Eurozone Banks – Better or Worse After the Return of Quantitative Easing?

INSIGHT

November 2019

How the recent European Central Bank easing measures might impact the credit profile of eurozone banks?

The European Central Bank's (ECB) recent reintroduction of Quantitative Easing (QE) received a mixed response from market participants and within the ECB's governing council.[1] It is also something that we believe should be taken into account when reviewing the credit profile of European banks. However, while negative interest rates will likely impact banks' lending margins, other measures, including tighter regulations and improved access for bank funding, should also be assessed when looking at the investment potential of eurozone bank credit – factors we believe paint a more optimistic picture for the sector.

Quantitative Easing Resumes

As 2018 drew to a close, the ECB ended its controversial QE programme, designed to provide economic stimulus after the financial crisis.[2]

In September 2019, less than 12 months later and against a backdrop of a struggling economy and lower inflations expectations, the ECB announced it will resume QE in November 2019. The latest package includes cutting interest rates to an historic low of -0.5%, a restart of the Asset Purchase Programme (APP) of €20bn monthly and forward guidance on the potential for further rate cuts and the APP.[3]

In our view cutting interest rates deeper into negative territory and reopening QE to act on the level of long yields has some consequences for the eurozone banking sector.

Assessing the balance between the positive and negative consequences of this policy is an ongoing debate. Yet the ECB complemented its recent decision with two modifications, one related to the TLTRO III (Targeted Long-Term Refinancing Operations) and the other to the excess reserves of the banking system, adjustments we believe will likely benefit banks.[4]

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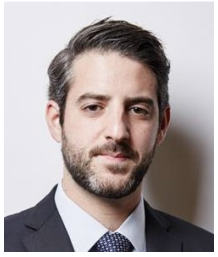

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Modification of TLTRO III

The ECB modified the terms of the pricing of TLTRO III and removed the 10-basis point charge over the main refinancing operations (MRO). TLTRO III will be set at an average MRO rate (currently 0%) over its lifetime with a built-in incentive allowing banks whose net lending exceeds a benchmark to benefit from a lower refinancing rate. These measures are designed to support bank lending to households and companies and ensure lending conditions remain favourable for banks. The maturity of each TLTRO III will also be extended from two to three years from their settlement date, which should benefit financing for the real economy and thus help support economic growth.[5]

Tiering Charges on Banks' Reserves

Historically the ECB's position has been to highlight the side benefits of lower rates for banks, which have largely outweighed the cost of a flatter curve and lower interest rates.

The estimated costs for the banking sector from a -0.5% deposit rate facility are approximately €9bn per year.[6] To mitigate the impact of negative rates, the ECB also implemented a two-tier system on eurozone banks which exempts a portion of their excess reserves (currently six times the minimum reserve requirement) from the (negative) deposit rate facility.

While part of the broader package of measures caused some public opposition by members of the ECB's governing council, there was no criticism of these additional modifications which we believe will likely benefit banks.[7]

In our view, the ECB's recent mitigating measures should be assessed as a form of insurance compensation in exchange for the likelihood of further rates cuts if the economic situation deteriorates further.

QE's Impact on Banks

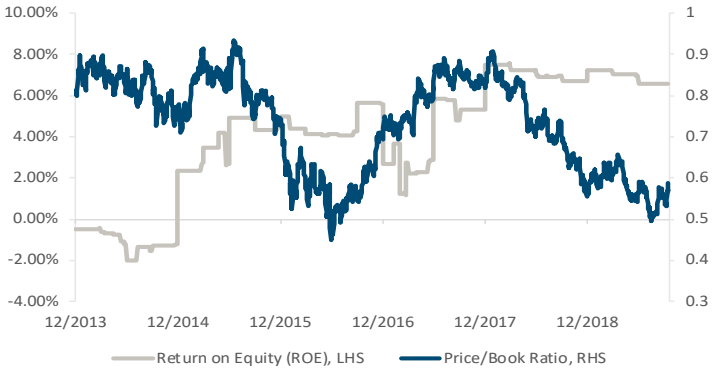
Since the start of QE, much has been made of the impact of lower interest rates on the banking sector.[8] Popular narrative suggests that, with deposit costs mostly floored at zero, lower rates and flatter curves reduce asset yields and are detrimental to lending margins - the primary source of bank revenue.[9]

However, we believe that, despite a significant increase in capital to meet new regulatory requirements, the primary bank profitability metric of return on equity (ROE) has improved in recent years, driven largely by lower loan loss provision expense as well as cost cutting, modest loan growth and shifts to more fee-based business lines.

Nevertheless, the prospect of another round of QE has led to a renewed concern in bank equity markets.[10] Shareholder returns are predicated on the ability of a bank to expand its profit, pay out, and/or equity valuation multiples – the likelihood of these has dwindled recently, along with consensus earnings estimates as the impact of lower-for-longer rates becomes priced in.[11]

Most European banks now trade at a discount to book value, indicating that their ROE does not cover their cost of equity (Fig. 1)

Fig. 1 Eurozone Bank Profitability Has Improved But Equity Valuations Have Languished



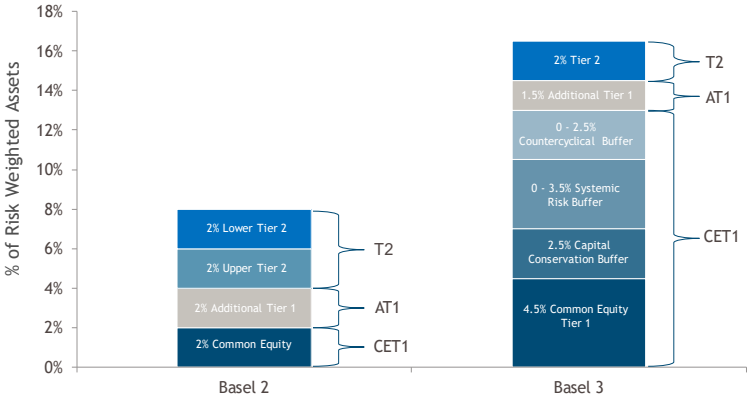
Source: Bloomberg, as of 16 October 2019. EuroStoxx Banks Index (SX7E).

Banks Fundamentals Have Improved

Profitability is only one factor used in assessing the credit quality of banks however – arguably paramount is the health of their balance sheets as evidenced by asset quality, capitalization and funding.

These areas have strengthened materially in recent years, partially as a result of QE as well as the post-crisis regulations that have led to a significant increase in capital requirements and thus deleveraging at banks (Fig. 2).

Fig. 2 Minimum Bank Capital Requirements are Much Higher

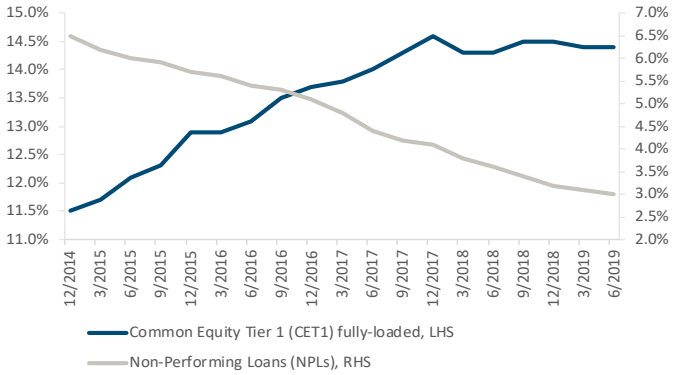


Source: Bank of International Settlements. For illustrative purposes only. As of September 30, 2019.

In terms of asset quality, we believe lower rates have made borrowing costs more affordable for corporations and households while also increasing collateral values, which has helped the system to significantly reduce its provision expense as well as its quantum of non-performing loans (NPLs) and non-performing assets (NPAs).

Lower rates have also resulted in a search for yield, which we believe has led specialized investors to buy NPLs/NPAs from banks at reasonable prices. This has further reduced the system's burden, particularly in the weaker peripheral countries.

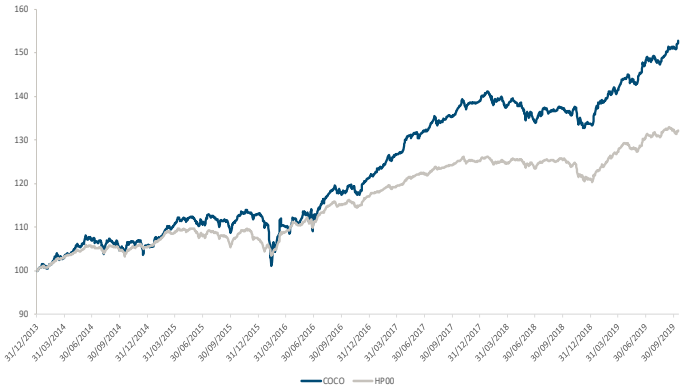
Fig. 3 European Banks Balance Sheets Have Materially Strengthened



Source: European Banking Authority (EBA) 2Q19 Dashboard, as of June 30, 2019.

The search for yield has also served to reduce credit spreads, which has further improved banks' access to and cost of wholesale funding (e.g. senior and asset-backed or covered bonds) and debt capital (e.g. Tier 2 and Additional Tier 1 securities). Given that bank spreads have largely traded wide to similarly-rated corporates, this has also resulted in significant outperformance of the sector in the credit markets (Fig. 4).

Fig. 4 CoCo's Performance versus European High Yield



Source: ICE BofAML, as of October 16, 2019. Total returns rebased to 100. Past performance is not an indication of future performance. HY is represented by the ICE BofA ML European Currency High Yield Index and CoCo by the ICE BofAML Contingent Capital Index.

Bank Credit Likely to Remain Supported

In our view, another round of QE is likely to result in a similar experience to the previous one. However, we believe the new deposit-tiering system and more generous TLTRO III terms should cushion the impact of rate cuts and highlight a focus on preserving bank profitability.

In our view, bank credit profiles are well placed to benefit from any pick-up in economic activity. At the same time, in a scenario of potential longer-term "Japanification" of the European economy, we would expect bank profitability and equity valuations to remain muted, but bank balance sheets to remain strong. This could underpin the valuation of their debt securities - particularly the more subordinated parts of the capital structure.

1. https://www.ft.com/content/de4a958a-eab3-11e9-a240-3b065ef5fc55; https://www.telegraph.co.uk/business/2019/09/12/markets-live-latest-news-pound-euro-ftse-1002/
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4. https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912~19ac2682ff.en.html
5. IBID
6. Source: Muzinich internal analysis, as of October 1, 2019 and https://www.db.com/newsroom_news/2019/ecb-ramps-up-monetary-stimulus-en-11578.htm
7. https://www.ft.com/content/de4a958a-eab3-11e9-a240-3b065ef5fc55
8. https://www.ecb.europa.eu/pub/economic-research/resbull/2019/html/ecb.rb190716~62990c3aeb.en.html as of July 16, 2019
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Index Descriptions

HP00-The ICE BofA ML European Currency High Yield Index tracks the performance of EUR & GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), have at least one year remaining term to final maturity, at least 18 months to final maturity at point of issuance, a fixed coupon schedule and a minimum amount outstanding or EUR 250 million or GBP 100 milion.

COCO-The ICE BofAML Contingent Capital Index tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets.

SX7E-The Eurostoxx Bank Index track sectors of the relevant benchmark index. Companies in the index are categorized according to their primary source of revenue. The Bank index represents one of the 19 sectors according to the Industry Classification Benchmark (ICB).

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility or performance of an account or fund.