EU Banking Sector: Risks from Unrealised Losses Appear Manageable, but Challenges Remain

DBRS Morningstar
17 March 2023

Pablo Manzano, CFA
Vice President - Global FIG
+34 91903 6502
pablo.manzano@dbrsmorningstar.com

Maria Rivas
Senior Vice President - Global FIG
+44 20 7855 6656
maria.rivasescrigas@dbrsmorningstar.com

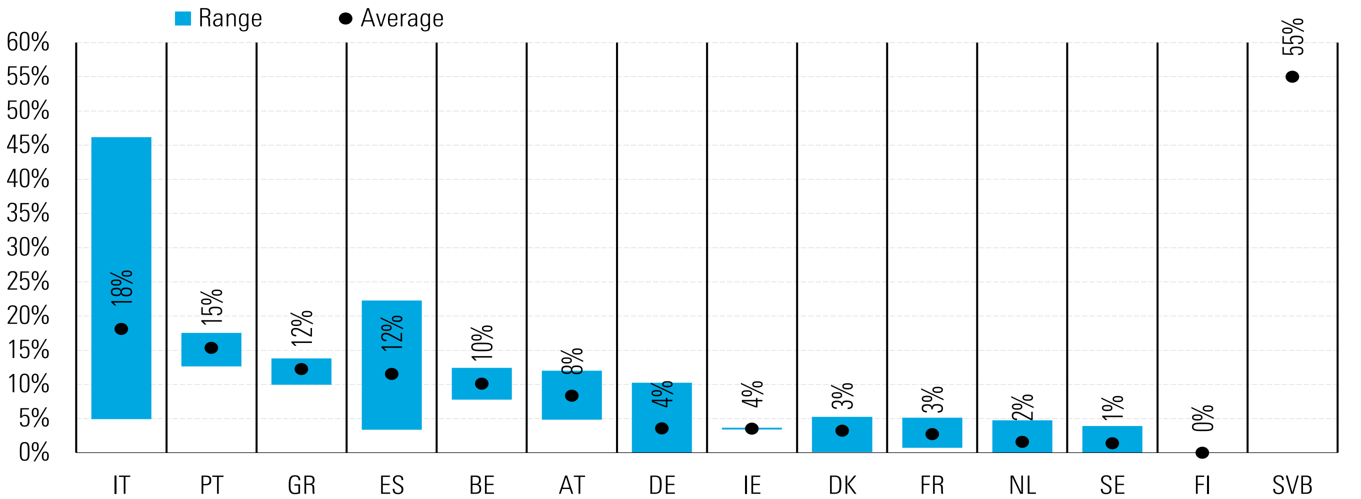
Elisabeth Rudman
Managing Director, Head of Global FIG
+44 20 7855 6655
elisabeth.rudman@dbrsmorningstar.com

Overview

The failures of SVB Financial Group and Signature Bank (both unrated by DBRS Morningstar) have triggered significant global market volatility, including in Europe (see SVB's Failure Sparks Sharp Sell-Off in the Sector as Banks Face Increased Scrutiny of Unrealized Balance Sheet Losses). We consider that some of SVB's problems that led to its failure were idiosyncratic and are not present to the same extent within the EU banking system. EU banks generally have a lower exposure to fixed income securities, more stable retail deposit bases, and a regulatory framework that includes tighter interest rate risk management policies even for smaller banks. Nevertheless, the changes in interest rates creates challenges for banks and we are closely monitoring EU banks' liquidity positions as well as their exposure to fixed income securities. In order to do that, we have also carried out a theoretical exercise to haircut EU banks' amortised cost bond portfolios, to see the potential impact on capital as these unrealized losses are not deducted from banks' CET1 capital. Under this theoretical exercise the capital impact seems manageable for EU banks.

However, the full impact of the current financial instability is still to be seen. Furthermore, global market volatility has increased and markets are wary of any signs of weakness. Concerns about potential contagion led to the Swiss authorities recently announcing a CHF 50 billion Liquidity Support Line for Credit Suisse Group AG (rated BBB (low), Negative trend). At this time, we do not expect similar measures to be necessary for other European banks, as Credit Suisse was facing ongoing compliance and restructuring challenges specific to its franchise but this was heightened by the current market volatility. Nevertheless, the ECB signalled during yesterday press conference that it stands ready to provide liquidity to the eurozone banking system if necessary.

Exhibit 1 Amortised Cost Bond Portfolio over Total Assets (June – 2022) - Selected European Banks and SVB (See Appendix 1)



Source DBRS Morningstar, EBA, Morningstar Inc,. *AC =Amortised Cost. SVB = SVB Financial Group as of End-2022.

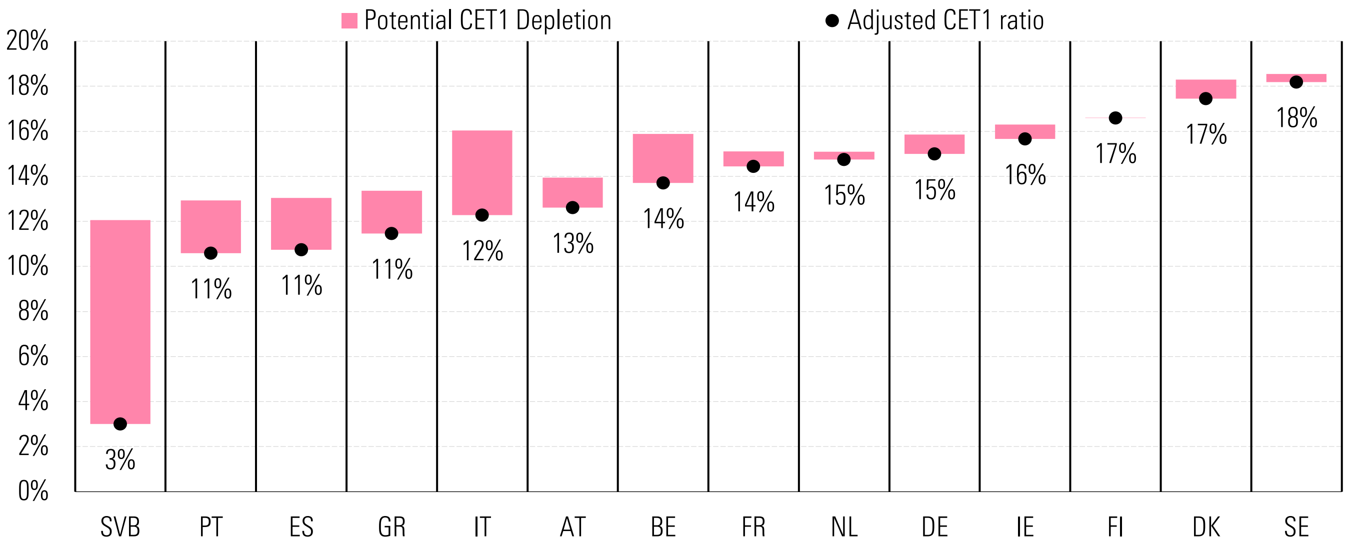
EU Banks: Significantly Lower Exposure to Bonds and in Many Cases Already Marked to Market

SVB had a very substantial fixed income portfolio accounting for around 55% of total assets at end-2022, and the marked to market was not required to be reflected in their capital ratios. On March 8th the bank sold one fifth of its bond portfolio realising an after tax loss of USD 1.8 billion and announced a capital raise to mitigate the impact of the loss. This sparked the attention of financial markets and participants regarding the size of the bond portfolio and the total unrealised losses of SVB, which were very significant and could have depleted most of its capital base.

We believe the situation is different in Europe, where banks have a smaller proportion of debt securities where the marked to market is not reflected in capital ratios. These securities are accounted for in their Amortised Cost (AC) portfolio and according to EBA data, range on average from 18% of total assets (mostly Italian banks) to close to 0% (banks in Finland, Sweden and the Netherlands) at end-June 2022 (Exhibit 1). In order to calculate a theoretical capital impact in a scenario in which EU banks are forced to sell their AC bond portfolios, we have stressed the portfolios with a pre-tax loss of 10% (see Annex 1). This translates into a manageable theoretical capital impact for the average of the sample (Exhibit 2), although the capital depletion would be significant for some banks. Nevertheless, all the banks in our sample will maintain a post-adjustment CET1 ratio above 8%.

We consider this theoretical scenario to be a stringent exercise, as our expectation is that the potential unrealised pre-tax loss for European banks is below 10%. In particular, the banks in our ratings coverage that have disclosed the unrealised loss in their AC portfolio are reporting a loss on average of around 5%. In addition, even the smaller EU banks have in place interest rate risk management policies and strong supervision. For instance, the ECB, which supervises 110 banks in the eurozone, identified market risks and interest rate risks as its first priority in its supervisory calendar for 2022-2024 (link). As a result, DBRS Morningstar understands many EU banks have in place hedging strategies with interest rate derivatives that will compensate for a proportion of the depreciation of their bond portfolios.

Exhibit 2 Average CET1 Ratio After Adjusting For Potential Unrealised Losses For EU banks and SVB (See Annex 1 for details)



Source DBRS Morningstar, EBA, Morningstar Inc,. *AC =Amortised Cost. SVB = SVB Financial Group as of End-2022. SVB after applying a 8.5% after tax loss on its bond portfolio.

Separately, we note that banks generally have been able to adapt their interest rate hedging structures since interest rates started to increase a year ago, particularly in the portfolios that are valued at fair value through capital. We saw a negative impact on CET1 ratios of some European banks during 2022 due to interest rate rises. However, the negative impact was more than offset by improving retained earnings as banks started to benefit from the repricing of their loan books at higher interest rates, so we expect these risks to remain manageable.

EU Banks' Deposits are Less Concentrated in Corporate Deposits

In addition, we are not expecting EU banks to realise these unrealised losses for two main reasons. First, unlike SVB, EU banks do not need to sell their bond portfolios to reposition their balance sheet to increase asset sensitivity to interest rates. EU banks have larger loan books (55% of assets vs. 35% in the case of SVB) and these are already repricing (given a large proportion are variable rate loans).

Secondly, the overall deposit bases of EU banks are stronger than at SVB. EU banks in our coverage have a much larger proportion of retail deposits, compared to SVB that had mainly corporate deposits. We consider funding from retail deposits to be generally lower cost and more sticky, enabling a bank to better withstand liquidity crises. Corporate deposits tend to be more concentrated, larger in size, not covered by the Deposit Guarantee Funds and consequently less stable. Excluding central bank funding, corporate deposits as a share of total funding in Europe averages between 8% to 30% by country in our selected sample. For SVB, corporate deposits represented around 90% of total funding (Exhibit 3).

Furthermore, we consider that the supervisory framework of EU banks is stronger than the one that was applicable to SVB. For instance, all EU banks are subject to Basel rules on liquidity, in particular the calculation of the Liquidity Coverage Ratio (LCR) as well as the Net Stable Funding ratios (NSFR).

Exhibit 3 % Of Corporate Deposits out of Total Funding* (June-2022)

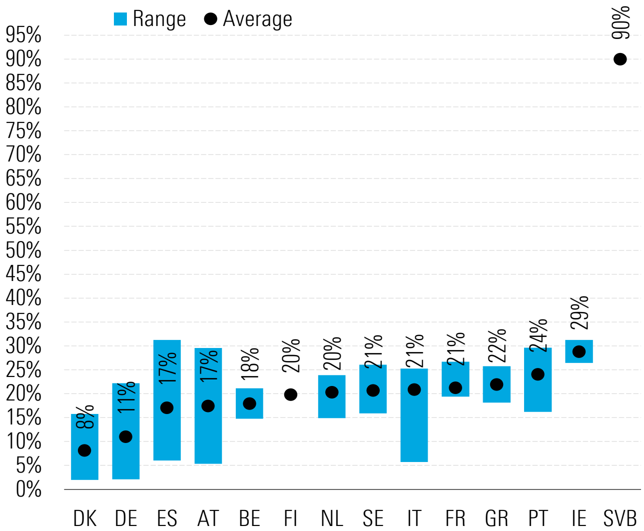
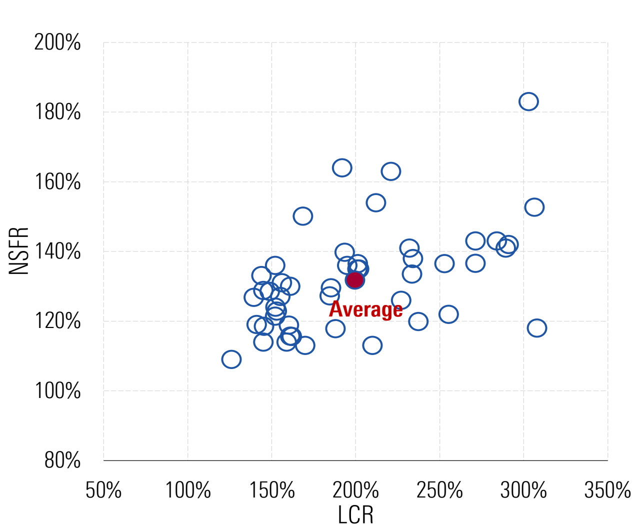


Exhibit 4 NSFR & LCR for EU Banks (End-2022 or last available)



Source DBRS Morningstar, Company Documents, Morningstar Inc, ECB. *Total Funding excludes Central Banks funding and FHLB advance for SVB.

However, in the US only the largest banks are subject to these requirements. Within our sample of banks, on average, EU banks have an LCR of 200% and an NSFR of around 130% at end-2022 (Exhibit 4). We recognise that in general, liquidity and funding accounting metrics have limited use in predicting events of defaults, as those metrics have a time lag compared to real time liquidity metrics. However, the LCR and NSFR ratios would have flagged some problems in SVB´s funding profile which could have triggered scrutiny from financial markets. As a result, we consider that Basel rules on liquidity foster market discipline and give strong incentives to banks to implement more adequate liquidity risk management policies than banks that are not subject to those rules.

SVB is an Important Lesson to be Learnt

Despite the full implications of the SVB failure remaining uncertain, there are some important key take aways from SVB's failure. This failure shows us that bank runs and liquidity crisis can unfold at a speed unseen before. In Europe, Banco Popular Espanol SA (Banco Popular), failed in 2017. In the case of Banco Popular´s crisis, the bank lost 20% of its deposits in 90 days. However, SVB experienced a 25% deposit outflow in just one day. Further tools to address liquidity crisis are needed, and this experience might be a very valuable input for the current revision of the EU bank crisis management and deposit insurance framework.

Annex 1 – CET1 Capital Depletion Theoretical Scenario

We carried out an extreme theoretical scenario in which EU banks are forced to sell the entire fixed income portfolio held at amortised cost (AC). In this scenario we applied a pre-tax loss of 10%, which we consider to be a sufficiently stringent scenario, as the banks in our coverage that have recently disclosed the unrealised losses in their AC portfolio are reporting losses of around 5% to 10%. Then, we calculated the CET1 impact for all the banks in our sample and aggregated the results by doing a simple average by country. We recognise the limitations of this exercise, as i) we are using end-June-2022 exposures as a proxy of the bonds that have experienced market depreciation ii) the pre-tax loss is in reality different across banks as the duration and hedging policies of the portfolios are different. Nevertheless, we consider this exercise as useful to identity potential risks within the EU banks. For this exercise, we applied an after tax loss of 8.5% to SVB's whole portfolio, which is consistent with the loss they reported to the market after they sold a portfolio of USD 21 billion.

Appendix 1 – Banks Included in the Theoretical Capital Depletion Scenario

We have selected a subsample of banks from the 2022 EBA Transparency Exercise. We have included banks from selected countries and removed specialised bank lenders from the sample.

Sample of Banks

Austria
Raiffeisen Bank International AG
Erste Group Bank AG
BAWAG Group AG
Belgium
Belfius Bank
KBC Groep
Denmark
Danske Bank A/S
Nykredit Realkredit A/S
Jyske Bank A/S
Finland
Nordea Bank Abp
France
Société générale
BNP Paribas
Groupe Crédit Agricole
Groupe BPCE
Confédération Nationale du Crédit Mutuel
Germany
Aareal Bank AG
Commerzbank Aktiengesellschaft
Deutsche Bank Aktiengesellschaft
DekaBank Deutsche Girozentrale
Norddeutsche Landesbank - Girozentrale -
DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main
Bayerische Landesbank
Landesbank Hessen-Thüringen Girozentrale
HASPA Finanzholding
Deutsche Pfandbriefbank AG
Greece
Piraeus Financial Holdings
Alpha Services and Holdings S.A.
Eurobank Ergasias Services and Holdings S.A.
National Bank of Greece, S.A.

Ireland
Bank of Ireland Group plc
AIB Group plc
Italy
Cassa Centrale Banca
Banca Monte dei Paschi di Siena S.p.A.
Banco BPM SpA
Intesa Sanpaolo S.p.A.
Banca Popolare di Sondrio, Società Cooperativa per Azioni
UniCredit S.p.A.
Gruppo Bancario Mediolanum
Iccrea Banca S.p.A.
Mediobanca - Banca di Credito Finanziario S.p.A.
Credito Emiliano Holding S.p.A.
Netherlands
Coöperatieve Rabobank U.A.
ABN AMRO Bank N.V.
ING Groep N.V.
Portugal
Banco Comercial Português, SA
LSF Nani Investments S.à r.l.
Caixa Geral de Depósitos, SA
Spain
Banco de Crédito Social Cooperativo
Kutxabank, S.A
Banco Bilbao Vizcaya Argentaria, S.A.
Unicaja Banco, S.A.
Ibercaja Banco, S.A.
Abanca Corporacion Bancaria, S.A.
CaixaBank, S.A.
Banco Santander, S.A.
Banco de Sabadell, S.A.
Bankinter, S.A.
Sweden
Svenska Handelsbanken - group
Skandinaviska Enskilda Banken - group
Swedbank - group

.

Notes:
All figures in Euros unless otherwise noted.
For more information on this credit or on this industry, visit www.dbrsmorningstar.com

Related Research

- German Cooperative & Savings Banks FY 2022: Resilient Despite Impairments on Securities Portfolios, March 16, 2023
- UK Banks: Solid Results in FY22 in Spite of Higher Loan Loss Provisions, March 15, 2023
- Irish Banks FY22 Results: Strong NII Growth but Varying Profitability; Improved Asset Quality, March 13, 2023
- SVB's Failure Sparks Sharp Sell-Off in the Sector as Banks Face Increased Scrutiny of Unrealized Balance Sheet Losses, March 13, 2023
- European Capital Markets Revenues Resilient in 2022, Despite Weak Investment Banking Revenues, March 1, 2023
- What to Expect for European Firms' Capital Markets Revenues in 2023, March 1, 2023
- Nordic Banks FY22 Results Driven by Strong NII Growth; Cost of Risk Remains Low, February 21, 2023
- Irish Banks' Mortgage Market Bucks the European Trend: Mortgage Lending Growth (Part I) February 20, 2023
- Irish Banks' Mortgage Market Bucks the European Trend: Mortgage Rates (Part II), February 20, 2023
- Dutch Banks: Solid FY22 Results Despite Challenging Economic Backdrop, February 16, 2023
- National Regulations and End of TLTRO a Drag on French Banks, February 15, 2023
- Solid 2022 Results Leave French Banks Well Equipped to Face 2023 Challenges, February 15, 2023
- Italian Banks: Higher Net Interest Margins And Lower Underlying Credit Costs Support 2022 Results, February 14, 2023
- Spanish Banks' Profitability to Benefit from Higher Interest Rates, February 13, 2023
- Credit Suisse: Restructuring Plan Under Way and Supported by Solid Capital, But Stress in Core Franchise Visible, February 9, 2023
- Portugal Interest Rate Measures Likely to Aid Borrowers, but Medium Term Asset Quality Risks Remain, February 9, 2023
- European Bank 2023 Outlook: Higher Rates Will Help in Navigating Weaker Economies, January 16, 2023
- Portuguese Banks: An Analysis of Sovereign and Other Debt Exposures, July 11, 2022
- Italian Banks: An Analysis of Sovereign Exposures, June 29, 2022
- Spanish Banks: An Analysis of Sovereign Exposures, June 22, 2022

About DBRS Morningstar

DBRS Morningstar is a full-service global credit ratings business with approximately 700 employees around the world. We're a market leader in Canada, and in multiple asset classes across the U.S. and Europe.

We rate more than 3,000 issuers and nearly 60,000 securities worldwide, providing independent credit ratings for financial institutions, corporate and sovereign entities, and structured finance products and instruments. Market innovators choose to work with us because of our agility, transparency, and tech-forward approach.

DBRS Morningstar is empowering investor success as the go-to source for independent credit ratings. And we are bringing transparency, responsiveness, and leading-edge technology to the industry.

That's why DBRS Morningstar is the next generation of credit ratings.

Learn more at dbrsmorningstar.com.

The DBRS Morningstar group of companies consists of DBRS, Inc. (Delaware, U.S.)(NRSRO, DRO affiliate); DBRS Limited (Ontario, Canada)(DRO, NRSRO affiliate); DBRS Ratings GmbH (Frankfurt, Germany)(EU CRA, NRSRO affiliate, DRO affiliate); and DBRS Ratings Limited (England and Wales)(UK CRA, NRSRO affiliate, DRO affiliate). DBRS Morningstar does not hold an Australian financial services license. DBRS Morningstar credit ratings, and other types of credit opinions and reports, are not intended for Australian residents or entities. DBRS Morningstar does not authorize their distribution to Australian resident individuals or entities, and accepts no responsibility or liability whatsoever for the actions of third parties in this respect. For more information on regulatory registrations, recognitions and approvals of the DBRS Morningstar group of companies, please see: https://www.dbrsmorningstar.com/research/225752/highlights.pdf.

The DBRS Morningstar group of companies are wholly-owned subsidiaries of Morningstar, Inc.