AT1 COCOS: A STORY OF BANK STRESS TESTS AND IMPROVING INVESTOR SENTIMENT

Wisdomtree EU
13 Jul 2021

Banks are at the core of a functioning global economy. Governments are aware of the role they can play in reducing some of the economic impact of the pandemic on their respective populations. Regulators in the US and Europe asked banks to temporarily suspend dividend distributions and share buybacks for most of 2020. Now halfway through 2021, the Federal Reserve (Fed) has softened these restrictions following recent stress tests. In this insight, we will explore what the results of the recent US bank stress tests tell us about the health of the banking system and what we can expect from European banks in the coming months.

Checking the pulse of the US banking system

The softening of restrictions follows optimistic results from the most recent round of stress tests on US banks[1]. Soon, US banks will dig deeper into their respective results and could look to share revised plans around shareholder pay-outs. Randal K. Quarles, Vice Chair for Supervision at the Fed, recently summarised the health of US banks and results of the stress tests in June. He said, "over the past year, the Federal Reserve has run three stress tests with several different hypothetical recessions, and all have confirmed that the banking system is strongly positioned to support the ongoing recovery[2]."

To provide some colour on the extent of these tests, one of the hypothetical scenarios mapped out was a severe global recession with US unemployment rates surpassing 10%, a 4% gross domestic product (GDP) fall until late 2022 and more than a 50% drop in in stock markets. The Fed stated[3] that “under this scenario, the capital ratios of banks within the study declined to 10.6%, a level that continues to exceed their minimum requirements.”

The health of European banks

Across the Atlantic, the European Banking Authority (EBA) conducted its own stress test at the start of 2021. These will have many eagerly anticipating the results given that the 2020 EBA stress tests were postponed due to the pandemic. Results are expected to be released this summer with the sample covering approximately 70% of the banking sector’s assets in the EU and Norway[4]. The adverse scenario in these stress tests are severe and include real GDP declining by nearly 4%, unemployment rates rising by 4.7%, and stock prices globally falling by 50% in advanced economies[5]. This will provide a glance into the resilience of the banking system under another severe scenario.

Since December 2020, the European Central bank has continued to request that European banks refrain from or limit dividends and share buy-backs until 30 September 2021. The recommendation is for dividends and share buy backs to be limited to the lower of a max of 0.20% of the banks' common equity tier 1 (CET1) or below 15% of cumulated profits for 2019-20[6]. Looking at earnings in Q1 2021, companies within the financial sector of the Euro Stoxx 50 showed a strong first quarter. 48% of companies within the sector reported earnings growth compared to Q4 2020[7]. Over the same reporting period, European banks continued to maintain buffers to their maximum trigger ratios for their Additional Tier 1 Contingent Convertible bonds (AT1 CoCos)[8].

Improving investor sentiment

Over the last twelve months, AT1 CoCos have delivered 18.43% return[9] and been one of the best performing areas in fixed income. With investor sentiment towards the European banking sector turning more positive and AT1 CoCos providing a yield enhancement relative to the banks more senior debt, the asset class is garnering strong investor interest. Against rising sovereign bond yields, investors have also been searching for historically resilient asset classes in rising rate periods. AT1 CoCos have historically been shown to hit this mark as well.

With yields across a broad set of fixed income markets generally lower than in 2020, we are likely to see companies take advantage of these lower yield levels with new bond issuance. Over the next three months, NatWest Group, UBS, Societe Generale, UniCredit and Banco Santander have outstanding AT1 CoCo bonds approaching their first call dates. With bond markets pricing in lower credit risk than at the height of the pandemic last year, we are likely to see these issuers call the bonds on these dates.

Sources

[1] Released on 24 June 2021, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210624a.htm

[2] Federal Reserve press release: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210624a.htm

[3] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210624a.htm

[4] European Banking Authority, dated 29 January 2021, https://www.eba.europa.eu/eba-launches-2021-eu-wide-stress-test-exercise

[5] European Banking Authority, dated 29 January 2021, https://www.eba.europa.eu/eba-launches-2021-eu-wide-stress-test-exercise

[6] Press release data 15 December 2020 https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201215~4742ea7c8a.en.html

[7] Bloomberg, as of 17 May 2021, first quarter 2021 earnings reported compared to fourth quarter 2020 earnings reported for companies within the Euro Stoxx 50 price index (SX5E).

[8] European banks is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index.CET1 change represents value change in CET1 ratios from data available as of 31 March 2021 (generally Q4 2020 available reporting) compared to latest data available as of 12 May 2021 (generally Q1 2021 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.

[9] AT1 CoCo asset class considering the iBoxx Contingent Convertible Liquid Developed

Europe AT1 Index (USD), as at 24 June 2021 total return in USD

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