European Banks – Credit Update

- Deutsche Bank's restructuring should be viewed with caution by bondholders. Execution risk is high, and the revenue target is optimistic, whilst another rights issue cannot be ruled out were the bank to face additional headwinds.
- The BoE's Financial Stability Report highlighted the solid position of UK banks and their capacity to withstand many months without accessing wholesale funding in case of a no-deal Brexit scenario.

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Recent Developments

Deutsche Bank Restructuring

Deutsche Bank's restructuring should be viewed with caution by bondholders. In short, the bank announced it will fully exit its Equities Sales & Trading (15% of the bank's revenues in 2018); further reduce FICC activities, particularly rates; cut headcount by 18,000 to 71,000 by 2022; move corporate banking to its core business and separate it from the rest of investment banking activities; increase focus on global transaction services and wealth management; and create a bad bank for low-return and non-strategic assets, totaling 20% of the bank's RWAs and Leverage Exposure. Altogether, this will lead to a total restructuring charge of €7.4bn to be booked by 2022, €3bn of which will occur in 2Q19 and €5bn in 2019 as a whole. That will result in a net full-year loss in 2019, and potentially another one in 2020.

The significant overhaul will lead to a simplified and more German-focused business model and to a reduction of some higher-risk activities, which we judge to be positive. In addition, the disposal of underperforming areas and focus on stronger ones is a sensible strategy. However, execution risk is high, particularly in light of the bank's poor track record on reforms to date. In addition, it will remain challenging for the bank to achieve a meaningful, and much needed, improvement in profitability, which has been its main weakness. The bank will struggle to find a way to reverse the steady decline in revenues, particularly in an adverse operating environment and with a damaged franchise. The fact that the restructuring plan is based on interest rate forecasts from May 2019, which are likely to be too high, gives us little confidence. In addition, DB's plan to strengthen global transaction services and wealth management in Asia is barely innovative. In global transactions, it faces fierce competition from J.P. Morgan, BofA and Goldman Sachs, whilst the Asian wealth management market is being targeted by banks with much stronger franchises in the area, such as UBS and Credit Suisse. In that context, we see DB's profitability targets – core revenues to grow from €22.8bn in 2018 to €25bn in 2022, and a RoTE of 8% by 2022 – as challenging.

The overhaul will initially be negative for debt-holders as a result of the restructuring charges being costlier early on in the process. If tangible progress in restructuring can be achieved, and revenues can eventually reverse the downward trend, the improvement in the bank's credit profile should be noticeable. That said, were the bank to face additional headwinds to its plan, we wouldn't rule out another rights issue. In the medium term, despite the reduction in the CET1 target from 13.0% to 12.5% by 2022, deleveraging should strengthen the balance sheet, as the reduction in assets should be greater than the reduction in capital. This is highlighted in the targeted increase in the leverage ratio – from the current below-peers 3.9%, to 4.5% at YE20 and 5% at YE22.

The senior preferred note issued by the bank in August 2018 will remain comfortably protected by a total loss absorbing capacity of €123bn, formed of €63bn of regulatory capital and €60bn of Senior Non-Preferred (SNP) debt. Trading with a Z-spread of 62bps, we see the paper as fairly valued, tighter than some southern European names, yet wider than its French peers. DB's SNP papers, which continue to trade significantly wider than peers despite some tightening since the news of the restructuring started to emerge, will remain exposed to potential rating actions. Moody's has the bank's SNP debt on Baa3/Negative, yet, despite the negative outlook, the agency seemed to have given the bank some time to execute its restructuring. According to Moody's, downwards rating pressure would only arise if DB failed to achieve tangible progress in the process or if it were to be faced by additional market headwinds. S&P is yet to disclose any view on the announcement, but its stable outlook means the risk of a downgrade is lower than at Moody's. A downgrade of the bank's SNP papers by both agencies could disrupt somewhat Deutsche's restructuring plan.

As a result of the deleverage and comfortable liquidity position, DB stated it has limited needs for additional debt issuance in 2019, but concrete changes to its funding plans for 2019 are yet to be disclosed. More details should be provided soon after the bank's 2Q19 results, out on the 24 July.

BoE's July Financial Stability Report

The BoE's Financial Policy Committee (FPC) published last week its biannual financial stability report, in which it reiterated the resilience of UK banks in a no-deal Brexit scenario. This was largely consistent with what the BoE has been saying for more than a year now, with the results of the stress tests undertaken in 2017 and 2018, and with our own view on the credit strength of UK banks. The FPC assessment shows a fairly benign banking system: with the exception of Brexit, there are no major concerns in the system as a whole, nor specific 'pockets of risk'. The BoE did, however, highlight that 'financial stability is not the same as market stability'. That is, significant volatility and asset price changes are to be expected in a disorderly Brexit, including in the sterling exchange rate, equities, corporate and government debt and bank funding costs, which would lead to a tightening in financial conditions for UK households and businesses. That said, with over £1tn of high-quality liquid assets, major UK banks would be able to meet their maturing obligations for many months without having to access wholesale funding or foreign exchange markets.

Markets

European banks' spreads continued to tighten in the past couple of weeks in both EUR and USD markets following continuous dovish signals from both the Fed and the ECB. The tightening impact on banks' spreads from monetary policy expectations continued to outweigh the widening impact from the weaker macroeconomic background. This tightening across the debt structure has led SP papers to trade at a differential of 35bps/46bps to SNP in EUR/USD, which we see as too tight, and at the same level as the SNP-T2 differential.

Activity in the primary markets is still good as we approach the Q2 earnings season and following a busy couple of months. Supported by favourable conditions and lower government yields, higher-risk European banks successfully ventured into the markets with issuance across the capital stack. Higher-rated names also met with good demand, leading to deals closing within 15/20bps within IPTs. We also saw Lloyds Bank Capital Markets (LBCM), the non-ring-fenced OpCo of the Lloyds Banking group, issue its inaugural public senior unsecured bond, with a GBP500m paper, out of the GBB2bn it's expected to issue annually.

Key recent transactions

- National Bank of Greece, T2, EUR400m, 10NC5, MS + 847, book orders over EUR1.6bn, MS+900bps
- Nationwide, SNP, USD1bn, 11NC10, priced at T+185bps, IPT at T+200bps
- BNP Paribas, SNP, EUR1bn, 6NC5, priced at T+75bps, book orders over EUR2bn, IPT at MS+95bps
- Banco Sabadell, SP, EUR1bn, 6Y, priced at MS + 105bps, book orders over EUR1.9bn, IPT at MS + 125bps
- BFCM, SP, EUR1bn, 5Y, priced at MS+43bps, book orders over EUR1.5bn, IPT at MS + high 50s
- LBCM, OpCo, GBP500m, priced at G+132, book orders over GBP1bn, IPT at G+145bps

Source: BondRadar

The JPY market continued to solidify its position as an attractive market for European banks with three new deals in the past couple of weeks. Santander Consumer Finance returned to the JPY after a one-year hiatus in 2018, with a JPY50bn transaction in the ever more popular EuroYen format. CASA, which last tapped the JPY in March 2019, seemed to have gone for pricing rather than size, with a JPY36bn deal in Samurai format, whilst NatWest Markets issued its inaugural JPY paper, with a JPY50bn deal in EuroYen format.

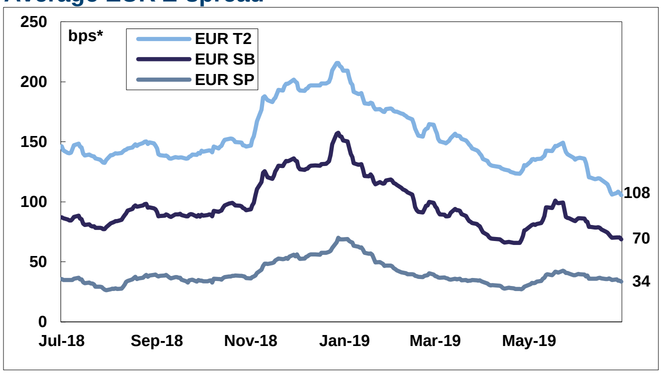
Key recent transactions

- Santander Consumer Finance, SP, JPY50bn, 3Y/5Y, YSO+40/+50, EuroYen*
- CASA, SNP, JPY36bn, 5Y/10Y, YSO+50/+60, JPY35.9bn, Samurai*
- NatWest Markets, OpCo, JPY50bn, 3Y/5Y, YOS +80bps/+90bps, EuroYen*

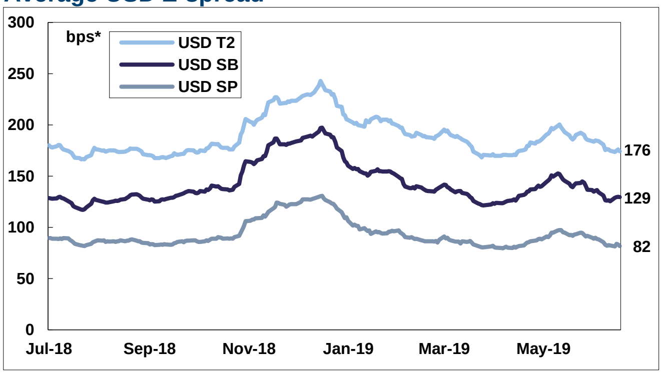
Source: Daiwa Capital Markets Europe.

**Daiwa Capital Markets acted as a joint book runner 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.

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