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MARKET UPDATE: COCO BONDS BOOM

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A CROSS BETWEEN A STOCK AND A BOND

Contingent convertible bonds, or CoCos, are a debt instrument issued by banks and financial institutions that can be converted into equity when certain circumstances occur, for example when a bank regulatory capital falls below certain level. These hybrid securities are also called ECN (Enhanced Capital Note) bonds.

They have been created to help undercapitalised banks and to prevent another financial crisis like the 2007 one. It's not surprising that their issuance has grown rapidly from 2014 in order to meet the higher capital requirement from Basel III: indeed, issuers are able to convert the bond, for example, when the level of Tier 1 goes below 6.0% of RWA (Risk Weighted Activities). In this case we talk about AT1 bonds and it's a high trigger category, being perpetual bonds without a maturity that potentially could never be repaid. Another one is the "T2", a low trigger category of bonds that can be converted when the sum of Core Equity Tier, Additional Tier 1 and Tier 2 goes below 8% of RWA.

The following graph shows how CoCo AT1 performed compared to European banks' stocks from 2014 until early 2019: in 2018 stocks have experienced a plunge of almost 11% and showed a volatility more than triple compared to CoCos.



Figure 1 – Cumulative performance of CoCo AT1 and EU Banks' stocks since common inception (2014-2019)
Source: widsomtree.eu

A cross between a stock and a bond, paying periodical coupons, a CoCo bond is made of two elements: the trigger, the pre-specified event causing the conversion, and the conversion rate, that is the actual rate at which debt is swapped for equity. The

trigger can be mechanical (bounded to the Book-value or Market-value) or discretionary.

The conversion option embedded helps the issuing financial institution absorb a capital loss coming from bad loans or other financial industry stress. The loss absorption mechanism can be realized not only through the conversion to equity but also with a principal write-down (a reduction of the original amount payable).

Since debt has no end date (when the principal must be repaid to investors), interest rates guaranteed by CoCo bonds range between 5% and 8%. Therefore, they have been defined as a high-yield investment with a hand grenade attached (T. Beardsworth and J. Glover). For this reason, such securities have become unavailable to ordinary UK retail investors since 2014 and their use is neither allowed in the U.S. banking industry.

Some investors are sceptic that the extra yield offered really reflects the risk embedded but nearly 200 issues by European banks worth a combined 160 billion euros (\$ 181 billion) have been snapped up since they entered the market (as of Feb. 15, 2019, according to Bloomberg). Many investors are willing to buy hoping that the bank will redeem the debt by buying it back one day. Until this happens, they would pocket the high returns along with the higher-than-average risk of the bond.

RISK OF EXTENSION

Risk of extension has had a primary role in defining the performance of subordinated financial debt in 2018. How does it work? Applied to the structure of a CoCo bond it refers to the chance for AT1 bonds to be extended in longer time if not redeemed at par at maturity. The risk comes from the fact that when this time spread widens, the demand for the bond decreases and its price consequently. In other terms, imagine a bank issuing a perpetual bond in USD with an 8% coupon and initial spread of 500 bp over the corresponding swap rate. If after 5 years the bank decides not to redeem the bond, the new coupon will be calculated through the current 5-year swap rate

plus the initial 500 bp spread (so-called “reset spread” or “back-end”).

For issuers, this means that they will repay the bond only if the spread of a new potential AT1 bond issue is lower than the reset spread (because the new instrument is cheaper). For investors the risk is bounded to the possibility of a missed reimburse and to a revaluation of the risk related to it, followed by lower prices.

The risk of extension was a primary concern for investors in 2018 because CoCo bonds were likely to be never repaid. Indeed, there was no incentive to do that because they were an efficient equity instrument for financial institutions with a medium cost of 6.2% (coupons) against the cost of equity set at 12%. During 2018, prices of perpetual maturity instruments increased, causing potentially higher refinancing costs and higher spreads over AT1 and, as a consequence, reducing their chance of reimburse.

The following graph shows that clearly: prices of CoCo bonds not expected to be repaid were almost 70% of the market in December 2018 compared to the 2% of January 2018. As evidenced, investors were expecting an extension in time for the redemption of the majority of such securities.

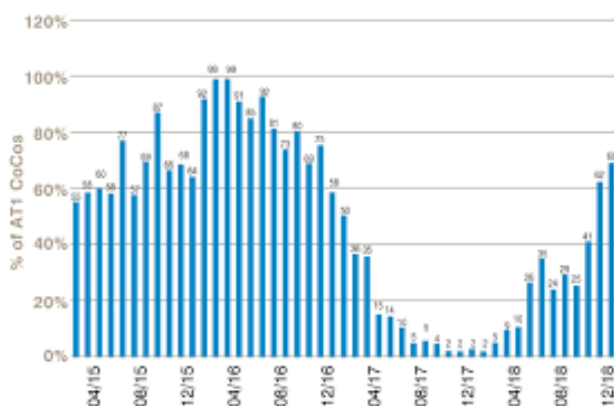


Figure 2 – Risk of extension - % of CoCo AT1 expected not to be repaid (Source: Bloomberg)

However, it’s unlikely that these bonds won’t ever be redeemed. Indeed, firms need to consider not only refinancing costs but also the “reputational cost” of a missed reimburse that may impact the demand and so the price of such instruments.

NASTY SURPRISE BY BANCO SANTANDER

On 12th February 2019 Banco Santander opted not to call a 1.5 billion euros (\$1.7 billion) contingent-convertible bond. Right at the deadline for a decision, the Spanish lender rattled the AT1 market: the bank announced a postponement of the end-date of the bond, so to pay lower interest rates than with a new issue. The decision has been a slap for investors (receiving a 6.25% coupon) and the market reacted by lowering the Santander’s bonds price to 97 basis points. Such reaction can be considered, after all, rather restrained and coherent with the expectations: Banco Santander SA missed the unwritten rule among European banks of repaying the bond and, quoting a Bloomberg article, “reminded investors that juicy bonds can hide surprises”. However, investors were aware of such risk of extension since 2018, according to what highlighted in the previous paragraph.

Nevertheless, in order to deny rumours about the fact that this decision of Banco Santander hid problems of liquidity and solvency, the firm proceeded to repay the bond in the following April. This was a very successful move for investors, whose belief in the Spanish lender was strongly confirmed also an year later: on 10th January 2020 Banco Santander decided to issue another bond for the same amount of 1.5 billion euros with a 4,375% coupon, facing a demand of 10 billion euros (quite 7x the value of the bond).

EVERYONE CRAZY FOR COCO BONDS

Since the beginning of 2020, a series of circumstances has contributed again to create favourable conditions for hybrid bonds’ emission: the liquidity flood, the wide seek of high yield and the sudden outbreak of COVID-19. This has significantly pushed banks towards emissions in the view of a prolonged period of economic recession and high market volatility. During the first month of 2020 \$15.6 billion of subordinated emissions have been registered (especially CoCos and 25% only in



Europe), more than the total of the last three months of 2019 (already a very favourable year, as previously analysed).

In Italy, the operations of Banco Bpm and Ubi Banca are worth mentioning: investors strongly believed that the supply of AT1 would have been limited and this led to requests 12-13 times above the amount of 400 million euros that each bank issued, with coupons ranging between 5% and 6%. Another Italian bank, Unicredit, realized a notable emission at the beginning of February, although it experimented less demand pressure, being able to fix one of the lowest coupons for this kind of instrument: 3,875%. An interesting point of this operation was the composition of investors, 70% of which made of investment funds. Experts underlined how, except for a minimum percentage, the majority of investors was in the search of securities to be integrated in new fixed-income products more attractive to retail clients, though exposing them to a non-negligible additional risk.

However, the coupon record low has been hit by the Austrian Erste Group Bank AG, with a perpetual deal at the incredibly low yield of 3.375% for an Additional Tier 1 regulatory capital bond. Despite the small yield, the 500 million euros (\$554 million) issue was subscribed more than 10 times by ravenous investors.

Another interesting European operation involved Alpha Bank, the Greek bank that recently recovered from the risk of bankruptcy. This has called a Tier2 for 500 million euros with a coupon of 4.25%, clearly a signal that, in a period of global uncertainties, negative yields and high liquidity boosts by central banks, investors barely look at fundamentals.

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