GIB ASSET MANAGEMENT

Developed Market Banks – When Perfect is the Enemy of Good

By Alex Latter, CFA

This is the first in an occasional series on Developed Markets banks from the perspective of sustainability driven bond investors.

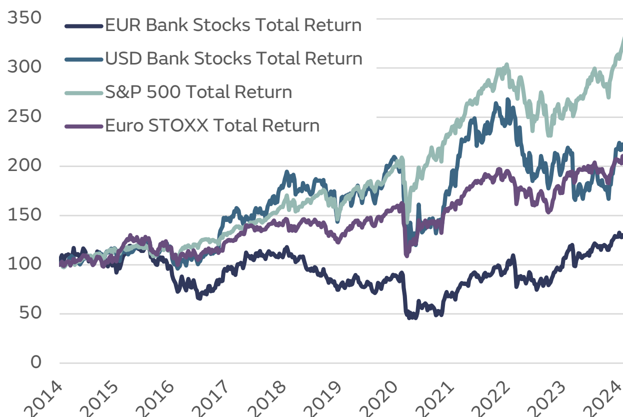
In this piece, we discuss why the sector is attractive to bond investors and how this may differ from our equity counterparts.

Developed Market (DM) Banks – When Perfect is the Enemy of Good

There has been much fretting in the equity markets over the past 12 months about the performance of DM banks. At the beginning of 2023, banks were finally starting to feel loved after years in the wilderness, but the SVB / Credit Suisse crisis in March rapidly returned the sector to the fringes. Investors on both sides of the Atlantic are increasingly watchful, questioning whether interest income improvements are sustainable. Credit spreads, which are often correlated with equity performance, have also remained above historic levels versus comparably-rated corporate issuers. It feels like banks must deliver perfection in order to see sustained stock market performance and, in an accident-prone sector, perfection is hard to come by.

In this piece, we argue that bondholders can take a different view. The dominance of banks within fixed income indices means that the sector is an important area of focus and, fundamentally, balance sheets are strong with improved earnings capacity. Governance, often the end cause of bank failures, is also much improved while sustainability analysis helps identify future growth and improve resilience. We show that bank credit can provide a compelling risk-adjusted return.

Chart 1



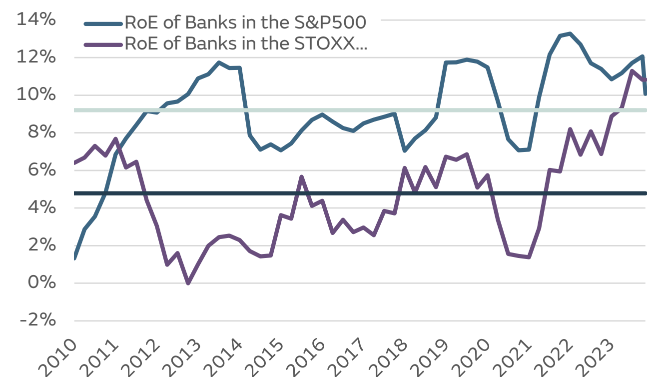
One Man's Trash is Another Man's Treasure

While it is clear why equity investors shy away from the banking sector, we think that bondholders can take a different view. There are three key reasons for this: fundamentals, market structure, and return dynamics.

The Fundamental View – Strong Balance Sheets and Improved Earnings

While the outlook for interest income will be the main driver of share prices over the early part of the year, we believe there are more important aspects of the banking story of which bondholders should be aware. While the variation in rates is significant, investors should bear in mind that bank profitability is at its highest level for over a decade and should remain above historic levels even if there are a significant number of rate cuts. As a rule of thumb, banks should make a return on equity of somewhere between 10-15% to be considered viable in the long term. While US banks do generally meet this hurdle, the European banking sector has barely managed to make a RoE of 5% in the post-crisis-era – something which has been flagged repeatedly by both regulators and investors as a critical weakness. With rates now at a level more aligned with the LT average, banks are seeing the benefit of their deposit franchises which insulate them from fluctuating market rates. Retail banks in the sector are finally making double digit returns and we think that these levels of earnings are defensible with rates in the 2-3% range.

Chart 2



Once an acceptable level of earnings has been reached, investors can turn their attention towards bank balance sheets.

Sources: Bloomberg & ICE, February 2024

This is the real source of strength (or weakness) for an institution. Thanks to years of regulatory focus, capital ratios are stronger than ever - the capacity to absorb losses has increased, a fact that is regularly underlined by regulatory stress tests. In contrast to equity investors, higher capital ratios and restrained payout policies are a boon to creditors. The capital hole related to unrealised losses on bond portfolios remains a tail risk, but applies predominantly to smaller US banks and is steadily reducing as rates have fallen and portfolio duration shortens.

Loan performance has been better than expected and new accounting rules have allowed banks to build up a buffer of forward-looking reserves which will help absorb a normalisation in defaults. There remain a few areas of weakness such as US Commercial Real Estate and credit card lending, but these products are typically only seen in worrying concentrations at specialist players and smaller local banks, which can be avoided with careful analysis. Large, diversified players should be able to ride out this increase in impairments. On a related note, we believe that high capital ratios and better loss reserves will allow banks to take a more conciliatory and socially responsible approach to customers who fall into arrears than in past cycles.

The potential wildcard for the sector is liquidity. While deposit levels remain high and liquid assets are plentiful, we have already seen several banks felled by deposit outflows and a loss of funding – most notably Silicon Valley Bank and Credit Suisse. However, these were somewhat idiosyncratic cases and we think that large banks, with strong retail franchises should remain solid. Balance sheets are at a point of historic strength. While we do not expect them to get any stronger, ever tighter capital requirements and a renewed focus on liquidity management should prevent material weakening. This, combined with a higher steady state level of earnings, is more than enough to keep bondholders happy.

As an industry that depends on customer confidence and trust, strong culture and governance in banking is essential. This remains one of the hardest variables to analyse given the 'soft' nature of the subject, but it is essential for investors to have a good understanding of how individual companies choose to operate. Poor culture and/or questionable oversight can be linked to many past bank failures from Credit Suisse to RBS to Lehman Brothers.

A word on Sustainability and Fundamentals

Fundamental strength and social/environmental sustainability are closely linked for bank investors. With many of the biggest financial losses in the sector being related to fines for misselling or other negative social action, strong governance is key – as discussed above. Beyond that, offering a socially impactful product set is also a fundamental strength. Providing loans and savings products to consumers and businesses, especially those who are historically underbanked, improves the stickiness of business and reduces revenue volatility, although it can come at the cost of somewhat higher credit risk. We prefer community-led retail banks that have a broad customer base and offer simple products such as mortgages, retail deposits and mass market asset management services.

There is also a clear future business opportunity available in financing the climate transition with an identified annual investment need in the energy sector alone of $2.4tn until 2035 to limit global temperature rises to 1.5 degrees. Banks are at the forefront of this need, providing lending to infrastructure projects and renewable energy generation as well as facilitating capex for companies developing new green technologies.

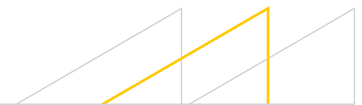
Market Structure – Ignore at Your Peril

It is important to understand how much more relevant banks are in bond markets versus equity markets. As a result of the years of share price underperformance discussed above, only 6% of the market cap of the S&P 500 is represented by banks and financial services stocks while the same sectors make up 24% of the USD investment grade bond universe. In Europe, the dynamic is similar with 11% of the Stoxx 600 but a third of outstanding bonds being represented by banks. As such, it is easy for equity investors to ignore the sector given its small size and questionable track record. Bondholders cannot make the same judgement with such a material portion of the investible universe concentrated in the sector.

Table 1

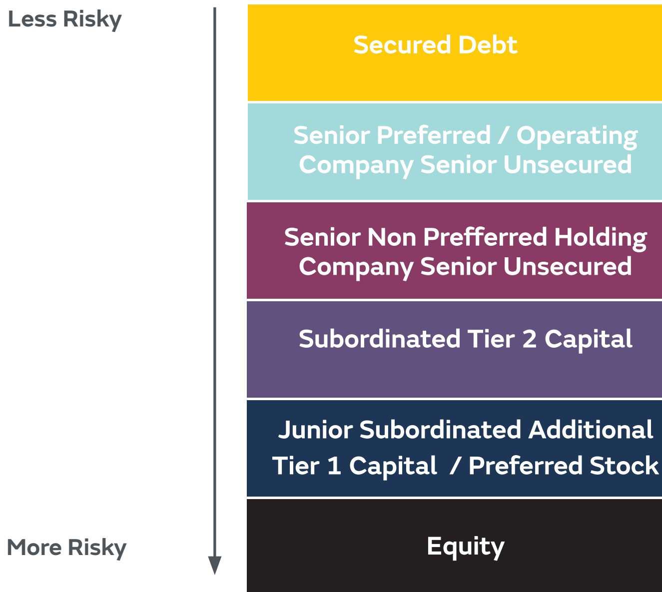
	Banks & Financial Services Index Weight by Market Cap
S&P 500	6%
USD IG Bond Index	24%
Stoxx 600	11%
EUR IG Bond Index	33%
GIB SWCBF Index	23%

Source: Bloomberg & ICE, February 2024



Risk Adjusted Returns

The bond markets provide investors a broad array of products with which to express their views. While the exact structure of bank capital stacks varies by jurisdiction, the diagram below presents a simplified representation of the instruments available to fixed income investors. At the safest end of the spectrum is secured debt, where bondholders have a direct claim over pre-identified assets in the event of bank failure. At the other end of the spectrum is tier 1, capital which contains many equity-like features and can be written off by regulators in times of stress. In between these two extremes there is a spectrum of bonds that face different risks in stress scenarios, some of which can be written off or converted to equity and others which cannot but may have a more junior claim in a liquidation. This spectrum allows fixed income investors to take a nuanced view of issuers, giving the opportunity to 'hide' further up the capital structure of weaker institutions and to express strong views on the relative quality of banks through subordinated debt.



Comparing the total return on AT1s – the most subordinated form of bank bond - to equity returns over the past ten years shows that volatility is significantly lower than stocks (albeit higher than other Fixed Income instruments).

Considering the entire bank bond universe (predominantly senior bonds) gives a similar result - fixed income returns over a long-term horizon are superior when adjusted for volatility.

Chart 3

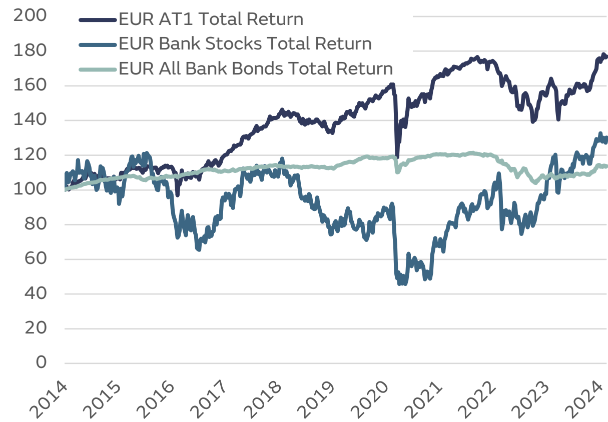


Chart 4

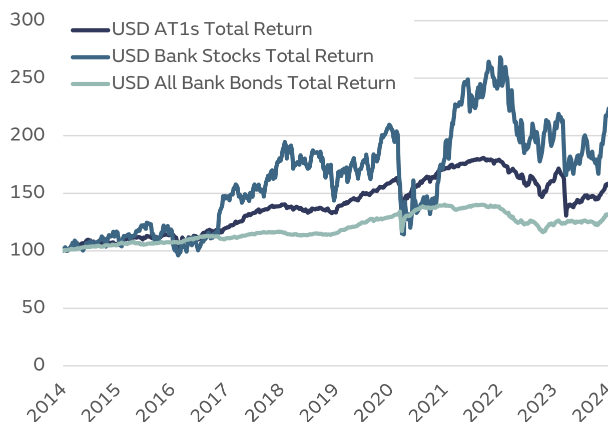


Table 2

	1y RAR	3y RAR	5y RAR	10y RAR
USD AT1	-2.2	-2.0	1.2	2.7
USD Stocks	0.4	0.4	1.1	2.1
USD All Bank Bond	8.0	-2.4	2.3	3.7
EUR AT1	5.9	1.0	2.5	3.4
EUR Stocks	2.3	5.2	2.0	0.4
EUR All Bank Bonds	10.1	-3.3	-0.3	2.5

RaR = Risk Adjusted Return (average return divided by standard deviation of returns)

Decent fundamentals, dominant market presence, good return opportunities

We believe that the banking sector has reached a point where credit investors can be comfortable that downside risks are reasonably contained by strong balance sheets and improved earnings. The sector offers good risk adjusted returns and the opportunity to invest in subordinated instruments that offer a higher yield than similarly rated corporate bonds. GIB Sustainable World Corporate Bond Fund has an overweight position in the sector with a preference for retail banks with steady earnings, strong capital and liquidity positions, and defensible market share.

Sources: Bloomberg & ICE, February 2024

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