

CoCos in Context: An Introduction to Contingent Capital Securities

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Contingent capital securities (CoCos) have been the fastest-growing segment of the preferred securities market in recent years, with income rates often competitive with high-yield bonds. These securities are issued mostly by large, well-regulated financial companies to satisfy stricter capital requirements in the wake of the financial crisis and have become increasingly accepted by the market.

Yet because they are still relatively new and are excluded from traditional fixed income benchmarks, we find that CoCos are often not well understood and therefore provide inefficiencies to be exploited. This paper seeks to provide investors with a deeper knowledge of what is now a sizeable portion of the evolving preferred securities universe.

Executive Summary

An expanding asset class. CoCos emerged following the financial crisis and have commanded strong investor attention, currently representing about 25% of the global preferred securities universe, up from 2% in 2011.

Loss-absorption mechanism. While similar to traditional preferred securities in many respects, CoCos contain specific triggers tied to an issuer's financial health, typically a core capital ratio of 7% for a "high trigger" or 5.125% for a "low trigger." CoCos that breach a trigger would be subject to loss absorption, either via a principal write-down or equity conversion. This type of "bail-in" of capital instruments is designed to avoid a repeat of taxpayer-funded bank bailouts.

Attractive income. CoCos may provide some of the highest yields among global fixed income securities, in part as compensation for their deep subordination in a company's capital structure. In many cases, we believe their yield advantage more than compensates for the additional risks.

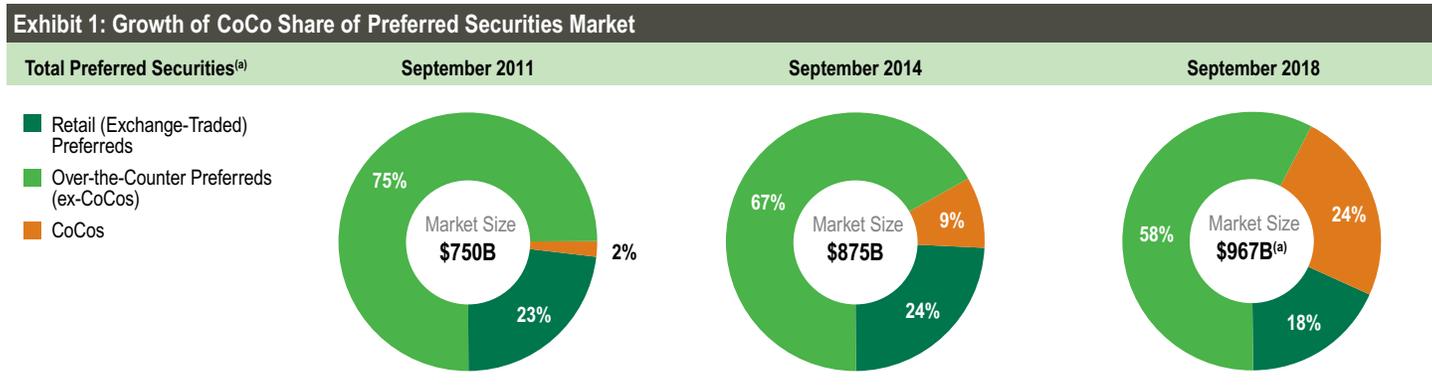
Potential for compelling total returns. In their relatively brief history, CoCos have delivered competitive total returns compared with other fixed income classes—but risk-weighted return prospects vary over time and require active management, in our view.

Relatively defensive against interest rates. Similar to other types of OTC preferreds, CoCos have characteristics that allow for more effective management of interest-rate risk, including coupons that often reset 5 to 10 years after issuance.

An Expanding Asset Class

CoCos emerged in the wake of the financial crisis, designed by policymakers outside the U.S. to lessen or remove the need for government-funded bailouts of foundering financial institutions. These hybrid fixed income instruments help banks satisfy capital requirements, while providing issuers with an attractively priced form of equity-like capital.

Given their complex features and non-representation in normal bond indexes, CoCos have high yields and have gained investor attention amid low interest rates. While a relatively new asset class, CoCos have seen a nearly 15-fold growth in market size since 2011 and now represent nearly 25% of the global preferred securities universe, as shown in Exhibit 1. Most of that growth has been in Europe (including many dollar-denominated CoCos). As the market has evolved, basic CoCo features have remained mostly unchanged, although the group has broadened its diversification in terms of sector, company size and jurisdiction.



At September 30, 2018. Source: Bloomberg, Bank of America Merrill Lynch, Cohen & Steers.

(a) Based on par values of approximately 1,400 capital securities denominated in U.S. dollars, euros and British pounds.

Features of CoCos

As with traditional preferreds, CoCos are deeply subordinated securities that typically sit above common equity and below senior debt in the capital structure. However, they differ by having specific loss-absorbing mechanisms, triggered by changes in regulatory capital levels.

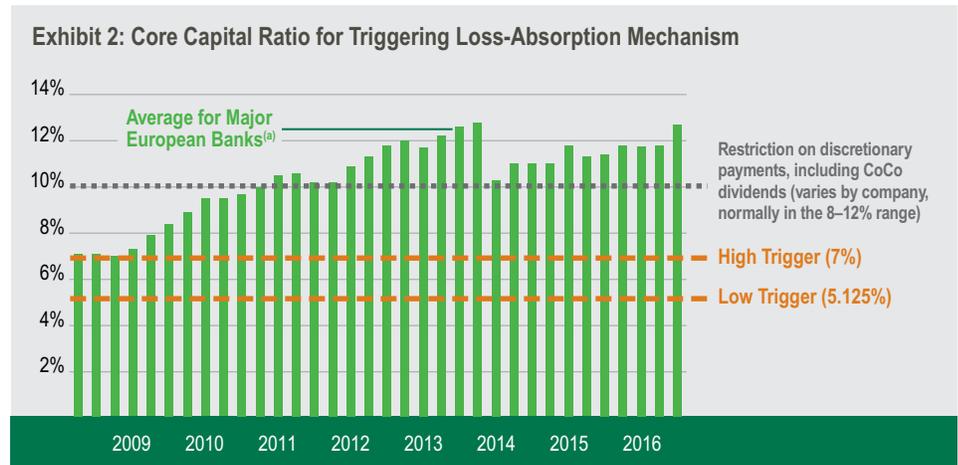
Loss-Absorption Triggers

In the event that a company experiences financial stress and its capital level falls below a certain threshold, the par value of the security could be written down, or the CoCo could convert to common stock of the issuer. In essence, a CoCo overlays more explicit loss-absorption features onto a traditional preferred security.

Typical triggers include:

- High trigger, or “going concern” (solvent institution): 7% Tier 1 common equity
- Low trigger, or “gone concern” (insolvent institution): 5.125% Tier 1 common equity
- Point of non-viability (PONV) triggers
 - PONV could be reached before a common equity trigger is breached
 - Regulator discretion could trip a PONV trigger
 - The U.S. has a de facto PONV trigger under its resolution authority

Exhibit 2 below shows where hard triggers stand in relation to the average core capital ratio (common equity relative to risk-weighted assets) of large European banks—the main issuers of CoCos—and how core ratios have improved in recent years. A higher core capital ratio is associated with stronger balance sheets and better credit quality. We expect most banks issuing CoCos to continue to have capital levels in the 10–14% range as they meet higher regulation requirements, leaving them generally far from the trigger points for equity conversion or write-down.



At March 31, 2018. Source: SNL, Bloomberg and company reports.

(a) Average capital ratios based on 15 large European banks. See back page for additional disclosures.

CoCo issuers have seen substantial improvements in their core capital ratios post the financial crisis.

Loss-Absorption Mechanism

Seeking to prevent a repeat of the taxpayer-funded bank bailouts that occurred during the financial crisis, policymakers around the world have focused on two main bail-in mechanisms: CoCos (explicit loss absorption) and resolution regimes (implicit loss absorption), which are legislated, government-led procedures for winding down a distressed financial institution without the need for taxpayer support.

The U.S has enacted a resolution regime to deal with failing financial institutions outside of bankruptcy court, but the Federal Reserve has stopped short of requiring capital securities with explicit loss-absorption features. However, U.S. bank preferreds are still subject to the regime and could be subject to loss absorption should the regulator deem it necessary for bank recapitalization. By contrast, Europe has been a proponent of both mechanisms, enacting a resolution regime while also forcing the replacement of pre-crisis bank and insurance preferred and hybrid securities with CoCos.

There are two methods for loss absorption if the trigger is breached: principal write-down or equity conversion. The write-down could be permanent or temporary, and it could be for the entire principal amount or for the amount necessary to return the bank to a solvent capital position. If the write-down is temporary, the principal amount of the CoCo can be recovered through bank profits over the years following the trigger breach.

With an equity conversion CoCo, the extent of investor losses will depend on the stock price at which the CoCo is converted. It is possible that the stock received at the time of the conversion will be worth less than the principal of the CoCo, making full recovery of the original investment dependent on future upside of the equity valuation.

Possibility of payment restrictions. Because banks would currently have to lose a significant amount of their capital base to be at risk of principal write-down or equity conversion, at what levels dividend restrictions would occur has become more of an investor concern.

As with other types of preferreds, coupon suspension is a risk with CoCos, depending on the underlying instrument. For some CoCos that count towards Tier 1 regulatory capital, coupon cancellation is dictated by whether a bank's core capital ratio falls below the minimum capital requirement, which is a level normally well above the CoCo trigger level (as indicated in Exhibit 2 on page 3).

Regulators may restrict a bank's discretionary payments based on changes in its core capital ratio.

If a bank's core capital ratio falls below the minimum capital requirement, bank payments deemed to be discretionary—common and preferred dividends and company bonuses—could be subject to regulatory restrictions. Preferred dividends would also be cancelled if a bank has insufficient distributable profit.

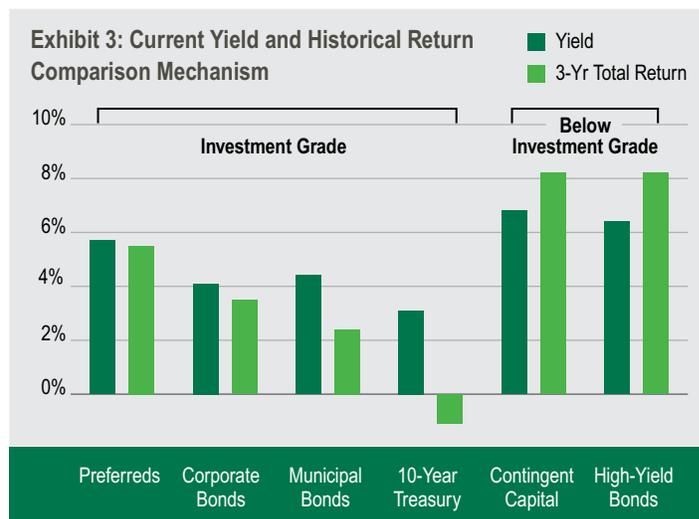
Payment restriction concerns became visible in 2016, when it appeared that a large German bank might miss payments on its CoCo securities due to the potential for insufficient distributable profit. As a result, European regulators changed the approach used to determine the minimum capital requirement, lowering the core capital ratio at which discretionary payments could be restricted and, thereby, reducing CoCo coupon risk.

Investment Characteristics of CoCos

CoCos are a unique form of fixed income investment offering high income rates and, we believe, the potential for attractive total returns. While their complex attributes clearly demand a wide risk premium, they also suggest investment opportunity. When managed actively in a diversified portfolio, we believe CoCos have the potential to offer investors many attractive characteristics.

High rates of income. CoCos can provide some of the highest yields among global fixed income securities. The ICE BofAML Contingent Capital Index yielded 6.5% at the end of September 2018, compared with 6.4% for the ICE BofAML High Yield Master II Index. While traditional high-yield bonds offer comparable levels of income, they often are issued by deeply speculative-grade, highly cyclical companies. In contrast, the banks issuing CoCos are generally systemically important, highly regulated and often rated investment grade at the senior debt level.

Potential for attractive total returns. While CoCos have not established a long track record (major CoCo indexes did not exist prior to 2014), their total return for the three-year period as of September 30, 2018, as shown in Exhibit 3 below, is compelling in absolute terms and compared with other fixed income segments. Notably, the outperformance occurred during a period of rising bond yields, with these credit-sensitive securities benefiting from demand for their above-average income amid a continued global economic recovery.



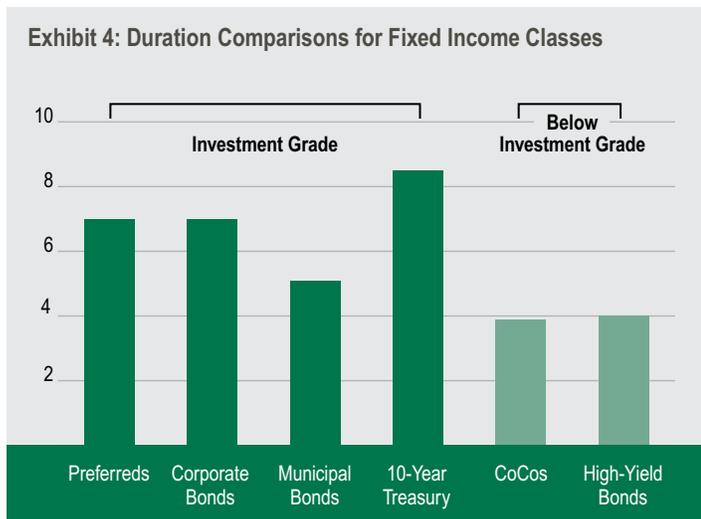
At September 30, 2018. Source: Bank of America Merrill Lynch, Bloomberg, Cohen & Steers. **Data quoted represents past performance, which is no guarantee of future results.** Total return is annualized. See back page for index associations, definitions and additional disclosures.

Attractive compensation for subordination in the capital structure. Rightfully so, CoCos offer a greater subordination premium than other types of preferred securities. The subordination premium is measured by the credit spread differential between the CoCo and the senior and/or subordinated debt of the issuer.

In many cases, we believe that the additional credit spread more than compensates for the additional risks. It is our view that a portion of the greater credit spread compensation can be ascribed to a “complexity premium” associated with the relative newness of the CoCo market.

Potential for managing interest-rate risk. Similar to other types of preferreds in the institutional over-the-counter (OTC) market, CoCos have characteristics that may allow for more effective management of interest-rate risk.

- The coupon rate resets at the call date, normally 5 to 10 years after issuance, thus offering lower durations than traditional preferred securities and other major fixed income groups, as indicated in Exhibit 4 below.
- CoCos’ high current income and wide credit spreads relative to traditional government and corporate bonds may provide a cushion against the impact of rising rates.
- Many CoCos are issued in non-U.S.-dollar currencies, which can provide a way to diversify interest-rate risk, as other countries’ economies may be at different points in the interest-rate cycle.



At September 30, 2018. Source: Bank of America Merrill Lynch, Bloomberg, Cohen & Steers. See back page for index associations, definitions and additional disclosures.

Participation in fundamental improvements at banks and insurance companies. Bank fundamentals have improved dramatically since the financial crisis, particularly with respect to asset quality and capital metrics. We expect this progress to continue, led by regulatory requirements that are considerably more stringent than pre-crisis standards.

Considering that they are issued by financial institutions, CoCos provide a way for investors to benefit from the constructive changes occurring in the sector. Insurance companies have also started to issue CoCos, which provides additional investment opportunities.

How CoCo Features Translate Into Investment Risk

As noted, CoCos are deeply subordinated securities, and their investors would stand behind holders of senior and subordinated debt in the event of company stress. CoCos have also exhibited a relatively high degree of credit sensitivity, tending to perform well during economic upswings but with negative reactions to signs of macro uncertainty and deteriorating growth. Such uncertainties have included negative political and monetary policy developments, such as Brexit, French and Italian general elections, and the tapering of quantitative easing by the European Central Bank.

As such, the group’s performance has typically been more correlated with high-yield bonds than other preferreds, despite having relatively little sector overlap with high yield. And because CoCos are not included in normal bond indexes, they may be “first to be sold” by active managers concerned about underperforming a benchmark during periods of uncertainty, economic or otherwise. Combined, these factors may contribute to relatively high short-term market volatility, even as the asset class continues to mature.

CoCo Market Tested by Banco Popular Write-Downs

In June 2017, the CoCo market weathered the first test of losses when the ailing Spain-based Banco Popular was put into resolution by regulators. Prior to being acquired out of resolution by Banco Santander for €1, its capital securities—both CoCos and subordinated debt—were written down to zero.

However, prices on CoCos from other issuers continued to move higher in the following months. This example of non-contagion reflected the increasing maturity of the CoCo market and its ability to distinguish between higher-quality and lower-quality companies, as well as between those that are globally systemically important and those that are not.

CoCos can offer higher coupons than U.S. bank preferreds with similar credit ratings.

CoCos vs. U.S. Bank Preferreds: An Illustration

To give a sense of the similarities and differences that can exist between CoCos and U.S. bank preferreds, the exhibit below compares a CoCo from a U.K. bank with a preferred issued by a U.S. bank. While the two securities have roughly similar credit ratings, the CoCo offers a much higher coupon. It also has the potential for more attractive coupon resets, if the security is not called, given its link to five-year swaps instead of three-month LIBOR, making it less interest rate sensitive.

The issuing bank of the CoCo is well capitalized, with a \$63 billion buffer to its 7% trigger. The U.S. bank preferred has no specified trigger or mandatory coupon cancellation, as these would be subject to regulatory discretion.

Exhibit 5: Example of CoCo That Converts to Equity		
	HSBC 6.875% CoCo	JPM 5.3% Preferred
Structure		
Coupon	6.875%	5.30%
Call Date	June 2021	May 2020
Coupon Reset	5yr USD swaps + 551bp	3-Month LIBOR + 380bp
Coupon Reset Frequency	Every 5 years after call date	Quarterly after call date
Modified Duration ^(a)	2.4 years	1.5 years
Maturity	Perpetual	Perpetual
Format		
"Going" or "Gone" Concern?	Going Concern	Going Concern
Trigger Level	7.0%	NA
Loss-Absorption Feature	Yes, in contract (equity conversion)	Yes, regulatory discretion
Mandatory Coupon Suspension	Yes, in contract	Yes, regulatory discretion
Suspended Coupons	Non-Cumulative	Non-Cumulative
Dividend Stopper	No	Yes
Risk Factors		
Senior Ratings (Moody's / S&P / Fitch)	A2 / A / AA-	A2 / A- / AA-
Capital Security Ratings (Moody's / S&P / Fitch)	Baa3 / NA / BBB	Baa3 / BBB- / BBB
Notching from Senior Ratings	4–5 Notches Lower	3–5 Notches Lower
Distance to Trigger	51% (\$63 billion)	NA
Resolution Regime	Yes, U.K.	Yes, U.S.

At September 30, 2018. Source: Cohen & Steers and Bloomberg.

(a) Modified duration is calculated assuming the securities are trading at par on 9/30/18. The actual modified duration of the securities may differ from the theoretical values presented. Modified duration expresses the measurable change in the value of a security in response to a change in interest rates.

The securities percentage of total market value of Cohen & Steers Preferred Securities and Income Fund at September 30, 2018 is HSBC 6.875%% (1.07%); JPM 5.3% (0.45%).

The securities percentage of total market value of Cohen & Steers Low Duration Preferred and Income Fund at September 30, 2018 is HSBC 6.875%% (1.11%); JPM 5.3% (1.39%).

Closing Perspective: CoCos and Your Portfolio

The adoption of new capital requirements for financial institutions globally has led to significant CoCo issuance in recent years and we expect it to continue.

CoCos offer unique features relative to traditional preferreds in that they contain triggers tied to the issuer's financial health. CoCos also require high rates of income to compensate investors for equity conversion or principal write-down features.

Considering our constructive outlook for bank fundamentals, we find that many securities offer attractive compensation for the subordination in the capital structure and loss-absorbing features. Many CoCos also have lower-duration structures that allow for more effective management of interest-rate risk.

At Cohen & Steers, we believe the best way to access opportunities in the preferred securities market is through an actively managed portfolio. As an institutional investor, we can access the entire preferred securities marketplace, including CoCos and other OTC issues, securities rated below investment grade and issues denominated in foreign currencies.

Index Definitions

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Contingent Capital Securities represented by ICE BofAML Contingent Capital Index through December 31, 2016 and Bloomberg Barclays Developed Market USD Contingent Capital Index for periods thereafter. The ICE BofAML Contingent Capital Index tracks the performance of US dollar denominated investment grade and below investment grade contingent capital debt publicly issued in the US domestic and eurobond markets, with a remaining term to final maturity of at least one month and at least 18 months to maturity at point of issuance. The Barclays Developed Contingent Capital Index includes hybrid capital securities in developed markets with explicit equity conversion or write down loss absorption mechanisms that are based on an issuer's regulatory capital ratio or other explicit solvency-based triggers. The ICE BofAML Corporate Master Index tracks the performance of USD-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. The ICE BofAML Fixed-Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market. The ICE BofAML Municipal Master Index tracks the performance of USD-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. The ICE BofAML U.S. High Yield Master II Index tracks the performance of USD-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The 10-year Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year, but not more than 10 years.

Important Disclosures

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