# AT1 COCOS REMAIN ATTRACTIVE

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**AT1 contingent convertible bonds (CoCos) were in the news in the first quarter of this year following the takeover of Credit Suisse by UBS. Atlanti's Head of Research Romain Miginiac says that despite this, the AT1 market remains viable and attractive within the subordinated debt of European financials.**

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The full write-down of Credit Suisse's (CS) AT1 CoCos imposed by the Swiss regulator FINMA has cast a shadow over the future of the asset class. A potential lack of demand for AT1s, significantly higher risk premia required by investors and an inability for banks to access the market were among the myriad of arguments floated following what has been the most significant event for the AT1 market to date. While elevated volatility may persist as the dust settles, over the medium- to long-term, permanent damage is unlikely, in our view, as nothing has really changed for AT1 CoCo holders in European and UK banks.

### The CS story is not a game changer for the AT1 market

Beyond CS, the end of the AT1 market has been called in the past, whether following the bail-in of Banco Popular's AT1 CoCos in 2017 or the first non-call of an AT1 by Banco Santander in 2019. These are now mostly remembered as non-events, and the asset class marched on. The write-down of CS's AT1 CoCos is without doubt the single largest event to hit the market. However, we do not think it is a game changer.

CS was around 8% of the European banks AT1 CoCo market in early 2023, with USD 17 billion of bonds outstanding (nominal value[1]). While this is a hit for the market, longer-term loss rates on the AT1 CoCo market remain low. CS and Banco Popular have been the only two loss events over the decade in which the AT1 market has been in existence, and annualised loss rates over 10 years on AT1s are around 1% per annum, which still compares favourably to circa 2.5% annualised loss[2] rates on global high yield. We believe investors are willing to invest in high yield with lower yields than on AT1 CoCos, as well as higher loss rates – hence the attractive case for the asset class does not seem derailed.

While CS was a sizeable event for the market, we think it has limited read across to the rest of the AT1 asset class. The crisis of confidence that ultimately forced the takeover by UBS was triggered by underlying issues at CS. The bank was loss-making in 2022 (CHF 7 billion of net losses) and expected to make another CHF 2 billion of losses in 2023, and embarked on a multi-year restructuring. No other large European bank is even remotely in the same situation; the sector is expected to deliver strong earnings in 2023. Looking at consensus earnings forecasts[3] for 2023, CS was the only large bank expected to be loss-making in 2023, compared to an average 10% expected return on equity for peers.

[1] As of Jan 2023, source: Atlanti, Bloomberg.

[2] Source: Moody's, as of 31 December 2022.

[3] Data as of 21/04/2023, 2023 forecast return on equity based on Bloomberg consensus for listed European banks with $250bn-equivalent or more total assets. Source: Bloomberg, Atlanti.

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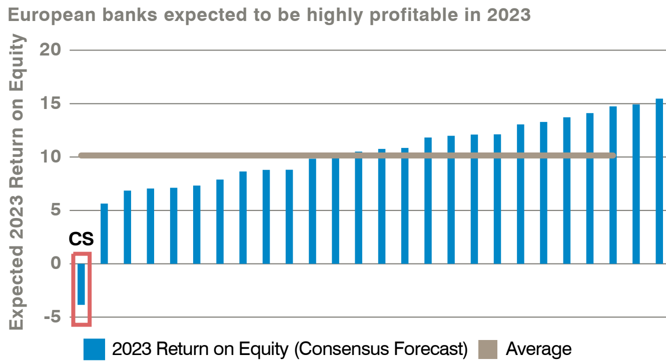
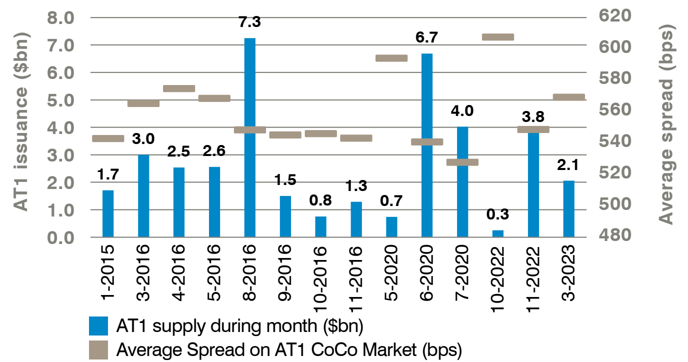
## Chart 1: CS was the exception in the banking sector as profitability is expected to be strong looking ahead




Source: Bloomberg, Atlanti, as of 20.04.2023.

## Chart 2: The AT1 market has been open in similar market conditions




Source: Bloomberg, Atlanti, data as of 21.04.2023.

Added to the highly specific nature of the CS case, the ability to write down CS's AT1s without a full wipe-out of equity was driven by Swiss-specific regulatory and legal considerations. Regulators in the EU and UK quickly reacted to the event by clearly stating that creditor hierarchy will be respected, which is required by law in the EU for example.

### What is the future of the AT1 market? Hit but not sunk

Perhaps the most important part of the joint statement from the SRB, EBA and ECB (EU regulatory and supervisory bodies) on 20 March was the last sentence: "Additional Tier 1 is and will remain an important component of the capital structure of European banks"[4]. Confirmation that AT1s are a core part of the regulatory framework in Europe is a strong signal that the market will not die. Highly dislocated markets could lead to prohibitive issuance costs in the near term, but it is unlikely to jeopardise the viability of the asset class.

Taking a step back, it is important to highlight that while AT1s may be seen as an expensive form of debt, these in fact tend to be a cheap form of equity for banks. Regulation is the key driver of issuance as banks are allowed to fill part of their capital requirements with AT1s instead of common equity. Hence AT1s are economically attractive if their cost is below banks' cost of equity, noting that coupons are mostly tax deductible. We have seen issuance in the past with double digit coupons and materially wider spreads compared to current levels. To illustrate, BBVA issued a EUR-denominated AT1 CoCo at more than 900 bps of spread in 2016, well above where the issuer could likely print a new AT1 today. While current market conditions are less favourable for issuers, this is not unchartered territory. Since 2014, more than USD 30 billion of AT1 CoCos were issued at times where spreads were around or above current spreads of ~550 bps.

Overall, there are few reasons to support the view that AT1s will become an "orphan" or zombie asset class; the market has seen previous cycles of spread widening where issuers have been willing to come to the market despite relatively high spreads.

### Valuations are attractive on AT1s – with catalysts to come

Valuations on AT1 CoCos from European banks are currently fully dislocated, with double digit yields and spreads close to the 90th percentile. At 10.7% average yield and circa 550 bps of spread, the asset class screens extremely attractive. Historically, when spreads have been this wide, total returns over the next 12 months have been strong, often double digit (as shown in Table 1). Forecasting future returns comes with significant uncertainty. However the 10.7% average yield on the asset class provides a large income buffer. On top of high income captured, we believe two catalysts on the horizon should be a tailwind for the asset class.

## Table 1: Wide spreads on AT1s have tended to lead to strong total returns

| Date | Spread (bps) | Total return - 1-year |
|---|---|---|
| 11.03.2020 | 509 | 14.3% |
| 03.01.2019 | 519 | 21.8% |
| 03.02.2016 | 559 | 14.4% |
| 15.10.2014 | 558 | 8.0% |

Source: Atlanticomnium, Bloomberg, spread and total return based on the Bloomberg European Banks CoCo Tier 1 index hedged USD. As of 21.04.2023. Past performance is not indicative of future results.

[4] Source: EBA, 20th of March 2023 SRB, EBA and ECB Banking Supervision statement on the announcement on 19 March 2023 by Swiss authorities | European Banking Authority (europa.eu)

**Catalyst #1 – Q1 Earnings as a reminder of banks' fundamentals**

Looking ahead, the first obvious catalyst – an immediate one – is the upcoming publication of bank earnings for the first quarter 2023. Interestingly, the most likely and best-case outcome for bondholders would be the status quo – a reminder that: (1) banks continue to benefit from higher rates through earnings; (2) capitalisation and asset quality remains strong; and (3) specific concerns around liquidity and deposit flows are unfounded for large European banks. As mentioned before, nothing has changed for investors in AT1 CoCos of European banks, and a show of strength with Q1 earnings will only highlight the blatant dislocation between valuations and fundamentals.

European banks have entered this period of uncertainty with rock solid balance sheets. In Q1, capital metrics are expected to remain very strong. European banks' capital ratios are around all-time highs – 15.3% average CET1 ratio as of end-2022 according to European Central Bank (ECB) data compared to a minimum circa 10% average requirement. This equates to roughly EUR 450 billion of excess capital for EU banks to protect bondholders.

A reminder that banks benefit strongly from higher rates can do no harm, as earnings tailwinds are expected to continue to be reflected in Q1. As an example, HSBC is expected to deliver a 13% return on equity in 2023, compared to an average of around 6% over the past three years (2020 to 2022). This is equivalent to a USD 15 billion increase in pre-provision profits per annum, to around USD 37 billion annually. The extra USD 15 billion is a material buffer to absorb a potential rise in non-performing loans in case of a recession. Coupons on HSBC's AT1 instruments would be automatically cancelled if the bank breached its regulatory capital requirements, but with around USD 37 billion of pre-provision profits and USD 28 billion of excess capital, the bank would need to take more than USD 60 billion of loan loss provisions and other losses for coupons to be at risk. Earnings tailwinds increase the protection for bondholders on top of large excess capital buffers.

Banks' liquidity buffer and deposit base will be closely scrutinised given the recent turmoil in the US banking system. But the SVB collapse and issues related to unrealised losses on banks' securities portfolios in the US do not impact European banks. In Europe, banks' liquid assets are mainly held as cash at the central bank (overnight) and holdings of longer-dated bonds are typically hedged using swaps. Moreover, European banks' deposit bases are typically very granular and sticky with a material quantum of insured deposits from households. One of the key drivers of the issues in the US was the lack of strict regulation for non-systemic banks, as SVB was not subject to stress tests, liquidity requirements and had minimal capital requirements. The whole banking sector in Europe is subject to very strict regulation, smaller domestic banks and large systemic banks alike.

Finally, while banks' asset quality has been highly resilient with record low non-performing loans (NPLs) ratios, Q1 results should see a focus on exposure to specific sectors such as commercial real estate. European banks overall have limited exposure to the sector – below 10% of overall lending exposures. In line with the structural de-risking of the sector since the global financial crisis (GFC) and eurozone (EZ) crisis, European banks have significantly tightened their underwriting criteria to the commercial real estate (CRE) sector. Exposures are typically well diversified with limited concentration risks, have low loan-to-value (LTV) ratios and are likely focused on the higher quality borrowers. While this may lead to some volatility in loan loss provisions, this is unlikely to be material in the grand scheme of things.

**Catalyst #2 – Majority of AT1s are still likely to get called on their first call date**

As discussed previously, European banks have been willing to issue AT1 CoCos in similar market conditions since the inception of the market. However, as banks have broadly issued sufficient quantum of AT1s according to regulation, the overwhelming majority of new AT1s will be issued to refinance instruments called. When sentiment is weak, extension risk (the risk of bonds not being called and left outstanding forever) comes back in focus on fears that AT1s will not be called, as new issuance would be more costly than keeping existing bonds outstanding.

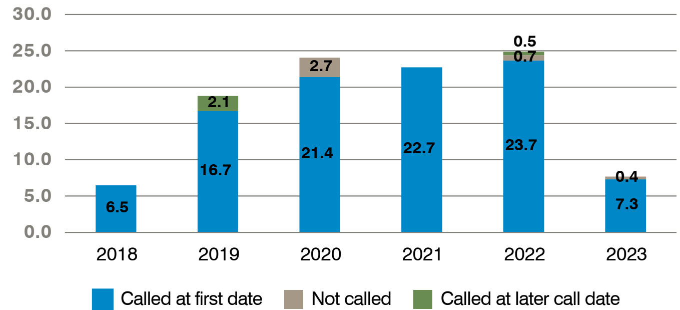
In a world where European banks only considered refinancing costs on a specific instrument when making call decisions, such a re-pricing to perpetuity could be warranted. Fortunately, the majority of AT1 CoCos would be more costly to refinance; the majority are still likely to be called at their first call date. Experience has shown that non-calls have been the exception so far, and more than 90% of AT1 CoCos have been called at their first call date since the inception of the market. While calling an AT1 CoCo and refinancing at a higher cost may seem counterintuitive, European banks tend to have a long-term approach to making call decisions. Large European banks are frequent issuers in debt markets, for example HSBC expects to issue ~USD 15 to 20 billion of senior and subordinated debt annually over the medium term. While saving even 100 bps on USD 1 billion of AT1s would most likely be a rounding error in the bank's income statement, a broader re-pricing of the bank's USD 150 billion total debt stack would be more material. As investors in AT1s may also hold banks' other senior and subordinated bonds, there is an argument that over the long term behaving in a bondholder-friendly way supports lower funding costs. While issuers are unlikely to be willing to refinance at any incremental cost, we have seen concrete examples of issuers willing to "pay-up" to call and refinance.

The AT1 market tends to overprice extension risk when spreads widen materially. Currently, around 90%+ of AT1 CoCos are priced as if they will not be called[5]. We have seen spikes in extension risk pricing multiple times in the past (2016, 2018, 2020 and 2022), and yet most AT1s have been called. While the market prices a scenario where the majority of AT1s are not called, the only AT1s truly at risk of not being called are those callable within the next few months. This is typically a small fraction of the market, for example there are around USD 11 billion of AT1 CoCos up for call for the rest of 2023, compared to circa USD 200 billion of AT1s outstanding. CFOs and treasurers will typically look to refinance those up to 12 months before the call date – hence spreads today are irrelevant for an AT1 with a call date in 2026 for example. Finally, large banks have significant flexibility when making call decisions, as they can refinance bonds well ahead or use excess equity capital to cover the call of an AT1 CoCo. We have seen UBS take this approach when calling an AT1 in January 2023 without replacing. Note that over the past 12 months spreads have been significantly tighter, which has provided the opportunity for banks to refinance calls in better market conditions.

The consequences of not calling also tend to be overestimated, as evidence (albeit limited) has shown that non-called AT1 CoCos have been called shortly after. Banco Santander called its AT1 CoCo only a year after its first call date, and Banco Sabadell recently called after a short quarter of extension. AT1s are callable frequently after the first call date (typically quarterly, annually or every five years), hence perpetuity may well be fairly short.

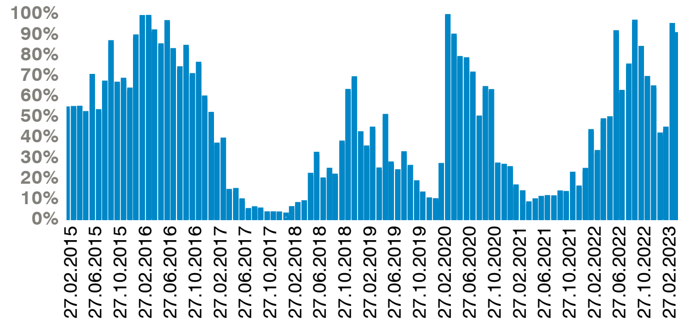
Overall, we expect European banks to continue calling AT1s at their first call date and non-calls to remain the exception. The recent turmoil, if anything, reinforces the case for AT1s to be called, as calling bonds is the best self-help measure banks can take to support the return to a normalised market. An efficient AT1 market is in the best interest of issuers, investors, and regulators, incentivising actions that alleviate investors' concerns around the asset class. In 2023 only one AT1 CoCo has not been called, while the rest has been called at the first call date. Around two thirds of remaining AT1s callable this year are likely to be called as they are already pre-financed or issued by large issuers that could use large excess capital buffers.

## Chart 3: Historically more than 90% of AT1 CoCos have been called at their first call date




Source: Bloomberg, Atlanti, as of 21.04.2023.

## Chart 4: Markets are pricing that >90% of AT1 CoCos will not be called at their first call date




Source: Bloomberg, Atlanti, as of 21.04.2023.

At least 75% of AT1s are likely to be called in 2023, compared to 90% of AT1s pricing extension risk; another dislocation. As the majority of AT1s continue to be called at their first call date, we expect this to act as a strong catalyst to re-price the asset class to call, which would lead to material upside.

[5] Source: Atlanti, Bloomberg as of 21 April 2023

## AT1s are alive and well – so is the rest of the subordinated debt market

With double digit yields and low historical loss rates underpinned by strong fundamentals of European banks and limited extension risk, AT1s continue to offer strong value in our view. While volatility may persist, earnings and upcoming AT1 calls are solid catalysts for a re-pricing of the asset class over the near term. Beyond AT1s, we believe subordinated debt markets more broadly offer strong value, be it within bank Tier 2s, insurance subordinated debt or corporate hybrids.

Within subordinated debt markets, AT1s are the most junior within the capital structure in terms of regulatory ranking and features mainly fully discretionary and non-cumulative coupons and explicit write-down triggers. This compares, for example, with bank Tier 2s where coupons are mandatory and there are no mechanical write-down triggers, making these more bondholder friendly. Naturally, more senior parts of the capital structure have exhibited less volatility compared to AT1 CoCos.

In our opinion, a diversified subordinated debt portfolio is helpful both in terms of risk management and capturing the best opportunities within the market. As an example, euro-denominated Tier 2s from banks and insurers were down around 2% at their lowest in March 2023 compared to euro-denominated AT1 CoCos down around 14% at the worst (worst point on a YTD basis reached on 20 March 2023). While AT1 CoCos typically offer the highest yields, other subordinated bonds offer highly attractive risk-adjusted yields.

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