RegCORE Client Alert

Revisiting AT1 bonds and navigating waterfalls going forward

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Financial Services

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QuickTake

Switzerland boasts at least 150 named significant waterfalls, including Europe's largest. Most Swiss waterfalls flow peacefully and in a set direction. Contractual waterfalls are supposed to be contractually clear, certain and navigable in their provisions, in particular as to who gets paid, when and ahead of whom and in what order depending on various trigger events.

As this Client Alert went to publication on 20 March 2023, following the wake of the largest-ever merger in the Swiss banking sector, holders of Additional Tier 1 (**AT1**) bonds around the globe, were assessing how contractual waterfalls were flowing perhaps differently to what they had expected. AT1 bonds have a central role for banks balance sheets as well as for institutional investors who assume the risks involved in these regulatory capital[1] instruments.

This Client Alert recaps some of the salient issues and considerations on AT1 bonds and waterfall considerations, notably in the context of the Banking Union. It also assesses whether there is a further need for supervisory reform of practices as opposed to just focusing on the adequacy of the rules in light of potential shortcomings to conduct early intervention in recently failed banks as well as their holding companies.

[1] In the EU, regulatory capital consists of (a) core capital (**Tier 1**) which, according to the traditional concept of loss absorption, is used on a "**Going Concern**" basis, and (b) supplementary capital (**Tier 2**) to absorb losses in the case of an insolvency (**Gone Concern**). The category of Common Equity Tier 1 (**CET1**) forms most of the Tier 1 capital while Additional Tier 1 (**AT1**) is also eligible, though to a lesser extent. The term Going Concern stems from accounting and is used to distinguish this phase from a Gone Concern scenario where liquidation values apply. In another, albeit similar, meaning, the concept of Going Concern is also used in banking regulation for the purpose of certain capital qualities, and in banking-specific insolvency law to distinguish "business as usual" from "entry into resolution". Even if losses reach the state of 'overall risk', the regulatory minimum capital ratio must be adhered to in a Going Concern phase without triggering insolvency.

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How the EU’s Banking Union authorities have responded

AT1 bonds as well as bail-in generally work, certainly as evidenced in the EU. However, the recent bank failings and the reverberations highlight the risks that can arise for AT1 bondholders as well as other investors more generally when supervisors may not conduct early intervention measures in perhaps as sufficiently of a timely manner as perhaps would have been warranted. This also raises questions for AT1 bondholders and whether they (assuming they had the means to) should have hedged or otherwise managed their exposures earlier.

On 20 March 2023, the European Central Bank (**ECB**), acting in its role at the head of the Banking Union’s Single Supervisory Mechanism (**SSM**), together with the Single Resolution Board (**SRB**) and the European Banking Authority (**EBA**) published a joint press release[2] welcoming the Swiss authorities’ actions to ensure financial stability. The press release reaffirms that the EU’s banking sector is resilient with robust levels of capital and liquidity as well as subject to a proven resolution framework as part of the EU legislative and regulatory instruments making up the “Single Rulebook” along with a clear waterfall setting out the “order according to which shareholders and creditors of a troubled bank should bear losses.” the joint press release goes on to state that:

> “In particular, common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down. This approach has been consistently applied in past cases and will continue to guide the actions of the SRB and ECB banking supervision in crisis interventions.
>
> Additional Tier 1 is and will remain an important component of the capital structure of European banks.”

It remains to be seen whether relevant regulatory and supervisory policymakers will publish further official guidance on contractual waterfalls along with the future evolution of what is a EUR 275 billion plus market in AT1 bonds. Whilst this is a globally active market, issuers are largely concentrated amongst European banks and to a lesser extent insurance firms. In addition to the formal press release above, various policymakers of EU and national-level authorities have reinforced the key messages in the press release in various press interviews.

What is likely, is that EU-27 authorities, both in the Banking Union and beyond, will certainly use this opportunity to step up supervisory scrutiny of regulated firms (regardless of whether they are AT1 issuers or investors therein). This will likely focus on the viability of their business models, resilience of their interest rate risk arrangements along with their recovery and resolution plans as well as what early intervention options might be available when and where in respect of whom.

Some supervisory policymakers may equally use the recent bank failures to remind the regulatory and legislative policymakers and notably politicians of the need to finalise Banking Union structural reforms, notably on the European Deposit Insurance Scheme (**EDIS**) proposal as the missing third pillar, as well as the finalisation of revisions to the EU’s crisis management framework. This priority also raises the need to address the larger issue of structural reform in certain EU-27 Member States. The latter is in particular necessary in order to finalise the ability of the reformed European Stability Mechanism (**ESM**) to act as a “common backstop” to the SRB’s Single Resolution Fund. While the ESM reforms were agreed in 2021, Italy is the only EU-27 Member State that has yet to ratify the reforms which require unilateral EU-27 approval.

Recap on AT1 bonds, what they do and why they matter

In the EU-27 AT1 consists of deeply subordinated debt instruments combined with equity features. To be eligible, issuances must have perpetual maturity (i.e., they have no maturity date and cannot be redeemed) and may only be repaid or repurchased after a minimum of five years after issue, with prior regulatory approval, which is set out in a call option. AT1s normally have a 'non-call' duration of five to ten years, after which investors anticipate i.e., expect the issuer to call and replace the AT1s with a fresh issue.

If the bonds are not called, the coupon resets to a rate equal to the underlying swap rate or government bond. Only the issuer of the AT1 instrument can decide whether to redeem the AT1 instrument or not. AT1 coupon payments are not cumulative and are entirely optional. Missed payments are not incurred as an expense by the bank, and non-payment is not deemed a default or credit event.

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[2] Available here.

The capital amount of AT1 instruments must share losses like CET1 to be eligible. Cancellation of distributions or payments due to a lack of distributable items (**MDA**)[3] must not trigger insolvency. In case a trigger event occurs, the repayment amount and the coupon of the instruments are permanently or temporarily reduced (write-off or write-down bonds), or the instruments are converted into common shares (**CoCos**).[4] This mechanism is automatically triggered if the institution's CET1 capital ratio drops below 5.125 % of the risk weighted assets (**RWA**). At this point AT1 bonds become loss absorbing and AT1 shares are created when, following a trigger event, such as a credit event, the bonds are converted into equity securities i.e., shares or fully written down, depending on the provisions of the individual bond documents.

Banks may specify an individually higher threshold and additional trigger events. Furthermore, the competent resolution authority must have the power to bail-in all instruments which qualify for regulatory capital earlier or to convert them into shares or similar instruments of the institutions and companies. This should be done according to the rationale of Basel III in any case before public funds are provided to the bank. AT1 along with CET1 qualifies for regulatory Going Concern capital, though, however, it does not comprise equity, but debt capital unless the trigger event occurs.

Importantly, AT1 yields can vary widely based on a variety of criteria, including the bank's size, region, and perceived quality, as well as the structure of the AT1 bond itself, although they can frequently offer a premium above all other types of bank debt and corporate bonds with a similar grade.

AT1 bonds and their risks

While not all AT1s are the same, they have entered the mainstream market for institutional investors and have been progressively incorporated in fixed income portfolios around the world. The expectation for many investors is that they would get repaid ahead of shareholders as part of their contractual waterfall but after all types of debt holders and not be written down to zero. AT1 bonds also carry their own instrument-specific risks, both in a Going Concern as well as Gone Concern basis, along with risks that may be inherent to certain types of issues – CoCos as well individual issuers. Such risks were compensated by a sufficiently attractive coupon – certainly for issuances during prevailing low interest rate conditions.

The first most obvious danger is that a bank's capital situation deteriorates to the point that its CET1 ratio falls below the trigger level, resulting in AT1 bondholders either losing their principal totally or retaining equity in a weakly capitalised bank. However, the largest European banks (and thus the largest AT1 issuers) are generally very well capitalised.

Second, banks can choose not to call their AT1 bonds at the conclusion of the non-call term as planned, otherwise known as 'extension risk'. A bank can opt not to call the bonds and keep the capital in perpetuity, which is an equity-like feature of AT1s that makes them higher quality capital from a regulatory standpoint. Banks, like all large bond issuers, rely on their continuous relationships with investors for frequent access to the bond markets; failing to call an AT1 bond as planned would almost surely harm a bank's image with investors and likely result in higher borrowing rates in the future.

Third, regulators have the authority to halt the distribution of AT1 coupons. Regulators can restrict a bank's distributions (including AT1 coupons) under a rule known as the Maximum Distributable Amount, or MDA, if its CET1 capital ratio falls below a certain level, though, as with AT1 trigger levels, European banks generally maintain large buffers above the individual MDA thresholds they are given. At times of stress or when losses are piling up, regulators can also prohibit dividends to trap capital in the banking system as a precautionary tool. Historically, regulators have preferred to prohibit other payments such as share dividends and bonus pools before halting AT1 coupons, as they did in reaction to the COVID pandemic.

Another key regulatory consideration for investors is that a bank's solvency is ultimately determined by its national regulator (or the European Central Bank for EU banks). Whenever a bank becomes seriously insolvent, regulators can (and should as required in the EU legislative and regulatory framework) proclaim a

[3] The MDA is a concept introduced by the EU’s CRD IV. MDA is the amount an institution can and may distribute to its shareholders and its holders of AT 1 instruments or to the beneficiaries of variable remuneration or a discretionary pension. If a bank fails to meet the combined buffer requirement (i.e., Capital conservation buffer/CA, Countercyclical capital buffer/CCyB, G-SII or O-SII buffer and systemic risk buffer) and its capital ratio falls below a certain limit (the MDA trigger point), regulators automatically have to restrict the amount of distributable profits. Pillar 2 guidance is not relevant for the MDA trigger. Article 141 CRD IV sets out the criteria and the formula required for calculating MDA. According to the stacking order clarified by the proposed CRD V, no distribution in connection with CET 1 or payments of variable remuneration or discretionary pension benefits can be made before payment of the sums due on AT 1 instruments.

[4] Some AT1 carry an equity conversion feature, often referred to as CoCo for Contingent Convertible. The important thing to highlight is that all CoCos are AT1, but not all AT1s are CoCos, although investors tend to use the terms interchangeably.

"Point of Non-Viability" (**PONV**) in order to safeguard depositors, stem losses, and prevent contagion. Crucially, AT1 bonds do not grant investors any rights in the PONV process and what follows in respect of the bank's entry into a resolution procedure. Some AT1 bonds are thus effectively write-down bonds. This is why investors must pay close attention to the individual capital requirements set by supervisory authorities for each bank, scrutinise annual stress tests and draw their own conclusions as to appropriate and timely risk management of their own exposures as well as assess the ability and willingness of competent supervisors to take timely action on early intervention measures ahead of trigger of a recovery plan affecting the AT1 issuer, whether this is at the bank holding company level or the actual supervised bank.

Time-bound risks frustrate AT1 bonds

The recent actions of Swiss regulatory policymakers in the context of a government brokered private sector merger and consolidation in the Swiss banking industry has caused the writing down CHF 16 billion worth of AT1 bonds down to zero while, in contrast to the expectation of creditor hierarchy of AT1 bondholders, the equity shareholders received compensation. This may raise fundamental questions for those bondholders but equally for the wider AT 1 market and possible repricing other AT1 issuances in light of "conversion risk" but equally "write-down risk". Most of that detail is in the fine print of the risk factors but equally the AT1's terms and conditions of individual AT1 issuances.

Conversion risk corresponds effectively the default risk. Complete write-downs of AT1 bonds are possible. However, the conversion risk is supposed to be the same for all subordinated debt, and should generally, at least in how the rules were conceived, not be a key focus for investors, at least not more than for other subordinated debt securities. The only example, in the EU-27 certainly of a default of AT1s in this segment prior to the developments 19 March 2023 was Banco Popular Español. That bank was placed under SRB-led resolution using EU rules as available in 2017 (and then bought by Santander). The outcome, a 100% loss, was exactly the same for shareholders, Tier 2 bondholders and AT1 bondholders.

The actions of 19 March 2023, taken by the Swiss authorities, and thus outside of the EU, but with very real impact inside the EU, however, did not follow that path taken in the EU. This is not so much a question of whether the rules work or do not work, but rather whether there were time-bound risks at play. Much will turn on the question of whether the Swiss authorities either (i) took early intervention measures quick enough or whether restructuring and recovery efforts simply ran out of time; and/or (ii) whether the PONV event leading to the write-down should and indeed could have occurred earlier. This then may raise the question of whether the resolution principle of "no creditor worse off" may have been followed as suitably as it could have been done (if at all), in particular if equity shareholders comparably where cushioned when bondholders rightly felt they should have been.

What firms should consider doing now

With regulatory pressures firmly putting banks and other relevant regulated financial services firms under pressure to press forward their regulatory capital positions, in particular in light of a challenging macroeconomic outlook, both market participants and supervisors will want to take a number of steps to shore up confidence in the market and the nature of specific instruments. Financial services firms investing in AT1 bonds should consider:

1. evaluating how AT1 instruments fit into the wider regulatory capital as well as portfolio allocation mix and put in place more intensive monitoring as well as demand for a higher premium for the additional risk(s);

2. mapping how AT1 issuances at holding company level (where issued) and at bank level may differ and otherwise alter contractual waterfalls;

3. reviewing the terms and conditions of the AT1 bonds in their portfolio and scenario plan the ability and willingness of relevant supervisory authorities to take appropriate action in a timely manner in respect of a AT1 issuer and what that means in terms of recovery;

4. assessing greater use of hedging issuer and instrument specific risk across exposures to AT1 bonds and other regulatory capital instruments as well as related financial instrument exposures;

5. analysing what impacts any pressures on AT1 and other adversely impacted financial instrument exposures and losses have in terms of one's own regulatory and market-facing disclosure and reporting obligations; and

6. scenario-planning whether adjustments are required to one’s own resilience, recovery and resolution arrangements as well as robustness of standby-capital and liquidity facilities in light of adverse impacts on portfolios and write-downs.

Outlook

As mentioned above, while the recent wave of bank woes have occurred outside of the EU-27, the relevant EU-27 policymakers and supervisory authorities will want to ensure that they “never let a good crisis go to waste”. Reform is needed as cracks that have emerged have deepened along various risk propagation channels. While the ECB-SSM, SRB and EBA’s press release confirms it will follow the EU Single Rulebook’s established principles on applying creditor hierarchy in waterfalls, some investors may (regrettably) be more cautious about adding AT1 bonds to their portfolios which thus makes it more difficult and costly for banks needing to raise regulatory capital to meet their requirements.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these developments. We have assembled a multi-disciplinary and multijurisdictional team of sector experts to support clients navigate challenges and seize opportunities as well as to proactively engage with their market stakeholders and regulators.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal’s RegCORE Team via de_regcore@pwc.com or our website.

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