AT1: Investors' Risky Bets that Keep the Banks Running

When you hear the word CoCo you probably think of a leather bag with the famous Chanel logo on it, or the 2017 critically acclaimed and commercially successful animated movie of the same name. What you probably do not think about is a complex financial instrument, created with the purpose of saving humanity from financial crises like we have seen in the past. And yet CoCos are exactly that for a very small part of the population, those few of the millions of people working in finance who actually deal with those kinds of financial instruments. Let us first uncover what exactly are these CoCos of finance, why they are called like that and most importantly, why they are considered so hard to evaluate and hence might represent a great investment opportunity.

Any book on finance will differentiate between two main types of investments initially: stocks and bonds. While there are a number of other investment instruments, these two stand out as the most common and well-known, while also easy to understand and value. Stocks give the investor ownership rights over a given company's assets, growth potential and future earnings and limited liability in case of a downfall. Bonds, in contrast, are essentially a way for an investor to loan out funds to the company, which then repays the initial investment (called the principal) at an agreed upon date and pays periodic interest in the form of coupons (called like that due to the fact that in the pre-computer era, investors had to hold and then exchange actual paper coupons for the interest payment each time interest was due). Some bonds only pay the final sum in the end with no interest payments in between, while trading at a discount initially (called "discount bonds"), while some do the exact opposite, never repaying the principal amount, paying periodic interest perpetually (hence "perpetual bonds").

Finance has long been known for its ability to come up with more and more sophisticated ways of pricing and trading risk. After all, finance is about the correct evaluation and constant monitoring of risks associated with any activity. After the global financial crisis (GFC) of the late 2000s, one of those ways of constraining the risks somewhat inherent to the financial sector was the introduction of a hybrid instrument, a sort of blend between a traditional bond or a perpetuity in particular, combined with a way to provide ownership rights in certain scenarios, all while acting as a risk restraining tool.

Contingent Convertible bonds (CoCos or CoCo bonds) were introduced as part of the Basel III regulatory framework, an act by European policymakers to prevent phenomena like the GFC from occurring again. These hybrid debt instruments, mostly issued by banks, have a contractual accounting trigger at which the debt is either written-off or converted into the issuer's equity. They are designed to relieve banks with insolvency issues when they find themselves in financial distress. CoCos predominantly have a contractual accounting trigger, that, when breached, relieves the issuer from debt-related payments by either converting the bond into equity or allowing the issuer to write the bond down.

Essentially, the bank takes the money from investors and gives them a contract in return, which, while the bank's fortunes are on the positive side, works precisely like a perpetual bond, paying out periodic interest indefinitely. When the bank runs into financial trouble, which might happen due to a myriad of reasons, these bonds serve as sort of a buffer for the bank in the following way.

A bank's assets, like any other company's, are comprised of equity, the part that shareholders own, and liabilities, the part owed to creditors (other banks, the government, depositors, etc.). The bank uses these assets to give out loans to customers (retail clients, corporations, etc.), aiming to pocket the difference in rates that it earns from loans and should pay to creditors. The money the bank actually owns (i. e. the equity) is referred to as CET1 (standing for common equity tier 1). The bank has an obligation towards its creditors, so any bondholder is entitled to get their interest payments and, whenever a bond matures, the principal. It has no obligation to the shareholders though, so in times of distress it may forego paying dividends with no legal repercussions at all.

In a theoretical setting of a bank having assets of $100, liabilities of $90 and CET1 (equity) of $10, the bank losing $1 changes the situation to $99 of assets, unchanged $90 of liabilities and $9 of CET1. This is where CoCos, which are part of AT1 (additional tier 1) capital, come into play. AT1 is the buffer between CET1 (or your usual equity), and the rest of the debt the bank has. If the bank had issued a CoCo of $1 to one investor, which should be converted into equity if the CET1 ratio (CET1/assets) falls below 10%, the bank losing $1 would have the following effect: $99 of assets, $89 of liabilities and $10 of CET1. The $1 CoCo got converted into equity, the investor now owns stock worth $1, while the bank is relieved of its duty to pay periodic interest to the investor. In case of a write-down clause in the contract, the $1 debt is written down completely.

The main advantage from an investor's point of view is that CoCos offer higher yields than traditional bonds, which is supposed to compensate for the inherent risk of getting converted into a distressed bank's stock or being written down completely.

Over the last 15 years the world got used to a very low interest rate environment, which prompted investors to pursue returns in many unconventional ways. Start-up financing went stratospheric, interest in speculative bubbles such as cryptos or NFTs skyrocketed, and yet some of the free capital was funneled into a new type of bonds, which can sometimes become stocks.