UK banks: managing through challenging times with regulatory encouragement

Because of their earnings capabilities and stores of available capital, Scope expects the major UK banks to manage through the pandemic. The Bank of England arrived at a similar conclusion after performing a desktop stress test. Revenues will undoubtedly suffer, and credit losses will increase. But as long as banks play their part in supporting the economy, there is likely to be a great deal of regulatory support.

Banks have been presented as part of the solution to the pandemic. In its May interim Financial Stability Report, the Bank of England (BoE) even made the case that the gain to individual banks of not extending credit to viable businesses needing temporary support was small compared to the cost to the wider economy. The reasoning is that as corporate failures rise, unemployment increases with knock-on effects for house prices and impairments on unsecured and secured household lending.

As banks play their role by supplying credit to the economy, there is a risk that non-performing exposures will materially increase. And while regulators will not necessarily judge elevated levels of impairments and reduced capital buffers in the same vein as before, investors and creditors may rightly have differing views.

Stress scenario with sharp economic disruption

In the same report, the BoE used an illustrative scenario to assess the resilience of major UK banks. Under the scenario, UK banks suffered from significant credit losses on their loan portfolios. However, their available capital buffers were more than enough to absorb the losses and they remained well above minimum regulatory capital requirements. We examine the details behind this reassuring conclusion.

The scenario sees UK GDP growth at negative 14% in 2020, with activity not returning to pre-Covid levels until the second half of 2021. This is accompanied by a sharp rise in unemployment, with rates at 8% in 2020 and 7% in 2021 (Figure 1). Underlying the scenario is an assumption that social distancing measures remain in place until early June and are gradually lifted by the end of the third quarter. The government's fiscal support measures are also assumed to remain in place over the same period.

The illustrative scenario is presented as a stress for the UK banking system. Others, like the European Commission and the IMF, forecast a somewhat milder picture for the UK economy, with GDP falling to a negative 7%-8% and unemployment reaching 5%-7% in 2020.

Figure 1: Indicative paths for selected economic variables (%)

						Illustrative scenario		
	1998-2007 (a)	2008	2009	2010-2018 (a)	2019	2020	2021	2022
UK GDP	3	0	-4	2	1	-14	15	3
LFS unemployment rate	5	6	8	6	4	8	7	4
Bank Rate	5.1	4.7	0.6	0.5	0.8	0.2	0.1	0.2
World GDP (PPP-weighted) (b)	4	3	0	4	3	-12	15	5
World GDP (UK-weighted) (c)	3	1	-3	2	2	-13	14	4

Notes: (a) Averages over the period. (b) Based on real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity weights. (c) Based on real GDP growth rates of 189 countries weighted according to their shares in UK exports.
Source: Bank of England.

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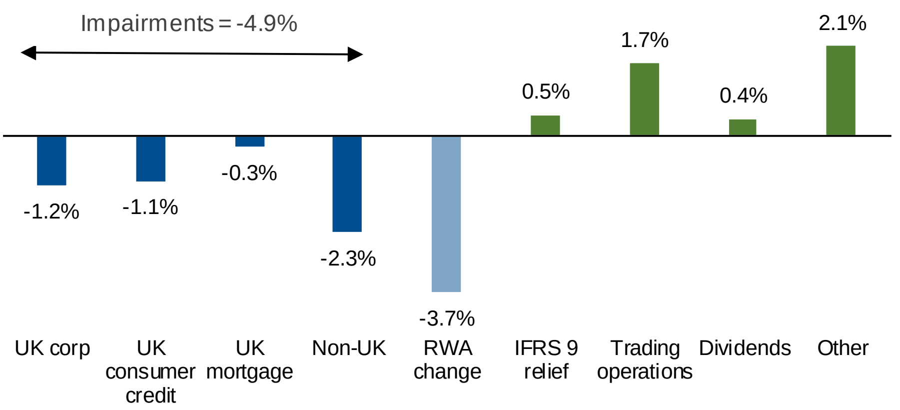
Available capital more than sufficient to absorb losses

Credit losses and RWA increase drive decline in CET1 capital

By the end of the second year in the scenario, the aggregate CET1 capital ratio of the major UK banks[1] falls to 11% from 14.8% (position at YE-2019). The drivers of the decline are total credit losses of over GBP 80bn and a 33% increase in aggregate RWAs as the credit quality of existing exposures deteriorates (Figure 2).

Figure 2: Key drivers of decrease in aggregate CET1 capital ratio



Note: "Other" comprises other profit and loss and capital movements.
Source: Bank of England, Scope Ratings.

In the scenario, banks incur impairments on 3.5% of their loans to households and businesses by YE 2021, with impairments nearly evenly split between UK and non-UK exposures. For non-UK exposures, the impairment rate is 5%, above the overall UK impairment rate of 3%, primarily due to the greater proportion of corporate lending compared to mortgages in banks' non-UK exposures.

Impairment rates lowest on mortgages and highest on consumer credit

As seen in other BoE stress tests, the impairment rates on UK exposures are highest for consumer credit (15.5%) and lowest for mortgage loans (0.4%) while corporate loans are in between (6.5%). Supportive factors incorporated in the scenario include the absolute low level of rates, extensive fiscal measures, the use of mortgage payment holidays and the more resilient position of households overall entering the stress.

Dividends, bonuses and AT1 coupons at risk

Meanwhile, there are notable offsets to the drawdown on banks' CET1 capital. It is assumed that banks do not pay dividends in 2020/2021 as on a cumulative basis they would be loss-making in aggregate. Further, variable remuneration is reduced by 50% and coupons on AT1 securities would be cut as required. The scenario also fully incorporated the impact of IFRS 9 transitional arrangements.[2]

As well, the assumption is that banks generate losses of only GBP 7bn on their trading and investment banking operations. The strong investment banking performance in the first quarter is considered temporary, with revenues projected to fall back.

The BoE further included a sensitivity for each additional two weeks of social distancing and policy support measures. This would result in an additional drawdown of 20bp on the banks' aggregate CET1 capital ratio as impairments and RWAs increase further.

[1] Comprises Barclays, HSBC, Lloyds, Nationwide, RBS, Santander UK, Standard Chartered.
[2] Under current EU law, the full capital impact of IFRS 9 is being phased in over time, with banks allowed to 'add-back' to their reported capital ratio a portion of expected credit losses that have not yet materialised. On 28 April, the European Commission proposed amending the transitional arrangements to allow for 100% relief of eligible provisions until YE 2021.

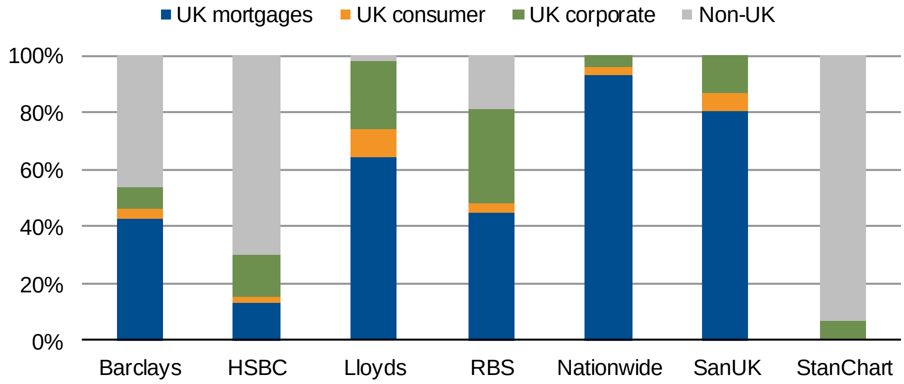
Extrapolating to individual banks

Different loan portfolios mean varying impairments

Using the BoE's impairment rates, we estimate how credit losses might develop for individual banks under the illustrative scenario. Where relevant and if data is available, we have applied more specific impairment rates for non-UK mortgages (1%) and corporate loans (4.1%) rather than the overall rate of 5% for non-UK exposures. These rates were included in the BoE's illustrative scenario.

We caution that the level of impairments may be over-estimated due to our assumptions. In the case of Barclays, for example, all non-UK consumer exposures were assumed to be consumer credit and a 15.5% impairment rate was used. For Standard Chartered, all non-UK exposures were impaired at the overall rate of 5%.

Figure 3: Breakdown of loan exposures



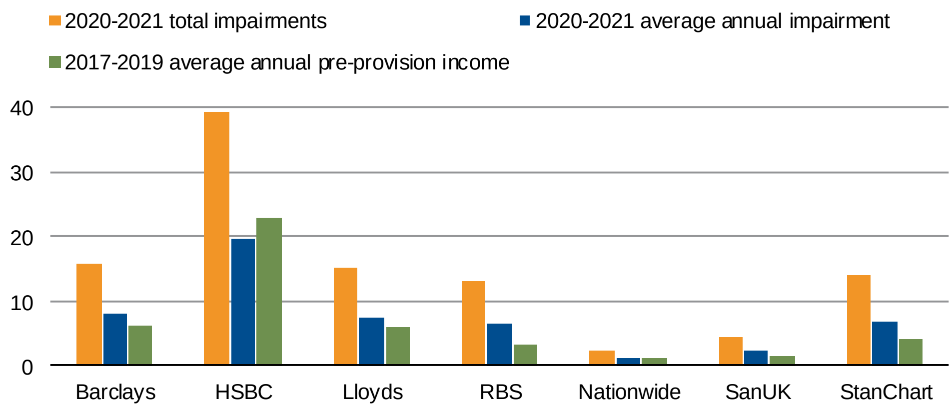
Source: Banks, Scope Ratings estimates.

First line of defense: earnings

Pre-provision earnings depressed in recent years by conduct costs

As shown in Figure 4, the capacity of the banks to cover estimated 2020-2021 impairments from pre-provision income varies. Over the last three years, pre-provision income has been depressed by sizeable conduct charges and in some cases by restructuring charges too. The more normalised earnings capabilities of some were just materialising before the pandemic. At the same time, future pre-provision income will be under pressure from reduced levels of client activity, additional costs and forborne revenues related to supporting customers, and lower margins due to interest-rate cuts.

Figure 4: Estimated impairments under BoE scenario (bn)



Note: Currency is GBP for all banks except for HSBC and Standard Chartered who report in USD.
Source: Banks, Scope Ratings estimates.

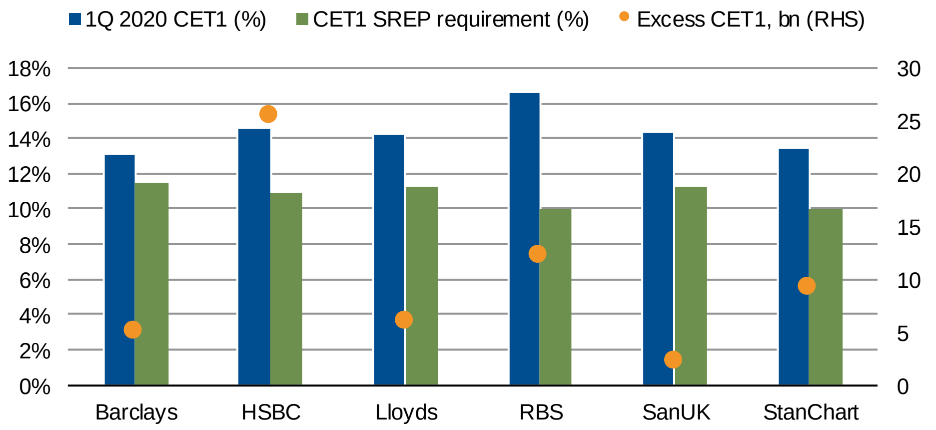
Second line of defense: capital

Meaningful regulatory capital relief measures

As a second line of defense, banks have capacity to absorb elevated impairments from capital in excess of requirements. The reduction of the UK countercyclical capital buffer to 0% from 1% along with reductions in many other jurisdictions has helped to increase the amount of available capital. Further, the BoE's plans to set banks' Pillar 2A requirements as nominal amounts will also increase available capital in a scenario where RWAs are expected to increase. (Further details below).

During 1Q 2020, banks' CET1 capital levels were bolstered by the cancellation of dividends for 2019 while lending growth driven by businesses drawing down on credit lines and increased market risk were offsetting factors.

Figure 5: Second line of defence against higher provisions - excess capital



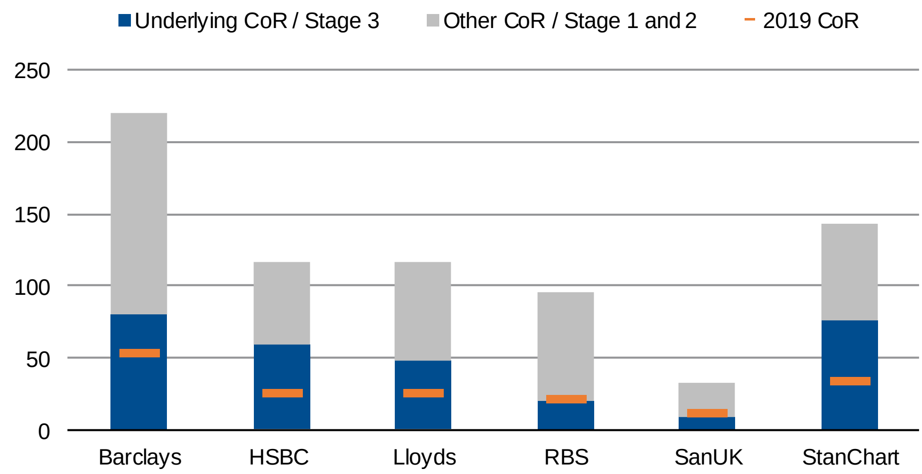
Notes: CET1 SREP requirement does not incorporate pending changes to Pillar 2A requirements. Currency is GBP for all banks except for HSBC and Standard Chartered who report in USD.
Source: Banks, Scope Ratings.

Materially higher provisioning in 1Q 2020

Material provisions for changed economic assumptions

Compared to 2019, the credit costs of major UK banks increased materially during 1Q 2020 (Figure 6). While there were no significant changes in Stage 3 exposures or non-performing loans, some banks experienced higher credit costs due to individual corporate exposures. Instead, the primary drivers of increased credit costs were changed economic assumptions and management overlays, with increased provisioning for Stage 1 and 2 exposures.

Figure 6: 1Q 2020 annualised vs 2019 cost of risk (bp)



Source: Banks, Scope Ratings.

Management teams were hesitant to provide firm guidance on where credit costs may end up for the year, although they conveyed the view that provisions were being recognised earlier rather than later because of IFRS 9. HSBC gave a range of USD 7-USD 11bn, equivalent to a cost of risk of 0.7% to 1.0%. Barclays indicated that provisions may be around GBP 5bn (1.3%). Meanwhile, RBS noted that quadrupling the cost of risk incurred in the first quarter would be as reasonable a guess as any (0.9%). At the levels guided to, banks should be able to absorb these impairments from earnings.

Meanwhile, extrapolating from the BoE's illustrative scenario, we arrived at estimated cost of risk for individual banks ranging from 1.1% to 2.5%. At these higher levels, banks would likely need to tap into available capital reserves.

Regulatory push to get banks supporting the economy

Regulatory initiatives to encourage lending

Like other regulators globally, the BoE has implemented various measures to encourage banks to continue supplying credit to the economy. These include specific statements regarding the availability and use of capital and liquidity buffers, guidance on incorporating unprecedented levels of government support in forward-looking expected credit loss (ECL) estimates under IFRS 9 and encouraging the use of transitional arrangements to phase-in the regulatory capital impact of ECLs.

Change to leverage ratio framework

Certain government-guaranteed loans exempt from leverage ratio calculation

On 4 May, the BoE announced a change to the leverage ratio framework to give banks the option of excluding certain government-guaranteed loans to small businesses from the leverage ratio total exposure measure. This applies to the UK's Covid-19 Bounce Back Loan Scheme as well as similar schemes with a 100% guarantee from an EEA government or central bank including the ECB, provided that such loans do not exceed EUR 60,000 per loan.

This is in addition to earlier clarifications that loans under the UK's Covid-19 business interruption loan schemes benefit from credit risk mitigation, with adjustments to risk weights and expected loss amounts being allowed.

The EU is working on approving a package of capital-relief measures for banks, including a proposal to temporarily exclude central bank reserves from the calculation of the leverage ratio. This has been the case in the UK since late 2017. The BoE was concerned that leverage ratio requirements would effectively tighten when bank balance sheets increased due to expanding central bank balance sheets. This was also considered a potential disincentive for banks to use central bank liquidity facilities. However, when implemented, the BoE raised the minimum leverage ratio requirement to 3.25% from 3%.

Change to Pillar 2A capital framework

Pillar 2A capital requirements to be fixed for next two years

On 7 May, the BoE announced that it was changing the way it will set Pillar 2A capital requirements, from an amount that varies with changes in RWAs to a fixed amount based on YE 2019 RWAs. This means that any potential increases in RWAs will not lead to an absolute increase in required Pillar 2A capital.

The BoE has held the belief that RWAs are not a good approximation for the evolution of risks captured in Pillar 2A in a stress scenario. Pillar 2A requirements are meant to capture risks not captured by Pillar 1 risk weights (e.g. risks associated with own pension schemes). As part of the 2020 and 2021 Supervisory Review and Evaluation Processes (SREPs), Pillar 2A requirements will be set as nominal amounts. Consequently, 2021 MREL requirements will also reflect this change, providing further regulatory relief for banks.

Effectively lowers MDA thresholds

As well, this change effectively lowers the threshold for the amount of capital that banks must hold to avoid triggering maximum distributable amount (MDA) restrictions as RWAs increase. In the illustrative scenario discussed above, the BoE concluded that this would provide major UK banks with an additional headroom of 40bp-50bps of CET1 capital based on RWAs.

Regulators globally have been concerned that banks may not be willing to use their available capital buffers for additional lending as it would lead to breaches of MDA triggers. Consequently, the idea of bans on AT1 coupons continues to be discussed. The BoE's changed approach to P2A capital is one way to address this concern, as well as the procyclicality of Pillar 1 and Pillar 2 capital requirements.

Appendix: Key support measures for businesses and households

Support measure	Summary details	Uptake
Bounce Back Loan Scheme (BBLS)	100% guaranteed loans up to GBP 50K with maximum term of 6 years. For smaller businesses.	GBP 18.5bn approved for 608K businesses.
Coronavirus Business Interruption Loan Scheme for SMEs (CBILS)	80% guaranteed loans. For companies with annual turnover < GBP 45m. Loans up to GBP 5m over a maximum 6-year term.	GBP 8.2bn approved for over 43K SMEs.
Coronavirus Large Business Interruption Loan Scheme (CLBILS)	80% guaranteed loans. For companies with annual turnover > GBP 45m. Loans up to GBP 200m.	GBP 820m approved for 154 mid-sized and larger UK businesses.
Covid Corporate Financing Facility (CCFF)	100% guarantee. Purchase of commercial paper with up to one-year maturity. For investment grade rated businesses as of 1 March 2020.	GBP 20.5bn of lending drawn under bank arranged commercial paper facilities for 63 businesses. Another 179 businesses in various states of approval. (As of 20 May)
Mortgage payment holidays	Up to 3 months. Extended to 31 Oct.	Over 1.8m payment holidays granted. One in six mortgages covered. (As of 20 May)
Credit card and personal loans payment holidays	Up to 3 months.	Almost 700K payment holidays on credit cards and 470K on personal loans. Over 27m customers offered the option of interest-free borrowing for three months on the first GBP 500 of their arranged overdraft. (As of 30 April)
Coronavirus Job Retention Scheme (CJRS)	Government grants to cover up to 80% of employee wages, up to a cap of GBP 2,500 per month. Extended to 31 Oct.	8.4m jobs furloughed by 1m employers, with GBP 15bn claimed.
Self-employment Income Support Scheme (SEISS)	Government grants of up to 80% of income based on taxable profits over the past three years, capped at GBP 7,500 over a three-month period.	2.3m claims worth GBP 6.8bn.

Notes: Data as of 24 May unless noted otherwise.
Source: UK government, UK Finance, Scope Ratings.

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