European Banks – Credit Update

- ECB Financial Stability Review finds deteriorating financial conditions in Eurosystem
- No adjustment to TLTRO deposit tiering multiplier expected as forthcoming ECB rate hikes will largely mitigate hit to bank profitability once favourable funding conditions end in late June
- Primary market activity sees sovereign issuers return to markets while FIG issuance extends into sub debt category. Secondary market spreads tighten for both EUR and USD bonds outstanding

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ECB finds financial stability conditions have deteriorated

The ECB's Financial Stability Review, published on 25th May, concluded that financial stability conditions have deteriorated as the post-pandemic recovery has been tested by higher inflation and Russia's invasion of Ukraine. The main messages from the report are:

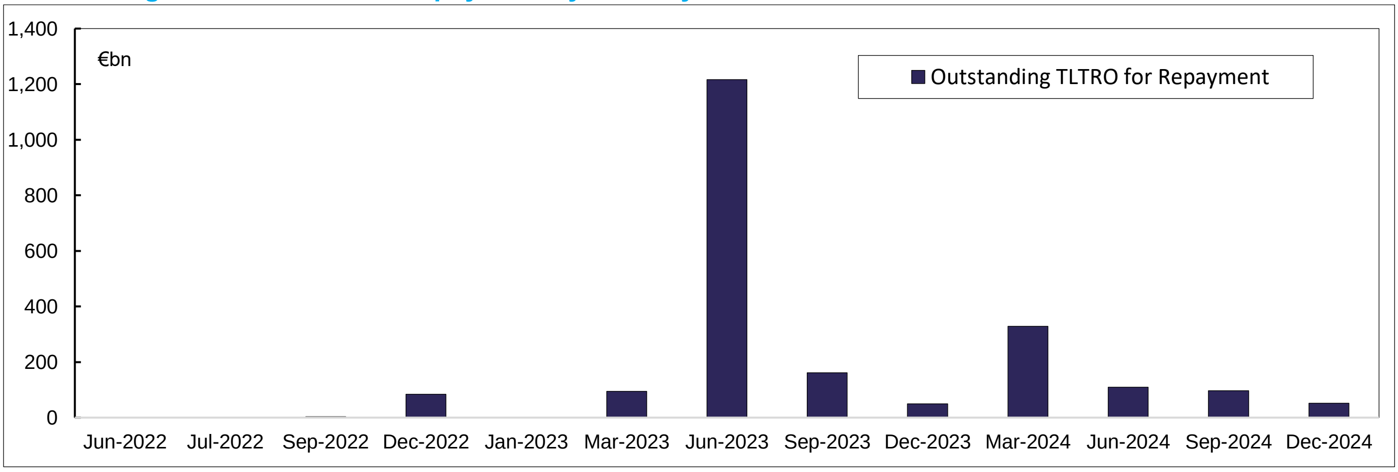
- Impact of war in Ukraine expected to weaken growth and push up inflation, amplifying pre-existing vulnerabilities
- Volatile financial markets at risk of further corrections
- More heavily indebted sovereigns, firms and households could be tested by higher interest rates and cost pressures
- Bank profitability improved markedly in 2021 but faces new headwinds

Projections for economic growth in 2022 have been downgraded, while inflation in the euro area is set to average more than 6%. The ECB stated that this backdrop is a particularly challenging one for companies in sectors that never properly rebounded from Covid-19 restrictions, including air transport, accommodation, and hospitality. There were also concerns of possible further asset price corrections as valuations remain stretched due to the deterioration in macro-fundamentals. According to the ECB, such corrections could be triggered by a further escalation of the war in Ukraine, emerging market stresses or by more persistent inflation than currently foreseen, which might prompt faster monetary policy normalization by major central banks. In particular, the central bankers warned of vulnerabilities in the euro area's housing sector, where prices jumped at the fastest pace in 20 years. This development was supported by tight supply conditions and continued demand amid household and investor preference for housing, resulting in signs of overvaluation and rendering some housing markets prone to price corrections.

Phasing-out of favourable TLTRO will likely weigh on bank profitability in 2022

In late June, the favourable funding conditions under the targeted longer-term refinancing operations (TLTRO) will be eliminated for Eurosystem banks, as stimulus measures are scaled back. Since March 2020, banks have benefitted from the risk-free arbitrage opportunity of borrowing funds at the ECB at -100bps (subject to meeting certain lending targets) and moving those funds to the central bank's deposit facility at a rate of -50bps. Excess liquidity from ECB asset purchases necessitated this favourable funding, as banks were depositing the additional liquidity with the central bank at negative rates. As this practise is coming to an end, the ECB estimates that banks will repay EUR700bn under the TLTRO programme by end-2022, which differs somewhat from the scheduled maturity dates that are concentrated around June 2023. Repayments are expected to return bank balance sheet sizes and the composition of liquid assets to pre-pandemic levels. Since these repayments are expected to be made using excess liquidity, bank's LCR ratios and HQLA compositions should also return to lower, pre-pandemic levels. Overall, TLTRO operations have resulted in EUR2.2tr in outstanding balances that banks have to repay over the next two years.

Outstanding TLTRO amount for repayment by maturity date



Source: ECB; Daiwa Capital Markets Europe

The phasing-out of favourable TLTRO funding rates in June is likely to weigh on bank profitability in 2022. Banks' return on equity (RoE), which averaged 6.6% at end-2021, is expected to be adversely impacted by 60-130bps. One way to offset the expected decline could come from adjustments to the deposit tiering multiplier, which exempts a portion of excess liquidity from mandatory deposits at the ECB and is currently set at 6. In effect, this means that an amount of 6-times the required reserves (incl. the required reserve itself) is exempt from negative deposit rates. The multiplier hasn't been increased since September 2019, despite the significant increase in excess liquidity in the market that has increased the cost base of banks. However, comments in the ECB's report suggest that when the Governing Council assesses the deposit tiering system in June, no changes to the multiplier will occur. We infer this from ECB policymakers' recent comments, which point towards imminent steps towards monetary policy normalisation. In particular, the rate hikes expected in July and September will likely lift the deposit rate to zero or above, reducing the incentive for banks to repay TLTRO funding sooner, which in turn is likely to partially mitigate the adverse impact on profitability.

Primary and secondary markets

European **primary market** issuance for SSAs stood at EUR13bn over the course of last week, within market expectations of EUR9bn-13.5bn. FIG supply of EUR17.4bn was above the weekly forecast amount of EUR7bn-11.5bn. The total 2022 year-to-date FIG volume of EUR265bn is 36.4% ahead of last year's issuance volume. SSA volumes, however, remain behind last year's level, down 27.8% at EUR284bn. For the current week, survey data suggest SSA volumes will range between EUR9.5bn-14bn and FIGs are expected to issue EUR7.5bn-12.5bn.

SSA activity remained steady for a second week running with several Euro trades coming to market. Daiwa Capital Markets Europe (DCME) acted as joint lead for the placement of a EUR1bn bond from **Japan Bank for International Cooperation (JBIC).** It was the issuer's first Euro trade since 2004 and the 7-year note priced at MS+12bps, bringing the total issuance this year to USD4.3bn. Based on the issuer's latest investor presentation, this represents 27% of the USD16bn JBIC expects to raise in international capital markets in 2022. In recent years, JBIC's foreign currency issuance has been predominantly USD and limited GBP. With its first Euro trade in almost two decades JBIC is diversifying its funding base, providing it with greater flexibility to react to a changeable funding environment, as monetary policy among the main central banks is currently diverging. Unusually, several sovereign issuers crowded the early part of last week, as Austria, Italy, France and Finland accessed markets, raising a combined EUR16bn. We see this as another sign that most issuers are driven into narrow funding windows, potentially cannibalising demand, further limiting access to smaller, less established issuers. **Austria** stood out among the crowd with its inaugural green bond, sized EUR4bn. The deal was well subscribed (6.25x) with the Austrian treasury retaining a small EUR250m amount, reducing the spread by 3bps from IPT. According to the issuer, the deal priced with a 2.5bps greenium, while the bonds will finance most of the Austrian government's EUR5bn eligible green expenditures. Furthermore, Austria is now the first sovereign issuer with a green bond framework that allows for short-term debt instruments in green format (i.e. green treasury bills or commercial paper), appealing to more short-term investors such as money market funds, central banks or bank treasuries to invest.

(Table 1) Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
Land Berlin	Sr. Unsecured	EUR650m	6Y	MS - 18	MS - 18	>EUR750m
ICO	Sr. Unsecured (Green)	EUR500m	4.5Y	SPGB + 9	SPGB + 12	>EUR1.8bn
RATP	Sr. Unsecured	EUR500m	10Y	OAT + 35	OAT + 35	n.a.
Italy	Sr. Unsecured	EUR5bn	15Y	BTPS + 8	BTPS + 11	>EUR24bn
Austria	Sr. Unsecured (Green)	EUR4bn	May-2049	MS + 22	MS + 25	>EUR25bn
JBIC	Sr. Unsecured	EUR1bn	7Y	MS + 12	MS + 12	>EUR1.3bn
France	Inflation-linked (Green)	EUR4bn	15Y	OAT + 12	OAT + 15	>EUR27.5bn
Finland	Sr. Unsecured	EUR3bn	10Y	MS – 15	MS - 13	>EUR12.7bn
FIG (Senior)						
ABN Amro	SNP (Green)	EUR750m	5Y	MS + 110	MS + 120	>EUR1bn
ABN Amro	SNP (Green)	EUR750m	10Y	MS + 135	MS + 150	>EUR1.2bn
DNB	SP	EUR750m	4NC3	MS + 58	MS + 75	>EUR825m
Credit Suisse	SP	EUR1bn	2Y	MS + 120	MS + 135	>EUR1.6bn
Credit Suisse	SP (FRN)	EUR750m	2Y	3mE + 123	3mE + 138	>EUR1bn
SocGen	SP	EUR1bn	3NC2	MS + 60	MS + 80	>EUR1.5bn
SocGen	SP	EUR1bn	7Y	MS + 110	MS + 125	>EUR1.6bn
Barclays	Sr. Unsecured	EUR1bn	4NC3	MS + 168	MS + 190	>EUR2.3bn
FIG (Subordinated)						
AXA	Tier 2	EUR1.25bn	20.8NC10.8	MS + 260	MS + 285	>EUR2.25bn
Athora	Tier 2	EUR500m	10.25NC5.25	5.375%	5.75%	>EUR950m
Allianz	Tier 2	EUR1.25bn	30.1NC10.1	MS + 255	MS + 270	>EUR1.9bn
Handelsbanken	Tier 2	EUR500m	11NC6	MS + 180	MS + 200	>EUR1.25bn

Source BondRadar, Bloomberg.

FIG issuance was characterised by several senior dual-tranche offerings by core European lenders as well as Tier 2 debt, mostly from insurers. **SocGen** and **Credit Suisse** both opted for the SP format with SocGen launching a 3NC2 and a 7-year note while also considering a potential 3NC2 floating rate note, subject to demand. The latter didn't materialise and the French bank managed to tighten both legs on the back of combined book orders of EUR3.1bn. New issue premiums are thought to have ranged between 10-15bps for both legs. Credit Suisse issued OpCo level debt from its London branch not long after the holding company was downgraded by S&P to 'BBB' from 'BBB+'. Moody's also changed its outlook on the lender to negative as both agencies point towards risk management failings and a difficult operating environment for Credit Suisse to achieve its business transformation, shifting the focus towards its wealth management offering in favour of its investment banking activities. In the wake of poor financial results in the last couple of quarters, new issue premiums of ~25bps for both fixed and floating rate notes were not surprising. **Barclays** on Wednesday announced a self-led, 4NC3 senior HoldCo offering in Euro. The EUR1bn deal was just one of two FIG deals in the market that day, with interest peaking at EUR2.3bn. It was not entirely unexpected for Barclays to come to market with an MREL eligible issuance as it communicated a GBP8bn MREL funding requirement for 2022 during its 1Q22 results presentation. Last week also saw three highly rated insurance companies and one bank come to market with Tier 2 bonds, signifying improving market conditions after the format had been absent from capital markets for more than two months. **Allianz, Axa and Athora** issued a combined EUR3bn while further supply came from **Svenska Handelsbanken** with its own EUR500m Tier 2. The deals provided investors with an appealing opportunity to buy bonds from high quality names at roughly double the spread level compared to comparable previous issuances. New issue premiums on the insurance deals were estimated between 25-40bps.

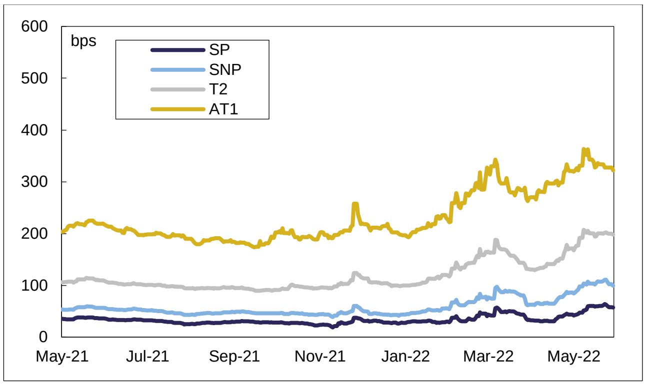
Secondary market spreads improved for EUR and USD. CDS indices on European senior (96bps) and subordinated financials (181bps), as measured by iTraxx benchmarks, priced -15bps and -31bps tighter against the previous week's levels.

Last week market conditions were relatively more benign, as some market activity was front-loaded due to the holiday on the continent, while US data suggested again that inflation has peaked while the possibility of pause to Fed tightening in September was also mooted. Some market impulses this week may arise from top-tier euro area data releases, with the calendar including the flash May inflation estimates (Monday and Tuesday), as well as unemployment (Wednesday), and retail sales numbers (Friday). In the UK, of most interest on Tuesday will be the BoE's latest bank lending numbers, which are expected to confirm that demand for consumer credit remained strong and new mortgage approvals remained steady at the start of 2Q22. The UK Bank Holiday-shortened week ahead is set to be exceptionally quiet on the economic data front and taking into account the Monday holiday in the US we expect only a narrow issuance window with activity centred around Tuesday and Wednesday this week.

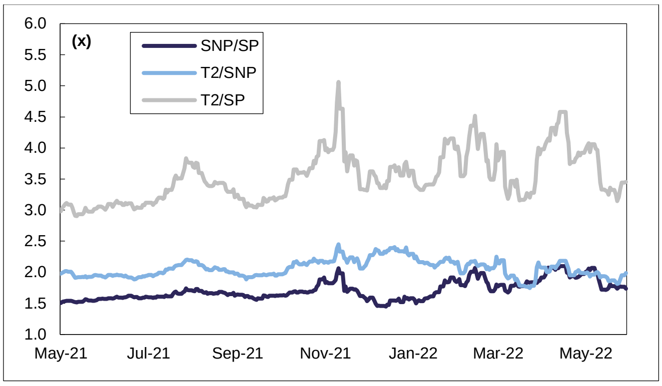
Weekly average EUR spreads were tighter across payment ranks with SP (-3.3bps), SNP (-5.8bps) and Tier 2 (-1.6bps). USD average spreads were also tighter week-on-week, with SP (-11.6bps), SNP (-11.4bps) and Tier 2 (-14.3bps). Based on Bloomberg data, 49% of FIG tranches and 67% of SSA tranches issued in May quoted wider than launch.

Western European Banks EUR Spreads and Yields

Aggregate EUR Z-spread LTM (bps)



Multiples (x)



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.

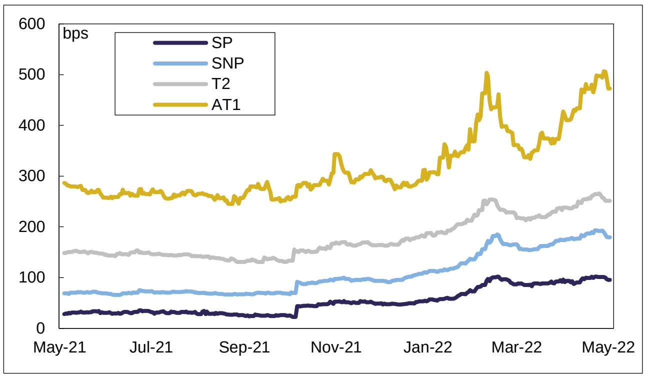
Selected Names

	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	3.7	2.1	64.4	-4.7	36.1	2.8	2.3	107.7	-4.4	62.0	3.5	3.8	234.9	-12.6	87.3
Barclays	2.0	1.4	21.4	-3.8	-2.7	3.5	2.1	119.5	2.6	74.9	6.3	3.2	237.0	1.6	140.4
BBVA	3.9	1.9	51.4	-5.7	11.1	3.4	1.9	52.2	-5.7	17.0	4.3	3.0	176.9	-4.4	81.7
BFCM	3.5	1.8	53.0	-5.6	24.4	6.8	2.8	110.8	-9.1	60.1	4.2	2.8	138.7	-8.3	68.2
BNPP	2.5	1.8	42.9	-5.3	0.7	4.8	2.4	103.4	-6.7	58.2	4.0	2.9	149.6	-4.2	83.5
BPCE	3.6	1.8	47.2	-6.0	12.1	5.1	2.5	108.2	-8.9	45.0	3.9	2.9	124.0	-3.0	68.0
Credit Ag.	3.8	1.4	29.4	-3.8	1.3	5.5	2.5	101.8	-7.6	56.7	3.5	2.9	152.0	-5.1	71.0
Credit Sui.	5.4	3.4	191.3	-5.8	87.2	4.8	3.2	186.5	-5.1	111.7					
Danske	2.4	1.2	39.6	-2.9	11.1	3.4	2.3	104.0	-5.3	41.9	7.0	3.5	231.6	-1.9	129.5
Deutsche	2.1	1.4	38.7	-3.6	13.1	4.0	3.2	175.2	-10.3	90.4	3.6	4.2	235.5	-8.6	74.7
DNB	3.7	1.8	54.9	-1.7	2.2	6.6	2.6	105.8	-5.5	54.3	5.2	1.7	128.6	0.2	79.1
HSBC	5.2	2.1	59.7	-5.4	27.3	4.2	2.0	105.4	-3.1	67.3	4.1	2.8	140.8	-6.7	81.6
ING	1.5	2.5	140.5	17.2	-25.4	5.0	2.5	98.6	-7.2	59.0	6.7	3.1	187.2	-2.0	109.4
Intesa	3.8	1.7	56.5	-5.0	22.2	3.2	2.7	137.9	-6.5	67.4	3.9	3.6	218.7	-3.4	59.7
Lloyds	2.6	1.5	26.6	-3.1	18.3	2.4	1.5	80.0	-2.9	55.6	5.7	2.6	186.1	3.5	142.1
Nordea	4.4	1.9	42.6	-4.8	31.8	6.3	2.5	80.4	-5.0	24.8	7.8	3.1			40.9
Rabobank	3.7	1.5	10.0	-5.8	3.1	5.1	2.3	74.5	-5.3	36.9	1.1	0.7	3.5	-3.7	2.9
RBS	2.8	2.8	135.4	-4.1	102.1	5.1	2.3	74.5	-5.3	36.9	1.1	0.7	3.5	-3.7	2.9
Santander	3.3	1.6	47.9	-5.3	23.2	4.7	2.4	100.4	-5.7	48.1	4.3	3.0	155.9	-6.8	70.2
San UK	2.7	1.6	36.4	-3.8	32.5	1.9	1.4	79.4	-3.4	50.9	4.3	3.0	155.9	-6.8	70.2
SocGen	4.7	2.1	73.4	-6.4	36.5	5.4	2.7	123.1	-6.7	65.1	5.4	2.6	203.2	-0.2	125.1
StanChart	4.4	2.0	53.9	-3.8	20.3	5.0	2.7	128.4	-5.1	78.3	5.7	3.6	229.4	-2.7	112.6
Swedbank	4.4	2.0	54.5	-4.5	12.8	4.7	2.4	97.8	-5.0	40.7	3.9	1.3	122.9	5.9	73.5
UBS	4.1	2.0	59.3	-3.8	35.9	4.1	2.2	89.3	-5.7	43.9	1.2	2.4	165.4	-18.2	102.6
UniCredit	3.8	2.7	138.2	-8.7	78.1	3.7	3.2	184.5	-9.3	92.8	6.5	4.4	316.7	-6.2	139.7

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.

Western European Banks USD Spreads and Yields

Aggregate USD Z-spread LTM (bps)



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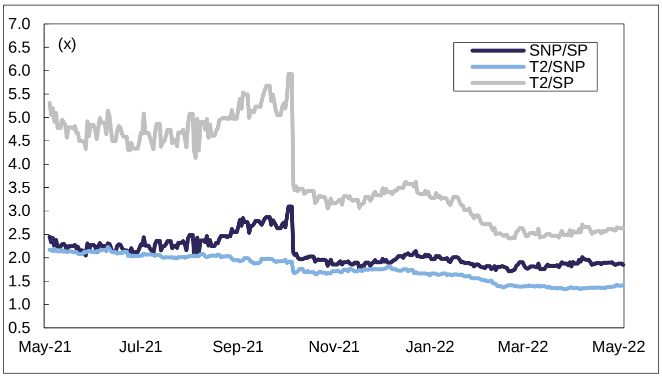

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Selected Names

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	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD	Dur.	Yield	Z	Z 5DΔ	Z YTD
Barclays	1.9					4.8	4.6	197.9	-18.8	69.1	5.2	5.2	262.3	-17.0	83.7
BFCM	3.5	1.8	53.0	-5.6	24.4	4.8	4.6	197.9	-18.8	69.1	5.2	5.2	262.3	-17.0	83.7
BNPP	2.5	1.8	42.9	-5.3	0.7	5.0	4.5	194.1	-15.7	84.8	4.2	4.8	196.7	-14.7	71.0
BPCE	3.6	1.8	47.2	-6.0	12.1	4.8	4.5	191.9	-11.4	78.6	3.0	5.3	263.4	-11.1	62.3
Credit Ag.	3.8	1.4	29.4	-3.8	1.3	3.7	4.3	170.2	-14.8	84.3	7.4	5.1	244.1	-16.0	88.5
Credit Sui.	2.4	3.7	106.9	-14.6	35.4	3.3	4.7	213.2	-13.6	113.1	1.2	4.4	167.3	-20.9	38.9
Danske	2.4	1.2	39.6	-2.9	11.1	2.2	4.2	169.1	-12.9	58.7	1.2	4.4	167.3	-20.9	38.9
Deutsche	2.1	1.4	38.7	-3.6	13.1	3.3	4.7	209.7	-15.7	108.9	7.6	6.4	370.3	-28.1	153.3
HSBC	5.2	2.1	59.7	-5.4	27.3	3.5	4.1	174.5	-16.7	74.0	8.8	5.3	262.5	-20.6	55.7
ING	1.5	2.5	140.5	17.2	-25.4	4.3	4.3	178.5	-13.8	57.2	1.9	4.2	170.5	-6.7	74.4
Intesa	3.8	1.7	56.5	-5.0	22.2	4.3	4.3	178.5	-13.8	57.2	3.2	6.5	377.3	-29.0	140.0
Lloyds	2.8					2.7	4.1	142.9	-17.0	62.7	8.4	5.1	236.3	-16.1	82.9
Nordea	4.4	1.9	42.6	-4.8	31.8	2.7	3.5	166.4	-4.5	58.4	7.4	5.4	288.2	-13.7	-13.7
Rabobank	3.7	1.5	10.0	-5.8	3.1	4.3	4.0	137.2	-13.6	42.4	3.7	4.7	200.3	-13.0	59.5
RBS	2.8	2.8	135.4	-4.1	102.1	4.3	4.0	137.2	-13.6	42.4	3.7	4.7	200.3	-13.0	59.5
Santander	3.3	1.6	47.9	-5.3	23.2	4.9	4.7	204.8	-15.4	82.8	7.2	5.3	267.6	-15.5	99.7
San UK	1.8	3.1	46.6	-26.6	3.3	4.3	4.5	182.1	-13.2	82.1	3.0	4.8	205.8	0.0	28.7
SocGen	4.7	2.1	73.4	-6.4	36.5	4.2	4.7	209.4	-12.8	87.1	3.5	4.7	206.0	-16.8	67.9
StanChart	4.4	2.0	53.9	-3.8	20.3	3.0	4.2	169.6	-9.4	77.6	8.4	5.5	280.1	-10.6	71.3
UBS	2.3	3.4	67.5	-8.8	30.2	4.4	4.3	177.2	-16.9	73.4	8.4	5.5	280.1	-10.6	71.3
UniCredit	3.8	2.7	138.2	-8.7	78.1	3.9	5.1	213.8	-3.7	93.3	6.2	7.2	457.5	-14.5	168.6

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.

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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