BANKS' SUBORDINATED DEBT

Capturing one of the highest yields within fixed income in one of the safest sectors (even the GFC agrees!)

Executive Summary

Romain Miginiac
Head of Research,
Atlanticomnium S.A.

In dislocated markets, opportunities arise as valuations become disconnected from fundamentals. Banks' subordinated debt, which offers a pick-up to high yield, is a very good example of this – despite banks being one of the few hiding places in the current macro environment. In a benign macro scenario, banks' earnings benefit significantly from higher rates, and even in a stressed scenario, the sector has historically demonstrated that it is one of the most resilient. The "higher beta" nature of bank credit (and financials more broadly) is well anchored in financial markets, and likely a residual stigma from the Global Financial Crisis (GFC) and Eurozone (EZ) crisis when banks were part of the problem. This "higher beta" is no longer justifiable, in our view, as post-GFC regulation has fundamentally transformed the sector. Indeed, banks' performance during the GFC may well be the strongest source of comfort regarding the resilience of the sector.

Analysing the GFC through a lens of "which activities are banks still involved in today" offers good insight into the sector. As with many topics, the angle taken can significantly alter the conclusion. UBS's headline cumulative net loss in FY 2007-2009 was around CHF 28 billion, but at the same time the group's wealth management/retail banking units delivered an estimated return on equity above 15% [1] throughout the crisis. A significant number of banks were profitable throughout the crisis and raised equity defensively in the face of rising capital requirements. Digging beyond the trillions of losses from activities no longer core to European banks' business models, performance during the GFC indicates their strong ability to absorb losses in a stressed scenario without negatively impacting bondholders.

Why is the market overly concerned with a recession?

Given the current economic uncertainty, it is understandable that investors are raising the question of how banks would perform in a recession. Banks are macro-sensitive by nature, given their lending activities and securities holdings. In a downturn, losses on loans increase as borrowers' capacity to service debt declines, and the value of securities declines as a result of weaker markets. Profitability is impacted as a result as banks need to absorb higher losses. In case losses exceed earnings, excess capital is used to absorb losses. The scale of losses depends on the severity of the recession as well as the risk on banks' balance sheets.

The stigma from the GFC (and other crises) continues to overshadow the sector and leads to an underappreciation of its resilience, in our view. The scale of losses, capital raising, and bailouts was stratospheric – showcasing the then vulnerability of the sector. Systemic risk emphasised vulnerabilities in the financial system, hence the widespread impact of the crisis. Post crisis, more than a decade of regulation has led to de-risking, capital accumulation and the reduction of other vulnerabilities (reliance on short-term funding etc.), fundamentally reshaping the sector. For bondholders, the focus should be on de-risking rather than capital accumulation, the former making the latter less relevant.

[1] Estimated based on UBS financial statements. Calculated using data from UBS' Wealth Management and Retail Banking Unit (RoE calculated as estimated net income from both divisions divided by allocated capital of both divisions). Net income is calculated as reported profit before tax times tax rate; allocated capital reported directly.

GAM Investments

The de-risking journey that banks have embarked on since the GFC will materially reduce the scale of losses in a future downturn, in our view. This is driven both by banks' exit from "sexy" investment banking activities and their increased focus on lower risk lending portfolios (namely residential mortgages). In our opinion, banks have become boring, which is exciting for bondholders. Ultimately, if losses are significantly lower and manageable through earnings, excess capital may prove redundant. This is a fantastic problem for a bondholder to have: sitting above a significant amount of capital that is unlikely to be needed as the magnitude of potential losses has been slashed.

In summary, banks are now overcapitalised and de-risked, utility-like entities. We believe this is a great starting point for the resilience of the sector in a downturn.

Even in a stressed scenario, bondholders are likely to remain extremely well protected by banks' earnings buffer

A downturn would inevitably lead to higher non-performing loans and loan loss provisions. As bondholders, our first focus should be on banks' ability to absorb losses through earnings – pre-provision profits (PPP) is our first line of defence instead of excess capital. PPP should be the key "profitability" consideration for bondholders, in our view, which are ultimately allocated to loan losses, shareholder payouts, growth and excess capital. In a stressed macro environment, where PPP are sufficient to cover elevated loan losses, shareholder payouts and growth, rather than excess capital, should be reduced. As bondholders, an issuer's strength is measured by its ability to maintain robust credit metrics through the cycle. For banks, this should be the ability to maintain high excess capital in a tail risk scenario as higher losses are absorbed through earnings. The outlook for PPP is bullish, as rising rates will undoubtedly boost net interest income (NII). As a consequence, the ability to absorb losses will rise, a credit positive. The variability of net income is irrelevant, unless potentially leading to material losses that would erode capital. Arguably, zero net income in a stressed worst-case scenario is a good outcome for bondholders. As the sector stands, capacity to absorb losses through PPP is increasing materially and excess capital is at all-time highs making European banks a good hiding place even in an adverse scenario, in our view.

Looking back at European banks' operating performance during the GFC provides some insight around their ability to absorb losses through earnings. Although the sentiment around banks' performance during the GFC is highly biased by large bailouts, a significant number of banks were in fact profitable.

As an example, BNP's return on equity (RoE) bottomed at 6% during the financial crisis from 15% in FY 2006 [2]. In FY 2020, during the Covid-19 crisis, the bank posted a modest decline in earnings, with only a mild decline in RoE to a still robust 6%, leaving significant headroom to absorb higher losses [3]. Some of the profitable banks raised capital during the financial crisis in the face of higher requirements. The most interesting takeaway from these banks' performance during the GFC relates to their business models. These were all either retail-focused banks (like BBVA and Banco Santander) or global diversified banks without outsized corporate and investment bank (CIB) units, such as BNP or HSBC. Ultimately these banks' business models during the crisis are the closest to the current banking landscape, and even if they have been de-risked over the past decade, we believe their track records during the GFC remain insightful.

Using a sample of 13 banks [4] that remained profitable during the GFC, the modelled impact of peak GFC loss rates would lead to RoEs dropping from roughly 6% in FY 2019-2021 to above 2% [5]. These banks would therefore remain profitable despite significantly lower profitability today compared to pre-GFC levels.

European banks have considerably de-risked their loan portfolios, hence the assumption of peak GFC losses is overly conservative – actual losses in a similar scenario nowadays would likely be significantly lower. Taking HSBC as an example, the stressed RoE applying peak GFC losses is -3% [6] (a loss of approximately USD 6 billion). However, more than 50% [7] of loan loss provisions taken during the GFC were from the group's US retail unit – which has since been fully exited. Adjusting for the change in business mix would lead to a RoE close to 3%, or around 6pp higher. Refining our analysis, assuming a conservative 100 bps rise in rates would lead to another 2pp uplift to the bank's RoE [8]. An adjusted, stressed RoE in a GFC-style scenario could therefore realistically be around 5% for HSBC, or broadly the same level as the last three-year average (2019-2021). For details of assumptions used and other considerations, please see Appendix 1.

[4] Sample includes BNP, HSBC, BBVA, Santander, Credit Agricole Group, Rabobank, Barclays, Standard Chartered, Erste Bank, Nordea, Nationwide, Svenska Handelsbanken and DNB.

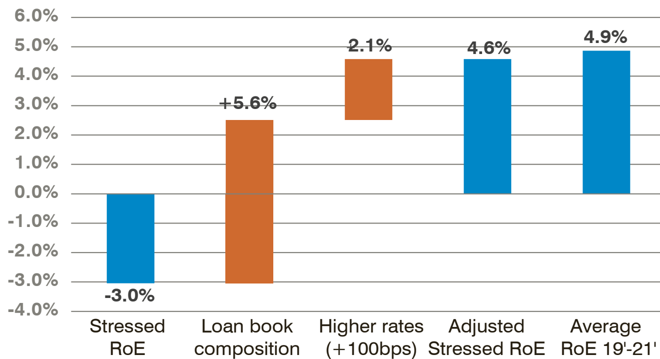
[5] 6% is the average return on equity (net income divided by shareholders' equity taken from company documents) from 2019 to 2021 for all banks listed in the sample. The 2% is computed as: cumulative pre-provision profits reported in 2021 for all banks in the sample, less cumulative estimated stressed loan losses (calculated as reported loans to customers in 2021, multiplied by highest annual loss rates on loans during in 2007-2009). The loss rate is calculated as the highest loss rate (loan loss provisions divided by customer loans) for each bank = cumulative pre-tax profits, less taxes (using the average tax rate over 2019-2021) = cumulative net income, divided by cumulative reported shareholders' equity for all banks = modelled stressed return on equity (2%).

[6] Estimated as: pre-provision profits reported in 2021, less estimated stressed loan losses (calculated as reported loans to customers in 2021, multiplied by highest annual loss rates on loans during in 2007-2009). The loss rate is calculated as the highest loss rate (loan loss provisions divided by customer loans) = pre-tax profits, less taxes (using the average tax rate over 2019-2021) = net income, divided by reported shareholders' equity = modelled stressed return on equity (2%). Source: Atlanticomnium, company documents

[7] Source: Company documents, namely the group's 2009 presentation to investors and analysts, where USD 13.5 billion of loan loss provisions were from the group's US consumer finance division (page 28 All reporting - Group | HSBC Holdings plc), out of approximately USD 26.5 billion of over loan loss provisions stated on page 5.

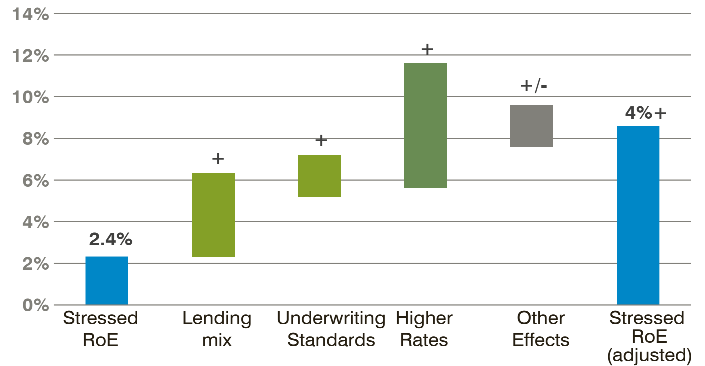
[8] Source: Atlanticomnium, Company documents

Chart 1: HSBC adjusted RoE likely to be significantly higher than stressed RoE purely based on GFC losses[9]



Source: Atlanticomnium S.A., Company documents. For further details, see footnotes 7-9.

Chart 2: Actual adjusted return on equity likely to be higher than estimated stressed RoE



Source: Atlanticomnium S.A, Company documents. For further details, see footnotes 5 and 6.

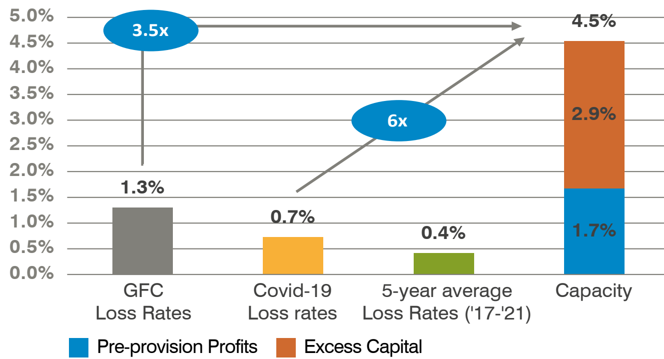
Consensus estimates forecast European banks' profitability to rise materially from higher rates, even though these already incorporate rising loan losses. Overall, the 2.4% aggregate stressed RoE for our sample would likely be higher in a stress scenario – testament to the sector's robust creditworthiness.

Chart 2 illustrates a potential adjusted return on equity in a stressed scenario for the banks in our sample, rising from 2.3% to 4%+. The differential is mainly due to the positive impact of higher interest rates that boosts banks' net interest income; de-risking since the financial crisis that would lead to lower loan losses as a result of a shift in lending mix (focus has shifted to lower risk lending such as mortgages); and tighter underwriting standards. Finally, the combined impact of other effects, such as operating expenses (effect of inflation and continued cost-cutting) and non-interest income (fee, commission, trading income) are expected to be roughly neutral.

Even though losses are mainly manageable through earnings, excess capital provides a very comfortable buffer of protection. We calculated that it would take loss rates of 4.5% to deplete both pre-provision profits and excess capital of our sample. Loss rates reflect annual loan losses as a percentage of loans, and the quantum of losses banks can absorb (as a percentage of loans) before PPP and excess capital are wiped out – the maximum loss rate tolerable for bondholders. Putting these number into perspective, wiping out banks' profits and excess capital equates to roughly 3.5 and six times the loss rates seen at the peak of the GFC and Covid-19 crisis, respectively, for our sample of banks. Note that peak losses during Covid-19 (in 2020) were expected credit losses, and actual loss experience has been significantly lower.

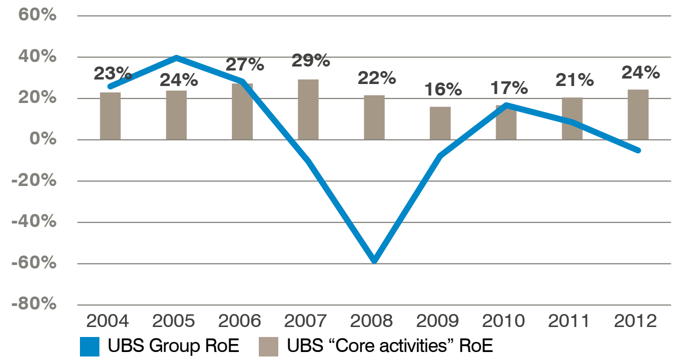
[9] Based on the -3% stressed return on equity previously mentioned, adjusted for (1) loan book composition, adjusting the loan loss rate to reflect the fact that loss would have been around 50% lower without the US consumer finance unit and, which increases pre-tax profits by around USD 13.5 billion (2) 100 bps increase in rates leads to USD 5.4 billion positive impact on pre-tax profits. Using the two assumptions leads to an adjusted stressed RoE of 4.6%. Sources: 2009 investor presentation; annual reports covering the periods 2007, 2008, 2009 and 2019-2021, supplemented by Atlanticomnium calculations.

Chart 3: Loan losses would need to rise close to four times levels seen during the GFC to deplete earnings and excess capital



Source: Atlanticomnium S.A., company documents. [10]

Chart 4: UBS's 'core' business delivered a 15%+ return on equity throughout the crisis



Source: Company documents, Atlanticomnium, 'core' business refers to Wealth management and domestic retail banking activities

Even when looking at GFC outliers, the thesis remains intact. UBS was one of the largest bailouts during the GFC, as the bank recorded a cumulative net loss of close to USD 30 billion in 2007 to 2009. This loss originated mainly from the banks' structured finance securities holdings and other subprime mortgage related financial instruments. The investment bank housed the bulk of the assets, and consequently losses. Stripping out the CIB's performance during the GFC, UBS's 'core' business (wealth management and domestic retail banking activities) generated a RoE consistently above 15% throughout the crisis. The investment banking division has since been rightsized and refocused towards client-driven activities, a very different risk profile than pre-GFC. As a test of UBS's new business model during a turbulent period, the firm generated a 11% RoE in 2020 at the peak of the Covid-19 crisis, boosted by strong activity in its investment bank and very low credit losses.

A disconnect between valuations and fundamentals [11]

The current disconnect between depressed valuations on banks' subordinated debt and resilient fundamentals is bewildering. In a stress scenario, we expect banks to be able to absorb losses with profits alone. A low or even zero return on equity under a tail risk scenario should be interpreted as a strong credit positive. Excess capital is likely to be unscathed (albeit with some potential impact from higher RWAs (see Appendix 2)), with bondholders remaining well protected. Despite rock solid fundamentals, current valuations reflect expectations of a significant weakening in credit quality as the macro environment deteriorates. While uncertainty and volatility logically should lead to wider spreads on subordinated debt of banks, this should be commensurate to the actual potential outcome for bondholders. Spreads on EUR-denominated AT1s of more than 670 bps (yield close to 9.5%) are around the widest levels seen (excluding Covid-19 where they peaked at approximately 900 bps) since the inception of the index in 2014. This is wider than Euro high yield at 650 bps, with BB-rated AT1s offering a "like-for-like" spread pick-up of close to 200 bps in comparison to BB-rated high yield.

[10] Loss rates calculated for our sample as loan loss provisions (aggregate for our sample) divided by loans (aggregate for our sample). GFC loss rates refers to the aggregate average loss rate (loan loss provisions divided by loans) during the GFC using the highest annual loss rate (2007-2009) for each bank (using customer loans of that year). Covid-19 losses calculated as loan loss provisions in 2020 (aggregate for our sample) dividend by customer loans in 2020 (aggregate for our sample). 5-year average loss rates ('17-'21) is calculated as the aggregate average annual loan loss provision in 2017-2021 for the sample of banks divided by aggregate average customer loans in 2017-2021. Capacity is calculated the sum of pre-provision profits: aggregate 2021 pre-provision profits divided by aggregate 2021 loans plus excess capital: aggregate excess capital in 2021 of our sample of banks (calculated as (CET1 ratio in 2021 less CET1 requirement in 2021)*risk-weighted assets in 2021) divided by aggregate 2021 customer loans.

[11] Percentages and bps sourced from Bloomberg, Atlanticomnium S.A. data, as of end June 2022. EUR AT1 CoCo Index refers to the Bloomberg Contingent Capital EUR Index. Euro High Index refers to the Bloomberg Pan-European High Yield (Euro) Index.

We believe the European banking sector's resilience and ability to absorb losses even in a tail scenario should be highly supportive of valuations compared to other sectors. Quarterly earnings should continue to act as a catalyst for a re-rating of the sector – as higher rates feed into higher profitability. In case a downturn materialises, this is also likely to act as a positive driver of valuations, as these would reflect a high ability to manage higher loan losses. While in the short term a downturn is likely to lead to continued market volatility, longer term, banks showcasing their resilience should materially improve the perception of the sector. The ability to navigate a downturn without impairing bondholders' war chest (excess capital) should imply banks trading at the tighter end of the market. Subordinated debt of banks offers investors the ability to add exposure to a highly resilient sector in an uncertain environment while capturing some of the highest yields available in the market.

Appendix 1: Discussion of assumptions of stressed RoE modelling

The analysis of banks' stressed RoEs is based on a set of assumptions for modelling purposes. However, we have also considered several other drivers. On balance, these do not materially alter the outcome of the analysis, but for completeness are discussed below:

- **Assumption on higher interest rates:** We assume a 100 bps rise in rates for all banks across currencies, and only consider the year one impact. This is likely to underestimate the net interest income uplift, as rates are expected to rise well beyond 100 bps, and the impact of higher rates tends to be higher in the medium term compared to the short-term (HSBC's NII would rise by USD 5.4 billion in year one for a 100 bps parallel shift in the yield curve, rising to USD 7.5 billion by year three) (See footnote 9 for more information).
- **Cost inflation:** inflation is likely to lead to higher costs (personnel etc.), which could lead to an overestimation of stressed RoEs. However, banks continue to focus on cost cutting efforts that mitigates this impact, and the assumption on higher rates is purposefully conservative (if inflation is high then rates are likely to rise well above 100 bps).
- **Pressure on non-interest income and lower lending demand in a stress scenario:** In a downturn (especially severe), non-NII income would likely come under pressure and loan demand would likely decline. This effect is difficult to quantify, and as for cost inflation, is taken into account in a purposefully conservative higher rates projection.
- **Covid-19 management overlay:** Banks continue to hold significant provisions on their balance sheet, built up during Covid-19. As these have not been used, they could be "recycled" and used to absorb losses in a future downturn. This would likely lead to somewhat lower loan loss provisions. Moreover, Covid-19 has led to a granular review of banks' lending portfolio, supportive of lower loan losses.
- **Front-loading of loan loss provisions under IFRS9:** under the current accounting regime, banks need to recognise losses upfront based on macroeconomic scenarios rather than as losses are incurred. This would distort somewhat the outcome. However, on average, this does not change the level of incurred losses overall throughout the crisis. During Covid-19, regulators have allowed banks to smooth the impact of IFRS9, which could also occur in the future.
- **Market risk losses:** Market risk losses are difficult to model, and based on Covid-19 experience, elevated market volatility on securities has supported strong performance in CIB units. European banks have de-risked their CIB operations because of tighter regulation and reduced risk appetite, and risk management practices have improved significantly. Actual market risk has become limited, as banks are broadly no longer taking risk on their balance sheets, but merely supporting client activity. Overall, we believe that on aggregate, market risk losses are unlikely to be material, although specific banks may face headwinds in specific segments – albeit at moderate magnitudes.

Appendix 2: Potential impact of higher risk-weighted assets on banks' excess capital positions

Capital would be unscathed by earnings, as we expect banks to remain profitable even in a stress scenario. Nevertheless, excess capital could be eroded by higher risk-weighted assets (RWA) – the denominator of banks' Common Equity Tier 1 (CET1) ratio. Risk-weighted assets are sensitive to the credit quality of banks' loan books and would increase in a stress scenario as a result of higher non-performing loans and higher uncertainty as to borrowers' ability to service their debt. As risk-weighted assets increase, capital ratios decline (assuming unchanged levels of CET1 capital), which leads to lower excess capital. Quantifying the level of risk-weighted asset inflation is very difficult and subject to elevated uncertainty. As a conservative approach, we turn to the RWA inflation expected by the European Banking Authority (EBA) under its 2021 stress test. Over the three-year time horizon of the stress test, the EBA expected aggregate RWAs to increase by around 12% [12]. This would lead CET1 ratios (Eurozone system-wide) to decline from 15.2% to 13.6% [13], well above the average requirement of approximately 10% [14]; and a comfortable EUR 341 billion [15] excess capital (from EUR 442 billion) [16]. Note that it would require a 52% [17] rise in risk-weighted assets to wipe out Eurozone banks' excess capital.

[12] Source: EBA stress test 2021 Stress tests 2021 | European Banking Authority (europa.eu)].

[13] Atlanticomnium calculations based on EBA figures

[14] Atlanticomnium estimate based on average CET1 requirements for Eurozone banks

[15] (13.6% CET1 ratio less 10% requirements) times risk-weighted assets inflated by 12%. Source: EBA

[16] (15.2% CET1 ratio less 10% requirement) times risk weighted assets. Source: EBA

[17] Atlanticomnium estimate

For more information, please visit GAM.com

Important legal information:

The information in this document is given for information purposes only and does not qualify as investment advice. Opinions and assessments contained in this document may change and reflect the point of view of GAM in the current economic environment. No liability shall be accepted for the accuracy and completeness of the information. Past performance is not a reliable indicator of future results or current or future trends. The mentioned financial instruments are provided for illustrative purposes only and shall not be considered as a direct offering, investment recommendation or investment advice. The securities listed were selected from the universe of securities covered by the portfolio managers to assist the reader in better understanding the themes presented and are not necessarily held by any portfolio or represent any recommendations by the portfolio managers. There is no guarantee that forecasts will be realised.

1919 17/08/2022

GAM Investments