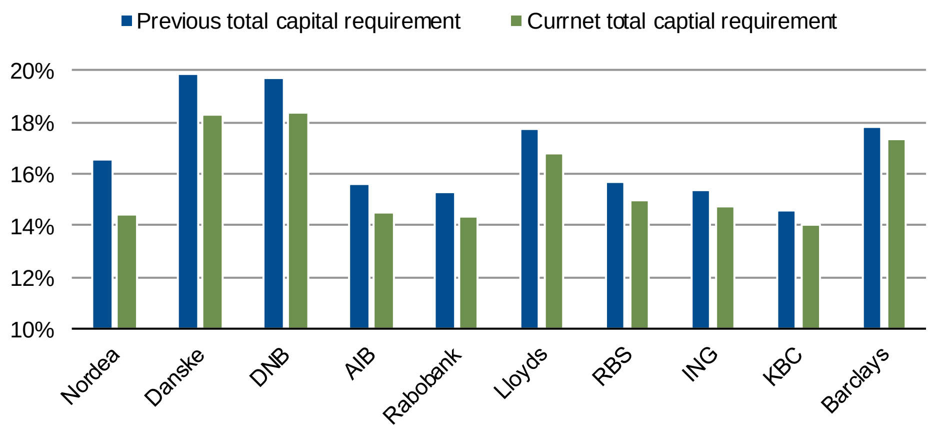
AT1 quarterly: Covid-19 effects increase risks for investors

The magnitude of the impact of Covid-19 on bank fundamentals is uncertain. However, with banks being treated as part of the policy solution they are benefiting from an easing in regulatory requirements. These measures are generally supportive for issuer fundamentals but as the pandemic endures and the economic fallout persists, we see the risks for AT1 investors increasing.

Regulators have responded quickly to ensure that banks are able to support the economy. They are taking measures to increase the amount of capital available to banks, easing requirements and exercising flexibility to soften the impact of expected credit losses. While these are generally supportive of bank fundamentals, the implications for AT1 investors are more nuanced.

The easing of capital requirements is helpful to an extent. While drawing down on capital buffers is permitted, breaching the combined capital buffer still has consequences. Regulators have made this explicitly clear. For AT1 investors, the most relevant relaxations in capital requirements have been the removal or reduction of countercyclical and systemic risk buffers in countries where these had been actively used before Covid-19: the countercyclical buffer in the UK and Norway and the systemic risk buffer in the Netherlands and Finland.

Figure 1: Selected AT1 issuers with material changes in capital requirements



Source: Company data, Scope Ratings calculations.

Meanwhile, strong regulatory guidance to restrict dividends and bonuses, with European AT1 issuers complying in some manner, has strengthened banks' solvency positions. In cases where banks change their dividend policy and decide not to pay, this benefits the reported CET1 capital position. For banks maintaining a proposed dividend but deferring payment, the amount will continue to be deducted from retained earnings for financial year 2019. And unless there is a change in dividend policy, interim dividends for financial year 2020 will also be deducted from interim profits.

This supervisory decisiveness has raised questions about the likelihood of regulatory intervention in the payment of AT1 coupons. Points in the debate include the limited potential savings from not paying AT1 coupons compared to the magnitude of dividends and bonuses and implications for future funding access and cost.

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For now, major European AT1 issuers generally remain sound, so we see limited risks. However, as the impacts of Covid-19 persist and issuer fundamentals deteriorate due to losses and capital depletion, the risk of non-payment will increase. This should not be a surprise given the inherent loss-absorbing features of AT1 securities.

Pre-virus levels of profitability and capital key to withstanding current stress

Not all banks will suffer from the economic fallout to the same degree due to differences in the robustness of business models and risk management capabilities. Issuers that already were under pressure before Covid-19, be it due to the need to improve competitiveness or profitability, remain at a disadvantage. Ultimately, with revenues falling, having sufficient capital to absorb potential credit and market-related losses will be key. The effectiveness of public-policy measures will also play a role in supporting bank fundamentals. And as the economy moves on from the current stress, sustainable business strategies and earnings capabilities will determine how quickly a bank recovers.

It is still early days and the capital positions of banks have not weakened to a level that threatens combined capital buffers. Regulators and supervisors appear to be highly supportive of banks, and further measures are possible. Again, this should be positive for banks overall but not necessarily for AT1 investors.

A blanket restriction on AT1 coupons is a risk

Preventing the payment of AT1 coupons is a severe step which would normally happen after other supervisory interventions have been made. However, in the current environment where dividends and bonuses have already been cancelled and the market is not conducive to asset sales, stopping AT1 distributions becomes a more likely scenario. Further, there is a possibility that supervisors could issue blanket guidance not to pay AT1 coupons to limit the risk of highlighting any individual bank's relative weakness.

If such bans on AT1 distributions were to occur, our analysis would focus on whether the coupon cancellation is due a temporary or more permanent change in an issuer's ability to make future distributions.

Measures to increase available capital

Regulators and supervisors are keen for banks to support the economy and have taken various measures to boost the amount of available capital. First, they have reiterated the message that capital buffers are available to absorb losses and can be drawn down i.e. buffers are an additional layer of capital above minimum requirements. We note this also applies to liquidity buffers.

Capital buffers can be used but…

Subsequently, many countercyclical buffers have been reduced or eliminated. Those remaining include in Norway, Hong Kong and countries in Eastern Europe. And while not as widely used, national regulators have also reduced or eliminated systemic risk buffers. Further, for ECB supervised banks there is explicit permission to use the capital conservation buffer. As noted above, however, using the conservation buffer would mean breaching the combined buffer and have consequences for distributions.

In addition to macroprudential capital buffers, regulators have also conveyed the message that Pillar 2 guidance in the euro area and the PRA buffer in the UK can also be drawn down in times of stress.

In recent days, regulators have also clarified that there is no pre-specified time period for banks to restore their capital and liquidity buffers and full replenishment is not expected until a significant period of time after the current stress has passed. The process will be gradual and take into consideration each bank's circumstances.

breaching the combined buffer will lead to distribution restrictions

Second, the amendment to Article 104a of CRD IV, permitting Pillar 2 requirements to be met with a mix of common equity and capital instruments has gone into force. With the average Pillar 2 requirement being 2.1% for banks supervised by the ECB, this means that CET1 requirements decline by 92bp on average. This change was originally scheduled to go into effect in January 2021. From the perspective of AT1 investors, this measure has limited benefits, as banks still need to meet their Tier 1 and total capital requirements to avoid distribution restrictions. This does, nevertheless, make it increasingly unlikely that issuers will breach 5.125% CET1 write-down/conversion triggers.

Third, supervisors have strongly encouraged banks to retain capital by not distributing dividends and limiting variable renumeration. More specifically, banks have been guided not to pay dividends for 2019 and to refrain from considering dividends for 2020 until the fourth quarter of this year. Both the UK PRA and the Swiss FINMA made publicly clear that banks ignoring the guidance would face supervisory consequences.

Within the universe of European AT1 issuers, there has been strong compliance with the guidance, with banks also halting share buyback programmes. At the same time, many banks indicated that this was driven by supervisory demand rather than concerns about their ability to afford them. Some have in fact continued with liability management exercises, redeeming capital securities losing regulatory capital value.

Implementation of new standards is postponed

More time to meet pending requirements

Upcoming or planned regulatory requirements are also being postponed at both the national and global level. The final implementation of Basel III standards has been postponed by one year to January 2023; the associated transitional arrangements for the output floor are also being extended by one year to January 2028. The revised frameworks for operational and credit valuation adjustment (CVA) risks as well as the output floor are expected to be material drivers of increased capital requirements for banks. At the national level, examples of easing include postponing the introduction of a risk-weight floor for mortgage loans in the Netherlands and excluding central bank deposits from the calculation of the leverage ratio in Switzerland.

The Single Resolution Board (SRB), the EU's resolution authority, has stated that it will consider postponing specific MREL requirements on an individual basis due to adverse market conditions. It will also continue monitoring market conditions to assess the potential impact on transition periods needed to build up MREL.

Less stringent supervisory stance on loans

Uncertainty about how individual banks will interpret guidance

In spite of government measures to support businesses and households, banks' asset quality will suffer and there will be an increase in credit costs. Here again, regulators are taking an approach which should soften the impact on regulatory capital. As the first-quarter reporting season begins, we will be monitoring the consistency with which banks assess the impact of Covid-19 on asset quality.

The ECB has expressed an intent to exercise supervisory flexibility in regard to the treatment of non-performing loans. Covid-19-related payment holidays and public guarantees will not necessarily be considered a signal of a significant increase in credit risk, requiring reclassification to Stage 2 from Stage 1 in the credit risk hierarchy.[1] Further, loans under public guarantee that become non-performing will benefit from preferential prudential treatment when it comes to loss provisioning. In addition, supervisors will exercise flexibility when assessing banks' NPL reduction plans.

[1] This is important for determining loan-loss provisions. In Stage 1, they are based on expected losses over one year while in Stage 2, they are based on expected losses over the lifetime of the loan.

In the UK, the Prudential Regulation Authority has also expressed its expectations about the treatment of borrowers who breach covenants due to Covid-19. In these instances, banks are expected to consider waiving the covenant breach, and such loans should not automatically trigger a default under CRR or result in a move to Stage 2 or Stage 3 for the purposes of calculating expected credit losses (ECL).

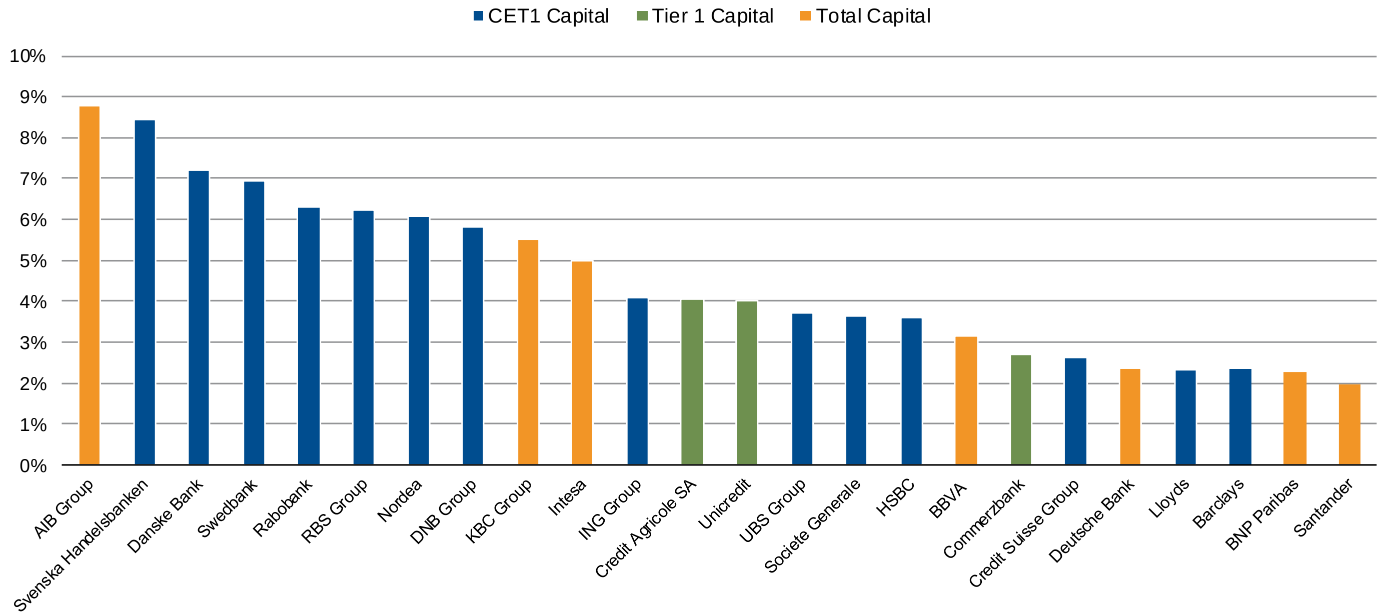
Moves to apply IFRS 9 in less procyclical manner

There has also been guidance from regulatory and supervisory authorities regarding transitional rules under IFRS 9 and the economic scenarios used for ECL estimates. For those which have not already done so, banks are being encouraged to take advantage of transitional rules. Under transitional rules, the regulatory capital impact of ECL is phased in and banks can add back the CET1 equivalent of a portion of "new" provisions stemming from IFRS 9. Further, in their forward-looking considerations of ECL estimates, banks are being urged to consider long-term economic trends and the support provided by fiscal authorities to avoid unduly boosting provisions.

Appendix I: Headroom to MDA-relevant requirements

Due to various measures meant to support the lending capacity of banks, capital requirements have generally been eased since the start of the year. Most relevant for AT1 investors, countercyclical and systemic risk buffers have been reduced or eliminated. For ECB supervised banks, Pillar 2 requirements can now also be met with a mix of CET1 and capital instruments. This does not reduce total capital requirements but may increase the buffer to the MDA-threshold in regard to CET1 capital.

Below we compare YE 2019 reported capital positions to 2020 requirements. The tendency is to focus on CET1 capital, but the MDA-threshold may be triggered by not meeting CET1, Tier 1 or total capital requirements as shown below.



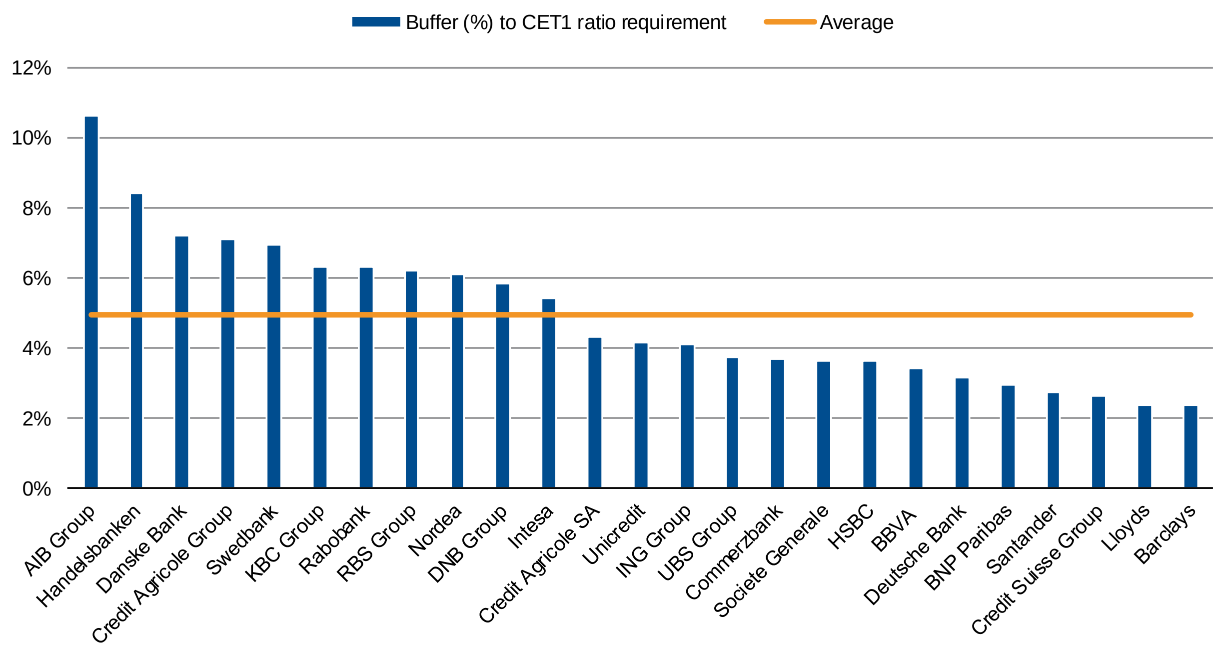
Notes: (1) Increases in CET1 capital stemming from decisions to cancel dividends for 2019 have not been incorporated in the above analysis.
(2) For RBS, the 1.5% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 6.2%. Excluding this, we estimate the headroom to the CET MDA requirement to be 7.3%.
(3) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 2.3%. Excluding this, the headroom to the CET1 MDA requirement would be 4%.
Source: Banks, Scope Ratings estimates.

Appendix II: Headroom to MDA-relevant CET1 requirements

		Previous	2020	3Q 2019	4Q 2019			
	Basis	Req CET1	Req CET1	3Q19 CET1	4Q19 CET1	Buffer (%)	Currency	Buffer (bn)
AIB Group	Transitional	12.1%	9.7%	20.3%	20.3%	10.6%	EUR	4.6
Barclays	Transitional	12.0%	11.5%	13.4%	13.8%	2.3%	GBP	4.3
BBVA	Transitional	9.3%	8.6%	11.8%	12.0%	3.4%	EUR	9.9
BNP Paribas	Transitional	9.9%	9.2%	12.0%	12.1%	2.9%	EUR	14.9
Commerzbank	Transitional	10.6%	9.7%	12.8%	13.4%	3.7%	EUR	6.0
Credit Agricole Group	Transitional	9.9%	8.8%	15.5%	15.9%	7.1%	EUR	34.9
Credit Agricole SA	Transitional	8.8%	7.8%	11.7%	12.1%	4.3%	EUR	11.2
Credit Suisse Group	Transitional	9.9%	10.0%	12.4%	12.6%	2.6%	CHF	7.6
Danske Bank	Transitional	14.9%	10.1%	16.4%	17.3%	7.2%	DKK	46.7
Deutsche Bank	Transitional	11.6%	10.5%	13.4%	13.6%	3.1%	EUR	5.8
DNB Group	Transitional	14.3%	12.8%	16.9%	18.6%	5.8%	NOK	44.2
HSBC	Transitional	11.3%	11.1%	14.3%	14.7%	3.6%	USD	28.7
ING Group	Transitional	11.8%	10.5%	14.6%	14.6%	4.1%	EUR	8.9
Intesa	Transitional	9.2%	8.5%	14.0%	13.9%	5.4%	EUR	14.8
KBC Group	Transitional	11.1%	9.8%	15.4%	16.1%	6.3%	EUR	5.6
Lloyds	Transitional	12.2%	11.3%	13.5%	13.6%	2.3%	GBP	2.9
Nordea	Transitional	13.1%	10.2%	15.4%	16.3%	6.1%	EUR	7.7
Rabobank	Transitional	11.8%	10.0%	15.8%	16.3%	6.3%	EUR	9.4
RBS Group	Transitional	10.7%	10.0%	15.7%	16.2%	6.2%	GBP	9.9
Santander	Transitional	9.7%	8.9%	11.3%	11.6%	2.7%	EUR	11.8
Societe Generale	Transitional	10.1%	9.1%	12.5%	12.7%	3.6%	EUR	9.1
Svenska Handelsbanken	Fully loaded	11.8%	10.1%	17.4%	18.5%	8.4%	SEK	47.5
Swedbank	Fully loaded	12.0%	10.0%	16.3%	17.0%	7.0%	SEK	32.2
UBS Group	Transitional	9.8%	10.0%	13.1%	13.7%	3.7%	USD	8.5
Unicredit	Transitional	9.8%	9.1%	12.6%	13.2%	4.1%	EUR	11.9

Notes: (1) For Lloyds, the 2% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 2.3%. Excluding this, the headroom to the CET1 MDA requirement would be 4%.
(2) For RBS, the 1.5% systemic risk buffer on the ring-fenced sub-group has been included in the CET1 MDA requirement resulting in a headroom of 6.2%. Excluding this, we estimate the headroom to the CET MDA requirement to be 7.3%.
(3) For Handelsbanken, Swedbank, DNB and Danske, Pillar 2 requirements are excluded from 2020 MDA relevant CET1 requirements.
(4) CET1 figures do not incorporate the benefit any cancelled dividends for financial year 2019.
Source: Banks, Scope Ratings calculations.

Headroom to MDA-relevant CET1 requirements



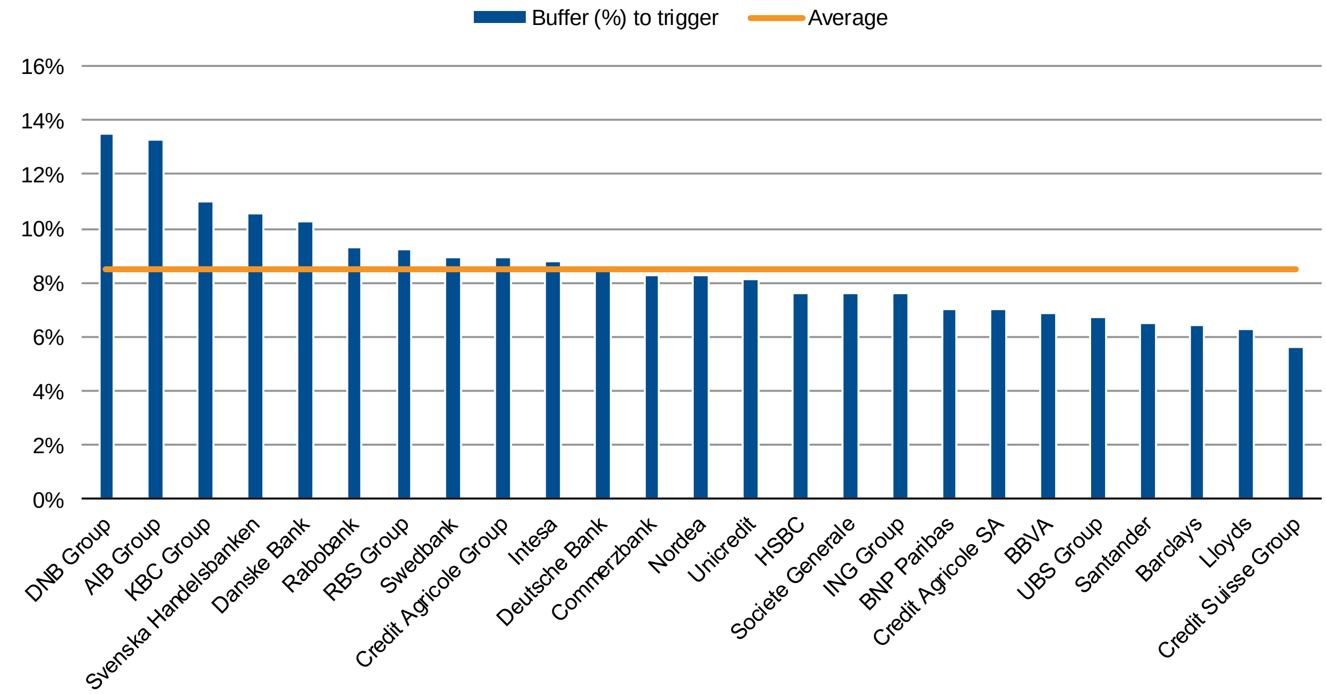
Source: Banks, Scope Ratings calculations.

Appendix III: Headroom to write-down/conversion trigger

			YE 2018		3Q 2019		4Q 2019	
	Basis	Trigger	2018 CET1	Buffer	3Q19 CET1	Buffer	4Q19 CET1	Buffer
AIB Group	Transitional	7.00%	21.1%	14.1%	20.3%	13.3%	20.3%	13.3%
Barclays	Fully loaded	7.00%	12.8%	5.8%	13.0%	6.0%	13.5%	6.5%
BBVA	Transitional	5.125%	11.6%	6.5%	11.8%	6.7%	12.0%	6.9%
BNP Paribas	Transitional	5.125%	11.8%	6.7%	12.0%	6.9%	12.1%	7.0%
Commerzbank	Transitional	5.125%	12.9%	7.7%	12.8%	7.7%	13.4%	8.3%
Credit Agricole Group	Transitional	7.00%	15.0%	8.0%	15.5%	8.5%	15.9%	8.9%
Credit Agricole SA	Transitional	5.125%	11.5%	6.4%	11.7%	6.5%	12.1%	7.0%
Credit Suisse Group	Transitional	7.00%	12.5%	5.5%	12.4%	5.4%	12.6%	5.6%
Danske Bank	Transitional	7.00%	17.0%	10.0%	16.4%	9.4%	17.3%	10.3%
Deutsche Bank	Transitional	5.125%	13.6%	8.4%	13.4%	8.3%	13.6%	8.5%
DNB Group	Transitional	5.125%	16.4%	11.3%	16.9%	11.8%	18.6%	13.5%
HSBC	Fully loaded	7.00%	13.9%	6.9%	14.2%	7.2%	14.6%	7.6%
ING Group	Transitional	7.00%	14.5%	7.5%	14.6%	7.6%	14.6%	7.6%
Intesa	Transitional	5.125%	13.5%	8.3%	14.0%	8.9%	13.9%	8.8%
KBC Group	Transitional	5.125%	16.0%	10.8%	15.4%	10.3%	16.1%	11.0%
Lloyds	Fully loaded	7.00%	14.3%	7.3%	13.2%	6.2%	13.3%	6.3%
Nordea	Transitional	8.00%	15.5%	7.5%	15.4%	7.4%	16.3%	8.3%
Rabobank	Transitional	7.00%	16.0%	9.0%	15.8%	8.8%	16.3%	9.3%
RBS Group	Fully loaded	7.00%	16.2%	9.2%	15.7%	8.7%	16.2%	9.2%
Santander	Transitional	5.125%	11.5%	6.3%	11.3%	6.2%	11.6%	6.5%
Societe Generale	Transitional	5.125%	11.0%	5.9%	12.5%	7.4%	12.7%	7.6%
Svenska Handelsbanken	Fully loaded	8.00%	16.8%	8.8%	17.4%	9.4%	18.5%	10.5%
Swedbank	Fully loaded	8.00%	16.3%	8.3%	16.3%	8.3%	17.0%	9.0%
UBS Group	Transitional	7.00%	13.1%	6.1%	13.1%	6.1%	13.7%	6.7%
Unicredit	Transitional	5.125%	12.1%	7.0%	12.6%	7.5%	13.2%	8.1%

Notes: (1) For banks with securities containing different trigger levels, the highest is used.
Source: Banks, Scope Ratings calculations.

Headroom to write-down / conversion trigger



Source: Banks, Scope Ratings.

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