European banks: strong profits, capital buffers protect creditors from softening macro outlook

At times of great uncertainty, it is useful to step back from the ambitious and often near-impossible goal of forecasting financial impacts with precision, and to focus instead on the availability of buffers for risk protection. In this report, we offer a simple, transparent framework for assessing the vulnerability of European banks to unanticipated shocks.

Since Russia's invasion of Ukraine, we have highlighted how direct exposures to both countries look manageable for European banks in our rated universe. At the same time, we have stressed great uncertainty around the macro outlook and the risk that the V-shaped rebound in the European economy could come to a halt. Forecasters have started adjusting their estimates downwards, but this process may only have started. While expectations still point to growth in positive territory in 2022, it is too early to conclude that banks will escape unscathed.

We have noted that the war and the sanctions on Russia expose European banks to a number of risks which are, by their own nature, impossible to quantify *ex ante*. These include the risk of losses related to cyberattacks, regulatory fines related to non-compliance with sanctions, and customer losses associated with mis-management of the newly-found ESG dimension of doing business in Russia.

High inflation readings have already triggered aggressive monetary tightening in the US and UK, with the ECB expected to follow suit. So far, rate hikes have been contained, but market expectations are for significant further tightening in all major currency areas.

Banks have been spreading a cautiously optimistic message. The lifting of policy rates (and expectations of further rate hikes) is a key support to interest revenues, while worst-case scenario impacts from full write-downs of Russian and Ukrainian businesses look manageable. Rising yields are hitting the value of securities portfolios, which is a drag on capital ratios for banks which still mark them to market, but these are few and far between.

We expect the environment to remain supportive for bank credit, with the better interest-rate environment more than offsetting a mild deterioration in credit quality as growth softens. However, we are cautious of downside risks. We believe that central banks are walking a tightrope, with significant risks of policy mistakes in both directions. If they hike too fast or too far, they risk killing the post Covid recovery.

If they are seen as too complacent against the inflation threat, they risk de-anchoring expectations and having to hit the brake harder later on. Asset quality has proven very resilient to the Covid shock, though this was the result of very significant public-sector support and extremely loose monetary policies. Whether this continues to be the case as central banks try to put a leash on inflation remains to be seen.

This report focuses on a sample of 50 large banks rated by Scope. European banks entered 2022 with strong balance sheets, including high capital, low levels of legacy NPLs, and decent profitability, largely the result of a cautious management of the Covid-19 shock in 2020. We measure their buffers in terms of capital and ordinary profitability and find that, with few exceptions, banks are well placed to withstand a deterioration in credit quality should this occur in the coming quarters.

We calculate that the majority of the banks sampled could withstand a trebling of credit provisions and still remain profitable. Nordic banks stand out as the most resilient to an asset-quality shock, thanks to their high pre-provision profitability coupled with a very low level of credit risk.

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Rapidly deteriorating growth outlook, with risks skewed to the downside

In our first reaction to Russia's invasion of Ukraine on February 21, we flagged the risk that the war could dampen prospects for economic growth throughout Europe (see European bank exposure to Ukraine manageable but second-round effects could be material).

Scope expects 2022 and 2023 growth momentum to slow from the very high recovery rates of 2021 but to remain generally above potential.

Lower growth in Europe ahead

Under Scope's baseline scenario, the recovery will slow, especially in Europe, hit by rising energy and commodity prices, negative confidence channels and a slowdown in international trade, including in relation to economic sanctions on Russia. Nevertheless, output is supported by a simultaneously easing of headwinds from the pandemic crisis and from a degree of extended fiscal policy accommodation. Annual output in 2022 remains consistent with an economic baseline of robust although uneven economic growth, with risks skewed to the downside.

Further escalation of geopolitical tensions and of the associated sanctions regimes could weigh on asset prices and risk sentiment, while a more substantive energy shock cannot be ruled out at this stage. Continued disruptions to supply chains from pandemic -related lockdowns in China and other emerging markets could raise the risk of stagflation and influence monetary policy outcomes.

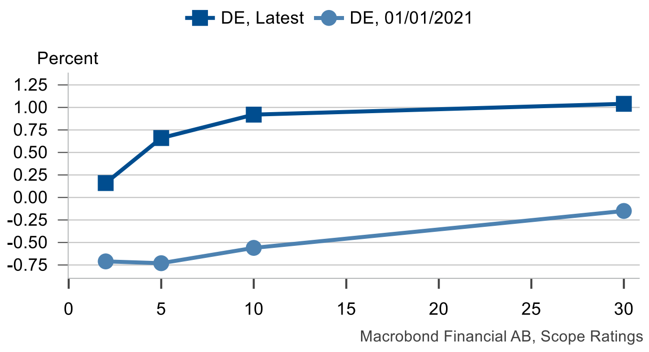
Inflation and higher interest rates a mixed blessing for European banks

Entering 2022, inflationary trends were already evident in several key energy commodities and a consensus had formed towards a pattern of gradual increases in policy rates in major Western economies. War in Ukraine, the steep deterioration in the Russia-European relationship, and the lockdown in Shanghai in April will only exacerbate price pressures. Policy rates in the UK and the US have started going up, and the rates market is pricing in an increasingly hawkish Federal Reserve. The ECB has so far signalled a more cautious approach, but our expectation is that euro rates will also start rising this year.

Higher interest rates supportive of bank revenues

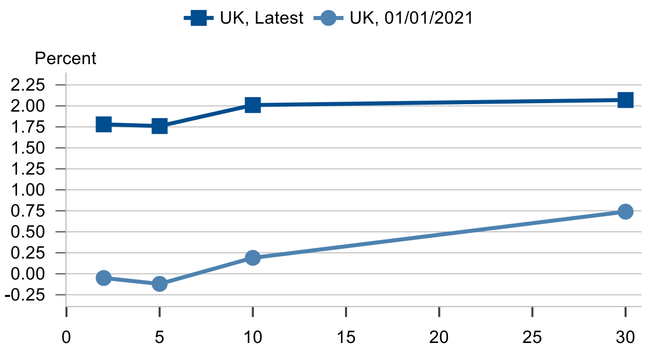
This environment has many advantages for banks but is not free of pitfalls. Short rates moving from negative to zero will reduce the cost of excess liquidity held at central banks. This has been weighing on banks' profitability for the best part of a decade, in particular in core Europe. Further increases in short-term rates will likely boost bank revenues, in particular for banks with large retail franchises, as non-remunerated current account deposit balances tend to be relatively sticky. A steeper yield curve in general will support income from traditional banking activities. Banks are, at their core, maturity transformation machines.

Figure 1: Steepening yield curve supportive of bank revenues, Germany



Source: Macrobond, Scope Ratings

Figure 2: Steepening yield curve supportive of bank revenues, UK



Source: Macrobond, Scope Ratings

Partly offsetting these benefits, higher interest rates could prove a headwind to banks with a greater share of wealth management in their business mix. For the past decade, low rates on savings deposits have increased the relative attractiveness of higher-yielding investment products, boosting fee income from asset management and distribution. Higher rates could mean a reversal of this trend, especially if coupled with greater volatility in risky assets.

In an inflationary environment, banks' management of their cost bases will be put to the test. The cost lever has been a key element supporting profitability in recent years, as banks have moved to shrink their physical distribution networks and workforces, while keeping wage inflation in check. The latter may be more difficult with CPI inflation running at high-single digit rate (if not higher).

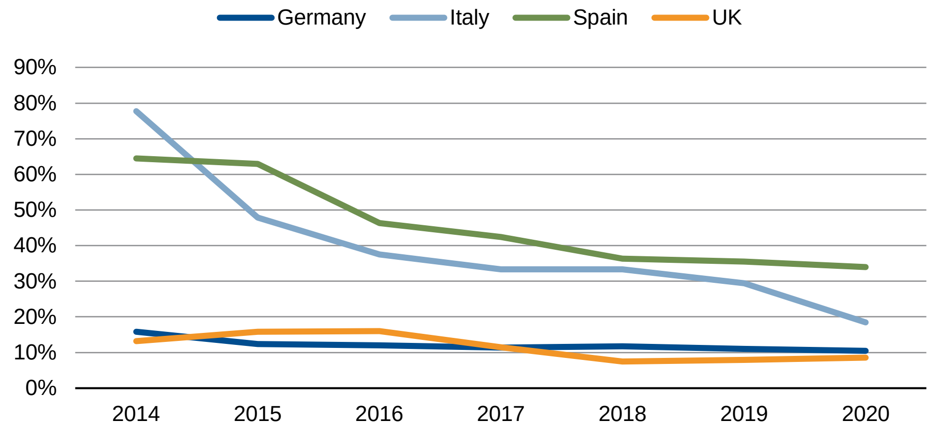
Asset-quality risks have increased

In the short term, asset quality is likely to deteriorate. Inflation will eat into household budgets, and rising mortgage rates may put pressure on customers with variable rates mortgages.

Positively, we note that the proportion of mortgages originated with variable rates has been declining over time in many European countries. While this will also likely negate some of the benefits of rising rates in the back book, it will also limit the likely decline in credit quality.

Governments may move, at least partially, to soften the blow from higher bills on more vulnerable households, but this is unlikely to fully negate the adverse impacts on repayment capacity.

Figure 3: Variable rate mortgages have been declining as a share of total mortgages (%)



Source: EMF, Scope Ratings

The resilience of different corporate sectors to higher inflation and rates raises question marks. A disinflationary environment has prevailed for the best part of the past 30 years in Europe, meaning that most entrepreneurs and top managers have no direct experience of managing businesses in inflationary environments. The same goes for bankers. The global financial crisis of 2007-2009 and the subsequent European sovereign and banking crisis have resulted in banks' origination criteria putting greater weight on borrowers' cash flows (as opposed to collateral).

Banks have to adapt to a higher inflation environment

This approach has resulted in recent years in better credit selection and loan performance across the board. However, in an inflationary or even stagflationary environment, corporate cash flows are likely to be more volatile. Real-estate collateral may provide rising protection for nominally fixed loan amounts. How quickly banks adjust their origination and risk management practices to the changing realities remains to be seen.

Longer term, we believe higher (but controlled) inflation should help engineer a beautiful deleveraging, in which the real value (and burden) of legacy debt declines, and incomes grow faster than debt. This may not be good news for credit investors, but it will help reduce asset-quality risks.

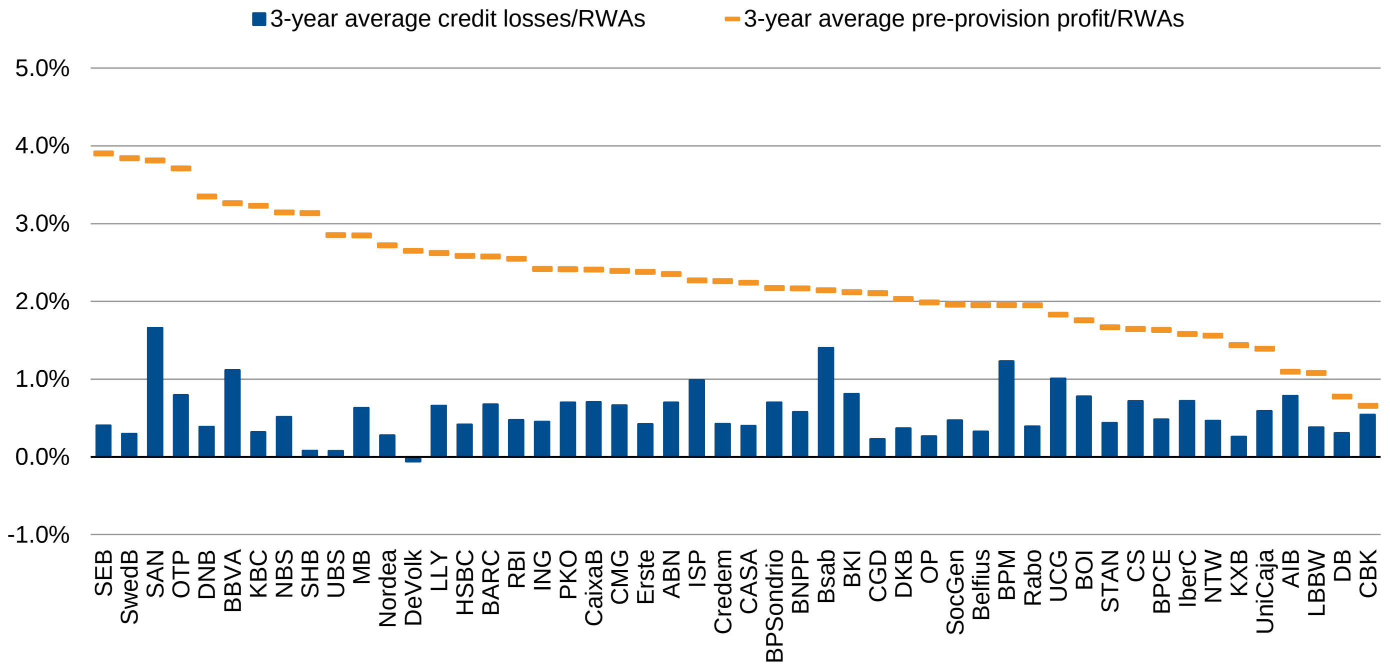
Solid earnings buffers provide a strong first line against credit deterioration

For the 50 banks in our sample, we calculate pre-provision profitability and cost of risk for the 2019-2021 period. This gives us a rough estimate of the room banks have to absorb additional costs through their P&Ls before capital is affected. High underlying profitability is also a key anchor determining banks' ability to raise equity if the need were to arise due to exceptional circumstances.

Banks can absorb rising credit losses out of ordinary profits

Nordic banks stand out for their very high profitability coupled with a low level of credit losses. Several banks with emerging-market exposures also display high profitability, often on account of higher interest margins – although this is sometimes coupled with high cost of risk. At the other extreme, we find banks with very high reliance on interest revenues whose profitability has suffered disproportionately from the very low-rate environment, in particular in the Euro Area.

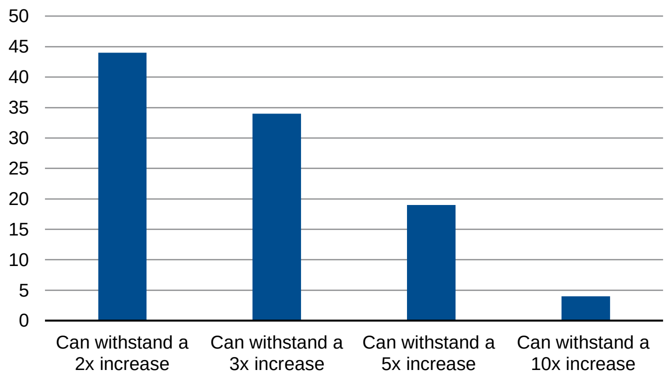
Figure 4: Pre provision profit and loan loss provisions, % of RWAs (average 2019-2021)



Source: S&P Capital IQ, Scope Ratings

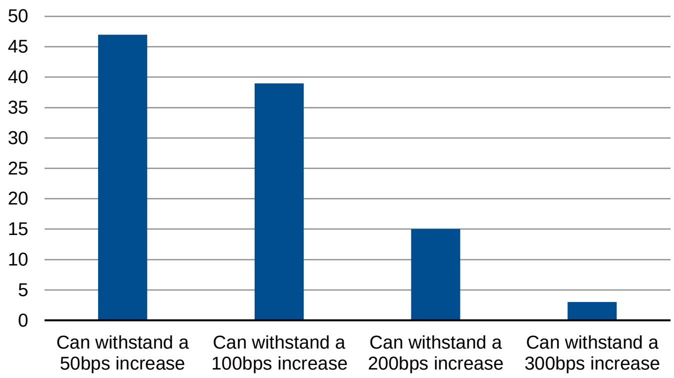
Our initial calculations allow us to stress cost-of-risk assumptions to model the banks' ability to withstand increases in cost of risk. We estimate that the majority of the banks in our sample could withstand a trebling in cost of risk while remaining profitable. According to our calculations, Svenska Handelsbanken, Swedbank, KBC and UBS would be able to withstand a tenfold increase in credit provisions while continuing to show a positive bottom line. Similarly, we calculate that close to 80% of banks in our sample could absorb a 100bp increase in cost of risk out of ordinary profitability. Swedish banks again stand out on this account: SEB, Handelsbanken and Swedbank would still be profitable in the extremely unlikely scenario where loan-loss provisions increase by 300bp of RWAs.

Figure 5: Majority of banks could absorb a threefold increase in CoR



Source: Scope Ratings

Figure 6: Majority of banks could withstand an increase in cost of risk of up to 100bp of RWAs



Source: Scope Ratings

Capital buffers remain sizeable despite generous distributions

Following years of high profit retention, European banks have accumulated very comfortable capital cushions relative to regulatory requirements. We calculate that the median CET1 ratio now stands well over 15%, and no bank has a CET1 ratio below 10%. This is largely the result of the great re-regulation that followed the global financial crisis. Chasing ever-higher requirements, European bank have built high capital stacks, which we have highlighted as a key source of strength for the industry. Prior to the GFC, the median CET1 ratio was 7%, and no bank had CET1 ratio of more than 15%.

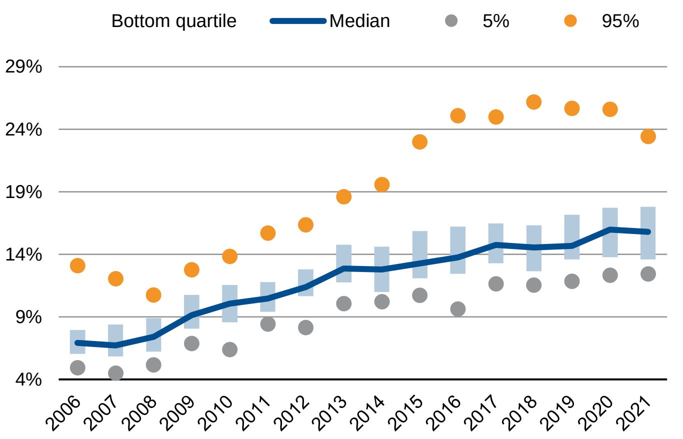
European banks have excess capital

As Covid-19 hit, the process of capital accumulation had another leg up. Prudently, supervisors nudged banks into retaining profits in anticipation of higher loan losses, which have – at least so far – failed to materialise. This has left European banks with significant excess capital.

Capital build went into reverse from the second half of 2021, when European banks started announcing plans for generous dividend distributions and share buybacks (see **EU bank stress tests: four key takeaways for investors** published in August 2021).

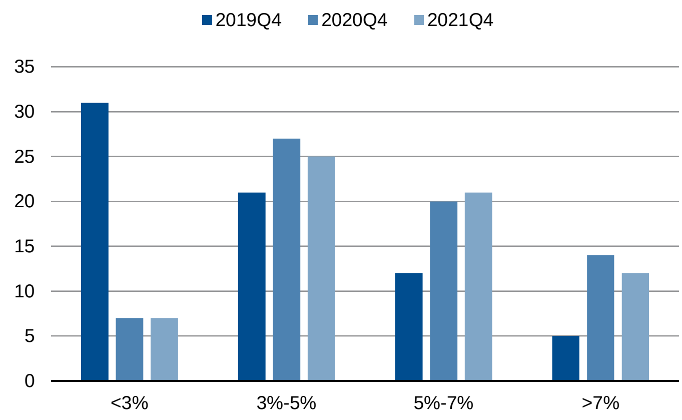
But buffers to capital requirements still remain large. If banks headed into the pandemic with buffers typically below 300bp, a more typical figure now is 500bp. This is well above the banks' own targets, affording significant flexibility with respect to organic growth, M&A opportunities and distributions.

Figure 7: Covid dividend ban boosts CET1 ratios



Source: Scope Ratings

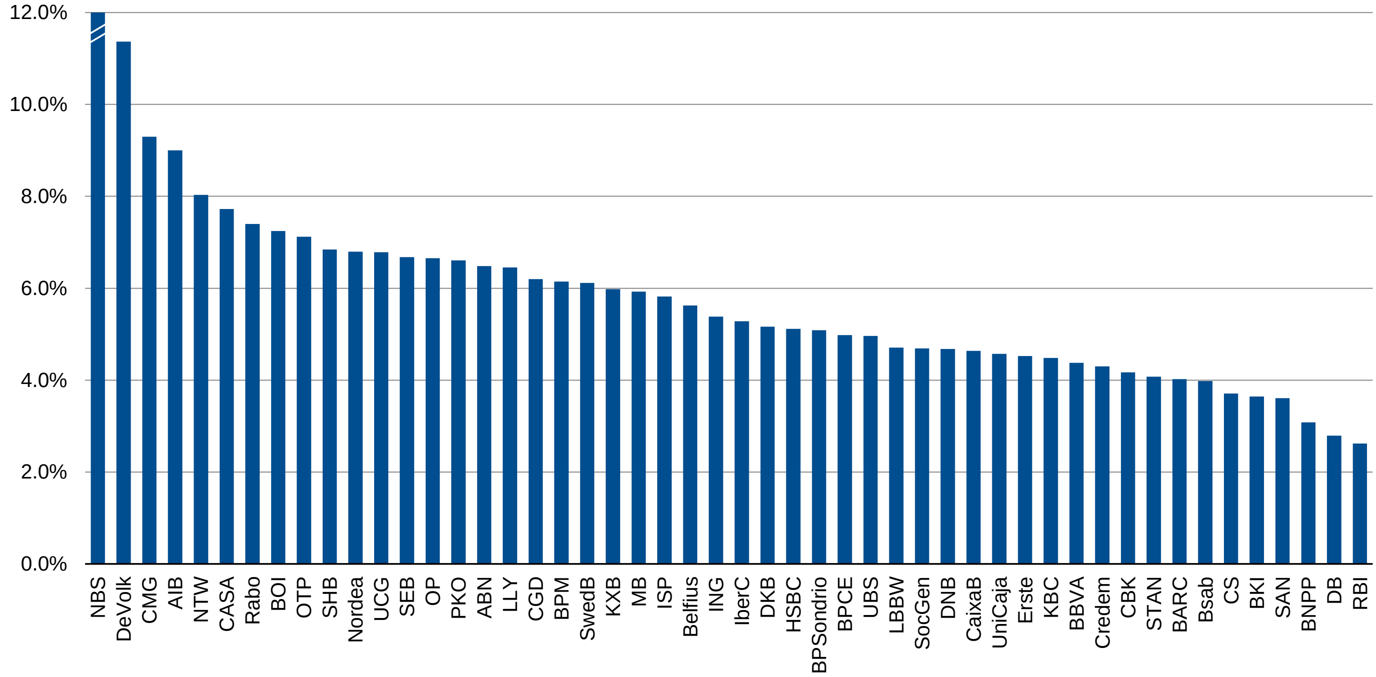
Figure 8: Distribution of minimum buffer to requirements



Source: Scope Ratings

So far, banks have largely stuck to their pre-war capital distribution plans, with RBI being the most notable exception. Even banks with sizeable exposure to Russia, such as Societe Generale and UniCredit, have indicated that they are comfortable with their distributions plans, at least for now. Supervisors have ruled out imposing blanket bans on distributions, which we take as a sign that they are relatively comfortable with banks' exposures and overall balance-sheet quality.

Figure 9: Minimum distance to capital requirements (% of RWAs)



Source: S&P Capital IQ, Scope Ratings
Note: NBS' minimum buffer stood at 23.3%

Looking at the combination of profitability and capital buffers, we consider European banks to be reasonably equipped against a deterioration of the business cycle.

Nordic banks best placed to withstand weaker macro environment

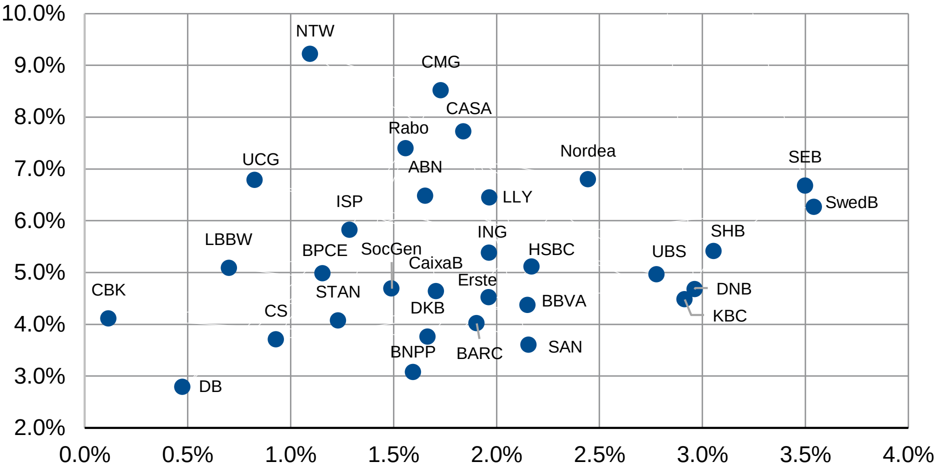
Nordic banks stand out both for their above-average post-provision profitability and high level of excess capital. Their strong efficiency metrics, underpinned by modern franchises and high digital penetration have combined with low credit losses in what has long been perceived a safe haven of European banking. Capital buffers have declined in recent years as a percentage of RWAs, although this typically reflects regulatorily-driven RWA inflation and higher buffer requirements.

Conversely, German banks look more vulnerable due to lower earnings capacity and relatively more contained capital buffers.

German banks have relatively low pre-provision profitability compared to European peers, which limits their ability to absorb increases in cost of risk in more extreme scenarios. This is driven by low net interest margins and cost/income ratios that are still far from international standards.

Even for German banks, it is useful to note that 2021 performance was stronger than it has been in the past decade, and that they would be especially positively geared to rising interest rates in the Euro Area, given their swathes of excess liquidity.

Figure 10: First line of defence: Capacity to absorb exceptional provisions (x) vs Second line of defence: minimum buffer to capital requirement (y)



Source: S&P Capital IQ, Scope ratings

Direct exposure to Russia and Ukraine: a tangible risk, but only to a handful of banks

European banks' exposures to Russia and Ukraine through local subsidiaries is limited.

Ukraine's banking market primarily comprises three State-owned systemic institutions (PrivatBank, Oschadbank and Ukreximbank). European banks are relevant players, though the size of their local balance sheets is limited to a few billion euros equivalent and is mostly funded via local deposits, leaving banks exposed primarily through their equity stakes.

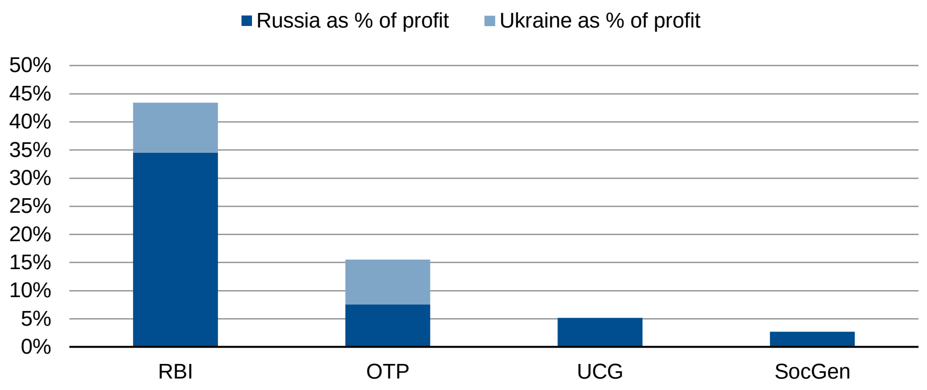
RBI's Bank Aval is the largest of the foreign-controlled banks, which also include BNP Paribas' Ukrsibbank, PKO's Kredobank, as well as Credit Agricole's and OTP's local subsidiaries. RBI's equity in Aval, excluding minorities, was worth approximately EUR 320m-equivalent at end of 2021, and this is the largest foreign-controlled bank in the country.

Despite the war, Western banks look keen to continue operating in Ukraine to support the local financial infrastructure and what remains of the Ukrainian economy. The banks have also joined international efforts to mitigate the humanitarian crisis in the country, in particular in support of refugees. For example, PKO allows refugees to exchange cash hryvnia into zloty at its local branches.

In Russia, European banks also play along local banks, many of them State controlled.

RBI, Societe Generale, UniCredit and OTP all have sizeable local operations in Russia. The size of their Russian subsidiaries' balance sheets varies from a few percentage points of total consolidated group assets (UniCredit and SG) to close to 10% of the total (RBI). RBI also maintains a significant profit dependency on Russia (Figure 11). OTP's profit dependency is similarly non-negligible, especially when considering the combined contribution of Russia and Ukraine to group profits.

Figure 11: Russia and Ukraine subsidiaries as % of 2021 profits



Note: For UniCredit, 5% of underlying net profit definition, excluding one offs, DTAs, AT1 coupons and CASHES
Source: Banks, Scope Ratings

Several European banks also reported offshore exposures to both Russia and Ukraine (see Box B). Large French, Italian and German banks reported sizeable exposures, and they could suffer material losses under a worst-case scenario (see Box B).

Box A: Selected European banks' exposures to Russia and Ukraine	
Raiffeisen Bank International (RBI)	**Russia:** Local subsidiary JSC Raiffeisenbank. Total assets (T/A) of EUR 19bn or 10% of consolidated T/A (RWA: EUR 12bn, 13%); total equity of EUR 2.1bn; c. EUR 400m in subordinated debt instruments at end-2021. No commitment to the entity beyond invested equity and subordinated debt of total EUR 2.4bn. Cross-border exposure to Russia of EUR 600m (net exposure to Russia: EUR 400m as of March 2022). **Ukraine:** Local subsidiary Raiffeisen Bank JSC, with T/A of EUR 4.1bn or 2% of consolidated T/A (RWA: EUR 3.5bn, 4%) and total equity of EUR 500m at end-2021. Cross-border exposure to Ukraine: EUR 200m. **Belarus:** Local subsidiary Priorbank OJSC, with T/A of EUR 2.1bn or 1% of consolidated T/A (RWA: EUR 1.7bn, 2%) and total equity of EUR 400m at end-2021.
Société Générale	**Russia:** Local subsidiary JSC Rosbank, with total assets of EUR 16bn and total equity of EUR 2.3bn as of June 2021. Total exposure to Russian counterparties: EUR 18.6bn at end-2021 (1.7% of group credit exposure); 83% via local subsidiary Rosbank (EUR 15.4bn). Offshore exposures: EUR 3.2bn, mainly to metals and energy sectors (EUR 2.8bn at end March 2022). **Ukraine:** Minor exposure of EUR 80m at end-2021 through its subsidiary ALD.
UniCredit	**Russia:** Local subsidiary UniCredit AO with total assets of EUR 14bn (1.5% of consolidated total assets as of Q3 2021), total equity of EUR 2.5bn and RWAs of EUR 9.4bn. Additionally the group has EUR 3.2bn in net cross-border exposure, mostly towards multinational and tilted towards energy (46%), and EUR 300mn of intragroup exposure. Finally, derivatives exposure of EUR 900m for a total of EUR 7bn.
OTP	**Russia:** Total assets of HUF 783bn at the end of March 2022 (2.7% of consolidated total assets). Outside of the Russian subsidiary's perimeter, the group held HUF 102bn in Russian bonds, with a net book value of HUF 40bn. The Russian operation posted HUF 37.6bn adjusted profit in 2021 which represented 7.9% of OTP Group's adjusted annual profit. **Ukraine:** OTP Group's Ukrainian operation incorporates the Ukrainian bank, as well as the leasing and factoring companies. Country-consolidated Ukrainian total assets represented HUF 959bn at the end of Q1 2022 (3.3% of total consolidated assets). The Ukrainian operation posted HUF 39bn adjusted profit in 2021 which represented 7.9% of OTP Group's adjusted annual profit. In Q1, OTP booked HUF 91bn of Russian bonds and goodwill impairments. For both the Russian and Ukrainian operations, it also recorded HUF 74bn of credit losses (vs HUF 19bn in the whole year in 2021).
Intesa Sanpaolo	Exposure to sanctioned counterparties amounted to EUR 400m as of 6 May 2022. The group's exposure to Russia and Ukraine net of the EUR 800m provisions taken in Q1 was as follows: **Russia**: approx. EUR 1bn balance-sheet exposure through its local subsidiary and EUR 3.85bn cross-border exposure (net of guarantees) to Russian counterparties from the rest of the Group. Lending to Russia represents 1% of the group total. Off-balance sheet positions stand at around EUR 1.1bn for the Group, partially guaranteed. **Ukraine:** EUR 300m of total assets and minimal cross-border or off-balance sheet exposures.

ING	**Russia:** Local subsidiary ING Bank (Eurasia) Z.A.O., with total assets of EUR 900m at end-2021. Total Russia-related exposures amounted to EUR 6.7bn (0.9% of total book) at end-February 2022 (reduced to EUR 5.8bn by end of April 2022) through wholesale banking activity. **Ukraine:** EUR 600m exposure at end of April 2022.
BNP Paribas	BNP Paribas reported a EUR 3bn gross exposure to Russia and Ukraine, equivalent to 0.16% of group exposure in 2021. **Ukraine:** Local subsidiary UkrSibbank (60% owned). Exposures to Ukraine amounted to EUR 1.7bn at end-2021 (0.09% of total group exposure). **Russia:** Exposure of EUR 1.3bn (0.07% of total group exposure).
Credit Agricole	Credit Agricole SA's exposure to Russia and Ukraine represented 0.6% of its commercial lending portfolio at end-2021 (approximately EUR 6bn) split between 0.15% for Ukraine and 0.45% for Russia. **Russia:** Local subsidiary Crédit Agricole CIB (CACIB AO). Exposure booked at local subsidiary of EUR 500m (EUR 700m, March 2021), while offshore on and off-balance sheet exposure amounted to EUR 4.4bn at end 2021 (EUR 3.7bn as of March 2022). **Ukraine**: Local subsidiary Crédit Agricole Ukraine (100% owned), universal retail bank, with total assets of EUR 1.8bn at end 2021. Exposure to Ukraine amounted to EUR 1.5bn (0.15% of total commercial lending).
Commerzbank	**Russia:** Local operating subsidiary (Commerzbank (Eurasija) AO) with total equity of EUR 100m at end-2021. Group net exposure of EUR 1.3bn (0.4% of total exposure). In addition, c. EUR 600m Russia-related exposure, mostly comprising pre-export financing of commodities at end-2021. By end of April, Commerzbank has reduced its total net exposure to Russia to less than EUR 1.2bn. **Ukraine:** Net exposure < EUR 100m at end-2021
Deutsche Bank	**Russia:** Local operating subsidiaries (OOO Deutsche Bank) with T/A of EUR 1.5bn (excess liquidity placed with group: EUR 400m, cash at central bank: EUR 900m, customer loans: EUR 200m) and Russia Deutsche Bank Tech Centre (1,600 employees). Cross-border exposure to Russia: loan exposure of EUR 1.3bn (net EUR 500m after ECA insurance and private risk insurance), additional contingent risk of EUR 1bn (undrawn commitments: EUR 800m, guarantees: EUR 200m) as of March 2022. Derivatives exposure is very limited following the wind down of the vast majority of the derivatives exposure. **Ukraine:** Net exposure < EUR 100m as of March 2022.

Source: Scope Ratings, Annual reports, Press reports

While Ukraine may come back as a smaller but still-viable banking market, we believe the prospect for European banks in Russia are very grim. Several large European banks such as Deutsche Bank, Commerzbank BNP Paribas and Credit Agricole have already announced intentions to wind down existing portfolios and exit the country.

Others may have not fully committed to a full exit but are reviewing their options. Even the fate of the local subsidiaries lies in the balance. A walkaway scenario is definitely on the cards. Societe Generale announced on April 11 that it had reached an agreement to sell its Russian subsidiary Rosbank to a Russian investor, Interros Capital, subject to regulatory approvals. The transaction is expected to result in a EUR 3.1bn P&L impact and decrease the group's CET1 ratio by approximately 20bp.

A few days before SG's announcement, UniCredit announced it was pushing back its board meeting to approve Q1 2022 results by one week to May 4 to have more time to manage its cross-border Russian exposure. In mid-March, UniCredit's CEO told the press the bank was evaluating an exit from Russia, though he stressed the consequences and complexity of disentangling the bank from the country.

Western banks eager to exit Russia

His comments were echoed in the following days by RBI and OTP, which have begun winding down operations and are considering all strategic options up to and including a complete exit. The attitude of Western banks to local operations in both countries speaks volumes about the social dimension of the banking business.

In our view, keeping operations in either country is not in the immediate financial interest of parent companies' shareholders. But pulling the plug on war-torn Ukraine just does not feel like the right thing to do and would likely harm banks reputations as lenders and employers globally.

Similar considerations apply to employees and customers in Russia, in large part innocent bystanders who are themselves facing grim economic circumstances. However, given the deterioration in international relationships and the broad sanctions regime, we believe banks would be happier to step away from Russia if given the opportunity to do so with limited financial and reputational damage. This could be the case if the banks are nationalised or local buyers emerge.

Box B: Selected European banks' strategies and potential impacts stemming from Russia and Ukraine exposures

RBI	RBI is in the process of assessing its strategic options for the future of Raiffeisenbank JSC, including a cautious exit from Russia. According to Scope's calculation, a total loss of the stake in RBI's Russian subsidiary would still result in a CET1 ratio of over 12%. In Ukraine, all essential banking operations are continued. Branches remain open where possible.
Société Générale	SG announced its intention to cease banking and insurance activities in Russia. An agreement to sell Rosbank, its Russian subsidiary (100% owned) was signed with Interros Capital. The transaction is subject to regulatory approvals. SG estimated that the disposal of its banking and insurance activities would have a 20bp impact on its CET1 ratio (based on end-2021 data) and a P&L impact of about EUR 3.1bn. At the same time, SG confirmed its distribution policy for the financial year 2021.
UniCredit	In Q1 2022, UniCredit completely wrote off the value of its Russian subsidiary and took material provisions against its cross border exposure to Russia. These actions led to a total impact on group's CET1 capital of 92bp. Management has indicated that under an extreme scenario of 60% loss on their remaining cross border exposure the residual impact would be 36bp. The bank has also adjusted its baseline scenario to account for weaker real GDP growth throughout its franchise from 4.7% to 2.6% in 2022.
OTP	Management is monitoring the situation of the Ukraine-Russia war and will take necessary steps to moderate business risk. At the moment, a walk-away scenario from both countries is considered unlikely. We estimate the consolidated maximum capital effect on the potential write-off of the Russian and Ukrainian operations, taking into account the equity, intra-group funding and the foreign risk-weighted assets at 60bp on the consolidated CET1 ratio, according to end-of-March figures (143bp as of YE 2021).
Intesa Sanpaolo	At the beginning of the war, the group activated a crisis unit and stopped any new investments and financing activities in Russia. In Q1 2022, the bank recorded EUR 800m of provisions, of which EUR 500m against cross-border Russian exposures (all moved to Stage 2). The group is looking for a buyer for its Russian subsidiary.
ING	ING announced its decision to suspend new business with Russian companies. In Q1 2022, ING booked EUR 800m in provisions for Russian exposures (mostly Stage 2) and added EUR 9bn to RWA for downgrades of Russian counterparties.
BNP Paribas	BNPP is monitoring the situation in Russia and Ukraine. No changes to the group's strategy for these countries has been announced at this stage.
Credit Agricole	The group has stopped new business with Russian companies and suspended its activity in Russia since the beginning of the war. Distribution of the 2021 dividend has not been affected.
Commerzbank	Commerzbank's subsidiary in Russia is continuing to operate for international clients in Russia but it has stopped new business. The group is closely monitoring developments in Russia and Ukraine. It intends to adapt its business strategy and risk assessment to the situation. At this stage, the group has not revised its objectives capturing the consequences of the war.
Deutsche Bank	Local footprint in Russia has been significantly reduced since 2014 to reduce risk and complexity. The bank has implemented the sanctions policies and continues to take care of local employees and to invest in the management of technology, cyber and other risks.

Source: Scope Ratings, Annual reports, Press reports

Lingering risk of sanction violations

Banks have to comply with far-reaching economic sanctions

Additional concerns stemming from the Russo-Ukrainian war and the related sanctions regimes affect European and global banks. As we flagged early on, a far-reaching economic sanctions regime has been imposed at warp speed.

In the space of one week at the end of February, three different EU sanctions packages were announced, on top of sanctions already in place since the annexation of Crimea in 2014. Two additional packages were adopted in March and April. A sixth package of sanctions is currently being discussed.

The regime of asset freezes and prohibitions to make funds available now applies to a total of 1,091 individuals and 80 entities, including politicians, businessmen, oligarchs and media personalities.

Internationally-active banks sit on the front line in the effective application of such sanctions and run the risk, willingly or inadvertently, of falling short of authorities' expectations. KYC processes have proven leaky in the past, and there is no assurance that they will not be so again. Crucially, it is our understanding that EU sanctions have no extra-territorial jurisdiction hence do not directly apply to banks in Russia or other third countries (including banking subsidiaries of European banking groups).

However, EU-based parent companies could be held accountable if authorities believe non-EU subsidiaries have been used to circumvent the sanctions regime. The incentives of management team of EU banking groups and their local subsidiaries may not always be fully aligned, given the circumstances.

Sanctions violation risk is on the radar of European supervisors. In mid-March, Reuters reported that the ECB was asking supervised banks to put accounts of all Russian and Belarusian national under high scrutiny. The ECB, as bank supervisor, is not directly responsible for the enforcement of the sanctions regime but the risk that future fines could put supervised entities at risk means that it is indirectly.

Another source of risk is that prohibited transactions could be layered via correspondent banks in third countries. Should violations occur (and be discovered, even at a later stage) proving the appropriateness of due-diligence processes could be a costly legal exercise.

Box C: Selected financial sanctions adopted by the EU

EU 1st sanctions package (February 23)	- Restrictive measures (asset freezes and prohibition to make funds available) against members of the Duma and other individuals and entities - Restrictions on Russia's access to EU capital and financial markets and services
EU 2nd sanctions package (February 25)	- Restrictive measures (asset freezes and prohibition to make funds available) against Vladimir Putin, Sergei Lavrov, members of the National Security Council and remaining members of the Duma - Prohibition to list Russian shares on EU trading venues - Prohibition to accept large deposits from Russian nationals or residents
EU 3rd sanctions package (February 28)	- Ban on transactions with the Russian central bank - Seven Russian banks (Bank Otkritie, Novikombank, Promsvyazbank, Rossiya Bank, Sovcombank, Vnesheconombank (VEB), and VTB Bank) excluded from SWIFT - Ban on investing, participating in or contributing to future projects co-financed by Russian Direct Investment Fund - Prohibition on selling, supplying, transferring or exporting euro banknotes to Russia or to any natural or legal person or entity in Russia
Additional measures (March 9th)	- Prohibition of transactions with the Central Bank of Belarus - Prohibition of the listing and provision of services in relation to shares of Belarusian State-owned entities on EU trading venues - Prohibition of provision of euro-denominated banknotes to Belarus - Restriction of provision of specialised financial messaging services (SWIFT) to three Belarusian banks - Restrictive measures on additional individuals
EU 4th sanctions package (March 15)	- Prohibition on transactions with certain State-owned enterprises - Prohibition of credit ratings to any Russian person or entity - Restrictive measures on additional individuals and entities
EU 5th sanctions package (April 8)	- Prohibition on deposits to crypto wallets to any natural or legal person, entity or body in Russia and Belarus - Prohibition on sales of currency and securities to any natural or legal person, entity or body in Russia and Belarus - Full transaction ban on four Russian banks - Restrictive measures on additional individuals and entities

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