2 December 2014

European Banks through New Eyes: An Outlook for 2015 and Beyond

This year Scope has assigned its first bank ratings, based entirely on its post-crisis resolution-based methodology (rather than rating banks based on increasingly unlikely state support). We currently rate and assess publicly 24 banking groups in 11 European countries, amounting to nearly two-thirds of the continent's aggregated bank assets. Our rating range includes long-term and short-term debt as well as capital securities (AT1 and Tier 2) – see table on page 3*. With this context in mind we are summarizing our view on the emerging regulatory and supervisory dynamics for European banks, as well as the credit outlook for 2015 and beyond.*

Contents:

A. Key themes and Scope's bank ratings
B. The new regulatory architecture now mostly in place
C. Growing strength of bank supervision adds reassurance to investors
D. Resolution and bailin: a transformational change for banks but also for investors
E. Regulatory steps still pending
F. Credit outlook for 2015 and beyond
G. Increasing convergence between credit and equity investors' targets
Appendix: The 43 banks in Scope's European peer group

A. Key themes and Scope's bank ratings

"The real voyage of discovery consists not in seeking new landscapes but in having new eyes" (Marcel Proust)

- The fundamentals of the European banking landscape are getting into better shape, strengthened over several years mainly through regulatory and policy action. We thus believe that market participants should increasingly settle to viewing banks from an angle different from the pre-crisis decade. The "new normal" is no longer aiming to converge towards the realities before 2008 and thus taking that view is probably a bridge to nowhere. Specifically:
- By far the main catalyst for the strengthening of the European banking industry through the crisis years and beyond has been the much enhanced regulatory architecture which is now in place. Many market participants have commented apprehensively on the barriers raised by the new regulations. However, we consider these as the real game changer which ultimately have made the difference between successful rebooting, on the one hand, and nationalization or at best open-ended taxpayer support, on the other hand. New tougher regulatory rules are the main reason why banks now display stronger and better-quality capital, liquidity and funding, why business models and strategies have been steered towards lower risk tolerance, and why governance and remuneration policies have been partially altered – even if much more still remains to be done.

Contacts

Sam Theodore
s.theodore@scoperatings.com

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Thue Sondergaard
t.sondergaard@scoperatings.com

Scope Ratings AG

The Gridiron Building, 8th floor
One Pancras Square
London N1C 4AG
T: +44 203 714 4980

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300

info@scoperatings.com
www.scoperatings.com

- More hands-on supervision is also a key reason why this process is bound to continue in the future, as we highlight in the report. We positively flag the strong supervision now in place – contents, people and process – noting that this essential aspect of the regulatory architecture is not always sufficiently appreciated by investors, analysts and rating agencies.
- While prudential metrics have been getting stronger and more reliable and the recently completed Comprehensive Assessment has brought some reassurance to market observers with respect to asset values (although some concerns understandably remain), we see other categories of risk emerging which will likely take increasing shelf space in investors' focus on bank risk. Chief among these may be conduct risk – both regarding wholesale and trading activities, such as market abuse and improper or illegal practices, and regarding retail activities related to customer protection or product suitability. As supervisors and the regulatory and legal framework turn more intrusive and less forgiving, misconduct events lead to fines, some very hefty, which can take a heavy financial toll. For the foreseeable future we expect heightened scrutiny and enforcement steps to remain in place.
- Aside from financial penalties, misconduct issues impact negatively the affected banks' reputation – with regulators, policymakers, market participants and also the general public. One lasting consequence of the crisis years has been the more prominent (and in general negative) public image of the banking industry, especially of the larger banks with a history of conduct problems – both wholesale and retail. Investors will need to be aware that a negative shift in a bank's public image could engender a rapid loss of market confidence with consequences for funding and equity values.
- In the new regulatory and macro landscape bank returns are likely to remain low also because profits are applied against a much higher capital base. Returns on equity (ROE) in the high single digits or low double digits may be considered as satisfactory.
- Despite current equity and credit investor perception shaped by banks' de-risking and sluggish earnings we caution that banks should not be viewed as "utilities". When economic conditions across Europe will improve and also when medium-term interest rates would commence rising again bank returns should improve, stemming from both higher volumes and higher margins.
- Even as they are faced with banks which on average are far safer and better supervised than before the crisis, going forward investors will be more directly exposed to bank risk due to the new resolution and recovery regime which is emerging and which expects them, rather than taxpayers, to shoulder the losses of a failing bank. This new reality, which has been acknowledged for some time, should create increased awareness about where bank risks are and how they evolve. We believe that, in light of this aspect, credit investors will need to be as proactive and forward-looking as equity investors, as their downside risk is more real than in the old "too-big-to-fail" environment.
- Despite the political and regulatory discourse about banks not being sufficiently committed to lending to the real economy across the EU, we actually see the more modest credit demand – from both businesses and individuals – as being the main cause of relatively reduced new lending. A return of confidence and clear signs of economic growth would boost credit demand, and of course banks have to properly signal to the market that, reinforced with stronger prudential metrics and risk characteristics, they are fully "open for business". Having said we believe that on average credit extension will remain structurally more expensive than before the crisis, due to higher capital charges, to othe regulatory rules and also to the banks' changed approach to risk taking.
- Our view is that, while the economic stress in Europe continues and future growth remains fraught with uncertainties, this time around the banks are no longer at the epicenter of the economic crisis the way they were a few years ago.

Scope's bank ratings reflect the post-crisis characteristics

- Our ratings aim to capture the main elements underpinning the credit characteristics of banks going forward in a holistic way. Reshaped regulatory framework, risk-based pro-active supervision, rebalanced funding, changing risk cultures, stronger prudential and risk metrics are all such elements. Our ratings take account of the forthcoming resolution and recovery regime in Europe (in fact already in effect in Switzerland), including the bailin options. They are not notched up based on expected state support for non public-sector banks, as we are of the view that taxpayer bailouts are no longer a viable option to rescue them.
- A majority of Europe's large banks is rated by Scope in the A range. We believe that as some large banks with weaker asset-quality metrics manage to gradually unburden their balance sheet from impaired-credit legacies their credit characteristics should improve further, which will be reflected in our ratings.
- With an increasingly converging regulatory and operational framework across Europe, we believe that a bank's business model and the way it implements it in a risk-averse manner should become the main differentiating factor for investors, analysts and rating agencies. Our bank ratings are the following:

Bank	ICSR	Outlook	Short-term Rating	Short-term Rating Outlook	AT1	T2
Banco Santander SA	A	Stable	S-1	Stable	BB+	
Barclays Bank PLC	A	Stable	S-1	Stable	BB	BBB+
BBVA SA	A	Stable	S-1	Stable	BB+	
BNP Paribas SA	A+	Negative	S-1	Stable		
BPCE SA	A+	Stable	S-1	Stable		
Commerzbank AG	BBB+	Positive	S-2	Positive		
Credit Agricole Group	A	Positive	S-1	Stable	BB+	BBB+
Credit Mutuel SA	A	Stable	S-1	Stable		
Credit Suisse AG	A+	Negative	S-1	Stable		A
Credit Suisse Group AG	A+	Negative	S-1	Stable	BBB, BBB-	BBB+
Danske Bank A/S	A-	Stable	S-1	Stable		
Deutsche Bank AG	A-	Positive	S-1	Stable	BB	
DNB Bank ASA	A+	Stable	S-1	Stable		
HSBC Holdings PLC	AA-	Stable	S-1+	Stable	BBB	
ING Bank NV	A	Stable	S-1	Stable		
Intesa Sanpaolo SPA	BBB+	Positive	S-2	Stable		
KBC Group NV	A-	Stable	S-1	Stable	BB+	BBB
Lloyds Bank PLC	A	Stable	S-1	Stable	BB+	
Nordea AB	A+	Stable	S-1	Stable		
Rabobank Group	A+	Stable	S-1	Stable		
Royal Bank of Scotland PLC[1]	BBB+	Stable	S-2	Stable		
Societe Generale SA	A	Stable	S-1	Stable	BBB-	
Swedbank AB	A-	Stable	S-1	Stable		
UBS Group AG	A	Stable	S-1	Stable		A-
Unicredit SPA	BBB	Positive	S-2	Stable		

[1] Rating benefit from a one-notch rating uplift due to the UK government's majority ownership

B. The new regulatory architecture now mostly in place

- The new regulatory framework should dominate the banking industry for the forseeable future and a return to the pre-crisis years, even partially so, is hardly possible. While during the crisis many investors and analysts expected the regulatory tightening to be temporary before going back to a "normalized" situation, it is now very clear for all that this is not and will not be the case. In the meantime, market participants have been gradually adjusting their expectations for the banking industry's returns and risk levels – although much more needs to be done. The starting point of assessing banks is now the regulatory situation and this consideration is unlikely to change for the forseeable future. The banking landscape taking shape now is in fact likely to be the "new normal" rather than mostly a post-crisis regulatory excess of a cyclical nature.

- Whereas in the pre-crisis years bank regulators were trying hard to keep up with the fast evolution of bank products and activities – especially in wholesale and investment banking where regulatory arbitrage was widespread – it is the banks which now appear to try hard to keep up with regulatory developments and to make sure they remain at all times safely tucked within the regulatory tent. To that effect banks are staffing up significantly in compliance and regulatory affairs to make sure they have both the expertise and the critical mass to handle their regulatory duties properly. This is a trend which we anticipate will not abate and which, while hopefully delivering better regulatory compliance, may limit in the future banks' capacity to reduce costs more effectively (alongside high spending in technology and cybersecurity). All banks across Europe by now are fully aware that avoiding regulatory action – which can result in restrictions or worse – should be the one priority to consider in carrying out their activities and setting up their strategies

- We view the regulatory and policy focus in the European Union as being streamed primarily into four main directions:

  i. CRD4/CRR steps to strengthen capital, leverage, liquidity and funding (both levels and composition) – process well under way
  ii. The start last month of the Banking Union via the Single Supervisory Mechanism (SSM) which is now in place, as well as the forthcoming start of the Single Resolution Mechanism
  iii. The emergence of a resolution and recovery framework to be effective in one month's time (with the bail-in regime following one year later)
  iv. The ECB's steps to stimulate economic growth via the banking system, notably TLTRO and the direct purchase program for asset-backed securities and covered bonds.

  While early days, we could also add the EC's recently proposed EUR 315 billion investment plan, which would rely primarily on private-sector investments.

- **Metrics vs. process**: Our assessment of banks' regulatory framework considers both its metrics and the process of it. When referring to regulations as a key driver in their assessment of banks, we observe that investors, analysts, rating agencies and other market observers alike refer in a large majority of cases to prudential metrics – on capital, leverage, liquidity, funding, as well as recently on loss-absorption capacity informing on resolvability. In essence, banks across a peer universe are being compared in terms of these metrics to assess which of them are more vulnerable to reaching danger zones of distress. But we believe that at the same time the other essential component of the regulatory architecture, the supervisory contents and process, needs to be thoroughly understood and assessed by investors and analysts, as it in fact represents the main safety fence for banks as going concern. Said otherwise, banks insufficiently supervised – which was often the case in the pre-crisis years – are more likely to reach danger zones of distress without being properly prevented from getting there, and thus offering sudden negative surprises to their creditors and investors (and of course to the supervisors themselves).

C. Growing strength of bank supervision adds reassurance to investors

- **Importance of supervision for credit ratings:** Scope's bank rating methodology notes that the ratings point to the relative default risk of debt-issuing banks (and if relevant the consideration of loss-severity mostly in regards to non-investment-grade ratings). In the case of the small number of banks defaulting in recent periods, they were unable to or prevented from meeting their debt repayment terms and other contractual financial commitments as a result of supervisory action imposed on them. This would range from the bank being prevented from making payments on specific categories of liabilities – such as hybrid securities, as was the case in several instances during the crisis -- to the bank being actually placed into insolvency proceedings or another form of closure.
- It is thus relevant to emphasize that for banks, unlike in other credit sectors, it is mostly regulatory action which leads to default-like scenarios. Bank credit ratings must therefore assess this probability.
- In this respect we believe that an essential ingredient in investors' evaluation of bank risk should be a proper understanding of how supervisors operate and what they aim to achieve. From this angle, we find a truly transformational shift in bank supervision – both cultural and procedural – from the pre-crisis attitudes to the current framework. Supervision has moved from being mostly procedural (often characterized by the "box-ticking" approach) to being increasingly substantive and intrusive as well. Bank supervisors are now expected to exercise ad-hoc judgment and to react early on on their observations rather than limit themselves to merely following the chronology of pre-planned procedures (see below).
- As in the aftermath of the crisis banks are far more sensitized to react to supervisors' feedback and demands, the latter's role is also becoming more catalytic (agents of change). When properly and consistently pursued, this aspect should be reassuring for investors, as bank supervisors' main brief is to keep the banks safely away from regulatory borderline situations.
- Importantly, we find that the new supervisory process starts well upstream – with the assessment of business models, governance and risk culture, risk management and controls, before focusing on capital and liquidity risk and protection against it. This is markedly different from the pre-crisis supervision, which was often confined downstream, to merely monitoring the adequacy of capital (and rarely of liquidity). Another significant difference from the past is the increasing use of stress tests as a supervisory tool – both challenging the institutions' own stress tests and running their own – supplementing the similar process for capital and liquidity adequacy monitoring – Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP).
- We note that most often investors' and analysts' focus on supervisors' work is trying to anticipate when a bank could reach the point of non-viability (PONV) for the treatment of capital securities, or when it would be placed into resolution. Yet we find that the supervisory activity occurring well ahead of reaching these extreme instances is essential to understand the credit dynamics of a regulated institution – how thoroughly is a bank monitored and steered to prevent it from getting into trouble – and we refer to it below.
- Supervisory Review and Evaluation Process (SREP): According to EU regulations, SREP includes the guidelines for bank supervisors' procedures and methodologies. Last summer the EBA published a consultation paper going into the details of SREP, which will start being applied as of 1 January 2016.
- The SREP framework is built around four core areas of supervision:
  - i. Business model analysis (by geographies, legal entities, business lines and product lines)
  - ii. Governance (including remuneration and risk culture) and controls
  - iii. Risks to, and adequacy of, capital
  - iv. Risks to, and adequacy of, liquidity.

- Overall the SREP assessment is meant to represent supervisors' up-to-date comprehensive, holistic view on an institution's risks and viability as reflected by findings over the supervision cycle (from 12 to 36 months, based on the proportionality principle). During this cycle the formal monitoring of financial and risk indicators is quarterly, although supervisors' work is continuous and multi-faceted. For it they rely on resolution and recovery plans, regulatory reporting (COREP and FINREP), internal reporting and strategic plans, as well as third-party reports (e.g., from equity analysts, rating agencies or consultants) – in addition to ongoing contacts with management and specialists from the institution.

  Each areas of the SREP supervisory work are scored 1-4, with 1 defining "no discernible risk" and 4 defining "high risk"; alternatively F (for firms "failing or about to fail"). Based on the results of this assessment the institution may be asked to provide more capital, more liquidity, to alter its business model or elements of its governance, to effect changes in senior management etc. It should be reassuring for market participants to know that any such supervisory action (which would include Pillar 2 add-ons) is not tied solely to the SREP score, but can also result from ad-hoc decisions in-between SREP cycles.

- **Early intervention:** Regulators have also published criteria for early supervisory intervention – which is a step ahead of actually placing an institution into resolution. Triggers for early intervention can be (i) a SREP overall score of 4 ("high risk to viability") -- or 3, with a 4 for at least one of the main areas of supervision, (ii) material anomalies identified by SREP even in the absence of a formal re-scoring, or (iii) the occurrence of "significant events" (a material rating downgrade which might trigger market-access problems for the institution can represent such an event).

  Early intervention measures can include more severe steps, such as senior management removal, temporary administration, forcing the conversion or write-down of capital instruments (suggesting PONV), assessing recovery options, reassessing asset and liability values, etc. Supervisors' decisions are informed by key financial and risk indicators, prudential metrics (e.g., on capital or liquidity), levels of minimum requirements for own funds and eligible liabilities (MREL), or market-based indicators (including credit ratings when deemed appropriate).

- **Placing into resolution:** Should the institution's viability not be shored up from the early intervention steps, by agreement between supervisory authorities and resolution authorities it will be placed into resolution and then follow the regulatory procedures. This step occurs when (i) the institution is deemed to be failing or about to fail, (ii) there is no reasonable prospect for alternatives provided by either the private sector or additional supervisory action, and (iii) a resolution would be necessary in the public interest (e.g., if the insolvency of the institution would disrupt financial stability, trigger other failures, etc.). Criteria for failure or imminent failure include insufficiency of regulatory capital or liquidity as well as other conditions which need to be met for the institution's continued authorization within the regulatory framework.

  At this time, besides the EU Bank Resolution and Recovery Directive (BRRD), relatively explicit and insightful details on the resolution process have already been published by both FINMA (in Switzerland the bank resolution and recovery regime is already in effect) and the Bank of England.

- **Our takeaways on the impact of supervision:** In Scope's opinion the details highlighted above should account for a material degree of reassurance for market participants that the new supervisory infrastructure, process and culture which have been emerging from the crisis are meant to prevent banks from sliding into the borderline zone of prudential floors – for capital, leverage, liquidity, funding or MREL – with their supervisors merely tiptoeing around. Again, we find that this consideration is often less present in the credit assessment of banks by some investors, analysts or rating agencies. While before the crisis a good dose of market skepticism regarding the efficiency of supervision was justified, the situation is materially different at this stage in our view.

- **Transparency of supervision may have to improve further:** We believe that to a certain extent the relative lack of transparency of the supervisory process – for example as opposed to the clarity and the details of prudential requirements for capital or liquidity – may have determined some market participants not to weigh it properly in their assessment. That said the supervisory architecture in Europe is more openly communicated publicly, with the EBA, the ECB and national competent authorities publishing detailed supervision guides and handbooks. We note that in recent years supervisory authorities' communications effort with market participants has improved considerably – to an extent driven by the former's consideration that the latter need more analytical clarity to participate in the banks' funding and recapitalization.

  We believe that supervisors' public communication effort may improve further in the future, especially since under a resolution and bailin regime investors can no longer count on government bailouts of banks and thus will need a heightened degree of visibility with respect to their investments.

  On the other hand it goes without saying that the individual dialog of supervisors with banks needs to remain confidential, to assure the effectiveness of the entire process (including Pillar 2 requirements). The same would go for the work that supervisors do in the background related to specific institutions or areas of concern, especially since they operate with non-public documents and data.

The SSM is a major step forward

- Scope views the Single Supervisory Mechanism (SSM) as a massive step forward for banks in the euro area (EA) which should provide clarity, coherence and more reassurance with respect to EA banks. We would specifically point to the following factors:
  - A pan-European supervisor should be able to rise above any or most national sovereign considerations, priorities or pressures, thus in time leading to loosening the link between large banks and their home sovereigns which has had a mutually harmful effect during the crisis. Even before this happens the mere market perception of looser links should be positive. Conversely, the perception that the SSM can be more easily influenced by some stronger sovereigns would be a negative for market confidence.
  - During the recent turmoil we have witnessed a certain degree of supervisory forbearance by some national authorities, which were looking to shelter domestic institutions from the full impact of the crisis, not anticipating how long it would last and how corrosive it would end up being. Eventually, when the full blast of the crisis hit, the impact was more severe for those banks than it would have perhaps been had the realities of the recession been recognized earlier on. Banks in southern European countries have been particularly affected. We believe that with the SSM in place such developments will be less likely to take place.
  - Related to that, the recently completed Comprehensive Assessment of the ECB revealed some inconsistencies in the level of non-performing loans (NPLs), a good part of it stemming from the identification of forborne loans. During the crisis we have observed loan forbearance practices in some markets (for example in "peripheral" countries) which were aiming to postpone NPL recognition in the hope that the borrowers would eventually be able to redress themselves financially and pay back the credits. Again, under the SSM we expect such practices to be more thoroughly identified and possibly stymied.
  - Also during the crisis some cross-border groups experienced forms of national ring-fencing (with respect to intra-group flows of capital and funding) which seems to have created a degree of market discomfort regarding some banking groups headquartered in financially weaker sovereigns with subsidiaries (sometimes even branches) in financially stronger sovereigns. The SSM would inherently be discouraging this practice within the EA and would be able to exercise more authority to prevent it from occurring outside of the EA.
  - In time, the SSM should be in the unique position – among bank regulators worldwide – to have full and unhindered supervisory insight into a very large population of significant banking groups indifferent of the respective country, and also ideally to be able to take supervisory actions without substantial national or

political hindrances. We see this possibility as a very powerful argument in favor of the SSM's eventual success across the EA banking landscape (and partially beyond it due to the massive presence of non-EA banks in the EA) in assuring a real level playing field which up until now has remained rather elusive – especially during the crisis.

- By applying a consistent set of norms and processes across the EA, and by developing in time a common supervisory culture – for both ECB supervisors and for national competent authorities (NCAs) – the SSM would provide enhanced reassurance to both banks and investors that there will be fewer areas of inconsistency and thus potential risk arbitrage – asset risk weights (RWAs) being one of them for the time being. The relatively successful outcome of the Comprehensive Assessment in our view has offered the SSM a good starting platform for its future activities, being also a good harbinger for improved transparency of credit disclosures.
- Importantly, we expect that EA banks will be increasingly compared and contrasted based on their own fundamentals – starting with their business model – and less based on the country of their headquarters' domicile. This should start being a reality especially from 2016 onward, when the SSM will apply common guidelines and procedures (see the discussion on SREP above). Following this, we believe that market participants will gradually shift their views in the same direction. This may have a certain impact on debt and equity pricing in primary and secondary markets – by changing parameters for relative values – as well as helping a certain de-correlation of bank debt and sovereign debt prices.
- Last but not least a successful supervisory integration of the EA banking landscape – with positive connotations for banks outside the EA as well – may lead to more pan-European consolidation. In fact this aspect seems to be encouraged within the ECB, based on a recent speech by a senior ECB official, as an avenue to boost lending to the real economy across the EU. We believe that once banks will have more regulatory clarity – with respect to future capital needs, including buffers, for example – more consolidation may occur, not only in-market but also cross-border.
- Based on all these considerations, we would expect the SSM to become relatively fast one of the most powerful and independent supervisory authorities in the world. This is because a significant number of very large internationally active banks are domiciled in the EA. For example 9 out of 30 G-SIB are EA banks. This unique position may in time give the SSM a much enhanced clout in shaping supervisory culture, criteria and practices worldwide.
- That said, any material dent in the SSM's independence or any real or perceived political or national biases developing in time would negate some or most of these advantages, especially since most market participants – and the banks as well – will understandably be watching for any worrying signs in this direction.

Other European supervisors display reassuring characteristics

- We consider FINMA, the Swiss financial regulatory authority, to be a very proactive and authoritative bank supervisor, especially with respect to the two global systemically important institutions of the country – which to different degrees experienced severe stress during the crisis years. Partly due to the fact that it did not need cross-border consensus (Switzerland not being part of the EU/EEA regulatory architecture), FINMA had early on during the crisis years moved relatively speedily to implement intrusive risk-based supervisory steps. As a matter of fact the strong regulatory framework represents a positive rating driver for the two large Swiss banks.
- In the UK, there is a sea of difference between the old Bank of England's "tap on the shoulder" approach or the pre-crisis FSA's "light-touch" supervision and the robust and rather intrusive process undertaken nowadays by the PRA – for prudential risk -- and the FCA – for conduct risk. The systemically important institutions are being supervised by large teams supported horizontally by groups of risk specialists (including stress-test experts). We find that on average UK bank supervisors' requirements are slightly more demanding than elsewhere in the EU – to some extent also stemming from "gold-plated" standards compared to CRD4-CRR (e.g., on capital or leverage).

- We note that in the Nordic countries the pre/post-crisis differences in supervision are less pronounced than in other countries. This is probably explained by the persisting regulatory memory of the severe regional banking crisis of the late 1980s-early 1990s which was eventually sorted out through massive state interventions. Reassuringly, we currently see the Swedish authorities -- both the FSA and Riksbank – demanding more conservative adjustments in banks' asset risk weights. We note that bank authorities in Norway already demand high capital standards.
- One area of potential uncertainty in the future would be a growing gap in regulations and supervisory practices across Europe – within and outside the EA – and beyond. Such a gap may produce in time pricing differences across jurisdictions for similar products and services, to the competitive detriment of some banks compared to others. One such example may be the forthcoming ring-fencing of core financial activities in the UK, a development which to date is not actively pursued in other jurisdictions where large internationally-active banks are domiciled.

D. Resolution and bailin: a transformational change for banks but also for investors

- Scope considers the forthcoming resolution and recovery regime as potentially the most transformational regulatory change for European banks in many years. The process of privatizing banks, which took place in Europe decades ago, is now being completed with the privatization of bank rescues. While under the BRRD all unsecured liabilities of a bank in resolution (save insured deposits) would be bailinable, we believe that such an extreme scenario of near-total asset meltdown is unlikely to occur. All unsecured investors and depositors in theory run some remote risk of loss in resolution. However, in practice this risk might not be materially different from the more traditional risk senior unsecured investors would have incurred had the bank been declared insolvent by supervisors – assuming no government bailout were forthcoming. The “no creditor worse off” (NCWO) principle underpins the bailin decision in resolution.
- The risk should be more real for investors in liabilities qualifying as MREL, which is at the front of the bailin process (ahead of disbursements from the resolution fund to which all banks contribute). According to BRRD the MREL threshold will be at least 8% of liabilities including own funds (resolution authorities will be able to set specific MREL thresholds for individual institutions, in a way resembling the Pillar 2 process for capital by the competent authorities). Below we provide a first-blush comparison of MREL gaps for the 22 EU/EEA banks rated by Scope, adding also for comparative purposes the two large Swiss banks (which however are not subject to BRRD).

  The table below shows estimates of MREL shortfalls and TLAC shortfalls (when appropriate) for the rated banks. We exclude from the calculation the banks’ outstanding senior unsecured liabilities.

			TLAC			MREL		
Bank	Issuer Credit Strength Rating (ICSR)	Outlook	TLAC (% of RWA)	Shortfall to 20% (%-points)	Shortfall (EUR bn)	MREL[2] (% of Liabilities + Own funds	Shortfall to 8% (%-points)	Shortfall (EUR bn)
Barclays	A	Stable	17.5%	2.5%	12.9	5.5%	2.5%	40.9
BBVA	A	Stable	15.3%	4.7%	15.8	8.6%	Above	Above
BNP	A+	Negative	13.3%	6.7%	41.6	4.3%	3.7%	69.8
Commerzbank	BBB+	Positive				5.8%	2.2%	12.9
Credit Agricole (2013Y)	A	Positive	17.4%	2.6%	12.6	4.9%	3.1%	53.3
Credit Mutuel (2013Y)	A	Stable				5.8%	2.2%	14.5
Credit Suisse	A+	Negative	22.1%	Above	Above	7.1%	0.9%	6.7
Danske Bank	A-	Stable				5.4%	2.6%	11.6
Deutsche Bank	A-	Positive	18.9%	1.1%	4.2	4.6%	3.4%	57.2
DNB	A+	Stable				7.0%	1.0%	2.9
Groupe BPCE (2013Y)	A+	Stable	14.7%	5.3%	19.7	4.8%	3.2%	35.2
HSBC	AA-	Stable	16.6%	3.4%	30.9	7.6%	0.4%	8.9
ING (2013Y)	A	Stable	17.4%	2.6%	7.4	6.2%	1.8%	13.9
Intesa (2013Y)	BBB+	Positive				8.0%	Above	Above
KBC	A-	Stable				6.8%	1.2%	2.9
Lloyds	A	Stable				7.6%	0.4%	4.6
Nordea	A+	Stable	20.6%	Above	Above	4.9%	3.1%	19.6
Rabobank	A+	Stable				6.1%	1.9%	12.6
RBS	BBB+[1]	Stable	18.3%	1.7%	8.1	7.1%	0.9%	11.1
Santander	A	Stable	14.3%	5.7%	31.8	6.8%	1.2%	14.2
SocGen	A	Stable	14.9%	5.1%	17.8	4.0%	4.0%	53.2
Swedbank	A-	Stable				5.3%	2.7%	6.1
UBS (2013Y)	A	Stable	19.0%	1.0%	1.9	4.3%	3.7%	31.1
Unicredit (2013Y)	BBB	Positive	15.2%	4.8%	18.5	6.9%	1.1%	8.9

Source: SNL and Scope Ratings

Notes: Data is from H1 2014 unless mentioned otherwise. [1] Rating includes one notch up for UK government majority ownership. [2] We have calculated Liabilities and Own Funds as Total Assets minus Minority Interests.

- With respect to these gaps, we expect that they will be filled during the next several years (2015-16 and beyond) with the following categories of liabilities:
  - AT1 securities – possibly up to the regulatory limit of 18.75% of the initial capital requirement of 8% of RWA
  - Tier 2 securities – possibly up to the regulatory limit of 25% of the initial capital requirement of 8% of RWA
  - Other junior debt not qualifying as regulatory capital (including in a first stage grandfathered hybrids which will gradually be disqualified from regulatory capital acceptance)
  - Senior unsecured debt issued either via a holding company – for those banks with a holding company structure (the large UK and Swiss institutions) – or possibly via an earmarked funding vehicle fully guaranteed by the parent operating bank (with a contractual bailin clause) – for those banks without a holding company structure (most large EA and Nordic banks).

  In general we assume that Tier 2 securities will be an often-utilized instrument – as they are aimed at a much larger base of debt investors than AT1. We would also expect contractually bailinable senior unsecured debt to be issued as well, especially via holding companies by those groups having such a structure, but at this time we do not yet see much clarity on this.

- What we do not expect is MREL-eligible senior unsecured debt without a contractual bailin clause to be issued by an operating bank which also holds deposits and has outstanding senior unsecured debt. This is because such issuance could make the totality of their bailinable liabilities (not only the MREL-eligible funds) more vulnerable to negative market sentiment and thus to re-pricing risk.

- Once the MREL norms are firmed out by regulators sometimes next year – possibly resembling the TLAC recognition process included in the FSB's recent proposals to the G20 – we expect that investors, analysts and rating agencies alike will increasingly consider MREL (and TLAC) coverage as a key risk-protection metric for banks, alongside CET1 and leverage ratios.

- **Importance of MREL and resolution for Scope's bank ratings:** We have already stated publicly (*TLAC emerges as a key prudential metric*, November 2014) that the future TLAC or MREL coverage of a bank, as well as the other elements related to its resolvability, will be important credit considerations in the assessment underpinning our bank ratings. Our rating analysis will address this topic in detail in the future, especially as regulatory rules are further clarified and banks adjust their disclosure.

  At the same time, the rating of any future senior unsecured debt with contractual bailin clauses, or senior unsecured debt issued by a holding company and which is specifically earmarked for MREL or TLAC coverage will be assigned in function of the securities' terms and conditions. For the time being, Scope has stated in its bank rating methodology that for holding companies of financially strong and well integrated banking groups – typically rated in the AA and A range – there would normally be no notching gap, ceteris paribus, between similar liabilities issued by the bank and the holding company. This analysis however may not apply to debt instruments issued specifically for MREL or TLAC coverage, for which some rating notching down could be applied.

E. Regulatory steps still pending

- Based on what European and global bank regulators have achieved so far, we consider that some three quarters of the new regulatory architecture is now in place – with the caveat that there will be full implementation within the announced timeframe. Aside from pursuing this implementation process, we expect regulators to focus next year on the following areas which need further adjustments and clarifications:
  - More consistency and accuracy in asset risk weights
  - Further details on resolution and recovery – in terms of structures, process, metrics, and policies
  - Heightened focus on, and enforcement of, conduct risk for banks – both regarding retail customers and markets and wholesale activities.

- **More consistency and accuracy in asset risk weights:** If Basel 3 and CRD4-CRR have dealt with the numerator of the regulatory capital ratio – the qualitative change in the composition of capital, going-concern loss-absorption capacity for AT1 and Tier 2, additional buffers, etc. – what has remained largely unchanged is the denominator, namely RWAs. The recently completed Asset Quality Review of the ECB did not tackle the inconsistencies in risk weights. We expect bank regulators to take on this aspect more decisively in 2015 – both the Basel Committee and European regulators (primarily the EBA but also the SSM and national supervisors). If left unaddressed, the RWA inconsistencies may threaten the credibility of capital and capital ratios in the eyes of market participants, thus negating the positive tide of regulators having spent much time and effort in trying to sort out this challenge. Scope's recent dialog with debt investors has revealed that, while the steps taken so far in strengthening regulatory capital are in general viewed as reassuring, the issue of material RWA discrepancies looms large and maintains discomfort. On the one hand, this is because the credibility of capital ratios suffers. On the other hand, the possibility that capital ratios will have to be materially boosted due to a RWA recalculation – in addition to the forthcoming buffers – adds further uncertainty – although most market participants admit that the current situation is not sustainable.

  Future regulatory efforts in RWA reforms will certainly address (i) revisiting banks' internal models for the IRB approach and (ii) demanding more conservative and more consistent standards. In this context, the SSM is well placed to impose consistent standards across the EA landscape, which in fact we expect it will start doing soon. In particular what needs to be addressed across the EU and beyond are the inconsistencies in mortgage risk weights across countries (e.g., Nordic markets vs. other European markets which do not only include vulnerable countries). The pro-cyclicality bias will need to be adjusted before negative market developments heighten further the degree of mistrust in mortgage risk weights.

  We should highlight that we do not believe that a return to the basic Basel 1 framework is an acceptable solution, as we can recollect the unhealthy situation created by arbitraging crude risk weights which had led to banks piling up risky exposures.

  We also expect at some point further supervisory reflection on risk weights for sovereign exposures. This inconsistency will need to be addressed eventually and the best time to do it would be when market confidence is at a reassuring level rather than in a bind during a new crisis. As more than one senior regulator and policymaker has stated publicly, and as most market participants agree, not all sovereigns present zero credit risk.

- **Further work on resolution and recovery**: The BRRD is in place and the new regime starts on 1 January 2015 – with the bailin requirements kicking in one year later – but there is still significant regulatory work to be done with respect to the various details which would have to reassure investors in bank debt and equity that the process is on track, reliable and sufficiently transparent. Now that debt investors know that they are in the front line for losses in the event of banks going into resolution, they need to be able to quantify the risk they take and thus to decide the degree of involvement in bank funding that they wish to accept.

While market participants are aware that supervisory colleges discuss institutions' resolvability or that crisis management groups assess G-SIBs' resolution and recovery plans, there is still very little transparency for market participants regarding developments on resolution. We note positively that the EBA has been active in recent months by publishing various consultation papers on draft guidelines related to the resolution and recovery process. We expect this to continue in 2015.

We also assume that the SSM will start being visible with respect to resolution and recovery decisions, not only for G-SIB but also for the other significant institutions supervised by the ECB. Inter alia we should expect details on the following topics of interest to market participants:

- Levels and composition of MREL and for G-SIBs the equivalence of MREL with TLAC (which we would expect although the calculation criteria seem to be different)
- Guidelines on any group restructuring steps to issue MREL-eligible liabilities, given that most EA institutions do not have a holding company structure (like large UK, US and now Swiss banking groups)
- Guidance on contractually bailinable senior unsecured debt, if it is going to be issued by operating banks as MREL-eligible paper
- Details on internal MREL, in case it is going to mirror the internal TLAC for G-SIBs proposed last month by the FSB to the G20: levels, composition, eligibility
- Possibly details on which institutions have to be resolvable beyond the G-SIBs, bearing in mind that the public interest criterion has to be met: is this a supervisory decision to be taken ex-ante or only at the time when the resolution option needs to be considered?
- Guidance on resolution avenues for specific institutions: single point of entry (SPE), multiple point of entry (MPE), combined, and ideally which subsidiaries will be affected.

We believe that the sooner transparency and clarity on the future resolution process is provided the better. This is not only because banks will need some time to plan their MREL/TLAC issuance but investors as well will also need sufficient time to assess the new debt categories and take investment decisions accordingly. In general we consider that there is a direct correlation between the clarity of regulatory communications to market participants and the latter's active involvement in investing in bank debt securities. For example, investors or analysts would need to assess the impact of SPE or MPE resolutions on the group and on the debt they invest in.

In this context we note that the EBA has just published a consultation paper including draft regulatory technical standards on criteria determining MREL and which roughly connects to the points raised above about the categories of liabilities likely to be included. In essence, the document highlights that institution-specific MREL levels are to be determined by the resolution authorities and that in terms of composition MREL should include primarily equity, own fund instruments and other subordinated debt. The EBA cautions that senior unsecured debt and liabilities like large corporate deposits present the risk of being excluded from contributing to loss absorption or recapitalization in bailin either if holders would have made high recoveries in insolvency (the NCWO principle) or if bailing them in were to increase the risk that critical functions provided by the operating entity would stop.

- **Heightened focus on, and enforcement of, conduct risk:** We anticipate that as prudential regulation gets closer to its final stages for the time being and the "job done" feeling is increasingly prevailing among policymakers, the focus will shift to a much larger extent on banking institutions' conduct risk – both with respect to retail customers and with respect to wholesale clients and market activities. We note that in fact conduct risk has been all along a concern for bank supervisors in different jurisdictions, although during the financial crisis this concern took a back seat as regulators had to focus fully on prudential risk and try to keep banks ashore. We also note that, to some extent similar to their lesser focus on the supervision process, investors and analysts have been less involved in the past in gauging scenarios of banks running afoul their supervisors due to misconduct. The reason may be, again, the difficulty to find metrics to estimate conduct risk (number of complaints, to the extent that it is public, may not be the sharpest metric for it).

This has started to change when several large banks ran into severe conduct issues, resulting in legal fines – some of them extremely heavy – regulatory warnings or specific actions, and in general blows to reputation. This arose against a background of large banking groups, especially those involved in material wholesale and investment banking/trading operations, facing a negative public image due to the real or perceived role running up the crisis (coupled with negative public sentiment regarding remuneration packages).

We expect both regulatory and public scrutiny to remain high for large banks engaging in wholesale and trading operations, with the possibility of regulatory enforcement and heavy legal fine dampening some of the activities – especially since trading is likely to become more commoditized, which alongside higher capital charges and market and operational risks would make it less economically viable. We note a concerted regulatory drive, especially in the large financial centers, to address the misconduct in activities related to interest rate benchmarks, commodities or foreign exchange, among other areas.

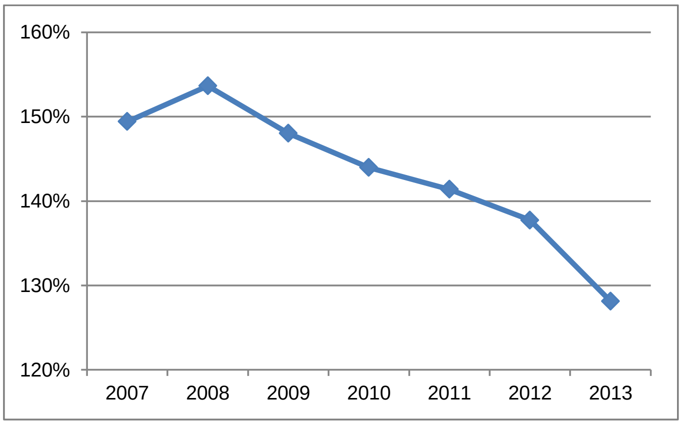
Other areas of regulatory action against misconduct are in private banking – regarding tax-avoidance issues – or in breaching local or international legislation – for example illegal transfers and related activities. A topic of heightened regulatory concern relates to banks' conduct vis-à-vis retail customers – individuals and small businesses. Mis-selling, improper product suitability, packages to consumers to include unnecessary products, doubtful marketing, mispricing of customer products – are all areas of supervisory concern as part of customer protection policies. We note that hefty fines have been already incurred by retail banks – for example in the UK – so market participants should be reassured that it is not only wholesale and investment banking which is under scrutiny.

Overall, we believe that all banks will need to take into account the fact that conduct-risk regulation is here to stay and also that their behavior will remain highly scrutinized by supervisors, politicians, the media and the general public.

F. Credit outlook for 2015 and beyond

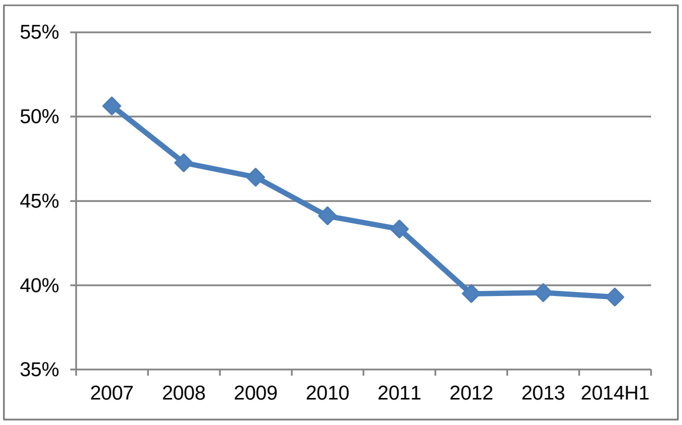
- **Strengthened balance sheets with ampler and higher-quality liquidity and capital levels and better balanced funding:** The road to implementing the new regulatory prudential standards and to de-risking and deleveraging has on aggregate led the large European banks into displaying strengthened balance sheets, with lower loan-deposit ratios, lower asset-risk intensity (partially a function of de-risking, although banks' internal models may to some extent artificially stretch the de-risking picture), higher regulatory capital levels and improved leverage. We also highlight the much improved quality and mix of both capital and liquidity.

Chart 1.a: Gross Loans to Deposits



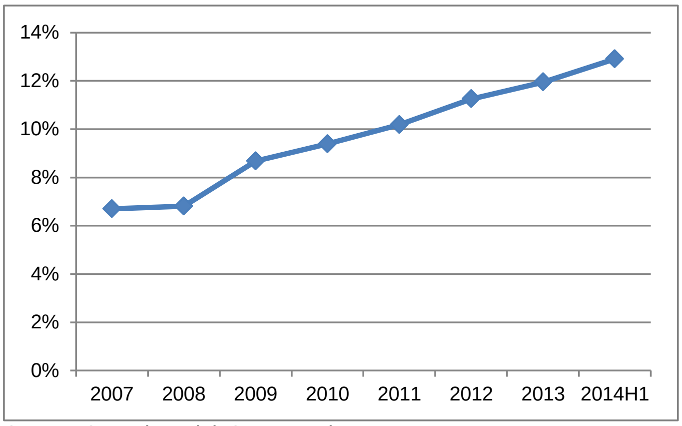
Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 1.b: RWA to Total Assets



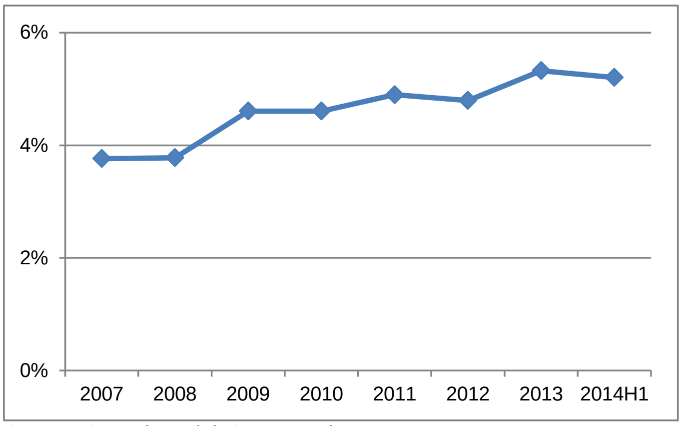
Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 1.c: Core Tier 1 ratio



Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 1.d: Tier 1 Leverage ratio

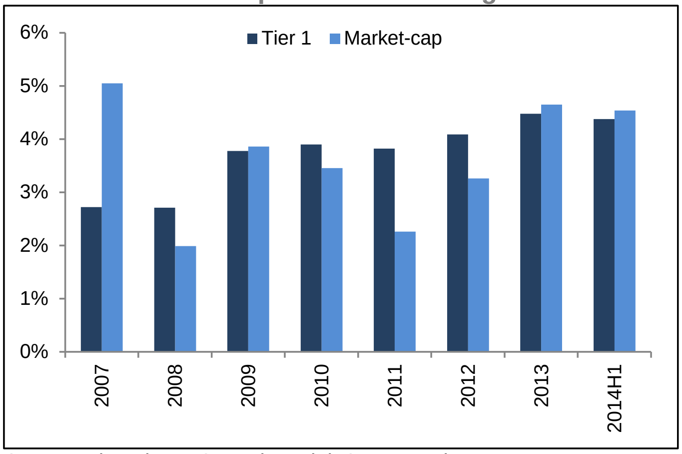


Source: SNL Financial, Scope Ratings
Notes: 43 European banks

We believe that the metrics of safety will be preserved for 2015 although balance sheets have started to grow again. Ore timidly now, this trend could become more visible next year, especially from H2 onward if the economic situation starts improving and new lending rises.

The stronger balance sheets, alongside other areas of credit improvement highlighted below, have also shifted market sentiment and valuations upwards, as the improvement in market-cap leverage levels attests – see below.

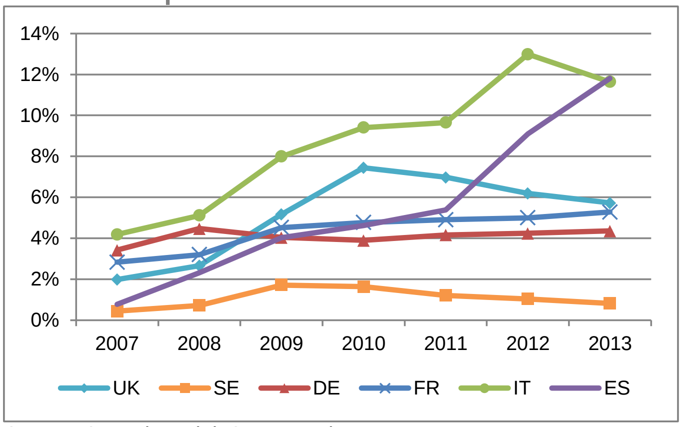
Chart 1.e: Market-cap vs. Tier 1 leverage ratio



Source: Bloomberg, SNL Financial, Scope Ratings
Notes: Calculated for 21 rated banks that are listed.

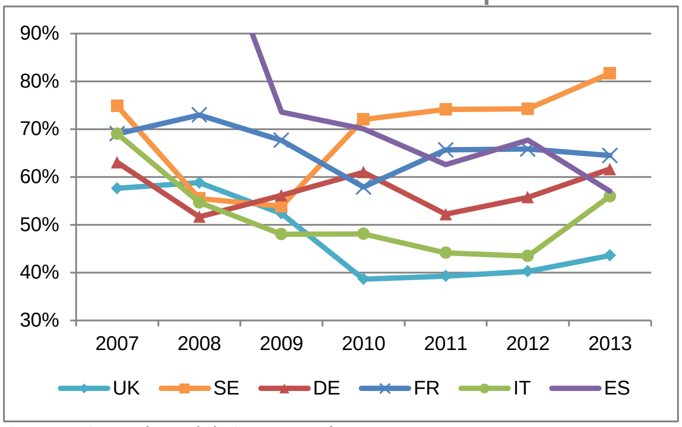
- **Asset quality indicators will remain a mixed bag, but improvement of credit metrics in some vulnerable countries will be visible**: The ECB's recently completed Asset Quality Review (AQR) did not reveal any major surprises to shock investors. If anything market confidence in the euro area (EA) banking system on aggegate seems to have been reinforced following the publication of the exercise which also offer a plethora of new data. We note however that a large share of the additional impairments identified by the AQR is linked to forborne loans. As we highlight below in this report, we expect forbearance policies and practices going forward to be streamlined and scaled down by the new Single Supervisory Mechanism (SSM), which should give reasssurance to investors.

Chart 2.a: Impaired Loans to Gross Loans



Source: SNL Financial, Scope Ratings

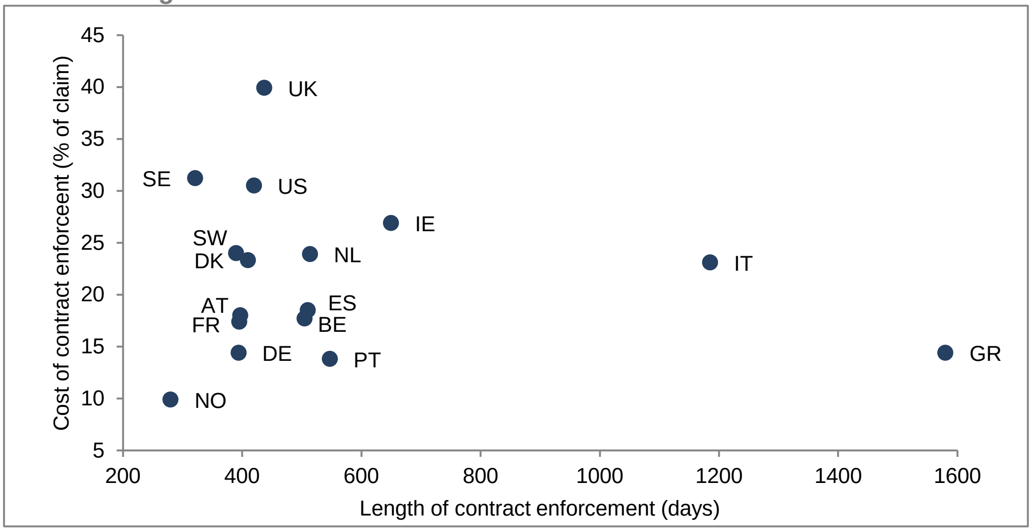
Chart 2.b: Loan Loss Provisions to Impaired Loans



Source: SNL Financial, Scope Ratings
Notes: Spain: 2007 = 367%, 2008 = 120%

In the two graphs above not surprisingly we note material differences in asset quality metrics between vulnerable and core countries' banks. We believe, however, that sorting out the crisis legacy remains an uneven process, as in fact it had been the situation before the crisis as well. The graph below shows that in Italy for example the legal system makes it very difficult to resolve non-performing loan situations in an economically acceptable timeframe – which in fact is a key reason why on average Italian banks carry large load of impaired credits (and several of them did not pass the Comprehensive Assessment). On balance, we believe that banks in Ireland, Spain or Portugal will be able to sort out the legacy of their impaired loans faster than banks in Italy or Greece. The ECB has righty flagged difficult legal enforcement regimes like in Italy as a hurdle in asset-quality legacy cleanup by local banks.

Chart 3: Length and cost of contract enforcement

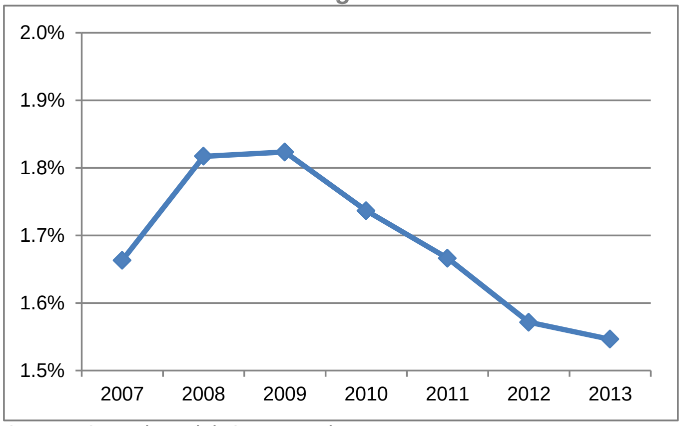


Source: World Bank

- **Sluggish earnings and weak returns to persist in the new year:** The difficult macro situation across Europe continues to be the main driver for banks' overall modest performance. On aggregate bank revenues are a mix of net margins and volumes, both still at depressed levels and not likely to improve visibly – at least not until EU economies pick up (at best in 2H 2015). The new more constraining environment in which banks now operate also makes it difficult for them to maximize earnings via strategies such as product cross-selling – which was popular before the crisis but is now questioned by supervisors. As well, banks' pricing policies, especially for retail products and services, remain under heightened regulatory and public-opinion scrutiny. We also note the increasing burden of extensive branch networks – especially high staff-related expenses – at a time when demand for retail products and services moves increasingly toward online and mobile channels (regarding this topic Scope is about to publish a research report on the growth of European banks' multichannel distribution and its impact on business models).

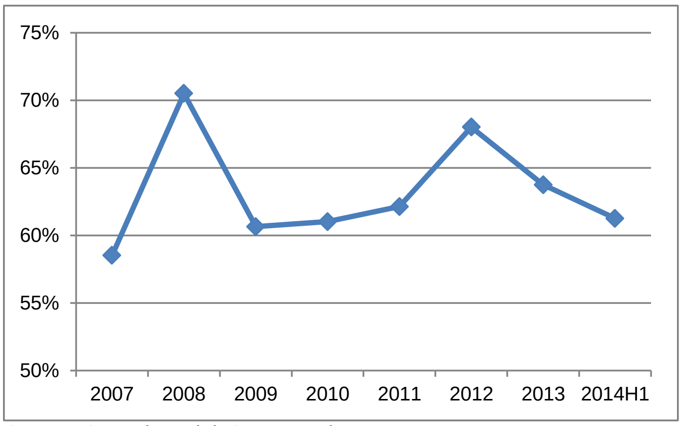
  Last but not least revenues from wholesale operations are a fraction of what they were before the crisis, due to the new regulatory landscape demanding higher capital charges and tougher leverage and liquidity metrics, restricting risky activities (such as proprietary trading), moving trading activities towards exchanges, and especially aiming at enforcing and penalizing conduct aspects, especially related to market abuse and legal issues. We believe that this relatively constraining regulatory and policy approach, which so far is fully supported and even pushed forward by politicians and the public opinion, is going to remain in place for the forseeable future, thus pressuring earnings in this area. In this respect, a key theme of the IMF's latest "Global Financial Stability Report" (October 2014) is the need for the banking industry to take less financial risk and more economic risk (meaning providing credits to businesses and individuals).

Chart 4.a: Net Interest Margin



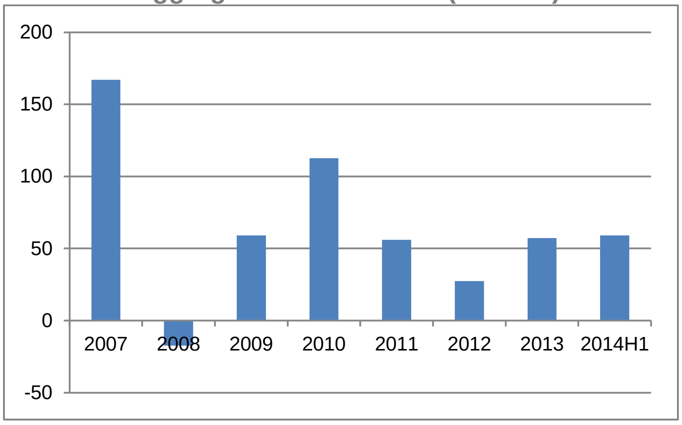
Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 4.b: Cost-to-Income ratio



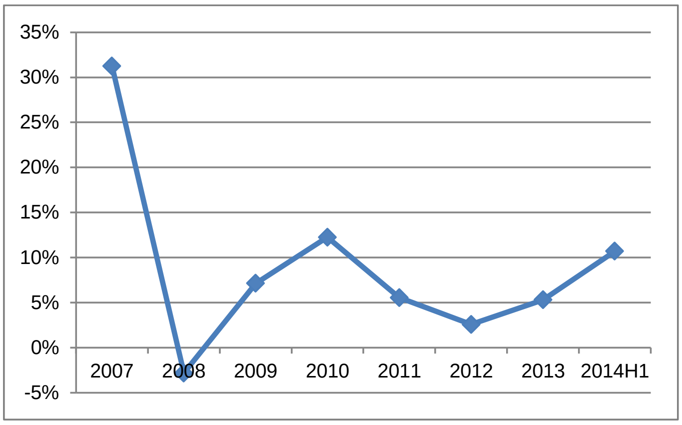
Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 4.c: Aggregate Pre-tax Profit (EUR bn)



Source: SNL Financial, Scope Ratings
Notes: 43 European banks

Chart 4.d: Pre-tax return on Core Tier 1



Source: SNL Financial, Scope Ratings
Notes: 43 European banks, 2014H1 annualized

We expect banks to continue to cut costs and pursue better efficiency as in fact one avenue allowing an improvement in profitability (as revenue growth is more difficult to achieve if market conditions do not permit it). However, as said, banks are increasing exponentially their cost related to taking on board compliance and regulatory affairs staff – a trend which is not likely to reverse itself anytime soon. Banks are also investing considerably in IT infrastructure for current needs and the multichannel strategy they increasingly embrace (although in that area pooling of resources and effort by several banks can help the process). Cybersecurity is a clear and present threat and banks are also increasing costs related to it. Last but not least large banks in several countries continue to have a rather negative public image so announcing massive staff reduction would not be a decision management would take lightly.

We believe however that next year profitability levels may be somewhat helped by lower levels of loan-loss provisions, although the positive effect is not likely to be spectacular.

Overall, banks will have to learn to live with mid-high single-digit or at best low double-digit ROEs. This is so not only because pre-tax earnings are a fraction of pre-crisis levels (see graph above) but also because the equity base (the numerator) is a multiple of pre-crisis levels as well. We consider that equity investors are gradually getting used to low ROEs for banks and are more realistic when expecting material boosts. This is why, as we highlight later in this report, expectation of dividend flow stability and predictability may become more of a driving factor for investing in bank shares, rather than mostly capital appreciation. At the same time we caution that structurally low ROEs, relative to heightened capital requirements (both equity and AT1), also mean that the pool of available distributable income may have to service both dividends and growing AT1 coupon payments, aside from other necessary disbursements. This would be comparatively more challenging in the case of some wholesale and investment banks which may be more exposed to legal and regulatory fines and which thus might display uneven levels of available distributable income.

- **Business models – safety of "back-to-basics":** For Scope a bank's business model relates to the business mix and strategic focus underpinning its capacity to preserve and grow sustainable risk-adjusted earnings in markets and sectors in which it maintains a material presence. From this angle we find that the business model which is considered increasingly attractive by most banks and regulators is the "back-to-basics" retail and commercial banking. An increasing number of large and less large banks have been pulling back from wholesale and investment banking/trading activities, although in most cases this has been the result of specific demands by regulators, including restructuring plans for those institutions which had to solicit state aid during the crisis.

  In turn, those few large European institutions which have managed to preserve a critical scale of wholesale and investment banking franchises – most often combined with commercial banking – such as Deutsche Bank, Barclays, HSBC, Credit Suisse, BNP Paribas or Societe Generale (in addition to five US institutions and one Japanese), have concluded that the pullout of competitors leaves them more room in this space despite the inherently high operational, legal, regulatory and reputation risks. But even in the case of these global financial powerhouses the strategy is more risk-averse and aims as well to boost retail and commercial banking revenues.

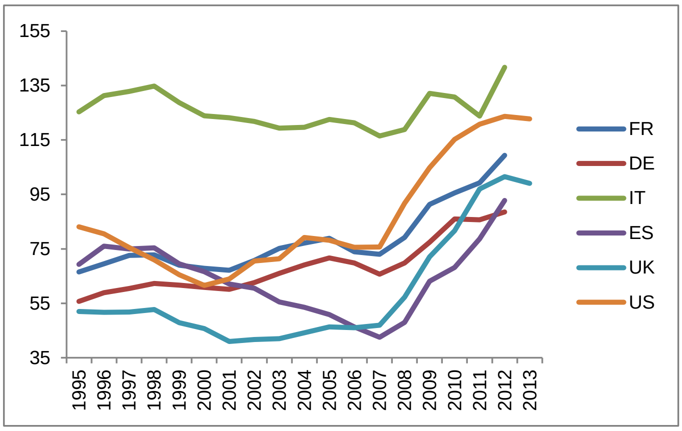
  We find in principle the more traditional retail and commercial banks as relatively less risky and more stable and predictable, but at the same time we note that the lack of growth and the low margins prevailing in the market do not yet make a compelling case for the the visible success of this business model – other than falling in line with regulatory, policy and public-image expectations of lending to the real economy. The low and generally predictable revenue line from traditional banking would not lead us to consider however this business as merely "utility" banking. We are fairly convinced that when economic conditions pick up again and through rising rates in the medium term net margins strengthen the retail and commercial banking business model will prove increasingly attractive from a revenue angle as well – with the proviso that credit costs be kept under control.

  Overall our assessment is that ultimately what makes a business model viable and reliable, aside from the capacity to generate sustainable revenues, is the bank's capacity to manage it in a proper way with adequate risk governance, management and controls and more than ever with proactive and effective regulatory compliance. This of course is easier said than done for those groups with extensive cross-border wholesale activities which need to respond to several regulators. The forthcoming resolution regime and the need to clarify and strengthen resolvability will represent an additional major challenge and clearly for Scope a rating driver.

- **Lending growth remains uncertain:** Ever since the peak of the financial crisis some five years ago banking institutions, while being asked to meet ever tougher regulatory requirements, were also expected by policymakers to increase lending to the real economy, especially to SMEs which are more dependent on banks for their financing as direct market access is more limited (unlike large corporates). While many banks, as well as investors, have considered the two goals as not being compatible – more lending cannot occur when the bank needs to boost its capital and liquidity and also to de-risk and deleverage – we are among those who believe that well-capitalized and highly liquid banks are in fact in a better position and more confident to expand their lending without the fear of leveraging up too much and running afoul of prudential norms.

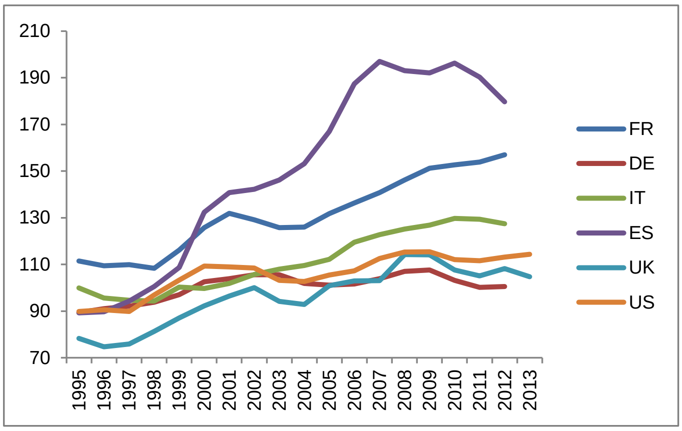
On the other hand, banks have tightened their lending criteria through the crisis, something that both they and their supervisors were aiming for. Also, during the difficult years it is not only the financial sector but the non-financial private sector as well – businesses and households – which pursued debt reduction and deleverage. It is only the public sector which has been seeing rising indebtedness (see below debt levels to GDP).

Chart 5.a: Public sector debt to GDP



Source: OECD, Scope Ratings

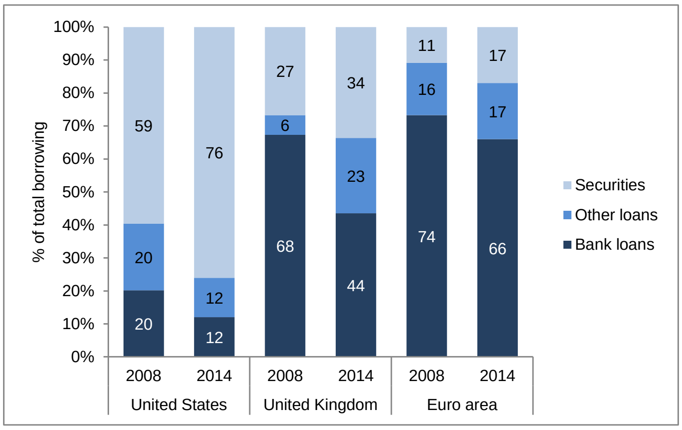
Chart 5.b: Non-financial corporations' (NFC) debt to GDP



Source: OECD, Scope Ratings

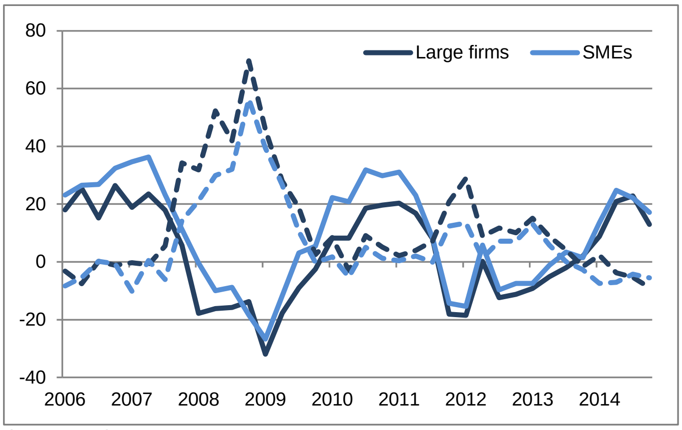
It is in this context that we find somewhat unfair the criticism of banks not being active enough in pursuing lending in a more committed manner. The economic crisis in Europe continues but at this time we do not believe that it is the banking system which is still at its epicenter. Of course the banking system's behavior continues to weigh significantly especially in continental Europe, which remains a bank-financed economy much more than the US – with the UK now being somewhere half-way (see graph 6.a).

Chart 6.a: Business credit intermediation



Source: National central banks, IMF
Notes: Exclude estimated value of intercompany loans

Chart 6.b: Credit standards and demand conditions in the NFC sector



Source: ECB
Note: Dotted lines represent credit standards; solid lines represent credit demand

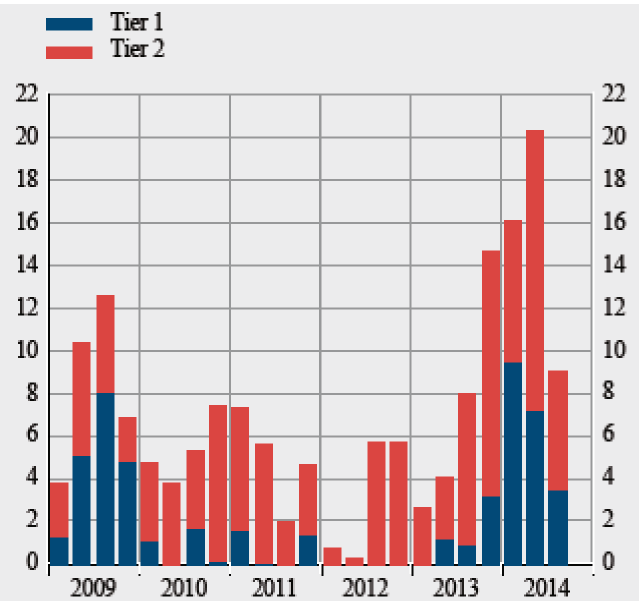
We believe that in 2015 bank lending will grow modestly, especially if after Q1, and more likely in H2, economic conditions will start improving. Graph 6.b reproduces the ECB's survey of the EA, showing that while credit standards remain tight demand has started to inch up – a trend likely to continue in the new year.

- **Mixed trends on bank funding:** For 2015 we do not see banks seking to shrink further their balance sheets, especially with respect to loans to the real economy in home markets, but we do not believe either that funding growth is going to resume on a material scale. EA banks' take-up of the first tranche of the ECB's TLTRO was fairly modest, well below market expectations. While the assumption was that banks back in September were still apprehensive regarding the outcome of the Comprehensive Assessment, the opportunities to use the proceeds – other than replacing older LTRO funds – were seen as limited (the carry-trade opportunities of the 2011-12 LTRO financing are no longer here). We expect the second TLTRO tranche to have a higher take-up than the first but not to the extent of opening the floodgates for new lending.

  It is likely that new covered bond funding next year will remain subdued, owing to low yield opportunities for investors, especially as the ECB's covered bond purchase program is likely to continue. Largely owing to ECB demand issuance levels may reach this year's, or perhaps less. On the other hand senior unsecured funding is likely to be far more active – probably higher than this year's cumulative issuance levels (see chart 7.b) but may not take off substantially as long as lending does not resume on a larger scale.

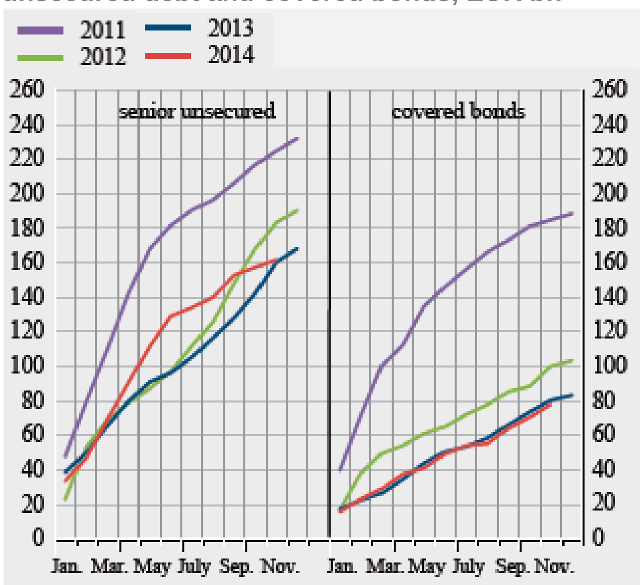
  What we do expect will increase significantly however is MREL funding, primarily in the form of subordinated debt and possibly even some senior unsecured debt issued by holding companies (in the case of banking groups with a holding company structure). This is not our central scenario, but alternatively MRELeligible senior unsecured debt might be issued in future via earmarked funding vehicles with a parent bank guarantee possibly referring to contractually bailinable securities (more visibility on this may develop next year). As our report has shown above there is a material gap in terms of MREL liabilities which may need to be filled up during the next two years or so. Issuance of AT1 and T2 securities is likely to go far beyond the levels reached so far in 2014 (see below).

Chart 7.a: Issuance of subordinated debt, EUR bn



Source: Dealogic and ECB
Notes: Excludes retained deals and government-guaranteed issuance.

Chart 7.b: Cumulative yearly issuance of senior unsecured debt and covered bonds, EUR bn



Source: Dealogic and ECB
Notes: Excludes retained deals and government-guaranteed issuance. November 2014 includes data up to the middle of the month.

Benefitting from a belated green light from policymakers, we also expect securitization to resume on a larger scale, probably focusing primarily on business loan collateral rather than mostly on mortgages as was the case before the crisis. The ECB's ABS purchase program represents a powerful attraction for new securitization deals, which we should see materializing in the near future. Scope will be publishing shortly its first credit outlooks for covered bonds and securitization in Europe.

- **Mergers and acquisitions – more activity likely in 2015:** Other than transactions spurred by regulators to repair ailing banking institutions or take out harmful excess capacity from a stressed banking system (such as the consolidation of *cajas de ahorro* in Spain) there has been very little significant bank M&A activity in Europe, not only cross-border but also domestically. As most banks' main concern has been during the last several years to remain attuned to the pace of regulatory changes, engaging in transformational mergers or acquisitions was seen as unwise and reckless, mainly from the angle of capital needs and of possible valuation holes in balance sheets. We would add that the same heightened uncertainties which prevented banks from engaging normally in cross-border interbank activities – thus contributing to systemic fragmentation and dysfunctionalities during the crisis -- has kept even the financially strongest of them away from the M&A scene.

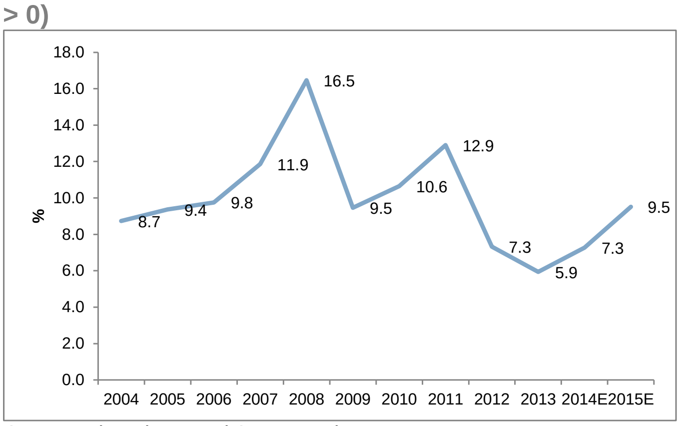
  Having said that, we believe this may change next year. First, there is more clarity on capital needs and asset valuations following the Comprehensive Assessment. Second, and very importantly, we highlighted above that the SSM seems to be encouraging more consolidation, to offset the harmful impact of systemic fragmentation and thus to encourage more lending to the real economy within the EA. Benefitting from the higher degree of visibility they will have into institutions across the EA, the ECB should be in a better position to encourage and authorize consolidation, including cross-border. In the past one factor of hesitation for large banks engaging in cross-border M&A has been national regulatory idiosyncrasies (e.g., of the acquired institution's national supervisors). With the SSM now in place, this fear, or the apprehension about national regulatory ring-fencing within the EA should subside considerably as we highlighted above in this report.

  Scope will be assessing future M&A transactions from an economic and risk angle to assess the rating impact on affected institutions. While mindful of the broader brief of policymakers to reduce systemic fragmentation across the EA (and the EU in general), we will be looking at the credit specifics for each rated institution.

G. Increasing convergence between credit and equity investors' targets

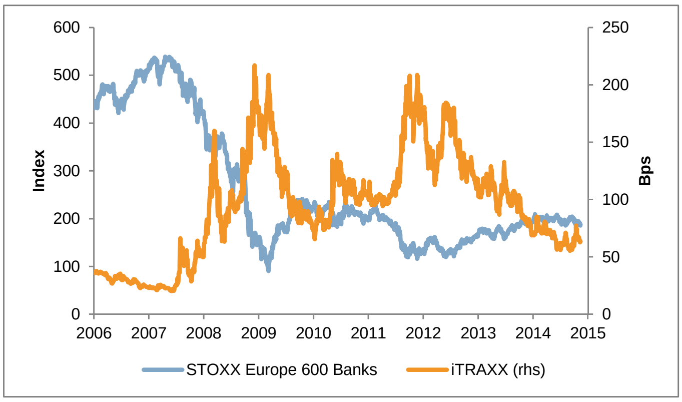
- A direct consequence of the regulatory and operating-environment trends for the banking industry since the onset of the financial crisis has been in our opinion an increasing convergence between equity investors' and credit investors' expectations and targets. More to the point, as the financial crisis moved in equity investors started to be more attuned to the traditional credit narrative, rather than mainly focusing on efficiency, high returns and profit maximization. Risk metrics became paramount, as equity investors became interested in downside risk, leaving the upside potential of stock prices on the back burner. The scenario of possible bank nationalizations was upsetting all investors, especially in equity as they were in the first line of loss-taking.
- During the EU sovereign crisis bank risk was highly interconnected with sovereign risk, with both credit and equity investors in bank paper following the same script on heightened sovereign risk and on the political debate and actions to address the tail risk of cracks in the EA. At the same time new bank regulations were coming in place, which demanded both equity and credit investors' full attention.
- At present, as our report has highlighted above, both equity and credit investors are witnessing a gradual convergence of prudential metrics and regulatory criteria for the European banking industry. Both categories are active in investing in bank capital instruments, notably AT1 which displays both debt and equity characteristics. Also, faced with structurally lower returns on bank equity – as already highlighted in this report – stock valuations are to a large extent influenced by the expectation of predictable dividend payouts rather than of more elusive at this time capital appreciation, which in our view bring equity investors closer to the targets and goals of fixed-income investors.
- We also add that the lower-risk and highly regulated banking landscape, alongside historically low risk-free rates, would suggest banks' cost of equity (COE) declining, thus narrowing the delta with ROE (above or below it). We are currently witnessing target convergence also from the vantage point of COE, with only two banks in our rated universe showing implicit COE higher than 10% (whereas there were 12 of them in 2006). Interestingly, credit investors themselves increasingly seem to observe COE which helps them in the valuation of AT1 securities.
- Below we show the trend in COE for the listed banks rated by Scope, and also converging trends for iTraxx and Stoxx Europe 600 banks which supports our arguments above.

Chart 8.a: Average implicit Cost of Equity (CoE) of Scope's rated banks universe 2004-2015E (when CoE > 0)



Source: Bloomberg and Scope Ratings

Chart 8.b: iTRAXX vs. STOXX Europe 600 Banks 2006-2014YTD



Source: Bloomberg and Scope Ratings

Appendix:

Peer Group Database	
Rated by Scope Ratings	Not rated by Scope Ratings
Barclays	ABN AMRO
BBVA	Allied Irish Banks
BNP	Banca Monte dei Paschi Siena
Commerzbank	Banca Popolare di Milano
Credit Agricole	Banco Popolare
Credit Mutuel	Banco Popular
Credit Suisse	Bank of Ireland
Danske Bank	Bankia
Deutsche Bank	Bankinter
DNB	BCP
Groupe BPCE	CaixaBank
HSBC	CGD
ING	Erste Bank
Intesa	Handelsbanken
KBC	Nykredit
Lloyds	RZB
Nordea	Sabadell
Rabobank	SEB
RBS	UBI
Santander	
Societe Generale	
Swedbank	
UBS	
Unicredit	

Scope's Bank Rating Team

Lead Analysts
Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Pauline Lambert
p.lambert@scoperatings.com

Marco Troiano
m.troiano@scoperatings.com

Associate Analysts
Juan Villalobos
j.villalobos@scoperatings.com

Chiara Romano
c.romano@scoperatings.com

Associate
Thue Sondergaard
t.sondergaard@scoperatings.com

Team Leader
Sam Theodore
s.theodore@scoperatings.com

Scope Ratings

The Gridiron Building

One Pancras Square

London N1C 4AG, UK

Phone +44 (0)203 714 4980

Lennéstraße 5

10785 Berlin

T: +49 (0)30 27891-0

F: +49 (0)30 27891-100

Disclaimer

© 2014 Scope Corporation AG and all its subsidiaries including Scope Ratings AG, Scope Analysis GmbH, Scope Capital Services GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope cannot however independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided "as is" without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or otherwise damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party, as opinions on relative credit risk and not as a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings AG at Lennéstraße 5 D-10785 Berlin.