Daiwa Capital Markets

European Banks – Credit Update

- Market conditions led U.S. banks to report strong trading gains in 1Q20, yet this was overshadowed by a sharp increase in impairment losses and lower CET1 ratios.
- European banks are expected to follow the trend, yet regulatory flexibility, particularly in the euro area, will allow for lower impairment charges and a lower impact on capital.
- French banks reopened the unsecured primary market for euro area names with 3 SNP placements, while the tightening trend in secondary spreads continued.

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1Q20 Results

U.S. Banks

Strong market conditions led to a sharp increase in **trading earnings** by the largest U.S. trading banks in 1Q20. Average FICC earnings were up 31% Y/Y, backed by strong performance across rates, foreign exchange and commodities, on strong client engagement and market volatility, which was partially offset by declines in credit products. Equities revenues were up 28%, also driven by increased client activity and market volatility. IB earnings however were down 9% Y/Y, as higher debt and equity underwriting in January and early February were offset by lower advisory fees. The Q1 performance in trading is not expected to continue in coming quarters, as client activity has largely already returned to normal levels.

Negatively, **loan loss provisions** booked in 1Q20 were between four and five times higher than in 1Q19 resulting from the significant deterioration in the economic environment and outlook. Moreover, **CET1 ratios** declined 40-110bps Q/Q due to higher counterparty credit risk, market risk and increased lending volumes (up 5% Q/Q).

U.S. Banks IB Revenues Growth (4Q19 Y/Y)

	Origination & Advisory	FICC	Equity
JPMorgan	-49%	34%	28%
Citi	0%	39%	39%
Goldman Sachs	8%	33%	22%
Morgan Stanley	-1%	29%	20%
BofA	10%	13%	39%
Average	-9%	31%	28%

Source: Banks' financial statements. Figures may not be directly comparable.

Western European Banks

In Europe, **trading gains** are also expected to be solid in Q1, as already signaled by Credit Suisse and UBS, yet the increase in loan loss provisioning is likely to be less dramatic than in the U.S., as European regulators have allowed for a significantly more flexible approach towards the recognition of impairment charges. Moreover, American banks are more profitable than their European peers, which gives them more headroom for elevated impairment charges.

That said, we are still likely so see a material **increase in impairments** by European banks. The timing and source of the charges remains unclear however, as the duration and severity of the economic impact of the Covid-19 outbreak remains highly uncertain, impeding any meaningful assessment by the banks themselves. Moreover, the positive impact of government guarantees and other supportive measures on banks' financials also remain uncertain. Accordingly, comments on more recent trends and their expected impact might arguably be more important in the forthcoming results calls than any particular Y/Y change on specific numbers.

Impact on capital will also be a key focus point. Although CET1 volumes will benefit from the dividends freeze, RWAs will increase on the back of higher lending volumes and RWA inflation. The latter will be a result of (1) ratings migration leading to higher counterparty risk – as the credit profile of banks' counterparties deteriorates, more capital needs to be held against related exposures; and (2) higher market risk RWA due to extreme volatility observed in the past two months. The impact on market risk RWA will be of greater relevance for the large trading banks (Barclays, Credit Suisse, UBS, BNP Paribas, SocGen and Deutsche). That said, euro area banks will benefit by a decision announced by the ECB on Thursday that it will temporarily reduce the so-called qualitative market risk multiplier.

For the more sophisticated banks, market risk RWA is currently based on a Value at Risk (VaR) model that calculates the maximum loss within a 10-day horizon at a 99% confidence level. VaR models take a holistic approach, and take into consideration portfolio diversification between asset classes. VaR figures are calculated daily on the basis of a historical observation period of at least one year. The capital requirement for market risk equals the average VaR figure over the preceding 60 business days multiplied by a range of quantitative and qualitative multiplication factors. The qualitative factor is added to ensure banks hold additional capital in case their VaR model underestimates market risk.

The measure will arguably help maintain liquidity in the markets, yet it will artificially reduce capital requirements in a period when banks will be under greater stress, reducing transparency and the insightfulness and usefulness of the key indicator used to assess capitalization and loss-absorbing capacity.

Primary and secondary markets

After 8 weeks of no activity, French banks finally reopened the unsecured **primary market** for euro area names last week. The key driver for the return was the rally on SNP paper in the previous week, ranging between 75bps and 100bps. UBS also came to the market, with a couple of short-term Senior OpCo transactions, which reportedly attracted significant demand. Activity remained subdued as a whole however, partly driven by the start of blackout periods. It is increasingly clear that the overall supply of senior debt is likely to fall noticeably Y/Y in Europe in 2020 as a result of the Covid-19 outbreak. In addition to a potential increase in customer deposits as savings rates increase, the measures announced by central banks (e.g. TLTRO by the ECB and the TFSME by the BoE) will provide a material and cheaper source of alternative funding.

Moreover, the reduction of buffer requirements in the UK, and potential increased flexibility of MREL rules in the euro area also means banks will face lower regulatory pressure to issue bail-in bonds this year. This drop in expected supply partly drove the tightening of senior secondary spreads in the past two weeks, particularly for euro area banks.

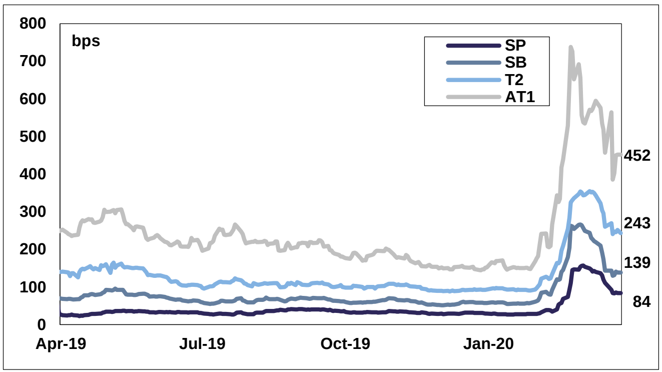
- SocGen, SNP, EUR750m, 6NC5, MS+150bps, IPT at MS+175bps, order book of EUR1.1bn. In January 2020 the bank issued a 7Y SNP paper at MS+80bps.
- Credit Agricole, SNP, EUR1.5bn, 6NC5, MS+125bps, IPT was at MS+155bps, book orders over EUR5bn. In early January 2020 the bank priced a 12Y EUR1.25bn SNP at MS+70bps.
- BNP Paribas, SNP, EUR1.25bn, 9NC8, priced at MS+135bps, IPT was at MS+175bps, book orders over EUR5.3bn. In February 2020 the bank placed a SNP 8NC7 at MS+73bps.
- UBS, Senior OpCo, EUR2bn, 3Y, MS+110, IPT at MS+145bps, book orders over EUR7bn.
- UBS, Senior OpCo, USD2.5bn, 2Y, T+160bps, IPT was at T+200bps.

The **secondary** market saw a continuation of the tightening observed in the past few weeks across the debt stack in both the EUR and the USD space, albeit at a much slower pace. The only widening observed was across French SNP paper due to the new supply in the primary market.

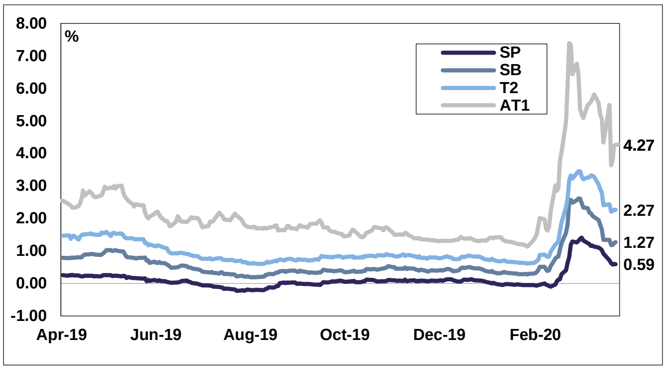
EUR SP spreads remain 56bps above pre-crisis levels (+83bps for SNP paper), whilst USD SP/Sr OpCo debt remains 72bps above pre-crisis levels (+962bps for SNP/Sr HoldCo paper). On AT1s, volatility remains high, in line with the equity market, yet concerns of regulatory driven restrictions on AT1 coupon payments have now dissipated, as regulators focused on capital buy-backs, dividends and bonuses, but made no comments on restrictions on AT1 coupon payments. This has further supported the recent tightening of AT1 spreads. That said, AT1 coupons remain discretionary and the risk of non-calls remains elevated due to the persistently wide spreads.

Western European Banks EUR Z spreads

Median Z-spread LTM (bps)



Median Yields LTM (%)



Median EUR SP/Senior Opco Z-Spread Net Change (bps)

	YTDΔ	Last 5 Days Δ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	74	-9	-7	-9	-9	-9
DENMARK	53	-7	-5	-8		
FINLAND	50	-8	-9	-7	-7	-11
FRANCE	48	-8	-7	-8	-7	-8
ITALY	67	-8	-8	-7	-7	-8
NETHERL.	140	-15	-15	-15	-18	-21
SPAIN	57	-9	-9	-9	-9	-8
SWEDEN	103	-8	-8	-8	-9	
SWITZ.	44	-6		-6		

Median EUR SP/Senior OpCo Z-Spread Value (bps)

	All	Z Spread Curve			
		1-3Y	3-5Y	5-7Y	> 7 Y
UK	103	103	104	104	104
DENMARK	84	81	87		
FINLAND	77	73	79	83	90
FRANCE	76	72	74	81	86
ITALY	109	93	118	94	105
NETHERL.	216	203	205	245	248
SPAIN	82	77	103	77	165
SWEDEN	149	110	152	163	
SWITZ.	81		81		

Median EUR SNP/Senior HoldCO Z-Spread Net Change (bps)

	YTDΔ	Last 5 Days Δ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	122	-5	-5	-6	-2	-3
DENMARK	103	-11	-11	-8	-8	
FINLAND	83	-12		-12		
FRANCE	70	11	8	12	11	13
ITALY	178	-6	-15	4	-5	-10
NETHERL.	71	-14	-17	-10	-10	-13
SPAIN	110	-11	-13	-12	-6	-10
SWEDEN	71	-11		-15	-11	-10
SWITZ.	97	1			3	1

Median EUR SNP/Senior HoldCo Z-Spread Value (bps)

	All	Z Spread Curve			
		1-3Y	3-5Y	5-7Y	> 7 Y
UK	184	155	179	200	184
DENMARK	169	149	173	186	
FINLAND	122		122		
FRANCE	126	112	114	127	136
ITALY	294	268	537	296	292
NETHERL.	119	102	99	126	127
SPAIN	172	130	201	170	188
SWEDEN	134		134	120	131
SWITZ.	164			170	164

Median EUR Tier 2 Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	204	-33	-38	-33	-33	-20
DENMARK	156	-24			-29	-19
FINLAND	197	-3	-3		-12	-6
FRANCE	114	-11	-9	-16	-17	-9
ITALY	202	1	-18	-26	-7	8
NETHERL.	151	-18	-23	-23	-21	-9
SPAIN	272	-26		-23	-35	-23
SWEDEN	134	-18			-8	-22

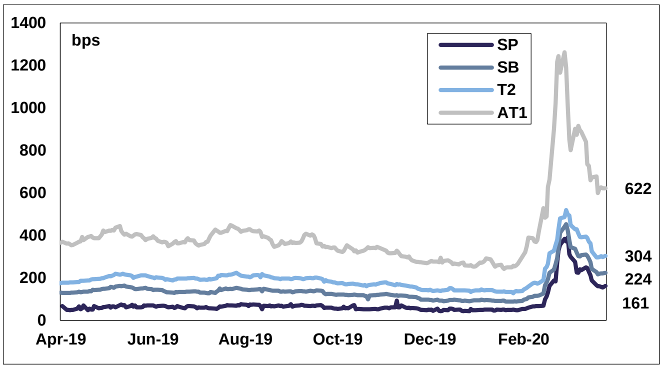
Median EUR Tier 2 Z-Spread Value (bps)

	All	Z Spread Curve			
		1-3Y	3-5Y	5-7Y	> 7 Y
UK	296	271	290	515	319
DENMARK	287			307	287
FINLAND	255	136		256	271
FRANCE	222	106	183	212	245
ITALY	476	341	309	336	526
NETHERL.	295	164	176	320	300
SPAIN	370		200	367	536
SWEDEN	259			256	260

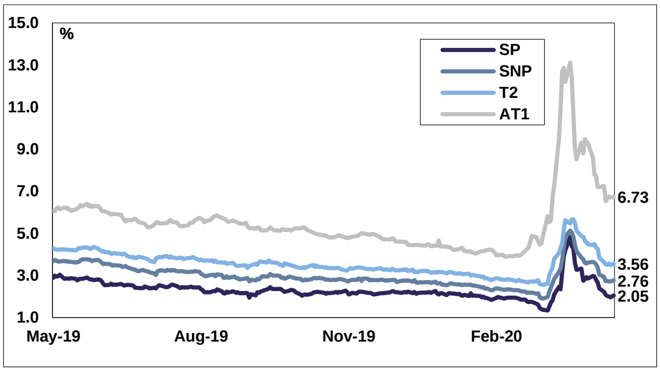
Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances. Blank cells represent lack of statistically significant data. Figures may not be representative of the whole market and are not corrected for duration.

Western European Banks USD Z spreads

Z-spreads LTM performance (bps)



Yields LTM performance (%)



Median USD SP/Senior Opco Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	105	-20	-40	-10		
DENMARK	7	0				
FINLAND	4	0	11			
FRANCE	77	-1	-15	-14		
ITALY	139	-5	-20	-45	-29	
NETHERL.	122	-7	-12		0	
SPAIN	59	-12		-62		
SWEDEN	11	0	-38			
SWITZ.	159	0	0	0		

Median USD SP/Senior OpCo Z-Spread Value (bps)

	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	170	153	170	177	
DENMARK	169	145			
FINLAND	135	123			
FRANCE	157	59	163	176	
ITALY	304	272	303		
NETHERL.	130	116		174	
SPAIN	203		179		
SWEDEN	180	150			
SWITZ.	146	137	183		

Median USD SNP/Senior HoldCo Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	116	-24	-25	-27	-24	-15
DENMARK	183	-22	-24	-11	-39	
FINLAND	158	-22		-22		
FRANCE	132	-22	-28	-29	-23	-18
ITALY	239	-9	6	-25		
NETHERL.	113	-22	-55	-33	-33	-18
SPAIN	135	-11	-33		-9	-10
SWITZ.	123	-41	-41	-71		-20

Median USD SNP/Senior HoldCo Z-Spread Value (bps)

	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	216	183	207	228	244
DENMARK	265	261	265	285	
FINLAND	187		187		
FRANCE	216	191	212	217	225
ITALY	369	343	395		
NETHERL.	185	152	171	190	212
SPAIN	241	206		261	260
SWITZ.	198	182	194		233

Median USD Tier 2 Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	160	-24	-25	-35	-8	-36
FINLAND	97	-21	-21			
FRANCE	158	-24		-47	-24	-19
ITALY	223	0		0	-5	18
NETHERL.	175	-24	-53	-24	0	-24
SPAIN	203	13			13	

Median USD Tier 2 Z-Spread Value (bps)

	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	326	297	291	275	329
FINLAND	254	228			304
FRANCE	305		299	282	365
ITALY	518		519	452	525
NETHERL.	270	217	239	264	405
SPAIN	315			315	

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances. Blank cells represent lack of statistically significant data. Figures may not be representative of the whole market and are not corrected for duration.

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