European banks' financial fundamentals: as good as it gets?

Following a decade of almost uninterrupted improvement, European banks display solid prudential metrics, good liquidity, and reasonable asset quality. But earnings remain weak at what could be the peak of their recovery, held down by low rates, flat yield curves and large cost bases, while cost of risk may soon turn from tailwind to headwind.

While the regulatory environment and banks' compliance with prudential rules remain supportive of credit quality, legacy physical distribution networks leave banks exposed to competition from tech companies.

We believe the decade-long build-up in capital ratios has come to an end, and banks will now have to think strategically about excess capital allocation against a backdrop of still-limited demand for credit. Some banks will need to retain earnings to meet regulatory RWA inflation; others may use earnings to speed up balance sheet clean-up; others still to finance M&A in a bid to achieve cost efficiencies or improve their competitive positioning in domestic markets. Shareholders will increasingly demand higher payouts, in the form of dividends or buy-backs.

Current equity valuations imply that most European banks are value-destroying operations, which makes capital return an appealing equity story. But crucially, a gradual increase in payouts is not necessarily bad news for bank credit because it demonstrates confidence on the part of regulators that buffers are sufficient. It would also vindicate the theory that following the great re-regulation of this decade, banking should increasingly be seen as a utility-like, low-risk and low-but-stable-return sector.

Indeed, we believe that the debate around bank profitability continues to be badly framed and influenced by outdated anchors and expectations of double-digit profitability which will remain out of reach for most banks in the current interest-rate and regulatory environment.

We calculate that the current median ROE for European banks stands at around 7% and believe that this may be as good as it gets for the sector post-crisis. Cost of risk, which is the main cyclical driver for bank profitability, is at a historical low, and is more likely to tick up than down in core Europe and the UK as manufacturing has softened and investment has slowed. Meanwhile, all the structural drivers for lower profitability (expensive excess liquidity, flat yield curves, high capital requirements, over-capacity and outdated distribution models) are unlikely to change drastically in the near future.

We expect continued improvements in asset quality in some Euro Area peripheral countries, including Italy, Portugal and Greece, which still display above-average NPL ratios. While Italian banks still account for about a quarter of total NPLs in the Eurozone, the gap to other countries banks in terms of NPL ratios has been declining fast, a trend which should continue into next year – especially as the Greek banks are planning to accelerate their de-risking. These positive developments are likely to be offset by core Europe where NPLs and provisions are likely to rise, albeit from very low levels. Given their diminished earnings power, even small changes in asset quality can have a significant effect on profitability of core EU banks, however.

Key downside risks to bank credit include an abrupt deterioration in macro conditions, an unexpected tightening of liquidity conditions, or a significant relaxation of the regulatory environment allowing the banks to pursue higher-risk strategies in the quest for better profitability.

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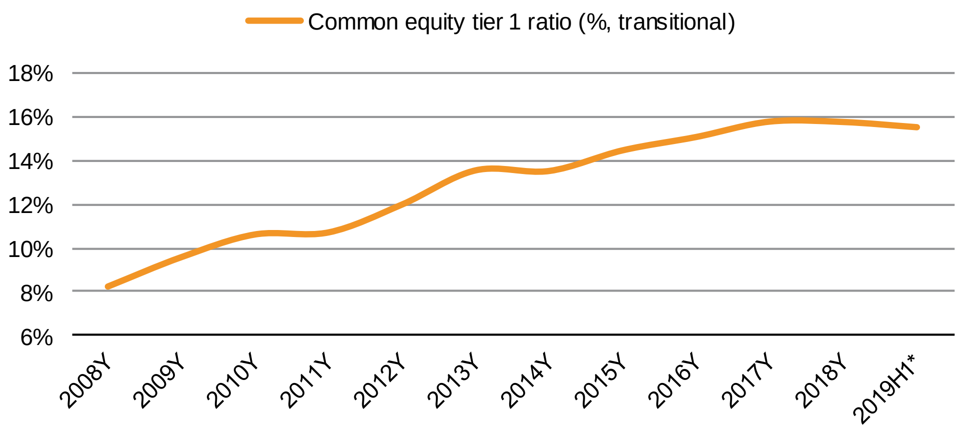
Capital ratios have likely reached a plateau. Any excess capital will likely be returned to shareholders

Capital ratios are unlikely to increase further

For over a decade, the capital base of European banks has been increasing. The median CET1 ratio for European banks[1] stood at over 15% as of Q2 2019. At the beginning of the decade, the comparable figure was just over 10%. Going back further, the ratio was even lower. This increase in the quantum (and quality) of bank capital has decisively supported bank credit quality. Looking ahead, however, we think capital ratios have peaked.

Figure 1: Median CET1 Ratio, transitional



Source: SNL, Scope Ratings
*Where half year data was not available, 2018Y

As requirements stabilise, capital ratios will plateau

The increase in banks' capital ratios over the past decade has been driven almost exclusively by regulatory requirements. A key role was played by the gradual phasing-in of CRD 4 capital buffers, and by Pillar 2 supervisory requirements. In addition, banks have built additional managerial buffers on top of the requirements to provide comfort to equity and AT1 investors around the timely payment of dividends and AT1 coupons.

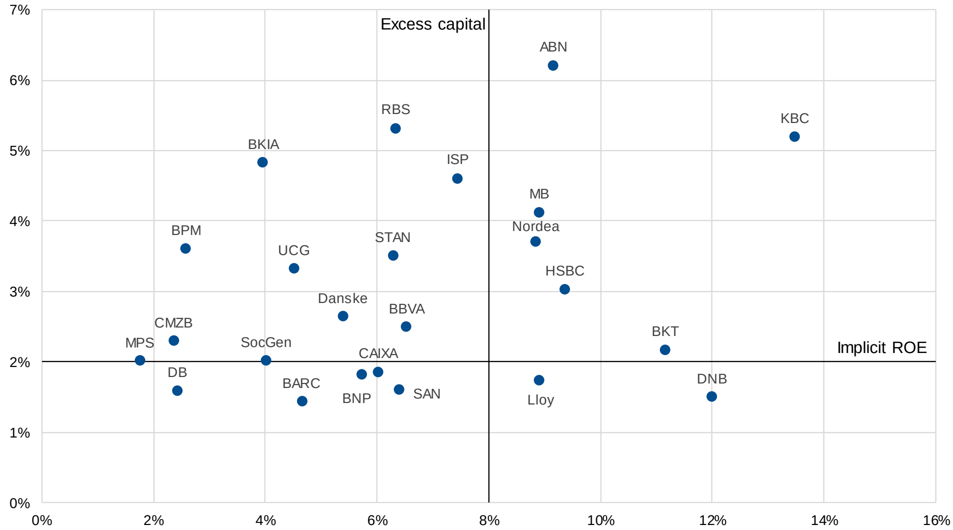
CRD 4 capital buffers are now fully phased in, and the supervisory process for determining additional requirements under Pillar 2 is more transparent and better understood than before. As the requirements stabilise at a high level, we believe reported ratios will also plateau, generally a couple of percentage points higher than the all-in requirement, allowing for management buffers to account for earnings volatility and some increase in RWA. Such RWA increases are unlikely to be driven by fast growth in loan volumes; rather they will reflect RWA inflation from further refinements to the capital framework, such as the supervisory Targeted Review of Internal Models (TRIM) and the phasing in of output floors and other Basel rules from 2022.

In the absence of value-creating growth opportunities, banks will increase capital returns to shareholders…

Volume growth will generally remain muted: the Eurozone economy is slowing down, while liquidity remains abundant. Such an environment is hardly stimulating for credit demand. Banks with decent-to-good organic capital generation but limited room to profitably deploy capital will, in our view, either look at increasing dividend payouts or share buybacks, subject to regulatory approvals. Indeed, with bank shares trading at a (often significant) discount to book value, bank shareholders should have limited appetite for growth-pursuing strategies and prefer capital return. DNB, Credit Suisse, HSBC and UBS were running or completed share buybacks in 2019, and other banks (UniCredit, Bankia, Barclays, RBS) have pointed to the possibility of initiating them.

[1] Our sample, which largely overlaps with the ECB's list of directly supervised institutions, includes 157 banks in the Euro Area, Switzerland, the UK, Scandinavia and Eastern Europe.

Figure 2: Excess capital* over requirements and market value-implied ROEs, large European banks**



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

A number of banks, which have only recently returned to profitability and have generally lagged peers, may re-initiate dividend payments after several years of poor capital returns to shareholders (and, in some cases, rights issues).

…but this should not be seen as a credit weakness

High dividends and share buybacks are usually seen as credit-negative from a creditor standpoint. However, this is not always warranted.

In today's highly regulated European banking sector, increased capital returns to shareholders are a signal that the bank is compliant with existing requirements, on track to meet future requirements and that such requirements can be met under stress[2].

In short, an increase in capital returns to shareholders indicates that supervisors are very comfortable with a bank's capital position. Hence it is a signal that the possibility of regulatory intervention is remote.

Banks could use excess capital for M&A, balance sheet clean-up or for boosting their digital capabilities

For banks with higher-than-average levels of non-performing assets, getting supervisory approval for increasing capital returns will likely be more difficult. Hence, these banks will continue to prioritise balance sheet clean-up, possibly deploying excess capital to raise provisions and facilitate disposals.

In fragmented and less profitable markets, excess capital could be used to facilitate M&A, aiming to restore profitability and in some cases business-model viability through deep cost restructurings. Some banks have acknowledged that they are open to M&A, and supervisors have often stated that they see consolidation as a way to improve efficiency and support bank profitability. At the same time, M&A can attract capital surcharges, be it in the form of additional systemic buffers or higher Pillar 2 requirements. We believe this possibility has acted as a roadblock to consolidation so far. Having some extra headroom to requirements could accelerate consolidation.

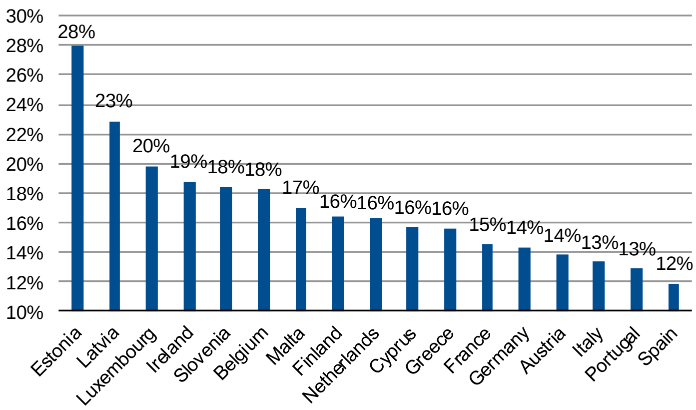
Finally, banks may use excess cash to finance the development of their digital offerings, including buying equity stakes in financial technology companies. The recent acquisition by Santander of a 50.1% stake in Ebury for GBP 350m is a good example of how incumbents can spend basis points of capital today to strengthen their competitive hand.

[2] See ECB recommendation on dividend distribution policies dated 7 January, 2019

Different risk-asset intensity largely explains differences in capital ratios

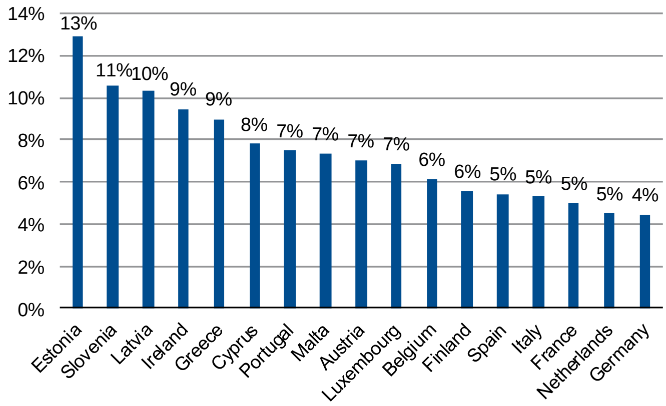
In terms of country dispersion, banks in Spain, Italy and Portugal continue to lag peers in core Europe when it comes to headline capital ratios. However, the ranking changes significantly when looking at banks through the lens of the leverage ratio, with German, Dutch, and French banks showing up among the most leveraged in the Euro Area.

Figure 3: CET1 Ratios



Source: ECB, Scope Ratings

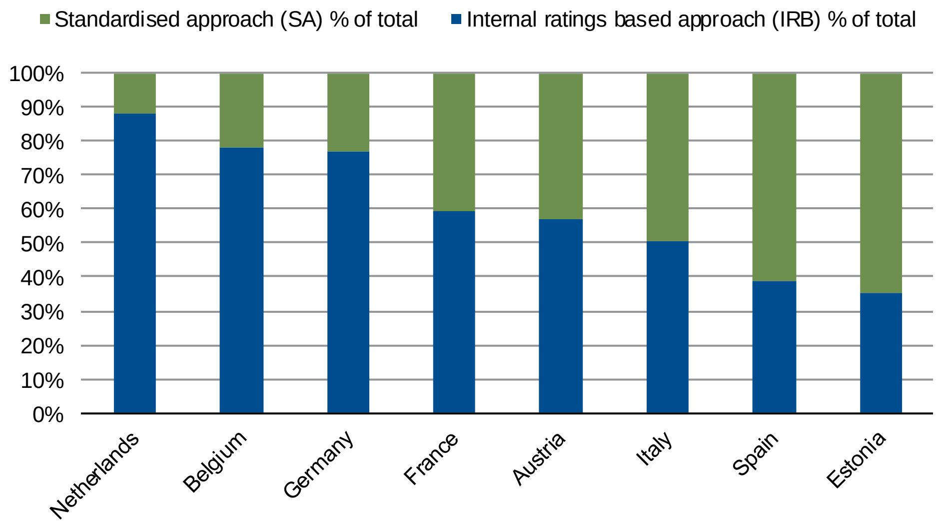
Figure 4: Leverage ratios



Source: ECB, Scope Ratings

The discrepancy between these two measures mainly reflects different asset composition and varying degrees of internal model usage. Southern European banks are more exposed to loans with high risk-weightings compared to core European banks that have more public sector assets. Likewise, banks that apply internal models to mortgages tend to report much lower RWAs than banks using the standard approach.

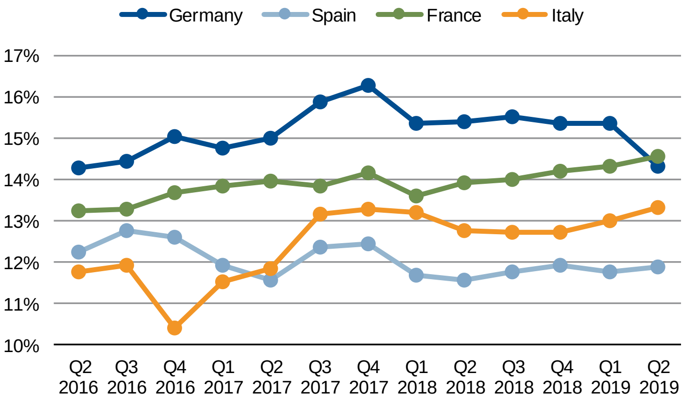
Figure 5: Banks' Internal ratings-based approach (IRB) % of total RWAs



Source: ECB, Scope Ratings

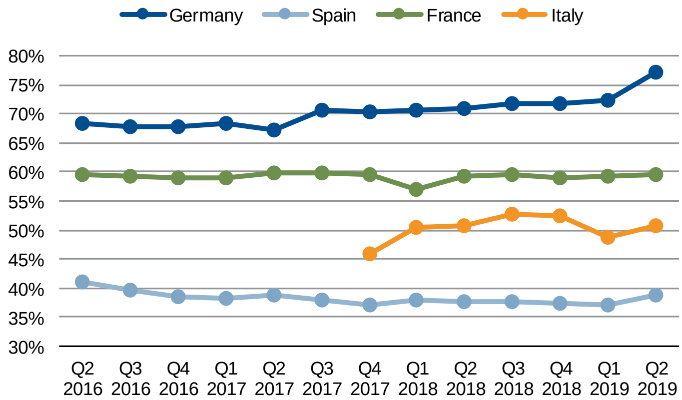
Looking ahead, we believe we are likely to see some convergence both in capital metrics and in the incidence of advanced risk-modelling for RWA calculations. Increased adoption of IRB techniques will lead to lower RWA intensity and growing capital ratios in Southern Europe, while regulatory headwinds may lead to RWA inflation and declines in headline ratios in core Europe and in the Nordic region. These will include the phasing in of output floors from 2022 onwards which will likely lead to an increase in risk RWA intensity, especially for banks with a higher incidence of low risk portfolios.

Figure 6: CET1 ratios, four largest EA countries



Source: ECB, Scope Ratings

Figure 7: IRB adoption, four largest EA countries



Source: ECB, Scope Ratings

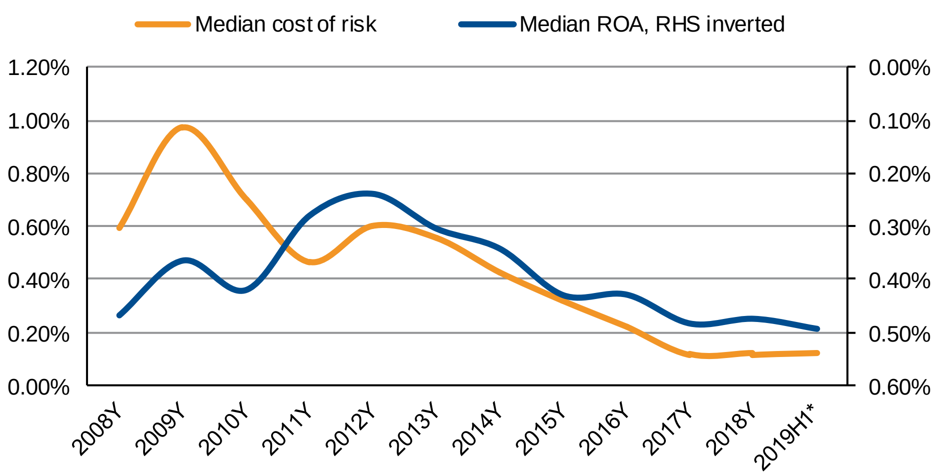
Profitability is low because of structural, not cyclical factors

Low profitably continues to be the Achilles' heel of European banks, and we do not expect this to improve meaningfully any time soon.

The credit cycle is as good as it can get for most banks

Cost of risk, the main cyclical driver of bank profitability, is just 12 basis points of loans, and in some cases includes write-backs. The credit cycle in Europe has been fairly benign for several years, and while there are still several pockets of asset-quality weakness, the vast majority of banks today are provisioning little for new bad loans. Only a couple of dozen banks, primarily in Southern and Eastern Europe, still have cost of risk of over 50bp, representing the exception rather than the rule.

Figure 8: Cost of risk is as good as it can get for most banks



Source: SNL, Scope Ratings

We believe there is still room for cost of risk to decline in the Euro Area periphery, as well as at some banks which, for more idiosyncratic reasons, are still dealing with legacy asset-quality problems from the past down-cycle. However, with more and more signs of an economic slowdown globally and in Europe, we may see cost of risk ticking up in several countries. New pro-active accounting and regulatory requirements mean that banks will need to recognise and provision for bad loans much earlier than in previous cycles.

Three main structural drivers explain low bank profitability

On the other hand, the structural drivers of low pre-provision profitability are still firmly in place, and unlikely to disappear anytime soon. The three key factors keeping returns at bay are:

1. a low and flat yield curve, which suppresses revenue generation from maturity transformation;
2. high capital requirements and regulatory constraints on business activities and balance-sheet structures;
3. Out-dated distribution models, which are increasingly challenged by aggressive newcomers.

Negative rates and tight regulation are here to stay

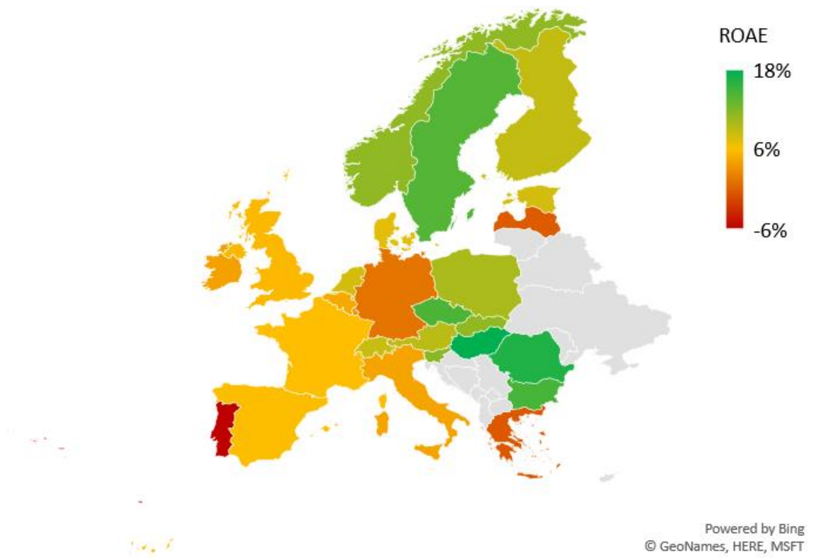
Banks may find themselves under even more pressure as the ECB doubles down on its unconventional monetary policies. In the absence of inflationary pressures, the prolonged period of negative interest rates is likely to continue, causing asset yields to compress, and forcing banks to pass on negative interest rates to customers whenever possible or adapt their liability structure by relying less on deposits.

Low interest rates and high capital requirements are structural, not cyclical drivers of banks profitability. What is worse, they are outside of the control of banks. Bank management can and surely does complain about both, but regulators and monetary authorities will remain unwilling to sacrifice inflation and financial stability objectives in order to safeguard banks' returns.

Cost of adapting distribution networks will continue to weigh on profitability

A third, but equally important structural driver for low profitability is the cost of legacy, over-sized physical distribution networks. As the average customer requires fewer physical interactions and increases interactions through digital channels, banks are tasked with adjusting their distribution to an adequate omni-channel approach. This often means investing significant sums in IT development, while at the same time shouldering the cost of reducing physical branches and workforce.

Figure 9: European banks' return on average equity, 2018

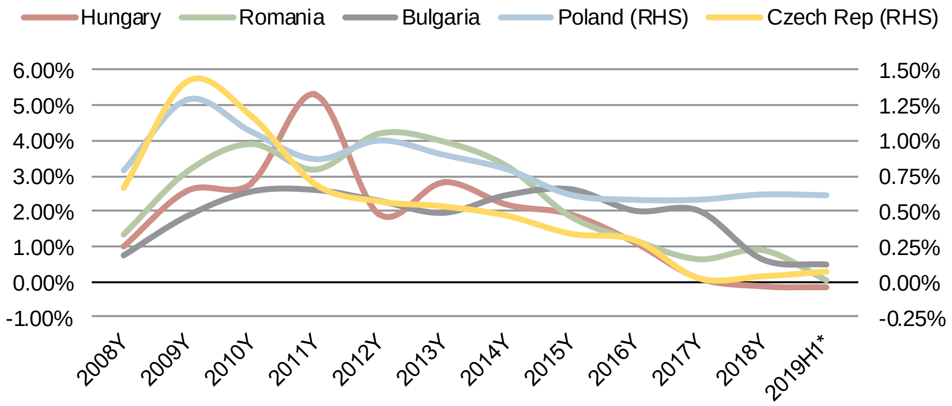


Source: SNL, Scope Ratings

Can double-digit ROEs in Scandinavia and Eastern Europe be sustained?

Average profitability remains especially weak in Portugal and Greece, where some banks are still burdened by legacy asset-quality problems from the previous crisis. We believe there is still material room for improvement in these countries. Profits tend to be stronger in Eastern Europe, where volume growth and higher interest rates still support revenue generation. This will likely continue to be the case in the medium term, although we caution that some near-term profit moderation can be expected as a result of a softening macro environment in the region.

Figure 10: Cost of risk in eastern Europe is at cyclical lows



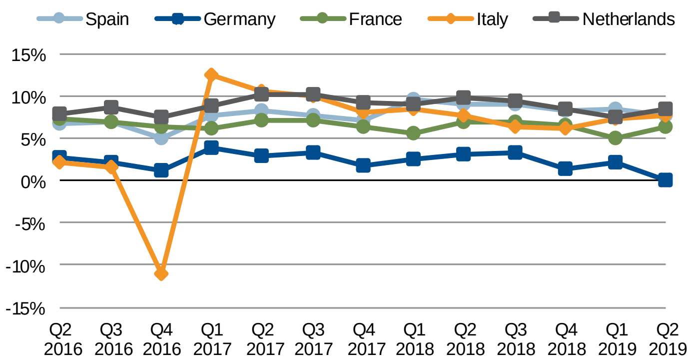
Source: SNL, Scope Ratings

ROEs are also very high in Scandinavia, partly due to banks' high concentrations in mortgage and their use of internal models. Higher earnings are a result of several other factors, including leaner cost structures, lower competitive pressures and a very benign credit cycle. In Norway, higher policy rates also support bank revenues and profitability. We expect profitability of banks in Scandinavia to remain solid, though we see current loan-loss provisioning levels in Sweden (six basis points) as too low to be taken as a reliable through-the-cycle cost of risk. This is also true for cost of risk at Dutch and Belgian banks (8bp and -1bp respectively).

Drivers for low profitability in German banking unlikely to change

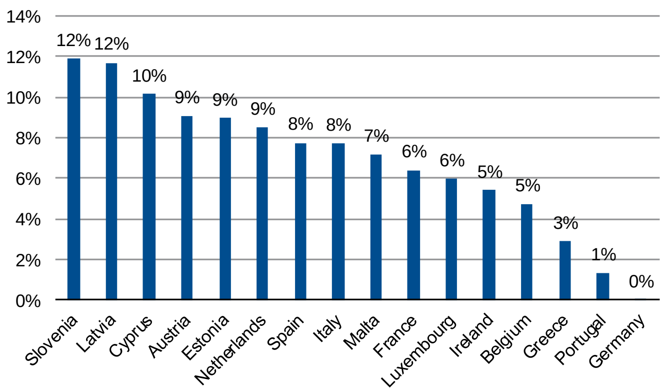
Among the larger countries, lack of profits is a primary issue in Germany, where the average return on equity of banks under the ECB's direct supervision has been stuck in the low single-digit range since the global financial crisis. Compounding the above-mentioned factors, fierce competition and inability to generate income from non-lending activities are two additional drivers that add to the profitability challenge for German lenders. We do not see these dynamics changing soon.

Figure 11: Banks' ROE by country



Source: ECB, Scope Ratings

Figure 12: Banks' ROE by country - Last quarter



Source: ECB, Scope Ratings

German banks have also been especially penalised by the ECB's loose monetary policy in recent years: reflecting the savings surplus in the German economy. German banks typically hold excess liquidity, which they re-deposit with the central bank at a cost (currently negative 50bp) or invest in safe government bonds (also at negative rates).

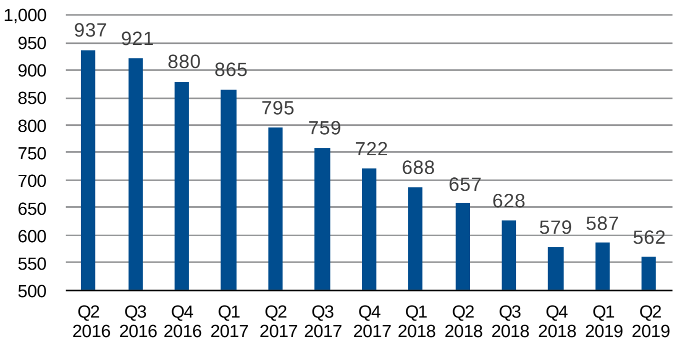
The recently-introduced tiering system for remunerating excess reserves will help at the margin, but it is unlikely to materially alter the profitability outlook for the sector (see our recent report Draghi's leaving message for euro area banks: learn to live with negative rates, published in September 2019).

The outlook for asset quality is mixed, with diverging regional trends

EA NPLs continue to decline

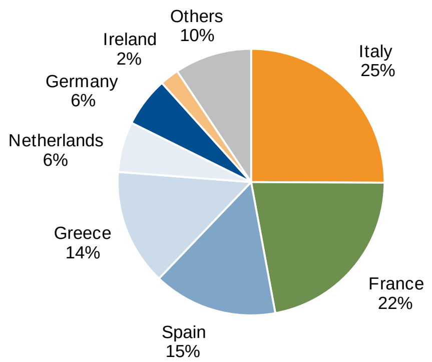
European banks continue to shed NPLs. In the EA, NPLs of banks supervised by the SSM reached a new low of EUR 563bn in June 2019, declining EUR 25bn QoQ and EUR 95bn YoY[3]. Italian banks continue to account for the largest portion of the NPL pool of EA banks, with 25% of total NPLs (EUR 141bn), though French banks now follow closely (22% of the total).

Figure 13: Total NPLs (bn)



Source: ECB, Scope Ratings
Note: The increase between 4Q18 and 1Q19 is due to the inclusion of Cassa Centrale Banca in the sample.

Figure 14: Banks' NPLs by country – EA periphery

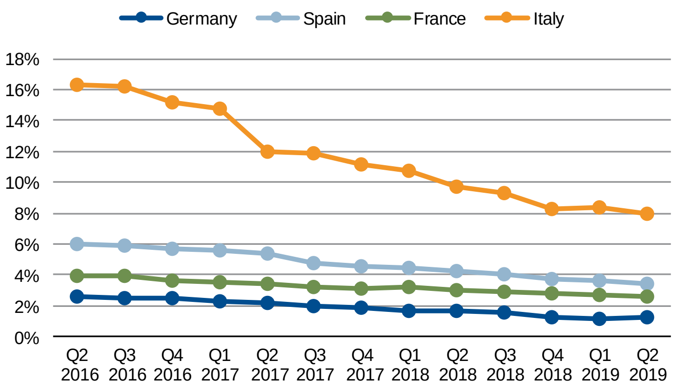


Source: ECB, Scope Ratings

Italian banks still account for a quarter of total NPLs, but their NPL ratio is falling

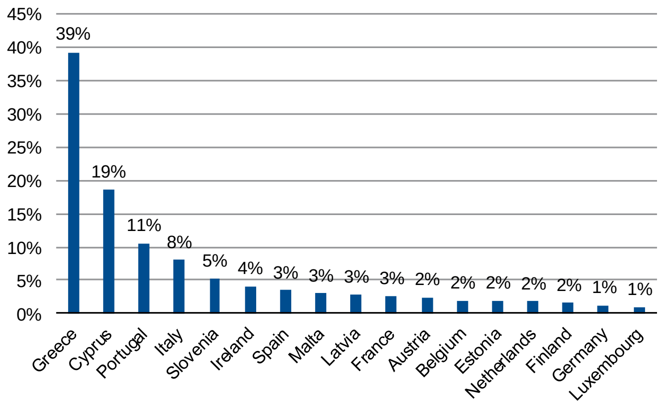
The gap between the NPL ratios of Italian Banks and banking peers in other large EA countries remains wide, but it is closing. As of June 2019, the NPL ratio of Italian banks in the ECB's supervisory returns dataset stood at just over 8%. This is still more than double the corresponding ratio for Spanish banks at the same date but has halved compared to the 16% Italian banks reported only three years ago. News reports point to further material de-risking in Italy in the coming quarters, with several banks reportedly studying additional large NPL sales.

Figure 15: NPL Ratios, large EA countries



Source: ECB, Scope Ratings

Figure 16: Banks' NPLs by country



Source: ECB, Scope Ratings

3 Source: ECB Supervisory Banking statistics

NPLs are still high Greece, Cyprus and Portugal

Elsewhere in Europe, high NPL ratios continue to weigh on Greek, Cypriot, Bulgarian and Portuguese banks, although the more supportive economic environment has led to some declines in these countries too.

Greek banks continue to carry big piles of NPLs, although the NPL ratio of Greek banks fell just under 40% in June. We expect an acceleration in the pace of decline of Greek NPL ratios from 2020, as banks will start using securitisation structures to dispose of NPLs. On October 10, the EC cleared Hercules, the Greek Government guarantee scheme for NPL securitisations designed to help move NPLs off banks' balance sheets. The scheme is similar to the Italian GACS scheme, which has supported Italian banks' de-risking efforts in recent years. Under the scheme, banks will transfer NPLs to a securitisation vehicle, which will then issue notes to finance the purchases. The Greek government will guarantee the senior notes, against remuneration which will be set at market rates.

The guarantee should widen the pool of potential investors and allow the banks to accelerate their de-risking. Such a process will be greatly helped by the current appetite for yield, as even Greece has recently managed to issue public debt at a negative interest rate (albeit at short-term maturities).

Asset-quality metrics may start worsening in the UK, Germany and the CEE

We do, however, see downside risks to bank asset quality in several Central and Eastern European countries, where an economic slowdown may lead to worse asset performance.

In the UK, banks' asset quality has so far been remarkably resilient, owing in part to their de-risking efforts. However, we believe it is safe to assume that the Brexit-related economic slowdown will eventually translate into worsening asset performance.

Climate change will also have impacts on loan portfolios

In the medium-term, climate change will emerge as a new source of asset quality risk for banks. Extreme climate related events can impair the creditworthiness of borrowers and damage collateral. Meanwhile the need to transition to a lower carbon economy will challenge many industries to which banks are exposed. Our recent report "The growing importance in bank analysis of the 'E' in ESG" explores different sources of climate-related risk for banks.

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