Daiwa Capital Markets

European Banks – Credit Update

- Banks with sizeable investment banking operations have been able to navigate the current crisis from a stronger position than pure retail-focused peers.
- A strong performance in FICC earnings led European investment banks to outperform their American peers in Q1.
- Measures announced by the European Commission and the ECB will provide material capital relief and liquidity support to European banks.

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The beauty of diversification

The current crisis is providing evidence in favour of universal banking models, which combine retail and investment banking operations. The usefulness of diversification in a crisis was already evident in the results of the American names. It became clearer in the past week as the material profit generated in the global market divisions of UK banks allowed them to report record high provisions for expected retail loan losses without impacting their capital base. This was the case for HSBC, Barclays and even RBS, with the long underperforming NatWest Markets doubling its revenues base in the quarter. Meanwhile, Lloyds, a purely retail-focused name, only managed to report a bottom-line profit in Q1 due to a tax benefit. We note that the UK has been the only country to force the ring-fencing of banks' retail operations. This measure created distortions, and arguably fuelled a mortgage-lending war, led to higher market funding for UK non-retail operations than European peers, and forced the exit from certain activities by retail-focused names.

Elsewhere in Europe, UBS and Credit Suisse are on track to report the best performances in our coverage universe, as their strong global markets performance was further supported by their also strong performance in wealth management. It is clear now why they resisted the local regulator call for a full cancelation of their dividend payments, different to their peers elsewhere in Europe. Even Deutsche managed to halt the long declining revenues trend, backed by an increase in FICC gains, although the latter was still below peers. SocGen's results are the counterargument here, as it reported a 99% decline in Equity trading revenues, impacted by dividend cancellations. However, this was partly offset by 32% growth in FICC earnings, whilst SocGen global markets operations have in fact long been underperforming.

FICC gains in coming quarters are indeed likely to make less of a positive contribution as client activity normalizes. Moreover, the economic environment has only started to impact banks, so that material investment banking losses in the coming quarters cannot be ruled out. Yet those with sizeable investment banking operations are navigating the current crisis from a stronger position than pure retail-focused peers.

1Q20 Results

Results published in the past week were more challenging than the ones published the prior week, as banks continued to significantly build up their loan-loss reserves, leading to bottom-line losses by SocGen, Danske and Deutsche. Positively, Barclays and UBS reported solid numbers, as their geographic and business diversification make them well positioned to face the crisis. Barclays' and UBS' impressive FICC performance also meant European banks at last outperformed their American peers in terms of investment banking revenues growth.

IB Revenues Growth (1Q20 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%
Credit Suisse	38%	26%	24%
Barclays	12%	106%	21%
Deutsche	8%	13%	-
UBS	44%	99%	18%
Average	8%	44%	26%

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

Impairment charges, capital ratios and liquidity levels are key points of focus in the current crisis. Impairment volumes varied significantly, so did the scenarios on which they were based. Yet given the continued uncertainty of the magnitude of the crisis, additional material impairment charges are expected in the coming quarters. IFRS9 rules dictate for upfront charging of expected losses, yet the magnitude of the losses, and flexible approach being pushed by regulators, mean loan-loss provisions will be gradually booked in coming quarters. Liquidity levels continued to hold up well, supported by deposit growth and the different facilities being provided by central banks. LCRs reported last week ranged between 138% and 182%, comfortably above requirements. The impact on CET ratios ranged from -70bps and +40bps, as higher lending volumes, increased counterparty and market risk were often offset by the cancelation of dividends and the earnings retained in the quarter.

In all, although profitability will remain under significant pressure in coming quarters, we continue to judge that most of the banks in our universe have sufficient capital to withstand even the most severe of the economic scenarios being predicted. That said, government support to corporates and individuals will become increasingly relevant for banks' financials. Moreover, the results reported so far made clear why central banks and regulators were so quick in providing a wide range of measures providing material support to capital, loan-loss provisions and liquidity, particularly in the euro area.

Regulatory updates

The **European Commission** approved a set of banking rules on Wednesday, aiming at preserving capital bases and hence facilitating bank lending, which will provide some relief to capital metrics. The key proposals include:

- Postponement of the introduction of the G-SIB buffer to leverage ratios from 2022 to 2023. European G-SIBs will add 50% of their G-SIB buffer to their leverage ratio requirement of 3%. For instance, as Deutsche Bank has a G-SIB buffer of 1.5%, its leverage ratio requirement from 2023 will be 3.75%.
- The extension of the current transitional IFRS9 rules by two years, allowing banks to add back to their regulatory capital any increase in new expected credit loss provisions that they recognise in 2020 and 2021 which have not defaulted. Only provisions incurred as of 1 January 2020 would be eligible. This rule will allow banks to add back to their capital a substantial proportion of the provisions being booked ahead of actual defaults, and will have a sizeable impact on banks' CET1 ratio for 2020 and 2021. Out of the €506m Deutsche Bank booked in new impairment charges in Q1 for instance, €230m will be added back to its CET1 capital.

Explainer: Under IFRS9, loans are classified as Stage 1, 2 and 3. Stage 1 loans are newly originated or purchased loans, and have provisions booked for credit losses expected within the next 12 months. A loan becomes Stage 2 when its credit risk has increased significantly since initial recognition, and provisions are booked for credit losses expected within the loans' lifetime. Stage 3 loans are defined when the respective credit risk increases to the point whereby the loan is considered credit-impaired. Lifetime expected credit losses are recognised on Stage 3 loans, as in Stage 2. The European Commission's rule established that provisions for expected credit losses for Stage 1 and Stage 2 loans can be added back to regulatory capital.

Additional liquidity measures from the ECB

On Thursday the **ECB** eased further the conditions on the forthcoming **TLTRO III**, with a further 25bps cut to the interest rate on the loans. The rates on these long-term loans will now be as low as -1.00% for banks whose net lending reaches the necessary benchmark.

To further ease liquidity strains, the **ECB** also announced a new series of seven monthly **PELTROs** (non-targeted pandemic emergency longer-term refinancing operations) commencing from next month and maturing between July and September 2021, thus matching the duration of the recent collateral easing measures. These will have a fixed rate and be allocated with full allotment. The interest rate to be applied will be 25bps below the average main refinancing operations rate (currently at 0%). In addition to pricing, PELTROs differ from TLTROs in that

(i) They will be offered on a monthly basis, whilst TLTROs are offered quarterly
(ii) They have no borrowing allowance limits. TLTROs are limited to 50% of a bank's loans to the 'real economy' (loans to corporates and non-residential loans to individuals).
(iii) Collateral is not restricted to lending to the real economy. It would thus be useful for banks with non-eligible lending (real estate, loans to public entities, etc.)
(iv) They will be operationally simpler than TLTROs, and could hence be useful for less sophisticated banks.

In all, given the vast amount of liquidity already being provided by the TLTROs, and generous pricing, a high intake of PELTROs could be a signal of liquidity stress in the euro area banking sector. That said, the ECB also stated it "stands ready to provide additional liquidity, if needed". Total outstanding LTROs amount to €950bn.

Rating actions

S&P took action on a range of Italian, Spanish and Austrian banks last week, with the outlooks on Unicredit and Banco Santander revised to negative, whilst the outlooks on Intesa and BBVA were already negative. The agency revised the outlook on Nordea from stable to negative.

Fitch downgraded the sovereign rating of Italy from BBB to BBB-/Stable, which is likely to lead to an action on Unicredit and Intesa, both currently rated at BBB/Negative. A downgrade of Unicredit would likely lead to a downgrade of the bank's SNP debt from BBB- to BB+, i.e. sub-investment grade.

Primary and secondary markets

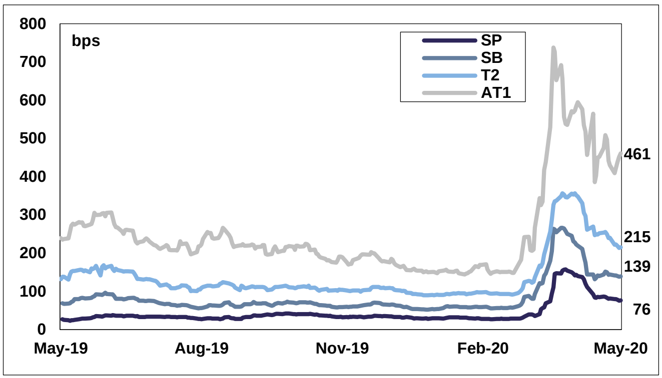
In the **primary market**, we saw the first non-French euro area banks returning to the market with Rabobank and Santander, whilst Barclays took advantage of the good results posted on Wednesday to place a senior HoldCo on Thursday. Demand was strong, yet backed by sizeable NIPs(15-25bps).

- Rabobank, SNP, EUR1bn, 8NC7, priced at MS+110, IPT was at MS+135bps, final books over EUR2bn.
- Banco Santander, SNP, 5.7Y, EUR1.5bn, price at MS + 170, IPT was at MS+200, final books over EUR4.8bn.
- Barclays, Sr HoldCo, USD1.75bn, 6NC5, priced at T+250bp, IPT+275bps.

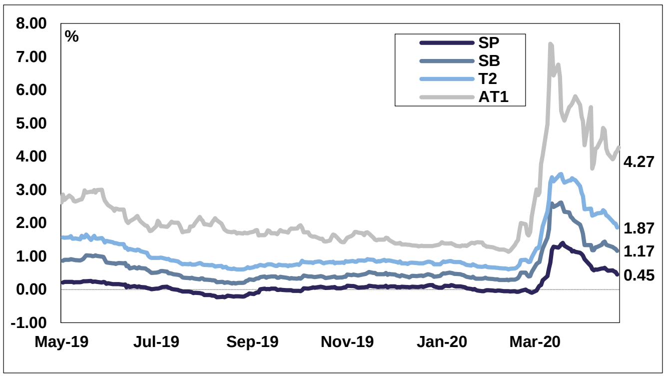
In the **secondary market** spreads tightened somewhat following banks' results, the European Commission's capital relief measures, the additional liquidity facility and better pricing on TLTRO's announced by the ECB, and the largely risk-on sentiment observed during the week. Italian spreads saw the most benefit from the ECB announcement on liquidity, whilst Deutsche Bank's strong trading results, and lower leverage ratio supported a strong tightening of its spreads. EUR SP spreads remain 47bps above pre-crisis levels (+83bps for SNP paper), whilst USD SP/Sr OpCo debt remains 54bps above pre-crisis levels (+94bps for SNP/Sr HoldCo paper).

Western European Banks EUR Z spreads

Z-spread LTM (bps)



Yields LTM (%)



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	72	-1	3	-3	-3	-3
DENMARK	41	-5	-4	-9		
FINLAND	38	-6	-5	-5	-9	-11
FRANCE	42	-2	-1	-3	-4	-5
GERMANY	64	-3	0	-3	-1	-8
ITALY	129	-12	-10	-12	-12	-15
NETHERL.	54	-2	1	-3	-5	-3
SPAIN	97	-4	-1	-5	-6	
SWEDEN	34	-6		-6		
SWITZ.	50	-4	-4			

EUR SP/Senior OpCo

	Yield (%)	Z Spread Value (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	0.70	101	104	95	95	95
DENMARK	0.47	75	74	75		
FINLAND	0.35	63	59	67	66	73
FRANCE	0.42	71	65	70	76	77
GERMANY	0.82	102	93	120	89	98
ITALY	1.91	215	214	239	218	233
NETHERL.	0.50	79	74	93	70	146
SPAIN	1.14	145	108	145	158	
SWEDEN	0.40	69		68	84	
SWITZ.	0.42	72	72			

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	121	-9	-6	-9	-9	-13
DENMARK	94	-7	-6	-8	-8	
FINLAND	72	-7		-7		
FRANCE	75	-5	-1	-4	-5	-6
GERMANY	114	-18	-21	-11	-30	-15
ITALY	193	-8	-7	-14	-7	-14
NETHERL.	65	-7	-5	-7	-7	-9
SPAIN	113	-4	-3	-4	-4	-2
SWEDEN	65	-9		-4	-8	-10
SWITZ.	100	-5			-5	-5

EUR SNP/Senior

	Yield (%)	Z Spread Value (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	1.53	181	157	173	202	178
DENMARK	1.35	161	140	163	178	
FINLAND	0.82	111		111		
FRANCE	1.03	129	119	115	128	133
GERMANY	1.54	182	283	169	241	164
ITALY	2.91	321	274	551	322	299
NETHERL.	0.85	108	100	93	121	118
SPAIN	1.55	177	131	202	172	201
SWEDEN	1.01	129		130	112	122
SWITLZ.	1.41	166			167	166

EUR Tier 2 Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	171	-23	-20	-20	-63	-26
DENMARK	148	-15			-20	-14
FINLAND	153	-11	-3		-34	-7
FRANCE	99	-19	-11	-17	-17	-19
GERMANY	246	-12				
ITALY	173	-27	-24	-25	-21	-33
NETHERL.	141	-17	-14	-10	-16	-18
SPAIN	239	-12		-11	-12	-13
SWEDEN	112	-12			-19	-12

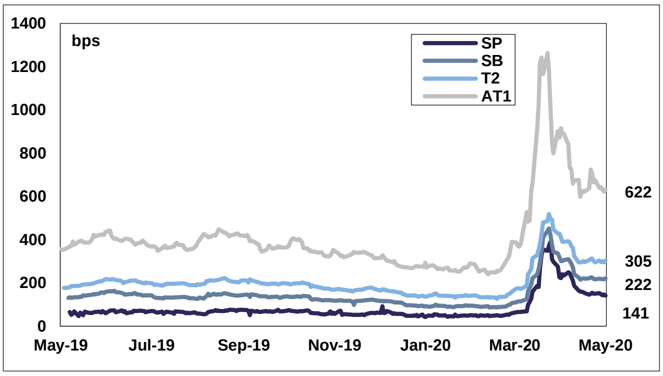
EUR Tier 2

	Yield (%)	Z Spread Value (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	2.31	259	230	257	489	292
DENMARK	2.31	260			297	259
FINLAND	2.19	245	134		212	302
FRANCE	1.86	199	145	173	193	216
GERMANY	3.53	373		373	431	206
ITALY	4.22	450	362	291	338	509
NETHERL.	2.44	263	162	155	281	295
SPAIN	3.50	370		199	370	517
SWITZ.	2.24	247			242	249

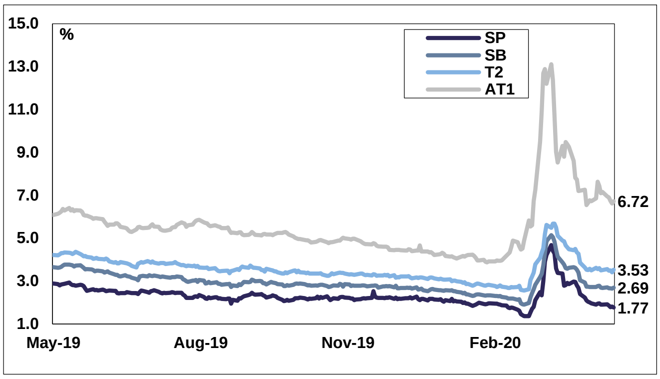
Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances. Blank cells represent lack of statistically significant data. Figures 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 (%)



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

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	95	0	-10	6		
DENMARK	27	1	-17			
FINLAND	10	0	-20			
FRANCE	70	-2	0	-3	-11	
GERMANY	9	0				
ITALY	167	-2	-9	-4	5	
NETHERL.	118	-9	-14			
SPAIN	59	-1		-8		
SWEDEN	16	0	-42			
SWITZ.	126	-15	-15	-9		

USD SP/Senior OpCo

	Yield (%)	Z Spread Value (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	2.05	124	99	159		
DENMARK	1.80	20	143			
FINLAND	0.59	23	66			
FRANCE	1.79	114	113	154	160	
GERMANY	0.50	12				
ITALY	3.98	328	291	327		
NETHERL.	3.17	243	96			
SPAIN	2.89	192		160		
SWEDEN	0.57	20	110			
SWITZ.	1.89	132	119	182		

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

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	115	-4	-17	-7	0	4
DENMARK	158	-15	-27	-55	0	
FINLAND	116	5		5		
FRANCE	126	1	-3	-2	4	8
GERMANY	231	-15	-37	22	-20	
ITALY	295	-15	-2	-29		
NETHERL.	102	-8	-9	-14	0	-5
SPAIN	140	-1	-15		10	10
SWITZ.	120	-21	-32	-30		10

USD SNP/Senior

	Yield (%)	Z Spread Values (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	2.61	213	157	202	218	249
DENMARK	2.99	260	232	265	285	
FINLAND	2.37	194		194		
FRANCE	2.68	224	183	214	227	237
GERMANY	4.19	377	367	394	400	
ITALY	4.90	433	413	453		
NETHERL.	2.35	186	136	166	199	216
SPAIN	2.91	240	209		270	268
SWITZ.	2.68	187	173	183		249

USD Tier 2 Z-Spread Net Change (bps)

	YTDΔ	5DΔ				
	All	All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	169	-2	-7	-2	-2	0
FINLAND	135	-11	-11			
FRANCE	163	0		1	-1	0
GERMANY	273	-8				
ITALY	257	-18		0	-24	-18
NETHERL.	166	-6	-3	-6	-7	-7
SPAIN	197	-8			-8	

USD Tier 2

	Yield (%)	Z Spread Values (bps)				
		All	1-3Y	3-5Y	5-7Y	> 7 Y
UK	3.90	321	298	304	268	292
FINLAND	2.92	216	216			
FRANCE	3.55	302		300	277	339
GERMANY	6.42	553		553		472
ITALY	5.88	570			503	576
NETHERL.	3.42	298	212	225	236	397
SPAIN	3.78	320			320	

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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