

AT1 Capital Instruments

Background and key risks for investors

In the current environment of low investment yields and increasing regulatory capital requirements, interest in Additional Tier 1 (AT1) capital instruments remains high amongst investors and financial institutions. The market for these instruments is still in its infancy, but has grown dramatically over the last year to approximately EUR 100bn. Investors are calling for more standardization and consistency in the instruments, especially in regards to the mechanics on distributions and trigger events. In this report, we highlight the key CRD4-CRR requirements underpinning the structure of AT1 capital securities, as well as the role they play in strengthening capital positions. We also point to some of the key risks that investors face when investing in AT1 capital instruments.

In the near future, Scope Ratings will expand on the latter aspects and provide a more detailed methodology for rating AT1 capital instruments.

Features of AT1 capital instruments

The structure of contingent convertible securities, of which AT1 capital instruments are the major component, is “shaped by their primary purpose as a readily available source of bank capital in times of crisis.”¹ Specifically, they aim to provide a private-sector alternative for recapitalizing financial institutions, aside from the issuance of new equity – which can at times be less appealing due to dilution effects. We note that the regulatory framework (CRD4-CRR) behind their structure aims primarily to minimize systemic risk and provide depositor protection, rather than to increase their market appeal.

CRD4-CRR defines certain criteria which must be met for securities to qualify as AT1 instruments and therefore to be considered regulatory capital. These include:

- Be perpetual with the terms containing no incentives for the issuer to redeem them.
- Subordination to Tier 2 (T2) instruments in the event of insolvency.
- Distributions under the securities are paid out of distributable items. Further, within CRD4-CRR, there are restrictions on making distributions under certain conditions.
- Distributions are at the full discretion of the issuer. Cancellation of distributions does not constitute an event of default.
- Upon the occurrence of a trigger event, the principal amount of the securities is written down on a permanent or temporary basis or is converted into common equity. The trigger event occurs when the CET1 capital ratio falls below 5.125% or at a higher level specified in the terms of the security.

In addition, CRD4-CRR includes a provision that AT1 and T2 capital instruments should be capable of being fully and permanently written down or converted into equity when an institution has reached the point of non-viability. In April 2014, this provision was incorporated and adopted in the EU Bank Recovery and Resolution Directive (BRRD). Further, the terms governing the instruments should state that they can be written down or converted at the request of regulatory authorities.

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¹ “CoCos: a primer”, BIS Quarterly Review, September 2013, p.44.

At the point of non-viability, the institution meets the conditions for resolution or ceases to be viable unless capital instruments are written down.

Point of non-viability

The point of non-viability (PONV) is the point where the relevant authority determines that the institution meets the conditions for resolution or the authority decides that the institution ceases to be viable if capital instruments are not written down. Resolution authorities will take resolution action only if all of the following conditions are met:

- it has been determined that the institution is failing or likely to fail,
- there are no other private sector measures, including early intervention measures or the write down or conversion of capital instruments, that would prevent the failure of the institution in a reasonable timeframe, and
- resolution action is necessary for the public interest.

Entry into resolution “will thus always occur at a point close to or at insolvency. Authorities nonetheless will retain a degree of discretion to ensure that they can intervene before it is too late for resolution to meet its objectives.”² Further, under BRRD, the power to write down or convert capital instruments may be exercised either independently of resolution action or together with a resolution action.

Resolution tools consist of powers to:

- sell parts of the financial institution
- transfer a business to a temporary structure such as a “bridge bank” to preserve essential banking functions or facilitate continuous access to deposits
- separate clean and toxic assets between “good” and “bad” banks through a partial transfer of assets and liabilities; and/or
- bail-in creditors in order to restore a financial institution’s capital position.

Sequence of writedown and conversion when bail-in tool is used under resolution

The bail-in tool enables authorities to recapitalize an institution so that it can continue as a going concern.

The bail-in tool enables authorities to recapitalize a failing bank through the writedown of liabilities and/or their conversion to equity so that the institution can continue as a going concern. Equity must absorb losses in full before any debt claim is subject to writedown and/or conversion. Then the principal of AT1 instruments is reduced to the extent required and up to their capacity. If still not sufficient, T2 instruments are reduced, followed by subordinated debt and other eligible liabilities. Subordinated debt and other eligible liabilities should be reduced in accordance with the hierarchy of claims in normal insolvency proceedings.

Sequence of write down and conversion when bail-in tool is used under resolution
AT1 instruments
T2 instruments
Subordinated debt that is not AT1 or T2 capital
Senior unsecured debt and non-covered deposits (wholesale and institutional)
Non-covered eligible deposits (individuals and SMEs)

Source: CRD4, Scope Ratings

² EC Memo, EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, April 15, 2014, p.6

While it appears relatively clear that common equity should be first in line to absorb losses when the bail-in tool is used under resolution, there is some uncertainty about the standing of common equity vs. capital instruments when there is a restructuring of debt outside of a resolution scenario. For example, conversion or writedown of AT1 or T2 capital instruments due to a trigger event may occur before shareholders have absorbed losses. In another instance, for issuers with both T2 and AT1 capital instruments outstanding, due to the different levels of triggers, it is not clear which instruments would be converted or written down first. It is possible situations like these which continue to concern investors in capital instruments.

Before writedown or conversion of capital instruments there are other early intervention measures

Before bail-in, other measures may be used to stabilize a financial institution.

Unsurprisingly, investors are focused on bail-in risks, however there are numerous other intervention measures that can be taken to bolster or restore the health of a financial institution before bail-in occurs under a resolution scenario. At the same time, BRRD recognizes that in an urgent situation resolution authorities should be allowed to take action without imposing an obligation to first use early intervention powers. Within BRRD, it is stated that authorities should have at their disposal at least the following measures when an institution breaches or is likely in the near future to breach the requirements of CRD4:

- require the institution to implement one or more measures set out in its recovery plan;
- require the institution to identify the problems and to draw up an action program to deal with these problems as well as an implementation timetable;
- change management as necessary;
- require the institution to draw up a plan for negotiation on restructuring debt with some or all of its creditors according to the recovery plan, where applicable;
- require changes to the institution's business strategy;
- require changes to the legal or operational structures of the institution; and
- obtain necessary information to update the resolution plan and prepare for the possible resolution of the institution.

Restrictions on distributions

When an issuer breaches its combined buffer requirement, it faces restrictions on the distributions it can make on AT1 instruments.

In line with their purpose to support issuers' solvency positions, AT1 capital instruments are structured so that distributions may be restricted or prohibited under certain conditions. This enables issuers to preserve capital as needed to bolster their solvency positions.

Under CRD4, an issuer is prohibited from making distributions on common equity when doing so would decrease CET1 capital to a level such that it no longer meets the Combined Buffer Requirement (see below). When in breach, the issuer is required to calculate a Maximum Distributable Amount (MDA) which determines how much it can distribute. Until this is done, the issuer is prohibited from paying variable remuneration, dividends to shareholders and coupons on AT1 instruments.

The MDA is the sum of interim and year-end profits not included in CET1 capital minus the taxes that would be payable on these profits if they were retained multiplied by a factor between 0 and 0.6. If the issuer is in the first quartile of its combined buffer requirement (i.e. meets 75-100% of the requirement), then 60% of profits can be distributed. If the issuer is in the second quartile, 40% of profits can be distributed; if in the third quartile, 20% can be distributed and if in the fourth quartile, 0%.

As combined buffer requirements are phased-in from 2016, issuers will need to meet

increasing CET1 capital requirements and consequently will likely need to maintain “management buffers” above these levels to “comfortably” avoid distribution restrictions on common equity and AT1 instruments. With increasing levels of CET1 capital, the risk of issuers breaching the trigger levels in these securities should generally decline.

At the same time, we note that restricting distributions can be a means of early intervention to help maintain the financial soundness of issuers and thus financial stability.

Combined buffer requirement

At this time, combined buffer requirements remain uncertain as in most countries, the various capital buffers are still being determined.

In addition to the base requirements (at least 4.5% CET1, at least 6% Tier 1 and at least 8% total capital), CRD4 introduces three capital buffers (capital conservation buffer, countercyclical buffer, and a systemic buffer with three components). The combined buffer requirement refers to the total CET1 capital required to meet the capital conservation buffer which has been set at 2.5% and the following buffers as applicable:

- Institution specific countercyclical capital buffer between 0% and 2.5% (may be higher)
- Systemic buffers
 - Systemic risk buffer between 1% and 5%
 - Global systemically important institution (G-SII) buffer between 1% and 3.5%
 - Other systemically important institution (O-SII) buffer up to 2%

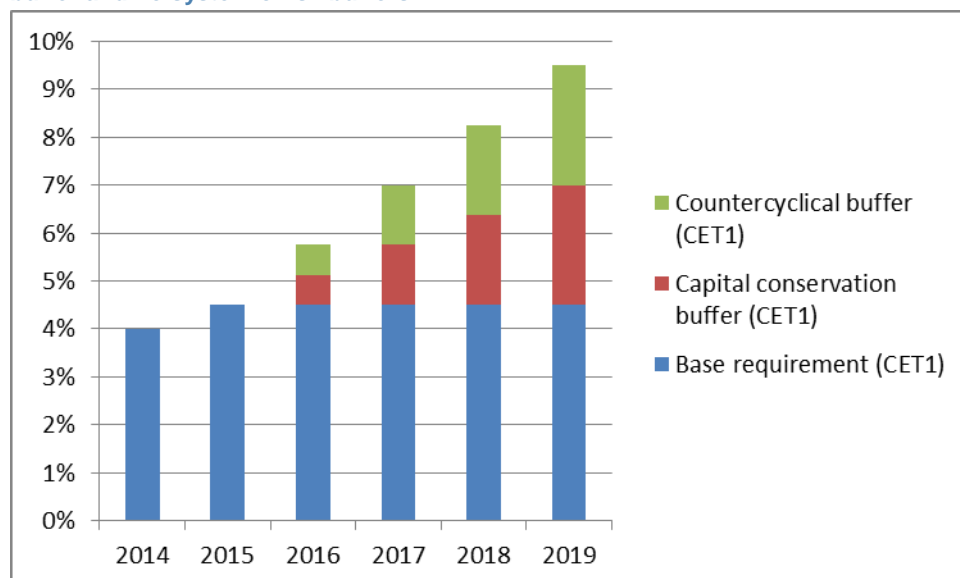
When an institution is subject to more than one systemic component, only the highest systemic buffer normally applies. However, when the systemic risk buffer applies only to exposures located in the institution’s domestic market, this systemic risk buffer is in addition to any O-SII or G-SII buffer in order to address domestic macroprudential risks.

CRD4 allows for the phase-in of the various capital buffers between 2016 and 2019.

The capital conservation and institution specific countercyclical capital buffer requirements will be phased in simultaneously between January 1, 2016 and December 31, 2018. During this transition period, the restrictions on distributions referred to above will apply.

While the capital conservation buffer has been set at 2.5%, many of the other buffers are still being determined by various national authorities and the ESRB. Further, under CRD4, national authorities have flexibility to adopt stricter capital requirements, including shorter transitional periods.

Chart 1: Phase-in of CET1 requirements, assuming a 2.5% countercyclical capital buffer and no systemic risk buffers



Source: CRD4, Scope Ratings

Notes:

1. Minimum CET1: 4% in 2014; 4.5% from 2015.
2. Capital conservation buffer: 0.625% in 2016, 1.25% in 2017, 1.875% in 2018 and 2.5% in 2019.
3. Institution specific counter cyclical buffer: up to 0.625% in 2016; up to 1.25% in 2017; up to 1.875% in 2018 and up to 2.5% in 2019.

A. Institution specific countercyclical buffer

Each quarter, national authorities will determine a countercyclical buffer rate which reflects the credit cycle and risks due to excess credit growth in their respective national economy. This will be based on the deviation of the credit-to-GDP ratio from its long-term trend. The countercyclical buffer is expressed as a percentage of an institution's total risk exposure amount and will be between 0% and 2.5%. If justified, the countercyclical buffer may be above 2.5%.

For institutions with international operations, the institution specific countercyclical capital buffer will consist of the weighted average of the countercyclical buffer rates that apply in the jurisdictions where the relevant credit exposures of the institution are located or are applied.

B. Global systemically important institutions

In November 2013, the Financial Stability Board updated its list of global systemically important banks to include 29 banks. The banks are categorized in one of five buckets, with bucket one requiring 3.5% of additional CET1 capital and bucket five requiring 1%. There are currently no banks in bucket one while the majority are in buckets four (8) and five (15). The list is updated on an annual basis, with the next update due in November 2014.

The higher capital requirements for these banks will be phased in from January 2016, with full implementation by January 2019. The initial requirements in January 2016 will apply to those banks identified in November 2014. Please refer to Appendix A for the list of global systemically important banks as of November 2013.

As issuers meet the base capital requirements under CRD4, focus will turn increasingly to national differences.

The key risks for investors are related to the non-payment of coupons and the write down or conversion of principal.

C. Systemic risk buffer

National competent authorities may introduce a systemic risk buffer in order to prevent and mitigate long term non-cyclical systemic or macroprudential risks not covered under CRD4-CRR. When setting a systemic risk buffer rate, the relevant authorities must justify how the buffer is likely to be effective in mitigating the identified macroprudential or systemic risk.

D. National differences

Within the European Union, we continue to note differences amongst national regulators in implementing CRD4. For example, the UK PRA has decided to utilize its discretion to accelerate the introduction of certain enhanced capital requirements without regard to any transitional provisions. Therefore, UK issuers have issued AT1 capital instruments based on a fully-loaded CET1 capital trigger level rather than a phased CET1 capital trigger.

Outside the EU, Switzerland does not follow CRD4 but adopted the Basel 3 framework along with legislation addressing the “too big to fail” problem in January 2013. This includes a 1% countercyclical buffer until July 2014 and 2% thereafter due to the “overheated” housing market in Switzerland as well as a 3% “too big to fail” buffer for the two largest banks.

Key risks for investors in AT1 capital instruments

Based on the specific features of AT1 capital instruments, we see four key risks for investors – two related to coupon payments (distributions) and two related to principal writedown or conversion:

Coupon cancellation risks:

- The issuer does not make distributions as it has full discretion not to do so. In general, we do not believe that financially viable issuers would exercise this discretion lightly as the reputational risk could be significant and future market access could be materially harmed.
- The issuer is restricted in making distributions as it has breached its combined buffer requirement.

Principal loss absorption risks:

- The instruments are written down or converted as the relevant CET1 ratio has breached the trigger level.
- The instruments are written down or converted as relevant authorities have determined that the issuer has reached the PONV – i.e. the point when the issuer meets the conditions for resolution or the authorities decide that the issuer ceases to be viable if the capital instruments are not written down or converted.

In addition to the structural risks inherent in the securities, investors must assess the credit fundamentals of the issuer to determine the risks of specific AT1 capital instruments. Considerations include the stability of an issuer’s earnings, the capacity of an issuer to generate capital and the issuer’s views on maintaining a management buffer. Scope’s rating approach which incorporates the forecasting of issuer capital positions can support the analysis, helping to assess the likelihood of an issuer breaching its combined capital buffer requirement or trigger level. We acknowledge that the PONV is subject to interpretation by relevant authorities, thus complicating the analysis.

We also note that the risks are dynamic and so should the risk assessment be. Presently, most issuers have CET1 capital positions which are in excess of current capital

requirements. However, capital requirements are under regular review and in many cases are still being determined. Along with higher capital requirements (via the capital buffers mentioned above), we further note that some regulators are exercising discretion in regards to the application of RWA floors, thus impacting the level of capital a financial institution must hold. For example, the Belgian National Bank has recently decided to remove the zero risk weighting for sovereign bond holdings and to increase risk weights for retail exposures secured by Belgian residential property. In time, there may also be greater convergence of the current disparate risk weights across countries. Therefore, investors need to be forward looking and assess how an issuer's capital position as well as capital requirements are likely to evolve.

Implications for investors in T2 capital instruments

As detailed in CRD4-CRR, the key criteria for capital instruments to qualify as T2 capital include subordination to all non-subordinated creditors and an original maturity of at least five years. Of note, there is no requirement for T2 capital instruments to have a trigger level which would lead to writedown or conversion. However, as mentioned above, BRRD states that AT1 and T2 capital instruments should be subject to writedown or conversion at the PONV.

Based on the requirements of CRD4-CRR, investors in T2 securities do not face the same coupon and trigger level related principal loss absorption risks as for investors in AT1 securities. However, the risk of writedown or conversion still exists at the PONV, a more qualitative measure subject to regulatory interpretation. This may help to explain why many issuers have issued T2 capital instruments with specific trigger levels.

Crucial to the risk analysis is understanding the terms and conditions of the specific capital instrument.

Importantly, we highlight that the risks for investors noted above are risks which are inherent in capital instruments in general – i.e. based on the minimum features that these securities must contain in order to qualify as regulatory capital under CRD4-CRR. However, the risks of individual capital instruments may be different due to their specific terms and conditions.

In the near future, Scope Ratings will provide a more detailed methodology for rating capital instruments.

Appendix A

Global systemically important banks as of November 2013 allocated to buckets corresponding to required level of additional loss absorbency

Bucket	G-SIBs in alphabetical order within each bucket
3.5%	Empty 'to discourage further systemicness'
2.5%	HSBC JP Morgan Chase
2.0%	Barclays BNP Paribas Citigroup Deutsche Bank
1.5%	Bank of America Credit Suisse Goldman Sachs Group Credit Agricole Mitsubishi UFK FG Morgan Stanley Royal Bank of Scotland UBS
1.0%	Bank of China Bank of New York Mellon BBVA Groupe BPCE Industrial and Commercial Bank of China Limited ING Bank Mizuho FG Nordea Santander Societe Generale Standard Chartered State Street Sumitomo Mitsui FG Unicredit Group Wells Fargo

Source: Financial Stability Board, November 2013



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