Elston Insights

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Swiss miss: how should CoCos be viewed now?

- Holders of Credit Suisse AT1 bonds have been wiped out
- Retail fund managers have emerged as significant AT1 holders
- Are these instruments appropriate retail investments?

What is an AT1 bond?

Additional Tier 1 bonds are bank capital securities that fall into the 'Contingent Convertible' (or 'CoCo') bracket. Primarily issued by European financial institutions, they work in a similar way to traditional convertible bonds. Once a CoCo's strike price has been breached, it can be converted into equity. CoCos are a useful instrument for shoring up a bank's Tier 1 balance sheet and indeed were created to help undercapitalised banks in times of stress.

What has happened to Credit Suisse AT1s?

Under US and European law, in the case of an insolvency, CoCos are written down *after* equity and are therefore deemed less risky. However, a change was made to Swiss law last week that meant Credit Suisse AT1 CoCos were written down *before* equity. This is controversial because at the point of sale, risk expectations for AT1s will not have taken this into account. In our view the decision is likely to be subject to litigation.

So are these instruments appropriate for retail funds?

As for any risk asset, due diligence is the key point here. There should be no issue with actively managed retail bond funds holding CoCos so long as they are within the scope of the fund's stated investment policy. It is up to the manager to select and manage that risk. The challenge is - as in 2008 - how do you find out quickly what your exposure is within an active fund? Phone lines tend to get busy in a crisis…

There are also CoCo Bond ETFs approved for retail distribution. The advantage of ETFs is that love them or hate them, you have transparency about what is being held and why. You also have the benefit of secondary market liquidity, so if you want to get in or out, you can. This may not be the case with active/strategic bond funds that are over-exposed.

Appropriateness is as much as a function of disclosure and transparency as it is of idiosyncratic risk. So long as funds are properly described and policy is followed, investors selecting those funds are taking that conscious risk. In short, like any risk asset, suitability and appropriateness is key. We don't see many DFMs allocating directly to CoCo funds. The question therefore is what exposure do strategic/actively-managed bond funds have to affected Credit Suisse CoCos? Time will tell.

If the balance sheets of banks are under more pressure than was previously understood, does this make CoCos a riskier investment?

Since their introduction in 2008, investors have considered AT1 bonds as safer than other high yield debt, predominantly due to the assumption that if a financial crisis were to materialise, central banks would undertake a bail-out and they would be protected. However, the way in which things have unfolded with Credit Suisse crisis has shaken that belief, as AT1 bond holders have suddenly woken up to the possibility that laws can change overnight. This has put bank balance sheets back under a microscope and investors are now re-adjusting their exposure to this particular asset class.

Like high yield bonds, CoCos have always been a risky asset. The levels they are currently trading at indicate a decent risk premium but investing in them is for not for the faint-hearted as there is currently a considerable degree of uncertainty. For the CoCos issued by UK and EU banks to get wiped out, a full-blown financial crisis would need to unfold, and this is currently unlikely. As recent events have shown us, having borne witness to the pain of the way in which things unfolded in 2008, central banks are ready to step in and take decisive action if required, albeit with some potential collateral damage is illustrated by the Credit Suisse affair. Central Banks are also much better equipped – both in terms of knowledge and tactics – to handle any future crises. In our view, Credit Suisse's collapse is an isolated event, but it has certainly raised the possibility of other banks (such as Deutsche Bank) coming under similar pressure, raising the risk premium for owning bank stocks.

Henry Cobbe, CFA, Head of Research

Hoshang Daroga, CFA, Investment Director

Elston Consulting

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