AXIOM
ALTERNATIVE INVESTMENTS

EBA 2018 Transparency report: a new analysis of NPE provisioning shortfalls

Summary

Non-Performing Exposures (NPE) risk remains a key driver of asset performance for EU banks as shown by the recent market reaction to the stance of the SSM on the legacy stock of NPE.

In this short memo we perform a new analysis of the provisioning shortfalls of EU banks, based on the latest EBA transparency data.

We believe banks have made enormous progress on that front:

- Strong reduction of EU bank's NPE (3.58% in average, -100bps YoY).
- Healthier banks with increasing coverage and CET1 ratios.
- All the drama is gone: according to our own estimates, there is no bank with a very high shortfall anymore and the problems now seem well identified (please refer to the analysis below to see the few banks at risk).

In conclusion, we believe the resolution risk has clearly receded in Europe.

EU banks have been under the crossfire of a challenging macro-environment (Italy, trade negotiations, Brexit, length of the cycle, central bank tightening) and never-ending discussions on asset quality and NPE. The recent piece of news on the supposed stance of the SSM on the legacy stock of NPE (as opposed to the addendum adopted recently that applies only to new NPE) had a sharp market impact. This alone shows that NPE remain a key driver of performance on EU banks.

In this note we perform a new analysis of the provisioning shortfalls of EU banks, based on the latest EBA transparency data, the only dataset that is both perfectly in line with the supervisors' definitions of troubled assets and consistent from one bank to another. In order to allow for a consistent comparison, we use the exact same methodology as in 2016 and 2017 (see our previous works for details.)

We should point out that i) the data does not include foreclosed assets and ii) the date of the data is June 30th, 2018.

RESEARCH AND MANAGEMENT TEAM

David Benamou
Managing Partner
Chief Investment Officer
+44 330822 03 74
david.benamou@axiom-ai.com

Jérôme Legras
Managing Partner
Head of Research
+33 1 85 7326 84
Jerome.legras@axiom-ai.com

Adrian Paturle
Partner
Portfolio Manager
+33 14469 43 90
Adrian.paturle@axiom-ai.com

Paul Gagey
Portfolio Manager
+33 1 85 73 26 81
paul.gagey@axiom-ai.com

Gildas Surry
Partner
Portfolio Manager
+44 203 807 0853
Gildas.surry@axiom-ai.com

Laurent Henrio
Portfolio Manager
+44 203 807 0529
laurent.henrio@axiom-ai.com

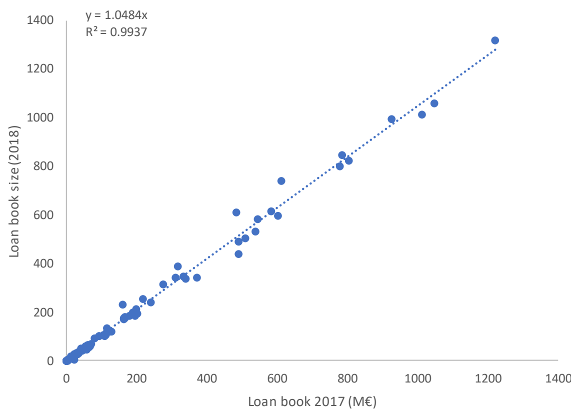
Antonio Roman
Research Analyst
+44 203 80 70 923
antonio.roman@axiom-ai.com

i. Aggregate data

At the aggregate level, there are still €746bn of gross EU NPE (in a sample with total equity of €1650bn), which is a 3.58% NPE ratio. This is a sharp reduction compared to 2017 (€887bn of gross EU NPE and 4.54% NPE ratio) as the ratio almost dropped -100bps YoY. Adding other categories of performing but "bad" exposures gives a total of €994bn, or a 4.78% ratio vs. 5.94% a year ago. The sector wide Texas ratio is 48.02%, another sharp drop from 60.15% a year ago.

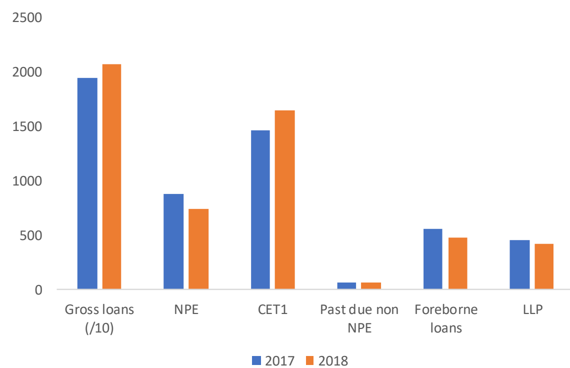
The charts below provide other interesting insights.

Loan book in Transparency 2018 (y-axis) vs. loan book in Transparency 2017 (x-axis)



Source: EBA, Axiom AI

There are less bad loans, more equity

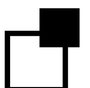


Source: EBA, Axiom AI

The upper left chart confirms that EU banks are not deleveraging anymore and the loan books are growing in a healthy way (4.84% p.a. vs. only 2% last year). Unlike last year, there is no significant outlier in the loan book growth chart. The upper right chart shows that the stock of bad exposure is down: NPEs are down -15.9%, forborne loans are down -14.8%.

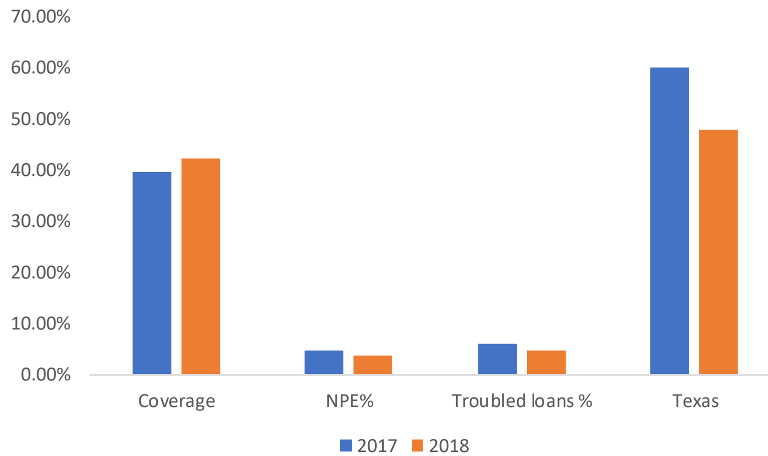
Finally, one can see from the chart below that metrics have also sharply improved: the coverage ratio is up 262bps to 42.29%, the NPE ratio is down -96bps, the "troubled loans" ratio is down -117bps and the Texas ratio is down -1213bps! **A similar improvement was observed last year but, as a consequence, CET1 capital was down, whereas this year it is up at +12.13%.** The overall CET1 ratio is now 14.51% vs. 14.22% a year ago.

This document is not legally nor contractually binding and is intended for strictly personal use. Although the information presented hereby comes from reliable sources it cannot be guaranteed. The judgement formulated hereby reflect our opinion as of the date of publication and may be subject to change.



AXIOM ALTERNATIVE INVESTMENTS - 1 Conduit Street – 4th floor London W1S 2XA
| Phone: +44 203 80 70 862 |contact@axiom-ai.com

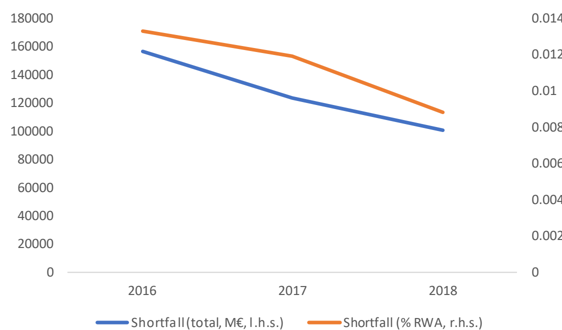
Asset quality metrics are improving



Source: EBA, Axiom AI

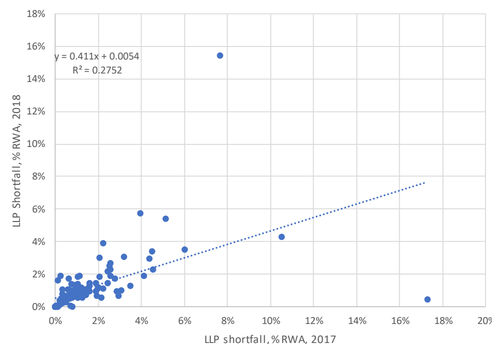
Going from the raw data to our provisioning shortfall estimates, we draw similar conclusions, as illustrated below.

The aggregate provisioning shortfall is going down



Source: EBA, Axiom AI

And this is a broad-based phenomenon: provisioning shortfalls in %RWA, 2017 (x-axis) and 2018 (y-axis)

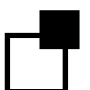


Source: EBA, Axiom AI

We can see (left chart) that the total provisioning shortfall is continuing to go down rapidly, both in absolute € number (-18.4% vs. -21% last year) and in % of RWA (-31bps vs. -14bps last year). The right chart shows that this is reasonably shared among EU banks, although we can see two large outliers and the quality of the regression is good but far from excellent.

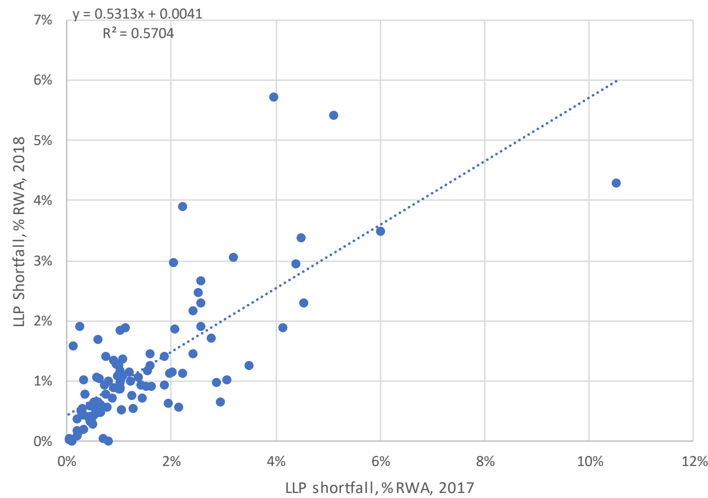
In order to improve the visibility of the upper-right chart, we remove (i) the two outliers and (ii) the banks for which there is no shortfall (which often means there is virtually no NPE – this sample is largely made of public bank, custodian banks, etc.)

This document is not legally nor contractually binding and is intended for strictly personal use. Although the information presented hereby comes from reliable sources it cannot be guaranteed. The judgement formulated hereby reflect our opinion as of the date of publication and may be subject to change.



AXIOM ALTERNATIVE INVESTMENTS - 1 Conduit Street – 4th floor London W1S 2XA
| Phone: +44 203 80 70 862 |contact@axiom-ai.com

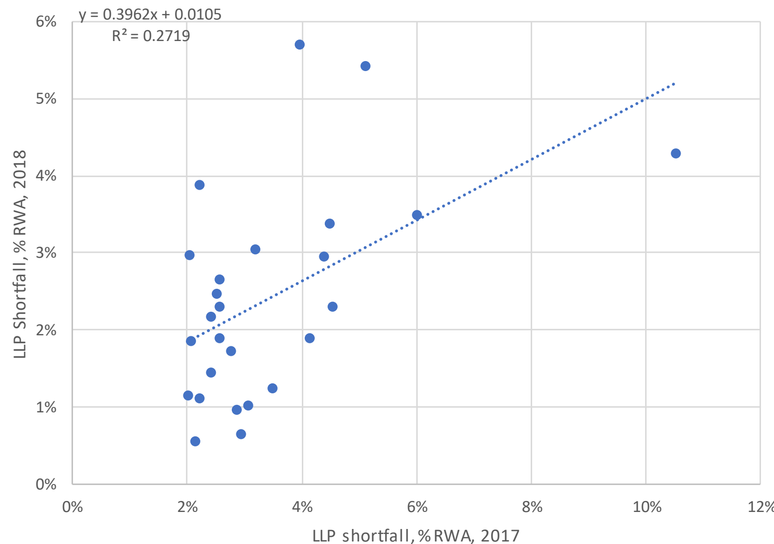
Change in provisioning shortfalls in %RWA, 2017 (x-axis) and 2018 (y-axis), cleaned-up sample



Source: EBA, Axiom AI

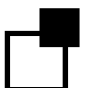
However, the fixed income or resolution risk for bank investors is not really connected to aggregate numbers but more to the behavior of the weak banks. We have performed the same calculations on banks that had a shortfall of more than 2% of their RWA (i.e. 200bps CET1) in 2017. The aggregate shortfall is down from €40.4bn to €25bn, a massive -38% drop after a -43% drop last year.

Change in provisioning shortfalls in %RWA, 2017 (x-axis) and 2018 (y-axis), for banks that had a 2%+ provisioning shortfall in 2017



Source: EBA, Axiom AI

This document is not legally nor contractually binding and is intended for strictly personal use. Although the information presented hereby comes from reliable sources it cannot be guaranteed. The judgement formulated hereby reflect our opinion as of the date of publication and may be subject to change.



. AXIOM ALTERNATIVE INVESTMENTS - 1 Conduit Street – 4th floor London W1S 2XA
| Phone: +44 203 80 70 862 |contact@axiom-ai.com

ii. Bank by bank analysis

On a bank by bank basis we draw the following conclusions from the detailed disclosures. **These are only our own <u>estimates</u> of the economic provisioning shortfall and do not express any view on the genuine adequacy of the provisioning practices of those banks from an accounting or supervisory point of view**.

- **What about the two outliers?** They are a Cypriot bank (Hellenic Bank) and a French bank (SFIL.) Hellenic has undergone a massive restructuration of its balance sheet and should be commended for an impressive improvement (from a 17% shortfall to virtually 0). SFIL is a public bank (indirectly owned by the government) and the amounts at stake are low (less than 1bn€). Moreover, the issues come almost exclusively from non-defaulted NPE on general government borrowers with very little provisions and we suspect this could be linked to Puerto Rico's default on which monoline guarantees were given – hence the performance of our model is probably poor in such a specific situation.

- **No drama anymore.** This is our most important conclusion: according to our calculations, there is no bank with a spectacularly high shortfall anymore. The problems are now concentrated in Greece, Germany and, perhaps surprisingly, Norway. The top three problem banks are (SFIL aside) SR-Bank, Nord LB and HSH (those two being well identified by investors and in the process of restructuring their balance sheets).

- **The Greek banks** are still not out of the woods. Very much like last year, we see sharp improvements (from -100bps to -251bps) but Alpha Bank and Piraeus remain close to a 3% shortfall or above and their Texas ratios are still above 150%.

- The data for **Irish banks** confirms that their NPL management policies are adequate and they are still improving (from -120bps to -140bps in the shortfall) but Bank of Ireland maintains a reasonably high shortfall (2.55%) and, more worryingly, we do not have data for the most troublesome Irish bank anymore as Permanent TSB is not in the EBA Transparency sample anymore.

- **Italian banks are obviously on everyone's mind and the changes are spectacular (mostly, we believe, due to large asset sales.)** There are only two banks left with a 2% shortfall, Monte dei Paschi (2.3%) and Banco BPM (2.17%). Carige has more than halved its shortfall and is now only at 1.88%, which is comforting news for its viability prospects. Unfortunately, there is still no data for Creval. The two largest banks have a shortfall of 1.1% (Unicredit) and 1.4% (Intesa.)

- In Portugal, there are only two banks left which require a close inspection, in our view: Caixa Económica Montepio Geral still has a 2.5% shortfall (almost unchanged) whereas Novo exhibits strongly improved metrics with a 1.25% shortfall vs. 3.49% a year ago.

- Spanish banks spectacularly improved their metrics in 2017 – this is not the case anymore. The overall Spanish banking system seems to have an unchanged provisioning shortfall. However, this is not worrying as the worst performing bank (Sabadell) only has a 1.3% shortfall. Perhaps more interesting is the case of Banco de Crédito Social Cooperativo, which many analysts view as weak or very weak: our estimated shortfall is only 1.2%, something we believe is manageable. It is however crucial to point out that in our view the largest NPA risk for Spanish banks is the foreclosed assets risk, something we do not analyze here.

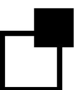
This document is not legally nor contractually binding and is intended for strictly personal use. Although the information presented hereby comes from reliable sources it cannot be guaranteed. The judgement formulated hereby reflect our opinion as of the date of publication and may be subject to change.

AXIOM ALTERNATIVE INVESTMENTS - 1 Conduit Street – 4th floor London W1S 2XA
| Phone: +44 203 80 70 862 |contact@axiom-ai.com

iii. Conclusion

NPE risk remains a key driver of asset performance for EU banks. Based on EBA Transparency data, which we think has proven to be very reliable in the past, we believe banks have made enormous progress on that front. Metrics are all improving: coverage ratios, Texas ratios, NPE ratios, CET1 ratios, loan growth, *etc*. Moreover, our in-house provisioning shortfall analysis provides further comforting insights: all the drama is gone, and the problems now seem located in (perhaps) unexpected countries: Germany, Norway and (of course) Greece. The logical conclusion is that resolution risk has receded… but German politicians might need to worry a bit more about what is going on, on their homefront, rather than requesting further risk reduction before EDIS can be implemented!

This document is not legally nor contractually binding and is intended for strictly personal use. Although the information presented hereby comes from reliable sources it cannot be guaranteed. The judgement formulated hereby reflect our opinion as of the date of publication and may be subject to change.



AXIOM ALTERNATIVE INVESTMENTS - 1 Conduit Street – 4th floor London W1S 2XA
| Phone: +44 203 80 70 862 |contact@axiom-ai.com