CREDIT SPECIAL

21. January 2020

European bank bonds 2020: Riskier credit growth with meagre margins

AUTHOR
Dr. Susanne E. Knips
Senior Credit Analyst
Tel: +49 69/91 32-32 11
research@helaba.de

EDITOR
Stefan Rausch
Head of Credit Research

PUBLISHER
Dr. Gertrud R. Traud
Chief Economist/
Head of Research

Helaba
Landesbank
Hessen-Thüringen
MAIN TOWER
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
Tel: +49 69/91 32-20 24
Fax: +49 69/91 32-22 44

In view of the considerable burden of regulations, the shift to a digitised economy and persistently low interest rates, the profitability of Europe's banks is set to remain under pressure. In order to boost earnings, banks are stepping up efforts to expand their lending activities. This means that their capital markets funding volume is once again likely to be very high. However, we also expect that competition on margins will become more intense. Although the solid economic environment that we anticipate should have a favourable effect on balance sheet quality, the danger that institutions will accept a greater level of risk for new business is rising.

On the positive side, regulatory reforms initiated in the aftermath of the financial crisis are gradually coming to an end. While some of them have yet to be implemented, regulatory uncertainty has fallen significantly and the reforms have largely been factored into current corporate planning. However, regulators are now turning their attention to new risks, for example from climate change. The geopolitical situation is also a constant source of surprises. We recommend focusing on bank bonds with good credit qualities and, in this respect, taking advantage of the yield premium on non-preferred senior issues.

Review of 2019 – further pressure on profitability

2019 saw no let-up in the progress of overriding trends that have dominated the banking sector in recent years. In terms of balance sheet quality, the industry is in a strong position following the implementation of regulatory reforms since the financial crisis. Most banks did their homework, cutting back on problematic areas and raising their amount of bail-in capital. On the other hand, profitability remained under pressure and continued to suffer from the twin burdens of high regulatory costs and enormous investments in digitisation. Although the low interest rate environment meant that refinancing costs were down and credit defaults minimal, it also had a negative impact on earnings in banks' core business segments as well as their proprietary investments.

Recently, however, there has been a noticeable increase in provisioning costs for credit risks in many cases, especially for corporate loans, driven in part by banks' taking a more cautious stance towards future prospects for the economy.[1] In general, though, credit loss expenses remained below their average historical levels. Furthermore, a number of major institutions have met their target ratios for regulatory capital and have announced an increase in their dividend payout ratios.

Outlook for 2020 – focus on cost-cutting programmes and lending growth

In 2020, the relatively sound economic framework that we described in the baseline scenario[2] of our macroeconomic outlook should underpin the credit quality of European banks. On the basis of improved equity ratios, they will increasingly be in a position to use their profits in order to drive growth and fund dividend payouts. In addition, financial institutions are pushing ahead with efforts to stabilise their net interest income by expanding their lending volumes. In the case of real estate loans, in particular, credit growth should continue in line with our expectations. As far as corporate

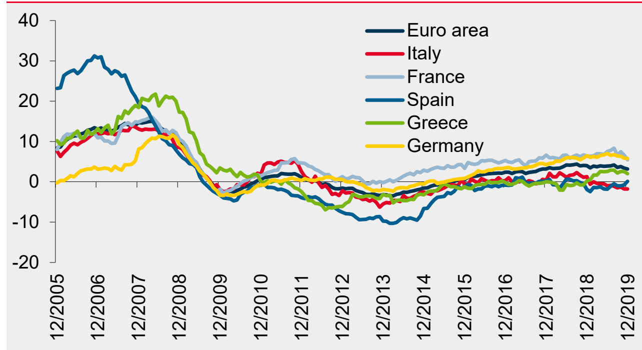
This publication was very carefully researched and prepared. However, it contains analyses and forecasts regarding current and future market conditions that are for informational purposes only. The data is based on sources that we consider reliable, though we cannot assume any responsibility for the sources being accurate, complete, and up-to-date. All statements in this publication are for informational purposes. They must not be taken as an offer or recommendation for investment decisions.

[1] In our view, this was reinforced by the IFRS 9 accounting standard in force since the beginning of 2018, which takes greater account of the economic outlook than before. For more details see Credit Special "Europäische Banken: IFRS 9 erhöht Gewinnvolatilität" of 18 July 2017
[2] See our publication: "Markets and Trends 2020: Melodrama - next act" of 26 November 2019

loans are concerned, new business has recently declined as the economy has weakened, but our economic outlook suggests that expansion will resume in 2020. Overall, however, it is clear that the credit cycle has now entered a mature phase and that, meanwhile, competition has become extremely tough. Our observations suggest that, in many cases, the pricing of new lending business is no longer commensurate with its risks. The danger that banks will accept a lower quality in their new credit business and relax their lending standards is mounting.

Credit growth partially offsets pressure on margins

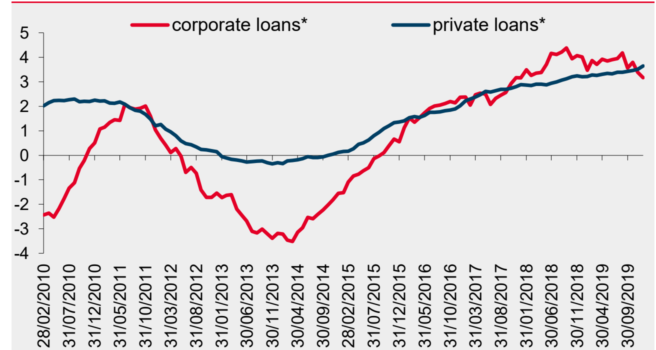
Corporate loans, % yoy



Sources: Datastream, Helaba Research

Growth in corporate lending levels off

% yoy



* euro area

Sources: Datastream, Helaba Research

The costs of digitisation and regulation remain enormous for the sector as a whole. In addition, there are increasing regional differences in quality: Scandinavian banks, for example, are struggling with the consequences of money laundering scandals; in Germany, institutions are suffering from structurally low profitability. Cost-cutting programmes, which have been launched in response to weak profitability, are therefore still on the agenda.

Low interest rates – banks reluctant to pass them on to retail customers

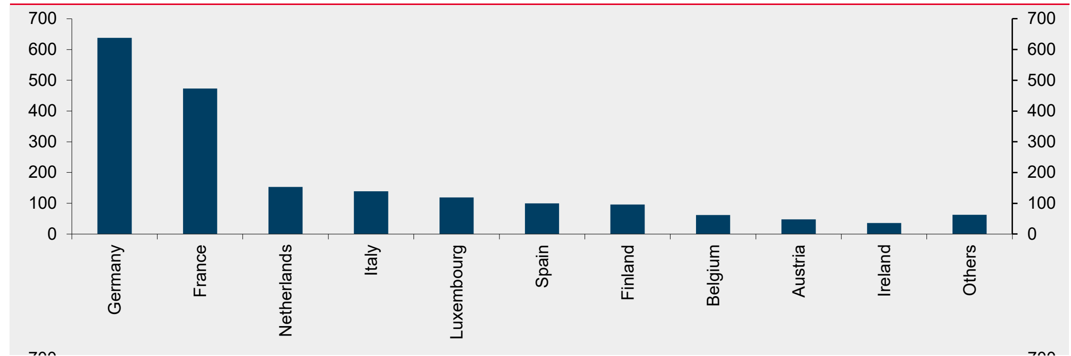
Hopes for higher interest rates were disappointed in 2019. The low interest rate environment is acting as an increasing drag on the profitability of European banks, with the principal areas affected being earnings from banks' own financial investments and net interest income from customer deposits. This is compounded by lower earnings from maturity transformation due to the flatter yield curve, which is attributable in no small part to the ECB's longer-term refinancing operations.

The consequences of negative money market rates are particularly noticeable in terms of customer deposits, which meanwhile represent a loss-making business for banks. Banks have already been levying negative interest rates on deposits from institutional and corporate customers for many years. When it comes to private customers, though, they are still reluctant to impose negative interest rates on deposits across the board. For many financial institutions, however, it appears that the limit to their tolerance has been reached, with the result that they are becoming increasingly willing to pass on negative interest rates to private customers as well.

Historically, deposits from customers have made up a substantial portion of German banks' balance sheets, which is reflected in the relatively high level of excess liquidity parked at the ECB. For this reason, the negative ECB deposit rate of -0.5 % has a more adverse effect on them compared to other European banks, notwithstanding the fact that the tiered system of interest rates announced by the ECB in September 2019 will bring some relief. French and Spanish banks, for example, have so far been more successful in stabilising their total earnings. Our research shows that French banks have primarily benefitted from strong net commission income, while the major Spanish banks are well positioned in the growth markets of South America.

German banks take biggest hit from negative ECB deposit rate

Deposits of European banks at the ECB, November 2019, in EUR (billions)

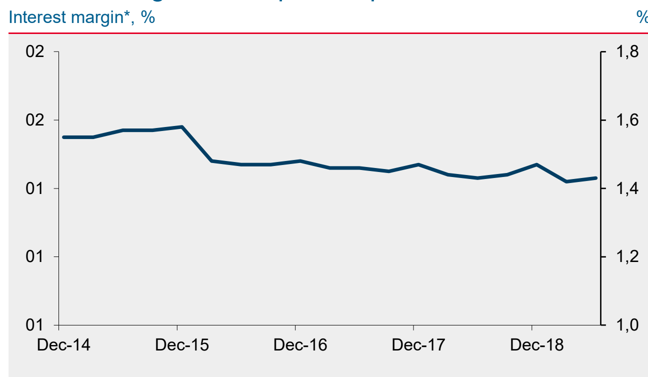


Sources: ECB, Helaba Research

Overall, we consider banks with traditional business models that are focused on regional markets and a comparatively high proportion of interest-bearing business to be most severely affected by the low interest rate environment. At many such banks in Germany, legacy portfolios of higher-interest loans and securities are increasingly reaching maturity and must be replaced by lower-interest bearing exposures.

Interest margin in Europe still quite stable …

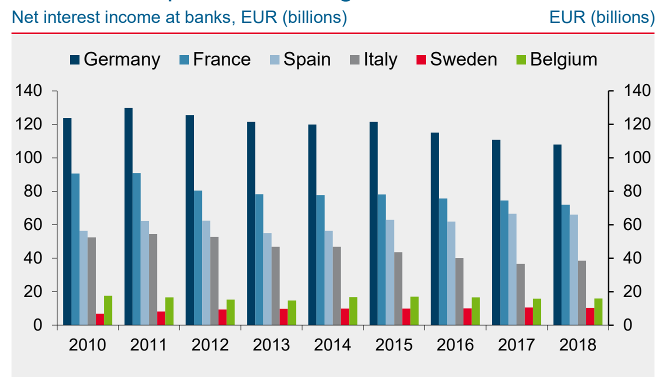
Interest margin*, % | %



* Net interest income/interest-bearing assets, weighted average
Sources: EBA, Helaba Research

... albeit with pronounced regional differences

Net interest income at banks, EUR (billions) | EUR (billions)



Sources: SNL, Helaba Research

According to the Bank for International Settlements in Basel (BIS), the core Tier 1 capital of 86 major global banks rose by around 91 % to EUR 3,720 billion between June 2011 and December 2018. Monetary policy easing is therefore largely negated by more stringent capital requirements for credit exposures.

Regulatory reforms – more new developments on the way in 2020 as well

The Basel Committee had already completed its work on post-crisis regulatory reforms as early as the end of 2017 when it published a catalogue of amendments to the Basel III framework (commonly known as Basel IV).[3] As a result, numerous statutory amendments were made in Europe in 2019, some of which applied immediately while others have yet to be implemented on a national basis over the course of 2020. Further amendments to legislation will be introduced this year. In the following section, we have detailed what we consider to be the most important changes for bondholders.

[3] Collective term for regulatory reforms adopted by the Basel Committee on Banking Supervision that have not yet been fully incorporated into the CRR and CRD. In contrast to Basel III, the changes introduced by which were primarily aimed at strengthening regulatory equity ratios, Basel IV focuses on risk-weighted assets - the measurement of a bank's risk positions (credit, market, counterparty and operational risks). The harmonisation of the liability cascade in the event of insolvency had already been brought forward by an amending directive to the BRRD and was to be implemented throughout the EU by the end of 2018 (see Credit Special "Bank bonds in Germany: Imminent launch of new preferred senior bonds" of 25 June 2018)

Package of banking reforms to be partially implemented in 2020

In 2019, the European Parliament adopted the so-called banking package with amendments to the framework for bank resolution (BRRD II/SRMR II) and minimum capital requirements (CRR II/CRD V). The amended Capital Requirements Regulation (CRR II) entered into force immediately on 27 June 2019, although in some cases with a substantive transition period of two years, i.e. until 28 June 2021. From the standpoint of bondholders, this will mean that requirements for the non-risk-based leverage ratio (LR, leverage ratio) and the structural liquidity ratio (NSFR, net stable funding ratio), for example, will be binding from the end of June 2021.The amended CRD V (Capital Requirements Directive) and BRRD II (Bank Resolution and Recovery Directive), on the other hand, must now be transposed into national law within 18 months in the individual countries, i.e. by the end of 2020 at the latest.

Moreover, since the end of June 2019, changes to the minimum requirements for total eligible liabilities (MREL) have already been in force for those European banks that are simultaneously classified as globally systemically important institutions (G-SII). These changes are aimed at aligning the European requirements to existing requirements at the level of the G-20 on total loss-absorbing capacity (TLAC) for globally systemically important institutions. While the globally applicable TLAC rules were also to be calculated on the basis of risk-weighted assets (RWA) from the outset, European law initially only provided for unweighted total assets as the denominator for the MREL ratio. Large systemically important institutions were thus faced with a multitude of different requirements for calculating their bail-in capital. This problem has now been eliminated and the international regulations have been harmonised. In addition, fixed minimum MREL ratios have been introduced for European G-SIIs. In principle, the respective supervisory authorities in Europe continue to set minimum ratios for specific institutions, but these may exceed the legal minimum ratios that have now been introduced.

MREL at a glance

Items and rules

	G-SIIs	Top-tier banks (> EUR 100 bn total assets and fishing option)	Other banks (for which a resolution process is intended)
Since entry into force of banking package (28 June 2019)	16 % RWA 6 % LRE Higher bank-specific requirement, if applicable	Bank-specific requirement	Bank-specific requirement
from 2022	18 % RWA 6.75 % LEA* Higher institution-specific requirement, if applicable	13.5 % RWA 5 % LEA Higher institution-specific requirement, if applicable	Bank-specific requirement
from 2024	See above, plus 8 % TLOF**	See above, plus 8 % TLOF** (but no higher than 27 % RWA)	Bank-specific requirement; plus 8 % TLOF** at discretion of resolution authority
Subordination requirement	Discretionary subordination requirement		Case-by-case decision (NCWO***- check)

* LEA: Leverage Exposure Amount ** TLOF: Total Liabilities and Own Funds *** No Creditor Worse Off, creditors may not be treated less favourably than in the event of insolvency
Sources: Deutsche Bundesbank, BaFin, Helaba Research

In addition, EU lawmakers expanded the group of banks subject to a statutory minimum MREL ratio to include other banks with total assets in excess of EUR 100 billion and those which, in the opinion of the national resolution authority, pose a systemic risk in the event of default. The term "top-tier banks" was introduced for this purpose. As far as we are aware, this is provided for by BRRD II and must therefore be transposed into national law within 18 months and thus by the end of 2020.

Proposed CRR III /CRD VI legislation expected shortly

The implementation of further elements of the Basel III catalogue of changes is still pending. In particular, changes in the areas of credit risks and trading as well as operational risks will, in our view, only be incorporated into a future CRR III regulation. The aim here is to limit the scope for

banks to apply internal models for measuring risk-weighted assets and to achieve convergence with standard models. A major change, an output floor that will ultimately reach 72.5 %[4] in its final state, is due to be gradually phased in between 2022 and 2027. In the near future, the EU Commission is expected to submit a legislative proposal to amend the CRR accordingly, with a view to the rules entering into force at the beginning of 2022.

This will be accompanied by a significant increase in RWAs, as impact studies by the EBA also show.[5] However, banks have long been aware of the additional capital requirements. Prior to the compromise struck in 2017, discussions had been ongoing for several years already and, in some cases, involved talk of even more stringent requirements. Consequently, institutions have spent many years preparing themselves for the introduction of stricter rules. Dutch banks, for example, will be particularly adversely affected by the output floor due to their considerable exposure to the private mortgage finance segment, which has hitherto benefitted from comparatively favourable treatment in terms of minimum capital requirements. ABN AMRO and Rabobank originally estimated the resulting increase in regulatory risk-weighted assets at up to 35 % each. Both banks have initiated a comprehensive range of countermeasures and are making very good progress in this respect. Rabobank, for example, has already announced a far-reaching transformation programme with a significant reduction in business volumes by 2015. In our view, Commerzbank's decision, announced at the end of September 2019, to sell its Polish mBank subsidiary as part of a strategic realignment can also be considered a reaction to the increase in risk-weighted assets resulting from Basel IV.

Furthermore, according to media reports, discussions are also taking place on the possibility of measures to provide relief. These include, for example, a proposal to reduce the share of Tier 1 capital as a proportion of the minimum ratio in favour of less expensive instruments. Another conceivable option appears to be a more flexible approach to switching between the standard approach and internal models used to calculate risk-weighted assets. Moreover, additional changes are already emerging. For example, it remains to be seen whether loans to the public sector will require a higher level of capital backing.

Completion of the banking union - no signs of uniform deposit protection in the near future

The harmonisation of European deposit guarantee schemes, which is needed to complete the banking union, will be back on the agenda in 2020 as well. The aim of the Basel reforms and the associated banking package is to further reduce risks on banks' balance sheets. Together with a reduction in non-performing loans, this is regarded by many observers as a prerequisite for the introduction of a uniform, Europe-wide deposit guarantee scheme.

In our view, a uniform deposit guarantee scheme for major banks' cross-border activities, over and above the harmonisation already achieved, does not constitute a decisive factor.[6] Instead, it is more crucial that national deposit guarantee schemes reach their target level in the interest of general financial market stability. We believe that a far greater degree of structural harmonisation between countries than is currently the case, underpinned for example by a uniform insolvency framework, would be a necessary precondition for uniform deposit protection. This is the only way to ensure that, in times of a deteriorating economic environment, there is no repeat of a divergent increase in non-performing loans from one country to another.[7]

[4] RWAs based on internal models must correspond to at least 72.5 % of the figure calculated using standard models
[5] See Credit Special "Europäische Banken: Finale Basel III-Regeln sorgen für Aufregung" of 8 August 2019
[6] We believe that our view is confirmed by UniCredit CEO Jean Pierre Mustier, who recently made it clear when he was presented with the Banker of the Year award that UniCredit's business model works very well even without a uniform deposit guarantee scheme.
[7] See Credit Special "Private Banken in Deutschland: Reform der freiwilligen Einlagensicherung" of 26 September 2017

Likelihood of major cross-border mergers rather low

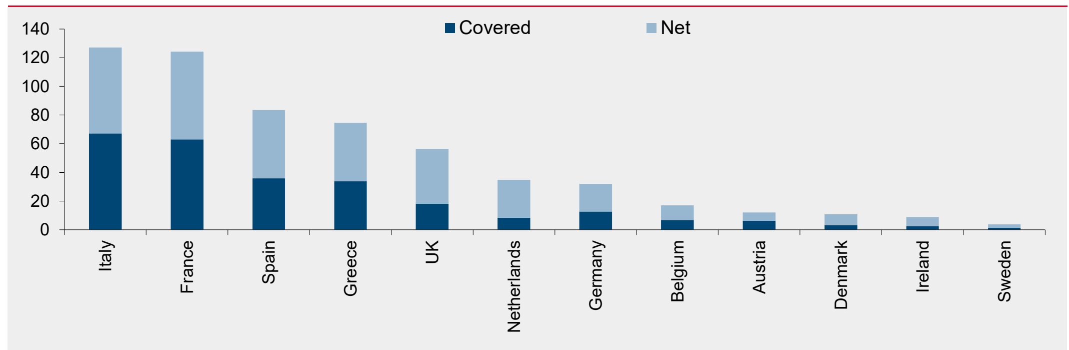
In view of the low profitability of many institutions, there are repeated calls for large-scale mergers. Consolidation within countries will continue in line with our expectations. Moreover, banks will continue to make opportunistic acquisitions and disposals of certain business units. However, in conjunction with partly weak business models, we regard structural divergence as a significant obstacle to cross-border mergers between major banks.

Decision on last resort for Single Resolution Fund (SRF)

The forthcoming reform of the European Stability Mechanism (ESM) should further strengthen the sector's resilience: From 2024 at the latest, the ESM is due to be used as a common backstop for the Single Resolution Fund (SRF). Both funds have a target size of at least 1 % of covered deposits, most recently around EUR 65 billion in each case. This was agreed by the EU-27's heads of government as early as the end of 2018.[8] Should an expert opinion, which is expected to be published in 2020, demonstrate sufficient progress in the reduction of risks on banks' balance sheets, the ESM's function as a last resort backstop for the SRF may come into force even earlier.

Reduction in non-performing loans making progress

EUR (billions)



Sources: EBA, Helaba Research

Sustainability – regulators dialling up the pressure

Based on what we have observed, the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board in Basel (FSB) now seem to be turning their attention to new risks. Their focus is trained on issues such as cryptoassets, cyber risks, digitisation and the risks associated with the transition to a more sustainable economy (ESG - Environmental, Social and Governance). When it comes to governance, legal and reputational risks in connection with money laundering allegations are particularly significant for banks. For example, a major case involved Danske Bank, which was implicated in money laundering activities and whose correspondent banks, including Swedbank and Deutsche Bank, have since been confronted with serious accusations of wrongdoing. Furthermore, attention is increasingly shifting to the risks associated with climate change.

Since the UN Climate Change Conference in Paris at the end of 2015, financing the transition to a sustainable economy has become a key issue. The EU Commission estimates the additional investment required to achieve net-zero CO_2 emissions in Europe at up to EUR 290 billion annually. This is underlined by the Green Deal announced by the recently appointed EU Commission President, Ursula von der Leyen. The banking sector plays a crucial role in financing sustainable projects. At the same time, banks' credit exposures will lead to an indirect increase in the transformation and physical risks on their balance sheets. Meanwhile, it has become standard practice to exclude certain sectors, such as coal - not least in order to avoid reputational risks. However, in

[8] See Credit Special "Europäische Bankanleihen 2019: Banken vor schwierigem Balance-Akt" of 13 January 2019

many cases sustainability risks have not yet been fully incorporated into lending decision-making and margins.[9]

International regulators have identified the consequences of climate change as a source of financial risks. The BIS and Banque de France recently even warned that climate change could be the trigger for the next systemic financial crisis. One of the driving forces is the Network for Greening the Financial System (NGFS), which at the end of 2019 included 54 regulators as members and other institutions such as the World Bank and the International Monetary Fund as observers. We view sustainability and climate neutrality as a new priority for international regulators and assume that this trend will gain further traction throughout 2020.

Our expectations are that the opportunities and risks associated with the transformation of the economy to climate neutrality will become increasingly important for banks. Although there is enormous potential for new business in this area, it will also entail additional high costs. What is more, the development of appropriate risk tools and the adequate assessment of these risks when it comes to making lending decisions will be accompanied by significant challenges.

Political environment to prompt volatility

The US presidential election in November has the potential to trigger disruption in the business environment.[10] Additionally, when the United Kingdom leaves the EU at the end of January, so will London's financial centre. Our analysis shows that banks are well-prepared and have established the necessary infrastructure within the EU.[11] There are also repeated calls for a stronger capital market union. This is an issue that we are rather sceptical about: in our view, Europe's clear focus on lending to the real economy is a deeply entrenched structural feature and closely linked to its fiscal and legal framework.

Primary market for senior unsecured bank bonds to remain strong

2019 as a whole was a record year for the issuance of senior unsecured bank bonds with fixed coupons in the EUR benchmark segment, which rose by 50 % year-on-year to almost EUR 150 billion. This was the highest level since the crisis year of 2009. In our opinion, the reasons for this were a broad range of maturities, an extremely favourable market situation and an ongoing trend away from floating to fixed-rate coupons in a low interest rate environment. Furthermore, banks' core business activities were characterised by brisk credit growth. In addition, many banks, particularly in France and Spain, issued large volumes of non-preferred senior bonds to meet their minimum regulatory capital requirements.

For 2020 we expect fixed-rate senior unsecured issues in the EUR benchmark segment to reach around EUR 130 billion. Shorter maturities and slightly fewer non-preferred senior issues indicate a slight weakening. Many banks have now managed to establish adequate levels of regulatory capital, although in certain cases, such as Sweden, a substantial number of non-preferred issues are still pending. Overall, however, it is likely to be another very strong year in terms of bank bond issuance, supported by further positive growth in lending in the context of a buoyant business environment with low interest rates. We expect a growing share of cheaper preferred issues. In addition, we anticipate that funds scheduled for repayment in the second half of 2020 from the longer-term ECB refinancing programme TLTRO-II.1-3 of around EUR 300 billion will be largely replaced by the TLTRO-III.1-7 programme, which has been in operation since September 2019; a little over EUR 100 billion was already allocated in the first two tranches.

[9] For more detail see Credit Focus: "Europäische Banken: Nachhaltigkeit rückt in den Fokus" of 4 July 2019
[10] See our publication: "Markets and Trends 2020: Melodrama - next act" of 26 November 2019
[11] See "Financial Centre of Frankfurt: More than Brexit" of October 2019 and Credit Special "Europäische Bankanleihen 2019: Banken vor schwierigem Balance-Akt" of 3 January 2019

TLTRO II-III: Targeted longer-term refinancing operations by ECB

Overview

	Allocation	Settlement	Maturity	Allocated amount (EUR bn)	Outstanding amount (EUR bn)
TLTRO-II.1	24.06.2016	29.06.2016	24.06.2020	399.3	222.7
TLTRO-II.2	22.09.2016	28.09.2016	30.09.2020	45.3	31.8
TLTRO-II.3	15.12.2016	21.12.2016	16.12.2020	62.2	48.2
TLTRO-II.4	23.03.2017	29.03.2017	24.03.2021	233.5	208.1
TLTRO-III.1	19.09.2019	25.09.2019	28.09.2022	3.4	3.4
TLTRO-III.2	12.12.2019	18.12.2019	21.12.2022	97.7	97.7
TLTRO-III.3	19.03.2020	25.03.2020	29.03.2023	.	
TLTRO-III.4	18.06.2020	24.06.2020	28.06.2023	.	
TLTRO-III.5	24.09.2020	30.09.2020	27.09.2023	.	
TLTRO-III.6	10.12.2020	16.12.2020	20.12.2023	.	
TLTRO-III.7	18.03.2021	24.03.2021	27.03.2024	.	

Sources: Deutsche Bundesbank Eurosystem, ECB Eurosystem, Bloomberg, Helaba Research

Spreads on senior unsecured bank bonds to remain low

Our expectation is that stable credit qualities should ensure that spreads on bank bonds remain low, even if we forecast supply to be once again rather high. The ECB's purchasing programme will also contribute to indirectly supporting valuations. In an overall rather volatile environment[12], we recommend focusing on issuers with high credit qualities while taking advantage of the yield premium on non-preferred senior bonds.

[12] ‘Melodrama‘ in the baseline scenario of our macroeconomic outlook, see publication: “Markets and Trends 2020: Melodrama - next act” of 26 November 2019

Further Credit Specials:

Corporate SSD market 2019 – newcomers prove popular
20.09.2019

Europäische Banken: Finale Basel III-Regeln sorgen für Aufregung
08.08.2019

Europäische Banken: Nachhaltigkeit rückt in den Fokus
04.07.2019

Corporate Schuldschein Market 2018 – solid issuers continue to dominate
16.01.2019

Europäische Bankanleihen 2019: Banken vor schwierigem Balance-Akt
09.01.2019

Non-preferred Senior Bankanleihen – Einführung in der EU und EZB-Fähigkeit
23.11.2018

Bank bonds in Germany: Imminent launch of new preferred senior bonds
25.06.2018

Notleidende Kredit in Europa: Neue Vorschriften in Europa kein großer Wurf
20.03.2018

Ungedeckte Bankanleihen in Deutschland: BMF-Referentenentwurf zur Insolvenzrangfolge
14.02.2018

The success story of corporate Schuldscheine – solid loans continue to dominate
22.01.2018

Europäische Bankanleihen: EZB regelt Notenbankfähigkeit neu
21.12.2017

Europäische Banken: Bewegung bei Harmonisierung von NPS-Anleihen
28.11.2017

Private Banken in Deutschland: Reform der freiwilligen Einlagensicherung
26.09.2017

NSFR: Banken auf Kurs, Malus für Covered Bonds?
02.08.2017

Europäische Banken: IFRS 9 erhöht Gewinnvolatilität
18.07.2017

Italienische Banken: Erneut Staatsgelder für Banken in Europa
27.06.2017

All publications are available on our homepage here. Information on all of Helaba's freely available research can be found at www.helaba.com/int/information-for/research/

You can subscribe to our newsletter at https://news.helaba.de/research. ■