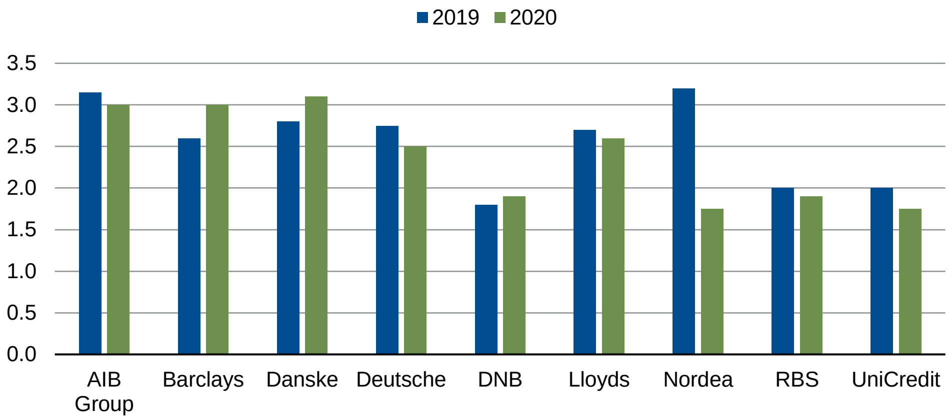
AT1 quarterly: where are bank capital requirements heading?

In this latest AT1 quarterly, we look at some of the moving parts regarding banks' capital requirements and the potential impact of the move away from Libor. As usual, an overview of key metrics of European bank AT1 issuers can also be found.

Helpfully for investors, the ECB recently disclosed the Pillar 2 requirements of the nearly 120 significant institutions that it supervises. These requirements, which must be met entirely with CET1 capital, stem from the Supervisory Review and Evaluation Process (SREP) and have been in force since the start of the year.

While the average Pillar 2 requirement remained unchanged from the previous SREP cycle, we highlight some changes for AT1 issuers below (Figure 1). Banks demonstrating some improvement in credit fundamentals such as AIB, Deutsche Bank, and UniCredit, have seen Pillar 2 requirements come down. For Nordea, the significant decrease follows on from the change to the ECB as supervisor. Meanwhile, Barclays has seen an increase following the removal of the Pillar 1 operational risk floor.

Figure 1: Changes in Pillar 2 requirements – selected AT1 issuers



Notes: For UK banks, the Pillar 2 requirements shown above reflect only the CET1 component.
Source: Company data, Scope Ratings.

There has been some excitement about Article 104a, an amendment to CRD IV, as it would allow for Pillar 2 requirements to be met with a mix of common equity and capital instruments. More specifically, at least three quarters should be Tier 1 capital; and at least three quarters of the Tier 1 capital referred to previously should be CET1 capital – so in effect, in the same manner that Pillar 1 requirements must be fulfilled. With the average Pillar 2 requirement being 2.1% for banks supervised by the ECB, this means that CET1 requirements could decline by about 92bp on average.

We raise a few caveats. First, the amendments to CRD IV still need to be adopted and transposed by member states. As the deadline is 28 December 2020, Article 104a will be in effect from 2021 at the earliest. Banks so far have sent mixed messages, with some expecting this to go ahead (e.g. UniCredit, Bankia) while others have been more cautious (e.g. Deutsche Bank). Second, supervisors maintain discretion to require a higher proportion of Tier 1 capital or CET1 capital, if they deem it necessary.

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Lastly, implementation of the final Basel III framework, which introduces a higher degree of risk sensitivity in the standardised approaches for measuring credit and operational risks as well as constraints on internal modelling, is expected to raise capital requirements. In December 2019, the EBA estimated that full implementation would increase minimum capital requirements by nearly 24% on average between 2022 and 2027.

For global systemically important institutions (G-SIIs), the increase is driven largely by changes to operational risk, credit valuation adjustments (CVA) and the output floor. For other systemically important institutions (O-SIIs), the most significant driver is the output floor, accounting for more than half of the increase.

While supporting full implementation, regulators have acknowledged that absolute capital needs should not increase mechanically just because risk-weighted assets have. Consequently, there is room to potentially lower Pillar 2 requirements, especially if the amended framework captures risks which were not previously included.

Sectoral countercyclical capital buffers may become more prevalent

In November 2019, the Basel Committee published guiding principles for the use of a sectoral countercyclical capital buffer (SCCyB). Importantly, the guidelines are voluntary as they are not part of the Basel standards. We note, however, that at European level the ECB has examined the advantages and shortcomings of using the countercyclical capital buffer to address sectoral systemic risks.

Currently, Switzerland is the only jurisdiction using a SCCyB. Banks are obliged to hold a countercyclical capital buffer equal to 1% of their risk-weighted mortgage-backed positions secured by residential property in Switzerland. Meanwhile, the Spanish government has introduced the legal basis for a SCCyB in Spain.[1]

Until recently, countercyclical buffer rates were rarely above zero in Europe. This has begun to change. An advantage of the sectoral approach is that regulators may be more willing to use such a tool as the impact could be more targeted –providing for the possibility to address segments such as mortgages and corporate lending which do not necessarily follow the same credit cycles, for example. Further, the SCCyB and the broader CCyB can be used as either as substitutes or complements, depending on the need.

The transition from Libor and capital instruments

With the increasing focus from regulators on getting market participants to move away from Libor by the end of 2021, we note that a practical approach will likely prevail. AT1 and Tier 2 capital securities that currently reference Libor will need to be amended. There are some concerns that changing the reference rate on legacy instruments may result in a need to reassess them as new instruments under CRR so consequently they may no longer fully count as eligible instruments.

The UK's PRA has communicated that it would not be "desirable" to reassess the eligibility of capital instruments when the sole change is a replacement of the benchmark reference rate. Therefore, we doubt these changes will trigger early redemptions under regulatory call provisions. Further, the PRA has made this point to the Basel Committee on Banking Supervision and is aiming to achieve an internationally consistent response.

[1] "A framework for the CCyB". Opening address at the Second Financial Stability Conference, Banco de España, June 2019.

Market summary – January 2020

Deeply subordinated FIG capital issuance amounted to a little over USD 15.6bn equivalent YTD to 4 February from a combination of US and European banks, US insurers and funds. That was more than the whole of Q4 2019. Proportionally, Western European banks accounted for roughly a quarter of the January 2020 total, but the month was more noteworthy for the flow of preferred stock issuance by US G-SIBs.

Investors came into 2020 with ample liquidity to put to work; the search for yield still very much front-of-mind. Demand for high-yielding securities and a firm conviction that supply of AT1 paper would be limited created ideal conditions for issuers.

Banco Santander's mid-January EUR 1.5bn non-call six AT1 drew EUR 10bn of orders and enabled the issuer to tighten the yield from 4.75% area at the start of marketing to 4.375%. Books for sub-benchmark EUR 400m offerings from Banco BPM and UBI Banca drew similarly impressive demand – book coverage of 12.25x and 13.75x respectively – and the Italian second-line lenders squeezed their yields at final pricing (5.875% for UBI; 6.125% for BPM). Erste Bank's EUR 500m non-call seven priced at 3.375%, close to the all-time AT1 yield low, on a book that was 12.5x covered during marketing after leads had gone out with a 4% handle.

Demand among dollar investors was very much intact; Credit Suisse selling a USD 1bn offering with a 10-year call period that was said to have been prodigiously oversubscribed.

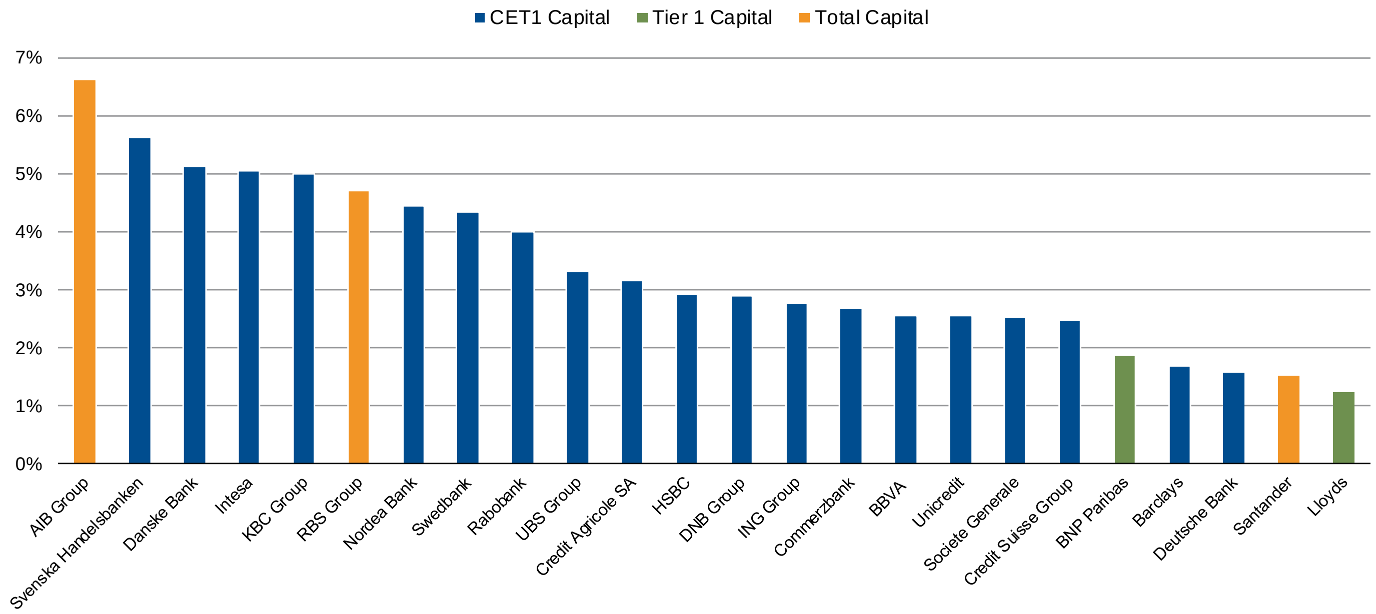
Similar story with US banks. Call dates on 2015/2016-vintage US subordinated debt will hit this year and next, and US G-SIBs have wasted no time pre-financing; Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, Wells Fargo (as well as Capital One) all tapping the market in January to lock in the low yields to refinance much higher-yielding outstanding securities. Bearing in mind that many of the outstanding capital securities coming up to call dates are paying out 6% and above, the fact that US prime banks were able to print in January at yields ranging from 4.3% (Bank of America) to 4.75% (Wells Fargo) neatly sums up the benefits of issuing in current market conditions.

In event-risk news, Barclays Bank PLC issued a notice on 5 February to holders of the remaining EUR 318.56m of its 4.75% non-cumulative callable preference shares that it would not be exercising the 15 March call, referring holders to its long-standing decision to exercise calls with reference to the economic impact, prevailing market conditions and regulatory developments.

On Deutsche Bank's 5 February fixed-income call, the upcoming April 2020 call date on the 2014-issued US dollar NC6 was the subject of questions, but the treasurer similarly referred participants to the fact that call decisions are taken based on several factors, principally economic but also including capital demand, future capital recognition, replacement cost and potential FX effects. He did point out, however, that in the case of its 6.25% AT1, the rate is significantly tighter than a new issue.

Appendix I: Headroom to MDA-relevant requirements

There is a tendency to focus on CET1 requirements. However, issuers must also meet Tier 1 and total capital requirements. Consequently, the most relevant headroom to the MDA level may in fact concern Tier 1 or total capital rather than CET1 capital.



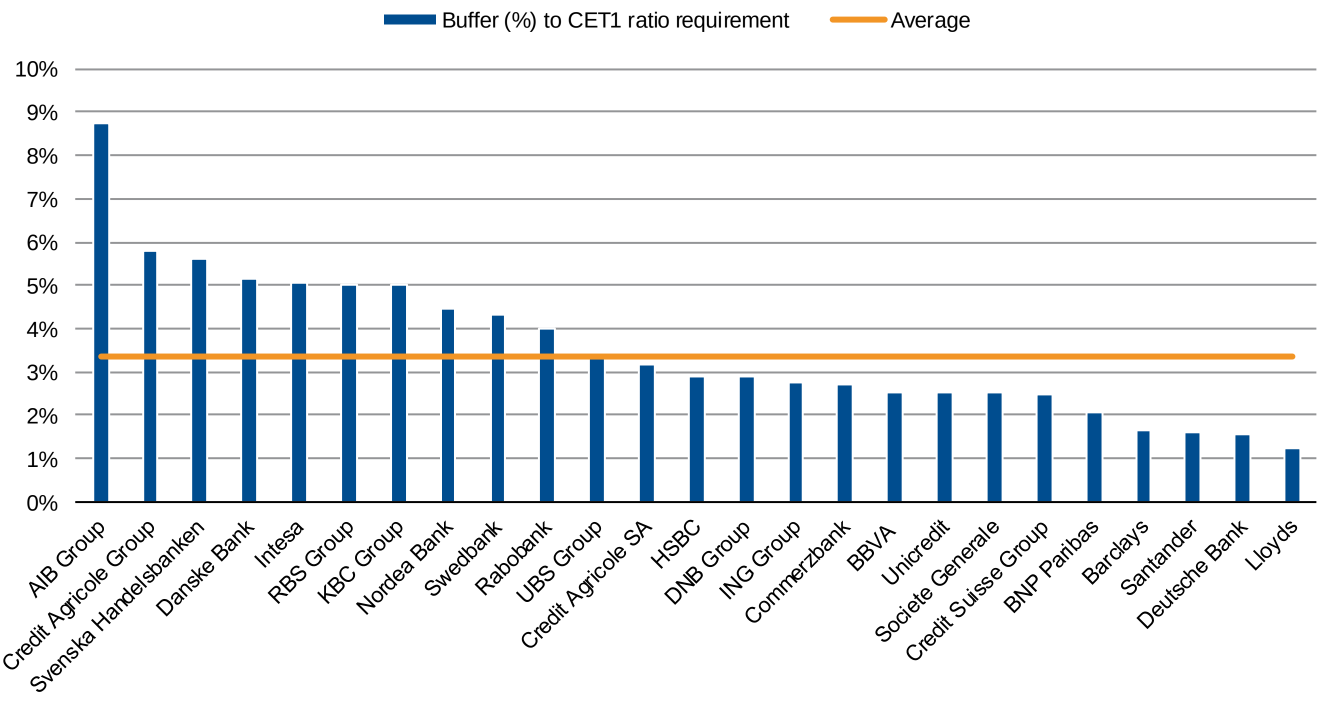
Notes: (1) Data as of 3Q 2019 except for AIB and Rabobank.
(2) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 1.2%. Excluding this, the headroom to the CET1 MDA requirement would be 2.9%.
Source: Banks, Scope Ratings.

Appendix II: Headroom to MDA-relevant CET1 requirements

		2019	2Q 2019		3Q 2019			
	Basis	Req CET1	2Q19 CET1	Buffer (%)	3Q19 CET1	Buffer (%)	Currency	Buffer (bn)
AIB Group	Transitional	11.6%	20.3%	8.8%	20.3%	8.8%	EUR	4.6
Barclays	Transitional	11.7%	13.4%	1.7%	13.4%	1.7%	GBP	4.1
BBVA	Transitional	9.3%	11.8%	2.5%	11.8%	2.5%	EUR	9.3
BNP Paribas	Transitional	9.9%	11.9%	2.0%	12.0%	2.1%	EUR	14.0
Commerzbank	Transitional	10.1%	12.9%	2.8%	12.8%	2.7%	EUR	5.1
Credit Agricole Group	Transitional	9.7%	15.4%	5.7%	15.5%	5.8%	EUR	32.5
Credit Agricole SA	Transitional	8.5%	11.6%	3.1%	11.7%	3.2%	EUR	10.4
Credit Suisse Group	Transitional	9.9%	12.4%	2.5%	12.4%	2.5%	CHF	37.8
Danske Bank	Transitional	11.3%	16.6%	5.3%	16.4%	5.1%	DKK	40.9
Deutsche Bank	Transitional	11.8%	13.4%	1.6%	13.4%	1.6%	EUR	5.4
DNB Group	Transitional	14.0%	16.5%	2.5%	16.9%	2.9%	NOK	33.5
HSBC	Transitional	11.4%	14.3%	2.9%	14.3%	2.9%	USD	25.2
ING Group	Transitional	11.8%	14.5%	2.7%	14.6%	2.8%	EUR	8.8
Intesa	Transitional	9.0%	13.6%	4.6%	14.0%	5.0%	EUR	15.0
KBC Group	Transitional	10.4%	15.6%	5.2%	15.4%	5.0%	EUR	4.9
Lloyds	Transitional	12.3%	13.9%	1.6%	13.5%	1.2%	GBP	2.5
Nordea Bank	Transitional	11.1%	14.8%	3.7%	15.5%	4.4%	EUR	7.0
Rabobank	Transitional	11.8%	15.8%	4.0%	15.8%	4.0%	EUR	8.3
RBS Group	Transitional	10.7%	16.0%	5.3%	15.7%	5.0%	GBP	9.5
Santander	Transitional	9.7%	11.3%	1.6%	11.3%	1.6%	EUR	9.8
Societe Generale	Transitional	10.0%	12.0%	2.0%	12.5%	2.5%	EUR	9.0
Svenska Handelsbanken	Fully loaded	11.8%	17.1%	5.3%	17.4%	5.6%	SEK	41.5
Swedbank	Fully loaded	12.0%	16.1%	4.1%	16.3%	4.3%	SEK	28.4
UBS Group	Transitional	9.8%	13.3%	3.5%	13.1%	3.3%	USD	34.6
Unicredit	Transitional	10.1%	12.1%	2.0%	12.6%	2.5%	EUR	9.8

Notes: (1) As AIB reports half-yearly, the data shown for 3Q 2019 refers to 2Q 2019.
(2) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 1.2%. Excluding this, the headroom to the CET1 MDA requirement would be 2.9%.
(3) As Rabobank reports half-yearly, the data shown for 3Q 2019 refers to 2Q 2019.
(4) For Nordea, Handelsbanken, Swedbank, DNB and Danske, Pillar 2 requirements are excluded from 2019 MDA relevant CET1 requirements.
Source: Banks, Scope Ratings.

Headroom to MDA-relevant CET1 requirements



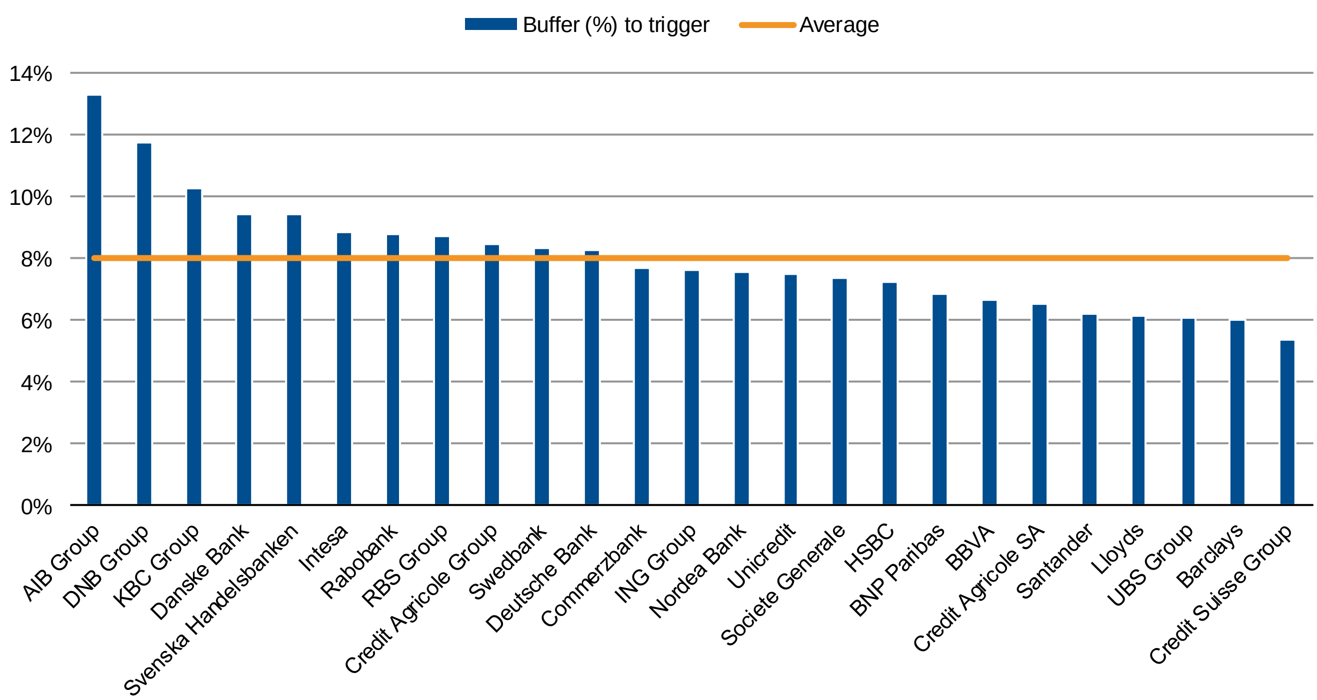
Note: Data as of 3Q 2019 except for AIB and Rabobank. Source: Banks, Scope Ratings

Appendix III: Headroom to writedown/conversion trigger

			YE 2018		2Q 2019		3Q 2019	
	Basis	Trigger	YE CET1	Buffer	2Q19 CET1	Buffer (%)	3Q19 CET1	Buffer (%)
AIB Group	Transitional	7.00%	21.1%	14.1%	20.3%	13.3%	n.a.	n.a.
Barclays	Fully loaded	7.00%	12.8%	5.8%	13.1%	6.1%	13.0%	6.0%
BBVA	Transitional	5.125%	11.6%	6.5%	11.8%	6.6%	11.8%	6.7%
BNP Paribas	Transitional	5.125%	11.8%	6.7%	11.9%	6.8%	12.0%	6.9%
Commerzbank	Transitional	5.125%	12.9%	7.7%	12.9%	7.7%	12.8%	7.7%
Credit Agricole Group	Transitional	7.00%	15.0%	8.0%	15.4%	8.4%	15.5%	8.5%
Credit Agricole SA	Transitional	5.125%	11.5%	6.4%	11.6%	6.4%	11.7%	6.5%
Credit Suisse Group	Transitional	7.00%	12.5%	5.5%	12.4%	5.4%	12.4%	5.4%
Danske Bank	Transitional	7.00%	17.0%	10.0%	16.6%	9.6%	16.4%	9.4%
Deutsche Bank	Transitional	5.125%	13.6%	8.4%	13.4%	8.3%	13.4%	8.3%
DNB Group	Transitional	5.125%	16.4%	11.3%	16.5%	11.4%	16.9%	11.8%
HSBC	Fully loaded	7.00%	13.9%	6.9%	14.2%	7.2%	14.2%	7.2%
ING Group	Transitional	7.00%	14.5%	7.5%	14.5%	7.5%	14.6%	7.6%
Intesa	Transitional	5.125%	13.5%	8.3%	13.6%	8.4%	14.0%	8.9%
KBC Group	Transitional	5.125%	16.0%	10.8%	15.6%	10.5%	15.4%	10.3%
Lloyds	Fully loaded	7.00%	14.3%	7.3%	13.7%	6.7%	13.2%	6.2%
Nordea Bank	Transitional	8.00%	15.5%	7.5%	14.8%	6.8%	15.5%	7.5%
Rabobank	Transitional	7.00%	16.0%	9.0%	15.8%	8.8%	n.a.	n.a.
RBS Group	Fully loaded	7.00%	16.2%	9.2%	16.0%	9.0%	15.7%	8.7%
Santander	Transitional	5.125%	11.5%	6.3%	11.3%	6.2%	11.3%	6.2%
Societe Generale	Transitional	5.125%	11.0%	5.9%	12.0%	6.9%	12.5%	7.4%
Svenska Handelsbanken	Fully loaded	8.00%	16.8%	8.8%	17.1%	9.1%	17.4%	9.4%
Swedbank	Fully loaded	8.00%	16.3%	8.3%	16.1%	8.1%	16.3%	8.3%
UBS Group	Transitional	7.00%	13.1%	6.1%	13.3%	6.3%	13.1%	6.1%
Unicredit	Transitional	5.125%	12.1%	7.0%	12.1%	7.0%	12.6%	7.5%

Notes: (1) AIB and Rabobank report half-yearly. Therefore, the figures shown for 3Q 2019 reflect 2Q 2019 data.
(2) For banks with securities containing different trigger levels, the highest is used.
Source: Banks, Scope Ratings.

Headroom to writedown / conversion trigger



Note: Data as of 3Q 2019 except for AIB and Rabobank.
Source: Banks, Scope Ratings.

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