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Understanding contingent capital securities (CoCos)

Contingent capital securities, sometimes called contingent convertibles (CoCos), have evolved from niche status to become a well-developed segment of the global fixed income markets. Strong issuer credit fundamentals, meaningful income generation and an attractive risk/return profile have resulted in broad adoption of the asset class. Liquidity has increased over the years and the CoCo market has grown to near its terminal size (or maximum required capital amount for existing banks). Today, the CoCo market has over \$US 230 billion¹ in face value of securities outstanding, representing nearly 100 different issuers and spanning multiple currencies.² In the pages that follow, we provide an overview and analysis of the asset class, as well as our insights on the important role CoCos can play in fixed income portfolios.

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WHAT ARE CoCos?

CoCos are hybrid securities created by regulators after the 2007-08 global financial crisis (GFC) as a way to reduce the likelihood of government-orchestrated bailouts. Issued primarily by non-U.S. banks, CoCos are designed to automatically absorb losses, thereby helping the issuing bank satisfy Additional Tier 1 (AT1) and Tier 2 (T2) regulatory capital requirements (as described under “capital structure position” below).

Today, European-domiciled issuers (mostly banks but also a small number of insurance companies) make up over 85% of the outstanding CoCo market. Insurance companies may use these securities for capital purposes or to help manage their credit ratings.

But why are CoCos “contingent”? Because of a feature that automatically imposes a loss on the investor should an issuer’s capital fall below a predetermined threshold — typically 7% of its total risk-weighted assets in a “high trigger” structure and 5.125% in a “low trigger” structure. When this occurs, depending on the structure, there are three possible outcomes:

- The security is converted to common equity
- The investor is forced to assume a temporary writedown of the security’s value
- The investor is forced to assume a permanent writedown of the security’s value

As of September 2023, minimum regulatory capital requirements for European banks were well above the high- and low-trigger CoCo thresholds, and most banks hold capital far in excess of the required minimum level.³

In the U.S., banks issue preferred stock rather than CoCos to fulfill their AT1 capital requirement. The main difference between a preferred stock and an AT1 CoCo, besides the issuer’s likely geography, is that only the CoCo has the contingency feature described above. In fact, because CoCos and preferred stock play nearly identical roles and rank similarly within an issuer’s capital structure — i.e., lower than senior debt but higher than common equity — CoCos are commonly held in strategies that invest in preferred stocks.

HOW DO CoCos WORK?

During the GFC, governments around the world bailed out banks at taxpayer expense and to the benefit of equity investors. CoCos, which did not exist prior to the GFC, were introduced to reduce the occurrence of such government actions in the future. They are structured to automatically absorb losses in times of crisis, with that loss absorption tied to a bank’s capital level.

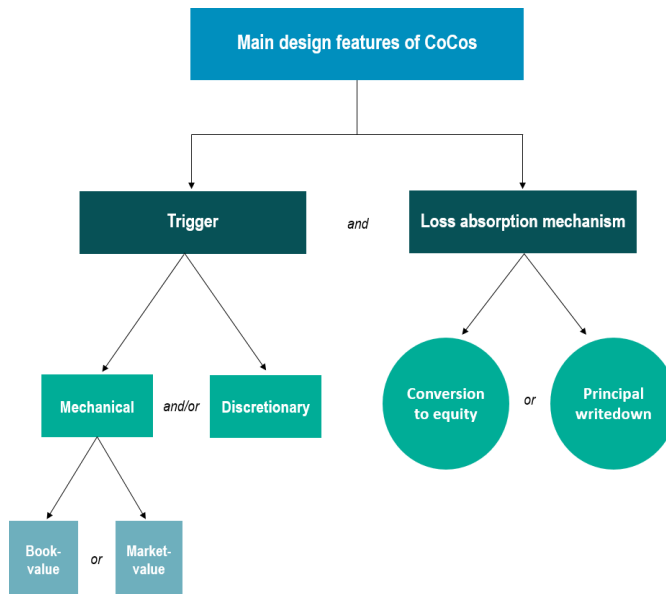
Most CoCos are defined by two elements (see Figure 1):

- **Trigger event.** This is the level of capital at which the loss absorption mechanism is activated. A CoCo trigger is mechanically based on the issuer’s regulatory capital levels. However, regulators reserve the right to declare a “point of non-viability” (PoNV) based solely on their judgment about the issuing bank’s ability to continue operating.

The concept and risk of PoNV determination is not unique to CoCo securities. U.S. regulators such as the Federal Reserve can make similar determinations about institutions under their purview. Generally, when a PoNV is declared, most investors holding securities lower in the capital stack — namely, common equity, preferred stock, CoCos or junior subordinated debt — experience a significant or full loss on their investment.

- **Loss absorption mechanism.** This may occur through (1) a conversion of the CoCo to common equity at a predefined ratio, or (2) a full or partial write down of the principal of the debt, either permanent or temporary.

Figure 1. CoCos structure



Source: *CoCos: a primer*, BIS Quarterly Review, September 2013.

While a PoNV trigger may not be an explicit part of a CoCo security’s design, in reality that trigger always exists. For European banks, it is the more likely way in which a CoCo would be triggered, because regulators will declare the PoNV well before the issuer’s capital level falls to an explicitly stated trigger threshold. As a result, the specific CoCo trigger is generally not expected to be activated.

That said, an actual PoNV determination would also be a rare occurrence given how well European banks are capitalized today. In fact, there has been only one officially declared PoNV event since the inception of the CoCo market.⁴

In 2017, the European Central Bank (ECB) declared that Spain’s Banco Popular had reached its PoNV. At the time, Banco Popular still had a CET1 capital level of 10%, much higher than the 5.125% trigger for its outstanding AT1 CoCos. The ECB, however, had determined that the bank was “failing or likely to fail,” a supervisory classification for banks that become unable to pay their debts or other liabilities as they come due.⁵

Another writedown of CoCos occurred in 2023, when FINMA (the Swiss Financial Market Supervisory Authority) sought to facilitate the purchase of Credit Suisse by UBS. As a result, the Credit Suisse AT1 CoCos were written down to zero.

For both preferreds and AT1 CoCos, investors bear the risk that the securities they hold could be written down to zero at the discretion of a regulator. (The same can be said for common equity investors of those same issuers.)

Capital structure position

Under Basel III, the banking regulations that govern European institutions, total regulatory capital consists of:

- Common equity Tier 1 (CET1)
- Additional Tier 1 (AT1) capital
- Tier 2 (T2) capital

CoCos can be structured to qualify as either AT1 or T2 capital, depending on the particular security’s features. In the Basel III framework, all AT1 instruments must be perpetual, so most CoCos are issued without a stated maturity date, similar to U.S. preferreds.

Figure 2. CoCos’ capital position per Basel III

Tier 2 (T2) <ul style="list-style-type: none"> • Non-CoCo subordinated debt • Grandfathered preferred securities • T2 CoCos
Additional Tier 1 (AT1) <ul style="list-style-type: none"> • Grandfathered preferred securities • AT1 CoCos
Tier I - includes Core Equity Tier (CET1) <ul style="list-style-type: none"> • Common shares • Retained earnings

Sources: *CoCos: a primer*, BIS Quarterly Review, September 2013; Nuveen.

Differences between U.S. preferreds and CoCos

- **No “dividend stopper” language.** Unlike most U.S. preferreds, AT1 CoCos (outside of Switzerland) lack “dividend stopper” language, which mandates that a bond issuer not pay a dividend if it decides to stop coupon payments on its perpetual bonds.

While it might seem like a drawback that there’s little dividend-stopper protection in the CoCo market, since its inception only three issuers have skipped an AT1 CoCo payment.⁶ In addition, the metrics that an AT1 CoCo issuer must meet to make AT1 CoCo payments are transparent and readily available, so investors may assess the likelihood (risk) of a skipped payment.

- **Payment deferral risk.** AT1 CoCos also have the ability to defer or eliminate interest/dividend payments if certain financial metric

thresholds are breached, while U.S. preferreds are not bound to specific thresholds. This risk is also transparent, because issuers proactively publish the metrics that could potentially trigger a dividend deferral, or investors can easily calculate these metrics themselves. As of September 2023, the average large bank in the western European Union held €7.5 billion in excess capital.⁷

Size of the CoCo market

The purposeful design of CoCos and the introduction of higher regulatory capital requirements have driven substantial growth in the market for these securities. Today, the combined face value of the AT1 and T2 CoCo market is near its terminal size (maximum required capital amount for existing banks) of over 250 billion (local currency).⁸ This amount could fluctuate over time based on the size of bank balance sheets and/or changes to regulatory capital requirements.

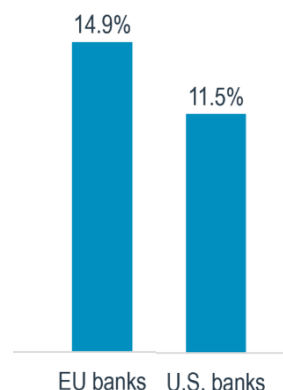
KEY INVESTMENT ADVANTAGES OF CoCos

CoCos provide investors with several attractive features:

- **Ample liquidity.** Two major indexes track the CoCo market, with the broader ICE BofA Contingent Capital Index including securities issued in multiple currencies. The average market-weighted deal size within this benchmark is about 1 billion (local currency).⁹
- **Strong underlying issuer fundamentals.** The European financial institutions that issue CoCos have stronger credit fundamentals than U.S. banks, as measured by CET1 levels (Figure 3).

Figure 3. Stronger credit fundamentals for CoCo issuers

Average common equity Tier 1 (CET1) ratio



Source: Morgan Stanley as of 30 September 2023, the most recent date for which this data is available.

Another way to evaluate the strength of CoCo-issuing European banks is to compare the size of their capital buffer relative to (a) their AT1 CoCo triggers and (b) minimum regulatory capital requirements. Figure 4 shows that EU banks have healthy capital cushions underpinning their ability to make interest/dividend payments on outstanding CoCos.

Figure 4. Healthy capital cushions

Average capital buffer for EU banks	
Amount over regulatory minimum	€7.5 billion
% over regulatory minimum	5.1%

Source: Morgan Stanley as of 30 September 2023.

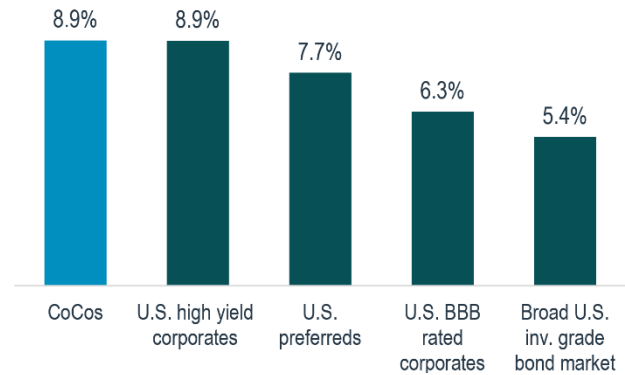
Low historical conversion and coupon deferral rates are also hallmarks of the CoCo market’s financial strength. The only writedown of principal or conversion to equity in the AT1 CoCo market since the first CoCo was issued is Banco Popular, as described on page 2.

Moreover, there have been only three instances of deferred AT1 CoCo coupon payments over the same time period.⁹ In contrast, high yield bonds and senior loans have posted average default rates of 3.2% and 3.0%, respectively.¹⁰

- **Meaningful income from a mid-quality instrument.** CoCos are lower in the capital structure than traditional debt instruments, such as investment grade corporate bonds, and therefore carry more risk. Investors in CoCos are compensated for this risk with a yield that’s equal to that of high yield bonds but well above those available in the broad investment-grade bond market and on corporate debt rated BBB (see Figure 5).
- This relatively healthy payout makes them a popular addition to yield-focused portfolios. And in the U.S., some AT1 CoCo distributions are deemed qualified dividend income (QDI) taxed at a more favorable rate than ordinary dividends. While CoCos themselves are generally rated BBB (the lowest investment grade tier) to BB (the highest below-investment-grade tier), the issuers’ senior ratings are typically four to five quality notches above that (Figure 6, at right).

Figure 5. CoCos provide investors with attractive yield income

Yield to worst



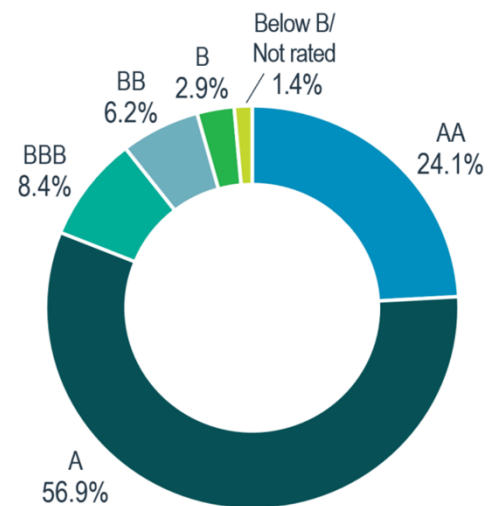
Sources: ICE BofA, Bloomberg LLC as of 30 September 2023.

Representative indexes: CoCos: ICE USD Contingent Capital Index; U.S. high yield corporates: Bloomberg U.S. High Yield 2% Issuer Capped Index; U.S. preferreds: ICE BofA U.S. All Capital Securities Index; U.S. BBB rated corporates: Bloomberg Investment Grade Corporate BBB Rated Index; Broad U.S. investment grade bond market: Bloomberg U.S. Aggregate Bond Index.

- **An attractive risk/return profile.** Given their income and quality profile, it’s not surprising that CoCos historically have delivered similar returns to preferreds and better returns than other mid-quality asset classes, albeit with moderately greater risk (Figure 7).

Figure 6. Senior ratings of CoCo issuers

Percentage of issuers rated ...



Source: ICE USD Contingent Capital Index as of 30 September 2023.

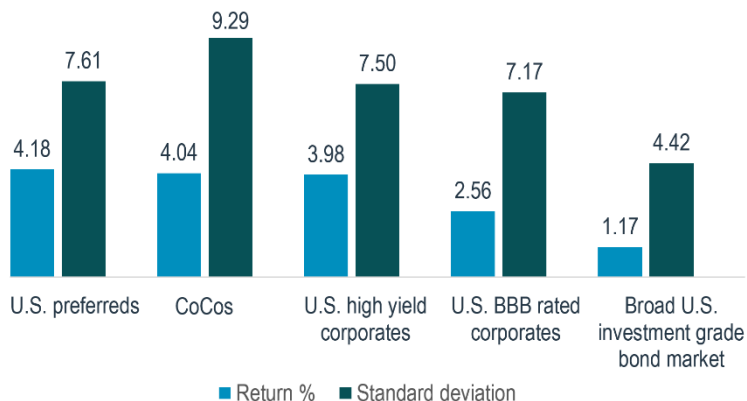
CONCLUSION

We believe CoCos offer several investment advantages. They have developed into a large, liquid market, are supported by strong issuer credit fundamentals, provide generous income for a mid-quality investment and have an attractive risk/return profile. However, given their relatively complex structure, CoCos are best suited to actively managed strategies backed by deep research capabilities.

“ *In our view, CoCos offer the advantages of ample liquidity, strong issuer fundamentals and an attractive risk/return profile.* ”

Figure 7. CoCos: an attractive risk/return profile

Returns (%) and standard deviation



Source: Morningstar Direct from 01 January 2014 – 30 September 2023.
 Representative indexes: U.S. preferreds: ICE BofA U.S. All Capital Securities Index; CoCos: ICE BofA USD Contingent Capital Index; U.S. high yield corporates: Bloomberg U.S. High Yield 2% Issuer Capped Index; U.S. BBB rated corporates: Bloomberg Investment Grade Corporate BBB Rated Index; Broad U.S. investment grade bond market: Bloomberg U.S. Aggregate Bond Index.

For more information, please visit us at nuveen.com.

Endnotes

- 1,2 Source: ICE BofA Contingent Capital Index, 31 October 2023.
- 3 Morgan Stanley, 30 September 2023.
- 4 Source: Morgan Stanley, 30 September 2023.
- 5 The Single Resolution Board, the new European Banking Union's resolution authority, exercised its power to resolve Banco Popular in a way that facilitated its transfer to Banco Santander. Equity and subordinated bondholders were wiped out. Preferred senior debt was spared. Source: Morgan Stanley, The EU's First Resolution, June 7, 2017.
- 6 Source: Morgan Stanley.
- 7 Morgan Stanley Research, 30 September 2023.
- 8 Source: ICE BofA Contingent Capital Index; Morgan Stanley.
- 9 Source: Bloomberg LLC, 30 September 2023.
- 10 Source: JPMorgan as of 30 September 2023.

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