Daiwa Capital Markets

European Banks – Credit Update

- Another quarter of declining IB revenues across Europe and America, whilst Barclays and Credit Suisse overtook Deutsche as the largest European banks by IB fees.
- UK banks are feeling the heat from high competition on mortgage lending in the country, yet solid capital and liquidity positions makes them ready to withstand any turmoil from a potential no-deal Brexit.

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Recent Developments

Global Investment Banking Revenues in 2Q19

It was another weak quarter for investment banking (IB) revenues across Europe and America, with the total pool of IB revenues for the largest investment banks down 6% Y/Y, to $37.1bn. On a 6M19 basis, the pool of IB revenues declined by 10% Y/Y to $73.8bn, with Origination & Advisory (O&A) down 10%, FICC down 6% and Equity trading down 15%. The 'noticeable improvement in market activity in March and April' and 'stronger pipelines in Q2', as suggested in the 1Q19 results' calls, failed to materialise.

There was a wide range of reasons for the weaker performance: weakening global economy, US-China trade tensions, increased likelihood of a no-deal Brexit, reversal on interest rates trends, etc. That said, even though O&A and Equities were almost uniformly weak across institutions, FICC results were much more mixed. In O&A, UBS was the only name to post a year-on-year increase in revenues in 2Q19, yet that's on the back of a weak 2Q18, whilst in Equities, only Goldman Sachs and Credit Suisse managed to report positive growth. In FICC, JP Morgan and Citi bank posted solid growth in America, mirrored by Barclays and Credit Suisse in Europe. All other names were hit by lower market activity.

JP Morgan and Citi bank increased further their leadership in IB, whilst Morgan Stanley was disappointing, with very weak performances across Advisory, DCM, Equities and Fixed Income, losing 1.3pp of the IB market share as a result.

In Europe, Barclays and Credit Suisse overtook Deutsche as the largest European banks by investment banking revenues. Barclays' performance was backed by the IPO of Tradeweb and a strong performance in rates and securitized products. The solid gains made as a result of the Tradeweb IPO led Barclays to overtake Morgan Stanley in the FICC fees table. Credit Suisse meanwhile have now shown tangible signs of recovery in its global markets division for a second consecutive quarter. Across the road, UBS posted a solid performance in O&A across all products and regions, putting to rest any doubts on the bank's ability to perform well in IB following the departure of Andrea Orcel, its former IB head. This was offset, however, by declining FICC profits, due to a difficult FX environment, while Equities were very weak, on the back of lower market volumes and client activity. Deutsche's dismal performance (IB earnings down 21% Y/Y) led it to lose 1.1% of the market share, yet it is unclear how much of the decline was driven by the bank's exit of specific markets or simply poor performance. Its decision to completely exit Equity trading will make it the smaller of the top 4 investment banks in Europe by IB fees.

US banks accounted for 73.7% of total IB earnings among the largest global groups in 2Q19, up from 73.2% in 2Q18.

UK banks profitability and Brexit readiness

The profitability of UK banks is under pressure from the highly competitive mortgage market. Net Interest Margin (NIM) across the 15 largest UK banks has decreased Y/Y as a result of the mortgage 'price war' in the country.

Investment Banking Market Share* (%, 2Q19)

	Total IB *(Y/Y ∆ in pp)*	Origination & Advisory *(Y/Y ∆ in pp)*	FICC *(Y/Y ∆ in pp)*	Equity *(Y/Y ∆ in pp)*
JP Morgan	**19.4 *(+0.8)***	16.5 *(+0.2)*	23.2 *(+1.7)*	16.6 *(-0.3)*
Citi	**14.6 *(+1.0)***	11.9 *(0.0)*	20.9 *(+1.7)*	7.6 (+0.1)
Goldman Sachs	**14.4 (+0.2)**	17.3 (+0.2)	9.3 (-1.2)	19.3 (+3.0)
Morgan Stanley	**12.8 (-1.3)**	13.6 (-0.5)	7.1 (-1.5)	20.5 (-0.9)
BofA	**12.5 (-0.2)**	12.7 (+0.8)	13.4 (-1.0)	11.0 (-0.3)
Barclays	**7.4 (+0.4)**	8.3 (+0.3)	7.4 (+1.2)	6.4 (-0.7)
Credit Suisse	**6.9 (0.1)**	8.6 (-1.1)	6.8 (+0.6)	5.5 (+0.6)
Deutsche Bank	**6.4 (-1.1)**	4.2 (-1.5)	9.3 (-0.9)	4.0 (-1.6)
UBS	**5.6 (+0.1)**	6.9 (+1.6)	2.5 (-0.7)	9.0 (+0.1)

*Source: Banks financial statements, compiled by 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 (%, 2Q19)

	Total IB	Origination & Advisory	FICC	Equity
JP Morgan	**-2**	-9	7	-12
Citi	**1**	-10	8	-9
Goldman Sachs	**-5**	-9	-13	6
Morgan Stanley	**-15**	-13	-18	-14
BofA	**-8**	-4	-8	-13
Barclays	**-1**	-6	18	-19
Credit Suisse	**-5**	-20	9	1
Deutsche Bank	**-21**	-34	-9	-36
UBS	**-4**	18	-22	-9
Total	**-6**	**-10**	**-1**	**-10**

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

The main driver behind this price war is the implementation of the ring-fencing rules introduced at the beginning of the year. The rules left ring-fenced entities of the largest lenders with a significant excess of customer deposits, which can only be put to use in the UK retail market, including mortgages. That said, return metrics are largely still healthy, whilst capital and liquidity positions are solid. In addition, most of the 2019 funding needs has already been met, enabling UK financial groups to stay out of debt markets for a prolonged period if needed. Thereby, we see the largest UK banks as well positioned to face any potential market turmoil from a Brexit no-deal scenario, although IT, operational and compliance issues may arise.

However, despite the largely solid fundamentals- better than many European peers - UK banks continue to pay a Brexit premium on their spreads, with the average Z-Spread on senior bail-in-able USD debt at 173bps for UK Banks, 27bps above the European average, and 111bps for senior bail-in-able EUR debt, 35bps above the European average. Although UK banks are well positioned to withstand a no-deal scenario, the potential deterioration in the economic environment would lead to a deterioration of their credit profile, which justifies the Brexit premium.

Markets

Primary markets have been very quiet following the results season as we are still in the summer break. The only large European bank to venture itself in the markets this week was Credit Suisse, whilst the prior week was somewhat busier with placements from UBS, Lloyds and HSBC. Activity is expected to pick up again by the end of the month, yet widening spreads in the secondary markets and the adverse economic environment may lead to rising New Issuer Premiums (NIP).

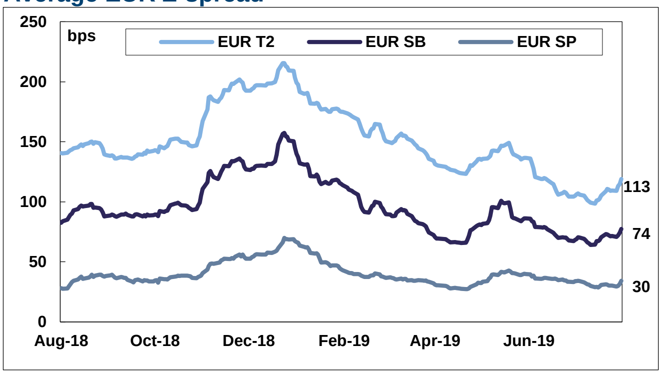
Key recent transactions

- Credit Suisse Group, AT1, USD1,750m, PNC7, 6.375%, IPT at 6.5%
- The Hongkong and Shanghai Banking Corporation Limited (HSBC OpCo), senior unsecured, NZD300m, dual, 3Y floating at 3mBKBM+65bps, and 5Y fixed at MS+85bps
- Lloyds Bank PLC (OpCo), senior unsecured, USD1,500m, 3Y, priced at T+85, IPT at T+95bps
- UBS Group (HoldCo), senior unsecured, USD1,500m, 11NC10, priced at T+140bps, IPT at T+155bps

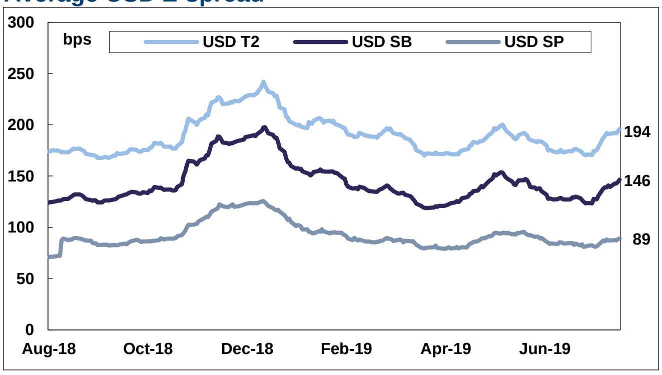
Source: BondRadar

A wide range of negative economic news is impacting yields in the secondary markets, with the USD Z-Spread of senior bail-in-debt up by 23bps since the last week of July, whilst the EUR Z-Spread was up 13bps. The risk-off mode is further confirmed in the Z-Spread dispersion, with the spreads of SNP/HoldCo papers trading closer to Tier 2 debt than to SP/OpCo papers, particularly in the USD market, which is not being as distorted by quantitative easing as the EUR market.

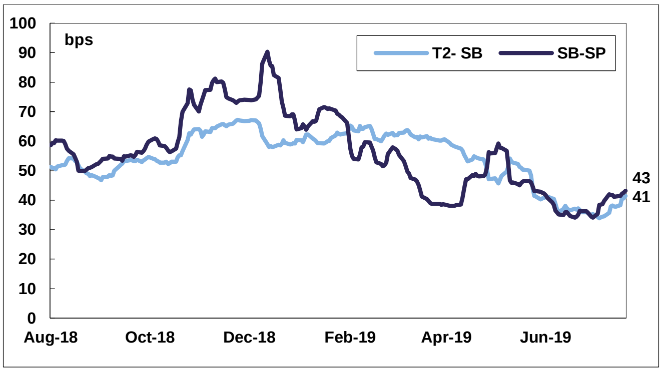
Average EUR Z-spread[1,2]



Average USD Z-spread[1,2]



Average EUR Z-Spread Dispersion[1,2]



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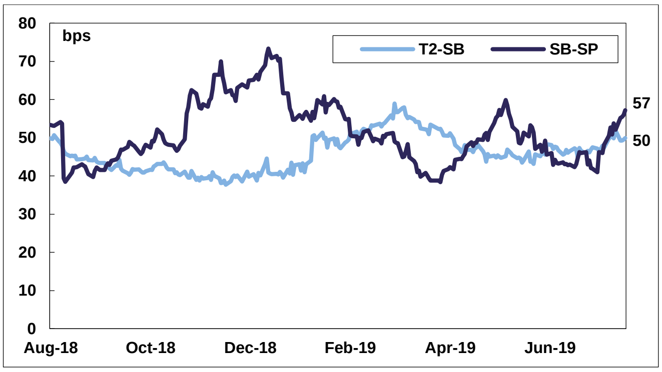

Source: Bloomberg. SP= Senior Preferred; SB=Senior Bail-in (Senior Non-Preferred, Senior HoldCo)

[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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