European Banks – Credit Update

- Deutsche Bank expects 2020 loan loss provisions to peak in Q2 at around €800m, with the CET1 ratio reaching its trough at around 12.5%, supported by a rebound in the German economy.
- The European Parliament approved a “prudential filter” to reduce the impact of higher sovereign bond yields on banks’ capital base.
- Weaker market sentiment lead to a reversal of the tightening trend, yet primary markets remained in rude health.

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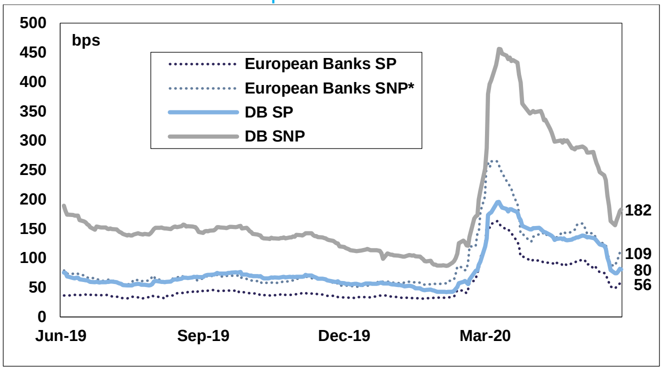
Deutsche Bank Q2 guidance

Deutsche provided some guidance on its Q2 numbers last week. The bank now expects loan loss provisions to peak in Q2, at around €800m (from €506m), and then normalize in the second half of the year. The bank also maintained its full-year guidance for cost of risk at 35-45bps cost for 2020 (around €1.6bn-€2bn), vs. €723m reported in 2019. On capital, the bank expects another 20-30bps drop on its CET1 ratio (currently at 12.8%), which it expects to be the trough for the year. Amid the relative strength of the German economy, Deutsche’s high quality loan book and limited exposure to consumer finance, we see the bank’s expectations on provisions and capital as reasonable.

Deutsche Bank EUR Z-Spreads



*Includes Senior HoldCo Debt. Source: Bloomberg.

The bank naturally sees its ratings and market confidence as critical, so it does not intend to dip into its capital buffers, as temporarily allowed by the ECB. Accordingly, it maintained its medium-term CET1 ratio target of >12.5%, although a temporary deviation from this target in the short term is possible. On the ratings front, the bank is naturally unhappy with the ‘Baa3’ rating from Moody’s and ‘BBB-‘ from S&P on Senior Non-Preferred (SNP) debt. It sees an improvement on those ratings as a key focus for coming years, to make the bank better aligned with peers. Deutsche sees the strength of its balance sheet as a supporting factor, yet it admitted that the lack of sustainable profitability is a key issue.

The bank also stated it no longer sees cost of funding as a barrier to doing business. Indeed, prior to March 2020, there had been a consistent reduction in the bank’s spreads in both absolute terms and relative to its peers (*see chart*). However, Deutsche’s EUR SP debt is currently trading 5bps wider Y/Y on aggregate, whilst its EUR SNP paper is trading around 12bps wider Y/Y.

As a high beta name, the widening of Deutsche’s spreads in March was significantly more pronounced than those of its peers, but so is the tightening observed since early-April, although it is yet to reach pre-crisis levels. The bank’s senior unsecured debt (SP and SNP) is now trading at around 41% of the end-March peak, whilst pre-crisis spreads traded at around 21% of the end-March peak.

Prudential filter

The European Parliament approved last week the temporary implementation of the so-called *prudential filter* for sovereign bonds held by European banks. Current CRR rules dictate that unrealized gains and losses on the holdings of sovereign bonds are deducted from CET1 capital, whilst the approved amendment to CRR Article 468 will allow banks to add back 100% of these deductions to CET1 in 2020, 70% in 2021 and 40% in 2022.

The aim is to make banks’ sovereign bond portfolios less vulnerable to market volatility, and is applicable to sovereign bonds measured at fair value through other comprehensive income. The EU is partly reintroducing the measures in place from 2014 to 2017, when the main definition of capital gradually moved from Basel II “Core Capital” to Basel III “Common Equity Tier 1” (CET1), the latter being a far better measure of loss absorption capacity.

This amendment comes on top of other changes previously proposed by the European Commission, which included (1) adding back the provisions for stage 1 and stage 2 loans as per IFRS9 to CET1 capital, (2) removal of central bank exposures from the leverage ratio, and (3) the postponement of the G-SIB buffer to the leverage ratio requirement from 2022 to 2023.

We see the measure as unhelpful, as it will reduce transparency, further masks the true loss absorption capacity of European banks, and further promotes the “doom loop”. Deliberately, banks in Southern Europe will benefit the most from the measure. That said, in a positive move for credit holders, MEPs did not go ahead with proposed restrictions on AT1 coupon payments, similar to the ones currently being applied to capital redistributions.

Primary and secondary markets

Weaker market sentiment lead to a reversal of the tightening trend, yet the **primary market** remained in rude health early in the week with a continued stream of issues across geographies, currencies and debt rank. The week started with strong demand, with book orders over 10x and 7x for the AT1 placements from ABN Amro and Commerzbank respectively, which was also reflected in strong IPT tightening, whilst NIC was largely limited. Activity did come to a halt towards the end of the week however, as market sentiment deteriorated.

In the **secondary market**, spreads marginally reversed the tightening trend observed in recent weeks, impacted by the dovish tone in the Fed statement on Wednesday and fears of second wave of Covid-19 infections in the US and China.

EUR SP spreads widened by 5bps, whilst EUR SNP spreads were up by 20bps on aggregate. This was not sufficient to reverse the gains observed in the previous week however, when EUR SP spreads tightened by 28bps and EUR SNP by 46bps. In the USD market, the widening was less material, with SP spreads up by 2bps, and SNP spreads up by 9bps.

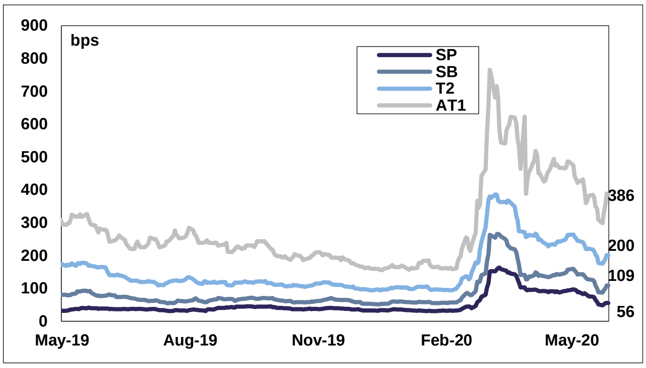
(Table 1) Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
ABN Amro	AT1	EUR1bn	PNC5.25	4.375% (coupon)	4.75% (coupon)	>EUR10bn
Commerzbank	AT1	EUR1.25bn	PNC5	6.125% (coupon)	7.00% (coupon)	EUR8.5bn
Lloyds	Sr HoldCo	USD1bn	3NC2	T+110	T + 140	USD4.4bn
RBI	Tier 2	EUR500m	12NC7	MS+315	MS+350	>EUR1.6bn
SocGen	SNP	EUR1bn	10Y	MS+135	MS+160	>EUR2.6bn
Credit Agricole	SNP	USD1.5bn	6NC5	T+150	T+185	USD4.1bn
Unicredit	SP	EUR1.25bn	6Y	MS+160	MS+185	EUR2.3bn
KBC	Sr HoldCo Green	EUR500m	7NC6	MS+72	MS+100	>EUR1.5bn
Nationwide	AT1	GBP750m	PNC7.5	5.75% (coupon)	6.25% (coupon)	>GBP4.4bn

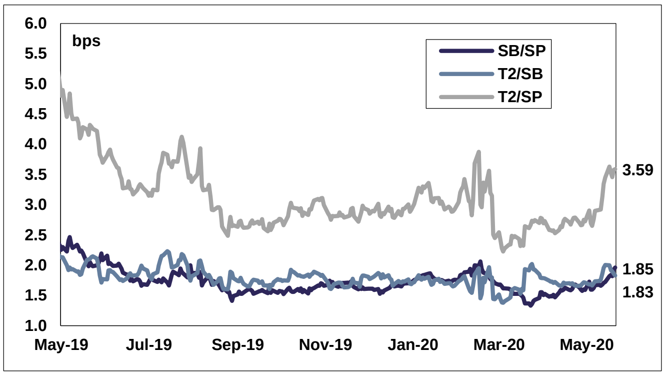
Source BondRadar, Bloomberg.

Western European Banks EUR Spreads and Yields

Aggregate Z-spread LTM (bps)



Multiples (x)



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.

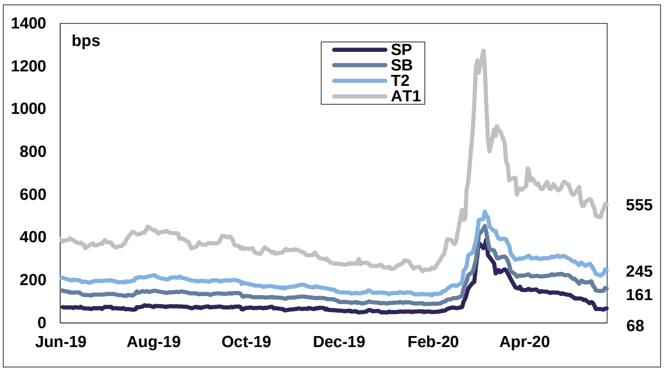
Selected Names

	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	4.8	0.7	99	3	50	4.2	1.4	160	13	88	5.2	3.4	356	32	162
Barclays	3.8	0.6	81	3	38	3.4	1.0	124	24	69	5.3	3.0	288	62	167
BBVA	4.9	0.6	87	11	35	4.5	1.1	132	24	77	6.0	2.1	236	24	118
BFCM	4.0	0.2	45	4	14	9.3	0.9	102	21	44	5.4	1.6	170	9	85
BNPP	2.6	0.0	31	2	11	5.2	0.8	103	20	46	5.5	1.5	165	19	66
BPCE	3.8	0.3	51	6	20	4.7	0.8	105	21	53	2.8	1.1	134	11	73
Credit Ag.	3.4	0.1	38	5	7	5.1	0.8	97	20	46	5.2	1.8	203	25	74
Credit Sui.						6.7	1.1	128	25	56					
Danske	2.9	0.2	44	1	8	3.3	1.0	126	12	53	6.3	2.1	234	7	87
Deutsche	3.1	0.9	114	13	24	3.4	1.6	182	20	58	5.0	4.1	431	21	134
DNB	3.4	0.1	34	5	3						7.0	1.5	172	5	113
HSBC	3.3	0.2	44	9	13	3.2	0.5	70	24	26	5.9	1.1	131	14	46
ING	1.6	0.1	37	2	23	5.2	0.6	84	16	35	5.5	1.6	183	13	87
Intesa	4.6	1.2	145	15	69						5.4	3.1	328	59	176
Lloyds	2.2	0.1	33	-3	2	4.0	0.9	118	18	63	7.6	2.0	221	26	108
Nordea	4.6	0.0	28	3	0	3.0	0.4	72	6	34	2.9	1.5	139	1	89
Rabobank	2.7	-0.1	19	2	3	6.3	0.6	78	14	40	2.9	0.8	99	-3	51
RBS						3.6	1.3	153	19	77					
Santander	4.0	0.3	56	7	22	4.9	1.0	124	30	62	5.6	1.8	201	26	100
San UK	3.1	0.3	50	1	19	3.4	1.1	144	15	82					
SocGen	1.9	0.2	45	4	20	6.1	1.2	140	21	68	4.4	1.4	169	10	84
StanChart						6.8	1.1	134	16	64	3.7	2.3	230	37	126
Swedbank	4.8	0.3	58	4		4.3	0.6	90	4	26	7.2	1.6	187	1	86
UBS	1.5	0.1	33	2	14	3.6	0.6	87	17	45					
UniCredit	4.4	1.4	162	20	77	5.1	2.4	256	54	135	2.8	3.8	383	56	198

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)



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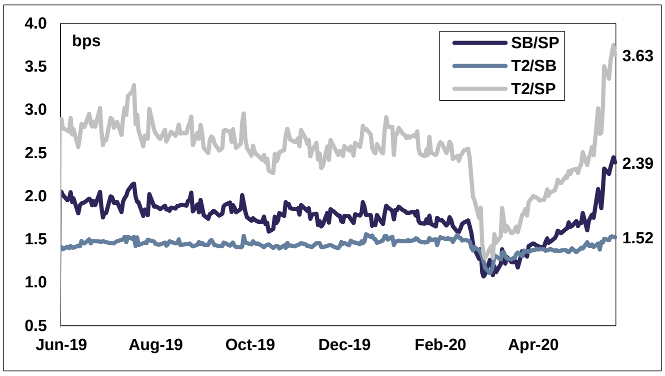

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCp; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

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	2.7	1.1	83	6	32	4.4	2.1	164	13	57	5.6	3.3	270	27	100
BFCM	2.4	0.9	68	-2	24										
BNPP	1.9	0.7	39	15	7	4.7	2.1	159	9	72	5.2	2.7	219	18	86
BPCE	2.5	1.1	78	0	27	4.3	2.2	164	0	67	3.7	2.7	224	11	99
Credit Ag.	1.7	1.0	61	3	24	4.0	1.8	126	9	53	8.2	2.7	199	9	76
Credit Sui.	1.8	1.0	63	7	21	4.8	2.1	125	4	60					
Danske	1.4	1.0	75	2	12	3.1	2.2	180	10	79					
Deutsche						3.1	2.9	259	7	108	6.7	6.1	540	48	165
HSBC	4.0	1.9	153	-17	44	5.0	2.1	160	15	66	10.8	3.7	274	16	118
ING	1.1	0.6	34	3	10	4.9	1.7	118	2	32	4.5	2.8	249	10	109
Intesa	3.7	2.4	213	-10	90						4.1	4.5	399	32	178
Lloyds	3.3	1.7	129	16	63	3.6	1.6	124	6	48	5.1	2.6	214	13	79
Nordea	2.9	0.8	49	-7		3.0	1.6	125	7	50	2.1	1.8	136	10	65
Rabobank	2.5	0.7	45	7	9	3.5	1.2	81	9	23	5.0	2.1	154	11	63
RBS						4.3	2.1	169	18	65	3.1	2.6	229	16	113
Santander	5.8	1.9	147	5	60	5.3	2.5	199	12	78	4.8	3.1	256	22	139
San UK	2.5	1.0	67	2	27	3.2	1.7	125	9	49	4.6	3.3	282	15	132
SocGen						4.2	2.4	197	12	95	4.6	3.3	279	14	128
StanChart	6.3	4.6	363	21	110	4.5	2.4	202	14	93	5.7	3.3	282	5	128
UBS	9.6	1.7	115	7	72	4.8	1.8	127	3	43					
UniCredit	2.3	3.2	282	9	116	2.3	3.6	307	13	172	7.6	5.5	472	7	142

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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February 2020