Daiwa Capital Markets

European Banks – Credit Update

- Draft Taxonomy criteria risk being too lenient in meeting low carbon economy targets while green covered bond issuers face overregulation which could significantly hit green issuance.
- ECB permits resumption of dividend payouts for euro area banks under narrow guardrails.
- Issuers expected to take advantage of stable funding conditions in early January 2021 following favorable policy announcements before adverse economic reality catches up with markets.

William Hahn
Credit Analyst
+44 20 7597 8355
William.Hahn@uk.daiwacm.com

EU Taxonomy risks missing the mark

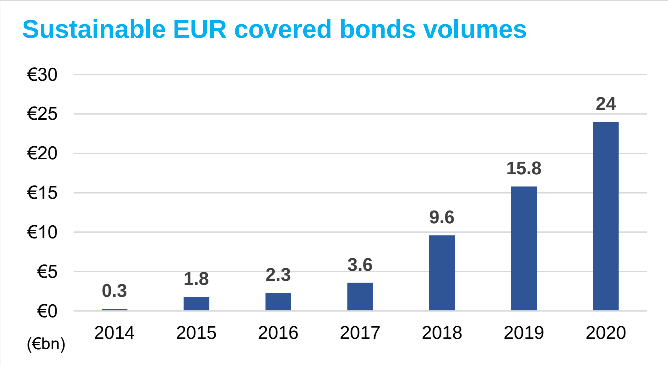
The EU Commission has come under pressure after it launched a month-long consultation on its draft delegated regulation covering two of the six technical screening criteria (TSC) that would determine which economic activities qualify as environmentally sustainable under the overarching EU Taxonomy regulation. By the end of the consultation period on 18 December it had drawn criticism for deviating from science-based thresholds intended to prevent green-washing, by softening requirements on biofuels, and giving in to political and industry pressure. The Commission generally follows recommendations from its technical expert group (TEG) but there remain differences in approach, particularly in relation to activities in transition to a low carbon economy and real estate standards. Any deviations from proposed TSCs are potentially contentious as they are introduced by the EU Commission through delegated acts that do not require approval from the EU Parliament or council.

For mortgage-backed green covered bond issuers the draft Taxonomy places stringent requirements on eligible collateral. The wording states that buildings built before 2021 require an ‘A grade’ energy performance certificate (EPC) to qualify as being sustainable. However, what constitutes the highest EPC varies vastly across Europe and only makes up 1-2% of existing real estate stock. The current framework underlying all green issuance is that 15% of the most energy efficient properties enter a dynamic cover pool which continually replaces older properties with new efficient ones, naturally evolving to a higher EPC standard over time. Prior to the Commission’s draft proposal the TEG had suggested that the tested 15% approach would continue to be applied but an unforeseen shift to a unified ‘A-grade’ EPC will likely make most mortgage-backed bonds Taxonomy non-compliant. Without sufficient eligible assets in this space, the number of green covered bond and senior unsecured programmes may collapse from what is currently a EUR80bn market. The EU risks running counter to what it intends to achieve with the Taxonomy, namely fostering a market for sustainable finance.

Sustainable EUR Covered Bond Issuers*	Maturity Date	Issuer Domicile
Nord LB Luxembourg	Jan-25	Luxembourg
KHFC (Social)	Feb-25	Korea
CAFFIL (Social)	May-25	France
KHFC (Social)	Jul-25	Korea
Kookmin (Sustainable)	Jul-25	Korea
Sparebank Vest	Jun-27	Norway
Sparebank 1	Sep-27	Norway
Sparebank 1	Sep-27	Norway
Berlin Hyp	Jul-28	Germany
Societe Generale SFH	Feb-30	France
BPCE SFH	May-30	France
Berlin Hyp	Sep-30	Germany

Source: Bloomberg; *Green if not otherwise denoted

According to Bloomberg data, sustainable euro benchmark covered bonds are predominantly green with an outstanding volume of EUR24bn (+52% yoy) representing less than 5% of the global euro benchmark market. Nevertheless, primary issuance volumes continued rising to EUR8.2bn during 2020 (+32% yoy), contrasted by the fall in the wider primary EUR96bn benchmark covered bond market (-29% yoy) during the same year. The strict requirements under the draft Taxonomy and continued favourable funding conditions offered under the ECB’s T-LTRO III programme will likely contribute to the reduction of euro benchmark covered bond issuances during 2021. However, due to the overall high demand for green bonds we anticipate further growth in sustainable covered bond issuances, albeit at a slower pace. Green issuers will continue issuing under their existing frameworks as the Taxonomy is only intended to create common standards and clarity on core features of sustainability, remaining a descriptive tool under which investors are required to describe their activities and make disclosures. Following the end of the consultation period, the EU is operating under a tight timeline to review any feedback received and intends to finalise the Taxonomy by end-2020, providing only little time for revision.



Source: Bloomberg

Restrictive ECB dividend policy credit positive for sub-debt

Following last week's ECB meeting, euro area banks may resume dividend payments and share buybacks as of January 2021 subject to a narrow framework. Payments shall not exceed the lesser of 15% of the respective bank's aggregate 2019 and 2020 profits; or 20bps of its 2020 CET1. The prohibition of interim dividend distributions from 2021 profits will remain in place until end-September 2021. Given the limited possibilities to return equity to shareholders and the resulting small impact on capital, this will protect bank capital ratios in the near term but arguably more importantly will support subordinated debt holders. Spreads of Tier 2 and AT1 tightened noticeably on the news. EBA data shows that average capitalisation levels for European banks were robust as at 1H20 with fully-loaded CET1 standing at 14.7%, benefitting from regulatory forbearance. The ECB together with local regulators permitted the discontinuation of the countercyclical buffer and allowed P2R to be satisfied with AT1 and Tier 2, freeing up regulatory capital of EUR150bn. These changes led to a sizeable increase in AT1 issuance of some EUR17bn during 2020, up from just EUR8bn in 2019. Nevertheless, we expect capital ratios to be challenged in 2021 as the pandemic induced economic decline will lead to RWA inflation and higher credit costs from IFRS9 provisioning.

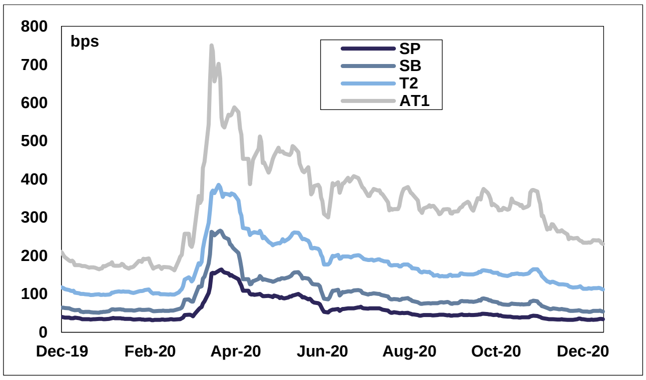
Primary and secondary markets

Primary market activity in EUR and USD was non-existent last week. This far into December investors have closed their books as financial market activity has slowed. Looking towards next year we expect issuers to frontload much of their senior unsecured requirements, taking advantage of benign funding conditions following major policy announcements by the Fed, BoE and ECB with limited scope for further tightening in the short term. Investment grade, core European issuers are likely to select longer durations to avoid offering investors negative yields while UK banks may opt to frontload their funding plans over fears of a deteriorating economic outlook. By 1H21 however, we could see spreads widen again when the adverse effect of the second wave becomes more apparent in the form of corporate defaults and rising non-performing loan volumes on bank balance sheets, laying bare the economic reality of the pandemic. As mentioned above, covered bond issuance will likely be reduced against previous years as the T-LTRO III funding programme provides favourable funding conditions, giving preference to unsecured lending over collateralised bonds.

Secondary spreads tightened on the whole, following the policy announcement from the ECB with regards to upsizing of the PEPP programme, and the extension and slight loosening of financial conditions via the T-LTRO III offerings. Limited capital outflows from restrictive dividend pay-out rules from both the ECB and the BoE further helped tighten junior spreads while last week's BoE's Monetary Policy Committee meeting kept the Bank Rate at 0.1% and extended the SME term funding scheme (TFSME) by six months. Influenced by the above, EUR spreads closed the week 0.9bps and 4.6bps tighter on SNP and Tier 2 but slightly wider on SP (+0.8bps). In the USD market the tightening was more pronounced with USD SP tighter by 1.9bps while SNP and Tier 2 were down by 4bps and 8bps respectively. The short-term outlook remains steady but with limited scope for tightening from a policy perspective. We would expect to see broad-based widening once the economic impact of the pandemic becomes more visible.

Western European Banks EUR Spreads and Yields

Aggregate EUR Z-spread LTM (bps)



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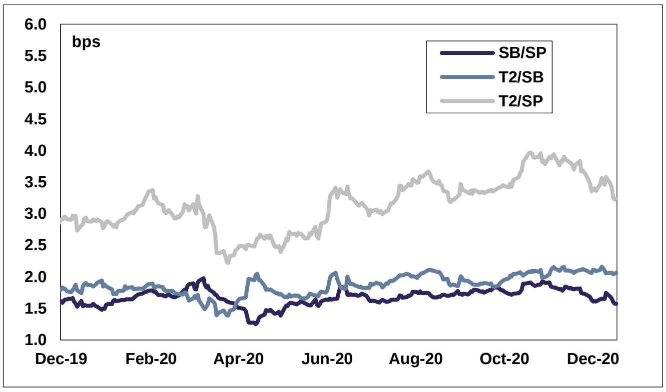


Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

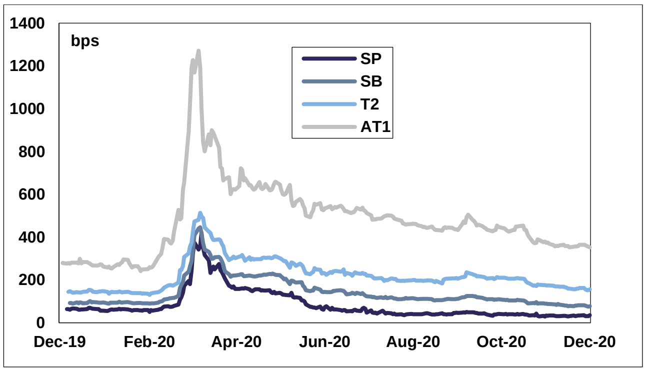
Selected Names

	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	53.7	0.9	0.7	4.0	0.3	73.8	-1.4	-3.5	4.7	1.8	217.2	-17.0	17.5
Barclays	3.3	0.2	61.7	2.6	18.2	2.9	0.1	56.6	-6.8	-4.9	2.1	1.0	143.5	-15.9	-26.7
BBVA	4.4	-0.1	33.2	-0.1	-4.0	4.0	0.1	51.8	-2.7	-7.7	5.5	0.9	132.7	-7.2	15.0
BFCM	4.2	-0.2	28.9	1.3	-4.7	8.9	0.4	64.8	-1.0	2.4	4.9	0.4	80.7	-0.8	-5.1
BNPP	2.1	-0.3	21.3	1.9	0.0	4.8	0.2	59.3	-1.0	0.3	4.6	0.6	99.0	-1.4	10.3
BPCE	3.4	-0.2	29.2	0.6	0.7	4.6	0.1	55.0	-0.7	0.4	2.4	0.2	59.3	-1.7	-0.8
Credit Ag.	3.2	-0.1	32.3	1.5	-3.0	5.7	0.1	54.1	-0.8	0.8	4.7	0.9	118.3	-3.2	3.9
Credit Sui.	5.5	0.1	53.7	0.9	0.7	5.4	0.3	65.2	-0.6	0.4	5.7	1.2	161.0	-5.4	3.4
Danske	2.4	-0.2	27.2	2.7	-7.5	2.4	0.1	56.0	3.2	-15.8	3.7	0.9	134.9	3.9	-12.9
Deutsche	2.7	0.0	44.1	1.0	-22.2	3.8	0.6	109.6	-1.0	-55.8	4.5	2.0	243.9	-15.5	-21.7
DNB	2.9	-0.2	25.0	1.4	-6.0	3.7	0.2	60.5	7.1	22.8	1.7	0.0	46.9	-0.1	-14.0
HSBC	3.4	-0.1	34.8	1.1	-2.3	3.3	0.0	45.1	-0.6	-3.1	5.5	0.4	79.3	-1.3	-6.1
ING	1.2	-0.4	6.9	1.1	-10.7	4.4	0.0	45.5	-0.6	-5.1	3.7	0.6	104.1	-3.7	5.5
Intesa	4.2	0.1	56.1	-1.1	-22.7						5.2	1.7	209.3	-6.9	31.3
Lloyds	2.8	-0.3	19.7	1.2	-11.6	3.7	0.2	63.3	-3.9	1.6	2.7	0.7	114.1	-8.6	-2.0
Nordea	4.0	-0.2	23.6	1.7	-4.9	2.5	-0.2	25.4	0.8	-12.7	0.7	0.3	66.3	-5.2	8.6
Rabobank	2.4	-0.3	16.5	0.5	3.1	5.8	-0.1	34.9	-0.2	-2.4	1.7	0.0	42.9	-0.3	-3.8
RBS	3.2	0.0	42.9	1.0	0.8	5.8	-0.1	34.9	-0.2	-2.4	1.7	0.0	42.9	-0.3	-3.8
Santander	3.5	-0.1	35.0	0.4	0.5	4.9	0.2	62.3	-1.8	-0.5	5.5	0.7	111.7	-4.2	1.7
San UK	2.6	-0.2	25.3	0.5	-5.9	2.5	0.1	63.6	-3.9	5.1	5.5	0.7	111.7	-4.2	1.7
SocGen	1.5	-0.3	21.2	0.3	-6.0	5.9	0.4	76.7	-1.8	2.9	3.1	0.5	98.4	-3.9	7.7
StanChart	3.8	-0.1	40.0	1.3	-12.3	5.5	0.2	64.1	-7.2	-10.2	3.2	0.7	109.6	-2.9	31.8
Swedbank	4.3	-0.1	38.6	0.8		3.8	0.0	47.7	3.5	-16.4	5.7	0.5	98.9	4.9	-1.8
UBS	2.0	-0.3	20.2	0.6	-6.9	3.2	0.0	47.5	0.0	1.8	0.4	0.9	81.2	6.4	-130.3
UniCredit	3.7	0.3	68.9	-1.5	-16.3	4.3	0.9	130.4	-3.8	-23.4	2.9	1.9	232.1	-8.8	4.6

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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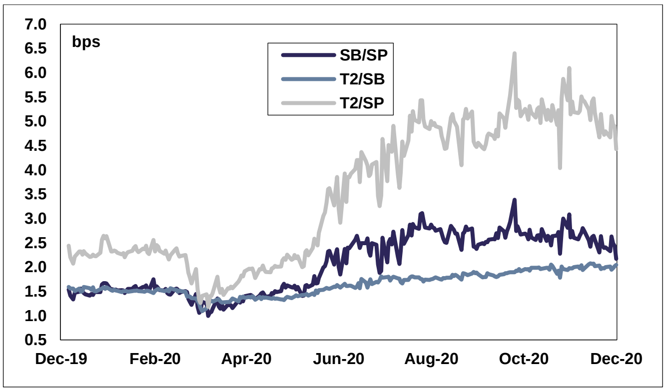

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

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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	0.5	24.9	-8.6	-27.8	4.1	1.3	91.8	-6.1	-12.3	5.6	2.5	182.8	-14.5	-10.4
BFCM	2.4	0.5	32.2	-1.5	-24.7	4.1	1.3	91.8	-6.1	-12.3	5.6	2.5	182.8	-14.5	-10.4
BNPP	2.1	0.4	17.2	-4.2	-19.1	4.0	1.1	75.4	-6.7	-12.0	5.2	1.7	116.4	-10.5	-25.0
BPCE	2.6	0.6	43.8	-2.3	-14.9	4.2	1.0	54.1	-2.8	-16.5	3.3	1.3	95.0	-4.5	-18.3
Credit Ag.	2.2	0.5	26.5	1.5	-23.6	2.9	1.0	44.9	-3.5	-21.5	6.5	2.1	130.2	-3.8	5.1
Credit Sui.	2.3	0.4	29.2	-1.7	-12.6	4.1	1.2	71.7	-3.1	-10.9	2.5	1.9	148.5	-3.9	-38.7
Danske	1.9	0.6	39.0	0.1	-42.2	2.6	1.1	85.0	-0.6	-18.1	2.5	1.9	148.5	-3.9	-38.7
Deutsche						3.4	1.5	88.7	-4.5	-45.1	6.4	3.3	287.0	-5.8	-60.1
HSBC	3.6	1.2	88.2	-2.3	-20.3	4.5	1.3	81.1	-6.3	-14.1	10.8	3.0	175.9	-5.9	22.7
ING	3.6	1.2	88.2	-2.3	-20.3	4.4	1.1	67.2	-1.6	-24.2	2.3	1.5	119.3	-1.3	-8.2
Intesa	3.3	1.4	108.3	-2.9	-40.1	4.4	1.1	67.2	-1.6	-24.2	3.8	2.6	220.7	-20.1	-20.1
Lloyds	4.1	1.0	67.5	-0.5	1.6	3.3	1.1	71.3	-5.5	-19.6	4.7	1.7	123.6	-7.9	-5.7
Nordea	3.5	0.6	27.2	0.7		2.6	0.7	43.7	-1.9	-38.7	1.7	0.8	47.5	-0.1	-29.6
Rabobank	2.0	0.4	17.6	-0.3	-21.0	3.9	0.8	46.0	-4.0	-25.3	4.6	1.3	85.7	-2.4	-9.3
RBS	2.0	0.4	17.6	-0.3	-21.0	3.9	0.8	46.0	-4.0	-25.3	4.6	1.3	85.7	-2.4	-9.3
Santander	5.4	1.3	76.9	-6.7	-10.1	4.9	1.5	96.6	-4.6	-23.5	6.6	2.1	142.0	-9.5	3.5
San UK	3.0	0.7	48.4	-4.8	-13.3	2.7	1.0	78.4	-2.1	-27.4	4.2	2.2	164.3	-7.6	0.5
SocGen	4.4	0.9	53.4	1.3		3.8	1.3	88.1	-2.5	-9.7	4.2	1.9	147.5	-2.9	5.8
StanChart	0.5	0.8	44.7	-3.5	-207.7	3.5	1.3	94.7	-8.3	-14.5	5.3	2.3	185.7	-6.9	19.3
UBS	9.4	1.4	62.7	-1.0	8.2	4.3	1.1	68.2	-4.6	-18.1	5.3	2.3	185.7	-6.9	19.3
UniCredit	1.9	1.4	120.2	-3.6	-28.6	3.6	1.7	131.9	-2.5	-20.1	5.9	4.3	341.7	-16.8	-0.3

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.

Daiwa Capital Markets

Credit Research

Key contacts

London		
Head of Research	*Chris Scicluna*	+44 20 7597 8326
Financials, Supras/Sovereigns & Agencies	*William Hahn*	+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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[Fitch]

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