

The European banking system is not the culprit of this crisis

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European banks play a key role in a functioning economy by providing liquidity to companies in many ways. One of the services that banks provide as part of their business model are lines of credit which are available to companies to draw on when required. As governments step up their measures to combat the spread of Covid-19 and implement strict rules aimed at locking down the population many companies see little to no demand for their goods and services. Depending on the balance sheet of the borrowing company, lack of revenue for a sustained period may lead them to face a cash liquidity crunch if adequate liquidity was not provided. A recent example could be drawn to plane makers and leasing companies including AerCap Holdings and Air Lease Corp. which used billions in loans and revolving credit facilities amidst the unprecedented drop in demand for flights. While banks form an important element of a company's liquidity measures, there are other avenues such as commercial paper that can be issued in the public markets to aid in short term liquidity needs. Even though the picture seems grim for the airline industry among other sectors severely impacted by the global pandemic, we are now seeing governments step in to provide support with large fiscal stimulus packages aimed at providing a bailout to wailing industries. Although banks may see a rise in their loan loss portfolio, governments have a strong incentive to keep banks afloat and provide the needed support to integral industries that may not otherwise survive in this crisis.

The current crisis is unlike the 2008 financial crisis when the banks were at the root of the issue. The severity of today's critical situation is around a commercial lockdown of both the supply and demand side of the economic equation. As governments around the world take measures to contain the spread of Covid-19, many supply chains are being interrupted and consumers are kept at bay as they are broadly prohibited from partaking in their otherwise daily activities.

What is the government doing to support banks?

On the 12th of March, the European Central Bank (ECB) left the main refinancing rate unchanged and opted to offer operational relief to Banks by boosting quantitative easing and liquidity. The ECB decided to inject additional liquidity via Targeted Longer-Term Refinancing Operations (TLTROs) on more favourable terms by effectively creating a dual-rate regime. The interest rate on TLTRO III can be as low as 25 basis points below the average deposit facility rate, which is currently at -.5%. The series of additional longer-term refinancing operations launched are aimed at safeguarding bank liquidity and money market conditions. While the actions thus far have not been as significant as other Central banks, the ECB also stated that it stands ready to provide additional liquidity. In the meantime, the ECB is allowing Banks to temporarily run lower capital ratios to allow the banks to support their customers (corporates) which have been negatively

impacted by the coronavirus. Furthermore, on the 18th of March the ECB launched a €750Bn debt buying program called the Pandemic Emergency Purchase Programme (PEPP) which is aimed at alleviating extreme stress in European bond markets and is an important move in the right direction. The purchases will be conducted until the end of 2020 and will include all asset classes eligible under the existing Asset Purchase Program (APP). In this crisis the banks are not at the root of the issue and we have noted steps in which the government is using them as one of many tools to provide lending to the real economy (companies in need of liquidity).

Sector update: AT1 CoCos¹ issued by European banks

Amid the market volatility, many asset classes have been faced with a strong correction from the high price levels noted in January 2020. While AT1 CoCo spreads (option adjusted spread was 1380 basis points) and yields (yield to worst was 14.21%) on the 20th of March were significantly higher than at the start of 2020, this was broadly in line with the massive moves seen in other risk assets this year. For the European banking sector, the AT1 CoCo asset class as represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Total Return Index Euro hedged (AT1 CoCo index) has benefitted from much lower drawdowns in performance than European bank equities as represented by the STOXX 600 Banks Net Total Return Index, outperforming European bank equities by 14.6% year to date to 20th March 2020.

A few key factors to watch with AT1 CoCos

1. Bail-in risk (write down or equity conversion): While this still remains a key risk given the market uncertainty around the economic impact of Covid-19, at the moment this risk appears more remote as common equity tier 1 ratios for the European banks are relatively high relative to their maximum trigger ratios which are typically 5.125% and 7%. AT1 CoCos allow for a supervisory body to establish when the point of nonviability of a bank has been reached and a statutory bail-in set up is required as was the case with Banco Popular back in 2017. Although regulators do tread this line carefully as it could create lack of clarity for this asset class. This is an area to continue to monitor as the economic impact of Covid-19 continues to unfold.

2. Coupon non-payment: this risk appears generally contained at the moment as high capital ratios is a positive indicator for banks having the capital adequacy, as deemed by the regulator, to continue to pay dividend and coupons. CoCo coupons are subject to maximum distributable amount when they must be cancelled which is aimed at making sure banks maintain the required capital buffers. Smaller regional banks with lower capital buffers may face greater pressures in this area as they may have lower capital buffers and more limited access to capital markets than larger banks with higher capital buffers.

3. AT1 CoCos not called at first call date (extension risk): this risk is rising as credit markets have been facing a broadbased repricing of risk and yields have risen from the lows of January 2020. In 2019 most issuers called their AT1 CoCos approaching their first call in the cases where it was economically sound and, in many cases, replaced existing CoCos with new issuance. Banco Santander was the exception as they did not call one of their Euro denominated AT1 CoCos on their first call date meanwhile calling their

Dollar denominated AT1 CoCos shortly afterwards. Most recently in 2020, Deutsche bank (DB) also did not call their dollar denominated AT1 CoCos with first call date on April 2020.

Market update amid Covid-19

In the current market situation, there is strong risk aversion in credit markets and there is less demand for new issuance than we have seen in recent past. This is broadly in line with the rest of the fixed income market which is facing lower demand for new allocations over the past week amidst heightened market volatility. This is likely to impact supply for the asset class this year and if faced with strong demand later in the year could be supportive of technicals for AT1 CoCos. Meanwhile, issuers will likely refrain from letting any capital come off their balance sheet and this is likely to make extension risk higher than it was four weeks ago. To mitigate some of this concern, if the AT1s are not called on the first call, AT1 issuers have the option to call them for example yearly or after 5 years depending on the terms of the prospectus. The extension risk can be adjusted downwards at any time before the call date based on the higher probability of the issuer to call the CoCo.

Another area where the risks may be rising is the issuers ability to not pay the coupon. As issuers assess the economic risks, this could be a way to mitigate falling capital ratios. Issuers may consider balancing their reputation risk and balance sheet risks very carefully.

In the case of capital ratios, as per recent actions taken by the ECB and Bank of England (BoE), central banks seem willing to help mitigate some of the negative impact that Covid-19 may have on bank balance sheets. BoE recently removed the countercyclical buffer allowing the UK banks more capital cushion to stay afloat as central banks have an incentive to keep banks running. One way the regulator may be able to influence the capital ratios directly is by potentially making temporary adjustments to how risk weighted assets will be calculated for the capital ratios. For example by lowering the penalty score applied to otherwise risky loans. Since the CET1 ratio compares a bank's capital against its risk weighted assets, one key element to the ratio is that not all assets have the same risk. The assets secured by a bank are weighted based on the credit risk and market risk that each asset presents. For example, a government bond may be considered risk free and given a zero percent risk weighting. This is one area to monitor as governments unfold a number of plans to tackle the economic impact of Covid-19.

With the above in mind, we note below a summary of the capital ratios for European banks that issue AT1 CoCos

If we consider the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 index) as a benchmark for the AT1 CoCo universe denominated in USD, GBP and EUR, we note that 53% of issuers reported a capital buffer greater than 5% and around 33% of the universe with capital buffers between 7.5% and 10% as of 28 February 2020. With a more detailed breakdown below for all issuers within the AT1 index. The AT1 index criteria include issuers with greater than \$1B, €1B or £1B outstanding in AT1 CoCos. Please refer to the full index rules for a more detailed description of the index criteria.

Unless otherwise stated, data source is Bloomberg, as of 20 March 2020. AT1 CoCo spreads and yields as reported by Markit using the iBoxx Contingent Convertible Liquid Developed Europe AT1 Total Return Index. Additional source: European Banking Authority website.

1 Contingent convertible bonds (“CoCos”) are a form of hybrid debt security that are intended to either convert into equity or have their principal partially or completely written off or written off with the option of revaluation under certain circumstances. CoCos, like subordinated bonds, serve to absorb the issuer’s capital losses before other higher-ranking liabilities.

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