RBC Global Asset Management

A “CoCos” Primer

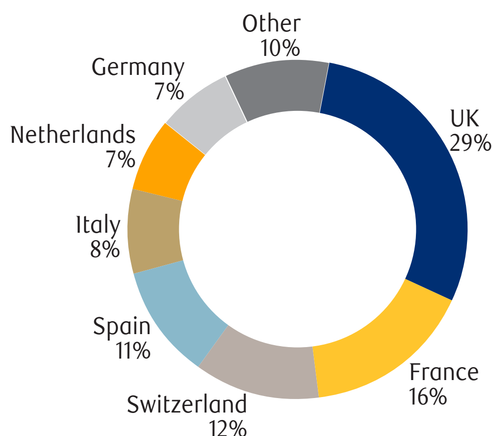
March 2023

What are “CoCos”?

- Additional Tier 1 (AT1) Contingent Convertible securities (otherwise known as “CoCos”) are a relatively new form of subordinated financial debt instrument
- The size of the global CoCo market is approximately US$250bn, with bonds issued by banks, predominantly in Europe. European banks like to issue CoCos because they are counted as additional Tier 1 capital. They’re a way for banks to improve their capital ratios without issuing more shares
- CoCos were created in the aftermath of the Global Financial Crisis of 2008 in a bid to restore market stability and help prevent future financial crises, without the use of taxpayer money
- If a bank runs into trouble, the CoCos could be converted into equity to shore up the bank’s balance sheet
- Following the creation of Basel III in 2010, banks have been subject to heightened regulatory scrutiny and increased capital requirements

Global CoCos market by country of issuer

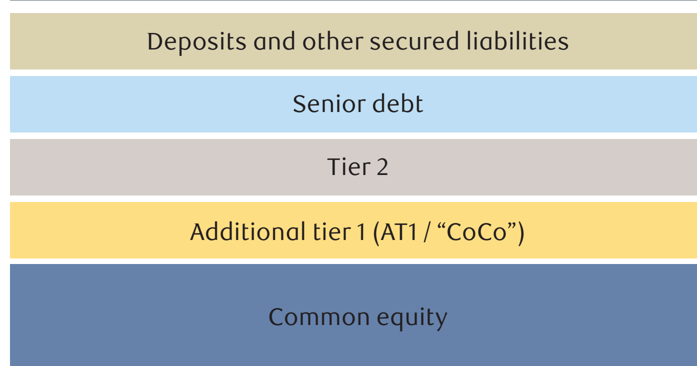
Breakdown of global CoCo market



Source: Bank of America as at March 7th 2023

- CoCos are structured in a way such that the bondholder can suffer in some way if the issuing bank’s capital strength falls below a pre-determined ‘trigger’ level set by the regulator; for example, a CoCo owner may miss a coupon or several coupons, may be converted into equity, may take a principal haircut or in extremis may lose the entire value of the investment. To compensate investors for these additional risks CoCos tend to offer investors higher return potential (higher yields) than other similarly rated fixed income instruments
- As you can see from the diagram below, CoCos are the most junior part of debt capital structure, subordinated to more traditional forms of senior debt, yet are senior to equity, which comes into play in terms of payment priority in the event of a bank’s liquidation

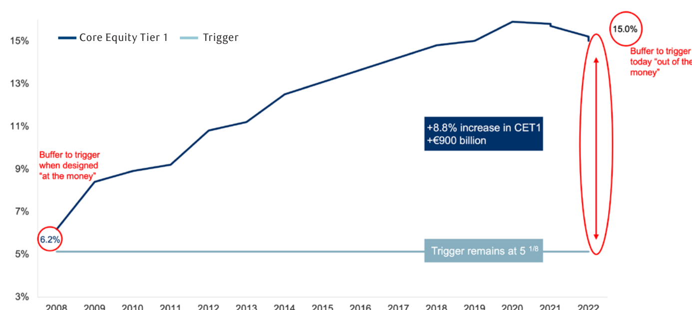
Simplified bank capital structure



What is the investment rationale for investing in CoCos?

- The CoCos investment thesis centers on the marked improvement in the credit profile of banks since the Global Financial Crisis (GFC) of 2008, driven by increased regulatory requirements for financial institutions
- Regulation has led to banks having a greater quantum and quality of capital, more liquidity and a more conservative risk appetite than at any point over the last decade

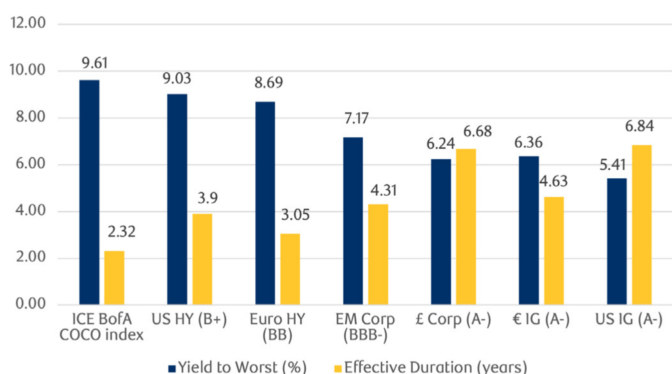
10+ years of capital build-up and yet yields remain elevated… "COCO" trigger is mispriced!



Source: EBA, RBC BlueBay Asset Management, as at 30 December 2022. For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue

- Regulators have spent over 10 years rebuilding bank balance sheets and repurposing their business models, making them significantly more resilient post 2008. Unlike during the GFC, Banks/Financials are not viewed as the problem but rather as the primary transmission mechanism for stimulus reaching the real economy in times of stress. This was demonstrated during the Covid-19 induced crisis
- While inherently riskier in nature than senior debt for the reasons given above, these securities typically offer significant spread premium versus similarly rated investment alternatives. Our thesis is that the compensation on offer in CoCos far exceeds the inherent risks.
- In our judgement, these bonds can offer investors the potential for higher investment returns by primarily seeking national champion banks and investing further down the capital structure. As a reminder, 'national champion' banks represent a large and important share of the lending that occurs in an economy. That's why regulators, central banks and policymakers are so focused on supporting these institutions – they are the lifeline that is needed to support the economy in a moment of crisis

Yields and durations of various sub asset classes in USD



Source: Bank of America as at March 15th 2023

- In addition, CoCo's are not included in traditional fixed income indices, and as such can be thought of as an "orphaned" asset class with no dedicated buyer base. As a result, Cocos typically are a less well understood asset class, are less well covered from a research perspective and as such we feel are less efficient and significant opportunities can exist from an alpha perspective ("complexity premium").

What happened and what is the current view on the asset class considering the recent uptick in volatility?

Markets are still digesting the news of UBS acquiring Credit Suisse in an emergency rescue deal put together by the Swiss National Bank.

- Over the weekend of March 19th 2023, UBS agreed to buy Credit Suisse (CS) in a government-brokered deal aimed at containing a crisis of confidence that had started to spread across global financial markets.
- The Swiss Authorities are providing liquidity support and guarantees and using several emergency measures to rush the deal through.
- The most controversial part of the rescue package was the treatment of the Additional Tier 1 Capital bonds (CoCos). The Swiss regulator FINMA has fully written off the AT1 securities of CS as part of a permanent write-down. In an apparent breach to conventional market wisdom, AT1s were not treated as senior to equity.
- A major correction occurred in the regional AT1 market for European banks, with investors having to reconsider the attractiveness and viability of the near $250 billion asset class.

Like many other market participants, we were shocked by the actions of the FINMA and as we pick through the wreckage there remain several unanswered questions. In this instance, the fact that AT1 holders were written down to zero, yet there was recovery for equity holders suggests that this was part of a commercial negotiation around the sale rather than a pure application of the rules. Based on the information available to us at this time, we believe that the Swiss government passed a law over the weekend of 19 March specifically to write down AT1 and subvert the capital structure. In our opinion, in doing so they may have acted contrary to their own bank insolvency ordinance and contrary to the terms and conditions of the notes.

As expected, the initial reaction from the market was negative, with very weak price action in the AT1 sector specifically and the broader banking sector more broadly. Announcements were swiftly made from the European Central Bank (ECB), European Banking Authority (EBA), Single Resolution Board (SRB) and the Bank of England (BoE); who all reiterated that the 'waterfall of

subordination' should be adhered to, and that AT1 ranks senior to common equity (CET1) in their jurisdictions. While this is small consolation to holders of CS' CoCos, this went a long way to reassure the market that the issue was primarily a Swiss one, and this, in turn, settled contagion fears. Since then, markets have since stabilized, albeit with risk premia at elevated levels.

Investors continue to work through the CS ruling and understand its impact. While it is too early to tell for certain the longer-term impact on AT1 risk premiums, we are seeing positive signals that the fallout has been contained. As described above, regulators outside of Switzerland have been quick to distance themselves from the Swiss ruling by FINMA and reiterate that AT1 remains an important part of bank capital structures. In our view they remain under no illusion that if AT1 were to be become un-investable (as is now the case in Switzerland in our view) or grandfathered and removed, issuers would need to replace that with core equity tier 1 capital (CET1) at a higher cost to the underling banks at a time when economic uncertainty persists and the strength of the banking sector is of critical importance to ongoing economic growth.

What is our outlook the Coco asset class?

Taking a more medium-term view, we remain constructive on the CoCo asset class. From a fundamental perspective:

- European banks remain well provisioned and should continue to benefit from the rising rate environment. Q4 results showed profitability meaningfully beating expectations and bank profitability is as strong as it has been in the last decade. expectations and bank profitability is as strong as it has been in the last decade.
- Capital levels remain close to all-time highs while the stock of non-performing loans (NPL) are close to the lows
- Liquidity, as a key focus from the regulators, remain robust with the Liquidity Coverage Ratio +190%

We would argue that higher rates and tighter financial conditions will impact most sectors negatively to varying degrees. In contrast, Bank profitability is enjoying a tailwind from higher rates. We think the trajectory for rates is that they will remain higher for longer and for central banks to continue to err on the side of caution in fighting inflation and inflation expectations. We expect for the fallout from Credit Suisse to subside and the fundamentals of the European banking sector will ultimately reassert themselves as the primary driver of returns. Achieving over 10%, from A-rated "systemically important" national champions, who are benefiting from the higher rate environment, should deliver superior risk adjusted returns over the medium turn as they have in the past.

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