

Impact of Recent Banking Sector Stress on Bond Funding Landscape

ECB Bond Market Contact Group

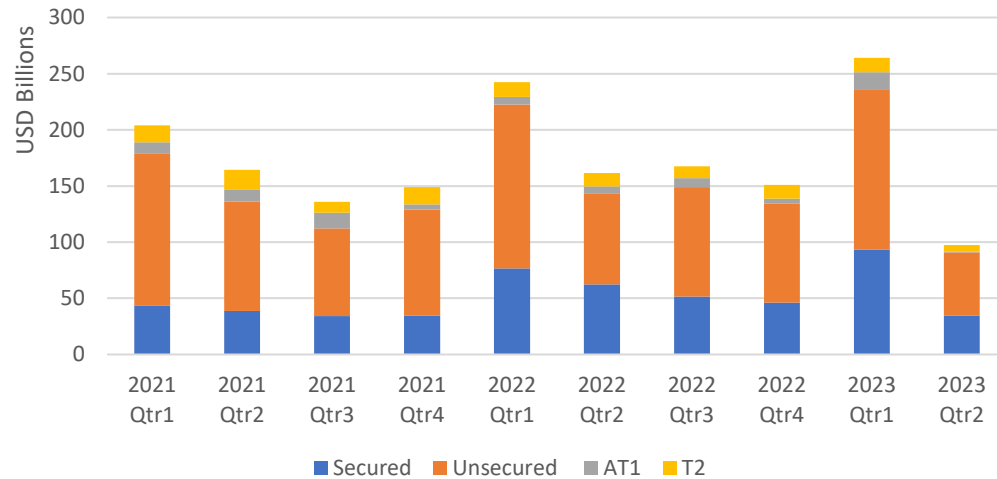
Bryan Pascoe – CEO, ICMA

June 1, 2023

Pre-stress Funding Environment

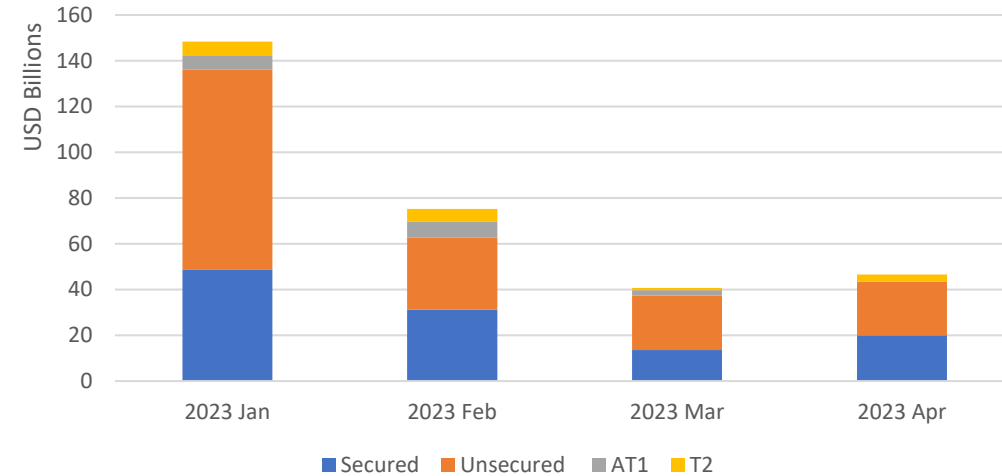
European FIG - All Currencies Issuance

Source: Dealogic



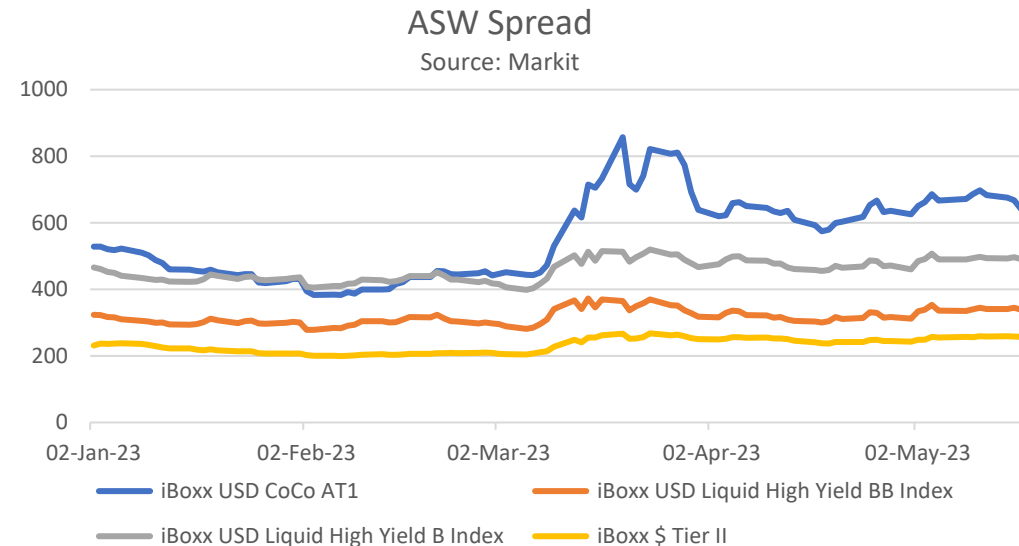
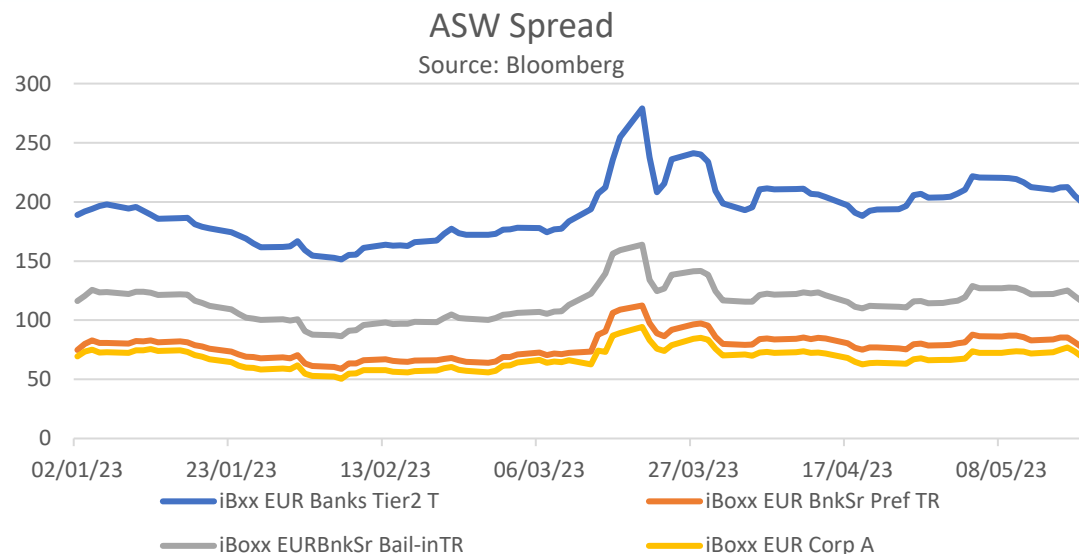
European FIG - All Currencies Issuance

Source: Dealogic



- Primary market buoyant across all asset classes at the beginning of 2023 - notably in EUR - against backdrop of better rates outlook and higher yield entry points, reduced recession concern and rotation of cash into fixed income
 - Record FIG volumes in first 2 months with significant front-loading of 2023 funding needs
 - Spread compression despite heavy supply and overhang of QT
 - Tight new issue premia and high levels of oversubscription
- AT1 issuance from European banks well-received in first 2 months with EUR13.8bn equivalent volume (in US\$ / EUR / GBP / S\$) from 7 jurisdictions
- AT1 issuance by European banks historically running at between EUR30-40bn pa

Impact of Recent Banking Turmoil on Issuance and Secondary Market Activity



- Overall liquidity held up well with dips in most heavily affected asset classes around 20% vs 'normal' market conditions
- Price performance and liquidity in AT1 severely impaired in immediate aftermath of CS
 - Prices marked-down 10-25 points – traded typically towards cost of equity at c11-12%
 - Bid-offers moved from 50c to 150-200c (some recovery since but still wide)
- AT1 liquidity returned to large degree with 2-way flow for European bank names
 - Swift regulatory response to communicate commitment to creditor hierarchy and liquidity management – contagion largely contained with investors differentiating US / Swiss experience from current stronger European banking environment
 - Real-money AMs strong buying interest at 'distressed levels'
 - Positive impact from Unicredit's announcement of intent to call EUR1.25bn 6.625% perpnc5 AT1 in June
- Orderly market activity in AT1s impaired due to frozen trades in settlement channels imposed over the weekend of the merger and AT1 write-downs

Impact of Recent Banking Turmoil on Issuance and Secondary Market Activity (cont'd)

- Some initial spread widening in T2 and senior space following US liquidity issues and CS but the market quickly recovered – sharp rebound in both Opco SP and Holdco SNP spreads
 - Spreads remain elevated to late February tightens but largely in line with January when funding programmes took off in size
 - Relative value maintained between products (with some T2 lag)
 - Senior financials have cheapened up notably vs IG corps
 - Primary issuance execution dynamics largely normalised (NIP / orderbook coverage ratios) at wider levels
- After a brief hiatus and some concerns over the liquidity position of smaller regional banks the new issue market for Opco SP and Holdco SNP resumed rapidly (with strong demand in evidence at wider spreads than February)
- Initially primary market for AT1 securities ground to a halt with the T2 market similarly heavily impaired. So far T2 issuance has resumed with no sign of reopening at this stage of the international market for AT1 securities
 - SMBC issued YEN140bn 2-tranche domestic AT1 with over 100 investors – but no read-across or implications for the international markets
 - Banco Santander launched first EUR T2 transaction since late-February in mid-May with 3x oversubscribed EUR1.5bn 10.25/NC5.25 deal – market deemed to be ‘wide open’ with NI spread of MS+285bps
- Overall, market has proven resilient, underpinned by current (attractive) yields, a more benign and stable rate outlook supportive of broader market activity, with fixed income fund flows remaining positive

Outlook for H2 2023

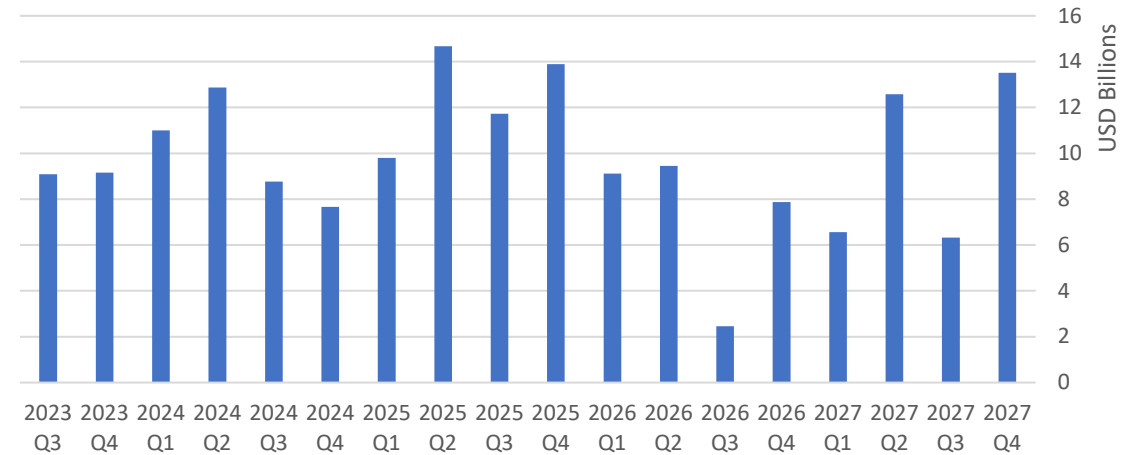
Amount Outstanding – European FIG Subordinated Debt

(As of 31st December - Source: Bloomberg)



AT1 Outstanding by next call date

(European Issuers - Source: Bloomberg)



- Around EUR250bn face value equivalent AT1s currently outstanding in the market for European banks
- Market generally optimistic that AT1 market can recover albeit at higher yields
 - Right national champions / G-SIB names to go first
 - European banking sector overall in good shape
 - Attractive risk-return for the right credits
 - Greater (reinforced) regulatory clarification on creditor hierarchy (EBA statements etc)
 - Clearer preference for equity conversion and ability to benefit from recovery (temporary absorption) / dividend stopper structures going forward
- Since outstanding stock of AT1s has largely reached ‘steady state’ in terms of filling capital buckets, supply will depend on upcoming calls and viability of cost for issuers relative to other capital products and ‘back-end’ coupons (or any regulatory adjustment in capital requirements)
 - Around 25% of outstandings have next call date before end 2024 and 50% before end 2025 (hence with expectation to refinance)
 - Note: a number of sizeable AT1 calls for Spanish and UK banks coming in September

Outlook for H2 2023 (cont'd)

- Future Asian / Swiss PB involvement (in US\$ AT1 product) to be limited
 - Marketing and distribution of AT1 issues to PBs has generally slowed in last 18-24 months
 - Leverage available on product substantially reduced
 - Reassessment of product suitability and risk appetite/tolerance frameworks
- Investor sensitivity will be heightened with greater onus on disclosure granularity
 - Overall sharpened focus in evidence on credit metrics and capital / liquidity ratios and frameworks (capital buffers / liquidity ratios / deposit concentration, flows and seasonality / IRRBB / internal risk management frameworks)
 - Greater scrutiny of bail-in language and assessment of PONV and POR
- Fundamentals and technicals for senior financial paper expected to be strong with front-loading of funding programmes, limited direct impact from QT and the asset class (relatively) undersupplied compared to covered bond issuance of late – TLTRO repayments sizeable but not problematic
- Fatigue in covered bond space (and impact of QT) could keep spreads wide there with knock-on effect on senior

High-level Discussion Points

- What is the likelihood of enhanced regulation post the recent events? How would this impact on bank funding needs and investor demand?
- Does the AT1 asset class totally lose its appeal to issuers given relative cost and position in the capital stack?
- What are your views on the current relative value in the capital stack – is it a fair assessment of fundamental risks?
- Is the market currently underestimating the impact of QT and spreads and market depth for primary issuance?
- What action (if any) should CBs consider to take to support market issuance and activity?