WHAT DOES THE COVID-19 CRISIS TELL US ABOUT THE EUROPEAN BANKS?

Wisdomtree EU
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2020 has been a remarkable year for investors. A Covid-19 induced lockdown across the world and a subsequent market crash has changed the shape of the global economy. In the months following the crash, investors have been looking at risk assets as they seek to take advantage of undervalued opportunities for growth. Some industries have been hit hard; some have weathered the storm and others have prospered. Going into January it would have been difficult to foresee buoyant industries being hurt so dramatically.

To give a sense of the impact, almost half of the FTSE 100 has either cut, cancelled, or delayed decisions around dividend disbursements until a later date[1]. The European banking sector is no different. The European Central Bank has requested Eurozone banks to stop dividend payments and share buybacks this year to help preserve cash levels amid the economic backdrop of Covid-19.

Sticking with the subject of European banks but looking at Additional Tier 1 Contingent Convertible Bonds (AT1 CoCos), there has been no intervention yet. Regulators have not requested banks to stop the coupon payments of their outstanding AT1 CoCos. Forcing banks to stop the coupon payments of their AT1 CoCos may upset credit spreads of other parts of the bank’s capital structure and create spread widening in the more senior bank debt as well, if investors worry about the financial position of banks. Regulators may be considering their actions and the risk that specific actions may have in creating distress in the banking system amid the existing global economic crisis.

We see three key factors that are interesting to monitor amid the current backdrop:

- Bail-in risk (write down or equity conversion): While this remains a key risk given the market uncertainty around the economic impact of Covid-19 and rising loan loss provisions at banks globally, at the moment this risk appears to be somewhat mitigated by the reported high capital ratios of European banks. Common equity tier 1 ratios for the European banks are relatively high relative to their maximum trigger ratios which are typically 5.125% and 7%. It is important to note that AT1 CoCos allow for a supervisory body to establish when the point of nonviability of a bank has been reached and a statutory bail-in set up is required. Historically, regulators have treaded this line carefully as it could create a lack of clarity for this asset class.

- Coupon non-payment risk appears to be mitigated at the moment as high capital ratios reported at the banks is a positive indicator that banks are meeting their capital adequacy requirements, as deemed by the regulator, to continue to pay coupons. It is interesting to note that CoCo coupons are subject to a maximum distributable amount when they must be cancelled, this is aimed at making sure banks maintain the required capital buffers. Smaller regional banks with lower capital buffers may face greater pressures in this area as they may have lower buffers and more limited access to capital markets than larger banks with higher capital buffers.

- AT1 CoCos not called at first call date (extension risk): this risk is rising as credit markets have been facing a broad-based repricing of risk and yields have risen from the lows of January 2020. Banks with AT1 calls in the next 12 months may choose to extend to the next call date as new issuance cost have risen significantly amid the market environment.

Most issuers, in 2019, called their AT1 CoCos in the run up to their first call in the cases where it was economically sound and, in many cases, replaced existing CoCos with new issuance. Banco Santander was the exception as they did not call one of their Euro denominated AT1 CoCos on their first call date, meanwhile calling their US Dollar denominated AT1 CoCos shortly afterwards. Most recently in 2020, Deutsche Bank (DB) decided not to call their US Dollar denominated AT1 CoCos with their first call date in April 2020. The next call date for these AT1 CoCos appears to be in 5 years' time and DB may decide to call these bonds then when market conditions may be more normalised.

Fundamental credit strength and guidance from the regulator are important aspects to monitor when considering which issuers are in a better position to withstand the current market conditions. Investors that are comfortable with the credit fundamentals of European banks and believe that the regulators may take steps to aid the European banks during the Covid-19 crisis to avoid broad systemic risks in the banking system may consider actively looking at the asset class. While a level of risk is inherent in risk assets, whether equities or AT1 CoCos, investors need to find comfort in them before allocating to any asset class.

Source

+ This is Money: Investors hit by £30bn in dividend cuts as companies fight to survive the coronavirus crisis, 19 May 2020

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