

Bank Pulse: Value in selected Tier 2 debt

European bank Tier 2 debt has widened this year amid geopolitical concerns and questions over economic growth. Callable Tier 2 paper has particularly underperformed. While the market's prospects may remain challenging for now, we see value in selected Tier 2 debt of stronger-rated European banks



Bank subordinated bond spread performance has suffered from the uncertain outlook

Banking sector spreads have suffered amid growing concern about the outlook for economic growth and inflation following Russia's invasion of Ukraine. Tighter monetary policy - while supporting bank net interest income - may pressure bank loan quality. These worries have been particularly evident in subordinated spreads, with spreads for the European bank Tier 2 debt in our bank universe over 110bp wider on a year-to-date basis.

The performance has been very mixed, however, both across issuers and especially across Tier 2 bond types. Bonds issued by banks exposed to Russia or Ukraine or with lower bond ratings have underperformed, in particular. In an uncertain economic environment, we would prefer taking subordinated exposure in banks with stronger pre-provision profit profitability and capital metrics, as these banks have a better capacity to absorb any weakening in loan quality and thus higher

loan loss provisions with both their earnings generation and existing capital buffers.

Callable Tier 2 debt has underperformed against bullet Tier 2 debt

We have seen callable Tier 2 paper underperform in particular, while the bullet structured bonds have shown relatively better resilience. The underperformance of callable debt means that markets are having second thoughts about the likelihood of banks calling their bonds at the first opportunity. The uncertainty on the economic outlook has resulted in volatile market conditions, which means that it may be more difficult, especially for some lower-rated issuers to access debt markets to refinance their subordinated debt at sustainable levels.

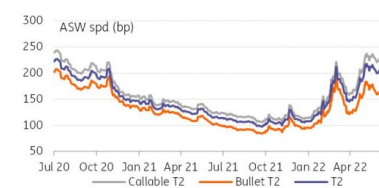
Furthermore, the wider spread levels also play into the calculation of the economic basis for a call or non-call. Calling a particular subordinated bond may look less appealing than issuing a new bond if the spread of issuing a new bond is likely to be fixed at a markedly wider level than where the reset level of the existing bond is. We would still expect stronger-rated banks to call their bonds at the first opportunity despite the economic optics. That being said, we would remain more careful with callable paper issued by lower-rated banks and especially with those bonds with lower coupon reset levels.

Value in selected Tier 2 debt after the recent underperformance

After the recent underperformance, callable Tier 2 paper offers a substantial pick-up versus bullet T2 debt in most countries. In callable paper, we have a preference for stronger bank names in France and certain Nordic or Spanish names. Bullet Dutch Tier 2 debt trades at very tight levels due to a combination of scarcity and short maturities. While callable Tier 2 debt offers more interesting spread levels, we do note that in times of market stress, bullet Tier 2 debt is likely to continue to show better resilience.

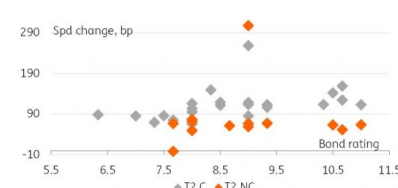
Subordinated bank bond performance

Selected Tier 2 performance: callable vs bullet debt



Source: ING, IHS Markit

Performance YTD vs bond type and rating



Source: ING, IHS Markit, rating agencies Note. C=Callable, NC=Non-callable/bullet, 7=A-, 11=BB+

Source: ING, IHS Markit, rating agencies

Author

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

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