CoCos not to all tastes

GRAHAM BUCK LOOKS AT A RECENT CAPITAL RAISING BY LLOYDS THAT GAVE A MAJOR ROLE TO CONTINGENT CONVERTIBLE BONDS.

The world of finance produces more than its fair share of acronyms. CoCo is one of the cosiest-sounding. It's an abbreviation for what are more correctly known as contingent convertible bonds. Traditionally, contingent capital has been used by the insurance industry as a means of raising funds to meet a major one-off loss, although in 2001 it formed the basis of a deal between Royal Bank of Canada and reinsurance giant Swiss Re.

But contingent capital returned to the business pages in November when Lloyds Banking Group offered CoCos as part of a £22.5bn capital raising, which also included a rights issue. Lloyds' bondholders were encouraged to exchange their existing bonds for the new securities and generally responded enthusiastically – although the bank's army of smaller investors complained that they were effectively frozen out of the offer.

It's worth noting that the bank sweetened the terms of the swap to the point where investors could hardly refuse. A fairly tempting carrot was needed to make the exchange sufficiently attractive to them, as contingent capital in this format is relatively untested and exposes investors to greater risks than subordinated bonds.

The new bonds offered Lloyds' investors a higher rate of interest in return for their existing notes. And if they didn't consent to the swap, they faced the prospect of no interest payments for the next two years as the European Commission would not allow Lloyds to pay discretionary coupons or dividends on its hybrid securities or subordinated bonds. In the wake of costly state-backed bailouts for a number of European banks, the Commission was keen for bondholders of the banks affected to shoulder some of the financial burden.

So what persuaded Lloyds to supplement the £13.5bn rights issue with a costly bond swap offer? The answer lies in its desire to strengthen its capital position so that it could make an early exit from the government's asset protection – or insurance – scheme for bad loans. Remaining in the scheme would have meant paying £15.6bn to insure £260bn in loans and could also have led to the government gaining effective control of the bank.

CoCos – or enhanced capital notes (ECNs) as they are referred to by Lloyds – will convert to equity if the bank's capital runs low as the result of any future financial crisis. This will allow Lloyds to strengthen its capital base without having to go to the markets or resort to a further injection of funds from the state and, ultimately, the taxpayer.

If the years ahead prove calmer than the last few, then the Lloyds CoCos will operate as a normal fixed investment. The difference is that should the bank run into further volatility, and its core Tier-1 capital ratio fall below 5%, the bonds will automatically convert to ordinary shares. Regulators deem cash invested in shares in a company (but not bonds) to be core Tier-1 capital. So this conversion would automatically shore up Lloyds' capital levels, while also giving the holders of the CoCos an actual stake in the group.

The bonds themselves are subordinated and will count as lower Tier-2 capital bonds prior to conversion. However, under the Financial Services Authority stress-test scenarios they are included as core Tier-1 capital – and will count as core Tier-1 capital if they are converted.

Earlier hybrid bonds, which incorporate features of both debt and equity, were intended to serve as a buffer between senior bondholders and shareholders. The latter are usually first in line to bear the losses on liquidation (but not on a going concern basis) if a bank's capital is eroded. However, they failed to provide such a safeguard on a going concern basis, nor did they find favour with regulators because of the limited loss absorbency characteristics on a going concern basis.

Georg Schroeder of Deloitte says regulators are developing a common definition of hybrid instruments through changes to the European Capital Requirements Directive. Among the future requirements for hybrid instruments is that they should not "hinder recapitalisation" of a financial institution in times of stress – implying that at such times hybrid instruments must automatically be written down or converted into equity.

Two significant issues that need to be considered alongside CoCos are pre-emption rights and the related tax and accounting treatment. The first arises when a CoCo converts into ordinary shares; as these are classed as equity securities, they must first be offered to ordinary shareholders unless an exemption applies. CoCos offer a step forward. They apparently satisfy regulatory concerns as they convert to equity at a predetermined trigger and price, thus removing the uncertainties that have attached to other hybrid bonds. And they enable a bank to absorb losses while it is still a going concern. "They are clear and concise in their triggers, which the bank, investors, regulators and the market clearly know," concluded one analyst.

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BEYOND THE LLOYDS OFFERING CoCos are evidently becoming of interest to investors, finance directors and capital managers as well as to regulators. This is despite the scepticism of many analysts and investors, who question whether the new bonds will prove effective if put to the test and whether there is any significant demand for them.

CoCos also got a frosty reception from some fixed-income index providers. Barclays announced that it would not recognise them and Bank of America Merrill Lynch, which initially proposed to include CoCos in its bond indices, was forced to ditch the idea in the face of investor opposition.

Reports quoted Johannes Wassenberg, managing director of the financial institutions group at Moody's Investors Services, as saying that the structure of CoCos was ideal for banks and regulators but not for investors, who would be left holding equity at the very worst time. He thought the new bonds would find favour with a relatively niche investor market only.

Ben Lord, a fund manager at M&G Investments, is also sceptical. He suggests that the hybrid bonds generate a "plethora of problems and inconsistencies", and thinks the regulators set aside their reservations in order to get the Lloyds deal completed and help the bank move nearer recapitalisation. At the same time, he admits that the Lloyds CoCos carries attractive yields and that his company will look more favourably at any launched by stronger banks where the risk of a subsequent conversion to equity is regarded as low.

At Standard & Poor's, a report by credit analyst Michelle Brennan concludes that CoCos are valid as an emergency tool but do not address the problems created by weak bank balance sheets. In the event of a bank running into difficulties, she queries whether they will convert into capital quickly enough to rescue it. As her report notes, unless and until a crisis hits, it is difficult to ascertain what level of capital represents an appropriate trigger, while capital ratios at banks vary as the method of calculation varies between them.

Another potential weakness of CoCos is the possibility that, should the bank's Tier-1 capital level hit the point where they automatically convert from bonds to equities, that conversion would send a clear signal to the market that the bank had problems. This would undermine confidence and cause the bank's position to deteriorate even further – a "death spiral". Building societies are particularly concerned about this reputational impact.

But not all analysts are pessimistic. Some believe that CoCos could prove a useful emergency tool in a wider kit and that they mitigate the risk of failure. However, they also stress that banks should beware of relying on them too heavily and they are no substitute for the need to raise permanent capital. Nor do CoCos do much to solve the knotty problem of producing a unified cross-border system that confronts the problem of how bank failures should be addressed.

Analysts believe that a number of European banks are waiting to see the response from both regulators and investors to the Lloyds CoCos, before they come forward either with their own or other new structures to shore up their finances.

Another option some banks are exploring is write-downs, where the value of bonds is reduced if the bank's capital levels are tested at any time. A write-down happens automatically as and when losses are incurred and any subsequent "write-up" to the original balance, which can then be used to reduce investors' losses, must await better times. The bank is able to preserve cash by reducing its liabilities and limiting interest/dividend payments until the crisis has blown over.

However, write-downs present their own problems. Temporary write-downs are not acknowledged under international accounting rules and there are serious doubts as to whether regulators would agree to accept the written-down value as part of core capital.

Another variation on contingent capital is the proposed merger of Yorkshire Building Society with struggling rival Chelsea. As with the Lloyds swap, the bonds convert if the merged society's Tier-1 capital falls below 5%, but holders get an equity-like instrument called PPDS (profit-participating deferred shares) rather than equity.

PPDS was first introduced earlier in 2009 by West Bromwich Building Society, which exchanged its subordinated debt (Tier-2 capital) into qualifying core Tier-1 capital in the form of PPDS. It is likely that this structure may be used in restructuring or refinancing of subordinated debt for other struggling members of the building society movement during 2010.

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