Financial Institutions

DBRS: Basel IV - Significant but Manageable Impact for Resilient Dutch Banks

Solid domestic economic growth supported FY2017 performance. Strong capital position and profitability as well as management actions are expected to mitigate impact of Basel IV.

Highlights:

- Major Dutch banks reported resilient profitability in FY17 on the back of stable core revenues and cost of credit at very low levels.
- Innovation and network rationalisation are underway.
- Strong asset quality underpinned by favorable economic conditions.
- Estimated Basel IV impact significant but mitigated by the Banks' strong capitalisation and profitability.

Overview

DBRS considers the full year (FY) 2017 results for the major Dutch banks[1] remained resilient, underpinned by exceptionally low credit costs and stable revenues from core business activities. Investments in innovation and digital transformation have continued as well as efforts to improve efficiency levels.

The new Basel IV framework, with an output floor on risk weighted assets (RWAs) calculated using internal models, is expected to increase the Banks' RWAs by approx. 25%, on a pro-forma basis, equivalent to around 300bps of CET1. Despite being significant, in DBRS' view the impact is manageable, considering the Banks' strong capitalisation and profitability, as well as the long implementation timeframe.

Low cost of risk and resilient core revenues support profitability

On an aggregate basis, Dutch Banks reported net profits of EUR 10.4 billion in 2017, up from EUR 8.5 billion in 2016, partly reflecting that 2016 was impacted by high non-recurring expenses. On an underlying basis, profitability was resilient supported by improving core revenues and lower cost of risk. Underlying costs increased, however, and efficiency improvement remains a priority for banks.

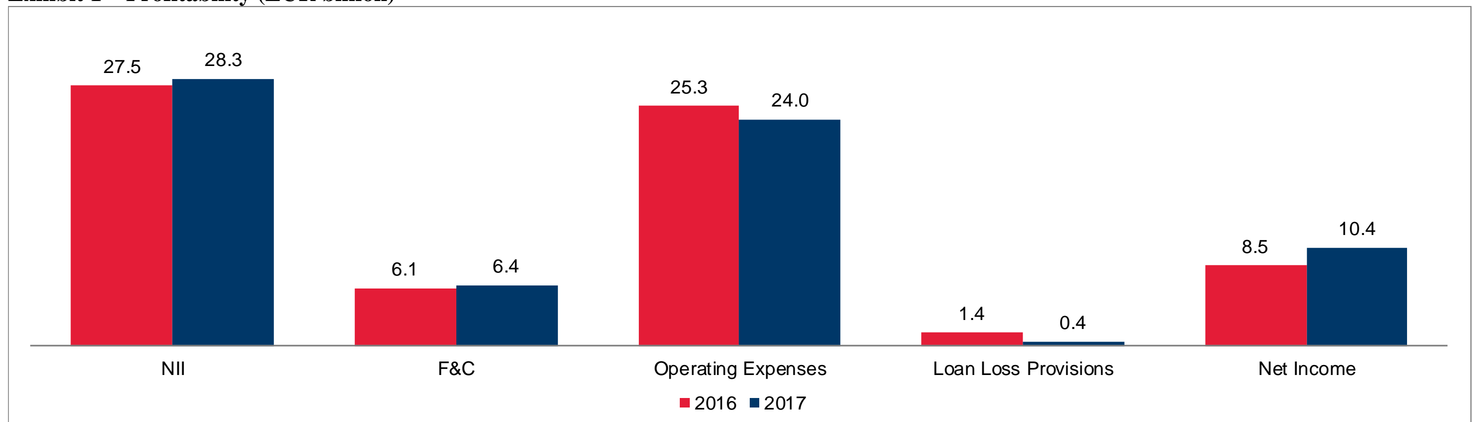
Net interest income (NII) increased by 2% year-on-year (YoY) to EUR 28.3 billion as new loan production and repricing efforts offset early mortgage redemptions and renegotiations as well as margin pressure. Transaction fees and growing investment products drove fees and commissions (F&C) up 5% to EUR 6.4 billion.

Operating expenses declined to EUR 24.0 billion, from EUR 25.3 billion in 2016, mostly driven by lower restructuring costs and SME-derivative related provisions. Adjusted for these, however, underlying operating costs increased by 2.6%, due to still high regulatory expenses and investments in innovation. These investments, together with the planned headcount and branch reductions, should support the Banks' efforts to improve efficiency and productivity and to move closer to their cost-to-income ratio targets.

The solid growth of the Dutch economy and low unemployment levels, alongside the recovery of the housing market and subdued interest rates, continued to drive the low cost of risk. This reduced further in 2017 to 3bps, from 11 bps in 2016, with ABN AMRO and Rabobank reporting net loan loss reversals. Asset quality also improved, with the stock of NPLs down 10% YoY, on the back of higher recoveries, whilst the gross NPL ratio decreased to 3.0% at end-2017 from 3.3% at end-2016.

In DBRS' view, core revenues in 2018 should remain stable, with moderate loan volume tailwinds and growing fees offsetting pressure on margins. Cost savings initiatives and innovation will continue. Considering the positive momentum in the Dutch economy, furthermore, DBRS expects cost of risk and NPLs to remain at low levels in 2018.

Exhibit 1 – Profitability (EUR billion)



Source: Company data, DBRS calculations.

(1) Major Dutch banks include ABN AMRO Group, ING Group and Coöperatieve Rabobank. Source: Company data and DBRS Calculations. Aggregate figures.

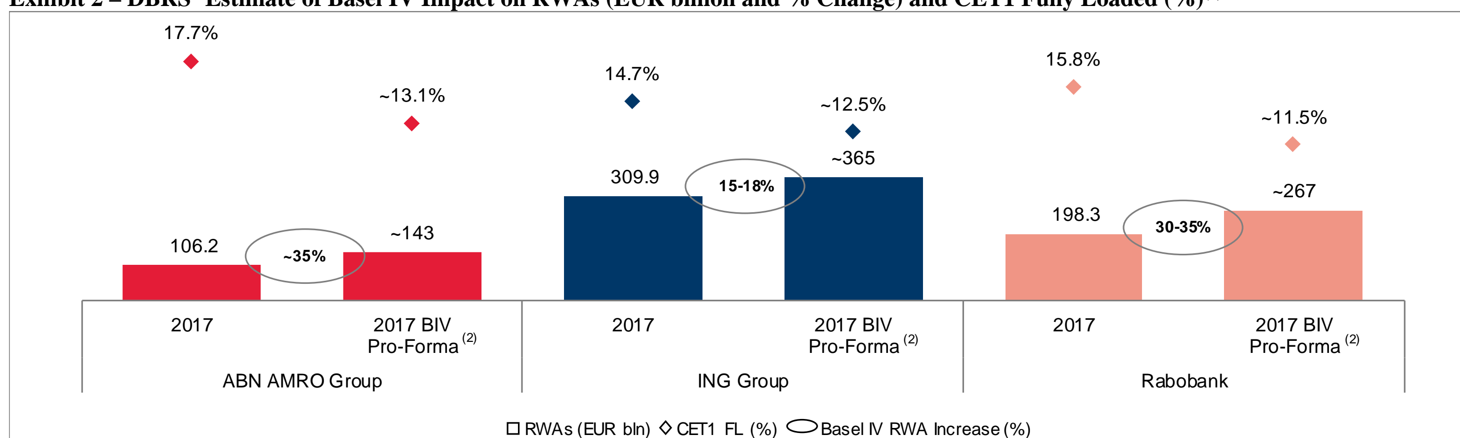
Basel IV impact on capital significant but manageable

The Banks' capital positions remained strong, with the aggregate CET1 (fully loaded) ratio improving to 15.5%, from 13.5% at end-2016, on the back of retained profits and RWA optimization. The improvement was also supported by EUR 1.6 billion proceeds from the issuance of Rabobank certificates at the beginning of 2017.

On December 7, 2017, the Basel Committee on Banking Supervision (BCBS) reached agreement on a new framework for calculating capital requirements for banks, often referred to as Basel IV. According to DBRS' calculations, Basel IV is expected to increase the major Dutch banks' aggregate RWAs at YE2017 by approximately 25%, on a pro-forma basis, which could push the aggregate CET1 ratio down by approximately 300bps to 12.2% [Exhibit 2].

The higher capital requirements will be mainly driven by tightened rules on internal models, in particular the introduction of an aggregate output floor, calibrated at 72.5% of the RWAs calculated under standardized approaches. This will restrict the regulatory capital benefits that banks can obtain from internal models. Dutch banks are significantly exposed to this output floor, due to their sizeable mortgage portfolios with relatively high loan to value ratios, for which historically low credit losses have resulted in low risk weightings. As of end-2017, Dutch Banks' residential mortgage portfolios accounted for almost half of their customer loan books, with an average loan-to-value ratio of circa 70%.

Exhibit 2 – DBRS' Estimate of Basel IV Impact on RWAs (EUR billion and % Change) and CET1 Fully Loaded (%)(2)



Notes: (2) DBRS Estimates for Basel IV RWAs and CET1 ratios are based on static balance sheets at end-2017 and do not consider management actions, future earnings retention or regulatory developments. – Source: Company data, DBRS Calculations.

In DBRS' view, the impact of Basel IV on the major Dutch banks is significant but overall manageable, given their strong capital and profitability levels as well as the long implementation timeframe. The output floor reform will be phased in over a 5-year period starting from 2022, giving banks time to strengthen their buffers. In this period, we expect banks to increasingly focus on internal capital generation and balance sheet optimisation. With an aggregate annual net profit of approximately EUR 8 billion in the last three years, equivalent to around 100 bps of CET1 per year including pro-forma Basel IV RWA inflation, Dutch banks are well positioned to generate capital organically. Banks have also started to reduce their RWAs via disposals of non-core assets and mortgage portfolios. In addition, policies on new loan origination and pricing are expected to be revised.

DBRS' Rated Dutch Banks – Individual FY2017 Results Snapshots

ABN AMRO Group N.V.

Issuer	Debt	Rating	Trend
ABN AMRO Bank N.V.	Long-Term Issuer Rating	A (high)	Stable

Resilient FY17 profitability supported by loan impairment reversals and slightly higher loan volumes

- ABN AMRO Group reported a FY2017 net profit of EUR 2.8 billion, versus a net profit of EUR 1.8 billion in 2016. The result, however, included several incidentals, such as gains from the disposal of the Private Banking business in Asia and from the sale of the equity stake in Visa, as well as restructuring charges and other provisions. In 2016 the results were negatively impacted by a pre-tax charge of EUR 361 million for SME-derivative related provisions, but included gains from the Visa disposal and Equens revaluation. Excluding the incidentals, pre-tax profit improved 20% YoY on the back of loan loss reversals, lower underlying costs, better equity participations and hedge accounting results, and resilient net interest income.
- NII was up 3% YoY to EUR 6.5 billion, but included a number of one offs (unearned interest, mortgage penalties, Euribor provisions). Adjusted for these, underlying NII was up 1% helped by volume growth in residential mortgages and corporate loans. Other income increased to EUR 1.1 billion, from EUR 501 million in 2016, driven by gains from the disposal of Private Banking Asia and higher contributions from equity participations.
- Operating expenses were slightly down 1% YoY to EUR 5.6 billion, thanks to lower staff and restructuring costs. Underlying cost-to-income stood at 60%, and the Group expects to achieve the 56-58% target by 2020 via cost efficiencies from digitisation and further network optimisation.
- Cost of risk benefitted from the benign economic environment in the Netherlands, with a net loan loss reversal of EUR 63 million, from a EUR 114 million charge in FY 2016. Positive developments were registered across the whole loan book, including the ECT portfolio for which cost of risk improved to 66bps, from 83bps. The Group's NPL ratio, which includes impaired and more than 90 days past due customer loans, decreased to 2.7% at end-2017, from 3.3% at end-2016.
- The CET1 ratio (fully loaded) remained strong at 17.7% at 2017, which compares favorably with a CET1 SREP requirement of 10.4% for 2018 and of 11.78% for 2019. At end-2017, the leverage ratio was 4.1%, up from 3.9% at end-2016, driven by the issuance of EUR 1 billion AT1 instrument in October 2017 and a lower exposure measure, which more than offset then EBA Q&A ruling on minority interests.
- Basel IV is estimated to increase ABN AMRO's RWAs at end-2017 by around 35%. This could push the Group's CET1 ratio down to approx. 13.1%, based on DBRS calculations. In DBRS' view, this impact is manageable, also considering that ABN AMRO has generated an average net profit of 200bps of CET1 capital in the last three years. Furthermore, the Group has announced that it aims to maintain a Basel IV implementation buffer of 4-5% in CET1 and has accordingly revised its 2018 CET1 target to 17.5%-18.5%. This target will be reviewed annually to reflect regulatory developments such as TRIM and SREP.

ING Group N.V.

Issuer	Debt	Rating	Trend
ING Bank N.V.	Long-Term Issuer Rating	AA (low)	Stable

Strong core profitability offset by higher investments in digital infrastructures and business growth

- ING Group reported a net profit of EUR 4.9 billion, from EUR 4.7 billion at end-2016, which was affected by material non-recurring items. On an underlying basis, however, net profit was stable at EUR 5.0 billion as higher investments in digital infrastructures and business growth offset growing net interest income and fees as well as lower loan loss provisions.
- NII increased to EUR 13.7 billion for FY2017, from EUR 13.2 billion for FY2016, supported by growing loan volumes in the Retail Challenger and Growth Markets as well as Wholesale Banking, whilst net interest margin improved slightly to 1.54%, from 1.52% (4-quarter rolling average), thanks to repricing. F&C went up 11.5% to EUR 2.7 billion, largely driven by growth in wholesale banking as well as retail investment products. Other income, however, was affected by lower market activity (-20.5% YoY to EUR 1.1 billion).
- Underlying cost-to-income ratio deteriorated slightly to 55.5%, from 54.2% in 2016, mainly due to higher marketing and staff expenses to support franchise growth and investments in digital. These investments should help to reduce the cost base in the future and to achieve the targeted cost-to-income ratio of 50-52% set for 2020.

- The benign operating markets drove loan loss provisions down by 30.6% to EUR 676 million, accounting for less than 10% the Group's income before provisions and taxes (IBPT). The DBRS-calculated NPL ratio decreased to 2.1% at end-2017, from 2.3% a year earlier, on the back of improvements in Retail Benelux and wholesale banking, in which the stock of NPLs decreased by 15% and 8% YoY respectively. The NPL ratio of the Oil and Gas loan book increased to 3.3%, from 2.1% in 2016, however, but the size of this portfolio remains small, representing just 6% of the loan book.
- The Group's CET1 ratio (fully loaded) stood at 14.7% at end-2017, up 50bps YoY thanks to internal capital generation and lower RWAs. This compares favourably with the CET1 SREP requirement of 10.4% for 2018 and 11.8% for 2019. Basel IV is expected to increase RWAs in the range of 15-18% all else equal which, according to our calculations, would imply a 190-225 bps negative impact on CET1. The leverage ratio (fully loaded) was 4.7%, down 10bps from end-2016 but well above ING's internal target of 4%.

Coöperatieve Rabobank U.A.

Issuer	Debt	Rating	Trend
Coöperatieve Rabobank U.A.	Long-Term Issuer Rating	AA	Stable

Loan loss reversals, lower one-offs and higher fees underpinned FY17 results

- For FY2017, Rabobank posted a net profit of EUR 2.7 billion, up from EUR 2 billion a year earlier, when results were impacted by higher non-recurring expenses, including the EUR 700 million impairment in the Group's stake in Achmea and EUR 514 million in SME derivative related provisions. Excluding non-recurring items and the contribution of Athlon sold at end-2016, but including the regulatory levies, underlying pre-tax profit improved to EUR 4.0 billion in 2017, from EUR 3.5 billion in 2016, on the back of loan impairment reversals, lower staff expenses as well as higher fees and commissions.
- NII was flat at around EUR 8.8 billion, with the pressure from the low rate environment and early domestic mortgage repayments offset by repricing in the residential mortgage and SME loan books. F&C were up 5% YoY to EUR 1.9 billion supported by the Dutch payment accounts and restructuring fees from the real estate management fund, Bouwfonds Investment Management.
- The Bank's efficiency remained modest, with a reported cost-to-income ratio (including regulatory levies) at 71% in 2017. This compares unfavourably with the 53-54% target set for 2020. The Bank continued to rationalise its network with FTE reductions and investments in digital banking. Since end-2015 approx. 7,000 FTEs left (or 8,200 FTEs including the sale of Athlon), and additional 5,000 FTE are expected to leave by 2020. Operating expenses in 2017 were impacted by EUR 310 million provisions for the settlement of past compliance issues at the Bank's American subsidiary RNA.
- The benign credit environment in the Netherlands supported the Bank's sound asset quality, with lower defaults and higher recovery rates. For FY2017, Rabobank booked EUR 190 million in loan impairment reversals, from a charge of EUR 310 million in 2016, thanks to releases in the domestic retail and real estate segments. Despite the stock of NPLs decreased by 3% YoY, the Bank's DBRS-calculated gross NPL ratio was stable at 4.5% (or 3.5% according to the EBA definition), due to a smaller loan book, following disposals and FX effects.
- The Bank's CET1 ratio (fully loaded) strengthened to 15.5% at end-2017, from 13.5% at end-2016, driven by EUR 1.6 billion proceeds from the issuance of Rabobank certificates in January 2017, retained profits as well as a 6% reduction in RWAs. This compares well with a CET1 SREP requirement of 10.4% for 2018 and 11.75% for 2019. The leverage ratio remained strong at 6% (5.4% fully loaded).
- Rabobank estimates a 30-35% increase in RWAs from Basel IV. In DBRS' view this impact is manageable, given the balance sheet optimization process and the average net profit (including payments on the Bank's capital securities) of ~70bps of CET1 capital generated in the last three years. Management actions, including disposals of non-core assets and mortgage portfolio, are already underway. The long implementation period (2022-2027), furthermore, gives Rabobank time to adjust its capital buffers.

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