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CMBI Credit Commentary

European AT1 Top Picks: BACR 6 ⅛ PERP, BACR 4 ⅜ PERP and INTNED 3 ⅞ PERP

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Executive summary

- European AT1s offer higher YTC compared with those of similarly-rated Asian AT1s. This partly reflects the technical of European AT1s is not as strong as that of Asian AT1s. The Asian AT1 space has been in net redemption over the past 2 years and local investors have a "stronger home bias". Besides, the higher YTC of European AT1s, in our view, partly reflects European banks' track records of non-call and cancellation of distribution. The write-down of Credit Suisse AT1s ahead of its common equity is the most recent example.

- Nonetheless, we see selected European AT1s offering decent risk-return profiles. We focus on issues from European banks with good cushions from PONV. Meanwhile, we prefer issues from regulatory regimes in which common equity will absorb losses ahead of AT1s, i.e. issues in the Eurozone and the UK rather than those in Switzerland. We also prefer AT1s with loss absorption through equity conversion, instead of permanent write-down in case the loss absorption is triggered.

- Our top picks in European AT1 space are **BACR 6 ⅛ PERP**, **BACR 4 ⅜ PERP** and **INTNED 3 ⅞ PERP** in view of these AT1s' more superior risk-return profile, yield pick-up over their respective senior bonds and lower cash prices. Despite the relatively low reset rates compared with their more recent issues, we acknowledge BARC and INTNED's track records of calling AT1s on the first call dates, as well as their comfortable CET1 ratios and limited exposure to the commercial real estates in the US and Chinese properties.

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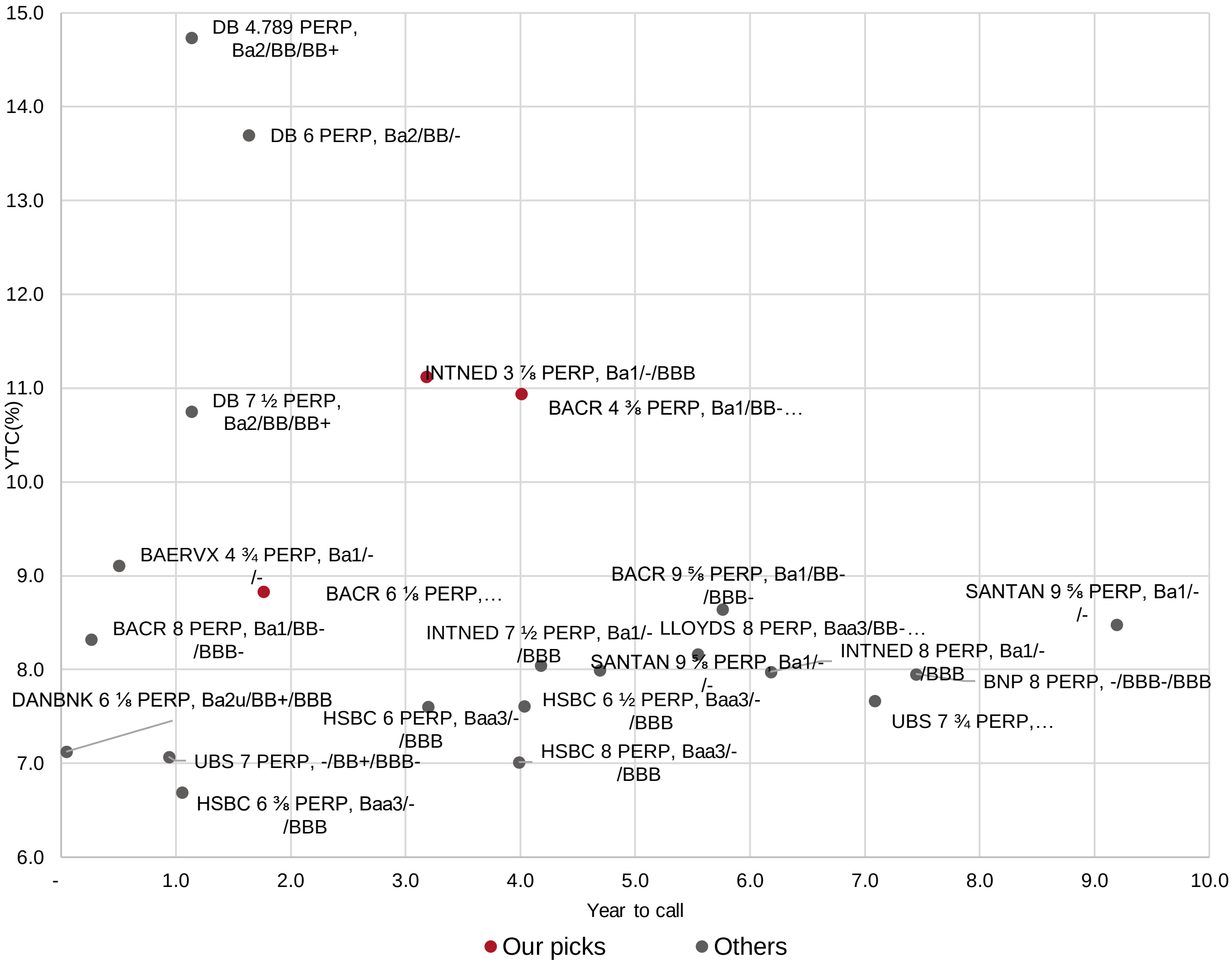
Table 1: Picked European AT1

Security Name	o/s amt (USD mn)	Next call date	Coupon reset	YTC (%)	Price	Trigger type	Loss absorption
BACR 6 ⅛ PERP	1,500	15/12/2025	H15T5Y+5.867	8.8	95.6	Mechanical	Equity Conversion
BACR 4 ⅜ PERP	1,500	15/3/2028	H15T5Y+3.410	10.9	78.9	Mechanical	Equity Conversion
INTNED 3 ⅞ PERP	1,000	16/5/2027	H15T5Y+2.862	11.1	81.0	Mechanical	Equity Conversion

Source: Bloomberg.

Chart 1: Yield comparison of European AT1 with active trades



Source: Bloomberg.

Top picks: BACR 6 ⅛ PERP, BACR 4 ⅜ PERP and INTNED 3 ⅞ PERP

European AT1s offer higher YTC compared with those of similarly rated Asian AT1s, partly reflecting that the technical of European AT1s is not as strong as that of Asian AT1s. To illustrate, the Asian AT1 space has been under net redemption over the past 2 years. The net redemption trend of Asian AT1 has been in line with that of the overall Asia ex JP USD bond market amid the availability of the lower-cost onshore funding alternatives and stronger USD. Asia-based investors, especially China-based investors, continue to be "home-bias", focusing on issues from China and other Asian countries. The demand for Asian bank papers including AT1s is even more notable as Asian investors continue to chase "quality" Asian papers including AT1s given the "investable" space in Asia has been shrinking.

On the other hand, the higher YTC of European AT1, in our view, partly reflects European banks' track records of non-call and cancellation of distribution. The write-down of Credit Suisse AT1s ahead of its common equity is the most recent example.

Nonetheless, we see selected European AT1s offering decent risk-return profiles. We focus on issues from European banks with good cushions from PONV, such that the risk of non-call and distribution cancellation is lower.

In terms of regulatory regime, we prefer regimes in which common equity will absorb losses ahead of AT1s, i.e. issues in the Eurozone and the UK rather than those in Switzerland.

In terms of structure, we prefer AT1s with loss absorption through equity conversion, instead of permanent write-down in case the loss absorption is triggered.

Under these backdrops, our top picks in the European AT1 space are **BACR 6 ⅛ PERP**, **BACR 4 ⅜ PERP** and **INTNED 3 ⅞ PERP**. Despite the relatively low reset rates compared with those of their more recent issues, we expect BARC and INTNED to call these AT1s on the first call dates given their comfortable CET1 ratios and their track records of calling AT1s on the first call dates. These track records help maintaining good access to capital markets and lower funding costs.

Additionally, these AT1s offer more superior risk-return profiles with decent YTC, yield pick-up over their respective senior bonds and lower cash prices. At 95.6 and 78.9, BACR 6 ⅛ PERP and BACR 4 ⅜ PERP were traded at YTC of 8.8% and 10.9%, respectively. INTNED 3 ⅞ PERP was traded at 81.0 with 11.1% YTM. Our picks also offer decent yield pick-up over their respective senior unsecured bonds (See Charts 2). As at 8 Mar'24, the yield differential of BACR 6 ⅛ PERP, BACR 4 ⅜ PERP and INTNED 3 ⅞ PERP are 323bps, 561bps and 571bps.

Table 2: Comparisons of selected European banks AT1s

Security Name	o/s amount (USD mn)	Region	Bond rating (M/S/F)	Next call date	Year to call	YTC (%)	Price	Capital Trigger Type	Loss absorption
BACR 4 ⅜ PERP	1,500	UK	Ba1/BB-/BBB-	15/3/2028	4.0	10.9	78.9	Mechanical	Equity Conversion
BACR 6 ⅛ PERP	1,500	UK	Ba1/BB-/BBB-	15/12/2025	1.8	8.8	95.6	Mechanical	Equity Conversion
BACR 8 PERP	2,000	UK	Ba1/BB-/BBB-	15/3/2029	5.0	8.3	98.7	Mechanical	Equity Conversion
BACR 8 PERP	2,000	UK	Ba1/BB-/BBB-	15/6/2024	0.3	8.3	98.7	Mechanical	Equity Conversion
BACR 9 ⅝ PERP	1,750	UK	Ba1/BB-/BBB-	15/12/2029	5.8	8.6	104.4	Mechanical	Equity Conversion
BNP 8 PERP	1,500	FR	-/BBB-/BBB	22/8/2031	7.5	8.0	100.3	Mechanical	Equity Conversion
HSBC 6 ⅜ PERP	2,450	UK	Baa3/-/BBB	30/3/2025	1.1	6.7	99.7	Mechanical	Equity Conversion
HSBC 6 ½ PERP	1,800	UK	Baa3/-/BBB	23/3/2028	4.1	7.6	96.2	Mechanical	Equity Conversion
HSBC 6 PERP	3,000	UK	Baa3/-/BBB	22/5/2027	3.2	7.6	95.5	Mechanical	Equity Conversion
HSBC 8 PERP	2,000	UK	Baa3/-/BBB	7/3/2028	4.0	7.0	103.4	Mechanical	Equity Conversion
INTNED 3 ⅞ PERP	1,000	NL	Ba1/-/BBB	16/5/2027	3.2	11.1	81.0	Mechanical	Equity Conversion
INTNED 7 ½ PERP	1,000	NL	Ba1/-/BBB	16/5/2028	4.2	8.0	98.1	Mechanical	Equity Conversion
INTNED 8 PERP	1,250	NL	Ba1/-/BBB	16/5/2030	6.2	8.0	100.1	Mechanical	Equity Conversion
UBS 7 ¾ PERP	1,000	CH	Baa3/BB/BBB-	12/4/2031	7.1	7.7	100.5	Mechanical	Permanent Write Down
UBS 7 PERP	1,250	CH	-/BB+/BBB-	19/2/2025	1.0	7.1	99.9	Mechanical	Permanent Write Down

Source: Bloomberg.

Chart 2: Yields differentials of picked AT1 with senior bonds

Source: Bloomberg.

Regulatory regimes in Europe at a glance

As of Feb'24, 21 Eurozone countries including Germany, France, Netherland, etc. participate in Single Supervisory Mechanism (SSM), a system of banking supervision in Europe. Under SSM, European Central Bank (ECB) directly supervise 113 significant banks of the participating countries and indirectly supervise less significant banks which are under supervision of their national supervisors. The 113 significant banks hold c82% of banking assets in the 21 participating countries. Currently, c99.7% (by o/s amount) outstanding USD AT1s from Eurozone countries are issued by significant banks which are under supervision of ECB.

The UK and Switzerland are not part of European Union and also the Eurozone, the banks of these two countries are under supervision of Bank of England (BOE) and Swiss Financial Market Supervisory Authority (FINMA), respectively.

Loss absorption in Eurozone, the UK and Switzerland is mechanical and will be triggered if bank's CET1 ratio is lower than threshold or bank is at point of non-viability. The trigger is stricter than some Asian regions such as Hong Kong, Singapore and Indonesia that the loss absorption in these regions is discretionary subject to local regulators' decisions.

The prominent difference of loss absorption in these three regions is the order of loss absorption. In Switzerland, AT1s are designed to be written down or converted into Common Equity Tier 1 capital before the equity capital of the bank concerned is completely used up or written down. In Mar'23, FINMA instructed Credit Suisse to write down its 13 AT1s totaled cUSD17bn before imposing full losses on its equity. In response to FINMA's move, ECB and Bank of England explicitly clarified that common equity is prior to AT1 in absorbing losses within their scope of supervision. We consider the likelihood of Eurozone and UK AT1s to absorb losses is lower than that of Swiss AT1s given different regulatory regimes.

Besides, the regulators in the UK and Switzerland allow AT1s to have dividend stopper clauses, which make AT1s in the UK and Switzerland to be more investor-friendly than Eurozone countries' regulation.

Table 3: Comparison of loss absorption triggers

	Eurozone	The UK	Switzerland
Supervisor	European Central Bank	Bank of England	Swiss Financial Market Supervisory Authority
Loss absorption classification	Mechanical	Mechanical	Mechanical
Loss absorption order	Common equity instruments are the first ones to absorb losses, and only after their full use would AT1 be required to be written down	CET1 prior to AT1 to absorb losses	AT1 can absorb losses before Common equity capital is completely used up or written down
PONV trigger	The point at which the relevant authority determines that the institution meets the conditions for resolution or the point at which the authority decides that the institution would cease to be viable if those capital instruments were not written down or converted.	The Bank of England or PRA determines the point of non-viability for such purposes as the point at which the relevant institution meets the conditions for resolution or will no longer be viable unless the relevant capital instruments are written down or extraordinary public support is provided and without such support the appropriate authority determines that the institution would no longer be viable.	PONV is triggered when there are reasonable grounds for suspecting that a bank is over-indebted or experiencing serious liquidity problems or when it fails to meet its capital adequacy requirements (8% total capital or 5% CET1) within a deadline set by FINMA. FINMA has certain discretion in determining whether or not the trigger is hit.
CET1 ratio trigger	5.125%	below 5.125%, or a level higher than 5.125% if specified in the terms of the instrument	5%
Dividend stopper	No	Yes	Yes

Source: ECB, BOE, FINMA.

Track records of loss absorption and non-call of European AT1s

Table 4: Loss absorption and non-call event in European

Year	Ticker	Bank	Country	Incident	Principal amount	Bond	Background
2017	SANTAN	Banco Popular Español, S.A.	Spain	Write-down	EUR750mn	SANTAN 8.25 PERP XS1189104356	ECB deemed the bank "failing or likely to fail" based on the deterioration in its liquidity position and deemed Banco Popular at the Point of Non Viability (PONV). Banco Popular was acquired by Banco Santander and its two outstanding AT1 securities were written down to zero.
2017	NDB	BremerLB	Germany	Coupon skip	EUR150mn	NDB Float PERP DE000BRL00A4 NDB 9.5 PERP DE000BRL00B2	NDB recorded loss due to its exposure to weak shipping industry
2019	SANTAN	Banco Santander	Spain	Non-call on first call date of 12 Mar'19	EUR1.5bn	SANTAN 5.481 PERP XS1043535092	The coupon reset to 5.481 from 6.25 on first call date, then AT1 was called on 12 Mar'20
2020	DB	Deutsche Bank AG	Germany	Non-call on first call date of 30 Apr'20	USD1.25bn	DB 4.789 PERP XS1071551474	To avoid high cost refinancing
2020	LLOYDS	Lloyds Banking Group	The UK	Non-call on first call date of 27 Jun'20	EUR750mn	LLOYDS 4.947 PERP XS1043545059	To maintain Tier 1 capital resources during Covid-19
2023	CS	Credit Suisse	Switzerland	Write-down	USD17bn	13 AT1s including: USH3698DBW32 CS 5.25 PERP XS0989394589 CS 7.5 PERP	CS received extraordinary support from the Public Sector and triggered point of non-viability event
2023	PBBGR	Deutsche Pfandbriefbank	Germany	Non-call on first call date of 28 Apr'23	EUR300mn	PBBGR 8.474 PERP XS1808862657	To avoid high cost refinancing under weak market condition
2023	SANTAN	Banco Santander	Spain	Non-call on first call date of 9 Sep'23	EUR1bn	SANTAN 8.1232 PERP XS1692931121	To maintain AT1 capital and save funding cost while the perp was called in Dec'23 after issuance of EUR2.5bn two AT1 with 9.625 coupon

Source: Bloomberg.

CS AT1 write-down

The write-down of Credit Suisse's (CS) 13 AT1s totaled cCHF16bn (cUSD17bn) is the largest AT1 write-down in Europe. CS was performing below market expectation and experiencing outflows of client funds for years. In Mar'23, CS was affected by turbulence of US banking market and the risk of being illiquid increased. Despite having required CET1 capital and solvency, CS was instructed by FINMA to be merged by UBS to prevent risks diffusion. The transaction was supported by Swiss Confederation and Swiss National Bank with additional liquidity supports via guaranteed loans. The extraordinary government support triggered point of non-viability (PONV) and following write-down of CS's AT1s. Based on Swiss regulation of AT1, FINMA instructed CS to fully write-off its outstanding cUSD17bn AT1s before completely using up its equity.

Non-calls of European AT1s

European countries broadly implemented Basel III in 2014 and issuance of AT1 with PNC5 tenor significantly increased since then.

Funding cost is the principal consideration when European banks weigh call option of AT1 on first call date. In 2019, Banco Santander chose not to call EUR1.5bn SANTAN 6.25 PERP with fixed coupon reset of 5.481% on first call date of 12 Mar'19 for economic perspective. In Mar'20, Banco Santander called the Perp on second call date of 12 Mar'20 after issuance of cheaper EUR1.5bn SANTAN 4.375 PERP in Jan'20.

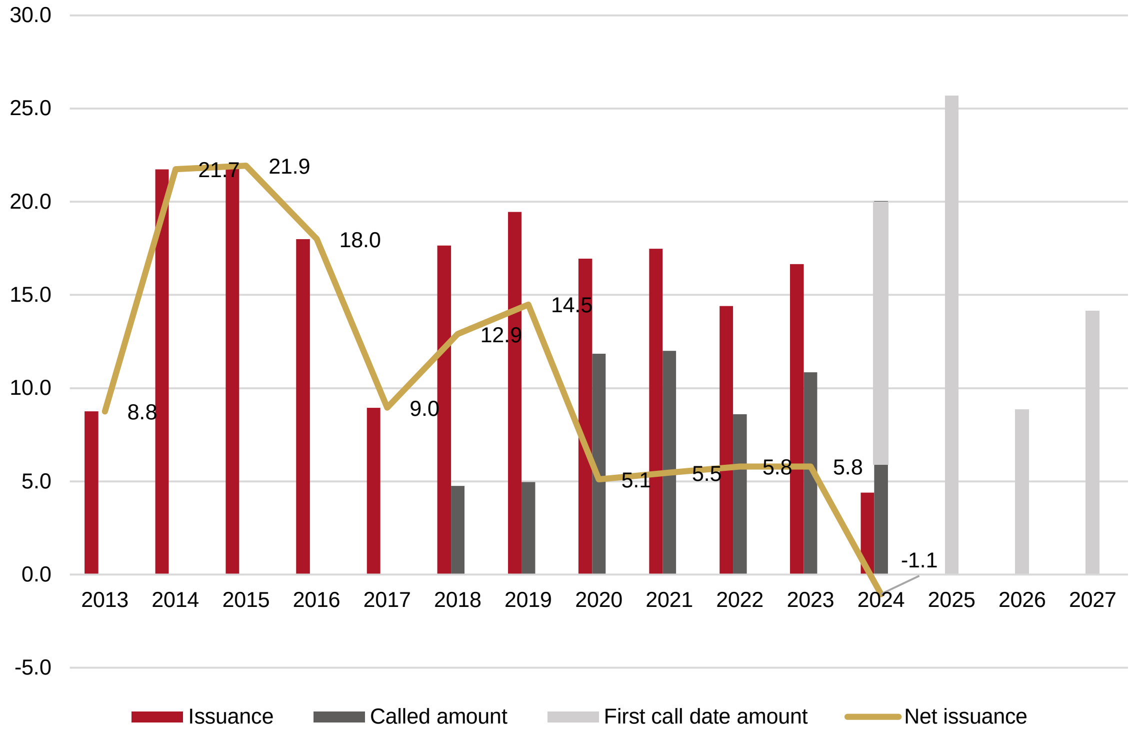
In 2020, Deutsche Bank chose not to call DB 4.789 PERP on first call date of 30 Apr'20 as the issuer viewed refinancing cost was high after issuance of another USD AT1 in Feb'20 at 6% coupon. Currently, DB 4.789 PERP remains outstanding given the higher USD rates condition. In 2023, another Germany bank Deutsche Pfandbriefbank elected not to call its only AT1 PBBGR 8.474 PERP which was issued in Apr'18 on first call date to avoid high refinancing cost.

On the other hand, European banks tend not to call AT1 to maintain abundant capital buffer amid volatile market. In 2020, Lloyds Banking Group of the UK elected not to call EUR750mn LLOYDS 4.947 PERP on first call date of 27 Jun'20 to maintain Tier 1 capital after Covid-19 pandemic outbreak in Europe. In 2023, Banco Santander did not call EUR1bn SANTAN 8.1232 PERP on first call date of 9 Sep'23 to maintain Tier 1 capital. In Dec'23 the Perp was called after issuance of EUR2.5bn 9.625% AT1.

The European AT1 market

European AT1 issuance overview

Chart 3: European USD AT1 issuance



Source: Bloomberg.

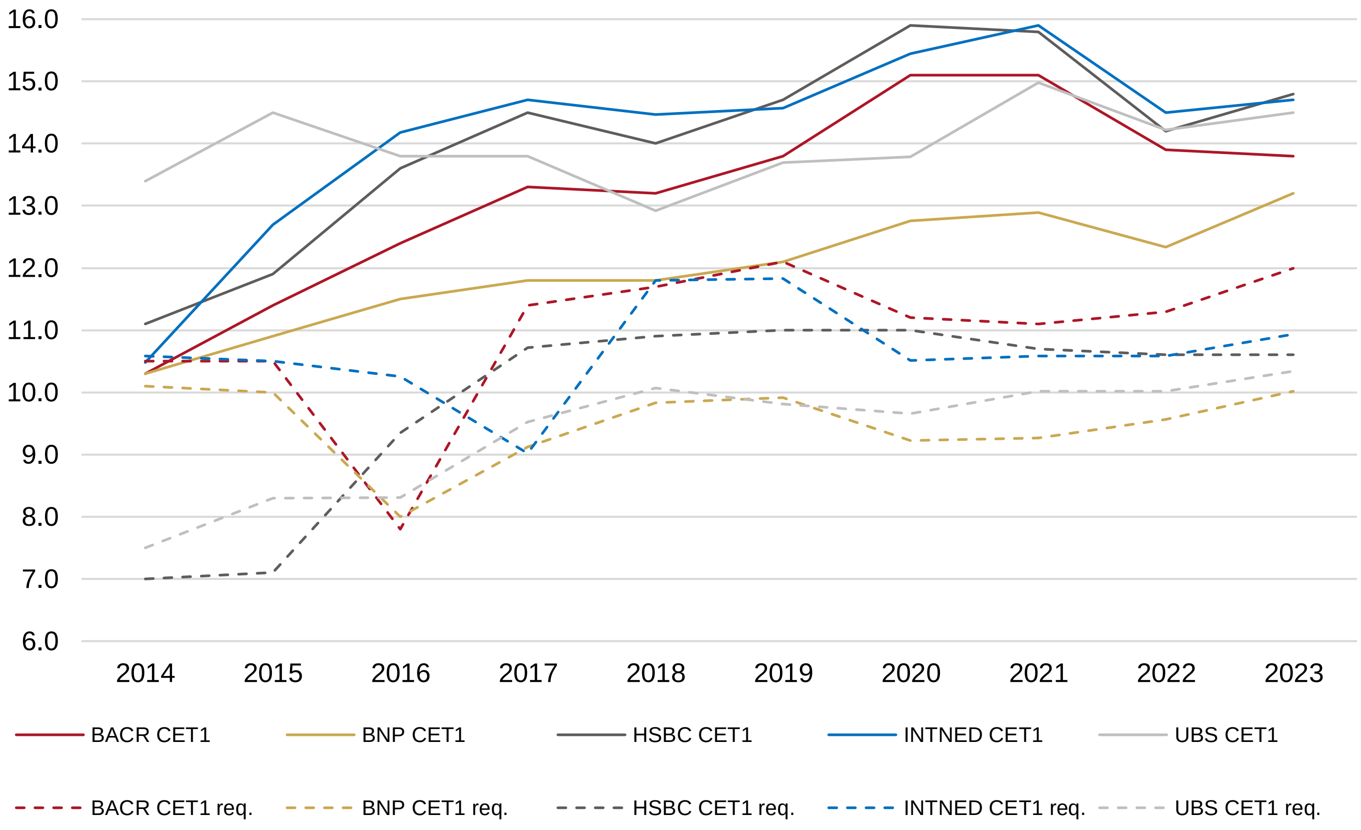
Since the Third Basel Accord (Basel III) was finalized in 2013, there were cUSD186bn USD AT1s issued in Europe. Eurozone (USD73.1bn), the UK (USD59.9bn) and Switzerland (USD39.5bn) were the regions with largest issuance amount. Within Eurozone, banks from France, Netherlands and Spain are the issuers with most AT1 offerings of USD38.8bn, USD11.1bn and USD10.7bn, respectively.

As of 8 Mar'24, the outstanding amount of European AT1s is cUSD111.2bn. The major issuers from Eurozone countries, the UK and Switzerland, accounting for 47%, 33% and 13% of the outstanding amount, respectively. There are cUSD20bn European USD AT1 with first call date in 2024 and cUSD14.6bn have yet been called. In 2M24, the new issuance amount of European USD AT1 was USD4.4bn, higher than USD1.5bn in 2M23. In view of the significantly higher amount of AT1s subject to call over the coming years and growing RWA, we expect the USD AT1 issuance from European banks to increase.

Stricter capital requirements for European G-SIBs

HSBC, BNP, UBS, BACR and INTEND are European Global Systemically Important Banks (G-SIBs) and also the top 5 European banks with most outstanding USD AT1s. Compared with Asian authorities, European regulators set stricter capital requirements to these G-SIBs. As of 2023, the required CET1 ratios for the five banks ranged 10%-12%, higher than those of Asian G-SIBs, e.g. 9% for BCHINA, ICBC in China and 8% for MIZUHO, SUMIBK in Japan. As of Dec'23, the buffers between selected banks' CET1 and regulatory requirements ranged 1.8%-4.2%.

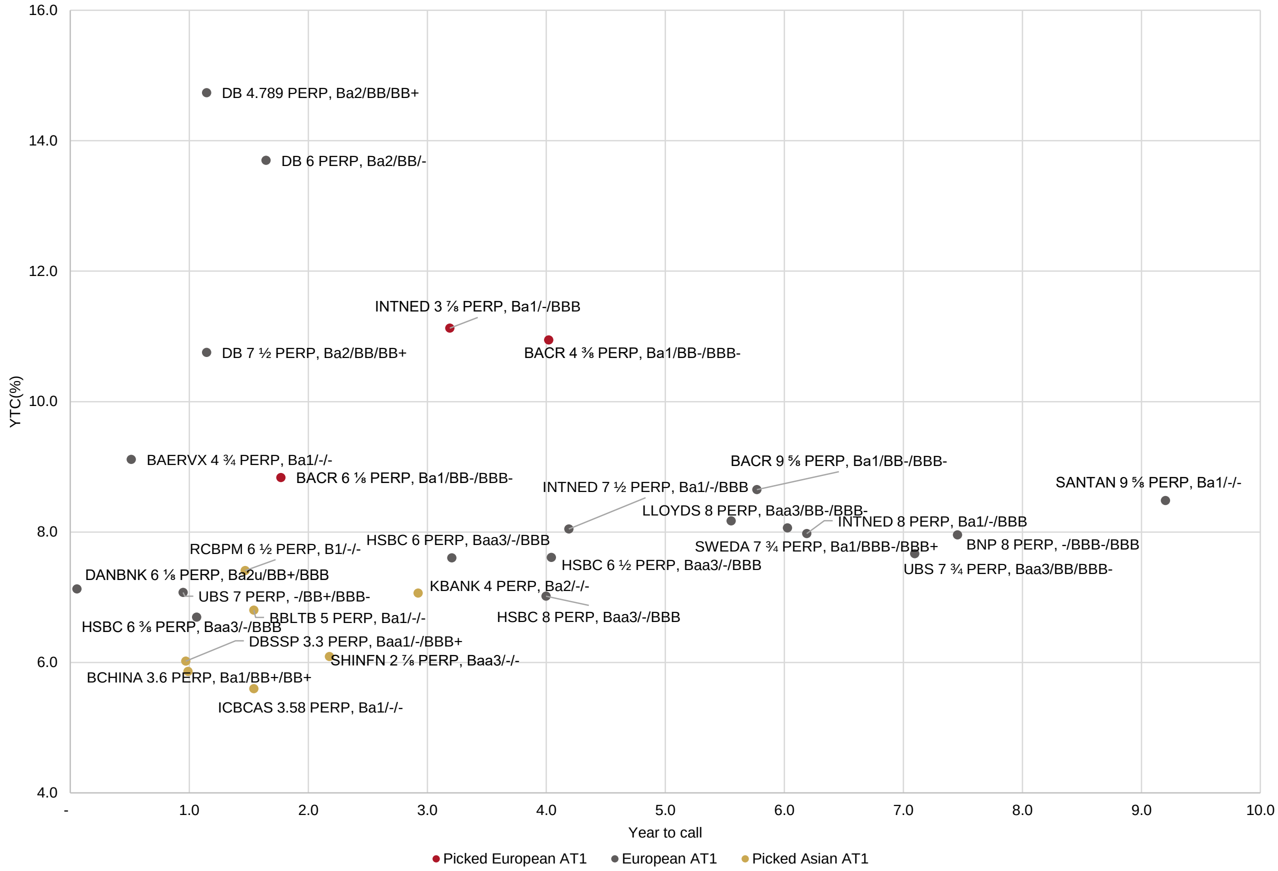
Chart 4: CET1 and requirements of BACR, BNP, HSBC, INTNED and UBS



Source: Companies' fillings.

Comparison between Asian and European AT1s

Chart 5: Yield comparison of European AT1 and our picked Asian AT1s



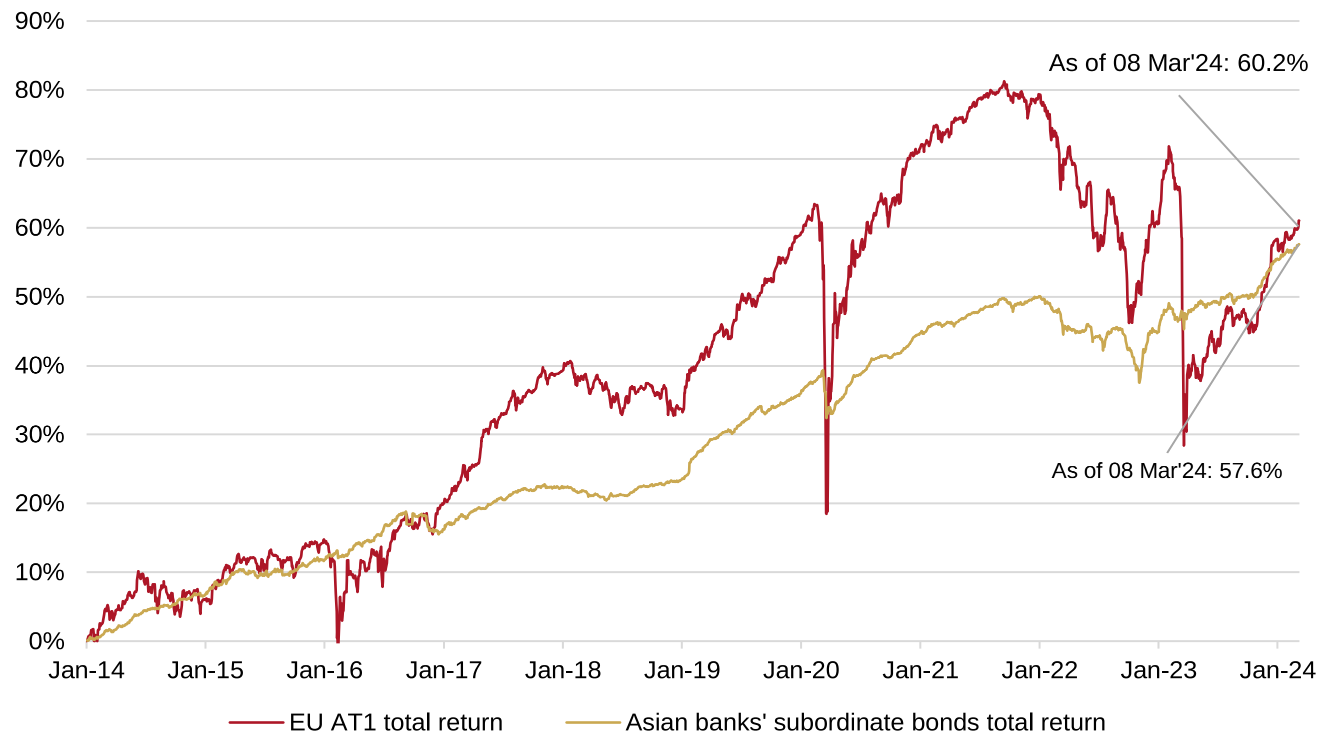
Source: Bloomberg.

Table 5: Comparison of picked European AT1 and picked Asian AT1s

Security Name	o/s amount (USD mn)	Region	Bond rating	Next call date	Year to call	YTC (%)	Price	Capital Trigger Type	Loss absorption
BACR 6 ⅛ PERP	1500	UK	Ba1/BB-/BBB-	15/12/2025	1.8	8.8	95.6	Mechanical	Equity Conversion
BACR 4 ⅜ PERP	1500	UK	Ba1/BB-/BBB-	15/3/2028	4.1	10.9	78.9	Mechanical	Equity Conversion
INTNED 3 ⅞ PERP	1000	NL	Ba1/-/BBB	16/5/2027	3.2	11.1	81.0	Mechanical	Equity Conversion
BCHINA 3.6 PERP	2820	CN	Ba1/BB+/BB+	4/3/2025	1.0	5.9	97.9	Mechanical	Equity Conversion
DBSSP 3.3 PERP	1000	SG	Baa1/-/BBB+	27/2/2025	1.0	6.0	97.5	Discretionary	Permanent Write Down
KBANK 4 PERP	350	TH	Ba2/-/-	10/2/2027	3.0	7.1	92.1	Discretionary	Permanent Write Down
ICBCAS 3.58 PERP	2900	CN	Ba1/-/-	23/9/2025	1.6	5.6	97.1	Discretionary	Equity Conversion
RCBPM 6 ½ PERP	300	PH	B1/-/-	27/8/2025	1.5	7.4	98.8	Discretionary	Permanent Write Down
BBLTB 5 PERP	750	TH	Ba1/-/-	23/9/2025	1.6	6.8	97.4	Discretionary	Permanent Write Down
SHINFN 2 ⅞ PERP	500	KR	Baa3/-/-	12/5/2026	2.2	6.1	93.6	Discretionary	Permanent Write Down

Source: Bloomberg.

Chart 6: Total return of developed European USD AT1s and Asian banks' USD subordinate bonds



Source: Bloomberg, Markit iBoxx.

According to iBoxx, the total return of European USD AT1s was c60.2% from Jan'14 to 8 Mar'24, representing a compound annual return of c4.8% in past 10 years. Compared with Asian banks' subordinate bonds total return of 57.6% in the same period, equivalents a compound annual return of c4.7% over the same period. European USD AT1s had provided slightly higher return although the sector is susceptible to idiosyncratic risk (i.e. concerns of non-call or loss absorption) and the resulting spill-over. For example, DB's unexpected loss of cEUR6.8bn in Jan'16, its announcement of not calling DB 4.789 PERP of USD1.25bn on first call date (30 Apr'20) in Mar'20 after the outbreak of COVID-19 in early 2020, and the panic caused by write-down of Credit Suisse's AT1s in Mar'23.

A closer look at selected European banks

Sustainable profitability of selected banks

The selected five G-SIBs (HSBC, BNP, UBS, BACR and INTEND) have stable operating profiles over the past few years with largely stable profitability and consistent dividend payout. The probability for loss absorption for their AT1s to be triggered to be low in the medium term given their adequate capital buffers and sustainable profitability.

Table 6: CET1 and trigger level of BACR, BNP, HSBC, INTNED and UBS

%	AT1 CET1 trigger level	Required CET1	Dec'23 CET1
BACR	7.0	12.0	13.8
BNP	5.125	10.0	13.2
HSBC	7.0	10.6	14.8
INTNED	7.0	10.9	14.7
UBS	7.0	10.3	14.5

Source: Companies' fillings.

Chart 7: NIM of selected banks (%)

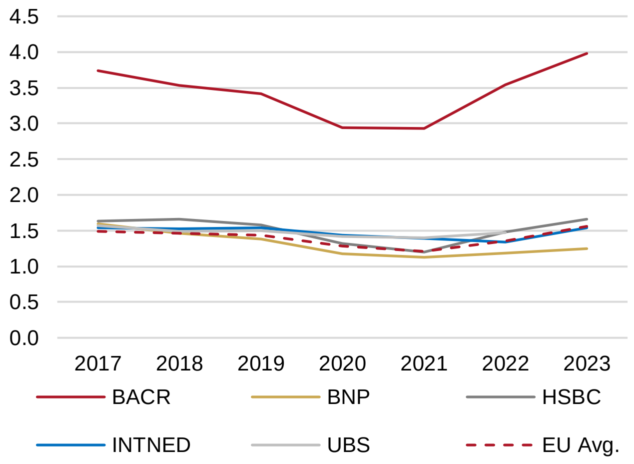
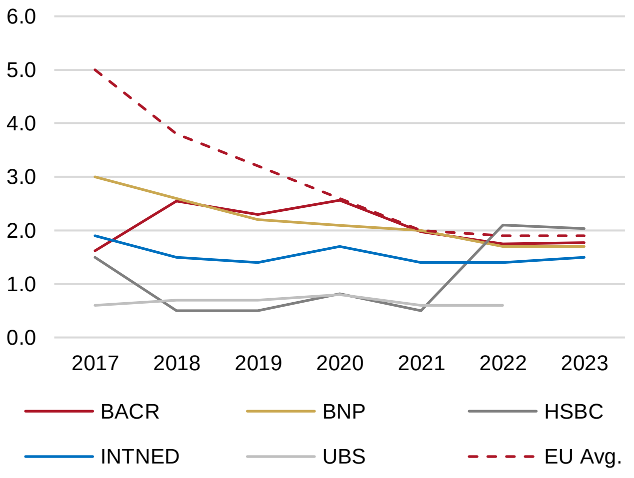


Chart 8: NPL of selected banks (%)



Source: Bloomberg, ECB.

Chart 9: Dividend payout ratio of the banks (%)

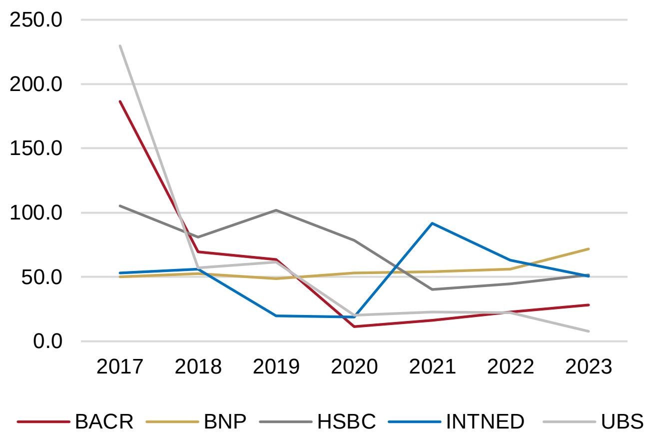
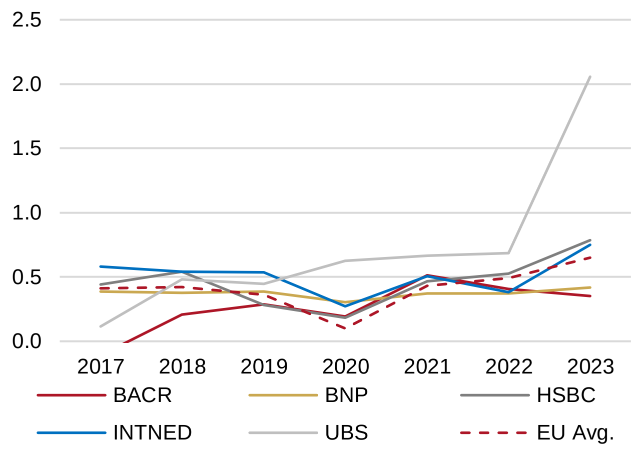


Chart 10: ROA of selected banks (%)



Source: Bloomberg, ECB.

Limited exposure to US CRE and Chinese properties

Table 7: Selected banks' exposures to US CRE and China property as of Dec'23

% of total loan	US CRE	Chinese properties
BACR	CRE loans were cUSD20bn, 4.54% of total loans. Loans to US CRE were less than cUSD10bn while loans to China were minimal.	
BNP	0.06%, cUSD1.2bn	0.08%, cUSD1.6bn (Asia exposure)
HSBC	0.42%,cUSD3.9bn	2.50%, cUSD23.5bn
INTNED	0.36%, cUSD3.9bn	0.34%, cEUR2.6bn (China exposure)
UBS	Not disclosed. As of Sep'23, stage 3 loans from real estate sector were USD23mn, c0.004% of total loans.	

Source: Company fillings.

As shown in Table 7, the exposure of our selected banks to the US commercial real estate (CRE) market and Chinese property market is well contained. Amongst them, BARC has the largest exposure to the US CRE market but we take comfort from the weighted average LTV of these loans is 49% with additionally protection through significant risk transfer (SRT). Out of these 5 banks, HSBC has the largest exposure to the Chinese property sector given its more Asia-focused operations but the total exposure is contained. Taking cues from 75% coverage ratio for impaired and unsecured exposure to Chinese commercial real estate sector, we expect that HSBC has adequately provided against the exposure to the Chinese property sector.

BACR and INTNED: Low risk of non-call and distribution cancellation

BACR and INTNED would have sufficient capital buffers against loss absorption trigger and regulatory threshold. As of Dec'23, CET1 ratios of BACR and INTNED are 13.8% and 14.7%, compared with regulatory requirements of 12% and 10.9%, respectively. On the other hand, both banks have stable profitability and consistent dividend payout in recent years. We consider the likelihood of non-call or distribution cancellation for these two banks to be low. Recalled that BACR and INTNED have no track record of non-call or distribution cancellation. As discussed before, despite the relatively low reset rates of our picks compared with those of their more recent issues, we expect BARC and INTNED to call these AT1s on their first call dates as the consistent call and distribution track records help maintain the good access to capital markets and lower funding costs.

Table 8: Credit metrics of our picks

	Barclays	ING Bank
Credit ratings (M/S/F)		
Issuer rating	Baa1/BBB+/A	Baa1/A-/A+
Outlook	Stable	Stable
Senior unsecured rating	Baa1/BBB+/A	Baa1/A-/A+
AT1 rating	Ba1/BB-/BBB-	Ba1/-/BBB
2023 Key credit metrics		
ROA	0.35%	0.75%
ROE	7.57%	14.41%
Net interest margin (NIM)	3.98%	1.54%
CET 1 ratio	13.80%	14.70%
Tier 1 ratio	17.70%	16.9%
Total capital ratio	20.10%	19.80%
NPL ratio	1.77%	1.50%
Loan-to-deposit ratio	75.21%	99.65%

Source: Bloomberg, Companies' fillings.

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