The Top Trends Shaping European Bank Ratings In 2019

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Key Takeaways

- We maintain a positive outlook bias on European bank ratings, but it has narrowed, pointing to more negative rating actions in 2019 than in 2018.
- We continue to see a relatively supportive environment for banks despite lower growth in the largest economies, and still quite strong prospects in Central, Eastern, and Southeastern Europe (CESEE).
- We expect stable balance sheets and capitalization given limited new lending prospects and benign asset quality.
- Profitability will likely remain below the cost of equity for many banks, leaving unresolved questions about the long-term sustainability of their business models.

S&P Global Ratings sees a more nuanced picture emerging for the European banking sector in 2019. As a result, we expect a far more balanced pattern of rating actions in 2019, though these could be skewed to the downside.

While we continue to have a positive outlook bias on the largest 100 banks in the region, in many respects this may be as good as it gets for the sector. Balance sheet strengthening is substantially complete, aside from an ongoing reduction in nonperforming exposures (NPEs) in countries like Ireland, Italy, and Spain. Italy aside, the economies that suffered most in the financial crisis have now largely bounced back, and their sovereigns have strengthened. Strong asset quality continues to flatter bank profitability, which, with some notable exceptions, remains poor.

We expect that banks will expand distributions to shareholders, but the absence of strong earnings growth makes many of them a difficult investment story for many shareholders and undermines confidence. Revenue growth remains a challenge across the board, and cost-cutting measures must balance investment in digitalization and structural efficiency initiatives that are needed to underpin long-term competitive position. Bank wholesale funding costs will likely rise as the era of super-cheap central bank money starts to end and investors discriminate more.

We expect the economy to remain supportive of bank credit quality in 2019, and previous concerns about looming asset bubbles have receded somewhat. We could still raise bank ratings where we see growing bail-in buffers that offer materially increased protection to senior preferred creditors, or a few turnaround cases that complete their post-crisis remediation. However, there is now a very limited window of opportunity to finish fixing problems revealed by the last crisis, and we see the balance of risks increasingly stacked to the downside.

The most pressing downside risks could emanate from:

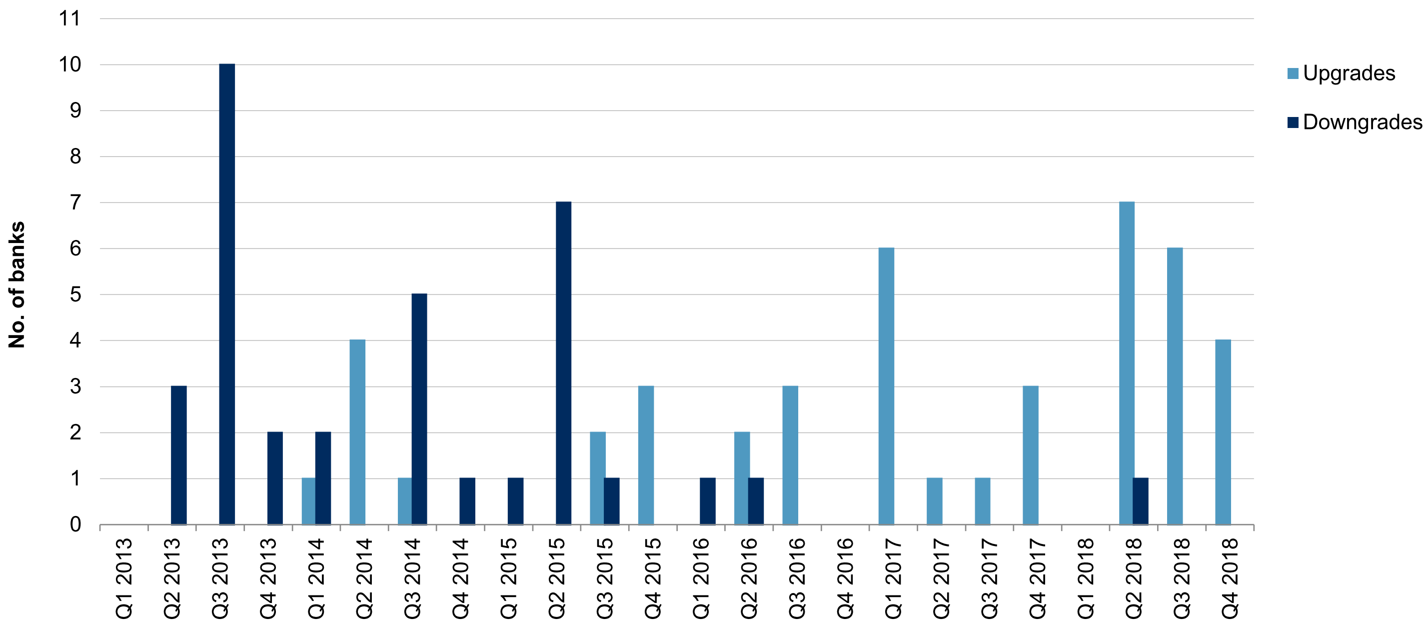
- Regional political risks, whether from Brexit, parliamentary elections, or otherwise, that could derail effective government and undermine business and consumer confidence.
- Global economic growth slowing faster than we expect, whether from a more rapid slowdown in global trade, or the turn of late in the cycle economies.
- Further delay in the expected gradual, orderly normalization in interest rates owing to easing inflation expectations linked to weaker European economic prospects. While helpful from a funding perspective, a decision to extend central bank financing for a third time would further impede bank revenue growth and reduce banks' incentives to rebalance their funding profiles.
- Banks remaining vulnerable to damaging criticism, fines, and settlements for past conduct missteps, as well as a target for political and fiscal objectives.
- Over the longer term, banks failing to fully adjust to the digital era, thus weakening competitive position where they are unable to provide cost effective and/or valuable services in response to changed customer demands and nimble new competitors.

Positive Rating Bias Reflects The Improving Fundamentals Of Previous Years

Our rating actions over the past several years reflected the generally improving macroeconomic picture in Europe and improving bank fundamentals, particularly balance sheets. Indeed, in 2017 and 2018 our rating changes, whether at BICRA (Banking Industry Country Risk Assessment) or individual bank level, had a very strong positive bias. We recognized systemwide improvement in our risk assessments across a raft of the, generally smaller, European banking systems--Austria, Cyprus, Ireland, Portugal, Slovenia--and Spain. We also recognized the strengthening of bail-in buffers, and a few idiosyncratic improving stories. Among the major banking markets, only Italy saw a significant negative rating action. Despite the recent agreement between the Italian government and European Commission regarding the country's budget, yield spreads on the sovereign's debt have only moderately declined so far, and investors remain wary of the intertwined prospects of the sovereign and domestic banks--a more sensitive issue when nominal GDP growth is stalling.

Chart 1

Across The Top 50 European Banks, Upgrades Have Far Exceeded Downgrades Over The Last Two Years

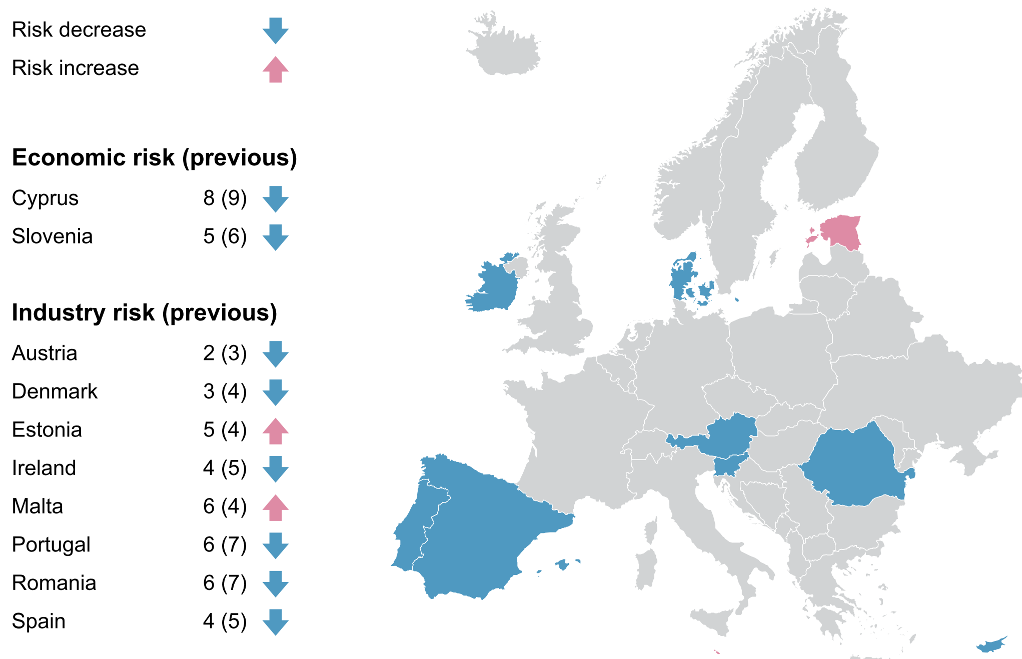


Data as of Dec. 31, 2018. Source: S&P Global Ratings.

Chart 2

Banking Sector Risks Have Declined In CEE And The Eurozone Periphery

Industry and economic risk changes since January 2018 for European economies

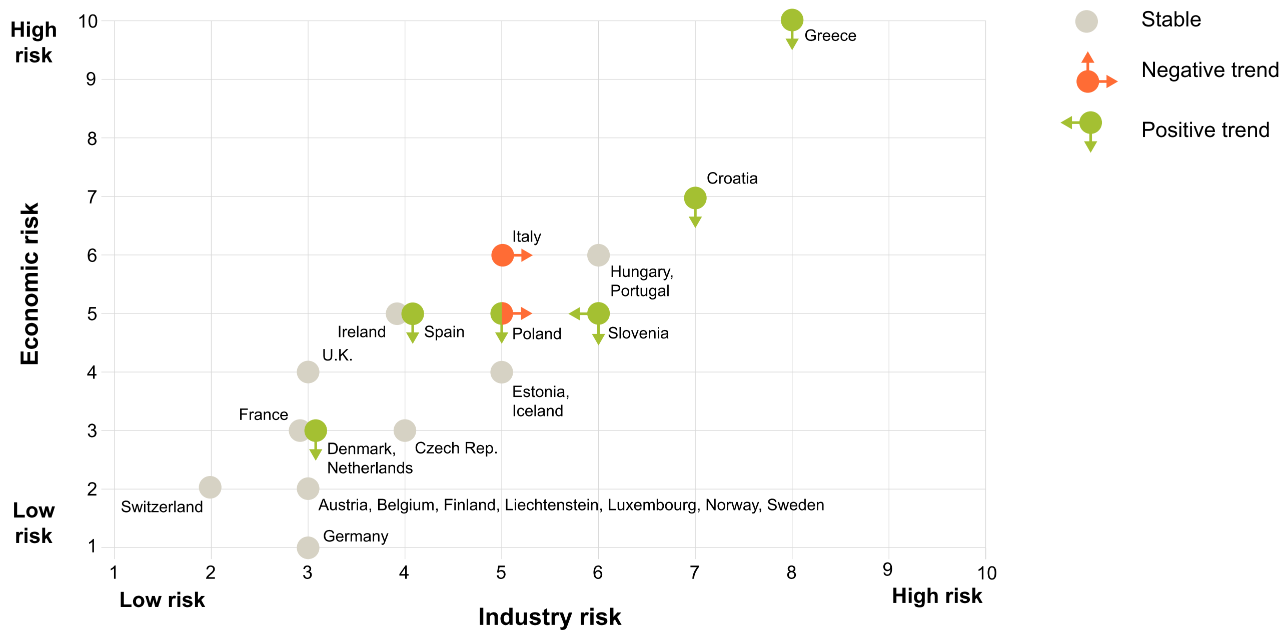


Data as of Feb. 26, 2018. BICRA--Banking Industry Country Risk Assessment. Source: S&P Global Ratings

As we move further into 2019, our ratings continue to show a positive bias, spurred in large part by positive economic risk trends for banking systems such as Denmark, The Netherlands, Slovenia, Spain, and our expectation of further bail-in buffer accretion for banks such as BNP and Societe Generale. Italy aside, our negative outlooks are linked more to idiosyncratic stories such as those of Danske Bank or BBVA, rather than to heightened risks in the operating environment in Europe.

Chart 3

BICRA Scores And Economic And Industry Risk Trends



Data as of Feb. 26, 2019. Our BICRA groups are on a scale from '1' to '10', with '1' denoting the lowest-risk banking sectors.
Source: S&P Global Ratings.

A Cautious But Not Bearish Macro Outlook

European economic momentum is slowing, but not stalled

Our economists continue to see a relatively supportive environment for European banks despite slightly slower growth in the largest economies. Yet, slack in the economy has diminished substantially, the external environment remains cloudy, and central banks plan to gradually withdraw monetary stimulus. Resilient labor markets and loose financial conditions could remain supportive to European domestic demand, however. Furthermore, we expect some brighter spots to remain, not least the CESEE region where our analysts expect the main economies to see 2.5%-3.5% annual growth in real GDP through 2020.

Table 1

S&P Global Ratings Economic Outlook -- Selected Major European Countries

%		Eurozone	Germany	France	Italy	Spain	Switzerland	U.K.
Real GDP	2018f	1.9	1.6	1.6	1.0	2.6	2.9	1.3
	2019f	1.6	1.6	1.6	0.7	2.3	1.6	1.3
	2020f	1.6	1.4	1.6	0.9	2.1	0.5	1.5
CPI inflation	2018f	1.7	1.8	2.0	1.3	1.9	1.0	2.5
	2019f	1.5	0.8	1.5	1.2	1.9	0.8	1.9

Table 1

S&P Global Ratings Economic Outlook -- Selected Major European Countries (cont.)

%		Eurozone	Germany	France	Italy	Spain	Switzerland	U.K.
	2020f	1.5	1.8	1.5	1.4	1.7	1.0	1.7
Unemployment rate	2018f	8.2	3.4	9.2	10.5	5.4	2.6	4.1
	2019f	7.7	3.0	8.9	10.2	14.1	2.4	4.2
	2020f	7.5	3.0	8.7	10.0	13.0	2.3	4.4
Short-term interest rate	2018f	0.0	0.0	0.0	0.0	0.0	(0.8)	0.7
	2019f	0.1	0.1	0.1	0.1	0.1	(0.7)	1.1
	2020f	0.5	0.5	0.5	0.5	0.5	(0.3)	1.4

CPI--Consumer price index. f--Forecast. Source: European Economic Snapshots: 1Q2019, published Dec. 18, 2018.

The record-low borrowing rates that stem from years of widespread monetary stimulus have led to sharp house price appreciation in the stronger economies, such as Germany and Sweden, or those housing markets that are bouncing back from declines in the financial crisis, such as Ireland. Positively, our economists now expect that house prices will increase at a slower pace through 2021. Among the major markets, Italy is the only exception to this trend as we expect prices to track sideways. Still, the risk of bubbles remains, and with lending competition rife we do not expect banks to markedly tighten their underwriting standards in the near term.

The continued uncertainty around the terms of the U.K.'s departure from the EU remains unhelpful. A no-deal Brexit would be disruptive to the U.K. and, to a lesser extent, other open European economies like Ireland or The Netherlands. While the risk of a no-deal Brexit remains, an orderly (though potentially delayed) Brexit continues to be our base case for rating purposes, as the political incentive for the U.K. and the EU to negotiate an orderly outcome remains very strong in our view. European political cohesion remains fragile as EU member states enter the upcoming Parliamentary elections in May that are widely expected to see marked gains for populist parties.

Global developments could undermine European growth

Even if Europe avoids dramas, external factors are now less supportive than at any time in the recent past. Heightened U.S.-China trade tensions, a slower growth Chinese economy, a U.S. economy that looks ripe to slow, and developing economies that struggle with dollar rate rises and investment outflows together provide reduced economic stimulus within Europe.

Bouts of volatility in financial markets in 2018 could become more frequent in 2019 as investors adjust to a slower growth and higher-rate environment. For sure, we expect spread widening that occurred through the second half of 2018 to persist in 2019.

We do not expect an economic storm to break in Europe in 2019, but there are now more clouds on the horizon, which increases the probability that alternative, more adverse, scenarios could materialize.

Policymakers And Banks Are Still Dealing With The Hangover From The Financial Crisis

If Europe does face a trickier economic climate, we cannot overlook that it does so while still trying to remedy the ill-effects of the last downturn, aided by unconventional monetary policy that risks asset bubbles in the stronger economies, government-backing for failed banks, and a heavy regulatory push on certain banks to dramatically reduce their NPEs.

Monetary stimulus will already take years to unwind, and could yet be extended

Even today, the ECB's deposit rate remains stuck at -0.4% and the central bank is making the first tentative steps towards ending its quantitative easing (QE). The pace of monetary policy normalization remains a key variable. If the economic prognosis deteriorates further it becomes increasingly likely that the ECB would not only delay a rise in the deposit rate but also launch a new funding program to at least partially replace its targeted longer-term refinancing operations (TLTRO II), for which banks are due to make their first major repayments due in mid-2020. Extending funding support would benefit in particular the second and third tier Italian banks, which are significant borrowers under TLTRO II, derive some competitive benefit from the associated cheap funding, and in some cases have constrained access to wholesale investors. Conversely, we expect the rest of the eurozone banks to be well-prepared to pay down their ECB borrowings at maturity if the ECB simply allows TLTRO II to lapse.

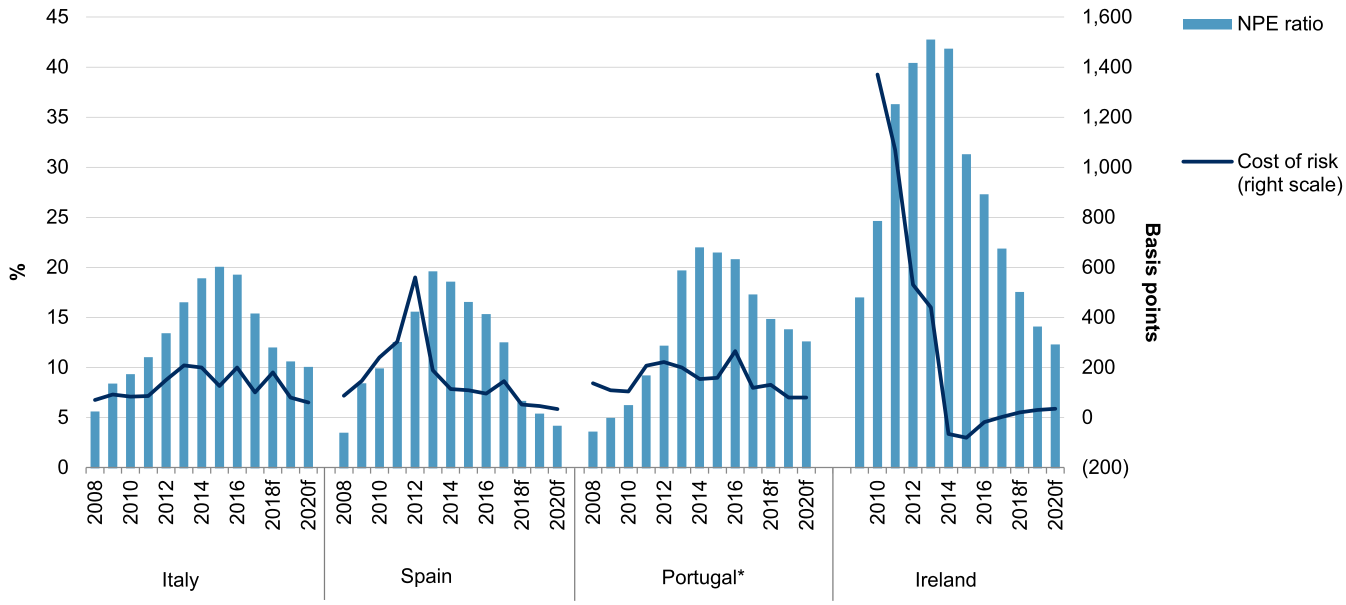
Outside the eurozone, the Bank of England could hold or cut the base rate if Brexit proves disruptive. In Sweden, if the Riksbank keeps to its inflation target strictly, we do not expect a further increase in the policy rate during 2019.

The NPE overhang is easing, but there's still lots to do

We acknowledge that many eurozone banks, particularly in periphery countries, have managed to reduce NPEs faster than we expected in the past two years, thanks to sizable disposals and the regulators' proactive stance over that time. We also believe that the NPEs still on banks' balance sheets are closer to market value than before, potentially supporting further sales without a significant hit to capital ratios. However, some eurozone banks remain on multiyear journeys to reduce NPEs to normal levels and thereby shore up investor confidence. According to the European Banking Authority (EBA), around one-quarter of EU banks still had gross NPEs above 8% as of September 2018--more than twice the EU average and well above the 5% gross threshold (2.5% net of provisions) that the EU summit set last December as a benchmark for measuring in 2020 whether banks had made sufficient progress in risk reduction.

Chart 4

NPEs And Cost Of Risk Trend For Banks In Italy, Spain, Portugal, And Ireland



*NPE data until 2012 do not include restructured loans. f--Forecast. NPE--Nonperforming exposure. Originally published in "Several Eurozone Peripheral Banks Are Racing To Resolve Problem Loans," on Feb. 13, 2019. Source: S&P Global Ratings.

Governments will remain reluctant bank owners for years to come

The financial crisis itself was characterized by the widespread provision of government solvency support for failing, systemically important European banks. This largely ceased by 2015 because the financial crisis had mostly run its course by then and because the public policy and resolution frameworks, notably the EU's Bank Recovery and Resolution Directive, started to move the dynamic away from government bailout to creditor bail-in. However, just as the effort to make banks truly resolvable is proving to be a long-term project, European governments will need many more years to exit their stakes in these rescued banks (see table 3 in the appendix). We saw even less progress in 2018 than our already cautious expectation, in part because of less supportive market conditions during the second half, for example:

- In Germany, Hamburg Commercial Bank (HCOB; former HSH Nordbank) was sold, but NordLB looks set to be rescued by its public sector and savings banks owners instead of following HCOB's path by accepting the private equity offer.
- In Italy, Cassa di Risparmio di Genova e Imperia (Carige) has now joined the list of troubled banks that rely on some government solvency support.
- The Dutch government's stake in ABN AMRO has not reduced further throughout 2018, and there is still no clear timeline for the IPO of De Volksbank.

- The Spanish government pushed back the divestment of its residual 61% stake in Bankia by two years to 2021.

We expect few divestments in 2019 while market pricing remains so unsupportive, but possible exceptions include The Royal Bank of Scotland (RBS), where the bank could repurchase from the government up to 5% of its shares.

Bank Profitability Remains The Perennial Achilles Heel

2018 earnings showed few reasons for immediate concern, but also few reasons for optimism

The 2018 earnings season has so far shown a mixed, but overall far from compelling, picture for bank performance despite an exceptionally low cost of risk for most European banks that continues to flatter reported return on tangible equity (ROTE).

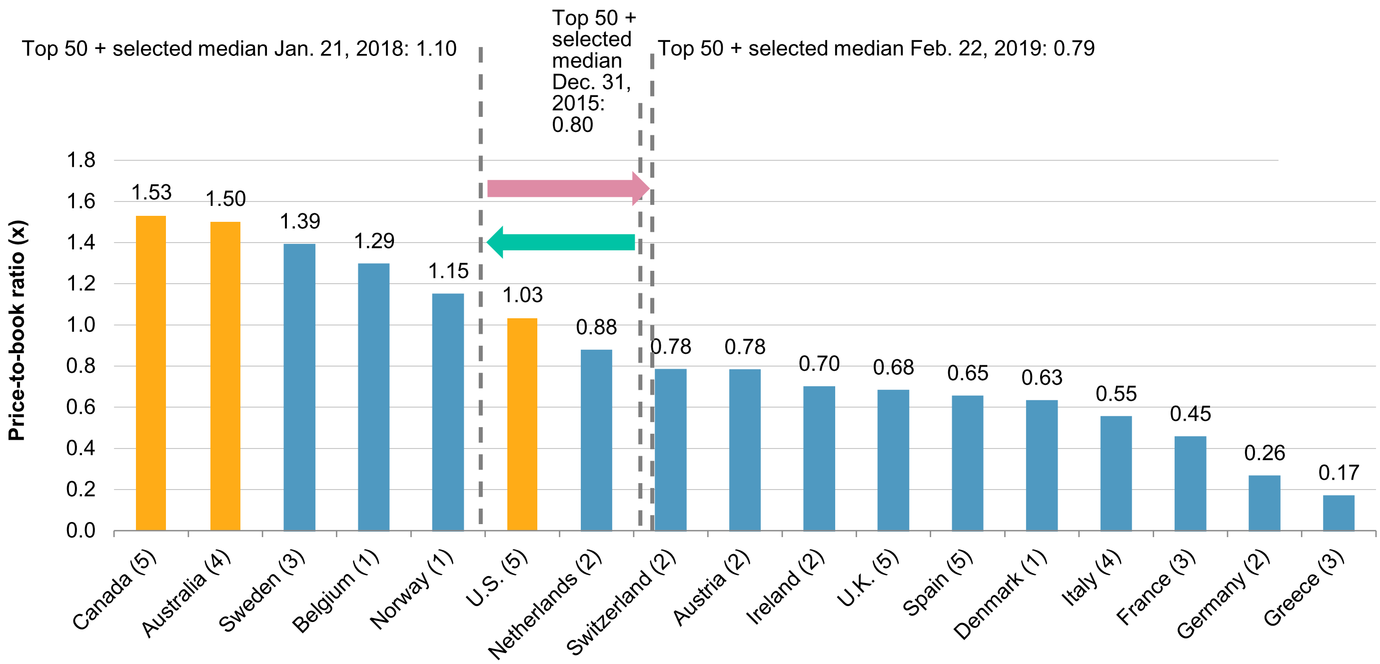
European investment banking businesses proved no more resilient to the fourth-quarter market downturn than those of U.S. peers--one reason why revenues and pretax earnings for Deutsche Bank, HSBC, Société Générale, BNP, and UBS all somewhat underperformed against market consensus. Weaker wholesale banking/market making activities was a recurring topic for Nordic banks also. Nordea saw an extra drag on revenue generation from asset margin pressure, and its transformation project. ING reported solid underlying results but was hit during the third quarter by a large fine relating to improper monitoring of illicit financial flows. Results for Credit Agricole were solid, but like for many peers, showed the continued pressure on revenues from a low growth environment amid persistent margin pressure.

In the absence of strong revenue growth drivers, many banks continue to aspire to cut costs in absolute terms despite investing heavily. A few of them succeeded in materially cutting the cost base, notably Unicredit and Credit Suisse, but for some banks long-term competitiveness could depend on them repeating this feat year after year. As they do so, branch closures will remain a common feature, though of themselves closures often do not lead to significant savings--they are related more to responding to changing patterns of customer behavior. For example, Caixabank plans to reduce its branch network by 18% in three years, and, more broadly, consolidation in Spain could accelerate this process across the market.

Today, we see highly efficient banks in the Nordics, wealth managers (such as UBS), and some retail-focused banks elsewhere (such as Credit Agricole, Lloyds, and KBC) churning out solid double-digit ROTEs. Elsewhere, corporate and markets-focused banks generally continue to struggle, as do banks in fragmented or low-return markets like Germany. Overall, plenty of European banks continue to promise better days ahead for their shareholders, but generally there seems to be a much greater risk of delay than of overachievement, to the increasing dismay of shareholders. The median price-to-book ratio for the largest banks is now around 0.8x, essentially unchanged from 2015, and still well below those for peers in other large developed banking systems.

Chart 5

Price-To-Book Ratios -- Top 50 European Banks And Selected Others



Data covers European top 50 banks (where available), plus selected U.S., Canadian, and Australian majors for comparison purposes. Count of banks in parentheses. Data as of Feb. 22, 2019. Source: Capital IQ.

Social and governance risks remain an important sensitivity

Legal, regulatory, and political risks remain a feature for banks across Europe. The major banks have now largely worked through the hangover of litigation from the financial crisis, but alleged weaknesses in anti-financial crime controls remain a recurring theme. U.K. banks are, years later, at the tail end of their hugely expensive remediation for the misselling of payment protection insurance, but the European banking industry remains vulnerable to criticism of past conduct failures. It also remains a target for new policy initiatives, and a source of politically attractive revenues for governments with squeezed fiscal positions. We note for example:

- In November 2018, Société Générale agreed to pay penalties of €1.2 billion (already provisioned) to the U.S. authorities to settle investigations relating to U.S. economic sanctions regulations.
- In January, French banks agreed to avoid fee hikes for retail clients in 2019 and an overdraft fee cap for the most vulnerable. Spanish banks have been landed with paying stamp duty where they provide mortgage finance for real estate purchases, though they hope to recoup this from clients.
- BBVA is being investigated by the Spanish authorities for an alleged wiretapping operation in 2004/2005.

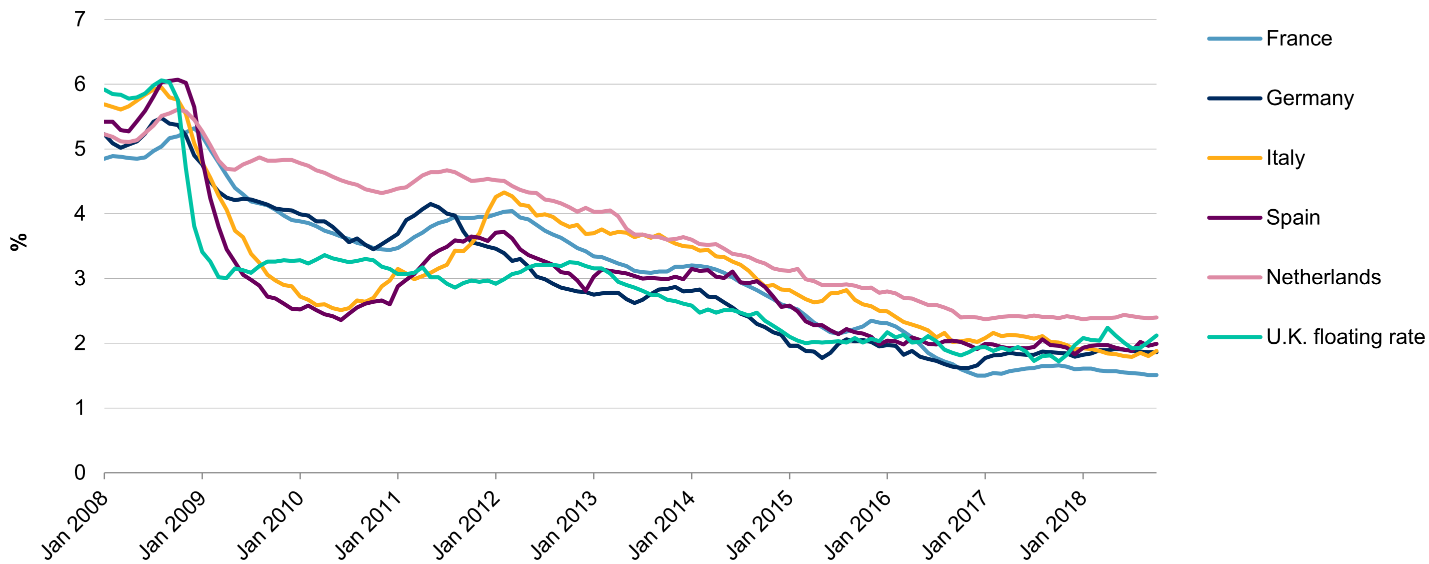
- Following accusations that between 2007 and 2015 Danske Bank's small Estonian branch was a conduit for huge flows of money from Russia and neighboring states, it faces criminal investigations in the U.S., Denmark, and Estonia, and has been told to close its operations in the Baltic states.
- Swedbank, a major player in the Baltics, now also finds itself embroiled, and has commissioned consultants to investigate related allegations.
- In recent days, the French trial court assessed that two UBS Group AG subsidiaries were guilty of illicit solicitation and laundering the proceeds of tax fraud and assessed that UBS should pay €3.7 billion in penalties and €0.8 billion in civil damages. (UBS has appealed this judgment.)
- In Poland, policymakers are proposing to apply a hefty levy on banks that would be used to help borrowers with foreign currency mortgages.
- Major eurozone banks in particular continue to contribute sizable fees to fully fund the Single Resolution Fund by 2024, and banks in countries like the U.K. and France remain subject to additional levies or taxes beyond those normally paid by other corporate entities.

Rising interest rates will lift, but not propel, bank profitability

Overall, we expect pretax profits for the Top 100 banks will have been slightly stronger in 2018 than in 2017, and they might be slightly better again in 2019. But even in our relatively benign base case with a gradual rise in the euro deposit rate starting in late 2019, it remains possible that we will see economic growth translate into only very limited bank profitability growth. Rising base rates will help investment income, but we expect liability costs to rise (whether from deposits or wholesale funding), fee income growth to remain relatively weak, and operating expenses to be overall flat at best as banks invest heavily to gain efficiencies in the digital future. Strong asset quality, and associated low impairments, have been a blessing for many European banks and might remain so. But aside from the eurozone banks that continue to make strides to cut bad loans, European asset quality can only get worse and we expect an at least gradual weakening trend, with some one-off event risk (e.g. on single-name exposures). Banks will doubtless continue to report exceptional costs for litigation and restructuring, but likely at lower levels than in previous years.

Chart 6

Interest Rates On Mortgage Loans Are Converging Downward In Many European Countries

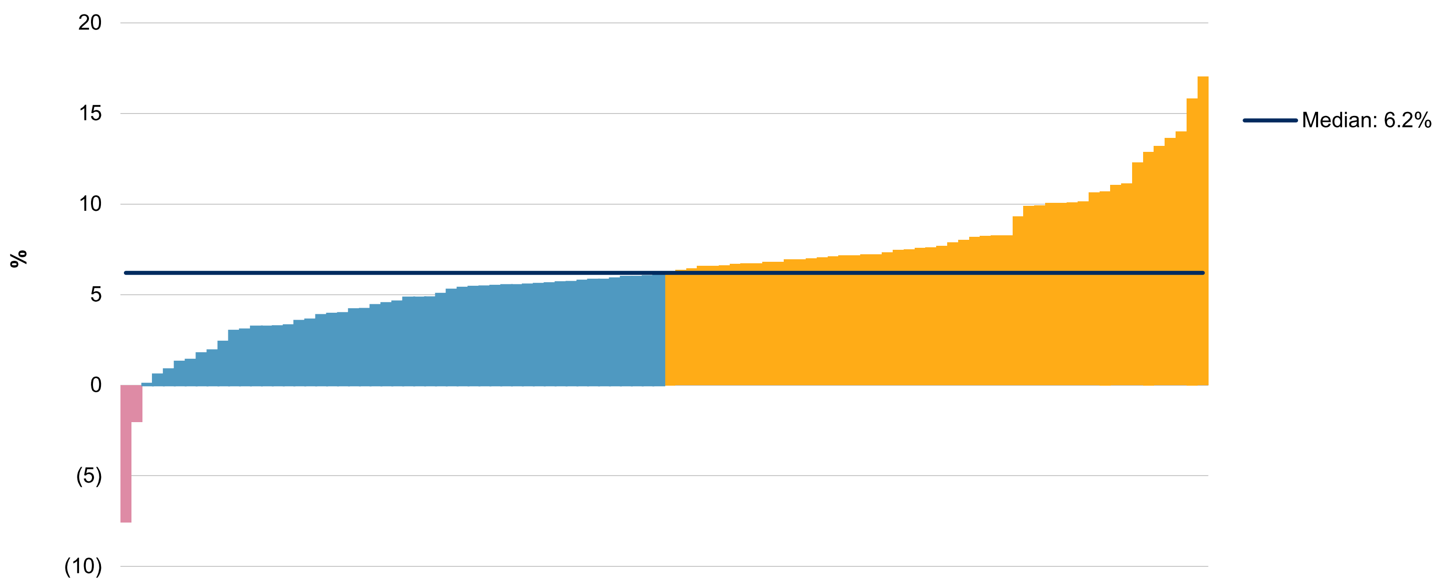


Originally published in "When The Cycle Turns: Rising Interest Rates Will Lift, Not Propel, Western European Banks," on Jan. 14, 2019.
Source: European Central Bank, Bank of England, S&P Global Ratings.

As we look further ahead to 2020, aside from a few individual improving cases and some consistent strong performers in Scandinavia and the Benelux, we struggle to see a period of emerging buoyant bank profitability. Among the Top 100 banks, we project the median return on equity (ROE) will remain stuck at 6% for 2019, against a perceived cost of capital for most banks of 8%-10%. We expect that only one quarter of them will generate a return on equity (ROE) of more than 8% by 2020, and that only 16 will generate ROE of more than 10%. The majority will likely remain stuck in the 4%-8% range. A handful of banks could even see a slight weakening, particularly those that are most susceptible to interest margin pressure.

Chart 7

Projected Return On Equity For The Top 100 European Banks In 2019



Data as of Feb. 26, 2019. Source: S&P Global Ratings.

The List Of Serial Underperformers Has Shortened

Some key names have made progress

While few European banks currently make a virtue of their profitability, last year we commented on a handful of large banks that continued to make significant strategic and operational adjustment in order to meet shareholder expectations (see “Chasing Shadows Or Rainbows? Sustainable Profitability Still Eludes Some Major European Banks,” March 15, 2018).

Positively, we have seen progress. Credit Suisse reported a 5.5% ROTE for 2018 and its first annual post-tax profit since 2014, and in 2019 it seems likely to show good progress towards its 10% ROTE target thanks to its tilt towards wealth management and completed refocusing of the investment bank. Barclays and RBS have also made strides and look to be now in the pack on underlying profitability, though still with some work to do to achieve the double-digit statutory ROTEs that they promise by 2020.

Standard Chartered remains a work in progress. Its 5.1% ROTE for 2018 was in line with market consensus, but this is short of the original 8% ROTE that management had envisaged when setting out their financial targets in 2015. Management's newly-announced target of 10% ROTE by 2021 assumes 5%-7% annual growth in revenues and further substantial cost savings, but could yet be undermined by the difficult revenue environment.

Others remain challenged, inviting takeover speculation

We maintain a negative outlook on Commerzbank and limit the issuer credit rating (ICR) on Deutsche Bank, having lowered it in mid-2018. Commerzbank has completed its restructuring and for 2018 reported a higher ROTE of 3.4% (from 0.5% in 2017), but management slightly reduced its 2020 ROTE financial target to 5%-6%. It remains challenging to see how management will deliver sufficient shareholder returns without a marked normalization of interest rates. Deutsche Bank's refreshed senior management team has made some in-roads since setting out revised financial targets and a further round of refocusing of the Corporate & Investment Bank division in Spring 2018, but continues to face a multiyear project to complete the restructuring of its operations, rebuild its reputation and franchise, and deliver the significantly enhanced profitability that shareholders hope for. Until these banks show that they can meet long-term shareholder expectations, they are likely to remain the target of speculation over potential mergers or takeovers.

While we do not yet see other banks under such direct pressure from shareholders, Commerzbank is not the only major European bank to have revised financial targets in recent weeks. BNP's revisions, for example, demonstrate the challenge of many banks--slower-than-anticipated revenue growth that forces renewed focus on costs, and overall slows the improvement in shareholder returns.

Table 2

Examples Of Banks That Revised Their Financial Targets

	Target Indicator	Initial Target	Revised Target
Société Générale	ROTE	About 11.5% by 2020	9%-10% by 2020
Commerzbank AG	ROTE	More than 6% by 2020	5%-6% by 2020
BNP Paribas	ROE	10% by 2020	9.5% by 2020
	Revenue growth	2.5% CAGR 2016-2020	1.5% CAGR 2016-2020
	Cost-income ratio	63%	64.5%
	Cost savings (recurring)	€2.7 billion from 2020	€3.3 billion from 2020

CAGR--Compound annual growth rate. ROE--Return on equity. ROTE--Return on tangible equity. Source: Company reports.

Capitalization Remains One Bright Spot, But The Debt Market Has Become Less Accommodating

Capitalization is generally solid; in time, Basel 3 completion could further impede satisfactory returns

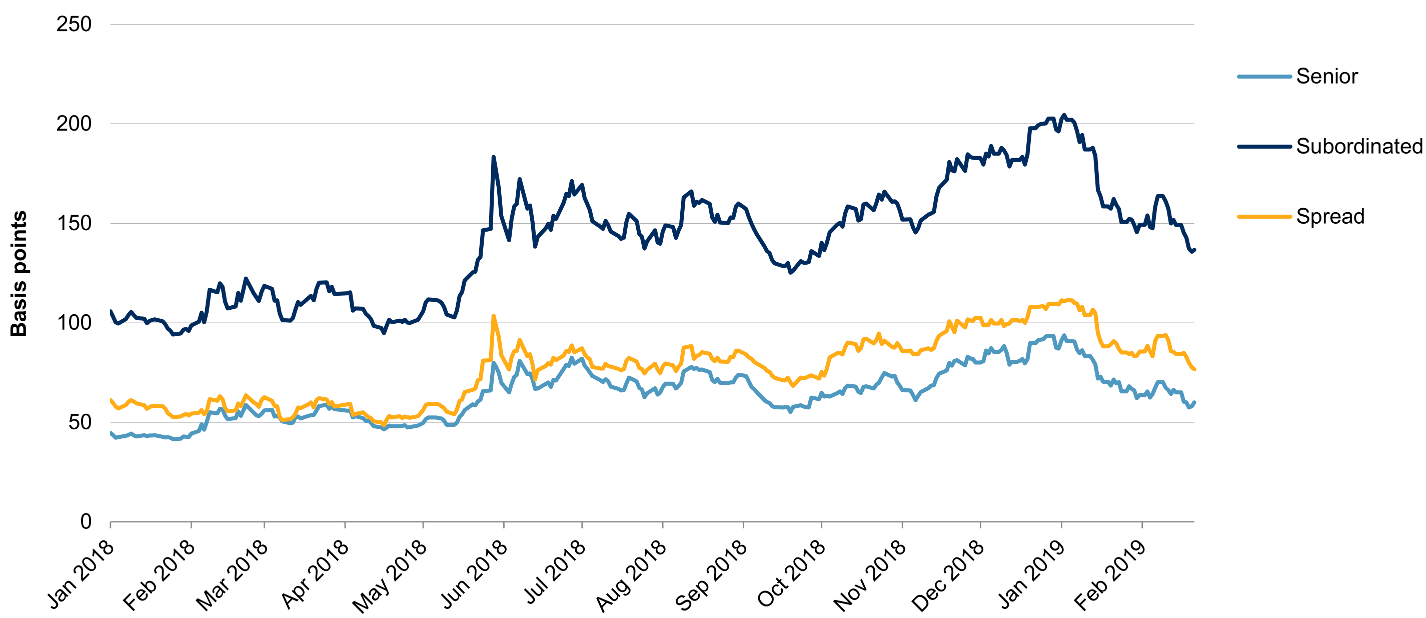
European bank regulatory capitalization improved significantly until 2017 and has largely now peaked. Through the lens of our risk-adjusted capital (RAC) framework, we see capital adequacy as a ratings strength for 21 of the largest 50 European banks, and a weakness for only nine banks. We see this view as somewhat corroborated by the results of the European Banking Authority's (EBA's) latest stress test, reported on Nov. 2, 2018. For 48 European banks (of which we rate 43), it confirmed that their capital buffers are sufficient to deal with adverse scenarios. That said, the test applied markedly different levels of stress across the region, from mild in some countries to substantial in others. The completion of Basel 3--model risk weight floors, the much delayed fundamental review of the trading book (FRTB)--offers no near-term catalyst for further capital accretion, but could do so in the coming years. This might be positive for some banks' RAC ratios. However, while the implementation phase that will run from 2022 to 2027 is long enough to allow for business model adaptation, it could accentuate the headaches of those already challenged to achieve a satisfactory ROTE.

The days of cheap, plentiful funding are ending

As central banks taper their QE, we expect this to lead to more competition for funding. Investors were flush with liquidity in recent years and banks found a ready appetite for their debt. However, investors are already starting to make more differentiated investment decisions, and we expect this to continue--indeed, to become more entrenched. We expect this to play out across the debt structure but to be most important for the senior nonpreferred debt (SNP) class. While senior preferred debt issuance might pick up compared with 2017, SNP seems likely to form the majority of European bank unsecured issuance activity in 2019, as in 2018. We see this as a pricing rather than availability risk for now. But with asset spreads already under pressure and hard to adjust upwards, more expensive debt adds pressure to net interest margins.

Chart 8

iTRAXX Indices Comparison -- Subordinated Versus Senior Debt



Data as of Feb. 22, 2019. Source: Capital IQ.

Shareholder payouts will rise, but weak profitability and high NPEs should breed caution

Since most European banks have now largely completed their build of core capital and with likely limited lending growth, this supports improved dividend paying capacity--a glimmer of hope for shareholders, many of whom have been offered scant reward in the past years, not least given the collapse in European (and other global) bank stock prices in 2018. Expanding distributions is also one lever available to bank Boards to placate investors when earnings growth falls short. We therefore expect distributions to rise in 2019. In recent weeks, Commerzbank has resumed dividend payments after a multi-year hiatus. Credit Suisse, RBS, UBS, and Lloyds are some of the major banks that have announced new or expanded share buyback programs or special dividends.

Nevertheless, we anticipate that where banks have still quite limited preprovision earnings capacity to absorb a spike in credit losses, management teams will be cautious about allowing capital ratios to weaken. If, as we expect, the market will differentiate more, then the very appearance of being lossmaking could be unhelpful, particularly if the capital ratios are only so-so. Banks with still-high NPE ratios could also be under pressure from the regulators to be highly cautious on distributions, so retain capacity to offload poor quality assets even if market pricing weakens.

The hybrid debt market remains open, but at a price

2018 was characterized by a marked widening in yields for additional Tier 1 (AT1) instruments. While the issuance pattern was a little more episodic than in 2017, European banks issued €30 billion of new instruments--similar to 2017. In 2019, we expect this yield widening to be sustained, but banks have so far continued to find an investor base for well-priced deals, even for low-rated paper.

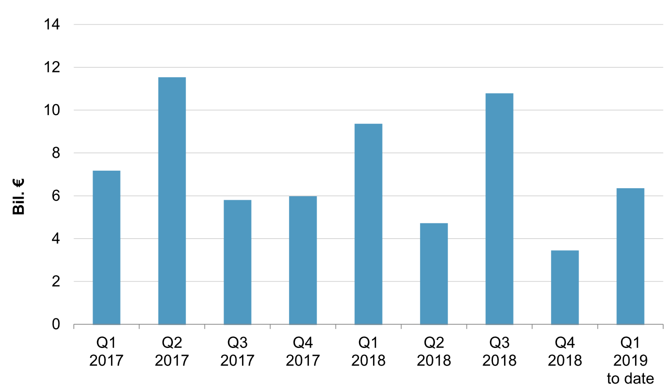
Chart 9

Barclays Global Contingent Capital Index Yield To Worst

Data as of Feb. 25, 2019. Source: Bloomberg.

Chart 10

European Banks' Additional Tier 1 Issuance



Non-euro issues converted using the exchange rate on the issue date.
Data as of Feb. 25, 2019. Source: Bloomberg.

Market caution on pricing reflects not just views on relative credit quality but also specific risks inherent in these instruments and expectations on issuance activity. For example, while issuers and, we think, regulators will likely be eager to avoid the nonpayment of coupons unless it becomes mandatory to do so, the EBA stress test provided a salutary reminder that it remains a more than theoretical risk for these hybrids--25 out of the 48 tested banks would have had to apply distribution restrictions on hybrids in the stress scenario. Furthermore, following Santander's non-call of an AT1 instrument this month, investors will watch closely the statements and behaviour of banks that have calls coming up this year.

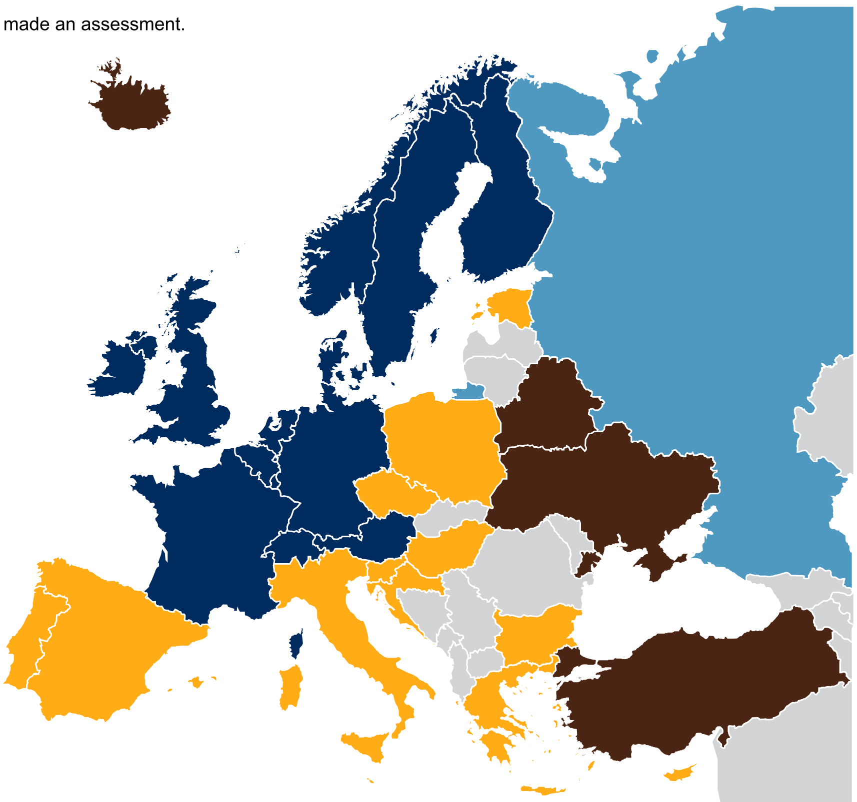
MREL-setting will spur further senior nonpreferred issuance, but the SRB's subordination requirement will influence volumes

We expect the publication of binding MREL (minimum requirement for own funds and eligible liabilities) for additional systemic European banks to spur a further wave of issuance of SNP (or nonoperating holding company senior) debt in 2019, as further banks join those that have already made headway in meeting these requirements. However, eurozone regulators have remained sensitive to imposing requirements to issue relatively more expensive debt (as SNP issuance typically replaces senior preferred) when profitability is already under pressure. This is most obviously seen in their willingness to count unsubordinated debt in MREL. We continue to regard this debt--which ranks pari passu with bank operating liabilities such as uncollateralized derivatives and, in most cases, corporate and institutional deposits--as inherently fraught with NCWO (no creditor worse off) legal risk if it is bailed-in. As such, its use as a source of bail-in (recapitalization) capacity could well be inconsistent with an orderly, open bank resolution. Banks have the option to issue more SNP than is required, but if they do they might be the exception--for example, in February Santander announced that, unlike in the previous two years, its 2019 issuance will not include SNP debt. It will likely be several more years before our European bank ratings reflect truly widespread uplift for additional loss-absorbing capacity (ALAC) support.

Chart 11

Ramp-Up Of Bail-In Buffers Remains A Work In Progress

- Government remains supportive.
- Government support is uncertain, the resolution regime is effective, and we include ALAC uplift for some banks.
- Government support is uncertain, the resolution regime is effective, but we do not include ALAC uplift for any domestic banks.
- Government support is uncertain, the resolution regime is not yet effective.
- We have not yet made an assessment.



Source: S&P Global Ratings.

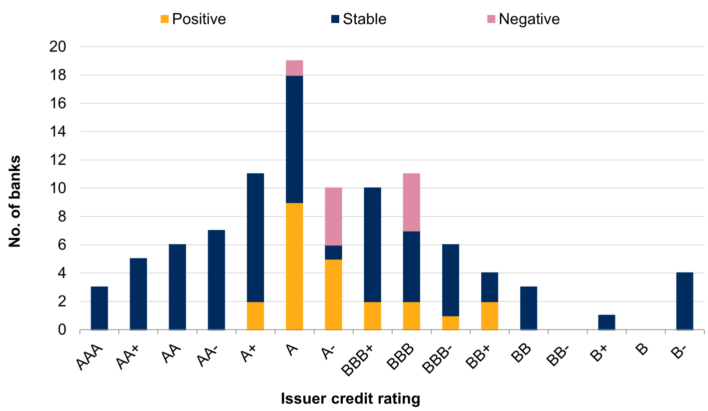
Further Upgrades Could Be Few And Far Between

Even in our benign base-case scenario, our ratings on senior nonpreferred and other hybrid instruments will improve only where we see an improvement in a bank's intrinsic creditworthiness, typically reflected in our assessment of the stand-alone credit profile (SACP) or, where appropriate, the unsupported group credit profile (UGCP). SACP/UGCP improvement is more likely in systems where our BICRA already acknowledges positive economic or industry risk trends--for example in Denmark and The Netherlands. Even so, SACP/UGCPs will only improve if we perceive a fundamental improvement in a bank's creditworthiness--for example, a BICRA improvement may be insufficient if the bank's performance is not improving.

By contrast, some of the current positive outlooks reflect only our expectation of strengthening bail-in buffers. If this should happen, we could add notches for ALAC, but these buffers benefit only senior (preferred) operating company creditors. While many European banks have not yet completed their bail-in buffers, we have positive outlooks on only a few of them, including BNP, Jyske Bank, Nationwide Building Society, NIBC, and Societe Generale.

Chart 12

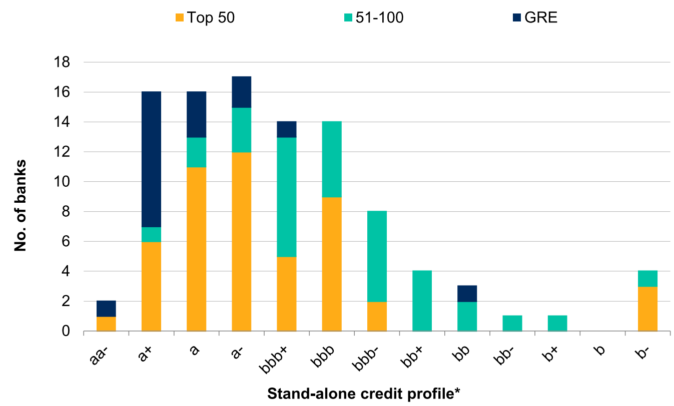
Top 100 European Banks -- Issuer Credit Ratings And Outlooks



Data as of Feb. 21, 2019. Source: S&P Global Ratings.

Chart 13

Top 100 European Banks -- Stand-Alone Credit Profiles



Data as of Feb. 21, 2019. GRE--government-related entity. *Or unsupported group credit profile, as appropriate. Source: S&P Global Ratings.

Appendix

Table 3

Top 100 European Banks On Positive Outlooks

Country	Bank	UGCP or SACP	Opco long-term issuer credit rating/outlook*	Holdco long-term issuer credit rating/outlook	Principal outlook driver(s)	Summary description of upgrade driver(s)
Austria	Erste Bank Group AG	a	A/Pos		C&E/SACP or ALAC§	We could raise the SACP and ICR if the bank's RAC ratio moves comfortably and sustainably above 10%, or just the ICR if we have improved visibility on the ramp-up of the bail-in buffer.
Austria	Raiffeisen Bank International AG	bbb+	BBB+/Pos		C&E/SACP	If the Raiffeisen Bank Group's RAC ratio moves comfortably and sustainably above 10% and other improvements also support an upgrade.
Belgium	Argenta Spaarbank N.V.	bbb+	A-/Pos		BICRA/SACP	If the bank benefits from a more favorable operating environment for its Dutch retail banking business, and it appears fairly rated in line with 'A' rated peers.
Denmark	DLR Kredit A/S	bbb+	A-/Pos		BICRA/SACP	If we see reduced economic risks in Denmark.
Denmark	Jyske Bank A/S	a-	A-/Pos		ALAC§	If the bank continues to build its ALAC buffer above 5% of S&P Global Ratings' RWAs.

Table 3

Top 100 European Banks On Positive Outlooks (cont.)

Country	Bank	UGCP or SACP	Opco long-term issuer credit rating/outlook*	Holdco long-term issuer credit rating/outlook	Principal outlook driver(s)	Summary description of upgrade driver(s)
Denmark	Nykredit Realkredit A/S	bbb+	A/Pos		BICRA/SACP or ALAC§	We could raise the SACP and ICR if we see reduced economic risks in Denmark, or just the ICR if it increases ALAC beyond 8% of S&P Global Ratings RWAs.
France	BNP Paribas S.A.	a	A/Pos		ALAC§	If the bank continues to build its ALAC buffer above 5.25% of S&P Global Ratings' RWAs, and it appears fairly rated in line with 'A+' rated peers.
France	La Banque Postale	bbb+	A/Pos		Parent§	If parent La Poste structurally benefits from La Banque Postale's partial takeover of CNP Assurances.
France	Societe Generale	a-	A/Pos		ALAC§	If the bank builds its ALAC buffer in excess of 8% of S&P Global Ratings' RWAs, while improving its profitability in comparison with that of its peers that we rate 'A+'.
Germany	Sparkassen-Finanzgruppe Hessen-Thueringen	a	A/Pos		C&E/SACP or Group support	If SFHT's RAC ratio sustainably passes 15% and the group demonstrates favorable asset quality and unchanged risk-averse culture. Alternatively, we could upgrade if see stronger links between SFHT and the German savings bank sector.
Ireland	Bank of Ireland Group PLC	bbb	BBB+/Pos	BBB-/Pos	RP/SACP	If asset quality metrics across the group significantly improve, while at the same time capitalization remains a ratings strength and internal capital generation improves.
Liechtenstein	LGT Bank AG	a+	A+/Pos		C&E/SACP or ALAC§	We could raise the SACP and ICR if the bank sustainably increases RAC beyond 10%, or just the ICR if the bank seems likely to build sufficient ALAC.
Netherlands	ABN AMRO Bank N.V.	a-	A/Pos		BICRA/SACP	If we see reduced economic risks in the Netherlands.
Netherlands	Cooperatieve Rabobank U.A.	a	A+/Pos		BICRA/SACP	If we see reduced economic risks in the Netherlands and we are confident that Rabobank will maintain strong capitalization.
Netherlands	De Volksbank N.V.	bbb+	A-/Pos		BICRA/SACP	If we see reduced economic risks in the Netherlands, and the bank continues its franchise recovery and delivers recurring earnings in a more competitive environment, assuming a favorable comparison with 'A' rated peers.
Netherlands	NIBC Bank N.V.	bbb	BBB/Pos	BBB-/Stbl	ALAC§	If NIBC builds, and then sustains, its ALAC buffer beyond the 5% threshold.

Table 3

Top 100 European Banks On Positive Outlooks (cont.)

Country	Bank	UGCP or SACP	Opco long-term issuer credit rating/outlook*	Holdco long-term issuer credit rating/outlook	Principal outlook driver(s)	Summary description of upgrade driver(s)
Slovenia	NLB Group	bb+	BB+/Pos		BICRA/SACP	If industry risk conditions in Slovenia improve, or if the bank's stand-alone creditworthiness otherwise improves.
Spain	Caja Laboral Popular Cooperativa de Credito	bbb-	BBB-/Pos		BICRA/SACP	If, alongside further easing of economic risks in Spain, Caja Laboral exhibits a clear capital strength that offsets inherent concentration risks.
Spain	Kutxabank S.A.	bbb	BBB/Pos		BICRA/SACP	If Kutxabank remains solidly capitalized compared with its risk exposure, likely aided by reduced NPAs and reduced economic risks in Spain.
Spain	Ibercaja Banco S.A.	bb+	BB+/Pos		BICRA/SACP	If Ibercaja markedly improves underlying profitability, or if strengthened capital offsets inherent concentration risks.
Switzerland	Credit Suisse Group AG	a-	A/Pos	BBB+/Stbl	Removal of negative ICR adjustment§	If CSG demonstrates that its earnings have sustainably recovered, moving more in line with peers', with a lower reliance on revenues from trading and investment banking
U.K.	Nationwide Building Society	a-	A/Pos		ALAC§	If Nationwide builds its ALAC buffer in excess of 8% of S&P Global Ratings' RWAs and its operating performance remains solid.
U.K.	The Royal Bank of Scotland Group PLC	bbb	A-/Pos	BBB-/Pos	RP/SACP	If RBSG sees no new material conduct and litigation charges, capital markets earnings improve despite downsizing, and reprivatization appears unlikely to affect strategy or weaken capitalization.

Data as of Feb. 26, 2018. ALAC--Additional loss-absorbing capacity. BICRA--Banking Industry Country Risk Assessment. C&E--Capital and earnings assessment. Holdco--Holding company. ICR--Issuer credit rating. NPA--Nonperforming asset. Opco--operating company. RAC--Risk-adjusted capital. RP--Risk position assessment. RWA--Risk-weighted assets. SACP--Stand-alone credit profile. UGCP--Unsupported group credit profile. *Long-term issuer credit rating is for the group's principal opco(s). §Upgrade would not affect ratings on the bank's hybrids or (where relevant) nonoperating holding company liabilities. Source: S&P Global Ratings.

Table 4

Top 100 European Banks On Negative Outlooks

Country	Bank	SACP/UGCP	Long-term issuer credit rating (opco level)	Principal outlook driver(s)	Summary description of downgrade driver(s)
Denmark	Danske Bank A/S	a-	A/Neg	SACP	If Danske Bank's franchise suffers lasting damage, or regulatory penalties could weaken capitalization, or control and governance weaknesses are not addressed.
Germany	Commerzbank AG	bbb+	A-/Neg	C&E/SACP or ALAC*	We could lower the SACP and ICR if the bank's capitalization and earnings fail to improve, or just the ICR if ALAC looks likely to slide below 5%.
Germany	Deutsche Pfandbriefbank AG	bbb	A-/Neg	C&E/SACP	If our RAC ratio forecast for PBB does not exceed 10%, particularly if the bank pursues credit expansion in regions with higher economic risks.

Table 4

Top 100 European Banks On Negative Outlooks (cont.)

Country	Bank	SACP/UGCP	Long-term issuer credit rating (opco level)	Principal outlook driver(s)	Summary description of downgrade driver(s)
Germany	Volkswagen Bank GmbH	a-	A-/Neg	Anchor/SACP	If VW Bank disproportionately increases its exposure to markets with higher economic risks.
Italy	Intesa Sanpaolo SpA	bbb	BBB/Neg	Sovereign FC rating	If we downgrade Italy.
Italy	Mediobanca SpA	bbb	BBB/Neg	Sovereign FC rating	If we downgrade Italy, or if operating conditions deteriorate, pressuring Mediobanca's funding profile.
Italy	UniCredit SpA	bbb	BBB/Neg	Sovereign FC rating	If we downgrade Italy and we conclude that UniCredit would still be unlikely to withstand a sovereign default.
Spain	Banco Bilbao Vizcaya Argentaria S.A.	a-	A-/Neg	SACP	If a material worsening of the economic and operating environment in Turkey hampers BBVA's financial strength, because the RAC ratio fails to sustainably exceed 7.0% or if asset quality deteriorates materially, for example.
U.K.	FCE Bank PLC	bbb-	BBB/Neg	Parent	If we downgrade Ford Motor Co., unless FCE's stand-alone credit strength improves.

Data as of Feb. 26, 2018. ALAC--Additional loss-absorbing capacity. C&E--Capital and earnings assessment. FC--Foreign currency. RAC--Risk-adjusted capital. SACP--stand-alone credit profile. UGCP--unsuported group credit profile. *Downgrade would not affect ratings on the bank's hybrids or (where relevant) nonoperating holding company liabilities. Source: S&P Global Ratings.

Table 5

Few European Governments Have Fully Divested Their Stakes In Rescued Banks

Country	Bank	(First) date of rescue	Current % ownership	Stage of divestment	Notes
Latvia	AS Citadele banka	2008	0%	Completed	The good bank that emerged from rescued Parex Banka. The government divested in 2010.
Switzerland	UBS Group AG	2008	0%	Completed	Swiss government bought mandatory convertibles in 2008 and sold out in 2009.
U.K.	Lloyds Banking Group plc	2008	0%	Completed	Government has sold down the stake from 43% in recent years. Full exit completed May 2017.
U.K.	Northern Rock plc	2008	0%	Completed	Trade sale of Northern Rock's good bank to Virgin Money in 2011. The bad bank remains 100% government owned via UK Asset Resolution Ltd, which also manages the closed mortgage book of another nationalized bank, Bradford & Bingley.
Germany	Commerzbank AG	2008	15%	Partial	Commerzbank acquired Dresdner Bank in 2008, but needed €18 billion of capital. Repaid much of initial injection but took until 2015 to run down Eurohypo. Divestment plan for remaining stake is unclear.
Germany	Deutsche Pfandbriefbank AG	2008	4%	Partial	Spun out of Hypo Real Estate in 2015 after state intervention in 2008. In May 2018, German government reduced its stake in PBB to about 3.5% from 20% previously. Further divestment strategy is unclear.
Netherlands	ABN AMRO NV	2008	56%	Partial	Dutch government ownership stems from its rescue of Fortis in 2008. Relisted as public company in 2015. Gradually being sold down.
UK	Royal Bank of Scotland Group PLC (The)	2008	62%	Partial	Government started to sell its original 78% stake in 2015 and plans to divest its remaining shares by 2024. RBS recently received shareholder approval to repurchase up to 4.99% of its shares per year from the government.
Iceland	Islandsbanki	2008	100%	None	The good bank that emerged from Glitnir. Divestment timing remains unclear.

Table 5

Few European Governments Have Fully Divested Their Stakes In Rescued Banks (cont.)

Country	Bank	(First) date of rescue	Current % ownership	Stage of divestment	Notes
Iceland	Arion Bank	2008	13%	None	The good bank that emerged from Kaupthing. 57% owned by Kaupskil creditor group, with private investors holding the balance. We anticipate some progress in the IPO of the government stake during 2018.
Iceland	Landsbankinn	2008	98%	None	The good bank that emerged after Landsbanki defaulted on its overseas liabilities. The government plans to reduce its stake in the bank to 34%-40% over time, but we expect no material divestment in the next two years.
Germany	Hamburg Commercial Bank AG (formerly HSH Nordbank)	2009	0%	Completed	Received €3 billion capital and a €10 billion guarantee from the states of Schleswig-Holstein and Hamburg in 2009. After delay, J.C. Flowers and Cerberus acquired the bank in late 2018--the first privatization of a public Landesbank.
Ireland	AIB Group plc	2009	71%	Partial	Stake acquired in two phases in 2009 and 2010. Undertaken as part of restructuring that saw CRE loans sold to NAMA. Bank redeemed some government-held preferred stock in 2015 and converted the rest to equity. Government sold an initial 28% equity stake in June 2017. Divestment timing of the rest remains unclear.
Ireland	Bank of Ireland	2009	14%	Partial	Stake acquired as part of restructuring that saw CRE loans sold to NAMA and government invest in equity and preferred stock. Bank redeemed the preferred stock in 2016. Timing remains unclear for the divestment of equity stake.
Ireland	Permanent TSB Group Holdings plc	2009	75%	Partial	Stake acquired as part of restructuring; Irish Life was subsequently split off from the bank and fully divested. Sold 25% in 2015. Divestment timing of the rest remains unclear.
Belgium	Belfius Banque SA	2011	100%	None	Former Dexia Belgium. Planned partial IPO (25%-35%) in the second quarter of 2018 but was postponed due to market conditions. Divestment timing remains unclear.
Slovenia	Nova Ljubljanska Banka D.D.	2011	41%	Partial	NLB was recapitalized by the government in 2011, 2012, and 2013. 59% of shares were sold via IPO in November 2018. Likely to be a further sale of shares up to 75% minus one share by end-2019. The Republic of Slovenia is to remain the largest individual shareholder.
Slovenia	Nova KBM d.d	2012	0%	Completed	Nova Kreditna Banka Maribor was recapitalized in 2012 and 2013, becoming 100% government-owned. Divested in 2016 via a sale to funds owned by Apollo Global Management LLC and the European Bank for Reconstruction and Development.
Greece	Eurobank	2012	2%	Partial	In 2012 the HFSF injected the funds to the banks through bonds, then subscribed to their capital increases in 2013. In 2015, Piraeus and NBG also received additional funds to complete further capital increases, while Alpha and Eurobank managed to do it through private sources. Eurobank and NBG bought back the government-held preference shares in 2017. Plans for the divestment of the equity stakes remain unclear.
Greece	Piraeus Bank	2012	26%	None	
Greece	Alpha Bank	2012	11%	None	
Greece	National Bank of Greece	2012	40%	Partial	
Spain	Bankia	2012	61%	Partial	Stake acquired under the state-backed recapitalization in 2012-2013. Government sold 7% in December 2017 but now aims to sell the rest only by 2021.
Spain	Banco Mare Nostrum	2012	61%	Partial	Stake acquired under the state-backed recapitalization in 2012-2013. Bank was merged into Bankia in December 2017. 61% figure reflects the state ownership of Bankia.

Table 5

Few European Governments Have Fully Divested Their Stakes In Rescued Banks (cont.)

Country	Bank	(First) date of rescue	Current % ownership	Stage of divestment	Notes
Slovenia	Abanka / Banka Celje	2013	100%	None	Banka Celje was merged into Abanka in 2015 to form the country's second largest bank. The deadline for divestment under the state aid agreement is 2019.
Netherlands	De Volksbank NV	2013	100%	None	Former SNS Bank. Following the March 2017 elections, the new government appears likely to push forward with a divestment, though exact timing remains unclear.
Portugal	Novo Banco	2014	25%	Partial	The good bank that emerged from Banco Espirito Santo. After a first attempt to sell the bank in 2015, Lone Star signed a definitive agreement to acquire 75% of the bank in October 2017. The remaining 25% (owned by the Resolution Fund) was stripped of voting and governance rights. Divestment plans are unclear.
Italy	Banca Monte dei Paschi di Siena	2017	70%	None	In June 2017, shareholders and junior bondholders were bailed-in and the Italian government proceeded with a precautionary recapitalization. Divestment plans remain unclear--initial commitment was by 2021, but change of government and current poor valuation could affect the decision.

Data as of Feb. 26, 2019. CRE--Commercial real estate. IPO--Initial public offering.

Related Criteria

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- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

Related Research

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This report does not constitute a rating action.