Red Cedar Investment Management

AT1 Perspective

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"The reports of my death are greatly exaggerated." –Mark Twain

As the news broke on Sunday afternoon that the holders of Credit Suisse's (CS) Additional Tier 1 (AT1) bonds would be completely written off in the UBS "take under" of Credit Suisse, commentators immediately questioned the viability of the entire $251bn asset class of AT1 securities.

It is important to put the CS default into its proper context. The AT1 asset class has existed in its current form since about 2013. In that time, there has only been one major default: CS.[1] Prior to its default, CS USD bonds represented roughly 6% of the COCO Index,[2] the second largest issuer in the Index. As a comparison, high yield default rates exceeded 7% in the 2015/2016 commodity bust and cumulative defaults since 2013 are materially higher for high yield bonds than they have been for AT1s. Most importantly, average annual total returns since inception of the COCO Index are 64 basis points (bps) higher[3] than they have been for high yield bonds while current spreads are 107 bps wider for AT1s.

Adding fuel to the financial media-driven, apocalyptic tone on the future of the asset class was the fact that common equity holders of CS would receive more than $3bn in the face of the total wipeout of the $16bn par value of AT1 bonds. Pundits the world over questioned how a fixed income investor could ever invest in AT1s again, knowing that they could find themselves not only completely wiped out but also subordinated to common equity holders!

Ironically, it has only been a year since economists at the Bank of England (BOE) and European Central Bank (ECB) questioned the existence of the entire AT1 asset class for essentially the exact opposite reason—that they would never actually be used and consequently represented just an expensive funding mechanism for the banks that issued them. We would argue that if Swiss Regulators would have decided to make AT1 holders whole and instead committed $16bn of taxpayer money in the form of capital, that would have spelled the end of the asset class for the exact reasons the BOE was arguing.

Admittedly, the lack of respect that the Swiss government had for payment rank is maddening. However, we view the media's focus on payment rank to be a red herring. **The real story is that the AT1 asset class was put to the test in the form of a major systemically important financial institution failure and the asset class performed its primary objectives of recapitalizing a failing institution, preventing financial contagion while limiting the use of taxpayer funds.**

In fact, as a dedicated investor to the AT1 asset class with exposure to AT1s in general but importantly not to CS specifically, the resolution of CS that has so far avoided broad based financial contagion presents a plethora of opportunities to invest at levels not seen since the Spring of 2020. Since CS's failure, Red Cedar has slowly and methodically deployed dry powder to the AT1 space, paying attention to both the highly idiosyncratic structural features of these instruments while also being laser-like focused on the credit quality of the issuers themselves.

[1]Banco Popular's €1.25bn of AT1s were written off in 2017 prior to its takeover by Santander. This was the only other major default from the COCO index and it was largely shrugged off by the broader market.
[2]COCO – ICE BofA Contingent Capital Index Currency Hedged.
[3]COCO average annual returns from 12/31/2013-3/22/2023 4.45% vs 3.81% for LF98TRUU - Bloomberg US Corporate High Yield index.

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