European banks still in decent shape but rising fumes backstage rankle the market (ten key themes for 2019)

The European banking sector should remain in relatively decent shape in 2019, displaying reassuring prudential, financial and business characteristics, and pursuing moderate-to-low-risk strategies. These characteristics can be sustained into the medium term, with only a marginal probability of material disruption to this relatively benign outlook. Scope's ratings on the large European banks – predominantly in the single A/low AA range (see *Appendix*) – reflect this assessment. We anticipate overall rating stability over the next 12 months.

2019 – the year of senior non-preferred debt: It is very likely that next year will be very active for bank issuance, with the bulk of new supply in MREL-eligible senior non-preferred or holding company-issued format. There is, at last, more regulatory clarity in the EU regarding MREL, and banks will now need to build the necessary cushions of bail-in-able debt. It is likely that the ECB will renew TLTRO facilities (or extend the repayment schedule past mid-2020) so that any funding panic due to worsening market conditions is not made any worse. But at the same time, MREL requirements and the need to comply with the net stable funding ratio (NSFR) – likely to become a regulatory requirement in the not-too-distant future – will drive banks to issue more market funds.

In exchange, we should see more senior preferred issuance by German banks, due to the fact that to date the stock of outstanding senior unsecured debt qualifies as bail-in-able in insolvency and resolution.

Forthcoming funding needs are, in fact, a key practical reason as to why market sentiment towards the European banking sector remains critically important.

Subdued profitability: Profitability is likely to remain subdued, with net interest margins remaining thin as rates are not likely to move up. New loan volumes will continue rising cautiously, but banks are likely to suffer a squeeze on fee growth (active asset management under pressure, impact of the payment transfer platforms), while material cost reductions will be increasingly difficult. However, the sector's low-risk characteristics mitigate this, and this should in our view provide more comfort to credit investors than having banks boost their bottom line by taking more risk. Bank that are too aggressive with profit targets will raise suspicions among investors, and rightly so. We do not view a high single-digit ROE as being a weakness, not if we assess the corresponding cost of capital to be in the 7%-8% range (below the low double-digit usual market assumptions).

Were interest rates to modestly rise from late next year (not the most likely scenario), it is not probable that they will help bank margins as there will be pressure to reflect such hikes first into higher yields for savings.

Backstage socio-political risks: Against the steady-as-she-goes financial and risk performance we see growing market apprehension towards the sector, stemming from backstage trends that can affect banks' creditworthiness either directly, or through a 'butterfly effect': Brexit, US politics – President Trump's strident protectionism and threats of 'trade wars' – as well as the rise of nationalism and populism, very visible in Europe (notably in Italy). While heightened market caution is understandable (with the trauma of the crisis of a decade ago still present in the collective memory), we believe that this needs not overshoot, unnecessarily souring the landscape and thus affecting banks' capacity to fund and/or issue equity. It bears highlighting that this time around the banks are not the culprits behind the current stress in the market.

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These developments could primarily hurt the sector's top-line revenue growth and potentially the bottom line if funding costs move up too much. At this stage there should not be excessive concern about a new wave of material asset-quality deterioration, although marking down sovereign bond holdings in banks' portfolios (e.g. in Italy) is a worry. We also doubt that the current regulatory architecture, including the two pillars of the European Banking Union, will in any way be seriously threatened by populism or nationalism in Europe.

Digital-age challenge on business models: We also point to the growing existential challenge of the evolving digital landscape and related changes in customer behaviour. Over the next few years, we may well start to see the integrated business model of most banks – cross-selling as many products as possible to their business and individual customers – becoming increasingly disaggregated, with the bank just one of the actors on the new stage. This is likely to be truly transformational in Europe, where not only the credit markets but also the financial system and circuits are far more bank-intermediated than in the US.

Cyber and misconduct risk: Investors should be increasingly focused on relatively more recent categories of risk that can affect banks' creditworthiness and future: cyber risk and misconduct risk. The fact that there are no clear metrics to gauge these risks (as is the case with more traditional ratio-driven risks – asset quality, funding and liquidity, or capital) is not a reason to overlook them. It is in fact very likely that both these risk categories will continue to grow in importance in the years to come, with a more frequent occurrence of cyberattacks, as well as money laundering or other misconduct events.

ESG: In the same context, we take note of investors' heightened interest in ESG factors related to banks – primarily governance but also environmental and social issues. The market focus on banks' behaviour and developments in this respect is becoming more important, although we are not convinced by some investors' box-ticking practice of having third-party ESG scores being a substitute to their own assessment.

Large-scale cross-border bank M&As best avoided: We neither expect nor see much value in large-bank consolidation across Europe, even though financial authorities are encouraging this and some segments of the market (analysts, financial media) are rooting for it. Banks can expand their footprints through investing in digital capacity, taking advantage of open platforms and APIs, rather than merging with 'legacy banks' and taking on unnecessary costs, as well as unknown potential cyber or misconduct problems. The report discusses this topic in some detail.

On the other hand, we see clear need for more domestic consolidation among second-tier banks – especially in Italy and Germany. In fact, for the latter, there would be economic value also in more consolidation among the Landesbanken, as well as, potentially, between the two large private-sector banking groups.

Resolution vs. bailouts: There is ongoing market debate about resolution scenarios for failing banks. While the resolution framework is firmly in place across Europe, many market participants continue to believe that, when push comes to shove, a national government will not let a large bank bail in depositors and will intervene. This may indeed be true for non-insured depositors, but it is highly unlikely that institutional investors will be bailed out, notably those having invested in MREL/TLAC-eligible securities (and plausibly senior preferred debt as well).

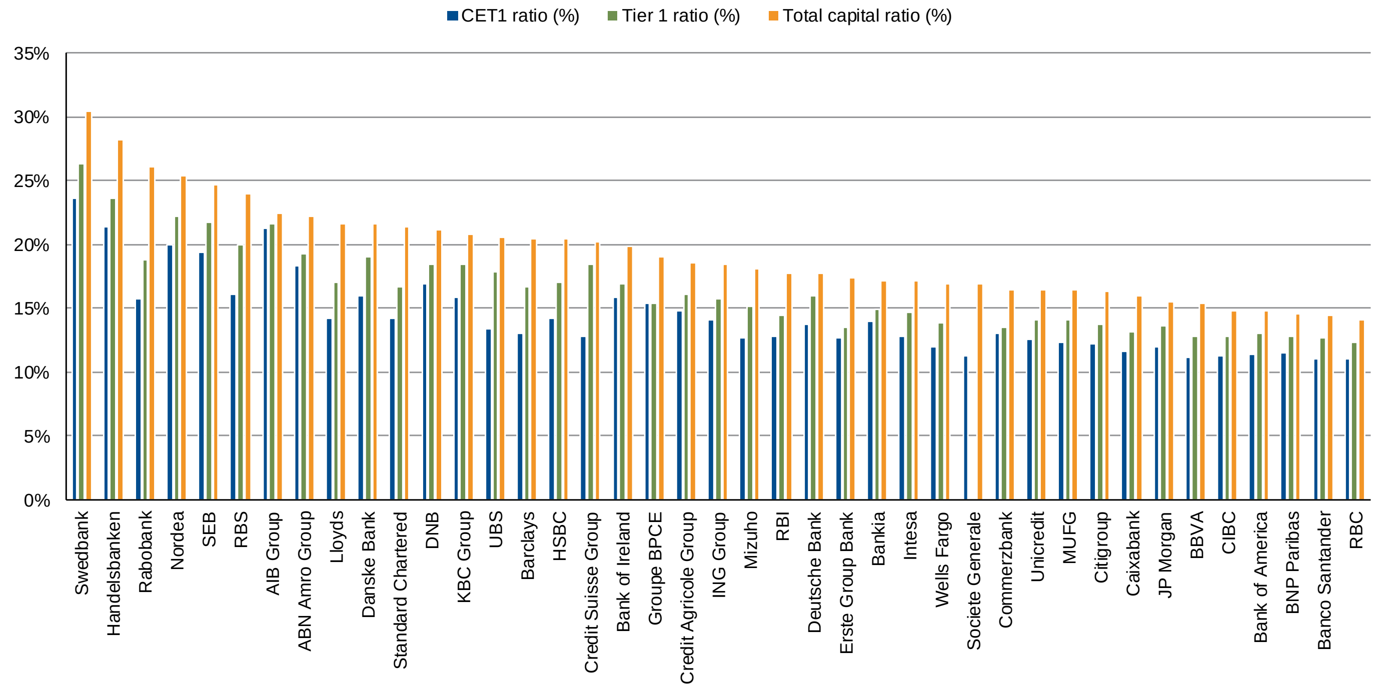
We have identified 10 themes that should be central for market participants looking at the sector. These themes aim to address the main areas of concern highlighted by the numerous institutional investors Scope bank analysts are in close contact with – primarily in Europe and North America.

1. Prudential and financial strength should not be under-appreciated but is no longer sufficient to completely reassure
2. Profitability will remain subdued, but if risks remain low this is not a structural weakness
3. Further cost reduction is increasingly difficult (need for IT investments) and excess capacity is not melting away
4. Rising clouds backstage – Brexit, nationalism, US protectionism, geopolitical threats – are hurting sentiment towards banks
5. The digital age threatens banks' traditional cross-selling business model: heightened investor alert is recommended
6. Cyber risk: banks' Achilles' heel is far from being properly understood
7. Misconduct risk has moved and will remain centre stage
8. ESG: higher market and policy expectations and higher standards
9. Large-scale cross-border bank M&A best avoided
10. Bail-in vs. bailout: "it's complicated".

1. Prudential and financial strength should not be under-appreciated but is no longer sufficient to be completely reassuring

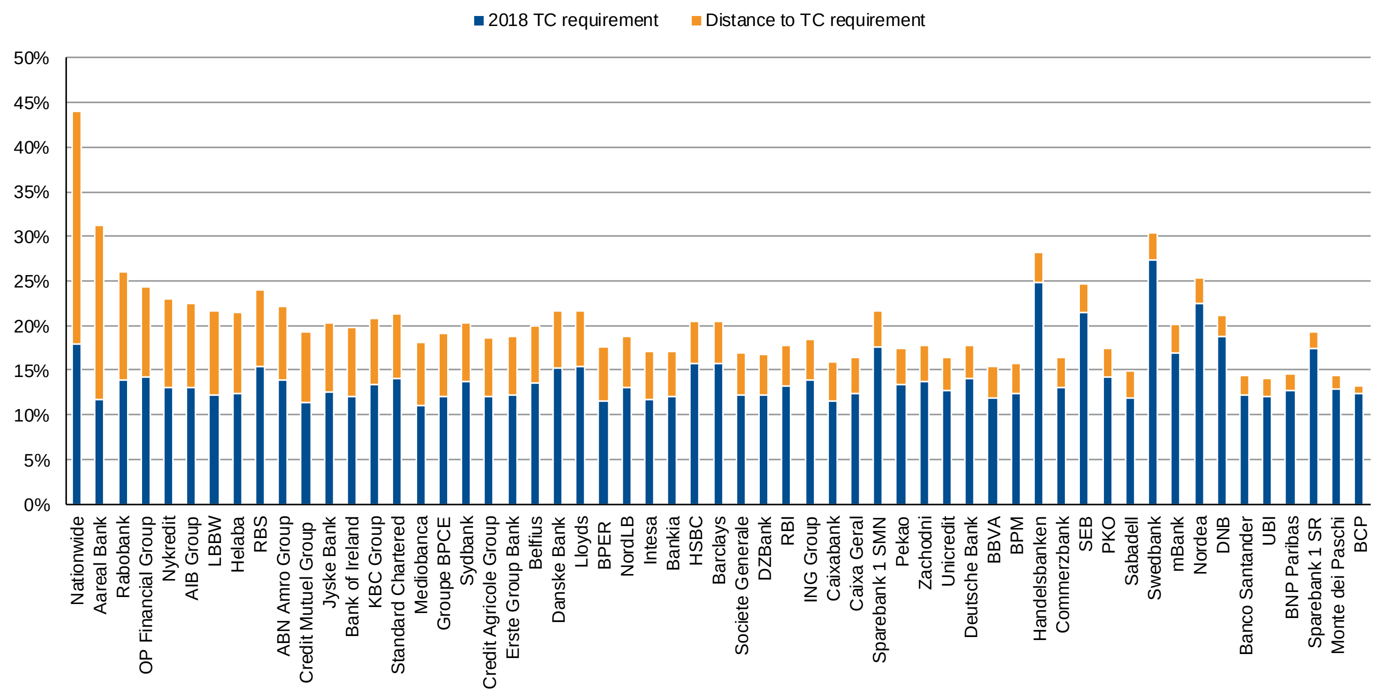
The European banking sector continues to display solid prudential indicators around capital and liquidity, even though some market segments – media, analysts and some investors (mostly in the US) – continue to stubbornly believe that the sector remains structurally under-capitalised especially when compared with the large US banks. Figure 1 shows this not the case: a worldwide sample of large banks (Europe, US, Canada, Japan, Australia) reveals a relative balance across geographies in terms of capital levels. Also, all 57 EU banks shown in Figure 2 (including all large banks) exceed their 2018 SREP requirements. Figure 3, which is based on the average of a 119-European bank peer group, also shows a reassuring trend for capital as well as for liquidity and funding (LCR and NSFR).

Figure 1: Capital ratios – Global comparison (H1 2018)



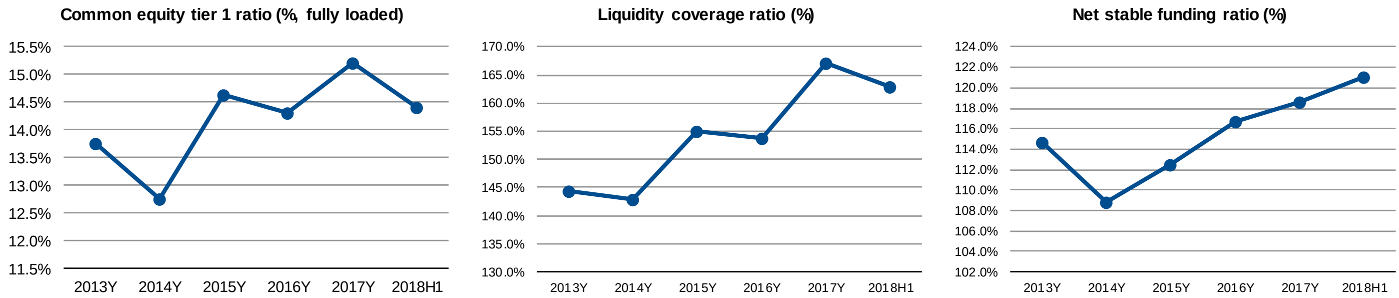
Source: SNL, Scope Ratings

Figure 2: Capital/SREP comparison (H1 2018)



Source: Company data, SNL, Scope Ratings

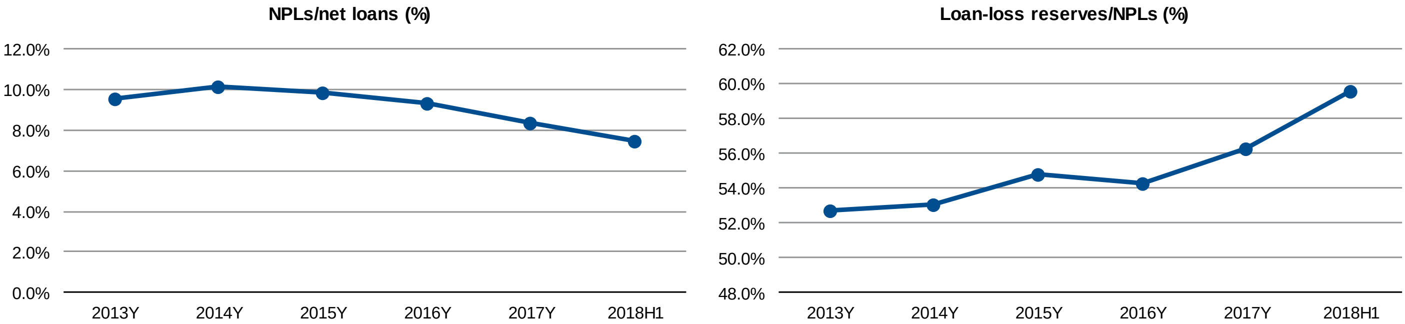
Figure 3: CET1 ratio (fully-loaded), LCR & NSFR*



*Peer group of 119 European banks
Source: SNL, Scope Ratings

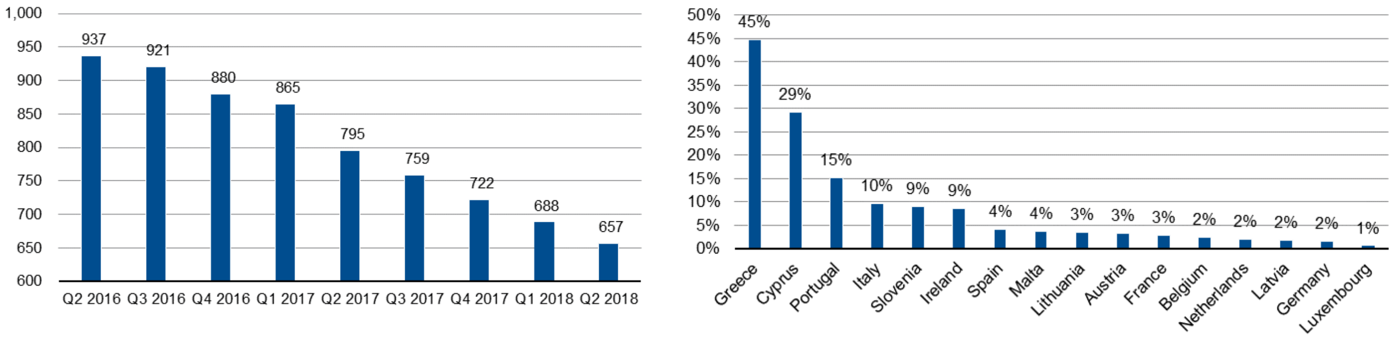
Despite ongoing market and supervisory concerns, the sector's asset quality problems – mostly a legacy of the past – are gradually being sorted out. The graphs in Figure 4 on NPL and loan-loss coverage trends for the 119-bank peer group illustrate these positive trends. In Italy, despite ongoing market fears, asset-quality problems are no longer spread across the entire sector but are clustered around an increasingly small number of outlier banks. 2018 was a very active year for the cleaning up of Italian bad loan portfolios, primarily through a vigorous NPL secondary market. We expect this to continue into the early part of 2019. In Central and Eastern Europe, high NPL levels are highly provisioned, and banks benefit from the mitigating effect of high lending margins. Greek and Cypriot banks (and to a much lesser extent Portuguese banks) remain saddled with asset-quality problems mostly due to sovereign stress and difficult economies. Figure 5 shows these positive trends across the euro area.

Figure 4: NPL ratio and loan-loss coverage ratio*



*Peer group of 119 European banks
Source: SNL, Scope Ratings

Figure 5: Total euro area NPLs (EUR) and NPL/loans ratio by country



Source: ECB, Scope Ratings

What is truly relevant for asset quality is that there are no visible signs of material deterioration in the quality of loan portfolios built in the post-crisis years – although an uptick in NPLs to more historically normalised levels should be expected in the medium term. On the one hand, this reflects tighter underwriting standards–demanded by supervisors and self-imposed by more conservative risk management. On the other, recent loans have been extended against a background of historically low rates, suggesting that future rate hikes may affect the repayment capacity of more leveraged borrowers. As a positive offset, the new IFRS 9 provisioning rules should significantly attenuate the negative effect of loan-quality deterioration by accruing provisions against expected, rather than incurred losses.

Good prudential metrics no longer offer complete reassurance: Major new risks have emerged for banks and other financial service providers, risks which cannot be easily (or at all) quantified and modelled, and against which prudential strength offers incomplete protection. Examples would be cyber risk and misconduct risk – including Black Swan events like instances of a money laundering, tax fraud or market-abuse scandals – or material ESG-related shortcomings. In addition to potentially leading to direct financial losses (triggered by a successful cyberattack or a massive IT failure, or regulatory and legal fines related to misconduct), the crystallisation of these risks can also engender a material negative impact on a bank's image with investors, business partners or public opinion at large. A harmful reputational blow can hurt a bank's business-generation capacity and alienate customers. Since the global financial crisis, the banking industry has not been able to restore its more positive pre-crisis image, thus from this angle it remains in a more vulnerable position.

The crisis also taught the banks that a threat materialises first in higher funding costs, stunting capacity to refinance and/or issue equity (if it needs so) at economically tolerable price points. This can happen also with banks which otherwise continue to display reassuring prudential capital levels. Some of the large European groups with substantial wholesale and/or geographically widespread activities – HSBC, Barclays, RBS, BNP Paribas, Credit Suisse, Deutsche Bank – have been affected in the past, with performance suffering, at least temporarily. Currently, Danske Bank is in a similar situation, with worrying developments stemming from the money laundering scandal.

Stress tests start showing their age: To no one's surprise, all stress-tested banks passed last month's EBA-led exercise, and more recently all UK banks successfully graduated from the Bank of England's own stress test (which included a very severe adverse scenario). Based on the very clear signals from senior EU bank supervisors in recent years about banks being sufficiently capitalised, we should not have expected to see banks failing the stress test (although a few outliers came closer to the lower limits of the EBA stress test).

Going forward we view traditional stress tests, highly relevant in the asset quality-challenged post-crisis years, as having marginally less pertinence. This is because the emerging major risk categories for the banking industry that are going to take up increasing shelf space among market concerns – the disruptive effect of digitalisation, cyber risk, misconduct risk, behaviour alienating segments of bank stakeholders -- are hardly stress-testable, at least not based on existing methodologies and models. If stress tests are going to remain a viable supervisory tool, which we believe will be the case, then fresh thinking is perhaps needed to revamp the criteria.

2. Profitability to remain subdued, but if risks remain low this is not a structural weakness

European banks continue to display low profitability because of: i) low-for-long interest rates that are not likely to budge much in 2019 and which depress investment yields and net interest margins; and ii) tough prudential regulations, with materially higher capital requirements and more constraints on balance-sheet structures and range of business activities. It is more difficult to boost ROE when the equity base is a multiple and the profits a fraction of pre-crisis levels.

But this is the very reason why credit investors should not be uncomfortable with current profitability levels. A high single-digit ROE is not a weakness for a bank, especially not when its risk profile is sound, and its business model is viable and sustainable. We take comfort from the fact that this message has gradually become more palatable to investors – even to equity investors, as bank equity valuations in recent years have been far from reflecting a general funk. Against evidence, a widespread belief is that, if only banks reduced their costs further, cleaned out their NPL portfolios more thoroughly, increased lending volumes, and went for more consolidation, they could somehow boost their profitability and become stronger. This belief is too often reinforced by senior regulators and policy makers, with the difficult-to-implement message that banks should boost profitability to get stronger, but without taking additional risks.

We do not expect the European banking sector to become substantially more profitable. High single-digit ROEs may in some instance move up to low double-digit ROEs (some banks are there already), but higher levels will be exceptions, and in fact might be worrying (indicating that the bank is taking excessive risks to maximise profits). Credit investors can safely live with high single-digit ROEs for banks, provided the fundamentals remain sound – including strong capital levels with only a remote probability of depletion (which as we have shown above is currently the case with most top-tier banks across Europe). The real discomfort should appear only when soft profitability indicators are combined with weak asset quality (requiring large provisions), below-average capital levels, risky business models, unconvincing strategies, or the loss of steam in a competitive market.

Cost of capital is overshot: The market seems to constantly overshoot the implied cost of capital for banks, which is routinely placed in the low double-digits (e.g. 11%-12%). For the large European banking sector aggregate we estimate it at around 7%-8%, taking into consideration a current risk-free rate close to nil and bank betas converging towards lower risk more so than before the crisis due to tighter regulations and improved risk profiles. Under such a scenario, a ROE in the high single-digits is far less worrying than if the cost of capital were truly a few percentage points higher.

Low net interest margins to persist but future rate hikes might not immediately help

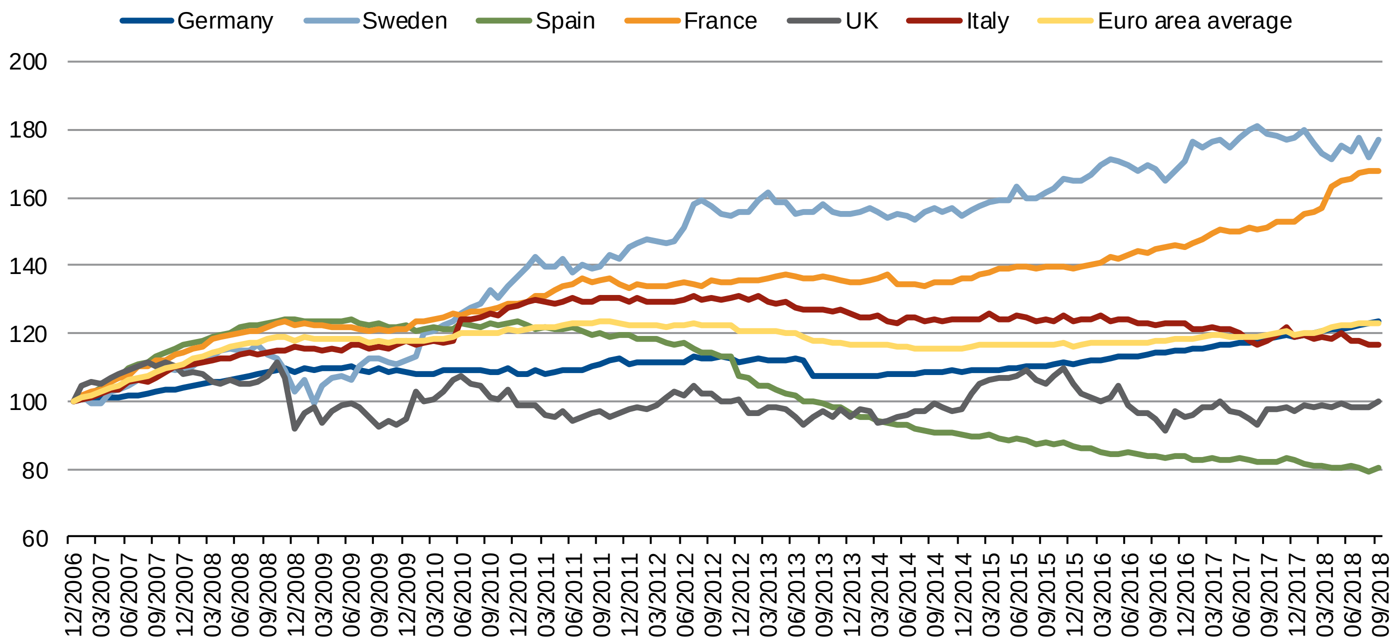
It is assumed that higher rates will help banks' bottom lines by hiking net interest margins. The assumption is based on the positive effect of higher rates on margins: boosting loan and other asset yields and thus widening the gap to liability costs. This would be especially true for assets comprised mostly of variable or resettable-rate loans.

However, in the current European economic and socio-political environment, things may evolve differently, at least in the first stages of a rate hike. Firstly, in several markets – such as France or Germany – a substantial segment of residential mortgages (usually a very large block of assets on a bank's balance sheet) are at fixed rates. Secondly, we anticipate that the first move a bank would make, when higher market rates justify it, would be to offer better terms to savers, who for many years after the crisis have been the unwilling victims of the low-rate environment (lest politicians forget savers are also voters). Repricing loans could come only at a later stage of the rate hike, and even then, more modestly. Therefore, it is probable that many banks' net interest margins will not visibly improve soon after a rate hike comes.

In addition, if a rate rise were to trigger credit repricing on a larger scale (as banks hope), many borrowers could run into repayment problems, thus heightening asset-quality problems and loan-loss provisioning needs for banks (especially as IFRS 9 has now kicked in). An incrementally higher net interest margin may not completely offset this potential growing cost.

As the current bout of economic growth in Europe seems to be less reliant on new bank lending, the volume effect (higher volumes of new loans being booked by banks) has not convincingly offset the margin effect, which keeps bank profitability metrics very low. Loan growth across Europe (Figure 6) shows a mixed bag, with Swedish and French banks at the top -- mostly mortgage-driven, thus building up on low-rate credits -- and Italian banks at the bottom, in negative territory.

Figure 6: Euro area countries loan growth (%, 2007-2008)



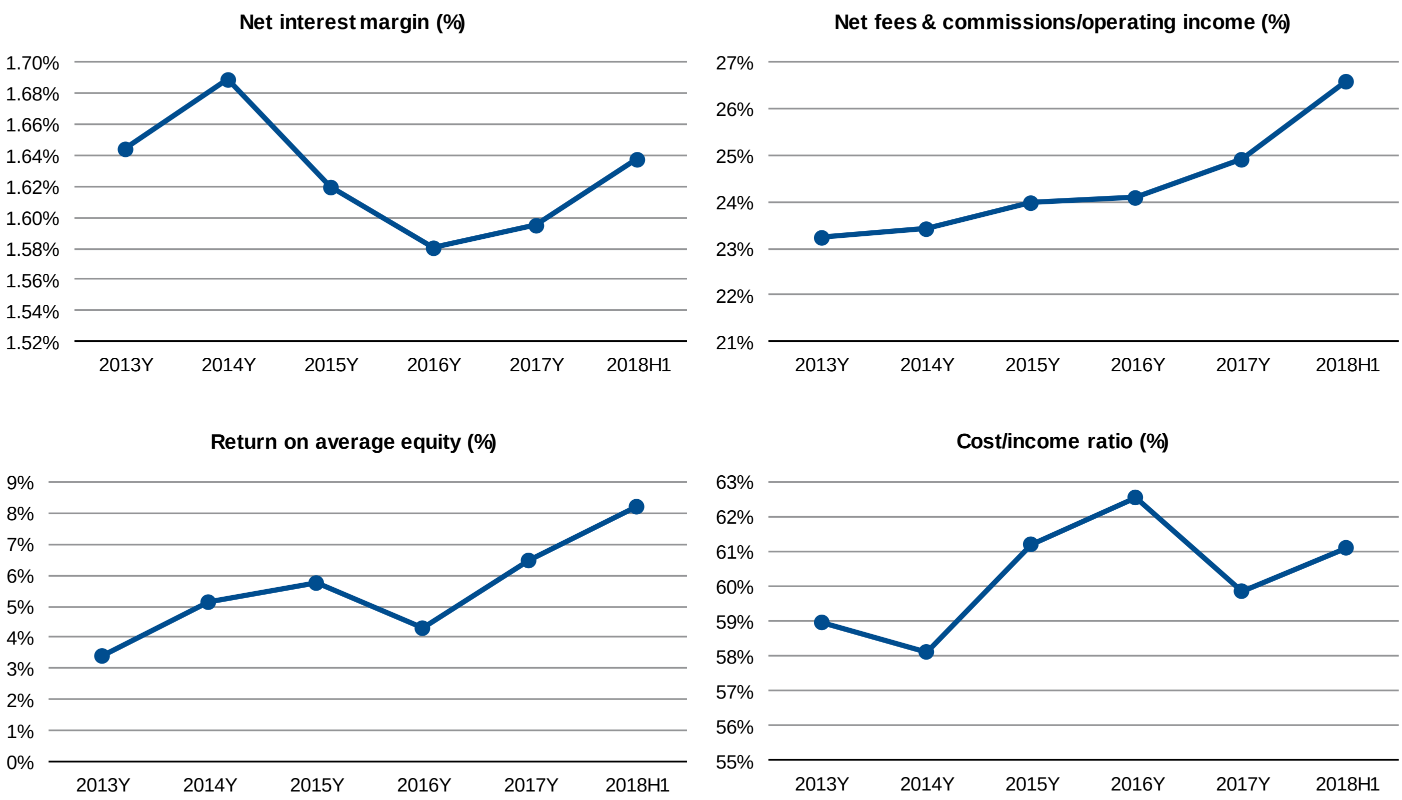
Source: ECB, Scope Ratings

Heightened pressure on fees going forward

Capitalising on business diversification, banks are increasingly relying on fees and commissions, which since the crisis have represented a higher share of revenues (notably in relative terms, as net interest income has remained subdued). But these sources of income will be under growing pressure, as demand for financial services, especially high-margin, high-risk products, remains more muted. And there are fewer high-margin products on offer. Investor preference is visibly more for low-fee passive investments like ETFs. On aggregate, millennials appear to be more financially conservative and less inclined or able than previous generations in the 1990s and 2000s to take financial risks. And as they enter the later stage in their lives, baby boomers, while generally sitting on more substantial savings and investment pools, are leaning towards risk-averse asset allocations. The adoption of new technologies is creating more transparency and efficiency and leading to product commoditisation – another blow to high fees and commissions. This process is facilitated by market regulations such as PSD2 or Mifid2. New digital alternatives also affect payment transfer and FX fees, which have traditionally been a stable source of revenues for banks. We do not anticipate any future reversal of these trends, on the contrary. This should significantly constrain banks' product and service pricing power and further pressure down fee revenues.

Figure 7 shows some aggregate ratios illustrating the trends discussed above.

Figure 7: Profitability metrics (2013-H1 2018)*



*Peer group of 119 European banks
Source: SNL, Scope Ratings

3. Further cost cutting is increasingly difficult (need for IT investments) and excess capacity is not melting away

Most European banks have been able to cut costs in the post-crisis years – a mix of more focused slim-down strategies, de-risking and deleveraging, as well as taking on board new more efficient technologies. However, short of more drastic restructuring steps – both at the bank level and systemically – this process is likely to become increasingly more difficult (last graph in Figure 7). This is not be good news for the industry. First, because dwindling flexibility to reduce costs offers fewer options to management in a fast-evolving environment; second, analysts and investors, rightly or wrongly, continue to look at this metric as being a key indicator of strength or weakness.

Without diminishing the merit of cost-income ratio related comparisons among banks, we see this metric as highly dependent on a bank's business model and activities mix, as well as the market(s) in which it operates. Pears in a German retail bank are not readily comparable with apples in a UK mortgage lender.

The more troubling challenge is the fact that, while playing up evolving digital strategies and adjusting to the new dynamics, primarily through significant multi-year investments in new technologies and digital platforms, a majority of retail and commercial banks across Europe continue to carry the burden of excessive legacy capacity – both in the physical branch network and in obsolescent back-office structures. It is easier, faster and less painful (with the appropriate investment in technology) to build digital product distribution than cut down a large branch network, as it is also easier to transfer operations to the Cloud than to slim down a top-heavy back office.

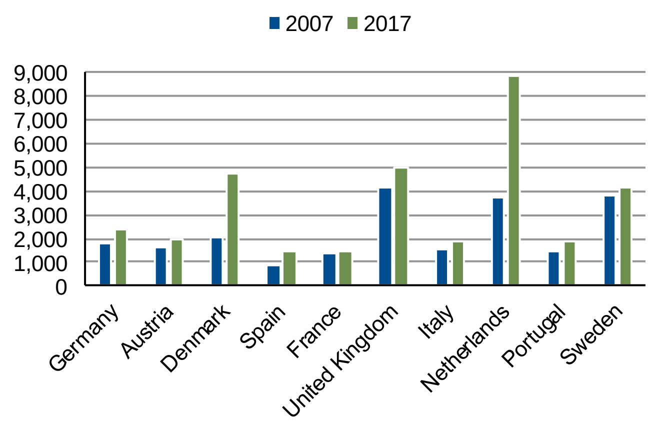
The task of reducing non-digital distribution and operational capacity is rendered very difficult by the need to adjust down employee payrolls. Sweeping staff reductions cannot be made rapidly or massively, as this would not earn banks any brownie points with public opinion. But they will nevertheless need to be implemented eventually to capture the evolving demographic dynamics, because there appears to be little alternative. Bank branches are not likely to disappear completely even when generational changes become more significant. But the surviving ones may one day end up being stripped down marketing posts (with very few or no employees) rather than representing a mainstream product distribution channel.

Some EU banking systems – the UK, Netherlands, Spain – have made some significant progress in reducing branch capacity during the last decade (see Figure 8). In fact, some UK politicians currently blame the banks for cutting branches from less densely populated areas. On the other hand, banks in Germany, France or Austria remain laggards.

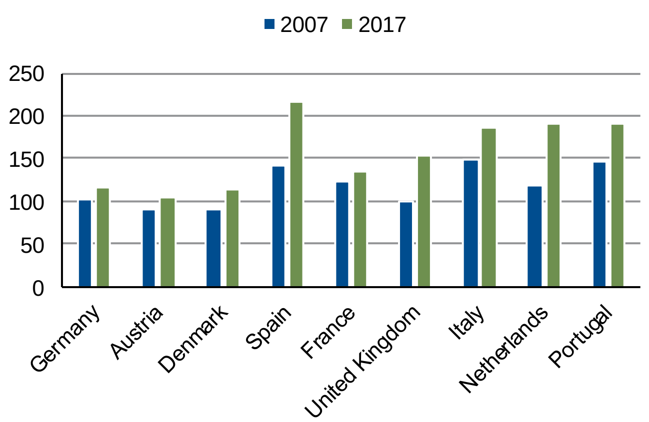
It is interesting in this respect to compare Germany with France. In Germany, regulators are encouraging faster in-market bank consolidation, which in their view should help reduce excess capacity and make the resulting entities more profitable, thus more competitive. And without a doubt more consolidation across the second-tier banking segment -- within the savings bank group and within the co-operative group – is necessary, but *ipso facto* may not be the straightest avenue to reducing costs. Not if we take the example of the highly consolidated French banking system (largely dominated by five or six groups), which despite this looks heavily over-branched and not that efficient.

Figure 8: Branch and employee excess capacity (2007 vs 2017)

Population over 15 / branch



Population over 15 / branch employee



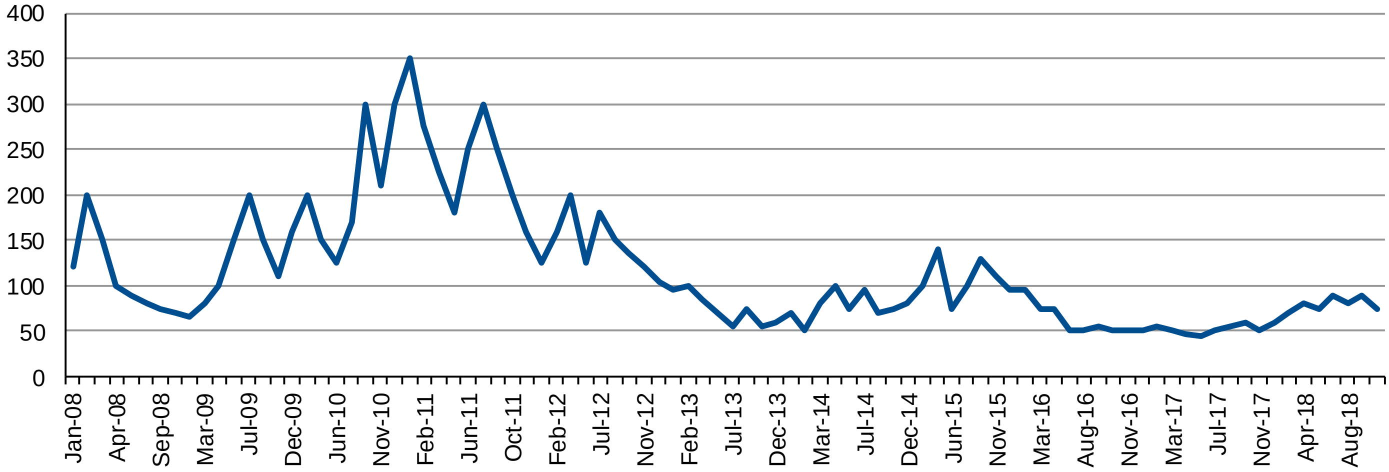
Source: Eurostat, ECB, Scope Ratings

4. Backstage rising clouds – Brexit, nationalism, geopolitical threats – hurt market sentiment on banks

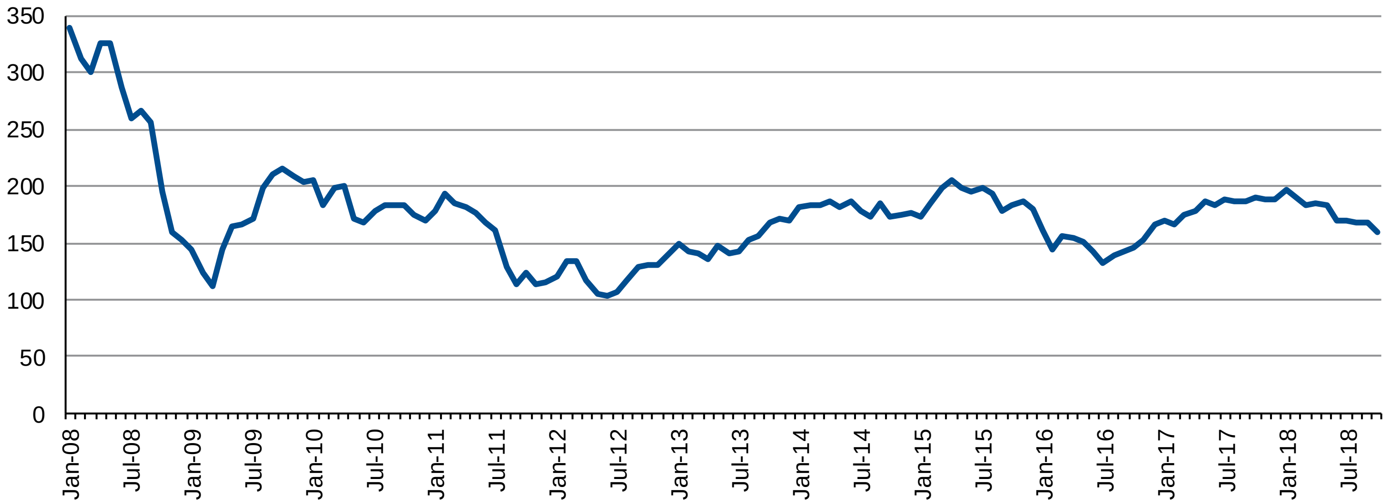
Despite the relatively decent shape of the European banking sector, the market has been showing increasing apprehension, evidenced by worsening indicators (see Figure 9). Post-crisis criticisms and warnings about European banks have been dusted off and resurfaced by analysts and the financial media. Negative market sentiment, whether justified to its fullest or not, can and does hurt banks' funding costs and equity prices, thus making it more difficult for some of them to refinance or issue fresh capital should they need it. The sources from which such negative market sentiment stems cannot be ignored. Some of them can affect directly the sector, by leading to more depressed top-line revenues (e.g. economic slowdown). Others can equally affect banks' funding costs through a 'butterfly effect'.

Figure 9: 10-year market indicators (2008-2018)

iTraxx Europe Senior Financials 5Y



Eurostoxx Financials index

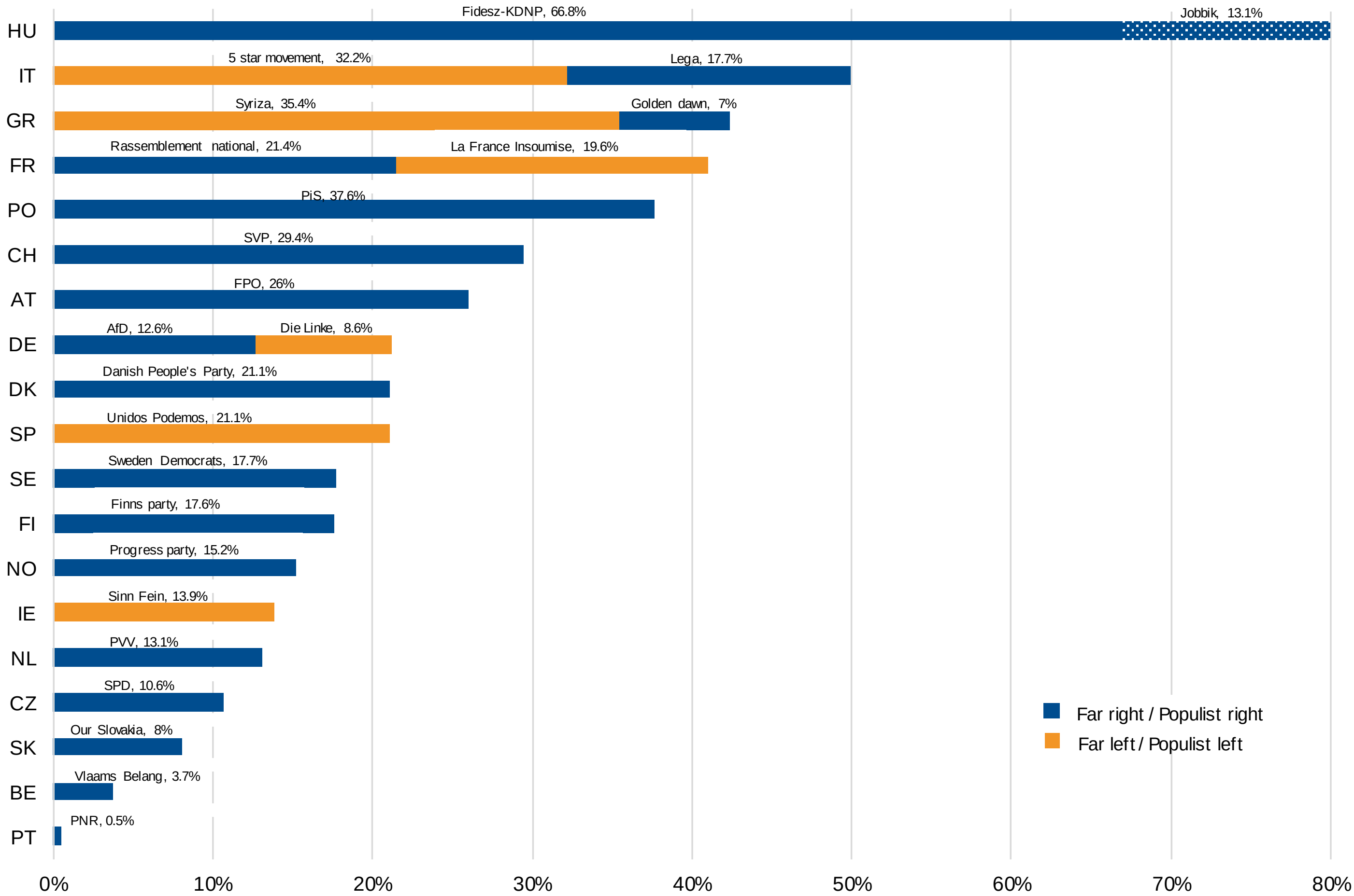


Source: ICMA, ECB, Yahoo,Scope Ratings

The seemingly close link between all these trends is worrying market participants. Brexit, President Trump's strident protectionism and threats of 'trade wars', as well as the rise of nationalism and populism, have all been moving against the shift towards globalisation (transfers of goods, services, ideas, and people) that has been with us since the fall of the Berlin Wall.

The financial crisis a decade ago painfully put a brake on this shift, but post-crisis the market has hoped, and acted based on this hope, that globalisation is back – this time without poorly regulated banks dumping risk into the market. The Brexit referendum and the US elections in 2016, the rise of populism and nationalism around the world – including closer to the core of European politics (e.g. this year's Italian elections), unmistakeably reflect the fact that a growing share of the population believes the system it had voted for before has not been delivering the goods and thus "things have to change". Figure 10 illustrates this state of fact across Europe.

Figure 10: European populist and nationalist parties % of votes in last national general elections



Source: BBC, The Guardian, The Independent, The Economist, El Pais, La Vanguardia, Statistics Finland, Robert Schuman foundation, Scope Ratings

Worsening market sentiment towards banks does not stem from any worrying trends that are directly related to the sector – as was the case a decade ago when the crisis erupted – but from what is happening in the socio-political sphere. Accordingly, we see market sentiment shifting gradually to adjust to the new realities, rather than reacting violently to full-on headline risk for which it is unprepared.

This is not about fears that unbridled bankers are sending the market 'to hell in a handbasket'; this is about learning (and learning to accept) where evolving societal shifts are moving the pendulum and how the banking industry is adjusting to it.

We would suggest four reasons to be concerned about the creditworthiness of the European banking sector. We highlight them in the order of what we believe may be the likely impact.

a. Hurting earnings generation: This can be most directly affected by a more difficult macroeconomic and socio-political environment. Specific for UK banks, a no-deal or other bitter-end Brexit is likely to lead to an economic slowdown in the UK or even a recession, which should affect earnings growth. More generally, a global economic slowdown stemming from a trade war or other protectionism-related measures by the Trump Administration would inherently lead to negative pressure on the top-line revenues of the large internationally active European banks, which contribute to global trade and financial flows. To be sure, higher market volatility can help revenues from secondary-market activities in investment banking. But neither the quality nor the stability of such earnings could be very reassuring.

Banks' bottom-lines can be affected if, and when, negative market sentiment hurts funding costs. Italian banks would be in the front line for this, especially in the unlikely event the ECB does not extend the TLTRO programme. UK bank funding costs would also hurt if Brexit has a very contentious finale. Equally, an outcome at next spring's European Parliament elections that would give populists and nationalists a clear victory could also translate in heightened market apprehension which would weigh on bank funding costs.

b. Emerging asset-quality problems: It is less likely that a deterioration in banks' asset quality is forthcoming to add material doubtful exposures on top of the dwindling legacy leftovers. After the crisis years, European banks did not in aggregate engage in risky lending on a material scale. The post-crisis generation of loans does not carry the same concentrations and risk characteristics as in the pre-crisis decade. This is true also in Italy, where new lending by the banks has not been convincing (banks preferred investing cheap funds in domestic sovereign bonds which, at zero risk weight, offered better returns).

However, if at some stage interest rates in the euro area start going up, marginally higher borrowing costs could pose problems for leveraged borrowers (especially businesses). Also, it is worth remembering that under IFRS 9 banks will have to start provisioning, on an expected-loss basis, at the first signs of problems in their loan portfolios.

Populist/nationalist power plays are however affecting banks' sovereign holdings – Italy being the most visible example. Spreads on Italian sovereign securities have moved up significantly following the aggressively anti-EU posture of the new coalition government. The market value of the portfolio in banks' books has thus been affected – added to the heightened funding costs in the market. This should be a concern for investors, it is for us.

c. Negative impact on the current regulatory architecture: The existing regulatory framework for banks across Europe is not threatened by the emerging populist and nationalist political shifts. In the UK, even under an undesirable Brexit scenario it is very doubtful that the current structure – prudential and conduct requirements, ring-fencing – will be altered. Both the Bank of England and the FCA have been clear in expressing the commitment to preserve the current regulatory environment and assure pro-active risk-based supervision. There is no reason to believe that a no-deal Brexit (a very negative outcome) would lead to a shift in regulatory focus.

In the euro area, the Banking Union is firmly in place with its two pillars – the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanisms (SRM). There is little reason to assume than the existing architecture would be under threat even if there were significant populist/nationalist victories in next spring's EU Parliament elections. At the same time, our view is that the current structure of the Banking Union is 'as good as it gets' and that the third pillar of the union – the European Deposit Insurance Scheme (EDIS) – will not be in place for the foreseeable future. EDIS is a nice-to-have rather than a sine qua non. Nevertheless, the preservation and enhancement of the SSM should offer a degree of reassurance and predictability for the supervision of the large and less large banks in the Banking Union. In fact, we expect more EU banking systems to join the Banking Union in the short to medium-term.

d. Political pressure on the large banks: There should be no plausible reason why a populist/nationalist European government – be it in Italy, Austria, Poland, or maybe in the future in the UK – would put pressure on the country's large banks to promote risky or politically-linked projects. Any government has a vested interest in preserving and enhancing a healthy domestic banking system. With the lessons of the crisis and pre-crisis years (the painful shrinkage of German Landesbanken, the collapse of Spain's cajas de ahorro), politicians – even those of a populist variety – would think twice before opening those doors again for any remaining public-sector bank, although the scenario may be different for non-deposit-taking development banks which have a public mission. Second, large private banks across Europe have gained significant independence from governments during the last decades – even in a country like France, where historically government influence had been more heavy-handed. Banks' independence from political interference is likely to be fully backed by the Banking Union structure in the euro area and by the Bank of England's independence in the UK.

We equally not believe bank nationalisations are on the cards at this time, even if a hard-left government were to come to power.

5. The digital age threatens banks' traditional cross-selling business model: heightened investor alert recommended

The evolving digital landscape is much more than merely a competitive challenge for banks – one for which no bank would publicly admit it is not adequately prepared. It is the very business model of the traditional bank that in time may be threatened by obsolescence. Over the next few years, we may well start to see the integrated business model of most banks – one institution competing with others by cross-selling as many products and services to its business and individual customers as possible – becoming increasingly disaggregated, with the bank as just one of the actors on a new stage.

This is likely to be transformational in Europe, where the financial system and circuits are more bank-intermediated than in the United States. By comparison, there is much more atomisation in the US financial sector, with the markets and many non-bank firms active in segments which in Europe are mostly in the hands of the banking industry: business loans and leases, mortgages, consumer loans, credit cards, funds, brokerage, insurance, etc.

The large banks that dominate the European financial landscape have managed, over the years, to capture a majority of financial services required by individuals and businesses, and by doing so to keep a firm grip on their customers' financial needs and solutions. In this process, the customer relationship has offered them an overwhelming advantage, as the banks know their clients' financial situation better than any other outside party and could thus offer the right solutions – typically in the form of the bank's own products or services.

Over the last few decades, the large European banking institutions have kept highlighting their unique and privileged relationship with their clients, strategically positioning themselves to boost revenues by cross-selling new products and broadening the customer footprint. The latter was achieved through competitive pricing (e.g. some products being loss leaders to capture new clients), as well as through M&As – at home and abroad. High product cross-sell ratios became a cherished metric showcasing a competitive advantage.

It is this business model which will become increasingly threatened by three significant developments: (i) the fast-moving pace of digitisation affecting everything and everyone; (ii) the significant behavioural shifts shaped by technology and demographic changes; and (iii) new regulations across Europe, primarily the Revised Payment Services

Directive (PSD2), aimed at facilitating openness and transparency and thus catalysing the erosion of the banking sector's protective walls.

We clarify these three developments below.

a. Global internet traffic is forecast by Cisco to reach 3.3 zettabytes (ZB)/year by 2021, from approx. 1.2 ZB in 2016 (a ZB is equivalent to a sextillion bytes, roughly the contents of 250 billion DVDs), moving the world towards a fuller use of the IoE (internet of everything). Also, it is anticipated that 76% of all internet traffic will be mobile by 2021, up from 46% in 2016. Cisco points out that the smartphone is becoming everyone's 'communications hub' for social media, music, video, and accessing the IoE through digitised aps. These megatrends will radically alter the way financial products, transactions and information circulate and are used, as well as the nature of customers' relationship with financial services providers.

b. Millennials (born between 1980 and 1996 and thus digital natives) are now the largest generation in the United States (surpassing baby boomers) and are about to become so in Europe as well. Added to millennials are large and fast-growing segments of digital adopters from earlier generations. Overall, millennials display more detachment and even aversion towards bank brands. A 2017 Accenture survey showed that a large proportion of millennials – 50% in the US, 40% globally – would switch their bank accounts to a big tech brand like Amazon, Apple or Google if a competitive offer existed. Interestingly, the same willingness to switch would not be the same if the alternatives to the respective bank were just fintechs.

   Dwindling trust in banks has primarily been the direct consequence of the traumatic years of the financial crisis, with the banking industry at the epicentre of the turmoil. As much as banks are now in a much better financial and prudential shape than a decade ago, the reputation of the industry remains damaged. A recent Pew Research report points out that the younger generations – those who trust tech brands more than banks – think of banking mostly through the digital visualisation of financial data. This is one area in which not too many banks have very attractive offers.

c. Regulations such as PSD2 are likely to lower entry barriers into banks' traditional turf. The Trojan Horse for this would be secure open APIs, which will have to be mandatorily shared by banks so that customers can more effectively manage their finances via their bank but also via other providers of financial services, depending on the attractiveness of the offer (again, assuming the customer allows the sharing of her data).

The future bank business model: For all the above reasons we believe that banks' integrated business models, which have worked quite well with respect to revenue streams and market positions, will be gradually replaced by the digital ecosystem's new business model with the customer at the centre and her bank, as well as other financial service providers, competing for her business on the open API.

Those institutions which adapt rapidly to the new landscape should inherently be in a pole position to compete. For example, banks bringing open APIs to their platforms will not only provide transparency and value to their own clients but may end up also attracting new clients. A few institutions, such as some Nordic banks or ING aim to go in that direction, and we understand there are other firms across Europe preparing themselves to do the same.

We do not believe that in this new digital world we can talk about a structural bank-vs.-fintech rivalry model. On the contrary, smart banks will find synergies with fintechs and go down a symbiotic route, often acquiring their business, in addition to funding start-ups themselves. The world of fintechs is becoming bigger and more diversified, spanning payments, savings, credits, investments, processes and compliance. Banks are looking to adopt the new technologies and avenues for business in the digital world, including blockchain, Big Data and Artificial Intelligence.

Banking not as disrupted as other service sectors, but it probably will: Many service sectors have been disrupted by online entrants having years ago displaced traditional business models: retail (Amazon), travel (Expedia, Booking.com. etc.), lodging (Airbnb), food delivery (Uber Eats, Deliveroo) or transportation (Uber). People can video-access lawyers or doctors via apps or pursue university degrees online.

It would be highly unrealistic to expect banks' business models and structures not to be significantly altered and disrupted, especially with new regulations like PSD2 encouraging the introduction of an open API structure. Banks like to justify the enduring value of a physical branch by pointing out that many clients choose to have a real person in front of them, not an app, when soliciting financial advice, for instance. But face-to-face contacts with a financial advisor can (and do) occur also via a live video meeting with an advisor on the smartphone or the tablet from the comfort and privacy of a home or office, rather than walking to a high-street office of the respective bank for a physical appointment.

Concerns for credit investors: An investor buying a new 10-year bond or perhaps even a five-year bond issued by a European bank, and planning to hold it to maturity, should realise that, by the time the bond matures, the issuing entity could be a very different institution, even if it still carries the same name. This need not, however, be a negative investor consideration; quite the opposite. Nevertheless, we would argue that investors, while remaining legitimately concerned about current issues – risk management, regulations, resolution scenarios, prudential metrics, asset quality, profitability, etc. – should also consider the different scenarios likely to emerge in the digital era and be able to assess which banks would be better positioned.

This is not about the likelihood of bank defaults as much as about some banks missing new opportunities while others take full advantage of them.

We would, however, be concerned about banks which, unable to adjust in an effective and competitive way to the new digital world, might try to compensate by taking unduly high 'non-digital' risks to preserve a certain revenue base and business case. At the end of the silent movie era, some actors did not make it to the talkies, while others retrained their voices and did well.

6. Cyber risk: banks' Achilles' heel, far from properly understood

Cyber risk is close to the top of the risk pyramid for financial institutions. The challenge for investors, analysts and supervisors is that a cyber threat cannot be properly quantified and measured. It might be a minor sideshow without relevance (other than some embarrassment for the bank's IT department), or it may have a truly devastating impact on the institution and its ecosystem. It all depends on the sophistication and determination of the hackers – cybercriminals or a hostile government – matched against the strength, depth and agility of the bank's cyber defences.

Investors and analysts generally feel reassured if they have a good degree of visibility over a bank's risks – be those in asset quality, funding, trading, or operations. In the case of cyber risks, this is not possible. It is understandable that banks will deliberately avoid providing too much transparency on their cyber defences, so outside observers are simply left to assume the best about a bank's cyber defence effectiveness; otherwise the colourful bank apps on people's smartphones would be rapidly deleted and accounts closed. The image, which banks like to entertain, is that of a rogue cyberattack being just a freak case, very unlikely to occur again. In general, banks have cyber protection plans, engage in self-hacking, sandboxing, simulations, emergency tests and, importantly, provide employee training around cyber risk and protective measures required.

Bank regulators are upping their own game, too, in understanding and acting on cyber risk issues. In recent years, we have seen an unprecedented co-operative effort between regulators across jurisdictions to build up cyber protection effectiveness in the supervisory process and bank regulations.

Co-operation against cyber threats is key: The key to credibility in the fight against cyber threats is co-operation between all parties, with a vested interest in making sure that the banking industry is not going to suffer deleterious consequences. To be successful, there needs to be a sustained effort, on a joint basis, on the part of the banking industry, regulators, governments, IT vendors, and external experts.

On the specific challenge of cyber risk, banks cannot be effective on their own and need to co-operate. The hypothetical minor upside that may be gained by having the reputation of being more effective on cyber risk than a competitor can be quickly drowned by a successful, massive cyberattack on that competitor which could significantly hurt trust in the viability of digital banking. Top managers and boards in banks need to shed the competitive approach when dealing with the cyberworld and embrace constructive co-operation. A tall order, but not an impossible one, and certainly a necessary step.

All the above suggests that investors who underestimate cyber risk in banks, or trust that the banks will handle it successfully in all occasions, do so at their own peril.

7. Misconduct risk has moved and stays centre stage

We see investors' concerns moving more forcefully towards heightened focus on bank misconduct risk. As noted above, prudential and balance-sheet financial metrics are far less of a concern for credit investors. In exchange, rules with acronyms like KYC (know-your-customer), AML (anti-money laundering), CTF (combatting terrorist finance), or GDPR (data protection) define the hard edge of misconduct-risk regulations, with clear legal consequences – financial and penal -- for infringement. In the decade since the crisis there have been numerous misconduct events, related to money laundering, tax fraud or avoidance, or market abuse. European banks have paid billions in legal and regulatory fines (especially related to their US operations).

In the years since the crisis, the major misconduct situations have been related to market abuse (e.g. manipulating interest-rate benchmarks, foreign exchange) and to the offering and transacting of US subprime mortgages. In recent years misconduct instances have related mostly to cases of tax evasion (or avoidance) and money laundering. The scandals currently affecting institutions like Danske Bank or Deutsche Bank are just the latest major developments, but banks like Credit Suisse or ING have also seen their share of misconduct in the more recent period.

In the UK, while the Bank of England (via the Prudential Regulatory Authority) is responsible for the prudential supervision, the conduct area falls under the responsibility of the Financial Conduct Authority. This is a clear division of the supervisory work, which brings transparency to the process. In the European Banking Union, however, this distinction is far fuzzier. The SSM is responsible for the prudential side, but the conduct supervision is in general handled at the national level by Competent Authorities. Overall, conduct supervision is kept separate from prudential oversight, in part because it requires different skills.

One relevant gauge of heightened supervisory focus on misconduct risk is the evolution of the EBA's mix of tasks. For the first several years of its existence – which covered the tail-end of the financial crisis and the years of the euro-sovereign crisis – the EBA mostly concentrated on prudential risk (e.g. capital, asset quality). While this focus continues, the EBA is now moving more forcefully on the misconduct front, looking at product suitability risk in banking, as well as money laundering and other related areas.

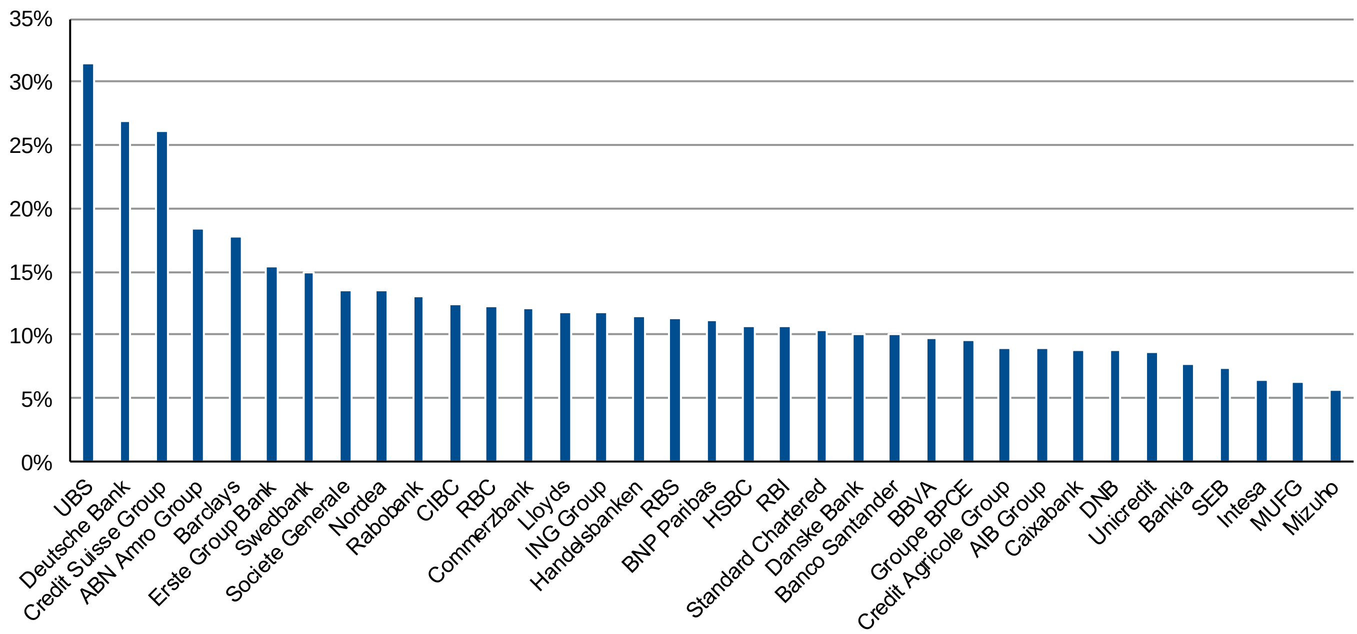
The focus on banks' misconduct risk should be firmly on investors' and analysts' front burner. At this point in the cycle, concern about misconduct risk (and about cyber risk as noted above) should be at least as important as concern about prudential and financial risk metrics (capital, liquidity, asset quality), if not more so. The problem is that in general analysts choose to focus primarily on risks they can quantify and model.

Misconduct risk and cyber risk cannot be modelled like capital or loan-loss provisioning metrics. This, however, does not make them any less lethal, on the contrary. And, aside from the prospect of hefty legal or regulatory fines (or worse), misconduct events on a material scale can have very corrosive effects for the respective bank's reputation – as indeed has been the case. And a damaged reputation can lead to a loss of clients, the erosion of new business volumes, or weakened market positions.

We believe European banks will pay heightened attention to misconduct risk, which should of course be a net positive. At the same time, the temptations for misbehaving are not likely to recede, as in general the level of political, business and personal corruption will probably not diminish either.

There are no capital charges specifically targeting misconduct risk (or cyber risk for that matter) in regulatory requirements, but banks, supervisors, and the markets have been focusing on the closest proxy – regulatory capital allocated to the share of operational risk in risk-weighted assets. Figure 11 shows that there are substantial differences in this metric across the large-bank universe, which in our view are largely explained by the banks' specific business models, balance-sheet structures, and risk management practices.

Figure 11: Share of operational risk in RWAs – Global comparison (H1 2018)



Source: SNL, Scope Ratings

8. ESG: higher market and policy expectations and higher standards

Institutional investors on both sides of the Atlantic are increasingly focused on environmental, social and governance (ESG) factors across the investable universe. Unsurprisingly, the banking sector is very much part of this approach. While the ‘G’ has been the most relevant for banks for many years, the other areas are growing in significance.

Spurred by investors, customers (millennials expect their banks to adhere to high business ethics and social responsibility norms), regulators, and policy makers, as well as acting on their own convictions, large banks are becoming more public about their ESG approach. This ranges from details on sustainable lending policies (e.g. less oil and gas, more renewable energy), across disclosure related to climate change and carbon footprint, to clarifications on their adherence to the Equator Principles (social and environmental principles underpinning project finance and related transactions), and the issuing and underwriting of green or social bonds (aiming to fund projects with environmental or social benefits). These are important aspects which investors and analysts increasingly focus on, and rightly so.

However, we are not reassured by some investors’ box-ticking approach of relying on third-party ESG scores rather than trying to undertake their own ESG assessment of names and sectors they invest in.

ESG disclosure by the banking sector has been improving, aiming to get closer to meeting investor and policymaker expectations. A review of the most recent (year-end 2017) detailed ESG disclosures by a sample of 20 large banking groups across Europe finds encouraging trends.

On environmental issues, nearly two-thirds of the banks in the sample say they have policies in place. The main areas are related to the management of water consumption, use of renewable energy, waste management, paper consumption, and to a lesser extent greenhouse gas emission-reduction measures.

On social issues, the banks report on practices which have a social impact in a community or society at large (working conditions, safety at work, human rights, etc.). The highest focus seems to be on employee diversity (by gender, ethnic mix, age, etc.) and well-being. Encouragingly, female employment in the banking industry across Europe is up, on average at 50% of the current workforce. At the top end on this metric would be Nordic and French banks, with Italian and Spanish banks at the opposite end. Nordic banks also report the highest percentage of women in management, at roughly one-third.

Governance: With respect to governance, some banks – but not all –made significant progress in the years following the crisis. While it is true that regulations are keeping banks on track, elements of ESG awareness are also changing banks’ culture for the better. A modified bank culture is leading to more responsible risk-taking, greater social, gender and ethnic awareness in employment policies and labour relations as well as higher health and safety standards.

The right approach to governance encompasses risk management, business ethics, responsible finance, product governance, and of course the organisation’s human capital. Avoiding unnecessary complexity (which may aim to obfuscate customers, investors and supervisors); staying away from fuzzier areas not solely because of fear of non-compliance but also because that it would not be doing the right thing; or taking the high road even when a close competitor chooses the low road – are – are all signs of good governance and a good culture.

Based on the disclosures of the 20 large European banks mentioned above, there is more transparency in reporting executive compensation, or board independence and composition. As an example, ca. one-third of large banks' board members are women.

In this respect, however, we believe that banks – European and non-European alike -- still have an uphill path to walk the talk in addition to talking it. One weakness that we continue to see in bank governance across the sector is the lack of diversity in top management teams (not at the middle management level). This is primarily an issue gender diversity. Even with a proper governance structure in place, the lack of gender and other diversity within a bank's decision-making ranks creates the danger of groupthink, which was one of the culprits behind the last crisis and which has clearly not waned.

Showing diversity awareness and adequate employment policies and practices at the level of the entire organisation but not implementing them to the same degree in the executive suite shows that there is still much room for improvement. Also, we note that, among the few women senior managers or executive board members at the top of the organisation, there is still a bias towards human resources or compliance functions. While these areas are clearly key for any organisation, having more women running the main revenue-generating businesses of the bank would in our opinion be net positives, and not just in terms of box-ticking gender diversity for the regulators and public opinion.

9. Large-scale cross-border bank M&A best avoided

Despite growing market expectations and official encouragements, large-scale M&A transactions in the European banking sector are nowhere to be seen. The message coming for some time from financial authorities (ECB, supervisors, IMF, EBA, etc.) has been that the European banking sector, insufficiently equipped to finance growth in the real economy, would benefit from more consolidation, including cross-border.

According to this type of message, the resulting European "champions" would display more robust profitability and thus be able to defend a global role against external competitors (e.g., large US banking groups with market caps that are multiples of their European counterparts). In addition, the ECB and the SSM, understandably, would feel that their role of pan-European supervisors would be better safeguarded (against possible future political interference of the populist/nationalist variety) if there were more pan-European groups to supervise.

One category of market participants that would immediately benefit from such transactions would be shareholders – especially those in the entity which is perceived to be the weaker M&A party. Equally, other agents with a vested interest in new dynamics stirring the markets – traders, short-term buy-and-sell investors, financial media – would be inherently in favour.

Serious doubts about rationales for large bank mergers: Nevertheless, credit investors should seriously question any large-bank M&A transaction, especially cross-border as not likely to add much economic value.

First, banks will have to aim for increased efficiencies and staving off competitors, which will undoubtedly be more challenging as time goes by if nothing effective is being done. Much of the competition comes from new digital structures and business models. A bank may feel the competitive pinch from another bank, but the chances are that both are impacted by the new digital ecosystem and the consequent changes in customer behaviour.

For this reason, rather than buying or merging with a legacy distribution capacity (e.g. another bank), banks should invest in digital capacity, be that existing fintechs or building their own. In the era of digital speed and transparency, banks should think twice before buying someone else's bricks-and-mortar– even if the plan is to subsequently trim down the branch network (which is not easy).

In fact, accessing new customers and new segments can be reached directly through open APIs and other digital distribution platforms, something that has already started to occur in some markets (e.g. the Nordics). This is true for domestic consolidation between large groups, but especially so cross-border.

Second, financial products are being increasingly commoditised, and customers have accepted this. Demand for customised high-touch products has severely reduced in the post-crisis years in both banking and asset management. Products and services can be more easily replicated through technology, without buying the factory.

Third, a significant factor in the past has been the trust customers place in a specific bank brand. This may still be the case to a certain extent, especially with groups that are perceived to be more customer-friendly, such as savings banks in Germany or Norway. However, as we have highlighted in this report, there is also an appreciable dose of scepticism about bank brands in the post-crisis decade. Boosting market position by acquiring another well-branded bank may no longer be that attractive.

Fourth, despite the positive evolution toward a supervisory level playing field across the SSM, banks rightly remain concerned about the regulatory and political treatment of cross-border mergers, including uncertainties about resolution structures or the possibility of capital or liquidity ring-fencing across jurisdictions, within or outside the EA. The Banking Union and the SSM are still viewed with a certain degree of suspicion by many politicians and even governments across Europe. By and large, national politicians and policymakers seem to have bought into the SSM-SRM concepts and structures, but, again, when the fear factor is back they may fall back on circling the home wagons first and displaying the European spirit later. The recent gains of populism and nationalism in European politics would support this scenario.

Fifth, while prudential and financial metrics are relatively transparent and can be assessed with some degree of confidence by parties considering an M&A transaction, new and more threatening areas of danger, such as cyber risk or misconduct risk, are far more opaque and difficult to gauge with any degree of confidence. Not surprisingly, a cautious bank would hesitate before walking into a mega-transaction without some reasonable comfort about these risks existing in the other party of the contemplated transaction.

In the current environment, there is always the viable scenario of a potential domestic merger between two large banks, attempting to stabilise the downslide of the weaker entity. This may be the current situation of Commerzbank (rated A) and Deutsche Bank (BBB+).

Need for consolidation among smaller banks: Having said that, there is a need for more systemic consolidation, primarily at the domestic level among second-tier and third-tier banks. We see no alternative to this, given the increased difficulty of smaller and inherently less diversified banks to generate profits at or above-survival levels. Low-for-long interest rates and digital advances will not make their lives any easier, on the contrary, even if they benefit from a lighter supervisory regime. This is true especially in Germany, Austria, or Italy, which are still burdened with too many institutions. We expect consolidation within the co-operative and savings-bank sectors in Germany (but not cross-sector) to continue.

In this respect, more consolidation among the remaining German Landesbanken, in parallel with a similar process for Sparkassen, could result in the S-Gruppe potentially becoming one of the more powerful retail and commercial banking groups in Europe. We hasten to add, however, that at the regional level the political process to achieve this is difficult, even if the will exists at the central group level.

Consolidation not a panacea for reducing excess capacity: Consolidating a banking system is not tantamount to reducing the system's excess capacity. France, a very large market, is dominated by between five and six banking and financial services groups, thus fitting the definition of a highly-consolidated market. Yet significant excess capacity continues to exist in the large French banks (in some more than others) which at some point will have to be reduced more substantially. This is one difficult bullet the French banks have yet to bite.

10. Bail-in vs. bailout: 'it's complicated'

Among credit sectors considered by institutional investors, banking is in the almost unique position of one of the top concerns being how an issuer will be handled in the event of failure. The difference between a large bank (i) collapsing, (ii) being bailed out with taxpayer funds, or (iii) being state-aided or placed into resolution, is of high importance for regulators, since their aim is to safeguard financial-system stability and protect depositors.

By now, unsecured credit investors will have realised that the safety of their investment depends first and foremost on the issuing bank's financial health. If they doubt the viability of a banking group, investing in a debt instrument on the expectation of potentially preferential treatment in a failure scenario is an unwise approach. Conversely, if the investment is in a bank with sound fundamentals, a resolution occurring for another institution should not unnecessarily lead to contagion and panic.

Excessive focus on funeral arrangements for an individual in good health can only go so far. Being comfortable with the name should be the key message for the fundamental credit analyst (although not necessarily for the trader or hedge fund manager).

Complex capital structures: European banks' capital structures have become more complex, with the introduction of various categories of seniority – including senior non-preferred debt. But there are not riskier, and they seem to us more transparent than before the new regulations came into effect. This should offer not just more choice to credit investors, but reassurance in equal measure.

Below we highlight our view on four regulatory-action scenarios for a deeply stressed bank: Early intervention by the supervisors; State aid; Resolution; and Liquidation.

These scenarios cannot be assessed in isolation. They may be overlapping (e.g. state aid accompanying other regulatory actions), sequential (e.g. resolution or liquidation following early intervention), or mutually exclusive (either resolution or liquidation). Junior securities are in the front row of vulnerability in all scenarios – first AT1, then T2.

Non-preferred senior debt should be vulnerable only in resolution and liquidation – and only after all junior securities have been written down or converted into equity. As all these debt classes were created in the post-crisis years to perform a primarily regulatory role (via CRD IV, BRRD, and subsequent amendments), we would not see them as being subject to political forbearance – unless they were mis-sold to retail clients.

The situation changes in the case of preferred senior debt and deposits (non-preferred but especially preferred deposits). Depending on the geography, some political protection can be envisioned for preferred senior debt, but less convincingly than for deposits. We expect deposits to be reassuringly sheltered in resolution or liquidation. The resolution framework is in place to safeguard financial stability and protect depositors, secured creditors, taxpayers and employees, not to shelter supposedly sophisticated professional investors from losses.

The table below provides a tentative vulnerability ranking of the various classes of a European bank's capital structure in the event of regulatory actions on failing banks.

Class	Early supervisory intervention (CRD IV)	State aid (EC state aid rules)	Resolution (BRRD)	Liquidation (national insolvency laws)
AT1	Very high	Very high	Very high	Very high
Tier 2	High	High	High	High
Non-Tier 2 subordinated	No	Relatively high	Relatively high	Relatively high
Non-preferred senior	No	No (most likely)	Material	Material
Preferred senior	No	No	Moderately low	Moderately low
Non-preferred deposits	No	No	Very low	Very low
Preferred deposits	No	No	Negligible	Negligible

Appendix: Scope's banks Public ratings

Bank ratings as of 10 December 2018

Bank	Country	Issuer Rating	Outlook	Senior unsecured		Short-Term Rating	Short-Term Rating Outlook	Capital securities	
				MREL/ TLAC eligible	Other			AT1	Tier 2
Banco Santander SA	Spain	AA-	Stable	A+	AA-	S-1+	Stable	BBB-	A- *(Santander Issuances SA)*
Bankia SA	Spain	BBB+	Stable	BBB	BBB+	S-2	Stable		
Banque Federative du Credit Mutuel SA	France	A+	Stable	A	A+	S-1+	Stable		BBB+
Barclays PLC	United Kingdom	A+	Stable	A	A+ *(Barclays Bank PLC)*	S-1+ *(Barclays Bank PLC)*	Stable	BB+	BBB+
BBVA SA	Spain	A+	Stable	A	A+	S-1+	Stable	BB+	
BNP Paribas SA	France	AA-	Stable	A+	AA-	S-1+	Stable	BBB	A-
BPCE SA	France	AA-	Stable	A+	AA-	S-1+	Stable		A-
Cassa Depositi e Prestiti Spa	Italy	A-	Negative		A-	S-1	Negative		
Commerzbank AG	Germany	A	Stable	A-	A	S-1	Stable		BBB
Credit Agricole SA	France	AA-	Stable	A+	AA-	S-1+	Stable	BBB-	A-
Credit Foncier de France SA [1]	France	AA-	Stable						
Credit Suisse AG	Switzerland	A+	Stable	A *(CS Group)*	A+	S-1+	Stable	BBB-, BB+ *(CS Group)*	BBB+, BBB *(CS Group)*
Danske Bank A/S	Denmark	A+	Negative	A	A+	S-1+	Negative	BBB-	
Deutsche Bank AG	Germany	BBB+	Negative	BBB	BBB+	S-2	Stable	B	BB+
DNB Bank ASA	Norway	AA-	Stable		A+	S-1+	Stable	BBB-	A-
HSBC Holdings PLC	United Kingdom	AA	Stable	AA-	AA *(HSBC Bank PLC)*	S-1+	Stable	BBB	A
IBL Banca	Italy	BBB	Negative						
ING Bank NV	Netherlands	AA-	Stable	A+	AA-	S-1+	Stable	BBB *(ING Group)*	A- *(ING Group)*
Intesa Sanpaolo Spa	Italy	A	Negative	A-	A	S-1	Stable	BB+	
KBC Group NV	Belgium	A+	Stable	A	A+	S-1+	Stable	BBB-	BBB+
KfW [2]	Germany	AAA	Stable		AAA	S-1+	Stable		
Landkredit Bank AS	Norway	A-	Stable		BBB+				
Lloyds Banking Group PLC	United Kingdom	A+	Stable	A	A+ *(Lloyds Bank PLC)*	S-1+ *(Lloyds Bank PLC)*	Stable	BB+	
Nordea Bank ABP	Finland	AA-	Stable	A+	AA-	S-1+	Stable	BBB-	A-
Rabobank Group	Netherlands	AA-	Stable		A+	S-1+	Stable	BBB-	A-
Realkredit Danmark A/S	Denmark	A+	Negative			S-1+	Negative		
RBS Group PLC	United Kingdom	A	Stable	A-	A- *(NatWest Markets PLC)*	S-1 *(NatWest Markets PLC)*	Stable	BB	
Societe Generale SA	France	A+	Stable	A	A+	S-1+	Stable	BBB-	BBB+
Svenska Handelsbanken AB	Sweden	AA-	Stable	A+	AA-	S-1+	Stable	BBB-	
Swedbank AB	Sweden	A+	Stable	A	A+	S-1+	Stable	BB+	
Totens Sparebank	Norway	A-	Stable		BBB+				
UBS AG	Switzerland	AA-	Stable	A+ *(UBS Group)*	AA-	S-1+	Stable	BBB *(UBS Group)*	A-
Unicredit Spa	Italy	A	Negative	A-	A	S-1	Stable		BBB

[1] Rating based on guarantee and solidarity mechanism within BPCE Group.

[2] KfW benefits from a guarantee by the Federal Republic of Germany.

Source: Scope Ratings

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