Additional Tier 1 CoCo Bonds – Investors *Caveat Emptor*

In a paper written in June 2014*, Scope Ratings explored some of the major credit issues investors in AT1 need to be aware of relative to securities more senior in the capital structure:

"The structure of contingent convertible securities, of which AT1 capital instruments are the major component, is "shaped by their primary purpose as a readily available source of bank capital in times of crisis."1 Specifically, they aim to provide a private-sector alternative for recapitalizing financial institutions, aside from the issuance of new equity – which can at times be less appealing due to dilution effects. We note that the regulatory framework (CRD4-CRR) behind their structure aims primarily to minimize systemic risk and provide depositor protection, rather than to increase their market appeal."

"Based on the specific features of AT1 capital instruments, we see four key risks for investors – two related to coupon payments (distributions) and two related to principal writedown or conversion:

***Coupon cancellation risks**:*

- *The issuer does not make distributions as it has full discretion not to do so. In general, we do not believe that financially viable issuers would exercise this discretion lightly as the reputational risk could be significant and future market access could be materially harmed.*
- *The issuer is restricted in making distributions as it has breached its combined buffer requirement.*

***Principal loss absorption risks**:*

- *The instruments are written down or converted as the relevant CET1 ratio has breached the trigger level.*
- *The instruments are written down or converted as relevant authorities have determined that the issuer has reached the PONV – i.e. the point when the issuer meets the conditions for resolution or the authorities decide that the issuer ceases to be viable if the capital instruments are not written down or converted."*

**AT1 Capital Instruments – Background and Key Risks for Investors, June 2014*

DealFolio.NET

Additional Tier 1 CoCo Bonds – A Credit Analyst's View on Market Developments

Pauline Lambert – Director, Financial Institutions, Scope Ratings

DealFolio: How has the market for AT1s been developing recently?
Pauline Lambert: 2014 and 2015 were very busy years in the Additional Tier 1 issuance market. European issuance (according to figures from Bloomberg) was around EUR85bn in 2014 and EUR45bn to November 2015. The 2015 issuance had a strong Dutch flavour as institutions there received the regulatory clarification to move forward with issuance.

DealFolio: Is the trend likely to continue?
Pauline Lambert: With Pillar 2 requirements, it is likely that institutions would have the capacity and willingness to issue further AT1 securities.

DealFolio: Are we seeing standardisation in deal structures?
Pauline Lambert: The trigger levels in each jurisdiction may be driven by the local regulator. This has driven specific deal structures. For example, the UK regulator has questioned whether the minimum 5.125% trigger would be effective which has led to UK banks issuing with a 7% trigger. Investor appetite has influenced the choice between the conversion-to-equity model and the write-down model, with some investors unable to invest in the conversion model due to restrictions in their mandate.

DealFolio: What is your view on documentary trends in terms of certainty for investors?
Pauline Lambert: In terms of the language regarding triggers, the language is pretty clear, particularly as the triggers are activated mechanically. The uncertainty arises to the extent there could be a conversion before hitting the trigger or a cancellation of coupon payments as a result of regulatory discretion. The terms and conditions as well as risk factors included in the prospectuses of the securities highlight these risks for investors.. For example, in transactions issued by UK banks, the consent to UK bail-in powers is explicitly specified. As regulations have evolved and been adopted, the language and documentation has become clearer.