AXIOM ALTERNATIVE INVESTMENTS

EBA 2019 Transparency report: a new analysis of NPE provisioning shortfalls

Summary :

Where do EU banks stand in terms of asset quality and provisioning remains an important question as there are growing concerns that the expansion cycle might soon end.

In this short memo, we perform a new analysis of the provisioning shortfalls of EU banks, based on the latest EBA transparency from June 2019.

Our main conclusion is that we continue to see a strong improvement in NPE reduction despite the huge progress already achieved by EU banks over the past years:

- Strong reduction of EU bank's NPE (3.03% in average, -55bps YoY) thanks to the large portfolio sales that have been going on
- Coverage and CET1 ratios remain stable
- The resolution risk has gone down sharply in the EU (the aggregate shortfall of banks with a 2%+ shortfall decreased from € 40.4bn to € 9.6bn in 2 years)
- The largest shortfall has reduced and there are no banks with a spectacularly high shortfall anymore. For more details please refer to our bank by bank analysis hereafter.

After several years of intense pressure from the supervisors, important regulatory changes (IFRS 9, calendar provisioning, etc.), after the development of a NPL market, etc., where do EU banks stand in terms of asset quality and provisioning?

We believe, more than ever, that this is an important question, as there are growing concerns that this expansion cycle might soon end and that the benign cost of risk that many banks currently experience could revert.

In this note, we perform a new analysis of the provisioning shortfalls on the basis of EBA transparency data. We use this dataset because it is the only one which is both perfectly in agreement 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, 2017 and 2018 (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, 2019.

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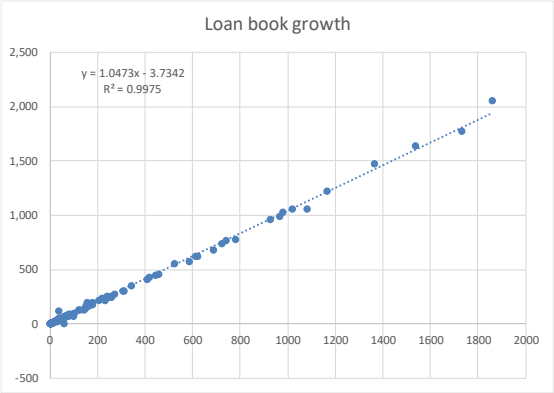
i. Aggregate data

At the aggregate level, there are still €632bn of gross NPE (in a sample with total equity of €1,537bn), which is a 3.03% NPE ratio (compared to balance sheet credit assets). This is a sharp reduction compared to 2018 (€746bn of gross NPE and 3.58% NPE ratio) as the ratio dropped -55bps YoY. Adding other categories of performing but "*bad*" (i.e. past due or forborne) exposures gives a total of €844bn (a substantial -€150bn drop from last year) or a 4.05% ratio vs. 4.78% a year ago. The sector wide Texas ratio is 44.58%, down from 48.02% a year ago. NPE have gone down, but so have loan loss provisions (LLP) and equity (CET1), probably due to the large portfolio sales that have been going on.

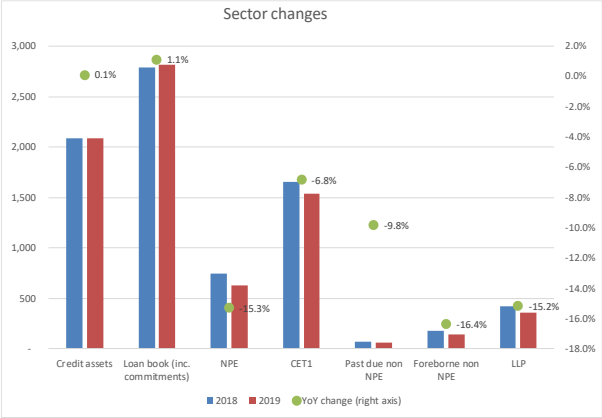
The charts below provide other interesting insights.

Loan book in Transparency 2019 (y-axis) vs. loan book in Transparency 2018 (x-axis)



Source: EBA, Axiom AI. The loan book includes loan commitments.

There are less bad loans, less equity, less provisions



Source: EBA, Axiom AI

The upper left chart confirms that EU banks are not deleveraging anymore, and the loan books are growing at a healthy pace (4.73% p.a. vs 4.84% last year – note this is the slope of the regression line, not the change in total loans.) There is no significant outlier in the loan book growth chart. The upper right chart shows that pretty much everything goes down, except the loan book: equity, NPE, provisions, *etc*.

Finally, one can see from the chart below that most metrics have stabilised, compared to the changes over the past few years: the coverage ratio is almost unchanged at 56.4% (banks have reached a provisioning steady state), the NPE ratio decrease is slowing down (-55bps), the "troubled loans" ratio is also down -72bps and importantly the Texas ratio is only down -3.4pp vs. -12.13pp last year. It appears that large portfolio sales have continued to impact positively the stock of NPE, but the provisioning levels are now stable.

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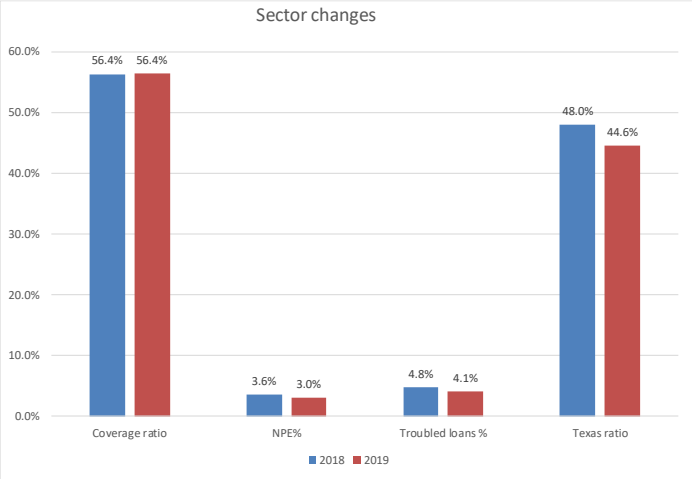
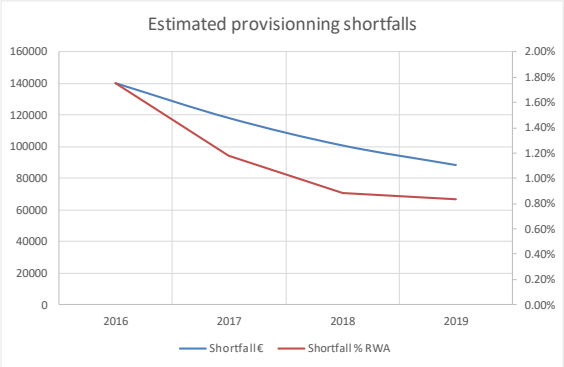
Asset quality metrics are stabilising



Source: EBA, Axiom AI

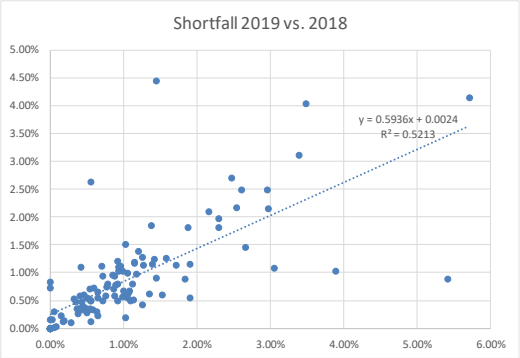
Going from the raw data to our provisioning shortfall estimates, we draw similar conclusions, as illustrated below.

The aggregate provisioning shortfall is still going down, but improvement is slowing



Source: EBA, Axiom AI

And this is a broad-based phenomenon: provisioning shortfalls in %RWA, 2018 (x-axis) and 2019 (y-axis)



Source: EBA, Axiom AI. One bank has been removed as it has a very unusual business model which skews the result and deteriorates the quality of the comparison.

We can see (left chart) that the total provisioning shortfall continues to go down, albeit at a slower pace, both in absolute € number and in % of RWA. The right chart shows that this is reasonably shared among EU banks, although we can see three "bad" outliers (banks that have substantially increased their shortfalls) and three good outliers (banks that have decreased their shortfalls much quicker than the rest). Of the three "bad" outliers, only two would concern us, as the third one is a small subsidiary of a large US bank.

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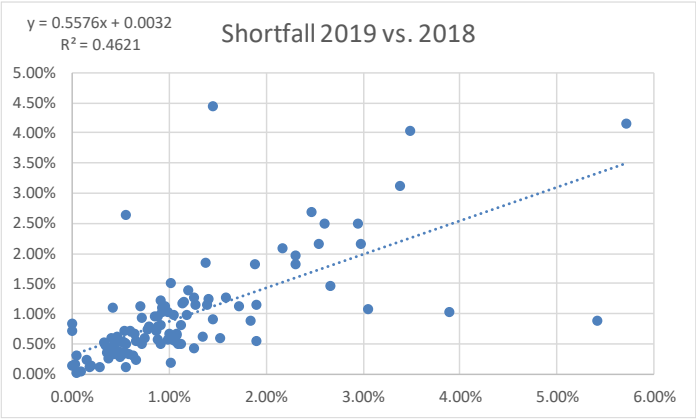
In order to improve the visibility of the upper-right chart, we remove the banks for which there is no shortfall (which often means there is virtually no NPE – this sample is largely made of public banks, custodian banks, *etc.*)

Change in provisioning shortfalls in %RWA, 2018 (x-axis) and 2019 (y-axis), cleaned-up sample



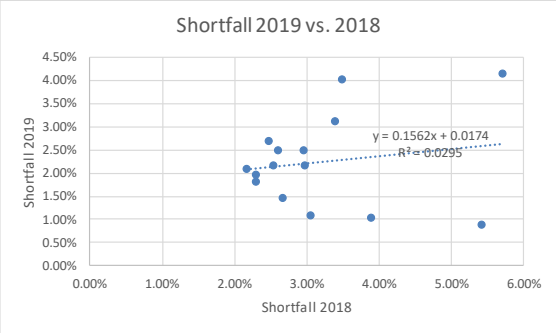
Source: EBA, Axiom AI

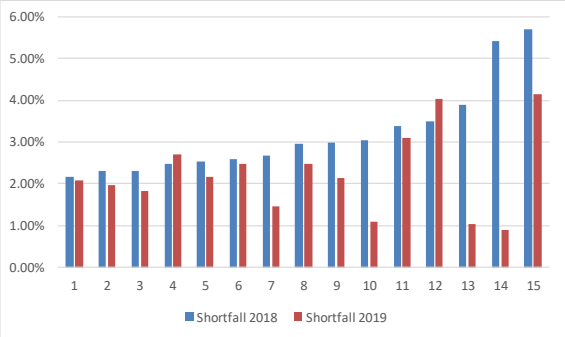
This does not change our overall conclusions although the improvement appears more substantial.

However, for bank investors, the fixed income or resolution risk is not really connected to aggregate numbers but more to the behaviour 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 2018.

The aggregate shortfall of banks with a 2%+ shortfall is now only €9.6bn - it was €40.4bn just two years ago. This shows that resolution risk has gone down sharply in the EU, in our view.

Change in provisioning shortfalls in %RWA, 2018 (x-axis) and 2019 (y-axis), for banks that had a 2%+ provisioning shortfall in 2018





Source: EBA, Axiom AI

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We believe this is an important chart: despite the global improvement, it points towards a handful of banks that already had a worrying provisioning shortfall and did not improve it, on the contrary.

ii. Bank by bank analysis

We now perform a bank by bank analysis. **These shortfall estimates are only our own estimates 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 "bad" outliers?** We identify several negative situations.
    - Out of the banks that had more than 2% shortfall in 2018, two have actually increased their shortfalls: Caixa Montepio in Portugal and Alpha Bank in Greece.
    - The largest outlier in terms of global improvement (or, rather, deterioration) is a Bulgarian bank, First Investment Bank, for which we estimated a 1.45% shortfall last year vs. 4.45% this year. This is not a bank we follow for investment purposes, so we do not know if this is an artefact coming from our automatic methodology to estimate provisioning shortfalls or not.
    - The second "worst performer" is Eurobank, another Greek bank, for which we estimate the shortfall has gone up from 0.55% to 2.64%.
- **The improvement continues.** This is again our most important conclusion: according to our calculations, the largest shortfall has gone down (it is now 445bps of RWA) and there is no bank with a spectacularly high shortfall anymore. The biggest problems last year were a French public bank - for which we believe our numbers were not really meaningful - SR-Bank in Norway (and this conclusion triggered discussions with the bank and we agree our methodology might not perfectly capture the specificity of that bank), Nord LB and HSH. Those last two banks have massively reduced their shortfall, following extensive balance sheet restructuring, government capital injections and asset relief measures. In addition to the banks already mentioned, the main concerns this year are with MDB Group (in Malta), Piraeus and Bawag, but all these banks have actually improved their metrics.
- **The Greek banks will be relieved** to see the Greek version of GACS finally arriving. Three of them are in the top 10 of the worst banks, with only NBG escaping that list. Even more worrying is the fact that two of them have deteriorated, according to our estimates and they all have a Texas ratio well above 100%.
- Compared to last year, which saw big improvements, the data for **Irish banks** is more mixed. Bank of Ireland still has a reasonably high shortfall (2.16%) even if it is going down. AIB still has a low shortfall (0.93%), but it is ticking upwards.
- **Italy is out of the woods.** The data for the largest NPL market in the world confirms the sharply improving trend, with no significant outlier.

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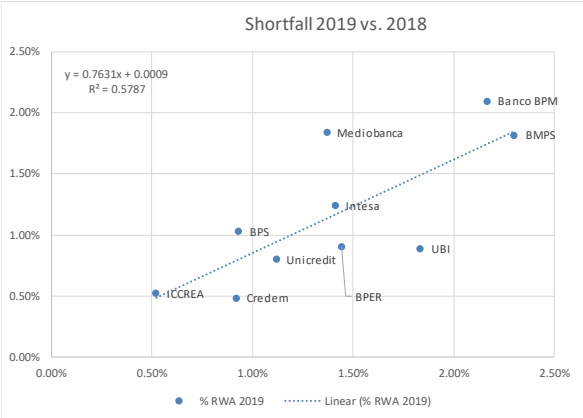
Change in provisioning shortfalls in %RWA, 2018 (x-axis) and 2019 (y-axis), Italy

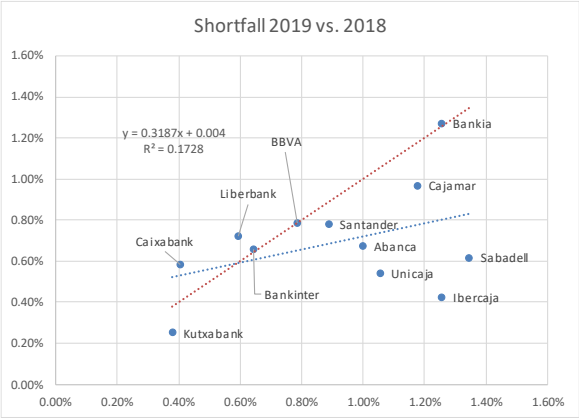


Source: EBA, Axiom AI

Obviously, the numbers at BMPS and BPM remain high, but we believe they are manageable, and the performance YoY of Mediobanca is disappointing, but overall the situation is very much stabilized and the huge cleanup effort has paid off.

- **In Portugal**, the performance YoY was rather poor. The actual € provisioning shortfall has increased and the bank with the largest shortfall, Caixa Económica Montepio Geral, has slightly deteriorated. The situation at Novo is a bit odd, with a large deterioration (2.45% now vs. 1.25% a year ago) but we did not include it in our analysis, as we suspect the complex mechanics of the asset relief program is skewing the results.
- The data for **Spanish banks** is very much similar to last year. After spectacular improvement in 2017, the changes are now more gradual. Liberbank and Caixabank even have slightly worse metrics. In our view, the two most interesting cases are Bankia and Cajamar: the first one has a virtually unchanged shortfall and is now the worst performing bank in Spain, based on our metrics, whereas the second one – still rated BB- by Fitch – now has a shortfall below 1%. We should however point out again that for Spanish banks, foreclosed assets risk, which we do not analyze here, remains a substantial risk.

Change in provisioning shortfalls in %RWA, 2018 (x-axis) and 2019 (y-axis), Spain



Source: EBA, Axiom AI. The red line corresponds to unchanged shortfall from 2018 to 2019.

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