AT1 securities:
In stress, MDA-driven restrictions ensue

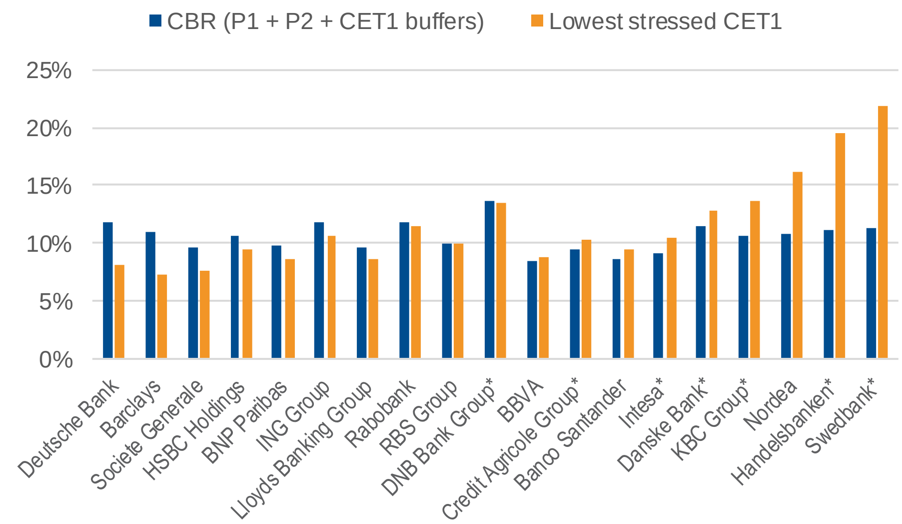
While there remain ongoing discussions about the effectiveness of AT1 securities as loss-absorbing instruments on a going-concern basis, the recent EU-wide stress test showed that in an adverse scenario 25 out of 48 banks breached their combined buffer requirement (CBR) and applied distribution restrictions. Following the maximum distributable amount (MDA) adjustments, these banks reduced their distributions by EUR 52bn, equating to a positive impact on CET1 capital of 60bp. In addition, a smaller number of banks breached the trigger for conversion or write-down in the adverse scenario.

When evaluating the results, one needs to bear in mind that the ECB stress test was based on static balance sheets as of December 2017 and did not incorporate actions banks would take in a real stress. Scope presumes that operating conditions would likely deteriorate over time allowing management teams to take progressive action, such as tightening lending standards, increasing pricing and reducing investments.

We also note that when assessing individual banks, there may be material factors which make the results less meaningful. For example, the Swedish FSA in August 2018 decided to change the current risk-weight floor for Swedish mortgages through Pillar 2 by replacing it with a corresponding Pillar 1 requirement, effective from 31 December 2018. This will in effect increase the CBR for Swedish banks and reduce the current wide headroom to the CBR to levels more in line with other European banks.

As well, we consider the Bank of England's (BoE) stress test to be more relevant for the UK banks. While the UK economy was subject to a more severe scenario than most other European economies in the ECB stress test, the scenario is similar to what the BoE has been assuming in its annual stress tests of major UK banks – e.g. UK unemployment increases by 4.5% and residential and commercial real estate prices decline by more than 30%. Importantly, the BoE tests do not assume a static balance sheet and there are hurdle rates for both CET1 capital and leverage. Further, the banks' performance will be assessed on a transitional basis. Results will be published 28 November along with the BoE's financial stability report.

Figure 1: Combined buffer requirement vs. lowest stressed CET1 ratio



Notes: CBR based on Pillar 2 requirement for 2018 and the required buffers in the year when the transitional CET1 ratio reaches its lowest point in the stressed scenario, usually in 2020 but not always.
* Banks whose results do not include MDA-related distribution restrictions.
Source: Company data, EBA, Scope Ratings

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Related research

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Other relevant developments

Regulatory approval for redemptions

The first wave of AT1 securities issued in 2013/2014 are coming up to their call dates. Scope has previously commented on the need for investors to be comfortable with the potential extension risk as the decision to call is no longer a given. So far, banks have been calling the securities with the approval of their regulators.

Recently, both Barclays and Credit Suisse highlighted that they had called or were calling securities which would translate into lower funding costs. In the third quarter and through early September, Credit Suisse called CHF 6.2bn in high and low-trigger capital instruments with coupons ranging from 6% to 9.5%. At the same time, Credit Suisse issued CHF 3.7bn of high-trigger tier 1 instruments with coupons ranging from 3.5% to 7.5%.

Barclays announced that it had received regulatory approval to call in December 2018 relatively expensive USD 2.65bn 8.125% retail preference shares and USD 2bn 8.25% AT1 securities.

Changing Pillar 2 requirements

With the release of the EU-wide stress test results, the ECB reiterated that they were not relevant for determining Pillar 2 requirements but were part of the supervisory review and evaluation process (SREP) and an input for determining Pillar 2 guidance. ECB-supervised banks are not expected to receive their updated SREP requirements until early 2019.

In the meantime, the UK's PRA has updated Pillar 2A requirements for UK banks, with some downward adjustments appearing to be driven by recent moves addressing pension liabilities. These include HSBC's Pillar 2A dropping to 2.9% from 3.5%, Lloyds to 4.6% from 5.4% and RBS to 3.6% from 4%. As a reminder, Pillar 2A requirements must be met by at least 56% of CET1 capital.

On the other hand, DNB's Pillar 2 requirement will be increasing to 1.8% from 1.6% from January 2019. Management has commented that this was likely driven by the Norwegian FSA's desire to offset the expected impact of removing the Basel 1 floor as CRD IV/CRR is fully implemented in Norway. Currently, Pillar 2 requirements in Norway are not included in the calculation of the MDA-trigger level but there is a pending proposal to change this.

Evolving capital buffer requirements

The Financial Stability Board (FSB) recently published its 2018 list of global systemically-important banks (G-SIBs). Of note, Nordea and RBS were removed from the list. From January 2020, both will no longer be subject to a G-SIB buffer of 1%.

Countercyclical buffer rates which are normally reviewed quarterly are also changing in some instances. Specifically, Denmark from 0.5% to 1% effective 30 September 2019, Czech Republic from 1.25% to 1.5% effective 1 July 2019, and Ireland from 0% to 1% effective 1 October 2019.

Appendix:

Headroom to MDA relevant CET1 requirements

	2016	2017	2018	2Q 2018	3Q 2018			
	YE CET1	YE CET1	Requirement	2Q18 CET1	3Q18 CET1	Gap %	Currency	Gap bn
Barclays	12.4%	9.1%	10.4%	13.0%	13.2%	2.8%	GBP	7.7
BBVA	12.2%	7.6%	8.4%	11.1%	11.6%	3.1%	EUR	10.7
BNP Paribas	11.6%	8.0%	9.2%	11.5%	11.8%	2.6%	EUR	16.9
Credit Agricole Group	14.4%	7.8%	8.6%	14.8%	14.9%	6.3%	EUR	33.7
Credit Agricole SA	12.1%	7.3%	7.9%	11.4%	11.5%	3.6%	EUR	11.2
Credit Suisse Group	13.4%	9.4%	9.7%	12.8%	12.8%	3.1%	CHF	35.4
Danske Bank	16.3%	8.1%	9.4%	15.9%	16.4%	7.0%	DKK	51.7
Deutsche Bank	13.4%	9.5%	10.6%	13.7%	14.0%	3.3%	EUR	11.4
DNB Bank	16.0%	13.2%	13.6%	16.2%	16.5%	2.9%	NOK	30.4
HSBC	13.6%	9.0%	10.2%	14.2%	14.3%	4.0%	USD	34.8
ING Group	14.1%	9.0%	10.4%	14.1%	14.0%	3.6%	EUR	11.3
Intesa	12.7%	7.3%	8.1%	12.8%	13.5%	5.3%	EUR	14.7
KBC Group	16.2%	8.7%	9.9%	15.8%	16.0%	6.1%	EUR	5.7
Lloyds Banking Group	13.6%	8.3%	10.0%	14.1%	14.6%	4.6%	GBP	9.6
Nordea Bank	18.4%	10.7%	10.7%	19.9%	20.3%	9.6%	EUR	11.6
Rabobank Group	14.0%	9.0%	10.4%	15.8%	15.8%	5.4%	EUR	10.7
RBS Group	13.4%	8.4%	10.1%	16.1%	16.7%	6.6%	GBP	12.8
Santander	12.5%	7.8%	8.7%	11.0%	11.3%	2.6%	EUR	15.5
Societe Generale	11.8%	7.8%	8.7%	11.2%	11.2%	2.5%	EUR	9.1
Svenska Handelsbanken	25.1%	11.2%	11.2%	21.4%	21.7%	10.5%	SEK	57.4
Swedbank	26.9%	11.3%	11.3%	23.6%	24.3%	13.0%	SEK	55.5
UBS Group	16.8%	9.4%	9.7%	13.4%	13.5%	3.9%	CHF	33.8

Headroom to writedown/conversion trigger

			2016	2017	2Q 2018		3Q 2018	
	Basis	Trigger	YE CET1	YE CET1	2Q18 CET1	Gap %	3Q18 CET1	Gap %
Barclays	Fully loaded	7.00%	12.4%	13.3%	12.6%	5.6%	12.8%	5.8%
BBVA	Transitional	5.125%	12.2%	11.7%	11.1%	6.0%	11.6%	6.4%
BNP Paribas	Transitional	5.125%	11.6%	11.9%	11.5%	6.4%	11.8%	6.6%
Credit Agricole Group	Transitional	7.00%	14.4%	14.8%	14.8%	7.8%	14.9%	7.9%
Credit Agricole SA	Transitional	5.125%	12.1%	11.7%	11.4%	6.3%	11.5%	6.4%
Credit Suisse Group	Transitional	7.00%	13.4%	13.4%	12.8%	5.8%	12.8%	5.8%
Danske Bank	Transitional	7.00%	16.3%	17.6%	15.9%	8.9%	16.4%	9.4%
Deutsche Bank	Transitional	5.125%	13.4%	14.8%	13.7%	8.6%	14.0%	8.9%
DNB Bank	Transitional	5.125%	16.0%	16.4%	16.2%	11.1%	16.5%	11.4%
HSBC	Fully loaded	7.00%	13.6%	14.5%	14.1%	7.1%	14.2%	7.2%
ING Group	Transitional	7.00%	14.1%	14.7%	14.1%	7.1%	14.0%	7.0%
Intesa	Transitional	5.125%	12.7%	13.3%	12.8%	7.6%	13.5%	8.4%
KBC Group	Transitional	5.125%	16.2%	16.5%	15.8%	10.7%	16.0%	10.9%
Lloyds Banking Group	Fully loaded	7.00%	13.6%	14.1%	14.1%	7.1%	14.6%	7.6%
Nordea Bank	Fully loaded	8.00%	18.4%	19.5%	19.9%	11.9%	20.3%	12.3%
Rabobank Group	Transitional	7.00%	14.0%	15.8%	15.8%	8.8%	15.8%	8.8%
RBS Group	Fully loaded	7.00%	13.4%	15.9%	16.1%	9.1%	16.7%	9.7%
Santander	Transitional	5.125%	12.5%	12.3%	11.0%	5.9%	11.3%	6.2%
Societe Generale	Transitional	5.125%	11.8%	11.6%	11.2%	6.1%	11.2%	6.1%
Svenska Handelsbanken	Fully loaded	8.00%	25.1%	22.7%	21.4%	13.4%	21.7%	13.7%
Swedbank	Fully loaded	8.00%	26.9%	24.6%	23.6%	15.6%	24.3%	16.3%
UBS Group	Transitional	7.00%	16.8%	14.9%	13.4%	6.4%	13.5%	6.5%

Source: Company data, Scope Ratings

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