



European Banking Sector : A Swift* Story

In the context of the Russia-Ukraine conflict, the European Union has announced the exclusion of several Russian banks from the Swift network, thus cutting off their access to international financial transactions. On the stock market, the entire banking sector is suffering a sharp decline due to fears of losses linked to these events. Is this movement exaggerated compared to the fundamentals? Analysis.

After a rebound of more than 40% in 2021, almost double the average performance of the European equity market over the same period, European banks are once again caught up in the turmoil of another major European crisis, that of Ukraine. This crisis, which originally seemed to be a political crisis, has turned into a major armed conflict in Europe. So much so that after a remarkably good start to 2022, the European banking sector once again lost nearly a quarter of its stock market value between February 10 and March 1.



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A major shock for Russian finance

International sanctions against Russia, including the banning of certain institutions from the Swift interbank system, will have major implications for Russian finance. Swift is an international payment system to which 11,000 financial institutions in 200 countries are connected. The exclusion from this system isolates the institutions concerned by preventing them from receiving or sending international transfers.

* Jonathan Swift (1667-1745), writer and essayist, is famous for his philosophical and satirical tales. He is notably the author of *Gulliver's Travels* (1726). The Swift interbank network is the acronym for "Society for Worldwide Interbank Financial Telecommunication".

Seven Russian banks were excluded from the Swift system on Tuesday evening: VTB Bank PJSC, Bank Rossiya, Bank Otkritie, Novikombank, Promsvyazbank PJSC, Sovcombank PJSC and VEB.RF. The Europeans decided to spare the country's largest bank, Sberbank, with 110 million customers and many branches in Europe, as well as Gazprombank, the third largest bank and subsidiary of Gazprom. However, the country's second largest bank, VTB, is indeed affected: Sberbank and VTB, both state-owned, together account for almost half of the Russian banking sector.

Since most of Russia's exports are denominated in foreign currencies, this decision will have serious implications for the entire Russian economy beyond the banking sector. The same is true for European companies that export goods to Russia. They will have real difficulties in receiving payment for their goods.

The response of the Russian Central Bank is a further shock to the Russian economy. It has raised its official interest rate from 9.5% to 20% and has put in place a capital control mechanism in the hope of limiting, as much as possible, the depreciation of its currency. The confidence shock is considerable for the Russian financial system: a significant flight of deposits is likely, as was the case in 2014.

International banks' exposure estimated at 100 billion euros

Is this a systemic event? To date, the transparency of each European bank's exposure to the Russian economy remains relatively limited and it is still too early to be able to make a precise estimate of the financial consequences for each institution. Nevertheless, according to data from the Bank for International Settlements (BIS), the exposure of international banks to Russia is around 100 billion euros. This exposure is mainly concentrated in France, Italy, the United States, the Netherlands, Japan and Germany.

Given the sums involved, the capital adequacy and the liquidity reserves of European banks, it seems to us today that these institutions are in a position to overcome the difficulties that will arise from the economic sanctions imposed on Russia. On the one hand, the figure of 100 billion euros of exposure probably overestimates the maximum risk envelope, and on the other hand, it should be noted that during the great financial crisis of 2008, the international financial system had to deal with almost a trillion dollars of realized losses. To date, European banking stocks have lost 100 billion euros in market capitalization since mid-February as a result of the Ukrainian crisis, a sum that may seem exaggerated since it corresponds to the entire exposure of international banks to the Russian economy, and not only to European banks.

A decline also linked to the fall in rates

However, the exposure of European banks to Russia is not the only factor to be taken into account to explain the stock market decline of the sector. Two other elements are contributing to the scale of this movement.

The first is a possible risk of recession caused by the economic sanctions against Russia. However, this risk seems low: we should keep in mind that growth is currently strong in most economies, particularly in Europe and the United States. If a recession seems inevitable in Russia, this is not the case in other countries of the world.

The second factor that has weighed on the banking sector is undoubtedly the fall in interest rates observed in fixed income markets since the outbreak of the conflict (February 24). Anticipating that central banks may slow their monetary tightening despite inflation, but also because some securities are considered "safe havens", investors have favored low-risk bond investments in recent days. As a result, sovereign rates have fallen sharply: for example, the German 10-year Bund interest rate has

returned to negative territory after having recovered since the beginning of February. However, European banking sector shares are strongly correlated with interest rates: economic theory dictates that the higher interest rates are, the higher the profit outlook for banks. The outperformance of the banking sector from January 1 to February 10 compared with the rest of the stock market, and in particular with the major growth stocks, was thus linked to the rebound in interest rates. It is not illogical that the decline in interest rates has had a negative impact on these stocks this time.

This raises a fundamental question about the outlook for the banking sector: does the Russia-Ukraine conflict call into question the prospects for higher rates that prevailed only a few weeks ago? In many ways, the answer seems to be 'no'.

It is important to keep in mind that the crisis in Ukraine is expected to add to the already strong inflationary pressures worldwide. Higher energy prices are already evident, given the recent rise in oil prices (globally) and gas prices (in Europe). More generally, the sudden halt in certain trade flows with Russia could once again cause temporary shortages, which we know played a role in the rise in prices following the lockdowns linked to the health crisis.

Faced with a new rise in inflation, central banks would have to react by raising their official interest rates, as they had been considering before the events in Ukraine. If this conflict does not drag on, central banks may even have to act more quickly than expected.

Thus, the prospect of a resumption of rate hikes on the fixed income market remains a likely scenario in the course of the year. This movement would therefore certainly reactivate the "sector rotation" that prevailed at the beginning of the year in favor of cyclical, quality stocks that are often undervalued and positively correlated to rising rates.

In short, the downturn in the European banking sector has already made it possible to incorporate the "worst case scenario" in which international banks would lose a large part of their commitments in Russia. At the same time, the sector has been driven down by the fall in interest rates, which have returned to abnormally low levels in the face of inflation figures. These could rise again over the course of the year under the impetus of the central banks. A return to better fortunes in the banking sector over the next few months therefore seems to us to be the hypothesis to be favored.

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