Focus on the AT1 Market – Part 1

AT1 is the acronym for Additional Tier 1 capital and was introduced with Basel III after the financial crisis to replace former Tier 1 securities. AT1 notes are a key instrument in regulators' post-crisis bail-in regime and fulfil a part of banks' regulatory capital.

Alexis Lautrette and **François Lavier**, both Fund Manager-Analysts specialised in Subordinated and Hybrid Financial Debt strategies, provide insight into the AT1 debt segment.

Summary:
- Market profile
- Main features
- Risk-return profile

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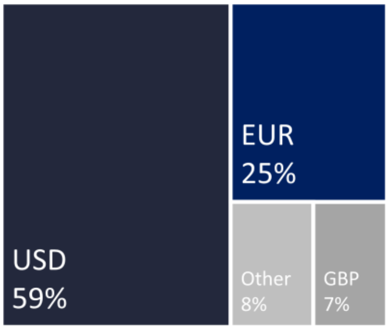
Market profile

The AT1 market is worth roughly **$254 billion**[1] with a majority of bonds denominated in USD despite being mostly issued by European entities.

Breakdown by currency

Source: Bloomberg, as of 30 September 2020.

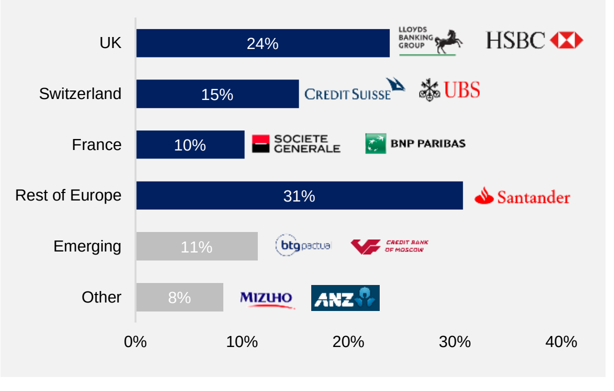


A mainly European universe

There are currently **100 issuers** and **245 bonds** in the investment universe. **97% of issuers are banks** and the remaining **3% are insurance companies.**
European issuers represent 80% of this universe.

Geographical breakdown of issuers[2]

Source: Bloomberg, as of 30 September 2020



US banks do not issue AT1, but **specific hybrid Tier 1 capital securities called Preferred Shares.** This is why they are not included in the chart above.

Issuer and security rating profile

These bonds are mainly issued by **large financial institutions with an investment grade issuer rating.** Nevertheless, due to rating agencies' methodologies, **AT1 securities have a high yield rating on average**.

A-
Average issuer rating

BB
Average security rating

The AT1 segment is the most liquid market in the bank debt structure, partly due to the **size of each security** with deals often exceeding $1 billion.

$1.3 Bn
Average issue amount
for $AT1[1]

Source: Lazard Frères Gestion, Bloomberg, as of 30 September 2020.
1. Bloomberg, based on the BCCGTREU index, as of 30 September 2020.
2. Example of issuers. For illustrative purpose only, does not constitute a recommendation.
The opinion expressed above is correct at the time of writing and liable to change.

Main features

AT1, CoCos, equity conversion… how do they differ?

Some AT1 carry an **equity conversion** feature, often referred to as **CoCo for Contingent Convertible**. The important thing to highlight is that **all CoCos are AT1, but not all AT1s are CoCos**, although investors tend to use the terms interchangeably.

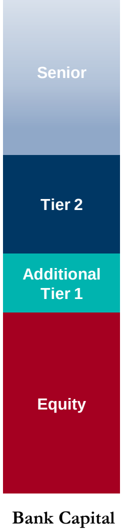
The **conversion risk corresponds to the default risk. It is the same for all subordinated debt, and should not be a key focus for investors**, at least not more than for other subordinated debt securities.

The only example of default in this segment so far is Banco Popular Español, which was placed under resolution in 2017 (and then bought by Santander). **The outcome**, a 100% loss, **was exactly the same for shareholders, Tier 2 bondholders and AT1 bondholders.**

AT1 breakdown by capital risk type

Source: Bloomberg, as of 30 September 2020.

Main differences between securities



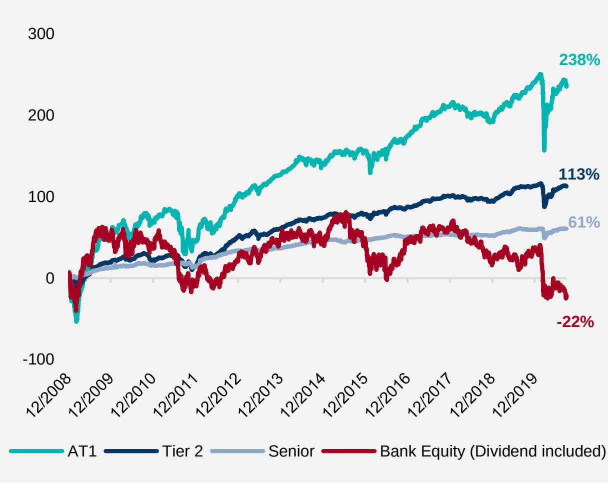
Bank Capital structure

	Senior	Tier 2	AT1
Subordinated	No	**Yes**	**Yes**
Perpetual / Dated	**Dated**	**Dated**	Perpetual
Callable	No	Possible	Yes
Coupon cancellation	**No**	**No**	Possible
Write down in case of resolution	Possible	**Yes**	**Yes**
Automatic Equity Conversion or Nominal Write down	**No**	**No**	Yes

Risk-return profile

Long-term return[1]

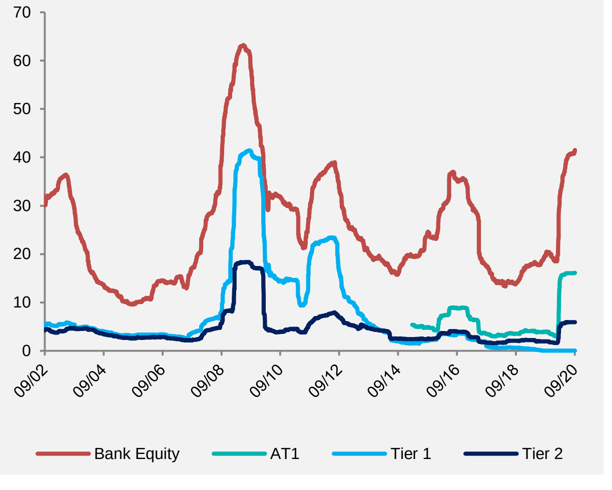
Source: Bloomberg, as of 30 September 2020, in % (euros).



Since December 2008, despite several crises, **Tier 1 bonds have outperformed senior bonds** but also equities with a total return of **+238% versus +61% for senior bonds** and -22% for bank equities.

Historical volatility[2]

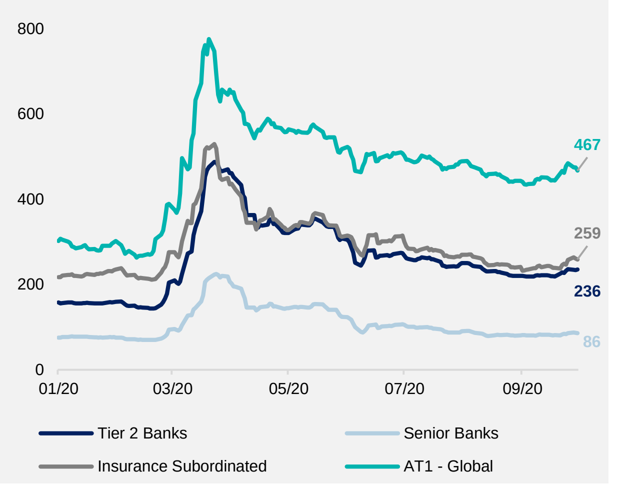
Source: Bloomberg, as of 30 September 2020.



This performance was achieved with **a reasonable volatility profile**, which is historically **between 5% and 15% for AT1**, and closer to fixed income products than to equities. Despite the recent pickup in volatility, it **remains well below that of equities**.

Spreads overview[3]

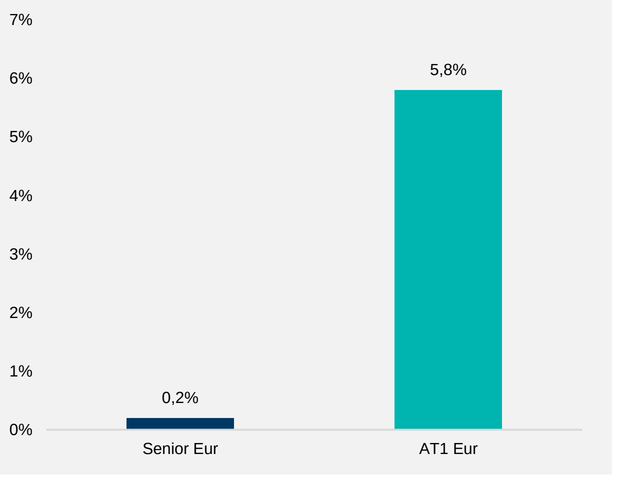
Source: Bloomberg, as of 30 September 2020.



Spreads have normalised for senior debt since the March 2020 sell-off. **However, this is not the case for subordinated debt, especially AT1s** where spreads are **165 bps wider on a year-to-date basis.**

Yield pickup[4]

Source: Bloomberg, as of 30 September 2020.



From a yield perspective, an investor gets **on average an extra pickup of 560 bps on AT1 debt compared with senior debt.**

Fund Manager-Analysts[5]

Alexis Lautrette

François Lavier, *CFA*

Source: Lazard Frères Gestion, Bloomberg, as of September 2020.

1. Indices used: JP Morgan Subordinated Security Index Senior, JP Morgan Subordinated Security Index Lower Tier 2 Banks and Bloomberg Barclays Global Contingent Capital for AT1 | Stoxx 600 Bank equity net of dividend.
2. Standard Deviation on a daily basis over 260 days. Indices used: Banks equity: Stoxx 600 Europe Banks ND | Tier 1: JPM SUSI T1 Index | Tier 2: JPM SUSI LT2 Index | AT1: Bloomberg Barclays Global Contingent Capital Total Return Index Value Hedged EUR (inception date: 30 April 2014).
3. Tier 2: JPSULTEG Index | Senior Banks: JPSUSBEG Index | Insurance Subordinated: JPSUIBEG Index | AT1:BCCGOAS Index.
4. Yield to maturity for senior debt. Yield to call for AT1. Senior EUR debt index: JPSUSBEI Index | AT1 EUR index: JPATTRER Index.
5. Our team is traditionally stable, but we are unable to guarantee the presence of the managers mentioned above during the entire product lifespan.

The yield is the counterparty of a capital risk. Past yields do not guarantee the capital or future performance.

Past performance does not guarantee future performance. Performance data is provided for information purposes only and should be assessed over the recommended investment period.

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Information on the risks associated with bonds

- **Credit risk:** The potential risk that an issuer defaults or its creditworthiness declines, which would lead to a fall in the price of its securities.
- **Liquidity risk:** The risk that a lack of liquidity in an underlying market will substantially increase the market's price volatility in response to large trades.
- **Risks associated with derivatives:** The use of derivatives may amplify the risk of loss.
- **Risk of capital loss:** The Fund is not guaranteed or protected; investors may not get back their initial investment in full.
- **Risk associated with investing and discretionary asset allocation:** Performance depends on both the securities and funds that the manager chooses and on the manager's asset allocation. There is a risk that the manager may not select the best-performing securities and funds or choose the optimal asset allocation between markets.
- **Interest rate risk:** There is a risk that the value of bonds, other securities and interest rate instruments may fall when interest rates change, and therefore that the value of the portfolio may also fall. Due to the boundaries of the sensitivity range, the value of this portfolio component may fall.
- **Risks related to contingent or subordinated securities:** The Fund may be exposed to contingent or subordinated securities. Subordinated debt and contingent convertible bonds are particularly subject to the risks of non-payment of coupons and capital loss under certain circumstances. According to a set solvency threshold, known as a 'trigger', issuers can or are required to suspend payment of their coupons and/or reduce the nominal value of the securities, or convert these bonds into shares. Notwithstanding the thresholds defined in the issue prospectuses, the regulatory authorities may also apply these rules as a precaution, depending on the circumstances and according to a discretionary threshold known as the 'point of non-viability'. Security holders may lose some or all of their investment following any conversion into shares at a predetermined price, or application of a discount, either provided for contractually in the terms of the issue prospectus, or applied arbitrarily by a regulatory authority. These types of securities also expose holders to potentially significant price fluctuations in the event that the issuer has insufficient equity or experiences difficulties.
- **Risks related to futures markets:** Risk from financial futures instruments. Exposure to markets, assets and indices through financial futures instruments may lead to a significantly greater or faster decline in net asset value than the change observed in the underlying instruments' asset values.
- **Counterparty risk:** Counterparty risk is related to the use of over-the-counter products. These transactions expose the holder to the risk of default by one or more counterparties, which may lead to a payment default and result in a fall in the fund's net asset value.
- **Currency risk:** Risk of investing in securities and UCIs that are authorised to acquire securities denominated in foreign currencies (outside of the eurozone). The value of the assets held by these UCIs may fall if exchange rates fluctuate, which may result in a fall in their net asset values.

Useful concepts and definitions

- **Senior debt:** a debt instrument where holders are repaid before subordinated debt holders. Financial institutions commonly use these securities to secure funding on the financial markets. These instruments can be used for bail-ins.

- **Subordinated debt:** a debt instrument where holders are only repaid after senior debt holders. In the case of financial institutions, several types of instruments called Tier 1 or Tier 2 exist. Their characteristics vary according to their particular issue details and degree of subordination. These instruments can be used for bail-ins.

- **Tier 2:** a Tier 2 subordinated debt instrument where holders are repaid before shareholders and Tier 1 debt holders but after all other types of debt holders.

- **AT1 (Additional Tier 1):** a Tier 1 subordinated debt instrument where holders are repaid before shareholders but after all other types of debt holders. These instruments are subject to specific risk of coupon non-payment as well as principal write-downs under certain circumstances.

Important information

Information

LAZARD FRERES GESTION – S.A.S au capital de 14.487.500€ - 352 213 599 RCS Paris
25, RUE DE COURCELLES - 75008 PARIS