HOW REGULATION STOPPED THE BANKS FROM BLEEDING IN Q2?

Wisdomtree EU
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The first quarter of 2020 was a not so distant memory of the start of lock down measures globally due to Covid-19. For the month of March, one would expect to see the start of a very deep impact on bank balance sheets as companies were asked to close their doors to new business. Upon reviewing the 1Q 2020 financial data for European banks within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 index), we noted that the common equity tier 1 capital ratio (CET1) of these banks fell only modestly with the biggest drop being 1.1% from Dec 2019 to 1Q 2020 as reported by Bloomberg data.

Since the second quarter was the period where strict lockdown measures globally impacted most of the quarter, one would expect more insight about the economic impact on bank balance sheets to be visible in 2Q 2020 financial data. While it is clear that European banks are facing an elevated amount of loan losses and a hit to their revenue over the coming years, we note that the CET1 ratios of a majority of banks within the AT1 index actually rose from 1Q 2020 to 2Q 2020. In this blog, we will review some of the changes that have been impacting European banks and discuss why some believe European banks will have more support than many non-financial corporates during the crisis.

What kind of non-performing loan losses are predicted?

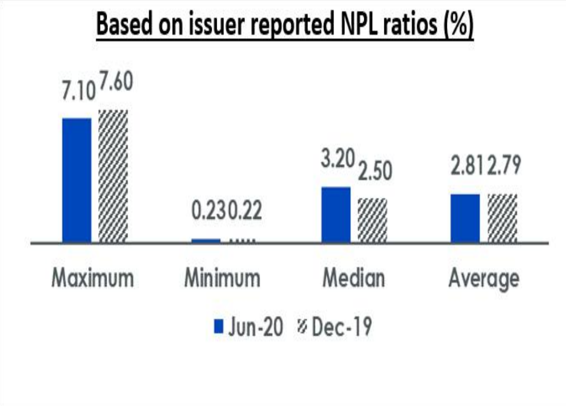
While the EU wide stress tests for 2020 were postponed this year as regulators asked banks to focus on dealing with the Covid-19 crisis and continue to lend to companies and households, we can look to different sources which have undergone their own analysis of the sector amid the crisis. Olyver Wyman, a leading management consultant firm, published a report on 30 June 20201 that provides some interesting insights on European banks, defined as those reporting data to the European Banking Authority (European Union, United Kingdom, Norway).

- Under their base case or expected scenario, where most countries avoid a second wave of sustained and comprehensive country wide lockdowns, the amount of bad debt at European banks would surge to €400bn which they estimate to be around 2.5 times the level seen in the last three years. While this figure is sizeable, the report draws a comparison to the global financial crisis (GFC) of 2008-10 and highlights that losses from COVID-19 would be less than 40 percent of those experienced during the GFC and a similar overall level to the Eurozone crisis of 2012-14.
- In the worst-case scenario, where a severe second wave of the Covid-19 virus occurs and governments choose to apply country wide lockdowns again, the bad debt figure would rise to €800bn or around 10% of their total lending.
- The report also notes that in their expected scenario, they forecast around 70 percent of banks in the European Union and United Kingdom to maintain a CET1 ratio of greater than 12 percent.

In light of the magnitude of the economic impact that broad lockdown measures has had on the global economy, these estimates highlight that the regulatory reforms imposed on banks to increase their capital position among other things following the GFC have helped support banks during this crisis. These estimates also provide insight to investors in additional tier 1 contingent convertible bonds (AT1 CoCos) where the trigger level for AT1 CoCos are typically associated with CET1 capital ratios of 5.125% for low-trigger CoCos or 7% for high trigger CoCos.

In Figure 1, we note that the average non-performing loans (NPLs) ratio reported by 19 banks within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 Index) in the 2Q 2020 was 2.81% and remains well below Olyver Wyman's base case prediction. Amid the health crisis and consequent central bank stance, it is no surprise that European banks will face higher credit losses both in their corporate and retail portfolios and continue to deal with margin pressure from accommodative monetary policy in the near term but the data appears to remain below the base case as we conclude the second quarter earnings season.

Figure 1: NPL ratios (company figures from Bloomberg, 19 issuers)



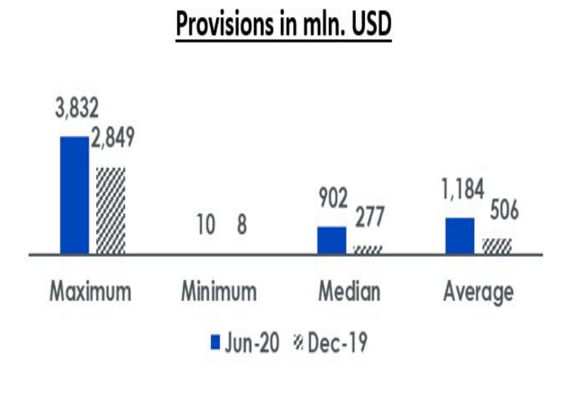
Top 5 banks by NPL ratios (%)

Issuer name	NPL ratio
Intesa Sanpaolo	7.10
Bankia	4.90
UniCredit	4.80
Banco de Sabadell	3.95
BBVA	3.70

Source: Bloomberg, as of 12 August 2020. Presented data covers 19 issuers or 63% index weight within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index based on the constituents data as of 30 June 2020 and include only those with available NPL ratios as reported by the issuers and available in Bloomberg as of 12 August 2020.

In Figure 2, we note the loan loss provisions (LLP) reported by banks with the AT1 index. Loan loss provisions 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. As of 12 August 2020, the latest aggregate LLP figure for the 27 issuers within the AT1 index that have available data in Bloomberg was $32 Bn which as expected has risen compared to $13.7 Bn in December 2019, with issuers such as HSBC reporting the max LLP within the data set.

Figure 2: Loan Loss Provisions for European Banks (Bloomberg figures, 27 issuers)



Top 5 banks by provisions (mln. USD)

Issuer name	Provisions
HSBC	3,832
Banco Santander	3,409
Lloyds	2,964
NatWest Group*	2,552
Barclays	2,015

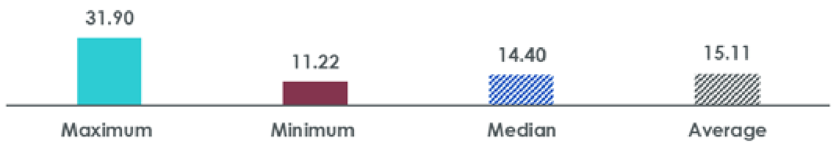
Source: Bloomberg, as of 12 August 2020. Presented data covers 27 issuers or 96% index weight within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index based on the constituents data as of 30 June 2020 and include only those with available provisions data in Bloomberg as of 12 August 2020.
**Royal Bank of Scotland changed its name to NatWest Group effective 22 July 2020.*

In Figure 3, we highlight the 2Q 2020 CET1 ratios reported by European banks within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Apart from a small number of banks, a majority of banks reported CET1 ratios that were higher than that reported for 1Q 2020[3]. Amid the health crisis, central banks and governments have tried to support the banking system by providing state guarantees for certain loans to distressed borrowers meanwhile also providing cheap loans and reduced capital requirements to banks. Among the notable regulatory changes aimed at supporting the banking system are the transitional arrangements for the capital impact of IFRS 9 on Expected Credit Loss (ECL) accounting, the acceleration of certain CRR II measures, and a temporary prudential filter on certain unrealised gains and losses.[2] The average CET1 ratio of issuers within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index was 15.11% with the data set ranging from issuers such as Nationwide with CET1 ratios of 31.9% and the lowest CET1 ratio reported was by BBVA at 11.22%.

Figure 3: Latest reported CET1 ratios for European Banks as of 12 August 2020.

Name	CET1 buffer to max. trigger	Max. trigger level	CET1 change	Weight	Country
KBC Group	11.46%	5.125%	0.25%	0.76%	Belgium
Danske Bank	10.30%	7.000%	-0.10%	1.06%	Denmark
Nordea Bank	10.68%	5.125%	-0.20%	0.95%	Finland
BNP Paribas	7.28%	5.125%	0.40%	6.07%	France
Credit Agricole	6.58%	5.125%	0.30%	4.05%	France
Societe Generale	7.18%	5.125%	-0.30%	5.93%	France
Deutsche Bank	8.18%	5.125%	0.50%	3.56%	Germany
Commerzbank	8.28%	5.125%	0.20%	1.63%	Germany
UniCredit	8.73%	5.125%	0.41%	4.87%	Italy
Intesa Sanpaolo	9.78%	5.125%	0.40%	3.66%	Italy
ING Groep	8.00%	7.000%	1.00%	4.09%	Netherlands
Rabobank	11.18%	5.125%	0.00%	2.70%	Netherlands
ABN AMRO	10.30%	7.000%	0.00%	2.32%	Netherlands
DNB Bank	13.88%	5.125%	0.80%	1.15%	Norway
Banco Santander	6.72%	5.125%	0.26%	5.50%	Spain
CaixaBank	6.68%	5.125%	-0.10%	1.66%	Spain
BBVA	6.10%	5.125%	0.38%	3.68%	Spain
Banco de Sabadell	7.58%	5.125%	1.10%	0.49%	Spain
Bankia	8.15%	5.125%	0.32%	0.55%	Spain
Skandinaviska Enskilda Banken	12.68%	5.125%	1.00%	0.62%	Sweden
Svenska Handelsbanken	13.58%	5.125%	1.10%	0.85%	Sweden
UBS	6.30%	7.000%	0.50%	7.50%	Switzerland
Credit Suisse	5.50%	7.000%	0.40%	7.50%	Switzerland
Barclays	6.50%	7.000%	0.80%	7.50%	United Kingdom
HSBC	8.00%	7.000%	0.40%	7.50%	United Kingdom
Lloyds	7.60%	7.000%	0.40%	4.34%	United Kingdom
NatWest Group*	10.20%	7.000%	0.60%	5.29%	United Kingdom
Standard Chartered	7.30%	7.000%	0.90%	2.91%	United Kingdom
Santander UK	7.50%	7.000%	0.10%	0.66%	United Kingdom
Nationwide Building Society	24.90%	7.000%	0.40%	0.66%	United Kingdom

Based on latest reported CET1 ratios as of 12 August 2020



*Source: WisdomTree, Markit, Bloomberg, respective issuers financial results. CET1 ratios based on the data available as of 12 August 2020. Index constituents data as of 30 June 2020. CET1 change represents value change in CET1 ratios from data available as of 31 May 2020 compared to latest data available as of 12 August 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.***

The second quarter 2020 earnings season reflected an overall improvement in the CET1 ratios of European banks as regulatory changes aimed at supporting the banking system began to take effect. Furthermore, the non-performing loans reported by European banks within the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index remain below the base case scenario estimated by Olyver Wyman for European banks amid the health crisis and by a similar token the more forward looking measure of total loan loss provisions (LLP) which was $32 billion appears contained so far considering the massive lockdown measures that were in place throughout most of the second quarter.

Related blogs

+ [Do you want to take an initial peek into the capital buffers of European banks?]

Source

1 Olyver Wyman report: https://www.oliverwyman.com/our-expertise/insights/2020/jul/european-banking-sector-outlook-2020.html

2 Prudential regulation authority: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/statement-on-crr-quick-fix.pdf?la=en&hash=74FBF81BF3D65D59AC5014A558708F114F376E2C and the European Commission: https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-310-F1-EN-MAIN-PART-1.PDF

3 Data is based on available quarter results but some issuers may have a different reporting cycle and as such quarterly data may not be available on Bloomberg.

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