European Banking Update

Revisiting the pre-Covid narrative: back to the old normal

Financial Institutions, Scope Ratings GmbH, Scope Ratings (UK) Ltd, 23 July 2021

Executive summary

European banks have proven their resilience in the face of the severe economic downturn brought about by Covid-19. As major economies normalise, we expect the focus will shift to incremental risks associated with the withdrawal of extraordinary fiscal, monetary and regulatory support, and to pre-crisis weaknesses related to the sector's core profitability.

Our key expectations for the remainder of 2021 are:

- As vaccination rates increase and European countries achieve or move closer to herd immunity, most likely in the second half of 2021, the market debate will shift to the sustainability of the economic rebound, and the pace and strategy for withdrawing the exceptional public-sector support with the right timing and sequencing. The normalisation of accounting and supervisory relief granted to banks will be an important element of this debate.
- Asset quality will deteriorate, but concerns over asset-quality cliffs are misplaced. Authorities will err on the side of caution when tightening their regulatory stance, and most banks will be able to absorb high credit costs through pre-provision profits. In our view, the asynchronous nature of the recovery could continue to create supply bottlenecks, which may result in asset-quality hotspots.
- Rising inflation expectations could signal an eventual change to a monetary policy regime that has burdened **the sector with negative rates and flat yield curves** for years. There may have been a ray of light at the end of the tunnel earlier in the year, but this will not result in any material change to banks' top lines because central banks, especially in Europe, will struggle to raise rates for years to come.
- We expect regulators to resume the path towards higher capital requirements in line with previously agreed targets. Absent decisive restructuring, many banks will not be able to clear their cost of equity even under a more supportive rate environment.
- **The sector will release trapped capital as earnings visibility improves.** Supervisors will allow banks to reinstate dividends and buybacks provided they can ease regulators' concerns over credit losses. As there are significant regional differences in the loss experience, we expect supervisory authorities to adopt a differentiated approach to dividend policies, backed by safeguards such as stress testing.
- **Cost cutting and M&A will continue to characterise the sector in 2021 and beyond.** Faced with rising penetration of digital channels and the emergence of non-bank competitors, banks are striving to accelerate technology investment while reducing physical distribution costs to protect market share and profitability. Domestic M&A as well as integration of new technology providers will allow for economies of scale in IT investments.
- **Recognition of banks' post GFC de-risking has led to a reassessment of capital markets activities as an important diversifier of revenues during a credit downturn**. We believe that the Covid crisis may validate industry claims of de-risking post GFC, as well as the status of large banks as diversified semi-utilities.

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Key trends in 2021

We expect bank revenues to remain subdued in 2021 due to the negative policy rate environment and flat yield curves. While rising inflation expectations have offered a ray of hope for banks, it is unlikely that the monetary policy stance will change any time soon.

A post-Covid hangover of bad loans will weigh on asset quality, as moratoriums gradually expire and leave weaker borrowers exposed. However, the sector should be able to avoid large losses and capital erosion.

As uncertainty starts to dissipate, banks will restart dividend payments, subject to ongoing regulatory stress tests. Banks are exiting the crisis with higher capital buffers thanks to regulatory capital relief.

We expect supervisors to push banks to address reserving early to avoid another build-up of NPLs like after the euro sovereign risis, particularly in countries with high use of moratoriums and government guarantee programmes, such as Italy or Spain and to a lesser extent France and the UK.

With limited room for growth, ongoing challenges to margins from the interest-rate environment and the need to scale up IT investments, banks will continue to seek cost savings from their distribution networks.

M&A activity and merger speculation will continue. We expect domestic deals in fragmented markets such as Italy, Germany or Spain to remain the option of choice, due to their stronger industrial logic.

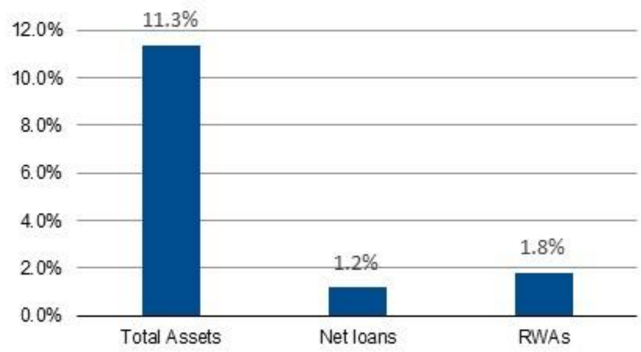
Asset quality

Contrary to initial fears, banks continued to lend through the crisis, supported by a robust fiscal response that included direct public sector support to households and companies, in the form of grants, generous furloughs, and tax breaks.

On top of these factors, the relaxation of accounting and solvency requirements provided banks and their clients with breathing room to avoid a credit crunch. Attractive TLTROs and the relaxation of the leverage ratio requirement by the ECB provided further incentives for banks to add assets during the crisis.

At the end of March 2021, the balance sheets of large European banks were 11% bigger than before the crisis, though only a small part of the growth went into extra lending (Figure 1). While lending balances only rose by 1.2% and risk-weighted assets were up by only 1.8%, this is still a remarkable outcome for banks faced with a severe recession.

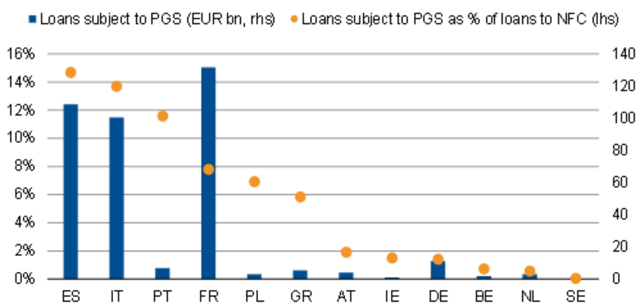
Figure 1: Banks have kept the taps open so far (% growth Q4 2019 vs Q1 2021)



Source: SNL, Scope ratings
Note: Sample of top 50 European banks by total assets

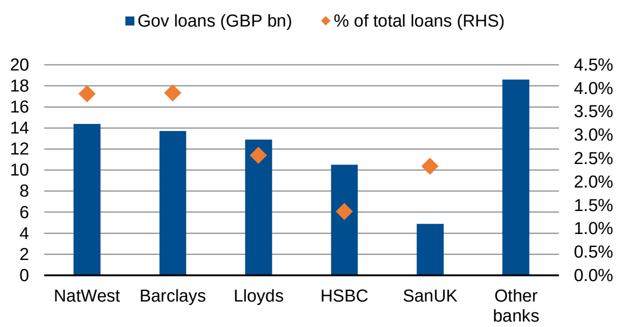
The uptake of public guarantee schemes (PGS) varied widely between countries. Banks in Italy, Spain, France account for by far the largest amounts in the EU (Figure 2). Outside the EU, UK banks originated almost GBP 80bn, which puts them on par with banks in Italy or Spain, though measured as a percentage of loans, they represent a smaller proportion of lending.

Figure 2: loans subject to public guarantee schemes (PGS)



Data at end March 2021. Source: EBA, Scope Ratings

Figure 3: loans subject to public guarantee schemes (PGS) in the UK



Source: banks' Q1 2021 reports, Scope Ratings

At this stage, it by and large remains an open question how long it will take governments to taper and unwind these schemes, and whether it is feasible for borrowers to repay or indeed desirable to insist on full repayment. This potentially puts banks in a difficult position, since they share a small tranche of the risk and depend on governments adjusting payment terms.

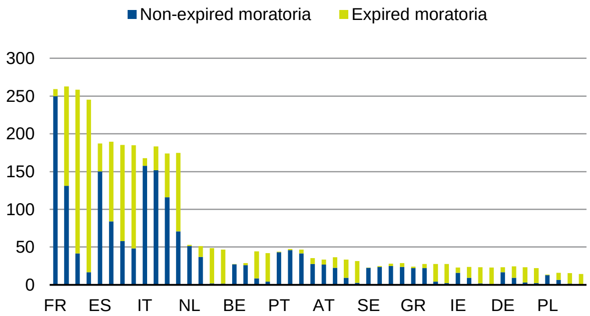
Especially for corporate borrowers, there will be a high degree of political controversy over repayment as many loans went to small borrowers, often in the services sector, that have little or no means to make up for revenues lost during the pandemic.

Therefore, while PGS have been an important source of stability for banks and their borrowers, they have added to the sovereign-bank nexus in highly indebted economies in the Euro Area such as Italy, Spain and Portugal.

We expect that banks and government guarantors will be looking for solutions this year, e.g. by restructuring the terms of these loans and by developing secondary markets for loan sales and securitisations.

Unlike PGS, the use of moratoriums under industry-wide and legislative schemes has decreased significantly among EU banks (Figure 4).

Figure 4: loans subject to moratoriums (EBA definition - Q2 2020-Q1 2021, EUR bn)

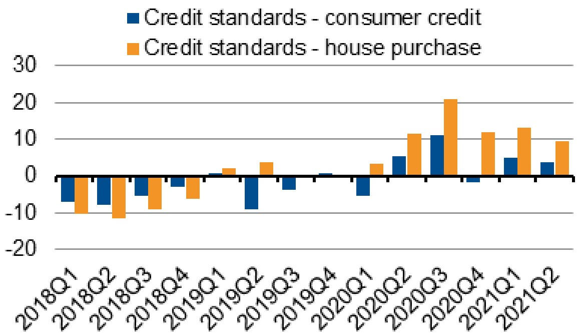


Source: EBA, Scope ratings

Contrary to fears last year, the phasing out has not caused a deluge of non-performing loans, though the number of bilateral renegotiations still in place is significantly higher in markets such as Italy. Thus, there remain pockets of uncertainty in this area, though they appear contained to specific markets such as Portugal, Italy, and to a less extent Spain.

Against this backdrop, Euro Area banks on average kept tightening their credit standards into 2021, though the bias has been receding since the beginning of the year, suggesting rising confidence among banks in the recovery.

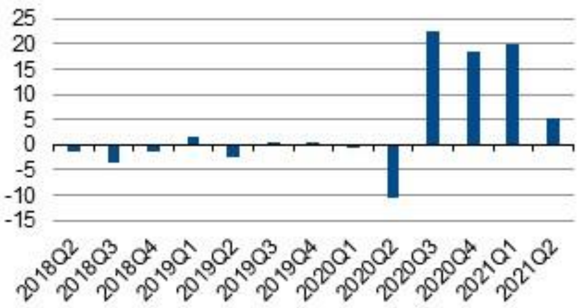
Figure 5: Expected tightening in credit standards, next three months – households



Source: ECB, Scope ratings

However, the low number of corporate insolvencies because of these policies hides a more concerning picture. Outside manufacturing, many small businesses, especially in the retail and hospitality sectors, have seen a collapse in activity and have often increased their recourse to debt, just as revenues and profits collapsed. They have avoided bankruptcy thanks to public support, and the willingness of banks to refinance them at affordable rates.

Figure 6: Expected tightening in credit standards, next three months – corporates



Source: ECB, Scope Ratings

Adding to asset-quality concerns stemming from the K-shaped recovery in the corporate sector, we believe the supply-side bottlenecks that have resulted in occasional shortages and price spikes may disrupt operations in certain industries and result in sudden, though most likely manageable, asset-quality hotspots.

Exit plan required for NPLs

Having shown largesse around NPLs in 2020, regulators and accountants now face the unenviable task of charting the return to normal:

1) Terminate moratoriums programmes.
   Given the sharp reduction in the use of legislative moratoriums, we see no need for these programmes to continue. Any remaining hardships, e.g. in hospitality or transport, should be dealt with directly through grants.

2) Restore proper accounting of NPLs.

This measure would greatly enhance transparency for bank investors and strengthen the confidence in stronger banks. Where necessary, regulators could temporarily lengthen calendar provisioning for new NPLs incurred as a result of the crisis, e.g. for government-guaranteed loans.

3) Withdraw public guarantees for new lending.
Few countries have made extensive use of PGS. We would expect these programmes to be phased out gradually, depending on the Covid exit paths of the respective economies.

Rates outlook weighs on earnings

The low rate/flat curves environment that has burdened Euro Area bank profitability for the last decade will continue to burden bank P&Ls. During the Covid crisis, the yield curve environment shifted to all major currencies, including the US, UK, Norway and Eastern Europe, leading to further falls in net interest margins and goodwill write-offs for EU banks that had made cross-border acquisitions e.g. in the US or CEE.

Rising inflation expectations in the US in the first half of 2021 provided a much-needed boost to bank share prices. This was accompanied by a more inflationary bias at the US Fed. However, with US growth expected to peak in 2021, these measures have so far failed to support a lasting repricing of the US yield curve.

Against this backdrop, the inflation picture for the Euro Area never really changed in view of the slower recovery and the more sluggish fiscal response. The recent strategy review may have reduced the ECB's hawkish bias but without any new monetary measures, the market's inflation expectations remain anchored well below the ECB's 2% target. Faced with fragmented banking markets, the ECB also remains very focused on managing financial conditions with its purchase programmes.

Consequently, rate expectations have hardly budged this year with the notable exception of the UK, where the BoE is no longer guiding towards negative rates; a clear positive for the UK banks. The Bank may decide to scale back QE earlier than the ECB. Another exception is commodity-driven Norway, where policy rates are expected to rise, thus supporting a more favourable rate environment for banks.

Nevertheless, with growth recovering and inflation rebounding, we expect central banks to keep debating the withdrawal of extraordinary monetary measures as well as eventual rate rises. For Euro Area banks, this leaves a mixed picture because asset purchases and TLTROs on attractive terms will eventually be withdrawn while negative policy rates are likely to persist for longer.

The scaling back of asset-purchase programmes could provide an uplift to government bond yields and credit spreads in the medium term, but this is unlikely to feed through to the P&L in 2021 and 2022.

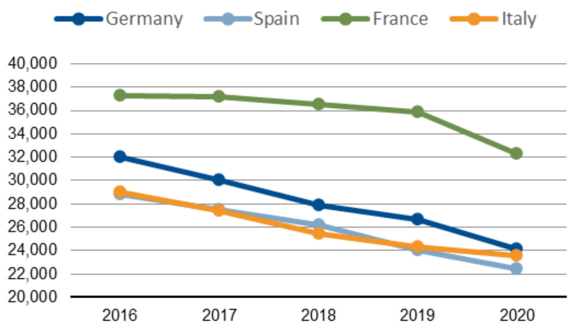
At the same time, the eventual refinancing of TLTRO liabilities between 2022 and 2024 with market-based funding will likely lead to higher funding cost for many banks, unless offset by a reduction in liquid assets. We expect the withdrawal of TLTRO, which has been in place for many years now, to be tied to the ability of banks to access wholesale funding markets i.e. capital levels and financial conditions.

Banks have contained costs

Faced with a persistent revenue challenge, banks continue to focus on cost reductions to protect their pre-provision profitability from rising budgets for IT investment. Branch networks and payments infrastructure have been a particular focus in the wake of the accelerating shift of retail and corporate clients to online transactions.

This led banks to take significant provisions in 2020 and 2021 to fund redundancies in their bricks-and-mortar operations, for example at CaixaBank in Spain or Commerzbank in Germany. This continues a trend that has been in place for several years (Figure 7).

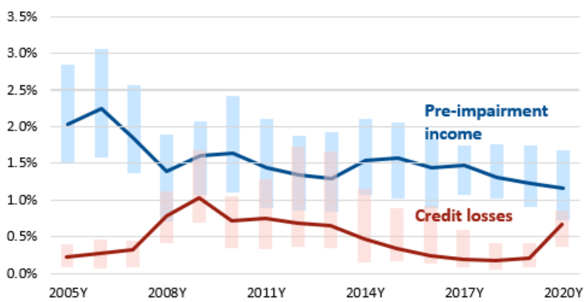
Figure 7: Branch numbers



Source: ECB, Scope Ratings

The combination of well contained costs and robust capital markets revenues is helping banks to maintain a level of pre-provision profitability that, at least on average, allowed them to cover the extra credit cost of the recession without dipping into their capital buffers (Figure 8).

Figure 8: Pre provision profit compared to loan loss provisions, scaled by net average customer loans



Source: SNL, Scope Ratings

Notes: Sample of top 50 European banks by total assets.
Vertical bars reflect range between the first and third quartile of the peer group

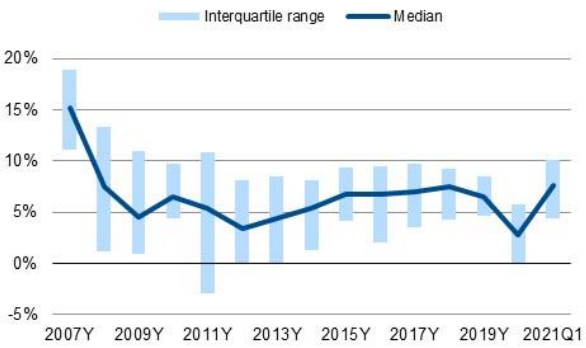
Very few banks reported credit losses that were higher than their pre-provision income. This represents a radically different outcome to the global financial crisis and the euro sovereign crisis, where the amplitude of credit and mark-to-market losses was much larger.

Good start to 2021 for European banks

The combination of falling credit costs and well contained expenses led European banks to report one of their best quarters in recent years. ROEs were above 2019 levels (Figure 9) and cost-income ratios approached the best in five years (Figure 10).

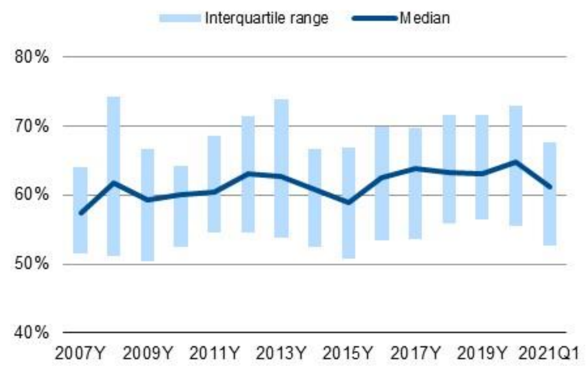
While the first quarter tends to be the strongest in capital markets operations, the positive environment for investment banking revenues suggests further support from capital markets activities in 2021. This also highlights that bank remain dependent on market-driven revenues.

Figure 9: Return on average equity



Source: SNL, Scope Ratings
Note: Sample of top 50 European banks by total assets

Figure 10: Cost-to-income ratio



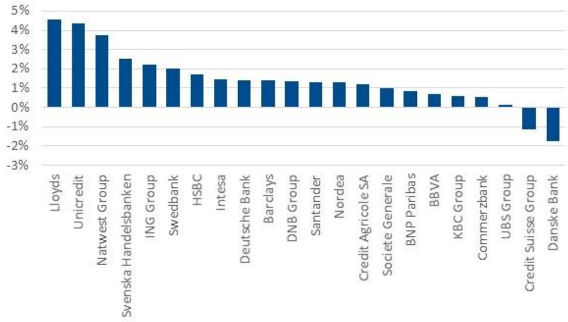
Source: SNL, Scope Ratings
Note: Sample of top 50 European banks by total assets

Capital release as visibility improves

As the pandemic hit, supervisors in Europe were quick to demand that banks abstain from capital distribution. The blanket ban on dividends appeared a rational supervisory move in 2020 to keep capital in the sector in the face of very low visibility over the scale of credit losses.

As a result, many large European banks consider that they now may sit on excess capital over their SREP requirement (Figure 11) and have comfortable buffers to MDA triggers – the level at which, according to European capital regulations, legal restrictions on dividends, AT1 coupons and bonuses are triggered.

Figure 11: Change in headroom to MDA-relevant requirements, from Q4 2019 to Q1 2021



Source: SNL, Company data, Scope Ratings

We expect dividends and share buy-backs to resume this year. The Fed and the BoE have already lifted restrictions, subject to stress test requirements; we therefore expect the ESRB to follow once the ECB's SSM has completed its stress test later this month.

The relaxation is likely to be differentiated depending on the degree of concern supervisors have with respect to individual lenders e.g. by setting higher Pillar 2 Guidance to ensure that individual banks retain sufficient equity above the MDA trigger to cover capital erosion in a worst-case scenario.

To preserve capital discipline, we expect supervisors to push back on some of the more aggressive capital targets pursued by banks pre-crisis.

Thus, while the ECB stress could serve as a catalyst for banks' equity valuations it may also reinforce further consolidation for weaker banks. Conversely, stronger banks may refrain from distributing capital and prefer to buy out fledgling competitors.

Regulators are also likely to be keen to resume implementation of Basel IV, though we do not expect this to start this year. The EU has already extended its leverage ratio exemptions for central bank cash to 2022 and may decide to retain this rule, as the UK has done.

The phase-in of Basel IV has already been postponed until 2023-2028. Yet the EU commission is set to decide on the implementation of the output floor by the end of this year, which has important implications for mortgage lending, a key driver of lending growth in the EU during the pandemic.

The question is whether is whether EU regulators insist on the onerous single-stack approach or accept the slightly less demanding parallel-stacks proposal. Based on 2019 data, the EBA estimated these changes could require between EUR 45bn (parallel stacks and EUR 52bn (single stack) of extra Tier 1 capital by 2028.

We continue to flag the reputational risk related to large dividend payments or buyback announcements at a time when banks' performance has benefited from material public support for their clients. However, we see the risk receding as the focus of public opinion and the media shifts from emergency measures to normalisation.

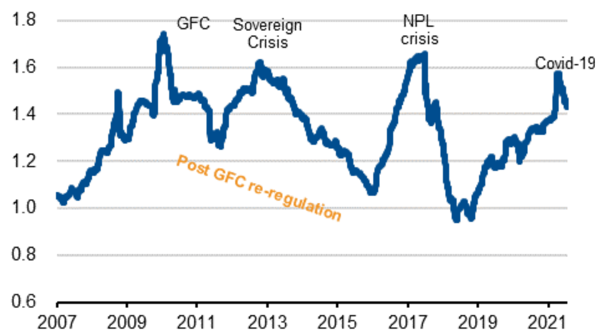
Are banks turning into utilities? Fundamentals vs market perception

Over the past decade, a combination of tighter regulations, higher capital stacks, reduced risk and low-yielding business models has significantly reduced the returns available to bank equity investors.

Covid has once again put a steep risk premium (Figure 12) on bank stocks in Europe, including the UK, which continue to trade at a discount to US rivals. Given the strong capital buffers reported by the banks, we attribute this to the market's concerns over the future earnings power of the sector rather than imminent capital needs because of Covid.

With profitability permanently depressed by low interest rates and the lack of profitable growth opportunities, capital return is an important support to equity valuations. However, the blanket bans on equity dividends and buy-backs by European bank regulators in 2020 left the sector without prospects for generating a stable dividend yield.

Figure 12: Banks' equity beta still does not reflect the sector's deleveraging and de-risking

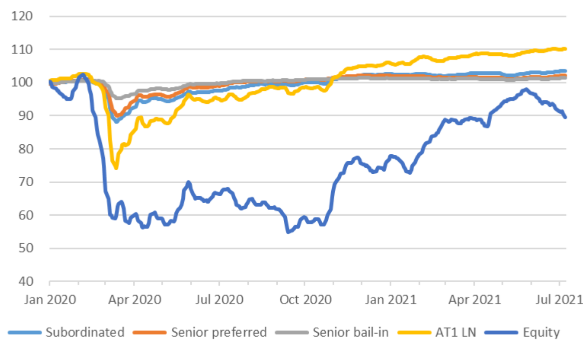


Source: Macrobond, Scope Ratings

Note: beta calculated on 12 month rolling daily returns; STOXX Europe 600 Banks vs STOXX Europe 600

In contrast to equity investors, fixed-income markets have taken a much more constructive view of the banking sector throughout the crisis. This includes the AT1 market, where investors benefit from coupons that are well protected by generous MDA buffers

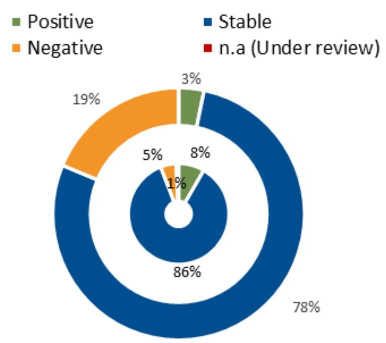
Figure 13: Total Return (Jan 2020=100)



Source: Markit, Blackrock, Invesco, Scope Ratings

Across our coverage of 78 European banking groups, we have only seen a handful of rating downgrades and negative outlook changes since the beginning of 2020, mostly related to banks with pre-existing financial health issues: unsustainably low levels of pre-provision profitability, still-high levels of NPLs, or high risk concentrations – including to domestic sovereign debt.

Figure 14: Scope's FI team outlook distribution



Source: Scope Ratings

Note: the inner ring shows the outlook distribution as of 2 January 2020, the outer ring the distribution as of 23 July 2021

M&A outlook: in-market consolidation remains the name of the game

In 2020, there was a noticeable pick up in M&A activity in Europe e.g. in Italy (Intesa/UBI) and Spain (CaixaBank/Bankia, Unicaja/Liberbank pending). There was also a very limited amount of bolt-on cross-border activity e.g. Credit Agricole strengthened its Italian operations by buying regional lender Credito Valtellinese.

Despite clear supervisory encouragement of cross-border deals and risk sharing, consolidation is happening within national borders because strategic M&A deals offer very little incremental returns in a low-rate environment. Faced with rapid transformation of consumer and corporate preferences, priorities for most banks lie elsewhere:

Post Covid, a rethink of distribution is more pressing now than at any time since the global financial crisis. Adding obsolete branch networks in new markets is not a priority for management teams. The benefits of cross-border mergers are limited by lack of cost and funding synergies due to regulatory ring-fencing and the absence of a complete Banking Union.

By contrast, the economic benefits of in-market consolidation remain very strong because the recession has enshrined the negative rates/flat yield curve outlook. This environment is highly damaging to bank revenues, and cost-cutting is the main managerial lever to protect the bottom line. The value of cost synergies is higher than before.

We see capacity reduction as positive, especially in countries like Italy, Spain, and Germany where banking is characterised by high degrees of fragmentation and/or very dense branch networks.

We expect the trend towards greater consolidation to continue in 2021 and 2022, with domestic deals taking the lion's share of activity.

Annex I: Related research

Asset-quality Quarterly: brighter prospects for European banks, July 2021

The Wide Angle – The case for European banks' cross-border mergers remains weak, July 2021

AT1 Quarterly: normalisation begins; EBA stands firm on ESG capital instruments, July 2021

French banks well placed to avoid a hard landing, June 2021

Charging negative rates on retail deposits is not without risk for banks, June 2021

EU Creditor Hierarchy Directive facilitates MREL issuance by Norwegian banks, June 2021

UK banks making progress on capturing climate-related financial risks, May 2021

French banks: supervisory pilot reveals moderate exposure to climate risks, May 2021

UK banks: asset quality improves as vaccine success, government support lifts economic prospects, April 2021

Italian banks have significant room to optimise their capital structures, April 2021

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