

Weekly Credit Update

Summary

- Credit spreads continue to move tighter
- Bank spreads have outperformed on the back of Basel 3 amendments

Market comment

Credit spreads have moved tighter during the week driven mainly by banks. The positive outcome of the CEBS stress test and – more importantly – significant amendments to the proposed Basel 3 rules on liquidity (see below) were the main factors behind the spread contraction seen for banks in particular.

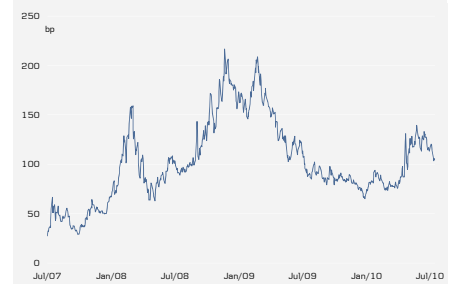
The investment grade index iTraxx Europe has tightened 6bp compared with last week and currently trades at 106bp. In the same period, the senior financial index has tightened 18bp to 114bp. The Crossover index has tightened some 20bp to 486bp. In the cash market flow remains limited and in the primary market we have seen a few deals out of Spain (BBVA and Santander) thereby taking advantage of the more positive view on (the largest) Spanish banks following the CEBS stress test.

Amendments to the Basel 3 proposal presented

At the beginning of this week, the Basel Committee disclosed some preliminary agreements on some of the proposals that were made in December last year. There were significant changes in both the contents and the timeframe in the original proposal and overall it looks as if the regulatory changes will be less dramatic than we previously anticipated. The most important changes concern the definition of capital, the leverage ratio, and the global liquidity standard – liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). The main changes are:

- Capital: Bank minority holdings will now be recognised to some extent and some tax assets can be recognised as part of tier-1 capital. These two changes do not have any material effect on Nordic banks.
- Leverage ratio: A leverage ratio of 3% will be introduced but not as a Pillar 1 requirement before 2018. Furthermore, the calculation will be less strict and e.g. netting of bought and sold CDSs is now allowed for. We had expected a leverage ratio around 4% and combined with the long implementation horizon the effect on Nordic banks of the introduction of the leverage ratio is limited.
- Liquidity:
 - LCR: A 'level 2' group of liquid assets with a cap that allows up to 40% of the stock to be made up of these assets is introduced. This pool includes high quality (at least AA-) non-financial corporate and covered bonds not issued by the bank itself with a 15% haircut (20% in December proposal).
 - NSFR: Importantly the NSFR is postponed to January 2018. Furthermore, haircuts on the liability side have been lowered and the required stable funding ratio for mortgages is reduced from 100% to 65%.

iTraxx Europe (5Y CDS)



Source: Markit

iTraxx Crossover (5Y CDS)



Source: Markit

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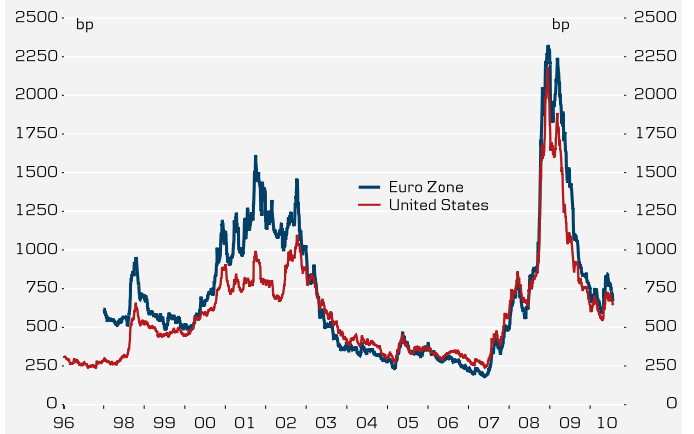
The positive news from Basel is the long introduction phase and the 3% leverage ratio. We stress that from a credit perspective tighter regulation is usually supportive and therefore the tightening of spreads may seem strange. However, this is clearly overshadowed by the lower supply pressure arising from the dilution of the NSFR. Furthermore, the risk that some banks would be in trouble *as a result* of the new regulatory requirements has been reduced.

US investment grade CDS index (CDX)



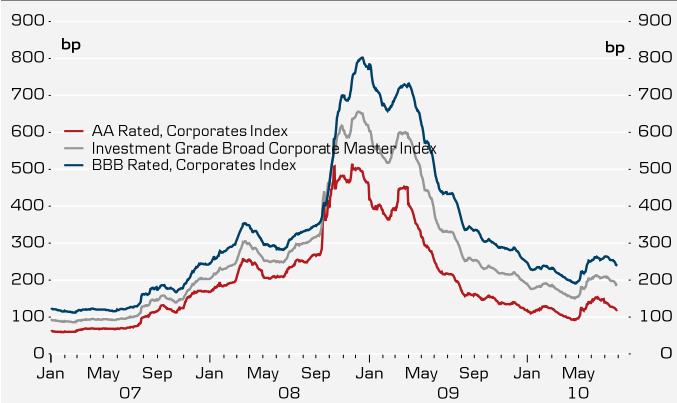
Source: Ecowin Pro

Merrill Lynch US & European high yield cash indices



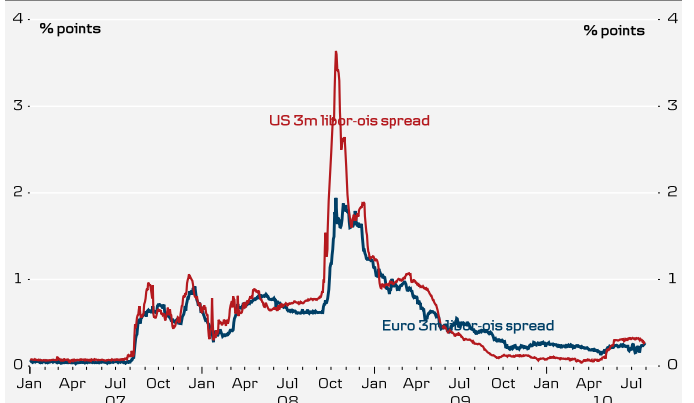
Source: Ecowin Pro

US cash indices



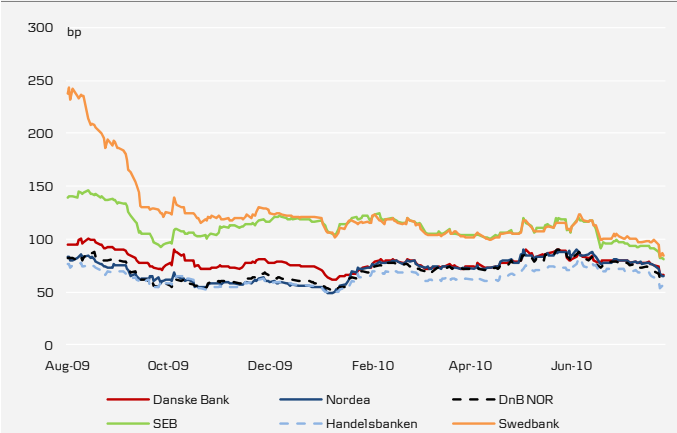
Source: Ecowin Pro

3M LIBOR-OIS spread



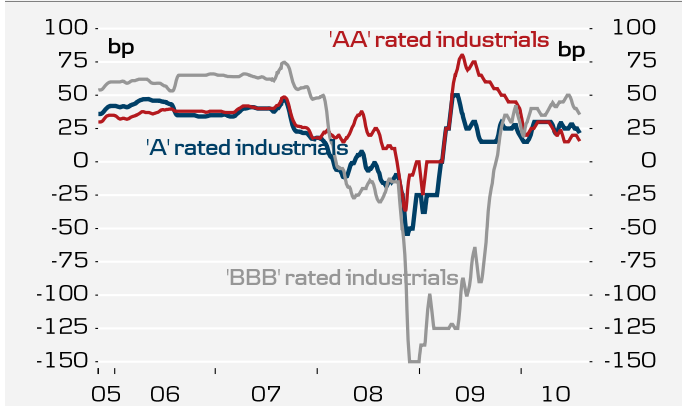
Source: Ecowin Pro

Nordic banks 5Y CDS spreads



Source: Danske Markets

Slope of US credit curves (2Y spread - 10Y spread)



Source: Ecowin Pro

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