AT1 Securities: Mind the Issuer

The Additional Tier 1 (AT1) asset class continues to evolve, with the associated investment risks becoming more evident. This month, the AT1 and Tier 2 securities of Banco Popular (not rated) were written down and Bremer Landesbank (not rated) announced that AT1 coupons would not be paid. In addition to understanding the terms of the securities, these events clearly demonstrate that issuer credit fundamentals remain key when assessing the risks. Furthermore, the market's contained reaction to these events can be seen as a sign of the growing maturity of the asset class

When Scope first published its rating methodology for AT1 securities in 2014, we highlighted their primary role in providing a private-sector alternative for strengthening the capital positions of financial institutions, in addition to the issuance of equity. Hence, our rating approach remains focused on the inherent coupon-cancellation and principal-loss absorption risks. As recent events show, the weaker the credit fundamentals of the issuer, the greater the risk of investor losses.

Issuer specific fundamentals drive losses

The natural tendency is to focus on quantifiable metrics but one cannot lose focus of the underlying fundamentals. For example, Banco Popular's CET1 capital ratio was in excess of 10% as of 1Q 2017, with no imminent danger of breaching the 5.125% and 7% contractual triggers on its AT1 securities. For years, however, the bank had been struggling with elevated provisions related to real estate assets. Combined with declining customer confidence and a deteriorating liquidity situation, the ECB and the Single Resolution Board (SRB) determined that the bank was failing or likely to fail. This resulted in the write-down of shares, AT1 securities and effectively Tier 2 securities (which were converted into new shares and then transferred to Banco Santander).

Interestingly, supervisors placed the bank directly into resolution without passing through the point of non-viability. We point out that Tier 2 securities can also absorb losses at the point of non-viability but only after AT1 securities have done so.

In the case of Bremer Landesbank, this was the first instance of management rather than supervisors deciding to cancel coupon payments on AT1 securities. The bank had been suffering losses on a portfolio of shipping loans for several years and reported a larger than expected loss for FY2016 due to increased provisioning. Further, in January 2017, the bank filed an application with the ECB to be waived from certain regulatory capital requirements on an individual basis as all of its shares had been acquired by NordLB.

AT1 securities perform their intended role

There have been concerns about the credit fundamentals of these two banks for some time. The decision taken by Bremer Landesbank allows the bank to conserve capital during a difficult period while the write-down of Banco Popular's AT1 securities aided in the recapitalization of the bank. Both of these aims are fully in line with the intended raison d'être of AT1 securities.

What we conclude from these events is that AT1 securities are performing the role they were intended to by regulators. We do not, however, extrapolate the losses incurred by investors in these securities to all AT1 securities issued by other banks. While certain risks are inherent to the securities, the probability of incurring losses depends to a large degree on the credit fundamentals of the issuer. In light of their deeply subordinated status in the priority of claims, their loss absorbing features and the coupon-cancellation risks, it makes sense to have a reassuring degree of comfort with an issuer's credit fundamentals even when yields appear compelling.

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The number of metrics multiply; some easier to gauge than others

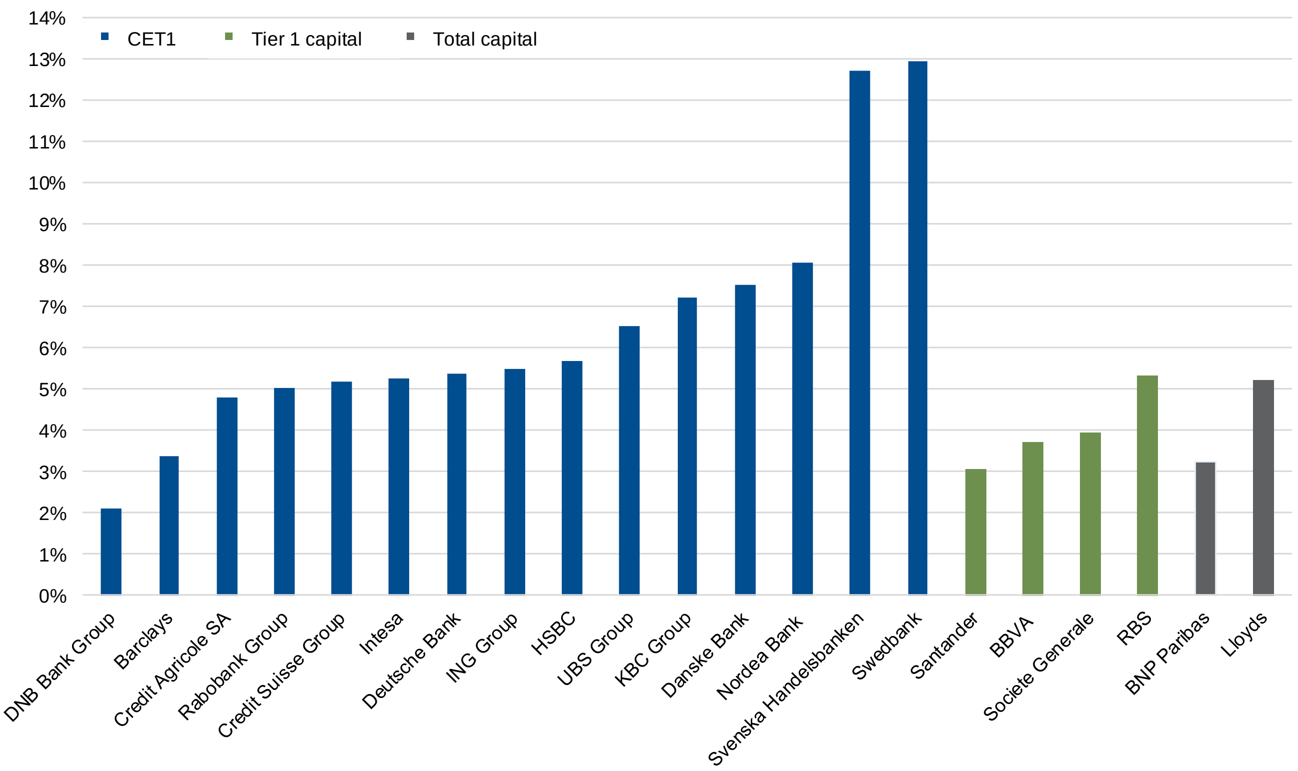
On the whole, banks continue to bolster their capital positions meaning that the risk of hitting the contractual trigger for write-down or conversion is receding. For rated issuers, this gap was on average in excess of 8% based on CET1 figures as of 1Q 2017. Meanwhile, the risk of coupon cancellation continues to increase as the hurdle for avoiding distribution restrictions rises. This is due in part to the ongoing phase-in of buffers comprising the combined buffer requirement (CBR) and deductions from capital.

Tier 1 and total capital also become relevant

The hurdle is also rising because the headroom to CET1 requirements is no longer the only relevant metric for assessing a potential breach of the CBR. In December 2015, the EBA issued an opinion which clarified that all capital requirements as well as the combined buffer were relevant for determining the maximum distributable amount (MDA) threshold (i.e. the point where the MDA needs to be calculated and distributions are restricted). This was then reiterated by the ECB in December 2016 when it detailed capital requirements for 2017 stemming from the Supervisory Review and Evaluation Process (SREP).

Disclosure regarding available distributable items and the headroom to CET1 requirements have materially improved but even better disclosure would include the headroom to Tier 1 capital and total capital requirements. Figure 1 shows that the binding constraint for an issuer can be CET1, Tier 1 or total capital.

Figure 1: Narrowest headroom to requirements



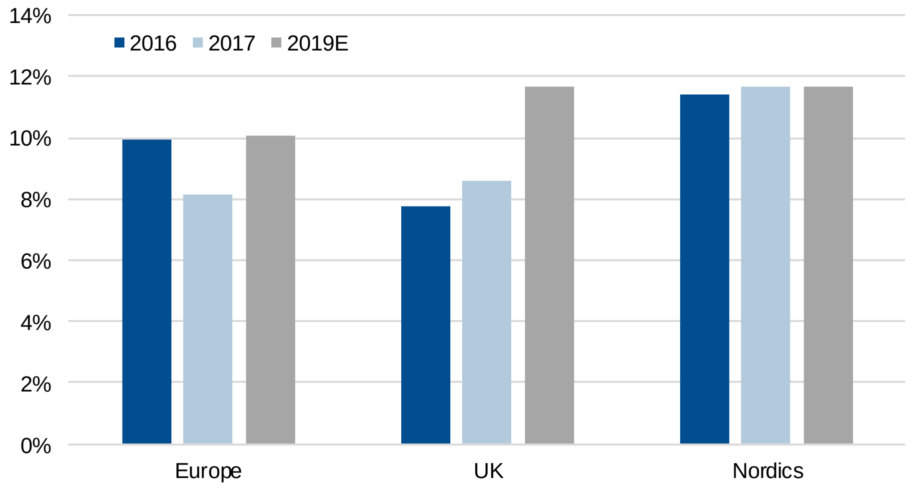
Note: Based on capital figures as of 1Q 2017 except for Rabobank which are as of YE2016. Credit Suisse and Deutsche Bank figures are pro forma recent capital raises.
Source: Company data, Scope Ratings

Improvement in headroom unlikely to be sustained

With 2017 SREP decisions, European issuers saw some respite due to the introduction of Pillar 2 guidance (P2G), but this does not alter the rising trajectory of capital requirements. Compared to 2016, the decrease in CET1 requirements has so far meant an increase in the headroom to the MDA threshold.

Meanwhile, the situation in the UK and the Nordic region is somewhat different. In the UK, the capital regime has been established earlier, with requirements continuing to phase-in as expected. In Norway and Sweden, capital requirements have generally been front-loaded with no transition period. The modest increase in requirements this year is due to rising countercyclical buffers driven by concerns about household debt and housing prices in these two countries.

Figure 2: MDA relevant CET1 requirements



Note: Europe = BBVA, BNPP, Credit Agricole, Deutsche Bank, ING, Intesa, KBC, Rabobank, Santander and SocGen. UK = Barclays, HSBC, Lloyds and RBS. Nordics = Danske, Nordea, Handelsbanken, Swedbank and DNB.
Source: Company data, Scope Ratings

What is an acceptable level of headroom?

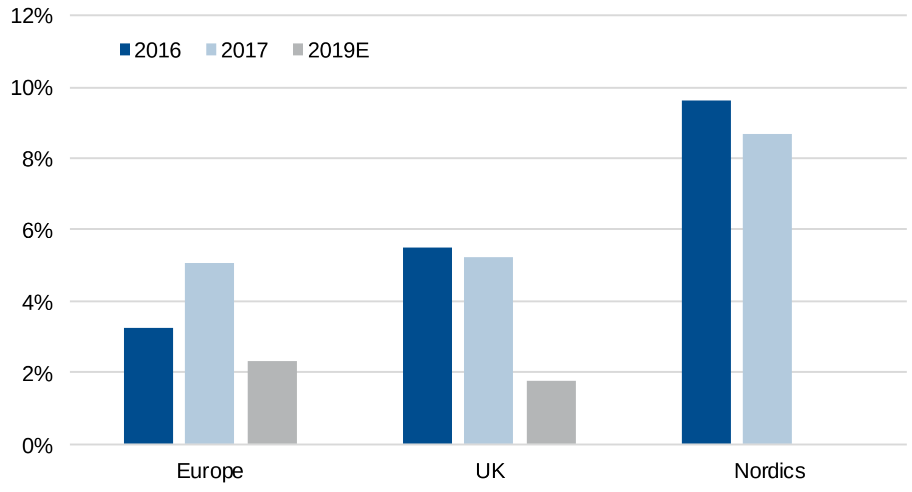
As one looks out to 2019 when requirements should stabilize for many issuers, we estimate that the headroom to the MDA threshold will be around 2% on average for European and UK issuers, lower than what it is currently (Figure 3). We arrive at this estimate from current capital targets publicly communicated by issuers, acknowledging that they are subject to change.

In light of the recently announced intention by the Bank of England to increase the countercyclical buffer rate to 1% with effect from 2018, UK banks may modify their targets. Further, these estimates do not take into consideration the potential impact of refinements to Basel III, in particular output floors.

This raises the question of what investors will consider to be an acceptable level of headroom going forward. Note that the average shown for the Nordics is skewed by the substantial Pillar 2 component of the Swedish banks, which is not relevant for the MDA threshold calculation.

Our view is that the acceptable level will depend to a large degree on the credit fundamentals of the issuer, e.g. the stability of earnings, the capacity to generate capital and the amount of exposure to material conduct and litigation costs. As banks reach the higher levels of capital required by regulators, management teams will need to juggle the sometimes divergent demands of various stakeholders. Consequently, for many issuers it is doubtful that the current headroom to the MDA threshold will be maintained.

Figure 3: Headroom to MDA relevant CET1 requirements



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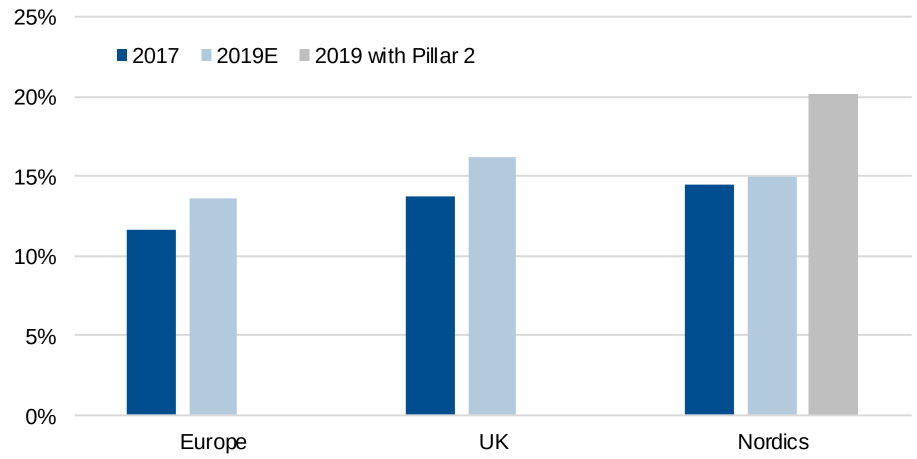
Source: Company data, Scope Ratings

Bear in mind capital requirements as well as guidance

As highlighted above, Tier 1 capital and total capital requirements are now just as important as CET1 capital when determining the MDA threshold. And while not strictly relevant for determining the MDA threshold, capital guidance can substantially add to the level of capital that a bank is expected to hold. This is particularly the case for Swedish banks where the inclusion of the Pillar 2 component can lead to a near doubling of total requirements (Figure 4). This also means that the Nordic banks' headroom to requirements (including Pillar 2) then becomes more in line with European and UK peers.

We maintain the view that regulators and investors are more comfortable when banks meet the higher level including Pillar 2, be it a requirement or guidance. For example, the EBA has indicated that P2G does not impact the MDA threshold but banks are expected to meet the guidance under normal circumstances. The complication for investors is that European and UK issuers are not obliged to disclose this guidance.

Figure 4: Total capital requirements



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Source: Company data, Scope Ratings

Other prudential requirements may impact the ability to pay coupons

It is informative to look at countries like the UK and Switzerland where regulators have progressed the furthest in deciding prudential requirements relevant for capital securities. In these countries, the largest banks (not just G-SIBs) are subject not only to capital requirements but also leverage and loss absorbing capacity requirements. While a breach of these requirements would not lead to an automatic restriction on distributions, they could impact an issuer's ability to pay coupons as they would likely be under heightened supervision.

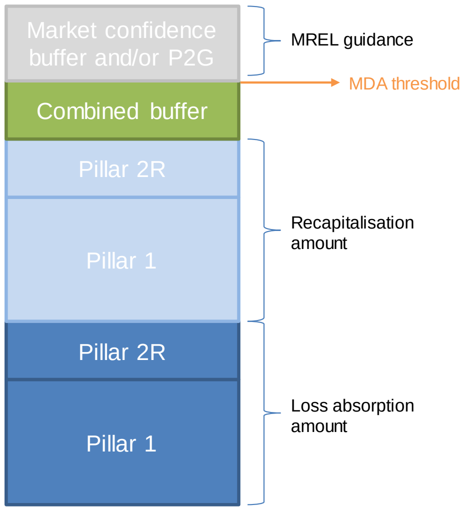
Leverage and MREL/TLAC could become constraints

As Switzerland is not subject to CRD IV, the concepts of the CBR and the MDA threshold are not applicable. However, the AT1 instruments of the two systemic banks contain language which prohibits coupon payments if they are not in compliance with all applicable minimum capital adequacy requirements. For the Swiss banks, this means TLAC requirements on both a RWA and leverage basis.

The UK is moving in a similar direction as breaches of loss absorbing capacity requirements (MREL/TLAC plus buffers) would mean that an issuer faces enhanced supervisory action and would be required to prepare a capital restoration plan, although there would not be an automatic prohibition on coupon payments.

The situation for SSM supervised banks may not be dissimilar in the future. In the November 2016 package of banking reforms, the European Commission (EC) proposed that the combined buffer sits on top of MREL/TLAC requirements. In a situation where a bank breaches the CBR due to an inability to issue new MREL-eligible liabilities (while continuing to comply with capital requirements), the bank would have six months to restore the breach before restrictions on distributions would apply.

Figure 5: Proposed future MDA threshold



Notes: MREL guidance is set as needed to ensure additional loss absorption. As a rule, should not exceed Pillar 2G plus combined buffer minus countercyclical buffer.
Source: European Commission, Scope Ratings

The prioritization of AT1 coupons now looks less probable

At the same time, the EC proposals included an amendment to Article 141 of CRD IV to prioritize the payment of AT1 coupons over dividends and variable compensation when the MDA is in effect. However, in an opinion published in May 2017, the EBA expressed the view that the fully discretionary nature of AT1 coupon payments was a key feature of these securities and “altering it could create the expectation that coupons will always be paid”. The EBA further points out this change could lead to a loss of confidence in the loss-absorbing capacity of AT1 securities. While less advantageous for investors, we consider that this change could lead to increased moral hazard and be somewhat of a set-back for improving the resilience of banks.

The EC package of banking reforms is currently working its way through the European legislative process with the final outcome being uncertain. Nevertheless, we highlight the discretionary nature of AT1 coupons and the broad powers of regulators. It is highly conceivable that a supervisor would exercise its early intervention powers and prohibit the payment of AT1 coupons.

Appendix: Summary of rated AT1 securities

Issuer	Trigger	Type of Loss Absorption	Senior Unsecured Debt Rating [1]	Minimum Notching	Additional Notching	AT1 Rating
Banco Santander	5.125% (issuer and group)	Equity conversion	A+	4	1	BBB-
Barclays plc	7% fully loaded	Equity conversion	A	4	1	BB+
BBVA SA	5.125% (issuer and group)	Equity conversion	A	4	1	BB+
BNP Paribas	5.125%	Temporary writedown	A+	4	0	BBB
Credit Agricole SA	7% (CA group) or 5.125% (CASA)	Temporary writedown	A+	4	1	BBB-
Credit Suisse Group	5.125% (CET1+ higher trigger)	Permanent writedown	A	4	0	BBB-
Credit Suisse Group	7%	Equity conversion	A	4	1	BB+
Danske Bank	7% (issuer and group)	Temporary writedown	A	4	0	BBB-
Deutsche Bank	5.125%	Temporary writedown	BBB+	4	2	B+
DNB Bank	5.125% (bank, bank group, group)	Temporary writedown	A+	4	1	BBB-
HSBC Holdings	7% fully loaded	Equity conversion	AA-	4	1	BBB
ING Group	7%	Equity conversion	A+	4	0	BBB
Intesa Sanpaolo	5.125% (issuer and group)	Temporary writedown	A-	4	0	BB+
Intesa Sanpaolo	5.125% (issuer and group)	Permanent writedown	A-	4	0	BB+
KBC Group	5.125%	Temporary writedown	A	4	0	BBB-
Lloyds Banking Group	7% fully loaded	Equity conversion	A	4	1	BB+
Nordea Bank AB	5.125% bank, 8% group	Temporary writedown	A+	4	1	BBB-
Rabobank	5.125% unconsolidated, 7% group	Temporary writedown	A+	4	1	BBB-
RBS Group	7% fully loaded	Equity conversion	BBB+	4	2	B+
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	Equity conversion	A-	4	1	BB
UBS Group	5.125% (CET1+ higher trigger)	Permanent writedown	A	4	0	BBB-
UBS Group	7% (CET1 + higher trigger)	Permanent writedown	A	4	0	BBB-

Note: 1 Senior unsecured debt rating eligible for MREL/TLAC as applicable.
Source: Scope Ratings

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