The Resilience of Additional Tier 1 Contingent Capital Market in 2023 and outlook for 2024

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2023 proved to be an eventful year for the Additional Tier 1 (AT1) Contingent Convertibles (CoCo) market, with one of the most significant occurrences being the full write-down of Credit Suisse's AT1s. The forced takeover of Credit Suisse by UBS sent shockwaves through the banking sector and had a profound impact on the AT1 CoCo market. Unexpectedly, Credit Suisse CoCo's were written down, while equity holders were not wiped-out. The traditional credit waterfall was not respected, to the surprise of almost the full market – a black swan had hit the CoCo market.

The announcement of the write-down of the Credit Suisse CoCos sent the CoCo market into a tailspin. Investors feared that the write-down would result in future potential CoCo bond conversions not respecting the traditional credit waterfall, leading to a cascade of sell-offs and price declines. This sudden market uncertainty and the resulting panic-selling caused CoCo bond prices to plummet, raising questions about the reliability of these instruments as a form of capital for financial institutions in general.

However, as the dust settled very quickly and regulatory authorities provided guidance, astute investors recognised a potential opportunity amidst the chaos. CoCo bond prices reached their lowest point, creating an ideal buying moment for those with long-term perspective. EU regulators brought clarity to the interpretation of CoCo regulations, alleviating concerns about potential trigger events – such write-downs not respecting the credit-waterfall and keeping equity alive was a distinct possibility for the EU CoCos. The Credit Suisse-UBS merger prompted regulators to clarify their stance on CoCo bonds, underscoring their importance as a risk-absorbing tool in the banking sector. This newfound regulatory clarity reassured investors, helping to stabilise the CoCo market and facilitate its eventual recovery.

Fall and Recovery

Source: iBoxx, WisdomTree. As of 31 Dec 2023. Performance of the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index is based on the EUR-hedged version of the strategy. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Several other factors also played a pivotal role in the CoCo market's recovery during 2023. Rising interest rates provided an attractive alternative to investors, leading to increased demand for higher-yielding CoCo bonds. Additionally, the overall health of the financial sector, benefitting from higher interest rates (read more in our previous blog) – with banks showing robust earnings and balance sheets, instilled confidence in CoCo investments.

In summary, the CoCo market's resilience in the face of the Credit Suisse-UBS merger and quickly rising interest rates highlighted the adaptability and strength of these instruments. Regulatory clarity and the broader economic landscape, characterised by rising interest rates and a healthy financial sector, were instrumental in the market's rapid recovery. Investors who remained vigilant and capitalised on the CoCo market's fluctuations reaped the rewards, demonstrating the value of a strategic, long-term investment approach.

As we step into 2024, the CoCo market stands on a strong foundation, bolstered by a robust financial sector and a unique combination of factors; including robustness of CoCos in different interest rate environments (read more here). High interest rates continue to provide an attractive investment landscape, driving investor demand for higher-yielding CoCo bonds, with potential cuts in interest rate from central banks leading to likely price gains. The financial sector, having weathered the challenges of previous years, is now thriving with healthier balance sheets and solid earnings. This favourable environment has spurred an influx of new CoCo issuances, as financial institutions seek to take advantage of the strong investor appetite for these hybrid instruments. With regulatory clarity from the previous year and a buoyant market, 2024 promises to be an exciting year for CoCo investors, as they navigate a landscape defined by stability, opportunity, and the ever-evolving dynamics of the financial sector.

Conclusion

CoCos have come out stronger from 2023, having weathered previously unknown storms. We believe that the events in 2023 have further strengthened the outlook of the asset class, with improved clarity and support from regulators and strong performance in a unique rates environment. CoCos have outperformed most of the other related asset classes and sub-groups over the last decade and could potentially continue to do so given the renewed injection of confidence from investors.

Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 31 Jan 2024. Based on returns in EUR. All fixed income indices are total return indices; all equity indices are net total return indices. Performance includes backtested data. Performance of the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index is based on the EUR-hedged version of the strategy. The iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (EUR Hedged) started its live calculation on 09 March 2018. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

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