

Thoughts on the AT1 non-call by Santander

Yesterday, Santander decided not to call its 6.25% bond. This decision was widely watched by the bond market for a very simple reason: it was the very first bond for which the call was not an obvious decision. We try to answer a few basic questions raised by this decision.

1. Was the non-call a surprise?

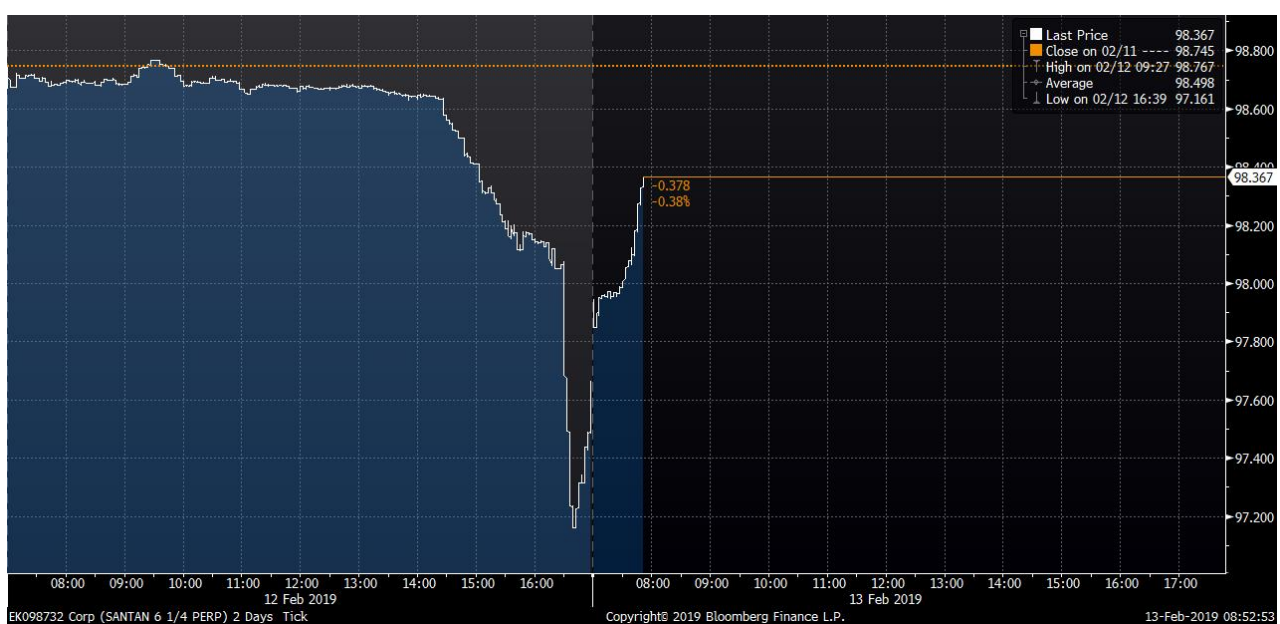
Yes and no.

Why no? Early January, the bond was trading at 95 and the market was split: only half of the people we talked to at the time believed the bond would be called. This was reflected in the price. As recently as yesterday, the views were still balanced (including at Axiom where a very unscientific poll led to a 50-50 result.)

Why yes? Because the communication by Santander was odd, to say the least. They had always said that call decisions would be made on an economic basis and the supervisors are generally expecting banks to refinance such bonds (especially for Santander which does not have ample capital.) However, last week they issued a bond at 499bps, 42bps inside the backend of the Santander 6.25. Some traders viewed this as a confirmation that Santander would call and the bond even briefly traded at 100. Moreover, as the call date notice period expired without a call, Santander took the time to issue a press release to explain that the market had wrongly read the day count in the bond prospectus and that the deadline was a few days later...Why bother doing that if you do not plan to call anyway?

2. What is the impact?

No drama as the following intraday chart shows.



Source: Bloomberg

The reasons for that are obvious: the bond can still be called every quarter and the running spread is (in €) still significantly above the running spread on the latest USD issuance from just a week ago! This is not a discounted perpetual bond where you get a meagre Libor + 10bps if the bond is not called!

3. Why did they decide not to call?

The honest answer is we do not have a clue and the only fair answer is probably “well, it is Santander!”. Let us expand on that.

Santander has always been unfriendly to investors. They have often taken steps that are very unfriendly to bond holders, such as collapsing Spanish law SPV in order to improve future MREL eligibility of some bonds to reduce the incentives to call.

Moreover, their call policy is hard to read, to say the least. Let us give an example: recently they decided to call a fixed for life perpetual bond that was trading above par. The market was a bit angry because Santander had skipped the delay for a call notice, but Santander argued that there had been an administrative error (not on their side) and that the call was legitimate. After receiving a few letters from lawyers, they backed down and did not call – but everyone expected the bond to be called at the next call date. To date, this bond has not been called!! They also decided to exercise a very generous make whole call on Santander UK for extremely complex regulatory reasons that frankly very few people understood.

This being said, the rationale for not calling can be:

- The supervisors do not agree to the call because the bank is undercapitalized, or the bond has not been adequately refinanced. Two weeks ago, we did not believe this to be a likely scenario and after the recent bond issue we believe this is extremely unlikely.
- An administrative error: they have issued a press release explaining the non-call, so this is very unlikely.
- Santander staff do not really agree internally on whether to call or not. This is quite likely: indeed, the Spanish press reported yesterday (midday) that Santander had not decided yet and that discussions were still ongoing! The bond is callable every quarter, so the decision can be easily postponed a few months after further internal discussions.
- Santander considers it economical not to call. This is a clear possibility, although far from obvious. As we explained above, the new issue was 42bps inside the 6.25 back-end, but this was a \$ bond. A similar € bond would probably cost around 550bps to issue – almost the same level as the back-end. If you have a very short-term view of “economic gain” (i.e. making 10bps on a bond instead of protecting your reputation) not calling is a possible decision.

4. What are the implications for the AT1 market?

Honestly, if the most sensational drama with a negative outcome that we can have on the AT1 market leads to a tiny -1pp drop, the answer to that question is rather obvious.

The truth is, investors are extremely well compensated for the risk they are taking. Let us take a very simple example: € SOCGEN 6.75 pays +450bps. A SOCGEN Tier 2 bond will pay a bit less than 200bps with almost the same credit risk. So 250bps are for coupon risk and extension risk. The coupon risk is frankly very low on such large, listed, investment grade issuers. Even if one is extremely pessimistic and assumes the bank misses



one coupon out of ten, you still have 400bps on the AT1 vs 200bps on the T2... that 200bps just for extension risk! (Which is not even a risk for many AT1 bonds since the yields to perpetuity are often higher than the yields to call.)

Contrary to what many commentators like to say (probably still influenced by what happened in 2008), the AT1 market is both extremely conscious of extension risk and very well paid for that risk.

The main consequence of Santander's decision could be a technical and very welcome one: we have long argued that the current coupon structures of many bonds are poor. We see many bonds where the reset coupons are set on a e.g. 5-year swap index, but the call options are quarterly. In case of extension, this creates a swaption for the issuer which is both expensive and not adequately priced, in our view. We tend to avoid those bonds. This will be clearer when investors will realize that on the Santander 6.25 they have no upside if yields go down (the bond will be capped at the call price, par) but all downside if yields go up. We hope this example will lead to more discipline on the coupon structures.

All Axiom funds sold their Santander 6.25 holdings on the 6th of February after the announcement of the new Santander 7 ½.



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