Daiwa Capital Markets

European Banks – Credit Update

- The largest European banks accessing the JPY market have around $500bn of excess capital to weather the current crisis, an increase of around $210bn as a result of the recent measures announced by central banks across the region.
- Liquidity levels at the start of the crisis were comfortable, whilst new funding and liquidity facilities provided by central banks should alleviate any short-term market strain.
- Unsecured primary markets re-opened last week for European FIGs, with very attractive spreads.

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Bank fundamentals and the ongoing crisis

Capital. Following the recent reduction in capital requirements across the continent, the largest European banks with a history of access to the JPY market have an estimated $500bn of Common Equity Tier 1 (CET1) capital in excess of minimum requirements. Recent measures by central banks across the regions raised this excess capital volume by around $210bn according to our estimates. Table 1 on page 2 provides a breakdown by bank.

The increase came largely from the euro area issuers (+$181bn), as the ECB's cuts to minimum requirements were more comprehensive than those undertaken by other supervisors across the continent. In particular, the ECB cut the Capital Conservation Buffer (2.5% of RWA) and the Capital Countercyclical Buffer (CCyB). It also brought forward the rules allowing banks to use AT1 and Tier 2 instruments to partly meet their Pillar 2 Requirements (P2R). Finally, it also removed the Pillar 2 Guidance, an undisclosed requirement based on which the regulator may push banks to increase their capital base, although still allowing for capital redistribution. Given the lack of disclosure and the non-impact on capital redistributions, the cut to the P2G was not included in our estimates. Meanwhile, other European regulators have largely only cut the CCyB so far, which gives them ample room for further loosening in requirements. In the Netherlands the local regulators also cut the systemic risk buffers (SRBs), whilst the Swiss regulator announced that deposits placed at central banks will not count towards banks' leverage exposure.

Prior to the changes, euro area JPY issuers had a total of $193bn of excess capital, vs $90bn of the largest banks in Denmark, Sweden, Switzerland and the UK. The difference arises from the lower capital requirements applied to euro area banks on average, whilst non-euro area bank issuers remain better capitalized on average, despite the lower excess volumes.

Capital levels will also be supported by the suspension of dividend payments. Following a similar decision by the Swedish FSA earlier last week, on Friday the ECB advised euro area banks to scrap dividend payments for the financial years 2019 and 2020 until at least October 2020, whilst capital buybacks should also be stopped. Elsewhere, Credit Suisse has also announced a suspension of its capital buy-back programme.

Liquidity levels at the start of the crisis were solid, with comfortable Liquidity Coverage Ratios backed by elevated volumes of Hiqh Quality Liquid Assets. That said, the data are now three months old, which is a long time for liquidity indicators, as we previously learned from Banco Popular. Banks' liquidity levels have been impacted by corporates reportedly fully drawing down credit lines with banks in recent weeks, and by the potential quick increase in new lending on the back of the several loan guarantee schemes launched by countries across Europe. Yet central banks are being quick in utilising all tools available to ensure continuous frictionless functioning of banking systems. In the U.K., the BoE launched the Term Funding Scheme with additional incentives for SMEs (TFSME), offering cheap four-year funding, with daily drawdowns for 12 months. It also launched its Contingent Term Repo Facility (CTRF), a temporary enhancement to its sterling liquidity insurance facilities designed to help alleviate frictions observed in money markets in recent weeks.

In the euro area, the ECB launched a new Long Term Refinancing Operation (LTRO), with weekly auctions all maturing on 24 June 2020, when banks will be able to shift outstanding LTRO facilities into TLTRO III. The conditions for the latter were improved, with an increase in the allowance amount per bank, early repayments available after 12 months (from the previous 24) and no take-up limit in each auction. The conditions on the TLTROs between 24 June 2020 and 23 June 2021 were amended. The rate applied to all outstanding TLTROs in the period will be 25bps below the ECB's main refinancing rate for those who do not reach the lending target (-0.25%), and 25bps below the average rate on the ECB's deposit facility (-0.75%) for those who do reach the lending target. The lending target itself was also eased. In all, the most favourable conditions will be in place for a year from 24 June 2020, so that a significant drawdown is expected on that day. In the past two weeks, euro area banks drew down €190bn in LTROs and €115bn in TLTRO III, whilst €93bn of outstanding TLTRO II funds were repaid. Total outstanding LTRO is now at €825bn, the highest since 2013.

In Switzerland, the SNB announced a Covid-19 refinancing facility for banks, following the Swiss government's announcement the week before of a CHF20bn fund of state-backed bridge loans to support small businesses. Swiss banks can use loans granted under the government bridge loan program as collateral for the facility, which has no upper limit and draw-downs can be made at any time. This will ensure local banks have sufficient funding and liquidity to cover the increase in lending.

In addition to strong liquidity buffers, the elevated level of primary market activity in January and early February in both secured and unsecured format means European banks are generally well ahead on their funding plans for the year. This will allow them to stay out of the markets for a prolonged period should it be needed. Lower business activity and reduced loan demand as a result of the economic downturn will also reduce banks' funding needs. The recent re-opening of the debt capital market for European banks is reassuring, yet spreads remain prohibitive for lower-rated entities and lower-ranked paper.

Profitability. The many moving parts of banks' profitability make a comprehensive assessment rather challenging, if not unfeasible at the moment. Although there are positive drivers, such as greater treasury activity, increased demand for some products, an upwards-sloping curve, recovery in Euribor and liquidity measures, the overall trend will be downward, hit by, among other, even lower interest rates, squeezed margins, higher funding costs, lower demand, lower banking activity, and higher impairment charges.

Profitability was already a key weakness before the crisis, with the outlook now for the short to medium term being particularly bleak. Accordingly, in a normal environment, we'd use previous year profits as a proxy of how much loss a specific bank can absorb through its P&L. Yet, amid this unprecedented environment, the conservative approach is for P&L not to be used as source of loss absorption or organic capital generation. Banks with a higher cost base (elevated cost to income ratio) and higher percentage of losses consuming pre-impairment profit (LLP / Pre-Imp. Profit) are the ones in a weaker position to weather the forthcoming reduction in revenues and increase in impairment charges (See breakdown in Table 1).

Asset Quality. Similar to profitability, it is unrealistic – not to say pointless – to make any reasonable estimate on how much the asset quality of European banks will deteriorate in the forthcoming quarters. But it will be material, as a result of the expected deep recession and sharp increase in unemployment. Consumer lending (e.g. credit cards, personal loans) and SME lending will likely deteriorate the most. Residential mortgages, often the biggest exposure of retail banks in Europe, will be given some relief from the payment holidays being offered by banks and governments, but defaults will increase nonetheless.

Another potential weakness is the elevated private sector indebtedness in specific countries, particularly in the UK (149% of GDP at end-3Q19) and France (135%). The French case is of greater concern, as, whilst the UK figure is down 10ppt since end-3Q09, France is an outlier in Europe as its private sector debt has increased since the financial crisis, +25ppt since 3Q09.

(Table 1) European banks fundamentals and excess capital (as of YE19)

Bank	CET1 (%)	LR (%)	LCR (%)	Liquidity Reserves ($bn)	CIR (%)	RoTE (%)	LLP / Pre-Imp. Profit (%)	Old CET1 Req. (%)	Est. New CET1 Req. (%)	Old CET1 Excess ($bn)	New CET1 Excess ($bn)	Δ Excess Capital ($bn)
Commerzbank	13.4	5.1	135	80	77	3.4	33	10.6	7.1	5.6	**12.7**	7.1
Deutsche Bank	13.6	4.2	141	246	120	-	-	11.6	7.9	13.0	**20.5**	7.5
Danske	17.3	4.6	140	69	69	12.6	10	14.9	13.2	2.8	**4.7**	2.0
BBVA	11.7	6.7	129	162	48	9.9	16	9.3	6.1	10.0	**22.9**	12.9
Santander[1]	11.7	5.1	163	237	47	12.6	43	9.7	6.3	13.1	**35.7**	22.6
Nordea	16.3	5.3	166	118	51	11.3	20	13.2	8.5	5.2	**13.0**	7.8
BFCM	17.3	6.4	143	149	61	5.7	19	8.8	5.3	21.4	**29.9**	8.5
Crédit Agricole	15.9	5.7	128	331	67	8.1	16	9.7	6.3	22.3	**34.3**	11.9
BPCE	15.6	5.3	110	256	72	5.3	25	10.0	6.5	26.4	**42.8**	16.4
BNP Paribas	12.1	4.6	125	343	71	9.8	24	9.9	6.7	16.2	**40.1**	23.9
SocGen	12.7	7.9	124	211	73	6.2	23	10.0	6.5	10.3	**23.8**	13.6
Intesa Sanpolo	14.1	6.3	>100	211	56	9.9	24	9.2	5.9	16.4	**27.2**	10.8
UniCredit	13.1	5.3	>100	202	52	10.8	38	9.8	6.5	13.7	**27.8**	14.1
Rabobank	16.3	6.4	132	123	64	5.3	24	11.8	7.5	10.3	**20.1**	9.9
ING Group	14.6	4.6	127	149	57	9.4	14	12.0	8.0	9.4	**23.8**	14.4
DNB	17.2	7.40	138	52	43	15	7	16.1	14.8	1.0	**2.2**	1.2
Swedbank	17.0	5.4	182	38	44	14.7	6	15.1	13.1	1.2	**2.5**	1.3
UBS[2]	13.1	5.6	138	166	81	9.0	1	9.6	9.6	4.8	**8.4**	3.6
Credit Suisse[2]	12.7	5.5	198	173	78	8.6	6	10.0	10.0	5.1	**8.3**	3.1
Lloyds	13.8	5.20	137	164	55	8	15	12.8	11.0	2.5	**7.1**	4.6
Nationwide[3]	31.5	4.60	140	39	73	4	14	13.1	12.1	1.9	**3.1**	1.2
HSBC	14.7	5.30	150	751	59	8.4	11	11.3	10.7	35.8	**42.2**	6.3
Santander UK	14.3	4.70	146	53	61	7.8	13	10.8	9.8	3.2	**4.1**	0.9
RBS	16.2	5.8	152	156	59	4.7	14	9.7	8.9	14.5	**16.3**	1.8
Barclays	13.8	5.1	160	264	63	9.0	31	12.5	11.4	4.8	**8.9**	4.1
Standard Chart.	13.8	5.2	144.0	198	68.2	6.4	19	10.3	9.90	11.7	**12.9**	1.2
Total										**283**	**495**	**213**

Source: Banks financial reports, Daiwa Capital Markets Europe. [1]Liquidity figures refer to Santander Spain only. [2] UBS and Credit Suisse excess capital is based on their leverage ratio and not on the CET1. [3] Figures as of September-2019.

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Moreover, in addition to the global pandemic, the sharp decline in oil prices has increased the risk of exposures to the oil & gas sector. ING, Credit Agricole, SocGen, Commerzbank, and Natixis (BPCE) are among the names most exposed in this respect. Yet credit risk mitigating measures taken in the previous slump in oil prices mean these banks are overall in a good position to withstand a potential increase in defaults in the sector.

Overall, the deterioration in asset quality of European banks will be sensitive to the shape of the economic recovery. Should it be V-shaped, which we see as optimistic, asset quality deterioration should be limited and should start reversing soon. Meanwhile, a L-shaped profile for activity would lead to more substantial volumes of new NPLs, although the overall deterioration should still be manageable by most of the largest European banks. As their loan books are currently healthy, i.e. with low NPL levels, banks will face this crisis from a strong starting point.

Finally, banks' balance sheets are being used by governments as a tool to mitigate the economic impact of the virus outbreak. Governments rely hence on well-functioning banking systems. As a result, in the unlikely scenario in which the current supporting measures provided by the different central banks and governments, such as loan guarantees and funding and liquidity facilities, prove to be insufficient, additional measures would be expected.

IFRS9

Despite the recently announced moves by both the BoE and the ECB to make the recognition and impairments of NPLs more flexible in the current crisis, there's a limit on how much flexibility is allowed under the internationally agreed IFRS9 accounting rules. In that context, the EBA, the ECB, ESMA and the European Commission are reportedly looking into either applying a temporary suspension of the IFRS9 rules, or the extension of the current transition period that was agreed before IFRS9 took effect in 2018.

IFRS9 rules are gradually being implemented since January 2019. This changed how banks book impairments on non-performing loans. The rules moved from an 'incurred losses' approach, to an 'expected losses' approach. That is, instead of booking a loss when a company or individual actually stops paying, the loss is booked as soon as the bank expects the debtor to default in the future. The main flaw with it is that, in downturns, in light of the negative outlook, expected losses will be much higher than incurred losses, as there's usually a lag before companies actually stop paying back their debt. The move to an expected loss approach makes impairment charges highly pro-cyclical and volatile, exactly what we expect to observe in the next few quarters.

It is worth noting it was these same regulators who originally supported the implementation of these rules, a clear example of overregulation backfiring. A temporary suspension of accounting rules could undermine investors' confidence on banks' financials. The fact that this is even being considered highlights expectations of a sharp deterioration in impairment charges.

Rating agency actions

Acting more sensibly than in the financial crisis, rating agencies are being quicker this time around in reviewing their ratings. On Thursday, Moody's changed the outlook of six European banking systems to negative from stable. These are France, Italy, Spain, Denmark, the Netherlands and Belgium. It also maintained the negative outlooks for the banking systems in Germany and the UK, and kept stable outlooks on the Swedish and Swiss systems.

On Friday, Fitch downgraded the U.K. to AA- with negative outlook. We expect the ratings of the UK banks to be reviewed soon as a result. The agency also reviewed some German banking groups. It downgraded Commerzbank's SP from A- to BBB+/Negative, and the bank's SNP from BBB+ to BBB. Deutsche Bank's rating were put on Rating Watch negative, meaning it will be reviewed soon. Earlier in the week, the agency took action on Italian banks reflecting the outbreak of Covid-19 and a change in the agency's banks rating methodology. Intesa's Senior Preferred debt was affirmed at BBB, whilst its Tier 2 debt was downgraded by one notch to BB+, and the AT1 paper was upgraded by one notch to BB-. Unicredit's Senior Preferred paper was affirmed at BBB, its Senior Non-Preferred was downgraded by one notch to BBB-, Tier 2 downgraded by one notch to BB+, and the AT1 was upgraded by one notch to BB-.

We expect a significant number of rating actions by all three agencies in the next couple of quarters, particularly as hard data on the economic and financial impact of the outbreak arise.

Primary and secondary markets

After four weeks of no activity, the **unsecured primary market** for European banks finally re-opened last week with UK and Swiss names. Euro area banks are yet to come back to the markets for senior unsecured paper, although BPCE has accessed the market for secured debt. The transactions were largely successful in terms of demand. Spreads widened substantially from previous transactions, a whole new reality in terms of funding costs for issuers. Investors on the other hand should be looking at these with strong interest, being accustomed to very tight spreads for the past few years. Key transactions:

- Lloyds Banking Group, Senior HoldCo, 6NC5, EUR1.5bn, priced at MS+375bps, IPT at MS+400bps, final book size EUR8.75bn. In November 2019 the bank issued a similar paper at MS+85bps.
- HSBC Holdings launched a USD2.5bn 10Y priced at T+415bps, IPT was at T+450bps. Back in October 2019 the bank issued a 6NC5 USD2bn paper at T+112bps.
- Barclays, Senior HoldCo, 5Y, EUR2bn, priced at MS+370, IPT at MS+410bps, book orders over €8.25bn. Back in December 2019 the bank issued a similar paper 5.5NC4.5 at MS+105bps.
- Standard Chartered, Senior HoldCo, USD2bn, 11NC10, priced at T+385, IPT at T+425bps. In January 2020 the bank issued a similar paper, 6NC5, at T+120bps.

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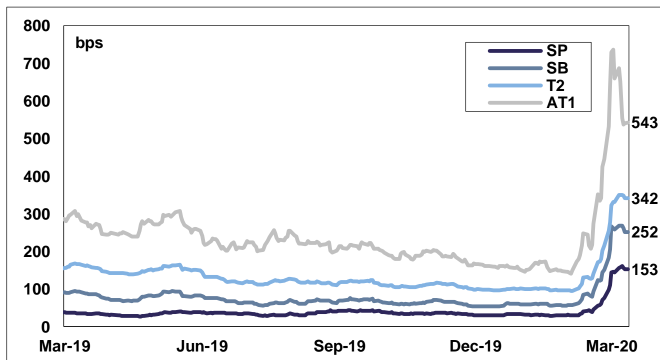
- RBS NRF OpCo (Natwest Markets), Senior Opco, EUR1bn, priced at MS+300, IPT at MS+340bps, books closed in excess of EUR5bn. In November 2019 the bank issued a similar paper at MS+95bps.
- Credit Suisse, Senior HoldCo, 6NC5, EUR2bn, priced at MS+350, IPT at MS+390bps, book orders over EUR12bn. In January 2020 the bank issued a similar paper, 8NC7, at MS+77bps.
- Credit Suisse, Senior HoldCo, 11NC10, USD3bn, priced at T+350bps, IPT at T+387bps. In September 2019 the bank issued a USD2bn Senior HoldCo 6NC5 at T+128bps.

In the secured market, BPCE placed a EUR1bn 5Y covered bond on Tuesday with just enough demand (1.2x), priced at MS+40, 31bps above the price of a similar deal executed in January 2020.

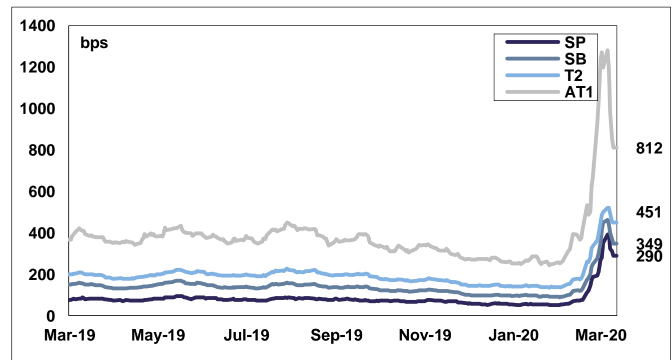
In the **secondary market**, after weeks of continued widening, lower-ranked secondary spreads tightened noticeably last week, particularly for lower ranked papers, and partly helped by real price discovery in the primary market. Average EUR SP was still up however, by 10bps W/W, whilst EUR SNP was down 6bps W/W, EUR Tier 2 was down 10bps W/W, and AT1 was down 116bps.

(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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This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of September 27th, 2019, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www. fitchratings.com/site/japan)

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