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Post-Credit Suisse: what is the outlook for the European AT1 market?

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The current crisis in the banking sector has shaken investor confidence in this asset class to the core. And yet, AT1 bonds were created to help banks cope with solvency or liquidity problems.

Executive Summary

- AT1 bonds are debt securities issued by banks to shore up their equity, in accordance with regulatory requirements laid down after the 2008 financial crisis. These requirements provide that, in the event that a bank becomes insolvent, shareholders will take the first hit, followed by AT1 bondholders, and then Tier 2 creditors.
- From 15 to 17 March 2023, Credit Suisse suffered massive withdrawals of deposits after a loss of confidence by its customers. The crisis culminated as the Swiss regulator stepped in and UBS took over Credit Suisse. As part of the deal, CHF 16 billion in Credit Suisse's AT1 debt was written down to zero, whereas Credit Suisse shareholders, while taking a big haircut, did receive CHF 3 billion in UBS shares. The deal thus failed to adhere to the hierarchy of subordination in the event of losses.
- In reaction, many regulators have sought fit to reiterate that they would comply with the hierarchy of subordination if a similar event were to occur in their jurisdictions. Credit Suisse must therefore be regarded as a special case, and the AT1 market seems to have calmed down somewhat for its main issuers. Even so, there are some outstanding questions regarding the exercise of calls in the coming months.
- We therefore feel it is premature to suggest that this is the end of the AT1 asset class. On the other hand, we will be on even higher alert with regard to unprofitable banks or those suffering a slide in their market capitalisation. The current crisis has made AT1 yields even more attractive, and there are opportunities out there that are worth taking while nonetheless paying special attention to risk management.

Understanding a bank's capital structure

Regulations require that a bank's liabilities be structured into several layers. The first of these, Common Equity Tier 1 (CET1), represents its tangible equity and is a measure of its banking solvency. It is at the bottom of the capital structure and therefore acts as a cushion that can be fully or partially absorbed in the event of stress. The European banking system's CET1 ratio(1) amounted to 15% as of the end of 2022, vs. an average regulatory requirement of 10.6%(2). The second layer consists of "quasi-equity" AT1(3) (super-subordinated debt), followed by Tier 2 (subordinated debt). Regulations require that in the event of insolvency, shareholders are first to absorb losses, followed by AT1 bondholders and then, Tier 2 creditors.

(1) CET1 / RWAs (Risk Weighted Assets: measure allowing banks to determine the quality of equity to hold to deal with unexpected losses that are beyond what they could bear)
(2) Source: ECB, January 2023.
(3) Additional Tier 1.

Focus: AT1, the sacrificial lamb of the Credit Suisse takeover

AT1 bonds are perpetual debt (bonds that don't mature) that come with a call, i.e., the option of calling in the debt based on pre-determined conditions. Because AT1 bonds carry greater risk than senior debt, they naturally pay out a higher coupon, but this is discretionary and non-cumulative. Regulations require that each bank possess a stock of AT1 debt that is equal to 1.5% of its risk-weighted assets (RWAs). Otherwise, AT1 bonds must be replaced by equity capital, which is riskier and therefore more expensive.

When a bank is under stress from massive withdrawals, capital shortfalls, etc., the regulator may trigger a resolution, and AT1 bonds may be tapped by being either converted into equity or written down. This subordinated debt (AT1 and Tier 2) is essential for protecting senior debt in the event of a capital shortfall and, by extension, customer deposits. This is the very purpose of banking regulations enacted after the Great Financial Crisis of 2008.

A precedent: the Resolution of Banco Popular

In June 2017, the ECB triggered a Resolution mechanism on Banco Popular, following massive deposit withdrawals, with a full write-down of CET1 capital, and then, full absorption by AT1 bonds (EUR 1.35 billion were written down to zero[(4)]) and then, Tier 2 debt. Banco Popular was then taken over by Santander for a token euro.

The Credit Suisse case

In reaction to massive withdrawals at Credit Suisse from 15 to 17 March 2023, the Swiss regulator and federal government triggered a process that culminated in UBS's taking over Credit Suisse. In this case, the hierarchy of subordination in place was probably not complied with. The CHF 16 billion in AT1 debt was written down to zero, while Credit Suisse's shareholders (CHF 40 billion in equity), while taking a big haircut, did receive CHF 3 billion Swiss in UBS shares. This decision can be considered as a huge destruction of value for Credit Suisse shareholders and, by ricochet, and even more so, for a bank's subordinated bondholders. This relatively low amount should be kept in perspective, however.

UBS does seem to have made a very good deal, despite the huge certainty on its future restructuring and, obviously, without having had the time to conduct the due diligence that is standard practice prior to any acquisition. It will also have to assume the first CHF 5 billion in losses incurred from the divestment of the fallen bank's assets, thus subtracting from its future earnings and requiring a contribution from Credit Suisse's former shareholders. Restructuring costs will also undermine the new group's profitability. The deal did spare holders of Tier 2 subordinated debt and senior debt, which accordingly rose in value on the secondary market.

All this was likely to scare off bond investors and hat's why regulators in the euro zone, the UK, Canada and Singapore reaffirmed the cascade of losses mechanism based on the hierarchy of subordination in the event of resolution, while pointing out how essential AT1 bonds are in financing structures.

What impact will this crisis have on the AT1 segment?

The fall of Credit Suisse has cast a shadow over the European primary market. Even so, in the short term, the secondary market seems to be absorbing the shock, even bidding up prices of AT1 subordinated debt. The most resilient issuers from 15 to 24 March 2023 were Intesa Sanpaolo, BNP Paribas and Rabobank, while the worst performers were mid-sized southern European banks, such as Sabadell, along with corporate and investment banks, including Deutsche Bank. The "Suisse risk premium" thus appears to be receding for the main European issuers and the main question now is the exercise of calls in 2023.

Thirteen issues (amounting to about EUR 20 billion) possess a call exercisable this year out of a total amount of about EUR 202 billion[(5)]. But calls are not automatically exercised. This is a business decision above all else. Can the bank replace the called issue by a new one that is cheaper or just as expensive? Is the bank in good financial health? Moreover, the exercise of an AT1 call must get prior approval from the ECB. That's why some issuers have recently chosen not to exercise their calls, without this impacting the price of their issues, as their decision was already priced in.

As regulations currently stands, and in light of statements by various regulatory bodies, Credit Suisse must be considered a special case that cannot be extrapolated to the entire system. Moreover, it is not now possible to find a replacement for AT1 that enhances banks' solvency without undermining their ability to lend to the real economy.

So, what impact will this have on our strategies?

Recent events prove that a bank's solidity is based on the trust placed in it by its customers and its investors and that a bank run[(6)] is inevitable if this confidence is lost, especially if its liquidity is insufficient, little diversified or potentially volatile. We were also reminded that, regardless of solvency ratios, if there is just one buyer, that buyer sets the price.

Generally speaking, stressed issuers, of which Credit Suisse had been one for several years, should be treated very cautiously. The recent crisis was therefore not a change in paradigm. Subordinated bonds absorb heavy losses in restructurings, and AT1 bonds are often wiped out completely and during such periods, should be considered as risky as equities.

(4) Source : Single Resolution Board, 17 mars 2020.
(5) Source: Market data, March 2023.
(6) Massive withdrawals.

Accordingly, we are paying special attention to banking groups that are loss-making, whether on an exceptional or recurring basis. For example, we did not hold Deutsche Bank bonds (AT1 or Tier 2) during its 2015-2019 restructuring that incurred heavy losses and required several recapitalisations. Another example: we had sold our Banco Popular AT1 bonds well before the bank failed, without a loss, anticipating a worsening in the situation. And, lastly, we did not hold AT1 or Tier 2 debt in Credit Suisse, only senior debt.

The regulator has nonetheless created a moral hazard that can't be ignored. We will therefore be paying greater attention, and will be more alert to, non-profitable banking groups, but also to those that have suffered a slide in their market capitalisation. This is a natural leading indicator of the behaviour of AT1 bonds, given equities' similar inherent risk. For the riskiest players – generally corporate and investment banks – the most discriminating factors are rating agencies' views, which are vital for counterparties' activities; balance sheet size; solvency; and reputation.

All that being said, AT1 bonds, which are risky by nature, currently offer yields of about 12%, which is higher than in 2022 or during the Covid outbreak in spring 2020[(7)], but also higher than the cost of capital demanded by shareholders. Recent volatility on the financial markets caused by the failure of three US regional banks (Silvergate Bank, Silicon Valley Bank and Signature Bank) and UBS's takeover of Credit Suisse is not the first crash test in real-world conditions for the AT1 segment. Some factors of uncertainty are vanishing, but that will require confirmation. As is often the case, such a level of stress generates opportunities with attractive yields that are worth seizing but while managing credit risk of the selected issuers.

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(7) Source: Bloomberg, March 2023.

Avertissements

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