European Banks – Credit Update

- The dovish shift from the Fed and the ECB last week has led to a further tightening of European banks spreads, yet the long-term impact of low interest rates on banks' profitability will further weaken their overall credit profile.
- European banks remained active in the JPY market in June, with BPCE showing that there remains demand for TLAC paper issued by G-SIBs.

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Recent Developments

Dovish central banks

Last week's dovish shifts from the Fed and the ECB led our economists to change our forecast for the ECB policy, with a 10bps cut in the deposit rate to -0.5% (accompanied with a move to tiering) in September now being our baseline. Although the prospect of lower interest rates may reduce spreads in the short term, it could further squeeze euro area banks' profitability, in turn weakening internal capital generation capacity. Euro area banks would hence be no better positioned to face any significant economic downturn. The dovish shift on interest rates could be particularly negative for German banks, the most sensitive to interest rate movements, and further reduces the attractiveness of Commerzbank as an acquisition target.

The introduction of a tiered interest rate system on deposits placed at the ECB, on similar lines to those of the BoJ and SNB, would provide some relief for euro area banks. These currently have to pay 40bps on all deposits held at the ECB, leading to an estimated annual cost to euro area banks of EUR7.5bn (40bps on an average of EUR1.87tn of deposits). However, we note that excess liquidity holdings at central banks is unevenly distributed among countries and banks within the euro area, with Germany and France accounting for around 60% of excess liquidity holdings. This is in part driven by the fact that banks in higher-risk/higher-yielding countries are likely to reinvest their excess reserves in their home country sovereign bonds. In that context, any benefit from changes to the ECB deposit facility would need to be assessed on a bank-by-bank case.

Finally, talks of a 'Japanification' of Europe – low economic growth, low interest rates and low inflation for a prolonged period – paint a bleak picture for the region's banking sector future. In addition to addressing the current negative pressure points (e.g. a high regulatory and compliance burden, intense competition, fintech, etc.), banks in the euro area in particular need to adjust their long-term strategies to a prolonged period of low interest rates and limited economic growth in order to ensure sustainable business models and stable credit profiles.

Natixis

Natixis (71% owned by BPCE) was hit last week by Morningstar's decision to withdraw its rating of a fund managed by H20 Asset management (50% owned by Natixis), citing questions over liquidity and governance at the H2O fund, driven by exposures of the fund to Lars Windhorst, a German entrepreneur with a history of legal troubles. The story has reportedly led so far to EUR3bn in outflows, and to a 17% drop in Natixis shares, although the share price recovered somewhat by the end of the week. Natixis accounted for 40% of Groupe BPCE's revenues in 2018, meaning any significant drop in earnings by Natixis would have a noticeable impact on the group, which already reports profitability weaker than its French peers. The EUR3bn may seem modest compared to the group's total AUM of EUR855bn reported at end-1Q19. However, the story raises questions about BPCE's strategy of maintaining a network of 25 affiliate asset managers held at arms-length from the group.

Markets

Following the dovish statements by the Fed and the ECB, spreads tightened further last week, leading to a 7bps tightening on the EUR Z-spreads of senior bail-inable debt of European banks, and a similar 4bps tightening of USD Z-spreads, a 20bps/13bps tightening in June alone in the EUR/USD market (see chart below). Despite the favourable conditions for issuers in the EUR and USD primary markets, activity slowed somewhat last week, following two weeks of strong activity. That said, transactions still closed with significant discounts to IPT, pricing at 20-25bps within IPT in both the senior preferred, and senior non-preferred space, with book orders on average comfortably more than two times the final transaction size.

Key recent transactions

- Banco Santander, SP, USD2.5bn, dual tranche 5Y/10Y, priced at MS + 95/130 bps, IPT at MS + 120/155 bps
- Santader Consumer Finance, SP, EUR1bn, 5Y, priced at MS+67 bps, books in excess of EUR3.4bn, IPT as MS + 90 bps
- Unicredit, SP, EUR1.25bn, 6NC5, MS + 155bps, book orders in excess of EUR4.75bn, IPT at MS + 185/190 bps
- Credit Suisse, HoldCo, EUR1bn, 8NC7, priced at MS + 105 bps, books orders in excess of EUR3.25bn, IPT at MS +130 bps
- Credit Agricole, SNP, EUR1bn, 5Y, priced at MS + 70, book orders in excess of EUR2.4bn, IPT at MS +90 bps

Source: BondRadar

The inclusion of a call option on Unicredit's senior preferred transaction was unusual. We believe the bank aims to use the senior preferred allowance under the bail-in rules, so that a non-call option one year before maturity would become more efficient. The format may have made economic sense for Unicredit due to the wide spreads currently on its senior preferred paper. Unicredit's transaction highlights that euro area banks are increasingly comfortable with the regulatory treatment of call options on MREL/TLAC eligible senior debt. That said, whilst call options should be an increasingly common feature on SNP papers, if economically feasible, we deem it as unlikely to become a common feature of euro area senior preferred papers.

The JPY market continued to be attractive for European banks in June, with BPCE and HSBC tapping the market in recent weeks, whilst NatWest Markets Plc, the non-ring-fenced entity of RBS group, announced yesterday a dual tranche 3Y/5Y bond, to be priced this week*. BPCE and Natwest transactions are in Euroyen format, highlighting the increasing comfort of Japanese investors with the less restrictive format.

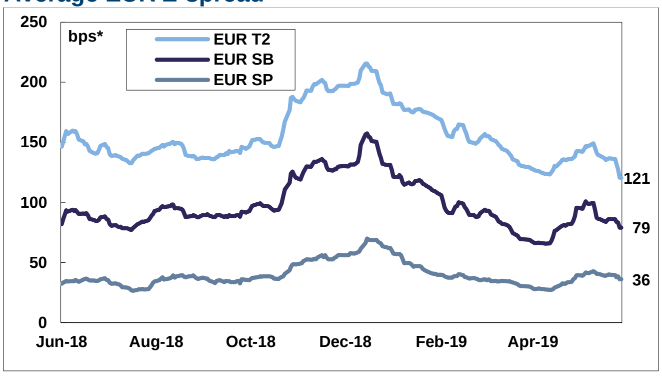
BPCE strengthened its position as the largest JPY issuer among European banks, with its second JPY transaction this year and over JPY1trn of outstanding Yen denominated bonds. The French bank transaction was the first G-SIB placement in Japan after the 150% risk weight on TLAC holdings for domestic banks was implemented in April 2019. The reception was deemed favourable, yet the final volume of JPY62.1bn was significantly below the January transaction, when the group raised JPY163bn. That said, the decline in volume can also be attributed to the significant reduction in spreads since the beginning of the year, reducing attractiveness to investors, and by the EuroYen format, which reduces the pool of investors.

- BPCE S.A., JPY6.5bn/JPY55.6bn, SP/SNP, 5Y,7Y, 10Y, EuroYen*
- HSBC Hong Kong, JPY60.0bn, 5Y, non-ring-fenced OpCo, YOS+24 bps, Samurai*

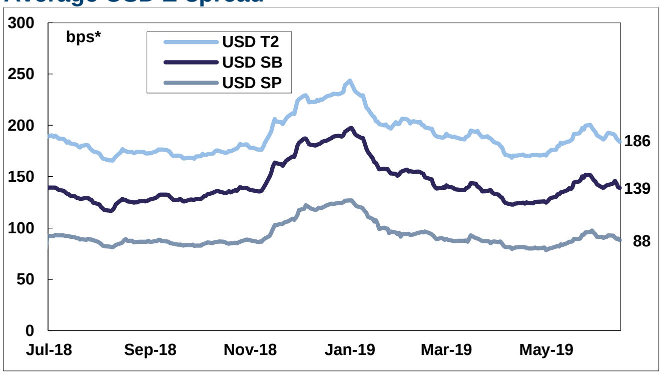
Source: Daiwa Capital Markets Europe.

**Daiwa Capital Markets acted as a joint bookrunner in all three JPY transactions mentioned.*

Average EUR Z-spread[1,2]



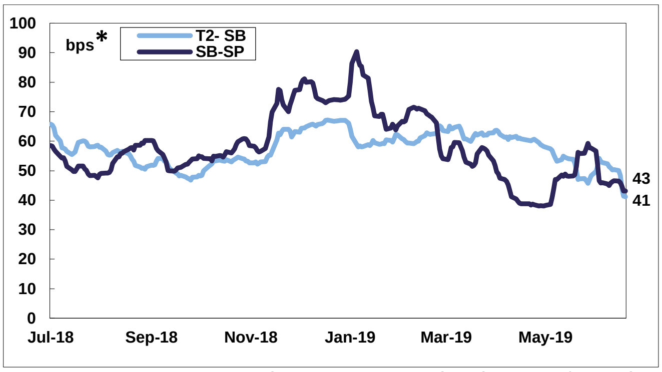
Average USD Z-spread[1,2]



Source: 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.*

Average EUR Z-spread dispersion[1,2]



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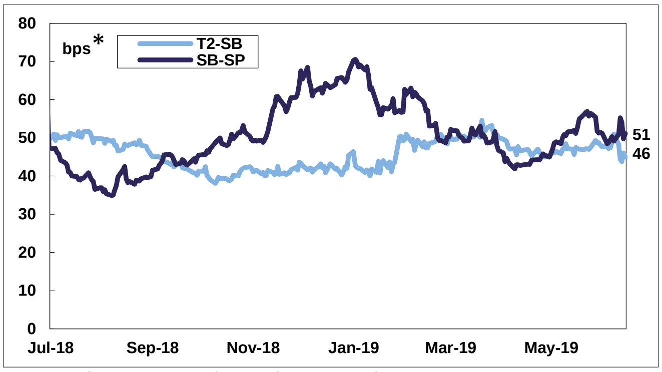

Source: Bloomberg. SP= Senior Preferred; SB=Senior Bail-in (Senior Non-Preferred, Senior HoldCo)

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