Contingent Convertible Bonds Embedding Write-Down Clause

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Historical Background

A move was engineered by Swiss government to conclude a takeover deal between two Swiss and renowned banks with an attempt to quell concerns of a financial crisis. One issue of the deal, which is controversial and confounding, is that some $17 billion worth of bonds issued by one of Swiss banks would get marked down to zero. It means that investors of the bonds will suffer a total loss of the investment. The bonds which were marked down to zero are not ordinary bonds but are Contingent Convertible Bonds ("**CoCo Bonds**") also known as "**AT1 Capital Bonds**".

CoCo Bonds are popular debt instruments which are primarily issued by European banks to support the bank issuer's compliance with the Basel III capital requirements since 2008 financial crisis. In particular, CoCo Bonds act as additional Tier 1 capital[1] allowing European banks to meet the Basel III requirements.

The core purpose of CoCo Bonds is to enhance the supervision, risk management, and regulatory framework of the critical financial sector.

Convertible Bonds and CoCo Bonds distinguished

Convertible bonds ("**Convertible Bonds**") will pay a regular rate of interest, and have seniority when the issuer defaults. Convertible Bonds' holders are at liberty to convert Convertible Bonds into equity at a specified strike price[2]. Investors can benefit from Convertible Bonds since they can be converted to equity when the issuer's equity price is appreciating.

CoCo Bonds also have a specific strike price that, once breached, the holders can convert CoCo Bonds into equity. Further, CoCo Bonds are high-yield and high-risk products carrying specialized options that help the bank issuers absorb a capital loss.

1. Under Basel III, Tier 1 capital consists of shareholders'equity and retained earnings.
2. The strike price is a pre-agreed price level which may trigger conversion to occur.

Characteristics of CoCo Bonds

CoCo Bonds expand on the architecture of Convertible Bonds with modified conversion terms as add-on. As with Convertible Bonds, specific strike prices are embedded in CoCo Bonds to trigger conversion to occur. Upon occurrence of the events below, the trigger will take place:

(i) the underlying equity of the bank issuer hits a specified price level;

(ii) the bank issuer is required to comply with regulatory capital requirements; or

(iii) the demand of competent or supervisory authority is made.

The investors of CoCo Bonds consist of high-net worth individuals in Europe and Asia and private banks. Coco Bonds carry a stipulation that the bank issuer may write down the full debt under CoCo Bonds to satisfy Tier 1 capital requirements.

CoCo Bonds help to shore up the bank issuer's balance sheets by permitting the bank issuer to convert its debt when specific capital conditions arise. The bank issuer absorbs financial loss through CoCo Bonds. Instead of converting bonds to equity based solely on equity price appreciation, investors in CoCo Bonds agree to take equity in exchange for the regular income from the debt when the bank issuer's capital ratio falls below regulatory standards whereas the equity price might not be rising but falling instead.

Pros and Cons of CoCo Bonds

By virtue of high yield in a world of safer and lower-yielding products, the popularity of CoCo Bonds has grown. The growth has purportedly resulted in added stability and capital inflow for the bank issuers. Most investors buy CoCo Bonds, hoping that the bank issuer will one day redeem CoCo Bonds by buying them back, and until the bank issuer buys back, investors will pocket the high returns along with the higher-than-average risk.

Investors receive equity at a conversion rate set by the issuer. The bank issuer may fix the equity conversion price at the same value as when CoCo Bonds was issued, the market price at conversion, or any other desired price level. One downside of equity conversion is that the equity price will be diluted, further reducing the earnings per unit ratio.

Also, no guarantee is given by the bank issuer that CoCo Bonds will ever be converted to equity or fully redeemed. Thus, investors could be holding CoCo Bonds for years. Further, a write-down clause may be embedded in CoCo bonds. Regulators that allow the bank issuer to issue CoCo Bonds desire that the bank issuers are well-capitalized and as a result, the desire may make selling or unwinding CoCo Bonds position quite difficult for investors. In particular, investors may have difficulty in selling CoCo Bonds if the sale is prohibited by regulators.