FINANCIAL SYSTEMS

Digging into the comprehensive assessment data: asset quality evolution

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NPL ratios are much higher in peripheral countries…

Cross country analysis shows high heterogeneity in asset quality indicators. Banking sectors from peripheral countries (Cyprus, Greece, Slovenia, Ireland, Italy, Spain, and Portugal) display higher non-performing-loan (NPL) ratios than those from Nordic and core European countries. In the baseline scenario NPL ratios more than double, almost tripling (from 2013 to 2016) in banking sectors with very low NPL ratios (Sweden, the Netherlands, Denmark, Luxembourg) and slightly below 2x in banking sectors with very high NPL ratios. These differences make sense but probably should have been amplified (less severe for bad starting points and more severe for good starting points) as it seems quite strict to have, for instance, a NPL ratio of 90% in Cyprus in 2016 in the baseline scenario.

In the adverse scenario the evolution of non-performing loans is worse than in the baseline scenario but the ranking order per banking sector does not change. The average NPL ratio for European banks stands at 16% in 2016 in the adverse scenario, versus 13% in the baseline scenario and 6% in 2013.

…as well as coverage ratios

Those banking sectors with the worst (lowest) NPL ratios are those with the best (higher) coverage ratios. In the Spanish context this is counter-intuitive because historically Spanish banks had very high coverage ratios before the crisis, when NPL ratios were at historically low levels. The differences across countries can be a reflection of: (i) still different provisioning and impairment criteria, in particular more severe in countries that have gone through a restructuring process (ii) higher recovery rates in those countries with lower NPL ratios as result of a faster judicial system, better workout of NPLs or just cyclical difficulties of the borrowers versus more structural problems in banking sectors with higher NPLs, and (iii) differences in the expected value of guarantees and collateral once default occurs.

The stress test might have been benign for some banking sectors

Throughout the stress test, coverage ratios fall significantly (mostly in 2014) reflecting the strong increase in NPLs in this year. The European average (for 123 banks) stands at 63% in 2013 and falls to 43% in 2016. If banks had been required to maintain constant coverage ratios, the stress test would have been significantly harsher. For some banking sectors, the adverse scenario might have been quite mild (or their balance-sheets quite resistant), particularly in Germany, the Netherlands, Belgium and Luxembourg and to a less extent in Sweden and Denmark because these banking sectors do not have a particular stressful starting point (low NPLs and low coverage ratios and the latter can be further reduced throughout the stress test). For the remaining banking sectors, the most stressed are the ones which maintained a coverage level closer to that in 2013 (Slovenia, Austria, UK, Italy and Spain) or a very high cost of risk (Slovenia, Greece, Italy and Ireland).

The cost of risk in the stress test does not stay at 2013 levels

As expected, the amount of impairments is higher in those banking sectors with the worst NPL ratios (with a couple of exceptions). The level of impairments in 2014 is usually lower than that of 2013, which indicates that 2013 was a “one-off” year for many countries. The only exception is in the Nordic countries where impairments increase in 2014 versus 2013, but remain at very low levels (below 30bps). In 2015 and 2016, impairments are also smaller than in 2014, reflecting smaller new NPLs compared to new NPLs in 2014. The lower level of impairments is the main driver of the improvement in profitability for European banks in the baseline scenario. The cost of risk for Spanish banks in 2016 is 72 basis points (bps) down from 190bps in 2013, while the average for European banks stands at 47bps in 2016 (123bps in 2013).

The information published by the EBA for the 123 European banking groups that participated in the stress test allows us to make some cross-country and cross-banks comparisons. When we refer to each banking sector, we mean the aggregate results of participating banks in a given country. To be more precise it includes 123 banks: 24 in Germany, 15 each in Italy and Spain, 11 in France, six each in Austria, Poland and in the Netherlands, five in Belgium, four each in Greece, UK, Sweden and Denmark, three each in Cyprus, Ireland, Portugal and Slovenia, two in Luxembourg and one each in Norway, Malta, Finland, Hungary and Latvia.

The focus of the report is on the evolution of asset quality indicators both in the baseline and the adverse scenario. We compare the evolution of (i) NPL ratios, (ii) the cost of risk (annual impairments as percentage of the loan book) and (iii) total coverage ratios (stock of provisions divided by NPLs).

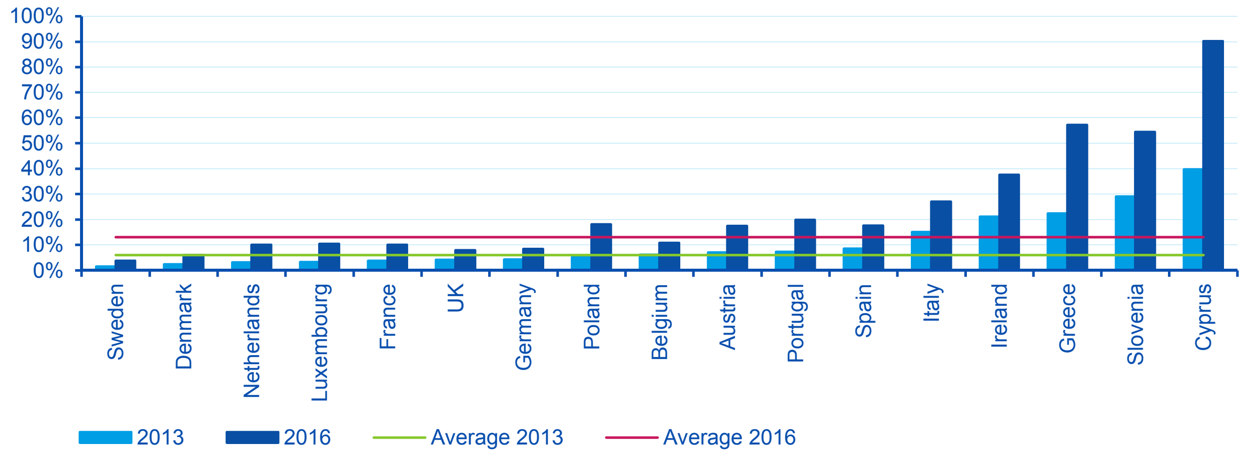
The evolution of asset quality indicators in the stress test

Baseline scenario

Chart 1 shows the NPL ratio at the end of 2013 and in the baseline scenario in 2016. On the right hand side we can see those banking systems with the worse NPL ratios (Cyprus, Slovenia, Greece and Ireland, which all have NPL ratios in 2013 above 20%).

In general, the ranking-order in 2013 and 2016 is maintained but we can observe that Poland, Luxembourg, Netherlands, Portugal and France had a higher than average increase in the NPL ratio throughout the baseline scenario. Contrarily, banking systems from Belgium, Italy and Ireland had a lower than average increase in the NPL ratio. The stress in Cyprus and to a less extent in Greece seems too strict as the starting point is already very high and therefore the NPLs' growth rate should not be similar to banking systems with lower NPL ratios in 2013. The NPL ratio in Cyprus jumps from 40% in 2013 to 90% in 2016 and from 22% to 57% in Greece.

Chart 1
Evolution of the NPL ratio in the baseline scenario



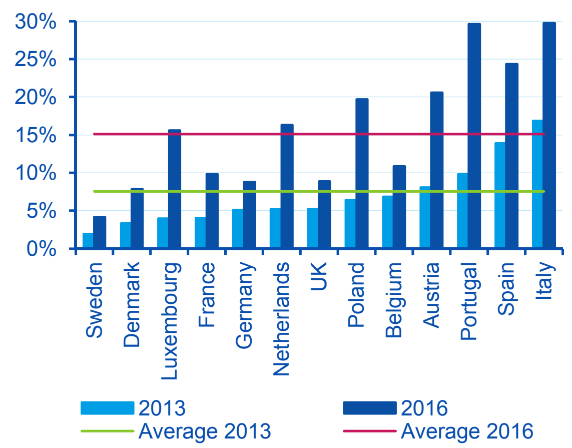
Source: BBVA Research based on EBA

The NPL ratio for Spanish banks stood at 8.6%[1] at the end of 2013 (it includes the international operations of BBVA and Santander, with lower NPLs) and jumped to 17.6% in 2016. For Italian banks the change is from 15% to 27%. Germany and France have a considerably better NPL ratio: at the end of 2013 they stood at around 4% (slightly higher in Germany) and reached 10% in France and 8% in Germany. UK banks' NPL ratio moves from 4% to 8%.

The loan information reported by banks to the EBA was classified in two broad categories: (i) retail, which includes mortgage loans, some SME loans and consumer loans and (ii) corporate, which includes the other portion of SMEs (most probably large SMEs), specialised lending and all other corporates.

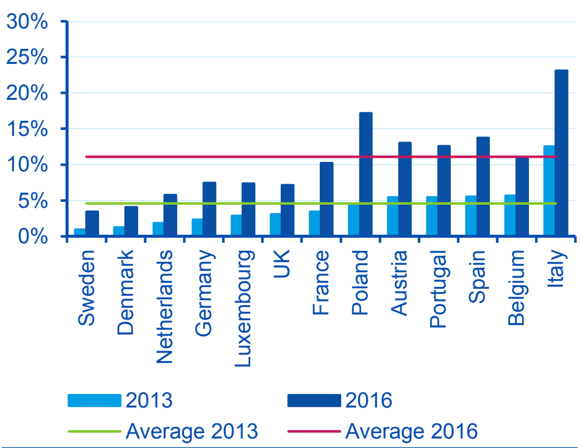
As expected, the evolution of the NPL ratio for the retail and corporate segments shows a similar trend to that at aggregate level. However, the differences among banking sectors are more pronounced in the corporate segment than in the retail segment, particularly in the starting point (December 2013). In addition, the NPL ratio standard deviation is higher in 2016 than in 2013 for both segments. The corporate NPL ratio doubles on average in the period projected, while retail NPL ratio more than doubles.

Chart 2
Corporate NPL ratio in the baseline scenario



Source: BBVA Research based on EBA and ECB

Chart 3
Retail NPL ratio in the baseline scenario



Source: BBVA Research based on EBA and ECB

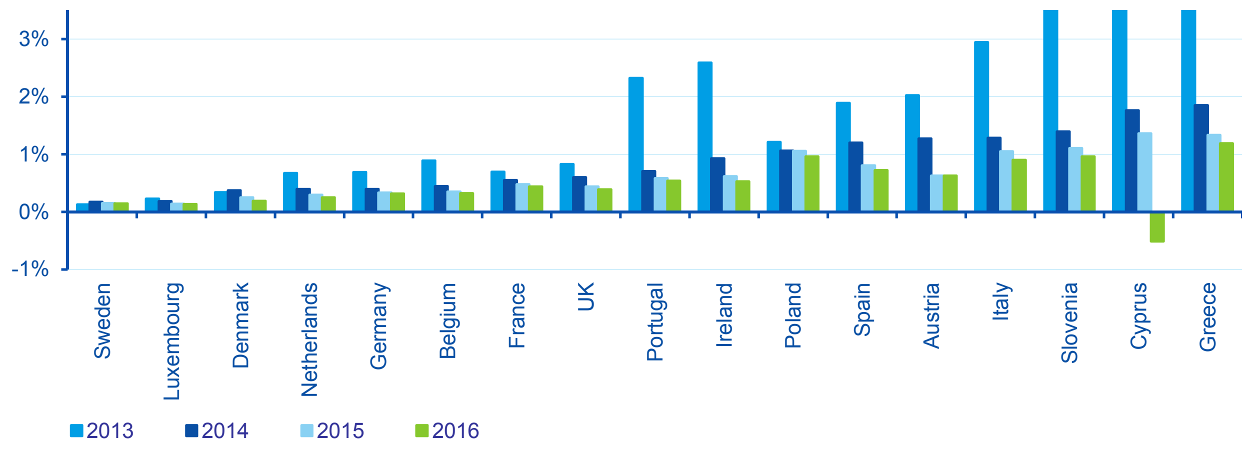
Similarly to the whole portfolio, we can observe that in the corporate segment, banking sectors from Luxembourg, the Netherlands, Poland and Portugal had an above average deterioration in the NPL ratio. In the retail segment the banking sectors with the largest change from 2013 to 2016 were Poland, Sweden, the Netherlands and Denmark. With the exception of Poland, the largest deterioration occurs in banking sectors with the best (lowest) NPL ratios in 2013.

Although there is an increase in NPLs (the static balance sheet assumption does not allow for any other alternative as there is no workout of NPLs, there is no new credit and some performing loans will necessarily turn non-performing[2]), the level of provisions booked each year does not necessarily increase vis-à-vis the previous year because the flow of new NPLs might be smaller. Chart 5 compares the cost of risk (impairments of each year divided by the total loan portfolio) for each banking sector.

1: The 8.6% is not comparable to the Spanish banking sector NPL ratio at the end of 2013 which stood at around 13% because EBA data includes the consolidated balance sheet of BBVA and Santander whose international activity displays better asset quality indicators than the Spanish.
2: There were 29 Eurozone banks which were allowed to use dynamic balance sheets as they had restructuring plans approved by the European Commission. For the non-Eurozone banks there is no information on if there is any bank which was allowed to use a dynamic balance sheet.

As expected, the amount of impairments is higher in those banking sectors with the worst NPL ratios. Some exceptions are Ireland with one of the worst NPL ratios but with an average cost of risk (because new NPLs are likely to be in line with the average) and Austria in 2014 as it displays one of the largest levels of impairments (the deterioration in the stress test is quite severe) despite an average NPL ratio.

Chart 4
Cost of risk (Annual impairments as % of loan portfolio) in 2013, 2014, 2015 and 2016



Source: BBVA Research based on EBA

Another conclusion from chart 4 is that the level of impairments in 2014 is usually lower than that of 2013, which indicates that 2013 was a "one-off" year for many countries. This is the case of Spain, where impairments gradually converge to the pre-crisis levels. The only exception is for Nordic countries where impairments increase in 2014 versus 2013, but remain at very low levels (below 30bps).

In 2015 and 2016, impairments are also smaller than in 2014, explained by the small amount of new NPLs in 2015 and 2016 versus the new NPLs in 2014 (most of the deterioration occurs in 2014). The lower level of impairments is the main driver of the improvement in profitability for European banks in the baseline scenario.[3]

The cost of risk for Spanish banks in 2016 is 72 basis points (bps) down from 190bps in 2013, while the average for European banks stands at 47bps in 2016 (123bps in 2013). All banking sectors with the exception of Greece have a cost risk below 100bps in 2016, with the Nordic, Dutch and German banks displaying a cost of risk of around or below 30bps.

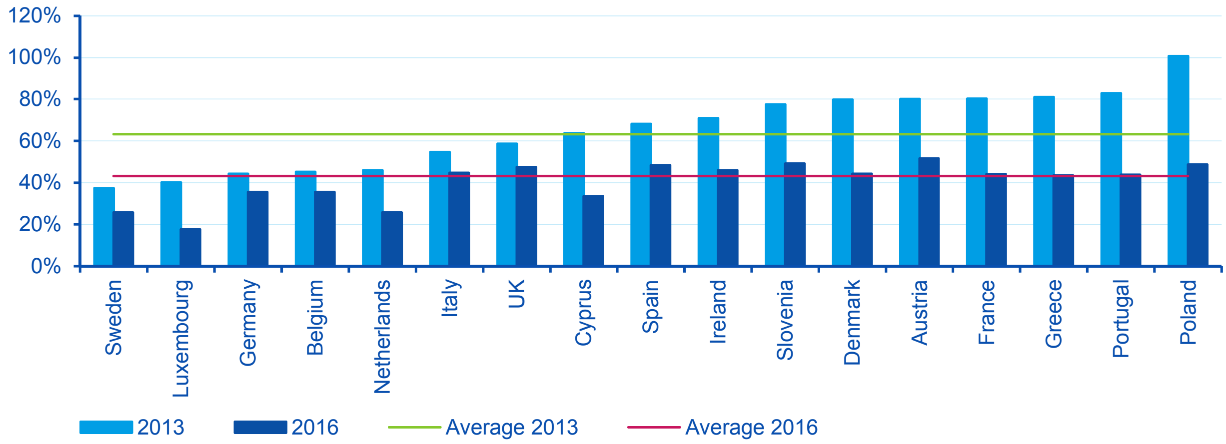
The fact that yearly provisions fall while NPLs continue to increase, translates into smaller coverage ratios (chart 5). The fall in coverage ratios occurs mainly in 2014 reflecting the strong increase in NPLs in this year. The European average for the sampled banks stood at 63% in 2013 and falls to 43% in 2016. If banks had been required to maintain constant coverage ratios, the stress test would have been significantly harsher.

There is substantial heterogeneity across the different banking sectors, with lower coverage ratios for countries with lower NPL ratios and higher coverage ratios for countries where NPL ratios are larger. There are some banking sectors which display a small coverage ratio (around or below 40%) at the end of 2013 and after the stress test end up with even smaller ratios (18% in Luxembourg, 26% in Sweden and the Netherlands, 35% in Germany and Belgium in 2016) which implies a boost on profitability.

3: See "Digging into the comprehensive assessment data: Profitability", November 2014, BBVA Research .

As mentioned before, banks with the worst NPL ratios display the highest coverage ratios (at around 80%) and were allowed to reduce this coverage ratio to just above 40%. Therefore the stress does not seem to aim to harmonise coverage ratios although there was a slight convergence.

Chart 5
Coverage ratio (Total stock of provisions as % of loan book) in 2013 and 2016



Source: BBVA Research based on EBA

Different coverage ratios across banking sectors after the stress test could mean that the level of losses in some banking sectors – Sweden, Luxembourg or Germany - are much smaller than in peripheral countries. This could result from a less risky portfolio concentrated for example in retail mortgages versus unsecured credit with the former requiring lower provisions given the lower severity. Notwithstanding, the analysis of coverage ratios per portfolio (retail and corporate) does not shed much light on this issue as some banking sectors always have lower coverage ratios both in the retail and in the corporate segment, possibly indicating that expected losses are always lower. This could be related to higher recovery rates, as result of faster judicial systems, a lower decrease in the value of collateral or just a reflection of cyclical difficulties of the borrowers that will recover quickly. Other explanation for the differences could stem from still different provisioning and impairment criteria.

In conclusion, in the baseline scenario asset quality indicators deteriorate across all banking sectors: NPL ratios increase (which is normal in a stress test) while coverage ratios decrease (which is also normal because provisions are to be used when NPLs increase, although probably the magnitude of the fall might have been excessive in some banking sectors). In addition, the amount of yearly impairments goes down throughout the exercise and is substantially smaller in 2016 than that booked in 2013 which implies a relief for most banks. The cost of risk reaches relatively low levels, which is compatible with the economic recovery implicit in the baseline macroeconomic scenario.

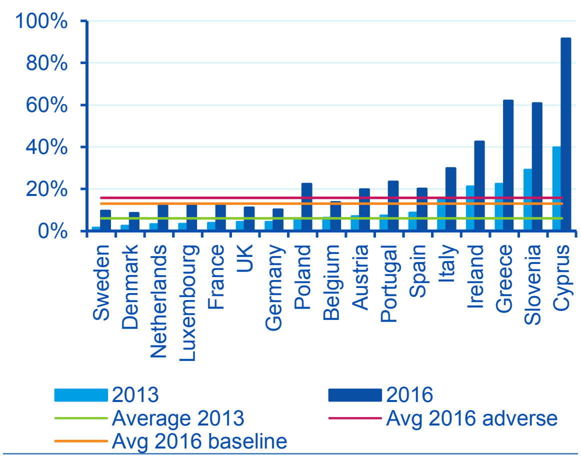
Adverse scenario

In the adverse scenario the evolution of non-performing loans is worse than in the baseline scenario, but the ranking order per banking sector does not change as the starting point is determinant in the evolution throughout 2014-2016.

The average NPL ratio for European banks stands at 16% in 2016 in the adverse scenario versus 13% in the baseline scenario and 6% in 2013. In the adverse scenario it is more common to have a larger increase in NPLs in those banking sectors with the best (lowest) NPL ratio. For example, Swedish banks reach a NPL ratio of circa 10% in 2016 (compared to 1.4% in 2013 and 3.8% in the baseline scenario). Spanish banks reach a NPL ratio of 20% in 2016 versus 17.6% in the baseline scenario and 8.6% in 2013.

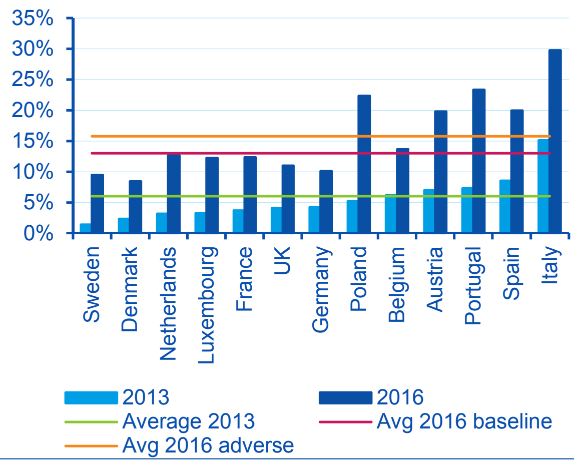
Therefore several banking sectors do not experience a severe deterioration from the baseline to the adverse scenario with most of the stress already occurring in the baseline scenario (this is the case of Cyprus, Slovenia, Spain, Italy, Ireland and Greece). In the other banking sectors, the deterioration in the adverse scenario is more pronounced. This behaviour is normal considering that the former already had a stressed starting point (and baseline scenario).

Chart 6
Evolution of the NPL ratio in the adverse scenario



Source: BBVA Research based on EBA and ECB

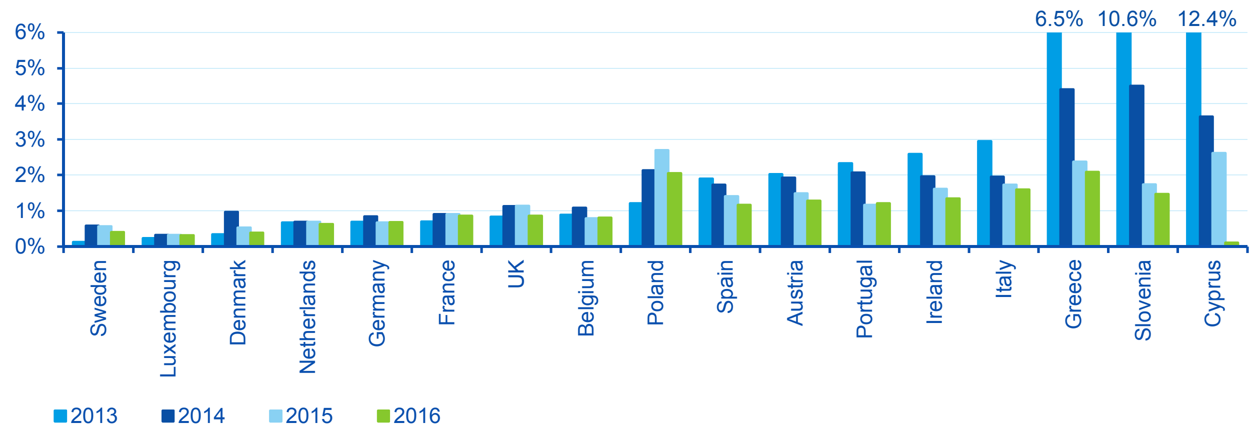
Chart 7
Evolution of the NPL ratio in the adverse scenario



Source: BBVA Research based on EBA and ECB

Regarding the cost of risk, the level of impairments is naturally higher in the adverse scenario than in the baseline scenario and in several banking sectors impairments increase in 2014 when compared to 2013 (Sweden, Luxembourg, Denmark, Netherlands, Germany, France, UK, Belgium and Poland) which was not the case in the baseline scenario. For the remaining banking sectors the level of impairments in 2014 is still below that booked in 2013, although the gap narrowed considerably.

Chart 8
Cost of risk (Annual impairments as % of loan portfolio) in 2013, 2014, 2015 and 2016 in the adverse scenario

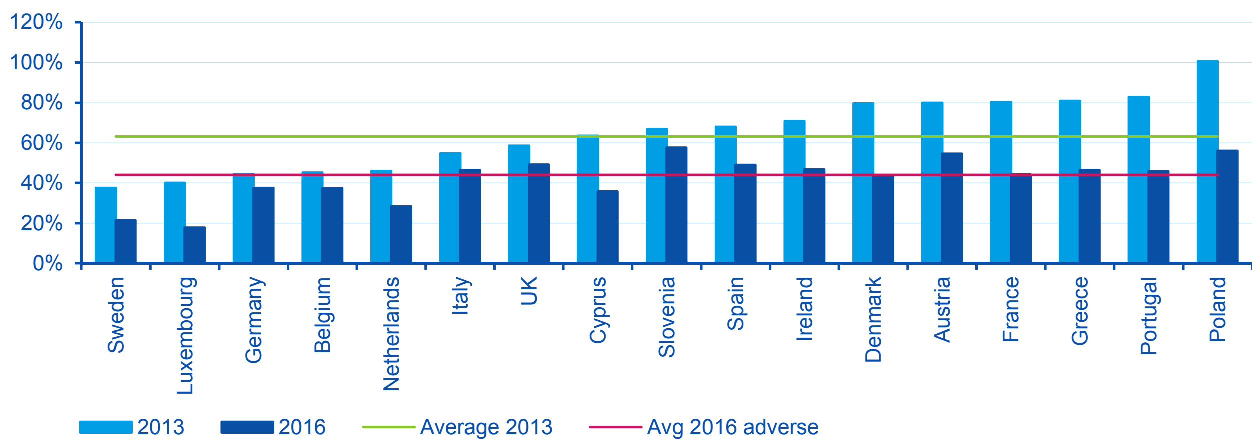


Source: BBVA Research based on EBA

The cost of risk for Spain stands at 172bps in 2014, 140bps in 2015 and 116bps in 2016. With the exception of Luxembourg, the cost of risk increases to at least 50bps in 2016 even for those countries with the best asset quality indicators in 2013. Nevertheless, and despite almost all banking sectors reaching NPL ratios of at least 10% in 2016, the level of impairments is relatively modest with an average cost of risk of only 92bps in 2016 at European level (the average level in 2013 was 123bps). For some banking sectors such as the German, the Dutch, the Belgium and Luxembourg, the adverse scenario does not imply a worsening in the level of impairments (which is common to other banking sectors in peripheral countries) but the key difference is that these banking sectors where not under stress in 2013 (which is the case of several peripheral banks which performed balance sheet clean-up that year).

Finally, regarding the coverage of NPLs by the stock of provisions, the level is very similar to that observed in the baseline scenario (chart 9).

Chart 9
Coverage ratio (Total stock of provisions as % of NPLs) in 2013 and 2016 in the adverse scenario

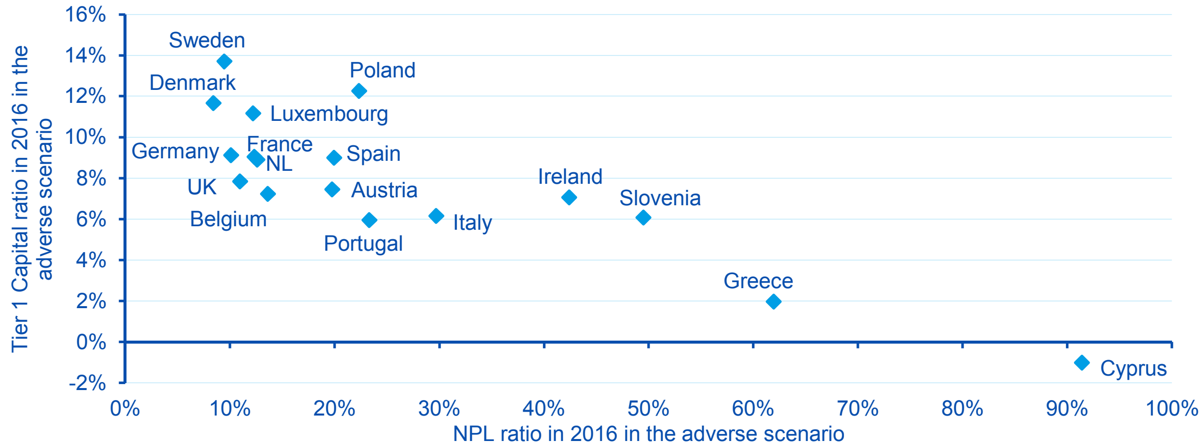


Source: BBVA Research based on EBA

In fact, the average is 44%, versus 63% in 2013 and 43% in the baseline scenario. Having a slightly higher coverage ratio in the adverse scenario is much more demanding that what the increase in the ratio could suggest, because the level of NPLs in the adverse scenario is larger than in the baseline scenario. This is compatible with the need of a high cost of risk in a stressed situation and, consequently, a stronger deterioration in profitability. The heterogeneity across banking sectors replicates the one observed in the baseline scenario.

Finally, chart 10 shows the relationship between the NPL ratio in 2016 in the adverse scenario and the CET1 capital ratio in 2016 in the adverse scenario. The banking sectors with the worst final capital are the ones with the highest NPL ratio.

Chart 10
CET1 capital ratio and NPL ratio in 2016 in the adverse scenario



Source: BBVA Research based on EBA

In conclusion, in the adverse scenario we could argue that the stress test might not have been sufficiently harsh for some banking sectors. Although it is true that the level of NPLs increases quite substantially from the level in 2013, this does not translate into a strong hit in the P&L as banks are allowed to reduce their level of coverage. This is particularly relevant for Germany, the Netherlands, Belgium and Luxembourg and to a less extent in Sweden and Denmark because these banking sectors do not have a particular stressful starting point. For the remaining banking sectors, the most stressed are the ones which maintained a coverage level closer to the one in 2013 (Slovenia, Austria, UK, Italy and Spain) or a very high cost of risk (Slovenia, Greece, Italy and Ireland).