DO YOU WANT TO TAKE AN INITIAL PEEK INTO THE CAPITAL BUFFERS OF EUROPEAN BANKS?

Wisdomtree EU
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As the fast spread of Covid-19 triggered governments globally to impose strict lockdown restrictions, companies that were not operating in essential services and goods were left depending on their cash reserves to initially help them survive the loss in revenues. Luckily, central banks have realised the magnitude of such a measure on the economy and have launched support packages well in excess of those put in place during the 2008-09 financial crisis. At the core of the support system in Europe, the European banking system is meant to continue to provide lending to the real economy to facilitate some of the life support provided by central banks. As part of the support framework, many countries are providing state backed loans for companies which can relieve some of the blow to the banks' balance sheet if loan losses begin to significantly rise in the later half of 2020. Amid the macro backdrop, Banks are in a better position today to weather the economic storm than during the last financial crisis and there could be part of the bank's capital structure where investors may find the right balance between risks and rewards. In this blog we will look into the bank's common equity tier 1 (CET1) ratio where investors seeking exposure to additional tier 1 contingent convertible bonds (AT1 CoCos) will typically take a closer look before considering the asset class.

Two areas that can help provide an initial insight into the impact on Banks are:

- Bank (Issuer) credit ratings

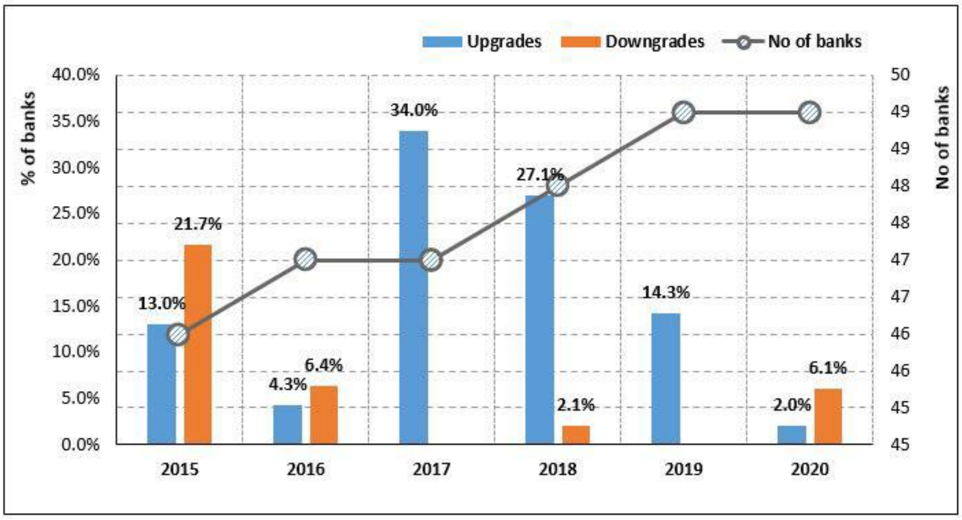
- Common Equity Tier 1 ratios (CET1)

Issuer credit rating trends to 19th May 2020

The average issuer rating for European Banks that issue AT1 CoCos is still investment grade but we note that 29 of 49 banks within the universe now have a negative credit outlook which reflects a new trend from year-end 2019 when the majority of issuer ratings had a stable outlook. Since the impact of Covid-19 on bank balance sheets is not fully reflected in the current financial data, we can expect more scope after Q2 2020 and may see rating agencies take action towards the downside with potential rating downgrades in the second half of the year. As referenced in Figure 1, there is a slight trend already reflected in the data indicating more issuer credit downgrades than upgrades in 2020.

Figure 1: Historical quarterly credit rating trends of European banks issuing

AT1 CoCos



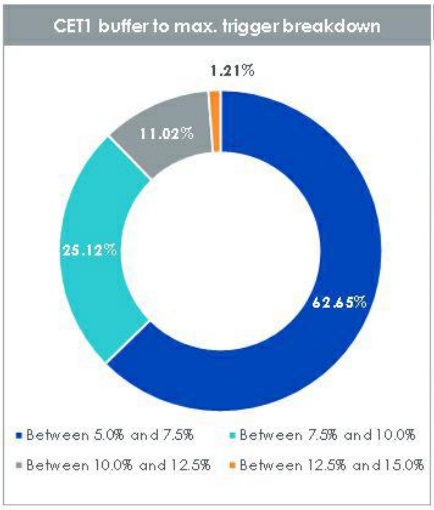
Source: WisdomTree, Bloomberg. Period from 31 December 2014 to 19 May 2020. Credit rating distribution is as of 19 May 2020. **The universe of banks** is represented by the banks from European countries issuing AT1 CoCos within the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index as of 30 April 2020. Banks that do not have historical rating data available for 2 consecutive quarters in Bloomberg as of a given quarter end are disregarded in the aggregate figures for that quarter. **Rating** is the S&P long-term local currency issuer credit rating reported by Bloomberg. **Upgrade** is an improvement in the rating as of a given quarter end as compared to a previous quarter end. **Downgrade** is a deterioration in the rating as of a given quarter end as compared to the previous quarter end. **Rating upgrades/downgrades** are based on quarterly data within each given year. **No of banks** is the maximum number of banks per quarter in a given year with existing ratings data from Bloomberg. **% of banks** is the percent of banks experiencing either upgrade or downgrade as compared to the **No of banks** in that given year.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Have the CET1 ratios fallen sharply?

The CET1 ratios for European banks within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 Index) displayed a decrease of no more than 1.1% from Q4 2019 to Q1 2020 as reflected in the quarterly data reported on Bloomberg for issuers to 19 May 2020. Furthermore, on 25 May 2020 the European Banking Authority published their preliminary assessment of the impact of Covid-19 on the EU banking sector and noted that the banks entered the crisis with strong capital and liquidity buffers. While they note that the effects of the crisis will have an impact on the asset quality and profitability of banks, they believe that the capital accumulated prior to the crisis tied to the capital relief provided by regulators amounts to a buffer above their overall capital requirements (OCR). In their perspective, the capital buffer is expected to allow banks to withstand the potential credit risk losses which they derived from a sensitivity analysis based on the 2018 stress test[1]. The European Central Bank (ECB) has already taken a number of steps to help assist banks which it directly supervises have the capacity to continue to provide funding to the real economy amid the Covid-19 crisis.

Figure 2: CET1 ratios buffer to maximum trigger: issuer level overview



Name	CET1 buffer to max. trigger	Max. trigger level	Weight	Country
KBC Group	11.21%	5.125%	0.76%	Belgium
Danske Bank	10.40%	7.000%	1.11%	Denmark
Nordea Bank	10.88%	5.125%	0.96%	Finland
BNP Paribas	6.88%	5.125%	6.35%	France
Credit Agricole	6.28%	5.125%	4.29%	France
Societe Generale	7.48%	5.125%	6.09%	France
Deutsche Bank	7.68%	5.125%	3.43%	Germany
Commerzbank	8.08%	5.125%	0.68%	Germany
UniCredit	8.32%	5.125%	4.91%	Italy
Intesa Sanpaolo	9.38%	5.125%	3.63%	Italy
ING Groep	7.00%	7.000%	4.28%	Netherlands
Rabobank	11.18%	5.125%	4.16%	Netherlands
ABN AMRO	10.30%	7.000%	1.59%	Netherlands
DNB Bank	13.08%	5.125%	1.21%	Norway
Banco Santander	6.46%	5.125%	5.68%	Spain
CaixaBank	6.78%	5.125%	1.63%	Spain
BBVA	5.72%	5.125%	3.78%	Spain
Banco de Sabadell	6.48%	5.125%	0.46%	Spain
Bankia	7.83%	5.125%	0.52%	Spain
Skandinaviska Enskilda Banken	11.68%	5.125%	1.53%	Sweden
Svenska Handelsbanken	12.48%	5.125%	0.91%	Sweden
UBS	5.80%	7.000%	7.50%	Switzerland
Credit Suisse	5.10%	7.000%	7.50%	Switzerland
Barclays	5.70%	7.000%	7.50%	United Kingdom
HSBC	7.60%	7.000%	7.50%	United Kingdom
Lloyds	7.20%	7.000%	4.60%	United Kingdom
RBS	9.60%	7.000%	4.45%	United Kingdom
Standard Chartered	6.40%	7.000%	2.31%	United Kingdom
Santander UK	7.40%	7.000%	0.67%	United Kingdom

Source: WisdomTree, Markit, Bloomberg. Updated CET1 ratio figures downloaded from Bloomberg on 8 September 2020. CET1 ratios data as of 31 May 2020. Index constituents data as of 30 April 2020. 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.

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Potential opportunities amid the economic landscape

The CET1 ratios of European banks in the first quarter of this year have only been marginally impacted thus far from generally very healthy levels at the start of 2020. As noted by the regulators, the capital buffers reported by European banks are in a better position to weather the current crisis than they were during the 2008-2009 Global Financial Crisis. While a key risk to this view is that the impact of the virus might last significantly longer than initially anticipated and the resulting impact on the economy is greater than had been projected, an extreme scenario such as that would likely have a negative impact across risk assets. Considering this risk, the coordinated central bank efforts and banking authority measures initiated amid the crisis appear to provide strong support for the banking system and are aimed at potentially helping to mitigate some of the broader systemic risks on the European banking system.

Additional Tier 1 Contingent Convertible bonds which faced strong volatility, albeit less severe than European bank equities, have experienced a strong rebound in April and May. While the AT1 index as represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 USD Unhedged index (AT1 Index) is down -5.59% year-to date to end of May 2020, from the trough in performance on 19 March 2020 to end of May the asset class returned 31.08% benefitting from the robust rebound in credit spreads of the subordinated debt from financials following the strong monetary support from the European Central Bank and European Commission. For investors considering investments in risk assets such as AT1 CoCos, investors should be comfortable with both the risks and rewards inherent in the asset class.

Source

[1] Source: www.eba.europa.eu publication "COVID-19 is placing unprecedented challenges on EU banks" 25 May 2020. Details of some of the measures put in place by the European Central Bank in March 2020 can be found on the European Central Bank Banking supervision website www.bankingsupervision.european.eu

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