European Banks – Credit Update

- The increased flexibility within the P2R offered by the ECB changed somewhat the dynamics of capital requirements, and was a key driver of the Tier 2 placement by Deutsche Bank last week.
- European banks' CET1 ratio declined by 29bps on average last quarter to 14.1%, with the changes ranging from +40bps to -110bps. The average LCR was down 1ppt at 145%.
- Activity in the primary market was decent, with placements in a range of currencies and across the capital stack, whilst the trend in the secondary market was mixed.

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The math behind Deutsche' Tier 2 issuance

(Table 1) Deutsche Bank MDA Buffers

1Q20	Current (%)	Required (%)	Buffer (bps)	Buffer (€bn)
CET1	12.83	10.44	239	8.1
Tier 1	14.84	12.41	243	8.3
Total Capital	16.59	15.04	155	5.3

Source Deutsche Bank.

As we discussed in March, the ECB brought forward the implementation of the CRD5 Article104(a), allowing euro area banks to partially meet their Pillar 2 Requirements (P2R) with Tier 2 and AT1 debt, rather than purely with CET1 capital. Specifically, the new legislation allows for up to 18.75% of the P2R to be met with AT1, and up to 25% to be met with Tier 2 debt. This increased flexibility reduces the CET1 requirement by 43.75% of the P2R and the Tier 1 requirement by 25% of the P2R, whilst the Total Capital requirement is unchanged. The change increases the likelihood that banks' Maximum Distribution Amount – *MDA, the point below which banks would incur a restriction on capital redistributions and AT1 coupon payments* - is driven by the Total Capital ratio rather than the CET1 ratio.

Therefore, the changes have the potential to increase Tier 2 issuance in the euro area. Indeed, this was a key driver of Deutsche Bank's decision to issue Tier 2 paper amounting to €1.25bn last week, as its MDA buffer is constrained at the total capital level, rather than at the CET1 level (see Table 1). With a P2R of 250bps, Article 104(a) reduced Deutsche's CET1 requirement by 109.4bps and the Tier 1 requirement by 62.5bps, while no changes were made to the Total Capital requirement. Assuming constant RWAs, the transaction increased Deutsche's buffer to €6.53bn, yet total capital remains the bank's binding constraint. Other banks with the MDA binding constraint at the Total Capital or Tier 1 level as at end-1Q20 include BNP Paribas, Credit Agricole, ING and Santander. That said, Tier 2 and AT1 capital are much easier to be raised, as shown by Deutsche bank and the Bank of Ireland last week.

On the same day of the T2 placement, Deutsche also announced a tender offer for some of its outstanding senior non-preferred paper, some of which will lose MREL recognition in 2020, with a target acceptance volume of €2bn. In contrast to elsewhere, all vanilla unsecured debt issued in Germany prior to July 2018 now ranks at the same level as SNP paper. This has led German banks to have SNP volumes in excess of MREL requirements.

1Q20 Results (…part IV)

Despite some negative shocks to profitability, the overall picture we got from banks' 1Q20 results was of balance-sheet resilience. The decline in CET1 ratios was indeed material for some names (see Table 2 below), with BBVA's ratio declining by 110bps Q/Q, whilst other names actually reported an increase in their CET1 due to the FY19 dividend cancellation, with Lloyds and RBS reporting a 40bps increase Q/Q. In all, capitalization levels remain sound whilst the 29bps average decline in outstanding CET1 was less than the 70bps average decline in CET1 requirement, meaning buffers to minimum requirements actually increased. Liquidity was stable, with an average LCR decline of only 1ppt Q/Q, with all banks reporting LCRs comfortably above minimal levels.

NPL levels remained largely stable across banks, helped by (i) the natural lag between economic downturn and NPL inflow, (ii) the fact that 1Q20 results are as at end-March 2020, at which point lockdowns had been in place for only a couple of weeks for several countries; and (iii) the payment holidays in place for mortgages and consumer lending and the government programmes supporting SMEs and corporates. Once the latter is no longer in place, payment defaults will increase significantly, so that we could see a sharp deterioration in NPL volumes from 3Q20.

(Table 2) 1Q20 Figures

	Net Income (m)	CET1 (%)	CET1 Q/Q Δ (bp)	MDA Buffer (bps)	MDA Buffer (bn)	LCR (%)	LCR Q/Q Δ (ppts)	Impairm-ents Y/YΔ (m)	Total LLP / Pre-Imp. Profit (%)	Total Cost of Risk (bps)
Commerzbank	-€295	13.2	-20	239	€4.4	130	-2	€248	54	47
Barclays	£605	13.1	-70	160	£5.2	155	-5	£1,750	73	223
BBVA	-€1,792	10.8	-110	230	€8.3	134	+5	€1,574	81	292
BNPP[1]	€1,282	12.0	-10	220	€15.1	130	+5	€657	52	67
BPCE	€181	15.5	-10	464	€19.6	138	-3	€211	51	29
Credit Agricole[2]	€908	15.5	-40	580	€33.2	130	+1	€650	39	40
Credit Suisse[3]	CHF1,314	12.1	-60	-	-	182	-16	CHF487	32	75
Danske	-$189	17.6	+30	440	$4.9	154	+14	$568	150	91
Deutsche[1]	-€43	12.8	-80	160	€5.3	133	-8	€366	71	44
DNB	$348	17.7	-90	210	$2.11	128	-10	$532	57	130
HSBC	$1,785	14.6	-10	370	$31.7	156	+6	$2,457	55	118

(Table 2) 1Q20 Figures (cont.)

1Q20 Results	Net Income (m)	CET1 (%)	CET1 Q/Q Δ (bp)	MDA Buffer (bps)	MDA Buffer (bn)	LCR (%)	LCR Q/Q Δ (ppts)	Impairm-ents Y/YΔ (m)	Total LLP / Pre-Imp. Profit (%)	Total Cost of Risk (bps)
ING[1]	€670	14.0	-60	330	€11.0	127	0	€454	39	42
Intesa	€1,151	14.2	+30	590	€16.5	>100	-	€423	30	40
Lloyds	£480	14.2	+40	460	£9.6	138	+1	£1,155	72	130
Nordea	€460	16.0	-30	580	€8.8	182	+16	€112	20	26
RBS	€288	16.6	+40	760	£14.1	152	0	£716	61	90
Santander[1]	€331	11.6	-10	208	€12.2	146	-1	€1,688	63	169
San UK	£85	14.4	+10	380	£2.8	138	-4	£112	50	31
SocGen	-€326	12.6	-10	360	€12.6	141	+17	€556	167	65
StanChart	$517	13.4	-45	340	£9.3	142	-2	$878	49	110
Swedbank	-$171	16.1	-90	300	$2.1	162	-20	$195	44	51
UBS[3]	$1,595	12.8	-90	-	-	139	+5	$248	12	32
UniCredit	-€2,706	13.4	+20	440	€15.7	143	0	€795	67	104
Average	-	*14.10*	*-29*	*372*	-	*145*	*-1*	-	*60*	*89*

Source: Banks' financial statements, Bloomberg. Figures as reported. [1]MDA binding constrain is based on Total Capital. [2] MDA binding constrain in based on Tier 1 capital. Total Cost of Risk: Annualized LPPs/ Gross loans. [3]Swiss banks are not bound by CRD IV, so that concepts of the combined buffer requirement and the maximum distributable amount do not apply. Swiss banks are prohibited from making AT1 coupons payments if they are not in compliance with all applicable minimum Swiss capital adequacy requirements, including TLAC requirements.

Rating Actions

Following the downgrade of the Italian sovereign rating on 28 April, Fitch downgraded four Italian names last week: Unicredit (SP downgraded from BBB to BBB-, SNP from BBB- to BB+, Stable Outlook) and Intesa (SP from BBB to BBB-, Stable Outlook). The other names also downgraded were Mediobanca (from BBB to BBB-/Stable) and UBI Banca (from BBB to BB+, Rating Watch Positive). UBI Banca's Rating Watch Positive reflects the potential acquisition by Intesa.

Unicredit's SNP debt has an elevated risk of becoming a *fallen angel** given its BBB-/Negative rating from S&P, whilst Moody's still rates it at Baa2/Stable. **A fallen angel is a bond that is downgraded to sub-investment grade by at least two of the three major rating firms after being formerly rated investment grade.*

On Friday, Fitch revised the Outlook on the sovereign rating of France from Stable to Negative, whilst affirming the rating at AA. The agency has the ratings of BNP Paribas, SocGen and BPCE on Rating Watch Negative, to be resolved once the near-term impact of the crisis is clearer. The latter is yet to materialize, whilst we do not see the change on the outlook of the French sovereign rating as sufficient to warrant a downgrade of these entities (Fitch might disagree with us). BFCM and Credit Agricole have their outlooks on negative already and are unlikely to be impacted by the change on the sovereign rating.

Primary and secondary markets

Despite negative sentiment, the **primary market** maintained adequate level of activity, with placements across the debt stack and in a range of currencies, including a sterling transaction from Barclays and an Australian Dollar placement by UBS. Demand levels varied, with the SP transaction of SEB and the Sr OpCo from Credit Suisse launched at 2bps and 7bps inside their curve, whilst NatWest Markets saw a limited 10bps IPT tightening for its Sr OpCo paper. We also saw Bank of Ireland launch an AT1, which was met with adequate demand, but elevated pricing (7.5% coupon). It was the first AT1 placed by an European bank since the ING transaction on 24 February.

(Table 3) Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
Barclays	Tier 2	£500m	10.5NC5	G+375	G+400	> £1bn
Natwest Markets	Sr OpCo (NRF[1])	$1bn	3Y	T+230	T+240	
Bank of Ireland	AT1	€650m	PNC5.5	MS+792 (coupon 7.5%)		> €1.4bn
Deutsche Bank	Tier 2	€1.25bn	11NC6	MS+600	MS+625	> €2.2bn
Credit Suisse	Green Sr OpCo	€1.5bn	2Y	3mE+95	3mE+115	> €2.1bn
		€500m	5Y	MS+80	MS+115	> €2.8bn
SEB	Sr Preferred	€1bn	3Y	MS+68	MS+95	> €2bn
UBS	Sr OpCo	AUD1.5bn	2.5Y	3mBBSW +105		

Source BondRadar, Bloomberg. [1]NRF: Non-ringfenced.

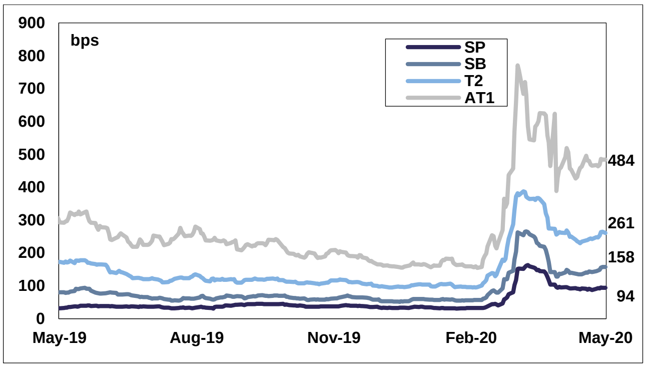
The **secondary market** saw mixed trends across currencies and debt rank in the past week. There was a sizeable widening in EUR spreads, particularly from lower-ranked paper in Italy and Spain amid the negative economic environment and by the downgrade of Italian banks by Fitch. In the USD market, spreads moved largely sideways, as secondary spreads are being contained by the purchase of corporate bonds by the Fed. This contrasting performance was also reflected in the ICE BofA corporate indices, with the ICE BofA US Corporates index up 0.5% in the week, whilst the ICE BofA Euro Corporate Index was down 0.8%.

EUR SP have remained largely flat, whilst USD SP tightened. The vast asset purchase programs by the ECB, BoE and the Fed are also bound to have a greater impact on SP, as investors are crowded out of safer paper and sectors. Moreover, once the impact of the economic downturn is better understood and better reflected in banks' financials, the bail-in probability of lower-ranked paper will increase, ultimately leading to a widening of SB and T2 spreads vs SP.

EUR SP are now at 94 on aggregate, up 5bps W/W, 62bps above pre-crisis levels (+101bps for SNP paper) but down 69bps from the peak in mid-March (-158bps for SB paper). USD SP/Sr OpCo debt are now at 136bps on aggregate, down 4bps W/W, this is 87bps above pre-crisis levels (+133bps for SNP/Sr HoldCo paper), yet 254bps down from the mid-March peak (-230bps for SNP/Sr HoldCo paper).

Western European Banks EUR Spreads and Yields

Aggregated Z-spread LTM (bps)



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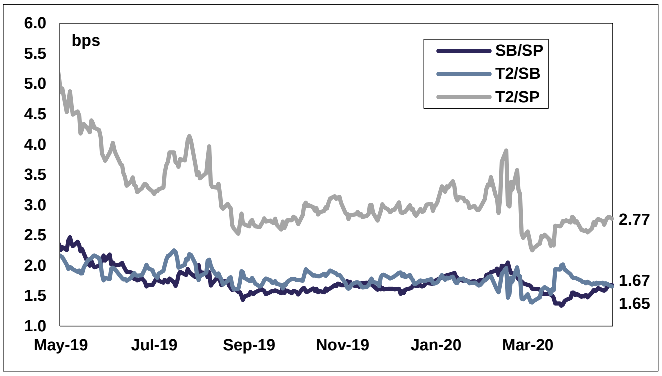


Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

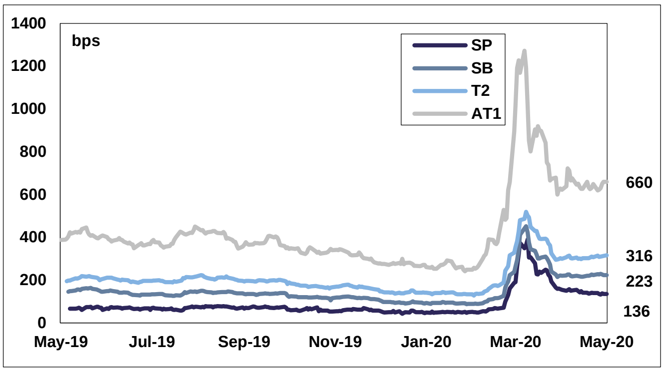
Selected Names

	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	1.3	150	23	101	4.3	2.2	237	23	168	5.6	4.5	471	16	281
Barclays	3.8	1.3	138	10	95	3.4	1.8	206	21	152	6.1	4.9	480	-3	359
BBVA	4.0	0.9	110	8	78	4.6	1.7	195	25	143	7.8	3.3	355	22	211
BFCM	4.1	0.5	78	7	48	8.8	1.4	148	16	93	5.5	1.9	209	13	137
BNPP	2.7	0.4	68	3	46	5.3	1.2	146	18	90	5.7	1.9	201	13	104
BPCE	3.9	0.6	82	8	54	4.7	1.3	152	17	99	5.5	1.8	202	10	141
Credit Ag.	3.4	0.5	75	7	47	5.7	1.3	152	19	93	5.2	1.9	203	25	71
Credit Sui.						6.8	1.7	191	17	121					
Danske	3.0	0.6	83	5	47	3.3	1.6	182	10	110	8.5	2.7	291	20	144
Deutsche	3.1	1.1	135	5	78	2.9	2.7	288	-11	159	5.2	5.2	536	29	225
DNB	3.5	0.6	81	4	50						7.0	2.0	221	6	163
HSBC	3.4	0.5	76	5	46	3.3	1.0	123	20	79	5.9	1.9	205	9	121
ING	1.7	0.6	81	1	64	5.3	1.2	136	13	87	6.2	1.9	209	8	109
Intesa	4.5	1.9	208	18	136						4.2	3.6	384	34	232
Lloyds	2.3	0.7	90	-13	60	4.0	1.7	190	18	138	7.7	2.7	295	18	181
Nordea	4.6	0.5	71	5	41	3.0	1.0	120	10	82	4.4	2.4	220	11	171
Rabobank	2.5	0.3	54	5	35	6.4	0.9	108	13	69	3.0	1.4	164	10	115
RBS						4.6	2.0	225	19	150					
Santander	4.0	0.8	103	5	74	5.0	1.6	184	19	110	5.7	2.4	263	21	160
San UK	3.2	0.8	102	2	70	3.5	1.7	204	12	139					
SocGen	2.0	0.5	78	9	51	5.9	1.6	189	20	115	4.5	2.1	235	6	157
StanChart						6.8	1.9	205	15	134	3.7	5.0	458	42	410
Swedbank	4.9	0.6	91	5		4.3	1.2	140	12	77	7.2	2.3	252	4	151
UBS	1.6	0.5	74	3	50	3.7	1.1	134	16	93					
UniCredit	4.2	2.1	234	21	151	5.1	3.6	372	41	249	6.3	6.0	573	35	404

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)



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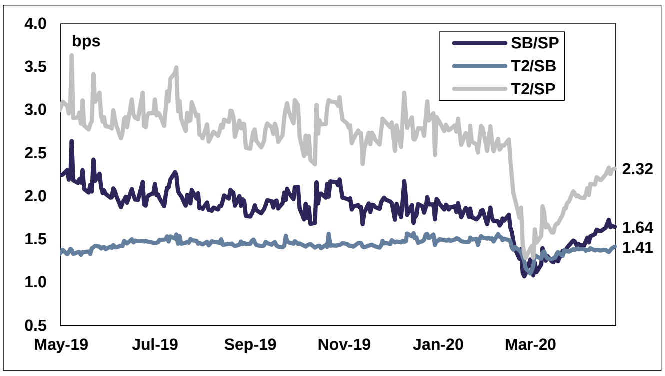

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SNP = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

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
Barclays	2.8	1.7	141	-48	106	4.7	2.8	233	-5	122	5.7	4.0	344	4	170
BFCM	2.4	1.7	136	-1	87										
BNPP	1.9	0.9	63	-28	32	4.7	2.8	224	-4	133	5.3	3.3	277	-4	152
BPCE	2.5	1.5	128	-7	66	4.4	2.8	223	-7	127	3.7	3.2	282	-6	171
Credit Ag.	1.8	1.6	118	-3	82	3.4	2.2	172	-5	112	8.2	3.3	264	-5	152
Credit Sui.	1.8	1.4	102	-11	69	4.9	2.6	186	-6	116					
Danske	1.5	1.5	130	-7	66	3.2	2.9	250	0	156					
Deutsche						3.1	4.0	345	-11	218	6.5	6.4	584	24	258
HSBC	4.1	2.4	202	-19	93	5.1	2.2	189	-3	96	10.8	3.9	308	0	152
ING	1.1	0.9	59	-23	38	4.9	2.3	174	-1	113	4.9	3.4	306	-5	158
Intesa	3.7	3.1	275	1	162						4.1	6.2	563	37	325
Lloyds	3.4	2.1	174	-6	108	3.8	2.5	203	-3	119	5.1	3.2	268	-3	132
Nordea	1.0	0.8	50	-19	26	3.1	2.3	189	-3	112	2.2	2.4	191	-23	127
Rabobank	2.5	1.3	100	-10	59	3.5	2.1	157	-3	97	5.1	2.8	216	-15	120
RBS						4.8	2.7	227	-4	128	3.2	3.6	315	1	186
Santander	5.8	2.5	209	0	122	4.4	2.9	245	-5	146	4.8	3.7	316	-4	199
San UK	1.5	1.5	117	-12	63	3.4	2.4	194	-3	117	4.7	4.1	354	-10	200
SocGen						4.2	2.8	239	-1	139	4.6	3.8	334	-1	185
StanChart	1.9	3.2	310	143	58	4.5	2.8	241	-4	147	5.8	4.0	334	-5	193
UBS	9.7	2.0	149	-8	87	4.8	2.2	167	-7	104					
UniCredit	2.4	3.8	349	13	195	2.3	5.3	474	21	341	8.5	6.5	576	35	269

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.

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The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.com/site/japan)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

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For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

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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