

Banking on Europe

The Road Ahead – From Capital Build to Capital Return

- **The Road Ahead Into 2013** — Key themes – 3 Rs: Return of Capital; Restructuring; and Regulation. ECB actions have significantly reduced eurozone ‘tail risk’, driving a significant sector re-rating of c40% to over 0.9x TBV, broadly consistent with a 2013E RoTE of 9%. In the ‘new normal’ environment of lower growth & returns, we believe that market focus will increasingly shift to prospects for ‘utility-like’ capital return, especially in the context of limited RWA growth.
- **Inflection Point in Sector Capital** — We expect the sector to close the €250bn capital ‘deficit’ of end-2011 by 2013E, before reaching a surplus of almost €200bn by 2015, on a Basel 3 ‘fully-loaded’ basis (Figure 2). This is after adjustments for minimum mortgage risk weights (15%) and applying a surcharge for internal model-based market risk (+50%) to reflect regulatory uncertainty.
- **From Capital Accretion to Return** — From major European banks, BNP Paribas, Credit Suisse and SocGen remain well-placed to offer progressive distribution into 2013 (Figure 9). Amongst smaller-cap banks, Bankinter and UBI Banca offer superior prospects. However, the ‘true’ capital return potential is likely to be back-loaded (ie 2014-15), given the current uncertain macro & regulatory environment.
- **IB Restructuring, The Beginning of the End** — We believe that UBS has ‘kicked-off’ the much-awaited industry restructuring, even if each bank takes a different path. Our “optimal” business model analysis suggests that there is scope to improve FICC ROEs by c1.5pp (see Figure 22), while Equities & Primary returns could improve by c3pp (see Figure 24). Equally important, this could allow the winners to gain incremental market share of up to 12-15% of industry revenues altogether (see Figure 28) – we view Barclays as the best placed beneficiary of the European IBs.
- **Cost Management Is a Constant** — To head-off top-line pressure, managements are increasingly focused on cost management. At the sector level, banks are targeting savings equivalent to c8% of their 2012E cost base, of which over half has yet to be realized, representing c1.5% RoTE benefit (see Figure 31). In addition, we estimate that further restructuring announcements could add cost savings worth a further 1pp RoE improvement (see Figure 32 and Figure 33). Credit Suisse offers significant 2013 potential, which is yet to be reflected in consensus.
- **LCR 2.0 Support, Focus on Leverage** — We believe that regulatory forbearance – expected in early-2013 – around the onerous LCR regime should serve to re-rate wholesale banks and most notably the French banks. However, we remain cautious on the forthcoming RWA review – expected in 1Q13 – especially in the context of Banking Union and Liikanen proposals. Leverage could be the next shoe to drop, with CASA and Deutsche Bank most at risk (see Figure 42).
- **Most & Least Preferred** – Our Most Preferred stocks are Barclays, BNP Paribas (replacing SocGen) StanChart and Credit Suisse (new addition). Our Least Preferred stocks are RBS, Intesa Sanpaolo, Banco Popular and Raiffeisen (new).

■ Industry Overview

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Key Themes

In our third edition of *The Road Ahead*, we focus on key themes for 2013 – Return of Capital; Restructuring; and Regulation (the 3 Rs).

Focus on Capital Return

Prior to the banking crisis, banks offered relatively high growth and profitability. In the new normal, we believe attractive & sustainable capital return will increasingly support bank valuations. We see a significant 'inflection' point for the sector having closed a €250bn capital gap on a Basel 3 'fully-loaded' basis over 2011-13E before turning out a near-€200bn surplus by 2015E.

Capital return will be an increasing differentiator of stocks – we would highlight BNP Paribas and into 2013, Credit Suisse and SocGen as best-positioned. Of course, the major Swedish banks also offer relatively strong capital return potential, over time, although this is largely priced into valuations.

On Restructuring

We believe that the 'deep' UBS FICC restructuring is likely to drive further industry restructuring. Further headwinds into 2013 from OTC derivatives reform and Volcker are likely to add further pressure. However, we do not expect 'mirror' strategies to UBS. Rather, for some banks, a narrower focus on geographical footprint as well as addressing sub-scale positions in not just capital-intensive but also capital-light operations, where margins have come under further pressure. Such moves could improve FICC returns by 1.5pp and Equities & Primary by 3pp.

In an environment of continued pressure on the 'top-line', we expect continued focus on cost management. To date, the sector has targeted cost savings representing c8% of total expense base, of which almost half has already been achieved. Looking ahead, we have estimated on a bottom-up basis that additional targeted cost savings could add a further 4%, representing a 1pp RoTE improvement. We expect Barclays and Credit Suisse should both provide cost-driven consensus earnings upgrades.

On Regulation

We expect significant forbearance on liquidity ratios in early-2013 which will be supportive for wholesale banks, notably major French banks. In this respect, the major central bankers have swung the debate pushing back on a notably onerous calibration which has served to negate central bank liquidity injections, impacted the functioning of the interbank market and added to near-term deleveraging pressure.

At the same time, we see risks of market focus shifting to leverage ratios as the forthcoming global RWA review, likely in 1Q13, increases uncertainty over risk-weightings – CASA and Deutsche Bank look most at risk. The recent Liikanen review also highlighted concerns over risk-weights – across both mortgage and trading books. In our capital return analysis, we adjust our mortgage risk-weights for a 15% minimum and apply a 50% surcharge on internal model-based market risk RWAs.

Country Sector Weightings & Most/Least Preferred

Figure 1. European Banks – Country Weightings

Overweight	Neutral	Underweight
UK Domestic	Germany	Spain
UK International	Nordic Region	Italy
France	Austria	Greece
Switzerland		
Benelux		

Source: Citi Research

Most Preferred

Barclays – (BARC.L; £1.81; 1)

We believe Barclays can be a winner in the consolidating world of capital markets. Meanwhile, in UK Retail Banking and in Cards, Barclays is already demonstrating respectable growth in these high RoE businesses. In the near-term the 12 February investor day, alongside a seasonal pick-up in capital market revenues, should act as positive catalysts for the stock. We forecast an underlying Group RoTE of 9.3% in 2012, which is ahead of our forecast average sector return. Despite this, Barclays trades at a discount to the wider sector, on 0.7x 2012E P/TB vs sector 1.0x.

BNP Paribas – (BNPP.PA; €44.21; 1)

BNP Paribas continues to benefit from solid tangible book growth, supported by robust franchises (French & Belgian retail cash cows, leading positions in equity derivatives and €-DCM). Trading at 0.7x 2013E TBV, we believe concerns are overdone on capital, regulation (we expect forbearance on LCR rules in early-2013) and French macro (liquidity buffers have been significantly increased since 1H11, pre-funding for 2013 has already been started). With a fully loaded B3 CET1 ratio of 9.5%, we believe that BNP Paribas is in a position to deliver a progressive cash dividend policy; we expect a 2012 DPS of €2.1, implying a payout ratio of 35%.

Standard Chartered – (STAN.L; £16.11; 1)

Our investment case on STAN is based on its strong growth profile (revenue CAGR of c9% from 2011-14E) and exposure to improving economic conditions in key markets. During 2012, SC shares lagged the sector (stock up 11% vs. 31% for HSBC and 24% for European bank sector), weighed down by fears of a China / EM slowdown, asset quality concerns, a settlement with the US over alleged breaches of US sanctions and core shareholder stock overhang concerns. However, with global slowdown fears abating and EM policy actions (like the recent acceleration in the policy reform process by the Indian Government) showing signs of turnaround in key STAN markets, we feel valuations are compelling at 1.55x 2013E P/TB with 2013E ROTE of 15%.

Credit Suisse – (CSGN.VX; SFr23.39; 1)

Despite a relatively conservative view on WM margins – broadly unchanged in 2015E vs 2012E – we believe CS offers scope for consensus earnings upgrades. At cSFr3 earnings per share in 2013E, we are 16% ahead of consensus. In the medium term, we believe that CS can generate a RoTE of over 15% vs current valuation of c1x tangible book value. Together with Barclays, we believe that CS remains well positioned to benefit from 1Q13 capital markets strength.

Least Preferred

RBS – (RBS.L; £2.21; 2H)

RBS has made substantial progress in repairing the balance sheet, with capital ratios now broadly in-line with UK peers. However progress on the P&L has not been as promising, hindered by heavy restructuring and regulatory charges, poor Irish asset quality, a sub-scale investment bank and the slow economic recovery in the UK. It also remains heavily exposed to any additional regulatory uncertainty in the UK. We struggle to see how the business can generate a double-digit return in the medium-term. RBS trades on 0.7x 2013E P/TB, in-line with Barclays, despite far weaker profitability.

- **Key catalyst for exiting Least Preferred** - Stronger than expected recovery of the Irish economy; more comprehensive investment bank restructuring than currently planned.

Banco Popular – (POP.MC; €0.63; 3H)

We believe that Spanish macro indicators will continue to show deterioration in the economy, Popular's main market. We also believe that the future recapitalisation process to take place in Spain will be expensive for Popular, given (i) dilution risk and (ii) the potential conditionality to be required, at both a name-specific and a country level.

- **Key catalyst for exiting Least Preferred** - Stronger than expected recovery of the Spanish economy.

Intesa Sanpaolo - (ISP.MI; €1.25; 2H)

Intesa SanPaolo's fortunes are tied to the Italian economy, with c90% of its activity based in the country and c€70bn of Italian sovereign bonds, or c150% of its shareholder equity; our economists forecast debt-to-GDP ratios to exceed 140% by 2016. We remain notably concerned with asset quality risks, especially given our economists' below-consensus macro expectations.

- **Key catalyst for exiting Least Preferred** - Stronger than expected recovery of the Italian economy.

Raiffeisen - (RBIV.VI; €32.62; 3)

We believe RBI faces two meaningful challenges: reversing the Net Interest Margin decline of the past year and addressing its capital shortfall. In our view, margins will continue to be depressed due to the ongoing negative effects of delevering and the low interest rate environment. Besides, we believe consensus estimates for Net Interest Income remain too high. In terms of capital, the bank's Basel 3 look-through CT1 ratio would 'only' reach 7.1% at end-2012E and 7.6% at end-2013E, below our preferred 9.0% minimum. Thus, RBI could need up to €1.2bn of capital, potentially raised in a dilutive manner. With RBI shares trading on 0.9x '13E P/TBV for 11% '14E ROTE, we see 13% total downside risk to the current price level (sector trading on 0.9x '13E P/TBV for 12% '14E ROTE).

- **Key catalyst for exiting Least Preferred** - Better than forecast improvement in Basel 3 'look through' capital position.

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Return of Capital

Return of Capital

From Capital Accretion to Return

Market demands have typically accelerated regulatory timetables

The combination of the new Basel 3 capital regime; G-SIB (global systemically important banks) & N-SIB (national systemically important banks) capital requirements; and stress-tests (including those by EBA or European Banking Authority) have raised the bar on banks' capital levels. Moreover, market demands have typically ignored transition timescales and 'pushed' banks to meet targets earlier than the 2019 target.

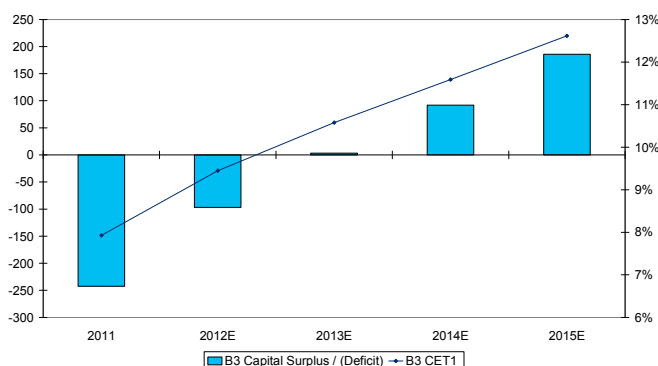
Hitting an Inflection Point

We see a significant turning point in the sector B3 capital position over 2013-15E

We see a significant inflection point for the sector Basel 3 capital position going into 2013-15E. From a starting capital 'deficit' position of €241bn at end-2011, we estimate that the gap has narrowed to €95bn – driven by a combination of retained earnings (c20%), RWA deleveraging (c25%) and other capital actions (c50%).

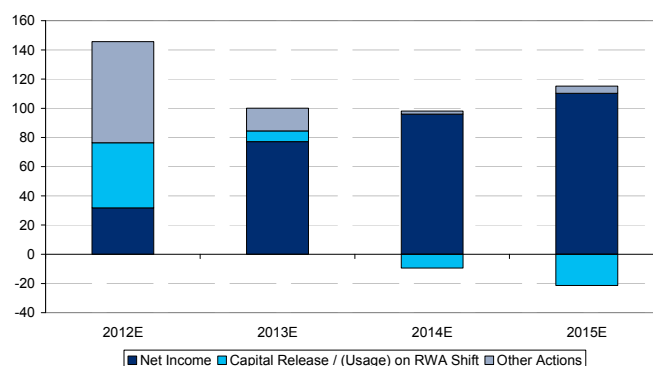
We expect the sector as a whole to move to surplus end-2013E and grow further to €187bn by 2015E, on a pre-distribution basis. This is primarily supported by earnings as well as modest deleveraging in 2013 (1% RWA decline), before a modest RWA growth trajectory in 2014-15E (1-2% pa).

Figure 2. Sector Capital Deficit Turning to Surplus, 2011-15E (€ bn)



Source: Citi Research
Note: Surplus / (Deficit) is before 2012E – 2015E dividends

Figure 3. Drivers of Capital Rebuild, 2011-15E (€ bn)

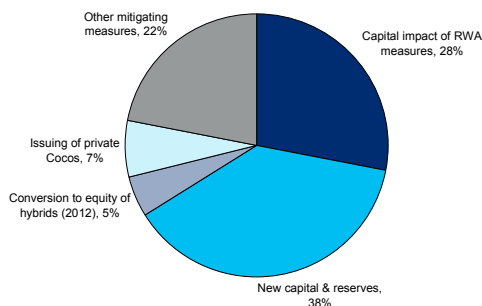


Source: Citi Research

EBA stress tests accelerate capital actions

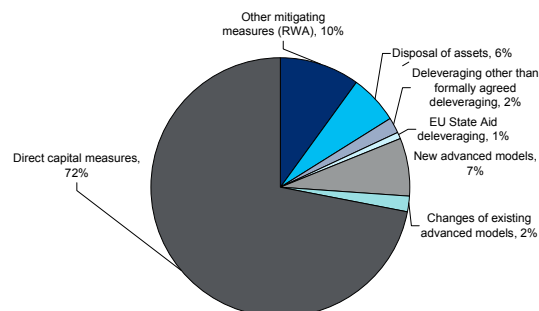
The 2011 EBA stress test resulted in capital strengthening of over €200bn for the European banking sector, including €116bn by the 27 banks with an initial capital shortfall of €76bn. For these 27 banks, direct capital measures amounted to 72% of the €116bn capital-raising, with the remainder due to RWA reduction.

Figure 4. Direct capital measures (%age of the recap amount)



Source: European Banking Authority

Figure 5. Capital impact of RWA measures (%age of the recap amount)



Source: European Banking Authority

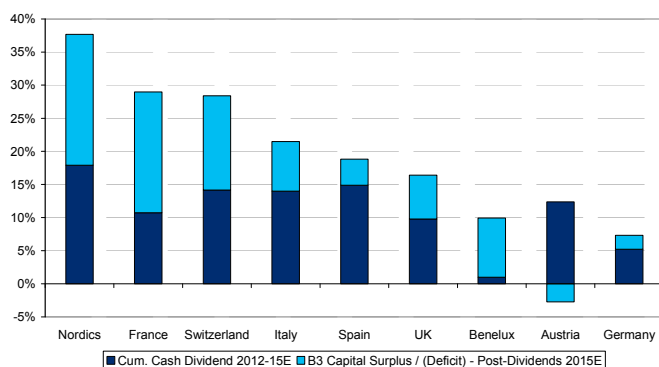
Which countries are best placed?

The Nordic, French and Swiss banks have the highest capital surplus position relative to market cap

The Nordic, French and Swiss banks remain best-placed to return capital over time. It goes without saying that the current political climate, as well as heightened macroeconomic and regulatory risks, is likely to result in any additional capital return coming later, rather than sooner (ie 2014-15). In addition, both Nordic and Swiss banks face additional super-equivalent capital requirement by their domestic regulators albeit reflected in our analysis.

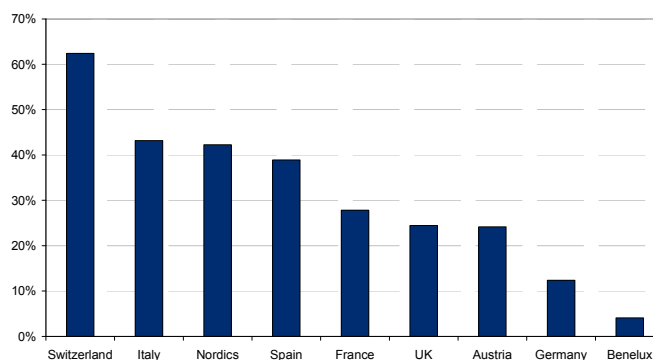
By contrast, we believe German, Austrian and Belgian banks offer the lowest capital return potential over the 2013-15E period, given their somewhat tighter capital positions to start. Likewise, the risks of a potentially more adverse legal, macroeconomic or regulatory environment are somewhat greater for these systems.

Figure 6. Capital Surplus Position: By Country, 2015E, % of Market Cap



Source: Citi Research

Figure 7. Payout Ratios: By Country, 2015E



Source: Citi Research

Note: Including our assumptions of special dividends, notably for major Swiss banks over 2014-15E.

Which banks are best placed?

In Figure 8 we highlight the timing of when individual banks meet their minimum Basel 3 'fully-loaded' hurdles. We also calculate their surplus capital positions by end-2015, expressed as a % of market cap (see Figure 9).

BNP has already reached its targeted B3 CT1 ratio of 9.5%. We expect this to support an above-consensus payout ratio of 35% in 2012E

From the large-cap banks, we would highlight BNP Paribas which we recently added to our Global Focus Five list ([Banking on Global - Key Takeaways from Global Financial Conference](#), 20 November 2012). Following its successful deleveraging plan, BNP Paribas already has a Basel 3 'fully-loaded' ratio of 9.5%, or one of the strongest among the major global banks. Given relatively low RWA growth and an absence of material M&A in the current regulatory environment, we forecast an above-consensus payout ratio of 35% in 2012E (vs 25% in 2011).

Into 2013, Credit Suisse and SocGen also stand out as banks that can start to implement strong, progressive distribution policies, meeting minimum capital requirements as well as generating significant surplus capital positions by end-2013. Likewise, the Nordic banks are also well-positioned, although these are typically reflected in the premium valuations of the Swedish banks. Also, Swedish banks may opt to maintain higher capital ratios in anticipation of countercyclical capital buffers (e.g. Swedbank intends to maintain a ratio of 13.5% - 14.5%). Danske Bank also screens relatively well on capital metrics, although we expect management's focus on credit spreads to drive a relatively cautious approach on capital return in the near future. On the other hand, banks such as CASA, Commerzbank, Deutsche Bank, MPS and Raiffeisen Bank International offer relatively weak prospects for capital distribution in the absence of further capital-bolstering actions.

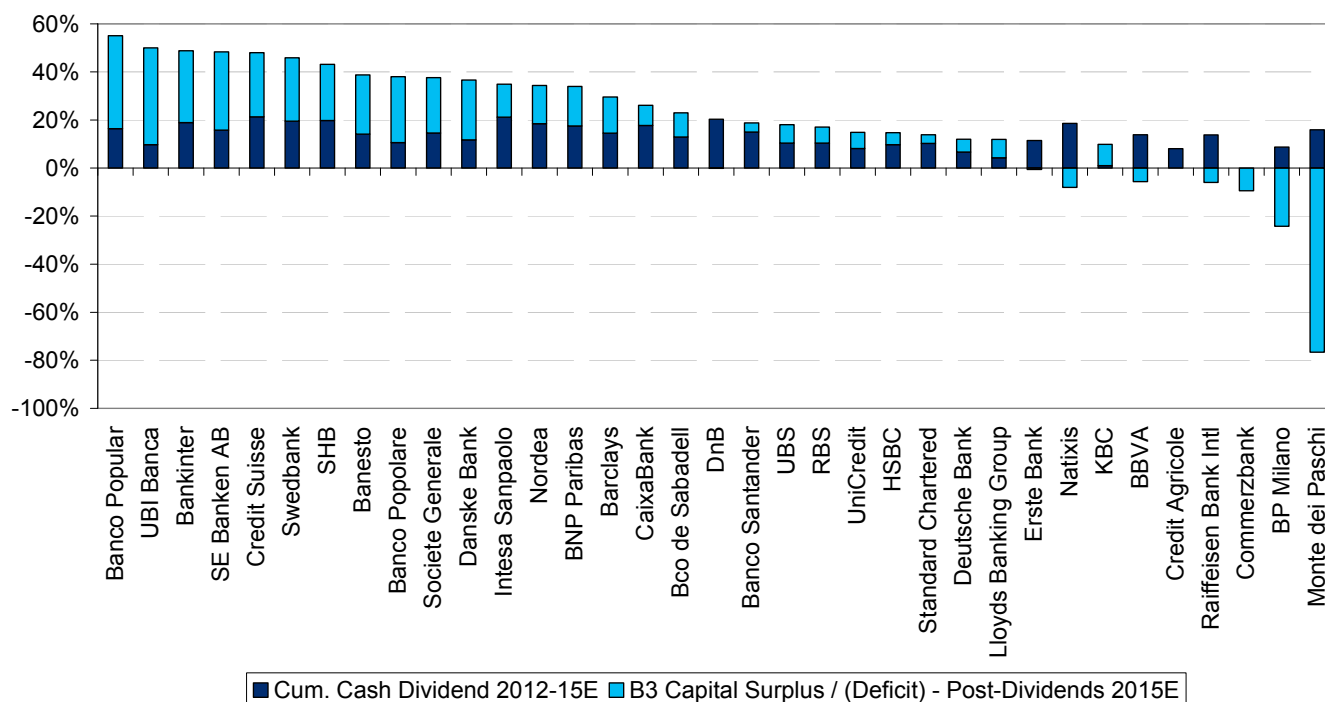
Figure 8. Timing of Meeting Minimum Capital Hurdle: By Bank, 2012-15E

2012	2013	2014	2015	Beyond
Banca Popolare	Banco Santander	Barclays	CASA	BP Milano
Banco Popular	Banesto	BBVA	Deutsche Bank	Commerzbank
Bankinter	Credit Suisse	CaixaBank	Raiffeisen Bank Intl	Monte dei Paschi
BNP Paribas	DnB	Erste Bank	UniCredit	
Danske Bank	HSBC	KBC		
Intesa Sanpaolo	SocGen	Lloyds Banking Group		
Nordea	UBS	Natixis		
Sabadell		RBS		
SEB				
SHB				
Swedbank				
Standard Chartered				
UBI Banca				

Source: Citi Research

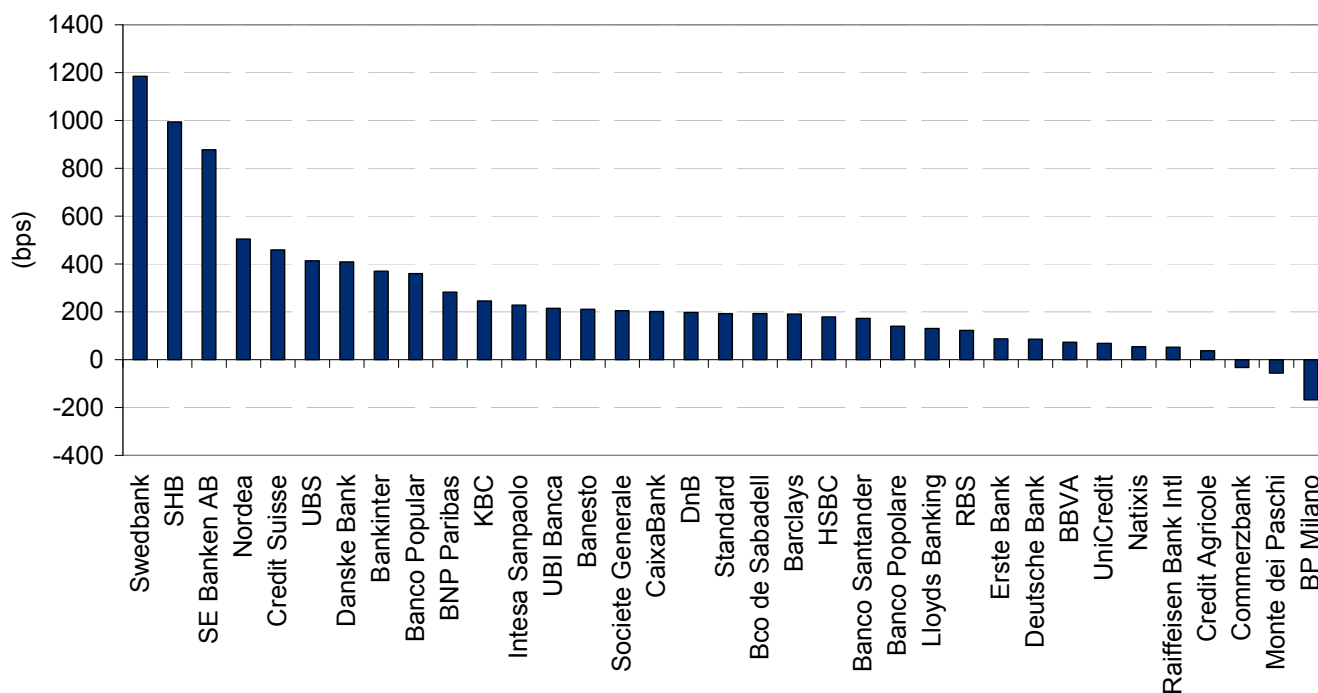
Note: Definition of minimum hurdle as specified in *Methodology* section (page 13)

Figure 9. Capital Surplus Position: By Bank, 2015E (% of Market Cap)



Source: Citi Research

Figure 10. Capital Surplus Position (Pre-dividends): By Bank, 2015E (bps on Adj. RWAs)



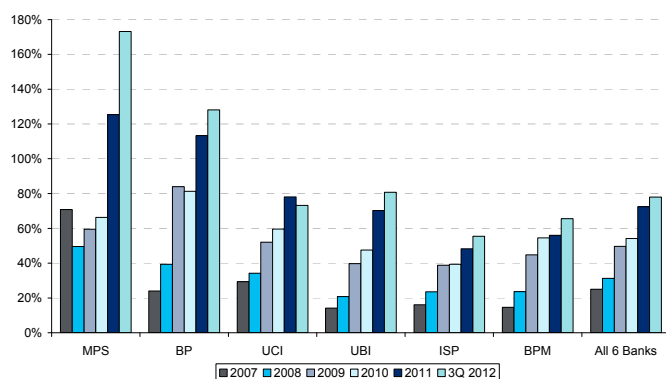
Source: Citi Research

Note: Analysis is before 2012E – 2015E cash dividend payouts

Amongst the smaller-cap banks, UBI Banca, Banco Popular, Bankinter and Banesto stand-out as being well-positioned, even if regulatory caution is unlikely to allow for a more aggressive capital return. This is reflected in our relatively lower dividend payout assumptions.

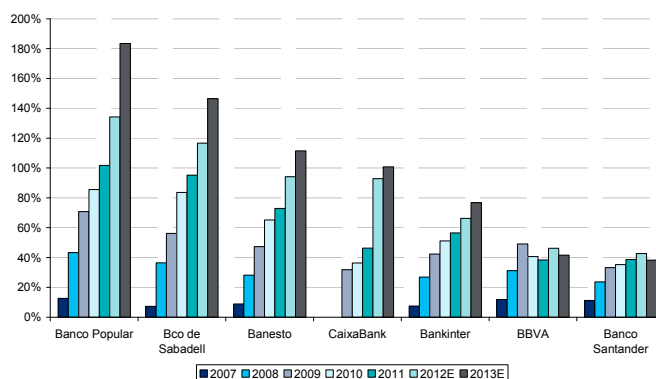
- From the smaller Italian banks, our preference would be for UBI Banca given its somewhat lower NPL exposure (as a % of equity) of c80% vs c130% for Banca Popolare.
- From the smaller Spanish banks, our preference would be for Bankinter given its somewhat lower 2013E NPL exposure (as a % of equity) of c80% vs c110% for Banesto and c180% for Banco Popular.

Figure 11. Italian Banks – Net NPLs as a % of Equity



Source: Company Reports

Figure 12. Spanish Banks – Net NPLs as a % of Equity



Source: Company Reports

Methodology

Our capital scenario analysis is based on our Basel 3 estimates and forecasts over the 2011-2015E period. As a base case, we assume a minimum 9% Basel 3 'fully-loaded' capital ratio unless either of the following is higher: (i) national 'finish'; or (ii) higher self-imposed requirements.

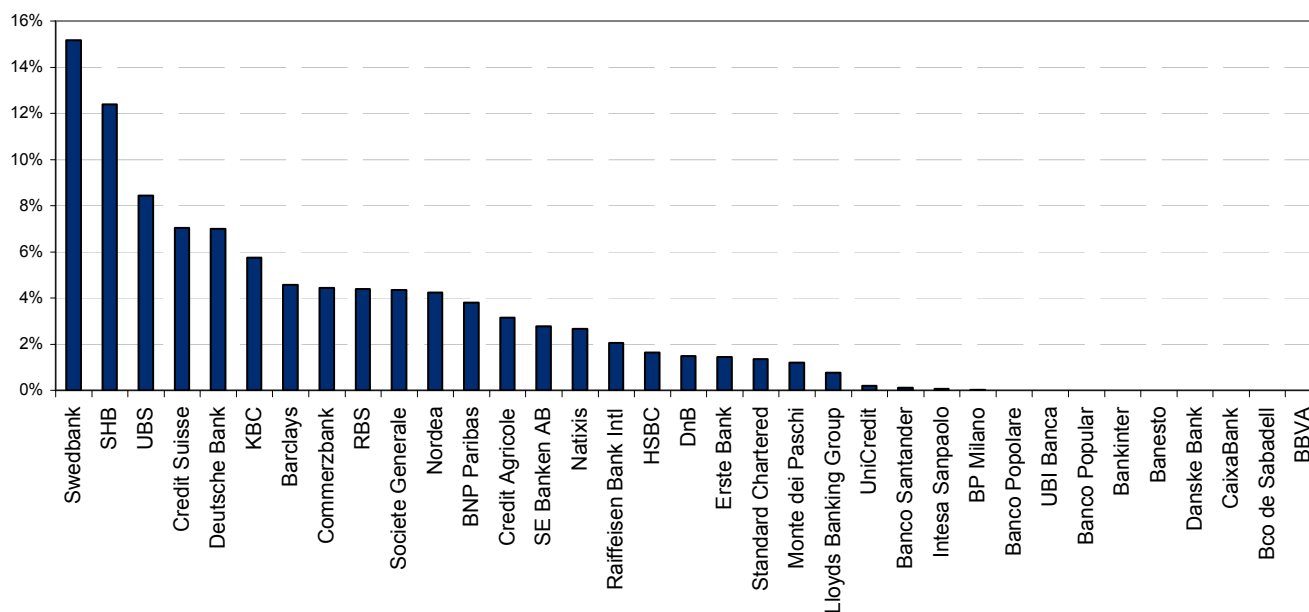
- **Nordic banks:** We assume a minimum requirement of 12% for the Nordic banks reflecting the more 'hawkish' approach of the domestic regulators. Some Swedish banks may actually choose to maintain even higher capital ratios in anticipation of countercyclical capital buffers (e.g. Swedbank intends to maintain a ratio of 13.5% - 14.5%)
- **Swiss banks:** We assume a minimum 13% for UBS and a lower 10% for CS which has essentially raised the additional 3% loss-absorbing capital via high-trigger CoCos.
- **UK banks:** We assume a minimum 10% requirement for both domestic and international banks.
- **German banks:** We assume 10% for Deutsche Bank based on management's 2015 aspiration.
- **French banks:** We assume 9.5% for the major French banks, modestly above their typical 9% self-imposed targets.
- **Italian banks:** We assume 10% for the major banks, namely Intesa Sanpaolo, MPS and Unicredit, and 9% for the remaining banks

We also adjust capital ratios to reflect mortgage risk-weight 'floors' as well as additional capital requirements on internal model-derived market risk RWAs. Overall, these adjustments drive c3% increase in sector RWAs – 12-15% increase for some Nordic banks – equivalent to c€25bn additional capital requirement.

- **Minimum Mortgage Risk-Weights:** On a portfolio basis, we assume minimum mortgage risk-weights of 15%. This would be consistent with the push for regulatory minimums in both Sweden (15%) and Norway (potentially up to 35%).
- **Additional Internal Model Trading Book RWAs:** We increase RWAs in respect of internal model market risk RWAs by 50% to reflect the uncertainty from the FRTB or Fundamental Review of the Trading Book. Indeed, in its proposal, the BCBS has recommended a stronger relationship between the internal model-based and standardized approach and is considering a potential standardized floor (or surcharge) on regulator capital generated by internal models.

Separately, in the recent Liikanen Review, the Group also raised the issue of risk-weights on the trading book, questioning the consistency and efficacy of internal model-based inputs. the Group also questioned risk-weights on real estate assets and recommended more robust RWA 'floors' to ensure sufficient buffers against substantial property market stress. For further detail, refer to [Separated, But Living Together](#) (3 October 2012).

Figure 13. % Change in 2012E RWAs from Methodology Adjustments: By Bank



Source: Citi Research and Company Reports

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Restructuring

Restructuring To Mitigate Headwinds

Not All Restructuring Is Equal

Not all body types are the same. "Endomorphs" find it more difficult to lose weight than "Mesomorphs"¹.

In the New Normal, focus on cost management is paramount. For some banks, capital management is also key

In the "New Normal" of lower-for-longer interest rates, below-trend growth and less leverage, we expect banks' management to increasingly focus on restructuring business models in order to improve returns. Restructuring will mean different things for different banks. For most banks, focus on cost management will be paramount. For others, capital actions will also play a role.

Like mesomorphs, we have previously argued ([The Road Ahead – Two-Speed Europe](#), 5 September 2012) that wholesale banks should shed assets more efficiently than retail banks (endomorphs) – partly due to the more 'global' nature of these asset markets. The UBS Investment Bank restructuring is a case in point, with its recent announcement² suggesting significant progress in RWA reduction; the bank has indicated a flat Basel 3 common equity Tier 1 ratio of 9.3%, despite additional litigation and regulatory provisions of SFr2.1bn, as well as early adoption of IAS19.

UBS' FICC exits will likely shift up the gears for industry restructuring

We believe that UBS' scale restructuring and strong positive share price reaction should shift up the gears to a new stage in industry restructuring. This does not necessarily imply a 'wholesale' exit from capital-intensive business, rather a shift to more optimal business models. In this section, we look at potential opportunities for further cost and capital management.

Wholesale Banking – The Beginning of the End

Capital markets regulatory headwinds – via Volcker and OTC derivatives reform – will also drive further restructuring

We expect 2013-14 to be a transition period for the wholesale banking industry. A confluence of regulatory changes (e.g. Basel 3, OTC derivatives reform, Vickers, Dodd-Frank) and cyclically-weaker client activity is likely to 'force' many more banks to reassess their business models.

UBS – Radical FICCx

With its 3Q12 results, UBS announced its intention to exit large parts of its FICC business, notably its credit and rates franchises (see [From Capital Accretion to Capital Return](#), 1 November 2012). The decision to exit these specific businesses and to focus on advisory, research, equities, FX and precious metals was mainly driven by them being **"rendered uneconomical by changes in regulation and market developments"**, whilst relatively weak market share was likely also a factor, in our view.

UBS's restructuring plan was positively received by the market, with the stock up +18% over the week of the announcement. This positive reaction can be broken into three components:

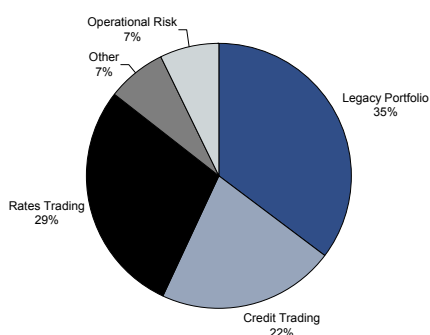
- **Capital Release** - Having already reduced group RWAs by cSFr100bn to SFr301bn since 3Q11, UBS is now targeting a further reduction of SFr100bn to <SFr200bn. Of this shrinkage SFr40bn is to come from Rates trading and SFr30bn from Credit trading (see Figure 14).

¹ Endomorph & Mesomorph are body type classifications. Endomorphs have a round physique and shed weight with difficulty; Mesomorphs are more muscular and shed weight with greater ease

² http://www.ubs.com/global/en/about_ubs/about_us/news/news.html/en/2012/12/19/20121219a.html.

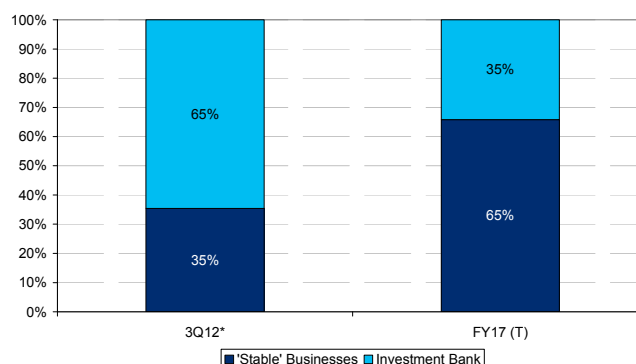
- **Cost Savings** – We forecast UBS's FICC revenues falling from an annualized level of SFr5.2bn for 9M12 to SFr1.6bn for 2013E – a 70% decline. With this announcement, UBS announced an increase in Group cost savings targets by SFr3.4bn to SFr5.4bn via direct expense reduction as well as overall complexity reduction. Of asset/RWA deleveraging and expense reduction, we see the latter as carrying the greatest execution risk.
- **Re-rating** – The restructuring plan will shift the balance of group equity away from the investment bank division and towards the 'stable' businesses of wealth & asset management (see Figure 15). We expect the relatively more stable earnings profile of these asset gathering businesses to support a re-rating of the group.

Figure 14. UBS - Half of Planned RWA Shrinkage from Credit & Rates



Source: Company Data, Citi Research Estimates

Figure 15. UBS - Shift of Group Capital Mix Towards 'Stable' Businesses



Source: Company Reports

Note: 'Stable' businesses include Wealth Mgmt, Retail & Corporate, Wealth Management Americas and GAM

Other banks have also announced changes to business model – albeit more incremental than transformational

Modest Steps From Other Banks

To date, several other banks have announced, or are reported to be considering, business model changes for their wholesale divisions, over and above what we consider to be Basel 3 capital 'arbitrage'.

- **Credit Agricole** – In December 2011, announced the intention to exit commodities trading and equity derivatives. Since then, the bank has announced the disposal of CLSA to CITIC Securities as well as the potential sale of Cheuvreux to Kepler Capital Markets.
- **Credit Suisse** – In a recent meeting, CS's CFO David Mathers indicated that CS would continue to re-focus its prime brokerage financing commitments as well as 'fold' its commodities and FX operations into its Private Banking division (see [Management Meeting Feedback](#), 26 November 2012).
- **Morgan Stanley** – In October 2012 the Financial Times reported that Morgan Stanley was in talks over a potential disposal of some or all of its commodities franchise to Qatar's sovereign wealth fund.
- **Nomura** – In September 2012, announced the intention to move its equities cash, programs and electronic executions services for the Americas, EMEA and Asia excl. Japan into Instinet, its agency-only broker, Instinet.
- **RBS** - In January 2012, RBS announced its intention to exit cash equities, corporate broking, and M&A advisory.

However, we consider most of these actions to be more 'incremental' rather than 'transformational'.

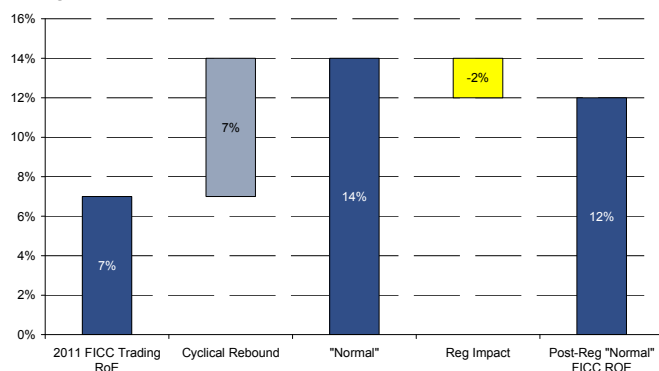
2013 – Pressure to Restructure Likely to Continue

We estimate that regulatory headwinds could reduce ‘normalized’ FICC industry RoEs from 14% to 10-12%

The pressure to restructure is unlikely to ease during 2013. Rather, the upcoming implementation of new regulation – such as Volcker and OTC derivatives reform – is likely to increase pressure on subscale FICC franchises. In [Sizing Up “The Elephant in the Room”](#) (30 May 2012), we estimated that for a “normalized” FICC revenue pool, the impact of upcoming regulatory reforms would be to reduce industry RoE from 14% to 10-12% (see Figure 16).

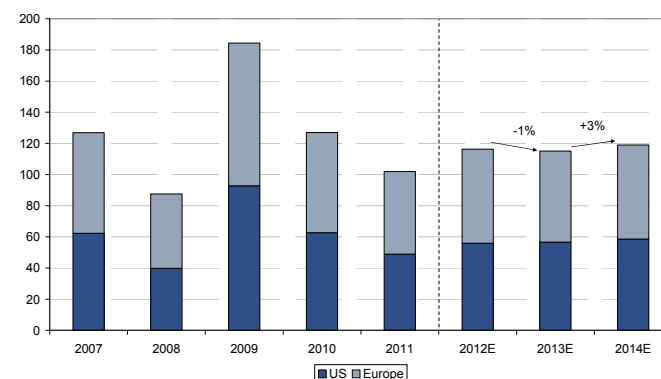
Within the industry, we expect the larger FICC franchises (e.g. Barclays, DBK) and those with leading market share in profitable niches (e.g. CS), to be better positioned to produce above industry-average RoEs. In contrast, sub-scale franchises are unlikely to meet their cost of equity.

Figure 16. FICC – “Normal” RoEs Reach 12% Post-regulation on Average



Source: Citi Research

Figure 17. FICC Revenue Pool – Still c10% Below “Normal” Pools of 2007 & 2010



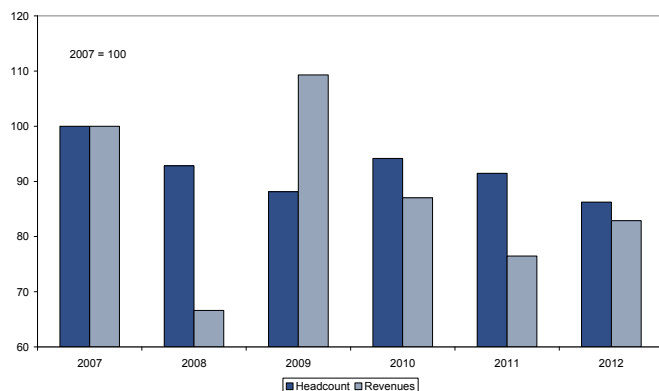
Source: Company Reports and Citi Research Estimates
Based on five largest US banks and nine European banks. For 2012E – 2014E, where no Citi forecasts available, growth rate for regional peers applied

Industry Restructuring is Lagging

The gap between revenue pool and headcount trends is greatest at CS

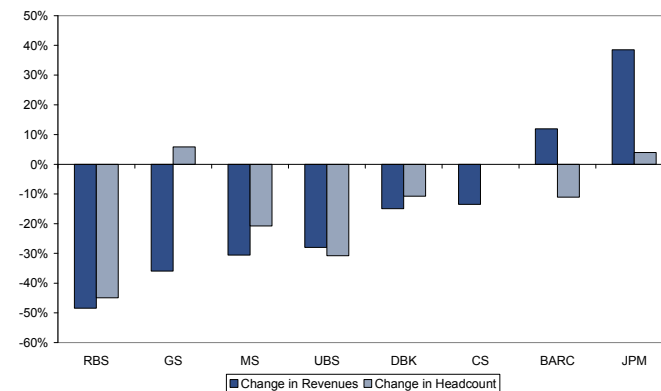
Although there has been material ‘narrowing’ of the jaws between IB headcount and revenues, there is still further restructuring to go. Among the major European franchises, the gap is greatest at CS.

Figure 18. IB Divisions – Headcount vs Revenues



Source: Company Reports
Note: Based on GS (Group), JPM (IB), MS (Group), CS (IB), DBK (CIB), UBS (IB), Barc (IB) & RBS (IB)

Figure 19. IB Divisions – Headcount vs Revenues by Bank, 2007 - 2012



Source: Company Reports
Notes:
- Based on GS (Group), JPM (IB), MS (Group), CS (IB), DBK (CIB), UBS (IB), Barc (IB) & RBS (IB)
- Barc & MS adjusted for acquisitions/disposals

Restructuring Options

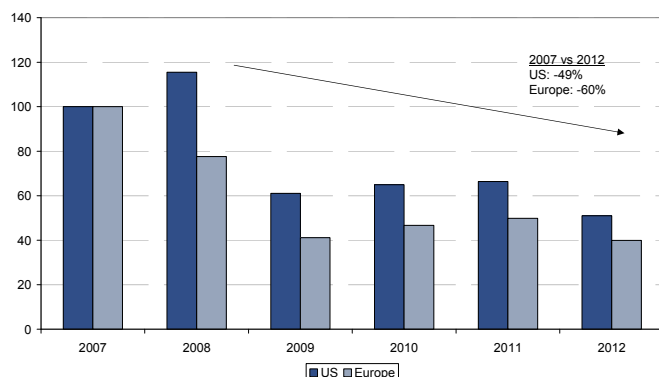
Sub-scale players in key products as well as second-tier global players will be under most pressure to restructure

By no means do we expect other banks to announce 'mirror' strategies to UBS or a 'wholesale' exit from capital-intensive business, rather a shift to more optimal business models.

- **Dilutive geographical footprint:** The trend to global or regional will reverse, in our view. Not all global players are likely to have sufficient scale to compete versus the 'flow-monsters' whereas other banks may choose to compete on a more domestic basis. In this respect, both second-tier global and subscale domestic players will be under most pressure.
- **Sub-scale positions in capital-intensive businesses:** Like UBS, others may rethink strategy where they have sub-scale positions in businesses like Credit, Rates or Securitised Products. Even scale businesses in highly-regulated businesses such as commodities may see changes to business models (eg Morgan Stanley negotiating commodities joint venture with Qatar).
- **Sub-scale positions in capital-light businesses:** On the other hand, so-called capital-friendly businesses have experienced significant margin pressure, turning this into loss-making businesses for sub-scale players, especially in a more challenged environment (eg shift to passive in cash equities and the more recent de-volatisation in FX). Recent exits from cash equities by CASA, RBS and Unicredit could be followed by others, while CS is also looking to 'fold' its FX ambitions into its Private Bank.

Whilst equity trading is relatively less effected by new regulations, particularly cash equities, client activity remains cyclically low. This is particularly true in Europe, where DataStream data indicates that equity volumes have fallen 67% from their peak in 2007 (see Figure 20).

Figure 20. Equities – US\$ Volumes Significantly Below Recent Peaks



Source: World Federation of Exchanges

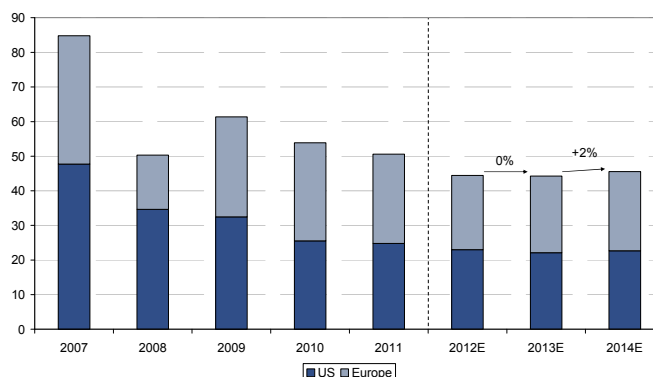
Notes:

Rebased; 2005 = 100

US based on NYSE Euronext (US) equity volumes; Europe based on NYSE Euronext (Europe), Deutsche Borse & LSE equity volumes

2012 annualised to full year from 11mth data

Figure 21. Equity Revenue Pool – Flat into 2013E



Source: Company Reports and Citi Research Estimates

Based on five largest US banks and nine European banks. For 2012E – 2014E, where no Citi forecasts available, growth rate for regional peers applied

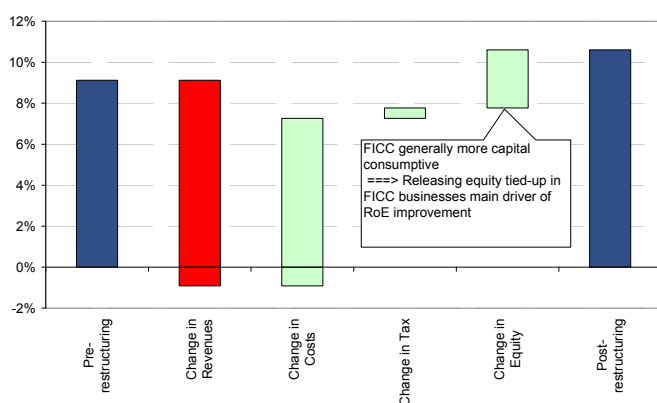
Towards the “Optimal” IB

We perform a scenario analysis on European IB restructuring. This highlights material scope to improve industry returns, even before any potential re-pricing benefit following the reduction in capacity. Restructuring could also result in a potential re-rating from lower earnings volatility and a simpler business model.

European wholesale banks could improve the RoE of their FICC business models from 9.1% to 10.7% through restructuring

■ **In Fixed Income**, RoEs could improve by c1.5pps from 9.1% to 10.6%. Taking into account our assumption that Barclays and Deutsche Bank FICC business models remain unchanged, the underlying improvement at restructured banks ranges from c2-4pps, with total equity release of cUS\$38bn.

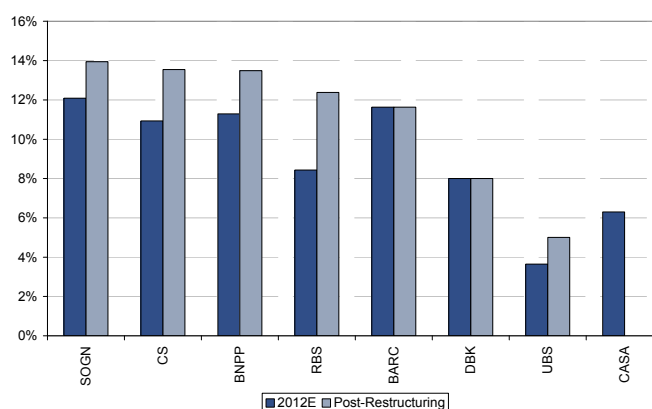
Figure 22. Wholesale Banks RoE– Restructuring FICC Franchises



Source: Citi Research Estimates

Note: Based on FICC operations of eight major European wholesale banks, CS, UBS, DBK, BARC, RBS, BNP, SOGN & CASA. See Appendix for further detail on underlying assumptions. FICC for BNP, SOGN & CASA includes DCM activities

Figure 23. Wholesale Banks RoE – Restructuring FICC Franchises by Bank

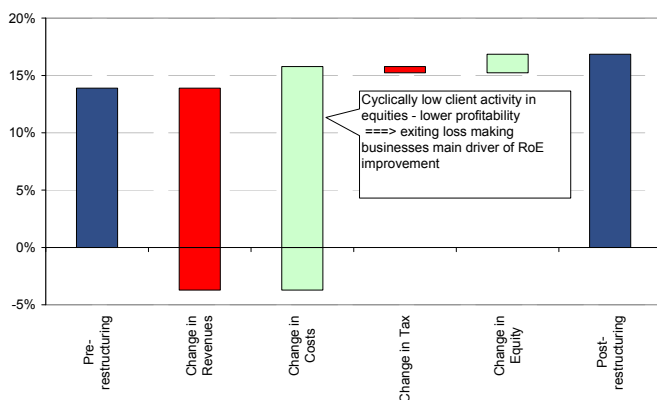


Source: Citi Research Estimates

Note: RoE represents FICC business 2012E RoE before and after IB restructuring

■ **In Equities & Primary** where we assume that sub-scale franchises are typically loss-making, we estimate that RoEs could improve by c3pps, albeit with a relatively modest US\$4bn of equity release.

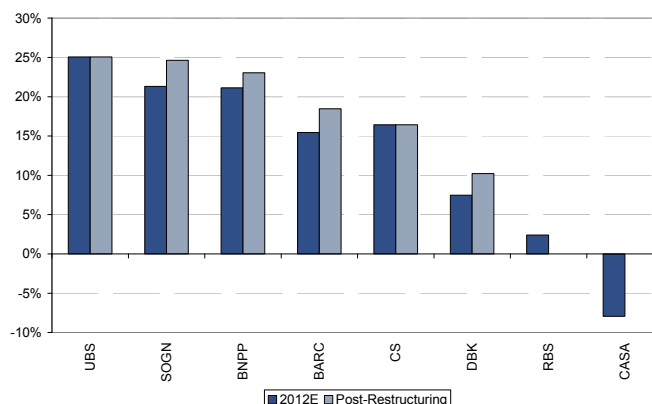
Figure 24. Wholesale Banks RoE – Restructuring Equity Franchises



Source: Citi Research Estimates

Note: Based on equity & primary operations of eight major European wholesale banks, CS, UBS, DBK, BARC, RBS, BNP, SOGN & CASA. See Appendix for further detail on underlying assumptions

Figure 25. Wholesale Banks RoE – Restructuring Equity Franchises by Bank



Source: Citi Research Estimates

Note: RoE represents equity & primary business 2012E RoE before and after IB restructuring

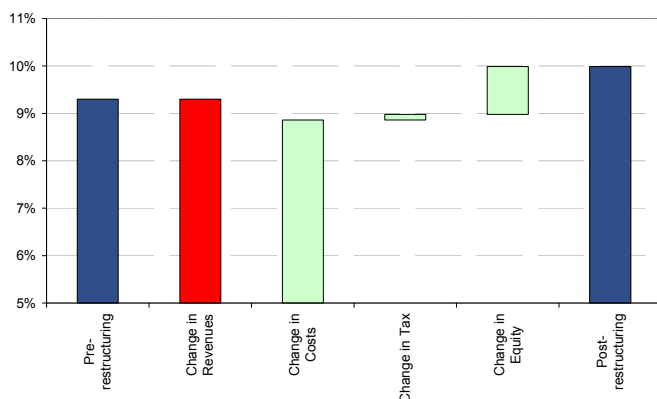
Optimizing IB divisions has the potential to lift the group 2013E RoE of European wholesale banks by c70bps

Group level 2013E RoE – To estimate the group level effect of our IB restructuring exercise, we benchmark our restructuring actions to group 2013E forecasts. This is to compare the effect of restructuring IB divisions to a more normalized performance by non-IB divisions (we use group 2012E forecasts for UBS as its announced IB restructuring plan is already captured in our 2013E forecasts). We estimate that group Basel 3 RoE could improve by c70bps to 10%. The strongest potential improvements are seen at UBS and CS, with 3pp and 2pp RoE improvements respectively. This is a function of the amount of capital both have in their FICC operations, and the low RoE of these businesses compared to the groups' asset gathering divisions.

Optimizing IB divisions releases cUS\$42bn of capital

Capital Released – In aggregate, our IB restructuring exercise releases cUS\$42bn of capital. At the group level this increases UBS's Core Tier 1 ratio the most, by over 3pp, followed by CASA with a 2pp improvement.

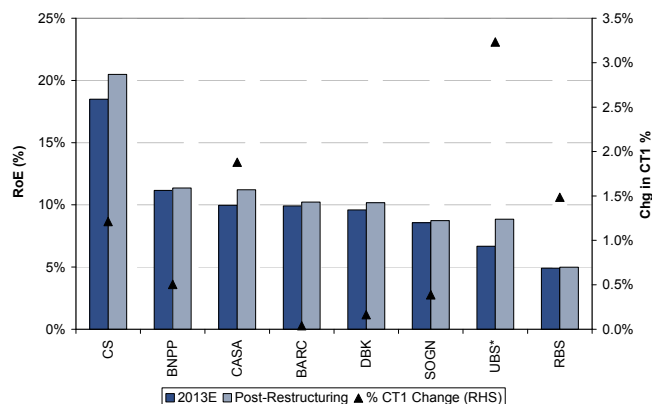
Figure 26. Optimizing IB Actions Improves Group 2013E RoE by c70bps



Source: Citi Research

Note: Based on aggregate 2013E estimates for CS, DBK, BARC, RBS, BNP, SOGN & CASA, and 2012E forecasts for UBS. See Appendix for further detail on underlying assumptions

Figure 27. Optimizing Actions Impact by Bank – RoE & Capital



Source: Citi Research

Note: RoE represents group level 2013E RoE before and after wholesale division restructuring, except for UBS, where group 2012E RoE is represented

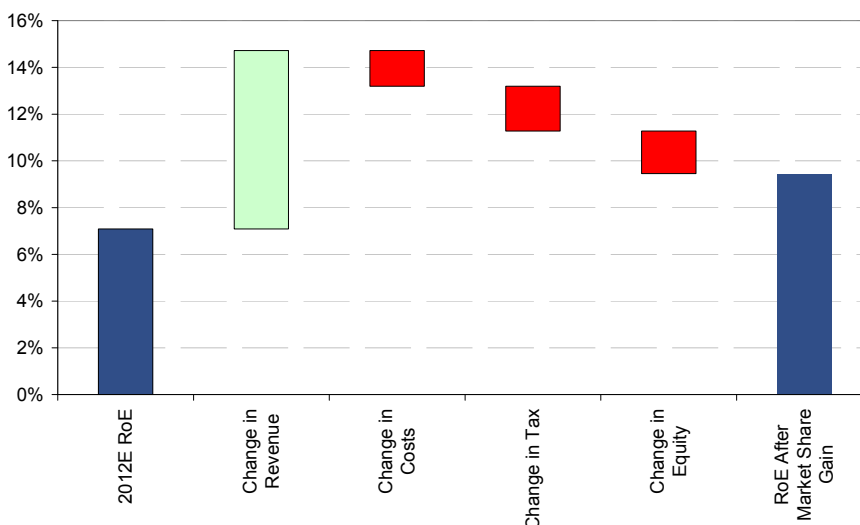
Capturing cUS\$14bn of FICC revenue from restructuring European wholesale franchises could lift the RoE of the top five global franchises (excl. Citi) from 7% to 9.5%.

To the Winner the Spoils

In aggregate, our restructuring scenario analysis results in capacity exit of cUS\$14bn of FICC revenues and cUS\$7bn of EQ revenues, representing 12% and 15% of the 2012E industry revenue pool (based on 14 global wholesale banks). This could offer meaningful opportunity for the industry 'winners' to gain market share, at relatively low incremental cost.

As highlighted in our analysis below (Figure 28), assuming that the top 5 players were to capture these revenues with a marginal cost-income ratio of 20%, our analysis suggests the aggregate 2012E RoE for their FICC operations of 7% could be raised to c9.5%.

Figure 28. Market Leader FICC RoE - Capturing Business from Restructuring Competitors Could Lift RoE by 2.5pp to 9.5%



Source: Citi Research

Note: RoE represents aggregate RoE of FICC franchises of JPM, GS, BoA, DBK & Barc

Setting The Scene

We identify wholesale businesses for restructuring based on their relative strength versus peers, capital consumption, profitability, and importance to non-wholesale group businesses

We highlight the relative product strength – across advisory, equities & fixed franchises – as well as potential businesses that could be exited, shaded in grey in Figure 29 and Figure 30. We emphasise that our scenario analysis is intended to be illustrative, and not the actions we expect banks to necessarily take:

- **Barclays & Deutsche Bank:** For both banks, we assume an exit from cash equities and part of the non-DCM primary franchises; we assume that the fixed income businesses broadly remain unchanged.
- **BNP Paribas & SocGen:** For both banks, we assume an exit from cash equities, commodities as well as c50% of credit trading (not directly related to corporate debt origination franchise critical to benefiting from disintermediation trend).
- **CASA:** We assume a 'wholesale' exit from capital markets although practically a small position could be retained to support the domestic debt origination franchise.
- **Credit Suisse:** We assume an exit from CS' sub-scale positions across its relatively sub-scale commodities, FX and rates franchises.
- **RBS:** We assume an exit from the non-UK FICC franchise as well as a complete exit from the remaining equities operations.
- **UBS:** Our analysis is consistent with their recently-announced strategy to exit significant parts of the Credit and Rates operations.

Figure 29. FICC – Relative Product Strength & Potential Scope for Restructuring

Product	BARC	DB	CS	UBS	RBS*	BNP	CASA	SG
FX - G10	●	●	○	●	●	○	○	○
FX – EM	○	●	○	●	○	●	○	○
Rates - G10	●	●	○	○	●	●	○	○
Rates – EM	○	●	○	○	○	○	○	○
Credit - IG & HY	●	●	○	○	○	○	○	○
Mortgages	●	○	●	○	●	○	○	○
Commodities	●	○	○	○	○	○	○	○

Source: Citi Research. Shading indicates product line reduced or exited in Citi analysis.

*Non-UK FICC only

Figure 30. Equities & Primary – Relative Product Strength & Potential Scope for Restructuring

Product	BARC	DB	CS	UBS	RBS	BNP	CASA	SG
Cash	○	○	●	●	na	○	○	○
Flow derivatives	○	●	○	○	○	●	○	●
Structured derivatives	○	●	○	○	○	●	○	●
Prime services	○	●	●	●	○	○	○	○
Electronic execution	●	●	●	●	○	○	○	○
Primary	○	○	○	○	○	○	○	○

Source: Citi Research. Shading indicates product line reduced or exited in Citi analysis.

European banks have targeted cost savings of c8% of 2013E expense base, with more than half yet to be realised

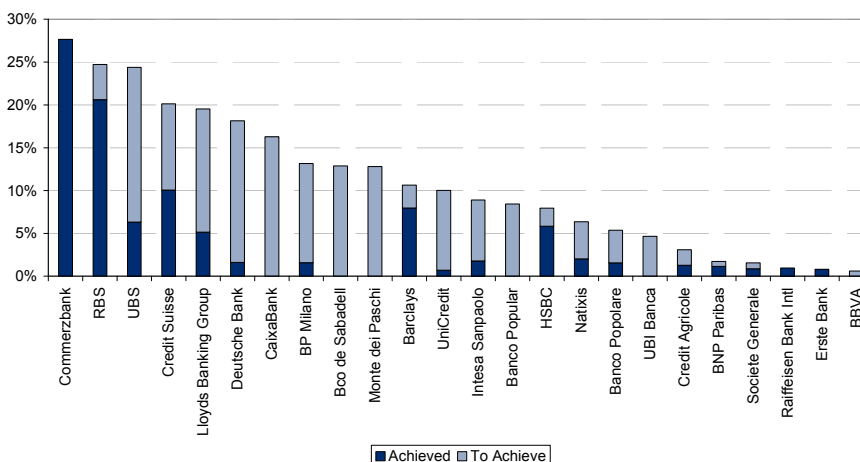
Cost Savings On Track, More To Come

Banks' management have increasingly focused on restructuring or cost management programmes, in order to head off increasing top-line pressures. These range from UBS' SFr5.4bn, Deutsche Bank's €4.5bn and RBS' £3.6bn cost savings, target to Nordic banks' flat cost growth ambitions (offsetting inflation).

At the sector level, we estimate that banks have targeted cost programmes of c8% of total 2013E expense base. To date, banks have achieved almost c45% of these targets, with the balance yet to come. These measures have supported B3 RoEs by 1.2% to-date, with a further 1.5% potential improvement to come.

The most ambitious of these programmes have targeted up to 15-30% of the 2013E expense base. While Commerzbank and RBS have largely achieved their targets already, the majority of benefits have yet to come through at the likes of UBS, CS, Lloyds, Deutsche Bank and CaixaBank.

Figure 31. Announced Cost Savings Targets (As a % of 2013E cost base)



Source: Company Reports and Citi Research Estimates

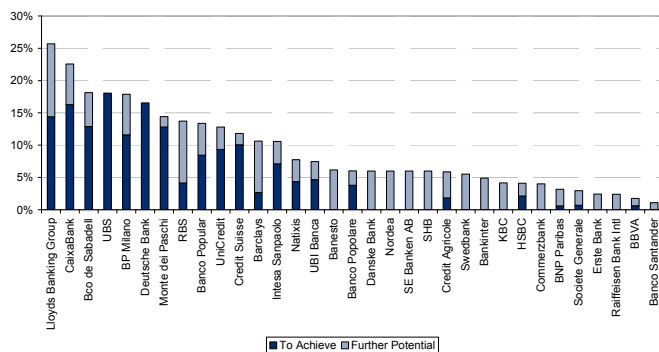
Scope For Further Restructuring

We estimate an additional 4% potential cost savings representing c1% boost to B3 sector RoE

Using a bottom-up approach, we estimate that banks' management have scope for further cost savings of c4% of the 2013E expense base. These measures could support B3 RoEs by a further 1pp.

In total, we therefore estimate that the sector could realize a further c8% of cost savings (c4% already announced by banks plus c4% in additional savings we estimate as possible). As well as the above-named banks, the greatest potential also sits with Sabadell, BP Milano and MPS.

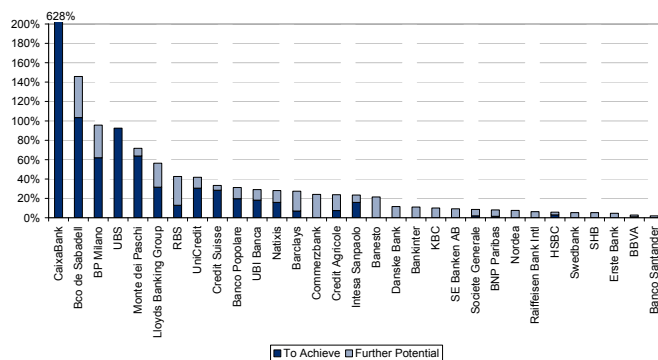
Figure 32. Potential Cost Savings Targets (As a % of 2013E cost base)



Source: Citi Research Estimates

Note: "To Achieve" cost savings represent amount of expense reduction outstanding from already announced cost savings plans. "Further Potential" represents further cost savings we estimate as possible

Figure 33. Potential Cost Savings Targets (As a % of 2013E post-provision profit)



Source: Citi Research Estimates

Note: "To Achieve" cost savings represent amount of expense reduction outstanding from already announced cost savings plans. "Further Potential" represents further cost savings we estimate as possible

Figure 34. Summary of Globally Announced Cost Reduction Initiatives

	Heads	Cost Saves Targets (\$bil)	Comments
US			
Bank of America	30,000	\$5.0 (Phase 1), \$3.0 (Phase 2)	<ul style="list-style-type: none"> ■ BAC eliminating 30K positions across firm over several years. Phase 1 targets Consumer segment (18% expenses or \$5.0 bil) ■ Commercial & I-Bank & With Mgmt targeted in Phase 2 of cuts reportedly ~\$3 bil (~10% of expense base). Phase 2 begins 2Q12 ■ Legacy Assets & Servicing - expect normalized quarterly expense rate of \$500 mil vs 3Q12 expense of \$3.4 bil
JP Morgan	unclear	unclear	<ul style="list-style-type: none"> ■ Assessing cutting costs from operations & technology across IBank and Treasury Security Services from a \$1.6 billion expense base. ■ Servicing expenses to drop from ~\$4 bil in '12 to ~\$1.3 bil longterm
Goldman Sachs	1,000	\$1.9	<ul style="list-style-type: none"> ■ Initial expense reduction initiative of \$1.2 billion announced in 2Q11 later increased to \$1.9 billion should fully be in runrate by YE12
Morgan Stanley	1,600	\$1.4	<ul style="list-style-type: none"> ■ \$1.4 bil in cost cutting by 2014 with \$500 million in the 3Q12 runrate ■ 2012 Headcount reduction targets reportedly met in 3Q12
Europe			
Deutsche Bank	1,900	\$6.0	<ul style="list-style-type: none"> ■ Cost saves versus 1H12 expense base ■ 1,900 jobs, including 1,500 in CB&S and related infrastructure
Credit Suisse	3,500	\$4.4	<ul style="list-style-type: none"> ■ Savings plan increased from \$2.2bn initially announced, achieved by 3Q12 ■ Cost saves versus 1H11 expense base, to be achieved by 2015 ■ \$2.3 from IB, \$0.3 Private Bank, \$0.1 Asset Mgmt, \$1.6 from Infrastructure
UBS	10,000	\$5.9	<ul style="list-style-type: none"> ■ Cost saves versus 1H11 expense base, to be achieved by 2015 ■ Cost saves from IB efficiency, organisational effectiveness, hubbing, lean front-back and independent buying entity ■ Majority of rates & credit trading being exited
BNP Paribas	1,000	\$0.7	<ul style="list-style-type: none"> ■ Planning cuts from struct finance & capital mkts, ~7% of total. 1/3 France, 2/3 international.
Societe Generale	1,580	\$0.35	<ul style="list-style-type: none"> ■ 880 CIB jobs in France and 700 abroad
Credit Agricole	2,350	\$0.5	<ul style="list-style-type: none"> ■ 2,350 jobs to be cut; 1,750 in the Investment Bank
UK			
Barclays	3,000	\$3.0	<ul style="list-style-type: none"> ■ 3K cuts through 2011, w/t 1,500 in I-Bank. Cost saves focused on "Non-performance" costs, 60% achieved
RBS	5,000	unclear	<ul style="list-style-type: none"> ■ Over 5K of 19K (~25%) in planned cuts RBS. Will exit cash equities, Corporate broking, ECM and M&A. Likely downsizing in equity derivatives, structured credit & rates as well.
HSBC	30,000	unclear	<ul style="list-style-type: none"> ■ 30K jobs (10% global workforce), distributed across the business
Japan			
Nomura	unclear	\$1.0	<ul style="list-style-type: none"> ■ \$1bn cost save program announced in Sep 2012. To be completed by Mar 2014 ■ Cost saves focused on wholesale division (primarily Equities, IB, Corporate) ■ 43% personnel expenses; 57% non-personnel expenses ■ Cash equities execution outside of Japan migrated to Instinet

Source: Company Reports and Citi Research

Figure 35. Summary of Globally Announced Deleveraging Initiatives

	RWA run-off	Deleveraging / RWA Management
US		
Bank of America	~\$30-50 bil	■ After \$500 billion of Basel 3 RWA reductions/mitigation since 2010 we see modest mitigation over the next 2 yrs offset by organic growth
JP Morgan	~\$215 bil	■ Mgmt sees RWA falling from \$1.600T at 3Q12 to \$1.475T at YE 2013 and \$1.450T trillion by YE 2014
Goldman Sachs	~\$90 bil	■ About \$30 billion passive runoff by YE 2013 and \$90 bil passive RWA reduction by YE 2015.
Morgan Stanley	\$30-50 bil+	■ Guided FICC RWA down \$135 bil from 3Q11 to 4Q14 with roughly \$30-50 billion more to go.
Europe		
Deutsche Bank	~\$120 bil	■ \$60 bil from non-core division run-off (including IAS 39 reclassified assets, Postbank structured products) ■ \$60 bil from optimisation measures (e.g. advanced risk models) ■ \$120 bil to be achieved over 2Q12-1Q13
Credit Suisse	~\$30 bil	■ ~\$30 bil of deleveraging to be reduced over 3Q12-2013 ■ ~\$20 bil of deleveraging in Investment Banking ■ FICC RWAs reduced by \$100 bil over 3Q11-3Q12, o/w \$36 bil in securitised products
UBS	~\$110 bil	■ \$110 bil of RWA reduction over 3Q12 - 2017 ■ ~\$150 bil of IB RWAs and other legacy assets to be reduced to ~\$30 bil by 2017, offset by growth in RWAs in asset management businesses ■ IB RWAs being reduced include ~\$40 bil of cash positions
BNP Paribas	~\$90 bil	■ €79bn RWA Equivalent between 3Q11 and end 2012, o/w €45bn CIB, €6bn Retail, €28bn other activities
Societe Generale	~\$40-55 bil	■ \$40-55 bil RWA deleveraging in the Corporate & Investment Bank (e.g. aircraft leasing, shipping, real estate, leveraged finance)
Credit Agricole	\$20-\$25 bil	■ \$20-25 bil RWA deleveraging in the Corporate & Investment Bank ■ Exiting equity derivatives & commodities given lack of critical mass
UK		
Barclays	\$65-\$90 bil	■ Sell-down & other management actions
RBS	~\$110 bil	■ \$110 bil in Basel 3 RWA reduction from exiting equities & reducing other b/s intensive businesses. Sold \$7.3 bil RBS Aviation to SMFG
HSBC	not specified	
Japan		
Nomura	not specified	
Total	c\$1 trn	Identified Passive & Active

Source: Company Reports and Citi Research Estimates

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Regulation

Regulation & the Business Model

Regulatory tightening has dampened the impact of liquidity support

Regulatory forbearance and liquidity support often go hand-in-hand. In three out of four banking crises, there has been some 'relaxation' of the banking rule-book. To-date, there has been significant liquidity support provided by the ECB, to the tune of over €1trn.

We expect significant regulatory forbearance on liquidity ratios – notably supportive for wholesale banks

By contrast, over 2010-2012 we have witnessed a significant tightening of the screws with respect to regulation – via Basel 3 capital, leverage, liquidity & funding requirements, OTC derivatives reform and related regulations. These factors have significantly negated liquidity easing measures and prompted central bankers to weigh into the debate, notably in relation to liquidity or LCR (liquidity coverage ratio) requirements. We expect significant regulatory forbearance in early-2013 which should notably support wholesale banks, including the major French banks.

Leverage could be the next shoe to drop; mandatory clearing also presents headwinds for FICC into 2013

Against this, the potential impact of the shift to mandatory clearing remains a key uncertainty and is likely to become a potential headwind for FICC revenues into 2013. Likewise, we also believe that leverage could become the next shoe to drop as the global RWA review adds further uncertainty to risk-weightings. In our capital return scenario analysis, we have reflected this via minimum mortgage risk-weightings as well as a surcharge on internal model-based market risk RWAs. Not all banks are equal in this respect, with risks greatest for CASA and Deutsche Bank.

Central Bankers Swing Liquidity Debate

Based on the latest QIS (quantitative impact study) at mid-2011, the aggregate LCR shortfall at mid-2011 was €1.76 trn, including €1.15 trn for European banks. For Group 1 banks (Tier 1 capital in excess of €3 bn and internationally active), average LCR ratios for European banks stood at 70% vs the global banks average of 90%.

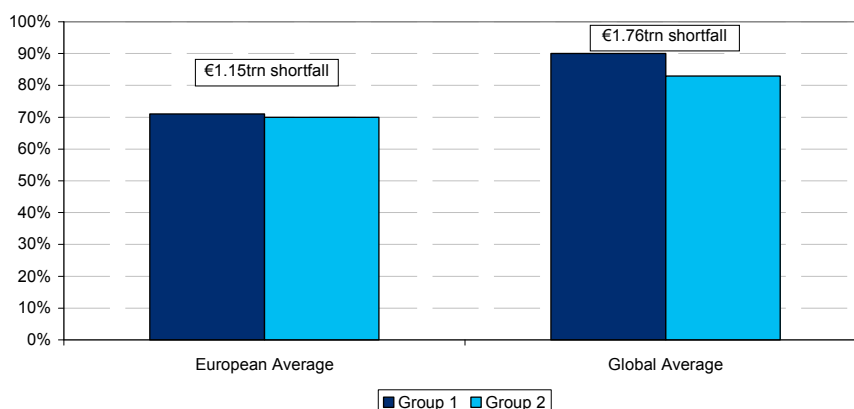
We expect regulatory forbearance of Basel 3 LCR requirements to come through in early-2013. The turning point, in our view, was the vocal criticism of the current calibration of liquidity requirements by prominent central bankers:

- **Daniel Tarullo, Federal Reserve Governor:** *"As currently constituted, the LCR may have the unintended effect of exacerbating a period of stress by forcing liquidity hoarding."* (6 June 2012)
- **Mervyn King, Governor of Bank of England** (also Basel Group of Governors and Heads of Supervision Chairman) recently stated that: *"In current exceptional conditions, where central banks stand ready to provide extraordinary amounts of liquidity against a wide range of collateral, the need for banks to hold large liquid-asset buffers is much diminished, and I hope regulators around the world will take note."* (14 June 2012)
- **Mario Draghi, President of the ECB:** *"The interbank market is not functioning, because for any bank in the world the current liquidity regulations make - to lend to other banks or borrow from other banks - a money losing proposition. So the first reason is that regulation has to be recalibrated completely."* (26 July 2012)

"In current exceptional conditions...the need for banks to hold large liquid-asset buffers is much diminished..." Mervyn King

"The interbank market is not functioning..." Mario Draghi

Figure 36. Global and European Banks Liquidity Shortfall – Mid-2011



Source: LCR Quantitative Impact Study

Indeed, Fed Governor Tarullo recommended 3 potential areas of forbearance:

- **Broadening of Liquidity Buffer:** The LCR's definition of high-quality assets should be broadened with the Fed supporting efforts to move away from the current credit risk-based approach and towards a quantitative liquidity-based approach.
- **More Realistic Run-Off Rates:** Some of the assumptions embedded in the LCR about run-off rates of liabilities and the liquidity of assets should be grounded more firmly in actual experience during the crisis, as the LCR may overstate, in particular, the liquidity risks of commercial banking activities.
- **Counter-cyclical, Not Pro-cyclical:** The LCR should be better adapted to ensure usability of the high-quality liquid asset buffer in appropriate circumstances: for example, by making credibly clear that ordinary minimum liquidity levels need not be maintained in the midst of a crisis. As currently constituted, the LCR may have the unintended effect of exacerbating a period of stress by liquidity hoarding.

Shifting The Goalposts Favorably

Recent press articles suggest that some LCR forbearance has already been agreed upon

A recent Risk magazine report (*Raft of changes could shrink Basel III liquidity buffers*, 20 November 2012) highlighted the following potential changes to outflow assumptions. The combination of these measures is expected to result in a 14% reduction in the size of the industry's liquidity buffer shortfall, according to the report, although we expect wholesale banks to do even better given their greater sensitivity to non-retail outflows.

- **The outflow rate for non-operational deposits** provided by non-financial corporates, sovereigns, central banks and public sector entities to be reduced from 75% to 40%;
- **The rate for committed liquidity facilities** to these market participants reduced from 100% to 30%;
- Reduction in the **outflow rate for derivatives receivables** from 100% to an unspecified level.

- Likewise, there could be a cut in the outflow assumption for **deposits protected by state insurance** – from 5% to 3%.

However, we believe that greater forbearance could also come from the definition of the liquidity buffer which could include lowering the minimum rating for corporate bonds from AA- to BBB or BBB- and the inclusion of equities.

Scope For Optimisation

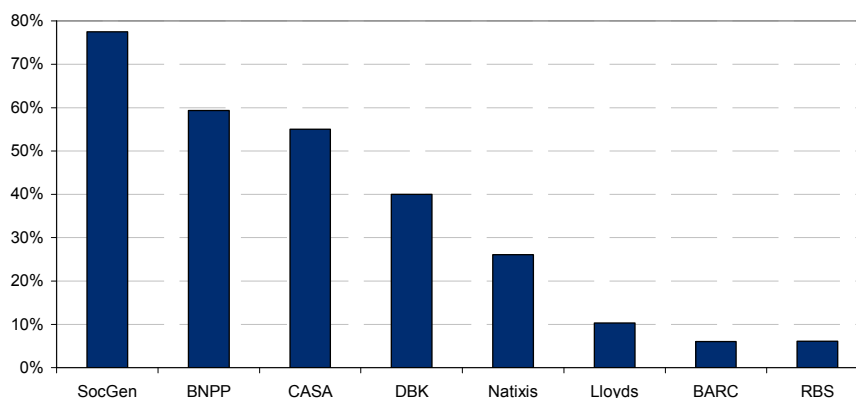
Since the BIS/EBA QIS at mid-2011, major European wholesale banks have bolstered their company-defined liquidity buffers by c30%, or c€0.4trn (from over €1.2trn to almost €1.6trn). In particular, the strongest increase in buffers has come from the major French banks. On the other hand, the UK banks have maintained their buffers having previously met the FSA's tougher liquidity regime.

Separately, the expansion of ECB collateral eligibility will have potentially supported the improvement of liquidity ratios to the extent that this has been financed into liquid assets via central bank repo operations. This notably includes:

- Additional credit claims for 7 NCBs (National Central Banks) based on specific national eligibility criteria (February 2012)
- Broadening the scope of ABS and RMBS-eligible collateral (June 2012).

Of course, any inclusion of such assets in the liquid asset buffer – with an appropriate discount – would also be very supportive for banks' LCR ratios.

Figure 37. European Banks Liquidity Buffer Increase, Since Mid-2011



Source: Company Reports

US Case Study

US case study highlights sensitivity of LCR calibration to wholesale, rather than retail factors

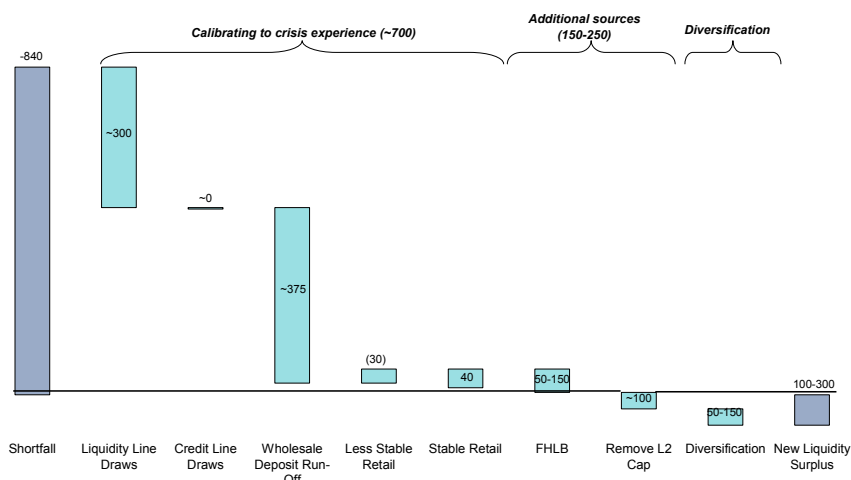
A recent study by The Clearing House (14 December 2012) identified a US\$840bn liquidity shortfall for the US industry, equivalent to an 81% LCR ratio in mid-2012, up from 59% at end-2010 when the shortfall was c\$1.5trn. Perhaps even more interestingly, their scenario analysis highlighted the sensitivity of the industry shortfall to changes in various assumptions, as highlighted in the charts below:

- **Reducing the outflow assumptions for credit and liquidity lines** to financials, currently treated at 100%, to a 10% outflow would increase the industry average LCR by about 20% and reduce the liquid asset buffer shortfall by about \$300B;

- **Calibrating wholesale deposit run-off rates to crisis levels** on a category-by-category basis would increase the LCR by about 20% and reduce the shortfall by about \$375B;
- **Increasing the assumptions around less stable retail deposit outflows** from a 10% to 20% run-off rate would reduce the industry average LCR by about 3% and increase the shortfall by more than \$30B;
- **Reducing stable retail outflow assumptions** from a 5% to 3% run-off rate would increase the industry average LCR by about 2% and reduce the shortfall by about \$40B;
- **Removing the cap on level 2 high-quality assets** would increase the industry average LCR by about 7% and reduce the shortfall by about \$100B; and
- **Treating undrawn Federal Home Loan Bank commitments as high-quality liquid assets** would increase the industry average LCR by about 7% and reduce the shortfall by about \$50-150 billion.

In total, these assumptions would increase the LCR ratio to over 140%, corresponding to a liquidity surplus of up to US\$300bn. Interestingly, as highlighted above, a dominant part of the improvement is driven by the changes in wholesale factors (liquidity line draws and wholesale deposit run-off) highlighting the greater sensitivity to such factors.

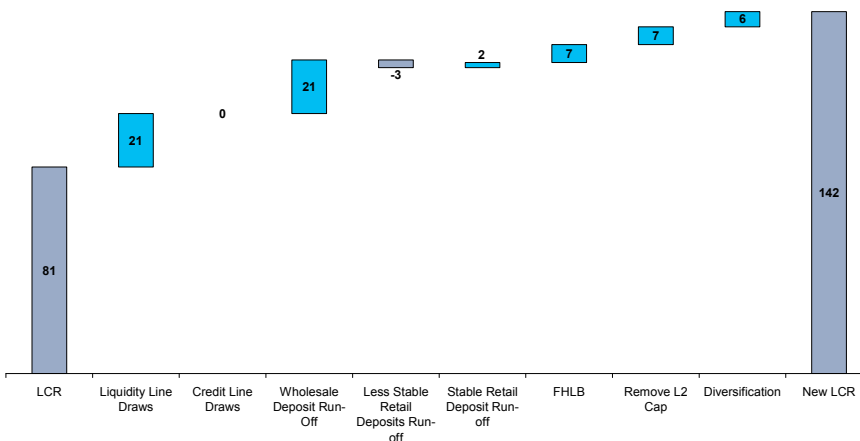
Figure 38. Scenario Analysis of US Banks' Liquid Asset Buffer Shortfall



Source: TCH

Note: Impact of liquidity/credit line draws & wholesale deposit run-off calculated by applying worst-case behaviour per LCR category from any bank, to all banks in place of LCR-assigned factors.

Figure 39. Scenario Analysis of US Banks' LCR



Source: TCH

Note: Impact of liquidity/credit line draws & wholesale deposit run-off calculated by applying worst-case behaviour per LCR category from any bank, to all banks in place of LCR-assigned factors.

...with an announcement expected in early-2013

From a timing perspective, the LCR rules may be agreed by central bank governors and heads of supervision (GHOS) as early as January 2013 with an observation period over 2012-14, before 2015 implementation. This may allow some banks to optimize their liquidity buffers. Moreover, clarity over the key regulatory uncertainty should serve to reduce risk premiums, notably for major wholesale banks.

The LCR has been designed to require global banks to have sufficient high-quality liquid assets to withstand a stressed 30-day funding scenario specified by supervisors. The LCR numerator consists of a stock of unencumbered, high quality liquid assets that must be available to cover any net outflow, while the denominator is comprised of cash outflows less cash inflows (subject to a cap at 75% of outflows) that are expected to occur in a severe stress scenario.

RWA Review – Leverage The Next Shoe To Drop

The euro zone crisis and the US money market storm have raised concerns about the size & funding of the European banks' balance sheets. If anything, the growing reliance of the sector on ECB funding – notably peripheral banking systems – has highlighted the 'dislocated' nature of its deleveraging trends.

In our previous [Road Ahead – Two-Speed Europe](#) report (5 September 2012), we highlighted that wholesale bank deleveraging has generally been 'smoother' than retail banking. Even then, this has been scant comfort for bears on the size of balance sheet. We also argued that leverage could be the next shoe to drop.

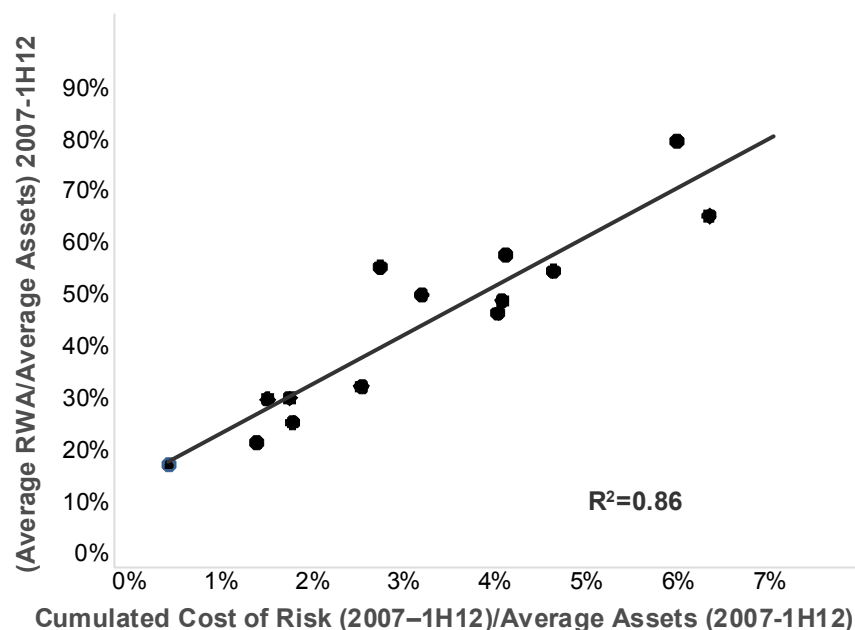
Indeed, the Liikanen Group (discussed later) raised the issue of risk-weights on both the trading book and real estate assets – recommending floors as well as questioning the consistency and efficacy of internal model-based inputs. Equally importantly, the upcoming RWA review (<http://www.bis.org/publ/bcbs220.pdf>), focused on both the Banking book and the Trading book, could further cloud concerns over risk-weightings and add weight to leverage ratios.

The Weighting Game

In our view, the primary driver of differences in risk-weights is the risk experience (refer to Figure 40), which has primarily affected Retail/Commercial operations – refer to [The Weighting Game](#) (20 June 2011).

Retail risk experience is the primary driver of differences in risk-weighting, in our view

Figure 40. Cost of Risk Has Been Correlated To Risk-Weights



Source: BNP Paribas based on sample of European banks, Bank of America, JPMorgan and Wells Fargo;

But RWAs present some key risks

At the same time, the following risks cannot be ignored:

- **Past experience not guarantee of future:** The pro-cyclicality in the 'risk-based' system is that, following an extended period of benign credit quality, relatively low risk-weights could leave banking systems relatively undercapitalized. Basel 3 aims to overcome this pro-cyclicality via TTC (through-the-cycle) estimates of default and counter-cyclical capital buffers although this may not go far enough.

- **Type of model:** Differences in supervisory approaches, with some jurisdictions relying more heavily on internal models approach and integrated VaR models while others continue to weight loans on the standardized approach.
- **Model calibration:** Calibration of model parameters such as PD and LGD estimation could also drive significant differences in risk-weights. For example, in [Weighing Down](#) (18 January 2012), we identified that not all banks use a TTC approach. Some banks adopt a hybrid approach while Deutsche Bank relies upon a less-conservative PIT (point-in-time) approach.

We now expect preliminary conclusions of this top-down and bottom-up analysis being conducted by the SIG (Standards Implementation Group) to be released in 1Q13 (originally planned for 4Q12). If the analysis is critical of consistency of current risk-weighting practices across banks and jurisdictions, as is our expectation, a greater market focus on balance sheet size and leverage will likely follow.

Not all banks are equal on leverage

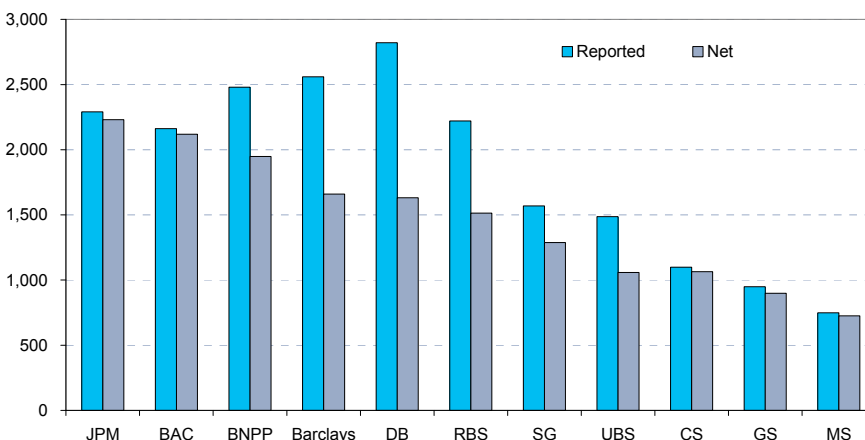
We have estimated net balance sheet size on a comparable basis

From the 1Q13 reporting period, both IFRS and US GAAP banks have to provide a reconciliation table, presenting both 'grossed-up' and 'netted' versions of the reported balance sheet (refer to [New Netting Disclosure, Focus on Leverage](#), 2 December 2012).

In anticipation of this new disclosure, we have analyzed (based on in some cases limited reported information) the difference between reported and net balance sheets for the major wholesale banks in Europe and the US, based on H1 2012 data (supplemented by 2011 annual report data where necessary).

On a reported basis, as shown in Figure 41, the largest major European/US wholesale banks by total assets are Deutsche Bank, Barclays and BNP Paribas followed by JPMorgan, RBS and Bank of America. However, on a netted basis, the pecking order changes, with JPMorgan, Bank of America and BNP Paribas followed by Barclays, Deutsche Bank and RBS. Lower levels of corporate disintermediation in Europe also contribute to larger balance sheets.

Figure 41. Balance Sheet Pecking Order – Reported & Net (\$USbn)



Source: Company Reports and Citi Research Estimates

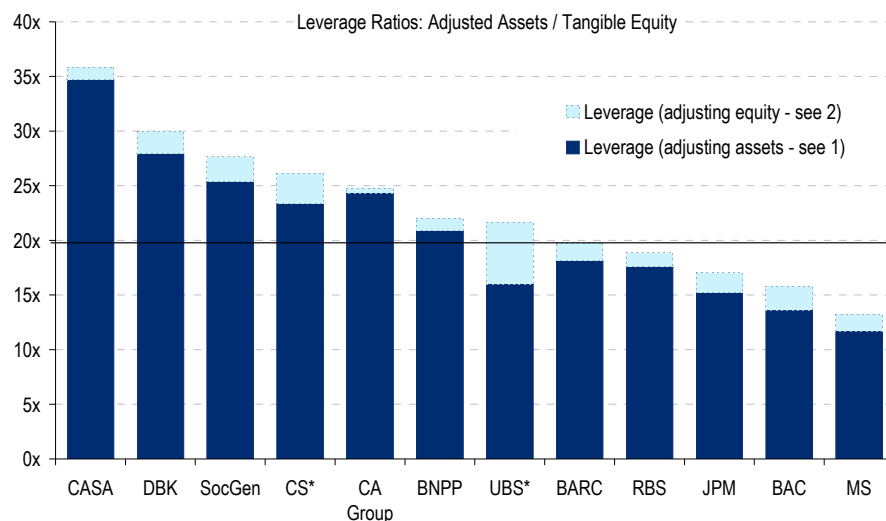
Note: US GAAP based on major US GAAP reporting banks including Bank of America, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley & assuming other collateral arrangements comparable to JPM disclosure

Turning to leverage ratios, we have calculated adjusted leverage ratios for the major US and European wholesale banks, which are shown in Figure 42. It is not a surprise that US banks' leverage ratios are comparatively below those of their European peers. This is partly driven by the structure of US and European mortgage markets (particularly Fannie Mae/Freddie Mac's significant role in the US) as well as lower risk-weights supported by a generally better risk experience in Europe over the past cycle.

CASA and Deutsche Bank run with the highest leverage ratios, on our estimates

From a European banks' perspective, CASA and Deutsche Bank run with the highest leverage ratios and therefore carry the greatest risk of capital raising to improve both capital & leverage ratios, in our view. On the other hand, the major UK banks tend to have lower leverage ratios and, together with the Swiss banks, have benefited from the greatest asset deleveraging to date.

Figure 42. Not All Banks Equal On Leverage



Source: Company Reports and Citi Research Estimates

Note: *CS & UBS adjusted to targeted balance sheet reductions

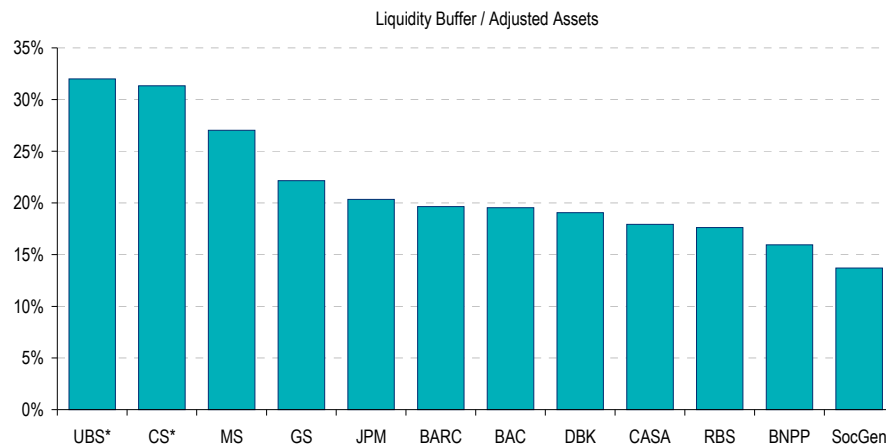
(1) Leverage = Adjusted Assets / Tangible Equity = (Assets - netted derivs - insurance - repos - brokerage receivables) / (Tangible Equity - FVOD + contingent capital)

(2) Leverage = Adjusted Assets / Adjusted Tangible Equity = Adjusted Assets / (Tangible Equity - FVOD - DTA NOL - Pension deficit + contingent capital)

It is also worth noting that the major Swiss banks also have the highest levels of liquidity buffer as a proportion of adjusted assets, as they have liquidity coverage ratios (LCR) well above Swiss & Basel requirements, as shown in Figure 43. CS has disclosed that its liquidity ratios are well in excess of requirements while UBS reported an LCR ratio of 113%. The Swiss approach is similar to the Basel 3 LCR although the requirements went into effect at the end of 2Q10.

Swiss banks run with the highest liquidity buffers relative to the balance sheet

Figure 43. Swiss Banks Carry Highest Levels of Liquidity Buffers



Source: Company Reports and Citi Research Estimates

Note: See comments in Figure 42 for definition of adjusted assets;

Liquidity buffers definitions: US banks = company defined liquidity reserves; Euro banks = assets eligible to central banks + cash at central banks; UK banks = company defined liquidity reserves; Swiss banks = Swiss liquidity buffers, with definitions similar to Basel 3 liquidity buffers (level 1 & level 2)

Note that we include two separate leverage calculations. In both calculations we adjust reported total assets for additional offsetting of derivatives, repos, and brokerage receivables not permitted on balance sheet, as well as excluding any insurance assets. The denominator in our default calculation is tangible shareholders' equity (excluding FV of own debt adjustments and including contingent capital), and in our alternative calculation we take a more penal view of equity components, deducting off-balance sheet pension deficits (IFRS only) and deferred tax assets related to carried forward operating losses.

LCR and OTC derivatives reform could drive a US\$1-4 trillion collateral crunch

Shift to Mandatory Clearing

The clock is ticking on the G20 requirement that all standardized derivatives be centrally cleared. Above and beyond Basel 3 liquidity requirements, banks and the financial system also potentially face collateral demands from i) margin posting via CCP clearing as well as iii) on uncleared derivatives transactions as part of strengthening the 'defaulter pays' model.

Indeed, central clearing requires collateral for both current exposure (variation margin) as well as potential future exposures (initial margin and default fund contributions). By contrast, bilateral transactions usually do not collateralize for potential future exposure while for certain counterparties including sovereigns and non-financial corporates often waive variation margin requirements (ie in effect, offering 'free' extension of credit).

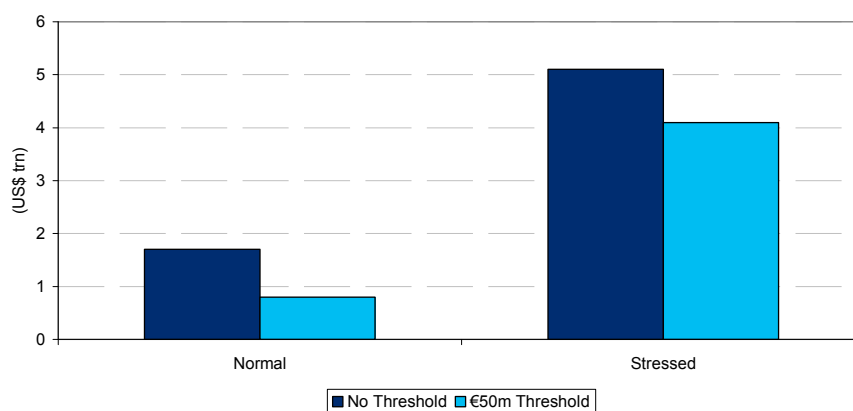
However, it is the collateral requirements from initial margin on uncleared derivatives transactions that potential pose the greatest challenge, based on a 10-day liquidation schedule compared to 5 days on cleared transactions.

Collateral Needs Up & Rising

In its 2012 Margin Survey, ISDA reported a 24% increase in the collateral backing uncleared OTC derivatives from US\$2.9trn to US\$3.6trn primarily as a result of downgrades of financial firms, the euro zone debt crisis and the decline in interest rates.

Under the proposed rules, ISDA has recently estimated that cUS\$127trn of OTC derivatives outstanding are unclearable or c20% of the global derivatives market (end-2011). Moreover, ISDA has estimated that collateral requirements for initial margins would amount to US\$0.8 trn (assuming internal models and a US\$50m threshold*). However, under stressed conditions this could increase to US\$4.1trn, creating significant pro-cyclicality feeding a negative feedback loop.

Figure 44. ISDA Initial Margin Estimates – Normal & Stressed



Source: ISDA

Note: Assumes all firms use internal models; threshold levels relate to the amount of counterparty exposures before initial margin requirements

The Elephant In The Room

As highlighted in our FICC report [Global Banks and Brokers - Sizing Up "The Elephant in the Room"](#) (30 May 2012), mandatory clearing is expected in 1H13. In particular, we estimated c7% impact of OTC derivatives reform rules on FICC revenues, including a 5% 'hit' from un-cleared derivatives. Taking into account Volcker provisions, we estimated that for a "normalized" FICC revenue pool, the impact of upcoming regulatory reforms would be to reduce industry RoE from 14% to 10-12% (see Figure 16).

From a timing perspective, the CFTC recently set (28 November 2012) the following compliance dates for clearing requirements for: March 11, 2013 for Category 1 Entities (including swap dealers, major swap participants, active funds); June 10, 2013 for Category 2 Entities; and September 9, 2013 for Category 3 Entities." We expect SEF trading and European rules to follow later in 2013.

Given the potential implications of the new rules, we believe there remains a high degree of uncertainty in terms of the form and timing of final implementation. Following significant lobbying, the CFTC has recently agreed to delay cross-border application of OTC derivatives reform until July 12, 2013 which (temporarily) allows for a level playing field between US banks and their European competitors.

Banking Union: Will Cure-Du-Jour Work?

"National supervisors...have asked their banks...to withdraw their activities within national boundaries." Mario Draghi, 26 July 2012

Supervisory nationalism is leading to fragmented regulation and an increasing 'home bias' of banks – whether expanding credit or investing in sovereign debt securities. In the near time, the announcement of the ECB's Outright Monetary Transactions (OMT) facility and the birth of the European Stability Mechanism in September 2012 have reduced the near-term risk of default and EA exit for any EA periphery state, including Italy and Spain. EA sovereign credit spreads have consequently narrowed substantially from their peaks and estimates of break-up probabilities have fallen.

Banking Union is a step in the right direction with single supervision by the ECB adding to credibility

The key question remains: *Will European Banking Union help to reduce some of the key challenges outlined above?* As discussed in our European Banking Union - Cure-du-Jour Will Take Time report (15 June 2012), the Banking Union would involve a combination of (1) Common banking rules and a single lead regulator; (2) a common bank resolution regime & recapitalisation fund; and (3) a mutualised DGS (deposit guarantee scheme).

- **Common Banking Rules:** We expect the ECB to be given the power in 2013/14 to choose to supervise directly any bank, and to overrule the national supervisor/regulator in case of conflict. For operational and political reasons, the ECB will likely directly only SIBs (systemically important banks) and banks in countries under programmes, while the day-to-day responsibility for other EA banks will remain with national supervisors.
- **Common Bank Resolution Regime & Recap Fund:** A common EA bank recapitalization fund (through the ESM) and a single bank resolution regime and fund are likely to follow soon after, probably in 2014.
- **Mutualised DGS:** We expect banking union to fall short of its most ambitious configuration namely a substantial pooling of resources, let alone sovereign backing or redenomination-proofness, for centralized EA deposit insurance, even though a gradual build-up of a limited, privately funded common deposit insurance fund remains plausible in the medium-term.

In our view, the fragmentation of financial conditions in the EA should fall, but still remain substantial, in coming years, as economic divergences between EA countries and excessive exposure of some banks to domestic sovereigns persist. In the near-term, we believe the greatest risks relate to ECB supervision of SIBs, notably those with weaker capital / higher leverage ratios namely CASA and Deutsche Bank.

Figure 45. New Banking Regulations – Timetable

Program	Detail	Timing of Disclosure	Timing of Implementation
Liquidity Coverage Ratio (LCR)	Review of current methodology including "the pool of high-quality liquid assets as well as some adjustments to the calibration of net cash outflows. The modifications currently under investigation apply only to a few key aspects and will not materially change the framework's underlying approach."	End-2012, although may be accelerated to summer 2012	2015 (observation period over 2012-14)
Net Stable Funding Ratio (NSFR)	Basel Committee has indicated changes, although no timetable provided; LCR is current priority on B3 liquidity requirements.	N/a	2018 (observation period over 2012-17)
Fundamental Review of the Trading Book (FRTB)	Consultative document released in May 2012 (http://www.bis.org/publ/bcbs219.htm). Fundamental review across: Trading/banking book boundary; differences between standardised and internal model approach; potential new risk measure of Expected Shortfall replacing VaR / stressed VaR; better methods of incorporating credit and illiquidity risk in the trading book. http://www.bis.org/publ/bcbs219.htm	Industry has until beginning of September to respond	Conceptual document at this stage
Peer Reviews	"The Committee will monitor, on an ongoing basis, the status of members' adoption of the globally-agreed Basel rules. It will review the compliance of members' domestic rules or regulations with the international minimum standards in order to identify differences that could raise prudential or level playing field concerns." Initial peer reviews focused on EU, Japan and US.	Reviews starting in 1Q12	N/a
Risk-Weighted Assets (RWA) Review	"The Committee will...review the measurement of risk-weighted assets to ensure consistency in practice across banks and jurisdictions." The Standards Implementation Group (SIG) has been tasked with reviewing the measurement of RWAs and has formed two groups to look at banking book (OCC, US and MAS, Singapore) and trading book (OSFI, Canada and ACP, France). This could include benchmarking a standard portfolio to compare results across firms.	Review process expected to be completed by end-2012	N/a
Cyclicality of Capital Requirements	"The Committee has reviewed a number of additional measures that supervisors could take to achieve a better balance between risk sensitivity and the stability of capital requirements, should this be viewed as necessary." These include the requirement to use long term data horizons to estimate probabilities of default and the introduction of so-called downturn loss-given-defaults LGD estimates.	N/a	N/a
Composition of Capital Disclosure Requirements	Detailed Pillar 3 disclosures by banks of the Basel 3 capital that banks use to meet their regulatory requirements, including transitional treatment: http://www.bis.org/publ/bcbs221.pdf	First set of financial statements from mid-2013	First set of financial statements from mid-2013
Leverage Ratio	The Basel Committee is undertaking a review of the 3% leverage ratio to examine whether it will serve its purpose of providing an effective backstop to risk-sensitive capital rules.	Changes to be implemented by mid-2017 although adjustments could be made earlier	Parallel run over 2013-17; migration to Pillar 1 in 2018
Central Counterparties	Final rules on capital required against CCP exposures are a modest positive via greater netting recognition as well as an alternative default fund capital calculation, which could potentially cap the charge in certain circumstances.	25/07/2011	Long-term growth of capital charge as cleared trade exposures build-up
Large Exposures Rule	"Credit risk concentrations of one kind or another have consistently been the source of a number of major bank failures over the years and many jurisdictions have in place regulations that limit large exposures. The Committee is currently reviewing large exposure rules in place across different jurisdictions to strengthen guidance in this area." We noted that the BIS's calibration in the use of CEM formula for CCP capital charges might portend positive recalibrations in other instances where the onerous CEM formula has been proposed (eg the Fed's highly controversial single-counterparty limit rule).	Consultation not expected until end-2012	N/a
Use of Credit Ratings	The Basel Committee continues to review the role of external credit ratings in its regulatory framework. The current rules clearly create a discrepancy with the US where Dodd-Frank has required removal of reference to external credit ratings which may require 'harmonisation'.	Longer-term effort	Longer-term effort
Operational Risk	The Basel Committee's Standards Implementation Group on Operational Risk (SOGOR) is reviewing banks' implementation of the operational risk framework.	Longer-term effort	Longer-term effort
Unrealised Gains & Losses	While Basel 3 rules argue for the addition of 'high-quality' liquidity assets, AFS mark-to-market volatility via Basel 3 regulatory capital creates a 'conflict'. In April 2012, a Joint Board Meeting between the FASB and IASB proposed moving to a "hold to collect" (HTC) approach in which assets held within a business model whose objective is to hold the assets in order to collect contractual cash flows (principal and coupon) would qualify for amortized cost accounting. IFRS 9 allows the use of either business model criteria or contractual cash flow criteria for amortised cost treatment. Such a move would serve to shield such portfolios - ALM rather than LCR - from mark-to-market volatility on regulatory capital.	IFRS 9 has already been issued	Not mandatory until 2015
IFRS vs US GAAP Reconciliation	In December 2011, the IASB and FASB jointly issued disclosure requirements which will require entities to disclose gross amounts subject to the rights of set-off, amounts set off in accordance with the accounting standards following, and the related net credit exposure. This information will help investors understand the extent to which an entity has set off in its balance sheet and the effects of rights of set-off on the entity's rights and obligations. In other words, it will improve the comparability of banks' balance sheet totals and leverage ratios between US and Europe.	Effective for annual period beginning on or after 1 January 2013. Retroactive application will be required to maximise comparability between periods.	Effective for annual period beginning on or after 1 January 2013. Retroactive application will be required to maximise comparability between periods.

Source: Citi Research, IIF

Earnings

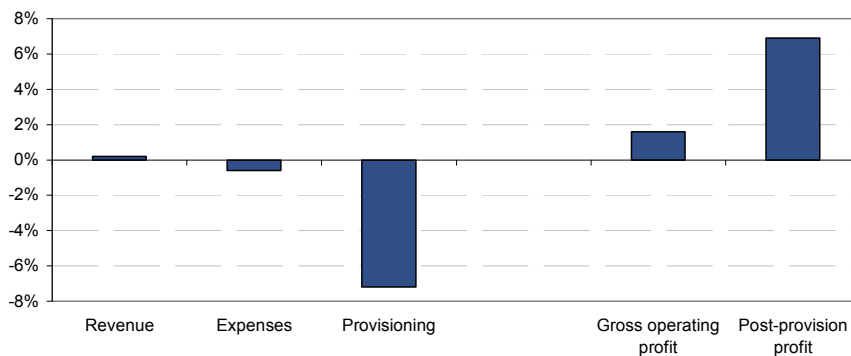
Focus on Earnings

Sector Forecasts

We forecast declining provisions to be the principle driver of earnings growth for European banks over 2013E

Overall, we forecast *underlying* 2013 sector post-provision profit growth of c7%. In turn, this is primarily driven by our forecast of provisioning decline of c7%. Indeed, we forecast operating profit to be a shade higher (+c2%) with flat revenues supported by slightly lower costs (-1%) as earlier restructuring programmes have kicked in.

Figure 46. Sector Underlying P&L Trends, 2012-13E



Source: Company Reports and Citi Research Estimates

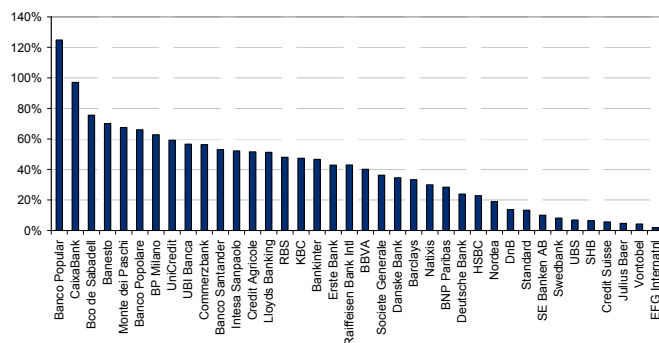
UK Banks Lead Turn In Provisioning Cycle

UK banks lead the decline in provisions in 2013E, with German and French banks broadly flat, and Nordic and Swiss banks higher, albeit from a lower base

We forecast a turn in the provisioning cycle for the UK banks, led by Lloyds and RBS. Irish impairments showed a steady decline throughout 2012 which we expect to continue in 2013. The run-down of non-core should also result in lower future impairments. Likewise, we expect Danske Bank provisioning to come down significantly again, primarily driven by a decline in Irish impairments from elevated levels as well as a continued improvement in Danish provisioning.

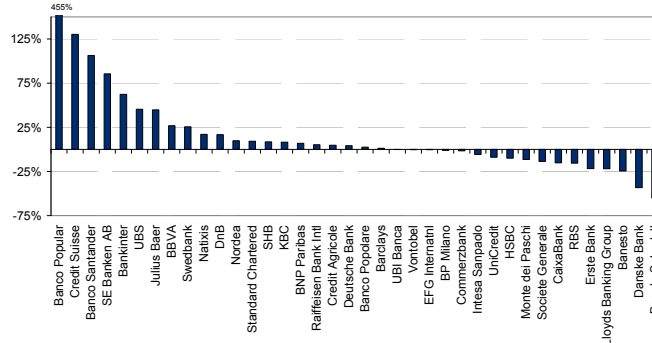
By contrast, we expect German and French banks' provisioning to remain broadly flat. From relatively low levels, we expect provisioning to increase at the Nordic and Swiss banks – albeit a relatively low proportion of operating profit.

Figure 47. 2013E Provisioning to GOP (%)



Source: Citi Research

Figure 48. Provisioning Growth – 2012E vs 2013E, %



Source: Citi Research

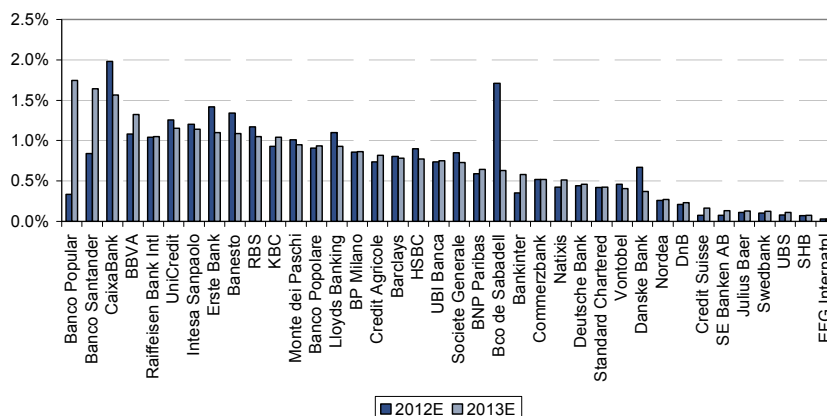
We expect provisioning to remain relatively high for Italian and Spanish banks, driven by the real economy weakness

Periphery Banks Weighed Down By Real Economy

Italian banks' provisioning is expected to remain high and pressure profitability. There is no evidence of a deceleration in NPL trends and building up provisioning coverage to 2007 levels – on a mix-adjusted basis – would result in a further €13bn of Italian banking sector provisioning, or comparable to 2013 forecast levels. Thus, we expect provisioning to remain higher for longer ([Italian Banks and Asset Quality - Political Uncertainty and Deteriorating Asset Quality](#), 11 December 2012).

Although we expect Spanish banks' reported provisioning to decline by c20% – after exceptional real estate-related provisioning – underlying provisioning is expected to remain high. Indeed, deteriorating NPL trends are expected to continue driven by the ongoing challenging macro environment and high unemployment. Caixabank was a case in point with a significant deterioration in non-real estate exposures in 3Q12 ([Spanish Banks - Revenue Pressure Ahead](#), 22 November 2012).

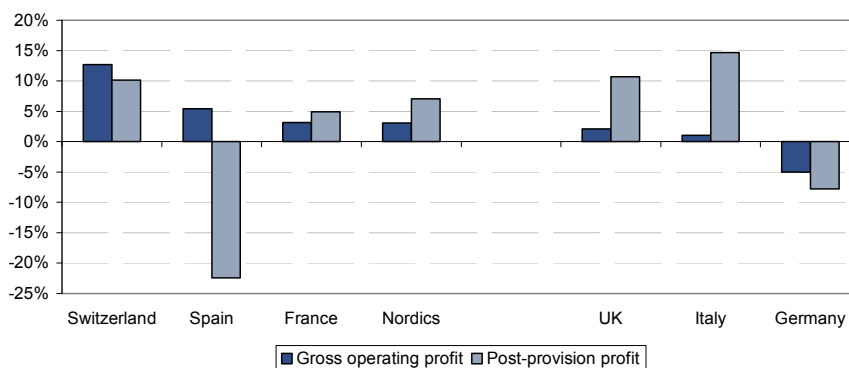
Figure 49. Provisioning Charge Trends, 2012-13E (% of Customer Loans)



Source: Citi Research

From a revenue perspective, we remain most cautious on Spanish banks, adjusted for scope effects. In particular, we expect commissions and NII to come under significant pressure due to weak margins and volumes, given the low level of economic activity. We expect this to outweigh cost control, driving deterioration in efficiency ratios. On the other hand, we expect Italian banks to exercise modestly better cost control driving a modest improvement in cost-income ratios.

Figure 50. Comparative Underlying P&L Trends, 2012-13E



Source: Citi Research

Our 2013 earnings forecasts are based on underlying trends excluding non-cash, non-recurring items.

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Macroeconomics

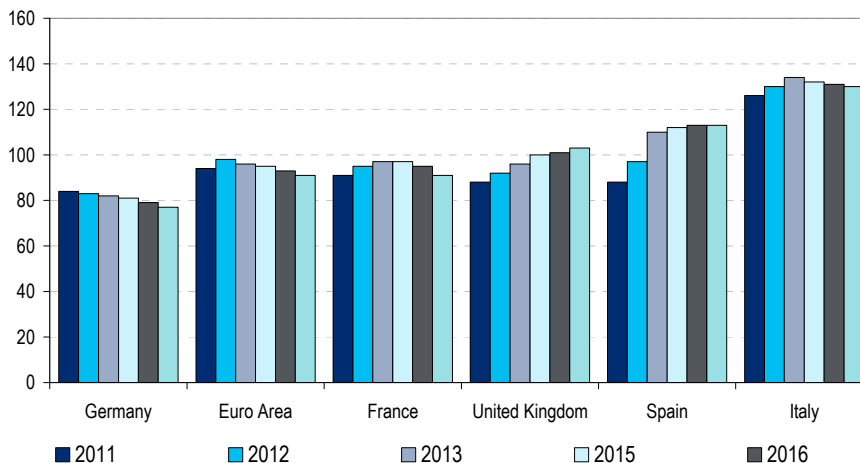
Global Economic Outlook³

Macro Backdrop

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Figure 51. Sovereign Debt-To-GDP Ratio Forecasts



Source: Citi Research Estimates, National Central Banks

Figure 52. Selected Countries — Financing Needs, Bond Redemptions and Budget Deficits, 2012-2014

Country/Group	2012		2013		2014		2012 - 2013 Q2		2012 - 2014 Q2	
	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit
Austria	0.0	0.8	16.1	6.7	24.8	5.8	2.8	4.1	19.7	10.4
Belgium	6.3	0.9	31.6	10.2	29.7	8.4	20.4	6.0	53.0	15.2
Cyprus	0.0	0.1	2.1	1.0	0.9	1.1	1.4	0.6	2.5	1.6
Finland	0.0	0.2	6.2	1.9	6.9	0.6	0.0	1.2	6.5	2.4
Greece	0.0	1.3	12.0	12.9	15.3	1.1	9.2	7.7	21.7	14.7
Ireland	0.0	2.2	5.6	12.9	7.6	9.2	-1.0	8.7	5.6	19.8
Italy	30.5	4.0	158.3	41.2	167.0	40.4	99.4	24.5	262.9	65.3
Spain	9.6	7.1	104.8	66.5	80.3	59.8	67.2	40.4	152.8	103.5
Portugal	1.3	0.7	8.2	8.1	17.0	6.9	1.6	4.7	18.6	12.2
France	5.7	7.3	105.6	77.4	121.8	63.9	45.3	46.0	165.1	116.7
Germany	19.8	0.1	208.0	9.4	189.0	13.7	137.1	4.8	334.6	16.3
Netherlands	12.7	1.9	50.7	21.3	33.1	23.6	45.8	12.6	79.3	35.0
GR+IR+PO	1.3	4.2	25.8	33.9	39.9	17.2	9.8	21.2	46.0	46.8
GR+IR+PO+BE	7.6	5.1	57.5	44.1	69.6	25.6	30.2	27.2	99.0	62.0
SP+IT	40.1	11.1	263.1	107.6	247.3	100.2	166.6	64.9	415.7	168.9
GR+IR+PO+BE+SP+IT+FR	53.3	23.5	426.2	229.2	438.8	189.8	242.1	138.1	679.8	347.5

Note: Excludes bailout programmes. Data collected as of 21 November. Budget deficit values correspond to Citi forecasts as 26 November

Source: Citi Research forecasts, Bloomberg

³ Extract From Pan-Europe Road Ahead 2013, published 5 December, 2012

Prospects for 2013 and Beyond: Recovery and Recession in a Divergent Outlook

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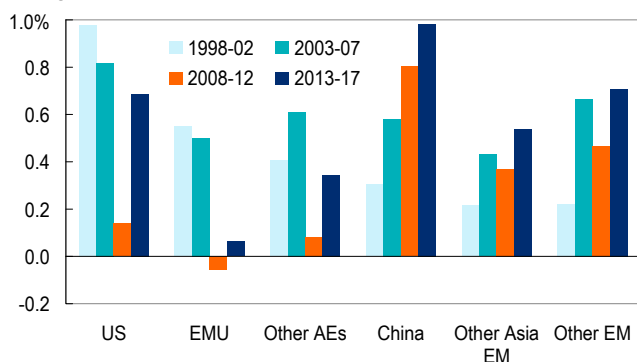
Global growth will probably remain subdued in 2013, gradually giving way to faster expansion subsequently

Growth will remain uneven, but more broad-based than recently

We expect that 2013 will be another year of modest global growth, a little below its longrun average, with sizeable divergences between regions and individual countries. Our base case is for global growth of 2.6% in 2013 and 3.1% in 2014 (at current exchange rates), after 2.5% in 2012. Our forecasts are a little below the consensus and IMF (the IMF expects global growth of 2.9% in 2013 and 3.5% in 2014 at current exchange rates). But, we do expect modest near-term growth to give way to faster expansion subsequently, with real global GDP growth of 3½%-4% YoY in 2015-17 (although our forecasts for later years also are a bit below the IMF's). Against this backdrop, major central banks will probably continue to keep policy loose near term, and generally loosen further in 2013, with tightening not until 2015 in the US and rather later in Europe and Japan.

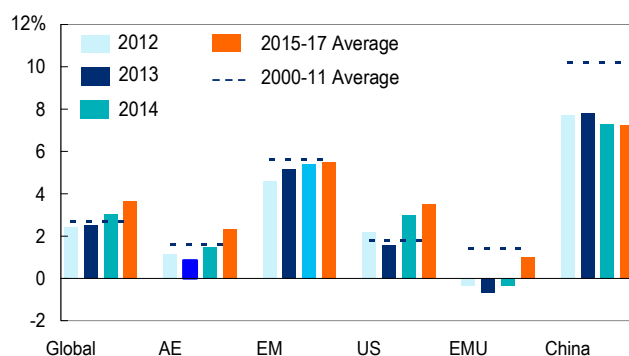
Over the last five years, global growth has been heavily China-dependent and China's growth has been heavily investment-dependent. In all, China's GDP has accounted for 45% of global growth in 2008-12 and an even bigger share including the spillovers from China's expansion to other countries. China's economy is now transitioning to a slower growth path of about 7% per year, with a marked pick up in consumer spending. China will remain a global powerhouse, with real GDP doubling every ten years or so and directly accounting for about a third of global growth in 2013-17e. Nevertheless, this impetus should be supplemented by a gradual but powerful renewed acceleration in US growth. In addition, we expect consumption and investment to grow rapidly across many emerging markets in coming years, especially in Asia and the Middle East, reflecting policy loosening plus background drivers of rapid growth of middle-income consumers, urbanization, and major infrastructure projects by cash-rich governments and state-linked bodies.

Figure 53. Global — Contributions to Global GDP Growth, Annual Averages, 1998-2017F



AE advanced economies. F Forecast. Note: Contributions measured at current exchange rates. Sources: IMF and Citi Research forecasts

Figure 54. Global — YoY Real GDP Growth By Region, 2000-17F



F Forecast. Source: Citi Research

The US is set for the greatest sustained outperformance versus the euro area for decades...

Although the global financial crisis hit both the US and Europe in 2007-09, we expect very different recovery paths, reflecting differing policy choices in managing the deleveraging process, plus underlying differences in terms of the supply-side and energy availability. In 2012, US real GDP growth outperformed the euro area by about 2¼%, the widest gap since 1993. We expect similar sustained US outperformance in coming years. With improving private sector balance sheets and falling energy costs, we believe that — provided near-term fiscal tightening is gradual — US growth will gradually transition to 3%+ from late-2013 and into subsequent years. US real GDP per head will probably regain the 2007 level in 2013 or 2014, and rise about 9-10% above the 2007 level by 2017 — clearly outperforming Japan's "lost decade" (real GDP per head rose by 5% from 1992-02).

...whereas the euro area and UK are likely to underperform Japan's "lost decade" in terms of real GDP per head

Key uncertainties concern the interplay between private deleveraging and fiscal tightening, plus the eventual resolution of the ongoing EMU crisis

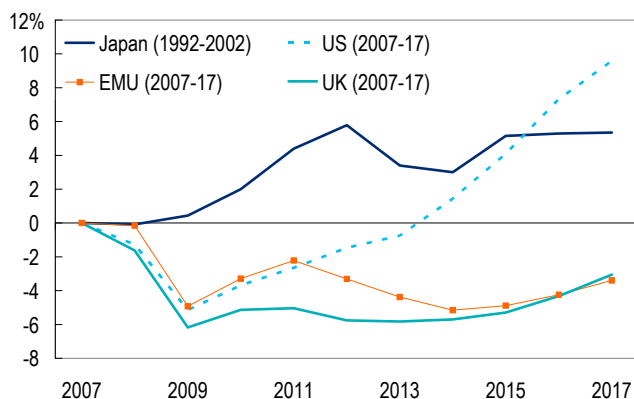
Global CA imbalances are likely to shrink, but may be a source of potential tension in some cases

By contrast, in the euro area, we expect continued recession in 2013 and 2014 and prolonged weakness thereafter — with ongoing financial strains and, over the next few years, Grexit plus a series of sovereign debt restructurings. In the euro area and UK, real GDP per head will probably remain 3-4% below the 2007 level even in 2017, with a greater shortfall in many periphery countries — markedly underperforming versus Japan's "lost decade". The European economies still have underlying potential to grow: but we expect that private sector deleveraging, weak banking system, early fiscal austerity and financial strains resulting from flawed EMU structures will continue to cap demand for an extended period.

The main uncertainties in the outlook concern the interplay between high private sector debts, and the high fiscal deficits across many advanced economies. Our base case assumes that US will manage a "Goldilocks" policy transition, with gradual fiscal tightening kicking in as private deleveraging eases. If fiscal consolidation is excessively deferred, then bond yields could back up sharply, especially as private savings fall. Conversely, as Europe's experience shows, aggressive early fiscal tightening could tip the US economy back into stagnation or worse. In Europe, we assume that in the near term, as recently, creditor nations will continue to do just enough — through official support — to prevent EMU disintegrating, but not enough to return the periphery countries to sustainable fiscal paths. Eventually, we expect Grexit and a series of sovereign debt restructurings, alongside moves towards tighter integration among EMU countries.

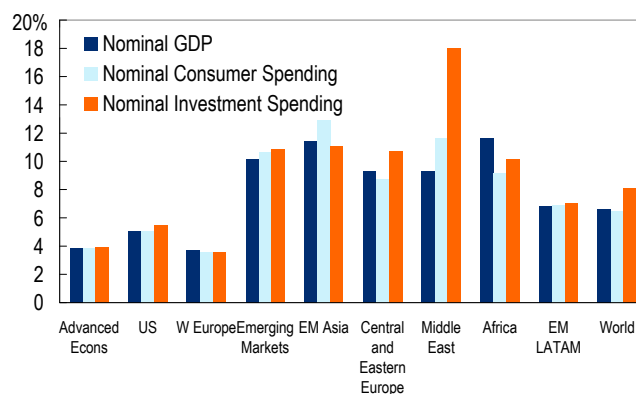
The aggregate current account surplus of EM countries is likely to vanish in coming years as the growth of domestic demand and imports continues to outpace advanced economies. However, sizeable imbalances will probably remain and some new ones will develop. We still expect that China will continue to run CA surpluses in coming years, while in aggregate other EM countries will run modest deficits. At the same time, the US will probably remain in CA deficit, while in the euro area, like Japan, sluggish domestic demand will probably produce persistent CA surpluses and capital outflows. By and large, we do not expect CA imbalances to be a major destabilising factor in the global outlook, but there may be strains in some individual EM countries.

Figure 55. US, Euro Area, Japan and UK — Cumulative Change in Real GDP Per Head After Banking Crises, 1992-2017F



Sources: World Bank, Datastream and Citi Research forecasts

Figure 56. Global — Expected Average YoY Growth of Nominal Economic Activity in USD Terms, 2012-20



Note: We aggregate nominal GDP at forecast exchange rates to 2017, extrapolations thereafter. Sources: IMF and Citi Research forecasts

Euro Area

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We expect the euro area to remain in recession in 2013 (-0.7%) and 2014 (-0.4%). The contraction will be deeper in the periphery countries than the core/ soft-core countries, but even the members of the latter group will at least flirt with recession. While there are differences in the weighting of the sources of economic weakness, in most cases it is a combination of private sector deleveraging, austerity measures and tight financing conditions producing an undershooting of the already-low growth potential. In addition, the ongoing risk of a euro area break-up — which has been substantially reduced by the ECB's OMT programme announcement — will undermine economic activity in the periphery countries. As we expect Greece to leave the euro within the next 12 to 18 months, probably in early 2014, our economic forecasts for the euro area from 2014 onwards excludes Greece. While we expect Grexit to happen (maybe followed by an exit by Cyprus) we do not foresee a broad break-up of the Euro area, because we expect governments and the ECB to put in place measures to contain its contagion.

Area-wide debt reduction only through Grexit and debt restructurings

In early 2013 weaker economic data than currently projected by governments are likely to raise doubts on government fiscal targets and we expect that most countries will fail to meet the requirements currently set by the Excessive Deficit Procedure (EDP). With a stronger focus on structural rather than headline deficits, the EDP targets will probably be amended and therefore we do not expect additional large rounds of austerity for 2013, maybe with the exception of Spain where even reaching the structural deficit target is questionable. However, with the exception of Germany, there seems to be little room for fiscal easing in 2013 and we do not expect that already planned fiscal tightening will be withdrawn. In our view, a crucial factor is that policy makers are unlikely to change their assessment that more fiscal tightening is necessary. Therefore additional gradual austerity measures are in the pipeline for 2014 and beyond. In this environment, we expect a reduction of the area wide deficit-to-GDP ratio from 3.3% in 2012 to 2.9% in 2013 and 2.4% in 2014. This would be substantially smaller than the pace of deficit reduction in the previous two years, when the deficit-to-GDP ratio fell by 2.9 points. We forecast a further increase of the area wide debt-to-GDP from 94.5% in 2012 to 97.5% 2013. If Greece stayed in the euro area in 2014 and without sovereign debt restructurings in Portugal, we estimate the debt-to GDP ratio would reach 100% in 2014. From 2015 onwards some debt restructuring in Spain, Italy and Ireland (mainly in form of maturity extension and a reduction of coupons by around 150 basis points) will probably help to lead to a reduction in the euro area 2015 deficit-to-GDP ratio to 1.5% and a decline in the debt ratio from 95.7% of GDP in 2014 to 95.0% in 2015 down to 91.4% in 2017.

Limited use of the OMT in 2013

With future sovereign debt restructurings, in most cases probably coming together with bank restructuring (Slovenia and Cyprus might see only the latter) spreads of public and private sector funding costs will remain large between periphery and core countries. While the ECB's OMT programme will likely keep sovereign bond spreads in a range of up to 300bp relative to Bunds, we doubt that the ECB will use it to force a narrowing of spreads below 100bp. In our view, there is no chance that the ECB will use the OMT programme for a country that is not under an ESM/EFSF programme. Therefore, we expect that, after facing increasing market pressure, first Spain, and then Italy, will ask for ESM programmes in the form of an Enhanced Conditions Credit Line (ECCL). As market participants will probably not be keen to "fight the ECB" at the beginning of the programme, the OMT purchases should be relatively small in 2013. With only Spain and Italy qualifying for the OMT in 2013, maybe joined by Ireland at the end of the year, we expect total OMT purchases in a range between €100bn and €200bn, maybe even lower. This suggests that with a likely use of the repayment option of the 3Y LTROs — which we expect to be

around €200bn — the ECB's balance sheet of currently €3.03trn (32% of GDP) is likely to move sideways in 2013.

The initial positive effects on government bond markets from the activation of the OMT in early 2013 are likely to prevent an escalation of the liquidity squeeze among banks at least in 1H 2013, despite some disappointment of market participants in respect of the speed of the implementation of the single supervision mechanism (SSM) and the strength of the banking union. While the ECB will remain ready to step in with an easing of collateral rules and additional multi-year (probably for 3 years) LTROs to prevent liquidity shortages in the banking sector, it will probably take until early 2014 (when we expect Grexit could happen) for the ECB to engage in further rounds of LTROs.

Further ECB rate cuts to come

We expect the ECB to cut interest rates further, as it is likely to become more obvious to the General Council that inflation will undershoot the inflation target of "close, but below to 2%" in the medium term. We expect a 25bp cut of the refi rate in 1Q 2013, followed by a second refi rate cut, which will be probably come in combination with a cut of the deposit rate by 25bp (to -0.25%) in mid 2013. With more possibilities for the banks to reduce excess liquidity (option to repay 3Y LTRO funding) the ECB will probably use the negative deposit rate to increase the pressure on banks to "use" the available liquidity. In addition, following the successful example of Denmark, the ECB might use a negative deposit rate to reduce upside pressure on the currency. The alternative to limiting upside pressure on the currency would be a Fed-like verbal intervention, by committing to keep interest rates low for a prolonged period of time. Such a policy does not look very likely for the ECB, in our view, because it would take away its ability to react quickly to a surprising increase of inflation risks. However, in a likely backdrop of low growth and low inflation, we see no interest rate hikes until 2016/17.

We publish further details of our European forecasts monthly in [European Economic Forecast Highlights](#)

Figure 57. Euro Area — Economic Forecasts, 2012-14F

					2012F		2013F				2014F	
		2012F	2013F	2014F	3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-0.4%	-0.7%	-0.4%	-0.6%	-0.7%	-0.9%	-0.7%	-0.6%	-0.2%	-0.3%	-0.4%
	SAAR				-0.3	-1.7	-0.7	0.0	0.1	-0.2	-1.2	-0.4
Final Domestic Demand	YoY	-1.4	-1.1	-0.5	-1.6	-1.6	-1.5	-1.2	-1.0	-0.7	-0.8	-0.7
Private Consumption	YoY	-1.1	-0.9	-0.2	-1.3	-1.1	-1.1	-0.9	-0.8	-0.6	-0.5	-0.4
Government Consumption	YoY	-0.2	-0.9	-0.5	-0.1	-0.6	-0.9	-1.1	-0.9	-0.6	-0.6	-0.5
Fixed Investment	YoY	-3.6	-2.1	-1.4	-4.1	-4.2	-3.4	-2.2	-1.6	-1.2	-1.6	-1.6
— Business Equipment	YoY	-3.1	-2.1	-2.4	-3.6	-3.7	-2.8	-2.0	-2.1	-1.4	-2.4	-2.7
— Construction	YoY	-3.9	-1.9	-0.5	-3.8	-4.1	-3.1	-1.7	-1.4	-1.3	-1.1	-0.8
Stocks (Contrib. to Y/Y GDP Growth)		-0.4	-0.1	-0.1	-0.5	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1
Exports	YoY	2.7	1.5	0.7	2.4	2.3	1.9	1.1	1.2	1.7	1.1	0.6
Imports	YoY	-0.5	0.2	0.2	-1.0	0.2	0.3	-0.1	0.1	0.3	0.0	-0.2
CPI	YoY	2.6	2.0	1.5	2.5	2.5	2.0	2.1	2.0	1.7	1.6	1.5
Core CPI	YoY	1.6	1.3	1.1	1.6	1.7	1.3	1.4	1.4	1.1	1.1	1.1
CPI Ex Energy and Food	YoY	1.8	1.4	1.2	1.7	1.8	1.4	1.6	1.5	1.2	1.8	-0.3
Unemployment Rate	YoY	11.3	11.9	12.2	11.5	11.7	11.7	11.8	11.9	12.0	12.1	12.2
Current Account Balance	EUR bn	89.1	118.9	122.5								
	% of GDP	0.9	1.2	1.3								
General Government Balance	EUR bn	-314.3	-276.3	-237.4								
	% of GDP	-3.3	-2.9	-2.4								
Primary Balance	% of GDP	0.0	0.5	0.8								
General Government Debt	EUR bn	8,977.9	9,342.9	9,277.9								
	% of GDP	94.5	97.5	95.7								
Gross Operating Surplus	YoY	-0.4	-0.5	0.1								

Sources: Eurostat and Citi Research forecasts

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Germany

With manufacturing suffering from weak external demand, the German economy is likely to enter a period of weak growth, with a risk of slipping into recession around the turn of 2012/13. However, resilient domestic demand, supported by historically low funding costs and low private debts, is likely to prevent a sharp economic downturn. We expect that fiscal easing of between ¼% and ½% of GDP will also help stabilize growth. Political stalemate is likely before the general election, which is due in autumn (probably September) 2013. In our view, it looks unlikely that the current CDU/CSU and FDP coalition will be re-elected, but Angela Merkel will probably stay as Chancellor, most likely of a grand-coalition of CDU/CSU and SPD.

France

Investors have been worried for some time about the French economy, wondering whether greater reliance on tax increases than expenditure cuts to close the budget gap would threaten the already-fragile GDP baseline. The evidence to date suggests that France has narrowly avoided falling back into recession, with a 0.2% QQ gain in 3Q GDP. Nevertheless, we continue to see downside risks to economic activity in 2013, and forecast a mild recession of 0.2% as the government's fiscal tightening strategy will have negative consequences on GDP. However, the government is taking clear steps to tackle some of its structural issues, having announced a National Pact for Growth, Competitiveness and Employment. We view this as a positive development, confirming that France is finally undertaking some of the necessary reforms that should over time help to lift potential growth.

Italy

The recession is likely to continue in the next couple of years, reflecting fiscal tightening (albeit smaller than in 2012), tight credit conditions and high uncertainty. Political uncertainty will probably rise ahead of the general election in spring 2013, with fears that the new government will be less committed to austerity and reforms than the current Monti-led administration. Italy's primary surplus will probably be close to 3% of GDP by end-2013, but the debt-to-GDP ratio is likely to go on rising due to the "snowball effect". Possible Grexit and further sovereign debt restructurings in the eurozone periphery should intensify headwinds to growth in 2014. We expect Italy will enter into an OMT/ESM financial support programme in 2013 which will cap financing costs. However, debt restructuring — probably through maturity extensions and coupon reductions — will probably be inevitable in 2015, once it becomes clear that austerity alone cannot restore fiscal sustainability.

Figure 58. Germany, France and Italy — Economic Forecasts, 2012-14F

		Germany			France			Italy		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	0.9%	0.5%	0.3%	0.1%	-0.2%	0.2%	-2.1%	-1.2%	-1.5%
Final Domestic Demand	YoY	0.7	1.2	1.2	0.4	-0.1	0.2	-3.9	-2.7	-2.3
Private Consumption	YoY	0.9	1.2	0.7	0.0	-0.1	0.1	-3.7	-2.8	-1.4
Fixed Investment	YoY	-0.3	1.9	2.8	0.4	-0.6	0.4	-8.0	-4.9	-7.5
Exports	YoY	4.1	0.7	1.3	2.5	1.4	0.6	1.4	1.4	-1.9
Imports	YoY	2.8	1.7	2.6	0.1	0.6	0.6	-7.9	-3.9	-5.2
CPI	YoY	2.0	1.9	2.5	2.3	1.5	1.8	3.3	1.8	1.2
Unemployment Rate	%	5.5	5.8	6.0	9.8	10.3	10.0	10.7	11.9	12.4
Current Account	€bn	162.2	133.3	112.1	-37.1	-20.5	-4.9	-19.7	-14.1	-10.2
	% of GDP	6.1	5.0	4.1	-1.8	-1.0	-0.2	-1.3	-0.9	-0.7
General Govt. Balance	€bn	-1.0	-9.4	-13.7	-87.1	-77.4	-63.9	-47.7	-41.2	-40.4
	% of GDP	0.0	-0.3	-0.5	-4.3	-3.7	-3.0	-3.0	-2.6	-2.6
Primary Balance	% of GDP	2.0	1.1	0.6	-2.1	-1.4	-0.6	2.2	2.7	2.9
General Govt. Debt	% of GDP	84.0	82.7	82.2	91.0	95.2	96.7	126.5	129.7	133.5
Gross Trading Profits	YoY	1.0	-2.4	-2.9	1.0	2.0	4.0	NA	NA	NA

F Citi forecast. YoY Year-to-year growth rate. Note: The German annual figures are derived from quarterly Bundesbank data and adjusted for working days. Forecasts for GDP and its components are calendar adjusted. Sources: Deutsche Bundesbank, Statistisches Bundesamt, INSEE, Haver and Citi Research forecasts

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Spain

We keep our GDP growth forecasts for 2012-14 virtually unchanged at -1.5% (2012), -2.4% (2013) and -1.9% (2014). Popular pressures to provide homeowners with mortgage relief and fading willingness of EA creditor countries to mutualise legacy bank liabilities lead us to assume an additional €60bn (6% of GDP) in bank bail-outs by the sovereign in 2014. We continue to expect Spain to enter a precautionary ESM programme (with OMT support) soon, but do not expect it to succeed in returning Spain to fiscal sustainability and expect some form of debt restructuring in 2015, via coupon reductions and maturity lengthening.

Greece

With ongoing recession, the 2012 fiscal deficit target (6.6% of GDP) is likely to be missed, despite savings from PSI. The disbursement of the latest bailout tranche remains uncertain, leaving some risks of Grexit near term. Even if the tranche is paid and creditors provide Greece with liquidity for a few more quarters, Greece will remain insolvent, in our view, unless there is major restructuring on official debt (unlikely, we believe). We see a likelihood that Greece decides (or is “gently” forced) to leave EMU in the next 12-18 months. We expect that the immediate aftermath of Grexit would see further economic weakness and surging inflation.

Ireland

Ireland’s economic and fiscal prospects remain weak, in our view. Domestic demand and employment have fallen for five consecutive years, while — even after relentless austerity — the European Commission judges that the structural fiscal deficit is still 7-8% of GDP. We expect that — on current policies — the debt/GDP ratio will peak above 120% and still exceed 110% even in 2020 (a debt/GNP ratio of 130-140%). With a high debt ratio and acute vulnerability to external shocks, we expect that Ireland will need external support for many years. We assume that the coupon payments on the promissory notes will be halved in 2013, no transfer of bank recapitalisation costs to the ESM, and eventual sovereign debt restructuring (coupon reductions and maturity extensions) in 2015 to cut the fiscal deficit further.

Portugal

With heavy fiscal tightening — worth 3.2% of GDP in 2013, including more tax hikes — plus high private debts, 2013 will probably be another year of deep recession. This will likely lead to a further deficit overshoot. We expect Portugal will probably need additional external support by the end of 2013/early 2014, when the current programme nears its end. Like Greece, this will likely prompt requests for a haircut on the sovereign debt in order to limit the exposure of official creditors. The re-balancing of the economy has only just started, we reckon, and it will take a few more years to complete.

Figure 59. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2012-14F

		Spain			Greece			Ireland			Portugal		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.5%	-2.4%	-1.9%	-7.2%	-7.4%	-11.8%	-0.1%	0.4%	1.0%	-3.3%	-4.6%	-2.4%
Final Domestic Demand	YoY	-3.9	-4.6	-3.4	-9.2	-8.6	-13.1	-3.6	-3.7	-1.6	-7.3	-6.0	-3.1
Private Consumption	YoY	-1.8	-2.7	-1.6	-8.2	-7.4	-14.5	-2.5	-2.3	-1.5	-6.2	-5.5	-1.0
Fixed Investment	YoY	-8.9	-7.7	-7.3	-17.8	-15.4	-22.3	-7.1	-9.9	1.5	-15.2	-10.7	-10.7
Exports	YoY	3.7	6.2	0.3	-1.5	0.0	-9.3	2.7	3.1	3.1	4.5	1.2	-0.9
Imports	YoY	-3.9	-0.5	-4.3	-7.5	-5.9	-14.1	-0.6	0.8	1.2	-6.3	-2.9	-3.2
CPI	YoY	2.4	1.9	0.4	1.0	0.3	16.7	1.7	1.2	1.4	2.8	1.7	0.9
Unemployment Rate	%	25.0	26.6	27.4	24.6	29.7	35.9	15.1	16.2	16.9	15.5	18.0	19.9
Current Account	€bn	-16.1	13.6	30.3	-8.7	-6.2	3.8	8.0	10.8	11.8	-6.2	-2.3	-1.7
	% of GDP	-1.5	1.3	3.0	-4.5	-3.5	2.0	5.0	6.6	7.0	-3.7	-1.4	-1.0
General Govt. Balance	€bn	-85.8	-66.5	-59.8	-15.4	-12.9	-1.1	-13.5	-12.9	-9.2	-8.3	-8.1	-6.9
	% of GDP	-8.2	-6.4	-5.8	-8.0	-6.7	-1.5	-8.3	-7.9	-5.5	-5.0	-5.0	-4.3
Primary Balance	% of GDP	-4.1	-2.6	-1.6	-2.3	-1.5	-1.5	-4.3	-2.6	-0.4	-0.5	-0.2	0.0
General Govt. Debt	% of GDP	87.9	97.5	110.0	178.0	192.8	453.2	117.8	120.9	122.1	121.1	132.2	105.1

F Citi forecast. YoY Year-to-year growth rate. For Ireland we show the GDP deflator rather than the CPI, for Spain fiscal deficits include the effect of financial support for banks in 2011 (€5.4bn) and 2012 (€11.6bn). Sources: ISTAT, INE, Haver Analytics, Eurostat and Citi Research forecasts

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Netherlands

The coalition of PM Mark Rutte's centre-right VVD and the centre-left PdL agreed on extra fiscal tightening worth about 2½% of GDP for the period 2013-17. Trying to reduce income inequality, the tightening is biased to high-income households. Tax deductibility of mortgage interest payments will be reduced from 2014 onwards. We expect that household deleveraging — which has barely started — will be a headwind for GDP growth in 2013 and beyond. With a likely contraction in GDP in 2013, we doubt that the government will be able to reduce the deficit to a ratio below 3% of GDP as required under the EDP.

Belgium

Prospects for the Belgian economy will remain challenging in 2013. Because of its high openness, the economy is sensitive to external demand (particularly from other EMU countries) for its intermediate goods exports. With less fiscal tightening than, for example, France or the Netherlands during 2013, we anticipate that domestic demand will recover marginally, helping limit the contraction in GDP to 0.3% in 2013. The main risk to the already elevated debt numbers continues to be related to the size of the contingent liabilities extended to the banking sector.

Slovakia

GDP increased by 0.6%QoQ in 3Q12 as we expected, still driven by car production, whereas there was a downward revision in previous quarters. We expect a larger deceleration to 2.1%YoY in 4Q12 (0.4%QoQ) owing to weaker export and industrial activity. As a result we cut our GDP growth estimates in 2012-2014. Although the government has both solid financing and budget reserves, the deficit is likely to slightly exceed 3% of GDP in 2013. We expect more cuts in the social and health care systems in the future to keep the consolidation on track.

Slovenia

Optimism after the MinFin tapped the market for USD2.25bn was impaired by referendum woes. While the 35-day period to collect 40k signatures to evoke a referendum on the Bad Bank started on 19 November, the government will ask the Constitutional Court for its review. If the Bad Bank law is not put in place, Slovenia is likely to be closer to ask for help from the ESM. The National Assembly approved the government proposal of tax, pension and labour market reforms in the first reading; however, the legislative process in the National Assembly is not yet finished. Previous PM Borut Pahor and current President Danilo Turk proceeded to the second round of the Presidential election, which will take place on 2 December.

Figure 60. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2012-2014F

		Netherlands			Belgium			Slovakia			Slovenia		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	-1.1%	-0.9%	0.2%	-0.2%	-0.3%	0.3%	2.5%	1.3%	1.7%	-2.0%	-1.6%	-0.5%
Final Domestic Demand	YoY	-1.6	-1.2	0.0	-0.3	0.2	0.6	-0.2	0.6	1.2	-3.5	-3.4	-0.6
Public Consumption	YoY	0.5	0.1	0.0	0.2	0.0	0.3	-0.5	-0.8	0.2	-2.9	-5.3	-1.0
Private Consumption	YoY	-1.6	-1.5	0.1	-0.5	0.1	0.5	-0.2	0.2	0.5	-1.9	-2.7	-0.8
Investment (Ex Stocks)	YoY	-5.0	-2.5	-0.2	-0.1	0.5	1.4	-0.3	2.3	3.3	-8.2	-3.6	0.0
Exports	YoY	2.5	0.5	0.8	-0.6	0.8	1.1	7.9	2.1	2.8	1.4	-0.2	0.1
Imports	YoY	2.2	-0.2	0.5	-0.8	0.9	1.4	4.5	1.6	2.3	-2.9	-3.3	1.0
CPI (Average)	YoY	2.6	2.8	1.7	2.9	1.9	1.9	3.7	3.0	2.5	2.7	3.0	2.5
Unemployment Rate	%	6.2	6.9	7.0	7.4	7.8	7.4	13.4	13.8	14.0	8.5	9.3	10.3
Current Account	% of GDP	10.1	9.6	8.7	-0.7	0.3	0.9	2.5	1.9	1.8	1.7	1.9	2.3
General Govt Balance	% of GDP	-3.8	-3.4	-3.7	-2.8	-2.7	-2.1	-4.9	-3.1	-2.9	-4.2	-3.3	-2.8
Primary Balance	% of GDP	-2.2	-2.1	-2.1	-0.3	0.3	1.0	-3.4	-1.6	-1.4	-2.1	-1.1	-0.5
General Govt Debt	% of GDP	69.6	72.2	74.6	109.9	116.0	115.8	52.1	54.5	55.4	52.9	57.1	60.5

F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Research forecasts

UK

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The economy continues to underperform versus consensus, official forecasts and recent cycles. The technical rebound in GDP in Q3 appears to have given way to zero or negative growth in Q4. For 2012 as a whole, growth was around zero, well below the start of year consensus (0.5%), making the fourth year in the last five with sub-consensus growth. We expect another undershoot in 2013, with growth of about 0.8% versus the 1.2% consensus. The economy faces powerful headwinds from private deleveraging, poor credit availability, heavy fiscal drag, the EMU crisis and the bias among companies to allocate new investment overseas. We expect that real GDP will not regain the prerecession peak (Q1-2008) until 2016. Real GDP per head will probably remain below its peak (Q4-2007) even at the end of this decade (ie Q4-2019). Inflation should remain sticky near term, reflecting increases in external costs and university tuition fees. However, we believe that medium-term risks are firmly tilted to an inflation undershoot, given the sluggish economy. As a result, we continue to expect some modest further increase in QE over time.

In the Autumn Statement (Dec 5), the Chancellor is likely to confirm that the weakness of nominal GDP growth has caused tax revenues to undershoot the OBR forecasts by 1-2% this year, with a further undershoot likely in 2013 and beyond. The Chancellor is likely to go ahead with the existing fiscal plans, which imply heavy drag — of about 1½% of GDP — in both 2013 and 2014. However, contrary to our fears last month, we no longer expect the Chancellor will have to scrap the debt target. Indeed, he may well extend the debt target, announcing a new target of lower debt beyond 2015. The key point is that the OBR will probably project that the UK remains on course to hit the debt target, despite weak revenues, because of downward revisions to debt service payments (reflecting lower gilt yields and a lower path for future RPI inflation) and the transfer of the APF's net interest income to the Treasury's accounts.

Figure 61. United Kingdom — Economic Forecasts, 2012-2014F

		2012F	2013F	2014F	2012F		2013F				2014F	
					3QF	4QF	1QF	2QF	3QF	4QF	1QF	2QF
Real GDP	YoY	-0.1%	0.8%	1.0%	-0.1%	0.2%	0.8%	1.3%	0.5%	0.8%	0.9%	0.9%
	SAAR				4.0	-0.4	1.1	0.7	0.5	0.9	1.7	0.5
Domestic Demand (Incl. Inventories)	YoY	0.4	0.1	0.8	0.2	0.5	0.5	0.0	-0.3	0.4	0.6	0.8
	SAAR				1.6	-1.6	0.3	-0.2	0.4	1.2	1.1	0.4
Consumption	YoY	0.7	0.9	1.3	1.3	1.3	1.1	1.4	0.6	0.5	0.8	1.1
	SAAR				4.1	0.7	0.5	0.5	0.5	0.6	1.6	1.7
Investment	YoY	0.3	-3.1	-1.6	-1.7	-0.4	-1.8	-4.0	-3.0	-3.6	-3.9	-0.6
	SAAR				-5.5	2.6	7.1	-18.4	-1.2	-0.1	6.0	-6.7
Exports	YoY	0.6	4.1	4.7	2.2	0.7	3.4	5.4	4.3	3.5	4.3	4.2
	SAAR				7.9	6.0	4.1	3.6	3.5	2.8	7.2	3.5
Imports	YoY	2.4	1.9	4.0	3.1	1.8	2.3	1.1	1.7	2.2	3.1	3.8
	SAAR				0.7	1.7	1.5	0.7	3.0	3.7	5.1	3.2
Unemployment Rate	%	8.0	7.8	7.6	7.8	8.0	8.0	7.8	7.8	7.7	7.6	7.6
CPI Inflation	YoY	2.8	2.5	2.1	2.4	2.6	2.5	2.6	2.6	2.3	2.2	2.1
Merch. Trade	£bn	-99.8	-86.9	-84.8								
	% of GDP	-6.4	-5.4	-5.1								
Current Account	£bn	-60.4	-40.4	-35.7								
	% of GDP	-3.9	-2.5	-2.2								
PSNB	£bn FY	-86.1	-73.5	-90.8								
	% of GDP	-5.5	-4.5	-5.5								
General Govt. Balance	% of GDP	-5.9	-5.0	-5.9								
Government Primary Balance		-3.3	-4.0	-3.1								
Public Debt	% of GDP	88.0	92.0	96.4								
Gross Nonoil Trading Profits	YoY	6.4	8.8	3.5								

Note: Fiscal deficit shown excluding financial interventions. F Citi forecast. YoY Year-to-year growth rate. Sources: ONS and Citi Research forecasts

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Switzerland

The Swiss economy has slowed in 2012, but continues to outperform the euro area — as it has done every year since 2004. Exports slowed during 2012, hit by EMU weakness, but this has been largely offset by a pick up in consumer spending — supported by solid gains in employment and house prices. We expect the Swiss economy will continue to outperform in coming years. Household debt remains quite low, offering continued traction from low interest rates, while exports are underpinned by high exposure to emerging markets. External uncertainties will probably sustain inflows to Swiss assets at a high pace, keeping inflation negative or low and hence allowing the SNB to keep interest rates ultra-low for many years.

Sweden

Earlier signs of Swedish resilience have now been reversed, but supportive economic policies suggest that a recession in Sweden should be avoided; fiscal policy will add stimulus of 0.6% of GDP next year and we expect expansion of an equivalent size in 2014. The Riksbank's policy rate stands near historically low levels and is likely to fall further heading into 2013. Being a small open economy, a major risk clearly relates to external demand prospects, especially from Western Europe.

Denmark

The Danish economy is expected gradually to return to the growth track next year, supported by households' large pent-up potential (which gradually should boost consumer spending), a delayed positive contribution from public sector consumption and investment and improved competitiveness. Risks, however, are substantial and tilted to the downside, and the Danish economy is unlikely to get back to pre-crisis output levels during the forecast period.

Norway

Norway will likely suffer a bit from the slowdown across advanced economies, but the cushion of high oil receipts should ensure that the economy continues to outpace most other European economies, and mainland GDP is seen above its long-term average in coming years. Underlying inflation remains low and, with the currency still strong, Norges Bank can afford to keep interest rates stable and see how the EMU crisis unfolds. Global slowdown or lower international policy rates will put a limit on how rapidly the Bank can tighten monetary policy ahead, but is unlikely to change the Bank's tightening bias.

Figure 62. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2012-2014F

		Switzerland			Sweden			Denmark			Norway		
		2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Real GDP	YoY	1.1%	0.9%	0.6%	1.0%	1.6%	2.3%	0.1%	1.0%	1.7%	3.4%	3.1%	2.7%
Final Domestic Demand	YoY	2.2	0.7	0.8	1.7	1.6	2.0	0.8	1.3	1.6	2.8	3.6	3.1
Public Consumption	YoY	2.1	1.5	1.4	0.9	1.1	0.8	0.2	0.8	0.6	1.9	2.5	2.3
Private Consumption	YoY	2.3	0.5	1.9	1.5	1.7	2.2	0.7	1.2	1.7	3.2	3.5	3.1
Investment (Ex Stocks)	YoY	1.9	0.9	-2.5	3.5	1.8	3.4	2.2	2.4	2.9	3.1	5.7	4.2
Exports	YoY	0.7	2.5	0.9	0.5	2.7	3.6	2.3	2.6	3.1	2.9	2.7	2.9
Imports	YoY	1.9	1.4	1.3	0.0	2.3	3.2	2.7	2.9	3.1	5.0	3.0	2.5
CPI (Average)	YoY	-0.7	-1.4	-0.9	0.9	0.6	1.7	2.5	2.0	2.1	0.8	1.7	2.0
Unemployment Rate	%	3.2	3.5	4.2	7.6	7.8	7.9	7.8	7.8	7.6	3.0	3.1	3.1
Current Account	% of GDP	12.7	13.1	13.0	6.6	6.6	6.3	5.4	5.4	4.4	14.3	14.9	15.2
General Govt Balance	% of GDP	0.6	0.4	0.3	-0.3	-0.9	-0.3	-3.8	-2.0	-1.2	13.2	14.0	13.7
General Govt Debt	% of GDP	46.6	45.5	44.1	36.6	36.7	35.6	49.1	49.7	49.0	NA	NA	NA

^a For Norway, mainland GDP. F Citi forecast. YoY Year-on-year growth rate. Sources: National sources and Citi Research forecasts

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Appendix

Figure 63. Wholesale Bank Restructuring – FICC Business Lines

Currency Bank Division	SFrm CS IB	SFrm UBS IB	EURm DBK CB&S	£m BARC IB	£m RBS IB Adv & Cap Mkts	EURm BNPP	EURm SOGN IB	EURm CASA IB
FICC (Pre-restructuring)								
Revenues	6,196	5,165	9,832	7,447	4,395	4,667	2,723	1,610
Comp Expense	2,478	2,944	4,129	2,383	1,494	2,427	1,334	757
Non-comp Expense	2,008	1,580	2,590	1,713	1,351	972	453	326
Pre-tax Profit	1,709	641	3,112	3,351	1,549	1,268	936	527
Net Profit	1,282	481	2,147	2,513	1,162	888	655	369
Gross RWAs	117,300	132,000	268,500	216,000	137,750	78,647	54,216	58,585
Equity	11,730	13,200	26,850	21,600	13,775	7,865	5,422	5,859
RoE (Pre-restructuring)	11%	4%	8%	12%	8%	11%	12%	6%
FICC (Exited)								
Actions	Exit Macro & Commodities	Exiting Majority of Rates & Credit	None	None	Exit Non-UK FICC	Exit 50% Credit & Commodities	Exit 50% Credit & Commodities	Exit FICC
Revenues	1656	3,609			2,276	1,633	681	1,610
% Change in Revenues	27%	70%			52%	35%	25%	100%
Comp Expense	745	1,985			1138	817	340	757
Comp/Revenue	45%	55%			50%	50%	50%	47%
Non-comp Expense	662	1,263			683	490	204	326
Non-comp/Revenue	40%	35%			30%	30%	30%	20%
Cost/Income	85%	90%			80%	80%	80%	67%
Pre-tax Profit	248	361			455	327	136	527
Post-tax Profit	186	271			341	229	95	369
RWAs	36,387	90,000			71,490	29,773	14,059	58,585
Equity	3639	9000			7149	2977	1406	5859
RoE (Exit Business)	5%	3%			5%	8%	7%	6%
FICC (Restructured)								
Revenues	4540	1,556	9832	7447	2119	3,033	2,042	-
Comp Expense	1733	959	4129	2383	356	1,610	994	-
Non-comp Expense	1346	316	2590	1713	668	482	248	-
Cost/Income	68%	82%	68%	55%	48%	69%	61%	na
Post-tax Profit (Restructured Business)	1096	210	2147	2513	821	659	560	0
RWAs	80,913	42,000	268,500	216,000	66,260	48,874	40,156	-
Equity	8091	4,200	26850	21600	6626	4,887	4,016	-
RoE	14%	5%	8%	12%	12%	13%	14%	na

Source: Company Reports, Citi Research

Figure 64. Wholesale Bank Restructuring – Equities Business Lines

Bank Division	SFrm CS IB	SFrm UBS IB	EURm DBK CB&S	£m BARC IB	£m RBS IB Adv & Cap Mkts	EURm BNPP	EURm SOGN IB	EURm CASA IB
Equities, IB & Other								
Revenues	7,360	4,644	6,077	4,302	376	1,713	2,206	946
Comp Expense	3,442	2,221	3,507	2,199	237	763	1,229	828
Non-comp Expense	2,386	1,420	1,601	990	116	357	367	192
Pre-tax Profit	1,532	1,003	969	1,113	23	593	611	(74)
Net Profit	1,149	752	669	835	17	415	427	(52)
Gross RWAs	69,955	30,000	89,500	54,000	7,250	19,662	20,052	6,509
Equity	6,995	3,000	8,950	5,400	725	1,966	2,005	651
RoE (Pre-restructuring)	16%	25%	7%	15%	2%	21%	21%	-8%
Exit Equities, IB & Other								
Actions	None	None	Exit Cash Equities & 1/4 IB	Exit Cash Equities + 1/3 IB	Exit Structured Equities	Exit Cash Equities	Exit Cash Equities	Exit Equities
Revenues			1,599	1,112	376	343	441	946
% Change in Revenues			26%	26%	100%	20%	20%	100%
Comp Expense			1,280	890	237	257	353	828
Comp/Revenue %			80%	80%	63%	75%	80%	88%
Non-comp Expense			560	389	116	103	132	192
Non-comp/Revenue %			35%	35%	31%	30%	30%	20%
Cost/Income			115%	115%	94%	105%	110%	108%
Pre-tax Profit			(240)	(167)	23	(17)	(44)	(74)
Post-tax Profit			(166)	(125)	17	(12)	(31)	(52)
RWAs			7889	1974	7250	1119	1441	6509
Equity			789	197	725	112	144	651
RoE (Exit Business)			-21%	-63%	2%	-11%	-21%	-8%
Equities, IB & Other (Restructured)								
Revenues	7,360	4,644	4,478	3,190	-	1,371	1,765	-
Comp Expense	3,442	2,221	2,228	1,309	-	506	876	-
Non-comp Expense	2,386	1,420	1,041	600	-	254	234	-
Cost/Income	79%	78%	73%	60%	na	55%	63%	na
Post-tax Profit	1,149	752	834	960	-	427	458	-
RWAs	69,955	30,000	81,611	52,026	-	18,542	18,611	-
Equity	6,995	3,000	8,161	5,203	-	1,854	1,861	-
RoE	16%	25%	10%	18%	na	23%	25%	na

Source: Company Reports, Citi Research

Figure 65. Companies mentioned

Company	RIC	Rating	TP Currency	Target Price	Current Price
Banco Popolare	BAPO.MI	2	EUR		1.32
Banco Popular	POP.MC	3 H	EUR	0.40	0.63
Banco Santander	SAN.MC	2 H	EUR	5.50	6.30
Banesto	BTO.MC	2 H	EUR	3.20	3.63
Bank of America	BAC.N	2	USD	12.00	11.97
Bankinter	BKT.MC	3 H	EUR	2.40	3.60
Barclays	BARC.L	1	GBP	4.00	2.74
BBVA	BBVA.MC	2 H	EUR	6.30	7.23
Bco de Sabadell	SABE.MC	3 H	EUR	1.10	2.02
BNP Paribas	BNPP.PA	1	EUR	50.00	44.30
BP Milano	PMIL.MI	2	EUR		0.48
CaixaBank	CABK.MC	3 H	EUR	1.76	2.72
Commerzbank	CBKG.DE	2 H	EUR	1.35	1.48
Credit Agricole	CAGR.PA	2	EUR	6.10	6.33
Credit Suisse	CSGN.VX	1	CHF	27.00	23.36
Danske Bank	DANSKE.CO	2	DKK	105.00	98.40
Deutsche Bank	DBGn.DE	2	EUR	33.00	34.58
DnB	DNB.OL	1	NOK	83.00	72.30
EFG Internatnl	EFGN.S	1 H	CHF	9.70	9.19
Erste Bank	ERST.VI	1	EUR	20.00	24.86
Goldman Sachs	GS.N	1	USD	140.00	130.94
HSBC	HSBA.L	1	GBP	6.80	6.62
Intesa Sanpaolo	ISP.MI	3 H	EUR	1.10	1.37
JP Morgan Chase	JPM.N	1	USD	50.00	44.57
Julius Baer	BAER.VX	2	CHF	32.00	33.08
KBC	KBC.BR	1	EUR	32.00	26.24
Lloyds Banking Grp	LLOY.L	1	GBP	0.50	0.49
Monte dei Paschi	BMPS.MI	3 H	EUR	0.17	0.25
Morgan Stanley	MS.N	2	USD	20.00	19.58
Natixis	CNAT.PA	2	EUR	2.60	2.67
Nomura	8604.T	1	JPY	370.00	524.00
Nordea	NDA1V.HE	2	EUR	7.60	7.48
Raiffeisen Bank Intl	RBIV.VI	3	EUR	27.50	32.69
RBS	RBS.L	2 H	GBP	2.85	3.32
SE Banken AB	SEBa.ST	3	SEK	50.00	56.60
SHB	SHBa.ST	2	SEK	235.00	238.70
Societe Generale	SOGN.PA	1	EUR	32.00	29.49
Standard Chartered	STAN.L	1	GBP	18.50	16.15
Swedbank	SWEDa.ST	2	SEK	127.00	129.70
UBI Banca	UBI.MI	2 H	EUR	2.85	3.70
UBS	UBSN.VX	1	CHF	16.00	14.69
UniCredit	CRDI.MI	2 H	EUR	3.70	3.87
Vontobel	VONN.S	1	CHF	31.10	28.85

Source: Citi Research. Jan 4th

Notes

Notes

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Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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