Banking forecast

Lending to increase in 2014 as economy emerges from recession

A return to growth in the Eurozone heralds better prospects for the banking industry. We therefore expect 2013 to mark the bottom of the current cycle. Total lending is forecast to be 1.2% lower in 2013 than in 2012, but will then pick up by 3.2% to reach €12,440b in 2014. The fall in lending this year is greater than we had previously forecast. This is partly the result of the impending AQR, which has prompted some balance sheet reduction.

We expect both personal and corporate lending to begin to pick up again next year. As confidence slowly returns, personal lending is set to increase by 1.5% to €4,473b in 2014, rising to €4,851b by 2017, 18% above the pre-crisis peak in 2008. We expect corporate lending to expand by 3.8% to €4,635b in 2014, reaching €5,366b by 2017, 11% above the 2008 peak. Lending growth could return more quickly if the authorities adopt a two-step approach to the recovery process. There are already signs that bank deleveraging — the first step — is speeding up, freeing resources for fresh lending. Additional support from the ECB could encourage banks to increase lending, particularly to SMEs.

Business investment set to rise ...

At present, however, surveys show that the demand for bank lending from companies is still falling as they continue to deleverage. The good news is that the rate of decline is slowing, according to the ECB's latest bank lending survey, although firms are still reluctant to borrow in order to invest. But, for some corporates at least, the deleveraging process is now coming to an end. Improving GDP growth and credit conditions will gradually feed an increased willingness to borrow. After contracting for seven consecutive quarters we expect business investment to pick up again this year, as companies become more confident about the economic outlook. Lending growth will be particularly strong in Germany, where business confidence has improved markedly in response to rising domestic consumption and investment, amid signs that exports are at last beginning to revive. Private consumption in Germany is forecast to increase by over 1% a year in 2014–17, and investment growth should average 3.5% a year.

... but loan book quality remains a prime concern

Some Eurozone banks have price-to-book ratios of less than one, indicating continued concern about loan book quality. The ECB's AQR, due to begin in early 2014, and the next round of stress testing, appears to have encouraged an early rise in the provisioning of NPLs. We now expect NPLs to reach 7.8% of total loans by the end of this year. High levels of provisions will continue into 2014, as banks get their houses in order before the ECB takes over responsibility for supervision in a year's time. But NPLs are projected to peak this year, before gradually falling to 6.8% in 2014 and then more sharply to 4.6% by 2017. In countries that have yet to emerge from recession, including Italy and Spain, the process will be slower. They are not expected to see a fall in NPLs until 2015.

Consumer credit forecast to pick up

Although overall credit conditions are still being tightened, consumer credit conditions eased in Q2 2013 for the first time since 2007. We have raised our forecast for consumer credit growth in light of an improved outlook for consumption. This follows stronger quarterly consumption growth than expected across the Eurozone in Q2 2013 of 0.1%, with the exception of the Netherlands. By contrast, residential mortgage lending is expected to fall 0.6% this year, continuing its decline, especially in Spain and Italy. It will start to pick up again in 2014, as the housing market revives in most Eurozone countries, supported by better credit conditions and a stronger labor market. The biggest falls will be in Spain, where the housing market has been hit particularly hard, but they will be partly offset by more buoyant conditions in Germany and to a lesser extent in France.

Operating income set to improve more rapidly from 2014

Total bank operating income should improve by 1% this year, and is set to rise by 7.1% in 2014, as banks put the worst of the provisioning behind them. This is mainly being driven by banks in Italy, Germany and France. They will also benefit from a growing deposit base. Deposits are forecast to increase by 3.2% this year and 3.6% in 2014. We then expect deposits to grow by 4.4% a year between 2015 and 2017, as interest rates slowly inch up in the medium term, attracting more savings. Rising deposits should contribute to increasing bank profitability in

most countries, with the exception of Cyprus, where the banking sector is still recovering from the effects of the 2012–13 crisis. Nevertheless, we now forecast a slightly slower increase in operating income than we had expected three months ago, reflecting our higher forecast for provisions against NPLs.

Profitability may be affected by other changes, too. Banks in some Eurozone countries may face increasing competition from non-traditional providers of banking services, such as fund managers looking for alternative investment classes, or crowd-sourced lending. For now, these are unlikely to threaten banks' core businesses, and they could be a benefit, especially if they take over some of the riskier lending. Insurers looking for new ways into bancassurance could also help to reduce lending risks through new underwriting or loan syndications.

Viewpoint

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The rapid approach of the AQR as part of Balance Sheet Assessment – the ECB's first major initiative in its new role as supervisor of the Eurozone's largest banks – is having a visible effect on the industry. Banks across the region are expecting the AQR to herald tougher and more consistent provisioning standards, with areas such as real estate loans and structured finance portfolios likely to come under particular scrutiny. Recent months have seen several Eurozone banks explicitly link increased impairment charges with the AQR's arrival.

The AQR is more of an affirmation than a source of concern for some Eurozone banks. The strongest are increasingly keen to move from compliance-driven spending to growth-focused investment.

At the same time, it is becoming clear that the AQR is just the first step toward a new SSM. The ECB's balance sheet assessment is also expected to include reviews of risks and risk-weightings, followed by stress-testing of banks' core tier 1 solvency.

The ECB will soon announce which banks will be coming under its direct supervision. Of course, the new regime will mean different things for different banks. Some will be all too aware that the process is likely to end with a call for them to raise fresh capital. A number of banks have tapped public markets for equity in recent months, and it seems inevitable that others may need to fall back on state support.

In contrast, the AQR is more of an affirmation than a source of concern for some Eurozone banks. The strongest are increasingly keen to move from compliance-driven spending to growth-focused investment. Although regulation will remain a major feature of their environment, they are making increasing efforts to optimize their business models for expansion. The latest forecasts suggest that growth in banks' operating income will accelerate in 2014, as economic recovery and a steeper yield curve boost lending and net interest margins.

Looking further ahead, now that the German federal elections are over it will be interesting to see whether Angela Merkel's domestic political momentum will translate into a stronger push for a full Eurozone banking union.

Corporate lending

3.8%

Business investment is expected to pick up after contracting for seven consecutive quarters. As a result banks will lend €4,635b to businesses in 2014, 3.8% more than in 2013.

Customer credit

€4,851b

By 2017 personal lending is expected to rise to €4,851b easing consumer credit conditions for the first time since 2007.

NPLs

7.8%

NPLs will peak at 7.8% of total loans in 2013, before falling to 4.6% in 2017.

Insurance forecast

Pressure easing on life premiums as Eurozone emerges from recession

As the Eurozone is now emerging from recession, rising household incomes will drive a slow recovery in premiums. Average life premiums across the Eurozone are expected to stabilize this year, after falling almost 12% in 2012. They should pick up more firmly from 2014, as the Eurozone economy gradually recovers, increasing at an average rate of 2.7% a year between 2014 and 2017. However the pattern in individual countries is expected to differ substantially. Premium income is forecast to grow just 0.6% in Italy this year, as its economy lags behind the rest of the Eurozone and remains in recession until early 2014.

Longer-term challenges to growth will define the life insurance industry's future

Consumers will still have to face weak Eurozone growth and high unemployment for some time. The slow recovery will limit demand for life products. In addition, low interest rates and the regulatory challenges of Solvency II will put pressure on firms to develop new products. These could include the introduction of more flexible guarantees, greater emphasis on risk products, and increasing interest in alternative investment classes.

New opportunities will also emerge from a more rapidly aging population, which is likely to raise demand for innovative new savings and retirement products to mitigate longevity risk. These could include single-premium investments with a limited payout period, and insurers providing their own network of health services and retirement homes. It is estimated that the number of people aged 65 or over will increase by 8% between now and 2017. The fastest growth will be in France (13%) and the Netherlands (15%), with fewer opportunities in Germany (5%).

German non-life insurance premiums to grow 4% this year, ahead of the rest of Europe

General insurance business has also been affected by the recession, but there are some signs of improvement as economies begin to recover. We expect premium incomes to increase by 1.3% this year. The greatest gain will be in Germany, with 4% growth, offsetting further contraction in Italy, the Netherlands and Spain. From next year, premium income across the Eurozone is expected to grow just over 2.5% a year between 2014 and 2017, although rates will be very subdued compared with pre-financial crisis expansion of over 12% between 2002 and 2008. The troubled southern European economies are expected to see the weakest non-life premium income growth — just 1% in Italy on average over the next two years, and a 2% fall in Spain.

Difficult economic environment limits general insurance prospects in southern Europe

Rate increases will be difficult to obtain, with southern European motor lines hit particularly hard as the decline in car sales continues. New car registrations fell 20% last year in Italy, and are expected to drop a further 7% this year and 5% in 2014. At the same time, squeezed household budgets ensure that policyholders remain very price sensitive. Rate increases for both motor and property insurance may be easier to achieve in the more buoyant core European markets, particularly in Germany, where unemployment is now at a post-unification low of 5.2%. Underwriting profitability is expected to remain flat in the near term, as the weak economy limits the ability to push through rate increases. There will be better opportunities for rate rises as the Eurozone economy returns to growth, especially from 2014 onwards.

The Solvency II delay has helped recovery

Some insurers have benefited from temporary regulatory support, including less onerous discount rates and accounting rules for government bonds. This has happened in Spain and Italy, and has helped to maintain firm capitalization levels in both nations. The Netherlands also benefited for a time, but is now pressing ahead with Solvency II requirements. Solvency II is not expected to be introduced until 2016 at the earliest, but firms will have to ensure they have sufficient capital in place, limiting the scope for business expansion.

Rapidly rising interest rates would pose a significant threat to insurers

A slow but steady return to growth should result in a gentle upward shift in the yield curve, helping insurers to recover margins. Although interest rates will stay low, we expect the ECB to start raising rates in H2 2017 from

the current 50 basis points (bp), to 100 bp by the end of 2017. For life insurers particularly, more rapid interest rate rises could hit profits. Product withdrawals if customers switch to savings products with higher returns would result in capital losses on low-yielding assets needing to be sold before redemption.

We expect inflation to remain low for the next few years, under 1.5% in 2014–17. This should encourage more product innovation as insurers are able to focus on technical risks rather than financial ones, enabling them to achieve higher margins. As well as new products for the growing retirement and care provision market, the current bancassurance model in some countries is also likely to change. Solvency II capital requirements may force French banks, for example, to sell their insurance subsidiaries, or banking partners elsewhere to end joint ventures. The need for continuing bank deleveraging in the face of higher capital requirements may provide opportunities for insurers.

Viewpoint

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The Eurozone economy is predicted to see a slow recovery in 2014, but the possibility of higher interest rates remains distant.

Growing longevity risks mean that low interest rates are putting balance sheets under ever-greater pressure. Another two years of very low rates will pose an existential threat to some European insurers.

Forecasts suggest that the ECB may keep rates at their current levels until 2017. This represents an increasingly serious challenge to Europe's life industry. Growing longevity risks mean that low interest rates are putting balance sheets under ever-greater pressure. Another two years of very low rates will pose an existential threat to some European insurers.

In this environment, even the strongest firms are being forced to accelerate changes to their business models. When European life insurance premiums do recover, they will not flow into annuities or other traditional guarantee products. Insurers will focus on unit-linked products that transfer more investment risk to policyholders, or contracts that invest lump sums for a defined period, while providing some life and illness protection. Insurers are also encouraging policyholders to accept limited guarantee periods, renegotiated every few years. This helps firms to manage their risks, and gives investors the prospect of better returns when interest rates recover.

Unfortunately, re-engineering balance sheets will take time. Life insurance contracts are measured in decades, and many small firms are too busy with short-term challenges to focus on long-term innovation. Some struggling firms might be able to sell closed books of business to stronger rivals, but most of Europe's larger firms would currently prefer to deploy spare capital in southeastern Europe, Asia or Latin America.

Turning to non-life insurance, it is striking that premiums are stronger in Germany than elsewhere in the Eurozone. This is partly about Germany's economic strength, but insurers are increasing rates as a result of the 2013 floods. European non-life cycles are often synchronized, so hopefully other core Eurozone markets will emulate this improvement next year.

The delay of Solvency II, and the fact that only a few European insurers are of global systemic importance, mean that regulation has slipped down the agenda of many insurers. Even so, insurers should be aware that some local regulators are considering placing firms of national importance under closer scrutiny.

Aging population

8%

By 2017 the number of people aged over 65 in the Eurozone will have increased by 8%, creating demand for innovative new savings and retirement products.

Non-life insurance

2.5%

Non-life premium income is expected to grow 2.5% per year between 2014 and 2017.

Regulation

2016

Solvency II is not expected to be introduced until 2016 at the earliest, limiting the scope for business expansion among insurers.

Asset management forecast

Signs that European funds are attracting flows at the expense of emerging markets

Assets in pan-Eurozone funds are forecast to grow by 6.1% this year, to €4,817b. This follows a 12% expansion in 2012, reflecting higher asset prices and a gradual improvement in confidence. A lack of potential for valuation adjustment will limit the scope for further gains, reducing average AUM growth to 3.9% between 2014 and 2017, well below the historic average of 6.7%. AUMs grew just 2% in H1 2013, held back in Q2, partly by investor concerns about when and how quickly the US Federal Reserve would taper its bond purchases. But European funds have benefited from a switch away from liquidity-sensitive emerging markets assets in response to the gradual withdrawal of liquidity, and are expected to continue to do so. Our forecast assumes that the slower pace of quantitative easing in the US from Q3 onwards is already anticipated in prices, and that there are no other major concerns, such as an escalation of the crisis in Syria.

Equity funds are set to outperform other asset classes

Relatively muted reactions to these recent events indicate that investors' risk appetites are more firmly entrenched than in 2012. Assuming this continues, we expect equity and multi-asset funds to see the largest AUM gains among asset classes in 2013 and 2014, as investors are prepared to take on more risk for higher returns. AUMs in pan-Eurozone equity funds are forecast to reach €2,079b by 2017, up from €1,349b last year, an increase of over 50%. By 2017, 37% of Eurozone assets will be invested in equities, up from 30% in 2012. Although multi-asset funds are a small proportion of the total market at present, they are expected to grow rapidly, by nearly 70%, reaching €645b by 2017, up from €383b at the end of 2012. They will benefit from the trend among smaller pension funds and insurance companies to outsource asset allocation decisions by investing in externally run funds. But as the population ages, increasing demand for products with guaranteed returns may alter the types of equity funds marketed.

Safe-haven investments will lose market share to riskier assets

Conversely, AUMs in bond funds will see little expansion as the need for safe havens falls. They will grow less than 12% between 2012 and 2017, reaching €1,502b. By 2017, AUMs in bonds will account for 26.7% of total AUMs, down from 29.6% at the end of last year. Peripheral markets, such as Italy and Spain, will fare better than the core countries, attracting investors through higher yields to compensate for some residual debt-restructuring risk. Funds invested in Eurozone-focused money market funds are expected to decline from €1,003b last year, to €827b by 2017. This will be driven by the core markets of France, Germany and the Netherlands, where the shift in risk perception is likely to be greatest. Elsewhere in the Eurozone, especially in Spain and Italy, domestic consumers will be more cautious in the face of depressed labor markets. Demand for money market funds in these regions is expected to remain high for longer. Enhanced funds, which typically take on more credit risk, are gaining market share at the expense of standard money market products. AUMs in enhanced funds have increased from a 2.6% share in Q1 2012, to 3.4% in Q2 2013. This reflects rising appetite for higher returns.

Hedge funds set to attract new investments from 2014

Outflows from pan-European hedge funds should slow as systemic concerns recede, including the survival of the Eurozone. The strong performance of hedge funds so far this year should attract new investors, with some buying into Eurozone-focused funds. As the risk environment gradually returns to normal and individual asset performance begins to diversify again, hedge funds will have a broader range of opportunities to make returns from stock-specific investment. We expect AUMs in hedge funds to reach €36b by 2017 — a return to 2011 levels — but not regaining their record high of €46b in 2007.

Alternative investments should also see growing interest

Alternative investments are growing in popularity, as many have low correlations with mainstream investments. These funds include investments in infrastructure projects, corporate debt and property. Infrastructure funds are starting from a low base, so even if they expand rapidly they will not be a

significant proportion of AUMs by 2017. After several tough years for the property sector, we forecast a 2% increase in property AUMs this year. The pace of expansion should steadily build over the next few years to reach 4.4% annual growth by 2017, with total AUMs of €119b, compared with €102b in 2012.

German property market funds particularly may benefit from this trend. Having fallen 8% from their peak in early 2010, the assets invested in German commercial property are starting to rise again. We expect growth of 3% this year and 5% in 2014. Property funds represent a sizeable share of the German industry, accounting for 16% of assets, compared with just 2% at the pan-Eurozone level. In contrast, the Spanish commercial property sector, in tandem with its economy, is still falling, and we expect a further decline in AUM this year before conditions start to improve in 2014.

Viewpoint

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The prospect of economic recovery and the growing value of funds under management are boosting the confidence of asset managers in the Eurozone. The urgent need for Europeans to save more during their working lifetimes – illustrated by the increasing strain on public sector pension schemes – underlines the vital role the sector has to play over the coming decades.

> The effects of increasing optimism are also being felt on the operational side of asset management. Many firms are shifting from a focus on pure cost control to a more value-based view that supports balanced investment.

Even though this is an encouraging picture, it seems unlikely that European equities will offer asset managers an easy route to growth. Despite recent improvements in the Eurozone's markets, the region's economic fundamentals have not changed materially. So while small caps may benefit from the economic recovery, this will have a limited effect on the wider market. Retirees' investment needs are also unlikely to provide much long-term support for equities. Current retirees need steady income and capital protection, while asset managers will struggle to deliver predictable outcomes for tomorrow's pensioners by investing in equities.

Instead, asset managers will continue to broaden their investment horizons. With real estate increasingly considered a mainstream asset class, many firms are keen to explore setting up funds as lending platforms. Infrastructure assets are one area of interest, owing to their predictable cash flows. Another priority is lending to the Eurozone's investment-starved SMEs – something that promises much better returns than low-yielding corporate bonds.

The effects of increasing optimism are also being felt on the operational side of asset management. Many firms are shifting from a focus on pure cost control to a more value-based view that supports balanced investment. Unfortunately there is no obvious letup in regulatory spending. If anything, national regulators are competing with each other to go beyond pan-European requirements. Eurozone firms are also seeing the first signs that they may be affected by Asian regulation, such as rules favoring onshore funds. Individual firms need to respond by identifying the opportunities that regulation brings, as well as the obligations.

Bonds

>12%

AUMs in bond funds are expected to grow less than 12% between 2012 and 2017 as the need for safe havens falls.

Hedge Funds

€36b

Hedge fund AUMs are expected to reach €36b by 2017, returning to 2011 levels, but not regaining their record high of €46b in 2007.

Equities

50%

Equity fund AUMs will reach €2,079 by 2017, an increase of over 50% from 2012.