Are AT1 CoCo bonds an attractive investment in 2025?

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Ayush Babel
Director, Quantitative Research

Prof. Wim Schoutens
Professor at the University of Leuven, Belgium

Key Takeaways

- Elevated rates improve banks' profitability through wider interest spreads and improved ROE, enhancing their financial strength and supporting the appeal of AT1 bonds.
- Healthy CET1 ratios provide a strong buffer against economic stress, lowering risks like coupon cancellations and improving AT1 bond security in volatile markets.
- Banks today are better capitalised and managed, with improved risk controls and oversight, making AT1 bonds more secure compared to a decade ago.
- The WisdomTree AT1 CoCo Bond UCITS ETF (COCB) tracks the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index that takes a broad market approach while applying strict liquidity and ratings criteria. The index captures all major currencies in which CoCos are issued in Europe, that is, USD, GBP, and EUR; thus, providing a diversified exposure.

As we move into 2025, many investors are re-evaluating their portfolios, and one question keeps coming up: are AT1 bonds (Contingent Convertibles) a wise choice for the year ahead? AT1 bonds, known for their high yields, are hybrid securities issued by banks to strengthen their capital bases. These bonds offer higher interest rates but come with certain risks, which can make them a compelling, if complex, investment option. Let’s explore why AT1 bonds might be worth a closer look in 2025.

1. Higher interest rates favour the banking sector

In recent years, central banks worldwide have raised interest rates to combat inflation and stabilise financial markets. While high rates have presented challenges to some sectors, especially many issuers of high yield bonds, the banking industry has largely benefited. Banks earn profit through the interest spread—the difference between the interest they pay on deposits and the interest they charge on loans. Higher interest rates widen this spread, allowing banks to charge more for loans relative to deposit rates, thereby increasing their interest income.

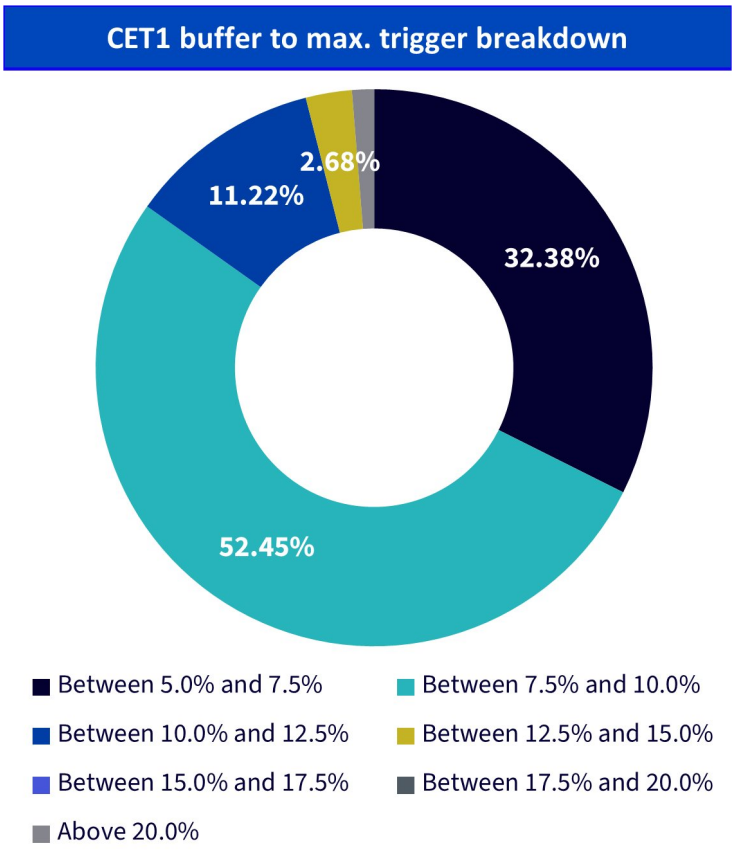
Looking forward, many analysts believe that interest rates will remain elevated and are unlikely to return to the near-zero levels of recent years. This is because many Western countries have taken on substantial levels of debt, especially following the economic disruptions of recent crises. To manage this debt burden, a degree of inflation is actually beneficial, as it helps reduce the real value of debt over time. However, inflation requires higher interest rates, creating an environment where central banks may be inclined to maintain rates above historic lows for the foreseeable future. This perspective supports the outlook for sustained profitability in the banking sector, as banks continue to benefit from wider interest spreads, further bolstering the attractiveness of AT1 bonds.

For investors, this dynamic is crucial. The banking sector's improved profitability, driven by higher rates, supports its financial health and, indirectly, the stability of AT1 bonds issued by these institutions. The environment of elevated interest rates has particularly bolstered banks' Return on Equity (ROE), with the increased interest margin adding resilience to their business models. This makes AT1 bonds, which hinge on the issuing bank's financial strength, potentially more secure investments.

2. Healthy CET1 ratios enhance AT1 bond security

One way to gauge a bank's financial strength is by looking at its Common Equity Tier 1 (CET1) ratio. This metric measures a bank's core equity capital against its risk-weighted assets, providing insight into its ability to withstand economic stress. In recent years, CET1 ratios have remained healthy across the banking sector, even amidst economic challenges. For AT1 bondholders, high CET1 ratios serve as a buffer, reducing the likelihood of adverse events such as coupon cancellations or bond write-downs.

This robust capitalisation makes CoCos more secure, especially as economic uncertainty looms. For investors in AT1 bonds, stable CET1 ratios could mean a reduced risk of capital loss and a more stable income stream, both of which are key considerations in today's volatile markets.



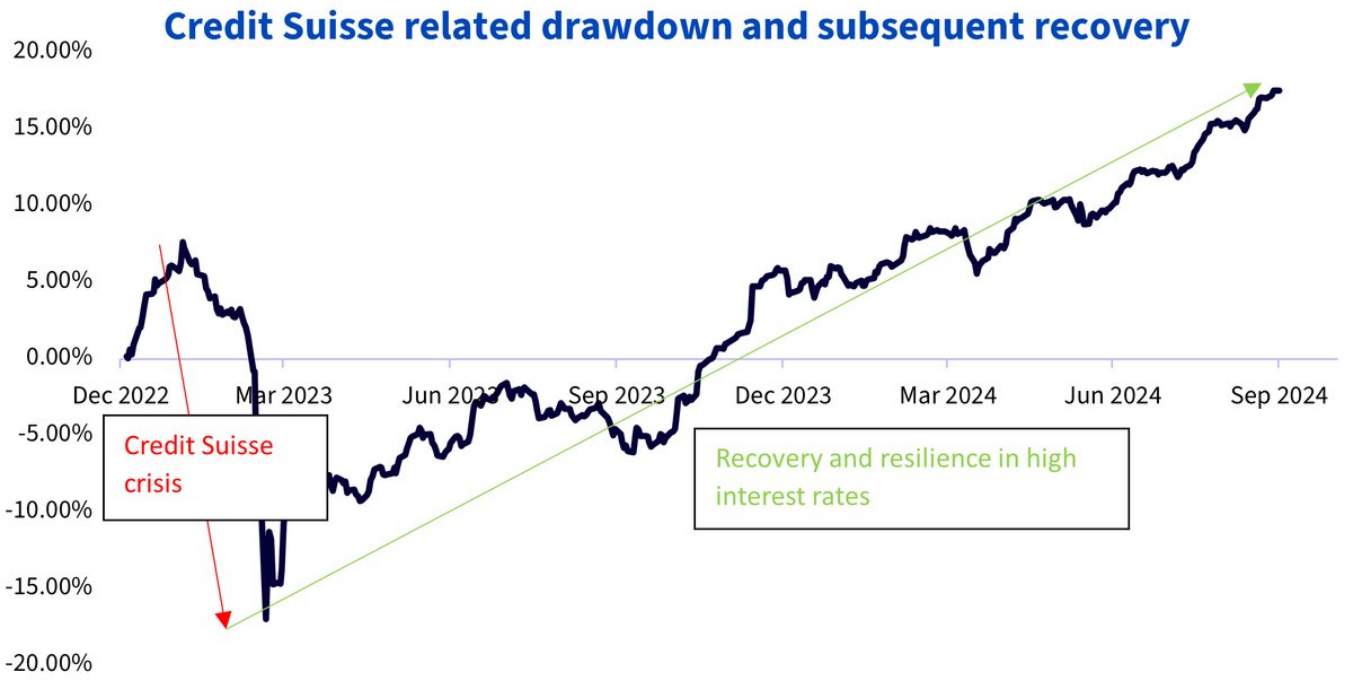
Source: WisdomTree, Markit, Bloomberg, respective issuers financial results. Data as of 30 Sep 2024. CET1 change represents value change in CET1 ratios from data available as of 30 Sep 2024 (generally Q2 2024 available reporting) compared to latest data available as of 30 Jun 2024 (generally Q1 2024 available reporting). No change may indicate reporting cycle has not ended. CET1 ratio is the Common Equity Tier 1 Capital ratio reported on a fully loaded basis available on Bloomberg and from the issuer's latest financial results, if not reflected on Bloomberg. Maximum trigger level is represented by the maximum trigger observed across all CoCo issues of a given issuer. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

3. Regulatory clarity following the Credit Suisse event

One of the major turning points for AT1 bond investors came with the Credit Suisse crisis. During this event, AT1 bondholders faced unprecedented losses, as Credit Suisse's bonds were written down to zero in a bid to stabilise the bank amidst severe financial distress. For investors in AT1 securities this was a shock since, in contrast to general belief, the Swiss regulator did not respect the waterfall structure.

While this was a challenging episode for Credit Suisse bondholders, there was a silver lining for the broader market. The Credit Suisse incident prompted EU and UK regulators to step in and clarify the conditions under which AT1 bonds could be written down or converted. Today, regulatory frameworks around AT1 bonds are clearer than ever: in the EU and UK, CoCo bonds will not be written down while equity is kept alive. This increased transparency has helped to stabilise the market for AT1 bonds, providing a more predictable environment for investors and potentially making AT1 bonds a safer investment than before the Credit Suisse crisis. And, finally, changing the law or passing some amendments over a weekend,

which happened in this black-swan event, is not something that is very likely in the European Union (EU), with 27 countries around the table.

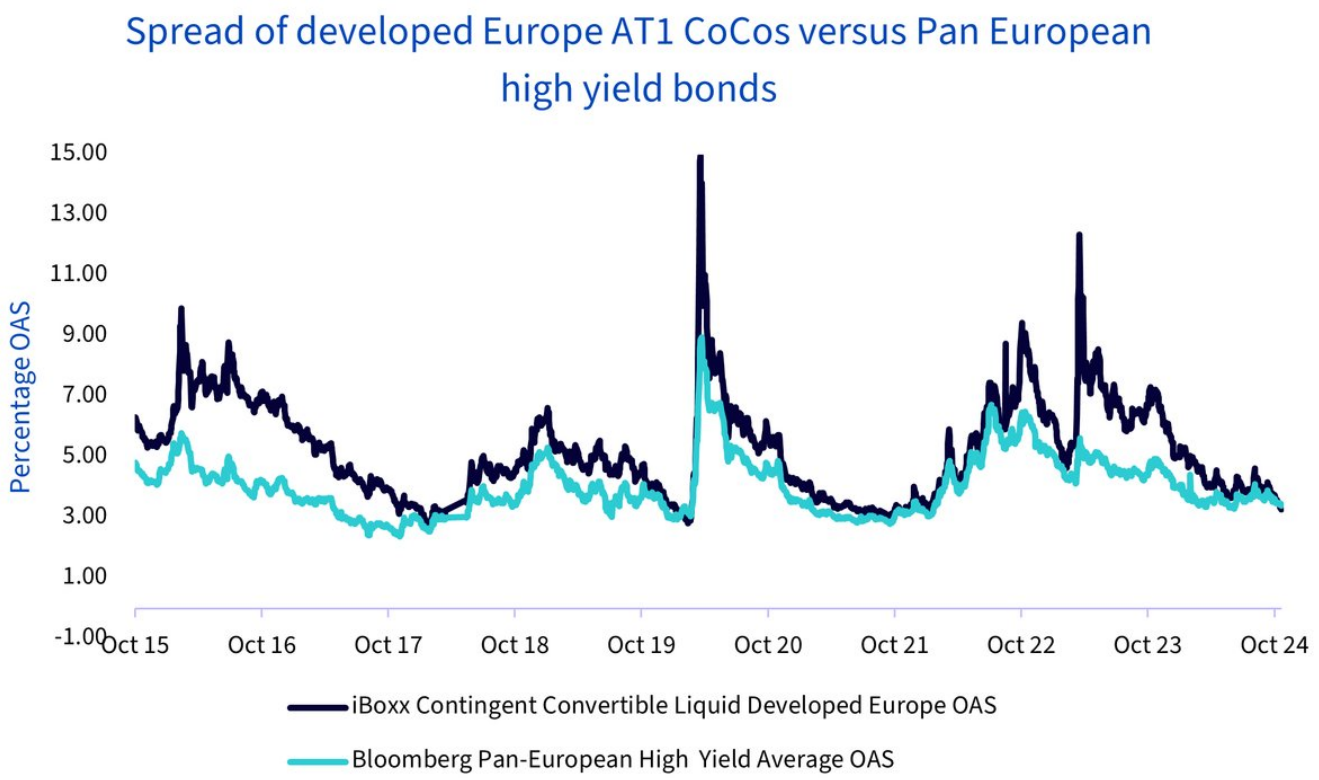


Source: iBoxx, WisdomTree. As of 30 Sep 2024. Performance of the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index in USD. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

4. Improved banking sector health vs previous years

Interestingly, despite current spreads for AT1 bonds being in a similar range to those nearly 8 years ago, the banking sector is in a far stronger position today than it was back then. Ten years ago, the financial landscape was marred by a sovereign debt crisis, with several European nations facing serious financial stress. Banks at that time were not as well-capitalised, and there was little regulatory clarity around instruments like AT1 bonds.

Today, banks are far more resilient, with much stronger capital buffers and more robust risk management practices. Regulatory oversight has also improved significantly, providing clearer guidelines on the treatment of AT1 bonds and enhancing the overall stability of the banking sector. This improved foundation means that AT1 bonds are now backed by institutions in a better financial state, with more predictable regulatory protections in place. For investors, this translates to potentially lower risk compared to similar investments made a few years back.



Source: WisdomTree, Iboxx, and Bloomberg. From 1 Oct 2015 to 30 Oct 2024. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

5. Strong demand and oversubscription in recent issuances

Another noteworthy trend in the AT1 bond market is the recent surge in new issuances, which have been met with strong demand and high levels of oversubscription. This high demand suggests that investor appetite for AT1 bonds is robust, likely driven by attractive yields and the perceived stability of the banking sector today. Oversubscription is often a positive indicator in financial markets, reflecting investor confidence in both the issuing institutions and the asset class itself.

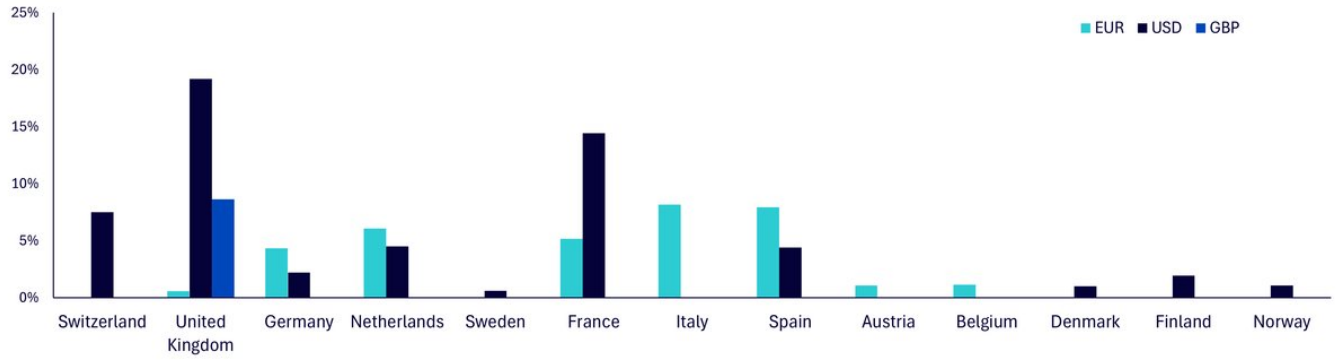
For investors, the oversubscription of recent AT1 issuances signals a strong market endorsement, suggesting that AT1 bonds are currently seen as a desirable investment. This demand may also imply greater liquidity for AT1 bonds, which can be an added advantage for investors seeking flexibility in managing their portfolios.

Final thoughts

In 2025, AT1 bonds appear to be a compelling investment option, supported by high-interest rates that favour the banking sector, strong CET1 ratios, enhanced regulatory clarity following the Credit Suisse event, and strong demand evidenced by recent oversubscription of new issuances. Additionally, the banking sector today is in much better shape than it was a decade ago, when uncertainty around regulatory frameworks and the sovereign debt crisis posed significant challenges. These factors have driven spreads

down over the last 20 months, but we believe further tightening will follow, given the supporting factors discussed.

For those with a tolerance for risk and a desire for high yield, AT1 bonds could potentially offer a promising opportunity in 2025, but diversification is key. The WisdomTree AT1 CoCo Bond UCITS ETF (COCB) tracks the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index which takes a broad market approach while applying strict liquidity and ratings criteria. The index captures all major currencies in which CoCos are issued in Europe, that is, USD, GBP, and EUR; thus providing a diversified exposure.



Source: WisdomTree, Markit. Data as of 30 Sep 2024. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Breakdowns are based on the index weights in underlying CoCos. **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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