GRANT'S

INTEREST RATE OBSERVER®

Vol. 37, No.01d | 233 Broadway, New York, New York 10279 • www.grantspub.com | JANUARY 11, 2019

Sacrificial securities

Mr. Market stifled a yawn when Italian lender Banca Carige S.p.A. disappeared into regulatory limbo the other day. Since 2012 the shares of Italy's 16th-largest bank by assets had changed hands below €1, finally sinking, on Dec. 28, to the concluding nominal price of €0.0015—the status of "temporary administration," or worse, seemed almost foregone. At least, it did until Monday, when Italy's populist government proffered the chance of a state bailout. Altogether, suspense remains the order of the day for the Old Continent's banks and their black-and-blue shareholders.

Now in progress is a review of the European banking situation with special emphasis on "contingent convertible bonds," a.k.a. CoCos, securities paradoxically issued for the ultimate purpose of trading at zero. Deutsche Bank, sovereign European debt and a short lesson in the art of not believing what you see on a bank's balance sheet are also on the agenda. In preview, the oddball, $245 billion, Western European "additional Tier 1" CoCo market constitutes one of the world's top laboratories of the risks attending the suppression of interest rates and the resulting clamor for yield. It is one of the many central-bank-blighted asset classes in which your money shouldn't be caught dead.

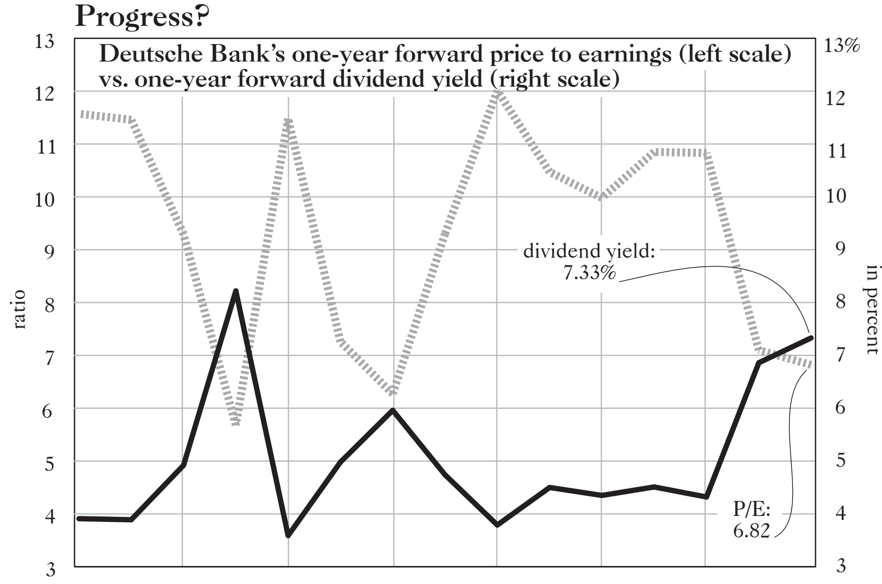
It can't be said that creative destruction is high on the list of European governing ideals. Some $31 trillion in Euro-area banking assets represents 226% of the region's GDP, compared to $17.6 trillion in American banking assets representing 85% of U.S. GDP. Slow loans continue to plague European lenders: On June 30, nonperformers totaled €820 billion, of which 41% were not provisioned, according to the European Commission.

To judge by 2018 bank-stock performance, those data are just as condemning as they look. Thus, except for FinecoBank S.p.A., an online financial-services subsidiary of Italy's Unicredit, all the remaining 25 stocks in the Euro STOXX Banks index registered losses, with Deutsche Bank and Commerzbank AG surrendering more than half their value. The price to forward earnings ratio of the index stands at 6.7, which happens to be lower than the forward dividend yield of 7.4 percent, the first such occurrence since 2008.

Bad bank-stock performance is no unfailing sign of systemic distress—the U.S.-focused KBW Bank index fell by 18% last year. Still, the KBW index components trade at 1.2 times book value, double the 0.6 price-book ratio of the Euro STOXX members. Conferring extra credibility on the bearish message of the European stock-market action is the loss of the investment signals once conveyed by European bond yields and credit spreads. Suppressing the yields and compressing the spreads, European Central Bank president Mario Draghi has rendered the bond market mute.

Neither do European bank financial statements tell all that they should. For example, one might assume that a bank showing a 7% leverage ratio—that is, good, "Tier 1" capital divided by total assets, including the ones off-

Progress?



source: The Bloomberg

balance sheet—would be able to stand on its own two feet. But Banca Carige, showing just that figure on Sept. 30, "amongst the highest in the Italian banking system," is now, as noted, at the mercy of regulators and politicians (even more so than the average bank).

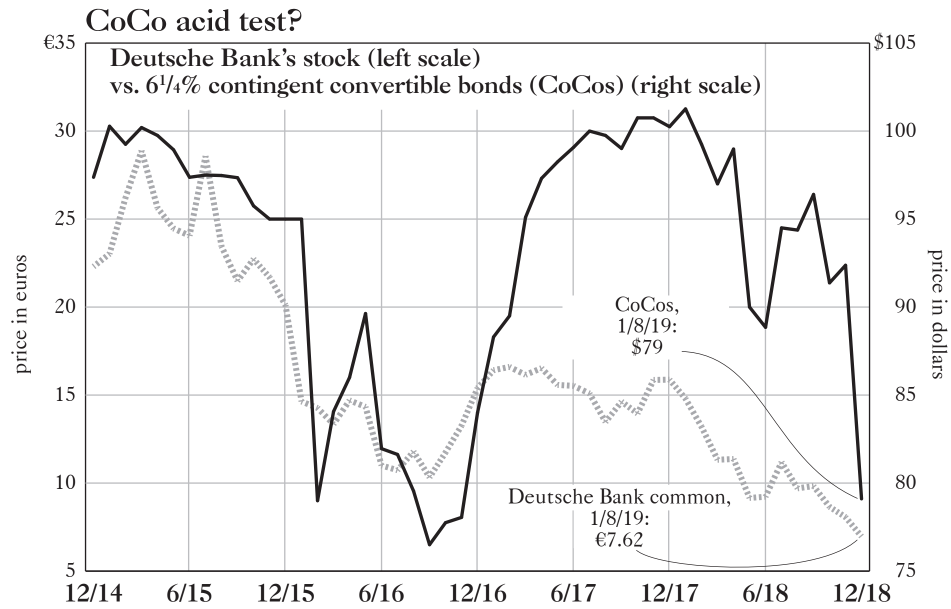
A prime cause of the mixed signals is the regulatory treatment of government bonds. It's a detail that helps to account for the growth in the CoCo market and (in smaller measure) for the gross underpricing of sovereign credit risk. For regulatory purposes in Europe, government debt is risk-free.

"Under the EU rules," observes colleague Fabiano Santin, "bankers may employ their customers' deposits to buy Greek bonds and/or their Italian equivalent, the musically named *Buoni del Tesoro Poliennali,* with no impact on the capital that the bank must set aside to absorb potential losses. They can then borrow to invest in sovereign debt, increasing the asset side of the balance sheet with no obligation to add a corresponding increment of loss-absorbing equity. The leverage thereby achieved generates higher returns on equity while ensuring that the next European sovereign debt crisis will not fail to take an even larger toll on the overextended banks."

In classical doctrine, sovereign debt was deemed to be an inherently unsuitable banking asset. Under European capital rules, that debt has become inherently desirable. Mindful, in 2011, of the perverse incentives created by the zero capital rule, the European Banking Authority began to make amends. Thus, it wrote a minimum leverage ratio, i.e., the one which Banca Carige boasted about, into the rule book. The minimum is 3%, and it takes effect this year.

Thus constrained, banks may no longer increase leverage *ad infinitum.* They can continue to buy all the yield-free sovereign claims they want—German Bunds, French OATs, Spanish *Bonos*—at the same zero-risk weighting, though they must not now breach the new leverage test. To raise the capital with which to comply, the European banks have sold billions of euros of CoCos.

CoCos are perpetual subordinated debt securities that—importantly—qualify as Tier 1 capital. They come with a fixed noncumulative coupon and are callable after five years, but the devil is in their details. One species of CoCo is designed to self-destruct in case of a breach of a defined solvency test. Another is designed to convert into common equity, also in the event of trouble. The triggering event could be a plunge in the issuing bank's Tier 1 capital or a press release from the EU's Single Resolution Board declaring that the issuing entity is, or is about to become, insolvent. In this sense, then, CoCos are the sacrificial lambs of a bank's capital structure.



source: The Bloomberg

Oddly enough, three-quarters of outstanding European CoCos wind up in the hands of non-Europeans, according to a 2017 study by the central bank of the Netherlands. Or maybe it's not so odd. The appeal of such paper to American investors is no mystery: The U.S. dollar-pay cohort, estimated at $110.5 billion, returned 5.8% a year for the five years ended Dec. 31, two percentage points better than dollar-denominated junk bonds. Two CoCo-focused exchange-traded funds, sponsored by American fund managers WisdomTree Investments, Inc. and Invesco Ltd., debuted in 2018. They are the first of their kind in the United States.

The theory of the sacrificial convertible bond has a ring to it, but what the sacrifice might avail the CoCo-issuing bank is not entirely clear. "For one thing," observes Santin, "troubled banks typically can't afford only to write off equity and subordinated liabilities. Even senior liabilities are problematic enough—Moody's has calculated that the recovery rate of senior unsecured bonds issued by financial institutions was 37.7% from 1983 to 2010. CoCos are subordinated to senior debt and normally make up only a slim percentage of a bank's total liabilities. So their sacrifice by itself would accomplish only so much in defense of the capital of the senior creditors."

Who wields the sacrificial knife is another question. In the case of the emergency acquisition of Banco Popular Español, S.A. by Banco Santander, S.A. in 2017, the executioner was Europe's Single Resolution Board, the agency charged with preventing the failure of a single bank from becoming a continental epidemic.

Nobody contests that Popular, then Spain's sixth-largest bank by assets, was in a bad way—its share price, like Carige's, had fallen below €1 when the SRB acted. The declaration of imminent insolvency—"failing or likely to fail"—cleared the way for the obliteration of the equity and subordinated creditors alike, of course including the CoCos, and sale of Popular to Santander for the symbolic price of €1; senior unsecured creditors were left unscathed.

The precise condition of Popular at the moment of truth is a question that pits the regulators against, among others, U.S.-based Pimco, whose funds are said to have owned €279 million of the €1.25 billion of Popular's then outstanding 11 ½s CoCos. Pimco and its fellow complainants, alleging that the regulators acted hastily and/or unlawfully, have filed suit at the EU's supreme court, the Court of Justice, in Luxembourg, and in the Southern District of New York. Santander, at least, seems to have come out of the transaction without regret, its ROE rising to 8.2% in the first nine months of 2018 versus 7.5% for the same period in 2017.

"There are a lot of tourists in the coco market," Greg Peters, senior portfolio manager at PGIM, Inc., told the *FT* a year after the regulatory intervention. "A lot of those investors are just in there because it has some yield to it. It's a highly idiosyncratic, document driven market, so for people to go in on a whim is a dangerous game to play."

Added Jérôme Legras, head of research at U.K.-based Axiom Alternative Investments: "Apart from the holders who got wiped out and a few regulation geeks, ultimately nobody seemed to really care. That's worrying, because the resolution did not work properly and there has not been enough transparent postmortem analysis of what happened."

Be that as it may, CoCos as a class have lost little, if any, of their investment appeal. Once-burned Pimco holds at least $12 billion's worth, according to Bloomberg. In the words of another European portfolio manager, also quoted by the *Financial Times* (though he spoke in the immediate aftermath of the Popular affair): the intervention was "actually very positive," as the market was tested, and "contagion is almost non-existent."

The acid test may still lie ahead. Deutsche Bank, which badly frightened the CoCo market in 2016 (*Grant's*, July 15, 2016), and which the Financial Stability Board designates as one of the top four global systemically-important banks, is back in the penalty box with its stock closing 2018 near the all-time low at a price representing a ratio of 0.2 times book value. The shares have returned negative 72% in the last five years versus negative 22% for the Euro STOXX Bank index and positive 42.8% for the KBW Bank index. With assets footing €1.38 trillion and a book value of €47.8 billion, Deutsche is nearly 29 times leveraged.

Deutsche's four most liquid CoCos change hands at around 80, down from par in the past year, thus implying a significant impairment risk; they are rated speculative grade, single-B-plus. Issued in U.S. dollars, euros and British pounds, the securities have a combined face value of $6.2 billion and offer current yields ranging from 7.5% to 9.4%. In comparison, Deutsche's senior unsecured claims, rated four notches above the CoCos, are a relative island of calm. The DB 10-year notes are priced at a yield of 2.7%, only 270 basis-points over Bunds.

On Dec. 30 Deutsche Bank's chairman Paul Achleitner told a German newspaper that the bank was strong, the turnaround strategy was bearing fruit and there was no need for state aid or a politically-designed merger with the also-battered Commerzbank AG. Achleitner praised Deutsche's "strong capital," a reference, perhaps, to the 14% Tier 1 capital ratio, defined as capital over risk-adjusted assets, and thus not to be confused with a leverage ratio.

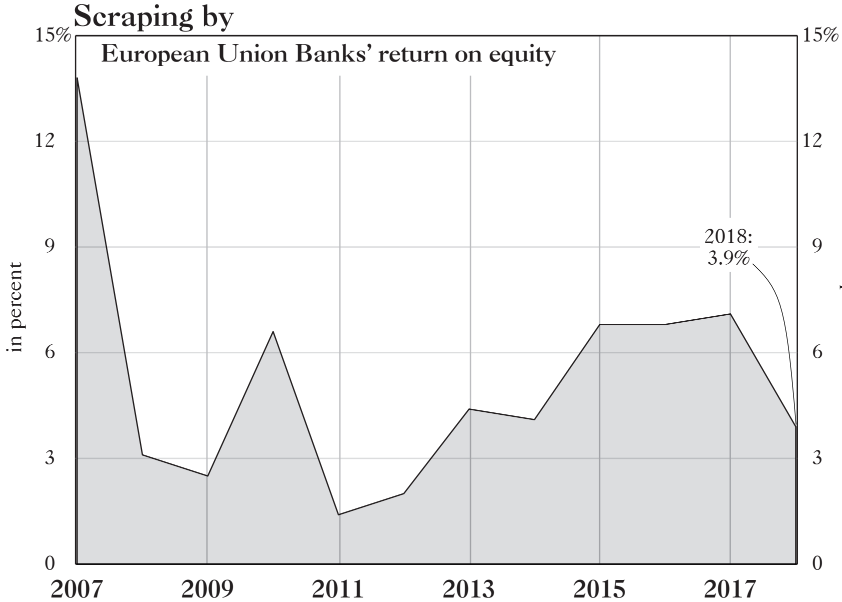
Recall, please, that a capital ratio (as distinct from a leverage ratio) is calculated by dividing capital by assets minus government securities, the latter being riskless, as regulators define risk. The regulatory pretense of risk-free government securities shrinks DB's assets for this friendly calculation to €342 billion from the balance-sheet footing of €1.38 trillion.

Deutsche's leverage ratio—equity plus CoCos divided by total assets not adjusted for risk-weightings—stood at a seemingly respectable 4% on Sept. 30. "Then, again," Santin points out, "it's hard to be confident about that number given that Carige reported a 7% ratio on that same date. You must make allowances, too, for banking regulations that incentivize exposure to negative- and low-yielding cash and government bonds and the dim prospects of a steeper yield curve in the region (the two-year to 10-year Bund spread is expected to go nowhere in the next two years). Even the better-run European banks seem doomed to generating mediocre mid-to-high single-digit ROEs. Low ROEs make banks more exposed to write-downs that could impact Tier 1 ratios (and CoCos prices) in the next downturn."

U.S. dollar-denominated CoCos are on offer from UniCredit S.p.A. for a current yield of 8.8%. The corresponding common is quoted at an earnings yield of 18.1% and a price-to-book ratio of 0.4. CoCos from Intesa Sanpaolo S.p.A., also chartered in Italy, yield 8.7% compared to the common with an earnings yield 11.5% and a price-to-book ratio of 0.7; from France's Société Générale S.A., whose CoCos yield 7.7% compared to the common with an earnings yield of 16.8% and a price-to-book ratio of 0.4; and from Spain's Santander, whose CoCos yield 6.7% compared to the common with an equity-earnings yield of 12.6% and a price-to-book ratio of 0.7.

"The common stocks of European

Scraping by



source: The Bloomberg

banks look relatively much more attractive than what's on offer from their CoCos, which reflect European bank CoCos trading at an average option-adjusted spread of 519 basis points, still lower than the 650 basis-points seen in early 2016," Santin notes. "Observe, too, that the common stocks yield more than the average European bank ROE, they trade below book value and offer unlimited upside should things turn out for the best. In early 2016, during the previous oil rout, the CoCos traded 7 to 17 percentage points below current price level.

"Such is the volatile nature of CoCos that investing in them is a bet that suffers tremendously whenever there is macro uncertainty," Santin winds up. "Because the European financial system is still largely leveraged and the region's economic growth has been dismal, with negative interest rates, the fate of the intertwined banks in the region will rise and fall in concert. Banks are black boxes and there is a high degree of subjectivity and a low margin of safety in investing in historical laggards. CoCos are first in line of debt impairment when losses accumulate, which means that, even if you earn a 10% coupon, it would take 10 years to get back your investment if it goes under. A lot can happen in 10 years, and it doesn't look like we're at past peak stress yet—the 'buy the dip' crowd is still chanting on the sidelines, drooling at the prospect of a Trump trade deal with China or—on the other side of the world—for the Italian government to ride to the rescue of little Banca Carige."

In Monday's *FT*, Elke König, head of the Single Resolution Board, defended her agency's decision to stage that shotgun wedding between Banco Popular and Santander. It was, she said, "a game changer," and "proof that we can resolve a bank." Proof, too, of the agency's power to assign to CoCos the value for which those securities were created: a price of zero.

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