Contingent capital and subordinated debt as an investment solution

Credit Suisse (Italy) S.P.A.
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For professional investors only.

Contingent capital and subordinated debt: a solution for issuers as well as investors

Rationale for issuers

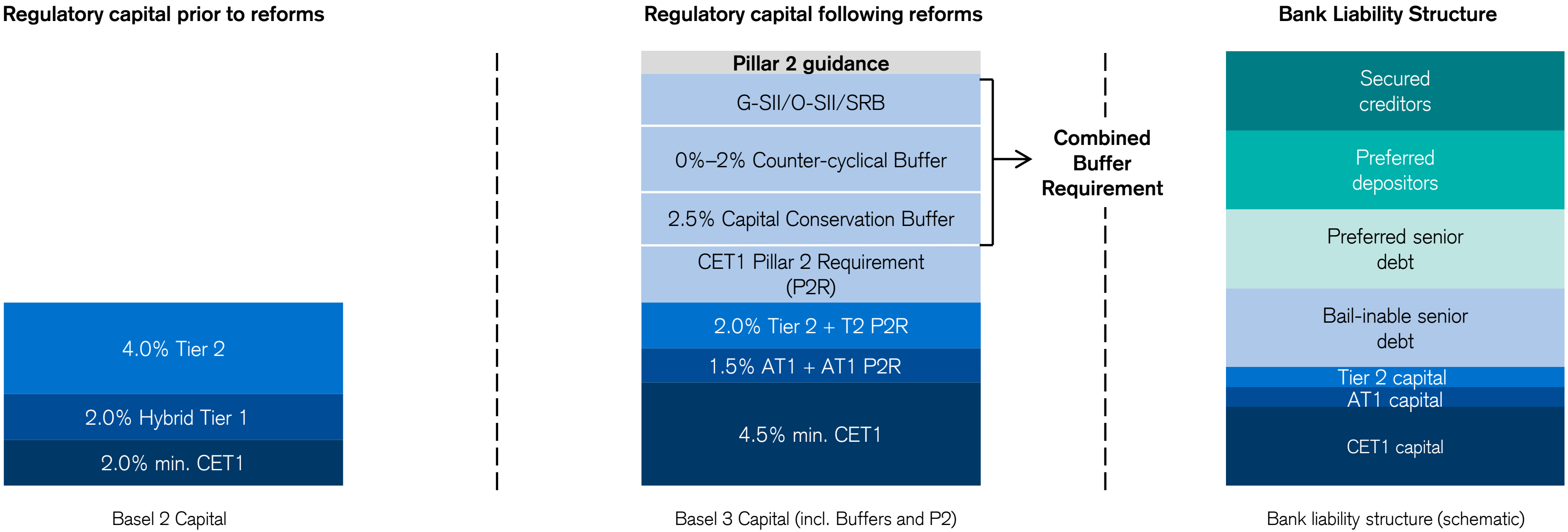
- Regulatory capital objective
- Credit-rating-focused objective
- Optimising weighted average cost of capital (WACC)

Rationale for investors

- Attractive risk-adjusted returns in high-quality issuers
- Significant yield enhancement to senior debt
- Benefits from regulatory reform that reduce risk profile

Regulatory capital and liability structure

Regulatory reforms have resulted in a significant increase in capital requirements



Sources: Credit Suisse, Basel Committee on Banking Supervision, European Commission
Data as of September 8, 2020

Key features of contingent capital

Basic design: Contingent capital has a **contractual trigger linked to an issuer's capital adequacy ratio.** When the relevant capital adequacy ratio of the issuer deteriorates to a level where the contractual trigger level is reached, the instrument will automatically be converted to ordinary shares or written down.

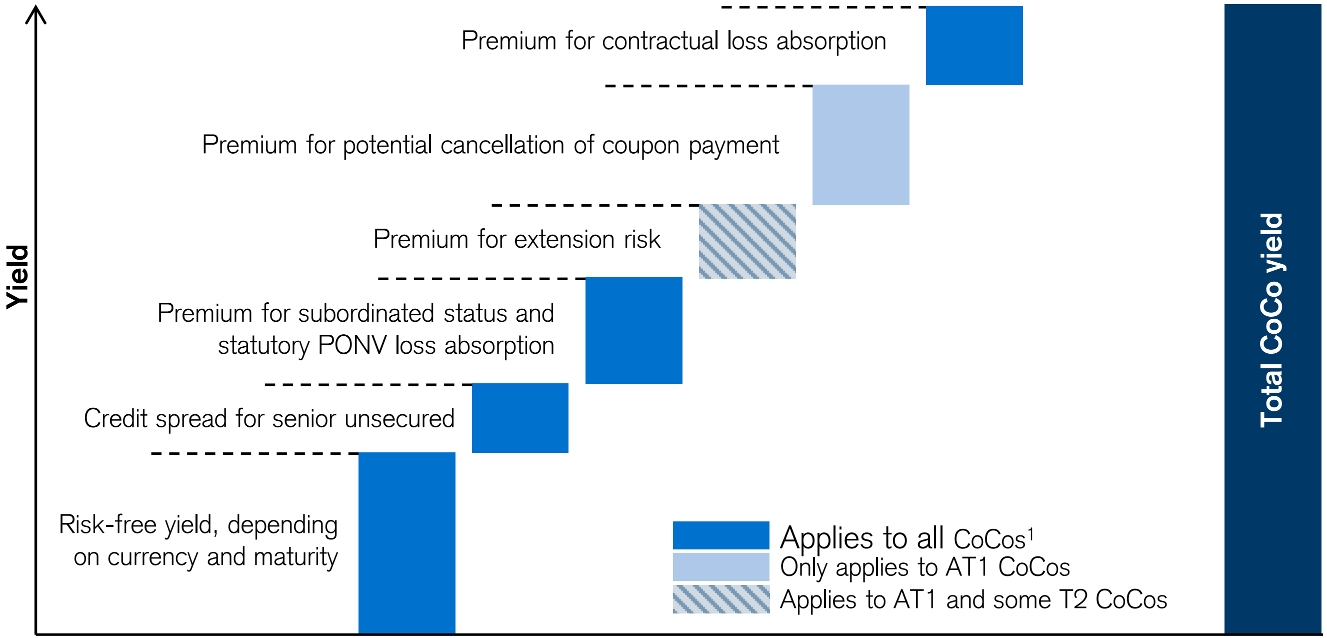
Additional tier 1 (AT1) contingent capital: the most typical contingent capital instrument is the AT1 instrument issued by European banks for regulatory capital purposes.

Key features of AT1 contingent capital:

- **Maturity:** AT1 contingent capital securities are perpetual securities; they cannot be called by the issuer earlier than year five from the date of issuance.
- **Coupons:** coupon structure is typically **fixed-floating,** being fixed to the first call date and reset to a floating basis plus the issue spread from the first call date.
- **Coupon cancellation:** coupons can be cancelled, either due to mandatory restrictions or based on issuer discretion.
- **Principal loss absorption:** Principal can be written down or converted into equity if the Common Equity Tier 1 (CET1) regulatory ratio falls below 5.125% or higher, as contractually specified. Discretionary write-up of the written-down principal from future profits is allowed, subject to maximum distributable amount (MDA) restrictions. Similar to tier 2 debt, principal can be written down or converted into equity if a bank is deemed to have reached a point of nonviability (PONV).
- **Subordination:** AT1 contingent capital ranks senior to ordinary equity and junior to subordinated debt.
- **Early redemption:** allowed in case of unforeseen changes to tax or regulatory framework.

Yield decomposition of contingent capital

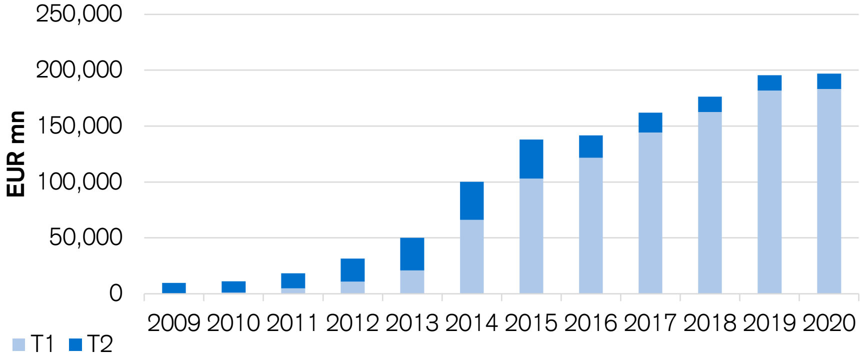
The yield on a contingent capital instrument can be broken down into several components. However, it is important to bear in mind that the various factors impacting each component of the yield structure vary significantly over time. The breakdown below demonstrates how the various main risks are factored into the overall yield.



Source: Credit Suisse
For illustrative purposes only
[1] Contingent convertibles (CoCos).

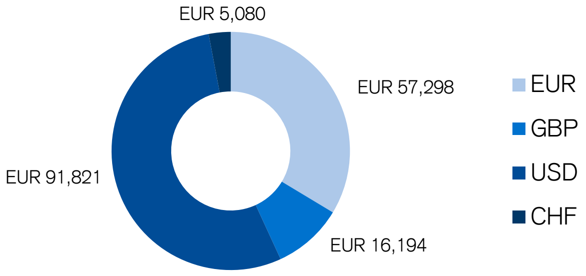
Growing contingent capital market

European bank contingent capital outstanding volume (EUR mn)



Source: Credit Suisse
Data as of July 3, 2020

European bank AT1 contingent capital outstanding volume by issuance currency (EUR mn)



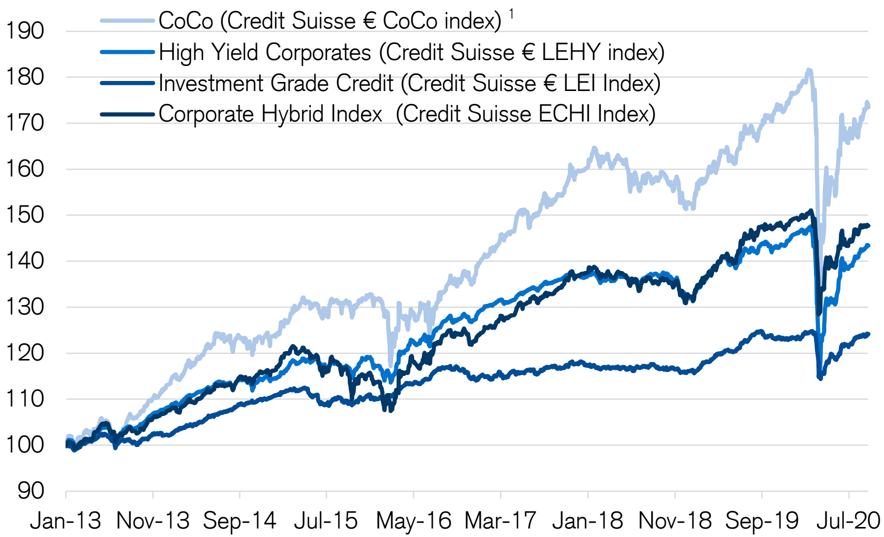
Source: Credit Suisse
Data as of July 3, 2020

- **AT1 contingent capital market of EUR 200 bn after strong growth over the last few years.** Most of the larger European banks are now at full or nearly full capacity utilization. Growth of the asset class will slow, as final stage of capacity utilization of smaller banks will be gradual.
- **Issuance activity will increasingly be balanced toward refinancing existing securities.** The assessment of the **extension risk** depends on the difference between the credit spread of a new replacement security and the reset or back-end spreads of the existing security, with decisions by issuers **increasingly based on economic considerations.**
- **Issuer incentive** is driven by lower costs than ordinary equity in meeting the 1.5% AT1 incremental requirement. Additionally, banks can strengthen their Tier 1 leverage ratios through AT1 issuance. Furthermore, the tax-deductible nature (in most countries) of AT1 contingent capital increases the economic efficiency for issuers while still offering an attractive yield for investors.

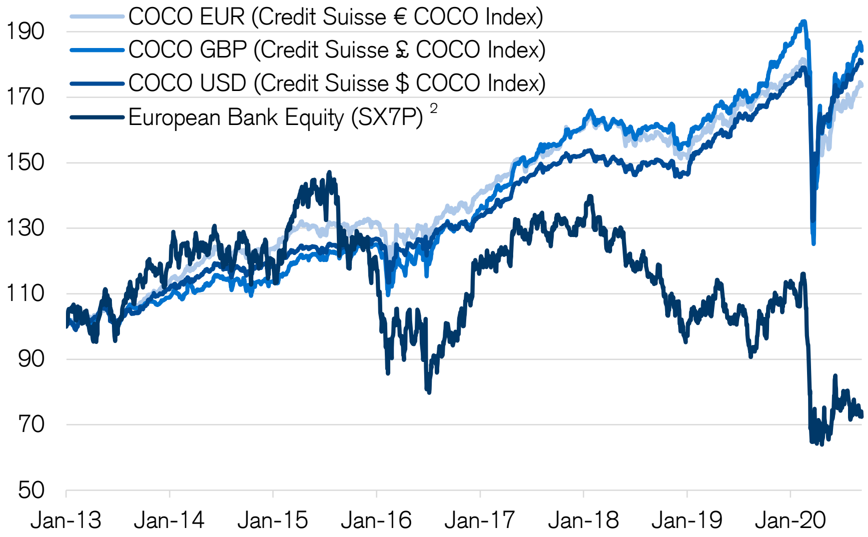
Source: Credit Suisse

European banks: historical performance of contingent capital

Contingent capital underperformed in pandemic-driven sell-off



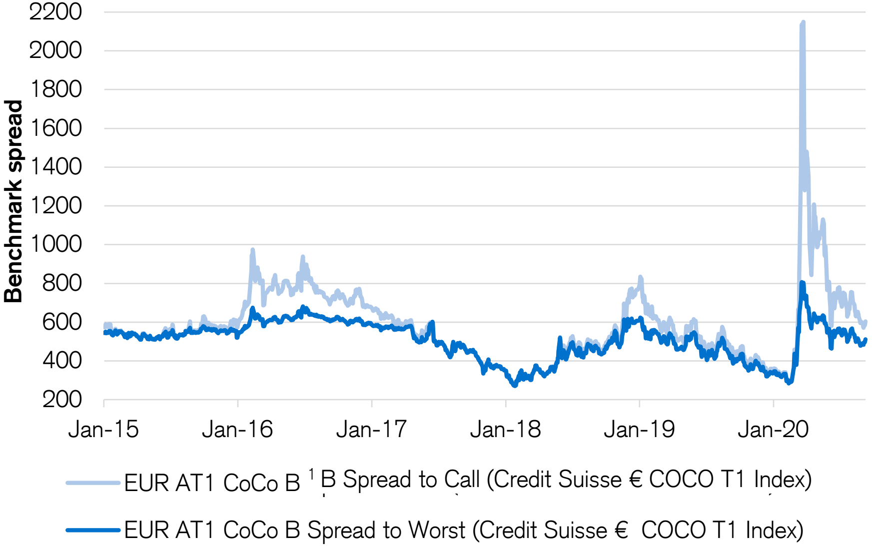
Bank equity had a modest participation in recovery post sell-off



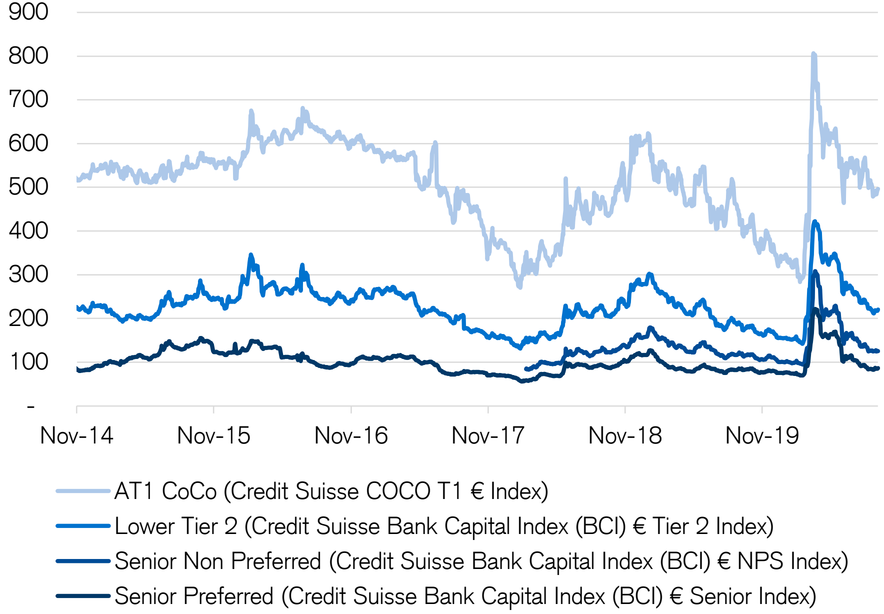
Sources: Bloomberg Professional Services, Credit Suisse
Data as of September 8, 2020
[1] Contingent convertible (CoCo).
[2] SX7P refers to the STOXX Europe 600 Banks (Price) Index.
Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

European banks: historical performance of contingent capital

Contingent capital (AT1) spread history



Capital structure spread history



Sources: Bloomberg Professional Services, Credit Suisse
Data as of September 8, 2020
[1] Contingent convertible (CoCo).
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European banks are well-prepared for an economic downturn

European banks are well-prepared for the current economic downturn, given the substantial improvement in capital adequacy since the 2008/2009 financial crisis. Common equity capital levels of European banks doubled from pre-crisis levels and **entered this challenging phase from a position of strength with average CET1 ratios at around 14% in 2019 compared to approximately 7% in 2007.** The current situation is thus distinctly different to the financial crisis in 2008/2009 when the banks were acutely undercapitalized and the source of the stress in the system. Results for H1 2020 have generally revealed resilient CET1 capital positions with increased headroom relative to the reduced regulatory requirements.

Responses from the ECB and other central banks are significantly mitigating the risks to the banking sector. In Europe, we have seen a wide range of accommodative responses from the ECB in its capacity both as central bank and as regulator. The funding measures in the form of additional longer-term refinancing operations at improved terms and collateral-easing measures, in addition to others, have largely removed funding risks.

Unprecedented fiscal and monetary stimulus will have a mitigating effect on the negative impact of the pandemic and related containment measures. In addition, the nature of this issue has prompted **more solidarity in Europe and has provided the impetus for taking a step closer to a fiscal union with the launch of a joint-debt-funded EU recovery fund**.

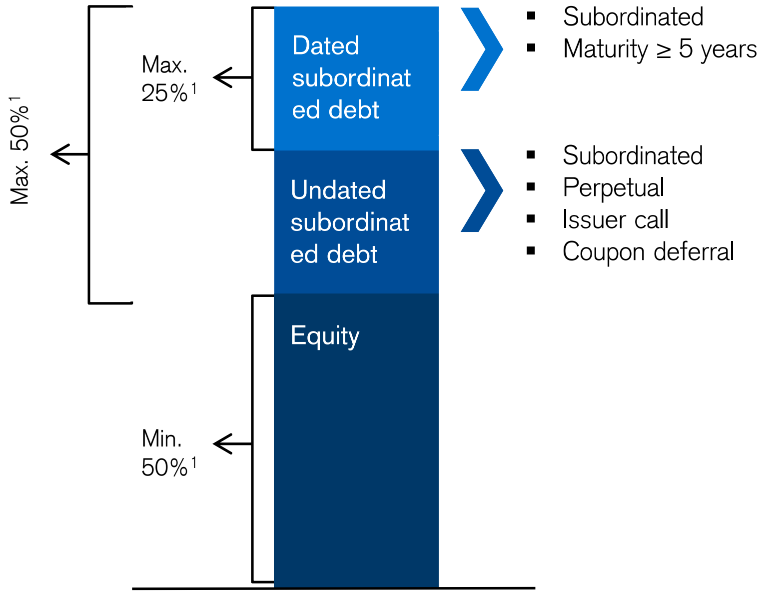
Capital adequacy impact will be mitigated by regulatory concessions or forbearance to banks, which include:

- Reducing regulatory buffer requirements like the countercyclical and Pillar 2 guidance buffers
- Flexibility in provisioning for loans in arrears/nonperforming
- Restrictions on ordinary dividends imposed by regulator-strengthened capital adequacy of the sector and confirmed the differentiation in regulatory approach between ordinary dividends and contingent capital coupons, with the latter unaffected

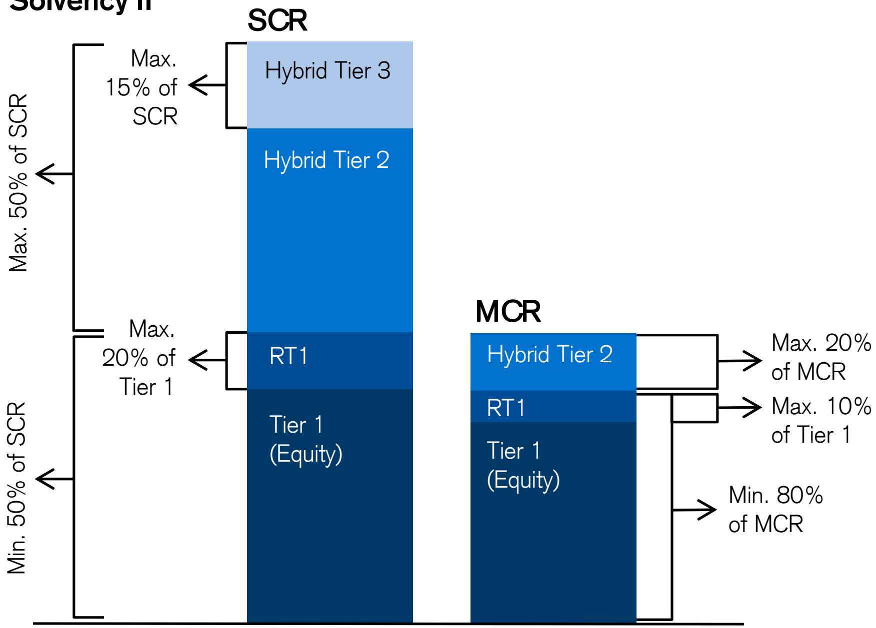
The nature of this event-driven growth contraction is distinctly different to a cyclical downturn and we **could potentially see a more rapid recovery following the containment of COVID-19 and not a prolonged downturn.**

Role of insurance restricted Tier 1 within capital requirements framework

Solvency I



Solvency II



Sources: EIOPA, Credit Suisse
Data as of September 8, 2020

[1] Minimum/maximum of the lesser of the available solvency margin and the required solvency margin.

Comparison of insurance restricted Tier 1 (RT1) vs. bank additional Tier 1 (AT1)

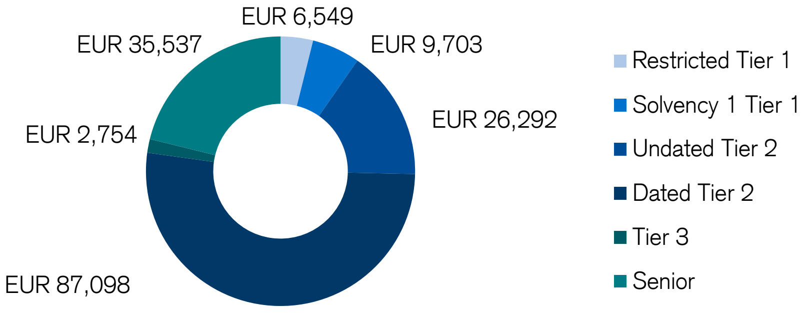
	Insurance Restricted Tier 1 (RT1)	Bank Additional Tier 1 (AT1)
1 Maturity	▪ Perpetual, callable not earlier than year 5 (including for unforeseen changes) ▪ Between year 5 and year 10 only repayable if SCR exceeded by appropriate margin ▪ No incentives to redeem (including no fixed-to-floating coupon rate)	▪ Perpetual, callable not earlier than year 5 ▪ No incentives to redeem ▪ Early redemption at par in case of unforeseen changes to tax or regulatory treatment
2 Coupon deferral	▪ No dividend stopper/pusher ▪ Mandatory coupon cancellation upon breach of SCR ▪ Non-cumulative ▪ No CBR/MDA[1] framework ▪ Coupons can only be paid from distributable reserves	▪ Fully optional coupon cancellation ▪ No dividend stopper/pusher ▪ Mandatory coupon cancellation upon breach of buffer capital requirements (CBR/MDA framework) ▪ Non-cumulative ▪ Coupons can only be paid from distributable reserves (ADI)
3 Principal loss absorption	▪ Write-down or conversion into equity if SCR $< 75\%$ once or $< 100\%$ over three months ▪ Write-up out of future profits provided the issuer is in compliance with SCR	▪ Write-down or conversion into equity if CET1 $< 5.125\%$ ▪ Discretionary write-up out of future profits pro rata with Tier 1 capital, subject to MDA[1] restrictions ▪ Write-down or conversion into equity if bank is nonviable (contractually or statutory)
4 Subordination	▪ Deeply subordinated in liquidation	▪ Deeply subordinated in liquidation

Source: Credit Suisse

[1] MDA means maximum distributable amount.

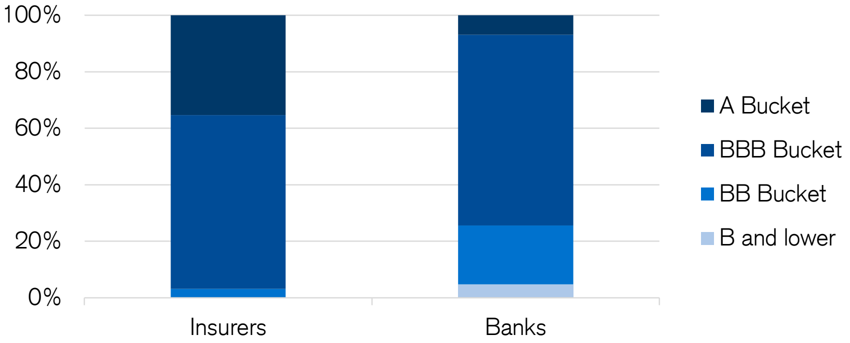
European insurance: debt market overview

European insurance debt market (EUR mn)



Source: Credit Suisse
Data as of July 3, 2020

Rating composition tier 2: banks versus insurers



Source: Credit Suisse
Data as of July 3, 2020

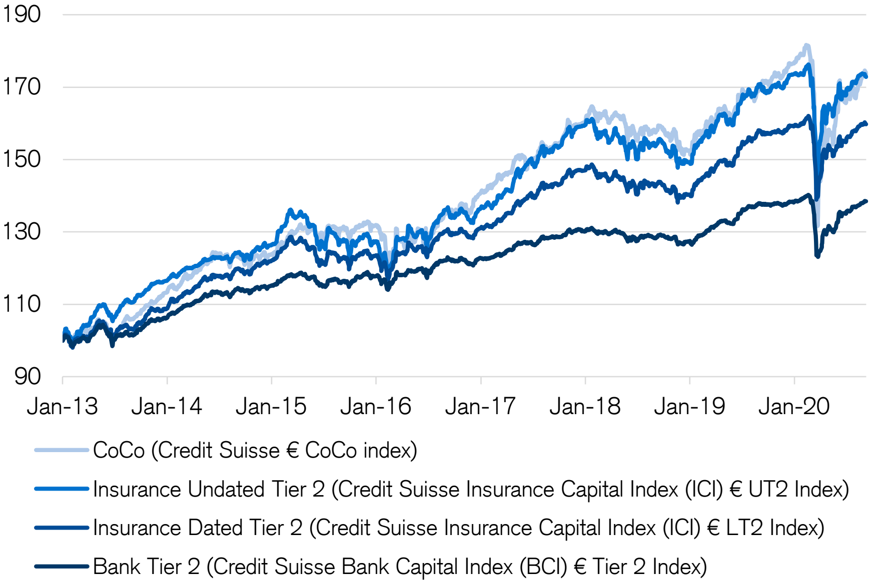
- **Subordinated debt market of EUR 122 bn:** larger insurers have utilized rating agency leverage capacity, with growth in asset classes more likely to come from new issuers going forward.
- **Restricted tier 1 growing but still small:** Rating agency models currently not incentivizing full restricted tier 1 regulatory capacity utilization by insurers. Potential changes to rating agency methodology and approaches in this regard can have a significant impact on potential size of the restricted tier 1 segment.

Source: Credit Suisse

- **Issuer incentive** is driven by lower cost alternative to common equity to meet capital requirements. Additionally, insurers obtain partial equity credit from the rating agencies for hybrid debt. Furthermore, the tax-deductible nature (in most countries) of restricted tier 1 contingent capital increases the economic efficiency for issuers while still offering an attractive yield for investors.
- **Rating distribution:** on average, rating quality is higher than for banks for the same part of the capital structure.

European insurance: performance relative to banks

Historical total returns: insurers versus banks



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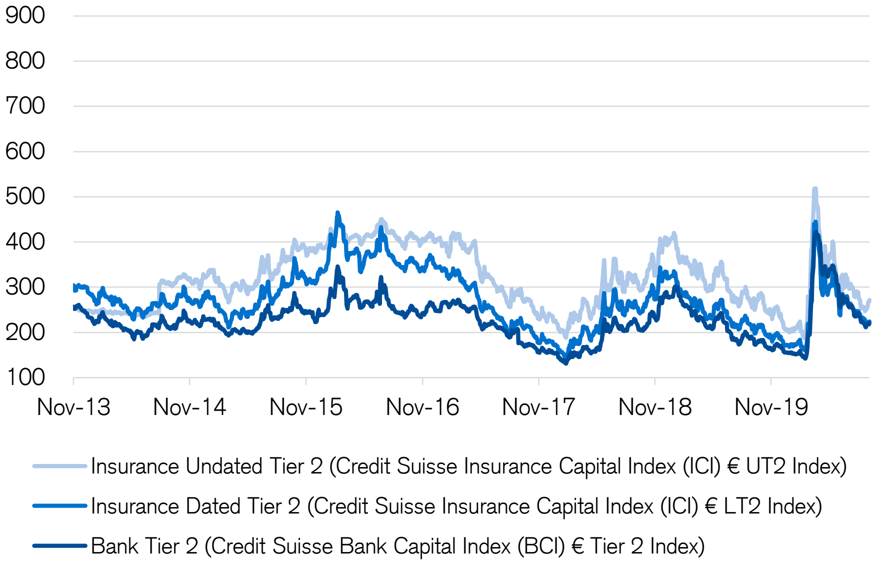
Benchmark spread-to-worst history



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Contingent capital: asset class attributes

Attribute	Description	
Attractive risk/return profile	▪ Contingent capital offers an attractive risk-adjusted return.	☑
High-quality issuers	▪ Contingent capital is unique in offering a relatively high yield despite the high-quality nature of issuers, consisting of regulated banks and insurers; strict regulatory regimes ensure that those issuers remain adequately capitalized. ▪ Significant yield enhancement compared to high-yield corporate bonds.	☑
High current income	▪ The asset class offers a high level of current income, with coupons still reflecting elevated spread premiums that are attractive in the current low-interest-rate environment.	☑
Improving fundamentals	▪ Regulatory reforms following the financial crisis have resulted in a significant reduction in the risk profile of banks with substantially improved capital adequacy. ▪ European banking sector fundamentals remain on a positive trajectory.	☑
Reduced capital volatility	▪ We expect inherent capital volatility of banks to fall as excessive risk is disincentivized under the reformed regulatory regime; combined with increased capital adequacy, this is positive for the risk profile outlook for contingent capital. ▪ Contingent capital investors take on predominately solvency risk, which is significantly reduced following extensive regulatory reform, leaving them considerably less exposed to earnings volatility than ordinary equity investors.	☑
Alignment of interest	▪ All key stakeholders in banks (including regulators, shareholders, management, bondholders and other creditors) are highly prioritizing prudent risk management and adequate capital adequacy following the financial crisis and related regulatory reforms, which ensures the alignment of interests with contingent capital investors.	☑
Positive technicals	▪ Most of the larger European banks are now at or nearly at full capacity utilization of contingent capital, and issuance activity will increasingly be balanced toward refinancing existing securities. ▪ The asset class is underinvested due to perceived complexities and constant changes to bank regulations, offering an interesting investment opportunity if underpinned by thorough analysis and research. ▪ Central bank valuation disturbance in the asset class is relatively low in our view compared to other credit classes.	☑
Relatively low interest rate risk	▪ Relatively low interest rate risk due to a combination of high coupons and product structure coupled with sector-specific positive net interest margin expansion in a rising rate environment.	☑

Risks

- Investors may lose part or all of the invested amount.
- Contingent capital instruments bear the risk of principal conversion or principal write-down.
- Contingent capital faces potential coupon cancellation risk.
- High sector-specific concentration risk.
- Market conditions can trigger fluctuations in total returns.
- Some investments may entail liquidity risk.

Presenter

Roger Wyss
Senior Portfolio Manager

Roger Wyss (BA, CFA), Director, is a senior portfolio manager for Global Corporate and Contingent Capital portfolios, as well as a member of the Global Credit Strategy Group and the Swiss Fixed Income Investment Decision Committee. Before joining Credit Suisse Asset Management in April 2006, he was a relationship manager for structured loans at Cantonal Bank of Zurich (ZKB), where he started in 1990, taking on a number of roles within corporate banking, including in structured finance, credit analysis and relationship management. Roger studied Business Administration at the Zurich University of Applied Sciences, Winterthur. He holds an executive master's degree in Corporate Finance from the Institute of Financial Services Zug IFZ, and is a CFA charterholder.

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