



## Rate cuts: What are the impacts on subordinated financial bonds?

### Synthesis

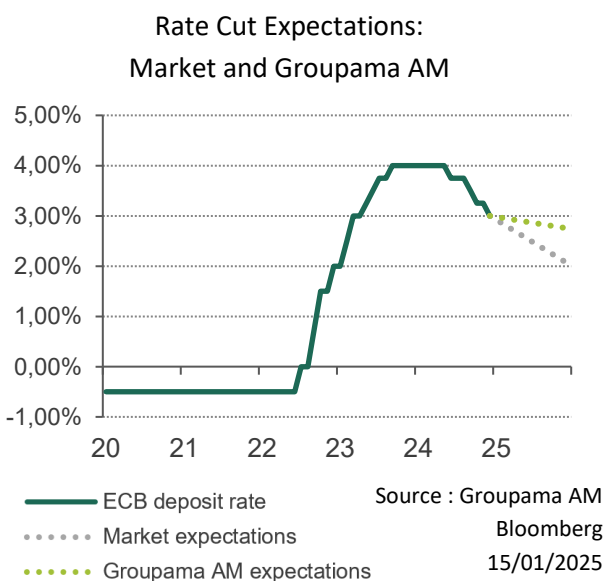
Banks' revenues are generally impacted negatively in a low-rate environment, which can put pressure on their net interest margins.

However, banks have implemented strategies to mitigate these adverse effects, including hedging instruments and cost rationalization measures such as sector consolidation and cost-cutting programs.

While a potential continuation of monetary easing by the European Central Bank could negatively affect banks' profitability, these impacts are expected to remain moderate, with an even more limited effect on the stability of subordinated bank debt.

As a result, we remain positive on subordinated financial bonds, which could also attract interest from yield-seeking investors within a bond carry strategy in a declining rate environment.

### Concerns over a compression of net interest margins



The European Central Bank (ECB) initiated a cycle of rate cuts in the summer of 2024. Since then, it has announced three additional rate cuts, bringing the deposit rate down to 3.00%. We believe the ECB is likely to adopt a more defensive approach in 2025, constrained by stronger-than-expected growth and persistent inflation. However, our central macroeconomic scenario still anticipates one more rate cut.

A rate cut cycle can sometimes result in a flattening of the yield curve, meaning a narrowing of the gap between short- and long-term yields for the same issuer. This phenomenon affects the revenues and net interest margins of banking institutions, leading to a negative impact on their profitability.

This outcome is linked to the operating model of banks, particularly commercial banks. Their business largely relies on maturity transformation—borrowing short-

term to lend long-term—which exposes them to the risk of net interest margin compression in the event of a yield curve flattening.

The calculation of this result is based on net interest income, which is the difference between:

- Income from loans and bond investments;
- Expenses related to interest paid to depositors and creditors.

### Banks are implementing strategies to mitigate negative impacts

Banks employ several strategies to minimize the effects of low interest rates on their financial results:

**Asset-liability matching:** Through this approach, banks aim to balance the potential impact of interest rate movements on their balance sheets. One lever available to banks is their investment bond portfolios, where they can adjust interest rate risk based on market expectations. For instance, by extending the duration of their bond portfolios, banks can lock in a specific yield over a longer period—a strategy that has gained traction in recent quarters to mitigate the risk of a low-rate environment.

Similarly, banks can extend or shorten the horizons of their loan, deposit, and borrowing portfolios to mitigate the effects of rate movements.

Example of a Simplified Balance Sheet for a Commercial Bank

	Asset	Liabilities	
Extend or reduce the horizon	Loans granted	Client deposits	Extend or reduce the horizon
Augmenter ou baisser la sensibilité aux taux	Investment portfolio	Interbank borrowings	
	Cash and reserves	Shareholders' equity Subordinated debt	

**Use of Derivatives:** Banks also use derivative products, such as interest rate swaps or options, to hedge against interest rate fluctuations. For example, an interest rate swap allows a bank to exchange a fixed interest payment stream for a variable one, or vice versa, depending on its market forecasts. The use of these instruments enables banks to either increase or decrease the sensitivity of their interest income to rate movements.

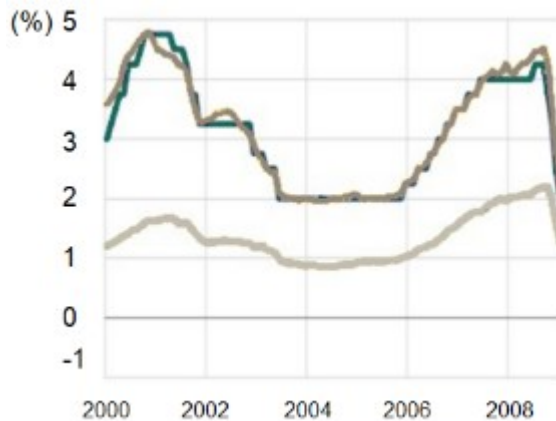
**Cost Rationalization Through Consolidation:** The consolidation of the European banking sector over the past 10 years has, in addition to rationalizing the cost base, also reduced competition for deposits. During the recent rate hike cycle, banks have only partially reflected these increases in the remuneration of demand and term deposits, which offer low returns but are favored for their perceived liquidity and safety. These low-cost deposits stabilize funding despite the compression of interest margins on loans. Moreover, this consolidation fosters rational competition, enabling banks to strategically adjust their pricing policies to preserve margins while avoiding price wars. As a result, the largest institutions gain resilience and profitability, reinforcing the sector's stability.

In order to assess the impact of this phenomenon, it is possible to observe the evolution of deposit beta, i.e. the percentage pass-through of an increase or decrease in the ECB deposit facility rate on household and business deposit rates.

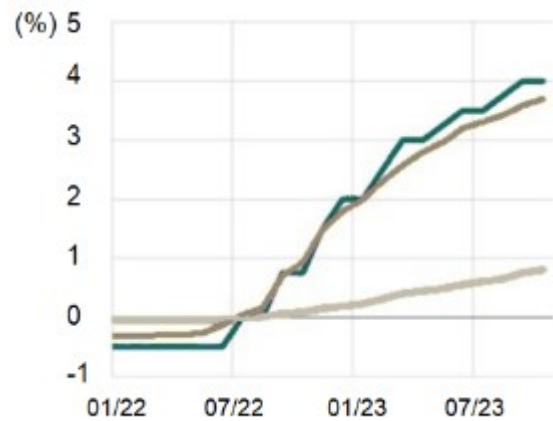
Changes in the ECB deposit rate and the remuneration of term and sight deposits held by companies and households in the euro zone

**Companies**

History from 2000 to 2008



Rate cycle initiated in 2022

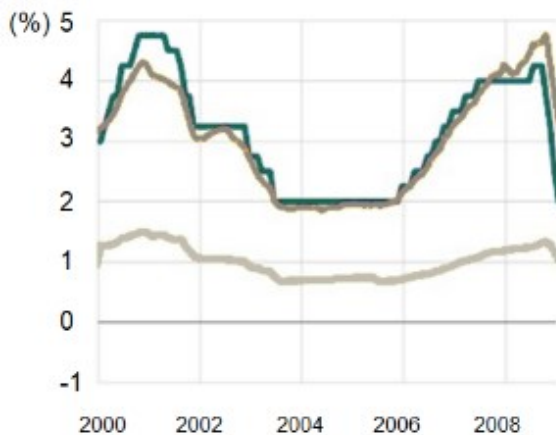


- ECB deposit rate
- Term deposits of non-financial corporations
- Sight deposits of non-financial corporations

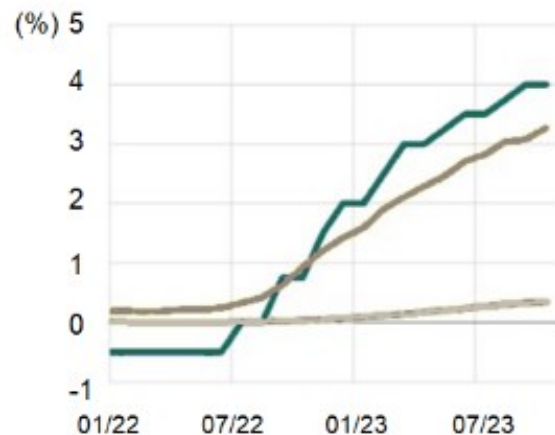
Source : ECB, Bloomberg

**Households**

History from 2000 to 2008



Rate cycle initiated in 2022



- ECB deposit rate
- Term deposits of households
- Sight deposits of households

Source : ECB, Bloomberg

These graphs show a different dynamic in the impact of ECB deposit rate hikes on eurozone term deposits. During the monetary tightening cycles of the 2000s and the 2006-2008 period, term deposits followed the rise in rates relatively assiduously. In the latest cycle, however, which began in 2022, we can observe a delay that intensified from 2023 onwards. This phenomenon illustrates the ability of banks to reduce the beta of deposits in a context of friendly concentration in the sector and a favorable domestic regulatory environment, in order to optimize their financing costs and revenues linked to maturity transformation.

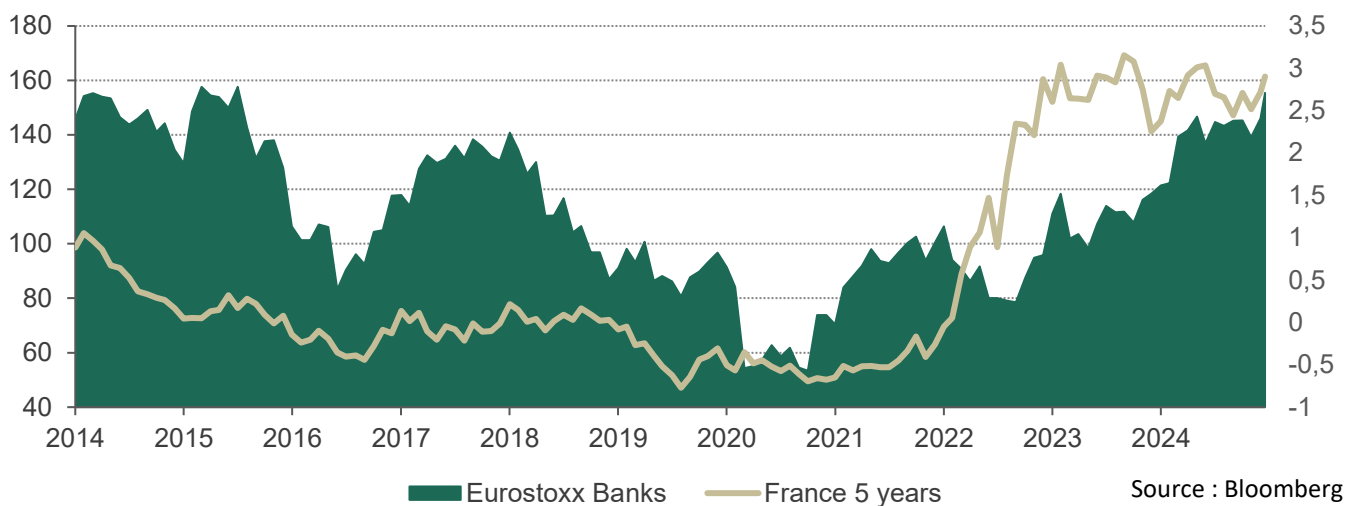
This phenomenon is all the more visible in household deposits, which remain the most important source of financing in Europe.

## Financial subordinated bonds remain relatively protected

**Greater impact on equities:** Equities are the first to be affected by falling interest income, which impacts on their profitability. Mechanically, lower net income implies a reduced payout capacity, and therefore a lower return to shareholders (dividends and share buybacks).

Financial subordinated bonds are by definition a fixed-coupon debt instrument. As such, they are less sensitive to declines in profitability, especially as they are currently protected by banks' robust balance sheets and a restrictive regulatory framework. With banking fundamentals at an all-time high, whether at the level of common equity tier 1 (CET1) ratios, low levels of bad debts or high levels of profitability, combined with the current situation of excess capital and the prudence displayed by the banking supervisor (ECB), the sector's capacity to absorb potential losses has never been greater. These factors mean that bank debt, even subordinated debt, is relatively unexposed to the risk of default or non-payment of coupon in the medium term.

Trend in Eurostoxx Banks index and yield on 5-year French government bonds over the past 10 years



This chart shows the trend in the Eurostoxx Banks index and the yield on the 5-year French government bond, illustrating the impact of interest-rate trends on valuations in the banking sector. Medium- and long-term interest rates remaining at high levels would be beneficial for banking revenues.

**The search for yield, a supporting factor:** In periods of falling rates, investors are generally in search of yield. For example, between 2019 and 2021, falling interest rates in major economies led to significant inflows into higher-yielding financial subordinated bonds.

As an example, overall net bond market inflows<sup>1</sup> in Europe fell from 223 billion euros to 185 billion between 2019 and 2021, a drop of 17%. At the same time, bank subordinated debt saw its net inflow rise from 1.2 billion euros to 6.9 billion over the same period, an increase of 460%.

A fall in government bond yields could thus be favorable to the asset class<sup>1</sup> inflows in response to investors' search for yield, offering a support factor for financial subordinated bond valuations

In conclusion, the fall in interest rates represents a challenge for banks, reducing their interest income, but this impact is largely mitigated by the hedging strategies put in place and an adjustment in operating

<sup>1</sup> Source: Morningstar

expenses. For financial subordinated bonds, the consequences are thus limited, thanks to the solidity of bank balance sheets and strict regulations in Europe.

We are therefore positive on the asset class in 2025, which can play a relevant diversification role within an allocation in a carry strategy, with yields remaining on high levels at 6.66% as of January 15, 2025, for *Additional Tier 1 (AT1)*<sup>2</sup> bonds and 3.82% for *Lower Tier 2*<sup>3</sup> bonds.

Furthermore, the asset class generally benefits from investor interest during periods of low interest rates, which could provide technical support for valuations in the event of more rate cuts.

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<sup>2</sup> AT1 bonds are financial instruments issued by banks as part of their regulatory capital structure under Basel III regulations to reinforce banks' financial stability. Data based on the ICE BofA Contingent Capital Index at 15/01/2024.

<sup>3</sup> LT2 bonds are subordinated debt instruments issued by banks to strengthen their regulatory capital under Basel III. They do not offer the same level of protection as Tier 1 capital, but constitute an additional capital reserve. Data based on the ICE BofA Euro Lower Tier 2 Corporate Index at 15/01/2024.

For more information on our subordinated debt fund :

- **Groupama Euro Financial Debt** - IC share: FR0013259132 - Institutional share
- **Groupama Euro Financial Debt** - NC Share: FR0013259181 – Retail share

**Principal risks: Risk of capital loss, Counterparty risk, Interest rate risk, Credit risk, Liquidity risk, Derivatives risk, Subordination risk.**

Please refer to the prospectus for a full list of risks.

Risk indicator: 2/7

Recommended investment period: 4 years

Document written on 16/01/2025

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