European banks: better value than many other sectors

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Solid profitability driven by a rates sweet spot that should see decent earnings combined with increased loan growth, plus a soft landing for the economy, mean we are broadly stable on the sector over the coming years

At Columbia Threadneedle Investments we believe research intensity is key to making informed investment decisions. Our team of analysts and research associates are dedicated to original, independent research which we share and debate with portfolio managers and investment teams. Here we look at the European banking sector, break down the various elements in more detail and set out how we think it will fare over the next couple of years:

Profitability

Over the past two years banks' profitability has really picked up. At the European aggregate level, return on equity (a measure of bank profitability) is now at 15-year highs.[1] We expect it to plateau around this level for the next two years. The improvement has been driven by the higher interest rate environment that has supported lending spreads on new and (in many cases) existing loans, higher yields on bond portfolio reinvestments, and comparatively low deposits costs. Net interest income (NII) on average has soared by around 50% while deposit costs have been far less sensitive to higher rates. The longer than anticipated period of higher rates is supporting net interest margins in 2024 in the UK, Scandinavia and southern Europe. However, rates should start to decline and we believe will normalise at around 2%-3% – a sweet spot where banks can comfortably earn their cost of capital and loan growth should pick-up.

Elsewhere, we expect domestic banks in France to see a pick-up in NII in 2025 after being hammered by the higher rate environment over the past couple of years. This is due to the significant proportion of deposits that are linked to inflation, large long-term fixed rate mortgage

[1] All figures are Columbia Threadneedle Investments' analysis of company reports, May 2024, unless otherwise stated

books, and usury laws slowing higher rates on new lending. Dutch banks have also been affected by their large fixed rate mortgage market.

Lower rates should help stimulate more lending across Europe at arguably better rates than what is on balance sheets. Profitability is also likely to benefit from improvement elsewhere on the income statement including a pick-up in fee and commission income as rates fall as well as a further focus on costs. We also expect restructuring banks in Germany and Switzerland to report enhanced performance.

Asset quality

We do not expect a significant deterioration in asset quality. Although there may be pockets of pressure, these are not material enough to change our overall view. Cost of risk is expected to rise to normalised levels, in line with our expectations for high yield default rates over a 24-month period (high yield lending equates to about a fifth of the loan book). Furthermore, banks have close to a year's worth of loan loss provisions on their balance sheets, built up during the pandemic, that they can first use to offset a deterioration in asset quality before having to increase provisions. Non-performing loans will likely rise modestly where pressure from rising rates is most apparent, but improved underwriting since the global financial crisis, some government guarantees remaining on higher-risk SME lending from the pandemic in some jurisdictions, and a better than feared economic backdrop is limiting deterioration. The household still looks strong and we are not overly concerned by residential mortgage lending in most markets. Although we could see some pockets of pressure in unsecured lending, this is a relatively limited portion of the loan book.

Commercial real estate exposure (CRE)

This remains a key risk, but exposure is lower at European banks than in the US and is more focussed on European CRE. The greatest area of concern is at small German RE-focussed banks. Exposure at Scandinavian banks is high but focussed on the safer credits and parts of the capital structure with, so far, no signs of deterioration.

Periphery Europe

This is well-placed given years of deleveraging and a strengthened risk culture. In addition, there has been better-than-average economic growth boosted by EU recovery programmes and governments' well-oiled fiscal toolboxes that can be rapidly deployed in crises, as seen during the Covid-19 pandemic. Debt levels remain high, however, but are gradually declining.

Capital

Capital levels remain at multi-decade highs while payout ratios are high at around 70%, well above long-run average levels. The latter could increase to a level comparable with larger US banks. This, together with strong levels of profitability, provide banks with significant risk buffers that can absorb any unforeseen losses. We expect bank capital levels to remain high and, if anything, to improve with ample buffers beyond regulatory requirements and to cover expected modest loan growth. All this is reflected in strong outperformance by banks in equity markets over the past year.

Supply

Supply is likely to be more balanced as banks have now largely replaced cheap central bank funding from the Targeted longer-term refinancing operations (TLTROs) with covered bonds, deposits and some senior preferred debt, as well as meeting new capital rules on loss absorbing senior debt.

Valuations

Spreads have tightened across the corporate index, though banks have not tightened quite as much as other sectors offering modest relative value. AT1s (Additional tier-1) or contingent convertible capital instruments (CoCos) look relatively rich compared with the high yield index, but we still see some value in tier-2s and senior bank debt.

Mergers and acquisitions (M&A)

There has been a recent pick up in interest in M&A with banks now comfortably earning their cost of capital, as well as a more certain economic outlook and greater clarity on asset quality. Managements are now looking forward to an environment where rates are lower, and are seeking to protect income statements by reviewing cost levers and building greater economies of scale. Cross-border M&A in Europe remains a challenge given the unfinished banking union, illustrated by the lack of both a common deposit guarantee fund, and capital and funding fungibility. Recent deals focus on in-market M&A where cost synergies are higher: in the UK with Coventry Building Society acquiring Coop Bank[2], and Nationwide seeking to acquire Virgin Money (pending regulatory approval)[3], and in Spain between BBVA and Banco Sabadell (although this has yet to receive approval from either shareholders or regulators).[4]

One of the challenges in M&A are the accounting rules. Under International Financial Reporting Standard (IFRS) 9 banks must mark to market the balance sheet. The relatively low duration bond portfolios, high proportion of floating rate lending and the shorter-term nature of corporate loan books, combined with the prospect of lower interest rates, make merger maths easier in certain jurisdictions like southern Europe. This contrasts with further north in Europe where loan books are longer dated. The bid by BBVA for smaller domestic peer Banco Sabadell is a good illustration of this, although it will take time to see if it is ultimately successful. Attention will no doubt return to the Italian market where M&A speculation is never far away and something could happen with one or more of the following banks: Banco BPM, Monte dei Paschi di Sienna and/or BPER with Unicredit or even Credit Agricole potentially looking to make a bid.

Conclusion

All-in-all we have a broadly stable fundamental outlook for the European banking sector over the next two years. This is supported by a soft landing for the economy, a constructive outlook on banks' profitability despite the expectation of lower rates, and a pick-up in loan growth. In terms of balance sheets, capital should remain strong and while asset quality indicators could deteriorate, we see this as a normalisation more than anything else. Supply is likely to be more balanced and although valuations remain tight, given how far spreads have come we think banks still offer slightly better value than other sectors.

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[2] The Co-operative Bank, The Co-operative Bank and Coventry Building Society, 24 May 2024

[3] Nationwide, An update on Nationwide's offer to buy Virgin Money, 24 May 2024

[4] FT.com, BBVA launches hostile bid for Sabadell, 9 May 2024

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