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Cocos: Coming of age?

by Jeffrey M. Oakes and Connie I. Milonakis, Davis Polk & Wardwell London LLP[1]

With the implementation of the Basel III capital reforms through the Capital Requirements Directive (CRD IV) and the adoption of the European Recovery and Resolution Directive (RRD), contingent convertible and write-down instruments, or CoCos, and debt subject to bail-in continue to receive significant attention. Much of the recent attention has been focused on Additional Tier 1 (AT1) securities, a class of regulatory capital that either converts into equity or is written down when a bank's financial position deteriorates and the relevant trigger is reached. Between 2009 and 2013, banks issued approximately US$70bn of CoCos. Over the past 12 months, against the backdrop of recovering peripheral economies and improved capital structures, approximately US$54bn (or equivalent) of CoCos have been issued, with US$36bn so far issued in 2014. Although CRD IV has increased regulatory certainty, based on issuances of CoCos to date, it is clear that a standardised market has yet to develop and concerns about risk remain. This chapter will briefly highlight some of the recent developments in the market and key disclosure considerations for CoCos and debt instruments subject to bail-in by European banks.

Background

CoCos are capital instruments (Tier 2) or perpetual instruments (AT1) which, upon the occurrence of a trigger event, convert to equity, or the principal amount is written down (either on a permanent or temporary basis). Depending on the trigger event, write-down or conversion will occur at different points in time, giving rise to two principal categories of CoCos: a going concern or high trigger CoCo, which are intended to prevent an institution from entering into an official administrative or judicial resolution proceeding; and a gone concern CoCo which may be triggered either before or during an official resolution proceeding, at the point of non-viability (PONV).

CRD IV became effective January 1, 2014. As part of its Regulatory Technical Standards on Own Funds (RTS), the European Banking Authority (EBA) has provided guidance on, among other items, the CRD IV AT1 capital requirements. The RTS for AT1 capital addresses the form and nature of incentives to redeem, the conversion or write-down of the principal amount and features of instruments that could hinder recapitalisation. Specifically, AT1 capital must have the following features: perpetual maturity, discretionary, cancellable and non-cumulative coupons and a trigger for write-down or conversion when the issuer breaches a 5.125% common equity tier 1 ratio (CET1 ratio). Dividend pushers and stoppers are not permitted.

Notably, CRD IV does not require PONV to be included as part of the terms and conditions of AT1 and Tier 2 instruments. This has instead been addressed through the RRD which entered into force on July 2, 2014. RRD measures which give authorities power to bail-in (write off or convert into equity) AT1 and Tier 2 instruments will be effective from January 1, 2015, and the bail-in tool for senior debt will be implemented from January 1, 2016 at the latest, which has been brought forward from the previous deadline of January 1, 2018.

Developments

Long awaited clarity on the tax deductibility of coupons in key jurisdictions (including most recently in Belgium and Germany) has removed one of the biggest barriers for issuers wanting to enter the AT1 market. In addition, release of the much anticipated European Central Bank's asset quality review and the EBA's stress tests in November 2014 may solidify investor confidence in this asset class for banks that satisfactorily pass, clearing the path for additional issuances. These developments may, however, be dampened by the increased scrutiny AT1 is receiving from certain European authorities, particularly in the UK and Sweden where the Bank of England has signalled that it may bar AT1 from counting towards leverage ratios and Sweden's regulator is considering requiring banks to issue with trigger levels as high as 8%, well above that required by the EBA. In addition, Bank of America Merrill Lynch's recent decision to remove CoCos from its global high-grade corporate and high-yield corporate indices has sparked sell-off concerns.

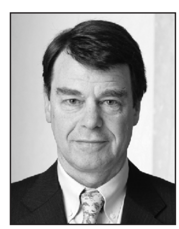
Although CRD IV's entry into force has increased certainty, uncertainties remain as the market standards for CoCos continue to develop and the debate about the nature of these securities, target investors and type of features continues. Over the past 12 months, the investor base has shifted from primarily high net worth investors in Asia to institutional investors and hedge funds. In addition, there is uncertainty among investors about how to assess certain features of CoCos and, therefore, the risks associated with them.

Trigger events

Over the last 12 months, 13 European banks issued 28 CoCos, predominantly AT1 instruments:

- Banco Popular
- Barclays
- BBVA
- Crédit Agricole
- Credit Suisse
- Danske Bank
- Deutsche Bank
- KBC Group
- Lloyd's
- Nationwide
- Santander
- Société Générale
- UBS

In order to satisfy eligibility requirements, CoCos must include either a permanent or a temporary write-down feature or a convertible feature that is triggered upon the occurrence of one or more specified capital adequacy trigger events. Of the CoCos issued by the European banks listed earlier, three included a permanent write-down feature, 11 included a temporary write-down feature and 14 included a convertible feature. Instruments with a temporary write-down feature which allow for the potential


Jeffrey M. Oakes


Connie I. Milonakis

Jeffrey M. Oakes
Partner and Head of European Financial Institutions Group
tel: +44 (0) 20 7418 1386
fax: +44 (0) 20 7710 4886
email: jeffrey.oakes@davispolk.com

Connie I. Milonakis
Counsel
tel: +44 (0) 20 7418 1327
fax: +44 (0) 20 7710 4827
email: connie.milonakis@davispolk.com

write up when the capital ratio recovers are attractive to investors that are precluded from owning instruments that convert into equity. Instruments with a convertible feature allow holders to participate in the future recovery of distressed banks. These factors influence an issuer's decision as to the appropriate structure for a given issuance.

A standard structure of AT1 instruments has yet to emerge, with the bespoke nature of the terms being largely reflective of the differing regulatory requirements and level of regulatory scrutiny across jurisdictions. The UK Prudential Regulation Authority (PRA), for example, has been very involved in the detailed review of terms, often adding to the overall timetable for the issuance.

In addition to the lack of standardisation among terms, the diversity of recent AT1 issuances is reflected in the currencies in which the instruments are being issued (Nationwide launched the first AT1 denominated in sterling in March 2014) and the expanding geographical footprint (with Danske becoming the first Nordic bank to issue AT1 in March 2014 followed by Unicredit in Italy in the same month). Perhaps best reflective of this diversity is Deutsche Bank's recent AT1 issuance, the first of its kind in Germany (which came to the market following long-awaited confirmation that interest payments on AT1 instruments would be tax deductible) which was a multi-tranche deal split into three separate currencies: dollars, euros and sterling. Dutch issuers such as ABN Amro and Rabobank may contribute to the expanding geographical footprint of the AT1 market once the tax treatment of AT1 is confirmed by the Netherlands, expected in the fall 2014.

Risk factor disclosure

As the reaction to RBC's recent CoCo suggests, given the complexity of and risks involved with CoCos, investors are demanding clear disclosures and the time and opportunity to consider them. In a recent statement by the Joint Committee of the European Supervisory Authorities, financial institutions were reminded that CoCo structures are highly complex and non-homogeneous in terms of trigger levels, necessary capital buffer levels and loss absorption mechanisms and that, while they can play an important role in inhibiting risk transfer from debt holders to taxpayers, it is unclear as to whether investors fully understand the potential risks involved. Concurrently with this statement, the European Securities and Markets Authority published a statement describing the potential risks associated with investing in CoCos.

Given the nature of the instruments and ongoing concerns as to whether CoCos are appropriate for retail investors[2], in addition to customary risk factors associated with the business of the issuing bank, risk factor disclosures for this class of security should be included and cover:

i. significance of trigger event;
ii. transparency/timing of public financial reporting around triggers that may result in non-payment of coupons; risk of cancellation of coupons at regulator's discretion;
iii trigger event occurring following maturity/during redemption;
iv. likelihood of reaching trigger;
v. explanation of CET1 ratio calculation and the factors which could affect the calculation; and
vi. disadvantages relative to holders of other instruments.

In addition, should conversion or write-down actually occur in an outstanding instrument – a consequence which may be more likely as additional banks, including those perceived as being more likely to breach the specified triggers, enter the CoCos market – there is a contagion risk that investors should be alerted to that could spread across the asset class with ramifications for liquidity in the secondary market.

PONV and bail-in

The RRD provides that all AT1 and Tier 2 capital instruments must fully absorb losses at the PONV of the issuing institution and their terms must recognise that resolution authorities have the power to bail-in (write off or convert into equity) such instruments at the PONV and before any resolution action is taken. For these purposes, PONV is the point at which the relevant resolution authority determines that the institution meets the conditions for resolution or the point at which the authority decides that the institution would cease to be viable if the instruments were not written down or converted.

To date, however, capital instruments have adopted varying approaches to bail-in, from contractual PONV provisions, to risk factor disclosure, and express acknowledgements by holders to be bound by and consent to the exercise of statutory bail-in power by the relevant authority. The approach has been driven mainly by regulators. In the UK, for example, the PRA requires AT1 and Tier 2 instruments issued by UK institutions that are governed by non-EU law to include contractual terms in which investors acknowledge the possibility of being written down or converted into equity in a way equivalent to instruments issued under English law. Accordingly, UK issuers such as RBS, Lloyds and Barclays, have included express acknowledgements by noteholders in their recent issuances of capital instruments to the application of bail-in to their instruments.

While there is doubt as to whether the senior unsecured market has priced in bail-in risk, the prospect of bail-in for senior instruments has become more prominent. The RRD has brought forward the implementation of the bail-in tool for senior debt from January 1, 2018 to January 1, 2016 (with certain jurisdictions such as the UK indicating that they will bring forward implementation even further) and rating agencies have during the first half of 2014 revised their outlooks on European banks to negative to reflect the fact that implicit sovereign support can no longer be assumed for senior debt.

In addition, the requirement to include contractual PONV terms or express acknowledgements in applicable non-EU law governed debt (including senior debt) will be required under the RRD. Some issuers have started including express acknowledgements of bail-in in their senior unsecured debt instruments. This has made the risk of senior debt bail-in much more prominent to potential investors than it previously had been, although in recent senior debt transactions done by UK banks and certain French banks there does not appear to have been any impact on pricing.

Bail-in, regardless of whether it is contractual or statutory, presents its own set of risks. Besides describing what could happen if an instrument is bailed-in, the principal risk is the uncertainty around the exercise of bail-in powers, which is at the discretion of the relevant authority. Although unlikely with a going-concern high trigger CoCo, the relevant authority could exercise its bail-in powers before a trigger event is reached. The regulator's determination to exercise its bail-in powers could occur at a time when not expected by investors and be influenced by external events, including perceived systemic risk in the applicable financial system.

Notes:

1 The foregoing provides some insights regarding issuances of CoCos by European banks in the US but is not intended to be an exhaustive analysis of all considerations which may be applicable.

2 On August 5, 2014, the Financial Conduct Authority in the UK published a statement explaining that firms will be restricted from distributing CoCos to retail investors from October 1, 2014 on the basis that such instruments are "risky and highly complex".

Contact us:

Davis Polk & Wardwell London LLP

99 Gresham Street, London EC2V 7NG, UK

tel: +44 (0) 20 7418 1300

web: www.davispolk.com