Polar Capital Global Financials
March 2015

European Banks – Recovery Reinforced

With European banks results season drawing to a close, we thought it would be worth taking a look at some of the core trends in this sector to see whether much of what we have been telling investors is actually happening (many remain dubious, which is perfectly understandable).

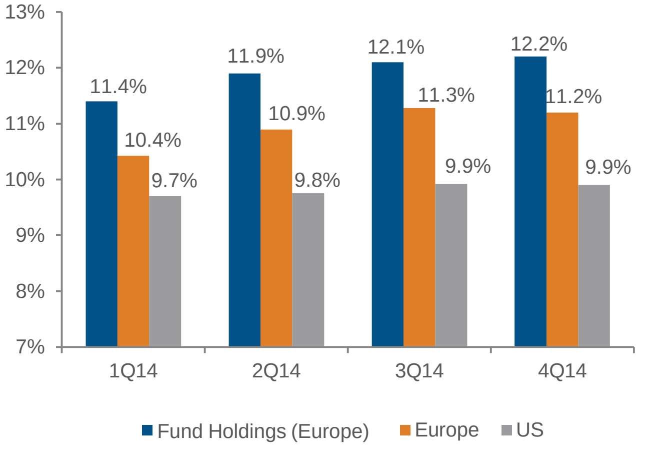
The sector has performed well, rising 13% since the beginning of the year, certainly helped by the European Central Bank's (ECB) plans for QE, but equally, we suspect, by a results season that has generally been positive. And so we ask: what will be required to achieve a re-rating of the sector, and on which of these issues should we focus?

Are capital positions strengthening and adequate?

Not all banks are adequately capitalised, but broadly speaking, the sector has achieved a good level of capital adequacy and is well positioned, should there be any further tinkering with capital regulations (the main issues being changes to the risk-weighting of assets or the treatment of deferred tax assets as capital).

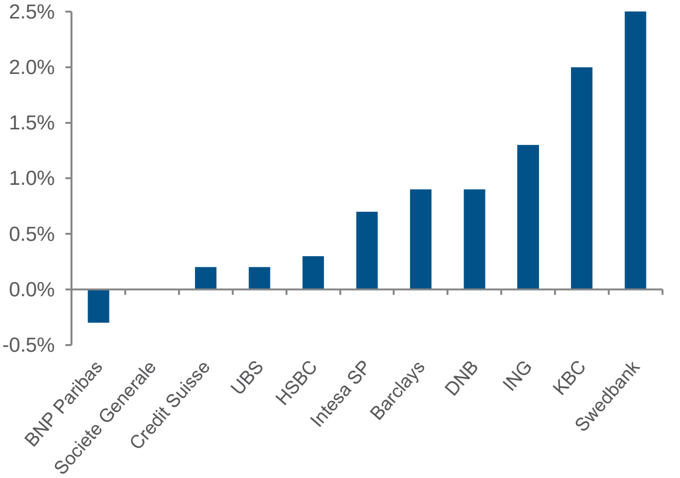
Below we have highlighted the trends in the Core Tier 1 (CT1) Capital Ratio of the banks we own in Europe (through both the Polar Capital Global Financials Trust and Polar Capital Financial Opportunities Fund) that show encouraging trends, with examples including ING, KBC, DNB, Swedbank, Credit Suisse, Barclays and Intesa; i.e., the vast majority of our holdings (the French being the notable exceptions). To put this into perspective, our European bank holdings saw their Basel III CT1 rise by an average of 83bps since Q1 2014 versus 20bps for large-cap US banks. Some highlights included Lloyds Bank guiding that pre-dividend, it can generate 150-200bps of capital every year, with DNB guiding to accumulate 80-100bps each year.

Core Tier 1 (CT1) development



Source: Polar Capital.

Polar Europe holdings CT1 build (bps) Q1 2014 – Q4 2014



Source: Polar Capital.

Are dividends increasing and does this help share prices?

In terms of the larger banks in the sector, Q4 2014 results showed approximately a third had better-than-expected dividends – a statement we haven't said for many years. The rest of the European banks we monitor were broadly in-line with expectations, and only 12% of the banks we follow missed dividend expectations. This is a very encouraging trend and makes us the most positive we have been on this issue for a while. Some highlights included Lloyds Bank starting to pay a dividend again and UBS paying well above expectations for dividends (UBS was one of the early movers, in terms of restructuring its investment banking business). Both ING and Intesa Sanpaolo have seen a 20% rise in share price following their fourth-quarter results, highlighting the amount of excess capital that could potentially be returned to shareholders (Intesa reported a Core Tier 1 of 13.3%, with ING reporting 13.1% pro-forma after the planned disposal of their insurance stakes).

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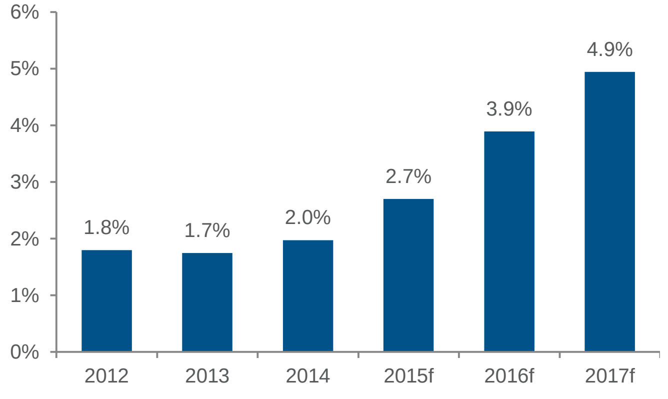
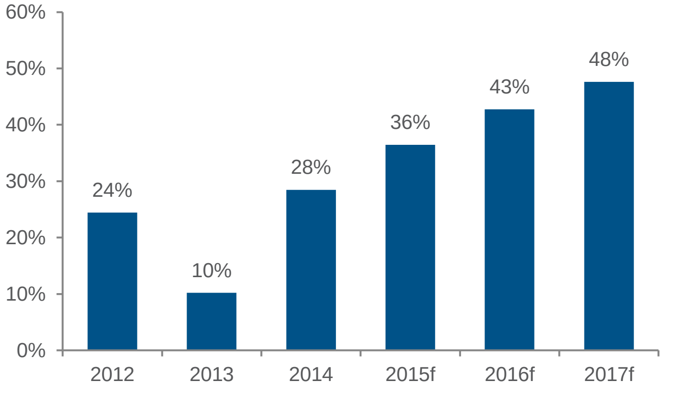
European banks dividend yield



Source: Polar Capital.

European banks dividend payout

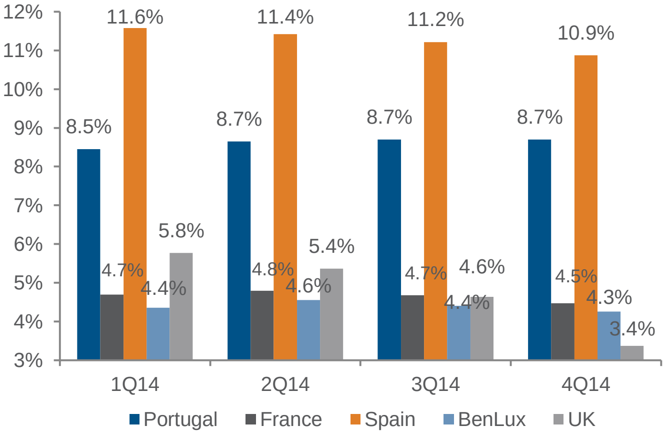


Source: Polar Capital.

Are operating trends improving?

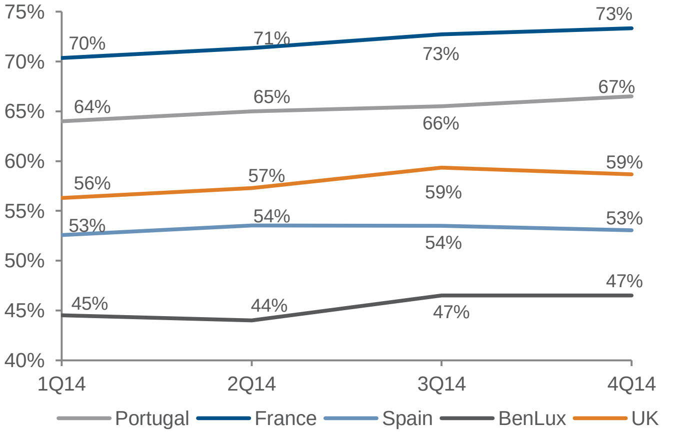
The critical operating trend which is showing signs of improvement is that of loan book quality. We can categorically say that non-performing loans (NPL) have peaked in Europe, with the one exception of Greece (where the new government's planned rules for the repayment of bank loans has sent the message that many loans will be cancelled, and so few borrowers are servicing them). In Spain, the pace of NPL reductions accelerated in Q4 2014 (Bankinter guided for provisioning to continue falling to a normalised level by 2016), with Intesa Sanpaolo guiding for a 'significant improvement' in provisioning in 2015 following the peak in NPLs.

Quarterly NPL trends



Source: Polar Capital.

Quarterly coverage trends



Source: Polar Capital.

Are there any restructuring opportunities?

We have been saying for a while that those banks that are dragging their heels on the issue of restructuring (such as Credit Suisse and Barclays) will inevitably face the reality that the new capital regulations make certain investment banking activities uneconomic. This finally seems to be being accepted, with changes in management and some aggressive cost cutting plans (Credit Suisse has risen 9% in the week following the announced CEO change on the expectation of further restructuring). RBS recently announced plans to cut its Corporate & Institutional division's balance sheet by two-thirds, with the aim of halving its group's risk-weighted assets. This follows plans by Barclays to reduce its investment banking headcount by 27%, with UBS having cut its investment banking headcount by 29% since it announced its restructuring in 2012.

In retail banking, banks are adapting to the low-rate environment and using technological developments to improve cost control (e.g. Swedbank's plans to cut costs by 9% by 2016 supported by digitisation and a 5% headcount reduction). Our recently published commentary, '*The end of banking as we know it?*' goes into greater details on how we expect these trends to affect the banking sector: the key issue we highlight is that the distribution of financial services is moving to the Internet and the mobile phone, with considerable implications for banks' branch networks.

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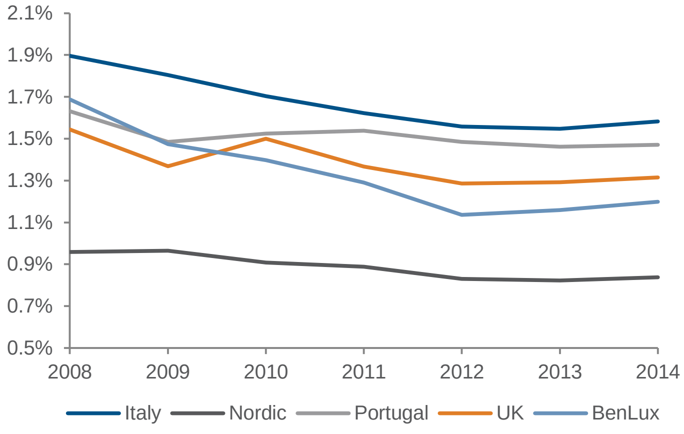
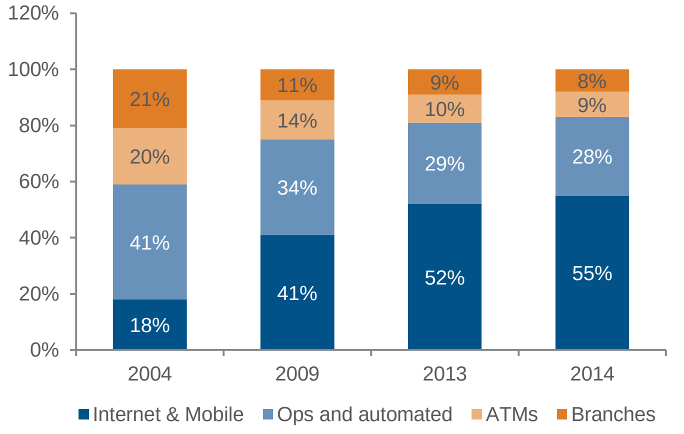
Core/Assets Development



Source: Polar Capital.

Transaction by channel – Caixabank (%)



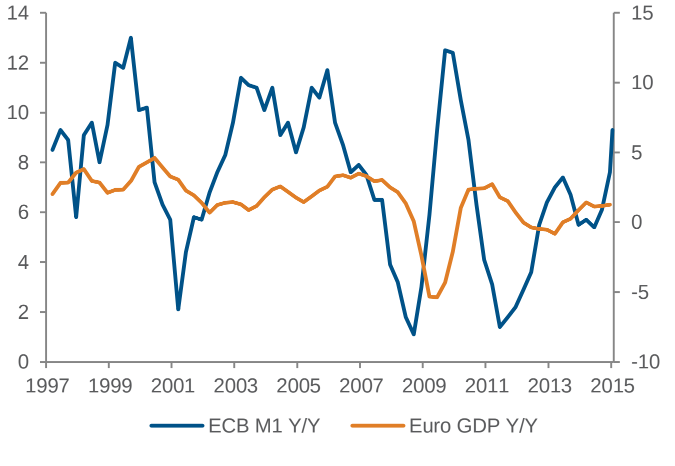
Source: Caixabank.

Is the macro environment recovering?

The perception of Europe is generally one of perpetual crisis and stagnation, yet many trends are showing some far more positive figures. We are not suggesting there will be a dramatic increase in loan demand (little new investment is being undertaken); however, bank balance sheets have started to expand following a prolonged period of contraction, and leading indicators are consistent with an upturn in economic growth (as shown below). Supported by easing monetary conditions and the fall in oil prices, the ECB has recently raised its 2015 GDP growth forecast by 50bps, to 1.5% (as evidenced in the chart below).

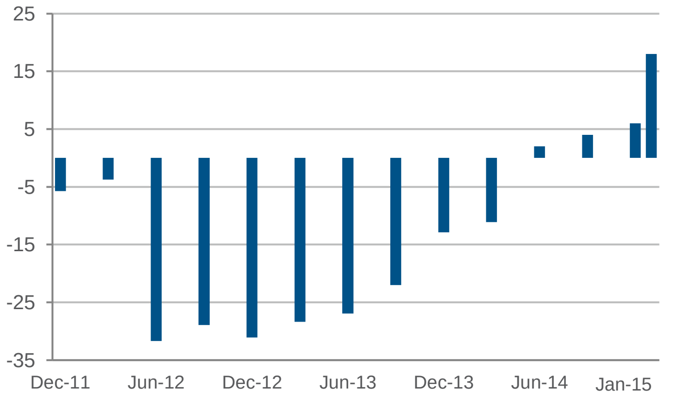
Related to this, is the issue of the possible impact of European QE on the banking sector. This is likely to drive down the cost of funding (although this remains relatively low already) for a banking sector which continues to have a loan/deposit ratio above 100%. It may also prompt increased demand for loans, although we remain cautious on the pace of improvement – we have recently seen evidence of improved demand (see chart below). In relation to their US, UK and Japanese counterparts, there is also less incentive to park reserves at the central bank given the ECB's negative deposit facility rate. Furthermore, the valuations attached to their bond portfolios will also rise further, enabling a recovery in their capital positions through increased trading gains. Less positive will be the impact on margins for new lending (which will fall), although the lack of competition may well mean that funding costs will fall more than asset yields. Ultimately, as banks are cyclicals, they should be one of the biggest beneficiaries of stronger economic growth.

ECB M1 versus Europe GBP



Source: ECB and Bloomberg.

ECB change in demand for loans to enterprises



Source: ECB and Bloomberg.

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For investors, the sector's health is looking better than it has done for a while. Shares have started on a recovery path, and the potential for income is improving every quarter, yet valuations remain in the doldrums. To us, this seems like an attractive investment prospect, even if Greece should cause some turbulence ahead, for we suspect this will be perceived as short-term in nature (few banks have much cross-border exposure having increasingly focused on their home markets, and we have no exposure to Greek banks).

But, we hear you ask: what about potential litigation hits and changes in capital requirements? Won't this derail the entire argument? It is worth looking at our actual investments, as the table below clearly shows that while a number of banks face residual risks ('Risk Impact'), this will be offset by the continued organic rebuild of their capital, through better profitability and falling levels of risk-weighted assets ('FY15 Net Profit'). Ultimately, the impact on their capital positions is small ('Final CT1').

It is also worth noting that many of our holdings are at the better-quality end of the investment spectrum, and other European banks (e.g. Greek banks) could be much more severely affected by some of these changes. Investors need to start differentiating within the sector, since risks are increasingly becoming focused on a few well-flagged examples.

Impact of future litigation and capital costs

Fund Holding	Key Known Risks	Core Tier 1 Current	Risk Impact[1]	Provisions & Divestments Local FX (Bn)	Adj Core Tier 1	FY15 Net Profit CT1 Build[2]	Final Core Tier 1 Excl Div
Barclays	FX, US Mortgages, Interest Rates	10.3%	-130bps	2,104	9.4%	80bps	10.2%
One Savings Bank	None	11.4%	0	0	11.4%	80bps	12.2%
Aldermore	None	13.0%	0	0	13.0%	-90bps	12.1%
Societe Generale	OFAC Settlement, Russia, Danish Compromise	10.1%	-110bps	1,100	9.1%	80bps	9.9%
BNP	FX Settlement, Danish Compromise	10.3%	-20bps	1,868	10.1%	70bps	10.8%
ING	Asset quality (Russia, Oil & Gas)	11.4%	-10bps	5,164	13.0%	120bps	14.2%
KBC	Danish Compromise	11.2%	-60bps	0	10.6%	190bps	12.5%
DNB	Oil exposure	12.7%	-10bps	0	12.6%	250bps	15.1%
Swedbank	None	21.2%	0	0	21.2%	300bps	24.2%
Intesa Sanpaolo	DTAs, Danish Compromise	13.3%	-170bps	0	11.6%	80bps	12.4%
Credit Suisse	US mortgage, FX, Interest Rates	10.2%	-70bps	2,126	9.5%	180bps	11.3%
UBS	US mortgage, FX, Interest Rates	13.4%	-340bps	2,919	10.0%	220bps	12.2%
HSBC	FX, US Mortgages, Interest Rates, Tax Evasion	11.1%	-50bps	2,184	10.6%	100bps	11.6%

Source: Polar Capital, March 2015.
Note 1. Risk impact to Core Tier 1 refers to the Polar Capital Financials team's forecast litigation provision and regulatory changes.
Note 2. FY15 Net Profit is based on consensus earnings. CT1 = Core Tier 1.

Further Information

Should you require further information on the European banking sector or on the Polar Capital Global Financials team, please contact your Polar Capital representative. Alternatively, you may contact Investor Relations on +44 (0)20 7227 2721 (investor.relations@polarcapital.co.uk), or visit our website at www.polarcapital.co.uk

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