Equity Research; UK banking stocks

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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What explains the drop in UK banks?

One surprise of 2022 is the weak performance of UK banks. Bank profits were expected to be helped by **i) rising global interest rates and ii) ECL (estimated credit loss) provision release**. However these tailwind factors have not worked out and **iii) geopolitics** has got in the way. Let us look at the details.

i) Investors have now grasped that near zero rates, the governing monetary policy framework since 2009 is no longer appropriate. Global interest rates must rise to dampen runaway inflation and restore central bank credibility. Central banks are perceived as 'behind the curve', late in addressing this issue.

Adding to upwards pressure on global interest rates is the US Federal Reserve's 'quantitative tightening' QT plans ($47.5bn market order pcm starting in June 2022) to sell US Treasuries / RMBS to a skittish market.

Rising rates should improve bank profits, not so?

NII sensitivity to instantaneous change in yield curves (12 months)

At 30 June 2021

Change in Jul 2021 to Jun 2022	Currency					
	USD $m	HKD $m	GBP $m	EUR $m	Other $m	Total $m
+25bps parallel	114	340	561	113	374	1,502
-25bps parallel	(122)	(393)	(616)	(83)	(391)	(1,605)
+100bps parallel	369	1,354	2,053	532	1,464	5,772
-100bps parallel	(224)	(837)	(2,257)	(330)	(1,542)	(5,190)

Source: HSBC

A 100 basis point move in the yield curve (i.e. +1%) adds $5.77bn to HSBC net interest income to end June 2022.

Impact of parallel shifts in interest rate curves (£m)	Year 1	Year 2	Year 3
25bps upward	c.275	c.375	c.525
25bps downward	c.(450)	c.(575)	c.(700)

Source; Barclays Fixed Income Call; 23 February 2022

Barclays says a 25 basis point move up (0.25%) adds £275m to net interest income over the first 12 months. The reason for the increased uplift in later years is the expiry of forward rate hedge positions.

However it is important to differentiate this profit guidance on the sensitivity of net income to "instantaneous change in yield curves" to the rate environment more broadly. This refers to fact that in making these net interest income sensitivity calculations banks have assumed *an upwards shift in the yield curve (rising rates) only.*

An upwards shift in the yield curve has occurred but alongside 'yield curve flattening' i.e. the spread between the long and short dated bonds reducing, which is negative as banks borrow 'short term' and lend 'long term'. Yield flattening (as below) reduces rate spreads and net interest income.

Treasury Yields

NAME	COUPON	PRICE	YIELD	1 MONTH	1 YEAR
GB3:GOV **3 Month**	0.00	0.03	0.03%	+3	-12
GB6:GOV **6 Month**	0.00	0.04	0.04%	+2	-12
GB12:GOV **12 Month**	0.00	0.07	0.07%	+3	-11
GT2:GOV **2 Year**	0.13	99.83	0.21%	+6	+2
GT5:GOV **5 Year**	0.75	99.45	0.87%	+5	+53
GT10:GOV **10 Year**	1.63	101.27	1.49%	-15	+78
GT30:GOV **30 Year**	2.38	106.47	2.08%	-28	+60

Source; Bloomberg 18th June 2021

Yield spread; 1YR – 5YR 0.80%
2YR – 10YR 1.28%
2 YR – 30YR 1.87%

Treasury Yields

NAME	COUPON	PRICE	YIELD	1 MONTH	1 YEAR
GB3:GOV **3 Month**	0.00	0.81	0.82%	+15	+83
GB6:GOV **6 Month**	0.00	1.29	1.32%	+21	+133
GB12:GOV **12 Month**	0.00	1.90	1.95%	+23	+193
GT2:GOV **2 Year**	2.50	99.63	2.69%	+18	+255
GT5:GOV **5 Year**	2.75	98.49	3.08%	+32	+230
GT10:GOV **10 Year**	1.88	89.09	3.18%	+48	+161
GT30:GOV **30 Year**	2.25	80.33	3.29%	+57	+101

Source: Bloomberg 9th May 2022

		Change (Δ) bps (since 21 June 21)
Yield spread; 1YR – 5YR	1.13%	+23
2YR – 10YR	0.49%	-79
2 YR – 30YR	0.60%	-127

Yield flattening over the last 11 months, has possibly run its course however will depend on the trajectory of interest rate increases.

The UK bank sector has started hiking lending rates on unsecured lending (PL's, cards, overdrafts) and mortgages, but are dragging their feet on deposit rate hikes. This should help the UK sector generate higher margins from their core retail businesses.

ii) ECL ('estimated credit losses')

Over 2021 UK banks released provisions made in 2020 for credit impairment. That means that credit loss provisions (charges made in 2021 for c-19) that were not used, were released i.e. reported as income. However expectations for ECL reversals have been scaled back in 2022.

Bank	2020 ECL impairment charge	2021 ECL release	2022 Q1 ECL impairment charge
Barclays	£4.8bn	£700m	£141m
HSBC	US$8.8bn	$900m	US$600m
Lloyds Banking	£4.2bn	£1.2bn	£177m
NatWest	£3.1bn	£1.27bn	-£38m
Standard Chartered	US$2.3bn	-$300M	US$197M
Total	£21.1bn	£3.6bn	£0.93bn

During the C-19 pandemic the banking sector added provisions via ECL impairment charges. However, the UK government's furlough program and the brief lockdown duration kept actual credit losses very low. Hence going into 2021, UK banks were overprovisioned and substantial ECL releases took place. In Q3 2021 former Barclays CEO Jes Staley said Barclays had c. £7bn in provisions. By 2022 investors had assumed the still substantial impairment provision 'cushion' would mean further ECL releases in 2022.

However due to higher inflation/ higher interest rates/ geopolitical problems, a far more cautious approach has prevailed. The UK banks added to ECL provisions over Q1 2022 except NatWest which reported a small ECL release, *contrary to expectations at the start of 2022*.

iii) Geopolitics in 2022

Cannot be understated. Post extensive sanctions on Russia, that rendered Russian assets in the hands of overseas investors worthless, there is a reappraisal of emerging markets investments in particular in 'Big Brother' authoritarian / totalitarian regimes (i.e. Turkey, Saudi Arabia, Kazakhstan, Egypt, Israel, China, Singapore) where property/ investor rights can be trampled on, where protest is stifled etc. In this post war divide, many of these countries have sided with Russia. China publicly said it will stand by Russia calling Vladimir Putin 'its best friend'.

Quite a few companies are in the geopolitical headlights due to substantial global footprints. Amongst UK financials are HSBC and Standard Chartered – companies riding both horses of Western liquidity / regulatory oversight / capital markets as well as China growth. If geopolitical problems intensify this strategy will become unsustainable. Short term investors are repricing China related earnings.

It is said the HSBC board are worried about the risk to their HK banking licence being suddenly revoked or altered. Threats were made last year when HSBC dragged its feet on freezing HK demonstrators' bank accounts. HSBC caved in and followed Beijing's instructions, responding that had to follow "local banking regulations". However, the incident demonstrated HSBC's vulnerability, its subservience, the fact it facilitated Beijing intimidation of demonstrators, depositors' money was subject to government interference.

Prudential plc which pivoted to Asia, over the last three years has lost 50% since the strategy to exit UK and US completed last November. This is largely due to the lack of investor confidence in Prudential's China focus. Investing in Prudential is now tantamount to a partnership with Beijing. This is a radically new trajectory that UK investors have mixed feelings about, and rightly so.

A wider question is whether globalization linked strategies where companies' productive capacity is based in the east and sold in the west can still be relied on (though I will save that for a future day).

Geopolitics should not hurt Barclays, Lloyds or NatWest given their footprint.

Conclusion;

UK banks have been counterintuitive – rate hikes have not helped, ECL releases have run their course and geopolitics has got in the way. Investors are also concerned about the fixed cost base and wage inflation factors. However the sell-off still appears overdone. We would urge holders not to panic and suspect the banking sector will stabilise soon.

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