risk, operational risk, and financial derivative risk.
> *Federal Reserve, July 2023*

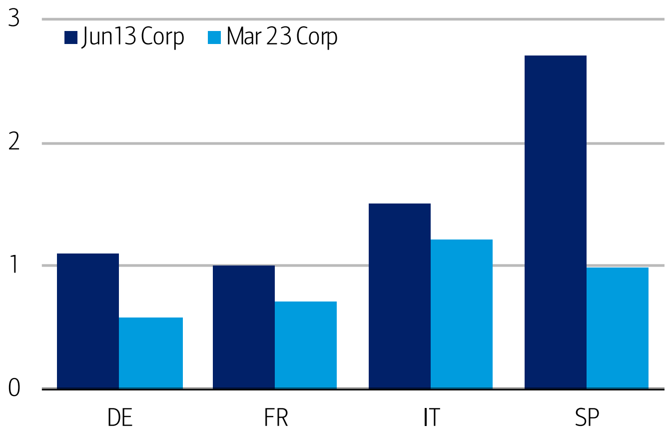
If regulation is fading as a theme in Europe, what of the perennial question for banks – their credit risk? The recession that has been just around the corner since early 2022 could finally arrive. We turn to why we remain confident in the bank earnings picture should this occur.

Bad debts a faded issue

Banks loan book is of better quality than for many years: Exhibit 27 and Exhibit 28 show European Banking Authority data for Probability of Default. We look at the 50th percentile of the book, to capture the midpoint of the performing portfolios. These show a significant reduction in PD across all of the four major economies, in both retail and corporate lending.

Exhibit 27: corporate Probability of Default is down 19-63%

Corporate loan books 50th percentile Probability of Default, 2013 and 2023 (%)



Source: BofA Global Research estimates, EBA

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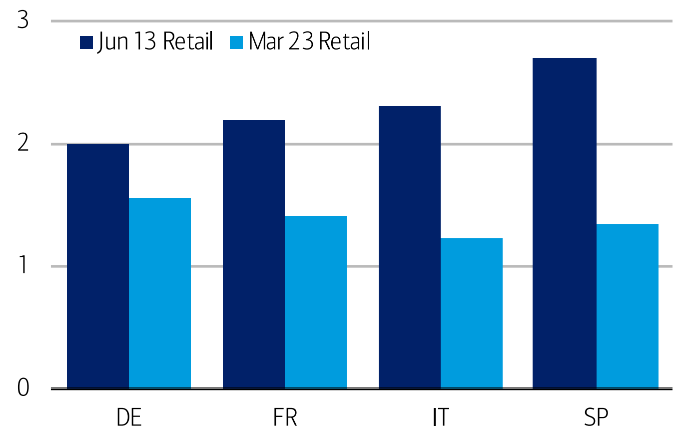
Exhibit 28: retail Probability of Default is down 22-50%

Retail loan books 50th percentile Probability of Default, 2013 and 2023 (%)



Source: BofA Global Research estimates, EBA

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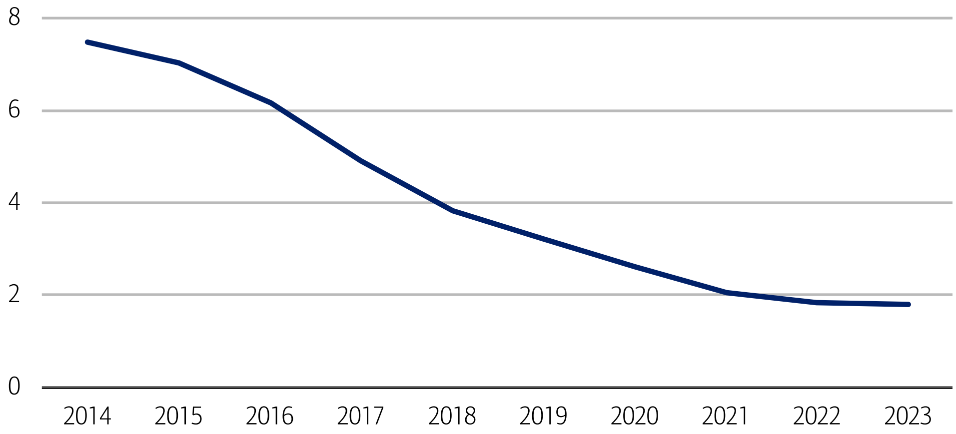
As we have shown previously in European Banks Strategy: Year ahead 2023: income up, profit up, dividend up, multiple up. Buy banks 30 November 2022 (report link), banks' bad debts will in any event be much lower, per unit of GDP shock than in previous cycles. This reflects three fundamental differences.

- First stress testing forced higher risk loans out of bank balance sheets into the non-bank sector
- Second, macroprudential rules reduced consumers ability to take on excess debt. Examples include loan to value, loan to income, minimum deposit, debt service to income and so on.
- Third, banks' level of non-performing loans is now low (Exhibit 29) and in the post-crisis era, pre-existing NPLs contributed half of the charges.

Exhibit 29: Non Performing Loans (NPLs) are down by three quarters since 2014
Euro area NPL %) 2014-23



Source: BofA Global Research estimates, ECB

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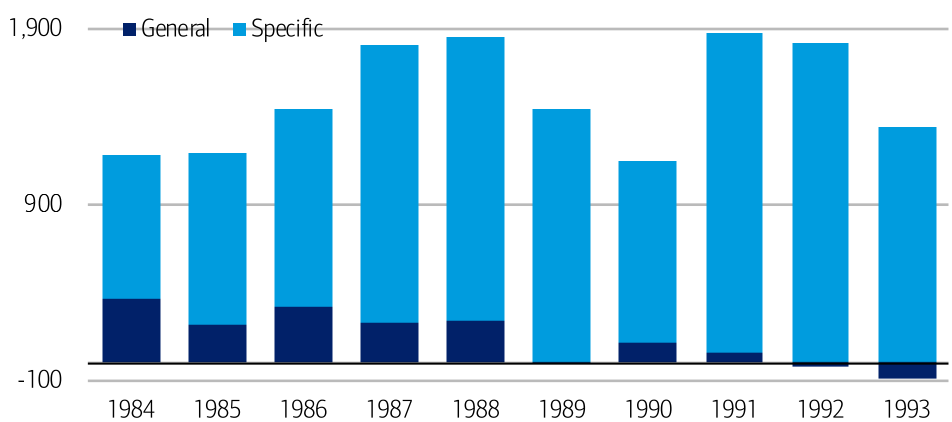
We recognise that the market's experience of bad debts is not one-sided though: banks have typically had to build loan loss reserves relative to potential loan losses in the last decade. This reflects a reversal in accounting policy: heading into the financial crisis, accounting rules limited banks to recognising losses when impairments were clear. This was itself a significant change from the rules applying a decade or two before, when banks were encouraged to make general provisions in good times and draw them down in bad, smoothing the P&L (Exhibit 30).

Exhibit 30: NatWest provisions used to be smoothed by general reserving
NatWest P&L impairment charges by bucket, 1984-1993 (£ mn)



Source: BofA Global Research estimates, company report

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The current rules are complex but in short require banks to make some provisions whenever economic circumstances look likely to deteriorate. This brings forward the P&L impact and raises the typical level of provision coverage to actual problem loans. Regulatory expectations that the banks will sell problem loans also accelerate loss recognition. The net impact is that banks have had to build reserves for this too. This is a current strength we think: banks carry more provisions against a given loan book than they used to over the late 1990s to mid-2010s, making loan losses from that period less representative of today's outlook.

Additional reserves on top

In addition, we can also see the banks in general hold significant overlays, analogous to historical general provisions, which are not really a part of the accounting set up, but have been widely used in practice (Exhibit 31).

Exhibit 31: many banks carry management overlays
Bank judgemental or overlay provisions (local currency, bn, 2Q 23)

	Management overlays
Unicredit	1.8
Intesa	0.9
Banco BPM	0.2
Santander	0.0
BBVA	0.2
CaixaBank	1.1
BNPP	0
SocGen	1.4
CAsa	1.5
ING	0.6
ABN	0.2
KBC	0.4
Commerzbank	0.5
Deutsche Bank	0.1
Barclays	0.6
Lloyds	0.5
NatWest	0.5

Source: BofA Global Research estimates, company report

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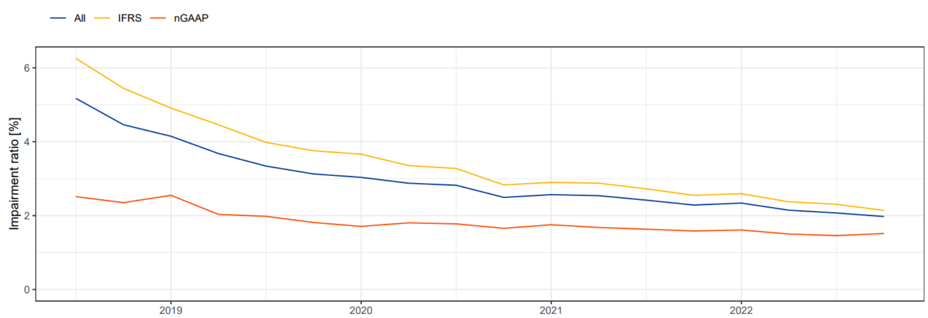
In the round, Exhibit 32 shows that current accounting has resulted in banks holding a materially higher stock of provisions against their problem or potentially problem assets than local accounting standards would have required.

Exhibit 32: banks have higher impairment provisions under IFRS9
IFRS9 provision stock continually higher than under national accounting standards (%)



Source: ECB Working Paper, Same same but different: credit risk provisioning under IFRS 9

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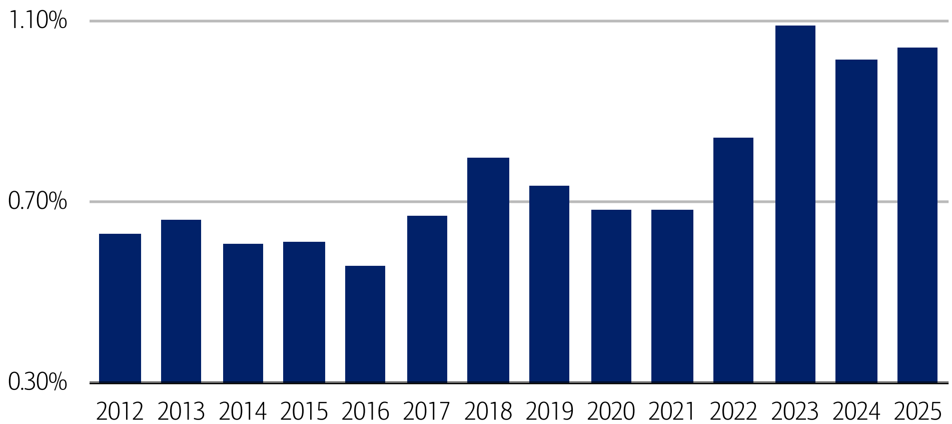
This should leave a system with structurally lower impairments and less risk of a P&L spike, thanks to the existence of "general" reserves already.

Moving, then, to cashflows and valuation…

Higher less-cyclical earnings, higher free cashflow

Banks have recovered deposit revenues, their highest quality earnings stream. We think it continues to grow if forward curves are realised. This returns pre-impairment profit back to levels seen in earlier decades. As illustrated in Exhibit 33, this has lifted pre-impairment profits by a half.

Exhibit 33: pre-impairment profits set to rise by a half compared with the zero rate era
European banks Return on Assets, pre-tax and pre-impairment (%) 2012-25E



Source: BofA Global Research estimates, company report

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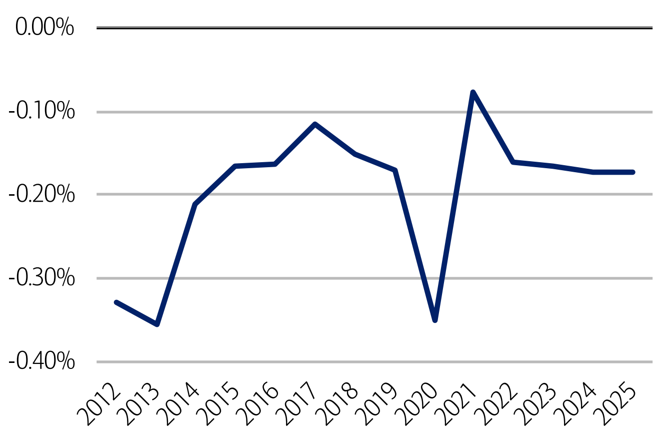
As discussed above, we expect credit costs to be structurally lower – half of the level experienced over 2012-19 (Exhibit 34). The combination results in Exhibit 35, with pre-impairment profits set to consume only 17% of pre-impairment profits, less than a half of the levels we think the market is using as its benchmark.

Exhibit 34: impairments set to be structurally lower
Impairments, % assets, 2012-2025E



Source: BofA Global Research estimates, company report

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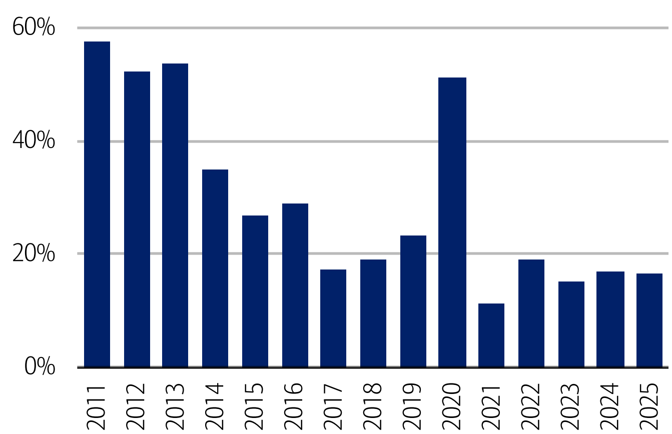
Exhibit 35: bad debts consumed 37% of pre-impairment profits for a decade, now set to be 17%
Impairments % pre-impairment profits, European banks, 2011-25E



Source: BofA Global Research estimates, company report

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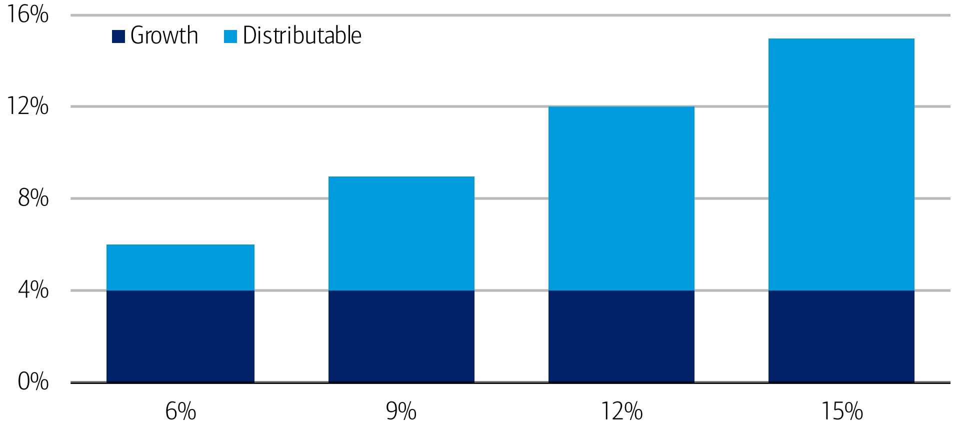
This means the bank earnings are set to be higher and less cyclical than for many years. Higher returns on equity mean higher sustainable distributions, as a constant amount of retained earnings are required for balance sheet growth – illustrated in Exhibit 36. A bank with a 12% Return on Common Equity Tier 1 has 4x the free cashflow as a bank with a 6% ROCET1, assuming a steady 4% growth rate.

Exhibit 36: a bank with a 12% ROCET1 has potentially 4x the distributable profit of one with a 6% ROCET1

Distributable profits, % points of Common Equity Tier 1, assuming steady 4% growth rate and solving for a stable capital ratio



Source: BofA Global Research estimates

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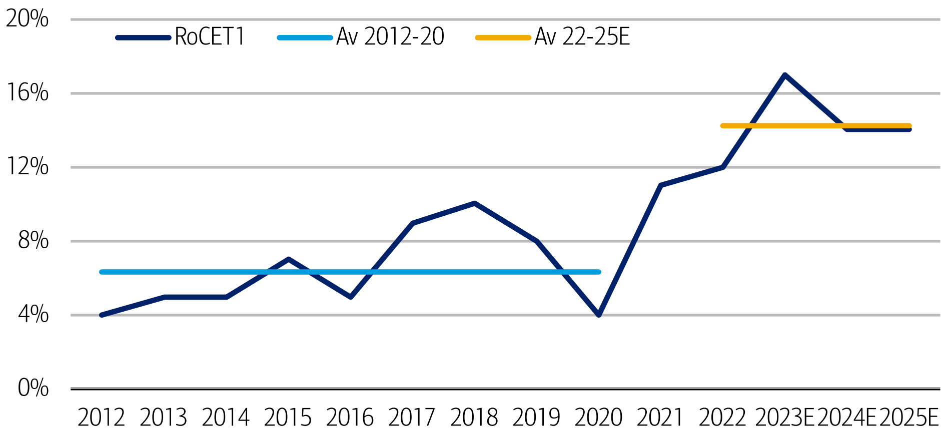
This closely resembles the picture for the European banking sector. We show in Exhibit 37 how the system averaged a 6% Return on Common Equity Tier 1 over 2012-20 and is set to average 13% over 2022-25E.

Exhibit 37: Returns now double those of the zero rates era

European bank Return on Common Equity Tier 1, 2012-25E



Source: BofA Global Research estimates, company report

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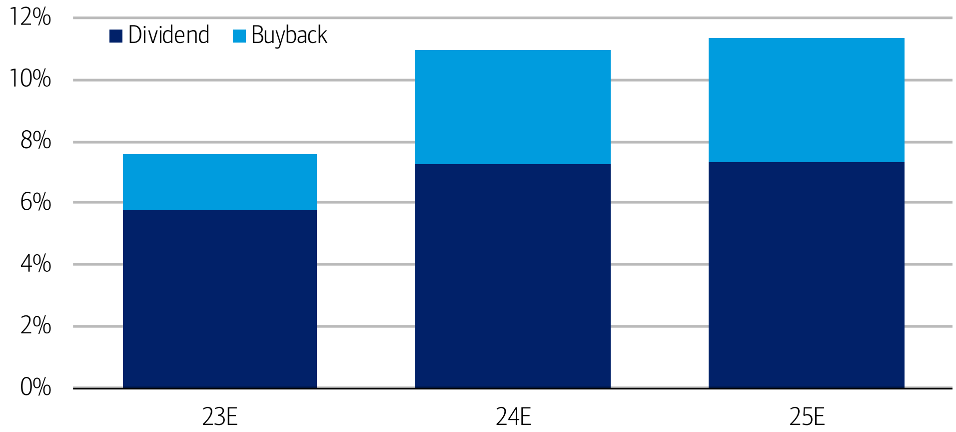
Cash, cash, cash

We see the system delivering a sustainable 11% cash yield in 2024E, shown in Exhibit 38.

Exhibit 38: cash yield at 11% per annum
European banks: dividend and buyback yield (%) 2023-25E. 2023E only remaining dividend and buybacks included; more than €25bn already returned YTD



Source: BofA Global Research estimates. 2023E only remaining dividend and buybacks included; more than €20bn already returned YTD
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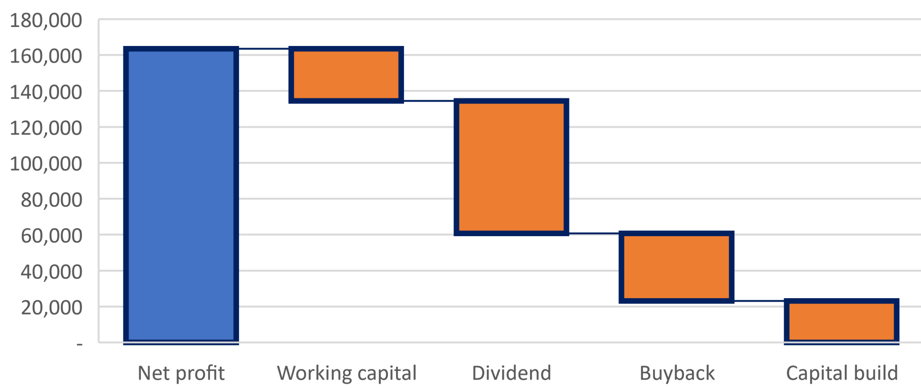
European banks paid €51bn in distributions in 2018. The doubling to €102bn in 2024E is sustainable we think, because of the free cashflow dynamics. We expect the banks to build capital over the year, net of the working capital need for balance sheet growth (Exhibit 39).

Exhibit 39: €102bn 2024E distributions still allow for working capital and capital build
European banks net profit 2024E and uses (€ mn)



Source: BofA Global Research estimates
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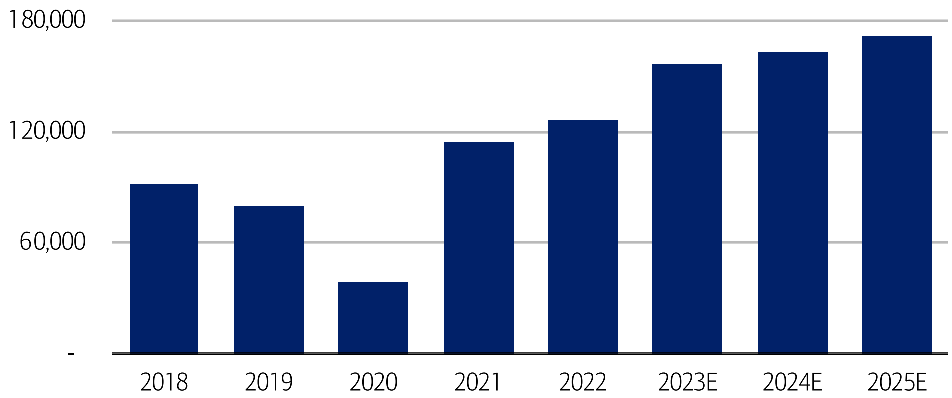
This makes a robust value case for the banks, we think. Earnings in 2024E are set to be roughly double those of the years of zero rates (Exhibit 40), supporting volume growth and high payouts.

Exhibit 40: European bank net profits set to be double the zero rate years
European banks net profit 2018-25E (€ mn)



Source: BofA Global Research estimates, company report. Excludes one-time gains at UBS 2023E
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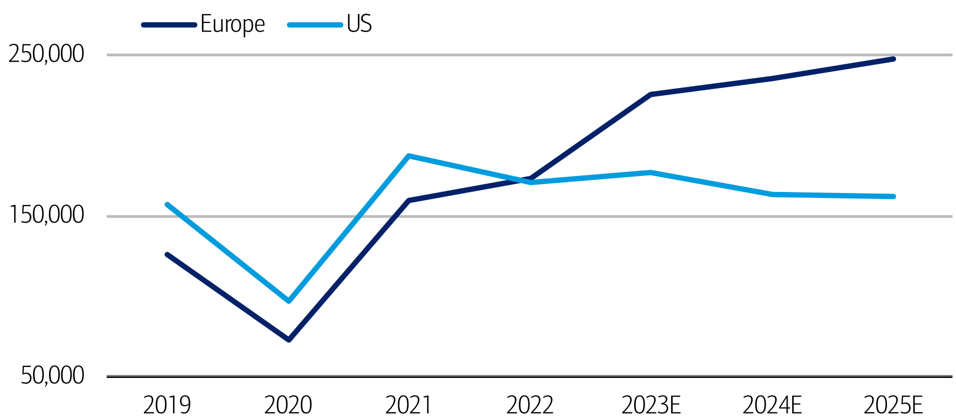
Better than America

In absolute profit terms, we see European banks delivering €85 billion a year more in earnings than the US banks by 2025E, as shown in Exhibit 41. This is the reverse of what was true for many years.

Exhibit 41: European banks set to deliver 50% more profit than American banks
Profit Before Tax, €, 2022-25E, banks



Source: BofA Global Research, Bloomberg. Europe 2023E excludes net badwill and other acquisition-related P&L at UBS
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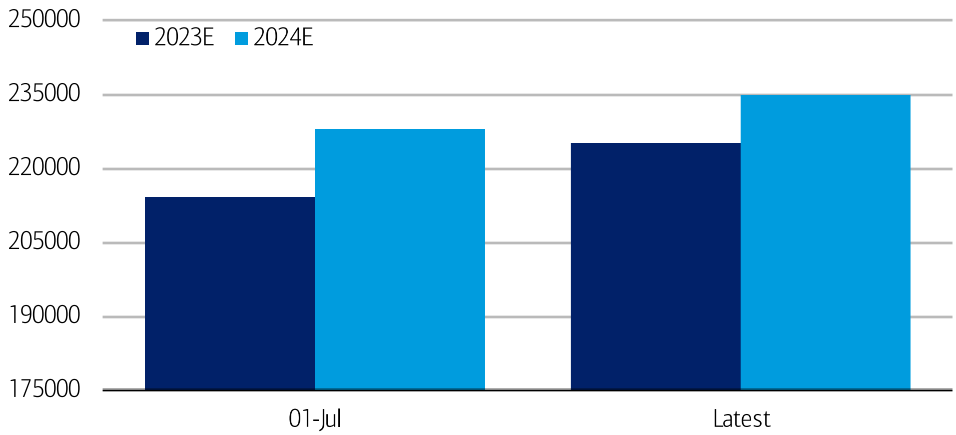
European revisions have also remained positive. Through the results season, we have lifted 2023E Profit before tax forecasts by 5% and 2024E by 3%, shown in Exhibit 42.

Exhibit 42: PBT revisions positive, growth into 24E

European banks Profit Before Tax forecasts, through 2Q 23 results (€ mn)



Source: BofA Global Research estimates. Europe 2023E excludes net badwill and other acquisition-related P&L at UBS

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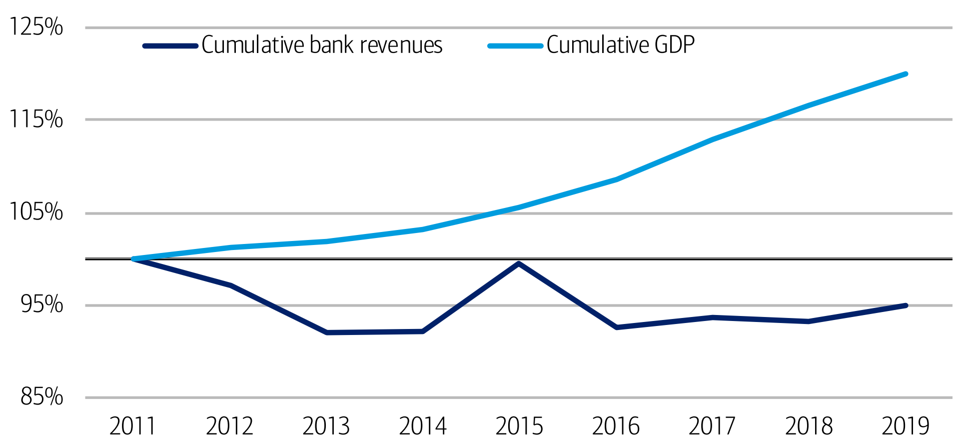
Growth should be rewarded

The 2010s were a long decade for European banks. A combination of ever-lower rates and yields, with ever-tighter regulations saw revenue growth underperform its traditional nominal GDP benchmark by 25 percentage points cumulatively (Exhibit 43).

Exhibit 43: in the 2010s bank revenues underperformed their nominal GDP benchmark by 25% points

Cumulative growth in European bank revenues and euro area GDP, 2011-19 (€, %)



Source: BofA Global Research estimates, company report

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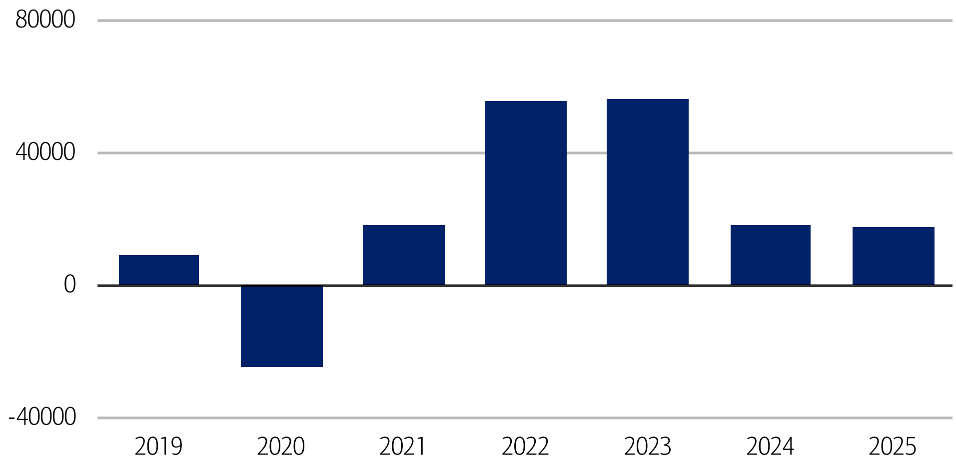
Much of the loss has been recovered over 2022 and 2023. We now see a post-regulation, normalised rate environment allowing for a more-typical revenue growth in line with nominal GDP at 3% over 2024-25E (Exhibit 44).

Exhibit 44: Revenue growth slows sharply but remains positive in 2024E
European bank revenues, change y/y € mn, 2019-25E



Source: BofA Global Research estimates, company report

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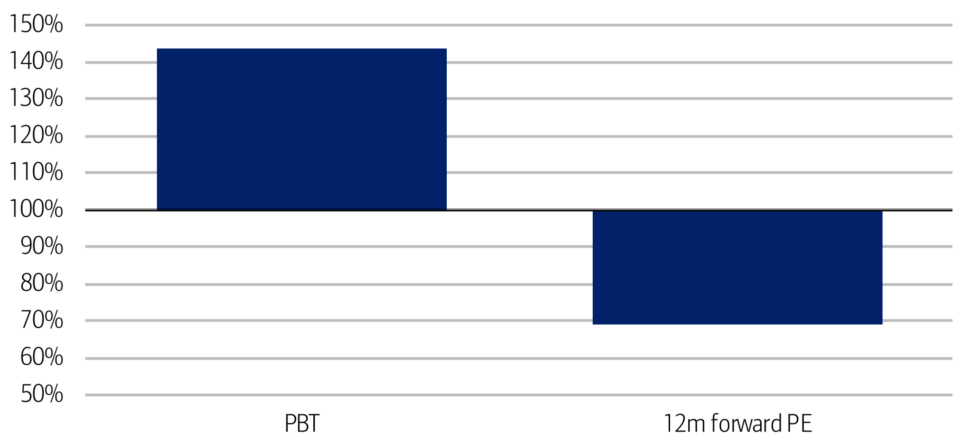
This leaves us back with the question of valuation.

Valuation at a low

The upgrades to 2023E have been massive since the rate cycle began two years ago. However, they have been offset by an almost equally massive de-rating, shown in Exhibit 45.

Exhibit 45: 43% earnings upgrades have been eaten up by a 31% de-rating of profits
European banks 2023E Pre-Tax Profit and 12 month forward PE (x), changes over the last two years



Source: BofA Global Research estimates

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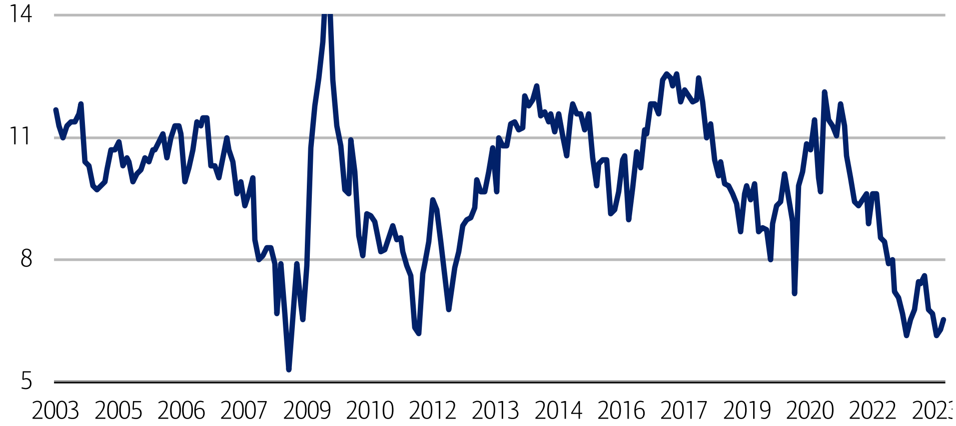
This leaves the banks at long-term low PE of 6.5x 12 months forward, or 6x 2024E (Exhibit 46).

Exhibit 46: European banks 12 month forward PE (x) at a 20 year trough
12 month forward PE since 2003



Source: BofA Global Research estimates, company report

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For a traditionally cyclical sector, de-rating peak earnings would be nothing new. For us, the opportunity is that we do not in any way see these as peak earnings. Indeed, the restoration of liability income should in our view have supported a re-rating of the system. The opposite having happened, we have a positive view on the sector. Exhibit 47 includes our Buy-rated banks, for an average 2024E PE of 6x.

Exhibit 47: Buy-rated European banks
PE 2023-25E (x), Price/ tangible book 2023E (x), dividend yield 2023-24E (%)

	2023E	2024E	2025E	P/TNAV 2023E	Dividend 2023E	Dividend 2024E
Erste Bank	5.0	5.1	4.9	0.8	8.1%	8.2%
ING Group	6.4	5.9	4.9	0.9	7.5%	8.1%
KBC Group	8.2	7.5	6.4	1.4	7.3%	8.0%
BNP Paribas	5.8	5.8	4.9	0.7	8.2%	8.7%
Credit Agricole SA	6.9	6.6	6.3	0.6	7.3%	7.6%
Societe Generale	6.7	4.7	4.1	0.4	4.3%	6.5%
Banco BPM	6.2	5.4	5.3	0.5	9.1%	10.1%
BFF Banking Group	9.5	8.8	7.9	2.3	10.5%	11.4%
Intesa Sanpaolo	6.6	6.5	6.4	0.8	11.1%	11.3%
UniCredit	5.8	5.3	4.7	0.6	6.4%	7.0%
AIB Group	6.2	6.1	5.8	1.1	3.0%	3.8%
Bank of Ireland	5.9	5.5	5.3	1.0	5.7%	7.4%
Permanent TSB	9.4	4.6	3.8	0.6	0.0%	7.2%
Danske Bank	6.9	6.7	6.5	0.8	8.8%	8.9%
Nordea	7.1	7.0	6.7	1.2	9.8%	10.0%
CaixaBank	6.6	6.6	6.3	1.0	9.6%	10.0%
Santander	5.4	4.8	4.3	0.7	4.9%	5.6%
UBS	45.7	12.6	7.3	1.0	2.3%	2.4%
Lloyds Banking Group	5.7	5.3	4.4	0.9	6.8%	7.5%
NatWest Group	5.2	4.7	3.6	0.8	7.7%	9.0%
Standard Chartered	6.7	5.2	4.4	0.6	2.8%	3.3%
Average		6.2	5.4	0.9	6.7%	7.7%

Source: BofA Global Research estimates

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