Will credit demand be sufficient for banks to draw on capital buffers?

With continuing regulatory guidance to banks to refrain from paying dividends, the risk of potential AT1 coupon bans refuses to go away. On the plus side for investors, major European AT1 issuers overall currently maintain capital buffers reasonably above MDA triggers with no imminent breaches in sight.

Support for the economy

On 28 July 2020, the ECB had extended its recommendation for banks not to pay dividends until January 2021 in order to preserve capacity for absorbing losses and to support the economy.

The Bank of England, in its Financial Stability Report published on 6 August, was the latest to reiterate the message that banks should draw on their capital buffers to support the economy. The Bank acknowledges that banks may be hesitant to do so, fearing the supervisory reaction, market stigma, or the implications for distributions if the combined buffer is breached.

The Bank of England also offered its view on how best to address this "problem" – make temporary amendments to the buffer framework so that fixed parts of the combined buffer could be released, or change the automatic consequences associated with using buffers. While countercyclical and systemic buffers have already been reduced in many cases, the one that has not been touched is the substantial 2.5% capital conservation buffer.

In the meantime, the BoE is allowing banks to fix their Pillar 2A requirements at a nominal amount in 2020 and 2021 Supervisory Review and Evaluation Processes (SREPs), based on RWAs as of YE 2019. In the current environment, where RWAs are more likely to rise than fall, this avoids absolute increases in Pillar 2A capital requirements and potentially reduces the threshold at which banks are subject to maximum distributable amount (MDA) restrictions.

It is worth questioning whether there is sufficient credit demand that would require banks to use their capital buffers. A recurring comment from bank management has been that the surge in draw-downs on credit lines in March had already started to subside in April. Some corporates have repaid their facilities, replacing them with wholesale market funding. Other corporate facilities appear to have been drawn down as a precaution, with the funds being placed on deposit with banks. Smaller businesses have taken advantage of government lending schemes, supported largely by State guarantees.

In the ECB's July euro area bank lending survey, banks expect net demand for loans to firms to increase less in the third quarter. This is accompanied by an expected tightening of credit standards as State guarantee schemes in some large euro area countries come to an end.

As the economy slowly and unevenly recovers, the question is whether loans are the answer. Loans, along with government measures while they last, can provide a bridge as conditions settle on a new normal but may not be enough. With the viability of some businesses being severely tested, there may be a need instead for equity support. If this is the case, banks are no longer necessarily the ones to provide such assistance.

Analysts

Pauline Lambert
p.lambert@scoperatings.com

Alessandro Boratti
a.boratti@scoperatings.com

Team leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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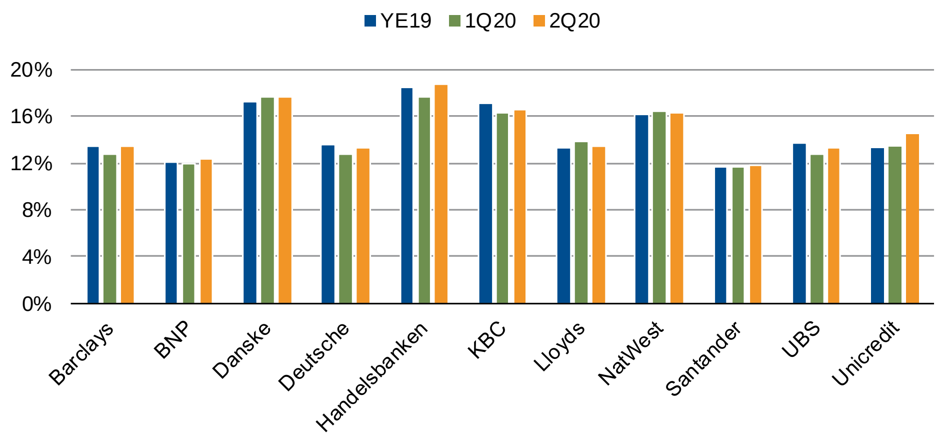
Absorbing losses

While demand for credit may be a question mark, capital buffers may still be needed to absorb losses. Many banks saw their capital positions dip in the first quarter as they made credit provisions, only to recover to some extent in the second quarter. The restraint on distributions, the easing of regulatory requirements and the (so far) limited credit risk migration have all helped.

Figure 1: Evolution of CET1 capital ratios, selected banks



Source: Banks, Scope Ratings.

As government support measures gradually wind down, there is likely to be a need for further loss provisioning. Determining the magnitude of such provisions is made more difficult by the forward-looking approach under IFRS 9 and the supervisory guidance on the treatment of payment holidays and moratoriums. Disclosure by banks varies; not all provide details on the staging of their loans. There is no clear trend except that the proportion of Stage 3 loans has been relatively stable. Where disclosure is available, the migration of loans from Stage 1 to Stage 2 varies greatly (Figure 2).

To arrive at second quarter provisions for expected credit losses, banks generally revised their economic forecasts to reflect a slower economic recovery. At the same time, a fair number indicated their expectation for provisions to be less in the second half of the year than in the first half. Others guided to credit-loss levels that should be absorbed by earnings without the need to tap into capital. This is clearly positive for AT1 investors.

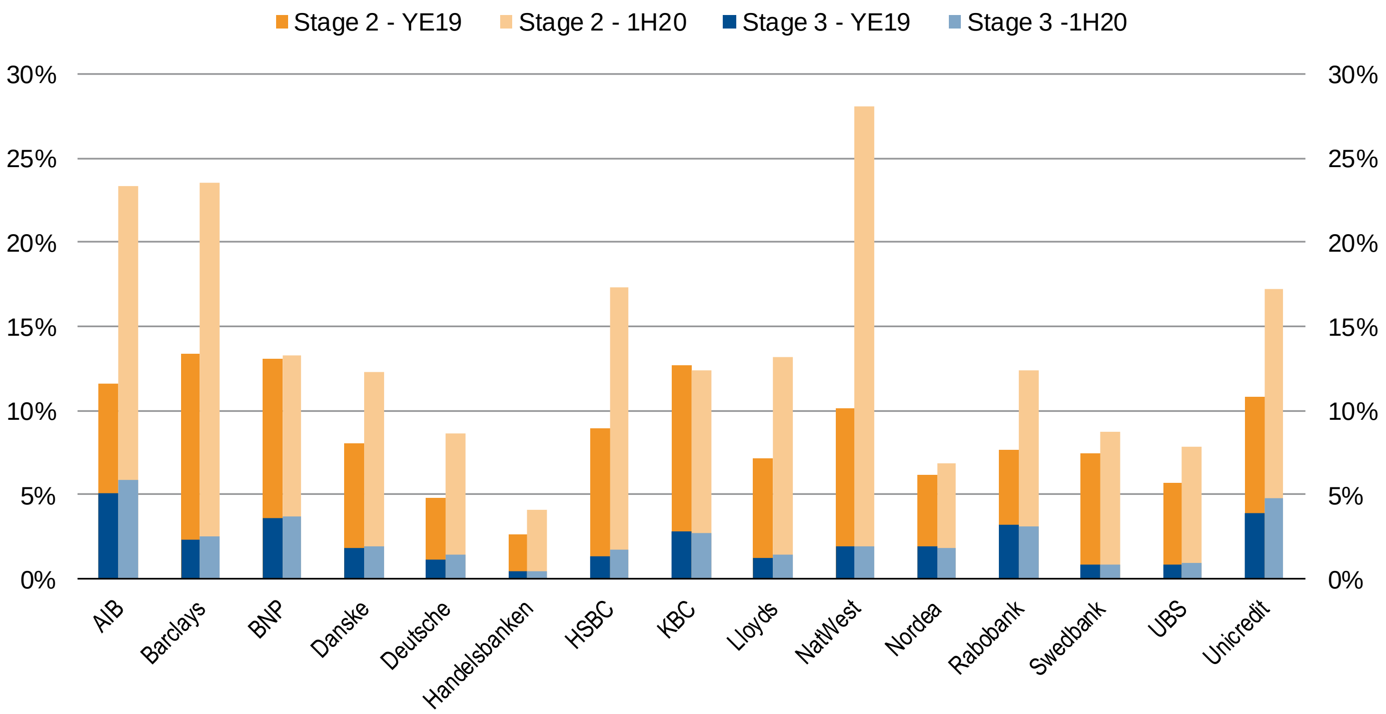
New issuance

As European banks can now meet their Pillar 2 requirements with a mix of CET1, AT1 and Tier 2 capital, there have been expectations for new issuance. Between the beginning of Q2 2020 and 14 August, 14 European banks raised almost USD 14.5bn equivalent in AT1 capital in euros, US dollars and sterling (Figure 3). Investor demand was very strong across the board. For euro-denominated and sterling supply, underwriters saw orders of EUR 36.5bn, equivalent to coverage of above 5x. Issues that priced in June did particularly well.

Of the nearly 120 banks supervised by the ECB, the average Pillar 2 requirement is 2.1% of RWAs. Consequently, banks could start covering nearly 20% of this amount with AT1 capital.

There is some concern that as less robust issuers come to market, this could potentially raise the attractiveness of solutions that remove the market stigma from drawing down on capital buffers – be it for increased credit losses or higher RWA from credit-risk migration.

Figure 2: Proportion of Stage 2 and Stage 3 loans, selected banks



Source: Banks, Scope Ratings.

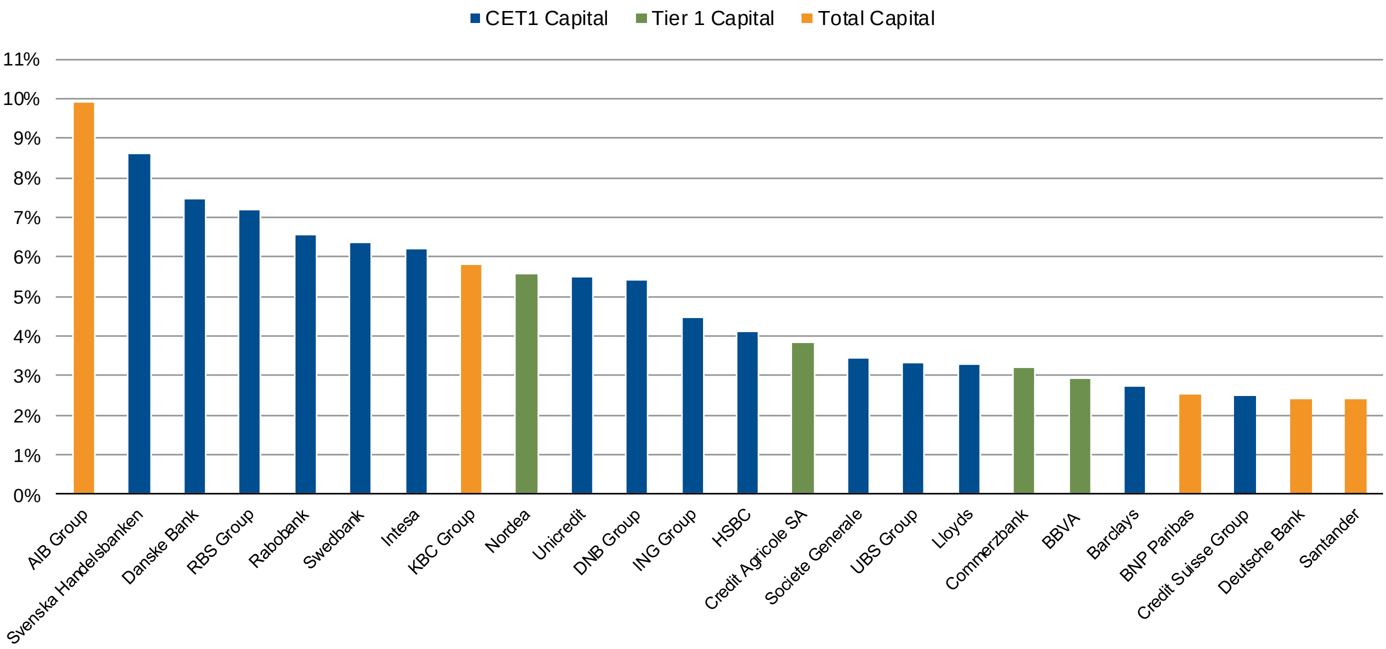
Figure 3: European bank AT1 issuance: 1 April 1 to 14 August 2020

Issuer	Issue date	Currency	Amount (m)	USD equiv (m)	Coupon	First call date
Barclays	5-Aug-20	USD	1,500	1,500	6.125%	15-Dec-25
Credit Suisse	4-Aug-20	USD	1,500	1,500	5.250%	11-Feb-27
UBS	22-Jul-20	USD	750	750	5.125%	29-Jul-26
Raiffeisen Bank International	22-Jul-20	EUR	500	580	6.000%	15-Dec-26
Bankinter	8-Jul-20	EUR	350	396	6.250%	17-Jan-26
Rabobank	7-Jul-20	EUR	1,000	1,130	4.375%	29-Dec-27
BBVA	7-Jul-20	EUR	1,000	1,130	6.000%	15-Jan-26
NatWest	24-Jun-20	USD	1,500	1,500	6.000%	29-Dec-25
Standard Chartered	17-Jun-20	USD	1,000	1,000	6.000%	26-Jul-25
Allied Irish	16-Jun-20	EUR	625	706	6.250%	23-Dec-25
Nationwide Building Society	10-Jun-20	GBP	750	953	5.750%	20-Dec-27
Commerzbank	8-Jun-20	EUR	1,250	1,413	6.125%	9-Apr-26
ABN AMRO	8-Jun-20	EUR	1,000	1,130	4.375%	22-Sep-25
Bank of Ireland	14-May-20	EUR	675	729	7.500%	19-Nov-25
				USD 14,416		

Source: Bond Radar

Appendix I: Headroom to MDA-relevant requirements

The MDA-threshold may be triggered by not meeting CET1, Tier 1 or total capital requirements. Below we show where banks have the smallest buffer to requirements.

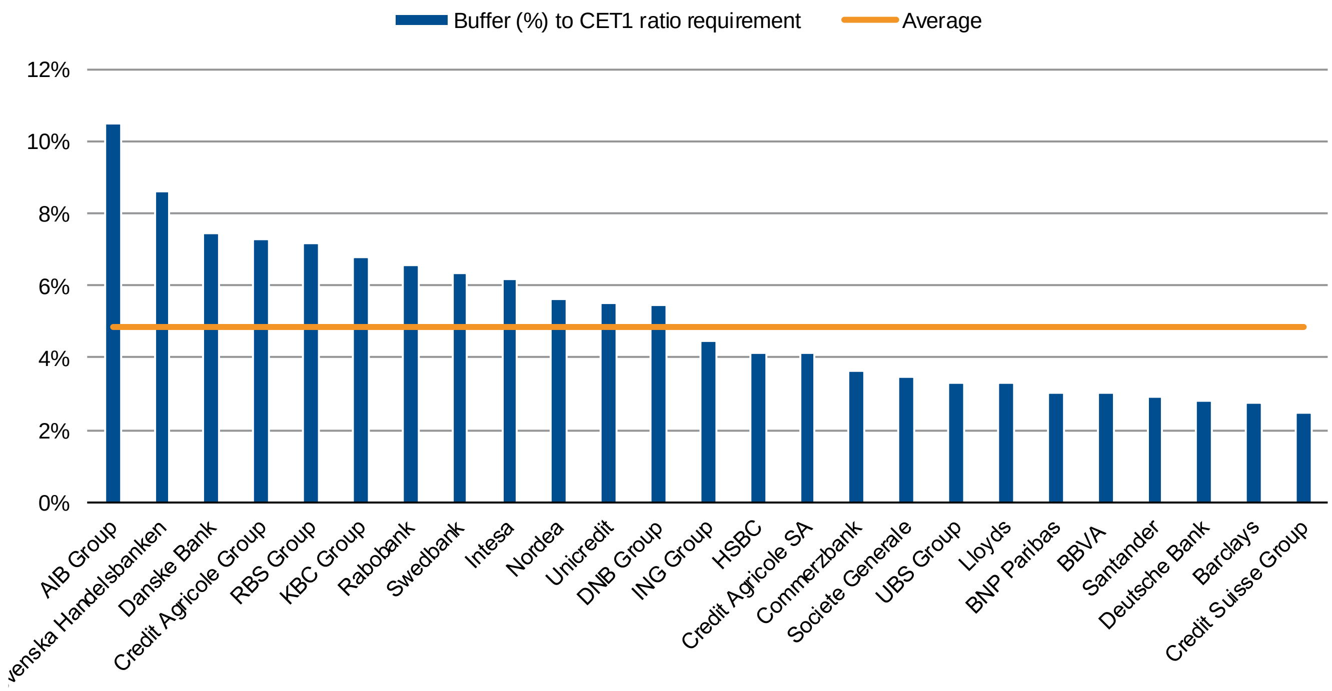


Notes: (1) For RBS, the 1.5% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in headroom of 7.2%. Excluding this, headroom to the CET MDA requirement would be 8.3%.
(2) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in headroom of 3.3%. Excluding this, headroom to the CET1 MDA requirement would be 5%.
Source: Banks, Scope Ratings estimates.

Appendix II: Headroom to MDA-relevant CET1 requirements

		2020	1Q 2020		2Q 2020			
	Basis	Req CET1	1Q20 CET1	Buffer	2Q20 CET1	Buffer	Currency	Buffer (bn)
AIB Group	Transitional	9.7%	20.3%	10.6%	20.2%	10.5%	EUR	5.3
Barclays	Transitional	11.5%	13.1%	2.3%	14.2%	2.7%	GBP	7.3
BBVA	Transitional	8.6%	11.1%	3.4%	11.6%	3.0%	EUR	11.0
BNP Paribas	Transitional	9.3%	12.0%	2.8%	12.4%	3.0%	EUR	21.8
Commerzbank	Transitional	9.7%	13.2%	3.7%	13.4%	3.7%	EUR	6.8
Credit Agricole Group	Transitional	8.8%	15.5%	7.1%	16.1%	7.3%	EUR	41.6
Credit Agricole SA	Transitional	7.8%	11.3%	4.3%	11.9%	4.1%	EUR	14.3
Credit Suisse Group	Fully loaded	10.0%	12.1%	2.6%	12.5%	2.5%	CHF	7.9
Danske Bank	Transitional	10.1%	17.6%	7.2%	17.6%	7.5%	DKK	58.5
Deutsche Bank	Transitional	10.5%	12.8%	3.1%	13.3%	2.8%	EUR	9.3
DNB Group	Fully loaded	12.8%	17.7%	5.9%	18.2%	5.4%	NOK	54.8
HSBC	Transitional	10.9%	14.6%	3.8%	15.0%	4.1%	USD	35.3
ING Group	Transitional	10.5%	14.0%	4.1%	15.0%	4.5%	EUR	14.4
Intesa	Transitional	8.4%	14.2%	5.5%	14.6%	6.2%	EUR	n.a.
KBC Group	Transitional	9.8%	16.3%	7.4%	16.6%	6.8%	EUR	7.1
Lloyds	Transitional	11.3%	14.2%	2.3%	14.6%	3.3%	GBP	7.4
Nordea	Transitional	10.2%	16.0%	6.1%	15.8%	5.6%	EUR	8.7
Rabobank	Transitional	10.0%	16.3%	6.3%	16.6%	6.6%	EUR	13.6
RBS Group	Transitional	10.0%	16.6%	6.2%	17.2%	7.2%	GBP	11.5
Santander	Transitional	8.9%	11.6%	2.7%	11.8%	2.9%	EUR	16.9
Societe Generale	Transitional	9.1%	12.6%	3.7%	12.5%	3.5%	EUR	12.4
Svenska Handelsbanken	Fully loaded	10.1%	17.6%	8.4%	18.7%	8.6%	SEK	60.7
Swedbank	Fully loaded	10.0%	16.1%	6.9%	16.4%	6.4%	SEK	44.1
UBS Group	Fully loaded	10.0%	12.8%	3.7%	13.3%	3.3%	USD	9.0
Unicredit	Transitional	9.0%	13.4%	4.2%	14.5%	5.5%	EUR	19.3

Notes: (1) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in headroom of 3.3%. Excluding this, headroom to the CET1 MDA requirement would be 5%.
(2) For RBS, the 1.5% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in headroom of 7.2%. Excluding this, we estimate headroom to the CET MDA requirement to be 8.3%.
(3) For Handelsbanken, Swedbank, DNB and Danske, Pillar 2 requirements are excluded from 2020 MDA-relevant CET1 requirements.
Source: Banks, Scope Ratings calculations.

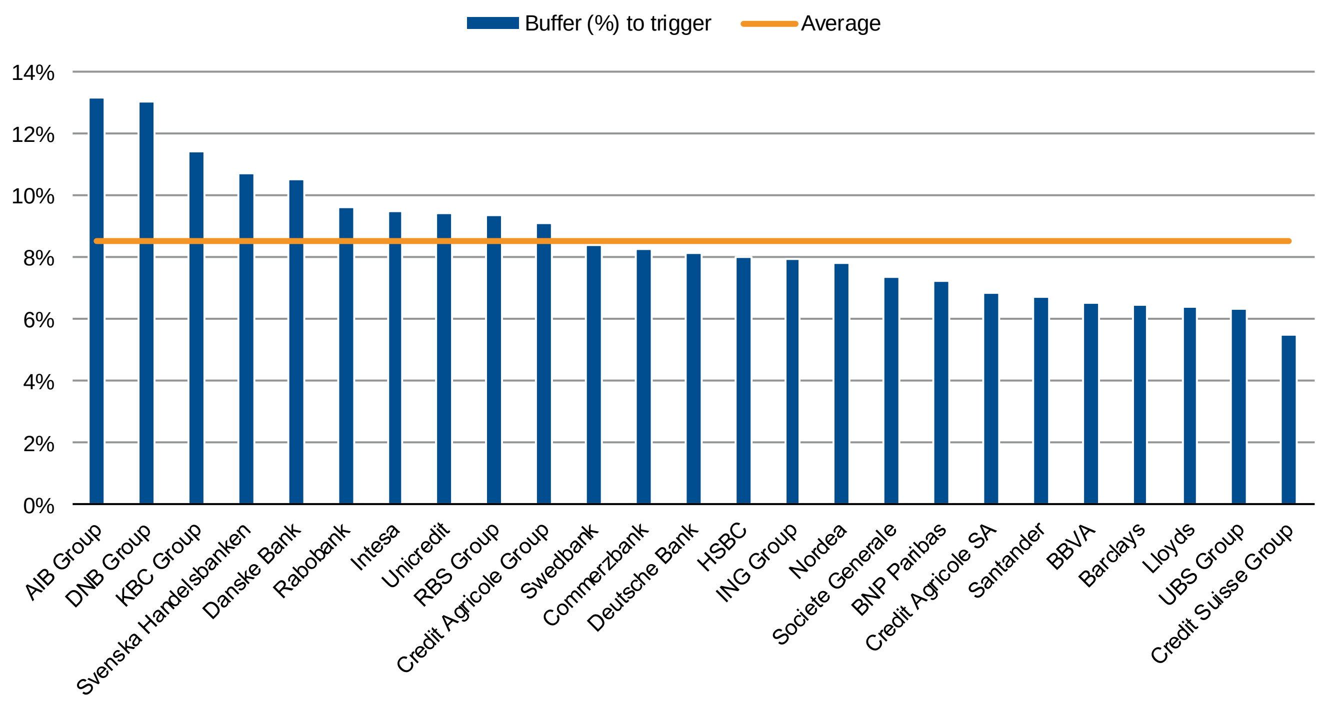


Source: Banks, Scope Ratings calculations.

Appendix III: Headroom to write-down/conversion trigger

			4Q 2019		1Q 2020		2Q 2020	
	Basis	Trigger	4Q19 CET1	Buffer	1Q20 CET1	Buffer	2Q 20 CET1	Buffer
AIB Group	Transitional	7.00%	20.3%	13.3%	20.3%	13.3%	20.2%	13.2%
Barclays	Fully loaded	7.00%	13.5%	6.5%	12.7%	5.7%	13.5%	6.5%
BBVA	Transitional	5.125%	12.0%	6.9%	11.1%	6.0%	11.6%	6.5%
BNP Paribas	Transitional	5.125%	12.1%	7.0%	12.0%	6.8%	12.4%	7.2%
Commerzbank	Transitional	5.125%	13.4%	8.3%	13.2%	8.0%	13.4%	8.3%
Credit Agricole Group	Transitional	7.00%	15.9%	8.9%	15.5%	8.5%	16.1%	9.1%
Credit Agricole SA	Transitional	5.125%	12.1%	7.0%	11.3%	6.2%	11.9%	6.8%
Credit Suisse Group	Fully loaded	7.00%	12.6%	5.6%	12.1%	5.1%	12.5%	5.5%
Danske Bank	Transitional	7.00%	17.3%	10.3%	17.6%	10.6%	17.6%	10.6%
Deutsche Bank	Transitional	5.125%	13.6%	8.5%	12.8%	7.7%	13.3%	8.1%
DNB Group	Fully loaded	5.125%	18.6%	13.5%	17.7%	12.5%	18.2%	13.1%
HSBC	Fully loaded	7.00%	14.6%	7.6%	14.5%	7.5%	15.0%	8.0%
ING Group	Transitional	7.00%	14.6%	7.6%	14.0%	7.0%	15.0%	8.0%
Intesa	Transitional	5.125%	13.9%	8.8%	14.2%	9.1%	14.6%	9.5%
KBC Group	Transitional	5.125%	17.1%	12.0%	16.3%	11.2%	16.6%	11.5%
Lloyds	Fully loaded	7.00%	13.3%	6.3%	13.9%	6.9%	13.4%	6.4%
Nordea	Transitional	8.00%	16.3%	8.3%	16.0%	8.0%	15.8%	7.8%
Rabobank	Transitional	7.00%	16.3%	9.3%	16.3%	9.3%	16.6%	9.6%
RBS Group	Fully loaded	7.00%	16.2%	9.2%	16.5%	9.5%	16.3%	9.3%
Santander	Transitional	5.125%	11.6%	6.5%	11.6%	6.5%	11.8%	6.7%
Societe Generale	Transitional	5.125%	12.7%	7.6%	12.6%	7.5%	12.5%	7.4%
Svenska Handelsbanken	Fully loaded	8.00%	18.5%	10.5%	17.6%	9.6%	18.7%	10.7%
Swedbank	Fully loaded	8.00%	17.0%	9.0%	16.1%	8.1%	16.4%	8.4%
UBS Group	Fully loaded	7.00%	13.7%	6.7%	12.8%	5.8%	13.3%	6.3%
Unicredit	Transitional	5.125%	13.2%	8.1%	13.4%	8.3%	14.5%	9.4%

Notes: (1) For banks with securities containing multiple trigger levels, the highest is used.
Source: Banks, Scope Ratings calculations.



Source: Banks, Scope Ratings calculations.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
London SW1W 0SR

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com