Europe's AT1 Market Faces The COVID-19 Test: Bend, Not Break

April 22, 2020

Key Takeaways

- As the global recession tests banks' capitalization, the European Additional Tier 1 (AT1) market faces key risks related to potentially waning investor appetite and increasing regulatory enforcement.
- The regulatory response to the COVID-19 outbreak--cutting buffer requirements and squeezing shareholder distributions--aims to encourage banks to extend credit to the real economy without fear of breaching regulatory requirements. We don't think that this increases the risk of coupon nonpayment per se, though issuers that incur sustained credit pressures might feel the strain.
- Material secondary market repricing of AT1 securities will likely result in more frequent noncall events, where banks choose not to exercise optional calls, and the emergence of "perpetual vintages" due to reduced economic incentives to call and refinance.
- Our ratings on hybrid instruments focus on relative default risk, such as the risk of coupon nonpayment. We do not treat a decision not to exercise an optional call, i.e., to "extend" a hybrid past an optional call date, as a default on the hybrid. We believe that enhanced disclosure by banks can help investors to appraise potential extension risks.

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2020 marks the 10th anniversary of the inaugural vintage of European bank Additional Tier 1 (AT1) contingent capital securities. It is also the first time that this asset class has encountered a global recession as the COVID-19 and oil market crises intensify. Against this backdrop, we assess how banks will use AT1 hybrids during the recession and note a combination of prudential relaxations that--in addition to the fact that many banks are entering this downturn with high common equity Tier 1 (CET1) ratios--will help European banks to continue to pay AT1 coupons. These include maintaining an accommodative monetary and fiscal policy, and swift regulatory actions to cancel dividends and share buybacks and to lower variable remuneration.

That said, the risk of instrument-specific noncall or "extension" and coupon cancellation has increased, particularly for banking systems and banks that have failed to recapitalize over the last decade. This relatively benign base case remains dependent on COVID-19 proving to be a short-term, cyclical crisis where timely and effective fiscal stimulus could significantly mitigate the impact on bank asset quality.

Although we expect that European banks will generally continue to pay AT1 coupons, AT1 hybrids can absorb losses on a going-concern basis, not just in resolution. At this point, we largely expect that banks won't need to consider nonpayment of AT1 coupons, supported by statements such as that from the European Central Bank's (ECB's) Prudential Supervisory Board that it has no plans to suspend payments on bank hybrids. However, while we don't see coupon nonpayment as a tool that banks will generally need to use, it could become more relevant to banks that face increased and sustained pressure on their creditworthiness. We reflect these payment risks by applying a gap of at least four notches between the stand-alone credit profile (SACP) of a bank and the ratings on its AT1 hybrids.

The European AT1 Market Flourished From 2010-2020, But COVID-19 Presents A Test

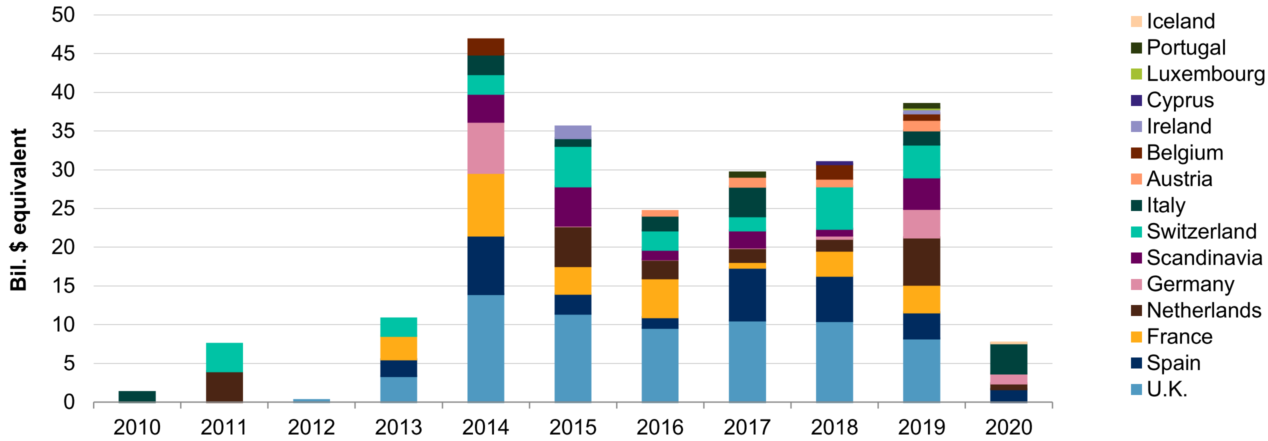
The regulatory overhaul since the global financial crisis sought to create a bank capital structure that would minimize usage of taxpayers' money and automate early-stage systemic or entity-specific crisis intervention via bail-inable securities. The introduction of the AT1 instrument was a core component of this effort and the global AT1 market has since grown to represent a total principal value in excess of $250 billion. Owing to banks' discretion to stop AT1 coupon payments at any time, AT1 instruments have more flexibility to absorb losses on a going-concern basis than previous bank Tier 1 hybrids. The removal of step-up features, which had a higher impact on servicing costs for banks that chose not to exercise an optional call, is also an important feature. European AT1 hybrids are all contractually perpetual instruments, again to give issuers more flexibility to manage their capitalization in times of stress.

European banks account for about 75% of the 275-plus outstanding securities and, by 2020, most of these banks had reached their targeted regulatory capital ratios following a decade of significant capital building. Until early 2020, banks had executed AT1 primary issuance at record low coupons and near all-time tight reset spreads. Net issuance levels were set to fall over the coming years due to the capital levels that banks had already met, and we expected a modest issuance calendar. We also expected occasional noncall refinancing decisions on account of the dramatically improved primary market access.

Chart 1

European Bank AT1 By Country

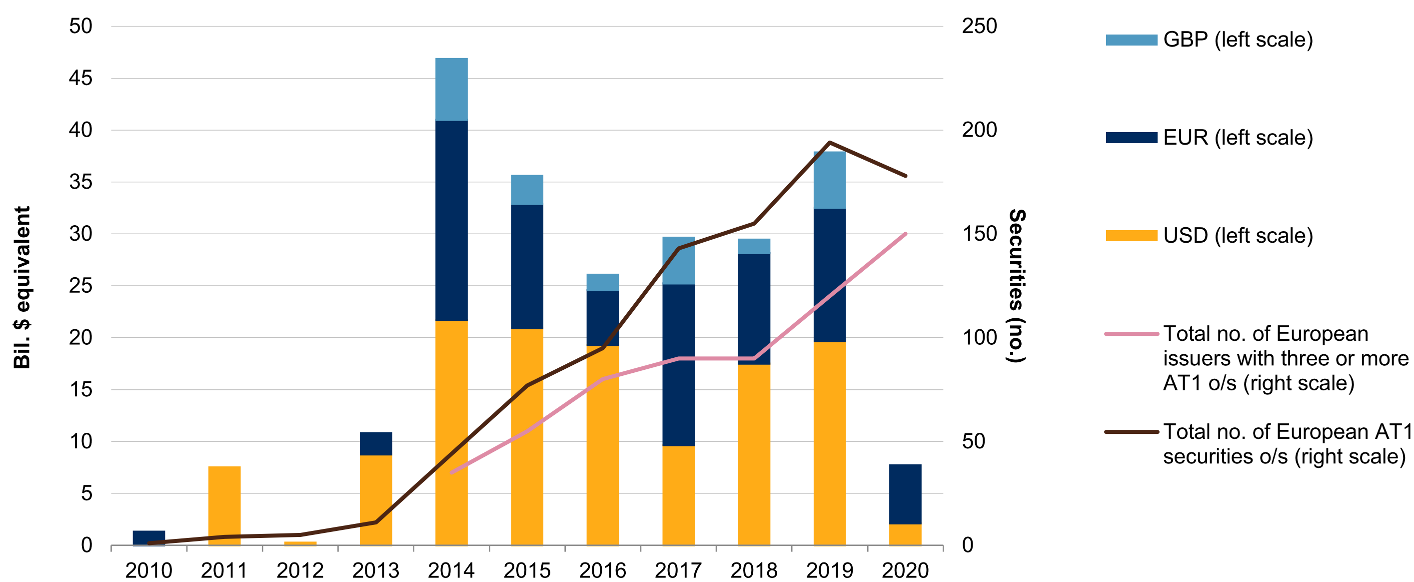
Market developing to include second tier names and full breadth of peripheral countries



Source: S&P Global Ratings, Dealogic.

Chart 2

European Bank AT1 Issuance By Currency



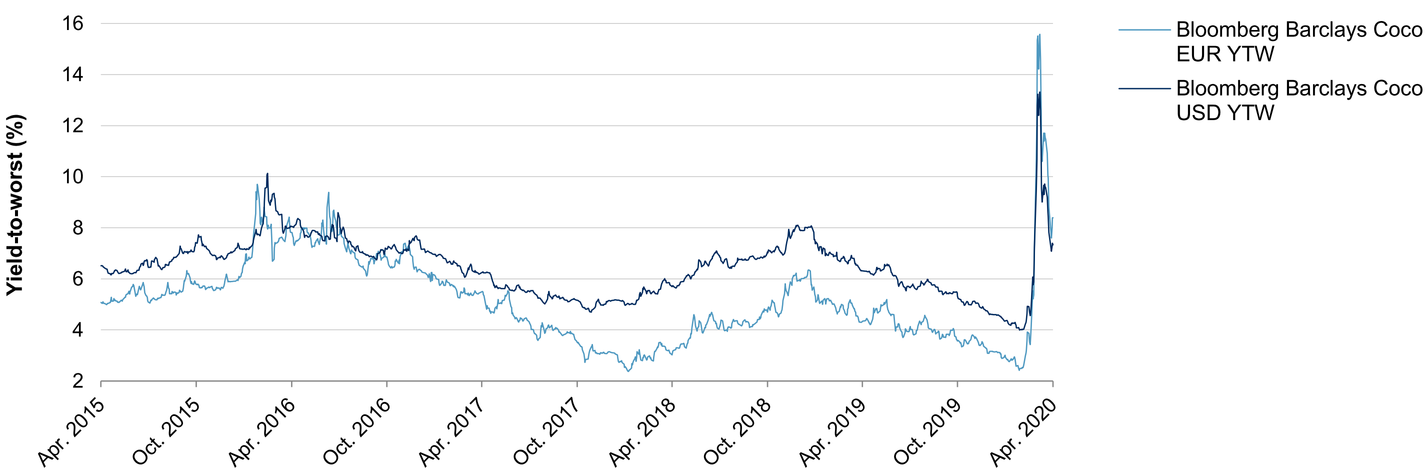
Source: S&P Global Ratings, Dealogic.

The AT1 investor base has widened considerably since 2010, despite these instruments being going-concern, loss-absorbing regulatory capital and perpetual in nature. This growth stems from: the reach-for-yield response to sustained quantitative easing and loose monetary policy, improving bank capital ratios, gradual structural standardization and investor mandate acceptance, and the increase in investment-grade rated AT1 hybrids (although many are rated below 'BBB-'). As the credit cycle turns, so the structural and regulatory nuances assume greater systemic significance for investors and for banks' financial flexibility.

The AT1 market has already hit bumps in the road--notably the 2012 eurozone crisis. However, this came early in the market's development when the range of issuers was smaller. As such, we see the COVID-19 pandemic as a true test for the market. It has abruptly reversed the constructive narrative and forced a dramatic secondary market repricing. The end-of-credit-cycle scenario--with deteriorating asset quality and bank capitalization--is not only testing investor appetite and credit market liquidity, but also establishing a new relative value assessment for bail-inable bank debt within the capital structure. More fundamentally, the new economic environment presents the first true test of regulatory resolution regime enforcement and accounting implementation (IFRS 9) while under intense systemic stress. It also gives insight into when regulators and banks might use AT1 coupons as a "going-concern" form of loss absorption and capital preservation.

Chart 3

AT1 Market Yield-To-Worst Repricing From All-Time Lows



YTW--Yield-to-worst. Source: S&P Global Ratings, Bloomberg.

The Role Of AT1 Hybrids

The AT1 regulatory design brief was for a distinct, contingent capital product capable of absorbing losses on a going-concern basis (rather than the gone-concern, loss-absorbing instruments such as Tier 2 hybrids, nonpreferred instruments, and holdco senior bonds, all of which only absorb losses in resolution or bankruptcy). The key going-concern feature is the unfettered ability to stop paying coupons (all of which are noncumulative). There is also an ability to write down the principal or convert the instrument into common equity on the breach of a predetermined CET1 ratio--this is usually a 5.125% CET1 ratio, and, although the regulatory standards see this as a going-concern level of capital, we typically see it as representing nonviability for a bank. There have been very few examples of an AT1 instrument absorbing losses by coupon nonpayment or before a resolution.

Several recent events have raised questions from some market participants as to whether AT1 will absorb losses before a bank resolution, such as the 2016 EU Maximum Distributable Amount (MDA) communication that made it easier for banks to maintain coupons, the Banco Popular subordinated debt treatment, and the recent interpretation of the state aid rule regarding NordLB that still allowed AT1 coupons to be paid. However, AT1 instruments are still set up to be going-concern hybrids and we expect that they can and will absorb losses prior to resolution in various scenarios.

Banks and regulators will, in our view, be reluctant to trigger AT1 coupon nonpayments too early in a credit stress for fear of reducing a bank's access to financing or otherwise reducing investor confidence in a bank. However, we expect that there would be conditions in which banks may, on balance, decide not to pay AT1 coupons before nonviability. This--allied with the financing flexibility accorded by the optional call features--underpins our view that AT1 hybrids are eligible for inclusion in our measure of bank capital.

Given the systemic nature of the COVID-19 shock, regulators have signalled a clear bias toward broad softening of regulatory capital requirements and accounting interpretations (see table 1). Should the lock-down response be extended, we cannot assume that such regulatory leniency would continue. While we do not expect banks and regulators to use AT1 as an early tool, the risk of loss-absorption may rise for some banks depending on the sustained magnitude of a downturn. However, we expect banks would consider extending hybrids past optional call dates more quickly than using coupon nonpayment as a capital management tool.

Table 1

European COVID-19 Regulatory Responses

One-year delay to the implementation of the latest revisions to the Basel III capital rules ("Basel IV").
Relaxation of counter-cyclical buffers and liquidity coverage ratio requirements (BOE, ECB).
Supportive guidance relating to IFRS 9 implementation (PRA, ECB).
Temporary relaxation of Pillar 2 guidance.
Unprecedented fiscal policy support (for example, business loans, partial staff salary payments).
ECB and BOE strongly encouraged eurozone banks to cancel dividends and share buybacks, as well as to manage staff bonus levels.

While a protracted weakening in operating conditions could lead to an increase in AT1 coupon risk, we expect the supportive monetary, fiscal, and regulatory response, combined with widespread cancellation of dividend, share buy-back, and discretionary bonuses, will be sufficient to contain such events to a minority. In the scenario of a prolonged material discount in market pricing of AT1s, we anticipate a material increase in the number of noncall events for European banks, because the economic cost associated with not calling will be less material. These pricing and call decisions are also likely to reinforce each other, leading to more frequent decisions not to call and associated impacts on not only secondary but also primary market pricing.

It remains too early to predict the ultimate impact of the COVID-19 outbreak on European banks' core capitalization. However, we expect widespread cancellation of ordinary dividends and share buybacks, as well as significantly lower variable remuneration in 2020. This is likely to represent a sufficient boost to retained earnings to enable AT1 coupon payments to be paid in full and in time. Regulators across Europe have strongly recommended that banks cancel or defer ordinary dividends, and pause share buyback programs, in order to preserve capital. We expect the vast majority to comply. The ECB has estimated eurozone banks would save around €30 billion of capital.

Re-pricing, Re-distributing

The AT1 market experienced a material improvement in pricing between 2010 to February 2020, reflecting a maturing asset class. A virtuous circle of factors included improving capital ratios and AT1 ratings (see chart 4), institutionalization of the investor base (see chart 5), and falling net supply issuance outlook. The extended period of exceptionally accommodative monetary policy and quantitative easing that relaxed investor perceptions of the key AT1 structural risks--namely perpetual duration, coupon cancellation, and principal write down--also had a positive impact on the above themes. In addition, intense global capital inflows into fixed income (specifically alternative, high yield) manifested in powerful reach-for-yield investor behaviour, supporting AT1 demand.

Average AT1 primary pricing tracked secondary market improvements (albeit less relevant than reset spread for most issuers) and lowered the cost of capital for market-opening country champion banks, paving the way for lower-rated banks and banking systems to follow. We see this in the growing number of issuers in the market and a larger range of min to max coupons priced within each currency in any given year (see charts 6 and 7 below).

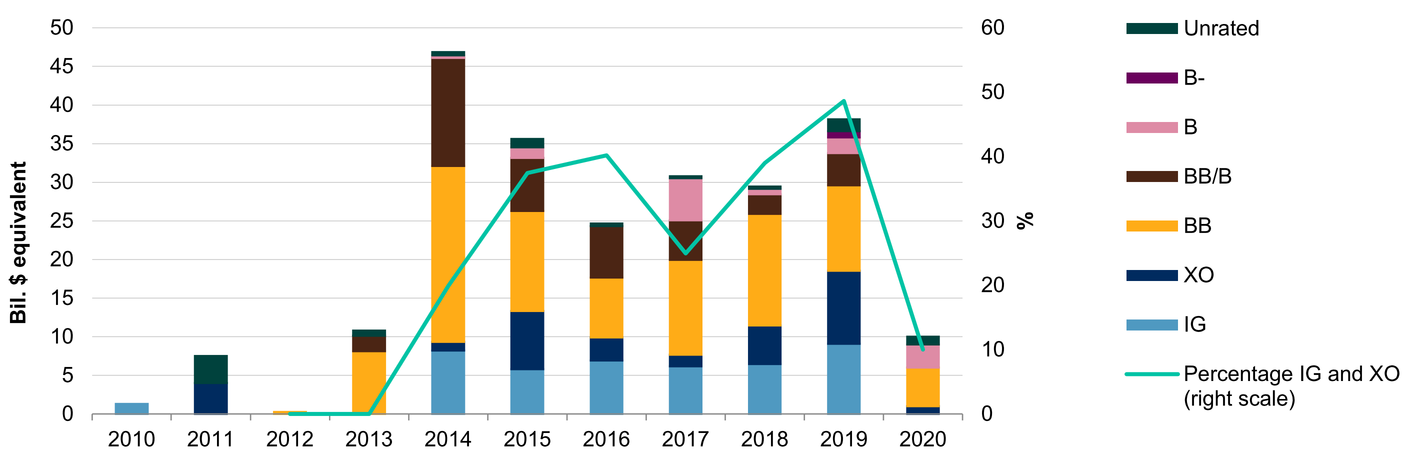
Since the start of the COVID-19 outbreak, we have seen an approximate average AT1 PNC5 yield to worst in the secondary market rise sharply from all-time lows (4.5% in euros, 5.5% in U.S. dollars) to all-time highs (14%+ in euros, 12%+ in U.S. dollars) as investors face outflows and reprice the inherently risky going-concern capital structure for the recessionary environment. Many European AT1 securities are now pricing a material risk of a noncall event at the next call date and the inherent negative convexity of the structure has resulted in 20-40 point cash losses in the secondary market in recent weeks. Secondary market spreads are relevant for bank ratings only to the extent that they indicate reduced market access for new financing and we note that a decision not to call a hybrid may, on balance, be beneficial to the issuer in a volatile environment.

The COVID-19 recession and related AT1 market repricing is set to alter AT1 primary supply dynamics. We expect market access to remain difficult for much of 2020, which could result in net negative AT1 supply for the first time, as more issuers decide to extend 2020 call decisions. That said, a rapid return to net positive supply through 2021 and 2022 is likely, given a combination of RWA inflation, widened Article 104 AT1 capacity, and unfilled 1.5% AT1 bucket capacity that forces issuers back to the market as soon as the recovery allows. This dynamic, while tough to quantify at this stage, is likely to contribute to an elevated cost of AT1 capital over our two-year ratings horizon.

Chart 4

European Bank AT1 Primary Ratings Composition

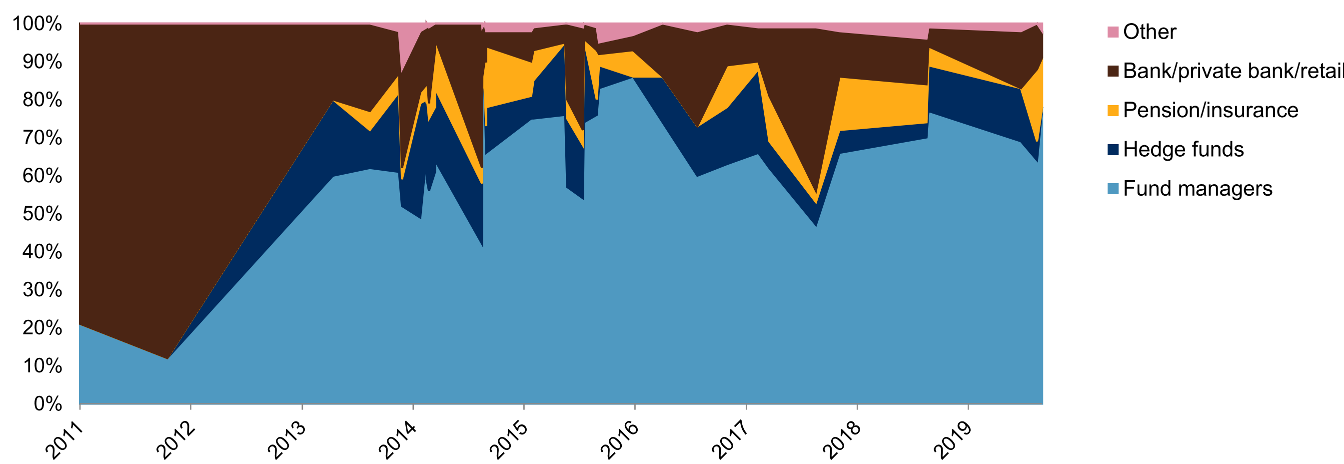
Percentage of issuance volume at IG or XO rated reached 50% in 2019 for the first time



IG--Investment grade. XO--Crossover. Source: S&P Global Ratings, Dealogic.

Chart 5

European Bank AT1 Distribution By Investor Type

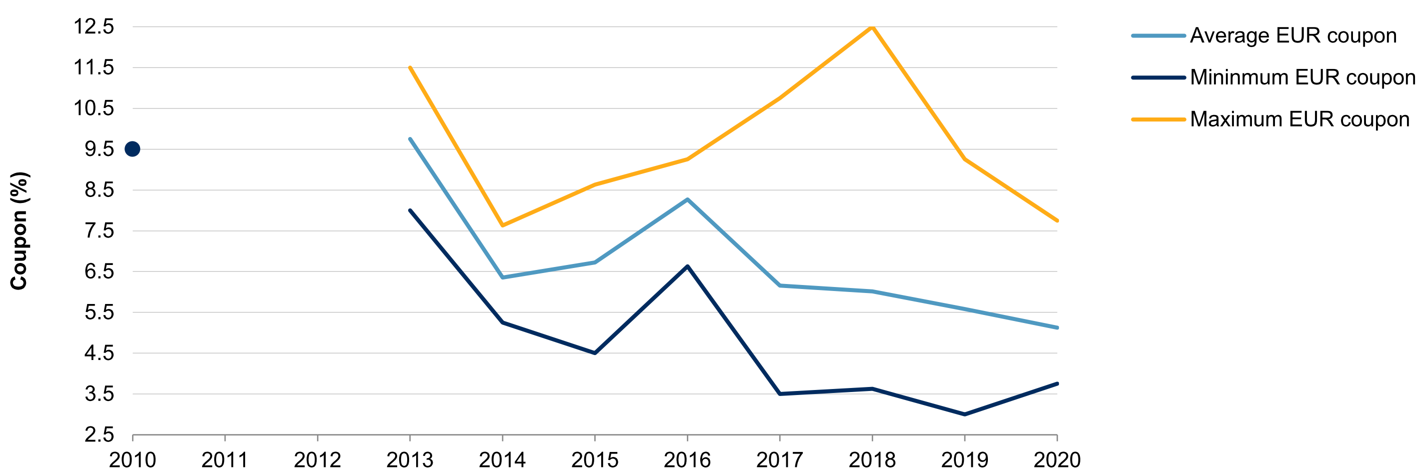


Source: S&P Global Ratings, Dealogic.

The changing nature of the AT1 investor base should not be underestimated. As the product became more broadly accepted, so the investor base became less concentrated in a mix of hedge funds, niche contingent capital-dedicated asset managers, and yield-targeting private banking, comprising more mainstream asset managers, pension, insurance, and sovereign wealth funds. Though this was constructive from a pricing perspective, it potentially raises the risk of pricing contagion across other MREL (minimum requirement for own funds and eligible liabilities) asset classes (such as holdco/nonpreferred senior and Tier 2) in the event of coupon cancellation or principal write-down, although these other instruments are gone-concern instruments that only absorb losses in a resolution or bankruptcy.

Chart 6

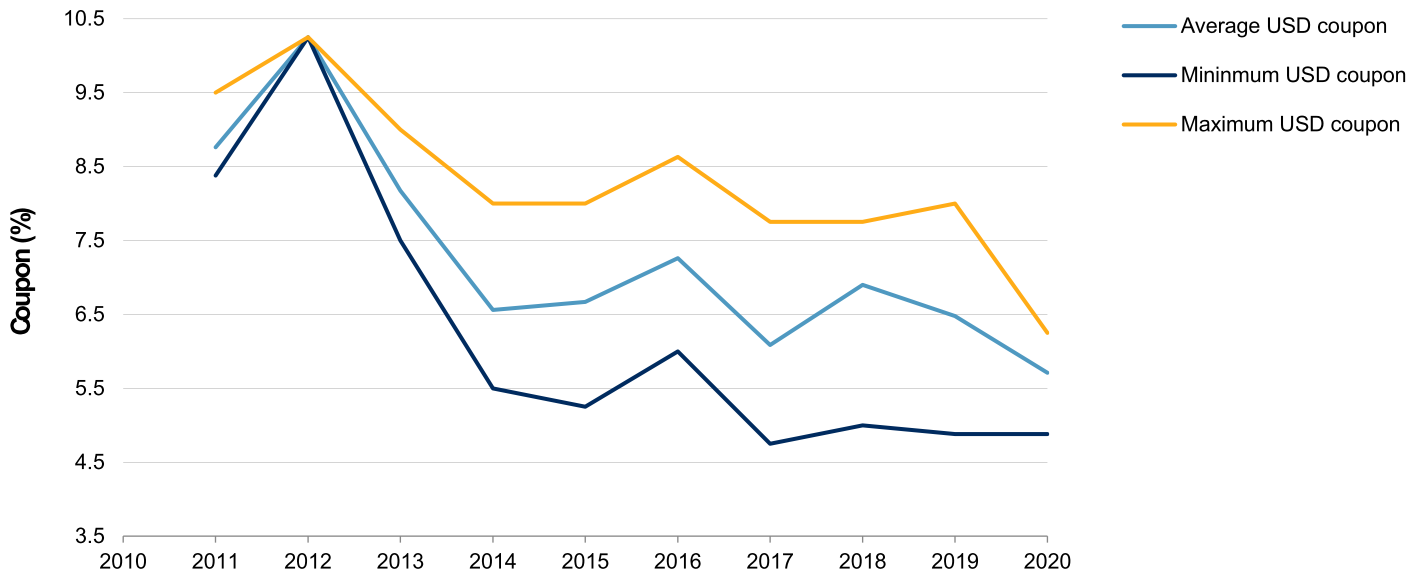
European Bank AT1--Euro-Denominated Coupon Price



Source: S&P Global Ratings, Dealogic.

Chart 7

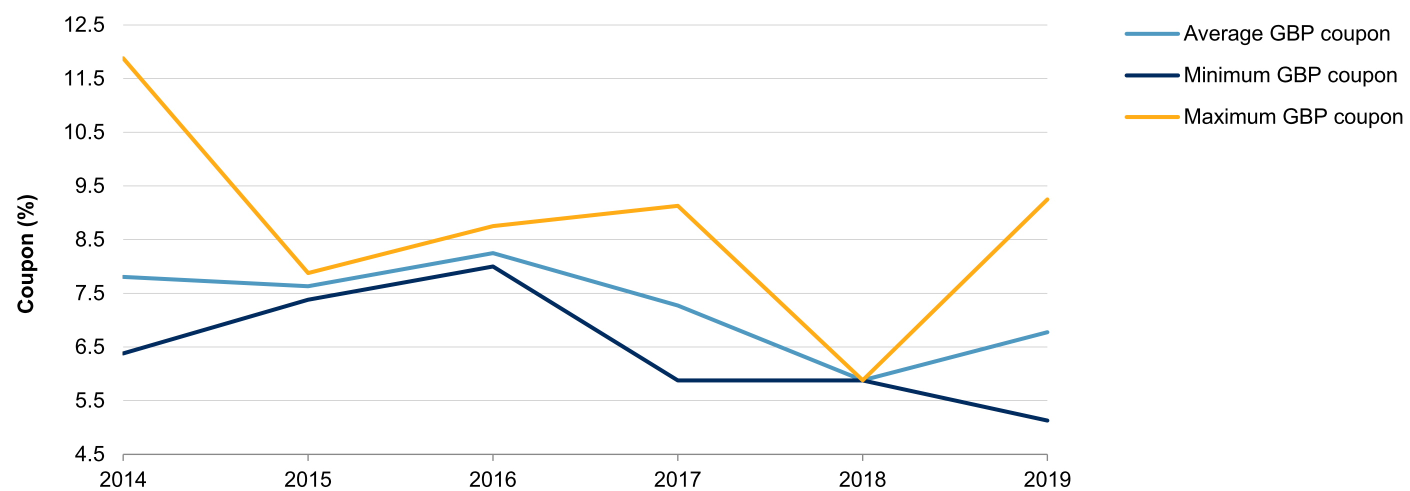
European Bank AT1--U.S. Dollar-Denominated Coupon Price



Source: S&P Global Ratings, Dealogic.

Chart 8

European AT1 Primary--GBP-Denominated Coupon Price

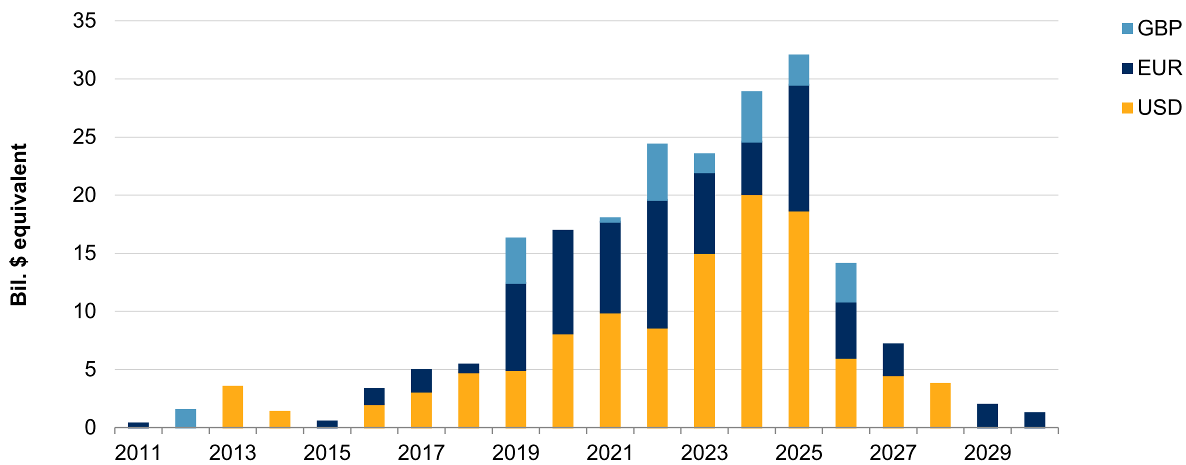


Source: S&P Global Ratings, Dealogic.

Chart 9

European Bank Tier 1 First Call Date By Currency

Annual total to increase from about $17 bil. in 2020 to over $30 bil. in 2025

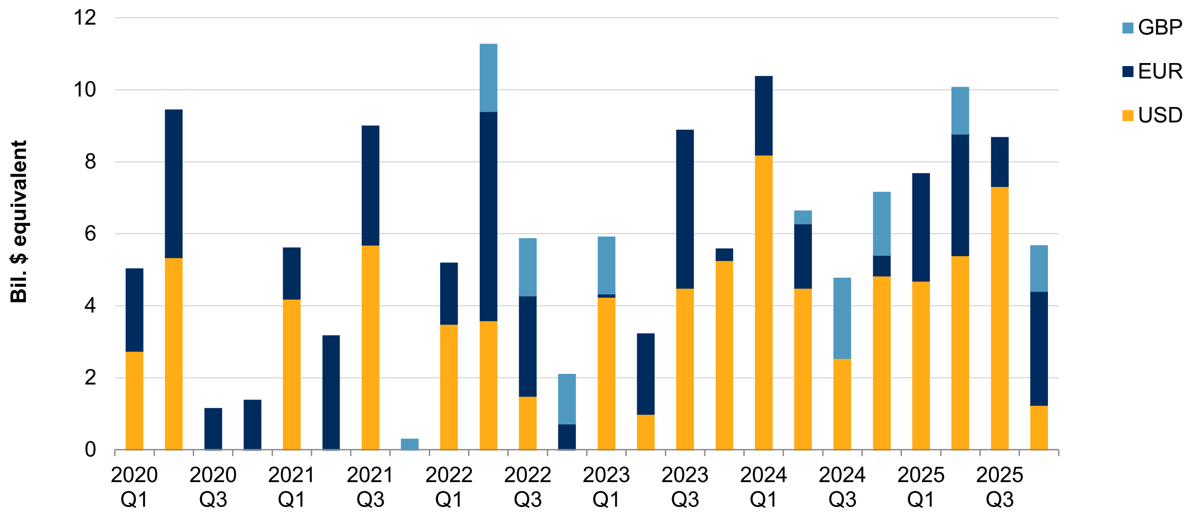


Source: Source: S&P Global Ratings, Dealogic.

Chart 10

European Bank AT1 Call Calendar Is Relatively Light With About $11 Bil. Equivalent From Q3 2020 To Q2 2021

Likely bridging the worst of the recession, potentially limiting the number of non-call decisions



Source: S&P Global Ratings, Dealogic.

Current Market Dynamics Highlight Call Risk

Though still rare in Europe, decisions by issuers such as Santander, Deutsche Bank, and Aareal Bank not to exercise AT1 call options have served as a reminder of the inherent "extension" risk embedded in the AT1 perpetual, callable structure--particularly in a period of economic stress. Although many market participants have recognized that refinancing prior AT1 vintages at ever-tighter reset spreads (and/or lower coupons) would eventually reach a limit at which point a "perpetual vintage" would result, the extent of the secondary market repricing has been exaggerated by the speed and severity of simultaneously increased extension, credit, coupon and arguably principal risk. ("Perpetual vintage" refers to AT1 hybrids that were priced with such low/tight back-end reset spreads that--given deteriorating market conditions--the bank is not incentivized to call for long periods, rather than call and refinance at the first call date.)

We currently consider a combination of factors that could drive increased likelihood of noncalls:

- Effective closure of the market for new issuance, which will likely last until at least the senior nonpreferred and subordinated markets have fully reopened.
- Once the market opens, the risk of persistently higher reset spreads on refinancing that reduces the economic incentive to call 2014-2016 vintages.
- A slight erosion in the historical European issuer view that calls--although optional--are typically exercised for reputational reasons (outside of extreme stress).

- Regulatory comfort with banks that prioritize the retention of capital and avoid unnecessary outflows amid current economic uncertainty. Capital conservation has become a more pressing priority for both bank boards and/or regulators, and such junior-investor friendly behaviour may be harder to justify in the short-to-medium term.

Nevertheless, noncall appetite varies among issuers, not least because they may need or want to return to the market in the coming year, for example, to take advantage of the ECB's early adoption of Article 104, giving an expanded role for AT1 in meeting Pillar 2 requirements. In this respect, it may be easier for strong, repeat issuers to return to the market after a noncall decision than for one-off issuers who lack the depth in investor base. (We note that several banks that have previously decided not to exercise optional calls have afterwards been able to access hybrid markets at accommodating pricing.)

Taken together, we anticipate the emergence of a "perpetual vintage" as noncall decisions become a more frequent occurrence. If so, this phenomenon serves as a reminder of the inherent perpetual risk in the asset class and could curtail further institutionalization of the investor base in the short-to-medium term. It also potentially embeds a greater bifurcation of issuer approach to the call decision-making between repeat issuers that are typically more generous to junior investors outside of stress conditions, and less frequent "one-off" issuers that may prioritize immediate economic incentives over investor friendliness--as is usual in the U.S. market already.

The Rating Implications Of A Bank Deciding Not To Exercise An Optional Call

Investors sometimes ask us whether we would consider a noncall of AT1s (or indeed other instruments) a default under our criteria. The answer is clear: it is not a default. When we look at the ratable promise as regards the return of principal, we look to the contractual maturity--which of course is perpetual for AT1s. The flexibility that an AT1 call option gives to an issuer is one of the features that supports a hybrid's ability to be available to absorb losses, by giving the issuer greater flexibility to manage its capital position and refinancing needs.

Moving beyond the implications for individual banks, the greater prevalence of noncalls in a market supports our stance of granting these instruments intermediate equity content (and so boosting banks' risk-adjusted capital ratios), as it does for the AT1 regulatory capital treatment. Being part of capital means that these instruments behave like equity when a borrower comes under stress. But if they show some of these characteristics in good times or when a bank is not yet under stress, but is facing more difficult operating conditions, then so much the better.

As regards an individual bank, we see positives for the stand-alone credit profile from a noncall decision, even though this may be balanced against some negative implications from market pricing, at least in the short term. Deciding not to exercise an optional call may head off a reduction in capitalization, or demonstrate a particular element of financial flexibility--that is, the willingness and ability to preserve balance-sheet strength, as well as a commitment to manage hybrids to address periods of potential stress. We recognize that in some cases a noncall may make future market access less economically viable--although that is only evident with time and may also be offset against more immediate considerations to maintain creditworthiness.

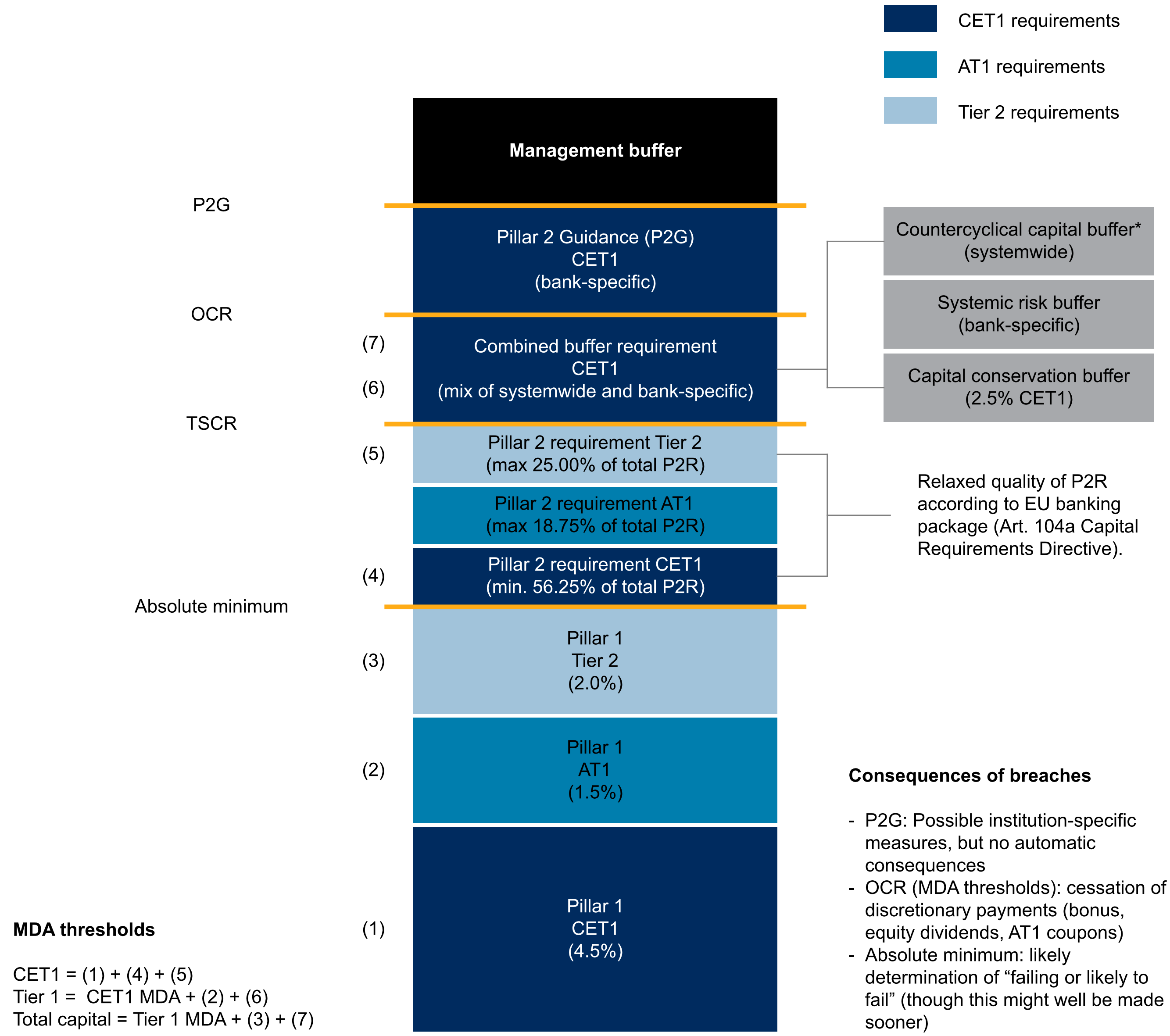
MDA Coupon Nonpayment Risks Have Generally Not Risen, But Remain Important

European regulatory capital frameworks invoke particular nonpayment risks for AT1 hybrids

The EU's CRD IV introduced the concept of Maximum Distributable Amount (MDA). This requires regulators to restrict earnings distribution if a bank's capital falls below the sum of its Pillar 1, Pillar 2, and CRD buffer requirements (see graphic). This threshold is variously known as the overall capital requirement (OCR) or SREP-MDA--the OCR being set as a product of the annual supervisory review and evaluation (SREP) process.

Chart 11

A Summary Of EU And U.K. Capital Requirements



Note: Banks may meet lower quality capital requirements with eligible higher quality capital components (i.e. Tier 2 with CET 1 or AT1, AT1 with CET1). TSCR--Total SREP capital requirement (P1R + P2R). OCR--Overall capital requirement (TSCR + CBR). MDA--Maximum distributable amount. ADI--Available distributable items. *CCyB includes sector-specific add-ons imposed under macroprudential interventions.
Source: S&P Global Ratings.

Despite a substantial increase in banks' capitalization in recent years, the final phase-in of the systemic risk buffers (SRB) at end-2019 and the steady rise in countercyclical buffers (CCyB) across Europe has meant that many were closer than ever to their SREP-MDA thresholds just as the COVID-19 pandemic struck. And, for some, headroom was set to narrow further through 2020 due to a planned rise in CCyBs--in many cases to within 100-250 basis points of the SREP-MDA. However, recent regulatory actions are likely to ease this pressure somewhat, at least through 2020.

When setting capital policy, bank management teams tend to be highly mindful of the risk of MDA threshold breach, so typically employ a management buffer of 1% or more, on top of the Pillar 2 guidance (P2G). But, they balance prudence with the imperative to meet expectations around shareholder returns. With RoTEs (returns on total equity) already difficult to achieve in the adverse revenue environment, this task becomes even harder as capital requirements rise, and it incentivizes management to trim further any perceived "excess" capital.

European banks would also be forced to stop payment of AT1 coupons if they have insufficient ADIs (available distributable items). Already a modest risk for most banks, we consider that this has substantially dissipated since 2019 as banks can now use a wider IFRS definition of distributable reserves.

European Regulators Have Walked The Walk

Backed by a policy imperative to expand credit to the real economy during a perceived temporary cyclical stress, European bank supervisors have fulfilled their previous insistence that they would cut some of the combined buffers--mainly the CCyB, as well as aspects of the SRB in some cases--in times of systemic stress. As these buffers have dissolved, MDA headroom has expanded across Europe--based on end-2019 ratios at least. Furthermore, the ECB has brought forward implementation of the proposed relaxation in how banks apply Article 104 CRD--allowing banks in all eurozone countries to count some AT1 and T2 instruments toward their Pillar 2 requirement, often easing banks' CET1 requirements by 1% or more.

It also seems clear that while European regulators have pushed banks hard to cut or defer shareholder distributions, they will not stand in the way of AT1 coupon payments at this time. Andrea Enria, Chairman of the Prudential Supervisory Board of the ECB has stated as much when discussing the actions around ordinary shareholder payments. In our view, this is unsurprising. While banks can stop paying AT1 coupons at any time, and payments will be suspended if banks breach MDA or ADI requirements, there is no clear regulatory incentive to intervene at this time, for the following reasons:

- Coupon cancellation would lead to marginal CET1 preservation relative to the amount saved by cancelling shareholder distributions;
- Regulators are trying to solve a real economy crisis, using the banking system as a key conduit for mitigation. Spurring risk aversion toward the banking system contradicts this aim;
- AT1s are issued to a fixed income investor base for whom there is no upside risk (and where the coupons are noncumulative). While they should, and are available to, absorb losses on a going-concern basis, they would become uninvestable except at extreme costs if coupons were stopped too early in a downturn. Banks and regulators will, in our view, continue to balance their unfettered ability to stop coupon payments with deciding when it is the right time to reflect a deterioration and stop distributions.

Regulatory Relaxations Provide Some Respite, Though This Could Be Temporary

The above moves are generally positive for coupon nonpayment risk--particularly for banks such as Lloyds and Barclays that might have moved within around 100-150bps of their SREP-MDA by end-2020. However, this risk has far from disappeared. First, the buffer and Article 104 easing has an unequal effect across Europe, indeed across the eurozone. Some jurisdictions already applied the softer Article 104 approach, and others had not yet implemented any CCyB. So for banks in those jurisdictions, this regulatory easing has no effect at all. Second, some banks have far more capacity than others to flex their discretionary distributions in the form of equity dividends and bonuses. Finally, as banks move through 2020, the extra headroom might anyway be consumed if underlying capital ratios fall. Again, we expect some CET1 ratios to have fallen and some to have risen at the end of the first quarter (see “European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers,” published April 1, 2020). However, the trend through the rest of 2020 would likely be discernibly downward. At this stage, we do not expect to widen our notching on European bank AT1s beyond the typical four to six notches below each bank's SACP. However, bank SACPs could yet move in some cases, and we do not rule out a widening of the AT1 notching in idiosyncratic cases. We may take into account several factors when assessing MDA headroom to evaluate coupon nonpayment risk in accordance with our hybrid criteria (see box).

Factors That May Inform MDA-Related Coupon Nonpayment Risk For EU Banks

If an EU (or U.K.)-based bank breaches its SREP-MDA threshold, coupon nonpayment is, in some circumstances, nonmandatory, as the breach constrains distributions from current-year earnings. When faced with a free choice on who to pay, European banks are typically quite clear that they would distribute first to AT1 holders ahead of shareholders. However, it seems highly likely that the leading (or significant) reason why a bank would breach its SREP-MDA threshold is that it made current-year losses. As such, current-year earnings would be zero, making coupon nonpayment mandatory. Since we consider coupon nonpayment to be a default event on the applicable issue credit rating (even though nonpayment is a contractual right of the issuer), a bank's proximity to the SREP-MDA threshold is a key consideration in our view of default risk on an AT1 hybrid.

Our methodology does not apply any prescriptive quantitative thresholds with regard to MDA headroom, due to the range of regulatory and accounting treatments. The following nonexhaustive list highlights some qualitative considerations, not all of which would be relevant every case. These allow us to view a bank's calculated MDA proximity in the context of a forward-looking view of its capital generation and capital requirements.

Current versus projected regulatory capital ratios Our assessment is forward-looking, so takes account of management capital targets, issuance plans (to the extent that we consider them reliably executable), and our view on expected profitability and capital retention.

Expected future capital requirements

- Buffers. Until recent weeks, regulators across Europe were raising CCyBs, with requirements due to rise further through 2020 and into 2021. While bank capital plans are often fluid in the face of evolving requirements, our forward-looking view means that we may react in advance if we see headroom looking unacceptably tight when the buffer requirements kick in. Regulators have now proven themselves willing to flex CCyBs during a systemic stress, but we do not routinely assume that these buffers would melt away for banks--not least because the stress might be idiosyncratic.
- Transitional versus fully-loaded ratios. MDA thresholds are binding on current (i.e., transitional) regulatory capital ratios. However, MDA headroom can look much narrower under the tighter definition of future (fully-loaded) capital requirements, i.e., at end-2021. We therefore consider how a bank will manage this transition because our ratings incorporate risk past the transition date.
- Article 104 CRD. More European jurisdictions will allow up to 44% coverage of P2R by AT1/Tier 2 instruments. Therefore, in some cases, proximity could prospectively widen, as long as the bank already has, or could issue, extra AT1 to fill a gap.
- Basel III finalization. While an ongoing, multi-year, and now delayed phenomenon, some banks could yet see substantial RWA inflation that, absent mitigation, could significantly alter their regulatory ratios. The effect might be substantially offset overall by an easing in Pillar 2 guidance from regulators, but this would not sustain headroom because ratios would fall toward MDA thresholds.

Historical and prospective volatility of earnings/capital stock This can relate to the bank's business model and risk appetite, but also includes the likelihood of restructuring or other one-off charges that could affect regulatory capital.

Earnings flexibility to absorb losses/cut back equity distribution As our earnings buffer measure shows, some banks have much greater capacity than others to absorb large credit losses through preprovision earnings. Similarly, we see a qualitative difference in the flexibility of a bank that is making sizable shareholder distributions (such as dividends, buybacks, etc.) and would likely cut them back sharply to avoid a MDA threshold breach, versus those that might continue to make heavy distributions or else have low earnings in the first place.

Historical and prospective trend and volatility of RWAs This can relate to the business model, strategy, and risk appetite, but also the potentially greater cyclicality of regulatory RWAs calculated on model-based versus standardized measures.

Regulatory stress testing The output and information value of a regulatory stress test depends on the scenario that it analyzed. However, some banks' capital ratios may look generally more or less volatile under stress than the average.

Which MDA threshold is narrowest SREP-MDA headroom is calculated in three ways--in reference to the CET1, Tier 1, or total capital SREP. A breach of any of these could lead to coupon nonpayment. As such, when considering proximity, we take into account the tightest headroom under all three measures. However, qualitative differences may apply. If a bank is tight on CET1, this might be particularly problematic if earnings capacity is poor or the bank is growing strongly. For the other thresholds, a bank could in theory issue more AT1 or Tier 2 to increase its headroom, but might in practice be unable to do so if it has impaired market access or would struggle to absorb the earnings impact of doing so.

Prospectively, the impending introduction of a binding leverage-based MDA threshold (L-MDA) in the EU and U.K. adds a further measure for investors to track, as a breach would have similar automaticity as for the SREP-MDA. By contrast, the consequences of a breach of the future MREL-MDA (i.e., MREL requirement) are less severe. It would lead to mandatory cuts to discretionary distributions (which might include AT1 coupon nonpayment) only after a nine-month breach has occurred, and even then the regulator could waive this if certain conditions are met.

What's Next For 2020?

The European AT1 market faces a complex year given the web of regulatory requirements within the EU, let alone across other European jurisdictions, the possibly greater divergent behaviour among European banks around call/noncall decisions, and strong regulatory influence over applicable thresholds and banks' call decisions. Bank disclosures around current and future MDA thresholds, capital policy, and ADIs have gradually improved, but remain variable in their frequency, consistency, and content.

Until the disruption caused by the COVID-19 outbreak, AT1 issuance volumes in January and February were strong. While 2020 AT1 issuance was already likely to be down on previous years, many European banks maintain a strong underlying incentive to come to the markets as they seek to:

- Call and replace early vintages of Basel III AT1 issuance;
- Replace legacy AT1 issuance that will have no regulatory Tier 1 capital value once grandfathering ends in 2021, after exercising calls or tender offers; and
- Fill untapped 1.5% AT1 buckets and take advantage of the widened AT1 (and T2) capacity under Article 104.

On the final point, banks may ultimately find issuing Tier 2 more attractive than AT1 should the current pricing environment persist. We note also that in past years when Tier 1 securities traded at deep discounts, banks have taken the opportunity to effect exchange or tender offers, and so book a capital gain. In the current environment, regulators could balk at signing off tender offers that erode capital buffers. However, if these discounts persist, it is possible that the market could see an outbreak of exchange offers, particularly for legacy instruments.

How long the market interruption lasts is uncertain, but we don't expect to see a broad market opening until at least September 2020. We are unlikely to see mass coupon cancellations or principal write-downs in the AT1 market provided the global recession doesn't persist. However, until investors have a clearer view on the near- and medium-term direction of European bank capital ratios, market access will remain difficult. They will also be mindful that the one-year delay to implementation of the revised Basel rules offers only temporary respite. The recent secondary market reaction has been more general than name-specific, but we expect that those issuers that can demonstrate superior resilience under duress will ultimately achieve differentiation in terms of better access to AT1 financing.

Even in the upside scenario of a rapid global rebound, we expect elevated market sensitivity will result in a higher cost of AT1 market access in the medium term: the ultra-tight spreads seen at the start of the year were already looking unsustainable from the perspective of risk-adjusted returns. Given the weak profitability and margin pressures that many banks face, we assume that they will delay their re-entry to the market in the hope that pricing becomes more attractive in 2021.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015

Related Research

- European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers, April 1, 2020
- COVID-19 Countermeasures May Contain Damage To Europe's Financial Institutions For Now, March 13, 2020
- Bail-in Debt Remodels The Risk Profile Of Bank Funding In Europe And North America, Sept. 26, 2019
- The Resolution Story For Europe's Banks: Life In The Halfway House, July 18, 2019
- EU Banking Reform Package: Enhanced Balance Sheets, Incomplete Market Integration, June 18, 2019

Appendix/Charts:

Table 1

European Bank AT1 Calls: 2020-2021

First call date	Issuer	ISIN	Priced	Currency	Size (mil.)	Coupon (%)	Reset spread	Post call structure	Call decision announced	Relevant security secondary (bid): Security	Cash price	i+sprd to next call	i+sprd to worst
18-Feb-20	BBVA	XS1190663952	11-Feb-15	EUR	1500	6.75	660.4	Interest will be reset every five years to 5yrs EUR MS + 660.4bps	Called	N/A	N/A	N/A	N/A
19-Feb-20	UBS Group	CH0271428317	13-Feb-15	USD	1250	7.125	546.4	Reset on the First Call Date and every 5-years thereafter, to a new fixed rate equal to the 5-yr mid swap rate plus 546.4bps.	Called	N/A	N/A	N/A	N/A
17-Mar-20	Swedbank	XS1190655776	12-Feb-15	USD	750	5.5	376.7	Coupon will reset to 5 year MS + 376.7bps. Callable every five years from 17 Mar 2020 at par	Called	N/A	N/A	N/A	N/A
26-Mar-20	DNB Markets	XS1207306652	19-Mar-15	USD	750	5.75	407.5	Coupon will reset every 5 years to 5 year MS + 407.5bps. Callable 20 Mar 2020 and annually thereafter.	Called	N/A	N/A	N/A	N/A
02-Apr-20	Standard Chartered	US853254AT77	26-Mar-15	USD	2000	6.5	488.9	Interest will reset every 5 years at the prevailing USD 5- year Mid-swap Rate + 4.889% per cent annum, being the initial credit spread on the securities.	Called	N/A	N/A	N/A	N/A
06-Apr-20	Danske Bank	XS1044578273	05-Mar-14	EUR	750	5.75	464	Coupon will reset to 6 year MS plus 464bps.	Called	N/A	N/A	N/A	N/A

Table 1

European Bank AT1 Calls: 2020-2021 (cont.)

First call date	Issuer	ISIN	Priced	Currency	Size (mil.)	Coupon (%)	Reset spread	Post call structure	Call decision announced	Relevant security secondary (bid): Security	Cash price	i+sprd to next call	i+sprd to worst
16-Apr-20	ING Groep	US456837AE31	09-Apr-15	USD	1000	6	444.5	Callable every 5 year after 16 Apr 2020.	Called	N/A	N/A	N/A	N/A
30-Apr-20	Aareal Bank	DE000A1TNDK2	13-Nov-14	EUR	300	7.625	718	Coupon will reset annually mid swap rate plus initial credit spread (no step-up) 718bp.	Not Called	AARB 7.625% PNC21	91.25	1718	795
30-Apr-20	Aldermore Group	XS1150025549	02-Dec-14	GBP	75	11.875	998	Coupon will reset 5 year MS plus 998bp	Called	N/A	N/A	N/A	N/A
30-Apr-20	Deutsche Bank	XS1071551474	20-May-14	USD	1250	6.25	435.8	Coupon will reset every five years to 5yrs USD MS + 435.8bps.	Not Called	DB 6.25% PNC25	68	1368	664
13-May-20	SEB	XS1136391643	06-Nov-14	USD	1100	5.75	385	Coupon will reset every 5 years to 5 year MS plus Reset Margin.	Called	N/A	N/A	N/A	N/A
18-Jun-20	Bank of Ireland	XS1248345461	11-Jun-15	EUR	750	7.375	695.6	Coupon will reset to 5 year MS plus 695.6bps.	TBD	BKIR 7.375% PNC20	97.875	2163	732
29-Jun-20	Rabobank	XS1171914515	15-Jan-15	EUR	1500	5.5	525	Coupon will reset to 5 year EUR mid-swap rate plus initial margin of 525 bps (no step-up).	TBD	RABOBK 5.5% PNC20	99.625	756	540
22-Sep-20	ABN AMRO Bank	XS1278718686	15-Sep-15	EUR	1000	5.75	545.2	Coupon will reset to 5 year MS plus 545.2bps.	TBD	ABN/ANV 5.75% PNC20	95.5	1751	587
26-Oct-20	Nykredit Realkredit	XS1195632911	19-Feb-15	EUR	500	6.25	598.9	Coupon will reset to 5 year EUR MS + 598.9bps. Callable annually from 26 Feb 2020	TBD	NYKRE 6.25% PNC20	99.625	719	619
15-Dec-20	Barclays	XS1002801758	04-Dec-13	EUR	1000	8	675	Callable every five years from 15 Dec 2020.	TBD	BACR 8% PNC20	99	981	714

Table 1

European Bank AT1 Calls: 2020-2021 (cont.)

First call date	Issuer	ISIN	Priced	Currency	Size (mil.)	Coupon (%)	Reset spread	Post call structure	Call decision announced	Relevant security secondary (bid)			
										Security	Cash price	i+sprd to next call	i+sprd to worst
19-Jan-21	Intesa Sanpaolo	XS1346815787	12-Jan-16	EUR	1250	7	688.4	Coupon will reset to 5 year Euro MS + 688.4bps payable semi-annually in arrear. Callable quarterly from 19 Jan 2021 at par.	TBD	ISPIM 7% PNC21	95.25	1412	746
01-Mar-21	Svenska Handelsbanken	XS1194054166	18-Feb-15	USD	1200	5.25	333.5	Coupon will reset to 5 year MS plus 333.5bps. Callable every 5 years from 1 Mar 2021 at par.	TBD	SHBASS 5.25% PNC21	99.25	562	333
22-Mar-21	UBS Group	CH0317921697	14-Mar-16	USD	1500	6.875	549.65	Coupon will reset every 5-year mid swap rate + 549.65bps. Callable annually from 22 Mar 2021 at par.	TBD	UBS 6.875% PNC21	102.5	580	482
30-Mar-21	BNP Paribas	USF1R15XK441	23-Mar-16	USD	1500	7.625	631.4	Coupon will reset every 5 years to 5 year USD mid-swap rate + 6.314%.	TBD	BNP 7.625 PNC21	102	491	491
01-Apr-21	Permanent tsb	XS1227057814	27-Apr-15	EUR	125	8.625	835.6	Coupon will reset to 5 yrs EUR MS + 835.6 bps, payable annually on 1 April each year and will reset every 5 years.	TBD	IPMID 8.625% PNC21	78	4129	1085

Table 1

European Bank AT1 Calls: 2020-2021 (cont.)

										Relevant security secondary (bid)			
First call date	Issuer	ISIN	Priced	Currency	Size (mil.)	Coupon (%)	Reset spread	Post call structure	Call decision announced	Security	Cash price	i+sprd to next call	i+sprd to worst
10-May-21	Bankinter	XS1404935204	28-Apr-16	EUR	200	8.625	886.7	Coupon will reset to 5yrs MS + 0.041% payable quarterly in arrear. Callable10 May 2021 and then at any time thereafter.	TBD	BKTSM 8.625% PNC21	99.25	962	933
23-Jun-21	Credit Agricole	XS1055037177	01-Apr-14	EUR	1000	6.5	512	Callable every 5 years from 23 Jun 2021 at 5 year mid swap rate +5.12%	TBD	ACAFP 6.5% PNC21	100	675	537
29-Jun-21	Rabobank	XS1400626690	19-Apr-16	EUR	1250	6.625	669.7	Coupon will reset every 5-year m/s + 669.7bps (no step-up).	TBD	RABOBK 6.625% PNC21	101.5	555	562
10-Aug-21	UBS Group	CH0331455318	03-Aug-16	USD	1100	7.125	588.3	Coupon will reset to 5 year MS plus 588.3bps.	TBD	UBS 7.125% PNC21	101	582	572
15-Aug-21	RBS Group	US780097BB64	10-Aug-16	USD	2650	8.625	759.8	Fixed until the First Call Date, reset every 5 years thereafter (non-step)	TBD	RBS 8.625% PNC21	103	579	584
10-Sep-21	UniCredit	XS1107890847	03-Sep-14	EUR	1000	6.75	610	Coupon will reset every 5 years to5 year MS + 610bps. Callable semi-annualy from 10 Sep 2021.	TBD	UCGIM 6.75% PNC21	93	1266	683
11-Sep-21	Santander	XS1107291541	02-Sep-14	EUR	1500	6.25	564	Coupon will reset every 5 years to 5 year MS + 564bps. Callable quarterly from 11 Sep 2021 at apr.	TBD	SANTAN 6.25% PNC21	95.5	1002	618

Table 1

European Bank AT1 Calls: 2020-2021 (cont.)

First call date	Issuer	ISIN	Priced	Currency	Size (mil.)	Coupon (%)	Reset spread	Post call structure	Call decision announced	Relevant security secondary (bid): Security	Cash price	i+sprd to next call	i+sprd to worst
13-Sep-21	Nordea Bank	XS1202090947	05-Mar-15	USD	550	5.25	324.4	Coupon will reset every 5 years to 5Y USD MS + 324.4bps.	TBD	NDASS 5.25% PNC21	98.125	624	333
13-Sep-21	Societe Generale	USF43628C734	06-Sep-16	USD	1500	7.375	623.8	5-yr Mid-Swap + 6.24% resettable every five years.	TBD	SOCGEN 7.375% PNC21	98.5	810	641

N/A--Not applicable. Source: Dealogic.

Table 2

Headroom

Bank	Reported (%) CET1	Reported (%) T1	Reported (%) Total	MDA threshold (%) CET1	MDA threshold (%) T1	MDA threshold (%) Total	Headroom: On Jan. 1, 2020*	Nearest MDA	Pro forma at end-2020§	Pro forma at end-2020§, after buffer easing	Pro forma at end-2020§, after buffer easing and art. 104a†	Total benefit of easing
Lloyds	13.8%	16.5%	21.5%	12.2%	14.6%	17.8%	160	CET1	95‡	250	250	155
Barclays	13.8%	17.7%	21.6%	12.1%	14.6%	17.9%	173	CET1	148‡	233	233	85
Banco Santander	11.7%	13.1%	15.0%	9.7%	11.2%	13.2%	184	Total	154‡	199‡	199	45
Deutsche Bank	13.6%	15.0%	17.4%	11.6%	13.1%	15.1%	192	T1	177	200	240	63
Commerzbank	13.4%	14.2%	16.4%	10.6%	12.1%	14.1%	208	T1	188‡	220	220	32
BNP Paribas	12.1%	13.5%	15.5%	9.9%	11.4%	13.4%	203	T1	185	220	220	35
Erste Group Bank	13.7%	15.0%	18.5%	11.2%	12.7%	14.7%	234	T1	220	254‡	298	78
BBVA	11.7%	13.4%	15.4%	9.3%	10.8%	12.8%	248	CET1	247	249	267	20

Note: Data is unadjusted for banks' recent decisions to cancel or defer their dividends in respect of 2019 earnings. *After final phase-in of systemic risk buffer and using 2020 Pillar 2 requirements. §End-2019 ratios plus previously announced changes to the CCyB. †CET1 headroom rises if the bank has excess AT1 or T2 capital. Rule is already applied in the UK at end-2019. ‡S&P Global Ratings' estimates. Source: S&P Global Ratings.

This report does not constitute a rating action.