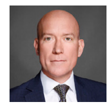
# What Is Next for the AT1 Bond Market?

Credit Suisse write-down does not spell the end of this market.

April 2023



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## KEY INSIGHTS

- With banks facing call dates in the coming months, we expect that AT1 issuance will return. When it does, this will be an important test of confidence in this market.
- Given the significant rise in rates this past year, there is a risk of bond extension by some issuers, however, underscoring the importance of detailed research on a name-by-name basis.
- There is potential for some future regulatory adjustments in Europe, but this is likely a number of years away.

The niche market for additional tier one (AT1) bonds was thrust into the spotlight in March when Swiss regulator Finma ordered the write-down to zero of Credit Suisse's AT1 bonds as part of the company's sale to UBS. This inflicted the largest loss in the history of AT1 bonds, which are a form of contingent convertible security (CoCo) that can be converted into equity if a bank falls below a certain capital limit or is deemed "not viable" by the regulator. The move was particularly controversial because equity holders received some compensation while AT1 bondholders were wiped out.

This decision to upend the traditional capital structure of bondholders ranking above shareholders left the AT1 market reeling and raised concerns that there might be permanent damage. Although it is still too early to say what the full impact will be for AT1 bonds, we believe the market is still viable but faces important tests ahead.

### New Issuance Will Likely Test Market Confidence

It should become clearer whether the market has suffered reputational damage when new issuance returns. According to T. Rowe Price estimates, there are more than EUR 10 billion worth of AT1 bonds with call dates over the remaining three quarters of 2023, and we expect some of these bonds to be called and reissued, particularly those of larger banks. The first few new deals will be closely watched to gauge both the level of demand and the pricing. It is certainly possible that because of Finma's action, AT1 bonds—already regarded as higher risk than other debt—will be considered even risker and that the cost of issuing may therefore rise.

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## CoCo Bonds Recover

(Fig. 1) Global Index of CoCo Bonds Performance since the start of 2022


As of April 10, 2023.

**Past performance is not a reliable indicator of future performance.**

Index = Bloomberg Global Contingent Capital Total Return Index Hedged USD.

Source: Bloomberg Finance L.P.

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Not all firms will look to refinance. Given the significant rise in rates this past year, we believe there is a risk of bond extension, whereby borrowers leave a callable security outstanding. For smaller banks in particular, this decision will come down to the economic cost: If it costs more to reissue than the coupon reset level of an AT1 bond when the call option expires, a bank may decide that it is not economical to redeem and therefore choose to extend the bond's maturity. Whether a bank decides to call or extend the maturity of their AT1 bonds will only be determined on a case-by-case basis, which is why it is important to undertake individual issuer and security analysis.

Some buyers have returned to the secondary market. In the immediate aftermath of Finma's decision, AT1 bonds initially saw sharp declines but have since recovered, albeit not quite to pre-crisis levels. The recovery came after European and UK authorities sought to reassure investors with statements that they would respect the capital structure hierarchy, with common equity instruments being the first ones to absorb losses. It should also be noted that Credit Suisse AT1 bonds were something of an outlier because there was a special provision given for a scenario where regulators could write them down without wiping out equity. The legislation does not allow for that elsewhere, which helped remove the tail risk that AT1s could absorb losses first.

### Regulation Spotlight

Recent developments have provided the first real test of the regulations implemented since the global financial crisis and, broadly speaking, they were shown to work: The Swiss authorities were largely successful in protecting financial stability and limiting contagion risk. As rules are different in the rest of Europe, it is unclear whether European regulators could have achieved the same feat because, under current legislation, a bank would need to be put into resolution before AT1 holders are wiped out. In such a scenario, we believe there is a potential risk of contagion to senior and other types of debt. Against this backdrop, we believe there is a possibility of regulatory adjustments in Europe in the future, although this is likely several years away.

It will probably be a while before the full impact of Finma's decision on the AT1 bond market becomes clear. New issuance is likely to provide a key test of confidence and give insight into how investors now value the instrument, which we believe needs to be closer in line with the cost of equity. Until that returns, we are focused on the secondary market, where there is potentially attractive value in select high-quality AT1 bonds. Although prices have recovered, we still see room for further spread compression and believe that in-depth fundamental research can help filter the most attractive opportunities of this market.

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