Citi Research

Equities

4 September 2014 | 80 pages

Diversified Banks

Western Europe

Banking on Europe

The Class of 2014: Stress Tests & Beyond

- **Wax and Wane –** After 18 months of 'riding the wave' since Draghi's "Whatever it takes" (European banks +c50% vs. market), jitters have crept in (-c7% since Apr 14). Various fears at play: ECB tests, regulation, litigation, geopolitics & potential deflation risks.
- **Whatever It Takes, Redux –** The ECB tests are transitory. Expect market nerves given uncertainty – potential AQR hits & Stress Test surprises. Citi's more conservative test (Figure 29) suggests a shortfall of €28bn (€12bn taking into account capital raised). But, the process will leave the class of 2014 stronger and, ultimately, drive consolidation, in our view. Since mid-2013, major €-area banks have bolstered balance sheets by c€100bn (Figure 21). Rewards to come by way of c€1trn TLTRO (cheap, term funding) and potential QE (Citi estimates €1trn). Don't fight the ECB.
- **Credit Cycle to Turn, Funding Cost Normalisation –** Front-loading of provisions, easing credit & inflection point in unemployment should support below-cycle loan losses and, by 2015E, improving credit demand. Earnings recovery also supported by lower funding costs and cost savings. Sector beat 2Q14 consensus expectations by c13% (Figure 37) from both higher revenue and lower provisions; top-line supported by both NII (Spain-led) and fee income (Italy-led).
- **More Acronyms –** As we get to latter stages of G20 agenda, regulatory 'winds' are firmly shifting to GLAC (gone-concern loss absorbing capital). Europe's equivalent is MREL (8% min), which we expect to be largely manageable (Figure 32).
- **Payback Will Be There –** Sector dividend yields should grow from c3% in 2014E to c4% in 2015E and c5% in 2016E, as payout ratios expand (Figure 12). By market cap, we estimate 'only' c12-13% of our universe faces significant litigation risks. Despite the US$9bn settlement, BNPP has maintained a flat dividend.
- **Go Overweight Italy, ISP on Focus List –** We go Overweight Italy and switch from Danske Bank to ISP in our Focus List. We think Italy offers a combination of strong earnings recovery via lower provisioning and funding costs, gearing to tightening sovereign spreads and scope to benefit from capital returns, with ISP among the top 3 European banks.
- **Implied Cost of Equity High –** In recent months, the sector's implied CoE has backed up from <11% to >12%. With more capital, liquidity and reserves than ever, there is more to play for. Reiterate Overweight. Focus stocks: DNB (Buy, DKr140 TP), CaixaBank (Buy, €5.30 TP) and ISP (Buy, €2.70 PT), reflecting our periphery bias into further ECB action.

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

Contents

1) Key Highlights – 3Rs of European Banking

Citi's View – Reiterate Sector Overweight Supported by Restructuring, Recovery and Return of Capital Potential

- **Regulation:** Banking Union should serve to reduce sector risk premium
  - AQR should drive much greater consistency on classification & treatment of 'problem' assets
  - ECB SSM from 4 Nov 2014 should drive greater 'harmonisation' of regulatory standards
  - Over time, Banking Union should improve cross-border flows of capital & funding and, ultimately, drive further consolidation
- **Restructuring & Recovery:** Significant earnings recovery potential from lower funding and provision costs – with a bias to periphery – while restructuring deepens
  - 'Front-loading' of provisions & gradual economic recovery should support below-cycle provisioning; unemployment rate key driver
  - TLTRO and QE should drive further reductions in term funding costs for the sector
  - Restructuring potential of c5-6% of cost base should support PBT uplift of c12-13%
- **Return of Capital:** 'Snowball' effect on sector dividend yield growing from c2% in 2013 to c5% by 2016E
  - Over three-quarters of dividend growth to come from Retail and Universal banks
  - 'Only' c12-13% of 2016E dividends from banks with significant litigation 'risk'
  - Key dividend growth stocks include: Benelux (KBC, ING), Italian (ISP), French banks (SG, CASA), UK banks (Lloyds, Barclays) and Swiss banks (CS, UBS)
- **Valuation:** Reiterate sector Overweight
  - 5.5x P/GOP (+1 year) vs pre-Eurozone crisis average of 6.3x (c88%); 0.8x US average vs. 15-year average of 0.8x (c98%)
  - Since June, we estimate the implied sector CoE (cost of equity) has backed-up from under 11% to over 12%
- **Focus List:** CaixaBank (€5.30 TP), DNB (DKr140 TP) and ISP (€2.70 TP); switch from Danske Bank, which remains a Buy (DKr185 TP)

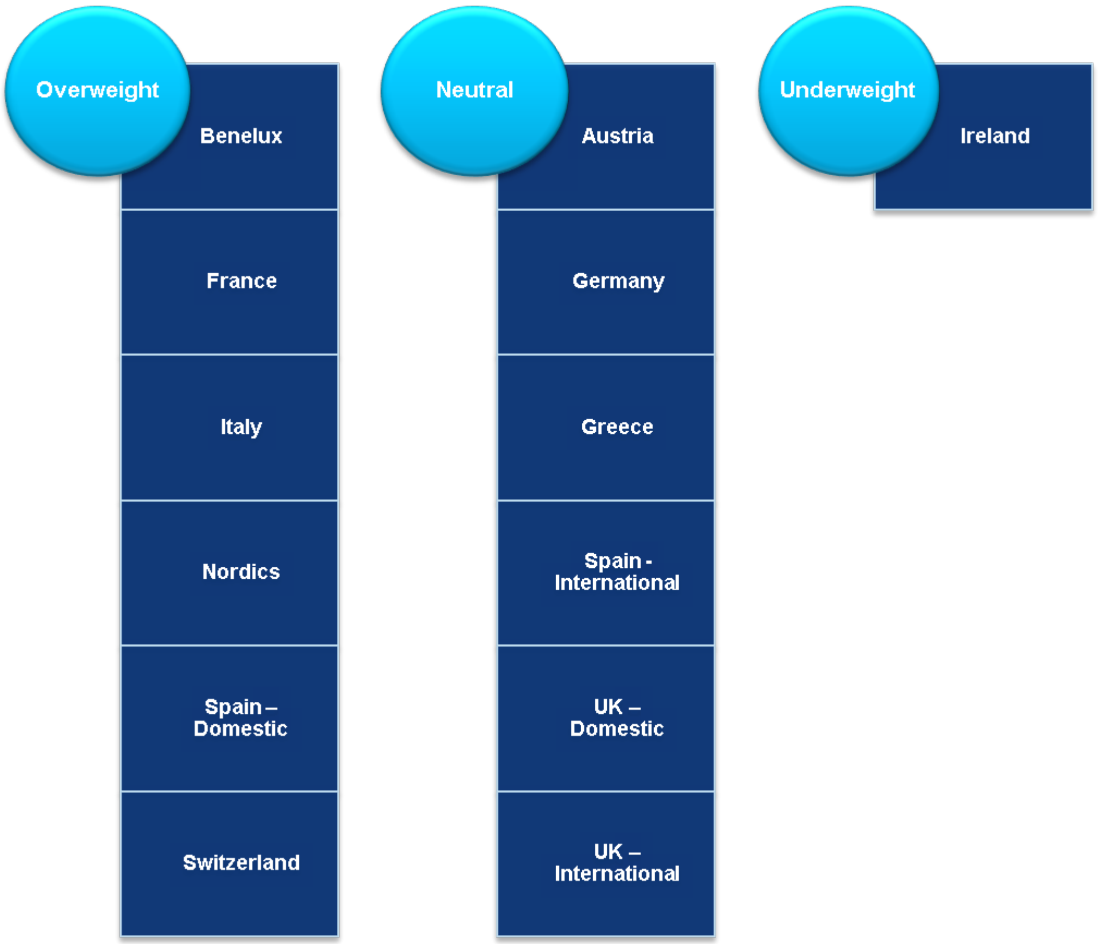
2H14 – What to Watch Out For?

Citi View - Focus on Rates Cycle and Resolution & Recovery Planning

- **Selective Capital Raising** from Stress Test as well as provision 'rebuild' from AQR
  - Major €-area banks have strengthened balance sheets by c€100bn since mid-2013 led by Italian, Spanish and German banks; driven by equity & B3 capital, disposal gains and 'one-off' provisions
  - Banks with relatively high levels of problem loans relative to capital remain most at risk: Greek, Irish, Italian and Spanish banks albeit with risks partly offset by DTA forbearance (eg Spain), Figure 22-Figure 27. Greater risks from unquoted sector given limited market access
  - Citi stress-test: Our analysis suggests that B3 capital sector-level capital ratio declines from 9.9% to 7.0% with shortfall of c€28bn at 5.5% min, c€52bn at 6.5% and c€95bn at 7.5%. Taking into account capital raised, the sector level capital ratio rises to 7.3%, while the shortfall at 5.5% reduces to €12bn. Note our analysis is somewhat more conservative, using a fully-loaded (rather than transitional) approach
- **Regulation: Shift to Recovery & Resolution planning**
  - **GLAC:** Into G20 Brisbane (15-16 Nov), focus shifts to GLAC (gone-concern loss absorbing capital), or MREL in Europe (Minimum Requirement for Own Funds and Eligible Liabilities)
  - **SPE vs. MPE approach:** SPE simpler for regulators; much depends on banks' existing structure
  - **Higher risk-weights:** Banking book, Trading book, potentially Sovereign exposure
- **Rates Cycle:** Higher USD rates offer opportunity for "under-earning" US$ balance sheets
  - 2yr US Treasury rates at levels not seen since mid-2011
  - Swiss Banks & UK International look best-positioned given surplus USD balance sheets

Country Weighting

Figure 1. Recommendations by Country Weighting



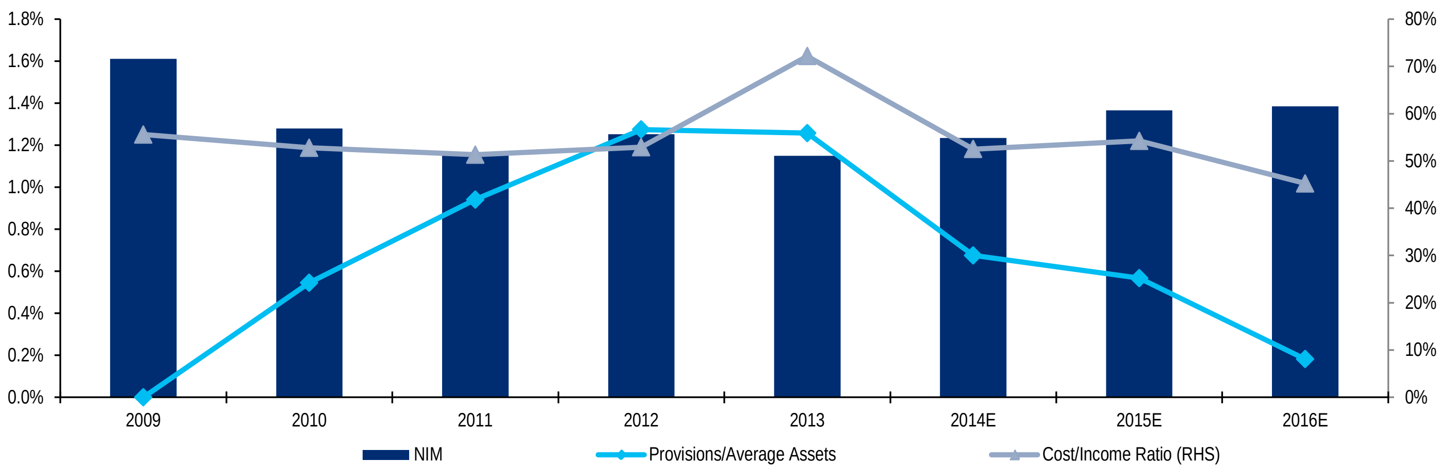
Source: Citi Research

CaixaBank (Focus) – (CABK.MC; Buy; TP €5.30)

Caixabank – The Self-Help Story of Europe's Periphery

- **Profitability –** Improving net interest margins (+24 bps to 1.38% in 2013-16E) owing to deposit repricing and more higher-margin SME lending
- **Consolidation & Cost Optimisation –** Major opportunities to optimise costs with a leaner branch network, more productive employees, digital channels and synergies from recent acquisitions, including Barclays Spain. We expect the Cost/Income Ratio to improve by 7.7% to 45.2% in 2012-16E
- **Asset Quality –** One of the highest coverage ratios in the country should lead to normalising provisions faster than peers (71 bps improvement to 0.57% over 2012-15E)
- **Solvency –** Even post recent Barclays Spain acquisition, still on track to be one of the best capitalised banks in Spain by 2016E (15.6% B3 FL CET1R vs 10.6-14.5% range for peers under Citi coverage in 2016E)
- **Catalysts –** Strategic Plan to be announced in 1Q15, management focus on revenue/cost optimisation programmes, integration of Barclays Spain, AQR/stress test

Figure 2. Caixabank NIM, Provisions and Cost to Income Evolution



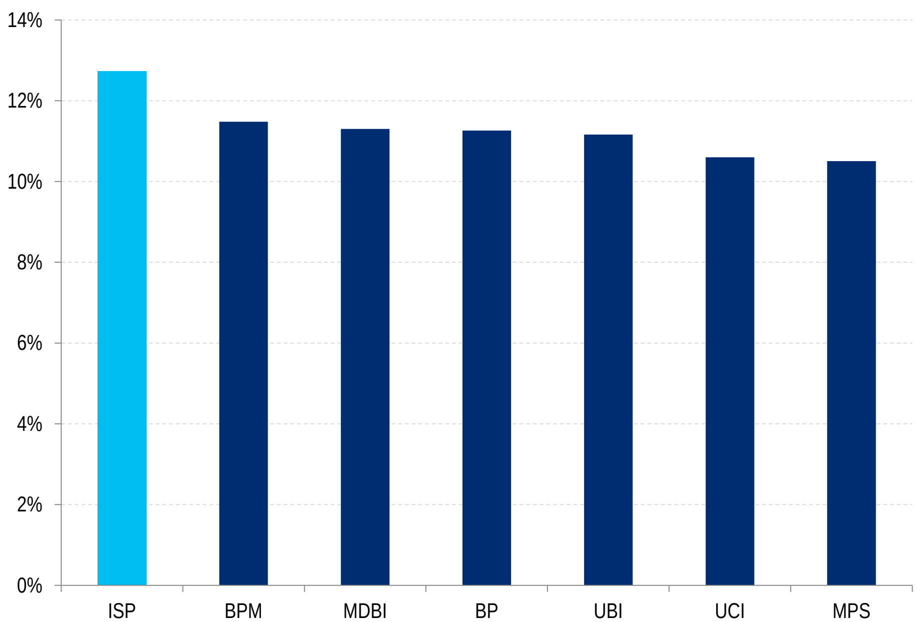
Source: Company Reports, Citi Research Estimates

Intesa Sanpaolo (Focus) – (ISP.MI; Buy; TP €2.70)

ISP – Quality Never Comes Cheap

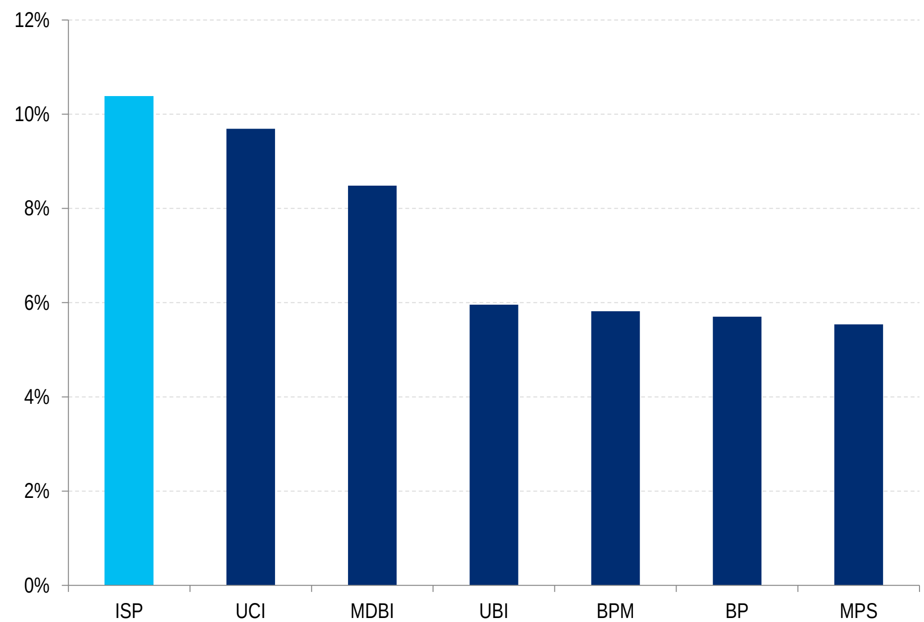
- We upgrade ISP to Buy from Neutral (Italian Banks: Ahead of AQR and ECB). It is the most expensive of Italian banks, but more attractive at sector level, in our view
- ISP has underperformed European banks by c10% over last 3 months; we see this sell-off as a buying opportunity ahead of AQR/stress test and potential ECB actions
- ISP has a top 3 capital position in the sector and has potential for high capital return, in our view
- ISP screens well in our AQR and Stress Simulation, given the high level of capital as a starting point (FL B3 of c12% in 2013)
- We see potential for profitability recovery due to provision normalisation, lower funding costs and increasing fee income given also high gearing to asset management

Figure 3. Italian Banks – Fully Loaded B3 CET1 Ratio, Dec 14E



Source: Citi Research Estimates

Figure 4. Italian Banks – 2017E ROTE



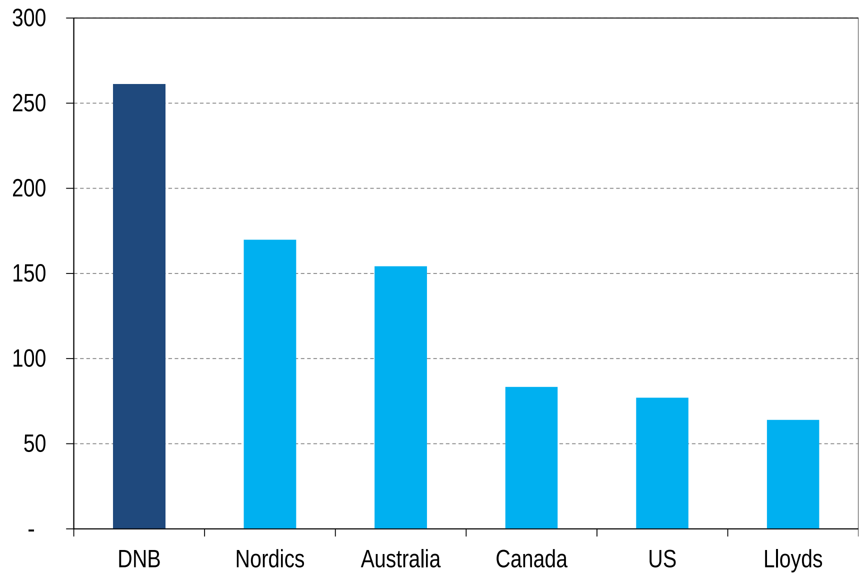
Source: Citi Research Estimates

DNB (Focus) – (DNB.OL; Buy; TP NKr140)

DNB – The Most Profitable Bank

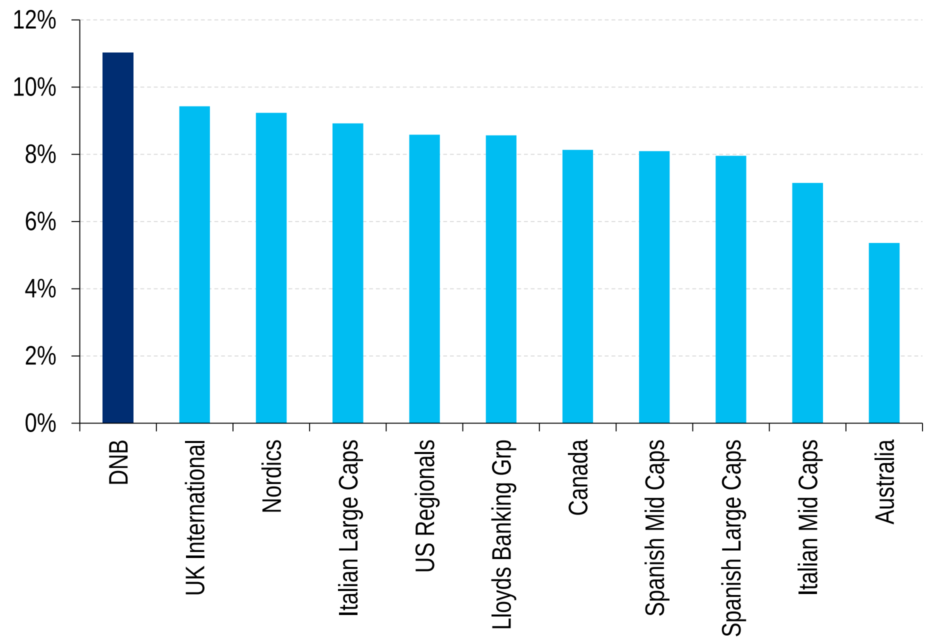
- Highest implied cost of equity, on our estimates
- Improving earnings quality
- The most profitable bank in the world
- High and rising capital ratios; we expect dividends to follow
- Our top pick among Nordic Banks, TP NKr140

Figure 5. FY14E Profit Per FTE in $'000s



Source: Citi Research Estimates

Figure 6. DNB Highest Implied Cost of Equity



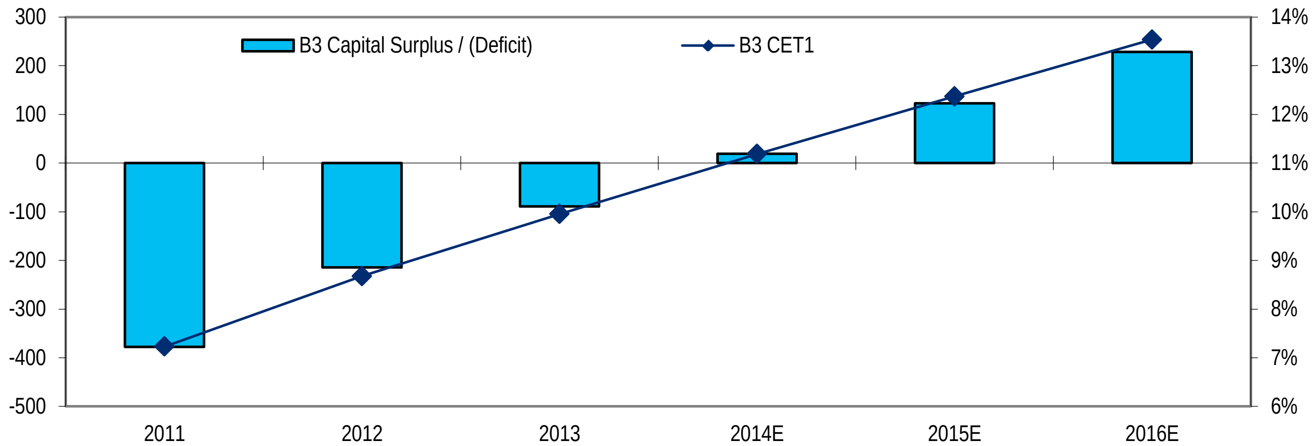
Source: Citi Research Estimates, FY16EROTE divided by FY14E P/TB

2) Return of Capital – Inflection Point

Sector capital surplus grows to over €200bn by 2016E, from deficit of almost c€400bn at end-2011

- We assume that banks meet a minimum B3 'fully-loaded' ratio of 10-14.5%. Risk-weights adjusted for mortgages and trading book.

Figure 7. Sector Capital Deficit Turning to Surplus, 2011-2016E (€bn)



Source: Company Reports and Citi esearch Estimates

Note: 1) Europe ex Greece and Portugal; 2) We assume minimum mortgage risk-weights of 15% and apply a +50% surcharge on internal model-based market risk RWAs

Figure 8. Citi B3 CET1 Ratio (Fully Loaded) Target Estimate, 2016E

Stock	Citi B3 CET1 Ratio Tgt	Stock	Citi B3 CET1 Ratio Tgt	Stock	Citi B3 CET1 Ratio Tgt	Stock	Citi B3 CET1 Ratio Tgt
Banco Santander	10.0%	Bankinter	10.5%	Piraeus Bank	10.5%	Raiffeisen Bank Intl	12.0%
BBVA	10.0%	Bco de Sabadell	10.5%	UBI Banca	10.5%	RBS	12.0%
BNP Paribas	10.0%	BP Milano	10.5%	UniCredit	10.5%	Danske Bank	12.5%
BOI	10.0%	CaixaBank	10.5%	Credit Suisse	11.0%	DNB	13.0%
Credit Agricole	10.0%	Commerzbank	10.5%	HSBC	11.0%	UBS	13.0%
Natixis	10.0%	Erste Bank	10.5%	ING	11.0%	Nordea	13.8%
Societe Generale	10.0%	Intesa Sanpaolo	10.5%	Lloyds Banking Grp	11.0%	SE Banken AB	14.0%
Banco BPI	10.5%	KBC	10.5%	Standard Chartered	11.0%	SHB	14.2%
Banco Popolare	10.5%	Mediobanca	10.5%	Barclays	11.5%	Swedbank	14.5%
Banco Popular	10.5%	Monte dei Paschi	10.5%	Deutsche Bank	12.0%		

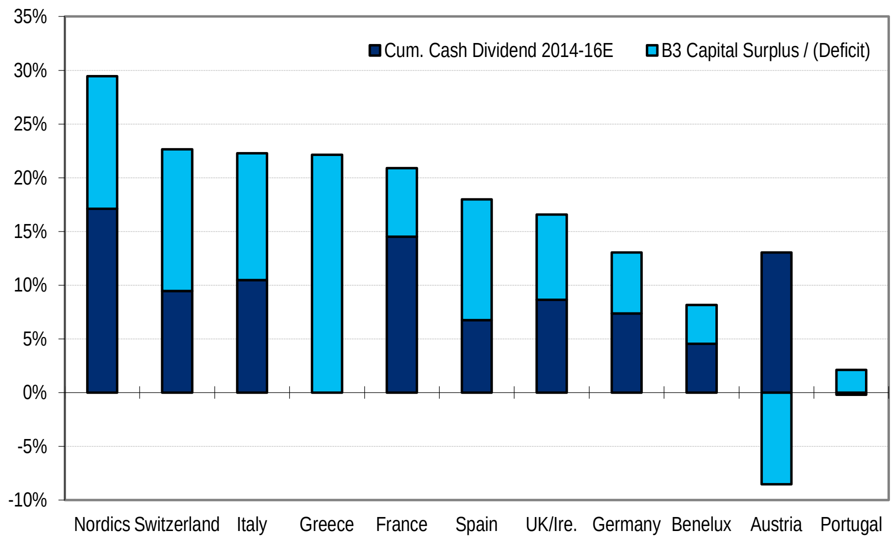
Source: Citi Research Estimates

Which Countries Are Best-Placed?

Italian and Spanish banks have moved up the rankings, following capital raising

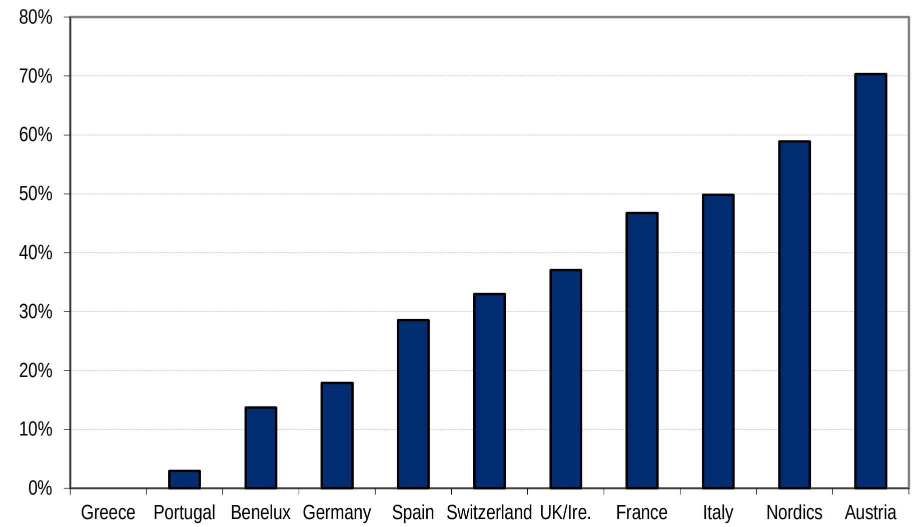
- Nordic, Italian, Swiss and French banks remain amongst the best-placed banks for capital return, in our view
- By contrast, Austria and Portugal continue to lag on surplus capital positions
- Subject to AQR risk (e.g. higher coverage for Italian banks)
- Regulatory 'creep' may delay 'specials' but not necessarily dividend payout 'normalisation'

Figure 9. Capital Surplus Position: By Country, 2016E, % of Market Cap



Source: Citi Research Estimates

Figure 10. Average Payout Ratios 2015-2016E: By Country



Source: Citi Research Estimates

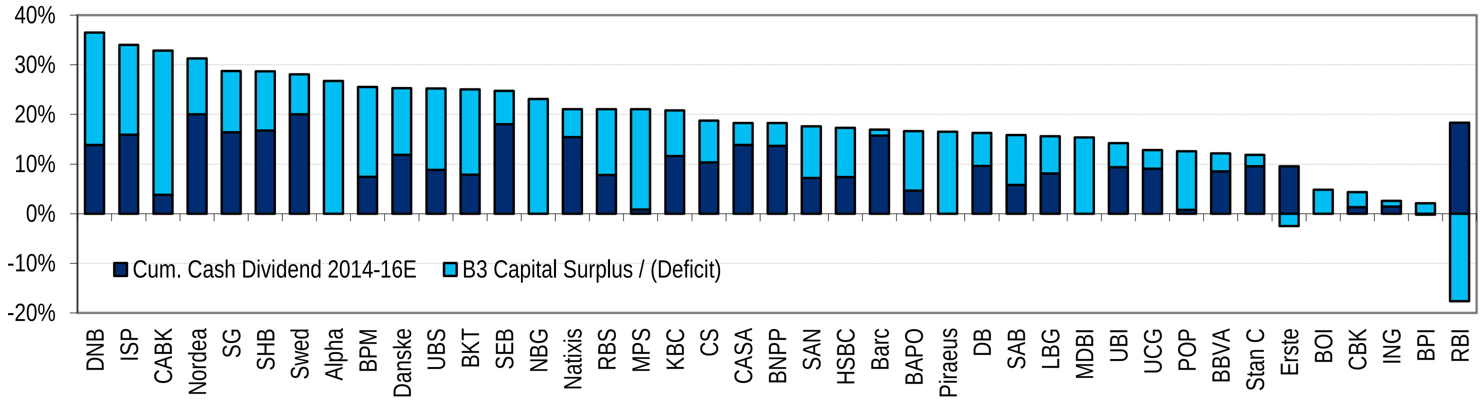
Note: Including our assumptions of special dividends, notably for Swiss banks over 2014-16E

Which Banks Are Best-Placed?

DNB, ISP and CaixaBank remain best-placed & on our Focus List

- We think DNB, ISP and CaixaBank remain best-placed
- Nordic banks feature highly in our top 10; SocGen also features highly amongst large-cap stocks

Figure 11. Capital Surplus Position: By Bank, 2016E, % of Market Cap



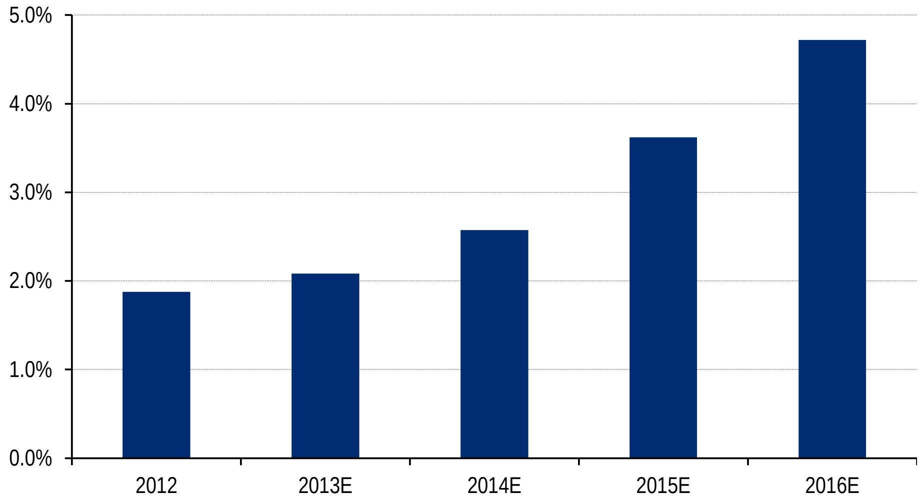
Source: Citi Research Estimates

The Dividend 'Snowball'

'Snowball' effect on sector dividend yield growing from c2% in 2013 to c5% by 2016E

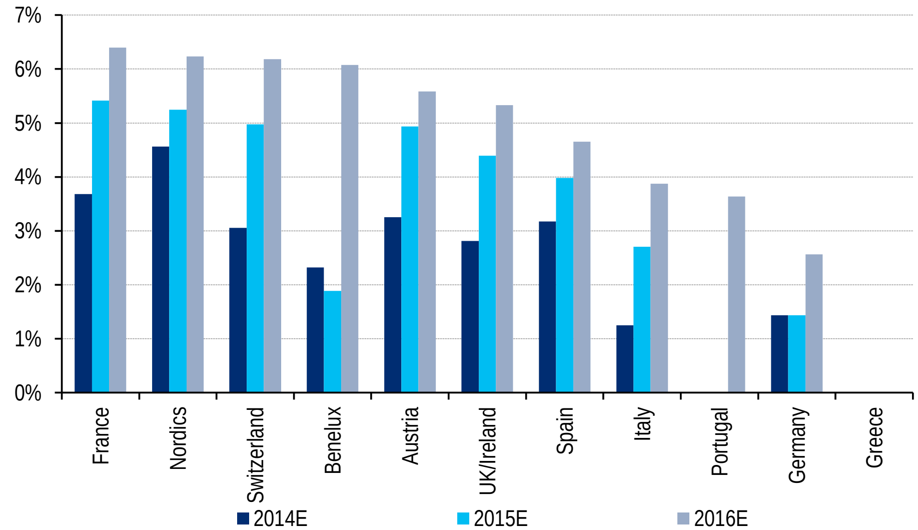
- French, Nordic and Swiss banks look best positioned; Benelux to deliver in 2016E

Figure 12. Sector Dividend Yield, 2012-2016E



Source: Company Data and Citi Research Estimates

Figure 13. Dividend Yield by Country Ranked on 2016E



Source: Citi Research Estimates

The Dividend 'Snowball' (contd)

Absolute sector dividends to double to 2013-16E

- Over three-quarters of dividend growth to come from Retail and Universal banks
- 'Only' c12-13% of 2016E dividends from banks with significant litigation 'risk'

Figure 14. 2013 Dividends by Bank Type (€bn, %)

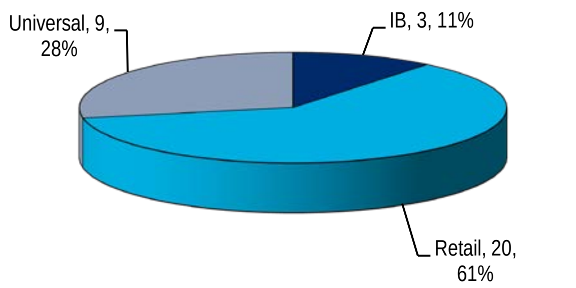


Figure 15. 2015E Dividends by Bank Type (€bn, %)

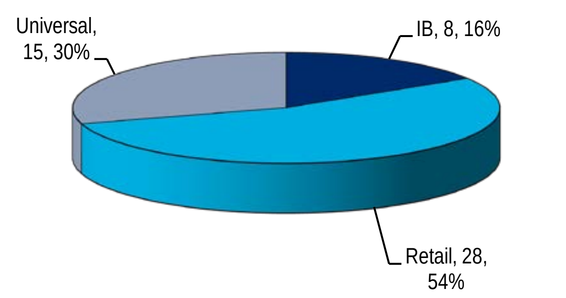


Figure 16. 2016E Dividends by Bank Type (€bn, %)

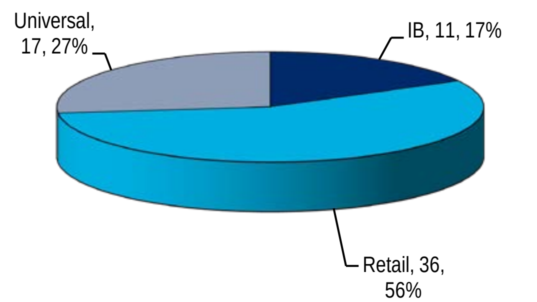


Figure 17. 2013 Dividends Top 5 (€bn, %)

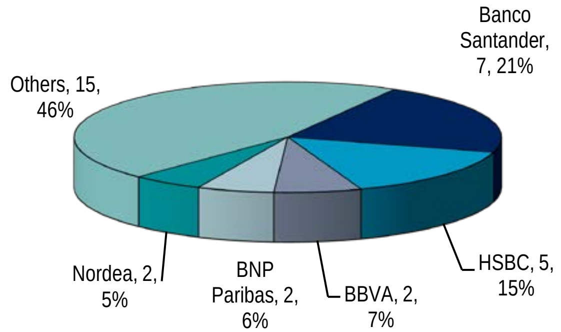


Figure 18. 2015E Dividends Top 5 (€bn, %)

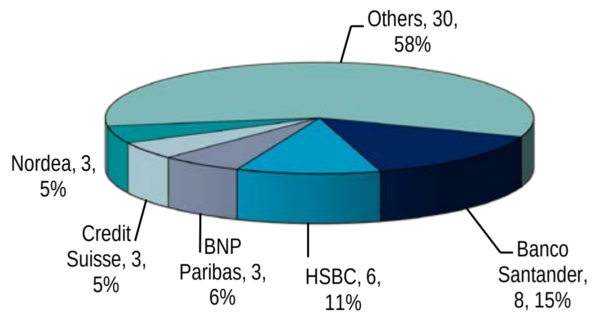
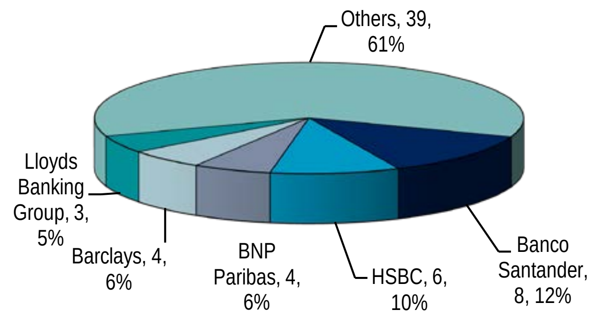


Figure 19. 2016E Dividends Top 5 (€bn, %)

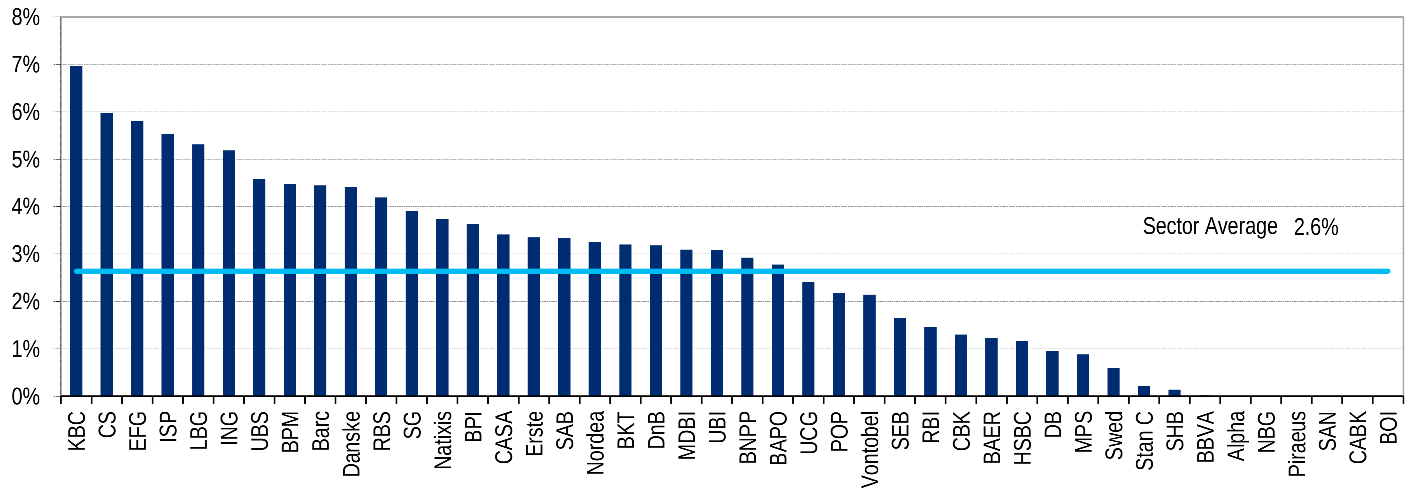


Source for all: Company Reports and Citi Research Estimates

The Dividend 'Snowball' (contd)

Key dividend growth stocks include: Benelux (KBC, ING), Italian (ISP), French banks (SG, CASA), UK banks (Lloyds, Barclays) and Swiss banks (CS, UBS)

Figure 20. Dividend Delta 2016E vs 2013



Source: Citi Research Estimates

3) Regulation – Banking Union to Reduce Sector Risk Premium

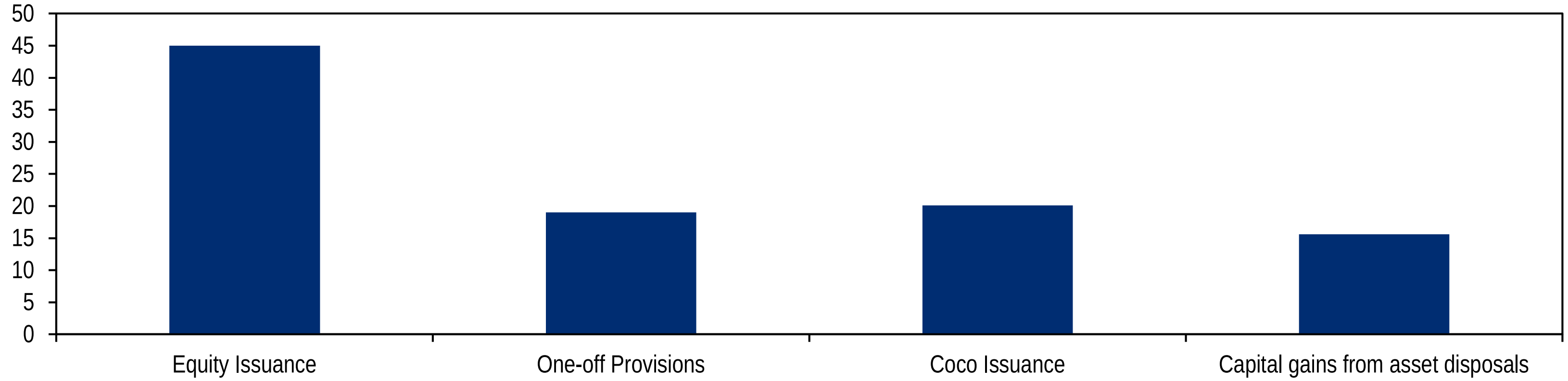
Banking Union to reduce sector risk premium; Regulation no longer one-directional

- ECB-supervised AQR/stress-test to speed-up the 'healing' process, especially via increased transparency
- Since mid-2013, major €-area banking groups have bolstered balance sheet by c€100bn via equity and B3 capital instruments, one-off provisions as well as capital gains
- Regulation is no longer one-directional e.g. FTT (Financial Transaction Tax), LCR (liquidity), Liikanen (ring-fencing), NSFR (stable funding), DTA forbearance (Spain)

Focus on:

- **AQR** – 'front-loading' of provision reserves
- **Stress-Test** – macro shock, sovereign shock, RWA harmonisation
- **BRRD & MREL** – recovery & resolution planning; Minimum Requirement for Own Funds and Eligible Liabilities

Figure 21. c€100bn Balance Sheet Strengthening by Major €-Area Banking Groups (EUR bn)



Source: ECB, Company Financials, Bloomberg, Citi Research

ECB Comprehensive Assessment

Key Issues:

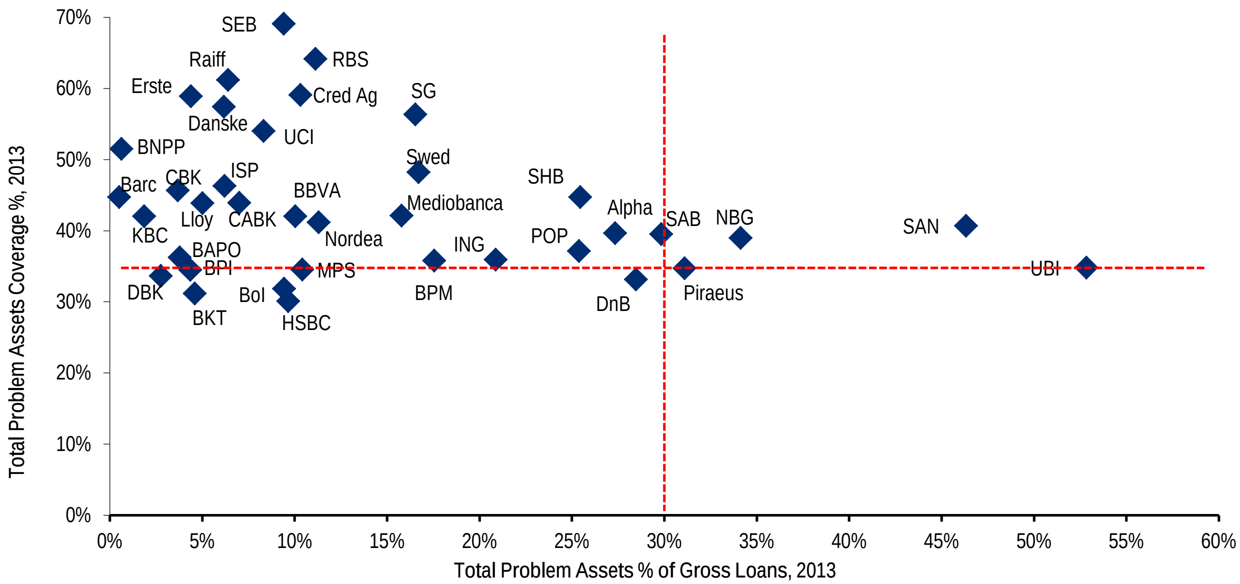
- **Supervisory Risk Assessment**
  - Addressing key risks in banks' balance sheets
  - Capital benchmark based on 8% 'phased' B3 CET1 comprising: 4.5% minimum + 2.5% capital conservation buffer + 1% systemic add-on
  - For the AQR, the relevant deduction will be as of 1 Jan 2014; for the stress test at 'end of the horizon', or 2016
  - Also covers liquidity, leverage and funding
- **Asset Quality Review**
  - Focus on asset-side of banks' balance sheets
  - All asset classes including NPLs, restructured loans and sovereign exposures will be covered
  - Both credit and market exposures with "special consideration on level 3" assets
  - Based on balance sheet data as of 31 Dec 2013
  - Run by the ECB with the support of NCBs and Oliver Wyman
- **Stress-Test**
  - Building-on and complementing AQR; in coordination & cooperation with EBA
  - Forward-looking view of banks' shock-absorption capacity under stress over 2014-16 with minimum 5.5% *transitional* CET1 ratio
  - Common stressed market parameters for trading, available for sale and fair value books
  - Final result expected in mid- to late-October 2014
  - Key unknowns: Macro shock impact; risk weight harmonisation; and extent to which systemic risk taken into account

AQR – Assessing 'Problem' Assets & Coverage

AQR will create much greater consistency on 'problem' loans, for the first time

- Focus on restructured loans & problem categories like shipping, CRE and mortgages in some markets
- Expect significant AQR-related re-build in 3Q14 – Pillar 1 adjustments via financial statement while Pillar 2 through regulatory deductions

Figure 22. European Banks Problem Assets Ratio vs. Coverage



Source: Company Reports, Citi Research

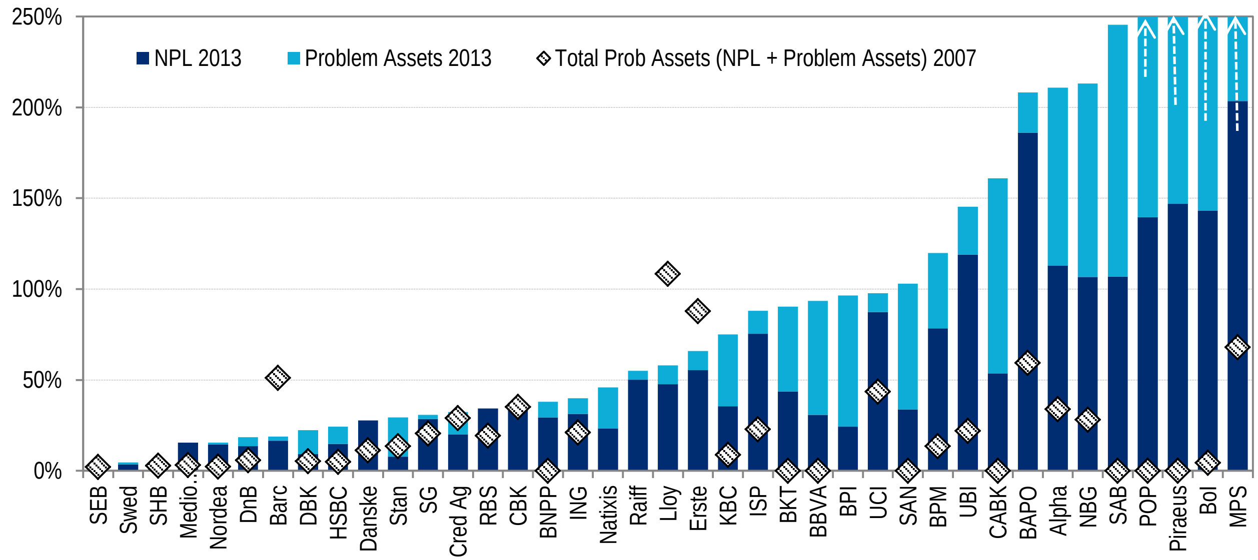
Note: 1) Problem asset add-ons (where available) include 90 day past due loans but unimpaired, foreclosed assets and performing / substandard restructured loans; Total Problem Assets = NPLs + Problem assets add-ons. 2) The ratio 'Uncovered Total Problem Assets % TBV' excludes collateral

AQR – Kicking the Tyres

AQR will help to speed-up the healing process

- Banks with relatively high levels of 'unreserved' problem loans relative to capital remain most at risk – Greek, mid-sized Italian and Spanish banks as well as BoI

Figure 23. Uncovered Total Problem Assets % Tangible Equity



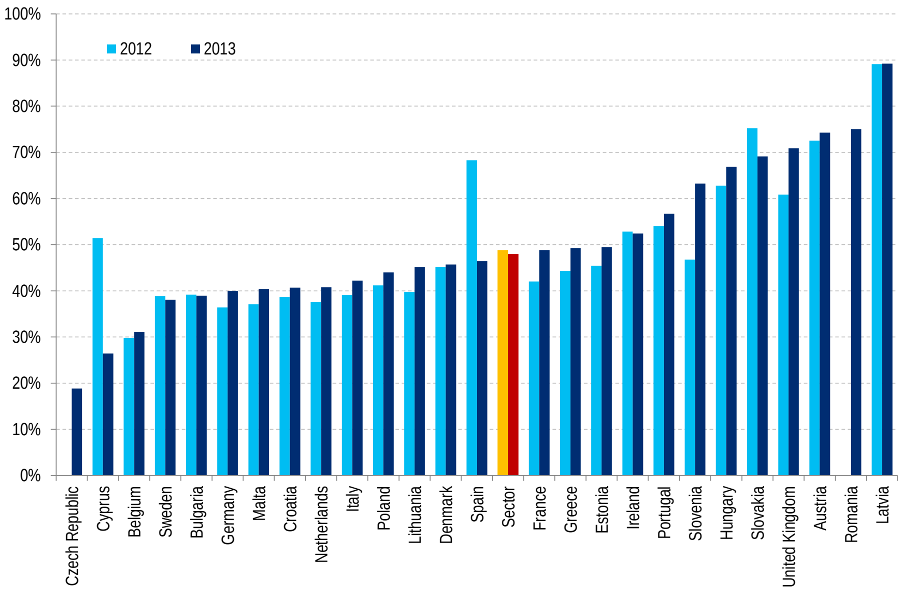
Source: Company Reports, Citi Research

Note: 1) Problem asset add-ons (where available) include 90 day past due loans but unimpaired, foreclosed assets and performing / substandard restructured loans; Total Problem Assets = NPLs + Problem assets add-ons. 2) The ratio 'Uncovered Total Problem Assets % TBV' excludes collateral ; 34) Greek banks data defined as all impaired loans

AQR – Country-Level Analysis

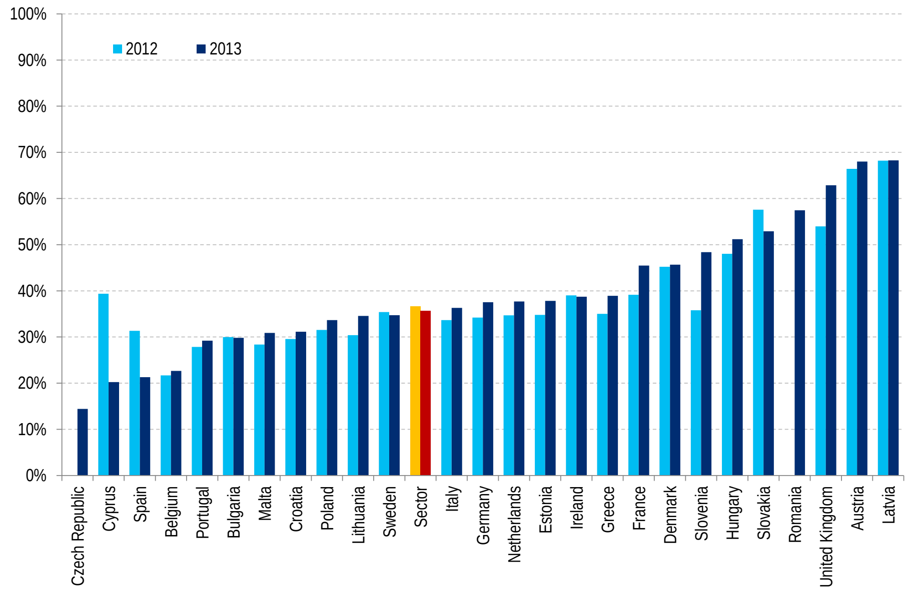
From 2012, most countries' coverage remained unchanged or improved with the notable exception of Spain and Cyprus

Figure 24. NPL Coverage Ratio (2012-2013)



Source: Company Reports, ECB, Citi Research

Figure 25. Total Problem Asset Coverage Ratio (2012-2013)

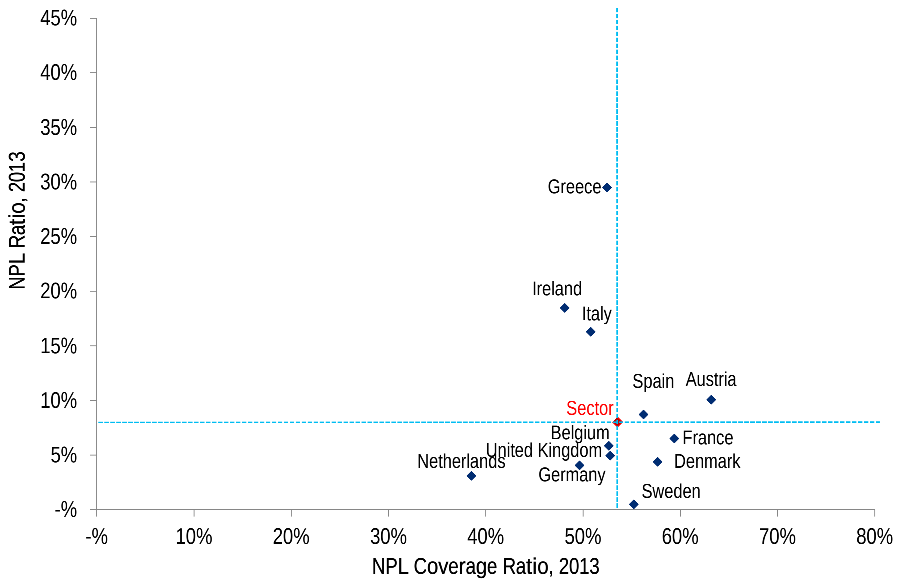


Source: Company Reports, ECB, Citi Research

AQR – Country Total Problem Assets

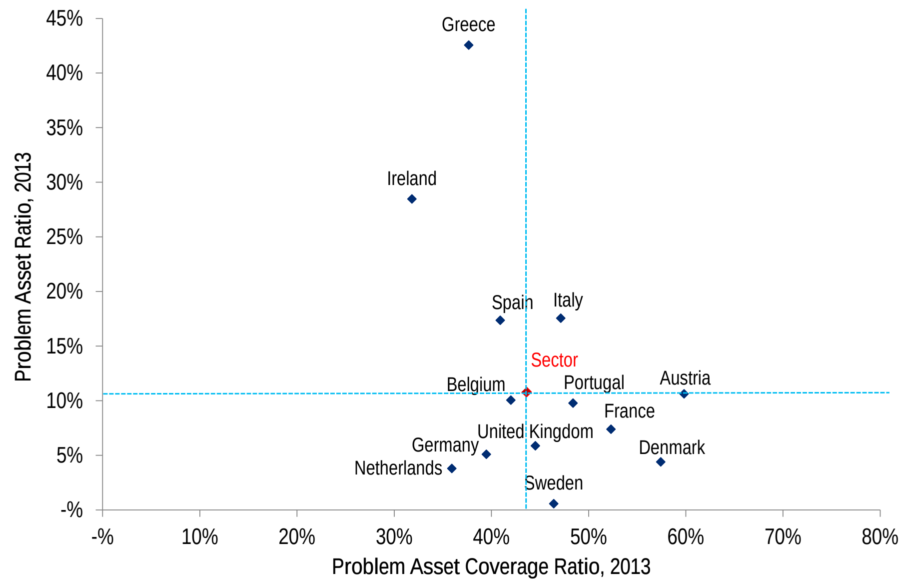
- At a sector level, European banks have 8% NPL ratio vs. 54% coverage; 11% problem asset ratio vs. 44% coverage
- On problem assets, Greece, Ireland and, to a lesser extent, Spain look most exposed

Figure 26. European NPL Ratio vs Coverage Ratio 2013



Source: Company Reports, ECB, Citi Research

Figure 27. European Total Problem Assets Ratio vs Coverage Ratio 2013



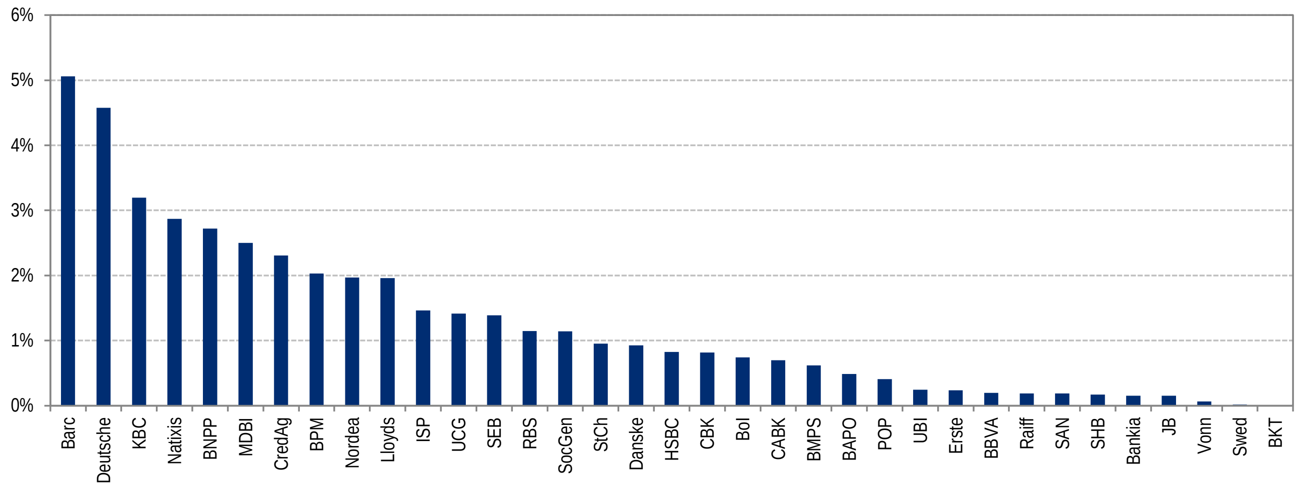
Source: Company Reports, ECB, Citi Research

Focus on Level 3 Assets

Unsurprisingly, wholesale banks most exposed to Level 3 risks

- Level 3 assets are those based on model-based valuation with unobservable inputs
- ECB AQR has a specific focus on Level 3 asset and trading book; conducted between early March and early-July (see Speeding-Up the Healing Process, Mar 2014)
- Most exposed banks: Barclays, Deutsche Bank, KBC, Natixis and BNP Paribas

Figure 28. Impact on Equity of 10% Change in Level 3 Asset Valuations



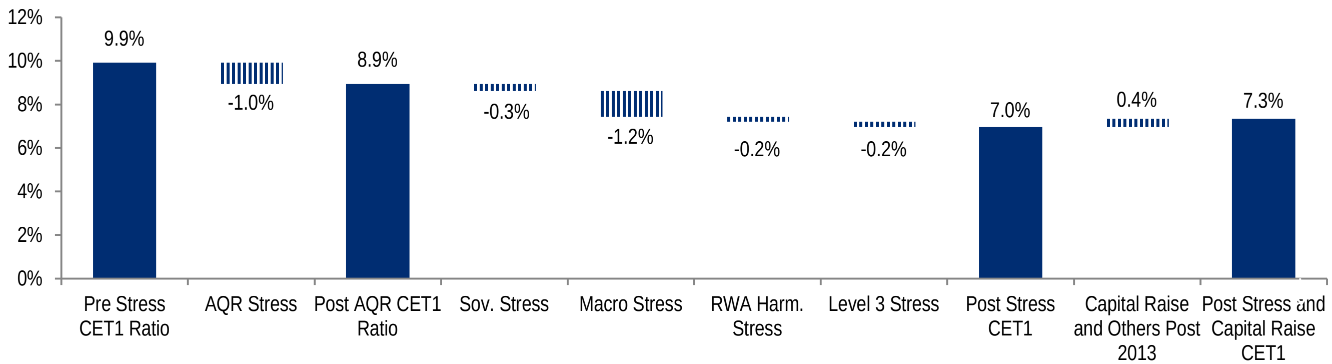
Source: Company Reports, Citi Research

Note: Impacts on equity ignore tax effects.

Illustrative Stress Tests – Sector Level

- **Our analysis suggests sector-level capital shortfall of €12bn at 5.5% min, €33bn at 6.5% and €72bn at 7.5% post capital actions, on a more conservative fully-loaded basis**

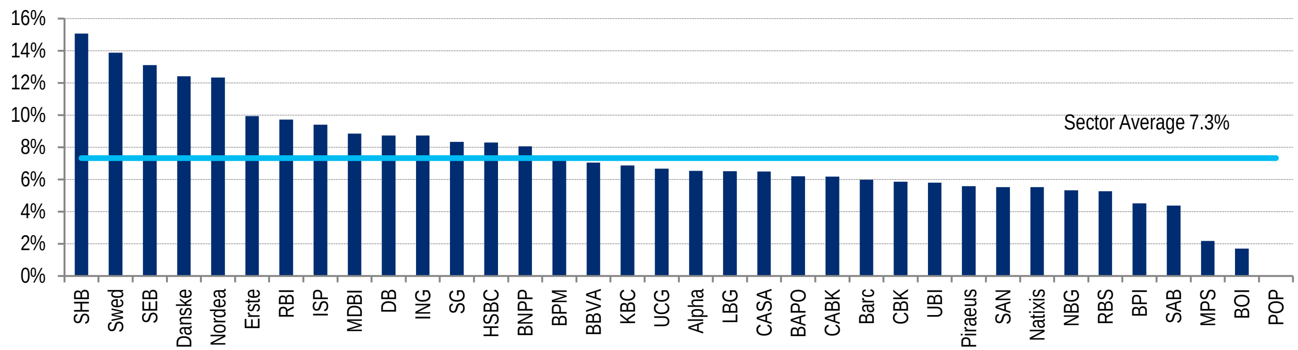
Figure 29. Stress Test – Citi European Banks Universe (More Conservative Fully-Loaded Basis)



Source: Citi Research Estimates, EBA 2011 Stress Test, Company Reports.

Note: See next page "Illustration of Stress-Test – Methodology & Assumptions" for details and stocks covered in analysis.

Figure 30. Stress Test – Detailed Impact on Citi European Banks Universe (More Conservative Fully-Loaded Basis)



Source: Citi Research Estimates, EBA 2011 Stress Test, Company Reports

Note: For BoI, we give credit for €1.3bn state capital, transitional capital (60% deduction) as well as 'macro' shock based on UK average. For Greek banks we take transitional capital (60% deduction).

Illustration of Stress-Test – Methodology & Assumptions

How do we do it?

- **Methodology – 4 Layers of Stress:**
  - Macro shock, based on revised impact from 2011 EBA stress test. Impact could be markedly different this time around.
  - Asset Quality Review (AQR) on expanded ‘problem assets’
  - Sovereign exposure shock on Trading + FVO and AFS exposures, based on 2011 EBA stress test
  - Level 3 assets: Assume 10% FV ‘hit’ (see European Banks Annual Report Review, June 2014)
  - RWA harmonisation across mortgage, trading and sovereign HTM exposures
- **Assumptions:**
  - Based on end-2013 fully-loaded B3 CET1 ratios (more conservative)
  - Macro shock based on 2011 EBA stress test albeit assuming 75% reduction in RWA inflation from securitisation positions, both banking & trading book. Worth noting that 2011 EBA stress-test may have extrapolated notably large trading losses, based on 2008 experience
  - AQR impact assumes coverage ratios remain unchanged on expanded ‘problem assets’ vs. existing NPL coverage ratio (may underestimate impact where issue is declining NPL coverage levels e.g. Italy)
  - Asset quality data is based on end-2012 except Spanish banks that are based on end 1H13
  - Stressed NPLs = Gross NPLs + Problem Assets (Restructured Loan, Foreclosed Loans, Past due > 90 days but not impaired)
  - RWA harmonisation assumes minimum risk-weight of 15% on mortgages, +50% surcharge on market risk-weight and +10% on EEA sovereign exposure
- **Stocks Covered in Analysis**:

Alpha Bank	Bco de Sabadell	Danske Bank	Lloyds Banking Grp	Raiffeisen Bank Intl
Banco BPI	BNP Paribas	Deutsche Bank	Mediobanca	RBS
Banco Popolare	BOI	Erste Bank	Monte dei Paschi	SE Banken AB
Banco Popular	BP Milano	HSBC	National Bank of Greece	SHB
Banco Santander	CaixaBank	ING	Natixis	Societe Generale
Barclays	Commerzbank	Intesa Sanpaolo	Nordea	Swedbank
BBVA	Credit Agricole	KBC	Piraeus Bank	UBI Banca
				UniCredit

Who Pays? Towards Greater Burden-Sharing

Key Issues:

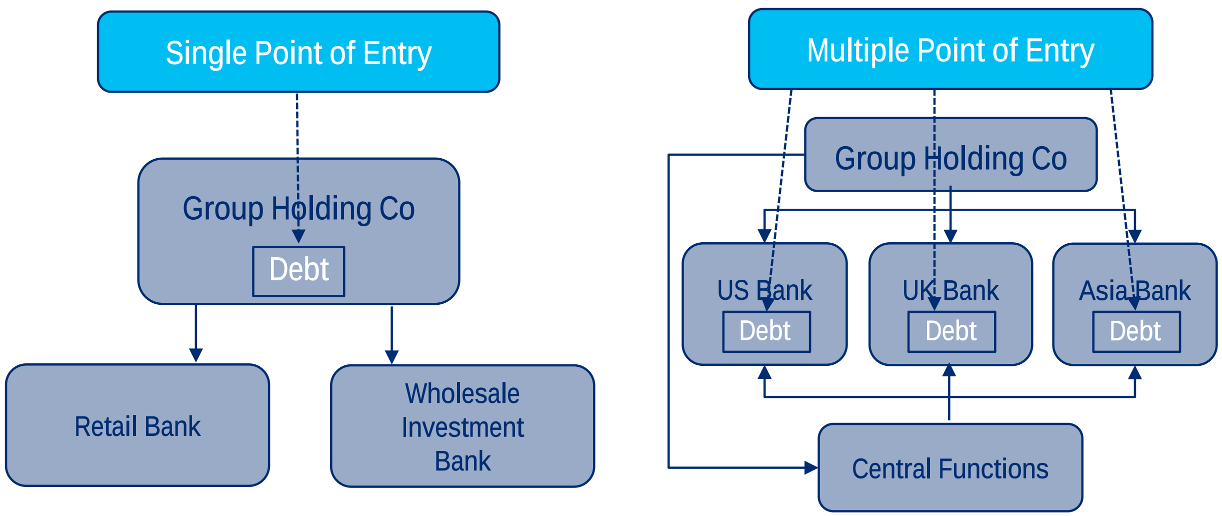
- **De Facto Bail-in**
  - Revised EC State Aid rules: *"all capital generating measures including the conversion of junior debt should be exhausted, provided that fundamental rights are respected and financial stability is not put at risk".* Banks are also required to have sound plans for restructuring or orderly wind-down before they can receive recapitalisations or asset protection measures
- **In Transition State (To 2015):**
  - Retained earnings, raise capital, asset sales, LME
  - Bail-in according to EU State Aid rules (see above)
  - National framework including resolution mechanisms and public backstops; credibility, effectiveness and consistency across national frameworks, reviewed regularly by the Commission State
  - Use of €-area/EU level instruments: (i) ESM loan to Member State (ii) €60bn ESM direct recapitalisation instrument although in practice we believe mutualisation of past problems/legacy assets is very unlikely
- **BES Case Study –** BES resolved into Good & Bad bank. Shareholders and sub debt-holders only invested in Bad bank. We believe EU & ECB were keen to isolate any remaining risks (eg Angola) from the domestic franchise.
- **In 'Steady' BRRD State (From 2016):**
  - Retained earnings, raise capital, asset sales, LME
  - Bail-in of investor capital, which is mandatory up to 8% of bank's non-risk-weighted assets before using any public sector money
  - National resolution fund
  - Single Resolution Fund
  - ESM with maximum exposure of €60bn

Resolution – Single & Multiple Points of Entry

SPE vs. MPE approach: SPE simpler for regulators; much depends on banks' existing structure

- CS has proposed a SPE structure and plans to issue bail-in eligible debt out of the group holding company
- Multi-local banks (e.g. HSBC, SAN) likely to follow the MPE route

Figure 31. Single & Multiple Points of Entry

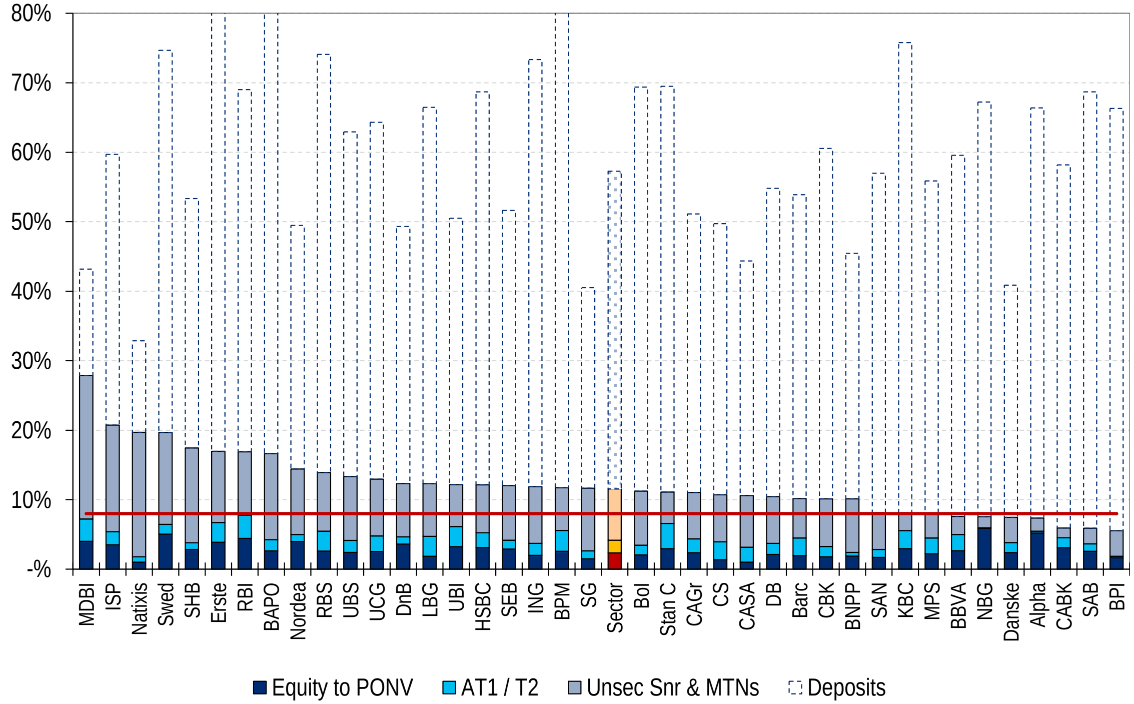


Source: RBS

Comparison of 'Gone-Concern' Proposals

- Banks expected to have buffer of gone-concern loss-absorbing comment. MREL is an EU requirement under BRRD: from PONV, 8% of total liabilities must be absorbed by capital/eligible liabilities before use of Resolution Fund permitted
- Sector ratio of c12%, excluding PONV (point of non-viability) CET1 of 5.125%
- Banks will increasingly need to focus on their corporate structures, choosing between either a single point of entry ("SPE") or multiple point of entry ("MPE") approach

Figure 32. Loss-Absorbing Capital vs 8% Threshold, 1H14



Source: Company Reports, Citi Research, Dealogic. Notes:

1. Senior unsecured debt and MTN data has been sourced from publicly-available information from Dealogic, except for Erste Bank, Santander, and Caixa Bank for which senior unsecured data is per company disclosures
2. Denominator based on Total Assets less Derivatives Netting. Erste Bank total assets reduced by 25% to remove effects due to consolidation of savings banks not fully owned
3. Equity to PONV = amount of equity that must be absorbed prior to PONV being reached, i.e. CET1 capital less 5.125% of RWA

Focus Shifts to GLAC Requirements

Discussions on gone-concern loss absorbing capital (GLAC) requirements likely to intensify into Nov 2014 G20 & beyond

Figure 33. Comparison of PLAC / MREL / GLAC

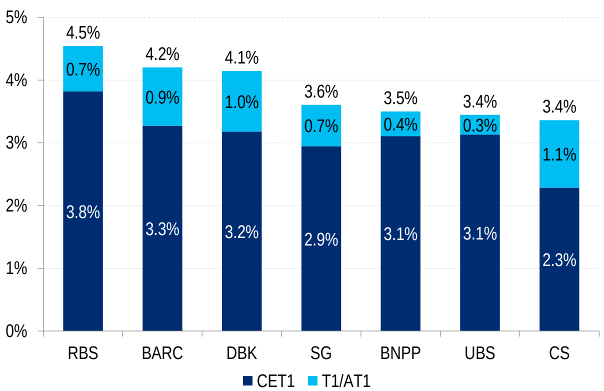
	Measure: Jurisdiction:		PLAC UK	MREL EU	GLAC Global (G-SIBs)
Qualifying Items	Equity (Regulatory Capital Requirement)		✓	✓	[×]
	Equity (Excess)		✓	✓	[?]
	AT1	High Trigger Low Trigger	✓ ✓	✓ ✓	[✓] ✓
	T2		✓	✓	✓
	Senior Unsecured (>1yr)		✓	✓	[?] May be subject to contractual bail-in feature (or structural (holdco) subordination?)
	Other		[✓] Clearly identified as subject to bail-in	[✓] Corporate deposits >1 year	[?]
Calculation Basis			% RWA	% Total Liabilities (including counterparty netted derivatives)	TBD (% RWA and/or % Total Liabilities)
Amount			Up to 17% (scaled down for smaller banks, may be higher for specified larger banks)	TBD Set individually for each bank [Speculation on 8% remaining from PONV; equivalent to 10+% initial level for most banks]	TBD Aiming for common minimum for all G-SIBs
Applicable Entity			• UK headquartered G-SIBs – Including UK/EEA operations – Excluding non-EEA where regional resolution strategy applies • Ringfenced banks / other D-SIBs	Solo & Consolidated	TBD Should reflect resolution strategy for each bank
Timing			• On hold, pending GLAC discussions	From Jan 2016 (although requirement could be built-up over time)	Consultation to follow G-20 in Nov 2014

Source: Citi, UK Draft Legislation, BRRD, FSB

Leverage Ratios

3% minimum met. Key risk is one of leverage requirements increasing from 3% to a higher level, say, 4%

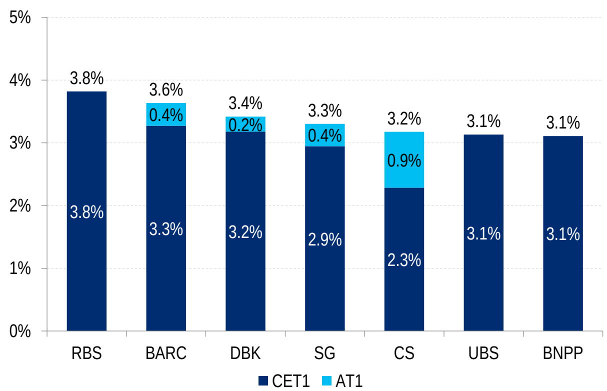
Figure 34. Wholesale Bank Leverage Ratios, 2Q14



Source: Company Reports, Citi Research

Note: includes existing Tier 1 hybrid instruments subject to phase-out. CRD4 leverage exposure

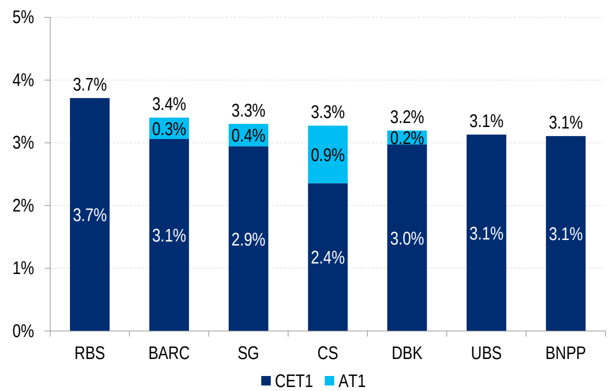
Figure 35. Wholesale Bank Leverage Ratios, 2Q14, CRD4



Source: Company Reports, Citi Research

Note: only includes Basel 3-eligible AT1. CRD4 leverage exposure

Figure 36. Wholesale Bank Leverage Ratios, 2Q14, BCBS



Source: Company Reports, Citi Research Estimates

Note: only includes Basel 3-eligible AT1. BCBS leverage exposure based on 1) company disclosure and 2) assumes mitigating impacts occur immediately

4) Restructuring & Recovery of Earnings

13% 2Q14 Earnings Beat Driven by Income & LLPs

- **13% earnings beat** supported by higher revenue (+c2.5% vs. cons.) and lower loan loss provisions (-9%)
- **Broad-based top-line support** supported by both NII and F&C across retail banks & trading revenues across wholesale banks

Figure 37. Sector Beat/Miss – Actual vs. Consensus PBT

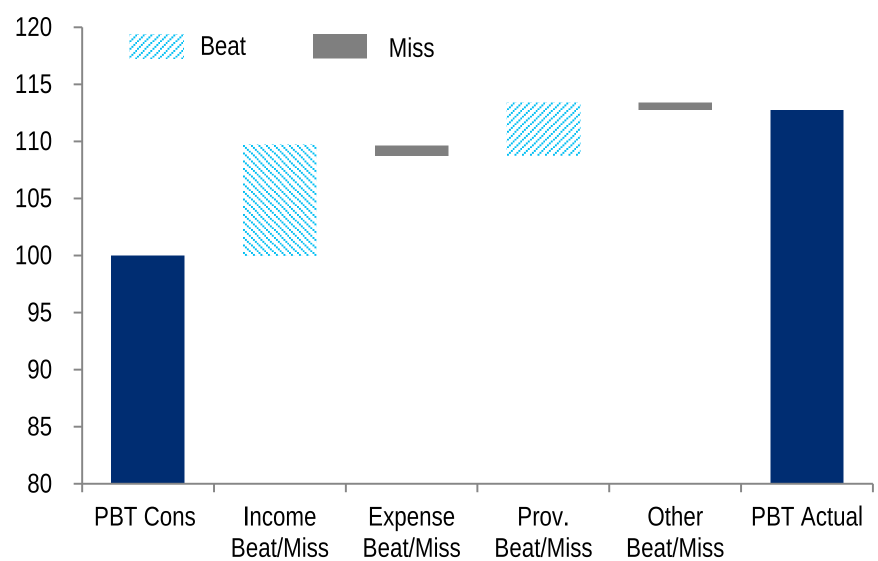
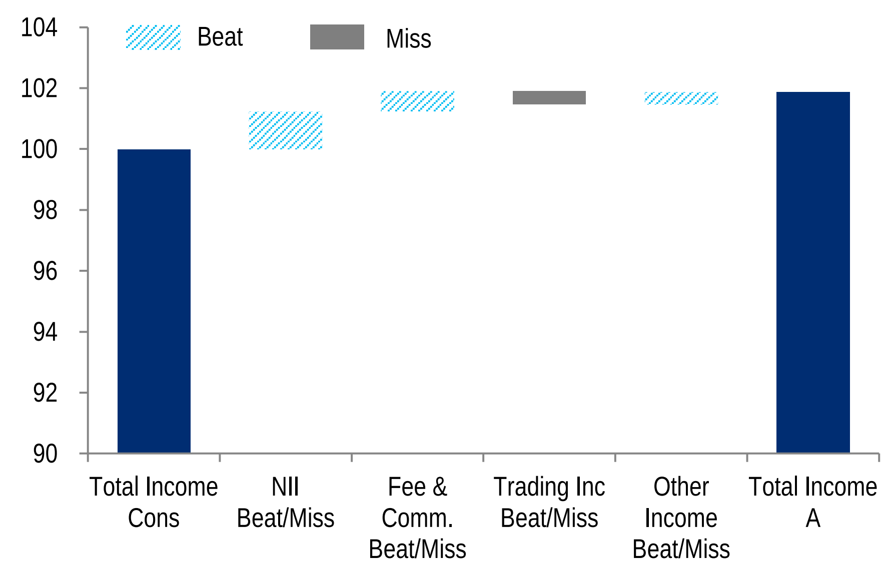


Figure 38. Sub-Sector Beat/Miss – Actual vs. Consensus Income

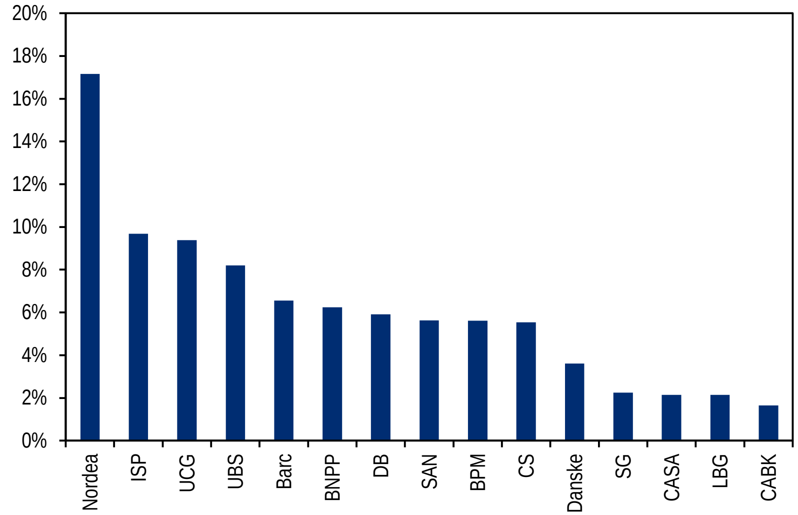


Source for both charts: Company Data, Consensus from Company, Citi Research

Restructuring Under-priced

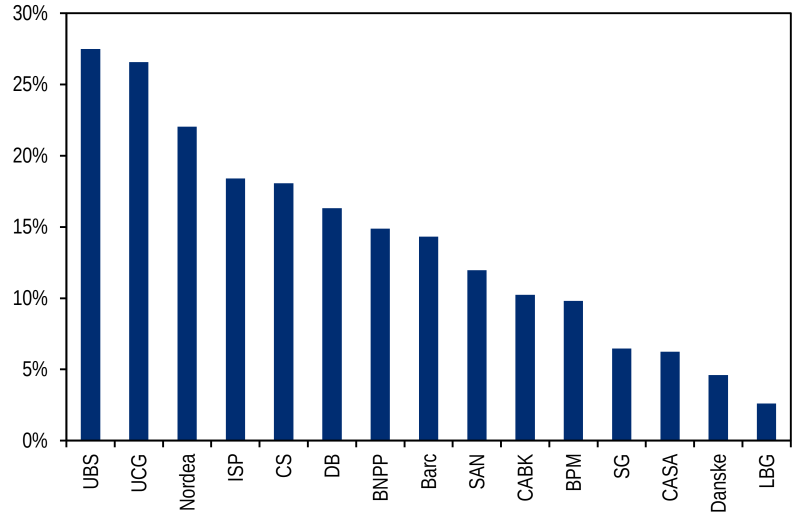
On average, restructuring potential of c5-6% of cost base should support PBT uplift of c12-13% by end-2016E

Figure 39. Cost savings as a % of *underlying* cost base



Source: Company Data, Citi Research Estimates

Figure 40. Cost savings as a % of *underlying* PPOP



Source: Company Data, Citi Research Estimates

The Credit Cycle to Turn

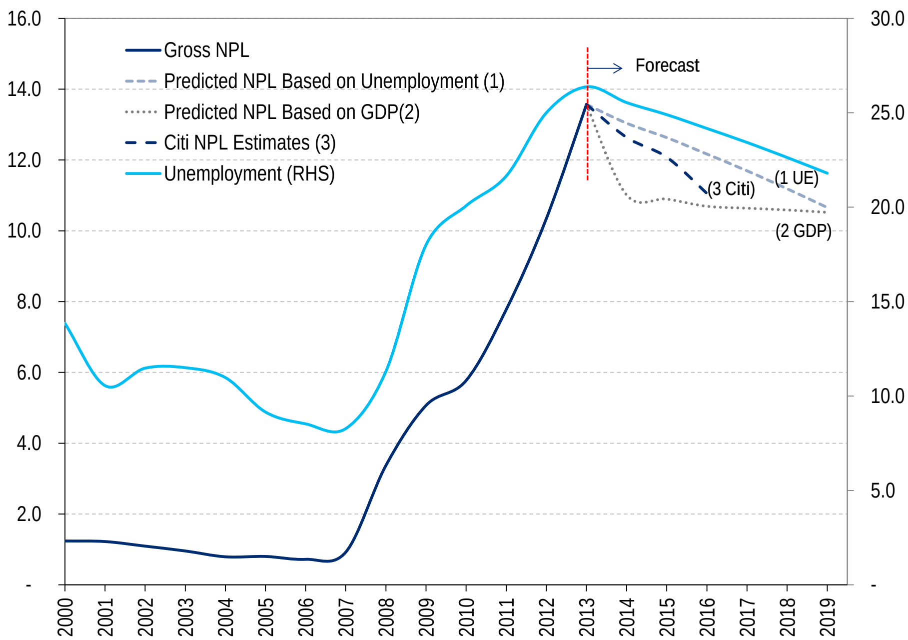
NPL cycle strongly correlated to unemployment across periphery; we expect an 'inflection' point

Figure 41. GIIPS Banks NPL Regression Analysis with GDP and Unemployment Rate

R-Square	Greece	Italy	Ireland	Portugal	Spain
NPL vs GDP	43%	1%	29%	42%	60%
NPL vs Unemployment	98%	88%	85%	82%	91%

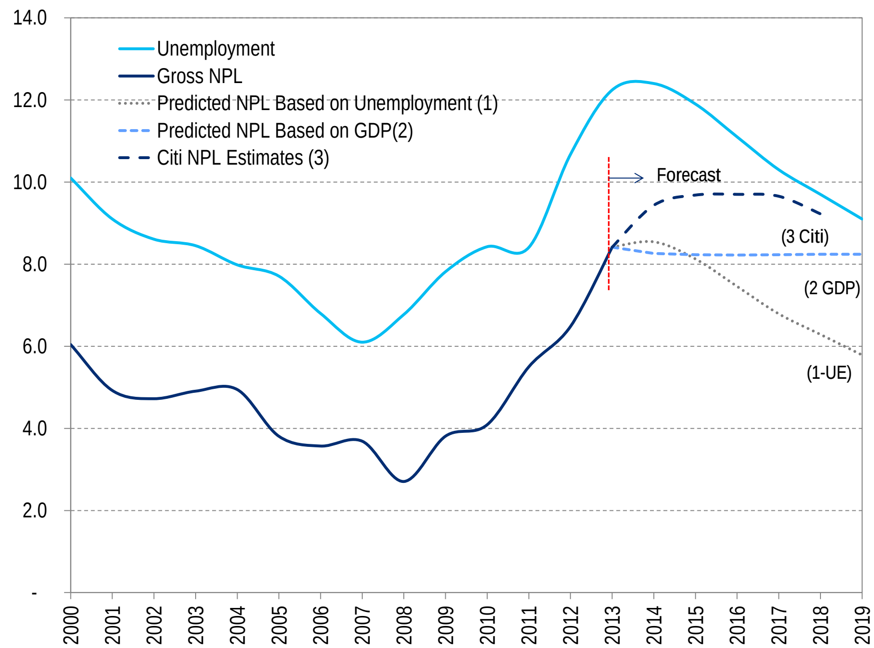
Source: Citi Research; All regression based on annual data from 2000-2013; Greece 2013 NPL is estimated based on the average of Greek banks' domestic NPL ratio.

Figure 42. Spain Gross NPL Ratio vs Unemployment Rate



Source: Banco de España, INE, Citi Research Estimates (Citi economists' estimates for unemployment)

Figure 43. Italy Gross NPL vs Unemployment Rate

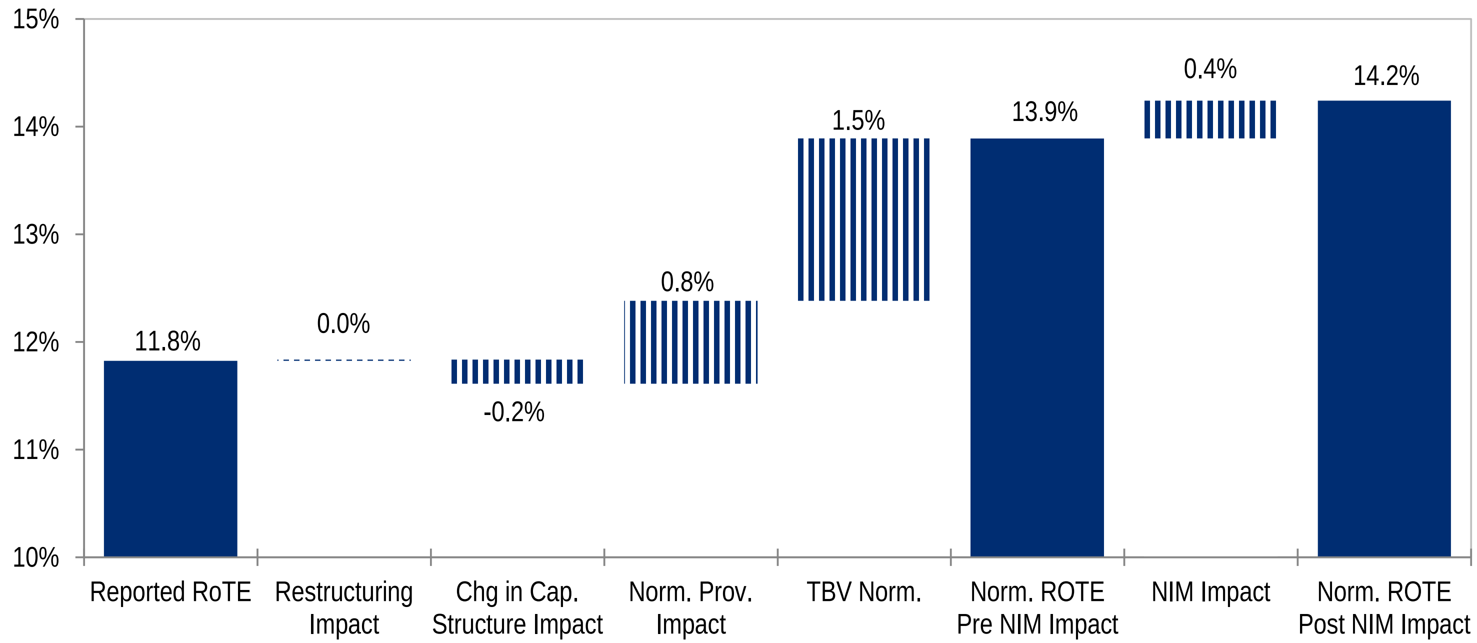


Source: Central Bank Data, IMF, Citi Research Estimates (Citi economists' estimates for unemployment)

Illustration of Normalised Sector Returns

We estimate normalised sector returns could increase to c14%, based on 'go to' capital ratios and through-the-cycle provisioning

Figure 44. 2016E RoTE Normalised for Restructuring, Change in Capital Structure, Provision, Tangible Book Value &+100 bps Upside in Yield Curve



Source: Citi Research Estimates

Notes: 1) NIM impact is assumed on parallel + 100 bps upside in yield curve. In some cases symmetrical movement is assumed to reach on +100bpsparalle shift NIM impact.
2) TBV is normalised for surplus/deficit B3 capital at end 2015E; 3) Change in capital structure is shift of focus to AT1& T2'bail-in' capital; 4)See below for banks covered in this analysis

■ Stocks covered in analysis:

Alpha Bank	BP Milano	DNB	National Bank of Greece	Societe Generale
Banco Popolare	Credit Agricole	HSBC	Nordea	Standard Chartered
Barclays	Commerzbank	ING	Raiffeisen Bank Intl	Swedbank
BBVA	Credit Suisse	Intesa Sanpaolo	RBS	UBI Banca
Bankinter	Danske Bank	KBC	Bco de Sabadell	UBS
BNP Paribas	Deutsche Bank	Lloyds Banking Grp	Banco Santander	UniCredit

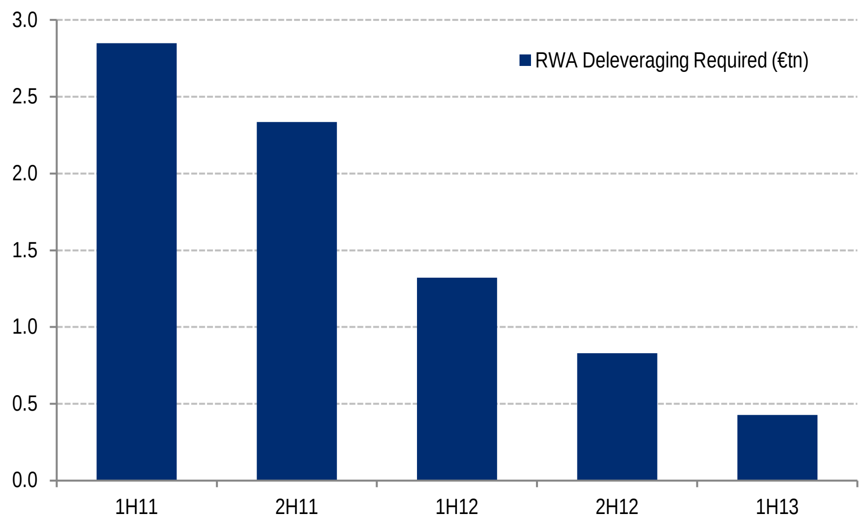
5) Deleveraging

How Much More Deleveraging? – Fully-Loaded BIII CET1 Ratio

Based on B3 capital requirement, capital deficit likely to have been ‘plugged’ by end-2013

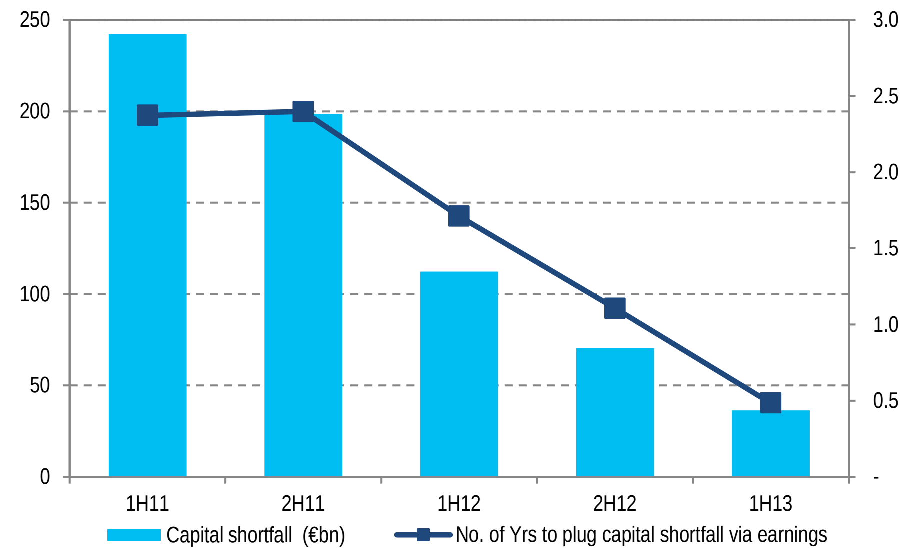
- Deleveraging needs have shrunk dramatically from c€3trn RWAs at mid-2011, to under €0.5trn at mid-2013
- Capital shortfall cut in half from €70bn at end-2012, to €36bn by mid-2013 and likely to have been ‘plugged’ by end-2013
- Analysis based on EBA monitoring exercise for Group 1 banks (T1 capital > €3bn & internationally active), carried out assuming full B3 implementation

Figure 45. How Much More RWA Deleveraging is Required



Source: EBA, Citi Research

Figure 46. Capital Shortfall to Be Plugged by Profit after Tax

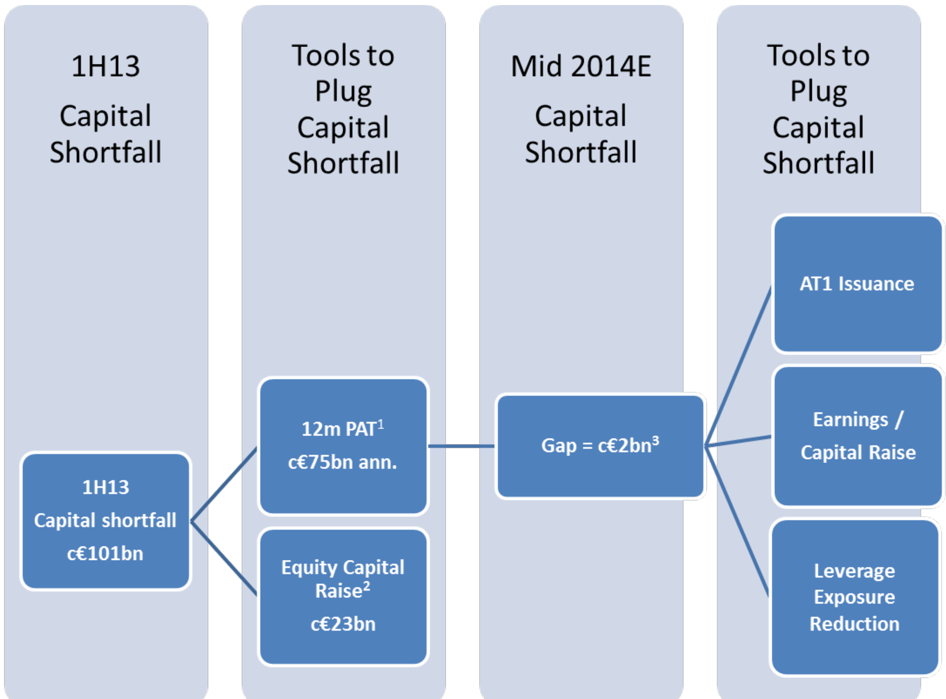


Source: EBA, Citi Research

How Much More Deleveraging? – Fully-Loaded BIII Leverage Ratio

- 3% min. requirement can be met but will the new benchmark be 4%?

Figure 47. Capital Shortfall – Basel III Leverage Ratio



Source: Citi Research, EBA [1] Year to June 2013; [2] Since 30 June 2013; [3] Gap of €2bn = Total €101bn shortfall less est. €75bn earnings and est. €23bn capital raising;
Note: Capital Raise is assumed for banks anticipated to have been part of scope of EBA monitoring exercise at end 2012 and may not include all banks

6) Capital Markets

Uneven Handover from FICC to Equity; FICC Comps Get Easier

- Global FICC revenues -10% (6M14); expect -5% yoy in FY14E
  - Weakness still driven by low activity and volatility in Macro businesses. Broadly flat yoy in 2Q14, beating consensus due to 1) lowered expectations (managements had guided down significantly), 2) easier comps (vs. Jun-13), and 3) slightly better client activity in Jun-14
  - Diverging yoy regional trends in 2Q14: US -6% vs. European +4%. Relative European strength as €-denominated issuance doubled in 2Q14 as well as supportive ECB actions (including TLTRO)
- Global EQ revenues -5% (6M14); expect -3% yoy in FY14
  - Cash and Prime Finance have outperformed Derivatives, which suffered in Q2, due to the ongoing low volatility (and associated low activity) environment.

Figure 48. FICC Revenue Pool – Actual/Normalised/Forecast, 2013 & 2014

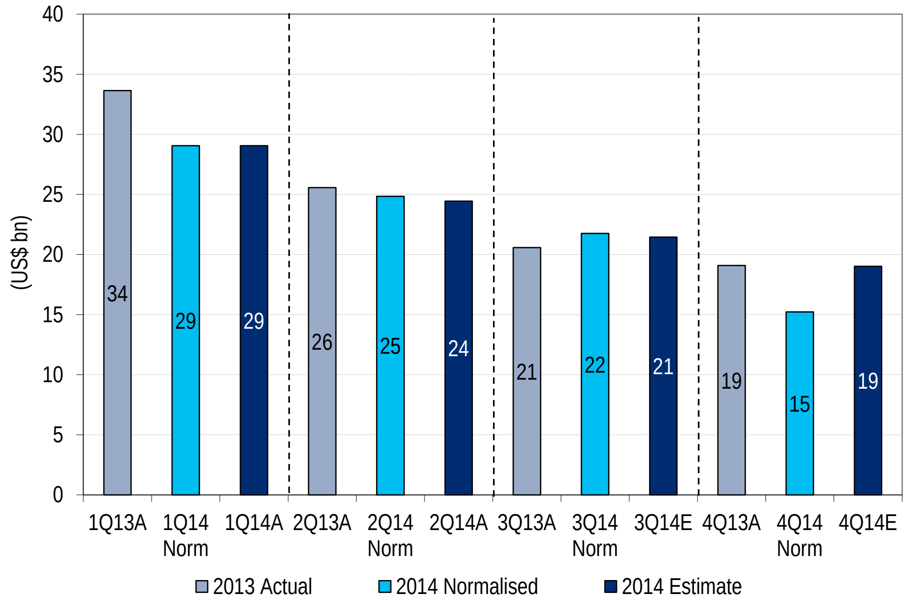
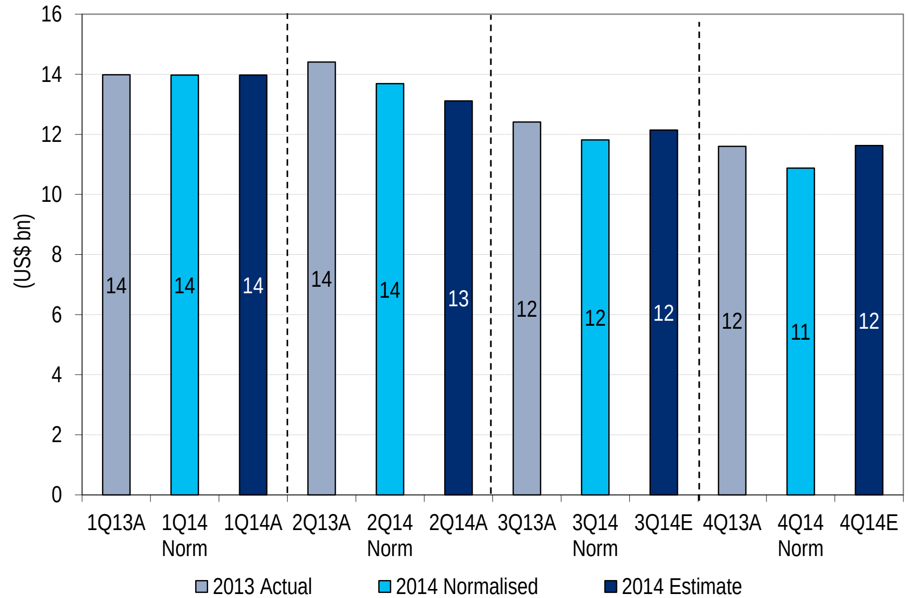


Figure 49. Equities Revenue Pool – Actual/Normalised/Forecast, 2013 & 2014



Source: Company Reports and Citi Research Estimates; Note: Based on 15 global wholesale banks

FICC Franchise Momentum – On-going Consolidation

- US banks gained c.4pp since 2006, largely at expense of European banks
  - However a 2% 1H14 market share gain confirms our view that mix effects (product & geographic) also play a key role with €-area disintermediation taking hold while ECB actions in early-June have provided a short-term 'boost'
  - While we expect US banks could continue to take market share – given heightened focus on leverage ratios – we expect greater €-based disintermediation to notably benefit BNPP, Deutsche Bank and SocGen
- Industry consolidation – market shares of Top 5 increased by c.8pp since 2006
  - Driven by retrenchment of smaller players to their core geographies & products or exits
    - General – UBS' 'radical FICCx' now followed by CS' more moderate restructuring and will likely be followed by other second-tier global and regional franchises
    - Commodities – Deutsche Bank, Barclays, and now CS are in the process of exiting their businesses, but maintain derivatives & precious metals
    - Rates, Credit & Securitised Products – RBS to reduce Rates prime broking and clearing businesses and wind-down securitisation trading over next couple of years

Figure 50. Global FICC Market Shares – By Underlying Revenue, 2006-1H14

	2006	2007	1H08	2009	2010	2011	2012	2013	1H14	1H14 vs. 2006
JP Morgan	9.0%	8.5%	7.2%	9.3%	10.2%	12.8%	12.0%	13.6%	11.2%	228 bps
Deutsche Bank	8.5%	9.8%	11.8%	8.5%	10.5%	11.8%	10.8%	9.7%	11.2%	274 bps
Bank of America	9.0%	9.4%	8.8%	9.4%	9.7%	8.3%	9.9%	10.0%	10.2%	115 bps
Goldman Sachs	9.8%	11.6%	12.3%	13.5%	10.5%	8.6%	9.3%	9.0%	9.7%	-8 bps
Credit Suisse	5.7%	5.4%	4.2%	5.3%	5.1%	4.4%	6.0%	5.9%	6.6%	89 bps
HSBC	3.6%	3.2%	4.8%	4.7%	4.6%	4.7%	5.1%	5.8%	6.0%	238 bps
RBS	10.3%	9.8%	5.4%	7.4%	6.4%	5.9%	6.2%	5.4%	5.4%	-488 bps
Barclays	10.5%	14.8%	15.0%	11.1%	10.2%	9.7%	7.0%	6.2%	5.3%	-514 bps
BNP Paribas	2.8%	3.5%	3.6%	6.2%	5.6%	6.3%	5.3%	5.0%	5.2%	238 bps
Morgan Stanley	7.0%	6.7%	5.9%	4.8%	5.7%	6.3%	5.3%	4.3%	5.1%	-188 bps
Nomura	3.6%	2.7%	2.7%	1.5%	2.2%	3.2%	4.1%	4.3%	4.0%	37 bps
Soc Gen	2.1%	1.9%	2.9%	2.9%	2.5%	2.7%	3.2%	3.3%	3.1%	99 bps
Credit Agricole	2.3%	2.1%	1.5%	1.8%	1.7%	1.8%	1.9%	1.8%	2.2%	-7 bps
UBS	4.9%	2.4%	1.6%	1.6%	3.9%	2.5%	1.8%	1.8%	1.6%	-332 bps
US	45.6%	44.4%	46.5%	49.1%	47.4%	47.0%	48.6%	50.8%	49.3%	366 bps
Europe	50.8%	52.9%	50.8%	49.4%	50.4%	49.9%	47.3%	44.9%	46.7%	-403 bps
Top 5	47.1%	47.5%	52.3%	52.7%	52.2%	52.5%	54.2%	56.1%	55.4%	828 bps
Rest	52.9%	52.5%	47.7%	47.3%	47.8%	47.5%	45.8%	43.9%	44.6%	-828 bps

Source: Company Reports, Citi Research

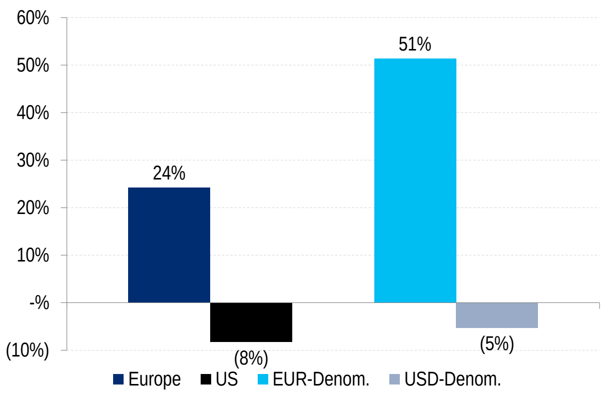
Note: JPM excl. tax-equivalent adjustment component; JPM, Bank of America, Barclays and Nomura proforma for acquisitions of Bear Stearns, Merrill Lynch, and Lehman Bros, respectively

Citi Research

Focus on FICC (1) – Greater €-Denominated Issuance Supporting European FICC Revenues

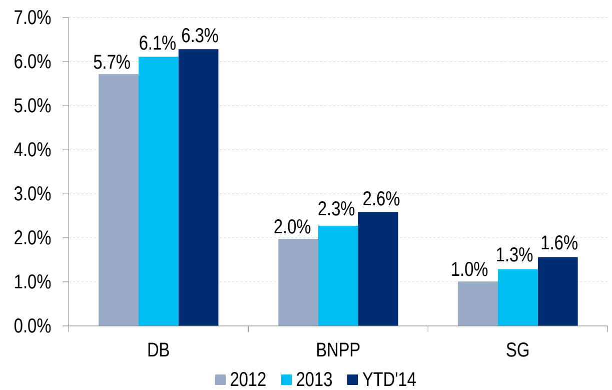
- Claw-ing Back Market Share – A 2% market share gain in 1H14 confirms our view that mix effects (product & geographic) also play a key role with €-area disintermediation taking hold, partially offsetting market share losses to US banks since 2011 (see European Wholesale Banks Claw Back).
- Disintermediation In Full Swing – We think Europe is in the early years of a 15-20-year disintermediation trend. In 1H14, €-denominated corporate debt issuance grew by >50%, led by the periphery, resulting in fast-developing European high-yield market. BNP Paribas, Deutsche Bank and SocGen look to us among the best-placed to profit.

Figure 51. Europe v. US & EUR v. USD-denom DCM, 1H14 v. 1H13



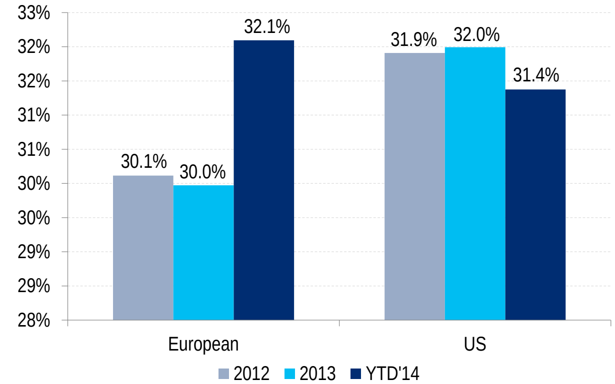
Source: Dealogic, Citi Research

Figure 52. DB, BNPP, and SG DCM Market Share (2012-2Q14)



Source: Dealogic, Citi Research

Figure 53. Europe vs. US DCM Market Share (2012-2Q14)



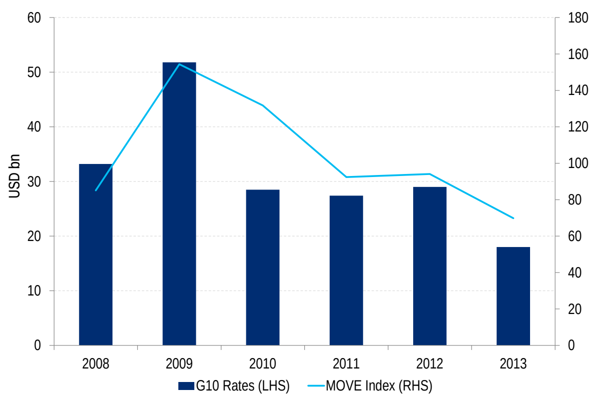
Source: Dealogic, Citi Research

Focus on FICC (2) – Global Macro Impacted by Low Volatility As FICC Tail Wags the Dog

- Global Macro Impacted by Low Volatility
  - Both FX and Rates demonstrate significant correlation with volatility
  - Volatility has continued to decline, as steady policy action and geopolitical uncertainty have weighed

- Estimated Two-Thirds of Regulatory Headwinds Behind Us
  - We estimate a normalised FICC revenue pool of c.$120bn, consistent with our previous estimates in June 2012
  - Cyclical factors continue to weigh, which we expect to rebound over time, partly offset by the further regulatory impact of OTC derivatives reform

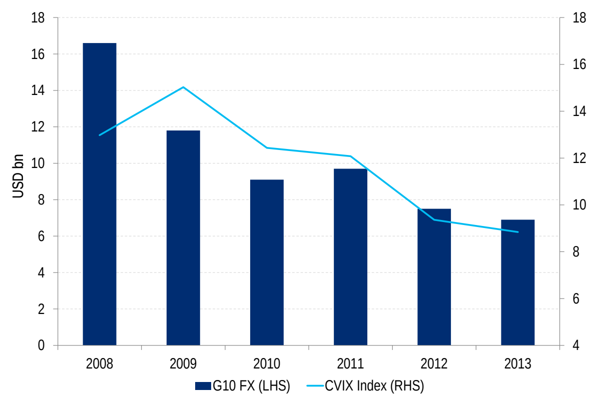
Figure 54. Rates Revenues Highly Correlated with Volatility[1]



Source: Coalition, Bloomberg, Citi Research

Note: 1. Based on MOVE index; 2. R2 = 65%

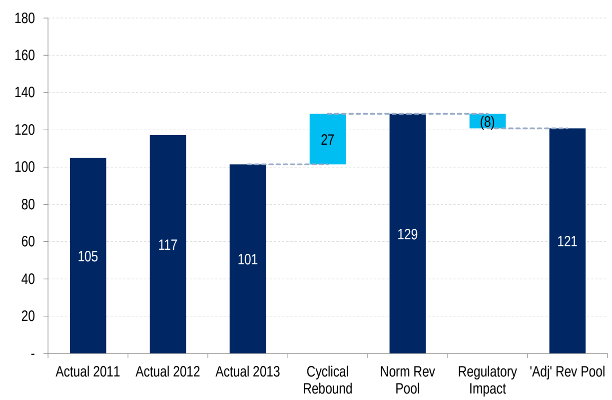
Figure 55. Forex Revenues Correlated with FX Volatility[2]



Source: Coalition, Bloomberg, Citi Research

Note: 2. Based on MOVE index; 2. R2 = 65%

Figure 56. We Still View Adj Global FICC Rev Pool At $121bn



Source: Company Reports, Citi Research Estimates

See FICC Tail Wags The Dog: The Great Financial Moderation And Triggers For FICC (Apr 2014) for further details.

Equities Franchise Momentum – Profile Exits

- European banks have maintained market share in Equities despite exits from players like CASA and RBS
  - CS largest market share gainer since 2006 (c3ppt) to c10% driven primarily by prime brokerage
- Industry consolidation – as with FICC
  - Top players have stronger Prime finance market shares
    - However, banks may have to re-price and/or rethink approach to Prime Finance in the face of leverage constraints given Prime Finance's relatively high capital usage
  - Consolidation on-going => CASA, RBS exiting; Nomura shrinking
    - Credit Agricole exited from Cash Equities, both Chevreux and CLSA
    - RBS sold its equity derivatives and structured products unit to BNPP, having already exited Cash Equities as part of its 2012 Restructuring Plan

Figure 57. Global Equities Sales & Trading Market Shares – By Underlying Revenue, 2006-1H14

	2006	2007	1H08	2009	2010	2011	2012	2013	1H14	1H14 vs. 2006
Morgan Stanley	9.4%	10.0%	12.9%	8.0%	8.9%	12.0%	12.8%	12.6%	12.9%	353 bps
Goldman Sachs	15.9%	16.2%	16.7%	17.5%	14.5%	15.8%	17.0%	13.6%	11.9%	-401 bps
Credit Suisse	7.0%	7.6%	8.5%	10.3%	10.0%	9.4%	9.9%	10.0%	9.6%	267 bps
JP Morgan	8.0%	6.7%	4.0%	7.3%	8.3%	8.8%	9.5%	9.1%	9.1%	112 bps
Bank of America	10.0%	9.9%	10.2%	7.4%	7.4%	7.2%	7.0%	8.0%	8.1%	-196 bps
UBS	9.3%	8.3%	8.8%	6.8%	7.6%	8.4%	7.0%	8.1%	8.1%	-122 bps
Barclays	5.6%	5.5%	5.8%	5.1%	5.7%	5.7%	6.9%	6.8%	7.5%	194 bps
Deutsche Bank	7.5%	7.3%	6.0%	6.1%	7.4%	6.1%	6.3%	6.9%	7.4%	-8 bps
Soc Gen	5.7%	5.3%	5.1%	6.9%	5.9%	5.8%	5.2%	6.3%	6.1%	41 bps
BNP Paribas	4.5%	4.4%	4.1%	4.1%	5.4%	5.6%	4.5%	4.6%	5.8%	127 bps
Nomura	3.8%	5.1%	3.6%	4.8%	4.9%	4.7%	4.4%	4.9%	4.4%	57 bps
HSBC	1.2%	1.2%	1.9%	1.0%	1.4%	1.9%	1.5%	2.5%	2.6%	131 bps
Credit Agricole	3.7%	3.7%	3.0%	3.2%	3.6%	3.8%	2.7%	1.0%	0.6%	-307 bps
RBS	2.7%	2.7%	2.8%	3.5%	1.9%	-%	-%	-%	-%	-270 bps
US	49.1%	48.9%	50.4%	48.3%	46.3%	48.6%	51.6%	48.8%	48.0%	-110 bps
Europe	47.1%	46.1%	46.0%	46.9%	48.8%	46.7%	43.9%	46.3%	47.7%	53 bps
Top 5	50.2%	50.4%	52.3%	50.5%	49.2%	53.2%	56.2%	53.4%	51.6%	135 bps
Rest	49.8%	49.6%	47.7%	49.5%	50.8%	46.8%	43.8%	46.6%	48.4%	-135 bps

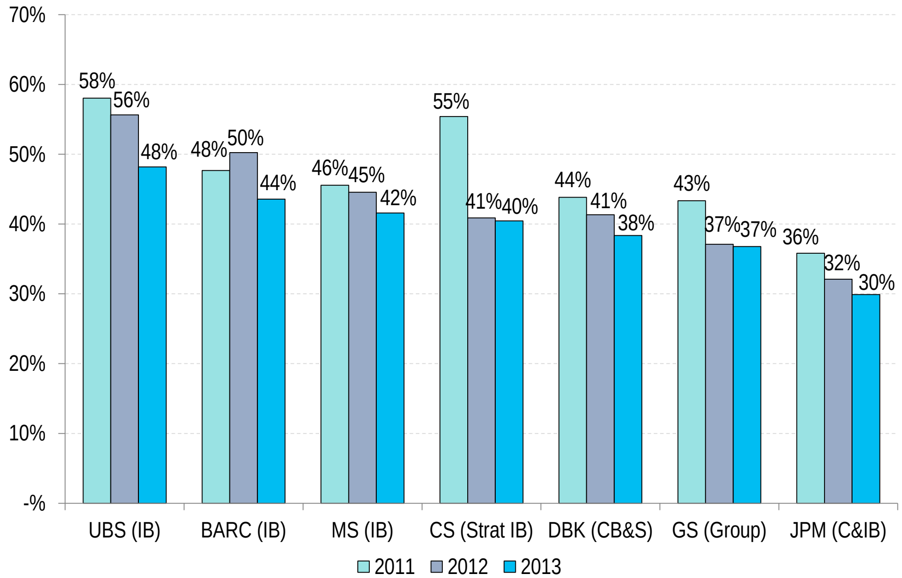
Source: Company Reports, Citi Research

Note: JPM, Bank of America, Barclays and Nomura proforma for acquisitions of Bear Stearns, Merrill Lynch, and Lehman Bros respectively

Declining Comp-to-Revenue Trends

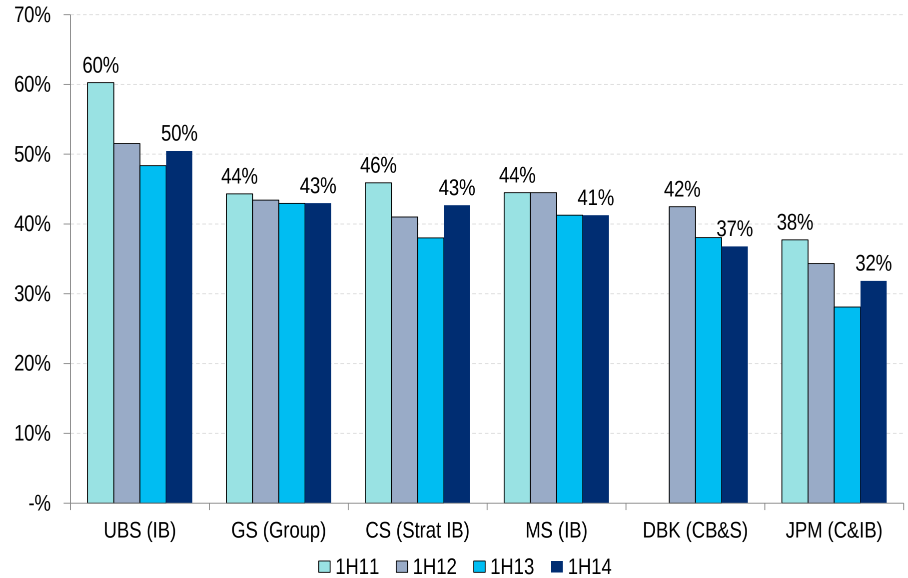
- Pendulum continues to swing in favour of shareholders
- 2ppt decline in comp-to-revenue ratio in FY13 following a 5ppt decline in FY12
- 1H14 comp-revenue at select wholesale banks (IB divisions) has increased by 1ppt yoy, driven by increases at CS[1], UBS, and JPM

Figure 58. Select Wholesale Banks Comp-Revenue – 2011-2013



Source: Company Reports, Citi Research

Figure 59. Select Wholesale Banks Comp-Revenue – 1H11-1H14



Source: Company Reports, Citi Research

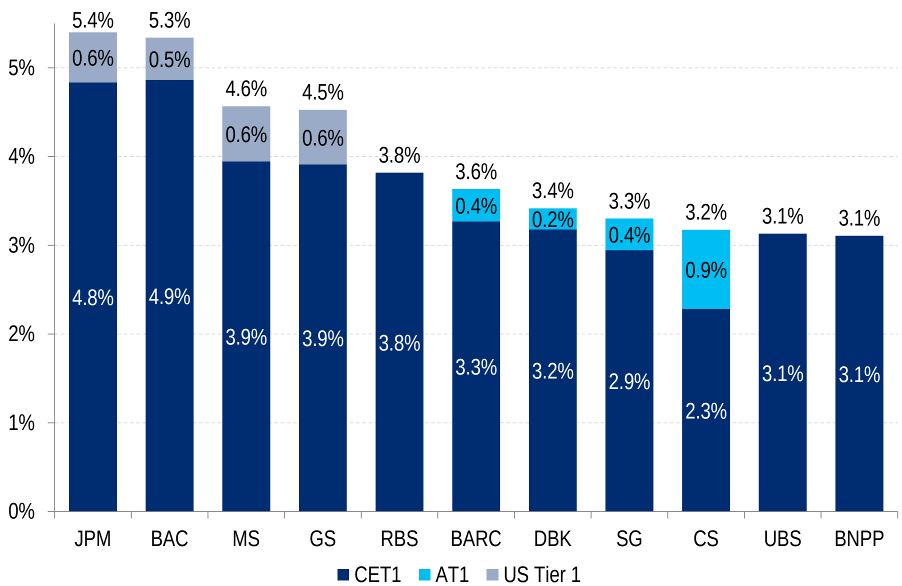
Note: CS increase due to change in methodology for comp accruals

[1] In 2014, CS adjusted their methodology of accruing for compensation by adjusting it according to seasonality. Quarters in prior years were accrued at an even rate

Focus on Leverage Ratio Management

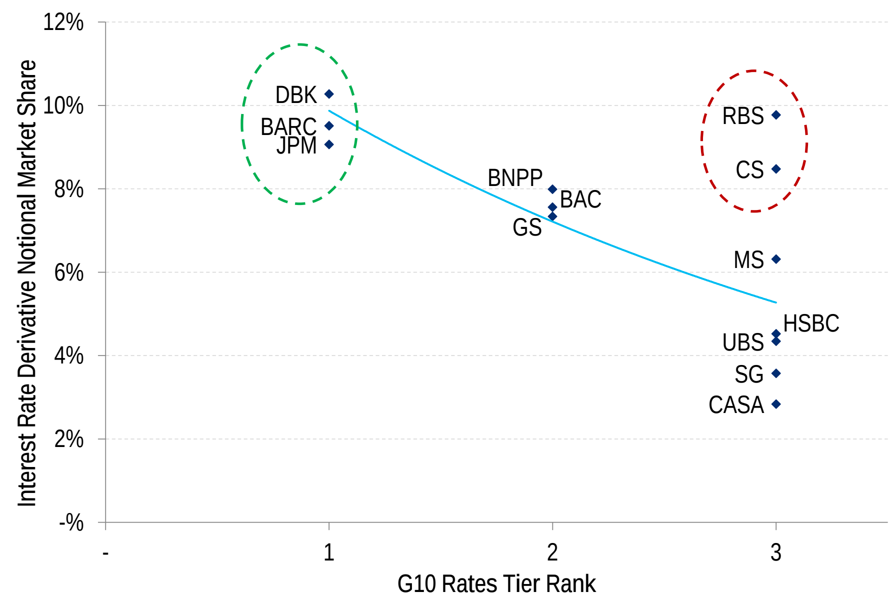
- Introduction of the leverage ratio has caused banks to focus on leverage exposure optimization as well as issue equity and AT1
- Business Exits
  - Deutsche Bank and Barclays: in the process of exiting their Commodities businesses, but maintain derivatives & previous metals
  - RBS: press reports (e.g. FT) suggest that it is winding-down securitisation trading over the next couple of years and reducing rate prime broking and clearing businesses. Already sold equity derivatives and structured products unit to BNP Paribas, having exited Cash Equities in 2012; Cred Ag exited Cash Equities
- Other Initiatives
  - Barclays: created Non-Core division containing 50% of FICC RWAs and 30% of FICC revenues; Core IB to contribute <30% of Core Group RWAs
  - CS: Further restructuring of Macro businesses, incl. exiting Commodities trading at 2Q14 results
  - DB: €8.5bn equity and €5bn AT1 in response to regulatory uncertainty, litigation risks and commitment to FICC; only global European wholesale bank remaining

Figure 60. Select Wholesale Banks' Leverage Ratios (2Q14)



Source: Company Reports and Citi Research. Note: only considers Basel 3-eligible AT1

Figure 61. Wholesale Banks Rates Businesses: Market Share of Notionals vs. Tier Ranks (2013)

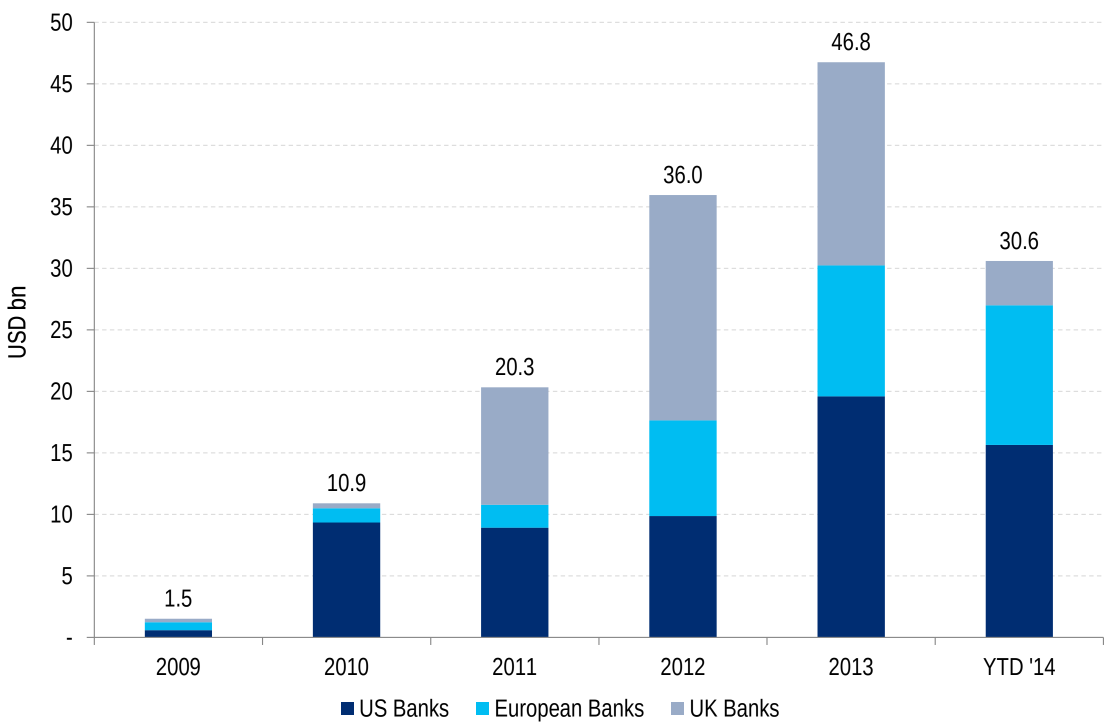


Source: Company Reports, JP Morgan 2014 Investor Day (CIB Presentation), Citi Research Estimates

Litigation Inflation

- During 1Q14 and 2Q14 results, BAC added c$6.2bn to litigation reserves for legacy mortgage-related matters, in addition to a previously-announced $3.6bn FHFA settlement. In August, it announced a $17bn settlement with US DoJ (additional $5.3bn charge).
- In May, CS settled for $2.8bn with the US DoJ on its Cross Border case, and provided a guilty plea at its Swiss banking entity, Credit Suisse AG. After existing provisions, the settlement resulted in a 70bps impact to capital.
- In June, BNPP settled for $9.0bn with the US DoJ on OFAC. It also provided a guilty plea and will have a one-year ban on US$ clearing to be applied from 01- Jan-15. After provisions, the settlement resulted in a 90bps capital impact.

Figure 62. Select Global Bank Litigation Charges (2009 – YTD 2014)



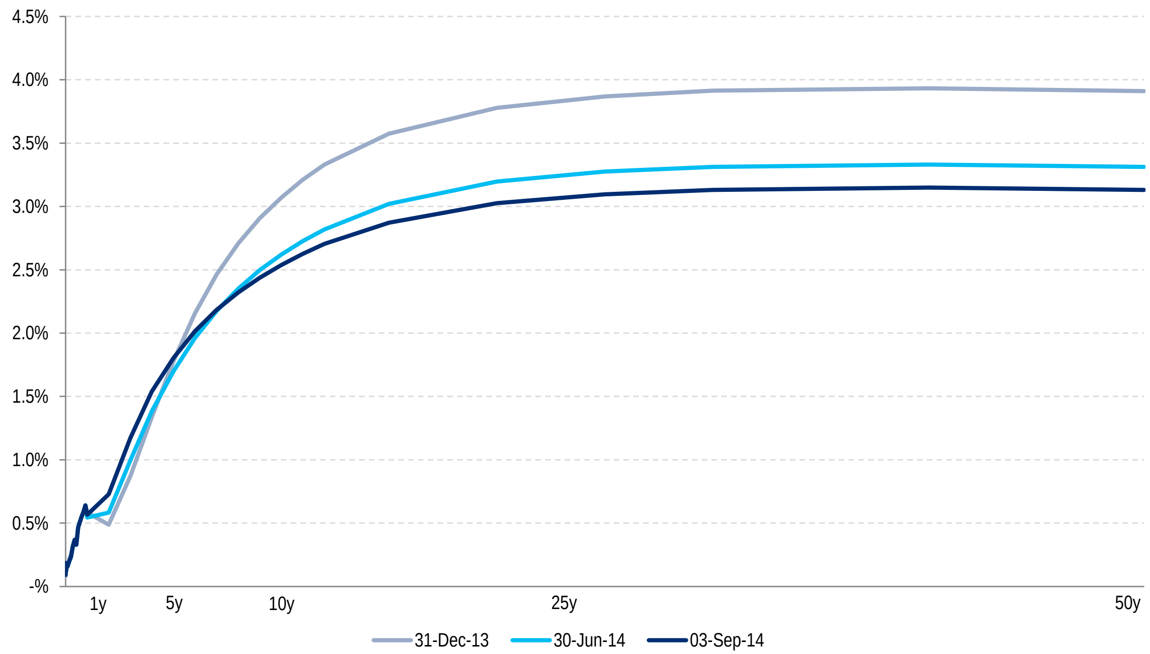
Source: Company Reports, Citi Research

7) Banks & Rates Cycle

Steeper Curves Helps “Under-Earning” USD Balance Sheets

- Over the past 7 months, 4/5 year yields of major currencies have respectively moved in diverging trends:
  - Increasing: GBP curve: +10bps / -4bps; USD curve: +15bps / 0bps
  - Decreasing: EUR curve: -50bps / -64bps; SFr curve: -36bps / -48bps
- Over time, this may provide scope for re-pricing & improving NIMs, notably for banks with surplus USD deposit balances
- UK international banks and major Swiss banks remain best-positioned

Figure 63. 4/5 Year Yields of the US Swap Curve Have Shifted Up Slightly



Source: Bloomberg, Citi Research

Credit Suisse WM Sensitivity to Rates

Figure 64. Credit Suisse – Wealth Management Sensitivity

	AuM (SFr m)	P&L (SFr m)	Specific Margin (bps)	Overall Margin (bps)	Comments
(1) Shift from Cash to Bonds/Equities	33.2	203	61.3	2.5	
1% Shift to Bonds	8.3	25	30.0		Assume +30bps margin
1% Shift to Equities	8.3	50	60.0		Assume +60bps margin
1% Shift to Discretionary Mandates	8.3	71	85.0		Assume +85bps margin
1% Increase in Loan Penetration	8.3	58	70.0		Assume UHNW loans (c40% of 1H14 new loans) have 100bps spread and HNW loans have 50bps
(2) Higher Global Markets	22.4	134	60.0	1.6	
10% Rise in Equity Markets	22.4	134	60.0		Assume +60bps margin
(3) Improved Risk Appetite	829.7	241	29.0	2.9	
10% Increase in Transaction Margin	829.7	241	29.0		2014E Transaction revenue margin
(4) Higher Interest Rates	190.8	410	21.5	4.9	
100bps parallel shift	190.8	410	21.5		A parallel upward shift of interest rates by 100 basis points would boost gross margins by 5bps in a full year (3Q13)
(5) Weaker Swiss Franc		313			
5% Weaker USD/CHF		259			A 10% movement in the USD/CHF rate affects 2013 pre-tax income by CHF647 m (4Q13 presentation); 80% WM-driven
5% Weaker EUR/CHF		54			A 10% movement in the EUR/CHF rate affects 2013 pre-tax income by CHF136 m (4Q13 presentation); 80% WM-driven
Total Revenue/PBT Impact		1,302			
Marginal Cost/Income Ratio		198	20.0%		Assume 20% marginal cost-income ratio
Total PBT Impact		1,104			
2016E Wealth Management PBT		3,346			
2016E Group PBT		8,387			
As a % of 2016E WM PBT		33.0%			
As a % of 2016E Group PBT		13.2%			
AuM (SFr bn)	829.7				2Q14
Memo					
% Bonds	17.0%				Average of UBS and JB disclosures
% Equities	27.0%				Average of UBS and JB disclosures
% Discretionary Mandates	33.0%				Average of UBS and JB disclosures
% Cash & Deposits	23.0%				Average of UBS and JB disclosures

Source: Citi Research Estimates

UBS WM Sensitivity to Rates

Figure 65. UBS – Wealth Management Sensitivity

	AuM (SFr m)	P&L (SFr m)	Specific Margin (bps)	Overall Margin (bps)	Comments
(1) Shift from Cash to Bonds/Equities	37.1	227	61.3	2.5	
1% Shift to Bonds	9.3	28	30.0		Assume +30bps margin
1% Shift to Equities	9.3	56	60.0		Assume +60bps margin
1% Shift to Discretionary Mandates	9.3	79	85.0		Assume +85bps margin
1% Increase in Loan Penetration	9.3	65	70.0		Assume UHNW loans (assume 40%, in line with CS) have 100bps spread and HNW loans have 50bps
(2) Higher Global Markets	25.1	150	60.0	1.6	
10% Rise in Equity & Capital Markets	25.1	150	60.0		Assume +60bps margin
(3) Improved Risk Appetite	928.0	191	20.6	2.1	
10% Increase in Transaction Margin	928.0	191	20.6		2014E Transaction revenue margin
(4) Higher Interest Rates	213.4	700	32.8	7.5	
100bps parallel shift	213.4	700	32.8		100 bps parallel shift in the yield curves of all currencies: ~CHF 700 million per year
(5) Weaker Swiss Franc		220			
5% Weaker USD/CHF		125			10% depreciation in the CHF vs. USD: ~CHF 250 million
5% Weaker EUR/CHF		95			10% depreciation in the CHF vs. EUR: ~CHF 190 million
Total Revenue/PBT Impact		1,489			
Marginal Cost/Income Ratio		254	20.0%		Assume 20% marginal cost-income ratio
Total PBT Impact		1,235			
2016E Wealth Management PBT		3,596			
2016E Group PBT		8,995			
As a % of 2016E WM PBT		34.3%			
As a % of 2016E Group PBT		13.7%			
AuM (SFr bn)	928.0				2Q14
Memo					
% Bonds	15.0%				Based on UBS disclosure, 2013 Annual Report p34
% Equities	27.0%				Based on UBS disclosure, 2013 Annual Report p34
% Discretionary Mandates	35.0%				Based on UBS disclosure, 2013 Annual Report p34
% Cash & Deposits	23.0%				Based on UBS disclosure, 2013 Annual Report p34

Source: Citi Research Estimates

Julius Baer Sensitivity to Rates

Figure 66. Julius Baer – Group Sensitivity

	AuM (SFr m)	P&L (SFr m)	Specific Margin (bps)	Overall Margin (bps)	Comments
(1) Shift from Cash to Bonds/Equities	11.0	62	56.3	2.3	
1% Shift to Bonds	2.7	8	30.0		Assume +30bps margin
1% Shift to Equities	2.7	16	60.0		Assume +60bps margin
1% Shift to Discretionary Mandates	2.7	23	85.0		Assume +85bps margin
1% Increase in Loan Penetration	2.7	14	50.0		Assume HNW loans spreads of 50bps
(2) Higher Global Markets	7.4	44	60.0	1.6	
10% Rise in Equity Markets	7.4	44	60.0		Assume +60bps margin
(3) Improved Risk Appetite	274.2	40	14.7	1.5	
10% Increase in Transaction Margin	274.2	40	14.7		2014E Transaction and Other revenue margin
(4) Higher Interest Rates	63.1	207	32.8	7.5	
100bps parallel shift	63.1	207	32.8		Assume UBS sensitivity, pro-rata for Julius Baer
(5) Weaker Swiss Franc		52			
5% Weaker USD/CHF		30			Assume UBS sensitivity, pro-rata for Julius Baer
5% Weaker EUR/CHF		22			Assume UBS sensitivity, pro-rata for Julius Baer
Total Revenue/PBT Impact		405			
Marginal Cost/Income Ratio		71	20.0%		Assume 20% marginal cost-income ratio
Total PBT Impact		335			
2016E Group PBT		968			
As a % of 2016E Group PBT		34.6%			
AuM (SFr bn)	274.2				1H14
Memo					
% Bonds	19.0%				Based on Julius Baer disclosure, 1H14 presentation p38
% Equities	27.0%				Based on Julius Baer disclosure, 1H14 presentation p38
% Discretionary Mandates	31.0%				Based on Julius Baer disclosure, 1H14 presentation p38
% Cash & Deposits	23.0%				Based on Julius Baer disclosure, 1H14 presentation p38

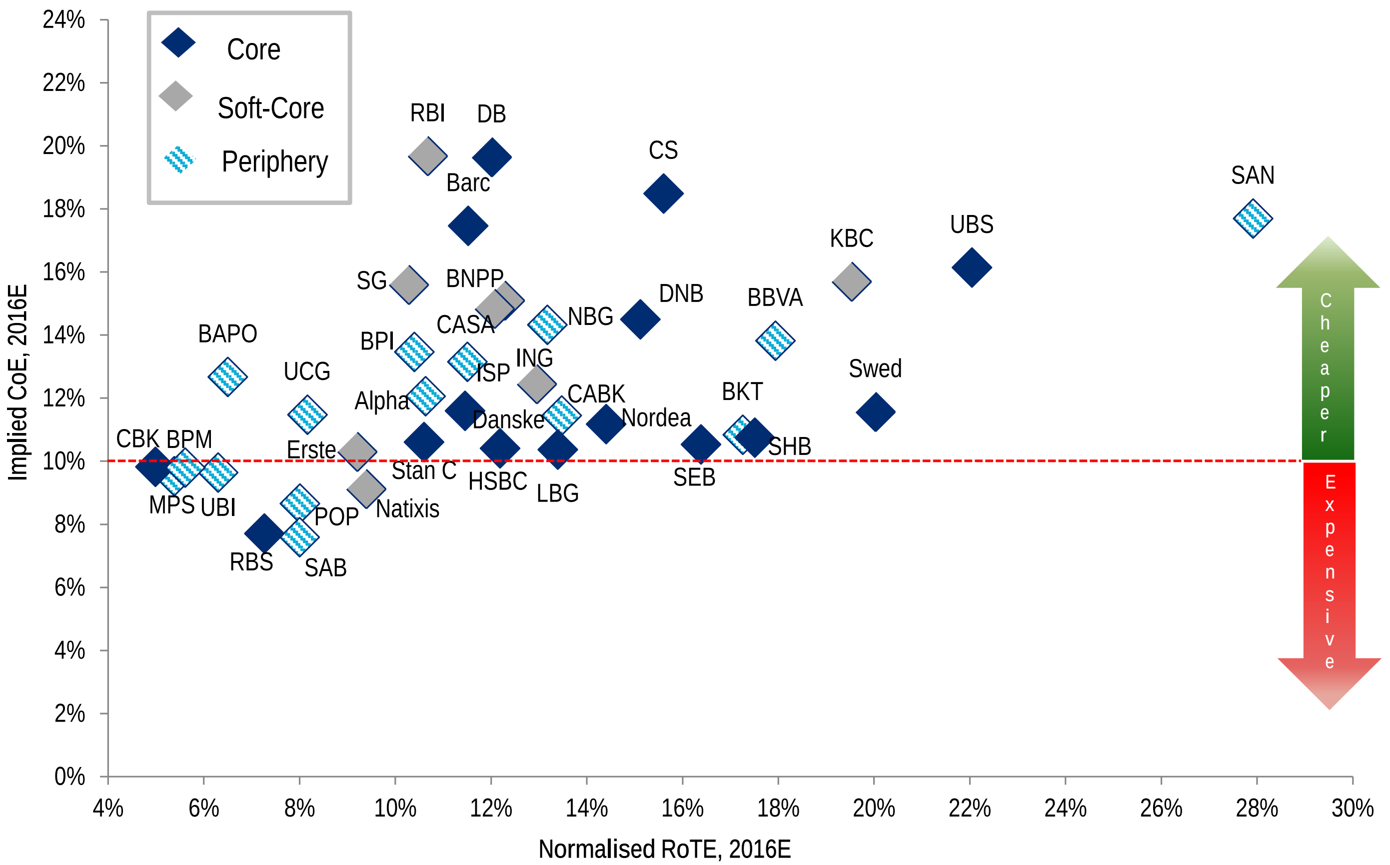
Source: Citi Research Estimates

Citi Research

8) Valuation

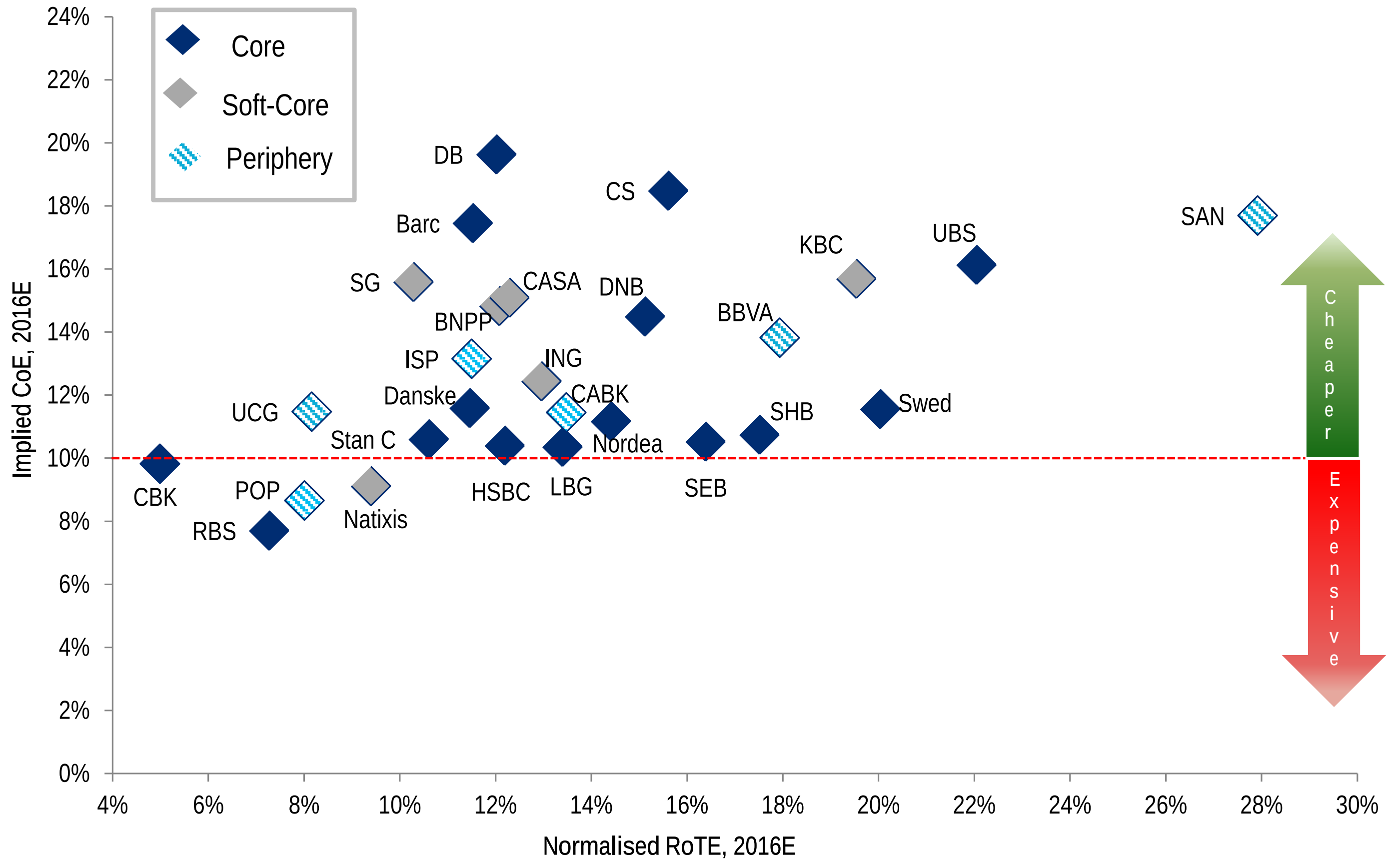
Implied CoE vs. Normalised RoTE

Figure 67. Fully Normalised RoTE vs Implied CoE, 2016E



Source: Citi Research Estimates

Figure 68. Fully Normalised RoTE vs Implied CoE, 2016E – Large Cap Stocks >€10bn)

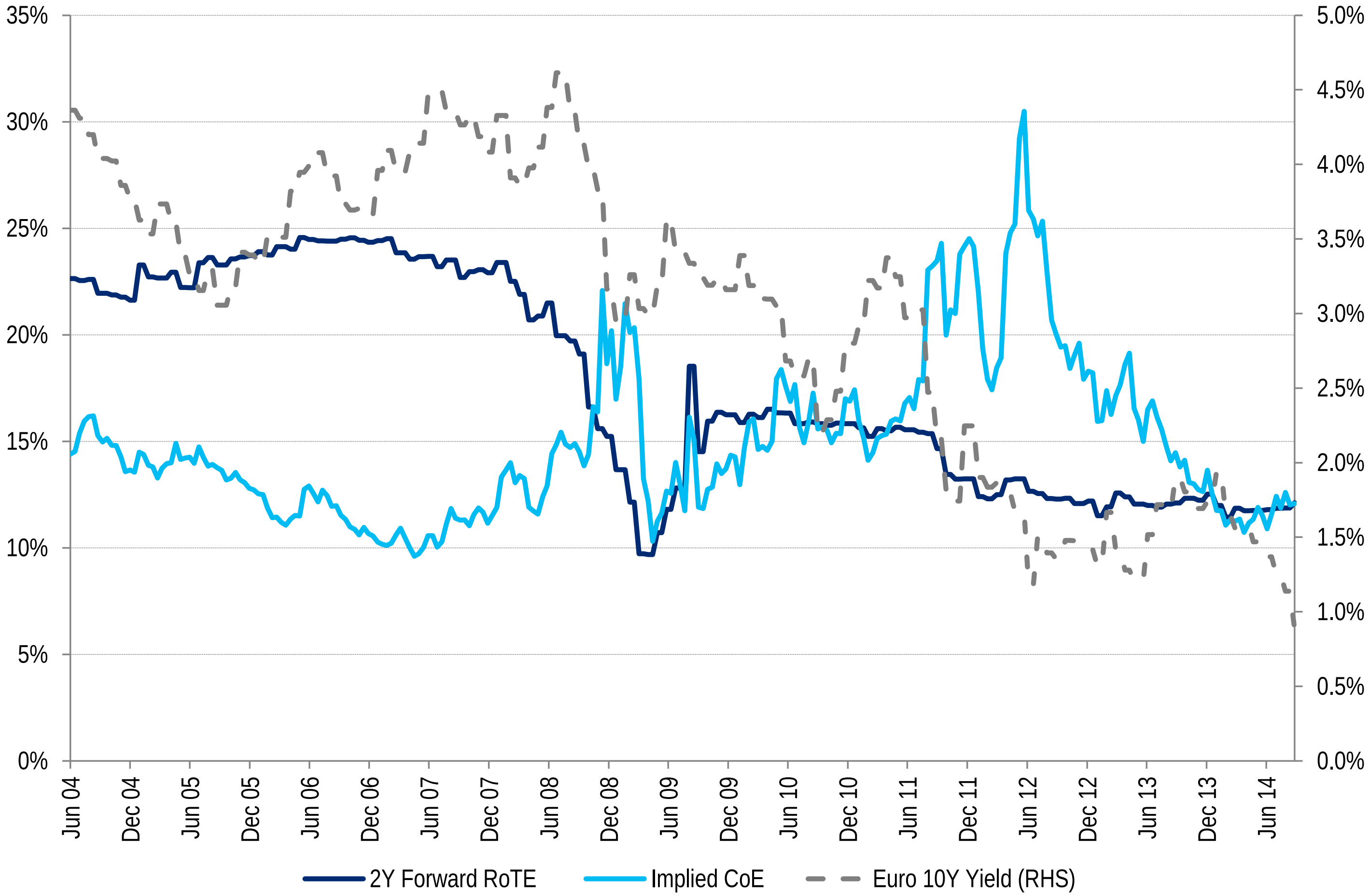


Source: Citi Research Estimates

Implied CoE trends

Since June, implied sector CoE (cost of equity) has backed-up from under 11% in April 2014, to over 12%, on our estimates

Figure 69. 2Y Fwd ROTE, Implied CoE and Euro 10Y Yield Trends



Source: Citi Research Estimates, Company Reports, dataCentral and Thomson Reuters Datastream

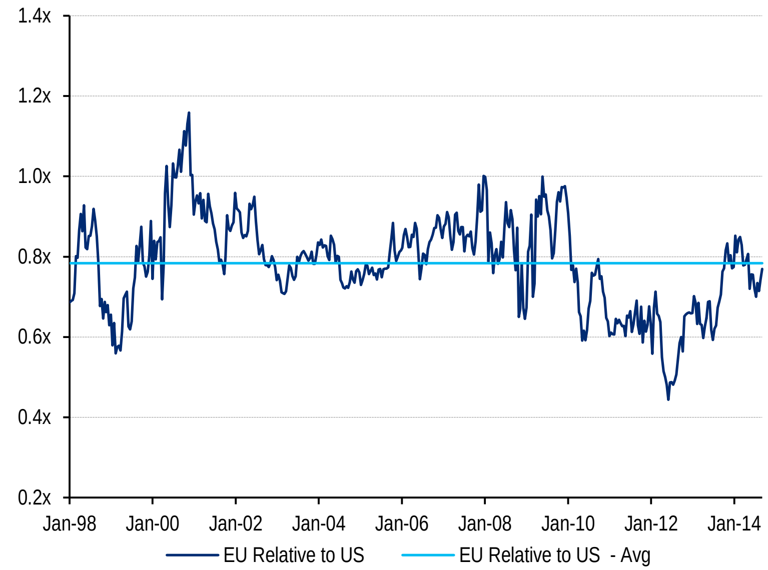
P/GOP

European banks trade at 5.5x P/GOP (+1 year) vs pre-Eurozone crisis average of 6.3x (c88%); 0.8x US average vs 15 year average of 0.8x (c98%)

Figure 70. European Banks Sector 1 Yr Forward P/GOP (Jan 98-Aug 14)

Source: Powered by dataCentral

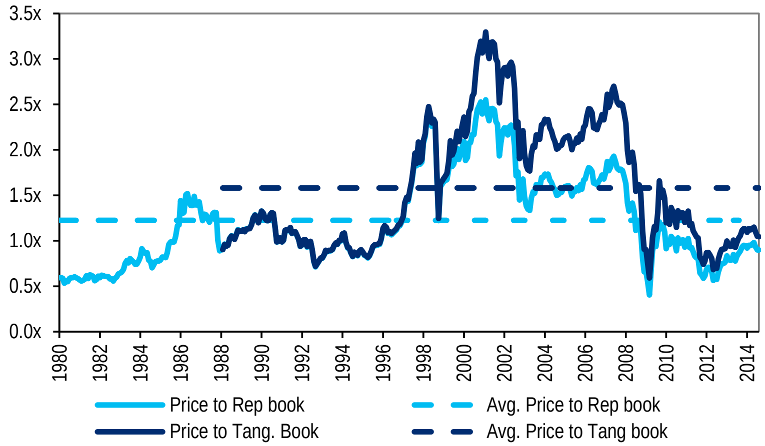
Figure 71. European vs US Banks Sector 1 Yr Forward P/GOP (Jan 98-Aug 14)



Source: Powered by dataCentral

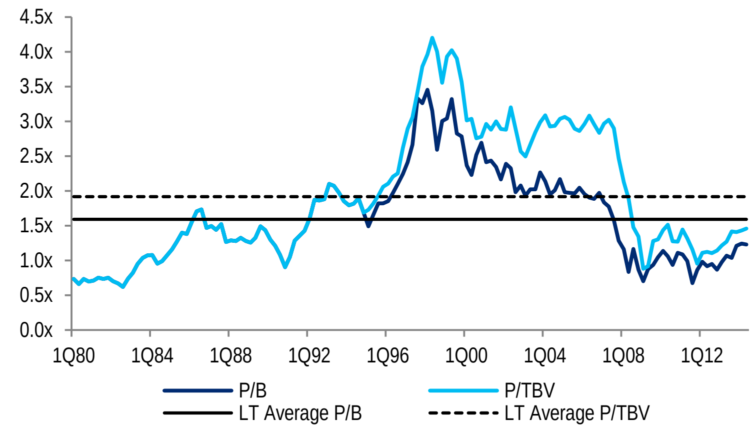
P/BV & P/TBV

Figure 72. European Banks' P/B and P/TB



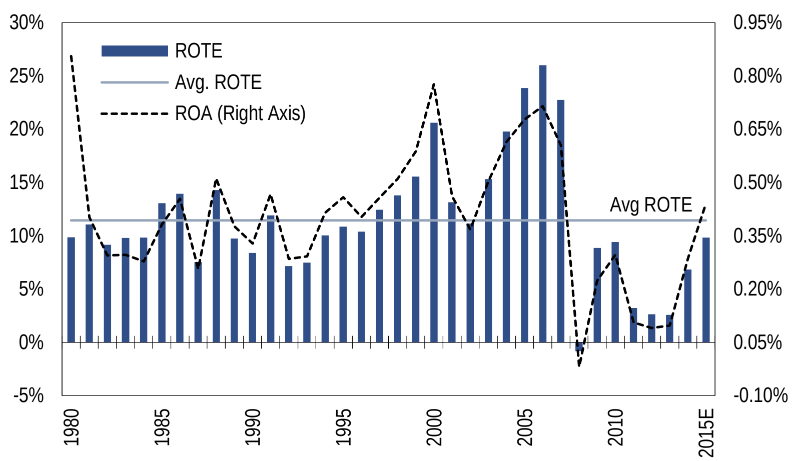
Note: Based on data for Citi Research Coverage Source: Wordscope, Citi Research

Figure 73. US Banks' P/B and P/TB



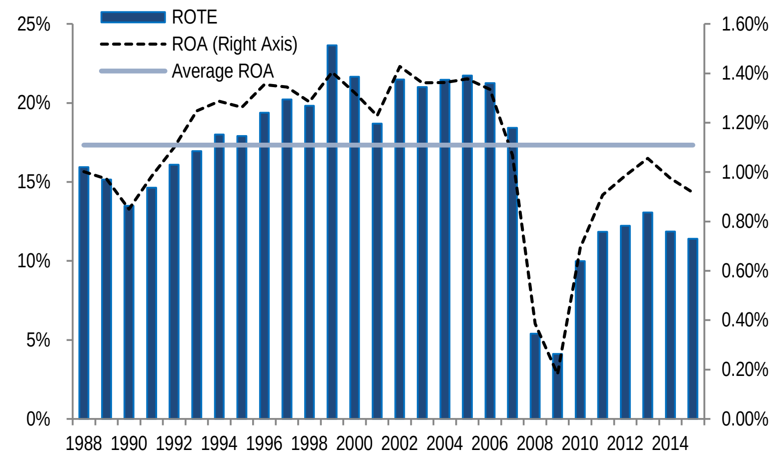
Note: Based on data for Citi Research Coverage Source: SNL Financial, Citi Research

Figure 74. European Bank ROTEs



Note: Based on data for Citi Research Coverage Source: Worldscope, Citi Research Estimates

Figure 75. US Bank ROTEs



Note: Based on data for Citi Research Coverage Source: SNL Financial, Citi Research Estimates (2014)

9) Country Views

UK Banks: Earnings Momentum, Regulation & TNAV Growth

- **Earnings Downgrades** – Four of the five large banks have seen consensus earnings downgrades in the past year. Costs are declining, but not enough to offset falling revenues, driven by disposals and the FICC environment.
- **Regulation** – Evolving. Leverage a new capital constraint, Pillar 2 concerns, ring-fencing on the horizon. This has delayed the capital return thesis for the UK banks relative to European peers.
- **TNAV Growth** – Hindered by restructuring, conduct costs, FX and reserve movements. Over time the gap between “underlying” earnings and statutory earnings should narrow.
- **Neutral UK Domestic Banks** – Barclays looks cheap and we think this value should materialise as it executes on the new restructuring plan. Lloyds & TSB valuations look full to us, despite better macro. RBS’s ability to deliver returns above cost of capital still appears to be some way away. Buy Barclays. Neutral Lloyds & TSB. Sell RBS.
- **Neutral UK International Banks** – EM vulnerability concerns look overdone; revenues starting to turn, renewed focus on costs. We see greater long-term upside potential as base rates rise. Buy Standard Chartered. Neutral HSBC.

Figure 76. Valuation – UK Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Barclays	BARC.L	Buy	p	222	300	+35%	7.5x	6.3x	0.69x	0.66x	9.4%	10.8%	5.4%	46
HSBC	HSBA.L	Neutral	p	647	685	+6%	12.0x	11.0x	1.23x	1.17x	10.5%	10.9%	5.2%	155
Lloyds Banking Grp	LLOY.L	Neutral	p	75	82	+10%	9.0x	8.6x	1.35x	1.29x	15.5%	15.3%	4.7%	67
RBS	RBS.L	Sell	p	352	330	-6%	14.2x	11.9x	0.97x	0.94x	6.8%	8.0%	2.8%	50
Standard Chartered	STAN.L	Buy	p	1218	1400	+15%	9.9x	9.0x	1.07x	1.00x	11.2%	11.5%	4.1%	38
TSB Banking Grp	TSB.L	Neutral	p	282	300	+6%	<0	nm	0.85x	0.81x	-0.9%	1.6%	0.0%	2

Source: Powered by dataCentral, Prices at 2nd September, 2014

French Banks – Re-rating Potential

- **The Big Picture: French Concerns Overdone**
  - French Retail remains 'cash cow': in 2Q14, sector PBT was down 'only' 2%
  - NIM pressure from lower rates, but partly offset by Livret A rate cut (by 25bps to 1.0%) and improving funding mix (led by sight deposits)
  - Gradual provision 'normalisation', down from 37bps in 2Q13 to 32bps in 2Q14
- **CIB - Improving Dynamics**
  - Exposure to disintermediation 'tailwinds', notably BNP Paribas and SocGen (top 3 €-denominated franchises, Figure 52)
  - Financing operations seeing 'inflection' point, 3 years after US MM funding crisis
  - Structured EQD franchises benefiting from consolidation and better demand (BNP Paribas and SocGen)
- **International Retail & Financial Services**
  - Scope for further significant provision 'normalisation'
  - SocGen's CEE operations could suffer from Russia-Ukraine crisis although we expect Russian exposure to be 'manageable': doubling NPL ratio = 2% TBV impact; write-off of full investment = c10% impact (with tax benefit)
- **Attractive Valuations**
  - BNPP, CASA and SG trade at c0.9x, c0.9x & c0.7x 2015E P/TBV for *underlying* RoTEs of c11-12%, offering significant value, in our view; Natixis looks to us fully-valued
  - We see BNPP as an 'exception to the rule' in the US sanctions case

Figure 77. Valuation – French Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
BNP Paribas	BNPP.PA	Buy	E	52	62	+20%	9.1x	7.7x	0.87x	0.81x	10.0%	10.9%	4.9%	64
Credit Agricole	CAGR.PA	Buy	E	11	15	+33%	8.1x	7.3x	0.92x	0.86x	11.2%	11.5%	5.8%	29
Natixis	CNAT.PA	Neutral	E	5.30	5.00	-6%	12.0x	11.1x	1.07x	1.03x	9.2%	9.5%	5.0%	17
Societe Generale	SOGN.PA	Buy	E	38	56	+46%	7.3x	6.4x	0.71x	0.66x	9.8%	10.4%	5.9%	31

Source: Powered by dataCentral, Prices at 2nd September, 2014

Swiss Banks – Geared to Rising US Rates

- **Overweight Swiss Wholesale Banks** – Self-help through cost-cutting and a refocusing of business models (away from capital-intensive FICC). Valuation gap caused by regulatory & litigation uncertainty: clarity on TBTF rules expected in early-2015. Neutral on wealth manager Julius Baer, ahead of US cross-border settlement.

- **Regulation** – Significant regulatory uncertainty driven by TBTF debate, with discussion of potential 6-10% leverage ratio. We expect focus of additional capital requirements to be mainly on GLAC with a potential increase in leverage ratio to c5%; latter could raise CS' CET1 capital ratio requirement from 11% to c12-13% (SNB Pushes Leverage & Risk-Weight Debate, June 2014). FX risks at UBS partly mitigated by strong capital position (13.5% B3 CET1 ratio), specific operational risk capital (SFr3.1bn) and likely cooperation with authorities.

- **Leverage & Self-Help** – Swiss banks are among the leaders in leverage reduction, led by UBS' radical FICC restructuring and CS' more gradual restructuring. Further Wealth Management, Non-Core and Infrastructure cost savings to be back-loaded over 2014-16E.

- **WM & Interest Rate Sensitivity** – The deposit franchises of WM operations are a large source of funding but also result in significant gearing to the rates cycle. Although 10y US Treasury yields are relatively low, 2-year yields are more reflective of potential for inflection point in US rates cycle (see Section 7) Banks & Rates Cycle).

Figure 78. Valuation – Swiss Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Credit Suisse	CSGN.VX	Buy	SFr	26	33	+27%	8.8x	7.2x	1.10x	0.84x	13.8%	13.9%	7.7%	35
EFG Internatnl	EFGN.S	Neutral	SFr	10.35	10.50	+1%	11.4x	9.4x	1.67x	1.53x	15.4%	17.1%	5.8%	1
Julius Baer	BAER.VX	Neutral	SFr	42	44	+6%	11.6x	9.9x	3.65x	2.83x	34.8%	32.2%	2.2%	8
UBS	UBSN.VX	Buy	SFr	16	22	+34%	9.3x	8.0x	1.41x	1.37x	15.0%	17.1%	4.6%	52
Vontobel	VONN.S	Neutral	SFr	34	30	-11%	10.6x	9.2x	1.37x	1.26x	12.9%	13.7%	4.8%	2

Source: Powered by dataCentral, Prices at 2nd September, 2014

German Banks – Concerns Overdone at Deutsche Bank

- **Fast-Forward Bail-in:** Germany to implement BRRD 'bail-in' tool from 1 Jan 2015 (a year earlier than the rest of Europe)

- **Commerzbank: Weak Core Profitability Remains Concern**
  - Commerzbank's 1H14 profitability was ahead of expectations, albeit driven mainly by write-backs in non-core, which we do not view as sustainable. Core profitability remains weak, hindered by the low-rate environment.
  - The company has accelerated non-core asset reduction and now targets <€68bn by end-2016 (vs original target <€93bn); this has helped to improve capital ratios, with the CET1 ratio +100bps yoy to 9.4%
  - Litigation risks remain (e.g. OFAC) while collateral values used on the shipping portfolio remain a concern into AQR (German banks currently utilise the favourable Hamburg Ship Evaluation Standard).
  - Commerzbank trades on 'only' 0.5x 2015E tangible book, but we believe this is fair based on the lacklustre core RoE outlook. The 2016 core RoE target is for only 10% and even this looks challenged (we forecast 8%).

- **Deutsche Bank: Risks Priced-In**
  - In 1H14, FICC market share recovered to c11% (in-line with JPM) confirming relative franchise strength; diverging central bank cycles (Fed vs ECB) could signal greater volatility (supportive)
  - Further significant net cost savings of c€1.5bn should add c15-20% to Core PBT by 2016E
  - Litigation risks remain significant (incl. FX, US sanctions, RMBS) albeit largely priced into valuation, in our view; 2015E P/TBV of 0.7x for sustainable RoTE of 12-13%

Figure 79. Valuation – German Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Commerzbank	CBKG.DE	Neutral	E	12	12	+3%	11.3x	8.3x	0.54x	0.51x	4.9%	6.3%	0.0%	13
Deutsche Bank	DBKGn.DE	Buy	E	26	36	+38%	6.3x	5.3x	0.68x	0.61x	11.2%	12.2%	2.9%	36

Source: Powered by dataCentral, Prices at 2nd September, 2014

Spanish Banks: Focus on Core Strategies for 2015

- **Well Prepared for AQR and Stress Test –** In the 1Q13-4Q13 period the Spanish banks addressed two of the most sensitive areas examined by the AQR and Stress Test: real estate provisions and the proper classification of forborne loans. NPL coverage ratios in Spain range from 45-60%, with Caixa and Bankia at the upper end. Popular, and potentially Sabadell, may need to increase coverage levels to reflect higher credit risks in their loan portfolios (SME, other consumer lending) but the rest of the Spanish should be well prepared for the Single Supervisory Mechanism, in our view.

- **The NPL Cycle May Have Peaked Already –** The system NPL ratio declined 33 bps month-on-month in June 2014, the 4th such decline since the beginning of the year. While downside risks remain, we believe that the balance of risk is to the upside. As asset quality improves and with capital levels largely above 10% (Basel 3 FL CET1R), we think the Spanish banks are likely to focus more on executing core strategies.

- **Opportunities for 2015 –** Managing down the cost of term deposits; further consolidation and cost-revenue optimisation; SME lending, driven partly by TLTRO take-up; and further capital rebuild via organic generation and RWA optimisation.

- **Overweight Domestic Spain, Neutral on the International Spanish –** Prefer Caixa on "Consolidate and Optimise" - Going into 2015, we have 3 domestic Buys (CABK, BKIA, LBK), 1 Neutral (BKT) and 2 Sells (SABE, POP). BBVA and SAN are both Neutral-rated as we see most of the potential upside from Spain, Mexico and Brazil as fully priced into the shares. Our top pick in Spain is Caixabank, which we see as the main beneficiary of consolidation, cost optimisation and upside potential from SME lending – while providing downside protection to AQR/Stress Test risks.

Figure 80. Valuation – Spanish Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Banco Popular	POP.MC	Sell	E	4.77	4.40	-8%	16.9x	11.0x	0.97x	0.93x	5.8%	8.6%	2.4%	10
Banco Santander	SAN.MC	Neutral	E	7.58	7.60	+0%	11.2x	10.2x	1.70x	1.58x	15.7%	16.1%	7.9%	91
Bankia	BKIA.MC	Buy	E	1.49	1.80	+21%	12.8x	10.4x	1.30x	1.16x	10.7%	11.7%	2.7%	17
Bankinter	BKT.MC	Neutral	E	6.39	6.35	-1%	15.0x	12.2x	1.72x	1.59x	12.1%	13.6%	2.4%	6
BBVA	BBVA.MC	Neutral	E	9.26	9.50	+3%	14.0x	10.1x	1.40x	1.30x	10.2%	13.3%	4.0%	55
Bco de Sabadell	SABE.MC	Sell	E	2.40	1.90	-21%	17.4x	11.0x	1.11x	1.05x	6.5%	9.8%	2.9%	10
CaixaBank	CABK.MC	Buy	E	4.63	5.30	+14%	11.8x	9.5x	1.25x	1.18x	11.0%	12.8%	4.3%	26
Liberbank	LBK.MC	Buy	E	.71	.83	+17%	13.3x	8.1x	0.82x	0.78x	6.3%	9.9%	3.5%	2

Source: Powered by dataCentral, Prices at 2nd September, 2014

Italian Banks – Back in the Spotlight: Upgrading to Overweight

- **Upgrade to Overweight –** Italian banks are among the worst-performing banks in Europe in the last 3 months (-10% absolute and -7% vs European banks) possibly due to disappointing GDP reading, several capital increases placed on the market, fears over AQR, limited delivery from government on reform as well as investor positioning. The recent underperformance has created, in our view, an interesting buying opportunity as we expected Italian financial stocks to benefit from: lower sovereign spread; not so scary AQR results; potential ECB actions and profitability recovery; and multiple expansion (due to potential lower cost of equity).

- **What to Buy –** Our Buy-rated stocks in Italy have been UCI, MDBI and UBI, and we are now upgrading ISP given the recent underperformance, and on the back of our expectation of the bank's solid capital position post AQR (it screens well in our simulation), profitability recovery, strong correlation with Italian sovereign, potential for high capital return, gearing to asset management and optionality from any potential ECB actions.

- **Sovereign Improving, Equity Lagging –** Italian banks have a large holding of Italian sovereign bonds (€236bn, c190% of TBV). Italian banks share prices showed a strong correlation with sovereign in the past, but since June they have decoupled: sovereign yield has improved by c5% and Italian banks declined by c10%, and we expect equities to recover ahead of the ECB announcement.

- **AQR Not So Scary –** The AQR/Stress test result will be published in the second half of October; we do not expect the results to show many new negative surprises. We have run our AQR simulation and expect Intesa to be the strongest among Italian banks, with MPS the weakest. For more on AQR/periphery NPLs refer to Summer Stress.

- **In Draghi We Trust –** Our economists expect the ECB to announce some form of QE in late 4Q14/1Q15 (ECB QE: Why, When and How?); coupled with T-LTRO, this is likely to support periphery bank share prices via lower deposit costs, some increase in lending, revaluation of sovereign holdings and lower cost of equity, in our view.

- **Profitability Recovering –** Italian banks' ROTE is among the lowest in Europe and below historical levels. We expect ROTE to improve to c8% in 2017 owing to credit cost normalisation and lower funding costs. Banks showed an encouraging trend in 2Q.

- **Key Risks –** We also highlight the major risks to our Overweight stance on Italy: weaker-than-expected GDP recovery in Italy, no further actions from the ECB, no recovery in lending growth over the medium term, rising sovereign spreads, slower-than-expected profitability recovery, political instability in Italy, negative surprise from AQR/Stress Test at the stock-specific level as well as geopolitical risks.

Figure 81. Valuation – Italian Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Banco Popolare	BAPO.MI	Neutral	E	12	na		14.8x	10.8x	0.53x	0.51x	3.7%	4.8%	1.7%	4
BP Milano	PMII.MI	Neutral	E	.61	.70	+15%	15.5x	11.0x	0.59x	0.57x	3.9%	5.2%	2.9%	3
Intesa Sanpaolo	ISP.MI	Buy	E	2.26	2.70	+16%	11.6x	9.3x	0.92x	0.87x	8.1%	9.6%	5.0%	37
Mediobanca	MDBI.MI	Buy	E	6.53	8.00	+23%	8.5x	7.9x	0.71x	0.66x	8.3%	8.5%	3.1%	6
Monte dei Paschi	BMPS.MI	Neutral	E	1.13	1.35	+20%	27.0x	15.6x	0.59x	0.57x	2.2%	3.7%	0.0%	6
UBI Banca	UBI.MI	Buy	E	6.02	7.30	+21%	16.5x	12.9x	0.67x	0.65x	4.1%	5.1%	3.4%	5
UniCredit	CRDI.MI	Buy	E	5.92	7.30	+23%	11.9x	8.4x	0.75x	0.71x	6.4%	8.7%	2.9%	35

Source: Powered by dataCentral Prices a 2nd September, 2014

Benelux Banks – Buy KBC and ING

ING – 3 Key Catalysts

- We identify 3 key catalysts: (i) probable repayment of remaining state aid in 4Q14, ahead of schedule, (ii) likely spin-off of the remaining 68% stake in NN in early-2015, as core debt is already covered by future proceeds from Voya and a spin-off would be tax efficient, (iii) reinstatement of dividends in 1H15, for the first time in 7 yrs.
- ING targets a 10-13% RoE and >40% payout ratio. We believe the upper end is achievable. We model a 2017 RoE of 11.9%, or 13.2% after adjusting for excess capital, as well as a payout ratio of c50%.
- ING's Commercial Bank has been repositioned and is now well set to grow again. Commercial loans have grown by an impressive 11% on an annualised basis in 1H14, driven by structured finance and general lending & transaction services.
- Based on current market values of NN and Voya we estimate ING Bank is trading on 1.0x P/TB. We believe a 1.3x multiple is more appropriate based on the return, growth and dividend prospects. We have a Buy rating, target price €12.40.

KBC – Financial Targets can be Surpassed

- KBC's deposit rate cuts in Belgium (in April, July and August), combined with the call of €2bn of legacy tier 1 instruments at end-May (which paid an 8% coupon), should more than offset asset margin pressure, in our view, while loans grew by 2% in Belgium and 1% in Czech Republic in 2Q14. Overall we model a revenue CAGR of 2.55%, ahead of the target >2.25%.
- KBC's planned deployment of excess capital from 2Q14-2017, based on retaining a CET1 ratio of >10.5%, is split a third on repayment of state aid (including penalties), a third on growth (including organic growth, M&A and regulatory uncertainties) and a third on capital return (dividends and coupon on AT1/YES). Based on the target payout ratio of >50% from 2016 onwards, we calculate that this implies that KBC is targeting a cumulative 2016-17 net profit of c€4.2bn. We believe this can be surpassed – we forecast €4.6bn in 2016-17.
- KBC's acquisition ban ends on 18 Nov 2014 and KBC has confirmed it has no plans to expand beyond its current geographical footprint, but aims to strengthen its bank-insurance presence via organic growth and acquisitions in its core markets. However if acquisitions cannot be identified we estimate it could payout >50% of earnings.
- KBC's leading bancassurance model, in smaller oligopolistic markets should serve shareholders well, in our view. KBC trades on 1.5x 2015E P/TB for a c15% RoTE, one of the highest returns in Europe, and generates more excess capital per annum than any other bank in the SX7E, offering the potential for significant capital return via dividends and buybacks in the long term. We have a Buy rating, target price €50.

Figure 82. Valuation – Benelux Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
ING Groep	ING.AS	Buy	E	10.55	12	+18%	10.0x	8.6x	1.12x	1.04x	10.1%	12.5%	3.8%	41
KBC	KBC.BR	Buy	E	43	50	+16%	8.5x	8.0x	1.47x	1.24x	17.5%	16.9%	0.0%	18

Source: Powered by dataCentral Prices a 2nd September, 2014

Nordic Banks – The 3Rs

- **Restructuring and Operational Efficiency:**
  - Nordic banks have best-in-class profitability as measured by profits and revenues per employee for DNB and SHB, return on equity in the mid-teens or cost/income ratios in the mid-40s for Swedbank and SHB.
  - We would expect Danske and SEB to improve on operating efficiency. SEB is turning from “problem child” to restructuring success. Its cost/income ratio declined to 54% in 2013, down from c65% in 2009-10. We expect it to improve further to c50% over the next two years.
- **Recovery:**
  - Danish economic recovery is turning from headwind to tailwind for Danske. There is recovery in property prices, which should translate into improving asset quality. Danske is restructuring its business by divesting low-return businesses and reducing costs.
  - DNB’s asset quality is improving, driven by shipping recovery. Norway house prices appear to be stabilising.
- **Return of Capital and Regulatory Clarity:**
  - Nordic banks have high capital ratios and despite higher regulatory requirements and political noise, we expect the Swedish banks to move from a capital rebuild to a capital return phase. Four out of six Nordic banks beating on 2013 dividends.
  - Danske restarted dividend payment in 2013; we expect Danske’s dividend payout ratio to reach 50% in 2016E (DKr8/share) and c55% in 2017E (DKr10/share).
  - DNB’s strong and improving capital position could translate into a 50% dividend payout by 2016E-17E.
  - More clarity on regulation. Swedish FSA has defined the minimum capital requirement for each bank, in-line with current levels. Danish FSA’s required minimum capital requirements are transparent and clear.
- **Top Picks:** DNB, Danske and SEB

Figure 83. Valuation – Nordic Banks

				Share Price			Adj. P/E		Tangible				Div. Yld	Mkt Cap
Bank	RIC	Rec	Curr	Now	Target	+/-%	2015E	2016E	P/B 15E	P/B 16E	ROE 15E	ROE 16E	2015E	€bn
Danske Bank	DANSKE.CO	Buy	Dkr	159	185	+17%	10.5x	9.3x	1.07x	0.99x	10.6%	11.0%	3.8%	21
DNB	DNB.OL	Buy	NKr	116	140	+21%	9.0x	8.5x	1.14x	1.04x	13.2%	12.7%	3.9%	23
Nordea	NDA.ST	Buy	SKr	90	101	+12%	10.4x	9.7x	1.35x	1.29x	13.4%	13.6%	6.7%	39
SE Banken AB	SEBa.ST	Buy	SKr	91	100	+10%	11.5x	10.8x	1.65x	1.56x	14.8%	14.9%	5.6%	22
SHB	SHBa.ST	Neutral	SKr	330	325	-2%	12.9x	12.1x	1.72x	1.63x	13.6%	13.8%	5.1%	23
Swedbank	SWEDa.ST	Neutral	SKr	177	180	+2%	11.7x	11.2x	1.81x	1.73x	15.8%	15.8%	6.4%	22

Source: Powered by dataCentral Prices a 2nd September, 2014

10) All You Want To Know On Banking Union

Three Pillars of Banking Union (BU)

Over-complicated and under-funded but wheels in motion – Banking Union to reduce sector risk premium

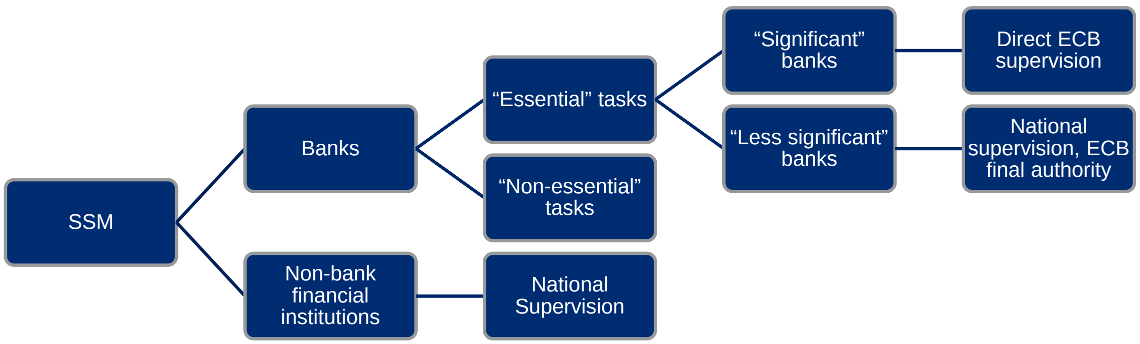
Figure 84. Three Pillars of Banking Union (BU)

SSM (Single Supervisory Mechanism)	• ECB to become the common banking *supervisor* • Monitor health and risks taken by banks covered
SRM (Single Resolution Mechanism)	• Single Resolution Fund (SRF) • Bank Recovery & Resolution (BRRD)
DGS (Common Deposit Guarantee)	• Up to a limit of €100K, by way of national prefunded DGS with scope for mutual borrowing between DGSs

Source: Company Reports and Citi Research Estimates

SSM – The First Pillar of Banking Union

Figure 85. Single Supervisory Mechanism



Source: Citi Research

All you need to know about SSM

- **What is it?:** The Single Supervisory Mechanism will create a new system of financial supervision comprising the ECB and the national competent authorities (NCA) of participating EU countries.
- **Why?:** To overcome financial fragmentation and breaking the sovereign-bank link.
- **When?:** ECB will assume its new banking supervision responsibilities from November 2014.
- **Who?:** EA countries participate automatically in the SSM. Non-EA Member States can also choose to participate by their NCA entering into "close cooperation" with the ECB.
- **How many credit institutions will be supervised?:**
  - It is expected that the ECB will directly supervise around 130 credit institutions, representing c85% of total banking assets in the euro area. Includes banks with assets >€30bn or over 20% of home country's GDP.
  - These credit institutions will be identified according to criteria to determine their significance. In each participating country, at least the three most significant credit institutions will be subject to direct supervision by the ECB, irrespective of their absolute size.
  - All other credit institutions in the participating countries will continue to be supervised by the NCA. The ECB can decide at any time to exercise direct supervision of any one of these credit institutions in order to ensure consistent application of high supervisory standards.
- **How will it be organised?:**
  - A Supervisory Board has been established to plan and carry out the ECB's supervisory tasks, undertake preparatory work and propose complete draft decisions for adoption by the ECB's Governing Council based on the principle of '*non-objection*'. It will be composed of:
    - a Chair (appointed for a non-renewable term of five years): Danièle Nouy;
    - a Vice-Chair (chosen from among the members of the ECB's Executive Board): Sabine Lautenschläger;
    - three additional ECB representatives;
    - one representative of the NCA of each participating country.

All you need to know about SRM

SRM – SRF

- **What is it?**
  - **The Single Resolution Mechanism** complements the Single Supervisory Mechanism which was proposed by the Commission in September 2012.
  - Aimed at significantly weakening the sovereign bank, which should, in turn, serve to reduce financial fragmentation
- **Who will sponsor bank bailouts and how will it work?**
  - It will be financed by bank levies raised at national level
  - **Single Resolution Fund (SRF)**: A hybrid fund (€55bn) will initially consist of national compartments and their progressive mutualisation over a 10-year transitional phase (10% pa)
  - **Funding**: (i) During initial build-up, bridge financing will be available from national sources, backed by bank levies, or from ESM; (ii) Lending between national funds will also be possible; (iii) In case of insufficient ex-ante funds, the DGS will collect immediate ex-post contributions from the banking sector
- **When can SRF be accessed?**
  - After bail-in, national resolution fund used first
  - Would require a two-thirds majority of the board of the resolution authority to approve any large-scale use of bailout funds – (i) liquidity support of > 20 per cent of fund; (ii) recapitalisation support of >10% of fund; (iii) access to fund once €5bn has been utilised in any single calendar year
  - One country does not mean one vote. Votes would be weighted by what's known as the "ECB capital key", ie the largest countries get the most say
- **Who will execute bank resolution?**
  - European Commission will be the main executor

All you need to know about BRRD

BRRD: Bail-in to avoid Bail-out

- **What?**
  - **The Bank Recovery & Resolution Directive (BRRD)**: To avoid taxpayer bail-out of banks, the European Commission proposed a common framework of rules and powers (see IP/12/570 and MEMO/12/416) in June 2012 to help EU countries intervene to better manage banks in difficulty. This law applies to all 28 Member States.
- **When?**
  - The European Parliament and the Member States reached agreement on this framework on 11 December 2013, subject to technical finalisation and formal approval by both institutions
  - The European Parliament formally approved BRRD on 15 April 2014
  - New rules enter into force from 1 Jan 2015 and allow authorities to intervene decisively before problems occur (e.g. recovery & resolution planning) or early on if they do (e.g. power to appoint an administrator)
  - The bail-in tool will apply from **1 Jan 2016** (instead of 2018); Germany to 'fast-forward' to **1 Jan 2015**
- **How?**
  - Harmonised rulebook on how the costs of bank failure are allocated
  - Banks have to make plans & authorities to take preventative steps to deal with bank failure
  - Shareholders and other creditors will bear losses first to the extent of 8% of a bank's liabilities before use of Resolution Fund is permitted; this is also known as **MREL** or Minimum Requirement for Own Funds and Eligible Liabilities
  - Tap national, prefunded resolution funds that each Member State has to build to a level of 1% of covered deposits within 10 years
  - Deposits under €100,000 exempt; above €100,000 after all other secured creditors claims are absorbed

All you need to know about DGS

DGS: Deposit Guarantee Scheme

- **What is it?**
  - The mechanism aims at robust financial sector is ensuring bank deposits in all Member States are guaranteed up to €100,000 per depositor per bank if a bank fails
  - Reform targets faster payouts – from 20 days to 7 days
  - Aimed at preventing panic withdrawals by depositors from their banks
  - The proposal also includes strengthened financing, notably through a significant level of ex-ante funding
  - A single supranational DGS is not planned at this stage
- **How?**
  - Target = minimum of 1% of covered deposits to be collected from banks over a 10-year period.
  - In case of insufficient ex-ante funds, the DGS will collect immediate ex-post contributions from the banking sector. As a last resort, it will have access to alternative funding arrangements such as loans from public or private third parties.
  - Voluntary mechanism of mutual borrowing between the DGSs from different EU countries
- **When?**
  - The European Parliament and EU member States are in the final stages of negotiation on this important text which should be formally approved early next year.

11) Macro

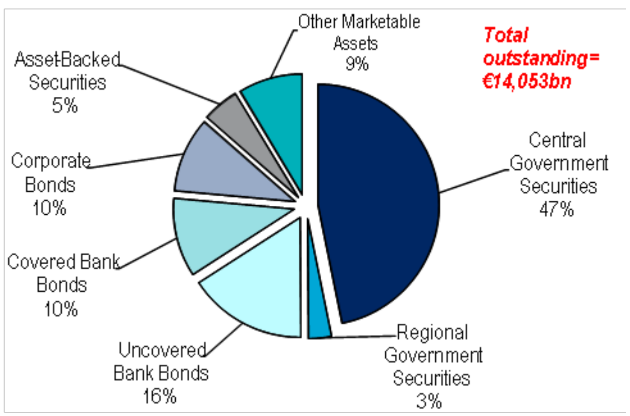
ECB QE

- Our economists expect €1trn QE in late 4Q14 and 1Q15
- Announcement likely in December (rather than September) post-AQR/Stress Test and to gauge TLTRO demand
- 60/40 split between public and private sector assets (ECB QE: Why, When and How?); follows on from their Apr-14 thesis ("Whatever it Takes", Redux)
- Private sector assets likely to be mainly focused on bank bonds (unsecured) and loans
- Sovereign bond purchases likely to be in proportion of ECB's capital contribution

TLTRO

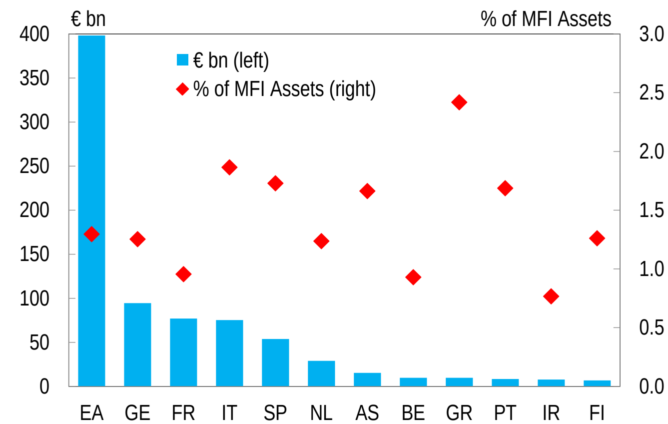
- Provides cheap, term funding which will support lower cost of funding across other liabilities (eg deposits), similar to UK's FLS (Funding for Lending Scheme)
- Our economists forecast likely take-up of €250bn, out of theoretical maximum of €400bn, split €150bn & €100bn in 1st and 2nd auctions; Consensus at c€300bn.

Figure 86. Euro Area — Eurosystem Eligible Market Assets, € Billions, Q1-2014



Sources: European Central Bank and Citi Research

Figure 87. Selected Countries — Maximum TLTRO Size (€ bn) and Share of TLTRO in Monetary Financial Institutions Assets (%), April 2014



Sources: European Central Bank and Citi Research

Citi Economic Research Forecasts Overview, 2014F-2017F

Data taken from Citi Economists' publication Global Economic Outlook and Strategy - August 2014: Willem Buiter et al

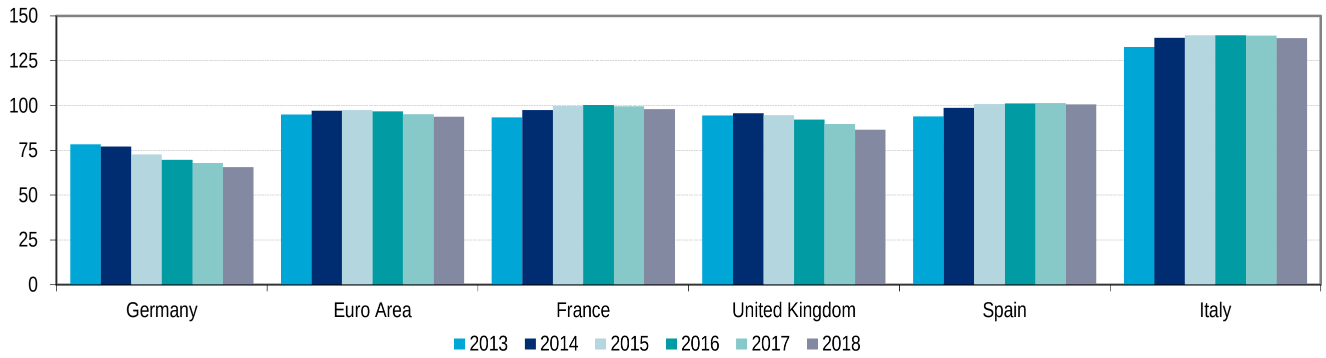
Figure 88. Citi Economic Forecasts Overview (2014-2017F)

	GDP Growth (%)				CPI Inflation (%)				Unemployment (%)	
	2014F	2015F	2016F	2017F	2014F	2015F	2016F	2017F	2014F	2015F
Global	2.8	3.4	3.6	3.6	2.9	3.0	3.2	3.2	6.8*	6.4*
United States	2.1	3.2	3.2	2.7	1.6	1.9	2.2	2.3	6.2	5.7
Japan	1.2	0.9	1.2	1.2	2.8	1.7	1.6	0.7	3.6	3.4
Euro Area	0.8	1.5	1.9	1.9	0.5	0.9	1.2	1.5	11.5	10.8
▪ Germany	1.6	2.0	2.3	2.3	1.0	1.7	2.1	2.3	5.0	4.9
▪ France	0.4	0.9	1.7	2.0	0.7	1.2	1.4	1.5	9.9	9.8
▪ Italy	-0.1	0.8	1.1	0.9	0.1	-0.2	0.3	0.9	12.6	12.3
▪ Spain	1.4	2.0	2.2	1.9	0.0	0.3	0.5	0.6	24.5	23.1
▪ Greece	0.1	1.5	1.4	1.5	-1.1	-1.0	-1.0	0.0	27.0	25.8
▪ Ireland	5.8	3.6	3.8	3.9	0.3	1.0	1.1	1.6	11.6	10.5
▪ Portugal	1.1	2.1	2.1	2.1	-0.3	-0.4	-0.2	0.3	13.7	11.5
▪ Netherlands	0.7	1.3	1.6	2.0	0.7	1.5	1.5	1.7	8.6	8.4
Sweden	2.0	2.6	2.7	2.6	-0.1	1.1	2.4	2.3	8.0	7.6
Switzerland	2.0	2.6	2.7	2.7	0.1	1.1	1.1	0.9	3.3	3.1
United Kingdom	3.4	3.7	3.1	2.4	1.6	1.7	1.9	1.8	6.3	5.1
Emerging Markets	4.4	5.0	5.1	5.4	4.9	5.0	4.6	4.8	5.6	5.4
China	7.5	7.1	6.7	7.1	2.3	2.6	2.7	3.3	4.2	4.3
India	5.6	6.5	7.0	7.1	8.0	6.5	6.5	6.5	-	-

Source: Citi Economics Research (GEOS: 20 August, 2014)

Long-Term Forecasts – Fiscal Balance, 2013-18F

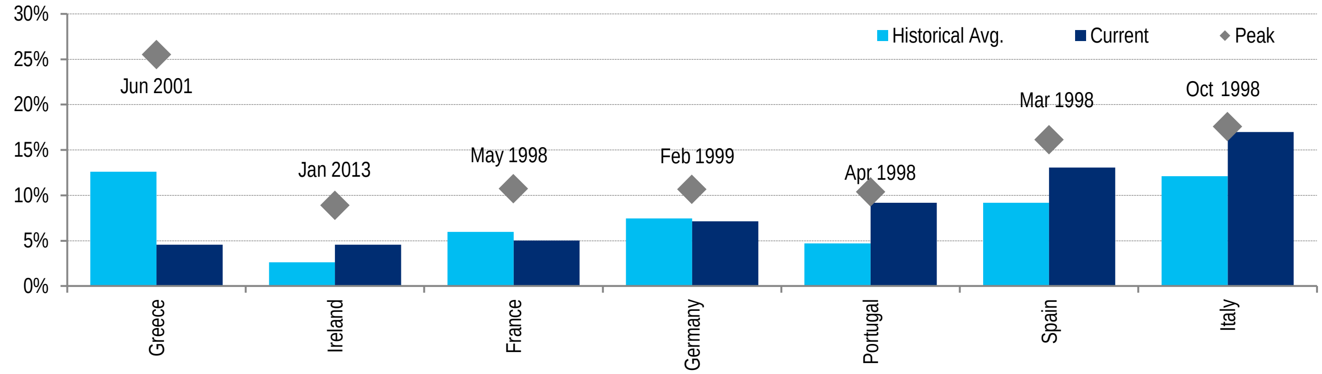
Figure 89. Sovereign Debt-To-GDP Ratio Forecasts



Source: OECD and Citi Economics Forecasts (2014-18)

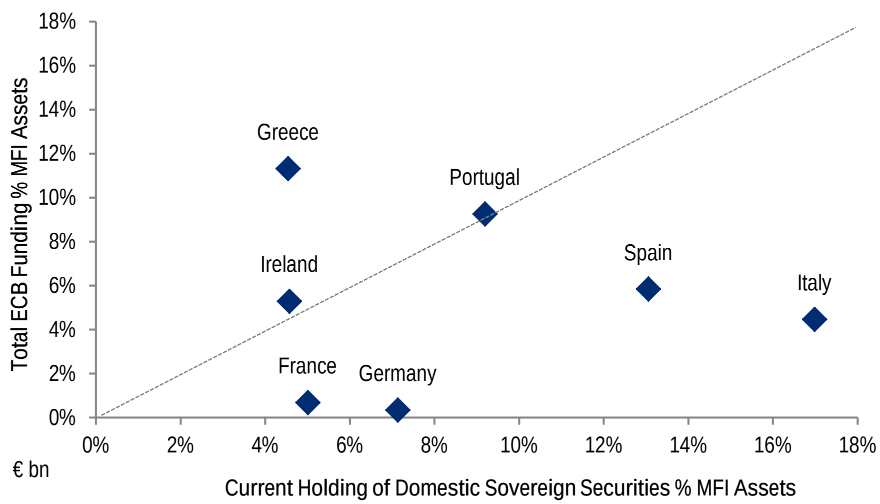
Bank-Sov. Link Grows, But Below Peak Levels

Figure 90. Total Exposure of MFIs to Domestic General Government as a % Balance Sheet



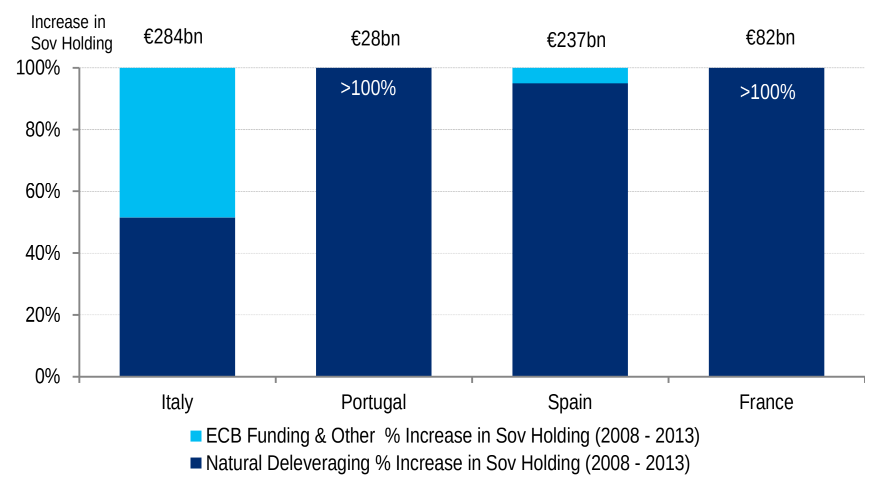
Source: Citi Economics Research, Current: Last updated for June 2014

Figure 91. Sovereign Holdings vs ECB Funding



Source: Citi Research, ECB, Havers, Note: Current: Last updated for June 2014

Figure 92. Funding of Sovereign Holdings – Natural Deleveraging vs ECB Funding



Source: Citi Research, ECB, Havers, Note: Current: Last updated for June 2014

Appendix

Figure 93. Companies Mentioned

Company	RIC	Rating	Currency	Current Price	Target Price	% diff
Europe						
Alpha Bank	ACBr.AT	2	EUR	0.65	0.65	0%
Banco BPI	BBPI.LS	2H	EUR	1.46	1.60	10%
Banco Popolare	BAPO.MI	2	EUR	11.76		-
Banco Popular	POP.MC	3	EUR	4.77	4.40	-8%
Banco Santander	SAN.MC	2	EUR	7.58	7.60	0%
Bank of Ireland	BKIR.I	3H	EUR	0.31	0.20	-35%
Bankia	BKIA.MC	1	EUR	1.49	1.80	21%
Bankinter	BKT.MC	2	EUR	6.39	6.35	-1%
Barclays	BARC.L	1	GBP	2.22	3.00	35%
BBVA	BBVA.MC	2	EUR	9.26	9.50	3%
Bco de Sabadell	SABE.MC	3	EUR	2.40	1.90	-21%
BNP Paribas	BNPP.PA	1	EUR	51.67	62.00	20%
BP Milano	PMII.MI	2	EUR	0.61	0.70	15%
Commerzbank	CBKG.DE	2H	EUR	11.62	12.00	3%
CaixaBank	CABK.MC	1	EUR	4.63	5.30	14%
Credit Agricole	CAGR.PA	1	EUR	11.30	15.00	33%
Credit Suisse	CSGN.VX	1	CHF	25.95	33.00	27%
Danske Bank	DANSKE.CO	1	DKK	158.70	185.00	17%
Deutsche Bank	DBKGn.DE	1	EUR	26.05	36.00	38%
DNB	DNB.OL	1	NOK	116.00	140.00	21%
EFG Internatnl	EFGN.S	2	CHF	10.35	10.50	1%
HSBC	HSBA.L	2	GBP	6.47	6.85	6%
Erste Bank	ERST.VI	2	EUR	19.40	21.00	8%
ING	ING.AS	1	EUR	10.55	12.40	18%
Intesa Sanpaolo	ISP.MI	1	EUR	2.26	2.70	16%
Julius Baer	BAER.VX	2	CHF	41.66	44.00	6%
KBC	KBC.BR	1	EUR	42.92	50.00	16%
Liberbank	LBK.MC	1	EUR	0.71	0.83	17%
Lloyds Banking Grp	LLOY.L	2	GBP	0.75	0.82	10%

Company	RIC	Rating	Currency	Current Price	Target Price	% diff
Europe (contd)						
Mediobanca	MDBI.MI	1H	EUR	6.53	8.00	23%
Monte dei Paschi	BMPS.MI	2H	EUR	1.13	1.35	20%
National Bank of Greece	NBGr.AT	1	EUR	2.55	2.90	14%
Natixis	CNAT.PA	2	EUR	5.30	5.00	-6%
Nordea	NDA.ST	1	SEK	89.85	101.00	12%
Piraeus Bank	BOPr.AT	1	EUR	1.38	1.55	12%
Raiffeisen Bank Intl	RBIV.VI	1	EUR	18.85	26.60	41%
RBS	RBS.L	3H	GBP	3.52	3.30	-6%
SE Banken AB	SEBa.ST	1	SEK	91.00	100.00	10%
SHB	SHBa.ST	2	SEK	330.10	325.00	-2%
Societe Generale	SOGN.PA	1	EUR	38.38	56.00	46%
Standard Chartered	STAN.L	1	GBP	12.18	14.00	15%
Swedbank	SWEDa.ST	2	SEK	177	180	2%
TSB Banking Grp	TSB.L	2	GBP	2.82	3.00	6%
UBI Banca	UBI.MI	1H	EUR	6.02	7.30	21%
UBS	UBSN.VX	1	CHF	16.39	22.00	34%
UniCredit	CRDI.MI	1	EUR	5.92	7.30	23%
Vontobel	VONN.S	2	CHF	33.60	30.00	-11%
Other Investment Banks						
Bank of America	BAC.N	1	USD	16.27	19.00	17%
Goldman Sachs	GS.N	2	USD	179.77	195.00	8%
JP Morgan Chase	JPM.N	1	USD	59.67	68.00	14%
Morgan Stanley	MS.N	2	USD	34.55	35.00	1%
Nomura	8604.T	1	JPY	683	1000	46%
Other Companies Mentioned						
Banco Espirito	BES.LS	N/R	EUR	0.12	-	-

Source: Powered by dataCentral; Ratings: 1=Buy, 2=Neutral, 3-Sell, H=High Risk. Priced as at 2 September 2014

Glossary of Acronyms

AFS	Available for Sale	LLP	Loan Loss Provision
AQR	Asset Quality Review	LME	Liability Management Exercise
BRRD	Bank Recovery & Resolution Directive	MPE	Multiple Point of Entry
BU	Banking Union	MREL	Minimum Requirement for Own Funds and Eligible Liabilities
DGS	Deposit Guarantee Scheme	NCA	National Competent Authority
DTA	Deferred Tax Assets	NPL	Non-Performing Loan
EBA	European Banking Authority	NSFR	Net Stable Funding Ratio
EC	European Commission	OFAC	Office of Foreign Assets Control
ECB	European Central Bank	PLAC	Primary Loss Absorbing Capacity
EEA	European Economic Area	PONV	Point Of Non-Viability
EQD	Equity Derivatives	QE	Quantitative Easing
ESM	European Stability Mechanism	SME	Small & Medium Enterprises
FICC	Fixed Income, Currency & Commodities	SPE	Single Point of Entry
FL	Fully Loaded	SRF	Single Resolution Fund
FTT	Financial Transaction Tax	SRM	Single Resolution Mechanism
FVO	Fair Value Option	SSM	Single Supervisory Mechanism
GLAC	Gone-Concern Loss Absorbing Capital	TBTF	Too Big to Fail
HTM	Held To Maturity	TLTRO	Targeted Long-Term Repo Operations
LCR	Liquidity Coverage Ratio		

Appendix A-1

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