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HERMES: COCOS – FUNDAMENTAL ANALYSIS KEY TO ASSESSING IDIOSYNCRATIC RISKS

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Last year, we voiced our concern around the abundant issuance, regulatory backing and investor demand that had made contingent convertible bonds – known as 'cocos' – one of the most popular and talked about credit trades. We recognised the investment opportunities provided by the instruments, but were wary of their inherent risks. Since then, the market has evolved, but is far from mature. In this article, we assess how it has changed.

Fundamental analysis of the quality of banks' assets, and determining which lenders are likely to burn through their capital buffers, will continue to be key in assessing the idiosyncratic risks of AT1 securities. Banks have used cocos to strengthen their additional tier (AT) 1 capital buffers under the European Capital Requirements Directive IV. In 2014, the market for AT1 debt began assertively. Strong issuance was met by willing buyers as the US Federal Reserve eased investors' anxieties about policy normalisation with dovish reassurances.

Apart from disappointing results on the PMI Index and for eurozone GDP growth, conditions were benign. Indeed, at times AT1 securities traded inside a yield of 6% to the next call date. Then, for the second consecutive year, credit markets experienced a volatile summer. The travails of Portugal's Banco Espirito Santo, the Ukrainian conflict, and bondholders' fears of poor results from the investigation by the European Central Bank (ECB) of balance-sheet strength among lenders in the region, called the Comprehensive Assessment, rattled the market.

At a more technical level, lawmakers and regulators in some jurisdictions introduced various restrictions on retail participation in the AT1 market. These events resulted in the average yield of AT1 securities increasing to 7.5% and even touching 8% before the ECB publicised its findings in late October.

Since then, the market has stabilised. In 2014, banks issued some €35bn-€40bn of AT1 securities, and 2015 has not disappointed. In February, €8.4bn of new supply was well absorbed by the market, in part helped by investors' bias towards higher-quality issuers – illustrated by two investment-grade AT1 securities issued by Swedish banks.

By analysing data from the European Banking Authority on the risk-weighted assets of banks and forecasting their capital requirements, we expect between €40bn-€60bn of new AT1 issuance this year, and between €80bn-€100bn by the end of 2016. Looking ahead, there is still a case for many banks to improve their common equity tier 1 (CET1) efficiency – which would effectively free up shareholders' equity – by filling their AT1 bucket up to 150bps of risk weighted assets.

If past form is any guide, the recent strength of the market will attract new issuers. We expect the composition of the top 10 issuing banks to change in the next two years, as lenders such as BNP Paribas, Royal Bank of Scotland and Intesa start supplying the market.

However, the idiosyncratic risks of investing in AT1 securities remain the same. We can view and analyse these risks from a number of perspectives. Firstly the 'distance to trigger' assesses how much CET1 must be lost in order for the AT1 to be triggered, or converted into equity or written off. There are also optional coupons: triggers may be left untouched, but a bank's management team or a regulator concerned about solvency may cancel coupon payments to preserve capital.

Thirdly, the return to investors, paid out of what a bank defines as its available distributable items (ADI), is also tested to gauge whether coupons can be paid. Lastly, if a bank fails to meet its combined buffer requirement, it must propose a maximum distributable amount (MDA) to be spread between shareholders, bondholders and employee bonus pools. The regulator will prohibit the bank from paying out more than its MDA in dividends, coupons and bonuses.

The market for coco investing is still in its nascent stage. There is no clear standardisation or uniformity among AT1 securities and fundamental analysis of bank assets of is crucial. So too is the ability to forecast the size of the future buffers that banks will require, and their ability to organically generate enough capital to preserve them.

As credit investors, our P&L modelling skills must enable us to discern which banks run the risk of burning through their buffers. This is what matters the most; investors cannot rely on the longevity of the capital defences presented by banks on the first day of a road show. Cocos present a compelling investment opportunity, but only by applying fundamental analysis can we identify the substantial idiosyncratic risks.

The views and opinions contained herein are those of Filippo Alloatti, Senior Credit Analyst, and may not necessarily represent views expressed or reflected in other Hermes communications, strategies or products.

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