Daiwa Capital Markets

European Banks – Credit Update

- The BoE is no longer ruling out negative interest rates. Should such move eventually materialize, it would weaken the credit profile of UK banks.
- Lloyds sensibly decided not to exercise the call on its €750m AT1 due on 27 June as it would be uneconomic.
- Activity in the primary market was decent, with BNPP re-opening the JPY market for European banks; secondary spreads tightened in both EUR and USD markets.

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Negative interest rates

With Bank Rate currently at 0.1%, BoE Governor Andrew Bailey confirmed last week that he is no longer ruling out an eventual move to negative interest rates. Instead, the Bank will study the policy with an open mind. While the economic benefits of such a policy are a matter of debate, such a move would be a negative credit factor for UK banks. As observed in the euro area, negative rates can weaken the viability of retail and commercial banks, whose very reason of being is to intermediate between depositors and borrowers and gain a spread from the maturity and risk transformation. Although it could ease short-term pressure on credit quality, for some banks the long-term impact on banks' profitability would seem likely to dominate.

It is indeed possible for banks to remain profitable when rates are negative, as long as lending rates are higher (or less negative) than deposit rates. Yet banks are reluctant to pass on negative rates to depositors. Accordingly, as lending rates diminish by a greater factor than deposit rates, negative interest rates lead to diminishing net interest margins, often the main source of banks' revenues. Moreover, negative rates incentivise greater credit risk taking as banks seek higher yields, and greater market risk taking as hedging costs increase.

UK banks started the crisis from a position of relative strength despite many negative macro and idiosyncratic factors in recent years (PPI, fines from U.S. authorities, Brexit uncertainty, weak economic growth, etc.). Compared to their peers in the euro area, the BoE's positive (if low) policy interest rate was more advantageous than the ECB's negative deposit rate.

Smaller, retail focused and less diversified names – particularly building societies – would be the most impacted by a negative interest rate policy. In our coverage, we see Nationwide, Lloyds, Santander UK and RBS as the most sensitive to negative interest rates. That said, we do not expect the BoE to cut Bank Rate to negative territory in the near term. The next move in policy will be expansion of its asset purchase programme. Indeed, Bailey himself stated that the BoE would first need a careful communication strategy to prepare the ground before implementing negative rates. And BoE Chief Economist Andy Haldane subsequently insisted that the Bank was still just in the review stage. However, in light of the ECB's recent move to cut the rate on its TLTRO-iii operations to 50bps below the deposit rate, the BoE might ultimately be tempted to apply a negative rate to its Term Funding Scheme with additional incentives for SMEs (TFSME). This would be a more targeted measure, which could provide a further easing of monetary conditions while also having a more limited impact on banks' margins.

In the **euro area**, where negative interest rates have been in place since June 2014, preceded by two years of interest rate at zero, the ECB rebuffed criticism of its negative interest rate policy in a recent article. Based on the findings from a modelled scenario comparing the current environment to an environment in which interest rates weren't negative, the article concluded that there is no evidence of an overall negative impact of negative interest rates on bank profits across bank business models. Among other things, it argued that policy has led to higher loan volumes, and also improved borrowers' creditworthiness as lower rates improve the interest rate payment capacity of corporates. Yet such benefits could largely be short-term, whilst, as noted in the article, the "detrimental impact on net interest margins is likely to be more significant as rates remain low for longer".

Finally, we do see evidence that the policy has had a substantive negative impact on banks' profits. It has been one factor behind the lack of viability of the – admittedly problematic - German banking system. Indeed, German banks reported an aggregate RoE of 0.08% in 4Q19, whilst in the euro area as a whole RoE amounted to a paltry 5.2% in 4Q19, down from 6.16% in 4Q18, highlighting the downward trend. Moreover, banks with a greater sensitivity to interest rates now find themselves ill-prepared to face the current crisis, as highlighted by a number of the more domestic and retail focused names in Germany, Italy and Spain.

There are indeed idiosyncratic issues in each of these banking systems, such as elevated costs, overbanking and legacy NPLs, whilst there are plenty of strong banks in the euro area despite the negative rates. In fact, most of the banks in our coverage universe are well positioned to face the current economic shock. That said, their strength often arises from lower sensitivity to euro area interest rates as a result of (i) their diversification into other business areas, such as asset management and insurance; (ii) diversification into Eastern Europe and Latin America; and (iii) from cooperative structures, which limits the need for capital redistribution, allowing hence for capital build up despite weak returns.

PELTROs

The ECB launched the inaugural round of its seven pandemic emergency longer-term refinancing operations (PELTROs) last week, yet demand was immaterial, with 19 banks bidding for only €850m. The low demand was expected, as the PELTRO ran in parallel to the weekly round of LTROs, which offers better pricing and had a total demand of €8.8bn from 47 banks in the same week. Demand for the monthly rounds of PELTROs might increase in the next round, on 19 June, at which point the weekly round of LTROs will no longer be in place.

That said, it will continue to 'compete' with the TLTRO facility, which provides better pricing. PELTROs are more relevant for banks with a low volume of corporate and consumer loans, and banks not sophisticated enough to take part in TLTRO rounds. Total volume of outstanding PELTROS+LTROS+TLTROS is currently at €938bn.

Lloyd's AT1 call extension

Lloyds became the third large European bank to extend an AT1 call last week as the group decided "it is prudent to not reduce Tier 1 resources at this time", whilst "market conditions mean it is uneconomic to call and refinance this security". The bank had a call due on 27 June on its PERP €750m 6.35% bond. It will now reset at MS+529bps, a coupon of around 5%, with the next call on 27 June 2025. The group follows Deutsche Bank in March 2020 and Santander in 2019 in extending its AT1 call. Launching a new deal would reportedly require a coupon of more than 7%, whilst the call would also lead to a FX charge of £50m to the bank's capital base.

Market reaction to the announcement was limited, with the bond price declining 2.5% to 94.6 cents on the euro, indicating the extension wasn't entirely unexpected. Lloyds' share price closed up 0.60% on the day. In light of the current crisis, the potential additional impact on the capital base over forthcoming quarters and the significant pressure regulators are imposing on capital redistributions, we see the decision as sensible, and positive for Lloyds' creditors (apart from those holding the extended AT1).

Primary and secondary markets

Activity in the **primary market** remained decent, with good volumes across a range of currencies and debt rank, including a JPY SNP transaction from BNP Paribas. Demand levels were adequate, with average book orders of 2.3x the size of the deals with available information, whilst IPT tightening ranged between 25bps and 40bps in the USD and EUR deals.

(Table 1) Forthcoming AT1 calls

Issuer	Amount	Coupon	Next Call Date
RBS	$2bn	7.5%	10 Aug.
ABN Amro	€1bn	5.75%	22 Sept.
Nykredit	€500m	6.25%	26 Oct.

Source: Bloomberg

In Japan, BNPP re-opened the JPY market for European banks, with a JPY50bn 6NC5 SNP, priced at YOS+130. It was the first public JPY issuance by a European bank since 20 February, when SocGen placed a JPY50bn 5Y SNP, priced at YOS+48bps. In Europe, Intesa re-opened the unsecured market for Italian banks, with a 5Y €1.25bn SP priced at very wide MS+245bps, impacted by the "Italian premium". Intesa launched an AT1 at 3.75% back in February. ING meanwhile issued a Tier 2 bond aiming to enhance its MDA buffer, similar to Deutsche Bank last week. In light of its much stronger credit profile, ING priced its T2 at MS+240bps, vs. the MS+600bps priced by Deutsche.

(Table 2) Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
ABN Amro	SNP	€1.25bn	5Y	MS+155	MS+185	> €3.3bn
BNP Paribas	SNP	JPY50bn	6NC5	YOS+130	YOS+125/130	
Banco Santander	SNP	$1.5bn	5Y	T+240	T+280	
		$1bn	10Y	T+280	T+320	
ING	Tier 2	€1.5bn	11NC6	MS+240	MS+270	>€4bn
RBS	Sr HoldCo Green	$600m	4NC3	T+215	T+245	
	Sr HoldCo	$1bn	8NC7	T+255	T+280	
Intesa Sanpaolo	SP	€1.25bn	5Y	M+245	MS+270	>€2.15bn
Credit Suisse	Sr OpCo	AUD1.5bn	2.5Y	3mBBSW +115		

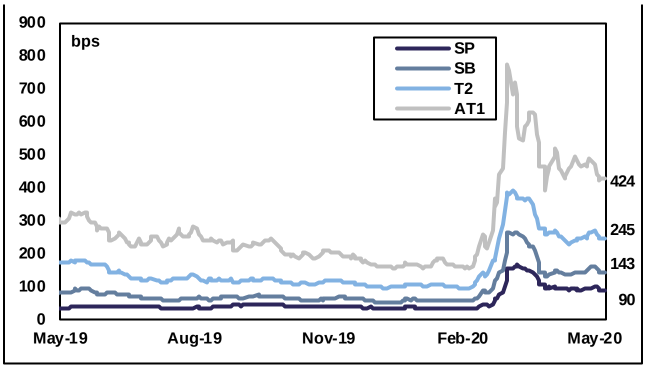
Source BondRadar, Bloomberg.

The risk-on sentiment was evident in the **secondary market** for unsecured bonds last week, with sizeable tightening across the debt stack, particularly for long-dated French, Italian, Spanish and UK paper. The overperformance of USD paper vs EUR continued, as also reflected in the ICE BofA corporate indices, with the ICE BofA US Corporates index up 1.6% and the ICE BofA Euro Corporate up 0.4%.

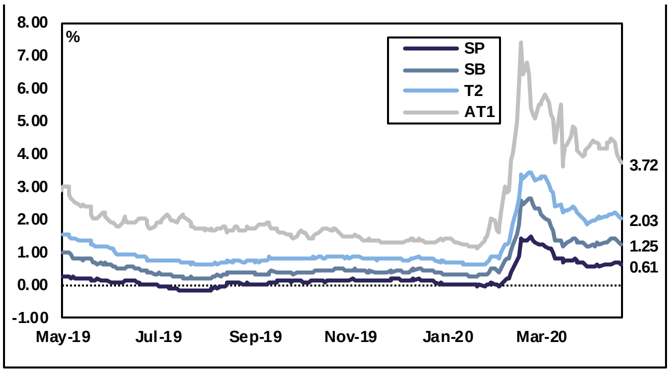
EUR SP/Sr OpCo paper closed the week at 90bps (143bps for SNP/Sr HoldCo) on aggregate, down 4bps (15bps) W/W, 58bps (87bps) above pre-crisis levels but down 73bps (123bps) since the peak in mid-March. USD SP/Sr OpCo paper closed the week at 113bps (206bps for SNP/Sr HoldCo) on aggregate, down 23bps (19bps) W/W, this is 64bps (116bps) above pre-crisis levels, yet 277bps (247bps) down from the mid-March peak.

Western European Banks EUR Spreads and Yields

Aggregate Z-spread LTM (bps)



Aggregate Yields (%)



Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; 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.

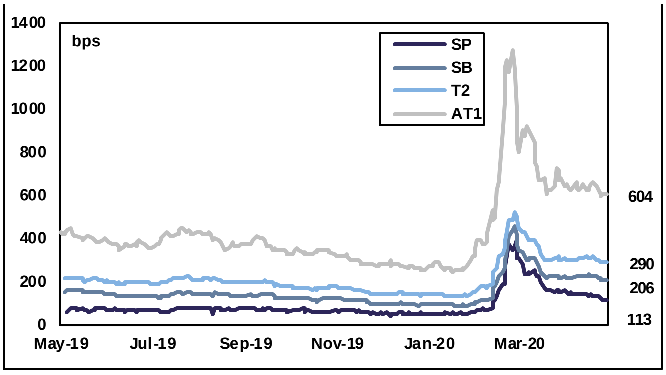
Selected Names

	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	4.9	1.3	153	1	102	4.2	2.1	232	-3	163	5.6	4.2	442	-29	252
Barclays	3.8	1.2	134	-4	91	3.4	1.6	184	-22	131	6.1	4.4	426	-54	306
BBVA	4.0	0.8	105	-5	72	4.5	1.6	183	-13	127	7.8	3.0	324	-31	186
BFCM	4.1	0.5	73	-5	43	8.7	1.2	131	-17	76	5.4	1.8	199	-8	127
BNPP	2.7	0.4	63	-5	41	5.3	1.1	132	-12	76	5.6	1.8	194	-8	96
BPCE	3.9	0.5	77	-5	49	4.7	1.1	138	-13	86	4.8	1.7	192	-12	129
Credit Ag.	3.4	0.5	72	-3	43	5.5	1.1	135	-14	80	5.2	2.1	212	-7	88
Credit Sui.						6.8	1.5	177	-13	109					
Danske	3.0	0.5	79	-4	43	3.3	1.5	171	-12	98	8.5	2.7	291	-1	144
Deutsche	3.0	1.1	136	0	79	2.9	2.7	280	-11	150	5.2	5.0	515	-24	203
DNB	3.5	0.5	75	-6	44						7.0	2.0	219	-2	160
HSBC	3.4	0.5	72	-3	42	3.3	0.8	109	-11	65	5.8	1.7	192	-13	107
ING	1.7	0.5	76	-5	59	5.2	1.1	122	-12	72	5.6	2.0	214	3	118
Intesa	4.6	1.8	208	-3	129						4.2	3.3	346	-38	194
Lloyds	2.2	0.5	79	-7	48	4.0	1.5	176	-15	125	7.7	2.6	284	-11	170
Nordea	4.6	0.4	64	-6	34	3.0	0.9	111	-9	74	4.1	2.2	204	-16	155
Rabobank	2.5	0.3	49	-6	31	6.4	0.8	99	-8	60	2.9	1.4	162	-5	114
RBS						4.5	1.8	210	-16	134					
Santander	4.0	0.7	91	-13	60	5.0	1.4	158	-24	90	5.7	2.2	245	-18	142
San UK	3.1	0.7	91	-11	59	3.5	1.6	198	-6	134					
SocGen	2.0	0.5	72	-6	46	5.9	1.5	173	-14	103	4.5	2.1	227	-10	149
StanChart						6.8	1.7	194	-11	122	3.7	4.2	391	-67	343
Sw edbank	4.9	0.6	85	-7		4.3	1.1	135	-6	71	7.2	2.3	245	-7	144
UBS	1.6	0.4	65	-6	44	3.6	1.0	123	-11	83					
UniCredit	4.2	2.0	220	-15	137	5.1	3.0	320	-52	214	5.9	5.2	512	-66	308

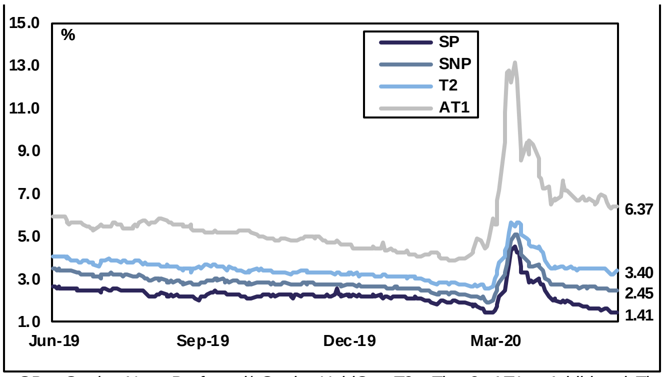
Source: Bloomberg, Daiwa Capital Markets Europe. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative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

Western European Banks USD Spreads and Yields

Aggregate Z-spread LTM (bps)



Aggregate Yields (%)



Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; 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	2.8	1.5	123	-17	87	4.5	2.5	215	-26	95	5.6	3.7	315	-26	146
BFCM	2.4	1.5	120	-22	69										
BNPP	1.9	0.9	58	-5	27	4.6	2.6	197	-24	113	5.3	3.1	259	-18	135
BPCE	2.5	1.5	128	-7	69	4.3	2.6	205	-13	116	3.7	3.0	258	-28	154
Credit Ag.	1.7	1.3	75	-26	45	3.4	2.1	166	-25	90	8.2	3.0	237	-20	133
Credit Sui.	1.7	1.2	67	-26	39	4.9	2.4	168	-23	105					
Danske	1.5	1.5	121	-9	58	3.2	2.8	235	-20	134					
Deutsche						3.1	3.7	322	-28	183	6.7	6.1	547	-47	210
HSBC	4.1	2.4	198	-4	90	5.1	2.1	169	-18	79	10.8	3.7	287	-19	136
ING	1.1	0.7	29	-29	9	4.9	2.0	156	-25	79	4.8	3.3	290	0	159
Intesa	3.7	3.3	272	-9	151						4.1	5.5	500	-51	274
Lloyds	3.4	1.8	145	-28	69	3.8	2.3	193	-21	103	5.1	3.0	248	-18	115
Nordea	1.0	0.8	52	2	29	3.1	2.1	164	-44	68	2.2	2.2	176	-15	111
Rabobank	2.5	1.1	85	-11	42	3.5	2.0	142	-28	68	5.0	2.6	207	-14	109
RBS						4.7	2.7	219	-15	111	3.2	3.3	281	-33	150
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San UK	1.5	1.2	96	-24	52	3.4	2.2	185	-20	103	4.6	3.8	333	-20	180
SocGen						4.2	2.7	223	-16	123	4.6	3.7	317	-10	177
StanChart	0.0	1.6	144	-166	-108	4.5	2.7	220	-18	125	5.8	3.9	327	-13	178
UBS	9.7	1.9	135	-14	77	4.8	2.2	166	-13	84					
UniCredit	2.4	3.7	340	-20	166	2.2	4.9	435	-43	298	8.5	6.5	576	-47	221

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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