AT1 bank securities: Have the risks changed for investors?

In contrast to 2013 when the Additional Tier 1 (AT1) market began to grow in earnest, one can clearly appreciate that the risks facing investors have increased. Back then, the asset class was relatively new and the market was still coming to terms with the principal loss absorption features of the securities. In hindsight, the risk that investors were going to miss a coupon or suffer from a write-down or conversion seemed rather hypothetical at the time. Now, however, some of these risks certainly appear more tangible.

Over the last six months or so there has been marked increase in the perception of coupon cancellation risks. While we had always understood that over time the risk of coupon cancellation should normally increase compared to the risk of principal loss absorption, we have been surprised by how quickly this has played out.

Coupon cancellation risks come to the fore

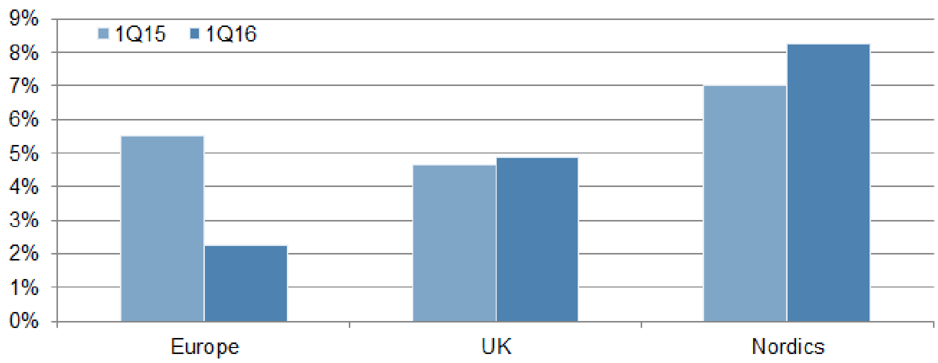
Previously, unless an issuer had limited available distributable items and/or suffered from meaningful earnings volatility, coupon cancellation risks were largely limited. Lately, however, three factors have led to increased coupon cancellation risk in general. First, various buffers comprising the combined buffer requirement (CBR) started to phase-in from January 2016. Second, amidst investor demand for greater transparency, EBA Opinion 2015/24 clarified that Pillar 2 capital requirements are considered minimum requirements which sit between Pillar 1 requirements and the CBR in the capital stack. And thirdly, European AT1 issuers disclosed their capital requirements stemming from the ECB’s supervisory review and evaluation process (SREP).

For the larger European banks, disclosed SREP capital requirements for 2016 have generally equated to 9.5% to 10% of CET1 capital. Systemic and countercyclical buffers where applicable are in addition. This effectively means that banks must maintain CET1 capital levels of at least 9.5% to 10% in order to avoid breaching the CBR and incurring mandatory restrictions on distributions, including coupons on AT1 securities.

Disclosed CET1 capital requirements roughly double

With the improved disclosure on capital requirements, we see that the distances to required CET1 levels for many banks within the EU are in fact much less than they were in 2015 as disclosed CET1 capital requirements have roughly doubled. The situation for banks in the UK, Switzerland and the Nordic countries is somewhat different as regulators in these countries had communicated and frontloaded various capital requirements somewhat earlier.

Figure 1: Development in distance to required CET1 levels



Notes: Europe includes KBC, ING, BNP Paribas, Credit Agricole, Societe Generale, Deutsche Bank, Intesa, Unicredit, BBVA and Santander. UK includes Barclays, HSBC, Lloyds and RBS. Nordics include DNB, Danske, Handelsbanken, Nordea and Swedbank. Source: Scope Ratings

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The SREP requirements for 2016 are comprised of Pillar 1 and Pillar 2 CET1 capital requirements as well as the capital conservation buffer. It is our understanding that the ECB has frontloaded the 2.5% capital conservation buffer and therefore SREP requirements overall are not expected to materially increase over the next few years. However, total CET1 capital requirements may still increase if systemic and countercyclical buffers are applicable and are phased-in. These buffers can translate into an additional 1-3% plus in CET1 capital requirements. In addition, some banks will see the phasing-in of deductions from capital.

Further, on a conference call in February the ECB communicated that going forward total Pillar 1 capital requirements would likely also be assessed in determining if there is a breach of the CBR. The Pillar 1 requirement consists of a minimum of 4.5% in CET1 capital, 6% in Tier 1 capital and 8% in total capital.

A closer look at coupon cancellation risks

Investors in AT1 capital instruments may not receive a coupon or receive only a partial distribution due to issuer discretion or a breach of the CBR. In general, Scope does not believe that financially viable issuers with sufficient, available distributable items would willingly utilise this discretion because the potential reputational damage could be very significant and materially harm future market access. Furthermore, issuers have the discretion to cut bonuses and dividends before not paying coupons on AT1 securities.

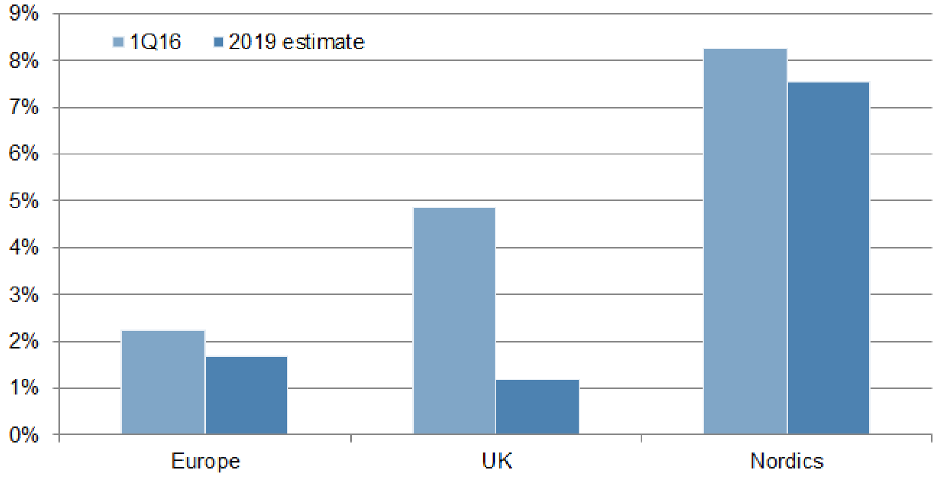
However, we believe that there may be a real risk of regulators influencing an issuer's discretion in regards to paying coupons or using their discretion under the supervisory process to restrict coupon payments. Such regulatory action occurred during the crisis and is very likely to occur again if warranted. In Scope's view, the most probable risk for AT1 investors is an issuer not making coupon payments because it does not meet the evolving CBR.

Factors preventing an issuer from meeting the CBR may include: (i) generating losses, (ii) unexpected provisions or charges related to litigation or conduct issues; (iii) a material increase in risk-weighted assets due to internal model changes or future regulatory requirements, (iv) an increase in the CBR due to changes in countercyclical capital-buffer rates or various systemic-risk buffer requirements and (v) material changes to Pillar 2 requirements.

As the banking industry moves through the transition period for implementing various capital buffers – with the final stage in 2019 – what appears as a comfortable capital position currently, may be less sufficient later on and impair a bank's capacity to pay future AT1 coupons. Looking ahead to 2019, the distances to CBRs appear to decline from current levels, with differences again amongst European, UK and Nordic issuers (Figure 2). We caution that the range is wide and that these are estimates based on currently disclosed CET1 targets, management buffers and our forecasts. Over time, issuers could refine their targets and management buffers in response to regulatory and market demands.

For investors and credit analysts, this raises the interesting issue of what would be considered a comfortable buffer. This is likely to vary depending on the issuer. For those issuers with more stable earnings and consistent organic capital generation capabilities operating under clear regulatory capital regimes, the "desired" management buffer is likely to be less. For those issuers with more volatile earnings or who are exposed to conduct and litigation fines or potentially higher capital requirements, the "desired" management buffer is likely to be larger.

Figure 2: Estimated future distance to required CET1 levels (%)



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Source: Scope Ratings

Ongoing discussions may mean that banks eventually have more headroom

Since the volatility in the AT1 market seen in January and February there have been ongoing discussions about potentially relaxing requirements for European banks. In particular, Pillar 2 requirements may be separated into two components – one which is required and relevant for determining if the CBR has been breached and one which is considered guidance and not relevant for determining if the CBR has been breached. The way Pillar 2 requirements are met could also change – currently for ECB supervised banks, the Pillar 2 requirement is met with CET capital. In the future, they could also be met with AT1 and T2 capital as is the case in the UK. As well, there may be a change to the automatic limitation on AT1 coupons when the CBR has been breached and the maximum distributable amount needs to be calculated – specifically in scenarios where an issuer has made a loss for the year.

Beware of all requirements

Naturally when assessing coupon cancellation risks we focus on the CBR and at what level would a breach lead to a calculation of the maximum distributable amount (MDA). However, we believe that it is important to take a broader view due to the discretionary nature of coupons and the broad powers of regulators.

For example, in Nordic countries (Denmark, Norway and Sweden), Pillar 2 requirements are not included when determining the level of CET1 capital required to avoid restrictions on distributions. However, Pillar 2 requirements can be material and significantly increase total capital requirements. In fact, we question how comfortable regulators and investors would be if an issuer were not meeting all of its capital requirements while technically not breaching the MDA trigger level. Besides Pillar 2 requirements, leverage ratio and MREL/TLAC requirements may also be relevant.

We note that in Switzerland which is not subject to CRD IV, the securities issued by the two large Swiss banks do not include a reference to the CBR. Instead, the terms and conditions state that the issuers are prohibited from making coupon payments if they are not in compliance with all applicable minimum capital adequacy requirements. These include going and gone concern requirements – as a percentage of RWAs and leverage exposure.

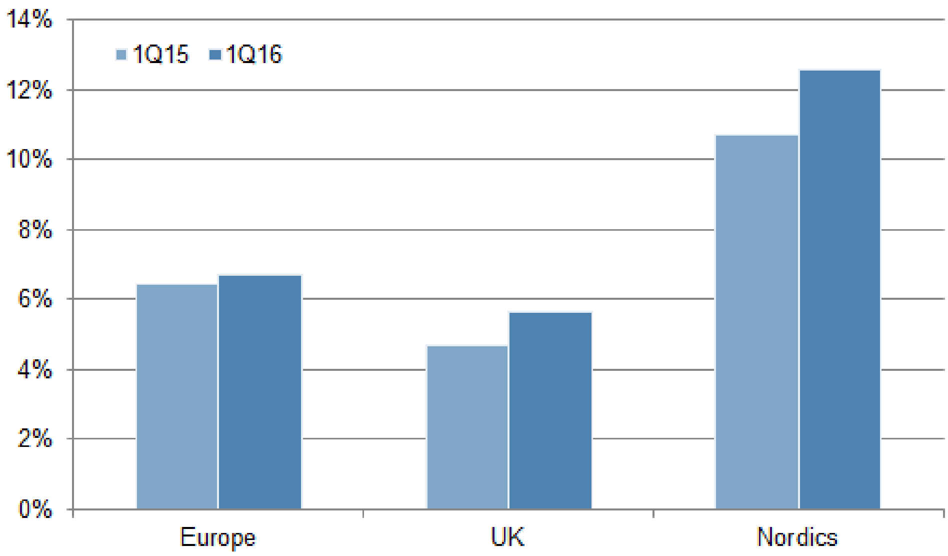
A closer look at principal loss absorption risks

Under the terms of AT1 capital instruments, write-down or conversion occurs when an issuer's CET1 ratio hits the specified trigger level or the issuer has reached the PONV (point of non-viability). Depending on the terms of the AT1 security, it may be written down on a permanent or temporary basis or be converted into equity.

Principal loss absorption risks recede further

With the trigger levels for write-down or conversion being clearly defined and fixed and issuers building capital positions to meet higher regulatory solvency norms, this should generally mean lower write-down or conversion risks. For example, if minimum CET1 requirements are around 10%, banks are unlikely to maintain capital positions that risk breaching a high trigger of 7%, let alone a lower trigger.

Figure 3: Distance to trigger levels (%)



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Source: Scope Ratings.

Principal loss absorption when the contractual trigger level is breached is relatively straightforward to understand. However, the PONV is less clearly defined and remains subject to interpretation. It is our understanding that AT1 securities may be written down or converted in early regulatory intervention and before resolution – when supervisors decide that action must be taken in order to remedy a bank's deteriorating condition. SREP results as well as other material events may be considered by supervisors in their decision making. A poor SREP result, substantial fines, a significant deterioration in the level of liabilities held for MREL purposes and an unexpected loss of senior management could be factors that lead to early regulatory intervention.

Appendix: Summary of rated AT1 securities

Issuer	Trigger	Type of Loss Absorption	Senior unsecured debt rating *	Minimum Notching	Additional Notching	AT1 Rating
Barclays plc	7% fully loaded	Full conversion	A	4	2	BB
BBVA	5.125% (issuer and group)	Full conversion	A	4	1	BB+
BNP Paribas	5.125%	Temporary writedown	A+	4	0	BBB
Credit Agricole	7% (CA group) or 5.125% (CASA)	Temporary writedown	A+	4	1	BBB-
Credit Suisse GAG	5.125% (CET1+ high trigger)	Permanent writedown	A	4	0	BBB-
Credit Suisse GAG	7%	Full conversion	A	4	1	BB+
Danske Bank	7% (issuer and group)	Temporary writedown	A-	4	1	BB
Deutsche Bank	5.125%	Temporary writedown	A-	4	1	BB
DNB Bank	5.125% (bank, bank group, group)	Temporary writedown	A+	4	1	BBB-
HSBC Holdings	7% fully loaded	Full conversion	AA-	4	1	BBB
ING Group	7%	Full conversion	A	4	0	BBB-
Intesa	5.125% (issuer and group)	Temporary writedown	A-	4	0	BB+
KBC Group	5.125%	Temporary writedown	A	4	0	BBB-
Lloyds Banking Group	7% fully loaded	Full conversion	A	4	1	BB+
Nordea	5.125% bank, 8% group	Temporary writedown	A+	4	1	BBB-
Santander	5.125% (issuer and group)	Full conversion	A+	4	1	BBB-
Societe Generale	5.125%	Temporary writedown	A	4	0	BBB-
Svenska Handelsbanken	5.125% issuer, 8% group	Temporary writedown	A	4	1	BB+
Swedbank	5.125% bank, 8% group	Full conversion	A-	4	1	BB
UBS GAG	5.125% (CET1+ high trigger)	Permanent writedown	A	4	0	BBB-
UBS GAG	7% (CET1 + high trigger)	Permanent writedown	A	4	0	BBB-

Note: * Senior unsecured debt rating eligible for TLAC/MREL as applicable.
Source: Scope Ratings.

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