

European Banks Strategy

Of cash and clouds

Industry Overview

Higher rates mean it's not the end of the cycle

Rates curves are up 15-115bp since 1Q 23 results (Exhibit 3) and as discussed in [Sailing on through 05 June 2023](#) (report link), evidence of accelerated deposit repricing is scant. We do expect rising deposit migration, but hedges are rewarding (Exhibit 4, Exhibit 5) and higher policy rates improve returns on nil-paid balances (Exhibit 9, Exhibit 10). It is premature to consider the margin story over: upgrades ahead, still (Exhibit 8).

An industry transformed

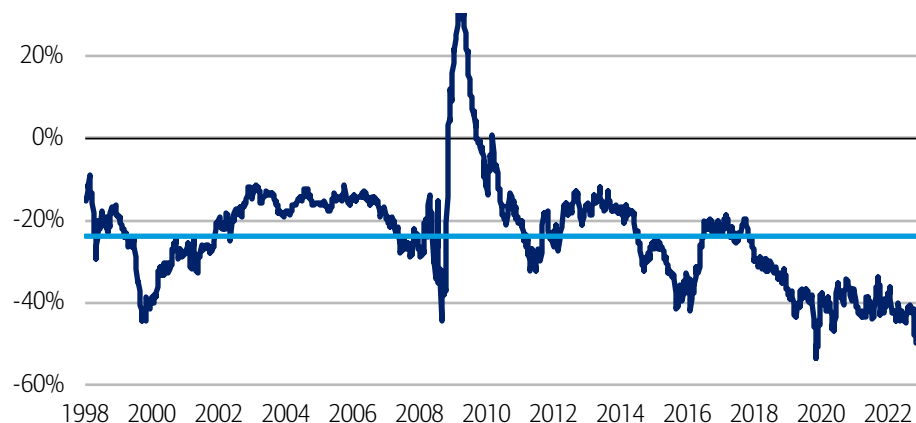
The 50% structural recovery in pre-impairment profits (Exhibit 11) meets impairments down two thirds (Exhibit 12), to leave provisions/ pre-provision profit a fifth of historical levels (Exhibit 13). This makes earnings less cyclical and distributions more resilient.

A 16% Cost of Equity and a record PE discount

Banks briefly traded at a lower PE to the market once in the last 25 years, for a month after the 2020 dividend ban (Exhibit 1) and never yielded more than they do now (Exhibit 14). The 16% Cost of Equity (Exhibit 2) reflects the cloud of potential tightened capital and liquidity standards. Specifically, though, we see no agenda to raise liquidity or capital across European banks: we track recent regulatory and supervisory comment in Box 1-Box 4. We reiterate our positive view on the bank sector.

Exhibit 1: a record PE discount to the market

Banks 12m forward PE relative to the market, 1998-2023



Source: BofA Global Research estimates, Eikon

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13 June 2023

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Europe
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Key charts

Exhibit 2: a 16% Cost of Equity applied to the sector
Gordon growth model, European banks 2023E

| | |
|-----------|-------|
| ROE 2023E | 12.5% |
| COE | 16.0% |
| g | 3% |
| P/NAV | 0.73 |

Source: BofA Global Research estimates, Bloomberg

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Exhibit 3: 2 year swaps up 15bp in the euro area, 115bp in the UK
2 year swaps (%), latest and two months ago

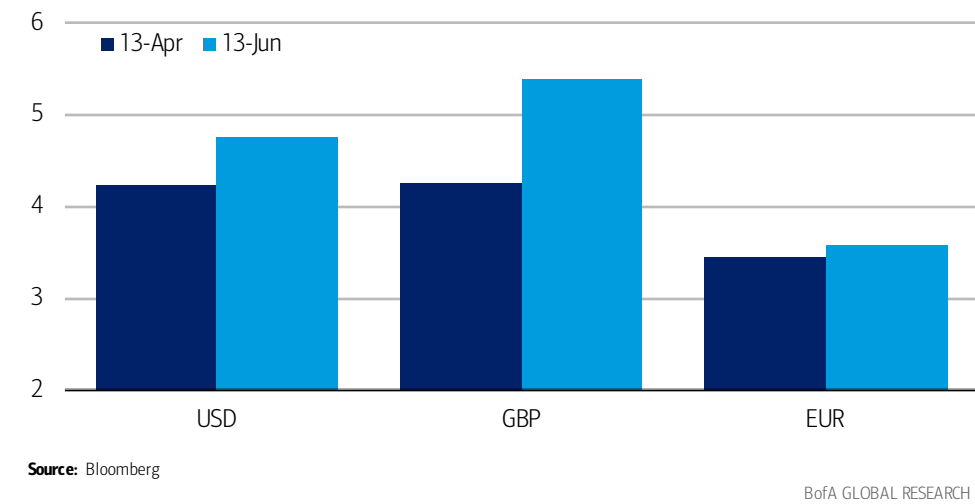


Exhibit 4: euro banks reinvesting hedges at 2.6% points higher
Euro area 5 year bond yield less yield 5 years previously (%) 2017-23

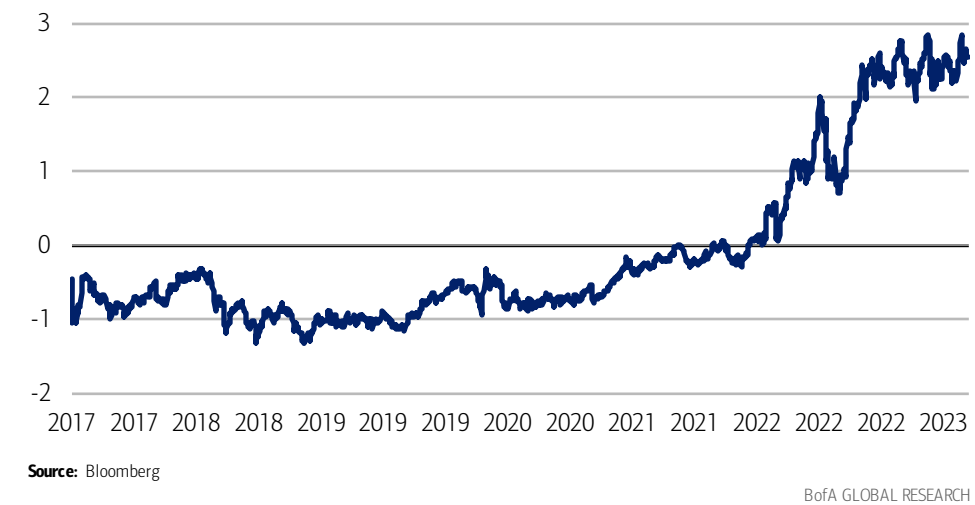
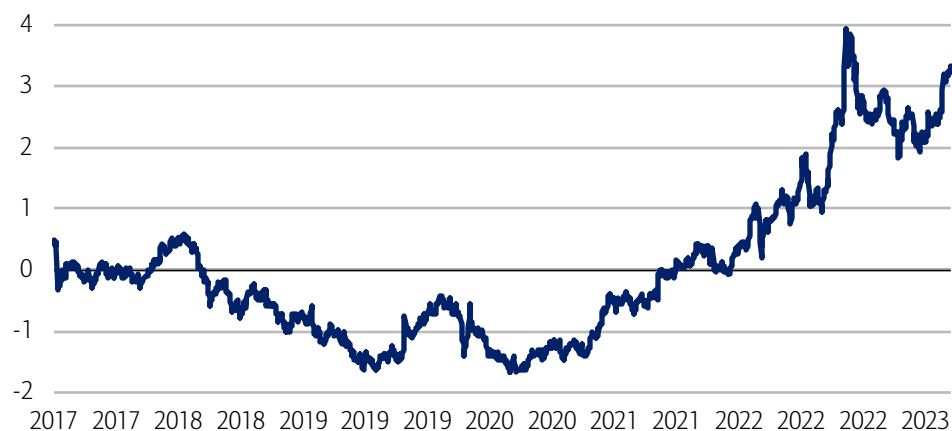


Exhibit 5: UK banks reinvesting hedges at 3.35% points higher

UK 5 year Gilt yield less yield 5 years previously (%) 2017-23



Source: Bloomberg

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Box 1

Basel Committee takes stock of recent banking turmoil, agrees to continue to examine lessons learned and emphasises importance of strengthening supervisory effectiveness.

Reaffirms expectation of implementing all aspects of Basel III in full and consistently.

Agrees to consult on planned revisions to the Core principles for effective banking supervision.

Basel Committee June 2023

Box 2

There is simply no reasonable level of minimum capital and liquidity that can make a bank viable if it has an unsustainable business model or poor governance...

With sufficient resources and the aid of technology, supervisors will be able to identify more vulnerabilities at an early stage and to act on them before problems become too large and complex to handle.

Agustin Carstens, June 2023

Box 3

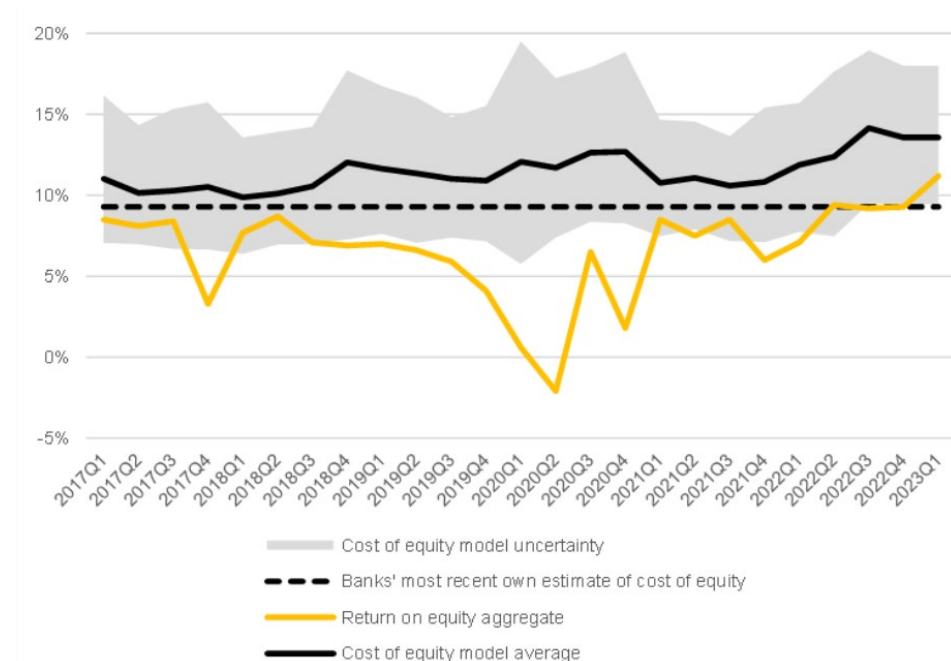
More importantly, I believe that supervision already has the potential to address the root causes of many bank failures, and that this potential is often not fully exploited. Frankly, before we even think of introducing

far-reaching changes in prudential rules or in the scope for deposit guarantees, I would first give supervision another chance

Fernando Restoy, Chair, Financial Stability Institute, May 2023

Exhibit 6: a Return on Equity not seen for a decade

Euro area significant banks ROE and Cost of Equity (%) 2017-23



Source: ECB/ Enria

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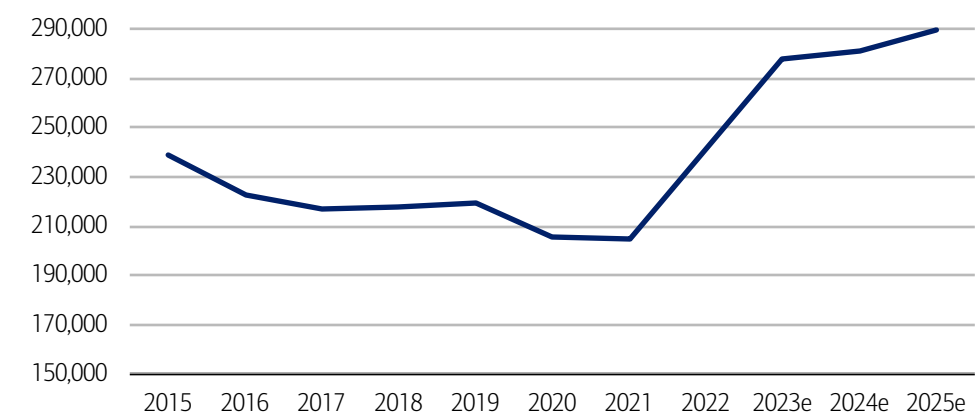
Box 4

European banks today are strong in terms of capital, liquidity and asset quality, and they tend to have well-diversified funding sources and customer bases. Most significantly, the chronic problems of low profitability and weak business models that held the sector back for so long are now finally starting to abate...

... [I] strongly believe that we need to remain focused on a bank-by-bank approach, taking into account the circumstances of each individual bank and tailoring our supervision accordingly.

Andrea Enria, head, SSM, June 2023

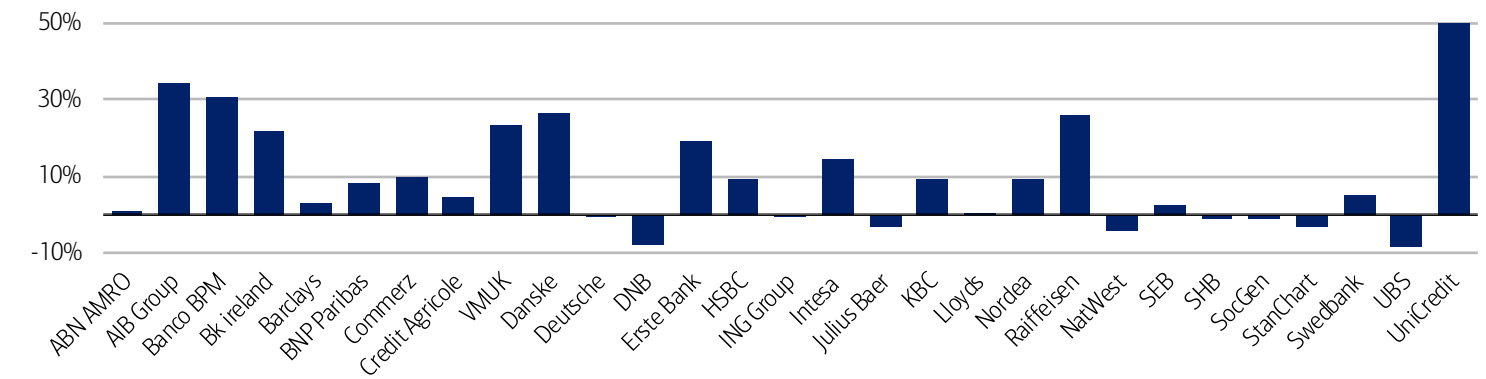
Exhibit 7: an €80bn uplift in revenues from the rate normalisation
European banks Net Interest Income 2015-25E (€ mn)



Source: BofA Global Research estimates, company report

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Exhibit 8: upgrades heavily outweigh downgrades YTD
2024E Profit Before Tax, change in expectations YTD (%)

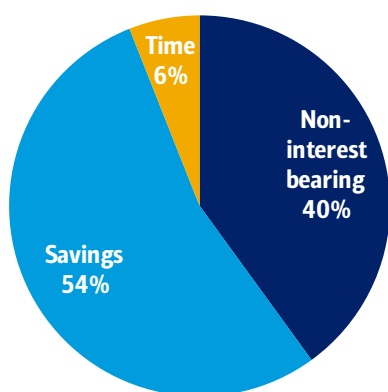


Source: BofA Global Research estimates

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Exhibit 9: NatWest deposits 40% non-interest bearing

Deposit mix 1Q23

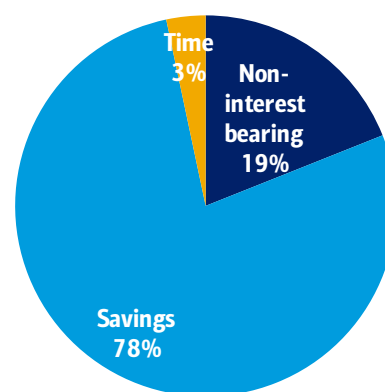


Source: BofA Global Research estimates, company report

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Exhibit 10: HSBC deposits 19% non-interest bearing

Deposit mix 2022

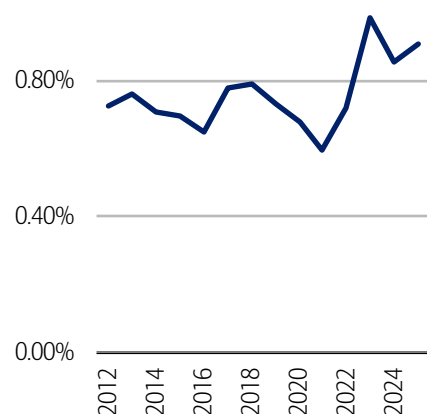


Source: BofA Global Research estimates, company report

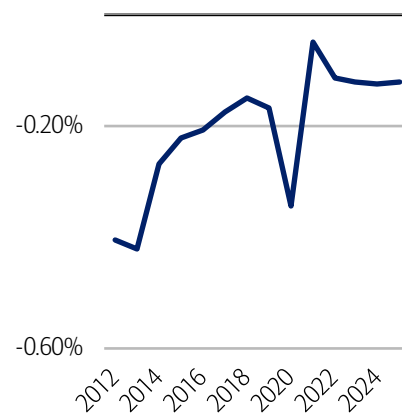
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Exhibit 11: Pre-provision ROA up by 50%

European banks pre-provision Return on Assets 2012-25E

Source: BofA Global Research estimates, company report
BofA GLOBAL RESEARCH**Exhibit 12: Provision assets down two thirds**

European banks provisions/assets 2012-25E

Source: BofA Global Research estimates, company report
BofA GLOBAL RESEARCH**Exhibit 13: ...means provisions/ pre-provision profits down by 80%**

Provisions/ pre-provision profit, European banks, 2012-25E

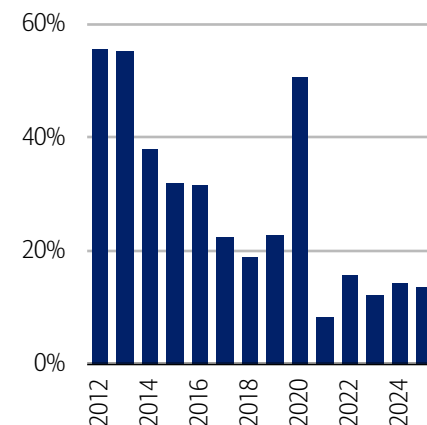
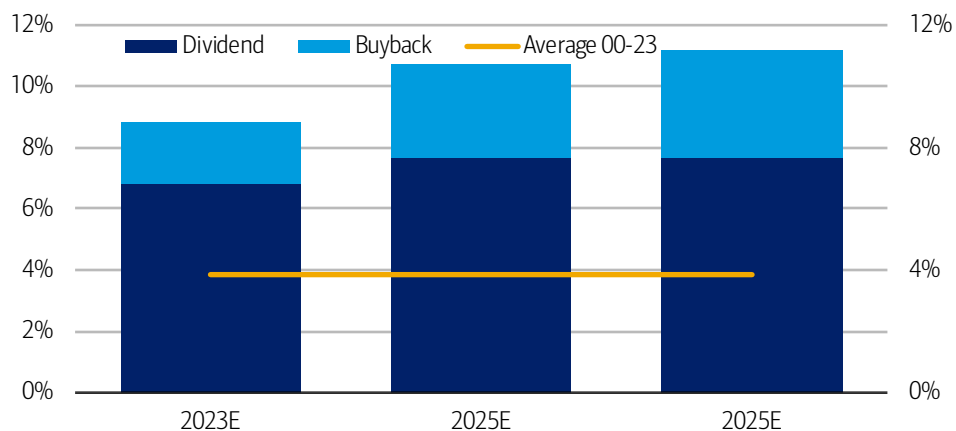
Source: Global Research estimates, company report
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Exhibit 14: all in yield above 10%

Dividend and buybacks, European banks 2023-25E

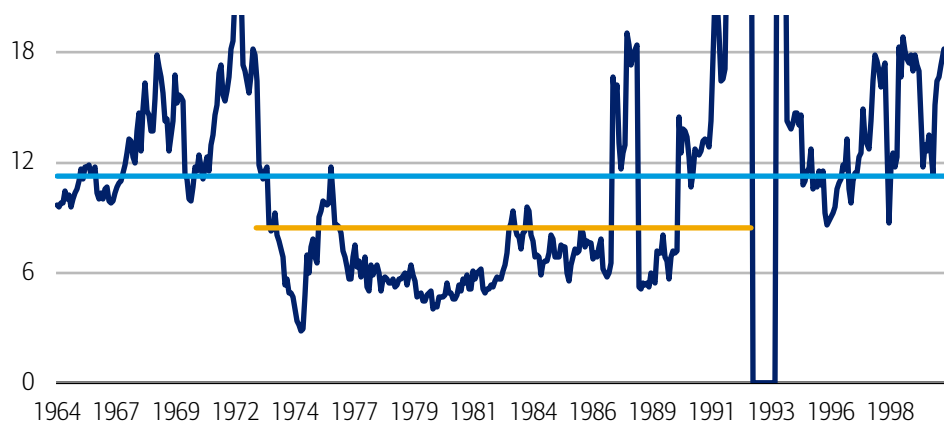


Source: BofA Global Research estimates, company report. 2023E shows buybacks remaining; €13b already completed

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Exhibit 15: the 1970s was an era of low bank multiples, but still well above today's

Barclays PE ratio, 1964-2000



Source: Eikon

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