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

The credit environment improved during 1Q17 as economic conditions resulted in moderate GDP growth, labor market improvement and a pickup in inflation for the advanced economies. However, the outlook remains cautious due to geopolitical risks over potential trade and financial system reform measures in the U.S., ongoing Brexit negotiations and the outcome of federal elections in Europe. In addition, monetary policy continues to diverge, with the U.S. having raised interest rates again in March 2017 while a zero to negative interest-rate environment remained in Europe and Japan.

For the large global financial institutions, the fixed income, commodities and currencies (FICC) rally continued for most banks, with the large U.S. banks outperforming global peers. Credit growth was mixed, with commercial lending lacking in certain parts of the globe while strong growth in consumer debt in areas such as Canada and Australia has served to pressure credit ratings for banks in those jurisdictions. That said, credit quality conditions remained benign globally with overall credit costs still near historical lows for a number of financial institutions. Further rationalization of the cost and organizational structure drove further efficiencies for a number of banks. A continued buildup in capital and liquidity to comply with regulatory requirements has served to further strengthen the health of bank balance sheets. Corporate earnings for the first quarter continued to show improvement thanks to higher commodity prices, benefits of cost control and better growth in emerging markets.

NORTH AMERICAN BANKS

The U.S. banking sector saw a strong start to the year as many banks saw improved profitability metrics and positive operating leverage, although profit pressures continued to linger. Operating conditions were favorable as the U.S. economy continues to improve and interest rates are finally on an upward swing. Some banks noted that customer sentiment reflects optimism for potential actions by the new administration. Most of the large U.S. banks experienced a rebound in capital market revenues, driven mainly by FICC, which improved from a weak 2016. Strategic priorities pertaining to savings initiatives continued to bear fruit as cost discipline was visible. The Federal Reserve Board’s tightening agenda continued during 1Q17 with another interest-rate hike in March 2017, with most banks receiving a boost in net interest margins from the December 2016 hike. This resulted in improved spread income, particularly evident at the regional banks where such income is the dominant revenue source. That said, mortgage revenue was lower as higher interest rates stalled mortgage origination and refinancing activity. Overall, loan growth was sluggish as the banks noted paydowns in energy loans, lower credit card balances, and corporate borrowers turning to the capital markets as reasons for the slowdown. Growing investor concern about banks’ auto-lending and retail exposures was addressed by some banks noting their high levels of comfort with risks given prime borrower status, relatively small exposures and geographic diversity. Credit costs were flat to down in a continuation of the benign asset-quality environment. U.S. banks continued to
actively issue total loss-absorbing capacity (TLAC) and net stable funding ratio (NSFR) eligible securities during the quarter, which further solidified their solid capital base.

For the most part, Canadian banks reported an increase in earnings driven by strength in capital markets, volume growth and modest margin expansion. Moreover, credit quality remains a strength enhanced by lower losses in the oil and gas sector. Banks with sizeable U.S. franchises noted a slowdown in commercial loan growth reflecting a lack of clarity regarding the new administration’s policies as well as borrowers funding in the capital markets. Some banks continue to seek diversification largely via expansion into the U.S. with some continuing to focus on growing their wealth management businesses. Funding remains good with the banks’ liquidity coverage ratio (LCR) between 119% and 132%. Capital levels remain robust with an average Common Equity Tier 1 (CET1) ratio of 11%. The housing market and high consumer indebtedness remain headwinds for the Canadian banks; however, a number of regulatory measures have been implemented to safeguard the financial system. That being said, Moody’s recently lowered the ratings of six large Canadian banks in light of the aforementioned risks.

It is worth reiterating that the Canadian government plays a vital role in the housing market via mortgage insurance. Furthermore, pivotal regulatory features include full borrower recourse, reduced amortization periods, and mortgage interest not being tax deductible, among others. Importantly, related asset quality for the banks remained solid, with almost one half of mortgage books insured and the uninsured portions having average loan-to-values (LTVs) in the mid- to low-50% range. Despite Moody’s negative outlook on Canadian banks, we expect that a buildup in loss-absorbing capital will serve as an offset to a potential reduction in government support if Canadian banks were to adopt a bail-in regime such that additional downgrade risk is minimal.

**EUROPEAN BANKS**

European banks generally reported strong earnings in 1Q17 despite the persistent pressure on interest income from the low-rate environment. Robust market performance was an offsetting factor, helping to lift trading and fee and commission income as client activity continued to improve. Investment banking revenues are normally strongest in the first quarter of the year; however, due to reorganization efforts by the European investment banks (IBs) and the exiting of certain business, they were not able to capitalize on 1Q17 activity to the same extent as their U.S. counterparts. Credit costs remained low as overall asset quality is strong, with pockets of weakness related to energy and shipping exposure being countered by stable housing markets, improving commercial real estate (CRE) segments, and provision releases related to formerly troubled regions. Expenses for many banks increased when compared to 1Q16 due to higher regulatory fees and bank levies along with investments related to digitalization efforts. Bottom-line profits continue to be led by the Nordic banks with an average return on equity (ROE) of 12.7%, followed closely by the Benelux banks at 12%. The European investment banks all reported positive results, with UBS the winner of the group.

French banks were led by BNP, with an ROE of 7.1% thanks to its geographic footprint and absence of major litigation charges or restructuring costs. Uncertainty over the French elections, which ended with a favorable outcome from a market perspective, had no visible impact on earnings. However, a level of political uncertainty in Europe will persist until German federal elections take place in September 2017.

European banks have historically been reliant on the capital markets for funding; nevertheless, all of the banks in our universe report sound liquidity coverage ratios and net stable funding ratios, well in excess of the 100% requirement. Liquidity in the banking sector has been helped by the targeted longer-term refinancing operations (TLTROs) administered by the European Central Bank (ECB). The fourth and final tranche was completed in March. The total take-up of $248.7 billion was more than twice what was expected as banks were eager to secure cheap four-
year funding. Regulatory capital ratios remain strong, although the CET1 ratio and leverage ratio at many banks declined a bit from YE16 values due to risk-weighted asset growth and the reversal of year-end balance-sheet manipulation that brought down liquidity balances and total assets. Two notable exceptions to this trend were Credit Suisse and Deutsche Bank, both of which announced capital raises during the quarter that, when completed, will bring the ratios more in line with peers and should put capital questions to rest, at least for the time being.

**UK BANKS**

Generally speaking, UK banks reported solid underlying results for 1Q17, but litigation expenses and restructuring costs were still prevalent. For several years now, UK banks have undergone various restructurings and cost-cutting initiatives, dealt with high litigation and conduct costs and reduced the size of their balance sheets. The banks are at different stages of reorganizing, but the end of downsizing non-core assets and businesses is in sight. At the same time, UK banks are preparing to ring-fence their retail operations from market-related operations as of January 2019, which could result in downgrades of the non-ring-fenced entities. Thus far, ‘Brexit’ has had a muted impact on UK banks. After the UK election in June 2017, negotiation with the EU could intensify, but the uncertainty regarding the medium- and long-term impact on UK banks remains.

**ASIA-PACIFIC BANKS**

Australian banks continued to post good overall profitability, with ROEs just below the mid-teens for the half-year period ended March 31, 2017. Overall earnings increased thanks to improved market-related income, additional cost-cutting and a continued benign credit environment that kept provision costs low; however, revenue growth was muted as margins compressed due to increased holdings of high-quality liquid assets and moderate lending growth, with the exception of mid-single-digit growth in mortgages. Regulators have stepped up efforts to stem potential risks in the Australian housing market by implementing restrictions on interest-only lending and investment property lending as well as increasing risk weights on residential mortgages, to which the banks have responded with tighter underwriting standards and higher levels of capital. As Australian banks have steadily grown deposits and increased high-quality liquid assets, they have reported LCR and NSFR ratios well in excess of the minimum 100% requirement with a reduced reliance on the committed liquidity facility. Notwithstanding the overall strength of the Australian bank credit profiles, the rapid increase of house prices and high levels of consumer debt could potentially pressure bank credit ratings.

A better operating environment in Singapore led to slightly improved profitability for the quarter, with the three major banks averaging a good ROE of 10.6%. A higher interest-rate environment served to reverse the margin compression trend experienced in prior quarters, but spread income remained flattish year over year despite a pickup in credit growth. The improvement in earnings was more influenced by fee income growth, particularly with respect to wealth management. Credit costs ticked higher, but remained relatively low while non-performers trended lower after rising in the past few quarters. While overall asset quality metrics are indicative of a benign credit environment, Singaporean banks remained cautious on the property-related and the oil and gas sectors. Overall, Singaporean banks maintained a solid liquidity profile and strong capital.

Profitability among Japanese banks trended lower, with the average ROE for the megabanks at 7% for the full year ended March 31, 2017. Further margin pressures from the negative-interest-rate environment, flat fee income and rising expenses were the primary headwinds. Earnings continued to be supported by securities gains, particularly with respect to equities, as Japanese banks have sought to reduce strategic shareholdings in an effort to lock in gains and reduce earnings volatility going forward. Credit costs remained near historical lows, further supporting profitability, while non-performers trended lower, which reflects a continued benign credit environment.
and indicates that Toshiba has not pressured asset quality in a meaningful way. Japanese banks continued to improve the quality of their balance sheets as they have built up significant levels of cash on the reduction of Japanese Government Bonds (JGBs) and equities, strengthened loan/deposit ratios to an average of 65% and solidified capital adequacy. An expectation of slightly higher credit costs and lower securities gains has prompted Japanese banks to modestly reduce earnings forecasts for the upcoming year. That said, improved economic conditions in Japan served as a catalyst behind Fitch's recent revision of Japan's credit outlook from negative to stable, which led to stable outlooks for Japanese banks to reflect the better operating environment.

CORPORATES

While the overall tone for first quarter 2017 corporate earnings was more positive, we remain cautious for the outlook for the full year given continued volatility and uncertainties in the global geopolitical environment. Corporate earnings for the first quarter continued to show improvement. Results were helped by higher commodity prices, easier year-over-year comparisons and the benefits of cost controls. Nevertheless, geopolitical risks and currency remain significant headwinds for many of these companies. The oil and gas sector was helped by improved operational performance from better pricing and market conditions. Pharmaceutical companies’ results were helped by the solid performance of growth products, offset by generic competition. Consumer products’ results were helped by strong emerging markets growth. Overall balance sheets and credit profiles remain healthy as credit ratings were relatively stable in the quarter. We continue to believe many corporates still have financial flexibility on their balance sheets for uncertainties and challenges in the economy.