What about supply and demand for financial debts?

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European banks
September has seen a **significant volume of bond issuance, and a large part is coming from European banks**. They are effectively advancing in their annual funding plans with approximately 70% of their needs already completed. Year to date (YTD) they have issued Eur258Bn debt securities, including Eur83bn senior preferred debt and Eur175Bn loss absorbing debt (ranging from senior non-preferred to AT1) to meet their various pockets of regulatory capital.

Of note, there has been an **increase in the number of primo issuers** in the senior non-preferred bonds space. Many are banks from Central and Eastern European countries, but given their small size, it is unlikely they will build a liquid bond curve. We also note Greek banks re entering the market.

Regarding the **deeply subordinated debt**, with Eur25bn issuance YTD, the AT1 market is still live and kicking, despite some banks turmoil last year. When investing in the assets class, we focus on two main factors: extension risk and loss absorption risk. We believe extension risk is decreasing, judging by banks' behavior, i.e. continuing to refinance their subordinated bonds ahead of their first call date.

As far as the AT1 loss absorption feature is concerned, we note different stances from regulators. While they question AT1 securities' actual ability to absorb losses in times of stress, the Australian regulator is proposing the phase-out of AT1, whereas regulators in Continental Europe and Switzerland are considering measures to reinforce their loss absorbing features, something that is naturally detrimental to bondholders in case of stress and they require to be remunerated for.

European Insurance companies have also been very active mainly in the European primary bond market. Year to date, they have issued **the equivalent of Eur15.4Bn subordinated bonds, close to record high**. While insurance companies do not need senior funding, as they are cash rich by the mere economics of their business model, those subject to Solvency 2 regulation do use subordinated bonds to replenish a portion of their regulatory capital ratios. They use such regulatory arbitrage by taking advantage of a cheaper, relative to common equity, form of capital to meet the same purpose.

The reason for the record high issuance is not fundamental though. On average, European insurance companies do exhibit strong regulatory capital ratios thanks first and foremost to the beneficial impact of higher interest rates. The largest positive impact is felt by those with large bias to life business. Non-life insurers also stand to benefit from increased interest rates, thanks to early impact from rolling their shorter dated investments into new, higher yielding assets.

The reason for issuance is technical. Many outstanding subordinated bonds, issued before Solvency 2 was put in place and exhibiting terms and conditions nonaligned with the new requirements, will lose their regulatory capital benefit at the end of the 10-year grandfathering period, i.e. December 2025. As a result, European insurers have all incentives to call them at first call date, or buy them back and replace them with Solvency 2 compliant ones.

We expect the call or buy back trend coupled with new issuance to continue into 2025, creating opportunities in the secondary and the primary market.

In addition to strong and resilient fundamentals, the financial sector is supported by **strong technical factors thanks to yields near their historical highs and attractive premiums** relative to the non-financial sector. Year-to-date, investment grade ETFs and funds attracted more than Eur30Bn of inflows. This favorable environment translated into strong investor demand in face of very high banks and insurance issuances that were extremely well absorbed, with deals oversubscribed more than 3 times in average.

Another consequence of the investor's appetite is the level of confidence demonstrated by issuers coming to the market, with deeply subordinated bonds issuances (AT1 and RT1). As well as issuances from relatively weak credit quality names. Indeed, investors welcomed those issuances with demand above 4 times the issue size on average. We took part in several AT1 and RT1 deals to benefit from attractive carry and solid fundamentals.

Every segment of the banking capital structure has already compressed tremendously but we still see some value and good carry assuming no hard landing of the main economies in the world. Also, we think new measures arising on the regulatory front and the return of M&A initiatives in the banking sector create great opportunities. As such, the APRA* announcement led us to reduce some exposures to Australian banks' subordinated debt. In the meantime, we choose to strengthen our exposure to issuers we deem as M&A targets and insurance names that may be subject to early buy back of subordinated bonds.

AT1 Additional Tier1; RT1 Restricted Tier 1; M&A Merger & Arbitrage. *Australian regulation agency.
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