Flash
Subordinated Debt

Written on
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What is the outlook after the rebound?

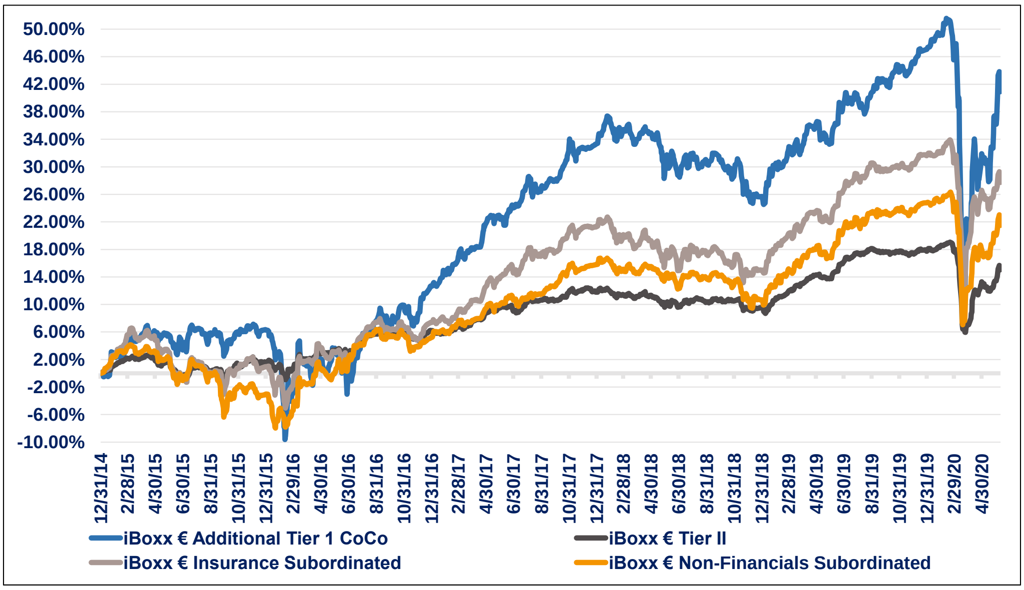
Subordinated debt issued by banks, insurance companies and non-financial companies has logically been very strongly impacted by the health and economic crisis of recent months, but has seen its valuations recover significantly in recent weeks, as per the equity and high-yield bond markets.

On closer inspection, the picture is becoming more complex, however, with various issues relating to subordinated structures: suspension of coupon payments, exercise of call options, changes in banking regulations and legislation.

Here we consider current market valuations, as well as issues specific to subordinated bonds and the fundamental trends of issuers.

Change in total return, normalized as at the end of 2014, of the iBoxx subordinated debt indices (total return; in %)

Sources : Markit, Bloomberg, La Française AM. Data as at June 10, 2020.

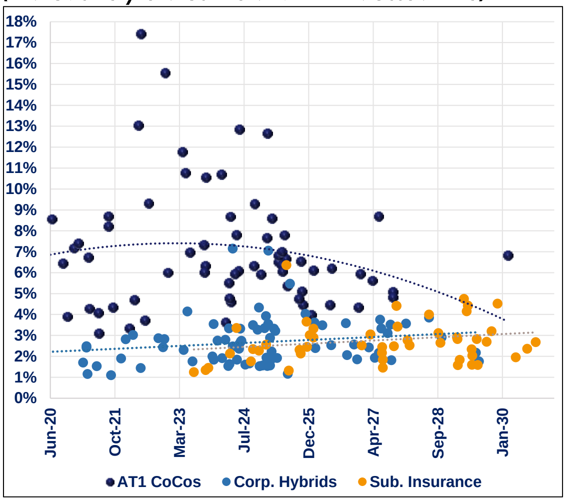


The general decline in the markets has had a greater impact on the € AT1 which, however, remained much more liquid than many other assets.

As can be seen on the above graph, **the performance of subordinated debt indices was quickly and heavily affected by the spread and consequences of Covid-19.** Additional Tier 1 (AT1, also known as CoCos) bank bonds suffered an unprecedented 29% decline between February 21 and March 19, compared to -16% for subordinated insurance debt, -15% for non-financial corporate hybrid debt and -11% for Tier 2 bank debt over the same period (iBoxx € indices taken as a reference). **The significant underperformance of the AT1€ is due to several factors**, including a "High Beta" characteristic compared to other segments, higher exposure to Italian and Spanish issuers and massive repricing of the issues according to the call probability of the securities. However, during this period, we once again observed that CoCos remained more liquid in times of stress than other subordinated debt segments, and even more liquid than parts of the Investment Grade segment, despite their potentially more volatile nature.

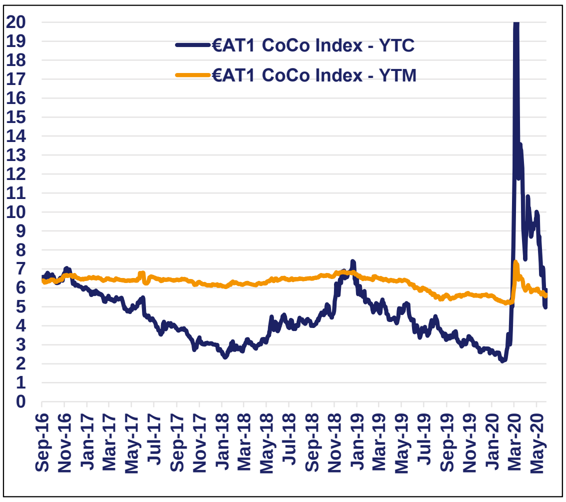
The market subsequently recovered strongly, driven by two factors: strong accommodative *measures conducted by governments and central banks and a faster-than-expected improvement of the health* situation. **Reassuring messages of unity from the European union in the face of the crisis and the ECB's unambiguous and significant support of the bond market led to a significant and rapid tightening of spreads**, with AT1 CoCos outperforming. As a result, the performance of the main subordinated debt segments has only fallen by around 2-4% since the beginning of the year (YTD performance as at 10 June depending on the iBoxx€ indices considered).

Yields-to-call of a selection of EUR-benchmark subordinated issues by asset class (indicative yield curve drawn in dotted line)



Sources : Bloomberg, La Française AM. Data as at June 11, 2020.

Average Yield to call and Yield to Maturity of the Credit Suisse AT1€ Index



Sources : Credit Suisse, Bloomberg, La Française AM. Data as at June 10, 2020.

Strong recovery of subordinated bonds, especially AT1s, thanks to the historical support plans of governments and central banks.

However, the recovery is taking place in an uneven manner

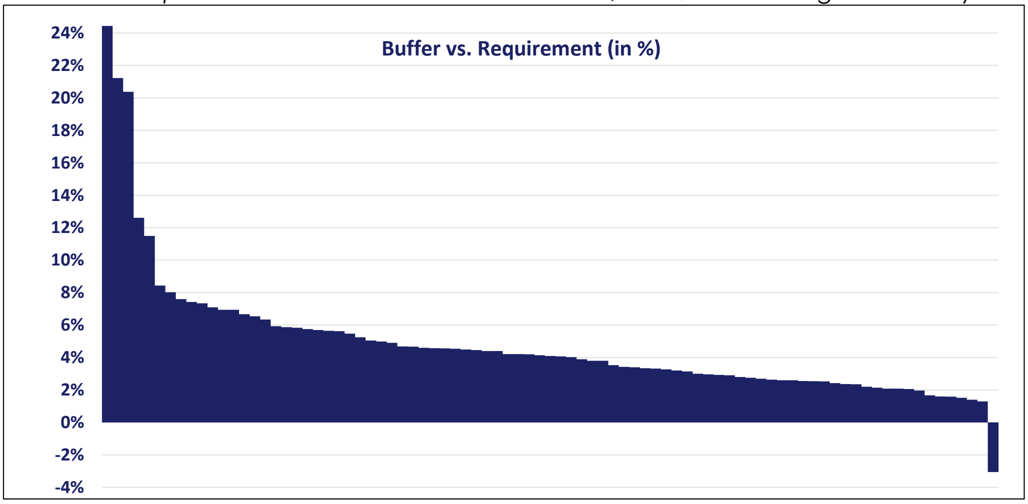
Valuations are still widely dispersed across segments, ratings, sectors and countries of issue. Corporate Hybrids reflect valuation differences that depend mainly on the sectors of the issuing companies. For example, an Accor hybrid redeemable ("callable") in 2025 currently offers a yield of 7.0%, while an Engie hybrid that is also callable in 2025 only trades at a yield close to 1.9%. On the insurance subordinated debt side, the country of issue remains the main explanatory variable for spread and price variations, if we take as an example the yield of a perpetual subordinated debt of Generali callable in 2025 which offers a yield to first call of 3.5%, while an equivalent AXA issue only offers a yield of 2.0%.

Valuations of AT1 CoCos are even more heterogeneous, as can be seen in the mapping of the yields of the issues in relation to their call dates (graph above, on the left). These valuations depend on the aforementioned factors, but must also take into account technical aspects related to the potential exercise of call options, namely : (i) the date of the 1st call, (ii) the theoretical coupon in case of default, (iii) the frequency of call dates following the 1st non-call, (iv) the situation of the issuer in terms of solvency ratios and regulatory needs with respect to subordinated issuance.

CHANGES IN BANKING REGULATIONS AND LEGISLATION

With regard to European banks, the various regulatory changes that have taken place over the last three months have led us to revisit our calculations of capital buffers beyond the regulatory requirements, making it possible to estimate both the risks of regulatory intervention (potential bail-in) and the risks of automatic suspensions of coupon payments for Tier 1 CoCos. The graph below highlights the result of our calculations on 85 European banks whose financial health we monitor via a database, Banca Carige, whose latest full solvency figures published at the end of June 2019 show a significant capital shortfall (the bank has since been recapitalised), all the banks have equity capital well in excess of regulatory minimums.

Capital buffer of 85 European banks compared to minimum regulatory requirements (taking into account potential deficits of subordinated debt; as a % of risk-weighted assets)



Sources: ECB, La Française AM. Most recent solvency data available (end of March 2020 for most of the sample, otherwise December 2019 and June 2019 only for Banca Carige).

Regarding the forthcoming quarters and the developments in terms of capital buffers, **we expect European banks to make full use of the flexibility granted to them by legislators and regulators with regard to the provisioning of non-performing loans, while preserving their equity capital by putting a halt to dividend payments.** Furthermore, we believe that **banks should issue more Tier 2 and AT1 CoCos to maximise their capital buffers** following the regulatory changes with respect to the composition of P2R. Commerzbank, for example, has issued EUR 750m of Tier 2 and EUR 1.25bn of AT1 in the last two weeks, allowing it to increase its capital buffers by a similar amount.

Regulatory requirements are becoming more flexible. Banks should take advantage of this flexibility without jeopardising their financial health, which remains generally satisfactory in the Eurozone.

We are not overly concerned about the financial health of European banks, as they should continue to be supported by regulatory relief, the main measures of which are summarised below. On the other hand, **they have entered this crisis with much more comfortable financial situations than in previous macroeconomic downturns** and even banks that still have problematic balance sheets such as Monte dei Paschi or Greek banks are currently pursuing drastic measures to reduce/transfer outstanding bad loans.

Summary of key regulatory and legislative support measures for the European banking sector taken between March and April 2020

- The European Commission has suspended bail-in rules: State aid (recapitalization) can be provided to banks without having to affect subordinated debt (EC, March 20)
- Capital requirements have been eased: banks are temporarily allowed to avoid complying with the Capital Conservation Buffer, the Pillar 2 Guidance component and the Countercyclical capital buffer has been lowered to 0% (ECB, March 20)
- According to SG Equity Research, these measures provide c. €440bn of capital relief (3.5-4% of RWAs)
- Banks can avoid complying with the Liquidity Coverage Ratio (ECB, March 20)
- The rules for calculating the Leverage ratio have been eased (EC, April 20)
- The rules for calculating market risk-weighted assets (RWAs) have been eased (ECB, April 20)
- Cheaper and easier access to central bank liquidity operations (TLTROs, PELTROs, LTROs) with looser collateral rules (ECB, March & April 20)
- More lenient accounting rules for loan loss provisions (the so-called IFRS9 rule) (ECB & EC, March & April 20)

Sources: Single Supervision Mechanism (SSM), ECB, European Commission, La Française AM.

CALL OPTIONS AND COUPON PAYMENTS

We ought to keep in mind that an AT1 CoCo not being called is no longer taboo and that several issuers have chosen not to exercise these options over the past 18 months without this having a significant impact on the valuations of their other subordinated securities. **Although the issuer's economic interest in redeeming or not redeeming a security remains the main decision-making factor** (in other words, is it better for the bank to issue a new, less expensive security and redeem the existing one or is it better to keep the existing one in circulation because the cost of a new issue would exceed that of the security not redeemed with its new coupon?), **other factors must also be taken into account**, notably the increased need for issues of subordinated AT1 CoCos and Tier 2 securities, which results from recent regulatory changes (one of the pillars of regulatory capital requirements, the Pillar 2 Requirement (P2R), can now be partly composed of subordinated debt). Finally, the reputational aspect remains relatively important, particularly in the case where the issuer has a potential refinancing cost close to that of not exercising a call.

Anticipations of non-repayment are no longer likely to destabilize the market.

Very low probability of suspension of payments of AT1 coupons

Recent decisions regarding the calls of EUR, GBP and USD denominated AT1

Issuer Name	Amount	Coupon (%)	First Call Date	Decision	ISIN
DNB Bank	USD750m	5.75	March 26	Called	XS1207306652
StanChart	USD2bn	6.5	April 2	Called	US853254AT77
Danske Bank	EUR750m	5.75	April 6	Called	XS1044578273
ING Groep	USD1bn	6.0	April 16	Called	US456837AE31
Aareal Bank	EUR300m	7.625	April 30	Extended	DE000A1TNDK2
Aldermore Gp	GBP75m	11.875	April 30	Called	XS1150025549
Deutsche Bank	USD1.25bn	6.25	April 30	Extended	XS1071551474
SEB	USD1.1bn	5.75	May 13	Called	XS1136391643
Bank of Ireland	EUR750m	7.375	June 18	Called	XS1248345461
Lloyds Bk	EUR750m	6.375	June 27	Extended	XS1043545059
Rabobank	EUR1.5bn	5.5	June 29	Called	XS1171914515

Sources : Crédit Agricole CIB, Bloomberg.

In recent weeks, Bank of Ireland has issued a new AT1 CoCo security with a 7.5% coupon to pre-finance the call on its existing security, which will be exercised on 18 June. ABN Amro has launched a new AT1 CoCo on June 8, 2020 in order to announce - most certainly - the redemption of its 5.75% issue in the coming weeks with a call date in September 2020. Similar movements from other issuers are to be expected, if the cost of financing seems attractive to them. In any case, **a non-exercise of call does not mean that the security no longer has any "value" for an investor, as it still has "at least" a considerable carry effect, which can be approximated by the yield to maturity, which is currently 5.6% on average for the € AT1 segment** (see graph, page 2 on the right).

We have already addressed the issue **of the possible suspension of coupon payments on CoCos AT1s** in previous communications and we reiterate here our view that **these are not at risk**, unlike dividends, which have been suspended until at least October 2020 (and probably at least until January 2021). This has been underlined several times by Andrea Enria, the Chairman of the ECB's prudential supervisory board, and **was confirmed once again this week by the European Parliament**, which did not vote any ban on the payment of AT1 CoCo coupon in the revision of the latest directive on bank's capital requirements (CRR/CRD).

Nonetheless ,**there may be a risk of suspension of coupon payments on hybrid debt for non-financial companies receiving government support to recapitalise them in the specific context of the Covid-19 crisis**, as long as they have not reimbursed those loans. This was decided on May 8 by the European Commission in an amendment to its legislative framework on state support. However, the devil is in the detail and suspensive measures could be circumvented, according to the nature of the government support received. To date, such a risk may exist for Lufthansa, which has some hybrid debt outstanding, but the price of those bonds (around 85-86 according to Bloomberg on June 9) already largely reflects this. **We believe that the risk of automatic suspension of hybrid coupons for issuers such as EDF, Volkswagen, Orange, Telefonica, etc., is not on the agenda**. As a theoretical example, if EDF (approximately 84-85% owned by the French State) were to proceed to a capital increase under "normal" market conditions, this would in no way, in our opinion, lead to a suspension of coupon payments of its hybrid debts... **knowing that the unpaid coupons remain cumulative, and must therefore ultimately be paid!**

With regard to the fundamentals of European companies, it is still too early to make assumptions about the evolution of their credit profile. However, we have judged the Q1 2020 results to be broadly

satisfactory for Investment Grade Corporate Hybrid issuers. Some issuers have been downgraded, but the trend remains much more under controlled overall than in the High Yield segment. European insurance companies have seen limited reductions in their solvency margins (in accordance with Solvency 2 standards) and they maintain very high levels of solvency. In addition, some have adjusted their dividend distribution forecasts downwards (or even eliminated them altogether), thereby supporting their capital ratios.

PERSPECTIVES

In terms of outlook, we remain confident about the underlying quality of subordinated debt issuers, although future Q2 and Q3 results need to be monitored closely. In our opinion, issuers and securities which are the most at risk are already identified by the market and this is reflected in the valuations of their securities.

Issuer fundamentals look solid to us

AT1 CoCos offer more value

Subordinated debt is expected to remain correlated to European government spreads and equities in the coming months.

In this environment, we favor AT1 CoCos, which offer attractive returns, either in absolute or relative terms compared to other subordinated debt segments or relative to BB European High Yield bonds. We appreciate bonds with close calls which trade at a discount relative to their par value or bonds with intermediate calls with attractive "coupon reset" options (i.e. bonds with a high carry component). We favor the European AT1 CoCos bonds, which are still discounted against their $ equivalents, although they might have greater liquidity in some cases, thanks to a wider investor base.

With respect to subordinated debt issued by insurance companies or non-financial companies, we remain comfortable with the fundamentals of the underlying issuers (mainly in so-called "defensive" sectors) **and believe that valuations may remain supported by the ECB's** senior *unsecured* corporate sector purchase programs. In these segments, we tend to favor securities with higher *durations*, and higher spread tightening potential.

In conclusion, we believe that subordinated debt remains attractive in the current environment due to consistently attractive returns (whether in returns at maturity or call dates) and more defensive fundamentals than in certain High Yield sectors and companies. In our view, price developments in the coming months should remain correlated with both the outlook for sovereign spreads in Europe and the major European and US equity markets.

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