# GAM Investments on Why European Financials' Subordinated Debt is a Great Choice Combining Safety, Yield and Upside

Gregoire Mivelaz, Fund Manager and member of Atlanticomnium's Management Committee at GAM Investments, delivered a fascinating Workshop at the Hubbis Investment Forum in Hong Kong in September. He focused on the logic of buying into fixed income primarily for yield, and especially subordinated paper issued mostly by banks and other financials. Subordinated debt issued by the financials in Europe have, he reported, offered decades of proven income and this is a great opportunity to gain yield advantage over, for example, the high yield market, but with issuers that are themselves investment grade and usually household names. He said a revaluation of the sector since the Credit Suisse fallout is now underway, offering potential for capital gains as well. He told guest how risks are low due to strong regulatory oversight and also as the banks have been strengthening their balance sheets ever since the GFC of 2008-9. Gregoire offered guests many interesting and valuable perspectives and insights which we have distilled into this short summary below. For further information and additional depth, readers can also watch the On Demand version of the talk, and refer to the slide show alongside his talk (SEE LINK to PDF).

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## Key advantages of subordinated financial sector debt in Europe

Gregoire ran through the key appeals. In his opinion, there is steady and attractive income that is more reliable compared to high-yield securities, as it is solidly backed by investment-grade issuers. He believes that there is yield enhancement, as it offers a yield advantage of circa 2% to 3% per annum over the economic cycle compared to senior unsecured paper, and a yield to call of around 10% currently [later September 2023].

Additionally, Gregoire believes that this paper is resilient to interest rate changes and the bonds are usually callable within 5 years. In the event of a non-call, the coupon becomes variable, mitigating interest rate risk. "If it is not called, the rates will go higher if interest rates are higher," he explained. "In the case of a Spanish bank earlier this year, their paper went from a coupon of 5.25% to paying more than 8%.

And there is a very liquid market, with an issuance size on average between USD1-2 billion, although the holders tend to exhibit a strong commitment to hold the paper. It is a highly regulated market predominantly comprised of financial institutions subject to rigorous rules and regulatory oversight. "The regulators prioritise sector stability, so are indirectly acting on behalf of bondholders," he explained.

## Some of the key challenges facing investors in the European subordinated debt market

Gregoire ran through some of the hurdles to overcome, with the overall conclusion that this is

### Setting the Scene

- One of the more exciting places for investors is in the subordinated debt of financial institutions. The market currently gives a yield to call of 10% from A-rated issuers, far in excess of the roughly 5%-plus an investor might get from putting money in a deposit in US dollars with a bank in Hong Kong of the same single-A rating.
- Gregoire said that he had been in this market for some 30 years, and despite the negativity around lower-rated bank debt coming from the demise of Credit Suisse, he reminded the audience that they had returned more than 1,000% since inception, achieving a compound return 7% per annum return.
- "I believe this is an asset class where you can target around a roughly 30% return over the next three years," he said. "The demise of Credit Suisse does not reflect the many strengths of the sector and in recent months we have seen more positive news, making this is a good time to come back and talk about this asset class. Which is why I am here today."

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a market for professional active investors such as GAM to manage on behalf of investors.

There is considerable complexity in what he called non-harmonized bonds, with Gregoire noting that bond diversity requires a deep understanding of individual prospectuses beyond just credit risk assessment. The regulatory environment is dynamic, meaning that unforeseen regulatory changes can create both risks and opportunities, necessitating vigilance and adaptability from investors.

There are callable and perpetual bonds, introducing extension risk and potential volatility. The market accessibility is determined by a high barrier to entry, both in the primary as well as secondary markets, with minimum tickets usually of USD100,000 - 200,000. Time-consuming prospectus analysis can pose other entry challenges.

"All these issues mean investors should really consider investing via specialists or investment funds to mitigate these complexities and benefit from diversification and access to the market," Gregoire told delegates.

## But why should banks and other financials issue subordinated debt at all?

Gregoire then explained in brief why banks and other financials issue regulatory capital in the form of subordinated paper.

He said pure capital is very expensive – the cost of equity in Europe is around 15%, it has risen this year and has been rising since the pandemic. The bulk of capital is met with equity, but the regulator allows banks to issue a modest amount of so-called subordinated debt for capital. In short, while sub debt is expensive, it is still cheaper than equity.

Gregoire explained that the subordinated debt serves as a vital regulatory capital buffer for banks seeking to bolster capital reserves. Regulators permit banks to partially fulfil capital requirements with such bonds, and while it carries a high coupon (of 8% or considerably more for single-A issuers) it remains a cost-effective alternative. In the historical context, the 1988 Basel Capital Accord determined that eligible capital equals equity plus subordinated debt. And the market is large and liquid, with some USD600 billion of bank paper in issue in Europe and more than USD200 billion of insurer paper.

And he also explained how the balance sheet comprises pure equity, Tier 1 capital and Tier 2, which is then split into upper T2 and lower T2. He explained that due to the regulatory changes in the past 20 or so years, the amount of sub-debt allowable to be counted as capital has gone down significantly, so structurally, owning subordinate debt today is much more attractive than 15-20 years ago, he remarked, even though it is still plenty large enough and sufficiently liquid a market.

## The European financial sector has seldom been more robust, especially the banks

Gregoire explained that since the GFC, the regulators have been driving banks to strengthen their financials and their practices. That was then emphasised even more when the pandemic hit, and the result is that today, the sector has never been so strong. Capital ratios are very strong. More than a decade of de-risking has led to a radical clean-up of banks' balance sheets. And liquidity is very impressive - European Banks' average regulatory liquidity ratios of more than 160% are far higher than the 100% regulatory requirement.

## The current environment in Europe is supportive of financials in general, especially the banks

He also explained that there are some excellent tailwinds for the sector. A backdrop of higher for longer interest rates is good for net interest margins and profitability. And the flows of stronger than expected macro data are good for asset quality, as indicated by low NPLs, provisioning and cost of risk. The expansion of net interest income amongst the banks is robustly counterbalancing potential

concerns related to any evidence of weaker asset quality.

## Subordinated debt is not expensive, in fact, it represents very good value for investors

Subordinated debt trades relatively cheap compared to high-yield paper, both on an absolute as well as relative basis. Subordinated debt also trades cheap to senior bank paper, and also cheap to equity. One of the core reasons is the complexity and also the risk of 'extension', or the bonds not getting called. "Actually," he said, "extension risk is an opportunity if you know how to position yourself. And all this means that the normalisation now underway will offer an opportunity to capture price appreciation as well as yield."

He added that normalisation is coming as a recovery from the fallout from the Credit Suisse collapse, when anomalies in the pricing of sub-debt relative to equity, senior and high-yield had all surfaced.

"I think subordinated debt is really a case where you do not take more credit risk and yet you're getting paid more, and that is why looking from s long historical viewpoint, the compound return per annum is so high," he stated.

## The catalysts for a revaluation of the paper and a re-evaluation of the sub-debt market are there, and the outlook is brightening

Gregoire also offered delegates some catalysts for the normalisation of valuations for this paper relative to other asset classes, before concluding that the outlook is indeed brightening. Resilient fundamentals are driven by the sector running with excess regulatory capital and excess liquidity, while investment grade issuers are by nature defensive, so providing a hedge against the risk of economic downturns.

He said compelling valuations are seen currently with valuation levels for subordinated debt remaining highly appealing, but the positive outlook means they are poised to revert to historical averages.

And finally, there are favourable technical, with net supply expected to be limited, fuelled by strong demand from global investors, while the technicality of extension risk should be seen as an opportunity, especially in the context where banks have once again demonstrated their ability and willingness to call at the first available call date. ■

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