European Banks – Weekly Credit Update

- The "desktop" stress test performed by the BoE found the UK banking sector to be well positioned to weather a plausible sharp economic downturn.
- French and Italian names dominated last week's results calendar, with the varying approach towards reserves building undermining the insightfulness of banks' data.
- Activity picked up in the primary market as the Q1 earnings season approached its end, whilst the trend in the secondary market was mixed.

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UK banks 'desktop' stress test

In its financial stability report published last week, the BoE's Financial Policy Committee (FPC) disclosed the results of its "desktop" stress test on the UK banking sector - *called "desktop" because the test was performed with data already available to the BoE, which did not reach out to the banks as would normally be done in a full stress test*. The test was based on the plausible illustrative economic scenario for the UK set out by the BoE's Monetary Policy Committee (MPC). Among other factors, the MPC's scenario predicts a 14% decline in the UK GDP in 2020, followed by growth of 15% in 2021 and 3% growth in 2022. Despite the severe economic downturn illustrated, **the FPC found that the UK banking sector is well positioned to withstand an even greater deterioration in the economy than the one described in the MPC report.**

Highlights:

- Banks entered into this period of stress with an aggregate CET1 ratio more than three times higher than before the global financial crisis, and holding approximately £1 trillion of liquid assets.
- The MPC scenario would generate material losses for banks on their corporate and household loans, with total credit losses of just over £80bn. Yet this draws down only 45% of the capital buffers banks have available above their minimum capital requirements.
- This is lower than the £100bn credit losses banks showed that they were able to withstand over the same period in the 2019 stress test. Although the MPC scenario incorporates a much sharper initial fall in output than in the 2019 stress-test scenario, the recovery from the initial fall is more rapid, such that the cumulative loss of output over three years is very similar to the 2019 stress-test scenario.
- The impact on the banking sector is mitigated by the reduction in Bank Rate, the various forms of support to corporates and individuals provided by the BoE and the government, and by the strong investment banking revenues booked in 1Q20.
- **In the 2019 stress test, the aggregate CET1 ratio of UK banks decreases from a starting point of 14.5% to a ratio of 9.3% in 2021. In the desktop test, based on the MPC scenario, CET1 ratios would decline from a starting point of 14.8% at YE19 to 11% at YE21.**

In all, the FPC assessment on the banking sector is reassuring and in line with our view on the resilience of the UK banking system. It is clear, however, that we will see a sizeable deterioration in UK banks' credit profiles, arising particularly from exposures to corporates and consumer lending.

1Q20 Results (Part III)

Last week's results calendar was dominated by French and Italian names. Different to their peers in Switzerland and the UK, French names failed to benefit from the strong client activity and volatility in Q1 to generate strong trading returns. **BNP Paribas** (net income: €1,282m, -33%Y/Y) and **BPCE** (net income: €180m, -47% Y/Y) followed SocGen's steps in reporting dreadful figures in Equity trading, impacted by restrictions in 2019 dividends across Europe. Yet both names benefited from the diversification of their business model to report still adequate top-line figures. Impairments increased by €657m (85%) Y/Y at BNPP, and by a marginal €211m Y/Y (43%) at BPCE. Although BPCE's figure was partly supported by a €120m reversal in loan loss provisions, and based on a GDP decline of 9% in France in 2020, the figure is low compared to its French and European peers. Surprisingly, BNPP guided for a group net income in 2020 only 15-20% lower than the €8.2bn net income reported in 2019, whilst BPCE guided for a 35-40bps cost of risk for 2020, up from the through-the-cycle loan impairment ratio of 25-30bps. All else equal, BPCE's guidance would imply a limited 22% Y/Y decline in pre-tax profits. Both outlooks would easily beat expectations if achieved amid the current economic outlook and given the elevated indebtedness of the French corporate sector before the crisis.

Credit Agricole (net income: €908m, -33% Y/Y) figures were robust, as usual, with the sharp increase in impairments easily absorbed by the group's decent profitability. Provisions for loan losses amounted to €930m in the quarter, up €650m Y/Y. The group refrained from giving more detailed guidance for its full year 2020 results.

In Italy, **Unicredit** (net income: - €2,706m, vs a €1,175 profit in 1Q19) reported its second consecutive quarterly net loss. The bank's Q1 numbers were hit by a €1.7bn charge from the disposal of a stake at its Turkish business (Yapi Kredi), €1.4bn in integration costs in Italy, and a €795m increase in impairment charges. Positively, core revenues were flat Y/Y, whilst the ongoing restructuring should improve efficiency. That said, profitability will remain significant pressure in forthcoming quarters given the economic environment. Moreover, on an underlying basis, impairment charges consumed an elevated 67% of the bank's pre-impairment profit in Q1, signalling limited headroom for further material increases in loan loss provisions.

Intesa's (net income: €1,151m, +9.6% Y/Y) figures were decent, with flat core revenues Y/Y further supported by a significant gain in trading. Impairments (+€423m Y/Y) were indeed low when compared to peers, yet the bank aims to use a €900m gain from the sale of Nexi, a merchant payment business, to generate a total of €1.5bn of provisions to tackle the crisis.

Interestingly, ISP also reported a somewhat optimistic outlook, with a minimum net income of €3bn for FY20 (vs. €4.2bn in FY19), including the sale of Nexi, followed by a minimum €3.5bn net income for 2021.

In all, we continue to judge that the largest European banks have adequate levels of capital, liquidity and funding to weather the current crisis, supported also by the different facilities and programmes provided by central banks and government. That said, there's little clarity yet on the volume of total losses banks will incur as a result of the virus outbreak, not least because the magnitude and duration of the crisis remains highly uncertain. In Q1, provisioning for loan losses varied significantly in both absolute and relative terms, with some banks booking upfront significant charges, whilst others, partly encouraged by regulators, taking a more optimistic view on the impact the economic downturn will have on their financials. Banks' loan books do naturally differ from each other, with varying exposures to different geographies and sectors. Yet the significant variations in provisioning and scenarios reported in Q1 reduces the insightfulness and transparency of banks' financials.

Regulatory updates

The **Danish** FSA announced on 01 May a significant change to the MREL requirement for Danish systemically important banks. Aligned with BRRD II rules, the regulator will apply a cap on the subordination requirement on MREL. Accordingly, Danish banks will now have a total MREL requirement and a subordinated MREL requirement. The subordination requirement must be met with SNP and lower ranked paper, whilst the total MREL requirement can be partly met with SP debt.

The new cap will be the higher of (i) 2 x (Pillar 1 Requirement + Pillar 2 Requirement) + Combined Buffer Requirement and (ii) 8% of Total Own Funds and Liabilities. Danske Bank for instance had a 36.2% MREL requirement, now it will still have a 36.2% total MREL requirement, yet the subordinated requirement is only 31.5%. The change is unwelcome in terms of clarity for investors, although the minimum subordinated requirement remains elevated in Denmark vs European peers given the higher buffer requirements in Denmark.

In the **UK**, the PRA will set Pillar 2A capital requirements as a nominal amount instead of a percentage of RWAs in 2020 and 2021, as the regulator does not see RWAs as a good approximation for the evolution of the risks captured in Pillar 2A in a stress scenario. The measure will avoid an absolute increase in Pillar 2A capital requirements in the current stress, thus reducing capital requirements. The regulator now judges major UK banks' CET1 capital requirement triggers for restrictions on distributions to be 40–50bps (of RWA) lower than they would otherwise be by 2021.

The change in the Pillar 2A requirement will also be reflected in the 2021 MREL requirement. The BoE also stated that it will "continue to keep MRELs under review and monitor market developments carefully in Q3 of this year to inform its approach in Q4 2020 to setting January 2021 MRELs and indicative January 2022 MRELs".

Primary and secondary markets

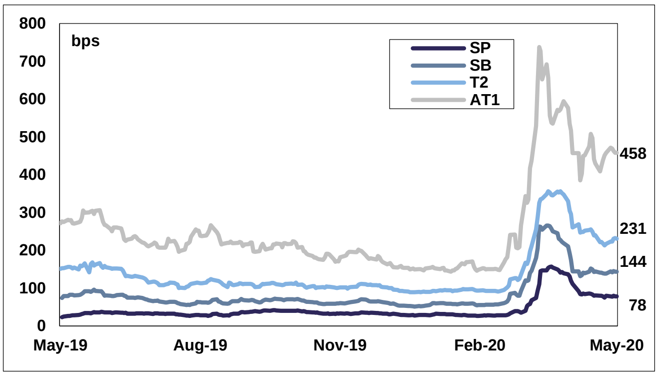
Activity in the unsecured **primary market** picked up last week as the 1Q earnings season approached its end. Placements came mostly in SP/Sr OpCo format, yet we also saw the first subordinated bond issued by a European bank since 24 February, with RBS placing T2 paper, which attracted strong demand. In all, reported primary market demand was adequate last week, with significant tightening from IPT, although NIP continue to be sizeable (12-22bps). Key Transactions:

- Erste, SP, EUR750m, 7Y, priced at MS+115bs, IPT was at MS+145bps, book size over 2.2bn
- Nordea, SP, EUR1.25bn, 7Y, priced at MS+85bps, IPT was at MS+110bps, book last heard over EUR2bn
- RBS, T2, GBP1bn, 10.25NC5, priced at G+355bps, IPT was at G+400bps, book over GBP5bn
- Danske, SP, EUR1bn, 5Y, priced at MS+103bps, IPT was at MS+125/130bps, book over EUR1.8bn
- Op Corporate, SP, EUR1bn, 5.25Y, priced at MS+85bps, IPT at MS+105bps, book over EUR1.5bn
- Barclays, Sr OpCo, 2Y, USD1.75bn, priced at T+155bps, IPT at T+200.

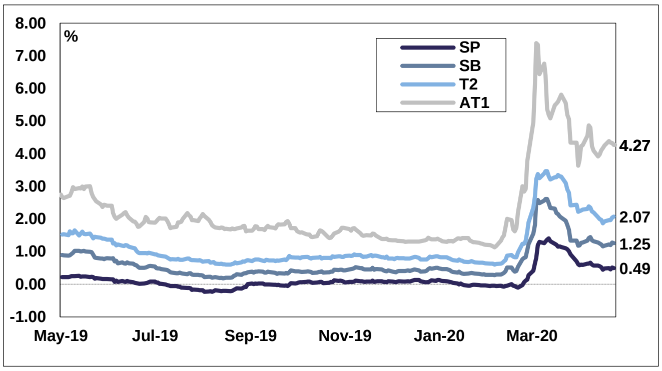
The **secondary market** saw mixed trends in both EUR and USD spreads amid dreadful economic data across Europe, and the decision of the German Constitutional Court to question the appropriateness of the ECB's bond purchase programme. The spreads of Senior Bail-in and Tier 2 paper widened somewhat, particularly for Italian and Spanish names. Meanwhile, despite the elevated supply, the widening in aggregate EUR SP spreads was marginal, whilst USD SP spreads actually tightened backed by the good performance of large USD SP issuers. EUR SP spreads remain 50bps above pre-crisis levels (+87bps for SNP paper), whilst USD SP/Sr OpCo debt remains 85bps above pre-crisis levels (+138bps for SNP/Sr HoldCo paper).

Western European Banks EUR Spreads and Yields

Aggregated Z-spread LTM (bps)



Aggregated Yields LTM (%)



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.

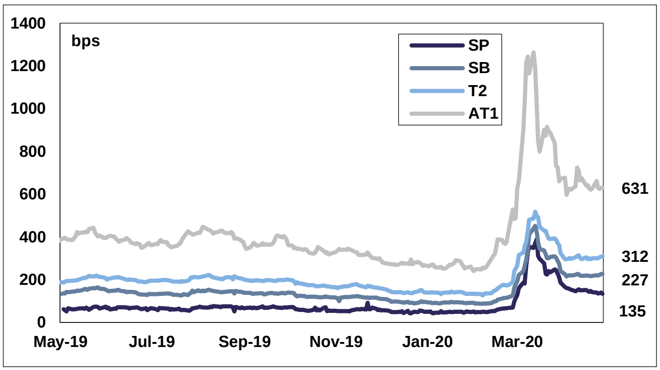
Selected Names

	Sr Preferred/Sr OpCo					Sr Non-Preferred/Sr HoldCo					Tier 2				
	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD
Commerz	4.9	1.0	122	2	73	4.3	2.0	218	6	146	5.6	4.4	455	27	265
Barclays	3.8	1.2	128	5	85	3.5	1.6	186	3	132	6.1	4.9	484	77	363
BBVA	4.0	0.8	102	1	70	4.5	1.5	171	7	116	7.8	3.1	334	43	189
BFCM	4.1	0.5	71	-1	41	8.8	1.2	132	6	79	5.5	1.8	199	10	124
BNPP	2.7	0.4	64	0	42	5.3	1.0	127	5	72	5.7	1.7	184	12	91
BPCE	3.9	0.5	75	-1	48	4.8	1.1	138	6	85	5.4	1.8	196	5	134
Credit Ag.	3.4	0.4	66	-1	39	5.8	1.1	133	6	76	5.2	1.9	193	9	69
Credit Sui.						6.8	1.5	170	6	104					
Danske	3.0	0.5	78	1	42	3.3	1.5	172	1	100	8.4	2.5	272	12	125
Deutsche	3.1	1.0	130	-3	73	2.9	2.9	300	1	173	4.7	4.3	443	17	196
DNB	3.5	0.5	77	-2	46						7.1	2.0	215	1	156
HSBC	3.4	0.5	70	2	41	3.4	0.9	103	3	59	5.9	1.8	196	3	112
ING	1.7	0.6	80	-2	62	5.3	1.0	123	4	74	6.1	1.8	202	7	99
Intesa	4.6	1.7	188	3	115						4.2	3.3	351	23	198
Lloyds	2.3	0.7	90	-3	68	4.1	1.5	173	3	121	7.7	2.6	277	17	163
Nordea	3.7	0.4	66	-2	35	3.1	0.8	110	-1	73	4.4	2.2	209	-3	159
Rabobank	2.6	0.3	49	-4	33	6.4	0.7	95	6	55	3.0	1.3	154	-1	106
RBS						4.6	1.8	206	0	131					
Santander	4.1	0.7	95	0	69	5.0	1.4	165	9	92	5.7	2.2	242	30	140
San UK	3.2	0.8	100	-2	68	3.5	1.6	192	3	126					
SocGen	2.0	0.4	69	-2	43	5.9	1.4	168	10	95	4.5	2.1	231	6	152
SCB						6.8	1.7	189	3	119	3.7	4.4	416	3	368
Swedbank	4.9	0.6	87	3		4.4	1.0	128	-2	64	7.2	2.3	248	-2	147
UBS	1.6	0.4	70	-2	48	3.7	0.9	118	2	77					
UniCredit	4.2	1.9	213	7	130	5.1	3.1	329	19	211	5.9	5.8	556	44	360

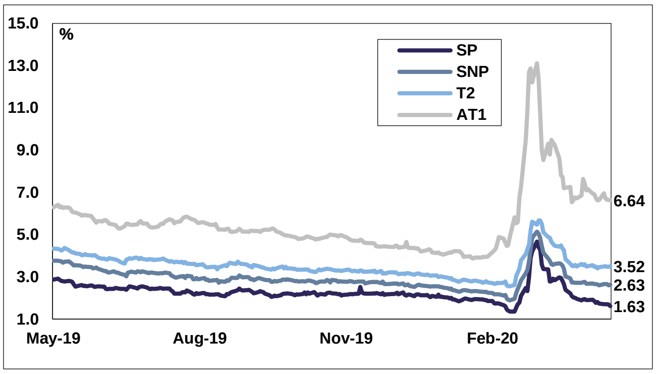
Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative of the whole market.

Western European Banks USD Spreads and Yields

Aggregated Z-spread LTM (bps)



Aggregated Yields LTM (%)



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Selected Names

	Sr Preferred/Sr OpCo					Sr Non-Preferred/Sr HoldCo					Tier 2				
	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD
Barclays	2.8	2.1	189	14	173	4.8	2.8	241	4	128	5.7	4.0	348	9	170
BFCM	2.4	1.7	136	6	87										
BNPP	2.0	1.2	91	-9	60	4.6	2.9	227	8	136	5.3	3.3	281	21	159
BPCE	2.5	1.7	144	-4	80	4.4	2.8	230	2	132	3.7	3.5	298	5	188
Credit Ag.	1.8	1.6	119	-14	83	3.4	2.3	189	-1	117	8.2	3.4	269	11	157
Credit Sui.	1.8	1.6	113	-8	81	4.9	2.7	202	12	134					
Danske	1.5	1.6	137	-13	74	3.2	3.0	258	-12	154					
Deutsche						2.5	4.2	369	-21	241	6.6	6.4	577	5	248
HSBC	4.1	2.6	221	-11	113	5.1	2.3	190	6	98	10.8	3.9	297	19	149
ING	1.1	1.1	82	-11	61	5.0	2.4	192	5	112	4.9	3.2	265	6	164
Intesa	3.7	3.2	274	7	161						4.2	5.7	520	38	288
Lloyds	3.4	2.1	174	0	108	3.8	2.5	205	8	130	5.1	3.2	271	9	136
Nordea	1.0	1.0	69	15	45	3.1	2.4	198	-1	115	1.6	2.6	195	-38	133
Rabobank	2.5	1.4	107	0	62	3.5	2.2	161	-6	99	5.1	2.8	230	0	133
RBS						4.8	2.7	228	8	126	3.2	3.6	315	7	195
Santander	5.8	2.5	209	9	122	4.4	3.0	250	7	153	4.7	3.7	320	13	203
San UK	1.5	1.7	150	-7	98	3.4	2.5	202	3	120	4.7	4.1	360	16	210
SocGen						4.3	2.8	241	6	142	4.6	3.8	332	16	186
SCB	3.1	3.0	251	-6	12	4.5	2.9	247	-6	148	5.8	4.0	334	2	198
UBS	9.7	2.1	157	3	93	4.8	2.3	183	8	109					
UniCredit	2.4	3.7	332	17	192	2.3	5.0	452	18	320	8.6	6.5	576	18	234

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