Asia Conference 2023: European Banks

Research 21 Jul 23, 08:30 AM Analysts:
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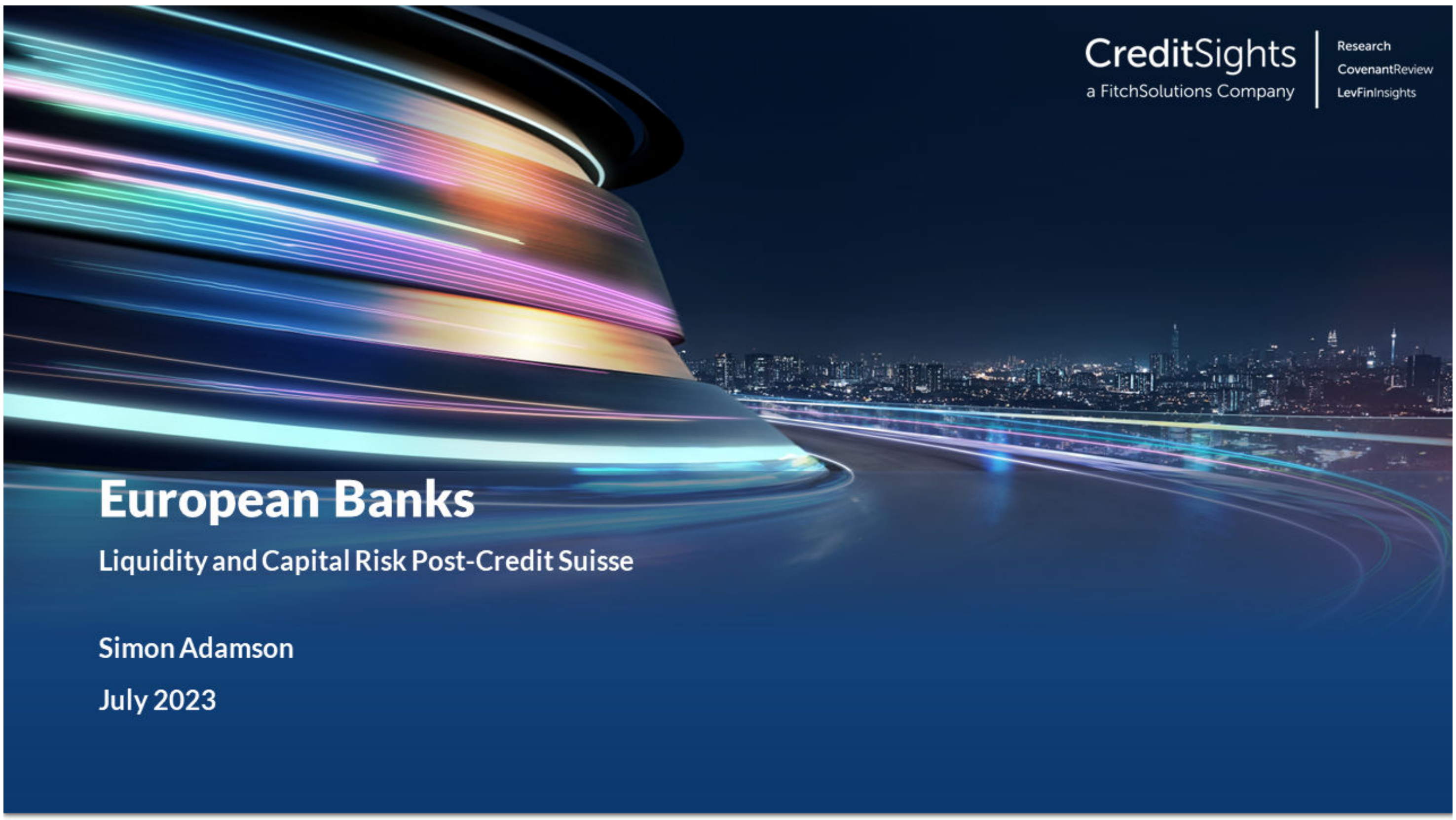
Executive Summary

- **CreditSights held its Asia Conference in Hong Kong and Singapore earlier this month.**
- **This is the transcript for the presentation "European Banks: Liquidity and Capital Risk Post-Credit Suisse".**



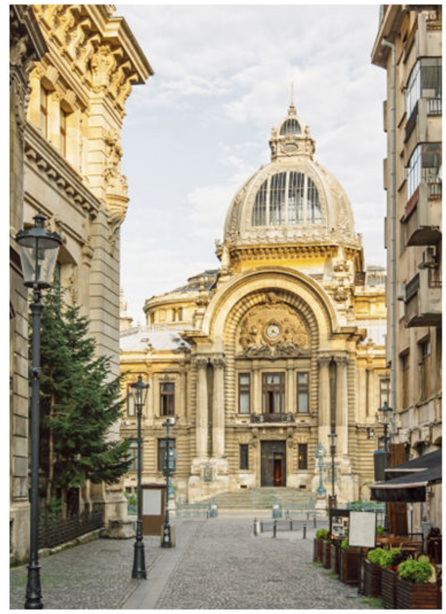
When I was in Singapore for the conference last year, I was looking at the implications for banks of the war in Ukraine. We're still dealing with the consequences of that, but of course there have been other dramatic events more recently.

The first six months of the year can be divided into BC – before Credit Suisse and AC – after Credit Suisse. So what I'm going to focus on today is whether the events at Credit Suisse, and indeed at some US regional banks, have implications for the wider banking sector in Europe.

Implications of Credit Suisse Failure

Concerns Raised By SVB/Credit Suisse

- Deposit outflows and liquidity measures
- Unrealised losses on holdings of debt securities
- Commercial real estate exposure
- Regulatory intervention in AT1s
- What does this mean for credit spreads?



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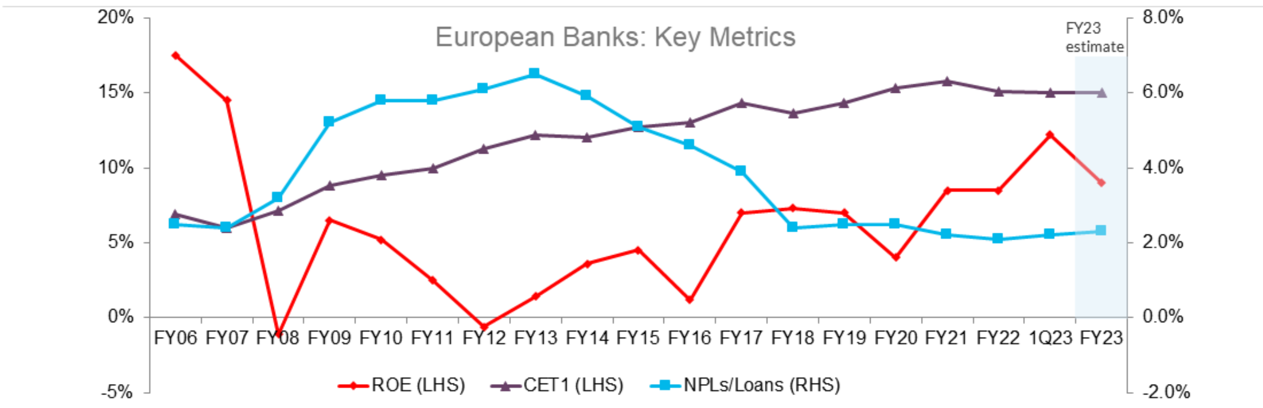
There are four areas where we're getting most questions at the moment:

- The potential for deposit outflows and whether liquidity management needs to be changed.
- The size of unrealised losses on holdings of debt securities as interest rates rise.
- Banks' exposure to commercial real estate.
- How the write down of Credit Suisse's AT1s will affect the wider AT1 market.

Finally, I'll take a look at the outlook for credit spreads.

Fundamentals Stable In 1Q23



- Credit metrics stable in 1Q23 – ROE boosted by rate rises and one-offs
- Expect ROE normalisation in rest of year, mild asset quality deterioration, stable capital

2 Source: Company reports, CreditSights Credit Metrics

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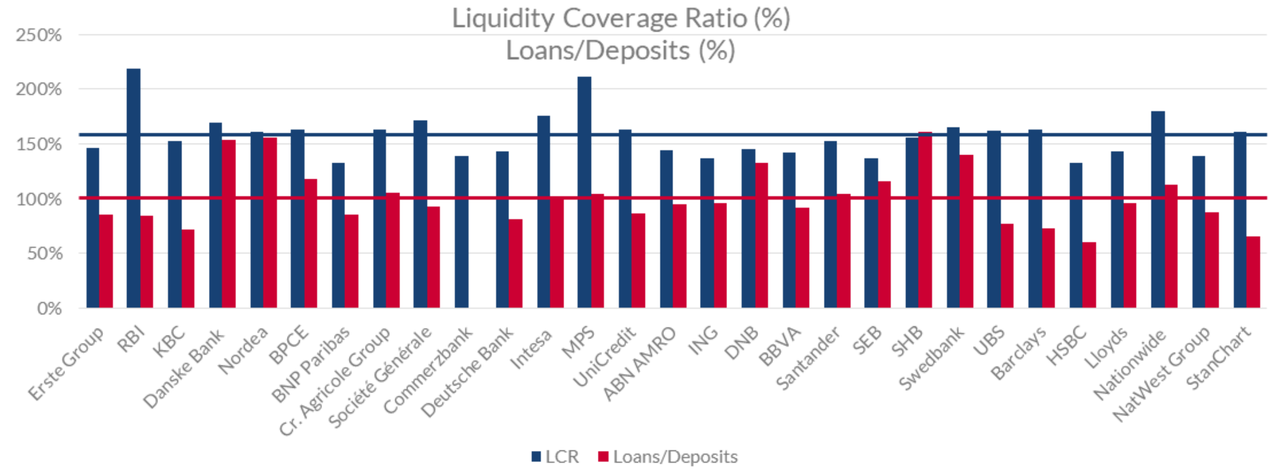
Let's start with fundamentals. This chart shows the development of three key credit metrics over the past few years, including the first quarter of this year. The shaded section shows our forecast for the full year. In general, capital, asset quality and profitability have been improving, and we expect these ratios to be broadly stable through the rest of the year. There was a jump in the average return on equity - the red line - in the first quarter, partly because of the revenue benefits from higher rates, but also partly reflecting some non-recurring profits. So if the fundamentals look solid - so far at least - where are the concerns coming from?

Liquidity Position



- Average LCR 157% - broadly unchanged in 1Q23
- Average loans/deposits ratio 101% - boosted by deposit inflows during pandemic

3 Source: Company reports, CreditSights Bank Capital Model

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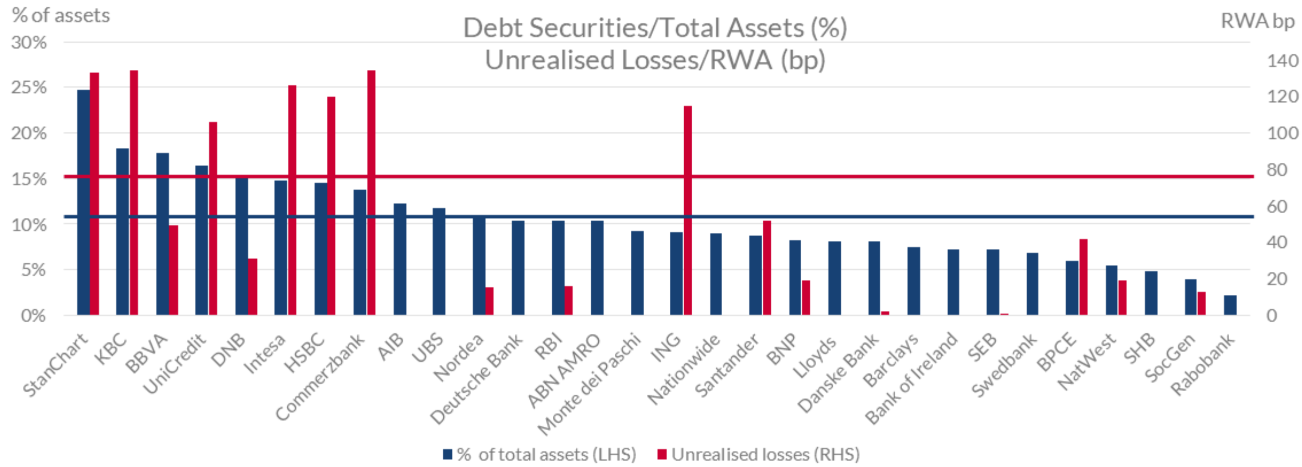
A feature of both Silicon Valley Bank and Credit Suisse was a massive outflow of deposits, and the natural question is whether we could see something similar at other banks. We think it's unlikely. Credit Suisse saw an unprecedented outflow in the fourth quarter of last year, as well as again in March this year in reaction to speculation about its financial health. Confidence also fell on the back of problems at some U.S. regional banks, but this was not a sudden decline - Credit Suisse had been struggling for a long time, and there was disappointment about its restructuring plan. Also, many of its deposits were linked to its wealth management business, including high net worth individuals and financial advisors who were quick to withdraw money as concerns grew. Only around 15% of its deposits were insured compared with the 60% to 70% average for European banks.

Incidentally, while insured deposits can often be a good indicator of deposit stability, you do have to be careful in using this data. For example, insured deposits at HSBC and Standard Chartered are a lower percentage even than at Credit Suisse, mainly because the deposit insurance limit in Hong Kong is much lower than in Europe or the US. You can see that the average liquidity coverage ratio in Europe is 157% compared with the 100% requirement - banks have kept this ratio higher than normal in this environment.

There are of course questions about the assumptions regarding stressed deposit outflows in calculating the LCR, and I think regulators will be taking a look at this over the next few months. But I think you should regard Credit Suisse as an outlier. While social media can help to spread rumours more quickly, and online banking makes it easier to move deposits around, runs on deposits only happen if a bank has serious fundamental problems. We think major European banks still look liquid, and while we think deposits will fall a little this year for various reasons, we see no sign of contagion from Credit Suisse.

Debt Securities Holdings



- Debt securities smaller on average as % of assets (11%) than at US banks (24%)
- Unrealised losses on amortised cost securities small as % of RWA (77 bp average)

4 Source: Company reports, CreditSights

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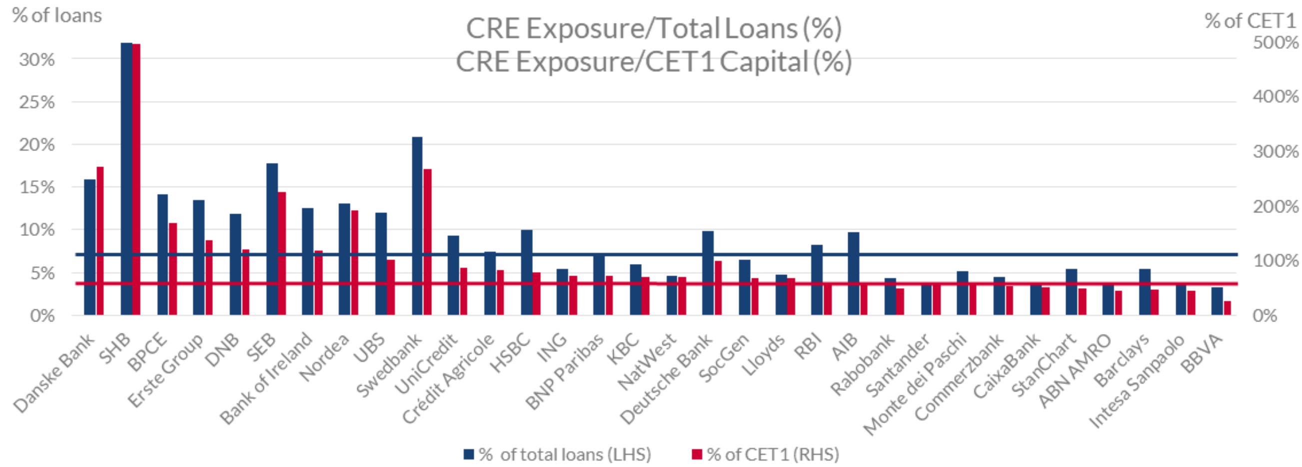
One concern for SVB and other US regional banks was the high level of unrealised losses on their holdings of debt securities. We don't see this as so much of an issue for European banks. This chart shows debt securities as a percentage of total assets (the blue bars) and unrealised losses on securities held at amortised cost in relation to risk weighted assets. As you can see, on average, debt securities are around 11% of total assets, less than half the level at US banks. Most are held at fair value, meaning unrealised losses are already captured in regulatory capital. Unlike for the US regionals, there is no opt-out for fair value losses. Unrealised losses on securities held at amortised cost are equivalent to less than 80 basis points of risk weighted assets. And remember that banks’ liquidity is concentrated in deposits with central banks, so the risk of them having to sell securities and realise losses is small.

Commercial Real Estate Exposure



- Nordic banks much higher than average – but underlying CRE exposure much smaller
- Average 7.5% of total loans – generally low LTVs, little sign of stress so far

5 Source: EBA Transparency Exercise, company reports, CreditSights

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The commercial real estate sector in Europe has a volatile track record and is one of the sectors most sensitive to rising interest rates and economic weakness. For that reason, we expect non-performing loans and credit losses to increase this year. However, we have seen little sign of stress in banks' loan books so far.

Much of the concern has been generated by problems in the US property market. At the moment vacancy rates in Europe tend to be much lower than in the US, although this might change. This chart uses the data for the category 'Real Estate Activities' reported by the EBA. However, many banks themselves report a lower number for commercial real estate. The average exposure is about 7.5% of total loans, and we think true commercial real estate lending is lower than that. This is much lower than in the past - since the global financial crisis, European banks have reduced their exposure to commercial real estate significantly.

You'll notice that Nordic banks, in particular the Swedish banks, have much higher than average exposure in relation to their loan books. However, in most scenarios we expect the Nordic banks' exposures to be manageable, and we don't expect the challenges faced by Swedish property companies to have a major impact on the bank's creditworthiness and their solid financial metrics, despite the headlines, as there are mitigating factors. We know the banks have been monitoring their exposures closely, pushed by their regulator to do so, and have made projections for interest coverage and other measures related to their exposures based on higher interest rates in 2023. None of them are reporting widespread problems in their commercial real estate portfolios, and realised losses remain low. Usually the banks exposures are secured and are based on moderate loan to value ratios, but their lending decisions don't just rely on this - taking possession of security is the last resort, not the first. Before that, they will be relying on cash flow and the companies' active efforts towards restructuring. As it happens, Stage 3, or credit impaired, loans are smaller as a percentage of commercial real estate loans at the Swedish banks than at any other European banks.

Regulatory Reaction to Credit Suisse AT1 Write-down

- Statement by ECB, SRB and EBA
- “common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down”
- “Additional Tier 1 is and will remain an important component of the capital structure of European banks”
- Statement by Bank of England
- “AT1 instruments rank ahead of CET1 and behind T2 in the hierarchy. Holders of such instruments should expect to be exposed to losses in resolution or insolvency in the order of their positions in this hierarchy”
- Residual investor concerns
  - AT1s are designed to absorb losses before CET1 instruments (triggers)
  - Some European regulators are known to question the value of AT1 capital
  - Governments may change the law overnight (as in Switzerland)

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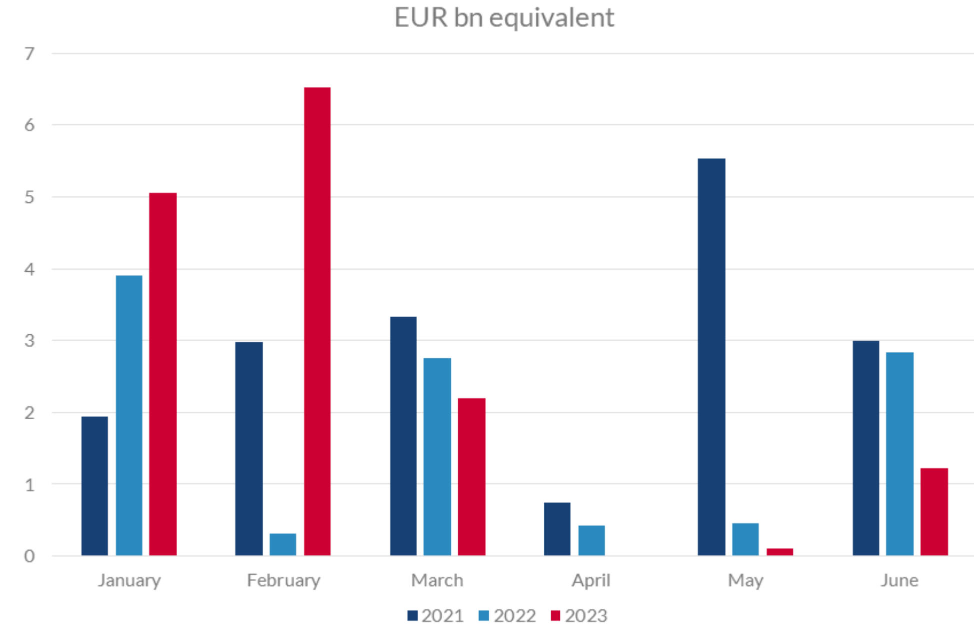
The statements on this slide were made by European regulators the day after the write-down of Credit Suisse’s AT1s. They helped to calm the AT1 market and were widely seen as expressing disapproval of FINMA's actions. It's certainly true that the Swiss framework for AT1s and for resolution are somewhat different to the rest of Europe. However, some scepticism persists - after all, AT1s are specifically designed to absorb losses on a going concern basis (in other words, before shareholders take losses), while some European regulators are known to have questioned the value in the longer term of AT1s in a bank's capital stack, and some investors are worried that if the Swiss authorities can amend legislation overnight to allow the write-down of AT1s, that could happen elsewhere. We do think European regulators are committed to the smooth running of the AT1 market, and investors should at least be reassured by that.

AT1 New Issuance



Year-to-date AT1 issuance (EUR equivalent)

- 2021: €17.5 bn
- 2022: €10.7 bn
- 2023: €15.1 bn

7 Source: CreditSights CoCo Database

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This chart shows year-to-date issuance in AT1s in 2021, 2022 and 2023. As you can see, there was virtually no issuance in April and May this year after the Credit Suisse write-down, until BBVA and the Bank of Cyprus reopened the market with euro deals in June. However, because of the heavy issuance in January and February, supply in the first six months of this year, totalling around €15 bn, was much higher than in the previous year and only a little below 2021.

So what's the outlook for the second half? It's notable that June's deals were euro denominated. Our sense is that US and Asian investors are still suspicious of European regulators, and although BBVA's deal was oversubscribed, it didn't perform very well on the re-offer. We think the market will recover, but it could take some time, and the summer is likely to be quiet. Deals will probably be sparse, and yields remain high in the short term. We see two main drivers of potential improvement in the AT1 market: continuing new issuance with strong demand, and banks redeeming bonds at the first call date.

AT1 Heatmaps

European Bank Excess Return Heatmap

	FY17	FY18	FY19	FY20	FY21	FY22	*YTD23*
EUR Senior	2.33%	-0.82%	2.79%	1.51%	0.65%	-0.74%	0.65%
EUR Sub-Senior	4.64%	-3.39%	6.38%	2.09%	0.80%	-1.82%	0.39%
EUR Tier 2	7.14%	-3.13%	8.34%	3.09%	2.69%	-1.20%	0.86%
USD Senior	2.36%	-1.20%	4.48%	0.79%	0.82%	-1.59%	-0.31%
USD Sub-Senior	4.25%	-3.14%	7.73%	2.10%	0.92%	-2.63%	0.59%
USD Tier 2	6.98%	-5.51%	14.05%	2.96%	2.39%	-3.63%	-0.38%
EUR AT1	15.70%	-5.20%	16.54%	8.28%	7.18%	-4.49%	-1.28%
EUR AT1 Core	15.18%	-4.78%	13.59%	6.21%	5.68%	-3.33%	-1.45%
EUR AT1 Periphery	16.65%	-5.89%	20.96%	8.94%	8.74%	-3.45%	0.94%
USD AT1	11.61%	-4.41%	13.03%	4.27%	5.84%	-4.13%	-2.71%
USD AT1 Core	12.35%	-4.93%	13.13%	3.50%	6.14%	-1.80%	-1.79%
USD AT1 Periphery	15.50%	-8.66%	22.07%	5.04%	7.18%	-1.08%	1.68%

Median spread multiple AT1/Tier 2: 4.0x
Through the cycle median: 3.0-3.5x

European Bank Excess Return Heatmap YTD

	Jan	Feb	Mar	Apr	May	*YTD23*
EUR Senior	0.05%	0.45%	-0.74%	0.25%	0.05%	*0.65%*
EUR Sub-Senior	-0.17%	0.15%	-0.74%	0.40%	-0.17%	*0.39%*
EUR Tier 2	0.38%	0.27%	-1.62%	0.23%	0.38%	*0.86%*
USD Senior	-0.19%	-0.21%	-0.53%	0.54%	-0.19%	*-0.31%*
USD Sub-Senior	0.04%	-0.06%	-1.49%	0.80%	0.04%	*0.59%*
USD Tier 2	-0.37%	0.14%	-3.27%	1.12%	-0.37%	*-0.38%*
GBP Senior	0.08%	0.00%	-0.49%	0.78%	0.08%	*2.12%*
GBP Sub-Senior	-0.09%	0.13%	-0.94%	1.40%	-0.09%	*1.67%*
GBP Tier 2	0.02%	-0.29%	-2.35%	2.07%	0.02%	*2.14%*
EUR AT1	1.96%	0.12%	-7.53%	1.24%	1.96%	*-1.28%*
EUR AT1 Core	*2.01%*	*-0.21%*	*-6.78%*	*0.69%*	*2.01%*	*-1.45%*
EUR AT1 Periphery	*1.73%*	*0.34%*	*-6.64%*	*1.90%*	*1.73%*	*0.94%*
USD AT1	1.30%	0.10%	-7.74%	1.42%	1.30%	*-2.71%*
USD AT1 Core	*1.31%*	*0.15%*	*-7.40%*	*1.33%*	*1.31%*	*-1.79%*
USD AT1 Periphery	*1.61%*	*-0.49%*	*-3.65%*	*1.37%*	*1.61%*	*1.68%*
GBP AT1	3.22%	0.24%	-8.88%	2.61%	3.22%	*-0.29%*

8 Source: ICE data, CreditSights

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This slide shows excess returns for different levels of bank debt. I've highlighted euro and dollar AT1s. The left-hand chart shows annual returns over the past seven years, while the right-hand chart shows monthly returns this year. In general terms, AT1s have been a good investment, producing very positive returns in four of the past six years.

As you would expect, excess returns this year have been negative, although perhaps not as much as you would imagine. Despite a very negative month in March, because of Credit Suisse obviously, the other months this year have produced positive returns, and there has been a mild recovery since April.

We also track spreads on AT1 versus Tier 2 and senior debt. In the past ten years, the median spread multiple of AT1 versus Tier 2 has almost always been between 3x and 3.5x. But just at the moment, it's around 4x, suggesting that spreads on AT1s have not recovered at the same pace as on other bank debt since March.

AT1 Extension Risk: Calls YTD

European Bank AT1s: 2023 Calls (1)

ISIN	Issuer	Ccy	Mn	Next call date	Coupon	Reset	Implied coupon	Next Calls	Price	Yield to Call	Yield to Perp	Extend Risk	Predict	
CH0400441280	UBS	USD	2,000	31-Jan-23	5.000%	USSW5YF + 243.2	6.60%	Annual	96.4	26.0%	5.8%	High	Call	Called
XS1571333811	Barclays	GBP	1,250	15-Mar-23	7.250%	BPISSD05 + 673.9	10.55%	5 years	99.9	7.5%	10.0%	Low	Call	Called
US404280BN80	HSBC	USD	2,350	23-Mar-23	6.250%	USISDA05 + 345.3	7.43%	5 years	95.4	21.6%	7.0%	High	Call	Called
US853254BH21	Stan Chartered	USD	1,000	02-Apr-23	7.750%	USSW5 + 572.3	9.72%	5 years	99.8	8.1%	9.1%	Low	Call	Called
ES0844251001	Ibercaja	EUR	350	06-Apr-23	7.000%	EUSA5 + 680.9	9.50%	Quarterly	95.4	22.4%	9.8%	n/a	n/a	Called
XS1808862657	Deutsche pbb	EUR	300	28-Apr-23	5.750%	EUAMDB05 + 538.3	8.10%	5 years	76.2	80.2%	10.0%	n/a	n/a	Not called
DE000A1TNDK	Aareal Bank	EUR	300	30-Apr-23	7.321%	EUAMDB01 + 718	10.59%	Annual	79.4	36.4%	13.3%	n/a	n/a	Not called
CH0411559377	*Raiff'n Schweiz*	*CHF*	*400*	*02-May-23*	*2.000%*	*SFSNT5 + 203.2*	*3.47%*	*Annual*	*99.5*	*3.2%*	*3.7%*	n/a	n/a	Called
XS1619015719	UniCredit	EUR	1,250	03-Jun-23	6.625%	EUSA5 + 638.7	9.08%	Semi-annual	99.5	7.8%	8.8%	Low	Call	Called
XS1640667116	**RBI*	*EUR*	*650*	*15-Jun-23*	*8.665%*	*EUSA5 + 595.4*	*9.01%*	*Semi-annual*	*85.5*	*147.7%*	*10.3%*	High	Non-call	Not called
XS1043552188	Lloyds	GBP	135	27-Jun-23	7.625%	BPSWS5 + 528.7	8.88%	5 years	101.9	4.4%	8.3%	Low	Call	Called

9 Source: CreditSights CoCo Database. Prices and yields at 25 November 2022.

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Much of that underperformance has been because of extension risk, which means that most AT1s are currently trading on a yield to perp basis rather than the usual yield to call. While these concerns are understandable, given that higher rates and wider spreads make calls less economic, we think the market is overstating the risk of non-calls. This slide shows AT1s that had a call date in the first half of this year. As you can see, the only bond not redeemed at its first call date was Deutsche Pfandbriefbank, which we don't cover. The other two non-calls were by Aareal Bank and RBI, which had not redeemed these bonds on their first call dates in previous years.

As you can see, we predicted that UBS and HSBC would both call their US dollar AT1s in January and March despite the market pricing in high extension risk. It's important to look at other factors as well as the economics of the call.

AT1 Extension Risk: Calls 2H23

European Bank AT1s: 2H23 Calls

ISIN	Issuer	Ccy	Mn	Next call date	Coupon	Reset	Implied coupon	Next Calls	Price	Yield to Call	Yield to Perp	Extend Risk	Predict
US06738EBA29	Barclays	USD	2,500	15-Sep-23	7.750%	USSW5 + 484.2	8.90%	5 years	97.1	21.4%	8.5%	Medium	Call
XS1880365975	CaixaBank	EUR	500	19-Sep-23	6.375%	EUSA5 + 622.4	9.51%	Quarterly	99.0	10.9%	9.3%	Low	Call
XS1882693036	HSBC	SGD	750	24-Sep-23	5.000%	SDSOA5 + 296.9	6.14%	5 years	99.5	7.0%	5.8%	Medium	Call
ES0813211002	BBVA	EUR	1,000	24-Sep-23	5.875%	EUSA5 + 566	8.95%	Anytime	98.9	10.4%	8.7%	Low	Call
XS1298431104	HSBC	EUR	1,000	29-Sep-23	6.000%	EUSA5 + 533.8	8.63%	5 years	99.4	8.3%	8.2%	Low	Call
XS1692931121	Santander	EUR	1,000	29-Sep-23	5.250%	EUSA5 + 499.9	8.29%	Quarterly	96.0	23.2%	8.2%	Medium	Call
ES0865936001	*ABANCA*	*EUR*	*250*	*02-Oct-23*	*7.500%*	*EUSA5 + 732.6*	*10.62%*	*Quarterly*	*97.4*	*18.7%*	*10.7%*	*n/a*	**n/a**
US83367TBV08	Société Générale	USD	1,250	04-Oct-23	7.375%	USSW5 + 430.2	8.36%	5 years	96.6	20.1%	7.9%	High	Call
CH0361532945	*Z Kantonalbank*	*CHF*	*750*	*30-Oct-23*	*2.125%*	*SFSNT5 + 212.5*	*4.03%*	*Annual*	*98.1*	*7.7%*	*4.1%*	*n/a*	**n/a**
CH0447353704	UBS	SGD	700	28-Nov-23	5.875%	SDSW5 + 360.5	7.10%	Semi-annual	98.7	8.9%	6.8%	Medium	Call
XS1640667116	**RBI*	*EUR*	*650*	*15-Dec-23*	*8.659%*	*EUSA5 + 595.4*	*9.24%*	*Semi-annual*	*89.3*	*35.0%*	*9.8%*	*High*	***Non-call***
US83367TBF57	Société Générale	USD	1,750	18-Dec-23	7.875%	USSW5 + 497.9	9.04%	5 years	97.5	13.4%	8.6%	Medium	Call
XS1865594870	*Bank of Cyprus*	*EUR*	*16*	*19-Dec-23*	*12.500%*	*EUAMDB05 + 1260.3*	*15.86%*	*5 years*	*102.8*	*n/a*	*n/a*	*n/a*	**n/a**

 Source: CreditSights CoCo Database. Prices and yields at 22 June 2023. *RBI was not called in December 2022 and is now callable semi-annually.

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The next slide shows those AT1s coming up for a call in the second half of this year. We think all the bonds of banks we cover will be called, except once again RBI. In fact, prices have been starting to recover on the back of more positive sentiment about calls, following the recent call by UniCredit, when it chose to call but not to refinance immediately. We have published several articles explaining the rationale for our predictions.

European Bank Recommendations

European Bank Recommendations: Senior		European Bank Recommendations: Subordinated	
Outperform	**Underperform**	**Cheap**	**Rich**
Senior (Market perform)		**Tier 2 (Market perform)**	
Barclays	RBI	Banco Sabadell	Monte dei Paschi
BBVA	BPCE	Barclays	RBI
Monte dei Paschi		BBVA	
NatWest		Deutsche Bank	
		Lloyds	
Sub-senior (Market perform)		**AT1 (Market perform)**	
BBVA		Barclays	CaixaBank
CaixaBank		BBVA	RBI
Deutsche Bank		Lloyds	
NatWest		NatWest	
		Nordea	
		Société Générale	

 Source: CreditSights analysts

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Finally, I'll leave you with our current recommendations. We divide these into Senior, Sub-senior, Tier 2 and AT1, and we're Market perform on all those segments. I've shown where we have Outperform and Underperform (or Cheap and Rich) recommendations on individual banks within each segment. We tend to favour banks that we think are undervalued based on fundamentals, such as some of the UK banks, or BBVA, or those where we don't think the market has yet fully priced in recent improvements, such as Deutsche Bank and SocGen.

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