Helaba

Focus on: Credits
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European banks 2022: Spotlight on the interest rate environment

We expect the credit quality of the banking sector to remain stable in 2022. While it is not possible to rule out the possibility of defaults in certain areas following the pandemic, given that institutions have already allocated a substantial level of risk provisioning, we anticipate further reversals in the course of the year. In addition, due to the excess capital that many banks have accumulated, they are likely to continue dividend payouts and share buyback schemes. When it comes to sustainability, a number of crucial decisions are on the agenda. However, the main factor defining the year ahead is the interest rate environment, with banks among the winners in a scenario of rising rates.

1 2021: Profits in the banking sector well above expectations

Dr. Susanne Knips
Senior Credit Analyst
T 0 69/91 32-32 11

For European banks, 2021 was an exceptional year marked by upward earnings revisions. In the fourth quarter, institutions are also expected to report strong results; consequently, their full-year earnings will be considerably higher than had been forecast at the beginning of the year, even in positive scenarios.

This was primarily driven by a low level of additional loan loss provisions, as banks had previously made generous allowances for potential crisis scenarios in their credit portfolios during the pandemic-hit year of 2020. As a result of major fiscal and monetary policy measures, these scenarios did not materialise and in some areas, institutions were even able to reverse provisions[1] in an environment of improving macroeconomic forecasts. This situation was further aided by buoyant capital market earnings, a further significant rise in new mortgage business, cost-cutting programmes and additional income from participation in the Eurosystem's TLTRO III[2] facilities, which were designed to provide extremely attractive refinancing conditions.

[1] For more information on credit risk provisioning pursuant to IFRS9, please refer to our Credit Special **"Europäische Banken: COVID-19 erhöht Kredit-Risikovorsorge drastisch"** of 27 May 2020
[2] Targeted longer-term refinancing operations

2 Outlook: Balance sheet quality to remain stable

We expect the credit quality of the banking sector to remain stable in 2022. While it is not possible to rule out the possibility of defaults in certain areas following the pandemic, given that institutions have already allocated a substantial level of risk provisioning, we anticipate further reversals in the course of the year. However, a certain level of risk is associated with the further course of the Covid-19 pandemic. On top of that, geopolitical conflicts have recently moved back into focus. Another factor that should not be underestimated are medium-term risks arising from high ratios of public and private debt.

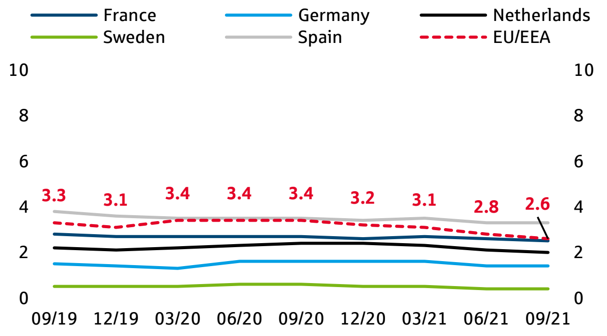
2.1 Prudence called for despite low level of credit defaults to date

Banks will have to set aside a slightly higher level of additional provisions for possible loan losses in 2022 compared to the prior year. However, in view of the fact that loan loss charges have so far remained low despite the pandemic, this represents more of a return to normality. Although it is not possible to rule out the possibility of larger credit defaults in certain areas in the wake of Covid-19, institutions still have a high level of special loan loss provisions in place from 2020 that they are able to draw on.

According to data from the European Banking Authority (EBA), the share of non-performing loans in banks' total credit portfolios continued to decline in September 2021. However, loans that have not yet been classified as non-performing are under special observation. The proportion of loans whose risk of default has increased significantly since the initial balance sheet date, but which are not yet considered non-performing, has increased noticeably as the pandemic has unfolded. Nevertheless, there have been recent signs of stabilisation on this front as well.

NPL ratio remains low

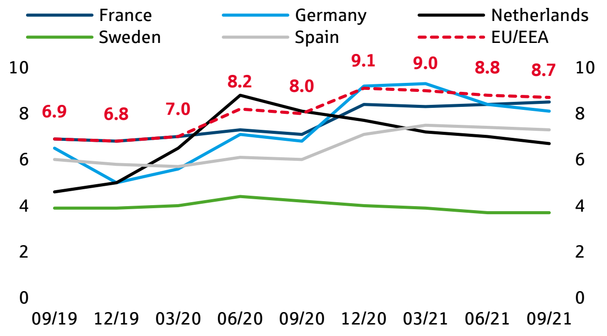
Share of stage 3* loans, in %



*loans already subject to impairment
Sources: EBA, Helaba Research & Advisory

Recent halt to rise in default risks

Share of stage 2* loans, in %



*risk of default for loans has risen significantly
Sources: EBA, Helaba Research & Advisory

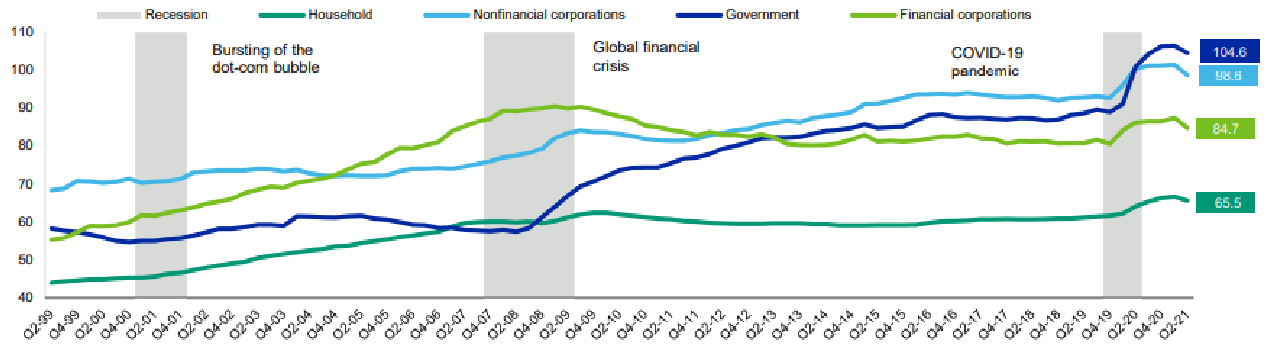
Encouraging signs are also emerging from expiring moratoria: according to the EBA, the volume of loans for which European banks have granted deferred repayments fell from EUR 871 billion in June 2020[3] to EUR 50 billion in September 2021[4], without any major distortions in credit metrics. The proportion of non-performing loans (NPL ratio), at 4.9 % for expired and 6 % for remaining moratoria, was higher than the aforementioned average of total credit exposure, but still at an easily manageable level. At the same time, though, there were considerable differences between each country. Moreover, there was also a noticeable rise in the share of loans not classified as non-performing whose risk of default had significantly increased, accounting for around as much as a third of remaining moratoria[5].

[3] EBA press release of 20 November 2020
[4] EBA press release of 10 January 2022
[5] The total volume of loans under public guarantee schemes (PGS) reached EUR 378 billion in September 2021, of which 2.4 % were classified as NPLs and 20.1 % were under stage 2 (significantly higher risk). In this case, however, banks are largely protected from default risks by the guarantees.

It will also be important, from the perspective of credit quality, to keep an eye on public and private debt ratios, which have meanwhile reached high levels. Based on our macroeconomic outlook, they are unlikely to have an

Global debt ratios soar to new heights

Global debt-to-GDP ratios by sector, in %



Sources: Moody's Investors Service, Helaba Research & Advisory

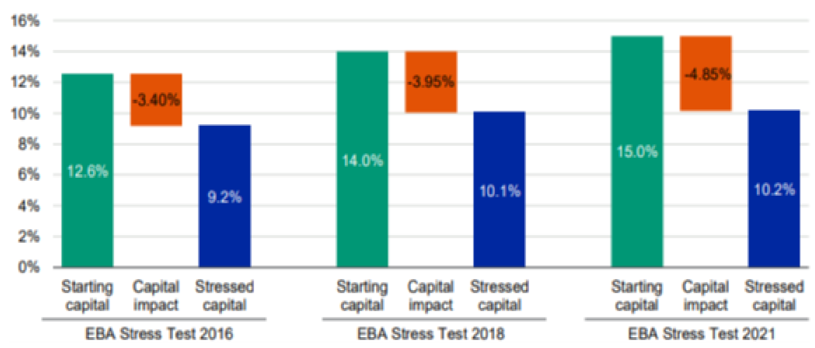
impact in 2022; however, they are associated with elevated risks in the medium term.
Sovereign debt ratios have been rising since the financial crisis ten years ago and have been further exacerbated by the Covid pandemic. As government support measures[6] are phased out, the danger is that those private individuals affected will also experience a deterioration in their capacity to shoulder debt.

2.2 High equity ratios used for dividend payouts and share-buybacks

Another reason for banks' impressive crisis resilience, as the Covid pandemic has shown, is their high level of regulatory capital. Prudential requirements were ratcheted up dramatically after the financial crisis and this led to banks reporting regulatory capital ratios today that are twice as high as before the financial crisis, despite more stringent calculation methods.

2021 stress test reveals high capital buffers despite strict requirements

Core capital ratio*, in %



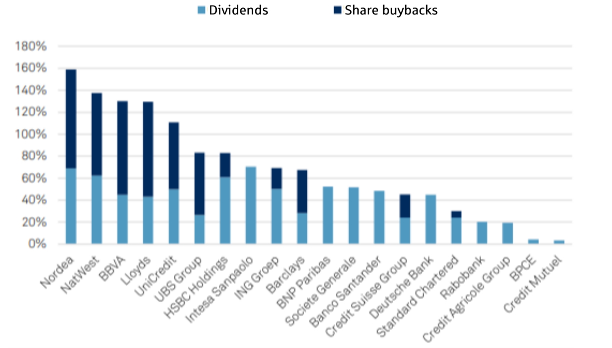
*CET 1, on average; capital impact: impact on equity under stress test assumptions
Sources: Moody's Investors Service, Helaba Research & Advisory

In addition, the wide-ranging regulatory reforms enacted in recent years have substantially improved the banking industry's institutional framework for preventing and managing crises.[7]

[6] For instance, Germany's furlough scheme ("Kurzarbeit")
[7] Particularly the Single Resolution Mechanism (SRM) and Single Supervisory Mechanism (SSM) for European banks

Banks distribute excess capital

Expected payout ratios* in 2022 according to S&P Global Ratings



*in relation to expected earnings

Sources: S&P Global Ratings, Helaba Research & Advisory

The freeze on dividend payouts imposed by regulators on all banks at the beginning of the Covid-19 crisis has also resulted in many banks accumulating a significant amount of excess capital.

The cap on dividends imposed by the ECB banking supervision was lifted at the beginning of October 2021. Since then, major listed banks have been rushing to announce share buyback schemes and dividend payouts. The equity ratios of many banks are therefore likely to decline steadily in 2022 towards pre-Covid levels.

Opportunistic acquisitions are also becoming increasingly popular again. In the medium term, the completion of the banking union with the introduction of a uniform European deposit protection scheme could act as an additional catalyse for larger transnational mergers. So far, this has faced strong resistance from Germany; however, the new "traffic light" coalition there may bring about a change of heart and EDIS[8] is likely to be back on the agenda in 2022.

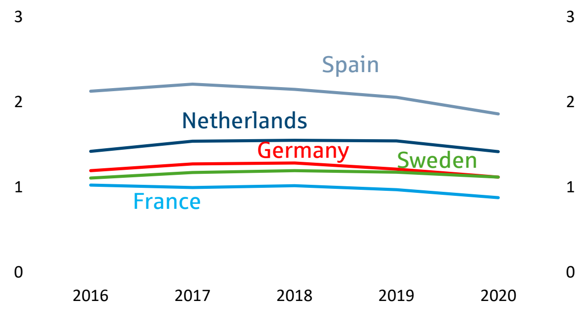
2.3 Steerable rise in interest rates bolsters profits

The interest rate environment will be a key driver for the earnings outlook for banks and therefore a defining issue in 2022. At a most recent level of 55 %[9], net interest income is the most important earnings component for European banks. A moderate rise in interest rates is a welcome development for the industry, especially with respect to the profitability of excess deposits and liquidity portfolios.

Yet, there are also risks associated with rates being hiked too quickly, e.g. in terms of valuation adjustments, credit defaults and a decline in new lending. The low interest rate environment, for instance, was accompanied by a boom in residential mortgages.

Low interest rates hit interest margin

Interest margin, in %



Sources: S&P Capital IQ Pro, Helaba Research & Advisory

Overall, however, we believe the banking industry will be a beneficiary of rising interest rates as it typically hedges interest rate risk. In a context of increasing rates, the falling value of assets is offset by the falling value of liabilities. We expect funding conditions for the sector to remain favourable, though not to improve any further in light of inflationary pressures and the Fed's tapering of its asset purchase programmes (see **"Primary Market Update EUR benchmark bank bonds: 2021 ends on high note"** of 11 January 2022).

However, the same level of additional earnings from the ECB's TLTRO programme is not on the cards in 2022. According to its monetary policy decisions of 16 December 2021, the Governing Council's assumption is that the special conditions applicable under TLTRO III will expire as planned in June 2022. Furthermore, the Council wants to "assess the appropriate calibration of its two-tier system for reserve remuneration so that the negative interest

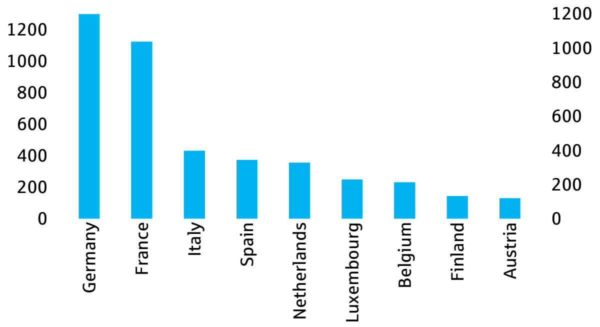
[8] European Deposit Insurance Scheme

[9] According to the EBA Risk Dashboard Q3 2021

rate policy does not limit banks' intermediation capacity in an environment of ample excess liquidity." Our understanding of this is that the exemption of excess reserves from being subject to the negative deposit rate (currently - 0.5%), which has been 6 times the minimum reserve[10] since September 2019, could be further extended.

German banks have high significant deposits at ECB

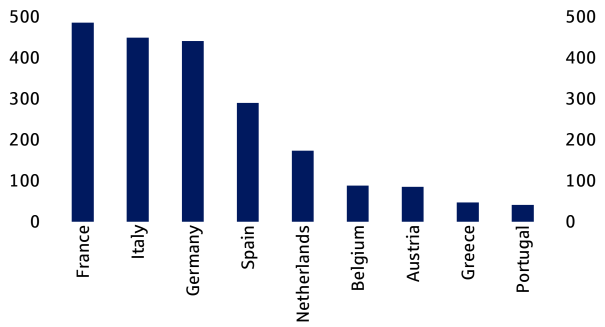
Banks' excess liquidity at ECB, December 2021, in EUR (billions)



Sources: ECB, Helaba Research & Advisory

Participation in TLTRO simultaneously boosts earnings

Participation in TLTRO III*, December 2021, in EUR (billions)

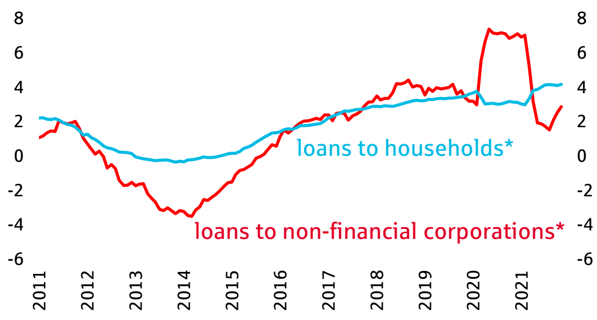


* ECB's third targeted longer-term refinancing operations
Sources: ECB, Helaba Research & Advisory

2.4 Other key factors behind earnings - demand for corporate lending and costs

Demand for lending from companies stabilises

Year-on-year change in credit volume, in %



*adjusted for securitised loans and other transactions
Sources: Refinitiv, Helaba Research & Advisory

We expect that demand from companies for lending will rise slightly from a rather modest recent level. In 2021, lending by banks was adversely affected by a high level of subsidised loans to businesses under governments' Covid support packages in 2020, the repayment of these loans and the generally strong liquidity position of many companies. In addition to the broadly favourable macroeconomic trend, the EU's **NextGeneration** programme could prove to be a major factor behind growth in 2022.

The central role that banks play in the transition to a more sustainable economy also presents opportunities. At the same time, however, business not considered sustainable will be lost (see **„EU-Taxonomie-Verordnung: Streit um die Kernkraft“** in our weekly outlook of 7 January 2022) and, ultimately, it will come down to the individual institutions to successfully position themselves in this new market.

What is more, the pandemic has resulted in digitisation, where the costs of investment remain high, receiving a further boost. As competition for margins is fierce, interest rates are still low and the pressure on costs high, cost-cutting programmes will remain the order of the day. In contrast, we believe that the negotiating power of banking sector employees - despite rising inflation - is relatively weak due to redundancy programmes that are already underway.

3 Regulation: focus on rollback of capital relief measures during pandemic

The aim of the banking package, which the EU Commission presented at the end of October 2021, is to fully implement changes to the Basel III framework agreed at an international level into EU law. Sweeping regulatory reforms

[10] so-called tiering

were introduced in the wake of the global financial crisis with regard to banks' regulatory capital and crisis management. These reforms have now been largely implemented. For this reason, from the perspective of bond investors the significance of regulatory adjustments is declining.

3.1 Basel IV – ambitious timeline

The legislative proposals submitted by the EU Commission in October for the final transposition of changes to Basel III (the so-called Banking Package) have prompted some relief: the proposals address the special features of the EU banking sector and are likely to result in lower capital charges than had initially been feared. Among other things, equity costs for loans to SMEs are to be kept as low as possible and compliance costs for smaller banks are to be reduced.

However, the timeline for the legal implementation of the proposals is ambitious. The legislative package is scheduled to enter into force as early as 1 January 2023, so that the regulations can apply in the individual EU countries as of 1 January 2025. We expect large banks that rely on capital market funding to provide indications of the impact on their capital requirements in the course of this year (for more detail, see our study **"Implementation of Basel III imposes uneven burden on banks"** of 5 November 2021).

3.2 Expiration of capital relief factored in

Right at the beginning of the Covid-19 pandemic in March 2020, the ECB banking supervision granted banks capital relief. This enables institutions to use capital buffers in excess of the minimum ratios agreed with the supervisor during the capital planning process to absorb losses.[11] In addition, national regulators, with the banking of the ECB banking supervision, temporarily reduced or abolished countercyclical capital buffers (CCyBs[12]) in their respective countries. (for more detail, see our publication **„EZB mit Maßnahmen gegen Corona-Schock“** of 13 March 2020).

These relief measures are now being progressively rolled back. However, due to the time needed to implement measures such as these, it is likely that they will not come into force for several months. Typically, there is a 12-month time lag between announcement and entry into force. Nevertheless, some countries have already announced the reinstatement of the countercyclical capital buffers. At the end of September 2021, the Swedish supervisory authority was the first to announce the gradual increase of the CCyB from the end of September 2022. Denmark, Norway and the United Kingdom followed with similar announcements in December. On 12 January 2021, the German banking supervisory authority BaFin stated in a **press release** that the CCyB would be restored in Germany in February 2023[13, 14].

From our point of view, this should not have any significant impact on most banks. As explained above, the sector has accumulated considerable excess capital and institutions have not had recourse to capital relief during the crisis. Moreover, banks have already factored in the expiration of capital relief measures into their capital planning process..

At this juncture, it is worth mentioning that the final minimum requirement for own funds and eligible liabilities (MREL) will apply from 2024 onwards (for more detail on this, see our publication **"Regulatory call option for non-preferred bonds becoming standard"** of 29 July 2021).

[11] Pillar 2 Guidance, capital conservation buffer

[12] Countercyclical capital buffer

[13] In addition, BaFin is planning to establish a systemic risk buffer for the residential mortgage sector. In this way, it is reacting to increasing risks as a result of the recent extremely rapid growth in prices and mortgage lending. See our commentary in **Helaba's weekly outlook of 14 January 2022**.

[14] The temporary suspension of the minimum liquidity coverage ratio **already expired on 31 December 2021.**

3.3 Sustainability - ongoing development of data, processes and disclosure requirements

Regulators have turned their attention to the transition to a sustainable economy and consider it priority. Indeed, they have long regarded ESG[15] risks as a source of financial risk (for more detail, see our publication **"Supervision wearing green-tinted spectacles"** of 8 December 2020. In 2022, the main focus here will be on ensuring greater transparency and understanding of the risks.

From the end of June 2022, large institutions will be required to outline their ESG risks in the **disclosure report**. Supervisors are currently reviewing the disclosure of banks' climate-related and environmental risks. The ECB banking supervision plans to present a corresponding report in the first quarter of 2022.[16]

From the 2023 financial year, banks will be required to report their "green asset ratio" in full for the first time, which means they will have to show their customer exposures as defined by the EU taxonomy in relation to their entire portfolio.[17] It is likely that institutions will report a ratio of taxonomy-compliant activities in their annual reports for 2021, which are due shortly. However, we believe that this ratio will be of limited informative value. Banks bemoan the fact, among other things, that it is difficult to obtain relevant data from their corporate customers.

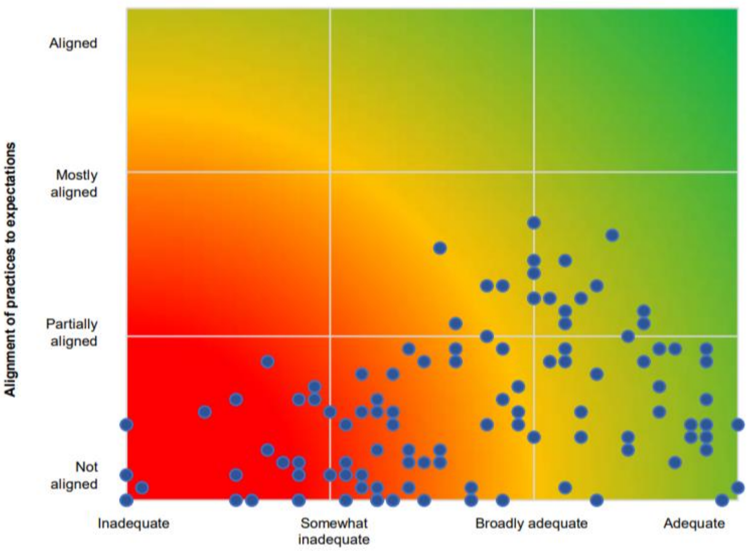
In addition, the focus of this year's **stress test** by the ECB banking supervision is on climate-related risks. The ECB considers the stress test to be a learning exercise for banks and supervisors alike, with the aim being to identify vulnerabilities, best practices and the challenges banks are facing in relation to climate-related risk management. The exercise will also help enhance data availability and quality and will allow supervisors to better understand how banks gauge their own climate risks.

Initially, the output of the stress test will be integrated into banks' Supervisory Review and Evaluation Process (SREP) using a qualitative approach, but it is unlikely that it will have any major quantitative impact on Pillar 2 capital requirements. The stress test is scheduled to be conducted from March to July 2022. Currently, it is unclear when and to what extent the results will be published. We assume that the banks themselves will provide comments on their own results.

In addition to the climate risk stress test, there are several other complementary regulatory initiatives in Europe focusing on sustainability. The ECB banking supervision's fundamental objective is to examine more closely how the banks it supervises manage climate-related and environmental risks. It had previously published a corresponding **guide** for banks on climate-related and environmental risks in November 2020, which set out its expectations with regard to the management of climate-related risks. In November 2021, the ECB supervisor issued its first **comprehensive report** on how banks under its supervision are adapting their risk management to climate-related and environmental risks. The report concluded that institutions

Expectations of supervisor a long way from being met

Status of implementation of climate-related and environmental risk management



Quellen: EZB-Bankenaufsicht, Helaba Research & Advisory

[15] Environmental, Social, Governance

[16] See also **report of November 2020**

[17] Pursuant to the Taxonomy Regulation and delegated acts

had taken some preliminary steps but that none of them even came close to meeting the expectations set out in the guide.

At the same time as the climate-related stress test, the ECB supervisors are due to conduct a review of the status of banks' implementation of systems and processes for managing climate-related and environmental risks and their integration into overall corporate strategy and governance structures in the first half of 2022.
In the run-up to the climate risk stress test by ECB supervisors in 2022, the ECB (Eurosystem) conducted an economy-wide climate stress test, the **results** of which were available in September 2021. In a top-down approach, this stress test focused on the stability of companies and banks in various climate policy scenarios. In addition to the ECB banking supervision's climate risk stress test, it also forms the basis for the climate stress test for the Eurosystem balance sheet, which is planned for the first quarter of 2022.

Furthermore, the European Banking Authority (EBA) has been tasked with integrating ESG principles into banking supervisory practices.[18] In June 2021, it published guidelines for banks on the management and supervision of ESG risks. In its May 2021 pilot study on the scope of climate risks, the EBA emphasised the need to address gaps in data in order to ensure a smooth transition towards low-carbon activities. Additionally, the EBA also highlighted significant disparity in banks' implementation of the EU taxonomy (see our publication **"EBA publishes pilot exercise on climate risk"** of 25 May 2021).

The legislative proposals for the final implementation of the EU Commission's Basel III amendments also contain draft provisions for ESG-relevant issues. These are largely based on the results of the above-mentioned initiatives and aim to ensure that banks systematically identify, disclose and manage their ESG risks as part of their overall risk management framework. This includes regular climate stress testing by both supervisors and the institutions themselves. The initial proposals did not contain any provision to integrate ESG aspects into minimum capital requirements (a so-called "green supporting factor"), which the Commission explained was due to a lack of data. However, the Commission has instructed the EBA to examine whether and how minimum capital requirements should be adjusted according to the ESG impact on individual assets. The results of this study should be available in 2023 (for more detail, see our study **"Implementation of Basel III imposes uneven burden on banks"** of 5 November 2021).
While the EBA will commence its EU-wide stress test in 2023, it will conduct its regular annual transparency exercise in 2022.

Conclusion: The issue of sustainability has long since become an important factor for the competitiveness of banks[19]. They will be seeking to benefit from the enormous business potential that will arise from economy's transition towards greater sustainability, although initially this means that a vast array of business activities will be discontinued. Sustainability issues also play an important role in banks' reputation management.

Above all, however, collecting and evaluating data poses enormous challenges for financial institutions. In our view, to a large extent the quantification of climate risks is still in its infancy. In 2022, the principal challenge for institutions and supervisors will be to enhance the relevant risk models and processes as well as the availability of data. At the same time, there will be improvements to transparency and disclosure.

There are unlikely to be many direct impacts on banks' credit quality as a result of ESG issues in 2022. However, this year will see crucial groundwork being laid for banks' medium-term approach to as well as risk management and disclosure of ESG issues.

[18] CRRII/CRDV
[19] See our publication **„Europäische Banken: Nachhaltigkeit rückt in den Fokus"** of 4 July 2019

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Publisher and editor

Helaba Research & Advisory

Editor:
Stefan Rausch

Publisher:
Dr. Gertrud R. Traud
Chief Economist/
Head of Research & Advisory

Neue Mainzer Str. 52-58
60311 Frankfurt am Main
T +49 69 / 91 32 - 20

Internet: **www.helaba.com**

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