European Securities and Markets Authority

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STATEMENT

Potential Risks Associated with Investing in Contingent Convertible Instruments

The European Securities and Markets Authority (ESMA) is issuing this statement to clarify to institutional investors risks from a newly emerging asset class referred to by most market participants as contingent convertibles instruments (CoCos). If they work as intended in a crisis CoCos will play an important role to inhibit risk transfer from debt holders to taxpayers. They along with standards to improve the quality and quantity of bank capital reflect a considerate response to the former regulatory capital framework. However, it is unclear as to whether investors fully consider the risks of CoCos and correctly factor those risks into their valuation. ESMA believes there are specific risks to CoCos and that investors should take those risks into consideration prior to investing in these instruments.

Introduction

1. In their response to the financial crisis, regulators globally explicitly recognised the structural weaknesses of the earlier generation of hybrid and subordinated bond capital securities. Importantly, the Basel Committee on Banking Supervision issued a set of proposals (Basel III) that called on national authorities to improve the quality, consistency and resilience of bank regulatory capital. The proposals were transposed into EU law through the Capital Requirements Directive IV (CRD IV) and Capital Requirement Regulation (CRR). As with Basel III, the EU law leaves unchanged the total amount of capital an institution needs to issue as a percentage of risk weighted assets (RWA) at 8%, although a number of capital buffers top up this global requirement. The implemented legislation mandates a change in the quantity of the highest quality capital layer Common Equity Tier 1 (CET1), increasing from what was effectively 2% to 4.5%. While the intent of the legislation is to ensure an increase in a bank's common equity, the regulation allows a financial institution to issue Additional Tier 1 (AT1) securities in non-CET1 capital but in the form of CoCos so that Tier 1 capital is at least 6% of RWA at all times. CoCos may also be issued as Tier 2 instruments so that Total capital is at least 8% of RWA at all times.

2. To qualify as AT1s the CoCos need to be able to be written down or converted into equity when a certain trigger CET1 relative to RWAs is reached. Further an AT1 CoCo must be issued as a perpetual instrument whose coupon payments (distributions) are discretionary and may be cancelled at any time, for any reason. Apart from these terms, CoCo issuance has been heterogeneous in its trigger levels and loss absorption features making comparability across instruments more difficult. In part, this was due to certain issuance taking place prior to the finalization of CRD IV/CRR and in part due to the specific needs of issuers (the CRR only sets a minimum trigger level and this is by definition an institution specific feature) and

investors. Many of the larger banks have embraced the use of CoCos as a cost effective way of meeting the level of going-concern capital required by CRR in addition to the CET1 capital requirement, and the issuance is expected to continue. There is now a AT1 CoCo market in which capital buffer levels vary across domicile of issuer, a variety of trigger levels (5.125%-8.25%), and loss absorption varying from equity absorption (at various pre-defined levels), to write-down and write-down/write-up mechanisms. Total issuance to date is around €60 billion and is expected to grow substantially. On the demand side, CoCos are now primarily purchased by real money investors - asset managers and banks - who have been attracted by the comparatively high yield of quality bank issuers.

3. Over the past year issuance among EU banks has been primarily AT1 with little in the way of Tier 2 CoCo issuance. As issuers are not mandated to fill the Tier 2 bucket with CoCos, they have instead opted to issue less costly plain vanilla subordinated debt. Nonetheless, there exists almost €29 billion in Tier 2 issuance in circulation, originating primarily from the Swiss banks and earlier dated EU bank issuance.

Reasons for this statement

4. CoCo structures are highly complex. Although there has been movement towards consistency in the terms and conditions,[1] issuance has remained dissimilar when comparing trigger levels, necessary capital buffer levels and loss absorption mechanisms.

5. In a crisis CoCos have the potential to play an important role to inhibit risk transfer from debt holders to taxpayers. They along with other standards to improve the quality and quantity of bank capital reflect a considerate response to the former regulatory capital framework. There exists a tension between (i) the prudential needs of an issuer to optimize its capital structure with affordable loss absorption funding that maintains the entity as a going concern, and (ii) the needs of investors to properly price the risk of loss of coupon or capital, which are particular challenges for CoCos. Similarly, given the varying trigger levels of issuance across a given banking group it is difficult to envision exactly how the contractual provisions relating to the conversion or write-down of CoCos will play out. There exists uncertainty in the context of a supervisory decision establishing when the point of non-viability has been reached as well as in the context of a statutory bail-in set up under the new Bank Recovery and Resolution Directive.

6. Investors should fully understand and consider the risks of CoCos and correctly factor those risks into their valuation. To correctly value the instruments one needs to evaluate the probability of activating the trigger, the extent and probability of any losses upon trigger conversion (not only from write-downs but also from unfavourably timed conversion to equity) and (for AT1 CoCos) the likelihood of cancellation of coupons. These risks may be highly challenging to model. Though certain risk factors are transparent, e.g., trigger level, coupon frequency, leverage, credit spread of the issuer, and rating of instrument, if any, other factors are discretionary or difficult to estimate, e.g. individual regulatory requirements

[1] On 8 December 2011, EBA issued a term sheet entitled 'Buffer Convertible Capital Securities Common Term Sheet '. http://www.eba.europa.eu/documents/10180/26923/Term+sheet+FINAL.pdf/72e03d1d-8b81-4996-a269-3314b537f606

relating to the capital buffer, the issuers' future capital position, issuers' behaviour in relation to coupon payments on AT1 CoCos, and any risks of contagion. A comprehensive appreciation of the value of the instrument also needs to consider the underlying loss absorption mechanism and whether the CoCo is a perpetual note with discretionary coupons (AT1 CoCos) or has a stated maturity and fixed coupons (T2 CoCos). Importantly, as one descends down the capital structure to sub-investment grade where the majority of CoCos sit, the level of precision in estimating value when compared to more highly rated instruments, deteriorates. ESMA believes that this analysis can only take place within the skill and resource set of knowledgeble institutional investors.

7. The timing of the Statement coincides with the ESA publication of the Public Statement on Self-Placement, which is a reminder to firms of their obligations when providing investment services to clients.

Potential risks to investing in Contingent Convertibles[2]

8. Trigger level risk: trigger levels differ and determine exposure to conversion risk depending on the CET1 distance to the trigger level.

   The conversion triggers will be disclosed in the prospectus of each issuance. Nonetheless, the investor needs an ongoing understanding of the amount of CET1 the issuer has in place relative to the trigger level. The amount of CET1 varies depending on the issuer while trigger levels differ depending on the specific terms of issuance. The trigger could be activated either through a material loss in capital as represented in the numerator or an increase in risk weighted assets as measured in the denominator. Transparency is critical to mitigating the risk.

9. Coupon cancellation: Coupon payments on AT1 instruments are entirely discretionary and may be cancelled by the issuer at any point, for any reason, and for any length of time.

   While all CoCos (AT1 and T2) are subject to conversion or write down when the issuing bank reaches the trigger level, for AT1s there is an additional source of risk for the investor in the form of coupon cancellation in a going concern situation. *Coupon* payments on AT1 instruments are entirely discretionary and may be cancelled by the issuer at any point, for any reason, and for any length of time. The cancellation of *coupon* payments on AT1 CoCos does not amount to an event of default. Cancelled payments do not accumulate and are instead written off.[3] This significantly increases uncertainty in the valuation of AT1 instruments and may lead to mispricing of risk. Perhaps most challenging to investors, given the required absence of dividend stoppers/pushers, the AT1 holders may see their coupons cancelled while the issuer continues to pay dividends on its common equity and variable compensation to its workforce.

[2] The following list contains examples of specific risks connected to Coco's and is non-exhaustive.
[3] See Article 52 of Regulation No 575/2013 for reference.

10. Capital structure inversion risk: contrary to classic capital hierarchy, CoCo investors may suffer a loss of capital when equity holders do not.

    In certain scenarios, holders of CoCos will suffer losses ahead of equity holders, e.g., when a high trigger principal write-down CoCo is activated. This cuts against the normal order of capital structure hierarchy where equity holders are expected to suffer the first loss. This is less likely with a low trigger CoCo when equity holders will already have suffered loss. Moreover, high trigger Tier 2 CoCos may suffer losses not at the point of gone concern but conceivably in advance of lower trigger AT1s and equity.

11. Call extension risk: AT1 CoCos are issued as perpetual instruments, callable at pre-determined levels only with the approval of the competent authority.

    It cannot be assumed that the perpetual CoCos will be called on call date. AT1 CoCos are a form of permanent capital. The investor may not receive return of principal if expected on call date or indeed at any date.

12. Unknown risk: the structure of the instruments is innovative yet untested.

    In a stressed environment, when the underlying features of these instruments will be put to the test, it is uncertain how they will perform. In the event a single issuer activates a trigger or suspends coupons, will the market view the issue as an idiosyncratic event or systemic? In the latter case, potential price contagion and volatility to the entire asset class is possible. This risk may in turn be reinforced depending on the level of underlying instrument arbitrage. Furthermore in an illiquid market, price formation may be increasingly stressed.

13. Yield/Valuation risk: investors have been drawn to the instrument as a result of the CoCos' often attractive yield which may be viewed as a complexity premium.

    Yield has been a primary reason this asset class has attracted strong demand, yet it remains unclear whether investors have fully considered the underlying risks. Relative to more highly rated debt issues of the same issuer or similarly rated debt issues of other issuers, CoCos tend to compare favourably from a yield standpoint. The concern is whether investors have fully considered the risk of conversion or, for AT1 CoCos, coupon cancellation.