European Banks Strategy

The stability of a graveyard

Industry Overview

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Equity
Europe
Banks-Multinational/Universal

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Fine for shareholders, but too little risk

Banks work fine for shareholders, with a 12% cash yield, on highly capitalised and liquid balance sheets. But banks don't *do* much any more (Exhibit 1)- the "stability of a graveyard" the UK authorities didn't seek (Box 1). Exhibit 2 and Exhibit 3 show no increase in loan defaults, after a 450bp+ rate shock, an energy price spike and a recession. Great for owners – these are low-risk earnings now. But surely a banking system should see higher credit losses after this magnitude of events? We think there is too little credit risk in the European and UK banks to support economic growth. Exhibit 4 shows the collapse in European bank trading and advisory revenues over the last decade – again, de-risking, but leaving little intermediation capacity.

A lack of incentive to grow

UK banks have delivered £nil of loan growth in 15 years (Box 2), euro area banks little better (Box 3). The banks are keen to lend. But their record-high 16-18% Cost of Equity (Exhibit 5 - Exhibit 7) makes required returns on new lending too high for politicians to bear. Better to return the capital to long-suffering owners (Exhibit 8). Regulators profess uncertainty as to low bank PE multiples (see Box 4); we think the answer is that post-crisis reforms increased the distance to loss for taxpayers, but not for investors. To re-rate banks to a historical multiple – enabling them to support Europe's recovery - demands regulatory balance. We highlight three measures that could make a difference:

G-SIB is anti-growth

Global Systemically Important Bank buffers were set a decade ago - economies have now grown 40-60% (Exhibit 10). There is no indexing of G-SIB and tripping up a bucket is prohibitive: as much as 8% of market cap (Exhibit 9), diluting returns across any bank. For banks to support economic growth, indexing G-SIB seems a minimum requirement.

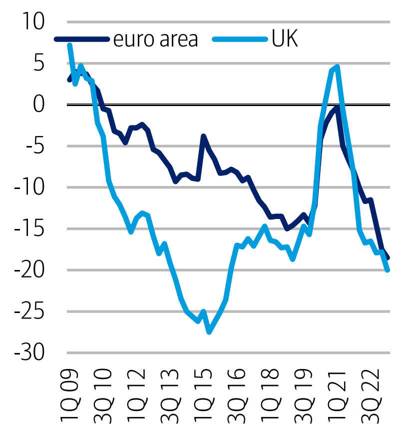
Liquidity Surplus

The Liquidity Coverage Ratio was designed to be onerous at 100%, but supervisors have frequently discussed how welcome the current 158% is, trapping €1.8 trillion of liquidity in the euro area alone (Exhibit 15). We discussed in Year Ahead 2024: calm and re-rating (report link) how most European banks have vast unencumbered asset pools: for these banks, we believe a move towards the intended 100% LCR would restore balance.

Stress tests and borrower-based measures

Stress testing is powerful: Exhibit 16 illustrates it is 3x more onerous than HSBC's own severe downside loss. Banks cannot price for this extra capital requirement, stopping them from much lending. Low risk banks result, but also – with macroprudential measures - Exhibit 11 highlights that this has driven 1.3 million missing UK mortgages since 2012. Balancing stress tests would free capital to lend.

Exhibit 1: credit to GDP gaps show lending shortfall
Credit to GDP gaps since 2009



Source: Basel Committee
BofA GLOBAL RESEARCH

Key charts

Box 1: "not seeking the stability of a graveyard"

We are not seeking the stability of a graveyard.
Chancellor George Osborne, 2012, Mansion House speech

Box 2: no lending

Since the financial crisis, non-banks, or the system of market based finance as we call it, has grown significantly both as part of the UK financial system but also globally, now accounting for around half UK and global financial sector assets. It also matters more to the real economy, for example, it contributed to nearly all of the c.£425 billion net increase in lending to UK businesses from 2008 to 2023.
Bank of England, Lee Foulger, 2024

Box 3: little in the euro area

Non-banks have increased their market share of credit granted to euro area non-financial corporates from 15% in 2008 to 27% in September 2023
Claudia Buch, chair, ECB Single Supervisory Mechanism, February 2024

Box 4: Bank of England notes a high Cost of Equity

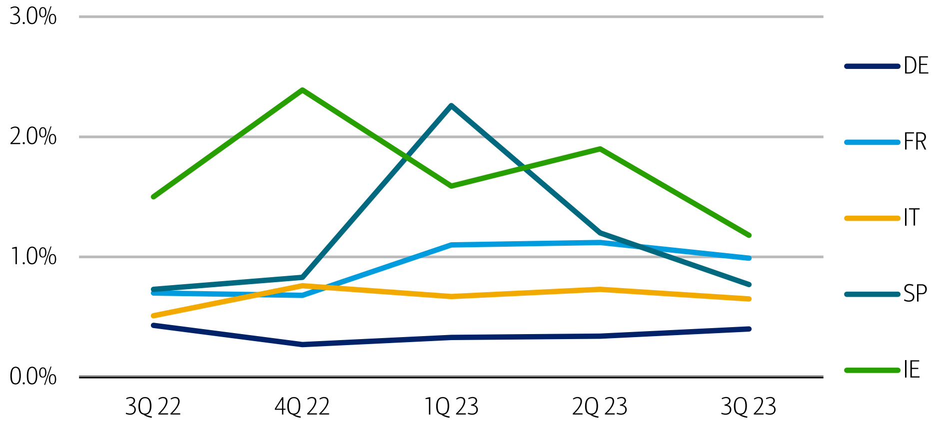
why are the valuations of banks so much in the doldrums?..
The cost of risk – the return equity investors demand – does not seem to have fallen in line with what appears to be greater stability and lower risk per unit of equity…
One remaining puzzle is the market valuation of the large UK banks… With interest margins restored to more normal levels, and loan impairments subdued by historical standards, this puzzle deserves further study
Andrew Bailey, governor, Bank of England, 12 February 2023

Box 5: Bank of England

To quote the Chancellor who established the PRA, we have no desire to establish the 'stability of the graveyard'
Sam Woods, deputy governor, Bank of England, 2022

Exhibit 2: There's just no increase in loan defaults

Default rate (%, trailing 12 months), major European markets. 50th percentile, corporate loan book



Source: EBA

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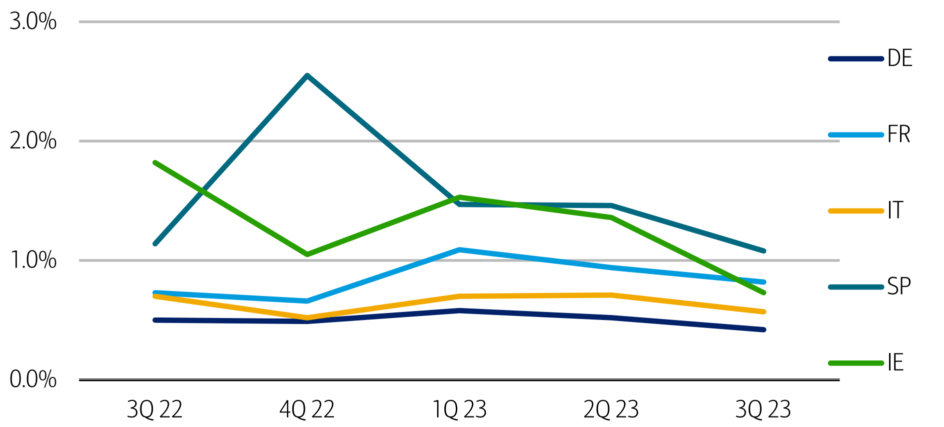
Exhibit 3: There's just no increase in loan defaults

Default rate (%, trailing 12 months), major European markets. 50th percentile, household mortgage book



Source: BofA Global Research, EBA

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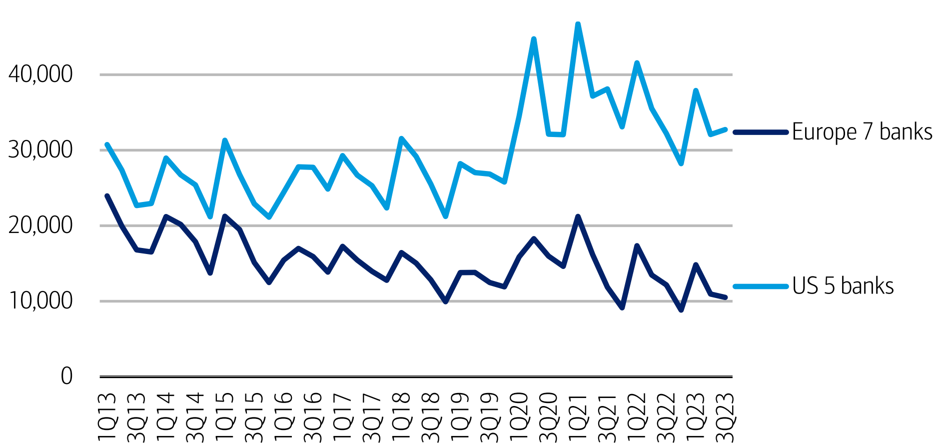
Exhibit 4: European banks declined from 80% of US bank investment bank revenues to 30%

Investment bank sales and trading and advisory revenues (US$ mn) 2013-23



Source: BofA Global Research estimates, company report. Major 5 US banks, seven largest Europeans

Exhibit 4: European banks declined from 80% of US bank investment bank revenues to 30%
Investment bank sales and trading and advisory revenues (US$ mn) 2013-23

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Exhibit 5: European banks – an implied 16% Cost of Equity (%)
12 months forward Return on Equity and Price/Net Asset Value (%, x), assuming a 3% growth rate

ROE	13.1
COE	16.1
g	3
P/NAV	0.77

Source: BofA Global Research estimates

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Exhibit 6: UK banks – an implied 18% Cost of Equity (%)
12 months forward Return on Equity and Price/Net Asset Value (%, x), assuming a 3% growth rate

ROE	14.0
COE	18.0
g	3
P/NAV	0.73

Source: BofA Global Research estimates

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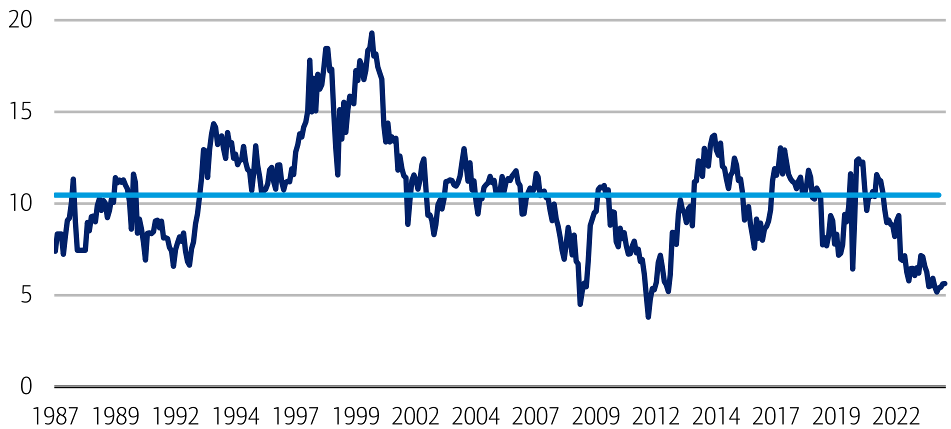
Exhibit 7: European bank PE ratios at their lowest since the 1980s
Major European banks, 12 months forward PE (x) 1987-2024



Source: Eikon

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Exhibit 8: banks have lagged heavily in total returns since 2009, even after recent outperformance

SX7P and SXXP total return since 2009 (%)

Source: Bloomberg

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Exhibit 9: tripping up a G-SIB bucket costs as much as 8% of market cap in additional capital demand

3Q 23 Risk Weighted Assets, current market cap

group	HSBC (US$)	Barclays (£)
RWA	840,049	341,900
Additional charge for one extra G-SIB buffer	0.50%	0.50%
Equity demand	4,200	1,710
Market cap	153,780	22,254
%	2.7%	7.7%

Source: BofA Global Research estimates, company report

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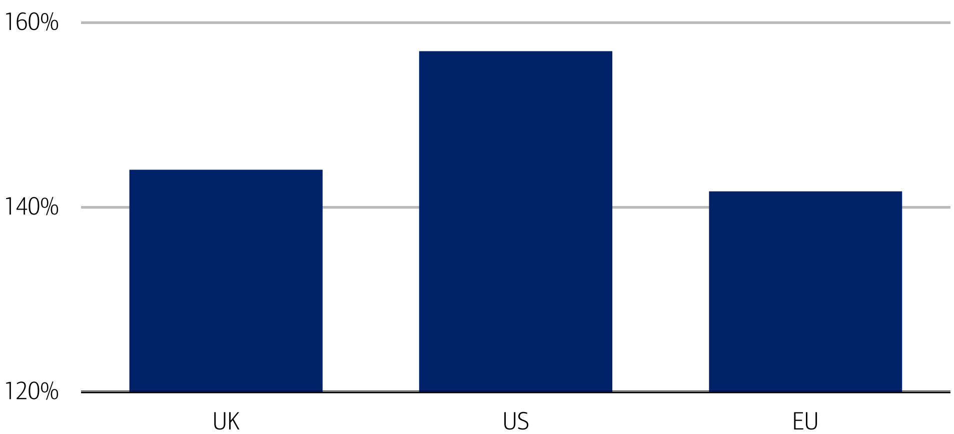
Exhibit 10: economies are 40-60% bigger in the last decade

Current GDP compared with 3Q 14, nominal, local currency (%)



Source: BofA Global Research estimates, St Louis Fed, Bloomberg

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Exhibit 11: 1.3 million missing mortgages in England since 2012
England number of homes and mortgages, 2012 and 2023 – and implied shortfall in 2023 mortgages at a constant 2012 level of mortgages relative to homes

	2012	2023	Shortfall
Homes	23,100	24,500	
Mortgages	7,381	6,500	1,328
	32%	27%	

Source: BofA Global Research , ONS

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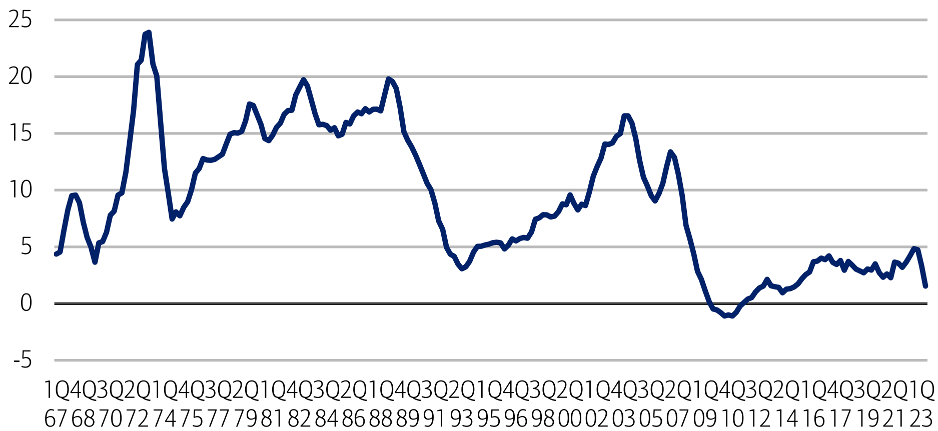
Exhibit 12: UK household credit growth averaged less than 3% in the last decade
UK household credit growth, % y/y, 1967-2023



Source: Bank of England

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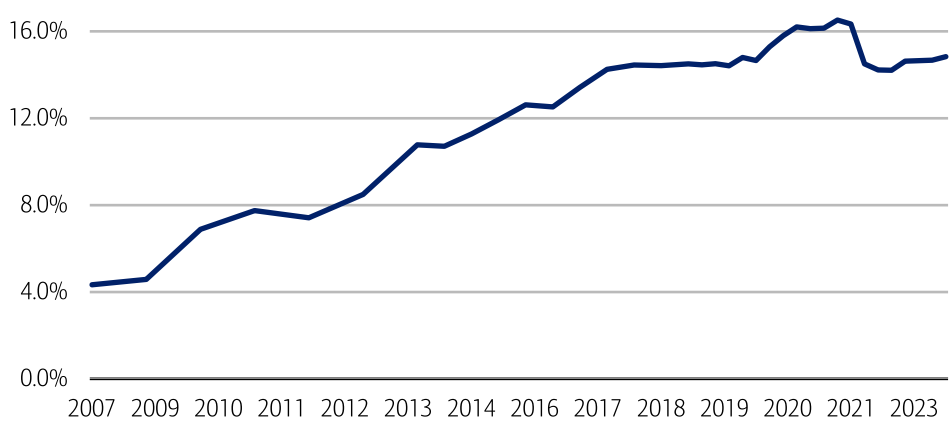
Exhibit 13: bank capital more than tripled
UK bank Common Equity Tier 1 ratio (%) 2007-23



Source: Bank of England

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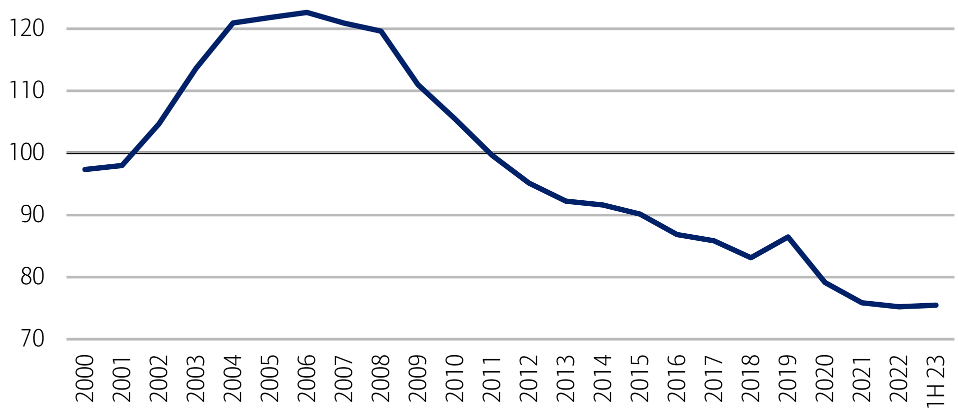
Exhibit 14: Loan/ deposit ratio improved from a 23 point shortfall to a 24 point surplus
UK bank loan/deposit ratio, 2000-23 (%)



Source: Bank of England

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Exhibit 15: €1.8 trillion liquidity trapped in the euro area alone
Euro area bank liquid assets and outflows (€ mn) 3Q 23

Outflows	3,115
HQLA	4,946
Ratio	159%
Target level	100%
Trapped liquidity	1,831

Source: BofA Global Research, ECB

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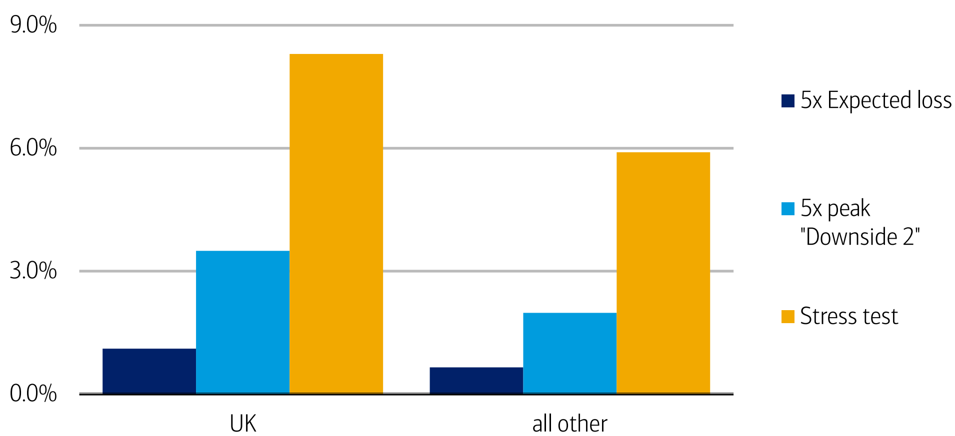
Exhibit 16: stress testing calibrated up to 3x worse than HSBC's "downside 2" worst-case – and >8x Expected Loss
HSBC UK and rest of the world, expected loss and Downside 2 scenario, compared with Bank of England 2023 stress test



Source: BofA Global Research, Bank of England

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