Bahnhofplatz 4
CH-9430 St. Margrethen
Tel.: +41 71 520 7588

CAPITAL MANAGEMENT AG
ALPSTEIN

office@alpsteincapital.com
www.alpsteincapital.com

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AT1 Instruments for German Public Banks
The Case for Alpstein Capital Management's (ACM) Fund Structure

1. The extent of secondary market liquidity in listed credit instruments

In **equity markets**, designated **brokers** must commit to **quoting prices** at which they will buy and sell securities, for the purpose of providing **liquidity** even in cases of sharp price up- as well as downturns. **Market makers** must always stick to these parameters and during all market outlooks. When the environment becomes erratic or volatile, they are obliged to remain disciplined to continue facilitating **smooth transactions**.

This convention in practice does **not apply to the broker community in credit secondary markets**. Banks and other brokers are not obligated to provide prices to buy or sell fixed-income instruments. While **bonds** and bond-like instruments are in most cases **exchange-listed**, it does not commit a market maker to provide liquidity in the form of two-way markets when the environment is not to its benefit.

It is for this reason that **credit markets can become illiquid** when under stress. We have been able to observe such phenomenon numerous times, for example in the AT1 market last year, when Credit Suisse was taken over by UBS and their CoCo instruments were irrevocably written down to zero. The **contagion effect** left the market virtually bid-less for days, and bond prices corrected by up to 20-25 points in short order. All these bonds are principally considered liquid by way of their **large issuing volumes** and **listed nature**, but in **times of distress** their price movement is **subject to erratic volatility**.

Very recently, the price of the **outstanding AT1 instrument of German mortgage lender Pfandbriefbank** came under **massive pressure**. It is widely known that the bank is suffering from the malaise in the commercial real estate market, particularly in the US, and is subject to painful value adjustments on its balance sheet. The **stock price has suffered substantially**, and even outstanding senior debt has also been discounted by approx. 10%.

The AT1 bond features a write-down trigger typical for such instruments. However, a crashing share price is no indication that the capitalisation level will be breached – significant losses of equity capital beyond regulatory requirements would have to occur. In any case, the price of the equity-like instrument has significantly dropped in sympathy with the decline of the share price. Amid the **rush of the selloff**, it doesn't appear to be a case of finding fair value but rather a de-risking from Pfandbriefbank exposure in general. In this wake, the bond **dropped by 50 points** in short order and at one point traded down **to roughly 20 cents** on the Euro**.**

This bond is **exchange-listed** like most of its peers, as per below. Nevertheless, the **steep fall in price** is a function of **market makers retreating**, trading volumes dropping significantly, and bids being entered almost **randomly if not disappearing entirely**. As a result, prices tumble, and individual bonds need to be marked down accordingly in investor portfolios. Conversely, when bottom fishers seem to be interested in taking exposure again, they might not find market participants to sell at rock bottom prices and bonds are quickly being bid up again, as to be seen in the chart of the Pfandbrief example.

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Despite their **formal exchange listing**, trading of bonds is traditionally being conducted **over the counter**. Bloomberg commands the probably most widely used medium for institutional trading. Transactions cannot only be settled via Bloomberg, it also provides banks and other market makers a platform where to express buying and selling interest and at what size considerations. However, the validity of a bid or an offer will have to be confirmed by direct contact before a trade is to be concluded.

It is not uncommon that featured price levels are **indications only** and **not actually firm prices** to trade on. Essentially, Bloomberg's BVAL function depicts an average of all posting market makers' combined interest, frequently used as a mark-to-market tool for investor portfolios. Again, however, in times of distress these **indications are quickly outdated** and can no longer be taken as **firm broker interest**, as to be observed below with Pfandbriefbank when it traded at around 20 Cents.

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PBBGR 8.474 PERP €↑20.587 -.642 18.984 / 22.190 77.098 / 68.383
As of 01 Mar --x-- Source BGN
PBBGR 8.474 PERP REGS Corp | Request Access | Settings | All Quotes
18:09:05 ALLX Overlay Axe Size Split Bid/Offer 94) Switch 95) Buy 96) Sell
Spreads vs BTF 0 02/26/2025 REGS Cor @CBBT 96.589 / 96.647 3.551 / 3.488 03/01
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PCS	Firm Name	Bid Px / Ask Px	Bid Yld / Ask Yld	BSz(M) x ASz(M)	Time
CBBA	CBBT TCA Adjusted	19.566 / 21.743	75.360 / 69.483	500 x 500	03/01
BVAL	BVAL (Score: 9)	20.000 / 20.921	74.113 / 71.595	x	03/01
EXCH	EXCHANGE TRADED	20.800 / 20.990	71.917 / 71.413	x	d03/01
	Last Trade	20.213	--	--	03/01
BTIG	BTIG	19.000 / 22.000	77.104 / 68.892	1,000 x 1,000	18:08
STNX	StoneX Financial Ltd	19.000 / 23.000	77.104 / 66.513	1,000 x 1,000	08:00
TSAF	TSAF OTC	18.655 / 22.315	78.172 / 68.126	1,000 x 1,000	07:22
EVET	Ever Capital	33.000 / 38.000	48.854 / 42.689	1,000 x 1,000	03/01
KECH	KEPLER CHEUVREUX ...	19.109 / 22.065	76.773 / 68.733	1,000 x 1,000	03/01
TRDG	TradeGate	18.215 / 21.000	79.521 / 71.387	1,000 x 1,000	03/01
AURX	AURIGA Global Inv	15.00 / 22.00	91.590 / 68.846	1,000 x 1,000	03/01
GETX	GETTEX	18.215 / 21.595	79.521 / 69.854	200 x 200	03/01
BAAD	Baader Bank AG	18.215 / 21.595	79.521 / 69.854	200 x 200	03/01
SEAP	Seaport Global Hldgs	20.000 / 21.000	74.165 / 71.436	x	11:19
HNVR	HANOVER EXCHANGE ...	20.820 / 21.000	71.864 / 71.387	x	d03/01
HMBG	HAMBURG EXCHANGE ...	20.810 / 21.000	71.890 / 71.387	x	d03/01
STGT	STUTTGART EXCHANG...	20.810 / 21.000	71.890 / 71.387	x	d03/01
BRLN	BERLIN EXCHANGE	20.800 / 20.990	71.917 / 71.413	x	d03/01
GERM	GERMAN EXCHANGE ...	20.800 / 20.990	71.917 / 71.413	x	d03/01
DUSS	DUSSELDORF EXCH	20.790 / 21.000	71.944 / 71.387	x	d03/01
FRNK	FRANKFURT EXCH	20.790 / 21.000	71.944 / 71.387	x	d03/01
DWZH	DWZ - HAMBURG FIX...	18.830 / 18.830	/ 18.830	x	d03/01
DWZG	DWZ - GERMAN FIXIN...	18.830 / 18.830	/ 18.830	x	d03/01
BBT3	CBBT - FUTURES CLO...	18.64 / 22.33	78.149 / 68.056	x	03/01
MNCH	MUNICH EXCHANGE ...	18.215 / 21.000	79.521 / 71.387	x	d03/01

In summary, the **exchange listing** of a fixed income instrument is **no guarantee of continuous liquidity** for investors. The **over-the-counter nature** of the market does **not obligate market makers to provide prices** beyond the benefits of earning bid-/ offer spreads or cases of investor relationship-driven transactions. **The reality is that the market can be fairly illiquid in times of distress and leaves investors exposed, on either side of the trade.**

2. Liquidity provision of ACM's Fund Structure

Alpstein Capital Management's proposition to providing institutional investors with exposure to **Additional Tier 1 instruments of German public banks such as Sparkassen and Cooperative Banks ("Volksbanken")** is unique in nature. It offers a solution that bridges across 1. a Schuldschein documentation feature of new capital issues, 2. typically much smaller issuing sizes as compared to public bonds, and 3. an approach to overcome concerns around redemption liquidity.

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The fund is designed to assume placement of **numerous EUR 10-50 million-sized AT1 Schuldschein issues** achieving broadest possible credit diversification for investors. ACM has managed to line up various Sparkassen and Volksbanken that are ready to issue an **initial combined total of approx. EUR 100 million**.

Purchased units are **not being traded in a regulated market** and are not priced as in a broker market. Their **net asset value** will regularly be determined by **ACM's calculation model** that considers a combination of 1. a target market return, whereby a **modified Capital Asset Pricing Model** determines a credit spread that is also based on the **issuer's price/book ratio** as well as the volatility of the asset class represented by approx. 80 European regional banks, 2. **risk of cancellation of coupon payment** based on individual issuers' ratings that will be adapted in certain credit- and rate stress scenarios, and 3. comparative **liquidity risk.**

To accommodate **investors' potential early redemption of invested capital**, ACM has committed to invest up to 30% of the fund volume in the most liquid of EUR-denominated AT1 capital issues of the largest European commercial banks. Under **normal market conditions**, these bonds trade **daily and in significant volumes**. This portion of the portfolio serves as a **buffer for such redemption requests**. In addition, as new purchases of fund units are principally only offered when new issues are being originated, the accrued buying interest will first be netted against redemption requests. This mechanism constitutes yet another layer of liquidity buffer for the fund.

This is not to say that these bonds are immune in overall **market stress scenarios**. In the case of the Credit Suisse-related fallout in March last year, the entire market suffered and was for a **few days volatile and subject to less liquidity**. However, the mentioned bonds constitute the most liquid segment of AT1 instruments, and market making is usually being offered by banks and brokers on a consistent basis. To that extent, see Deutsche Bank AT1 bond's intra-daily chart for the past 30 trading sessions.

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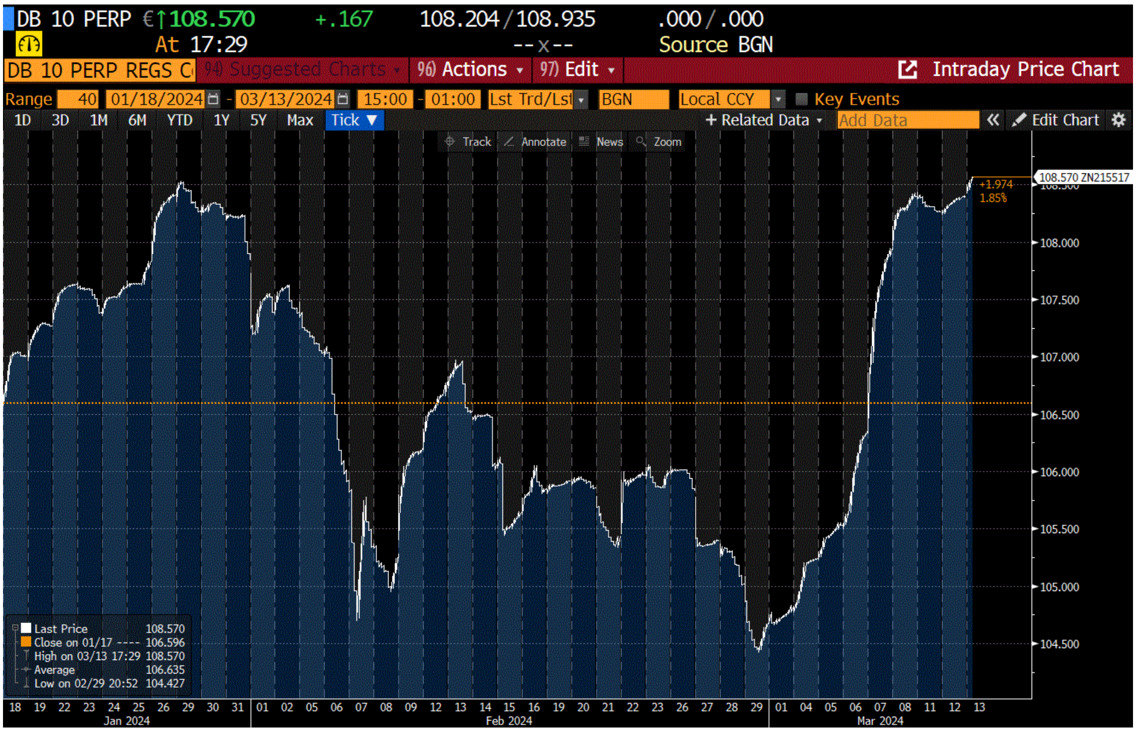

Beyond this up to 30% portion of liquid public bonds, it is obviously also possible to sell/assign Schuldschein instruments to other buyers, but it is typically a slower process to complete transactions and not comparable to a more transactional broker market.

3. **Summary**

Investors can neither be completely protected from the credit risks of banks' AT1 instruments nor isolated from liquidity risks in market stress scenarios. **What ACM's fund structure is offering, however, is not only a deeply diversified credit risk proposition but also a sensible approach to liquidity provisions in case of redemption requests.**

Alpstein Capital Management AG

Dr. Christof Grabher (Managing Partner)
Mail: christof.grabher@alpsteincapital.com

Roland Hinterkörner (Managing Partner)
Mail: roland.hinterkoerner@alpsteincapital.com

Bahnhofplatz 4
9430 St. Margrethen
Schweiz

Tel : +41 71 520 7588
Mail : info@alpsteincapital.com
www.alpsteincapital.com