European Banking Outlook for 2017 and Beyond: Balance Sheet Safety vs Profitability Challenges

Enhanced regulation and supervision continue to support European bank credit fundamentals, steering the sector towards safer business models, stronger capital and liquidity profiles, and benefitting financial stability. We expect these characteristics to prevail in 2017, which should be reassuring for investors in bank credit.

A year ago, Scope's European bank outlook noted that challenged earnings would remain the industry's Achilles' heel. This has indeed been the case, and we believe that banks will continue to face profitability challenges into 2017, as much higher capital levels are not matched by higher earnings.

Unlike other market observers, however, we do not simply blame the lower returns on tougher regulations and more proactive supervision. Our view is that insufficient earnings among European banks stem from: (i) low credit demand (especially from businesses) due to soft economic growth, (ii) ultra-low interest rates underpinned by highly accommodative monetary policies, (iii) the imbalance between supply and demand for financial services, and (iv) more risk averse management strategies. Our 2017 outlook report elaborates on all these aspects, as well as on emerging socio-political risks.

Key takeaways

Stronger supervision and regulation should continue to benefit bank creditors. Proactive, hands-on bank supervision should to some degree reassure investors that emerging problems are dealt with early on, including through capital increases or dividend suspensions as necessary (which would affect equity investors and protect credit investors). Resolution and bail-in remain very remote scenarios, well beyond the horizon of plausible investor concerns – notably for senior debtholders.

The sector is now well capitalised. We also see the new regulatory architecture coming to an end, and do not subscribe to those market views which fear further regulatory demand for higher levels of bank capital. We take European regulators at their word when they state that banks' capital requirements will not be significantly increased further. Our own view is that, on aggregate, the European banking sector's level of capital is reassuring, though the level may not be sufficiently ample for some on an individual basis.

Political risk is emerging as a key new challenge for bank and credit analysts alike. With upcoming elections in the Netherlands, France and Germany, and following the Brexit vote in 2016, political risk is moving to the front burner of concerns. This is all the more true with the forthcoming advent of a Trump Administration in the US. Euroscepticism is on the rise, feeding on citizens' disaffection towards European institutions, which they see as being remote and bureaucratic. In some cases, challenger parties openly question membership in the euro currency. Any electoral outcome resulting in doubts about the stability of the currency union would negatively impact banks.

Low volume/low margin headwinds will continue impacting European bank earnings. Volume growth remains subdued and margins are increasingly under pressure due to the ultra-low and flat yield curve environment. On the positive side, with the usual lags, improving macro conditions in 'peripheral' euro area countries are helping banks to recover or sell bad credits.

Analysts

Marco Troiano, CFA (author)
m.troiano@scoperatings.com

Pauline Lambert (co-author)
p.lambert@scoperatings.com

Chiara Romano (co-author)
c.romano@scoperatings.com

Michaela Seimen Howat
m.seimenhowat@scoperatings.com

Alexandre Jeanjean-Récamier
a.jeanjean-recamier@scoperatings.com

Jorge Fernández Montoto
j.fernandez.montoto@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Investor Outreach

Michael Pinkus
m.pinkus@scoperatings.com

Scope Ratings AG

Suite 407
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0452

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100
Service +49 30 27891 300

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

While banks have deleveraged, economies have not. Some deleveraging in selected countries' private sectors was more than offset by higher debt levels in the public sector. For now, the debt servicing of both public and private sectors is facilitated by ultra-low interest rates, but credit growth will likely have to remain below nominal GDP growth for several years before monetary policy can normalise.

Competition from fintechs threaten revenues. Every year, new fintech start-ups emerge with the potential to disrupt at least some part of the financial services value chain. Compared to banks, they offer more convenience and lower costs, and are rapidly winning over customers. Positively, banks can incorporate and adopt fintech processing and delivery in their infrastructure, preferring internal disruption of traditional branch-based business models to more threatening external disruption.

Profitability challenges (regulation, fragmentation, overcapacity, competition) are structural rather than cyclical in our view. It is becoming evident that double-digit returns will likely remain out of reach for most banks until the debt overhang is removed, the monetary environment normalises, cost structures are optimised, and the balance between credit supply and demand is restored. Until then, banking in Europe is and will likely remain a value-destroying business – as reflected by equity valuations.

More consolidation ahead. While many of the above factors are outside of banks' control, one avenue to restore a materially stronger bottom line would be via sector consolidation. Such a development, which seems to be increasingly supported by regulators – in addition to being encouraged and hoped for by the markets – would also help bank-equity valuations.

Business models need to be continually reassessed. Banks need to continuously re-evaluate their business lines and assess whether each can sustainably deliver acceptable returns through the cycle and determine which strategies to adopt to improve profitability. In doing such reviews, banks should be realistic about their revenue assumptions and acknowledge the above-mentioned headwinds. Some banks will benefit from a material downscaling of or exit from unprofitable activities where their competitive advantage is inconsequential. Material cost efficiencies are available to banks that can grab the opportunities offered by multichannel distribution, which may help support bottom lines.

Table of Content

Relatively stable rating outlook for 2017

Three years covering European banks and their securities

Scope publicly rates 26 banks in 11 European countries and EUR 1.6trn of bank securities including EUR 101bn in CRD IV compliant capital securities.

A majority of the rated banks' Issuer Credit-Strength Ratings (ICSRs) fall within the A category, reflecting our assessment that the credit quality of large banking groups in Europe has converged over the past few years. The large banks are subject to a single rulebook, a single supervisory mechanism and a single resolution regime.

The creation of a European banking union has levelled the playing field for the sector's large banks. Converging prudential requirements and capital levels supports the relative concentration of large European banks' ratings in the A range.

Over the past year, our issuer ratings have been stable, with a few exceptions: the upgrade of Crédit Agricole and the downgrade of Deutsche Bank, both driven by credit considerations. Currently, three banks have Positive Outlooks (Danske Bank, ING Bank and UBS) while one has a Negative Outlook (Deutsche Bank).

There were also selected rating upgrades after the publication of our updated bank rating methodology in May 2016, which addresses the ranking of senior unsecured debt eligible for, or allocated to, the minimum requirement for own funds and eligible liabilities (MREL) and/or total loss-absorbing capacity (TLAC).

In the methodology Scope notes that "as a general rule, all senior unsecured debt which may be specifically allocated or eligible for MREL and/or TLAC would be rated at least one notch below the ICSR – whether they are issued by a top holding company or an operating bank of the group."

The application of the updated methodology translates into a one-off uplift, by one notch, of the ICSR and the ratings for senior unsecured debt not eligible for MREL/TLAC. We have already enacted these upgrades for banks issuing MREL/TLAC debt through holding companies, e.g. UK and Swiss banking groups. We have also upgraded the ICSRs of the two German banks we cover, reflecting the statutory subordination of senior unsecured debt, which inherently enhances the safety cushion for liabilities and financial commitments not eligible for MREL/TLAC.

Stable outlook for bank ratings in 2017

For 2017, on aggregate, we see relative stability for our bank ratings, largely due to our forward-looking approach when we initially assigned them.

ICSRs will benefit from the issuance of MREL/TLAC debt

In line with our methodology, certain banks' ICSRs may be upgraded as banks issue MREL/TLAC debt, offering more protection for senior non-MREL/TLAC creditors. We expect this to be the case in the first instance for French and Spanish banks, and in function of developments for Italian banks as well.

Risks to this outlook relate primarily to the political situation in the major European countries, including the possibility of Eurosceptic movements gaining significant ground and causing funding disruptions for banks.

Figure 1: Scope's bank ratings

Bank	ICSR	Outlook	Senior unsecured		Short-Term Rating	Short-Term Rating Outlook	Capital securities	
			MREL/ TLAC eligible	Other			AT1	T2
Banco Santander SA	A+	Stable	A+	A+	S-1	Stable	BBB-	
Barclays Bank PLC	A+	Stable	A	A+	S-1	Stable	BB *(Barclays Plc)*	BBB+
BBVA SA	A	Stable	A	A	S-1	Stable	BB+	
BNP Paribas SA	A+	Stable	A+	A+	S-1	Stable	BBB	
BPCE SA	A+	Stable	A+	A+	S-1	Stable		
Commerzbank AG	A	Stable	A-	A	S-1	Stable		
Credit Agricole Group	A+	Stable	A+	A+	S-1	Stable	BBB- *(CASA)*	A- *(CASA)*
Credit Mutuel SA	A	Stable	A	A	S-1	Stable		
Credit Suisse AG	A+	Stable	A	A+	S-1	Stable	BBB-, BB+ *(CS Group)*	BBB+, BBB *(CS Group)*
Danske Bank A/S	A-	Positive	A-	A-	S-1	Stable	BB	
Deutsche Bank AG	A-	Negative	BBB+	A-	S-1	Negative	B+	
DNB Bank ASA	A+	Stable	A+	A+	S-1	Stable	BBB-	
HSBC Holdings PLC	AA	Stable	AA-	AA	S-1+	Stable	BBB	A
ING Bank NV	A	Positive	A	A	S-1	Stable	BBB-	
Intesa Sanpaolo SPA	A-	Stable	A-	A-	S-2	Stable	BB+	
KBC Group NV	A+	Stable	A	A+	S-1	Stable	BBB-	BBB+ *(KBC Bank NV)*
KfW[1]	AAA	Stable	AAA	AAA	S-1+	Stable		
Lloyds Bank PLC	A+	Stable	A	A+	S-1	Stable	BB+ *(Lloyds Banking Group Plc)*	
Nordea Bank AB	A+	Stable	A+	A+	S-1	Stable	BBB-	
Rabobank Group	A+	Stable	A+	A+	S-1	Stable		
Royal Bank of Scotland PLC[2]	A-	Stable	BBB+	A-	S-2	Stable		
Societe Generale SA	A	Stable	A	A	S-1	Stable	BBB-	
Svenska Handelsbanken AB	A	Stable	A	A	S-1	Stable	BB+	
Swedbank AB	A-	Stable	A-	A-	S-1	Stable	BB	
UBS AG	A+	Positive	A	A+	S-1	Positive	BBB- *(UBS Group)*	BBB+
Unicredit SPA	BBB+	Stable	BBB+	BBB+	S-2	Stable		

[1] KfW benefits from a guarantee by the Federal Republic of Germany.
[2] RBS benefits from a one-notch rating uplift due to the UK government's majority ownership
Source: Scope Ratings

More intrusive and transparent supervision should strengthen banks

A key feature of our credit risk analysis of banks is our focus on the supervisory process. This is based on the observation that, unlike in other sectors, default-like situations and credit losses for investors are determined by regulatory action, rather than the lack of immediate liquid resources.

As SSM matures, supervisory process to continue as source of strength

The supervision of large euro area banks in the post-crisis years has strengthened, moving from national responsibilities to the Single Supervisory Mechanism (SSM), and from a mostly procedural, box-ticking approach to a more proactive, intrusive presence. We see this as a current source of structural strength for the European banking system and one that is set to grow as the SSM becomes more established.

Process vs metrics

Compliance with capital requirements is (and will remain) important to the bank-supervisor relationship, but so is the continuous dialogue with respect to the business model, strategy, liquidity, governance and controls, and resilience to stress scenarios. The 'new normal' of supervision in Europe entails continuous two-way feedback between the SSM and banks.

In this environment, it is important for investors to move beyond simplistic comparisons of capital ratios and to understand the supervisory process in its entirety. For junior securities, credit risks could materialise before capital thresholds are formally breached. For example, supervisors can request at their discretion the suspension of coupon payments on Additional Tier 1 (AT1) instruments.

As the market for capital securities matures, investors will increasingly focus on the likelihood of discretionary supervisory action. As a result, we believe that investors will increasingly demand better disclosure with respect to the supervisory process.

Investors will demand more transparency with respect to supervisory process

The move towards better Pillar 2 disclosures in 2016 was a step in this direction. Historically, Pillar 2 decisions had not been disclosed, but in early 2016 euro area banks started publishing their capital requirements stemming from the Supervisory Review and Evaluation Process (SREP). This was a welcome development, although the disclosure initially caused some confusion among investors on the nature of Pillar 2, and hence to the Maximum Distributable Amount (MDA) threshold relevant for investors in AT1 securities.

For 2017, the SREP process will identify a separate Pillar 2 requirement and Pillar 2 guidance, with the latter not being relevant for the MDA calculation.

More capital is not always the answer

While the post-crisis years have seen a material increase in capital levels, we believe the regulatory push for more and more capital has come to an end. Banks are gradually converging towards the fully operational CRD IV regime, and in most cases have already met their requirements on a fully loaded basis, including CRD IV buffers. From a supervisory point of view, the banks still exhibit risks, as evidenced by the fact that all SSM-supervised banks rated by Scope had a Pillar 2 surcharge included in their SREP outcome.

While a Pillar 2 requirement may be a temporary safeguard and an incentive for banks to address their deficiencies, generally they are not sufficient to solve the underlying problem. Unprofitable and unsustainable business/funding models often need a material redesign, as well as adequate time for restructuring. Carrying an extra equity buffer can help reassure markets and stabilise market funding in the transition phase, but cannot be a substitute for fixing the underlying weakness.

Supervisors will not materially increase capital demands

Hence we expect the supervisor to use Pillar 2 decisions as a way to nudge bank management towards more resilient business models. At the same time, we believe supervisors will refrain from increasing capital levels much higher, as this could unnecessarily unnerve the contingent capital securities market and sink confidence in the wider market. Moreover, the marginal benefit of additional capital may be offset, in terms of financial stability and economic growth, by the negative impacts from a less profitable banking system and from reduced lending to the real economy.

Supervision to be proportional to a bank's systemic risk

Just as capital buffers are designed to enhance the resilience of potentially dangerous systemic institutions, the supervision of large and complex institutions is also more intense. Larger banks are directly supervised by the ECB, while less-significant institutions remain under the direct supervision of national competent authorities (although these are subject to the same supervisory framework). Cross-border institutions are supervised by colleges that coordinate the work of 'home' and 'host' supervisors. Crisis management groups bring together all the key authorities of a global systemically important bank (G-SIB), including its supervisor, central bank, resolution authority, finance ministries, and administrators of deposit-guarantee schemes.

For reasons we explain in the following pages, we think that European bank profitability will likely remain structurally low until excess capacity is removed. While this may be of concern to equity investors, we do not expect large losses that could challenge the credit fundamentals of large banks.

In fact, should a bank's financial performance start to deteriorate more materially, the institution would be subject to increasingly intrusive supervisory action. Early intervention measures by supervisors can be triggered by low SREP scores, material anomalies or other significant events. Measures could include heightened supervision, management change, asset sales, the request for capital increases, and suspension of discretionary payments (including coupons on capital securities), among others. In more severe circumstances, actions can include principal write-down or conversion of capital securities.

Unlikely for large EU bank to get close to resolution

Should the above actions fail to restore a bank to health, the supervisor could then place the bank into resolution and hand over responsibility to the relevant resolution authority. We, however, do not expect this to happen for any of the large banks we rate.

Regulation has been good for banks

The intensification of regulation and supervision since the financial crisis began has been positive for bank fundamentals. If we were to identify the most important driver of the past decade's build-up of European banks' capital, it would undoubtedly be the introduction of CRD IV.

Concerted efforts to finalise regulatory reforms

From the global level of Basel to the national level, we see that regulators are now striving to finalise the regulatory environment for banks. Though we are likely to get clarity at the international level early next year, precision at the national level is likely to take more time, as global standards will need to be enacted via the legislative process. For a more detailed account of the likely, upcoming regulatory changes for 2017 (and beyond), see Appendix 1.

As the development of new regulations comes to an end, we would expect regulators to shift their focus to implementation and supervision.

The resolution policy framework is also largely in place

Policies largely set; implementation in progress

The Financial Stability Board (FSB) considers that the development of policies to address the risks of G-SIBs is largely complete, but that implementation is ongoing. The final standard for TLAC was published in November 2015, and a consultation paper on the technical implementation of internal TLAC is expected by year-end. Further consultations on issues such as liquidity needs in resolution, operationalising bail-in, and continuity of access in resolution to financial market infrastructures are planned for end-2016/2017.

Over the last few years, G-SIB recovery and resolution planning work has progressed significantly[1]. However, work is still needed on the signing of cross-border co-operation agreements, the development of operational recovery plans and adherence to the ISDA Resolution Stay Protocol.[2]

G-SIBs make advances in implementing TLAC

Within EU, MREL implementation lags

To date, Japan, Sweden, the UK and the US have published policy proposals or consultation papers on the national implementation of TLAC; Switzerland has adopted final rules. The situation in Europe is more complex as the EU resolution framework includes a firm-specific requirement for MREL that applies to all banks. In May 2016, the European Commission adopted a delegated regulation on the criteria for determining MREL, which removed any explicit reference to the 8% minimum bail-in requirement and the 48-month limit for the transitional period, as contained in the EBA's draft regulatory technical standards.

Based on the EBA's interim report on MREL, we expect the European Commission by year-end to put forward a proposal to:

- **Merge MREL and TLAC requirements** such that G-SIBs in the EU would have the same MREL and TLAC requirements. This approach is being adopted by the UK: For UK G-SIBs, MREL will be set in line with the TLAC standard, and G-SIBs will not have a TLAC requirement that is separate or different from their MREL.
- **Base MREL on risk-weighted assets and the leverage-ratio denominator** rather than on total liabilities.
- Implement TLAC **subordination criteria** for MREL-eligible instruments into EU law.
- Specify the **position of capital buffers** in relation to MREL requirements and the treatment of capital-requirement breaches.

The above would effectively align MREL and TLAC requirements, making it easier for European G-SIBs to comply.

Within the EU, some jurisdictions have amended the insolvency creditor hierarchy

Unlikely to be a harmonised approach to TLAC subordination

The TLAC term sheet requires the subordination of TLAC-eligible instruments. To achieve this subordination, EU jurisdictions have taken varying approaches (Figure 2). We note, however, that not all jurisdictions have communicated their chosen approach, and there continues to be ongoing discussions on how this may be harmonised within the EU. The EBA has proposed that it should be made clear which liabilities are subordinated, but that the legal form of subordination can vary.

[1] Financial Stability Board. Resilience through resolvability – moving from policy design to implementation. 5th Report to the G20 on progress in resolution. 18 August 2016.

[2] Adherents to the protocol agree to be bound by temporary stays under identified resolution regimes with respect to their financial contracts (e.g. bilateral OTC derivatives contracts and securities financing transactions) with other adhering parties.

Figure 2: Different approaches to achieving subordination of TLAC instruments

Contractual	Statutory	Structural
• Subordination of debt is stated in terms and conditions • Examples: France, Spain	• Subordination of debt is determined by insolvency hierarchy • Examples: Germany, Italy	• Subordination of debt is due to bank structure (e.g. holding company vs operating bank) • Examples: UK, Switzerland

Source: Scope Ratings

French and Spanish G-SIBs likely to issue TLAC debt next

UK and Swiss G-SIBs have already started issuing TLAC debt, facilitated by their holding company structures and better regulatory clarity. Meanwhile, other EU G-SIBs have not yet issued these, though we expect French and Spanish banks to do so within the next year.

Transposition of BRRD in EU is nearly complete

Bail-in is a reality

Within the EU, the Bank Recovery and Resolution Directive (BRRD) has been fully transposed by practically all member states. Consequently, authorities have been granted the power to intervene in banks' operations in order to prevent failures. Also, in the case of failures, authorities have the power and the tools to restructure banks, to preserve the most critical functions, and to allocate losses to shareholders and creditors under a defined hierarchy.

The resolution process will hence apply to any resolvable EU bank that runs into very serious difficulties. At the same time, we stress that resolution is an 'extrema ratio', and is highly unlikely to be deployed in most cases. In the majority of circumstances, we expect that early supervisory intervention would restore a bank's viability, with credit losses unlikely for investors in the most senior layers of a bank's capital structure.

European deposit scheme still in proposal stage

A European deposit insurance scheme is being studied

In November 2015, the European Commission proposed a euro-area-wide insurance scheme (EDIS) for bank deposits as the third pillar of the banking union. The scheme would develop in three stages. The first would last for three years and consist of the re-insurance of national deposit guarantee schemes. Access to EDIS funds would only be available after a national scheme has exhausted its own resources. In 2020, the EDIS would become a co-insurance scheme and contribute from the first euro of loss. By the final stage in 2024, the EDIS would insure national deposit guarantee schemes in full. In addition, a European deposit insurance fund would be created from the outset and financed by risk-adjusted bank contributions. In October 2016, the European Commission issued a paper analysing the effects of the three options for setting up deposit insurance within the banking union.

Lack of political consensus makes EDIS unlikely in near term

However, debate continues as to whether the Commission's proposal is the most appropriate way to protect deposits and prevent bank runs. Opponents believe that more needs to be done first at the national level to strengthen banks, e.g. building up adequate buffers of bail-in-able liabilities, reducing sovereign risk on bank balance sheets, and achieving greater integration of economic policy, including a general insolvency regime. If these are necessary precursors to the EDIS, we are not hopeful that a European deposit insurance scheme will be forthcoming in the near future. At this time, economic policy and sovereign risk remain divisive issues.

Political risk: the increasingly real tail risk

From most viewpoints, the European banking system seems to have developed a high degree of resilience, driven by regulatory reform. In the absence of misguided errors in policy, banks' solidity should continue to strengthen despite the weakened profitability outlook.

Political risk is becoming more prominent

In our view, a major threat for European banks stems from the evolving political dynamics in Europe (and more specifically, in the euro area) and now in the US.

In 2016, scenarios previously seen as implausible, such as Brexit and the recent US election outcome, became realities, often with material consequences for banks and investors.

Looking forward, there are several major political events due to happen in 2017, from the Dutch elections in Q1 to French general elections in Q2 and the German federal elections in Q3. Italians are also voting on a major constitutional reform in December 2016, with the sitting prime minister heavily invested in the outcome.

One clear legacy of the long, protracted economic slump in Europe has been the steady decline in the popularity of established political parties – accompanied by the emergence of new actors on the political scene. The newcomers have capitalised on popular discontent toward political elites by posing as challengers of the status quo, including with respect to European institutions, which are often perceived as being distant and bureaucratic.

Threats to established political parties and institutions

In all major European countries, Eurosceptic sentiment has risen markedly, often accommodated by the rhetoric of challenging parties. To differing degrees, these parties have demanded change in the EU's structure and governance, at times openly threatening to withdraw from some of its institutions (including the single currency).

For the time being, these parties have not manage to oust incumbents, scoring minor political victories locally, but failing to establish themselves as governing parties. Nevertheless, their weight in national and EU parliaments has grown, and so has their influence on policy, as demonstrated by Brexit.

In the coming electoral year, we could see a further strengthening of these positions. We, however, still believe that these parties will be unable to seize executive power in the foreseeable future.

In any case, we highlight the risk that political news flowing around these events could disrupt confidence, and eventually funding markets in the shorter term, and advise that banks exercise caution when planning and executing their 2017 funding.

Over the longer term, we note that the pace of reform for EU institutions seems insufficient to deliver a more sustainable and inclusive economic growth model for all countries. Left unaddressed by fiscal and structural reforms, and with monetary policy nearing the edge of its effectiveness, the perception of the arrogance and inadequacy of EU institutions will continue to feed Euroscepticism across the continent and increase political risks. For countries in the EU currency union, the potential impact of this is likely to be more disruptive to economies and banks than Brexit will be for the UK.

Banking in a low-volume, low-rate environment

We expect credit volumes in Europe to remain stagnant for some time. Indeed, we believe that there is already more debt in the economy than can be serviced by current income in any normalised interest rate environment. The fast growth in credit in the decade preceding the crisis, which outpaced growth in income, was enabled by falling interest rates – especially in the euro area periphery – and sometimes by speculative excesses. Since the crisis, new loan production has slowed or stagnated, but so have incomes, while borrowers remain highly indebted.

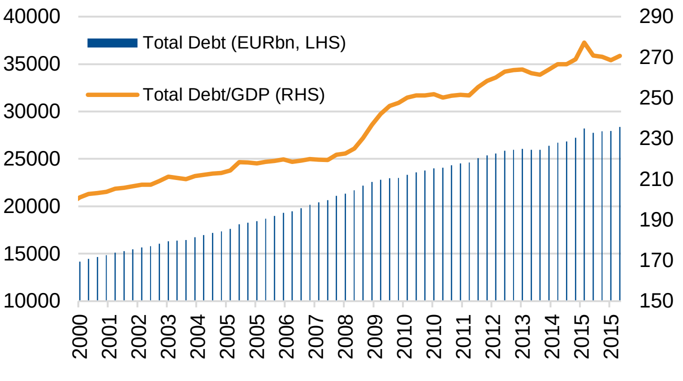
Banks have deleveraged, economies have not

Debt levels are growing, not shrinking

Data from the Bank for International Settlements (Figure 3) shows that total debt is still growing – both in absolute terms and relative to euro area GDP. What has happened is that as private-sector debt slowed, government borrowing increased (Figure 4). In other words, the economy as a whole has not deleveraged, it has simply reshuffled debt around. This situation is not unique to the euro area, and the same dynamic can be observed for other major countries outside of Europe (Figure 5). Within the euro area, trends differ by country. For example, private-sector debt has declined in Spain (especially in real-estate-related credit), while it has increased in France (driven by non-financial corporate borrowing). For the euro area as a whole, non-financial corporate debt has increased to 105% of GDP in March 2016 from 91% in March 2007. In the same period, household debt has increased marginally to 59% of GDP from 58%. Government debt in the euro area has risen to 107% of GDP from 70%.

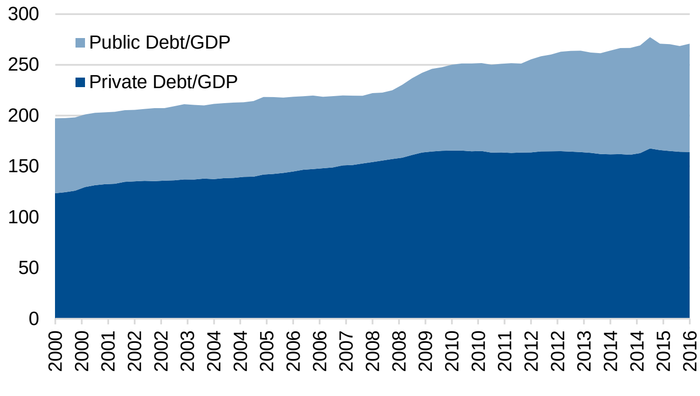
Hence, it is misguided to think that credit growth can resume when deleveraging ends. From a demand standpoint, the market for credit in Europe still looks saturated – there has been no deleveraging.

Figure 3: Total debt continues to increase in euro area



Source: BIS, Scope Ratings
Note: Total debt at market value, excluding financial sector

Figure 4: Public debt vs private debt in euro area



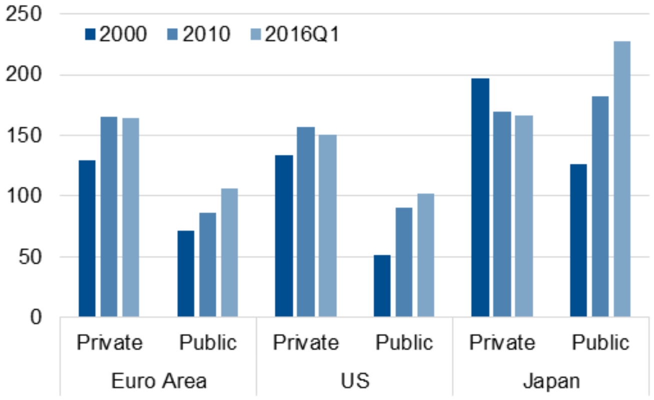
Source: BIS, Scope Ratings

Undeniably, leverage has declined among European banks. Without exceptions, banks carry more capital than they did ten years ago. Many of them have also shed assets. This is partly the result of more-stringent capital regulations, which have made some assets and activities less palatable from a return/capital absorption perspective; as mentioned above, this has been a key driver towards greater stability in the financial sector and the lower credit risk for banks.

No demand as there is still too much debt on the whole

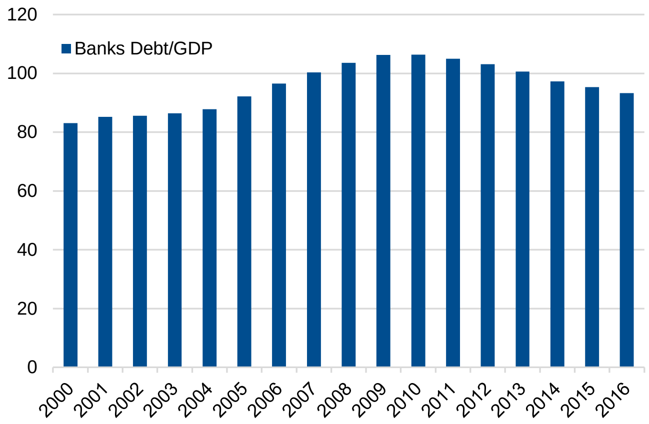
As a result, European banks now intermediate a lower share of credit than they did in the past. (although their role in credit intermediation remains more prominent than their counterparts in the US). On the whole, however, individuals, companies and governments in Europe still have too much debt and are unlikely to take on much more.

Figure 5: Private and public debt evolution



Source: BIS, Scope Ratings
Note: Total debt at market value, excluding financial sector

Figure 6: Euro area banks intermediate less credit



Source: BIS, Scope Ratings

Implications of low rates and flat yield curves

Interest rate declines have helped banks

Over the past few years, European banks have benefited from a very supportive monetary policy environment. Lower rates have boosted banks' profits in several ways, from cheaper funding to capital gains on marketable assets. Crucially, the low interest rate environment has supported banks' asset quality, by boosting the sustainability of the large existing debt stock, both for private- and public-sector borrowers.

Going forward, ultra-low interest rates are a headwind

Going forward, however, we believe positive impacts from the ultra-low interest rates have largely petered out, and that negative impacts will prevail from 2017. In essence, deposit margins are inevitably squeezed between declining market rates and the zero lower bound (whether nominal or effective). In particular, the room for further declines in funding costs is very limited, given depositors and institutional investors are unlikely to accept large negative returns on their investments.

Trading gains are inherently not repeatable, unless a new round of interest rate cuts takes policy and market rates more deeply into negative territory – which is unlikely in our view. Asset quality continues to be supported by low rates, and while we expect banks' balance sheets to continue improving, the impacts on P&L are marginally decreasing. On the other hand, many asset yields linked to interbank rates are still declining and will continue to do so in 2017.

A flat yield curve reduces opportunities to make profits

At the same time, a flatter yield curve has eaten away at a key component of banks' revenues: the term premium earned for performing maturity transformation.

The combination of the above elements poses serious challenges for bank profitability, with fairly limited room for a potential response. We have reviewed the strategies being pursued by banks in our recent report "Ultra-Low Interest Rates: A Threat and a Catalyst for Structural Changes in European Banking", and we believe banks can only sustainably support returns by aggressively reducing their cost base.

The monetary environment is unlikely to change

We expect the current environment to persist, as monetary policy remains loose, especially in the EA. If and when policy reverses course, we would expect normalisation to happen gradually and in phases. The speed and sequence of exiting from the current monetary policy will determine the impact on banks. In our view, the most likely exit sequence will be as follows:

1. **Asset purchase programmes are tapered and eventually terminated**, while policy rates are left very low (even negative). This should lead to a re-steepening of the yield curve, and to an increase in risk premia. In this phase, banks could suffer from trading losses on their security portfolios, while the better term structure should support front-book asset yields.
2. **Forward guidance is lifted; interbank rates start to price rate hikes.** This will support asset yields on variable-rate loan books. It will also likely increase banks' wholesale funding costs, but at the same time create some room for deposit margins to recover.
3. **Rate hikes.** Successive rate hikes would continue to support banks' net interest income (NII), in our view, as deposits are likely to adjust with some lag, especially in an environment of high liquidity and low competition for customer funds.
4. **Funding support for the banking system is gradually terminated.** The last TLTRO2[3] loans are due to be repaid in March 2021. By this time, banks should have completely cleaned up their legacy problems, be fully capitalised and compliant with a stable but demanding regulatory environment, and hence be able to fund autonomously in capital markets.

Difficult and slow exit from current monetary accommodation

We highlight that, at all stages of a possible exit strategy, the balance of risks will be skewed to the downside. Underlying deflationary forces (demographic, technological and distributional) outside the control of monetary authorities will persist. Sovereign-debt affordability (as well as the possibility of fiscal stimulus in Europe) rests on the very low borrowing costs of governments.

Finally, financial markets have become accustomed to cheap and abundant liquidity, and central banks' (artificial) support of asset prices. Withdrawing support too swiftly could precipitate a loss of consumer and investor confidence, pushing Europe back into recession and potentially eroding the equity base that banks have so painfully accumulated over the past decade.

For the above reasons, we believe the above process will be very slow, with central banks more likely to err on the side of too-loose rather than too-tight policies.

[3] Targeted Long Term Refinancing Operations

Why do investors buy negative-yielding instruments?

A cursory look at the euro-denominated fixed-income market reveals an uncomfortable picture: A large portion are trading with a negative yield. In the sovereign space, highly rated countries (like Germany, France, the Netherlands, Belgium, Switzerland, Finland and Sweden) can borrow at negative rates, even at long maturities (seven years). On the other hand, lower-rated countries, such as Italy, Spain, and many central and eastern European countries, have negative yields at short maturities (up to two years), and marginally positive ones at longer maturities. A vast majority of euro-denominated covered bonds trade at negative yields, and, more recently, unsecured corporate bonds issued by some banks (e.g. Nordea, Handelsbanken) and large corporations (e.g. Henkel, Sanofi) have pierced the zero threshold.

Investing in these securities and holding them to maturity is a guaranteed way to lose out, at least in nominal terms. We have identified three main reasons why investors buy negative-yielding securities:

- **Speculation that yields will drop further.** This is essentially a trading position based on the belief that someone else will buy these assets at an even higher price in the future. In the 2016 European version of the 'greater fool game', the greater fool is played by the ECB asset purchase programmes.
- **Cost of non-physical cash.** Many investors have fairly rigid mandates, giving them limited options. For a bond fund, for example, the choice tends to be between investing in high-grade bonds and cash, where cash is often a money-market deposit. Euro money-market rates closely track the ECB deposit rate (currently negative 0.40%); hence investing in a bond with a negative return actually still yields more than cash does.
- **Conflicting interests.** Arguably, if investing in bonds and maintaining a high cash allocation will likely destroy value for the final investor, asset managers should simply return funds to their owners. This does not always happen, due to the rigidity of mandates, as well as the incentive for asset managers to keep clients' assets under management. However, the low returns under current conditions will put pressure on asset managers' margins, in our view.

How can banks offset revenue pressures?

In 2017, revenue growth will be challenged by a lack of credit demand, low and flat yield curves, and competitive pressures driven by abundant bank liquidity.

Banks will try to offset profit pressure in several ways…

Banks are likely to pursue several avenues to counteract the pressure on their net interest income. While the strategies are diverse, as spelled out by each individual bank, they can be ascribed to the following four buckets:

1. **Volume-driven strategies**. These would include more capital allocation to faster-growing emerging markets, or aggressive market share grabs in developed countries.
2. **Pricing-driven strategies**. These would include trying to charge customers for deposits (at least up to a point) or increasing the loan mark-up to compensate for the lack of deposit margin.
3. **Business-mix shifts.** These would include actively targeting a change in the product or funding mix (for example, by moving away from low-margin secured lending into higher-margin unsecured lending), or making material changes to the funding structure in order to replace expensive forms of funding (subordinated finance) with cheaper ones (short-term, secured or central-bank-provided).
4. **Cost-driven strategies.** Last but not least, banks can acknowledge that revenue stagnation is a permanent reality and try to protect the bottom line by cutting costs.

We believe that all four strategies have merits in theory, as long as they are pursued in line with the business model of the bank. In practice, we think they have inherent limits, as they require capital, entail risks or because of competitive pressures.

…but most strategies have inherent limits

Figure 7 details several approaches that we expect banks will deploy in 2017, their expected impact on reported financials, and the main risks.

Whether these strategies (or a combination) would sufficiently offset the pressure from the headwinds mentioned above depends on:

1. The coherence between each bank's business model and starting point, and the (set of) chosen strategies.
2. The execution of the chosen strategy.

An emerging-market-focused, volume-driven strategy would be more suited to banks that already have a longstanding market presence, experience and customer data in many emerging markets; entering new markets and pursuing fast volume growth may add risks that banks may later regret. Pricing-based strategies are more likely to be effective in concentrated markets (Sweden or France) than in those that are highly competitive (Italy). Similarly, the returns from cost-driven strategies may be higher in some countries (Spain, Italy or Germany) where physical-distribution capacity remains material, compared to countries where distribution networks are already quite lean.

Figure 7: Selected strategies for supporting profitability

Strategy	Volume	Margin	Revenue	Profit	Credit Risk	Required Capital	ROE	Downsides
Volume growth – EM	++	+	++	++	++	++	+	Requires capital; credit risk
Volume growth - DM	+	=	+	+	=	+	+	Requires capital; competition limits
Pricing (loans)	=	++	+	+	=	=	+	Competition; slow repricing of back book
Pricing (deposits)	=	+	+	+	=	=	+	Competition; loss of customers/goodwill
Asset mix	=	+	+	+	+	+	+	Slow; entails risk
Liability mix	=	+	+	+	=	=	+	Funding risk
Wealth management push	-	=	+	+	-	-	+	Competition; decline in wealth management margin
Cost-cutting	=	=	=	++	=	=	++	Social issues; loss of customer goodwill/franchise value

Source: Scope Ratings

Structural challenges require a radical rethink of business models

In addition to monetary headwinds, banks face other challenges that will require changes in business practices. These include fragmentation in banking markets, new competitors, and higher compliance and regulatory costs.

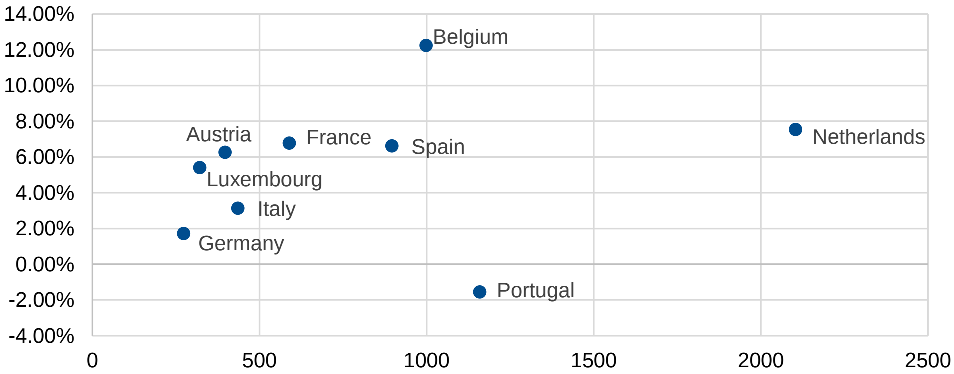
Fragmentation remains a key driver of low returns

Industry dispersion negatively impacts returns

In a mature industry with little room for growth, and where historically profitability had been driven by excessive leverage (now challenged by regulation), the capacity to adjust pricing assumes a greater importance in driving profit. However, ECB data show that the banking industry remains very fragmented in the EA, limiting the ability of banks to reprice.

Looking at bank returns across the EA, we note a degree of negative correlation between the returns of banks and the concentration within each country (Figure 8). While we are aware that some data may be explained by idiosyncratic factors, we think consolidation may help boost pricing, revenues, and eventually return-on-equity ratios in the more fragmented markets.

Figure 8: Herfindahl Index vs bank return on equity (2015)

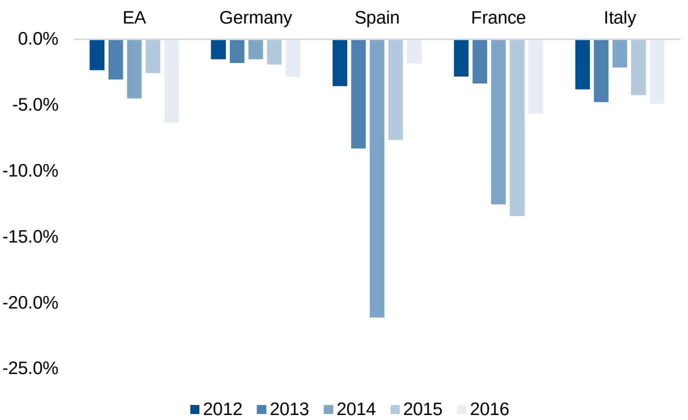


Source: ECB, Scope Ratings

Still room for sector consolidation in Italy and Germany

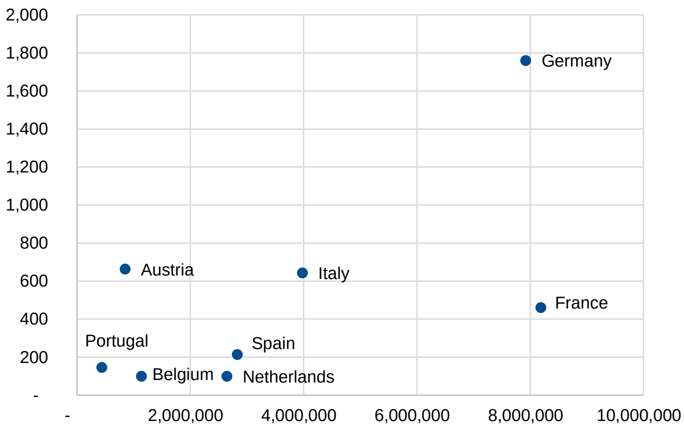
As shown by the ECB's data in Figure 9, the process is ongoing. The number of EU-based credit institutions has been falling across the euro area, but Italy and Germany are lagging behind. Spain has been consolidating at a faster pace, largely because the crisis has led to the mergers of a number of weaker banks.

Figure 9: Number of credit institutions and other deposit-taking corporations, YoY % change



Source: ECB, Scope Ratings

Figure 10: Number of credit institutions (y) and total assets (x, EUR m)



Source: ECB, Scope Ratings

Reform of popolari banks in Italy is a catalyst for industry M&A

For 2017, we see Italy as the country most likely to see deal announcements. The reform of popolari banks, as announced in 2015, has opened the door to consolidation within this segment, and the recently approved merger between Banco Popolare and Banca Popolare di Milano may be just the first in a long series of deals. In the short term, mergers would also support the bottom line through synergies, primarily on costs and branch-network restructuring.

Disruptive new competitors

Technological advances tearing down sector barriers to entry

Looking beyond 2017, a more formidable competitive threat lies with new entrants into banking or banking-related services. Technology and changing customer behaviour are creating opportunities for fintechs and wearing down the banking industry's historically high entry barriers. The trend in customers moving away from cash and towards electronic currency has undermined the importance of a capillary ATM network. The growing adoption of internet and mobile banking has rendered physical interaction with banking personnel largely unnecessary (if not an inconvenience).

Small, nimble financial services technology companies, or fintechs, do not carry the burdensome cost structure of traditional banks and can often out-compete the latter both on cost and convenience. Unaddressed, this cost advantage will likely drive business away from traditional banks and towards this new breed of competitor, adding a structural revenue-pressure component to banks' return equation. Fintechs have so far successfully targeted areas such as payments, currency transfers, trading and short-term SME lending.

However, fintechs are also starting to attract increased scrutiny from regulators. This is a welcome development – we think. With the banking system increasingly becoming regulated and supervised, more risk has been shifting from banks' balance sheets, towards the shadows of unregulated finance. This has sometimes included financial technology companies.

Banks need to adapt to changing landscape

Regulation and compliance costs will slow but not stop the advancement of fintech competitors. For banks to remain competitive, it is paramount that they embrace, rather than resist, the emerging technologies. These can bring about a much improved customer experience, as well as lower costs.

How do bank business models need to adapt?

Against such threats, banks will continue to review their business models and reassess their scope. Doing nothing is likely to lead to underperformance and a loss in market share. Depending on their activities, banks may find that they are unable to hold on to market share in every area; in which case, they may plan a profitable exit, possibly retaining a lesser part of the value chain where they feel they can defend their competitive advantage.

It is work-in-progress, but banks are adapting to deal with the challenges. These include right-sizing investment banking operations, reducing complexity and re-focusing retail-banking activities.

Right-sizing wholesale and investment banking activities

Regulations challenge WIB activities

Wholesale and investment banking (WIB) activities continue to be severely challenged by the higher requirements on capital, liquidity and leverage. Many European banks have materially reduced the scale of their WIB operations after the crisis, and this process is ongoing. Many have refocused their whole strategy on more-traditional retail- and commercial banking activities, while others have tried to maintain some profitable niches where they can defend their competitive advantage – whether domestic dominance or specialised expertise in selected business lines.

We believe the economics of secondary-market activities will be even more challenged going forward as technology increases liquidity and transparency, and as new regulations continue to burden returns from market-making, trading and brokerage. Meanwhile, the economics of primary investment banking should be more sustainable: companies will continue to need advisory services such as for M&A, Equity and Debt Capital Markets. The question is whether, with reduced or no secondary-market operations, banks will still be best-placed to provide such services, or whether these services will be taken over by boutique firms, issuing platforms, or the two combined.

Banks that rely on WIB revenues will have to strike the right balance between scale, scope, geographical reach, service level and cost in order to deliver adequate profitability.

Reduce complexity and become more focused

Transparency in revenues, costs and capital allocation are crucial to properly analyse various business lines and make the right business decisions. Crucially, it is also very important for supervisors and investors to assess risks in each business line. Large corporate-centre losses, or disproportionate risk-weighted-asset allocations are likely to raise eyebrows and attract increased scrutiny.

In the decade before the crisis, many banks aimed for a global universal-bank model. The value of such a business model is now regularly questioned, with many banks since reversing course. Banks are now generally targeting a handful of markets at most, where they can command a high market share and at least some degree of pricing power, as well as benefit from the in-market economies of scale (distribution or informational advantages). We also note that the additional regulatory burden of operating in several jurisdictions has increased materially. We expect banks with international retail franchises to look for exits where they are sub-scale, which could drive consolidation in some emerging markets, including eastern Europe and Latin America.

Generally we see business models evolving towards one of the following:

1. **Universal bank 'redux'.** Until 2007, many large European banks aimed at becoming a universal bank with an international reach. Today, banks have refocused and, going forward, we see even less acceptance for this model. However, the diversification benefits and cross-selling potential of the universal-banking model remain. We expect at least some of the banks we cover to continue providing a wide range of services to core corporate customers, including corporate finance, markets and advisory, but without a global ambition.
2. **Specialised, tailored banking.** Some banks will review the breadth of products and services offered, trying to focus on those with a more direct competitive advantage that fintech companies cannot easily attack, either due to a lack of expertise or brand. For example, we believe private-banking business models are inherently less exposed to cost-driven competition.
3. **Utility bank**. Some banks will review their vertical reach, potentially becoming distributors of third-party and more-efficient producers of commoditised financial services.

Some activities that are profitable but easy to replicate may need material investment in order to build or maintain a competitive advantage and to stave off competitors. Others areas where banks hold a material advantage may need to be restructured in order to salvage profitability.

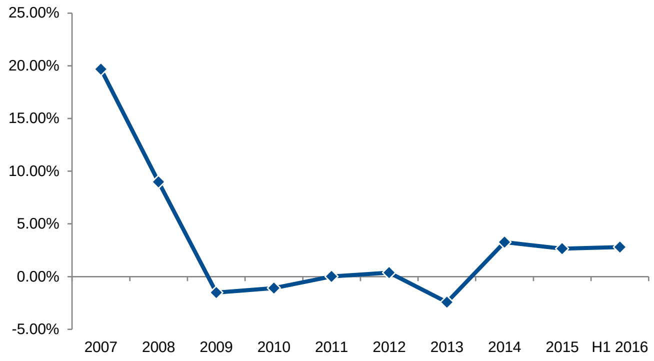
Outlook for bank balance sheets: continued strengthening

The credit quality of banks will continue to be supported by improving balance sheets. With little need to finance growth, capital and funding will continue to strengthen, while legacy asset-quality problems will continue to fade.

Loan growth will remain subdued

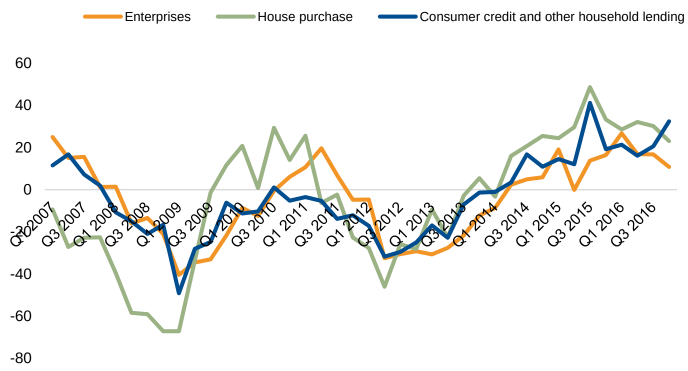
Loan growth in Europe will remain subdued. Lending surveys show that demand is improving (Figure 12), but we believe this is constrained by structural elements, including the large debt overhang from the previous decade. In recent years, loan growth for our sample of banks has been in the low-single-digit range. This includes higher volume growth for banks with a more material emerging-market exposure. For domestic banks in Europe, we believe loan growth is likely to be immaterial.

Figure 11: Net loans to customer growth (YoY)



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 12: Loan demand – weighted net percentage (QoQ)



Source: ECB lending Survey, Scope Ratings

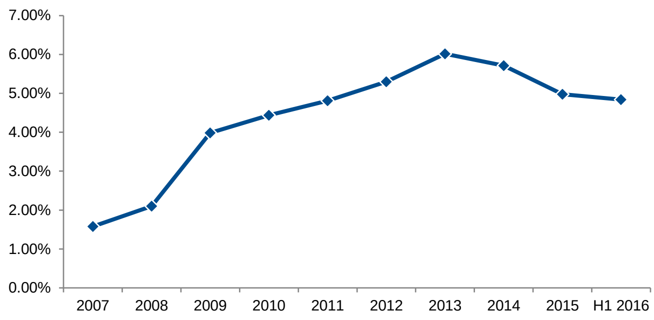
Asset quality has been improving over the last few years, underpinned by more-supportive macro conditions. Gross non-performing-loan (NPL) ratios may still increase for some banks, sometimes through the delayed recognition of problem loans, but we note that provisions have also improved materially, at times driven by supervisory requests. In our sample, the average net NPL ratio peaked in 2013, and has since declined (Figure 13). Similarly we note that net NPLs are increasingly well covered by capital (Figure 14).

A few more problematic pockets of asset quality remain, for example, in Italy, but even there we believe we are past the peak of the NPL cycle. In some countries, such as Spain, NPL sales have helped remove problematic assets from banks' balance sheets, materially supporting earnings visibility.

Asset quality to improve, especially in euro area periphery

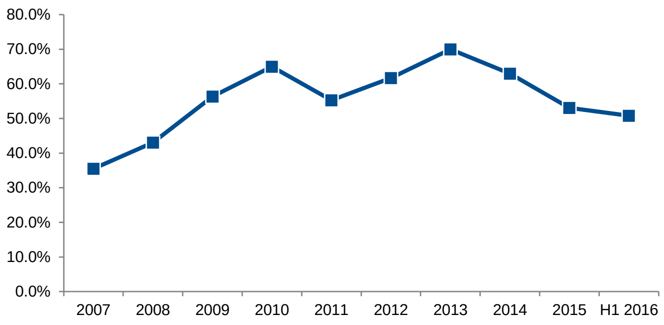
We expect these trends to continue into 2017. Continued macro strength will boost recoveries and slow the inflow of new NPLs. The continued modest rise in European house prices should also support asset quality in real estate portfolios. Moreover, we note that the increased supervisory focus on asset quality may lead to a few banks raising their provisions (and capital).

Figure 13: Net NPLs % net customer loans



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 14: Texas ratio (net NPLs % CET1 capital)



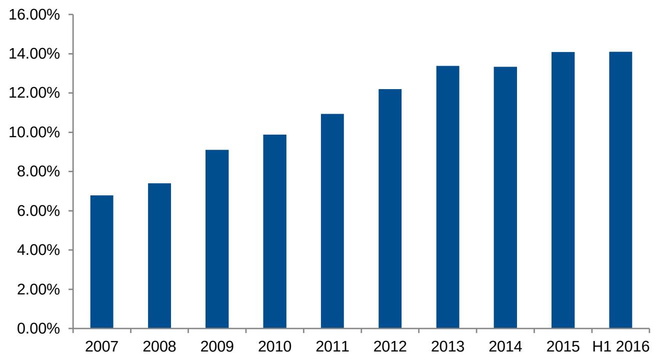
Source: SNL, Scope Ratings
Note: Transitional provisions with the exception of Nordea, Swedbank, Handelsbanken and SEB
Note: for peer group composition, see Appendix 2

The significant build-up of bank capital over the past decade is probably one of the key achievements of regulators. Since the beginning of the crisis in 2007, capital ratios have more than doubled (Figure 15). Moreover, the quality of capital has also improved. This has been driven by the implementation of Basel III in Europe, through the Capital Requirements Regulation (CRR) and CRD IV. Common equity tier 1 (CET1) buffer requirements are currently being phased in (through 2019) and the grandfathering of hybrids due to end in 2021. However, under pressure from investors, European banks have already anticipated most of the requirements, and we believe capital levels may be plateauing.

Capital levels to plateau, but quality of capital is still increasing

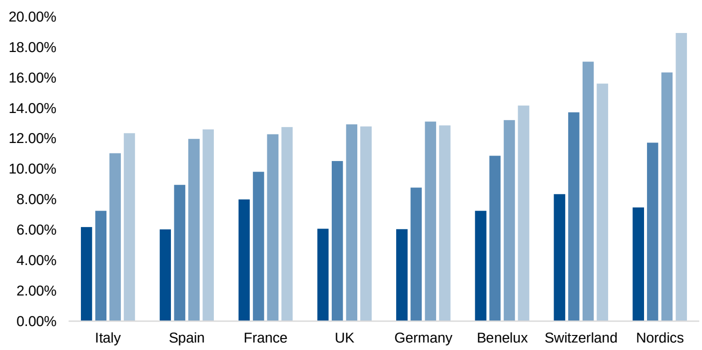
That said, we do expect further improvements in the quality of capital, as banks gradually replace old-style Tier 1 instruments with CRD IV-compliant, higher-quality AT1 instruments. We also note the material variation among the capital ratios reported by different banks. Often these are driven by supervisors imposing higher requirements through Pillar 2 decisions, in order to reflect specific risks, as is the case in some Nordic countries.

Figure 15: CET1 ratio (%)



Source: SNL, Scope Ratings
Note: Transitional provisions with the exception of Nordea, Swedbank, HSB and SEB
Note: for peer group composition, see Appendix 2

Figure 16: Transitional CET1 by region (2007, 2010, 2013, H1 2016)

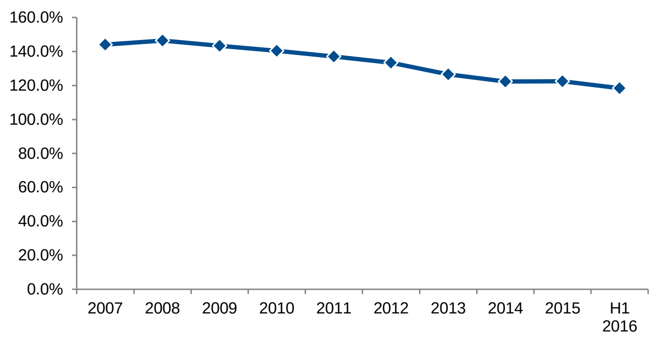


Source: SNL, Scope Ratings
Note: Transitional provisions with the exception of Nordea, Swedbank, Handelsbanken and SEB
Note: for peer group composition, see Appendix 2

Funding profiles continue to strengthen

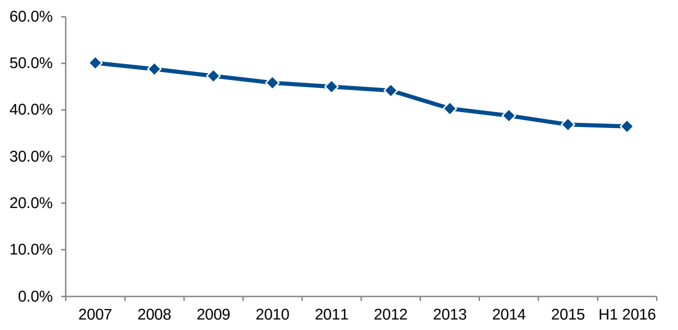
The funding profile of banks has continued to improve year after year. The average loan-to-deposit ratio for our sample of banks has declined from over 140% to c. 120% (Figure 17). Similarly, banks' reliance on wholesale funding has dropped, while the stability of their wholesale funds has increased materially (Figure 18). As of today, wholesale funding mostly comprises long-term senior financing, capital instruments and covered bonds, with less reliance on short-term market funds. This development is also the result of the significant funding available from central banks, often at advantageous rates. We expect the current trends to persist.

Figure 17: Gross loans % total deposits



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 18: Wholesale funding % total funding



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Regulatory value and cost will drive funding strategies

Against a backdrop of stagnant volume growth, we expect banks' issuance to be largely limited to refinancing needs.

However, we do not expect banks to simply refinance maturing debt with like-for-like instruments. In particular, we expect issuance to be concentrated in instruments with either high regulatory value or low costs.

Most banks we rate have yet to fill their AT1 and Tier 2 regulatory buckets, and this is more so for smaller institutions. Provided there is market appetite for these instruments, we expect significant issuance in this space.

With the clarification of MREL/TLAC requirements, we also expect banks to increasingly issue MREL/TLAC-eligible instruments. For banks in the UK and Switzerland, and more generally for banks with a holding company structure, senior issuance is likely to come primarily from the holding company, gradually replacing operating-company, non-MREL/TLAC-eligible debt. Similarly, we believe the requirements for contractually subordinated senior debt in France and Spain may drive the first issuance of MREL/TLAC senior debt in these countries.

From a rating perspective, such issuance activity would support the senior part of the capital structure. As discussed in our report "Ranking of MREL/TLAC Senior Unsecured Debt: Roadmap of Scope's Bank Rating Adjustments", we will reflect such support by upgrading the ICSR and the ratings of senior unsecured debt not containing a subordination clause for banking groups in Spain and France.

As the issuance of subordinated debt negatively impacts funding costs, some groups may increase the use of cheap available finance, including central-bank-provided funds and covered bonds.

Issuance of plain-vanilla senior unsecured debt without any regulatory value is likely to be rarer, we believe.

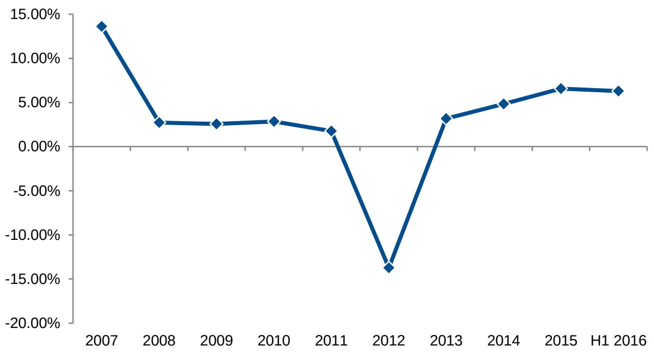
Outlook for bank profitability: challenges remain

Profitability too low for shareholders but banks are safer

The profitability of European banks has improved materially since the crisis; returns, however, remain unsatisfactory (Figure 19). The average European bank has a return on equity in the mid-single digits, does not cover its cost of capital, and is a value-destroying operation (from a shareholder's perspective). The scale of such value destruction is, however, debatable. As banks have become safer businesses, we argue that a lower cost of capital should follow, reflecting the more stable cash flows. Banks are, of course, and will remain cyclical businesses, with fortunes invariably tied to the economies in which they operate. However, with the new regulations effectively limiting their appetite for risk, we believe the fluctuations in their earnings should be less than they used to be.

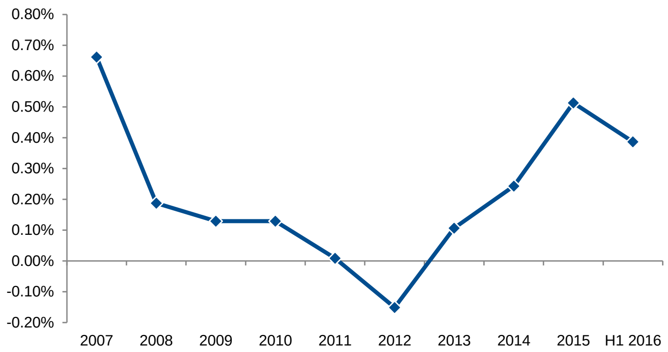
That said, we do not expect profitability to improve much in 2017. In addition to persistently high provisions for some banks, we believe the overall sector faces more challenges than tailwinds. Structurally higher capital levels, rather than cyclical factors, have been the cause of the structural decline in returns.

Figure 19: Return on average equity



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 20: Return on average assets



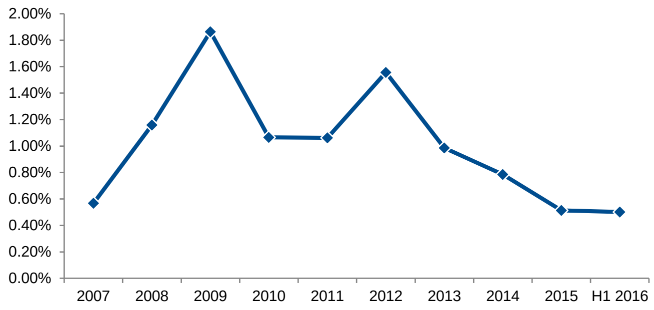
Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Sector's return on assets is close to its cyclical peak

In fact, the sector's return on assets is close to its cyclical peak (Figure 20), driven by a very low cost of risk. Loan-loss provisions have declined for several years, and further room for decline is limited – Italy being the sole exception among large European countries.

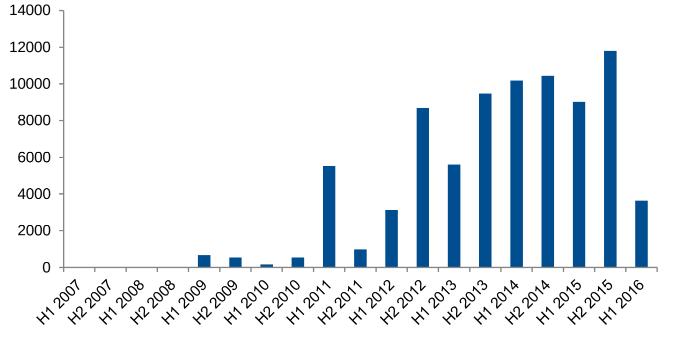
Moreover, the cost of legal settlements remains very material (Figure 22); and while we may be moving closer to the end of the fines and provisions stemming from the financial crisis, next year we will probably still see several-billion euros of new fines being announced. Important outstanding sources of litigation risk include investigations relating to US residential mortgage-backed securities (impacts those with investment banking operations), costs to compensate misspelling of payment protection insurance in the UK (for those with UK operations), and trade-sanction violations (e.g. related to Iran and Russia). Once the backlog of crisis-related misconduct is resolved, we may start to see these costs declining, reflecting a change in banking culture in the post-crisis years, although regulators are likely to remain vigilant towards potential misconduct by banks.

Figure 21: Cost of risk has fallen materially



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 22: Legal settlements (EUR m)



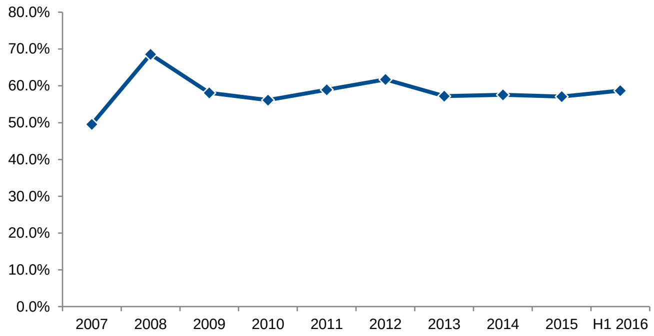
Source: Company data, Scope Ratings
Note: RBS, HSBC, BNP, Barclays, DB, UBS, CS, SG and Lloyds
Note: for peer group composition, see Appendix 2

For the next year, we expect declining risk provisions will not provide much support to the bottom line; returns will instead be driven by revenues and costs.

Going forward, revenues may suffer

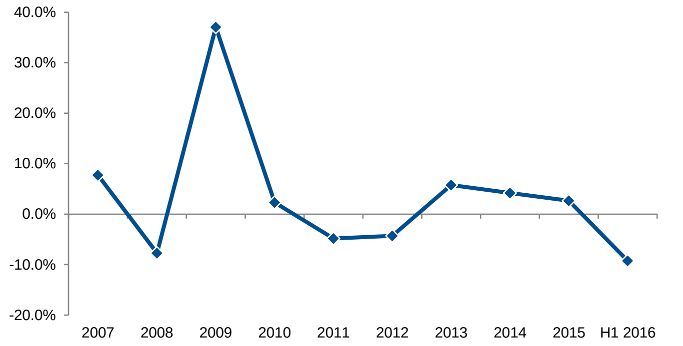
As we discussed above, we believe net interest income, which makes up 60% of banks' revenues on average, faces considerable challenges that will extend well beyond 2017. Without volume growth and with revenue margins under pressure from both an ultra-accommodative monetary environment and low-cost competitors, sector revenues will likely stagnate. For some players, retrenchment from non-core investment banking and/or foreign activities will only add to top-line pressures.

Figure 23: NII % total revenues



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

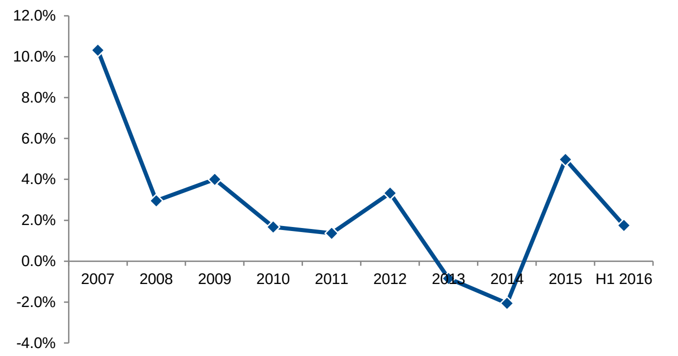
Figure 24: Revenue growth (YoY)



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

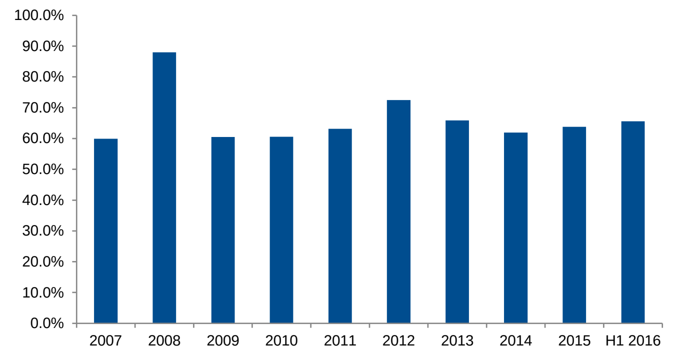
Against such a difficult revenue environment, we expect management to keep cost growth on a tight leash. For 2017, this may be the main avenue that banks have to protect already unsatisfactory profitability from external downward pressure. Indeed, without a rolling-back of the high capital requirements imposed in the past decade (which is impossible, in our view), further efficiency gains seem the only way to restore an acceptable level of returns.

Figure 25: Cost growth (YoY)



Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

Figure 26: Costs % income



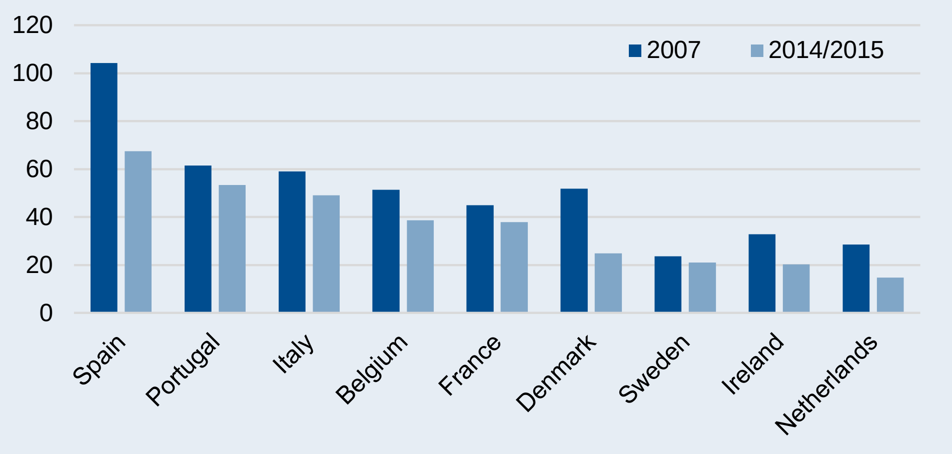
Source: SNL, Scope Ratings
Note: for peer group composition, see Appendix 2

The role of branches in the bank-customer relationship

Changing bank-customer behaviour and pressures on profitability are leading to a fundamental review of traditional distribution models. While the physical branch still represents a critical contact point for a customer, especially in the acquisition phase, it is losing importance in day-to-day interactions.

With the aim of optimising distribution and cutting costs, banks will continue to reduce and rationalise their branch networks, as they have already done in the past few years. This trend is evident in Figure 27: Data on 590 EU-based banks show how the total number of branch locations reported has dropped from above 44,000 in 2013 to 41,600 in 2015, with the average size of each branch, calculated by number of employees, slightly increasing.

Figure 27: Branch density (branches per 100,000 adults), selected countries



Source: IMF Financial Access Survey Data, Scope Ratings
Note: for Portugal, Sweden and Netherlands, latest data available is from 2014

This process has not been uniform across Europe. Relative measures on branch density still show significant cross-border disparities and hence room for manoeuvre in a number of countries.

Symmetrically, the increasing demand for mobile- and internet-banking services means banks are reinvesting part of their cost savings in digital transformation. This requires substantial one-off initial costs, with benefits materialising with some lag.

Appendix 1: Bank regulation: what remains to be done?

Final Basel reforms expected early next year

Reforms to reduce variability in risk-weighted assets

In 2012, the Basel Committee on Banking Supervision (BCBS) initiated a comprehensive evaluation of the risk-weighted capital framework, including reviews of the banking book, the trading book and operational risk. Early next year, we expect the BCBS to put forward a package of revisions to the Basel III framework. The revisions will especially aim to improve the comparability of bank capital ratios, by reducing excessive variability in risk-weighted assets. At the same time, the revisions should not significantly increase overall capital requirements as directed by the BCBS's oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS).

Reforms expected to be toned down from initial proposals

Consequently, we expect the final revisions to be toned down from the initial proposals published between December 2015 and April 2016.[4] Banks that are 'outliers', however, are still likely to be impacted by the final revisions. In arriving at decisions, the BCBS considers the feedback it receives on proposals and uses the analytics available from quantitative impact studies, with input coming from over 200 banks globally.

In recent public comments,[5] William Coen, secretary general of the BCBS, emphasised that the process is consensual and that there have been significant changes to the initial proposals. He has indicated, for example, that business divestments and insurance cover are likely to be considered in regards to operational risk and that the use of internal models will be allowed for certain portfolios.

We expect the final revisions to be presented as a 'package' of reforms, as they are more effective in combination than in isolation. Below are key pieces of the BCBS work programme that remain outstanding:

- **Revisions to the Standardised Approach and constraints on the use of internal model approaches for credit risk** – part of the banking book review. The proposals: (i) exclude the use of internal models for certain exposures (banks, large corporates, specialised lending and equity), (ii) introduce floors on key parameters such as probability of default, exposure at default and loss given default in internal models, and (iii) establish new risk drivers for unrated exposures as well as residential mortgages and commercial real estate under the Standardised Approach. While the current Standardised Approach applies a risk weight of 35% for all residential mortgages, the proposal suggests using the loan-to-value ratio to determine a risk weight ranging from 25% to 120%; this is particularly relevant for EU banks.
- **Credit Valuation Adjustment risk framework** to address the risk of a variation in the price of counterparty credit risk embedded in derivatives in the trading book – part of the fundamental review of the trading book. This is relevant for only a few large banks and generally accounts for less than 2% of risk-weighted assets.
- **Operational risk framework.** The proposal replaces the current internal modelling approach with a new standardised measurement approach, which considers bank-specific operational-loss experience. This new approach would have a particular impact on banks with high historical misconduct costs.
- **Review of existing capital floor based on standardised approaches.** The Basel II framework introduced a capital floor to ensure the capital requirements of banks using the internal ratings-based approach would not fall below a certain percentage of capital

---

4 Revisions to the Standardised Approach for credit risk, December 2015. Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches, March 2016. Standardised Measurement Approach for operational risk, March 2016. Revisions to the Basel III leverage ratio framework, April 2016.

5 Panel discussion at the 2016 Annual Membership Meeting of the Institute of International Finance, Washington DC, 7 October 2016. Remarks made at meeting with the European Parliament's Committee of Economic and Monetary Affairs (ECON Committee), Brussels, 12 October 2016.

requirements under the previous Basel I framework. A potential capital floor of 60-90% is being considered. The current level is 80%, although not all jurisdictions have maintained the option of using the floor.

- **Leverage ratio.** Amendments are being considered for the calculation of the leverage ratio. In addition, the proposal introduces a higher requirement for G-SIBs, above the minimum 3%. The proposal also considers whether the use of AT1 capital should be limited to meeting the requirement; whether the G-SIB additional requirement should be fixed or vary by bank; and whether the higher G-SIB add-on should be considered a minimum requirement or a buffer.

Issue of sovereign risk weights likely to remain outstanding

- **Sovereign risk.** While included in the BCBS's 2015/2016 work programme, no proposal has been communicated. We are not confident that a proposal will come shortly, given the sensitivity of the issue. While the BCBS has indicated that CRD IV/CRR is materially non-compliant with Basel III regarding the credit risk approach for sovereign risk, we do not believe the EU would move forward on this issue without first receiving further guidance from Basel.

Move to IFRS 9 may not impact capital initially

In addition, the BCBS is consulting on accounting provisions due to the move to expected-credit-loss models from incurred-loss models (e.g. IFRS 9). The proposal suggests to keep the current regulatory treatment of provisions for an interim period to allow time to assess the implications for regulatory capital and introduce transitional arrangements for implementation.

Europe also keen to stabilise the supervisory and regulatory framework

In recent months, European regulators have been more outspoken on their concerns related to potential BCBS reforms. We expect the views of European regulators to be reflected in any final Basel reforms. This further leads us to believe that final revisions to the Basel III framework will be softened. About a third of the BCBS's members are from the EU, including the European Central Bank, the Single Supervisory Mechanism and the European Commission. The BCBS, when making major decisions, also seeks endorsement from its governing body, GHOS, which comprises central-bank governors and heads of member-country supervisors.

Basel standards need to be adapted for EU banks

Further, as Basel standards are designed for large internationally active banks, they need to be adapted for the EU's over 8,000 banks, many of which are national or regional.

CRD IV/CRR review closely linked to Basel III framework review

By the end of this year, the European Commission is expected to finish its review of the CRD IV/CRR and to propose amendments. As potential revisions to the Basel framework are a key driver for the review, the outcome will depend to some extent on decisions made at the Basel level. We see, however, limited appetite in Europe to increase banks' capital requirements.

Implementation process is ongoing

Within the EU, the implementation of Basel standards would begin when the European Commission makes a proposal to the Council of the European Union and the European Parliament. The latter two entities would consider the proposal and then decide on whether to adopt legislation. In addition, the three European supervisory authorities (EBA, ESMA, EIOPA) will provide their view on the issues to the European Commission and are important contributors to the process. For further details, please refer to our publication "How Do EU Financial Regulations Come About? Status of the CRD IV/CRR Review".

In addition to risk-weighted asset variability, several other key issues are still moving through the EU legislative process, as detailed below.

Net stable funding ratio (NSFR)

In October 2014, Basel published the final standard, with implementation from January 2018. In December 2015, the EBA recommended a NSFR of at least 100% on an ongoing basis (in line with Basel) but with some European specificities regarding its calibration. In May 2016, the Commission launched a consultation on further considerations, e.g. whether implementation would have an excessive impact on specific activities such as covered bond issuance and trade-finance activities, and whether the principle of proportionality should be applied.

Leverage ratio

In August 2016, the EBA recommended a mandatory Pillar 1 minimum of 3%, based on Tier 1 capital from January 2018 (in line with Basel). In its study, around 9% of credit institutions analysed had a leverage ratio below 3% as of 30 June 2015, with an aggregate Tier 1 capital shortfall of EUR 6.4bn. The EBA also considers that a higher requirement may be warranted for global systemically important institutions, but the pending decisions at BCBS level need to be taken into account.

Interest rate risk in the banking book

In April 2016, the Basel standards were published, with implementation planned by 2018. The new standards update the principles governing the management of interest rate risk in the banking book, with more extensive guidance, stricter supervision and enhanced disclosed requirements, but do not go as far as imposing a Pillar 1 requirement on interest rate risk. CRD IV/CRR would need to be amended to incorporate the revised framework.

Market-risk capital framework

In January 2016, Basel published a revised capital standard for market risk, stemming from the fundamental review of the trading book, with final implementation by January 2019. Key features of the revised framework include revised rules for the use of internal models, a new standardised approach, a shift from value-at-risk to an expected-shortfall measure of risk under stress and the incorporation of market illiquidity risk. In November 2016, the EBA published a report in response to the Commission's call for advice. In particular, the EBA recommended introducing greater proportionality in the framework.

Pillar 2

The Commission has undertaken a review of the MDA mechanism in relation to AT1 securities and the function of Pillar 2. In August 2016, the Commission's Expert Group on Banking, Payments and Insurance considered options for a possible clarification of EU rules concerning Pillar 2. If adopted, some of these clarifications would be supportive of the AT1 market, e.g. the prioritisation of AT1 coupon payments and the obligatory disclosure of Pillar 2 requirements. For further details, please refer to our publication "AT1 Bank Securities: Latest Developments Reassure".

Large-exposures framework

In October 2016, the EBA published a response to the Commission's call for advice to align certain aspects of the EU large-exposures regime with Basel standards, for example, to strengthen the large-exposures capital base by limiting it to Tier 1 capital, to reduce the limit to 15% for G-SIB exposures to other G-SIBs, and to remove certain exemptions, subject to the discretion of competent authorities.

Appendix 2: Peer group

Peer group for this report – 40 banks	
Publicly rated by Scope	**Not publicly rated by Scope**
Barclays	ABN AMRO
BBVA	Allied Irish Banks
BNP Paribas	Banco Popolare
Commerzbank	Banco Popular
Credit Agricole	Bank of Ireland
Credit Mutuel	Bankia
Credit Suisse	Caixabank
Danske Bank	CGD
Deutsche Bank	DZ Bank
DNB	Erste Bank
Groupe BPCE	La Banque Postale
Handelsbanken	Sabadell
HSBC	SEB
ING Bank	UBI Banca
Intesa	
KBC	
Lloyds	
Nordea	
Rabobank	
RBS	
Santander	
Societe Generale	
Swedbank	
UBS	
Unicredit	

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Rüsterstraße 1
D-60325 Frankfurt

Phone +49 69 97944 754

Paris
21, Boulevard Haussmann
F-75009 Paris

Phone +33 1 53 43 29 89

London
Suite 407
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

info@scoperatings.com
www.scoperatings.com

Disclaimer