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European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers

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Key Takeaways

- While European banks' first-quarter results might be important indicators of the impact of the economic "stop" across much of Europe, we expect management disclosures and comments to be more revealing than the results themselves.
- The COVID-19 pandemic will result in most European banks applying forbearance measures across their loan books, as well as raising questions about the future shape of loan provisioning under IFRS 9--a standard that has not yet seen a full economic downturn.
- We don't currently see forbearance measures as an indication of a sharp rise in future credit losses, but losses will inevitably rise through 2020 and banks' transparency in reporting will be important to investor confidence.
- We expect the effect on bank liquidity and capital ratios to be uneven. Having eased buffer requirements, regulators are comfortable seeing ratios start to decline, but for a decade investors have seen ever-increasing ratios and so will want a refreshed view from bank management on how they could develop through 2020.
- Many market movements that will affect 2020 results may not be visible in first-quarter disclosures, such as further margin pressure from low base rates and likely widening in pension fund deficits.

In just a few short weeks, the COVID-19 pandemic has changed the European economic landscape completely. In addition to the human cost, large parts of economic activity in Europe have ground to a halt. With isolation strategies still expanding across Europe and none having been relaxed, our economists expect first-quarter economic indicators to be a precursor of a truly dire second quarter. Authorities have delivered unprecedented policy responses in the form of monetary, fiscal, and regulatory support to their economies. On the bright side, unlike during the global financial crisis, banking sectors in Europe have not been a direct source of stress or amplification of travails for the real economy. Indeed, elements of monetary and fiscal policy responses, such as keeping low cost credit flowing to households and businesses, or applying forbearance measures on their loan repayments, rely on operationally effective and robust banking systems for their delivery. The better-capitalized, better-funded, more-liquid banks that have gradually emerged since the global financial crisis have, so far, been part of a solution rather than part of the problem.

While it feels like an age already, the economic slowdown and market volatility emerged quite late in the quarter. Indeed, we may even see some delays in banks' first-quarter reporting and reductions in the scope of disclosure because of COVID-19-related resource constraints or, more likely, exceptional uncertainties in preparing estimates for financial reporting purposes. We also note that there are no formal quarterly reporting requirements in the EU (see box 1). Irrespective of their differing views on the reasonable economic base case, credit investors will be alert to the rest of 2020 and 2021--looking for clues on profitability, liquidity, and capitalization amid significant uncertainty. In this regard, we expect that many management teams will see the merits of disclosing what they can on the key drivers, even if they cannot offer any certainty on the outcome.

Prospects For Preprovision Income In The First Quarter

We set out below our broad views on the possible effects of the COVID-19 pandemic for banks' first-quarter results, focusing on key income statement line items. At the same time, we recognize that idiosyncratic events will likely dominate results for some banks. For example, ABN AMRO's recent announcement that it will recognize a pre-tax loss of $250 million in the first quarter, related to its clearing business--specifically, the failure of a client to meet a margin call following extreme stress and dislocations in U.S. markets.

Neutral to positive for interest income:

While authorities across Europe are encouraging or mandating banks to apply loan forbearance measures such as loan repayment holidays, interest will continue to accrue during any such holiday period and will therefore continue to be recognized in interest income. New loan origination is likely to have stalled after the start of March, but the effect of customers drawing down pre-existing credit facilities may flatter interest income. This may include overdrafts for retail customers, but in our view will arise primarily from drawdowns on facilities granted to corporate borrowers. The effect of lower policy rates or other actions to loosen monetary policy may be limited given that they took place in the final month of the quarter.

Negative for interest expense:

With deposit rates already at or close to zero at the start of the year, there is limited room to cut further. At the same time, retail deposits may be higher, reflecting more limited consumer spending as a result of curbs on activity and consumer caution more generally. In our view, this is the last thing that banks want. Even if they can immediately on-lend those deposits, they will be acutely aware that the deposit spike may be temporary and excess deposits (on which banks are unwilling to charge negative rates) will dilute net interest margins. And, if fiscal support for the unemployed or prorogued employees doesn't kick in immediately, the effects of lost wages from job losses may be less of a feature for retail deposit volumes in the first quarter, given employee notice periods and the timing of those job losses being more weighted to the latter part of the quarter.

Overall, small and midsize enterprise (SME) and corporate deposit volumes may have increased--the net product of two opposing trends. We expect some erosion for badly affected SMEs and corporates given the rapid decline in earned cashflows and the continued need to pay out salaries and other expenses for a while. By contrast, others will have moved to rapidly hoard cash (cancelling investments and drawing on revolving credit facilities), leaving the excess buffer as deposits.

Banks that have been able to borrow in the wholesale markets in the latter part of the first quarter have done so at a much higher cost than in January. Most have simply sat it out, however, or taken in ultra-low-cost funding from central banks. In the eurozone, banks' interest expense after first-quarter 2020 could benefit from the ECB's decision of March 12, 2020, to significantly ease the pricing of, and banks' access to, its targeted long-term refinancing operations (TLTRO III), in particular to support lending to small and midsize enterprises (SMEs). The decision means that banks will be able to borrow from the ECB at negative rates for down to -0.75% from June 2020 until June 2021, compared with down to -0.5% previously (assuming an unchanged interest rate of -0.5% on the ECB's deposit facility and that banks maintain or expand credit volumes in line with ECB benchmarks).

These overall effects on net interest income in the first quarter are likely to be somewhat positive, primarily from a rise in loan assets and the timing of reductions in policy rates. Existing structural hedges will also mitigate the impact of lower policy rates.

Negative for fees and commissions net income:

We expect that both retail and corporate transaction volumes will be substantially below normal levels so fee income will be significantly lower in many respects. That said, we understand that revenues from underwriting and M&A advisory activity were strong in January and February, before dropping sharply in March. We expect that asset management income will see steep declines, with essentially zero performance fees and sizeable investor outflows reducing management fees.

The decision by many banks to reduce overdraft fees will also hit, though will likely be more visible only in subsequent quarters. By contrast, some banks will have seen a spike in risk solutions revenues from corporates and nonbank financial institutions clients that moved rapidly to hedge volatility in currencies, interest rates, and equities. We therefore think that the net effect will vary, depending on the weight of each bank's franchise.

Positive for sales and trading revenues:

Investment banks' sales and trading revenues have spiked due to high transaction volumes and wider bid-offer spreads. Gains will also arise from investment banks' typically long market volatility and neutral market direction at the start of year. Fair-valued assets will likely show marked declines, including on leveraged finance underwriting and CLO warehousing exposures where the primary market remains shuttered amid the current market volatility, though volumes were strong earlier in the quarter. Banks also have less inventory than a decade ago, and many will have sought to avoid directional risk with hedge overlays or pricing flexibility in leveraged loan underwriting, for example against spread widening.

Neutral to positive for operating expenses:

Despite the wholesale move to remote working arrangements, and the closure or reduced operations of some bank branches, salaries must still be paid and office premises hardly cost much less than when they are brimming with people. Banks may have seen significant savings in travel and expenses, but also an unexpected outlay in remote working kit for an unexpectedly high number of staff. Many banks have delayed planned spending on non-essential investments (such as IT-related spending or planned change programs), both in order to actively manage down expenses and because implementation would be impractical during a period of remote working. However, the effect would likely be seen in second-, rather than first-, quarter results. Equally, for those banks that are restructuring but have now frozen job losses, this could delay the anticipated reductions in salaries by several quarters.

Credit Loss Provisions Will Inevitably Rise--But Not By Much In The First Quarter

IFRS 9 will be applied sensitively

In 2018, the application of IFRS 9 marked a step change for how banks measure credit (loan) losses under IFRS. It shifted the accounting for credit losses to a more forward-looking expected credit loss (ECL) model that requires earlier recognition of credit losses in banks' financial reporting compared to the previous (IAS 39) "incurred loss" approach.

The timing of the initial application of IFRS 9 was broadly fortuitous for banks globally, because asset quality metrics were generally benign. As we noted back then, as and when economic cycles turned downward, the potential pro-cyclical effects of IFRS 9 would become clearer (see "The Adoption of IFRS 9 And Bank Ratings," Feb. 19, 2018). These arise primarily from the IFRS 9 requirement to move from stage 1 (performing loans, requiring a 12-month ECL) to stage 2 (requiring a lifetime ECL) when loans are assessed as having experienced a "significant increase in credit risk".

The assessment of what constitutes a significant increase in credit risk--and therefore a move from stage 1 12-month ECLs to stage 2 lifetime ECLs--depends heavily on management judgement about future outcomes. As such, we believe that this creates a risk of bias from management over-optimism or toward delaying the recognition of losses. That said, for the first quarter, we don't expect that banks' COVID-19-related forbearance activity will, or indeed should, automatically result in forborne loans being considered to have experienced a significant increase in credit risk and moving from stage 1 to stage 2. In particular, we understand that interest will continue to accrue during loan payment holiday periods already being offered by some European banks, and therefore the present value of expected contractual cash flows on the loan wouldn't necessarily fall below the original contractual amount. Some fiscal measures for households and corporates may also be a supportive factor in the assessment, particularly where such measures limit job losses--for example in the U.K., history shows that outsized credit losses in consumer loans correlate with peaks in unemployment. Expectations of a strong rebound in European economies in the latter half of the year and into 2021 as we currently forecast suggest that short-term forbearance activity now may limit credit losses later (see "COVID-19: The Steepening Cost To The Eurozone And U.K. Economies," March 26, 2019).

In the same vein, we expect no general shift of portfolios from stage 1 to stage 2 due to materially weakened economic circumstances. This view is in tune with our economists' base case that COVID-19 amounts to a temporary economic shock and, more importantly, the guidance from regulators. The European Central Bank (ECB), for example, has stated that banks should take note of its central economic assumptions and place greater weight on the long-term element of this.

Separately, we don't see credit guarantees announced by various governments across Europe as a factor that influences the assessment of a significant increase in credit risk and therefore the migration of loans from stage 1 to stage 2. This is because that assessment focuses on the probability of default, not the loss-given default--the latter is a factor that informs the quantum of credit losses. That is why credit guarantees may result in banks' stage 2 provisions being lower than otherwise would be the case.

But loan losses will inevitably rise

In essence, we do not expect a knee-jerk reaction of additional, mechanical provisioning to appear in European bank results for the first quarter or beyond, as long as the assumption of a temporary shock and quite rapid recovery plays out in practice. In particular, as long as unemployment remains low, we expect no spike in retail mortgage provisioning. However, this does not mean that banks will be immune to seeing and reporting a rise in credit losses in 2020, including for the first quarter. Far from it, in fact, as we see several factors that will drive up provisioning:

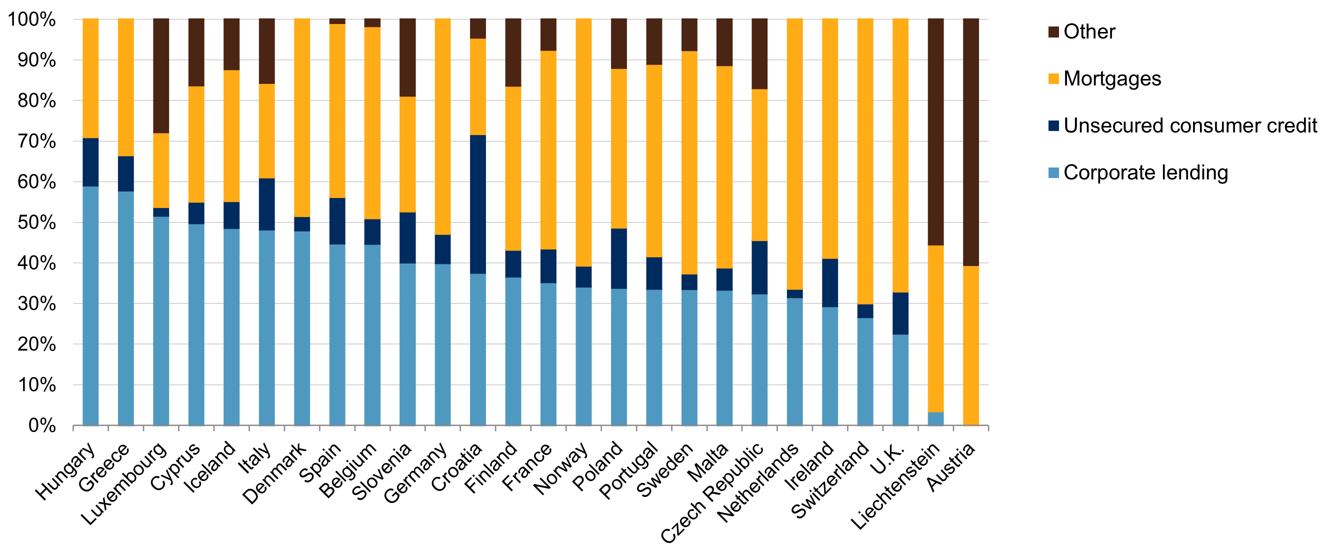
- Writebacks/releases, which have helped keep provisioning low in recent years, were already coming to an end--one reason why our pre-COVID base case was for a moderate, but discernible rise in European bank impairments in 2020;
- Corporate borrowers in some industries--leisure, oil and gas, and shipping to name a few--have likely not undergone a temporary weakening, something that banks will have to recognize sooner rather than later; and
- Some borrowers will never recover, which could be for two reasons. First, despite ultra-cheap debt, they were already struggling amid Europe's slow-growing economies and marked structural trends in consumption, or second, the mitigation provided by fiscal stimulus--much of which leads to the roll-up of debt not the avoidance of it--is too little or too late to be of practical help to those borrowers.

What's more, this effect becomes more profound under the adverse case of ineffective mitigation of economic stress and/or delayed or sclerotic economic recovery.

Overall, we expect corporate and SME lending to be more challenged than retail lending, and some banks' and banking systems' loan books are far more weighted to corporate (including SME) lending, than others (see chart 1).

Chart 1

Corporate Lending Dominates Bank Loans In Some European Countries
Estimated loan book proportions by asset class



Source: S&P Global Ratings' estimates from national central banks data. The 'other' category for Liechtenstein is primarily comprised of Lombard loans. For Austria, this category consists of all lending other than mortgages.

We do not expect banks to have all the answers when they report first-quarter figures, as even the near future will remain deeply and particularly uncertain. However, we expect investors to be alert to the assumptions used by banks, and on loan book composition. Banks will need to rise to that challenge, as many did in the 2008-2010 financial crisis.

Some Important Financial Reporting Aspects Are Unlikely To Be Apparent In First-Quarter Reporting

We do not expect the condensed information set for quarter-end financial reporting to reveal much about the effects on banks' defined-benefit pension schemes or deferred tax assets (DTAs). We should see some more detail on this at half-year reporting--unlike voluntary quarterly reporting, condensed financial statements are mandatory at the half-year for European listed entities--though the full picture will be clearer in year-end financial reports.

For defined-benefit pension schemes, there could be a double whammy for banks, with potential increases in the valuation of pension obligations and declines in the returns from pension assets:

- Present value measurement of pension obligations: Banks use period-end, long-term high quality corporate bond yields as the discount rate to estimate the present value of pension scheme obligations. This means that lower yields increase the present value of the obligations.

Such bond yields have been volatile in recent weeks and could fall to new lows by year-end, and therefore increase the balance sheet liability for banks.

- Plan assets: Banks apply the same discount rate to calculate the return from pension plan assets, with any differences between calculated and actual returns recognized through equity.

Taken together, potentially higher obligations and lower actual income from plan assets could blow a hole in pension plans, creating an increase in liabilities on bank balance sheets and the need to agree funding plans with pension scheme trustees to fund the resulting deficits over time.

DTAs that arise from tax losses are recognized on balance sheet on the basis of estimates of future profitability that would be offset against those past losses. Such DTAs may shrink even if we see an economic recovery, because ongoing lower interest rates will likely still encumber bank profitability. For countries such as Italy and Spain, DTAs arising from timing differences include the timing difference between when a loan impairment is recognized in financial reporting (under IFRS 9) and when it is later allowed as an expense for tax purposes--the latter being, in essence, when the loan is charged off. In a persistently negative environment these charge-offs could occur more quickly as loan recovery prospects diminish, thus accelerating the utilization of DTAs.

Goodwill on European banks' balance sheets is not directly relevant for our credit analysis. We neutralize goodwill in our risk-adjusted capital framework, which is also in line with its regulatory capital treatment. Still, goodwill impairments--which banks tend to reveal in year-end reporting rather than during the year--may provide information regarding management's recognition of deteriorating earnings prospects, weaker financial flexibility, and strategic failures. That said, we tend to see goodwill impairment charges typically lagging actual economic declines in the value of the underlying business to which the goodwill relates.

Box 1: Quarterly Reporting Requirements In The EU/EEA And U.K.

Quarterly financial reporting requirements for European listed entities are very limited. EU-wide rules for quarterly interim management statements were abolished by 2015, as mandated in the revised Transparency Directive (Directive 2013/50/EU). Those rules did not require quantitative financial statements so disclosure could be purely qualitative.

Despite this absence of formal quarterly financial reporting requirements, most large European banks provide quantitative quarterly financial reports to the market, reflecting investor demand for transparency. So, while the longer-term effects of the pandemic for European bank creditworthiness will only become apparent over coming months, first-quarter results could be a useful reference point to inform around key areas of strength or vulnerability.

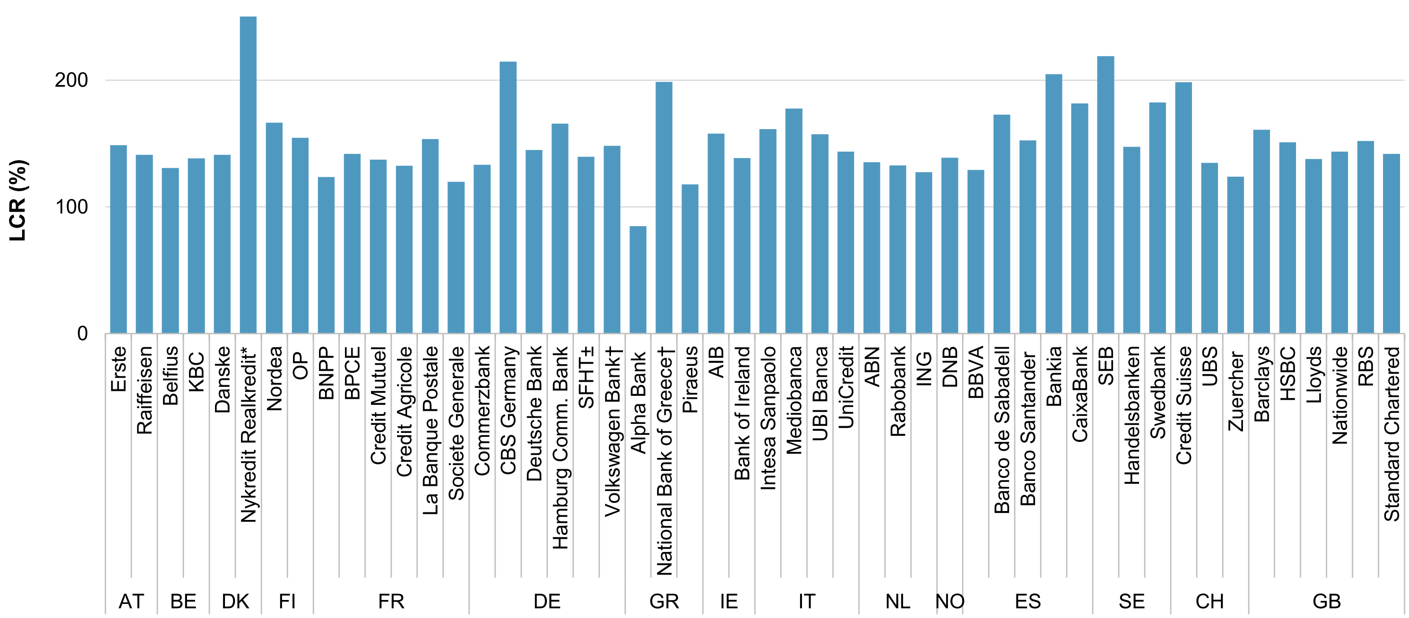
Separately, there remains a requirement under the Market Abuse Regulation (Regulation 596/2014) to disclose price-sensitive information (information that is likely to have a significant effect on the price of financial instruments listed on regulated markets) on a timely basis. Exceptions apply for banks receiving central bank support, at the discretion of the authorities (under EU Regulation 596/2014).

Liquidity Ratios Are Likely To Show Some Buffer Erosion

The liquidity coverage ratio (LCR)--aimed at ensuring that banks hold a sufficient reserve of high-quality liquid assets to allow them to survive a period of significant liquidity stress that lasts 30 calendar days--takes a particularly short view on liquidity. In normal times, the LCR is the most manageable among the principal regulatory metrics (others being risk-based and leverage-based capital ratios, the stable funding ratio, and Minimum Requirement for own funds and Eligible Liabilities [MREL]). While some banks' business models can confer particular advantage in this area, for example where they generate surplus franchise deposits, all the major European banks had solid, if not excellent, LCRs at the start of the pandemic (see chart 2).

Chart 2

European Banks Entered Into The Covid-19 Pandemic With Solid Liquidity
2019 year-end liquidity coverage rations (LCRs) for the top 50 European banks, by country



Source: S&P Global Market Intelligence, Bank reports. LCR--Liquidity coverage ratio. *LCR of 955%. †LCR as at Sept. 30, 2019.

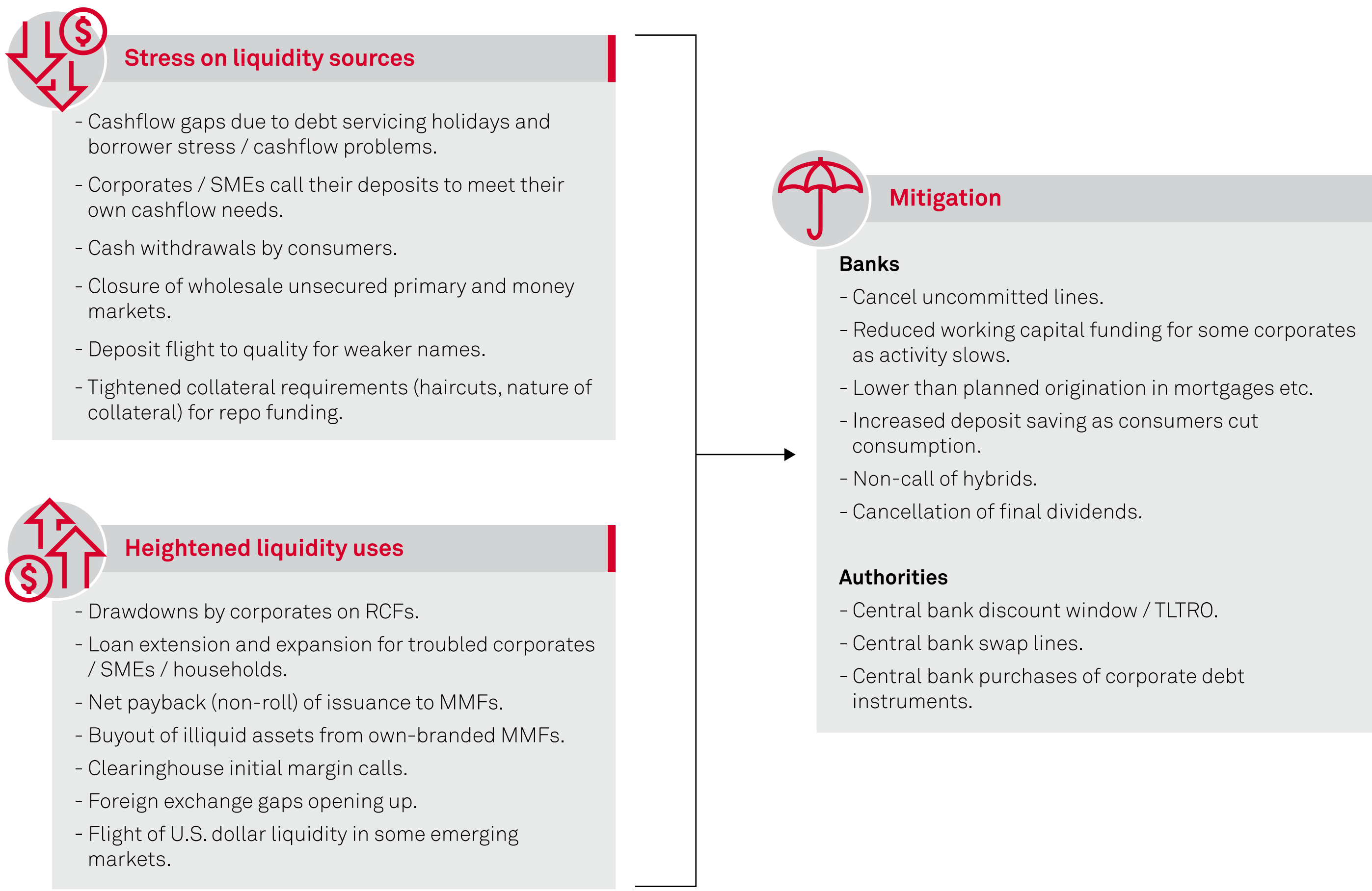
±LCR as at Dec. 31, 2018.

So why did the ECB, for example, immediately waive the requirement for eurozone banks to maintain a minimum 100% LCR ratio? We see at least two reasons: to avoid banks feeling unable to pass through central banks' increasingly ample measures to ensure that households, SMEs, and corporates withstand a short-term cashflow problem; and to recognize that LCRs for many banks could decline significantly, for example if loan books expand far faster than the deposit base.

Each bank will be different, but considering the main pressures and mitigants on liquidity (see chart 3), we expect that bank LCRs will have declined moderately through the first quarter. To a large extent, this would be a positive indication that banks are meeting regulatory and government objectives and that they are lending. However, since these ratios will very likely fall further through the second quarter, we expect that investors might now be ready to see banks with previously healthy ratios move already closer to, or possibly below, 100%.

Chart 3

Examples Of Influential Factors For Bank LCRs



LCR--Liquidity coverage ratio. MMFs--Money market funds. RCF--Revolving credit facilities. Repo--Repurchase agreement. SME--Small and midsize enterprises. TLTRO--Targeted long-term refinancing operations. Source: S&P Global Ratings.

The Effect On Capital Ratios Is Likely To Be More Disparate

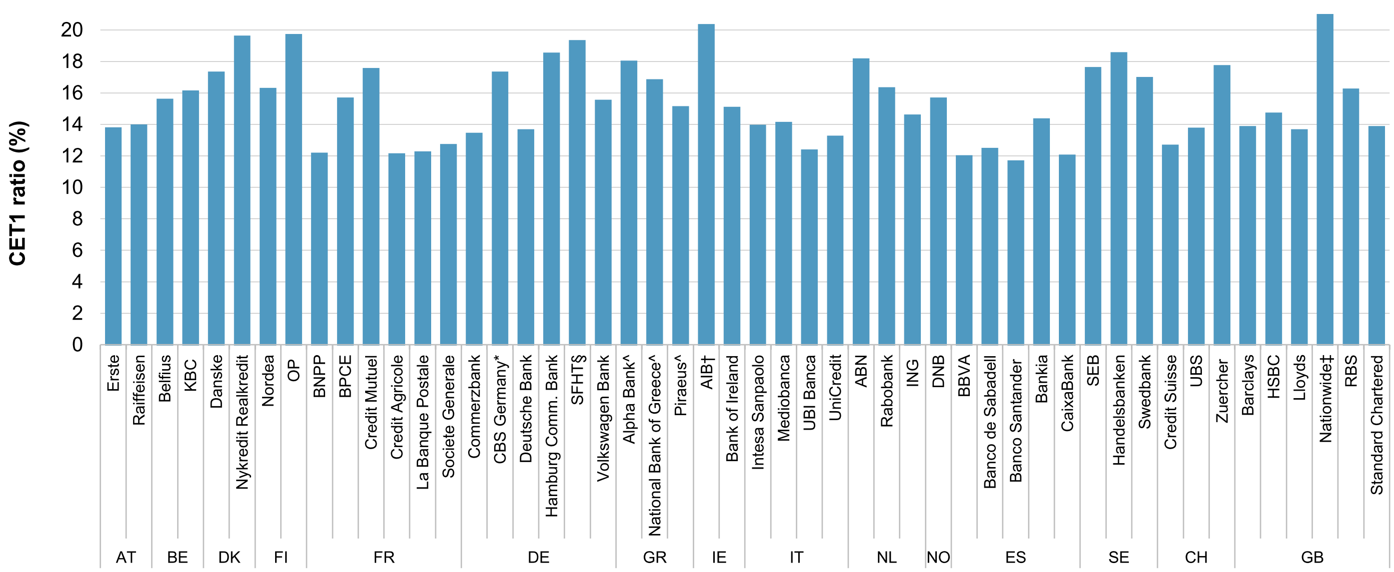
Major European banks spent the last decade improving their capital ratios at the behest of regulators keen to build resilience into the financial system. This effort broadly plateaued in 2018, in terms of S&P Global Ratings risk-adjusted capital (RAC) ratios at least (see "Risk-Adjusted Capital (RAC) For The Top 50 European Banks: September 2019", Sept. 26, 2019). Nevertheless, regulators continued to push banks to build countercyclical buffers--despite weak profitability in some systems, ultra-low credit losses mean that these recent years were somewhere near peak earnings, and cheap credit has spurred asset bubbles in some jurisdictions. The completion of

Basel III over subsequent years was, and remains, the final bridge for banks to cross, with European banks likely to be the most affected by the latest revisions. The recently announced one-year delay to such revisions, to 2023, means less immediate pressure to build or preserve capital. Still, at end-2019 most major European banks reported comfortable regulatory capital ratios (see chart 4).

Chart 4

European Banks Entered Into The Covid-19 Pandemic With Healthy Regulatory Capital

2019 year-end Common Equity Tier 1 (CET1) ratios for the top 50 European banks, by country



CET1--Common equity tier 1. *CET 1 ratio as at June 30, 2019. §Fully-loaded CET1 ratio at Dec. 31, 2018. †CET ratio of 20.3%. ±CET ratio of 32.2%. ^CET1 ratio as at Sept. 30, 2019. Source: S&P Global Market Intelligence, Banks' reports.

The key tenets of this new regulatory regime remain in place, but during 2020 the effects of COVID-19 will change the direction of European bank capitalization, at least in the medium term. As they did for the LCR, supervisors across Europe moved rapidly to reduce capital buffer requirements (or at least cancel planned increases), no doubt for the same two main underlying reasons. However, we do not see this as an indication that European banks will see an immediate decline in their risk-based regulatory capital ratios. Though many will, we expect significant variability, and ratios could even rise thanks to lower distributions, or for those banks with the strongest pre-provision profitability, and those that had started to squeeze new origination early in the first quarter (see chart 5).

Chart 5

Key Drivers For Bank CET1 Ratios

Common Equity Tier 1 capital

(+) Period earnings, which could be weaker than planned.

(−) Pension deficit widening.

Increases in prudential valuation overlays due to increased uncertainty.

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Mitigation

Banks

- Cancelled final dividend for 2019 and interim dividends during 2020.

Authorities

- Guidance to banks to avoid procyclical effects, such as categorising short-term forbearance as NPLs / TDRs.
- Move the goalposts, ie reduce / remove buffer requirements and so MDA threshold.

RWA expansion

Credit

- Expansion of loan book – slowed repayments of principal, roll-up of interest, expansion of credit to cashflow-stressed borrowers, drawdown by customers on RCFs / revolving consumer credit / etc.
- Asset quality migration within the performing portfolio.
- Transition of exposures into bucket 3 / rising NPLs.
- Increased provisioning on NPLs due to reduced collateral values.
- Inability to refinance maturing securitizations backed by revolving assets.

Market

- VaR / stress VaR / incramental risk charge rise due to volatility.
- VaR / stress VaR rise if backtesting exceptions rise.

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Mitigation

Banks

- Curtailed new lending to non-pre-existing customers.

Authorities

- Delay in introduction of further Basel 3 tightening measures, TRIM, etc.
- Guidance to banks to avoid procyclical effects, such as categorising short-term forbearance as NPLs / TDRs.
- Move the goalposts, ie reduce / remove buffer requirements and so MDA threshold.

MDA--Maximum distributable amount. NPLs--Non-performing loans. RCFs--Revolving credit facilities.
RWA--Risk-weighted assets. TDRs--Trouble debt restructurings. TRIM--Targeted review of internal models.
VaR--Value at risk. Source: S&P Global Ratings.

Regulators will not want to see banks hoarding capital at a time when the real economy needs them to extend their balance sheets. Indeed, we don't expect banks to shutter to credit extension: recent recommendations for banks to cut shareholder distributions will help to keep credit flowing to the real economy (and may enhance banks' reputations and franchises). But, the easing of buffers helps some European banks much more than others, and all banks will look for some areas of mitigation. As confidence-sensitive as they are, unexpectedly weaker regulatory capital ratios are not ideal for any bank, even in a short-lived economic crisis. Many banks have sizeable domestic government securities portfolios, and rises in government bond yields could directly affect the value of such portfolios, and thus their capital. That said, we don't expect a material direct impact on capital unless yields rise to extremes for a sustained period.

At quarter-end, we expect no strong trend in European banks' regulatory ratios--some might rise and some will fall a bit. In line with strong recommendations by regulators, many banks have halted planned dividend payments and share buy-back plans. Where dividends are cancelled rather than deferred, it could support capital ratios, in particular for banks with sound earnings profiles. As the year goes on, though, we would expect a more discernible declining trend in ratios, but for European bank capitalization to remain generally robust. Investors will likely see more CET1 ratios that start around the 12% mark, and fewer around 13%. As banks announce first-quarter results, investors will likely look to bank management teams to clearly explain the trajectory, and the range of plausible outcomes.

Related Research

- COVID-19: The Steepening Cost To The Eurozone And U.K. Economies, March 26, 2020
- COVID-19 Countermeasures May Contain Damage To Europe's Financial Institutions For Now, March 13, 2020
- Risk-Adjusted Capital (RAC) For The Top 50 European Banks: September 2019, Sept. 26, 2019
- The Adoption of IFRS 9 And Bank Ratings, Feb. 19, 2018

This report does not constitute a rating action.