Covid-19: Dutch banks' strong financial fundamentals facing tough test

The financial fundamentals of Dutch lenders have improved significantly since the financial crisis. Solvency metrics and balance sheets have both strengthened. But the challenges stemming from the economic fallout from Covid-19 represent an unprecedented test.

The largest Dutch commercial banks display highly distinct business models; the common denominator being a strong international presence. Hence, we see credit risks primarily deriving from exposures to industries sensitive to the fall in oil prices but also from disruptions to trade finance. A prolonged contraction in domestic GDP, amplified by the open, export-oriented nature of the Dutch economy, could lead to a significant worsening of the credit quality of the banks' domestic portfolios.

For the three largest Dutch lenders (ING, Rabobank and ABN AMRO), bottom-line profitability has been boosted by historically low cost of risk. On a normalised level, the pre-provision profitability of the top three lenders would be able to absorb between 60bp and 100bp of additional impairments this year.

Rabobank reports the largest oil and gas exposure in both absolute and relative terms, but it is still limited to just 1.6% of total exposures. However, since the drop in crude oil prices is a demand-led one, we expect oil-related sectors to suffer, which will make ING's and ABN AMRO's books more vulnerable.

ABN AMRO announced it is expecting a Q1 net loss mainly due to an exceptional charge in its clearing subsidiary, coupled with what we estimate as a tripling in cost of risk (to 45bp) likely related to its oil and gas exposure.

However, these estimates do not capture the effects a prolonged recession could have on profitability and credit losses for Dutch lenders. On the positive front, all banks have de-risked in the past few years and have much stronger solvency metrics today.

On top of a comfortable capital position, the relaxation of requirements from both ECB and the Dutch central bank (DNB) leave considerable additional room for manoeuvre. All three lenders have elected to adhere to the ECB recommendation to suspend 2019 final dividend payments, setting aside roughly EUR 2.7bn in aggregate previously earmarked for distributions.

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Significant government measures temporarily shield domestic exposures

Sizeable and well targeted government package

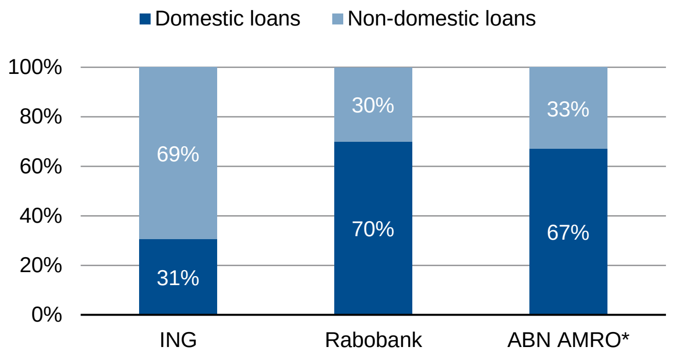
The Dutch government announced a sizeable stimulus package in response to the Covid-19 pandemic, entailing approximately EUR 15.6bn of fiscal measures and EUR 1.4bn of public guarantees, together totalling 2.2% of GDP: The majority of measures are intended to protect household income and to allow SMEs and corporates to access financing, including bridge loans.

While the direct fiscal measures, loan and guarantee packages remain relatively small compared to peers such as Germany, we expect additional support measures if containment is prolonged and/or intensifies. Compared to other and more strongly-hit economies, the Dutch government has ample fiscal space to raise additional funds to mitigate the economic and health impact of the Covid-19 shock.

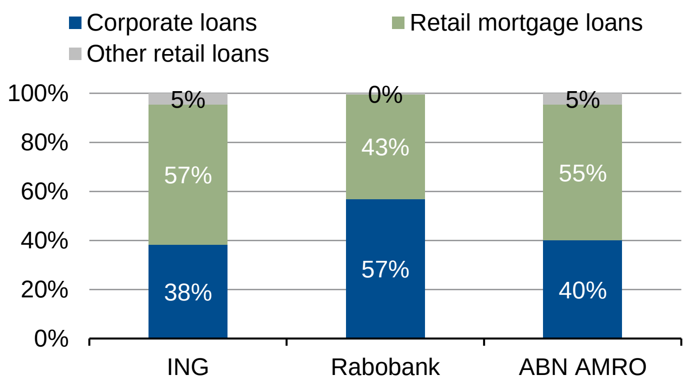
In a baseline scenario, Scope anticipates a contraction of output in the range of 4%-5% of GDP in 2020, followed by a recovery of between 3%-4% in 2021.

Even with income support from the government, we expect weaker categories of the workforce, such as the self-employed (which in the Netherlands represent ca. 15% of the adult employed population) to take longer to recoup losses from the partial lockdown measures. The same applies to SMEs and corporates operating in tourism, catering and culture and entertainment in a first wave but gradually covering all 'essential' businesses.

Figures 1 & 2: Lending breakdown



Source: For ABN AMRO, geographical breakdown of exposures
Source: Company disclosures, Scope Ratings



Source: Company disclosures, Scope Ratings

ABN AMRO, Rabobank and ING have all announced that households can temporarily defer debt service on their mortgages, either interest and principal or just principal.

High indebtedness a weakness for the private sector

Despite an adequate household savings rate, the ratio of private debt to disposable income in the Netherlands is among the highest in Europe, the housing market being the main driver.

The residential mortgage market has traditionally been dominated by interest-only loans, with high LTVs at origination relying on borrower's income capacity, which have so far led to historically low default rates. However, as saving accounts pledged against mortgages cover on average 15% of debt[1], an adverse scenario of prolonged recession with high unemployment would see lenders coming under stress from decimated borrower income and inadequate savings.

[1] DNB working paper No. 655 / September 2019 (on loan level data)

We expect cash flow from commercial real estate activities to have already declined in the first quarter, which could lead to price declines later in the year. However, the large Dutch banks have reduced their exposure to this sector in recent years to only 4.5% of gross lending.

Sizeable energy, transportation and trade finance exposure

Statistics from the DNB show Dutch banks' lending to foreign counterparties stood at 36% of the total at end-2019. Moreover, given the open nature of the small Dutch economy, domestic lenders are significantly exposed to global growth and international trade.

ABN AMRO and ING in particular are exposed to the global energy sector, which at current oil prices will suffer.

ING and ABN AMRO sensitive to single exposure risk

ING's wholesale banking (WB) had approx. EUR 246bn of lending and trade finance at YE2019, including transportation and logistics (9%, or EUR22bn) and energy (13%, or EUR 32bn). Of oil and gas-related exposure at YE2019 ca. EUR 4.4bn was directly linked to commodity price risk.

Cost of risk of the wholesale bank has averaged 18bp over the past three years, peaking in 2019 at 29bp of average lending due to large concentrations and a fraud case. Given the declining revenues recorded in 2019, the WB division had room for approx. 70bp of additional impairments.

ABN AMRO reported approx. EUR 55bn of lending in its Corporate and Institutional Banking (CIB) division as of end-2019, of which EUR 4bn (8%) was oil and gas exposure and EUR 2bn (4%) in offshore activities. The CIB division's cost of risk averaged 56bp of average lending, with the most significant impairments in the offshore sector (EUR 465m over the past three years). With the current earnings capabilities, the division could withstand ca. 75bp of additional provisions.

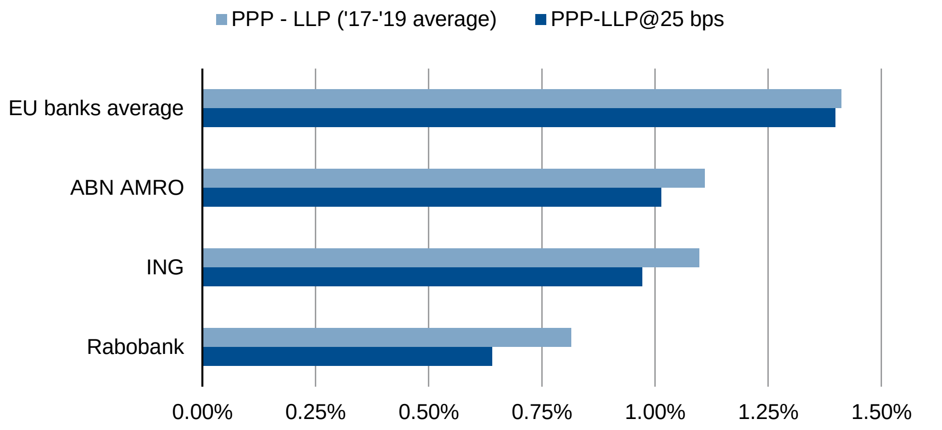
Rabobank has largest oil and gas exposure in absolute and relative terms

Rabobank has ca. EUR 9bn of oil and gas exposure and EUR 8bn in transportation. In 2019, impairments on large individual unrelated exposures drove the cost of risk in the Wholesale, Rural & Retail (WRR) segment to 55bp of private sector loans, above the 52bp long-term average.

Operating profitability able to withstand, at normalized levels 90bp of exceptional loan-loss charges

While not being particularly strong by European standards, Dutch banks could absorb approx. 100bp of additional provisions on pre-provision income based on the past three-year average. This is based on historically low levels of provisioning in recent years, compared to an average of 25bp-30bp at ABN and ING through the cycle. Given the pro-cyclicality of IFRS 9 provisioning rules (it is not clear if they will be applied in the short term), coupled with historically low default rates of domestic retail exposure, the provisioning needs in this downturn could be significant compared to previous episodes.

Figure 3: PPP absorption ability 3yrs average vs normalized



Source: SNL, Scope estimates

Given the strong top-line earnings compared to peers in recent times, ABN AMRO could absorb ca. 110bp of exceptional impairments. We see Rabobank weaker on the profitability side; a significant share of its domestic and international corporate exposure is concentrated in the food and agricultural sector.

Increased capital buffers provide extra protection

The Dutch banking sector has become increasingly resilient over the past couple of years, strengthening its capital.

Significant capital release from central banks' measures

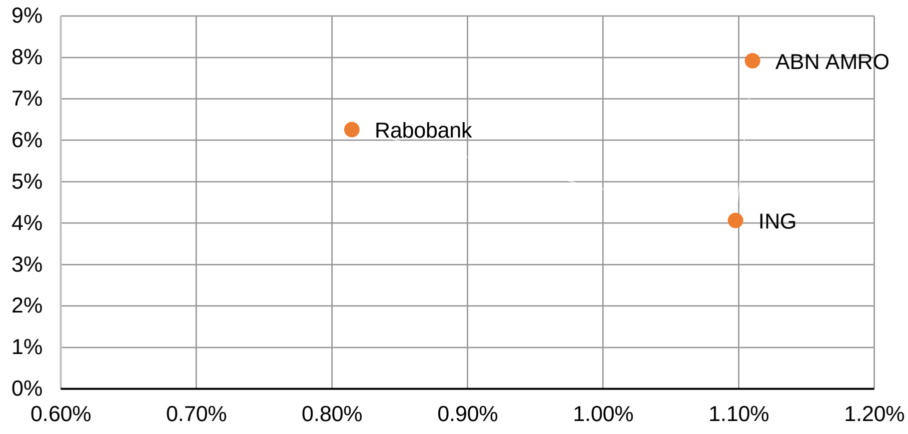
At the same time, the ECB and national central banks are playing their part in making sure banks are allowed room for manoeuvre in order to support the real economy. Measures include relaxation of capital and liquidity requirements, the ECB's Targeted Long-Term Refinancing Operation (TLTRO) and Pandemic Emergency Financing Facility (PEPP) and allowing leeway on recognition and treatment of non-performing loans from an accounting and regulatory perspective.

The ECB has allowed banks under its direct supervision to operate below their Pillar 2 guidance and capital conservation buffer.

Moreover, by applying Article 104, the ECB allows its directly supervised banks to utilise AT1 and T2 capital to fill the Pillar 2 Requirement. Combined, the three lenders could see ca. EUR 5.4bn of CET1 capital move from a CET1 to a total capital requirement.

The Dutch central bank has reduced the systemic buffer for ABN AMRO, Rabobank and ING, which releases approx. EUR 4.8bn of capital in aggregate for the three banks. For ABN AMRO, a 2% O-SII buffer now applies. The DNB has also postponed the introduction of a risk-weighting floor for mortgage loans, which would have been an additional burden in 2020.

Figure 4: First line of defence: Capacity to absorb exceptional provisions, 3ys average (x) vs Second line of defence: Buffer to CET1 (COVID) requirement (y)



Source: SNL, Scope estimates

Moreover, all three banks have elected to follow ECB recommendations on dividend distributions: ING would likely have set aside ca. EUR 1.7bn; ABN AMRO EUR 640m; and approx. EUR 360m for Rabobank.

I. Appendix – Government measures in detail

Expenditure measures

Temporary arrangement to compensate labour costs: companies facing a 20% drop in turnover can apply for an allowance to pay up to 90% of wages for three months. Cost estimated at EUR 9.1bn.

Income support for self-employed/one-person companies, with income topped up to the social minimum wage (ca. EUR 1.6k gross per month) over a three-month period with no obligation of repayment. Cost estimated at EUR 3.8bn.

Compensation scheme for the hospitality and health sector, to be approved under State Aid rules. Estimated cost EUR 0.8bn.

Tax measures

Companies can apply for a deferral of payment for various taxes ((corporate) income tax, VAT and payroll taxes). Estimated cost EUR 37.9bn deferred.

Sectorial and other measures

Extension of the SME support scheme (up to 250 employees): SMEs can access bridge loans or increase overdraft limits, with a government guarantee of up to 75% of the credit. Both the single-company maximum and the overall ceiling was increased (to EUR1.5bn).

Qredits, the microcredit provider, is granting six-month deferment of repayments, with interest rate on loans automatically lowered to 2%.

Source: European Commission, Dutch Government

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