Daiwa Capital Markets

European Banks – Credit Update

- Q3 was a largely positive one for investment banking in both Europe and the US, whilst both Barclays and Credit Suisse maintained the solid performance reported in the first half of the year.
- The demand by the German Finance Minister for action on the completion of the European banking union is a welcome development, yet any tangible progress is likely to be slow.

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Recent Developments

Global Investment Banking Revenues in 3Q19

It was a fairly positive quarter for investment banking (IB) and global markets across Europe and America. Revenues from Origination & Advisory by the largest investment banks in the two continents rose by 1.9% Y/Y, as good overall funding conditions supported DCM activity. However, continued global macro uncertainty led to largely flat ECM fees on the other hand, and a 3.2% decline in M&A fees. Similarly, in global markets, FICC trading was solid, with earnings up 9.8%, yet Equities trading was down by 1.7% Y/Y.

DCM and FICC performance was strong almost uniformly across the largest European and American institutions, ECM and M&A results were mixed, whilst Equity trading was largely weak.

In the US, the highlight was once again the solid performance of JP Morgan across most divisions, and a reversal of the negative trend in M&A at BofA, which had been disappointing in recent quarters. On the negative side, Citi's performance was subpar across most divisions. In Europe, both Barclays and Credit Suisse delivered strong earnings in global markets for the third quarter in a row, strengthening their case for a strategy that was often questioned in recent years. Among the French names, BNPP results were convincing, backed by strong FICC. Meanwhile, Equity trading at BNPP, which was somewhat weak in Q3, in line with the market, should grow significantly once the acquisition of the Equity prime brokerage business of Deutsche Bank is finalised. Results at SocGen were less convincing, with Equity trading down 20% Y/Y, blamed on lower volumes and adverse market conditions, whilst FICC trading was also weaker than peers. At Deutsche Bank the picture is unclear as the bank's significant restructuring is still ongoing. Its performance in DCM and M&A was good, yet the weak performance in ECM highlights the side effect of completely exiting Equity trading. Deutsche has also failed to benefit from the generally positive quarter for FICC trading.

IB Market Share* (%, 3Q19)

	Origination & Advisory *(Y/Y Δ in pp)*	FICC *(Y/Y Δ in pp)*	Equity *(Y/Y Δ in pp)*
JPMorgan	17.7 (+1.0)	21.2 (+2.6)	14.8 (-0.5)
Citi	11.6 (+0.2)	19.1 (-1.8)	7.4 (-0.2)
Goldman Sachs	16.0 (-3.1)	8.4 (-0.2)	18.3 (+1.1)
Morgan Stanley	14.5 (+0.5)	8.5 (+0.8)	19.4 (+0.1)
BofA	14.5 (2.9)	12.4 (-1.2)	11.2 (+1.4)
Barclays	8.0 (+1.4)	6.0 (+0.1)	5.9 (0.0)
Credit Suisse	7.6 (+2.2)	5.5 (+1.8)	6.1 (+0.3)
Deutsche Bank	5.1 (+0.6)	8.2 (-2.6)	-
UBS	5.0 (-1.3)	2.3 (-0.2)	8.2 (-0.4)
BNP Paribas	-	5.5 (+1.0)	3.7 (-0.6)
SocGen	-	3.1 (-0.3)	4.9 (-1.1)

*Source: Banks financial statements, compiled by Daiwa Capital Markets Europe. *As a percentage of the herein included global investment banks. Deutsche Bank is no longer reporting its Equity trading earnings, whilst BNPP and SocGen do not disclose O&A revenues separately.*

Euro banking union reform

German Finance Minister Olaf Scholz last week published an opinion piece at the FT calling for the EU to act on the completion of the banking union. His proposal had four key steps: (i) common insolvency and resolution procedures for all banks; (ii) further reduction of NPLs and inclusion of risk weights to sovereign bonds; (iii) the creation of the European Deposit Insurance Scheme (EDIS) via a three-tier mechanism; and (iv) uniform taxation of banks in the EU.

First proposed by the European Commission in November 2015, the creation of a common EDIS has failed since to gain traction due to political opposition in Northern Europe, particularly in Germany. It was therefore a positive surprise to see the German Financial Minister himself pushing for action. EDIS would be a welcome – and needed – development for the European banking sector. It would lower the barriers for free flow of liquidity and capital within the union, which, in turn, would significantly improve efficiency and would facilitate cross-border consolidation in the sector.

It would also enable further development of the Capital Markets Union (CMU), which, first announced by the European Commission in 2014, was designed to reduce reliance on bank lending and to further integrate and develop capital markets in the EU. Yet it has failed on both fronts. On the former, according to the Association for Financial Markets in Europe (AFME), European companies' reliance on bank lending has actually increased, with 88% of new funding for corporates in 2018 coming from banks and only 12% from capital markets – a decline from 14% on average in 2013-2017. The latter was negatively impacted by London's scheduled departure from the EU.

Revenues Growth (%, 3Q19 Y/Y)

	Origination & Advisory	FICC	Equity
JPMorgan	8	25	-5
Citi	4	0	-4
Goldman Sachs	-15	8	5
Morgan Stanley	5	21	-1
BofA	27	0	13
Barclays	24	11	-1
Credit Suisse	-21	63	3
Deutsche Bank	15	-16	-
UBS	-19	-1	-7
BNP Paribas	-	35	-15
SocGen	-	1	-20
Total	**2**	**10**	**2**

Source: Banks financial statements, compiled by Daiwa Capital Markets Europe.

There are still political challenges to overcome, not least in Germany itself, with material attrition within the grand coalition. In addition, the Italian Finance Minister positioned himself against adding risk weight to sovereign bonds held by financial institutions. This is hardly surprising as Italian banks held €286bn of Italian sovereign bonds as of August 2019. Any tangible progress is hence likely to be slow, yet the positive tone of the discussions in recent days is encouraging.

Stress Tests

The EBA published last week the methodology it will use in its EU-wide biannual stress test, the results of which will be published before 31 July 2020. Once again the test will have no hurdle rates, which reduces the usefulness of the exercise in our view. That said, the results will be used as an input for local regulators to establish minimum capital requirements.

In the UK, the BoE will publish the result of its more useful stress test on UK banks on 16 December, postponed from 10 December due to the snap general election taking place on 12 December. The stressed scenario is somewhat similar to last year's one, as such we expect UK banks to perform well and comfortably pass the hurdle rates. The focus will be on the drawdown of the capital ratios in the stressed scenario. This drawdown will be used by the PRA to establish minimum capital requirements.

Markets

Primary market conditions have been largely constructive in recent weeks, backed by an improvement in market sentiment, yet investors are being selective. This was highlighted by the decision of Nykredit to pull the €500m 10Y SNP deal last week, due to tight pricing and competition with other high quality names that were also in the market on the same day.

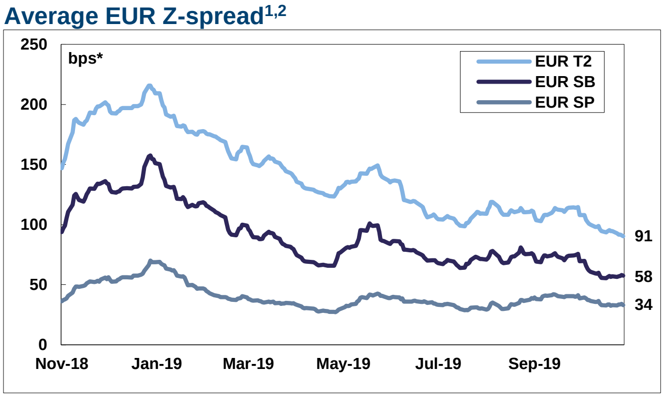
Key recent transactions

- RBS Group, Senior HoldCo, social, €750m, 6NC5, MS + 100bps, IPT at MS + 120bps, final book orders over €2bn
- BBVA, SP, €1bn, 7Y, MS + 52bps, IPT at MS + low-70s bps, final book orders in excess of €2.2bn
- DNB Bank, SP, €2bn, 4Y, MS + 35, IPT at MS + 50bps, final book orders around €3bn
- Santander Consumer Finance, SP, €500m, 7Y, MS + 68bps, IPT at MS + 85bps
- Lloyds Banking Group, senior HoldCo, €1bn, 6NC5, priced at MS + 85, IPT at MS + 105/110bps, book orders last heard over €4bn at guidance
- Standard Chartered PLC, Tier 2, $1bn, 10.25NC5.25, T + 185bps, IPT at T + 220bps
- Danske Bank, Tier 2, €750m, 10.25NC5.25, MS + 170bps, IPT at MS + 190bps, final book at €2.3bn

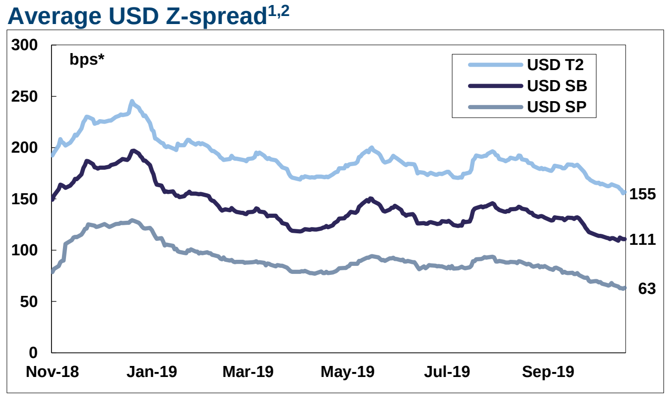
Source: BondRadar

Spreads performance has been mixed in recent weeks. There has been a clear tightening trend in USD spread across layers, backed by the positive news coming from the US - China trade talks and continued monetary easing. Movements in the EUR market were much less clear. Tier 2 spreads have indeed tightened, yet Senior Preferred and Senior Bail-in papers moved largely sideways, impacted also by elevated supply levels.

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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