European Banks – Credit Update

- Higher cost of risk and downward pressure on income expected from upcoming bank earnings reports
- Primary markets issuance remained muted and only accessed by high quality names. Widening spreads to Bunds resulted in strong demand for the few Euro SSAs that came to market while FIG deals were largely concentrated in USD
- Secondary market spreads for Euro denominated senior titles largely tightened as risk assessments provide market with clarity. USD spread remain wide across payment ranks

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Ukraine war - Secondary effects on European banks

While European banks closed 2021 on a positive note with mostly strong performance indicators, the conflict in Ukraine has markedly lowered confidence in the sector, particularly in those institutions from France, Italy and Austria most exposed to Russia. Banks will have to take write-downs on their Russian, Belarus and Ukrainian assets. We expect to see a sector-wide rise in cost of risk (CoR) measures, reflecting higher risk perceptions and intensified inflationary pressures. These effects have been reflected in significant declines in bank share prices. While support to the periphery might be maintained via ongoing net asset purchases, this week's Governing Council meeting of the ECB could add earnings pressure to the mix should it indicate that rate hikes are unlikely before 2023.

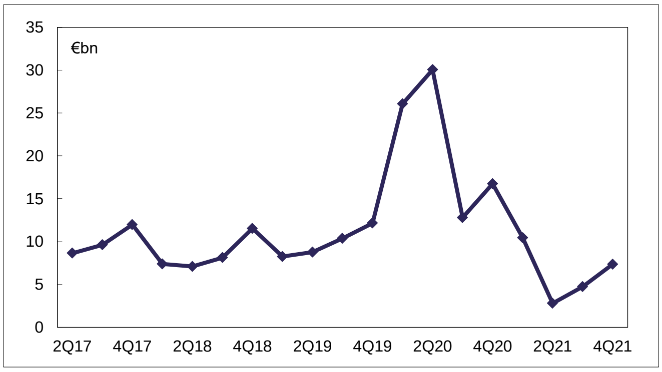
Rising cost of risk likely to impact earnings

A bank's cost of risk measure provides an indication of future expected losses, taking into account the expected macroeconomic environment as well as provisions taken by an entity to stem future losses. We will likely see cost of risk measures rise across the sector during 1Q22 reporting, and most pronounced among entities with the highest exposures to Russia, ultimately dampening bottom line results. This comes at a time when many banks had just normalised their CoR measures, as significant pandemic-related balance sheet deterioration did not materialise. Although 2022 and 2023 macroeconomic outlooks were often cautiously optimistic, we believe the conflict between Russia and Ukraine will lead to a revision of risk-perception. After aggregate loan loss provisioning among European banks picked up from 1H21, we expect this to continue through 1H22. An increasingly challenging business environment will likely weigh on bottom line profitability.

Softer loan demand paired with a possible delay to ECB rate hikes may result in a decline of top-line revenues. Lenders most removed from the conflict, with diversified business profiles and international footprints, have seen their share prices rise over recent weeks. Notably HSBC and Standard Chartered Bank (SCB) are among the best performers YTD, in part also reflecting advanced internal restructurings and fleshed out growth plans focused around Asian markets that enable them to escape a drawn out conflict in Europe. Even without significant exposures to Russia, certain European centric and market focused lenders such as Deutsche Bank or BNP could see their earnings diminished. In the second half of 2021, income from M&A related activities helped them offset declines in equity and FICC trading income but given the diminishing risk appetite in the sector this might not be the case in the near term.

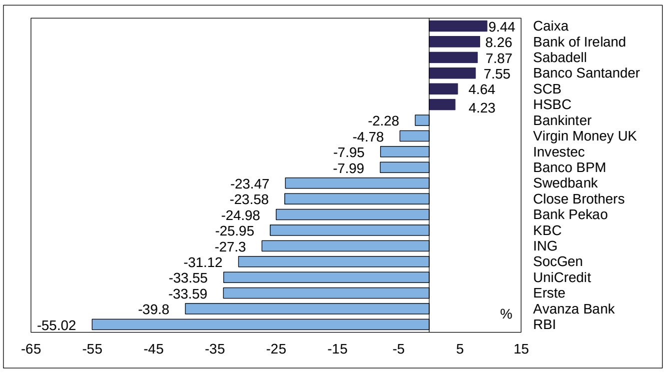
As two of the most exposed European entities, Société Générale and ING recently provided updates on their dealings. The updates affirmed their relatively small exposures compared to the overall group balance sheets, making up only a limited portion of their income. However, we note that ING revised its Russian credit exposure upwards to EUR6.7bn compared to EUR4.7bn reported in their 4Q21 earnings release, most likely to better account for non-Russian borrowers under Russian ownership. Nevertheless, combined credit exposures to Russia and Ukraine only amounted to 1% of total loans and any losses should be comfortably absorbed by FY21 pre-tax profit of EUR6.8bn. SocGen also provided additional information, stating that 83% of exposures were held by its subsidiary Rosbank. 2021 activities contributed 2.7% to group net earnings. It also outlined the effects a "potential extreme scenario", in which it would be stripped of all of its banking assets in Russia. SocGen estimates that this would lead to a 50bps hit to its 13.7% CET1 ratio but deemed it manageable given the sizeable 470bps MDA cushion.

European Banks: Aggregate Loan Loss Provisions*



Source: Bloomberg; *Bloomberg major pan-European banks

STOXX Europe 600 Banks – Best and Worst Performers YTD



Source: Bloomberg; As of 04.03.2022; Total Index declined -14.34% YTD

Capitalisation in focus

Assessing and quantifying the impact of the conflict, and with it the associated costs from policy measures and sanctions, is a near-impossible task. However, we can reasonably expect near-term implications for bank share buybacks and dividend pay-out plans. For instance, Raffeisen Bank international (RBI) already announced full retention of its 2021 profits. European banks' 4Q21 results implied that capital buffers over regulatory requirements were starting to come down compared to the previous quarter, due to announced share buybacks and dividends as well as increased regulatory headwinds. As communicated by the banks themselves, this was expected to continue through to 2023 but earnings pressure and the uncertainty caused by the conflict in Ukraine could result in regulators recommending to limit equity distribution once more as they had done during the pandemic. Likewise, the re-introduction of the countercyclical capital buffer (CCyB) in many European countries could also be halted or delayed, reducing near-term capital burdens.

Primary and secondary markets

European **primary market** issuance volumes for SSAs stood at EUR9.2bn over the course of last week, within market expectations of EUR6bn-10.5bn. FIG supply of EUR3.3bn was also within the weekly forecast amount of EUR2bn-5.5bn. The total 2022 year-to-date FIG volume of EUR125bn is 33.7% ahead of last year's issuance volume. SSA volumes, however, remain behind last year's level, down 17.7% at EUR176bn. For the week ahead, survey data suggest SSA volumes will range between EUR7bn-12bn and FIGs are expected to issue EUR3.5bn-7.5bn.

SSA supply was limited again as the conflict in Ukraine raged on. Notable deals stem from **Rentenbank** that benefitted from widening Euro spreads between swap-rates and Bund yields, in part to the ongoing 'flight to quality' that pushed Bunds yields markedly lower. The German development agency printed a EUR2bn bond for 5-year at MS-25bps, reportedly the issuer's lowest mid-swap spread at reoffer while also recording its largest order book. It priced some 48bps above Bunds, two times higher than normal levels, offering investors sizeable pickups. According to Rentenbank, two more benchmark bonds are planned for 2022, spread across the first and second half of the year. The intention is to print longer maturities between 7 and 10 years. **Nordic Investment Bank (NIB)** launched an environmental bond for EUR500m. The 7-year deal was 2.9x subscribed tightening 2bps from guidance to MS-18bps. The proceeds will be used for financing selected loans to projects aimed at enhancing the environment in NIB member countries. The bond priced almost 55bps above Bunds. NIB's estimated funding plan for 2022 is EUR6.5bn-7.5bn of which it has so far raised EUR2bn.

(Table 5) Key Transactions

Issuer	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
EIB	Sr. Unsecured	USD3bn	7Y	SOFR MS + 32	SOFR MS + 34	>USD9.5bn
CoE	Sr. Unsecured (Tap)	GBP200m	Jul-2027	G + 50	G + 50	n.a.
CoE	Sr. Unsecured	EUR1bn	5Y	MS – 21	MS - 18	>EUR3bn
KfW	Sr. Unsecured (Tap)	EUR1bn	Nov-2028	MS – 31	MS – 29	>EUR3.7bn
NIB	Sr. Unsecured (Environmental)	EUR500m	7Y	MS – 18	MS - 16	>EUR1.45bn
Rentenbank	Sr. Unsecured	EUR2bn	5Y	MS – 25	MS – 20	>EUR7.75bn
Germany	Sr. Unsecured (Tap)	EUR4bn	Aug-2052	B + 3.5	B + 4	>EUR21bn
FIG (Senior)						
CBA	Sr. Unsecured	USD1.25bn	3Y	T + 63	T + 80/85	n.a.
CBA	Sr. Unsecured (FRN)	USD650m	3Y	SOFR + 79	SOFR equiv.	n.a.
CBA	Sr. Unsecured	USD1bn	5Y	T+ 83	T + 100/105	n.a.
CBA	Sr. Unsecured (FRN)	USD350m	5Y	SOFR + 97	SOFR equiv.	n.a.
HSBC	Sr. Unsecured (HoldCo)	USD1.75bn	4NC3	T + 133	T + 160	n.a.
HSBC	Sr. Unsecured (HoldCo)	USD500m	4NC3	SOFR + 143	SOFR equiv.	n.a.
FIG (Subordinated)						
CBA	Tier 2	USD1.25bn	10Y	T + 195 (3.784%)	T + 220	n.a.

Source BondRadar, Bloomberg.

FIG issuance occurred almost entirely in USD, bar two covered bond transactions, one Euro-denominated CB by the Canadian Imperial Bank of Commerce (CIBC) and a Sterling CB by the Bank of Montreal. **HSBC** issued USD2.25bn across two senior HoldCo tranches, while the **Commonwealth Bank of Australia (CBA)** supplied USD3bn across five tranches, including a subordinated Tier 2 note. As markets are adjusting to geopolitical realities, USD issuers appear to be keen to access markets ahead of the Fed's FOMC statement on 16th March, when it is expected to announce a rate hike of 25bps. FIG Euro/Sterling supply could resume as soon as this week after some corporates paved the way last Thursday with issues in both currencies. Any potential FIG deals are most likely to come from high quality, core-European names that are most removed from the conflict in Ukraine. Borrowers will have a somewhat compressed issuance window as the ECB's Governing Council meeting takes place on Thursday.

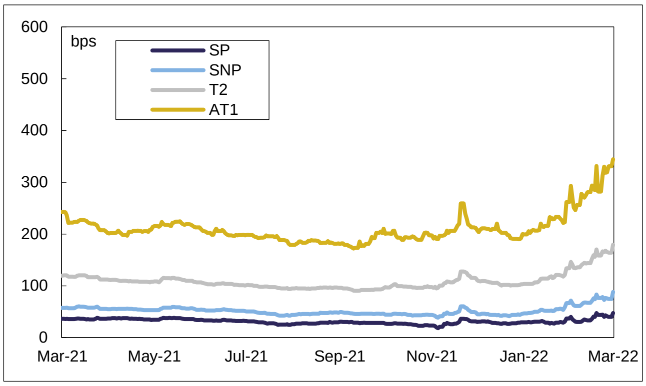
Secondary market spreads were mostly wider in EUR and USD, as risk indicators widened significantly week-on-week as the war in Ukraine intensified. CDS price indices on European senior (105bps) and subordinated financials (203bps), as measured by iTraxx benchmarks, priced +24bps and +51bps higher than last week's levels, setting new 52-week highs.

Despite the high degree of uncertainty surrounding current events, we don't expect to see significant impulses into the market from the ECB when it makes its policy announcements on Thursday. Markets have pushed back any expectation of a rate hike in the near term and we expect the Governing Council to avoid committing to any sweeping policy adjustments anytime soon. In the meantime, secondary market spreads of European bank bonds have generally widened since the beginning of the conflict. But over the past week average European SP and SNP Euro-denominated bond spreads actually tightened. Perhaps some initial issuer-specific uncertainty was lifted as particular banks provided additional information on their respective regional exposures. Bank fundamentals generally remain robust and should be able to weather the anticipated expense pressure and possible decline in income. Currently, bank AT1s appear to be most likely to experience further declines, in line with entity equity valuations, further increasing non-call risk for AT1s.

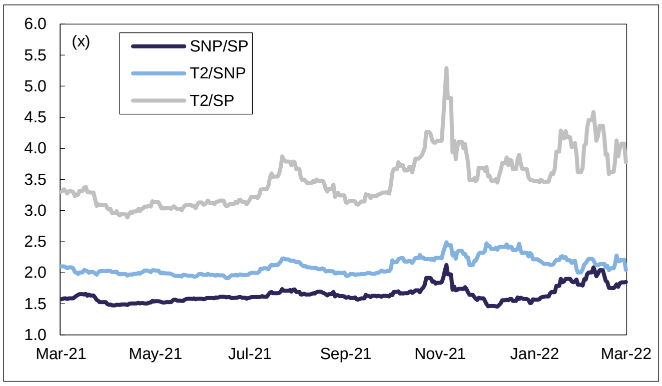
Weekly average EUR spreads were mixed across payment ranks with SP (-3.4bps), SNP (-2.1bps) and Tier 2 (+11bps). USD average weekly spreads were wider week-on-week with SP (+14bps), SNP (+17.7bps) and Tier 2 (+21.4bps). Based on data collected from Bloomberg, 98% of FIG tranches issued in February and 67% of SSAs tranches quoted wider than launch.

Western European Banks EUR Spreads and Yields

Aggregate EUR Z-spread LTM (bps)



Multiples (x)



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.

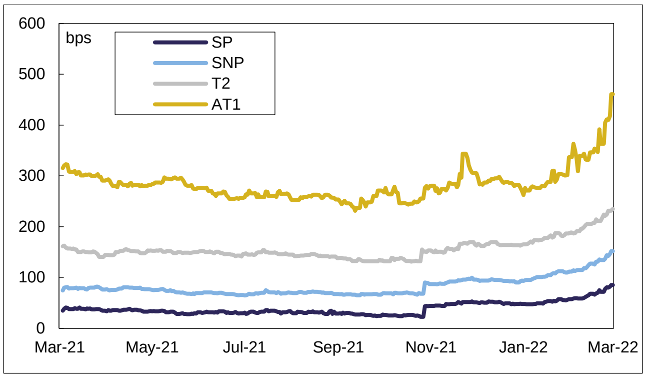
Selected Names

	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	3.9	0.9	53.7	-4.7	14.7	3.0	1.1	86.4	-1.0	28.3	3.6	3.2	280.1	25.3	102.8
Barclays	2.2	0.5	28.3	-0.6	2.5	2.8	0.9	81.9	1.0	33.5	4.6	2.0	194.8	12.5	72.8
BBVA	4.7	0.9	53.7	-4.0	11.0	3.6	1.0	73.6	-2.1	23.8	4.6	2.1	177.4	-0.5	59.8
BFCM	4.0	0.8	48.2	-5.2	14.2	7.1	1.6	102.2	-2.3	30.6	4.5	1.9	147.6	6.4	55.4
BNPP	2.4	0.5	36.8	-3.2	16.3	4.5	1.3	88.0	-0.7	31.5	4.0	1.9	146.7	5.0	58.1
BPCE	3.1	0.6	37.0	-5.2	9.8	5.1	1.5	108.2	-1.8	31.0	4.1	1.8	143.4	3.5	39.0
Credit Ag.	4.1	0.6	26.4	-4.3	-2.9	5.7	1.4	94.9	-0.9	32.0	3.7	1.9	149.0	6.2	57.4
Credit Sui.	5.6	2.0	154.8	1.2	42.7	5.1	1.8	142.9	0.8	50.3					
Danske	2.2	0.3	30.0	-5.1	0.4	2.2	0.7	69.1	-4.4	14.4	2.9	1.9	164.4	2.8	49.4
Deutsche	1.5	0.5	36.5	-2.1	7.2	4.2	1.9	151.2	2.0	51.2	3.5	3.0	264.3	33.1	116.1
DNB	3.7	0.5	29.4	-5.3	3.7	6.9	1.4	91.3	-4.6	28.1	4.6	1.0	116.9	6.3	48.3
HSBC	3.8	0.7	46.0	-3.8	19.1	4.3	0.9	80.0	-1.7	24.1	4.4	1.8	136.0	3.5	56.8
Intesa	1.7	1.7	156.3	10.4	-2.7	5.6	1.3	92.8	-2.1	32.2	5.3	1.8	157.9	4.0	56.7
Lloyds	4.3	0.9	51.2	-2.8	14.9	3.0	1.4	114.3	-0.2	34.6	4.1	2.9	250.3	14.8	63.9
Nordea	2.8	0.4	23.6	-0.3	10.4	2.5	0.7	72.5	-1.1	32.4	1.5	1.1	119.4	7.4	46.0
Rabobank	4.7	0.7	28.0	-5.2	10.2	5.7	1.2	63.9	-3.8	14.5	7.5	1.9	150.5	-1.9	55.3
RBS	3.5	0.5	21.3	-4.6	7.0	5.3	1.2	70.9	-7.0	17.3	1.3	0.3	29.3	4.3	8.8
Santander	3.0	2.3	186.9	75.3	142.4	5.3	1.2	70.9	-7.0	17.3	1.3	0.3	29.3	4.3	8.8
San UK	3.4	0.6	36.1	-5.8	8.4	4.9	1.4	100.0	-3.9	29.7	4.6	2.0	155.7	0.6	46.2
SocGen	2.9	0.5	26.3	-1.2	12.1	1.5	0.4	71.2	-1.5	32.1	4.6	2.0	155.7	0.6	46.2
StanChart	4.7	1.0	71.5	1.1	27.9	5.6	1.8	130.7	6.3	49.3	4.3	1.6	154.8	16.7	67.3
Swedbank	4.7	0.8	40.4	-6.3	2.5	5.0	1.4	102.2	-0.9	32.7	6.0	2.4	202.9	4.3	63.3
UBS	3.9	0.6	32.9	-4.7	7.2	5.0	1.2	81.4	-4.6	21.1	3.9	0.9	124.2	10.2	51.3
UniCredit	4.2	0.8	49.0	-3.0	17.0	4.4	1.1	81.1	-0.8	24.3	21.3	3.7	300.1	34.4	91.5

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 USD Z-spread LTM (bps)



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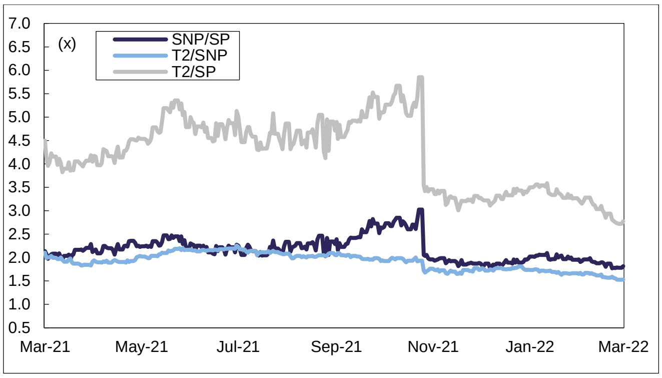

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

Selected Names

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	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD
Barclays	2.1					4.9	3.2	173.0	20.0	60.6	5.4	3.9	232.5	20.2	67.7
BFCM	4.0	0.8	48.2	-5.2	14.2	4.9	3.2	173.0	20.0	60.6	5.4	3.9	232.5	20.2	67.7
BNPP	2.4	0.5	36.8	-3.2	16.3	5.2	3.2	170.4	19.3	58.4	4.4	3.5	194.0	17.4	67.9
BPCE	3.1	0.6	37.0	-5.2	9.8	5.0	3.2	165.7	16.6	52.3	3.2	3.4	174.9	18.5	56.1
Credit Ag.	4.1	0.6	26.4	-4.3	-2.9	3.1	2.9	139.7	14.5	53.7	7.8	3.8	222.3	18.1	71.7
Credit Sui.	2.1	2.4	81.1	13.6	43.4	3.0	3.2	172.3	18.9	64.5	1.4	3.4	186.5	22.6	76.9
Danske	2.2	0.3	30.0	-5.1	0.4	2.2	2.6	131.9	19.0	56.6	1.4	3.4	186.5	22.6	76.9
Deutsche	1.5	0.5	36.5	-2.1	7.2	3.5	3.3	176.7	20.8	66.2	7.9	4.8	321.1	31.6	97.8
HSBC	3.8	0.7	46.1	-3.8	19.1	3.6	3.1	165.1	18.3	58.1	9.7	4.2	247.0	17.5	54.4
ING	1.7	1.7	156.3	10.4	-2.7	3.8	2.9	143.9	16.9	56.6	1.2	2.9	161.2	28.6	64.3
Intesa	4.3	0.9	51.1	-2.8	14.9	3.8	2.9	143.9	16.9	56.6	3.4	5.0	342.8	30.1	123.9
Lloyds	3.0					2.6	2.9	134.0	15.7	55.1	8.8	3.8	222.1	25.4	70.5
Nordea	4.7	0.7	28.0	-5.2	10.2	2.9	2.3	149.2	9.5	36.9	8.8	3.8	222.1	25.4	70.5
Rabobank	3.5	0.5	21.4	-4.6	7.0	3.8	2.7	113.2	14.8	41.2	4.0	3.5	187.2	14.7	50.9
RBS	3.0	2.3	186.8	75.3	142.4	3.8	2.7	113.2	14.8	41.2	4.0	3.5	187.2	14.7	50.9
Santander	3.4	0.6	36.1	-5.8	8.4	5.2	3.2	166.4	12.6	52.4	7.6	4.1	253.6	19.8	71.5
San UK	2.0	2.3	77.6	12.3	34.4	4.6	3.1	162.1	17.7	52.9	3.2				
SocGen	4.7	1.0	71.5	1.1	27.9	4.4	3.5	197.4	25.6	70.2	3.7	3.8	225.0	38.0	81.3
StanChart	4.7	0.8	40.4	-6.3	2.5	3.5	2.9	151.4	16.7	54.1	7.5	4.2	262.8	17.1	63.1
UBS	2.6	2.3	72.4	10.6	33.2	4.0	2.9	141.6	13.0	47.7	7.5	4.2	262.8	17.1	63.1
UniCredit	4.0	1.4	108.2	5.1	38.5	3.7	3.7	216.1	33.1	93.9	6.5	5.9	423.7	34.3	128.7

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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If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association