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Looking for Yield in All the Wrong Places
(at Least from a Relative Value Perspective)

January 13, 2020

Dear Shareholder,

As we enter a new year, we continue to have conviction about the strength of EJF Investments Limited ("**EJFI**") and its investment portfolio. The majority of EJFI's investments are "Securitisations and Related Investments", principally the equity tranches of securitisations, or collateralised debt obligations ("**CDOs**"), backed by legacy and contemporary debt issued by smaller US financial institutions.

We note in recent times there have been many articles discussing the collateralised loan obligation ("**CLO**") market. It is EJF Capital LLC's (**"EJF"**) contention that while there are some similarities, there are many vital differences between the CDOs that EJF and EJFI are involved in, and the broader CLO market. Indeed, we at EJF Investments Manager discussed this topic a year ago *(please click on the link to read previous manager commentary)*. Again, we note a proliferation of such articles of late, including the article in the *Financial Times* referred to below. We deem it important to discuss the topic directly and outline why we continue to strongly believe that our CDOs are differentiated and will continue to perform robustly, and that they provide attractive relative value versus the broader CLO market.

Expressions of Warning

Jennifer Ablan, the *Financial Times*' Markets Editor, recently discussed on a podcast the 2019 phenomenon of "stretching for yield" in the lowest rated tranches of high yield junk bonds. She sounded a "warning" of the U.S. junk bond market rallying in 2019 "against the backdrop of nearly 12 trillion dollars of negative yielding bonds". Ablan attributed the mass

purchasing of higher risk high yield to "investors scrambling for any kind of yield they can get their hands on." Ablan also noted that the phenomenon accelerated as the year came to a close; as she put it succinctly, "in the last several weeks [of December] we have seen a huge shift into CCC credits, which is the junkiest of junk … [but] offering double digit yields, 10-11%." The *Financial Times* pointed out that even retiree age retail investors have succumbed to the temptation of high yield bonds.

The explanation Ablan and other commentators have given for this strategy of looking for yield in the lowest rated junk bond tranches is the persistence of low yields available elsewhere. Does this buying spree and search for yield signal a potential high yield bubble? Both regulators and rating agencies have echoed earlier this month the concerns about high yield and leveraged loan collateral that undergirds the expanding CLO market. CLOs have attracted inflows of institutional and non-institutional capital because such securities offer the promise of yield with the risk mitigation of diversification.

On December 4th, 2019, the U.S. Financial Stability Oversight Council ("**FSOC**") issued its annual report on the state of the financial markets and its participants. The FSOC continued to express its concerns about the proliferation of high yield debt, leveraged loans and the CLOs that have largely absorbed the new issuance of leveraged loans. The FSOC noted the following:

> "While CLO capital structures are more robust [since the 2008 global financial crisis (**"GFC"**)], the underlying loans held in these portfolios are more vulnerable because borrowers generally have less subordinated debt outstanding that could serve as a cushion against potential losses. A more diversified investor base could reduce the risk that losses and market dislocations will be borne by any particular type of holder. However, if credit markets deteriorate, investors—including those invested in CLOs and certain investment vehicles holding most of their assets in leveraged loans—may face liquidity risks or shortfalls in loss-absorbing capacity. How these holders will fare in a stressed environment and the impact of potential spillover effects to market liquidity and prices remains a key uncertainty."[1]

In its report, the FSOC observed that banks, in a post crisis regulatory world, do not pose the same risk as CLOs with respect to their holdings of leveraged loans: "The share of the term portion of newly issued leveraged loans held by banks has shrunk from 18 percent in 2006 to approximately 13 percent in 2019, while the share in CLOs increased from 48 percent to roughly 60 percent."[2] On December 10th, Moody's Investor Service issued a series of FAQs specifically addressing the rising amount of corporate credit and the impact of leveraged loans on the CLO market. Much like the FSOC, Moody's signaled a warning about the proliferation of leveraged loans once the business cycle weakens.[3]

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[1] https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf, page 35.

[2] *Id*. at 34. It should be noted that U.S. Community Banks typically have minimal exposure on their balance sheets to leveraged loans.

[3] https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1208611

The Relative Value of Debt Issued by Regulated U.S. Community Banks and Small Insurers

At EJF, we believe investors should consider the relative value of bank and insurance company credit versus that offered by the high yield and leveraged loan markets. In our opinion, comparable total returns can be achieved with substantially less structural risk. As the FSOC noted in its report, there are several factors that suggest that bank and insurance company issued debt is attractive from a credit risk perspective, especially when considered alongside the available yields they offer, as outlined below.

For banks:

- "Regulatory capital at BHCs [bank holding companies] has risen significantly since the 2008 financial crisis. The ratio of common equity tier 1 (CET1) capital to risk-weighted assets of U.S. [global systemically important banks] has more than doubled since the crisis."[4]
- "The [bank] stress test results show that BHCs are well capitalized and would be able to continue lending to households and firms during a severe economic downturn."[5]
- "During the 2008 financial crisis, BHCs experienced disruptions in access to short term wholesale funding. Since then, the ratio of this unstable funding source to total assets has declined to well below its 2007 level and has remained largely unchanged for the past four years. At the same time, BHCs attracted large inflows of more stable sources of funding such as core deposits."[6] , and
- "Overall delinquency rates on all loans at U.S. G-SIBs and other BHCs continued to decline in the first half of 2019, reaching their lowest levels since 2001."[7]

For insurance companies:

- "Overall, the life [insurance] sector has managed to consistently operate with positive profits and growth in equity for each of the past 10 years."[8]
- "U.S. P&C [property and casualty] insurance companies remained relatively stable at year-end 2018, reporting $1.9 trillion in assets. Capital and surplus was $780 billion, an increase of 2.8 percent from the year before."[9], and

[4] https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf, page 67.
[5] *Id*. at 68.
[6] *Id*. at 69.
[7] *Id*. at 70.
[8] *Id*. at 85.
[9] *Id*. at 85.

- "Net income from the P&C insurance sector has been consistently positive though somewhat variable since 2008. This has been attributed to the consistent growth in the capitalization of P&C insurers over the past decade."[10]

Although the FSOC acknowledged that growth in net interest margins for banks, and the profitability of insurance companies, are expected to be negatively impacted by low interest rates, it pointed to the offsetting costs of capital: "Deposit rates at certain BHCs have declined in recent months along with the decline in the federal funds rate."[11]

In our view, during an economic slowdown or in a recessionary environment, debt issued by banks and insurance companies may withstand and perform better than leveraged loans and high yield instruments, largely due to the below key factors:

- **Highly regulated financial institutions:** The oversight of banks and insurance companies has been stricter since the GFC which has encouraged them to operate under better structural mechanisms, such as the amount of tangible equity capital they must hold, the liquidity of their assets and their corporate governance.
- **Reduction in leverage:** Banks have generally reduced balance sheet leverage significantly since the GFC while many reports point to leverage being increased in the high yield and leverage loan market.
- **Covenants:** Bond covenants and bond investor protections have improved for financial institutions since the GFC by giving the banks and insurance companies less flexibility on setting covenants as the regulators have pushed for uniformity of covenants across the capital structure. We compare this to the emergence of covenant-light structures in the high yield and leverage loan markets.

Spreads on CLOs and Bank/Insurance TruPS and Bank Sub Debt CDOs

When comparing CLOs collateralized by leveraged loans with CDOs backed by debt issued by regulated bank and insurance companies, there are several factors to consider. In addition to stronger credit quality, CDO structures are typically static pools, and have less leverage in the structure. Bank collateral, in particular, also benefits from the consolidation trend (over 200 banks M&A per year since the GFC in 2008) driven by market and regulatory forces. As banks consolidate, credits improve and the duration of CDO paper shortens, allowing the structure to bring forward yield. In terms of diversification, we believe the collateral underlying these CDOs provides a broad exposure to the U.S. market, a vibrant, growing economy, even given the historic length of the current expansion. A mild recession, in our view, would have little impact on the existing CDO structures given the strength of their underlying collateral.

The consequence of this confluence of positive tailwinds has been strong performance of CDOs sponsored by EJF. Indeed, of nine transactions to date, the first of which was in 2015, one transaction has already been refinanced and subsequently called, and another two have

[10] *Id*. at 85.
[11] *Id*. at 69.

already been called due to strong performance, most prominently positive prepayment behavior. As such, of the greater than $3 billion of financial debt assets securitized by EJF to date, transactions accounting for greater than $1 billion of these assets have already enjoyed an early redemption event. This demonstrates a positive feature of EJF-sponsored CDOs driven by favorable tailwinds and our ability to select strongly performing financial instructions. The remaining securitizations continue to perform strongly and provide attractive risk adjusted returns, in our view.

The spreads on the senior tranches of CLOs and bank/insurance TruPS and bank subordinated debt CDOs do not reflect their comparable strengths in our opinion, and this serves to emphasize the relative value offered by EJF's CDOs. In addition to the structural, regulatory and industrial features briefly outlined above, and noting there is widespread expertise within the CLO sector in our opinion, we would similarly like to highlight that our collateral is analyzed and selected by an experienced team who focus purely on the financial services sector. Furthermore, the team looks at all aspects of the capital structures of such issuers which we believe generates an underwriting and pricing expertise, as demonstrated by the strong performance and redemption activity cited above.

Conclusion

In the global hunt for yield, and in light of many column inches being expended on the broader CLO market, we at EJF Investments Manager believe it is important for investors to differentiate our CDOs. These CDOs are backed by regulated collateral issued by smaller US banks and insurance companies that we expect will continue to benefit from several powerful tailwinds. We strongly believe these favorable features augment the relative value of our transactions and are major reasons why EJF Capital is an investor.

Neal J. Wilson
Chief Executive Officer

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