Daiwa Capital Markets

European Banks – Credit Update

- Italy windfall tax softened after announcement caused market volatility
- Primary market activity in the summer break surprised with a number of senior trades among FIGs as well as subordinated trades from high quality Swedish and French issuers
- Secondary market spreads were mostly wider for EUR and USD affected by market moves from the surprise Italian bank tax announcement. The Tier 2 segment remained robust and improving the most, encouraging further issuance

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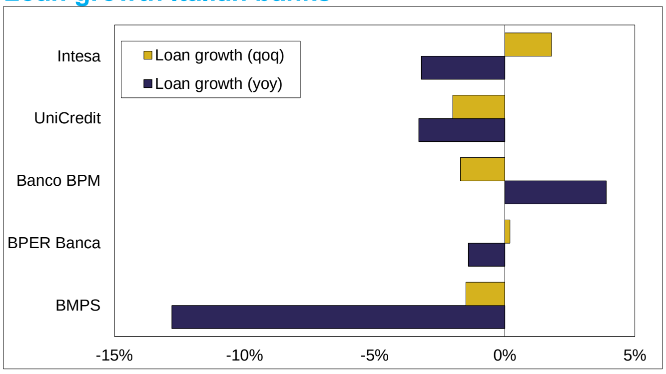
Italy's windfall tax on banks likely to raise risk premiums

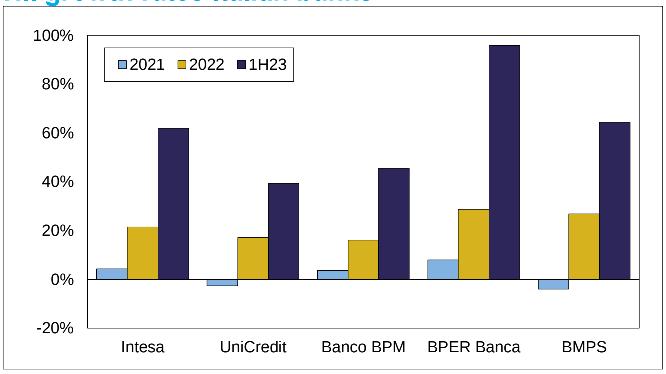
Last week Monday, the Italian government announced plans for a one-off windfall tax of 40% on 'extraordinary bank profits' that refers to the portion of domestic banks' 2022 net interest income (NII) that is 5% in excess of its 2021 NII, or the portion of 2023 NII that is 10% in excess of 2021 levels, whichever is greater. The unexpected announcement and the rather opportunistic definition of what constitutes an 'extraordinary profit' in an environment of rapidly rising interest rates resulted in significant volatility in the share prices of affected banks. In response to market uproar, the Italian finance ministry softened the language the following day and capped the tax at 0.1% of each bank's 2022 total assets. The tax is expected to come into force at the beginning of 2024 and will not be deductible from corporate tax. We looked at the country's five largest banks by assets at 2Q23 – Intesa Sanpaolo (EUR955bn total assets), UniCredit (EUR827bn), Banco BPM (EUR198bn), BPER Banca (EUR143bn), and Banca Monte dei Paschi di Sienna (EUR121bn) – and estimate that the new law could affect 55-60% of the banks' 2022 NII given observed NII growth rates in recent years.

Loan growth Italian banks



Source: Bloomberg;

NII growth rates Italian banks



Source: Bloomberg

However, in addition to the above, when estimating the impact on Italian banks we also need to consider their international footprints. While the majority are primarily domestically focused, UniCredit for example has significant operations in Germany, Austria and Central and Eastern Europe (CEE), which implies that the affected portion of UniCredit's total 2022 NII is around 35%. Given the strong interest income growth rates, we expect most banks to benefit from the balance sheet cap of 0.1%. Looking ahead, we don't expect the tax to materially affect Italian banks' profitability for 2023 but in the short to medium term this form of haphazard government intervention will likely impact risk premiums on Italian banks in anticipation of future intervention, thus raising funding costs. Lending volumes are also not expected to be strongly impacted by the tax as economic activity and associated lending activity was already low. The decline in credit demand is already underway, as suggested by recent lending surveys conducted by Banca d'Italia. Similar windfall taxes have been introduced in other European countries, such as Spain, Hungary, the Czech Republic and Lithuania. Spain adopted its bank tax in November 2022 and intends to raise EUR3bn by end-2024. The levy imposes a 4.8% charge on NII and net commissions income applicable to banks with a taxable income above EUR800m or that are supervised by the ECB.

Primary and secondary markets

European **primary market** issuance volumes for SSAs stood at EUR1bn over the course of last week, in line with market expectations of EUR1-3bn. FIG supply of EUR2.1bn was also in line with the weekly forecast amount of EUR1.5-3bn. The total 2023 year-to-date FIG volume of EUR388bn is 15.6% ahead of last year's issuance volume. SSA volumes are also ahead of last year's level, up 21.1% at EUR445bn. For the current week, survey data suggest SSA issuance volumes will range between EUR1-3bn and FIGs are expected to issue EUR2-5bn.

Among **SSAs**, a handful of deals made it to market despite the slower summer trading months. The highly rated German **state of Schleswig-Holstein** made its outing with an upsized EUR750m, 10-year deal that was covered by EUR890m in orders. Spreads tightened by 1bps, flat to mid-swaps leaving no concession on the table. On the same day, **Municipality Finance** issued a GBP250m, 4-year bond with a spread of 60bps over gilts, in line with initial guidance. The short tenor and relatively small issuance volume allowed the deal to price inside secondary market levels of comparable transactions.

(Table 1) Key Benchmark Transactions

Bank	Rank	Amount	Maturity	IPT (bps)	Final Spread (bps)	Book Orders
SSA						
IBRD	Sr. Unsecured (SDB Tap)	NZD500m	Feb-2028	MS + 30	MS + 30	n.a.
Land Schlesw. Holst.	Sr. Unsecured	EUR750m	10Y	MS + 1	MS +/- 0	>EUR890m
Municipality Finance	Sr. Unsecured	GBP250m	4Y	G + 60	G + 60	>GBP280m
IFC	Sr. Unsecured (Green)	CAD1bn	3Y	CORRA + 15	CORRA + 14	>CAD1.3bn
FIG (Senior)						
HSBC	Sr. HoldCo	USD2.3bn	4NC3	T + 170	T + 145	>USD5.65bn
HSBC	Sr. HoldCo	USD700m	4NC3	SOFR MS	SOFR MS + 157	>USD2.1bn
ANZ Bank	Sr. OpCo	USD1bn	5Y	T + 150	T + 120	>USD3.8bn
BNP Paribas	SP	GBP750m	6NC5	G + 175	G + 155	>GBP1.6bn
FIG (Subordinated)						
BNP Paribas	AT1	USD1.5bn	PNC5	9.0%	8.50%	n.a.
Svenska HB	Tier 2	EUR750m	11NC6	MS + 220	MS + 190	>EUR2.75bn
SEB	Tier 2	EUR500m	10NC5	MS + 210	MS + 190	>EUR1bn

Source BondRadar; Bloomberg; CAB = Climate Awareness Bond; SAB = Sustainability Awareness Bond; SDB = Sustainable Development Bond;

FIGs have been surprisingly active during this usually quiet period. Last week, **BNP Paribas** arguably made the most amount of noise with two transactions, a SP sterling and a dollar AT1. It was only the second time for the French bank to issue in sterling this year and the GBP750m, 6NC5 attracted strong interest (2.1x subscribed) that led to a final price of G+155bps. The 7bps new issue premium (NIP) was a strong outcome in light of generally slightly softening market conditions. This deal brings BNP's total sterling funding this year to GBP1.6bn across two senior unsecured trades compared with just GBP450m from a single SNP deal issued in 2022. The French issuer also hit markets with a USD1.5bn AT1, the first benchmark-sized hybrid instrument from a major European bank since the write-down of Credit Suisse's AT1s. BNP was able to improve pricing by 50bps to 8.5% despite a volatile environment for dollar issuance, brought on seemingly in part by the sovereign downgrade of the United States by Fitch at the beginning of August. However, BNP is primarily a USD issuer when it comes to AT1, as 10 of its 14 outstanding junior-subordinated instruments are dollar denominated. Generally speaking bank funding appeared unaffected by the downgrade as HSB and ANZ Bank both launched senior dollar transactions last week for a combined USD4bn. More subordinated debt supply came from **Svenska Handelsbanken** and **SEB**, both placing euro denominated Tier 2 bonds last week. SEB issued a EUR500m Tier 2 with a 10NC5 maturity at MS+190bps. Compatriot Handelsbanken also placed a Tier 2 bond that was larger at EUR750m and a with a longer maturity of 11NC6. The latter clearly proved popular with investors and generated an order book of 3.7x deal size. Spreads tightened to MS+190bps (-30bps from IPT) implying a NIP of 5-10bps. Considering both banks are similarly rated yet Svenska issued a larger deal with a longer maturity at the same price this should be seen as a strong outcome.

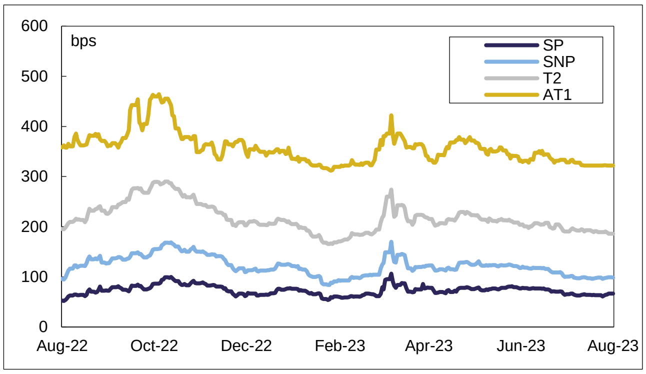
Secondary market spreads were mixed for EUR and USD. CDS indices on European senior (82bps) and subordinated financials (151bps) as measured by iTraxx benchmarks priced +2bps and +3bps against the previous week's levels.

Spreads in secondary markets were generally wider for EUR and USD. Italian bank bond spreads were adverse affected across payment ranks due to the sudden announcement of a windfall tax on extraordinary profits. Consequently euro-denominated SP bonds were widest in Italy (+6.7bps) followed by UK banks (+4.4bps), while SNP also saw strong widening among Italian names (+7.4bps) and French entities (+5bps). The picture was somewhat more nuanced among Tier 2s that registered modest tightening on average. The best performers were Danish entities (-2.1bps) while Finnish names were widest (+2.9bps).

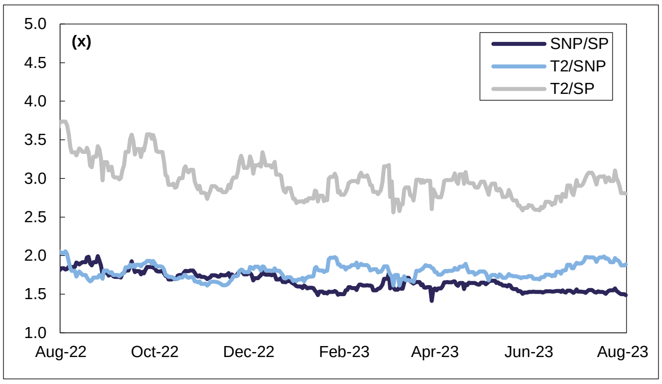
Weekly average EUR spreads were generally wider with SP (+3.7bps), SNP (+3.2bps) and Tier 2 (-0.1bps). USD average spreads were wider for SP (+3.0bps), but tighter for SNP (+0.1bps) while Tier 2 traded tighter (-1.5bps). Based on Bloomberg data, 67% of FIG tranches but none of the SSA tranches issued in August quoted tighter than launch.

Western European Banks EUR Spreads and Yields

Aggregate EUR Z-spread LTM (bps)



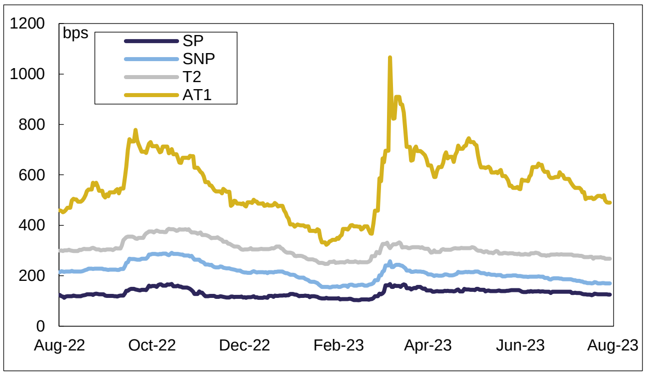
Multiples (x)



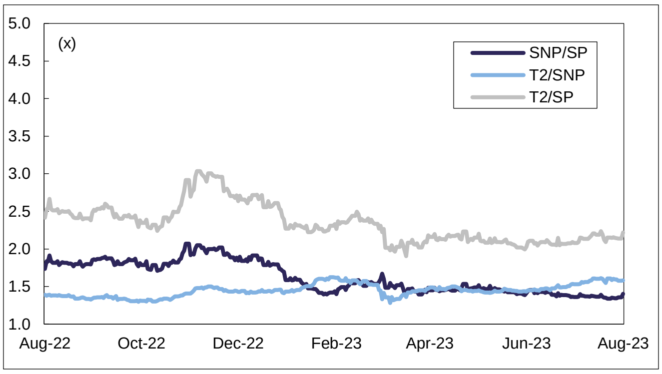
Source: Bloomberg, Daiwa Capital Markets Europe. SP = Senior Preferred/Senior OpCo; SB = Senior Non- Preferred/ Senior HoldCo; T2= Tier 2; AT1 = Additional Tier 1. All figures based on Z to worst spread of public benchmark issuances.

Western European Banks USD Spreads and Yields

Aggregate USD Z-spread LTM (bps)



Multiples (x)



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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%.

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- 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.

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