

EUROPEAN BANKS SURPRISE TO THE UPSIDE AGAIN

Wisdomtree EU
25 Nov 2020

While European bank earnings per share for Q3 2020 generally beat earnings per share (EPS) estimates¹, European banks were not unscathed from the economic impact noted in the first half of 2020. The interest rate environment remains low and continues to weigh on revenues meanwhile the deteriorating economic picture has led to a rise in loan loss provisions for banks. Amidst this backdrop, it appears that the reported common equity tier 1 ratios (CET1) at European banks rose once again compared to the second quarter 2020. The CET1 ratio measures a bank's core capital as a percentage of its risk-weighted assets and can act as a cushion against unexpected loan losses. In this blog, we will explore some key drivers influencing European banks and what it could mean for the sector in 2021.

But why would the CET1 ratios rise in times of crisis?

At the start of the crisis, regulators asked banks to stop dividend payments and delay share buybacks to help secure more cash at the banks amid the uncertainty². Banks remain an integral part of the European economy and regulators remain in support of the idea that the banking system should continue to run smoothly, and systemic risk should be contained. As banks were asked to expand their balance sheets to provide loans to companies and households during the pandemic, governments stepped in to provide public guarantees for large portions of these loans helping to maintain liquidity in the economy amid rising fears the lockdown could trigger a sharp rise in bankruptcies. Given that banks hold government bonds within their assets partly for their lower risk profile in Basel III reporting, the strong performance in European government bond assets year-to-date has translated to a rise in the value of those assets for banks. One component that has supported banks this year.

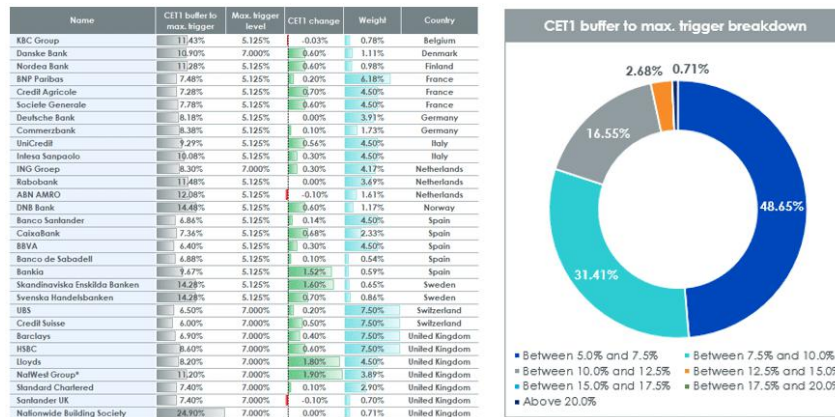
Banks have also benefited from a rise in demand for credit and greater trading activity this year, although some of this was outweighed by the rise in loan loss provisions (LLPs) stemming from the pandemic. Loan loss provisions can be a forward-looking measure on how banks may be assessing some of the loans within their loan books. The aggregate LLPs for 26 issuers within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 Index) was \$14.4 Bn, a 55% drop from the \$31.7 Bn in LLPs reported for the second quarter 2020 for the same issuers within the AT1 index³. A drop in LLPs for Q3 2020 could indicate that banks are more optimistic about the outlook given the massive amounts of central bank intervention. The European banking system continues to benefit from extraordinary central bank support to the real economy that has helped mitigate the economic impact that some of the rare government restrictions have had on households and companies. A few notable measures that governments have launched this year include loan guarantees, implemented furlough schemes, permitted mortgage holiday periods, injected significant amounts of capital into hard hit industries and allowed banks to temporarily waive some of the accounting rules to support their balance sheets amid the crisis.

What does this mean for banks?

With the potential for a Covid-19 vaccine passing phase III testing next year, 2020 could reflect the bottom in European economic activity and European banks' CET1 ratios appear not have been dented during 2020 thus far. A viable vaccine could mean a swifter recovery than initially forecasted and upside potential for bank balance sheets although this must be considered within the context of lower bank earnings. In the wake of the news on the efficacy of Pfizer's vaccine, STOXX Europe 600 Banks jumped 20.38%⁴. As noted in Figure 1, CET1 ratios have generally risen from the second quarter of 2020 to the third quarter of 2020. An upward trend that has continued since the start of the year.

While Europe enters the second wave of the health crisis and lockdown measures are reinstated, the European Central bank (ECB) will likely need to provide further relief to the economy over the next few months supporting growth and inflation. Two measures the ECB could take are to lower the rates charged to Banks' on the targeted longer-term refinancing operations (TLTRO III) as was the case earlier this year, in addition, to expanding the size of the pandemic emergency purchase programme (PEPP) to help alleviate further tightness in credit lending to the real economy and reignite growth⁵. In the absence of these measures, Banks may need to tighten their lending standards as they prepare for further economic weakness in the next few quarters.

Figure 1: Latest reported CET1 ratios for European Banks



Source: WisdomTree, Markit, Bloomberg, respective issuers financial results. CET1 ratios based on the data available as of 16 November 2020. Index constituents data as of 31 October 2020. CET1 change represents value change in CET1 ratios from data available as of 31 August 2020 compared to latest data available as of 16 November 2020. No change may indicate reporting cycle has not ended. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 Index). CET1 ratio is the Common Equity Tier 1 Capital ratio reported on a fully loaded basis available on Bloomberg and from the issuer's latest financial results, if not reflected on Bloomberg. Maximum trigger level is represented by the maximum trigger observed across all CoCo issues of a given issuer. The CET1 buffer to maximum trigger represents the difference between issuer's CET1 ratio and the maximum trigger level observed across all CoCo issues of a given issuer within the AT1 Index. The sum of "CET1 buffer to maximum trigger" and the "maximum trigger level" is equal to the issuer's CET1 ratio. *Royal Bank of Scotland changed its name to NatWest Group effective 22 July 2020.

Historical performance is not an indication of future performance and any investments may go down in value.

¹ Source: Bloomberg as of 16 November 2020, considering the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (ticker IBXXXCL1) as a representation of the European banks universe.
² Source: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_1~42a74a0b86.en.html.
³ Source: Bloomberg as of 16 November 2020. Loan loss provisions (LLPs) are effectively an income statement expense set aside as an allowance for uncollected loans and loan payments. It can be a forward-looking measure on how banks may be assessing some of the loans within their loan books. LLP data for Q2 and Q3 2020 is based on the aggregate LLP figure for the 26 issuers within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 Index) that had available data in Bloomberg as of 16 November 2020.
⁴ Based on the performance of the STOXX Europe 600 Banks Net Return EUR Index from the close on 06 November 2020 to the close on 16 November 2020.
⁵ Source: ECB website: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312_1~39db50b717.en.html.

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