CoCos: Attractive yields from investment-grade bank issuers

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The arrival of a new asset class in financial markets is a rare event. Many "new products" are repackaged versions of existing products, dressed up as a potential new addition to portfolios.

However, the global financial crisis significantly changed the financial landscape and out of this traumatic experience a new form of bank capital, called Contingent Capital (CoCos), was designed, creating what we believe is a new, diversifying asset class.

After the substantial injection of capital into the global banking system by every government in the developed world post the collapse of Lehmans, regulators and politicians wanted to ensure that taxpayers would never again be called upon to bail out the banking system.

The last 10 years has seen a massive increase in the capital ratios banks hold, as well as a complete reassessment of risk weightings for their assets and operational risk exposure. Typically banks that had Tier 1 capital ratios of 7% prior to the financial crisis now hold around 14%, according to the Bank of England.

HOW HAVE BANKS ACHIEVED THIS?

Traditionally banks have three ways to increase their capital ratios. Firstly, they can have a rights issue (European banks have issued around €600m of equity in the last decade). Secondly, they can shrink their balance sheets, and thirdly they can hold on to capital (withholding dividends). The banking system has done all of this.

However, the authorities realised that this was a long winded and expensive process, which also had significant negative macroeconomic effects. The sharp reduction in balance sheets caused a credit crunch, and regulators and authorities were desperate to alleviate this.

The market needed a new form of capital that was cheaper and easier to issue. Regulators wanted a new kind of capital to absorb losses in circumstances of extreme stress. Along with banks, they designed CoCos.

HOW DO COCOS WORK?

CoCos are eligible capital that can make up to 1.5% of the Tier 1 capital of banks in the Eurozone (more in the UK and Switzerland). They are issued in perpetual form but with an initial call at a specified date and then regular calls every five years after that. During these call periods they pay semi-annual coupons.

If banks do not issue CoCos then they have to issue equity, which is significantly more expensive (as a guide, equity costs a bank 10% to issue vs 5% for CoCos). So there is an incentive for banks to issue CoCos but only up to a certain level.

Importantly there are a couple of trigger points for CoCos:

Figure 1: HSBC Equity Base

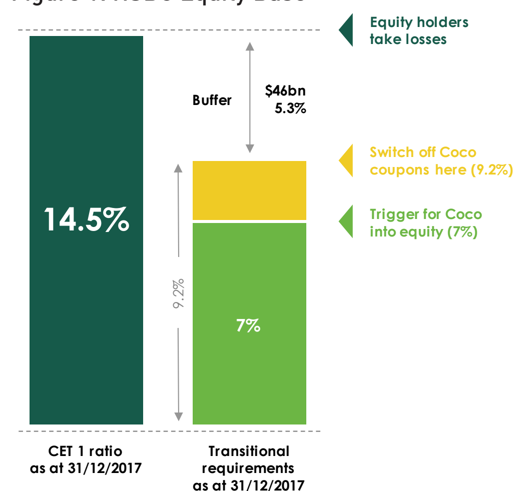

Chart for illustrative purposes

In this example if the capital ratio for HSBC falls below 7%, then HSBC's CoCo issuance will be converted into equity. There is also an interim trigger level at a capital ratio of 9.2% for HSBC (it is different for every bank) where CoCo coupons get turned off, but also dividends are stopped – and also management bonuses! However, the regulator would have insisted on a recovery plan well before this 9.2% level was reached.

Typically bank capital ratios move 10-20bps a quarter, so a 530bp fall in HSBC's capital ratio would be a monumental event.

Banks are still highly leveraged institutions, but they are unrecognisable from the leveraged beasts they were prior to the financial crisis.

ARE COCOS CHEAP FOR INVESTORS?

Possibly the best analysis of this is to compare CoCos to other types of bank exposure: how much they yield relative to other forms of bank issuance and most importantly, how much volatility is experienced by the investor to access that yield.

The table below looks at three different indices of bank issuance: equity, senior bank debt and CoCos:

Table1

	Barclays Senior Bank debt index	Barclays CoCos Index	Euro Stoxx Banks (USD)
Annualized return	-1.49%	0.56%	-19.26%
Volume	6.8%	3.7%	16.7%
Yield	3.65%	6.95%	8.00%
Yield per unit of risk (bps)	54	187	48

Source: Bloomberg/Datastream as at 29/06/2018

All of these indices are denominated in US dollars and the data is over the last year. A few things stand out:

Firstly, given where they stand in the structure of the bank, many investors would expect CoCos volatility to be somewhere between senior bank debt and equity. However, this is not the case, and CoCos realise significantly less volatility than senior debt or equities.

Secondly, the yield associated with that volatility is significantly higher on CoCos. For this the important row is yield per unit of risk for CoCos, which is over four times that of equities.

The third thing was how similar the yield per unit of risk was on equity and senior debt despite their very different yield and volatility characteristics. This highlights to an even greater extent how cheap CoCos look.

WHY DO THEY LOOK CHEAP?

CoCos are a new asset class, and it takes time for investors to get comfortable with new products; there has been a lot of issuance – around US$190bn – and this has kept the asset class cheap; given their post-financial crisis genesis, investors expected the asset class to be risky; and finally, investors have been unsure where to place CoCos.

The subsequent question is, are these reasons transitory or permanent? We believe they are transitory. Investors will get comfortable with the asset class; the scale of issuance will slow and top out around US$250bn. The asset class has volatility far lower than many expected, and when an asset is this cheap we believe investors will find a place for it in their portfolios.

We believe CoCos are a diversifying and very attractive new form of bank capital. We would go as far to say that they look mis-priced. High yield from investment-grade national banks, what's not to like?

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