In November, we traveled to Europe to meet with the majority of Nordic and Dutch banks under our coverage to discuss recent results, regulatory reform and local market conditions. We met with representatives from Nordea, Swedbank, Skandinaviska Enskilda Banken (SEB), Svenska Handelsbanken (SHB), DnB Bank, ING, ABN AMRO and Rabobank. Observations on the trip left us with the sense that the Nordics maintained a safe haven status, enjoying low funding costs thanks to consistent profits, strong asset quality and very high regulatory capital ratios while the Dutch banks have managed through a difficult, but stabilizing, economic environment with restructuring efforts, where necessary, now largely complete. The trip proved to be very informative and confirmed our conviction that investing in the Nordic and Dutch banking sector should remain consistent with potentially minimal credit risk.

For 3Q14, performance was generally solid for the institutions in both regions. The Nordic banks benefited from strong credit demand and asset quality along with a continued focus on costs. Interest income in Sweden was pressured following the 50bps repo rate cut in July by the Riksbank, although this was largely offset by lower funding costs and some re-pricing. With inflation remaining well below the 2% target, the Riksbank cut the repo rate again at the end of October to 0.0% while the deposit rate moved further into negative territory, thus placing additional pressure on interest income. The highly expansionary monetary policy does not ease concerns over household indebtedness in Sweden, which had already been a highly debated topic between banks and regulators. In an effort to manage this risk, an 85% loan-to-value (LTV) cap has been instituted on new mortgages along with a required 2% per year pay-down until a 70% LTV is attained. At the same time, the risk-weight on mortgages has been raised to 25%, forcing the domestic banks to hold more capital against these assets. Regulatory capital ratios at the Nordic banks are very strong, with an average fully loaded core equity Tier-1 (CET1) ratio of 17.5% as of September 30, 2014.

The Dutch banks also reported strong numbers in the third quarter. With the domestic economy and housing market stabilizing, the banks enjoyed the lowest level of impairments in recent memory. Nevertheless, risk costs are expected to remain elevated, as not all segments of the real estate market are improving at the same pace. Given the positive performance, ING completed the final payment of state aid in November, six months ahead of schedule, and the Dutch government now appears ready to IPO ABN AMRO in 2015. The IPO has been pushed off several times as the government waited for a more favorable market environment, and also to give the bank time to complete its restructuring and strengthen the balance sheet.

The Nordic and Dutch banks were eager to discuss the Asset Quality Review (AQR) and stress test, as they all easily passed the examination, reporting an average CET1 ratio under the adverse scenario of 13.6% compared to the 5.5% hurdle. The largest adjustment from the AQR was 80bps at Rabobank, related to commercial real estate exposure. Rabobank has taken part of the adjustment in1H14, which will limit the effect on 2H14 results.

On the topic of bail-in, only Nordea and ING fall into the Total Loss Absorbing Capacity (TLAC) discussion amongst the banks we visited, as the other banks are not considered a Global Systemically Important Bank (GSIB). However, it’s very likely all EU banks will need to comply with Minimum Requirement for own funds and Eligible Liabilities (MREL), which is very similar to TLAC. The main difference being TLAC is calculated on risk-weighted assets while MREL uses total liabilities and own funds. Although not part of the EU, DnB advised us that Norway will adopt some form of a TLAC/MREL requirement. The banks were reluctant to give guidance on their plans for bail-in, as requirements around eligible forms of capital and amounts have not yet been finalized. Additionally, there is debate over where
capital should reside within the corporate structure, either at a holding company or an operating company. This could be a major hurdle for European banks, which do not normally have a holding company structure. MREL could be effective toward the end of 2016 while TLAC is likely to begin in 2019, so the banks do have some time to adjust their capital stack accordingly.

A common theme among the banks was a push to enhance their digital footprint. They see this as a way to continue to reduce costs. ABN AMRO went so far as to say they would close roughly 100 branches over the next four years due to the expansion of online banking. The banks also shared muted concern over the Russia/Ukraine conflict. The impact has thus far been minimal regardless of direct or indirect exposure to the region. The Russian operation at Nordea remained very profitable, although they are not looking to expand their footprint. ING will reduce its Russian exposure by roughly 25% over the next few quarters. Rabobank will take a manageable provision related to Russia in 2H14.

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