Daiwa Capital Markets

European Banks – Credit Update

- The largest European investment banks continued to lose market share to their US peers in 1Q19, despite some gains made by Barclays and Credit Suisse.
- Deutsche showed fragility in its capital base on its Q1 results, reporting a Leverage Ratio of 3.9%, the lowest among global peers. Yet Moody's, which has the bank's ratings on Negative Outlook, seemed less sanguine about the bank's capital deterioration.

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Recent Developments

Global Investment Banking Revenues in 1Q19

The weak performance in investment banking was a common feature among US and European bank results in Q1, as market volumes and client activity took some time to catch up on the improvement in market performance. Activity was low in both the primary and secondary markets, impacted by the US government shutdown, investor concerns over slowing GDP globally and a somewhat negative geopolitical environment in major markets. That said, as the main concerns diminished, several banks pointed to a noticeable improvement in market activity in March and April, whilst Origination and Advisory pipelines look stronger for Q2.

The whole wallet was down in 3M19 year on year, partly as a result of strong figures reported in 1Q18. Equity sales & trading was down by 20% Y/Y, while the revenue reduction in FICC and Origination & Advisory was less material, at -10% Y/Y, leading to an overall 13% decline in total Investment Banking revenues.

Deutsche's weak performance confirmed the continued loss of market share by the top European global investment banks to their US peers. On an aggregate basis, the four-largest European banks accounted for only 24.8% of investment banking revenues of the largest global investment banks in 1Q19, down from 26.4% in 1Q18.

UBS saw the largest drop in Investment Banking revenues (-26%), due to its dismal performance in Origination & Advisory (-48%), closely followed by Deutsche (-23%), which once again reported very weak performance in FICC sales & trading (-10%), partly driven by the bank's exit of some key product areas in the US.

On a positive note, Credit Suisse, which seems to be on track to overtake Deutsche as the largest Investment Bank in Europe by revenue, made solid market share gains in FICC and Equity, whilst Barclays made good progress in FICC, marginally improving its overall standing.

In all, European banks continue to underperform their American peers. This is partly driven by a much better investment banking environment in America, also supported by more developed capital markets, higher economic growth and higher interest rates. As none of these are likely to change in the near term, European banks are unlikely to make significant gains soon.

Investment Banking Market Share* (%, 1Q19)

	Total IB *(Y/Y change in pp)*	Origination & Advisory	FICC	Equity
JP Morgan	**19.9 (+0.3)**	19.6 (+3.5)	21.7 (-2.2)	17.1 (+1.2)
Citi	**15.6 (+2.0)**	15.2 (+3.8)	20.1 (+2.1)	8.3 (-0.4)
Goldman Sachs	**14.9 (+0.1)**	20.3 (+2.2)	10.7 (-0.2)	17.4 (-0.9)
Morgan Stanley	**13.5 (-0.8)**	12.9 (-2.4)	10.0 (0.1)	19.8 (-0.4)
BofA	**11.3 (0.0)**	6.0 (-0.1)	13.8 (0.3)	11.7 (-0.3)
Deutsche Bank	**7.6 (-1.0)**	5.8 (-0.2)	10.0 (-2.1)	5.2 (-0.3)
Credit Suisse	**6.9 (+0.2)**	8.6 (-2.5)	5.7 (+0.8)	7.3 (+1.5)
Barclays	**5.4 (+0.2)**	6.4 (-0.5)	5.3 (+0.7)	4.6 (-0.1)
UBS	**4.9 (-0.9)**	5.1 (-3.8)	2.6 (+0.5)	8.7 (-0.3)

*Source: Banks financial statements, Daiwa Capital Markets Europe. *As a percentage of revenues of the largest global investment banks. Figures may not be directly comparable due to different disclosure methodologies.*

Investment Banking Revenues Growth (%, 1Q19)

	Total IB	Origination & Advisory	FICC	Equity
JP Morgan	**-12**	10	-18	-14
Citi	**0**	20	1	-24
Goldman Sachs	**-12**	1	-11	-24
Morgan Stanley	**-18**	-24	-9	-21
BofA	**-13**	-12	-8	-22
Deutsche	**-23**	-12	-26	-24
Credit Suisse	**-11**	-30	4	1
Barclays	**-10**	-17	4	-21
UBS	**-26**	-48	9	-22
Total	**-13**	**-10**	**-10**	**-20**

Source: Banks financial statements, Daiwa Capital Markets Europe
** Figures may not be directly comparable due to different disclosure methodologies.*

Deutsche Bank

The discontinuation of the merger talks between Deutsche and Commerzbank is positive for stakeholders. As highlighted in previous notes, the merger would have been credit neutral at best for debtholders. Deutsche highlighted that dis-synergies related to the overlap of clients and significant execution risks were key factors that led to the end of the talks. Overall, the merger would have led to a dilution of the bank's RoE target.

In the end, the two struggling banks wasted 6 weeks they could have used to focus on much needed further optimization of their business models. Commerzbank is reportedly going to be an acquisition target for ING and Unicredit, whilst other potential acquirers can't be ruled out. For Deutsche the path forward is less clear. Its size and complexity make it a difficult acquisition target. The bank hast stated it will stick to the current strategic plan, whilst looking for further business optimization opportunities on a business as usual basis. This is probably sensible for now, as it has already gone through several restructurings, strategic changes and CEOs in recent years, all of which are yet to deliver a sustainable business model.

As the largest European bank by investment banking revenues, Deutsche still has a strong franchise to defend across Origination & Advisory, Equity and FICC. It also has a valuable name with the powerful German corporate sector. That said, 1Q19 results published last Friday highlighted once again the bank's perils, with revenues down year on year for the ninth consecutive quarter. As its often the case when banks reduce Investment Bank operations, revenues decline almost immediately, whilst costs can take much longer to fall. Deutsche's focus on costs reduction is hence sensible; however, these have invariably led to further declines in revenues so far. Both Barclays and Credit Suisse have recently undergone significant restructurings, which are now largely complete. The fact that both made gains in investment bank market share in Q1 shows that there can be a way forward for Deutsche as well.

We also take note of the 20bps reduction on the bank's Leverage Ratio (LR) to 3.9%, significantly lower than all its global peers - SocGen, the second lowest, had a LR of 4.3% as at YE18 - and €1.5bn below the 4.0% requirement from 2022. That said, as a result of reductions in the bank's G-SIBs indicators as at YE18, Deutsche expects a reduction in its G-SIB capital buffer from 2.0% to 1.5% from 2021, which would reduce its LR requirement from 4% to 3.75%. The capital base remains much weaker than Deutsche's peers nonetheless.

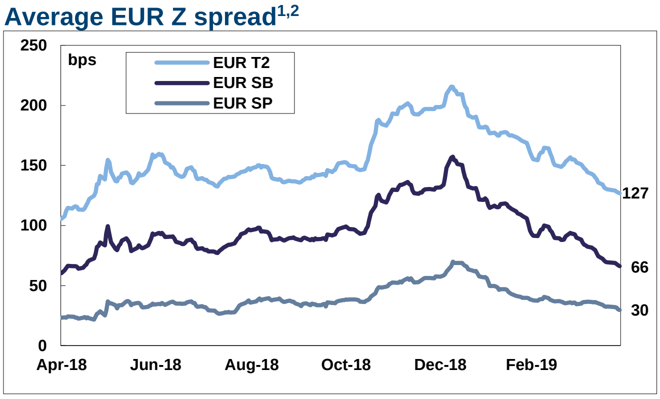
Moody's rates Deutsche's Senior Non-Preferred debt (SNP, senior unsecured bail-in-able debt), at Baa3, just one notch above sub-investment grade, with a Negative Outlook. However, whilst we see a deterioration in the bank's credit profile following the Q1 results, the agency still sees Deutsche's capital base as 'sound', meaning it remains unclear when and if the agency will downgrade the bank's notes. S&P rates Deutsche SNP debt at BBB-, also just one notch above sub-investment grade, albeit at Stable Outlook.

Markets

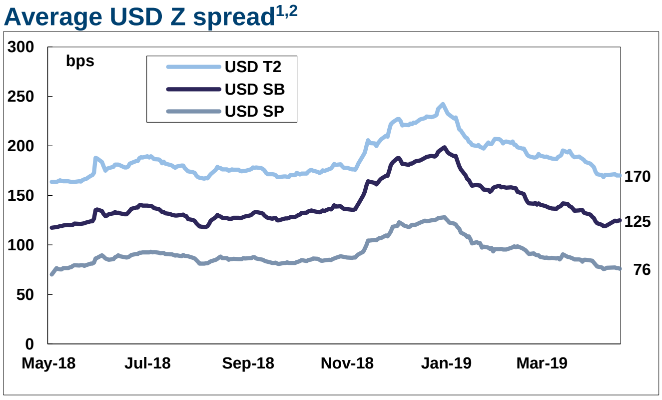
EUR and USD spreads followed somewhat different trends over the past couple of weeks in secondary markets. EUR rates continued to tighten significantly, particularly since the signals from the ECB that it would consider a tiered system on deposits placed at the central bank, which accompanied the confirmation of a new round of TLTROs. In the past couple of weeks, the decline in EUR rates was also supported by further evidence of the weak economic sentiment in the euro area. This compression in spreads led senior bail-in-able paper to trade at only 36bps above senior preferred paper on average, the lowest level since early 2018. USD spreads on the other hand moved largely sideways in the past couple of weeks, in the absence of major shifts in economic trends, with Senior Bail-in-able paper still trading at its long-term average of 49bps above Senior Preferred debt.

Driven by the favourable conditions in the EUR market, US dollar equivalent of euro funding moved to flat or only marginally in favour of US dollar funding for North American banks, leading them to seek investor diversification in the EUR market, with RBC, Citi, Morgan Stanley and Wells Fargo tapping the EUR market in the past couple of weeks. The primary market for European banks on the other hand was much quieter, given the traditional slow Easter period and ongoing earnings season. In the past couple of weeks, we've only seen Svenska and Credit Agricole tapping the market. The former with a 5Y GBP300m placement priced at G+85,5bps within IPT, the latter with a 12NC7 SGD325m Tier 2 paper. Today we saw Rabobank in the market, with a €750m 12Y SNP paper, guidance at MS+60/65bps.

Average EUR Z spread[1,2]



Average USD Z spread[1,2]



Source: Daiwa Capital Markets Europe Ltd, Bloomberg. SP= Senior Preferred; SB=Senior Bail-in (Senior Non-Preferred, Senior HoldCo)

[1] Average Z-Spread of the largest European banks' debt securities across maturities. Not adjusted for duration. Herein included figures may not be reflective of the whole market. [2] Mid Z Spread to maturity/call.

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