European Banks – Credit Update

- 2021 SREP findings warn of cliff edge for bank balance sheets in the sudden absence of Covid-related support measures, despite rising regulatory capital ratios
- Capital strength and business model sustainability among ECB's key supervisory priorities for 2021
- Resurgence of senior FIG primary issuance on the back of improved sentiment and solid 4Q20 reporting carried through to secondary, helped by Italian politics with hopes pinned on Mario Draghi

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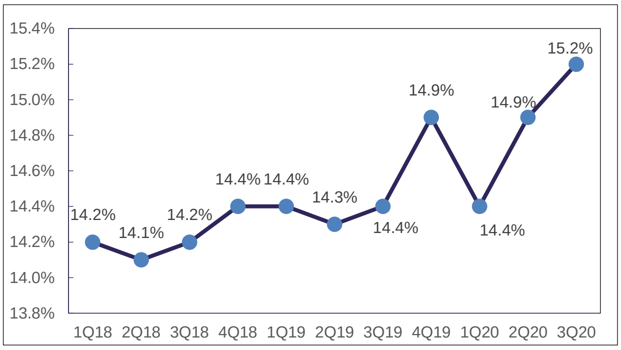
SREP results and 2021 ECB supervisory priorities

In late January, the European Central Bank (ECB) published the outcome of its 2020 Supervisory Review and Evaluation Process (SREP) alongside its supervisory priorities for 2021 upon the assessment of key risks and vulnerabilities in the banking sector. The review concluded that coordinated policy measures have provided considerable protection to the retail, corporate and banking sectors alike and helped avert excessive pro-cyclicality from the Covid-induced shock. In the medium term however, there remain considerable uncertainties in the areas of credit risk, capital adequacy, business model sustainability, and internal governance.

The SREP review found that the phasing out of several Covid-related support measures by the first half of 2021 may trigger cliff-edge effects with respect to banks' asset quality. It will therefore be the supervisory focus to ensure banks adequately classify and measure risks in their balance sheets and that they are operationally prepared to address distressed debtors in a timely manner. To encourage satisfactory outcomes in this context, supervisors have communicated a significantly increased number of recommendations to banks, building on prior initiatives. Concerns were also expressed over the feasibility of business plans for some banks to improve operational efficiency and profitability. The ECB will thus continue to challenge underlying measures taken by banks' senior management to overcome existing deficiencies.

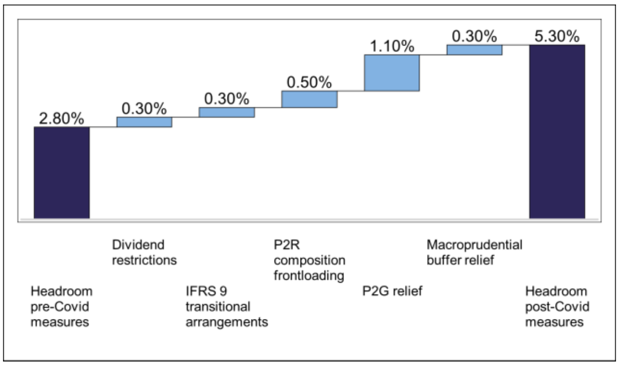
Average Quarterly CET1 ratio EU Banks



Source: ECB data

The reliability of capital planning frameworks of banks was also identified as a weakness, especially for those entities with small margins between their capital ratios and minimum regulatory requirements. Despite concerns about capital adequacy in a few cases, euro area banks entered the pandemic from a stronger capital position. This was further strengthened through the frontloading of new rules on P2R capital compositions, which reduced overall CET1 requirements for banks by around 90bps. Banks may also fully use capital buffers, including Pillar 2 Guidance, until end-2022. However, the SREP identified nine banks making use of the aforementioned relief measures, with 3Q20 CET1 levels below requirements and guidance pre-COVID-19 measures. Based on the above, the ECB Banking Supervision formulated four supervisory priorities for 2021 that will receive particular focus:

Average Capital Headroom EU Banks as at 3Q20



Source: ECB data

I) **Banks' credit risk management** with a view to fostering timely identification, efficient monitoring and the mitigation of procyclicality as the deteriorating macroeconomic environment is expected to have a direct impact on banks' asset quality, as further credit downgrades, increasing numbers of distressed borrowers and impaired collateral values are likely to materialise. For this purpose, the Joint Supervisory Teams (JSTs), which consist of staff from the ECB and relevant national supervisors, will scrutinise banks' practices in these areas and, if needed, targeted deep dives and conduct on- and off-site inspections if deemed necessary.

II) **Capital strength and resilience** will be assessed through the EU-wide stress test coordinated by the European Banking Authority (EBA). The EU-wide stress test will be conducted on a sample of 50 banks covering 70% of total banking assets in the EU, the results of which will be published 31st July 2021 and will form the basis of bank's SREP capital requirements. It will scrutinise the appropriateness of banks' capital planning and the adequacy of banks dividend and share buyback policies, among other things.

III) **Business model sustainability** will be reviewed as the pandemic is exacerbating pressures stemming from the low interest rate environment, excess capacity and low operational efficiency. Where appropriate, JSTs will engage in a structured supervisory dialogue with banks' management on the oversight of their business strategies. We believe this point in particular will be of great importance to banks as any involvement in business strategy by supervisory entities could be interpreted as management weakness by market participants, ultimately affecting access to capital markets.

IV) Sound **Governance** and robust internal controls are deemed crucial for ongoing risk mitigation. A particular focus will be placed on the adequacy of banks' crisis risk management frameworks, risk data aggregation, IT and cyber risks, and anti-money laundering risks.

Primary and secondary markets

European **primary market** issuance volumes for SSAs stood at EUR38bn over the course of last week exceeding market expectations of EUR16bn-21bn. Sovereign issuers as well as L-Bank, the Japanese Bank for International Cooperation (JBIC) and the European Financial Stability Facility (EFSF) pushed SSA volumes up yet again. FIG supply of EUR8bn was within the survey data expectation that forecast EUR4.5bn-9bn in weekly volumes. Total 2021 FIG volumes of EU60.3bn closed 40% behind last year's issuance, however the gap registered in January was reduced by 4%. SSAs were up overall by 29.2% at EUR155.8bn compared to last year. Market participants expect SSA issuance to carry forward momentum into February leading the way for a sixth strong week in a row. Survey data suggests SSA volumes will range between EUR13.5bn-18.5bn and FIGs to issue EUR7bn-11bn over the course of this week.

The EFSF issued the largest non-sovereign SSA bond of the week with a EUR2bn tap issuance, taking the total outstanding to EUR5bn. The 6-year bond priced with a 1bp new issue premium while the EFSF announced two more funding windows this quarter (8th and 22nd March). However, it was JBIC's GBP250m SEC registered 5-year issue that registered the largest order book (3.88x). Currently there is no indication that supply from SSAs will subside anytime soon with issuers based in Europe even looking to gear up their capital market activities. For instance, the funding agency for French local authorities (AFL) announced that it plans to raise EUR1.8bn in funding this year, almost double that of previous years with a view to building a EUR5bn annual funding programme, including structured private placements. AFL is looking to issue another Euro benchmark transaction this year having come to market already in January.

The green SNP format returned to market for FIG investors last week as BayernLB and Caixabank issued some of the most subscribed FIG deals of the week. Book orders were 4.2x and 3.7x times over deal size respectively which helped both price through fair value. This stands in contrast to previous weeks where issuers struggled to build sizeable order books and ended up paying premiums on senior bond issuances. The Caixa transaction in particular showcased how much sentiment had improved as the pricing of the EUR1bn, 8NC7 tightened by 25bps from IPT MS+115bps bringing the deal 6-7bps through value at close. Additionally, European banks have reported solid fundamentals during the 4Q20 reporting season so far. Both Caixa and merger-partner Bankia reported a good set of results, which bodes well for when their merger completes at end 1Q21. With regards to covered bond supply there appears to be no improvement in sight as January saw a 67% reduction in volumes against the same period last year. Despite EUR13bn in redemptions in February we don't expect to see a pick-up in issuance as the structural weakness of competing with the ECB's TLTRO funding programme remains and many European banks are still in blackout during reporting season. The only standout transaction in this space was the highly successful EUR500m bond by Argenta Spaarbank with peak demand 7x over deal size helped by scarce supply and rare outings from Belgian issuers in this format.

(Table 1) Key Transactions

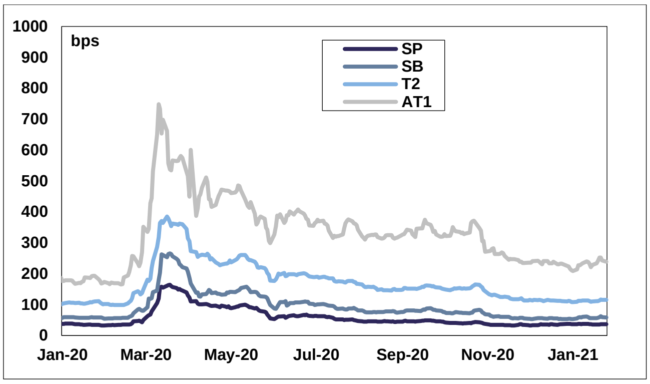
Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
BCP	SP	EUR500m	6NC5	MS +155	MS + 180	>EUR1.0bn
Santander	SP	EUR1.25bn	7Y	MS + 52	MS + 70/75	>EUR3.0bn
Morgan Stanley	Senior Unsecured	EUR1.75bn	10NC9	MS + 70	MS + 90/95	>EUR3.6bn
Caixabank	SNP (Green)	EUR1bn	8NC7	MS + 90	MS + 115	>EUR3.7bn
BayernLB	SNP (Green)	EUR500m	7Y(WNG)	MS + 53	MS + 75	>EUR2.1bn
JBIC	Senior Unsecured	GBP250m	5Y	G + 34	G + 38	>GBP970m
EFSF	Senior Unsecured (Tap)	EUR2bn	6.6Y	MS - 11	MS - 9	>EUR7.6bn

Source BondRadar, Bloomberg.

Secondary market spreads tightened across EUR and USD, reflecting perceived improvements in political stability in the European periphery. CDS price indices on European senior (58bps) and subordinated financials (109bps) as measured by iTraxx benchmarks priced lower against the prior week's levels by 5bps and 9bps respectively. Capital markets responded positively to the news that former ECB chief Mario Draghi had agreed to try to form a new government in Italy. This seemingly garnered relatively widespread support across the political spectrum in Italy with hopes pinned on him to define plans that would allow Italy to receive its full entitlement of grants and loans, worth more than EUR200bn, from the EU rescue funds, as well as keeping the ECB onside as it conducts its PEPP purchase programme. We also note the extension of the Spanish furlough scheme by the government until end-May 2021, which we deem credit positive for bank's balance sheets. Weekly average EUR spreads tightened considerably, led by the developments in Italy, with SP (-3bps), SNP (-7bps) and Tier 2 (-11bps) all improving. We witnessed a similar picture among USD spreads which carried forward the positive momentum from strong financial earnings reports, as the average weekly change of SP (-4bps), SNP (-8bps) and Tier 2 (14bps) mirrored the developments in EUR. Based on data collected from Bloomberg all FIG and SSA tranches issued in February quoted tighter than launch.

Western European Banks EUR Spreads and Yields

Aggregate EUR Z-spread LTM (bps)



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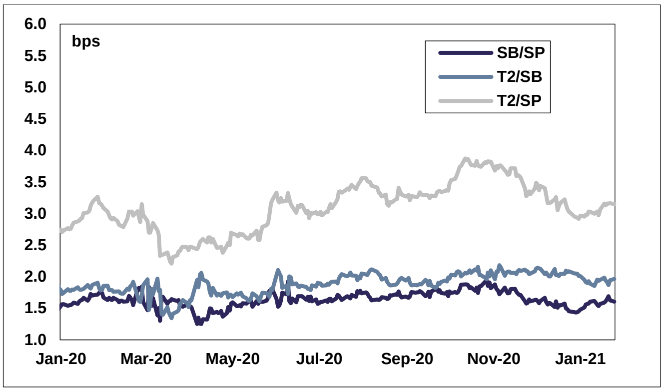


Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

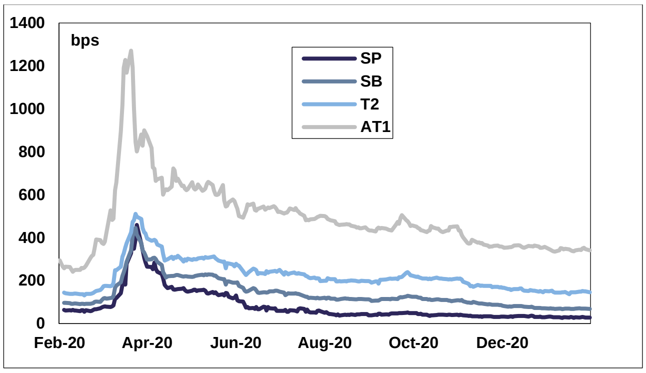
Selected Names

	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	5.4	0.1	50.3	0.8	-3.6	3.8	0.3	73.5	2.4	-0.1	4.6	1.8	216.3	10.5	3.6
Barclays	3.2	0.2	61.0	2.5	2.4	2.8	0.0	52.3	1.8	8.9	1.9	0.9	139.6	8.6	1.4
BBVA	5.0	0.0	43.3	0.6	4.4	3.9	0.1	54.1	0.7	2.8	5.4	0.8	125.7	6.0	1.4
BFCM	4.4	-0.1	32.1	1.5	1.3	8.7	0.5	67.4	2.0	5.9	4.8	0.5	87.3	5.0	4.3
BNPP	2.3	-0.3	21.1	0.6	-1.2	5.0	0.2	61.2	1.5	1.6	4.6	0.6	98.8	5.3	-0.1
BPCE	3.4	-0.2	30.3	0.6	0.2	4.5	0.2	60.0	2.3	5.9	2.3	0.2	64.8	2.8	3.6
Credit Ag.	3.2	-0.1	31.8	1.2	-0.6	5.6	0.2	59.2	2.6	5.9	4.6	0.8	118.6	5.9	2.3
Credit Sui.	5.4	0.1	50.3	0.8	-3.6	5.2	0.3	70.2	-1.7	5.3	5.6	1.3	161.2	6.4	8.0
Danske	2.3	-0.2	31.0	1.6	0.4	2.3	0.0	49.8	-0.4	-2.9	3.6	0.8	125.6	3.4	-7.4
Deutsche	2.5	0.0	43.4	1.1	-3.8	3.9	0.7	114.2	3.9	1.6	4.4	1.9	227.6	8.2	-7.3
DNB	2.8	-0.2	24.1	1.3	-1.3	3.6	0.0	47.0	2.5	-5.3	1.6	0.0	50.0	2.7	3.1
HSBC	3.3	0.0	34.3	1.6	1.8	3.2	-0.1	46.9	2.1	6.4	5.4	0.5	82.3	7.4	3.8
ING	1.1	-0.4	8.0	1.1	-1.2	4.7	0.1	49.5	1.0	3.4	3.5	0.7	108.0	4.6	2.8
Intesa	4.5	0.2	63.5	-1.9	6.5						5.1	1.7	204.8	7.9	6.2
Lloyds	2.7	-0.2	21.5	2.3	2.1	3.6	0.1	55.6	3.3	4.3	2.5	0.6	108.2	6.1	1.5
Nordea	3.9	-0.2	23.4	0.7	-3.6	2.4	-0.2	28.7	2.3	1.8	0.6	0.2	60.0	0.7	-7.7
Rabobank	3.2	-0.3	19.3	-0.2	-5.6	5.7	0.0	39.0	1.4	2.3	1.6	0.0	42.2	0.5	-0.7
RBS	3.1	0.0	39.4	1.0	-2.0	5.7	0.0	39.0	1.4	2.3	1.6	0.0	42.2	0.5	-0.7
Santander	3.4	-0.1	35.1	0.0	1.8	4.8	0.3	62.5	0.1	4.2	5.5	0.8	115.2	6.9	2.5
San UK	4.0	0.0	38.5	2.8	2.1	2.4	0.0	58.9	3.4	5.1	5.5	0.8	115.2	6.9	2.5
SocGen	1.8	-0.3	21.5	1.0	-2.6	6.2	0.4	78.0	2.0	1.7	3.0	0.5	94.8	3.7	-2.3
StanChart	3.6	-0.1	36.9	1.3	-2.5	5.4	0.3	69.2	3.6	18.1	3.1	0.6	106.6	4.1	-1.1
Swedbank	4.2	-0.1	36.4	0.9	-1.4	5.3	0.2	54.7	1.7	-0.1	4.9	0.4	88.8	-2.8	-10.8
UBS	2.0	-0.3	22.0	1.8	-2.2	3.1	0.0	54.0	2.9	6.2	0.3	1.0	76.0	1.5	-30.1
UniCredit	4.1	0.4	84.6	-2.3	10.1	4.4	0.9	130.4	-2.2	7.0	2.8	1.9	228.5	11.4	5.4

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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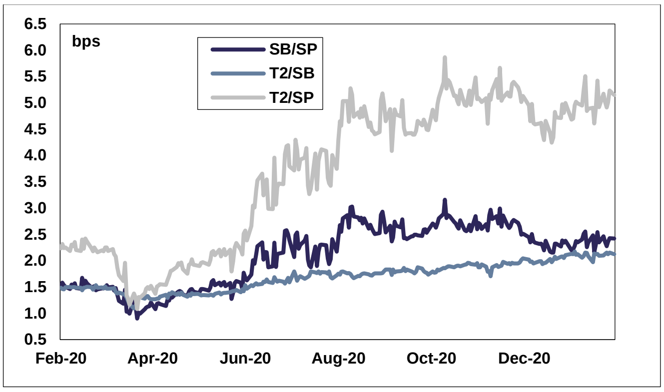

Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

Selected Names

	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	2.1	0.4	19.2	-4.0	-8.7	4.0	1.3	84.4	1.3	2.7	5.5	2.2	147.6	5.0	-3.5
BFCM	2.4	0.5	31.1	1.1	-2.3	4.0	1.3	84.4	1.3	2.7	5.5	2.2	147.6	5.0	-3.5
BNPP	2.0	0.3	7.9	-4.0	-7.3	4.1	1.3	64.2	0.9	-2.7	5.4	1.8	107.8	1.7	3.7
BPCE	3.9	0.8	45.8	-0.4	-4.3	4.5	1.2	50.3	0.0	-3.1	3.2	1.2	81.6	1.5	-2.8
Credit Ag.	2.5	0.6	31.6	0.8	-2.2	4.4	1.2	50.6	-2.4	-3.1	7.0	2.4	134.0	4.2	1.0
Credit Sui.	3.0	0.4	24.6	-1.3	2.2	4.1	1.2	67.9	1.1	-1.3	2.4	2.0	159.4	12.5	27.9
Danske	1.8	0.6	39.3	-0.3	4.5	2.6	1.0	74.3	-0.2	-6.7	2.4	2.0	159.4	12.5	27.9
Deutsche						3.3	1.3	69.1	-2.2	-7.2	7.6	3.5	279.0	8.5	15.5
HSBC	3.5	1.1	84.6	3.6	2.3	4.7	1.3	71.5	0.7	0.8	10.7	3.1	170.5	5.6	-1.0
ING	3.5	1.1	84.6	3.6	2.3	4.4	1.1	62.1	1.9	-2.3	2.2	1.2	85.5	-3.6	-9.4
Intesa	3.2	1.4	106.0	0.2	4.1	4.4	1.1	62.1	1.9	-2.3	3.7	2.6	208.2	21.3	6.8
Lloyds	4.0	1.0	59.4	-0.7	-3.3	3.5	1.0	62.7	0.8	3.2	4.6	1.7	110.8	0.9	-7.0
Nordea	3.4	0.6	24.5	0.5	0.0	2.4	0.6	33.3	-0.2	-7.4	1.6			17.0	3.3
Rabobank	3.0	0.5	21.6	0.1	0.3	3.8	0.8	39.9	2.2	-2.0	4.5	1.3	70.1	1.2	-0.9
RBS	3.0	0.5	21.6	0.1	0.3	3.8	0.8	39.9	2.2	-2.0	4.5	1.3	70.1	1.2	-0.9
Santander	5.4	1.3	67.7	2.1	-4.7	4.8	1.4	81.8	-1.2	-5.2	6.5	2.1	130.5	3.4	2.3
San UK	2.9	0.6	34.1	0.6	-6.3	2.6	0.9	58.9	2.0	-6.4	4.1			-12.1	-41.8
SocGen	4.3	1.0	54.8	4.5	4.2	4.2	1.4	86.0	0.0	-3.4	4.1	1.8	131.6	0.9	-13.9
StanChart	0.3	0.6	43.6	7.8	-11.1	3.8	1.2	76.6	1.3	-7.5	5.4	2.3	187.2	5.3	-7.9
UBS	9.4	1.5	60.3	0.8	0.8	4.2	1.2	62.0	-0.3	-0.9	5.4	2.3	187.2	5.3	-7.9
UniCredit	1.8	1.4	118.7	2.7	-4.7	4.3	1.9	148.7	2.6	0.6	5.8	4.5	343.5	10.3	5.7

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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[Moody's]

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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.

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February 2020