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Why coco bonds are worrying investors

Thomas Hale and Dan McCrum

Shares and debt of eurozone banks are being hammered as investors question the sector's ability to make coupon payments on contingent convertible bonds, popularly known as "cocos".

What are cocos?

At a simple level a company has owners, and it borrows money from lenders who expect to get their money back. If the business runs into trouble, the owners lose their stake and the debt becomes equity — lenders turn into owners — in what can be a drawn-out process of restructuring.

Because a bank in trouble would not have time for such negotiation, coco bonds are designed to anticipate that process and transform automatically from debt to equity when certain conditions are met. Their full name is tier one contingent convertible bonds, and most are also known as additional tier 1 capital (AT1 bonds).

They have their roots in the financial crisis, when governments were forced to bail out banks. Devised to help rebuild the capital that regulators require banks to hold in case of losses, cocos pay a fixed coupon, but convert to equity or can be written off when losses force a bank's capital below a certain threshold.

They also allow the issuer to miss coupon payments, and this prospect no longer seems remote, setting off the latest bout of market anxiety.

Cocos are the riskiest debt issued by banks, with only a quarter of the eurozone market judged investment-grade by credit rating agency Fitch last year. Retail investors are not supposed to be involved in the €95bn market where coupons are high — frequently 6-7 per cent, compared with below 1 per cent for senior bank debt — to compensate for the risk of loss-absorption, and the risk that payments will be halted.

Why are investors worried?

Concerns have swirled around a range of European banks, including Deutsche Bank, Santander and UniCredit, amid questions about the way these bonds will be treated in the future.

While cocos are best known for the risk of capital losses, the immediate question for some banks is whether they will miss coupon payments. Deutsche Bank's €1.75bn coco bond is trading below 75 cents on the euro, its lowest level, a 19 per cent fall in price this year.

A second question is whether buyers of coco bonds ever get their initial investment back. The bonds are perpetual, meaning they will not mature unless the bank exercises an option, typically after five years.

Investors had expected banks to almost always take up the option to redeem coco bonds, but regulators may not allow this if the bank would then have to issue new bonds at

much higher costs. A perpetual bond with a 7 per cent coupon is worth much less than a five-year bond offering the same income.

Other European bank cocos hit new lows on Monday, with those of Santander and UniCredit touching 85 and 76.3 cents on the euro respectively. Investors are not taking any chances. They are selling bank debt and shares, and paying up for credit default protection on institutions seen as being in the vanguard of coco risk.

So far no bank has defaulted on a coco bond, and losses are limited to secondary markets.

Why have cocos been popular?

Governments have encouraged the sale of coco securities because they want to strengthen banks so that depositors and taxpayers are protected from problems in the banking system. Lenders to banks are supposed to take, and assess, the risks instead.

Bank capital contributes to the strength of an institution's balance sheet. When it falls these bonds help to shore it up by converting to equity or being written off. They count as additional tier one capital — and are a way of banks raising their capital ratio without selling new shares.

The question is whether they are a signal or a cause of problems for a bank. A rush to sell and so avoid potential losses could undermine broader confidence in an institution.