RBC BlueBay
Asset Management

Thoughts on the AT1 asset class

Markets should not be climbing a wall of worry with European banks

For professional investors only | Marketing communication

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As the dust settles on the collapse of Credit Suisse and several large US regional banks, we thought it a timely moment to take a step back and provide our thoughts on European banks, the additional tier 1 (AT1) asset class and our view going into the second half of 2023.

The fundamental backdrop

We have long been advocates of the fundamental strength of the European banking system and it remains the case in our view that the fundamental position of the sector is on extremely solid footing. Capital is robust, earnings continue to rise, liquidity is strong and non-performing loans remain at through the cycle lows. To an extent we get the sense that the ongoing apathy in bank equities is in part driven by the fact that it's hard to see further fundamental upside from here.

We are, however, a bit more optimistic than the market in this regard and while we don't expect the trajectory of ever higher capital levels and improvement to continue, the outlook remains very robust and completely at odds with both equity and credit valuations at this juncture.

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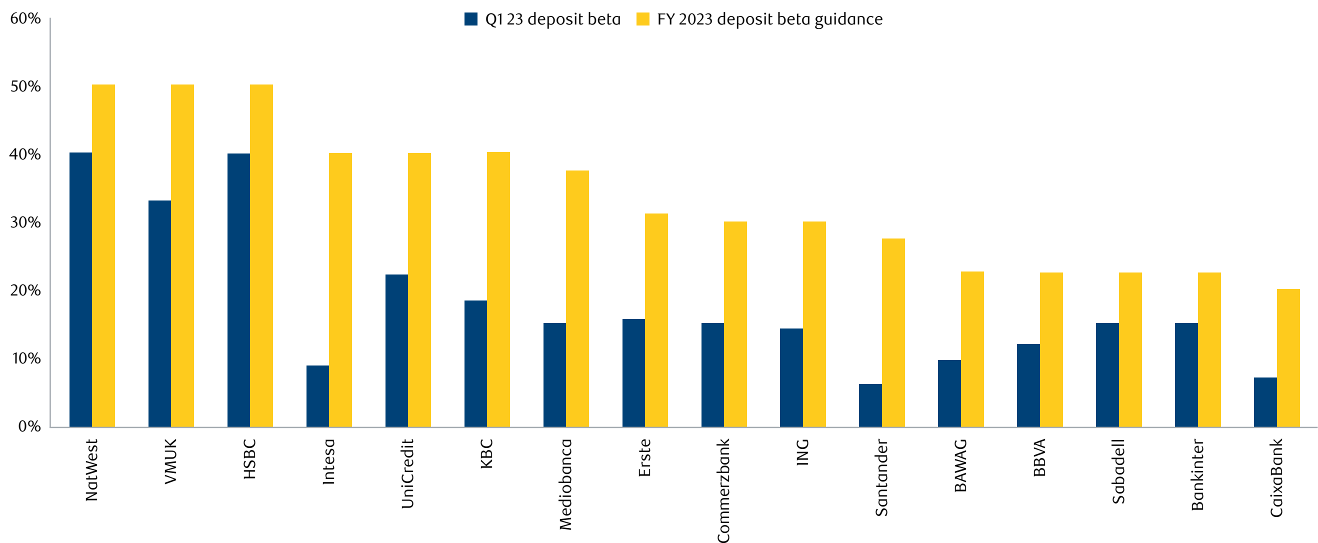
Looking at Q1, 80% of European banks beat earnings estimates with a median beat of 15%. Net interest income (NII) was up 30% YoY on average. And common equity tier 1 (CET1) capital levels beat expectations by 30 basis points (bps) rising by 39bps in the quarter, which included generous shareholder returns. While asset quality showed no signs of deterioration with provisions continuing to run below both market and management expectations and all the while liquidity levels remained robust.

European banks are all guiding for deposit betas to increase from Q1 levels (to a range of 30-50% for FY 2023)



Source: Autonomous Research, 22 June 2023.

Why the concerns?

Following the events of Q1, we see debt and equity markets climbing up a wall of worry when it comes to European banks. On the equity side, this is more earnings-related and the prevailing view is that even though the environment can't get much better for banks, bank stocks still can't seem to rally.

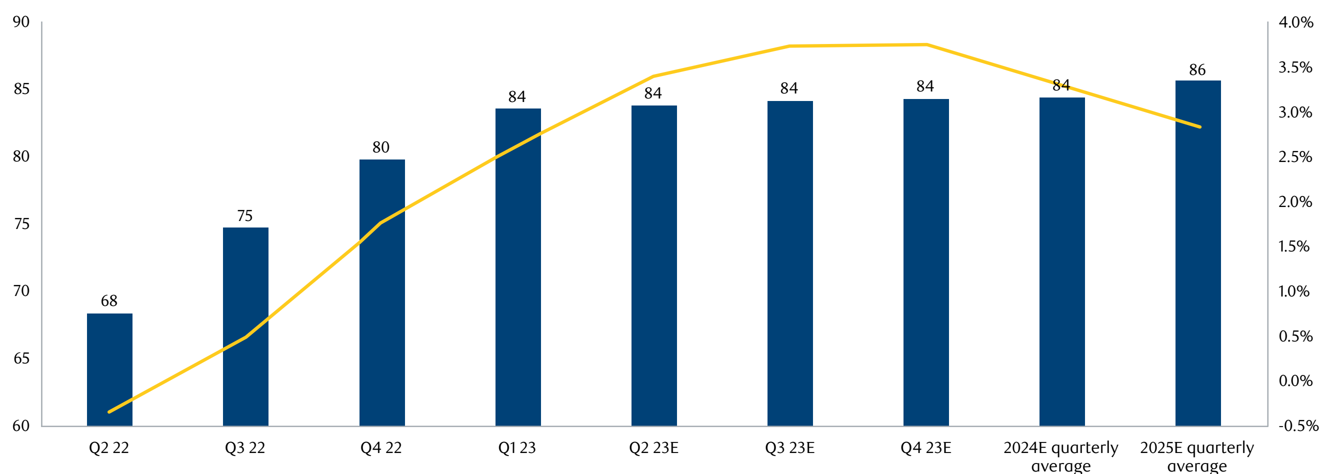
However, while consensus is beginning to point towards peak NII, we remain of the view there could be more to come. Deposit betas (the pace of passing through rate hikes to depositors) remain much lower than expectations and on top of this more rate hikes have continued to be priced in as we have moved through the year.

Consensus estimates are for deposit betas to run between 40-50% but in reality, they are running much lower than both consensus and the guidance banks themselves are giving to the market (which may have a political angle to it).

Notwithstanding, even if NII were to flatline from here we don't see that as an issue for credit, or indeed equity valuations, that are currently pricing in a recessionary environment rather than a levelling off in the earnings outlook.

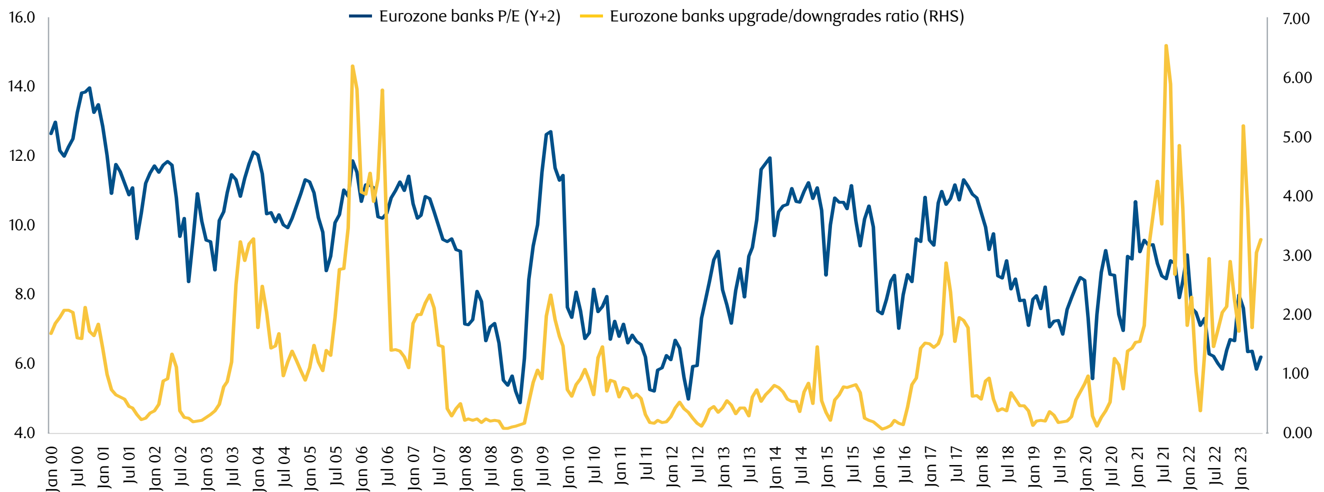
In fact, the disconnect between the sectors earning momentum and very low price-earnings ratio (P/E) has never been so acute.

Consensus assumes net interest income flat-lines for the rest of 2023 and through 2024



Source: Autonomous Research, 22 June 2023.

Upgrade/downgrade ratio based on consensus Y+1 and Y+2 earnings



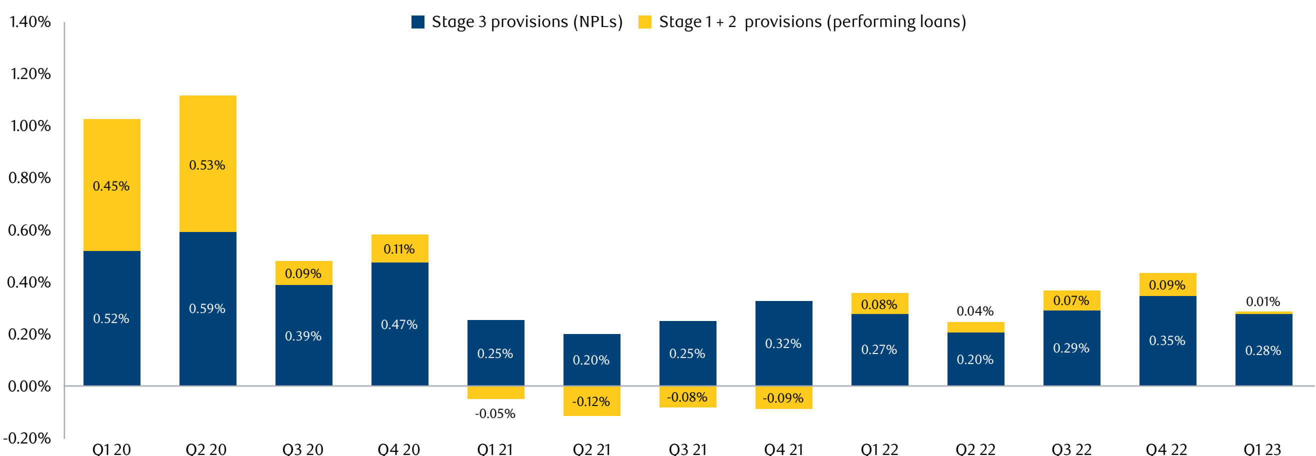
Source: Autonomous Research, Factset, Bloomberg, Visible Alpha, as at 22 June 2023.

On the balance sheet side, as rates have increased there have been growing concerns of the impact this will have on credit quality and we have seen banks tighten lending standards as a result. Undoubtedly, non-performing loans and intra-sector dispersion will pick up at some point but again it's not anything we have seen to date. Not only have non-performing loans (NPLs) remained below through-the-cycle levels but banks continue to retain significant excess provisions (c.€50bn) against loans that are continuing to perform.

> **"On the balance sheet side, as rates have increased there have been growing concerns of the impact this will have on credit quality."**

Following the developments in the US market, there have also been growing fears arising around corporate real estate (CRE) exposures, but Q1 also proved to be reassuring in this regard with additional disclosures being provided by most banks. On average European banks have around 8% of their loan books in CRE and of this, the LTV is on average 52%, with NPLs remaining extremely low and in line with the overall loan books. While this solid position may be a surprise to some, we would note that any keen follower of European central bank (ECB) regulatory papers would know that CRE has been an area of intense scrutiny by the ECB for some time. With a CRE on-site inspection campaign which started back in 2018 and a targeted review of exposures launched in 2021. Correspondingly, we have seen tightening credit standards and little to no growth in the sector exposure over this period which gives us a lot of comfort.

European banks' bad debt provisions were 29bps in Q1 2023, well below a normalised level of ~44bps



Source: Autonomous Research, 22 June 2023.

Liquidity has been the other area of intense scrutiny following the events surrounding SVB and Credit Suisse. Again though, despite the fears of the market, liquidity has remained extremely robust and deposit franchises have proved to be very resilient. As we note above, deposit betas have remained extremely low, flows have been stable and liquidity coverage ratios (LCR) have remained robust. We have started to see an increasing rotation from overnight deposits into term deposits, which is a trend one should expect to continue, but if anything, this increases the stickiness of these deposits and strengthens their liquidity profile, albeit at the expense of some profit.

Related to liquidity are the concerns about the expiry of the targeted longer-term refinancing operations (TLTRO), which originally had a large maturity cliff of €1.3trn in June but we remain sanguine on the impact this could have on banks and the market. Supply was very robust in the first quarter of the year, with banks taking advantage of the market conditions to get well ahead of their issuance plans, which we see as c.70% completed). We would also note that not only has €800bn already been prepaid but there also remains €4.1trn in overnight deposits at the ECB which will be utilised by the majority of banks in their repayment plans. Notwithstanding, the ECB and BoE have been quite vocal that they are cognisant of their roles in being the lender of last resort to the banking sector and that there are a broad range of facilities in place with very clear collateral standards that banks can use to access liquidity. Furthermore, the banking sector is encouraged to test on an ongoing basis, giving us further comfort that no stress points will arise from targeted longer-term refinancing operations (TLTRO) repayments.

European banks vs US banks

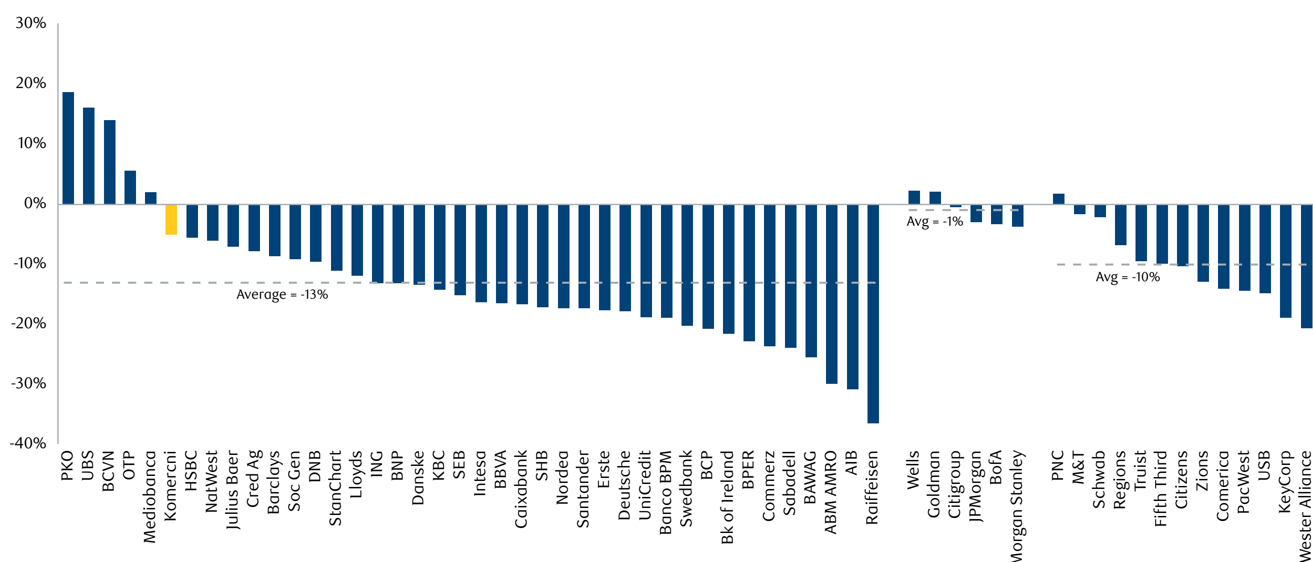
The stresses that emerged from the US regional banking sector led many to question the fundamental improvements that we have long lauded in Europe since the global financial crisis. We would push back against this scepticism, and we find it very surprising that European banks have repriced as much as US regionals, which we would view as the eye of the storm with more stresses likely to emerge.

However, while consensus is beginning to point towards peak NII, we remain of the view there could be more to come. Deposit betas (the pace of passing through rate hikes to depositors) remain much lower than expectations and on top of this more rate hikes have continued to be priced in as we have moved through the year.

In our view, the market has not fully understood the detail between the different regulatory regimes that European banks, who follow Basel standards, and the US regional banks adhere to and the currently much more favourable operating environment for the European banking sector.

While we are by no means suggesting that the events at SVB (which in many ways was idiosyncratic due to its business model) are a blueprint for the entire US regional bank sector; a post-mortem of what happened here is a useful means to highlight the differences in regulatory regimes. Under the US regulatory regime US regional banks (any bank below Category II as defined by the federal deposit insurance corporation (FDIC) do not have to mark to market their available-for-sale (AFS) portfolios. These are the most liquid portion of their security portfolios that are meant to be used for Treasury management.

Change in share price minus Y+2 consensus earnings revisions since early March 2023



Source: Autonomous Research, Bloomberg, Komercni highlighted due to large 'miss' on net interest income with recent Q1 results. As at 22 June 2023.

Following the huge runup in deposits that many banks saw post Covid, customers started to draw down liquidity as rates went higher. This was particularly acute in the US where rates are already much higher at the front end and there is also a very accessible alternative in money market funds. SVB was in this situation, but they had also taken a massive duration bet and invested all of these deposits in long-dated securities. While the quality of this portfolio wasn't an issue (they were mostly US Treasury's and agency mortgage-backed securities (MBS) the problem for them was that as they sold down these securities to fund the deposit outflows it was leading to the crystallisation of large capital losses that had not been reflected in the bank's capital position. This brought huge focus onto the mismanagement that had been taking place and this in turn led to the run on the bank and its ultimate downfall.

A favourable operating environment

The securities portfolios held by European banks and US globally systemically important banks (GSIBS) are completely different in structure to what we saw at SVB as they have fully translated the Basel recommendations on interest rate risks into their regulation. This forces banks to report the capital impact of shifts in interest rates on an ongoing basis i.e., they need to mark to market these portfolios and so the moves in rates and the subsequent impact on valuations are already reflected in banks capital positions. In addition to this, banks subject to Basel regulations are limited in the amount of interest rate risk that they can take such that a 200bps move in interest rates cannot have more than a 15% impact on capital ratios. The combination of these rules means that European banks are extremely limited in the duration risk that they take and which reduces the impact of interest rate volatility on capital ratios.

> **"The money market for retail depositors in Europe is less developed and the rate differential is not yet nearly as large as in the US."**

Through Basel, European banks are also subject to both liquidity coverage ratio (LCR) requirements and net stable funding ratios (NSFR). These ratios require banks to maintain enough liquidity to cover outflows with no access to markets over a 30-day period and to ensure that they have enough stable funding over the longer term i.e., the available stable funding as a ratio to required stable funding over a 1-year period. While these requirements may have some shortcomings and have come under scrutiny following the run at Credit Suisse this is an additional layer of regulation that US regional banks do not need to adhere to which provides significantly more protection against the occurrence of an SVB-type event in Europe.

As mentioned above, the operating environment for European banks is currently, in our opinion, also more favourable than for their US counterparts who are facing several headwinds. We would highlight them as follows:

- Rising rates have reached the point in the US where depositors are withdrawing deposits and buying money market funds. Even if this doesn't directly lead to funding stresses, it dramatically increases the cost of funding for banks to retain a stable funding base. In Europe, these same stresses have not yet emerged. The money market for retail depositors in Europe is less developed and the rate differential is not yet nearly as large as in the US, so deposit bases have remained much more stable and we expect this to continue to be the case.

- European banks have taken far less interest rate risk than their US counterparts. The fallout from SVB highlighted this risk for US regionals and these banks are going to be much more closely scrutinised by both the regulator and the market going forward which will impact future returns.

- Curves are more inverted in the US than in Europe. Banks make money through maturity transformation. In the same way that European banks suffered from negative rates, inverted curves are also a severe headwind for profitability.

- Commercial real estate exposures appear more problematic in the US than in Europe. Regional banks have far higher exposures to local CRE markets than the larger US or European banks. As they have reigned back lending in response to funding concerns, this has put more pressure on these markets which will likely lead to higher non-performing loans and credit costs in these sectors.

- We expect significant regulatory changes for the US regional banking sector in response to the events that have unfolded. It is almost inconceivable to us that you see three of the five largest bank failures within a few months and a regulatory response not being forthcoming. European banks have suffered from an extremely tight regulatory oversight over the past decade which has promoted balance sheet strength at the expense of profitability, and we see a similar outlook on the horizon for the US regional sector.

Regulatory changes

Since the Swiss financial market supervisory authority's (FINMAs) actions around Credit Suisse, there have been numerous market rumours about potential positive changes to the asset class as European regulators looked to bolster support for AT1 which they stated, "will remain an important component of the capital structure of European banks". However, while we have seen a noticeable uptick in engagement from regulators, we don't see any changes being imminent. In our engagements with both European banking authorities, the SRB (single resolution board) and EBA (European banking authority), they have been very clear that while they want to support the asset class (pointing to the joint statement with the ECB they released the day after the Swiss authorities' actions and their ongoing engagement with investors) they do not think it is necessary or wise to make expedited decisions. Therefore, while we would not rule out changes being forthcoming, our impression is that they want some time to pass between what happened in Switzerland and their reopening of the rule book.

Valuations

The events in the US and the downfall of Credit Suisse caused a significant repricing of the AT1 asset class as the market digested the events that had passed. While comments from regulators and Q1 results have gone someway to providing stability to the market, spreads remain at very elevated levels.

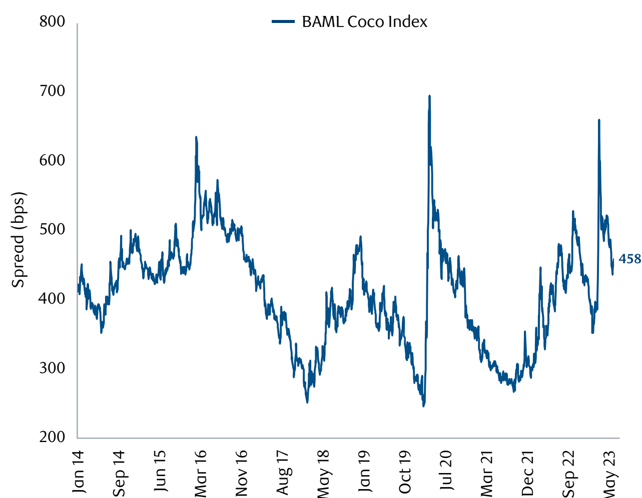
Year-to-date tights in spread were 352 with wides of 659 reached in the week after the Credit Suisse rescue. Since then, we have retraced somewhat and are now at an index spread of 458.

While this is a significant retracement we are still at very elevated levels on a historic basis and at the same time, the risk-free rate is at levels last seen pre-financial crisis. As a result, the all-in yield of the asset class remains at c.8.5% (as at 22nd June) which looks extremely attractive, particularly for a sector that is naturally quite short duration and where the fundamentals benefit from higher rates.

In the chart opposite, we have plotted the historic 12-month forward returns for a given level of spread since the inception of the CoCo index. Using a 'best-fit' line of historic returns, the level of spreads we are currently at predicts double-digit levels of returns for the next 12 months. Further, this predictive model does not take into account that yields are at these highs since the index inception, which will also play their part in the total return for the asset class over this period.

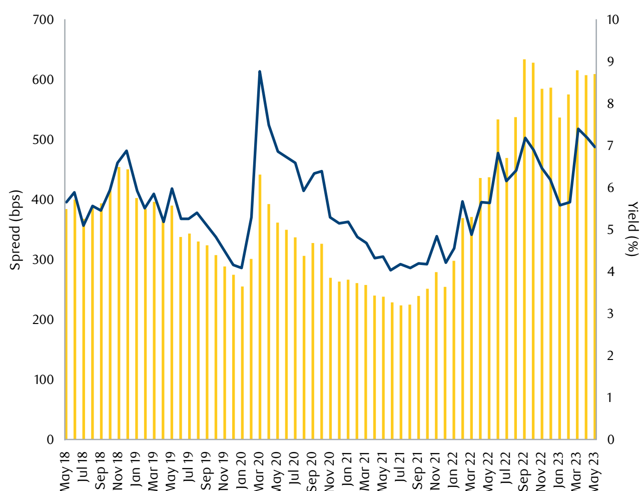
When combined with the fundamental backdrop described above, we are very optimistic that these types of returns are realistically very achievable.

Valuations



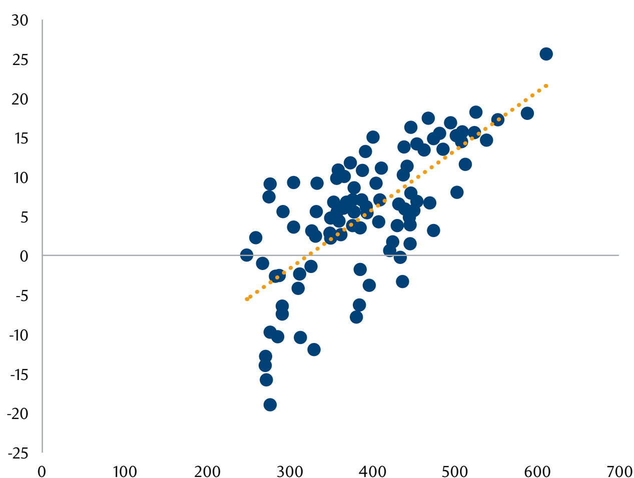
Source: RBC BlueBay Asset Management, Bloomberg, as at 21 June 2023.

ICE BofA COCO Index



Source: RBC BlueBay Asset Management, Bloomberg, as at 31 May 2023.

12 month returns at a given spread



Source: RBC BlueBay Asset Management, Bloomberg, as at 31 May 2023.

Market technicals

Given the fundamentals of the asset class, we believe the valuation of late has been quite technically driven. Flows have been challenged as investors have reassessed their risk appetite following the events in the banking space, but we are cautiously optimistic that these technical dynamics are starting to turn become more favourable.

On the flow front, after an initial step back from end investors as they digested the news, fund flows have become much more balanced as investors gain comfort around the idiosyncratic events at Credit Suisse and the US regional banking stress. Regulators have helped the tone by being at the forefront in addressing the market, but it's been refreshing to see banks themselves also being proactive to stabilise the market. We have seen this through enhanced disclosures – such as Deutsche Bank being very quick to give granular data on their deposit book, strong capital positions that has meant no bank has been forced to come to the market for a prolonged period, and ongoing calls of securities at the first call date, which has helped turn around the technical picture.

Calls versus non-calls

The debate about extension risk and the inclination for issuers to call securities at the first call date has been ongoing for the life of the asset class, especially since interest rates have moved so much in the last 12 months. At RBC BlueBay we have always favoured bonds with high back-end reset spreads to limit this risk, however, what we have noted, and continue to believe will remain the case going forward, is that issuers will take a holistic view on their cost of capital. By this, we mean that issuers are more likely to consider their entire cost of capital across the curve and in various tiers of debt and equity when making decisions about the economic viability of calling or not calling a given security.

Issuers consider the impact of not calling an individual bond on a) their entire cost of capital, and b) their reputation in the market when making that decision. In our experience, the most sophisticated issuers understand this dynamic and will attempt to manage those two elements, it often is the case that their decision is not based on the economic impact of any one particular bond.

Indeed, this is the approach we have seen this year, including since March, with calls from UBS, UniCredit, BBVA and HSBC all without initially refinancing. Regarding UBS specifically, the bond they called without refinancing in January this year was the lowest back-end reset bond in the market at the time which set a strong precedent for other issuers to follow and helped contribute to the asset class's strong start to the year.

> **"Regulators have helped the tone by being at the forefront in addressing the market, but it's been refreshing to see banks themselves also being proactive to stabilise the market."**

This measured approach to calls has had a very positive impact on the market and while we saw the AT1 market reopen in the last week with issuance from BBVA and Bank of Cyprus, the window to issue is short before Q2 results which should help maintain this positive technical dynamic over the summer months. This should allow the market more time to recover before issuance becomes more normalised later in the year.

Looking ahead

We continue to be encouraged by the strength of the banking sector's underlying fundamentals, particularly as European banks remain well-provisioned and continue to benefit from the rising rate environment. Over the last 12 weeks, banks have been at the epicentre of a crisis of confidence, but we believe it has now been contained and the market is finally at a point where it can begin to look forward against a stronger technical backdrop.

While the price action within banks seems contrary to these fundamentals, we are confident that this will correct over time. Even considering a possible recession, which is what is being priced despite central banks making ongoing upgrades to their near-term outlooks, the sector will be coming into any downturn from a position of strength.

Banks are generating very strong earnings, capital levels remain close to all-time highs and the stock of NPLs is close to the lows. Although we are conscious that these factors are often overlooked in times of stress, fundamentals always reassert themselves eventually.

> **"The market is finally at a point where it can begin to look forward."**

As we note above when spreads on the asset class reach these levels typically this has led to double-digit returns over the following 12 months. When viewed in the context of a high-interest rate environment, we continue to believe European Bank AT1 offers a very attractive return proposition.

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