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EBA 2017 Transparency report: a new analysis of NPE provisioning shortfalls: a few clouds on a sunny horizon

Summary

- The banking union is not yet achieved: European Deposit Insurance Scheme (EDIS) is its most important tool and is still mostly work in progress. To accept EDIS, some countries demand that banks are cleaned up from legacy assets (the famous Non-Performing Loans or Non-Performing Exposures), especially in the periphery. The regulator is working hard on reducing the NPE risk.
- Non-Performing Exposures in European banks is a transparent matter: the European Banking Authority (EBA) publishes extensive and precise data on Non-Performing Exposures. Latest data were published last Friday close of business. Here are the results of Axiom's 2017 modelling.
- Non-Performing Exposures are not 100% of the risk: if Monte dei Paschi's was NPEs, Banco Popular's problem was more foreclosed assets (not taken into account in NPEs).
- We see globally a strong improvement in banks' asset quality in Europe in peripheral countries.
- We detail in this note the results, bank by bank, of our NPE/NPL model analysis

1. Introduction

NPL remain the key risk in the EU banking sector, especially with the political discussions around EDIS (European Deposit Insurance Scheme) heating up again. 2017 has been a very busy year on that front, with resolution announced for several banks (Vicenza, Veneto, Popular, Monte) always on asset quality grounds. This is why it is key to have an accurate estimate of the risks involved.

We have long argued that the EBA is the only source of (almost) perfectly consistent asset quality data over all EU banks. It is also the only data source which is perfectly in agreement with the supervisors' definitions of troubled assets. Hence, it is the most precious source of information we have on the status of asset quality within EU banks, despite three shortcomings that we should mention:

- The frequency of the data is low (one report a year)
- The data is not very recent (30^{th} June 2017), which means that some important and recent transactions must be taken into account for an accurate snapshot
- **The data does not include foreclosed assets**.

Based on that data, we have built asset quality models designed to assess the provisioning shortfalls on the existing stock of NPL (not on the new flow of NPLs). Naturally, this is not an exact science, and modelling assumptions must be made. Banks with low provisioning coverage always argue that "*books are different and cannot be compared*", "*portfolio mixes are different*", "*collateral values are not the same*", *etc*. All this is true to some extent, naturally, but the EBA data is granular enough to make a difference between various types of exposures, different amounts of collateral and types of non-performing assets (defaulted, impaired, forborne, etc.) Therefore, we believe our model provides a fair and reasonably unbiased estimate for each bank and should help investors go beyond the easy "*we're different*" language that every under-provisioned bank will use.

2. How did the model perform last year?

The best criteria to judge our model is simply to look at last year's forecasts and assessments and to see what happened. Let us look at the main stories of 2017:

- On Unicredit we had estimated a 13bn€ shortfall. This is very close to the size of the extra provisioning required by the new CEO when he joined the group (along with a… 13bn€ capital increase.)
- On Monte dei Paschi we had estimated a 4.9bn€ shortfall. This is very close to the loss taken on NPE in the restructuring plan approved by the ECB.
- On Veneto and Vicenza, we had estimated a combined 2.3bn shortfall – the buyer, Intesa, decided to increase that number, probably because the Italian state was paying the bill, but that estimate was enough to convince us that the viability of the two banks was clearly in jeopardy.
- Popular was a good example of the shortcomings of the report as mentioned above: the shortfall was only 1bn€, which is consistent with steps taken by Santander post acquisition, but fails to identify the true risks that were in the balance sheet (foreclosed assets, i.e. not loans anymore.)

  Regarding foreclosed real estate assets, the situation is very different for those and very specific to Spain. Spain has been "penalized" by the quality of its enforcement procedures: in many EU jurisdictions, banks are struggling to repossess the collateral on their loans and, logically, own very few real assets. On the contrary, in Spain, NPE have been going down because banks have been able to write them off against the collateral (which is good) but now have large real estate books. It is not easy to harmonize the disclosure of all banks on this, especially smaller ones, but we believe EBA data provides, again, the best disclosure. In this data set, real estate is booked as NCO, i.e. non-credit obligation. Apart from a few odd cases (e.g. VW Bank which obviously has many cars…) the 7 banks which have the largest share of RWA in NCO are all Spanish. More details on this topic could be found in Axiom Q2 2017 report.
- Outside Spain and Italy, the model had identified several difficult situations (mostly in Cyprus on Greece) but none of which materialized into resolution actions or drastic changes, but still

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led to fairly large subsequent increases in the provisioning ratios (on the legacy stocks.) We believe the main reason for that complacency was political, especially in the countries which are under a EU bailout program (Greece and Cyprus) and were sector wide "solutions" have already been applied. The moment of truth has probably only been delayed a bit longer.

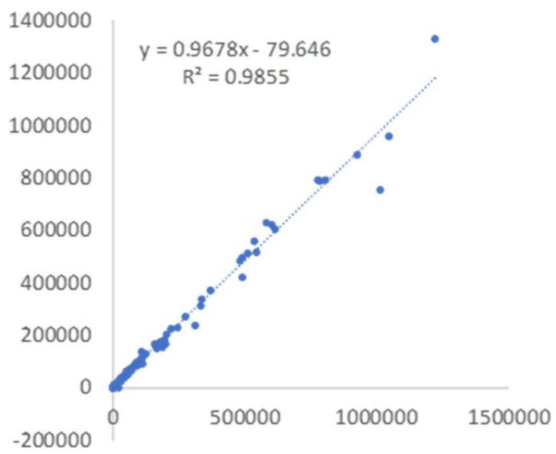
3. What does the 2017 data tell us?

Overall, we feel the results of our 2016 modelling has been satisfactory, especially on a topic as complicated a NPL provisioning[1]. In our opinion, the 2017 dataset should be useful to navigate NPL risk in 2018. What are the main conclusions we draw from it:

i. Aggregate data

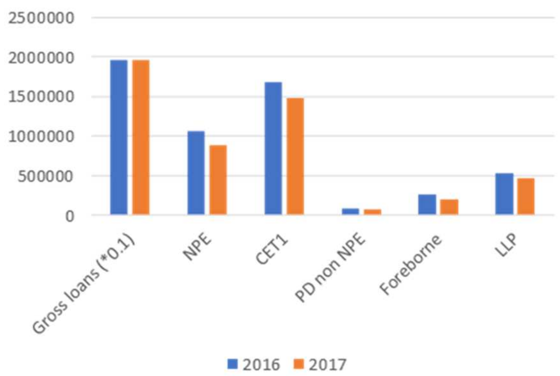
At the aggregate level, there are still 887bn€ of gross EU NPE (in a sample with total equity of 1471bn€), which is 4.54% NPE ratio. This goes up to 5.94% if one adds other categories of performing but "bad" exposures (1162bn€). Provisions are 2.35% of total loans and 39.66% of bad exposures (both performing and non-performing.) The sector wide Texas ratio is 60.15%. The changes over a year are illustrated in the following charts.

The deleveraging is over! Loan book in 2017 (x-axis) vs. loan book in 2016 (y-axis)



Source: EBA, Axiom AI

There are less bad loans



Source: EBA, Axiom AI

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[1] Remember that our analysis only aims to assess the provisioning shortfall on the existing stock and does not deal with further provisioning coming from new NPLs.

[2] Texas ratio = non-performing exposures / [CET1 + provisions]. Texas ratio measures the credit problems of particular banks or regions of banks. A ratio of more than 100 (or 1:1) is considered a warning sign.

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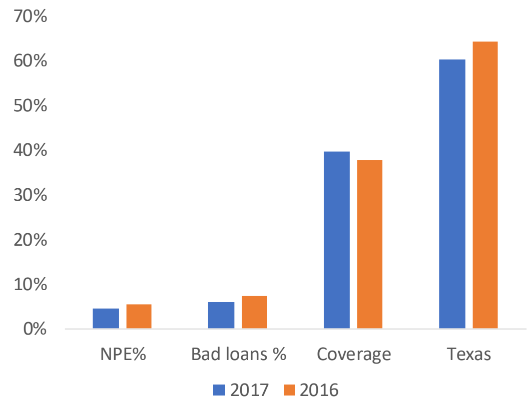
The upper left chart shows that the long-term deleveraging process in EU banks is over and this is a widespread process. On average, for banks that have reported EBA data in 2016 and 2017, the loan book has grown ~2%, and there is a remarkably small dispersion around this average (with two obvious outliers on the chart which are BNP and HSBC ...)

The upper right chart shows that the stock of bad exposure is down: NPEs are down 16.4%, bad loans are down 18%. Finally, on can see from the chart below that metrics have improved: the coverage ratio is up 200bps to 39.7%, the NPE ratio is down 89bps, the "bad loans" ratio is down 131bps and the Texas ratio is down 409bps. However, this comes with an obvious cost: CET1 capital in the system is down -13.5% but the CET1 ratio is up 68bps due to RWA decrease.

<u>Asset quality metrics are improving</u>



Source: EBA, Axiom AI

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

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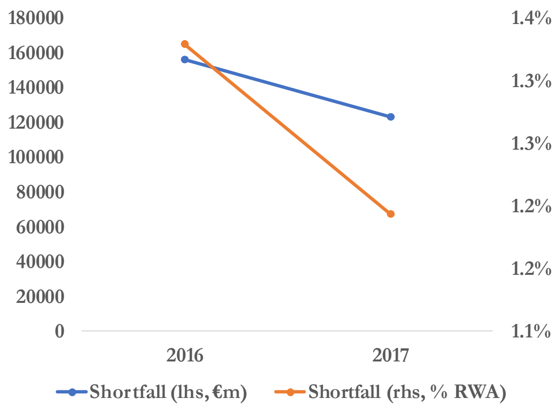
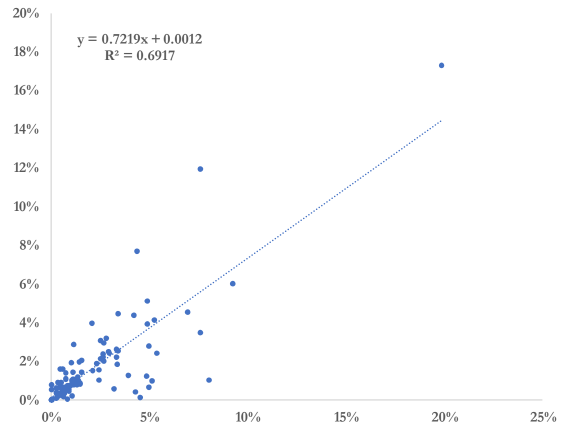
The aggregate provisioning shortfall is going down



Source: EBA, Axiom AI

And this is a broad-based phenomenon: provisioning shortfalls in %RWA, 2016 (x-axis) and 2017 (y-axis)



Source: EBA, Axiom AI

We can see (left chart) that the total provisioning shortfall is going down, both in absolute € number (-21%) and in % of RWA (-14bps.) The right chart shows that this is reasonably shared among EU banks, with an average 28% drop in shortfall for EU banks that did report in 2016 and 2017 – although there are outlier and the quality of the regression is good but far from excellent (69% R^2).

However, the fixed income or resolution risk for bank investors 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 2016 (2% is obviously an arbitrary threshold, but using 3% would not significantly alter the conclusions.) The aggregate shortfall is down 35bn€, or -43%, and this represents 71bps of RWA for these banks, a truly impressive drop.

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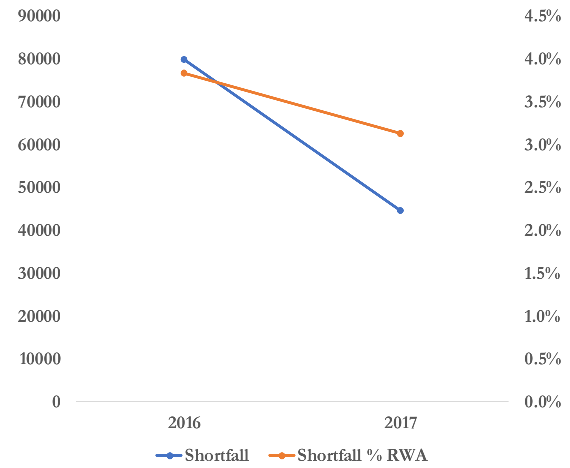
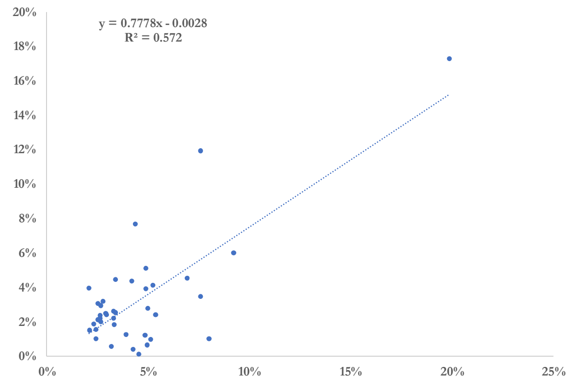
On riskier banks, the aggregate provisioning shortfall is going down



Source: EBA, Axiom AI

Riskier banks: provisioning shortfalls in %RWA, 2016 (x-axis) and 2017 (y-axis)



Source: EBA, Axiom AI

ii. Bank analysis

On a bank by bank analysis we draw the following conclusions from the detailed disclosures.

- **Three banks remain hugely problematic**, we believe: Hellenic Bank in Cyprus, VTB Bank Austria (but as a subsidiary it can be recapitalized by its Russian mother company) and HSH, which is in the process of being sold and recapitalized and which benefits from elaborate government guarantees which complexify the detailed analysis.
- **The Greek banks** are not safe. There has been significant improvement at Alpha Bank and NBG, but the absolute shortfalls remain high, especially at Alpha and Piraeus, and the asset quality metrics are hardly sustainable (Texas ratios between 134% and 162%.)
- Despite still high NPE ratios and Texas ratios between 102% and 166% (setting aside Depfa and Citibank Ireland which are very specific entities), **Irish banks** are often considered the posterchild of EU policy when it comes to NPL management. This is backed by the data with limited shortfalls (except at Bank of Ireland, but where the shortfall has gone down 25%) even at Permanent TSB which seems to have an adequate provisioning despite its high Texas ratio.
- There has been a lot of action at **Italian banks**, with NPE sales, capital raises, resolution decisions, etc., so the EBA data provides a very useful recap of the current situation. We can see that both Monte and Carige remain the most problematic banks, but the full sale of Monte's NPE book was not achieved. Pro-forma for this, Carige exhibits the largest shortfall at 4.12% of RWA and its viability clearly depends on its recapitalization plan – 700m€, vs. our estimated 675m€ shortfall. Unfortunately, there is no data for Creval and we are still in the dark there. The second most problematic bank is Banco BPM with a 1.9bn€ shortfall. This is large (2.42% RWA) but is sharply down from more than 4.2bn and is, we think, manageable from a credit point of view (not good news from an equity point of view, obviously) and close

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to peers (BPER). Intesa and Unicredit still exhibit shortfalls (however the sale of Unicredit's book has not been booked) but manageable ones and both also sharply down.

- In Portugal, the situation of BCP, Novo and Caixa Geral have to be watched closely. Clearly the macro outlook has helped there, and the total shortfall is down a staggering 53%! Novo Banco is now the only bank with a shortfall we estimate above 3% of RWA, at 1.1bn€ (the bank is in the process of doing a 1bn€ recapitalization) or 3.49% RWA. The reduction at Caixa Geral (-71%) is impressive and justifies a more bullish stance on this bank, we believe. BCP is now below the 2% RWA threshold.

- But the most spectacular progress has been achieved in Spain, despite the lack of massive NPE transactions like in Italy – which shows that the single solution to a large NPE stock is simply… economic growth! (easier said than done, obviously.) The aggregate shortfall we estimate in Spain has gone down from 16bn€ to 12bn€ with impressive progress at some banks (Abanca, Cajamar, Ibercaja, Kutxabank, Liberbank and Unicaja.) None of these banks are now in what we would consider dangerous territory on the NPE front (however, remember that Spanish banks still have a large forecloses asset risk which is not analyzed here.)

4. Conclusion

The banking union is not yet achieved: EDIS is its most important tool and is still mostly work in progress. To accept EDIS, some countries demand that banks are cleaned up from legacy assets, especially in the periphery. Now that the political situation is getting clearer (M. Macron in France, a likely coalition in Germany, a likely anti-M5S coalition in Italy, a stable government in Spain, *etc.*) we think stars are aligned to allow further progress on this decisive tool to strengthen the Eurozone. For banks, this means that supervisors will be keen to deliver on one front: the reduction of NPE risk in the Eurozone. Banks will be "incentivised" to shed their NPE books and this will drive their profitability and fixed income risk in the two years to come, in our view. Therefore, the analysis of the latest asset quality data from the EBA is of outmost importance – and one has to say it points to a rather bullish picture. Efforts to tackle the NPE legacy are paying off. The aggregate numbers are improving but, more importantly, the outlier risk is receding. Banks in the periphery have done huge efforts, in Spain, in Italy, in Portugal, in Ireland and even in Greece. Some risks remain – mostly in Greece, Cyprus and Germany –the recapitalisation process has to be finalized for Carige and Credito Valtellinese and some banks still need to deliver on their NPE reduction plans, but these are only a few clouds on a sunny horizon.

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