Should we still be in love with the CoCos?

The UBS/Credit Suisse affair has caused the AT1/CoCo bond markets to struggle

By tightening their monetary policy sharply and rapidly, central banks have highlighted certain weaknesses in our financial system: insufficient risk coverage, liquidity problems, lack of business diversification, governance issues, and now uncertainties in the treatment of hybrid instruments. After the failure of some US regional banks, the UBS/Credit Suisse affair has shaken the financial world and more particularly the specialists of a specific bond segment which weighs about 250 billion dollars: Additional Tier 1 bonds (AT1) and/or Contingent Convertible bonds (CoCos).

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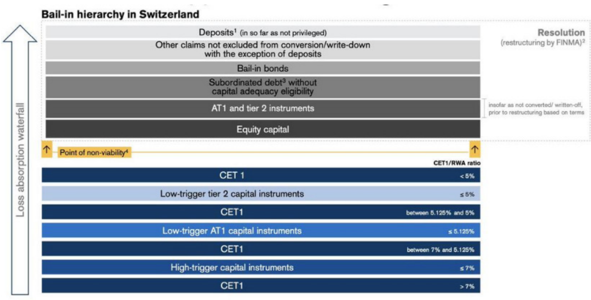
PRIVATE BANKING

Indeed, a global coordination of the FINMA (the Swiss regulator), the SNB (Swiss National Bank), and the Swiss Confederation decided to breach the hierarchy of claims by giving more than 3 billion dollars to the shareholders of Credit Suisse but wiping out the entire 16 billion dollars of Credit Suisse AT1 bonds. This has caused the bond markets to struggle.

What are the AT1/CoCos bonds?

Additional Tier 1 bonds were introduced in Europe after the global financial crisis in 2008 to serve as shock absorbers when banks start to fail. AT1s are a deeply subordinated debt eligible for regulatory capital requirements/purposes under Basel 3. The instruments are designed to absorb losses in two ways: the first is via partial or complete suspension of coupon payment at the discretion of the issuer and the second is via either a (full or partial/temporary or permanent) principal write down or a (full or partial) conversion of the nominal amount into equity. The latter is triggered by a so-called quantitative capital trigger event with a predetermined regulatory capital ratio (5.125% or 7%). This bond segment has been sharply growing over the last decade to reach a size of about $250bn.

Bank Capital Structure with bail-in hierarchy in Switzerland



Source: Credit Suisse

Why are these hybrid instruments essential to the stability of the financial system?

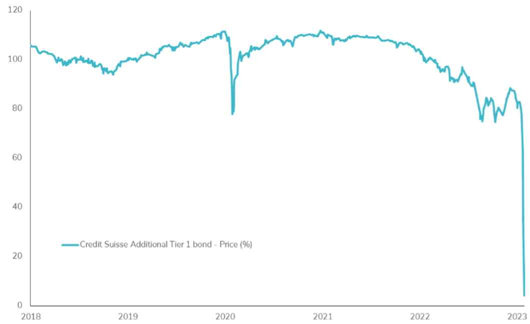
AT1s are "regulatory" bonds that are an integral part of a bank's capital structure. They are used to ensure the soundness of a so-called systemic bank and to protect the financial system in case of bank failure. AT1s are also a good indicator of investor sentiment: if a bank cannot issue or refinance an AT1 bond, it will not be able to meet the capital requirements imposed by its jurisdiction. It is therefore crucial for the stability of the financial system that the AT1 bond market is not under severe stress. Finally, AT1s are an important and cost-effective source of capital for banks, which can finance themselves at a lower cost than raising capital through the equity market.

Why did the Swiss decision on Credit Suisse's AT1s shock the market?

The only time AT1 bonds were written down was in the case of Banco Popular Español. In 2017, the Single Resolution Board (SRB) triggered the resolution of Banco Popular Español. This decision was based on the ECB's conclusion that the bank was imminently non-viable, given the rapid deterioration in liquidity and the failure of the sale process. To ensure continuity of operations and preserve financial stability, the SRB decided to transfer Banco Popular Español to Banco Santander. To fill in the capital shortfall, all shares and AT1 instruments were written down and Tier2-Securities (T2s) converted into shares transferred to Santander for the price of 1 euro.

The Credit Suisse case is different, as liquidity and capital ratios were above minimum requirements. But market and investor sentiment toward the bank was so negative that it could not be restored, according to the Swiss authorities. Even after a statement from the Swiss authorities that the bank was solvent. At this point, a merger with UBS was the most viable and fastest solution. Credit Suisse shareholders will receive 3 billion dollars in UBS shares, Credit Suisse AT1 bondholders will be reduced to zero, and UBS will receive a $200 billion liquidity line and other guarantees from the Swiss government. To complete the deal, Swiss authorities excluded shareholders from the approval process in a law passed Sunday night and wiped out all AT1 bondholders. The consequences for Credit Suisse AT1 bonds were swift: all AT1 bonds plunged to (almost) 0 on Monday.

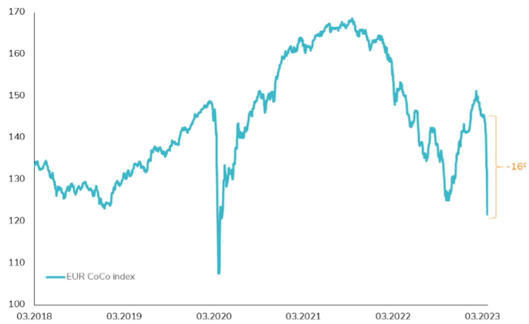
Credit Suisse Additional Tier 1 bond – Price evolution



Source: Bloomberg

But it wasn't just Credit Suisse AT1 bonds that fell, the entire AT1 bond market massively plunged on Monday. The main reason? The breach of the hierarchy of claims by the Swiss authorities. Indeed, the fact that shareholders receive compensation but AT1 bondholders are wiped out raises questions about the subordination of AT1 bonds to equity.

ICE BofA Contingent Capital Index – Price evolution



Source: Bloomberg

In order to stabilize the market, the European regulator, followed by UK regulator, issued a statement reminding of the European bank's resilience and confirming that AT1 holders should expect to be senior to shareholders and that they will continue to respect that order. In other words, they differentiated themselves from the decision taken by Swiss authorities. Since those statements, the market has stabilized.

Many questions were raised to understand how AT1 bondholders have been wiped out while the bank was still solvent. It appears that after the statement of support for Credit Suisse was issued and the new liquidity line was decided, the Swiss authorities passed a new law during the weekend about emergency liquidity funding for systemic banks, which allows the write down of AT1s. So, they passed a new law, which allowed them to write down the AT1s.

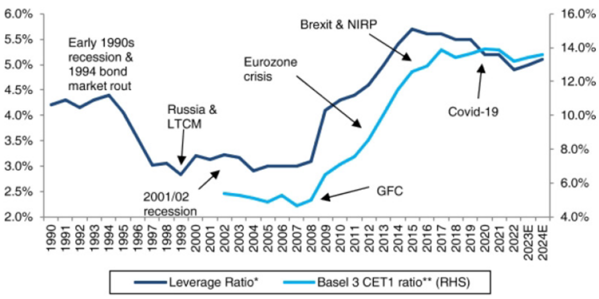
And now what about AT1 bond future?

The regrettable and peculiar treatment of CS bondholders in Switzerland should not cause a credit crunch and recession in the Eurozone.

AT1 is a liquid asset class, majorly held by institutional investors and any consternation caused by Swiss regulators not respecting the creditor hierarchy at Credit Suisse should been seen as an idiosyncratic event.

European banks are in a much stronger capital and liquidity position than in 2008 or 2012.

European bank's capital levels are at multi decade highs



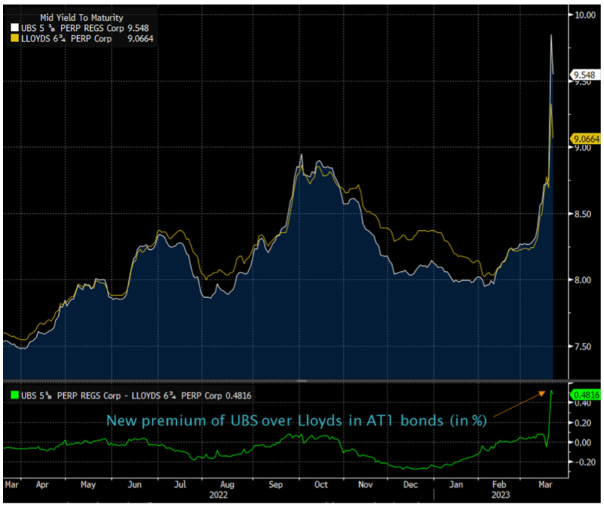
Source: ECB

The Eurozone and UK authorities have already provided welcome reassurance to credit investors via their press release. The Covid crisis is a good example of their policy towards credit investors, when in 2020 they temporarily decided the ban of dividends but maintained the payment of AT1 coupons.

In Europe, it would not be possible to write down Credit Suisse AT1 to zero whilst equity recovered value thanks to the Directive Resolution (BRRD). Eurozone authorities also stated in their statement "additional Tier 1 will remain an important component of the capital structure of European banks." This last point is very important for bank's future required capital levels. The AT1 market is therefore here to stay. Since their creation, AT1s have been issued by banks to optimize their capital structure, mainly by Global Systemically Important Financial Institutions (G-SIFI) and national champions, which have an ample market access.

In other words, this event is specific to Switzerland and not applicable to other regions as demonstrated by European regulators and the Bank of England speaking almost in unison to distinguish their approach from the one taken by FINMA. Swiss banks' AT1 will now require structurally higher risk premium than EU and UK. And they will also need to be clear about the way they treat investors and probably show more investor friendliness.

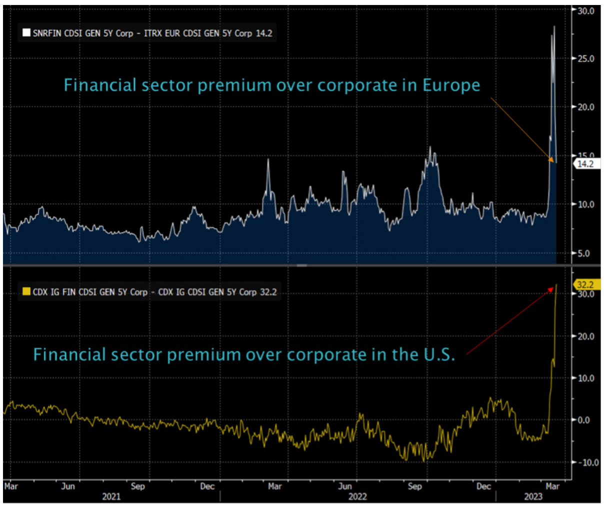
A new sustainable premium for UBS on its AT1 funding cost over its peers?



Source: Bloomberg

The yields on major European banks' AT1s are currently trading at distressed levels, roughly the same as March 2020. But so far it seems that the Credit Suisse story is more an isolated risk. If we compare spread differentials between financial and corporate bonds on both sides of the Atlantic, the risk continues to materialize in the US, while in Europe it has retracted quickly.

A minor problem in Europe, a major problem in U.S.?



Source: Bloomberg

In conclusion, the main question we have is whether this sell-off in European banks' AT1 bonds is a buying opportunity or the first signs of a financial system freeze. It may indeed be a buying opportunity given the strong fundamentals of European banks. The risk reward is at a level rarely seen. But there will be a before and after to this case and the market is not out of the woods yet given what is happening in the US and their financial system. In the meantime, Goldman Sachs has already indicated that it will file a lawsuit, following by other investors to enforce the hierarchy of claims.

Pour plus d'informations

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