Daiwa Capital Markets

European Banks – Credit Update

- The SRB has signaled it may take a flexible approach towards MREL requirements.
- The restrictions on capital redistributions announced last week will have limited positive impact on banks' capital buffers, yet already unloved banks' shares will become even less attractive given the increased uncertainty regarding dividend payments.
- Unsecured primary market activity was weak; secondary spreads tightened further, albeit remaining still substantially above pre-Covid-19 crisis levels.

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MREL changes

The Single Resolution Board (SRB), the resolution authority for euro area banks, disclosed last week that it is considering taking a flexible approach towards MREL requirements. It stated that it will "carefully monitor the market conditions in the next months and analyse the potential impact on transition periods needed for the build-up of MREL. The SRB is ready to use its discretion and the flexibility given by the regulatory framework to adapt transition periods and interim targets applied to banking groups, as well as to adjust MREL targets in line with capital requirements, with particular reference to capital buffers". Were MREL requirements to remain unchanged whilst CET1 requirements are reduced, the issuance needs of senior bail-in bonds (SNP, Senior HoldCo) by euro area banks would potentially increase.

Restrictions to capital redistribution

The BoE followed in the footsteps of its euro area and Swedish peers last week by requesting the seven largest UK banks to suspend dividend payments and capital buybacks. Despite some early resistance, the confirmation by the banks that they would indeed follow the regulator's advice led to a sharp decline in their share prices. Indeed, the STOXX Europe 600 Banks (SX7P) was down 11.5% last week, whilst the overall European market, as measured by the STOXX Europe 600 (SXXP), was down by only 0.6%. The retained dividends will lead to an improvement in impacted banks' YE19 CET1 ratios of less than 100bps.

It is understandable that regulators want to use all available means to ensure a well-functioning banking system in the current environment, particularly as banks are being used as a tool by governments and central banks in their response to the social and economic turmoil. And banks will also benefit if and when policies succeed in minimising the economic downturn and eventually facilitating a sustainable recovery. The many bailouts provided during the financial crisis are also a strong reminder of the need to have banks well capitalised and with adequate liquidity levels. That said, European banks are already largely well capitalized, whilst, in theory, restrictions to capital redistribution were only supposed to be applied once banks' capital ratios are below their minimum capital requirement. As a result of the request for a freeze on divided payments this year, banks' shares, already unloved by the markets, will become even less attractive in the future given the increased uncertainty investors will have on dividend payments.

In Switzerland, Finma stated that any payments to shareholders will now be deducted from the capital relief the regulator applied to leverage ratios, adding pressure hence for UBS and Credit Suisse to suspend capital distributions. Yet both banks have so far ignored the regulator's pressures and are sticking to their capital redistribution plans.

Although highly negative for equity holders, the suspension of dividend payments is positive for debtholders, at least in the short term, as retained earnings are turned into capital, further improving their loss absorption buffer. Accordingly, whilst share prices declined significantly last week, bond spreads tightened on average (see secondary market comment below).

Liquidity

Although overall liquidity in financial markets is reportedly under strain, banks' liquidity buffers remain adequate. In fact, given the decline in expenditure by depositors, savings volumes may actually increase. This was confirmed by Danske Bank last week, which is seeing a surge in deposits. The bank has also confirmed that its Liquidity Coverage Ratio (LCR) is "quite a bit higher" after it tapped funding facilities offered by central banks. In the euro area meanwhile, banks drew down €350bn in LTROs in the past three weeks, with a total €870bn of LTROs outstanding.

The surge in deposits, the significant intake of LTROs and the potential flexibility on MREL targets help explain why euro area banks are yet to tap unsecured markets for funding, in contrast to UK and Swiss banks for instance.

Rating agencies actions

Fitch has been in a rush to review the ratings of a large number of European banks in recent days. The majority of changes has been on Outlooks, Tier 2 and AT1 so far, whilst changes in the agency's methodology resulted in some poorly timed upgrades. We continue to expect a considerable number of downgrades by all three agencies in the next couple of quarters, particularly as hard data on the economic and financial impact of the outbreak start to arise.

Unicredit, Deutsche Bank and Commerzbank currently have their SNP ratings just one notch above sub-investment grade, which makes them the most exposed to downgrade risk among the European banks with a track record of JPY issuance. That said, the rating methodology changes by both Moody's and Fitch may provide some support to SNP ratings.

Moody's last week downgraded Swedbank's Senior Preferred rating to Aa2, from Aa3; whilst the Senior Non-Paper was downgraded to Baa1 from A3. The downgrade was driven by the recent findings on the bank's AML failures rather than a result of the covid-19 crisis.

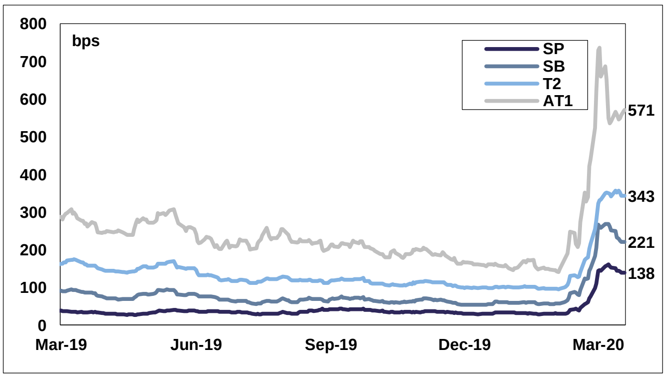
Primary and secondary markets

Primary market activity was subdued last week, with Lloyds being the only European bank tapping the unsecured market, whilst Credit Agricole and Credit Mutuel went for safer covered bond transactions. Key transactions:

- Lloyds, Senior HoldCo USD1.5bn 5.25NC4.25, launched at T+350bps, 25bps inside IPT.
- Lloyds, Non-Ring Fenced Senior OpCo (LBCM), EUR1bn, 6Y, priced at MS+270bps, 30bps inside IPT, with orders over EUR3.25bn.
- Credit Mutuel, CB, EUR1.75bn, 5Y, priced at MS+40. In January 2020 the bank issued a 10Y covered bond priced at MS+6bps.
- Credit Agricole, CB, EUR2bn, 4.5Y, priced at MS + 40. In February 2020 the bank issued a 12Y covered bond priced at MS+7bps.

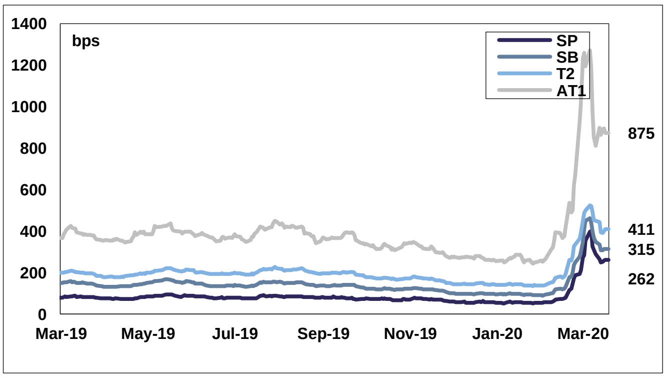
In the **secondary market**, spreads continued to tighten last week yet remained substantially above the levels reported before the crisis. The tightening was consistent in the euro market, yet some widening was observed towards the end of the week in the USD market. The EUR SP Z-Spread was down 14bp W/W at 138bps at Friday closure, whilst the average EUR Senior Bail-in paper was down 31bps at 221bps. In the USD market, the average SP Z-Spread was down 28bps since Friday closure at 262bps, whilst Senior Bail-in paper was down 33bps at 315bps.

(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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[Moody's]

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[Fitch]

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