European Banks – Weekly Credit Update

- The ECB's guide on bank mergers published last week brought additional clarity to inform further banking sector consolidation in Europe, yet significant barriers remain
- News of a potential NPL sale from Unicredit may confirm the resilience of the NPL market in Italy despite the pandemic, a welcome development for the local banking sector
- Markets started last week rather quietly, but rallied somewhat on Thursday on the back of better than expected job figures in the U.S.

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ECB guide on banking consolidation

The ECB published on Wednesday a guide on how it would oversee bank mergers. In particular, this provided some clarification on how it would determine the capital requirement of the merged entity, how it would treat so-called "badwill", and how it would arrange the different internal models (for credit risk calculation) of the merging entities. These are the three supervisory factors judged by the central bank to have the most important role in impacting the feasibility of a bank merger.

On capital requirements, the ECB clarified that the P2R and P2G capital requirements of the merged entity will, at a starting point, be the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation. It will not automatically impose a higher requirement on the new entity. This initial requirement could be adjusted at a later point, although not necessarily upwards as the new entity's enhanced business model could have a lower risk level (e.g. through diversification) leading to a reduction of the capital requirement.

On badwill (*negative goodwill, created when one company purchases another at a price below book value*), the guide recognises its accounting value, as it could strengthen the feasibility of the proposed merged by being used to cover for restructuring costs and/or for NPL provisions for instance. In addition, the supervisor expects potential badwill profits to be distributed to shareholders only once the business model feasibility of the merged entity is well established. The creation of EUR2bn in badwill is indeed one of the key rationales given by Intesa on its ongoing bid to acquire UBI Banca.

On internal models, the ECB acknowledged the need for the temporary utilisation of the internal models of the merging entities that were in place before the merger. This would "avoid an unnecessary supervisory burden linked to undue volatility in risk-weighted assets and reduction in risk sensitivity if legal entities temporarily revert to the standardised approach."

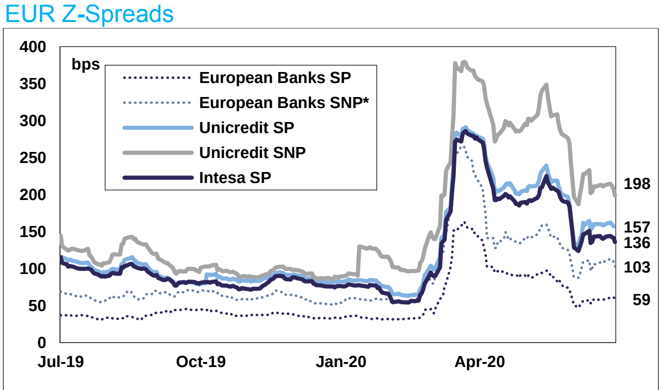
The guide provides useful clarity on M&A in the sector to both banks and investors. In fact, any progress and clarity towards further banking sector consolidation in Europe is welcome in light of the sector's weak profitability and crowded space. Amid digitalisation efforts and negative interest rates, likely to stay in place for years to come, economy of scale is becoming increasingly relevant for the sustainability of banks' business models. That said, there remain significant barriers limiting consolidation in the EU arising from various economic, operational, political, and cultural factors. Moreover, there also remain significant regulatory barriers in place, including higher capital requirements for cross-country exposures within the Union and lack of free flow of capital and liquidity between euro area subsidiaries of the same group.

The current economic environment is unfavourable to significant M&A activity in the sector, as banks (and regulators) are now focused on capital conservation and boosting lending growth to support the economy. Moreover, negative interest rates and flattened yield curves significantly reduced the attractiveness of banks' business models, so that excess capital has been used for diversification into payments systems, insurance, wealth management and other financial services. Digitalization efforts and restructurings have also limited the availability of excess capital. That said, consolidation opportunities may arise from the current environment, as weak, poorly-positioned business models might be challenged further.

Unicredit, Intesa and the Italian NPL market

Bloomberg reported on Thursday that Unicredit is close to selling a total of EUR1.5bn of NPLs by the end of the month (vs. EUR24.9bn of the bank's total NPL book as at end-March 20) to other smaller Italian banks active in the NPL market. That's on top of a EUR335m sale the bank announced last week. If executed, the sale would confirm the strength of the NPL market in Italy. The latter was robust before the crisis, enabling both Intesa and Unicredit to significantly reduce their NPL ratios. A confirmation of the health of the Italian NPL market despite the pandemic is hence highly welcome for the local banking sector, as NPLs in Italy are likely to start increasing again as a result of the result of the crisis.

EUR Z-Spreads



*Includes Senior HoldCo Debt. Source: Bloomberg. Intesa is yet to issue SNP paper.

This significant reduction in the NPL book of both Unicredit and Intesa was indeed one of the key drivers leading their SP paper to trade just 23-30 bps wider than the European average before the crisis, at the same level as the spread on European SNP paper (including Sr. HoldCo). The gap to the European average has widened significantly since the start of the crisis, however, as Italy has been one of the most economically impacted countries in Western Europe.

Yet, we see the credit profile of both Unicredit and Intesa as sound, backed by robust capitalisation, diversified business models, ample liquidity and the strong franchise in their core countries. Negatively, the crisis will naturally harm their asset quality, whilst Unicredit profitability has been underwhelming amid disposals, restructuring and impairment charges. In 3M20 the total impairment charges of EUR1.3bn consumed 67% of Unicredit's pre-impairment profits on an underlying basis, signalling limited headroom for further material increases in provisions for loan losses. Intesa's profitability profile is indeed in a much better shape, which is also reflected in its share price (P/B of 0.60, vs 0.35 from Unicredit). However, the bank's lack of geographic diversification makes it make more vulnerable to the Italian economic performance.

In all, even though we are cautious on the outlook for European bank spreads over the short and medium term, we do see some room for a tightening of the gap of the spreads of Unicredit and Intesa to their European peers based on the banks' fundamentals. That said, the ratings of Unicredit and Intesa are still capped by the sovereign ratings of Italy, making the SP ratings of both names borderline investment grade, whilst Unicredit's SNP is already rated BB+ by Fitch, although still rated BBB- by S&P and Baa2 by Moody's.

Intesa's 2Q results are scheduled for 04 August, followed by Unicredit on 06 August.

Financials

Key Data (1Q20)	Unicredit	Intesa
Revenues	4.4	4.9
Impairments	1.3	0.8
Net income (EURbn)	-2.7	1.2
NPL Stock (EURbn)	24.9	30.2
CET1 (%)	13.4	14.5
Total Capital (%)	18.0	18.5
Sub. MREL (%)	21.0	18.5
Leverage (%)	5.5	6.6
LCR (%)	143.0	>100
NPL (Stage 3, %)	4.9	7.1
LLP* / NPL Reserves (%)	65.2	53.6
LLP / Pre-Imp. Profit (%)	66.9	30.3
Cost to Income (%)	56.9	44.4

Source: Banks' financial statements. LLP= Loan loss provisions

Commerzbank

Martin Zielke (CEO) and Stefan Schmittmann (Chairman) offered their resignation on Friday, following a letter last month from Cerberus, the second largest shareholder with a 5.0% stake, calling for a "significant change at the supervisory board, the management board and the company's strategic plan". The American fund saw the current plan as flawed, unambitious and poorly implemented. The fund's letter came two months after the German state, the largest shareholder with a 15.6% stake, replaced its representatives at the board due to the bank's poor performance.

Commerzbank was in the process of reviewing – again – its medium-term strategy. The bank has been severely impacted by the ECB's negative interest rate policy ever since it was first introduced in 2014. Yet it has also failed to generate and successfully implement any meaningful strategic change that would minimally adapt its business model to this environment, already in place for 6 years. Zielke is rumoured to be replaced by Roland Boekhout, currently the head of corporate clients.

Primary and secondary markets

The **primary market** was rather quiet last week amid some uncertainty early in the week and the U.S. bank holiday on Friday, with only three deal taking place. **Deutsche** kick-started the week with a USD500m Tier 2, in the unusual 11NC10 format. *Tier 2 paper is usually issued in either in the 15NC10 or 10NC5 format, as its recognition for regulatory capital purposes reduces linearly in the last 5 years to maturity (i.e. 20% of face value each year).* The longer maturity (10Y) was due to U.S. investors' preference for longer duration, whilst the 1 year call makes it eligible for MREL purposes until the maturity of call option.

On Wednesday, Caixabank tapped the market for a Covid-19 Social Senior Preferred bond, which attracted solid demand levels, partly driven by its ESG label, with a 33bps tightening from IPT and 3bps inside fair value. The 6NC5 format is similar to other euro area SP paper issued recently, as regulatory changes in the EU now allow for a proportion of MREL requirement to be met with SP paper, yet these still require an above 1 year maturity.

The **secondary market** started the week flat, but saw a bit of a rally on Thursday backed by better than expected job figures in the U.S. and further signs of stability in the number of Covid-19 cases in the Europe. The positive market sentiment was further supported by the (aforementioned) news on NPL sales by Unicredit, and by another stimulus package announced by the Spanish government, resulting in a strong performance by Italian and Spanish banks.

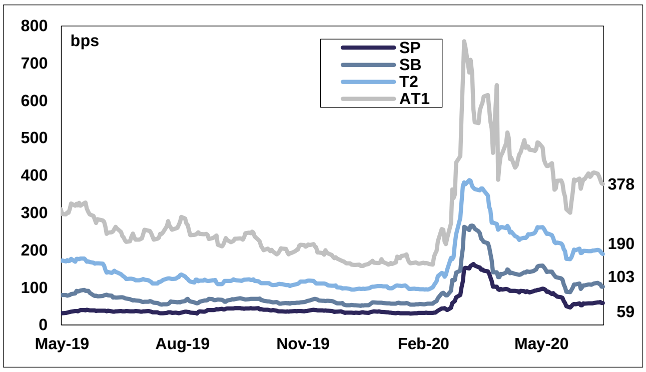
Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	NIC (bps)	Book Orders
Caixabank	SP Covid-19 Social	EUR1bn	6NC5	MS+117	MS + 150	-3	>EUR2.8bn
SocGen	SP	USD500m	8 July 25	T + 115	T + 125/130	8	USD1.4bn
	Tier 2	USD500m	15NC10	T + 300	T + 310	15	USD1.1bn
Deutsche Bank	Tier 2	USD500m	11NC10	T + 525	T + 525	-	-

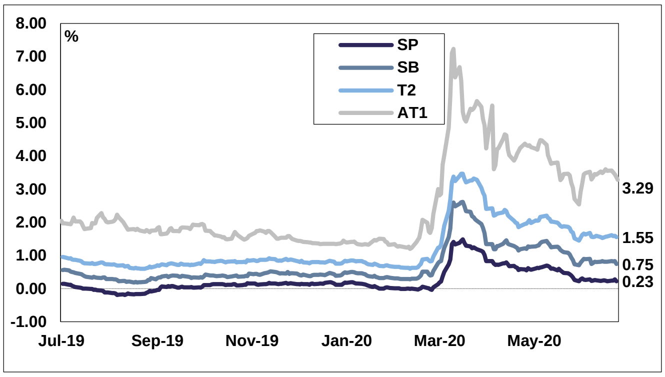
Source BondRadar, Bloomberg.

Western European Banks EUR Spreads and Yields

Aggregate Z-spread LTM (bps)



Aggregate Yields LTM (bps)



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

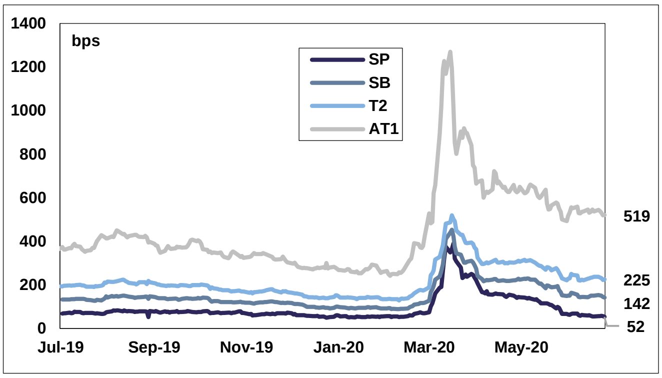
Selected Names

	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	4.8	0.7	99	-1	49	4.1	1.2	152	-8	78	5.1	3.3	352	-6	159
Barclays	3.8	0.6	81	3	38	3.3	0.8	110	-14	56	4.9	2.4	241	-40	120
BBVA	4.8	0.6	82	-3	33	4.4	1.0	126	-10	69	5.9	1.9	224	-15	107
BFCM	4.0	0.2	50	1	20	9.2	0.8	97	-6	36	5.4	1.4	165	-6	71
BNPP	2.6	0.1	37	1	19	5.2	0.7	100	-7	44	5.4	1.4	152	-6	64
BPCE	3.8	0.2	55	1	25	4.6	0.7	98	-7	46	2.8	1.0	123	-11	65
Credit Ag.	3.4	0.1	42	1	12	5.7	0.7	94	-6	42	5.0	1.8	203	-5	71
Credit Sui.						6.7	1.0	120	-6	48					
Danske	2.9	0.1	47	-1	11	2.8	0.9	122	-6	48	6.3	2.0	225	-14	78
Deutsche	3.9	0.7	103	-5	16	2.8	1.5	176	-9	50	4.9	3.7	393	-24	101
DNB	3.3	0.1	43	0	12						6.9	1.2	152	-16	93
HSBC	3.3	0.2	52	1	16	3.1	0.4	67	-4	24	5.9	0.9	111	-6	26
ING	1.6	0.1	42	-1	27	5.1	0.5	75	-6	27	5.4	1.4	169	-10	72
Intesa	4.6	1.1	135	-10	55						5.4	2.4	266	-9	113
Lloyds	2.1	-0.1	23	-3	-1	3.9	0.7	103	-13	52	7.6	1.8	210	-9	96
Nordea	4.5	0.0	31	1	6	2.9	0.3	67	-6	29	2.3	1.2	120	-16	70
Rabobank	2.6	-0.1	25	0	9	6.3	0.5	72	-5	34	2.8	0.6	85	-8	36
RBS						3.5	1.1	139	-11	63					
Santander	3.9	0.3	62	-3	19	5.3	1.0	124	-10	55	5.6	1.7	200	-7	99
San UK	3.0	0.2	48	-1	17	3.4	0.9	133	-10	71					
SocGen	1.9	0.2	53	1	27	6.1	1.1	134	-7	62	4.4	1.3	159	-13	70
StanChart						6.8	1.0	122	-9	54	2.3	1.5	90	-13	38
Swedbank	4.7	0.3	62	0		4.2	0.5	84	-6	21	7.1	1.5	174	-12	73
UBS	1.4	0.1	37	1	17	3.5	0.5	81	-8	38					
UniCredit	4.3	1.2	151	-11	65	5.0	2.0	228	-14	97	2.7	3.1	334	-32	147

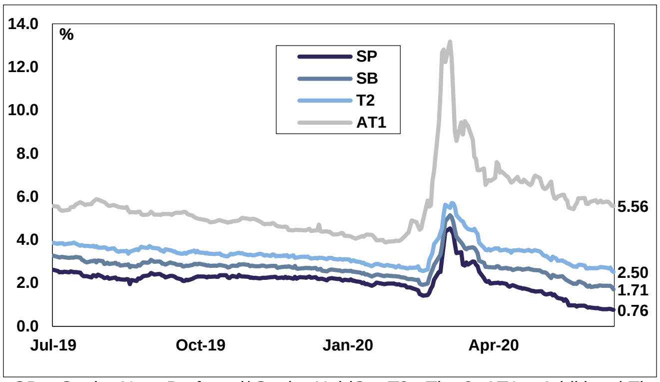
Source: Bloomberg, Daiwa Capital Markets Europe. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative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

Western European Banks USD Spreads and Yields

Aggregate Z-spread LTM (bps)



Aggregate Yields LTM (bps)



Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = 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	2.7	0.9	64	-9	22	4.5	1.9	145	-11	35	5.5	3.1	255	-10	84
BFCM	2.3	0.9	56	0	13										
BNPP	1.8	0.4	14	-4	-17	4.7	1.7	132	-4	46	5.2	2.5	195	-9	74
BPCE	2.4	1.0	75	-2	26	4.2	2.0	149	-11	51	3.6	2.4	195	-11	81
Credit Ag.	2.2	1.0	76	-2	21	4.0	1.6	111	-7	37	8.2	2.5	183	-7	57
Credit Sui.	1.7	0.8	53	-4	7	4.7	1.9	121	-5	43					
Danske	1.6	1.0	68	-2	4	3.0	2.1	152	-11	62					
Deutsche						3.0	2.6	211	-13	66	6.6	6.0	539	-1	161
HSBC	4.0	1.9	154	4	45	5.0	1.9	142	-7	45	10.8	3.5	268	-6	108
ING	1.1	0.9	29	-4	5	4.9	1.4	93	-7	15	4.1	2.6	225	-18	85
Intesa	3.6	2.4	203	-5	72						4.1	4.3	383	-22	147
Lloyds	3.3	1.3	114	0	48	3.6	1.4	98	-6	37	5.0	2.6	206	-2	68
Nordea	2.9	0.7	43	-2		2.9	1.5	111	-4	26	2.1	1.5	109	11	51
Rabobank	2.4	0.7	38	-8	-3	3.8	1.1	66	-7	12	5.0	1.9	131	-4	51
RBS						4.2	1.9	144	-10	44	3.1	2.5	205	-11	89
Santander	5.8	1.8	136	-7	49	5.2	2.3	180	-10	60	4.7	2.7	225	-10	110
San UK	2.4	0.9	64	-3	17	2.9	1.5	96	-4	22	4.6	3.0	239	-13	102
SocGen	4.8	1.4	103			4.1	2.2	173	-5	74	4.5	3.0	242	-13	98
StanChart	0.9	1.5	110	-52	-142	4.4	2.2	180	-5	70	5.7	3.1	260	-5	114
UBS	9.8	1.6	102	-6	54	4.7	1.6	111	-3	28					
UniCredit	2.3	2.9	263	-10	89	2.2	3.0	252	-18	118	7.5	5.2	455	-13	129

Source: Bloomberg, Daiwa Capital Markets Europe. 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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