

Banking on Europe

The Road Ahead: Turning Point

■ Best Ideas



- **The 3Rs of European Banking** — Regulation, Return of Capital and Restructuring & Recovery of Earnings (*The Road Ahead: From Capital Build to Capital Return*, Jan 2013). We reiterate our Overweight with the sector at an inflection point on capital, restructuring and real economy, while the transition to ECB supervision should serve to reduce the sector risk premium (as the Fed has done for US banks).
- **Regulation & AQR Catalyst** — Regulation is no longer one-directional – we expect more realistic LCR and Liikanen 'ring-fencing' outcomes. We expect AQR (Asset Quality Review) to 'speed-up' the healing process. Banks with relatively higher levels of problem assets – notably restructured loans – and lower coverage are most at risk of reserve & potential capital rebuild. These include mid-cap Spanish, Italian, Greek, and to a lesser extent, Austrian banks (see Figure 4).
- **Return of Capital** — The sector is getting 'ripe' for raising return of capital in the context of limited balance sheet growth – French, Nordic and Swiss banks are best-placed. Although less well-capitalised banks will continue to raise equity capital, especially under the spotlight of AQR, we expect market focus to increasingly shift to additional 'bail-in' buffers, namely AT1 and T2 capital raising. Banks with relatively high levels of 'legacy' hybrids have less to lose from this substitution process – by contrast Greek, Portuguese and Spanish banks are the most impacted (see Figure 20).
- **Restructuring & Recovery of Earnings** — Restructuring is underpriced by the market. With a low starting point of profitability, bank managements will likely deliver on targets. We expect market focus to gradually shift from balance sheet metrics towards 'normalised' provisioning & returns, in the context of a prospective modest European economic recovery. We favour Bankinter, BBVA, BES and UniCredit for peripheral exposure. (Figure 38)
- **Themes Meet Stocks** — We introduce our *new* European Banks thematic matrix, which ranks stocks on each of our primary themes – capital return potential, impact of AT1/T2 capital rebuild, AQR risks and eventual provisioning normalisation; we also include valuations based on normalised ROTE. The major French banks, wholesale banks, and ING screen strongly on our thematic matrix. (Figure 1)
- **Most & Least Preferred** — Barclays, BNPP (new addition to MP list), ING (new addition to MP list) and Nordea fit the bill on our 3Rs thesis and are our Most Preferred stocks; Barclays, BNPP & ING are also on our Citi Focus List Europe. By contrast, we remain concerned on AQR risks at Banco Popular (new addition to LP list), regulatory uncertainties & increased competition at DnB, and longer-term profitability at Intesa Sanpaolo and RBS – our Least Preferred stocks. (Figure 3)

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

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The Road Ahead

Citi European Banks Thematic Matrix

Figure 1. Themes Meet Stocks

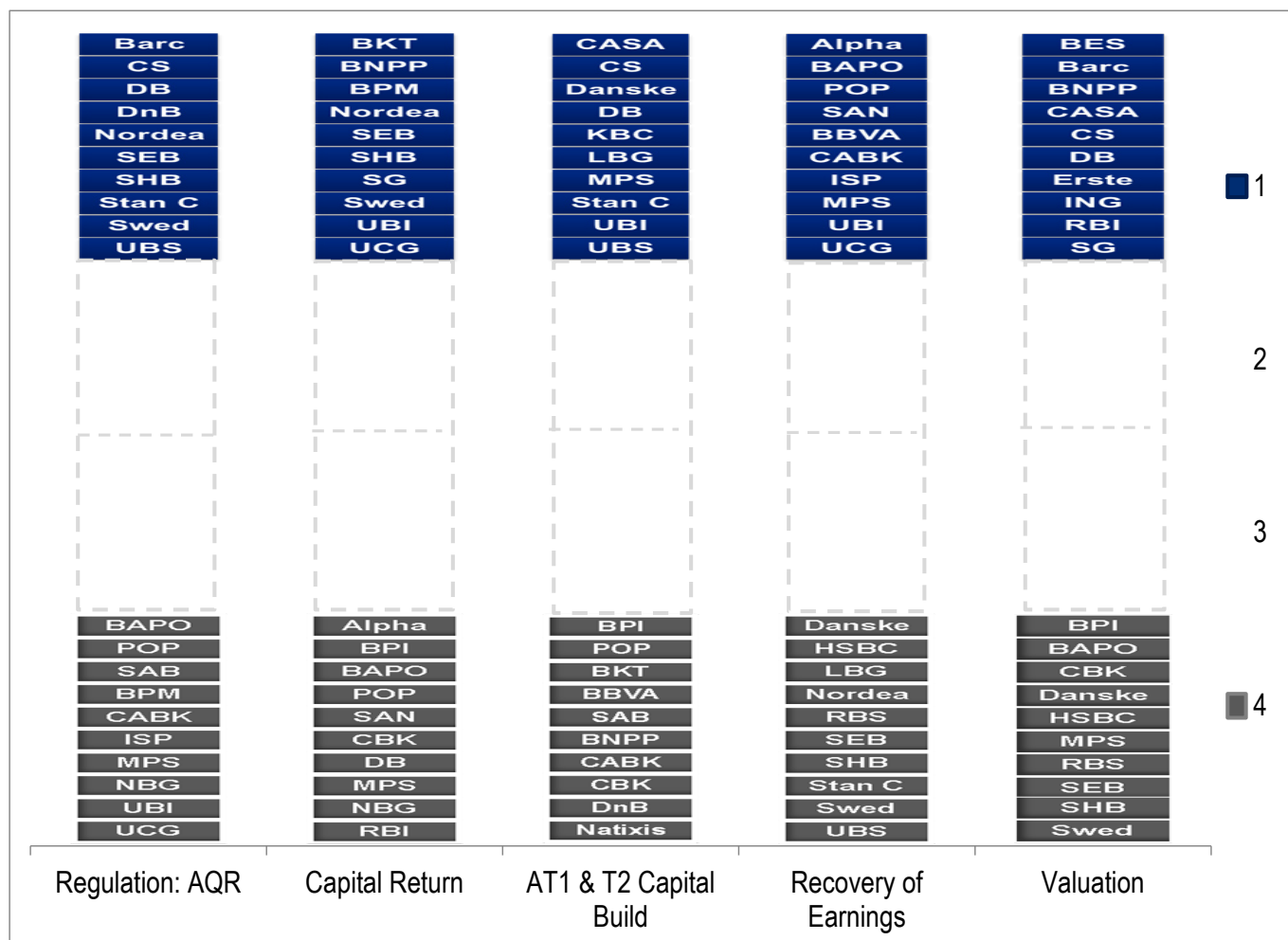
Theme	Regulation: AQR	Return of Capital		Recovery in Earnings	Valuation
		Capital Return	AT1 & T2 Capital Build		
Rank Parameter	Uncovered Total Problem Assets as a % of TBV	B3 Capital Surplus/ Deficit Pre Dividend	P&L Impact as a % Norm - PPOP	P&L Impact Upon Provision Normalisation % GOP	Normalised Implied CoE
Period	2012	2015E	2015E	2015E	2015E
Alpha Bank	○ 4	○ 4	○ 4	● 1	○ 4
Banco BPI	● 3	○ 4	○ 4	● 2	○ 4
Banco Espirito	● 2	● 3	● 3	● 2	● 1
Banco Popolare	○ 4	○ 4	● 3	● 1	○ 4
Banco Popular	○ 4	○ 4	○ 4	● 1	● 2
Banco Santander	● 3	○ 4	● 3	● 1	● 2
Bankinter	● 3	● 1	○ 4	● 2	● 2
Barclays	● 1	● 2	● 2	● 3	● 1
BBVA	● 3	● 3	○ 4	● 1	● 2
Bco de Sabadell	○ 4	● 3	○ 4	● 2	● 3
BNP Paribas	● 2	● 1	○ 4	● 3	● 1
BP Milano	○ 4	● 1	● 2	● 2	● 2
CaixaBank	○ 4	● 3	○ 4	● 1	● 2
Commerzbank	● 2	○ 4	○ 4	○ 4	○ 4
Credit Agricole	● 2	● 3	● 1	● 2	● 1
Credit Suisse	● 1	● 2	● 1	● 3	● 1
Danske Bank	● 3	● 2	● 1	○ 4	○ 4
Deutsche Bank	● 1	○ 4	● 1	● 3	● 1
DnB	● 1	● 2	○ 4	● 3	● 3
Erste Bank	● 3	● 2	● 2	● 3	● 1
HSBC	● 2	● 2	● 2	○ 4	○ 4
ING	● 2	● 3	● 2	● 2	● 1
Intesa Sanpaolo	○ 4	● 2	● 3	● 1	● 3
KBC	● 2	● 3	● 1	● 3	● 2
Lloyds Banking Grp	○ 4	● 2	● 1	○ 4	● 3
Monte dei Paschi	○ 4	○ 4	● 1	● 1	○ 4
National Bank of Greece	○ 4	○ 4	● 2	● 2	● 3
Natixis	● 2	● 3	○ 4	● 3	● 3
Nordea	● 1	● 1	● 3	○ 4	● 3
Raiffeisen Bank Intl	● 3	○ 4	● 3	● 2	● 1
RBS	● 3	● 3	● 2	○ 4	○ 4
SE Banken AB	● 1	● 1	● 2	○ 4	○ 4
SHB	● 1	● 1	● 2	○ 4	○ 4
Societe Generale	● 2	● 1	● 3	● 3	● 1
Standard Chartered	● 1	● 3	● 1	○ 4	● 3
Swedbank	● 1	● 1	● 3	○ 4	○ 4
UBI Banca	○ 4	● 1	● 1	● 1	● 2
UBS	● 1	● 2	● 1	○ 4	● 3
UniCredit	● 3	● 1	● 3	● 1	● 2

Source: Company Reports, Citi Research and Citi Estimates

Note: Rating of ● / 1 being best and ○ / 4 being lowest. See detailed methodology on page 6.

Thematic Screening of Top and Bottom 10

Figure 2. Top and Bottom 10, Citi European Banks Thematic Matrix



Source: Citi Research, Company Reports & Citi Estimates

Methodology: Citi European Banks Thematic Matrix

Themes & Key Parameters: We assess 39 European banks on the 3Rs ('Regulation: AQR', 'Return of Capital', 'Restructuring and Recovery in Earnings') and Valuation. We assign rankings of 1 to 4 with corresponding symbols for ease of reading: '1' is considered the best rating (full black circle) with '4' being the lowest (full white circle).

- **'Regulation':** We measure the AQR (Asset Quality Review) risks through Uncovered Total Problem Assets as a % of Adjusted Tangible Book Value (TBV) metric. We define total problem assets as the sum of NPLs and problem assets add-ons i.e. restructured loans, foreclosed assets and arrears more than 90 days past due but not impaired. Given lack of consistent disclosure, we have ignored collateralisation; lack of disclosure of potential problem asset add-ons could also impact comparability. We also adjust TBV for announced or completed capital raises.
- **'Return of Capital':** We look at end-2015E surplus equity capital (pre-dividends) as a % of market cap as a measure of scope for return of capital. Moreover, we look at the potential impact from building minimum AT1/T2 capital structures as a % of normalised pre-provision operating profit.
- **'Recovery of Earnings':** We gauge the potential impact of macro recovery by measuring the P&L impact of normalisation in provisioning levels as a percentage of normalised gross operating profit. This way, we identify banks with most potential for recovery in earnings.
- **'Valuation':** In addition to our 3Rs themes, we estimate 2015E implied cost of equity using the 'normalised RoTE' and market-based price-to-book values. We define normalised RoTE as 2015E RoTE adjusted for 1) Normalised provisioning levels; 2) Ex-restructuring charges; and 3) 'Go to' capital structure including our target B3 CET1 ratios and P&L impact on funding costs from minimum AT1 & T2 requirements.

Key Themes

Our 3Rs thesis – Regulation, Return of Capital and Restructuring & Recovery in Earnings – remain key drivers of banking sector performance (The Road Ahead – From Capital Build to Capital Return, Jan 2013). In particular, we look at 3 areas that will become the focus over the coming 6-12 months: (i) AQRs or Asset Quality Reviews which could drive additional provision reserves and in some cases, further capital raising; (ii) additional capital buffer needs via AT1 and T2 capital; and (iii) beyond AQR, the scope for provisioning normalisation in the context of modest economic recovery.

We highlight key themes, based on our 3Rs thesis:

I. Regulation – Focus on AQR

Regulation has become less one-directional with forbearance on LCR & likely softening on Liikanen ring-fencing

Since the start of the year, regulation has become less one-directional with significant forbearance on LCR (liquidity coverage ratios); DTAs (Spain) and likely on Liikanen ring-fencing proposals, amongst others. Current focus is squarely on the leverage proposals, notably the Basel proposals. Although risks are greater for the likes of Deutsche Bank and SocGen, we expect leverage exposure mitigation to be faster and less costly than anticipated (notably from a reduction in off-balance sheet derivatives PFE and credit lines).

Asset Quality Reviews (AQR): We expect the AQR to be performed over 4Q13-1Q14 and see the greatest risks at banks with relatively high levels of problem assets – notably restructured loans – combined with relatively low levels of coverage. Although some banks should get away with reserve strengthening, capital raising cannot be ruled out at others. We believe risks are greatest amongst Spanish, Italian, Greek and, to a lesser extent, Austrian banks.

II. Return of Capital – Inflection Point

We see a sector inflection point on capital in 2013E with French, Nordic and Swiss banks well-placed to significantly raise payout ratios

We see the sector passing through an inflection point on capital. From a 2011 capital deficit of c.€300bn, we expect break-even in 2013E, before moving to a c€200bn pre-dividend surplus by 2015E. French, Nordic, and Swiss banks are best-placed – BNP Paribas, Credit Suisse, Danske Bank, Nordea and UBS remain among the best-placed. By contrast, less well-capitalised banks have raised capital including Commerzbank, Deutsche Bank and Erste Bank. Banco Sabadell, Barclays, BPM and MPS have also announced capital plans.

From equity to AT1/T2 capital raising: Although further capital raising cannot be ruled out through the AQR process, we expect the focus of capital build to increasingly shift to AT1 & T2 'bail-in' capital, based on minimum requirements of 1.5% and 2.0% of B3 RWAs. The impact on profitability will partly depend on the incremental substitution cost from existing hybrids. We see Greek, Spanish and Portuguese banks as being most exposed to this risk, over time.

III. Restructuring Under-priced, Provisioning Normalisation To Drive Upgrades

Cost savings from restructuring plans as well as provisioning normalisation could potentially drive earnings upgrades

Restructuring is increasingly gaining traction and over time will be a driver of earnings upgrades. Credit Suisse, Deutsche Bank, Lloyds, UBS and UniCredit remain amongst the best-placed. Like restructuring, provisioning normalisation is increasingly likely to be a theme in the context of a modest economic recovery. Peripheral banks are naturally most exposed although not before banks have dealt with potential AQR-related reserve rebuild.

Investment Conclusions – Inflection Point

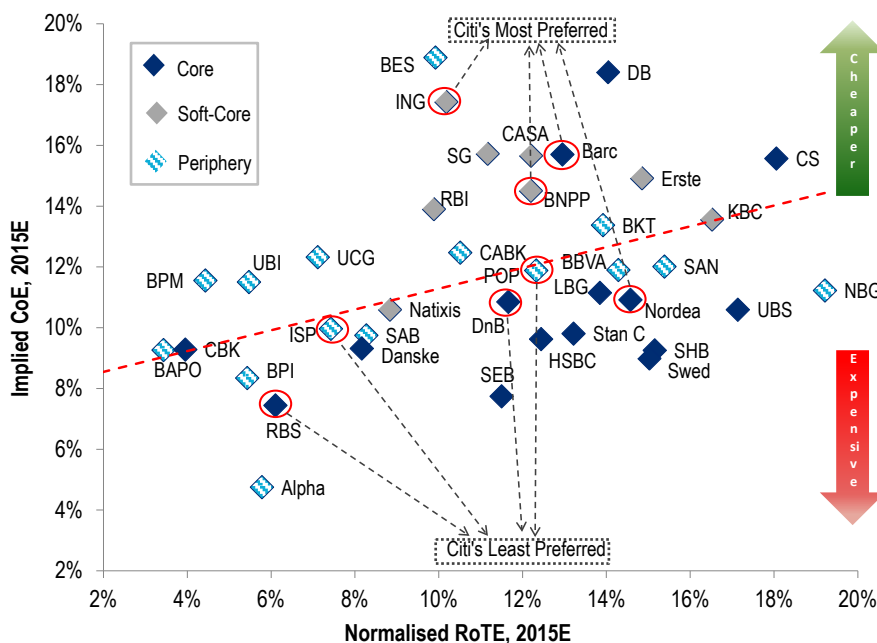
Overall, we believe that the European banking sector is passing an inflection point over the next 12 months – on capital, restructuring & real economy – which should support dividend yields and earnings upgrades. While the overall impact of ECB Single Supervision Mechanism should help to reduce sector risk premium, there are clearly ‘tail risks’ for banks with relatively high problem loans and low coverage, relative to capitalisation. Thus, our approach to periphery banks remains on a selective basis.

We rank European banks on each of these key themes, namely potential for capital return, impact of AT1/T2 capital requirements, relative AQR risks, provisioning normalisation as well as valuation (defined as implied cost of equity on normalised returns). Best-positioned banks include the major French banks, wholesale banks, and ING, which screen strongly on our thematic matrix.

Most Preferred – Barclays, BNP Paribas, ING & Nordea; Least Preferred – Banco Popular, DnB, ISP & RBS

Most & Least Preferred — Barclays, BNPP (new addition to MPs list), ING (new addition to MPs list) and Nordea fit the bill on our 3Rs thesis and are our Most Preferred stocks; Barclays, BNPP & ING are also on our Citi Focus List Europe. By contrast, we remain concerned on AQR risks at Banco Popular (new addition to LPs list), regulatory uncertainties & increased competition at DnB, and longer-term profitability at Intesa Sanpaolo and RBS – our Least Preferred stocks.

Figure 3. Fully-Normalised RoTE vs Implied CoE, 2015E



Source: Company Reports Citi Research and Citi Estimates

Note: We define normalised RoTE as 2015E RoTE adjusted for 1) Normalised provisioning levels 2) B3 Capital surplus/deficit 3) Restructuring costs 4) P&L impact of change in cost of funding due to change in capital structure (AT1 & T2)

Most Preferred:

Barclays (BARC.L; £2.71; 1)

Barclays continues to face economic and regulatory risks in the UK, but we believe the recently announced rights issue should materially reduce future uncertainty. In our view Barclays can be a winner in the consolidating world of capital markets, based on its dominant position in FICC sales & trading, while its retail banking operations, especially the UK and BarclayCard, are already demonstrating respectable growth and returns. The increased payout ratio target, to 40-50%, should also provide a supportive dividend yield. Despite this, Barclays trades at a discount to the wider sector, on 0.9x P/TB vs the wider sector on 1.1x.

BNP Paribas (BNPP.PA; €51.09; 1)

We replace Credit Suisse with BNP Paribas as BNP Paribas offers a nearer-term catalyst into its strategic plan via higher dividend payout ratio. BNP Paribas looks well positioned to benefit from our key themes (1) Restructuring: €2bn cost reduction plan (c8% of cost base) with a track-record of over-achievement; (2) Return of capital: fully loaded B3 CET1 ratio of c11% at end 2013E, offering a capital surplus of c€8bn (c10% of market cap) - we expect increasing dividends and a payout ratio of 45%; (3) Regulation: reduction of the cost of equity as clarity emerges on regulatory concerns (e.g. leverage, asset quality review); (4) Recovery with domestic markets in France, Italy and Belgium.

ING (ING.AS; €8.57; 1)

The ING share price is sensitive to two factors: (i) progress on divestments; and (ii) earnings momentum. Both are now trending in the right direction. The sales process for Asia is almost done, ING has completed the IPO of its US insurance business and Insurance Europe appears to be on track "for a base case IPO in 2014". These steps should ensure focus returns to the underlying value contained in ING Bank, which we estimate the market is only valuing at 0.7x tangible book, vs the wider sector on 1.0x. We believe the size of this discount is far too large. After two years of negative earnings momentum at ING Bank there are also signs that this has now reversed.

Nordea (NDA1V.HE; €9.14; 1)

Nordea looks well-placed in the Nordic market with a strong management focus on returns and cost efficiency. In addition rapid capital build has led to Basel 3 core capital ratios above regulatory and management minimum targets, and hence we expect increasing capital return via a high dividend payout policy. Recent fears of a tougher regulatory environment - and capital return implications - may be overdone.

Least Preferred:

Banco Popular (POP.MC; €4.34; 3H)

We have a Sell/High Risk rating on Popular. While the bank is cost efficient and should enjoy solid NII recovery in 2014, risks from asset quality deterioration are meaningful, in our view. Popular has the highest 'content' of problem assets among the Spanish banks we cover at c.28% of assets and a middle of the pack coverage (c32%). The upcoming ECB asset quality review could mean capital is allocated to provisions in order to reach a higher NPL coverage ratio (2014E: c50%) – or a dilutive capital raise. In addition, the removal of mortgage floors could impact 2014E NII by 4%. Trading at 1.09x 2013E P/TBV for a c.11% sustainable ROTE, we find the shares overvalued.

DnB (DNB.OL; NOK95.75; 2)

The corporate investment and economic cycle in Norway appears to be maintaining momentum. But there is a lack of clarity on regulation. New concerns for DNB include the use of Basel 1 transitional floors that reduce capital ratios by c130bps vs full IRB. While in time the new Centre Right Government may be a positive on seeking a pan-Nordic level field for now the pressure is for more capital. DNB has been successful in re-pricing during 2Q13 but competition levels from state and niche banks are high.

Intesa Sanpaolo (ISP.MI; €1.70; 3H)

We are cautious on Intesa shares due to (1) them being a proxy for the Italian sovereign as the bank has c90% of its activity in Italy and a large sovereign exposure to Italian government bonds, (2) asset quality risks in Italy and (3) more limited recovery in NII vs. other Italian banks in our view. Intesa trades at c0.8x 2013 TBV and this valuation seems high in light of the expected group ROTE (7% in 2015E) and implied cost of equity currently priced in by the market.

RBS (RBS.L; £3.68; 3H)

Short-term steps have been taken at RBS in order to improve the capital position and therefore appease the regulator. However these steps have come at the expense of long-term profitability, damaging shareholder value, in our view. The "good bank / bad bank" proposals now being considered by the UK government add to existing uncertainty.

The First 'R' – Regulation: Focus on AQR

Focus Shifts to AQR

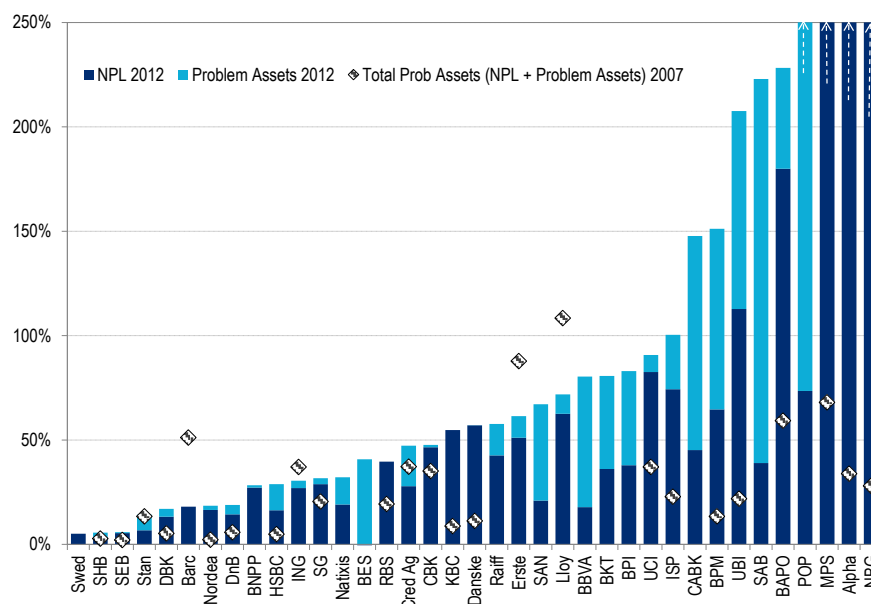
“...the need to ensure that banks provision against expected losses in a timely fashion, with supervisory authorities – at the European and national level – called upon to examine and monitor the quality of bank assets. In this context, there is a need for better and more consistent data to help supervisors ensure that forbearance is accompanied by appropriate provisioning and to foster greater market transparency.” European Systemic Risk Board, 20 Dec 2012¹

Kicking The Tyres Across Banks

Banks with relatively high levels of problem loans relative to capital remain most at risk – Greek, Italian and Spanish

Banks with relatively high levels of problem loans (notably restructured loans) and low related coverage remain most at risk from the upcoming asset quality reviews (AQRs). Of course, levels of collateralisation also matter in terms of mitigating LGD (loss given default), although comparable data across European banks is difficult to find and creates limitations across the entire scope of our analysis. Overall, we see the greatest potential risk at the Greek, Italian, mid-cap Spanish and, to a lesser extent, Austrian banks – based on uncovered problem assets as a percentage of tangible book value. Of course, our analysis only covers a fraction of the c130 banks under review which will potentially drive capital & provisioning needs across the unlisted space.

Figure 4. Uncovered Total Problem Assets % TBV



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.

3) 2012 TBV adjusted for capital raises for Barclays, BPM, Commerzbank, DB, Erste, MPS & SAB;

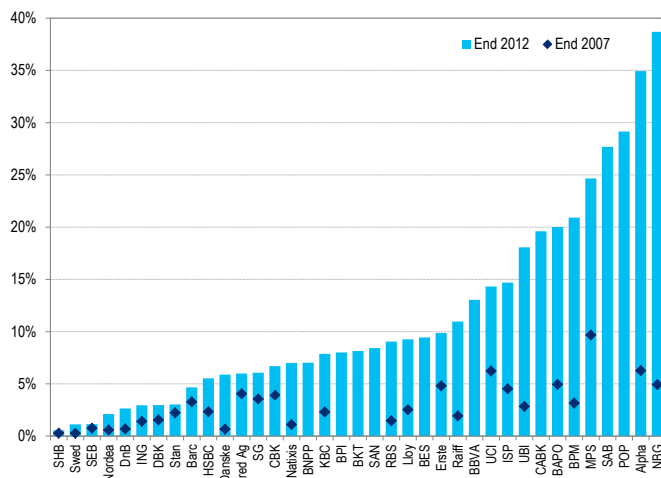
4) Greek banks data based on 2Q13, defined as all impaired loans

5) Adjusting BES' problem assets in line with BES definition on problem asset add-ons would inflate the total problem assets moderately.

As highlighted in the next charts, banks with greater risk typically face relatively higher levels of problem assets and lower coverage.

¹ <http://www.esrb.europa.eu/news/pr/2012/html/pr121220.en.html>

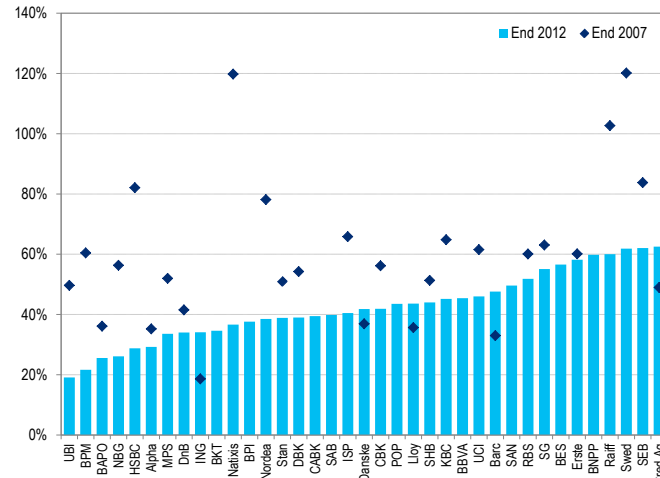
Figure 5. Total Problem Assets % Gross Loans



Source: Company Reports, Citi Research

Note: Problem asset add-ons (where available) include 90 day past due loans but unimpaired, foreclosed assets and performing/substandard restructured loans

Figure 6. Total Problem Assets 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.

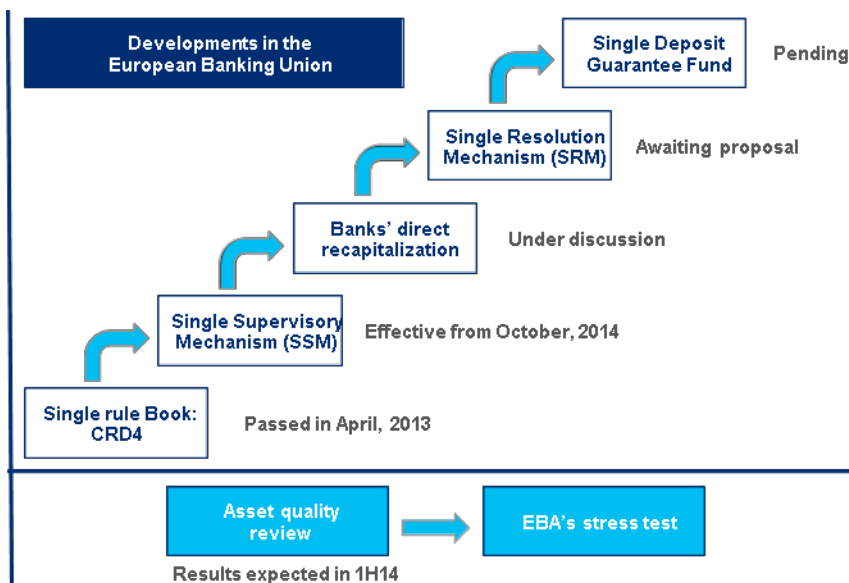
The UK banks provide mixed disclosure on forbearance and restructured loans. Four banks provide the outstanding stock of total restructured loans (RBS is the one exception), but only Lloyds, HSBC and Standard Chartered split out how these loans are then classified between 'performing' and 'non-performing' (RBS provides similar disclosure, but only on loans that were renegotiated during the year, rather than the stock). For this reason we have not included an add-on for performing restructured loans for the three UK domestic banks in Figure 4 - Figure 6, which we have done for select European peers (but not for the Austrian banks, Nordic banks, BNPP, Commerzbank or KBC where disclosure is also lacking). If we were to include this add-on then uncovered total problem assets as a proportion of tangible book would be higher for the UK domestic banks e.g. for Lloyds we estimate this add-on would increase the percentage from 72% to 108%. Barclays, which has a smaller stock of restructured loans, is likely to be less impacted.

EBA leads the charge

The EBA-led AQR kicks off the process towards ECB's Single Supervisory Mechanism

The EBA is driving the process for supervisors to conduct asset quality reviews (AQRs) on major EU banks. The objective is to review banks' classifications and valuations of assets to overcome market concerns over asset quality via a unified approach. Such concerns have been elevated in the context of the recessionary backdrop that followed the 08-09 financial crisis and post-2010 euro zone sovereign crises. This process will also support the ECB's balance sheet assessment ahead of SSM (Single Supervisory Mechanism), currently scheduled for October 2014.

Figure 7. European Banking Union Timetable



Source: Company Reports and Citi Research

The AQR will drive a common definition of non-performing and forborne loans

The focus will essentially be on 2 key areas addressing related concerns:

- **Forbearance:** The extent of use of forbearance, potentially delaying loss recognition and creating the perception of “zombie” banking; and
- **Non-Performing Loans:** Drawing a clear, consistent line between performing and non-performing assets across different jurisdictions.

According to a recent Reuters article (*EU wants one definition of bad loans for bank tests*², 16 Aug 2013), the reviews will also focus on ‘problem categories’ looking at areas like shipping, commercial real estate and mortgages in some markets. The article also suggested that the EBA is looking to firm up definitions by September (the consultation process ended on 24 June 2013). The AQRs will be followed by the 2014 stress test which could rank banks against various yardsticks including: (i) coverage ratios; and (ii) RWA treatment.

Forbearance – The Waiting Game

The AQR takes particular aim at identifying forborne loans, on a consistent basis

“Forbearance on the part of banks dealing with delinquent borrowers is unproblematic if it is simply the result of entrepreneurial judgments to the effect that patience may eventually pay off. Such forbearance is problematic, however, if it is designed to disguise problems in lending, delaying write-downs of bad loans, as a

² <http://www.reuters.com/article/2013/08/16/us-europe-banks-loans-idUSBRE97F0CF20130816>

way of gaming with creditors and supervisors. Such behaviour is to be expected, in particular, if a bank has many problem loans.” ESRB³, July 2012

The EBA has defined **“debts with forbearance measures are contracts the terms of which the debtor is considered unable to comply with due to its financial difficulties so that the institution decides either to modify the terms and conditions of the contract to enable the debtor to service the debt or to refinance, totally or partially, the contract”** (emphasis is ours).

Specifically, the EBA highlights forbore exposures as modified contracts that are:

- Non-performing or modifications were necessary to avoid contract becoming non-performing or 30 days past due (without being non-performing); or
- Include more favourable trends than those the debtor could have obtained in the market; or
- Have been more than 30 days past due at least once in the last three months.

NPLs – Tightening Definitions

The EBA has defined non-performing exposures as those that satisfy at least one of the following criteria:

- Material exposures are more than 90 days past-due
- Exposures present a risk of not being paid back in full without collateral realisation, regardless of the existence of any past-due amount or the number of days past-due (sometimes referred to as “well-defined weakness”)

The NPL requirement of 90 days past due tends to be a generally-accepted practice in most major European countries. By contrast, CRR1 regulatory requirements clearly allow national discretion to take into account longer payment delays in specific cases (e.g. central governments, public administrations). Often, days past due (“dpd”) requirements tend to be longer for retail.

Moreover, the concept of “well-defined weakness” remains more subjective i.e. based on a bank’s assessment that the borrower’s economic or financial standing has seriously deteriorated, potentially ahead of the 90 days+ period. It is also important to note that the EBA applies a credit risk approach rather than a loss approach i.e. collateral not assessed in the NPL definition.

Thus, forbearance and non-performing are linked but different concepts. The EBA’s proposal is that a forbore exposure should only be considered as non-performing to the extent that it meets the non-performing criteria, i.e. presents a risk of not being paid back in full without collateral realisation.

³http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1_1207.pdf?7ea9759bf252d03b8917bb9bdb079cb6

Figure 8. Illustration of the 'umbrella approach' for the forbearance and non-performing definitions

Performing	Cured	Non-Performing
Fully Performing Loans and debt securities that are not past-due and without risk of non-repayment and performing off-balance sheet items	On- and off-balance sheet exposures that exited the non-performing category, including forbore exposures	Generic criteria: Past due more than 90 days and unlikely to pay All other non-defaulted and non-impaired loans and debt securities (banking & trading books) and off-balance sheet exposures meeting the generic criteria
Performing assets past due below 90 days Loans and debt securities between 1-30 days past due Loans and debt securities between 31-60 days past due Loans and debt securities between 61-90 days past due	Forborne loans and debt securities (banking and trading books) and eligible off-balance sheet commitments can be performing or non-performing or cured Modifications of terms and conditions Refinancing Other forbearances	Defaulted banking book (loans & debt securities): Fair value option Impaired Fair value through other comprehensive income Amortised cost Off-balance Sheet Items: Loan commitments Financial guarantees (except derivatives) Other commitments
Performing assets that have been renegotiated Loans and debt securities whose renegotiation or refinancing did not qualify as forbearance		

Source: European Banking Authority (March 2013)

Something Has To Give On EBA Proposals

Current EBA proposals may need to be 'watered down' to practically allow for implementation in a reasonable timeframe

There has been significant industry pushback on the differences and typically more onerous requirements of the EBA proposals versus existing accounting (IFRS) and regulatory (CRR1) requirements. These not only relate to principles but also new disclosure requirements. This would make a 1 Jan 2014 implementation virtually impossible, in our view. Something has to give – EBA moving closer to existing accounting/regulatory definitions or delaying the implementation date by at least 12-18 months from 1 Jan 2014, which we see as very unlikely.

- **Trading book risk is already marked-to-market:** None of the new proposals have created as much pushback as the requirement to include trading book exposures under the non-performing and forbearance definitions, thereby going far beyond current accounting and regulatory requirements. After all, trading exposures tend to be dynamic and short-term in nature while the impairment risk is embedded in the market value and not considered separately per se.
- **Tests could be too prescriptive:** The EBA proposes a broader definition of forbearance and NPLs that could be complex, debatable and time-consuming. In particular, these include the 'safety net' criteria for assessing forbearance; the arbitrary 'pulling effect' thresholds for NPLs; and probation period for forbore cures.

Thus, a number of banks argue that the EBA proposals should be principles-based rather than rules-based as well as make the rules much more consistent with existing accounting and regulatory concepts.

Figure 9. Mapping NPL & Forbearance Across Frameworks

	EBA	CRR	IFRS
Scope			
On-Balance Sheet	Banking & Trading Book	Banking Book only	Banking Book only (except Fair Value Option)
Off-Balance Sheet	Exposures include off-balance sheet exposures comprising loan commitments given, financial guarantees given, and other commitments given.	Exposure includes off-balance sheet items.	N/A
Consolidation	Accounting scope (i.e. including insurance company)	Prudential scope.	Accounting scope
Forbearance			
Definition	Debts with forbearance measures are contracts the terms of which the debtor is considered unable to comply with due to its financial difficulties	N/A	IAS 39 par 59 (c) states that objective evidence of impairment includes circumstances when the lender, for economic or legal reasons related to the borrower's financial difficulty, grants to the borrower a concession that the lender would not otherwise consider.
Definition of debtor	"Debtor" encompasses all the natural and legal entities in a group within the accounting scope of consolidation	Rating frameworks typically recognise the extent of accounting group interdependence	N/A
Non-Performing			
Definition	Non-performing exposures are those that satisfy at least one of the following criteria: (i) Material exposures are more than 90 days past-due (ii) Exposures present a risk of not being paid back in full without collateral realisation, regardless of the existence of any past-due amount or the number of days past-due	A default shall be considered to have occurred with regard to a particular obligor when either or both of the following have taken place: (i) The institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security (ii) The obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. Competent authorities may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities	A financial asset or group of assets is impaired, and impairment losses are recognised, only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset. An entity is required to assess at each balance sheet date whether there is any objective evidence of impairment. If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognised. [IAS 39.58] The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate. [IAS 39.63]
Definition of past due	Definitive rule	National discretion to take into account longer payment delays in specific cases (eg central governments, public administrations)	N/a
Scope of exposure	Debtor approach for non-retail exposures and possibility of a transaction approach for retail exposures subject to "pulling effect" thresholds.	In the case of retail exposures, institutions may apply the definition of at the level of an individual credit facility rather than in relation to the total obligations of a borrower.	N/a

Source: OENB and Citi Research

Kicking The Tyres Across Jurisdictions

We believe that there are 3 key differences in NPL/forbearance practices:

- **NPL definition:** NPL definitions typically assume 90 day past due definitions with some measure of well-defined weakness. However, subjectivity comes from: (i) national discretion on longer past due definitions for certain loan categories (ii) subjectivity in the concept of well-defined weakness.
- **Forborne loan definition:** Forborne loan definitions typically relate to loans where – due to financial difficulties experienced by the debtor – the bank agrees to change the contractual terms of the loan agreement or agrees to refinance (partially or totally) the existing credit facilities on different terms (often providing concessions). Of course, practices may vary from bank to bank not only on the definition but, equally importantly, the treatment of forborne loans as performing or non-performing.
- **Valuation of collateral & NPL coverage:** The EBA's proposed valuation methodology for collateral is based on fair value capped at the carrying value of the collateralised exposure. However, there is likely to be a fairly high degree of subjectivity in the valuation of often illiquid collateral.

We outline key differences at the country level as follows:

1. Italy: Conservative Scope, Albeit Declining Coverage

As a rule of thumb, most countries appear to adopt a 90dpd + well-defined weakness approach to NPLs. Italy stands out as being more conservative by covering both substandard loans and restructured exposures (in addition to doubtful and 90dpd past due and/or overdrawn exposures).

Indeed, substandard loans in Italy are defined as “loans to customers that are in temporary difficulties that can be expected to be cleared up in a reasonable time” – which goes beyond the generally-accepted concept of well-defined weakness. Forborne exposures (loans for which a bank, as a result of deterioration of the borrower's financial situation, agrees to amendments to the original terms and conditions) are also typically considered as non-performing.

Against this, our more cautious stance on the Italian banks has partly been a function of declining coverage levels – which are partly driven by changing NPL mix and increased collateralised exposures although collateral valuations remain subjective, by their very nature.

2. France: Conservative Forbearance Practice

In France, NPLs are typically based on either 90dpd or where there is objective evidence of impairment. French banks practices entail that clients whose loans have been restructured are automatically classified in the non-performing category, as long as the bank is uncertain of the debtor ability to meet future commitments. Once again, this is a relatively conservative practice. Thus, it is no surprise that in its commentary to the EBA proposal, the FBF (French Banking Federation) suggested that “there should be no case where forbearance...can escape from default at the moment when the forbearance measure is granted”.

3. Spain: Reclassifying Forborne Loans

Spanish banks' NPL definition covers “doubtful due to customer arrears” (of more than 3 months), “doubtful for reasons other than customer arrears” (reasonable doubts about full repayment on contractual terms) and “write-off” (possibility of

recovery is remote) loans. Forborne loans are typically classified as impaired for reasons other than default when there are significant doubts regarding whether the terms of the refinancing will be met or substandard where there is material uncertainty regarding possible non-compliance, with the remaining loans considered as performing risk with special monitoring.

The key issues in Spain have been twofold, in our view:

- **Collateral valuation** especially on real estate / development loans;
- **Forborne loan classification** between performing, substandard or non-performing loans.

As the Bank of Spain restructured loan review deadline approaches (30 September), the Spanish banks have started reclassifying performing and substandard loans into NPLs, with some banks also taking provisions in 2Q13.

4. UK – Individual Bank Practices

UK banks' NPL definitions are dependent on individual bank practices but generally follow the concepts of 90dpd + well-defined weakness. For example, HSBC classified all restructured or renegotiated loans as impaired "until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flow, and there are no other indicators of impairment". By contrast, Standard Chartered's practice is narrower in that renegotiated loans are classified as non-performing unless: (i) renegotiated before 90dpd & on which no default of interest and principal is expected; (ii) renegotiated after 90dpd but on which no default has taken place in interest or principal for >180 days after renegotiation and against which no loss of principal is expected.

Although the general practice of NPL definition appears to be 90 days, Lloyds does not appear to use dpd as a primary tool for its wholesale portfolios while it applies a 180 dpd metric for secured mortgage portfolios. Where the renegotiated payments of interest and principal will not recover the original carrying value of the assets, the asset continues to be reported as past due and is considered impaired,

5. Germany – Individual Bank Practices

The general principle of NPLs in Germany is based on 90dpd + well-defined weakness, i.e., the bank deems it improbable that the debtor will fulfill their credit obligations without resorting to the liquidation of available collateral.

In practice, there appear to be meaningful variations in banks' practices. In particular, Commerzbank's definition of well-defined weakness appears narrower ie based on insolvency, financial restructuring or demand for immediate repayment of claims. By contrast, DBK's primary focus is on objective evidence of impairment (eg debtor experiencing significant financial difficulty or a breach of contract, for example, default or delinquency in interest or principal payments); the same test is used in classifying forborne loans as non-performing.

6. Austria – Individual Bank Practices

NPLs in Austria are generally defined on the basis of 90bpd and well-defined weakness where repayment of interest or principal appears partly or fully jeopardised. Classification of forborne loans is typically dependent on individual bank practices. For example, Erste Bank classifies restructured debts as non-performing if the agreed restructuring measures lead to a "forbearance of debts". RBI classifies a loan as non-performing if "the workout unit is considering stepping in to help a company restore its financial soundness".

7. Portugal – Narrower NPL and Forborne Definitions

In Portugal, the NPL definition is based on the concept of Credit at Risk (as required by the Bank of Portugal Instruction 23/2011) which includes:

- Total value of credit with capital or interest 90dpd; or
- Restructured credit where principal or interest were 90dpd and have been capitalised or refinanced without full coverage by collateral or the interest fallen due has not been fully paid by debtor; or
- Credits of an insolvent bankrupt debtor.

Given the reference of well-defined weakness 'only' to bankruptcy or liquidation of the debtor, it appears to be narrower. Likewise, forborne loans are classified as non-performing where the 90dpd condition was met. It is also worth noting that whenever a restructured loan operation represents more than 25% of the total exposure to the same debtor, all the loan operations of that debtor are considered as restructured loan operations, i.e., a partial client view which is more conservative than the typical adoption of product views. A loan operation is no longer considered as restructured after 12 months, as long as during that period the debtor has not defaulted or applied for a restructuring mechanism.

Figure 10. Mapping NPL & Forbearance Across Jurisdictions

	Non-performing	Loan & NPL categorisation	Collateral Consideration for Loan Classification	Full NPL or Partial Installments Outstanding	Forbearance	Downgrade requirement
Austria	90dpd + well-defined weakness	Standard - Watch/Special Mention - Non-Performing - Loss	No	Full	Depending on bank's practice	No
France	90dpd + well-defined weakness	NPLs categorisation by "créances douteuses" (Doubtful) and "créances irrécupérables" (Loss)	No	Full	Typically classified as impaired (depending on each bank's credit assessment)	No
Germany	90dpd + well-defined weakness	No prescriptive categorisation	No	Full	Depending on bank's practice	No
Ireland	90dpd + well-defined weakness	No prescriptive categorisation	No	Full	Classified as non-performing	Yes
Italy	90dpd + well-defined weakness + sub-standard	Italy features "performing loans," "substandard loans," "past due/overdrawn more than 90 days," "bad loans" and "restructured exposures." The Banca d'Italia views loans under the last four of these credit quality categories (from "substandard" to "restructured exposure") as NPLs.	No	Full	Classified as non-performing	No
Portugal	90dpd + well-defined weakness (on bankruptcy or liquidation of debtor)	No prescriptive categorisation	Yes	Partial	Classified as non-performing	Yes (subject to threshold)
Spain	90dpd + well-defined weakness	Spain distinguishes "standard," "substandard," "doubtful due to customer arrears," "doubtful for reasons other than customer arrears," and "write-off" loans. According to the Banco de España, the last three categories comprise NPLs.	Generally not	Full	Classified as non-performing, substandard or performing	Yes (subject to threshold)
UK	90dpd + well-defined weakness	No prescriptive categorisation	No	Full	Depending on bank's practice	No

Source: OENB and Citi Research

The ECB will take on its supervisory role from October 2014 following a comprehensive balance sheet assessment.

Towards SSM – “Hub & Spoke” Structure

The ECB is currently targeted to assume its supervisory tasks within the SSM from October 2014. Indeed, we see the operational build-up towards this target as an immense task requiring close cooperation with national regulators in what can be best described as a “hub and spoke” structure.

Although national supervisory authorities would undertake most of the day-to-day ‘heavy lifting’, the ECB would retain ultimate authority as well as implementation of macro-prudential regulation. In this sense, the ECB can be characterised more as a ‘supervisor’ than a ‘regulator’. This would help to avoid the home ‘bias’ of national regulators as well as allow the ECB to take a more ‘holistic’ view on impending risks.

What will the scope of SSM be?

The geographical scope of the SSM is euro area banks as well as non-euro area member states that decide to ‘opt-in’. According to a recent speech by Jörg Asmussen, Member of the Executive Board of the ECB, supervision is expected to extend to c130 banks, covering c85% of total banking assets in the euro zone.

What are the key challenges?

The extent of Burden-sharing from legacy asset issues remains the key unknown

We believe that there are a number of very important challenges, not least those of an operational variety, discussed separately:

- **How will the ECB gain comfort on banks that it is taking over lead supervisory role?** The ECB will undertake a comprehensive assessment – comprising risk assessment or AQR, balance sheet assessment and stress test. The stress test will be undertaken with close cooperation of the ECB with the EBA (European Banking Authority). The first stage is the AQR (Asset Quality Review) which we expect over 4Q13/1Q14.
- **How will the ECB manage its dual mandate of monetary policy and banking supervision?** In our view, the risks of the ECB’s credibility on its monetary policy mandate being impacted by potential concerns over banking supervision – especially in a European banking sector that is far from homogeneous – is not insignificant. Such challenges could be addressed by strong corporate governance to reduce the risks of national political interference. Identifying the ECB’s supervisory function under a separate name (e.g. European Banking Supervisory Authority) could also serve to reinforce this.
- **Who bears the cost of so-called legacy assets?** This has probably been the single most controversial issue since the June 29, 2012 statement which suggested that: “*When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly.*” However, in September 2012, the Finance Ministers of Germany, the Netherlands and Finland stated that “the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities”.

An alternative solution that has been suggested is that the ESM should be considered as an instrument for ‘risk-sharing’ rather than ‘loss-sharing’ namely that the ‘first loss’ risk could be assumed by the member state under the EC State Aid rules.

The operational challenges

We do not underestimate the operational challenges that the ECB faces in taking on its new SSM role. Although the ECB does have some experience via the creation of the Eurosystem between 17 NCBs (national central banks) and itself, the SSM task is markedly more complex especially given that the various banking systems are far from homogeneous. According to press reports, the ECB may need to hire between 500-1,000 individuals, some of these from NCBs.

The other significant challenge is the question of which non-euro member states will enter “close cooperation arrangements” with participating member states of the SSM and how non-members will interact.

What are the potential implications from SSM?

Of course, the principal *raison d'être* for the SSM is to reduce the linkage between sovereigns and banks, not least via potential use of the ESM for bank capitalisation. Over time, we expect the ECB to increasingly influence greater harmonisation of supervisory practices across Europe as well as dictate macro-prudential regulation.

However, in the near-term, we believe that given the scale of the legal & operational challenges, there are unlikely to be any direct new regulatory initiatives. Of course, the stress-tests always have scope to throw up surprises although we broadly expect them to confirm the gradual ‘healing’ of the European banking sector. As always, the challenge remains of identifying ‘fault lines’ in the system without having the means to ‘resolve’ or pay for them.

1. http://www.consiliium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

The Second 'R' – Return of Capital

From Capital Build to Capital Return

The capital return theme is already playing through Nordic banks; French and Swiss banks also remain well-placed

In our report [The Road Ahead – From Capital Build to Capital Return](#) (4 Jan 2013), we identified Nordic, Swiss and French banks as best-placed for capital return. Year-to-date, this theme has paid off. Relative to European banks, Swiss banks (+18%), Nordic banks (+12%), and French banks (+14%) have been the best performers amongst European banks. From here, BNP Paribas, CS, Danske, Nordea, SocGen and UBS are key stocks to own for this theme.

Further capital requirements – to a total of at least 13-14% – are likely to be met more by AT1/T2 than equity capital

What's changed? Is capital return potentially an "illusion"?

There remain ongoing concerns that potential capital return is more of an "illusion", as regulators continue to raise the capital bar. We argue that although **total** capital requirements are likely to be higher than current market perception – at least 13-14% driven by additional 'bail-in' capital requirements – these will largely be met by AT1/T2 capital rather than common equity (see below). Likewise, it is important to note that leverage ratio requirements can be met not just by common equity but also T1 capital (please see Focus Shifts Squarely Onto Leverage on page 33).

Raising Counter-Cyclical Capital Buffers – In a surprise move, the Swedish government recently outlined plans to introduce counter-cyclical capital requirements for Swedish banks, at the higher-end of the 0-2.5% range. This is in addition to the minimum 12% requirement from 2015 and could suggest hurdle levels of closer to 13-14%. We believe this news has no fundamental impact on Swedish banks' high dividend payout potential in the coming years, but may limit the ability of the banks to do significant buy-backs or special dividends in the next 12-18 months.

Focus Shifts to Leverage Ratios – As highlighted in our recent report, [Leverage-in but Not Sweatin'](#) (15 July 2013), market focus has shifted squarely to leverage. Although concerns may linger for longer – as discussed in the next section – we expect most banks to 'tick the box'. In any case, we use banks' leverage ratios as a cross-check for potential capital return.

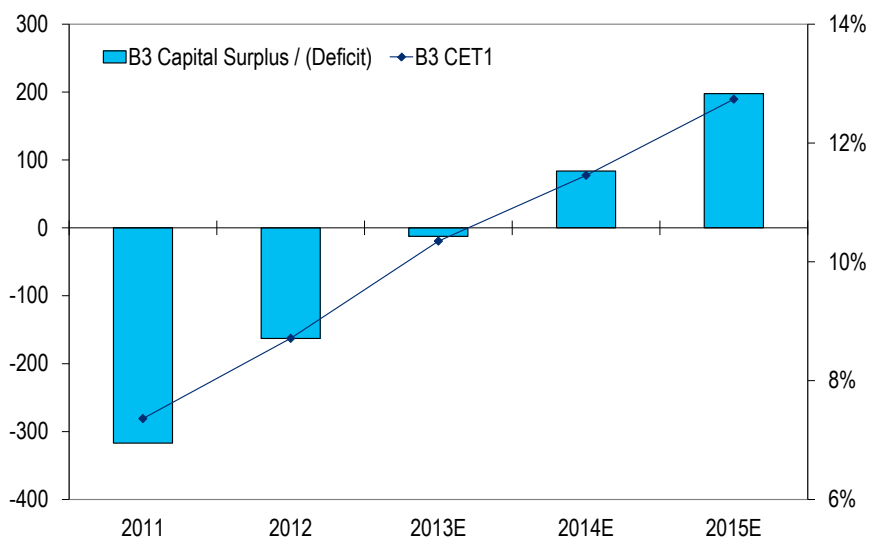
Risk of Higher Risk-Weights – The Basel Committee's RWA review remains one of the key risks for banks. According to the BCBS study on banking book credit risks, differences in banks' assets composition account for the primary difference in risk-weights (up to three-quarters of the variation), although "practice-based" differences also played an important role (mainly in IRB approach). Likewise, the study on market risk RWAs suggested that wide variations were driven by (i) asset mix; (ii) bank-specific differences in modeling; and (iii) supervisory-specific application of market RWA rules. As mentioned above, we take this into account by assuming minimum mortgage risk-weights of 15% and apply a +50% surcharge on internal model-based market risk RWAs.

'Top-down' view - Inflection point in 2013

European banks are going through an inflection point on capital, in 2013

We expect the sector to close the c€300bn end-2011 capital *deficit* by the close of 2013. By end-2015, we expect the sector to record a pre-dividend capital *surplus* of c€200bn. We assume that banks meet a minimum B3 'fully-loaded' ratio of 10% – with the exception of Barclays at 10.5%, CASA at 11%, Banco Popular and Credit Suisse at 11.5%, Deutsche Bank and Danske Bank at 12% and other Nordic banks and UBS at 13%, adjusted for risk-weights. The higher minimum levels for Barclays, CASA, Credit Suisse and Deutsche Bank reflect 'tighter' leverage ratios.

Figure 11. Sector Capital Deficit Turning to Surplus, 2011-15E (€ bn)



Source: Company Reports, Citi Research & Citi Estimates

Note: 1) Europe ex Greece and Portugal.

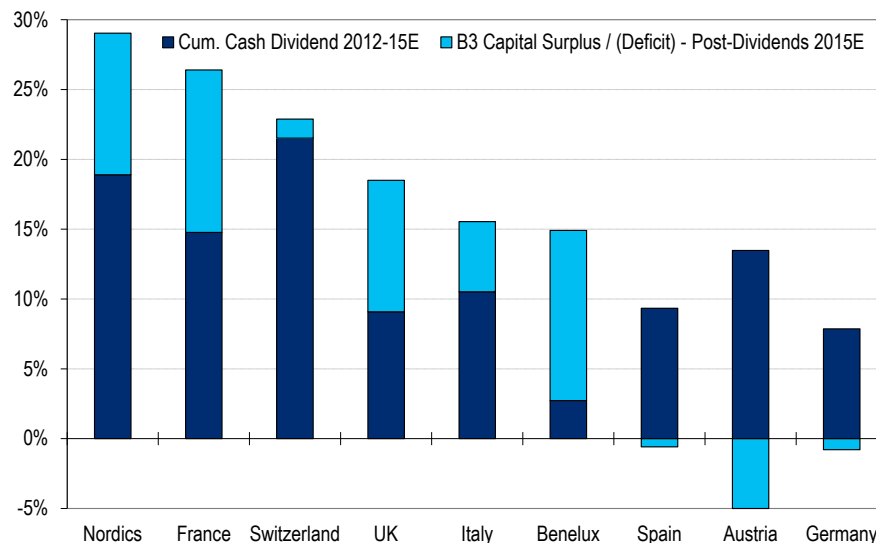
2) We assume minimum mortgage risk-weights of 15% and apply a +50% surcharge on internal model-based market risk RWAs.

Which countries are best-placed?

The French, Nordic and Swiss banks remain amongst the best-placed banks for capital return

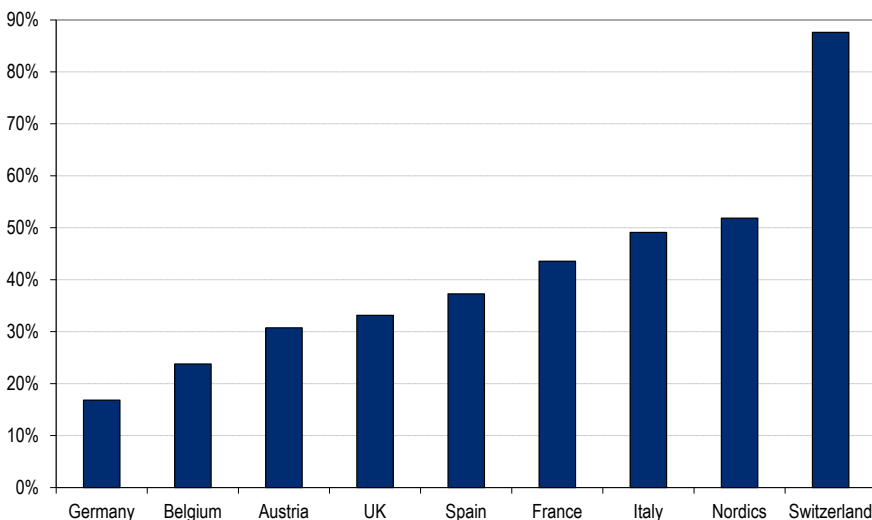
The French, Nordic and Swiss banks remain amongst the best-placed banks for capital return, even after strong year-to-date performance. By contrast, Austria, Germany and Spain continue to lag. Moreover, Spain also has relatively higher AQR risks implying greater risk of further capital raises; the recent Sabadell announcement is a good case in point.

Figure 12. Capital Surplus Position: By Country, 2015E, % of Market Cap



Source: Citi Research

Figure 13. Average Payout Ratios 2014-15E: By Country



Source: Citi Research

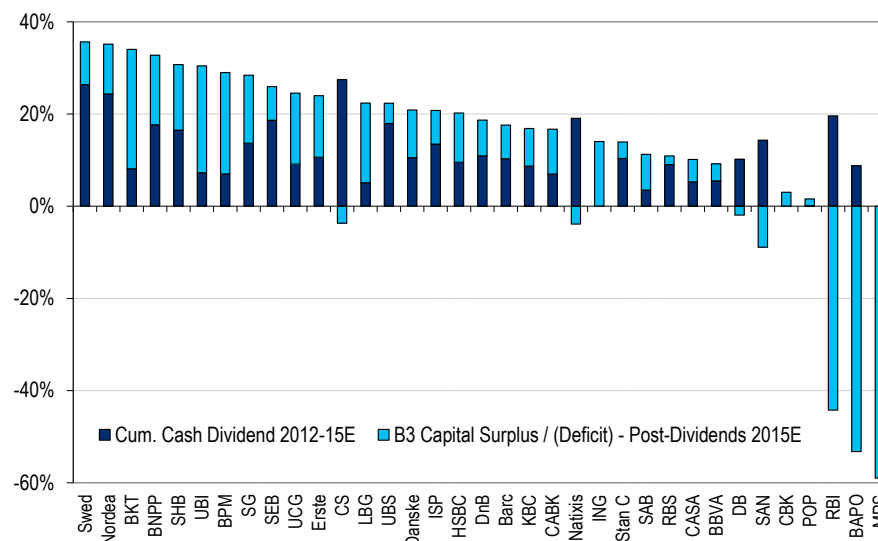
Note: Including our assumptions of special dividends, notably for major Swiss banks over 2014-15

'Bottom-up' view – Which banks are best-placed?

The major Swedish banks, Swiss banks, BNP Paribas and SocGen remain best-placed for capital return

As a percentage of market capitalisation, the Swedish banks represent four out of the top 10 best placed banks for capital return. Likewise, both BNP Paribas and SocGen feature highly, as do the major Swiss banks CS and UBS. With higher levels of uncovered problem assets, we expect surplus capital at the likes of UBI and UniCredit to be deployed in loan loss reserve rebuild. Finally, our preferred Spanish bank Bankinter demonstrates a leading capital surplus position, even after taking into account AQR risks.

Figure 14. Capital Surplus Position (Post-Dividends) % Market Cap: By Bank, 2015E



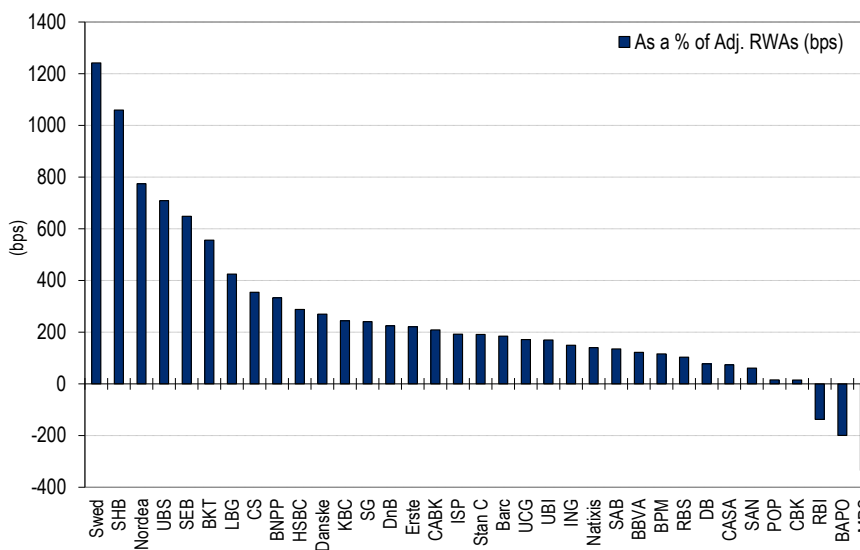
Source: Citi Research

Note: Barclays, BPM, MPS and SAB are adjusted for planned Capital Raise.

Swiss banks are adjusted for Special Dividends as well.

BAPO excludes potential positive effect from conversion of outstanding convertible.

Figure 15. Capital Surplus Position (Pre-Dividends) % Adjusted RWAs: By Bank, 2015E



Source: Citi Research

Note: Analysis is before 2012E-15E cash dividend payouts.

Barclays, BPM, MPS and SAB adjusted for Capital Raise

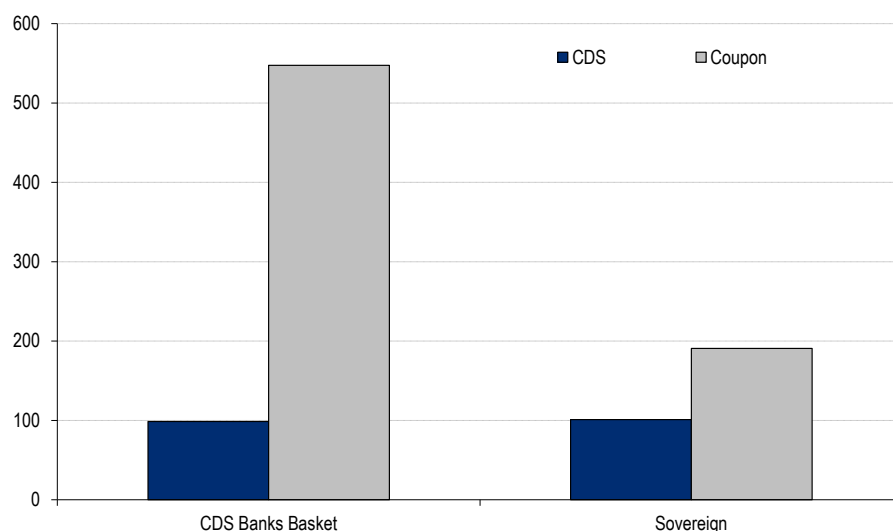
Strategy view – Overweight Banks

Banks offer a top 3 risk-adjusted dividend scope, based on our strategists' dividend yield & growth model

As highlighted by our strategists in our [European Portfolio Strategist – Buying European Banks: Returns, Restructuring & Regulation](#) (9 May 2013)

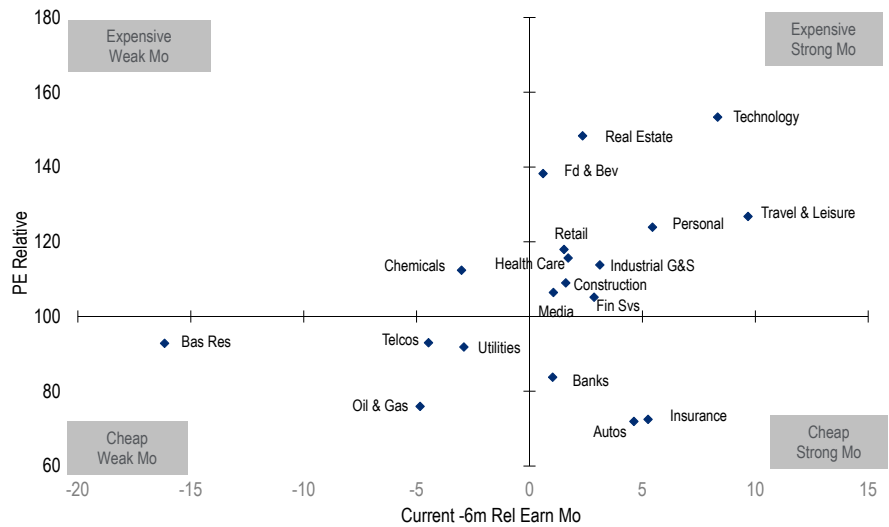
- Banks is one of two sectors that trade on a P/E discount to the market and also have positive relative earnings momentum over the past six months. Insurance is the other sector. Financials are our strategists' preferred value plays in Europe.
- Banks' dividends are normalising and the sector scores increasingly well on various income approaches. Banks is a top 3 sector using a CDS-adjusted DY*G score, i.e. growth and risk adjusting current DY, after Food & Beverage and Healthcare.
- Our strategists' banks basket has a coupon that is almost 3x the yield from 5-year government bond yields. The risk-reward profile from sovereigns does not appear that attractive relative to the one from Banks unless the European and/or global economy is about to take a cold bath.

Figure 16. European Banks* Offer 3x Coupon For Same CDS as European Sovereigns



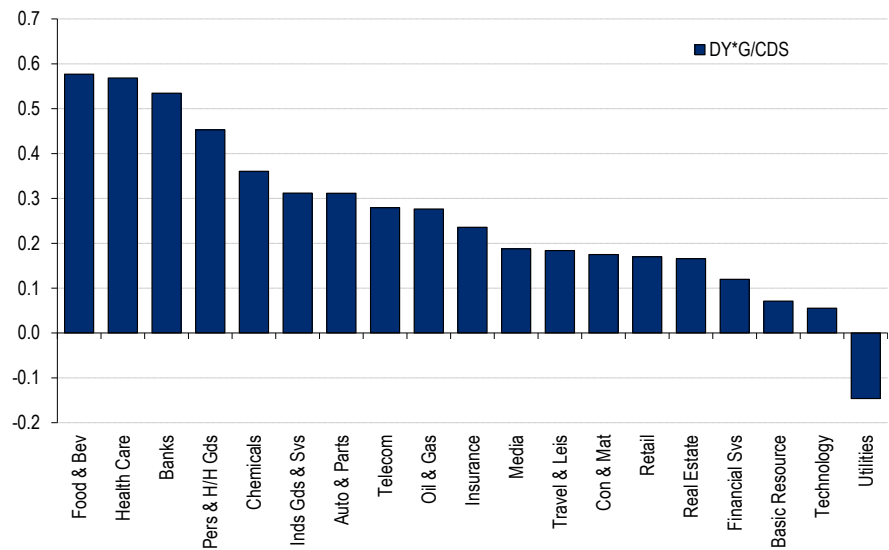
Source: Bloomberg, Datastream & Citi Research. *10 European Banks with sub-125 CDS and 2014E DY >4%.

Figure 17. P/E Relative vs Earnings Momentum, By Sector



Source: Citi Research

Figure 18. CDS- Adjusted DY*G Score



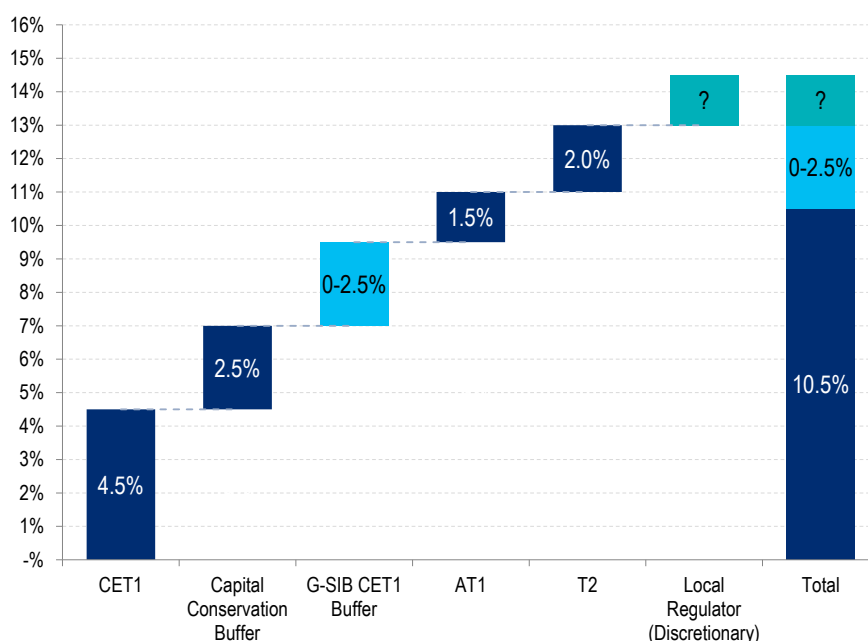
Source: Bloomberg, Datastream & Citi Research

From Equity to Additional 'Bail-In' Capital

The B3 capital stack includes 1.5% AT1 and 2.0% T2

To date, much of the market's focus on banks has been on the building up of *equity* capital ratios. CET1 is only part of the equation (Figure 19). AT1 and T2 minimum requirements of 1.5% and 2.0% of RWA, respectively, represent at least a quarter of the total capital stack. In practice, national regulators could raise these minimum requirements to higher levels. It is worth noting that AT1 also forms part of the Capital Measure to meet leverage ratio requirements. Further details on key characteristics of CRR-compliant AT1, T2 and CoCo instruments can be found in Appendix 1.

Figure 19. Fully-Loaded Basel III Minimum Capital Requirements Plus G-SIB and Discretionary Regulatory Buffers



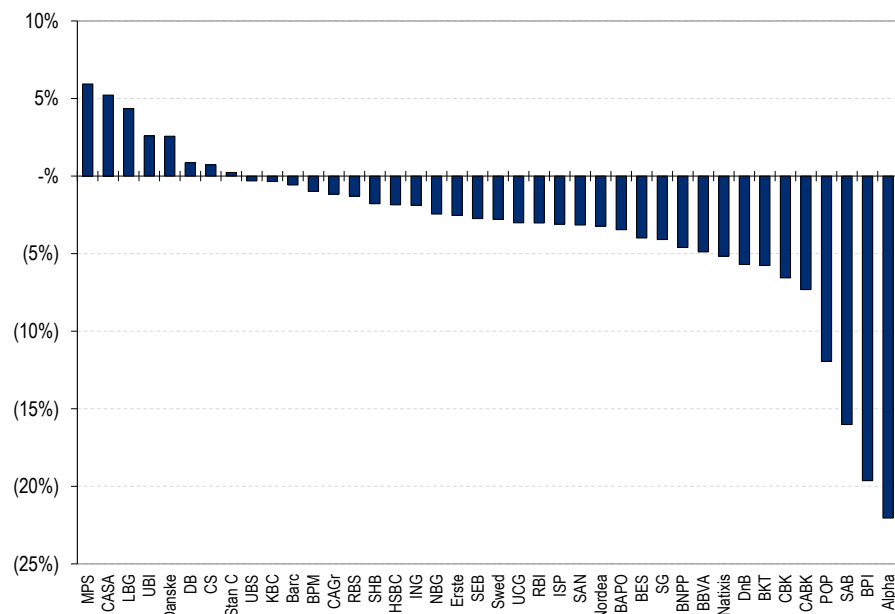
Source: www.bis.org, Citi Research estimates

Winners & Losers from Transitioning To New Capital Structure

Greek, Spanish, Portuguese banks are likely to be most impacted by the new capital structure requirements

Banks with relatively high levels of 'legacy' hybrids are likely to see a more limited negative earnings impact from substitution to 'new generation' AT1/T2 instruments. We find that a higher proportion of banks meet the 2.0% T2 requirement than the 1.5% AT1 requirement. With the exception of MPS, CASA, Lloyds, UBI, Danske, Deutsche Bank and Credit Suisse, the vast majority of European banks are likely to be negatively impacted from the new capital structure (see Figure 20). In particular, Greek, Portuguese and Spanish banks are likely to be the most heavily impacted, together with BNP Paribas and SocGen. This is largely explained by their relatively lower levels of AT1/T2 hybrid instruments, discussed next.

Figure 20. Illustrative P&L Impact, as a % of Normalised Pre-Provision Operating Income



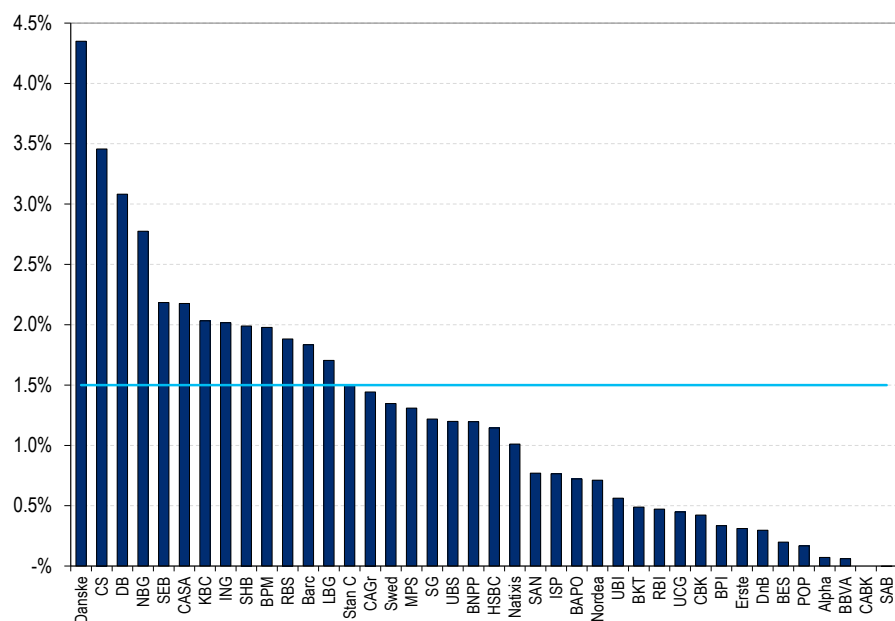
Source: Citi Research estimates

Note: illustrative P&L impact of replacing legacy positions with new AT1/T2 capital to meet minimum B3 requirements

Danske, CS and Deutsche Bank have the strongest legacy T1 capital positions

AT1 capital: Danske, CS and Deutsche Bank have the strongest legacy T1 capital positions with c.3-4.5% of B3 RWAs, far in excess of the 1.5% requirement. UK domestic banks are also relatively well-positioned, amongst others. By contrast, Spanish banks are amongst the weakest from an AT1 capital perspective.

Figure 21. Gross AT1 Capital, as a % of B3 RWAs (vs. 1.5% B3 Requirement), 2Q13

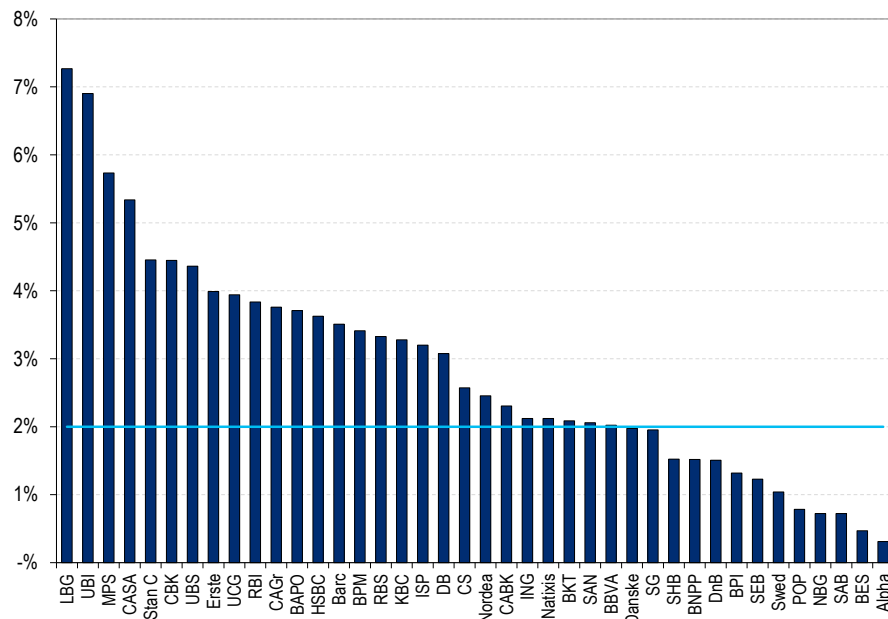


Source: Company Reports, Citi Research

Note: assumes 10% grandfathering of AT1 securities p.a.

T2 capital: We find that most banks have already built up enough capital to meet the 2.0% B3 requirement, although Lloyds and UBI Banca stand out as having by far the largest amounts of T2 capital, at c7% apiece. Broadly-speaking, Italian and UK banks on average have the greatest surplus to the threshold level. We find that Greek, Portuguese, Nordic (Swedbank, SEB, DnB and SHB) and Spanish (Sabadell and Banco Popular) banks fare the worst while BNPP has the least T2 capital of all major European wholesale banks.

Figure 22. Gross T2 Capital, as a % of B3 RWAs (vs. 2.0% B3 Requirement), 2Q13



Source: Company Reports, Citi Research

Key Assumptions

We assume that banks replace legacy positions with new AT1/T2 capital to meet minimum B3 fully-loaded requirements. The output is illustrated in Figure 20. We estimate the impact on bank P&Ls by comparing the implied change in the cost of funding such capital buffers to normalised operating profit. In particular, we assume an increase in the interest spread to senior debt through the replacing of old-style T1/T2 instruments with new-style AT1/T2 instruments – AT1 spread to senior from 4% to 6% and the T2 spread from 3% to 5%. For AT1 capital, we assume that all Tier 1 instruments not eligible under B3 and subject to phase-out are grandfathered at a rate of 10% per annum and replaced by CRR-compliant AT1 instruments.

Focus Shifts Squarely Onto Leverage

"Leverage could be the next shoe to drop" The Road Ahead, Jan 2013

What's new?

The 'leverage' shoe has dropped with significant uncertainty over B3 proposals

Focus on leverage – The focus on leverage ratios has, if anything, intensified. Towards the end of August Dutch Finance Minister and Eurogroup President, Jeroen Dijsselbloem set out proposals that European banks considered too big to fail should target leverage ratios of 4% not 3%, claiming that *"further steps are needed to make the banking industry more solid and stable to ensure it can perform its role in the economy adequately"*. Notwithstanding this, we continue to believe that prevailing consensus of 3% CRD4 ratio is likely to remain.

Banks already meet minimum requirements – Select European banks have disclosed leverage ratios at 2Q13 results, as can be seen in Figure 23.

Figure 23. European Bank Reported Leverage Ratios – 2Q13

Select European Banks	Disclosure
BARC	2.2% PRA leverage ratio and 2.5% CRD4 Tier 1 leverage ratio
BARC proforma for capital raise	2.6% PRA leverage ratio
BNPP	3.4% CRD4 CET1 leverage ratio and 3.8% CRD4 Tier 1 leverage ratio
CAGr	3.5% CRD4 Tier 1 leverage ratio at CA Group level
CS	2.7% B3 Swiss Total Capital leverage ratio
DBK	3.0% CRD4 Tier 1 leverage ratio
HSBC	4.1% PRA leverage ratio
RBS	4.3% CRR Tier 1 leverage ratio
SG	3.2% CRD4 Tier 1 leverage ratio
UBS	2.9% B3 Swiss Total Capital leverage ratio

Source: Company Reports

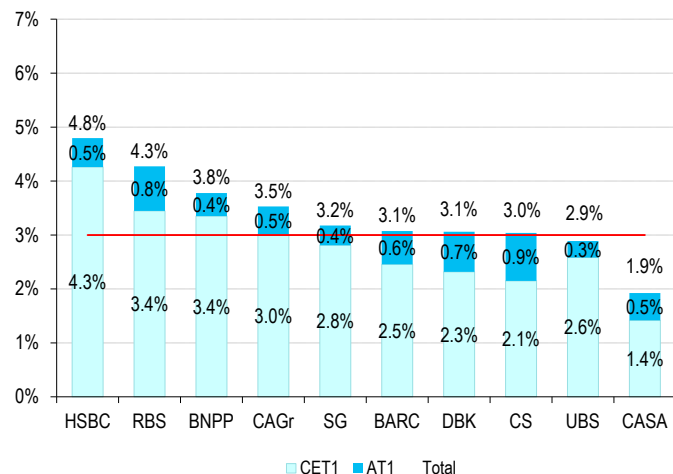
Note: Including AT1, Barclays proforma leverage ratio at 3.1%, excluding PRA 'stress test' at 3.5%

Most banks have met CRD4 leverage requirements and should be comfortably over 3.5% by end-2014 although CS, DBK and SG remain at the 'sharp-end' of the spectrum

On a CRD4 basis, most banks have met the minimum 3% leverage requirement at 2Q13 (giving credit for existing AT1) and should certainly be well above this threshold ahead of public disclosure starting in 2015 (Figure 24). It is worth noting that regulators continue to look at CASA at the parent company level – CA Group clearly meets leverage requirements.

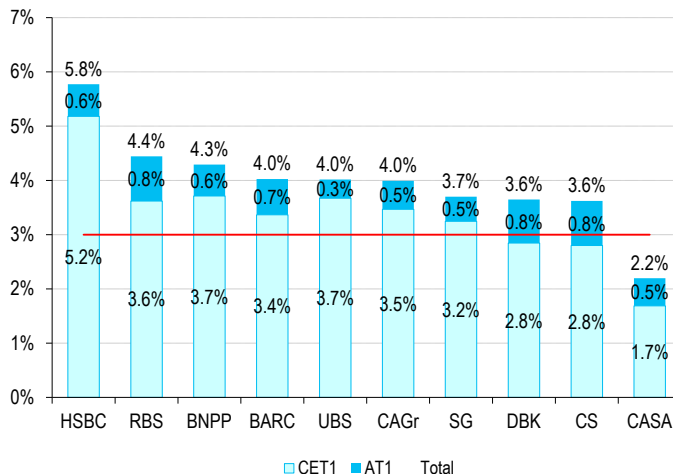
The market has taken mixed comfort from banks achieving this target. We observe three categories of banks: 1) those such as HSBC, BNPP and CA Group that comfortably meet expectations; 2) those that just meet or have a plan to exceed requirements, such as CS and UBS; and 3) those that just meet requirements but residual concerns persist, SocGen and notably Deutsche Bank. If anything, the Barclays capital raising has weighed on Deutsche Bank; both banks have leading IB franchises.

Figure 24. CRD4 Leverage Ratio – 2Q13



Source: Company Reports, Citi Research estimates

Figure 25. CRD4 Leverage Ratio – 2014E



Source: Citi Research estimates

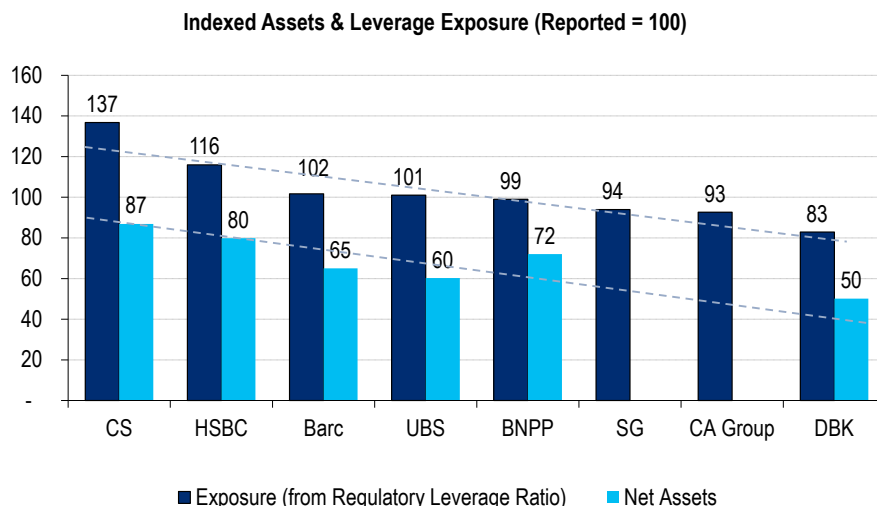
Key issues from here

The more stringent B3 proposals as well as earnings impact from leverage exposure mitigation remain key issues

Assuming Basel proposals remain unchanged & become the de facto standards (over and above CRD4), we believe that there are three issues:

1. **Risks from more stringent B3 requirements** – this primarily derives from:
 - a. **Less collateral netting on SFTs (securities financing transactions) and derivatives** – Under CRD4, SFT exposure is typically calculated net of collateral, taking into account legally enforceable master netting agreements. However, under the B3 proposal (still subject to comments), no recognition of accounting cash netting is permitted and so gross SFT assets and the PFE (potential future exposure) add-on determine bank exposure.
 - b. **Treatment of CDS protection sold** – The effective notional amount of a written credit derivative may be reduced by the effective notional amount of a purchased credit derivative (i.e. protection bought) as long the derivative purchased has 1) the same reference name & seniority, and 2) a maturity at least as long as the derivative sold. At this stage it is very difficult to quantify the contribution to Total Exposure given available disclosures and we view this factor as the key unknown.
2. **Differences in leverage exposure ratios** – In *Not All Banks Equal on Netting & Collateralisation* (15 Aug 2013), we find that the ‘average’ bank reported a leverage exposure broadly comparable in size to the reported IFRS balance sheet (c.100%), as shown in Figure 26. Broadly, the gross-up of derivatives PFE and off-balance sheet commitments was offset by derivatives and SFT netting. Although there have been some concerns about Deutsche Bank’s lower exposure (€1.6tn vs. IFRS balance sheet of €1.9tn), we believe that this is largely accounted for by a higher degree of netting or collateralisation of its balance sheet.

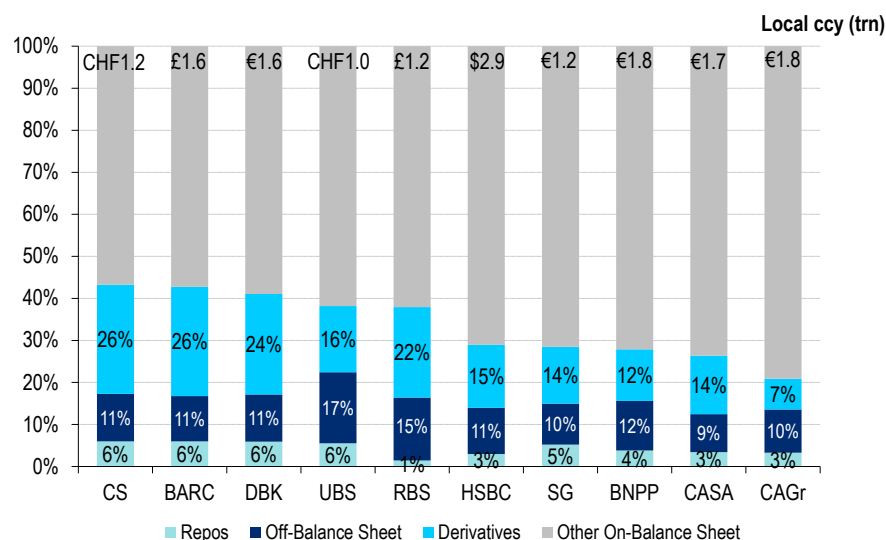
Figure 26. Netted balance sheets help explain regulatory leverage exposures – 2Q13



Source: Company Reports, Citi Research estimates

3. Potential earnings hit from balance sheet mitigation – The market remains concerned about earnings hits from balance sheet mitigation actions across derivatives, legacy/non-core and repo portfolios as well as further rationing of off-balance sheet commitments. In their 2Q13 results presentations, Deutsche Bank outlined €200-300bn reduction in leverage exposure, while Credit Suisse outlined targeted reductions of SFr200bn (incl. SFr70bn of off-balance sheet assets by end-2013) and JPMorgan is targeting up to 70bps of asset actions. Deutsche Bank has quantified the impact of its exposure reduction plans at c€600m upfront cost and €300m on an ongoing basis; with c60% of reduction driven by CRD4 add-ons we expect a manageable impact. Figure 9 shows the percentage of exposure to SFTs (securities financing transactions), OBS (off-balance sheet) and derivatives.

Figure 27. Composition of Total Exposures – 2Q13



Source: Company Reports, Citi Research estimates

Leverage-in but Not Sweatin'

We expect leverage exposure mitigation to take place at a relatively fast pace, with a manageable earnings impact

We see the leverage ratio as a backstop measure rather than a 'race to the top' (*Leverage-in but Not Sweatin'*, 15 Jul 2013). By end-2014, we see banks achieving leverage ratios of comfortably above 3.5%, well ahead of minimum standards of 3% by 1 Jan 2018. It is important to remember that the Capital Measure includes AT 1 capital and we believe it is appropriate to give credit for existing Tier 1 qualifying for grandfathering on the expectation that, to the extent required, it will be replaced with eligible capital under the new regulations. Capital issuance should thus be seen in the context of AT1, rather than common equity.

We expect more challenged banks to announce further 'low impact' balance sheet mitigation across derivatives, legacy/non-core and repo portfolios as well as further rationing of off-balance sheet commitments. Credit Suisse, Barclays, Deutsche Bank and UBS have the greatest percentage exposure to these (see Figure 27) and we see the greatest scope for management actions at a relatively manageable cost here. As with the LCR rules, there remains scope for regulatory forbearance, especially given potential risks to Treasury markets via much more stringent repo rules.

The Third 'R' – Restructuring & Recovery of Earnings

Restructuring Underpriced Cost Savings On Track, More To Come

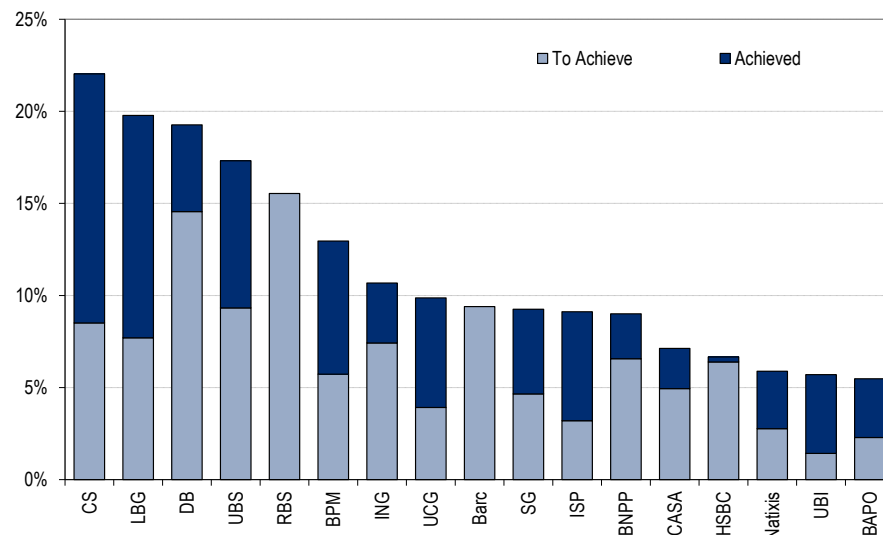
Banks have targeted cost programmes of c10% of expense base, of which one-third has been achieved

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

At the sector level, we estimate that banks have targeted cost programmes of c10% of total 2013E underlying expense base. To date, banks have achieved some one-third of these targets, with the balance yet to come. These measures have supported post-tax B3 RoEs by c1% to-date, with c1.5% potential improvement to come.

The most ambitious of these programmes have targeted up to 15-20% of the 2013E expense base. The majority of benefits have yet to come through at the likes of Barclays, Deutsche and UBS, amongst others.

Figure 28. Announced Cost Savings Targets (As a % of 2013E Cost Base)



Source: Company Reports and Citi Research estimates

Year-to-date, a number of banks have announced updated targets, while there has been increasing evidence of delivery of previous targets. We highlight a few notable examples:

Barclays announced an absolute cost reduction target from £18.5bn to £16.8bn implying *net* cost reduction target of £1.7bn or 9%. This combines with targeted revenue growth of 9% to drive operating 'jaws' of 18%, although we are more conservative in our forecast of revenue attrition from the restructuring plan.

BNP Paribas announced targeted cost savings of €2bn based on its "Simple & Efficient" program. At c8% of its cost base (vs c17% for its global peers) and with a strong cost-cutting track record (including Belgium, Italy & Turkey), we believe BNP Paribas is well-placed to meet these targets.

CASA announced a €650m restructuring plan, representing c5% of the 2012 Group cost base, of which €320m is expected to be delivered in 2013. Savings are mainly expected to come from rationalisation of structure, reduction of external cost and review of real estate.

Credit Suisse raised its cost savings from SFr4bn to SFr4.4bn & has largely achieved its direct IB targets (SFr1.7bn out of SFr1.8bn) even though the vast majority of Private Banking & Wealth Management and Infrastructure savings have yet to come. We expect the latter to be back-loaded over 2014-15.

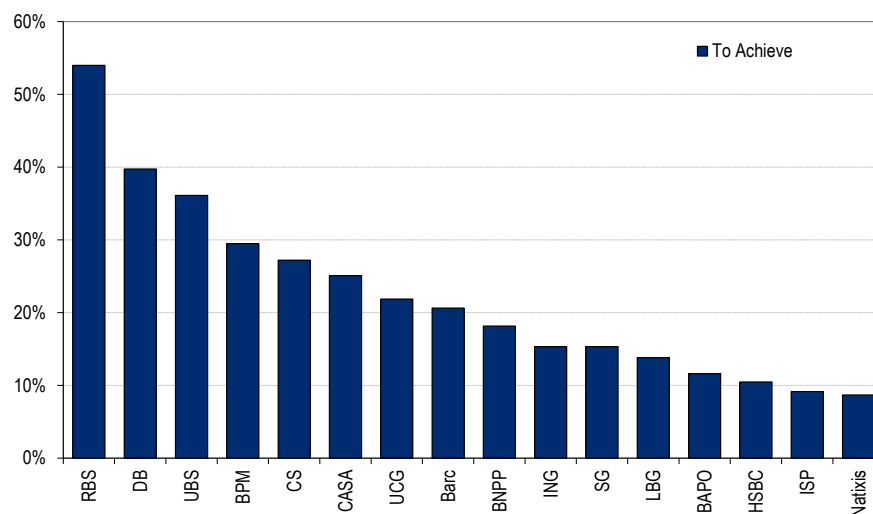
Deutsche Bank's annualised 1H13 cost base of c€24bn was over €1bn below the 1H12 run-rate of €25bn.

SocGen recently announced targeted cost savings of €900m over 2013-15, or c5-6% of its cost base, builds on €550m of savings achieved in 2012.

BES announced €100m, or c14% of the expense base of domestic operation over 2013-15, which should allow the bank to achieve double-digit RoE in a 'normalised' environment.

Overall, we believe that although the retail/commercial networks will be rationalised over time to counter the challenging medium-term top-line outlook, the largest cost savings in the near-term are likely to accrue from corporate & investment banking. Indeed, comp-to-revenue ratios have already been materially adjusted in 2012, with further downward pressure in our view, while non-comp expense bases will be addressed via complexity reduction.

Figure 29. Potential Cost Savings Targets to be Achieved (As % of 2013E Post-Provision Profit)

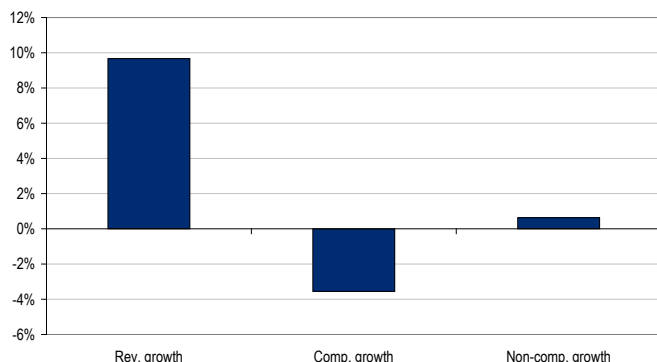


Source: Citi Research

Investment Banking: Revolution in Cost Management

We believe that the market has not given the investment banking industry enough credit for structural reform in the way costs and compensation are being managed. In 2012, industry revenues recovered by c10%. At the same time, compensation expense declined by c4% while non-comp expense was also controlled. Thus, industry cost-income ratios improved by c8pps. Likewise, the comp-to-revenue ratio came down to a level not seen since 2009, a record year in capital markets. Belatedly, the balance of power has clearly shifted from employees to shareholders, which we see more as a *revolution* rather than an *evolution*.

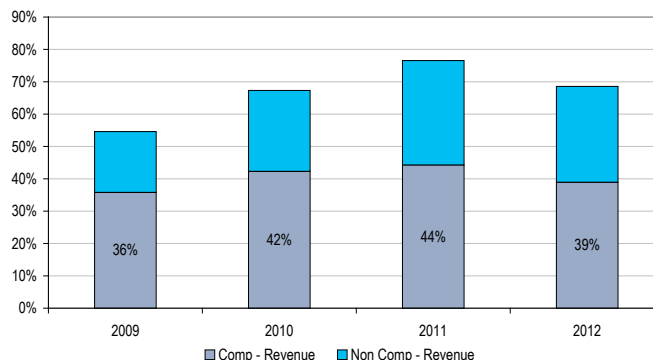
Figure 30. Industry Revenue vs Cost Trends, 2012 (YoY)



Source: Citi Research, Company reports

Note: Based on Barclays, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley and UBS

Figure 31. Industry Cost-Income Ratio Trends, 2009-2012



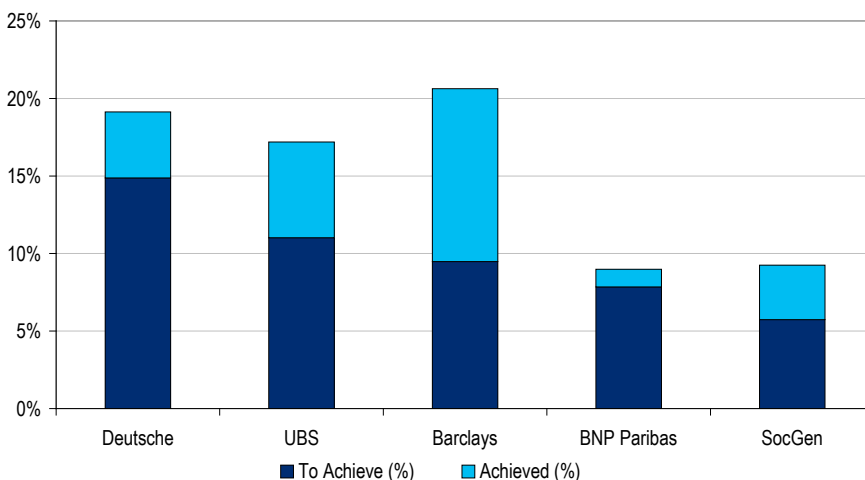
Source: Citi Research, Company reports

Note: Based on Barclays, Credit Suisse, Goldman Sachs, JPMorgan, Morgan Stanley and UBS

Focus on Complexity Reduction

At the same time, there is increased focus on complexity reduction and non-comp expense which should drive further significant cost synergies, over time. On our estimates, these should drive additional synergies of up to 15% of the cost base. These should support further improvement in industry profitability, discussed next.

Figure 32. Targeted Cost Reduction Plans*



Source: Citi Research, Company reports * As a % of underlying 2013E cost base

Investment Banking: Market share Consolidation

- **Top 5 gaining FICC share:** In FICC, our analysis suggests that there has been a modest shift in market share from European to US banks of c 3pp since 2006 relative to 1H13, which we attribute to deleveraging pressures (see Figure 33). We expect that this trend could continue – given the heightened focus on leverage ratios – although this is likely to be offset by gains from greater €-based disintermediation notably benefiting BNP Paribas, Deutsche Bank and SocGen.
- **Equities shares more stable:** European banks have maintained market share in Equities despite exits from players like CASA and RBS. Indeed, Credit Suisse

has been the largest market share gainer over 2006-1H13 of c3ppt, to a market share of c10% primarily driven by the prime brokerage business.

Top 5 banks have gained 8pps and 3ppt market share in FICC and EQ respectively, since 2006

■ **Regulation likely to drive further consolidation:** Industry consolidation continues, with market shares of the Top 5 players increasing by c8% and c3% in FICC and Equities since 2006, respectively. In both cases, this has been driven by retrenchment of smaller players to their core geographies & products (especially in FICC) or exits (as highlighted above, CASA & RBS in equities). UBS' significant restructuring of its FICC franchise is likely to be followed by other second-tier global and regional franchises especially in the context of increasing operational regulatory burdens notably OTC derivatives reform, which could include CASA, CS, and RBS.

Figure 33. FICC Market Shares – By Underlying Revenue- 2Q13

	2006	2007	1H08	2009	2010	2011	2012	1H13	1H13 vs 2006
JP Morgan	8.8%	8.5%	7.2%	9.4%	10.2%	12.5%	11.6%	12.9%	411 bps
Deutsche Bank	8.3%	9.7%	11.8%	8.5%	10.5%	11.3%	10.5%	10.3%	202 bps
Goldman Sachs	9.6%	11.5%	12.3%	13.9%	10.5%	8.4%	9.0%	9.5%	-15 bps
Barclays	10.3%	14.7%	15.0%	11.4%	10.2%	9.5%	10.0%	9.2%	-109 bps
Bank of America	10.0%	10.0%	8.8%	9.1%	9.8%	8.1%	9.6%	8.7%	-125 bps
HSBC	3.6%	3.2%	4.8%	4.7%	4.7%	4.6%	5.0%	6.2%	264 bps
Credit Suisse	5.6%	5.4%	4.1%	5.2%	5.1%	4.4%	5.4%	5.8%	19 bps
RBS	10.9%	9.7%	5.4%	7.3%	6.4%	5.8%	6.0%	4.9%	-597 bps
BNP	2.8%	3.5%	3.6%	6.2%	5.6%	6.2%	5.1%	4.6%	180 bps
Morgan Stanley	6.8%	6.6%	5.9%	4.7%	5.7%	6.1%	5.1%	4.4%	-240 bps
Nomura	3.5%	2.7%	2.7%	1.5%	2.2%	3.1%	3.9%	3.7%	17 bps
Soc Gen	2.1%	1.9%	2.9%	2.9%	2.5%	2.6%	3.1%	3.0%	88 bps
UBS	4.8%	2.4%	1.6%	1.5%	3.7%	4.8%	2.0%	1.7%	-308 bps
Credit Agricole	2.3%	2.0%	1.5%	1.8%	1.7%	1.8%	1.8%	1.5%	-74 bps
US	45.9%	44.8%	46.5%	49.2%	47.5%	45.9%	47.1%	49.1%	318 bps
Europe	50.6%	52.6%	50.8%	49.3%	50.3%	51.0%	48.9%	47.2%	-335 bps
Top 5	47.6%	52.5%	58.5%	55.0%	52.7%	52.4%	53.0%	55.4%	777 bps
Rest	52.4%	47.5%	41.5%	45.0%	47.3%	47.6%	47.0%	44.6%	-777 bps

Source: Company Reports, Citi Research

Note: JPM adjusted for tax equivalent adjustment component; JPM, BoA, Barc & Nomura pro-forma for acquisitions of Bear Sterns, Merrill Lynch & Lehman Bros respectively

Figure 34. Equities Sales & Trading – By Underlying Revenue

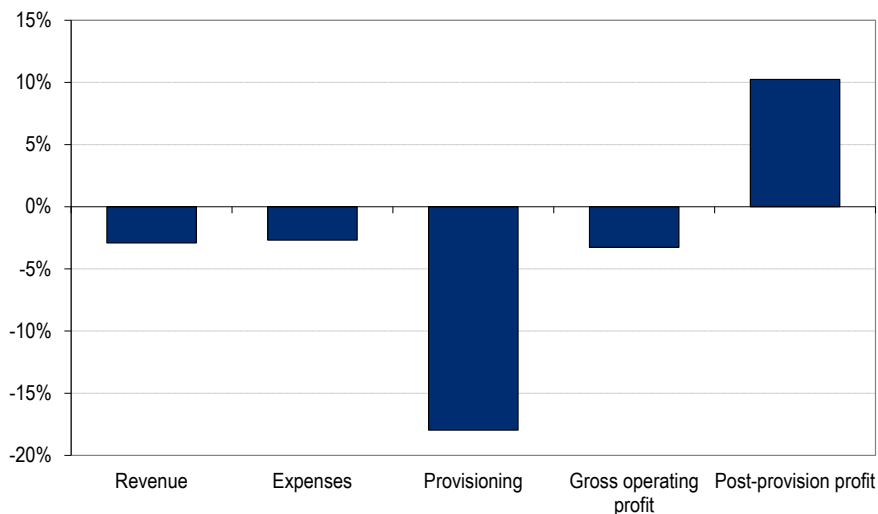
	2006	2007	1H08	2009	2010	2011	2012	1H13	1H13 vs 2006
Goldman Sachs	15.9%	16.2%	16.7%	18.0%	14.6%	15.6%	16.7%	13.2%	-276 bps
Morgan Stanley	9.4%	10.0%	13.1%	7.9%	8.9%	11.9%	12.4%	11.8%	246 bps
Credit Suisse	7.0%	7.6%	8.3%	10.3%	10.3%	9.9%	9.8%	9.8%	282 bps
JP Morgan	8.0%	6.7%	4.0%	7.2%	8.3%	8.6%	9.4%	9.2%	121 bps
UBS	9.3%	8.3%	8.8%	6.8%	7.6%	8.0%	7.0%	8.3%	-100 bps
Barclays	5.6%	5.5%	5.8%	5.0%	5.7%	5.6%	7.3%	8.2%	264 bps
Bank of America	10.0%	9.9%	10.2%	7.3%	7.5%	7.1%	6.9%	8.2%	-187 bps
Deutsche Bank	7.5%	7.3%	6.0%	6.1%	7.4%	6.5%	6.5%	7.1%	-42 bps
SocGen	5.7%	5.3%	5.1%	6.9%	5.9%	6.4%	5.7%	6.3%	64 bps
Nomura	3.8%	5.1%	3.6%	4.8%	4.9%	4.7%	4.5%	4.6%	86 bps
BNP	4.5%	4.4%	4.1%	4.1%	5.4%	5.6%	4.4%	3.9%	-60 bps
HSBC	1.2%	1.2%	1.9%	1.0%	1.4%	1.9%	1.4%	1.8%	61 bps
Credit Agricole	3.7%	3.7%	3.0%	3.2%	3.6%	3.7%	2.7%	1.5%	-223 bps
RBS	2.7%	2.7%	2.8%	3.4%	1.9%	-%	-%	-%	-270 bps
US	49.1%	48.9%	50.7%	48.5%	45.9%	47.8%	50.7%	48.5%	-61 bps
Europe	47.1%	46.1%	45.7%	46.7%	49.2%	47.5%	44.9%	46.9%	-26 bps
Top 5	49.5%	48.9%	50.9%	50.2%	49.7%	54.0%	55.3%	52.2%	273 bps
Rest	50.5%	51.1%	49.1%	49.8%	50.3%	46.0%	44.7%	47.8%	-273 bps

Source: Company Reports, Citi Research

Recovery of Earnings

Overall, we forecast *underlying* 2013 sector post-provision profit growth of c10%. In turn, this is primarily driven by our provisioning decline of 18%, partially offset by c3% decline in revenues. Indeed, we expect expense to decline broadly in line with revenues with further scope for cost savings as restructuring programs kick in.

Figure 35. Sector *Underlying* P&L Trends, 2012-13



Source: Company Reports and Citi Research estimates

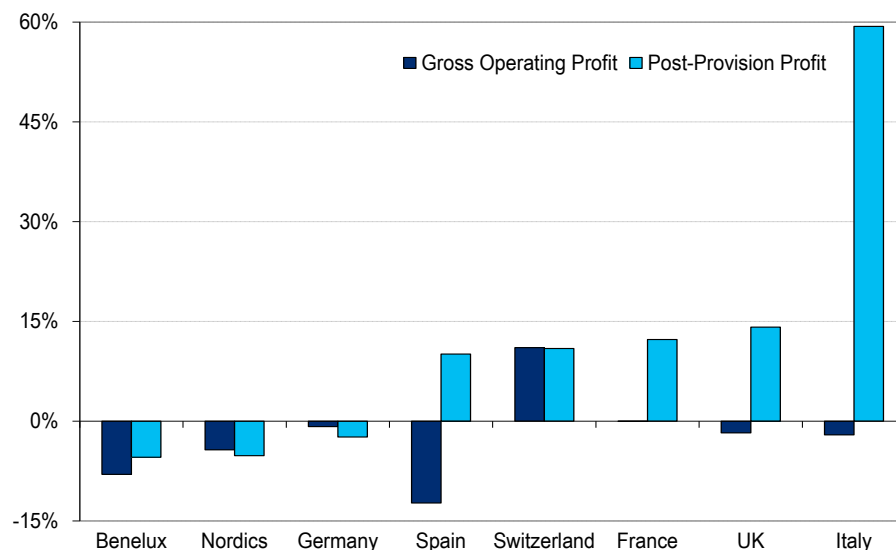
Note: Europe ex Greece and Portugal.

Early Provisioning Decline Supportive

Lower provisioning has been supportive at UK, French, Spanish & Italian banks while Swiss banks supported by better GOP trends

Better post-provision trends are being supported mainly by lower provisioning; Switzerland is the only market where we are seeing improving operating profit trends. Lower provisioning has been notably supportive at the likes of UK (lower Irish impairments), French (international, consumer finance), Italian and Spanish banks although we have argued that AQR risks remain elevated in the periphery.

Figure 36. Country-wise *Underlying* P&L Trends, 2012-13E



Source: Company Reports and Citi Research estimates

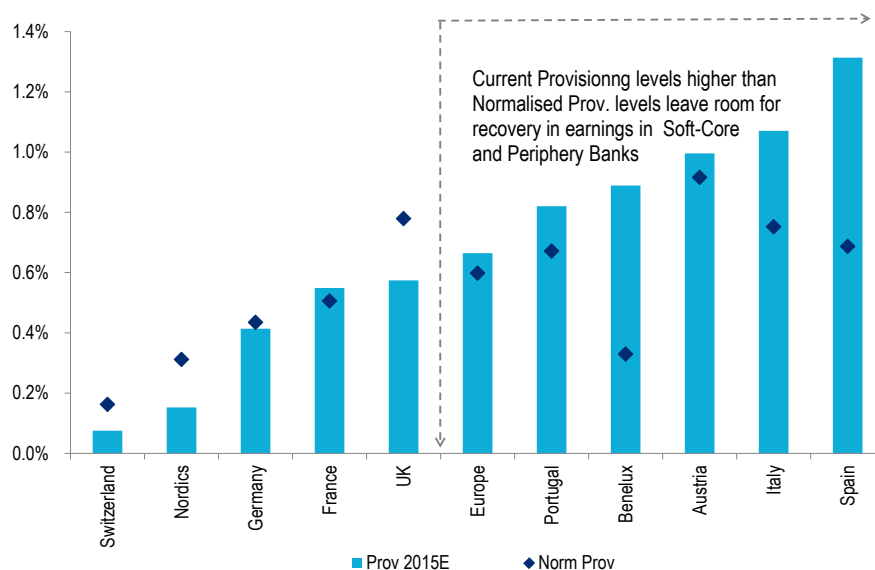
Note: Italy: 2012 includes Bank of Italy review related special provisions

Moving Towards Normalised Provisioning

Benelux & periphery banks are most exposed to provisioning normalisation

With Euro-area showing signs of macro recovery, provisioning could potentially normalise ahead of expectations and drive further earnings upgrades. Italian, Spanish and Benelux banks could benefit the most from provisioning normalisation although upfront AQR risk remains elevated for the periphery.

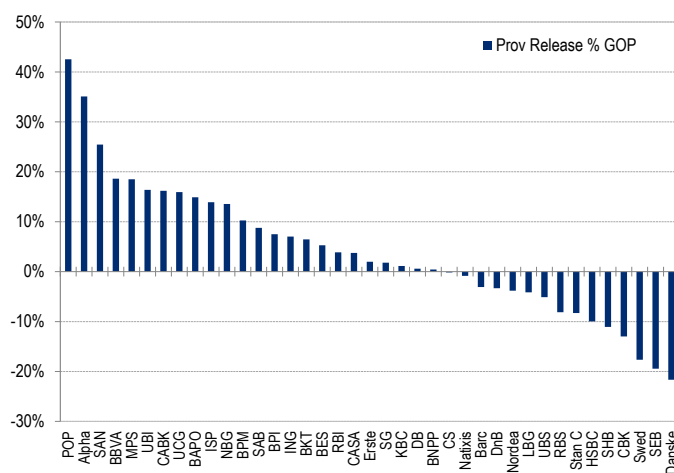
Figure 37. Country-wise Provisioning, 2015E and Normalised Provisioning



Source: Citi Research

We favour Bankinter, BBVA, BES and UniCredit for periphery exposure (Figure 38) where we are also more relatively comfortable on AQR risk.

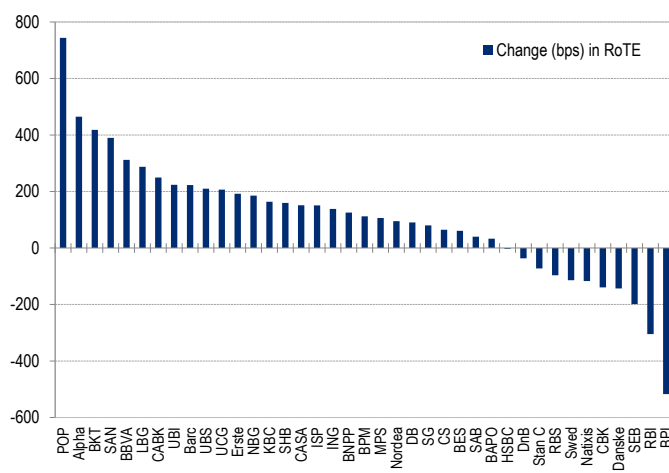
Figure 38. P&L Impact Upon Provision Normalisation % GOP, 2015E



Source: Company Reports and Citi Research estimates

Note: We define Normalised Provisioning as long term provisioning levels

Figure 39. Change (in bps) RoTE, 2015E Upon Provision Normalisation



Source: Company Reports and Citi Research estimates

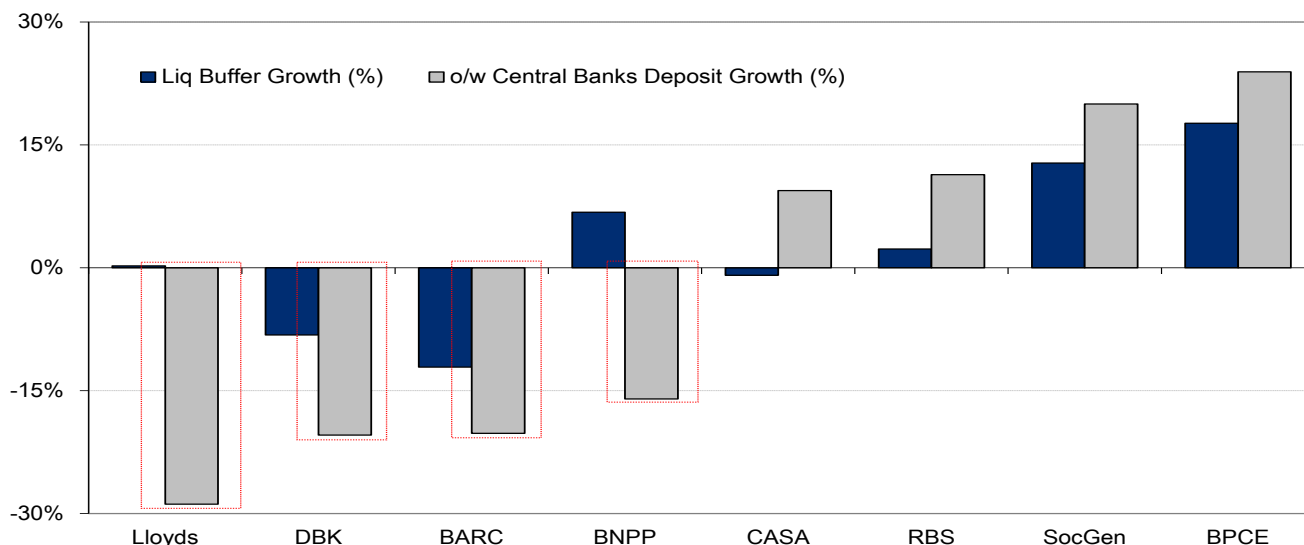
Note: We define Normalised RoTE as 2015E RoTE adjusted for 1) Long term provisioning levels 2) B3 Capital Surplus/Deficit 3) Restructuring 4) P&L impact of change in cost of funding due to change in capital structure (AT1 & T2)

Easing Liquidity = Margin Support

As highlighted in our note [European Banks – Funding Indicators](#), 30 Aug. 2013, we also expect banks to benefit from liquidity optimisation – in particular by reducing central bank deposits where the opportunity cost is greater – which could drive earnings upgrades over time. While Deutsche Bank, Barclays and BNPP are already making progress by reducing central bank reserves by >15% over 1H13, there remains scope for further optimisation across the sector, supporting NIMs. For example, Deutsche Bank referred to its cash & liquidity pool as part of its leverage tool box, while SocGen CEO Oudea recently highlighted scope for a €30bn reduction in central bank deposits.

In the UK, we have observed liquidity forbearance: “Major banks meeting the minimum 7% capital threshold [can] reduce the level of required liquid asset holdings... the effect will be to lower total required holdings by £90bn, once all meet the capital threshold.” The PRA has also issued a press release detailing the amendments to its Individual Liquidity Guidance (ILG) framework. More specifically firms will now be allowed to run with a Basel LCR of 80% until 1 January 2015, rising thereafter to 100% by 1 January 2018. The objective is to boost credit supply, although given current demand constraints we expect this may instead result in healthier NIMs, given the reduction in the opportunity cost of having to hold “excess” liquidity.

Figure 40. Growth in Liquidity Buffers & Central Banks Deposits, 1H13 vs. End - 2012 Change



Source: Company Reports and Citi Research

Note: DBK central bank deposit growth based on Cash & Cash Deposit with Banks

Appendix

What is Additional Tier 1 Capital?

The Basel Committee has stated its belief that common equity is the highest quality component of capital (along with retained earnings), and, accordingly, should be *'the predominant form of Tier 1 capital'*⁴. The remainder of the Tier 1 capital base should be comprised of Additional Tier 1 (AT1) subordinated instruments.

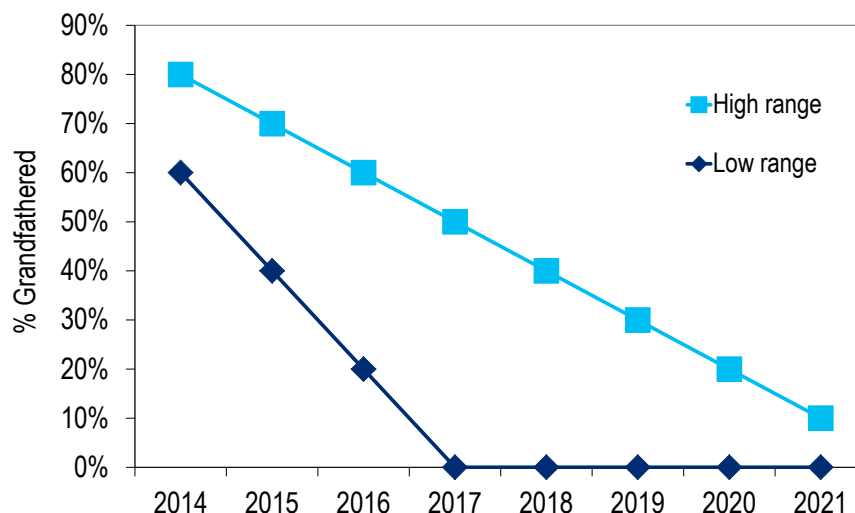
Broadly, the criteria required for an instrument to qualify as AT1 include, but are not limited to, that it:

1. Is issued and paid-in;
2. Is subordinated to depositors, general creditors and subordinated debt of the bank;
3. Not have enhanced seniority to the claims of a bank's creditors (incl. secured and/or covered by a guarantee of the issuer or related entity);
4. Is perpetual with no step-ups or incentives to redeem; and
5. May be callable at issuer's initiative after a minimum of five years.

The Basel Committee refers to Tier 1 capital as 'going-concern' capital, i.e. it has a distinct role in maintaining the bank's status as a going concern. Tier 1 capital is subordinate to Tier 2 capital, which is referred to as 'gone-concern' capital and acts to support depositors in the event of bankruptcy.

In our analysis in From Equity to Additional 'Bail-In' Capital on page 30, we assume that all Tier 1 instruments not eligible under B3 and subject to phase-out are grandfathered at a rate of 10% per annum and replaced by CRR-compliant AT1 instruments. We expect that grandfathering will generally follow the path set out in Figure 41, i.e. amortising cap starting in the range of 60-80% on 1 Jan 2014 and amortising 10-20% p.a. – the exact values being set by the relevant authorities.

Figure 41. General Grandfathering Schedule of Tier 1 in EU



Source: Official Journal of the European Union, Citi Research

Another form of capital is contingent capital, of which the most commonly known is Contingent Convertible bonds, or 'CoCos'. CoCos function as fixed income

⁴ BCBS – Basel III: A global regulatory framework for more resilient banks and banking systems, June 2010

instruments until a capital level is triggered, at which point the instrument the bond converts to loss-absorbing equity. CoCos rank equal to Tier 2 capital instruments.

In Figure 42 below we illustrate some of the key characteristics of CRR-compliant capital instruments. In particular, there are three forms of principal loss absorption mechanisms on new-style AT1 instruments that occur should a trigger be breached:

1. A temporary writedown of capital will, in the event of a recovery, result in a writeback from future profits;
2. A permanent writedown may be full or partial, depending upon the structure, although this type of security is likely to have a lower trigger; and
3. Share conversion, of which the future value of the security will be dependent on share price performance (if investors hold on to shares).

Figure 42. Key Characteristics of CRR-Compliant Capital Instruments

Feature / Instrument		Tier 2	Additional Tier 1	Dated CoCos
Tenor		<ul style="list-style-type: none"> • >5 years • Typically 10yr bullet or 10NC5 	<ul style="list-style-type: none"> • Perpetual • > NC5 	<ul style="list-style-type: none"> • Typically 10yr, 10NC5 or longer
Coupon Step-Up		<ul style="list-style-type: none"> • Not permitted 	<ul style="list-style-type: none"> • Not permitted 	<ul style="list-style-type: none"> • Not permitted
Coupon Deferral / Cancellation		<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • Fully Optional • Non-Cumulative 	<ul style="list-style-type: none"> • N/A
Subordination		<ul style="list-style-type: none"> • Senior to Tier 1 	<ul style="list-style-type: none"> • Senior to equity 	<ul style="list-style-type: none"> • Pari passu with Tier 2
Going-Concern Loss Absorption	Trigger	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • CET1 <5.125% (or higher) 	<ul style="list-style-type: none"> • CET1 <[5-7]%
Going-Concern Loss Absorption	Mechanism	<ul style="list-style-type: none"> • N/A 	<ul style="list-style-type: none"> • Temporary writedown, • Permanent writedown, or • Conversion to shares 	<ul style="list-style-type: none"> • Temporary writedown, • Permanent writedown, or • Conversion to shares
PONV Mechanism		<ul style="list-style-type: none"> • Permanent writedown or conversion to shares 	<ul style="list-style-type: none"> • Permanent writedown or conversion to shares 	<ul style="list-style-type: none"> • Permanent writedown or conversion to shares
Issuance Rationale		<ul style="list-style-type: none"> • Tier 2 (Pillar 1) • Eligible liabilities (bail-in) • Credit support to senior creditors 	<ul style="list-style-type: none"> • AT1 (Pillar 1 & Pillar 2) • Eligible liabilities (bail-in) • Credit support to senior creditors • Leverage ratios 	<ul style="list-style-type: none"> • Tier 2 (Pillar 1) • Incremental Pillar 2 benefits • Switzerland - Capital Buffer (7% trigger) or Progressive Component (5% trigger) • Eligible liabilities (bail-in) • Credit support to senior creditors

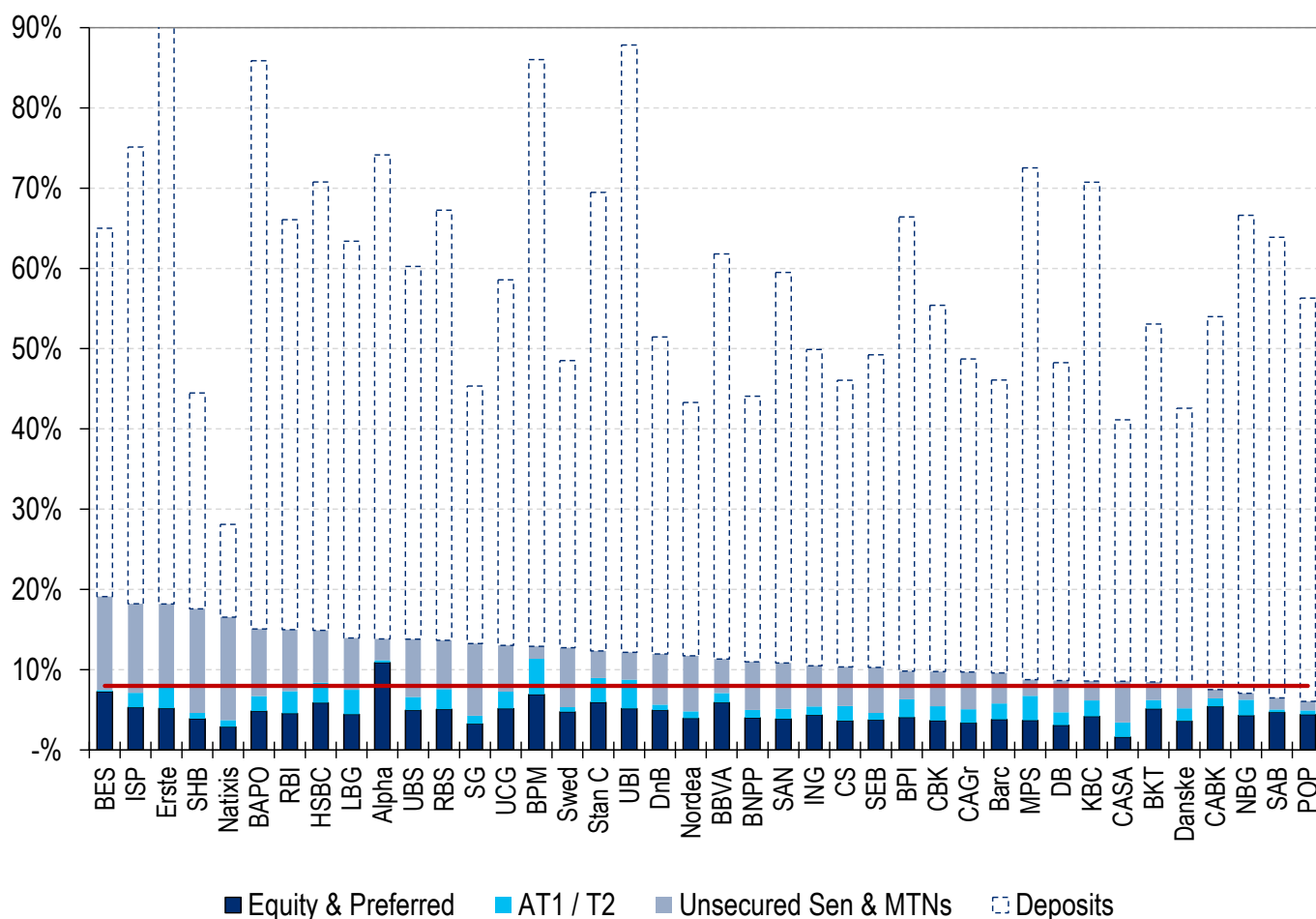
Source: Citi Research

Bail-in Capital Analysis

- **European Resolution & Recovery Directive (RRD)** – The RRD framework looks to reduce the cost of future crises by improving financial stability and reducing taxpayer losses. In particular, resolution looks to protect critical functions and stakeholders – payment systems & depositors – while other parts that are not crucial to financial stability, may be allowed to fail. One of the key resolution tools is the concept of ‘bail-in’ of creditors, i.e. the mechanism of recapitalisation via write-down of liabilities and/or conversion to equity, to allow the bank to continue as a ‘going concern’. This concept is also known as the ‘open bank resolution’. The alternative, or ‘closed bank resolution’ is when a bank is split into two – a ‘good’ or ‘bridge’ bank and a ‘bad’ bank.
- **Priority of liabilities** – Bail-in would potentially apply to liabilities with the exception of covered deposits (i.e. protected by a deposit guarantee scheme (DGS)); secured liabilities including covered bonds; client assets; short-term lending (e.g. interbank lending); or liabilities such as salaries, pensions or taxes). The write-down would require that equity would be the first-loss tranche, followed by the creditors of the institution under resolution in order of preference. It is also worth noting that the latest proposal ranks individual & SME deposits above that of other ordinary unsecured creditors. Likewise, covered deposits and the DGS have a higher priority than individual/SME deposits not covered by the DGS.
- **Loss-absorbing capital thresholds** – For debt write-down to be a credible resolution tool, it is necessary to ensure that there are sufficient ‘in-scope’ liabilities. Our understanding is the latest proposal requires that resolution funds cannot be tapped until a ‘bail-in’ contribution of at least 8% of total liabilities (including own funds) has been made. Moreover, the contribution of the resolution fund would be capped at a minimum of either: (i) 5% of the total liabilities of the institution; or (ii) the amount of resources available to the resolution fund that has been raised by levies plus the amount that could be raised by ex-post levies within 3 years.

Figure 43 below shows the current availability of loss-absorbing capital (LAC) within the context of the ‘8% rule’; the scope of ‘bail-inable’ deposits is obviously difficult to determine from an ‘outside-in’ standpoint but suggests that nearly all banks in our universe should have sufficient ‘in-scope’ liabilities. We expect the level of LAC to increase over time through the retention of earnings and, in select cases, the issuance of AT1 and T2 capital.

Figure 43. Loss-Absorbing Capital Vs. 8% Threshold, 2Q13



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 Spanish banks for which total senior unsecured is per company disclosure;
2. Senior unsecured debt and MTNs includes facilities at end-2Q13, except for SAN and CABK, which are at end-2012;
3. Senior unsecured debt and MTNs includes facilities with maturities and/or call dates after 30-Jun-14, except for POP, SAN, BKT, BBVA, and CABK, which include facilities for all maturities;
4. Erste Bank total assets reduced by 25% to remove effects due to consolidation of savings banks not fully owned;
5. Monte dei Paschi is proforma for expected €2.5bn equity issuance, per company announcement;
6. Banco de Sabadell is proforma for c.€1.4bn equity issuance in Sep-13; and
7. Barclays is proforma for c.€5.8bn equity issuance in Sep-13.

Definitions of NPLs

■ **Basel:** See Basel Committee on Banking Supervision (2004), paragraph 452:

“Definition of default: A default is considered to have occurred with regard to a particular obligor when either or both of the following events have taken place:

- The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group.”

■ **CRR:** A default shall be considered to have occurred with regard to a particular obligor when either or both of the following have taken place:

- The institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security;
- The obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. Competent authorities may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities).

■ **The IIF** has proposed the following categorisation of non-performing loans:

- Standard
- Watch/Special Mention
- Substandard
- Doubtful
- Loss/Write-off

■ **IMF FSIs** (Financial Soundness Indicators) defined NPLs on the basis of a uniform criterion of “principal or interest payments 90 days overdue”.

Figure 44. European Banks – Valuations (as of 24 September, 2013)

Bank	RIC	Rec	Curr	Now	Share Price	
					Target	+/-%
Benelux						
ING	ING.AS	Buy	E	8.43	10	+21%
KBC	KBC.BR	Buy	E	37	42	+15%
Austria						
Erste Bank	ERST.VI	Neutral	E	24	23	-3%
Raiffeisen Bank Intl	RBIV.VI	Neutral	E	24	25	+4%
France						
BNP Paribas	BNPP.PA	Buy	E	51	60	+18%
Credit Agricole	CAGR.PA	Buy	E	8.15	10	+23%
Natixis	CNAT.PA	Neutral	E	3.60	3.33	-7%
Societe Generale	SOGN.PA	Buy	E	37	42	+12%
Germany						
Commerzbank	CBKG.DE	Neutral	E	9.53	9.70	+2%
Deutsche Bank	DBKGn.DE	Buy	E	35	45	+28%
Greece						
Alpha Bank	ACBr.AT	Neutral	E	0.56	na	
National Bank of Greece	NBGr.AT	Neutral	E	2.99	na	
Iberia						
Banco BPI	BBPI.LS	Neutral	E	0.96	1.25	+30%
Banco Espirito	BES.LS	Buy	E	0.82	1.30	+59%
Banco Popular	POP.MC	Sell	E	4.44	2.80	-37%
Banco Santander	SAN.MC	Neutral	E	5.90	4.90	-17%
Bankinter	BKT.MC	Buy	E	4.09	4.00	-2%
BBVA	BBVA.MC	Neutral	E	8.25	7.10	-14%
Bco de Sabadell	SABE.MC	Sell	E	1.87	1.49	-20%
CaixaBank	CABK.MC	Neutral	E	3.27	2.90	-11%
Italy						
Banco Popolare	BAPO.MI	Neutral	E	1.17	na	
BP Milano	PMII.MI	Neutral	E	0.44	0.40	-10%
Intesa Sanpaolo	ISP.MI	Sell	E	1.69	1.10	-35%
Mediobanca	MDBI.MI	Buy	E	5.25	6.00	+14%
Monte dei Paschi	BMP.S.MI	Sell	E	0.21	0.17	-19%
UBI Banca	UBI.MI	Neutral	E	4.02	3.50	-13%
UniCredit	CRDI.MI	Neutral	E	4.87	4.25	-13%
Nordics						
Danske Bank	DANSKE.CO	Buy	Dkr	123	140	+14%
DnB	DNB.OL	Neutral	NKr	96	100	+4%
Nordea	NDA1V.HE	Buy	E	9.06	11	+16%
SE Banken AB	SEBa.ST	Neutral	SKr	71	65	-8%
SHB	SHBa.ST	Neutral	SKr	286	265	-7%
Swedbank	SWEDa.ST	Neutral	SKr	155	160	+3%
Switzerland						
Credit Suisse	CSGN.VX	Buy	SFr	28	35	+26%
EFG Internatnl	EFGN.S	Neutral	SFr	13	14	+10%
Julius Baer	BAER.VX	Neutral	SFr	43	38	-14%
UBS	UBSN.VX	Buy	SFr	19	22	+16%
Vontobel	VONN.S	Buy	SFr	36	36	-0%
UK						
Barclays	BARC.L	Buy	p	266	320	+20%
HSBC	HSBA.L	Buy	p	687	770	+12%
Lloyds Banking Grp	LLOY.L	Neutral	p	74	80	+8%
RBS	RBS.L	Sell	p	361	270	-25%
Standard Chartered	STAN.L	Buy	p	1528	1775	+16%

Source: dataCentral, Citi Research

Macroeconomics

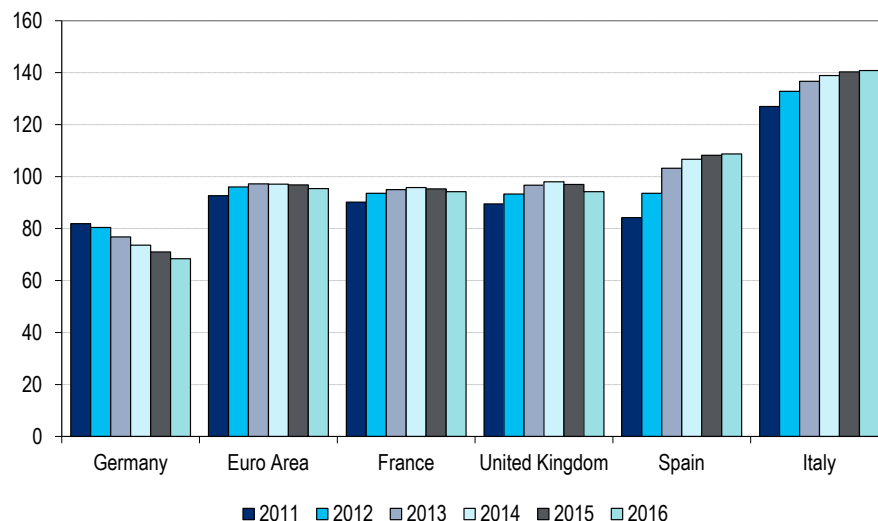
European Economic Outlook

Macro Backdrop

Economic Research

Taken from the latest edition of **Global Economic Outlook and Strategy**

Figure 45. Sovereign Debt-To-GDP Ratio Forecasts



Source: Citi Research estimates, National Central Banks

Figure 46. Selected Countries — Financing Needs, Bond Redemptions and Budget Deficits, 2013-2015

Country/Group	2013		2014		2015		2013 – 2014		2013 - 2015	
	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit	Redemptions	Budget deficit
Austria	19.0	4.6	34.5	4.9	17.9	3.9	53.4	9.4	71.4	13.3
Belgium	40.8	8.1	56.4	11.3	40.9	8.5	97.1	19.4	138.1	27.9
Cyprus	1.0	0.7	3.9	1.1	1.4	1.3	4.9	1.8	6.3	3.1
Finland	4.3	2.7	13.7	2.7	13.4	1.4	18.0	5.4	31.4	6.8
Greece	15.8	6.4	24.4	8.2	8.9	6.0	40.2	14.6	49.1	20.6
Ireland	1.3	9.0	9.2	9.1	4.9	6.0	10.5	18.1	15.4	24.1
Italy	180.4	36.8	354.7	47.5	261.6	11.3	535.1	84.3	796.7	95.5
Spain	73.1	45.0	174.0	61.7	133.8	58.2	247.1	106.7	380.9	164.9
Portugal	12.5	6.5	37.9	9.2	19.9	7.4	50.4	15.7	70.4	23.0
France	198.8	47.9	237.4	56.0	198.3	50.8	436.2	103.8	634.4	154.6
Germany	122.2	1.9	306.6	-7.1	245.4	4.8	428.8	-5.2	674.2	-0.4
Netherlands	31.4	15.8	51.8	21.3	68.1	18.2	83.3	37.1	151.3	55.3
GR+IR+PO	29.6	21.9	71.5	26.5	33.7	19.4	101.1	48.4	134.9	67.8
GR+IR+PO+BE	70.4	30.0	127.9	37.8	74.7	27.9	198.3	67.8	272.9	95.7
SP+IT	253.5	81.7	528.7	109.2	395.4	69.5	782.2	190.9	1177.6	260.4
GR+IR+PO+BE+SP+IT+FR	522.6	159.6	894.0	203.0	668.4	148.1	1416.6	362.6	2085.0	510.7

Note: data collected as of 27 August 2013. We assume that bills outstanding in 2013 will be refinanced with new bills that will mature in 2014. We make the same assumption for 2015 data collected as of 27 August 2013. Source: Citi Research forecasts for budget deficit (as of Aug 2013) and Bloomberg

Euro Area

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The better-than-expected 2Q GDP data, showing the first gain in seven quarters, plus the more constructive tone from recent surveys, call for some upward adjustment in our GDP forecasts. We raise the 2013 average by 0.2ppt to -0.5% and the 2014 average by 0.4ppt to 0.6%. We must go back to 3Q 2009 to find an upward adjustment of a similar magnitude. Given better growth dynamics, we no longer expect the ECB to cut rates in Q4, with the main refi rate and the deposit rate staying unchanged (at 0.5% and 0% respectively) for a long period. A cut in one or both interest rates could be back on the agenda if there were a sharp strengthening of the euro or 'unwarranted' increases in market rates, but even then the authorities would probably aim to talk down the currency and rate expectations first.

Germany and France are outperforming in the upswing, with some evidence of restocking as surveys suggest that inventories remain below desired levels. Net trade is also showing signs of contributing to GDP growth. While the recovery is probably here to stay, we continue to expect that the magnitude of upturn will likely disappoint given the many structural impediments across the euro area. The non-exhaustive list includes: widespread private sector deleveraging, limited credit availability, still adverse financing conditions and additional fiscal tightening. Hence, we do not expect growth in 2014 to improve significantly from the 0.6% QoQ SAAR pace that we envisage for 2H-13.

With GDP growth remaining below potential, and muted domestic demand dynamics, the excessive debt problems cannot be fixed and the large amount of excess capacity cannot be absorbed fast enough to lead to a fall in unemployment. This means that political risk needs watching carefully, with a particular focus on Italy. The German elections are also an important sign-post in late September since the Bundestag will be required to give its approval to any financial assistance programmes, either in the form of OSI in Greece, a second programme for Portugal or precautionary credit line under the ESM framework for Ireland.

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

Figure 47. Euro Area — Economic Forecasts, 2012-14F

		2012	2013F	2014F	2013				2014			
					1Q	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	YoY	-0.5%	-0.5%	0.6%	-1.1%	-0.7%	-0.5%	0.3%	0.7%	0.6%	0.6%	0.6%
	SAAR	-	-	-	-1.1	1.1	0.4	0.7	0.6	0.6	0.7	0.6
Final Domestic Demand	YoY	-1.7	-1.1	0.2	-2.0	-1.2	-0.9	-0.2	0.3	0.2	0.3	0.3
Private Consumption	YoY	-1.3	-0.4	0.3	-1.3	-0.5	-0.3	0.5	0.5	0.3	0.3	0.2
Government Consumption	YoY	-0.4	-0.3	-0.2	-0.5	-0.2	-0.1	-0.2	-0.1	-0.3	-0.3	-0.3
Fixed Investment	YoY	-4.2	-4.0	0.6	-5.9	-4.3	-3.7	-2.1	0.1	0.4	0.8	1.0
— Business Equipment	YoY	-3.5	-4.3	2.6	-6.4	-5.0	-3.8	-1.8	1.8	2.7	3.1	3.0
— Construction	YoY	-4.8	-4.0	-1.6	-5.5	-3.9	-3.9	-2.8	-2.0	-1.9	-1.4	-1.0
Stocks (Contrib. to Y/Y GDP Growth)		-0.3	0.0	0.0	0.0	-0.1	0.1	0.1	0.1	0.1	0.0	-0.1
Exports	YoY	2.9	0.7	2.8	0.5	0.2	0.1	1.7	3.3	2.8	2.7	2.6
Imports	YoY	-0.7	-0.7	2.3	-1.9	-1.1	-0.7	1.1	2.9	2.3	2.1	1.9
CPI	YoY	2.5	1.5	1.4	1.9	1.4	1.4	1.5	1.4	1.6	1.3	1.3
CPI Ex Unprocessed Food & Energy	YoY	1.8	1.4	1.2	1.5	1.3	1.3	1.4	1.2	1.3	1.1	1.1
Unemployment Rate	YoY	11.4	12.2	12.3	12.0	12.1	12.3	12.3	12.2	12.3	12.3	12.3
Current Account Balance	EUR bn	118.3	242.2	224.2								
	% of GDP	1.2	2.5	2.3								
General Government Balance	EUR bn	-352.7	-281.1	-241.4								
	% of GDP	-3.7	-2.9	-2.5								
Primary Balance	% of GDP	-0.6	0.1	0.5								
General Government Debt	EUR bn	8,794.6	9,219.8	9,549.7								
	% of GDP	92.7	96.0	97.2								
Gross Operating Surplus	YoY	-0.3	-0.1	0.2								

We publish further details of our European forecasts monthly in [European Economic Forecast Highlights](#). Sources: Eurostat and Citi Research forecasts

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Germany

This month, we revise up our GDP growth forecasts to 0.6% and 1.7% for 2013 and 2014 (from 0.3% and 1.5%). Q2 GDP growth (0.7%QQ) came in slightly stronger than expected and recent data have also been fairly strong, notably for industrial production, suggesting positive (albeit moderating) growth into Q3. Net trade is likely to be a modest drag on growth this year, with high consumer confidence and robust wage gains lifting household spending. Business investment, which probably registered the first increase in seven quarters in Q2, also is likely to gain some momentum.

France

We raise our 2013 GDP forecasts to 0.2% from -0.2% last month after a better than expected 0.5% QQ gain in 2Q. We also lift our 2014 GDP forecast by 0.3pp to 0.8% to reflect the continued gains in recent surveys. Overall, the recovery remains fragile, with unemployment still trending up, while muted corporate profits and tax uncertainties leave many businesses in a wait-and-see mode.

Italy

Recent data suggest GDP may return to modest expansion in H2, supported by a significantly less-tight fiscal stance (partly related to repayments of government arrears). We lift our GDP forecasts by 0.4pp for 2013 and by 0.5pp for 2014, although we still expect the economy will shrink on average in both years. In 2014, additional fiscal consolidation is likely which, together with still tight financing conditions, will cap domestic demand. The fiscal deficit is re-widening and risks of political instability remain high – two risk factors for further rating actions and renewed market tensions. The political backdrop hinders scope for structural reforms and public spending cuts. We do not see the debt ratio stabilising in the next few years, and we think some form of debt restructuring (maturity lengthening and/or coupon reductions) may be likely eventually.

Figure 48. Germany, France and Italy — Economic Forecasts, 2012-14F

		Germany			France			Italy		
		2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
Real GDP	YoY	0.9%	0.6%	1.7%	0.0%	0.2%	0.8%	-2.4%	-1.6%	-0.1%
Final Domestic Demand	YoY	0.3	0.7	2.1	-0.1	0.0	0.4	-4.7	-2.5	-0.5
Private Consumption	YoY	0.7	1.5	2.0	-0.3	0.3	0.5	-4.3	-2.2	-0.6
Government Consumption	YoY	1.2	0.5	0.8	1.4	1.3	0.5	-2.9	-0.1	-1.0
Fixed Investment	YoY	-2.0	-1.8	3.7	-1.2	-2.4	-0.1	-8.0	-6.2	0.3
Exports	YoY	4.5	0.0	2.9	2.5	0.9	2.2	2.2	-0.4	2.6
Imports	YoY	2.6	0.3	3.8	-0.9	0.6	1.4	-7.8	-3.1	1.8
CPI	YoY	2.0	1.7	1.9	2.2	1.1	1.7	3.3	1.5	1.3
Unemployment Rate	%	5.5	5.6	5.5	9.8	10.8	10.9	10.7	12.3	12.6
Current Account	€bn	187.7	188.0	170.2	-44.4	-32.7	-17.1	-8.4	22.0	32.5
	% of GDP	7.0	6.9	6.0	-2.2	-1.6	-0.8	-0.5	1.4	2.1
General Govt. Balance	€bn	4.1	-2.9	7.1	-98.2	-78.1	-67.7	-47.6	-55.2	-47.5
	% of GDP	0.2	-0.1	0.3	-4.8	-3.8	-3.2	-3.0	-3.5	-3.0
Primary Balance	% of GDP	2.6	2.3	2.6	-2.3	-1.2	-0.6	2.5	1.9	2.3
General Govt. Debt	% of GDP	81.9	80.4	76.8	90.2	93.6	95.0	127.0	132.8	136.6
Gross Trading Profits	YoY	0.1	1.4	2.2	-0.9	0.0	1.0	NA	NA	NA

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

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Spain

We are lifting our growth forecasts for 2013 (by 0.3pp to -1.4%) and 2014 (by 0.7pp to -0.2%), reflecting better Q2 data, reduced fiscal drag and lower inflation. We still think, however, that the ongoing internal adjustments (private deleveraging, fiscal balance and housing) together with tight financing conditions are likely to leave the economy with almost no growth until early 2015. We see 2013 fiscal deficit (net of bank recap costs) narrowing marginally to 6.5% of GDP, while extra bank recap needs may also emerge. The debt ratio keeps rising and we think that some form of debt restructuring (maturity extensions/coupon reductions) may be likely eventually.

Greece

Recent data suggest the recession may be less deep than we expected, and hence we have revised up our GDP forecasts by 0.6pp (to -4.4%) in 2013 and by 0.4pp (to -3.9%) in 2014. Nevertheless, the bailout programme probably is off-track again, due to shortfalls in privatisation revenues and poor tax collection. Major uncertainties lie ahead, with key discussions on further public debt restructuring likely before year-end. A large debt relief from official lenders would probably be the only viable (but politically painful) option to restore fiscal sustainability. We still think risks of Greece leaving the euro remain high, although this is not our base case.

Ireland

Ireland's economy slipped back into renewed recession from Q2-2012 to Q1-2013, but recent data suggest that period of decline is over. Industrial production surged 3.5% QoQ (non annualised) in Q2, the strongest gain since Q1-2010 with a strong gain in new orders as well (up 6.4% QoQ). In all, we estimate that real GDP rose 1.0% QoQ in Q2, and we are lifting our forecast for the full year from minus 0.2% to plus 0.2%. The public debt/GDP ratio is likely to peak this year, but decline will be slow and this ratio will probably remain above 100% for many years to come.

Portugal

The strong Q2 GDP print (+1.1% QQ) and gains in other monthly indicators are behind the revision of our GDP forecasts to -1.9% for 2013 and -0.9% for 2014 (versus -3.0% and -1.4% last month). The reduction in fiscal tightening will likely cause more overshooting of budget targets and a smaller likelihood of a smooth exit from the bailout programme in mid-14. More fiscal austerity will be necessary over the next couple of years, especially if (as we expect) a second bailout programme is agreed. With about half of the debt in official hands, we think some further OSI and perhaps PSI (in the form of coupon-reduction/maturity extensions) may eventually occur to restore debt sustainability.

Figure 49. Spain, Greece, Ireland and Portugal — Economic Forecasts, 2012-14F

		Spain			Greece			Ireland			Portugal		
		2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
Real GDP	YoY	-1.4%	-1.4%	-0.2%	-6.4%	-4.4%	-3.9%	0.1%	0.2%	2.5%	-3.2%	-1.9%	-0.9%
Final Domestic Demand	YoY	-4.0	-3.7	-1.1	-9.7	-7.0	-5.3	-1.1	-1.9	-0.4	-6.9	-4.1	-2.8
Private Consumption	YoY	-2.2	-2.6	-0.6	-9.1	-7.1	-5.2	-0.3	-0.8	0.5	-5.6	-3.3	-1.8
Government Consumption	YoY	-3.7	-3.6	-2.0	-4.0	-3.5	-4.6	-3.8	-2.0	-1.6	-4.4	-1.6	-2.5
Fixed Investment	YoY	-9.1	-7.0	-1.8	-19.0	-11.3	-6.8	-0.7	-7.0	-2.7	-14.5	-10.1	-7.4
Exports	YoY	3.0	3.3	4.4	-2.0	1.3	1.5	1.6	-0.6	7.0	3.3	4.6	3.6
Imports	YoY	-5.0	-3.1	1.9	-9.3	-4.1	-3.6	0.0	1.7	3.6	-6.6	-2.0	-1.1
CPI	YoY	2.4	1.8	0.9	1.0	-0.4	-0.9	0.7	-0.4	1.4	2.8	0.6	0.1
Unemployment Rate	%	25.0	26.6	27.6	24.1	28.3	31.2	14.7	13.5	13.3	15.7	16.8	17.3
Current Account	€bn	-11.5	12.0	21.5	-6.5	-0.7	1.3	7.3	7.5	12.0	-2.6	1.9	5.1
	% of GDP	-1.1	1.2	2.0	-3.4	-0.4	0.8	4.4	4.6	7.1	-1.5	1.2	3.2
General Govt. Balance	€bn	-111.6	-67.4	-61.7	-19.4	-9.5	-8.2	-12.5	-13.5	-9.1	-10.6	-9.8	-9.2
	% of GDP	-10.6	-6.5	-5.9	-10.0	-5.3	-4.9	-7.6	-8.2	-5.4	-6.4	-6.0	-5.7
Primary Balance	% of GDP	-80.3	-32.6	-23.0	-5.0	-1.2	-0.7	-3.9	-3.2	-0.3	-2.0	-1.6	-1.3
General Govt. Debt	% of GDP	84.2	93.6	103.2	156.9	179.3	196.8	118.6	124.6	122.2	123.8	133.6	151.1

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

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Netherlands

Dutch 2Q GDP matched our expectations, showing a drop of 0.2% QQ, leaving the level of economic activity 1.8% lower than in the same quarter last year. Domestic demand contributed nothing to GDP, a situation consistent with the continued increase in the jobless rate (up to 8.7% in July versus 6.5% a year ago). With house prices expected to fall further in the rest of 2013, it is difficult to envisage any gains in consumer spending much before the start of the 2H-14, although better performance from large trading partners may support Dutch exports. We anticipate a clearer recovery only during 2014, coming from better investment trends.

Belgium

We leave our forecast for Belgium unchanged. 2Q GDP rose by 0.1% QQ after a flat reading in Q1, leaving the YY rate at -0.1% vs. -0.6% YY in 1Q. Sentiment surveys have been improving throughout 2Q and the July survey suggests that the gradual uptrend continued into the third quarter. Economic activity should improve gradually thanks to the better performance in Germany and France. Nevertheless, we expect Belgium to underperform compared to France, given the strong focus on budget consolidation after some criticism from the European Commission in June. The main catalyst for investors remains the 2014 May 25 legislative elections.

Slovakia

We slightly increased our GDP forecast to 0.8% in 2013 (0.5% previously) and 1.8% next year reflecting a better outlook for foreign demand and the better-than-expected GDP growth in 2Q13 (0.3% QQ and 0.9% YY probably lifted by net exports). Our forecast of milder GDP gains in 2H13 (0.3% cumulatively) reflects weaker prospects for industry. We expect industrial output growth to decelerate to 0.9% YY in 3Q13 from 2.3% in 2Q13, following survey evidence of weaker export orders and capacity use.

Slovenia

We keep our GDP forecast unchanged reflecting offsetting factors. The contractions in industrial output and construction eased further in June (to -0.6% YY and to -11.3% respectively, both slightly better than we expected). However, exports decreased, perhaps reflecting temporary distortions from a drop in the number of working days. Though external demand prospects are improving, we think that the announcement of complex banking stress test results by end-2013 is likely to keep uncertainty high, exacerbating negative consequences for domestic demand from tight fiscal policy and the credit crunch.

Figure 50. Netherlands, Belgium, Slovakia and Slovenia — Economic Forecasts, 2012-2014F

		Netherlands			Belgium			Slovakia			Slovenia		
		2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
Real GDP	YoY	-1.3%	-1.3%	0.3%	-0.3%	-0.2%	0.4%	2.0%	0.8%	1.8%	-2.2%	-2.2%	-0.3%
Final Domestic Demand	YoY	-1.8	-2.9	-0.2	-0.5	-0.7	0.0	-1.4	-1.5	1.6	-3.8	-2.9	0.1
Private Consumption	YoY	-1.6	-2.0	-0.3	-0.3	-0.1	-0.2	-0.6	-0.3	0.8	-2.8	-4.2	-0.1
Government Consumption	YoY	-0.7	-0.9	-0.6	0.4	0.2	0.3	-0.6	0.2	0.1	-1.6	-0.5	-0.6
Investment (Ex Stocks)	YoY	-4.0	-8.2	0.4	-0.6	-3.0	0.4	-3.7	-5.4	4.3	-9.1	-2.1	1.4
Exports	YoY	3.2	1.2	1.4	0.7	-1.1	2.2	8.6	3.1	4.1	1.3	2.9	2.1
Imports	YoY	3.3	-1.4	0.8	0.5	-1.6	2.2	2.8	0.8	3.8	-4.3	2.6	2.6
CPI (Average)	YoY	2.8	3.0	1.9	2.8	1.3	1.9	3.6	1.7	1.9	2.6	2.3	2.8
Unemployment Rate	%	6.4	8.3	8.8	7.6	8.7	9.3	13.6	14.6	14.8	8.9	10.2	11.1
Current Account	% of GDP	10.1	9.4	8.9	-1.6	-2.0	-1.6	2.2	3.6	3.0	2.3	2.2	3.2
General Govt Balance	% of GDP	-4.1	-3.9	-3.4	-3.9	-3.2	-2.9	-4.3	-3.4	-3.2	-4.0	-9.1	-6.6
Primary Balance	% of GDP	-2.2	-2.0	-1.4	-0.5	0.4	0.7	-2.9	-2.0	-1.7	-1.9	-6.4	-3.7
General Govt Debt	% of GDP	71.3	74.9	76.2	99.8	102.3	103.3	52.1	55.3	56.1	54.1	63.3	68.3

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

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UK

We are significantly changing our UK interest rate forecasts, advancing the first rate hike from 2017 to 2015. We expect that the tightening cycle will be relatively shallow, but now look for Bank Rate to be 0.75% at end-2015 and 1.75% at end-2016 (both 0.5% before), with the 2017 average revised up to 2¼% from 1.0% previously, and Bank Rate leveling off at about 3-3.5% in 2018.

These revisions reflect two main factors: first, we are again revising up our growth forecasts, and now expect growth of 1.4% this year, 3.0% in 2014 and 3.1% in 2015 (versus 1.1%, 2.1% and 2.7% respectively last month); second, as discussed last week, we now believe that productivity will rebound more slowly than we previously expected, partly because of continued declines in the cost of labour. With the higher GDP growth outlook, this implies a much faster decline in unemployment than our prior forecast, so that the jobless rate falls to the 7% threshold around end-2014 or early 2015 – hence ending the MPC's guidance framework. The MPC will almost certainly not return to a neutral stance as soon as the jobless rate hits 7%. But, we do expect that, provided the economy's momentum remains solid, they will nudge rates up in subsequent quarters, while keeping rates well below neutral for a while.

Figure 51. United Kingdom — Economic Forecasts, 2012-2014F

		2012	2013F	2014F	2015F	2016F	2017F
Real GDP	Y/Y	0.1	1.4	3	3.1	2.7	2.3
Final Domestic Demand	Y/Y	1.4	1.1	2.8	3.1	2.6	1.8
Private Consumption	Y/Y	1.2	1.8	2.6	3.4	3.1	2.1
Public Consumption	Y/Y	2.8	1.6	-0.5	-0.4	-1	-1.7
Fixed Investment	Y/Y	0.5	-2.9	9.5	7.1	5.5	5.6
Business Equipment	Y/Y	1.8	-3.5	4.9	6.2	6.4	8.9
Construction of Private Dwellings	Y/Y	-3.4	3.8	25.1	10.8	7	2.5
Stocks (Contribution to GDP Growth)	Y/Y	-0.4	-0.1	0	-0.1	0	0
Net Exports (Contribution to Y/Y GDP Growth)	Y/Y	-0.9	0.4	0.2	0	0.2	0.5
Consumer Prices	Y/Y	2.8	2.6	2	2.2	2.1	1.9
Unemployment Rate		7.9	7.8	7.3	6.7	6.3	5.9
Current Account Balance	% of GDP	-3.7	-3.2	-2.8	-2.8	-2.6	-2.2
Public Sector Net Borrowing	£bn	89	96	78	65	39	25
	% of GDP	-5.7	-5.9	-4.6	-3.6	-2.1	-1.3
General Government Debt	% of GDP	89.5	93.1	95.3	96.1	95.6	94.4
Gross Non Oil Trading Profits	Y/Y	4.5	8.1	10.2	6.5	5.4	3.4
Bank of England Base Rate(Yearend)	%	0.5	0.5	0.5	0.75	1.75	2.75
APF Asset Purchases (Yearend)	£bn	375	375	375	375	375	300

Note: Percentage changes unless indicated. Annual data are period averages. Sources: ONS and Citi Research

Switzerland

The conditions that prompted the SNB to adopt its exchange rate cap have now partly faded. EMU sovereign spreads have fallen sharply, CPI inflation is no longer negative and the economy is growing steadily. We are lifting our 2013 growth forecast to 1.7% from 1.5%. Nevertheless, we expect the SNB will continue to resist FX appreciation for some time to come. First, core inflation, which excludes food, drink, tobacco and energy, remains slightly down YoY (minus 0.2% YoY in June). Second, the economy has ample slack to allow growth without creating domestic inflation pressures. Third, the strong CHF and weakening EM growth pose serious headwinds, especially for Switzerland's top-end consumer goods industries.

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Sweden

Although lead indicators suggest the worst is behind us, economic recovery is likely to be weak in a historical perspective, especially given household deleveraging risks. GDP shrank by 0.1% Q/Q in 2Q, and the surprising gain in inventories suggests that underlying demand may be even weaker than headline GDP. Weak growth, low capacity utilisation, rising unemployment and very low inflation support additional monetary policy easing. However, given the Riksbank's focus on financial stability risks, the Bank is unlikely to ease monetary policy further.

Denmark

The Danish economy appears to have very little momentum at present, and a near-term return to trend growth is not on the cards with house prices showing few signs of recovering, private spending being restrained by high private debts and sluggish euro area growth. Although the Danish economy likely will not contract in 2013, as it did in the past year, the overall rate of real GDP growth in Denmark probably will remain lacklustre for the next few years. The government has now largely exhausted its scope for additional counter-cyclical fiscal support. The key policy rate will be kept low for at least an extended period as the ECB.

Norway

Norway's economy continues to be supported by strong activity in the petroleum sector and construction industry. However, momentum has peaked and lead indicators suggest that mainland GDP should settle at a slightly below-trend pace ahead. Combined with below-target inflation and no apparent near-term triggers for a pick-up, plus high lending margins, the Norges Bank lowered its conditional interest rate path in June, signalling a 50% probability of a Sep cut. However, with financial stability concerns weighing increasingly in interest rate decisions and with a weaker-than-expected NOK, we doubt Norges Bank will cut rates in the near term.

Figure 52. Switzerland, Sweden, Denmark and Norway — Economic Forecasts, 2012-2014F

		Switzerland			Sweden			Denmark			Norway		
		2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F	2012	2013F	2014F
Real GDP	YoY	1.0%	1.7%	1.5%	1.1%	1.0%	2.2%	-0.4%	0.1%	0.7%	3.3%	2.2%	2.6%
Final Domestic Demand	YoY	1.7	1.7	1.2	1.9	0.6	1.8	0.4	-0.1	0.7	2.8	2.5	2.9
Private Consumption	YoY	2.5	2.4	1.6	1.6	1.7	1.9	0.5	0.5	0.7	3.1	3.0	3.1
Government Consumption	YoY	0.5	1.0	1.4	1.1	1.0	0.7	0.7	-0.5	0.4	1.6	2.1	2.0
Investment (Ex Stocks)	YoY	-0.2	0.0	-0.1	3.9	-2.7	3.0	-0.1	-0.9	1.0	3.8	1.6	3.9
Exports	YoY	1.1	1.1	3.7	1.3	-2.3	2.8	0.2	-1.3	1.5	3.4	2.1	2.5
Imports	YoY	2.1	-0.1	3.4	0.5	-2.6	2.0	1.0	1.2	1.4	4.2	1.7	3.9
CPI (Average)	YoY	-0.7	-0.2	0.3	0.9	0.1	1.0	2.4	0.9	1.5	0.7	1.7	1.5
Unemployment Rate	%	2.6	1.8	1.7	8.0	8.3	8.2	7.5	7.5	7.4	3.2	3.6	3.6
Current Account	% of GDP	12.8	12.9	13.0	6.9	7.1	6.9	6.7	5.3	4.7	14.2	14.5	14.9
General Govt Balance	% of GDP	0.5	0.7	0.9	-0.6	-1.5	-1.5	-4.3	-2.0	-1.5	13.8	13.1	13.0
General Govt Debt	% of GDP	46.7	45.3	43.3	38.4	39.4	39.8	45.8	47.4	47.8	NA	NA	NA

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

Appendix A-1

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