



Insigneo Weekly Dispatch

What is a CoCo?

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What is a CoCo?

Before the beginning of March, most of us would have thought of a fruit, or chocolate, when we heard the word “CoCo”. However, that word has been all over the financial media these past few weeks. Before the collapse of Credit Suisse, most people never heard of the term, and of those that did, few knew what it actually meant.

CoCo is a term used to describe a hybrid debt instrument known as a Contingent Convertible bond. A type of CoCo that made the news recently was Credit Suisse’s Additional Tier 1 securities, or AT1’s. Although similar to a traditional convertible bond, it is important to note that they are not the same instrument. In fact, there are major differences. Both have a strike price or “trigger price” that once hit, can trigger the conversion of the bond into stock. Both also pay a fixed interest rate and are subordinate to more senior debt. However, this is where most major similarities end. Convertible bonds allow investors to receive a fixed interest payment and at the same time provide the option to potentially participate in a company’s stock price appreciation. As we mentioned above, Contingent Convertible bonds also pay a fixed interest payment, most of the time higher than other debt instruments of the same company. However, as with most things in the financial markets, this higher yield comes with a higher level of risk.

In order to understand the risk behind CoCo’s, it is important to first look at why they were created in

the first place. This type of instrument became popular in Europe after the 2008 financial crisis. Regulators back then implemented capital requirements for financial institutions under what became known as the Basel III accord. This accord stated that banks had to meet minimum capital requirements to be able to confront unforeseen events. One of the most important levels of these capital requirements is known as Tier 1 Capital. This is supposed to be the highest-rated level of capital used to offset any unforeseen losses in loans or investments, and includes a bank's retained earnings, as well as common equity. Some banks have issued additional common equity to build up their Tier 1 Capital ratios. But as we know, issuing common equity can also dilute earnings for existing shareholders. This is where CoCo's come in. Additional Tier 1 notes provided banks with a "safety valve", where they had an instrument that could be converted into common equity in a future emergency to bolster Tier 1 Capital ratios, without the need to issue equity in the present. Banks then issued these notes with higher yields to reward investors for the additional risk.

In retrospect, it appears that some investors might have purchased some of these CoCo's thinking that they were basically slightly riskier convertible bonds with higher yields. After all, the instances where CoCo's had been triggered into an equity conversion were few. As we now know, although improbable, the level of risk associated with these investments is high.

But where does this high level of risk come from? Mainly from two sources: The conversion and write-down covenants associated with these bonds, as

well as relatively unclear parameters surrounding their triggering. A CoCo's conversion and write-down covenants could range anywhere from a simple conversion to equity, as many expected would be the case with Credit Suisse's AT1's, to what actually happened, which was a complete write-down of the notes. Some CoCo's allude to conversion, temporary write-downs, partial write-downs, and full write-downs in their investment agreements. We must also remember that even, if a conversion is triggered, then investors could end up holding stock that is in decline. At the same time, what triggers some of these covenants can be murky. As we saw with Credit Suisse, these CoCo's were supposed to be triggered if the Tier 1 Capital ratio dropped below 7%. However, the ratio was between 13% and 14% before the bank's collapse, yet Swiss regulators still pushed through a complete write-down of the bonds. Additionally, they side-stepped the traditional capital seniority waterfall, by eliminating the CoCo debt, but still paying common equity holders. Contingent Collateral debt ranks towards the bottom of the seniority waterfall, but it was assumed that, as debt, it ranked higher than common equity. Granted, the Credit Suisse CoCo notes appeared to contain very specific provisions that seemed to indicate that this particular scenario was a possibility. Not everyone agrees, obviously, and the matter is already up for litigation.

What is not up for debate is the negative impact that the collapse of the Credit Suisse AT1 notes had on the entire \$275 billion CoCo bond segment. European and Latin American banks are the main issuers of this type of instrument, and many have come out stating that the particulars of the Credit

Suisse AT1 notes were specific to the Swiss industry. This might be true, but the uncertainty surrounding this type of investment is certainly real. We were on a call earlier this week with the head of J.P. Morgan's Latin America Corporate Research, where she alluded to the fact that what struck her the most out of the collapse of the Credit Suisse CoCo's was the uncertainty over the triggers that led to their write-down. This sentiment is being echoed across the industry. In Latin America in particular, Banco Itau, Banco do Brasil, Banorte, and Banco Davivienda are the most prominent issuers of CoCo notes. According to many on Wall Street, these CoCo's appear to be fine at the moment. We are not disputing that. However, write-down languages, regulatory entities, and bank recapitalization practices vary from country to country, whether it's in Latin America or Europe.

This adds a complex and multi-level layer of risk. The important point to remember is that when dealing with CoCo's, or any type of investment for that matter, we have to account for the potential risks associated with the investment, seen and unforeseen, as best we can. It pays to read the fine print.



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