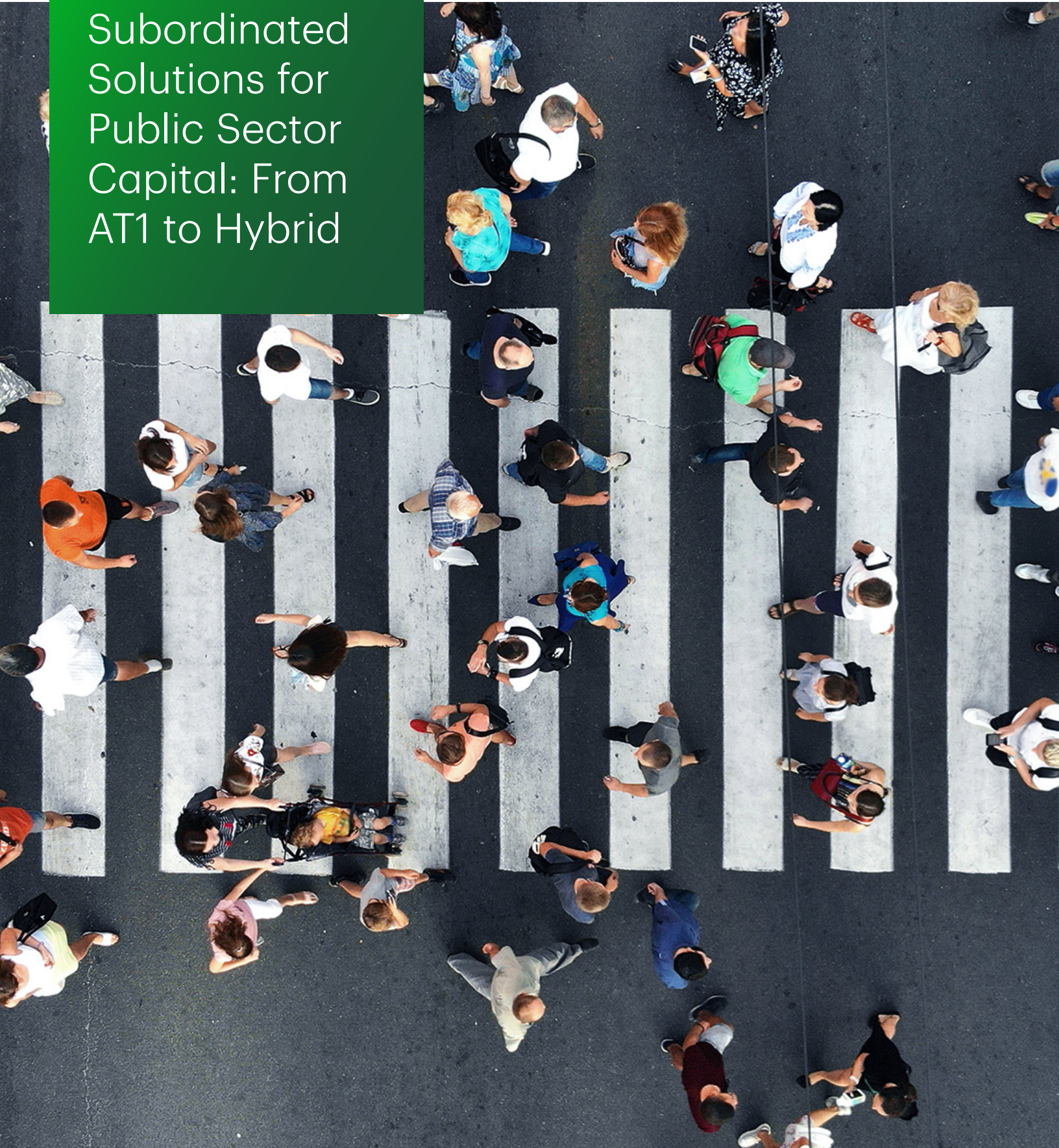


Subordinated
Solutions for
Public Sector
Capital: From
AT1 to Hybrid



Background

- In 2022, an Expert Panel published a report called "Boosting MDBs' investing capacity" which recognizes that multilateral development banks are uniquely positioned to respond to challenges facing our world right now – what they deem as "a challenging combination of short-term crises and longer-term development needs that is straining the capacity of the international community." This has brought hybrid capital into the spotlight for MDBs, but other SSAs issuers like Munifin as well as FIG and corporate issuers have utilized sub-debt for many years.
- The topic of subordinated solutions has been brought into the spotlight this year with AfDB's announcement of an inaugural USD Global Sustainable Hybrid transaction.
- Other MDBs have publicly stated they are looking into the possibility of hybrid capital, and expect the movement to grow in 2024.
- TD Securities hosted a roundtable discussion to discuss how the public sector is thinking about these developments with a number of views represented including an AT1 issuer, an investor across the credit spectrum, two rating agencies, SSA & FIG DCM originators, and a secondary market maker.

Attendees

- Joakim Holmström, Executive VP, Capital Markets and Sustainability, Municipality Finance
- Sam Dorri, Managing Director, Total Fund Management - Exposure, Leverage & Liquidity Management, CPP Investments
- Myer Khalid, Senior Associate, Total Fund Management - Exposure, Leverage & Liquidity Management, CPP Investments
- Alexander Ekbon, Global Head Multilateral Institutions and Supranationals, Nordic Region Office Head, S&P Global Ratings
- Kathrin Muehlbronner, Senior VP, Global MDB Lead, Sovereign Risk Group, Moody's Investors Service
- Katie Davis, Managing Director, SSA Debt Capital Markets, TD Securities
- Christy Jenkins, Managing Director, FIG Debt Capital Markets, TD Securities
- Alex Gerrard, Director, Credit Trading, TD Securities

Summary of Key Takeaways

- While Moody's and S&P's approaches to assigning equity content contain some similarities, helping to underpin some consistency in MDG hybrid structures, there are also differences to navigate for issuers.
- Using equity/assets as a absorption trigger is easily observable and replicable, although Moody's would also consider other metrics in its assessment.
- Munifin's AT1, issued in 2015, had to comply with bank regulatory requirements and was issued to meet increased leverage ratio requirements at the time.
- From a rating agency perspective, permanence in the capital structure needs to be demonstrated and ideally the agencies want to see replacement of a called hybrid.
- There is arguably much less pressure for MDB issuers to make uneconomic hybrid calls, compared with banks, especially given the stronger focus on costs.
- From a markets perspective, the base case remains that majority of bank hybrids will continue to be called, assisted by technical bid for short-call paper recently.
- Relative value of MDB hybrids remains a debating point as the lack of sector level comps invites a myriad of approaches and differing views.
- The market/investors will assign spread value to MDB hybrids versus bank AT1s but a debate remains around how much this is worth - some investors are looking for a premium of 150-200bps over senior debt, while issuers are looking for a premium closer to 100-150bps.
- Different investor types (traditional AT1 vs traditional SSA buyers) will likely value MDB hybrids through different lenses.

Structural Considerations

MDB Hybrids can achieve High/100% equity credit under Rating Agencies' criteria, although Moody's and S&P approach the analysis differently.

- AfDB's proposed Hybrid scored "100% equity credit" with Moody's and "Intermediate" with S&P
 - Moody's focus is on absorption/write-down triggers to differentiate between a 75% and a 100% equity content instrument. It was able to award AfDB proposed hybrid 100% equity content because it has the write-down feature, whereas other proposed hybrids (for example the West African Development Bank transaction proposed in 2022) did not have such a feature and therefore has 75% equity content. Moody's would include 100% of the AfDB's hybrid issuance into its calculation of useable equity.
 - S&P approach differs in that hybrids are included in an issuer's total adjusted capital based on a scale; instruments can be included up to 33%/50% of adjusted common equity for intermediate and high equity content assessments, respectively. As such for many issuers, due to large equity bases, S&P will often include all the issuer's hybrids in total adjusted capital. AfDB has intermediate equity content under S&P, meaning it would include the notes up to 33% of equity, but all of the proposed issuance would be eligible to be included in the total adjusted capital.
- Key features needed for MDB hybrids to achieve a high equity content: Longer maturity, permanent subordinated ranking, coupon suspensions, mandatory write down.

Thinking about the appropriate loss absorption/coupon suspension trigger

- Various proposals have been discussed. Equity/assets is one that is available but other options may be available.
 - For S&P, if an entity is regulated (like a bank), the capital ratio can be used, but if not regulated (like an MDB), then the trigger will be the equity to assets metric. This is easily observable and replicable by all market participants and is not subject to changes (some market participants had suggested S&P use the RAC ratio, but this was rejected as the calculation could change in the future and was more complex). Moody's would consider a similar metric.

Discussing MuniFin's experience in issuing €350mm AT1 securities

- In 2015, MuniFin was in a unique position where it needed to strengthen its capital base in anticipation of needing to comply with a leverage capital ratio requirement. As such, the issuer started accumulating capital to retain earnings which left them less competitive versus their peers. Munifin decided to look to alternative sources of funding (i.e., AT1) to improve leverage and take some pressure off an environment where they were potentially losing market share. It turned out to be a very good decision and was the first public SSA in the AT1 market.
- They undertook quite a lengthy process internally and with the Board as this was a brand-new transaction to the institution.
- In summer of 2021, there was an amendment to capital ratio rules, recognizing public development institutions when solving for leverage ratios which meant Munifin no longer needed to comply with the more stringent rules. So overnight, leverage ratio improved 4% to 13%. This led them to calling the securities in 2022.

Extension Risk

Rating Agencies' approach to the possible redemption/call of these securities in the context of ensuring equity content is retained and the view of the issuer's credit quality is not diminished.

- S&P's criteria requires a replacement clause in the documentation, meaning that if the hybrid is to be called it must be replaced with equal or higher quality capital before the redemption. Arguably, unlike banks where there is a certain amount of expectation and investor pressure to call instruments even when it might cost more to do so, S&P thinks this is much less likely to be the case for an MDB as there would be more focus on costs pressures. As such, extension risk could be higher for MDB hybrids.
- Moody's approach is broadly similar in that permanence needs to be demonstrated. Noting that Moody's permits 60 year instruments as effectively perpetual and also it takes into account that equity content is derecognized when instrument is <10yrs to maturity – although this is not really a consideration for these hybrids.

Trading/Investor View on Extension Risk

- Base case remains that calls will be exercised unless there is obvious distress or issuer has made clear calls are purely economic.
- Fallout from UBS/CS has largely been mitigated by UBS looking to simplify capital stack and late 2023 central bank pivots.
- Technical bid to short-call AT1 and Tier 2 product has re-emerged as a "cash alternative", demonstrating faith in issuers to call.

Secondary Market Trading & Relative Value

Trading bank capital securities (Tier 2 and AT1s)

- This is very much a sentiment driven market in terms of liquidity. As seen with Credit Suisse's struggles in 2023, the entire market can ripple from one instance/event.
- It's still to be determined if MDB hybrids would behave in a similar fashion during periods of volatility/instability given the sector is less vulnerable to capital and liquidity outflows than banks, but something to bear in mind when pricing and investing in the asset class.
- Markets generally have short memories. Once the market began to find itself, especially once rates volatility settled later in 2023—i.e. expectations that terminal rate reached - the asset class is back in vogue again with strong demand for new issues and a recovery in secondary market. For example, the late-2023 UBS multi-tranche AT1 deal had the largest book ever for the asset class.
- That said, some market participants decided to exit the space entirely during 2023 and may either never return or only come back much further down the line. For others, they may remain selective and be more price sensitive than historically.

How investors evaluate the investment opportunity in hybrids

There are a variety of ways investors can think about hybrids in their portfolio based on their risk tolerance, investing parameters, etc. One perspective is to evaluate the hybrid offering with a baseline sovereign exposure and add incremental risks including:

- Valuation
 - Relative value across asset classes or currency
 - Liquidity
 - Optionality – key challenge for hybrid capital
 - Tail risk scenario and extension risk
- Hedging
 - Major consideration from investor and issuer perspective
 - Difficult to value the cost of hedging for hybrid capital

A typical investor base for AT1, particularly FIG and Corporate AT1:

- Active asset managers (hedge funds) with specialized portfolios
 - Also includes some investors who buy bank equity and feel there can be arbitrage between AT1 vs. equity
- Yield hunters (retail / high-net-worth investors) which developed during a low-rate environment

Issuer (Munifin) experience with the relative value debate

- There was a healthy discussion with investors around the new AT1's relative value versus Munifin's existing securities.
 - Targeting traditional AT1 buyers (Asset Managers, Pensions, Insurance, yield hunters) vs traditional SSA investors (Central Banks, Bank Treasuries).
 - Overall, a successful outcome that was 3x oversubscribed with very strong feedback from investors, especially the domestic investor base which is familiar with the credit story and saw strong relative value of a 4.5% coupon with Finnish public sector exposure.

Debating the relative value of an MDB hybrid security

- Since there is a lack of sector level comps, it has been difficult for the market to determine a fair price for MDB hybrids, evidenced by the lack of issuance in 2023. There are many things to consider such as evaluation of the trigger metric, liquidity of the potential asset class, extension risk, etc. Overall, there is risk that without a common approach the asset class is too disparate and lacking in homogeneous features for the market to gain momentum.
 - Some investors are looking for a premium of 150-200bps over senior debt, while issuers are looking for a premium closer to 100-150bps.

Impact of MDBs not being a Regulated Sector

- From an investor perspective, the lack of a regulator for MDBs can also be seen as a negative attribute; investors may value the stability and financial discipline and transparency that stems from having strong regulatory oversight over regulated sectors.
- The market does assign some spread value to MDB hybrids due to the lower credit risk and higher credit rating vs bank AT1s; but the key question is just how much that is worth, and this is where the discussion needs to continue.



Best Guesses for the Future of Public Sector Hybrids

- It makes sense for most MDBs and the wider SSA issuer base to structure an instrument that works for them. Benefits include:
 - Diversify the capital structure
 - Once the structure is ready to go, it can be rolled out quickly into the capital markets
 - Attracts new capital and new investors without impacting voting rights of existing shareholders
- A capital markets hybrid for a MDB is just one of several tools they must solve for the lending capacity challenge. It may ultimately be the smallest component of that toolbox – they can also issue hybrids to existing shareholders, and they can also work on asset side solutions.

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