



We entered a new year carrying a sizeable bag of worries and uncertainties. But the health and viability of Europe's large banks should not take up much space in it. I trust the comments below will add some context for the imminent Q4 bank earnings season.

In a brief outlook two months ago¹ I made the point that, on balance, Europe's large-bank sector is displaying its best prudential and financial shape in three decades.

Perusing the usual year-end sector credit outlooks by sell-side firms and rating agencies revealed several areas which are on their front burner. I highlight them below, adding my take.

Rising asset-quality problems

Most market participants expect asset quality problems to explode when moratoriums and other public-sector borrower support measures stop. Provisions could indeed go up this year, but my central scenario is not for a sudden drop in financial support from governments and central banks. To prevent sharp disruptions, support steps will see a gradual downward adjustment

through the year, most probably in parallel with economic recovery rates.

Because this is not so much about protecting banks' balance sheets as it is about shoring up the entire economy.

Besides, in most cases (I refer mainly to Europe's larger banks) there are sufficient financial and prudential cushions to absorb higher provisions – within limits. Capital buffers are also there to mitigate shocks – although the market would be unimpressed with buffer erosion even though supervisors are encouraging it.

Over the last decade, banks have not engaged in the type of reckless lending that they undertook in the bubble-building pre-crisis years, so the peaks from which to fall are not as high as last time around.

1

<https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=a0115536-09d1-4608-955f-5bb4fab0e5d5>

If there is one segment of higher concern in terms of large sectoral bank exposures, it is commercial real estate – especially office, retail, and hotels – although bank underwriting of CRE has been more conservative in the post-crisis decade than in the preceding years.

Underwhelming revenue growth

Rates are anchored in negative territory and there will be more competitive pressure on fee income than there was in 2020. The new reality of the banking business for the foreseeable future is weak revenues, as befits banks’ role as quasi-utilities. Bank CEOs – at least the more realistic ones – seem to be in the final stage of the Kübler-Ross five stages of grief: acceptance. But many analysts and investors, primarily on the equity side, are still in the third stage: bargaining (“if only they did that extra bit, ROE would jump so high”). Which is neither wise nor defensible.

People need to accept that banks are now acting on a different stage, especially in the post-pandemic era, and need to start assessing them as such.

Risk-taking for the sake of inflating returns is out. Striving to help businesses and households survive the pandemic and rebuild after it is in.

It is a new social contract and one that offers a new dawn to banks’ public image. By the look of it, banks seem ready to take it on. Investors should start considering it too.

Due to net interest margin collapse, earnings from fees and commissions should represent the lion’s share of revenues for many large banks with more diversified activities. Which of course creates a dimmer outlook for the numerous second-tier firms with limited diversification potential. On the other hand, neither fee income nor trading gains for those banks which can generate them are likely to match the hefty volumes of last year, which was full of surprises.

Cutting costs to match weak revenue growth

This is probably the main challenge in terms of financial targets. Most banks are committed to it but the road to higher efficiency is difficult because in most cases it entails a radical restructuring and re-engineering of operations.

Analysts still swear by the cost-income ratio (CIR) – the traditional efficiency metric for banks. But in the age of digital transformation it is less relevant, in light of massive IT investments. In fact, the degree of success in migrating fully to a new digital ecosystem should be an important driver of value creation for banks. But, in and of itself, this is not the case right now. In most instances, by relying too easily on CIR, the market puts a value on a bank’s digital transformation only when cost savings materialise.

And savings are not possible unless banks shed excessive legacy infrastructure i.e. branches and back offices. This readjustment process is more advanced in the Nordic region, although several other institutions are showing significant advances in the digital space, among them ING, BBVA, Lloyds, and Société Générale.

Consequently, a solid consideration in investment decisions – the success of digital transformation – is unfortunately not being properly taken into account.

A busy year for M&A in European banking

There is an abundance of imagined merger scenarios for the large banks in many year-end outlooks; some cross-border, some domestic. But by-and-large, most large banks do not have existential problems for which only a merger would be the solution. Second and third-tier banks do, however. Stuck with vanilla business models, weak and undiversified earnings and with nowhere to go, it is these banks that are most



threatened by digital disruption and which should aim for consolidation.

Domestic consolidation is indeed the main banking M&A arena for now. Spain and Italy are showing a degree of dynamism in this respect. But against the relatively modest number and size of transactions, feverish combination scenarios appear excessive – especially transformational cross-border deals, which will remain elusive. On the other hand, “at long last, M&A is here” narratives from analysts and financial media (in which the profiles of the CEOs in question invariably have to play a part) help equity and debt price gyrations, which keep the markets busy – and therefore happy.

But in the end, the impact on sector fundamentals will not be that dramatic. Because the main water carriers across Europe do not seem that interested in transformational M&A.

Which is just as well, busy as they are with pursuing digital transformation or looking for smaller peers to buy. Boxed into a position of financial weakness, however, one or two of the large institutions (in Germany perhaps) may convince themselves to consider it.

Q4 results will probably shed more light on what can be expected in this area.



This report is published by Scope Insights, a Scope Group subsidiary which is separate from Scope Ratings. The content is an independent view not related to Scope's credit ratings.

Scope Insights GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

© Scope Insights

DISCLAIMER

© Scope Insights GmbH ("Scope Insights") produces independent and objective non-credit-rating-related research and opinions ("research and opinions"). Forward-looking statements are based on estimates, so the research and opinions do not constitute a factual claim; they merely express an opinion, which may subsequently change and may then be reflected in an altered research or opinion. Consequently, Scope Insights does not assume any liability for damage resulting from decisions taken based on any research and opinion it produces. The information contained in the research and opinions is derived from sources that Scope Insights deems to be reliable; it has been compiled in good faith. Nevertheless, Scope Insights cannot give any guarantee that the information used is correct, nor can assume any liability for the correctness, completeness, timeliness or accuracy of the research and opinions. The parties involved should only, if at all, regard such research and opinions as one out of many other factors in a possible investment decision; the research and opinions cannot replace the parties' own analyses and assessments. The research and opinions therefore only comprise the expression of an opinion with respect to quality and do not constitute any statement as to whether the parties to an investment could generate any income, recover any capital invested, or assume any specific liability risks. Scope Insights does not provide any financial, legal, tax, advisory or consultancy services and does not give advice on structuring transactions, drafting or negotiating transaction documentation. Scope Insights does not consent to being named an "expert" or any similar designation under any applicable securities laws or other regulatory guidance, rules or recommendations. Scope Insight's research and opinions are not a part of the credit analysis of Scope Ratings GmbH and do not represent the rating methodology of Scope Ratings GmbH. The research and opinions do not represent or constitute a credit rating, rating driver, or rating action and do not affect any of Scope's credit ratings. Managing Director: Florian Schoeller Commercial Register: District Court Berlin-Charlottenburg HRB 202433 B