Granate
ASSET MANAGEMENT

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AT1s

What are they and why are so many people talking about them?

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Many of you would have read about the Credit Suisse collapse and the resultant takeover by UBS, both very big global banks nestled between the mountain ranges of central Europe. Had Credit Suisse been left to fail, the snowstorm would have turned into an avalanche for the global financial system. At a time when US banks Silicon Valley and Signature Bank had very recently failed, this was a big test in the resilience of the global banking system.

But fixed income investors were left rattled. Credit Suisse Additional Tier 1 Bonds (AT1 bonds) were alarmingly valued at zero for the transaction, while equity holders received shares in UBS. That's not how it's meant to work. That's not how the credit hierarchy is traditionally stacked. An equity investment holds the highest risk in the capital structure of a company, undertaken with the hope of receiving higher returns. Investing in the bonds of that same company involves lower risk and therefore typically delivers lower returns. The law of markets says that equity holders lose all their money before debtholders incur losses. Turns out it's not necessarily law.

What are AT1 bonds anyway?

AT1 bonds are a fairly new asset class in the world of fixed income. They were the offspring of the Global Financial Crisis. Remember how ticked off American and European taxpayers were when they had to foot the bill for the reckless behaviour of the big global banks? AT1 bonds were designed to stop that from happening again. Rather than leaving the taxpayer holding the bucket and mop, investors could fill the gap by choosing if they would like to hold these instruments for a commensurately higher yield.

AT1 bonds are debt securities issued by banks, which, unlike other bonds, have no maturity date. They are therefore referred to as perpetual bonds. The happy ending for these bonds is when the bank decides it would like to buy them back. The bank then pays the investor what the bonds are worth, allowing the investor to pocket the capital they put in along with the yield the bonds have been generating over time. There is also the possibility of a not-so-happy ending. If a bank's balance sheet comes

under stress, AT1 bonds can be converted into shares or written down to zero permanently, depending on the severity of the situation and on what is specified in the legal documentation for each instrument. Investors are therefore left either with shares they had hoped not to hold or a fist full of melted snow.

So what just happened at Credit Suisse?

Normally, bondholders (of whatever nature) only have their capital penalised once equity holders have taken their pain. In the case of banks that issue AT1s, it is generally understood that senior bondholders have the first right to pay-outs, followed by more junior bondholders, and finally those who hold AT1 bonds.

When things go awry for a bank, the regulator can step in and institute the conversion or write-down of its AT1 debt. This is exactly what happened in the Credit Suisse scenario. However, equity holders were compensated while AT1 holders were not. Why? Because there is no universal law for the treatment of AT1 bonds. Each issuance and country of issuance is nuanced. In this example, the AT1 documentation for Credit Suisse and Swiss legislative powers made this outcome possible. Many market participants may not have realised this. And when the market gets an unpleasant surprise, it's not *un*surprising that negative emotions develop towards the instruments involved. Sell orders typically outnumber buy orders and prices reflect this imbalance.

What does this mean for the AT1 bonds issued by South African banks?

The framework and capital structure in our South African banks are different to the Credit Suisse example. Firstly, our banks have not optimised their capital structures as efficiently as their offshore counterparts, which benefits debtholders. Our banks are very conservatively and prudently managed, with large capital or common equity buffers that are way ahead of the minimum capital requirements set by our regulator. Local banks are profitable, have diversified sources of funding and their AT1 ratios are significantly smaller than those seen offshore, as shown for our Big Four banks in the table below. Credit Suisse had an AT1 ratio of 5.8%.

	ABSA	Nedbank	FirstRand	Standard Bank
AT1 ratio*	1.6%	1.6%	1.0%	1.0%

* Actual capital ratio against minimum capital requirements as at Dec 2022

Source: ABSA Research

In other words, Credit Suisse issued a lot of AT1 paper while local banks haven't. In a scenario where South African banks fall on hard times, writing off AT1 debt is unlikely to return a bank to viability due to the low volumes in these capital structures. They're not significant enough. In a closed banking system like South Africa's, writing off AT1 debt will likely only cause havoc in the rest of the banks' pricing and would potentially restrict its ability to access further funding.

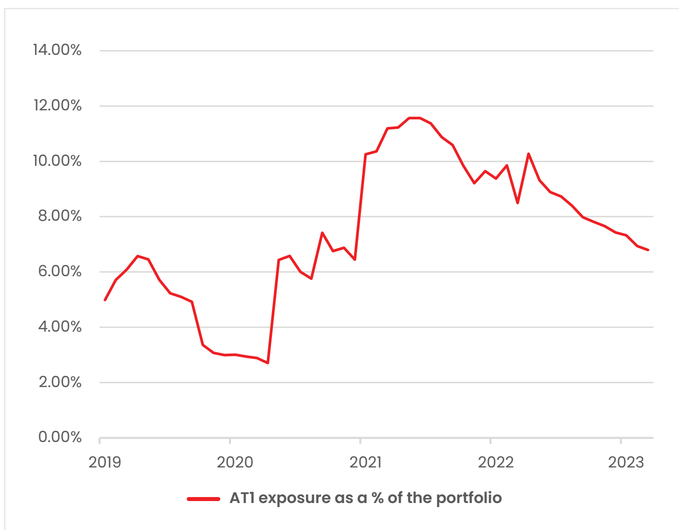
While some uncertainty remains around the hierarchy of the capital structure in local banks while related legislation is finalised, the proposed hierarchy is in line with how you'd traditionally expect it to be. Ordinary shareholders will take losses before AT1 bondholders. We therefore believe that if one of our banks became distressed, it is unlikely to play out in the same way as Credit Suisse.

Given what we know, is it wise to hold the AT1 bonds of South African banks?

We think so, but selectively and in appropriate amounts. Our job is to make sure that the investors in our funds are compensated for the risks they take. Therefore, we must be acutely aware of the risk of each instrument we hold and how, in aggregate, they impact the risk profile of the overall portfolio. As discussed, the issuance of AT1 bonds in South Africa is far lower than what we have seen in developed markets. When these instruments first came to market, their attractive spreads (the difference between

what they were yielding vs. cash) meant that it made sense to allocate capital into this space. However, as they grew in popularity their prices increased, dampening spreads somewhat. Following a spike in 2020, with AT1 bonds trading at close to 500 basis points above Jibar, spreads had compressed to around 340 basis points by the end of last year. Relative exposures in our funds to these instruments (as a percentage of the overall portfolio) have therefore declined.

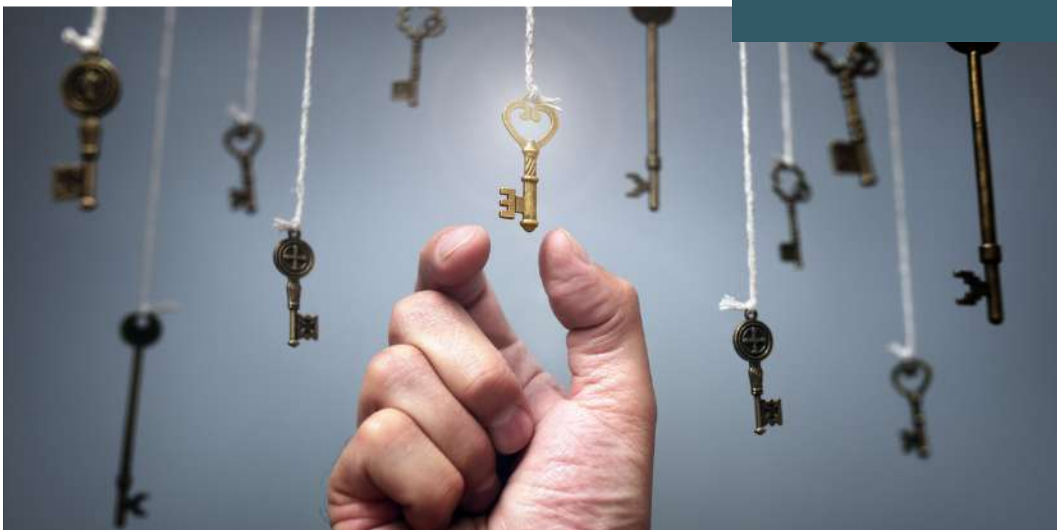
Figure 1:
Granate BCI Multi Income Fund - AT1 exposure



Source: Granate Asset Management

What next for South African banks' AT1 bonds?

It's possible that the Credit Suisse scenario could reduce appetite for these instruments. This could result in the repricing of South African AT1 bonds, which could provide attractive opportunities. But there is no evidence of this yet. We have not been increasing our exposures, as spreads remain tight and we have found attractive opportunities elsewhere in fixed income markets. Current exposures are likely to roll off in the next two years when they become callable by the issuing banks. For now, we remain vigilant to the potential of new AT1 issuances at material repricings. For our funds to invest, this would always need to be at a level where there is sufficient compensation for risk.



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