The Frontier Line

Hybrid securities part 2:

Global capital securities – it’s the little differences

Issue 207 | April 2023

Frontier Advisors | Forefront Thinking

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on around $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Andrew Kemp

Senior Consultant

Andrew Kemp joined Frontier Advisors in 2016 as a Senior Consultant before being promoted to Principal Consultant in 2018. He is the head of the Debt and Currency Team, leading Frontier's fixed income and currency research program. Andrew has around twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK.

Andrew was Head of Fixed Income at DBS Asset Management (Singapore) for three years and prior to that spent a decade as Fixed Income Portfolio Manager at Alliance Bernstein Australia.

Andrew joins Frontier from Chimaera Capital, where he was the Director of Asset Management, most recently in Melbourne, but chiefly in the Capital Management division in Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.

Madeline Chelper

Senior Consultant

Madeline Chelper is a Senior Consultant at Frontier Advisors and is a member of Frontier's Debt and Currency Team. In addition, she has consulting responsibilities for clients within the superannuation sector. Madeline originally joined Frontier in 2016 and later transferred to Frontier's UK-based Global Investment Research Alliance partner, Lane Clark & Peacock. Madeline spent almost three years with the firm, providing consulting advice to UK-based defined contribution pension schemes and performing investment and manager research, before re-joining Frontier in October 2021.

Prior to Frontier, Madeline was a Financial Analyst at K2 Asset Management, after beginning her professional career in Audit at KPMG Melbourne, focusing on clients in the consumer and industrial, and financial services industries. Madeline holds a Bachelor of Commerce (Accounting and Finance) from The University of Melbourne and a Master of Applied Finance (Investment Management) from Kaplan Professional and is a Chartered Accountant.

Regulators and securities provisions questioned in Additional Tier 1 markets

Global capital securities (similar in nature to Australian hybrids) have had a bright light shone upon them in the wake of the arranged marriage of UBS and Credit Suisse (CS), where investors in certain classes of securities lost their capital. Scrutiny by investors around the various provisions as to whether a security can be 'written down' or otherwise impacted beyond typical market risk, has become an area of investor concern over the last month.

This should be a wake-up call for investors to know the risks in their portfolio, yet it remains unclear if the CS case is somewhat unique or something more systemic is unfolding. Either way, the events in March highlight the nuances of these types of assets issued in the global capital securities market.

In December 2022, we published our first research piece on Australian hybrid securities and these securities can share similar features to global capital securities. In part two, we expand the universe and consider the global landscape for these securities, including if it has become compromised by recent events and look at how the market has reacted.

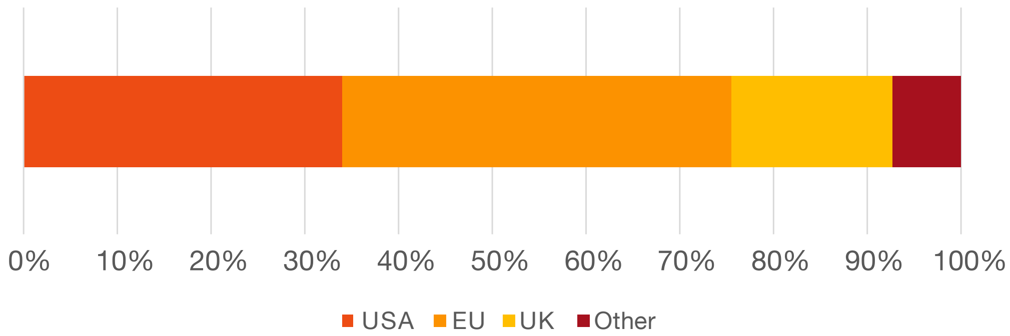
Capital securities go by different guises across global markets. Whether it is Additional Tier 1 (AT1) bonds, contingent convertibles (CoCos), hybrids, preferred shares or perpetuals, it's the little differences investors must be across to avoid losses. Despite recent volatility, this is a market that remains highly important to the capital structure of the world's banks and likely presents some compelling tactical opportunities for institutional investors.

What are global capital securities?

Often known in Australia as hybrid securities, global capital securities are a type of financial instrument combining elements of both debt and equity. These securities can have a fixed or floating rate coupon, or both, depending on how they are structured. They are issued by various types of entities, including financial institutions and some corporations. Generally, in the event of insolvency these securities sit above equities but below senior debt in the capital structure. They tend to offer a higher level of return to compensate for this risk.

Some of these securities can be converted to equity on a contingent basis (known as CoCos), i.e. in a recapitalisation scenario, while others have temporary or permanent write down features. These features are similar to default risk, but in some cases, there can be zero recovery value like the situation for the CS AT1 bondholders. Much of the global AT1 market is comprised of European financial issuers, who issue securities in major currencies such as GBP, USD, and EUR. US banks typically issue different forms of preferred shares.

Chart 1: Regional composition of global capital security issuance by market capitalisation



Source: Frontier Advisors, Bentham, ICE BofA, Bloomberg. Proportions representative of bottom-up aggregation of issuer country domicile across ICE BofA Contingent Capital, Preferred and Hybrid indices as at March 2023.

Global capital securities are an important funding source and capital adequacy tool for issuers. They provide issuers with non-dilutive capital from a diversified funding base which can be especially beneficial for entities with limited access to particular markets. Securities can be tailored and therefore provide balance sheet efficiency by optimising the mix of debt and equity financing. Basel III regulations also impose various regulatory capital limits on banks for which capital securities are useful for risk management to manage and maintain certain levels of capital as a buffer against potential losses. Capital securities are higher risk and return credit instruments and accordingly have a number of unique facets which require consideration.

What are some of the features that increase the risks in capital securities?

Complexity

Capital securities often have complex structures making them difficult to understand and evaluate for investors, which can lead to poor decision-making.

Subordination

Capital securities are subordinate to senior debt holders in the issuer's capital structure and therefore investors carry a greater level of risk in the event of default.

Interest rate sensitivity

Capital securities with fixed interest payments, such as perpetual bonds or preferred shares, are sensitive to changes in interest rates.

Convertibility

Some capital securities, such as convertible bonds or convertible preferred shares, have equity conversion features that allow the investor to convert the security into shares of the issuer's common stock. This introduces equity risk into the investment.

Event risk

Capital securities may be subject to write down provisions under certain 'viability event' conditions. For example, if a bank experiences financial difficulty or breaches certain capital levels.

Callability

Some capital securities may have a call feature, which allows the issuer to redeem the security before maturity. As a result, the investor may not be able to earn the expected return on their investment if the security is called before maturity.

We consider some of these risks in the context of CS's AT1 bonds in the next section.

Frontier Advisors

The AT1 market gets tested again

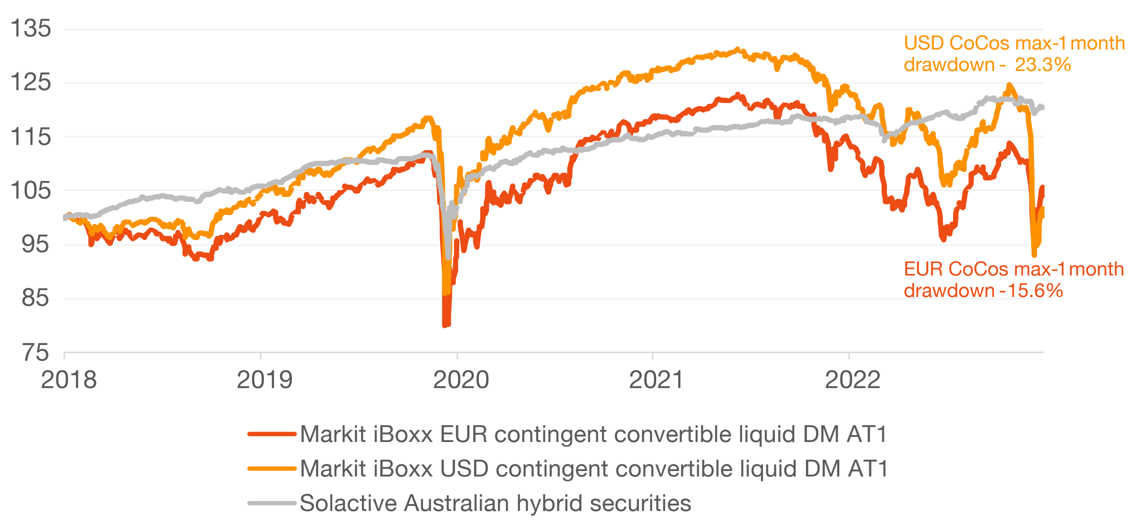
The AT1 market has weathered a range of idiosyncratic events and shocks over the years, particularly in European banking sector, and the market has been tested again in the CS case. In the wake of the Silicon Valley Bank (SVB) collapse, volatility was elevated in global banking securities markets. Perhaps this prompted action by the Swiss regulator on 19 March 2023, as Switzerland announced an emergency rescue of CS, which led to the takeover by UBS. As part of the deal, Switzerland's financial regulator, FINMA, confirmed over A$20 billion of the lender's AT1 bonds would be written down to zero, while common equity shareholders would receive some financial compensation.

The decision to prioritise shareholders over AT1 bondholders rattled investors around the globe, prompting an immediate slump in prices for these securities. According to FINMA, the AT1 bonds in question contained explicit contractual language that they would be "completely written down in a 'viability event', in particular if extraordinary government support is granted". This allowed the regulator to prioritise shareholders ahead of AT1 bondholders. This contractual language is sometimes observed and can introduce asymmetry to the return profile of AT1 securities (as the most active AT1 issuers are systemically important banks potentially eligible for government support). The CS case highlights the importance of active management and robust credit underwriting, as many of CS' issues predated the recent government intervention.

The market impacts

Chart 2 shows the typical reference indices for AT1/CoCos indices versus Australian hybrids; comprised of Australian and offshore banks, denominated in USD, EUR and AUD respectively. The chart highlights the sharp price correction of USD and EUR denominated AT1 bonds following the write-down of CS AT1s in mid-March 2023. By comparison, AUD denominated AT1s have been largely unaffected by recent events. The outsized moves in global markets versus Australia have been stark and reflect uncertainty over future actions of offshore banking regulators, less confidence in the credit quality of offshore bank issuers and the different offshore investor base. Australia's market has a broad retail investor base therefore it is an area ASIC is evaluating because it relates to regulations around distribution of these securities. We discussed this in our paper, The case for Australian hybrids - Part 1.

Chart 2: Comparing relative index performance for AT1 securities by market



Source: Frontier Advisors, Bloomberg.

A black eye for global banking regulators?

Shortly after the UBS/CS deal was announced, other large market regulators began to distance themselves from the decision, fearful of its impact on the ability of banks to raise capital in the future. The Swiss intervention was designed to stabilise its financial markets and was perhaps well intentioned, but the global fallout has been far from stable. In the US, the federal and state-based regulators overseeing the collapse of SVB and other regional banks also face a challenging period given the source of that volatility came from asset versus liability mismatches, which should be within the purview of a regulator's remit. Other regulators sought to clarify their positions and to calm market nerves:

- **Bank of England**

  The BOE statement welcomed the actions taken by the Swiss authorities in its attempt to ensure financial stability. It also reassured investors of the capital strength of the UK banking system. The BoE referenced its resolution framework, which has a statutory order in which shareholders and creditors bear losses in a resolution or insolvency scenario. This approach was applied in the recent resolution of SVB UK.

- **Single Resolution Board, European Bank Authority and ECB Banking Supervision**

  Similarly, the joint statement issued by the above European entities welcomed the set of actions taken by the Swiss authorities to ensure financial stability. It also reassured investors of the resilience of the European banking sector and reiterated the order in which investors should bear the losses of a troubled bank, noting common equity instruments are the first to absorb losses, and only after their full use would AT1 bonds be written down.

- **Hong Kong Monetary Authority and Monetary Authority of Singapore**

  Both central banks noted they would retain the traditional hierarchy of creditor claims if a bank was to collapse in their respective jurisdictions.

Losing capital in the absence of a default makes investors wary

Whether the CS case was an idiosyncratic issue or more systemic to the asset class remains an open question. Markets whilst calmer, remain somewhat depressed in offshore geographies. CS held sufficient Tier 1 capital yet it was deemed not viable by its banking regulator. Perhaps broader system wide factors were considered prompting a swift resolution. Its balance sheet had deteriorated over time and was plagued by a number of controversies which had adversely impacted the firm's reputation and investor confidence. The financial health of CS has been brought into the spotlight on several occasions and in early March 2023, the bank delayed the release of its 2022 annual report following questioning from the US Securities and Exchange Commission regarding previous revisions made to its cash flow statements in 2019 and 2020.

The dramatic sell off in prices across the offshore market and the tepid bounce seen as the dust settled suggests investors are considering if the structure of these securities is impaired going forward. It is likely there will be a reset on certain types of provisions particularly in new deals, and perhaps a more bifurcated pricing structure in existing deals where various clauses in documents remain in force.

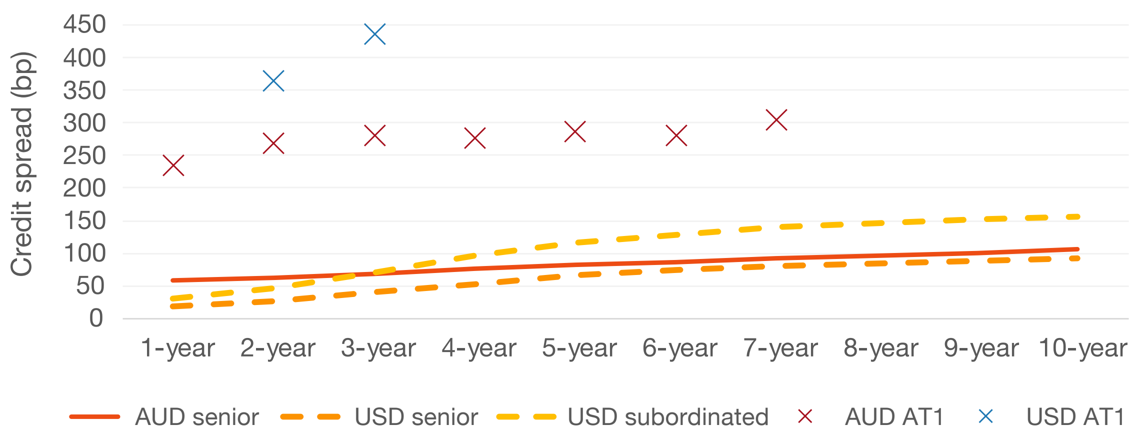
> It is likely there will be compelling opportunities for institutional investors who are active and have the necessary tolerance for complexity within the credit allocations of the portfolio.

Frontier Advisors

The impact on Australian bank AT1s trading offshore was significant but calmer now

At the time of writing this paper, USD denominated pricing for Australian AT1 securities trading in offshore markets offered better entry levels than locally with Australian domestic bank balance sheets in good shape. Some recovery in prices has been noteable in recent weeks. Furthermore, in addition to relevant documentation being explicit on conversion and AT1s ranking ahead of common equity, regulators are unlikely to be called on to adjudicate in the first instance given the capital adequacy of domestic banks.

Chart 3: Relative major Australian bank spreads by level of credit subordination



Source: Frontier Advisors, Bloomberg. Credit curves represent the median spread of CBA, WBC, ANZ, NAB and Macquarie as at March 2023. USD credit curves are represented by credit default swaps.

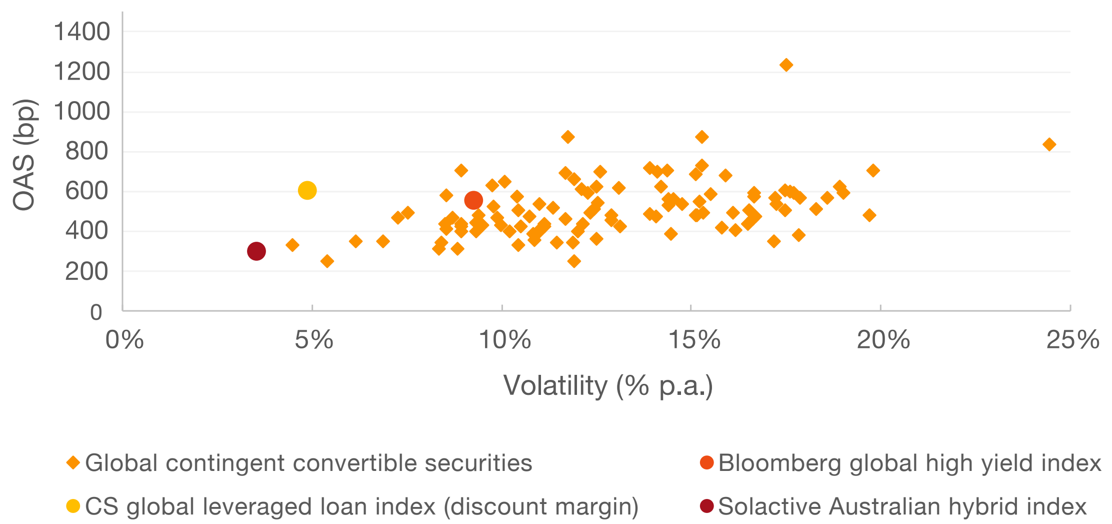
Frontier Advisors

Measuring the risk and return potential for global capital securities

Investors are attracted to global capital securities for the income potential (versus Australia and on an outright basis). Deal sizes tend to be large (>$1billion) which provide a level of liquidity, particularly relative to smaller corporate credit deal sizes. Assessing how these securities compare to other markets given their subordination and additional complexity remains a fluid discipline. Most securities are rated by major agencies and although sub-investment grade (typically ratings are ~BBB/BB) are technically deemed to be higher quality than leveraged finance markets, such as loans and high yield bonds, periods like March appear to refute that claim. While the perceived credit quality and default potential is currently being called into question, we highlight how these securities compare verus other sub asset classes across the debt spectrum.

In lieu of recent events, modest yield enhancement is available; commensurate with higher levels of price volatility and equity correlation. Dispersion exists between individual capital securities however, with yield enhancement (relative to other leveraged finance markets) dependent upon both issuer capital structure and degree of subordination. This is well suited to active credit managers with the ability to compare relative valuations across the entire capital structure.

Chart 4: Relative spreads across global capital securities can be widely dispersed



Source: Frontier Advisors, ICE BofA, Bloomberg. Volatility calculated using three-year lookback as at March 2023.

The final word

Investor confidence in AT1s has been shaken by recent events. A continued risk premium repricing remains following the CS deal, as the uncertainty around deal structures keeps spreads wide. There are undoubtedly lessons for investors in understanding the finer details of risk exposures across this complex segment of the market.

Should the elevated risk premium remain, the higher costs could lead to a more segmented market, where the largest and strongest banks have access to the market, while some weaker or lower rated banks may struggle to access this market given prohibitive costs.

Active management by professional investors is recommended in this segment. Yet whether the CS AT1 write-down was a forecastable credit risk remains difficult to ascertain. Its business was certainly challenged on a number of fronts in recent years and therefore put at odds with other global bank peers which have been building capital buffers following the GFC.

The premise for investing in any subordinated exposure (including AT1) is one that relies heavily on the financial strength of the issuer in question. CS was a deteriorating credit, yet it may have survived without regulatory intervention, we'll never know. Without question, the scrutiny of AT1 issuance will remain elevated and it is likely spreads may be slow to revert to normal in some areas. For Australian investors however, our banks are unquestionably strong, and this means the 'sell all' mantra in this segment has likely created some compelling opportunities for those willing to do the credit legwork.

Want to learn more?

If you want to learn more about global capital securities, we can help. Please reach out to your consultant or a member of the Debt and Currency Team.

Frontier Advisors

Frontier Advisors

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266