Daiwa Capital Markets

European Banks – Credit Update

- Extension to ECB funding programmes broadly in line with market consensus. PEPP extension implicitly acts to contain yields while T-LTRO provides additional EUR300bn in cheap financing.
- BoE allows resumption of dividend pay-outs under temporary guardrails and deems UK banks sufficiently resilient to withstand a wide range of severe economic scenarios, including no-deal Brexit.
- Limited EUR primary activity puts spotlight on USD issuances by SocGen and HSCB that took advantage of stable market conditions for 2021 pre-funding and the replacement of a legacy AT1.

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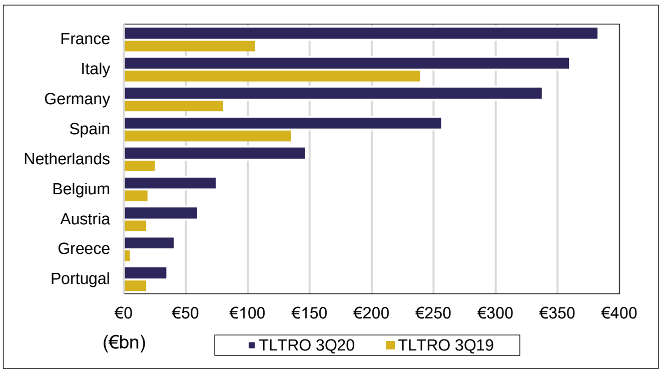
ECB decisions to impact banks funding conditions in 2021

Last week, the ECB's Governing Council announced monetary policy decisions that will likely significantly impact how banks fund themselves over the next few years. The resurgence of the pandemic and accompanying fears of further economic damage led the central bank to extend its T-LTRO III funding programme by 12 months with minor calibrations to borrowing limits. There was also an increase in the envelope of its Pandemic Emergency Purchase Programme (PEPP) by EUR500bn which importantly was also extended by 9 months until at least March-2022. The extended time horizon and the full flexibility of the envelope paired with the ECB's desire to avoid any tightening of financial conditions should ultimately suppress any undesired spread widening or yield increases. Lastly, the ECB decided to keep interest rates on the main refinancing operations, marginal lending facilities and deposit facilities unchanged at 0%, 0.25% and -0.5% respectively.

Banks usage of T-LTRO by country



Source: ECB

The extension of T-LTRO III until June 2022 will allow banks to continue borrowing from the ECB at rates up to -1% as long as their lending does not fall below a net rate of 0% between October 2020 and December 2021 – a benchmark that ECB President Lagarde acknowledged has become "more challenging". The maximum amount that banks will be able to borrow however, was raised from 50% to 55% of their stock of eligible loans as at end-February 2019. This effectively increases the programme volume by EUR300bn from the existing EUR3.0trn and arguably partially moves banks' funding sources further away from capital markets during 2021. The increased borrowing volumes will provide French, Spanish and Italian banks additional funding opportunities as they are already the highest users of the programme and in some cases are near or at their borrowing limits. Furthermore, the choice to provide three additional operations to the existing programme rather than launching a fourth with substantially eased conditions meets the ECB's main objectives of maintaining rather than loosening financing conditions while also avoiding liquidity outflows in 2H21.

BoE leads the way on bank dividend resumption in Europe

In its December Financial Stability Report, the Bank of England (BoE) stated that it would permit UK banks to resume dividend payments under certain conditions. Back in March 2020 banks were told to suspend dividend payments and share buybacks in order to preserve their capital positions in light of the record economic downturn. The easing of the suspension follows two stress test that were carried out by the Prudential Regulation Authority (PRA) which judged that banks' capital positions were resilient enough to a variety of stressed outcomes, including economic scenarios that are materially more severe than current central expectations. Recognising that equity distributions are an important element of the banking system, the PRA allowed prudent dividend distributions within a framework of temporary guardrails. These cap any payouts at the higher of 20bps of RWA as at FY20 or 25% of bank cumulative profits over the past two years. The ECB is yet to decide whether it will follow the BoE's example and is expected to announce its own stance by end-2020.

Furthermore, the BoE stated that UK banks are sufficiently resilient to withstand a wide range of possible economic outcomes, including a major economic downturn, even if the EU and UK fail to reach an agreement on an FTA to succeed the Brexit transition period at year-end. In such an event, significant market volatility and some disruption to the provision of certain financial services, particularly to EU-based clients, could arise, as some participants may not be fully ready to trade with EU counterparties yet. The aggregate CET1 ratio increased at end-September to 15.8%, three times higher than at the start of the global

Fully-Loaded CET 1 (%) at 3Q20	
Lloyds Banking Group	15.2
Barclays Bank	13.9
HSBC Holdings	15.6
Standard Chartered	14.4
NatWest Group	18.2

financial crisis. This would allow banks to face significant headwinds such as rising unemployment levels (up to 15%), house price declines of 30%, business insolvencies and rising RWA levels. Under these conditions, major UK banks would need to incur around GBP120bn in credit losses (in addition to the GBP100 billion of losses already provisioned for) to deplete aggregate end-2019 capital ratios by 5.2%.

In order to maintain the unimpeded supply of credit to the economy, the decision was taken to keep the countercyclical capital buffer (CCyB) at 0% until 4Q21. Due to the implementation lag of 12 months, this means this buffer would not increase until at least 4Q22. A return to a 2% buffer rate will depend on banks' ability to rebuild their capital bases while continuing to support the economy. Looking ahead, the results of the next UK-wide bank stress tests will be announced towards the end of 2021 on a bank-by-bank basis, with a change in approach to previous tests to reflect the current severity of economic conditions.

Primary and secondary markets

Primary market activity was noticeably muted last week, especially for EUR FIG issuance, with two German federal state issues the notable EUR exceptions. While the EUR market seemingly entered the quiet holiday season, USD primaries were still very busy as market conditions were stable and provided good pre-funding opportunities for issuers. HSBC and SocGen followed Barclays into the USD market, which had issued an AT1 for MREL purposes the week before. SocGen raised USD2bn, pricing tightly after registering healthy demand for its SNP bond (2.37x). HSBC was in the market for USD1.5bn with its first AT1 in two years. High demand (6.26x) saw the transaction tighten by 37.5bps. Similar to Barclays' recent Tier 2 Coco buyback, HSBC is redeeming some of its older outstanding debt instruments which will no longer be eligible as capital at the end of the Basel III transition period in January 2022. In this case, HSBC redeemed a preference share deal issued in 2005.

(Table 1) Key Transactions

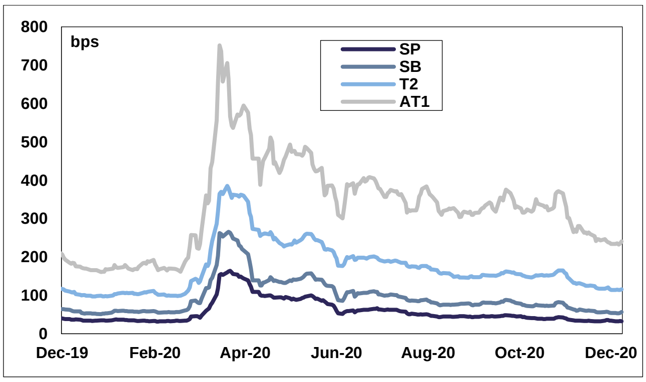
Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
HSBC	AT1	USD1.5bn	PNC10	4.875%	5.25%	>USD9.4bn
Societe Generale	SNP	USD2bn	6NC5	T + 110	T + 135/140	>USD4.75bn
Morgan Stanley	FRN	USD2.5bn	6NC5	T + 60	T + 75	N/A
Land Berlin	LSA (SU)	EUR250m	10.7Y	MS – 2	MS - 2	N/A
Saxony	LSA (SU)	EUR500m	15Y	MS + 4	MS + 4	N/A

Source BondRadar, Bloomberg.

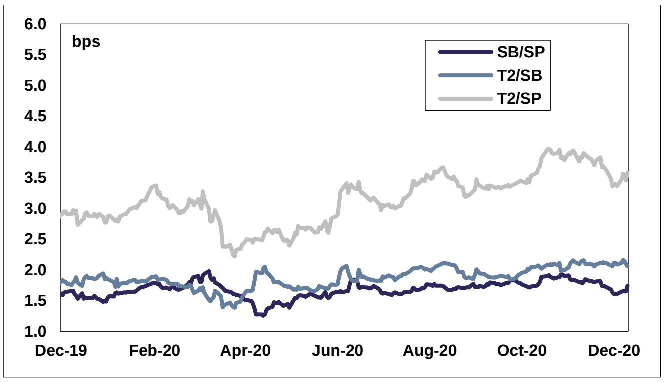
We observed **secondary market** spread tightening for EUR and USD most of last week in anticipation of the ECB Governing Council meeting on Thursday. Following the policy announcement, the picture was a bit more mixed as we saw broad-based tightening in EUR SP except for UK issuers, which widened marginally on the news of Brexit talks dragging into the weekend. Widening was even more pronounced for UK SNP and Tier 2 spreads, which increased 8.2bps and 2.6bps respectively over the same period with mixed results elsewhere. USD SP and Tier 2 saw overall widening by 1.3bps and 4.9bps on average.

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.

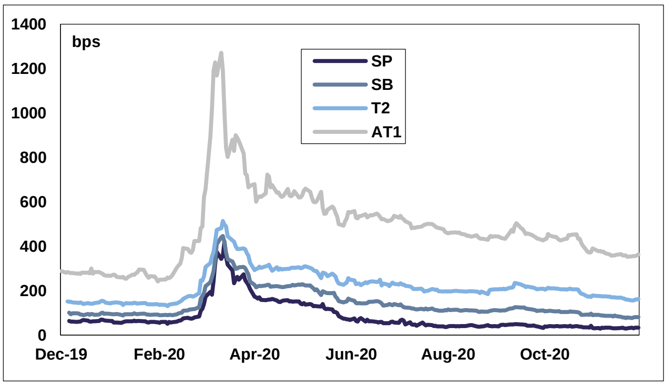
Selected Names

	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	5.5	0.1	52.4	-1.6	0.0	4.0	0.3	73.7	-1.5	-1.9	4.7	1.9	232.5	-5.7	37.3
Barclays	3.4	0.2	59.3	-3.2	16.1	2.9	0.1	60.8	14.1	6.8	2.1	1.1	157.3	15.2	-8.6
BBVA	4.4	-0.1	33.2	-1.0	-5.1	4.0	0.1	53.2	-0.2	-5.0	5.5	0.9	137.7	2.3	22.4
BFCM	4.2	-0.2	26.5	-1.2	-6.5	8.9	0.3	64.3	0.4	2.8	5.0	0.4	79.7	-0.6	-4.8
BNPP	2.1	-0.3	19.0	-0.8	-1.6	4.8	0.1	57.6	-0.5	0.6	4.7	0.5	93.8	0.9	8.0
BPCE	3.4	-0.2	27.1	-1.9	-0.8	4.6	0.1	53.4	-0.1	0.7	2.5	0.2	57.8	0.7	-2.4
Credit Ag.	3.2	-0.2	28.0	-1.1	-5.1	5.7	0.1	53.3	-0.1	0.9	4.7	0.8	123.0	-0.4	5.2
Credit Sui.	5.5	0.1	52.4	-1.6	0.0	5.4	0.2	65.0	-0.4	0.7	5.7	1.3	165.9	-3.4	4.8
Danske	2.4	-0.3	23.8	-1.6	-10.7	2.4	0.0	51.9	0.0	-20.3	3.7	0.8	130.0	-4.3	-17.0
Deutsche	2.7	-0.1	42.6	-1.7	-25.1	3.9	0.6	108.6	-1.4	-54.7	4.5	2.1	256.1	-2.3	-3.8
DNB	2.9	-0.3	22.2	-2.5	-8.8	3.7	0.1	56.0	-4.9	18.6	1.7	0.0	43.8	-1.3	-15.1
HSBC	3.4	-0.1	32.4	-0.7	-3.9	3.3	-0.1	44.0	6.2	-1.3	5.5	0.4	79.7	1.6	-4.8
ING	1.2	-0.4	5.3	-0.7	-12.6	4.4	0.0	43.8	0.4	-4.8	3.7	0.6	105.4	-1.6	7.9
Intesa	4.2	0.1	55.2	0.2	-23.1						5.2	1.7	210.6	-1.7	38.1
Lloyds	2.8	-0.3	18.8	3.0	-12.4	3.7	0.2	64.6	10.4	6.2	3.9	0.7	121.6	13.8	7.8
Nordea	4.1	-0.3	21.3	-1.3	-7.6	2.5	-0.3	23.4	-0.8	-14.3	0.7	0.3	67.4	-0.5	13.1
Rabobank	2.4	-0.4	13.9	-1.4	1.4	5.8	-0.1	33.8	0.4	-2.0	1.7	0.0	40.8	-0.6	-3.7
RBS	3.2	-0.1	41.2	-1.0	-0.4	5.8	-0.1	33.8	0.4	-2.0	1.7	0.0	40.8	-0.6	-3.7
Santander	3.5	-0.2	34.4	-0.6	-1.9	4.9	0.2	62.3	-0.6	1.1	5.5	0.7	112.9	0.6	5.9
San UK	2.6	-0.2	23.5	1.1	-8.0	2.5	0.1	65.1	5.9	7.8	5.5	0.7	112.9	0.6	5.9
SocGen	1.5	-0.3	18.8	-0.7	-7.1	6.0	0.3	76.4	-0.5	4.7	3.2	0.5	99.4	-2.4	13.5
StanChart	3.8	-0.1	38.1	-2.0	-13.8	5.5	0.3	71.6	6.0	-0.5	3.2	0.7	113.0	2.8	37.9
Swedbank	4.3	-0.1	37.0	-2.9		3.8	-0.1	43.7	-1.0	-20.1	5.4	0.4	92.6	-4.8	-8.2
UBS	2.0	-0.3	19.0	-2.4	-8.2	3.2	-0.1	45.4	1.7	1.5	0.4	0.7	78.8	9.4	-126.3
UniCredit	3.7	0.2	67.1	-1.3	-16.2	4.5	0.9	133.2	-1.4	-20.8	2.9	2.0	240.0	-0.6	12.3

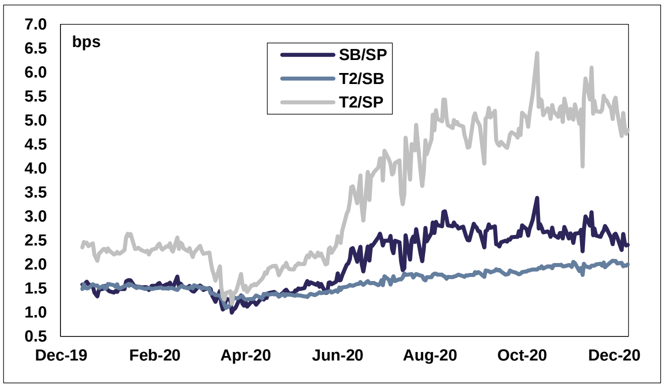
Source: Bloomberg, Daiwa Capital Markets Europe. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative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

Western European Banks USD Spreads and Yields

Aggregate Z-spread LTM (bps)



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
Barclays	2.3	0.6	33.4	-4.5	-25.6	4.1	1.4	101.7	10.1	-1.4	5.6	2.6	197.1	14.8	7.3
BFCM	2.5	0.5	30.8	1.0	-22.9	4.1	1.4	101.7	10.1	-1.4	5.6	2.6	197.1	14.8	7.3
BNPP	2.1	0.4	24.1	16.9	-12.3	4.0	1.2	79.3	4.8	-3.8	5.2	1.8	121.3	0.2	-12.8
BPCE	2.6	0.6	44.1	1.1	-13.5	4.2	1.1	58.8	3.1	-11.4	3.3	1.4	98.3	4.4	-13.1
Credit Ag.	2.2	0.5	27.2	-3.1	-20.4	2.9	1.0	47.3	3.9	-18.5	7.9	2.2	136.1	3.0	15.0
Credit Sui.	2.4	0.4	31.7	4.8	-9.6	4.1	1.2	77.4	5.0	-4.3	2.5	2.0	166.2	9.8	-18.2
Danske	2.0	0.6	42.0	4.8	-39.0	2.6	1.1	84.6	3.1	-18.1	2.5	2.0	166.2	9.8	-18.2
Deutsche						3.5	1.6	92.6	2.7	-41.9	6.4	3.2	287.8	9.2	-55.4
HSBC	3.7	1.2	92.0	0.6	-16.4	4.5	1.4	86.8	8.4	-3.7	10.8	3.0	182.9	6.3	25.9
ING	3.7	1.2	92.0	0.6	-16.4	4.4	1.1	68.9	4.8	-18.6	2.4	1.5	123.5	3.4	-4.4
Intesa	3.3	1.4	106.6	-1.5	-33.3	4.4	1.1	68.9	4.8	-18.6	3.8	2.6	223.9	10.8	-1.8
Lloyds	4.1	1.0	68.9	-5.2	3.0	3.3	1.2	77.0	7.7	-10.3	4.7	1.8	131.0	10.9	3.2
Nordea	3.5	0.6	29.5	10.4		2.6	0.7	39.0	0.5	-40.0	1.7	0.8	42.7	-2.1	-26.9
Rabobank	2.0	0.4	19.4	0.9	-19.0	3.9	0.9	47.9	3.7	-21.0	4.6	1.4	89.4	5.0	-6.6
RBS	2.0	0.4	19.4	0.9	-19.0	3.9	0.9	47.9	3.7	-21.0	4.6	1.4	89.4	5.0	-6.6
Santander	5.4	1.4	85.5	5.9	-1.4	4.9	1.6	104.1	5.4	-17.6	6.6	2.2	147.6	6.7	9.5
San UK	3.0	0.8	51.4	4.6	-10.9	2.7	1.0	78.4	6.4	-21.8	4.3	2.2	169.8	-4.9	8.3
SocGen	4.4	0.9	53.0	5.7		3.9	1.3	95.2	4.0	-6.0	4.2	2.0	154.4	-0.1	10.2
StanChart	0.5	0.7	49.6	-9.4	-202.9	3.6	1.4	99.6	5.2	-4.6	5.6	2.4	186.2	7.6	15.0
UBS	9.5	1.4	63.4	-1.0	8.6	4.4	1.1	70.7	5.8	-10.4	5.6	2.4	186.2	7.6	15.0
UniCredit	1.9	1.5	130.5	2.2	-23.0	3.6	1.6	131.0	4.3	-16.3	5.8	4.4	350.7	11.6	16.9

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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[Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

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Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.com/site/japan)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

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February 2020

IMPORTANT

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Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

Other Disclosures Concerning Individual Issues:
1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
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