Why did AT1 bonds gain traction during the Credit Suisse collapse?

The ripple effects from the collapse of Silicon Valley Bank (SVB) breached the contours of the financial world when its impact was seen in the European markets too. Credit Suisse, Switzerland’s second-largest bank saw a 20% drop in its share value, ultimately impacting the European banking index (fall by 6 %) and setting the stage for the next biggest banking collapse. Additional Tier 1 (AT1) investments, which primarily consisted of the riskiest bonds issued by banks, now face $17 billion being blotted out, which could destabilize the $275 billion European market for these bonds and have a ripple effect on other regions.

AT1 Bonds and their Current Effect on Global Bond Markets

AT1 bonds, referred to as "CoCos" or 'contingent convertible bonds' are debts issued by a bank that could be converted into equity if its capital levels drop below requirements and hybrid bonds normally make up AT1 capital. This reduces debt while increasing the bank's capitalization. After the 2008 financial recession, they were implemented as a mechanism to "bail-in" failing banks without using taxpayer money by enforcing losses on investors. The risky nature of the bonds makes them more attractive to investors in exchange for higher returns. With a valuation of $130 trillion, the international credit market exceeds the stock market holding a towering influence on the world economy, notably when governments need money to cancel out deficits. Banking industries are struggling, and further inconsistencies within credit markets will severely impact the issue of AT1 debt. AT1 bonds of Europe and Asia recorded lower figures after FINMA (the Swiss banking regulator) declared that Credit Suisse's AT1 bonds were written down by CHF 16 billion (about $17.3 billion).

The Indian Situation

Post-acquired by UBS, the AT1 bonds of Credit Suisse had zero value, increasing the cost of capital for banks, particularly Indian lenders. When Yes Bank faced similar issues in 2020, the RBI stepped in to write off its AT1 bonds. With its help, Indian banks got higher premiums close to 75 basis points over government bonds.

In India, values less than 150 basis points come in as the difference between normal bonds and AT1 bonds, compared to 200-250 bps in the EU and the U.S. Therefore, a limited risk is only there for Indian lenders. As they underwent rigorous stress tests under the direction of the RBI, Indian lenders have looked better up to this point, which has helped them fend off possible threats from the Credit Suisse incident and the U.S. banking crises. The presence of credible projects, higher savings rates, and stable social security programs are some factors allowing domestic banks to have secure reserves in combating losses against government securities under higher interest rates.

ECONOMICSTAAN
— Economics Aboard —