European Banks Strategy

After the lost decade

Industry Overview

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Equity
Europe
Banks-Multinational/Universal

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One of three steps in place; headwinds slackening

The 2010s were a decade to forget in European banks (Chart 3). Things still aren't ideal, but we see some signs of life. Negative rates are bad for banks, but at least headwinds have lessened (Chart 7). The second step of the three-step recovery from repression has arrived: the ECB provided €74bn of relief against potential capital inflation in December. The third, Banking Union, flared briefly into view, but has receded into the background.

Ample noise: Swedish example mixed

The ECB's Strategic Review will confuse rather than inform through 2020. We see the end result a 2% inflation goal and the ECB's tool kit unchanged. We would love negative rates to be consigned to the Book of Historical Curiosities, as in Sweden. But the Riksbank had a weak currency to fall back on (Chart 9) and the SEK already started to reverse since the move to zero. This provides support for the extensive body of evidence ECB chief economist Philip Lane and ECB staff have recently marshalled in support of existing monetary policy settings (Exhibit 8, Exhibit 9, Exhibit 10).

Rate expectations drifting up: levered to the upside

We think taking rates much lower has fallen out of fashion at central banks. So while we do not expect hikes in 2020 or 2021, market pricing could anticipate them during the ECB review. Bank shares are geared to rates; 25% on PBT for 50bp on rates (Table 2); even the debate can help a little. Forward rate expectations are already becoming unanchored: the market is pricing ECB hikes in 2022, well before inflation hits its goal.

Hard work to do

Banks need to grow volumes 3%+ to keep revenues flat. For a system making a 6% Return on Equity, this keeps dividend payouts at no more than 50%, even without regulatory capital inflation. Many banks still have work to do there.

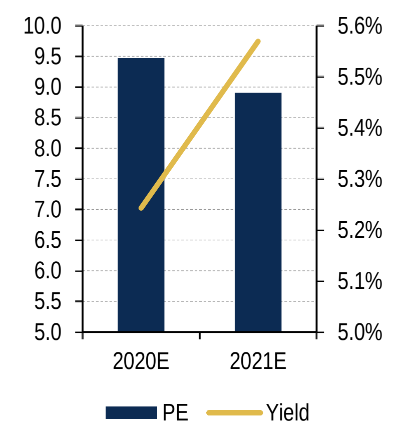
Options abound

We see 2020 as hard yards for the banks: we have just 3% PBT growth after the declines of 2019E. But the banks are rich in options. They are positively geared to any improvement in GDP or interest rates. The euro regulatory cycle has lagged those of the US, Switzerland and the UK; stabilisation would allow distributions to pick up. And any sign of Banking Union would enable a start to long-overdue consolidation.

Bank stocks to Buy; value traps still around

We have Buy ratings on ING, Nordea, KBC, CASA, Bank of Ireland, Intesa, Mediobanca, Unicredit, Erste and Raiffeisen. These offer a yield of 5.2% on 9.4x 2020E earnings. We see these banks with 6% earnings growth into 2021E and 7% dividend growth (Table 6).

Chart 1: Buy rated stock multiples



Source: BofA Global Research estimates

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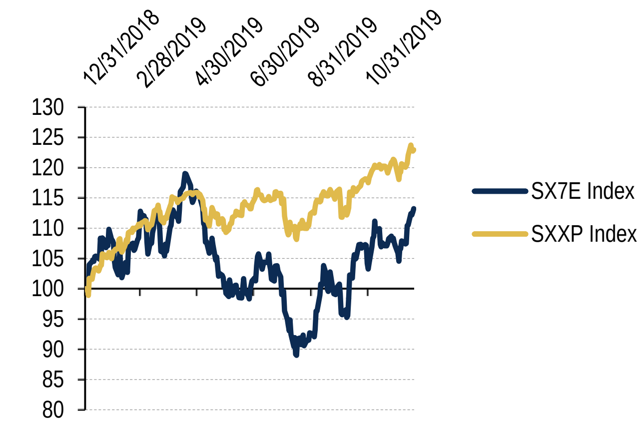
After the lost decade

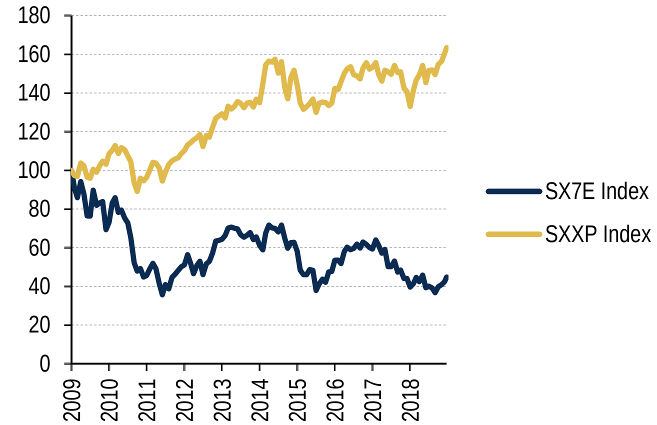
Last year was alright for banks in the end, although they still underperformed (Chart 2). As Chart 3 shows, this capped a decade of challenges and poor performance.

Chart 2: stock performance 2019 (indexed)



Source: BofA Global Research, Bloomberg

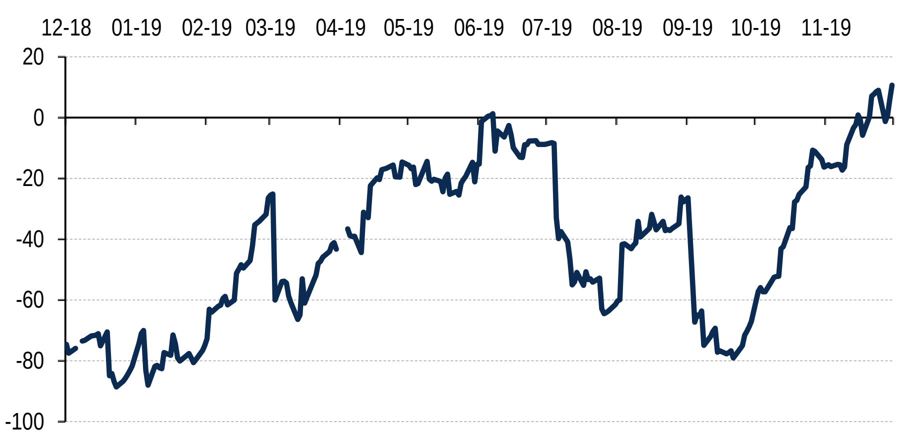
Chart 3: stock performance, 2010-19 (indexed)



Source: BofA Global Research, Bloomberg

We believe several of the building blocks of the problem are still very much with us: in particular, negative rates and the impact of regulation on revenue opportunities. We discuss these in this report. However, some parts of the picture are brighter. Europe is a low-growth polity, but the growth trajectory has improved substantially, shown in Chart 4.

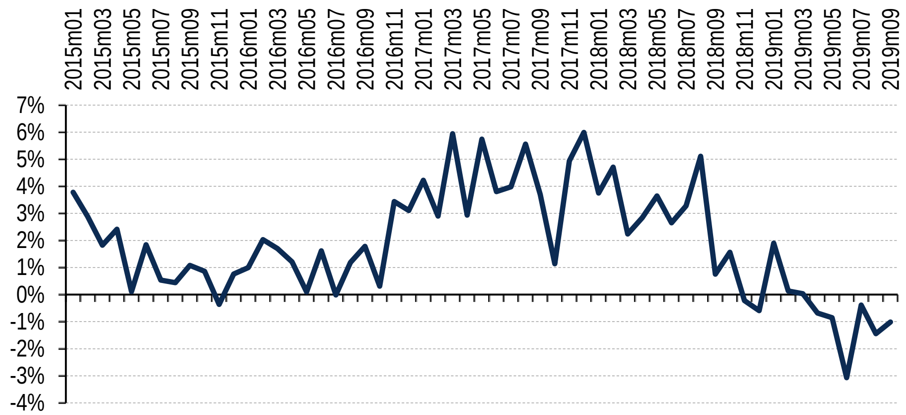
Chart 4: Citi economic surprise index



Source: Bloomberg

The trade deal between the US and China and the passing of the USMCA in December are hardly ground-breaking, but at least represented a de-escalation of the trade wars, which were such a drag on European growth (Chart 5).

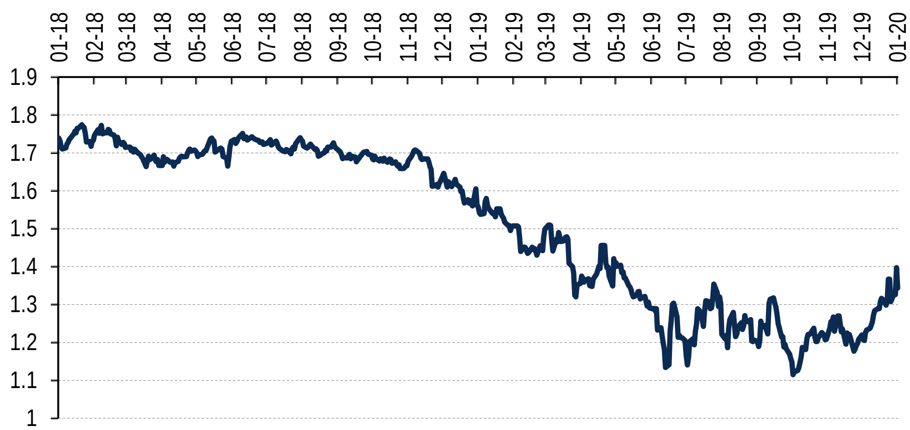
Chart 5: global trade volumes (% y/y)



Source: CPB Netherlands

Inflation expectations are off their lows, shown in Chart 6. However, they remain well below the current ECB inflation target of “below, but close to, 2%”and as we discuss in this report, an effective rise in the ECB goal to “2%” is likely by the end of 2020. We discuss the Strategic Review in depth later in this report.

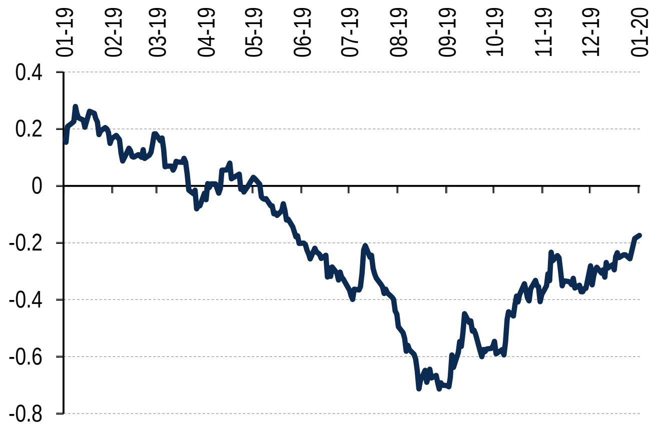
Chart 6: Forward Inflation Swaps 5Y5Y (%)



Source: BofA Global Research, Bloomberg

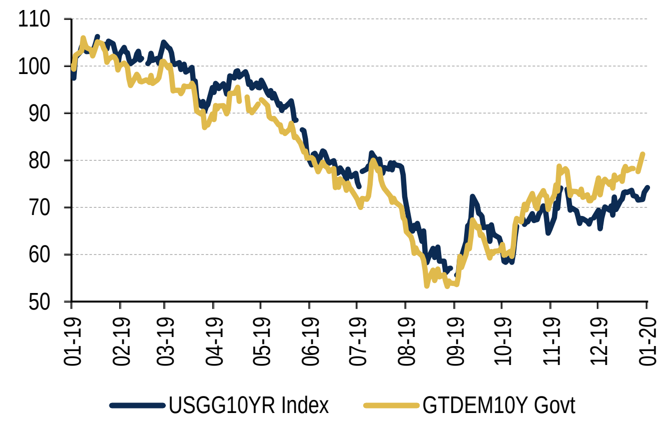
Longer term yields are better (Chart 7). Even if this may be largely a function of US yields improving (Chart 8), it is certainly welcome.

Chart 7: 10Y Bund yield (%)



Source: Bloomberg

Chart 8: yield on 10Y government bonds, indexed: US and Germany



Source: Bloomberg

Banks are not particularly dependent on the long end of the yield curve for their profits, as shown in Table 1. Overnight rates are by far more important. However, replication portfolios do matter over time – the reinvestment yield on the securities banks hold to hedge their deposit income is typically of the 3-7 year duration. Therefore, banks benefit from higher long-term yields. The rise in confidence about longer term economic growth that comes with higher yields is also helpful.

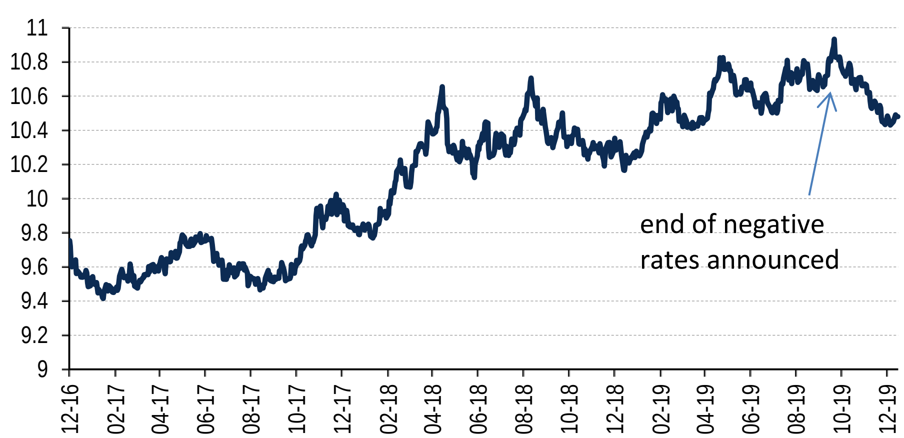
Table 1: importance of various points on the yield curve

	Banks	Life insurance	Pension funds
Overnight	Very	Not	Not
2Y	Rather	Quite	Quite
5Y	Quite	Rather	Quite
10Y	Not usually	Very	Rather
30Y	Not	Very	Very

Source: BofA Global Research estimates

Might short-term rates move? We think not. The recent Swedish example of the Riksbank moving back to zero is tempting to consider, but ultimately not helpful, we think. The Riksbank was advantaged in being able to move out of negative rates for several reasons. First, a significant weakening in the SEK against the euro is inflationary and stimulative to economic growth in Sweden's highly open economy. We note in this context that the SEK has strengthened against the euro since the announcement.

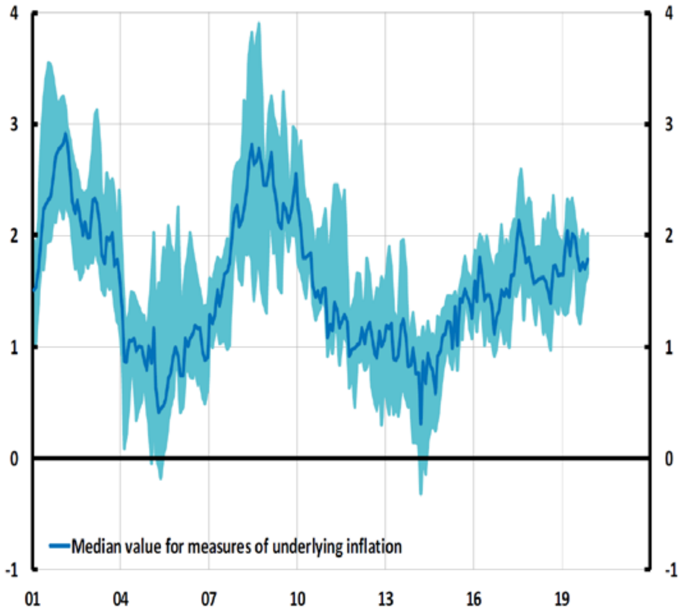
Chart 9: EUR/ SEK, last 3 years



Source: BofA Global Research, Bloomberg

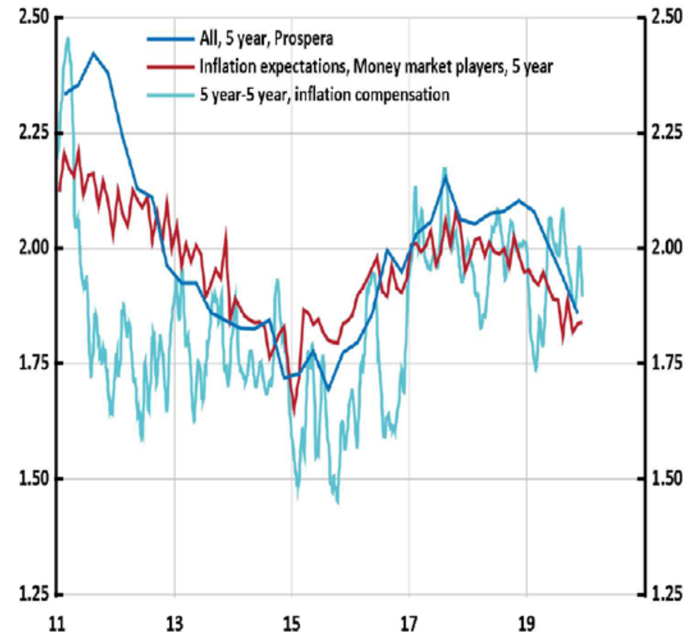
Sweden was also closer to its 2% inflation goal than is the ECB, shown in Exhibit 1 and Exhibit 2. This compares with Chart 6, showing the considerable distance the ECB still has to travel.

Exhibit 1: Sweden: underlying inflation (%)



Source: Riksbank

Exhibit 2: Sweden: inflation expectations (%)



Source: Riksbank

The Riksbank specifically references the problem being permanently negative rates in its decision to raise the repo rate back to zero: see box.

> The negative repo rate and purchases of government bonds have worked well and had a positive impact on the economy. But if negative nominal interest rates are perceived as a more permanent state, the behaviour of economic agents may change and negative effects may arise
> *Riksbank, December 2019*

In this report, we discuss the ECB Review and what will be a key distinction between rates negative forever; and rates negative for long enough to be a problem for bank shareholders. These are potentially two different things. Chart 10 shows that since the summer of 2019, when the ECB was considering significant rate cuts ,the number of months we estimate the market is pricing it has to wait until the ECB has raised by 20bp has more than halved. However, it is at 55 months still a long wait.

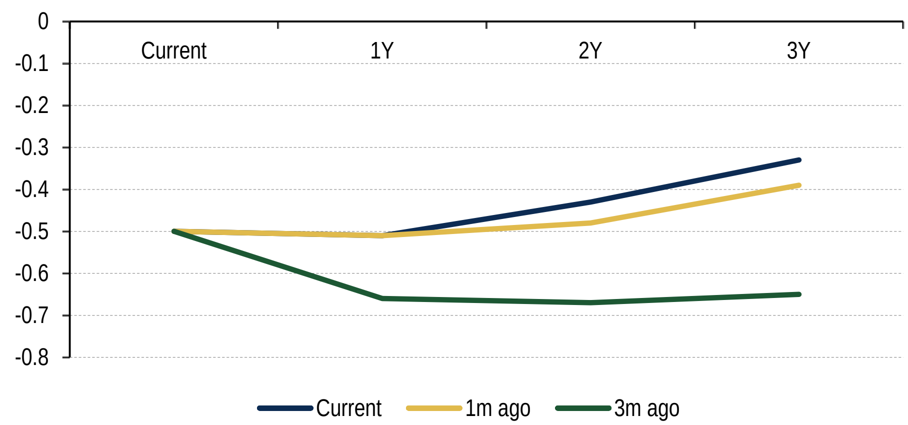
Chart 10: months until the ECB has hiked by 20bp

Source: BofA Global Research estimates

Even a discussion is helpful

The ECB Strategic Review is already undermining one element of its policy, that of Forward Guidance. Policy is clear: rates will not rise until inflation has moved towards its goal "in a sustained manner". As shown in Chart 6, market pricing is that this will not occur within the next five years. Yet Chart 11 shows that the market is now pricing rate hikes within the next three. Confusion is certainly building. In some ways, this is helpful for the banks.

Chart 11: Market Implied Policy Rate, ECB (%)



Source: Bloomberg

A doubling of profits for current Fed Funds equivalent

The banks are exceptionally sensitive to changes in rates. We show in Table 2 that 50bp higher rates would drive a 25% uplift to industry pre-tax profits. While the impact would fade gradually as rates moved above zero, this illustrates that were rates at today's US levels, 200bp higher, industry profits may be close to double current levels.

Table 2: interest rate sensitivity (€ mn)

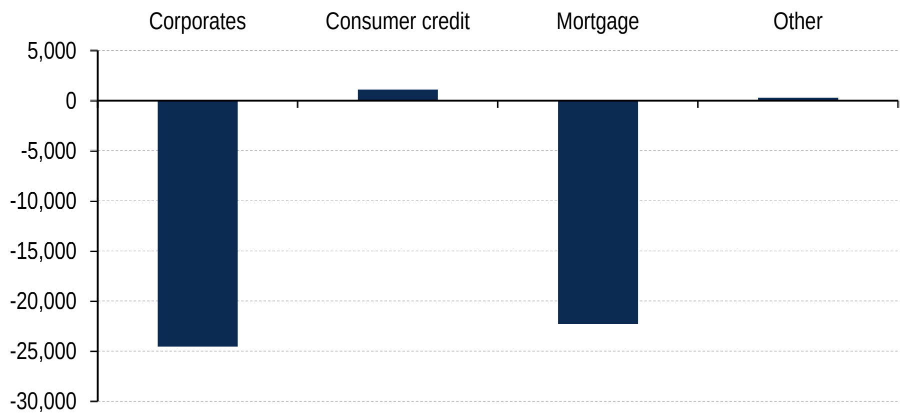
	Balance	% EURIBOR linked	Euribor exposed	euro rate change	Change in income	System income	System PBT	Change in income	Change in PBT
Corporate loans	5,052	90%	4,547	0.50%	23				
Household loans	5,497	25%	1,374	0.50%	7				
Total	10,549				30	461	116	6%	25%

Source: BofA Global Research estimates, Single Supervisory Mechanism

Patience is expensive

Meanwhile, income pressure on the system is significant. We laid out in Goodbye 70s, 24 October 2019 how loan books rolling from back book yields onto current yields is a €45 billion revenue hit to come. Chart 12 shows that the pressure is relatively evenly split between corporate loans and mortgages.

Chart 12: income loss ahead from rolling loan books to current yields (€ mn)



Source: BofA Global Research estimates

How long does this take to come through? Corporate loans are typically less than three years in duration, often shorter. Mortgages are more often 30 years, but ultra-low long term rates means that in many countries, behavioral duration is now short, at five years or less. Using a weighted four year loan book life, Table 3 then shows that margin pressure from loan spreads is 2.5% income pressure per annum.

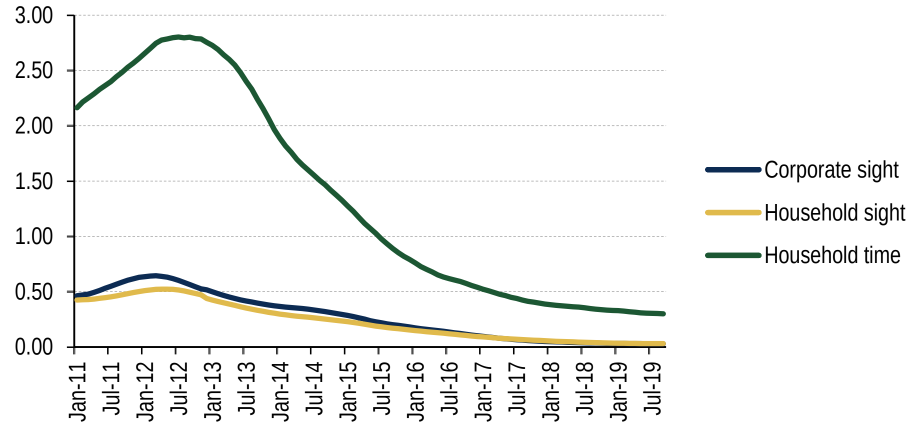
Table 3: loan book margin pressure (€ bn)

System income	460.9
Drag to come from moving to current front book loan rates	45.4
Averag loan book life (years)	4.0
Annual drag	11.4
Annual drag relatve to income	2.5%

Source: BofA Global Research estimates, SSM

There will naturally be other moving parts within banks revenues. Deposit income would usually be a key component, but as we have discussed extensively, is now largely a cost instead. Chart 13 shows that deposit costs are close to zero. There is going to be a wave of charging for deposits, but as discussed in our Year Ahead, we do not see any prospect of banks charging for insured deposits, which account for 60% of the total.

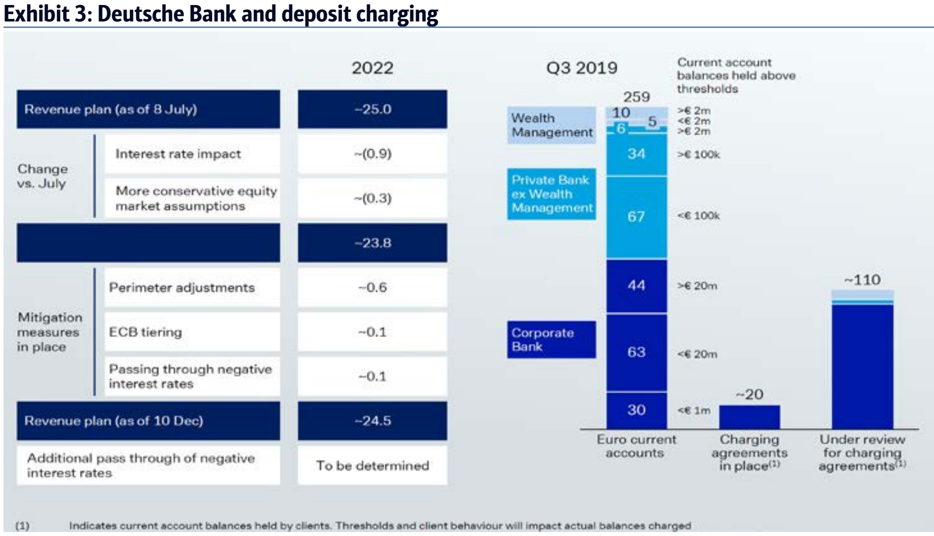
Chart 13: yield on bank deposits (%)



Source: ECB

Nor so we see banks charging the full 50bp negative rates to small and midsize corporates. So while the current, 0.2% contribution to Net Interest Income from deposit charging will grow, we believe its contribution will be modest. Exhibit 3 shows that Deutsche Bank, one of the most affected, only expects to be able to charge 40% of its deposits over time.

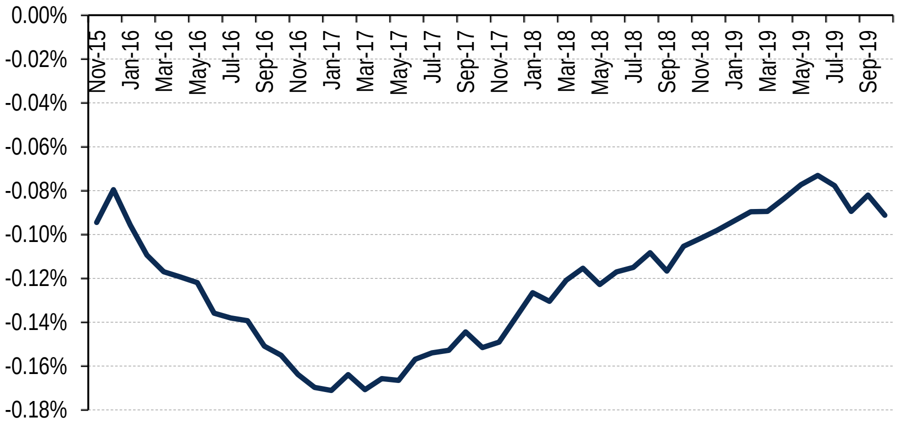
Exhibit 3: Deutsche Bank and deposit charging



Source: company

This combination is likely to see further top-line pressure. Chart 14 shows our estimate of the year over year compression in customer spread – the difference between the yield on loans and the cost of deposits. With the spread at 1.97% in October 2019, the 9bp y/y reduction represents a 4.5% annual reduction in spread income on a static balance sheet.

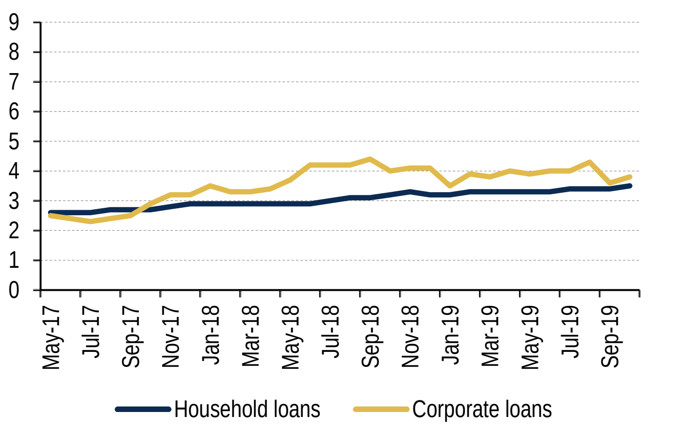
Chart 14: change in customer spread, euro area banks y/y



Source: BofA Global Research estimates, ECB

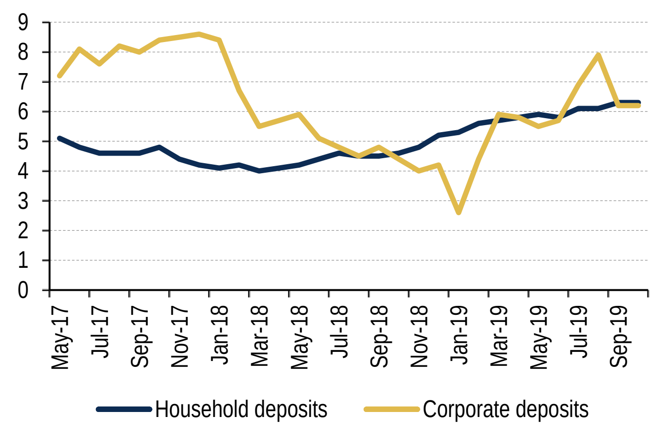
There is loan growth in the system, shown in Chart 15. At about 3.5% this is a meaningful offset to the spread pressure on income – although as we discuss later in the report, a capital-intensive one.

Chart 15: euro area loan growth (% y/y)



Source: BofA Global Research estimates, ECB

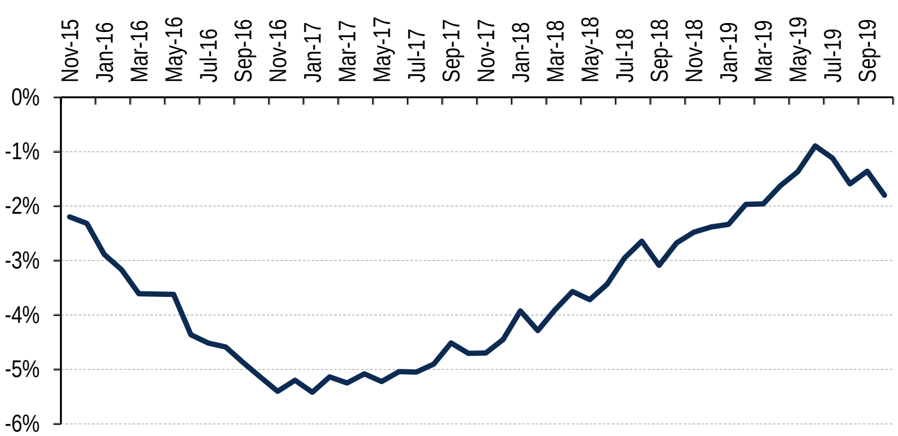
Chart 16: euro area deposit growth (% y/y)



Source: BofA Global Research estimates, ECB

Put together, spread income can't quite get back to flat, as illustrated in Chart 12.

Chart 17: spread revenue in the euro area, change % y/y

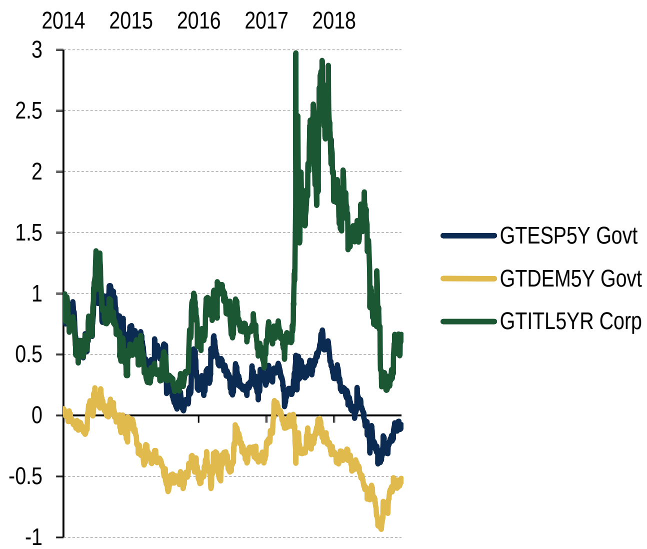


Source: BofA Global Research estimates, ECB

Cheap funding schemes such as the Targeted Longer Term Refinancing Operation III recently launched by the ECB could in theory lower banks' funding costs. But both auctions so far have seen a net reduction in bank borrowing, emphasising that banks had taken all they wanted in prior TLTROs.

Carry trades and replication portfolios will typically be the second largest component of Net Interest Income, in a negative rate environment. We show in Chart 18 that government bond yields are lower than historically; and that except in Italy (Chart 19), the credit spread is also well down.

Chart 18: 5Y government bond yields (%)



Source: Bloomberg

Chart 19: 5Y government bond spread to Germany (%)

Source: Bloomberg

Bank debt spreads are at long-term lows, which will help. But pressing in the opposite direction, banks still have significant subordinated debt issuance to undertake.

Fintech fee pressure: transferwise an example

Fintechs will not be helping from a fees perspective. A recent youtube post from transferwise stated that its customers had saved US$1.5 billion in bank fees through using its service instead. This is not a verifiable figure, but it chimes with our own experience of the expense of a retail transfer being up to 90% lower than your author's bank used to charge (discussed in our Year Ahead).

Using the figure as an illustration, adding in the comparable user figures of revolut and assuming that all the other fintechs such as n26, and UK novobanks such as monzo are the same size in retail FX as transferwise or revolut, Table 4 provides an example of the profit pressure resulting on the banks.

Table 4: illustrative fintech revenue and PBT cost for banks, 2019 (€ mn)

Bank fees saved (US$)	1,500
EUR	1.14
Bank fees saved EUR)	1,316
transferwise implied fintech share	33%
Implied fintech revenue pressure	3,987
Bank revenues	460,900
Bank PBT	116,100
Fintech hit % revenues	0.9%
Fintech hit % revenues	3.4%

Source: BofA Global Research estimates, SSM

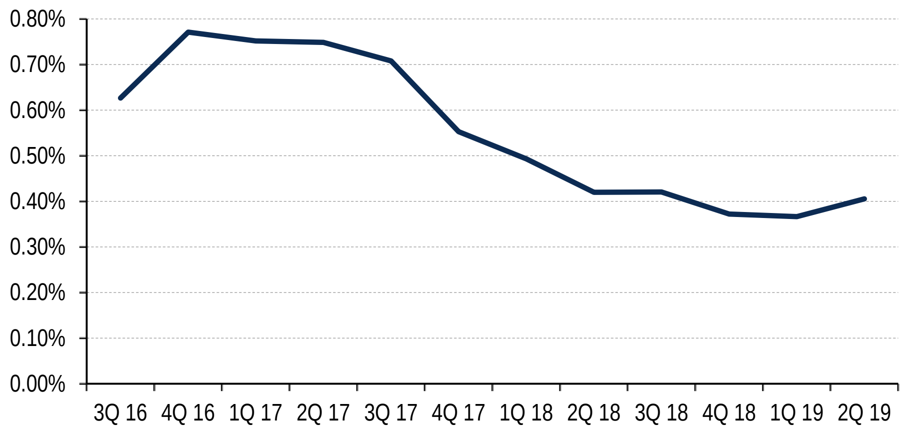
Retail FX is not a dominant income stream for the banks. But neither are marginal costs very high. So losing €4bn of income is more or less the same as losing €4bn in pretax profit. This is 3% of industry profit.

Fintech financing was very strong in 2019. The industry raised as much money in Europe last year as in all prior years put together. We believe it is likely to grow strongly in 2020 at least. Whether all the business models work out is highly debatable, but the income squeeze on the banks is not, we think. We see it very difficult for banks to grow fees beyond those associated with balance sheet growth.

Upside to payouts only when rates move

Overall then, banks are growing loans at around 3.5% to present. Our analysis shows that at least this pace of growth is necessary to keep income flat. As discussed in Year Ahead: momentum, euro-style 27 November 2019 and Goodbye 70s, 24 October 2019, we see costs no better than flat – banks are accelerating tech investments, which will consume any lessening in regulatory costs. And impairments are already at historical lows, as shown in Chart 20. We see little further operating leverage from this source.

Chart 20: trailing 12 month impairments % loans, euro area



Source: BofA Global Research estimates, SSM

Therefore, the system with a 6% Return on Equity is using over half its earnings to keep income steady. The listed banks, making over 7% are slightly better off, but the maths is still challenging. As an illustration, Table 5 shows what level of payout is sustainable, cut by Return on Equity and loan growth.

Table 5: what's left over after supporting loan growth: sustainable dividend (%)

Dividend sustainable	ROE %	ROE %	ROE %	ROE %
Loan growth	8	7	6	5
2%	75%	63%	50%	38%
3%	63%	50%	38%	25%
4%	50%	38%	25%	13%
5%	38%	25%	13%	0%

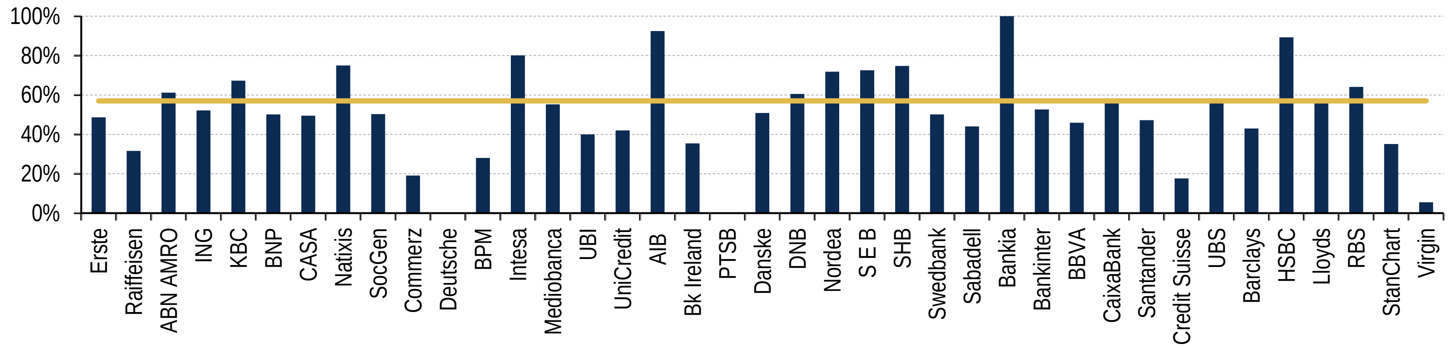
Source: BofA Global Research estimates

The underlying assumptions in Table 5 are that

- The bank wants to maintain a stable capital ratio year-on-year
- Loans being made have the same Risk Weight as loans on the book
- There are no other regulatory changes

Chart 21 shows that European banks are paying out 57% of 2020 profits in dividends. Outside the euro area, buybacks add several points to this; within the euro area, buybacks remain a rarity.

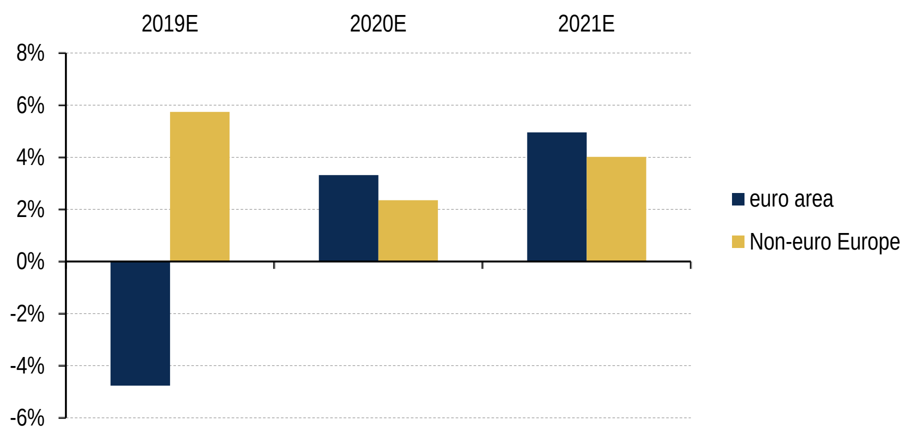
Chart 21: 2020E dividend payouts (%)



Source: BofA Global Research estimates

At 57%, distributions are maxed out for the system, until there is a change in the direction of earnings. We do expect PBT growth in 2020, shown in Chart 22, at a modest 3%. This is not likely to move the dividend dial a lot.

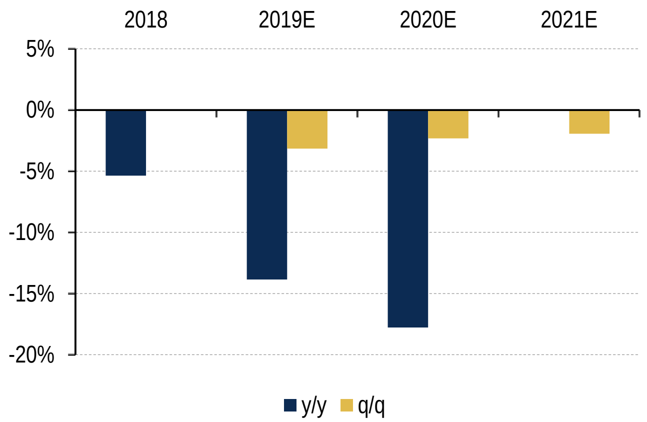
Chart 22: PBT growth (% y/y)



Source: BofA Global Research estimates

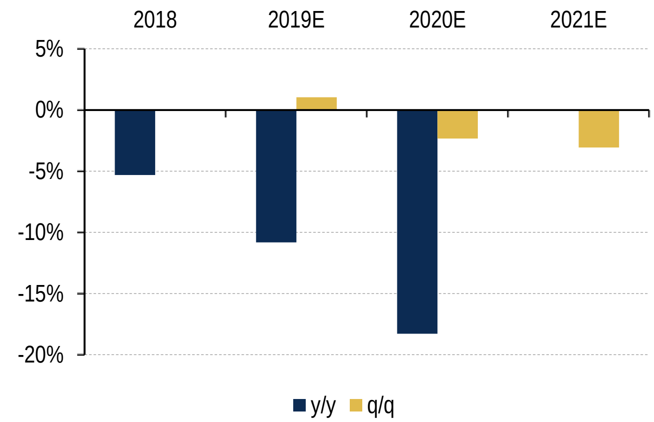
Revisions have remained negative, but at a significantly more moderate pace than in mid-2019 when global rates were falling rapidly. Chart 23 shows the 2% downgrades over the last 3 months compare with 12-16% over the prior nine for the euro banks.

Chart 23: euro area PBT revisions (%)



Source: BofA Global Research estimates

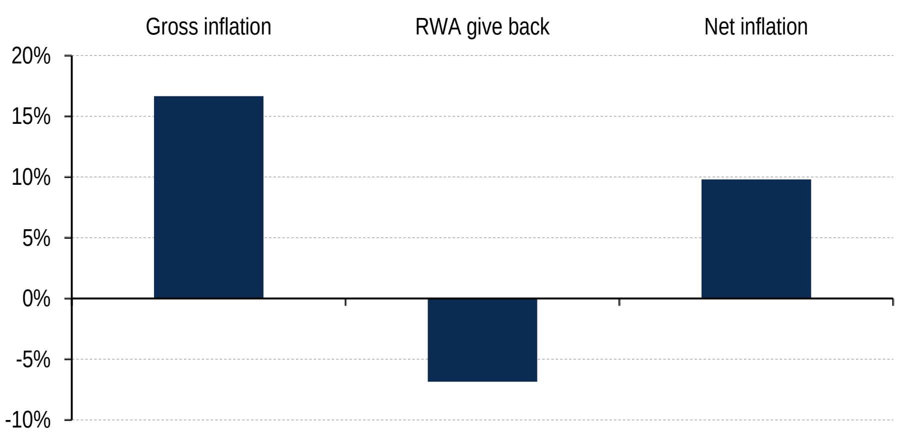
Chart 24: non-euro Europe PBT revisions (%)



Source: BofA Global Research estimates

The Pillar 2 give-back from the European Central Bank reduces regulatory inflation by close to a half over the next few years (Chart 25). This is very welcome. However, for a typical bank the ECB relief comes after 2021; and in each of the next two years there is likely to be several percentage points of RWA inflation. This means that the typical bank will have very little free cash flow for distribution to shareholders in the short term and will only be able to pay around 40 to 50% of its earnings sustainably, without disposals, optimisation or balance sheet constraints.

Chart 25: changes to capital requirements from regulation, stable balance sheet (%)



Source: BofA Global Research estimates

We now turn to the likely cause of much of the 2020 debate: the ECB Strategic Review set to be launched in coming weeks.

The ECB Strategic Review

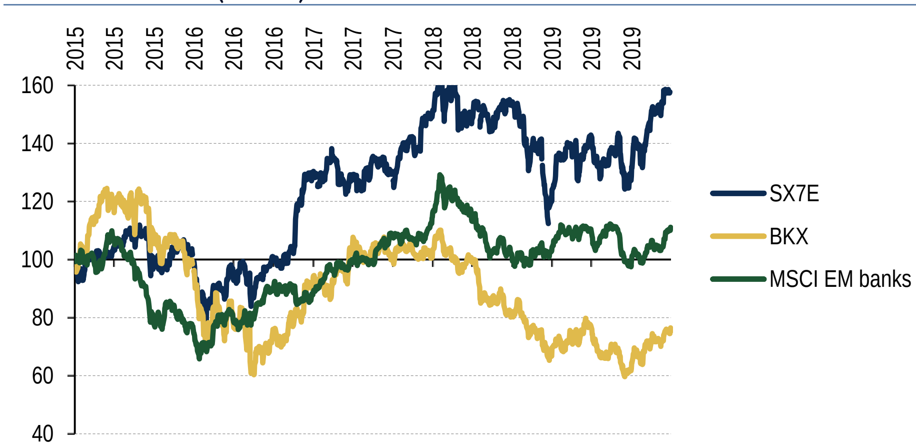
The ECB will launch its Strategic Review this month. As discussed in our Year Ahead, we see this introducing considerable confusion over the course of 2020. The Review will not address the mandate of price stability, but will include most everything else:

- The definition of price stability, currently "below, but close to, 2%"
- The time frame in which price stability should be achieved, or averaged
- The tools used and the combination of them
- The inflation measure considered. This could for example include a greater weight for property, which currently contributes about 7% to the basket but for many Europeans, much more than that in their living costs
- How the ECB should operate and disclose its discussions – for example, some other central banks publish who voted for what in monetary decisions
- The proposal to include climate change and income inequality in the debate will further increase complexity (see box).

> It will include the immense challenge that climate change is addressing to each and every one of us… It will include aspects of inequality that are certainly rising in our economies… serving the euro area citizens, and delivering on the mandate of price stability
> *Christine Lagarde, December 2019*

We have a contribution to make to the debate: we have long argued that negative rates will wreck the banking system in the end. There is no change that view. In fact, the evidence continues to build (Chart 3, Chart 23 and Chart 26)

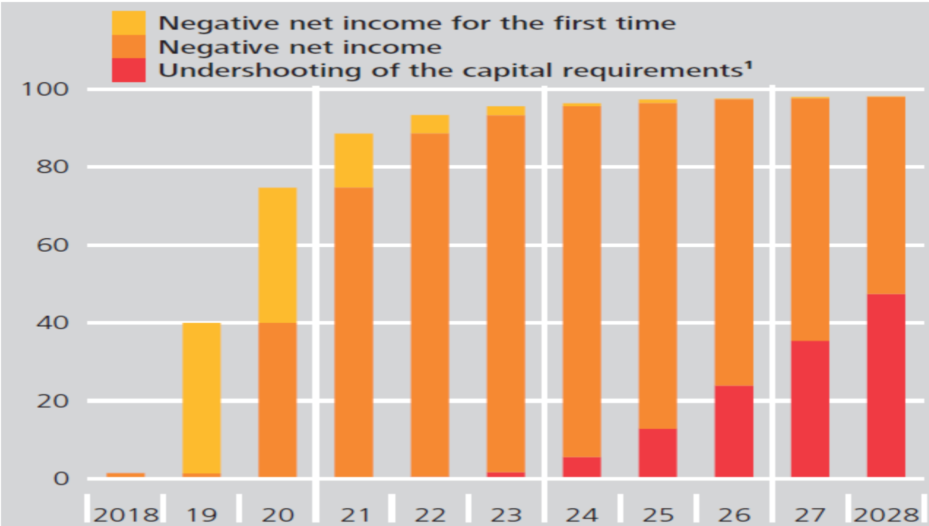
Chart 26: bank indices (indexed)



Source: Bloomberg

However, the weakening is a slow burn in a system with strong capital and liquidity. It may be some years before aggregate credit supply visibly deteriorates. As the Bundesbank showed (Exhibit 4), even for what is the most impaired European banking market by earnings capacity, it is several years before banks burn through their capital reserves.

Exhibit 4: percentage of German banks at risk in the low interest rate scenario (%)



Source: Bundesbank Financial Stability Report

We think the likely outcome is an inflation goal of "2%", but the market will have go through the full range of possibilities through 2020, as they are all on the table. And while we think there is little real argument against negative rates as a dominant problem for banks, banks are not the whole story.

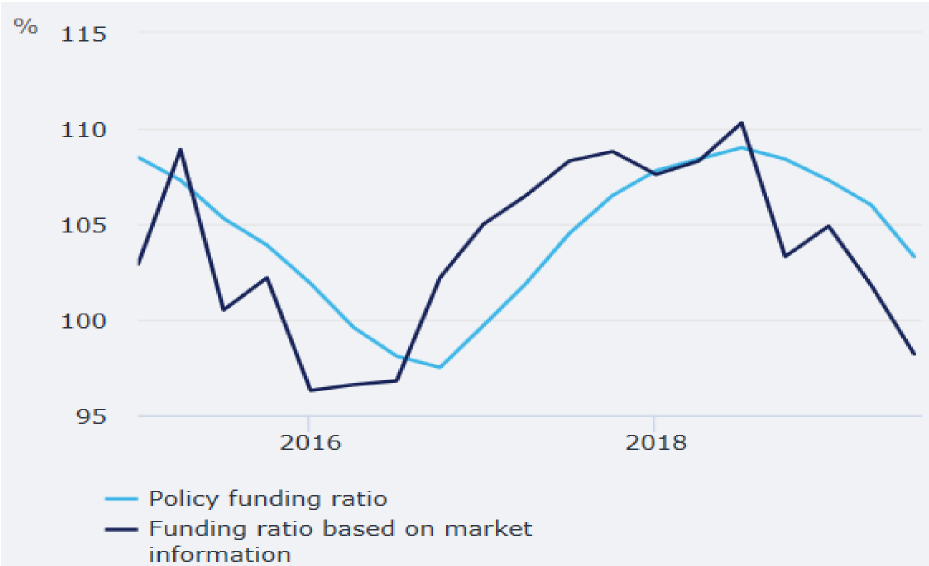
Banks will not charge for insured deposits

Other parts of the tool kit are problematic for other financial stakeholders and perhaps more relevantly, may have a more direct impact on voters. For example, the vast majority of people (voters) have savings below €100,000. We do not expect banks to charge negative rates to depositors with balances below this level. Therefore, while companies and wealthy individuals will increasingly see the direct effects of negative rates, for most voters they are comparable to simply very low rates.

Pensions hits very visible

In contrast, many voters receive statements predicting their future pension. Most visibly in the Netherlands, but across Europe, these statements will increasingly show that peoples retirement income expectations are not going to be met, because of ultra-low Long term interest rates (Exhibit 5). German 30 year bond yields are below those of Japan. We believe this may be directly attributed to the ECB asset purchase program.

Exhibit 5: (policy) funding ratio, Dutch pension funds



Source: DNB

This implies, we believe, that the asset purchase program may be more controversial than negative rates with voters. It already is with many ECB governing Council members. If we were to identify the piece of unconventional monetary policy that is most problematic with the public, it is not negative rates. And it may not be for the financial system as a whole. The banks are on their own here.

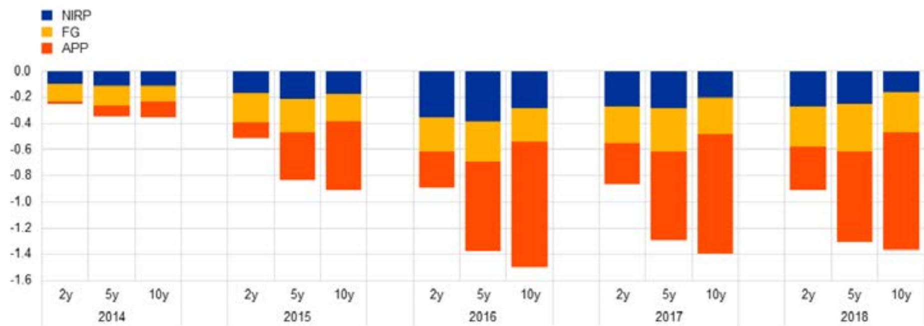
Considering the likelihood of their removal, we now turn to the considerable evidence marshalled by the ECB's chief economist and the (staff) director of monetary policy in defence of negative rates and the other pieces of unconventional policy.

We never liked them, but…

We never liked negative rates. The market has fallen out of love with them. And it's not at all clear that the animal spirits they were expected to generate have indeed appeared. However, this lacklustre picture is different from clarity on their comprehensive failure. For a central bank that has not achieved its inflation goal, removing one or more of its tools is a very high bar, we believe.

The chief economist Philip Lane has laid out considerable evidence over seven speeches in recent weeks in the recent past of how effective various parts of the toolkit have been, including negative rates. We detail some of these here, starting with Exhibit 6, which shows that each of the Negative Interest Rate Policy, Forward Guidance and the Asset Purchase Programme have contributed to compressing government bond yields.

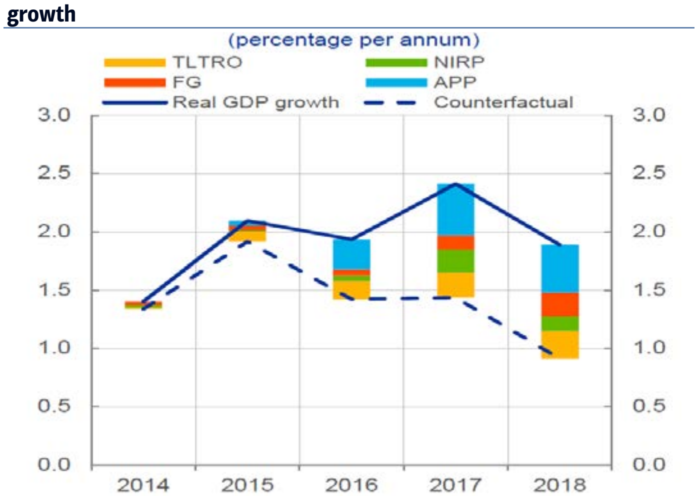
Exhibit 6: compression of euro area sovereign yield curve due to ECB's non-standard measures (%)



Source: ECB, Lane 25/11/19

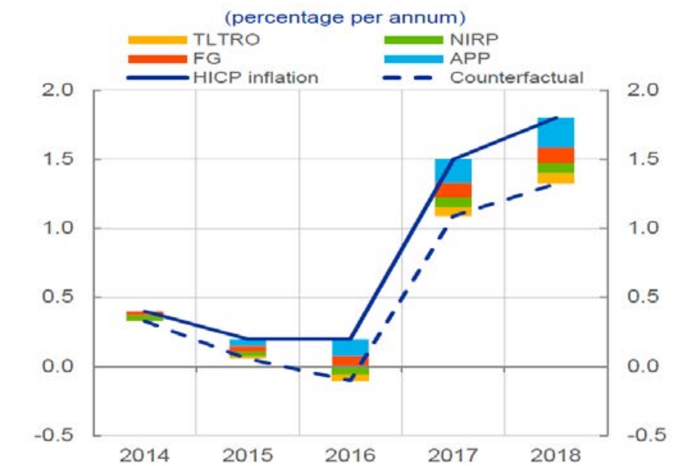
Each component has also been a significant contributor to both inflation and GDP, according to the presented evidence, shown in Exhibit 7 and Exhibit 8.

Exhibit 7: contribution of ECB non-standard measures to real GDP growth



Source: ECB, Lane 16/10/19

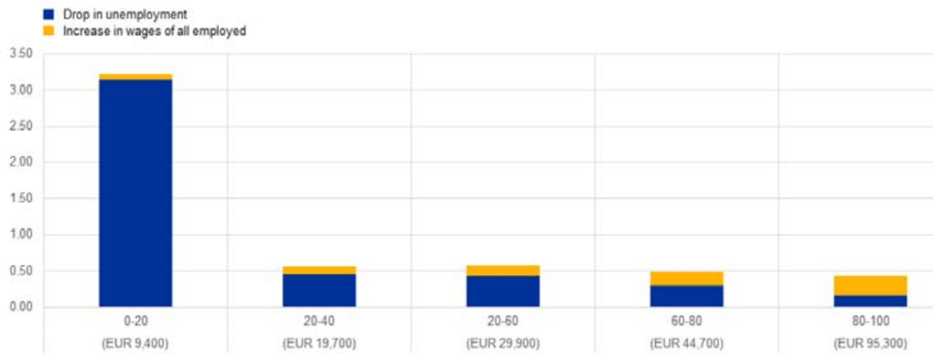
Exhibit 8: contribution of ECB non-standard measures to HICP inflation



Source: ECB, Lane 16/10/19

Lane goes on to show that the lowest income quintile have benefited disproportionately, in Exhibit 9. For an ECB set to include income inequality in its Strategic Review, this is strong stuff.

Exhibit 9: effect of monetary policy easing on household income by income quintile

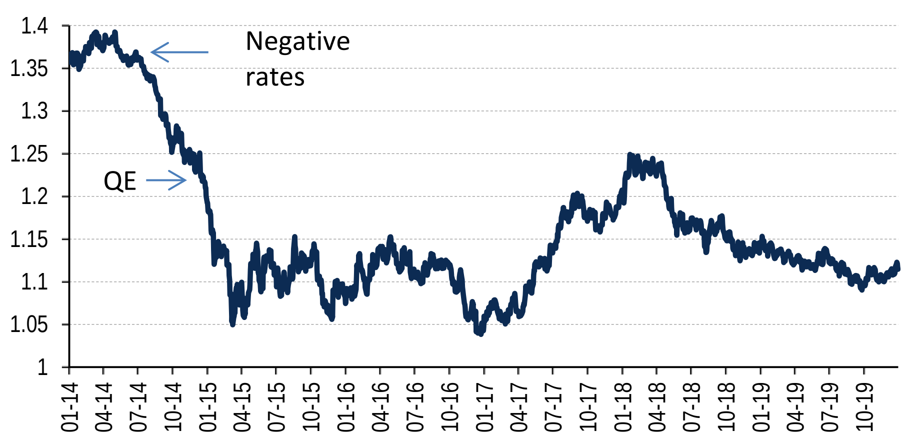


Source: ECB/ Lane 16/12/19

Counterfactual is key

The counterfactual is the key argument. Sure, we missed our inflation target. But look how much worse it would have been without us applying these tools. Again, an argument hard to prove, but not one obviously wrong. Chart 27 is an example, showing that the euro weakened significantly as unconventional monetary policy was introduced by the ECB, something which will certainly have been stimulative to the economy and inflation.

Chart 27: euro/dollar exchange rate



Source: BofA Global Research, Bloomberg

Perhaps it's too soon to tell

And perhaps there is even an argument that negative rates have not had time to work their way through yet. If banks have yet to charge depositors for holding their money, then depositors have yet to experience negative rates. As discussed in A three-step recovery from repression 02 September 2019, banks are set to accelerate their pass through to customers. This could mean, at least from the ECB's perspective, that negative rates will be more impactful as they reach savers, a process which is just beginning.

There is evidence it has worked outside the banks

The evidence provided by the ECB shows that cutting rates and purchasing assets have been highly significant. Those of us who may wish either or both policies to be withdrawn may need to offer robust evidence that withdrawal will not spike the euro, or Italian bond yields, or the cost of credit to companies.

There has certainly been a great deal of evidence provided to support the ECB's policies. A 337-page ECB Working Paper published in December 2019 by the director of the Monetary Policy at the ECB frames much of the Strategic Review, we believe. We highlight some key points, as those wishing for a different monetary policy will have to calibrate their arguments accordingly

First, the summary in the Working Paper does not see bank challenges outweighing other benefits:

> The all-in general equilibrium advantages of the strategy have consistently outstripped any adverse effect that banks might have had to endure
> *ECB working paper A tale of two decades, Rostagno, December 2019*

The paper does consider that there could be a reversal rate, something we discussed in Re-flooring required 31 January 2019. We think bank share prices are strong indicators that the market thinks we are there already. However:

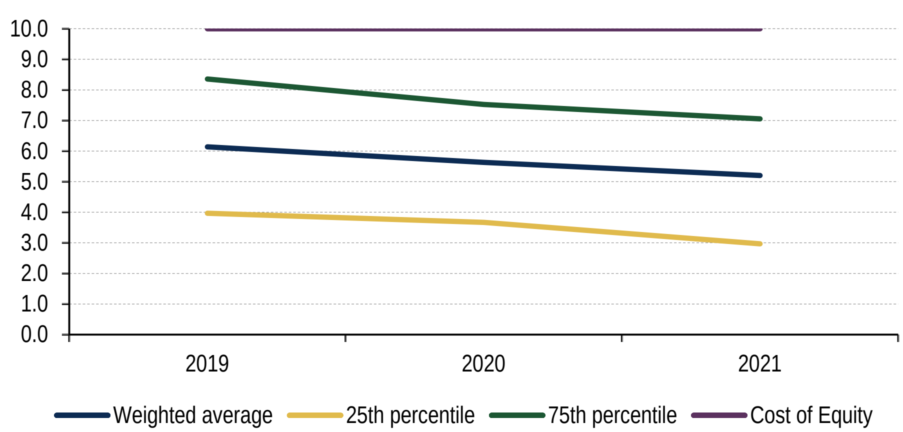
> Looking forward, we entertain the notion of the "reversal rate"… We do not find evidence that such an inflection point might have been anywhere in sight in the euro area at the end of 2018.
> *ECB working paper A tale of two decades, Rostagno, December 2019*

In large part, this is because:

> The over-emphasis that much of the literature places on deposits as the source of funding for banks has led to an under-estimation of the space left for banks to offset the NIRP-induced rate pressure on their asset side with substantial cuts in a wide spectrum of funding costs on their liability side
> *ECB working paper A tale of two decades, Rostagno, December 2019*

Our own view is quite the opposite. We absolutely see deposits as central to banks profits. A bank is built on its ability to raise deposits at below the wholesale cost of money. Otherwise, there really isn't much point in building a retail and SME funding franchise. If wholesale money costs less than nothing, there is always going to be a fundamental problem with bank profitability – as indeed there is (Chart 28).

Chart 28: ECB forecasts for bank Return on Equity, baseline scenario and BofA estimate of Cost of Equity (%)



Source: ECB Financial Stability Review, BofA Global Research estimates

Negative rates central to policy

Nevertheless, the centrality of negative rates to the assessment of the success of ECB policy is evident. We believe this sets a very high bar for the ECB to step away from negative rates: if it believes that excluding negative rates from the policy playbook inherently tightens monetary policy, the very idea of excluding negative rates must be problematic.

> Because the NIRP shatters the notion that zero is the lower bound on policy rates – so much so that the qualifier "zero" has now disappeared from the economic debate on the lower bound constraint – the probability distribution of the expected future short-term rates becomes immune to the upward tilt and tightening bias at low levels of interest rates
> *ECB working paper A tale of two decades, Rostagno, December 2019*

Indeed, the paper states that negative rates avoid banks creating a liquidity trap for ECB policy

> To enforce negative rates, central banks charge a fee on the reserve holdings of commercial banks. That fee … is in effect a Pigovian tax which, when applied on polluting activities, forces agents to internalise the uncharged disservice that they impose on the rest of the system while pursuing their own best interest. In the case at hand, the disservice is created when banks decide to hoard excess liquidity instead of lending it on
> *ECB working paper A tale of two decades, Rostagno, December 2019*

Perhaps most importantly, the paper sees negative rates as central to the whole framework. Without negative rates, the argument goes, forward guidance; the Asset Purchase Programme; and liquidity provision to banks would be less impactful:

> Each instrument had …positive cross-externalities… combined into a holistic frame, with each of the constituent tools intended to reinforce the others… The package matured into a unified policy strategy in which the targeting features of each instrument were perfected, integrated and calibrated to achieve mutually complementary effects
> *ECB working paper A tale of two decades, Rostagno, December 2019*

This is captured in chart form, shown in Exhibit 10.

Exhibit 10: complementarities between instruments

FROM \ TO	NIRP	FG	APP	TLTRO
NIRP	1.1 Empowered rate cut effect on rate expectations (removes their typical upward skew) and term premium (Gesell tax effect)	1.2 Signals a potential future rate cut, which generates curve inversion and downside pressure on lending rates	1.3 Reinforces impact of APP on term premium through the Gesell tax effect	1.4 Reinforces incentive scheme: stronger loan origination entitles banks to negative borrowing rate
FG	2.1 Contains potential term premium volatility created by larger future rate uncertainty (open possibility to increase or cut rates in future)	2.2 Controls the front-end of the forward curve by pricing out expected rate paths inconsistent with the central bank's language	2.3 Anchors the short-end of the curve to ensure it doesn't back up prematurely as APP stimulates the economy	2.4 Together with NIRP, keeps the intermediate segments of the risk free curve used by banks to price loans at low levels, thus stimulating loan demand
APP	3.1 Extra liquidity contributes to keeping overnight rate at the DFR. Contains potential term premium volatility created by larger future rate uncertainty (open possibility to increase or cut rates in future).	3.2 Extra liquidity makes the overnight rate indirectly controllable even if FG applies to DFR. Strengthens signal of accommodative stance for a long period of time	3.3 Extracts duration risk and compresses term premium directly through vast array of assets	3.4 Favours a decrease in the banks' return on bond holdings relative to the return on loan creation. Generates capital gains for banks and frees up balance sheet capacity that banks can redeploy to commercial loans under TLTRO
TLTRO	4.1 Exempts borrowed funds from NIRP tax on reserves	4.2 Strengthens signal of low rates for longer through a fixed borrowing rate	4.3 Favours increase in banks' return on loan creation relative to bond holdings	4.4 Squeezes intermediation wedge by compressing funding costs while preserving lending margins

Source: ECB Working Paper December 2019

To 2%, no further

We note that the last major ECB policy review, in 2003, saw the inflation goal moved from "below 2%" to "below, but close to 2%". We expect the 2020 review to likely result in a further step, to "2%". Moving further seems too much to hope for.

Declare victory and move on

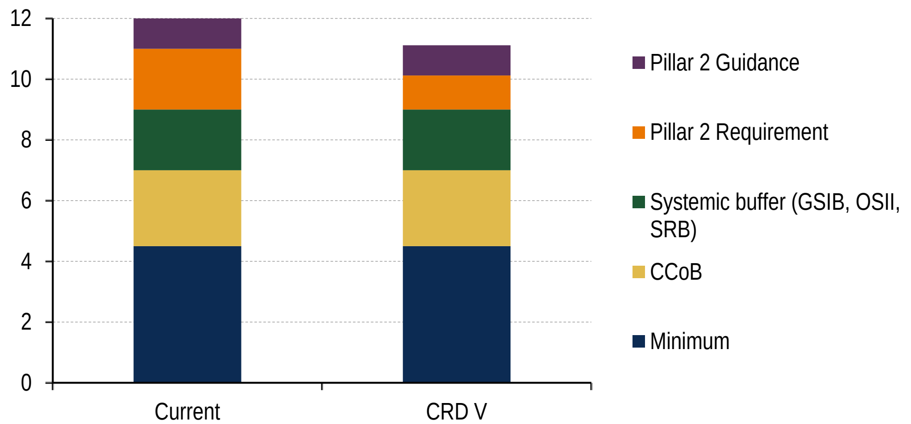
We do not see the Review concluding that negative rates are problematic. The most that realistically can be expected is that better economic growth, a weaker euro or higher realised inflation make it possible for the ECB to declare victory and move on.

We now turn to regulation, another of the three steps out of repression. Here, we do see real progress at hand.

The regulatory pillar: approaching the end

A pleasant surprise for once in December, discussed in Finally some good news on capital 12 December 2019, from the Single Supervisory Mechanism. Chair Andrea Enria stated that it would not seek to offset the proposal in the next round of EU bank regulation "CRD V" that will allow banks to use 44% non-equity capital in their Pillar 2 Requirement. Chart 29 shows that this would move a typical capital stack from a minimum 12% Common Equity Tier 1 ratio to 11.1%.

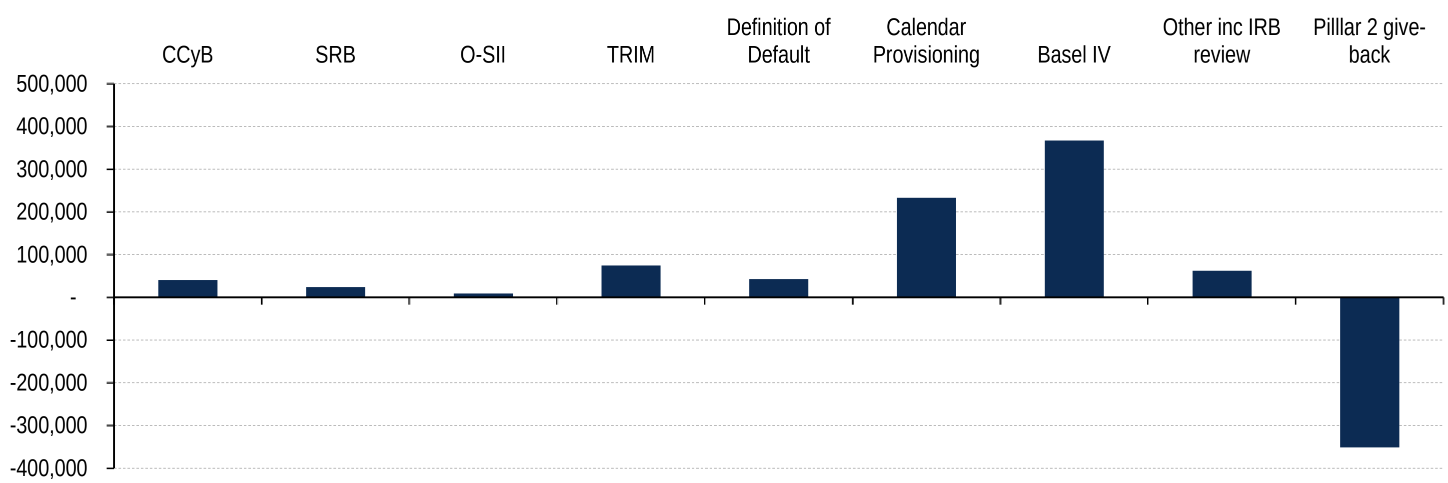
Chart 29: typical Common Equity Tier 1 stack, euro area (%)



Source: BofA Global Research estimates

Industry figures suggest a €74bn lower equity requirement than would otherwise have been the case. This is not the same as the banks having €74bn more cash to distribute, but it is €74bn that they do not have to find from somewhere, through exits, or optimisation, or securitisations. And as Chart 30 shows, expressed in Risk Weighted Asset equivalent, this is a halving of the inflation in capital requirements that otherwise lay ahead.

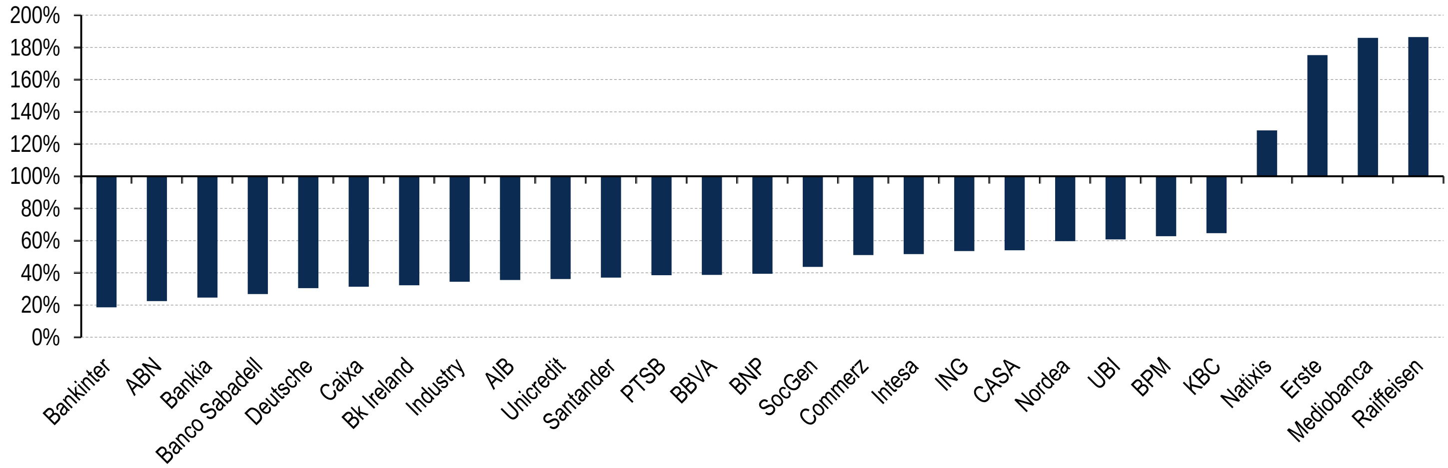
Chart 30: Risk Weighted Asset equivalent of regulatory inflation ahead (€ mn)



Source: BofA Global Research estimates

We break this down by bank in Chart 31, which shows how big the Pillar 2 relief is compared with other inflation that lies ahead on a static balance sheet.

Chart 31: Pillar 2 give-back as a proportion of other capital drag ahead



Source: BofA Global Research estimates

Buy rated stocks with high yields

We see 2020 as hard yards for the banks: we have just 3% PBT growth after the declines of 2019E. But the banks are rich in options. They are positively geared to any improvement in GDP or interest rates. The euro regulatory cycle has lagged those of the US, Switzerland and the UK; stabilisation would allow distributions to pick up. And any sign of Banking Union would enable a start to long-overdue consolidation.

Bank stocks to Buy

We have Buy ratings on ING, Nordea, KBC, CASA, Bank of Ireland, Intesa, Mediobanca, Unicredit, Erste and Raiffeisen. Our Buy—rated banks in the euro area have an average current year PE multiple of 9.5x (Table 6) and a dividend yield of 5.2%. We see these banks with 6% earnings growth into 2021E and 7% dividend growth, both well above the sector average (Chart 22).

Table 6: Buy rated euro area banks

	PE 2020E	PE 2021E	P/TNAV 2020E	Yield 2019E	Yield 2020E
Erste Bank	10.4	9.7	1.0	4.4%	4.7%
Raiffeisen International	6.6	6.2	0.6	4.4%	4.8%
ING Group	8.1	7.9	0.8	6.2%	6.4%
KBC Group	11.5	11.1	1.7	5.7%	5.9%
Credit Agricole SA	9.1	8.6	0.7	5.3%	5.5%
Intesa Sanpaolo	10.8	9.9	0.9	7.9%	7.4%
Mediobanca	10.5	10.0	1.0	4.7%	5.2%
UniCredit	9.3	8.6	0.5	4.7%	4.5%
Bank of Ireland	7.6	6.5	0.6	3.8%	4.7%
Nordea	10.8	10.6	1.0	5.4%	6.6%
Average	9.5	8.9	0.9	5.2%	5.6%

Source: BofA Global Research estimates

Stocks mentioned

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
XBOIF	BIRG ID	Bank Of Ireland	EUR 5.015	C-1-7
CRARF	ACA FP	Credit Agricole	EUR 13.105	B-1-7
EBKDY	EBKDY US	Erste Bank	US$ 19.17	B-1-7
EBKOF	EBS AV	Erste Bank	EUR 34.13	B-1-7
ING	ING US	ING	US$ 12.43	B-1-7
INGVF	INGA NA	ING	EUR 10.948	B-1-7
IITSF	ISP IM	Intesa	EUR 2.3495	B-1-7
KBCSF	KBC BB	KBC	EUR 68.18	A-1-7
MDIBF	MB IM	Mediobanca	EUR 9.914	B-1-7
NBNKF	NDA FH	Nordea	EUR 7.337	B-1-8
XSABF	NDA SS	Nordea	SEK 77.05	B-1-8
RAIFF	RBI AV	Raiffeisen Bank	EUR 22.68	B-1-7
UNCFF	UCG IM	Unicredit	EUR 13.328	C-1-7

Source: BofA Global Research

Price objective basis & risk

Bank Of Ireland Group (XBOIF)

We value Bank of Ireland using a Gordon growth model. Assuming an elevated 11% CoE and no growth, our theoretical P/B model based on our 2020 earnings estimates indicates a valuation of EUR5.40 per share.

Risks to our PO: macro and capital
Top-down risks are those typical for a retail and commercial bank - credit quality, asset quality, competitive pressures on margins. BKIR has a significant UK bank, which now faces heightened risk. We also note the Irish state's high debt to GDP level is elevated. On capital, BKIR now has a Basel III fully-phased, pro-forma 13.6% CET1. As its core system replacement is delivered over 2019-21E, this should build, but regulatory uncertainties around required capital remain.

Credit Agricole (CRARF)

Our price objective of EUR14.0 is based on our standard sum-of-the-parts valuation model, based on 2020 estimates, and takes into account changes to the bank's financial structure based on our best estimate of the final outcome of Basel III rule changes as adopted by CRD IV in Europe. Our sum-of-the-parts valuation methodology values the bank on a divisional basis applying PE multiples to our divisional earnings forecasts or PBV multiples to our allocated equity forecast. Instead of using management's allocation of capital, we apply our own internal method to allocate capital and value any capital surplus or deficit at 1x.

Our valuation model arrives at the following target multiples for the key divisions: French Retail at 1.2x allocated capital (ROE 10%, COE 9%, G 1.0%) or an implied 11x earnings, International retail at 0.8x allocated capital (ROE 8%, COE 10%, G 0.5%) or a implied 10x earnings, Corporate and Investment Banking at 0.7x allocated capital (ROE 10%, COE 13%, G 1.0%) or an implied 8.5x earnings and asset gathering at an implied 11x earnings. We value the capital surplus at 1x BV.

Downside risks are: 1) stagnant French and Italian macro backdrop given the bank large exposure in these markets, 2) higher than expected impact from Basel 4 regulation. The upside is higher rates in Europe supporting the bank's revenues in France and Italy.

Erste Bank (EBKOF / EBKDY)

Our price objective of EUR35 / USD19.38 is based on our standard sum-of-the-parts valuation model. Our sum-of-the-parts valuation methodology values the bank on a divisional basis, applying PNAV multiples to our divisional forecasts on the basis of an ROE/COE model [(ROE - G) / (COE-G)]. Rather than use management's allocation of capital, we apply our own internal method to allocate capital.
ROE = Expected earnings / Average allocated capital assuming 13.5% CET1 ratio
COE = 10 YR bond rate (10 year average) + ERP (7%) * beta (1.3 to 1.6)
G = 0 to 3% depending on nominal GDP growth trends and market share position.

Our valuation model arrives at the following target multiples:
- Austria at 1.2x allocated capital (ROE 11%, COE 9%, G 2%) or an implied 11x earnings
- Central & Eastern Europe at 1.8x allocated capital (ROE 19%, COE 13%, G 0-3%) or an implied 11x earnings
- We value the corporate centre at the average P/E of the operating divisions
- We value the capital surplus at 1x BV

Downside risks to our price objective are: 1) a deterioration of asset quality, 2) a failure of loan growth to materialise despite strong GDP growth in CEE, 3) further political measures that hamper bank profitability. Upside risks are: 1) a further lowering of bank levies, 2) a more aggressive cost cutting plan, 3) higher policy rates.

ING GROEP NV (INGVF / ING)

Our price objective of EUR14.4 (US$16.0 per ADR) is based on our standard sum-of-the-parts valuation model. Our sum-of-the-parts valuation methodology values the bank on a divisional basis, applying PNAV multiples to our divisional forecasts on the basis of an ROE/COE model [(ROE - G) / (COE-G)]. Rather than use management's allocation of capital, we apply our own internal method to allocate capital. ROE = Expected earnings / allocated capital assuming 13.5% CET1 ratio. COE = 10.0%. G = 2%.

Our valuation model arrives at the following target multiples:
Retail at 1.8x allocated capital (ROE 15%, COE 10%, G 2%) or an implied 12x earnings
Commercial Banking at 0.7x allocated capital (ROE 9%, COE 11%, G 2%) or an implied 8.5x earnings. We value the capital surplus at 1x BV.

Downside risks to our PO are 1) material macro slowdown in ING Bank's core markets (Netherlands, Belgium and Germany), 2) lower than expected rates in Europe, 3) significant deterioration in the lending book asset quality and in Turkey and 4) higher than anticipated impact from capital regulation.

Upside risks to our PO are 1) an even more favourable dividend distribution from 2019E, 2) sustainable asset quality normalisation at the bank and 3) achieve or exceed 10-12% new ROE target, especially in terms of margins and costs efficiency (implementing new cost saving plan).

Intesa Sanpaolo (IITSF)

Our EUR 2.80 price objective is based on our sum-of-the-parts methodology. We value each business line by a warranted equity valuation method to determine value on the basis of estimated cross-cycle sustainable ROCE per business unit taking into account the specific characteristics of each business. We then apply a 9.0x PE to value the losses from corporate activities (same as the average of the banking business) . We allocate Tier 1 equity to individual business units in proportion to our estimated allocation of economic capital. Any excess capital (or deficit) is then added back to the valuation at the 1x price/book. We use an average COE of 9.5pc.

The downside risk to our price objective is a protracted slump in the Italian economy. The upside risk is an accelerated way out of the crisis. Note that the bank is a holder of Italy's government bonds and movement in sovereign yields may affect its valuation.

KBC Group (KBCSF)
Our price objective of EUR77 is based on our standard sum-of-the-parts valuation model. Our sum-of-the-parts valuation methodology values the bank on a divisional basis applying PE multiples to our divisional earnings forecasts or PB multiples to our allocated equity forecast. We value Belgium at 12.9x PE, Czech Republic at 14.2x PE and International Retail at 9.7x PE while for Corporate Centre we use a 11.5x PE. We ignore management's allocation of capital and instead apply our own internal method to allocate capital and value any capital surplus or deficit at 1x. The capital surplus in our SOTP includes our estimated excess capital above 15.7% fully loaded Basel 3 CET1 ratio.

The downside risks to our price objective are 1) prolonged unfavourable monetary policy in Europe, 2) hostile regulation against the banking sector in Europe, 3) material macro slowdown in KBC's core markets. On the upside risk, we see potential more favourable dividend policy and higher interest rates in Europe sooner than expected.

Mediobanca (MDIBF)
Our EUR 12.5 price objective is based on our sum of the parts methodology. We value each business line by a warranted equity valuation method to determine value on the basis of estimated cross-cycle sustainable ROCE per business unit taking into account the specific characteristics of each business (average 15%). We then apply the average PE (10.7x) implied by the valuation of the business lines to value the recurring losses from corporate activities. We allocate Tier 1 equity to individual business units in proportion to our estimated allocation of economic capital. We assume that the capital allocated to the units stands at 12.5% RWA. Any excess capital (or deficit) is then added back to the valuation at the 1x price/book. We use an average COE of 9.0%.

The downside risks to our price objectives are a protracted slump in the Italian economy or a loss in value in Generali shares given MB's exposure to the Italian insurer.

Nordea (XSABF / NBNKF)
We use a sum-of-the-parts Gordon growth model, based on forecast profits, allocating a CoE and growth rate to each division. We think it is reasonable to use the SOTP methodology as it allows us to differentiate between the quality of different profits by assigning different costs of equity and growth rates to different divisions. Our PO is SEK80.

Upside risks to our price objective are: 1) a stronger than expected pick-up in loan growth in Sweden or markets-related income, 2) higher capital distributions, 3) less revenue slippage than estimated.

Downside risks to our price objective are: 1) failure to deliver on the announced cost/it program, 2) larger revenue slippage than assumed from reducing balance sheet and reallocating capital.

Raiffeisen Bank International (RAIFF)
Our price objective of EUR 30 is based on a Gordon growth model, cross checked with our SOTP valuation. Gordon growth inputs are a 10% cost of equity, 2020E ROE and 4% sustainable growth. Our SOTP methodology values the bank on a divisional basis, applying PNAV multiples to our divisional forecasts on the basis of an ROE/COE model [(ROE - G) / (COE-G)]. We apply our own internal method to allocate capital.
ROE = Expected earnings / Average allocated capital assuming 10% CET1 ratio
COE = 10 YR bond rate (10 year average) + ERP (6.5%) * beta (1.0 to 1.3)
G = 0 to 4% depending on nominal GDP growth trends and market share position.

We use the following multiples:
- CEE at 1.5x allocated capital (ROE 11%, COE 9%, G 3%) or an implied 14x earnings
- SEE at 2.1x allocated capital (ROE 20%, COE 12%, G 3%) or an implied 10x earnings
- EE at 2.1x allocated capital (ROE 36%, COE 15%, G 4%) or an implied 8x earnings
- Group Corporates & Markets at 1.2x allocated capital (ROE 12%, COE 10%, G 1%) or an implied 10x earnings
- We value the corporate centre at the average P/E of the operating divisions
- We value the capital surplus at 1x BV

Downside risks to our PO are: 1) a worsening economic outlook, and 2) setbacks in the Ukraine economic recovery. Upside risks are: 1) recoveries in Ukraine, 2) general asset quality improvements, 3) a lowering of capital requirements. 4) worse than assumed outcome in polish fx mortgage exposures

Unicredit (UNCFF)

Our EUR 15.0 price objective is based on our sum-of-the-parts methodology. We value each business line on a warranted equity valuation method to determine value on the basis of estimated cross-cycle sustainable ROCE (average 7%) per business unit. We then apply the operating business PE of 8.3x in line with the average level of the operation to value the recurring losses from corporate activities. We allocate Tier 1 equity to individual business units in proportion to our estimated allocation of economic capital. Any excess capital (or deficit) is then added back to the valuation at 1x price/book in line with level we use for the rest of the sector. We use an average COE of 10.5pc.

The downside risks to our PO are a protracted slump in the Italian economy, widening of Italian sovereign spreads, and political uncertainty.

Analyst Certification

We, Alastair Ryan, Alberto Cordara, Andrew Stimpson and Tarik El Mejjad, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

BofA Securities is currently acting as Financial Advisor to Nordea Bank AB in connection with its proposed Strategic Partnership with Gjensidige, which was announced on 2 July 2018.

BofA Securities is currently acting as financial advisor to Unicredit Banca SpA and Unicredit SpA in connection with its proposed sale of a 9% stake in Yapi ve Kredi Bankasi to Koc Holding AS, which was announced on November 30, 2019.

BofA Securities is currently acting as advisor to SGEF S.A in connection with Société Générale SA proposed sale of all shares in SG Finans AS to Nordea, which was announced on December 19, 2019.

BofA Securities is currently acting as financial advisor to Nexi S.p.A. in connection with its proposed acquisition of the merchant acquiring activities of Intesa Sanpaolo S.p.A. ("ISP"), which was announced on December 19, 2019.

EMEA - Banks Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Bank Of Ireland Group	XBOIF	BIRG ID	Alastair Ryan
	Credit Agricole	CRARF	ACA FP	Tarik El Mejjad
	Credit Suisse Group	CSGKF	CSGN SW	Andrew Stimpson
	Credit Suisse Group	CS	CS US	Andrew Stimpson
	DNB	DNBHF	DNB NO	Andrew Stimpson
	Erste Bank	EBKOF	EBS AV	Alastair Ryan
	Erste Bank	EBKDY	EBKDY US	Alastair Ryan
	HSBC	HBCYF	HSBA LN	Alastair Ryan
	ING GROEP NV	ING	ING US	Tarik El Mejjad
	ING GROEP NV	INGVF	INGA NA	Tarik El Mejjad
	Intesa Sanpaolo	IITSF	ISP IM	Alberto Cordara
	KBC Group	KBCSF	KBC BB	Tarik El Mejjad
	Mediobanca	MDIBF	MB IM	Alberto Cordara
	Nordea	NBNKF	NDA FH	Andrew Stimpson
	Nordea	XSABF	NDA SS	Andrew Stimpson
	Raiffeisen Bank International	RAIFF	RBI AV	Alastair Ryan
	StanChart	SCBFF	STAN LN	Alastair Ryan
	UBS	XUHJF	UBSG SW	Andrew Stimpson
	UBS	UBS	UBS US	Andrew Stimpson
	Unicredit	UNCFF	UCG IM	Alberto Cordara
NEUTRAL				
	Allied Irish Banks	AIBRF	AIBG ID	Alastair Ryan
	Banco BPM	BNCZF	BAMI IM	Alberto Cordara
	Barclays	BCLYF	BARC LN	Rohith Chandra-Rajan
	Barclays	BCS	BCS US	Rohith Chandra-Rajan
	BNP Paribas	BNPQF	BNP FP	Tarik El Mejjad
	BNP Paribas	BNPQY	BNPQY US	Tarik El Mejjad
	Danske Bank	DNSKF	DANSKE DC	Andrew Stimpson
	Natixis SA	NTXFF	KN FP	Tarik El Mejjad
	Natixis SA	NTXFY	NTXFY US	Tarik El Mejjad
	Santander	SAN	SAN US	Marta Sanchez Romero
	Santander	BCDRF	SAN SM	Marta Sanchez Romero
	SEB	SVKEF	SEBA SS	Andrew Stimpson
	Swedbank	SWDBF	SWEDA SS	Andrew Stimpson
	UBI	BPPUF	UBI IM	Alberto Cordara
UNDERPERFORM				
	ABN AMRO	ABMRF	ABN NA	Tarik El Mejjad
	Banco Bilbao Vizcaya Argentaria	BBVA	BBVA US	Marta Sanchez Romero
	Banco Bilbao Vizcaya Argentaria	BBVXF	BBVA SM	Marta Sanchez Romero
	Banco Sabadell	BNDSF	SAB SM	Marta Sanchez Romero
	Bankia	BNKXF	BKIA SM	Marta Sanchez Romero
	Bankinter	BKIMF	BKT SM	Marta Sanchez Romero
	Bankinter	BKNIY	BKNIY US	Marta Sanchez Romero
	CaixaBank	CIXPF	CABK SM	Marta Sanchez Romero
	Commerzbank	CRZBF	CBK GR	Andrew Stimpson
	Deutsche Bank	DB	DB US	Andrew Stimpson
	Deutsche Bank	XDUSF	DBK GR	Andrew Stimpson
	Handelsbanken	SVNLF	SHBA SS	Andrew Stimpson
	Lloyds Banking Group	LLDTF	LLOY LN	Rohith Chandra-Rajan
	Lloyds Banking Group	LYG	LYG US	Rohith Chandra-Rajan
	Permanent TSB	ILPMF	IL0A ID	Alastair Ryan
	Royal Bank of Scotland Group PLC	RBSPF	RBS LN	Rohith Chandra-Rajan
	Societe Generale	SCGLF	GLE FP	Tarik El Mejjad
	Societe Generale	SCGLY	SCGLY US	Tarik El Mejjad
	Virgin Money UK PLC	CBBYF	VMUK LN	Rohith Chandra-Rajan
	Virgin Money UK PLC	XZPRF	VUK AU	Rohith Chandra-Rajan
RVW				
	Cembra Money Bank	XMUHF	CMBN SE	Tarik El Mejjad

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	80	41.03%	Buy	69	86.25%
Hold	53	27.18%	Hold	47	88.68%
Sell	62	31.79%	Sell	46	74.19%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2019)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1560	50.49%	Buy	991	63.53%
Hold	717	23.20%	Hold	461	64.30%
Sell	813	26.31%	Sell	415	51.05%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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