Lincoln Private
Investment Office

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CoCos go *Loco*

In just the first few weeks of 2016, the prices of many bank stocks suddenly plunged to deeply distressed territory. Credit default swaps, a marker of the price of insuring against default on the bonds of those banks spiked. Spreads across the capital structure widened, driven by concerns over AT1 securities – also known as Contingent Convertible Bonds (CoCos).

CoCos had their roots in the financial crisis, when governments were forced to bail out the banks embroiled in the unwinding of their own financial excess. Unlike standard Convertible Bonds, CoCos convert into equity when a bank runs into trouble, allowing the bank to rebuild the capital that it is required by regulators to hold in case of losses. Or for the cynics among us, they convert into a riskier instrument with no claim on the business's assets right at the moment said business exhibits signs of stress. For this reason, they pay a higher coupon than conventional bonds to compensate investors for taking additional risk. Covenants within their structure also allow issuers of CoCos to write off the bonds when losses force a bank's regulatory capital below a certain threshold, as well as allowing issuers to miss coupon payments.

While the potential of capital loss is usually the greatest source of anxiety for CoCo investors, the swift deterioration in market confidence this year was driven by fears surrounding one institution in particular. Deutsche Bank, Germany's flagship lender, had trailed its rivals in bouncing back from the 2008 financial crisis, hampered by having to pay out billions of dollars in fines to end a string of legal disputes, and fixing its aging technological infrastructure. Its new CEO, John Cryan, had set out a two-year time horizon to revamp and restructure its bloated investment bank in the face of the tougher regulation and rock-bottom interest rates that had dramatically reduced profitability. But even with promises of change, investors had lost patience – and then the bank posted a EUR 6.8bn loss for 2015. This news, compounded by fears over waning global growth, sent bank stocks tumbling, along with their bonds. Poor liquidity in markets meaningfully amplified volatility. The major worry was that, without a capital cushion, this loss would force Deutsche Bank to miss a coupon on its CoCos.

Deutsche Bank was able to provide some reassurance to investors that it was good for the cash. But the selloff in the sector sparked some awkward questions about the solvency of European banks. In our view, these fears are overdone. Money markets remain open; there is no evidence of strain in EUR or USD funding. Customer deposit growth is growing solidly, adding further to liquidity positions. Over the longer term, the restructuring trend in the sector continues. Banks continue to dispose, deleverage, and retain earnings. This should result in a stronger, safer, utility-like sector. And to those asking whether this is the beginning of the next financial crisis, we would point to the ECB's emergency overnight lending facility, used by European banks in need of a short-term loan. On the days of highest volatility in the asset class this year, the ECB lent EUR 20mn on 5th February, EUR 127mn on 9th February and EUR 31mn on 11th February. In contrast, the ECB's daily loan to troubled banks in 2008 reached highs of around EUR 25bn – yes, *billion*.

Of course, issuer selection will be key going forward and there will always be poor performers. But, fundamentally, our view on the asset class has not changed. This space is one of the only remaining places in fixed income markets where an investor can earn a higher yield to own a good quality company's debt. This compares favourably to the conventional high yield market, which is divided between poorer quality companies that pay a very attractive yield, and higher quality companies that hardly yield anything at all. On the other hand the increased yield on CoCos, particularly relative to the higher credit quality of the issuer, is very attractive – as is the peculiar feature of these bonds that they benefit more than their conventional counterparts in a rate-rising environment. On the whole, the outlook remains positive: fundamentals are improving, and, ultimately, capital still has to be retained on bank balance sheets for regulatory reasons.

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