COVID-19 impacts on European banks: pre-existing financial health condition matters

The COVID-19 outbreak is adding considerably to the challenges faced by European banks, already suffering from weak revenues and insufficient profitability. Deterioration in asset quality is likely in view of the economic disruption caused by governments' policies to contain the outbreak.

Whether this morphs into a negative driver for bank ratings will depend on the length and depth of the unfolding economic downturn. This will be determined by the effectiveness of the regulatory, fiscal and monetary policy response as well as by the spread and intensity of the virus itself. For individual banks, the rating outcome depends crucially on each bank's starting point in terms of asset quality, profitability and capital buffers as the sector entered 2020.

Italy lockdown far from the worst case. As the virus spreads, the risk that European governments respond with measures that undermine economic growth, at least for the short-term, has increased significantly. The extensive lock-downs mandated by the Chinese and, to a lesser extent, Italian governments are likely to be followed by similar measures in other countries – and they may need to be tightened up if ineffective. Once in place, normalisation will be gradual and the risk for banks is that economic activity will recover only slowly, thus, putting pressure on asset quality.

Growth downturn likely, policy responses key. While the range of economic scenarios remains very broad, it is clear that global growth will take a hit, with recessions in H1 2020 possible in Europe (and likely in Italy). The uncertainty is compounded by the unknowns around policy responses from public health, fiscal and monetary authorities – as well as from the financial system itself. Stopping the liquidity crunch in locked down areas from turning into widespread solvency issues will prove key; we expect the financial system to keep the liquidity taps open, especially if governments move to extend guarantees on portions of their loan books. The ECB, which some believe has run out of effective additional policy options, will in our view continue to play a key role by keeping debt service costs from increasing out of control – a crucial piece of the policy puzzle especially for highly indebted countries such as Italy. Obviously, the room for policy mistakes, lack of coordination or belated responses is large, and represents a key downside risk to our relatively benign base case.

The crisis will further weigh on profitability, before turning into a credit issue. Any economic slowdown is likely to affect the banking industry. Slower volume growth, slower investment banking revenues and higher loan defaults are all to be anticipated at this point. Fortunately, the Coronavirus crisis meets a banking sector which has successfully rebuilt its standing after the great financial crisis. Strong balance sheets, with lower levels of NPLs, high capital ratios (both in absolute terms and relative to requirements) and more balanced funding profile should offer some protection to bank creditors, especially those sitting in the most senior parts of the capital structure. On the other hand, we note that the likely increase in loan losses will further depress sector profitability, which is already low (and on average insufficient to deliver sustained shareholder value creation through the cycle). The heightened level of uncertainty may also cloud the outlook for dividends and buybacks, which had emerged as a pivot in the banks equity story in recent months.

Pre-existing conditions to determine rating impacts under most scenarios. Whether the current crisis turns into more severe credit problems for the banks will depend on the length and depth of the economic slowdown, as well as on banks' own state of business and financial health entering 2020.

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Italy lockdown is the best-case scenario; downside risks abound

Italy announced total lockdown

On March 7, Italy announced the lockdown of Lombardy and 14 other provinces in northern Italy, alongside severe measures to slow the spread of COVID-19 contagion. This was quickly expanded to the entire country. Italy is the euro area's third largest economy, accounting for 17.7% of the population and 15% of GDP. The decisions were driven by:

- growing pressure on intensive care capacity due to the high (and growing) number of patients with acute respiratory crises;
- realisation of significant community transmission
- experience in the previously cordoned-off "red zone", an area of about 50.000 inhabitants where severe social distancing measures proved effective in controlling the contagion curve.

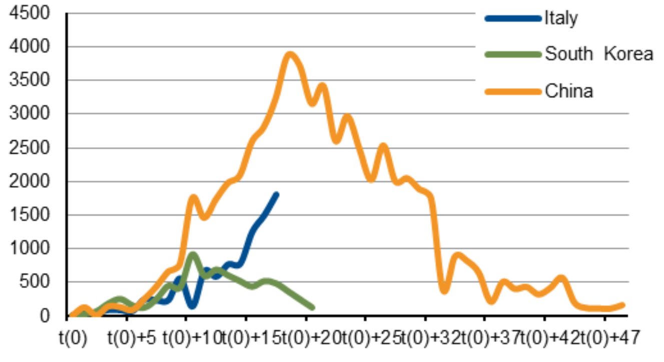
The lockdown is expected to last at least until April 3 (i.e. three weeks) but could be prolonged if needed, which is likely across the Easter travel season.

Italy's measures are not as severe as China's lockdown of Hubei

We stress that we are far from a worst-case scenario, as it remains unclear whether the measures will be enough to stop the virus spreading. For comparison, China announced the Hubei lockdown on January 23, with just 570 total confirmed cases and around 150 new daily cases, while South Korea enacted very severe measures on February 23, with 190 daily cases confirmed (Figure 1).

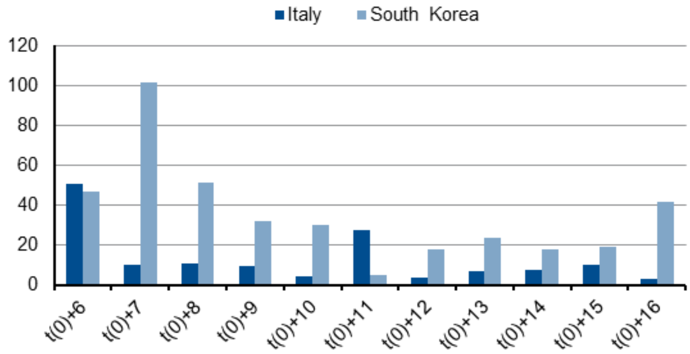
By comparison, Italy's public-health response has been more gradual: by the time the Northern Italy lockdown was announced, there were already close to a thousand daily new cases. We also believe that the severity of the Italian "social distancing measures", while unprecedented for a Western democracy, is not comparable with the ones put in place in China and South Korea. Moreover, the degree of citizens' compliance with the social distancing measures and therefore their effectiveness in Italy may be lower than that experienced in China. Finally, the number of tests administered in Korea is much higher than in Italy, which may have contributed to better case-tracing in the early stages of the epidemic (Figure 2). One caveat to these comparisons is the reliability of the data on infectious cases, which are widely believed to be under-reported. We note that data on the effectiveness of social distancing measures in the original Italian "red zone" in the Lodi province proved effective in significantly slowing down local contagion within two weeks, although these measures were more severe than the ones subsequently announced for the Italian territory.

Figure 1: Daily new cases in Italy, China and South Korea since outset of sustained local transmission



Source: ECDC, Scope Ratings
Note: t(0) = beginning of sustained local transmission, typically 10 new daily cases

Figure 2: Daily number of tests per new case discovery (t-1) in South Korea vs Italy

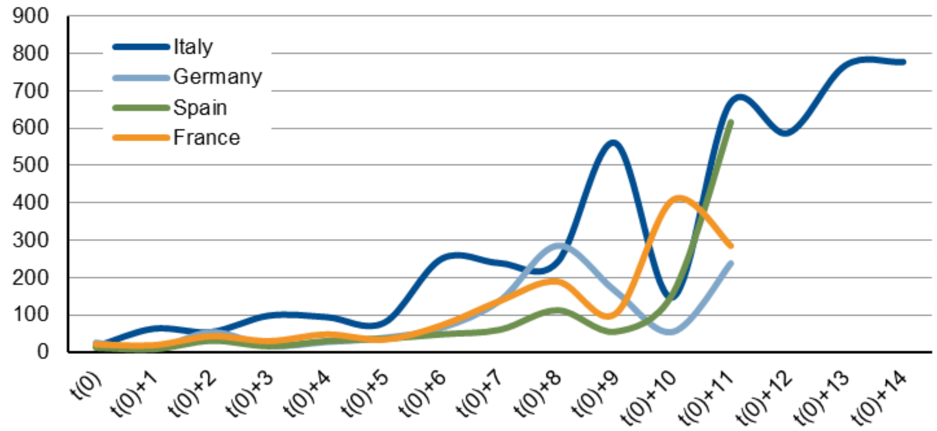


Source: ECDC, Press, Scope Ratings
Note: t(0) = beginning of sustained local transmission, typically 10 new daily cases

Other EU countries may announce similar measures in the coming days

We also note that, given the very fast spread of the virus combined with a high mortality rate and the stress COVID-19 places on public health systems, other EU countries will be under pressure to prioritise public health over economic disruption, which may lead to further downside. In our view, given the degree of integration and cross-border mobility in Europe, there is no reason to assume that some other European countries will be any less affected than Italy. In fact, contagion curves in France and Germany seem to track the Italian data, and these countries' governments may soon have to move more aggressively to get ahead of the infection (Figure 3).

Figure 3:Contagion in major EU countries is tracking Italy's curves



Source: Source: ECDC, Scope Ratings
Note: t(0) = beginning of sustained local transmission, typically 10 new daily cases

Economic growth forecasts will have to be materially adjusted to the downside

A swift V-shaped rebound in economic activity is unlikely. First, there is enough evidence of community transmission across Italy and the EU, where public health policy responses have so far lagged. Second, assuming the spread is contained by social distancing measures, any return to normality will have to be gradual, to prevent further epidemic episodes in coming months. Moreover, the co-ordinated slowdown in global GDP and trade will weigh on external demand. Meanwhile, the fiscal cost associated with supporting economies will likely leave already-fragile public finances, in countries such as Italy in a worsened condition. Lastly, even if the virus were to disappear quickly, even a short drought in economic activity could cause lasting economic damage to smaller companies and the self-employed sector in many countries.

Even before the lockdown, forecasters around the world had cut GDP estimates for Italy, among other affected countries. The OECD, for example, cut Italy's 2020 GDP growth forecast to 0% at the beginning of March. The lockdown announcement is likely to push growth estimates into the red, at least for this year. A likely significant tightening of containment measures in other EU countries will further depress the growth outlook for Europe.

At this stage, it is difficult to estimate the full economic blow from the health crisis, which will depend, among other things, on the degree of reduction in human and economic activity, the time it takes to bring contagion under control and to rebuild supply chains and inventories, as well as the policy response of fiscal and monetary authorities.

Both monetary policy and fiscal policy are constrained, but constraints can be eased

Given the perceived impotence of monetary policy, fiscal policy is widely seen as the saviour in this situation. At this point, most countries have yet to define their fiscal response, which could be decisive in limiting the depth and length of the downturn. Coupled with the likely decline in tax revenues from the growth slowdown and the equally likely need to increase healthcare-related expenditures in the short term, it is already clear that government finances are set to deteriorate.

While these measures will support banks' asset quality, banks are in many cases already heavily exposed to highly-indebted sovereigns, particularly in the euro area (EA). Rising debt/GDP ratios will once again lay bare the structural deficiencies of the EA, though it is unlikely that this will be of immediate concern to policy makers in crisis mode. The ECB, which is widely regarded as having little dry powder left, will likely still play a key role ensuring that the system stays liquid, financial market volatility stays within reasonable bounds and additional public debt stays serviceable.

Short term impacts manageable, long-term impacts uncertain, policy and regulatory response key

Short term, banks' contingency planning will be tested

In the early phases of contagion (and containment), banks' contingency plans are being be put to the test. Remote working capabilities, capacity to serve customers through remote channels, robustness of cyber risk management protocols under stress and managerial capacity will prove key in minimising disruptions to the retail and corporate banking businesses.

Dip in markets activity likely temporary

Investment banking revenues will take a hit, as uncertainty is holding back business during a usually very active period for primary markets. At the same time, banks' trading activity will get a boost from market volatility and clients' financing needs are most likely to rise as the year goes on.

Longer term, asset quality, profitability and capital are likely to be affected

The economic drought related to the containment measures and the recession that could start in Q2 will strain the budgets of borrowers and, if protracted, the lack of liquidity will turn into increased loan defaults and the need for banks to increase provisions. The weakness could be related to regional factors, especially household and SME borrowers in heavily-affected areas as well as sectoral factors. The latter include manufacturing, especially cars and original equipment manufacturers (OEMs), tourism and leisure.

Balance-sheet erosion for the banks in 2020 will come through a number of channels, notably a rise in the demand for liquidity as corporate and retail customers draw down lines and extend payment terms.

Banks in Italy working to prevent the liquidity crisis from spiralling into a widespread credit crisis

Judging by the banks' first reactions in Italy, the liquidity taps may stay open, which may help viable customers to stay in business.

Banks have announced measures to support customers and protect the franchise. These include loan moratoria for retail and SME customers affected by the emergency. Our understanding is that suspension of payments will not automatically result in accounting re-classifications of assets to impaired (stage 3) or heightened risk (stage 2) under IFRS 9.

However, should the situation lead to an assessment of increased risk relative to initial recognition, banks will have eventually to recognise higher expected losses on the loans. Forbearance programmes for mortgages, consumer debt and SMEs are a sensible strategy, but this will ultimately find its way into reported non-performing loans and later defaults, if customers do not recover quickly enough from the crisis. Asset quality will deteriorate over time if the current consensus of a swift V-shaped cycle turns out to be too optimistic.

For banks with weaker underlying profitability, the need to increase provisions may eat into capital bases, just when balance sheets are undergoing risk inflation. As companies draw down their credit lines and banks downgrade their internal ratings, risk-weighted assets will start to rise, reducing capital ratios even before any losses materialise.

A key question mark revolves around the regulatory response to the current crisis

Unlike some of the recent downturns, this crisis did not originate in financial markets, nor was it caused by any fundamental flaws in the way banks are managed. Nevertheless, high levels of household, corporate and sovereign indebtedness across a variety of countries could well prolong the initial economic shock. In this instance, policy makers are likely to see banks more as part of the solution than part of the problem, at least initially and we do expect a certain degree of regulatory forbearance as banks and their clients adapt to the situation.

Regulatory forbearance could come in form of lower minimum capital buffers, provisioning requirements and specific lending programmes directly underwritten by governments and public development banks.

For example, banks in Hong Kong have been encouraged by the regulator to offer relief measures to clients. These include low interest rate loans to SMEs, allowing interest only payments on mortgages for up to one year and reducing late payment fees on credit cards. Clients must request the relief measures and the banks have stated that they are offering them to those with good credit histories. As well, the government has introduced a special 100% guarantee for SME loans with a repayment period of up to 36 months and an optional principal moratorium for the first six months.

Further monetary easing will further challenge top-lines

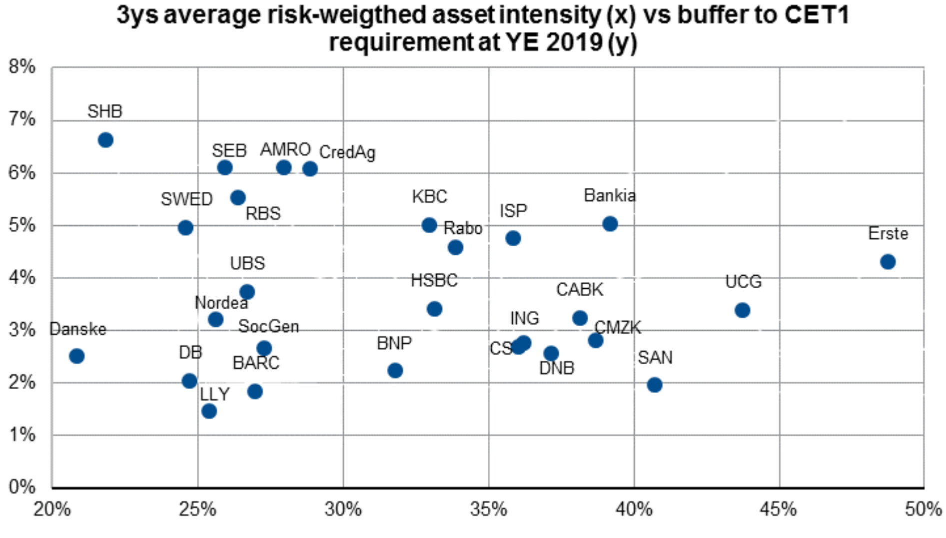
As mentioned above, we also expect a forceful policy reaction both from governments and central banks. However, we note that any further monetary easing will only exacerbate the already-challenging revenue outlook for those banks that rely primarily on intermediation income. While revenue diversification into fees has been a key success factor for many large EU banks in recent years, this may not be the case in 2020, as fee income from capital markets, asset management, bancassurance and wealth management will contract this year, eroding many of the gains of 2019.

While this type of volatility is largely discounted in credit ratings at this point, falling revenues will put pressure on management teams to pursue further cost cutting, digitisation and eventually M&A.

Promised dividend payouts will be under pressure

Our base case is that loan losses and RWA inflation will stop short of putting bank credit in jeopardy, especially for the more senior layers of banks' capital structures. That said, we do expect that the recent leeway some banks gained with respect to increased capital distribution (via buybacks and higher dividends) may be reduced, at least while the emergency is ongoing.

Figure 4: CET1 buffer over SREP requirement (2020) and RWA intensity, top European banks



Source: SNL, Scope Ratings

Which banks are more vulnerable from a credit standpoint?

Banks facing uncertainty from a strong staring point

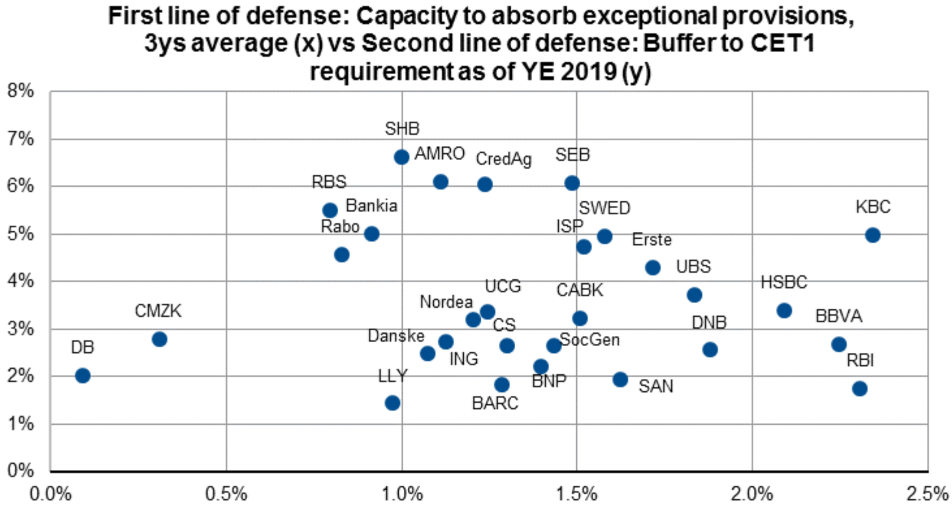
Fortunately, the coronavirus crisis comes at a point in the cycle where European banks have on one hand rebuilt their balance sheets – a point of strengths for creditors – although the recovery of pre-provision profits has been lagging as banks struggle with very low rates, flat curves and a high cost base; a point of concern for shareholders. Strong balance sheets explain, in our view, why bank credit markets have – at least initially – responded in a relatively muted way to the sell off, when compared with rates and equity markets and inflation expectations.

While it is hard to fathom the depth of the oncoming asset-quality cycle, it is already clear at this point that the profitability of many banks is inadequate to manage through a prolonged economic crisis that results in heightened provisioning needs. Cost income ratios are simply too high and are burdened by the double impact of high legacy costs from ageing IT and back-office operations, over-sized branch networks on one side and the need to invest in new technology to fend off new competitors on the other.

Profitability buffers will be the first line of defence against asset quality shocks

We look at banks' pre-provision profits as their first line of defence against loan-loss provisions, and a key buffer against capital erosion. High structural profitability is also a key anchor determining banks' ability to raise capital in a more severe scenario. Figure 5 plots major European banks' average pre-provision profits minus average loan loss coverage over the past three years against their CET1 buffers (measured against 2020 SREP requirements). It shows that most European banks could easily cope with higher levels of loan loss provisions of 100bp or more compared to the levels of the past three years.

Figure 5: Most European banks could absorb over 100bps of loans in excess provisions a year without eating into their capital bases



Source: SNL, Scope Ratings

Among larger banks, German banks look particularly vulnerable to an increase in provisions – which were close to zero in recent quarters – due to their low pre-provision profitability. Next to this structural deficiency, the German manufacturing sector was already weakening going to this crisis, and the fall in global trade will put further pressure on external demand, notably for automobiles. For the UK banks, profitability over the last few years has been materially depressed by various legacy conduct costs (PPI in particular) which should no longer be the case in the future. However, the impact from COVID-19 could exacerbate any potential weakening of the UK economy due to Brexit.

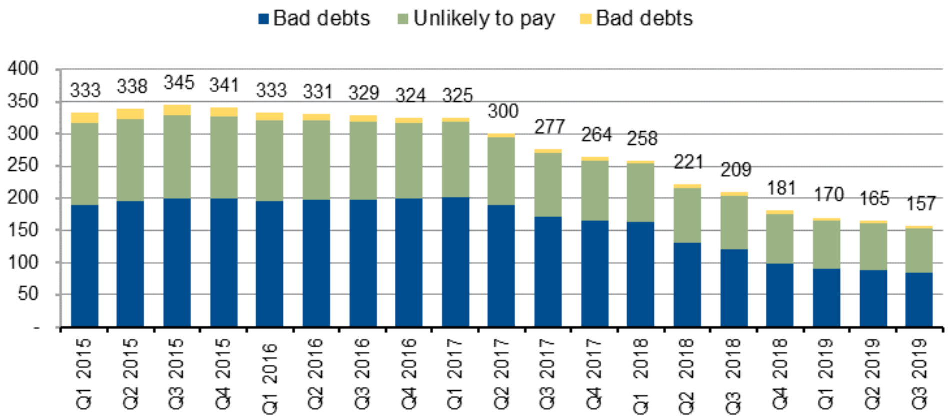
Italian banks: is a U-turn in asset-quality improvements around?

Zooming in on Italy, the country most directly impacted (for now), the public health crisis has the potential to invert a positive trend in asset-quality metrics.

For several years, Italian banks have worked to reduce their levels of NPEs.

Since their peak in Q3 2015 at EUR 345bn, gross NPE decreased fast to EUR 180bn at YE 2018, and then to EUR 157bn at September 2019 (Figure 6).

Figure 6: Italian bank's NPE stock (EUR bn) decreased further in 2019



Source: Bank of Italy, Scope Ratings

In 2019, the progression in the NPE stock decline was facilitated by two main factors:

- Supportive operating conditions: stagnation in Italian GDP did not translate into higher default rates, which remained low.
- Renewal of the GACS scheme: on March 2019, the Italian government renewed the public guarantee scheme on the senior tranches of bad loan securitisations. The GACS scheme played a key role in boosting NPE disposals

COVID-19 recession will lead to higher defaults

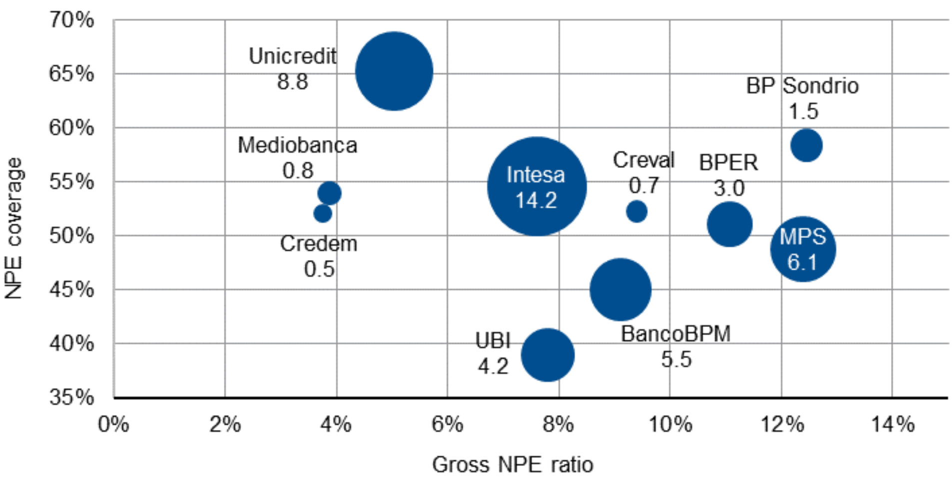
We believe the COVID-19 related recession in Italy will likely lead to higher defaults, possibly reversing the favourable trends. Autonomous workers and SMEs will be particularly affected by the restrictive measures being imposed, although the government has promised relief. EUR 7.5bn (0.4% of GDP) has been earmarked to support the economy of the areas initially cordoned off and isolated – with a much larger package of fiscal support being considered. In the initial response, measures included:

- temporary suspension of fiscal and bill payments in the affected municipalities
- State payment of wages to affected workers (cassa integrazione) to private employees and independent professionals
- Increased SME guarantee fund, and, for firms operating in the red area (for 12 months) guaranteed access to bank lending with a grant of up to EUR 2.5m per firm.
- At national level, a EUR 350m increase to the fund supporting exporting firms.
- Measures to support the tourism sector with the postponement of tax payments.

With the wider lockdown this week, these measures are unlikely to make a lot of difference and we believe that some pressure on asset quality will be unavoidable.

The key driver for the improvement in recent years has been a relentless pressure from supervisors to clean up legacy bad loans from the global financial and EA sovereign crises. This pressure has been unwelcome, forcing the banks' hands into disposals that may have not always maximised shareholder value. Among the larger banks, only a handful still display double-digit NPL ratios, while coverage levels are strong (Figure 7). With hindsight, the sector may have been in much worse condition today if it had to face a highly uncertain outlook while still dealing with an unmanageable pile of legacy bad loans.

Figure 7: Gross NPE ratio, coverage, and net NPEs (bubble size) as of 2019 YE



Source: Company data, Scope Ratings

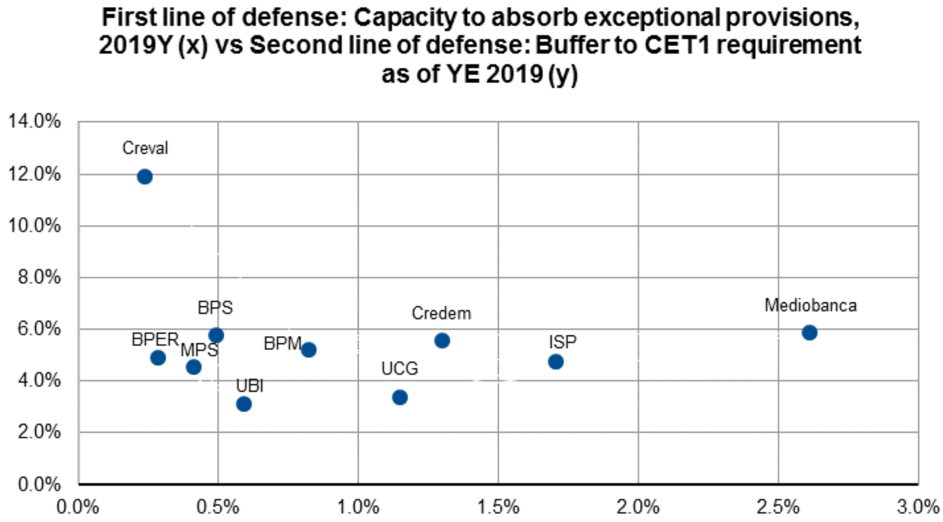
Italian banks: pre-existing conditions will determine severity of COVID-19 impacts

When facing any asset-quality shock, the pre-existing state of banks' financial health matters a lot. Banks with strong business models and good underlying profitability will be able to withstand it relatively better than others, and may come out stronger as competitors are hit.

UniCredit, Mediobanca, Intesa and Credem best placed to withstand a shock

In Italy, only a handful of banks have high profitability buffers against a new asset-quality crisis (Figure 8). Intesa, UniCredit, Credem and Mediobanca stand out, although the latter's top line may suffer disproportionately in 2020 from the market volatility, due to the large contribution to its revenues from investment banking. Credito Valtellinese stands out for its strong capital cushion, although this may be eroded fast if loan losses spike, due to the low underlying profitability of its business model. Other second-tier Italian banks (largely former popolari banks) look more vulnerable owing to lower underlying profitability. However, for most of these banks, 2019 was still burdened by relatively high provisions on legacy NPEs.

Figure 8: Loss absorption capacity of Italian banks in 2019 vs CET1 buffer over 2020 SREP



Source: SNL, Scope Ratings

Bank dividends and promised buybacks are first in the firing line

The increased uncertainty over the economic outlook will in our view lead banks to be cautious with respect to dividend payouts, despite management teams' recent commitments to increased capital distributions. Supervisory approvals for buybacks may prove more difficult to obtain in the changed scenario.

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