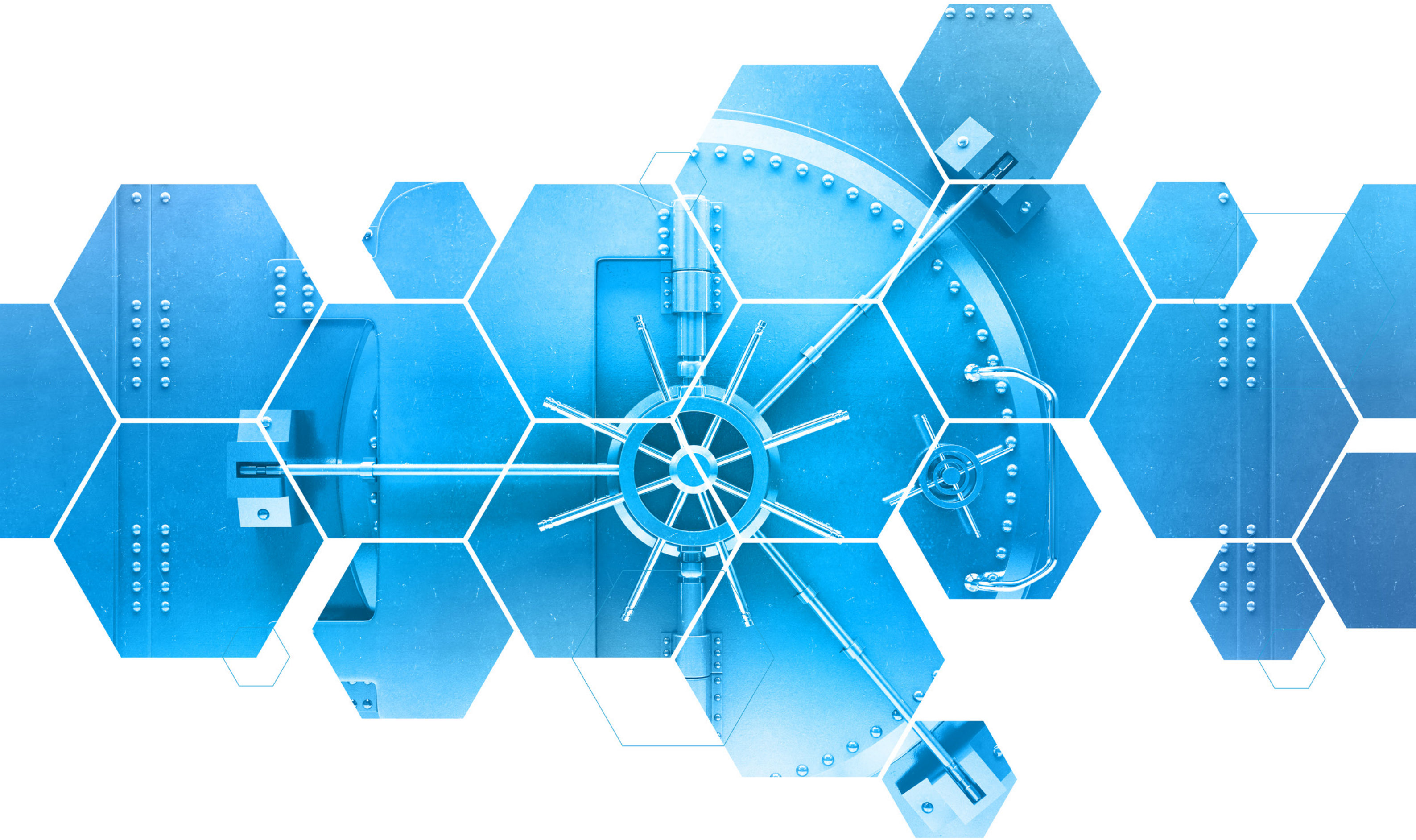
Polar Capital Global Financials Team

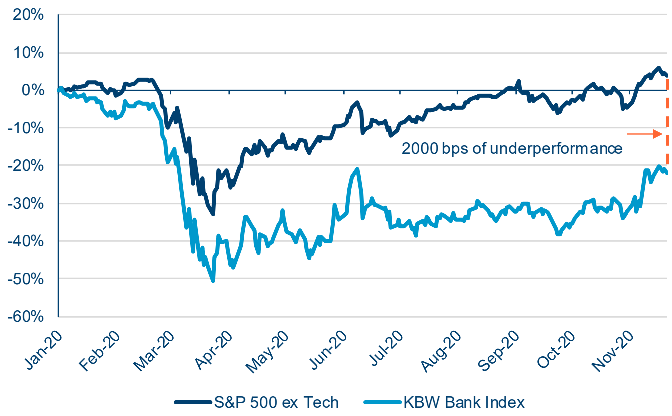
Banks and COVID-19

Structural Positioning Damaged or Enhanced?



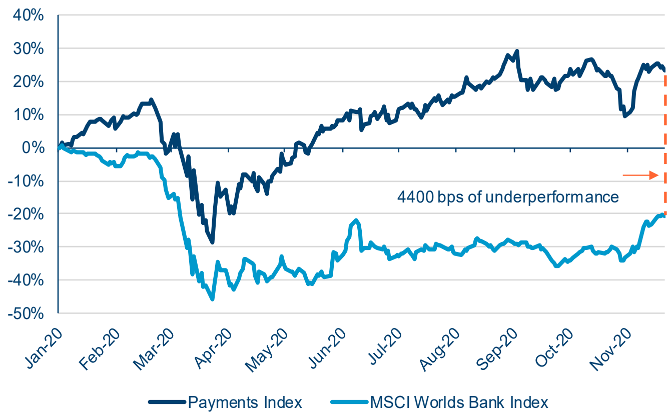
Our most recent commentary focused on the state of banks' balance sheets, when we argued that not only are they well reserved for future loan problems (even though there is little evidence, as yet, of these problems) but they have considerable surplus capital should current assumptions prove too generous (and, in our view, more than enough to start paying dividends again). However, what if the underlying reason for the discount attached to banks (see charts below) is nothing to do with the quality of their balance sheets, but more about investors' views on the outlook for their business models in a digital era? After all, the chart below highlights how investors are happy to assign large premiums in the payments space on the perceived strength of their longer-term structural positioning.

S&P 500 ex-Tech v KBW Bank Index



Source: Bloomberg, November 2020

Payments Index versus MSCI World Bank Index



Source: Bloomberg, November 2020

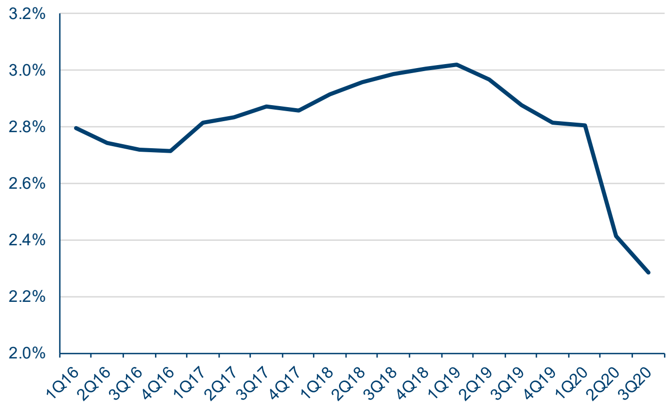
Underpinning this view is that a balance sheet-driven model (making loans/taking deposits and earning a margin) as espoused by banks will no longer be profitable in an era of low interest rates, while fee income from specialist services will come under pressure as nimbler new entrants without high distribution costs price lower and take share from the banks. The restrictions imposed by the COVID-19 crisis will further accelerate the shift to a digital model and the historic advantage of an extensive branch network will become meaningless. Fortunately, for those of us still investing in the banking sector, during the COVID-19 pandemic many of these arguments have been exposed as froth, not too dissimilar from the valuations often attached to fintech stocks, and the incumbent banks have proved to be as much beneficiaries of many of the structural trends currently underway.

Margins: Lower but still profitable and with considerable upside

Most banks' revenues come from the margins they make between their asset yields and their funding costs and the trends on those margins would imply the current model is under severe pressure. Our view is that the trends are highlighting a certain resilience even in the face of exceptionally low interest rates. Below we have shown the trend in margins for the major US banks, which is clearly downwards as interest rates have fallen, and we expect some further pressures ahead assuming interest rates remain at such low levels. However, this cannot be looked at in isolation to the risk of the balance sheet (e.g a book of credit card lending has excellent margins but is much higher risk than lending to a large corporate on lower margins). Also, the table below highlights how the decline in loan margins at JP Morgan has been far less dramatic than overall net interest margins, suggesting much of the change in margins reflects a change in the asset mix of the balance sheet and lending continues to be done at very profitable levels. The COVID-19 crisis has seen huge flows of new deposits that cannot be lent out in the form of corporate and retail lending in a weak economy and so are being invested in low-earning assets. Cash as a percentage of interest-earnings assets has on average increased by six percentage points while loans as a proportion of assets have fallen five percentage points, to 51%, from the end of 2019 to 3Q20. Today, margins are lower partially because the balance sheet risk is lower and that is reflected in lower levels of provisioning and consequently has much less impact on total profitability than originally perceived.

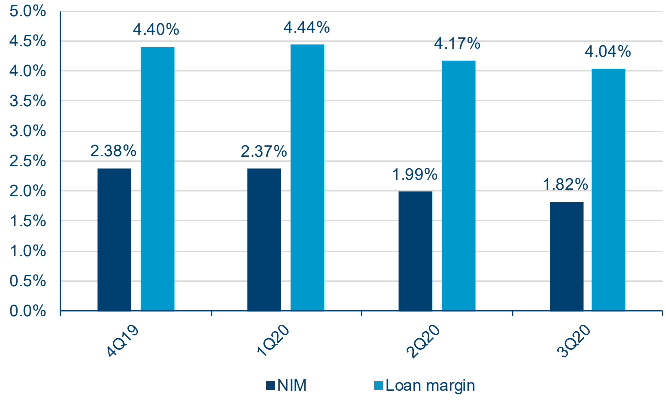
When the economy recovers, these deposits and the corresponding low-yielding assets on banks' balance sheets will either be used for spending or will be lent out thereby boosting margins. What is also completely ignored is that the banking sector globally has become far more sensitive to rising rates as the proportion of non-interest-bearing deposits rise. From the end of 2019, non-interest-bearing deposits in large US banks grew from 25% of deposits to 31% by 3Q20. In the event of small rate rises, banks will not only see wider loan spreads but the changing mix of assets and the zero cost of deposits will provide an additional boost to their margins.

Net interest margin US banks



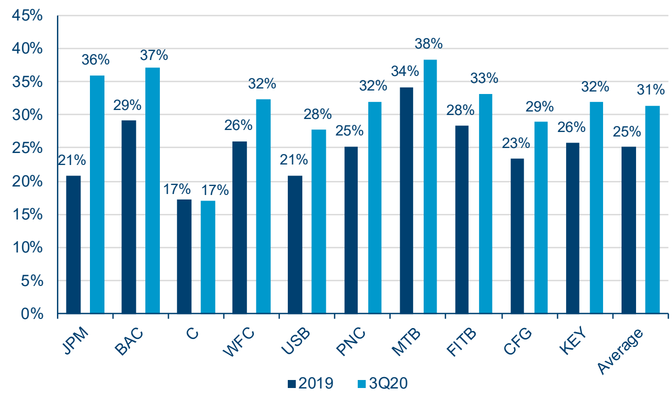
Source: Polar Capital, company filing, November 2020

JP Morgan NIM and loan margin



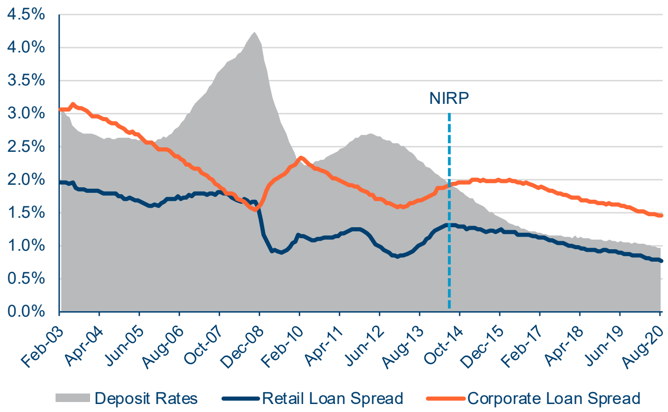
Source: Polar Capital, company filing, November 2020

Non-interest-bearing deposit



Source: Company filing, November 2020

Eurozone loan spreads and deposit rates

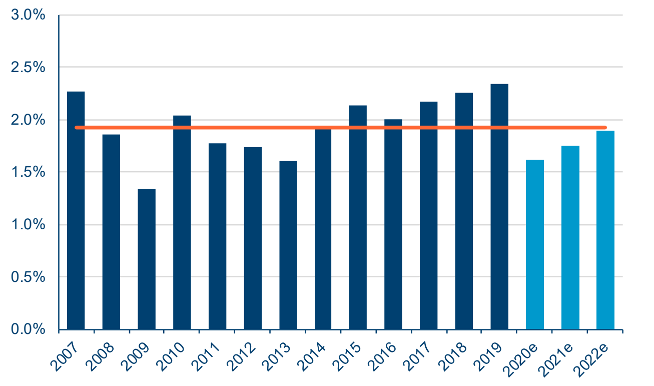


Source: European Central Bank

Though some of the issues are the same in European banking (bank margins have faced headwinds from negative interest rates and seen a surge in deposits during the recent downturn) the potential benefits could very well be less. Large low-earning mortgage books (where it can be politically difficult to raise rates) along with a negative rate environment can make it more difficult to capitalise in a recovery on changing the mix and repricing loans upwards. However, given the low-rate environment and high levels of surplus liquidity, European banks would still be clear beneficiaries of a rising rate environment with the banking sectors in peripheral Europe particularly sensitive, given the shorter repricing timeframe on assets and a higher proportion of floating rate loans linked to Euribor.

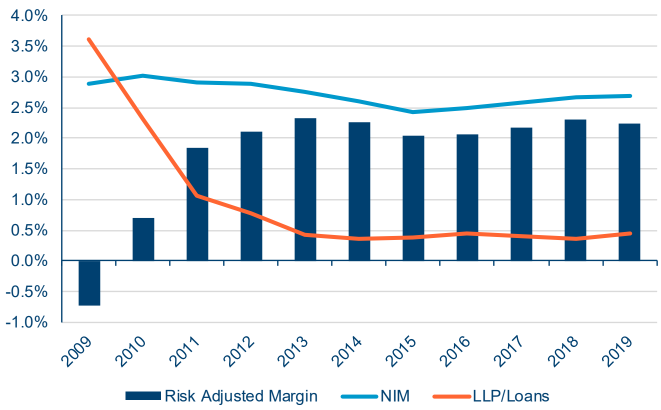
Even within European banks, however, when adjusted for risk (ie taking account of loan loss provisioning), bank margins are expected to recover to past averages once loan loss provisioning starts to fall. To reinforce the message of lower-risk balance sheets impacting margins, the charts below also show the make-up of the loan book has improved, with banks increasingly shifting to lower risk and lower margin products. Within corporate loans, banks' share of the leveraged loans market has decreased since the global financial crisis (GFC). Similarly, within the consumer book, US banks have grown lower-risk mortgages while letting second-lien lines (HELOCs) run off. We would reiterate that lower margins are partly a reflection of lower risks rather than some fundamental undermining of banking business models.

European Banks: risk-adjusted margin



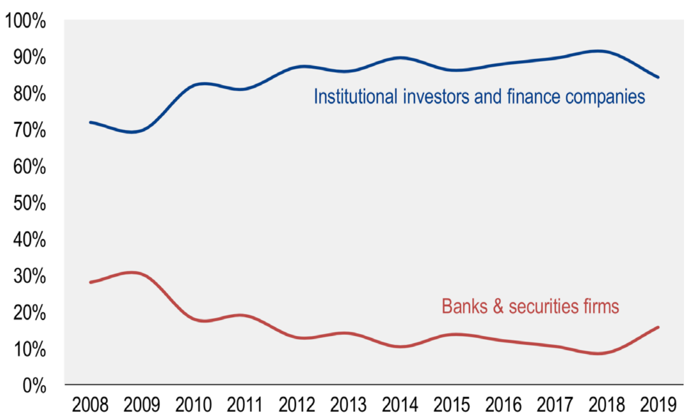
Source: KBW, November 2020

US bank NIM vs provisioning



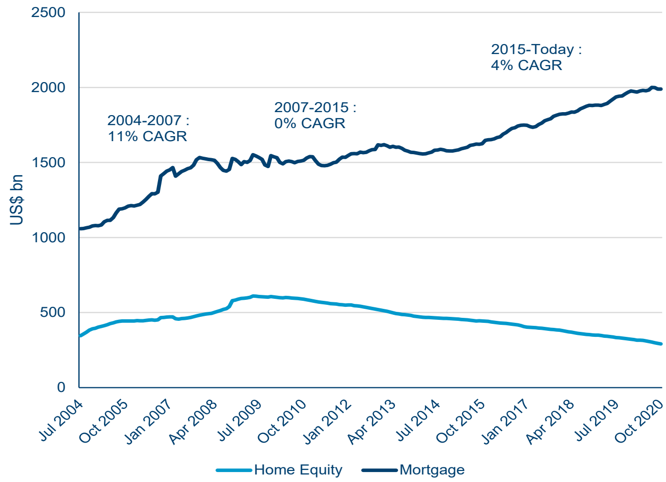
Source: Polar Capital, company filing, December 2020

Primary market for leveraged loans (banks vs non loans)



Source: LCD, an offering of S&P Global Market Intelligence

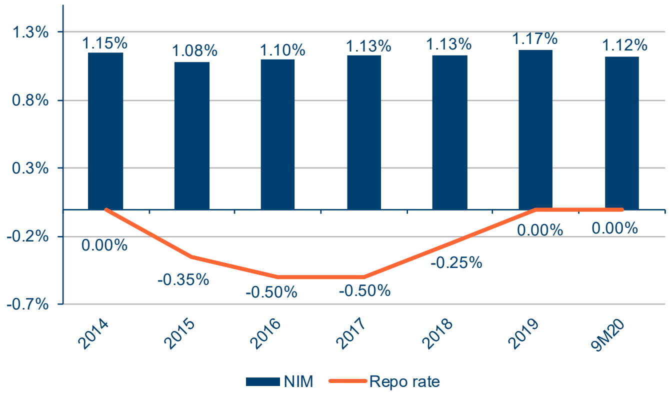
Mortgage vs HELOC loans - US banks



Source: Fed H8 data; December 2020

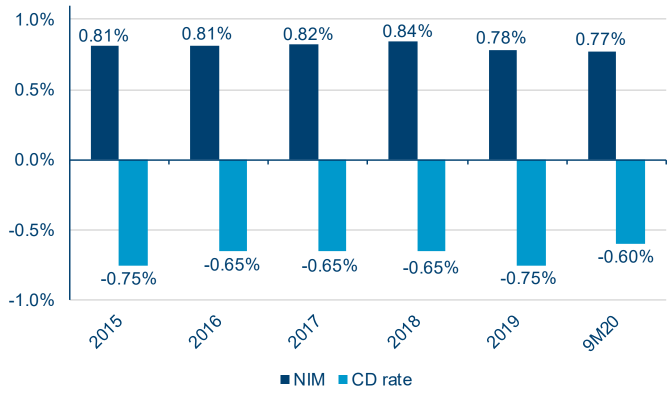
Another commonly held assumption is that in a negative interest rate environment banks will simply not be able to earn a reasonable return. However, the evidence in Scandinavia (see charts below) is that negative rates have not had a material negative impact on banks. Denmark and Sweden have been in a negative rate environment for over five years yet have experienced only a marginal change in margins. To a large extent this reflects the different funding structure in the Nordics which incorporates a significant portion of wholesale funding, through covered bonds, with both banking sectors therefore less reliant on retail deposits. Added to this, the ECB has introduced various measures designed to stimulate lending through lower funding costs (TLTRO-III provides funding as low as -1% if lending criteria are met) and shield the impact from negative rates (a tiering system allows banks to deposit with the ECB at 0% instead of the -0.5% deposit facility rate). While the tiering system provides some mitigation to negative rates, it is capped at 6x a bank's minimum reserve requirement and so negative TLTRO funding rates have contributed to the narrowing in loan spreads.

Swedbank: Swedish NIM trend and Riksbank repo rate



Source: Bloomberg, November 2020; Swedbank company reports

Dankse: NIM Trend Nationalbank CD rate



Source: Bloomberg, November 2020; Danske company reports

Within emerging markets not only are margins still at highly profitable levels but action taken by central banks to lower interest rates in response to COVID-19 has led to margin expansion in a number of markets (Indian private sector banks, the Philippines, Pakistan and Russia) driven by a fall in the cost of funding. While asset spread compression (repriced with a lag to funding) is expected to weigh on margins in Pakistan and the Philippines in 2021, the outlook remains positive in India (private sector banks have widened their funding cost competitive advantage and have support from deploying excess liquidity).

Most investors are not even factoring meaningful rises in interest rates and these will provide a further boost. The consequence of the unprecedented response by governments to the crisis has been a material increase in the levels of public debt. With world non-financial debt to GDP at record levels, governments could look to inflate this debt away while also controlling longer-dated yields through yield curve control. However, with bank share prices closely tied to inflation expectations, a scenario of higher inflation and rates rises along with intervention at the long end is still likely to be a net positive for the sector as it would challenge the current consensus expectation of negative rates and 'Japanification'.

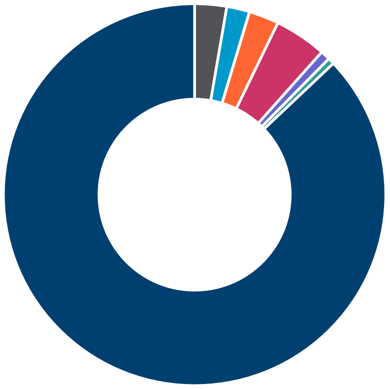
Our view is that even if rates were to rise, the long-term level of interest rates will remain low by past standards so long-term margins will remain lower, but banks can offset this by originating and then selling loans. US banks have been doing this for years in terms of their mortgage lending. A banking sector which takes a more asset-lite approach could have very meaningful positive upside to future RoEs, with European banks potentially the greatest beneficiaries. We may have recently seen a preview of possible action banks may take, with JP Morgan in November signing an agreement with two European pension managers to transfer an undisclosed amount of risk from a $2.5bn corporate loan portfolio thus reducing the amount of capital it needs to keep aside. We reiterate that current margins also need to be looked at in relation to risk which consequently has implications on capital requirements and future RoEs.

Bond markets, not fintech, remain the key competitor in lending

In the event of economic recovery, although banks will see improving returns on their historic stock of lending as margins widen, some could argue they are not the best investments to capture growth in new lending and much of this will move to new entrants pricing aggressively with a more targeted approach to credit risk. Though there is no evidence of this when looking at deposit growth, there is some truth when looking at loan growth although the true competitor of the banking industry has been the bond market rather than new fintech models of lending.

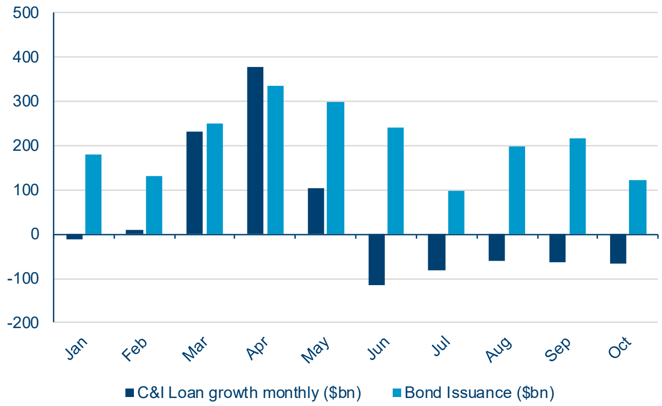
In the US, at the outset of the pandemic, we witnessed corporates draw down on their bank credit lines as they looked to raise liquidity. However, following actions by the US Treasury and Fed to calm capital markets, yields fell resulting in record corporate bond issuances (+63% y/y) and paydowns of bank loans (see chart below). As these facilities by the US treasury and FED are wound down, we expect the relative advantage of capital market funding over bank borrowing will dissipate and corporate loan growth at US banks will resume growth as the economy recovers.

Coronavirus Business Interruption Loan Scheme (CBILS) Lenders



Source: HM Treasury, November 2020

US corporate loan growth and bond issuances



Source: SFIMCA October 2020, FED H8 data

With regards to fintech models, while UK neobanks have been successful in driving scale in customer numbers (neobank penetration is 27% of the UK market in 2020 versus 7% in 2018) this has not translated into a significant market share in lending. Neobanks have played a larger role in 2020 in terms of lending as part of state-backed relief schemes (see pie chart above) with digital banks and Funding Circle representing 13% of the UK's Coronavirus Business Interruption Loan Scheme (CBILS – £18.5bn approved by 15 November) while Funding Circle's P2P platform has provided an efficient means of approval (24% market share in number, rather than value, of loans approved, as of November 2020). The high level of automation in Funding Circle's decision-making (40% of loans are processed by instant decision technology, taking nine seconds on average to make a decision) is ideally suited to the recent surge in applications for government guaranteed lending (CBILS carries an 80% government guarantee) but their asset quality experience in a benign credit environment prior to the crisis (evidenced by a weaker return profile on 2017 and 2018 vintages) has raised questions as to their ability to underwrite over a cycle without the benefit of state-supported lending. While there are examples of digital banks that have achieved profitability through balance-sheet lending (OakNorth has a run-rate RoE of c23% in 2020 supported by a 29% cost/income ratio), they are rare while the challenges faced by lending platforms achieving profitable growth has been highlighted by their share price performance post IPO (Funding Circle -80%, LendingClub -94%, OnDeck Capital -92%).

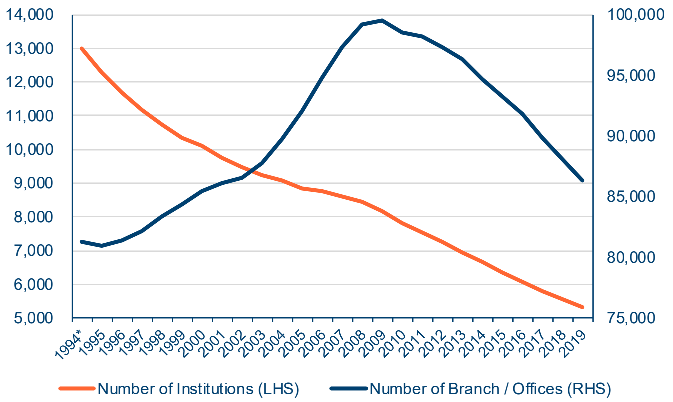
It could be argued that the banks are also being replaced by government lending schemes. The US Congress established the Paycheck Protection Program (PPP) under the Cares Act, whereby banks would lend to small and medium-sized businesses at a fixed 1% rate and receive additional fees of 1-5% depending on the loan amount. The loans under PPP would be forgiven if certain criteria were fulfilled, such as the amount spent on paycheques and rent – banks estimate 80% of these loans to be forgiven. While this program offset the strong loan growth witnessed earlier in the year, as the borrowers paid back on their bank lines, significantly it reduced credit risk for the banks as it provided borrowers, mostly existing bank clients, with grants to help overcome cashflow crisis. To further assist banks, the Fed established a PPP lending facility allowing banks to borrow from the Fed with the PPP loans – which are 100% guaranteed by the Small Business Association – as collateral at a fee of 35bps. Additionally, PPP loans were assigned a risk weight of 0% under the risk-based capital rules. In essence, while these loans are margin dilutive, the impact is mitigated by the healthy fees component, reduced credit risk, attractive funding for the loans provided by the Fed and finally freed-up bank capital at a time of increased uncertainty. The limited duration and one-off scope of the program ensures banks are not undermined.

Banks are capitalizing on shift to digital distribution

With regards to whether branch closures will result in an erosion of banks' ability to maintain and control customer relationships, we would argue the pandemic has simply accelerated trends which were happening previously and could provide considerable cost-cutting benefits enabling them to compete more directly with fintech models.

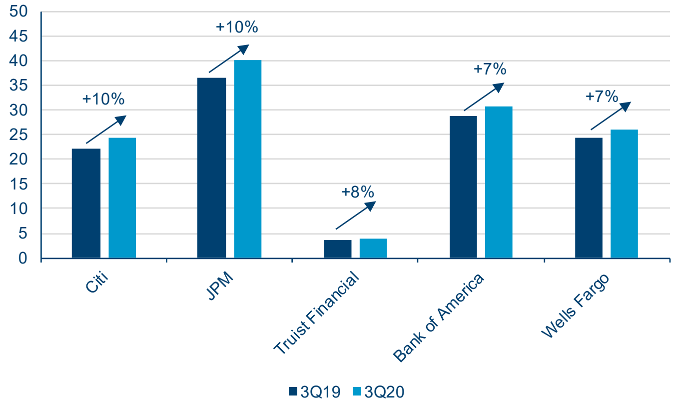
The trend of branch closures in the US, as the below chart shows, has been continuing for some time. Truist bank, formed after the merger of Suntrust and BB&T, plans to close 800 (c28%) of its 2,884 branch footprint over the next two years. Further, given the boost large banks have enjoyed to their digital active accounts due to the pandemic and substantially lower costs involved in servicing clients digitally, we expect branch closures to accelerate. US Bancorp, which had closed 300 of its 3,000 branch footprint this year, announced in October that it will be closing an additional 450 branches by early 2021, most of which were already closed due to the pandemic, resulting in an additional $150m of cost savings or 3% of their operating expenses.

Commercial and savings institutions and branches



Source: FDIC, RBC, November 2020. *Includes 18 conservatorships

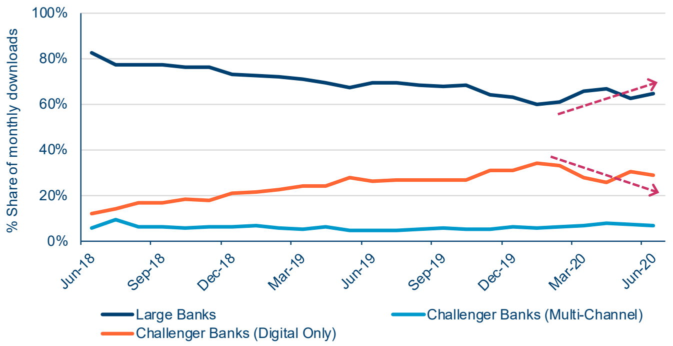
Active mobile phone users (millions)



Source: Company filing

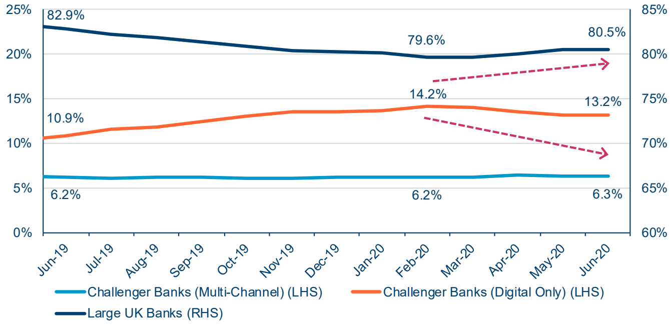
Interestingly, though data in the UK suggests that the pandemic has accelerated the shift to digital distribution, digital challenger banks have not been a beneficiary during this period. As highlighted by the graphs below, digital engagement trends have shifted during the crisis, with incumbent banks increasing their market share of app downloads and install penetration. Digital engagement, measured by the percentage of those opening the app daily, remains relatively high at incumbent banks although it has increased more at traditional, multi-channel challenger banks such as Virgin Money and TSB. This could reflect temporary risk aversion to relatively new digital banks during a crisis but highlights inherent customer caution to financial service providers, particularly those where you keep your savings. The competitive advantages of digital challengers from speed of innovation and cost efficiency will continue to present a longer-term threat to the incumbents but the crisis does not seem to have been a catalyst for their wider adoption. Consequently, customer behaviour highlights the longer-term opportunity for those incumbents that embrace an efficient digital strategy and leverage their competitive advantages in funding costs and customer trust.

Market share of downloads of UK banking apps by bank size



Source: SimilarWeb, Jefferies, November 2020

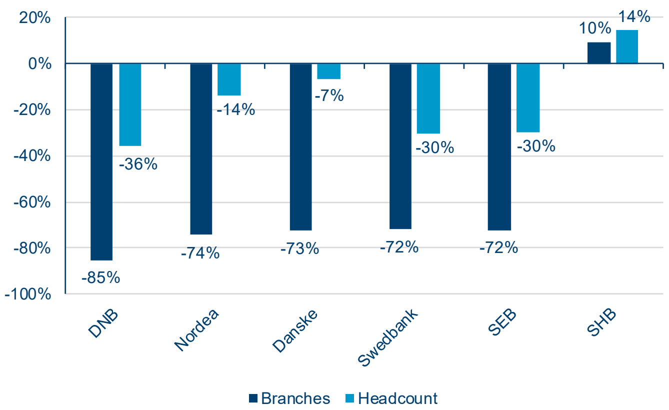
Install penetration of market share % of UK banking apps



Source: SimilarWeb, Jefferies, November 2020. Please note, market share is defined by install penetration

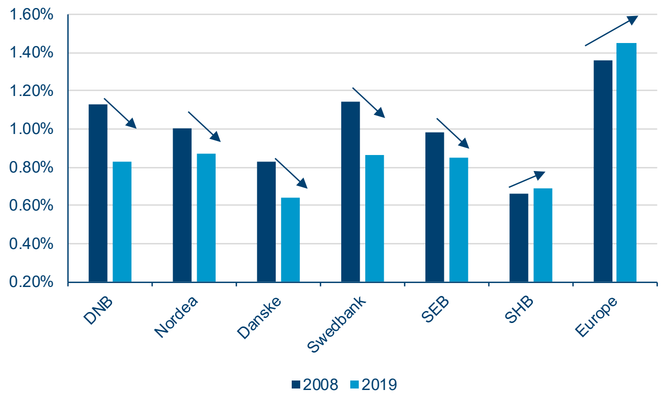
Within Europe, the largest improvements in efficiency can be found in the Nordics (see graphs below) which has been supported by significant cuts to branch networks as well as headcount (supported by a higher use of automation). DBS of Singapore notes that their digital bank customers have a cost/income ratio of 34% compared to 54% for their traditional customers) while the Commonwealth Bank of Australia's use of cloud services reduced its IT infrastructure costs from 50% of capex to 26% with the number of data centres falling to two from 23. More onerous regulatory requirements requiring data to be pulled from a core system and at a much higher frequency have added to banks' costs but also increased incentives to migrate from legacy systems (typically 30-40% of IT spend is linked to regulation that can reduce to <10% by shifting to the cloud). Within Europe, the largest improvements in efficiency can be found in the Nordics (see graphs below) which have been supported by significant cuts to branch networks as well as headcount, themselves supported by a higher use of automation. Handelsbanken has been the exception during the period, growing its branch network and headcount while seeing a deterioration in efficiency, and it is telling that it has recently announced a strategy update that will involve cutting almost half its Swedish branches by the end of 2021 while increasing investment in digital channels. With the pandemic accelerating the shift to online banking, managements are increasingly taking the opportunity to drive synergies through materially reducing branch networks (Société Générale recently announced a c30% reduction in its French retail network by closing 600 branches by 2025 as part of a €450m cost reduction programme).

Branch and headcount change: 2019 vs 2008



Source: Company reports; UBS Research

Nordics and European Costs/Assets: 2019 vs 2008

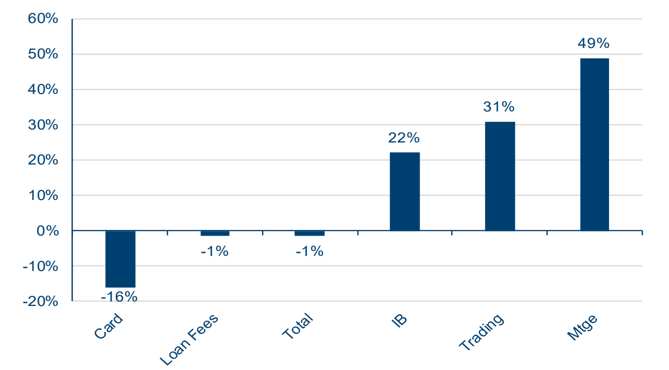


Source: Company reports; UBS Research

Strong recovery in key fee income sources (wholesale and mortgage banking)

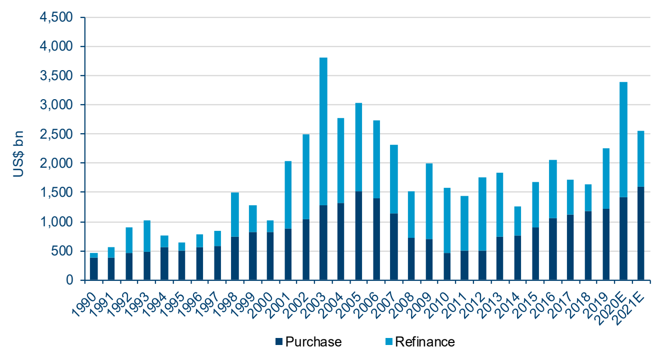
Most fintech models have focused on trying to capture some of the fee income of the banking sector rather than a direct assault on their lending and deposit-taking. However, this crisis has highlighted that those banks with large, diversified revenue streams have performed better and been able to capture growth in fee income (accepting that most of the benefits have come from either investment banking or mortgage lending in the US). As the graph below on JP Morgan shows, investment banking, trading revenues, mortgage banking and asset management fees have all benefitted from lower short-term rates. Admittedly, mortgage banking has benefitted from an increase in refinance which we expect to ebb, however it has also benefitted from the growth in purchase volume. While we have chosen JP Morgan as an example, the growth in mortgage revenues has occurred across the banking sector, with mortgage banking representing 7% of revenues in the most recent quarter, up from 3% two years ago.

JP Morgan fee 9M20 fee income (y/y)



Source: Company filing, November 2020

US refinance and purchase volumes



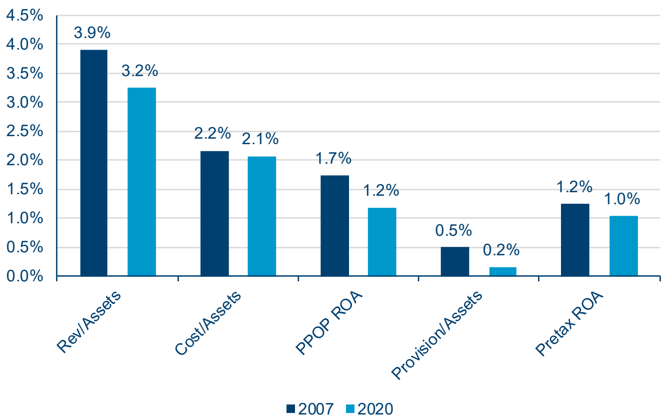
Source: Mortgage Bankers Association of America, 16 November 2020

Card fees and lending and deposit-related fees have been negatively impacted by the current pandemic. Deposit-related fees were impacted by banks offering fee waivers at the onset of the pandemic, but these have now run off. Card fees were impacted by the lockdowns and the ensuing uncertainty leading to a sharp decline in overall card spending. While overall card spending has continued to normalise as economies have reopened, this has been driven by debit cards which carry lower fees to banks while credit spend has lagged. Visa reported that from 1-21 October, its US volumes were up 9% y/y with debit growing 24% y/y and credit card volumes down 3% y/y. We expect the negative mix impact to continue to subside as vaccine developments progress, economies reopen and consumer confidence increases.

Bank profitability in line with pre-GFC

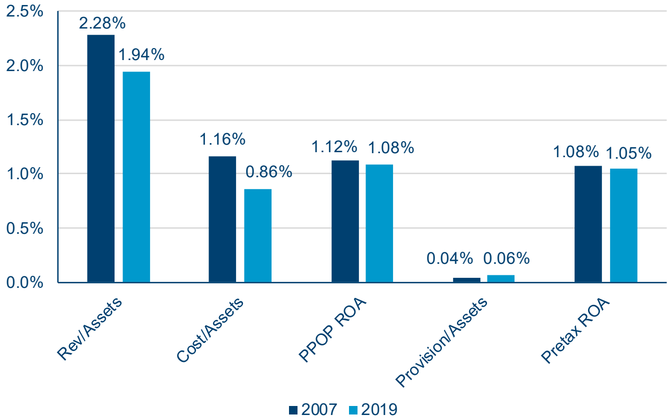
The chart below highlights the change in profitability at Bank of America from before the GFC to how it stands now. The lower margin is a function of lower interest rates and a lower risk balance sheet but should be looked at in the context of lower provisioning levels observed over the past five years (at an average of 15bps compared to 47bps in 2007 – this year's provisioning figure is impacted by the adoption of the new accounting standard: Current Expected Credit Losses). While the limited improvement in cost structure is disappointing, the opportunity to rationalise the branch structure, boosted by the pandemic, combined with interest rates already near zero, highlights the upside to future profitability. The opportunity to lower costs is highlighted by the Nordic banks with Swedbank (see graph below) maintaining profitability at the same levels as pre-GFC with margin pressure offset through efficiency improvements.

Bank of America profitability: 2020 vs pre-GFC



Source: Company filing

Swedbank profitability: 2019 vs pre-GFC



Source: Company filing

Investors are looking at a banking sector which not only has a conservative balance sheet (high levels of capital and provisioning) but equally will see further benefits to cost structures as the shift to digital distribution accelerates. It is also showing little evidence of pressure in deposit-taking, lending or fee generation from new entrants and even during an era of very low interest rates continues to make good margins. Yet both share performance and valuations continue to materially lag the overall market.

Polar Capital Global Financials Team

15 December 2020

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