Daiwa Capital Markets

European Banks – Credit Update

- More than a decade of making European banks far more robust and ready for the next crisis is now coming to fruit, yet their fundamentals will invariably weaken. The duration of the crisis will be a key determinant on the magnitude of its impact.
- Flexibilization on the recognition and impairments of NPLs by both the BoE and the ECB will be welcomed by the banks, yet flexibility of IFRS9 rules is limited.
- Secondary spreads continue to widen significantly, primary markets remained shut.

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Overview

It's been a hectic couple of weeks, in which several governments and central banks announced vast direct and indirect measures aiming to mitigate the social and economic impact of the Covid-19 outbreak. The overall magnitude and duration of the current crisis remains highly uncertain. Accordingly, any assessment of its impact on the financial sector remains unforeseeable. That said, more than a decade of making European banks far more robust and ready for the next crisis is now coming to fruit. Despite the likely strong economic shock, we do believe in the resilience of most of the largest European banks. Their profitability has indeed been a key weakness in recent years, yet their capital bases are mostly solid, liquidity volumes are vast and asset quality has largely been healthy.

A key determinant on the magnitude of the impact will be the duration of the crisis. Some banks are modelling a v-shaped recovery, which we increasingly see as optimistic. Yet the support given by governments in the form of, among others, loan guarantees, direct funding to companies, mortgage moratorium, tax deferrals and direct salary payments will provide European banks some relief. Moreover, the regulatory flexibility in the way impairment charges and NPLs are booked - announced Friday by both the BoE and the ECB - will also be highly welcomed by banks, although there are limitations on the flexibility permitted by the IFRS9 international accounting rules.

In the short to medium term European banks' fundamentals will invariably weaken. The worsening economic outlook will lead to weaker lending growth and lower business activity, leading to lower revenues. Corporate and consumer lending asset quality will deteriorate, leading to a potential spike in impairment charges and significantly higher inflow of new NPLs, despite the measures being implemented by the different governments and regulators. Finally, some of the actions being taken by central banks, although supportive of the economy, will also have negative side effects to the banks. Interest rate margins will tighten significantly as a result of the recent moves by the Fed and the BoE for instance, potentially also resulting in a sustained flattening of yield curves. Higher credit spreads will make funding more expensive (when debt capital markets for European banks eventually re-open), whilst reduced bond and equity issuance will lead to lower fees. Some banks with large trading operations will indeed benefit from the elevated volatility, as highlighted by Credit Suisse earlier last week, but the overall impact will still be negative in the medium term. Finally, should there be significant irrational behaviour among depositors, banks' liquidity could come under strain, yet we'd expect central banks and governments to quickly step in decisively in such scenario.

Bank of England: The BoE announced further measures to reduce the strain on UK banks on Friday morning by cancelling the 2020 stress test, following a similar announcement by the EBA the week before. They've also proposed some relief on how banks are allowed to book NPLs. The unique measures being implemented, such as mortgage payment holidays, should not automatically count as NPLs. Whilst impairment charges, which will depend on the economic outlook, should take into consideration (1) the fact that forecasts are extremely challenging to make at the moment, and (2) the many mitigation measures being announced by the government. Earlier last week the BoE also cut the bank rate by another 15bps, to 0.10%, relaunched QE and announced a new commercial paper funding facility. Although this further loosening of monetary policy may reduce the level of impairment charges and may support the overall economy, top-line revenue will be further hit by a reduction in margins.

European Central Bank: Also on Friday, the ECB announced measures similar to those adopted by the BoE to make NPL rules more flexible. It focused particularly on loans guaranteed by governments or insured by ECAs, and on loans covered by legally imposed payment moratoriums as a result of Covid-19 related distress. It also disclosed that the capital relief measures announced on 12 March will provide euro area banks with a total of €120bn of capital relief to absorb losses without triggering any supervisory action and to support the local economy. The release of the full Pillar 2 Guidance (P2G) buffer accounts for around €90 billion of the relief, whilst €30bn will arise from the flexibilization of how the Pillar 2 Requirement (P2R) can be met. The latter refers to the ruling that, as of last week, 19% of the P2R can be met with AT1 and 19% with Tier 2, instead of being 100% met with CET1 capital only.

Countercyclical Capital Buffer: Following the indication from the ECB last week, both the French and German authorities have announced a cut to their respective CCyBs. In France, the CCyB was at 0.25%, and scheduled to increase to 0.5% by April 2020. The cut to 0% will free up around €8bn of CET1 capital for French banks. In Germany, the CCyB was scheduled to increase from 0% to 0.25% by July 2020. The cut will free up more than €5bn for German banks. In addition, the Swiss National Bank is considering a cut to the 2% requirement on residential mortgages it implemented in 2014 to address the then overheating of the local real estate market.

Banks' Impact

A few banks dared to give some advice on how the ongoing crisis might impact their fundamentals. **Santander** was the boldest one earlier last week, with guidance that its revenues would decline by only 5% in 2020, yet based on a v-shape recovery scenario.

Similarly, **Deutsche**, which also reportedly expects a v-shape scenario, stood by its 2020 and medium-term targets on capital, leverage and profitability. **Lloyds** has confirmed it will delay its planned £3bn investment in technology, whilst **HSBC** might delay parts of its recently announced strategy plan. HSBC also announced earlier last week that the interim CEO Noel Quinn would become permanent. We see the appointment as credit positive, as uncertainty surrounding leadership is highly undesirable in periods of significant distress.

Meanwhile, some banks are actually benefiting from the significant volatility. This was highlighted by **Credit Suisse**, which stated last week that it will report higher Y/Y revenues in wealth management as a result of higher transaction revenues, whilst positive performance in trading and sales has so far offset the negative impact of the market environment on primary markets.

Swedbank

As a reminder that European banks had other issues before the outbreak of the Covid-19, the Swedish FSA published last night their findings from their investigation of Swedbank, which resulted in a warning and a SEK4bn (~$390m) fine. This came as a relief to the bank, as it can be comfortably covered by its $2.4bn of excess CET1 capital reported at end-2019. The bank's excess capital went up from $1.3bn to $2.4bn following the Swedish FSA decision last week to remove the capital countercyclical buffer. We've previously highlighted the $2.0bn net profit the bank reported for 2019, which would also provide a relatively strong buffer, yet, given the current crisis, it's highly unclear how much of the fine the bank will be able to absorb through its P&L. In addition, the bank is still being investigated by the Swedish economic crime authority and by the U.S. authorities. The latter is of greater concern as the bank's internal investigation found that the bank potentially broke US sanctions through 586 transactions amounting to $4.8m. The full findings of the bank's internal investigation were published today. That said, the U.S. investigation might linger for years to come.

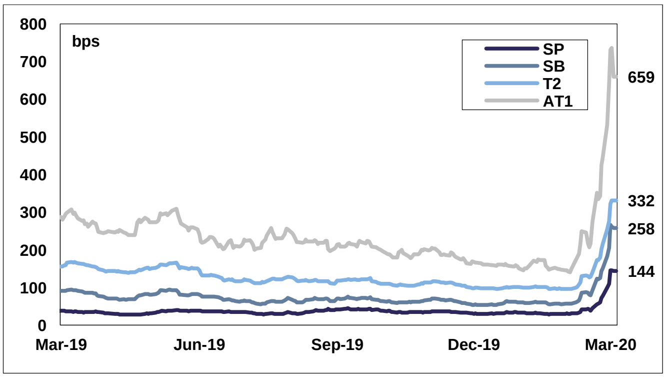
Market Reaction

Secondary spreads continued to widen significantly last week, although there was some stabilization towards the end of the week. The average EUR Z-Spread of AT1s is now trading at 659ps, up 215bps W/W as of Friday closure, and +518bps since mid-February 2020; Tier 2s were up by 116bps W/W and by 235ps since mid-February (at 332bps); senior bail-in debt was up by 107bps W/W and 200bps since mid-February (at 258bps); whilst senior preferred debt was up by 68bps W/W and by 114bps since mid-February, at 144bps.

The primary market remained shut for European banks last week, whilst, in a weak sign for SSAs, L-Bank pulled a 2Y deal on Thursday as it only got €800m in orders for a €1bn deal size. Yet there were some encouraging signs from European corporates with deals from Unilever (dual tranche 5Y/10Y, €1bn/€1bn, MS+140/+170bps) and Engie SA (triple tranche 5Y/8Y/12Y, €1bn/€750m/€750m, MS +160/+180/+210bps), albeit with substantial concessions. Back in October, Engie paid MS+52bps for a similar 11Y note.

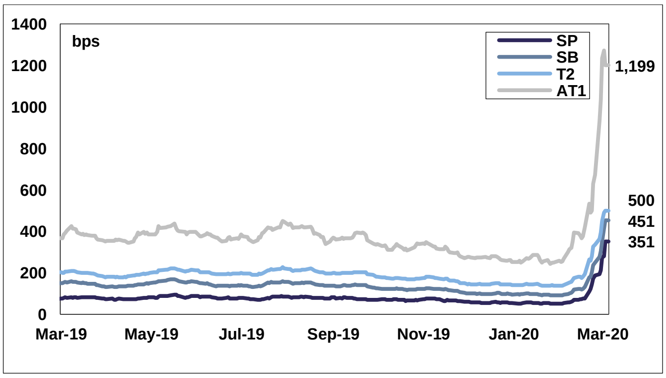
The SX7P closed the week down by 4% last week, vs -2% of the STOXX Europe 600. The SX7P is down 39% YTD, vs -29% of the STOXX Europe 600.

(Chart 1) Western European Banks Average EUR Z-spread



Source: Bloomberg. SP = Senior Preferred/Senior OpCp; SNP = Senior Non-Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1.

(Chart 2) Western European Banks Average USD Z-spread



Source: Bloomberg. SP = Senior Preferred/Senior OpCp; SNP = Senior Non-Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1.

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[Standard & Poor's]

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