2020 European Bank Outlook

Over the hills but far away from a profitable future

Financial Institutions, Scope Ratings GmbH

Executive summary

In 2020, Scope expects the credit quality of western European banks to come under some pressure, due to continuing low or negative rates, flat yield curves and low GDP growth in the wake of global trade frictions. In addition to the general economic factors affecting bank operations globally, the European sector is dealing with a mounting list of specific challenges that will eventually weigh on credit ratings if left unresolved.

- Fragmentation along national lines within the euro area and a lack of consolidation in major markets such as Italy or Germany remain key obstacles to a more profitable banking sector in Europe. Despite isolated attempts in Germany, there was no material progress in 2019 and there is no indication that 2020 will be any different, with shareholders baulking at the cost of consolidation and its limited upside.
- Digitalisation continues to reshape banking markets in Europe, spurred by regulatory changes such as PSD2 and by new market entrants with cheaper and more effective technologies. We expect the arms race between banks and technology providers to intensify during 2020, widening the competitive gap for small banks and those with expensive legacy operations. A second, already well-advanced race with criminals and rogue states is underway in the area of cyber security, a major operational risk for banks and investors alike.
- Conduct risk remains a source of irritation for investors and regulators. It has led to the outright failure of smaller banks, while larger banks have suffered substantial reputational and financial damage, at times limiting their access to capital markets. With several large cases related to money laundering and tax fraud pending, we expect conduct risk once again to prove expensive for banks in 2020.
- Climate transition risks will intensify for banks as governments adopt new policies to combat global warming. Bank asset portfolios are heavily exposed to downstream ‘brown’ risks, on which, regrettably, disclosure has so far been limited. Instead, banks are positioning themselves as part of the solution by expanding their green and sustainable bond offerings. In 2020, we expect policymakers to step up the pressure on investors and banks to improve clarity on their current and future investments related to climate transition.

Financial Institution Ratings Team

Dierk Brandenburg
Managing Director, Head of Financial Institution Ratings
d.brandenburg@scoperatings.com

Marco Troiano
Deputy Head
m.troiano@scoperatings.com

Pauline Lambert
Executive Director
p.lambert@scoperatings.com

Jennifer Ray
Executive Director
j.ray@scoperatings.com

Chiara Romano
Senior Analyst
c.romano@scoperatings.com

Alvaro Dominguez
Associate Analyst
a.dominguez@scoperatings.com

Alessandro Boratti
Associate Analyst
a.boratti@scoperatings.com

Chai Kumar
Associate Analyst
c.kumar@scoperatings.com

Andre Hansen
Analyst
a.hansen@scoperatings.com

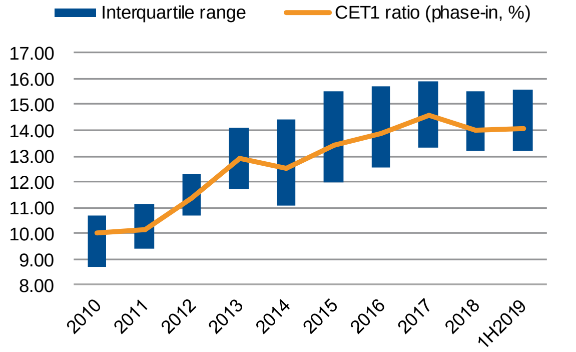
Key themes for 2020

Fundamentals aren't forever

Despite ongoing concerns about bank profitability in Europe, 2019 brought relief for banks on several fronts.

Bank balance sheets emerged unscathed from the very sharp deterioration in global financial conditions at the end of 2018. Capital levels among large banks withstood the volatility and ensuing slowdown in global GDP growth without any lasting damage. Strong supervision and high capital remain the key pillars of European bank ratings in this environment.

Figure 1: CET1 ratio (%)

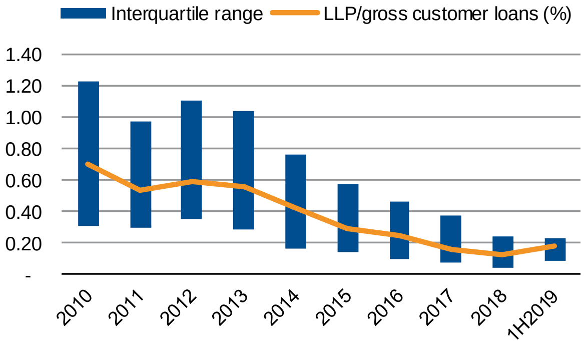


Source: SNL, Scope Ratings

Banks in southern Europe also improved asset quality, thus addressing a significant part of the legacy of the euro area crisis and despite weaker GDP growth.

This has led to a significant decline in the cost of risk in Europe, though data from the first half of 2019 suggest that the trend may have bottomed out. Banks reporting to the EBA since mid-year have shown a slower decline in NPL ratios. Faced with slowing growth, global trade wars and Brexit, banks are anticipating deteriorating asset quality for most of their loan portfolios. At the same time, many banks are planning to increase volumes to counter margin pressures, e.g. in SME and consumer lending, which may cause problems further down the line.

Figure 2: Loan loss provisions, % of gross loans



Source: SNL, Scope Ratings

Thus, the primary question for 2020 is whether the trend in asset quality will reverse. This is especially relevant in the core euro area as well as in Scandinavian and UK markets, where loan growth has been strongest in recent years. The latter two markets are also dealing with specific issues related to their export-oriented manufacturing bases and high household leverage.

New accounting standards under IFRS9 as well as tougher regulatory guidance on NPL provisions, e.g. by the ECB from 2020, are pointing to more pro-cyclical provisioning by banks next year, which are set to meet structurally lower pre-provision income levels. Therefore, even a small deterioration in asset quality could lead to a big drop in profitability.

Shareholders want their money back

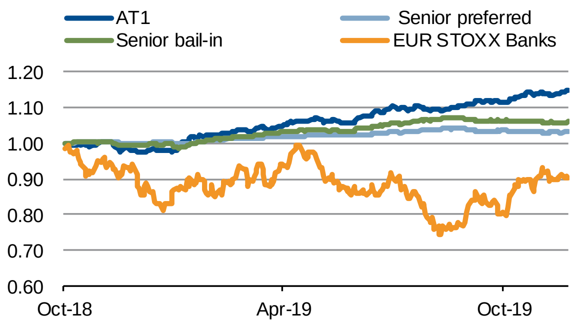
The flipside of developments in 2019 was that central banks had to step in with additional monetary easing. This has supported asset quality and capital gains but dimmed prospects for bank profitability.

Above all, the low rates led to very strong performance of bank debt, thus improving funding costs. Notably, spreads for bail-in-eligible debt have benefited despite their slightly higher risk, reflecting the much-improved clarity on MREL requirements and eligibility in Europe. This should allow smaller banks to follow through with MREL issuance in 2020.

Further down the capital structure: the riskiest AT1 tranches performed very strongly in contrast to falling equity prices, despite the ability of both instruments to absorb losses on a going-concern basis.

Bank equity underperformed the broader European equity market by 40%, leaving most listed banks trading at steep discounts to book value. Less than a third of listed EU banks traded above book value at the end of 2019, according to the EBA, compared to 80% in the US. This is essentially a damning equity market verdict on the impact of negative rates on the banking sector in the euro area and elsewhere. With central banks locked into low rates, this situation is unlikely to change in 2020.

Figure 3: Total return (Oct 2018=100)



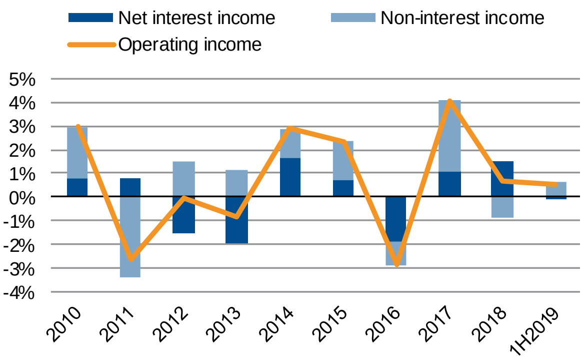
Source: Markit, Scope Ratings

Despite market concern over margin contraction, banks have so far maintained net interest income at reasonable levels thanks to volume gains and structural hedges. However, these effects will eventually vanish: we expect income to fall in 2020 because banks will find it hard grow portfolios to compensate for falling asset margins. In our view, the ability of banks to pass on negative rates to household deposits is very limited.

In contrast, non-interest income has proven to be highly correlated with markets and should increase provided financial conditions remain stable, i.e. central bank policy remains supportive to asset prices.

Well-diversified banks will benefit from businesses whose performance is correlated to asset price inflation, such as sales and trading, bancassurance or asset management. However, the margins of many of these businesses are also under pressure, especially asset management.

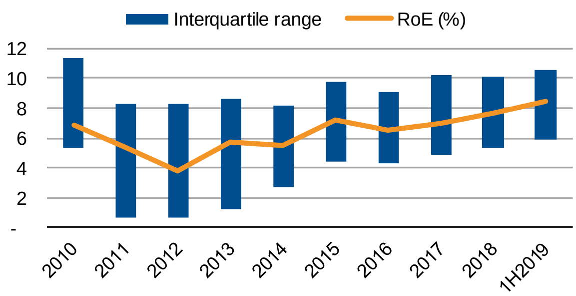
Figure 4: Operating income growth



Source: SNL, Scope Ratings

Realised ROEs for the sector so far have remained steady in the 6%-10% range. The median ROE among the larger western European banks has even increased slightly since 2016 thanks to better asset quality and higher asset valuations.

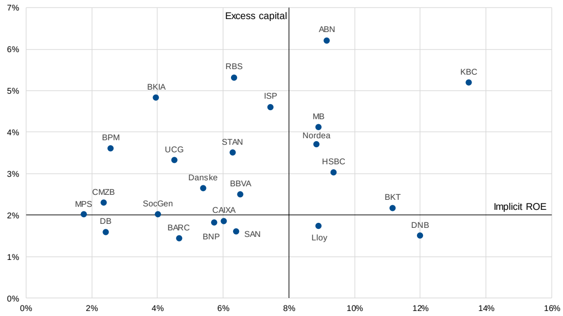
Figure 5: ROE of main western European banks



Source: SNL, Scope Ratings

The equity market is taking a very dim view of revenue and profit growth in the banking sector. In this situation, we would expect at least the stronger listed banks to try to accelerate capital returns in 2020 in the form of higher dividends or share buy-backs, subject to available excess capital. While we do not see this as a credit-negative due to the much stronger regulatory environment, it does indicate that capital levels have peaked in this cycle.

Figure 6: Excess capital* vs implied ROE**



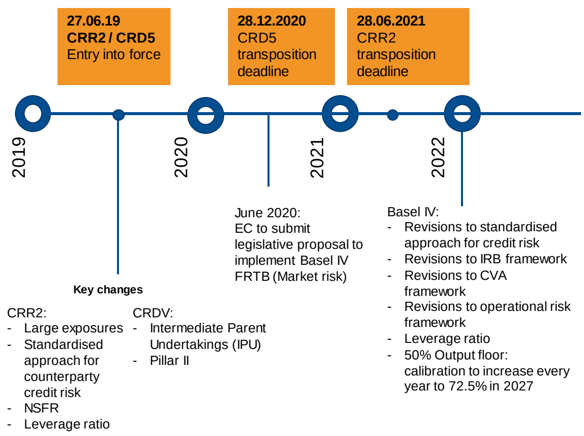
Source: Company data, SNL, Scope Ratings
* above 2019 SREP. **Assuming CoE of 10% and no growth

With some caution?

However, in view of the final Basel III package, some banks may approach additional distributions with more caution. Although upcoming regulatory developments will mostly kick in from 2022, we expect affected banks to start making the required adjustments from 2020.

Following the compromise in 2017 over the final implementation of Basel III, EU lawmakers have given themselves until the end of 2020 to transpose CRD V, and until mid-2021 to implement CRR II. Banks will be affected in a variety of areas including, but not limited to, large exposures, operational risk, CVA adjustments and leverage.

Figure 7: Basel 3 implementation in EU

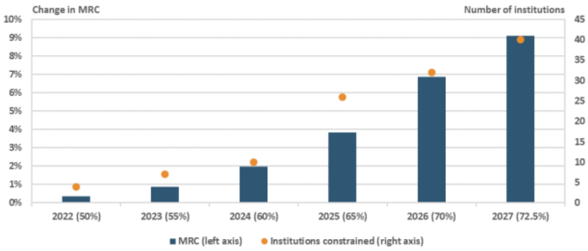


Source: Scope Ratings

The most controversial part of the legislation remains the output floor under the finalised Basel III framework. It remains to be seen how the EU will implement this piece of legislation – which effectively penalises banks with high asset quality – as well as the kinds of offsets that will be available, if any, from lower capital buffers, for example.

However, even if floors are phased in from 2022 as planned with no offsets, they will not bite before the output floor rises above 60% in 2024, according to the EBA's impact study. This will give banks time to adjust, not least by securitising high-quality assets and moving them off-balance sheet.

Figure 8: Capital impact of output floor



Source: EBA Nov 2019
Minimum required T1 capital (MRC) for 189 banks

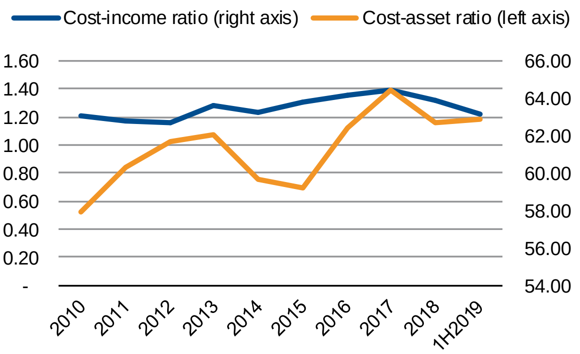
The few banks that have disclosed the expected impact of the EU banking package so far show great variance, with lenders in the Netherlands, Germany and the Nordics most affected. Given the current and expected levels of profitability, but especially the extended implementation timeframe, we expect these banks to be able to absorb risk-weight inflation and amend their business models where necessary.

Bricks and mortar under a cloud

Persistently weak profitability in Europe mainly stems from the market structure of the euro area. In other parts of western Europe, banks are less afflicted because their home markets have already consolidated, e.g. in the UK or Scandinavia.

Many euro area banks never fully aligned their costs to their shrinking asset bases, low rates and flat curves. As a result, cost-asset ratios have remained at around post-crisis highs while cost-income ratios deteriorated.

Figure 9: Cost efficiency of main euro area banks



Source: SNL, Scope Ratings

Within this cost block, IT-related expenses, such as upgrades and maintenance as well as digital innovation, account for one-third of EU banks' total administrative expenses on average – a staggering EUR 141bn in 2018, according to the EBA.

2019 saw isolated and (so far) unsuccessful attempts at consolidation, notably in Germany, with the process hampered by national ringfencing and regulatory complexity.

For 2020, we do not see much scope for cross-border consolidation in the euro area, nor much appetite for in-market consolidation, with shareholders baulking at the sheer cost and limited upside in the current environment.

This leaves euro area banks with outsized operations for the foreseeable future – in other words: too many bricks and probably not enough inter-connectedness in the digital marketplace.

Digital challenge: not all winners

These delays in restructuring could prove costly, as banks are faced not only with mounting costs for inefficient legacy operations but also the need to invest in new technology to defend market shares against technology firms and shadow banks.

In Europe, these developments are shaped by EU regulatory moves towards open banking (PSD2) and new legislation covering the privacy and portability of data (GDPR). These will define the level playing field between tech providers and banks in the coming years.

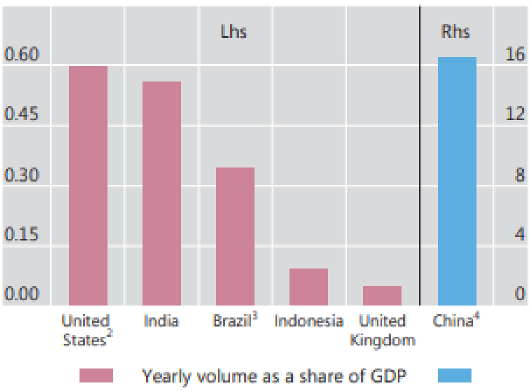
While tech firms, with their often much larger market capitalisation, appear to be formidable competitors to banks, their business models have their own constraints. Compared to banks, they have less historical data and need to reach a larger number of users to achieve network externalities. This provides relief to banks that have strong regional franchises or a diversified focus such as bancassurance.

The presence of tech firms and shadow banks in key banking products such as mortgages and corporate loans has so far been very limited, due to their small funding bases and high reliance on originate-to-distribute business models.

This means banks still have time to reposition their franchises, by making better use of their own customer data and providing customers with efficient and well-connected platforms. However, this transition is needed at a time when bank revenues are already weak, which limits the amount that can be invested quickly. The lack of funds especially affects smaller banks, confining them to a passive approach.

Even if banks are able to invest heavily in IT, it is unclear whether this race can be won simply by out-spending competitors, or whether an entirely different payment infrastructure will emerge that can serve consumers and corporations more effectively than banks' proprietary systems, which is already the case in China.

Figure 10: Use of mobile payment services



Source: BIS Annual Report 2019
2017 data, except 2): 2016. 3) Mercado Libre. 4) consumer only

As banking platforms become more interconnected, the rise of cyber risk and IT failure as important sources of operational risk is inevitable, posing an additional cost and reputational burden on banks and tech firms alike. While this area has been of prime focus for supervisors and banks in recent years, investors are largely left in the dark on the effectiveness of cyber defences.

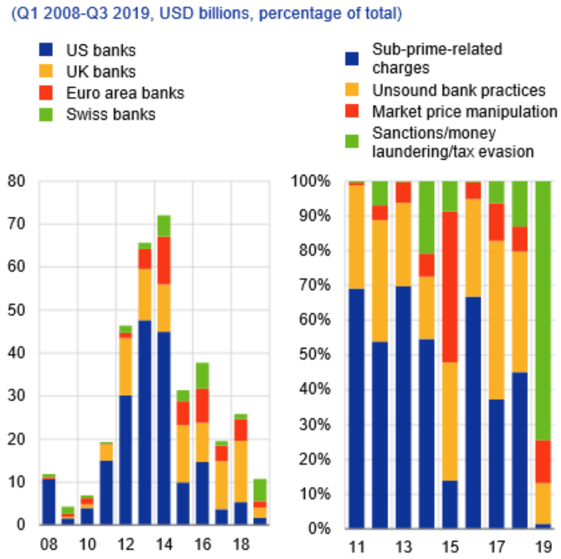
Figure 11: Operational risks

Source: EBA survey 2019 Transparency Exercise

Conduct risk: banks against the bad

Even though more than 10 years have passed since the sub-prime crisis, banks remain mired in a lengthy litany of legal cases related to fraud, mis-selling, money laundering and tax evasion. Nevertheless, the most notorious cases – US sub-prime underwriting, PPI in the UK and Libor rigging – have been addressed; 2019 was relatively benign for conduct-related losses.

Figure 12: Global cost of conduct risks to banks



Source: ECB Financial Stability Review Nov 2019

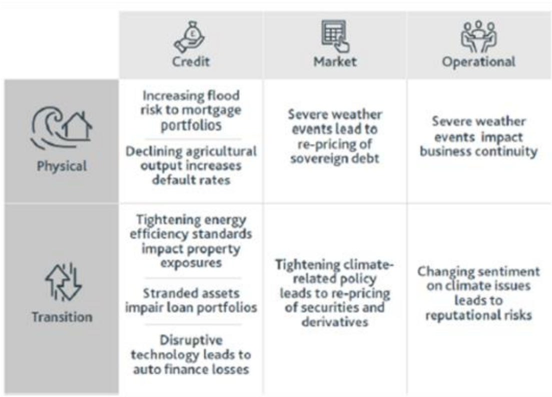
Even so, we expect losses to pick up again in 2020. Several large-scale money laundering cases are yet to be resolved and the Europe-wide cum/ex scandal is only getting underway.

Money laundering in the euro area is a particular risk. Poor information-sharing and lack of central oversight and enforcement especially make it hard for banks to build effective controls. We hold a positive view of the recent agreement among several member states to support the creation of a central EU body. The new European Commission will be tasked with implementing measures in 2020 while convincing investors of their effectiveness.

Climate transition: brown vs green

Climate risks have been rising over the past two decades. While physical risks tend to fall upon insurers rather than banks, the latter remain heavily exposed to risks resulting from a disorderly exit from carbon-intensive sectors, particularly in energy and transport.

Figure 13: Physical and transition climate risk

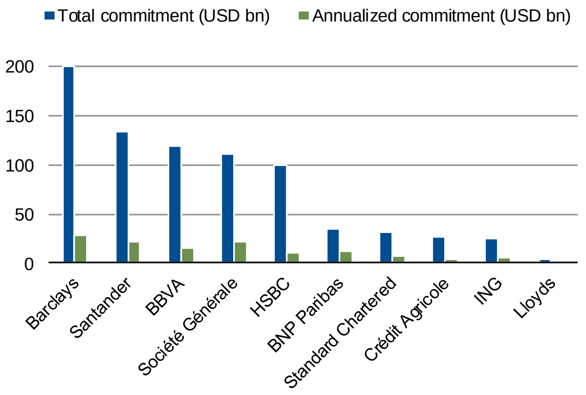


Source: Bank of England

Banks will need many years to reposition asset portfolios away from climate transition risks. During this time, their asset quality will be vulnerable to sudden policy changes such as a sharp rise in carbon taxes, or other government interventions in energy-intensive sectors.

Faced with increased political and investor scrutiny, banks have so far positioned themselves as part of the solution, by boosting corporate social responsibility credentials and offering green and sustainable financing, while limiting insight into existing downstream exposures to 'brown' assets.

Figure 14: Sustainable finance pledges by banks



Private sustainable finance commitments of selected large European private-sector banks
Source: Scope Ratings

Climate transition is raising new questions among bank investors, long accustomed to analysis of asset quality, specifically on whether climate transition will result in higher default correlation in bank asset portfolios, both now and in the future, and when the risks will be relevant. We expect that the banks and regulators that are truly committed to EU climate change policy will provide investors with increased transparency in 2020.

Annex I: Related research

2020 outlooks:

“The Wide Angle: six talking points for European banking in 2020”, published 19 November 2019 available here

“The growing importance in bank analysis of the E in ESG”, published 2 December 2019 available here

“European banks’ financial fundamentals as good as they get“, published 5 December 2019 available here

“Covered Bond Outlook 2020”, published 28 November 2019 available here

“Plotting a future for banks’ anti-money laundering practices in Europe”, published 5 December 2019, available here

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone + 33 1 8288 5557

London
Suite 301
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

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Directors: Torsten Hinrichs and Guillaume Jolivet.