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Pandemic policy measures don’t derail credit preference

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Christopher Hult
Portfolio Manager,
Investment Grade

Paul Smillie
Senior Investment Analyst

Rosalie Pinkney
Senior Credit Analyst

- **Policymakers have taken several steps to prevent the banking sector from becoming an amplifier of the shock caused by the Covid-19 pandemic, instead making it part of the solution.**

- **We believe the sector has enough capital and liquidity to ride out the pandemic.**

- **Despite recent outperformance in senior preferred (SP) bonds, we remain confident in our original thesis and have only very selectively switched into senior non-preferred (SNP) bonds.**

- **The bigger change to our banking exposure has been a repositioning towards institutions in countries in a strong fiscal position.**

In Q4 2019 we outlined our thoughts on why we believed SP bank bonds were an interesting late-cycle opportunity and the last big piece of decade-long regulatory overhaul of the banking sector[1]. Since then a lot has changed in the world, and especially in banking regulation, in response to the Covid-19 pandemic.

In our original thesis we outlined the view that SP bonds could eventually trade close to covered bonds with spreads to swaps in the low double-digit area as they became fewer and increasingly loss remote. Could the emergency programmes enacted to tackle the Covid-19 fallout actually accelerate this outcome?

[1] All credit to European banks’ senior preferred bonds, by Christopher Hult and Paul Smillie, November 2019

In our view, the net impact of the measures implemented support our thesis and we continue to favour SP over SNP bonds, despite recent outperformance (Figure 1). If the current ratio of SNP-to-SP had existed back in 2019, we would probably have been tempted to switch several of our SP holdings into SNP. However, given today's very different regulatory and economic backdrop we think this ratio can remain elevated for a while and have only selectively chosen to switch into SNP where the ratio is well above the historical average, ie where we are over-compensated for SNP's added risks, and predominantly in regions with a solid fiscal stance.

Policy measures are working … so far

The policy measures taken by governments and regulators in response to Covid-19 are designed to ensure the financial sector does not amplify the shock of the pandemic. These include government guarantees of lending, fiscal transfers, payment moratoria, capital relief and (near) unlimited liquidity. The verdict so far? It's working.

Lending guarantees and fiscal packages shape the distribution of losses between the sovereign and banking sector balance sheets. For example, furlough schemes allow households and small and medium-sized enterprises (SMEs) to continue to service their bank debt at the expense of the taxpayer. With around a quarter of the workforce on such schemes across Europe's large economies, this is having a powerful effect in protecting the household, the corporate sector and, indirectly, the banking sector.

State guarantees of lending provide financing to the corporate sector. The bank provides the loan, the European Central Bank provides the funding to the bank via targeted longer-term refinancing operations (TLTRO), but the state takes most of the credit risk. This way, unlike in the global financial crisis (GFC) of 2008/09, both the banking and corporate sectors have enough liquidity. We estimate corporate loan growth of more than 5% for the first half of this year across Europe, predominantly via the guarantee schemes. These measures have prevented a credit crunch but also transferred credit risk from the banking sector to the sovereign.

Moratoria (or payment holidays) work alongside furlough schemes and fiscal support schemes by easing the debt burden of households and SMEs. Interest isn't being paid on the debt, but the loans are not classified as non-performing. From a bank's perspective it pushes loss recognition out into the future, allowing more time to build up buffers from earnings.

Our sense is that payment holidays and fiscal schemes could continue into next year in many countries, especially for more impacted sectors. Governments in France, Germany and Spain, for example, are discussing such an extension for furlough schemes. We may be well into the recovery phase before these schemes are cancelled completely and banks start to process the losses.

There will be, of course, associated fiscal costs and questions around servicing sovereign debt further down the line, but the ECB's Pandemic Emergency Purchase Programme (PEPP) QE program is alleviating stresses, at least for now. There is also the recently agreed €750 billion recovery fund at the EU level[2] which could allow the stronger nations to help the weaker.

[2] Bloomberg, EU Clinches Massive Stimulus Deal to Bind Continent Together, 21 July 2020

How does this play out for banks?

Given the unprecedented level of support, we feel the European banking sector has enough capital to ride the crisis. Our preference is for banks in countries with large fiscal support programmes and both the fiscal room and political will to extend further if necessary. This includes Germany, the Netherlands and Nordic countries which had extensive pre-existing social safety nets.

However, we also forecast bad debt charges for European banks in 2020/21 similar to those experienced at the peak of the GFC, despite GDP growth being much weaker than GFC levels. We expect losses to be recognised slowly in Europe, with roughly only a third in FY20 as banks take advantage of the government schemes and regulatory relief.

In our base case[3] we expect core capital ratios to fall by around 100bps across the sector over the next year or so. At the same time regulators have granted capital relief which frees more than 300bps of additional capital at the aggregate sector level. Thus there is a lot of room for capital ratios to fall, if necessary, before regulators would start to intervene.

What does abundant liquidity mean for bank supply?

As part of the package of regulatory relief, banks have been granted more time to build out the layer of SNP to meet minimum requirement for own funds and eligible liabilities (MREL) rules[4]. Banks in Italy and Spain especially are taking advantage of the relaxation. We think this could increase the proportion of SP issuance relative to SNP over the next year or so. This creates a negative technical for our positioning.

On the other hand, the policy response has provided other sources of funding to banks, reducing the need for SP. Eurozone banks drew down an additional €550 billion in June from the TLTRO with Spanish and Italian banks leading the way. Moreover, deposit bases are growing as the ECB's QE program adds liquidity to the system.

So, all things considered, we still expect the SP asset class to shrink to almost half of its current size by 2024. In the first half of this year more than 60% of the €145 billion senior debt funding from European banks was in SNP or holdco format, so the trend of SNP replacing SP is still very much in place.

What this means for portfolios

The SP trade was a defensive, end-of-cycle trade and we were positioned for the cycle to turn and credit to deteriorate. Clearly, we did not predict the catalyst, but our SP positions have outperformed SNP (the ratio in Figure 1 has increased). As a result of Covid-19 and the various support packages and regulatory changes, we were forced to examine the impact on our thesis.

On the one hand we had an elevated SNP-SP ratio, an extended deadline to meet MREL and lower risk of SNP bail-in as regulators have effectively wrapped their arms around senior bank bonds, all supporting the idea of switching into SNP.

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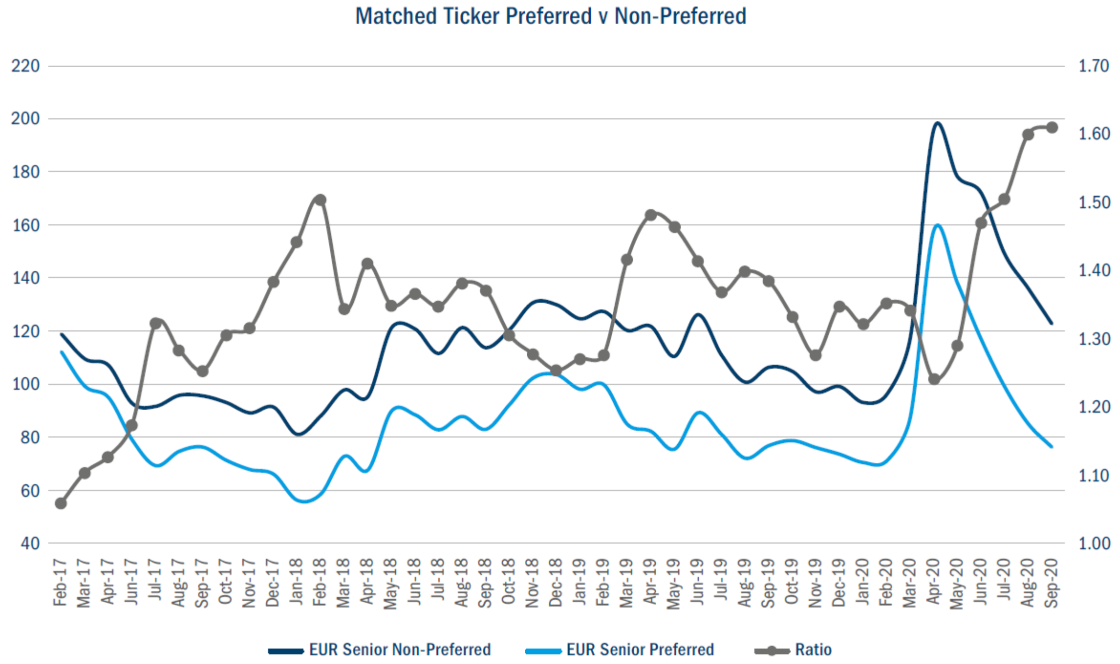
[3] Columbia Threadneedle's base case scenario for economic recovery is a U-shape, meaning it will take 10 calendar quarters to return to prior levels of activity

[4] MREL is the minimum amount of equity and subordinated debt a firm must maintain to support an effective recovery or resolution

Figure 1: Senior preferred (SP) versus senior non-preferred (SNP) [5]



Source: Bloomberg/Columbia Threadneedle Investments, June 2020

On the other hand, arguing for keeping SP, banks now have more deposits, near unlimited liquidity at the ECB via TLTRO and less need for SP bonds. Could this lead to a wave of Liability Management Exercises (LME)[6] and for SP bonds to continue to outperform?

As we discussed this internally and with bank management teams, it became clear that issuers have to consider the fact that TLTRO and rising deposits aren't permanent sources of funding; they do not want to be seen as overly arbitraging emergency facilities; and must maintain a good relationship with regulators. So we think the outcome is in fact a marginally improved technical picture for SP, as there is less need for them, partly offset by the delay in MREL deadline – ergo the thesis broadly remains intact. We don't expect a wave of LMEs, rather a slight shift from SP to a slight increase in funding from deposits and TLTRO at the margin.

As you can see from Figure 1, SP bonds have outperformed significantly in the past few months. If the ratio had hit 1.60x last year we probably would have been tempted to switch several of our SP holdings into the SNP at this level. However, acknowledging the slightly improved technical backdrop we think this ratio can remain elevated for a while and have only selectively switched some SP into SNP where the ratio is well above the historical average, ie where we are clearly over-compensated for the added risks in SNP versus SP, and have not made a broad strategic shift into SNP.

We have, however, shifted our exposure in favour of banks in countries with a strong fiscal position and political willingness to support households, corporates and the banking sector, increasing our exposure to Dutch, Nordic and German banks, having trimmed exposure to French and UK banks.

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[5] Index constructed by CTI using ICE Indices including all issuers that have index eligible SP and SNP, this ensures we have the same constituents in the numerator and denominator of our ratio, reducing the risk of constituent mismatches

[6] Liability Management Exercise (LME): when a bank offers to buy back or swap their bonds to adjust their funding or capital structure. In this case, it was potentially to reduce the amount of SP outstanding and replace with cheaper funding. To incentivise holders, banks usually have to offer to buy back their bonds at a premium to market prices