

Déjà Vu All Over Again: Money-Laundering And Sanctions Woes Continue To Haunt Europe's Banks

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Key Takeaways

- Money laundering remains a key operational risk for banks globally, but European banks appear to be over-represented in the steady flow of cases of banks censured for anti-money laundering and sanction breaches.
- These cases vary in their fact pattern and gravity, and so financial and franchise implications for the affected banks can vary significantly.
- Similarly, our related rating actions have varied on a case-by-case basis, informed also by whether we see the weaknesses as bank-specific or systemwide.
- We see some signs of progress at the bank-specific, member state, and regional levels, but in the near term at least we see few reasons to be optimistic that such problems will not recur in Europe.

2018 has been inauspicious for European banks in the context of anti-money laundering (AML) and sanctions breaches. After several reported AML cases earlier this year (Latvia's ABLV Bank, Estonia-based Versobank, and Pilatus Bank in Malta), much larger players are once again under the spotlight. These failings are not systemic across the region. However, their continued frequency contrasts with the toughened prudential standards that have bolstered European banks' financial resilience over the past decade. European banks may be domiciled in countries where transparency is typically relatively high and corruption relatively low by global standards, but the consequence is that they need to live up to higher regulatory standards.

To weary investors, this feels like the re-emergence of control failings for which many other European banks have been censured in the past. In many cases, the problems originated from weaknesses in a specific bank's governance standards, operational processes, risk controls, and/or risk appetite. In others, they appear to be influenced also by the intrinsic characteristics of some banking systems--for example the quality of supervision, close ties with sanctioned countries, or being a tax-attractive jurisdiction. Either way, these weaknesses persist despite an active EU legislative agenda.

Such cases carry mixed rating implications. S&P Global Ratings sees greater risk for a bank that reveals widespread internal control and organizational failures, where there is a risk of substantial fines and remediation costs that could have a sizable effect on earnings or even

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capitalization, and where there could be sustained reputational or franchise damage. For example, we recently revised our Banking Industry Country Risk Assessment (BICRA) on Estonia and Malta due to a changed perception of regulators' effectiveness, and took a negative rating action on Danske Bank. By contrast, while not insignificant, cases carry fewer rating implications where they relate to demonstrably historic, discrete failures, with rather more limited financial and/or franchise impact.

We acknowledge that other banks globally have experienced similar AML and sanctions problems and that most European banks have avoided such problems altogether. However, European banks appear over-represented in such cases.

Positively, we see some signs of progress. For example, many internationally-active European banks have exited their higher risk correspondent banking relationships in recent years and devoted increased resource to AML and sanctions compliance. We anticipate that banks' greater use of technology (notably machine learning and artificial intelligence [AI]) could improve the sophistication and efficiency of their control frameworks, if implemented correctly. At a system level, increased global information sharing, for example the automatic exchange of tax-related information under the OECD's Common Reporting Standard, could improve detection rates and inhibit some criminal activity.

At this stage though, there are few reasons to be optimistic that such problems will not recur in Europe, at least in the near-to-medium term. In part, this is because European banks continue to play a key role in the international financial system, the nature of the threat continues to evolve, banks vary in the sophistication and dynamism of their control environments, and bank control frameworks target substantial risk mitigation but not 100% risk elimination.

As we look to the future, we consider the regulatory and legal environment to be an important factor that will heavily influence bank behaviour. We therefore note with interest the EU's intent to increase transparency of beneficial ownership of companies, and to bring digital money firmly under scrutiny, via its Fifth Anti-Money Laundering Directive which came into force in July this year. It also plans to toughen penalties for money laundering and is pushing member states to address the risks posed by virtual currencies. However, it could take up to two years for these changes to be implemented by member states. We also look to see whether supervisors improve the effectiveness and consistency of their coordination and supervision. Specifically within the European Banking Union, for AML controls, as for other areas of banking supervision, delivering a level playing-field--that is, a consistent and evenly enforced rulebook--could further bolster the Banking Union's credibility.

History Repeating

At first sight, 2018 appears to be unusual in the number of reported European bank AML and sanctions cases. However, the reality is rather a steady drip of cases over many years related to AML, whether from tax evasion or other financial crimes, and sanctions enforcement.

We see 2018 as unusual in the range and dispersion of cases that have come to light:

- The year started with the failure of Latvia's ABLV Bank after a deposit run, spurred by the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) proscribing it for being "an institution of primary money laundering concern". This case had echoes of the 2015 proscription and rapid failure of Banca Privada de Andorra.
- In March, the European Central Bank shut down Versobank after a request from the Estonian authorities, concerned about the bank's failure to remedy AML controls.

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- In Malta, the authorities froze the operations of Pilatus Bank; the European Banking Authority's subsequent report raised concerns over deficiencies in local regulatory AML supervision.
- Most recently, Danske Bank has come under the spotlight due to historic problems in its Estonian branch, ING agreed a €775 million settlement for weak AML controls, and Julius Baer found itself having to investigate the activities of a rogue banker who pleaded guilty in August to helping launder \$1.2 billion from Venezuela's state-owned oil producer.
- Other cases continue to rumble along: for example, Standard Chartered's multi-year remediation program that leaves it still under a deferred prosecution agreement (DPA) six years after it took effect and possibly facing an additional fine, UBS continues to face prosecution in France for allegedly aiding French clients evade taxes, and Societe Generale appears to be close to agreeing a possible \$1 billion settlement with U.S. authorities for breaching sanctions rules, not long since it reached settlements in other cases.

Where these banks stand today, others have been already. Since 2009, around a dozen European banks have reached settlements with the U.S. Office for Financial Assets Control (OFAC) after alleged breaches of the EU and U.S. sanctions regimes, notably as regards Iran and Sudan. Among them, BNP Paribas remains the stand-out case after it agreed to settlements with numerous agencies in 2014 totalling an eye-watering \$8.9 billion. From 2012, after its initial \$1.9 billion fine for AML failings in the U.S. and Mexico, HSBC spent five years under a DPA as a court-appointed monitor oversaw the bank's substantial global remediation effort. Julius Baer remains under a DPA after its 2016 admission that it helped U.S. clients hide their wealth. Deutsche Bank was fined \$670 million in 2017 for allowing Russian clients to engage in what are thought to have been financial crime-related mirror trades, and it still has a related unsettled case with the U.S. Justice Department. And in Cyprus, the central bank continues its push to clean up the offshore banking sector.

This is not to say that these failings are a uniquely European problem--and US Bancorp, Western Union, and Commonwealth Bank of Australia incurred substantial penalties in the past year for AML deficiencies, while JP Morgan Chase, Bank of America, ANZ, VISA and others have also reached settlements with OFAC and other agencies in the last few years--but European banks appear over-represented nevertheless and have paid the largest fines. Furthermore, while not necessarily a reflection of the U.K. banking system, U.K.-registered shell companies (LLPs) appear to have been a key conduit for financial crime.

Table 1

Non-Exhaustive List Of European Banks Being Alleged Breaching Money Laundering, Terrorist Financing, Or Sanction Laws Between 2010-2018 (Sorted By Date Of Settlement Since 2010)

Bank	Headquarters	Allegations and Legal Shortcomings	Fines and Other Consequences
Danske Bank	Denmark/Estonia	Between 2007 to 2015, Danske was not sufficiently effective in preventing the branch in Estonia from potentially being used for money laundering due to critical deficiencies in governance and internal controls.	Investigation Ongoing. Danish FSA decided to increase the bank's capital requirement by DKK10 billion due to increased compliance and reputational risk. CEO resignation in September 2018. Discontinuance of share buy-back programme in October 2018.

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Non-Exhaustive List Of European Banks Being Alleged Breaching Money Laundering, Terrorist Financing, Or Sanction Laws Between 2010-2018 (Sorted By Date Of Settlement Since 2010) (cont.)

Bank	Headquarters	Allegations and Legal Shortcomings	Fines and Other Consequences
ING Bank	Netherlands	Due-diligence shortcomings at ING's banking operations in the Netherlands during 2010-2016 regarding various requirements for client on-boarding and the prevention of money laundering and corrupt practices. Allegations of breaching U.S. economic sanction regulations outside the U.S. in 2012.	€775 million and CFO resignation in September 2018; and \$619 million in 2012.
Société Générale	France	Investigations on violations of U.S. And French anti-corruption laws in connection with historical conduct involving Libyan counterparties.	Approximately €500 million in June 2018 and bank's remedial steps to ensure that its internal policies, procedures and controls are designed to prevent and detect violations of the relevant anti-corruption and bribery laws.
Pilatus Bank	Malta	Bank's owner and chairman accused of having set up a scheme to funnel money illegally from Venezuela to Iran to avoid U.S. economic sanctions.	The Maltese FSA froze the assets of Pilatus Bank in March 2018, after the chairman was arrested. The removal of Pilatus Bank's banking licence is pending upon ECB's decision.
Versobank	Estonia	Serious and long-lasting breaches of anti-money laundering and combating the financing of terrorism standards.	Liquidated in March 2018.
ABLV Bank	Latvia	Named by FinCEN as an institution of primary AML concern due to their suspicion that weak controls left it open to money laundering by non-resident clients.	FinCEN announced its intention to block US dollar correspondent banking activity for ABLV. Bank suffered a deposit run, and was closed down in February 2018.
Rabobank	Netherlands	Deficiencies in anti-money laundering compliance program and related conduct by former employees before 2014.	Approximately €298 million in February 2018.
Deutsche Bank	Germany	Unidentified customers transferred about USD10 billion, of unknown origin, from Russia to offshore bank accounts in a manner that may be consistent with financial crime.	€585 million in 2017, plus commitment to substantial remediation program. (US Dept. of Justice investigation remains unresolved.)
Credit Agricole	France	Allegations of U.S. dollar transactions between 2003 and 2008 subject to U.S. economic sanctions and certain related New York state laws.	Settlement of €693 million in 2015 and three year deferred prosecution agreement with US authorities. The bank has taken important voluntary steps to improve its procedures and controls that are necessary to ensure strict compliance with applicable sanctions regulations.

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Bank	Headquarters	Allegations and Legal Shortcomings	Fines and Other Consequences
Commerzbank	Germany	Allegations of breaching U.S. sanctions between 2002 and 2008, and failure to maintain adequate anti-money laundering practices between 2008 and 2013.	€1,196 million in 2015.
BNP Paribas	France	Allegations of processing billions of dollars of transactions through the U.S. financial system on behalf of Sudanese, Iranian, and Cuban entities subject to U.S. economic sanctions.	Almost \$9 billion in 2014 and other remedial steps.
Standard Chartered	U.K.	Allegations of hiding funds in transactions with Iran from U.S. authorities before 2012, and continued failures to remediate anti-money laundering compliance problems as required in the Bank's 2012 settlements with the U.S. authorities.	\$300 million in 2014 and \$667 million in 2012. Business restrictions with certain clients and two years monitoring of AML rulebook in 2014 agreement.
Royal Bank of Scotland	U.K.	Allegations of breaching U.S. economic sanction regulations outside the U.S..	\$100 million in 2013 and \$500 million in 2010.
HSBC	U.K.	Failing to maintain an effective anti-money laundering program and to conduct appropriate due diligence on its foreign correspondent account holders. The bank breached U.S. sanctions by illegally conducting transactions on behalf of customers in Cuba, Iran, Libya, Sudan and Burma.	\$1.9 billion in 2012 and five year deferred prosecution agreement with US authorities.
Barclays	U.K.	Violations related to transactions Barclays illegally conducted on behalf of customers from Cuba, Iran, Sudan and other countries sanctioned between 1990 and 2006.	\$298 million in 2010.

Source: Banks' Ad-hoc announcements and Authority statements.

Some Cases Are More Troubling Than Others

While any censure of a bank for AML and/or sanctions deficiencies is of concern, in our view the causes, fact pattern, and consequences can vary significantly in their gravity.

In many cases, problems have originated from weaknesses in a specific bank's governance standards, operational processes, risk controls or risk appetite, or a combination of these factors. While, by their nature, all cases involve historic deficiencies, some can be more easily seen as legacy issues that are unlikely to recur, whereas others point to problems that continue to leave the bank exposed and needing remediation. In extreme cases, remediation programs can take

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years and be more expensive than the related fines/settlements.

The extent of wrongdoing also varies. There have been numerous cases of regulators, notably in the U.S., issuing less serious enforcement actions against banks, ordering them to improve their AML systems and controls even though no actual money laundering was found. But for many of the European cases, the very reason that deficiencies were identified was in part because law enforcement bodies were already examining potential criminality, or else because whistleblowers sounded the alarm about such activity. For example, the DOJ statement of facts for the 2012 HSBC case indicates that at least \$880 million of drug trafficking proceeds were laundered through HSBC Bank USA. And Danske Bank's internal investigation published in September 2018 identified €200 billion of cross-border transactions as potentially questionable--though the volume that are confirmed as truly suspicious could well be lower. The conduct of the firm can also be an aggravating factor. As regards settlements, the costliest cases have typically involved more than just lax or substandard controls. For example, ING was censured for serious controls deficiencies. By contrast, BNP Paribas--whose fines were significantly higher than ING's--admitted to have actively concealed payment information on sanctioned transactions and was perceived by law enforcement to have initially refused to fully cooperate with their investigation.

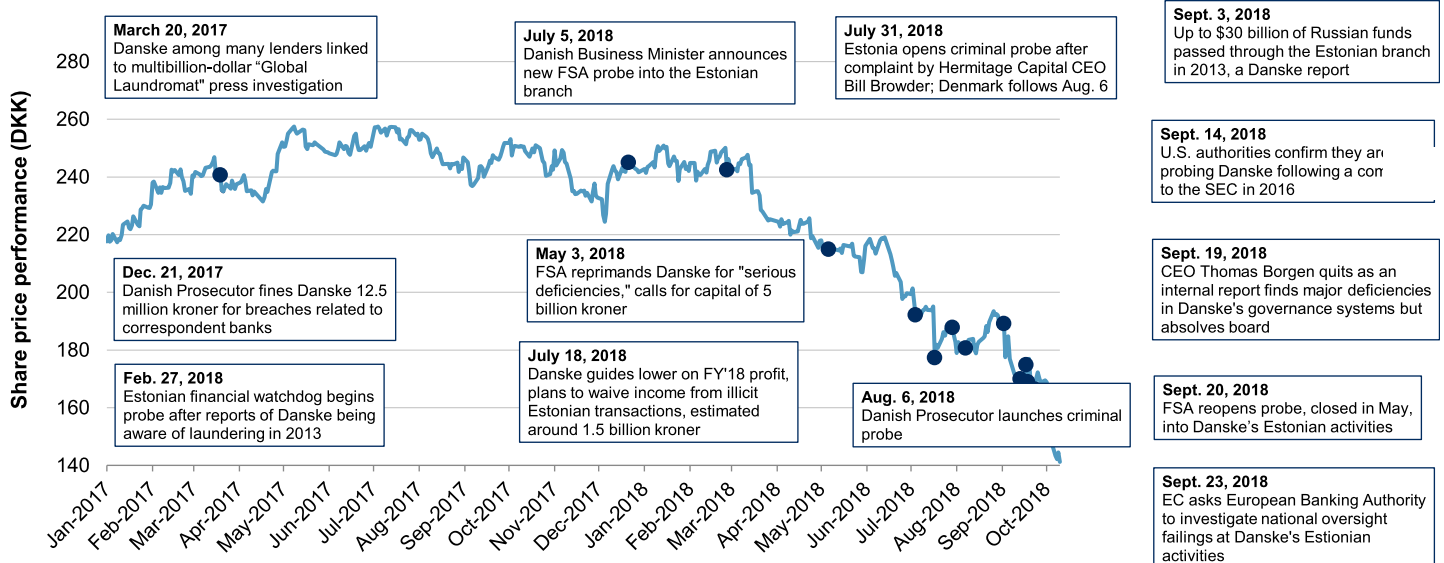
Bank-specific problems aside, we observe that some cases may be symptomatic of deeper, intrinsic problems in a banking system, for example due to weaker AML standards or ineffective supervision, being in jurisdictions that have close ties with sanctioned countries, or which offer tax advantages to nonresidents or strict secrecy.

In terms of consequences for the affected banks, we see three main types:

- First, the shortcomings in internal controls and related governance failures might not be limited to AML/sanctions compliance, but rather could be more pervasive within the institution. AML/sanctions cases tend to be more significant and have lasted longest where there has been a breakdown in all three lines of defence--front-line staff, independent risk management, and internal audit. This is of particular concern where the failures and weaknesses are not obviously purely historic in nature.
- Second, substantial fines, settlements, and remediation costs could have a sizable effect on earnings or even capitalization. This is admittedly rare, since negotiated settlement size tends to be dictated in part by the depth of the offending bank's pockets, but aggravating factors can weigh heavily also.
- Third, there could be substantial damage to a bank's franchise. This could arise from direct restrictions imposed on the banks' business activities, or else be a reputational problem that affects its credibility and client loyalty. This can spill over into a severe and sustained weakness in investor confidence, as the significant negative impact on the stock price (see chart 1). In turn, a bank could face constrained supply or more expensive roll-over of their wholesale funding due to the increased risk premium investors require. In extremis, and the ABLV case is highly unusual in this regard (not least because its business model depended so heavily on nonresident clients), the bank could suffer a deposit run.

Chart 1

Estonian Money Laundering Control Failures Haunt Danske Bank



Data compiled Oct. 4, 2018. Data is for Jan. 2, 2017, through Oct.4, 2018. FSA--Danish Financial Supervisory Authority. DKK--Danish kroner. Source: S&P Global Market Intelligence.

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To date, we observe that after AML/sanctions issues arise, bank stock prices--after an initial reaction--have generally recovered somewhat once the range of likely penalties becomes reasonably estimable. It remains possible, however, that with the rise of ESG-led investment policies, the market might be somewhat less forgiving in future.

Ratings Implications Are Mixed

Reflecting the above factors, AML and sanctions cases carry mixed rating implications. We see greater risk for a bank where the case reveals widespread internal control and organizational failures, where there is a risk of substantial fines and remediation costs that could have a sizable effect on earnings or even capitalization, and where there could be sustained reputational or franchise damage. By contrast, while not insignificant, cases carry fewer implications where they relate to demonstrably historic, discrete failures, with rather more limited financial and/or franchise impact, or where management teams take actions to preserve capital in light of potential fines.

Given that the cases highlighted in table 1 differed significantly in their nature and magnitude, it follows that they led to differing rating outcomes. Our rating actions also reflected whether we saw the case related to bank-specific weaknesses or rather to a systemic issue involving our assessment of an entire banking industry. They also reflect other unrelated factors that may be bearing on the rating at the time.

At the most benign end, we took no rating action on banks involved in sanctions cases like Lloyds, Barclays, and Commerzbank where we considered the creditworthiness of the banks involved to

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have been materially unaffected by the settlements and the control implications to be limited. Commerzbank was also an example where we already recognized the bank's relatively weaker risk management record than peers. ING reached a more expensive settlement, in relative and absolute terms, in 2018, but the case related to control deficiencies rather than proven money laundering and it was able to easily absorb the settlement cost within current year earnings.

Examples with more significant rating implications include:

- Danske Bank: In September we affirmed our 'A/A-1' issuer credit ratings (ICRs) and lowered our issue ratings on the bank's subordinated debt. We would have lowered the ICR if we had not also recognized the bank's growing bail-in buffer. Law enforcement agencies in Europe and the U.S. are investigating the case and a substantial settlement appears inevitable in our view. It also remains uncertain whether there could be any other consequence, beyond the management changes that already took place. Our outlook is negative.
- BNP Paribas: In July 2014, we affirmed our 'A+/A-1' ICRs and removed them from CreditWatch, but lowered our issue ratings on the bank's subordinated debt. The huge fine consumed the group's 2014 earnings. Despite BNP Paribas' capacity to restore its capitalization rapidly (within a couple of years), the fine weighed on the group's retained earnings, hence on the loss-absorbing capacity of the group, and contributed indirectly to our lowering of the long-term ICR to 'A' in 2016.
- HSBC: In mid-2012, we assigned a negative outlook to the bank after its \$1.9 billion settlement and entry into the five-year DPA. We saw the settlement sum as affordable, but the failures as potentially symptomatic of a broader failure of the group's enterprise risk management. In addition, the DPA carried with it the threat of a damaging constraint on the bank's direct access to dollar clearing, something that is crucial to its position as a leading institution in global trade finance, and its U.S. franchise. We removed this as a potential downgrade driver only in late 2014 after the bank appeared to make good progress in its subsequent remediation.

Whereas the actions above have centered on individual banks, in recent months we revised our Banking Industry Country Risk Assessments (BICRAs) on Estonia and Malta due to a changed perception of regulators' effectiveness.

In the case of Malta, for example, the allegations of money laundering against Pilatus Bank, a small international bank, and our perception of poor transparency at some banks have increased reputational and operational risks for the Maltese banking sector. This ultimately resulted in us lowering the rating on the largest Maltese bank, Bank of Valletta (BOV), although the bank was not itself under investigation for AML breaches. This is because even if potential weaknesses in Malta-based internationally-oriented financial institutions do not pose direct risks for the domestic financial stability, the jurisdiction's reputation could be at risk, in our opinion. In this context, we may see Maltese banks, including BOV, adjust their business models to focus more on their domestic operations. We also anticipate that some banks are likely to increase provisions against some litigation and reputational risks, which could hamper their capitalization and earnings.

The still-high proportion of nonresident deposits and relatively weaker transparency are two reasons why we continue to see relatively high institutional risk in Cyprus. Swiss and Liechtenstein-based banks also operate in key financial centers for international wealth. However, while some residual AML/sanctions cases continue to filter through these jurisdictions, they now operate in a legal environment that is far more supportive of tax transparency.

More Work Needed To Combat Money Laundering In Europe

While we see signs of progress, at this stage there are few reasons for us to be optimistic that such problems will not recur in Europe, at least in the near-to-medium term. In part, this reflects the ever-evolving nature of the threat and the need for banks to continue to adapt their control systems by increasing sophistication, and that bank control frameworks target substantial risk mitigation but not 100% risk elimination. In part, it reflects a still fragmented and uneven application of regulatory standards.

Positively, we observe that many internationally-active European banks have exited their higher risk correspondent banking relationships in recent years and devoted increased resource to AML and sanctions compliance. However, simply hiring more staff to tackle the problem is not a viable long-term solution for banks, particularly when they are already under a degree of profitability pressure. We anticipate that banks' greater use of technology (notably machine learning and AI) could improve the sophistication and efficiency of their control frameworks, if implemented correctly.

At a system level, increased global information sharing, for example the automatic exchange of tax-related information under the OECD's Common Reporting Standard, could improve detection rates and inhibit some criminal activity. That said, while we acknowledge that international cooperation and information-sharing is generally not visible to outside observers, on the face of it in the last 10 years it was the U.S. authorities that were seemingly central to the pursuit of the vast majority of the high profile cases when European banks appeared to have breached sanctions or AML regulations (see table 1). They have also carried by far the biggest stick historically--in terms of financial and business consequences for offenders--although ING's substantial settlement with the Dutch authorities suggests that this might be changing. It may be also that European supervisors are becoming more intrusive--in September, the German regulator BaFin appointed an external auditor for three years to monitor Deutsche Bank's progress in remediating its AML and sanctions controls--apparently, the first time it has done so for any bank.

There appears now clear recognition among European policymakers that, notwithstanding the strength of the existing and incoming requirements of EU money laundering directives, the effectiveness and enforcement power on the operational level needs a boost. Part of the problem is that while AML legislation is set at the EU level, most of it seeks to achieve only a minimum degree of harmonization, and may not always be implemented consistently in the EU member states. It is enforced by national, not regional, supervisors, with competence for AML (and broader conduct of business) supervision sometimes also split between regulators in each member state. Combating money laundering remains the responsibility of the national competent authorities in the EU, in most cases the country's Financial Intelligence Unit (FIU) and financial supervisory authority.

No matter how strong the supervision in one country, international cooperation between intelligence units and supervisors remains key to identifying and stopping illegal money flows. There is currently no pan-European supervisory body for AML matters, and from previous cases it appears that the cross-border coordination and information exchange between the authorities could be more timely, responsive, and effective.

While we expect no immediate practical change, positively the 2018 AML cases have catalyzed policymakers across the bloc to address this problem. Notably, in September, the European Commission proposed to give more power to the European Banking Authority (EBA), enabling a better cross-border communication of authorities, a faster exchange of critical information, and stricter controls to check whether AML laws are enforced effectively in EU member states. The

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EU's imminent directive on Combating Money Laundering by Criminal Law additionally seeks to toughen penalties for money laundering and pushes relevant member states to address the risks posed by virtual currencies.

However, the pace and effectiveness of change will depend also on strong commitment and initiatives at member state level to take a critical eye to the national implementation of financial crime laws, aided by independent assessments by bodies like FATF and Moneyval, and address fully any identified areas of weakness.

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

Related Research

- Danske Bank Outlook Revised To Negative, Hybrids Downgraded, On Further Disclosure On Money Laundering Issues In Estonia, Sept. 25, 2018
- Estonia's Banking Sector To Benefit From Receding Imbalances But The Regulatory Track Record Is A Relative Weakness, Sept. 20, 2018
- ING Groep's Earnings Can Absorb €775 Million Settlement With Dutch Authorities; Ratings Unaffected, Sept. 4, 2018
- Malta-Based Bank of Valletta Rating Lowered To 'BBB' On Increased Industry Risk; Outlook Remains Negative, Aug. 1, 2018
- Société Générale Ratings Unaffected By Litigation Settlements Relating To IBOR And Libya Investigations, June 5, 2018
- Gone But Not Forgotten: Orderly Failure Of Latvia's ABLV Bank Leaves Ripples Of Discontent, Feb. 27, 2018
- European Banking Union 2.0: The Creation Of A True Single Market? Nov. 6, 2017

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