FLASH NOTE

US & European banks: what matters and what does not

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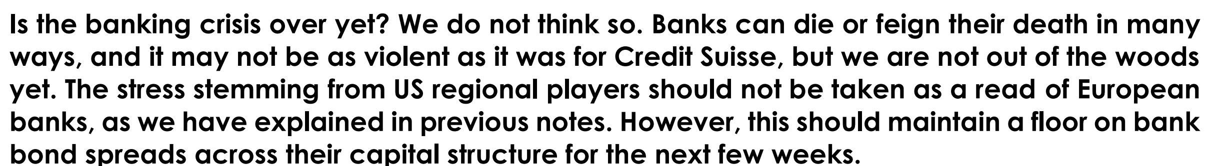

Is the banking crisis over yet? We do not think so. Banks can die or feign their death in many ways, and it may not be as violent as it was for Credit Suisse, but we are not out of the woods yet. The stress stemming from US regional players should not be taken as a read of European banks, as we have explained in previous notes. However, this should maintain a floor on bank bond spreads across their capital structure for the next few weeks.
It is important to avoid clickbait headlines and misleading indicators. Let's analyse the current batch of Q1 results, which is now over in the US, but still unfolding in Europe. We aim to give you simple answers to questions that may arise or have arisen in the last few days. It is all about "separating the wheat from the chaff".

1/ The results of European banks will not matter for bank bondholders.

It may sound bold to make that claim as we are still in the middle of the Q1 results announcement season, but we already have enough evidence so far to state that nothing tremendous is happening in Europe.

Bank equity and bondholders and analysts are subject to passing fads when it comes to assessing balance sheet robustness. In the past few years, we were mostly looking out for solvency ratio and non-performing loans trends, which were improving dramatically. All eyes are now turning to customer deposit trends, liquidity ratios and exposures to commercial real estate. This too shall pass.

Santander unveiled its results on April 25 with quarter-on-quarter Spanish customer deposits dropping by 5.6% and its stock price largely underperformed other bank stocks on that day due to this headline (along with poorer profitability in Brazil). Could that be the sign of upcoming liquidity stress? No, definitely not. Here is why: (i) customer deposits on a group basis were down only 1% on a QoQ basis and were up by 4% YoY, (ii) customer deposits in Spain were up by 7.9% YoY, (iii) management stated that most of the QoQ Spanish deposit decline was driven by corporates and CIB in January mostly, before the onset of the banking crisis. Customer deposits can be and are volatile, are subject to seasonal adjustments and depend on both customer-type lending and geographical mixes, and it seems like investors have forgotten about that.

Anecdotal evidence from other bank results in Europe has shown so far that there was nothing significant to see here.

<u>As a conclusion, long-term trends on banks matter more than quarterly figures. Do not hold your breath on this season of results from European banks.</u>

2/ The European Commission wants to strengthen depositor preference: a whistle in the wind

The European Commission (EC) published on April 18 a proposal to adjust the EU's existing bank crisis management and deposit insurance framework, with a focus on medium-sized

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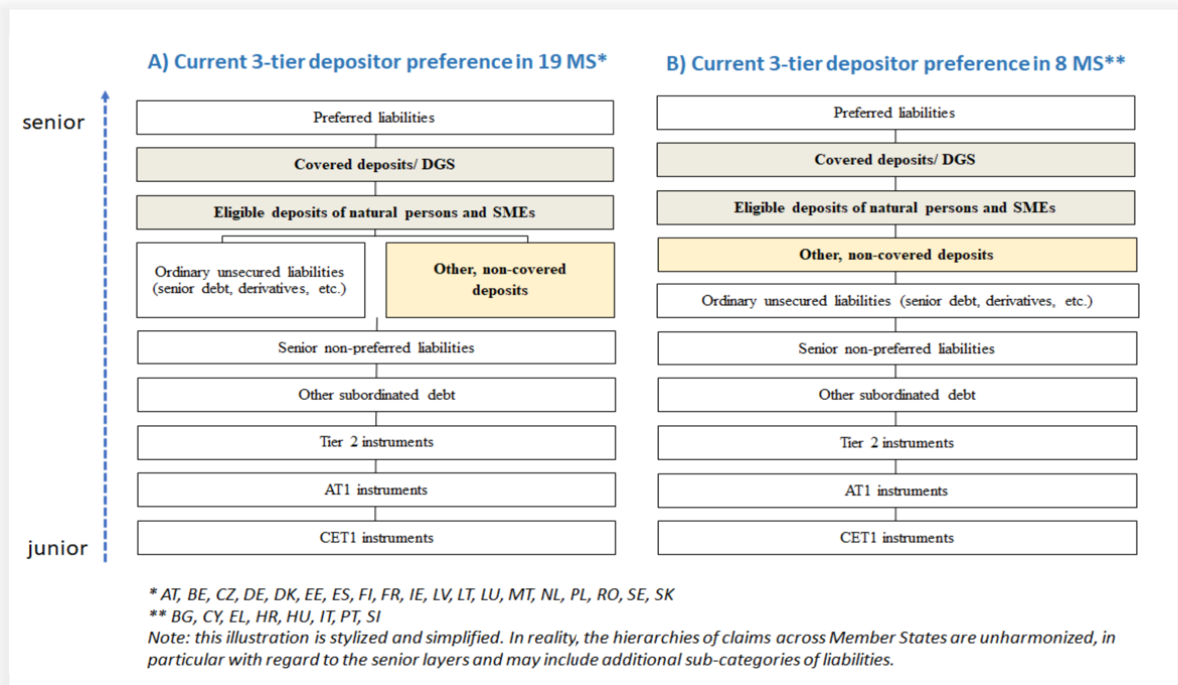
and smaller banks. As with all regulatory topics, it gets technical, so we we will keep our explanation as simple as possible.

The basic idea is to enshrine depositor preference against senior unsecured bondholders (and other similarly-ranked claims). Wait, wasn't that already the case? More or less. It was already explicitly the case in several countries, such as Portugal or Italy, but it was only implicit in most other countries. As always, it is the regulator's (and the government's) decision if a bank falls into resolution (and, in Europe, bank resolutions have not touched either depositors nor senior unsecured bonds during the past seven years).

Stylised view of the three-tier depositor preference in the current creditor hierarchies in insolvency laws.



Source: European Commission Services (230418-impact-assessment_en.pdf (europa.eu))

Another positive aspect for depositors is that Deposit Guarantee Scheme funds will now complement the loss absorption capacity in resolution for small and medium-sized banks. It sounds good on paper, but it will have consequences for senior bondholders, as some small and medium-sized banks may see their senior preferred debt ratings downgraded by one notch at Moody's (we do not see any impact for other rating agencies) and they will also have to issue more senior unsecured debt to bolster their "loss absorption capacity" to shield depositors.

Banks are the only sector where leveraging up your balance sheet means that you can benefit from higher ratings and be perceived as safer. Yet, accessing primary markets for smaller banks has become very pricy, and replacing TLTRO funding (which costed nothing, or could even be beneficial to banks) by expensive senior unsecured bonds will not be positive for their profitability.

We won't mention here several other proposals from the EC, which – in our opinion – have little chance to break through political hurdles or have any concrete impact for bondholders, aside from giving us food for thought.

<u>What lessons can we draw from this:</u>

-Protecting depositors is positive in order to limit theoretical "bank runs", but it will not change anything in practice for bank resolutions and for the perception of how "safe" deposits can be when a bank suffers from a liquidity crisis. Depositors have been shielded during the failures of Credit Suisse and the three US banks, but it does not prevent depositors from fleeing other banks, such as First Republic Bank (more on this below).

-Forcing small banks to issue more debt will hinder their profitability and their capacity to build stronger capital ratios. We have already expressed our concerns about forcing small banks to issue senior bonds at unsustainable costs, but this does seem to be a concern for the EC. The European Banking Authority and the ECB may think otherwise.

3/ US Banks: the crisis is far from over

Headlines usually focus first on big US banks and how they fare. Spoiler alert: nothing significant for bondholders here. Then come the results of "smaller" (yet systemic) US banks. Much attention was logically paid to customer deposit attrition. Results were mixed and did not really alleviate fears, but deposit outflows seem to have stabilized as at the end of March 2023.

And then came First Republic Bank (FRB). We had already written more than one month ago about how this bank fell so quickly and how rating agencies also played a significant role by downgrading it to High Yield ratings, thus fueling the circle of doom surrounding the credit institution.

Its customer deposits fell by c. 40% from March 9 until March 31 and by 60% if we exclude €30bn of deposits injected by a consortium of big US banks. These locked-up deposits from big banks, along with liquidity lines from the Fed, now account for c. 63% of FRB's liabilities (excluding equity).

This bank cannot survive on its own, and it is now a question of how quickly it needs to be resolved. The FDIC, along with the Fed and the government will have to act very soon to propose a decent solution. These agencies are also supposed to give their first conclusions in May about the state of US regional banks.

What happens next for US banks?

- We maintain our view that FRB is the next shoe to drop, but more banks (smaller banks that do not bear a systemic importance) will require help in the coming months (FDIC receivership, forced mergers and takeovers, resolutions…). The lack of trust towards frail institutions will not stop with FRB.

- Regulations for banks outside of the top 6 will come at the expense of their shareholder remuneration. The chart below shows how banks outside of the top 6 have Common Equity Tier 1 ratios, the levels of which were last seen in Europe before the implementation of Basel 3, more than ten years ago. Building stronger capital and liquidity buffers, along with more debt issuance if TLAC regulation is applied to them will have a cost, whose burden shall be borne by shareholders. These banks are running behind ten years of harsher bank regulations when compared to European standards, and regulators have acknowledged that it may have been a mistake. Nevertheless, regulation should be implemented in a smooth way in order to prevent disorderly solvency ratio cliff effects. We do not see credit events happening for the top 20 of US banks by assets, but we remain wary of their deposit trends (especially for Schwab and Truist, whose deposit base fell by more than 10% QoQ at end March 2023). The velocity of deposit flows in the US is a true subject, that cannot be overlooked.

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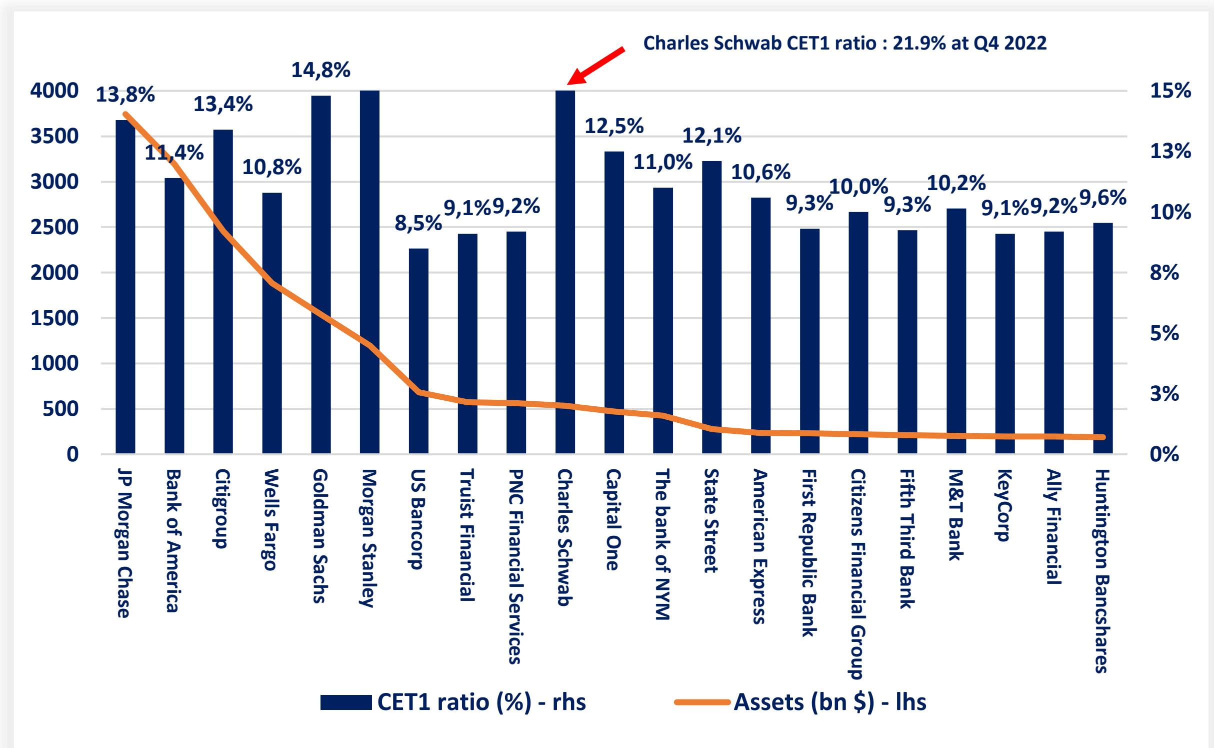
- The crux of the matter comes from all the banks that we cannot keep an eye on. Those circa 4,200 institutions, whose assets stand below $100bn. We have shown in our previous reports that they were the key financiers of US commercial real estate, and we have no idea how properly managed they can be. What is for sure is that, if Silicon Valley Bank was able to run its balance sheet as it was without any trigger warning from regulators, we cannot be too cautious about the state of all of these much smaller banks.

- More regulation + more debt issuance + inverted yield curves = less profitability & less credit distribution. Consequences shall also be felt on the macroeconomic front.

Top 20 US banks ranked by asset size (in $bn; left-hand scale) and their Common Equity Tier 1 ratio as at end-March 2023.



Sources: companies, Bloomberg. Data as end of March 2023, except for Charles Schwab (end 2022).

Conclusion - Why are we cautious on bank bonds across their subordination layers?

The most obvious reason is that we do not think that spreads from European banks can be spared from the fate of US banks, even though regulation standards and fundamental trends vary greatly from one side of the Atlantic to the other. Bondholders do not neglect the potential from a theoretical credit crunch in the US to reach European shores.

The second reason is that credit markets continue to trade with the same (poor) level of liquidity that we have been experiencing since 2022. Lackluster flows and elevated rate volatility do not mix well.

The recent call announcement of UniCredit's AT1 CoCo on April 27 could be seen as a positive sign for the asset class, but the bank was able to redeem it without replacing it thanks to excess AT1 buffers (we estimate a pro-forma AT1 regulatory buffer of 0.44%, i.e., c. €1.4bn,

post call with solvency figures as at end 2022). One swallow does not make a summer, so let's not forget that not all banks can, nor will, call their AT1 or Tier 2 bonds in the coming months. That is quite reflected in most prices nowadays, but spread volatility is still present, across AT1s, Tier 2 and senior unsecured bonds.

Bank bonds trade with steep discounts against their non-financial counterparts but should continue to fluctuate in such a way for the foreseeable future. Credit markets seem to be pricing a recession and a potential credit crunch, while equity markets are pricing luxury goods and artificial intelligence.

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