

AT1 CoCos: the major questions for 2024

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2023 was a chaotic year for AT1 CoCos. Between the disappearance of around 7% of the outstanding amount of bonds following the write-down of Credit Suisse securities and the trauma it caused, the asset class seemed to be in a state of moribund decline, before regaining favour in the eyes of investors in the last quarter of the year, with record levels of demand for primary issues and UBS's return to prominence as a symbol of renewed enthusiasm. Is all well that ends well? That's what we're going to find out.

So, we intend to answer in this note to the main questions that are troubling investors at the start of the year: Is the breakdown in loan production a risk? Does the fall in interest rates jeopardise the surreptitious return to profitability of lending institutions? Can commercial real estate derail credit risk provisions? Will there be any AT1 non-calls, and might they disrupt the markets? Is the carry a good enough reason to own AT1 CoCos? How should we handle this market segment in 2024?

1/ Giants with clay feet: Are there more bank failures/rescues to come? Is the deterioration in fundamentals inevitable?

It seems like a long time ago, but in fact it was less than a year ago that Silvergate Bank, Signature Bank, Silicon Valley Bank, First Republic Bank and Credit Suisse collapsed in the span of a few weeks. While the first three were placed in resolution, the last two were rescued from the troubled waters by another banking institution. However, in the case of Credit Suisse, the price to pay was a total write-down of almost \$16 billion on AT1 CoCos. We won't go into the causes and consequences of these placements in resolution, which we commented on at length last year, but we will look into the risk of such events recurring this year.

While it's presumptuous to believe that no resolution can occur in 2024, there are some necessary conditions (here simplified to the extreme):

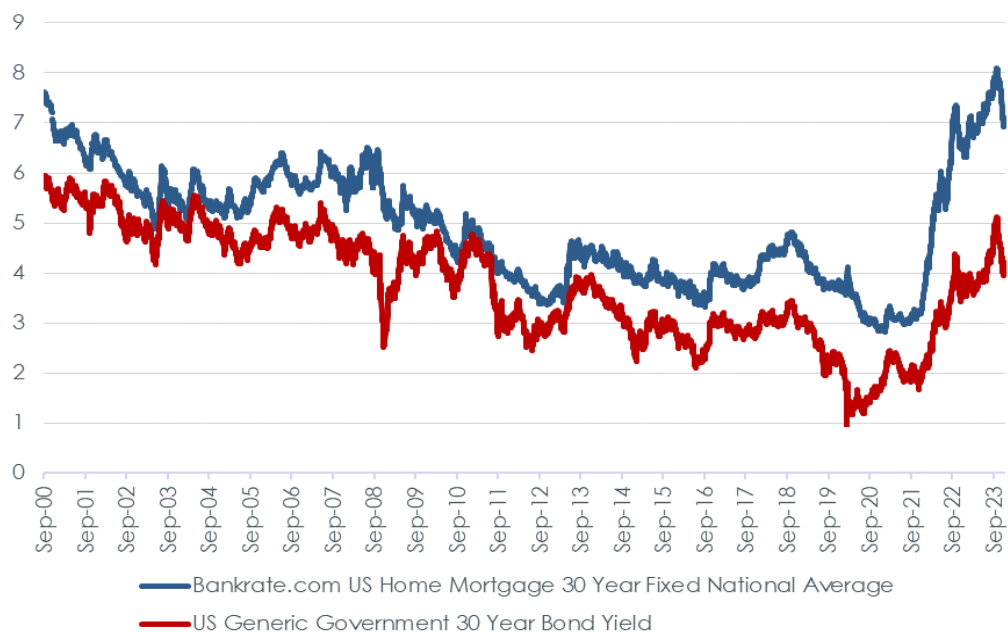
- ❖ A considerable financial/governance problem, which cannot be easily solved...
- ❖ and which leads to a bank run on customer deposits or at counterparties...
- ❖ ... creating a self-fulfilling effect, forcing the bank into resolution.



In the United States, the introduction of the Bank Term Funding Program (BTFP) and the safeguarding of all deposits of banks placed in resolution prevented the contagion from spreading and creating a widespread crisis among regional banks. More importantly, media attention quickly turned away from the woes of the regional banks, which was enough to restore serenity and stability in terms of deposits.

However, we remain very cautious on US regional banks, which are still far more exposed to commercial real estate than the six largest banks. At the same time, they also face pressure on (i) deposit yields, which remain inadequate in face of local money market funds, (ii) loan production, which is slowing despite a possible recovery if borrowing rates adjust to lower levels (see graph) and (iii) distributions to their shareholders, given that they will (finally) have to comply with higher solvency ratios as well as liquidity and bond debt holding ratios (long-term debt requirement; which has existed in Europe for over seven years).

Trends in US 30-year sovereign interest rates and 30-year mortgage rates (in %)



Sources: Bankrate.com, Bloomberg as at 9/1/2024.

The complete absence of prudential supervision in the case of an institution such as Silicon Valley Bank¹ may raise the concern that other institutions are being managed in a similarly amateurish way, although we do not expect any systemic crisis. Larger institutions are much more robust and properly regulated, and generally benefit from the deposit leakage of smaller institutions. On the other hand, regulators and politicians will certainly not be afraid to grant other backstops, like the BTFP, or safeguard measures on a federal scale (setting up a bad bank, for example, or another TARP²), especially in a presidential election year.

¹ The bank did not have a Chief Risk Officer in place for nine months and had apparently not seen fit to enter into swaps to hedge its balance sheet against the risk of interest rate rises, which had precipitated its losses when it was forced to liquidate bond assets at the end of 2022-beginning of 2023, without this bothering its regulators.

² Troubled Asset Relief Program.

In Europe, the spectre of Credit Suisse is no longer lurking, and, in our opinion, systemic institutions are not experiencing any significant governance issues. Nevertheless, there are several matters that have caught our attention:

- ❖ **Banks with greater exposure to commercial real estate and to the potential increase in provisions.** There are two types of banks with greater exposure to this sector: Swedish banks (SEB AB, Svenska Handelsbanken, Swedbank, etc.) and German banks (Helaba, Deutsche Pfandbriefbank, Aareal Bank, etc.).
 - German banks are particularly exposed to US commercial real estate and are clearly identified on the markets, since their bonds are trading at significant discounts, especially following Deutsche Pfandbriefbank's profit warning in November 2023. German retail banks exposed to non-negligible amounts of distressed US market segments bring back bad memories.
 - Swedish banks are mainly exposed to Nordic real estate and local property companies, some of which are in serious difficulty (SBB, Heimstaden Bostad). Unlike their German counterparts, Swedish banks have not increased their provisions in recent quarters, believing that the extra provisions set aside during the Covid-19 crisis were sufficient for the time being to offset the deterioration in their market. If the situation persists, one cannot be certain that this will prove true in the coming year.
 - More generally speaking, European banks made relatively few provisions over the first nine months of 2023, compared to their historical "cost of risk"³. This can be justified by the fact that macroeconomic conditions remain stable and impaired loan ratios remain at their lowest levels (1.8% of loans on average for European banks, according to EBA data at the end of September 2023). While we believe that management's projections of provisions for 2024 are low, they could rise more sharply in the event of a further deterioration in the macroeconomic environment. Nevertheless, we do not expect a significant rise in impaired loan ratios in Europe, which are notably a lagging indicator of unemployment rates in each country concerned.
- ❖ **Pressure on net interest margins.** At a time when banks are finally getting some breathing space after years of negative interest rates (see below in the sector's average RoE in the sector), their net interest margins are already under threat. This is the result of very low production of new loans in view of the rates offered to customers, an ongoing deposit war in several European countries (competition is fierce to offer attractive interest rates that can exceed 3-4% on term deposits) and the disappearance of remuneration on minimum reserves with the ECB since July 2023⁴. These factors are unlikely to improve over 2024, whether in terms of the expected trend in central bank rates (and their slow impact on customer lending rates) or the possible increase in minimum reserves at the ECB.

All the elements described above point to a potential deterioration of banks' fundamentals, which are on a very high qualitative basis. Is this a risk for banking sector bond valuations, and more specifically for AT1 CoCos? We don't think so because:

- (i) **Changes in banking sector fundamentals (profitability, balance sheet health, solvency) have absolutely no correlation with bond spreads;** otherwise, spreads should have tightened in 2022 (and not diverged sharply) and moved in a straight line towards tightening since 2016; and

³ The cost of risk measures a bank's provisioning effort over a given period, compared with its loan portfolio.

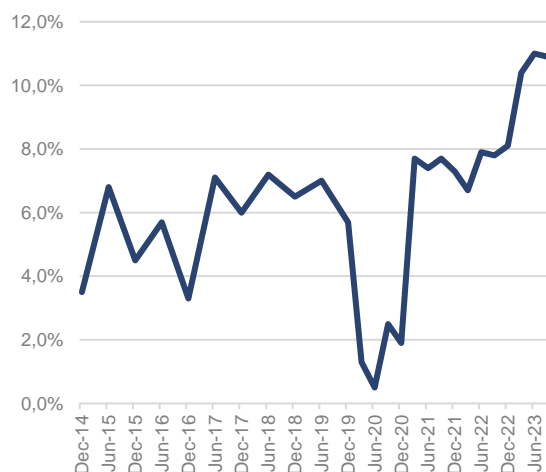
⁴ ECB adjusts remuneration of minimum reserves (europa.eu).

- (ii) **These are primarily issues for shareholders, not bondholders.** In fact, the first line of defense for a deteriorating income statement comes from the reduction in distributions in the form of dividends or share buybacks. It should be borne in mind that the banking sector is heavily administered by the public authorities, which control dividend policy (see total suspension for nine months in 2020 during the Covid-19 crisis) and banks' solvency and liquidity requirements, while also determining their risk policy (in particular credit risk provisions) and lending policy.

This implies that the relative deterioration in year-on-year profitability that we expect to see in 2024 should not constitute a warning signal for creditors, for whom solvency and liquidity ratios should remain very comfortable.

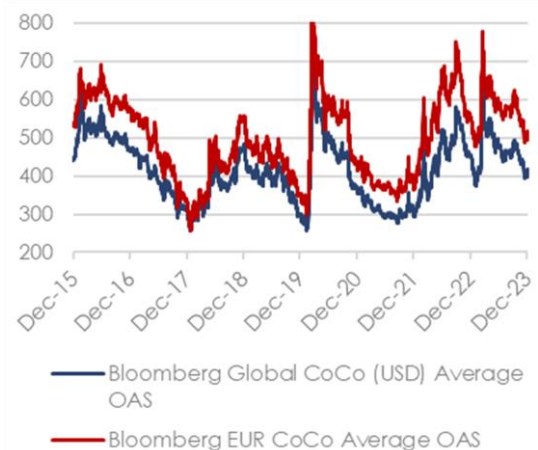
Instead, we are staying away from Swedish AT1 CoCos (which are expensive in relative terms and for which we expect a more marked deterioration in fundamentals) and from German banks with the greatest exposure to US commercial real estate, due to the very deteriorated liquidity of their securities. We like the Spanish and Italian banks, whose fundamentals are the most resilient in this environment, with less pressure on profitability and margins, and which have higher provisions than their continental European counterparts.

Average return on equity for the European banking sector (in %)



Source: European Banking Authority (EBA) risk dashboard, data as at June 2023.

Average spread (OAS) of CoCos in EUR and USD (in bps)



Source: Bloomberg as at 9/1/2024.

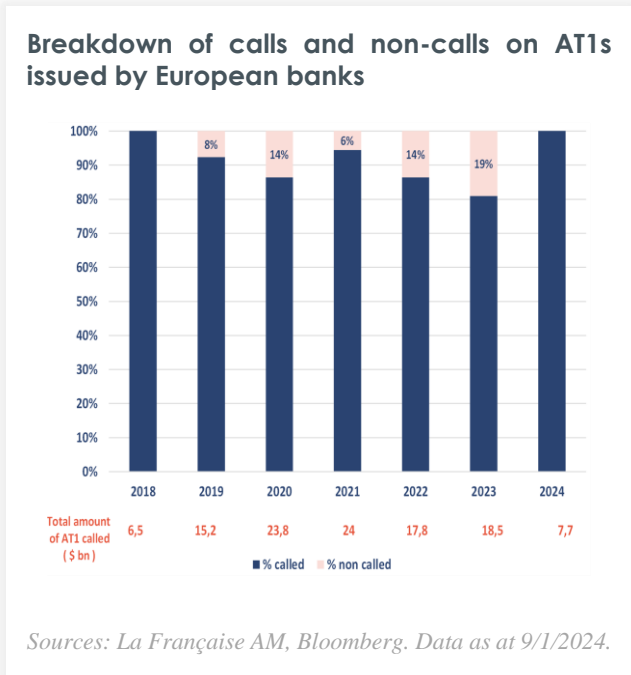
2/ Should we still be afraid of AT1 non-calls?

No, not really. **Non-calls stir up the unconscious and collective memory of investors⁵ much more than the reality of the AT1 CoCos market.** Not because they don't exist, but because they have NO impact on the market as a whole. This was already the case in 2019, when Banco Santander was the first bank not to repay its AT1 CoCo (in the "Basel 3" format); it was again the case in 2023, as we will illustrate, and it will once again be the case in 2024.

Here are all the non-calls in 2023 and the lessons we can learn from them:

⁵It's time to forget the traumatic non-call of Deutsche Bank's Tier 2 in 2008, which I still hear about regularly. We've seen dozens and dozens of non-calls since then!

- (i) **Santander:** the dunce has been at it again, being the first "major" bank not to redeem in 2023 its €5.25% AT1 callable on 29 September 2023, even though it could very well have refinanced it during the summer. Is it due to a lack of foresight or a desire to shave a few basis points off the cost of financing? In any case, the security, which was trading at around 98-99%, was completely unaffected by the announcement of the non-repayment, which becomes callable every three months, with a coupon recalculated at 8.123%. The bond was ultimately redeemed in December 2023, with Santander having carried out two new issues a few weeks earlier in November.
- (ii) **Aareal Bank, Deutsche Pfandbriefbank and Raiffeisen Bank International:** these three banks did not redeem their respective AT1s, but this was widely expected and reflected in bond prices, which were trading at discounts of 10-20 percentage points. These three banks are facing problems with their credit profiles (commercial property for the two German banks and a presence in Russia for Raiffeisen) and the securities of Aareal and RBI had already been the subject of early non-redemptions.
- (iii) **ZKB:** Zurich Cantonal Bank briefly made news on the confidential CHF-denominated AT1 CoCos market, with the non-call of its 2.125% AT1 announced on 31 August 2023, which caused the price of the security to fall by around 4 points, from 98.5% to 94.5% at the time of the announcement, before rebounding to near parity at 99.5% at the end of December 2023. There was no reaction on the € or \$ markets, as this security is essentially reserved for local retail customers.



European AT1 bonds sorted by call date to September 2024

Bond	Cmcy	Coupon	Call date	Called?	Price	Reset spread (bp)	Comment
ACAFP 7.875 PERP	USD	7.875%	23/01/2024	Yes	100,1	490	Refinanced
BCPLP 9.25 PERP	EUR	9.250%	31/01/2024	Yes	100,2	941	
UBS 7 PERP	USD	7,000%	31/01/2024	Yes	100,0	434	Refinanced
SANTAN 7.5 PERP	USD	7,500%	08/02/2024	Yes	100,1	499	Refinanced
SHBASS 6.25 PERP	USD	6,250%	01/03/2024	No	99,8	369	
KBCBB 4.75 PERP	EUR	4,750%	05/03/2024	Yes	100,1	469	Refinanced
BNP 6.625 PERP	USD	6,625%	25/03/2024	No	99,7	415	Refinanced
DANBNK 6.125 PERP	USD	6,125%	28/03/2024	No	99,6	390	
BBVASM 6 PERP	EUR	6,000%	29/03/2024	No	99,9	604	Refinanced
VOWIBA 7.75 PERP	EUR	7,750%	09/04/2024	No	98,3	788	
ERSTBK 6.5 PERP	EUR	6,500%	15/04/2024	No	100,0	620	Refi. + tender
INTNED 6.75 PERP	USD	6,750%	16/04/2024	No	99,5	420	
ISPIM 6.25 PERP	EUR	6,250%	16/05/2024	No	100,2	586	Refi. + tender
LPTY 7.375 PERP	EUR	7,375%	29/05/2024	No	100,3	756	
UCGIM 8 PERP	USD	8,000%	03/06/2024	No	99,8	518	
VMUKLN 9.25 PERP	GBP	9,250%	08/06/2024	No	100,2	831	Refi. + tender
CABKSM 6.75 PERP	EUR	6,750%	13/06/2024	No	100,3	650	Refi + tender
BACR 8 PERP	USD	8,000%	15/06/2024	No	99,3	567	Refinanced
BAMIIM 8.75 PERP	EUR	8,750%	18/06/2024	No	101,4	892	Refi. + tender
SANUK 6.75 PERP	GBP	6,750%	24/06/2024	No	99,7	607	
LLOYDS 7.5 PERP	USD	7,500%	27/06/2024	No	99,3	476	
BAERVX 4.75 PERP	USD	4,750%	12/09/2024	No	93,1	284	
BACR 5.875 PERP	GBP	5,875%	15/09/2024	No	96,4	519	
HSBC 6.375 PERP	USD	6,375%	17/09/2024	No	99,4	371	
SWEDA 5.625 PERP	USD	5,625%	17/09/2024	No	98,2	413	
COVBS 6.875 PERP	GBP	6,875%	18/09/2024	No	97,9	611	
ACAFP 6.875 PERP	USD	6,875%	23/09/2024	No	99,5	432	
NDASS 6.125 PERP	USD	6,125%	23/09/2024	No	99,1	339	

Sources: La Française AM, Bloomberg. Data as at 9/1/2024.

If there is no reason to cry foul at the AT1 non-calls, it is quite simply **because it is the market that decides whether or not an issuer is able to redeem its security early**, by valuing the security essentially on its refinancing assumption (and therefore cost). This is why there is no linear yield or spread curve on AT1 CoCos: they deal for the same issuer almost solely on the

basis of their probability of repayment at a given point in time. This is measured by comparing the spread of the issue with the reset spread used to calculate the new coupon⁶.

To put it crudely, the lower the existing coupon on a security, the lower its probability of redemption, which explains why some bonds are trading at levels with significant structural discounts (e.g.: La Banque Postale €3%, priced between 58% and 75% in 2023 with a first call date in 2028). **AT1 prices therefore primarily reflect investors' obsession with calls, which makes surprise announcements very rare.**

If issuers behave in a friendly manner towards AT1 holders by refinancing their securities well in advance of their redemption date, this tends to have a favourable effect on the issuer's entire curve, or at least on the short end, by fostering investor confidence, which in turn enables the issuer to be able to finance itself at costs comparable to, or even lower than, those of securities in circulation.

This positive feedback loop may have had its limits in highly volatile credit markets, with sudden spread widening, but issuers have found an effective response: **the joint launch of a buyback offer on the soon-to-be-redeemed bond with the issue of the new bond**. This trick enabled second-tier issuers with more difficult access to the primary market to roll over their maturities without a hitch. An emblematic example is Bank of Cyprus, which was able to refinance its 12.25% bond maturing on 19 December 2023 six months early thanks to a buyback offer coupled with a new bond issued with a coupon of 11.875%. Many other banks have done the same on their AT1s, such as Abanca, Erste Bank, Intesa Sanpaolo, CaixaBank, Banco BPM, Virgin Money (see calls table above), and there are several similar operations on Tier 2s.

In conclusion, AT1 calls are not a subject where surprises materialise and upset valuations, since the market constantly evaluates and re-evaluates these assumptions at every moment. In other words, the market makes the calls, the calls don't make the market.

This implies that the supply of new paper is not a real issue either, since AT1 issues today are almost exclusively linked to refinancing. And issuers know how to keep the market moving by offering buybacks in parallel with new issues, which makes for greater stability in valuations on securities close to maturity.

3/ What will drive AT1 performance this year? How do they fit into an allocation?

2022 and 2023 proved highly challenging for bond managers. Moreover, subordinated debt managers also had their fair share of drama with the brief banking crisis of February-March 2023, which reshaped the AT1 universe by wiping out around 7% of the universe with the total depreciation of Credit Suisse securities.

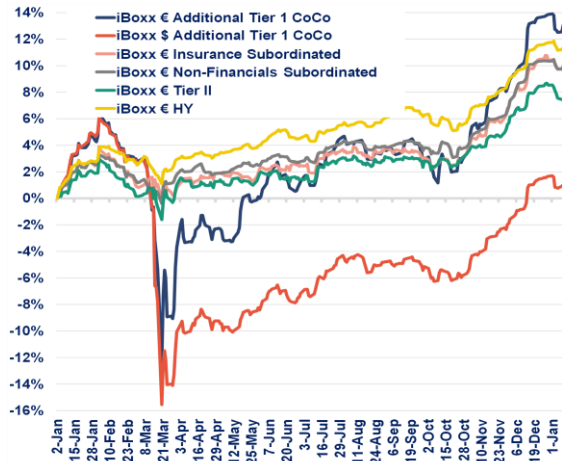
Although the recovery from the collapse of the Swiss bank was immediate and very strong, thanks to the hedge funds which opportunistically picked up a lot of paper, it was mainly driven by the major bond rally in the last quarter of 2023 (see performance graph below). This period of euphoria was marked **by UBS's return to the AT1 primary market**, where demand reached \$36bn for the group's two new issues, with a cumulative amount issued of \$3.5bn. Beyond the symbolism of this transaction, its success has above all highlighted the beginning of **a return to normality for this market segment, with much stronger demand for new transactions and a visibly renewed appetite on the part of more investors.**

However, the start of 2024 encapsulates what credit managers have had to endure for several quarters: highly volatile market sentiment, linked to volatile interest rates and erratic movements in credit indices such as the iTraxx Crossover. Over and above changes in prices and yields, this can be seen in the demand for new AT1 issues over the last few days. Crédit

⁶ As a reminder: new coupon in the event of a non-call = 5-year swap base rate + reset spread. The reset spread is the credit margin at the time of issue and remains the same throughout the life of the security (no step-up possible, prohibited under Basel 3 rules).

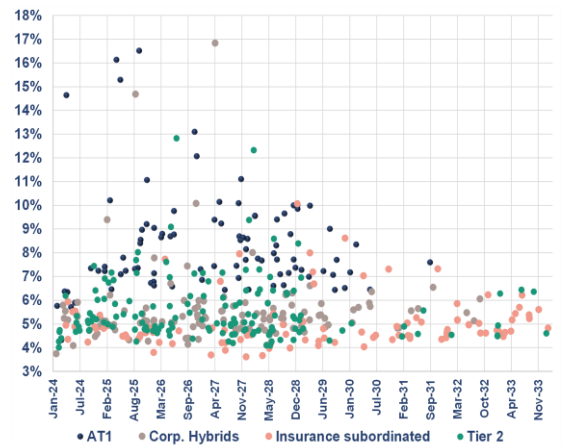
Agricole and CaixaBank reopened the market in the first week of January, but did not attract considerable demand for their new euro-denominated issues, covering only around twice the amounts issued, whereas Italian bank Banca Popolare dell'Emilia Romagna was able to attract six times more demand than it issued (over EUR 3bn of demand for EUR 500m issued) for its inaugural issue, which is never easy for lesser-known domestic banks.

Performance of subordinated debt segments and HY€ since the end of 2022 (in %)



Sources: La Française AM, Markit, Bloomberg. Data as at 9/1/2024.

Mapping of call yields on a selection of subordinated securities by call date and segment (in %)

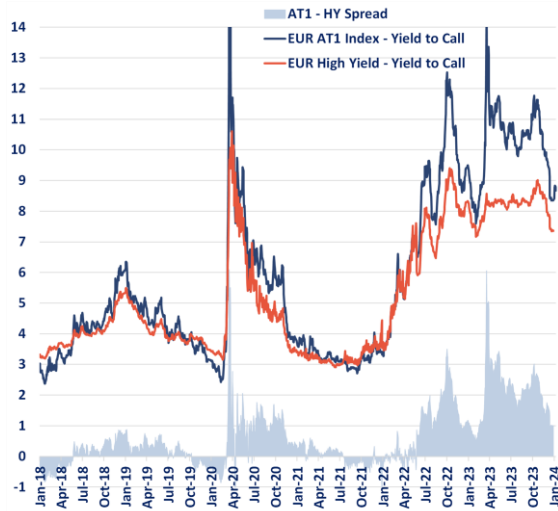


Sources: La Française AM, Bloomberg. Data as at 9/1/2024.

The volatility of rates and returns on the credit markets, while still considerable, has nevertheless fallen significantly over the last six months, which means that we can look forward to 2024 with a little more peace of mind as regards the dynamics of flows in our asset classes. **Average yields at call and maturity (i.e. perpetuity) on AT1 CoCos are still hovering at historically high levels, and they remain at a discount to European High Yield** (see charts below). The case for investing in the asset class in 2024 is therefore still valid, even after the strong performance of Q4 2023, with a substantial carry level despite the tightening of the interest rate base and spread since November 2023.

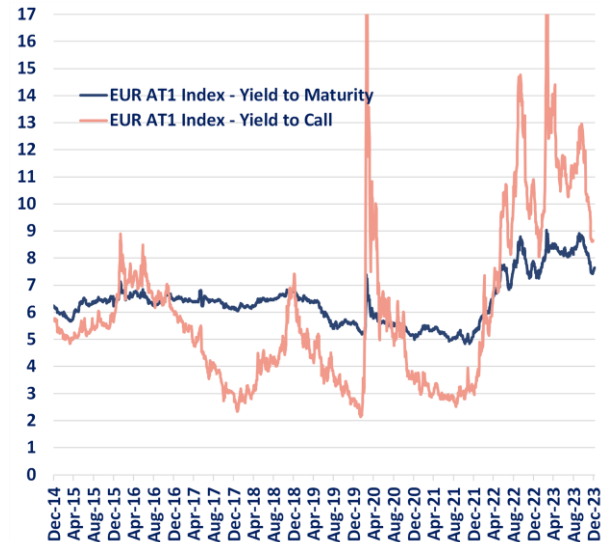
How do you decide when to invest in the asset class? In our view, the answer could be similar to that of an investment in government bonds. AT1s are an area of the market where there are currently few specific/idiosyncratic elements, since the Credit Suisse crisis has been resolved, which means that it can be seen – in simplified terms – as a **leveraged bet on rates**. One might argue that spreads could widen, but the level of embedded carry is sufficient to compensate for this scenario, and spreads in recent years have been correlated mainly to the directionality and volatility of sovereign rates, and not to upheavals in the economic health of issuers.

Evolution of the average call yield of AT1€ and High Yield € (in %)



Sources: La Française AM, Bloomberg. Data as at 9/1/2024.

Average Yield to Call and Average Yield to Maturity (i.e. perpetuity) on AT1€ (in %)



Sources: La Française AM, Bloomberg. Data as at 9/1/2024.

In terms of allocation:

- ❖ We prefer AT1€ to AT1\$ because of a more favourable return adjusted for the cost of hedging currency risk and because the € portfolio is less sensitive to fluctuations in sovereign interest rates.
- ❖ We prefer AT1s with high and medium-high coupons (i.e. above 5%), which may be less convex than those with lower coupons, but are more resilient in bear markets.
- ❖ We are avoiding AT1s issued by issuers with a high exposure to commercial property (Swedish banks and certain German banks).
- ❖ We also like Tier 2 bank bonds as a complement to AT1 CoCos, which offer attractive yields on average and are still at a discount to their redemption value, whether in callable structures to play up their convexity, or in structures with no early redemption, in order to take advantage of interest-rate tightening.

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