

## Flash AXIOM AI – The coupon risk on AT1s

### In a nutshell:

- In an announcement on March 27, the ECB recommends that banks should not pay dividends until October 1, 2020. [https://www.ecb.europa.eu/ecb/legal/pdf/ecb\\_2020\\_19\\_f\\_sign.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/ecb_2020_19_f_sign.pdf)
- There is no direct link between dividends and coupons on Tier 1 securities. In fact, the ECB's recommendation does not mention Tier 1 debt coupons.
- Andrea Enria, Chairman of the Prudential Supervisory Board (responsible for the banking supervision of the ECB), has just publicly stated "that the ECB has no plans to order banks to suspend coupons on their hybrid debt "  
<https://t.co/KaBcdl0JJM>
- The PRA has issued a formal request to banks under its authority asking for a common effort on dividends, share buybacks and cash bonuses suspension to face the exceptional situation caused by Covid-19. No mention has been made of hybrid debt coupons.

### Why suspend dividends and not AT1 coupons?

**Dividends and AT1 coupons are of a very different nature:** an unpaid dividend is not definitively lost. The money remains in the bank and therefore remains the property of the shareholders. It is possible to pay a double dividend the following year. An unpaid AT1 coupon is lost (with the impossibility of paying a double coupon the following year). The suspension of dividends represents a substantial saving (about 50 basis points of CET1, variable depending on the bank). The suspension of AT1 coupons represents an insignificant saving (about 5 basis points of CET1) while the potential negative impact on the market (and the banks' ability to issue in the future) could be significant. **You will see below the note we wrote on that topic on March 26<sup>th</sup> a day before the ECB's recommendations.**

Given the macro-economic outlook, the issue of coupon payments on AT1 is now, in our view, the main risk in this market. It can come from two sources:

1/ As a matter of principle, banks may be forced not to pay coupons if their capital level falls below a threshold, the "MDA Threshold", for Maximum Distributable Amounts.

2/ The authorities could impose this non-payment on banks.

The issue of non-payment of AT1 coupons must therefore be broken down into three questions that we detail below. We do not see any pressure to push the banks not to pay AT1 coupons. On the contrary, some banks (ING, SEB) have been authorized to reimburse AT1.

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## What will be the level of bank capital coming out of the looming recession?

Naturally, this is a very difficult question and very diverse GDP estimates are circulating (it should be noted that the below are forecasts at annualized rates, which makes the figures more spectacular than they really are!)

### Here are a few recently published estimates:

	Annualised rates	US GDP Q2
JP Morgan		-14%
Goldman Sachs		-24%
Morgan Stanley		-30%
Bank of America		-12%
Deutsche Bank		-13%
James Bullard (FED St Louis)		-50%

Our work is based on the following assumptions:

- In general, the European economy is less volatile than the US economy (larger share of the public sector, labor market rigidity, etc.). We assume a 20% (annualized) rate of decline over the duration of the economy's lockdown, which we conservatively estimate at three months (Wuhan's lockdown was 2 months.) We then conservatively assume that recovery takes place at a much slower pace, estimated at 50% of the rate of decline (no V-shape).
- We then use the 2018 stress tests to estimate the sensitivity of each bank's capital to macroeconomic shocks. These calculations incorporate both the cost of risk (provisions) and risk-weighted inflation.

This allows us to identify the list of banks that have a higher risk of coupon non-payment. In this scenario, among our sample of large banks, we see only five banks that are at risk of not meeting the MDA threshold, once it is modified by the decisions of the supervisors (see below).

In our view, four of these banks would also have no difficulty raising capital if this scenario were to materialise.

On the other hand, there are several things that need to be emphasized.

- (a) Not all the banks we have talked to in the last few days, or who have contacted us, have indicated that they expect very large provisions. Some have even indicated that their profit or capital forecasts remain unchanged.
- (b) A fundamental reason for this optimism is the unprecedented deployment of public resources. The United Kingdom, France and Germany, to mention only these three countries, have announced public guarantee programmes each in excess of €300bn! A very large share of the losses will therefore be borne by the States, and not the banks.
- (c) ABB, ECB, Bank of England, ESMA, etc., have indicated that IFRS 9 accounting rules and ABB guidelines on non-performing loans would be applied with great flexibility. It is clear that the objective is not to trigger NPL registrations or provisions when banks are called upon to support companies temporarily affected by the virus.
- (d) Of course, the stresses used as a benchmark for calculating banks' own funds did not involve any public support and did not include any of these support measures! Not even funding from the ECB. They are therefore very conservative, compared to the current reality. The new TLTRO (rate at -0.75%, broadening of collateral), for example, is a very important support for banks, both in terms of liquidity and profitability.

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## How is the "MDA Threshold" evolving?

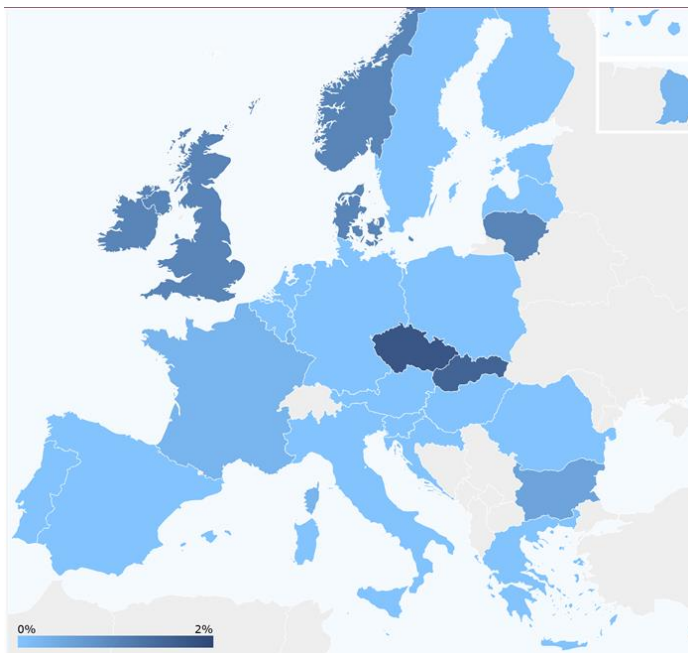
The authorities have decided on a dramatic **reduction in the capital requirements for banks - which increases the capital cushion available to them before reaching the "MDA Threshold"**.

The measures taken are as follows:

**a) Disposal of Pillar 2 Guidance**

**b) Authorization to complete the Pillar 2 Requirement with AT1 and Tier 2 capital.**

The ECB quantified these two measures as €120bn less required capital. This is therefore directly an additional cushion of 120 billion for banks.



c) **Elimination of the counter-cyclical cushion in most European countries (including Belgium, Denmark, Germany, Ireland, UK, France, etc.)** Again, these are very significant amounts as shown on the European map of pre-change counter-cyclical cushions.

d) **Some countries (e.g. the Netherlands) that had high systemic risk cushions have also lowered these cushions. At the European level, the authorities have therefore created an additional cushion of more than €200bn, according to our estimates.**

**Finally, banks have an additional cushion which comes from dividends:** if they were to decide not to pay the planned dividends on 2019 profits, they would see their CET1 capital ratio increase by around 50bps, since these dividends, even if unpaid, have for the most part already been deducted from capital under prudential rules.

**The latest cushion that has been modified is the capital conservation cushion of 2.5%. This is a very important cushion, representing almost €300 billion at European level. The ECB has indicated that banks could continue to operate outside this cushion.** However, if this were the case, they would still be subject to the MDA and would have to choose whether to pay dividends or AT1 coupons - or neither. In this regard, it should be noted that, in response to the crisis, the U.S. authorities have decided to modify the MDA rules to allow distributions of the past year's earnings. A similar measure in Europe would be very positive in the extreme case of a bank falling below the MDA threshold.

### 3 What is the position of the authorities and supervisors?

Non-payment of coupons could also result from pressure from the authorities or the supervisor.

We note the following points:

- a) **There is undeniable pressure not to pay dividends on 2019 profits.** Several authorities have expressed themselves very clearly on this point (but not the ECB, which has taken a much more flexible position). This pressure is logical since banks must put themselves in a position to withstand a major macroeconomic shock. But the impact is only temporary: what has not been paid in 2020 can be paid later! The choice not to pay would be very beneficial to holders of AT1 (see above.) To our knowledge, however, there is no position to encourage banks not to pay AT1 coupons. In our opinion, this is logical, for at least three reasons:
  - i. Unlike dividends, unpaid AT1 coupons are permanently lost. The decision is therefore more far-reaching.
  - ii. Non-payment on a debt instrument could greatly increase systemic risk and market fears (see what we experienced in 2016 on Deutsche Bank.) The authorities, who have a health crisis to manage, have no desire to add a financial crisis to it.
  - iii. Compared to dividends, the payment of AT1 coupons is a tiny issue. For a bank with 1.5% AT1, the non-payment of 5% coupons represents, after tax, a tiny gain of about 5 bps. This certainly doesn't deserve the risk of a crisis in the debt markets.
- b) **There is a consensus that, unlike in previous crises, banks are not part of the problem but part of the solution.** All the measures adopted (TLTRO, NPL, capital cushions, public guarantees) point in the same direction: it is the banks that will be on the front line when SMEs in difficulty are in trouble and they must be helped so that they themselves can help their customers.

- c) Finally, and most importantly, the Commission has made a crucial point on state aid. It should be recalled that during the 2008 crisis, the non-payment of coupons on hybrid (Tier 1) debt came mainly from decisions of the European Commission, which refused to allow public aid to be "used" to pay coupons on hybrid debt. This led to guidelines on state aid to banks, which now impose a very significant "burden sharing" on holders of equity securities (AT1, T2). However, when communicating the Covid19 package, the European Commission explicitly stated that these guidelines would not apply if a bank was in difficulty as a result of this crisis and if it therefore had to receive state aid.

**We therefore do not see any particular pressure to push banks not to pay AT1 coupons. On the contrary, some banks (ING, SEB) have been allowed to reimburse AT1. All recent announcements indicate that the consensus seems to be on restrictions on dividends and buybacks.**

## 4 Risks specific to subordinated debt

### Credit risk

Since the introduction of the Bank Recovery and Resolution Directive (BRRD), the risk of a bank being resolved is the greatest risk for a long-term investment in subordinated debt. In the event of resolution, default or deterioration of the credit quality of the issuers (for example, if their rating is downgraded by credit rating agencies), the bonds in which the fund is invested will decline in value resulting in a lower net asset value.

### Coupon

It is possible that the coupon will not be paid (apart from any resolution scenarios).

Subordinated debt entitles holders to receive coupon payments at a specified frequency. In some cases, the issuer may cancel coupon payment(s). The non-payment of a coupon is irrevocable, at the discretion of the issuer or by bond (in cases related to rules restricting coupon payments based on regulatory capital levels).

### Extension

It is possible that a bond issuer will fail to redeem a bond when expected. The initially promised maturity date may be extended. As a result, investors might recoup their capital at a later time than initially scheduled.

### Interest rate risk

Investors are exposed to interest rate risk, meaning when market interest rates rise, the prices of bonds fall, thus lowering the fund's net asset value.

For an overview of the risks associated with investing in the Axiom funds, consult the "Risk Profile" section of the respective prospectuses.

## 5 Glossary

- AT1 and RT1 - Additional Tier 1 and Restricted Tier 1** bonds are a new deeply subordinated debt format eligible for regulatory capital requirements/purposes under Basel 3 and Solvency 2. The instruments are designed to absorb losses in two ways: the first is via partial or complete suspension of coupon payment at the discretion of the issuer and the second is via either a (full or partial/temporary or permanent) principal write down or a (full or partial) conversion of the nominal amount into equity of the institution. The latter is triggered by a so-called quantitative capital trigger event with a predetermined regulatory capital ratio.
- MDA (Maximum Distributable Amount):** the MDA is a limit introduced by the CRDIV on the amount banks can distribute if they do not meet the combined buffers requirement. The limit applies to dividends, AT1 coupons and bonuses.

3. **SSM - The Single Supervisory Mechanism (SSM)** refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating countries.
4. **CET1 - (Common Equity Tier 1)** – Under Basel 310, Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.
5. **Pillar 2** - This pillar requires banks to develop their risk management beyond the minimum requirements set out in Pillar 1. Additional types of risk such as interest rate risk should be incorporated into this more comprehensive risk management system. Pillar 2 can be divided into two major components: (i) for institutions, where they should establish sound, effective and comprehensive strategies and processes for assessing and maintaining, on an ongoing basis, the amounts, types and distribution of capital corresponding to their risk profiles (ICAAP) and (II) Supervisory Review and Evaluation Process (SREP).
6. **TLTRO3 - Targeted Longer-Term Refinancing Operations** - The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions. By offering banks long-term funding at attractive conditions they preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy.
7. **NPLs - A non-performing loan is a loan** that is in default or close to being in default. Many loans become non-performing after being in default for 90 days, but this can depend on the contract terms
8. **Calls** -capacity for the issuer the redeem a bond before maturity, usually – but not always – at par. Calls can either have a specific date or be triggered by regulatory, credit or tax events
9. **Make-whole - make-whole** corresponds to a calculation of compensation ("make-whole") which corresponds to the discounting of future payments (coupon and principal) that the investor would have expected.
10. **Step-up – Step-up bonds** are investment securities that pay an initial interest rate but also have a feature where set rate increases happen at periodic intervals.
11. **Bâle 1, 2, 3 - Under Basel 3, Common Equity Tier 1** is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.

## Disclaimer

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