The impact of higher interest rates on banks and the attractiveness of CoCo bonds

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Key Takeaways

- As interest rates remain higher for longer, banks continue to benefit from tangible improvements in margin and return on equity, leading to lower probabilities of default in CoCos.
- The CET1 ratios have regained healthy levels, supported by higher margins and increased stability.
- CoCos have come back strong after the banking crisis that involved the default of Credit Suisse bonds. We expect further strengthening in the asset class given the favorable macro environment.

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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.

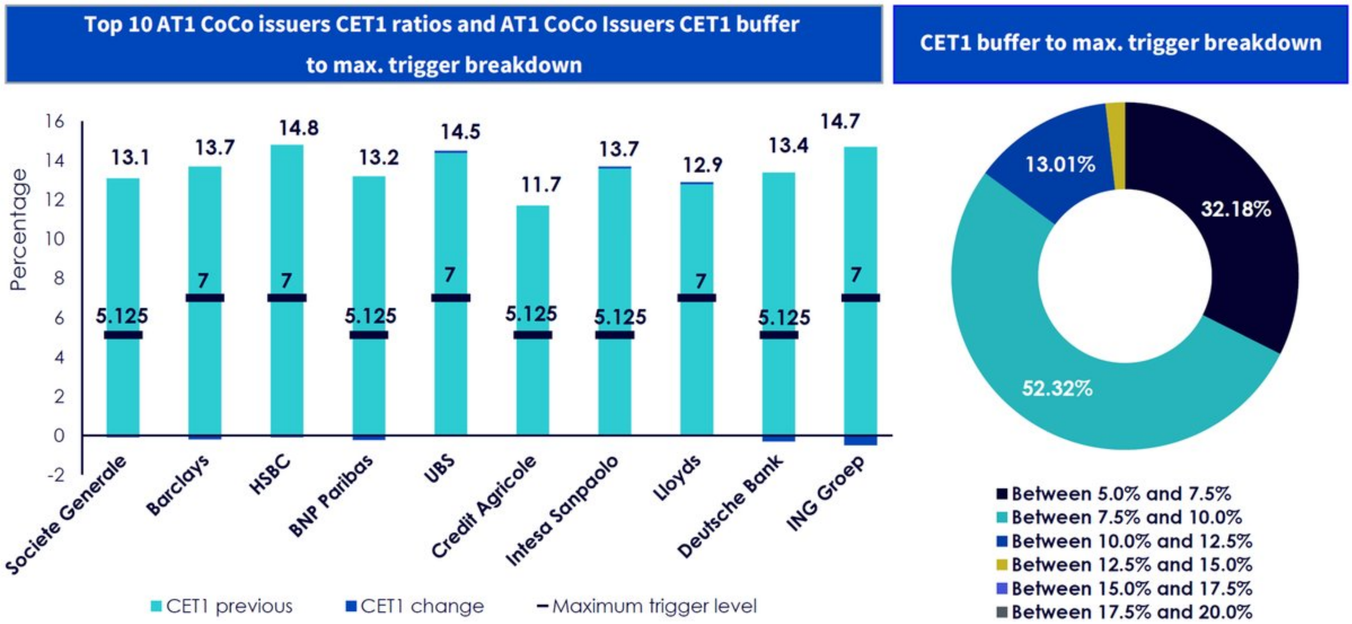
The primary mechanism through which banks earn a profit is through the spread between the interest they pay on deposits and the interest they earn on loans and investments. As interest rates rise, banks are generally able to charge disproportionally more for loans compared to the interest they pay to 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.

	RI	Threshold	Traffic light: Current vs previous quarters for the worst bucket	202009	202012	202103	202106	202109	202112	202203	202206	202209	202212	202303	202306	202309	202312
Profitability	Return on equity	> 10%		5.1%	2.0%	14.8%	13.7%	18.2%	23.1%	17.8%	21.5%	21.1%	26.7%	55.4%	58.9%	60.6%	45.2%
		[6% - 10%]	●	18.9%	19.3%	51.8%	58.6%	53.8%	44.9%	29.4%	51.5%	52.8%	47.1%	15.2%	30.0%	23.8%	38.3%
		< 6%		76.0%	78.8%	33.4%	27.8%	28.0%	31.9%	52.8%	27.0%	26.1%	26.2%	29.4%	11.0%	15.6%	16.5%
	Cost to income ratio	< 50%		15.8%	16.5%	17.7%	16.0%	16.1%	19.7%	17.0%	17.6%	19.8%	19.8%	22.5%	33.9%	36.1%	27.8%
		[50% - 60%]	●	13.0%	11.4%	12.8%	17.8%	15.3%	9.9%	12.9%	20.0%	17.9%	21.1%	24.3%	18.0%	19.0%	27.2%
		> 60%		71.2%	72.1%	69.5%	66.2%	68.6%	70.4%	70.0%	62.5%	62.2%	59.1%	53.2%	48.1%	44.9%	45.0%

Source: European Banking Authority

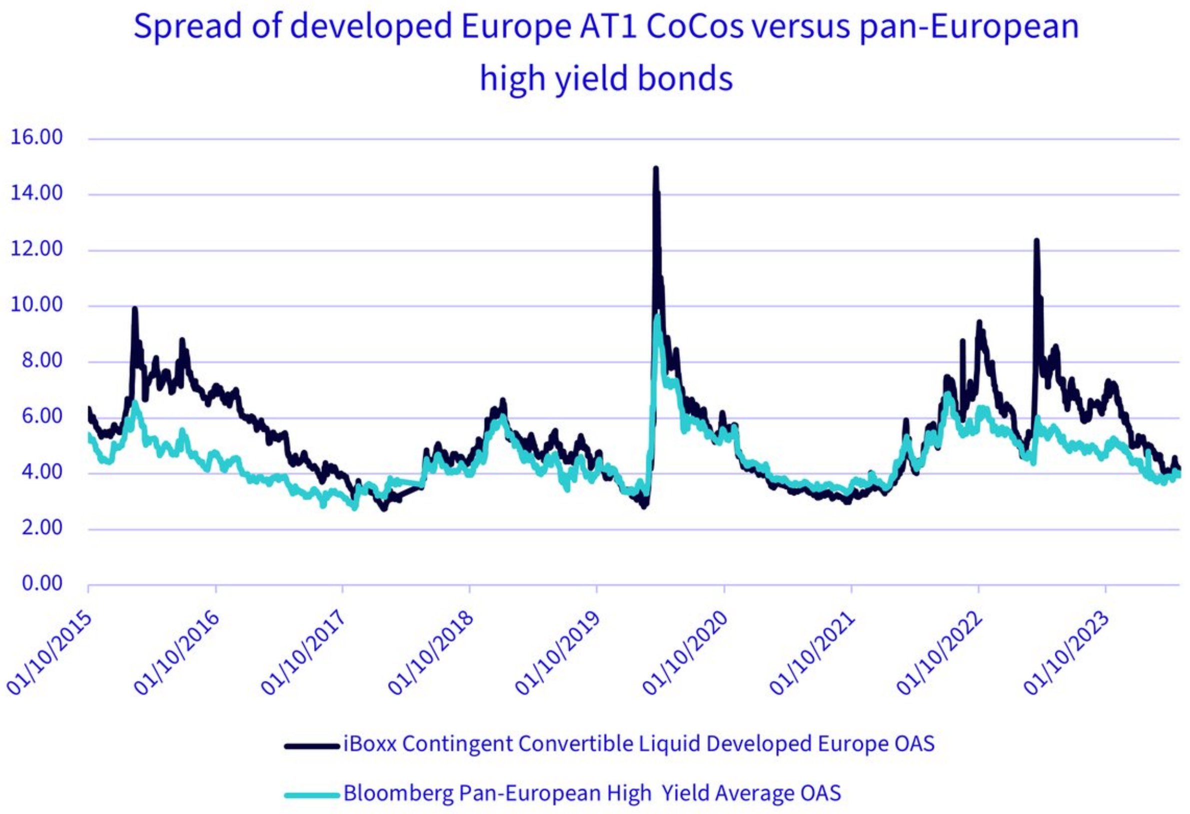
A higher ROE signals strong profitability and reassures investors about the bank's overall financial health. With central banks increasing rates almost globally, many financial institutions have reported substantial gains in net interest income, bolstering their financial statements and appeasing stakeholders.

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.



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.

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