SCOPE

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Contrary to the broadly held market view that European banks continue to be insufficiently profitable, I believe the sector's bottom line is now reaching an adequate level. Analysts and investors should revisit their views that profits remain a major risk for the sector.

Sub-par bank profitability has been a key concern for analysts, investors, rating agencies and supervisors for years. Every strength showcased by the industry – ample capital and liquidity, improving asset quality, more risk-averse strategies, advances in digitalisation etc – has been met with the "yes but profitability is weak" counterargument.

Third-quarter results have shown that profitability is finally being strengthened; not least thanks to the banking sector at long last leaving behind the negative or zero interest-rate environment, thus displaying improving net interest margins. This trend should continue through Q4 and well into 2023, especially for banks with large variable-rate components in their loan portfolios e.g. business and consumer credit, and variable-rate mortgages.

Loan-loss provisions, the other key metric of concern for the market, remain manageable. More provisioning is likely over the next several quarters, but banks will not reach for the panic button. I see three reasons for this.

First, provisions are rising from historical lows. Second, they are mostly against post-GFC loan portfolios, so underwritten on more conservative criteria and with more realistic collateral values than before that crisis. Third, they are bolstered by stronger capital.

Asset quality will display more stresses in 2023. But short of a severe economic crisis that would dwarf the benefit for businesses and households of public-support measures, I do not anticipate this being nearly as worrying as the GFC years.

Bank profitability is adequate even if sub-stellar

But despite reassuring trends, the markets still view mainstream European banks with suspicion. Shares stubbornly trade at discounts (sometimes material) to book values, and relatively wide credit spreads do not reflect the sector's much-reduced risk compared to past periods. The market flags the reason for this, again, as insufficient profitability, which would presumably not protect banks from economic or asset-quality shocks.

In the current difficult environment, if banks fully comply with prudential and conduct-related regulatory requirements, avoid excessive risks and diligently perform their primary role of financing businesses and households, I believe a bank operating with a reasonable if not stellar bottom line is a good outcome. There is more, much more to the value of a bank than hitting or beating consensus on the quarterly results racetrack.

Banks should not be viewed as growth stocks. Being able to pay expected dividends on time and avoid excessive risks that would get them into trouble should satisfy most equity investors. Stable and sustainable profitability against a non-threatening risk profile should also keep most bond investors fully reassured, even if profits fall short of being spectacular. And that should not only be the case at the senior preferred level but lower down the risk scale too – senior non-preferred, Tier 2, and, on a name-specific basis, AT1 as well.

Below I challenge three beliefs underpinning sub-par bank profitability claims.

1 Return on equity is below cost of equity

I wrote, in a previous edition of The Wide Angle, that Europe's tightly regulated and de-risked banking sector would suggest a true cost of equity lower than the generally assumed low-mid double-digit rule of thumb (although I haven't seen an updated analytical framework for this). Even with risk-free rates now rising, I can't see the large European banks' average cost of equity being higher than 7%-8%. Which is the level already reached, about to be reached, or exceeded by many banks' ROE.

One way for banks to boost earnings would be getting into high return/high risk activities but most banks have rightly shunned that approach in the post-GFC world. And for good reason. It would be a source of revenue growth that neither equity nor bond investors would appreciate and reward. An example is Credit Suisse, whose troubles are not so much the result of recently initiated transactions but rather of risky activities booked earlier which were not properly controlled and addressed.

2 Low profits impact banks' ability to issue new equity when needed

In the view of the market and of supervisors, banks need to be at the ready to issue new capital should the need arise. This can become necessary, first, if a bank is faced with a major hit that can threaten its prudential capital requirements. Second, a bank may wish to issue new equity if it wants to engage in a major event, like M&A. In this context, institutions with strong ROE are better positioned to raise fresh capital compared to banks with weak ROE.

But this is rather theoretical in the current environment. First, the European banking sector remains well capitalised, successfully riding the pandemic and the current stages of the energy crisis despite hiking provisions. At present, there is no imminent need for, or intention from, any large bank to issue new equity capital. The exception are outliers on the risk map, like Monte dei Paschi di Siena (which just completed its EUR 2.5bn rights issue), Credit Suisse (targeting CHF 4bn), or previously then-outlier Deutsche Bank.

If anything, some banks (UniCredit, ING) are currently pursuing share repurchases in addition to normal dividend payments. Speaking of which, I do make a distinction between dividend payments and share repurchases. While the former is a necessary and value-adding route to keep shareholders on board (unless it is excessive), the latter can be controversial, especially in periods of uncertainty and crisis.

Second, issuing fresh equity to finance a transformational M&A transaction is not likely in

the current environment. I do not believe this will change next year, unless specific political or regulatory pressures emerge.

3 Market price is below book value

The equity prices of mainstream European banks are in general and have been for some considerable time trading below book value. I am not clear what the latter truly means for a bank and how reliable the number is. Traditional corporate valuation defines book value as the difference between assets and liabilities. Is this fully applicable to a bank, or is it an artificial concept?

First, there is more variability between the balance sheet of a large bank – especially one with more extensive trading and investment banking activities – and a non-financial corporate. This variability is not reflected by a book-value number but would inherently be captured and discounted by the bank's market valuation.

Second, the capital structure of European banks is multi-layered, from senior preferred to equity, going through subordinated and hybrid forms like Tier 2 and AT1. They all contribute to a bank's value.

In recent years, the trend has been to increase the non-equity component of regulatory capital, which makes the traditional definition of book value more difficult with any form of precision.

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