SCOPE Scope Ratings

2023 European Banking Outlook

Strong ships in turbulent waters

Financial Institutions, Scope Ratings GmbH, 4 January 2023

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Executive summary

Difficult as it is to make predictions (especially about the future), it's that most wonderful time of the year again.

Visibility as we enter the new year is extremely low, owing to a cocktail of uncertainties about the policy mix, geopolitical factors and, not least, unusually cold weather at a time when the European economy remains abnormally susceptible to weather gyrations due to its dependency on hostile Russian energy supplies.

That notwithstanding, we paint a benign base-case picture for banks in 2023 despite a deteriorating macroeconomic environment. As opposed to previous crises, banks' anti-cyclical features (namely the positive gearing of revenues to rising interest rates) will be on display. In our base case, margins will expand significantly, more than offsetting a somewhat weaker performance of fee and commission income and somewhat higher provisioning.

In this outlook, we highlight our key expectations for 2023:

- **Profitability will end up at similar levels to 2022 but with very different drivers**. Top lines will benefit from expanding banking margins on the back of a more supportive-interest rate environment, but they will be less and less boosted by artificial TLTRO carry-trade earnings. Rising wholesale funding costs, partly reflecting greater issuance in a more expensive market to meet fully-loaded MREL requirements – applicable from January 2024 – will also weigh on revenues. After many years of a deflationary or at best disinflationary environment, banks will have to deal with rising wage demands driving up their cost bases but also facilitating over-capacity management.

- **The decade-long improvement trend in asset quality will go into reverse**. The deterioration in the macroeconomic environment, high energy prices and rising debt-servicing costs will lead to new NPL formation, requiring banks to set aside provisions for loan losses. The increase in cost of risk should be manageable, though, in the context of expanding pre-provision profits.

- **Liquidity metrics will deteriorate (from very strong levels)**. We believe current bank funding and liquidity ratios partly reflect structural improvements, as banks adapted their liability structures to the post-GFC regulatory environment. However, the more recent leg-up in liquidity ratios is driven by the extremely loose monetary conditions following the Covid shock, which are now going into reverse. We expect Liquidity Coverage Ratios to decline as cheap central bank funding is repaid and carry trades are unwound.

- **Capital strength will be preserved (willingly on not)**. Against the more uncertain scenario, we believe regulatory scrutiny over capital distribution will increase, and banks' plans to distribute capital excess will be put on hold, at least temporarily. It is worth highlighting that, despite generous dividend distribution and share buyback programmes in 2021 and 2022, banks enter 2023 with strong capital positions and material buffers over requirements, which continues to support their credit profiles.

Downside risks to our base-case scenario relate to a much deeper contraction leading to a steep deterioration in asset quality, rising funding costs negating the effect of asset repricing, and banks failing to contain cost inflation. Under stressed assumptions, European bank profitability would decline materially and, in some cases, banks would post losses. Capital erosion, however, would be limited even under severely stressed scenarios.

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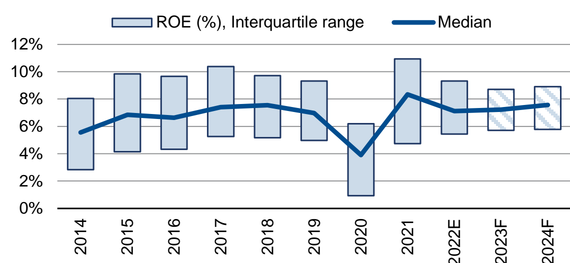
Key expectations for 2023

We expect European banks to perform reasonably well in 2023 despite a markedly worse macroeconomic environment.

We expect median ROE to remain stable in the high single-digit range, roughly on a par with 2022, with strong revenue growth offsetting an increase in credit provisions.

Figure 1: ROE expectations, 2022-2024



Source: Scope Ratings

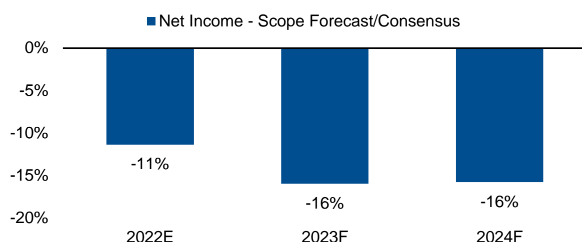
As opposed to previous crises, banks' anti-cyclical features (namely the positive gearing of revenues to rising interest rates) will be on display.

In our base case, margins will expand significantly, more than offsetting a somewhat weaker performance of fee and commission income and somewhat higher provisioning.

Costs will also be under pressure, as general inflation will eventually make its way into wages and therefore into banks' expenses. Still, capacity adjustments will partially offset wage growth.

We consider our base case forecasts to be conservative, with net income for the top 50 banks in our sample roughly 16% below consensus for 2023 and 2024 on average.

Figure 2: Base case forecasts vs consensus



Source: Scope Ratings, S&P Global Market Intelligence

Note: consensus as of November 30

Asset quality will start deteriorating, finally bucking a decade-long trend of improvement. Corporate borrowers will feel the combined pinches of high energy bills, rising interest rates and higher debt-service costs, wage inflation and softening demand.

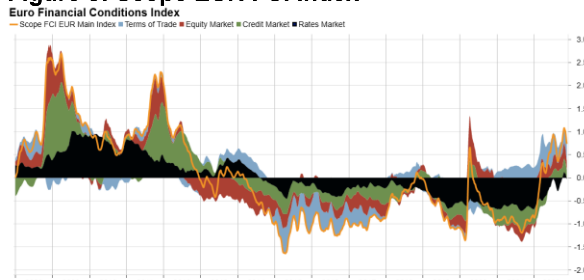
Solvency, however, will continue to support credit. We believe exceptionally high payouts in 2021 and 2022 will not be repeated, as supervisory pressure mounts to protect balance sheets against an uncertain near future.

Short of large systemic financial shocks originating from outside of the banking industry, we believe bank credit remains well protected, which supports our rating positioning

European economies face recession risk in 2023

Financial conditions deteriorated sharply in 2022, driven by energy prices, recession risk and inflation. Monetary tightening added to pressure in fixed-income, equity and credit markets.

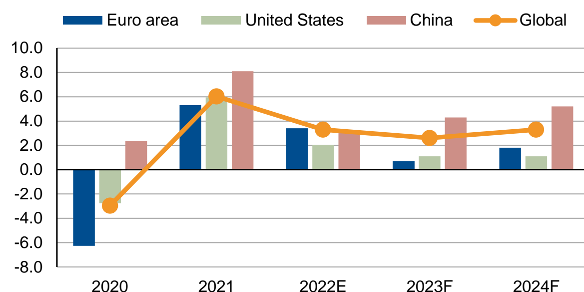
Figure 3: Scope EUR FCI Index



Source: Scope Ratings

We forecast a sharp slowdown in global growth to 2.6% in 2023 from around 3.3% this year. This reflects direct and second-round effects of Russia's war in Ukraine, high inflation and significant monetary tightening. For the euro area economy, we anticipate near-stagnation (0.7%), with Germany contracting 0.2%. The UK economy is expected to contract by 0.6%.

Figure 4: Scope EUR FCI Index



Source: Eurostat, National Statistical agencies, Scope Ratings

We foresee a gradual decline in inflation next year from multi-decade highs, as supply-side constraints ease and central bank policies start affecting demand and employment in the euro area, the UK and the US. However, central banks are likely to maintain tight financial conditions throughout 2023 in view of tight labour markets, rising wage demands, and persistent core inflation in goods and services.

Significant risk remains for delays in inflation falling back into line with central bank targets as price pressures broaden.

We expect rate hikes to slow by early 2023, but most central banks will have limited room to ease monetary policy next year. Further upside surprises in inflation could lead to a more drawn-out cycle of rate increases than in our baseline scenario. The high level of private-

and public-sector indebtedness increases risks to financial stability as central banks tighten monetary policy.

Banks' anti-cyclical features will gain more prominence

Despite the significant de-risking of the sector, banks continue to be perceived as high beta plays on the economy. But they no longer are! Since the post-GFC re-regulation of the sector, European banks have transitioned to lower risk business models, reduced balance-sheet leverage and improved their liquidity profiles. At the same time, while they can no longer be expected to be bailed out in case of idiosyncratic problems due to the implementation of resolution regimes, they will still benefit from material support in case of systemic crises. In fact, given the key role they play in the transmission of economic policy, their health and well-being is often a consideration for politicians and central banks in the design of policy intervention.

This implicit support comes at the cost of greater demand from supervisors and lower restraint from politicians when it comes to extracting financial resources from the sector – provided this does not jeopardise stability.

The 10% windfall tax in Hungary, payable on 2021 and 2022 net revenues is one example, as is Spain's levy on domestic bank revenues for 2022 and 2023, currently in the middle of the legislative process and expected to raise EUR 3bn from large banks over two years.

But the cost of solidarity goes beyond taxation. Hungary imposed caps on mortgage rates in 2022, initially as a temporary measure but extended twice, currently until June 2023. Similar caps were extended in October to SME loans.

In Poland, on top of higher regulatory costs to fund new and existing institutional and borrower protection schemes, banks have been forced to bear the cost of legal credit holidays for struggling mortgage borrowers (suspension of up to eight instalments from July 2022 to December 2023).

In Spain, the banks and the government have agreed on a relief scheme for vulnerable mortgage borrowers experiencing large increases in the cost of mortgage servicing. This is a voluntary scheme agreed between the Spanish Banking Association and the government. It can be argued that this is in the banks' own self interest as it protects financial stability. The fact that banks and the government see this as a joint responsibility underscores the increasingly semi-public role banks play in Europe.

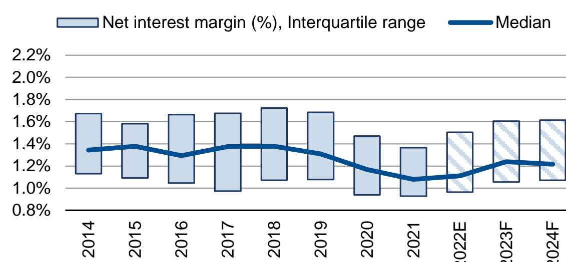
Bad as it may be for providers of equity, we believe this step is credit positive, at least in the near term. At the same time, it is a trend that needs to be carefully monitored as to the ability of policymakers to strike the right balance and avoid making the sector un-investable.

Revenues will benefit from balance sheet repricing

At their core, large commercial banks make money by transforming risk and liquidity. Bank deposits, by far the principal source of bank funding in Europe, are significantly more liquid and less risky than their assets. With policy and market interest rates gradually moving off the zero bound, the premiums banks can extract for these two very important economic functions also expand.

Net interest income, the principal source of bank revenues, will expand by double digits in 2023, driving the top line and more than compensating for the more difficult outlook for asset management fees and trading income.

Figure 5: Net interest margins are due to expand in 2023

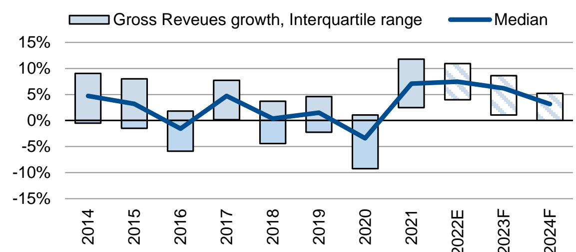


Source: Scope Ratings
Note: net interest margins calculated on total interest-earning assets

Volumes will be less dynamic, reflecting the fading effect of the post-Covid economic rebound, lower affordability at higher rates, less support from public guarantees as well as a more cautious approach by banks and their customers. Structurally, we see limited upside for growth in leverage in Western Europe, while Central and Eastern Europe may still offer banks growth opportunities in the medium term.

Commission income will be a drag on revenue growth in 2023 and especially 2024 and asset management product sales will face stiffer competition from deposits and plain-vanilla fixed-income investments, which will be seen as increasingly attractive by savers given rising yields.

Figure 6: Total revenue growth may have already peaked



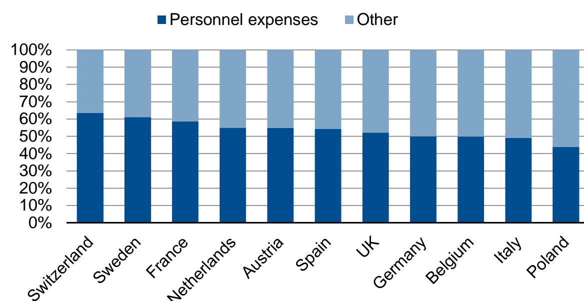
Source: Scope Ratings

Our expectation is that revenue growth may still be in the high single-digit range in 2023, supported by continuing rate hikes and balance-sheet repricing, but growth will fade in 2024.

Costs will come under pressure from inflationary environment

Cost inflation barely showed up as a theme in 2022, but this may change. While price increases were initially driven by high energy costs, price pressures have spread beyond energy and are now feeding through to wage negotiations. Personnel expenses are the single largest cost item in banks' P&Ls and they will go up in 2023.

Figure 7: Personnel expense/total expense by country – 2021

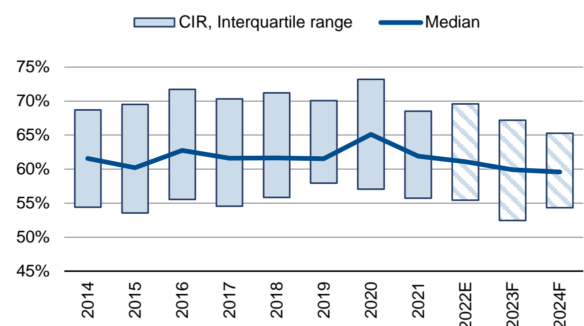


Source: Scope Ratings

However, cost increases should remain well below broader inflation trends. Inflation is a fool-proof way to reduce real incomes, including in sectors where labour productivity has declined (such as in post GFC-banking). Banks will manage employee remuneration and some attrition in the workforce will be welcome, as overcapacity is a structural feature of the industry.

We believe management will increasingly move to absolute cost targets. Several European banks are still on a mission to restructure their distribution models and adapt them to new customer preferences of more frequent, but digital, interactions and in the process get rid of excess capacity, both in branch numbers and in the number of employees.

Figure 8: Cost/Income ratios expected to remain stable

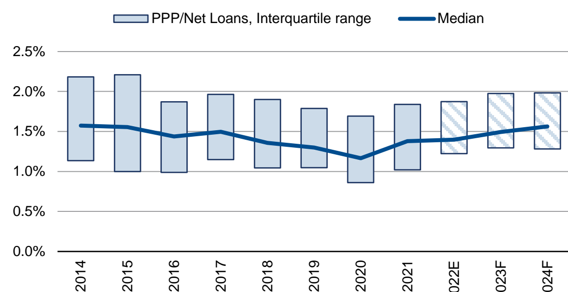


Source: Scope Ratings

Pre-provision profits will keep expanding, providing strong first line of defence

We expect pre-provision profits to expand, from 1.4% of customer loans in 2022 to 1.5% in 2023, increasing the banks' ability to absorb higher credit provisions through the P&L. Growth in pre-provision profitability will flatten out in 2024, as revenue growth subsides and growth in operating expenses remains elevated.

Figure 9: Revenue growth drives better pre-provision income

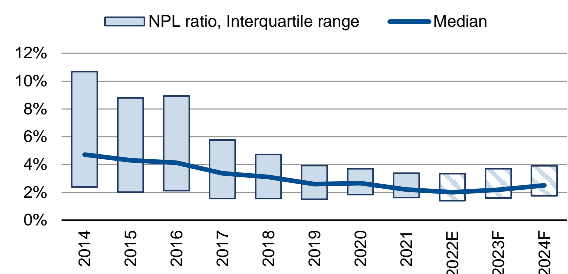


Source: Scope Ratings

Asset quality will deteriorate and provisions will increase

We believe that the stagflationary environment (weak growth, tightening monetary policy and high energy prices) will drive up default rates. Governments may support asset quality as they did during the Covid pandemic, but the monetary stance will make a difference. Vulnerable mortgage borrowers will feel the pinch from higher rates, higher energy costs, and general cost inflation. NPLs will increase from a median ratio of 2% to 2.5% in December 2024.

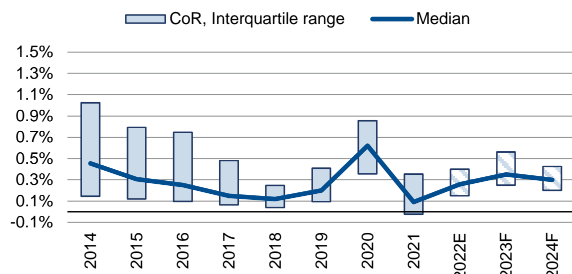
Figure 10: NPL ratios to increase in 2023 and 2024



Source: Scope Ratings

Even if actual NPL rates only rise in the second half of the year, banks are likely to spread out provisioning throughout the year under IFRS 9, possibly even frontloading in the fourth quarter of 2022. Under our base case, average cost of risk will go up to 40bp in 2023. With the exception of 2020, when Covid-related uncertainty drove significant precautionary provisioning, this level has not been seen in nearly a decade. It is well within the capacity of banks, however, to absorb the increased provisions through the P&L.

Figure 11: Cost of risk increasing from 30bp to 40bp on average in 2023



Source: Scope Ratings

Noticeably, we expect a much narrower range in cost of risk for the top 50 banks that we rate, compared to previous crises. This is driven by the fact that both origination and risk management are much more tightly regulated today than in the past, which has driven convergence in the quality of loan books at different lenders.

Taxation will weigh more on profitability

The weight of taxation on bank profitability is set to increase, as governments in Europe increasingly see bank profits as a source of additional tax revenues to finance their spending plans.

In the UK, the corporate tax rate is increasing from 19% to 25% from April 2023. At the same time, though, the bank levy will drop to 3% from 8%. The current threshold of the bank levy is profits above GBP 25m. This will increase to GBP 100m. Banks will continue to be subject to a higher tax rate than most companies (28% vs 25%), and the overall rate is higher than last year (28% vs 27%).

In Hungary, a 10% windfall tax on net revenues has been in place for 2021 and 2022.

Windfall taxes on banks are being introduced in Spain, and the Czech Republic and we believe more banks across Europe face a risk of greater taxation as their profitability expands.

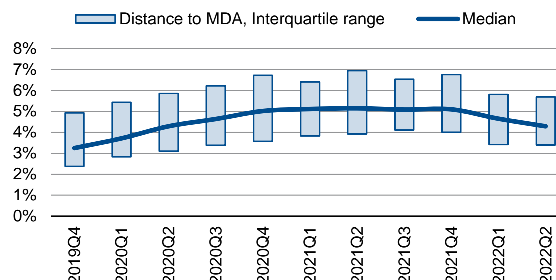
Capital strength will continue to support credit quality.

Capital positions have been normalising from the peaks seen during the pandemic but remain sound and above pre-pandemic levels. Meanwhile, more and more regulators are asking banks to be prudent and consider the risks from a weaker economic outlook in their capital planning.

Given the change in monetary policy, it is unlikely that banks will receive the same regulatory relief as during the pandemic. To date, there have been no reversals to announced increases in countercyclical capital buffer rates; they are moving into positive territory from zero in countries including France, Germany and Ireland.

Further, a growing number of regulators (e.g. in the Netherlands and the UK) consider that the neutral countercyclical buffer rate should be set above zero, providing flexibility to use the buffer when needed.

Figure 12: MDA buffers remain comfortable



Source: Scope Ratings

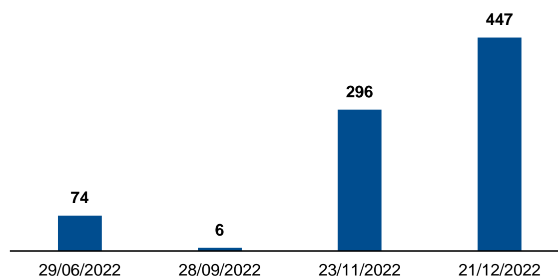
Banks will issue more in 2023, but risks to liquidity are increasing

Funding structures continue to reflect the solid structural trends established since the end of the GFC, with reduced reliance on short-term wholesale funding. High customer deposit bases will continue to support Net Stable Funding Ratios, although we believe deposit growth will abate as private-sector savings are attracted by higher yields on offer in fixed income.

Banks will have to tap wholesale markets for MREL-eligible debt to meet January 2024 fully-phased requirements, including on subordination. This will be in general costly and, depending on the market's behaviour, could prove prohibitively expensive for second-tier banks who are less frequent issuers in debt markets. This could raise pressure to withhold dividend payments in the near term to avoid tapping the market for MREL debt.

We expect bank liquidity metrics to worsen in 2023, as the ECB turns to quantitative tightening.

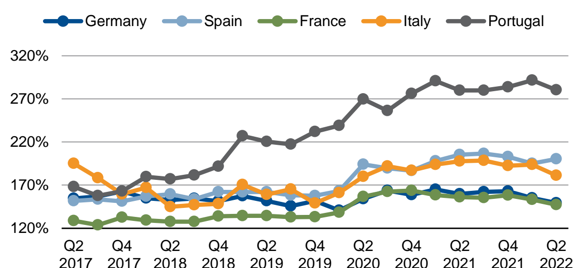
Figure 13: TLTRO repayment are accelerating



Source: Scope Ratings, ECB

High LCRs partly reflect central bank deposits and liquidity portfolios that are artificially boosted by TLTRO carry trades, which will be unwound in 2023. Falling financial asset prices add further stress to bank coffers via lower repo valuations.

Figure 14: LCR ratios have peaked



Source: Scope Ratings, ECB

Given the very high starting point, we do not foresee banks coming close to regulatory breaches, though risks are skewed to the downside. Banking remains a highly confidence-sensitive business and market sentiment can change quickly. Depositor protection schemes are an important support but do not extend to larger corporate or institutional deposits. In volatile markets, there may also be increased outflows related to derivatives exposures and other collateral requirements.

Banks' ESG journey: from promises to delivery on climate disclosures

European banks' sustainability journeys will continue, in parallel with the development of regulatory initiatives and strongly incentivised by investor demands. As the publication of the Green Asset Ratio in 2024 gets nearer, banks will increasingly seek to reassure investors on their preparedness.

Large banks have started to develop measurement frameworks for climate risks in their loan books, and while disclosures have been patchy at best so far and preparedness well below supervisory expectations, we noticed a greater willingness in 2022 to share such measurements with the market, which we take as a sign of confidence in the stability of the measurement models, at least for the large corporate books.

Work is ongoing on measuring climate risk in more granular portfolios, especially SMEs, and competition remains intense between standards-setting bodies to establish disclosure standards. Regulatory Pillar 3 disclosures will start in 2023 (based on 2022 year-end data). While they will only offer a partial view of banks' greening trajectory, they will allow some peer benchmarking.

Banks resilient to more stressed macro scenarios

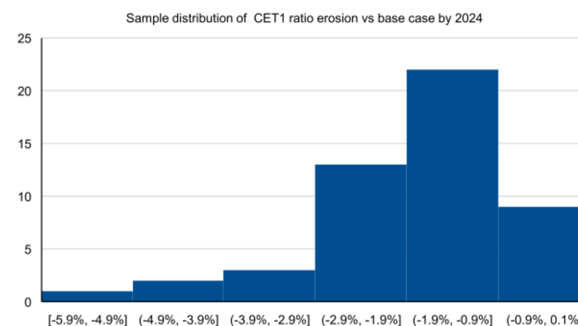
In the above sections, we have painted our core assumptions for 2023. Our forecasts are relatively conservative, among other things on the pace of balance-sheet repricing and on the likely increase in loan-loss provisions.

Given the broad range of macro outcomes, we have added several stresses to our numbers to check on the resilience of performance and capital to even more challenging scenarios.

- **Downside #1.** In our first downside scenario, we assume banks cannot reprice assets faster than liabilities, due to competitive or political hurdles. Net interest margins stay flat vs 2022, essentially negating growth in revenues and pre-provision income.
- **Downside #2.** In our second downside scenario, we assume central banks fail to rein in inflation, which becomes more entrenched and exerts greater pressure on operating expenses (we add 5% to our baseline cost growth assumptions). In addition, we increase our cost-of-risk assumptions by 50bp across the board, reflecting a less benign asset quality path.
- **Downside #3.** In our third and most severe downside scenario, central banks tighten very aggressively to rein in inflation, pushing the global economy into very deep recession. Conservatively, we do not assume additional uplift to net interest revenues in this scenario but costs remain aligned with our base case. The key stress factor is a threefold increase in cost of risk, which hits those banks with a high starting CoR particularly hard, such as some second-tier banks in the euro area periphery and banks with large emerging-market exposures.

Our results are telling. While bank performance is obliterated under our more severe stresses, capital buffers are sufficient to protect solvency – and credit. A handful of banks see a more material decline in capital levels, driven primarily by their high starting point cost of risk.

Figure 15: Material CET1 erosion under severe stress for only a handful of banks



Source: Scope Ratings

Annex I: Related research

European Bank Capital Quarterly: solid capital buffers against weaker outlook, October 2022

Italian banks: solid Q3 performance; constructive outlook for 2023, November 2022

Spanish banks: solid 9m results, risks from real estate exposures manageable, November 2022

French banks and 2023 recession risk: a game of cat and mouse, December 2022

Sovereign Outlook 2023: rating pressures rise due to war in Ukraine, slow growth, high inflation, December 2022

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