Daiwa Capital Markets

European Banks – Weekly Credit Update

- The Q2 earnings season starts this week with the Nordic and American banks – we expect most large trading houses to perform well, whilst provisioning levels remain uncertain.
- Lloyds' departing CEO has materially strengthened the bank's credit profile, yet its interest rate sensitivity will present a challenge in the new environment.
- Primary markets were mostly quiet over the past week, with less than a handful of issuers targeting lower- ranked paper; the trend in the secondary market was mixed.

Israel Da Costa, CFA
Credit Analyst
+44 20 7597 8355
Israel.DaCosta@uk.daiwacm.com

2Q20 Earnings Season

JPMorgan and Citibank will kick-start the second quarter results season for American banks tomorrow, followed by Goldman on Wednesday, BofA on Thursday and Morgan Stanley on Friday. In Europe, DNB started the earnings season today, to be followed by SEB and Svenska HB on Wednesday, and Nordea, Swedbank and Danske on Friday. In all, we expect strong client activity to have supported revenues, yet provisioning levels remain a key concern. Positively, the economic scenarios on which provisioning levels will be based should be more harmonized than in Q1.

For large global trading banks, the expectation is for another quarter of strong trading profits, particularly in FICC. This was recently highlighted in Jefferies' results for the quarter ending May-20 results, and by Christian Sewing (Deutsche's CEO), who stated that the positive momentum in FICC trading observed in Q1 carried over into Q2. Sewing also pointed to a deceleration of FICC and DCM activity in the second half of the year however. Equity trading results should be mixed, with French names expected to continue to underperform in the space. UBS will be the first European G-SIB to publish their Q2 results on 21/07, followed by Deutsche, Barclays and Santander on 29/07.

Lloyds & Barclays

On Monday, Lloyds announced that its CEO António Horta-Osório will step down in June 2021. Under his leadership, since March 2011, Lloyds moved from being a 43.4% government-owned bank* to a solid credit, with healthy profitability (underlying RoTE of 14.8% in 2019), clean balance sheet, sound capital base and strong franchise as the UK's largest retail bank, with a 20% market share in deposits and mortgage lending.

Yet, significant challenges lie ahead for the bank. Profitability was already under pressure in 2019, whilst its retail banking focus makes it more sensitive to the low interest rate environment in the UK. Moreover, the bank's limited business diversification made it more vulnerable to the current crisis when compared to peers with sizeable securities trading operations. The group is reportedly looking into strengthening its Wealth Management and Insurance business, which would offset its reliance on interest rate margins but take time to grow to a meaningful size.

In Q1, the bank increased impairment charges by £1.1bn Y/Y in anticipation of losses related to the economic fallout from the pandemic. Yet the figure was based on optimistic scenarios, with a "base case" UK GDP decline of 5% in 2020 (followed by a 3% recovery in 2021) and a "severe downside" UK GDP decline of 7.8% in 2020 (followed by a 0.1% decline in 2021). DCME outlook for GDP growth in the UK in 2020 is currently at -10.1%.

As a result, we expect the bank to report additional substantial charges in coming quarters, with loans to sectors more vulnerable to the pandemic amounting to £10.6bn at end-March 20 (2.4% of the loan book).

The bank's lack of geographic diversification also makes it more vulnerable to political developments in the UK, so that on top of the economic impact of the virus, the bank will be particularly exposed to potential negative fallouts from the UK's full exit from the EU from 01 January 2021.

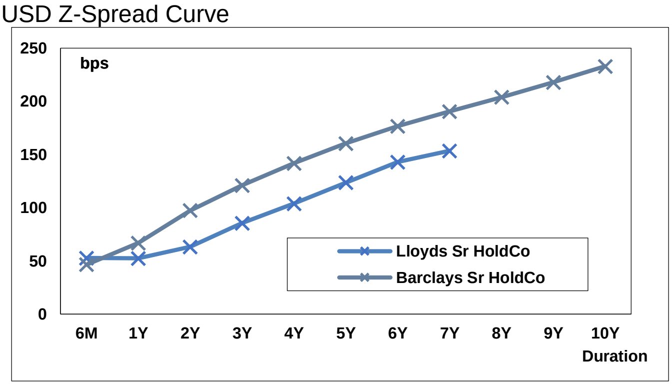
At Barclays, Bloomberg reported last week that the bank has sounded the market for potential replacement for Jes Staley, the bank's CEO since December 2015. Staley, despite his fair share of controversies, has successfully implemented a strategy focused on business diversification, including the maintenance of sizeable FICC and Equities trading operations.

Financials

Data as of 1Q20	Lloyds	Barclays
CET1 (%)	14.2	13.1
CET1 (bn)	29.7	42.5
Total capital (%)	21.9	20.4
Leverage Ratio (%)	5.3	4.5
MREL (%)	34.5	29.3
NPL (Stage 3, %)	1.8	1.3
NPL Coverage (%)	25.0	40.4
Revenues	3.9	6.3
LLP (£m)	1,430	2,115
Statutory Profit (£m)	480	605
Cost to Income (%)	49.7	51.9
LCR (%)	138.0	155.0
CDS 5Y EUR HoldCo (bps)[1]	72.8	93.5
P/B (x)[1]	0.46	0.36
Stock Price YTD ∆ (%)[1]	-51.3	-34.5

Consolidated figures. Source: Banks' financial statements, Bloomberg. [1] As of 10/07/2020

USD Z-Spread Curve



Source: Bloomberg

The latter is proving particularly beneficial during this crisis, as the solid performance in the area in Q1 (FICC earnings were up 106% Y/Y, Equities were up 21% Y/Y), which is expected to have carried over into Q2, allowed the bank to take a more conservative approach towards loan loss recognition. It posted £2.1bn in impairment charges in 1Q20 (vs £0.4bn in 1Q19) based on an assumption of a GDP decline of 8% in 2020 in its baseline scenario. Exposure to sectors more vulnerable to the pandemic amounted to £10.7bn (3.2% of the loan book), a similar volume to Lloyd's exposure.

In all, Lloyds' balance sheet remains stronger and healthier than credit than Barclays', given the latter's stronger focus on corporates and investment banking. But Barclays' more diversified business model, in terms of both activity and geography, is proving particularly beneficial in the current crisis and making it less sensitive to lower interest rates in both the US and UK.

This better through-the-cycle position of Barclays compared to Lloyds is not priced into spreads in our view. Lloyds' HoldCo 5Y USD debt is trading with an aggregate Z-spread of 103bps (duration of 3.7 years), vs a 145bps (4.5) from Barclays. We do still see Lloyds Sr HoldCo (A3 Negative /BBB+ Negative by Moody's/S&P) and overall credit profile as stronger than Barclays' (Baa2 Stable/ BBB Negative), as also reflected in its ratings, warranting tighter overall spreads, but we also see room for tightening of the gap between the two credits.

**The UK government injected £20.3bn into the group at the height of the financial crisis, acquiring a 43.4% stake. It began to reduce its ownership in September 2013. Following a series of granular share disposals, it announced in May 2017 the sale of all of its shares with a £900m nominal profit.*

ECB Tiering Multiplier

As excess liquidity leapt to a new record high €2.8trn following the latest TLTRO-iii operation, we expect the ECB's Governing Council to agree to increase the tiering multiplier to exempt a larger share of bank reserves (currently six times each credit institution's minimum reserve requirement) from the -0.50% deposit rate this Thursday. This tiering system was implemented in September 2019, when total excess liquidity in the euro system stood at €1.8tn. Based on the current level of excess liquidity, euro area banks will pay over €9bn per year to the ECB according to our estimates, up from the around €5bn estimate based on September 2019 data.

Primary and secondary markets

Primary market activity was limited throughout the week in the absence of a clear market trend, the start of the black-out period for several issuers and continued concerns about the number of Covid-19 infections in the US. That said, less than a handful of European names tapped the market for lower-ranked paper, which were met with varied demand levels. BBVA was the most active, with an EUR AT1 placed on Tuesday, followed by a GBP Tier 2 on Friday. Whilst demand for the former was adequate, the latter seems to have been less successful. BBVA became the first bank to issue a Green AT1, launched at 6.0%, with a book order above €2.75bn for a final deal size of €1bn. It is unclear whether the Green label led to stronger demand, yet the final price was 50bps inside IPT, with no clear NIC. According to the bank, the new issue may replace an 8.875% AT1 with a call option maturing in April 2021. The latter has raised theoretical questions on the 'greenness' of the bond, as it would be used to both finance green projects and refinance AT1 paper. That said, in practice, banks' funds are fungible, so that the format in which the ESG bonds are issued makes little difference, as long as the bank has enough ESG assets to fund.

The trend in the **secondary market** last week was mixed, albeit with the tightening observed early in the week reversing somewhat on Thursday and Friday. SP tightened marginally on aggregate (particularly in EUR), so did SNP (particularly in USD), yet Tier 2 paper widened marginally (particularly in USD).

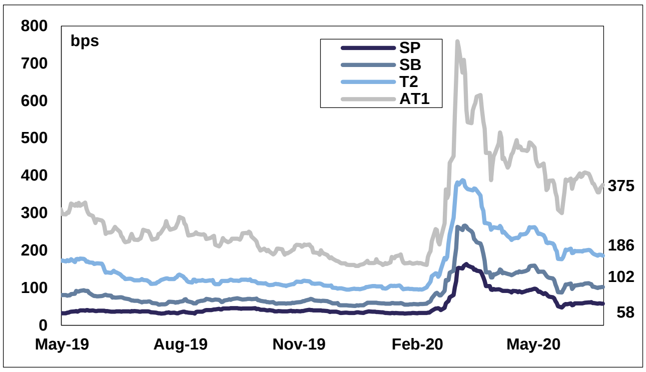
Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	NIC (bps)	Book Orders
Rabobank	AT1	EUR1bn	PNC7.5	4.375% (coupon)	4.75% (coupon)	-	EUR3bn
BBVA	AT1	EUR1bn	PNC5.5	6.0% (coupon)	6.5% (coupon)	0	>EUR2.75bn
BBVA	Tier 2	GBP300m	11NC6	G + 315	G + 315	-	>GBP300m
SocGen	SP	AUD	3Y	3mBBSW +93	3mBBSW + 105	-	-
Bankinter	AT1	EUR350m	PNC6	6.25% (coupon)	6.5% (coupon)	-	EUR800m

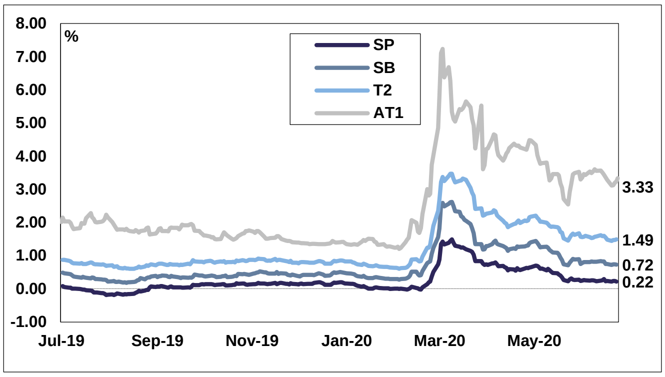
Source BondRadar, Bloomberg.

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.

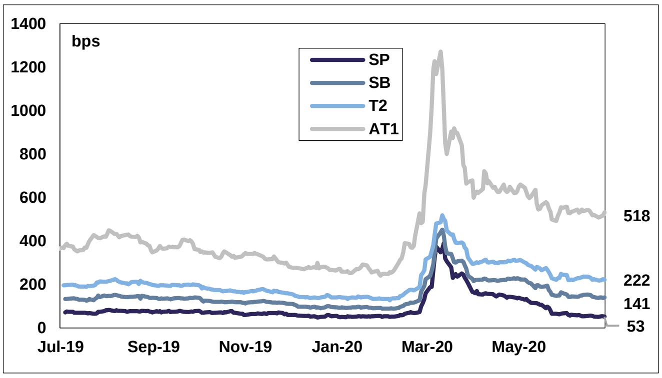
Selected Names

	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	97	-2	48	4.1	1.2	153	1	80	5.1	3.3	358	6	161
Barclays	3.8	0.5	76	-5	33	3.3	0.8	108	-3	53	4.9	2.4	236	-5	115
BBVA	4.8	0.5	81	-3	31	4.4	0.9	125	-1	68	5.9	2.0	235	16	120
BFCM	4.0	0.2	49	-1	18	9.2	0.8	97	0	36	5.3	1.4	163	-2	71
BNPP	2.6	0.0	37	-1	17	5.2	0.7	100	-1	43	5.0	1.3	147	1	67
BPCE	3.7	0.2	53	-1	24	4.6	0.7	97	-1	45	2.8	1.0	121	-2	64
Credit Ag.	3.4	0.1	43	-1	12	5.6	0.7	94	0	42	5.1	1.8	204	2	74
Credit Sui.						6.7	0.9	119	1	49					
Danske	2.9	0.1	46	-1	10	2.8	0.9	120	-2	44	6.3	2.0	226	1	79
Deutsche	4.8	0.7	99	-4	13	2.8	1.5	172	-2	48	4.9	3.6	386	-7	92
DNB	3.3	0.1	42	0	11						6.9	1.2	151	-1	92
HSBC	3.2	0.2	51	-1	15	3.1	0.4	73	5	29	5.9	1.0	130	19	46
ING	1.6	0.0	37	-3	23	5.1	0.4	74	-1	26	5.4	1.3	165	-1	70
Intesa	4.6	1.0	132	-2	54						5.4	2.5	273	7	120
Lloyds	2.1	-0.1	19	-5	-6	3.9	0.7	99	-5	46	7.6	1.8	209	-1	95
Nordea	4.5	0.0	31	0	4	2.9	0.3	66	-1	28	2.3	1.2	118	-2	68
Rabobank	2.6	-0.1	24	0	8	6.2	0.4	72	-1	33	2.8	0.5	83	-2	35
RBS						3.5	1.0	133	-6	56					
Santander	3.9	0.3	61	-1	20	5.3	1.0	128	2	52	5.6	1.8	207	6	106
San UK	3.0	0.1	45	-3	13	3.4	0.9	130	-3	67					
SocGen	1.9	0.2	51	-2	24	6.1	1.1	133	0	62	4.2	1.3	156	-3	67
StanChart						6.8	1.0	123	1	52	2.3	1.4	90	7	42
Swedbank	4.7	0.3	61	-1		4.2	0.5	84	0	20	7.1	1.4	173	-1	72
UBS	1.4	0.0	35	-1	16	3.5	0.4	79	-2	37					
UniCredit	4.2	1.2	148	-3	63	5.3	2.0	226	-2	92	2.7	3.2	338	6	145

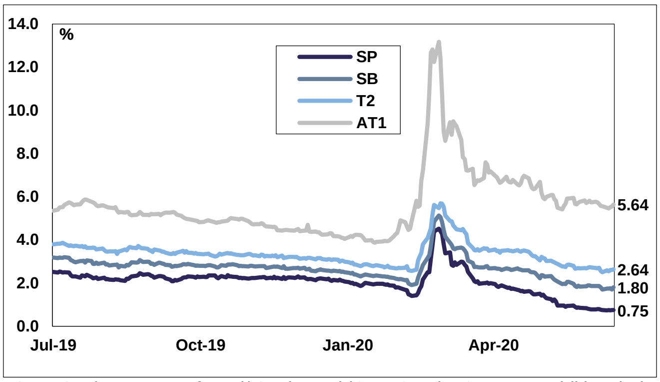
Source: Bloomberg, Daiwa Capital Markets Europe. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative 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	2.6	0.9	65	1	15	4.5	1.8	145	1	40	5.5	3.1	258	0	85
BFCM	2.3	0.8	59	0	15										
BNPP	1.8	0.4	18	4	-13	4.6	1.7	132	-5	44	5.2	2.3	191	-2	68
BPCE	2.4	0.9	66	-3	14	4.3	1.9	146	-2	41	3.7	2.3	192	4	80
Credit Ag.	2.2	1.0	74	-3	17	3.9	1.5	107	-3	32	8.3	2.4	177	0	59
Credit Sui.	1.7	0.7	45	2	10	4.7	1.8	115	-1	41					
Danske	1.6	1.0	74	-2	5	3.0	1.9	141	-4	51					
Deutsche						3.0	2.5	204	-14	60	6.6	6.1	549	-6	151
HSBC	4.0	1.7	142	-12	33	5.0	1.9	138	4	46	10.7	3.1	245	8	116
ING	1.1	0.5	24	-5	0	4.9	1.3	94	-1	18	4.2	2.7	238	1	86
Intesa	3.6	2.3	202	0	74						4.1	4.4	398	19	166
Lloyds	3.2	1.3	97	-16	31	3.7	1.4	103	-10	21	5.0	2.4	198	-8	65
Nordea	2.9	0.6	38	-5		2.9	1.4	103	-10	16	2.1	1.4	103	-16	35
Rabobank	2.4	0.6	38	0	2	3.8	1.2	78	-4	7	4.9	1.8	138	0	46
RBS						4.2	1.8	144	-1	42	3.1	2.5	212	0	88
Santander	5.8	1.8	134	-2	47	5.2	2.2	177	0	58	4.7	2.7	231	6	115
San UK	2.4	0.8	60	-2	17	2.9	1.4	93	-2	22	4.6	3.0	255	-10	91
SocGen	4.8	1.3	96	-8		4.1	2.1	174	-1	74	4.5	2.9	245	-1	96
StanChart	0.9	1.2	94	-16	-158	4.4	2.3	178	2	73	5.7	3.1	269	3	115
UBS	9.8	1.5	98	-4	52	4.7	1.5	106	-2	33					
UniCredit	2.3	2.9	266	0	91	2.2	2.8	237	-15	104	7.5	5.2	456	0	128

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.

Credit Research

Key contacts

London		
Head of Research	*Chris Scicluna*	+44 20 7597 8326
Financials, Supras/Sovereigns & Agencies	*Israel Da Costa, CFA*	+44 20 7597 8355
Research Assistant	*Katherine Ludlow*	+44 20 7597 8318
Tokyo		
Domestic Credit		
Chief Credit Analyst	*Toshiyasu Ohashi*	+81 3 5555 8753
Electronics, Automobiles, Non-Banks, Real Estate, REIT	*Takao Matsuzaka*	+81 3 5555 8763
Chemicals, Iron & Steel	*Kazuaki Fujita*	+81 3 5555 8765
International Credit		
Non-Japanese/Samurai, European Sovereigns	*Hiroaki Fujioka*	+81 3 5555 8761
Non-Japanese/Samurai	*Fumio Taki*	+81 3 5555 8787
Non-Japanese	*Jiang Jiang*	+81 3 5555 8755
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

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