Special Report

Extension Risk for US Bank Preferred Securities

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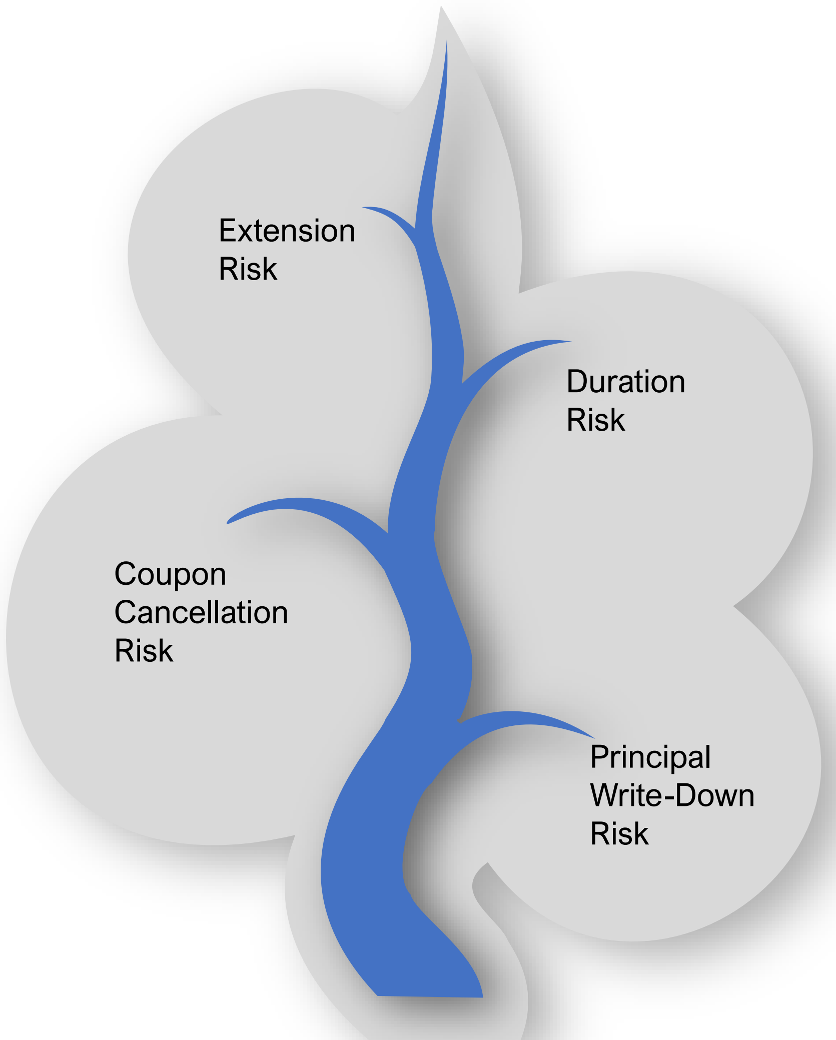
September 2022

Contents

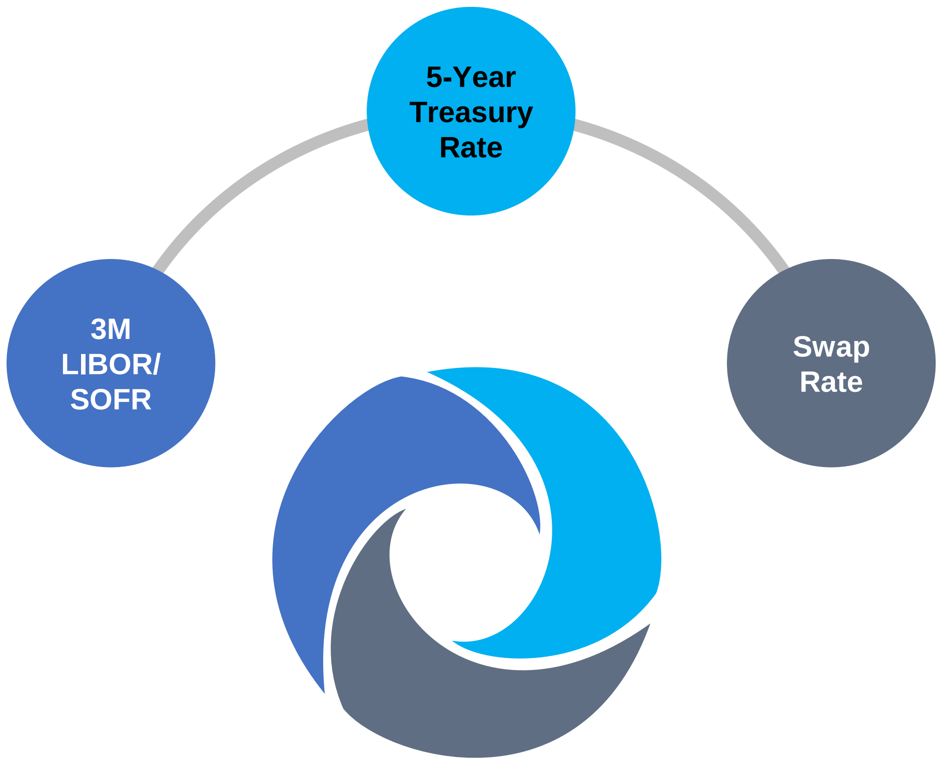
Extension risk for US Bank preferred securities increases amid rising interest rates



- Preferred securities qualify as Tier 1 capital for US banks.
- Preferred securities are perpetual instruments with a call date after five years.
- Preferreds are generally issued at fixed coupon rates for five years which gets reset to a floating rate after the first call date, if not called.
- Key risks associated with US bank preferred securities include write-down of the principal amount in the event of liquidation of the bank and coupon cancellation in case the Common Equity Tier 1 (CET1) ratio of the bank falls below the minimum threshold level, among others.
- Extension risk has superseded other risks for high-quality issuers in the current rising rate environment.
- Preferreds are generally priced to the first call date based on implicit market expectation. However, banks may sometimes opt to not call back the preferred securities on the first call date due to unfavorable economic value. The non-call of preferred securities, in contrast with market expectations, results in a repricing of these securities to perpetuity; this, in turn, results in a drop in their prices. This is referred to as extension risk.
- With interest rates expected to be higher for longer, refinancing of the preferreds will become more expensive, resulting in higher probability of extension of existing securities based on economic value.

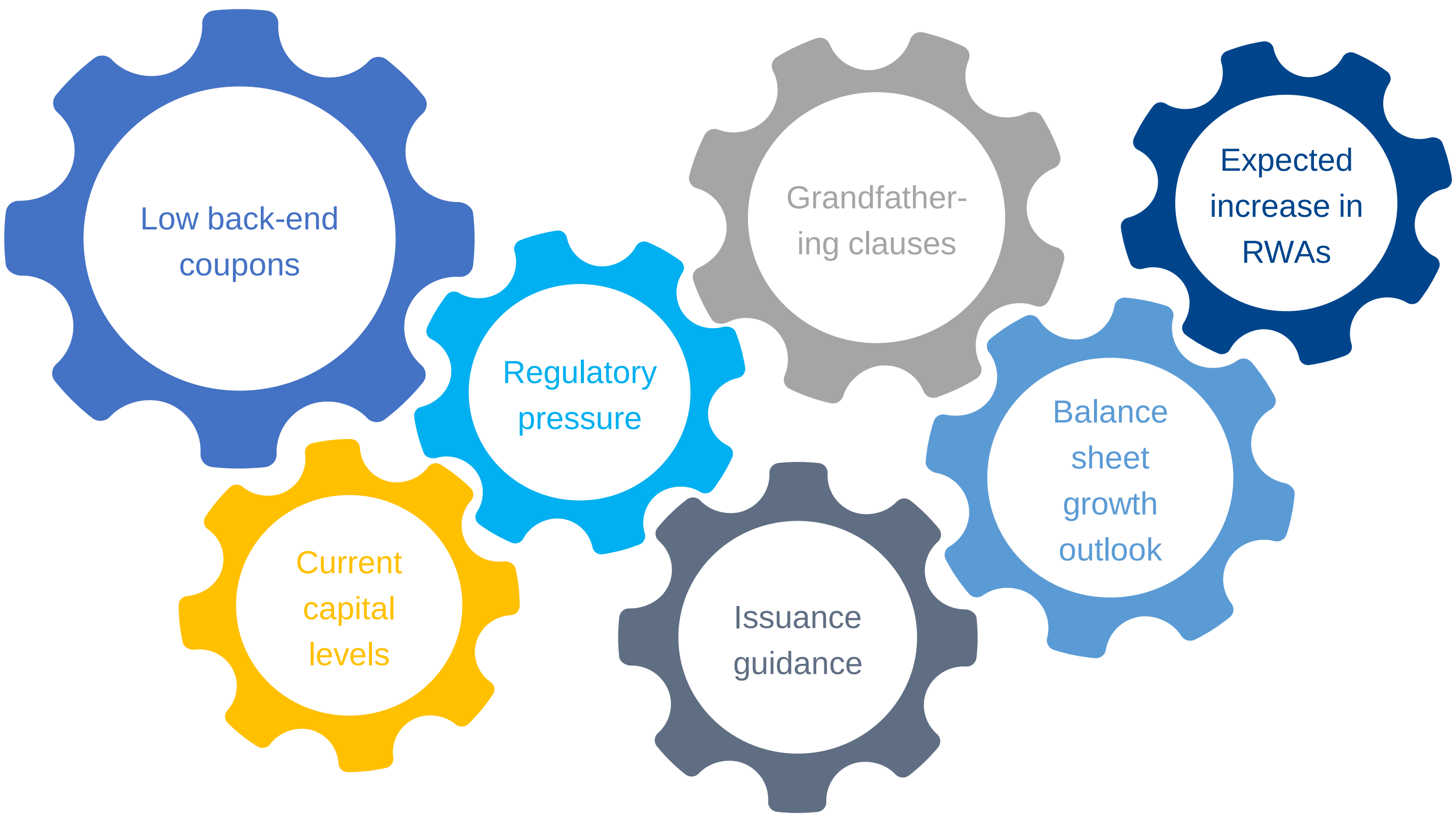
Economic value – Key extension risk driver

- Economic value is determined by the back-end spreads of preferred securities.
- Back-end spreads are spreads at which coupons of preferred securities are reset following the first call date. The back-end/reset spreads are pre-decided at the time of the issuance and are applicable over and above the benchmark rates such as LIBOR/SOFR, 5-year Treasury rate and Swap rate. The lower the reset spread, the higher the chance of the preferred getting extended beyond the first call date.
- In a rising rate environment, the reset rates for preferreds with low back-end spreads become more attractive than the potential interest rate for a new issuance. This raises the extension risk for preferreds with low back-end spreads.



Other extension risk drivers

- Bonds with low back-end coupons at a higher risk of extension in a rising rate environment
- Legacy bonds which would potentially qualify as regulatory capital due to grandfathering clauses
- Regulatory pressure on the issuer against calling back the bonds due to inadequate capitalization
- Bank's existing Tier 1 capital level vs requirement and management guidance for potential issuance
- Bank's outlook for balance sheet growth and the resultant increase in capital requirements
- Potential increase in risk-weighted assets (RWA) due to regulatory reasons

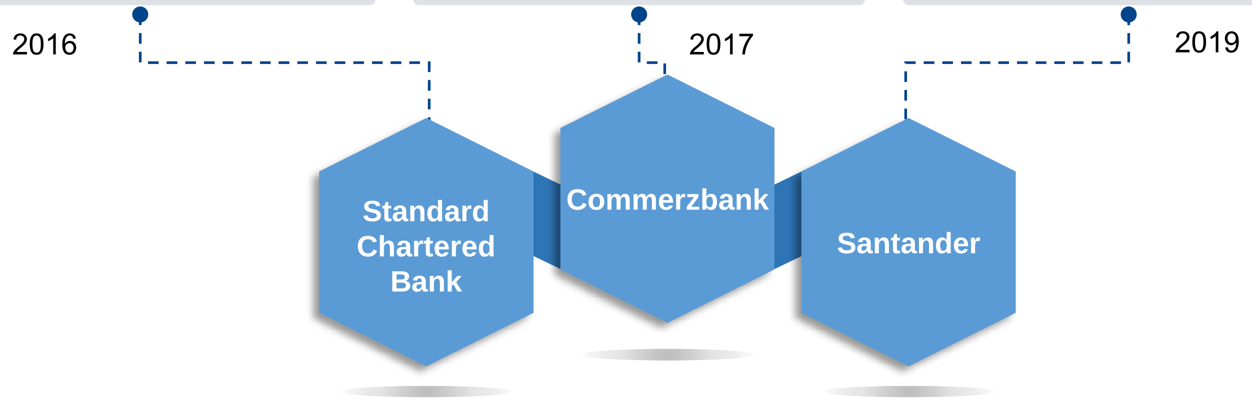


European precedents of Tier 1 bond extension

- In November 2016, holders of Standard Chartered Bank's USD 750mn legacy Tier 1 bonds were in for a rude shock as the bank announced that it would not exercise the call option on the bonds at the next call date (due in January 2017). The 6.409% bonds plummeted 14 points, subjecting investors to heavy losses. The issuer, Standard Chartered Bank, had its own strong reasons for going against the norm: (1) a lower coupon reset of about 2.4% as against new issuance at a potential coupon rate of about 7.5% and (2) inclusion of the legacy bonds as regulatory capital, given the non-step feature.

- Following Standard Chartered Bank's announcement, Commerzbank's 6.352% USD 416mn bonds, which were callable in June 2017, plunged eight points. Investors expected similar treatment for these bonds as Commerzbank had posted one of the biggest losses during the quarter. Commerzbank announced the extension of these bonds for economic reasons and as they would continue to qualify as regulatory capital.

- In February 2019, Santander announced the non-call of its 6.25% EUR 1.5bn bonds. Although markets expected the bonds to get extended, there were mixed signals as Santander issued a new USD 1.2bn Additional Tier 1 (AT1) bond in the beginning of the month which implied that the bond would be called back. Also, the reset spread was higher than the spread for the latest issuance. Impact on the bond prices was marginal. The reason could be the bond was callable every quarter.



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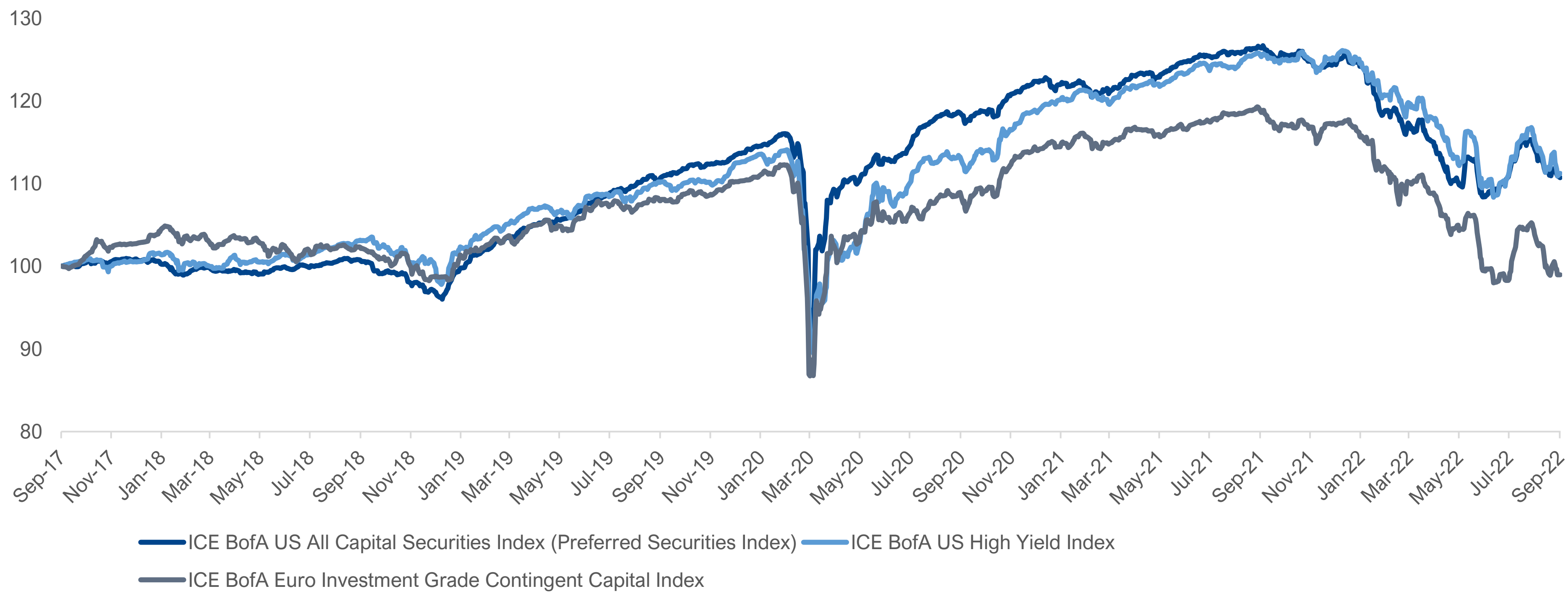
US Bank Preferred Securities Index not reflecting growing extension risk

- **The US Bank Preferred Securities Index has clearly outperformed the Euro Investment Grade (IG) Contingent Capital Index** since the beginning of the COVID-19 pandemic, reflecting stronger balance sheets of US banks compared to their European counterparts.
- The index also outperformed the US Corporate High Yield (HY) Index during the pandemic, underpinned by strength in the sector.
- In the current environment dominated by rising interest rates, global inflation, and macro economic uncertainty, the Euro IG Contingent Capital Index remains the most impacted, given the rising extension risk.
- However, performance of US Bank Preferred Securities Index is in line with that of the broader US Corporate HY index and does not reflect the growing extension risk for US bank Tier 1 securities.



Source: Reuters

JPM 5.15% 05/23, BofA 5.2% 06/23, Citi 5.95% 01/23 and 5.9% 02/23 most at risk

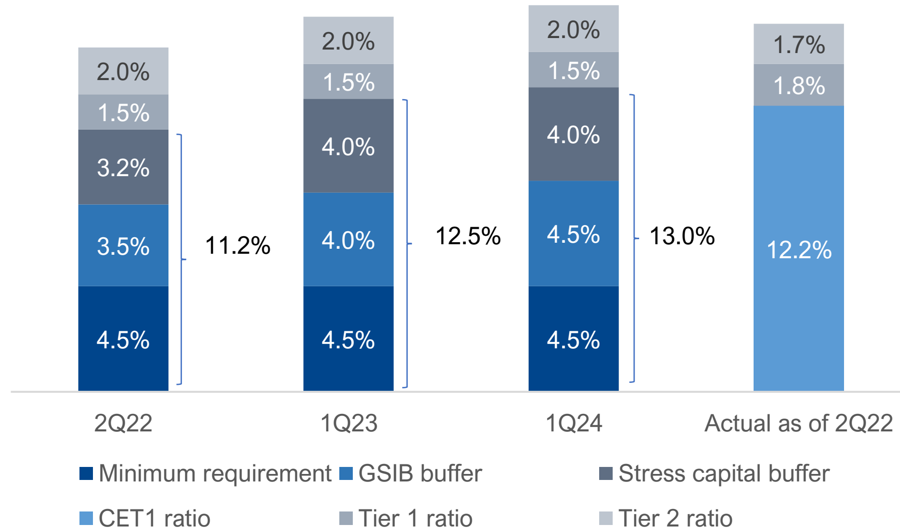
- The following preferreds with upcoming first call dates before June 2023 face high level of extension risk, given the huge coupon differentials. With interest rates expected to be higher for longer, refinancing of the preferreds will become more expensive.
- We believe extension risk is not fully captured in the spreads of JP Morgan's 5.15% USD 1,500mn callable in May 2023, Bank of America's 5.2% USD 1,000mn callable in June 2023, Citigroup's 5.95% USD 1,500mn callable in January 2023 and 5.9% USD 750mn callable in February 2023. Hence, we see an opportunity to sell these bonds as we expect the spreads to widen considerably.
- We evaluate in detail the extension risk for the outstanding preferreds of each of these banks.
- Despite some of the preferreds having quarterly calls following the first call date, we do not expect them to reprice to the next call date as the banks would prefer to wait and watch until interest rates cool off meaningfully before calling back these securities.

Bonds	JP Morgan	Bank of America	Citigroup	
ISIN	US48124BAC90	US060505ED21	US172967GD7	US172967GF21
Coupon	5.15%	5.200%	5.950%	5.900%
Maturity Type	Perpetual	Perpetual	Perpetual	Perpetual
Currency	USD	USD	USD	USD
Amount Outstanding (mn)	1,500	1,000	1,500	750
First Call Date	May 01, 2023	June 01, 2023	January 30, 2023	February 15, 2023
Reset Index	US 3M LIBOR	US 3M LIBOR	US 3M LIBOR	US 3M LIBOR
Floater Spread	325	314	407	423
Indicative Reset Rate	**6.820%**	**6.700%**	**7.630%**	**7.800%**
Potential Coupon	**9.000%**	**9.000%**	**10.000%**	**10.000%**
Coupon Differential (bps)	**218**	**230**	**237**	**220**
Rating (Moody's/S&P/Fitch)	Baa2/BBB-/BBB+	Baa3/BBB-/BBB+	Ba1/BB+/BBB-	Ba1/BB+/BBB-
Mid Price	98.5	98.1	99.4	100.1
Z-Spread to Call	427	467	398	240
YTM	6.910%	6.810%	7.710%	7.800%

Source: Bloomberg

JP Morgan faces increasing CET1 requirement, likely to optimize capital structure

- JPM is building capital to meet upcoming regulatory requirements. CET1 ratio target is 12.5–13% (as of 2Q22) but is likely to increase. The bank has suspended share buybacks and aims to reduce RWAs by cutting down lower margin businesses such as mortgages.
- Supplementary leverage ratio of 5.3% (as of 2Q22) remains above the 5% regulatory requirement.
- We believe JPM will optimize its capital structure by reducing the excess Tier 1 preferreds and issuing Tier 2 bonds to fill the bucket, particularly when BBB+ rated Tier 2 bonds are pricing at ~5.7% vs reset rate of 6–7% for Tier 1 preferreds with upcoming call dates in October and November.
- JPM recently announced the redemption of 5.60% USD 2.5bn Tier 1 preferreds callable on October 03, 2022. The preferred had a reset spread of 332bps over 3M LIBOR, implying a potential floating reset rate of ~6.9%. JPM also issued a USD 3.5bn Tier 2 bond recently at a fixed coupon of 5.7%.
- We expect JPM to call back the 6.28% USD 2.93bn preferred which will bring down its Tier 1 capital near the 1.5% area. However, if interest rates move further north, pushing up the cost of Tier 2 issuance, it will not make economic sense to call the Tier 1 preferred.



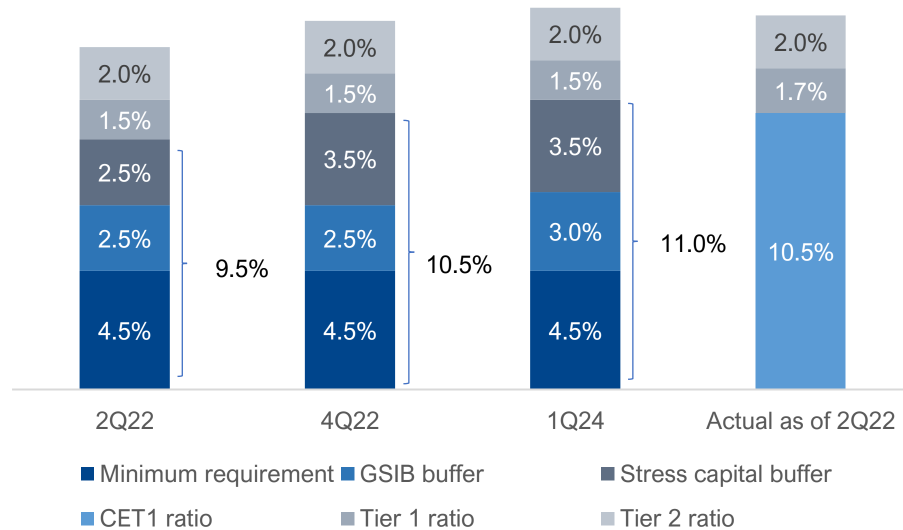
- We believe JPM will extend the 4.63% and 5.15% preferreds due to be called in November 2022 and May 2023, respectively, given their lower reset rates. The extension risk is already reflected in the spreads of the 4.63% preferred. However, we see potential for significant spread widening for the 5.15% preferreds as the extension risk is not fully priced in.

Coupon	Maturity Type	Curr	Next Call Date	Mid Price	YTM (Mid)	YTC (Mid)	YTW (Mid)	Reset Index	Floater Spread	Amount Outstanding (USD mn)	ISIN	Moody's	S&P	Z Spread Bid	Issue Date	Indicative Reset
6.28	PERP/CALL	USD	10/30/2022	99.88	7.04	7.87	7.04	US0003M	347	2,930	US46625HHA1	Baa2	BBB-	366	4/30/2018	7.04
4.63	PERP/CALL	USD	11/1/2022	95.90	6.45	43.47	43.47	US0003M	258	1,260	US48128BAD3	Baa2	BBB-	4,509	10/20/2017	6.15
5.15	**PERP/CALL**	**USD**	**5/1/2023**	**98.50**	**6.91**	**7.71**	**7.71**	**US0003M**	**325**	**1,500**	**US48124BAC90**	**Baa2**	**BBB-**	**427**	**4/23/2013**	**6.82**
6.00	PERP/CALL	USD	8/1/2023	100.25	6.85	5.69	5.69	US0003M	330	1,500	US48126HAA8	Baa2	BBB-	296	7/29/2013	6.87
6.75	PERP/CALL	USD	2/1/2024	100.87	7.29	6.06	6.06	US0003M	378	2,000	US46625HJQ4	Baa2	BBB-	196	1/22/2014	7.35
6.13	PERP/CALL	USD	4/30/2024	99.10	6.93	6.72	6.72	US0003M	333	1,000	US46625HJW1	Baa2	BBB-	235	3/10/2014	6.90
5.00	PERP/CALL	USD	8/1/2024	93.50	6.01	8.86	8.86	SOFRRATE	338	2,250	US48128BAF8	Baa2	BBB-	532	7/31/2019	5.65
6.10	PERP/CALL	USD	10/1/2024	99.37	6.89	6.44	6.44	US0003M	333	1,600	US48126HAC4	Baa2	BBB-	248	9/23/2014	6.90

Source: Bloomberg; Note: Preferreds with amount outstanding >= USD 750mn and next call date before December 31, 2024

Bank of America's capital structure broadly in line with regulatory requirements

- Similar to JPM, BofA faces rising capital requirements. BofA's stressed capital buffer increased by 100bps due to higher credit provisions under the adverse scenario in the 2022 Stress Test. The bank increased dividend but will prioritize capital building over share buybacks.
- The bank is also optimizing RWAs to mitigate the impact of rising regulatory requirements.
- BofA's capital structure remains broadly in line with regulatory requirements. Supplementary leverage ratio of 5.5% was well above the regulatory requirement of 5.0% as of 2Q22. We believe the 0.2% excess Tier 1 capital, i.e., USD 3bn, will get absorbed as RWAs increase and hence BofA will not reduce its Tier 1 base.
- BofA's 5.2% USD 1bn Tier 1 preferreds with first call date of June 01, 2023, have a low backend of 314bps over 3M LIBOR implying a floating reset rate of 6.7% vs potential fixed coupon rate of ~9.0% on a new preferred issuance rated BBB-.
- Also, with rates expected to remain higher for longer, refinancing of the preferreds will become more expensive in 2023. Hence, we expect the 5.2% preferreds to get extended.
- The scope for spread widening is much higher for BofA's 5.2% preferreds as, unlike majority of the preferreds, these securities are not callable every quarter after the first call date.

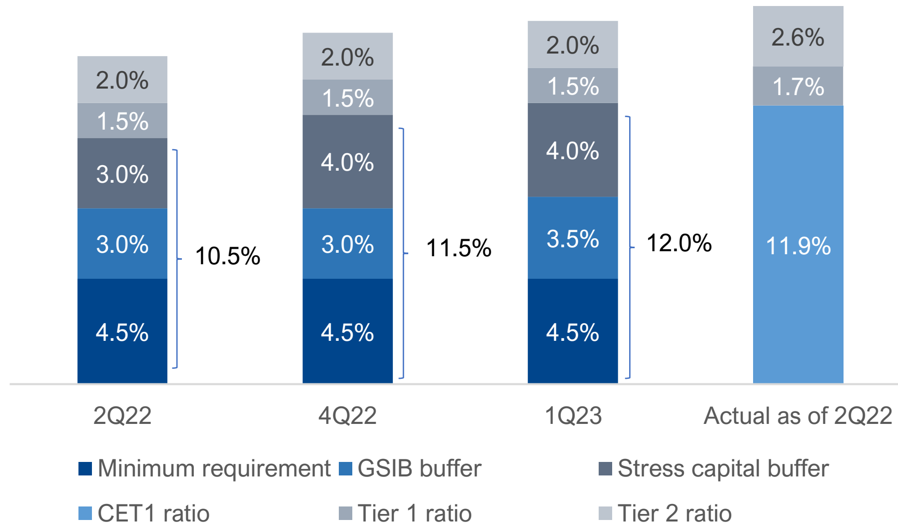


Coupon	Maturity Type	Curr	Next Call Date	Mid Price	YTM (Mid)	YTC (Mid)	YTW (Mid)	Reset Index	Floater Spread	Amount Outstanding (USD mn)	ISIN	Moody's	S&P	Z Spread Bid	Issue Date	Indicative Reset
5.20	**PERP/CALL**	**USD**	**6/1/2023**	**98.13**	**6.81**	**8.02**	**8.02**	**US0003M**	**314**	**1,000**	**US060505ED21**	**Baa3**	**BBB-**	**467**	**5/9/2013**	**6.70**
5.13	PERP/CALL	USD	6/20/2024	97.04	6.92	6.95	6.95	US0003M	329	1,000	US060505FP4	Baa3	BBB-	371	6/20/2019	6.86
6.25	PERP/CALL	USD	9/5/2024	98.75	7.29	6.94	6.94	US0003M	371	2,000	US060505EH3	Baa3	BBB-	296	9/5/2014	7.27
6.50	PERP/CALL	USD	10/23/2024	100.25	7.60	6.37	6.37	US0003M	417	1,400	US060505EL47	Baa3	BBB-	231	10/23/2014	7.74

Source: Bloomberg; Note: Preferreds with amount outstanding >= USD 750mn and next call date before December 31, 2024

Citigroup CET1 requirement to increase, capital levels in line with regulatory requirements

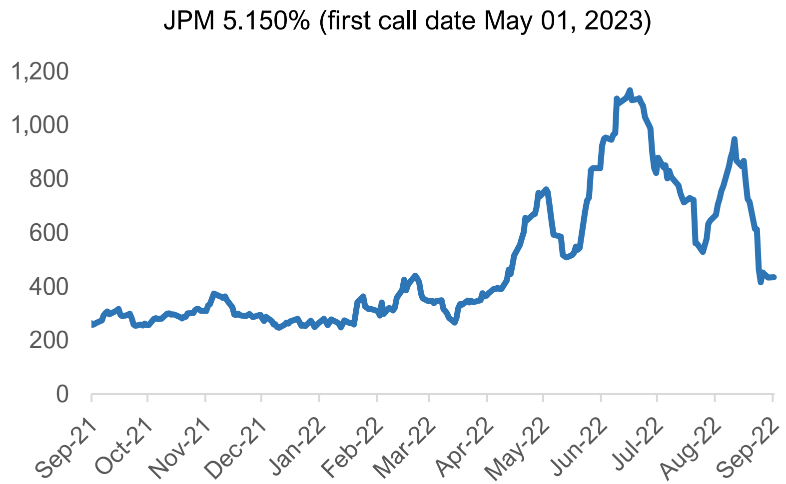
- In line with the other Wall Street peers, Citigroup is building capital to meet potentially higher regulatory requirements. Citi paused share buybacks and is closing the divestitures of its international retail operations which will reduce RWAs.
- Citigroup has a CET1 ratio target of ~13%, implying a 100bps management buffer. However, the medium-term target is lower at 11.5–12% which can be justified by the expected drop in capital requirement due to the divestitures.
- Citigroup's capitalization ratios are in line with regulatory requirements. Supplementary leverage ratio was 5.6% as of 2Q22, well above the 5% regulatory requirement. We believe the excess Tier 1 capital will be absorbed with balance sheet growth.
- Regarding the upcoming call dates for Tier 1 securities, Citigroup will consider the economic trade-off between calling and leaving them outstanding.
- We believe Citigroup will extend the 5.95% and 5.9% preferreds callable in January and February 2023, respectively. Despite the high back-ends, the potential floating reset of 7.5–8.0% is still lower than a potential fixed coupon of 10.0% on a new preferred issuance rated BB+. Hence, we expect spreads to widen significantly from current levels.

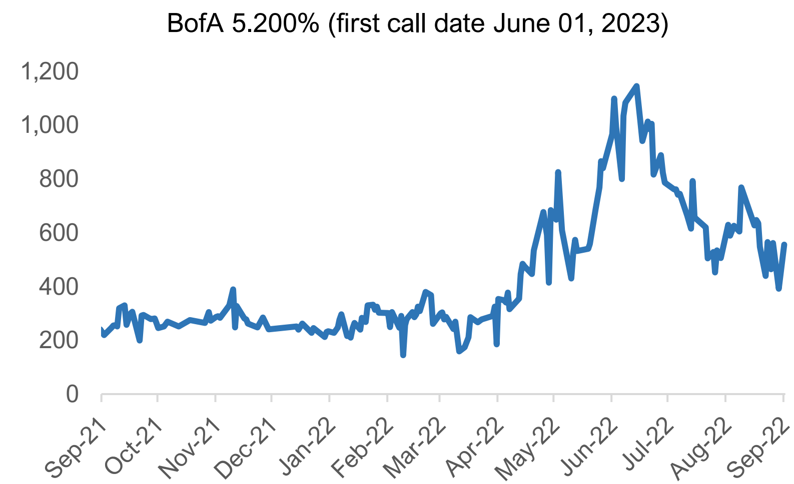


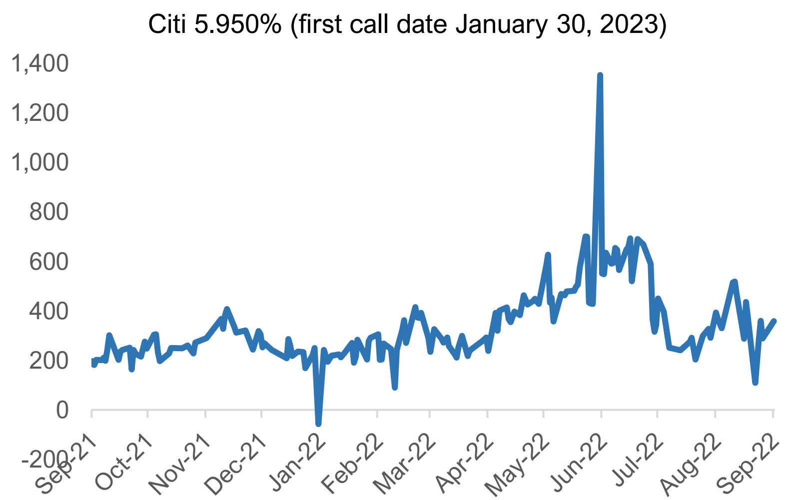
Coupon	Maturity Type	Curr	Next Call Date	Mid Price	YTM (Mid)	YTC (Mid)	YTW (Mid)	Reset Index	Floater Spread	Amount Outstanding (USD mn)	ISIN	Moody's	S&P	Z Spread Bid	Issue Date	Indicative Reset
5.95	**PERP/CALL**	**USD**	**1/30/2023**	**99.36**	**7.71**	**7.73**	**7.73**	**US0003M**	**407**	**1,500**	**US172967GD7**	**Ba1**	**BB+**	**398**	**10/29/2012**	**7.63**
5.90	**PERP/CALL**	**USD**	**2/15/2023**	**100.11**	**7.80**	**5.58**	**5.58**	**US0003M**	**423**	**750**	**US172967GF21**	**Ba1**	**BB+**	**240**	**12/13/2012**	**7.80**
5.35	PERP/CALL	USD	5/15/2023	97.15	7.22	9.98	9.98	US0003M	347	1,250	US172967GR6	Ba1	BB+	616	4/30/2013	7.03
6.30	PERP/CALL	USD	5/15/2024	96.10	7.25	8.89	8.89	US0003M	342	1,750	US172967HQ7	Ba1	BB+	481	4/30/2014	6.99
5.00	PERP/CALL	USD	9/12/2024	92.50	6.48	9.25	9.25	SOFRRATE	381	1,500	US172967MG3	Ba1	BB+	509	9/12/2019	6.08

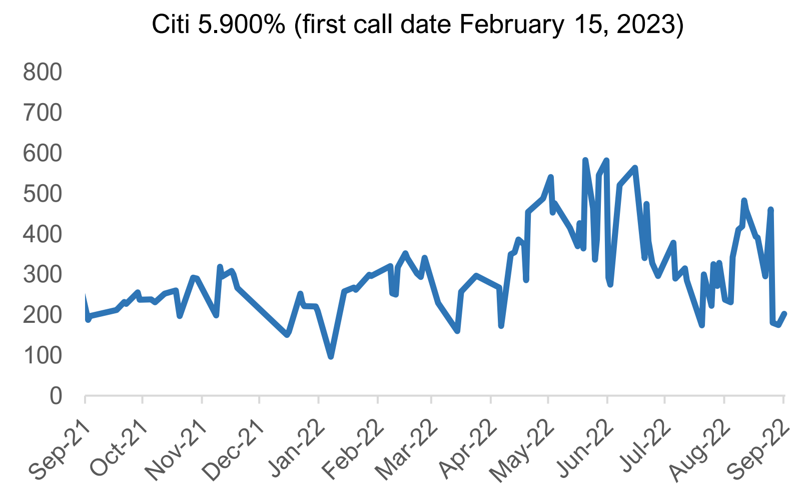
Source: Bloomberg; Note: Preferreds with amount outstanding >= USD 750mn and next call date before December 31, 2024

Extension risk not fully captured in spreads of JPM, BOFA, Citi preferreds









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