European Banks – Credit Update

- Lower securities exposure and higher cash balances limit contagion risk for European banks, while Swiss regulator seeks to clarify steps taken in Credit Suisse intervention
- Market volatility surrounding Deutsche Bank not deemed justified given its recent clean-up act
- Primary market activity almost reduced to zero as issuers avoided adverse funding conditions while awaiting monetary policy decisions by the Fed and BoE. Secondary market spreads tightened in EUR and to a lesser degree in USD following regulatory assurances in Europe and the U.S.

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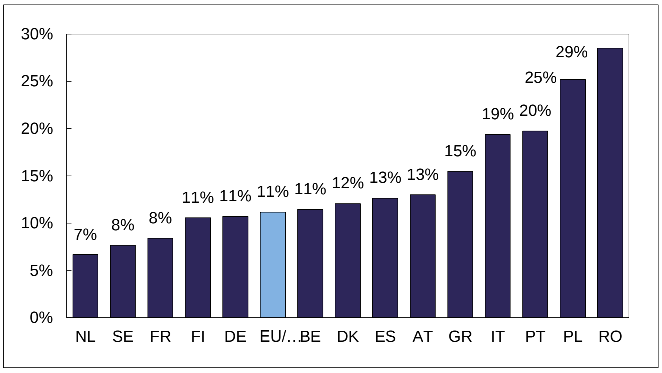
Lower securities exposure and higher cash balances limit contagion risk for European banks

The demise of SVB, Signature Bank and Credit Suisse have severely disrupted global financial markets in recent weeks but regulators and policymakers have arguably promptly responded to the crisis in an effort to mitigate ripple effects into the rest of sector. The sudden collapse of these institutions highlighted that the main threats to the banking system stems from funding and liquidity conditions and not necessarily from credit and capitalisation as was the main supervisory concern of the past decade. All three banks were adequately capitalised and underlying credit quality was generally sound but a loss of confidence by the market in these institutions ultimately removed them from the banking landscape.

The rapid pace of central banks interest rate adjustments in response to inflationary pressure has had diminishing effects on the value of bank's securities holdings. In the case of SVB, the deterioration of its bond portfolios contributed to its demise as losses mounted on its balance sheet. Based on data gathered from the EBA's risk dashboard, we can see that European banks' balance sheets are less exposed to debt securities than their U.S. counterparts. Total debt securities account for just 11% of EU banks' total assets compared to 24% in the U.S. Of these, 40% comprise of government debt securities versus 80% government and agency securities for U.S. banks. This structural difference was enhanced by the ECB's TLTRO programme that resulted in European banks placing considerable amounts of cash with the central bank, some of which was to be used to eventually repay cheap ECB funding. Additionally, these high cash balances, which account for 16% of total assets, also mean that banks are less likely to sell off their securities portfolios during periods of stress, thus limiting realised losses. Moreover, the ECB and BoE also have contingent liquidity facilities in place, which can be used by banks if required, further reducing liquidity risks. Nevertheless, as reassuring as these mitigants may appear, they cannot completely remove the risks that confidence driven bank runs entail.

Banks debt securities as % of Total Assets – 3Q22



Source: European Banking Authority (EBA); by country

FINMA defends decision to write-down Credit Suisse AT1

Last week, Swiss banking regulator FINMA published a statement about the basis for writing down Credit Suisse's AT1 capital instruments, as it felt compelled to clarify its decisions following numerous enquiries on the matter. Indeed, there was a degree of confusion immediately after it had written down the notes, especially since FINMA stated just four days prior that Credit Suisse met all capital and liquidity requirements imposed on systemically important banks. Key indicators appeared solid, the group had a regulatory capital ratio of 14.1%, ahead of its 13% target, and a liquidity coverage ratio (LCR) of 144%. However, what was of concern to the Swiss regulator were significant deposit outflows observed since 4Q22 (37% of the total). This trend accelerated in 1Q23 and according to a recent article by the Financial Times, more than CHF10bn were leaving Credit Suisse per day in March. At that point, it was clear that under the current group structure the business was not viable. FINMA then saw two critical conditions met. Firstly, the CHF50bn in extraordinary liquidity assistance already provided was likely not sufficient to stem the significant deposit outflows that were undermining the lenders liquidity position. This enabled the second factor, which was the triggering of the 'Viability Event' clause of Credit Suisse's AT1 documentation. This was possible under the Swiss Capital Adequacy Ordinance (CAO; Art. 29), stipulating the full write-down of AT1 instruments prior to a bank's support by public authorities. Since extraordinary government support was already granted and the regulator deemed the lender's situation to be rapidly deteriorating, it was decided to write down Credit Suisse's AT1s in their entirety.

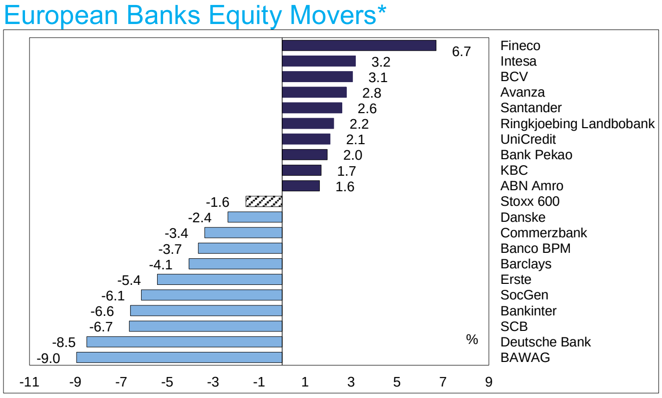
We expect there to be legal challenges in response to FINMA's actions as it was reported that Credit Suisse's AT1 bondholders are currently seeking legal advice on the matter. However, the handling of the situation also opens up a debate on the Swiss regulatory treatment of such investors. Unlike equity holders, AT1 investors have little to no input on bank strategy but they were forced to bear maximum losses. Nevertheless, we maintain our view that while AT1 instruments are clearly riskier than other forms of bank debt, they should be considered less risky when compared to equity. The comprehensive set of actions taken by Swiss authorities may have ensured financial stability domestically but European and UK supervisory entities were quick to try to undo the uncertainty created around AT1 instruments. A joint-statement by the SRB, EBA and ECB and a statement by the BoE sought to affirm the loss absorption hierarchy established in their respective resolution frameworks, stating that AT1 instruments still rank ahead of common equity and behind Tier 2 instruments in their jurisdictions.

Why Deutsche Bank is not the next Credit Suisse

The fallout from the recent bank collapses has shone a spotlight on other lenders that may be susceptible to a loss in confidence. One bank that was particularly affected by speculation last week was Deutsche Bank that saw its stock price decline by more than 13% on Friday before recovering somewhat in later trading, while the price of its 5-year CDS also increased 13% to 203.8. It is not clear cut what caused the pressure on the share price and CDS but likely a combination of several factors. The relative stability that FINMA's intervention awarded the UBS acquisition, and the broader financial sector for that matter, was possibly seen to come under attack by the prospect of legal action. This stoked concerns of further volatility in the market. In addition to this, Deutsche Bank's lengthy restructuring programme, which went through various iterations, has often been touted as a blueprint for what could be expected of Credit Suisse in the years ahead. There are however fundamental differences between the two institutions in this regard, as Deutsche completed its reorganisation during a much more benign operating environment. Credit Suisse wasn't awarded that same luxury as it embarked on its restructuring on the back of several scandals and missteps and a period of more restrictive monetary policy which ultimately destabilised parts of the financial sector.

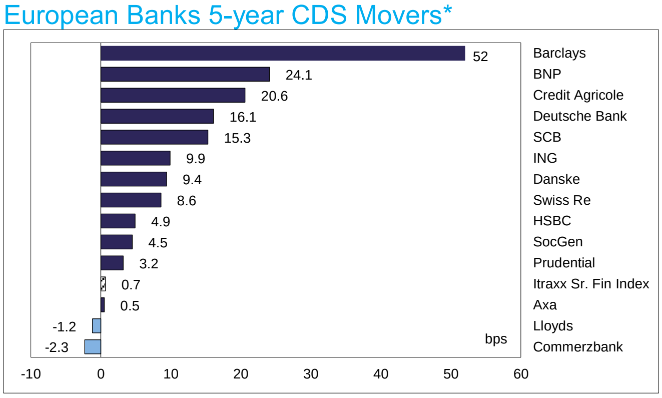
The approximation of both entities after the matter does a disservice to where Deutsche stands today, having recently reported its 10th consecutive quarters of profitability. It closed 2022 with its highest net income result (EUR5.5bn) since 2007 compared to combined losses of CHF8.9bn at Credit Suisse over the past two years. The German bank has also not been reported to be haemorrhaging deposits, as was the case at SVB or Credit Suisse and it has not sought extraordinary liquidity support. In fact, it sought to reassure markets of its financial standing by announcing its intention to redeem its USD1.5bn 2028 Tier 2 note (callable May 24th) at the full principal amount together with accrued interest. The early redemption notice came on the first day Deutsche was permitted to make such a statement, underlining its intent. Deutsche undoubtedly has its own set of challenges to overcome as it carries forward a heightened cost base as reflected in its high cost-to-income ratio (75% compared to sector average of 60%), which suggests a degree of operational inefficiency. Ongoing reliance on its FICC trading franchise and the prospect of diminishing returns in its retail franchise despite the heightened rates environment are partially offset by the fact that Deutsche today is a significantly less leveraged entity compared to a few years ago.

European Banks Equity Movers*



*Source: Bloomberg, *Between 20.03.23-24.03.23*

European Banks 5-year CDS Movers*



Source: Bloomberg, spread change from week low to week high

Primary and secondary markets

European **primary market** issuance volumes for SSAs stood at EUR0.5bn over the course of last week, well below market expectations of EUR3-7bn. FIG supply of EUR0.1bn was also below the weekly forecast amount of EUR2-5bn. The total 2023 year-to-date FIG volume of EUR208bn is 19.5% ahead of last year's issuance volume. SSA volumes are also ahead of last year's level, up 11.6% at EUR236bn. For the current week, survey data suggest SSA volumes will range between EUR8-12.5bn and FIGs are expected to issue EUR5-9bn.

Primary market activity for **SSAs and FIGs** almost came to a complete standstill as markets reeled from the initial SVB, Signature Bank and Credit Suisse fallout. Despite markets slowly coming to terms with the recent turbulence and risk indicators retreating, issuers opted to stay away from new deals, especially as they awaited difficult monetary policy decisions by the Fed and BoE last week.

(Table 1) Key Transactions

Bank	Rank	Amount	Maturity	Final Spread (bps)	IPT (bps)	Book Orders
SSA						
Lower Saxony	Sr. Unsecured	EUR500m	5Y	MS - 9	MS - 9	>EUR500m

Source BondRadar, Bloomberg;

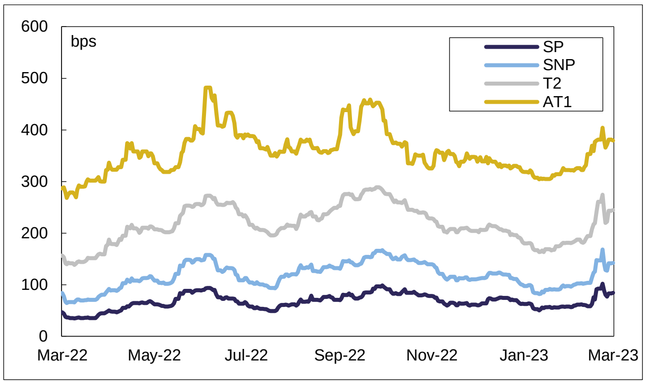
Secondary market spreads were mostly tighter last week for EUR and USD, while CDS indices on European senior (114bps) and subordinated financials (216bps) as measured by iTraxx benchmarks priced -3bps and +/-0bps against the previous week's levels.

Last week's monetary policy decisions were fine balancing acts by policymakers. The actions taken by the Federal Open Market Committee signalled that policymakers remained focused on reducing inflation, while remaining aware of the risks generated by recent events in the banking industry and are monitoring developments, but they see risks as contained for now. Thus, Fed officials took additional steps to limit price pressures (a dovish 25bps hike in the target range for the federal funds rate to 4.75% to 5.00%). In the UK meanwhile, the BoE slowed the pace of tightening to 25bps, taking the Bank Rate to 4.25%. The Committee left the door open to further tightening ahead, maintaining its forward guidance that "If there were to be evidence of more persistent [inflationary] pressures, then further tightening in monetary policy would be required." But we see no further rate hikes from the BoE. Admittedly, it also noted that the Financial Policy Committee (FPC) judged the UK banking sector to be resilient to recent developments in the US and Switzerland.

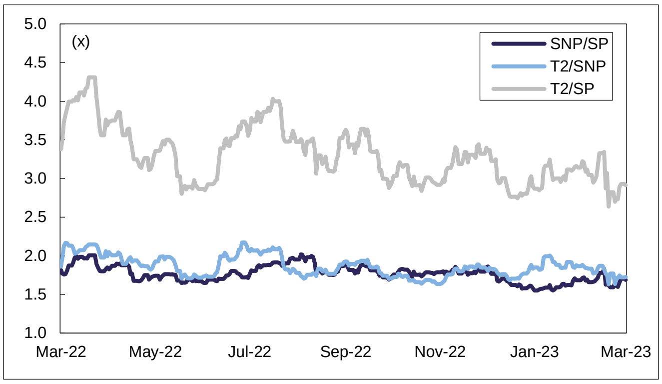
Weekly average EUR spreads were tighter with SP (-16.1bps), SNP (-23.2bps) and Tier 2 (-30.1bps). USD average spreads were wider for SP (+3bps), but tighter for SNP (-8.2bps) and Tier 2 (-3.5bps). Based on Bloomberg data, 90% of FIG tranches and 56% of SSA tranches issued in March quoted wider than launch.

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.

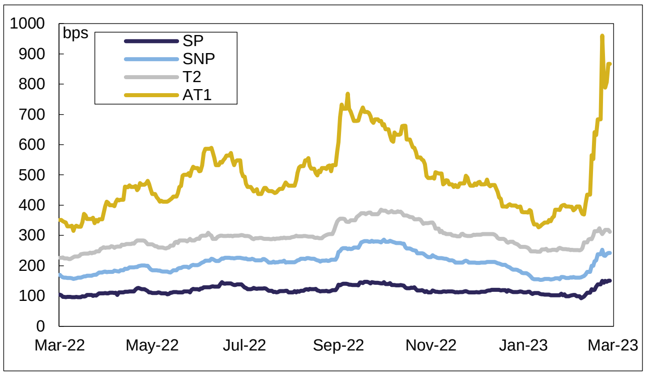
Selected Names

	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	3.2	4.2	106.9	-1.9	52.9	3.4	5.3	204.7	-20.7	38.2	2.8	6.3	289.5	-36.9	120.0
Barclays	1.2	3.7	15.1	-23.1	41.8	3.5	5.0	195.7	-35.2	20.1	7.2	7.0	370.2	-42.5	52.9
BBVA	3.7	3.9	75.9	-32.5	11.5	3.4	4.1	93.6	-30.6	29.5	3.6	5.8	214.9	-59.6	57.0
BFCM	4.3	3.9	77.4	-16.3	22.9	5.9	4.4	146.3	-26.1	38.2	5.6	5.0	200.5	-46.3	57.2
BNPP	3.8	3.9	67.7	-16.2	16.3	4.7	4.4	138.5	-25.8	18.1	3.4	4.9	181.5	-50.3	50.8
BPCE	3.8	3.9	82.3	-27.0	22.1	4.6	4.5	146.4	-28.3	26.5	8.6	5.8	203.9	-53.5	46.3
Credit Ag.	3.7	3.9	74.1	-25.5	12.3	4.6	4.3	128.2	-28.6	23.9	2.9	4.3	102.2	-14.1	3.9
Credit Sui.	4.6	4.4	121.1	-18.1	-68.6	4.1	6.5	323.6	-142.3	-99.5					
Danske	2.4	4.0	69.4	-17.1	-11.6	3.7	4.5	135.1	-25.6	6.4	6.2	5.9	247.7	-36.7	5.8
Deutsche	2.1	4.8	156.6	9.3	67.8	4.1	6.4	322.3	-10.2	137.4	4.3	9.2	547.4	40.5	356.1
DNB	3.3	3.6	49.8	-9.4	-4.5	4.7	4.0	92.7	-20.0	13.6	5.8	5.1			
HSBC	4.3	3.5	39.2	-10.0	11.5	3.7	4.3	138.8	-21.8	18.6	4.0	4.9	183.7	-56.4	35.8
ING	2.4	7.4	409.9	15.5	108.2	4.8	4.5	138.2	-26.8	37.4	6.0	5.9	257.6	-43.4	38.7
Intesa	3.4	4.1	81.5	-22.4	4.9	3.9	4.9	183.0	-17.2	37.4	3.8	5.1	180.8	-12.4	39.9
Lloyds	1.8	3.8	43.3	-20.3	24.0	3.0	4.2	94.1	-28.9	17.5	4.9	7.0	307.1	3.3	-160.6
Nordea	3.5	3.7	51.4	-10.1	39.5	5.4	3.9	89.9	-25.5	31.1	6.8	5.1			
Rabobank	2.9	3.5	35.5	-3.9	29.0	5.2	4.1	114.2	-26.0	16.9	6.4	5.4	228.3	-35.9	50.6
RBS	3.4	5.1	202.7	-16.6	17.5	5.2	4.1	114.2	-26.0	16.9	6.4	5.4	228.3	-35.9	50.6
Santander	2.6	4.0	70.4	-28.3	14.0	3.9	4.2	126.1	-30.8	29.5	3.5	4.8	164.2	-68.3	58.4
San UK	1.9	3.7	34.8	-3.5	25.9	3.3	5.2	208.0	-21.1	13.7	3.5	4.8	164.2	-68.3	58.4
SocGen	4.2	3.9	84.2	-17.4	9.2	5.0	4.6	156.4	-18.9	23.3	6.9	6.3	299.2	-37.6	52.6
StanChart	3.5	3.9	83.1	-17.3	-9.3	4.5	4.8	164.2	-21.7	9.1	4.9	6.0	272.1	-45.6	-24.7
Swedbank	3.0	3.9	70.7	-15.6	21.6	4.0	4.5	145.1	-12.3	31.6	7.6	5.7	266.5	-30.4	33.2
UBS	3.2	3.9	84.2	-37.1	19.9	4.5	4.8	165.0	-52.7	49.5	2.9	38.3			-106.4
UniCredit	3.3	4.4	129.3	-17.3	-9.4	3.2	5.4	224.4	-18.5	17.9	5.7	7.6	437.8	-140.8	58.4

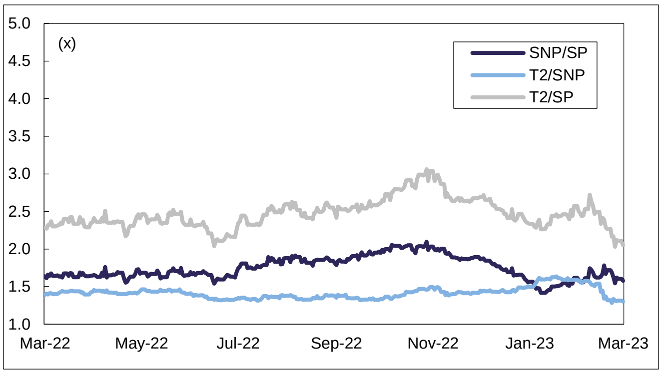
Source: Bloomberg, Daiwa Capital Markets Europe. Dur.= Duration. Yield= Yield to worst (%). Z = Z-Spread to Worst (bps). Z 5DΔ = last 5 days Z-spread net change (bps). Z YTD = year to date Z-Spread net change (bps). Blank cells represent lack of statistically significant data. Figures may not be representative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

Western European Banks USD Spreads and Yields

Aggregate USD Z-spread LTM (bps)



Multiples (x)



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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	1.1					3.8	6.3	269.1	-25.3	26.8	4.9	7.1	338.9	-11.8	22.3
BFCM	4.3	3.9	77.4	-16.3	22.9	3.1	6.6	265.8	-6.3	56.8	4.9	7.1	338.9	-11.8	22.3
BNPP	3.8	3.9	67.7	-16.2	16.3	4.4	5.8	237.6	-12.1	37.9	3.5	6.3	245.8	2.6	45.4
BPCE	3.8	3.9	82.3	-27.0	22.1	4.1	6.1	249.1	-7.2	20.3	2.7	7.0	367.2	-6.7	8.8
Credit Ag.	3.7	3.9	74.1	-25.5	12.3	3.2	5.8	195.9	-9.0	30.4	6.8	6.2	283.3	-14.3	-6.8
Credit Sui.	1.8	7.8	326.7	0.0	28.8	3.6	8.2	392.4	-88.3	-86.9	2.3	10.3	607.7	-4.3	62.2
Danske	2.4	4.0	69.4	-17.1	-11.6	2.9	6.1	188.2	-3.8	-4.1	2.3	10.3	607.7	-4.3	62.2
Deutsche	2.1	4.8	156.6	9.3	67.8	2.9	7.8	407.8	0.0	94.9	7.0	10.6	609.4	-5.6	192.9
HSBC	4.3	3.5	39.2	-10.0	11.5	3.8	6.1	239.7	-22.4	18.6	8.6	6.4	306.5	-12.7	-2.9
ING	2.4	7.4	409.9	15.5	108.2	3.5	5.6	212.4	-16.5	20.5	8.6	6.4	306.5	-12.7	-2.9
Intesa	3.4	4.1	81.5	-22.4	4.9	7.0	8.1	471.9	-50.4	37.6	4.7	9.2	584.5	-0.7	137.8
Lloyds	2.0				0.0	3.6	6.0	227.5	-15.9	32.6	6.6	6.7	309.7	-5.4	19.7
Nordea	3.5	3.7	51.4	-10.1	39.5	3.6	5.4	178.8	2.4	33.7	6.7	6.1			
Rabobank	2.9	3.5	35.5	-3.9	29.0	3.9	5.5	182.6	0.0	19.1	7.4	5.8	189.4	1.9	15.6
RBS	3.4	5.1	202.7	-16.6	17.5	3.9	5.5	182.6	0.0	19.1	7.4	5.8	189.4	1.9	15.6
Santander	2.6	4.0	70.4	-28.3	14.0	4.2	6.0	236.3	-21.0	27.2	6.5	6.7	334.4	-13.6	41.4
San UK	1.2					3.9	6.3	248.0	1.6	0.3	2.3				
SocGen	4.2	3.9	84.2	-17.4	9.2	3.7	6.6	280.8	0.0	33.8	7.2	7.4	405.8	7.6	70.0
StanChart	3.5	3.9	83.1	-17.3	-9.3	2.6	6.2	204.2	-2.4	6.7	8.8	6.7	328.6	0.1	23.8
UBS	2.4	6.2	154.0	-24.1	72.9	4.0	6.2	259.0	-32.5	67.3	8.8	6.7	328.6	0.1	23.8
UniCredit	3.3	4.4	129.3	-17.3	-9.4	3.2	6.8	218.3	0.0	11.0	7.0	9.3	580.3	1.2	58.0

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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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