

Bank Pulse: Pressure on bank bond spreads accelerates on the situation in Ukraine

Bank bond spreads are under renewed widening pressure following Russia's invasion in Ukraine. In our view, covered bonds will remain best shielded against current volatile market circumstances, and so will names and regions furthest removed from the conflict



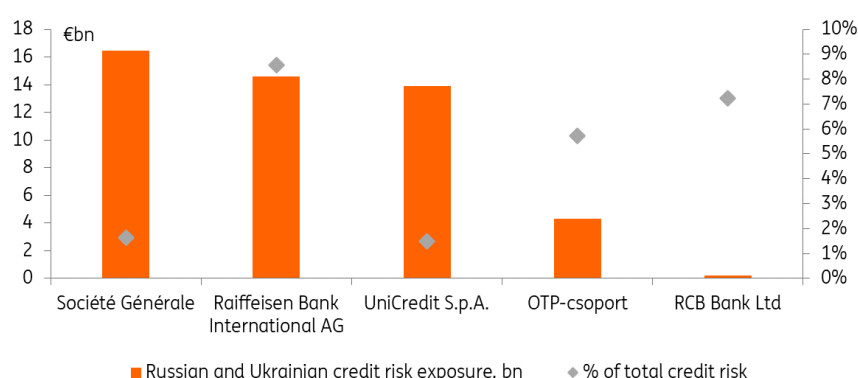
Credit markets under pressure on Russia's invasion in Ukraine

Credit markets have clearly been under widening pressure today following Russia's attack on Ukraine. In CDS, the iTraxx senior Financials index has widened by 6bp this morning, to levels 30bp wider than at the end of last year. In cash, the Markit iBoxx indices have shown the strongest spread widening YTD further out the liability structure in T2 bonds (+48bp), followed by bail-in senior (+28bp) and preferred senior (+15bp) instruments. The widening in covered bonds has thus far been relatively modest with 2bp. These levels are based on yesterday's close and do not reflect today's spread widening yet.

Tensions on Ukraine have been building for a while now

The tensions regarding Russia and Ukraine have been building for a while now. We assess bank exposures to Russia and Ukraine. The European Banking Authority (EBA) transparency data gives details on the geographic split of European banks' credit risk exposure value as of 1H21. These exposures include different counterparties such as central governments and central banks, institutions, corporates, retail and items secured by mortgages on immovable property, among others. Banks that have exposures in one or both of these geographic regions include Société Générale, Raiffeisen Bank International, UniCredit, OTP-csoport and RCB Bank based on the EBA data. The most exposed banks have exposures ranging between 5-9% of their total credit risk exposures.

Banking sectors most exposed to Russia and Ukraine



Source: EBA (Transparency Data 2021), ING

Names with least regional exposure to the conflict to see less volatility

At this point in time, it is difficult to estimate the full potential impact on European banks. In our view the whole sector is likely impacted by the first round effects that come in the form of market moves such as higher bond spreads. Banks operating closer to these areas are likely more impacted. For now, we would anticipate regions and banks furthest removed from, and exposed, to the Ukraine conflict to show best performance resilience. This leaves unchanged that spread widening trends typically do see an underperformance of wider spread products, jurisdictions, names and parts of the curve. We expect these dynamics to remain dominant.

Covered bonds will continue to show most performance resilience

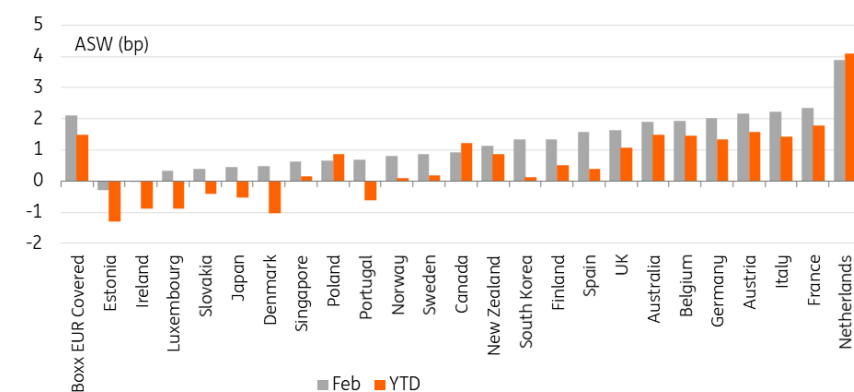
On the bank liability structure, covered bonds are the most secure bond product and as such should be best protected in terms of performance within the current volatile market circumstances. That said, with credit spreads in general under widening pressure, covered bond spreads will undoubtedly follow suit.

The YTD performance in covered bonds is so far showing an underperformance of eurozone jurisdictions, with Dutch covered bonds leading the way. We see two important explanations for this underperformance:

1. The rising eurozone inflation levels and the (anticipated) less accommodative monetary policy conditions as a consequence thereof. For instance, while not visible in core Eurozone government bond asset swap spread levels yet, a further reduction of ECB purchases of sovereigns and SSAs this year, may result in a certain underperformance in this segment, impacting covered bond spreads in its wake. This will likely have a stronger impact on covered bonds than any further reduction in the ECB's direct buying of covered bonds under CBPP3. We do note though, that in light of the crisis in Ukraine, the phasing out of QE could take longer.
2. Covered bond supply activity. Banks from countries such as Germany, France, the Netherlands, and Austria, have together with Canada, been among the most active so far this year in the covered bond primary market.

Besides, as shown earlier in this article some banks located within the eurozone have also been among the ones more exposed to the Russia-Ukraine situation.

Eurozone covered bond markets are among the weakest performers YTD



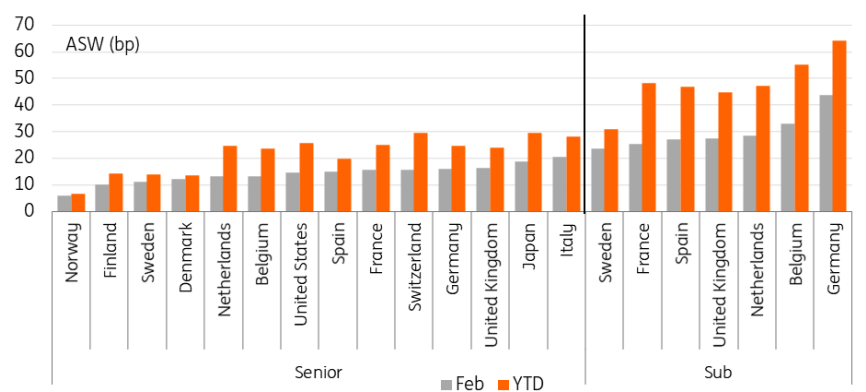
Source: Markit iBoxx, ING

Senior and T2 markets confirm a softer performance of eurozone banks

In a way, the performance pattern visible in covered bonds is mirrored by the senior unsecured and T2 markets. Also here we see particularly eurozone member countries underperform, while for instance Nordic bank bonds show best performance resilience.

This underscores the importance of the anticipated changes in the ECB's response to inflation as explanatory factor to the YTD relative performance of bank bonds. Besides, also in senior unsecured paper eurozone banks from France, and to a lesser extent, Spain, Italy and Germany have been most active in primary.

Nordic markets show most performance resilience YTD in senior and T2



Source: Markit iBoxx, ING

Higher beta names and bond products remain most vulnerable

However, in our view, Russia-Ukraine headlines will for now take the lead as performance driver, with banks operating closer to the region likely most affected. Inflation and interest rate concerns may feel less important against this backdrop. Prospects of a longer phase of monetary accommodation in light of the crisis could possibly even cushion some of the spread volatility. Ultimately however, we do believe that common spread dynamics will take the upper hand again, with tighter spread products and names performing best under more challenging market circumstances.

Author

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

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