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Circulation of Hybrid Securities in the Debt Instruments Market

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Abstract: This article examines the circulation of hybrid securities in the debt instruments market, with particular focus on Additional Tier 1 (AT1) bonds. The study reveals the key characteristics of these securities and analyzes their role in bank financing as well as their significance within the subordinated debt instruments market. Furthermore, the paper highlights the distinguishing features of hybrid securities compared to other types of bonds.

Keywords: joint-stock companies, issuer, investor, capital market, risk, return, securities, institutional investors, bonds, stock exchange, bank.

Introduction

In contemporary capital markets, financial instruments have been structurally complex, and hybrid securities and subordinated debt instruments are gaining importance. Overview Hybrid securities are financial instruments that have both debt and equity features. Long-term they pay interest like bonds, but can have equity-like characteristics in given situations. When they are converted into equity, or participate in loss absorption, depending on the financial condition of the issuer. In this sense, they stand between traditional bonds and equities on risk-return spectrum.

The basic categories of hybrid securities are:

AT1 (Additional Tier 1) bonds

Convertible bonds

Preferred shares

Subordinated debt is that which is repaid after senior obligations are met in the case of an issuer's bankruptcy. Payment on such debt comes only after higher-priority liabilities have been satisfied, in other words. This feature makes subordinated debt more risky but providing it investors with comparatively higher returns. For use in practice, these instruments can be seen to form a primary element within bank capital and thereby directly impact stability [1].

Hybrid and subordinated instruments currently play a diverse number of important roles in the capital market. First, they allow banks and large corporations to obtain extra capital and assist in fulfilling international regulations on the administration of capital (notably Basel III). Second, they help diversify sources of financing, allow the distribution of the risk among investors, and thus foster development in capital markets. This enhances

overall financial system stability and broadens the prospects for attracting new categories of investors.

Among hybrid securities, Additional Tier 1 (AT1) bonds occupy a unique position, particularly for banks. They are classified as part of Tier 1 capital and help to boost capital coverage and resilience. AT1 bonds come with a built-in loss-absorption mechanism, meaning their value can be wiped out or converted into equity in times of financial distress. This also decreases the necessity for government bailouts and diminishes systemic risks [2].

Simultaneously, AT1 bonds present higher yields to investors, but such returns are tied with elevated risks like a coupon cancellation or write-down in the value of the instrument. Specific instruments in bank financing that will allow banks to attract international investors and contribute to the development of the capital market would be relevant for such developing economies as Uzbekistan. This will probably also be the same with hybrid securities and subordinated debt instruments, which play an essential role in the capital structures of firms operating in ever-evolving capital markets [3].

Literature Review

Scientific literature on hybrid securities and subordinated debt instruments has developed mainly in tight liaisons with corporate finance, structural aspects of bank capital, and financial stability. Theoretical and empirical research in this area shows that hybrid instruments are a key feature of the optimal debt-equity balance, as well as for diversifying sources of financing [4].

Franco Modigliani and Merton Miller (1958) put it forward that under perfect market conditions, there is no effect of debt-equity ratio on firm value. More recent research has found that various conditions relevant to the real world, including tax benefits, bankruptcy costs and asymmetric information, make financing decisions far more important. In this connection, Stewart C. Myers (1984) and Nicholas Majluf (1984) proposed the so-called "pecking order theory," according to which firms prefer financing from internal funds, then debt and issue of hybrids. Finally equity will be preferred as a last resort; hybrid instruments are considered as an intermediate financing [5].

Research in the banking sector, and especially after the Basel III standards came into effect, paid more attention to the quality of capital as well as its loss-absorbing capacity. Regulatory documents such as those created by Bank for International Settlements (BIS) describe AT1 instruments as a significant piece of bank capital and confirm their importance in maintaining financial stability through loss absorption in situations of economic hardship. Additionally, research by Mark J. Flannery (2014) and Stefan Avdjiev, et al. Hilscher and Raviv (2013) extensively study how CoCo bonds, an abbreviation for contingent convertible bonds, in particular AT1 instruments impact bank risk and investor response [6].

The empirical evidence on hybrid securities indicates that they embody the sacrifice of higher risks for higher returns. Specifically, AT1 bonds have discretionary coupon payments for the issuer and can be subject to a write-down or convert into equity when pre-defined conditions are met, so this is one of the most crucial factors impacting investor's risk (Brady et al., 2018). Concurrently, those instruments are viewed as one of the more affordable and agile ways to access capital for banks [7].

Interest in hybrid instruments has been steadily rising over the past few years, including in emerging financial markets. International organizations like OECD and EBRD report that these tools deepen capital markets, broaden economic investor base and increase efficiency of financial intermediation. Especially in bank-oriented economies, hybrid and subordinated debt instruments are considered to be key tools for the development of market mechanisms [8].

Research Methodology

The research uses various scientific methods: statistical, logical, analysis and synthesis, comparative.

Analysis and Results

Companies issue bonds in response to financial requirements, and corporations choose the correct types of instruments by considering existing financial obligations as well as how they plan to put the debt capital raised into use. This, indeed, is a modern high flying banking sector instrument that has increased exponentially over the years – Additional Tier 1 (AT1) bonds.

AT1 bonds are debt instruments created by banks to make Additional Tier 1 capital, and typically understood in practice as contingent convertible bonds (abbreviated as CoCo bonds). These instruments are hybrid, having characteristics of both debt and equity. While they do have some characteristics similar to those of convertible bonds in the traditional sense, their predominant purpose is that of bolstering bank capital [9].

The creation of AT1 instruments is intimately tied to the aftermath from the 2008 global financial crisis, which underscored the need to make banks more resilient. Stricter capital requirements have now been in place under Basel III since the early amost developed by September 2010. In accordance with these standards, banks should have enough high-quality capital to provide for its obligations and be able to deal with financial shocks. The Basel III framework aims to ensure the stability of the financial system as a whole, reduce systemic risks and enhance market discipline [10], with AT1 bonds forming an important part of these objectives.

These bonds not just augment capital adequacy but also upgrade banks' credit profile. At the same time, they foster financial stability because they partially shift risk from depositors to investors. AT1 bonds are usually perpetual and relatively high yielding. They may, in dire financial circumstances, be converted into equity or written down, increasing their risk profile.

Despite these risks, such instruments continue to be appealing for institutional investors chasing higher returns. A main characteristic is greater interest income, in return for some assurance of a restrictive repayment of principal. Furthermore, these bonds can be freely traded on secondary markets by investors [11].

AT1 bonds also serve as a risk management option for banks and determine better tier 1 capital ratios. This, in turn, bolsters the financial strength of institutions, enhances their ability to absorb losses and supports lending to the real sector. The use of these instruments also aids in the diversification of funding sources and increases financial flexibility [12].

AT1 bonds also have the characteristic of a call option that enables issuers to repurchase the bonds after a certain period. In practice thus many such bonds are redeemed at pre-specified dates, boosting investor confidence. As a result, banks can tap into these instruments to widen their investor reach such as domestic as well as internationally [12].

AT1 bonds are issued mainly to reinforce the capital adequacy ratio of banks because sufficient capital is necessary for financial stability.

Table 1. Bank Capital Requirements (Cross-Country Comparison), %
(Prepared by the author based on official data).

Indicator	Basel III	European Union	Turkey	Malaysia	Uzbekistan
CET1 (Common Equity Tier 1)	4.5	7	7	7	8

Tier 1 Capital	6	6	6	6	10
CAR (Capital Adequacy Ratio)	8	10.5	10.5–12	10.5	13
Capital Conservation Buffer					2.5
Supervisory Authority	Basel Committee on Banking Supervision	European Central Bank	Banking Regulation and Supervision Agency	Central Bank of Malaysia	Central Bank of Uzbekistan

Basel III Capital Requirements

According to Basel III requirements:

- CET1 shall no be less than 4.5% to RWA;
- At least 6.0% of RWA must be in the form of Tier 1 capital;
- The minimum capital ratio must be at least 8.0% of RWA (the total capital ratio corresponds to Tier 1 and Tier 2 capital)
- A 2.5% capital conservation buffer to absorb potential losses.
- Besides, Tier 1 capital is made up of Common Equity Tier 1 and

Additional Tier 1 capital. CET1 should be minimum 60% of regulatory capital and Tier 1 capital a minimum 75% of the regulatory capital.

Table 2. Bank Capital Adequacy Indicators as of January 1, 2025, %
(Prepared by the author based on official data).

Country	CET1 (%)	CAR (%)	Minimum Requirement (%)
European Union	15.8	19.99	10.5
Turkey	12.8	17.7	10.5–12
Malaysia	14.3	18.3	10.5
Uzbekistan	14.3	17.4	13

Global AT1 Bond Market

The worldwide market for Additional Tier 1 (AT1) bonds amounts to about USD 260–300 billion International Swaps and Derivatives Association. The main issuers of such instruments are banks in Europe and Asia.

However, U.S. banks have generally preferred to issue preferred shares instead of AT1 bonds when they raise Tier 1 capital. However, American banks remain key players in the European AT1 bond market as lead bookrunners [13].

The largest share in this segment is held by Europe while banks from China, Singapore and Malaysia are also aggressively entering the market.

Table 3. AT1 Bond Issuances by Lloyds Bank
(Prepared by the author based on official data).

No	Volume	Coupon (%)	Issue Date	ISIN
1.	USD 1bn	6.625	03.11.2025	US539439BF59
2.	GBP 750m	7.500	27.02.2025	XS3013997666
3.	USD 1bn	6.750	03.10.2024	US53944YBB83
4.	USD 1.25bn	8.000	13.03.2023	US53944YAV56
5.	GBP 750m	8.500	17.01.2023	XS2575900977
6.	GBP 750m	8.500	07.09.2022	XS2529511722
7.	USD 0.5bn	6.750	19.06.2019	US53944YAJ29
8.	GBP 750m	7.875	01.04.2014	XS1043552261

Discussion and Implications

The U.K's Lloyds Banking Group is one of the most active issuers of AT1 bonds in the market and has earned a reputation for success with this type of subordinated debt instruments. The bank has been redeeming AT1 bonds at call dates and using capital markets to issue new AT1 instruments for several years in succession. The bank has been able to issue at lower and lower rates, due to a combination of strong investor demand and a proven track record for issuance [14].

The write-down of AT1 bonds issued by Credit Suisse in 2023 represented a major inflection point for European banks with over ten years' worth of experience in the AT1 bond market. Such event led both issuers and investors to rethink on AT1 instruments.

What happened with Credit Suisse in 2023 was considered a crucial moment in the AT1 market. Switzerland's financial regulator FINMA stepped in with extraordinary measures amid drastic financial deterioration and a liquidity crunch. Liquidation of the assets shall follow resolution of the entity and its acquisition by UBS, which fully written down ~USD 17 billion of AT1 bonds. This case explicitly highlighted the peculiarities of AT1 instruments. Under the contractual terms, these instruments can be partially or fully written down or converted into equity if a bank's capital falls below a specified level or there is a so-called "non-viability" event declared by regulators. For the Credit Suisse case, that mechanism was totally put into action and this confirmed how risky AT1 instruments are for investors. The effect on global capital markets was significant. In the near term, investor confidence slipped, setting off a reassessment of risks. Consequently, AT1 bond prices slumped and yields surged. This resulted in increased funding costs for banks that then had to issue new AT1 instruments [15].

Investor behavior also changed notably. In the past, some investors concentrated purely on yield without paying proper attention to instrument terms. But after that event, scrutiny of issuance documentation has increased as investors focused on trigger mechanisms, coupon cancellation risks and write-down or conversion conditions. [This change deepened market discipline and fostered better-informed decision-making.] The AT1 market did not collapse in the medium term but rather evolved to reflect new realities. There was increased focus on transparency and clearer contractual terms, from regulators and issuers. Consequently, newer issuances described risks and investor rights in a more explicit manner. Consequently, investors were more careful and analytical in their investment choices. Importantly, these developments did not have a weakening effect on the AT1 market but rather had a qualitative improvement of it. The market developed stricter requirements, better transparency, and more sophisticated risk evaluation infrastructure [16].

The Credit Suisse episode illustrates how complex and sensitive the AT1 bond market is, offering salient lessons for a new issuer like Uzbekistan. On the other hand, hybrid and high-risk instruments such as AT1 bonds must be introduced with caution and in an orderly manner.

The terms of AT1 bonds — particularly their trigger mechanisms — need to be clearly defined. They must clearly state under what circumstances these instruments can be converted into equity or written down, providing legal certainty and allowing investors to gauge their risks in advance.

Second, transparency and full disclosure are crucial. Due to the complexity of AT1 instruments investors must have a full knowledge of their characteristics, including that they are high risk level products which may be subject to a coupon cancellation and potentially principal loss. If not, the market risks a crisis of confidence due to misunderstandings.

Third, clear and consistent rules must be established by regulatory authorities. A stable cohort of stakeholders can have higher confidence in resolution outcomes, leading to improved pricing for value and risk while reducing uncertainty on capital hierarchy and rights such that the market improves. Consequently, a regulatory system that considers national specifics [17] and complies with international guidelines needs to be created.

Ignoring these norms can lead to loss of trust from investors, incorrect risk assessment and instability in the market. At worst, demand for such instruments may drop sharply, affecting the development of the entire segment. Hence, in Uzbekistan, the adoption of AT1 bonds must be done slowly, prudently and with a great level of transparency. These instruments can only help to improve banking system stability, deepen capital markets and bolster investor confidence, if these conditions are met.

AT1 Bonds in Uzbekistan

The banking sector of Uzbekistan has been undergoing major reforms in recent years to enhance the financial stability and integration with international capital markets. Against this background, the need to enhance the quality of bank capital to align with Basel III norms—especially by extending various capital instruments—has risen to prominence.

From this angle, Additional Tier 1 (AT1) bonds are an attractive financial vehicle for the national banking system. Their introduction offers several advantages:

- reinforcing financial stability by establishing Tier 1 capital;
- assist banks without further burdening the state budget;
- increasing the participation of foreign investors and deepening capital markets.

AT1 instruments are still new among banking products, and limited in their application in Uzbekistan, but their interest has been growing in recent years within the framework of bringing the banking system closer to international standards.

In particular, O'zsanoatqurilishbank successfully entered AT1 bonds in the international financial market. This issuance was a significant milestone for the banking sector in Uzbekistan, allowing the bank to:

- form additional Tier 1 capital;
- expand its international investor base;
- improve access to global capital markets for Uzbek banks.

In addition, O'zsanoatqurilishbank also became first AT1 bond issuer in Central Asia — which would facilitate further integration of Uzbekistan's banking sector into the global financial markets.

Table 4. AT1 Bond Issuance of O'zsanoatqurilishbank (SQB)
(Prepared by the author based on bank data).

Volume (USD mln)	Coupon (%)	Financial Intermediaries	Trading Platform	CAR Impact	Tier 1 Impact
300	9.45	Citibank, J.P. Morgan, Société Générale, Standard Chartered, Raiffeisen Bank, Mashreqbank	London Stock Exchange	Increased from 15.9% to 19.0%	Increased from 11.3% to 14.7%

O'zsanoatqurilishbank placement were attracted by investors attention to Uzbekistan in the international capital markets at a time when interest in bonds from emerging markets is growing. Woodyty saw a total amount of USD 300 million issued, with overall demand at over USD 1.4 billion as investor confidence remains strong. Hence, the coupon rate was lowered from its earlier guidance of 10–9.75% to 9.45%.

The issuance of AT1 bonds enabled the bank to continue around USD 2.1 billion of additional loans during 2026–27 and an estimated USD 80 million in net interest income.

Increasing access to lending domestically will likely promote production and further development of new financing mechanisms for infrastructure projects.

Conclusion

In summary, AT1 bonds play an important role in modern banking practice through capital adequacy, financial stability and risk management. These hybrid instruments, therefore, allow banks to raise extra capital but also help diversify funding sources and improve integration with international investors. In developing markets, especially the banking sector of Uzbekistan, AT1 bonds are a new financial instrument. If properly developed and implemented in a balanced and systematic way, they can be an important factor to contribute towards the stability of the national financial system and in turn its competitiveness.

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