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Subordinated debt: a niche high yielding investment opportunity

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The fixed income bond market is comprised of different types of debt. Subordinated debt sits at the lower end of the debt stack, just before equity. In case of a default, repayment of subordinated debt will come after the other bond tranches. This implies that subordinated debt bears a higher risk for investors. Therefore, in return, subordinated debt bonds compensate investors with higher yields. As a result, the asset class offers a compromise in terms of risk and returns, positioning it in the middle of the capital structure, just between equities and senior bond tranches.

European banks represent the largest sub-segment of the subordinated debt asset class. This is related to the regulatory framework and its stringent rules in terms of bank capital requirements. Issuing subordinated debt allows banks to increase their capital ratios while at the same time it serves to strengthen their creditworthiness.

In 2023, after a turbulent month of March, the subordinated debt market has moved back in the spotlight. The asset class's valuations have improved, offering an opportunity to gain access to higher yields from subordinated bonds issued generally by investment grade quality signatures.

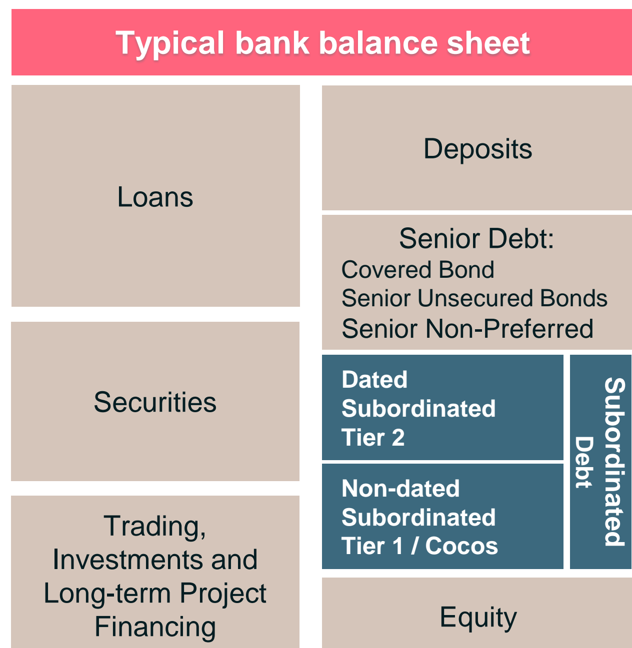
The subordinated debt market is characterised by a strong "euro" bias, resulting from technical factors (European regulatory framework) that favour issuance versus issuing equity to strengthen capital structures. According to Ostrum Asset Management (Ostrum AM), subordinated debt is an instrument which can be used to diversify fixed-income allocations, offering additional yield pick-up. And it can add value to responsible bond allocation as the sustainable subordinated bond market is developing.

I - SUBORDINATED DEBT, WHAT IS IT? DEFINITION AND CONCEPT

1.1. What is subordinated debt?

In the fixed income bond markets, and particularly in the credit bond market, there are different types of bonds with each carrying different types of risks. The largest and most well-known segment of the credit market is **senior debt**.

As a general rule, if a credit event occurs regarding an issuer (company or bank), bond investors rank lower in terms of priority for reimbursement relative to a government or tax authority. However, bond holders do rank higher than equity shareholders. For a bond investor, it is default risk that is amongst the biggest risks. This compares to an equity investor that is mainly concerned about company profitability.



As mentioned in the introduction, subordinated debt has a lower priority ranking than senior debt. This implies that in some cases, such as bankruptcy or a safeguarding procedure in France, or a bank resolution regime[1], subordinated debt holders will likely not be reimbursed in an identical manner to senior debt holders. Instead, subordinated debt holders will have to wait until several other stakeholders have been served, such as employees, the tax authorities, certain depositors and suppliers, in addition to the senior debt holders.

Subordinated debt, therefore, incurs a higher probability of loss, if the company or the bank goes bankrupt.

"The higher risk embedded in subordinated debt must be remunerated. It is this supplementary yield opportunity that investors can capture, after ensuring a rigorous analysis of the issuer's quality."

1.2. Who issues subordinated debt?

Although non-financial companies do issue subordinated debt, **the main issuers are financial companies and insurers, and especially banks**. Banks issue subordinated debt to fulfil regulatory capital requirements and European regulators recognise subordinated debt as capital. This is clearly an advantage for banks as it implies that can raise capital, without diluting shareholders via a capital increase in the equity markets.

Non-financial companies (called **hybrid debt** or **corporate hybrids**) also have incentives to issue subordinated debt as ratings agencies may consider subordinated debt as part of the shareholders' equity (generally 50% of the nominal issued) and part debt. This provides an advantage for the issuer as

[1] Resolution is the restructuring of a bank by a resolution authority through the use of resolution tools in order to safeguard the public interest, including the continuity of the bank's critical functions, financial stability and minimal costs to taxpayers. Source: Resolution Q&A, Single Resolution Board, www.srb.europa.eu

subordinated debt generally costs less to issue than equity. Considering that issuing subordinated debt will generate positive outcomes for the issuer, rating agencies have a tendency to also ascribe higher ratings to the issuers, which then will also position the issuers for more advantageous financing on their senior debt.

"Subordinated debt offers niche financing window for issuers to use, up to the limit authorised by the regulator."

We raised that a same issuer may issue several types of debt, with each tranche targeting different funding needs. Subordinated bond, for example, may be issued to bolster the firms balance sheet structure (capital) whereas a senior debt bond may be issued to cover general financing requirements.

Summary of reasons why a firm may issue subordinated debt:

- **To respect the regulatory framework** (banks and insurers): these firms are required to maintain a certain level of capital, for their business activities and/or to distribute dividends.
- **To maintain a rating and optimise overall financing costs incurred by the issuer:** as subordinated debt is considered partly as shareholders' equity by the ratings agencies, companies use subordinated bonds to maintain their debt ratios at a level which is compatible with their rating. The issuer accepts to pay a higher yield on a small proportion of its debt in order to "secure" its rating. Buy securing its rating, the issuer will benefit from reduced financing costs on its senior debt. The higher yield pay out on the subordinated debt tranche represents a reasonable cost relative to the higher cost of a downgrade.
- **To finance growth**: subordinated debt may be issued to build-up capital, in order to finance investments or acquisitions, or simply to replace higher cost capital. Many non-financial issuers prioritise green bonds or sustainability-linked bonds in their subordinated debt programs, as these formats have quasi-shareholders' equity characteristics, and can be used to finance long-term energy transition investments, particularly in the utilities and telecoms sectors.
- **An alternative to issuing new equity**. In this case, subordinated debt issuers have the advantage of not diluting existing shareholders or not granting voting rights or control to investors. In addition, certain issuers, generally in the public domain, simply cannot call on the equity markets and therefore use these bonds as shareholders' equity instruments.

European issuance dominates in the Subordinated Debt Market

Subordinated debt is issued mainly by European issuers. Since 2019, regulatory authorities in Europe have been driving issuance in the banking sector with strict capital requirements imposed on banks. In the United States, the market is instead dominated by preferred shares.

	Bank Tier1	Bank Tier2	Hybrids & Insurance
UK	22%	9%	13%
Europe-Core	40%	70%	67%
Europe-Periphery	16%	17%	13%
North America	1%	1%	4%
Asia	3%		2%
Latam	9%		
Japan	7%		1%
Oceania	2%	4%	1%
	100%	100%	100%

Source: ICE BofA subordinated Debt indices (Global CoCo, Global Hybrids IG & HY, Euro Subordinated Debt), 2023

Issuance of subordinated debt comes at 2 levels for banks: dated Tier 2 bonds and un-dated **additional tier-1 capital (AT1) or contingent convertibles (CoCos),** representing the lowest layer of a bank's capital structure, just above equities. AT1 (or CoCos) are perpetual bonds with early redemption facilities, known as "calls". These types of subordinated bonds are the most advantageous for banks, particularly in Europe, as it is these bonds that are recognised as regulatory capital, explaining why this segment is especially dynamic.

Subordinated debt issuance from non-financial companies is referred to **hybrid debt or corporate hybrids**. Again, this market is dominated by European issuers, although there is occasional issuance denominated in dollars, as some European issuers like EDF have issued in USD.

As for international issuance, there has been some issuance out of Asia, particularly Korea. During May (2023) AT1 bank bonds were issued in Japan and in Latin America.

In the US, preferred shares are a more advantageous type of instrument than subordinated debt. Their level of risk is close to AT1s, but preferred shares are equity without voting rights. At Ostrum AM, we prioritise Canada, which issues AT1s, for subordinated debt investments in the North America region.

1.3. A growing share of Green, Social and Sustainable bonds

Non-financial subordinated bonds are naturally suitable for financing long-term investments. This explains the growing share of sustainable bonds in new hybrid subordinated bond issues. The most represented sector is *Utilities,* as issuers need significant funding for the transition of their productive equipment to clean energy.
Regarding bank Additional Tier 1 bonds, the low share of sustainable bonds in Europe is explained by the position of the regulator which hesitates on the compatibility between the equity nature of these instruments (capital) and the characteristics specific to sustainable financing. As a result, few issuers have issued AT1 sustainable bond. However, this position may change in the future[2].

Source: ICE BofA subordinated Debt indices (Global CoCo, Global Hybrids IG & HY, Euro Subordinated Debt), 2023

[2]Source :www.eba.europa.eu. EBA Report on the monitoring of Additional Tier 1 (AT1) Instruments of European Union (EU) institutions

Source: ICE BofA subordinated Debt indices (Global CoCo, Global Hybrids IG & HY, Euro Subordinated Debt), 2023

Ostrum AM has proprietary methodologies and tools which is key in the sustainable bond market, as issuers "autolabels" their issues. Our analyses are conducted by dedicated sustainable bond analysts, at issuer level and at project level, and include all types of bonds, including subordinated debt.

« The wider sustainable subordinated bond market makes it possible to construct sustainable portfolios. As a portfolio manager, I must be able to rely on solid analyses of issuers and issues. »

1.4. What are the characteristics of subordinated debt?

Subordinated debt benefits from a "premium" compared to senior debt, which is associated mainly with three factors: the inferior priority ranking, maturity and coupons.

We have outlined **priority rankings** in the bond stack already, highlighting that subordinated debt holders have higher risk in the event of bankruptcy or resolution. This explains why the asset class offers additional remuneration.

The maturity of subordinated bonds is also treated differently. Subordinated bonds are often perpetual bonds, with early redemption facilities, known as "calls" (purchase options), or bonds with an extremely long-dated maturity. The risk related to the redemption facilities is referred to as "extension risk". Generally, these repurchase options are exercised by the issuer; however, extension risk is taken into consider in the overall analysis of the bond before purchasing.

There is specific mechanism regarding coupons paid on subordinated debt. For corporate hybrid debt, coupon payments may be deferred. Coupons on subordinated financials can be cancelled. It should be noted however that such deferrals or cancellations are very rare for issuers.

II - THE SUBORDINATED DEBT MARKET

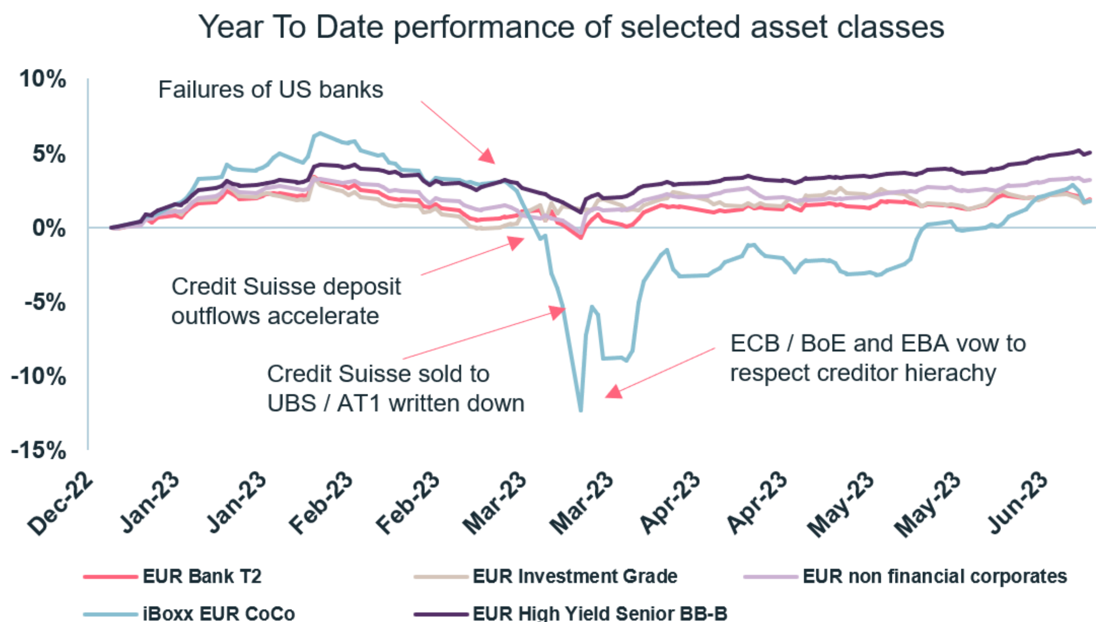
2.1. Subordinated debt market overview in H1 2023

> "After a period of uncertainty in March 2023, the subordinated debt markets have made a recovery. Ostrum AM believes there is still potential for the asset class to appreciate further".

In March 2023, the financial markets were hit by major events (Credit Suisse and US Regional banks bankruptcy). These events affected in particular the credit market and financial issuers. The markets encountered a surprise effect, triggering a disproportionate selloff in Europe. It should be noted that US banks are not regulated in the same way as their European counterparts.

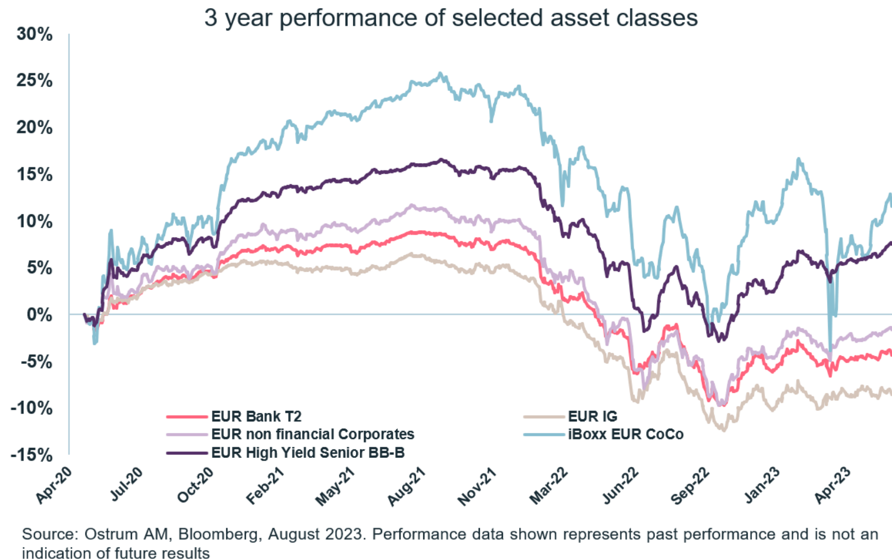
The following chart reflects the performance trends of several asset classes and by type of subordination. We can see that subordinated debt (blue plotline) was the asset class which was hit the hardest by the market reaction. The brutal market swing heavily impacting the valuation of the asset class.

After a short-term period of uncertainty, regulators intervened rapidly. In Europe, regulators firmly reiterated their support for the "risk hierarchy", confirming a subordinated debt holder should not lose more than an equity shareholder. Our view at Ostrum AM is that these bankruptcy events were highly specific and related to idiosyncratic risk, versus systemic risk. The quick reaction from the regulators and the central banks enabled the market to rebound sharply, despite a short period of uncertainty regarding the subordinated debt asset class. This situation does, however, provide visibility on what we can anticipate in the coming months for the asset class.



Source: Ostrum AM, Bloomberg, August 2023. Performance data shown represents past performance and is not an indication of future results. ECB: European Central Bank ; BOE: Bank Of England ; EBA: European Banking Authority.

In the next chart, we can see that despite the period of tensions, subordinated debt (light blue plotline) remains the asset class that has delivered the best 3-year performance, compared to the high yield and investment grade credit indices, whether it be financial or non-financial issuers and also in comparison to senior investment grade debt over the period.



Source: Ostrum AM, Bloomberg, August 2023. Performance data shown represents past performance and is not an indication of future results

2.2. What are the current support factors in the subordinated debt market?

At Ostrum AM, we believe the subordinated debt market, particularly the AT1 banking segment, is currently at an attractive investment level. Despite the recovery rally and long-term performance described previously, the AT1 segment continues to benefit from **supporting factors: robust bank fundamentals, favourable technical factors and an attractive valuation**.

- **Investment grade European banks: robust fundamentals**

European banks announced healthy H1 2023 results, with profitability supported by the rise in interest rates. The **quality of banking assets** - a key factor for subordinated debt investors - and their businesses are solid and positioned at all-time highs. Deposits remain stable and banks continue to have access to central bank facilities. However, in a context of persistent inflation, difficulties could be on the horizon. Potential defaults could affect balance sheets. Office and commercial real estate credit could see pricing adjustments and/or higher vacancy rates. Our view, however, is that these are relatively minor risks that are manageable and under control.

Banking capital is another important factor – for subordinated debt investors. Since the 2008 crisis and with the introduction of more stringent regulations, banks have built up historically high levels of capital. They have had to create buffers to respect the constraints imposed, notably by Basel 3 and Basel 4, which enable them to absorb shocks and set aside provisions. This backdrop supports our positive view on banks' fundamentals.

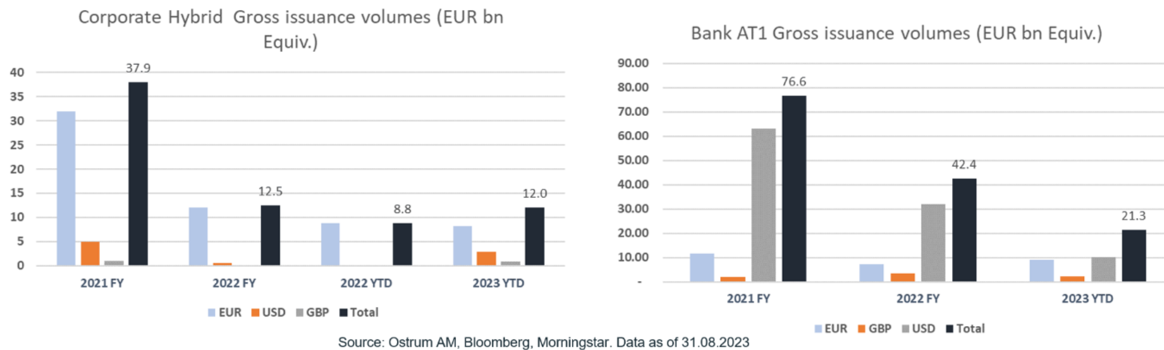
- **Favourable technical factors: stable flows and low supply**

Our analysis of technical factors adds positive context for the subordinated debt asset class, on both the supply and demand side. The technical picture influences future yields and spreads, as well as the risk premium level.

After the market events at the start of 2023, mass disinvestment in the asset class could have been expected. This, however, has not been the case. There is a strong correlation between the amount of AT1 bonds in circulation and performance as AT1 bonds represent around 60% of fund investments in subordinated debt. In March, the amount of bonds in circulation was stable, indicating the market was relatively resilient in terms of demand.

In terms of supply, new issuance has a strong influence the setting the level of spreads. Although the level of new issuance is far from the record set in 2021, the sharp rise in interest rates explains the lack of issuer appetite and thin issuance volumes. In addition, the low level of mergers & acquisitions also accounts for the lack of enthusiasm among companies.

It should be noted that non-financial subordinated debt is often backed by high ESG scores with an increasing proportion of issuers launching in green bond formats, attracting investor demand. Telefonica[3], for example, issued a green hybrid issue, with a primary market orderbook which was 4x larger than the size of the issue allocated.



Source: Ostrum AM, Bloomberg, Morningstar. Data as of 31.08.2023

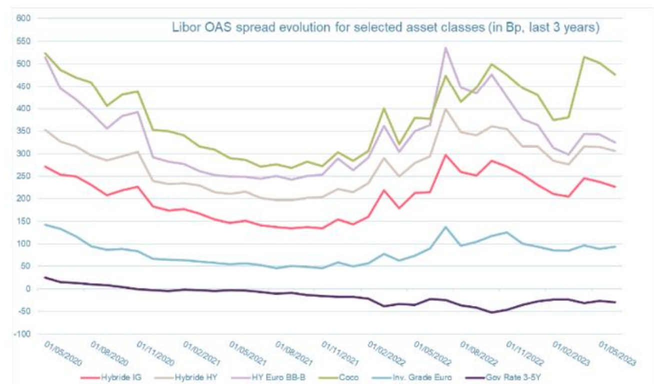
- **Attractive valuation**

Valuation is factor that can attract investors.

> "We believe that prices are attractive, despite the recent rally, with spreads still hovering at historically wide levels, interest rate stabilisation will likely be a favourable factor".

✓ *Yields at all-time highs*

Subordinated debt is considered a "liquid" credit alternative. Subordinated debt represented by AT1 debt (green plotline) has historically offered the highest yields and premiums within the credit stack. The following chart represents risk premiums over the swap rate curve, illustrating the dislocation observed in March 2023. We continue to anticipate a normalisation, with a return towards slightly wider levels than high yield credit.



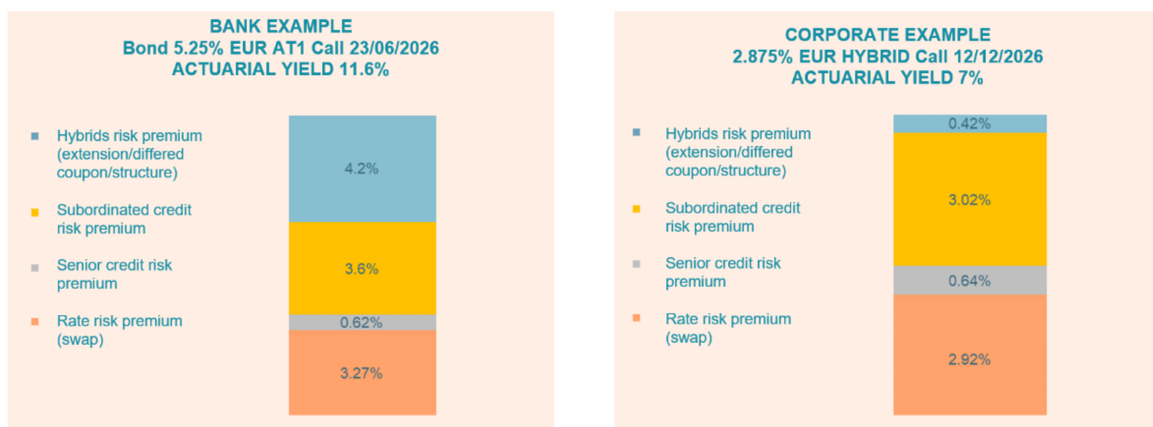
Source: Bloomberg, August 2023. Performance data shown represents past performance and is not an indication of future results.

[3] Source: Bloomberg. Telefonica Europe 6.5% €750m green hybrid bond (XS2646608401) issued on 30/08/2023.

✓ *Positive convexity*

Convexity is defined as the possibility for an acceleration in a bond price in a given direction (positive when the price increases, or negative when the price falls). For AT1 bonds (CoCos), extension risk is a factor which adds convexity to the bonds, compared to non-callable bullet bonds. For example, if the market suddenly starts anticipating that a bond currently priced at its call value has a strong probability of not being called, it is like anticipating that a 3 to 4 year bond with a certain coupon (as an illustration) would immediately be transformed into a bond with 2x the duration with a similar coupon. Hence, a sudden revaluation and a negative price acceleration. In this case, the aggressive price fall is defined as negative convexity. The inverse could also occur. We observe positive convexity when the market prices a longer-term or perpetual call and then begins to anticipate that the bond is likely to be reimbursed at the call date and pay the initial coupon.

We have used two examples to explain the risk premium: a bank issue and a corporate hybrid issue, as illustrations[4].



In the bank example (left image), we can see that the AT1 bank debt yield is 11.6%, which is very high. If we decompose the different levels of the risk premium, the "rate" risk premium (sovereign yield) represents 3.27% and the senior-subordinated credit premium is just below 4% (0.62% + 3.27%), leaving 3.6% for the specific bond features (ie extension risk) risk premiums, considering that the bond is a perpetual bond, with a call option. In principle, it can be assumed that the bond will be called at the first call date, generally 5 years.

As at end of August, just under 70% of AT1 bonds are priced "in extension", implying the market does not believe that they will be called on their first call date.

This number can be compared to historical data that shows that 95% of AT1 debt has been redeemed at the first call date[5]. Why? Because AT1 subordinated debt is a major source of financing for banks, thus banks have sought to redeem? Redeeming is positive for their reputation, and it allows them to come back to the market for future financing needs. We believe that the market will ultimately adjust and reprice with higher investor confidence. The situation has already changed rapidly and favourably: spreads are readjusting, and risk premiums have narrowed, implying to a certain extent that that market is more confident and believes that extension risk will move lower, although at the end of August it is still very present.

[4] Source = Ostrum AM, Bloomberg 05/06/2023
[5] Source= What Are The Odds?: Assessing AT1 Extension Risk Probabilities, Roberto Henriques, CFA AC, European Credit Research, J.P. Morgan 25/04/2023.

> "In our opinion, there are reasons to anticipate positive convexity (positive acceleration in prices) for Bank AT1 debt, considering that the market is still pricing significant extension risk compared to historical data that points to banks continuing to redeem at call date."

- **Market sentiment and investor confidence levels**

Following the period of risk aversion in March 2023, market sentiment has improved, and we believe that it will remain on a favourable trend. Statements from regulators are supportive for subordinated debt and have contributed to restoring confidence.

The visibility in regard to the exercise of calls represents a key factor underpinning market sentiment. So far, since March, there are examples of banks that have called their bonds, some have even done so with the bond pricing-in extension risk, and have re-issued new debt, which again highlights the importance of this source of capital financing for issuers.

The launch of new issues will serve to help restore confidence and attract investor flows again. We can observe that the current low volume in issuance tends to a be a positive factor for spreads. It is, however, nevertheless important that the market remains active and that issues run smoothly. The latest and largest issues included Japanese banks in April and BBVA in June. The Bank of Cyprus, which is a smaller lower-quality player, also issued subordinated debt, which nonetheless attracted investors. Since August, we have also seen issues in Spain, Belgium and Austria. Demand for these issues has been strong, with orderbooks oversubscribed even during mid-August. In terms of green issuance for the subordinated asset class, it should be noted that for the time being, only two green AT1 bonds have been issued, by BBVA and by De Volksbank.

2.3. Ostrum Asset Management, a subordinated debt expert

Ostrum AM is one of the largest European fixed income managers. Ostrum AM manages 7 billion euros of AUM in subordinated debt and has been investing in this asset class for a long time, through open-ended funds, segregated funds and investment mandates.

> "Ostrum AM is recognized for its credit analysis capabilities. In subordinated debt management, it is key to select the right issuer in accordance with its credit risk profile".

Choosing the right issuer is crucial, along with understanding the potential extension risk. The investment management team dedicated to our Global Subordinated Debt strategy is highly experienced and draws on the support of 23 credit analysts - including two sustainable bond specialists – based in the US, Asia and Europe, covering more than 1,200 issuers.

Ostrum AM's Global Subordinated Debt strategy is certified with the French state SRI label and is classified SFDR Article 8. The strategy is focuses on responsible investments, integrating ESG criteria into fundamental analysis. Sustainable objectives are embedded into the investment process: a superior ESG score than the investment universe, lower carbon intensity (environmental indicator) and more stringent anticorruption policies (governance indicator).

Ostrum AM's subordinated debt strategy is global. The management team invests in the OECD region, with leeway to invest up to 40% outside of the OECD. However, as we have outlined above, most of the issuance for this asset class is in Europe, giving the portfolio a euro bias. The portfolio managers apply a flexible

investment process, seeking to generate alpha and ensure “blend” diversification in terms of types of issuers - banks, corporates, insurers.

The aim of this strategy is to identify quality issuers with a high credit rating (investment grade), while investing for attractive yield in the lower part of the debt stack.

CONCLUSION

According to our analysis, the subordinated debt asset class offers attractive levels of yield within a universe comprised of highly creditworthy issuers. Ostrum AM proposes a global subordinated strategy with a long performance track record, characterized by controlled volatility and opportunistic dynamic investment management. We identify fundamental and technical factors that currently support the market, along with valuations and improving market sentiment. We believe that spreads will continue to improve with bond calls by issuers serving to normalize market conditions. This asset class provides an investment opportunity to consider within the higher yielding fixed-income universe, serving high levels of carry. And opportunities are developing in the sustainable subordinated bond market!

Additional notes

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