Commentary by the Credit Research Team at BNY Mellon Cash Investment Strategies (CIS), a division of The Dreyfus Corporation.

The operating environment during the first quarter of 2018 was mixed as improved global economic growth and higher commodity prices occurred against the backdrop of divergent monetary policy, heightened geopolitical risks and evolving regulatory developments. This affected the results of issuers common to money markets to varying degrees. For financial institutions in North America, rising interest rates favorably impacted margins while banks in Europe and Japan continued to face earnings pressures from accommodative policies with interest rates anchored at zero. Geopolitical tensions over potential trade wars, North Korea negotiations, election outcomes in Europe and other headlines on the world stage served to create increased market volatility during the first part of the quarter and may pose a headwind for financial institutions and corporate borrowers going forward. Still, the global credit environment remained benign, reflecting favorable economic conditions as many banks across jurisdictions displayed sound asset quality. The aforementioned increased volatility helped boost capital markets earnings during the quarter for global investment banks, with North American firms outperforming European counterparts.

Our thoughts about how the above issues affected the various sectors we cover are as follows:

**U.S. BANKS**

U.S. banks benefited from seasonally strong capital markets revenues, a boost in net interest margins from rising interest rates and low credit costs. On the capital markets front, most banks noted a more favorable environment characterized by higher volatility, increased customer flows and synchronized global economic growth expectations, which fueled a turnaround in fixed income, currencies and commodities (FICC) revenues and a rebound in equities.

More importantly, banks are starting to benefit from years of business-model reengineering, investment in their franchises, continued expense discipline, favorable organic customer growth across franchises — particularly within asset and wealth management franchises, positive operating leverage and lower taxes. The large banks in particular saw strong profit growth in all segments, with pretax earnings up about 15% year over year.

Liquidity remained excellent for the banks, with healthy reserves and Liquidity Coverage Ratios (LCRs) well above regulatory requirements. Capital ratios remained solid with the banks having Common Equity Tier-1 (CET1) capital ratios that are comfortably above regulatory requirements and internal targets. On the regulatory front, the Federal Reserve proposed the incorporation of a Stress Capital Buffer (SCB) and modifications to the Supplementary Leverage Ratio (SLR) in an effort to adjust capital requirements to a more forward-looking model. The impact of the capital changes should be
manageable for large U.S. banks while proposed changes, as they relate to potential deregulation, are not expected to be directed at large U.S. banks as much as they might serve to relieve small regional banks from intense scrutiny.

CANADIAN BANKS

Canadian banks reported healthy earnings fueled by favorable margin expansion on account of the rising rate environment, good growth in wealth management, higher capital markets income, positive operating leverage and a lower effective tax rate. Regulators continued to implement tighter macro-prudential measures, which began to bear fruit in 1Q18 with slower mortgage-lending growth and a decline in the still-elevated household debt to disposable income ratio. The overall credit quality of the banks’ portfolios remains sound, although implementation of accounting standard IFRS 9 could result in increased variability of credit loss provisions going forward. That said, this should be manageable from a capital perspective as the average CET1 capital ratios remained strong and well above the regulatory minimum of 8%.

Canadian regulators recently published bail-in regulations and Total Loss-Absorbing Capacity (TLAC) requirements for the six systemically important banks that will become effective on September 23, 2018 and November 1, 2021, respectively. We do not expect any significant changes to the funding structure of Canadian banks as money market instruments, deposits, structured notes and all legacy senior unsecured debt issued prior to the effective date are out of scope and will not be subject to bail-in. However, senior unsecured debt with a maturity greater than 400 days issued after the effective date will be subject to bail-in. Canadian banks are expected to comfortably meet TLAC requirements by November 2021. With both bail-in and TLAC rules finalized, we expect that Moody’s will resolve its negative outlook on the Canadian banks in the near term.

EUROPEAN BANKS

European bank earnings were mixed in 1Q18 as the banks continued to wrestle with a number of headwinds, the largest of which has been the persistently low rate environment. Although quantitative easing (QE) is expected to end later in the year, European Central Bank (ECB) President Mario Draghi commented that rates will likely remain low for some time. Other consistent trends in the quarter included negative foreign exchange effects from the strengthening U.S. dollar, higher resolution fund payments on a year-over-year basis, and the first-time implementation of new accounting rules, specifically IFRS 9. Similar to 4Q17, investment banking performance was once again hurt by weakness related to FICC operations while equity sales and trading, along with advisory and origination, fared much better. With a few exceptions, the quarterly results were largely void of regulatory, litigation or other one-time charges, a nice change from recent history. On the positive side, wealth management and insurance operations were both solid contributors to earnings, benefiting from strong asset flows.

Although there was a one-time uptick in impaired loans on January 1 related to IFRS 9, which changed the calculation in recognizing impairments, asset quality continued to trend in the right direction. On the capital front, most banks saw modest declines in regulatory ratios from year-end 2017, also related to IFRS 9; however, the banks in our universe are all meeting current requirements and are now issuing TLAC and Minimum Requirement for own funds and Eligible Liabilities (MREL)-eligible debt in an effort to fill any gaps to future needs. During the quarter, the UK banks moved ahead with plans to ring-fence retail and commercial banking operations from the non-ring-fenced wholesale banking operations with all banks already or expected to be in compliance by the regulatory deadline of January 2019.
ASIA-PACIFIC BANKS

Japanese banks continued to face profitability pressures from the Bank of Japan’s (BOJ) negative interest-rate regime as margins were squeezed further while loan growth remained muted. A number of banks have initiated restructuring programs to combat rising expenses in an effort to become more efficient. Despite the operating challenges, Japanese banks continued to benefit from the benign credit environment that has allowed some banks to realize gains on the release of reserves while favorable financial market conditions in Japan have helped boost results in the form of realized securities gains — particularly with respect to equity holdings. The latter trend is expected to continue for some time as Japanese banks look to unwind non-strategic shareholdings that are carried on the books with significant unrealized gains. While these unrealized gains serve to inflate the robust regulatory capital ratios, Japanese banks reported solid CET1 ratios, excluding unrealized gains. Australia’s four major banks reported improved earnings supported by volume growth, stable-to-improving margins and low credit costs reflective of the benign credit environment. Margin expansion reflected higher asset pricing and lower liquid assets, partly offset by the impact of the banking levy and higher funding costs. Still, Australian banks continued to post LCRs and Net Stable Funding Ratios (NSFRs) well in excess of the regulatory requirements. The banks’ bottom lines continued to benefit from favorable revenue growth coupled with a focus on cost containment even as the banks saw higher investment spend. Elevated home prices and household leverage remained headwinds, but were tempered in part by continued macro-prudential measures. The Royal Commission is currently conducting an inquiry into misconduct in the financial system in Australia. An interim report is due by September 30, 2018 with a final report due on February 1, 2019. While the final results are currently undeterminable, the impact from potential penalties is expected to be manageable in the context of the banks’ robust earnings. While such scrutiny and focus on bank lending could lead to a tightening of mortgage underwriting and potential softer profitability, the Australian banks remained well positioned to meet the Australian Prudential Regulation Authority’s (APRA) unquestionably strong CET1 ratio target of 10.5%.

CORPORATES

First-quarter 2018 earnings were mostly solid on an organic basis. Corporates continued to benefit from an improving global economy and higher oil and gas prices. Pharmaceuticals and consumer products benefited from new products and innovation. For 2018, managements remain cautiously optimistic as benefits from cost-cutting and leaner organizations are offset by headwinds such as geopolitical risk in certain markets and increased competition. We continue to see M&A activity within the corporate sectors, funded by a combination of cash on hand and debt. Most of these acquisitions, we believe, are strategically significant, but they increase credit and business risk which could pressure companies’ credit ratings. Overall, though, liquidity levels and credit profiles remain intact. And despite more shareholder-friendly activities, we believe corporates are committed to their current credit ratings.