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Strengthening the going-concern role of AT1: options and trade-offs

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Strengthening the going-concern role of AT1: options and trade-offs[1]

Highlights

- *Additional Tier 1 (AT1) instruments are designed to operate as going-concern capital. In instances where the issuer reaches the point of non-viability, these instruments also support an orderly resolution of a gone concern.*
- *Nonetheless, in practice, the effectiveness of AT1 Instruments in fulfilling their primary role as going-concern capital is undermined by low trigger thresholds, the discretionary nature of activation and insufficient incentives for recapitalisation.*
- *Restoring this function rests on three elements: (i) sufficiently dilutive, variable and market-linked conversion as a principal loss-absorption mechanism; (ii) elimination of writedown and of discretionary going-concern triggers; and (iii) Common Equity Tier 1 (CET1)-linked triggers set high enough to support recovery.*
- *Such reforms have to be weighed against potential adverse implications for banks' funding costs, buffer usability and resolution funding.*

1. Introduction

Key to making the banking sector more resilient is ensuring that losses on bank balance sheets are absorbed early enough. This principle led regulators in the aftermath of the Great Financial Crisis to create Additional Tier 1 (AT1) capital – a class of debt-like instruments that can help cushion shocks, like equity.[2] The Basel Framework classifies AT1 as going-concern capital: instruments designed to absorb losses while the bank remains viable and operating. The objective is to restore the bank's financial health before it reaches the point where resolution becomes necessary.

AT1 instruments absorb losses through two channels. First, an automatic trigger, typically linked to the bank's Common Equity Tier 1 (CET1) ratio falling below a predefined threshold, results in the bank writing down or converting the instrument into equity, immediately improving the bank's CET1 capital position. Second, bank management has broad discretion to cancel interest (coupon) payments to conserve capital. Beyond these going-concern mechanisms, AT1 instruments also carry a non-viability clause that requires authorities to write down or convert them when the bank is no longer viable. This gives AT1 a secondary, gone-concern function, making it available to support resolution alongside its primary role in recovery.[3]

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[2] This brief concerns AT1 instruments classified as liabilities – perpetual debt instruments that absorb losses through a writedown or conversion trigger tied to the issuer's CET1 ratio. The Basel Framework also recognises equity-classified AT1, such as US-style preferred shares, which absorb losses as equity without a contractual trigger.

[3] Coelho et al (2023).

In practice, however, AT1's going-concern function has not materialised. Current design features mean that AT1 instruments rarely absorb losses while a bank is still viable, and markets do not price them as if they will. The instruments have instead functioned primarily as gone-concern capital, activated only at or near the point of failure.[4]

The writedown of Credit Suisse's AT1 instruments in March 2023 demonstrated this. Indeed, it was only once the Swiss supervisory authority declared a viability event that Credit Suisse AT1 instruments were written down. Prior to that, they did nothing to contribute to the firm's recovery efforts, while continuing to distribute coupons. Moreover, the sharp repricing in AT1 instruments issued by other banks following the Credit Suisse event indicates that investors had not priced key state contingencies, in particular viability events and supervisory discretion (Di Stefano et al (2026)). Unsurprisingly, AT1 instruments have since faced heightened scrutiny, echoing previously voiced scepticism.[5]

The gap between design and function creates uncertainty rather than stability, an outcome that is not viable from a prudential perspective. Against that background, policymakers are left with two broad options. The first is to phase out AT1 entirely as regulatory capital. The Australian Prudential Regulation Authority (APRA) has taken this path, concluding that AT1 does not fulfil a stabilising function in a crisis due to the complexities of using it and the risk of causing contagion.[6] The second option is to reform AT1 so that it functions as originally intended.

The case for reform rests on whether a well designed AT1 can support early recapitalisation. When a bank is highly leveraged and its capital base is eroding, shareholders are reluctant to inject fresh equity. Much of the value restored by new capital accrues to creditors through reduced default risk, while shareholders bear the full cost of issuance and gain only residually. This is the standard debt overhang problem. Shareholders prefer to delay recapitalisation even when early action would increase the value of the bank as a whole. Yet if failing to recapitalise results in AT1 conversion that transfers value from incumbent shareholders to bondholders, inaction becomes costly to shareholders (Flannery (2005); BCBS (2011); Calomiris and Herring (2013)). Unfortunately, the current AT1 designs do not deliver a sufficiently strong incentive. The question is whether they can be made to.

The incentive failure is one of several design shortcomings that prevent AT1 from functioning as going-concern capital. This paper examines whether they can be addressed. It is structured as follows: Section 2 outlines a framework to identify why AT1, as currently designed, behaves de facto as gone-concern capital. That framework helps to articulate, in Section 3, the features that could address the identified shortcomings. Section 4 concludes by pointing to a series of trade-offs that policymakers would face were they to pursue these options.

2. Why current AT1 design fails as going-concern capital

2.1 What going-concern AT1 must achieve

CET1 is the benchmark for loss absorption on a going-concern basis. CET1 is perpetual and never repaid outside of liquidation. It immediately reflects a bank's profits and losses and is therefore the first and most direct buffer against losses. The effectiveness of debt instruments as going-concern capital hinges on how well they replicate the core attributes of CET1.

The Basel Framework requires that AT1 instruments classified as liabilities include specific structural features that seek to emulate CET1. They must be perpetual, offer discretionary coupons and

[4] Borio et al (2025).

[5] For an early criticism of the conversion mechanism, see Goodhart (2010).

[6] See APRA (2024).

incorporate a mechanism for principal loss absorption, either through writedown or conversion. These structural features provide the foundation for going-concern loss absorption. Capital-linked triggers are set at a minimum of 5.125% CET1, with many jurisdictions requiring a higher threshold of 7%. This means that if the bank's regulatory capital ratio (ie ratio of CET1 to risk-weighted assets (RWA)) falls below this level, the AT1 instruments can be written down or turned into equity. In addition, the Basel Framework allows for loss absorption based on conditions beyond a specific CET1 ratio. This discretionary trigger is activated when a bank reaches the point of non-viability (PONV), which is defined as the earlier of: (i) a decision by the relevant authority that conversion or writedown is necessary to restore the bank's viability; or (ii) a decision by the public sector to provide financial support.

In principle, debt instruments with these broad features can support the recovery of a bank that shows early signs of distress. These features may be necessary, but they are not by themselves sufficient. For AT1 to support recovery, the key conditions are that losses are imposed early enough, through a clear mechanism and in a way that supports timely corrective action. Moreover, the mechanism must be operationally sound. The instrument must transform into CET1 with clear legal mechanics and minimal uncertainty or procedural friction. Collectively, these features foster market discipline and reduce the stigma associated with the eventual loss absorption by these instruments. Most importantly, the design should create an incentive structure that encourages bank management and shareholders to initiate necessary recovery actions at an early stage rather than to wait and hope ("gamble") for resurrection.[7]

2.2 Why AT1 instruments are triggered too late to support recovery

Debt instruments can absorb losses on a going-concern basis only if the trigger is activated while the bank is still in a position to recover. A trigger set too low activates only when the situation has become irreversible, at best briefly delaying resolution rather than facilitating recovery.

As long as stress remains moderate, a bank retains access to funding, can process payments and continues to extend credit. As stress intensifies, these functions erode: depositors withdraw, counterparties retreat and market access narrows. A trigger that activates while these functions remain intact preserves the bank's ability to recover. Equally important, a trigger that activates early is less likely to be interpreted as a signal of impending failure. Conversely, a trigger that activates too late forces the bank into asset sales at steep discounts, crystallising losses and potentially transmitting stress to other institutions.

With that in mind, the thresholds mandated by the Basel Framework appear to be set at too low a level to effectively support going-concern loss absorption. To understand the issue, consider the capital requirements faced by large banks. Global systemically important banks (G-SIBs) often face CET1 requirements exceeding 10%, depending on the jurisdiction and the individual risk profile. These requirements encompass the minimum CET1 requirement, capital conservation buffer, countercyclical capital buffer and G-SIB surcharge. To illustrate, as of end-2024, 14 out of 29 G-SIBs faced CET1 requirements higher than 10%, even excluding non-binding capital buffers, and all 29 faced CET1 requirements higher than 8%. In many jurisdictions, these are further supplemented by additional Pillar 2 requirements and buffers.

A trigger set at 7% or even 5.125% is significantly below these levels.[8] By the time a bank's CET1 ratio falls to the trigger point, the bank has already depleted a substantial portion of its buffers. At this stage, supervisory intervention is likely to be well underway, markets have repriced the bank's debt,

[7] Formal models confirm this: instruments that absorb losses on a going-concern basis reduce shareholders' incentive to gamble for resurrection, in contrast to instruments that absorb losses only at the point of non-viability (Martynova and Perotti (2018)).

[8] Incidentally, the same logic may apply to AT1 instruments that are not classified as liabilities. For example, preferred shares in the United States only start absorbing losses after capital reserves have been depleted, ie where CET1 may already be at a rather low level.

counterparties are pulling back and depositors are withdrawing funds. Under such conditions, raising fresh equity becomes extremely challenging, if not impossible.

The Credit Suisse case highlighted this issue. Prior to its equity raise in October 2022, Credit Suisse reported a CET1 ratio of 12.6%. Even so, the success of its equity raising was far from guaranteed. Rather, it depended on an existing shareholder (Saudi National Bank) acting as an anchor investor in a private placement, raising CHF 1.76 billion out of a total capital raise of roughly CHF 4 billion. Much of the remaining proceeds were from other existing shareholders, against a steep discount relative to the market price of the time, of 32%.

Against that background, it is fair to hypothesise that an internationally active large bank would typically be a gone concern well before reaching a CET1 ratio of 5.125% or 7%. And it is reasonable to conclude that such trigger is set well below the range where stress typically begins to materialise. Indeed, the capital-linked trigger never did activate, and AT1 instruments failed to absorb losses in the recovery phase. For Credit Suisse, it was only at the point of failure where, on the basis of the non-viability trigger, AT1 bonds contributed to loss absorption.

A trigger that activates this late functions more like gone-concern capital than going-concern capital. By this point, losses that might have been manageable earlier have compounded, and the activation of the trigger comes too late to stabilise the bank's financial position or support recovery effectively.

2.3 How writedown discourages early recapitalisation and why conversion can be writedown in disguise

AT1 can support recovery not only when it is triggered, but also before the trigger, by shaping shareholder incentives. As discussed, shareholders facing capital erosion have weak incentives to recapitalise voluntarily because the value of new equity accrues largely to creditors. AT1 can change that calculus, but only if triggering imposes a meaningful cost on existing shareholders. If shareholders expect activation to dilute their stake or transfer value to bondholders, they have reason to recapitalise early or back other corrective action. If activation instead benefits them, that disciplining effect disappears.

Writedown is precisely such a case. When an AT1 bond is written down, the debt is cancelled. If the bank is no longer viable and the writedown occurs at the point of failure to support resolution, existing equity will in most jurisdictions also be written down, so shareholders do not benefit.[9] In contrast, if the bank continues to operate as a going concern, value is transferred from bondholders to shareholders without shareholders contributing anything. They retain the same number and proportion of shares, but those shares become more valuable at bondholders' expense. Rather than encouraging early recapitalisation, writedown rewards delay.

Whether conversion avoids this problem depends on its design. When AT1 converts into equity, new shares are issued to bondholders. If the conversion implies a significant transfer of value from shareholders to bondholders, shareholders have an incentive to recapitalise early to avoid it. The extent of that dilution depends on how the conversion price differs from the market price of the shares at the time of conversion. If it is sufficiently lower than the market price, bondholders receive substantially more shares for each dollar of the debt they hold than they would be able to purchase on the market. If, however, the conversion price is set above the market price, conversion starts to resemble writedown: bondholders lose, shareholders gain.

The composition of outstanding AT1 bonds among European G-SIBs reflects a diverse mix of loss-absorption mechanisms. UBS, for instance, has increasingly shifted towards conversion instruments,

[9] In the Credit Suisse case, AT1 bonds were entirely written down while shareholders received CHF 3 billion in UBS shares as a consequence of the merger.

particularly for recent issuances. However, writedown instruments remain prevalent across the market. Credit Suisse exclusively issued writedown AT1 bonds, a practice mirrored today by Deutsche Bank and Société Générale. For these banks, the issue of potential shareholder windfalls is inherently embedded across their entire AT1 structures.

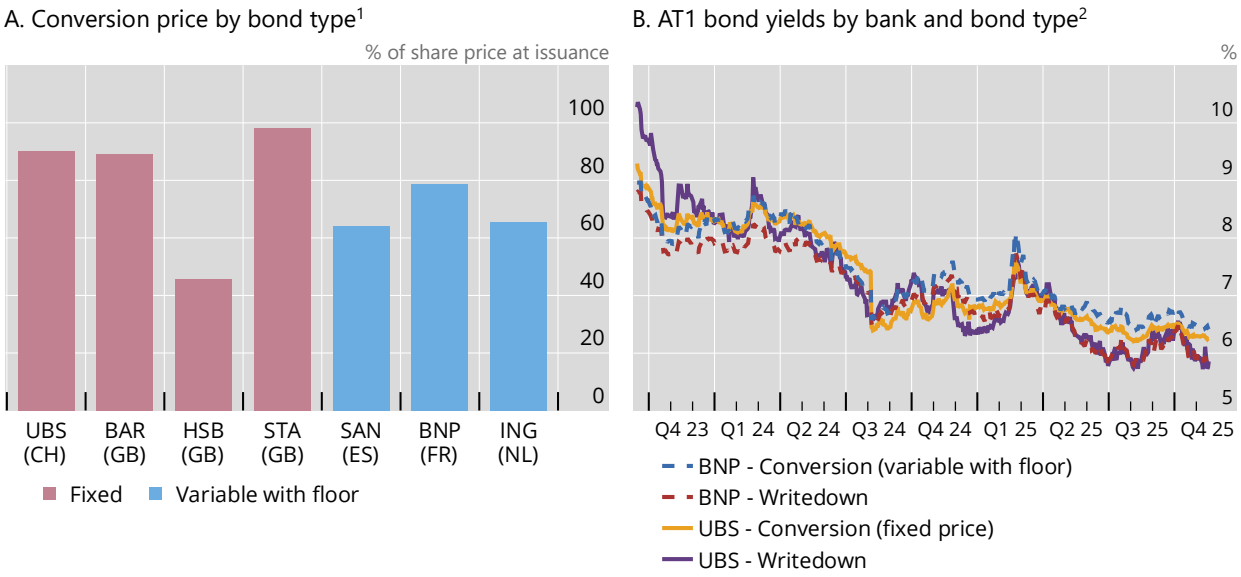
For banks that rely on conversion instruments, the relevant question is whether their conversion terms avoid this problem by imposing sufficient dilution on existing shareholders. Graph 1.A addresses that question by focusing on the key economic margin: the conversion price. For a given amount of AT1 principal, the conversion price determines how many shares bondholders receive at conversion: the lower the conversion price, the more shares are issued and the greater the dilution for existing shareholders. The graph therefore plots the conversion price, or the floor price for market-linked instruments, as a percentage of the bank's share price at AT1 issuance. A higher ratio means that even a modest fall in the share price is enough to push the market price below the conversion price. Once that happens, bondholders receive too few shares for the loss they absorb, and conversion stops being meaningfully dilutive for existing shareholders. A ratio of 90% means the share price needs to fall by only 10% for that point to be reached. A ratio of 50% means the share price must fall by half.

Most banks set fixed conversion prices at issuance. At UBS, the average conversion price is approximately 90% of the share price at the time of AT1 issuance. Barclays and Standard Chartered are similar. A modest decline in the share price is enough for conversion to stop being dilutive and start transferring value to existing shareholders.

Variable conversion prices could, in principle, solve this problem. Under a market-linked structure, the conversion price adjusts to the share price at the time of conversion. If the share price has fallen significantly, the conversion price falls with it, and bondholders receive correspondingly more shares. This would ensure sufficient dilution regardless of how far the stock has dropped.

Conversion prices and yields of AT1 bonds

Graph 1



[1] Average ratio of conversion price to share price at issuance for USD-denominated AT1 bonds of European G-SIBs. For fixed conversion bonds, the numerator is the contractual conversion price; for variable conversion bonds, it is the floor price. Sample restricted to active bonds as of February 2026. The list of banks includes UBS Group AG (UBS), Barclays PLC (BAR), HSBC Holdings plc (HSB), Standard Chartered PLC (STA), Banco Santander SA (SAN), BNP Paribas SA (BNP) and ING Groep NV (ING). [2] Average daily yields of USD-denominated Additional Tier 1 (AT1) bonds issued by BNP Paribas SA (BNP) and UBS Group AG (UBS).

Sources: LSEG Datastream; banks' disclosures and authors' calculations.

But in practice, banks set floors on these variable prices. Santander and ING use market-linked conversion, yet Santander's floor is approximately 65% of the share price at AT1 issuance, and ING's is

similar. Once the share price falls below the floor, bondholders stop receiving additional shares, and shareholders begin to capture the benefit. For context, Credit Suisse's share price fell approximately 80% between 2020 and the eve of the merger. At that level of decline, even market-linked instruments with floors would have failed to impose meaningful dilution on shareholders.

Whether fixed or market-linked, current conversion terms do not offer bondholders much more than writedown does. Graph 1.B confirms this by plotting average daily AT1 bond yields, by bond type, issued by UBS and BNP Paribas. Both issuers have writedown and conversion instruments outstanding, allowing a within-bank comparison that controls for issuer-specific risk. If conversion offered meaningful protection to bondholders, they would accept lower yields on conversion instruments compared to writedown instruments. However, yields on the two types are nearly identical. The market confirms what the design implies: at current conversion prices, conversion is economically equivalent to writedown.

The result is that neither mechanism, as currently designed, reliably creates incentives for shareholders to act early. Writedown instruments transfer value directly to shareholders. Conversion instruments, with conversion prices set near issuance levels, do much the same.

2.4 AT1 spreads and coupon practice are inconsistent with a going-concern role

If AT1 instruments genuinely absorb losses on a going-concern basis, investors in weaker banks should face higher expected losses compared to those in stronger banks, leading them to demand higher yields as compensation. Spreads should then differentiate based on the financial health of individual banks. However, if investors do not believe that going-concern losses will actually be imposed, this logic collapses. Spreads would then fail to differentiate between stronger and weaker banks.

Graph 2 examines this for AT1 spreads of stronger and weaker European banks. Prior to the Credit Suisse event, the lines moved in tandem, with spreads on weaker banks barely distinguishable from those on stronger banks. This pricing behaviour suggests that the market did not expect AT1 instruments to absorb going-concern losses. After the Credit Suisse writedown a wider gap emerged, with weaker banks facing significantly higher spreads than their stronger counterparts. Nonetheless, the previous pattern gradually re-established itself a few months after the event. The pattern is more consistent with markets not expecting AT1 to absorb losses in recovery than with AT1 being priced as a routine recovery instrument.[10]

That interpretation may also help explain both the strong reluctance of AT1 issuers to cancel coupons and the sharp market reaction when cancellation comes into view. Under the current AT1 framework, issuers have discretion to preserve liquidity and conserve capital. In some jurisdictions, coupon payments may be further restricted, as they can only be made from specific balance sheet positions.[11] However, there are no publicly known cases where an issuer has exercised this discretion or been required to cap a coupon payment when due. Even during the peak of the Covid-19 pandemic, when banks in many jurisdictions were required to cancel dividends, AT1 coupons continued to be paid without interruption.[12] Put differently, in terms of coupon payments, AT1 behaves much like Tier 2 instruments, which are designed as gone-concern instruments for which the Basel Framework does not require a coupon cancellation option.

If markets already treat AT1 coupons as near certain, even the suggestion of cancellation becomes a distress signal. In early 2016, when Deutsche Bank appeared to approach the maximum

[10] The results hold even if a different measure is applied, for example return on assets. A similar dynamic is observable in markets for total loss-absorbing capacity (TLAC) bonds: Di Stefano et al (2026) show that bail-in-eligible bond spreads tightened disproportionately for weaker banks in the year following the Credit Suisse event, and that investor responsiveness to quarterly earnings announcements declined.

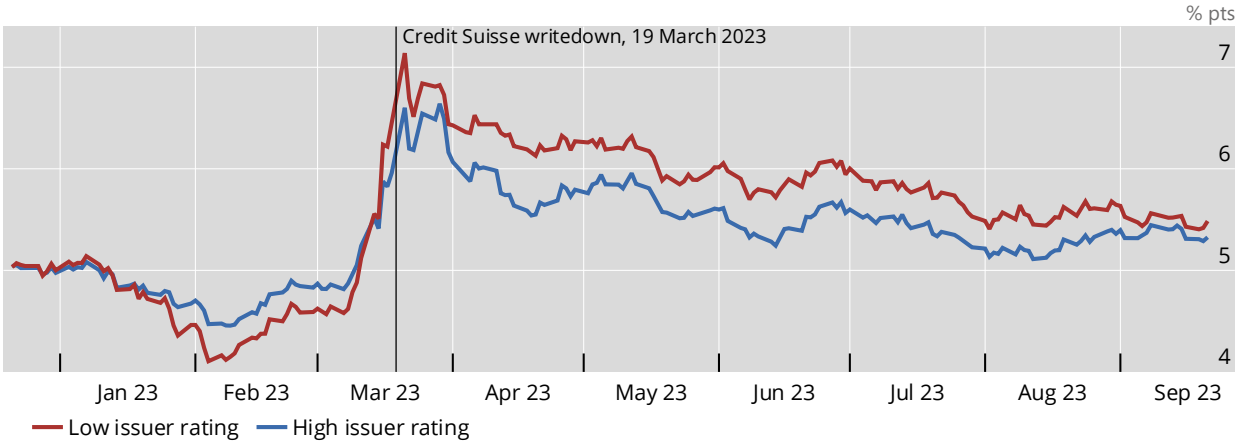
[11] This is the case in the European Union and United Kingdom; see Article 141 of the Capital Requirements Directive (CRD).

[12] See BCBS (2021).

distributable amount (MDA) threshold at which coupon cancellation would become mandatory, AT1 spreads widened not only on Deutsche Bank's instruments but across other G-SIBs.[13] A variety of factors are likely to have played a role. First, the asset class was fairly new at the time, with large-scale issuance having started only around 2013, and holders reportedly included "tourist" investors seeking to earn a higher yield without necessarily having a thorough understanding of the instrument's terms. Second, Deutsche Bank appeared to be approaching the MDA threshold, where coupon cancellation would cease to be a management option and become mandatory. Lastly, there was uncertainty around "available distributable items" under German accounting rules, which would have also constrained coupon payments.[14]

If markets treat AT1 as a gone-concern instrument, coupon cancellation carries the stigma of a distress signal rather than serving as prudent capital conservation. By continuing to pay coupons, banks effectively seek to demonstrate to markets that the point of failure is remote.

AT1 yield spreads of European banks around Credit Suisse event, by issuer rating[1] Graph 2



[1] The graph shows median AT1 yield spreads over the 10-year sovereign benchmark by issuer rating group. Spreads are calculated as the difference between the yields on AT1 instruments and government bonds denominated in the same currency. The charts exclude Credit Suisse AT1 instruments and do not account for bank- or contract-specific differences. The vertical line denotes the Credit Suisse writedown event on 19 March 2023. Issuers are grouped by long-term issuer credit ratings from Moody's, Standard & Poor's (S&P) and Fitch, mapped to a common 22-point scale ranging from strongest to weakest. Low issuer ratings include 1–15 (Baa1/BBB+ and below), while high issuer ratings include 16–22 (A3/A– and above). Group assignment is based on ratings as of 30 December 2022 and held fixed thereafter.

Sources: LSEG Datastream, banks' disclosures and author's calculations.

3. Restoring going-concern functionality

3.1 Incentivise early recapitalisation

Whether or not AT1 incentivises early recapitalisation depends on how losses are allocated at the trigger point. The previous section showed that neither writedown nor conversion, as currently designed, imposes costs on shareholders at the trigger point. The question is what design choices would.

[13] See Fatouh and Neamțu (2023).

[14] See European Parliament (2016) and EBA (2016).

Writedown cannot be redesigned to solve this problem. Cancelling debt always transfers value to shareholders in a going concern. A shift towards conversion-only AT1, with existing writedown instruments replaced at next call date, would remove the most problematic design from the market.[15]

To create proper incentives for shareholders to recapitalise early, the conversion of AT1 has to dilute the value of shares sufficiently. This is guaranteed if the conversion price applied to AT1 is below the market price of the shares. This implies that the prospective conversion price moves with the share price.

However, this may raise practical concerns. The issuer needs preauthorised conditional capital, waiver of pre-emptive rights and delegated board authority to issue shares at the trigger without a fresh shareholder vote. Listing and settlement mechanics must be ready for immediate delivery. There is also a market integrity risk: as the share price falls and expected share issuance rises, AT1 holders may have incentives to short the stock to hedge their exposure. Short-selling can push the price down further, particularly near the measurement window.

To mitigate these risks, a floor on the conversion price may be necessary. But the floor must be set low enough that it does not recreate the problem it is meant to solve. Current floors, as shown above, are set too close to issuance prices and effectively eliminate dilution well before serious stress. A floor set at a small fraction of the issuance price, low enough that it binds only in extreme scenarios, would preserve the dilutive incentive through most of the stress range while limiting the scope for price manipulation near conversion.

3.2 Rely on automatic triggers for going-concern use

If AT1 is to function as an incentive for shareholders to recapitalise early, this has implications for how the trigger is defined: AT1 can only absorb losses on a going-concern basis if the trigger activates while the bank can still recover. A trigger set too low activates only when losses have become irreversible, pushing the bank towards resolution rather than recovery.

Discretionary triggers are subject to a similar logic: they are likely to be activated only at a relatively late stage of a distressed bank's decline. This is because authorities tend to pursue an intervention policy that prioritises private sector action and therefore seeks to ascertain that such options are exhausted before they intervene themselves, as a last resort.[16] This, in turn, implies that markets are likely to interpret authorities' interventions, once they occur, as a signal of a bank's terminal decline or imminent failure. In other words, discretionary triggers work well in resolution, where they offer much needed flexibility, but do not work well in recovery, where their inherent nature as a last resort measure has a dilatory effect.

A recent alternative view argues for the opposite design: rather than reserving discretionary action for resolution, supervisors should have the power to activate going-concern AT1 conversion directly, as a way to close the "intervention gap" between business-as-usual supervision and resolution (Martino and Perotti (2025)). Yet, the reasoning above suggests that, even with strengthened powers, the signalling cost of discretionary action in recovery is hard to overcome: markets would read public supervisory action as a marker of imminent failure, and authorities, anticipating that, would delay action. An automatic CET1-based trigger set well above the point of non-viability sidesteps that dynamic while preserving discretionary authority for resolution.

Yet relying exclusively on automatic, CET1-based triggers may raise concerns. One such concern is that CET1 ratios are backward-looking. They are based on accounting data, measured quarterly and

[15] An exception is mutual and cooperative banks, which lack publicly traded equity. For such institutions, conversion into equity is not straightforward, and writedown may remain the practical design choice.

[16] See BCBS (2015).

published with a lag. By the time a breach is detected, the bank's condition may have deteriorated further. One might argue that discretionary triggers compensate for this weakness, since supervisors can act on more current information. But as mentioned, authorities rarely invoke the discretionary trigger early enough to support recovery. The stigma associated with a public declaration of non-viability, combined with the uncertainty it creates for investors, means the discretionary trigger in practice does not correct for the backward-looking nature of CET1. Scenarios where confidence erodes so fast that the last quarter's accounting and regulatory data are already stale are precisely those that lead to inevitable failure. In those cases, AT1 should act as gone-concern, not going-concern, capital. In such a scenario, linking AT1 to specific metrics is not desirable. Rather, authorities should have flexibility to use AT1 as the circumstances of the case require.

Market-based signals such as stock price movements, CDS spreads, or AT1 yield spreads could in principle provide a forward-looking complement. But using market prices to trigger loss absorption directly creates well known problems: self-fulfilling prophecies, multiple equilibria and vulnerability to manipulation and short-selling. A more practical approach is to use market signals as an early warning rather than a direct trigger. For instance, when market indicators suggest emerging stress, the bank could be required by the supervisor to produce an ad hoc assessment of its CET1 position, accelerating the detection of a potential breach. More broadly, increasing the frequency of CET1 disclosures and leveraging improvements in reporting technology would reduce the lag inherent in accounting-based triggers. Finally, a sufficiently high trigger level itself provides a buffer: even if detection is delayed, a trigger set well above the point of non-viability gives the bank room to act before losses become irreversible.

This implies that going-concern triggers should remain CET1-based, complemented by market signals as early warnings, with a clear separation of roles: automatic triggers for recovery, discretionary authority for resolution.

3.3 Calibrate trigger at a sufficiently high level

The case for a higher trigger is clear. The question is where to set it.

The simplest approach is a fixed but high enough threshold applied uniformly to all AT1 instruments. For example, AT1 could trigger at a CET1 ratio of 10%. Investors can compare AT1 instruments across banks without adjusting for differences in regulatory regimes. But any fixed number is ultimately arbitrary. For banks with high G-SIB surcharges or Pillar 2 requirements, 10% may already fall well below the regulatory requirements. And if expectations of adequate capitalisation shift upward over time, a fixed threshold risks becoming obsolete.

One potential approach is to link the trigger to each bank's specific regulatory requirements. This ensures that the trigger consistently remains above the regulatory threshold and adjusts automatically as requirements evolve. However, CET1 capital stacks differ across jurisdictions and may include components that are not disclosed to the public. As a result, investors may be unable to independently verify the exact placement of the trigger. This may argue in favour of setting triggers at levels that are subject to disclosure requirements anyway, for example the MDA level.

A further concern arises when authorities raise bank-specific (ie Pillar 2) or system-wide (eg countercyclical capital buffer) requirements, as this would mechanically push the AT1 trigger closer to activation. This implies that activation could ultimately be driven by authorities' decisions. Additionally, if the trigger is set as a margin above the upper limit of the buffer range, it may incentivise banks to increase their management buffers, potentially undermining the usability of capital buffers.

Yet another alternative is to issue AT1 instruments at multiple trigger levels rather than one. For example, a bank could be required to issue tranches triggering at 13%, 11% and 9% CET1. As the bank's capital ratio declines, conversion occurs in stages rather than all at once. This spreads the dilution signal over time. However, if banks are free to choose their own trigger levels, they will gravitate towards

the lowest permissible threshold, defeating the purpose. For staged loss absorption to function, the trigger levels would need to be mandated. While this approach also inherits the limitations of any fixed threshold and introduces some additional complexity, it comes with an additional advantage: it avoids converting a large volume of AT1 in a single event, reducing the market disruption and contagion risks associated with sudden activation of large volumes. And while markets may at first struggle to price multiple triggers, they may overcome that complexity as multiple triggers resemble strike features of option rights, which markets are accustomed to pricing.[17]

4. Conclusion

AT1 instruments were originally conceived as a component of going-concern capital, supplementing CET1 and designed to absorb losses at an early stage to support the recovery of distressed banks. However, the current design of AT1 instruments falls short of effectively fulfilling this role. AT1 de facto behaves like gone-concern capital, and is probably perceived by markets as such, stigmatising its usage. Policymakers face a choice: they may decide to abandon AT1 as going-concern capital altogether. Or they may seek options on how to restore at least some of the going-concern functionality of AT1.

The purpose of this paper was to identify an option that can work in the latter sense. It rests on three core elements: First, making conversion at sufficiently dilutive, variable and market-linked prices the primary mechanism for going-concern loss absorption. This encourages shareholders to seek early recapitalisation. Second, eliminating writedown as a mechanism of loss absorption and discretionary triggers in going concerns. This removes elements that frame AT1 as a gone-concern instrument whose activation indicates the bank's failure. Third, raising the level of the remaining, CET1-linked triggers to a level high enough to support recovery. Higher automatic triggers may also reduce stigma by normalising activation as an early corrective measure rather than signalling impending failure.[18]

These elements will strengthen the going-concern function of AT1. Yet policymakers need to weigh them against potential drawbacks. One such drawback is that AT1 instruments, if reformed as described above, will be relatively less relevant when the bank becomes non-viable. Of course, the option does not imply abandoning discretionary PONV-linked triggers altogether. At the point of failure, having discretionary writedown options and the flexibility they offer is useful. Yet their scope of application will probably be smaller, as they would only apply to any residual AT1 that has not already converted in the run-up to the PONV. As such, these triggers would primarily apply in scenarios where a sudden loss large enough to bypass the recovery phase takes the bank directly to the PONV, or if resolution is triggered for reasons unrelated to solvency. That said, if the failed bank possesses adequate gone-concern loss-absorbing capacity – such as through Tier 2 instruments – authorities should still be well positioned to execute an orderly resolution.

Importantly, a more pronounced loss-absorbing capacity in a going concern is likely to make instruments more expensive. The net effect of the design changes discussed in the paper on AT1 yield spreads is an empirical question. But to the extent that cost does rise, it reflects AT1 bearing more equity-like risk. Moreover, if the reformed instruments incentivise investors to differentiate based on bank performance, stronger banks may experience a smaller cost increase. Also, it remains possible that an enhanced design will deliver on its objective and the instrument, while more expensive, will still be less

[17] Another point is whether to define the AT1 trigger in terms of CET1 or, possibly, Tier 1. As long as AT1 are a cheaper source of funding than CET1, banks will hold as much AT1 as possible. If AT1 design is changed to absorb losses earlier, the cost advantage will diminish. By defining the trigger level in terms of Tier 1, triggering becomes independent of the bank's choice of AT1 and CET1.

[18] Pursuing a redesign along the lines proposed here does not exclude incremental changes, especially in a transition period. Pending a broader reform debate, AT1 features could be enhanced by, for example, making more active use of coupon cancellation or limiting the callability of AT1 under stress.

expensive than equity. This rests on the assumption that AT1 coupons would continue to be expressed in terms of a percentage of the AT1 principal, in the style of a conventional fixed income instrument, rather than as a right to participate in profits, in the style of a share. This feature may attract a broader investor base and help keep funding costs in check.[19] The margin would have to be sufficiently large to offset the likely increased cost of bank equity, given it risks being diluted well in advance of insolvency, hence raising return expectations of bank equity investors. If this holds and the margin is sufficiently large, issuing such an instrument would be attractive for banks.

Lastly, even though a reformed AT1 design would have instruments convert mechanically at a given capital threshold, thus avoiding the stigma of discretionary writedown, markets are still likely to view a forced conversion as a somewhat disruptive event, whose repercussions are difficult to foresee. Bank management will therefore have incentives to avoid conversion, including by expanding management buffers. This, in turn, may have adverse procyclical implications. In the worst case, if AT1 issuing banks were to collectively deleverage, this might impose costs elsewhere in the real economy.

Phasing out AT1 eliminates the complex trade-offs around funding costs, buffer usability and resolution funding. Yet it also removes one of the few contractual mechanisms that can counteract shareholders' reluctance to recapitalise under stress. Simply requiring more CET1 cannot replicate this. Assuming potential drawbacks can be mitigated, a well designed and reformed AT1 instrument can play an important role in supporting going-concern recovery. From that perspective, the debate on reforming AT1 deserves to be continued.

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