Does the ECB want to end CoCos?

Completed on
22 | 04 | 2022

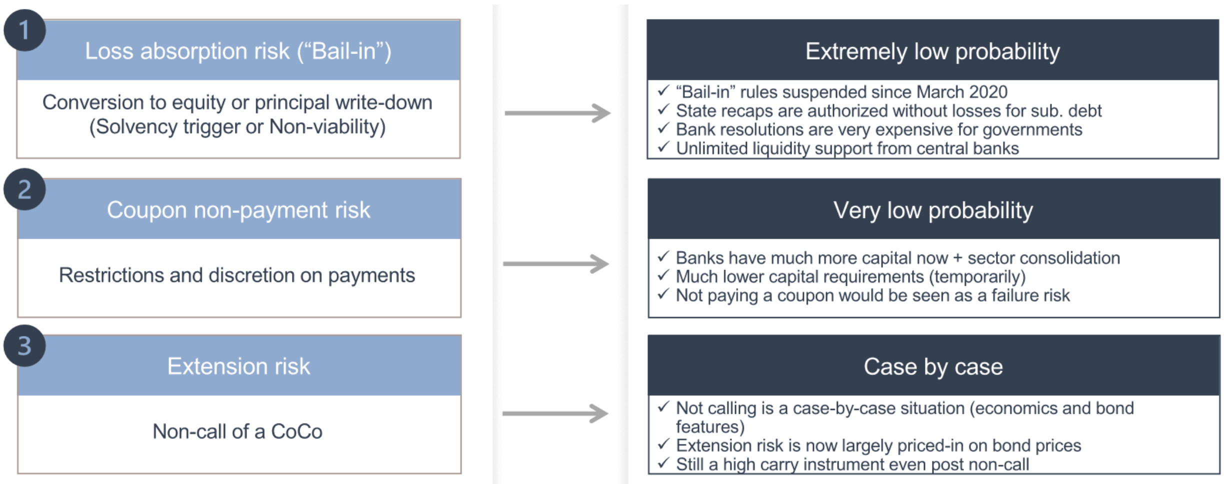
CoCos: “If we want things to stay as they are, things will have to change.” (The Leopard)

The ECB published in March a response to the Call for advice by the European Commission on the macroprudential framework for European banks (link here), which makes several proposals that could affect the Additional Tier 1 (AT1) CoCo segment in Europe… or will it really?

First, let’s provide some context regarding this text and more specifically how it could eventually be translated into law. The Commission’s review is broad and encompasses several topics, among which the way AT1 CoCos are being used by banks. The ECB acts as an advisor on these matters, and though other regulatory bodies will also make recommendations (EBA, ESRB), we cannot deny that the ECB has a strong say in these macroprudential adjustments. The Commission should publish its review by end-June 2022. Possible legislative proposals by end-December (or later) would be followed by the Parliament’s and Council’s versions, before rule changes are finalized, potentially in 2024 or 2025. It is important to stress that (i) **not all changes proposed here will be implemented, as they will be most certainly watered down or suppressed** by the miscellaneous stakeholders drafting up and voting the law (including bank lobbies), (ii) **the timing for any change is highly uncertain,** but we do not expect anything before at least 2024… for an application at least one year later. Our view is that **most of what is proposed here will be implemented rationally and slowly to avoid any market disruption, as is often the case with regulatory proposals.**

Let’s now address the main proposals from the ECB, according to their impact on the 3 main structural risks that are encompassed in CoCos:

Figure 1: our current assessment of CoCo-related risks



Source: La Française AM.

1/ Risk of loss absorption (CoCo triggers).

The ECB acknowledges that current solvency triggers for AT1 CoCos (i.e., 5.125% and/or 7%) are too low to be ever reached. This is true. These triggers are completely useless. The “real” trigger is what regulators call the “Point of non-viability” (PONV). In other words, regulators can decide to trigger loss absorption when they deem the bank non-viable, which they determine without any specific solvency/liquidity metric. This is what happened for Banco Popular in June 2017, as the bank’s solvency ratios were way above automatic triggers when it was put into resolution by the ECB. The ECB is quite vague in its proposal, stating that “triggers should be set at a “level where the write-down or conversion takes place before the institution is declared failing or likely to fail”.

<u>What could it mean?</u> The most certain impact would be the **disappearance of so-called “low-trigger AT1 CoCos” (i.e., with a CET1 trigger at 5.125%).** They could either (i) impose a 7% minimum trigger for all AT1 CoCos, as is already the case in Switzerland (and there are a lot of banks which already have 7% triggers in their bond documentation in Europe), (ii) impose an even higher minimum trigger (8%, 10%?), which is very unlikely in our view (and lobbies would fight hard if that were to be the case) or (iii) remove altogether solvency triggers to just keep the PONV threshold. This would be the smartest decision in our opinion, since many jurisdictions outside of Europe do not include solvency triggers, such as… the USA. This does not represent an impediment against bank resolutions, nor does it go against Basel III. This would however mean the end of CoCos, which would be replaced by non-CoCo AT1s, theoretically resulting in higher ratings and lower spreads for newly-issued bonds. Basically, European AT1 bonds should then trade on an equal footing against their US counterparts (US Preferreds), which would be good news for the segment overall.

Figure 2: Selected structural features of AT1 CoCos vs. US Preferred Shares.

	AT1 CoCos	Preferred shares
Country of issuance	EEA, Canada, Australia, China, South America, Russia…	USA
Regulatory treatment	Tier 1 capital	Tier 1 capital
Solvency trigger	Yes, explicit at 5.125% or 7% CET1 ratio	No contractual conversion triggers
Coupon distribution	Fully discretionnary Mandatory deferral in case of capital breach	Fully discretionnary No automatic deferral
Dividend stopper*	No for European banks Yes for most countries outside of Europe	Yes

Source: La Française AM.

**A clause that prevents a bank from paying a dividend to common stockholders if they do not pay the coupon on their hybrid securities.*

<u>What will the European Commission decide?</u> We do not think that they will remove triggers altogether (as it would be seen as a relaxation of their requirements, which is difficult to justify politically), but rather **impose a 7% minimum trigger for all CoCos.** The CoCo market does not discriminate between 5.125% and 7% CET1 triggers and never has, since they are not relevant for assessing the risk of loss absorption anyway. As a result, **we do not see any significant market impact if such a proposal were to be adopted.**

Probability of change: likely.

Potential market impact: negligeable for new bonds and positive for grandfathered “low-trigger” bonds, which would have to be called.

2/ Coupon cancellation.

The ECB states that "The CRR (Capital Requirements Regulation) definition of "distributable items" (…) should be reviewed to ensure that only profitable banks or banks with positive retained earnings could make AT1 coupons / CET1 dividend payments". Roughly speaking, banks are currently allowed to make AT1 coupon payments as long as they have positive distributable items, which include positive retained earnings and some other reserves, which are usually very large. Restricting what is included within these "distributable items" would potentially mean coming back to the stressful situation of Deutsche Bank in early 2016, when the German bank had but small reserves to make payments, since they were calculated at the time based upon local accounting rules. Ironically enough, rules have since been simplified and unified in Europe to avoid such a situation!

What will the EC decide? It would be very difficult to effectively implement an automatic coupon cancellation in the event of a net loss, as dividends would also have to be completely skipped and employee bonuses as well. The average cost of capital for banks would increase by a significant amount, and the impact on both AT1s and equities could be very significant, as coupon/dividend skips would become much more common.

The more realistic possibility would be **slight adjustments to the definition of "distributable items"..** This would still go against the direction of regulations outside of Europe, which have been "relaxing" AT1 coupon cancellations when banks are no longer able to maintain their minimum solvency requirements (UK and USA) and could thus put European banks at a disadvantage. Lobbies and national regulators are often prone to defend banks against such harsh proposals, and this time should be no exception.

Probability of change: unlikely to be significant.

Potential market impact: difficult to gauge, but negative for spreads if the European Commission really wants to restrict the definition of "distributable items".

3/ Exercise of calls.

The ECB merely states a proposal to limit "the **possibility to call the instrument only if replaced with a CET1 instrument or a cheaper AT1 instrument".** That is actually how things already work, more or less. Making this proposal an explicit regulatory requirement might put some more uncertainty and volatility on CoCos when their call option goes out-of-the-money a few months before the call window. However, CoCo **investors have already grown accustomed to managing call expectations as bonds come closer to their exercise date and extension risk is already largely priced-in on bond prices.**

Probability of change: unlikely to be significant.

Potential market impact: negligeable.

As a conclusion, this paper by the ECB could inspire some changes for AT1 CoCos, but we do not think that this market segment will change significantly in any case. Concrete changes will not materialize before several quarters and are very likely to be watered down in the end. We quoted "The Leopard" in the title of this note, but it may rather end like "Much ado about nothing".

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