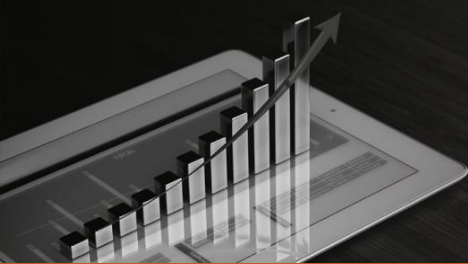


BERENBERG
Funds and Solutions

INSIGHTS – FIXED INCOME

September 2024

The following publication is part of the Berenberg Funds and Solutions series:

- Spotlight
- ▶ Insights
  - Equities
  - Fixed Income
  - Multi Asset
  - Risk-focused Solutions
  - Sustainability
  - Consulting

*In **Insights,** we give you a deeper understanding of our investment philosophy and thinking.*

Financial bonds: a hidden gem

Banks have been all the rage again since the end of the negative interest rate environment and are once more of great interest to both equity and bond investors. European financial institutions, in particular, have done their homework since the financial crisis, and have strengthened their balance sheets and demonstrated high earnings power. Financial bonds are structurally more attractive valuation-wise than non-financial bonds due to their better ratings and lower interest rate sensitivity. However, the asset class struggles with many prejudices, which we would like to clarify and dispel.

In our opinion, there are still many hidden gems to be discovered in the jungle of financial bonds. We have a long-term focus on subordinated bonds from banks and insurance companies. However, not all subordinated bonds are created equally. In our view, it makes sense to actively manage the allocation along the capital structure, especially in an environment of tight valuations. We believe that smaller banks offer attractive opportunities for financial bonds in comparison to larger banks, and banks outside of core European countries can also generate an appealing long-term added value in a portfolio context.

In the following, we take a detailed look at the attractiveness of (1) financial bonds in general, (2) financial bonds issued by small banks, (3) bonds issued by banks in the European periphery and (4) insurance bonds.

1. Subordinated bonds as a structural yield driver

Banks and insurance companies issue subordinated bonds mainly to comply with regulatory capital requirements

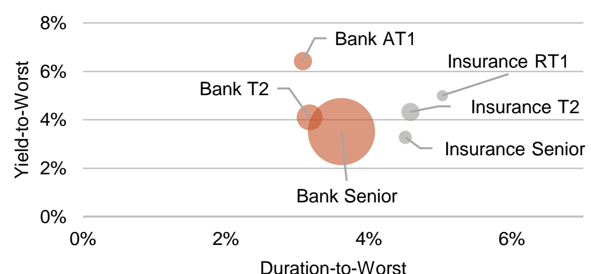
Similarly to industrial companies, financial companies also issue subordinated bonds. While the former tend to do so with the aim of supporting ratings, banks and insurers must issue subordinated bonds in order to comply with capital requirements. There are certain capital requirements that must largely be covered by equity and subordinated debt instruments. Issuers utilize the various layers of capital in order to achieve an optimum between regulatory eligibility and capital costs. In the event of a bank resolution, professional investors in the subordinated bonds are asked to pay first, before senior creditors and depositors are affected (see Figure 1).

Figure 1: The liability cascade of a bank balance sheet
Ranking of the capital structure in the event of a bank liquidation

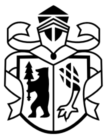
Investment risk & return	Capital Structure		Priority on Insolvency
Low ↓	Senior debt	Secured debts	High ↑
		Deposits	
		Unsecured debts	
	Hybrids	**Tier 2 Capital (Subordinated debt)**	
		Additional Tier 1 Capital ("Hybrids")	
High	Common Equity Tier 1 Capital (Ordinary Shares)		Low

Source: Berenberg

Figure 2: Senior bonds are the largest market segment
Outstanding volume of Euro-denominated financial bonds by capital structure (the size of the bubbles represent the outstanding volume)



Data as of: 30.08.2024
Source: ICE BofA Euro Financial Index, ICE BofA Euro Financial High Yield Index, ICE BofA Euro Contingent Capital Index, Berenberg



After the 2008 global financial crisis, regulatory capital requirements were tightened considerably in order to put banks on a more stable footing and to ensure that taxpayers would not have to pay for their losses in the event of a liquidation. As a result, banks are now much more conservative and have better credit ratings than before the financial crisis.

Banks today are on a more robust financial footing than before the financial crisis

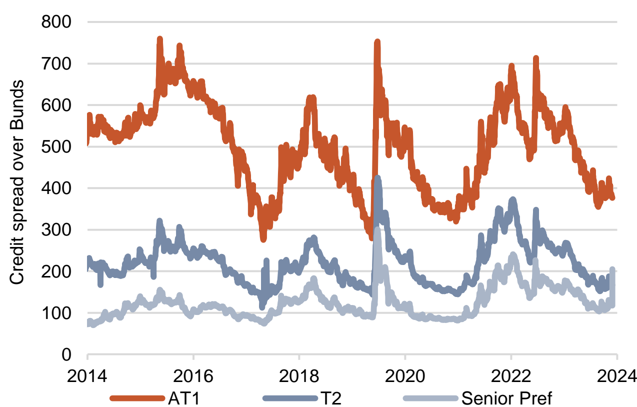
In the event of a bank being liquidated, the shareholders will suffer a total loss first. Only then will bonds of the most subordinated debt capital structure, the so-called Additional Tier 1 (AT1) bonds, suffer a (partial) write-down or conversion into shares. This is followed by Tier 2, senior non-preferred and senior preferred bonds (see 4. Insurance companies). Thus, there is almost a cascade of liability. The larger the relevant subordinated capital layer, the lower the risk for the more senior layers. For example, in the context of the Credit Suisse near-bankruptcy and eventual takeover, its AT1 bonds were written off as worthless, while investors in Tier 2 and senior bonds did not have to recognize a loss. Another risk for investors is that the coupons on AT1 bonds are not guaranteed. The regulator can prohibit banks from paying out coupons due to a lack of sufficient capital or distributable income. This naturally also affects the risk/return profile of bank bonds. Senior capital structures offer better ratings but are also associated with lower risk premiums than more subordinated bonds (see Figure 3).

The liability cascade of a bank balance sheet describes the order in which bonds can suffer a loss in the event of a bank's liquidation

The subordination risk is compensated by a higher return

Figure 3: Nothing ventured, nothing gained: subordinated bonds offer higher risk premiums

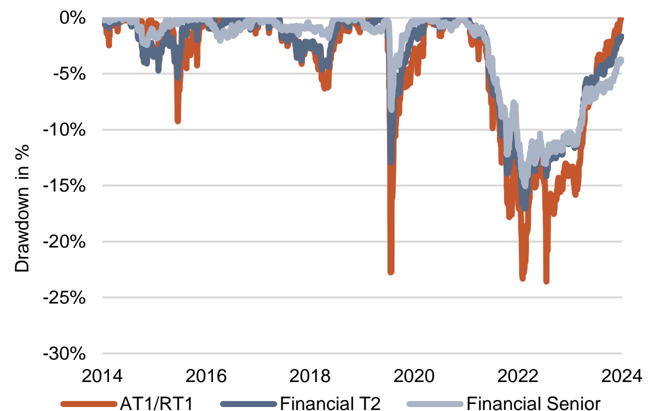
Development of the average risk premium on bank bonds in basis points



Period: 31.08.2014-31.08.2024
Source: ICE BofA Euro Corporate Index, Euro High Yield Index, ICE Contingent Capital Index, Berenberg

Figure 4: Drawdowns can be higher for subordinated bonds than for senior bonds

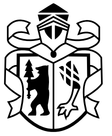
Historical drawdowns of IG AT1/RT1 bonds, Tier 2 and senior bonds of banks and insurers



Period: 31.08.2014-31.08.2024
Source: ICE BofA Euro Investment Grade Contingent Capital Index, ICE BofA Euro Subordinated Financial Index, ICE BofA Euro Unsubordinated Financial Index, Berenberg

If – after thorough research – one is convinced of an issuer's long-term creditworthiness, the subordination premium on a bond may be an attractive yield-enhancer. The yield can be higher than that of senior bonds from weaker issuers, with perhaps the same or an even lower risk. In terms of how this works, we note that not all investor groups have the freedom or the willingness to invest in all layers of the capital structure. This can lead to mispricing and offer opportunities for additional returns. For example, in a stress scenario with an accompanying rating downgrade, some investors would have to sell the most subordinated AT1s because the investment guidelines require them to do so. At the same time, holders of investment-grade senior bonds can usually continue to hold the bond. Although there is only one true probability of default for a bank, the different capital layers may price the probability differently. However, opportunities can also arise in calm market phases if subordinated bonds offer relatively high-risk premiums compared to their history.

Bonds from banks with high issuer ratings offer attractive investment opportunities due to the subordination risk and not the additional default risk



Active quota management of the various capital structures in a portfolio context is of crucial importance. By only focusing on the added return potential, one would neglect the increased volatility of such a strategy. It is also advisable to limit the maximum quotas in order to reduce pronounced drawdowns and achieve a more attractive risk-adjusted return (see Figure 4). We are convinced that it is not worth investing exclusively in subordinated bonds during market phases that exhibit tight valuations. The compensation for possible spread widening and credit defaults would seem too low. In this case, an allocation to senior bonds offers dry powder to allocate to attractive opportunities after a spread widening.

Subordinated bonds are more volatile than senior bonds with the same rating

Active management of the capital structure within a fund can reduce drawdowns

2. Small but mighty: why big banks are not always the more attractive choice

When investors think of banks, they think first and foremost of the world's major American and European banks. However, the Credit Suisse case has taught us that the global systemically important institutions are not necessarily the safest issuers. On the other hand, some American regional banks also failed due to the rapid rise of interest rates in 2022. However, in our view, overly lax regulation appeared to be partly to blame here. At the time, only around a dozen of the largest American banks were obliged to implement the Basel III regulations regarding higher liquidity and capital ratios, balance sheet reporting and the fulfilment of regular stress tests. In Europe, on the other hand, almost 1,000 banks supervised by the ECB had to fulfil the increased regulatory requirements. The feared spillover of the American wave of regional bank failures to the European banking landscape did not materialize, partly due to the stronger focus on liquidity buffers in Europe. Consequently, small European banks cannot be considered equivalent to US regional banks.

US regional banks are not the same as small European banks

Liquidity buffers at European banks are at a high level thanks to stricter regulation

Contrary to expectations, small European banks, defined as the fourth quartile by total assets, have higher capital ratios compared to large European banks (defined as the first quartile, by total assets) (see Figure 5). One reason for this is that small banks do not always have access to the primary market and want to make themselves less dependent on the capital market through higher equity and long-term debt financing. These higher buffers provide a safeguard against possible credit losses as well as the time required to recapitalize a bank in an emergency. In addition, they can often only issue subordinated bonds at unattractive conditions, which is why they are forced to cover a large part of their capital requirements with equity.

Small banks supervised by the EBA have higher capital ratios than large banks

Small banks also come out ahead in terms of asset quality. While at the time of the Euro crisis they were still struggling with a five-times-higher ratio of non-performing loans (NPLs) compared to large banks, the picture is markedly different today (Figure 6). The loan books have been cleaned up gradually through disposals of problematic loan portfolios and through the organic work-out of NPLs.

Small banks have a lower ratio of non-performing loans than large banks

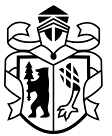
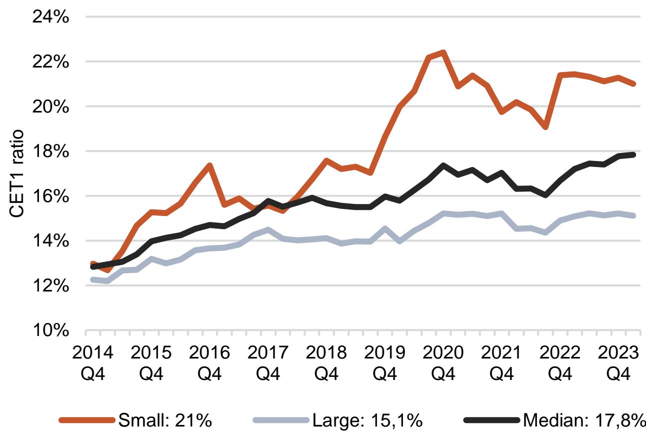
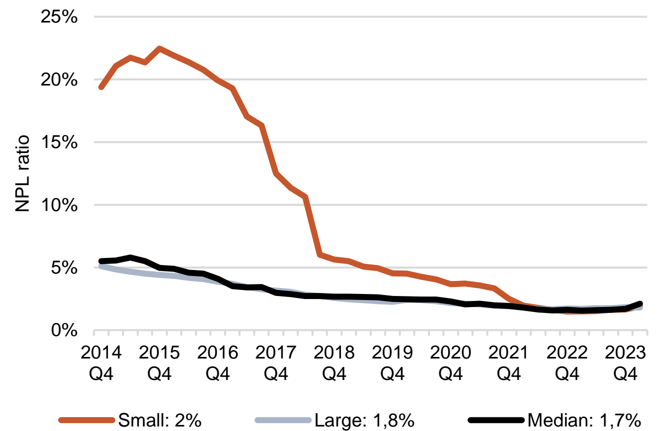


Figure 5: Small banks have significantly higher capital ratios
Capital ratios by bank size



Period: 31.12.2014-31.03.2024
Source: European Banking Authority, Berenberg. Small banks with the 25% smallest total assets supervised by the EBA

Figure 6: Small banks have dramatically reduced their NPLs
Non-performing loan ratio by bank size



Period: 31.12.2014-31.03.2024
Source: European Banking Authority, Berenberg. Large banks with the 25% largest total assets supervised by the EBA

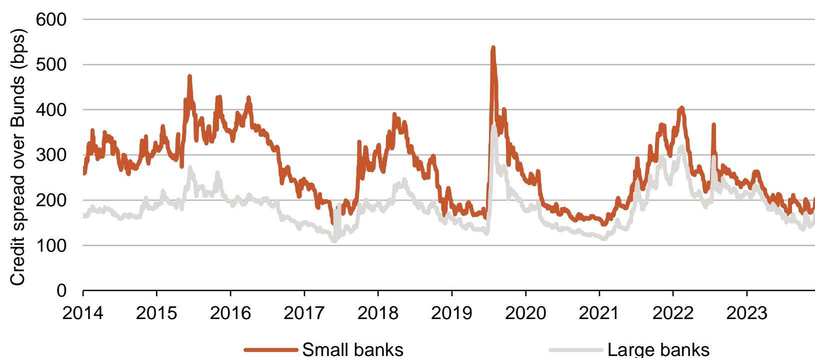
As the lending business is their core business, small banks attach great importance to the quality of their loan book with their lending criteria. Data from the European Banking Authority (EBA) also shows that small banks are more profitable in terms of net interest margins and return on equity. Overall, it would therefore appear that investor scepticism is unfounded on the basis of these key metrics. However, we must take into account that only the biggest banks are likely to receive state aid in the event of a crisis, while small banks would probably have to be wound up. This should be another reason for the more conservative balance sheets.

Bonds from small banks trade with attractive credit spreads

However, it is not only the better key metrics that make small bank bonds a particularly exciting investment. Their bonds have significantly more attractive credit spreads than comparable bonds from large banks (Figure 7). There are several reasons for this. On the one hand, the liquidity of a bond depends on the outstanding volume and on the so-called "outstanding curve". The more bonds an issuer has outstanding, the higher their liquidity, according to the assumption. It would make it possible to allocate a certain issuer in the portfolio and decide which of the particular bonds is perceived to be the most attractive. This leads to a kind of segmentation of the investor base. The bonds of smaller banks, which are sometimes smaller in issuance size and frequently fewer in number, thus offer an attractive illiquidity premium.

The increased credit spreads reflect both an illiquidity premium and the reduced interest of large institutional investors in small issuers

Figure 7: Small banks offer higher long-term risk premiums than large banks
Average credit spreads of T2 bonds by bank size



Period: 31.08.2014-31.08.2024
Source: ICE BofA Euro Corporate Index, Euro High Yield Index, Berenberg

However, the higher credit spread cannot entirely be explained by structural illiquidity. One possible explanation for this tendency could be the low level of attention paid to these issuers by research analysts. Some investors need their assessment to validate their own analyses. Another driver is the increased market beta of these bonds, which, like equities, participate disproportionately in the broad market performance. In falling markets, the liquidity of these bonds can decline more sharply than in normal market phases. On the other hand, illiquid bonds offer protection in falling markets because they are only held by a few long-term investors, leading to lower price drops. Adding bonds of smaller banks should therefore be done strategically in order to earn the excess return over the long-term cycle.

The illiquidity of bonds issued by small banks harbours advantages and disadvantages

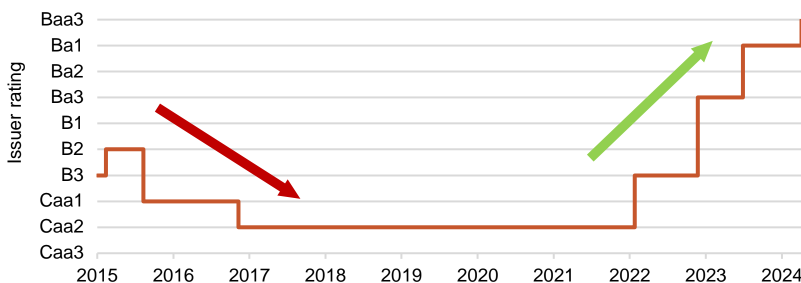
3. Nothing is as it used to be: the Euro-periphery is back in the mainstream

Despite being ostracized for a long time, banks from the Euro-periphery have made a lot of progress over the last 10 years. Countries such as Portugal, Cyprus and Ireland have been able to reduce their national debt in relation to GDP since the financial crisis. At the same time, their economic growth is stronger than the EU average. However, attractive issuers are not only to be found in the classic peripheral countries, but also in Eastern Europe, the Baltic states and the Balkans.

The banks themselves have also done their homework and have substantially reduced their stock of NPLs. On average, the NPL ratio is now even slightly below that of the aggregate Eurozone. Numerous banks that faltered in the wake of the financial and Euro-crisis have gradually recovered and have already reported significant rating improvements (see Figure 8).

Banks from the euro periphery have improved significantly on a fundamental level

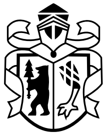
Figure 8: Rating migration of an illustrative Portuguese bank



Period: 28.05.2015-06.09.2024
Source: Novo Banco, Berenberg

Nevertheless, many investors are still skeptical about these issuers, which leads to structurally higher credit spreads. Interestingly, banks in peripheral countries are sometimes more conservatively capitalized than those in core European countries. For example, Cypriot banks supervised by the EBA had an average CET1 ratio of 21.1% in the first quarter of 2024, whereas the EU average was about 16%. Large banks, such as BNP Paribas or Deutsche Bank (all from core European countries), must fulfil higher minimum CET1 ratios due to their systemic relevance and the associated risks for the global financial system. Smaller banks therefore overfulfil their requirements more than larger ones. The financial crisis has shown that access to inter-bank financing can quickly dry up in stress scenarios. The banking market in smaller countries often has an oligopolistic structure and lacks competition from major global banks. As a result, banks in the periphery are often more profitable than comparable banks in core Europe.

Although banks from core European countries have high capital ratios, the buffers above the capital requirements are often lower than the buffers of banks from the periphery



A detailed analysis shows that comparable risk premiums/yields can be earned investing into senior bonds from local "national champions" as compared with Tier 2 bonds issued by German banks (see Table 1). The former are structurally senior to and sometimes better rated than average German Tier 2 bonds.

Senior bonds from the periphery sometimes offer higher credit spreads with better ratings than subordinated bonds from German banks

Table 1: A comparison of German Tier 2 bonds with seniors from the periphery

Average credit spread of bank bonds in basis points

	Tier 2	Senior Non-Preferred				
	Germany	Hungary	Greece	Cyprus	Estonia	Czech Republic
OAS Spread over Swaps	154	164	129	165	181	135
Rating	BBB-	BBB-	BB+	BB	BBB	A-

Data as of: 30.08.2024
Source: ICE BofA Euro Corporate Index, ICE Euro High Yield Index, Berenberg

4. Insurance companies: the Cinderella of financial bonds

Insurance companies are rarely spoken of by investors, and if they are, they are considered boring. Compared to banks, insurers have significantly higher liquidity ratios, are subject to even stricter regulation and have no risk of a bank run. While banks finance their assets with short-term deposits that can be withdrawn at any time, the majority of an insurance company's capital will be tied up in the long-term through various types of insurance policies. Early redemption of the saved capital is usually only possible with a time delay or after incurring a considerable penalty. The premiums flow regularly into the insurer's coffers, while claims occur irregularly and to a lesser extent. In addition, they are often viewed as conservative on the asset side of the balance sheet due to their fixed income-heavy investment strategy. However, it is precisely these facets that can be an advantage for bond investors.

Insurers offer the advantage over banks of not being exposed to a bank run

Compared to bank bonds, a large proportion of which consist of senior bonds, insurers have less regulatory eligibility for senior bonds. Insurers therefore mainly issue subordinated Tier 2 or Restricted Tier 1 (RT1) bonds. The former is considered the counterpart to the Tier 2 bank bond and the latter to the AT1 bank bond. In addition, the outstanding notional of the insurance bond universe is much smaller than that of banks and financial service providers (see Figure 2).

Insurers largely issue subordinated bonds

A consequence of this, the investor base in this market is segmented. Insurance regulation differs significantly from that of banks and requires separate analysis, which leads to a complexity premium for this asset class. Due to the low-index weighting of insurers, many investors therefore pay little attention to these issuers. As can be seen in Figure 9, subordinated investment grade bonds from insurers generate a higher historical performance than the broad universe of investment grade bank bonds (including both senior and T2 bonds). The former have the same average rating despite a significantly higher subordination ratio. Nevertheless, subordinated bonds from insurers have temporarily higher drawdowns, driven by investor preferences for senior bonds in periods of stress. In the long term, however, the performance more than compensates for the temporary volatility.

Insurance bonds are subject to their own regulation and therefore pay a complexity premium compared to bank bonds

Subordinated bonds from insurers offer a very attractive long-term risk/return profile

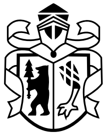
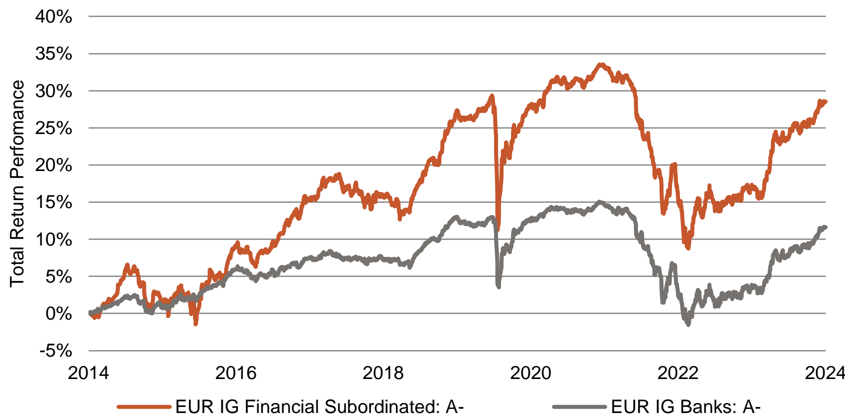


Figure 9: Insurance subordinates outperform the broad universe of bank bonds with the same rating

Relative total return (normalised at 0%) of IG insurance bonds versus IG senior and T2 bank bonds



Period: 31.08.2024-31.08.2024

Source: ICE BofA Euro Subordinated Insurance Index, ICE BofA Euro Banking Index, Berenberg

Conclusion: a look at the niches of financial bonds offers attractive investment opportunities throughout the cycle

Financial bonds are a structurally attractive asset class that should not be missing from any fixed-income or multi-asset portfolio. All too often, investors make use of old prejudices and wrongly assess financial bonds as highly risky. Yet there are many arguments in favour of this asset class. The **Berenberg Credit Opportunities**, which focuses on financial bonds, makes use of various return sources, such as allocation to bonds across the capital structure and insurance bonds as well as considering smaller issuers. Particular attention is paid to risk management and actively steering the allocation between different capital structures, as major market distortions regularly offer attractive opportunities to exploit market inefficiencies.

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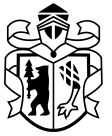

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