

Banks in turmoil

Credit Suisse Group AG

Additional tier 1 bonds: the wiped-out debt at centre of Credit Suisse takeover

Controversy around decision has rippled across the wider \$260bn AT1 market



Holdings of \$17bn of Credit Suisse's additional tier 1 bonds will have their investment wiped out following the bank's takeover by UBS © Fabrice Coffrini/AFP/Getty Images

Thomas Hale in Shanghai YESTERDAY

The sale of Credit Suisse to UBS is the most dramatic moment in global banking since the financial crisis of 2007-08. It has also thrust into the spotlight the reforms that the global financial system has undergone in the past 15 years.

Since the last crisis, regulators have sought to transfer more of the risk of a systemic bank failure away from depositors and on to bondholders. This was seen as a way of strengthening bank balance sheets, and avoiding contagion between banks or the need for taxpayer-funded bailouts.

On the face of it, the [Credit Suisse](#) episode fulfilled that ambition. About \$17bn in Credit Suisse additional tier 1 (AT1) bonds were wiped out as part of the transfer to UBS, essentially reducing the burden on its new owner and hitting investors who knew they had bought risky instruments.

But the controversy around the decision — particularly the fact that bondholders were [treated more harshly](#) than shareholders — has rippled across the wider \$260bn AT1 market. It is the biggest test to date of a regulatory framework that has, until now, been mostly untested.

What are AT1 bonds?

When bond investors lend money to companies, they typically have a claim on the company's assets if it cannot pay back the money. But AT1 bonds, a type of debt issued by banks, are deliberately designed so that investors' claims disappear at times of distress.

Banks must maintain certain so-called capital ratios — a measure of financial health that compares an institution's equity capital with its risk-weighted assets. AT1 bonds are a part of the bank's overall debt that is wiped out when the capital ratio falls below a certain level, automatically strengthening it and benefiting creditors with higher-ranking claims, such as owners of senior debt.

But as well as an automatic trigger, the bonds can also be wiped out by the stroke of a regulator's pen. This is the issue under discussion following the Credit Suisse sale.

Why are some investors angry?

Investors in AT1s, which have no clear maturity but can be called by the issuer, are paid relatively high returns of 6 to 7 per cent to compensate them for the risk of a writedown. In Credit Suisse's case, the returns were even higher: the bank issued an AT1 bond at a yield of 9.75 per cent last year.

Other lenders to the bank, such as senior bondholders or depositors, receive much lower returns but are protected by the existence of AT1s and other bonds that are more exposed in the so-called creditor hierarchy, such as tier 2 debt (regulators require banks to issue various kinds of capital that are ranked by different tiers).

Additional tier 1 bond prices tumble

Invesco AT1 bond ETF net asset value (\$)



Source: Bloomberg
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Even riskier than AT1s, according to the conventional understanding, is equity. Investors in equity can make much greater returns than 6 to 7 per cent if the bank performs well, but they stand to be wiped out if it performs badly or becomes worthless (which, in simple terms, would mean that the bank's assets are not worth more than its liabilities, and so its net assets are zero).

However, shareholders were not wiped out as part of the Credit Suisse sale to UBS. This, in the words of some investors, appeared to be an “obvious breach of the hierarchy of claims” — a widespread sense that AT1 would be in the line of fire after equity.

Has this happened before?

Alongside requirements to issue loss-absorbing debt, regulators have also increased the power of so-called resolution authorities to make critical decisions regarding the fate of an institution at times of distress.

There are so far very few precedents. The most significant is the failure of Spain's Banco Popular in 2017. In that case, the equity was wiped out as well as the AT1 bonds. It is worth noting that in that instance, bondholders also complained of foul play and pursued unsuccessful [legal action](#) against the regulator.

In this case, it is unclear whether aggrieved bondholders might have more success. The bonds' documentation states that Finma, the Swiss authority, "may not be required to follow any order of priority, which means, among other things, that the notes could be cancelled in whole or in part prior to the cancellation of any or all of CSG's equity capital".

Simon Adamson, at CreditSights, noted that the Credit Suisse AT1 bonds also included a clause that they could be written down in a "viability event", which can include a situation where the bank has received "an irrevocable commitment of extraordinary support from the Public Sector".

UBS has received some backstops from the Swiss government as part of its [rescue of Credit Suisse](#), though Adamson suggested this was "stretching the intended meaning".

What are the wider implications?

The principle reflected in AT1 bonds — that bond investors should bear the risk of failure — is also applied in another part of the bank bond market. Globally systemically important banks have also needed to meet requirements to increase their total loss-absorbing capacity (TLAC). In simple terms, this means that more of their liabilities will be designed to take losses in a crisis.

While the AT1 market is about \$260bn in total, the world's biggest banks were issuing \$350bn to \$400bn of TLAC debt annually in the three years to 2019, according to the Financial Stability Board, a global regulatory body. This market is therefore much larger, and a much more significant backstop if the health of the banking system were to deteriorate more than it already has in recent weeks.

It is also a market that relies heavily on regulatory decision-making in times of crisis. The debate around the Credit Suisse AT1 debt is likely to have important implications on that front.

Finally, one unexpected consequence of the invention of the AT1 market was the impact of its volatility on sentiment. In 2016, Deutsche Bank came under repeated pressure in markets because of the falling price of its AT1 debt. The bonds, which can, like equity, trade in ways not always clearly related to underlying fundamentals, have the capacity to become a crude proxy for the health of a bank. While they stand to protect against the risk of a depositor run, they may fuel the risk of other kinds of panic within financial markets themselves.

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The global banking system has been rocked by the collapse of Silicon Valley Bank and Signature Bank and the last-minute rescue of Credit Suisse by UBS. Check out the latest analysis and comment [here](#)

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