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

Operating conditions generally improved during 2Q17 based upon better macroeconomic metrics globally, improved commodity prices and a continued benign credit environment. Lending growth also picked up in a number of jurisdictions, with banks in the U.S. and Canada benefiting from an increase in policy rates; banks in Europe and Japan, however, continue to grapple with low interest rates as monetary policy remained accommodative despite the economic recovery in both regions. In some jurisdictions, such as Canada and Australia, high levels of consumer debt have gained the attention of regulators and rating agencies, while the credit metrics remained favorable. The second quarter featured a lack of volatility within capital markets, which pressured fixed-income trading results for a number of global investment banks. Somewhat offsetting was a rebound in other fee-based businesses such as wealth management and asset management. Litigation and regulatory expenses connected with legacy businesses and restructuring costs associated with non-core businesses have dwindled, but still remain a headwind for a handful of financial institutions. Bank and corporate issuers alike continued to focus on cost-saving initiatives to combat revenue challenges. It is too early to tell at this point what impact the ongoing debate over potential tax reform and financial deregulation in the U.S. may have on issuers; however, the global financial and corporate issuers within our coverage currently benefit from solid levels of capital and liquidity that are supportive of stable credit profiles.

NORTH AMERICAN BANKS

For 2Q17, U.S. banks in general saw better results although return on equity (ROE) are still lower than the cost of capital for a majority of the banks. During the quarter, loan growth improved following a tepid start to the year. The recent rate hikes and disciplined retail deposit pricing helped to boost earnings, although margin expansion was more measured than in the previous quarter. Modest revenue growth, strong asset quality and controlled expenses all contributed to positive earnings and operating leverage. Of note, the yield curve has flattened since the start of the year, which could present headwinds to future earnings growth for banks exposed to the long end of the curve, such as those with large mortgage operations, as gain on sale margins could be pressured. For the major U.S. banks, capital market revenues were lower despite strong investment banking activity. This was largely due to weak Fixed Income Clearing Corporation (FICC) results attributed to low market volatility in the quarter, especially as compared to a strong year-ago quarter after the Brexit referendum. Positively, higher equity...
market valuations enhanced wealth management and asset management results. All Comprehensive Capital Analysis and Review (CCAR) banks met the quantitative requirement demonstrating their capital strength and the banks subject to the qualitative assessment did not receive objections to capital plans.

Canadian banks all reported an increase in quarterly earnings and improved returns with an average ROE of 15.8%. Momentum was driven by good volume growth, favorable wealth management performance, healthy investment banking fees and continued expense discipline. Credit quality remained a strength enhanced by lower losses in the oil and gas sector as the latter’s exposure remained manageable. While the housing market and high consumer indebtedness present headwinds for the Canadian banks, it is worth reiterating that performance in the uninsured portions of the banks’ mortgage portfolios was sound with loan-to-values (LTV) in the high forties to mid-fifties range. Funding profiles were attractive with bank liquidity coverage ratios (LCR) between 123.0% and 139.0%. Capital levels remained robust with an average Common Equity Tier 1 (CET1) ratio of 11.2%. Of note, Canadian regulators recently released proposals for the bail-in regime and total loss-absorbing capacity (TLAC) requirements, which were largely in line with expectations. With the comment period ended, regulations are expected to be finalized this fall with an implementation date about 180 days after that. The effective date of compliance is not until November 1, 2021, leaving sufficient time for the banks to build up the necessary TLAC ratio requirement of 21.5% and TLAC leverage ratio requirement of 6.75%. However, public reporting of TLAC ratios will begin in 1Q19. Subsequently, Standard & Poor’s (S&P) affirmed its ratings noting that the release does not imply a near-term reduction in the likelihood of reduced government support. Moody’s noted that it may reduce support, which would pressure ratings; however, the application of its loss given failure (LGF) component could serve as an offset, although the net effect is not currently determinable.

EUROPEAN BANKS

It was a relatively uneventful quarter for European banks. Earnings overall were decent, with the usual outperformance coming from the Nordic region. Revenue trends were consistent within peer groups, exceptional items were minimal, costs remained a focus, and credit quality was stable. While UK banks continued to grapple with payment protection insurance (PPI)-related litigation costs, an end to such costs is in sight as regulators have established an August 2018 deadline for PPI complaints. With low market volatility and depressed client activity, trading revenues were pressured during the quarter while retail banking and wealth management earnings were sound. At the large European investment banks, profitability was generally weak although UBS was the group leader with an ROE of 9.2%, in no small part due to its early restructuring efforts and focus on wealth management. The drag from non-core units continues to lessen as portfolios are wound down and litigation charges were small. Performance from the Nordic region was consistent with stable spreads, modest volume growth, excellent asset quality, and strong efficiency ratios. UK banks reported decent underlying profitability amid signs of a weakening UK economy. In France, retail banking was challenged by the rate environment despite solid volume growth. The wave of refinancing appears to have peaked, although loan portfolios are now dominated by lower-yielding mortgages which will weigh on interest income for some time. Nevertheless, 2Q17 results were resilient, helped by asset management and insurance operations. Asset quality
trends have been generally positive across the region. Shipping, oil and offshore portfolios, particularly at DNB and ING, remained under scrutiny but have not caused any significant issues. The turnaround of the Irish economy has led to provision releases at KBC, while impairments at the Italian and Russian subsidiaries of the Belgian bank have stabilized.

On the capital front, Deutsche Bank and Credit Suisse saw their fully loaded CET1 ratios come in line with peers following a rights issue, while UBS slipped due to regulatory risk-weighted asset (RWA) inflation. The Swedish banks maintain the highest capital ratios in Europe, although they await guidance on minimum requirements for eligible liabilities (MREL) requirements which the Swedish authorities should be finalizing by year-end. Ratios remained strong at the Benelux banks while the French held steady at the low end of the European peer group. Overall, capital levels across the region continue to gradually increase as banks issue varying forms of additional loss-absorbing capacity (ALAC)-eligible securities. The growth of loss-absorbing buffers has led to several rating upgrades and positive outlook revisions, a trend we expect to continue. For the UK banks, S&P informed the market in July 2017 that rating actions related to ring-fencing, if any, will likely be in the form of updates to rating outlooks, with outlooks to be resolved on a case-by-case basis in the first nine months of 2018 upon a banking group receiving court approval.

**ASIA-PACIFIC BANKS**

Japanese banks continued to face earnings pressure as net interest margins were squeezed further while fixed-income trading was broadly lower. The latter trend impacted Japanese banks to varying degrees during the quarter with Mizuho most acutely affected as reflected in its weak results. Excluding Mizuho, the Japanese banks reported respectable results for the quarter as buoyant equity markets helped produce strong equity-related gains while the benign credit environment kept credit costs low, with some banks reporting credit-related gains on the release of reserves. Japanese banks continued to benefit from sizable unrealized securities gains, mostly equity-related, which should continue to support profitability; however, in the case of Mizuho, the bond portfolio now shows a modest unrealized loss. In a reversal of recent trends, two of the Japanese banks marginally added to their Japanese Government Bond holdings during the quarter while another bank added to its foreign bond position. Still, cash equivalents remained a sizable component of Japanese bank balance sheets.

Australian banks reported improved results with revenues flat to modestly up and expenses that were well-contained. Despite weaker earnings in treasury and markets, margins have been stable to slightly up as a result of the loan repricing as well as improved funding conditions. However, such momentum is expected to be offset in the interim due to the implementation of a bank levy on wholesale funding, which will be reflected in the cost of funds. Asset quality remained solid as provisions were generally lower. While there have not been signs of stress yet in the sizable interest-only mortgage books, Australian banks have been increasing lending rates in an effort to slow growth in such mortgages. Capital ratios were healthy, with the banks having an average CET1 ratio of 9.9% vs. a recently announced Australian Prudential Regulation Authority requirement of 10.5% by 2020 for major banks to be viewed as “unquestionably strong.” The banks noted that the household sector continues to face challenges with high levels of household debt, tempered consumer sentiment and soft wage growth, all of which contributed to a recent broad-
based Moody's downgrade. In addition, CBA has been the center of legal proceedings and a regulatory inquiry related to its anti-money-laundering procedures, which could present additional ratings pressure.

The three major Singaporean banks had another good quarter as earnings increased across the board for an average ROE of 11%. Earnings were supported by improved loan growth, stabilizing net interest margins and higher fee income, particularly within wealth management. Although impairment costs were generally lower in the quarter, nonperforming loans (NPL) were stable to slightly higher as oil and gas exposure remained stressed, with some banks indicating that provisions and NPL could increase further based on current collateral values. However, this should be manageable as the Singaporean banks are highly capitalized.

CORPORATES

Corporate earnings in the second quarter of 2017 continued to reflect a more positive macroeconomic environment. Earnings benefited from improved commodity prices and cost-saving initiatives. There are still headwinds in the global economy, though, such as geopolitical risks and currency. Earnings in oil and gas were helped by improved operational performance due to better commodity pricing and market conditions. Consumer products were helped by diversity in geography and product offerings. Pharmaceutical companies continued to benefit from growth products, offset by the negative impact of generic competition. Overall liquidity and credit profiles were solid and credit ratings remained stable in the quarter. However, we believe the appetite for shareholder-friendly activities and acquisitions has increased, which could put pressure on ratings in the intermediate term.

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