European banks: keep calm amidst stormy markets

Whenever there is a bank in trouble somewhere in the world, investors tend to get nervous. In 2023, in a couple of months, three American regional banks have been put in resolution and a large systemic bank in Europe has been forced into a merger.

The US Regional banks for which these events revealed regulatory weaknesses remain under scrutiny for good reasons. But unfortunately, European banks which are about to publish a glorious Q1 got punished. Forget the February enthusiasm, European banks are now left with questions, not to say suspicion.

Let’s revisit the European Banking sector key themes to the investment thesis that emerged or been challenged recently.

1. **Is deposit flight a real threat to the European banking sector?**

That has been the key theme in Q1. After the recent events, investors got worried about deposit flight and whether the assumption on deposit outflows are accurately modelled or not. Of course, the fallen banks were quite singular banking animals from a deposit standpoint, but it is worth looking into their deposit outflow stories to assess the read across for European banks.

Banks deposits are generally classified in four main categories: stable retail deposits, less stable retail deposits, operational corporate banking accounts and other corporate deposits accounts. For each deposit type, the Liquidity Coverage Ratio assumes a maximum outflow in stress cases. During the recent stress episodes, while less stable retail deposit outflow has massively surpassed the LCR assumptions *(which is are of 12% in 30 days)*, outflow have remained in line for the other categories. Hence, European regulators will probably reconsider less stable retail deposit outflows assumption, but the others seem valid. Assuming the less stable retail deposit outflows would be modelled at 100% in 30 days, this would still leave European banks with a buffer.

At a certain moment during the quarter, the FT published suspicion to another level with an article titled *“Money pulled from eurozone banks at a record rate”*. This probably attracted loads of readers, but we couldn’t find anything scary in the related February ECB data. Out of EUR 54bn of deposits outflows, EUR 32bn went to other financial institutions. Households sight deposits went down EUR 46bn, but term deposit went up EUR 35bn. All in all, this is a EUR 12bn monthly decline in the context of a EUR 14.3trn deposit base.

Hence, deposit flight, although a justified concern within the current context, is in no way a current major weakness for European banks.

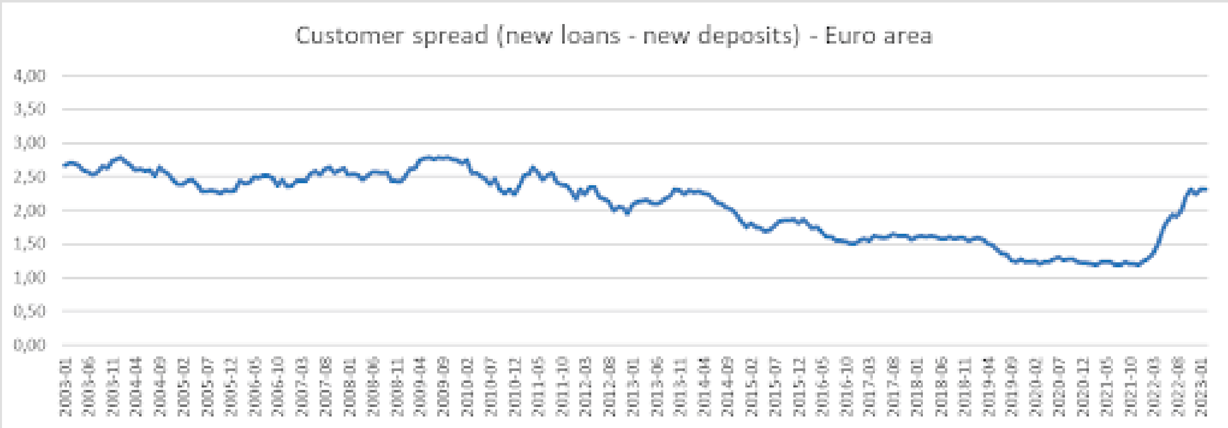
2. **Will Net Interest Margins will fade away?**

Fears on deposits outflows led to the assumption that NII would be at risk. Indeed, interest margin on deposit are expected to be one of the key components of European banks 2023 profits. So, this is obviously a serious challenge to the sector profitability. However, Eurozone customer spread history looked quite stable before negative rates were introduced.

The share of transaction accounts is currently high by historical standards at c. 60% in the Euro area. It is expected that customers will gradually shift to savings and term accounts as well as other fixed income products to optimise their finances. Assuming the deposit mix reverts back to its pre-2014 average (household transaction accounts at 35%), deposit spreads would still remain in the 75 bps to 150 bps band in a scenario where rates remain above 2%.

Although we are at the very beginning of the Q1 reporting for European banks, these assumptions align with what some banks have been guiding for 2024-2026.

Bankinter for instance, expects the customer spread to stay in a sustainable range of 2-2.5% in the current rate environment, which is lower than the current 3% in Q1 given deposit repricing is still to catch up.



Hence, although Net Interest Margin may decrease at some point, we still expect it to rise in 2023 as assets and hedges keep repricing faster than liabilities. This Net Interest Margin increase is in line with bank management guidance. From an expected 2023 Q3-Q4 peak, NII should start decreasing slightly and stabilize in 2024.

All-in-all, as long as rates remain in positive territory, there is no reason why Net Interest Margin should not stabilize back to pre-2014 levels.

3. Will recession increase cost of risks and damage profitability?

Recession increases cost of risk and damages profitability indeed. But the question is to which extent and what is already priced in.

Banking history tells us that a recession sees the cost of risk rising by 40 basis points while a severe recession would see the cost of risk moving up by 80 basis points. On average, every 40 bps increase translates into 3 points decrease in banks' pre-tax Return on Equity. So, depending on the magnitude of the recession, the impact on Banks pre-tax RoE would range from 3 to 6 points.

At the time we are writing, just at the beginning of the European banks Q1 2023 release, the SX7P's expected 2023 RoE stands at 10.4%. Assuming no further RoE upgrades in 2023, a recession in 2024-2026 would bring down RoE to 8% and potentially 5% in a severe scenario (which macro data does not suggest today).

European banks market valuations currently stand at 0.6 x book value. This implies a 6% RoE, hence a combination of a protracted recession and interest rate cuts with some sort of political intervention such as increased taxes, moratoria, etc. Additional Tier 1 market valuations are no different. AT1 currently trade above 500bps in asset swap spreads corresponding to the Covid period.

Current risk premia are consequently extremely elevated, and we believe in disconnect with recent macro data as well as Central banks scenario, however not surprising following SVB and CS fallout.

4. Will buy back and dividends be constrained?

Distributions (buyback and dividends) is one of the major themes in 2023-2025 for the European Banking Sector investment thesis. With profitability restored, European banks distributions are about to surpass their highest pre-crisis history. European Banks have planned distributions that are ranging between 30 to 40% of their market cap over the period 2023-2025.

Covid dividend ban is however still on investors ‘mind and the fact that distributions plans could be reviewed to the downside seems is probably not off the table for many investors.

Several banks have already announced distribution plans validated by their respective regulators *(Unicredit or BNP Paribas for instance).* But more importantly for Eurozone Banks, the regulator has recently clarified its position on future distributions and potential restrictions within the current context.

A few days following CS forced merger with UBS, Mr Enria Chair of the SSM was asked by Members of the European Parliament whether the SSM was considering any restrictions on banks’ dividend and share buy-backs given the recent turmoil. His answer was quite clear *"no that is definitely not something we are considering. We have already reviewed the distribution plans of the banks. They have submitted their capital projections also under adverse scenarios and nothing has changed which affects our assessment of those capital plans...all in all, we wouldn’t see any need to correct our assessment on banks' distributions.".* Hence, European Banks distribution plans seem on track with a clear backing from the regulators.

All in all, yes following the recent events, investing in the banking sector requires a higher degree of vigilance. But we must not forget that all these troubled banks were either very singular or in an already concerning financial situation (CS was the only unprofitable systemic bank in Europe and the one by far with the least stick deposit base). None of these single story changes the European Banks investment thesis, except of course the price point, which is cheaper today than two months ago.

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