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European Banks – Credit Update

- Financial institutions across Europe are taking a range of exceptional measures to continue to support borrowers impacted by the Covid-19 outbreak, with additional financial flexibility being provided by central banks, yet these will weaken banks' credit profile.
- Banks' secondary spread levels have now reached early 2016 levels, with the tightening observed throughout 2019 and early 2020 now more than reversed.

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Overview

Financial institutions across Europe are taking a wide range of measures to support borrowers affected by the Covid-19 outbreak, including, among others, the temporary suspension of existing mortgage and loan instalments, increase of overdraft facilities, and repayment relief. Supporting these measures, central banks are providing additional financial flexibility to banks through lower capital and liquidity requirements. In a reversal of what we observed in the 2008 financial crisis, central banks, government and regulators are now using banks' balance sheets to support the economy. That said, regulators won't change the rules on when banks must book impairments for non-performing loans (NPLs), as some authorities are still handling NPLs associated with the financial crisis. Although several EU member states have indeed announced vast loan guarantee schemes, partially shielding banks' balance sheet, altogether, European banks' credit profile will invariably deteriorate in 1H20.

Bank of England: The BoE announced last Wednesday the reduction of the countercyclical capital buffer (CCyB) rate to 0% of banks' exposures to UK borrowers – the rate had been 1% and had been due to reach 2% by December 2020. We see the announcement as measured and in line with the purpose of the countercyclical buffer. It maintains UK banks' strong credit profile, whilst enabling an additional £190 billion in business lending. The BoE also announced a Term Funding scheme with additional incentives for SMEs (TFSME), which will, over the next 12 months, offer four-year funding of at least 5% of participants' stock of real economy lending at interest rates close to bank rate. The BoE believes the TFSME could provide in excess of £100 billion in term funding. We note, however, that an emergency facility supporting lending to a risky sector could eventually become a source of bad loans – the banks, and not the central bank, is bearing thee risk on these transactions. On the liquidity front, the BoE highlighted that major UK banks have over £1tn of high-quality liquid assets, which were built up in preparation for a disorderly Brexit. Further supporting UK banks' funding and liquidity needs, the BoE also has operations in place to make loans to banks in all major currencies on a weekly basis, on top of the additional USD swap line agreed by the Fed on Sunday night with the BoE, Bank of Canada, BoJ, ECB and SNB.

European Central Bank: The ECB went much further in its easing of regulatory requirements. A day after the BoE's announcement, the ECB announced that Euro area banks will temporarily not need to comply with (1) the Pillar 2 Guidance (P2G), which should free up about 1.5% of RWA in CET Capital; and (2) the capital conservation buffer (CCB), another 2.5% of RWA; while (3) the CCyB will be relaxed at the national level (e.g. 0.25% in France, 1% Ireland). Moreover, Banks will also be allowed to partially use AT1 and Tier 2 instruments to meet their Pillar 2 Requirements (P2R). The latter brings forward a measure that was initially scheduled to come into effect in January 2021, and frees up around 1% of RWA in CET1 capital. Altogether, the ECB reduced the CET1 requirement by a significant 5% of RWAs. This should provide local banks some significant flexibility to continue to support the euro area economy amid the Covid-19 outbreak.

The full utilisation of this flexibility would lead to a significant weakening of banks' credit profile. That said, the temporary nature of the announced measures reduces the incentive for banks to reduce capital ratios materially, as, eventually, they'll have to strengthen their capital bases again. Furthermore, were markets or depositors to observe any significant weakness by any euro area bank, the latter wound incur significant additional financial distress. Other measures included the allowance of banks to temporarily operate their liquidity coverage ratio (LCR) below the minimum requirement, which we deem as careless. The ECB also announced an improvement in the pricing and funds available under TLTRO III. As the funding market continues to be closed and challenging, and amid the more favourable conditions applied to the TLTROs, we now do expect a material intake of TLTROs in the forthcoming rounds.

European Banking Authority: The EBA has decided to postpone its 2020 EU-wide stress test to 2021, to allow banks to prioritise operational continuity. The results of the 2020 stress test were scheduled to be announced in July 2020.

Nordics: Elsewhere, the Swedish FSA cut the local CCyB from 2.5% to 0%, freeing up around $4.6bn of capital. The Norwegian central bank cut the CCyB from 2.5% to 1%, when it also cut its main interest rate from 1.5% to 1%. Similarly, the Danish Central bank cut the CCyB from 1% to 0%, whilst it also created new short-term lending facility to ensure the banking sector's access to liquidity on favourable terms. The Swiss National Bank is yet to announce any specific measure, but note that the CCyB in Switzerland is already at 0%.

Market Reaction

The continued market rout in the equity market is also being observed the credit market. Spreads in the secondary market are now at the highest levels since early-2016 following the Fed's first rate hike since the financial crisis and its signal of further steady tightening to come. The average EUR Z-Spread of AT1s has now increased by 386bps since mid-February 2020, with T2s up by 158bps, Senior Bail-in debt by 127bps, and SP by 70bps. The increase in AT1 spreads has significantly raised the risk of no-calls, exemplified by Deutsche Bank last week, when it announced it will skip the April call on their $1.25b 6.25% AT1.

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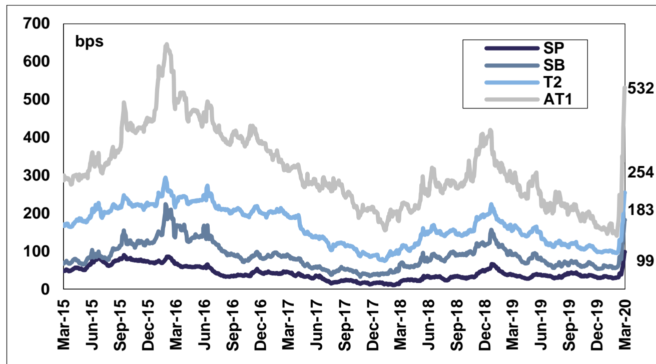
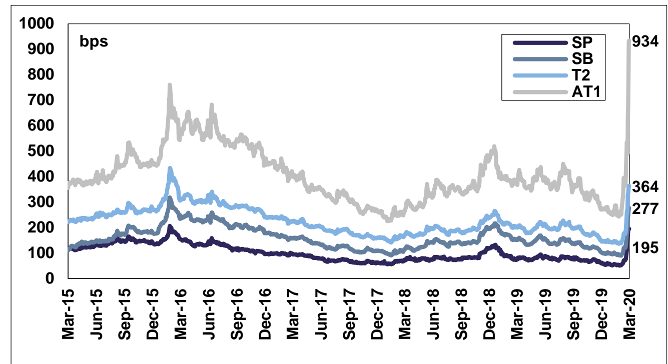
The next call on the bond is in 5 years. Overall, the primary market has now entered the fourth week of complete closure for senior unsecured paper of Western European banks.

(Chart 1) Western European Banks Average EUR Z spread



Source: Bloomberg. SP = Senior Preferred/Senior OpCp; SNP = Senior Non-Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1.

(Chart 2) Western European Banks Average USD Z spread



Source: Bloomberg. SP = Senior Preferred/Senior OpCp; SNP = Senior Non-Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1.

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