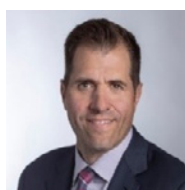


Systemic risk or isolated tremors?

A credit market check-in

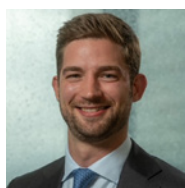
Events in the US have raised concerns that non-bank lending may pose a systemic risk. While we continue to monitor banks' exposures closely, we believe the risks are manageable.



Carl Pappo
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We continue to hold a high conviction in investment grade bonds issued by the financial sector, while reducing our exposure where valuations have become less compelling, particularly in the subordinated part of the capital structure.

First came the bankruptcies of subprime auto lender Tricolor and auto parts manufacturer First Brands. Then there was news that US regional banks Western Alliance and Zions suffered losses resulting from allegedly fraudulent loans tied to commercial real estate. Given the surge in private credit transactions over the past few years, these events raised questions about whether private credit poses a systemic risk to the financial system.

Key takeaways

- Bankruptcies and alleged fraud in the US non-bank lending sector triggered a sell-off in regional bank stocks amid fears of contagion.
- Based on our analysis of banks' exposures, and the scale of non-bank lending, we do not believe these events indicate systemic risks.
- In investment grade credit, we retain a high conviction in the financial sector while recognising that overall valuations in the asset class are modestly rich.

Do these cases reflect isolated lapses in underwriting, or point to a broader asset-quality deterioration within banks’ loan portfolios? While we continue to monitor these exposures closely, we do not believe they pose a systemic risk given the diversity of loans within the non-bank financial institutions (NBFI) category and manageable exposures relative to total loans and capital. Within investment grade credit, we continue to hold a high conviction in bonds issued by the financial sector, while recognising that valuations across investment grade credit are modestly rich.

Banks’ exposure to bad loans

Banks including JPMorgan, Fifth Third and Barclays had exposure to Tricolor, but the impact was either not material, or we believe the costs to be manageable. On First Brands, investment bank Jefferies drew media attention due to its involvement, but we do not believe the risks are material to the bank’s financial profile at this time. Several other US banks are reported to have exposure to First Brands, and a few non-US banks too – for example, UBS and Japan’s Norinchukin Bank – however, we believe the sums are manageable.

Overall, we think the banks exposed to these bankruptcies will be able to absorb any losses.

Our view is similar in the case of regional banks Zions and Western Alliance. Zions announced a USD 50

million credit loss in its third-quarter earnings due to the bad loans. Western Alliance did not realise a credit loss citing sufficient collateral coverage. The news triggered a sell-off in regional bank stocks. Zions lost roughly USD 1 billion in market capitalisation the day after announcing the exposure – around 20 times the value of the disclosed loss.¹

The scale of NBFI exposure across the sector

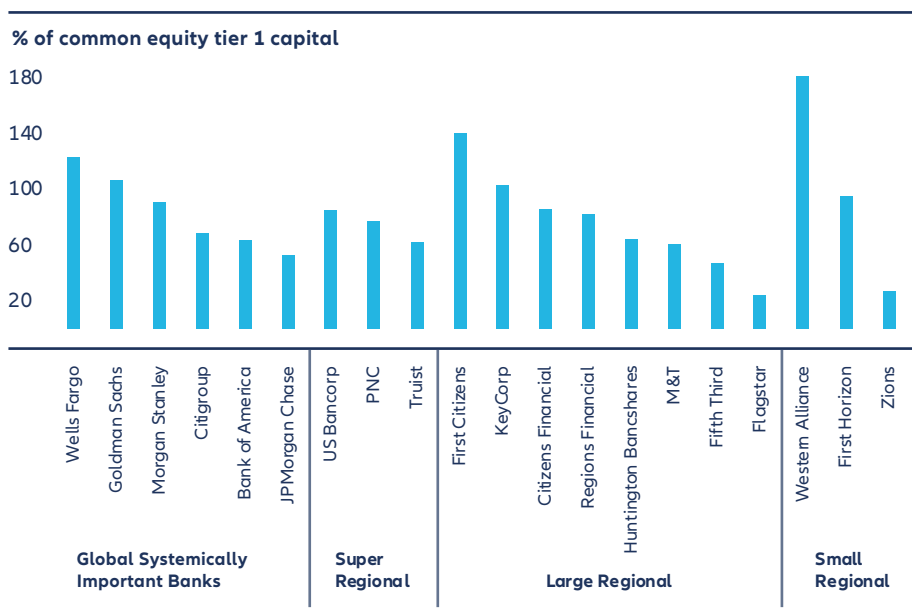
Was the sell-off in regional bank stocks proportionate? Traders who engaged in selling may have reasoned that these cases were the tip of an iceberg. It is true that bank lending to NBFIs has been one of the fastest-growing segments of the US banking system. In the first quarter of

2025, it represented over 10% of total loans, or more than USD 1 trillion in funded exposures.²

These exposures span a range of financial institutions and business models, including auto lenders, commercial real estate mortgage originators and servicers, equipment lessors, insurance companies and private equity or private debt funds.

Recent problems have raised questions about the reliability and recoverability of collateral supporting some of these loans. However, it is important to see banks’ exposure to this segment in context. Exhibit 1 shows that across the 20 largest US commercial banks in terms of asset size, loans to NBFIs averaged 85% of common equity tier 1 (CET1) capital. In our view, this does not indicate a systemic risk.

Exhibit 1: US banks’ exposure to NBFIs as proportion of common equity tier 1 capital



Source: Allianz Global Investors, Barclays.

1) Source: Bloomberg and AllianzGI calculations

2) Source: S&P

In Europe, the NBFi ecosystem is smaller, less diverse and less mature than in the US. Europe lacks a regulatory definition of NBFIs, but using a proxy, we can estimate that NBFIs accounted for less than 5% of corporate customer loans as of June 2024 (Exhibit 2). Again, we do not think this indicates a systemic risk.

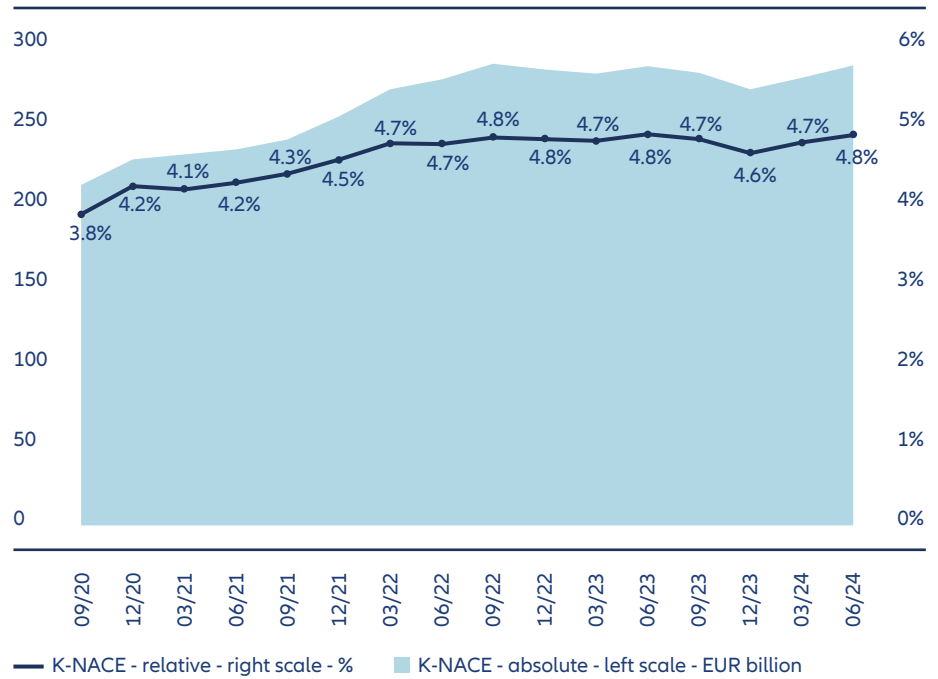
How we are positioned in investment grade credit

Based on our analysis, we view the recent events in US private credit to be isolated tremors that do not significantly impact our outlook on investment grade credit. This is an asset class that has performed strongly this year, supported by solid fundamentals and strong technicals as elevated all-in yields have helped to drive strong investment flows.

At a sector level, our highest conviction remains in financials, given that bank fundamentals are broadly solid, with stable asset quality, strong capital and profitability reflected by continued strong earnings results. Exhibit 3 shows how tier 1 ratios at European banks have increased over time, indicating greater strength and ability to absorb losses – the trend is broadly similar in the US. Our analysis of banks’ exposure to NBFIs does not induce us to alter our conviction.

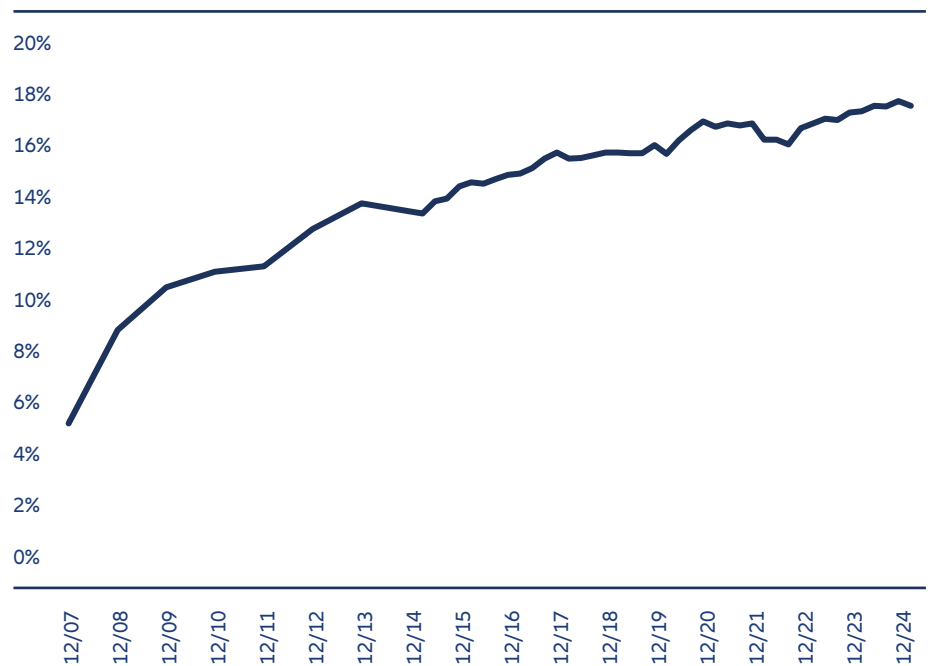
Of course, it is always important to monitor valuations. Credit spreads have compressed since tariff-induced widening took place back in April. At current levels, we consider investment grade bonds to be modestly rich.

Exhibit 2: Growth of NBFi exposure in Europe



Source: European Banking Authority. Section K of the statistical classification of economic activities in the European Community (K-NACE) is used as a proxy for lending to NBFIs.

Exhibit 3: European banks’ tier 1 ratios have increased



Source: European Central Bank Data Portal

SYSTEMIC RISK OR ISOLATED TREMORS? A CREDIT MARKET CHECK-IN

Through the year, we have made changes in our portfolio positioning to reflect these developments.

- We have focused on sectoral and idiosyncratic opportunities, within the context of an overall light credit risk footprint.
- While retaining our high conviction to financials, we have reduced our relative exposure to the sector, based primarily on valuations; spreads have compressed considerably since the Credit Suisse event in 2023.
- We have prioritised quality names with compelling yields.
- We have rotated into more senior parts of the capital structure.

In regard to non-financial corporates, we do not see a direct read-across from the First Brands event to other US corporates. We prefer non-cyclical industrials and remain cautious on consumer cyclicals, given the continued downside risk to growth and higher expected interest costs. Given the relative value to financials, risks in the sector appear to be skewed to the downside. In general, the consumer sector also screens as more vulnerable to tariff-related pressures, given the reliance on global supply chains.

We are constructive on securitised products as relative value looks compelling to corporates. The asset

class continues to benefit from a supportive macro environment that has resulted in stable credit trends on underlying assets. Structures include credit enhancement and other structural protections as well as tests and covenants that protect bondholders, particularly at the AAA level.

Overall, our allocation process remains valuation-driven and risk conscious. We are comfortable maintaining a defensive posture for now and will be patient in increasing exposure to lower-rated credit. Our modest risk positioning provides us with high flexibility to capitalise on any volatility.

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Past performance does not predict future returns. If the currency in which the past performance is displayed differs from the currency of the country in which the investor resides, then the investor should be aware that due to the exchange rate fluctuations the performance shown may be higher or lower if converted into the investor's local currency.

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