3 July 2018 Commentary

European banks in aggregate achieve satisfactory US stress test results

The US units of the eight European banks assessed under some severe hypothetical conditions in the latest US stress tests passed the quantitative part with flying colours. The Fed's qualitative objection to Deutsche Bank's DB USA's capital plans was anticipated and caused few ripples.

Scope Ratings believes the Deutsche Bank stress-test result is unlikely to impact its current ratings, despite some ongoing negative market sentiment. "The Negative Outlook in place on Deutsche's BBB+ Issuer Rating already reflects, among other considerations, headline risks related to the Group's activities in various geographies," said Chiara Romano, senior analyst in the bank rating team at Scope.

In fact, DB USA represents just 7% of Deutsche's group assets and only 28% of the combined US operations. The fail will likely not divert the attention of the group's top management from the more existential issues on the agenda, although it will very likely firm up the resolve to accelerate the in-process shrinking of the bank's US footprint.

The Fed objected to DB's capital plan because of deficiencies across the firm's capital planning practices. These included material weaknesses in data capabilities and controls supporting its capital planning process; in approaches and assumptions used to forecast revenues and losses arising from many key business lines and exposures under stress; and in risk management functions, including model risk management and internal audit.

"Together, these weaknesses raise concerns about DB USA's ability to effectively determine its capital needs on a forward-looking basis," the Fed concluded. This is not new, however, as Deutsche Bank Trust Corp failed the qualitative test in 2015 and 2016.

To an extent, the fail showed that the bank has yet to implement steps to rectify operational shortcomings in the US operations. "Deutsche Bank's USA Corp is not new to the CCAR process. It was subject to a confidential review process in 2017, and the assessment incorporates information from supervisory activities conducted throughout the year," Romano pointed out.

As for the rest …

As for the other subsidiaries of European banks stress-tested, the results were positive. "For BBVA and Santander, the results are very satisfactory. They performed very solidly in the quantitative stress tests; the Santander subsidiary in particular maintaining one of the highest solvency ratios among the 35 banks subjected to the tests," said Marco Troiano, executive director in the banks team at Scope Ratings.

"The results show once again that business model matters: BBVA and Santander are retail banks, principally having to manage balance-sheet credit risk. Trading losses even in the stressed scenario are limited."

"The results show that you can run a high-risk business model as long as you price risk well. Case in point: Santander took one of the largest hits in the sample in terms of loan-loss incidence – in the severely adverse DFAST scenario 9.9% of the loan book vs a median for all 35 banks of 6.1%. Yet the very high marginality means that capital sees one of the smallest impacts."

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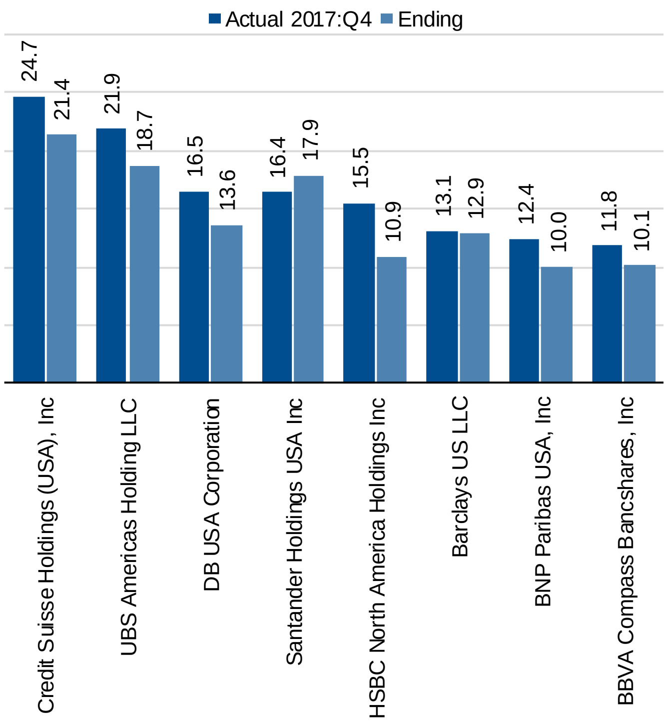
Pauline Lambert, executive director in the banks team at Scope Ratings, noted the positive results for Credit Suisse and Barclays. “Overall, their results were reassuring as both have been restructuring, and their investment banking/capital markets activities remain under investor scrutiny,” Lambert said.

CS and Barclays were among six intermediate holding companies (IHC) firms subjected under DFAST to a Supervisory Market Risk Component (along with DB, HSBC, RBC and UBS). From 2019, this will be replaced with the Global Market Shock Component. In this year’s DFAST, this only applied to six US banks with large trading portfolios (BAML, Citi, GS, JPMC, Morgan Stanley and Wells Fargo).

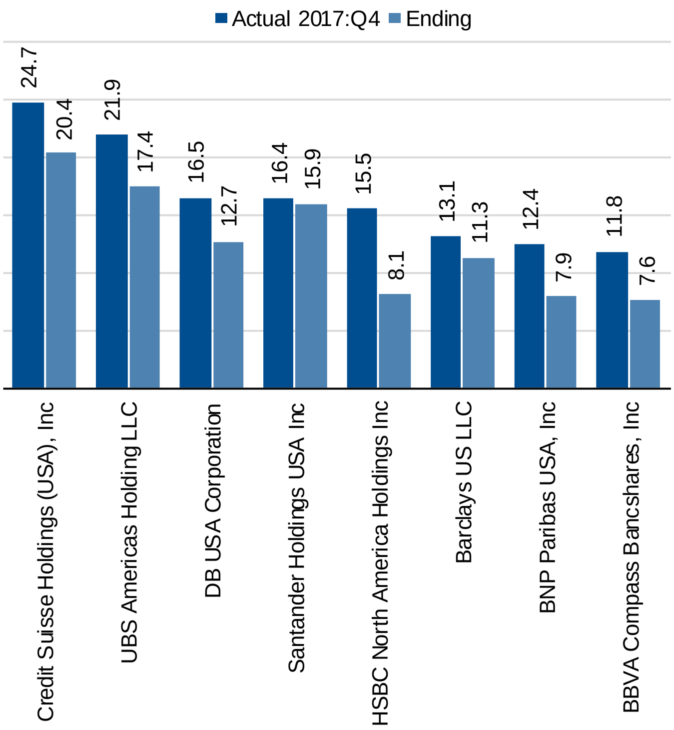
“When looking at the impact of the stress tests on pre-provision net revenue, bear in mind that not all banks were subject to these additional components relating to market and counterparty risks,” Lambert noted.

Figure 1: CET1 ratios projected under the adverse scenario



Source: Federal Reserve DFAST results, Scope Ratings

Figure 2: CET1 ratios projected under the severely adverse scenario



Source: Federal Reserve DFAST results, Scope Ratings

Summary notes[1]

Barclays

- In the DFAST severely adverse scenario, the impact on the CET1 ratio (from 2017 Q4 to minimum) was below the median of 4% at 3.5%
- The pre-tax net income rate (as a percentage of average assets) was -0.1% compared to the median of -1.1%.
- Loans losses were driven almost entirely by credit cards – an important business for Barclays in the US
- Drivers of the decline in pre-provision net revenue were USD 4.2bn in loan loss provisions and USD 1.2bn in trading and counterparty losses

BBVA

- BBVA's is a retail bank, so its losses in the DFAST severely adverse scenario come mainly from the highest-risk portions of the balance sheet: CREs loans and loans to SMEs.
- The CET ratio drops considerably (4.2%) under severe stress but this is in line with the median of sampled banks (4%)

BNP Paribas

- BNP Paribas USA covers the group's California-based bank subsidiary Bank of the West, which focuses on consumer banking and banking for mid-sized companies, First Hawaiian Bank, and the US wholesale business. Bank of the West is by far the largest by assets, representing nearly 80% of total US assets of c. USD 110bn.
- In the severely adverse scenario the credit card business generates a loss-rate of over 20%, but it is small enough in scale that it generates only 3% of the losses.
- With much lower projected loan loss rates (under 2%), commercial and industrial loans account for the largest share of losses (35%), and US commercial real estate a further 29%.
- The projected minimum CET1 capital ratio (which takes into account actions submitted in capital plans) of 7.9% is above the 6.2% average for the 35 banks tested, albeit declining from a starting point of 12.4% in 4Q17, although the latter does not appear to be untypical.

Credit Suisse

- Under CCAR, the results include the bank's planned capital distributions to the parent in four quarters (3Q 2018 to 2Q 2019)
- The results reflect the business in the US which is skewed towards investment banking and capital markets. In its own reporting, the bank noted, however, that the most complex products and lending portfolios of Credit Suisse Group in the US are booked outside of CSH USA
- Nearly half of the decline in the CET1 ratio was due to the Supervisory Market Risk Component, which led to trading and counterparty losses of USD 3.5bn
- Loan losses were minimal – the lowest for all banks

[1] Unless otherwise specified, Scope comments refer to banks' DFAST results under the severely adverse scenario.

Deutsche Bank:

DB USA Corporation excludes DB US branch assets but consolidates, inter alia the securities business, transaction banking, and wealth management activities in the US.

DFAST:

- The impact on the CET1 ratio under severely adverse and adverse scenarios is in line with the median of the eight IHCs.
- Projected loan losses as a % of portfolio is below median under both scenarios; the highest impact is on junior liens and CRE.
- The impact on the P&L under both scenarios is less severe than for other banks. Under the severely adverse scenario, however, the 16bp pre-provision net revenue margin on average assets the unit recorded in 2017 drops to 13bp p.a. and the pre-tax net income margin (of 18bp in 2017) turns negative.

CCAR:

- Results from the quantitative assessment, using the bank's own assumptions, look relatively solid, bearing in mind the regulator's objections related to weaknesses identified in the bank's own planning.

HSBC

- Drivers of the decline in pre-provision net revenue were USD 4.6bn in loan loss provisions and USD 800m in trading and counterparty losses
- HSBC was the only bank to have a negative pre-provision net revenue rate (as a percentage of average assets). With total assets of USD 273bn at YE 2017 and operating as a universal bank, HSBC is the largest IHC
- Management has acknowledged the low profitability of the US business and improving returns is a strategic focus. Over the last few years, the bank has had to work through the consequences of the Household International acquisition, run-off legacy consumer and mortgage loans (CMLs) and work through a US deferred prosecution agreement. For the first time last year under the CCAR, HSBC was able to distribute dividends to the parent and will be able to do so again this year.

Santander

- The results are a consequence of Santander's business model in the US: a well-run, high-margin consumer business (SCUSA), complemented by the acquired Sovereign franchise.
- We can see this from the results: as opposed to other banks, the majority of the losses at Santander come from the "other consumer loans", which includes the auto loans portfolio.
- In the severely stressed scenario, this portfolio incurs a 18% loss rate, producing USD 4.8 bn in losses, more than half of total losses for Santander US. Despite the high loan losses, Santander US turns in an overall profit over the period, as it has among the highest pre-provision profitability in the sample.

UBS

- Loan loss rates were below the median of 6.1% at 3%
- Drivers of the decline in pre-provision net revenue were USD 2.5bn in loan loss provisions and USD 600m in trading and counterparty losses.

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Figure 3: Projected loan losses (% of total assets) – adverse scenario

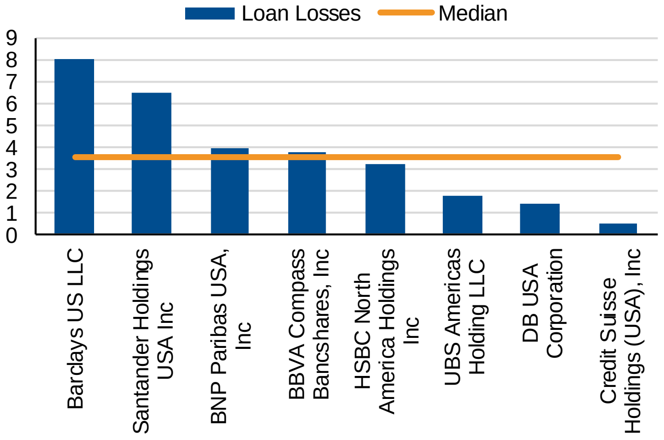


Figure 4: Projected loan losses (% of total assets) – severely adverse scenario

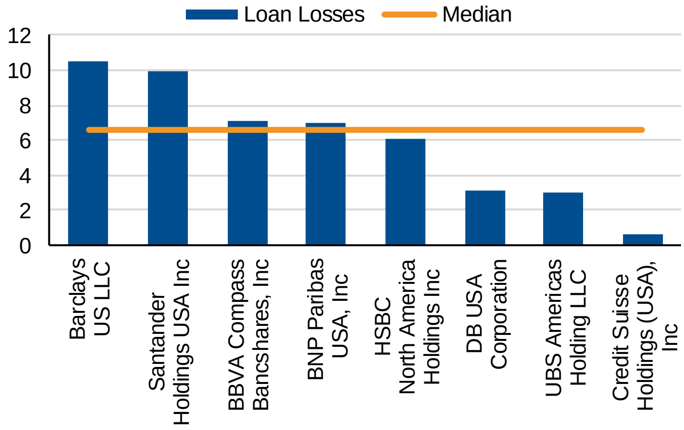


Figure 5: Pre-provision net revenue (% of total assets) – adverse scenario

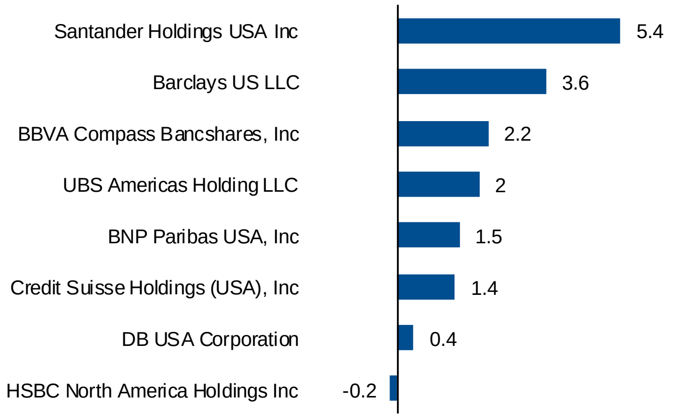


Figure 6: Pre-provision net revenue (% of total assets) – severely adverse scenario

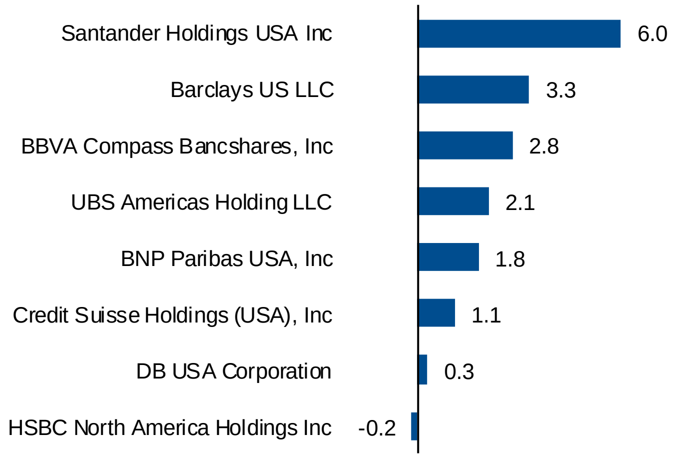


Figure 7: Pretax net income rates (% of average assets) – severely adverse scenario

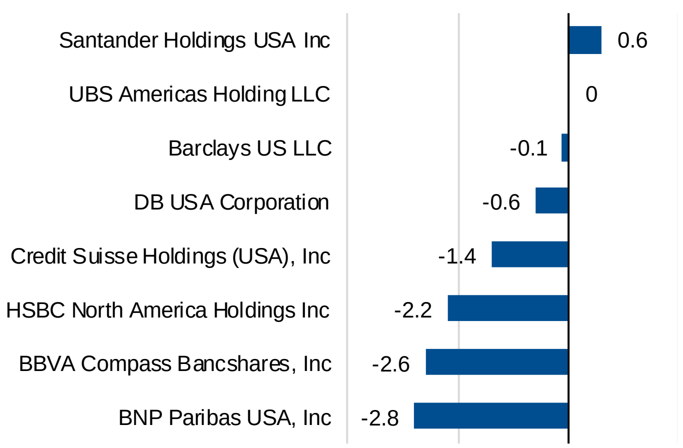
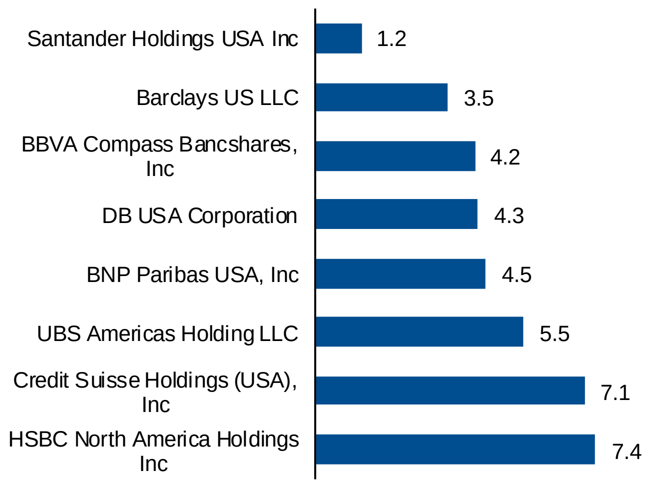


Figure 8: Difference from Q4:17 actual to minimum CET1 ratio in the severely adverse scenario



Source: Federal Reserve DFAST results, Scope Ratings

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