

Bank Pulse: Preferred senior most expensive of all

Some volatility in bank bond spreads is likely to persist towards year end against the backdrop of the ongoing inflationary and economic uncertainties. Preferred senior unsecured bonds could start seeing some relative underperformance



European Central Bank building and the Frankfurt skyline

Bank bond spreads: no convincing further tightening anticipated

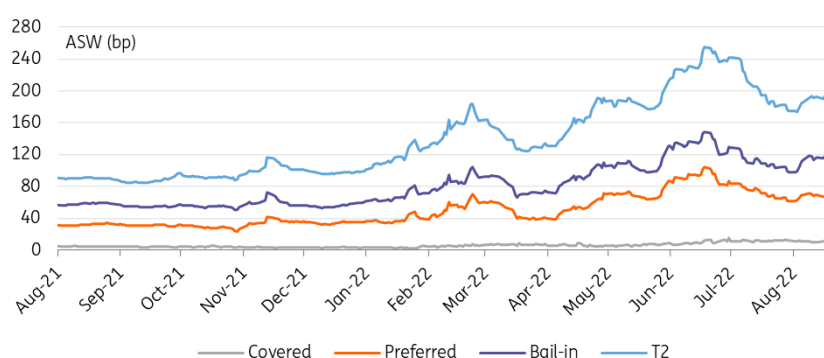
The retightening trend of EUR bank bonds spreads, that set in early July ahead of the ECB meeting, has started to experience some headwinds since mid-August. Not only did the early opening of primary markets post summer weigh on performance, there have also been signs that economic growth may be slowing down more than anticipated. To name an example, two weeks ago the August decline in the ZEW index pointed towards worse economic growth expectations than during the Covid-19 pandemic in 2020. Albeit not as bad as the ZEW index, also last week's flash composite PMI for August suggests the eurozone economy has tipped into negative growth territory again.

Meanwhile, the signs have become more worrisome that the high inflation is more persistent than

thought and is turning into a phenomenon stretching well beyond high energy prices alone. This underscores the tough balancing act for central banks to curb inflation on the one hand, while on the other hand not suffocating economic growth by doing so. Isabel Schnabel's speech at Jackson Hole this past weekend left, however, little doubt about where the priority of the European Central Bank should be, namely to act forcefully now to avoid losing confidence in the central bank's willingness and ability to bring inflation back to target.

Until inflation is convincingly curbed, this will probably leave markets torn between the occasional (post-)rate hike optimism on inflation expectations, and periods of uncertainty regarding the monetary tightening needed to get a grip on inflation and the impact thereof on economic growth. As such, spreads will likely continue to move within the range seen for EUR denominated bank bonds since the end of May. Although with some widening from current levels, as inflation remains high, and central banks continue their tapering and rate hiking. In the case of a more significant recession we may see spreads widening more substantially through the range, and could approach the wide levels hit back in early July.

Figure 1: The spread tightening trend that set in early July came to an end recently



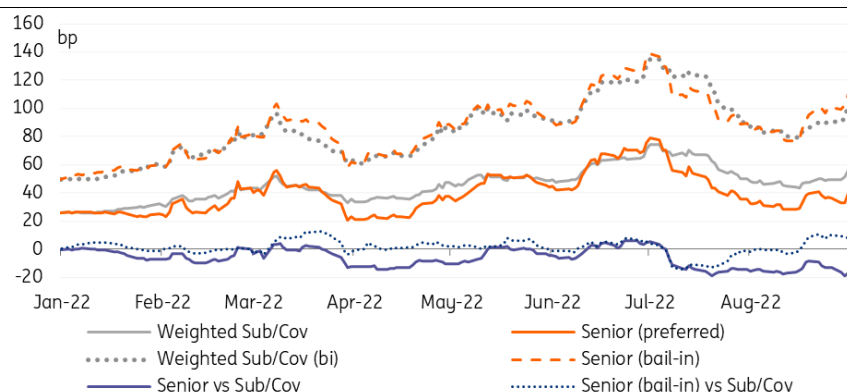
Source: IHS Markit, ING

Preferred senior bank bonds most expensive of all

Despite the fact that the recent widening has impacted spreads across the liability structure, preferred senior unsecured bonds have continued to hold up better than bail-in senior unsecured bonds, both in terms of their absolute spread performance as well as relatively in comparison to their covered bond and T2 comparable. This is nicely illustrated by figure 2, which gives insight in the relative performance of French preferred senior and bail-in senior bonds versus covered bond and T2 comparables.

To this purpose performance is measured against a weighted combination of covered bonds and T2 paper, spread neutral versus preferred senior or bail-in senior bonds at the start of the year. The dark blue line in the chart confirms that the preferred senior bonds of French banks do trade relatively tight at the moment versus the covered bond/T2 comparable. Instead, French bail-in senior instruments (dotted blue line) currently trade a tad wider than their covered bond/T2 equivalent.

Figure 2: The relative performance of French senior bonds versus covered & T2 bonds



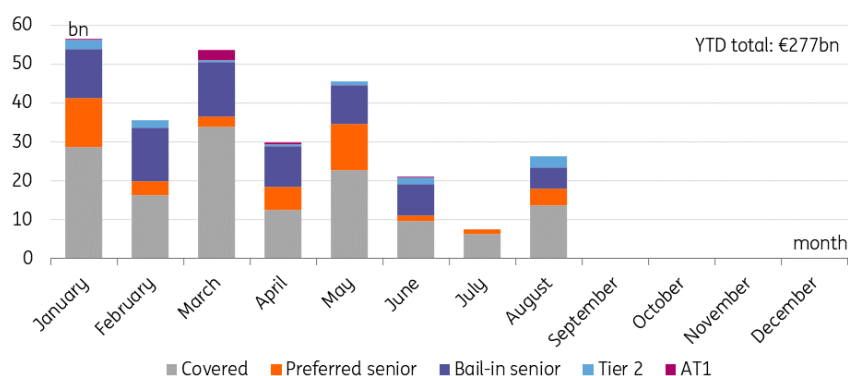
Source: IHS Markit, ING

The relative outperformance of preferred senior unsecured instruments versus covered/T2 instruments is uniform across all countries. Preferred senior bonds are expensive for essentially every single banking sector. For bail-in senior instruments, the picture is a bit more diverse. In countries such as France, Germany, Finland, Denmark, Ireland and Austria, bail-in senior has underperformed the covered/T2 comparable on a year-to-date (YTD) basis. Instead, in the Netherlands, Sweden, Norway, Spain, the UK and Belgium, bail-in senior paper is more expensive compared to covered/T2 than it was at the beginning of the year. Italy is the only exception where both preferred senior unsecured bonds and bail-in senior bonds trade wider than the spread neutral combination of covered/T2.

That said, even in countries where bail-in senior bonds did outperform their covered/T2 comparable YTD, the outperformance of preferred senior versus covered/T2 has been stronger. This despite the fact, that the ECB restored the 2.5% collateral limit for eligible (preferred) senior unsecured paper per 8 July, down from the temporarily higher 10% limit applicable till then. In our view, preferred senior is, across the board, the tightest product on the liability structure in relative terms. This has different reasons:

- The **more limited supply pressure in preferred senior** post summer: The restart of primary market activity since mid-August has, once again, had the strongest focus on covered bonds. However, also issuance further down the liability structure in bail-in senior (and to a lesser extent T2) has been stronger than the supply in preferred senior. This confirms that primary market technicalities in general remain constructive to the relative performance of preferred senior bonds versus other bank bond products on the liability structure.
- The **thicker layer of bail-in buffers** offers protection to preferred senior instruments: In its 'resolvability assessment 2021' of 13 July 2022, the Single Resolution Board (SRB) highlighted the significantly improved abilities of European banks to absorb losses, thanks to the steady build-up of their MREL capacity. Most banks already meet the final minimum requirements for own funds and eligible liabilities (MREL) target set for 1 January 2024. In the first quarter of this year, the shortfall to the final target was €36.7bn, of which €11.5bn was the subordination component. This not only confirms the modest further MREL supply needs, but also gives comfort on the protection in place, before losses would be imposed on preferred senior bonds in case of a resolution.

Figure 3: Primary markets have seen a strong early reopening post summer

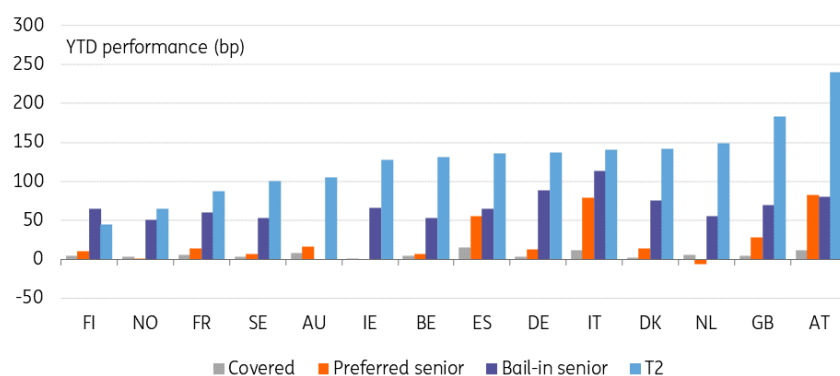


Source: IHS Markit, ING

Italian, Spanish and Austrian preferred senior: performance outliers

While the absolute spread performance of bank bonds has been weakest further down the liability structure, there are a few countries that stand out for their almost equally soft performance in preferred senior as in bail-in senior. These countries include Italy, Spain and Austria.

Figure 4: EUR Bank bond performance across the liability structure by country



Source: IHS Markit, ING

In our view, there are different explanations for the comparatively weaker performance of preferred senior unsecured instruments from these banking sectors:

- **Link versus the sovereign through ratings and bond holdings:** Italian and Spanish senior unsecured bonds are more susceptible to spread movements of, and any debt sustainability or rating concerns with reference to, their respective sovereigns. This is not only related to the home country sovereign bonds held by these banks, but also due to the stronger link of the ratings of the senior bonds (including preferred senior unsecured bonds) with their

sovereign. On 5 August for instance, Moody's changed the outlook of its Baa3 rating for Italy to negative, citing the accumulating risks to Italy's credit profile because of the economic impact of Russia's invasion of Ukraine and domestic political developments. Subsequently the rating agency changed the outlooks to negative on the ratings of 14 Italian financial institutions. On top of that, the Transmission Protection Mechanism (TPM) introduced by the ECB on 21 July does come with strict conditions (see box), making it uncertain if and to what extent it may be applied if needed and cushion volatility in Italian sovereign bond spreads. That said, our rates strategists do believe that the widening pressure on Italian sovereign spreads could ease, in the event that the ECB would 'underdeliver' on the rate hike expectations. (See the note ["Sovereign spreads: how big exactly is the ECB's bazooka?"](#) of 2 August 2022).

- **A stronger vulnerability to a cut-off from Russian gas:** Some of the Austrian and Italian banks have been among the names with most exposure to Russia. This has for sure had a negative impact on their performance YTD (see ["Bank Pulse/Pressure on bank bond spreads accelerates on the situation in Ukraine"](#) of 24 February 2022). However, these country's may also be among the jurisdictions most exposed to the risk of a halt in Russian gas supply. Last week, Fitch concluded that Italy, Austria and Germany are most vulnerable to a Russian gas cut-off. Two weeks ago, Moody's also came to the conclusion that Italy and Austria, together with countries such as Hungary, Slovakia, Czech Republic and Germany, are most exposed to Russian gas. The rating agency believes that in the event of a complete cut-off of Russian gas supply, these banking systems would be the first to experience a rise in problem loans and risk-weighted assets from exposures to the industrial and manufacturing sectors in particular. Moody's calculated that the energy-intensive industries account for the highest share in the bank capital of Italian banks, although Moody's believes that banks generally have good buffers to absorb any pressure.
- **Somewhat lower capital capacity than peers to cushion the impact of losses:** Indeed, throughout the past number of years capital levels and non-performing loan levels of Italian and Spanish banks have also improved substantially. Nonetheless, Spanish and Italian, but also Austrian banks do remain at the weaker end of the range in comparison to European peers in terms of their capital levels and NPLs. Besides, the SRB's MREL dashboard the first quarter of 2022 illustrates that, of the modest €36.7bn MREL shortfall versus the 2024 final target, Southern European banks represent the most substantial part. Greek banks have the biggest shortfall of €11bn. Italian banks have a €7.9bn shortfall (with a €4.6bn subordination component), Spanish a €4.3bn shortfall and Portuguese banks a €3.9bn shortfall. Albeit modest, the shortfall does confirm that some more MREL eligible issuance is needed to meet the final target, while at the same time it is also indicative of a somewhat thinner protection layer for preferred senior bonds.
- **TLTRO-III repayments:** Italian and Spanish banks are together with French and German banks the biggest users of ECB targeted longer-term refinancing operations (TLTRO) funds. This means they are also among the banks that have quite a bit of refinancing to do, particularly if the ECB would not offer Eurozone banks a (slimmed down) rolling opportunity into a new longer term refinancing operation or through additional TLTRO-III tranches. In the report "European Banks/TLTRO-III to repay or not to repay" of 15 June 2022 we showed that when looking at the fourth quarter 2021 liquidity coverage ratios (LCR) of the respective banking sectors compared to their first quarter 2020 all four banking sectors have substantial head room to repay their TLTRO drawings without having to refinance these redemption payments. However, the difference between this headroom versus the amount attracted under the TLTRO's is highest for Italian banks. This suggests these banks may have

a more substantial refinancing need. One mitigating factor is, that Italian banks had higher LCR ratios to begin with, also before the Covid-19 pandemic, and as such more liquidity to use for the purpose of repaying the TLTRO-III funds than implied by the difference between their 4Q21 and 1Q20 ratio alone. Meanwhile, the ECB will continue to monitor bank funding conditions and ensure that maturities under the TLTRO-III does not hamper the smooth transmission of monetary policy. When push comes to shove, we consider it likely that the central bank will offer banks a rolling opportunity, albeit purely for refinancing purposes, but not necessarily linked to lending growth and surely without offering any unanticipated carry opportunities between funding and deposit facilities.

- **Country specific circumstances:** There are also some country specific circumstances that have weighed on the performance of Italian and Spanish instruments. These include for instance the political situation in Italy following the resignation of Mario Draghi as prime minister and with elections upcoming on 25 September. Elsewhere in Spain, the Spanish government came in July with a proposal to temporarily tax its largest banks by €1.5bn per year in 2022 and 2023. Fitch calculated for instance that this would represent around 10% of the banking sector's 2021 pre-tax earnings. The proposal of the Spanish sovereign makes a good example of how some countries are seeking ways to share the burden of helping households deal with the current inflationary pressures, including through their banking sector.

The conditions to ECB's Transmission Protection Mechanism

On 21 July 2022 the ECB added the Transmission Protection Mechanism (TPI) to its toolkit. The main purpose of the TPI is to counter unwarranted, disorderly market dynamics that are a serious threat to the transmission of monetary policy across the euro area. The TPI allows the ECB to buy public sector securities (ie, marketable debt securities of central and regional governments as well as agencies) with a 1yr to 10yr maturity from countries that experience a deterioration in funding conditions not justified by their fundamentals. The scale of TPI purchases will depend on the severity of the risks for the transmission of monetary policy. Besides, purchases will be dependent upon the ECB's judgement that the applicable country does pursue sound and sustainable fiscal and macroeconomic policies. This conclusion will be based upon several criteria, such as 1) compliance with the EU fiscal framework, 2) absence of severe macroeconomic imbalances, 3) fiscal (ie, public debt) sustainability, and 4) sound and sustainable macroeconomic policies. Activation of the TPI is also dependent upon the ECB's judgment that purchases under the TPI are proportionate to the achievement of the central bank's primary objective. In turn, buying will end upon a durable improvement in the transmission of monetary policy, or upon an assessment that persistent tensions on a country's funding conditions are due to country fundamentals. The ECB also clarified that purchases under the TPI would be conducted in a way that they would not cause a persistent impact on the Eurosystem's balance sheet and monetary policy stance.

The ECB furthermore confirmed at its July meeting that pandemic emergency purchase programme (PEPP) reinvestment flexibility will continue to be the first line of defence to counter pandemic-related risks to the transmission mechanism. The ECB intends to reinvest redemptions under the PEPP until at least the end of 2024, while the future roll-off of the PEPP portfolio will in any event be managed to avoid interference with the appropriate monetary policy stance. Asset purchase programme redemptions will be reinvested for an extended period of time, following July's rate hike, and in any case for as long as necessary

to maintain ample liquidity conditions and an appropriate monetary policy stance.

Conclusion

Against the uncertain macroeconomic and political backdrop, bank bond spreads will remain susceptible to some volatility during the rest of this year. Preferred senior unsecured bonds may, in particular, suffer relative weakness on the liability structure, considering their tight spread levels and with supply set to pick up. Meanwhile, where it comes to the absolute spread performance this year, the preferred senior bonds of Italian, Spanish and Austrian banks are outliers on the weaker side, be it with good reason. With the exception of Italian bank bonds, this does not alter our opinion however that preferred senior is the most expensive of all on the bank bond liability structure.

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