Scope Ratings

2024 European Banking Outlook

Sound fundamentals support credit profiles but profitability will decline

Financial Institutions, Scope Ratings GmbH, 15/01/2024

info@scoperatings.com | www.scoperatings.com

| Bloomberg: RESP SCOP

Executive summary

Stable sector outlooks for European banks. We enter 2024 with over 90% of our ratings on Stable Outlook. Positive and Negative Outlooks are broadly balanced and reflect idiosyncratic credit developments at individual issuers. The European banking sector will remain resilient in 2024, thanks to strengthened credit fundamentals built in recent years. Improved profitability, clean balance sheets, and excess capital provide significant buffers to withstand a moderate deterioration in operating conditions, including slow growth, a reversal of the asset-quality cycle and tightening funding conditions.

Declining profitability in 2024. Our base-case expectations for 2023 have largely materialised, with bank revenues benefiting from positive gearing to rising interest rates while asset quality remained well controlled. In our view, sector profitability will have peaked in 2023, and will start declining in 2024 and 2025, driven by a normalisation of net interest margins and a moderate increase in credit risk. Yet, none of the banks in our sample[1] will report a net loss in 2024 under our base case. We consider our base case forecasts to be conservative, with net income in our sample roughly 10% and 18% below consensus for 2024 and 2025 respectively.

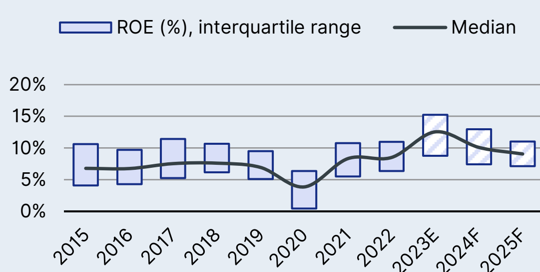
Limited upside for revenues. While policy rates will likely pivot in 2024, there is still near-term upside to bank revenues in the first half of this year due to base effects and to slower repricing in some countries and in some segments, such as France's heavily regulated mortgage market. However, margins will start contracting at a moderate pace in the second half of the year as competition for deposits increases following targeted longer-term refinancing operations (TLTRO) repayments and the acceleration in the ECB's quantitative tightening. Growth in fee and commission income will not be enough to offset lower net interest income (NII). As such, we believe overall revenues for this year will marginally decline and drive a mild deterioration in cost/income ratios, albeit from very comfortable levels.

Asset-quality cycle to turn. Asset quality will deteriorate in 2024, a result of only modest economic recovery coupled with continued high borrowing costs. However, we expect the increase in non-performing loans (NPLs) to remain modest and its impacts to be easily absorbed out of banks' ordinary profitability. Pockets of credit vulnerability, such as commercial real estate (CRE), are unlikely to turn into a systemic banking issue given the adequate degree of diversification among Europe's larger banking groups. Cost of risk will only increase modestly from current levels, as banks still have large unused provisions overlays that should help smooth out the P&L impacts of credit deterioration, at least initially.

Comfortable headroom to regulatory requirements. Capital metrics will remain a key credit strength for the sector, with solid profitability feeding through to capital formation despite high dividend payouts and share buybacks. Funding and liquidity will continue to normalise from very strong levels, as the last TLTRO III instalments are repaid. In this context, a reversal of the strong deposit growth of recent years is to be expected, which will lead to increased competition for retail funding and greater issuance activity in wholesale markets.

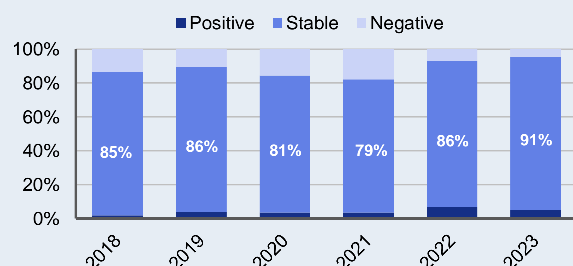
Downside and upside risks broadly balanced. Downside risks include: i) any risk of economic recession in large EU countries, in particular a rise in unemployment that could have a deeper impact on asset quality; ii) greater competition for deposits, both among banks and between banks and alternative savings products, as seen with recent government bond issues targeting retail investors. This could hurt revenues and profitability and in more extreme scenarios, lead to funding shortages; iii) a significant financial or geopolitical shock, undermining confidence in the sector, which, as the Silicon Valley Bank and Credit Suisse cases have shown, remains fickle. Upside scenarios include: i) a steepening of the yield curve driving further expansion in net interest margins; ii) faster than expected economic growth, supporting both volumes and asset quality; iii) an acceleration in institutional reforms leading to completion of the European Banking Union and greater consolidation within the single market.

Figure 1: ROE expectations, 2023-2025



Source: Scope Ratings

Figure 2: 91% of bank ratings[2] on Stable Outlook



Source: Scope Ratings

[1]Sample includes 40 largest rated banks by total assets. See Appendix I.
[2] Public ratings are available on **Scoperatings.com**. Subscription ratings are available on **ScopeOne**, Scope's digital marketplace.

Contents

Executive summary 2
1. Economic soft landing and reversal of interest rate cycle 4
2. The great balance sheet repricing is coming to an end 4
3. Wage inflation difficult to offset 5
4. Pre-provision profits will moderate but remain high relative to risks 5
5. Asset quality set to deteriorate at a controlled pace 5
6. Higher taxes are here to stay 6
7. Excess capital supports credit profiles 6
8. 2023 banking mini-crises a useful reminder of illiquidity risk drivers 7
9. Banks' Environmental, Social and Governance (ESG) journey: high expectations 7
10. Western European banks far from geopolitical fault lines 8
11. Implications of AI will need to be closely monitored 8

Regional outlooks 9
Annex I: Research sample 12
Annex II: Selected research available on ScopeRatings.com: 13

Scope Financial Institutions Ratings

Marco Troiano, CFA
Managing Director,
Head of Financial Institutions
m.troiano@scoperatings.com

Nicolas Hardy
Executive Director,
Deputy Head
n.hardy@scoperatings.com

Pauline Lambert
Executive Director
p.lambert@scoperatings.com

Carola Saldias
Senior Director
c.saldias@scoperatings.com

Christian van Beek
Director
c.beek@scoperatings.com

Alessandro Boratti, CFA
Senior Analyst
a.boratti@scoperatings.com

Alvaro Dominguez
Analyst
a.dominguez@scoperatings.com

Milya Safiullina
Associate Analyst
m.safiullina@scoperatings.com

Tatiana Fomenko
Associate Analyst
t.fomenko@scoperatings.com

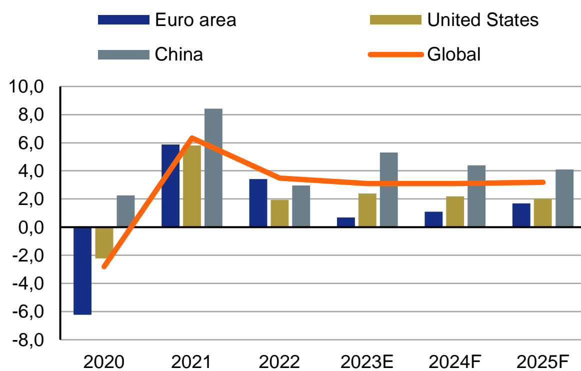
Andre Hansen
Associate Analyst
a.hansen@scoperatings.com

Economic soft landing and reversal of interest-rate cycle

Our baseline is for a soft landing for the global economy following the fastest rate rises in modern history. Scope forecasts point to 3.1% global economic growth for 2024, the same as our estimates for 2023 (**Figure 3**), and thus for global growth to stay above its medium-run potential (estimated at 2.6%) next year, as it has since 2020.

In 2024, we assume recovery in the euro-area economy of 1.1%, following estimated growth of 0.7% in 2023. Nevertheless, euro-area growth will remain below potential this year, reflecting weak growth in Germany (0.3%), alongside growth at around potential in France (1.0%), Italy (0.8%) and Spain (1.8%).

Figure 3: Global growth %, 2020-2025



Source: Eurostat, National Statistical agencies, Scope Ratings

We assume rates will remain at their peaks for a large part of 2024, and for longer than markets currently expect. This reflects our expectation that inflation will generally remain above 2% even as it recedes further this year. Core inflation is still well above 2% in many economies.

Unless there is a significant weakening in the economic outlook, we see the ECB starting to cut rates later in 2024 than markets are pricing in. Despite below-potential projected growth for the euro area, unemployment is at record lows and a pre-condition for easing rates is a further reduction in both core inflation as well as wage growth, given negotiated wages of 4.7% YoY as of Q3 2023.

For more, see Scope's 2024 Global Economic Outlook.

The great balance sheet repricing is coming to an end

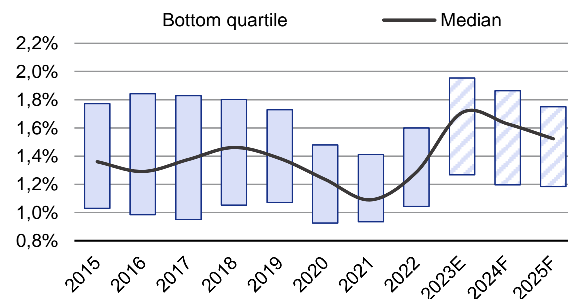
If we were to single out the most important driver of bank revenue and profit growth in 2023, this would undoubtedly be balance-sheet repricing. After a long period of low-for-longer interest rates (creating a low and flat euro yield curve), the interest-rate environment finally turned from a sector headwind to a tailwind in mid-2022 when the ECB started raising policy rates.

Rapid repricing of the asset side of banks' balance sheets, coupled with a significant stickiness of deposits on the liabilities side, led to a rapid expansion of net interest margins, drastically changing the economics of retail and commercial banking operations, which sit at the core of most large and mid-sized European banks' business models.

However, we believe 2024 will mark the end of this positive development. The progressive tightening of liquidity conditions will drive greater competition for deposits, including a shift from sight deposits to savings accounts and an overall catch-up in the cost of liabilities with asset repricing.

This trend will become more evident in the second half of 2024, as base effects fade and quantitative tightening further drains excess liquidity from the system. We expect the median net interest margin to contract from 1.71% in 2023 to 1.63% in 2024 and to 1.52% in 2025. This remains higher than in 2022 (1.3%). For most banks, it is also higher than it has been in the previous decade and will continue to drive good levels of profitability.

Figure 4: Net interest margins peak in 2023

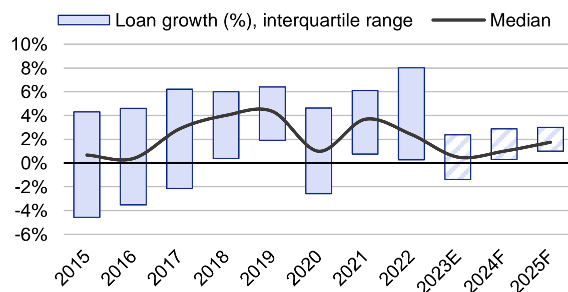


Source: Scope Ratings

Note: net interest margins calculated on total interest-earning assets

In addition to the turnaround in margins, we expect volume growth to stagnate, reflecting lower demand at higher interest-rate levels and lacklustre economic growth. The ECB's recent lending survey confirmed lower appetite from both households and corporates to increase leverage, while lenders are increasingly wary of borrowers' prospective credit quality and report tighter liquidity constraints.

Figure 5: Loan growth will continue to stagnate

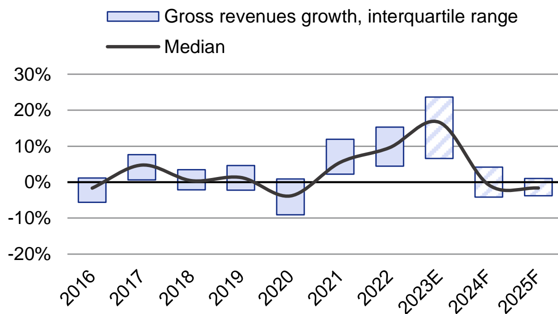


Source: Scope Ratings

Looking beyond 2024, we see limited upside for further growth in leverage in Western Europe, though banks with emerging markets exposure may offer a faster growth profile in the medium term.

Under our base case, revenue growth will turn marginally negative for 2024 as a result of the margin contraction, despite some offset from growth in non-interest income.

Figure 6: Revenues to decelerate in 2024



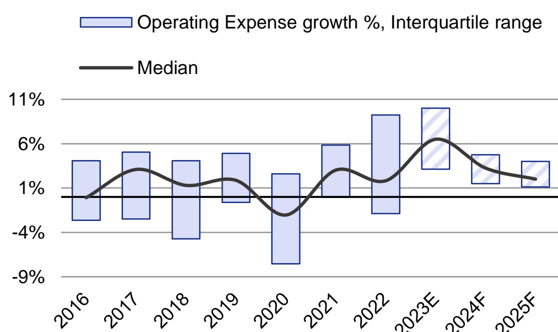
Source: Scope Ratings

For pure commercial banks with a greater focus on Western Europe, revenue declines will be sharper. More diversified business models will generally fare better owing to more dynamic volume growth in emerging markets and greater activity in capital markets as public and private sector wholesale issuance picks up – a welcome side effect of quantitative tightening.

Wage inflation difficult to offset

Against a background of a slight deterioration in revenues, cost inflation will likely drive a deterioration in efficiency metrics even with growth in operating costs moderating from 2023 highs. Wage pressure was already a theme in several countries in Europe, a trend we expect to continue in 2024. Personnel expenses are the single largest cost item in banks' P&Ls and they will increase in 2024.

Figure 7: Growth in operating costs to moderate in 2024



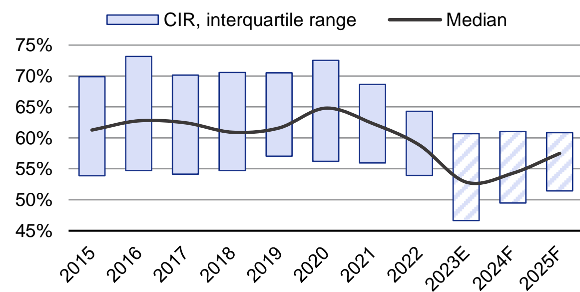
Source: Scope Ratings

Furthermore, several banks are pointing to an acceleration in IT-related investments, taking advantage of better profitability to address long-standing investment shortfalls. That said, we expect banks' cost inflation to trail broader inflation trends.

We believe that banks continue to have excess capacity in physical distribution relative to the needs of the bankable population that is increasingly moving to digital channels.

Even with this caveat, growth in costs will outpace growth in revenues in 2024 and 2025, driving a deterioration in efficiency ratios, albeit from very strong levels in 2023.

Figure 8: Cost/Income ratios (CIRs) will deteriorate from strong levels

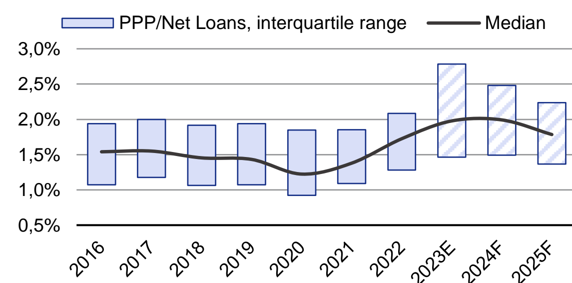


Source: Scope Ratings

Pre-provision profits will moderate but remain high relative to risks

We expect pre-provision profits to decline from 2% of customer loans in 2023 to 1.9% in 2024. This is a strong level compared to recent history and in particular compared to banks' needs to provision for souring credit.

Figure 9: High pre-provision profitability provides buffer to absorb rising credit costs



Source: Scope Ratings

Asset quality set to deteriorate at a controlled pace

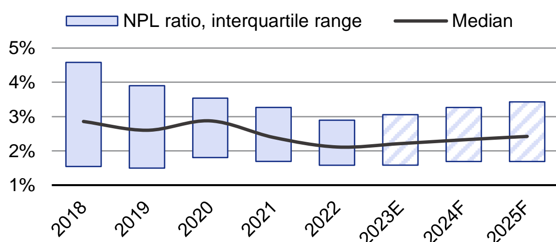
Our baseline for 2024 is for a deterioration in asset quality as a result of higher interest rates and a modest economic recovery in most European countries. But any deterioration will be gradual and moderate and fears of a repeat of the post-global financial crisis rapid build-up of NPLs are misplaced.

Business model de-risking, better origination standards, more proactive supervision of credit risk and a largely positive inflation outlook are key differentiating factors

compared to a decade ago, while countries that contributed extensively to the accumulation of NPLs in the past, such as Italy and Greece, are due to perform well compared to peers.

Banks entered this credit cycle with much cleaner balance sheets and we do not observe a broad-based deterioration in asset quality; rather contained deterioration in well-flagged vulnerable sectors such as commercial real estate, in particular in Nordic countries and some specific sectors affected by Covid that have not fully recovered, such as hospitality, food & restaurants, and transportation. Asset-quality concerns could be exacerbated in the case of a more prolonged period of tight monetary policy, however.

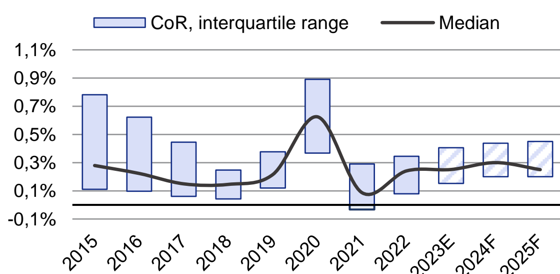
Figure 10: NPL ratios to increase in 2024 and 2025



Source: Scope Ratings

Against such deterioration, we expect banks to post higher loan-loss provisions, although well within their ability to absorb them through operating profitability. Banks with large operations outside the EU, especially in emerging markets, could experience higher volatility in their cost of risk (CoR).

Figure 11: Moderate increase in cost of risk ahead



Source: Scope Ratings

Higher taxes are here to stay

2023 was the year of windfall taxes. Across Europe, special banking taxes were introduced to fund a heterogeneous mix of public expenses, from energy costs (Czech Republic) to military expenses (Lithuania) to general budget deficits (Hungary). Among larger countries, bank taxes in Italy and Spain were aimed at banks' fast rising profitability. Germany and France have held off – for the time being.

While the purpose and structure of the new schemes vary, these new taxes support our view that European banks should be seen as semi-public utilities, extremely well protected both from external shocks through a variety of operational support mechanisms but equally exposed to glass ceilings when it comes to their profitability and shareholder returns.

This may be unwelcome news for shareholders and could in part explain the sector's lacklustre equity valuations. But it should be reassuring for credit investors.

Excess capital supports credit profiles

High levels of profitability supported organic capital build-up in 2023, allowing banks to increase their shareholder payouts through dividends and share buybacks. Capital ratios stand well above regulatory requirements and are a key element supporting current rating levels. Crucially, they also stand above managerial capital targets, implying that a normalisation of capital buffers is potentially on the cards.

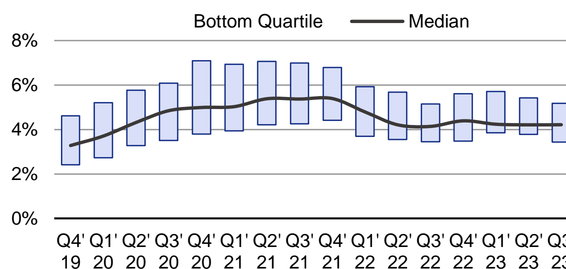
We note the moderate increase in capital requirements in 2023, as several regulators moved to increase countercyclical capital buffers or to introduce new systemic risk buffers related to specific segments of the loan book.

We do not expect capital ratios to converge to targets any time soon. In fact, we believe targets may creep up over time as market expectations adapt to a new normal of higher managerial buffers. Moreover, we expect greater convergence of managerial buffers among large banks, as differences in approaches to capital management are subject to greater market scrutiny.

While share buybacks may look attractive in the near term, especially for banks suffering from very low valuations, larger managerial buffers afford banks greater strategic freedoms to operate without having to worry about volatility in capital requirements.

RWA inflation linked to the final implementation of Basel III (Basel 3.1) should be manageable as the requirements are phased in over a long timeframe.

Figure 12: Maximum Distributable Amount (MDA) buffers remain comfortable



Source: Scope Ratings

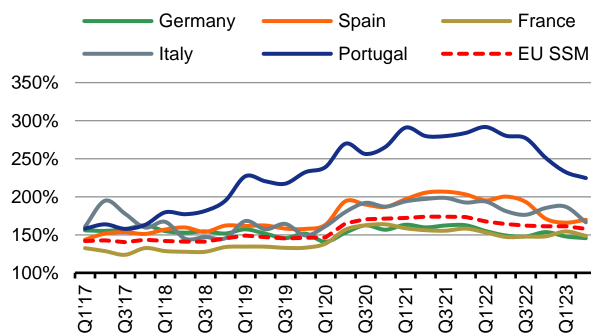
2023 banking mini-crises a useful reminder of illiquidity risk drivers

In our 2023 outlook, we warned that deposit growth would moderate and that quantitative tightening would pressure liquidity metrics. Those predictions bore fruit, and the receding liquidity tide exposed some fault lines among US regional banks and at Credit Suisse.

Above all, it is a useful reminder that uninsured large depositors remain flight-prone and that bank liquidity can evaporate rapidly when confidence wanes.

Even with this caveat, we still believe the regulatory prism offers good insight into the way banks manage liquidity. As expected, liquidity coverage ratios (LCRs) declined over 2023 as banks repaid TLTROs but remained at a comfortable distance above regulatory requirements. Detailed LCR disclosures allow investors to scrutinise the stability of funding sources. With very few exceptions, European banks display a very solid base of retail deposits, with a predominantly stable component.

Figure 13: Liquidity coverage ratios



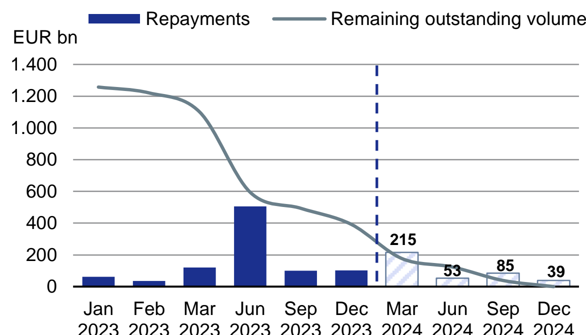
EU Single Supervisory Mechanism (SSM): EU banks supervised by the ECB
Source: Scope Ratings, ECB

The funding profiles of European banks will continue to normalise in 2024, from a solid starting point. Retail funding is already contracting and will likely continue to do so. Central bank funding will virtually disappear, to be replaced with wholesale issuance.

Our base case is that covered bonds will play a larger role in banks' funding strategies, but smaller banks and non-bank financial institutions' funding could come under greater pressure as the system weans itself off central bank money. We note that TLTRO III repayments are not being replaced by other forms of central bank funding, which had been a consistent feature in banks' funding for the past 15 years.

Higher reserve requirements, which have been discussed, would further drain liquidity and tighten funding conditions for banks.

Figure 14: TLTRO repayments and upcoming maturities



Source: Scope Ratings, ECB

Banks' Environmental, Social and Governance (ESG) journey: high expectations

In 2024, the EU's efforts to position itself at the forefront of the fight against climate change and the implementation of its sustainable finance agenda will raise the pressure on European banks to meet demanding disclosure challenges and improve risk management. But it will also provide opportunities to finance the green transition.

Disclosure challenges arise from the unprecedented obligation to collect large and new datasets in a short period of time. The first Pillar 3 ESG disclosures under the European Banking Authority (EBA) templates were made available in 2023. These early data sets are of limited use to investors because they lack consistency and completeness. Other disclosure deadlines are approaching. Complying with the Corporate Sustainability Reporting Directive will be a major step forward. But data collection for banks is dependent on the readiness of the entire data supply chain.

The polarisation in the public and political spheres about sustainability issues and the need to build greater global consensus around transition pathways and disclosure requirements continue to demand a flexible approach. Maintaining this flexibility, including via exemptions, use of proxies and grandfathering, will be at the expense of data availability and accuracy in the short term. It also exposes banks to policy and reputational risks.

Building more robust risk-management capabilities that also embrace ESG risks goes hand in hand not only with more pressing regulatory requirements but also the need to better assess the potential financial losses associated, for instance, with climate change, in particular physical risks. The materialisation of credit risk from natural hazards in the form of wildfires, floods or droughts has been limited but the availability and cost of insurance will change and impact underwriting criteria.

Business opportunities associated with climate change are increasing for banks simply because public spending alone is not enough. It comes with increasing scrutiny of greenwashing and greenwishing. Over-selling or using unsubstantiated aspirational language are becoming sources of reputational and operational risks for banks. This is a positive sign of greater stakeholder sophistication.

In 2024, we expect to see a greater convergence in sustainability strategies, driven by regulatory and supervisory expectations. Banks' strategies can be clustered in to three groups.

First, a diminishing number of banks for which addressing sustainability issues is not a priority or is a low priority. Intentionally or because of more pressing concerns.

Second, a majority of banks working primarily to address risks and vulnerabilities, which is already an important milestone supporting their creditworthiness.

Third, a handful of more agile banks that are managing risks but also taking advantage of opportunities, such as financing climate-change adaptation.

We expect a gradual, broad-based improvement year after year in the way banks measure and manage ESG risks. At the same time, we are unlikely to see drastic shake-ups among banks in terms of relative positioning, driving competitive advantages. Such changes require deep cultural or social transformation and a repositioning of medium-term strategies, both of which are slow processes.

Western European banks far from geopolitical fault lines

Geopolitical risk remains high, but we consider it a tail risk for European banks. Direct exposures to wars in the Middle East and Ukraine are small and unlikely to turn into credit concerns. Barring an escalation of the hostilities between the EU and Russia, risks to European banks are indirect and linked to growth and inflation, which is dependent on the price of imported energy and on global trade.

However, as the era of US-led globalisation gradually gives way to a more distributed power balance among old and new geopolitical actors, banks' diversification strategies will be tested and could, under more extreme scenarios, turn from elements of strength to handicaps.

Implications of AI will need to be closely monitored

We have long looked at digitalisation as a potential driver affecting the longer-term viability of banks. Last year saw the rapid commercialisation of generative artificial intelligence (Gen-AI). Gen-AI will radically change many aspects of banking. Its full impacts are extremely hard to predict. Positively, it will likely lead to significant opportunities for efficiency improvements, and more sophisticated marketing strategies.

A recent study by McKinsey[3] puts the gains from Gen-AI at 9% to 15% of revenues for the banking industry, primarily from increased productivity in retail and corporate banking, and software development. At this initial stage, it could represent a significant competitive advantage for early adopters, potentially leading to some reshaping of competitive landscapes.

Over time, as the technology matures, we believe it could turn into another industrial driver of consolidation, as its effectiveness will rest on banks' ability to benefit from large customer data pools (while complying with a dynamic regulatory environment).

[3] http://tinyurl.com/49b7fwcz

Regional outlooks

German banks

The recent improvement in profitability to moderate levels reflects a combination of several factors: the higher interest rates over the past 18 months coupled with persistently low risk costs but also successful efforts to reduce high cost structures. Regional consolidation has also supported these efforts.

Our expectation for 2024 is for profitability to plateau. On the one hand, the upward trend in revenues will be halted by stable or falling interest rates and by continuous weak demand for loans in the context of weak property markets and modest levels of corporate investment. On the other hand, cost pressures will tend to increase due to the high inflation of the last two years, increasing regulatory requirements and necessary investments in IT infrastructure.

We expect loan loss provisions to remain at a modest level. Although we see isolated issues such as commercial real estate exposures in the US and other international markets as well as the insolvency surrounding the SIGNA real estate group, these will only lead to significant risk provisioning at individual institutions and remain manageable overall. In the event of a prolonged economic downturn and corresponding moderate rating migration, we believe that further risk costs for model adjustments are likely – though they should remain manageable.

German banks still lag their European peers in digitalisation, but we see the banks' determination to close this gap through increasing investment. These investments will have only a positive effect on the banks' earnings capacity in the medium to long term but we consider them very important to ensure that increasing competition from foreign banks does not become a long-term disadvantage for German banks. Digitalisation is an area that we will continue to monitor closely in 2024.

French banks

For French banks, the path to normalisation of net interest income will continue in 2024. Unlike European peers, which immediately captured the benefits of rising rates and are now guiding to a plateauing or decline in interest revenues, French banks are more optimistic. Margin improvement in retail banking, a core business, is expected.

But there are other moving parts. Confirmation that pressure on margins is indeed temporary and that credit cost can be sustained at current low levels will be credit positive in 2024. This is because high interest rates are putting a brake on economic growth and lending dynamics. Our baseline economic scenario points to moderate economic activity in 2024 with real GDP growth of 1% in 2024 in France, very close to 2023.

The slower increase in interest rates has been a protective feature for customers, especially in mortgage lending. Identified pockets of credit risk, such as commercial real estate or SMEs facing margin compression will remain under scrutiny but we do not anticipate a broad-based asset quality deterioration.

French banks' ability to compensate for margin pressure with business or geographic diversification has been key but uneven: a solid bottom line for some, weak performance for others. Only the largest and most diversified groups reported positive earnings momentum in 2023. In this context, cost control will remain high on the agenda.

Spanish banks

We believe Spanish banks will have reached peak profitability in 2023, thanks to the material improvement in interest margins, limited loan loss provisions and cost containment. While headline profitability could moderately decline as a result of deposit repricing and slightly higher cost of risk, it will continue to support the credit profiles of Spanish banks in 2024, alongside controlled asset quality and adequate capital positions.

A wider performance gap between domestic and international operations in 2024 will be mainly due to higher loan growth in emerging markets as loan volumes in Spain flatten and eventually decline as demand adjusts to lower growth expectations and still-high interest rates. For 2024, we expect Spanish economic growth to maintain its resilience, outperforming average euro-area growth but showing a slowdown to 1.8% from 2.4% in 2023.

Deposit repricing will put pressure on margins. Banks accelerated the pass-through of interest rates in the second and third quarters of 2023, which will reduce net interest margins. The large retail funding base represents a strength of Spanish banks but customers are increasingly switching from current accounts to time deposits.

Asset quality is stable but retail and SMEs could create higher credit risk. Asset-quality metrics have so far proved resilient, although the decline in NPLs appears to have reached a floor. We expect some deterioration to start materialising in the first half of 2024 driven initially by loans to consumers, SMEs and highly leveraged corporates as well as volatility in emerging markets.

The risk of an extension of the windfall tax beyond 2024 adds uncertainty to the operating environment for banks in Spain, a trend that is seen also in other EU countries.

Italian banks

Italian bank profitability is high thanks to wide interest margins and low loan-loss provisions. Italian lenders are confident they can repeat or even beat 2023 results this year, thanks to continued high rates, a rebound in fees, cost efficiencies and expected low credit losses.

We see risks skewed to the downside with respect to volume growth, funding mix and asset quality.

The improvement in headline credit quality metrics is ending but there are no clear signs of deterioration yet. This is likely down to the resiliency of businesses and households, combined with time-lag between a slowdown in the real economy and defaults.

Capital positions are strengthening thanks to earnings retention and a reduction in risk-weighted assets. Law 136/2023 allowed banks to convert the windfall tax on 'extra-profits' into non-distributable reserves (2.5x the tax amount), therefore with no impacts on profits and capital.

Stability in deposits in recent quarters may indicate that savvier customers have already moved their money out of current accounts. That said, we expect more deposit attrition in 2024, especially if the ECB maintains peak rates for longer than expected. That notwithstanding, Italian banks are well placed to face a soft economic-growth outlook and any uncertainties, particularly surrounding lending and deposit dynamics.

UK banks

We expect the operating environment to remain challenging for UK banks, with sluggish GDP growth (<1%), and an elevated central bank policy rate for longer. Another downside risk for the sector is the upcoming general election in 2024, where the latest voting intention poll shows a large gap in favour of the Labour Party, which is keen to bring banks back to the country's high streets after the significant branch closures of the last few years.

UK bank profitability likely peaked in 2023. In 2024, revenues will be supported by banks' structural hedges against interest-rate risks and for those with more diversified business models, high growth in the US and Asia as well as a pick-up in capital markets activity. However, the benefit from higher interest rates is fading given the increased competition for deposits, including from new entrants, muted growth and tight margins on new mortgage lending as well as larger loan-loss provisions due to a more challenging operating environment.

Controlling and reducing costs remains a strategic priority given the pressure on margins, with several UK banks announcing layoffs or jobs at risk.

Asset quality remained resilient in 2023, with indicators displaying only mild deterioration. Asset quality continues to be supported by low unemployment and the stress testing of affordability at origination. Banks with exposure to Chinese commercial real estate have made additional provisions but corporate exposures on the whole have not been problematic so far. We expect UK asset quality to continue deteriorating in 2024, with the cost of risk gravitating towards banks' guidance on through-the-cycle levels. Arrears should remain at a lower level than in the previous cycle of 2008.

In 2023, capital positions improved for most large UK banks driven by earnings retention. Requirements also increased as the UK countercyclical capital buffer rate rose to 2% from 1%, in line with the Bank of England's policy to maintain a neutral rate of 2%. We expect capital positions to decline in 2024 driven by share buy-backs and dividend payments, and as banks focus on efficient capital management, bringing Common Equity Tier 1 (CET1) capital ratios close to target levels, typically around 13%-14%.

Swedish banks

We expect the economic environment to remain tough for Swedish banks, with GDP growth near zero in 2024, inflation among the highest in the Nordic region and the krona likely to remain volatile.

Peak earnings growth in 2023 puts Swedish banks in a strong position to confront shrinking volumes, high funding costs and the risk of higher provisions in the year ahead despite the gloomy economic outlook, with a decline in asset quality, notably in CRE.

The CRE and property management sectors have represented historically high concentration risk for Swedish banks. Banks are becoming more cautious about exposures in CRE, but sector concentration is here to stay in our view, as it is hard for banks to quickly reduce it – evidenced by the almost no change in total CRE exposure during the first nine months of 2023.

We also expect extra pressure from higher funding costs as deposits and debt issuance become more expensive.

CET1 should decrease for most of the banks by year-end 2024, through high dividend payouts and share buybacks, as banks target more efficient management of buffers. Current capital levels are well above management targets, however, hence there is little risk of regulatory pressure to increase them in 2024.

Norwegian banks

Following the boost from the oil and gas sector last year, we expect the Norwegian economy to perform more moderately in 2024 with growth at 0.9%. Higher rates will continue to dampen consumption and a higher level of inflation will persist.

The profitability of Norwegian banks was strong throughout 2023 due to credit growth, elevated interest rates and largely floating-rate loans, which allowed for repricing, as well as low loan losses. Despite being at the end of the interest-rate hiking cycle, we foresee Norwegian bank profitability remaining solid in 2024.

Asset quality has continued to be resilient and we expect low levels of unemployment to continue supporting low loss rates in retail lending. Norwegian banks' loan books are skewed towards personal customers and mortgages. In general, we expect corporate sector losses to increase in 2024 with performance varying across industries but remaining at

manageable levels. Banks have a structurally high exposure to commercial real estate, which continues to be a pocket of risk and uncertainty.

Banks in Norway remain well capitalised, in part driven by relatively high requirements. The countercyclical buffer rate stands at 2.5% and the systemic risk buffer at 4.5%. Since 31 December 2023, banks can meet Pillar 2 requirements with a mix of capital, in line with CRR/CRD. Smaller banks using standardised models may receive additional capital relief when final Basel III standards are implemented in 2025.

We expect continued competition for deposits as market funding remains more costly. At the same time, given the flexibility to meet Pillar 2 requirements with a mix of capital, we see increased Tier 2 and AT1 issuance.

Consolidation in the Norwegian banking sector has intensified as smaller banks face challenges meeting increasing regulatory requirements as well as greater competition. We expect this trend to continue into 2024 given the still large number of smaller banks.

Annex I: Research sample

For this report, we have used a sample of the 40 largest banks by total assets rated by Scope in Europe[4].

Bank	Country
ABN AMRO	Netherlands
AIB Group	Ireland
Banco Bilbao Vizcaya Argentaria	Spain
Banco BPM	Italy
Banco Comercial Português	Portugal
Banco de Sabadell	Spain
Banco Santander, S.A.	Spain
Bank of Ireland Group	Ireland
Barclays	United Kingdom
Belfius Bank	Belgium
BNP Paribas	France
Caixa Geral de Depósitos	Portugal
CaixaBank	Spain
Commerzbank	Germany
Coöperatieve Rabobank	Netherlands
Crédit Agricole Group	France
Crédit Mutuel Alliance Fédérale	France
Danske Bank	Denmark
Deutsche Bank	Germany
DNB ASA	Norway
Erste Group Bank	Austria
Groupe BPCE	France
HSBC Holdings	United Kingdom
ING Groep	Netherlands
Intesa Sanpaolo	Italy
KBC Group	Belgium
Landesbank Baden-Württemberg	Germany
Lloyds Banking Group	United Kingdom
NatWest Group	United Kingdom
Nordea Bank	Finland
OP Financial Group	Finland
OTP Bank	Hungary
Raiffeisen Bank International	Austria
Skandinaviska Enskilda Banken	Sweden
Société Générale	France
Standard Chartered	United Kingdom
Svenska Handelsbanken	Sweden
Swedbank	Sweden
UBS Group	Switzerland
UniCredit	Italy

[4] Access all Scope rating & research reports on ScopeOne, Scope's digital marketplace.

Annex II: Selected research available on ScopeRatings.com:

Asset-quality review: European banks at a crossroads in 2024, December 2023

Spanish banks 2024 outlook: high earnings, clean balance sheets and adequate capital support credit profiles, December 2023

Swedish banks brace for subdued lending, poorer asset quality next year, buffered by strong earnings, November 2023

Commerzbank's updated strategy promises profitable future; implementation will be challenging, November 2023

Italian Bank Quarterly: growing resilience despite uncertainties, November 2023

European banks face disruptive retail funding dynamics, November 2023

European Bank Capital Quarterly, October 2023

French banks quarterly: sobering times, September 2023

SG strategy update: it doesn’t have to be fancy, September 2023

Spanish Bank Quarterly: earnings solid but limited room for growth from here, August 2023

Italian Bank Quarterly: record Q2 results will be hard to repeat as windfall tax looms, August 2023

European Bank Capital Quarterly: funding and liquidity under the spotlight, July 2023

Asset-quality review: falling NPL ratios hide rising vulnerabilities, May 2023

Italian banks: strong Q1 results pave the way for a promising 2023, May 2023

Italy paves the way for revived covered bond issuance, May 2023

European Bank Capital Quarterly: Capital remains important support for sector, April 2023

Italian banks: solid funding and liquidity against challenging backdrop, April 2023

Sound fundamentals protect Swedish banks from emerging challenges, February 2023

Italian banks: promising 2023 outlook after bumper Q4, February 2023

European Bank Capital Quarterly: New year, new requirements, January 2023

2023 European Banking Outlook: strong ships in turbulent waters, January 2023

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid
Phone +34 91 94 91 66 2

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 8295 8254

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2024 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, and Scope ESG Analysis GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5, D-10785 Berlin.