AT1 Quarterly: regulatory backdrop evolves on Covid-19 lessons, final Basel 3 push

The AT1 market continues to be supported by the strengthened capital positions of banks over the last year. Towards the second half of the year, however, we may see some credit losses crystallise and capital distributions resume. In the meantime, the regulatory backdrop surrounding AT1 securities continues to evolve as lessons are gleaned from the Covid-19 pandemic and work on implementing the final Basel 3 package progresses.

Systemic risk buffer now additive and higher O-SII buffer possible

CRD V has introduced material changes to capital buffers after the transposition deadline passed on 28 December 2020. National competent authorities can now set buffers of up to 3% for other systemically important institutions (O-SIIs), up from 2% previously. These can be set on a consolidated, sub-consolidated or individual basis. And with approval from the European Commission, the O-SII buffer could be even higher than 3%.

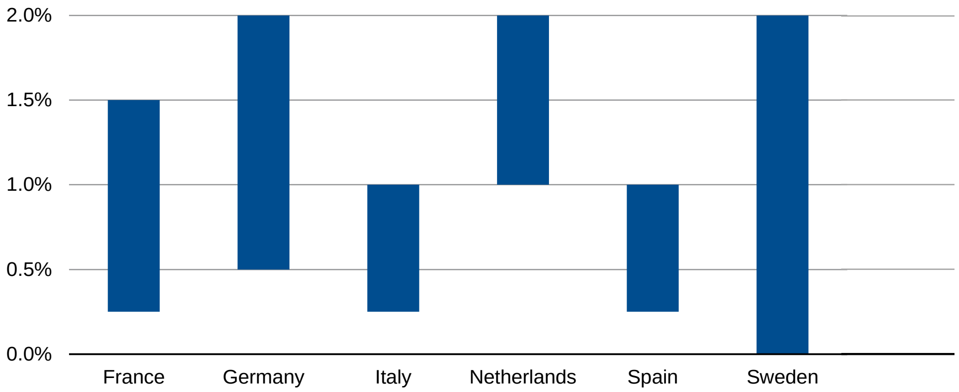
O-SII buffers can also now be offset only against G-SII buffers and not against the systemic risk buffer. In effect, the systemic risk buffer will always be additive to the higher of the O-SII or G-SII buffer.

Proposal to floor O-SII buffer rates

Responding to a request from the European Commission, the EBA published a report in December 2020 on the design and calibration of O-SII buffer rates[1]. Based on a survey of national practices in late 2019, the EBA concluded that there was a great deal of heterogeneity across the EU in buffer rates for O-SIIs with comparable scores. The report pointed to the following:

(a) Sweden and Iceland typically set buffer rates at a high level or for a much wider range of O-SII scores than others; (b) Germany requires O-SIIs to meet capital buffer rates at a relatively higher level than other jurisdictions; (c) Italy and Spain require O-SIIs to meet comparatively lower levels of buffer rates; and (d) in some jurisdictions, O-SIIs are subject to a buffer requirement of 0%.

Figure 1: Distance from maximum to minimum O-SII buffer rates



Note: Data as of year-end 2018.
Source: EBA, Scope Ratings.

Noting the risks associated with the under-calibration of O-SII buffer rates, the EBA recommends that an EU-wide floor methodology be introduced, ideally by 2022, as part of a comprehensive review of the capital buffer framework.

[1] EBA Report on the Appropriate Methodology to Calibrate O-SII Buffer Rates, December 2020.

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Related research

AT1 Quarterly: legacy instruments, infection risk and usability of capital buffers

November 2020

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Opportunity to re-evaluate AT1

Useability of capital buffers a key issue

While immediate concerns remain focused on the asset-quality implications of the pandemic, there is growing attention on the need to prepare for an orderly unwinding of regulatory support measures. The Financial Stability Board (FSB) will be reporting on this issue next month. The FSB has also been working with other standard-setting bodies to review the useability of capital and liquidity buffers. In July, the FSB will report on this work as part of a broader assessment of initial lessons learned from the pandemic.

Potential rebalancing of structural and cyclical buffers

In the last AT1 Quarterly, we wrote about a potential rebalancing of the structural and cyclical elements of the capital stack. Specifically, increasing the level of countercyclical capital buffer in good times so that it can be lowered when needed.

Ongoing discussions about the structure and useability of capital buffers could easily extend into a review of AT1 securities themselves. To meet the 2023 deadline for implementation of the final Basel 3 package, the European Commission is expected to present its legislative proposal for CRR3/CRD6 in the next few months.

CRR3/CRD6 provides legislative opportunity

This review of CRR/CRD provides a legislative opportunity to modify the way AT1 securities work. For some time, their effectiveness as going-concern instruments has been questioned, as minimum CET1 requirements stand well in excess of the 5.125% trigger level.

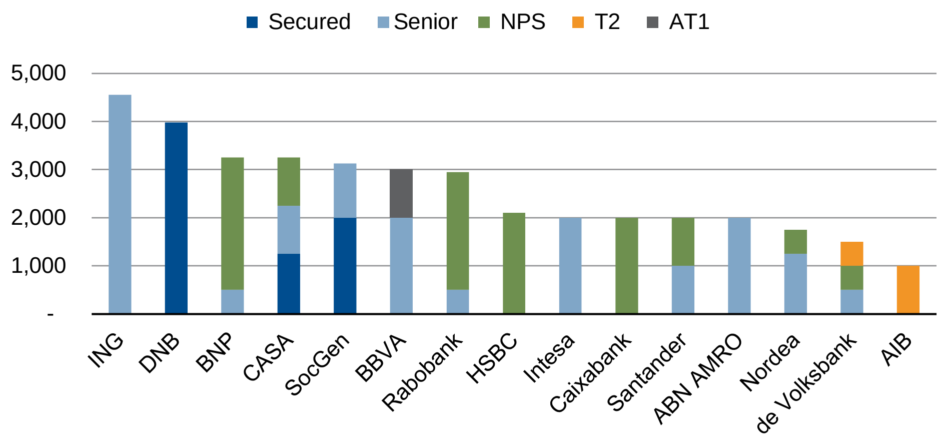
The last year has also highlighted the limits posed by the MDA mechanism. Changes on this front are also possible as shown by the Bank of England. At the end of last year, the restriction on UK banks to make distributions (including AT1 coupons) if doing so caused CET1 capital levels to fall into the combined buffer was removed. As well, the MDA definition was amended to include profits already recognised as CET1 capital over the last four calendar quarters.

Our perspective on green AT1s

Only one green AT1 to date from a European bank

The growing interest by regulators and investors in the role that banks have in addressing environmental concerns is being accompanied by an increase in green bond issuance. To date, almost all FIG issuance has been in senior unsecured format. Only five European banks (De Volksbank, Allied Irish Bank, CaixaBank, Paragon and TSKB) have issued green Tier 2 bonds; seven European insurers have issued green T2s.

Figure 2: Selected green bond issuance (EUR bn)



Note: Figures do not include structured green bonds/notes.
Source: Banks, Scope Ratings.

Only one major bank – BBVA in 2020 – has issued a green AT1 to-date to finance or refinance green eligible assets/projects in its portfolio. The prospectus highlights that there is currently no clear definition (legal, regulatory, or otherwise) or any market consensus as to what constitutes a green project. Consequently, proceeds may not meet investor expectations or be suitable for an investor's investment criteria. In addition, there are concerns about the complexity of maintaining sufficient eligible assets over the lifetime of an AT1 security (although the BBVA deal can be called in January 2026).

A tool for managing client transition

From a credit rating perspective, our focus is somewhat different as we are concerned with how green bond issuance may impact an issuer's creditworthiness. Regarding the "E" in ESG, we tend to concentrate on the potential risks. This includes whether a bank is addressing potential climate-related risks in their business as well as its preparedness for meeting supervisory expectations in this area.

Green bond issuance adds to funding diversification

Green bonds can be part a bank's toolkit for supporting their clients' sustainability efforts. Their use indicates that climate-related risks in the loan portfolio are being actively managed. It also presents a business opportunity and is likely to be perceived well by investors and other stakeholders. Green bond issuance can therefore further diversify a bank's funding sources and investor base. These are all supporting factors for a bank's risk profile and business franchise.

Notable changes to capital requirements

In 2020, regulators took a pragmatic approach to the annual supervisory review and evaluation process (SREP), focusing on the ability of banks to respond to the challenges posed by the pandemic. For ECB supervised banks, this meant that Pillar 2 requirements were stable overall. Meanwhile, UK banks were set nominal Pillar 2A requirements.

There were more meaningful changes on required capital buffers, including:

- Commerzbank's O-SII buffer was lowered to 1.25% from 1.5% in 4Q 2020
- Deutsche Bank's G-SII buffer was lowered to 1.5% from January 2021 but its 2% O-SII buffer is now the prevailing one
- Intesa's O-SII buffer increased to 0.75% from 0.56% as of January 2021. This is now fully phased in

Following changes in CRD V, Sweden moves on buffers

For the three largest Swedish banks (Swedbank, Handelsbanken and SEB), the additional requirements for systemic risks which were previously part of Pillar 2 requirements have been removed. Instead, the O-SII buffer has been lowered to 1% and is now additive to the systemic risk buffer of 3%. With the full implementation of the EU banking package in Sweden, Pillar 2 requirements will also become relevant for the MDA trigger level. They are currently excluded.

Moves to include P2R in MDA trigger level for Nordic banks

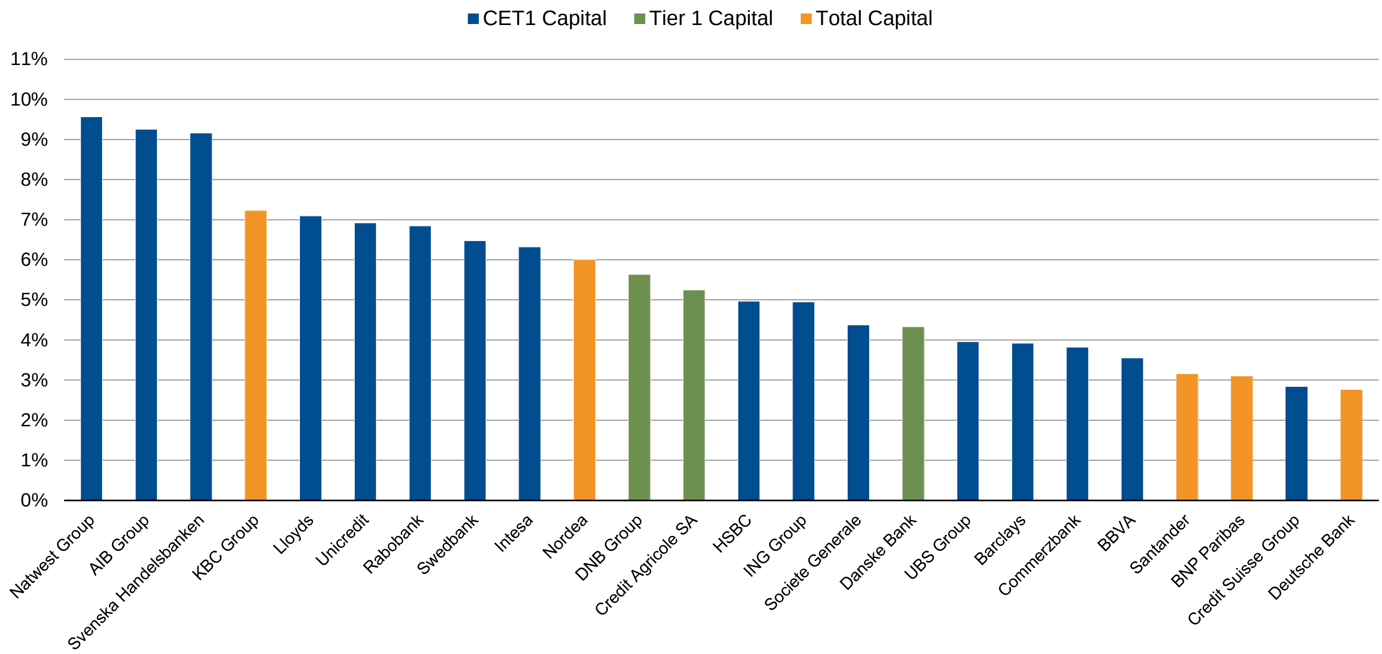
The inclusion of Pillar 2 requirements in the MDA trigger level was implemented in Denmark in 4Q 2020. It has also been included in Norway's proposed implementation of CRD V, expected sometime later this year.

Appendix I: Headroom to MDA-relevant requirements

Various measures implemented last year to support the lending capacity of banks remain in place. Most relevant for AT1 investors, countercyclical and systemic risk buffers were reduced or eliminated. As well, the supervisory guidance on paying dividends for EU and UK banks remain in place until at least September 2021.

Since June 2020, ECB-supervised banks can also meet their Pillar 2 requirements with a mix of CET1 capital and capital instruments. While this does not reduce total capital requirement, it may increase the buffer to the CET1 MDA-threshold.

Below we compare reported capital positions as of year-end 2020 against MDA-relevant requirements. The narrowest buffer to relevant requirements is shown – this may be in relation to CET1, Tier 1 or total capital.



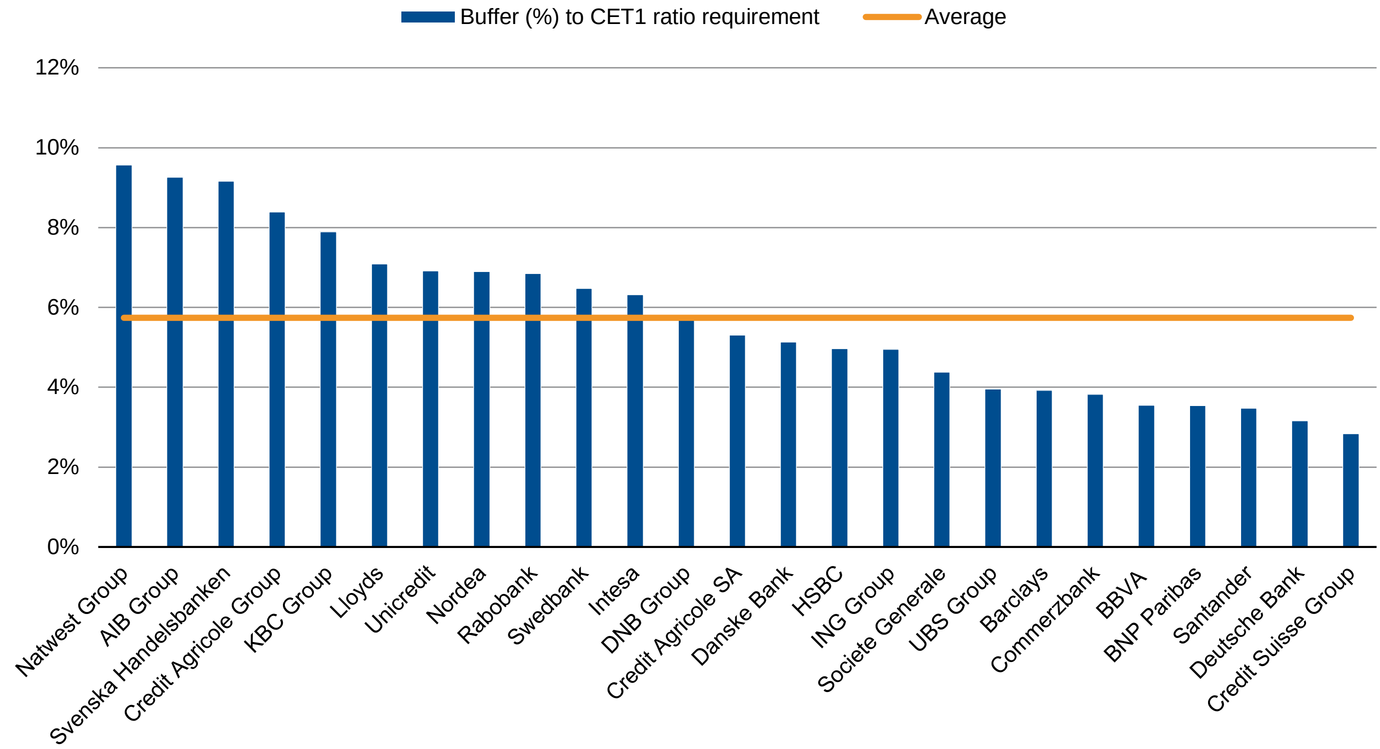
Source: Banks, Scope Ratings estimates.

Appendix II: Headroom to MDA-relevant CET1 requirements

	4Q 2019			4Q 2020				
	Req CET1	CET1 ratio	Buffer	Req CET1	CET1 ratio	Buffer	Currency	Buffer (bn)
AIB Group	11.6%	20.3%	8.8%	9.7%	18.9%	9.3%	EUR	4.9
Barclays	11.7%	13.8%	2.1%	11.2%	15.1%	3.9%	GBP	9.5
BBVA	9.3%	12.0%	2.7%	8.6%	12.2%	3.5%	EUR	12.5
BNP Paribas	9.9%	12.1%	2.2%	9.2%	12.8%	3.5%	EUR	24.6
Commerzbank	10.1%	13.4%	3.3%	9.4%	13.2%	3.8%	EUR	6.8
Credit Agricole Group	9.7%	15.9%	6.2%	8.9%	17.2%	8.4%	EUR	47.1
Credit Agricole SA	8.5%	12.1%	3.6%	7.9%	13.2%	5.3%	EUR	17.8
Credit Suisse Group	9.9%	12.6%	2.7%	10.0%	12.8%	2.8%	CHF	7.8
Danske Bank	11.3%	17.3%	6.0%	13.2%	18.3%	5.1%	DKK	40.2
Deutsche Bank	11.8%	13.6%	1.8%	10.4%	13.6%	3.2%	EUR	10.4
DNB Group	14.0%	18.6%	4.6%	13.0%	18.7%	5.7%	NOK	55.4
HSBC	11.4%	14.7%	3.3%	10.9%	15.9%	5.0%	USD	42.6
ING Group	11.8%	14.6%	2.7%	10.5%	15.5%	4.9%	EUR	15.2
Intesa	9.0%	13.9%	5.0%	8.4%	14.7%	6.3%	EUR	21.9
KBC Group	10.4%	17.1%	6.7%	9.7%	17.6%	7.9%	EUR	8.1
Lloyds	10.6%	13.6%	3.0%	9.1%	16.2%	7.1%	GBP	14.4
Nordea	11.1%	16.3%	5.2%	10.2%	17.1%	6.9%	EUR	10.7
Rabobank	11.8%	16.3%	4.6%	10.0%	16.8%	6.8%	EUR	14.1
Natwest Group	10.7%	16.2%	5.5%	8.9%	18.5%	9.6%	GBP	14.6
Santander	9.7%	11.6%	1.9%	8.9%	12.3%	3.5%	EUR	19.5
Societe Generale	10.0%	12.7%	2.7%	9.0%	13.4%	4.4%	EUR	15.4
Svenska Handelsbanken	11.8%	18.5%	6.7%	11.1%	20.3%	9.2%	SEK	66.1
Swedbank	12.0%	17.0%	5.0%	11.0%	17.5%	6.5%	SEK	44.6
UBS Group	9.8%	13.7%	3.9%	10.0%	14.0%	4.0%	USD	11.4
Unicredit	10.1%	13.2%	3.1%	9.0%	16.0%	6.9%	EUR	22.5

Notes: (1) For Handelsbanken, Swedbank and DNB, Pillar 2 requirements are excluded from MDA relevant CET1 requirements.
(2) For Danske Bank, Pillar 2 requirements are excluded from MDA-relevant CET1 requirements for 4Q 2019 but not for 4Q 2020.
Source: Banks, Scope Ratings calculations.

Headroom to MDA-relevant CET1 requirements – as of YE 2020



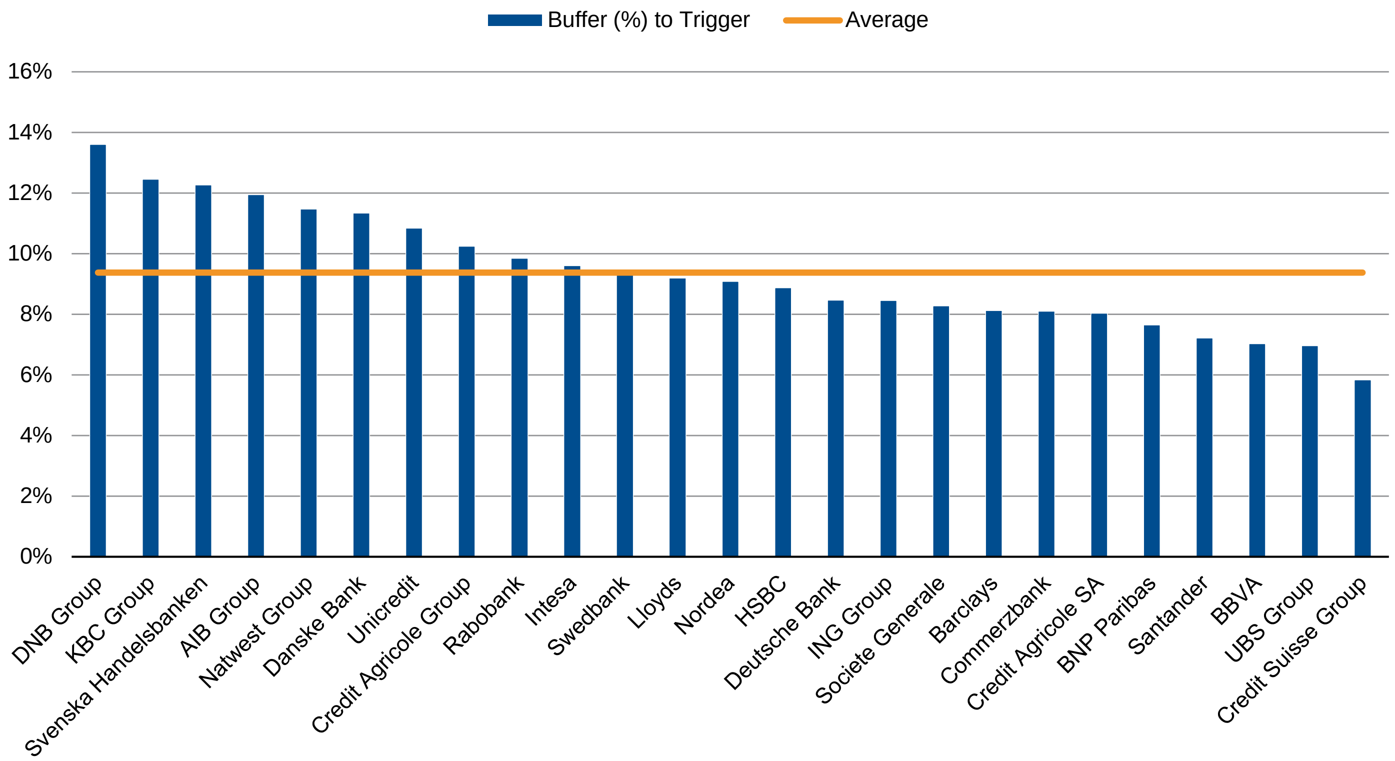
Source: Banks, Scope Ratings calculations.

Appendix III: Headroom to write-down/conversion trigger

			2Q 2020		3Q 2020		4Q 2020	
	Basis	Trigger	CET1 ratio	Buffer	CET1 ratio	Buffer	CET1 ratio	Buffer
AIB Group	Transitional	7.00%	20.2%	13.2%	20.2%	13.2%	18.9%	11.9%
Barclays	Fully loaded	7.00%	14.2%	7.2%	14.6%	7.6%	15.1%	8.1%
BBVA	Transitional	5.125%	11.6%	6.5%	12.0%	6.9%	12.2%	7.0%
BNP Paribas	Transitional	5.125%	12.4%	7.2%	12.6%	7.5%	12.8%	7.6%
Commerzbank	Transitional	5.125%	13.4%	8.3%	13.5%	8.4%	13.2%	8.1%
Credit Agricole Group	Transitional	7.00%	16.1%	9.1%	17.0%	10.0%	17.2%	10.2%
Credit Agricole SA	Transitional	5.125%	12.0%	6.8%	12.6%	7.5%	13.2%	8.0%
Credit Suisse Group	Fully loaded	7.00%	12.5%	5.5%	13.0%	6.0%	12.8%	5.8%
Danske Bank	Transitional	7.00%	17.6%	10.6%	18.2%	11.2%	18.3%	11.3%
Deutsche Bank	Transitional	5.125%	13.3%	8.1%	13.3%	8.2%	13.6%	8.5%
DNB Group	Fully loaded	5.125%	18.2%	13.1%	18.9%	13.8%	18.7%	13.6%
HSBC	Fully loaded	7.00%	15.0%	8.0%	15.6%	8.6%	15.9%	8.9%
ING Group	Transitional	7.00%	15.0%	8.0%	15.3%	8.3%	15.5%	8.5%
Intesa	Transitional	5.125%	14.6%	9.5%	14.7%	9.6%	14.7%	9.6%
KBC Group	Transitional	5.125%	16.6%	11.5%	16.6%	11.4%	17.6%	12.5%
Lloyds	Fully loaded	7.00%	14.6%	7.6%	15.2%	8.2%	16.2%	9.2%
Nordea	Transitional	8.00%	15.8%	7.8%	16.4%	8.4%	17.1%	9.1%
Rabobank	Transitional	7.00%	16.6%	9.6%	16.6%	9.6%	16.8%	9.8%
Natwest Group	Fully loaded	7.00%	17.2%	10.2%	18.2%	11.2%	18.5%	11.5%
Santander	Transitional	5.125%	11.8%	6.7%	12.0%	6.9%	12.3%	7.2%
Societe Generale	Transitional	5.125%	12.5%	7.4%	13.2%	8.1%	13.4%	8.3%
Svenska Handelsbanken	Fully loaded	8.00%	18.7%	10.7%	19.4%	11.4%	20.3%	12.3%
Swedbank	Fully loaded	8.00%	16.4%	8.4%	16.8%	8.8%	17.5%	9.5%
UBS Group	Fully loaded	7.00%	13.3%	6.3%	14.0%	7.0%	14.0%	7.0%
Unicredit	Transitional	5.125%	14.5%	9.4%	15.1%	10.0%	16.0%	10.8%

Note: For banks with securities containing different trigger levels, the highest is used.
Source: Banks, Scope Ratings calculations.

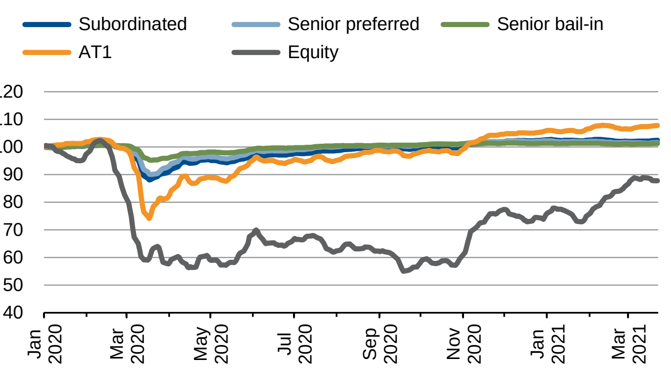
Headroom to write-down / conversion trigger – as of YE 2020



Source: Banks, Scope Ratings calculations.

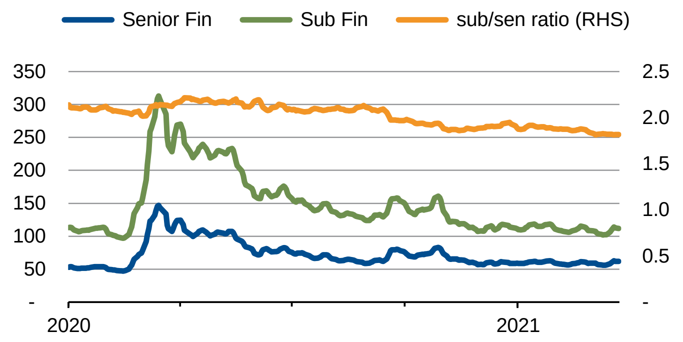
Appendix IV: Market metrics

Bank capital structure performance (total return) Jan 2020 = 100



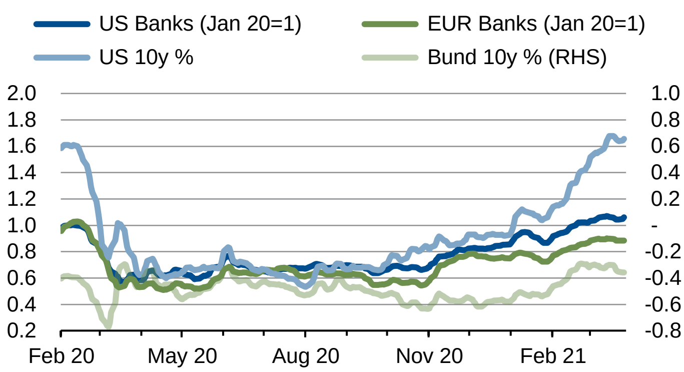
Note: Last data point as of 29 March 2020.
Source: Bloomberg, Markit.

ITraxx (spreads)



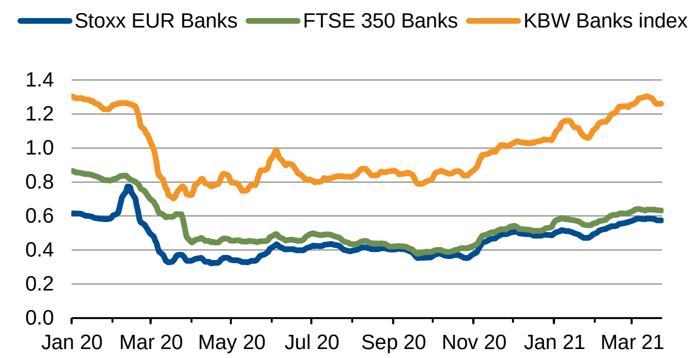
Note: Last data point as of 29 March 2020.
Source: Bloomberg.

Bank equity vs 10 gov bonds



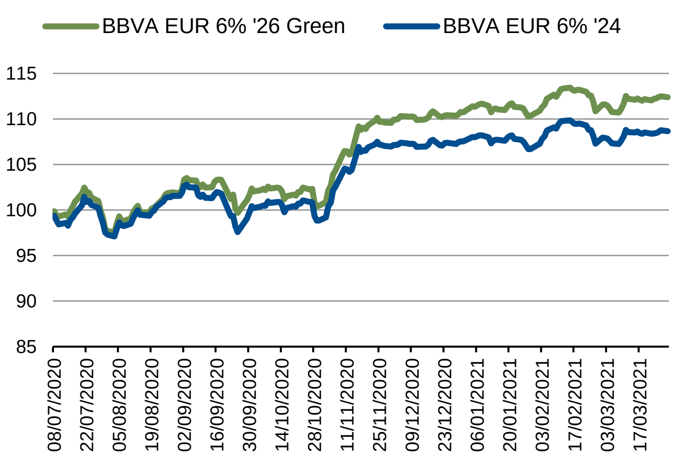
Note: Last data point as of 29 March 2020.
Source: Bloomberg.

Price to book ratio (x)



Note: Last data point as of 29 March 2020.
Source: Bloomberg.

BBVA AT1 performance



Note: Last data point as of 29 March 2020.
Source: Bloomberg.

European bank AT1 issuance: First quarter 2021

Date of issuance	Issuer	Currency	Volume (m)	Coupon	First Call
7-Jan-21	Abanca	EUR	375	6.000%	20-Jan-26
12-Jan-21	Banco BPM	EUR	400	6.500%	19-Jan-26
2-Mar-21	Banco de Sabadell	EUR	500	5.750%	15-Mar-26
18-Feb-21	BNP Paribas	USD	1,250	4.625%	25-Feb-31
18-Jan-21	EFG International	USD	400	5.500%	25-Jul-27
2-Mar-21	HSBC	USD	1,000	4.000%	9-Mar-26
		USD	1,000	4.700%	9-Mar-31
4-Feb-21	Luzerner Kantonalbank	CHF	200	2.000%	8-Jun-28
9-Mar-21	NatWest	GBP	400	4.500%	31-Mar-28
12-Mar-21	Raiffeisen Schweiz	CHF	200	2.250%	31-Mar-27
5-Jan-21	Standard Chartered	USD	1,250	4.750%	14-Jan-31
1-Feb-21	UBS	USD	1,500	4.375%	10-Feb-31

Source: Bond Radar, company reports

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