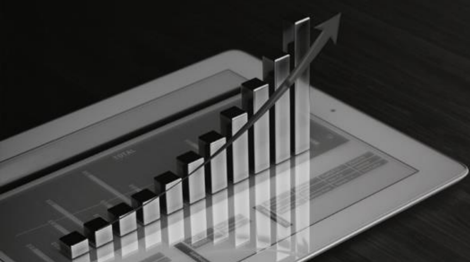

BERENBERG
Funds and Solutions

INSIGHTS - BONDS

May 10, 2022

European banks unjustly tainted by reputation

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

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

Bond investors currently need nerves of steel: persistently high inflationary pressure, rising yields and the Russia-Ukraine conflict have been weighing on the prices of fixed-income securities since the beginning of the year. At the same time, the combination of high input costs and still-disrupted supply chains threatens to spoil companies' quarterly results. In this publication, we examine the extent to which European banks are affected and demonstrate that it is well worth taking a closer look at bonds from banks, for the following reasons:

- European banks have significantly cleaned up their balance sheets over the last few years. These large institutions offer a stronger capital base, fewer problem loans and good earnings opportunities in an environment of rising interest rates.
- While bonds issued by industrial companies are likely to suffer from the European Central Bank's (ECB's) weakening support and a simultaneously expected high volume of new issues, bank bonds are much less affected by both factors.
- After the correction of the last few weeks, subordinated bonds – especially contingent convertible (CoCo) bonds – or legacy structures of European banks offer an attractive entry opportunity, in our view.

European banks have done their homework over the last few years and are in a more solid position

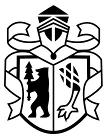
A look at the balance sheets of European banks demonstrates that financial institutions have cleaned up considerably over the past few years and are now on more solid ground, motivated by the pressure of stricter regulation. Compared to the pre-Lehman era, the average capital ratio – measured by the "Tier 1" capital of the largest 22 listed banks in the euro area – has increased by more than six percentage points since 2010 (Fig. 1). To achieve this, the institutions have, on the one hand, improved their capital cushions through capital increases and subordinated issues, but they have also achieved this by releasing equity capital through balance sheet contractions.

European banks shine with higher capital buffers and significantly reduced problem loans.

At the same time, problem loans on the banks' books have been significantly reduced, especially since the end of the sovereign debt crisis in Southern Europe in 2013 (Fig. 1). Contrary to expectations, even the multiple lockdowns and the recession that temporarily set in as a result of the COVID-19 crisis did not lead to a noticeable increase in loan defaults in 2020 and 2021. Most institutions were able to reverse the risk provisions they made within a few quarters. This gives hope, as many market participants are concerned about the quality of the debtors in the loan books of financial institutions. In addition to the possible bursting of a real estate bubble, critics also cite the current Russia-Ukraine conflict, in conjunction with high energy costs or a resurgence of the sovereign debt crisis in Southern Europe, as risks for the lending business.

Negative effects from rising interest rates, with record high real estate prices, should be well tolerable for the loan books.

There are increasing reports in the press saying that we could be heading for the bursting of a real estate bubble in some of Germany's metropolitan areas. Fuelled by record-low interest rates, real estate prices have soared to dizzying heights in many



places. If, as has already been observed in the early stages, construction interest rates now rise noticeably, this could become a problem – not only for new buyers, but especially for refinancing bank customers. Ever higher purchase prices have forced customers to higher loan-to-value (LTV) ratios and thus larger monthly charges. If higher interest rates now sustainably exceed the monthly burden limit of customers, the banks are threatened with payment defaults, according to the first admonishers.

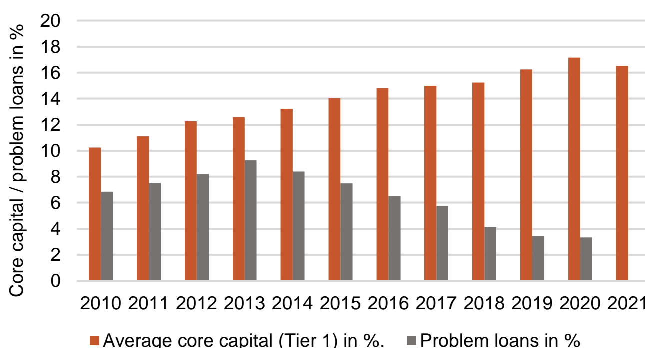
On the surface, this scenario may be correct, but it ignores several important aspects, in our view. First, banks have not fully financed the properties as LTVs of 60-80% represent the broad base. At the same time, numerous real estate buyers and refinancers have taken advantage of the low interest rates of recent years to secure favourable terms over long fixed-interest periods of more than 10 years. Last but not least, the critics disregard what they themselves criticise: the real estate prices, which have risen significantly over the years, and naturally also mean greater security in the event of liquidation should the loans really default. Even if real estate prices should initially fall in such a scenario, it is not to be expected that the many years of value growth will be completely lost as the basic problem of the housing shortage will remain to buttress the value of the market.

The Russian activities of European banks do not pose a threat to their existence.

Rumours are currently circulating on the market that some European banks could be in trouble because of their Russian activities, whether through subsidiaries or cross-border transactions. The names Raiffeisen Bank, UniCredit and Société Générale are the ones that keep coming up. As far as we know today, even the worst-case scenario, ie a complete write-off of all assets in Russia, would not put any of the three institutions in serious distress. Even for Raiffeisen Bank, which is involved in Russia to the tune of approximately EUR2.4bn in equity, the complete write-off would not mean a breach of regulatory capital requirements. Irrespective of this, the institutions would have the option of replenishing the capital cushions in the coming quarters by stopping dividend payments, disposing of other assets or increasing capital.

Fig.1 - European banks have cleaned up their balance sheets

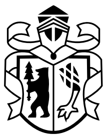
Development of core capital (Tier 1 capital in %) and problem loans (in %) of European banks (banks in the Euro Stoxx Banks Index)



Data as of: 31.12.2021
Source: Bloomberg, Berenberg

It remains to be seen whether higher energy prices will become a sustained problem for the economy and to what extent government programs can counteract this.

Initially, it seems justified to fear that the current high energy prices could push companies, primarily in energy-intensive sectors of the economy, to the breaking point and thus also cause unrest in the banks' loan books. However, after just a few weeks of high commodity prices, we consider these concerns to be premature as numerous companies have proven over two years of the COVID-19 crisis that they have significantly more staying power than initially feared. In addition, both the EU and



numerous national governments are working on short-term support measures for businesses and consumers. For the time being, Moody's, the rating agency for European high-yield bonds, is also showing little concern. For the next 12 months, Moody's recently forecast a default rate of 3.1%, only marginally higher than the long-term average of a good 2%.

Another concern that is repeatedly raised about investments in European banks is the potential resurgence of the peripheral crisis. Far-reaching spending programmes during the COVID-19 pandemic and declining tax revenues at the same time could plunge individual southern European states, with still high sovereign debt ratios, into crisis again, and with them the banks that carry the domestic government bonds on their balance sheets.

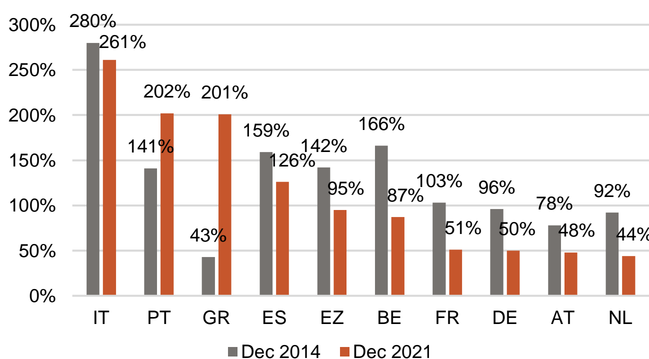
An analysis by Morgan Stanley (Fig. 2) reveals some remarkable facts. While in Germany and France, for example, the holdings of European government bonds, measured in terms of banks' core capital (CET1), have declined significantly since the end of 2014, in Italy, Greece and Portugal they remain high or have once again increased significantly. However, it remains unexplored whether these changes are mainly due to actual movements in holdings or to the above-mentioned increase in capital reserves.

Holdings of Southern European sovereign bonds now have much less impact on the capital positions of European banks.

As differently as bond holdings have developed in individual countries, financial institutions have uniformly adjusted their accounting for these securities, according to Morgan Stanley. Most European banks have moved to change the holding intention of bonds from "held-for-trading" and "available-for-sale" to "held-to-maturity".

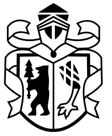
Fig. 2: Banks have not reduced peripheral risks everywhere

Holdings of European sovereign bonds (in %) as a percentage of banks' core capital (CET1) at year-end 2014 and 2021



Data as of: 12/31/2014 and 12/31/2021 respectively.
Source: Morgan Stanley

This not only means that the holdings no longer have to be valued at daily market prices, but also that the regularly flowing coupons sustainably reduce the entry prices. Accordingly, for example, burgeoning spread widening on Italian government bonds would no longer directly and excessively burden banks' core capital. The analysis here shows that a theoretical spread widening in Italy of 0.50% should only lead to capital charges of 0.03% to 0.17% on average and, therefore, no longer mean any significant cuts for banks.



Another positive balance sheet factor for banks is increased cost efficiency, measured here by the cost/income ratio (Fig. 3). Despite declining interest income in the persistently low interest rate environment and, at the same time, cost-intensive regulatory requirements – such as investments in IT infrastructure – European banks have succeeded in successively improving their cost/income ratios.

Despite meagre interest income and higher costs from regulation and IT, European banks were able to increase their cost efficiency.

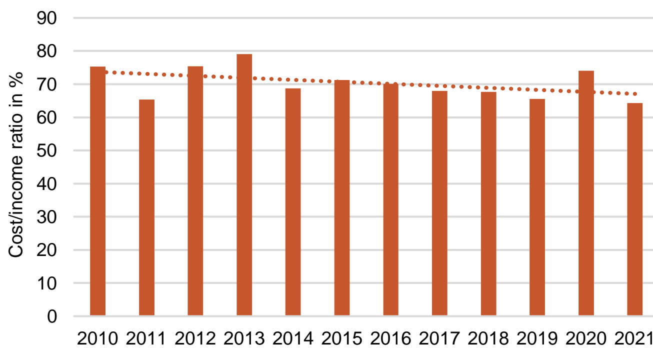
In addition, banks are likely to benefit again from higher interest rates and steeper yield curves in the future, after the interest results of numerous institutions had been declining for years.

European banks are now on a much more stable footing than they were at the time of the sovereign debt crisis 10 years ago.

The analysis shows that European financial institutions have done their homework. Many banks are in a much better position today than in the past, both at the operational level and in terms of risk management and capitalisation. Issues such as the bursting of a real estate bubble or high commodity prices would temporarily cloud the solid situation of the loan books, but would not threaten the banks' existence in the long term, in our view.

Fig. 3: Despite high cost burden, banks have become more efficient

Development of the cost-income ratio (in %) of European banks (banks in the Euro Stoxx Banks Index)



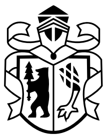
Data as of: 31.12.2021
Source: Bloomberg, Berenberg

Supply and demand – 2:0 for bank bonds

In addition to the solid balance sheet quality of banks, we believe that technical factors also speak in favour of exposure to bank bonds over corporate bonds. Over the past few years, the ECB has massively supported the market through its continuous purchases of corporate bonds (not financial bonds) and taken away much of the segment's historical volatility. With the scaling back of the purchase programmes, the market now needs to find a new equilibrium. Risk premiums, which have been kept artificially low, are likely to widen. Although financial bonds are unlikely to escape this widening pressure entirely, they will be less affected as they were not included in the central bank's purchase programmes.

Another factor that should have a positive impact on the perception of bank bonds is the expected volume of new issues. Here, numerous analysts had expected very high volumes for the overall market at the beginning of the year. However, now that the sharp rise in yields and the Russia-Ukraine conflict have led to a pause in issuance in the market, these expectations must be reassessed. Although issuance volume assumptions appear uncertain, the relationship between market segments should remain roughly intact: pent-up investment and the green transition, as well as rising M&A activity and share buybacks, point to more issuance pressure among industrial companies. To make matters worse, new issue markets have dried up since the outbreak of the Russia-Ukraine crisis. We think that it is quite possible that the pent-up

No immediate impact from the scaling back of the ECB purchase program and comparatively lower expectations for new issues speak in favour of bank bonds.



supply could be unloaded in waves over the coming weeks and cause significant spread widening in the secondary market.
For financials, on the other hand, net new issue targets are much more muted. Consolidation through M&A seems to be only a marginal issue in some Southern European countries. In addition, capital buffers and liquidity reserves are well filled, so that the new bonds are mainly refinancings of maturing bonds.

Opportunities in subordinated bonds

While, thanks to shorter duration and better credit quality, an investment in senior bank bonds can already appear worthwhile compared to traditional corporate bonds, we think that there are opportunities, especially in the subordinated segment.

Financial bonds offer an almost equal return with a lower duration and better rating.

Table 1: Financial bonds with the more attractive key data

	Industry-Bonds	Financial-Bonds
Effective interest rate	2,09%	2,01%
Modified duration	5,54	4,42
Average rating	BBB+	A-
Risk premium in basis points	145	157

Data as of: 30.04.2022
Source: ICE

Deep subordinated bonds (CoCos) issued by European banks currently represent an attractive investment opportunity. Close to the bank's equity, these subordinated bonds are issued with a fixed coupon and an unlimited term, but with a repurchase right on the part of the bank after five years at the earliest. Even if the majority of subordinated CoCo bonds are rated in the high-yield range, all major European banks have solid investment-grade ratings in the senior range. As shown in Figure 4, risk premiums have risen significantly since the beginning of the year and are currently at levels close to the market correction in the fourth quarter of 2018 and the outbreak of COVID-19 in March 2020. In our view, they represent an attractive entry level in the short to medium term, with yields around 6.1% at the end of April.

European CoCo bonds currently offer a yield of 6.1% with moderate interest rate risk.

In return, the investor accepts a (partial) write-down or conversion into shares if the regulator determines that the financial institution is insolvent. Strictly speaking, coupon payments are a firm declaration of intent on the part of the issuer, but not an obligation to pay. Even if it has not happened in history, it is theoretically up to the discretion of the financial institution not to pay the coupon. However, this is not without fatal consequences – in this case, the bank would jeopardise its credibility on the capital market and make future transactions, at the very least, significantly more difficult or more expensive.

With CoCo bonds, the investor accepts intervention in his capital in the event of insolvency - through share conversion or write-off.

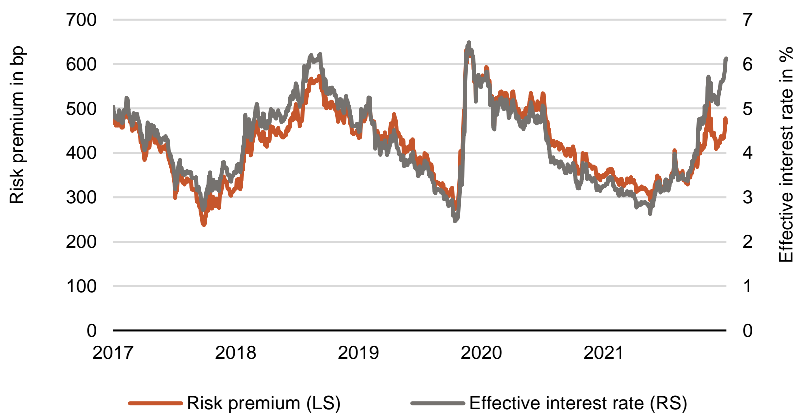
More conceivable would be an intervention by the regulator with a payment ban if the bank's earnings situation did not allow it to pay out the coupon without reducing the bank's core capital too much. In this rare but bitter case, the coupon would be lost for the investor: there is no obligation to make subsequent payments for these bonds in subsequent years. But even during the COVID-19 crisis, with dividend freezes ordered by the ECB, all coupons on European CoCo bonds were serviced. Both contingencies should be considered in a careful issuer analysis. We note that sufficiently large reserves above the regulator's capital requirements and in distributable earnings can significantly reduce both risks.
A further risk exists if the issuer of a CoCo bond does not exercise the repurchase option. The reasons for this could be that the regulator does not approve the

Sufficiently high capital and earnings cushions reduce the risk of loss with CoCo bonds.

refinancing or that the issuer, despite the regulator's permission, does not consider the prevailing market conditions to be attractive for refinancing the bond. While both of these have tended to be the exception in recent years, they can cause significant short-term volatility in individual cases. The focus on CoCo bonds with a high risk premium at the call date ("high back-end") generally means a somewhat lower yield and less market beta (compared to "low back-end" bonds). At the same time, however, this feature variant increases the motivation of the issuer to take the bond off the market and refinance it.

Fig. 4: CoCo bonds are as profitable as they were at the outbreak of the COVID-19 crisis

Risk premium (in basis points) and effective yield (in %) for CoCo bank bonds



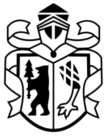
Dates: 14.03.2017 - 29.04.2022
Source: Bloomberg, Berenberg

Most outstanding CoCo bonds carry too little capital risk due to low trigger levels. The regulator could call for improvements in the future.

A regulatory weakness is evident in the choice of "trigger levels" – ie the threshold for the bank's core capital (CET1) at which the investor, in the event of insolvency, suffers a sustained loss on their capital. The prevailing mark in most CoCo bonds is 5.125% of core capital. However, considering that the average CET1 capital of European banks recently stood at 15.4%, well above the regulator's capital requirements, the trigger event is an extremely theoretical marginal scenario, which for the vast majority of banks would not even be reached in the extreme scenarios of the ECB stress test. One could even say that the CoCo bonds in their current form miss their actual purpose as a substitute for equity. It is conceivable that the regulator will make improvements here in the future and demand higher trigger levels. If "new" instruments are introduced, this could open up interesting opportunities for CoCo bonds: ie if "old" CoCo bonds with low triggers are only at risk of default in marginal scenarios, they are likely to gain in value compared to instruments with higher triggers, and risk premiums will narrow. Moreover, it is conceivable that investors will demand a premium in the event of buybacks in order to get rid of the old bonds, in our view.

Legacy bonds offer attractive return opportunities, with low interest rate risk and low market beta.

Legacy bonds issued by European banks represent another exciting investment alternative. These are old subordinated securities that, due to their specific features, have lost their eligibility for equity capital as of the end of 2021 under current regulation. Even before the expiry of this deadline, the regulator had recommended that the financial institutions concerned buy back these structures or amend the contractual terms in agreement with the investors. Against this background, legacy structures are interesting, as they often trade significantly below nominal value and, therefore, often promise double-digit returns in the event of a call or buyback. In addition, legacy structures, as mostly floating-rate securities, are characterised by lower interest



rate risks and a low market beta, making them an interesting addition to bond and multi-asset portfolios.

However, the first quarter of 2022 demonstrated that this asset class also bears risks. Whereas in the two previous years, numerous issuers had followed the regulator's recommendation, this year a few issuers had expressed themselves in a less investor-friendly manner, causing market sentiment in this segment to deteriorate. Deutsche Bank and DNB, for example, said that their bond structures would remain in the market until the regulator forced them to buy them back, even if they had lost all relevance to bank capital by then. In the case of Deutsche Bank in particular, this statement comes as a surprise, as it had withdrawn a comparable legacy structure from the market as recently as the fourth quarter of 2021, citing its expiring eligibility.

It is possible that the banks are trying to buy an extended time window for the call and hope for more favourable conditions in the event of refinancing, in our view. At the same time, however, they risk permanently damaging the relationship with their investors. As a consequence, this surprising news triggered significant price losses for some legacy structures. It may take the first positive examples to restore confidence in this investment area. However, contrary to the outlook for other pension segments, significant price potential beckons in this case. Indeed, we believe that the isolated negative examples only illustrate that it makes sense to diversify broadly by issuer and to actively manage the structures.

After the gloomy mood, the first positive signals are needed before the legacy segment can recover sustainably.

How we take advantage of these opportunities

Solid balance sheets and improved earnings power, along with supportive technical factors, are just some of the points that make European banks attractive for investment. The widening of risk premiums in recent weeks has opened up an attractive entry opportunity in subordinated bonds of European banks, in particular. In addition to CoCo bonds, the niche segment of legacy bonds offers high-return potential. In view of the high complexity of both segments and taking into account a sensible diversification, an investment via a broadly diversified fund vehicle is recommended. In addition, it is generally sensible to be able to react to the volatile market environment via a flexible and dynamic investment approach and to take advantage of investment opportunities in any market phase.

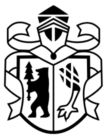
The current market environment requires flexible and innovative fixed income approaches

A market environment characterised by rising interest rates and high volatility favours innovative and flexible fixed income strategies. However, the tight corset of a market benchmark, extensive investment restrictions or a lack of derivatives capability often limit flexibility and , therefore, the exploitation of opportunities.

Berenberg Credit Opportunities is an innovative bond fund that was able to fully exploit and invest in the attractive entry opportunities in legacy and CoCo bonds of European banks described above due to its high flexibility. The fund has no benchmark or extensive investment restrictions; therefore, it can act opportunistically and be broadly diversified, using the entire rating keyboard, as well as a capital structure adapted to the current market environment.

Berenberg Credit Opportunities is an innovative fixed income fund, which is able to take advantage of opportunities in different market phases through high flexibility and opportunity-oriented management

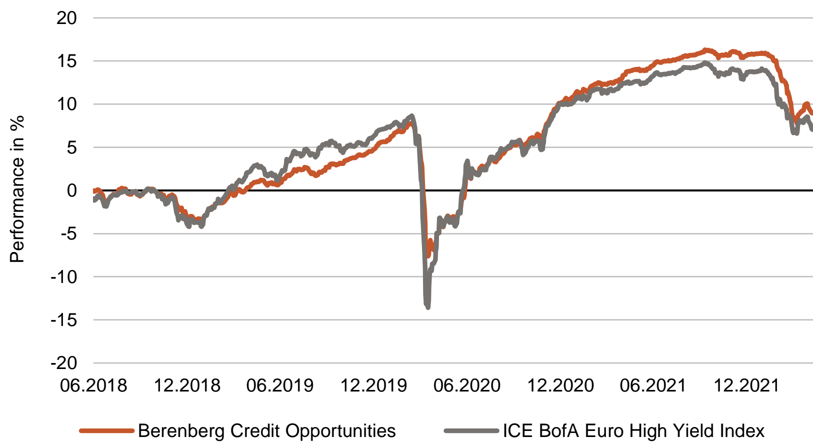
With a high yield-like payoff profile, the Berenberg Credit Opportunities fund offers an attractive alternative to a pure Euro High Yield fund, thanks to a better average



credit quality (investment grade), low volatility, as well as lower correction movements (Fig. 5).

The Berenberg Credit Opportunities fund is an attractive alternative to the pure Euro High Yield fund, with better rating and lower volatility

Fig. 5 : Performance - Berenberg Credit Opportunities versus ICE BofA Euro High Yield



Dates: 06.07.2018 - 30.04.2022
Source: Bloomberg, Berenberg

The portfolio management focuses its bond selection on a combination of interesting bottom-up ideas and global macro themes in order to identify interesting investment opportunities and market inefficiencies, and to achieve an attractive risk/return profile over the long term. The Berenberg Credit Opportunities fund is, therefore, suitable as a sensible and attractive addition to fixed income or multi-asset portfolios, which can improve returns while diversifying interest rate risks.

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