# Financial Banks Sector Report
**2023-2024**

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# *Table of Contents*

# *Sector Overview*

Banks are a Subsector of the Financial sector in the Global Industry Classification Standard (GICS®), which is made up of thirteen sectors. At its core, a bank is an institution within the financial sector that serves as a crucial bridge between those who have excess funds and those who require funds to meet their various financial needs. The primary idea behind a bank revolves around the concept of financial intermediation. In essence, banks facilitate the efficient allocation of resources in an economy by collecting funds from individuals, businesses, and institutions with surplus funds and channelling these funds towards borrowers who need capital for various purposes, such as investments, purchases, or operational expenses.

There are three main forms of banking, the first two fall under Commercial Banks, banks that primarily make their money by lending to customers and profiting from their interest margin. Investment banks, who advise clients on mergers and acquisitions (M&A), facilitate equity and debt offerings, manage wealth for high-net-worth clients and businesses, and more. Lastly Universal banks which combine the two.

**Retail Banking:** Retail banks are the most common type of bank and the type of bank that most people are familiar with,  also known as consumer banking or personal banking. Retail banks offer a wide range of services such as checking and savings accounts, mortgages, personal loans, credit cards, and certificates of deposit (CDs). The purpose of retail banking is to provide individual consumers with a way to manage their money, have access to credit, and deposit their funds in a secure manner. Some examples of retail banks include Bank of Ireland, Wells Fargo, and AIB.

**Corporate Banking:** Corporate banking, also known as institutional banking, is a division in a bank responsible for putting together loans to corporations, financial institutions, and governments. The purpose of corporate banking is to provide businesses with the necessary funding to grow and expand. Some examples of corporate banks include Bank of Ireland, Citibank, and JPMorgan Chase.

## *Sector Overview*

**Investment Banking:** Investment banking is a type of banking that organises large, complex financial transactions such as mergers or initial public offering (IPO) underwriting. Investment banks may raise money for companies in a variety of ways, including underwriting the issuance of new securities for a corporation, municipality, or other institution. They may also manage a corporation's IPO and provide advice in mergers, acquisitions, and reorganisations. Some examples of investment banks include Goldman Sachs, Morgan Stanley, and JPMorgan Chase.

Overview of the different operations carried out by investment banks:

**Mergers and Acquisitions:** Investment banks provide advice and assistance to companies involved in mergers, acquisitions, and other corporate restructurings. This includes valuing potential targets, evaluating the potential synergies of a merger or acquisition, and providing advice on the structure and financing of the deal. Examples of M&A deals include Facebooks (now Meta) acquisition of Whatsapp, or more recently, in the banking sector UBS's takeover of Credit Suisse

**Sales and Trading:** Investment banks act as intermediaries between buyers and sellers of securities. They make markets in stocks, bonds, and other financial instruments, providing liquidity to the market by facilitating the buying and selling of these assets. Investment banks are on what is called the 'Sell-side,' where salespeople work with asset managers, hedge funds, insurance companies, and other buy-side investors to pitch ideas and to buy or sell securities or derivatives (financial contracts, i.e., warrants, options, futures etc)

**Asset Management:** Investment banks often have asset management divisions that manage money for high-net-worth individuals, pension funds, and other institutional investors. Asset managers invest in a range of securities, including stocks, bonds, real estate, commodities, and alternative investments

**Wealth Management:** Investment banks may also offer wealth management services to high-net-worth individuals. Wealth managers provide a range of financial services, including investment advice, estate planning, accounting, retirement planning, and tax services

**Research**: Investment banks employ analysts who research companies, industries, and markets to provide insights and recommendations to the bank's clients. Research analysts produce reports on individual companies or sectors that can be used by the bank's salespeople to pitch ideas to clients

# *Sector Overview*

**<u>Universal Banking vs Focused Banking</u>:** Universal banking is a system in which banks provide a wide variety of comprehensive financial services, including those tailored to retail, commercial, and investment services. In contrast, focused banking refers to banks that specialise in one particular area of banking. The benefits of universal banking include the ability for banks to better diversify risk and offer a wider range of services to their customers. However, some argue that dividing up banking operations into specialised areas is a less risky strategy.

**Universal Banks:**

Deutsche Bank

J.P.Morgan

UBS

**Focused Banks:**

Morgan Stanley

Goldman Sachs

Evercore

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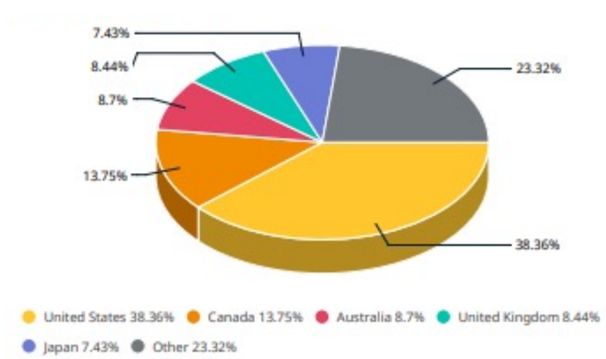
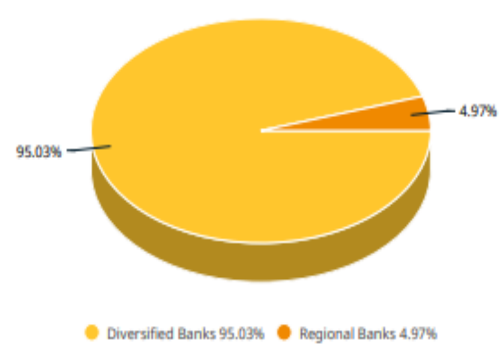
**<u>Country Weights</u>**




**<u>Sub-Industry Weights</u>**




**<u>Top 10 Constituents of Index</u>**

| | Country | Float Adj Mkt Cap ( USD Billions) | Index Wt. (%) |
|---|---|---|---|
| JPMORGAN CHASE & CO | US | 463.05 | 14.13 |
| BANK OF AMERICA CORP | US | 230.38 | 7.03 |
| WELLS FARGO & CO | US | 173.71 | 5.30 |
| HSBC HOLDINGS (GB) | GB | 166.14 | 5.07 |
| ROYAL BANK OF CANADA | CA | 137.65 | 4.20 |
| TORONTO-DOMINION BANK | CA | 120.35 | 3.67 |
| COMMONWEALTH BANK OF AUS | AU | 120.27 | 3.67 |
| CITIGROUP | US | 92.77 | 2.83 |
| MITSUBISHI UFJ FIN GRP | JP | 92.10 | 2.81 |
| BNP PARIBAS | FR | 73.51 | 2.24 |
| Total | | 1,669.94 | 50.94 |

# *Sector Overview – MSCI World Banks Index*

<u>**Cumulative Index Performance (Gross Returns in USD)**</u>

**CUMULATIVE INDEX PERFORMANCE — GROSS RETURNS (USD) (JUL 2008 – JUL 2023)**


**ANNUAL PERFORMANCE (%)**

| Year | MSCI World Banks | MSCI World | MSCI ACWI IMI |
|---|---|---|---|
| 2022 | -10.60 | -17.73 | -18.00 |
| 2021 | 31.72 | 22.35 | 18.71 |
| 2020 | -11.67 | 16.50 | 16.81 |
| 2019 | 24.63 | 28.40 | 27.04 |
| 2018 | -19.61 | -8.20 | -9.61 |
| 2017 | 22.99 | 23.07 | 24.58 |
| 2016 | 12.59 | 8.15 | 8.96 |
| 2015 | -6.19 | -0.32 | -1.68 |
| 2014 | -0.01 | 5.50 | 4.36 |
| 2013 | 25.21 | 27.37 | 24.17 |
| 2012 | 28.16 | 16.54 | 17.04 |
| 2011 | -17.92 | -5.02 | -7.43 |
| 2010 | 0.59 | 12.34 | 14.87 |
| 2009 | 40.41 | 30.79 | 37.18 |

The MSCI World Banks Index illustrates that the banking sector has provided mostly consistent growth since 2007, with the US accounting for a majority of the sector. It includes 106 constituents, the top 3 being JPMorgan Chase & Co, Bank of America Corp, and Wells Fargo & Co. The sector has decreased 6.25% YTD as 2023 provided challenges with the rate of inflation rising to 9.6%, the highest level in 38 years.

Bank stocks are generally considered to be cyclical. This means that their businesses and stock prices tend to follow the business cycle. They generally perform very well during economic expansions but typically underperform during recessions as sales drop, however, Consumer banking (taking in deposits and lending money) is highly cyclical, and this is especially true for banks that specialize in riskier forms of lending such as credit cards. On the other hand, investment banking tends to do even better during turbulent times, so banks that have large investment banking operations tend to see profits hold up quite well

<u>**Key Risk & Return Factors Exposure**</u>

**Value** - Relatively inexpensive stocks

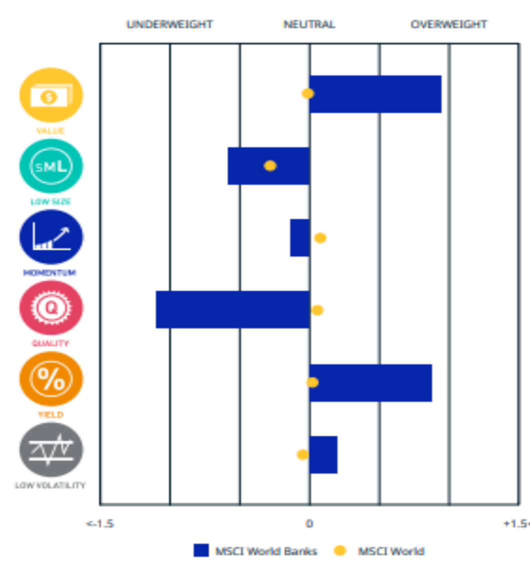
**Size** - Smaller companies

**Momentum** - Rising stocks

**Quality** - Sound balance sheet stocks

**Yield -** Cash flow paid out

**Low Volatility** - Lower risk stocks



# *Sector Overview –Key Performance Indicators*

| | |
|---|---|
| **Customer Retention** | A high customer retention rate indicates that the bank is providing satisfactory services and products to its customers, leading to customer loyalty and repeat business |
| **Customer Penetration** | Measures the bank's success in reaching and acquiring new customers. A high customer penetration rate indicates that the bank is effectively marketing its products and services to potential customers and expanding its customer base |
| **Asset Quality** | Measures the credit risk associated with a bank's assets, such as loans and investments. A high asset quality indicates that the bank's assets are performing well and are not at risk of default, reducing the potential for financial losses |
| **Capital Adequacy** | Measures the bank's ability to absorb potential losses from its operations. A high capital adequacy ratio indicates that the bank has sufficient capital to withstand potential losses. Certain levels of capital adequacy are mandated by regulators |
| **Assets Under Management (AUM)** | A measures the total market value of the assets managed by a bank on behalf of its clients. A high AUM indicates that the bank is successfully attracting and retaining clients, and is effectively managing their assets |
| **Loan Loss** | This measures the amount of money a bank has lost defaulted or def loans. A low loan loss ratio indicates that the bank is effectively managing its credit risk and is not experiencing significant losses from defaulted loans. Loans that are not being repaid on time are called Non-Performing Loans (NPL) |

**Useful metrics that demonstrate a banks profitability:**

| Profitability Metric | How to Calculate | Ideal Benchmark |
|---|---|---|
| **Return on Equity (ROE)** | Net Income ÷ Total Shareholder's Equity x 100 | At least 10% |
| **Return on Assets (ROA)** | Net Income ÷ Total Assets x 100 | At least 1% |
| **Net Interest Margin (NIM)** | Net Income ÷ Total Interest Generating Assets x 100 | At least 3% |
| **Efficiency Ratio** | Non-interest Expense ÷ Net Revenue x 100 | 60% or lower |

**Return on Equity (ROE):** Measures a company's profitability by calculating the net income divided by shareholder equity. It shows how much profit a company generates with the money shareholders have invested.

**Return on Assets (ROA):** This ratio measures how efficiently a company is using its assets to generate profit. It is calculated by dividing the net income by the total assets.

**Net Interest Margin (NIM):** Measures the difference between the interest income generated by a bank and the amount of interest paid out to their lenders, relative to the amount of their interest-earning assets. It is used to evaluate the profitability of a bank's lending and investment activities.

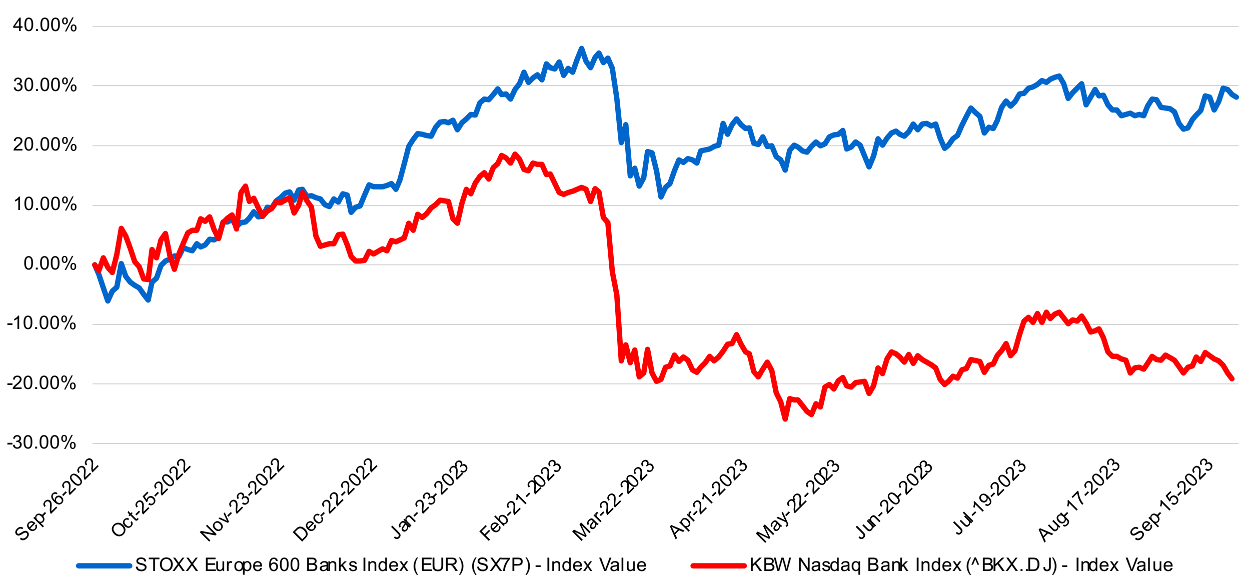
**Efficiency Ratio:** How efficiently a company is using its resources to generate revenue. It is calculated by dividing non-interest expenses by the sum of net interest income and non-interest income. A lower efficiency ratio indicates that a company is operating more efficiently.

# *Current Climate*

The decision by central banks to raise interest rates, a response to the pressing need to curb inflation, initiated a ripple effect throughout the banking sector. The shift away from the era of easily accessible, cheap credit to an environment of higher rates has invigorated profitability for banks by boosting their Net Interest Income (NII). NII is the difference between the revenue generated from a bank's interest-bearing assets and the expenses associated with paying on its interest-bearing liabilities. Higher interest rates increase the yield on a bank's assets, leading to an increase in interest income. At the same time, the pass-through of interest rates to deposit rates has been contained, meaning that the bank's interest expense has not increased as much. With interest rates currently hovering at between 4% - 5.5%, the sector is experiencing a resurgence, albeit shadowed by uncertainty regarding the continuation of rate hikes. Recent data revealing US inflation at approximately 3.2%, down from 6.4% at the beginning of this year (Statista; 29/08/2023), which has tempered concerns about an immediate uptick in rates, yet the spectre of potential hikes remains if inflation does not continue to fall to the target of 2%. The possibility of another rate hike in September varies between the EU and the US because of the differing impact of higher rates on economic growth. Business activity in the Eurozone has contracted sharply this August, with the euro falling to a two month low against the dollar. This demonstrates that there is a possibility that the ECB overtightened and thus are more likely to pause any rate increases. This is in contrast to the US economy which continues to show resilience. Chair of the Federal Reserve, Jerome Powell stated that if the economy kept growing above trend it could further progress inflation and hence could warrant further tightening of monetary policy.

**<u>EU vs US Performance</u>**

Even though the major banks in the US performed well this year, the stark difference in performance between European Union and United States bank indexes is rooted in distinct regulatory approaches. The EU bank index benchmark has experienced a robust year-to-date increase of 13.91%, while the US bank index, in contrast, has suffered a concerning decline of 14.65%. This discrepancy is a testament to the regulatory variations that have shaped the paths of these major economies.



# *Current Climate*

A critical aspect of these differences lies in liquidity ratios. European banks maintain a liquidity ratio of around 160%, while their US counterparts maintain a ratio of 120%. These ratios came into sharp focus during the collapse of Silicon Valley Bank (SVB), a crisis triggered by significant losses on bond portfolios. This event was exacerbated by the lack of capital that would have allowed SVB to meet the withdrawal demands of depositors when bond losses occurred. The culmination of higher interest rates, inadequate liquidity, and insufficient capital created a perfect storm.

The fallout from SVB's collapse reverberated through the banking landscape, setting off a chain reaction. Other regional banks, similarly vulnerable due to lax regulations on capital adequacy in the US, faced a similar fate. The interconnectivity of financial institutions meant that weaknesses in one could amplify vulnerabilities across the board. This cascade of collapses underscored the urgency of robust regulation to ensure stability and depositor confidence.

European banks, in contrast, exhibited a higher level of resilience due to better liquidity regulation  but also because of healthier levels of credit default swaps, a form of insurance for a company's bondholders against default. This distinction underlined higher investor confidence in the EU banks' lower perceived default risk

This comparative advantage over US counterparts not only accentuated the divergence in performance between the EU and US bank index benchmarks but also emphasised the role of regulatory frameworks in shaping this disparity.

**Windfall Taxes**

This boost in profitability in Europe has drawn attention from governments and populations who believe that the banks should have passed on these profits from increased rates to customers. Due to this certain governments, namely Spain, Italy and Lithuania have introduced a 'windfall' tax which would take a substantial portion of a bank's Net Interest Margin (NIM). In Italy the government announced a plan for a windfall tax of 40% which according to analysts at Citi could wipe out nearly 12% of Italian banks profits. However since it was announced Italy's Prime Minister has cooled on this plan, and the European Central Bank (ECB) will undoubtedly send Rome a legal opinion criticising the plan. The Italian banks index dropped 7.3% after the tax was announced. The Irish government has dismissed any suggestion that they would follow suit.

**Dealmaking Activity**

As the effects of higher rates kick in, economic growth will slow towards the end of the year and the possibility of recession is likely. However, it is possible that these conditions over the next few months could provide a more buoyant environment for dealmaking in the Financial sector. The period of cheap money is over and this has caused the golden era of FinTech and digital only banks losing much of its lustre  with a 36% drop in market cap in the industry. For example Klarna, Europe's largest FinTech company had a decrease in its market cap of 85%, from $45.6bn to $6.7bn. This is of great benefit to the incumbent and now cash rich banks. This could potentially present a major catalyst for topline revenue growth and in turn, growth in share price. Some banks have already started taking advantage of these discounts to extend their offerings to clients, some notable deals include BNP Paribas acquiring a currency risk management company Kantox, or Lloyds' acquisition of the digital insurer Cavendish Online. This could play into investment themes for the year by looking at which banks this would impact the most, either cash rich banks who are looking to expand, or banks focused on dealmaking.

# *Investing Themes – Diversified and Capital-Strong Banks*

**Diversified Banks**

One of the primary investment themes in our portfolio is diversified banks or universal banks. This strategy is underpinned by the anticipation that dealmaking opportunities may materialize in the coming months. As stated previously, interest rates have risen and traditional banks have benefitted significantly, given the potential for greater profitability through wider interest rate spreads. Simultaneously, FinTech and digital-only banks may face headwinds in a high-rate environment, potentially making them attractive acquisition targets. This possibility of increased deal-making is not limited to banks, any firms with excess cash may look to take advantage of the discounts a high rate environment create. However, it's crucial to note that this scenario is not guaranteed, and we remain cautious. In line with our outlook that interest rates may decrease in the near future, we have deliberately steered clear of banks that primarily rely on lending, such as commercial or retail banks. By concentrating on diversified banks, our aim is to harness potential opportunities in dealmaking while minimizing exposure to the potential impact of fluctuating interest rates.

**The Fortress Balance Sheet**

One of the core investment themes within our portfolio is inspired by JP Morgan CEO Jaime Dimon. It is focused on capital-strong banks with quality assets. This strategic approach underscores our commitment to prioritize banks with robust capital adequacy ratios, significant cash reserves, and a portfolio comprising high-quality assets. By emphasizing this theme, we strategically position our portfolio in a market marked by low interest rates, offering banks ample resources to seize opportunities and acquire undervalued companies. These banks, with their solid capital buffers and substantial liquidity, are not only well-prepared to capitalize on discounted opportunities but are also fortified against potential adverse consequences stemming from fluctuating interest rates. Furthermore, the inclusion of high-quality assets is integral to this strategy. It serves as a safeguard against economic volatility, ensuring that our investments remain well-protected and resilient, regardless of market conditions.

# *Investing Themes – European Banks*

**European Banks**

We find that there is little overlap between the difficulties affecting US regional banks and those faced by European banks. European banks have superior capitalization, stable deposit dynamics, and more moderate interest rate risk management. They additionally enjoy less concentrated exposure to CRE (Commercial Real Estate, explained further in risks) among smaller companies. Additionally, smaller banks in Europe operate in a less unstable regulatory system. These distinctions favourably position European banks for potential future expansion.

Market sentiment suggests that rate cuts are not expected until 2024. This outlook aligns with our expectations of a slowdown in Net Interest Income (NII) over 2024/25, which is in line with consensus projections. While rate cuts could impact net floating rate exposure, it is likely to be offset by the benefits of falling rates, including reduced deposit funding costs and better reinvestment yields. Thus, we anticipate a flattening of NII estimates for 2024. Importantly, despite this mediocre outlook, analysts believe there are possible drivers of earnings that could contribute or even boost earnings year-over-year. These drivers include fee income, a reduction in the inflationary impact on operating expenses, a reduction in late-cycle credit risks, and capital deployment for share reduction.

Furthermore, variables like the reasonable exposure to commercial real estate (CRE) serve to highlight the solidity of the European banking sector and Consumer Finance, which constitute less than 10% and 6% of total loan exposure, respectively. The risk diversification within major listed European banks and their healthy capitalization positions them well to withstand CRE-related losses or higher NPL ratios in the Consumer Finance segment.

Lastly due to under-performance over the last few years the sector has de-rated to circa 6x P/E in 2024, leaving banks as one of the most discounted sectors in Europe, despite offering one of the most attractive forward growth opportunities.


Comparing P/E for 2023 & EPS CAGR (Compound Annual Growth Rate) from 22' – 25'

# *Priced in Sector Drivers*

## Interest Rates

There is much uncertainty about the direction of interest rates in the short to medium term. Rates have risen in an attempt to control the inflationary pressures stimulated by the War in Ukraine and the resultant shock to energy and food prices, as well as the post Covid recovery and the downstream effect of quantitative easing. This has come after a prolonged period of historically low interest rates following the 2008 global financial crisis. The Federal Reserve has raised the federal funds rate to a target range of 5.25%-5.50%, marking the highest level of benchmark borrowing costs in over 22 years. This is the Fed's 11th interest rate hike in its last 12 meetings. Likewise, the European Central Bank's fixed rate tender is also at its highest level in years, at 4.00%, but there are fears of overtightening in Europe as the economy has slowed sharply. The Fed may have to raise rates again due to the robustness of the US economy and a limited supply in the labour market. JP Morgan research believes that UK inflation will be slower to recede.

These high rates can be good news for banks, by increasing the spread between interest paid to depositors and that earned on loans. Many have made great profits over the last two quarters. This has left them vulnerable to the threat in windfall taxes as we have seen proposed in Italy.

However, any resultant slowdown in economic activity may threaten the security of the loans. Underlying inflation may also erode the value of monetary assets including bonds held as security. Overall, the current interest rate climate presents both opportunities and challenges for the banking sector.

## Slowing Economic Growth

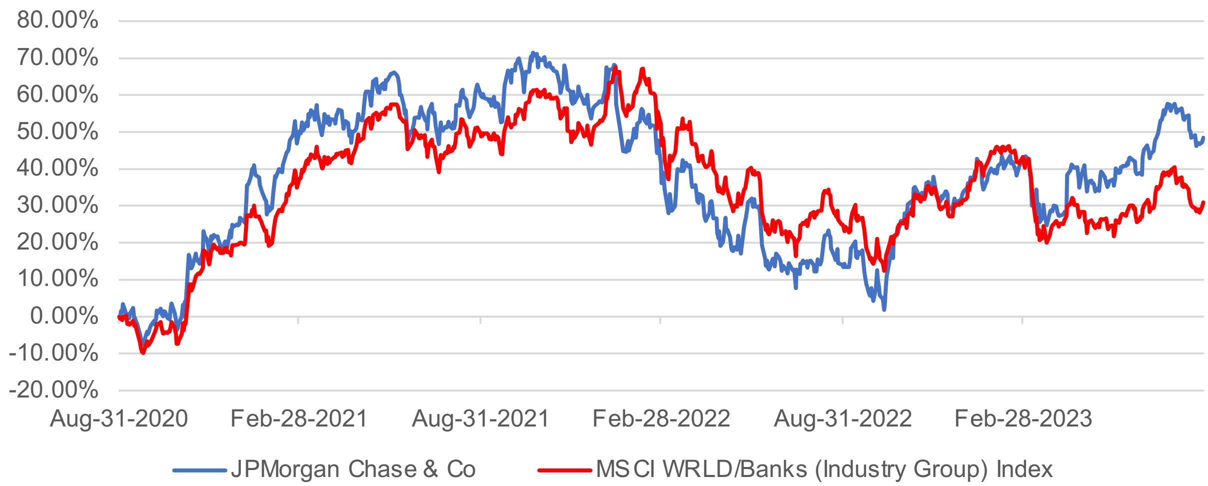
Tighter credit conditions can significantly impact economic growth. For businesses, these conditions may result in reduced capacity to invest in expansion or fund operations due to increased borrowing costs. This could potentially lead to a decrease in production and even layoffs, thereby contributing to rising unemployment rates. For consumers, tighter credit conditions could mean diminished borrowing power, leading to decreased consumer spending, a major driver of economic activity.

Both the U.S. and EU are projected to enter a mild recession towards the end of 2023. This is largely due to the restrictive policy stances from the Federal Reserve (Fed) and the European Central Bank (ECB), which create tighter credit conditions, gradually pulling down growth. However, by the second quarter of 2024, it is anticipated that inflation will decline and unemployment will rise sufficiently for the central banks to start easing economic restraints.

## *Current Holdings – JP Morgan (Hold)*

J.P.Morgan

<u>*Stock Performance*</u>




<u>Performance since Purchase:</u>
Entry Price - $114.58
Price on 30/08/2023 – $148.18
Price increase: 29.32%

<u>Thesis Outline:</u> **Hold**

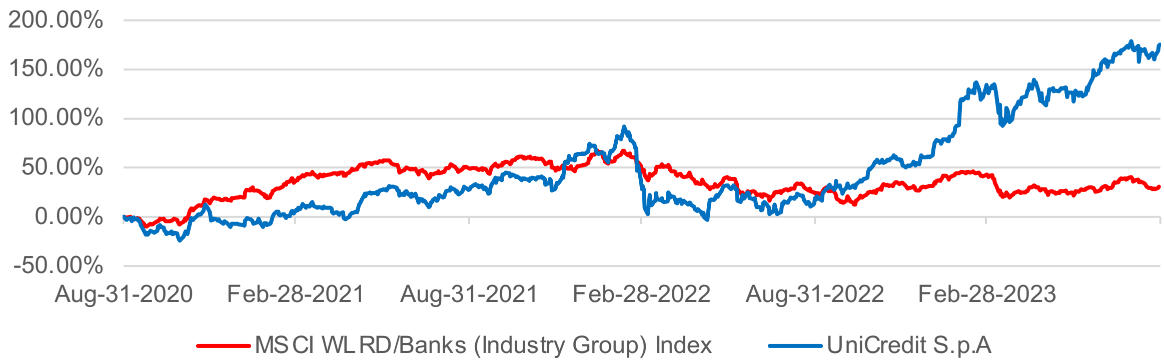
JP Morgan outperformed its benchmark by an impressive 28.91% year-to-date, showcasing its ability to generate strong returns for investors. Despite a slowdown in investment banking dealmaking activity, the company has achieved a remarkable year-over-year revenue growth of 20.57%. Although it increased Commercial Real Estate (CRE) lending, its robust adequacy ratios allow for far more loan defaults than expected, boasting a CET1 (Common Equity Tier 1; a metric representing a bank's core capital, the most stable and highest-quality capital, and serves as a buffer to absorb losses and ensure a bank's stability) standard of 13.8% and Total Loss-Absorbing Capacity of $496 billion. Notably, JPM's efficiency ratio has been steadily declining, reflecting improved cost management. The recent increase in NII guidance from $74 billion to $87 billion for the current year underscores its ability to capitalise on diverse revenue streams. The decline in demand for investment banking services has made JPM extremely competitive relative to its peers in that space, highlighting its resilience and adaptability.

The acquisition of First Republic Bank has already proven to be a success, contributing 6% to NII and attracting $6 billion in positive Net Deposit Inflows. Given First Republic's track record of customer satisfaction and with funding and investment from JPM, it positions First Republic for robust growth compared to other regional banks. With its strong market presence and diverse revenue streams, JPMorgan Chase & Co. offers the best exposure to the U.S. banking market. Hence, holding JPM stock is a prudent choice for us long-term.

## *Current Holdings* – *UniCredit (Hold)*

UniCredit

<u>*Stock Performance*</u>




<u>Performance since purchase:</u>
Entry Price - €17.99
Price on 30/08/2023 - €22.70
Price increase: 26.18%

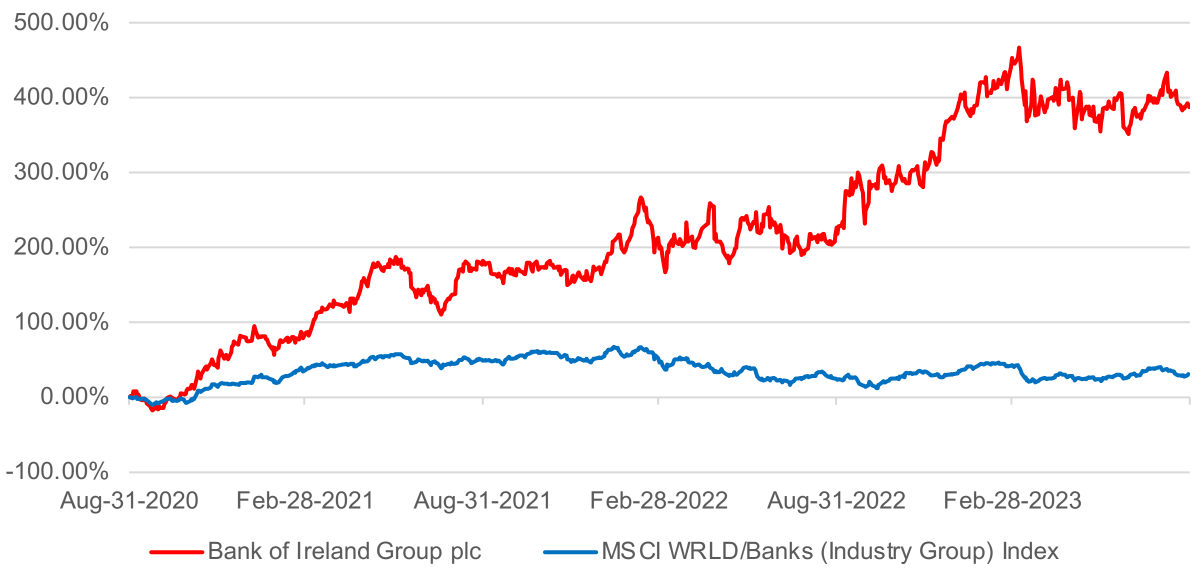
<u>Thesis Outline:</u> **Hold**

Over the past 12 months, UniCredit's stock has seen a robust and impressive surge, marked by a growth rate of 137%, with 74% achieved year-to-date. This growth has been driven by UniCredit's solid operational performance, fueled by higher interest income, which has pushed the share price higher.
UniCredit is a rate-sensitive bank, meaning it benefits from higher interest rates. As interest rates have risen, UniCredit's net interest income (NII) has increased, driving a 15% growth in net profit year-on-year. This is a key factor behind the bank's strong commercial momentum, which refers to its ability to generate consistent revenue growth and maintain a strong market position.
In 2022, UniCredit demonstrated this momentum with total revenue of €20.3 billion and NII of €10.7 billion. The fourth quarter of 2022 marked the 8th consecutive quarter of growth. Despite facing extraordinary inflationary headwinds, UniCredit managed to reduce costs by 2% for FY22 without impacting growth.
In Q2 of 2023, UniCredit achieved a net profit of €2.3 billion, a growth of almost 15% from the previous year. The primary contributor to this earnings growth was the net interest income of €3.5 billion, reflecting a growth of 41.3% on a year-on-year basis.

Following the period of a dividend cap imposed by the European Central Bank throughout most of 2021, there was an intense selloff of UniCredit's stocks. This resulted in a significant increase in cash within the bank. UniCredit has since started to reimplement a dividend targeting 35% of net profits and has bought back €2.6 billion of stock so far this year to bolster share price.
However, it's important to note that the recent introduction of a 40% windfall tax by the Italian government led to a 6% decline in shares. Analysts believe this tax will have a more pronounced effect on smaller banks, so its impact on UniCredit is projected to be less profound, underscoring the company's resilience in the face of regulatory changes.
These outstanding results are proof that UniCredit is a transformed bank with a solid capital position, providing it with the ability to withstand macroeconomic headwinds.

# *Current Holdings – Bank of Ireland (Sell)*

*Stock Performance*




Performance since purchase:
Entry Price - €9.70
Price on 30/08/2023 - €9.19
Price decrease: 5.26%

Thesis Outline: **Sell**

The Irish government disposed of all its holding in Bank of Ireland by October 2022, initially causing the share price to rise. Their disposal was influenced by a wish to exit from the commercial banking sector as well as ensuring a good return to the tax payer. A large state holding could be argued to serve as a buffer to share price movements, i.e. If share price rises, gov will sell and if share price falls they will hold.

The share price has remained stable since March 2023, despite an increase in revenue of 56.43% YoY, a 193.77% increase in net income and a 87.76% increase in net profit margin.

Analysts have raised concerns that BoI's reliance on a glut of deposits puts the peak profits within sight and hence potentially putting a cap on share price. One potential risk to Bank of Ireland's earnings from deposits lies with the €30bn of its excess liquidity stashed with the ECB, with the bulk of it earning the 3.75 percent ECB deposit rate. Interest on these liquid assets, which also include bond holdings totalled €648million in H1 2023, up from €210mn in the H2 2022. This has put investors off so much so that despite reporting net profit growth of over 200% last quarter the share price was still trading below its March peak.

# ***Risks*** *– Non-Performing Loans and Decreasing Rates*

**Non-Performing Loans (NPL)**

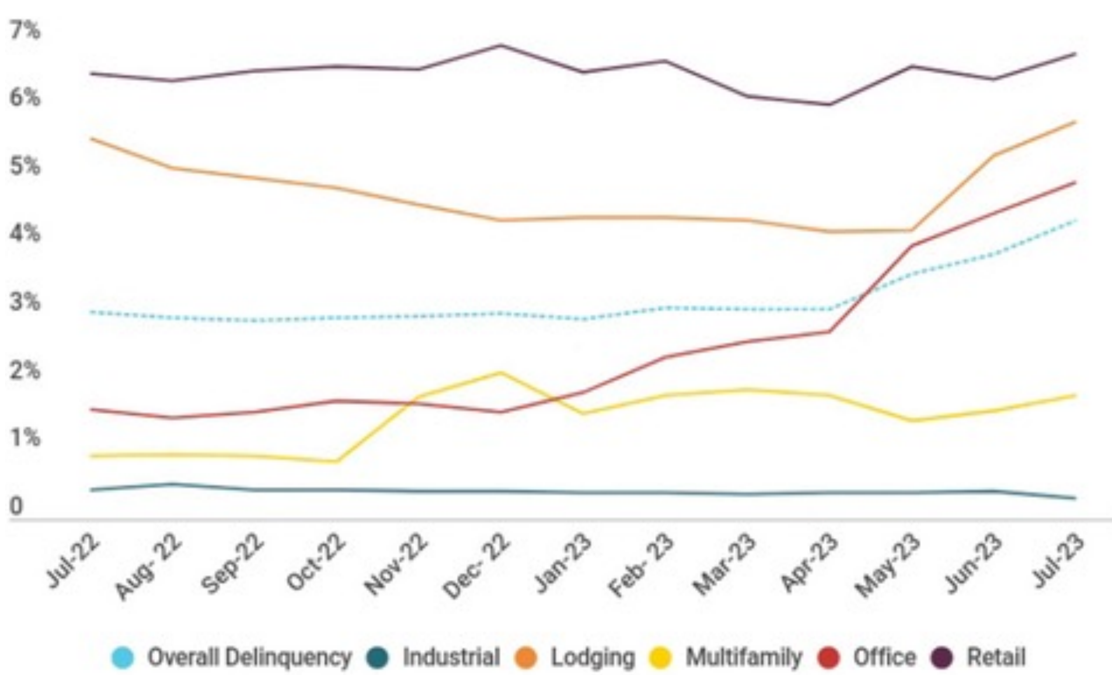
NPLs (Non-Performing Loans) are loans that borrowers have failed to repay as per their agreed terms, typically indicating financial distress or default, and are considered risky assets for banks.
Slowing economies, particularly in Europe, pose notable risks to various sectors, including finance. As economic growth decelerates, banks face a series of challenges that could impact their performance. One major concern is the potential rise in NPL's as individuals and businesses struggle with lower income and reduced economic activity. A weaker economy may lead to increased loan defaults, which can directly affect a bank's profitability and asset quality, as they will need to absorb the investments lost by using profits to write them off. Moreover, a sluggish economic environment can limit opportunities for banks to expand their loan portfolios and generate new revenue streams. Another risk in a slowing economy is the potential for reduced demand for banking services, including loans, investments, and other financial products. Consumer and business spending tend to contract in such conditions, which can hinder the growth of banks' fee-based income and reduce the overall volume of banking transactions. Additionally, a slow-growing economy may necessitate stricter regulatory scrutiny and increased compliance costs for banks, further impacting their operational efficiency.

**Decreasing Rates**

Interest rate decreases, which are anticipated to potentially begin in 2024, pose significant risks to the banking sector. A sustained decline in interest rates can erode a bank's net interest margin, as the spread between the interest it pays on deposits and the interest it earns on loans narrows. This can lead to reduced profitability for banks, impacting their ability to generate income from traditional banking activities. Additionally, lower interest rates may incentivize borrowers to refinance existing loans at more favourable rates, resulting in reduced interest income for banks. Furthermore, banks may face challenges in managing their interest rate risk and maintaining a healthy balance sheet in a low-rate environment. These risks could be exacerbated if interest rates decrease rapidly or unexpectedly, potentially causing disruptions in financial markets and increasing pressure on banks to adapt to changing economic conditions.

**Commercial Real Estate**

Commercial Real Estate (CRE) market appears to be lagging behind other economic indicators. This is because when interest rates rise, borrowing costs increase, making it more expensive for investors to finance new deals or refinance existing loans. This can lower investment in the commercial real estate sector and put downward pressure on property prices. It is also caused by an increase in working from home which has reduced the need for office space. A recent report highlighted a significant increase in delinquency rates, up by 51 basis points to 4.41% last month, marking the highest level since December 2021. The office segment within CRE is experiencing an even more rapid deterioration, with delinquencies rising by 46 basis points to 4.96%, a substantial increase of over 350 basis points since the end of 2022. This trend is concerning as it indicates that commercial real estate, particularly the office sector, is facing challenges despite the broader economic relief seen in the form of higher equity prices and better-than-expected corporate earnings. The rise in delinquency rates is putting pressure on the banking sector, given its exposure to commercial real estate loans. While analysts at UBS have pointed out that the scope of the issue in terms of office exposure for banks is relatively small compared to their total capital, it's still a noteworthy risk to monitor, especially if the trend continues. As building owners in various regions return office towers and malls to lenders, this is likely to contribute to an uptick in Commercial Mortgage-Backed Securities (CMBS; securities made up of loans for offices, hotels etc) delinquencies, potentially impacting the banking sector's stability moving forward.



# *Case Study - UBS*

UBS, the Swiss banking giant, has recently made headlines in an unprecedented move purchasing its main rival, Credit Suisse, in a government-led rescue operation. This acquisition came at a price tag of $3.25 billion, a mere half of Credit Suisse's book value. Such a strategic manoeuvre has set UBS on a trajectory for record-breaking quarterly windfall profits, positioning it as a dominant force in the financial world.

One key aspect of UBS's transformation is its restructuring plan for Credit Suisse, which includes the closure of two thirds of its Investment Banking (IB) division. This move simplifies the bank's operations and allows UBS to pivot toward becoming not only the largest Global Wealth Management (WM) player but also the largest in the Ultra High Net Worth (UHNW) segment. Projections indicate that UBS is set to generate an impressive $7.00 billion in pretax profits from Wealth Management in 2027, with a substantial influx of almost $150.00 billion per annum in Net New Money inflow.

Furthermore, financial experts are optimistic about UBS's prospects, forecasting it to become a $3+ earnings-per-share (EPS) bank by 2027, with a relatively low price-to-earnings (P/E) ratio of 6.5x. Notably, the bank has a safety net in the form of the optionality of a Swiss Bank IPO or spin-off, with a minimum estimated valuation of $10.00 billion. This safeguard ensures downside protection if the integration of Credit Suisse proves more complex than anticipated. With a CET1 ratio of 14.2% and a proven management team of Colm Kelleher and Sergio Ermotti, USB is well-prepared for the merger, UBS seems poised for a successful transformation into a financial powerhouse.

In the post-acquisition landscape, UBS envisions a business model that is the envy of the global banking industry, with a staggering 60% of its Group Profit Before Tax (PBT) coming from Wealth Management and only 10% from Investment Banking. Goldman Sachs even predicts that the combined entity will be a capital-generating behemoth, boasting nearly 160 bps in CET1 capital pre-distribution in 2027 through a capital-light model primarily focused on asset gathering.

One prominent risk is the elevated share price driven by high expectations surrounding the Credit Suisse acquisition. In the event that the integration or execution of this deal encounters unexpected challenges or fails to meet anticipated outcomes, shareholders may face potential losses. Another risk, is regulators could impose new rules and regulations now that UBS has a monopoly in the Swiss market.

| | | | |
|---|---|---|---|
| **UBSG.S** | 12m Price Target: **SFr25.80** | Price: **SFr18.13** | Upside: **42.3%** |

Source: Goldman Sachs Equity Research 18th July 2023

# *Strategy for the Year Ahead*

In the banking sector, the upcoming year offers both promise and the need for prudence. With the backdrop of high interest rates, we have a unique window to capitalize on current conditions while navigating the impending rate reductions that will inevitably impact profitability.

**Seizing the Opportunity**

The immediate focus lies in seizing the existing opportunity. High interest rates offer a chance to enhance profitability through prudent lending and the expansion of investment portfolios. This period allows banks to bolster their balance sheets, creating a robust financial foundation for the future.

**Cautious Optimism**

However, the banking sector is not without its challenges. The anticipated decline in interest rates looms on the horizon, casting a shadow on profitability. As rates recede, the margins on lending and investments will narrow, impacting the core revenue streams of financial institutions.

**Strategic Balance**

The key to our strategy in the banking sector for the upcoming year is to strike the right balance between exploiting the present opportunity and preparing for inevitable rate reductions.

**September Watchlist**

1) UBS Group AG (+85.7% past year, +8.3% YTD) is a multinational investment bank and financial services company founded and based in Switzerland. It is the largest Swiss banking institution and the largest private bank in the world.

- ROE – 11.46% (Q1 2023)
- ROA – 0.60% (Q1 2023)

2) Wells Fargo & Company (-4.75% last year, +0.22% YTD) is an American multinational financial services company with a significant global presence, dominating the mortgage market.

- ROE – 9.23% (Q2 2023)
- ROA – 0.88% (Q2 2023)
- Efficiency Ratio – 63% (Q2 2023)

3)Société Générale (+21.58% past year, +8.52% YTD) is a French based multinational financial services company, with presence in 66 countries.

- ROE – 4.39% (Q1 2023)
- ROA – 0.20% (Q1 2023)

## *Further Articles*

- McKinsey's Global Banking Annual Review1
- Banking in 2035: global banking survey report2
- Guide to key performance indicators(KPI)3
- 2023 Irish Banking & Capital Markets Outlook by Deloitte Ireland
- 2023 Global Outlook for Banking and Financial Markets by IBM
- SX7E.pdf (stoxx.com)
- 2023 Outlook: The Future of the Banking Industry by West Monroe1
- Top 10 Banking Trends for 2023 by Accenture
- Global M&A Industry Trends: 2023 Mid-Year Update: PwC