

European Banks Strategy

Maybe it is the 70s. Banks well positioned

Industry Overview

QE mistakes becoming clear

The scale of the mistake that late Quantitative Easing – the last US\$10 trillion or so – represented is becoming evident. Inflation lingers; rates are up sharply but still historically low in real terms (Exhibit 2); central bank balance sheets are damaged (see Box 1). A massive misallocation of capital was created by low-to-negative government bond yields (Exhibit 3). Recent shocks to US and Swiss banks form part of a picture with the UK Gilt crisis of 3Q 22 and the unfolding Commercial Real Estate downturn. It is fortunate in this light that European banks are well-placed to absorb stress, profitably.

Margin expansion not yet over

Net Interest Income from loans and deposits annualised in February 2023 at 26% above the January 2019 level, with continued monthly growth (Exhibit 7). This compares with the SX7P index flat over the same period (Exhibit 8), emphasising the de-rating the banks have faced (Exhibit 16). We expect the banks to deliver 50% higher earnings than in 2019, with continued growth into 2024-25E (Exhibit 9).

Deposits out not the same as deposits in

What did we learn on deposit flight or, more broadly, counterparty behaviour? Certainly, the speed with which deposits left Silicon Valley Bank was exceptional. But banks with concentrated deposit bases could always see rapid exits. Europe's banks are typically highly-diversified in deposits. The unwind of QE will not be stress-free, but we see the banks well placed: outflows of demand deposits to end-February were only 20% of inflows since Covid (Exhibit 5); total deposit outflows 6% of net inflows since 2019 and only 1% of deposits (Exhibit 5). Exhibit 1 and Exhibit 13 emphasise how deposit inflows were invested in cash, not duration.

Learnings? Profitability, not capital or liquidity

Credit Suisse had been Europe's least profitable large bank for years and restructuring left it unprofitable for some time to come (Exhibit 11). Its capital and liquidity positions were robust (Exhibit 10) – it was somehow that too-low profits and too-many public issues combined to crystallise a crisis of confidence, that no level of capital and liquidity would likely have addressed. For European banks in contrast, the restoration of profitability contributes further to the stability built through higher capital (Exhibit 12).

Franchise return returns

Banks' franchise is their deposit book. When this did not earn, no bank could deliver a high Return on Equity. Now deposit profits are normalising, we see many banks delivering mid-teens ROE – see Exhibit 14. These are better banks than for many years. Those few that remain stuck in single digits are likely to face recurrent questions over strategy and distributions, which for these are typically low relative to assets (Exhibit 15). But overall, at 6.7x 12 month-forward earnings, back at lows, we remain positive.

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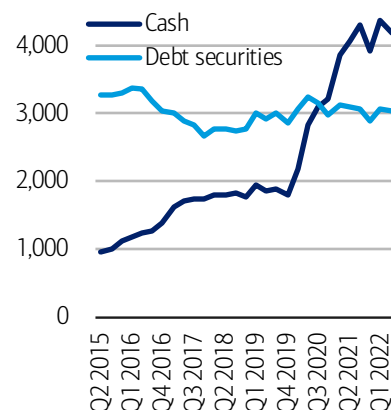
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Exhibit 1: euro area bank cash and securities holdings (€ mn) 2015-22

Cash build provided resilience



Source: ECB

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Key charts

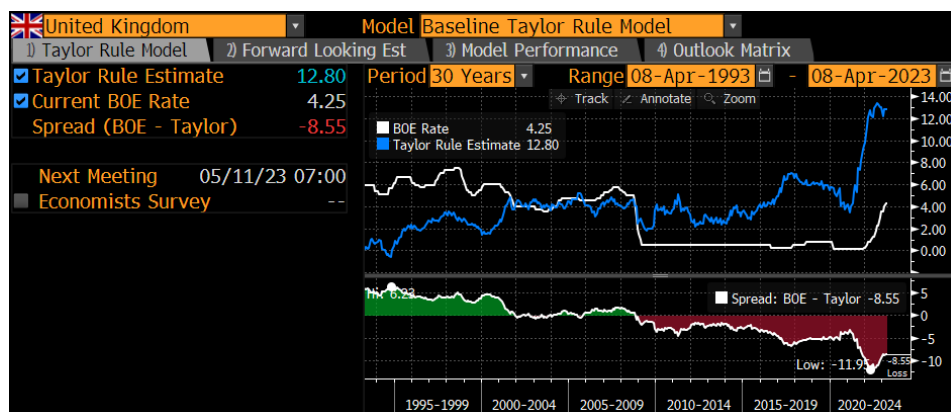
Box 1

The table on page 49 shows that the balance sheet values of securities held for monetary policy purposes exceed the corresponding market values by €138.7 billion as at 31.12.2022. These holdings are carried at amortised cost, i.e. write-downs are only charged if impairment is expected to be permanent. The Governing Council of the ECB decided that there was no need to recognise any impairment losses on securities held for monetary policy purposes as at 31 December 2022

Bundesbank, 2023

Exhibit 2: Taylor Rule model for UK interest rates (%)

UK real rates historically very low

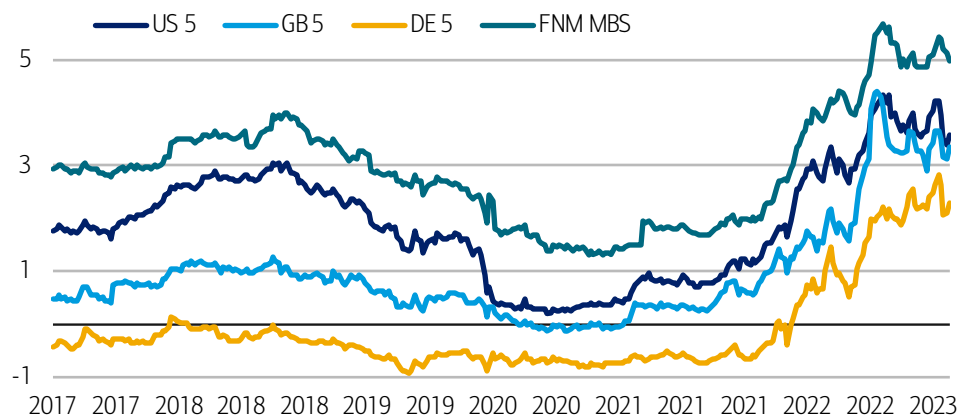


Source: Bloomberg

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Exhibit 3: yields on 5 year government securities and US Mortgage Backed Securities (%) 2017-23

German yields were negative for years, US MBS always offered a yield pick-up

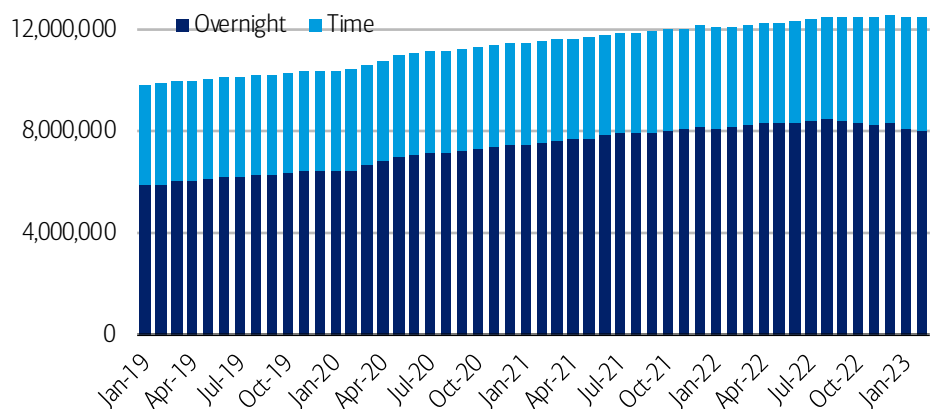


Source: Bloomberg, ICE BofA

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Exhibit 4: euro area household and corporate deposits, 2019-23 (€ mn)

Strong growth, even after recent modest declines

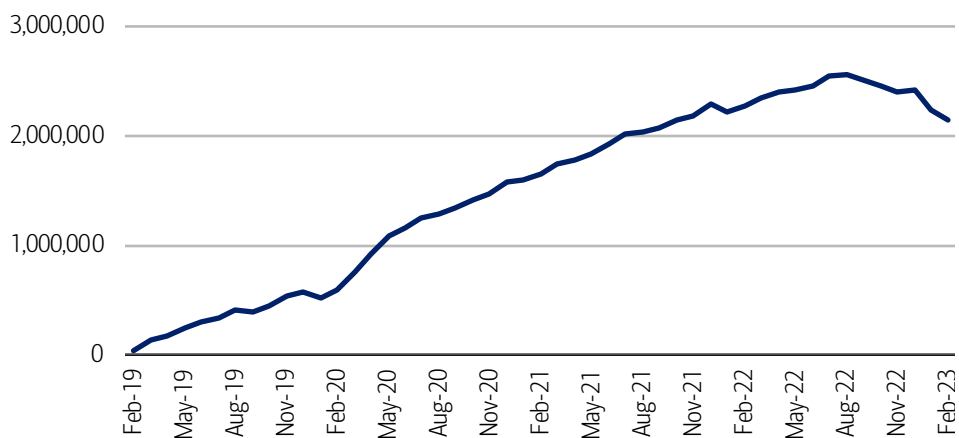


Source: BofA Global Research estimates, ECB

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Exhibit 5: cumulative change in overnight deposits since 2019 (€ mn), households and corporates

€0.4t of a peak €2.6t growth unwind, mainly into time deposits

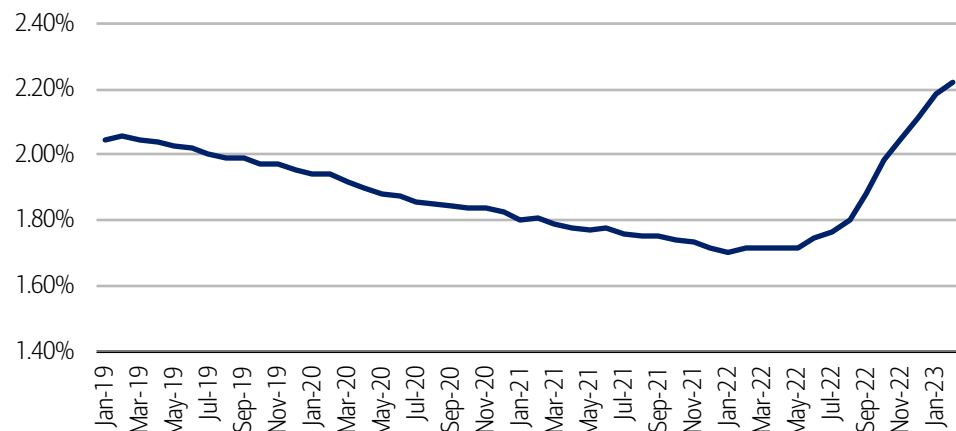


Source: BofA Global Research estimates, ECB

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Exhibit 6: Net Interest Margin from loans and deposits, % annualised, 2019-23

Margins more than recovered and continue to grow

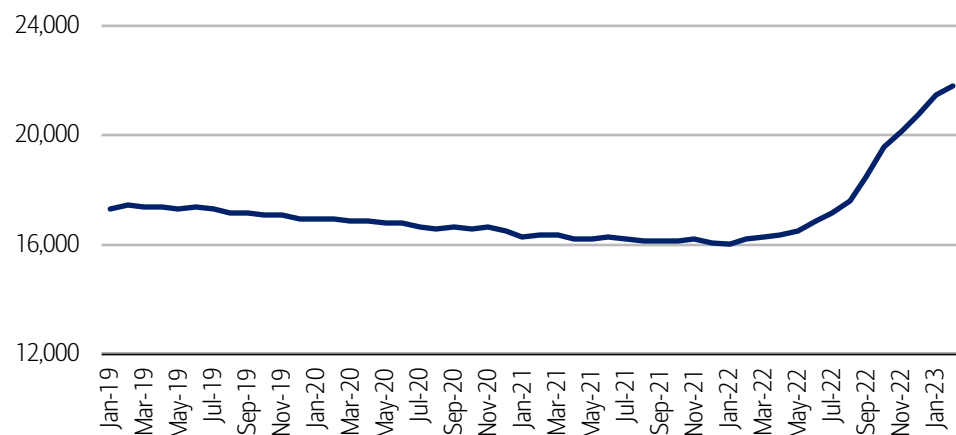


Source: BofA Global Research estimates, ECB

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Exhibit 7: monthly Net Interest Income from loans and deposits (€ mn) 2019-23

As the balance sheet has grown, NII now 26% above January 2019 level



Source: BofA Global Research estimates, ECB

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Exhibit 8: SX7P index, level, since 2019

Flat over 4 years



Source: Bloomberg

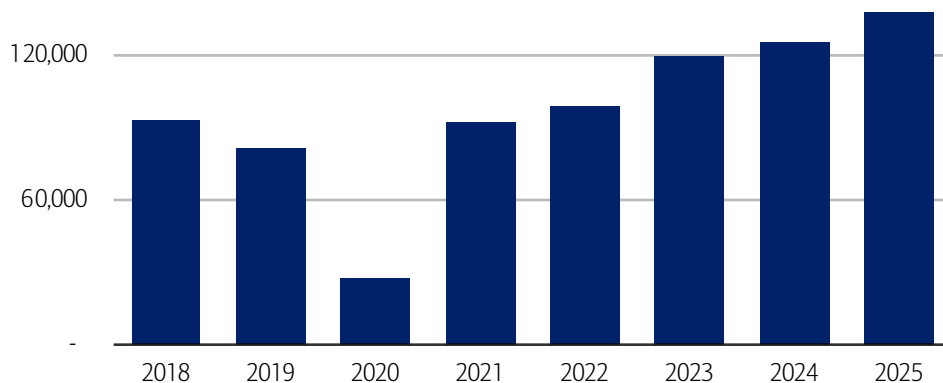
Exhibit 8: SX7P index, level, since 2019

Flat over 4 years

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Exhibit 9: European banks net profit (€ mn) 2018-25E

We see 2023E Net Profit 50% higher than in 2019, with continued growth into 2024-25E



Source: BofA Global Research estimates, company report

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Exhibit 10: Credit Suisse 2007 and 3Q 22 (CHF mn) key balance sheet metrics

Measures very significantly stronger

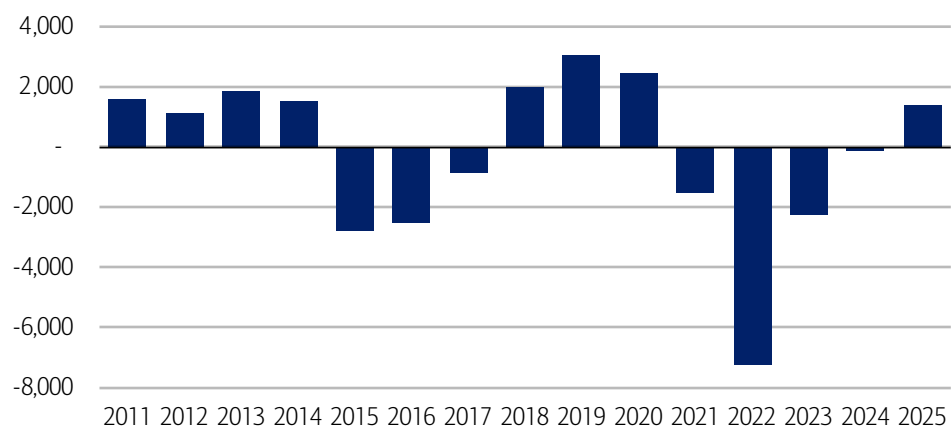
	2007	3Q 22
Cash	38,459	149,191
Trading assets	532,083	90,343
Total assets	1,360,860	700,538
Deposits	426,369	371,270
Tangible Equity	31,873	39,825
Cash/ trading	7%	165%
Cash/ deposits	9%	40%
Equity/ assets minus cash	2.4%	7.2%

Source: BofA Global Research estimates, company report

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Exhibit 11: Credit Suisse net profit (€ mn) 2011-25E

Five of eight historic years unprofitable, another two were ahead

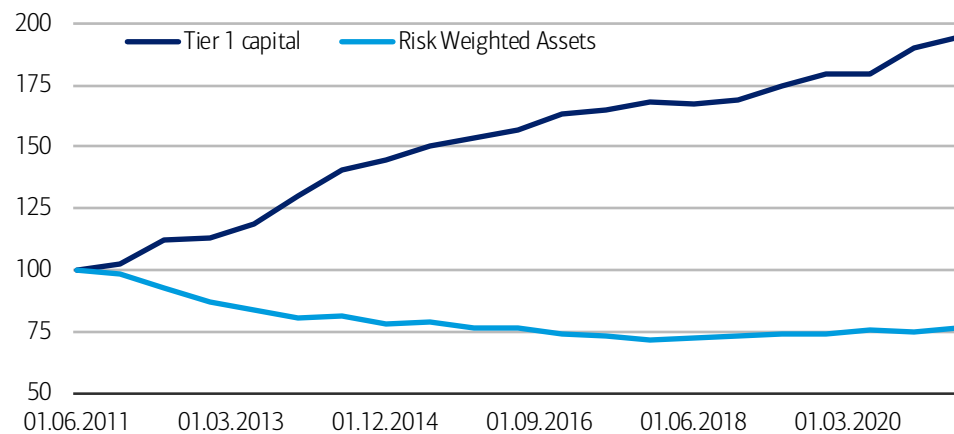


Source: BofA Global Research estimates, company report

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Exhibit 12: European banks: Tier 1 capital and Risk Weighted Assets, 2011-21 (indexed)

A doubling of capital compares with a 25% reduction in RWA

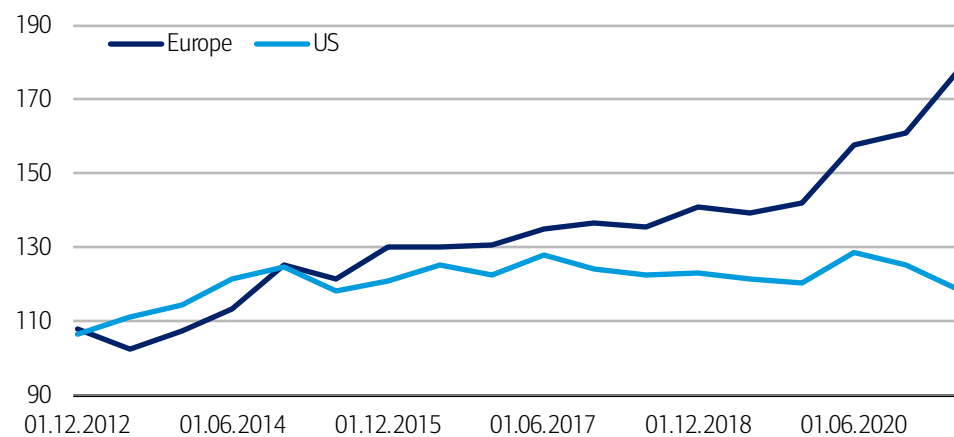


Source: Bank for International Settlements

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Exhibit 13: European and US banks, Liquidity Coverage Ratio 2011-21 (%)

Europe notably used Covid inflows to build LCR

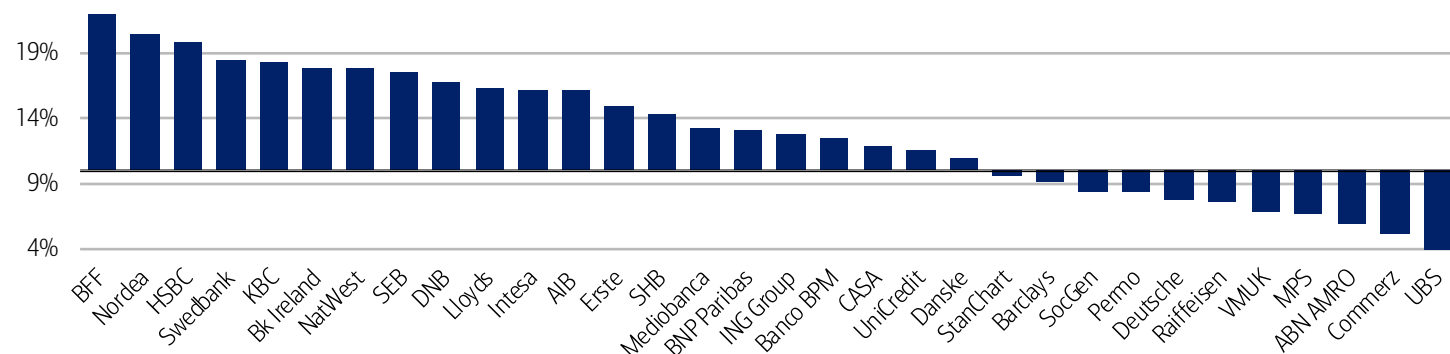


Source: Bank for International Settlements

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Exhibit 14: European banks: Return on Common Equity Tier 1 (%) 2023E

Cut by potential 10% Cost of Equity, most banks now making acceptable returns



Source: BofA Global Research estimates, company report

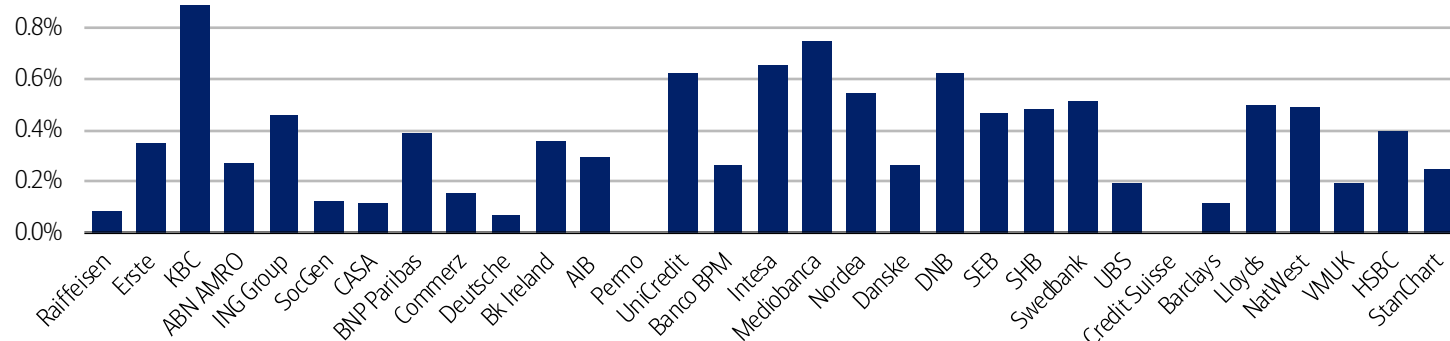
Exhibit 14: European banks: Return on Common Equity Tier 1 (%) 2023E

Cut by potential 10% Cost of Equity, most banks now making acceptable returns

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Exhibit 15: shareholder distributions (dividends and buybacks), % assets 2023E

Banks with low distributions relative to assets are geared from a shareholder perspective

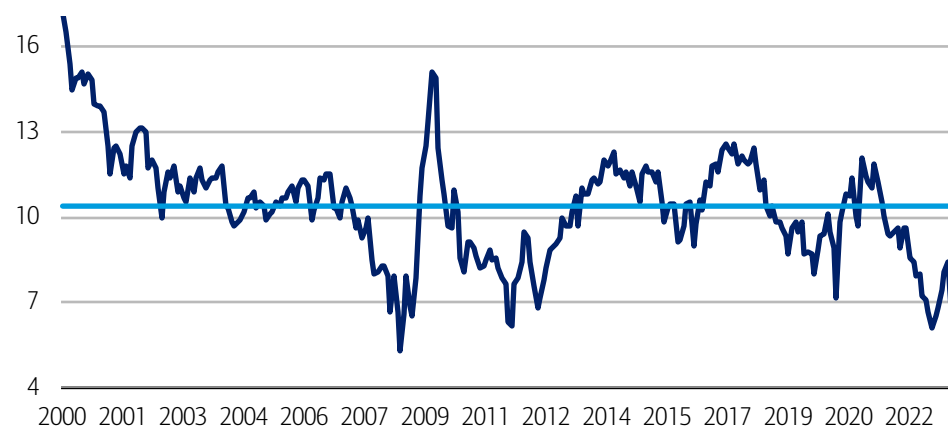


Source: BofA Global Research estimates

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Exhibit 16: European banks 12 month-forward PE (x) 2000-23

Back to 23 year-lows



Source: BofA Global Research estimates, company report

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