Market Bulletin

October 2016

European banks: It's not all bad news

IN BRIEF

- The European banking system is not on the brink of collapse, and digging into bank balance sheets reveals more cause for comfort than concern.
- European banks face an ongoing challenge: how to increase low profitability in an environment where non-performing loans (NPLs) and a sluggish economic recovery have weighed on earnings.
- Valuations offer interesting opportunities for investors in this sector, but they need to be highly selective, looking for financial institutions that are either less affected by these problems or taking effective measures to cut costs and/or boost profitability.

A EUROPEAN BANKING COLLAPSE IS NOT IMMINENT

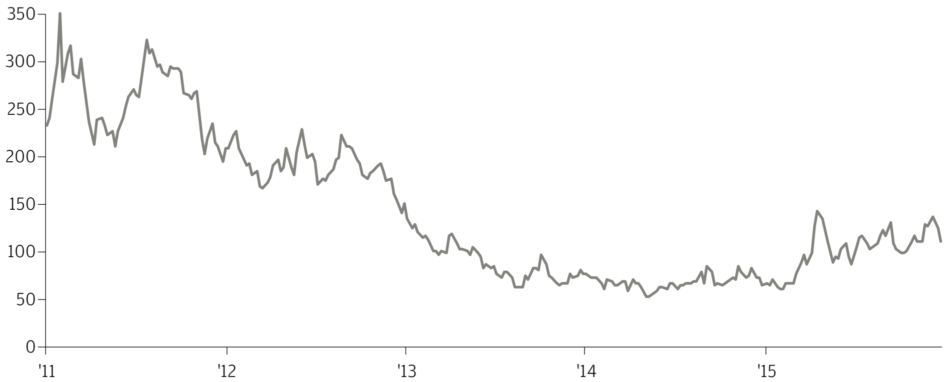
European banks have had a particularly tough 2016, with the Stoxx 600 banking sector seeing declines of over 15% so far this year. This puts the European banking sector on track for its worst year since the depths of the eurozone debt crisis in 2011.

Despite the sharp pullback in banking share prices, the European banking system is not on the brink of collapse and—despite feverish media speculation—investors are not currently pricing in the impending collapse of one or more European banks. As we show in **Exhibit 1**, the cost of purchasing insurance against European financial firms remain well below the highs seen during the eurozone debt crisis.

The cost of buying insurance against European financials firms has ticked up in 2016, but is still below the highs of the eurozone debt crisis

EXHIBIT 1: ITRAXX EUROPEAN FINANCIALS INDEX

Index level, CDS spreads*



Source: Bloomberg, J.P. Morgan Asset Management. *CDS = Credit Default Swaps. Data as at 20 October 2016.

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If we dig a little deeper into the balance sheets of European financial companies, there is actually more cause for comfort than concern. These show that European banks have taken significant steps to strengthen their position since the Global Financial Crisis (GFC) and eurozone debt crisis.

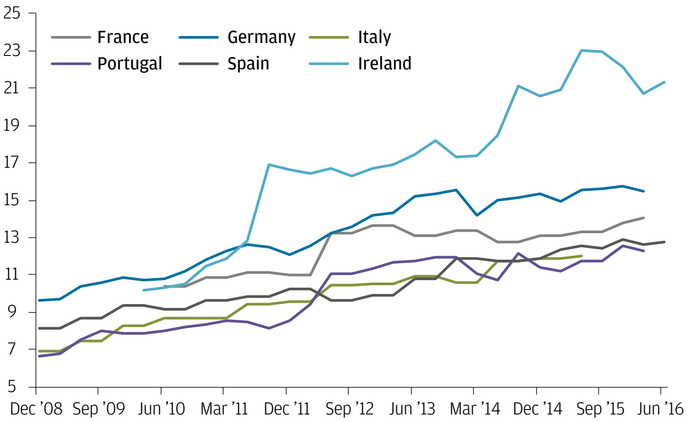
Capital levels are one area where banks have made particular progress. In many ways, tier-one capital, which includes common equity and retained earnings, is the banks' "rainy day savings" fund. In tough times, banks can dip into the reserves in order to absorb losses or pay fines. As **Exhibit 2** shows, European banks have nearly doubled their tier-one capital ratios[1] since the GFC, increasing their overall health and stability.

Some banks may have to raise additional capital to top up these rainy day savings, if they are forced to dip into them. This would dilute existing shareholders, which explains recent declines in some banks' share prices, but the figures provide little reason to fear that a major bank will run out of tier-one capital or go bust.

Banks have made significant progress since the GFC towards improving the quality and strength of their balance sheets

EXHIBIT 2: TIER-ONE CAPITAL RATIOS

% of risk-weighted assets



Source: European Commission, J.P. Morgan Asset Management; data as at 20 October 2016.

Many banks had become highly reliant on short-term market funding in the years before the GFC, and quickly got into trouble when credit markets started to dry up from 2007 onwards. But they look much less exposed to that risk today. Long-term debt now represents 50% of European financials' total funding, compared to only 33% in 2007.[2] Taken together, more long-term financing and higher capital levels should make the European banking sector much more resilient to shocks.

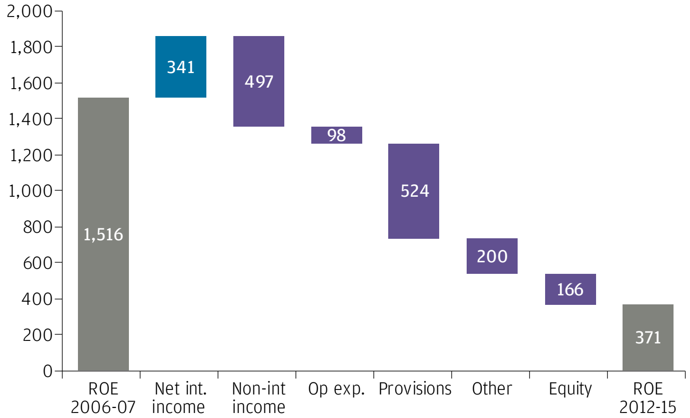
I. THE CHALLENGE FOR EUROPEAN BANKS IS NOT STABILITY, BUT PROFITABILITY

Does this mean that European banks are a good investment? Unfortunately, investors must still take care investing in the sector, because even if European banks' stability and survival are not in question, their capacity to generate attractive levels of profits remains in doubt. As we highlight in **Exhibit 3**, a number of factors have eaten into banks' return-on-equity (RoE) since the GFC.

Provisions against NPLs have been the biggest headwind in recent years, but there are signs the issue is receding

EXHIBIT 3: ROE DECOMPOSITION OF DEVELOPED EUROPEAN BANKS

2006-2015, basis points



Source: Fitch Ratings, IMF, SNL Financial, J.P. Morgan Asset Management; data as of 20 October 2016.

This decline in profits has seen a number of European banks operating with a RoE below their cost of equity (CoE). When CoE exceeds RoE, it means that investors are no longer being adequately compensated for the risks they are taking on and shares will trade at a discount. The International Monetary Fund (IMF) estimates that in 2015, 47% of European banks had a CoE higher than their RoE.[3]

As highlighted in **Exhibit 4**, provisions against non-performing loans (NPLs) have been the single biggest headwind for European banks in recent years. A sluggish economy since the GFC, combined with loose lending standards in the preceding years, has seen NPLs mount across the eurozone. They remain a significant issue, even after several years of economic recovery, particularly in Italy. In 2015, around 18% of Italian loans were non-performing—three times the eurozone average of 6%. NPLs will continue to weigh on European bank profitability going forward, but there are signs that the level of NPLs is beginning to turn a corner.

[1] Tier-one capital ratio is total tier-one assets as percentage of total risk-weighted assets.

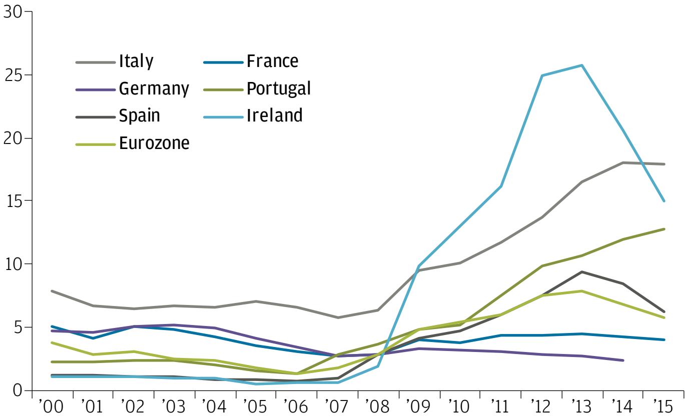
[2] Stoxx, FactSet. Data as at 20th October 2016.

[3] *Global Financial Stability Report - Fostering Stability in a low-growth, low-rate era*, IMF, October 2016.

NPLs have risen due to a sluggish economic environment and loose lending standards prior to the crisis

EXHIBIT 4: NON-PERFORMING LOANS

% of total gross loans



Source: European Commission, J.P. Morgan Asset Management; data as of 20 October 2016.

ITALIAN BANKS UPDATE

A severe recession in Italy in recent years has seen a sharp deterioration in the credit quality of Italian firms. This has caused the level of NPLs to increase sharply, which has weighed on Italian bank profitability. There have been a series of measures implemented to try to deal with the issue of NPLs and increase the stability of the Italian banking system. But the clean-up job has been complicated by the introduction of new bail-in legislation which requires private sector investors to be "bailed in" to any restructuring plan and constrains the government's ability to offer financial support. Italian bank have some work to do to recapitalise their balance sheet. However, we do not believe that these challenges present a systematic threat to the European banking system. For more information on Italian banks, please see our recently released Market Bulletin on the topic.[4]

II. WHAT COULD HELP EUROPEAN BANKING PROFITS?

Two factors could assist European banking profits: an improvement in the economic environment and a change in approach from the European Central Bank (ECB).

The first—and probably most important—factor would be a stronger cyclical recovery. Faster growth would help reduce the burden of NPLs, as well as generating higher non-interest income through greater fee-generating activity, including trading revenues. In fact, the IMF estimates that a strong cyclical recovery within the eurozone could see RoE rise by approximately 40% as the economic outlook improves.[5]

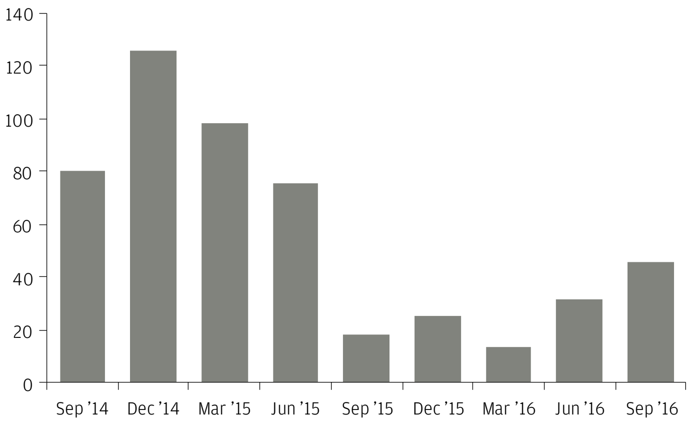
The second factor that could help the banks would be higher interest rates. Negative rates are often cited as a key factor hurting bank profitability. In fact, net interest margins have not fallen sharply in recent year. Staying roughly constant at around 1.7%. But the ECB's decision to cut the deposit rate into negative territory in 2014 has hurt banks' profits by effectively imposing a tax on banks' deposits with the central bank.

The challenge that low or negative interest rates poses to the region's banking sector has not gone unnoticed by the ECB. With the advent of negative interest rates, the ECB allowed European banks to borrow at negative rates, directly from the ECB, as long as those funds are loaned out to the real economy. This amounts to the ECB paying banks to make loans. But, as **Exhibit 5** shows, these extremely attractive terms have only just started to have an impact on bank borrowing from the ECB, which is only slowly creeping up.

Since the ECB changed the terms of its Targeted Longer-Term Refinancing Operations (TLTRO) allotment in March, borrowing has slowly begun to increase

EXHIBIT 5: AMOUNTS BORROWED IN TLTRO ALLOTMENTS

Net borrowing in € billions



Source: European Central Bank, J.P. Morgan Asset Management. *TLTRO stands for Targeted Longer Refinancing Operations. Data as of 20 October 2016.

An improving economy and higher interest rates would be good for Europe's banks, but these scenarios are not in the banks' control and may not happen any time soon. In the meantime, these institutions should be focussed on revamping business models and cutting costs.

[4] *Italian banks: A new political text for Europe after Brexit*, Maria Paola Toschi, Market Insights, J.P. Morgan Asset Management, July 2016.

[5] *Global Financial Stability Report - Fostering Stability in a low-growth, low-rate era*, October 2016.

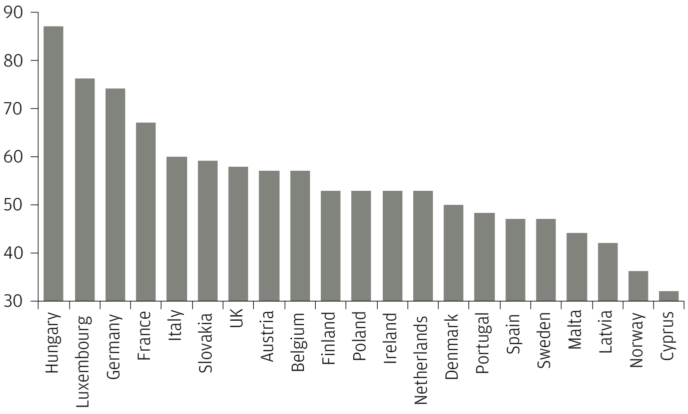
A. Revamping business models and cutting costs

As **Exhibit 6** shows, only banks in eight countries report cost-to-income ratios at or below 50%, with major countries such as Germany and France reporting cost-to-income (COI) ratios of 73% and 67%, respectively, according to the ECB.

Banks still have some way to go in order to cut costs and improve profitability

EXHIBIT 6: COST-TO-INCOME RATIO BY COUNTRY

%, June 2015



Source: European Central Bank, J.P. Morgan Asset Management; data as of 20 October 2016.

Such high COI ratios in many European nations highlight the need for European banks to assess the services they currently offer. New regulatory requirements have reduced RoE in some areas of finance such as fixed income trading, particularly for smaller players without the necessary scale. Going forward, European banks need to look to downsize their businesses and withdraw from services where the potential RoE is below CoE, in order to have a more profitable business model. Mario Draghi, President of the ECB, has highlighted this point when stakeholders have criticised the negative interest rate policy implemented by the central banks.

B. Political reforms

Another area of focus for politicians is uniting and consolidating the European banking system, since, in its current form, it remains too fragmented and heavily overbanked. The latest data from the ECB show that the eurozone has 6,053 banking institutions, compared with just 393 in the UK. On a GDP-adjusted basis, the average is USD 7.0 billion per bank in the UK, compared to just USD 1.9 billion per bank in the eurozone.[6]

One solution to this issue would be to allow more cross-border merger-and-acquisition (M&A) activity between European banks. Unfortunately, political and regulatory issues make life difficult for any bank trying to purchase a European neighbour. There has been some progress on this front, with the number of major German Landesbanks falling from 11 to five and the number of large Spanish banks falling from 50 to just 11. Meanwhile, new reforms in Italy look to increase cross-border M&A activity. However, there is still scope for further consolidation in the market.

III. INVESTING IN EUROPEAN BANKS

After looking at the stability and overall profitability of European banks, it is worth considering whether European banks offer a decent investment opportunity. As **Exhibit 7** shows, falling bond yields have weighed on the share price of European banks. However, there are tentative signs that bond yields are beginning to bottom out. This could add some support for the sector going forward.

With a price/book value of just 0.70x vs. 1.64x for the Stoxx 600 index, the sector is relatively cheap. Despite the attractive valuations, it may be too early for many investors to enter into this sector considering the long list of hurdles European banks must overcome in the near future.

Falling bond yields have weighed on the share price of European banking stocks, but there are early signs that bond yields are beginning to rebound

EXHIBIT 7: EURO STOXX BANKS VS. GERMAN 10-YEAR YIELDS

Rebased to 100 in 2008 (LHS); % (RHS)

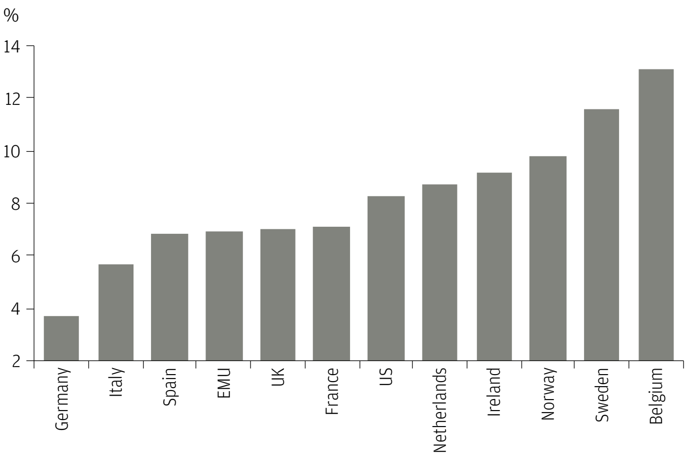
Source: Bloomberg, Stoxx, J.P. Morgan Asset Management; data as of 20 October 2016.

6 ECB, IMF. Data as of 20th October 2016.

The most important message for investors is that not all European financials are banks, and not all banks are facing these problems to the same degree. There is a wide variation within the sector, both in terms of profitability and the strength of the balance sheet. As **Exhibit 8** highlights, there is a large degree of variation in RoE levels between European nations: banks in countries like Belgium and Sweden are performing strongly, with higher RoE levels than US peers. However, there are laggards particularly in major economies such as Italy and Germany. Such variation means it is difficult to make a call on the sector as a whole, suggesting that investors should look for potential opportunities at an individual stock level.

Wide variation in the RoE for different banks in different countries creates an opportunity for stock-pickers

EXHIBIT 8: BANK ROE BY COUNTRY



Source: FactSet, MSCI, J.P. Morgan Asset Management; data as of 20 October 2016.

INVESTMENT IMPLICATIONS

- Profits have been weighed down by a sluggish economi environment and mounting NPLs however, there are signs that these headwinds are beginning to recede.
- A cyclical recovery and a U-turn in monetary policy would help bank balance sheets. However, both of these factors lie outside of European banks' control. Instead banks should continue with the difficult task of cutting costs a reforming their business models.
- While we are not positive on European banks as a broad sector, there is a wide variation among individual banking stocks creating opportunities for stock-pickers.
- The key takeaway for investors is that European banks are not on the brink of a crisis and remain significantly more stabl than they were prior to the GFC and eurozone debt crisis.

GLOSSARY

NON-PERFORMING LOANS (NPLS): An NPL is where the debtor is no longer making payments on the loans principal or paying the interest on the loan. Once a loan becomes non-performing, the chances of it being repaid are significantly lower.

BAIL-IN LEGISLATION: At the beginning of 2016, the European Union implemented new legislation that impedes a government's ability to bail out struggling financial firm Going forward, tax payer money cannot be used to support a bank unless private creditors are bailed-in first. This mean bond holders will have to face significant losses before th government steps in, reducing the overall bill for the tax payer.

RETURN-ON-EQUITY (ROE): RoE is a measure of how efficien a company is in generating profits. Typically it is measured as the amount of net income generated as a percentage of overall shareholder equity.

COST-OF-EQUITY (COE): CoE is the minimum required return investors demand in order to feel that they are being adequately compensated for the risks they are taking in an investment.

TARGETED LONGER-TERM REFINANCING OPERATIONS (TLTROS): TLTROs are a cheap loan scheme launched by the ECB in 2011. It allows European banks to borrow at very low, or even negative, interest rates and then use the funds to make loans to the real economy. The ECB launched the scheme to encourage banks to start lending to the real economy again and get the credit cycle going.

TIER-ONE CAPITAL RATIO: Tier-one capital is essentially a bank's "rainy-day" fund. Only the safest assets like common stock or retained earnings qualify as tier-one capital. In the event of fines or defaults on assets a bank can then use these rainy-day funds to absorb the losses. In the build-up to the GFC, banks were not holding significant enough tier-one capital and its quality was questionable. Since then, regulators have insisted that banks increase their tier-one ratios, as well as improve the quality of the assets the hold.

NET-INTEREST MARGIN: The most traditional source of income for banks has always come from collecting deposits from savers and making loans to borrowers. The difference between the interest rate paid to savers and the higher interest rate received from borrowers is also called net-interest margin.

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