BlueBay
Asset Management

European banks – stress tested

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From financial-crisis villain to Covid-crisis solution – the proven resilience of European bank credit fundamentals, combined with the prospect of a more favourable operating and regulatory environment, suggests to us that bank capital is a meaningfully mispriced asset class.

Summary

- There has been a profound strengthening of banks' credit fundamentals, ensuring they remained resilient through the pandemic, providing financing to households & corporates, as well as a channel for policy support.
- The suspension of share dividends and buybacks crucially did not extend to coupons on additional tier 1 (AT1) or coco bonds.
- In our view, against the backdrop of proven resilience of bank credit fundamentals to the stress of the Covid crisis, bank capital is a meaningfully mispriced asset class.
- The greatest potential risk that we anticipate for AT1s/cocos is that they are written down or converted into equity, but we believe this risk to be small.
- Our asset-class outlook is positive from a fundamental and valuation perspective, but active investment skill is required to select the most attractive instruments.

The profound economic shock of the Covid-19 pandemic has provided a severe stress test of banks' resilience and the fundamental changes wrought by the global financial and eurozone debt crises. Banks have proven themselves to be a source of stability – remaining resilient and continuing to provide financing to households and companies, as well as a channel for policy support to the broader economy.

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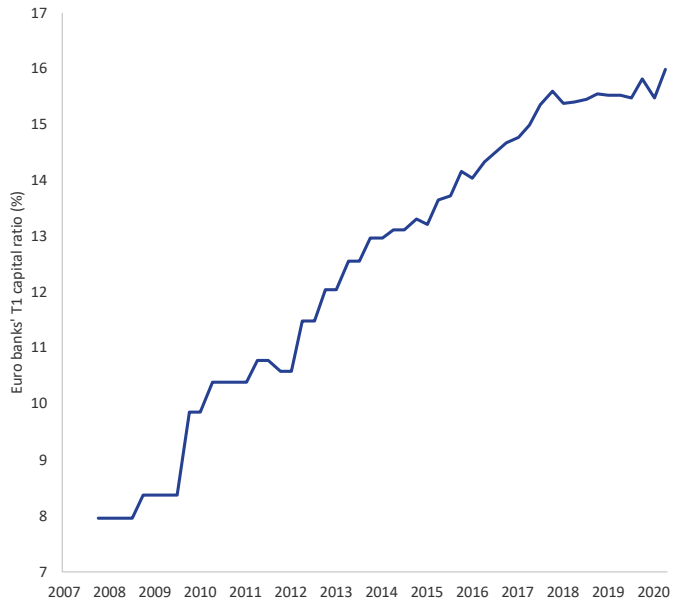
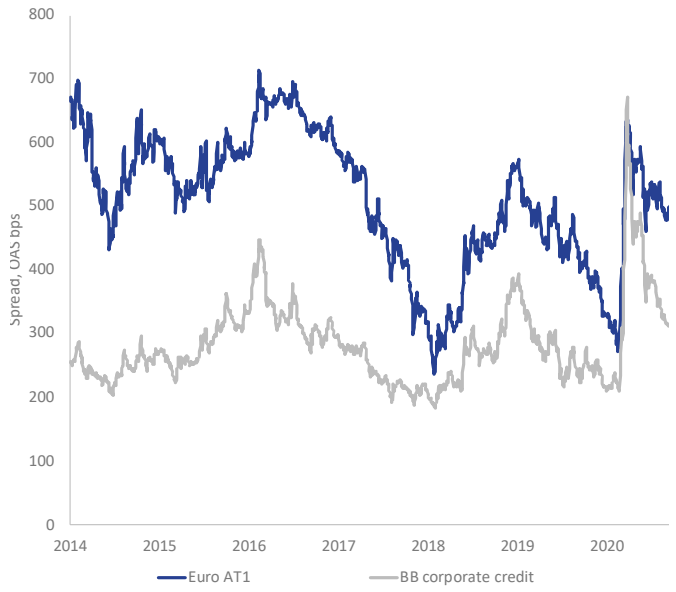
As the Covid crisis unfolded, the valuation of bank stock prices and capital instruments fell sharply, reflecting investors' fear of a surge in bad debts as the economy entered its deepest contraction in modern history. Yet, despite the stress of a surge in loan-loss provisions and falling profits, the banking sector proved resilient. This underscored the profound strengthening of banks' credit fundamentals over the last decade, reflected in the near doubling in the common equity tier 1 (CET1) ratio of European banks to 16%, alongside enhanced risk-management practices and ample liquidity. The latest earning reports by European banks (Q3 2020) show an increase in capital and a reduction in loan loss provisions as asset quality has held up better than expected.

Chart 1: European banks' rising capital ratios



Source: European Central Bank, Eurostat Q2 2020

Chart 2: Euro AT1 vs BB corporate credit spreads



Source: JP Morgan Euro AT1 spread to worst; Bloomberg Barclays Euro HY BB-rated spread; latest data at 27 November 2020

The capital strength of the banking sector on entering the Covid crisis meant that it was well-positioned to absorb losses. In fact, policy authorities turned to banks to become part of the solution to the economic crisis, rather than labelling them as part of the problem, as was the case during the global financial crisis.

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Banks have been encouraged to use liquidity and capital buffers to support the flow of credit while preserving capital by suspending share dividends and buybacks. Critically, the suspension of dividends did not extend to coupons on additional tier 1 (AT1) or coco bonds (contingent convertible bonds), underscoring regulators' preference to shield bank creditors (bondholders) rather than owners (shareholders). Governments have provided extensive bank-loan guarantees, while the European Central Bank has acknowledged the strain on banks' net interest margins by providing financing at below its negative deposit rate.

In our view, banks are positively leveraged to a more effective and rapid vaccine rollout than expected. The economic outlook is at less risk to future waves of infection and asset quality is recovering. The prospect of steeper yield curves should further boost expectations for bank earnings and, in our view, will likely be followed by a relaxation of capital distribution restrictions.

We believe the principal challenge facing the European banking sector as it emerges from the Covid crisis is low profitability. But bank management, regulators and politicians have acknowledged the need for consolidation to increase efficiency, reduce costs and improve profitability. We anticipate M&A will provide active investors in European bank capital with a rich alpha opportunity, as well as improving the long-term fundamentals of the sector.

There is also renewed momentum for putting in place a common deposit insurance scheme – we believe this is the key outstanding pillar required to complete the European banking union. In addition, we view the EUR750 billion 'Next Generation EU' fund as a giant step towards fiscal union that meaningfully reduces the tail risk of a repeat of the eurozone sovereign debt crisis and euro break-up that has cast a persistent shadow over the European banking sector.

In our view, against the backdrop of light at the end of the Covid tunnel, the prospect of a more favourable operating and regulatory environment, along with the proven resilience of bank credit fundamentals to the stress of the Covid crisis, bank capital is a meaningfully mispriced asset class. To illustrate this, the JP Morgan Euro CoCo/AT1 index is currently yielding around 4%, while some national champion banks' coco bonds yield between 5% and 6% compared to the average yield on BB-rated European corporate bonds of just over 2%.

The greatest potential risk that we anticipate for AT1s/cocos is that they are written down or converted into equity at a very unfavourable ratio if the issuing bank's capital ratio falls to the 'trigger level' of 5.125% or 7% (depending on the bank's home country), or the bank is deemed 'non-viable'. With most banks capital ratios in excess of 14%, banks would have to face catastrophic losses – greater than even in the global financial crisis – for more than half the capital base to be eroded. Therefore, in our view, the risk of write-down or equity conversion is extremely small.

A remote, but more probable risk than write-down is a coupon suspension, which occurs if capital falls below regulatory minimums plus buffer levels set for each bank. However, as the Covid crisis has demonstrated, coupon payments have been maintained even as dividends have been suspended (rendering the risk of coupon suspension even smaller) and capital buffers have remained ample.

Finally, a risk that has arisen in a few cases is extension risk, whereby an issuer chooses to leave an AT1 outstanding past its first call date because it is cheaper than calling it and issuing a new one. In our view, at current valuations and structures, this risk is moderate for most AT1s but can be further minimised by focusing on instruments with a high coupon reset level that makes it uneconomical not to be called.

Our view on the asset class is positive from a fundamental and valuation perspective, but as ever, it remains important for investors to carefully select banks and instruments based on the credit fundamentals of the issuer and the terms of the instrument.

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