Covid-19: an acid test of European banks' diversification and de-risking strategies

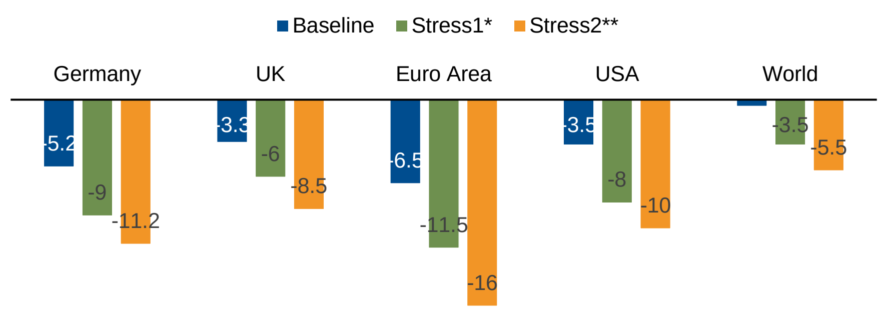
With the health crisis now at its peak in Europe and North America, we are updating our view on European banks. Our ratings view continues to be biased to the downside in view of the sheer magnitude of the event although on the plus-side, policy makers and regulators are supporting banks as shock absorbers and part of the effort to mitigate the economic impact of the pandemic.

Our main conclusion at the beginning of the lockdown period in Europe was that the impact of the crisis on bank credit quality would need to be assessed on a case-by-case basis, taking due account of the different starting position and franchise value of each bank at the outset of the crisis. Our approach focuses on the relative strength of business models and their ability to deliver appropriate returns across the cycle. A temporary dip in earnings does not necessarily lead to increased credit risk. That conclusion remains intact.

A high degree of uncertainty persists

A high degree of uncertainty will persist around the magnitude of the economic impact of the pandemic. Since our previous note (see Related Research), Scope has materially revised its sovereign outlook for global GDP growth. Scope estimates that GDP could fall between 0.5% and 5.5% this year, at the bottom of the range were government-mandated lockdowns to continue remainder of the year. This would represent the deepest global contraction since the great depression, exceeding output losses over the 2008-09 Global Financial Crisis. The euro area could be the hardest hit, contracting between 6.5% and 16% in 2020.

Figure 1: Scope's economic outlook



Source: Scope Sovereign Outlook 2020 update report, April 2020
*Stress1: Lockdown through Q3 20; **Stress2: Pronounced US recession and quarantine relief only by Jan21

Next to the uncertainty regarding the initial hit to GDP, there is a lot of uncertainty around how governments will end lockdowns and how fast the global economy recovers. Recovery scenarios will define the recovery of bank profitability, which has already been heavily impacted by negative policy rates, flat yield curves and volatile credit spreads.

Faced with such bleak scenarios, our rating actions on European banks over the coming months are skewed to the downside. Ratings actions will depend on the fundamentals of banks entering the crisis but also on the degree of support from central banks and governments to banks' borrowers and the economy as a whole

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Will the banking sector fundamentally change?

Not all banks are riskier

Despite the challenges, banking sector risk has not necessarily changed fundamentally at this point. Not all banks are riskier than before the crisis, especially if they are highly rated. A prolonged downturn and the emergence of excessive risk concentrations could change that view, however.

We take the medium to long-term view

Our ratings provide a medium to long-term view of a bank. This means that a temporary dip in earnings – quarterly, semi-annually or even annually – is not in itself a reason to downgrade a bank's rating. Our current ratings already reflect the relative ranking of how sustainable banks' business models are in their respective markets.

Deep cyclical downturn is a concern

In our macro assessment, we favour relative levels and structural, long-term dynamics, rather than short-term shifts in GDP, interest rates or cyclical indicators. However, deep cyclical fluctuations caused by Covid-19 impacts can lead to material changes in banks' business and financial fundamentals, and this should be reflected in ratings.

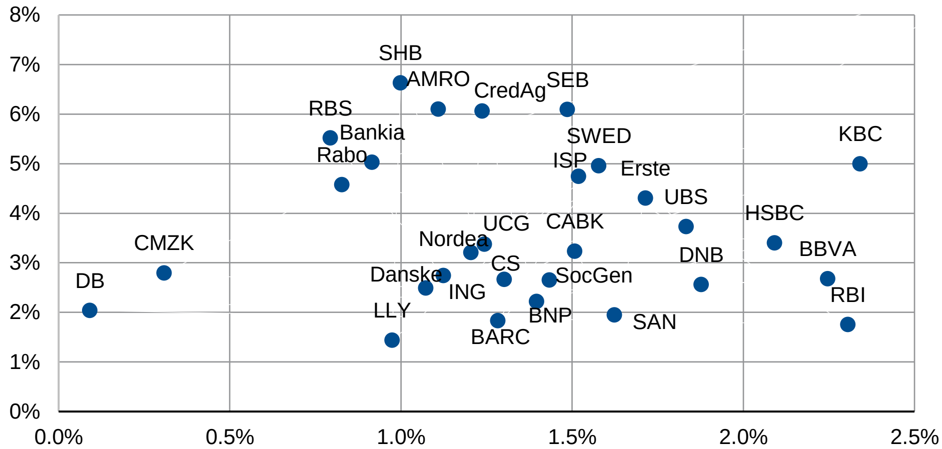
Banks are not equal

The downturn will not affect all banks equally, so we avoid blanket ratings actions, opting instead for a bottom-up approach to our rated portfolio of almost 100 banking entities in Europe.

Earnings and capital matter

The starting point in this crisis is banks' earnings diversification and capital buffers. These two items define the amount of stress the balance sheet can take upfront and the speed of internal capital generation to absorb losses over time (see Figure 2 below).

Figure 2: First line of defence: Capacity to absorb exceptional provisions, 3ys average (x) vs Second line of defence: Buffer to CET1 requirement as of YE 2019 (y)

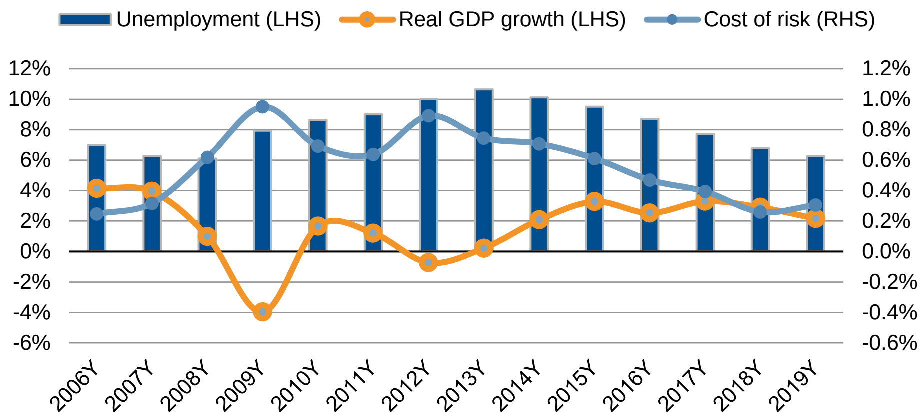


Source: SNL, Scope calculations

GDP and employment drive loss rates

The chart above can be compared to the aggregate loss history of European banks (see Figure 3 below) reflecting a mixture of widely-dispersed loan portfolios that would have changed over time. To that, one should add mark-to-market losses on credit portfolios and other trading activity, although banks have scaled back this area considerably since the global financial crisis.

Figure 3: Historical credit losses in Europe



Source: SNL, Scope calculations

Asset-quality deterioration not clear

We base our opinions on forward-looking metrics and estimates, taken from publicly-available financial data, macroeconomic scenarios, and management guidance. It may take time before the full picture emerges. Looking at the last deep economic crisis in 2008, credit costs are very likely to consume most bank earnings this year and next – depending on the shape of the economic recovery.

Corporate and real estate exposures a concern

Given the sharp economic downturn, we are especially concerned over concentrations in corporate and real estate portfolios where losses can be considerably larger than in a diversified retail and commercial banking portfolio.

Acid test for de-risking

For the larger, higher rated banks in our portfolio, this crisis will be the acid test for de-risking strategies of recent years and the value of geographical and sector diversification. The question is whether these banks have de-risked enough to withstand the cycle. Banks with low capital and profitability buffers and more vulnerable business models are most likely to see downward rating migration in coming months. This could reflect above-average exposure to severely-hit countries or sectors, poor profits or slim capital buffers, or excessive exposures to sovereign risk if sovereign spreads rise.

Cost base delays recovery

Regardless of the size and shape of the cyclical downturn, high costs and low returns remain the key structural issue facing many banks in our coverage universe. Most costs are fixed in the short term; strategic investment in IT remains a top priority for banks to defend their franchises. Even more so as the lockdown accelerates the migration of customer transactions to digital channels. Absent mergers, operating costs will fall only slowly in coming years, lengthening the time it will take to rebuild capital levels.

Risk of regulatory intervention is low

Policy makers supportive

Operating conditions for most banks are severe, but regulators, central banks and governments are very supportive, making it unlikely that a major bank will be pushed into distress at this stage of the crisis. See Appendix for a list of regulatory relief measures.

Reaction function key to ratings

Since we rate not to default but to the risk of regulatory intervention, the reaction function of regulators and supervisors is a key driver of our credit assessment. Our base case is that loan losses and RWA inflation will stop short of putting bank credit in jeopardy for most banks, especially for the more senior layers of banks' capital structures.

Reduced risk of regulatory action low in the short term

The likelihood of regulatory action to the detriment of bond holders is lower than before the crisis, though clearly that is subject to change as the situation evolves. Once the damage is known, we expect regulators to mandate recapitalisation plans, which will again put pressure on banks that are lagging in the recovery.

Capital structure will matter more than ever before

Senior debt well protected

We do not expect the crisis to result in a material increase in probabilities of regulatory action on senior bank debt. This category of debt can only be bailed-in in resolution; a possibility that remains remote even if the outlook deteriorates further. Bank resolution is ill suited to systemic crises, though it may emerge at a later stage to resolve specific banks that fail to come out of the crisis strong enough.

Tier 2 bonds less exposed to mandatory bail-in

Under EU legislation, Tier 2 bonds would be subject to mandatory bail-in in case of a pre-cautionary recapitalisation from public funds, though evidence from recent restructurings in Germany and Italy shows that this is not always enforced. Given that EU authorities have shown a much more lenient stance towards State subsidies for non-banks in this crisis, we assume that this will be extended to the banks as well, provided their financial problems are caused by the coronavirus crisis and are not due to pre-existing conditions.

Elevated risks further down the capital structure

More junior layers in the capital structure are closer to the regulatory action frontier, and losses and capital depletion increase the risk to these securities, starting with AT1.

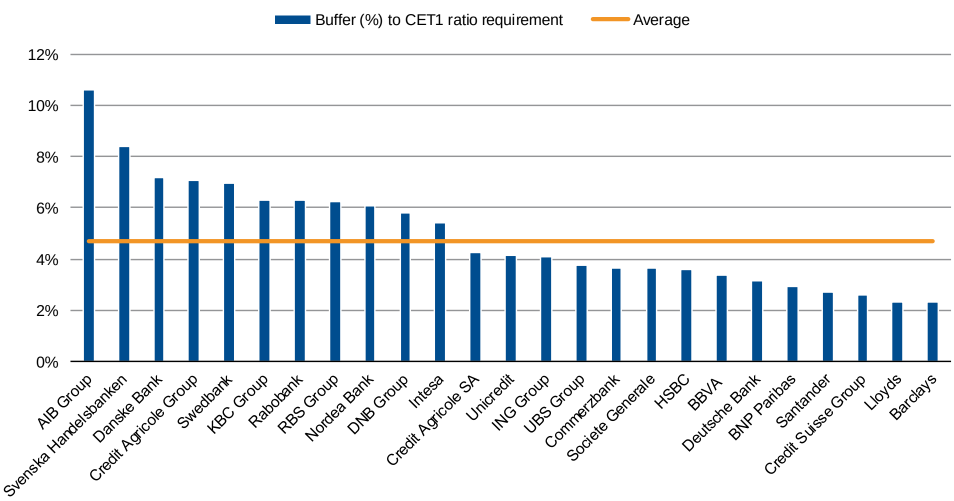
Cost of equity very high after dividend suspensions

European regulators have already put immense pressure on all banks to suspend equity dividends and buy-backs, regardless of their financial strength. While allowing banks to conserve capital in the very short term, this may negatively affect their cost of equity capital.

AT1 coupons at risk

As our rating approach is rooted in the likelihood of regulatory action, we see higher risk to the ratings of going-concern capital instruments, where regulatory action leading to coupon suspension could materialise early on and possibly before banks hit MDA triggers (see Figure 4 below).

Figure 4: Buffer to trigger



Source: SNL, Scope calculations

Low risk of blanket coupon bans

While dividend bans raise concerns about similar blanket action on AT1 distributions, we do not see this as an immediate risk. Unlike equity distributions, AT1 distributions are not cumulative; suspending coupons would be seen as a sign of severe financial distress affecting not only AT1 prices but also raising funding costs across the capital structure. Meanwhile, reduced distributions improve AT1 buffers in the short term and stronger banks have been using capital to redeem obsolete subordinated and hybrid debt.

How effective are government support packages?

Policy response determines outcome for banks

Government support to the economy, and specifically liquidity and solvency support to banks' borrowing customers, is a key factor limiting the damage to bank creditworthiness at this stage of the downturn.

Quick monetary policy response

These measures have come far earlier and more decisively than in previous downturns. Notably the ECB and other central banks have moved quickly to increase their asset purchases and significantly broadened their collateral criteria. For details on other non-standard policy monetary policy measures in Europe, please refer to the Appendix.

Regulatory relief supports solvency

These measures come on top of very significant capital and liquidity buffers the banks have built up over the past 10 years. Regulators have either removed or reduced countercyclical buffers and clarified that banks can temporarily operate below Pillar 2 Guidance and capital conservation buffers until the end of the public health emergency. Regulators have relaxed regulations on liquidity to avoid a credit crunch. In addition, new requirements under the final Basel III package and for MREL in Europe have been delayed. For details on regulatory relief measures in Europe, please refer to the table in the Appendix.

Very strong fiscal response

While unemployment is rising sharply, governments have reacted with generous unemployment and temporary furlough benefits, including for the self-employed, which buffer the effect of unemployment in the short term. The European Commission has greatly relaxed State Aid rules, facilitating government interventions in the corporate and SME sectors with guarantees of up to 100%. Most governments have put sizeable lending programmes in place to support companies with liquidity and grants where necessary. For loans with partial government guarantees, the ECB has waived provisioning requirements to entice banks to continue lending.

Fiscal policy helps domestic banks

Assuming the lockdowns are short lived and support packages prove to be effective, the outcome for banks may be quite benign, especially for smaller banks with domestic exposure to retail borrowers and politically well-connected domestic corporates or SMEs. Sectors such as real estate and hospitality will, nevertheless, suffer disproportionately in the downturn and recover more slowly.

International banks face larger challenge

The situation for large international banks or banks with exposure to large international corporates will be more difficult to assess, as these companies have complex supply chains and may struggle to find appropriate government support unless they are considered national champions. Next to real estate and hospitality, large international banks are also exposed to problems in the energy and transportation sector.

Debt moratoriums only help in the short term

On the downside, some countries have declared debt moratoriums for mortgages and most banks have offered payment holidays to their retail borrowers, sometimes for longer than three months. Weak growth and high unemployment will have a negative effect on collateral values in real estate lending. This highlights the risk that the asset quality of banks could deteriorate sharply if lockdowns persist.

Banks more exposed to sovereign risk

As will all government largesse, there is the risk of moral hazard and expensive deadweight effects, especially if such extraordinary subsidies last too long. This could lead to problems for banks over time as defaults are simply delayed or government support is abruptly withdrawn. Government-guaranteed lending programmes also increase the exposure of banks to sovereigns.

Reduced accounting volatility

To protect the P&L in the short-term, regulators and accounting bodies have relaxed the requirements for IFRS 9 staging in banks' loan books, so banks do not have to add pro-cyclical lifetime credit losses at this point, especially for exposures covered by legislative and non-legislative moratoriums. Instead banks have been asked to consider the possible impact of government support and to rely on long-term economic projections that go beyond the immediate contraction in GDP.

This will again allow banks to smooth losses across the cycle and protect the regulatory capital base. The phase-in of IFRS 9 will reduce the likelihood of regulatory intervention in the short term, but delays in provisioning will ultimately eat into capital if the recovery is slower than anticipated. Thus, we consider such measures as neutral to credit ratings.

Will the bank-sovereign doom-loop re-emerge?

No mechanistic link between ratings

Our bank ratings are not mechanistically linked to sovereign ratings and we do not expect a direct correlation between rating actions in our bank and public finance franchises. For our approach to sovereign ratings over the Covid-19 crisis, please refer to Scope's framework for potential sovereign rating actions during the COVID-19 crisis.

Sovereign part of asset risk

However, Scope's assessment of sovereign credit risk is an input into our analysis of asset risk. This is relevant especially for banks with large holdings of sovereign debt and poorly-diversified geographical franchises, particularly as banks are relying on full or partial government guarantees for their crisis lending.

Monetary accommodation provides buffer

Monetary accommodation can provide a significant buffer for sovereigns for the time being as major central banks such as the Federal Reserve or the ECB have significantly upscaled their asset-purchase programmes or moved temporarily to outright monetary financing in case of the Bank of England. It will take time before policy makers are in a position to address the increase in national debt. The main risk is that the credibility of the responses from central banks comes under scrutiny, which will have a negative effect on the financial systems at large.

Euro area frictions pose risk to banks

The situation is different in the euro area where the mandate of the ECB is comparatively narrow, and the ECB has less flexibility to support fiscal policy compared to the US or the UK. In the aftermath of this crisis, we expect the well-known political conflicts between euro area members over fiscal policy to resurface. The institutional deficiencies of the euro area (the absence of common issuance, common deposit insurance or a credible common resolution regime with sufficient scale) could put banks at risk.

Political risk could increase post crisis

In harder hit countries, Eurosceptic political forces could be emboldened by the ECB's relative inability to help compared to other central banks. At the same time, similar forces in better-off countries will argue that the ECB has gone too far. Euro break-up remains an extremely unlikely scenario, but were it to happen it could lead to multiple-notch downgrades for European banks, due to material disruption to financial systems and likely funding stresses in weaker countries.

I. Appendix: Regulatory relief measures, government packages and moratoriums

	Fiscal Policy & guarantees	non-standard monetary policy measures	Regulatory Relief
EU	EUR 200bn extra EIB lending capacity to corporates and SMEs EUR 100bn EU loans to protect jobs (SURE)	N/A	EBA postponed stress tests to 2021 EBA clarifications on NPL, IFRS9 & forbearance
Euro area	EUR 540bn Pandemic Crisis Support from ESM	EUR 120bn extra ECB asset purchases (APP) upt to EUR 750bn extra ECB asset purchases (PEPP) expanded range of private sector asset purchases (CSPP) expanded collateral range (ACC) & lower haircutsfor refinancing	Large banks can operate temporarily below Pillar 2G, CCB & LCRs requirements Pilar 2R can be met with T1 capital. Temporary flexibility for NPLs covered by public guarantees and public moratoria Recommendation to release countercyclical buffers and opt for IFRS9 transitional rules MREL phase-in until 2024
Euro area members			
France	EUR 100bn fiscal envelope EUR 312bn loan guarantees extra benefits & tax deferrals to workers, companies & self-employed	N/A	Reduced countercyclical buffer to 0
Germany	EUR 156bn federal fiscal package EUR 48bn state-level support at least EUR 757bn loan guarantees (up to 100%) EUR 63bn state-level guarantees	N/A	Reduced countercyclical buffer to 0 extended ECB relief to nationally supervised banks
Italy	EUR 25bn emergency package (Cura Italia) further measures considered EUR 400bn state guarantees (Liquidity Decree)	N/A	Debt moratorium for households extended ECB relief to nationally supervised banks
Spain	at least EUR 13.9bn for health and expanded social security suspension of debt service for government loans (incl tourism) rent moratorium for housing associations EUR 110bn loan guarantees (incl. ICO)	N/A	Debt moratorium for vulnerable households
Netherlands	EUR 10-20bn fiscal measures tax deferrals (EUR 35-45bn) guarantees for corporate & SME loans	N/A	Reduced capital buffers for 3 systemic banks temporary regulatory relief to less significant banks postponed mortgage risk floor large banks offered 6 month repayment moratorium no mortgage foreclosures before July
Austria	EUR 38bn fiscal package incl 9bn loan guarantees	N/A	
Belgium	EUR 10bn fiscal envelope EUR 50bn loan guarantees	N/A	reduced countercyclical buffer to 0%
Portugal	EUR 1bn of unemployment support pcm EUR 6.2bn tax deferrals EUR 3.7bn credit lines to SMEs	N/A	6 month moratorium on bank loan repayments for households extended ECB relief to nationally supervised banks
Ireland	EUR 7.2bn fiscal measures incl EUR 1bn liquidity support to companies	N/A	reduce countercyclical buffer from 1% to 0% 3 month payment moratoria on mortgages, personal and business loans.
other EU Members			
Denmark	DKK 60bn fiscal measures plus automatic stabilisers		release of countercyclical buffers relaxation of LCR
Sweden	SEK 380bn - SEK 668bn fiscal measures incl 235bn loan guarantees	SEK 300bn extra asset purchases SEK 500bn corporate lending via banks broader collateral rules	Easing of countercyclical buffers by 2.5 ppts suspension of loan amortization until June 2021 MREL phase-in until 2024 easing of LCR across currencies
Poland	PLN 66bn fiscal measures PLN 75b credit guarantees & micro loans PLN 100bn liquidity grant program by PDF	asset purchase programme for treasuries funding programme for bank loans	3% systemic risk buffer repealed smoothing of credit losses over longer time period flexibility on capital & liquidity requirements
Hungary	various fiscal measures to reduce fiscal burden on businesses, incl social security contributions, extra spending on healthcare Anti-Epidemic Protection Fund Economic Protection Fund	asset purchases of treasuries, mortgages, corporate bonds, SME loans loan deferral on Growth Funding Facility long-term unlimited collateralised facility	systemic capital buffer temporarly eliminated reduction of FX mismatches from 15 to 10% (FECR) repayment moratorium on all exixting corporate and retail loans until end-2020 interest cap on consumer loans
Rest of Europe			
UK	extensive tax and spemdig measures targeting coporates, workers,s elf-employed, healthcare GBP 330bn business interruption loans through BoE	GBP 200bn of extra treasury purchases ouright government financing through overdrafts new Term Funding Scheme contingent term repo facility	reduced countercyclical buffer to zero for next 12 months financial firms to offer up to 3 month payments freeze on loans and credit cards stress test postponed
Norway	NOK 139bn fiscal measures, incl loan guarantees and corporate bond purchases		easing of countercyclical buffers by 1.5 ppts temporary breaches of LCR easing of mortgage rules
Switzerland	CHF 22bn fiscal measures CHF 40bn loan guarantees	increased neg rate exemptions expanded collateral range (incl. gov. gtd. Loans)	deactivation of countercyclical buffer exclusion of central bank depsoits from leverage ratio

Source: compiled by Scope on the basis of IMF information

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