

# THE IMPACT OF HIGHER INTEREST RATES ON BANKS AND THE ATTRACTIVENESS OF COCO BONDS

Ayush Babel – Global Associate Director, Quantitative Research, Prof. Wim Schoutens – Professor at the University of Leuven, Belgium  
 15 May 2024

The global financial landscape has undergone significant transformations in recent years, reshaped by various macroeconomic factors, including shifts in monetary policies, geopolitical tensions, and evolving market dynamics. Among the most impactful changes has been the steady climb of interest rates, a trend that has both challenged and benefited different sectors of the economy. Understanding the nuances of these shifts, particularly within the banking sector, is crucial.

The primary mechanism through which banks earn a profit is through the spread between the interest they pay on deposits and the interest they earn on loans and investments. As interest rates rise, banks are generally able to charge disproportionately more for loans compared to the interest they pay to account holders, which can significantly enhance their interest income. This environment has been particularly beneficial in recent years, as central banks across major economies have hiked rates to combat inflation and stabilise financial markets. For banks, higher interest rates have directly supported Return on Equity (ROE) by widening the interest margin.

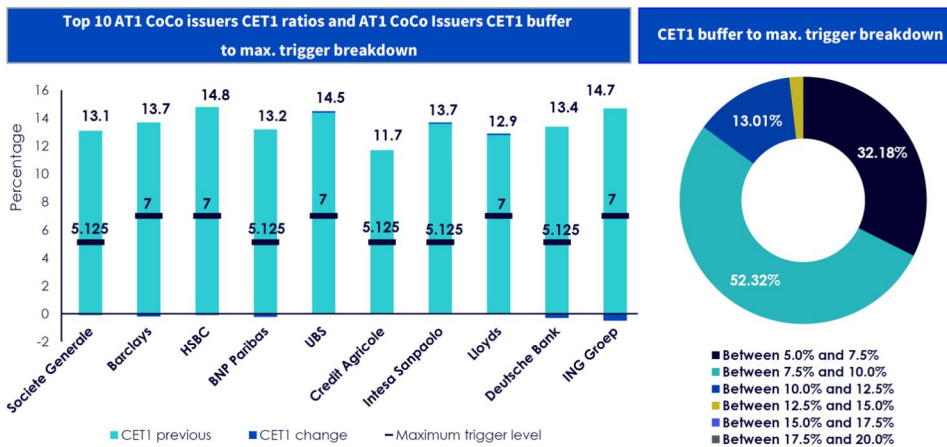


Source: European Banking Authority

A higher ROE signals strong profitability and reassures investors about the bank's overall financial health. With central banks increasing rates almost globally, many financial institutions have reported substantial gains in net interest income, bolstering their financial statements and appeasing stakeholders.

While the rising interest rates regime has sparked concerns regarding the fundamentals of high-yield companies – owing to the increased cost of borrowing and its subsequent impact on their financial health – the banking sector tells a different story. Over the past few years, banks have not only managed to navigate through these higher rates but

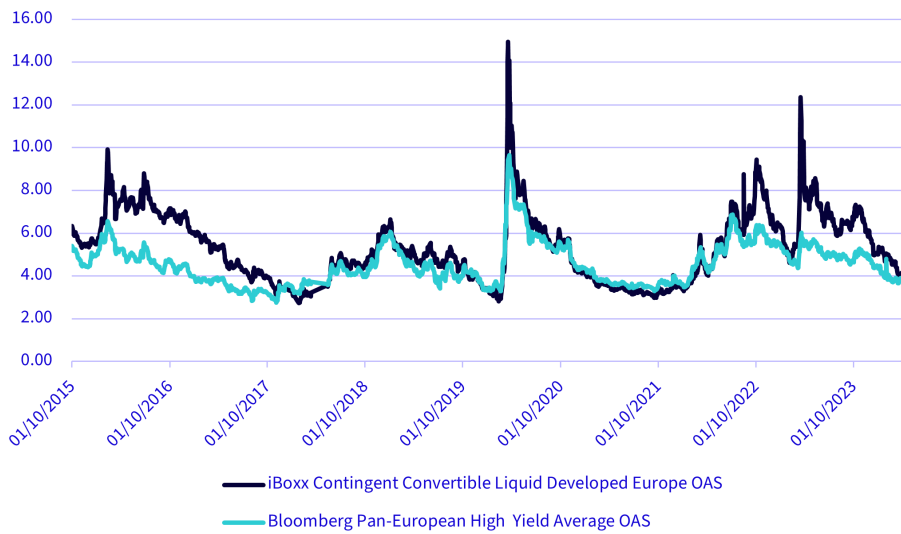
have also strengthened their fundamental operations. The CET1 ratios have also maintained healthy levels, making CoCos more secure investments. Despite these improvements, the valuation the hybrid capital instruments like CoCos remains relatively low. The undervaluation Continent Capital's CoCo bonds presents is intriguing.



Source: WisdomTree, Markit, Bloomberg, respective issuers financial results. Data as of 31 Mar 2024. CET1 change represents value change in CET1 ratios from data available as of 31 Mar 2024 (generally Q4 2023 available reporting) compared to latest data available as of 31 Dec 2023 (generally Q3 2023 available reporting). No change may indicate reporting cycle has not ended. CET1 ratio is the Common Equity Tier 1 Capital ratio reported on a fully loaded basis available on Bloomberg and from the issuer's latest financial results, if not reflected on Bloomberg. Maximum trigger level is represented by the maximum trigger observed across all CoCo issues of a given issuer. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Despite the bank's robust fundamentals and the broader sector's resilience, these bonds have historically traded at relatively high yields, whereas bank fundamentals have improved in recent years. The gap has closed over the last few months, but in the current environment, given the robustness of CoCos, we expect further improvements in option adjusted spreads (OAS), thus leading to further upside for CoCos.

### Spread of developed Europe AT1 CoCos versus pan-European high yield bonds



Source: WisdomTree, Iboxx, and Bloomberg. From 1 October 2015 to 20 April 2024. **Historical Performance is not an indicator of future performance and any investment may go down in value.**

#### Conclusion

While the landscape of rising interest rates tests the resilience of various sectors, the banking industry, supported by strong fundamentals and strategic regulatory compliance, appears well-positioned to thrive. In that context, CoCos could be a compelling investment that benefits from the current high interest regime.

#### Related Products

+ [WisdomTree AT1 CoCo Bond UCITS ETF - USD Acc \(COCB\)](#)

#### Related Blogs

+ [why higher interest rates could be good news for CoCos](#)

View the online version of this article [here](#).

Important Information

**Marketing communications issued in the European Economic Area (“EEA”):** This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

**Marketing communications issued in jurisdictions outside of the EEA:** This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

**For professional clients only.** The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.