Convertible Bonds Commentary

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Credit missed with Credit Suisse?

Paolo Angeles, Yield Book Product Management; Luke Lu, Yield Book Research

Following the dramatic demise of SVB and Signature Bank in the US, the banking turmoil quickly spread to Europe and took down Credit Suisse, which was forced to merge with its domestic rival UBS by Swiss regulator FINMA on Sunday. Credit Suisse shareholders got 3 billion Swiss francs ($3.2 billion) whereas the Additional Tier 1 (AT1) bondholders were completely wiped out in a historic write-down of 16 billion Swiss francs ($17.2 billion) which stunned the $275 billion AT1 debt market.

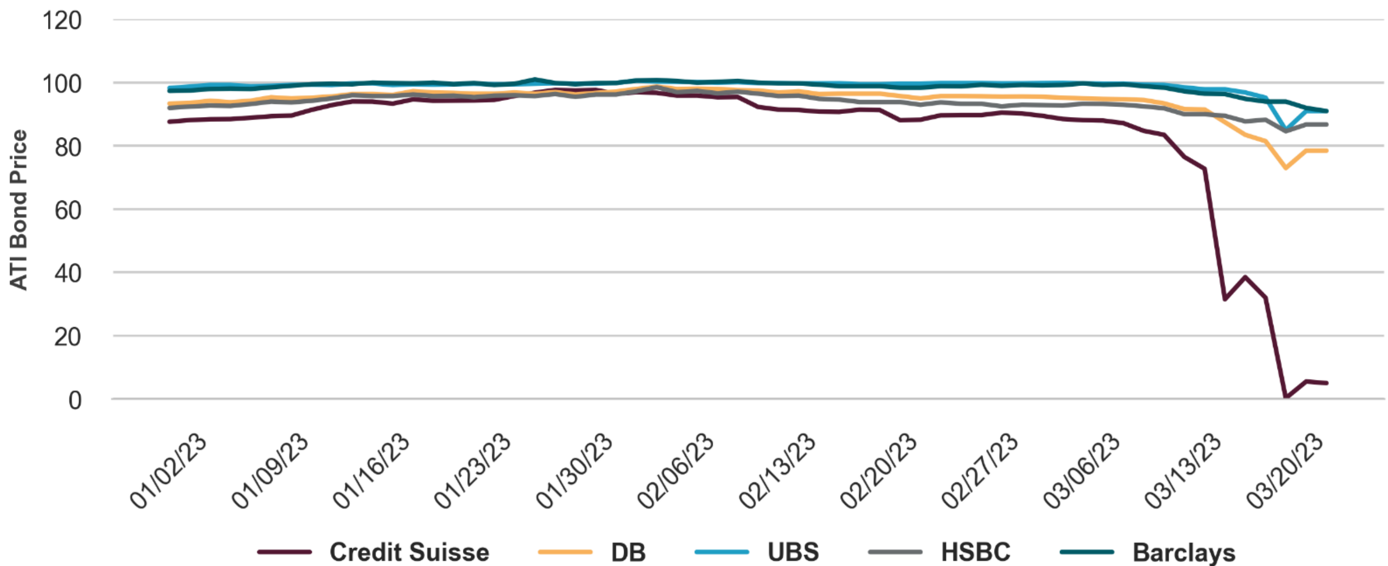
AT1 bonds, also known as “contingent convertibles” (CoCo), are bonds created after the 2008 financial crisis for banks to bolster regulatory capital on top of equity. While they typically provide a higher yield than ordinary bonds, they can be converted into equity or written off in the event of a bank’s capital ratio falling below a certain threshold to shore up capital without resorting to taxpayer money.

Although bondholders ought to bear the risks of investment in AT1 bonds, they argued that shareholders should have taken the losses ahead of bondholders and FINMA’s order of the AT1 bond wipeout is “an obvious breach of the hierarchy of claims”. A significant portion of bondholders are seeking possible legal action. However, FINMA have claimed that in a restructuring process, it is under no obligation to adhere to the traditional capital structure hierarchy as is written in the bond’s prospectus where the write-down is covered by an existing clause in the document.

This, as expected, has caused backlash in the market with the ECB, SRB and EBA releasing a statement on Monday reaffirming the capital order of losses with common equity instruments being the first to absorb losses (ECB Banking Supervision, SRB and EBA statement on the announcement on 19 March 2023 by Swiss authorities (europa.eu)). Jurisdictions outside of Switzerland have voiced similar sentiment of reaffirmation. A similar case happened previously with Santander’s takeover of Banco Popular in 2017 where the AT1 bondholders were wiped out, but so were the shareholders.

Markets have reacted accordingly due to this potential risk in holding AT1 bonds, with a slump in AT1 bond prices after the Credit Suisse AT1 write-down announcement. Prices rebounded on Tuesday as regulators sought to reconvince investors of the integrity of AT1 bonds, however the general market sentiment towards the asset class remains fragile.

Indicative AT1 Bond Prices of Major European Banks



Source: Refinitiv (3/22/2023)

While the market strain is easing to some degree, the wipeout of Credit Suisse AT1 bonds may continue to weigh on the wider AT1 bond market and will have great ramifications for the prospect of the whole sector. Investors will likely be more cautious buying AT1 bonds amid higher uncertainty and perceived risk, making it more difficult and expensive for banks to raise debt capital to meet regulatory requirements. Furthermore, given the resulting volatility of the markets, it would be important to closely observe the movement of the Tier 1 Capital Ratios across the banking sector, especially for those banks with smaller trigger margins. LSEG Yield Book's Convertible Bond Analytics, currently open to beta trials, will look to cover AT1 bonds towards the end of 2023.

CDS spreads for banks have increased significantly over the last few days, indicating rising credit risk of the banking sector. LSEG Yield Book's Credit Default Analytics and QPS's Credit Analytics are well positioned to help clients evaluate risk and return of credit instruments. Additionally, StarMine's Credit Risk Model projects 12-month forward looking probability of default based on the equity market, analyst estimates, company financials, news and announcements.

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To learn more, contact us at sales@yieldbook.com or visit our website: solutions.yieldbook.com

Americas
+1 646 989 2200

EMEA
+44 20 7334 8963

Asia Pacific
Tokyo +81 3 6441 1015
APAC +866 2 8979 4966

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