Daiwa Capital Markets

European Banks – Credit Update

- The spike in PPI charges faced by UK banks is material and its timing is unfortunate. But their resilience to the current political turmoil and a potential no-deal Brexit is unchanged.
- Primary markets have returned from the summer break, yet investors have been selective. Average EUR senior preferred paper continued to deliver negative yields, although the trend reversed in recent days following the sell-off of sovereign bonds.

Israel Da Costa, CFA
Credit Analyst
+44 20 7597 8355
Israel.DaCosta@uk.daiwacm.com

Recent Developments

PPI charges are material, but resilience is unchanged

A spike in claims related to the mis-selling of Payment Protection Insurance (PPI) before the deadline of 29 August is leading UK banks to substantially increase related provisioning. RBS announced last week an increase in PPI provisioning charges in the range of £600m to £900m. Lloyds (an additional £1.6bn to £1.9bn) and Barclays (£1.2bn to £1.9bn) followed yesterday and, prudently, both announced the suspension of their ongoing share buyback programmes. HSBC and Santander UK are yet to provide any update, but we expect them to increase charges too.

These charges will be included in the banks' 3Q19 results, to be published in the week before 31 October, which will lead to negative headlines just days before the potential Brexit day.

That said, the large charges being announced will be absorbed through the banks' P&L, with no impact on capital by the end of the year. The largest UK banks will hence continue to be well-positioned to withstand the current political turmoil and a no-deal Brexit scenario. On top of solid capitalization levels and vast volumes of liquidity, this is also thanks to their healthy asset quality, with low Loan-to-Value on mortgage books and low proportion of assets classified as Stage 3 (see table).

In addition, according to the BoE, UK households' indebtedness is elevated but not critically high, whilst consumer credit lending growth has slowed in the past year as banks tightened borrowing conditions. Resilience is further supported by the current record low – and for the time being, still declining – unemployment rate of 3.8%. That said, some weakening of UK banks' credit profile in a no-deal Brexit would be inevitable. We'd expect to see a deterioration in corporate lending books, whilst revenue generation would also decline.

A negative scenario would likely also be observed under a (for now relatively unlikely) Labour majority government. RBS – 62% government owned – would be particularly exposed to this scenario given Labour's stated aim to halt the ongoing privatisation of the bank and to use it for ill-defined policy purposes. The likelier this scenario, the higher would likely be the 'government ownership premium' on RBS' yields.

UK Banks Financials (6M19)

	RBS (£m)	HSBC ($m)	Lloyds (£m)	Barclays (£m)	San UK (£m)
Revenues	6,127	29,372	8,822	10,790	2,117
Expenses	3,900	17,149	4,049	6,758	1,267
Impairments	323	1,140	579	114	69
Net Income	2,410	9,937	2,225	2,469	411
(%)					
LCR	154	136	130	156	155
RoTE	12.1	11.2	11.5	9.4	7.9
CET1	16.0	14.3	14.0	13.4	13.8
LR	5.9	5.4	5.1	5.1	4.5
MREL	32.1	29.3	32.2	30.2	33.2
UK mortgage book LTV[1]	57.0	50.0	42.6	50.1	42.0
Stage 3[2] **ratio**	2.3	1.3	1.3	1.3	1.3
Stage 3[2] **coverage**	32.0	38.2	24.2	37.2	33.1
(GBPm)					
Total PPI charges (end-2Q19)	5,300	4,255	20,075	9,600	1,717
2Q19 charges	-	440	550	-	70
3Q19 charges (announced)	600-900	TBD	1,600-1,900	1,200 - 1,600	TBD

*Source: Banks financial statements, compiled by Daiwa Capital Markets Europe * Figures may not be directly comparable due to different disclosure methodologies. [1]Loan-To-Value; [2]As per IFRS9 rules.*

Despite the political turmoil, UK banks' spreads performed largely in line with the market trend in recent weeks, with the average Z-Spread on senior bail-in-able USD debt trading at 160bps for UK banks, 22bps above the European average, and 103bps for senior bail-in-able EUR debt, 28bps above the European average. In fact, this premium over the European average tightened by 3bps to 6bps in the past couple of days on the back of the lower probability of a no-deal Brexit, and the better-than-expected July UK GDP growth figure (+0.3% vs exp. +0.1%). In all, based on fundamentals only, we see UK banks' paper as cheap, yet the political risks justify the premium paid over European peers.

Markets

The summer break is certainly over in the primary market, with solid issuance numbers across the capital structure. We've had more than 18 deals in the past couple of weeks by the largest European entities, as banks take advantage of the somewhat benign market conditions and ahead of the widely expect ECB announcement this Thursday. In all, deals have been fairly successful so far, mostly for lower ranked paper, as investors continue to chase yields, with deals closing significantly within IPT and with barely any NIP. That was the case for Rabobank last week, which broke Nordea's record on the lowest coupon for an AT1 issuance, with a 3.25% coupon on a €1,250m PNC7.25 3.25% on a 37.5bps down from IPT.

Investors have been selective however, as shown by the Bank of Ireland's decision to postpone last week their €300m 10NC5 T2 paper during the book-building process, impacted by the Brexit noise. Books were said to have reached €340m, but there was barely any tightening from the IPT of MS + 270bps. Yesterday, the main transaction among the names we cover came from Commerzbank, which priced a 5Y SNP paper at MS +80, 10bps within IPT, yet total demand was only €700m, vs. final size of €500m.

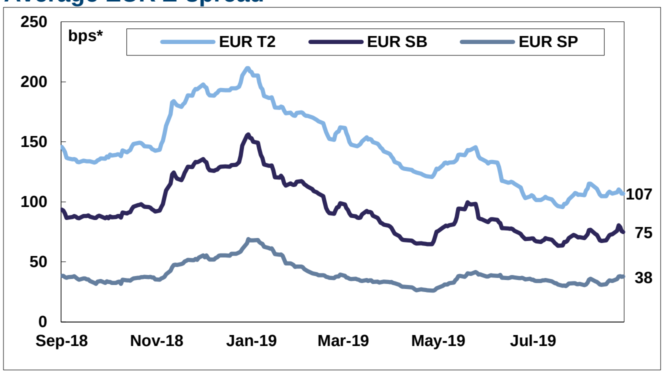
Key recent transactions

- Commerzbank, €500m, SNP, 5Y, MS + 80, IPT at MS+90, book orders over €700m
- Credit Suisse, $2bn, 6NC5, HoldCo, T + 128, IPT at T+145/150
- Credit Suisse, €1bn, 10Y, HoldCo, MS + 97, IPT at MS+115bps
- Rabobank, €1.25bn, AT1, PNC7.25, 3.625%, IPT at 3.25%
- ING, $1.5bn, AT1, 5.75%, PNC7.25, IPT at 6.125%
- BBVA, $1.0bn, AT1, 6.5%, PNC5.5.5, IPT at 7%
- BNPP, €1bn, SNP, priced at MS+70bps, IPT at MS + 95bps, book orders over €1.7bn
- SocGen, €1.75bn, SP, 3mE + 23bps, IPT at 3mE + 30bps
- HSBC France, €1.25, SP, MS + 48, IPT at MS + 60, books over €1.9bn

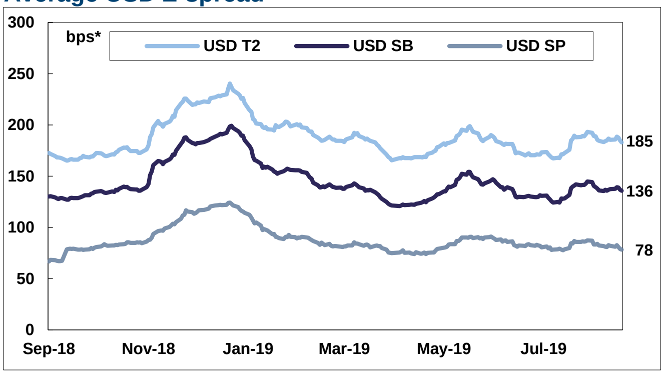
Source: BondRadar

The secondary market was fairly volatile in August, with no clear trend in light of the many different macro events. This trend continued in past couple of weeks, due to mixed economic and political data and ahead of the ECB decision this Thursday. UK bank spreads declined marginally driven by the reduction in the probability of a no-deal Brexit, and better than expected economic data. Elsewhere in Europe spreads were largely wider, due to weaker economic data coming from Germany and the fresh supply of paper. Meanwhile, the recent sell-off in sovereign bonds led to an uptick in yields in the past couple of days, marginally reversing the downward trend observed since the beginning of the year. The average EUR SP yield remains negative however, at -0.08% (not corrected for duration), whist USD SP paper are yielding 2.36% on average.

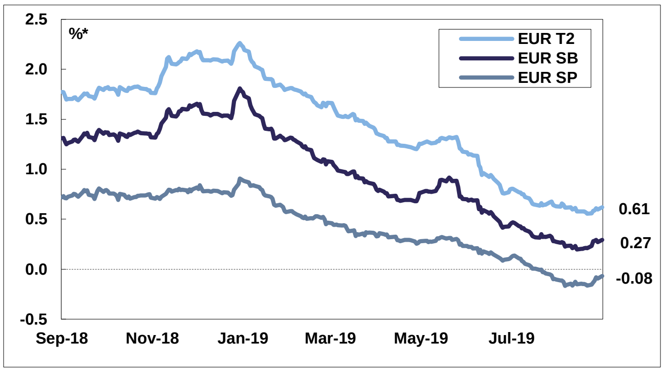
Average EUR Z-spread[1,2]



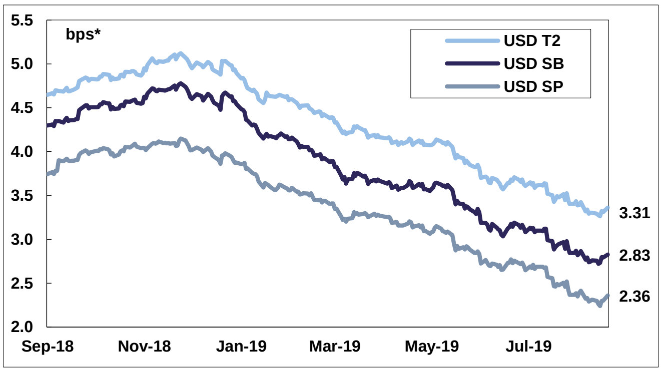
Average USD Z-spread[1,2]



Average EUR Yields[3]



Average USD Yields[3]



Source: Bloomberg. SP= Senior Preferred; SB=Senior Bail-in (Senior Non-Preferred, Senior HoldCo). Not adjusted for duration. Herein included figures may not be reflective of the whole market. [1]Average Z-Spread of the largest European banks' debt securities across maturities. [2]Mid Z Spread to maturity/call. [3]Average Yield to call/maturity of the largest European banks' debt securities across maturities.

Daiwa Capital Markets

Key contacts

London		
Head of Research	*Chris Scicluna*	+44 20 7597 8326
Financials, Supras/Sovereigns & Agencies	*Israel Da Costa, CFA*	+44 20 7597 8355
Research Assistant	*Katherine Ludlow*	+44 20 7597 8318
Tokyo		
Domestic Credit		
Chief Credit Analyst	*Toshiyasu Ohashi*	+81 3 5555 8753
Electronics, Automobiles, Non-Banks, Real Estate, REIT	*Takao Matsuzaka*	+81 3 5555 8763
Chemicals, Iron & Steel	*Kazuaki Fujita*	+81 3 5555 8765
International Credit		
Non-Japanese/Samurai, European Sovereigns	*Hiroaki Fujioka*	+81 3 5555 8761
Non-Japanese/Samurai	*Fumio Taki*	+81 3 5555 8787
Non-Japanese	*Jiang Jiang*	+81 3 5555 8755
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

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