Credit positive for EU domiciled banks amid improvement in asset quality

by Anthony Prayugo

In spite of the low interest rate environment that continued to dent EU domiciled banks' profitability, the European Banking Authority (EBA) reported in Nov 2019 that EU[1] domiciled banks' asset quality continued to display a significant improvement in recent years. EU domiciled banks' weighted average non-performing loans (NPLs) ratio, which has been a major concern for market participants since the aftermath of the financial crisis, has almost been halved from 5.4% in Jun 2016 to 3% in Jun 2019, below the 5% attention threshold defined by the EBA (see Figure 1a). Corresponding to the drop in the NPL ratio, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of publicly-listed EU domiciled banks has also fallen from a record 30bps in mid-2016 to around 6bps in Feb 2020 (see Figure 1b).

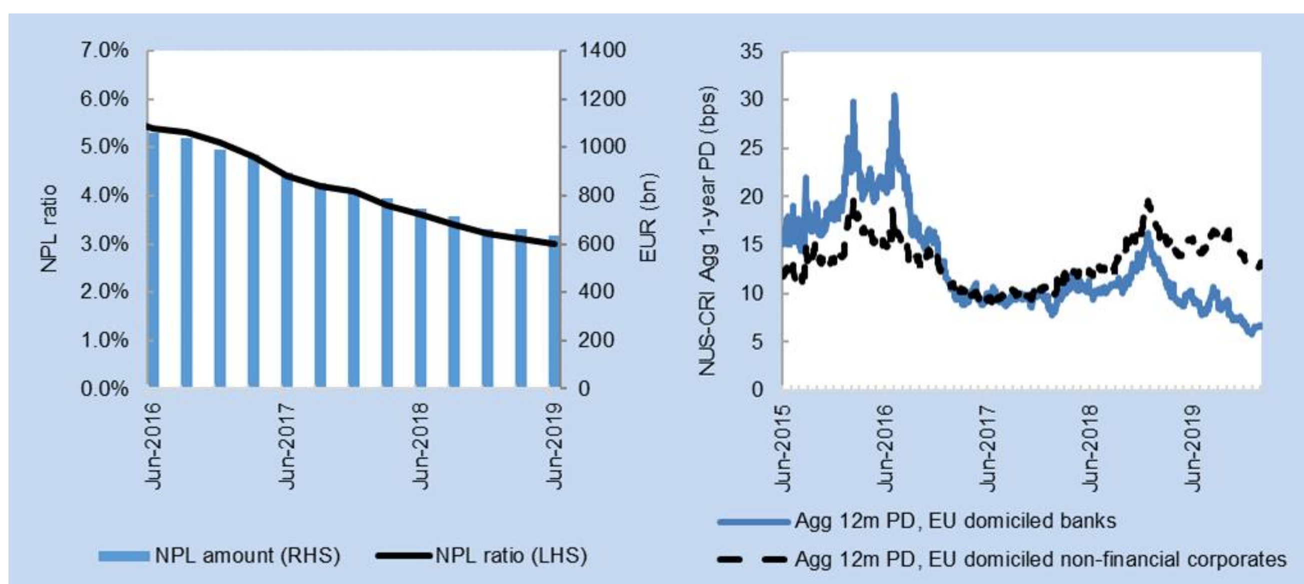

Figure 1a (LHS): EU domiciled banks' NPLs amount and ratio. Figure 1b (RHS): NUS-CRI Aggregate 1-year PD for EU domiciled banks from Jan 2016. *Source: EBA, NUS-CRI*

The fall in EU domiciled banks' NPLs ratio can be attributed not only to the action and policy stance of the supervisory community, but also to the banks' effort to strengthen their governance and the development of the NPL secondary market. High NPL levels could pose problems to banks as they could increase funding costs and risk the viability of banks. Besides higher funding costs, high NPL levels could have detrimental effects on the banks' liquidity and causes capital shortfall. To address the problem of NPLs in the banking sector, the Council of the European Union outlined a mix policy actions in 2017 to further help reduce stocks of NPLs and prevent their future emergence such as by highlighting the need for reforms in the insolvency and debt recovery frameworks. It also underscored the need for restructuring the banking industry and developing secondary markets for NPLs. The latter is particularly useful in reducing EU domiciled banks' NPLs stockpiles as yield-starved investors hunt for higher yields amid the low interest rate environment. In 2018, completed NPL transactions across EU member states was approximately EUR 200bn in gross book value, higher than EUR 156bn in 2017 and EUR 112bn in 2016.

[1] Despite having already left the EU, the United Kingdom (UK) is included in this analysis as it was still an EU member state before Jan 31, 2020.

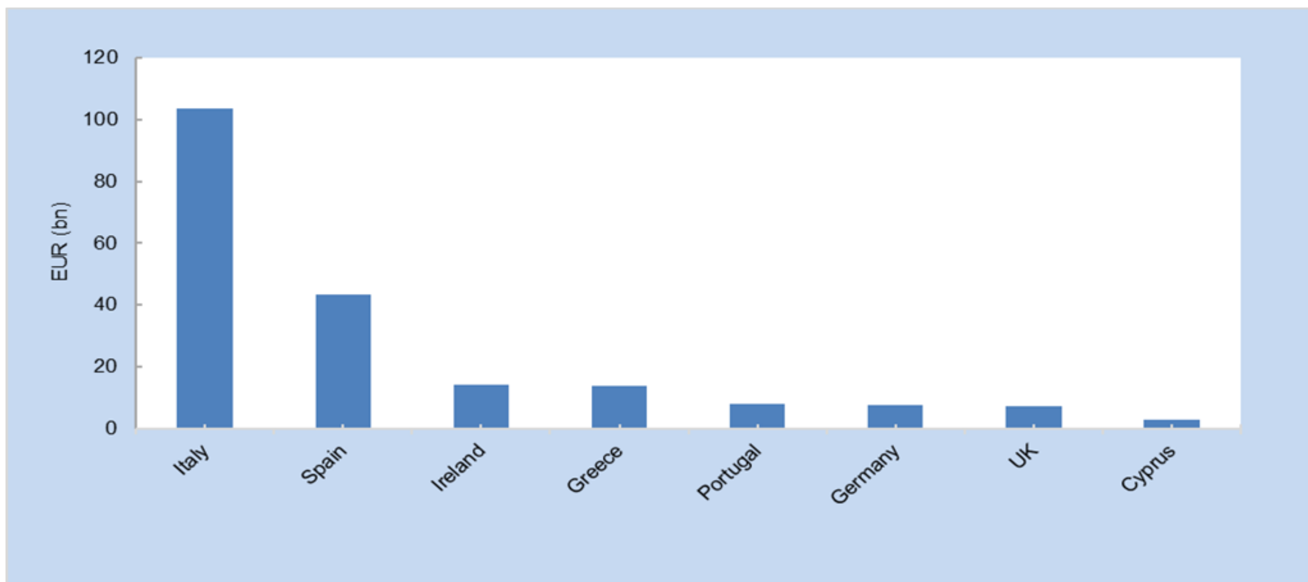

Figure 2: Total gross book value of NPL transactions in 2018 among EU member states. *Source: Ashurst*

EBA data indicated that banks in countries with initially high NPL ratios as the main driver of the decrease of the NPL ratio in the EU. For instance, Italian banks, which have one of the highest NPL ratio and volume of NPLs among EU domiciled banks in Jun 2016, managed to reduce their NPLs from EUR 277bn in Jun 2016 to EUR 137bn in Jun 2019. During the same period, Spanish banks also reduced their NPLs from EUR 141bn to EUR 84bn. Government policies played a major part in the reduction of NPLs stockpiles in such countries. Schemes introduced by the several governments such as the CAGS scheme in Italy, enabled banks to obtain a state guarantee to back the less risky portions of the repackaged debt (securitized bad loans), which in turn boosted the debt's profile for prospective buyers. The Greek government has also similarly introduced the Hercules Asset Protection Scheme, which enables the government to buy certain segments of distressed debt that the country's lender aim to sell the investors. Greece's deputy finance minister forecasted that the plan will help to cut up to EUR 30bn of NPLs which is around 40% of the total outstanding pile.

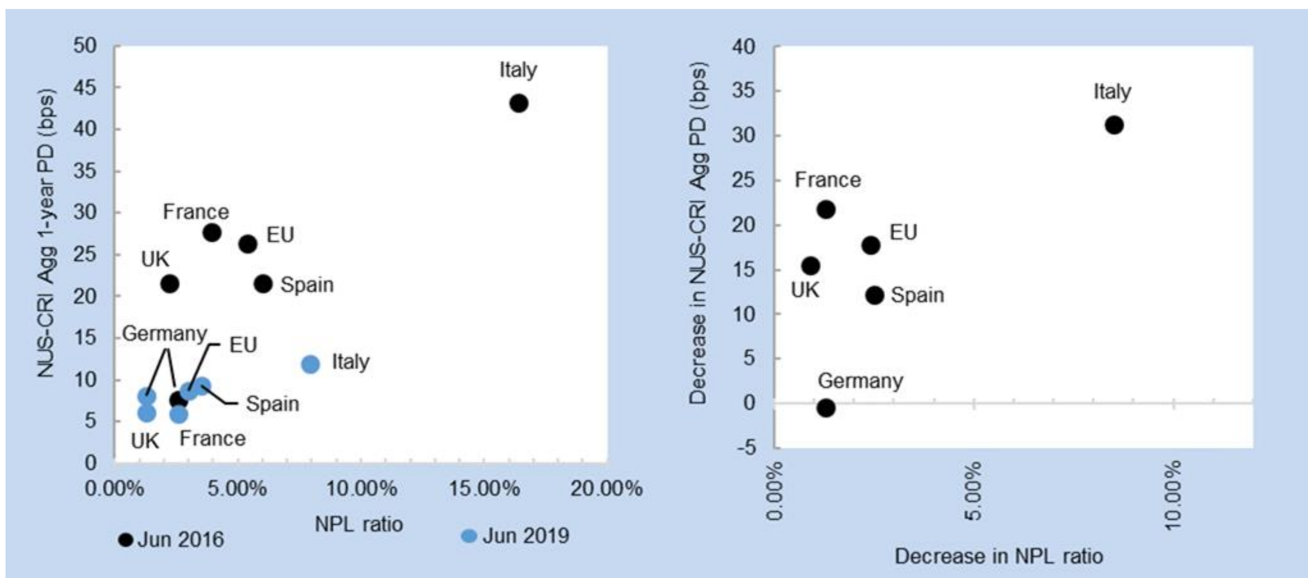

Figure 3: NUS-CRI Aggregate 1-year PD and NPL ratio for banks in leading EU member states in Jun 2016 and Jun 2019. *Source: NUS-CRI, EBA*

Figure 3 compares the credit profiles and NPL ratio of banks in leading EU member states in Jun 2016 and Jun 2019. The figure indicates that there is a positive correlation between the decrease in NPLs ratio and the

improvement in the banks' credit profiles. Italy domiciled banks, which managed to reduce their NPL ratios by almost 50%, also saw their credit profile improved the most compared to the other banks.

Liquidity wise, the European Central Bank (ECB) reported that Euro area banks have adequate liquidity reserves to withstand stress. Around half of the 103 banks that took part in ECB's 2019 supervisory stress test reported a "survival period" of more than 6 months under an adverse shock and more than 4 months under an extreme shock, exceeding the requirement for banks to hold a sufficient liquidity stress lasting 30 calendar days. Looking at the EU level, regulatory liquidity ratios for EU domiciled banks are at solid levels with an aggregate liquidity coverage ratios of 171.6% in the second quarter of 2019, an increase from 150.3% in Sep 2016. Meanwhile, the banks' aggregate Common Equity Tier 1 ratio, a key measure of capital strength, stood at 15.5% during the same time period, up from 14.3% in mid-2016.

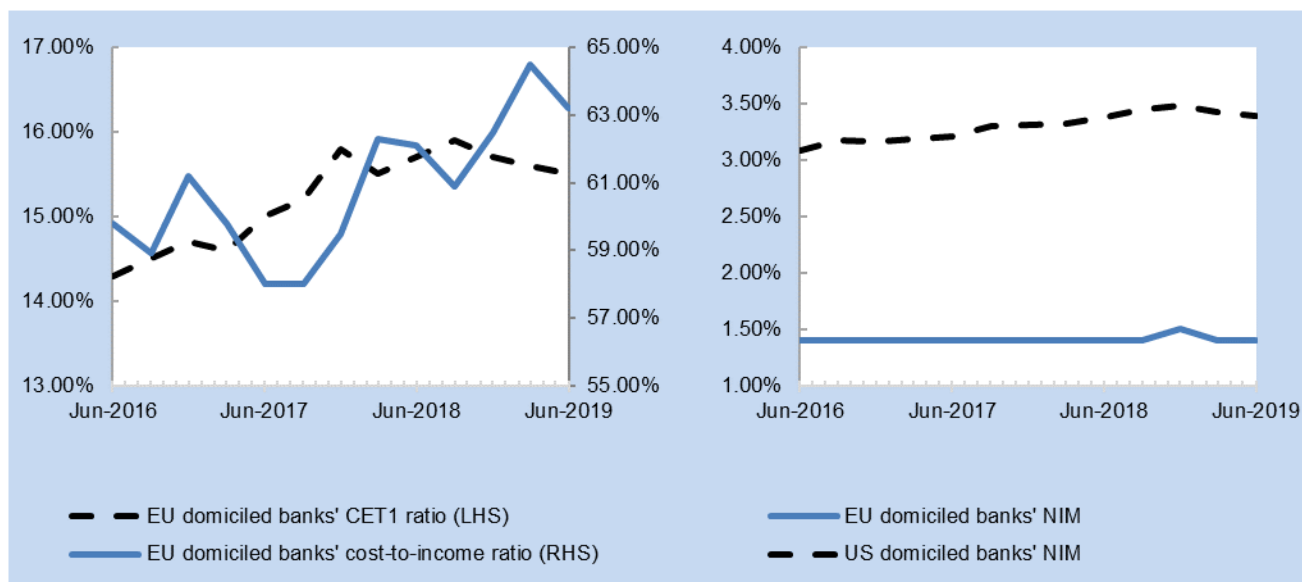

Figure 4: Selected financial ratios of EU and US domiciled banks. *Source: EBA, FDIC.*

Challenges, however, remain for EU domiciled banks. Years of low interest rate environment in Europe have taken a toll on the profitability of EU banks as this made earning money through loans less profitable. The net-interest-margin for EU domiciled banks continued to hover around 1.4%-1.5% since 2014, much lower than that of the US domiciled banks' which never dropped below 3% during the same period. In addition, the EU domiciled banks' cost-to-income ratio, at 63.2% in Jun 2019, was higher than their US peers. Lastly, despite the overall reduction in NPL ratio among EU domiciled banks, the NPL ratio remains relatively higher than that of other developed countries such as the US (1.5%). Banks in countries such as Greece and Cyprus were still saddled with high NPL ratios (39.2% for Greece banks and 21.5% for Cyprus banks in Jun 2019), highlighting that the post-financial crisis recovery process of EU domiciled banks has yet ended.

Credit News

Chinese developers hit by coronavirus sales ban

Feb 16. Local governments in China have moved to cushion the blow of coronavirus outbreak for highly indebted property developers. The developers have been forced to freeze home sales during the crisis but still face USD 100bn in maturing bonds this year. A number of large cities have allowed developers to delay payments on land and taxes in order to improve cash flows. Restrictions on presales will also be loosened, allowing the developers to raise cash from homes that are not yet completed. The crisis would hit property developers hard, and policy support from local government would be crucial to maintaining cash flows in the coming months as home sales suffer. (FT)

Asian corporates gorge on debt as coronavirus pushes down yields

Feb 14. Asian corporates are raising hard-currency debt at a record rate as the deadly coronavirus pushes down bond yields in the region. Bond yields have come down as investors seek safer assets due to concerns over the potential impact of the coronavirus on global economic growth. Business in Asia excluding Japan has raised USD 37.5bn debt dominated in dollar since the beginning of 2020, as they seek to lock in the low financing costs. It is likely that monetary policies remain accommodative and bond yields are unlikely to increase materially near term, as central banks consider the economic risks from the virus. (FT)

Chinese companies tap 'virus bonds' to raise billions quickly

Feb 13. Chinese companies are using cheap funds raised via 'virus bonds' in part to bolster their balance sheets as they capitalize on Beijing's effort to channel money into virus-hit areas of the economy. Numerous companies ranging from drug makers to food producers have announced plans over the past week to issue such virus bonds via the interbank market. The virus bonds are under a new fast-track regulatory process for virus prevention and control, and they carry yields much lower than other debt. Issuers of anti-pandemic bonds must use some proceeds to combating the epidemic, while a Reuters analysis reveals only a third of the fund raised will actually be used for the cause. (Reuters)

Rock-bottom borrowing costs pull U.S. companies to Euro market

Feb 13. Europe's central bank has been conducting open market purchases to ease the money market and that has led to a fall in interest rates in the European bond market. As a result, American corporations have been taking advantage of the relatively lower cost of borrowing in Europe by issuing euro-denominated bonds and some companies are also borrowing for longer now. In 2019, the investment-grade euro-denominated market saw eight 30-year bonds for the first time since 2015, as written by Barclays. This is beneficial to the US bond market as we can expect the returns in the US market to improve when the supply of US corporate debt decreases after corporations switch to the European bond market. (Bloomberg)

Leveraged debt investors push borrowers on ESG disclosures

Feb 13. Investors are increasingly concerned with diversity, sustainability and climate change. In a European Leveraged Finance Association (ELFA) survey, 72% of the 100 respondents address environmental, social and governance (ESG) considerations as part of their investment process on half or more of their fixed income assets. Given this trend, ELFA is planning to develop an agreed set of ESG disclosure topics that investors would expect issuers to report on publicly. This will create a standardised system for all borrowers so that it is fair for investors and also less of a hassle for borrowers to answer similar questions repeatedly. (Reuters)

Indian banks lured by 14-year low borrowing costs binge on bonds (Bloomberg)

North America and Asia fail to keep pace in green bond boom (FT)

Europe bond investors brace for data that may show virus impact (Bloomberg)

Regulatory Updates

After Fed and ECB, India may turn next to BOE for inspiration

Feb 17. The weak economic growth in India has motivated the Reserve Bank of India (RBI) to learn from the Fed and ECB in using unconventional tools to manage bond yields. In December, the RBI announced Fed-style "Operation Twist" which consists of buying long-dates bonds and selling shorter tenor ones. While this

week, the RBI will inject USD 14bn into the financial system through long term repo operations inspired by ECB. However, because the banking and financial system in India has failed to fully pass on the reductions by RBI to the non-financial market due to their bad loans, India is now looking to BOE's strategy of accepting eligible collateral from banks and building societies at a haircut and exchanging it for short term treasury bills that could be rolled over for up to four years for inspiration. This may help to lower funding cost for banks and increase net lending to the non-financial sector hence solving India's problem of low borrowing. (Bloomberg)

ECB negative rates not harmful, but inflation rise to stay elusive: Reuters poll

Feb 17. Economists are pessimistic that the negative interest rate policy implemented by the European Central Bank (ECB) will bring inflation up to the Central Bank's target of just below 2%. Some ECB policymakers believe that such negative rates can fuel asset bubbles and business inefficiency. However, two-thirds of the economists surveyed has conveyed that so far the negative rates have not brought about detrimental effects to the economy. Given the unstable global economic outlook, with the looming coronavirus and turbulent trade environment, ECB is expected to keep its policy stable this year. (Reuters)

US Fed buys USD 427mn of mortgage bonds, sells none (Reuters)

IMF mission to Argentina starts under a cloud of bond market uncertainty (Reuters)

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Contributing Editor: Luo Weixiao