Bank+InsuranceHybridCapital Briefing

MEPs' AT1 coupon cancellation proposals raise remote but serious risk to product

Moves to target Additional Tier 1 coupons are ill-conceived and counterproductive, argue CACIB's FI team, threatening an option that can help banks contribute to the recovery just as supportive market conditions and the first AT1 issues have shown the sector to be reopening. *Neil Day* reports.

MEPs have tabled amendments to the CRR Quick Fix that could see AT1 coupons suffering a similar fate to bank dividends, with market participants warning that, although the risk of the proposals making it through the legislative process appears to be remote, it would be a "hammer blow" for the asset class were such distributions to be cancelled.

The European Commission published the original legislative proposal for amendments to the Capital Requirements Regulation (CRR) on 28 April to build on initiatives from regulatory authorities aimed at helping EU banks support economies amid the Covid-19 crisis, with a view to having the Quick Fix in place by 30 June ahead of bank's second quarter reporting of results and capital ratios.

The Rapporteur of the Committee on Economic & Monetary Affairs (ECON) published Parliament's first draft on 20 May and last week it emerged that MEPs have tabled a variety of amendments that raise the prospect of Additional Tier 1 (AT1) coupons being cancelled — something envisaged in neither the Commission or initial ECON drafts.

According to Crédit Agricole CIB (CACIB) analysis, among the amendments that threaten such an outcome are proposals that could see:

An extended temporary suspension on any kind of distribution, share buybacks and excessive bonus payments until October 2021 for ECB-regulated banks

A general prohibition on discretionary distributions (dividends, AT1 coupons, discretionary compensation) for all EU banks in the event of application of temporary operational and capital relief measures

A profound, permanent and prominent strengthening of supervisors' powers to impose temporary suspensions on discretionary distributions every time there is a declaration of serious disturbance to financial markets in the EU

Such amendments have been proposed by green, left-leaning and independent MEPs who are members of groupings that collectively hold close to 40% of seats in Parliament.

ECON members will vote on selected amendments on Monday (8 June) to produce the committee's final version. This is then set to be voted on at the parliamentary plenary on 18 June.

Doncho Donchev, DCM solutions, CACIB, said that although parliamentary arithmetic and the subsequent Trilogue with the European Council mean the proposals are unlikely to pass into legislation, the possibility of their being adopted following horse-trading cannot be ruled out.

He noted how similar circumstances led to a cap on bankers' bonuses being included in CRR in 2013, in spite of a lack of consensus around the idea, due to the pressure to finalise a package that would allow banks to strengthen their capital.

However, even if Parliament adopts the proposals for its negotiating position, he expects Council to reject them as governments, interested in financial stability, adopt a more pragmatic approach.

"You get more bang for your buck if you cancel banker bonuses or maybe equity dividends, and the tabloids write about it," said Donchev, "but the man in the street might not know what AT1 is. And the Council doesn't want to upset the apple cart by throwing the funding market up in the air, so I have faith that it will be hard-headed with Parliament and this won't go through."

Donchev added that AT1 coupons are not protected, as payment flexibility is one of the key features of AT1. There are nevertheless clear rules and intent in the regulatory framework as to when coupons are to be switched off, namely at CET1 levels close to or within the combined buffer zone.

"Indiscriminate switching off coupons at current CET1 levels will completely invalidate a key valuation metric — distance to buffers," he said.

According to Vincent Hoarau, CACIB head of FIG syndicate, although the AT1 market was a little softer last Friday (29 May) and this Monday after news of the proposed amendments emerged, the asset class has otherwise remained robust, in line with the prevailing strength of credit markets.

"With fear of missing out being the overriding theme, AT1 holders cannot afford to sell on this news," he said. "We continue to have a very strong AT1 market, with yields drifting lower, and so far investors have remained calm, even if a few see this as a real risk."

A French investor noted how even a rumour of a coupon skip can have a material impact on the market, but that prices have held up.

"This is a topic we are watching closely," he added. "But we did not de-risk."

Should AT1 coupons ultimately be cancelled alongside bank equity dividends, the impact on a sector of the market that has only recently started to reopen would be profound, according to Neel Shah, financial credit analyst at CACIB.

"The probability is low, but it's not zero, and if it were to materialise then it would be a big hammer blow for the AT1 market and investor base," he said. "You wouldn't be able to get traction from investors to buy AT1 bonds where the coupons are not going to be paid for a year or so — and once the coupons are switched off, it's difficult to overcome the inertia and switch them back on.

"Spreads have halved from their peak and we've seen issuance in the month of May from Bank of Ireland and Bank of Nova Scotia," added Shah, "so banks are definitely looking to start issuing, because the market remains firm and spreads are definitely more attractive. But if this decision goes the wrong way then it would be a big setback for banks issuing AT1s."

Ironically, the proposals come towards the end of a process that began with capital relief measures in March that included bringing forward banks' ability

Andrea Enria, ECB

to meet part of their Pillar 2R requirements through AT1 and Tier 2.

"The ECB is asking for banks to fully utilise the newly created headroom in terms of capital so that they are able to lend," said Donchev, "so they need to be able to issue more AT1 to fill the P2R bucket allocated to AT1s, and the market is conducive to this. But at the same time certain MEPs are threatening them with a blanket ban on coupons.

'You wouldn't be able to get traction from investors'

"That just doesn't work. They want to have their cake and eat it."

Andrea Enria, chair of the ECB's supervisory board, has already said the central bank has no plans to ask banks to not pay coupons on hybrid debt, and in the context of Covid-19 it has even been cautious about AT1 coupon cancellation due to MDA triggers being hit.

"Credit institutions might not be willing to use their buffers for additional lending due to concerns of being obliged to cancel AT1 coupons and face the potentially negative reactions of market participants," it said. "Such behaviour would impair the intended beneficial effect of the buffer framework."

A briefing paper prepared for ECON also noted that the amounts saved by a move against AT1 coupons would be much smaller than for dividends, approximately €6bn versus €30bn. The impact of AT1 coupon cancellation would also hit better capitalised banks while not supporting smaller players, according to Shah.

"The dividend suspension benefits the weaker banks, such as the smaller peripheral banks, because their capital is weak and they need to preserve capital," he said. "But while the stronger banks have to suspend dividends, too, they have the capacity to pay those dividends at a later date, so it's not a big negative.

"If you have a blanket ban on paying AT1 coupons, you are effectively punishing the stronger banks and their ability to issue subordinated capital, an area you don't really want to encroach on. And the weaker banks haven't had a chance to issue AT1 given that the market was just not willing to take that risk."

Market participants have also highlighted a lack of differentiation among some politicians and commentators between equity dividends that are suspended and AT1 coupons that are cancelled, noting that the way both are classified as "discretionary distributions" has inadvertently led to the two being similarly perceived.

"Whether this goes through or not this time around, AT1 investors in general are going to be more cautious going forward," added Shah. "If this Covid-19 crisis ends up lasting longer than expected, then dividend suspensions will be extended from October, and if further drastic measures on banks are required, then nothing should be ruled out."

And any political moves against the product will only result in the cost of AT1 rising, according to Donchev.

"It would effectively mean changing the rules on a whim and show that there is no stability in the bank capital framework," he said. "There would be a premium for political risk, and how are you meant to price that on top of the already complex optionality built into the current framework?" ●

Main photo: ECON Committee hearing; Credit: EP/Didier Bauweraerts; Enria photo credit: ECB/Flickr.

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