Fred Jeanmaire
Fund Manager

The ECB adopts a more positive approach to the banking sector

Fred Jeanmaire, fund manager in Threadneedle's European Equities team, provides insights into the more positive sentiment towards the banking sector emanating from the ECB, and outlines investment ideas in the European banking sector:

A more Anglo-Saxon approach to Central Banking

Draghi's latest speech has emphasised the need for Europe to develop a vision, and "not least for investors". It is apparent (from the latest dealings we have had with the ECB) that the central bank is looking for feedback from the market and the market's likely reaction to potential ECB decisions. Market valuations, for example, of peripheral bonds, are now a distinct objective of monetary policy. **The ECB also made clear that they have some additional tools at their disposal should the crisis worsen**, in particular, another potentially longer LTRO (deemed not necessary at this stage), additional collateral requirement softening, and "unlimited" purchases of sovereign debt;

A more pro-banks regulator

We believe that the ECB – the new European banks regulator – now lists among key risks, an "excessive pace of bank deleveraging" as well as "low bank profitability". This represents a shift from the national regulators' previous emphasis on capital building and the pursuit of a broadly conservative regulatory regime for banking, irrespective of the impact on business models and economies. We believe that **the ECB does not see an immediate need for the convergence of capital ratios and business models in Europe**, thus paving the way for more lenient regulation than is generally expected. A wave of capital raising by European financials seems unlikely at this stage;

Financial fragmentation the enemy

The likely catalyst for the ECB's further involvement in the European crisis and the launch of the OMT (Outright Market Purchase) programme was the increased perception of a re-denomination risk (i.e. euro breakup), as well as the retrenchment of financial institutions in their domestic markets (encouraged by their regulators). This led to further divergence in country economic performance and therefore the "non-transmission of monetary policy". This has led to a de facto rise in the cost of doing business in the periphery vs the core, preventing any rebalancing. To prevent this, **one tangible measure undertaken by the ECB would be a "re-calibration" i.e. softening of some Basel 3 weighting for inter-bank lending** and, more generally, potentially the re-evaluation of some particularly pro-cyclical capital rules.

Investment conclusions:

- **Neutralise European banks (and not only financials)**: adverse regulation has been a powerful negative driver for the sector since the start of the crisis. Similar to telecoms, where a change in stance from the European Commissioner proved a catalyst for sector performance earlier this year, this could help banks' relative performance. Lower concerns over capital raising across the sector could help the

"The ECB's more aggressive approach could boost growth expectations"

banking industry move above its current 0.8x TBV towards 1.0x, with valuation capped by low profitability and provision risk;

- **Positive for multi-domestic banks:** as the regulator seeks to prevent the effects of fragmentation, multi-domestic banks should benefit. This confirms our long-standing positive view on **BNP Paribas**, which is still attractive at 0.7x tangible book and low-teens ROTE. But this also is a positive for **Unicredit**, given that its operations are spread out across Europe. Unicredit is trading on a 0.5x price to book due to very weak profitability but should benefit from a lower risk premium;

- **Controlled austerity and de-leveraging positive for GDP growth revisions**: from an economic and monetary point of view, the more aggressive stance taken by the ECB could lead to better growth versus expectations, while a recession in Europe is the consensus. Our base case remains a very difficult year for the periphery in 2013, however, highlighting that the ECB is now "all-in" in this operation and has put its reputation at stake.