Understanding Contingent Convertible Securities: A Primer

By Erin McHugh, CFA

While a contingent convertible security (CoCo) may sound like a sweet treat, it is actually a novel hybrid financial instrument that has recently been in the headlines. Since 2009, banks have issued more than USD 380 billion of CoCos. To date, no CoCo has missed a coupon payment or has experienced a trigger event. However, recent market turmoil may have some investors reassessing their appetite for these securities.

This white paper provides a brief introduction to CoCos, describing their characteristics and risks, as well as issuance trends to date. The author also discusses recent developments in the markets for these securities and potential future challenges that issuers and investors may face.

Product Characteristics

CoCos are securities, issued by a bank, that are designed to absorb the bank’s losses during a period of financial stress, thereby improving its capital position. CoCos absorb losses by automatically converting to equity or having their principal written down (either partially or in full) when a pre-specified trigger event occurs. Absent a trigger event, the securities are hybrid financial instruments with debt-like characteristics (such as a specified coupon rate). CoCos are subordinated to senior debt within the bank’s capital structure.

CoCos were first issued in the aftermath of the 2008 financial crisis. Lloyds Banking Group’s November 2009 offering of enhanced capital notes (ECNs) is generally recognised as the first issuance of CoCos. Some regulators have encouraged CoCo issuances to reduce the likelihood of taxpayer bailouts such as those that were required during the financial crisis. Depending upon the specific features of the security, CoCos can qualify as Additional Tier 1 (AT1) or Tier 2 (T2) capital under the Basel III international regulatory framework for banks. To qualify as AT1 capital, CoCos must be perpetual instruments with coupon payments that can be deferred or cancelled at the issuer’s discretion without causing an event of default.
CoCos are more complex than most conventional debt instruments. For an investor, key considerations include the probability of a trigger event (i.e., the probability that the security will be forced to absorb losses) and the potential losses if a trigger event occurs. To date, most issuances of CoCos have had accounting-based triggers and/or discretionary triggers:

- **An accounting-based trigger** is activated if a capital ratio (e.g., the Common Equity Tier 1 ratio) drops below a specified level. The specified levels can vary, with higher triggers intended to provide additional equity capital at earlier intervention points.

- **A discretionary trigger** gives the bank’s national regulator responsibility for triggering the CoCo when it has determined that the issuer has reached the point of non-viability.

In order to evaluate the probability of a trigger event, the transparency of the trigger mechanism is important. For CoCos with accounting-based triggers, it may be difficult to forecast the future evolution of the issuer’s capital ratio. With a discretionary trigger, it can be difficult to predict the regulator’s use of its discretion.

For AT1 CoCos, there is also the risk that the issuer may defer or cancel coupon payments (which can occur even while the issuer continues to pay dividends on its common stock). Also, even when an issuer is able and willing to make interest payments on AT1 CoCos, it could be prevented from doing so by the regulator.

AT1 CoCos, while perpetual in nature, are generally callable by the issuer after a stated period (a minimum of five years in order to qualify as AT1). Many T2 CoCos are also callable by the issuer. Additionally, most CoCos include regulatory call and tax call provisions. A **regulatory call provision** allows the CoCo to be repurchased by the issuer if the regulatory environment changes and the security no longer qualifies as required capital. A **tax call provision** allows the CoCo to be repurchased by the issuer if the tax treatment of the CoCos changes (for example, the tax deductibility of interest payments). If securities are called at par, and if purchases were made at prices above par, this can result in losses for investors. Moreover, investors may not be able to reinvest the call proceeds at comparable rates (referred to as **reinvestment risk**). The possibility of a regulatory or tax call is an important consideration for investors.

### Issuance to Date

Investors’ search for yield in a low-interest rate environment may have played a role in the willingness to accept the risks associated with CoCos. Since 2009, banks have issued more than USD 380 billion of CoCos. After a rapid rise between 2009 and 2013, issuance peaked at USD 175 billion in 2014. Issuance in 2015 was down 42% from its 2014 level. Moody’s noted that in 2015 a number of banks postponed their CoCo issuances “due to weak market conditions associated with the Greek debt crisis, concerns about China’s economic growth, and uncertainty surrounding a rate hike by the U.S. Federal Reserve.” See Figure 1.
AT1 CoCos represented 76% of the total issuance volume (by amount) in 2015 (as compared to 52% in 2009–2014). European and Asian banks have represented the largest CoCo issuers by volume. See Figure 2. US banks have not issued any CoCos for reasons which may include: a) uncertainty as to the tax deductibility of interest payments on CoCos under IRS guidance, and b) the fact that US regulators do not currently allow CoCos to qualify as AT1 capital under their implementation of the Basel III framework.¹

Figure 1. Issuance of CoCos (USD Billions), 2009–2015

Figure 2. Issuance Amount of CoCos, by Region (USD Billions), 2009–2015

Notes and Sources:
Data are from Moody’s Investors Service, Moody’s Quarterly Rated & Tracked CoCo Monitor Database—Year End 2015.

¹Includes “Europe—Euro Area” and “Europe—Non-Euro Area.”
²Includes “North America”, “Latin America”, and “Middle East & Africa.”
While CoCos have primarily been issued by banks to date, Moody’s recently noted that many insurers are examining CoCo issuance “given low interest rates and successful issuance from banks.” Purchasers of CoCos have included retail investors, hedge funds, asset managers, and private banks.

**Credit Ratings**

All three main credit rating agencies—Moody’s, Standard & Poor’s, and Fitch—rated Lloyd’s ECNs, issued in November 2009. In February 2010, Moody’s established a moratorium on rating CoCos where loss absorption was subject to regulatory discretion and/or the breach of regulatory capital triggers, citing lack of clarity and potential modeling difficulties. In May 2013, Moody’s decided to end its ratings moratorium on CoCos with regulatory capital triggers set at or near the point of non-viability (i.e., low trigger CoCos), but maintain its moratorium on rating high trigger CoCos. In July 2014, Moody’s ended its moratorium on rating high trigger CoCos.

Figure 3 shows the number of Moody’s-rated AT1 and T2 CoCos by rating at issuance for the years 2009–2015. Overall, 48% of the AT1 CoCos (by number) and 57% of the T2 CoCos rated by Moody’s received investment grade ratings at issuance. For both AT1 CoCos and T2 CoCos, a larger percentage of the Moody’s-rated CoCos received an investment grade rating in 2015 than in 2014 (for AT1, 50% in 2015 vs. 41% in 2014; for T2, 96% in 2015 vs. 84% in 2014).

**Figure 3.** Moody’s Rating Distribution at Issuance for Tier 1 and Tier 2 CoCos, by Number of Securities, 2009–2015

Notes and Sources:
Data are from Moody’s Investors Service, Moody’s Quarterly Rated & Tracked CoCo Monitor Database—Year End 2015.
Recent Developments

Disputed Exercise of Regulatory Call Provision

In early 2014, Lloyds announced that it might exercise its regulatory call option, as its ECNs were unlikely to count towards the minimum amount of capital required in future stress tests. This announcement raised concerns amongst bondholders that the bonds, which were trading above par at that time, would be repurchased at par. Lloyds ultimately offered to repurchase some of the ECNs from retail investors at prices above par, and to exchange others held by institutional investors for new capital instruments. More than half of the Lloyds ECNs were repurchased or exchanged in early 2014.

Later that year, Lloyds announced that it planned to seek permission from the Prudential Regulatory Authority (PRA) to call some of the remaining outstanding series of ECNs at par, again raising concerns amongst bondholders. While Lloyds received permission from the PRA for the redemptions in March 2015, the case was then referred to court for a declaratory judgment. On 3 June 2015, the High Court ruled against Lloyds’ plan to redeem the ECNs. Lloyds appealed the decision and received approval on 10 December 2015 from the Court of Appeal to redeem the ECNs. The U.K. Supreme Court began a hearing to review the Court of Appeal’s decision on 21 March 2016.

Further attempts by financial institutions to exercise regulatory call provisions may also result in disputes.

Regulatory Scrutiny

Several regulatory bodies have issued warnings in the last few years regarding sales of CoCos to retail investors. For example, on 31 July 2014, the European Securities and Markets Authority issued a statement explaining the risks of investing in CoCos and stating that their analysis “can only take place within the skill and resource set of knowledgeable institutional investors.” On 5 August 2014, the UK’s Financial Conduct Authority announced a temporary restriction on the distribution of CoCos to the mass retail market, effective 1 October 2014 to 1 October 2015, with final rules taking effect on 1 October 2015. On 1 October 2014, Denmark’s Financial Supervisory Authority warned financial institutions against selling CoCos to retail clients. And on 15 October 2014, Germany’s Federal Financial Supervisory Authority stated that “[i]n general, [CoCos] are not suitable for active distribution to retail clients.”

CoCos have been reported to be popular with retail investors in Australia. While the Australian Securities & Investments Commission (ASIC) provides explanations of the features and risks of CoCos on its investor education website, the regulator has not restricted their sale.

Regulators’ concerns regarding potential mis-selling of CoCos to retail investors could result in investigations and/or enforcement actions.

Performance to Date

The Bank of America Merrill Lynch Contingent Capital Index tracks the performance of CoCos. The Index had total returns of 5.8% in 2014 and 6.9% in 2015. See Figure 4. However, even during this period, the performance of the Index was somewhat volatile, particularly in the second half of 2014, a period when market participants were concerned about the financial condition of banks following the collapse of Portugal’s Banco Espírito Santo that summer. This coincided with the period during which several regulators issued warnings about the risks of CoCos.
Concerns have been raised about banks’ ability to make discretionary coupon payments on AT1 CoCos.

Events in late 2015 and early 2016 have rekindled concerns about the financial strength of banks and the risks associated with their CoCos, with the Bank of America Merrill Lynch Contingent Capital Index declining by 10.6% between 31 December 2015 and 12 February 2016 (and declining by 2.6% year-to-date through 31 March 2016). In particular, concerns have been raised about banks’ ability to make discretionary coupon payments on AT1 CoCos, in the face of narrowing profit margins (due to, amongst other factors, weakness in commodities markets, negative interest rates, and slower global growth).

Also, there have been new disclosures regarding the capital requirements European banks must meet before they can make payments on AT1 CoCos. On 16 December 2015, the European Banking Authority (EBA) released an opinion that banks should ensure that they meet all of their capital requirements (including any bank-specific requirements imposed by regulators) when calculating the maximum distributable amounts for dividend and coupon payments on Tier 1 capital instruments. The EBA also recommended that regulators require banks to disclose all capital requirements relevant to the calculation of maximum distributable amounts. While the European Central Bank (ECB) had initially wanted banks to keep their specific capital requirements confidential, the ECB has since accepted the EBA’s recommendation regarding the calculation of maximum distributable amounts. During the 2015 Supervisory Review and Evaluation Process, some banking groups including, amongst others, UniCredit and BNP Paribas, disclosed their total capital needs for the first time under the ECB’s harmonised framework.
Recent actions have also underscored the risk of losses for bank creditors in a restructuring, even when those obligations rank senior to CoCos in the capital structure. On 29 December 2015, the Bank of Portugal approved a re-transfer of liabilities from Novo Banco (the “good bank” that was formed as part of Banco Espírito Santo’s restructuring) back to Banco Espírito Santo, imposing losses on some senior creditors. Further, on 1 January 2016, new bail-in rules went into effect in the European Union requiring banks to absorb losses equal to “an amount not less than 8% of total liabilities including own funds of the institution under resolution” (through write-down of those liabilities or otherwise) before any taxpayer support can be provided. These events may have contributed to the recent performance of CoCos.

Prices for several banks’ CoCos (e.g., Deutsche Bank, Santander, and UniCredit) dropped to their lowest levels ever in early February 2016. Despite a press release on 8 February 2016 asserting Deutsche Bank’s ability to make upcoming coupon payments, Deutsche Bank’s May 2014 EUR AT1 CoCo reached a low price of €71.094 on 9 February 2016.

Figure 5 shows the price performance of Deutsche Bank’s May 2014 EUR AT1 CoCo issuance (blue line) and its common stock (gray line), both pegged to 100 as of 21 May 2014.

Correlation measures the degree of co-movement between two variables. The green line (using the right-hand axis) shows the observed trailing 60-day correlation between the price returns of the CoCo and the common stock. The trailing 60-day correlations ranged from 0.11 to 0.79, and were at their highest during periods when the common stock price had declined (for example, around December 2014 and September 2015). This is unsurprising,
as one would expect a CoCo to perform more like common stock as the size of the bank’s capital cushion declines.

Deutsche Bank’s common stock price declined by 33.7% year-to-date through 31 March 2016, while the CoCo’s price declined by 12.6%. In that same period, the trailing 60-day correlation between the securities’ returns increased from 0.38 to 0.60.

**Potential Market Reaction to Missed Coupon Payment or Trigger Event**

Market participants use different methods to value CoCos. For example, a 2014 survey of CoCo investors by RBS found that the majority applied relative value analysis, comparing CoCos to other subordinated debt instruments. However, some investors surveyed used more complex valuation models. When trying to model the likelihood of an extreme event, including a trigger event, there is the potential for modelling errors.

To date, no CoCo has missed a coupon payment or has experienced a trigger event. Concerns have been raised regarding whether market participants are correctly assessing the risks associated with CoCos. It is possible that a missed coupon payment or a trigger event could affect valuations across the asset class.

If investors suffer losses on their CoCo investments, it is possible that disputes between investors and issuers or distributors of these securities may result.

**Key Takeaways**

- CoCos are novel hybrid financial instruments. While at issuance CoCos have debt-like characteristics (such as a specified coupon rate), they can convert to equity or have their principal written down upon a trigger event.
- Since 2009, banks have issued more than USD 380 billion of CoCos, with the majority of issuances coming from European and Asian banks.
- CoCos are more complex than most conventional debt instruments. Several regulatory bodies have issued warnings regarding sales of CoCos to retail investors.
- Prices for several banks’ CoCos dropped to their lowest levels ever in early February 2016, amid concerns about banks’ ability to make discretionary coupon payments.
- To date, no CoCo has missed a coupon payment or has experienced a trigger event. It is possible that a missed coupon payment or a trigger event could affect valuations across the asset class.

While CoCo issuance stalled earlier this year due to the turmoil in the markets, UBS and Banco Bilbao Vizcaya Argentaria have recently come to market with new issuances of CoCos. As of the writing of this paper, it remains to be seen whether investor appetite for CoCos will continue to drive market growth at the pace observed in recent years.
Notes

1 For example, Moody’s reports that 38% of CoCos issued in 2015 (by issuance amount) had an accounting-based trigger, 34% had a discretionary trigger, and the remaining 28% had both an accounting-based and a discretionary trigger. “Moody’s Quarterly CoCo Monitor: Issuance to be Flat in 2016 After 42% Drop in 2015,” Moody’s Quarterly CoCo Monitor, 3 February 2016, p. 4.

2 Data from Moody’s Investors Service, Moody’s Quarterly Rated & Tracked CoCo Monitor Database–Year End 2015 (Excel Data).


21 Frances Schwartzkopff, “Banks Warned on CoCo Sales to Retail Clients by Danish FSA,” Bloomberg, 1 October 2014.


24 For example, ASIC’s MoneySmart website states that “[c]apital notes, convertible preference shares and subordinated notes are complex investments. While they are issued by banks and insurers, they are very different to a savings account or term deposit.” Available at: https://www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes/bank-hybrid-securities, accessed 13 March 2016.

25 On 30 July 2014, Banco Espirito Santo posted a loss of €3.6 billion for the first half of the year, wiping out the company’s capital buffer. On 4 August 2014, the Bank of Portugal announced a bailout plan for Banco Espirito Santo.

26 European Banking Authority, “Opinion of the European Banking Authority on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions,” 16 December 2015, pp. 5-6.


About the Author

Erin McHugh is an Associate Director in the Securities and Finance Practice of NERA Economic Consulting, and manages projects in the areas of economics, finance, and valuation. She has consulted in litigation and arbitration matters in various venues, as well as in internal and regulatory investigations. Ms McHugh has worked extensively in the area of disputes between brokerage firms and customers concerning investments in equities, derivatives, fixed income, and structured finance securities. She has evaluated issues including the risk characteristics of the investments, suitability, concentration, and damages.

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