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Weekly Credit Brief
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Banco Santander sends reminder about the investment risks of AT1 perpetuals

By Dexter Tan

AT1 notes are a subordinated class of bonds issued by financial institutions that may be writen down or converted into equity during a pre-defined trigger event such as a breach of minimum capital adequacy ratio. Banks issue AT1 bonds to satisfy capital requirements and their cost of issuance is often lower than new equity. Additionally, the bonds are designed to help repair the balance sheet or facilitate the orderly resolution of the bank without the need to issue extra shares in stressful conditions. AT1 securities are issued as perpetual bonds with callable features but banks generally repay the bonds to keep their reputations.

Last week, the yields-to-call on Euro and US dollar denominated AT1 notes belonging to Banco Santander, Deutsche Bank and Barclays Bank have risen to the highest levels in the market. The high yields are a result of a number of factors, including terms specific to the call option of individual bonds and the issuer's credit quality.

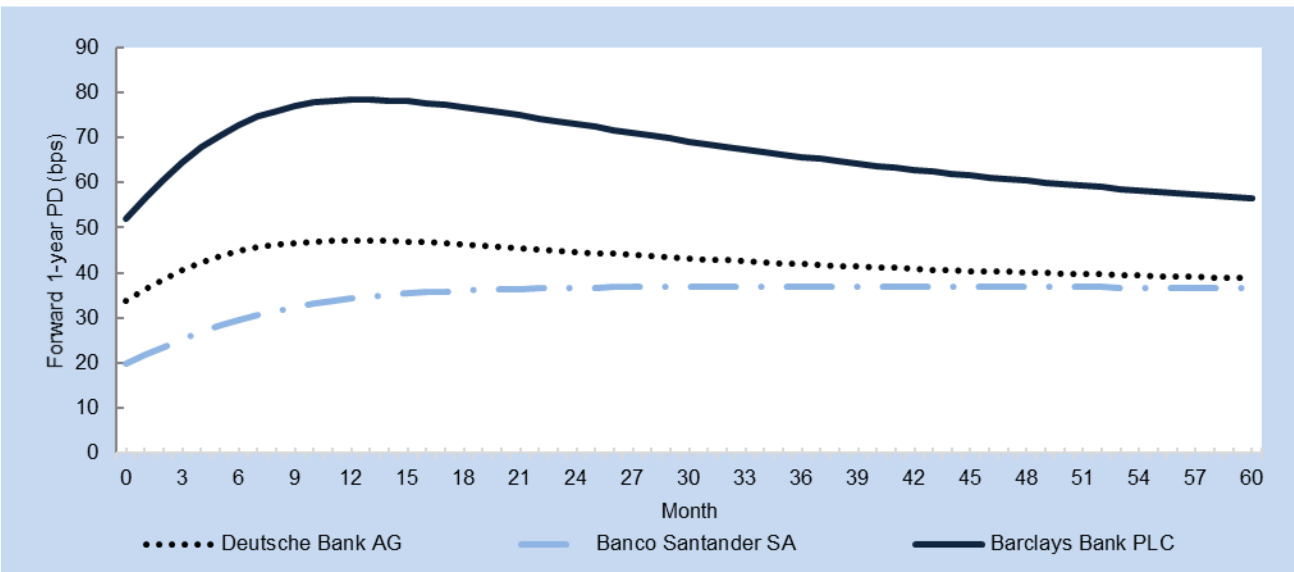

Figure 1: Term structure of Forward PDs for banks using available market information on Feb 15. *Source: NUS-CRI*

As shown in Figure 1, the credit quality of the three issuers will continue to deteriorate over the following six months. The term structures of the NUS-CRI Forward 1-year Probability of Default (Forward PD) on Feb 15 display an increasing 1-year probability of default, which is steeper in the next six months, indicating a heightened credit risk associated with uncertainties inherent in the European financial sector namely low net interest margins and political risks surrounding Italy and Spain. The NUS-CRI Forward PD works similarly to a forward interest rate. For example, the 9-month Forward 1-year PD is the probability that the firm defaults during the period from 9 month onwards to 1 year plus 9 months, conditional on the firm surviving the next 9 months.

The higher credit risk profiles for Deutsche Bank and Barclays Bank compared with Banco Santander are a reflection of the issuers' individual business conditions. Deutsche Bank is in the midst of integrating its Postbank merger and the market value of the German issuer has tumbled to near record lows after shareholders lost faith in the bank's turnaround strategy. Likewise, Brexit worries and a GBP 1.4bn settlement with US authorities have weighed on the market capitalization of Barclays Bank as it declined to its lowest level in two years.

On Feb 12, Banco Santander became the first European issuer after the financial crisis not to call its additional tier 1 (AT1) bond. The decision not to pay off the EUR 1.5bn AT1 issue may have surprised bondholders as issuers have traditionally kept a strong track record of calling their perpetual bonds on the first call dates. Prices on Santander's 6.25% note dropped initially to 97 cents on the euro following the announcement, but climbed above 98 cents on the euro by the end of the week. The muted reaction in the debt market to the Santander event may tempt other banks to follow suit and not call back their bonds.

Issuer	Currency	Coupon (%)	Call schedule	Floating rate reference after next call date	First call date	Ask yield-to-call
Deutsche Bank	USD	6.25	Callable every 5 years after 4/30/2020	US 5y swap + 4.358%	4/30/2020	22.33
Banco Santander	USD	6.375	Callable every quarter after 5/19/2019	US 5y swap + 4.788%	5/19/2019	10.30
Barclays Bank	EUR	4.75	Callable every quarter after 3/15/2020	EURIBOR 3m + 0.710%	3/15/2020	14.88
Banco Santander	EUR	6.25	Callable every quarter after 3/12/2019	5y EURIBOR 6m swap + 5.41%	3/12/2019	10.65

Table 1: Coupon references and call schedules of selected AT1 notes based on available information on Feb 15. *Source: Bloomberg*

As shown in Table 1, AT1 notes issued by the three banks currently trade below par. Due to the terms embedded in the security, issuers may not pay off some of these bonds at their call dates. Coupon rates for the notes will reset at a lower floating rate after their next call dates and issuers have a cost incentive not to exercise the call option. The new coupon rates are based on Euro and US dollar swap rates which move together with central bank target rates. As of now, the next move for swap rates may head lower as the Federal Reserve and the European Central Bank are likely to loosen monetary policy in consideration of slower eocnomic activity.

2019 could shape up to be a test for the AT1 market as more banks decide with how best to manage their redemption profiles, while investors ensure they are well positioned to avoid potentially heavy losses from bond repricings. As demonstrated recently, banks can risk their reputations and trigger a sell off in their bonds. Issuers may also take a step further to irk investors by changing the structure or benchmarks of their outstanding AT1 bonds. But if the market freezes or gets disorderly, regulators could step in and change the rules.

Credit News

Taiwan insurers skirt restrictions to load up on dollar bonds

Feb 15. Taiwan's insurance industry is buying locally listed exchange traded funds that purchase overseas, dollar-denominated corporate and sovereign bonds in order to achieve higher returns and circumvent a crackdown on risky overseas bet. The move came after Taiwan's Financial Supervisory Commission (FSC) set a cap for Formosa bonds ownership last year, effectively curtailing the market's growth. As a result, the Formosa ETF market growth exploded and is expanding at about 30% a month in 2019. However, if the USD depreciates strongly against the TWD, value of assets held in ETFs will decline and could hit the local insurance industry. Taiwan's FSC is currently monitoring the ETF market development and the potential currency exposure risk to the insurers. (FT)

China's banks throw open spigots in January, lend record RMB 3.23tn

Feb 15. In order to jumpstart sluggish investment and prevent a sharper slowdown, China banks have made the most new loans on record in January – reaching RMB 3.23tn. China banks tend to front-load loans early in the year to get higher quality customers and win market share but are facing pressures from regulators to increase lending to smaller firms. To stimulate lending, the central bank has cut the reserve ratio requirement five times over the past year. Strong credit expansion can help boost fixed asset investment as regulators fast track approvals for infrastructure and streamline financing. Several other key credit gauges such as the broad M2 money supply and outstanding total social financing also picked up modestly in January as PBOC shift to policy easing. (Reuters)

Subprime auto bond market is unmoved by record late loan payments

Feb 14. Despite report from the New York Federal Reserve that the number of car loans that have not been paid in at least 3 months have exceeded 7 million, investors are still buying up subprime auto asset-backed securities (ABS). The tighter bond spreads in these securities indicated that investors remain confident as they have yet to see late payments leading to an increase in defaults and expect credit protections to continue to prevent losses. The 60-day-plus delinquency rate for loans underlying subprime auto bonds has been rising steadily since 2011 and is higher than its peak in 2009 but it have not been translated into heavy losses for investors. Despite the stability of some bonds issued between 2015 and 2018, concerns are growing that there might be fewer protections into the lower end of subprime ABS due to strong demand for higher yields. (Bloomberg)

China credit hedging tool seen benefiting stronger firms

Feb 14. China revived a credit risk hedging tool - credit risk mitigation warrants (CRMW), which insure bondholders against defaults of the underlying debt in a way similar to credit default swaps. About 60 of these warrants have been sold on private sector debt to help weaker companies sell bonds since October 2018 and the biggest beneficiaries so far have been the stronger private firms. 64% CRMW were on obligations sold by companies with stronger ratings of AA+ and above, since underwriters are fearful of being exposed to the credit risks transferred to their balance sheets if the underlying borrowers fail. (Bloomberg)

Russia expects to recover far less from 'bad bank' assets: Sources

Feb 12. After the collapse of its three major lenders, Russia will dramatically cut its estimate of the sum it expects to recover from a "bad bank" set up. In an attempt to rescue these lenders, most of the troubled assets from the three banks were transferred to Trust Bank, the bad bank, last year. While it has previously hoped to recover between 40% and 60% of their assets worth RUB 2tn, it now expects to receive only 20% of the value. A downward revision to the estimate, however, could erode public trust in the central bank and also point to more weakness in the banking sector. (Channel NewsAsia)

Altria's USD 11.5bn bond sale meets strong investor demand (FT)

Euro falls after ECB official says fresh round of loans possible (FT)

Softbank says leverage not a problem. Rating firms not convinced (Bloomberg)

Regulatory Updates

Parliament panel seeks review of credit rating rules following IL&FS debacle

Feb 14. A parliamentary panel called for investigations to agencies that gave high ratings to entities of IL&FS group, as well as an overhaul of the rules governing credit ratings in India. The parliamentary panel also sought a wider review of the credit rating processes in India. The panel suggested that the Securities and Exchange Board of India should explore "mandatory rotation" of rating agencies every three years to avoid long association between companies issuing securities and rating agencies. It also suggested that more than one rating should be compulsory if the debt instrument or bank credit is worth over INR 1bn. Another suggestion was to widen the eligibility criterion for rating agencies. (Bloomberg)

Norway sets credit limits for booming consumer loan market

Feb 12. Norwegian debt levels are at a record high after years of low interest rates. In order to cool the debt growth, the central bank raised rates for the first time in seven years and has flagged more increases will come this year. The historically high household debt could be one of the major vulnerabilities for the Norwegian economy as consumer loans have expanded twice as fast as overall debt levels. In order to protect the economy from the increasing household leverage amid rising interest rates, Norway stepped in to limit the growth of high interest rate consumer loans and credit card debt. The limits prohibit banks to give loans to people who cannot be deemed to handle a 5 percentage point rise in interest rates on their overall debt or whose debt exceeds five times their annual income. (Bloomberg)

China considering measures to adjust lending rates for companies: central bank official (Business Times)

Turkish central bank changes reserve levels to encourage lending (Bloomberg)

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