Daiwa Capital Markets

European Banks – Credit Update

- The low take-up of ECB funds in the first round of TLTRO III operations strongly suggests that overall disbursements under the program will be lower than under the TLTROs II.
- The Fed's monetary easing is already impacting American banks and is negative for European banks too.
- Primary markets were busy with solid supply and demand, with strong tightening from IPTs.

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Recent Developments

Lower TLTRO III intake

At €3.4bn, the intake of the TLTRO III auction last week was well below the - wide ranging - forecasts, which varied from €20bn to €100bn. Only 28 euro area banks took part, compared to the average of 360 entities that attended, on average, the four auctions of the previous program (TLTRO II). Yet his was only the first of the 7 quarterly auctions to take place until March 2021. The low intake was largely driven by calendar as the vast majority of outstanding TLTRO II will mature in 2020 and in March 2021 (see table), when we expect the TLTRO III intake to be much more material.

ECB's TLTRO Operations

Operation	Settlement Date	Maturity Date	Allotted Amount	Outstanding amount
TLTRO III	25/09/209	28/09/2022	€3.4bn	€3.4bn
TLTRO II	29/03/2017	24/03/2021	€233.5bn	€226.2bn
TLTRO II	21/12/2016	16/12/2020	€62.2bn	€61.4bn
TLTRO II	28/09/2016	30/09/2020	€45.3bn	€43.7bn
TLTRO II	29/06/2016	24/06/2020	€399.3bn	€358.1bn

Source: ECB

That said, we still think the overall intake under TLTRO III will be lower than the total €740bn taken in the TLTRO II operations as the incentives are more limited:

(i) Despite the recent changes, the maturity of the TLTROs III is still only three years, compared to four years under the previous round;

(ii) The pricing in the new round is not necessarily more favourable. Whilst in the second round the best pricing achieved was the deposit facility rate at the time of the auction (i.e. -0.4%), in the new round the price will be the average rate charged for the deposit facility over the term of the TLTRO. That is, if interest rates are increased during the three years of the loan, the final price might be greater than the -0.4% paid previously;

(iii) Funding conditions are now better than in 2016, on the back of lower euro swap prices and tighter spreads, enabling banks to issue covered bonds and Senior Preferred (SP) paper at comfortable terms;

(iv) It cannot be guaranteed that banks will meet the increase in lending required to get the best pricing in the TLTRO, in light of the weak economic environment;

(v) Finally, with the exception of Italian and Greek banks, most euro area banks already hold excess liquidity above the exempted limit, meaning more excess liquidity will cost banks 0.5%.

Central banks actions

The Fed's rate cuts in July and September, which are expected to be followed by further easing by year-end and in 2020, is already impacting U.S. bank revenues and is thus marginally levelling the playing field with European banks. JP Morgan, Citigroup and Wells Fargo have already lowered their net interest income outlook for 2019 as a result of declining rates. That said, the fall in USD rates is also negative for European banks, as it will impact returns on international businesses and USD-based securities, further squeezing interest margins.

The Danish central bank cut its main interest rate by 10bps to -0.75% immediately after the ECB's cut, aiming to maintain a stable currency against the euro, but made no changes to its tiering framework. As a result, Jyske bank, which recently offered the first 10-year mortgage with negative coupons, announced it will reduce the threshold at which depositors will be charged the central bank main deposit rate from around $1m (DKK7.5m) to around $100k (DKK750k). This is the most aggressive transfer of negative rates to retail depositors in Europe, for now.

In Switzerland, the SNB maintained its main interest rate at -0.75%, yet it amended its tiering policy in light of global monetary conditions. The SNB will now revise monthly the threshold of excess liquidity held by Swiss banks that shall be exempt from the negative interest rate. The change to a more dynamic tiering will provide some relief for Swiss banks, including Credit Suisse and UBS. Nonetheless, both banks are reportedly going to start charging negative rates to depositors. UBS is said to start charging the 0.75% rates to deposits over CHF2m, whilst Credit Suisse is said to start charging clients with over CHF1m in deposits. Both banks aim to push their wealthier clients towards wealth management products.

In all, the outlook for banks' net interest income across the globe is challenging, with those with more diversified business models and less dependent on interest rates likely to be in a better position to face the incoming and prolonged headwinds.

Markets

It was a busy week in the primary market last week, with periphery names taking advantage of the very favourable conditions, whilst investors were keen to capture the marginally higher yields. Deals closed strongly within IPTs, whilst book orders were mostly above 2x the final deal size.

UK banks also took advantage of the marginally reduced political noise to tap the sterling market with AT1s ahead of the expectedly uneventful BoE meeting, which were met with very strong demand. Barclay's £1bn AT1 was 7.5x oversubscribed, whilst Nationwide's £600m AT1 was 6.25x oversubscribed.

In the JPY market, we saw BNP Paribas tapping the market with a dual EuroYen transaction totaling JPY42.9bn, being JPY34.4bn in SNP format and JPY8.5bn in Tier 2 format, priced at YSO+55bps/+100bps. Although the SNP volume was much lower than in January 2019, when the bank issued JPY106.6bn in 6NC5 SNP paper, the pricing was significantly tighter, issued at YSO+55bps, vs YSO+130bps in January*.

Key recent transactions

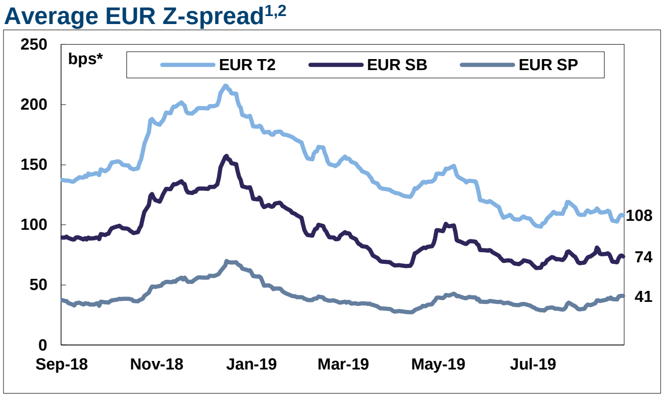
- BNP Paribas, dual tranche, SNP/Tier 2, JPY34.4bn/8.5bn, 6NC5, 15NC10, prices at YSO+55bps/+100bps*
- Barclays, GBP1bn, AT1, PNC6, 6.375%, IPT at 6.875%. book orders over GBP7.5bn
- Banco Sabadell, EUR500m, SNP, 5.5Y, MS+155bps, IPT at MS+185bps, book orders over EUR1.7bn
- Nationwide, GBP600m, AT1, PNC5.25, 5.875%, IPT at 6.375%, book orders GBP3.75bn
- Caixabank, EUR1bn, SNP, 5Y, MS+113bps, IPT at MS+135bps, book orders over EUR2bn
- Societe Generale, EUR750m, SNP, MS+95, IPT at MS+110bps, book orders over EUR1.6bn
- Intesa Sanpaolo, 3-tranche deal, SP, 5Y/10Y/30Y, USD750m/750m/500m, priced at T+165bps/+225bps/245bps, IPTs at T+180bps/+240bps/+260bps
- Danske Bank, dual tranche deal, SNP, USD1bn/750m, 3NC2/6NC5, priced at T+125bps/+155bps, IPTs at +145bps/+175bps
- Unicredit, EUR1.25bn, Tier 2, 10NC5, priced at MS+240bps, IPT at MS+265bps, book orders over EUR2.7bn

Source: BondRadar

**Daiwa Capital Markets Europe acted as a joint bookrunner in the BNP Paribas JPY transaction.*

While the FOMC's post-meeting statement was somewhat less dovish than expected, USD yields of European banks' unsecured paper resumed their downward trend last week, following a jump in yields the week before, in line with the movements observed for longer-dated treasury yields. EUR yields moved sideways for SP paper, as these are more directly impacted by the restart of QE and by the changes in the TLTRO rules. Yields on SNP and Tier 2 paper maintained their upwards trend, which followed the recent sell-off in sovereign bonds. Spreads largely followed the trend in yields despite the heavy supply.

Average EUR Z-spread[1,2]



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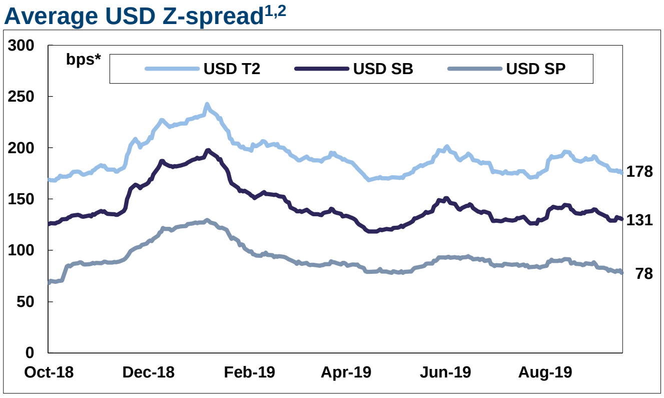
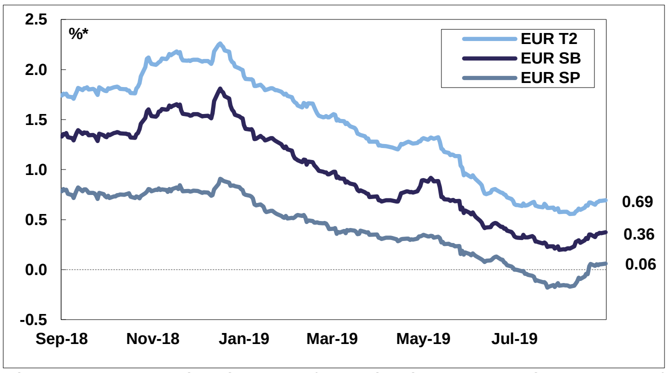
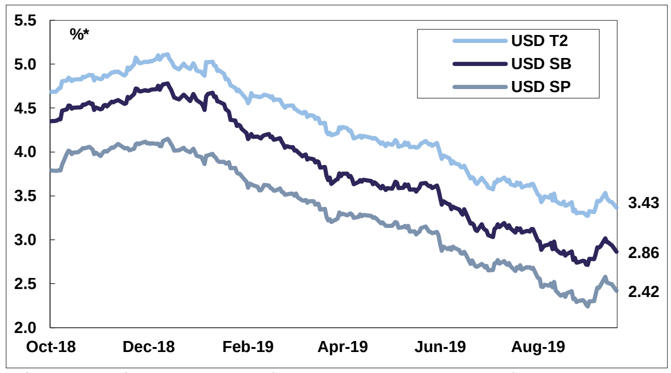


Average EUR Yields[3]



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.

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