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Europe
Special Report

2009 Credit Outlook for European Banks: Prognosis Negative

Analysts

Julia Peach
+44 20 7682 7433
julia.peach@fitchratings.com

Maria Jose Lockerbie
+44 20 7417 4318
mariajose.lockerbie@fitchratings.com

James Longsdon
+44 20 7417 4309
james.longsdon@fitchratings.com

Gordon Scott
+44 20 7417 4307
gordon.scott@fitchratings.com

Alexandre Birry
+44 20 7682 7550
alexandre.birry@fitchratings.com

Anna Van Zoest
+44 20 7682 7353
anna.vanzoest@fitchratings.com

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Executive Summary

The European economy has entered a sharp recession. Global demand has fallen sharply in the wake of US consumer retrenchment and the dramatic tightening of credit conditions since September 2008. The UK, Spain and Ireland are among the most severely affected as domestic property market adjustments are exacerbating the turnaround in household borrowing but no economies are escaping the external shock. Germany's export prospects are dimming rapidly as demand in its major trading partners — the US, the UK and eastern Europe — declines, with little prospect of faster consumption filling the void. With unemployment starting to rise rapidly, consumer confidence is at record lows across Europe and while sizeable and co-ordinated fiscal policy expansion and aggressive monetary easing will limit the depth of the downturn, the impact may not be felt until 2010.

The most unpredictable part of the financial crisis is now behind us. A more traditional, albeit severe, global recession is now ahead. Government support for banks, which has taken the form of liquidity, funding, capital injections and full-scale nationalisation across Developed Europe will continue to attempt to restore confidence in banking systems and unlock credit markets. While governments are keen to reduce their role in financial markets, they will not do so until investor confidence has returned to more reasonable levels.

Weaning banks off their high dependency on government sponsored funding will be key. Policymakers will be challenged to facilitate banks' return to a normal market anytime soon. Fitch Ratings believes that schemes due to expire in 2009 will likely be extended and/or revised.

A sharp deterioration in the quality of banks' loan books during 2009 and 2010 is anticipated with few economies and banking systems immune to this crisis. Fitch sees contagion between developed and emerging markets. On account of globalisation, a higher level of synchronisation between geographies and sectors is also inevitable. Non-performing loans will rise sharply across most banks this year.

Negative underlying profitability is expected among many banks in 2009 largely as a result of challenging revenue generation and significant rises in loan impairments. Large-scale redundancy programmes and ongoing reductions in spending on infrastructure investment will be recurrent themes but will not be sufficient to offset the other more significant pressures. As banks move to less risky business models, further pressure on profitability is inevitable.

Further government-sponsored capital raising will be necessary in 2009. Additional investment and trading book write-downs, increased loan loss impairments and draw-downs on corporate loan commitments will add further strain to bank capitalisation. Pressure from investors and regulators is expected to be ongoing. However, regulatory forbearance in certain countries is becoming a distinct possibility given the likely protracted nature of the financial crisis and the political pressure on banks to continue lending in order to support their respective economies. Ultimately, stronger international coordination will be required if regulatory arbitrage is to be avoided.

Forced domestic consolidation among European banks will continue to be a key theme in 2009 as governments scramble to avoid taking too many financial institutions into public ownership. However, some constraints are expected as the

concept of strength in size is increasingly questionable, with a number of clear examples of weaker partners contaminating the stronger ones. Also, some large banks which would have been viewed in 2008 as potential consolidators will be constrained to venture into acquisitions at a time when the extent of their own risks is uncertain, or when the government has a controlling stake.

Prognosis: Negative Rating Trends Expected Throughout 2009

Around one third of our European bank ratings are on negative rating outlook or watch and many of these will remain in place beyond 2009. Fitch's expectation of continued weakness in financial performance will be reflected in lower Individual Ratings, thereby indicating a greater probability of failure, although proactive capital injections could increase certain banks' buffers and ability to absorb weaker financial performance. Ongoing government support reduces the probability of default, and is thus supportive of banks' Long-Term IDRs. As a result, downgrades of Long-Term IDRs may be more muted given increases in government support measures. However, European banks are still one step behind their counterparts in the US, where Fitch considers it possible that a greater proportion of banks will see their Long-Term IDRs revert to a Stable Outlook in the latter half of 2009. Ratings of several of the largest institutions in Europe have migrated close to the Support Rating Floor. Expectations of wider loss levels and further consolidation will create ratings variability in both Long-Term IDRs (which express the probability of default) and Individual Ratings (which express the probability of failure).

Support Rating Floors will continue to indicate the rating level below which Fitch will not lower its IDRs and senior debt ratings. In the current financial crisis, the agency recognises that the failure of a bank may carry more contagion risk than in more benign times. It is clear that the likelihood of a sovereign to provide support is higher and that Support Rating Floors have been raised on a temporary basis in an increasing number of cases over recent months. During the current crisis Fitch has raised the Support Rating Floor for a number of entities including the major UK banks where the floor was raised to 'AA-' from 'A-' when the first government support measures were introduced in October 2008. More recently, the Support Rating Floors for a number of Irish banks were raised following support initiatives from the Irish government in January 2009, and there are an increasing number of individual cases where government support has come in and where the Support Rating Floor has been raised. Fitch anticipates that this trend will continue as comprehensive bank support schemes continue to be announced by national authorities. The implication of this is that the downside risk for IDRs for the remainder of the financial crisis should be limited given the anticipated ongoing high level of government support. Some IDRs and senior debt ratings will be lowered to the level of the floor but not beyond this level. It should be noted that Support Rating Floors do not underpin subordinated and preferred obligations. There are a number of examples of specific obligations which benefit from explicit, irrevocable state guarantees to their contractual maturity which have been equalised with the rating of the guarantor, in many cases at 'AAA' (please refer to the agency's "*Bank Ratings, Confidence Sensitivity and Support — Cliffs and Safety Nets*" report, dated 17 October 2008 and available at www.fitchratings.com).

Significantly reduced operating earnings combined with a number of banks reporting losses have elevated the risk of banks being unable to service their most subordinated obligations, both Tier 1 and Upper-Tier 2. This may be the case where payment is closely linked to earnings or because of regulatory intervention, in particular to safeguard tax payers' interests. Fitch believes that coupon deferral risk of bank hybrid capital instruments has increased significantly since the beginning of this financial crisis. The agency continues to regard such deferrals as non-performance from a ratings perspective. This will lead to instrument ratings in the low 'B' to 'CCC'-'C' range. In response to the heightened risk of deferral, Fitch has taken rating actions which have widened the number of notches between the IDR and the rating assigned to the hybrid and preferred instruments for certain issuers. In cases where a bank has some financial flexibility but where the ability to service the hybrids has been clearly reduced, the hybrid ratings have been lowered to the bottom of the investment grade range ('BBB' or 'BBB-' respectively in the cases of UBS and Commerzbank). In recognition of the negative trend in financial performance of such entities, such ratings have also been placed on Rating Watch Negative. This recognises the potential that speculative grade ratings may be warranted in the short-term should repayment capacity be further reduced. In cases where a government has taken control of a bank with an economic stake greater than 50% and where there is a heightened possibility of deferral as a result of ongoing deterioration of financial performance and greater government influence, Fitch has lowered the hybrid ratings to 'BB-' and typically also placed them on Rating Watch Negative (for example, RBS and Anglo Irish).

The Key Symptoms of the Financial Crisis

The European banking sector at the start of 2009 is faced with a number of considerable challenges. One of the main ones is the loss of confidence in and between banks, which has led to restricted access to funding sources. Restricted access to funding has led to lower levels of lending to customers, particularly across borders, thereby amplifying the effect of the economic downturn which is affecting all European markets. This in turn is leading to the expectation of further deterioration in asset quality, which will materially impact a number of European banks throughout 2009. As a result, greater uncertainty has arisen about the capital levels required by European banks, at the precise time when capital has become a scarce resource. Fitch expects that market mechanisms will remain severely impaired throughout 2009, although the extent of the potential downside risk should become gradually clearer, a first step towards slow progressive recovery after 2009.

- Liquidity-related concerns will remain although some relief should be felt in 2009
- Government schemes to offset restricted access to private-sector funding
- Full recovery of funding markets will not be achieved in 2009

Symptom One: Dependency Risk

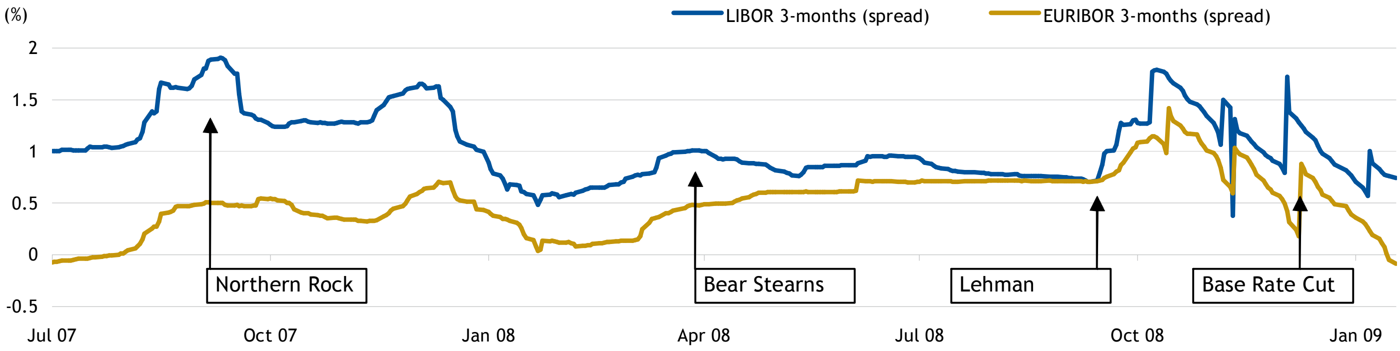
Not only the cost, but the availability of funding itself was a key issue in 2008. Fitch expects that public authorities' responses, and banks' review of their liquidity strategies since the start of the crisis, should have reduced the risk of sudden liquidity-driven bank collapses. Nevertheless, how to diminish banks' reliance on "artificial" public-sponsored liquidity sources will be a key debate in 2009.

Banking is a confidence-sensitive industry, as has been shown over the past few quarters. When confidence fails, banks can collapse in a very short period of time. The very rapid development of the crisis since August 2007, the increasingly restricted access to wholesale funding sources for banks, and the lag in some cases in public authorities' responses, saw a period of mistrust within and towards the banking sector, exacerbated by self-fulfilling concerns as to banks' liquidity and access to funding. Mistrust and perceived high counterparty risk led banks to hoard liquidity, and interbank lending rates reached historical peaks. Central bank actions brought some relief, as many central banks significantly expanded their term liquidity provision in recognition of the scarcity of alternative funding sources and, in some cases, also loosened lending criteria. Later in 2008, the announcement of government schemes guaranteeing bank debt helped bring interbank spreads down, although they remained high compared with historical levels.

Although Fitch has welcomed government liquidity support, which it has considered as generally supportive for bank ratings, it recognises that it will be difficult for many banks to wean themselves off such non-market funding sources. (Please refer to Fitch's *"The Role of the ECB: Impact of Increased Liquidity on European Financial Markets and Banks"* report, dated 7 May 2008 and available at www.fitchratings.com.) While the provision of extra central bank liquidity to the European banking system has been critical in relieving liquidity and funding pressures experienced by banks, policymakers will be challenged to facilitate a return to a normal market in 2009 and beyond, as

Crunch-O-Meter

Euribor and Libor Differential to ECB Minimum Bid Rate and BOE Bank Base Rate



Source: EURIBOR, BBA

banks will find it difficult to finance maturing debt in a market that is accessible to only a few. Central banks may decide to make their funding less attractive, either by increasing the cost of such funds and/or by changing collateral requirements. However, unless an active market for structured credit instruments is restored, Fitch believes that it will be difficult for central banks to tighten collateral rules for these products, especially if governments are at the same time trying to encourage banks to maintain customer lending at reasonable costs.

Government debt guarantee schemes have already been rolled out in many countries. In certain markets, a number of banks have been unwilling to participate in the available schemes, whether because of the conditions attached to them or their cost. In Sweden, for instance, three of the four major banks, namely Nordea Bank, Skandinaviska Enskilda Banken and Svenska Handelsbanken, have all so far resisted any participation in the Swedish guarantee scheme, with Swedbank being the only one to have issued under the guarantee programme. Nevertheless, those European banks which decided to use their respective national guarantee schemes have regained better access to wholesale funding markets, although the overall cost, including the fee payable to the government, remains relatively high. It appears that in some jurisdictions, a stigma is attached to the use of the national guarantee scheme, especially in countries where the market is still open for those banks that benefit from high levels of public confidence, for example in France and the Netherlands. In these cases, banks will be less keen to issue debt under the government guarantee, as this might cause reputational damage. Fitch believes that those government guarantee programmes, which will expire in the latter half of 2009, including those in Italy, Portugal and Sweden, are likely be renewed. Nevertheless, any scheme that is extended could see more restricted terms and conditions attached to it, as governments will be keen to gradually reduce their involvement in wholesale funding markets.

Meanwhile, Fitch expects to see banks continue to expand their customer deposit bases in 2009 in response to restricted access to capital markets. In this respect, banks are aided by the increased covers offered by national deposit guarantee schemes, which were implemented by most national governments in the second half of 2008. As customers are less inclined to invest in riskier asset classes, including investment funds, and as they reduce spending due to uncertain economic conditions, overall savings should increase in most European markets. Nevertheless, competition for retail deposits is expected to stay intense, especially for the smaller European banks, and the cost of customer deposits will likely remain high, exacerbated by the historically low interest rate environment. In addition, there is a risk that the latter could lead to a behavioural shift with savers shunning deposits due to historically-low yields, and investing instead in alternative investment products. Fitch recognises that it is a slow process to shift loans/deposits ratios meaningfully.

Overall, funding and liquidity pressures will remain a key challenge in 2009, especially for those banks that do not have access to a large retail funding base. Funding pressures should be easier to manage for most entities and some relief may start to be felt as government support helps reduce the uncertainty and unpredictability that characterised the first part of the financial crisis. However, Fitch does not expect that funding markets will achieve a full recovery in 2009.

Symptom Two: Asset Quality Deterioration

- Loan impairment charges to rise substantially across Europe
- Contagion between markets, emerging and developed
- Compounded effect of increasing probability of default and increasing loss severity

Since mid-2007, banks have faced problems initially arising from US subprime assets but which quickly migrated to other asset classes. Fitch believes that by the time that FY08 results are reported, banks will generally have dealt with most of the subprime issues. These have resulted in massive write-downs in some cases, but additional problems will still lie in leveraged finance, commercial real estate and structured credit portfolios as those markets continue to deteriorate. Fitch also expects some (sizeable in some cases) write-downs in Q408 on exposures to defaulted financial institutions.

Of perhaps greater concern is the rapid economic deterioration being witnessed across most developed economies, which will result in a sharp deterioration in the quality of banks' loan books. What is becoming clear is that few, if any, economies and banking systems will remain immune to this crisis. The impact of this stress has been widening, even in emerging market systems that had hitherto been relatively unaffected. It will lead to significantly lower economic growth rates in these markets, and in many cases recessions. Compared with previous severe economic downturns, Fitch believes that banks are now generally more diversified, and with better risk management skills and systems, and this would typically limit a bank's exposures to serious problems. However, this time around there is a significantly higher level of synchronisation between geographies and sectors, and the real benefits of diversification are questionable.

Real estate markets came under increasing pressure in 2008, particularly those that witnessed an asset price bubble in recent years — most notably those in the UK, Ireland and Spain. France, Italy and Germany have suffered to a much less extent although it is noticeable in Germany that forced sales of residential property are now resulting in very significant market value declines which belies official statistics that show a stable market. In the UK, some buy-to-let and higher risk lending (eg, where documentation, affordability and/or loan-to-value (LTV) criteria had become stretched) have suffered quite sharply, with a significant increase in arrears since mid-2008, albeit from a low base.

Unemployment has always been a key determinant of problems in personal lending books. Fear of job losses was an important factor in declining consumer confidence during 2008 and with increasing job losses across the financial sector and beyond, that fear is turning to reality. Significantly lower (and still declining) interest rates have helped ease the debt service burden for many, but rising personal and corporate insolvencies look set to be a major factor in banks' P&Ls in 2009.

Commercial real estate (CRE) portfolios seem likely to suffer as market conditions continue to weaken significantly. Banks' exposures comprise a combination of CMBS assets in trading books and CRE lending predominantly in the banking book. Market indices suggest the possibility of significant market value declines on some assets. Banks that had focused on strong interest cover, high-quality properties and tenants and low LTVs ought to be protected more than others. Conversely, exposures to speculative/development property with weak criteria and covenants could face imminent pressure. In the construction sector, a number of real estate developers in Spain have become insolvent, and the housebuilder sector in the UK faces increasing pressure. UK, Spanish, Irish and German banks are among those most exposed to commercial real estate.

The corporate sectors which Fitch expects will cause European banks most concern are those that have proved most vulnerable to the current crisis, such as real estate and construction, autos, shipbuilding, steel production, pubs and hotels, and high street retail fashion. As we have moved into a credit crunch environment, those sectors most reliant on non-essential consumer spending are under increasing pressure. This should continue well into 2009 and beyond. In the auto industry, a significant slowdown in spending closely linked with house price declines and limited availability of credit has led to significant problems at some of the world's largest auto manufacturers and a severe drop in demand at others. State support, however, should help protect the interests of lending banks to some extent. Conversely, those corporate sectors which benefit from essential and/or 'defensive' spending behaviours remain in good health, such as bus and train travel, food retail, utilities, aerospace and defence and pharmaceuticals.

There is now contagion between emerging and developed markets, either because developed European economies are linked to emerging markets or because of individual banks' operations or exposures there. A year ago, it was widely believed that exposures to emerging markets provided valuable geographical diversification, with HSBC a notable example of the extent to which a powerful global franchise could offset severe problems in its US operations. Standard Chartered, with its diversified emerging markets franchise, has also, so far, proved to be resilient to the problems experienced by its larger international peers. However, the recent widening of the credit crisis to emerging markets will now represent a drag on banks' earnings for the foreseeable future. This is particularly critical for Germany (where the likely prospect of a hard landing in eastern Europe will hit German export growth), Sweden and Greece (through their banks' ownership of banks in the Baltics and Balkans respectively), and Belgium, Austria and Italy (through their exposures to CEE).

Overall, Fitch expects NPL ratios and impairment charges to rise sharply across most European banks in 2009 due to a combination of a low historical base and a more rapid than expected cyclical deterioration. In the UK, Spain and Ireland, which have not had a significant downturn to deal with since the early 1990s, the impact will be more severe. German banks have spent the mid-2000s working out the problems of their last downturn, which ought to have protected them from the excesses that have affected their large international peers. However, the wholesale nature of a large part of the sector has meant that some have fallen victim to the same influences as their international peers. Given the continued build-up of negative trends across a number of portfolios, Fitch expects European banks' NPL ratios in 2009 to be a multiple of 2007 levels, and with declining asset values, the resultant increase in loss severity is likely to have a significant impact on banks' P&Ls throughout the year.

Symptom Three: Profitability Takes a Turn For The Worse

- Core revenue generation under pressure
- Potentially less volatility from financial income, but volatility from impairment charges likely
- Some flexibility on the cost side

European banks' bottom line profitability will continue to come under material pressure. Two of the main drivers for this in 2009 will be more challenging revenue generation and rising impairment charges as asset quality deteriorates. As a consequence, Fitch expects earnings to reduce in 2009 and the number of banks reporting operating losses to increase, although the agency anticipates that credit write-offs may be lower in 2009. The pain will be mostly felt by those banks that have a heavy reliance on corporate and investment banking revenues.

Fitch expects net interest income, the primary source of revenue for the majority of rated European banks, to suffer from a combination of continued pressure on the net interest margin and new lending volumes remaining at low levels (see *Remedy One: Deleveraging*). In an attempt to de-lever third party assets and trading positions, banks will be keen to focus on domestic lending, moving away from international lending. Funding costs are likely to stay high, with uncertainty in the markets likely to continue to impact banks' access to wholesale markets and the pricing of wholesale funding. However, the agency notes that if funding costs are high, this will simply mean that borrowing costs will also remain high, so the nominal base rates will soon have little meaning. Government guarantees, which a large number of European banks have been able to benefit from since 2008, have helped banks regain some access to markets but do not come cheap.

As a result of the poor wholesale market backdrop, competition for customer deposits will remain intense with the added complication in 2009 of a historically low-interest rate environment in most European markets. The net interest margin will also be affected by the cost of holding substantially larger and low-yielding liquidity portfolios. However, the dramatic shift in the competitive landscape in most European markets will be visible in higher pricing of lending by the vast majority of banks, even for asset classes traditionally perceived as low-risk. As the new pricing is gradually passed on to a greater proportion of the banks' back-books in 2009 compared with 2008, banks should have greater flexibility to support their overall net margin. As a result, despite substantial negative pressure points, Fitch expects that a large number of European banks should be in a position to achieve at least a flat net interest margin in 2009. However, net interest income will be directly impacted by the banks' success in deleveraging. Although repayments have dropped due to the increasing scarcity of new lending in most markets, net new lending volumes will remain particularly low in 2009, and negative new lending volumes cannot be excluded for a number of markets.

Similarly, other income sources will remain under pressure in 2009. Net fee income will be directly impacted by low or negative GDP growth rates in European economies, lower world trade volumes and lower investment banking activities. Fees from banks' investment fund activities will be particularly affected, as assets under management (AUM) have been strongly reduced as a result of outflows (mainly towards current or term accounts) and price falls. The impact will potentially continue to be accentuated by regulatory oversight, as illustrated for instance by the review of payment protection insurance in the UK and that of other banking fees in a number of European markets. While net financial income was a key contributor to earnings volatility in 2008, Fitch expects this income line to be less volatile, albeit still under material pressure, in 2009. The profitability of many European banks in 2008 was severely depressed by the fall in the value of a number of structured credit products, starting with US subprime, and the drop in equity markets. In addition, accounting changes which occurred in October 2008 should help banks reduce the volatility in reported profitability in 2009. The change the International Accounting Standards Board (IASB) rushed into International Accounting Standard (IAS) 39, hastened by intense political pressure from the European Commission, allows banks from the beginning of the Q308 reporting period to reclassify assets from the trading book to the loan book or held-to-maturity category. It thereby enables them under certain conditions to avoid taking further fair-value hits through the profit and loss account or directly through equity. In the Nordic region for instance, only one out of the six major banks had not made use of this option in Q308.

Banks will have some flexibility to absorb part of the more difficult revenue generation through cost reductions. This was already illustrated in H208 by material redundancy programmes in sectors most directly impacted by the financial crisis, particularly investment banking. In Fitch's view, further redundancies, affecting other less cyclical activities, will occur in 2009, and banks will limit their investments in tangible assets, such as branch networks and IT systems, as much as possible. However, the benefits of cost reduction programmes could be delayed by one-off costs, arising from restructuring costs, as banks reshape their lines of activities.

Loan impairment charges (see *Symptom Two: Asset Quality Deterioration*) will increase substantially in 2009 across the European banking sector, due to the multiplying effect of increasing probability of default and increasing loss severity, but also as a result of the limited buffer in the form of impairment allowances since the implementation of IFRS. In western Europe, only Spanish banks have been building generic reserves despite the implementation of IFRS, and consequently have more of a buffer to absorb part of the rise in impaired loan levels. Combined with an already more challenging performance expected at a pre-impairment operating profit level, larger impairment charges for European banks will likely lead to operating losses for a number of players. In addition, Fitch expects to see a wave of goodwill impairments in 2008 statements and into 2009 as a result of an anticipated deterioration in the profitability of business, particularly for those businesses acquired at the peak of the market in 2006-2007.

Symptom Four: Capital Raising Has Barely Covered Write-Downs

- Further capital raising necessary in 2009 as further demands on banks' capital are likely
- And investors and regulators share higher expectations

In 2008, bank capital took a hit across the region after rounds of asset write-downs on structured finance portfolios. As a result, banks were challenged to boost capital cushions in order to improve financial health and investor confidence. Since the start of the crisis, around EUR245bn of capital has been raised by European banks from a variety of sources (*Bloomberg,* 23 January 2008). These included, firstly, traditional rights issues, which were in some cases hampered by falling stock prices undermining the capital raising process, leaving underwriters with significant shares of unsold stock. Secondly, across Europe, banks' capital ratios were boosted by government-sponsored capital. In other cases, banks decided to sell the 'family silver' and disposed of non-core assets such as insurance companies, foreign subsidiaries or investment funds to restore capital cushions. Lastly, banks took advantage of the appetite of sovereign wealth funds, mostly based outside of Europe, which bought into banks' equity in the midst of a rapidly deteriorating market environment.

It is already evident that those capital raising initiatives effected in 2008 will, in many cases, be insufficient to cover potential losses in 2009. New capital support plans announced in January 2009, including those in Ireland, France, Denmark and Belgium, illustrate the fact that the capitalisation of European banks could come under further or renewed pressure in 2009. The extent of the capital injections required will depend on factors such as:

1. further potential write-downs in the banks' investment and trading books given continued illiquid markets and falling prices (although write-downs are less likely now that international accounting rules allow for a reclassification of assets, and fair value movements will therefore be subdued, credit losses are likely);
2. banks' increased requirement for loan loss impairments in 2009 and 2010 given the deteriorating economic environment (see *Symptom Two: Asset Quality Deterioration*);
3. the potential draw-down of banks' commitments to lend to corporate borrowers under undrawn revolving credit facilities. Fitch estimates that EMEA banks have at least EUR3trn in lending commitments to the corporate universe (see Fitch's "*European Corporates' Demands upon Banks' Capital*" report, dated 11 November 2008 and available at www.fitchratings.com). It is not unthinkable that some banks may need to ration the usage of corporates' undrawn credit lines, in order to protect their vulnerable capital cushions, and the first signs of this have arisen in late 2008/January 2009.

Further pressures to raise additional capital will also come from investors and regulators, who have stressed the need for banks to boost capital buffers to confront a weakening economy as well as further losses. Higher capital ratios, even if maintained for only a limited number of years, will be one pre-requisite to re-establish the confidence in the European banking system. In some countries, regulators have redefined Tier 1 capital targets for their banking system as a whole or on an individual basis (see *Remedy One: Deleveraging)*. However, the UK

Financial Services Authority (FSA), for instance, stressed in its statement of 19 January 2009 that the recapitalisation scheme would not lead to stricter statutory capital requirements, but was only aimed at encouraging banks to create extra buffers to ensure that they would be able to meet the core Tier 1 minimum, after stress and while continuing to lend. Some governments may choose to follow the route of regulatory forbearance, temporarily loosening capital-related prudential rules to encourage lending to the corporate and retail sectors (see *Remedy Two: Government Support Essential to Avert European Bank Systemic Crisis*). Hybrid capital instruments may now represent a significantly greater proportion of Tier 1 capital in several European markets, with a number of regulators, for instance in Denmark and Sweden, having changed prudential rules determining maximum usage of these instruments. Nevertheless, expectations from market participants in terms of capitalisation levels will continue to be higher in 2009, and a number of European banks will be challenged to hold more capital in relation to their assets than was the case pre-credit crisis. This will affect all European banking systems, even those which have so far appeared less affected by the credit turmoil.

Remedies: Key Mitigators For European Banks

The substantial challenges that European banks face and the potential collateral damage a prolonged banking crisis will have on the economies, have led to a widespread debate on the approach required to break through this seemingly vicious cycle and restore investor and depositor confidence. Despite the severity of the current situation, banks have a range of tools at their disposal to help tackle the challenges thrown up by the credit crisis, including the capacity to deleverage and mechanisms for consolidation. However, Fitch expects that government support will remain key in 2009 at a time when free-market mechanisms remain gripped by uncertainty.

Remedy One: Deleveraging

- Deleveraging to accentuate in 2009
- Direct threat to "real" economy, leading to increasing government intervention
- Possibility of regulatory forbearance

Deleveraging is a strategy followed by a growing number of European banks and is likely to accelerate in 2009. The key objectives sought in this process are for banks to either increase the relative portion of capital buffer in their balance sheets, particularly given the rapid deterioration in the economic background in Europe, or to reduce risk-weighted assets. In so doing, banks seek to regain market confidence, and thus restore better access to funding markets. It is also to some extent a trend forced onto banks which continue to suffer from restricted access to funding. There are numerous examples of banks that are currently trying to improve both sides of their leverage ratios. Some European regulators have also actively supported this trend, for example, the Swiss National Bank, the UK's FSA and Portugal's central bank were the first to redefine minimum capital ratios for banks on a case-by-case basis.

While certain countries, like the UK or Spain, have seen a more rapid implementation of deleveraging compared with, say Italy or France, Fitch expects the trend to accelerate throughout Europe in 2009. As a result, the relativity of market expectation in terms of leverage and capital ratio has already increased substantially.

In more normal market conditions, capital injections from institutional and private investors and sovereign wealth funds would represent the most straightforward option to reduce leverage. In these strained times, however, with even sovereign wealth funds having been burnt by recent investments, and therefore unwilling to invest more capital in banks, this has proved increasingly difficult or costly, and government injections have become increasingly common in a number of countries.

Reducing the total size of risk-weighted assets is an alternative to capital injections, but can prove a slow and sometimes painful process. Given the limited demand from investors for asset portfolio sales, the most common way in which banks are currently seeking to reduce total assets and risk exposure is by substantially reining in new lending. In some cases, redemptions have started to exceed new lending, as is illustrated for instance by the UK mortgage market. The removal of the aggressive players Bradford and Bingley (B&B) and Northern Rock from the market and the withdrawal of international lenders have had a significantly detrimental effect on UK mortgage lending. This trend is also one that has a material negative impact on the economy as a result of the shortage of credit supply. This has exacerbated the economic downturn and contributed to rapid asset depreciation, with direct consequences for asset quality.

Given the negative impact deleveraging can have on the "real" economy, government intervention has become more common and is likely to increase in 2009. There have already been cases where governments have injected capital into banks, for example in the UK, Germany, Ireland, Belgium and the Netherlands. Stronger political interventionism is possible in a large number of European markets, and government-assisted deleveraging could take other forms, such as the creation of government-owned "bad" and "good" banks to support asset sales and the overall supply of credit by banking sectors.

Overall, Fitch expects banks in 2009 to operate with higher capital ratios than before August 2007. Until the summer of 2007, a general trend of gradually decreasing capital ratios to boost reported profitability ratios was visible, in some cases supported by the expectation of capital benefits with the implementation of Basel II, particularly for mortgage lenders. Expectations from analysts and investors, and relative levels, have changed dramatically in 2008, and this should lead to banks operating with higher regulatory capital ratios. In addition, US-style leverage ratios appear to be receiving a greater level of attention from market participants once again.

Remedy Two: Government Support Essential to Avert European Bank Systemic Crisis

- Government support is likely to be the most important mitigator of the financial crisis in 2009
- Further rounds of capital injections and extra liquidity support are being announced
- Support measures unlikely to be unwound until 2010 or beyond
- Sovereign CDS widening to level of banks as a result of support measures

Fitch believes that government support has been an important mitigator of the challenges raised by the financial crisis throughout 2008, particularly those related to funding, liquidity and capital, and will continue to be so in 2009. (see also Fitch's *"European Bank Systemic Crisis: Government Measures Supportive of Bank Ratings"* report, dated 28 October 2008 and available at www.fitchratings.com). In 2008, government support to banks in different European countries was provided on three fronts. Straight-out nationalisation brought a number of troubled, privately-owned banks under government control; funding and liquidity support, including the raising of the amounts covered by deposit guarantee schemes, provision of additional central bank liquidity and government guarantees on bank debt provided welcome relief from funding and liquidity pressures; and capital injections helped to strengthen banks' capital ratios as well as general stakeholder confidence.

In 2009, Fitch anticipates a continuation of such measures, implementation of similar measures by those countries which have not done so yet, the renewal of existing schemes and the announcement of new ones. Nationalisation remains an option for governments to prevent large bank defaults, as Fitch believes that a renewed understanding of the systematic importance of financial institutions, both to the financial and the economic system, effectively precludes governments allowing a disorderly collapse of a major bank. However, the agency does not believe that the nationalised banks will remain in public hands indefinitely, as European governments appear to share the intention to maintain ownership until a suitable buyer or merger partner has been found. However, in the current state of the capital markets, solutions for re-privatisation might not take shape until 2010 or beyond. In addition, nationalised banks could be temporarily seen as a government tool to support what is perceived as public interest, for instance by providing credit to those sectors which cannot obtain it from private sector banks.

Public funding and liquidity support measures, as noted earlier, are likely to remain a feature of the European financial landscape in 2009, as funding and liquidity pressures should remain a key challenge for European banks. As government guarantee schemes on new debt issuance will expire in 2009 (in the UK, Finland, Greece, Italy, Netherlands, Portugal and Sweden) and 2010 (in Denmark and Ireland), Fitch believes that there is an extremely high probability that such schemes will be continued if financial markets do not show signs of material recovery. In this respect, the UK has served as a test case, as the issuance period under its guarantee scheme has been extended from 9 April 2009 to 31 December 2009, subject to parliamentary approval. Also the Danish government announced in January 2009 that its current guarantee scheme, expiring on 30 September 2010, would be partly prolonged by an additional three-year guarantee scheme for senior debt issuance.

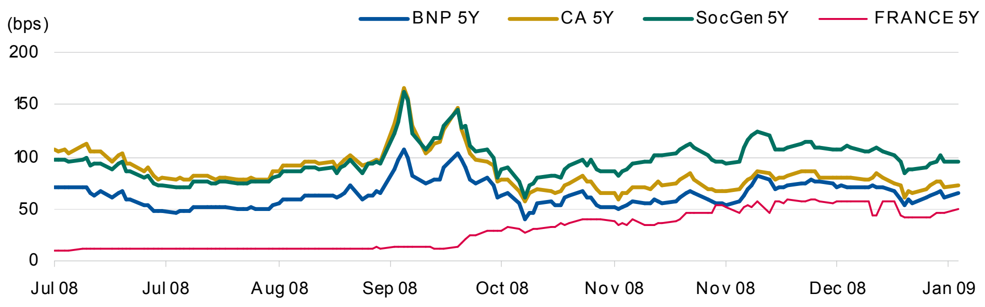
With a large number of banks expected to reduce earnings in 2009, and further asset write-downs likely, Fitch believes that further rounds of capital injections, likely to consist of ordinary or preference shares, are inevitable. Some of these capital injections will be used to absorb losses. As was the case in 2008, strings will continue to be attached to such means of support also in 2009, ranging from caps on executive compensation, board appointments and a say in underwriting criteria to regular public reporting on lending practices. Overall, those banks accepting capital support will accept a larger role of government in day-to-day management and decision-making.

If capital markets do not respond sufficiently to existing schemes, new government support measures are likely to be developed in the course of 2009. Innovative tools to support banks' financial health and aid the general economy could include government-backed insurance contracts for bad assets on banks' balance sheets, conversion of government-owned preference shares into ordinary bank equity to reduce dividend payments (but simultaneously increasing public ownership), and government guarantees on corporate and retail loans to induce banks to continue lending. In the UK, such plans are already in the making, and if they prove successful, other European governments are expected to follow suit.

Although governments will be keen to reduce their role in financial markets, support mechanisms will be withdrawn only when investor confidence has returned to more reasonable levels, and this might not be until 2010 at the very earliest. Meanwhile, further rounds of capital and liquidity assistance will create more pressure on public finances in 2009 and increase perceptions of sovereign risk. Capital injections, which require direct funding from the state, are a particularly expensive means of support. The graphs showing sovereign and bank CDS spreads illustrate this point. As national governments have taken on an increasing amount of banking risk, the CDS spreads of the sovereign and the largest national banks have started to converge. While Fitch accepts that the propensity for bank support is high across all European countries, it will closely monitor countries' ability to support national banks. Fiscal support measures, while large in size, are not so great as to imperil sovereign ratings at this point in time.

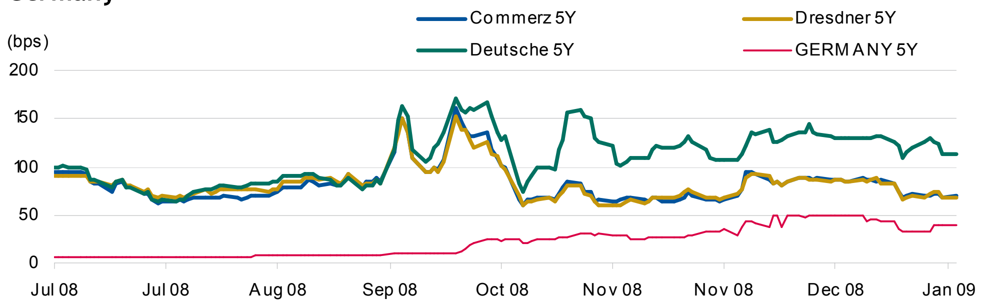
Sovereign Convergence: Sovereign and Bank CDS Spreads

France



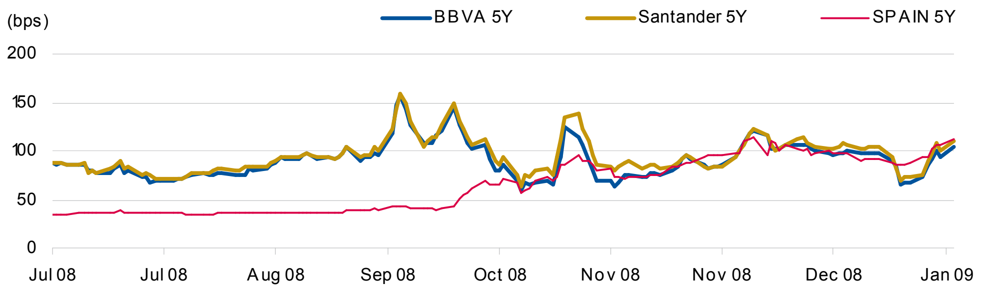
Source: Bloomberg

Germany



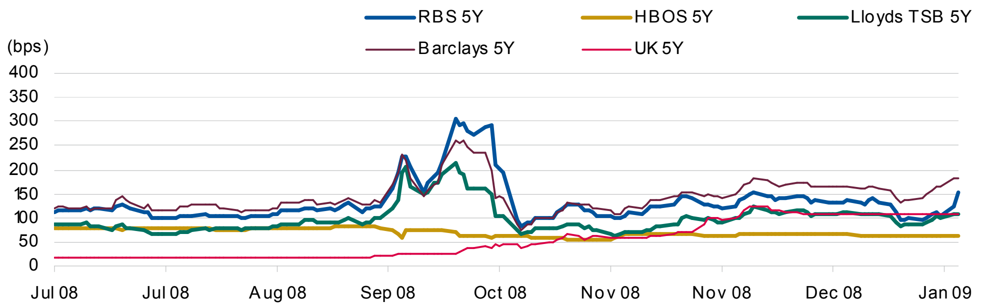
Source: Bloomberg

Spain



Source: Bloomberg

UK



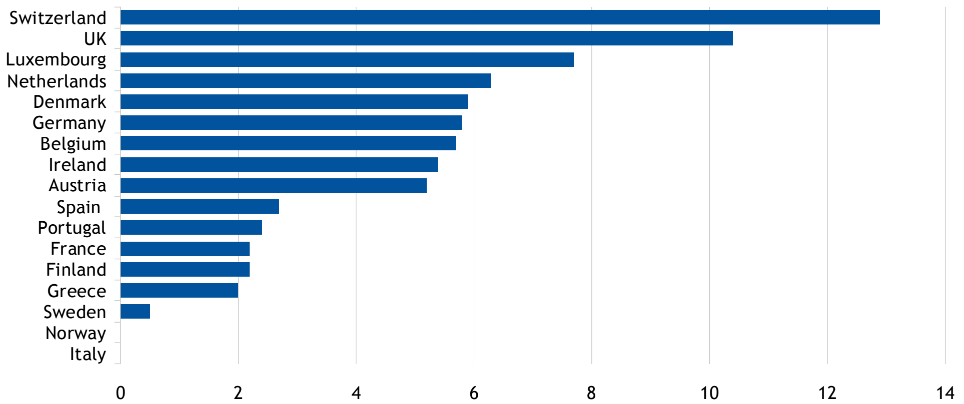
Source: Bloomberg

Alongside hands-on support measures, there may also be a number of regulatory changes in 2009. These may involve closer supervision of bank liquidity levels by regulatory agencies, as reporting requirements are being tightened and more transparency will be required, as well as changes relating to capital requirements. Although a number of regulatory agents already announced plans to raise the bar for banks' capital in late 2008, hoping to boost investor confidence, there may be a certain level of regulatory forbearance to support banks' ability to provide credit to the retail and corporate sectors. Also, Basel II is likely to face another round of scrutiny. Among other issues, pressure is mounting to alter capital requirements in regard to structured products and off-balance-sheet vehicles, although from a rating agency perspective, the preference would be for a higher level of capital. Also, the Basel II rules on value-at-risk (VaR) calculation have been changed in mid-January 2009 to reflect credit risk in banks' trading portfolios. This change is scheduled to take effect in 2010, but could be delayed on account of the further impact on banks' capital ratios.

Key regulatory decisions in 2009 are likely to be made after stronger international coordination, rather than by national governments alone, although national governments will be keen to protect national interests in the process. The events of 2008 have shown that unilateral action in the fields of financial regulation and supervision may lead to regulatory arbitrage, and governments will be careful not to cause further market disturbance. In this respect, it is interesting to note the progressive convergence of support measures initiated by European governments despite limited initial coordination. Fitch expects to see a further copying of blueprints if different approaches are seen to be successful. Although calls for a single European regulator are still far off, Fitch believes that, especially within the European Monetary Union, cross-border cooperation will be a key feature of the financial landscape in 2009.

Government Bank Support in Europe

(% 2007 GDP)



Source: Various, Fitch

Remedy Three: Consolidation Back on the Agenda

- Further consolidation expected
- Whether forced, defensive or opportunistic
- Finite capacity for acquisitions by a number of larger players

The crisis has triggered changes in the competitive landscape of a number of European markets, and further corporate actions remain very likely. Since the onslaught of the crisis in August 2007, there have been three main types of consolidation: forced, defensive and opportunistic. Fitch believes that the main items supporting the rationale for these three types of mergers will persist in 2009, although significant concerns now exist about the concept of strength in size and the 'banking giant' model.

'Forced mergers' may occur as an easier or cheaper way for governments to support an ailing bank. Defensive mergers are likely to continue to occur in 2009 as small to medium-sized banks continue to be at a disadvantage compared with larger peers due to smaller cost efficiencies attainable, and the fact that they are likely to be at the bottom of the pecking order as and when wholesale funding markets reopen. There may, for example, be a potential for mergers in the cajas sector in Spain, or for medium-sized banks in Italy. Finally, opportunistic consolidation will remain on the agenda for 2009 as regulatory approvals appear easier to obtain for 'predators', as valuations of banks remain weak and as the propensity of banks' management to accept unsolicited approaches is higher (the white knight phenomenon).

However, some constraints will develop in 2009 which will limit the extent of consolidation in the European banking sector. First of all, the validity of the concept of strength in size is increasingly debated, as mergers may not necessarily alleviate the problems of an ailing bank, and contagion risk is not negligible. The Lloyds TSB/HBOS and Commerzbank/Dresdner mergers are illustrations of this point and of the limits of what has been seen by certain commentators as a "forced" merger. Also, M&A activity may lead to increased concentration, as was the case for The Royal Bank of Scotland (RBS), whose single name exposures were significantly higher as a result of its acquisition of ABN AMRO. Lastly, a number of the larger European banks which could have been seen in 2008 as potential consolidators are under increasing pressure and are more likely to be reluctant to venture into acquisitions at a time when the extent of their own risks is uncertain, or when the government has a controlling stake. Finally, players that have participated in the 2008 consolidation movement only have a finite capacity to absorb other entities. Spain's Santander, with the acquisition of Sovereign in the US, and Alliance & Leicester's and Bradford & Bingley's deposit base in the UK, as well as the UK's Nationwide Building Society, which announced the acquisition of two smaller societies in 2008, are two examples of entities which will be less likely to be able to participate in further consolidation in 2009 without endangering their own creditworthiness.

Remedy Four: Back to Basics

- Relationship-based banking back in vogue
- Focus on retail deposit collection
- Less risk, less innovation, less growth, lower levels of profitability

As a consequence of the crisis, many banks are returning to a more traditional banking model, and this trend is likely to persist in 2009. This will be evidenced in lending practices; as lenders rein in new lending levels, the focus is on directly-originated business as opposed to that which is intermediary-introduced. New lending will continue to be originated with a view to keeping associated risks on-balance-sheet until contractual maturity as markets for risk transfer instruments are likely to remain materially subdued.

In addition, given the difficult wholesale market conditions, banks will continue to compete aggressively for customer deposits, the 'traditional way' of funding banks' activities. While the uncertainty surrounding most European housing markets and mortgage funding initiatives (particularly in the UK) will continue to undermine demand for securitisation, Fitch believes that this instrument may gradually reappear for banks later in 2009, but will be used as a funding rather than a risk-transfer tool. The level of collateralisation and granularity of collateral should make it one of the preferred instruments once wholesale funding markets reopen.

Strategic changes will also take place at management level. As high risk-taking and fast growth strategies are out of vogue with investors and regulators alike, banks' leadership is likely to revert to lower-risk and longer-term approaches. This will be reflected particularly in market risk policies and the instalment of improved risk control systems. In particular, banks will return to more disciplined approaches to risk and return in their lending businesses, with less emphasis on cross-subsidising between product groups. Also, some of the more exotic elements of investment banking will be severely restricted. With risk management and financial prudence being key priorities in 2009, CFOs and risk managers will be at the forefront of any kind of strategic decision-making.