OUTLOOK 2022: SUBORDINATED DEBT OF FINANCIALS – BACK TO THE FUTURE

Marketing material for professional / institutional / accredited investors

Executive Summary

The Covid-19 pandemic can be seen as the first real stress test of the revamped European banking sector since the global financial crisis

We remain in a bondholder friendly regulatory paradigm

Capital levels are likely to decline from the record levels of 2021, but there are positives to this, particularly in terms of dividend payouts and share buybacks

For 2022, our focus will be on conviction issuers and bonds that could offer robust structures

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The Covid-19 crisis is, in our view, a strong catalyst for a broad re-pricing of subordinated debt of financials. The biggest lesson learned from the health crisis is that not only could banks have absorbed losses above those of the global financial crisis (GFC), but also that the regulatory paradigm is extremely supportive for bondholders. This leads us to the conclusion that investors are paid too much on the most junior parts of the capital structure, with strong upside potential with a long-term view of potential re-pricing. Looking at 2022, we believe the weakness in spreads in the fourth quarter of 2021 represents an attractive entry point. Investing across the capital structure has the potential to yield attractive outcomes, with opportunities beyond Additional Tier 1 (AT1) CoCos. In AT1s, investors may benefit from being selective, focusing on high quality issuers and structures less exposed to downside risk in case of selloff.

Fundamentals: we now have the anatomy of a crisis, and it is credit positive

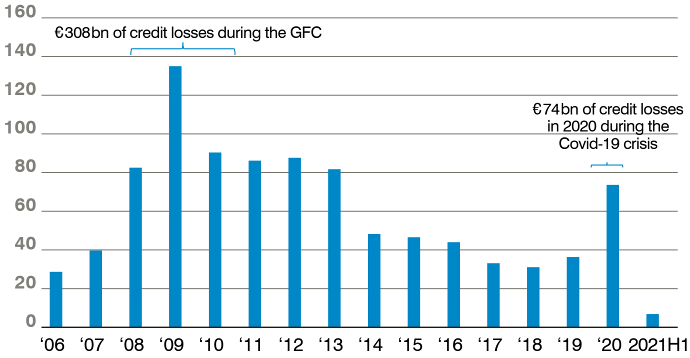
The transformation of the European banking sector is not a new story and the current strength of the sector, using a single metric – the amount of capital (common equity tier one CET1 ratios) at 15.8% as of June 2021 – is undeniable[1]. The sector rose from the ashes of the GFC to become a fortress, dampening the impact of economic shocks.

As we reflect on 2021, it is tempting to focus on two large events of the past decade – the GFC and Covid-19 crisis – to evaluate the path forward. The Covid-19 crisis can be seen in some ways as the first real stress test of the revamped European banking sector since the GFC. With a headline macro scenario worthy of the European Banking Authority's (EBA) stress tests, this was a good challenge for the sector. Ultimately, given the amount of monetary, fiscal and regulatory support,

[1] Source: EBA Risk Dashboard Q2 2021

it turned out to be a semi-stress test – as a lot of the losses of the sector have been absorbed by governments. What matters more is what we have learned from this.

Chart 1: Covid-19 credit losses have so far been limited to a fraction of those taken during the GFC

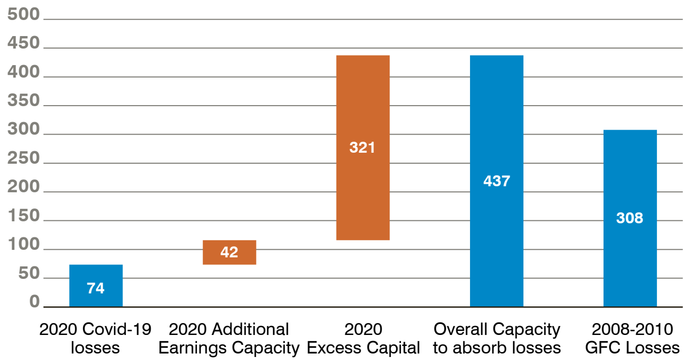


Source: Company documents, Altlanticomnium. Past performance is no indicator of current or future trends. For illustrative purposes only.

Covid-19 was not a GFC event, but the banking sector could have absorbed GFC-sized losses

At first glance and using a sample of European banks[2] the EUR 74 billion of loan loss provisions in 2020 were well absorbed through earnings, with the capacity to absorb another EUR 42 billion. However, compared to the EUR 308 billion of losses during the GFC (2008-2010 cumulative) these were limited, and even a fraction of 2009 losses of EUR 135 billion. Positively, even if banks had to absorb GFC-like losses, there was EUR 440 billion of capacity to absorb losses during 2020 including earnings (residual profits before tax after Covid-19 losses) and excess capital (see Chart 2). The EUR 320 billion of excess capital available to absorb losses should clearly be the focus, as banks have accumulated a significant amount of capital post-GFC, to be used in a tail scenario. During the GFC weak levels of capital exacerbated outsized losses given an average 6.3% CET1 ratio for our sample of banks in 2007. To put the 6.3% figure into context, a large number of new-style AT1s have a trigger at 7% (the level at which the bond is written-down or converted in equity), so clearly European banks would not have been viable by today's standards.

Chart 2: Banks could have absorbed more than EUR 400 billion of credit losses in 2020 without hitting capital requirements, above the EUR 308 billion taken during the GFC



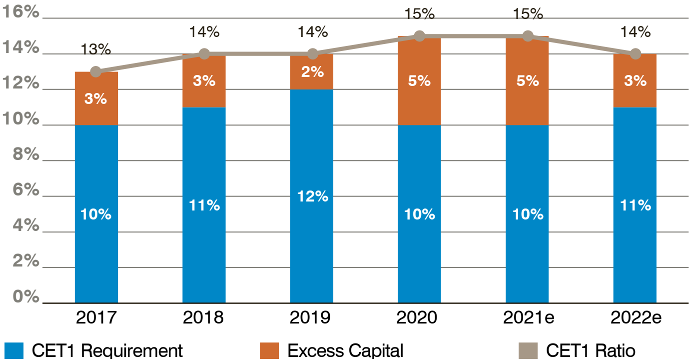
Source: Company documents, Altlanticomnium. Data as of 26 November 2021. For illustrative purposes only.

Covid-19 has confirmed that we are stuck in a bondholder friendly regulatory paradigm

A first credit positive is that the banking sector would have been able to absorb more losses than during the GFC without breaching capital requirements. But an even more interesting lesson from the Covid-19 crisis is that we are likely to remain stuck in a bondholder friendly conundrum. This is one where in good times regulators will force banks to accumulate capital, by increasing requirements (notably countercyclical buffers). This accumulated capital is then only released in times of crisis to protect depositors (ultimately the role of regulators), at which time dividends will be banned to safeguard capital positions. Chart 3 below illustrates excess capital is reduced during good times as requirements increase, but excess capital increased during the Covid-19 crisis as requirements were relaxed were dividends banned. Arguably bondholders were better off during the Covid-19 crisis than the year before, benefiting from more excess capital. More importantly, this is a positive for bondholders; higher capital requirements during good times to force banks to accumulate capital and higher excess capital during weak times to protect bondholders. The decline in excess capital during good times is counterintuitively positive, as requirements are adjusted as soon as the macro picture weakens (as we saw during the Covid-19 crisis), therefore the 'lower' excess capital is purely optical. The only difference between the Covid-19 crisis and future crises more akin to the GFC is that absolute capital levels (CET1 ratios) might not increase but instead decline as losses could be larger than during the Covid-19 crisis. But, as stated previously, bondholders could likely benefit from buffers being released to protect excess capital positions.

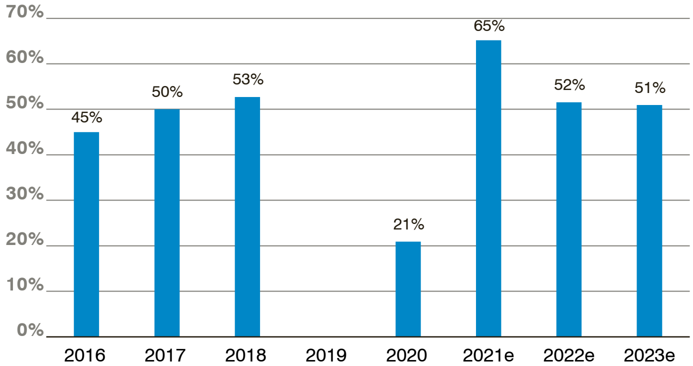
[2] BBVA, Santander, BNP, UniCredit, ING, HSBC, Intesa, NatWest, Nordea, Barclays, ABN, SocGen, Standard Chartered, Lloyds, Commerzbank, Deutsche Bank, Credit Agricole and Rabobank.

Chart 3: The regulatory paradigm is credit positive across the cycle – stylised evolution of CET1 ratios and requirements through a crisis



Source: Company documents, Altlanticomnium. Data as of 26 November 2021. For illustrative purposes only.

Chart 4: BNP Paribas' dividend pay-out ratio for 2021 of 65% including buybacks, modest increase versus pre-Covid-19 levels (the year refers to the fiscal year, payment date is the next year)



Source: Atlanticomnium, Bloomberg. Past performance is no indicator of current or future trends. For illustrative purposes only. Reference to a security is not a recommendation to buy or sell that security.

Capital levels will likely decline from record high 2021 levels, but this is good news

A highly topical debate is that the positive outlook for banks' credit profiles is fading as shareholder distributions are likely to be the focus of banks for 2022 (which has already started). Factually, management teams are focusing on how to distribute the pent-up excess capital accumulated as capital positions have strengthened since the onset of the crisis. Banks were already operating well above requirements ahead of the Covid-19 crisis, even more so currently. Excess capital is great for bondholders, but at some point the inefficiency of holding too much excess capital weighs on the appeal of bank equities for investors and in turn weighs on their ability to raise capital when required. More importantly, the opening of dividend and buyback taps also sends another positive message – the stamp of approval of the ECB – regulators are comfortable enough with the macro picture and resilience of the financial system to allow significant shareholder distributions. Moreover, we are mostly talking about catching up with previously cancelled dividends, not paying out astonishingly high levels of dividends. To put things into perspective, Chart 4 below illustrates BNP Paribas' historic and future pay-out ratio as a percentage of earnings. For 2021, even including a EUR 900 million share buyback programme should result in the bank paying out roughly 65%, which falls to circa 50% in future years (note that this could be revised upwards in case of future buybacks). These numbers hardly suggest an aggressive pay-out policy, merely a catching up of previously cancelled dividends (in 2020 BNP Paribas decided not to pay the dividend for fiscal year 2019). The pay-out story is clearly well flagged and sends a positive message on the state of the sector, not a negative deterioration of fundamentals. If anything, with Basel IV on the horizon (even in the watered-down version applicable to EU banks), the trend in capital remains that of strengthening, not loosening.

Our lessons from the Covid-19 crisis are:

- This has only been a semi-stress test given the support from the central bank, governments and regulators
- Even though loan losses were a fraction of GFC loan losses, banks could have absorbed GFC-style losses without breaching capital requirements
- The regulatory paradigm has been confirmed to be bondholder friendly through the cycle
- Focus on shareholder distributions is credit positive, as it reflects regulators' stamp of approval

Overall, the Covid-19 crisis has been a positive catalyst for the European banks' credit profiles. One of the concerns from the Covid-19 crisis is a deterioration of asset quality – ie rising non-performing loan (NPL) ratios – however asset quality has surprised to the upside, with NPL ratios on a continued downtrend since the Covid-19 crisis. While it is likely that we will see some degree of deterioration, this will most likely have a limited impact on banks' credit profiles, in our view.

Valuations appear cheap when thinking long-term

Subordinated debt spreads widened in the fourth quarter 2021 and, as of the end of November, sat at around 340 bps on AT1 CoCos, used as a proxy for the wider asset class. Relative to the 'recent' past in the last five years, this is only 70 bps wide of the tightest levels, and below the circa 410 bps five-year average spread levels. At first glance, you could argue that the market still has some juice, but spreads do not screen as cheap. The more interesting debate lies in the long-term outlook.

Chart 5: Spreads on AT1s still have some room to compress compared to pre-Covid-19 levels

Source: Atlanticomnium, Bloomberg. Data from 30 November 2016 to 30 November 2021. Past performance is no indicator of current or future trends. For illustrative purposes only.

Look further into the past to assess the attractiveness of subordinated debt

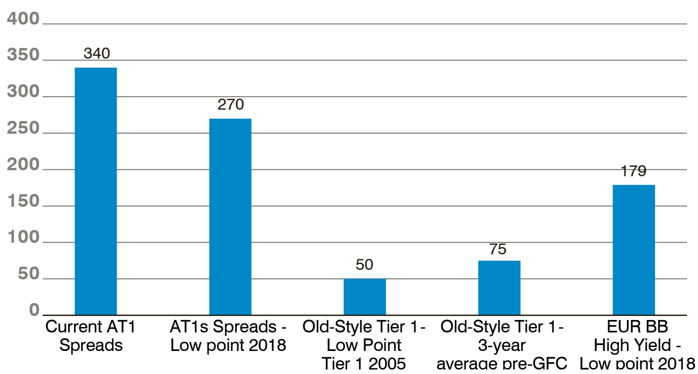
Over a longer horizon, spreads of 340 bps compare favourably to pre-GFC tightest levels of 50 bps on old-style Tier 1 bonds of banks in 2005 (three-year average pre-GFC of 75 bps). Considering overall levels of spreads on investment grade credit (IG) at the time, this was 1.3x above EUR IG spreads, so the equivalent of 130 bps today. Whether this is 50 or 130bps – this is in any case materially tighter than current 340 bps spreads. Could (or should) spreads on new-style AT1s be half (or less) than what they are today? Looking at Chart 5 above, spreads never breached the 270 bps level since the index was launched in 2014 with the birth of the asset class. This argument is fairly weak, as spreads were never lower than 400 bps before breaching this level too. Rather, the focus should be on whether we are fairly rewarded on subordinated debt or on the other hand overly paid for the risk taken.

There are a few arguments as to why spreads should be materially wider than pre-GFC. We think these have only limited merit.

The first relates to the structure of the bonds. Previously generations of bank Tier 1s had no explicit trigger level (versus mechanical write-down or conversion today in case CET1 < 5.125 / 7%) and coupon language was more favourable than on AT1s (coupons are now fully discretionary and non-cumulative with automatic restrictions in case specific capital levels are breached). As we discussed previously, the regulatory paradigm has been confirmed to be very supportive for bondholders – with excess capital rising during the Covid-19 crisis – making coupon risk very remote. In a situation of crisis, coupons have not been switched off (regulators have made it clear they will not impose AT1 coupon bans unless issuers breach requirements), nor have capital positions come even remotely close to these levels. On triggers, these are set at irrelevant levels, meaning AT1s will be wiped out before reaching even 7%. While old-style Tier 1s were more favourable structures, this does not mean these have been spared any burden-sharing. Banks that have failed have seen subordinated bonds wiped out (or close) and coupons have been deferred / cancelled on several bonds during the GFC (Lloyds had several old-style Tier 1s with coupons cancelled during the GFC). The real difference is therefore the potential "mechanical" restrictions upon breach of MDA (requirements). In the current regulatory paradigm of regulation being bondholder friendly, this should not be worth much.

The second aspect is that of ratings. Old-style Tier 1s were rated significantly higher pre-GFC compared to AT1 CoCos currently. Currently, the average AT1 is BB/BB+ rated, compared to A/A- on old-style Tier 1s pre-GFC. This is driven by both (1) assumption of government support in bank ratings pre-GFC (no bail-in regime at the time) and (2) features of the old-style bonds were more bondholder-friendly. On the face of it, there is some merit to this argument, especially as there were a few old-style Tier 1s wiped out during the GFC. However, this needs to be contrasted sharply with the fundamentals of the sector at the time. Using BNP Paribas as an example, the bank had a 5.6% CET1 ratio in 2007 ahead of the GFC but was rated AA+, compared to 12.8% as of 2020-end and rated A+ (S&P issuer rating). Despite the lack of government support and the fact instruments are somewhat less bondholder friendly, this is offset by a considerably stronger and resilient banking sector on a standalone basis. Net net, bondholders are better off currently than pre-GFC despite lower ratings. Giving some credit to this argument and assuming ratings are a constraint (AT1s are high yield-rated and investors would not buy non-IG bonds unless spreads are wider), spreads on BB high yield were as low as 160 / 180 on USD / EUR BB high yield respectively in the past five years. Spreads of AT1s should not be constrained by BB high yield given the significantly stronger credit quality, but even 160 / 180 bps compared to current levels of AT1 spreads represents significant compression potential.

Chart 6: Even if BB high yield spreads act as 'lower bound' for AT1s given average BB/BB+ rating, compression potential is significant



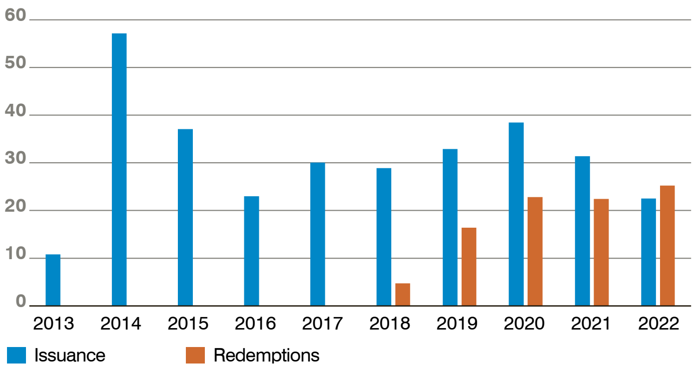
Source: Atlanticomnium, Bloomberg. Data as of 26 November 2021. For illustrative purposes only.

Third, there is an argument of AT1s not being index eligible while old-style Tier 1s were included in indices. While this argument was true at the birth of the asset class with no “natural” home for AT1s, dedicated subordinated debt funds with large holdings of AT1s have gained critical mass. Effectively, AT1s have already started having a natural home and long-term holders. Moreover, as the asset class has become increasingly mature the buying base has broadened significantly. This considerably weakens the index eligibility argument, albeit it does keep some value. **Long-term, spreads of 150-200 bps on AT1s does not seem out of reach considering all the above.**

Supply is a positive catalyst for the asset class

Historically, it can also be argued that supply was a drag on performance of AT1s, as the market grew from close to nothing in 2013 to around USD 220 billion currently. Heavy supply, to the tune of USD 30 billion or more in most years since 2014, has inevitably weighed on spreads. As the market has now become mature and grown in size then stabilised, the focus has turned to refinancing existing deals coming up for call, and net supply has declined materially, for example in 2021 (year to 25 November 2021) the USD 31 billion of issuance compares to USD 22 billion of calls – only USD 9 billion of net supply. 2022 is likely to be the first year where supply is negative on a net basis (issuance less redemptions), with an expected USD 20-25 billion of gross supply and USD 25 billion of expected calls during the year. This is also at a time where the legacy bond market is shrinking at a rapid rate as issuers redeem bonds given the 2021 grandfathering deadline, adding to the downward pressure on supply. Overall, a stable market size for the next few years and zero (or even negative) net supply is a very constructive supportive technical for the AT1 market.

Chart 7: AT1 supply likely to turn negative in 2022 as issuance declines below redemptions



Source: Atlanticomnium, Bloomberg. Past performance is no indicator of current or future trends. For illustrative purposes only.

With that in mind and a bullish long-term outlook comes the question of 2022. 340 bps and 70 bps wide to post-GFC tights in AT1s is an attractive entry point, especially combined with the belief that long-term spreads should be materially tighter.

For 2022 – focus on conviction issuers and robust structures

Markets are typically cyclical, with a tendency to overshoot one way or the other. This is particularly true for AT1s and other perpetual bonds, where extension risk has significantly influenced volatility over past cycles. Our sanguine outlook is therefore not a recommendation to buy the whole market indiscriminately, but rather to pick-up conviction names in structures that could offer balanced risk-reward.

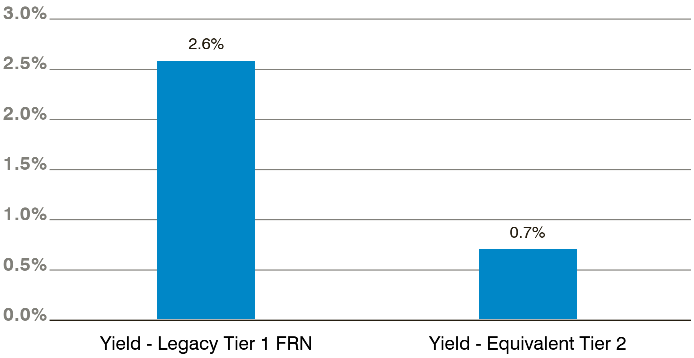
Starting with the AT1 market, compression has been a key theme post Covid-19 turmoil. This is using ‘compression’ in a very broad sense. Extension risk has been in focus with a sharp re-pricing to call with market strength. This means that bonds with weaker structures (low reset spreads, more vulnerable to a sharp re-pricing to perpetuity in case of turmoil) have previously performed strongly and are unattractive compared to more robust structures with higher reset spreads. Peripheral (Italian, Spanish etc) names have also significantly compressed, with a decline in pick-up for Italian / Spanish names compared to core European names. Even though the mini-blip we have seen recently has somewhat changed this dynamic, the upside / downside remains unattractive on the weaker structures and peripheral names. Investors should focus on high quality conviction names (national champions, G-SIBs or idiosyncratic stories) and bonds offering better structures to protect against extension risk.

AT1s remain attractive, but significant value lies in hunting for opportunities across the capital structure

Outside of AT1s, there remain pockets of value across the capital structure. Legacy bonds, a theme we have written on in the past, have been an active area of the market in 2021 with an acceleration of clean-ups ahead of the 2021-end grandfathering deadline for banks (at which point the bulk of bank legacy bonds lose all capital value and become inefficient funding). While opportunities on the banks side have become sparser, on the insurance side old floating rate Tier 1s remain attractive. These can offer a strong spread and yield pick-up compared to new-style Tier 2 bonds with good visibility on a take-out in December 2025 – end of the grandfathering period. Our basket[3] of EUR insurance legacy floating rate notes (FRNs) yields 2.6% to a base case of par call in December 2025, compared to 0.7% yield for comparable Tier 2s callable around December 2025 – close to 2% pick-up in yield.

[3] Basket includes Aegon, AXA and CNP, legacy perpetual FRNs matched against Tier 2s with call dates matching best the expected Dec-2025 call date on legacy FRNs.

Chart 8: Insurance legacy FRNs offer highly attractive yields compared to new-style bonds

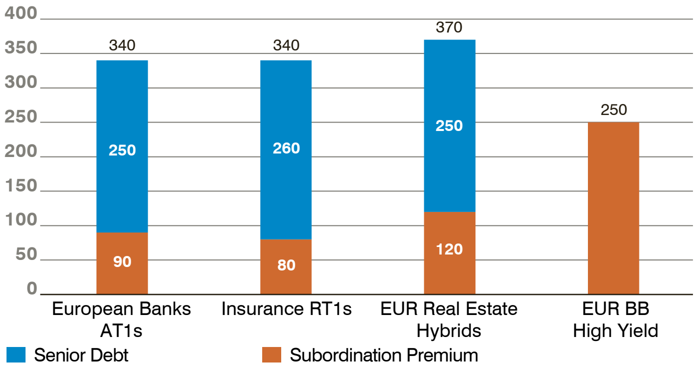


Source: Atlanticomnium, Bloomberg. Data as of 26 November 2021. For illustrative purposes only.

Staying within the realm of insurance, select Restricted Tier 1s offer attractive valuations, trading in line with AT1s despite a stronger structure (no bail-in regime, coupon structure more bondholder friendly) and mainly IG-rated bonds (average BBB-/ BBB rating). With similar spreads on RT1s compared to AT1s around 340 bps, the segment is an attractive way to capture enhanced income. Another important factor in the comparison is that the European RT1 market is almost exclusively comprised of high-quality core European issuers, while the AT1 market is 23% peripheral issuers.

Outside of these three focus areas (defensive AT1s, insurance legacy bonds and RT1s), other pockets of value exist. Taking financials more holistically, hybrids from the real estate sector also can offer attractive valuations with an ability to capture spreads above 350 bps for quality Nordic names in structures where coupons are cumulative, and bonds are structured to be called at the first call date[4] (remote extension risk). Subordination spreads (pick-up in yield / spread compared to seniors) remains extremely wide – up above 250 bps on some names – and investors could capture 2.5% more by going into the hybrids compared to the senior bonds in select names.

Chart 9: Away from AT1s, Insurance RT1s and real estate hybrids also screen cheap compared to senior debt and high yield (spreads in bps)



Source: Atlanticomnium, Bloomberg. Data as of 26 November 2021. For illustrative purposes only.

[4] Bonds are typically structured to lose rating agency credit at S&P if not called.

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