Helaba

CREDIT SPECIAL

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European banks: Adequately prepared for rising credit defaults?

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Have banks made sufficient provision in setting aside additional reserves in 2020 for an expected increase in defaults by corporate and private customers as a result of the Covid-19 pandemic? Our expectation is that credit risk charges in 2021 will be lower than in the previous year, but that the effects of the pandemic will continue to be felt well into 2022. That said, many banks have created very sound risk buffers in the form of equity and operating profit retention, not least thanks to suspending dividend payments and share buyback schemes. On the other hand, it cannot be taken for granted that additional net interest income by taking part in the ECB's refinancing operations will be generated in light of a recent slowdown in demand for credit from companies. Furthermore, while fiscal and monetary policy measures have alleviated some of the immediate pressure on banks, we believe that long-term risks have increased. Bond investors should also keep a close eye on a widening differentiation in credit quality.

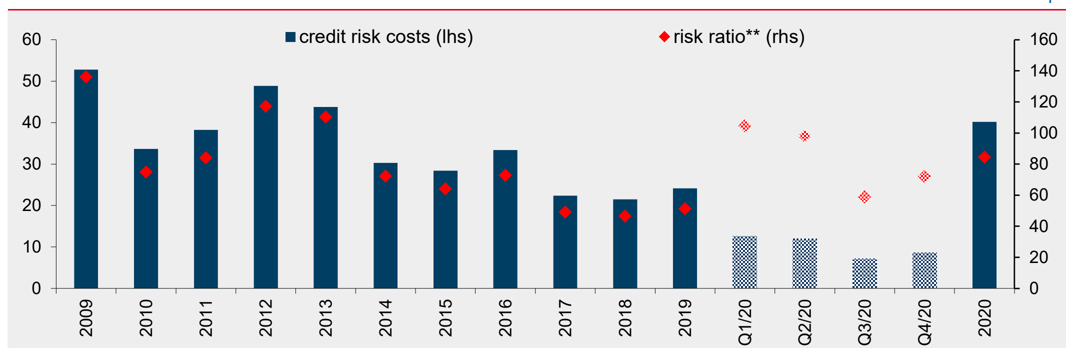
High loan loss provisions in 2020 mainly covered by operating profits

In 2020, banks' earnings were primarily impacted by a sharp rise in loan loss provision expenses due to the Covid-19 shock. Financial institutions were forced to drastically bolster their risk provisioning, especially in the first half of the year. However, the situation calmed down as the year went on and, in line with our expectation, there was a marked decline in loan loss provision expenses in the second half of the year[1]. Credit risk charges as a % of total lending rose from an average of around 50 bps in 2019 to 84 bps in 2020 at banks we analysed and were thus considerably lower than the approximately 100 bps recorded in the first six months of 2020.

Banks* set aside considerable loan loss provisions in 2020

EUR billions

bps



*banks included from our universe: ABN AMRO, ING, Unicredit, BNP, Société Générale, BBVA, SEB, Nordea, Commerzbank, Santander, Swedbank; **credit risk charges in % (bps) of average total lending volume.
Sources: company information, Bloomberg, Helaba Research

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Almost all banks in our universe were able to cover the additional loan loss provisions by operating profits before accounting for risk costs. This was not the case for Commerzbank which, in addition to structurally low profitability in its home market of Germany, was adversely affected by further

[1] see Credit Special: "Europäische Banken: COVID-19 erhöht Kredit-Risikovorsorge drastisch" of 27 May 2020

restructuring costs that weighed on its operating profit. At Banco Santander, Unicredit, Société Générale and ABN AMRO, the exceptional negative impact of goodwill amortisation and restructuring costs led to a net loss; the remaining banks even managed to close out 2020 - a year marked by economic turmoil - with a net profit after tax.

Banks take varying approaches to setting aside loan loss provisions

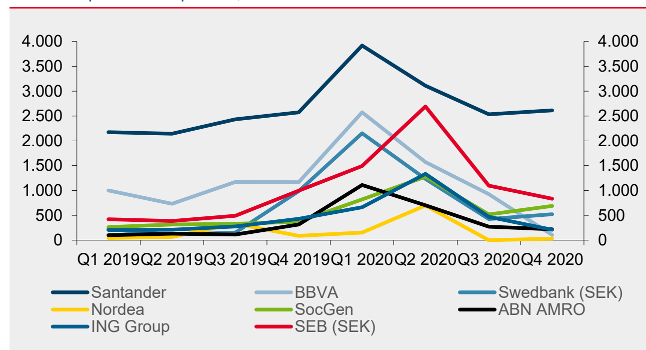
Loan loss provisions based on expected credit losses

So far, the increase in credit risk charges is predominantly due to *expected* credit losses (ECLs)[2]. In the pandemic year of 2020, the share of loans as a percentage of total credit exposure that were already classified as non-performing declined even further in most cases, despite having previously reached historic lows. There is likely to be a gradual rise in loan defaults, though, due to the crisis-hit economic environment, particularly in corporate loans. In order to prepare themselves, banks have bolstered their loan loss provisions by supplementing them with extraordinary management overlays.

However, banks took varying approaches in setting aside loan loss provisions. The ECB banking supervision had called for the avoidance of pro-cyclical assumptions in the models used to value loan loss provisions during the crisis, but this was interpreted in quite different ways by the banks. Some - BBVA for instance - had taken a conservative approach and recognised a high level of Covid-related allowances up-front in the first quarter of 2020. Others, such as Commerzbank, Unicredit and BNP Paribas, were forced to considerably raise their loan loss provision expenses in Q4 after having set aside relatively low amounts before.

Many banks see declining credit risk charges, …

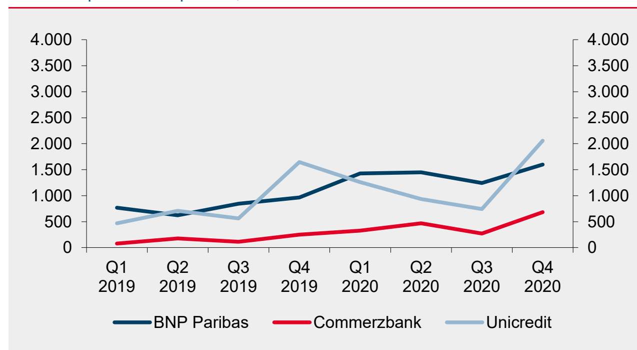
Loan loss provision expenses, EUR millions



Sources: Bloomberg, Helaba Research

… while others had to top them up again in Q4

Loan loss provision expenses, EUR millions



Sources: Bloomberg, Helaba Research

Insolvencies expected to rise - will accumulated reserves be sufficient?

The key questions that now have to be answered are (1) how will insolvencies and payment difficulties among borrowers continue to develop and (2) will loan loss provisions that banks set aside in 2020 be sufficient to cover defaults?

[2] In order to understand loan impairment charges, it is vital that they not only reflect loans that are already non-performing (Incurred Credit Losses pursuant to IAS 39, which applied until 31 December 2018) but also take into account expected credit losses. Under the current accounting standard IFRS 9, for performing financial instruments whose risk of default has increased significantly since they were first reported in the balance sheet (stage 2) expected losses over their entire remaining term must be recognised (Expected Credit Loss pursuant to IFRS 9, which has applied since 1 January 2019). This results in a noticeably pro-cyclical effect. The banks have some leeway in terms of when they can classify a credit exposure as having significantly higher risk. Among other things, the impairment to be recognised is based on current assumptions of the reporting banks with respect to economic growth in regions in which they operate and thus, ultimately, to the further course of the Covid-19 pandemic and the duration of lockdowns that have been imposed.

Government-backed support has relieved immediate pressure

The hitherto low default rates can largely be attributed to extensive state-backed support and monetary policy measures[3]. However, instruments deployed during the crisis to stabilise the situation will gradually expire, depending on the further course the pandemic takes. This will result in lagging effects: When the support schemes expire, it will become clear to what extent they had the desired impact of sustaining companies and protecting jobs as well as what the true underlying effects of the crisis are on the economy.

Strong willingness to pay after moratoria expire

There have recently been encouraging signs in relation to expired loan moratoria. According to the European Banking Authority (EBA), the volume of loans for which European banks had granted a payment moratorium fell from around EUR 810 billion at the end of June 2020 to EUR 587 billion at the end of September 2020. This decline occurred without a significant increase in defaults: The share of non-performing loans among those with expired moratoria stood at a low 2.6 % in September 2020 according to the EBA. However, the proportion of loans with possible default risks that have not yet materialised (stage 2) rose from 16.7 % in June to 20.2 % in September 2020. Furthermore, the share of non-performing loans among those with unexpired moratoria was 3.0 %, slightly above the average for all loans of 2.8 %.

The banks we monitor were also once again in a position to report encouragingly low default rates among loans subject to moratoria in the most recent reporting season. By way of example, at the Spanish Banco Santander, a volume of EUR 89 billion or 79 % of credit moratoria it had previously granted during the crisis had already expired by the end of 2020. The fact that only 3 % of these exposures were classified as impaired (stage 3) is cause for optimism. Together with French and Italian banks, Spanish banks had granted particularly generous moratoria on loans. At their peak, moratoria at Banco Santander had reached EUR 112 billion or 13 % of the bank's entire credit portfolio.

Lagging effects for German corporate insolvencies expected

Market participants in Germany, especially, will no doubt be paying close attention to how corporate insolvencies evolve as the year goes on. Here, the requirement to file for insolvency has been temporarily suspended for companies that got into difficulties due to the Covid-19 pandemic, as long as certain conditions are met. In light of this, the number of corporate insolvencies fell from an already low figure of around 18,750 in 2019 to 14,620 in the period of January to November 2020. The previous all-time high was just under 33,000 corporate insolvencies in 2009. We understand that Commerzbank's CRO, Dr Marcus Chromik, expects the number of corporate insolvencies in Germany to jump to roughly 40,000 in 2021. This projection is based on lagging effects due to temporary moratoria and state-backed relief programmes as well as on the assumption of an increase compared to an historically low pre-crisis level.

The general consensus for the outlook among banks we monitor is that loan loss provision expenses should decline in 2021 compared to 2020. On the one hand, this is based on the high amounts that have already been set aside. On the other hand, the banks concur in their view that the economy should begin to recover, particularly in the second half of 2021. Nevertheless, they disagree on the extent to which credit risk charges will decline in 2021. While some institutions expect them to remain at a high level, others even anticipate a reduction to long-term average levels as early as this year.

Credit risk charges should decrease in 2021 compared to high level in 2020

We also expect credit risk charges to be significantly lower in 2021 compared to 2020. However, we assume that the repercussions of the crisis will be felt for a longer period, albeit not drastically, and will continue to have an impact at least into 2022. This assumption depends on the rapid progress of vaccination programmes across Europe and the absence of any potentially serious new mutations emerging. The lockdowns imposed during the pandemic affected companies to varying degrees. Firstly, this is because they impacted specific sectors of the economy and secondly, they are likely to have exacerbated problems for companies that were already struggling before the crisis struck. Accordingly, we expect to see widening spreads in credit quality among companies. In our opinion, the historically low levels of credit defaults that existed before the crisis will not be achieved again for the time being.

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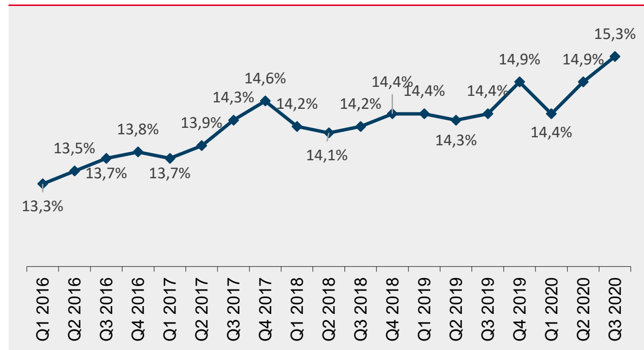
[3] see our regular update "Vertrau(d)lich: Corona News", most recently of 5 February 2021

Some banks boast very healthy capital surpluses

A positive development to note is that the major European banks have made tangible strides in improving the quality of their balance sheets over the last few years. In an environment of more stringent requirements, many institutions have more or less doubled their regulatory capital ratios and made consistent steps to reduce problematic areas since the financial market crisis. Most recently, bans on dividend payments and share buybacks have further bolstered their capital ratios. In addition, they have made further efforts to manage their risk-weighted assets and, in many cases, have continued to post net operating profits.

CET-1 capital ratios show welcome rise after temporary decline

CET-1 ratios of European banks*

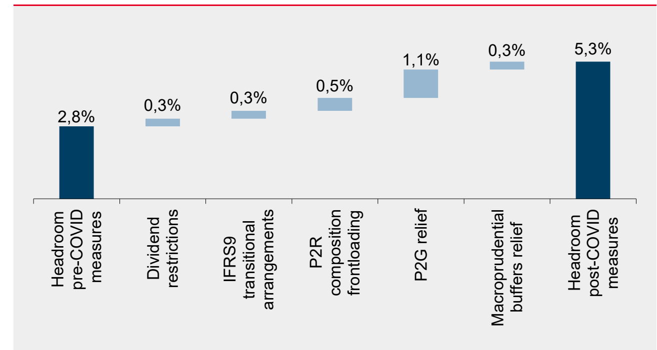


*average for banks supervised by the ECB

Sources: ECB banking supervision, Helaba Research

Capital buffers strengthened thanks to lower regulatory requirements

Capital buffers versus regulatory minimum*, September 2020



*aggregated figures for European banks

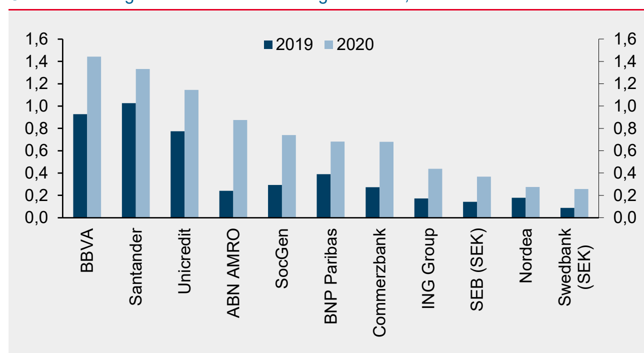
Sources: ECB banking supervision, Helaba Research

Surplus equity more than enough to cover credit risk charges

Moreover, measures to lighten the regulatory burden on banks have led to an increase in the buffer to the regulatory minimum, although they will be largely revoked after the crisis. Nonetheless, in the meantime a number of banks have amassed substantial surplus capital. For many insitutions, the capital they held at the end of 2020 in excess of minimum regulatory requirements would be enough to cover credit risk charges for that crisis-ridden year by a factor of more than five. For this reason, quarterly reporting was dominated by the banks' senior management reaffirming their intention to resume dividend payments as soon as possible and announcing share buyback schemes.

Substantial rise in provisions for credit risks

Credit risk charges as a % of total lending volumes*, %

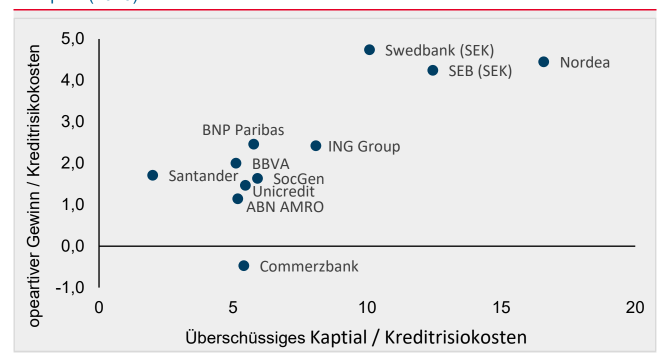


*loan loss provision expenses / average lending volumes

Sources: Bloomberg, Helaba Research

Surplus capital more than covers credit risks

Multiplier (2020)



Sources: Bloomberg, Helaba Research

The capital buffers, which are high in some cases, are also repeatedly cause for speculation over possible takeovers within the fragmented European banking industry. While smaller, opportunistic transactions and consolidation within certain sectors are continuing, there have been no major deals, especially those involving banks from different countries. According to our observations, large acquisitions do not fail due to a lack of capital but rather to the absence of attractive takeover candidates. Within individual countries, overlapping customer bases often act as deal breakers. Cross-

border consolidations continue to be hampered by divergent frameworks. During crises, institutions tend to focus on their home countries and, ultimately, the close ties between banks and the countries where they are based becomes even stronger.

Interest rate premium from ECB's refinancing operations cannot be taken for granted

The ECB's third round of targeted longer-term refinancing operations (TLTRO III), which is currently underway, is also intended to provide additional support and to incentivise banks to lend during the crisis. If certain lending criteria are met, the participating institutions can obtain an additional premium in the form of a temporary preferential interest rate. Banks have made extensive use of this, with the ECB allocating them a total of EUR 1.3 trillion through its TLTRO III.4 programme in June 2020. At present, around EUR 1.8 trillion in all TLTRO tranches is outstanding.

However, new lending business has recently shown signs of weakening, with demand for credit particularly subdued among companies. On the one hand, they had already hoarded liquidity at the start of the crisis; on the other hand, many firms have been deferring investments in the current lockdown phase. What is more, companies have taken advantage of favourable windows on the capital markets to issue bonds[4].In addition, according to the bank lending survey, banks have become somewhat more restrictive in their lending policies given that the difficult economic environment has led to greater credit risks. Consequently, it is not yet a foregone conclusion that all institutions will meet the minimum lending requirements in March that are a condition for obtaining the attractive interest rates provided by the ECB's TLTRO III operations.

ECB refinancing operation in March to offer broader eligibility criteria

At its meeting on 10 December 2020, the ECB's Governing Council increased the maximum volume of loans eligible for TLTRO III operations from a previous level of 50 % to 55 %. Accordingly, banks that meet the lending criteria may once again draw down higher amounts from the upcoming TLTRO III.7 tranche in March 2021 compared to the two previous TLTRO tranches. In the latter cases, institutions had already fully utilised the maximum drawable volume available to them.

Banks taking full advantage of ECB's Targeted Longer-Term Refinancing Operations

Overview of TLTRO II to III

	Allocation	Settlement	Earliest voluntary repayment (settlement)	Maturity	Allocated amount (EUR bn)	Outstanding amount (EUR bn)
TLTRO-II.4	23.03.2017	29.03.2017		24.03.2021	233.5	15.7
TLTRO-III.1	19.09.2019	25.09.2019	29.09.2021	28.09.2022	3.4	3.4
TLTRO-III.2	12.12.2019	18.12.2019	29.09.2021	21.12.2022	97.7	97.7
TLTRO-III.3	19.03.2020	25.03.2020	29.09.2021	29.03.2023	115.0	115.0
TLTRO-III.4	18.06.2020	24.06.2020	29.09.2021	28.06.2023	1,308.4	1,308.4
TLTRO-III.5	24.09.2020	30.09.2020	29.09.2021	27.09.2023	174.5	174.5
TLTRO-III.6	10.12.2020	16.12.2020	22.12.2021	20.12.2023	50.4	50.4
TLTRO-III.7	18.03.2021	24.03.2021	30.03.2022	27.03.2024	.	.
TLTRO-III.8	17.06.2021	24.06.2021	29.06.2022	26.06.2024	.	.
TLTRO-III.9	23.09.2021	29.09.2021	29.06.2022	25.09.2024	.	.
TLTRO-III.10	16.12.2021	22.12.2021	29.06.2022	18.12.2024	.	.

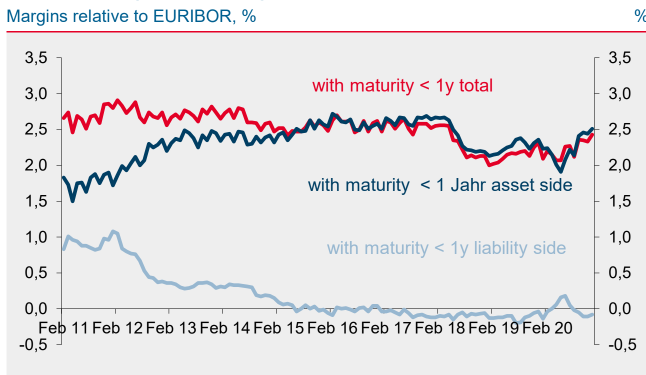
Sources: Deutsche Bundesbank Eurosystem, ECB Eurosystem, Bloomberg, Helaba Research

[4] aggregated analysis with significant differences among individual companies

At the same time, private households have been delaying purchases and increasing savings rates during the lockdown. The resulting growth in deposits, which is a loss-making business for banks with money market rates below zero, is having a negative impact on their profitability. To compensate for this, they need to generate profitable lending business. A ray of light in this respect is mortgage lending, which has received a shot in the arm due to the low interest rate environment. The annual growth rate for residential mortgages in the euro area had risen to 4.7 % by the end of the fourth quarter, its highest level since 2008. Commerzbank, for example, even reported that its margins in this segment had recently been on the rise.

Credit margins picking up

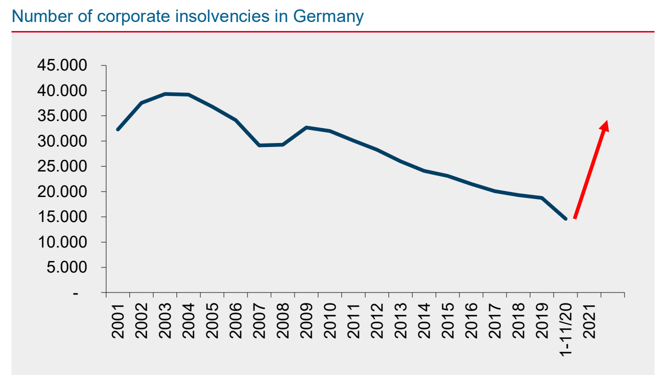
Margins relative to EURIBOR, % %



Sources: Datastream, Helaba Research

Lagging effects for German corporate insolvencies expected

Number of corporate insolvencies in Germany



Sources: Datastream, Helaba Research

Long-term risks for public finances have increased

While we expect profits within the banking sector to stabilise in 2021, driven by declining credit risk charges, and assume that any negative rating migrations in the loan books will be adequately covered by reserves, we believe that the crisis will result in long-term risks. On the one hand, the entrenched low interest rate environment means that the outlook in terms of profitability will remain gloomy. The recent debate over reflating the economy that has entered the spotlight does not change our assessment in this regard for the time being. On the other hand, the sharp increase in sovereign debt has further increased the medium to long-term risks of corresponding exposures.

On top of that, substantial regulatory costs and enormous investments in digitisation - a trend that has simultaneously proven its worth and accelerated during the crisis - continue to exert downward pressure on profitability. In addition, extraordinary factors are weighing on certain institutions, for example high costs due to allegations of inadequate anti-money laundering processes. As outlined above, we expect credit risk charges to remain above pre-crisis levels for the time being.

Banks have been taking steps to offset this for some time by imposing negative interest rates on companies and institutional clients. According to projections by the Bundesbank, at the end of 2020 more than 75 % of the demand deposit volume of non-financial sector companies in Germany was subject to a negative average interest rate. This proportion had reached as much as 35 % for retail customers and there is a noticeably growing willingness on the part of banks to impose negative interest rates on this clientele as well. What is more, in order to boost their fee and commission earnings, banks are making efforts to encourage their customers to invest their steadily rising volumes of savings in securities and asset management products. In addition, cost-cutting programmes are still on the agenda, although they will initially involve a certain amount of restructuring costs. Finally, further goodwill amortisation cannot be ruled out.

Take into account wider differentiation in credit quality

Based on our forecasts for the economy and monetary policy[5] , we expect spreads to remain low for the rest of the year. Although negative rating migrations in loan books, which are expected to occur going forward, are having an adverse effect on the outlook for credit ratings of bank bonds, the consequences of the second lockdown are likely to have been largely factored into valuations already.

Nevertheless, bond investors should proceed with a certain degree of caution. Setbacks in the fight against the pandemic could lead to volatility in bond valuations at any time, especially since spreads have already become extremely tight. Moreover, discussions about a reduction in central bank purchases would put pressure on spreads. At the same time, an overall rise in yields would even support banks' earnings prospects in the long run.

Credits: important to differentiate more strongly

Compared to expensive covered bank bonds and government bonds, in our view a number of uncovered issues offer relatively attractive risk premiums. Investors should focus on issuers with good credit ratings but with a preference for non-preferred issues with attractive spread premiums. The pandemic has impacted companies in various sectors in different ways. Even at the individual company level, the situation is very fragmented with winners and losers. For that reason, it is crucial to take a particularly close look at the quality of individual issuers' credit portfolios. After all, even isolated major default events can wreak havoc. Furthermore, as is often the case, issuers with highly diversified business activities and loan books are at an advantage - even in this crisis. For the rest of the year, the prospects for the issuance of preferred instruments are still relatively weak (see "EUR Benchmark Bank Bonds Q4 2020: Issuance remains in the doldrums" 14.01.2021). However, negative rating migrations and the MREL requirements that will apply from 2022 onwards are likely to result in further non-preferred issues, which could present interesting opportunities for bond investors.

[5] see our latest "Wochenausblick: Lockerungsübungen" of 5 March 2021

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