EDMOND DE ROTHSCHILD

MARKETING COMMUNICATION

AT1[1] POST (CREDIT SUISSE) MORTEM

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THE AT1 BOND SEGMENT HAS BEEN BACK IN FAVOUR SINCE END 2023, EVEN IF THE LONG-TERM CONSEQUENCES REMAIN UNCERTAIN.

On March 19th, 2023, the decision to write down CHF 16 billion worth of Credit Suisse AT1 instruments was taken by the FINMA as part of the bank's rescue by UBS. Instantly, the CoCo market lost around 7% of its volume at the start of the year and around 13% relative to the sole US$ CoCo market[2]. As the event spread to the rest of the AT1 market, the performance of the ICE BofA CoCo index was down -14.3% at market close on March 20th, after hitting a record high of +6% on February 3rd, 2023[3].

Fast forward to 2024 and the index has enjoyed a sharp rebound, closing at +5.7% at the end of 2023. On March 11th, the index had rebounded +26.4% from its lowest point in March 2023. In relative terms, the CoCo segment remains attractive, particularly thanks to its yield (7.06%) and to a lesser extent to its credit margin (credit premium of 371 bp), although many other bond segments have narrowed further in the meantime.

Very soon after the Credit Suisse crisis, European and British regulatory authorities reaffirmed the role played by AT1s in the capital structure of banks, and the fact it was impossible for shareholders to receive better treatment than bondholders, even junior - statements that contributed to the recovery of the asset class.

Most of all, the primary market is back to full steam, with cumulated issuances of 30 billion (in euro-equivalent) over 2023. First via issuances in Euro from June 2023, and later, in the dollar market from August 2023, including the much-awaited issuance by UBS in November 2023 which received combined orders of around $30 billion - a record[4].

The strength of the primary market is one of the factors behind this improved performance. Most European banks have more or less achieved their target AT1 emission volumes. The ability to issue new first tranches at an acceptable cost is a condition for 'calling' existing instruments. And this working assumption remains valid for investors in 2024: most of the 'calls' should be carried out within the AT1 segment this year, as was the case in 2023, turning the 7.06% yield calculated at the time of the call into an attractive potential performance for investors.

* The fund manager featured in this document may change during the product's life.
1. These complex financial instruments are reserved for sophisticated investors. Access to them is subject to restrictions, and their use requires a thorough understanding of the associated risks. Before making any investment decision, please consult a qualified financial advisor to assess your suitability for this type of instrument.
AT1s (or **Cocos** - contingent convertible securities) are subordinated debt securities issued by credit institutions or insurance or reinsurance companies, eligible in their regulatory capital and which have the specificity of being convertible into shares, or whose nominal value can be reduced (a so-called "write down" mechanism) in the event of the occurrence of a "trigger", previously defined in the prospectus. A Coco includes an option to convert into shares at the issuer's initiative in the event of a deterioration of its financial situation. In addition to the credit and interest rate risk inherent in the bonds, the activation of the conversion option may result in a decrease in the value of the Coco above that of the issuer's other conventional bonds. Depending on the terms of the relevant Coco, certain triggering events may result in a permanent write-down to zero of the principal investment and/or accrued interest or a conversion of the bond into equity.
2. Source : Bloomberg
3. Source : Bloomberg
4. Source : Bloomberg

In this environment, we have observed the return of a broader base of investors, both in terms of type (dedicated CoCo funds, diversified asset managers or private banks) and origin (European demand and renewed risk appetite from Asia or the United States).

HAS EVERYTHING NOW BEEN DIGESTED?

Performance and valuations wise, the segment has indeed normalised.

Holders of Credit Suisse AT1s are currently suing the FINMA, and the proceedings are expected to last several years.

The mid-term regulatory impact is uncertain. Several members of the Basel committee have spoken out, criticising the workings of AT1s and their actual capacity to absorb losses before resolution. Similarly, some market players have continued to advocate stricter rules on the conditions deemed to be “acceptable” for the exercise of calls. However, for the time being, the status quo prevails.

The impact on Swiss AT1 issuers has also been noticeable. UBS’ recent issuances have generated a structural change (introducing an actual conversion into equities, following approval by the AGM in April 2024). The cost at which UBS can issue CoCos has now normalised. It is more difficult to estimate a residual “Swiss” risk premium on the CoCo market, as the country’s second largest issuer, Julius Bear, is a specific case due to its exposure to the Signa group.

It is important to bear in mind that the normalisation of the market stems principally from the very high solvency and liquidity levels enjoyed by banks at this point in the cycle. Higher interest rates have enabled European banks to achieve unseen levels of profitability over the past ten years, as further demonstrated by the Q4 2023 earnings publications. The macroeconomic slowdown - which has been weaker than feared - has maintained the credit quality of assets held on bank balance sheets at satisfactory levels, even if some exposure (commercial real estate - and notably offices, particularly in the US) and several specific issuers with large concentrations within these segments are under high scrutiny.

Finally, turning to the psychological dimension, the ghosts of Silicon Valley Bank and Credit Suisse are still haunting the market, leaving investors mindful that a specific and contained situation can get out of control, as if the slow propagation of the cost of risk called for an immediate capital-based solution.

So yes, everything has been digested.... until the next spate of indigestion....

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