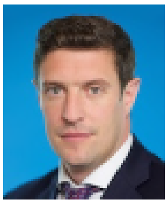
Confidence must be earned

Amundi ASSET MANAGEMENT

September 2019

The ECB and the EU banking sector: some relief, with winners and losers

Kasper ELMGREEN
Head of Equities



Ciaran CALLAGHAN
Equity Analyst, banking sector

- ***The new two-tier deposit-reserving scheme:*** *With this measure the European banking sector could save up to c. €4 billion in annual interest costs (based on avoiding the -50bps deposit rate). However, while a large number in absolute terms,* ***this only accounts for c. 2% of earnings on average for the main banks*** *in the sector and therefore has little impact on overall Returns on Equity and profitability metrics.*
- ***Asset purchasing programme:*** *Banks' funding costs should benefit from the new (now open-ended) QE purchase programme. In this regard, we have already witnessed a number of the higher beta peripheral issuers approach the primary market over recent days and successfully price loss absorbing deals at relatively attractive pricing levels. However, a low yield environment will continue to weigh on bank revenues. The provision of more attractive funding for the sector (per TLTRO III) does also not, perversely, bode well for margins, with the surplus liquidity fuelling further competition (particularly from smaller less viable peripheral banks) in the new lending space.* ***Consequently, front-book asset yields are likely to remain under pressure.***
- ***Outlook for the sector:*** *The earnings outlook is still challenging,* ***with only a few banks able to deliver EPS growth in a low yield enviroment****. Balance sheets have been significantly strengthened since the last financial crisis, with* ***solvency levels effectively doubling*** *(average CET1 Capital Ratio is now over 13%) and the average Loan to Deposit Ratio (LDR) is sub-100%, meaning that there are more deposits than loans on the balance sheets of the listed banks. In a 'normal' world, this would be a positive development; however, negative rates mean that it now is a drag on earnings. Although the financial stability of the sector has been materially enhanced since the last crisis thanks to regulatory imposed deleveraging, profitability has suffered.* ***As a result, the sector is not covering its cost of capital****, and only generating an average Return on Equity of c. 8%. In light of this, it is not surprising to see the stock market pricing the sector at a large discount to book value at an average of c. 0.7x, despite it offering dividend yields of +6%. We see banks that focus on costs and digital, with diversified business models, strong market shares, and scale, as the long-term winners in the space.*
- ***Investment opportunties:*** *The banking sector underperfomed the broad market since March 2018, but we have seen an outperformance since August. We think that recent rotation with '****value' stocks out-performing 'momentum' may have more-room to run****. More medium term, a move towards more fiscal stimulus by governments would be perceived positively by the banking sector. In the meantime, we prefer banks that currently exhibit strong profitability, generating returns above their cost of equity and a focus on cost take-out with the ability to generate positive operating leverage or with a footprint in high growth markets which are more conducive to revenue expansion.*

What are the key measures introduced by the ECB to support European Banks?

In one respect, the ECB again took some more earnings from the banking sector at its latest Governing Council meeting (12 September) by deciding to further reduce the deposit facility (by -10bps, to -50bps) while also keeping forward guidance dovish, so interest rates are expected to remain at current, or lower levels, until inflation converges close to 2%. However, on this occasion, the ECB finally acknowledged that the accommodative monetary policies seen in the recent past were having a detrimental impact on the banking sector profitability and the transmission mechanism. **As such, the ECB announced plans for a new two-tier deposit-reserving scheme, which will see a portion of balances exempted from negative rates.** The finer details are complex (with 6x banks' minimum reserve requirements exempted from negative rates)**, but the scheme should broadly outweigh the earnings drag from the additional deposit rate cut.**

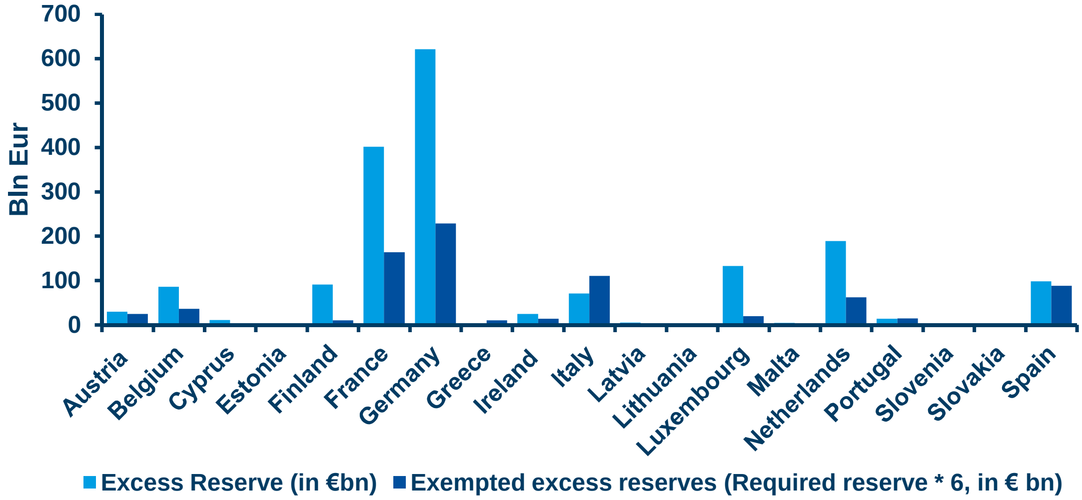
"The new two-tier deposit-reserving scheme should broadly outweigh the earnings drag from the additional deposit rate cut".

In addition a new round of liquidity assistance was unveiled (TLTRO III), with more favourable terms (pricing as low as the deposit facility rate of -50bps, if lending targets are met) and longer maturity (duration extended to three years, from two previously).
We think the improved terms will make it slightly more attractive for some banks to purchase sovereign bonds and benefit from 'carry trades', albeit the large income kicker from these tactical measures has dissipated in the negative rate environment.

How do you expect these measures to impact the banking sector and its profitability?

The European banks currently have c. €1.8 trillion of excess liquidity parked with the ECB. Under the terms of the new two-tier deposit-reserving scheme, c. €800 billion is set to be exempt from negative rates (from 30 October 2019).

EU banks: excess of reserves and exemptions



Source: Amundi Research. Data as of 20 September 2019.

"The saving for the banking sector should have little impact on overall RoEs and profitability metrics".

In theory, this should save the European banking sector (including listed and unlisted institutions) up **to c. €4 billion in annual interest costs** (based on avoiding the -50bps rate on the portion of eligible exempted balances). Banks will still have to pay the negative 50bps on c. €135 billion of minimum reserve deposit balances that must be kept with the ECB and any other deposits above the 6x exemption threshold, which currently is c. €800 billion also. However while a large number in absolute terms, **it only accounts for c. 2% of earnings on average for the main banks in the sector and therefore has little impact on overall Returns on Equity (RoEs) and profitability metrics.**
More interestingly there have been **some positive movements for the banks in the short end of the yield curve since the ECB meeting**, with the Euribor 3 month c. 5bps less negative at -40bps. This reference rate has a key bearing on income for the European banks**, with many of the loans of southern European banks in particular priced at a spread over Euribor**. More talk about the increasing importance of fiscal measures, along with technical factors associated with the new deposit tiering system, have been attributed with driving the back-up in short end rates. Although we can't envisage the ECB being too happy with rising short term rates (as it effectively amounts to a form of tightening from a consumer/corporate perspective), we continue to monitor evolutions closely in this space.

The Governing Council also recommenced the asset purchase programme (APP) as part of its Quantitative Easing (QE) toolkit, committing to buy (public and private) bonds at a monthly pace of €20 billion (from 1 November 2019). In the absence of any large near-term macro shocks, **we believe this technical bid should help to keep corporate bond spreads largely**

"The surplus liquidity from TLTRO III will likely fuel further competition (particularly from smaller less viable peripheral banks) in the new lending space".

underpinned, with the crowding-out effect and chase for yield across debt markets also suppressing bank spreads. **Therefore banks' funding costs should benefit from the new (now open-ended) QE purchase programme**, supporting industry efforts to comply with regulatory debt bail-in requirements. In this regard, we have already witnessed a number of the higher beta peripheral issuers approach the primary market over recent days and successfully price loss absorbing deals at relatively attractive pricing levels. On the flip side however, **negative sovereign bond yields and the lower for longer rate outlook will continue to weigh on bank revenues** via lower reinvestment yields as bonds roll over and via reduced structural hedge swap income (the latter making up a material part of net interest income for many institutions). Perversely, the provision of more attractive funding for the sector (per TLTRO III) converesely does also not bode well for margins, with the surplus liquidity fuelling further competition (particularly from smaller less viable peripheral banks) in the new lending space. **Consequently, front-book asset yields are likely to remain under pressure.**

What is your view on the European banking sector for the coming months?

The low interest rate environment makes it increasingly difficult for the sector to increase top line revenues, as **loan volume growth struggles to offset margin contraction**. At the same time, cost bases are seeing salary inflationary pressures, while regulatory expenses continue to mount. **These dynamics will make operating leverage for the sector more elusive going forward**. On the positive side, credit affordability is supported by the loose monetary accommodation, ensuring that defaults and loan losses remain at cyclical lows, at least for the time being (assuming no further significant economic downturn).

Driver for the banking sector

Negatives	Positives	Overall Assessment
▪ Low interest rate enviroment ▪ Salary inflationary pressure ▪ Regulatory expenses ▪ New entrants, reducing pricing power	▪ Asset quality benefits from loose monetary policies (default and loan losses at cyclical lows, but expected to trend up from here) ▪ Cheaper funding costs	▪ Cautious on overall earnings growth, with very few banks delivering meaningful earnings growth ▪ Balance cost reduction and investment on digital and IT, cyber security

Source: Amundi Research, as of 24 September 2019.

"Very few banks in the sector will actually be able to deliver meaningful earnings growth over the next few years".

However, the benefit of provision writebacks that many banks have been recognising in recent years (legacies from the last crisis) is increasingly diminishing, and therefore it seems inevitable that loan losses will gradually trend upwards to more normalised levels. Furthermore, we note that new IFRS 9 (International Financial Reporting Standards) provisioning rules will accelerate the crystallization of loan losses for banks going forward in the event of any marked economic deterioration, adding to the earnings and capital volatility. This could be happening at a time when the pre-provision profit buffer is being squeezed by margin contraction and elevated cost bases, driving significant earnings downgrades across the sector. In aggregate, **these moving parts imply that very few banks in the sector will actually be able to deliver meaningful earnings growth over the next few years,** and that current consensus expectations on earnings and dividends may be too optimistic. While many banks have successfully passed on the cost of negative deposit rates to corporates, this is more problematic when it comes to unsophisticated retail customers given financial stability concerns and the importance of maintaining primary banking relationships. Over time, we expect more management teams to address the controllable items under their remit and tackle the cost bases. This is a multi-year process for many institutions, however, which still need to invest in digital and new IT systems to keep pace with cyber security issues and peer developments.

What are in your view the implications of the capital ratio for banks?

Balance sheets have been significantly strengthened since the last financial crisis, with solvency levels effectively doubling (average CET1 Capital Ratio is now over 13%) and wholesale funding exposures declining materially. The liquidity profile of the sector has actually

Amundi
ASSET MANAGEMENT

been de-risked so much now that the average **Loan to Deposit Ratio (LDR) is sub 100%,** meaning that there are more deposits than loans on the balance sheets of the listed banks. In a 'normal' world this would be a positive development; however, negative rates mean that it now is a drag on earnings. So, although the financial stability of the sector has been materially enhanced since the last crisis thanks to regulatory imposed deleveraging, profitability has suffered. As a result, **the sector is not covering its cost of capital, and only generating an average RoE of c. 8% (which reflects a wide dispersion across the sector).** In light of this, coupled with the uncertain economic outlook, it is not surprising to see the stock market pricing the sector at a large discount to book value of c. 30% at an average of c. 0.7x, despite it offering dividend yield of +6% (a significant premium to other sectors).

What do you expect will be the key trends and what kind of banks will be the long-term winners?

"Further consolidation is warranted to drive efficiencies and cost synergies".

On a fundamental basis, the outlook for the sector continues to be structurally challenged in our view, until the negative interest rate environment changes. The business model is under threat from new (often capital-light) digital / non-bank entrants, decreasing the industry pricing power. Meanwhile further regulatory headwinds abound, as the phase-in of new Basel capital rules and non-performing-loans calendar provisioning rules approach. Against this backdrop, **further consolidation is warranted to drive efficiencies and cost synergies** – but large pan-European bank mergers face many regulatory and political obstacles. Capital and Liquidity across Europe are not currently fungible, to the detriment of the wider economy. There is some hope that a new leader at the helm of the ECB (Lagarde) may help on this front, reigniting efforts to progress the Banking and Capital Markets Unions, but further integration may take time. **We see banks that focus on costs and digital, with diversified business models, strong market shares, and scale, as the long-term winners in the space.**

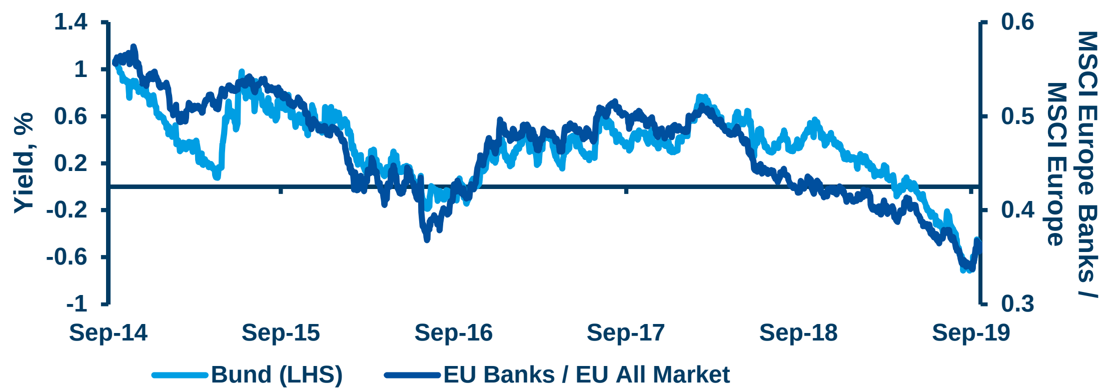
From a European equity perspective, what are your convictions for banks?

"We see banks that focus on costs with diversified business models, strong market shares, and scale, as the long-term winners in the space".

Notwithstanding our cautious fundamental view on the sector with earnings momentum likely to stay negative over coming periods, we still see plenty of alpha generating opportunities for stock pickers in this sector given the volatility, depressed valuations and generally bearish investor sentiment and positioning across the bank universe. Since early 2018, after the anticipated reflation trade ran out of steam, the sector has underperformed the wider market (by c. 30%), initially partly due to macro and geopolitical concerns (such as slowing global growth, trade wars, Brexit). More recently the low interest rate environment has begun to take its toll, weighing on revenues and driving negative earnings revisions. Despite this, the Eurozone bank stocks have bounced-backed from their lows of the summer as bond yields have recovered (German 10Y Bunds are c. 15bps tigher since late August at c. -55bps).

"A sector rotation, with 'value' stocks out-performing 'momentum' may have further to run".

European banking sector relative performance and Bund yields



Source: Amundi Research. Data as of 24 September 2019.

Amundi ASSET MANAGEMENT

"We prefer banks with strong profitability, generating returns above their cost of equity and with a focus on cost take-out with the ability to generate positive operating leverage or with a footprint in high growth markets".

Share price performance has also benefited from a sector rotation, with "value" stocks out-performing "momentum". We think **this reallocation may have further to run given the extreme consensus positioning in momentum names and as sovereign bond yields stabilise**.

More medium term, a move towards **more fiscal stimulus by governments would be perceived positively by the banking sector**, potentially alleviating the negative interest rate headwinds and reinvigorating economic growth (or at least reducing the dependence on monetary easing via more negative rates). In the meantime, **we prefer banks** that currently have **strong profitability, generating returns above their cost of equity, with a focus on cost take-out with the ability to generate positive operating leverage** or **with a footprint in high growth markets which are more conducive to revenue growth**.

Given the depressed sector valuation levels, **regulatory approval for stock buy backs would be very earnings accretive and provide a positive catalyst for the sector,** although we presume some of the event risks (such as Brexit) may need to pass before we see regulators approve reductions in own funds (capital).

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at www.amundi.com

Definitions

- **Alpha**: The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.
- **Beta:** Beta measures an investment's sensitivity (volatility) to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.
- **Capital fungibility:** It means that an asset of the group is readily available for meeting any commitment of the group, regardless of the entity within which asset is held or commitment arises.
- **CET1**: Common Equity Tier 1 is a capital measure for bank capitalization. It is a component of Tier 1 consisting mostly of common stocks held by a bank.
- **Crystallization of loan losses:** The process of realizing losses (related to bad debt/loans/non performing loans) in the financial statements.
- **Cost take-out:** To redesign the elements of a business to the lowest cost structure that can support a company's strategic objectives.
- **Front-book asset yields:** Loans/assets provided to new customers of the bank.
- **Operating leverage:** The degree to which a bank can increase its profits by increasing its revenues.
- **Provision writebacks:** The process of restoring to profit a provision for bad or doubtful debts previously made against profits and no longer required.
- **QE:** Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions. QT: Quantitative tightening is the opposite of quantitative easing.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period of time. They offer long-term funding at attractive conditions to banks in order to further ease private sector credit conditions and stimulate bank lending to the real economy.

Chief Editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Officer

Amundi
ASSET MANAGEMENT