# Learning to live with CoCo non-calls

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We have been asked lately whether there would be some non-calls on Additional Tier 1 CoCos for the months to come and whether higher rates/yields were an obstacle to the refinancing of AT1 CoCos. Our short answers to these questions are respectively: 1/ yes, non-calls are to be expected, and it is quite a non-event actually; and 2/ No, what matters is the spread on CoCos, not their yield or the level of core rates. Let's focus on these matters to demonstrate why non-calls are set to become more and more common and why it is not an impediment to the performance of the bonds, nor is it to their carry.

## 1/ How do AT1 CoCo calls work?

### a/ The economics of calling a CoCo bond

AT1 CoCos are regulatory instruments that count as Tier 1 capital (hence their name!) and that need an approval from the bank's regulator in order to be called. Basically, **bonds can be called only as long as they have been refinanced already at a lower or similar cost** or if the bank has replaced them with an equivalent amount of higher quality capital (i.e., common equity). As such, there is no direct incentive for the issuer to call the bond if it has not been replaced by a similar capital instrument.

**Issuers usually strive to refinance their CoCos whenever they can, sometimes as much as 6 to 12 months before an upcoming call date**. Their idea is to secure the funding on a new bond at a similar or lower cost than the existing instrument while assuaging investors about the exercise of the call on their existing CoCo. Santander had failed to refinance one of their CoCos back in Q1 19 and therefore had to extend it (they eventually called it afterwards when they could refinance it at a lower cost). **Non-calls usually happen some time after or during a period of market stress, when issuers cannot properly access primary markets at a decent cost.** That is what happened during the Covid-19 crisis, when Deutsche Bank, Aareal Bank and Lloyds Banking Group decided to not call their respective AT1 CoCos in Q2 2020. In order to avoid the potential price friction on an upcoming call, several issuers have included within their documentation the possibility to call the bonds during a 6-month call window rather than on a specific day. This is a welcome documentation adjustment, but that will solely apply to issues whose call dates are far from now since it was first introduced back in 2019.

**Breakdown of calls and non-calls on AT1s from European banks[1]**

| | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|
| **Number of bonds** | 4 | 13 | 22 | 18 | 22 |
| *- called* | 4 | 12 | 19 | 18 | 9 |
| *- not called* | 0 | 1 | 3 | 0 | 0 |
| % called | 100% | 92% | 86% | 100% | 41% |
| Total amount of AT1s called ($bn) | 6.475 | 15.2 | 23.8 | 24.3 | 7.7 |

[1] *Sources: Bloomberg, La Française. Data as of 15/03/2022.*

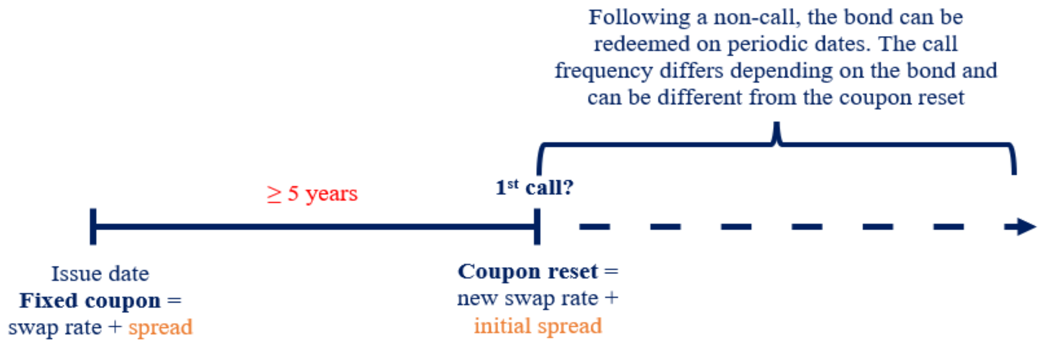
### b) Spreads matter, rates don't

Let's now address why **rates and yields do not really matter for the exercise of CoCo calls**. Banks manage their balance sheet on a floating-rate basis. It means that most, if not all, fixed-rate assets and liabilities are usually swapped to a variable basis. **The bank does not think in terms of yield to determine whether it should call a bond or not, but rather in terms of spreads, since the rate component is systematically swapped.** The economics of calling thus become a question of determining the cheapest option between refinancing (i.e., issuing a bond at a new spread over the swap rate) or keeping the existing one, whose coupon shall be reset with a set formula.

**CoCos are issued at a fixed coupon until the first call date**, which is the sum of a rate component and a spread over this rate. In order to simplify our demonstration, let's say that the rate component is the 5-year swap rate for the currency of issuance[2]. Just add the spread at issuance and you get the yield at issuance (and yield at issuance = coupon if the price of issuance is 100%). The documentation for all CoCos around the world is similar on the spread component: it is always the spread over swap at issuance that shall be used for the coupon reset if the bond does not get called (it is often referred to as the "reset spread" or the "back-end spread"). In other words: **coupon post non-call = Swap rate + spread at issuance.**

As an illustration, the **Raiffeisen Bank International (RBI) €-CoCo callable in December 2022** currently bears a fixed coupon of 6.125% until its first call date. At the time of issuance in 2017, this coupon had been determined as the 5Yr swap rate back then + a 5.954% spread over this rate, thus equaling a yield/coupon of 6.125%. To determine whether RBI will be capable of calling this bond, one must compare the theoretical cost of issuing a new CoCo at current market conditions versus letting the existing CoCo being not called and seeing its coupon being reset as: 5Yr swap rate at the call date + the spread at the time of issuance (i.e., 5.954%). With the 5Yr swap rate currently at +0.75% at the time of writing (according to Bloomberg), that would give a theoretical coupon of c. 6.7% (subject to the level at which the swap rate will trade in December 2022). For this bond specifically, the coupon can only be reset every five years, while the bond shall be callable every 6 months after the first call date. Again, the spread at issuance is the one that will be mandatorily used, in any case, as the "reset spread" on the coupon formula. **For this bond to be called, RBI would have to be able to price a new CoCo with a cost close to or below that of its existing one post reset. These conditions cannot realistically be met at the moment, hence the price discount below par.**

**Illustrative simplified view of how calls and coupon reset work for AT1 CoCos**




*Source: La Française*

**This shows how we assess potential calls vs. non calls for AT1 CoCos: by comparing current spread levels over the swap rate against the so-called "reset spread"** (i.e., the spread that shall

[2] For almost all €-denominated AT1s, the rate component used by banks is the 5-year € swap rate (EUSA5 on Bloomberg), regardless of the call date of the bond. For $-denominated CoCos, there are mainly two rate bases used by issuers throughout the world: the US 5-year swap rate (USSW5) and the 5-Yr Treasury Constant Maturity rate (H15T5Y). Exceptions do exist for several bonds, depending on the issuer or its country of issuance.

be the basis for the reset coupon formula). That is the reason why the level of yields does not really matter per se. **Banks think in terms of spreads, and so should CoCo investors.**

A simplified way of assessing the call option of a CoCo would be to compare its current spread (either I-Spread or Z-Spread) against the "reset spread". **If the current Z-Spread (i.e., the trading level) is above the "reset spread", then the call option can be deemed out-of-the-money.** And if you want to simplify even more, let's just say that if the bond price trades below par (100%), then the call option is out-of-the-money, regardless of how far the call date may be. The reality is somewhat more complex, but this is how most CoCos have been trading for the past five years or so.

## 2/ The current state of the CoCo market

### a/ Upcoming calls

**Market data of European AT1 CoCos callable before the end of S1 23 sorted by their next call date[3]**

| Issuer | Currency | Call date | Coupon | Mid price | Reset spread | Call announcement ? |
|---|---|---|---|---|---|---|
| SWEDBANK AB | USD | 17/03/2022 | 6 | 100.061 | 410.6 | Yes |
| DNB BANK ASA | USD | 26/03/2022 | 6.5 | 100.055 | 508 | Yes |
| CAIXA GERAL DE DEPOSITOS | EUR | 30/03/2022 | 10.75 | 100.332 | 1092.5 | Yes |
| STANDARD CHARTERED PLC | USD | 02/04/2022 | 7.5 | 100.295 | 630.1 | Yes |
| DANSKE BANK A/S | EUR | 06/04/2022 | 5.875 | 100.299 | 547.1 | Yes |
| ING GROEP NV | USD | 16/04/2022 | 6.875 | 100.261 | 512.4 | Yes |
| BANCO SANTANDER SA | EUR | 25/04/2022 | 6.75 | 100.601 | 680.3 | Yes |
| DEUTSCHE BANK AG | EUR | 30/04/2022 | 6 | 100.325 | 469.8 | Yes |
| AAREAL BANK | EUR | 30/04/2022 | 6.641 | 97.647 | 718 | Not yet |
| SKANDINAVISKA ENSKILDA | USD | 13/05/2022 | 5.625 | 100.329 | 349.3 | Yes |
| BANCO DE SABADELL SA | EUR | 18/05/2022 | 6.5 | 100.215 | 641.4 | Not yet |
| BANCO BILBAO VIZCAYA ARG | EUR | 24/05/2022 | 5.875 | 100.405 | 577.9 | Not yet |
| UNICREDIT SPA | EUR | 03/06/2022 | 9.25 | 101.217 | 930 | Not yet |
| BNP PARIBAS | EUR | 17/06/2022 | 6.125 | 100.538 | 523 | Not yet |
| SANTANDER UK GROUP HLDGS | GBP | 24/06/2022 | 7.375 | 100.176 | 554.3 | Not yet |
| CAIXABANK SA | EUR | 18/07/2022 | 6 | 100.504 | 581.9 | Not yet |
| BARCLAYS PLC | GBP | 15/09/2022 | 7.875 | 101.116 | 609.9 | Not yet |
| HSBC HOLDINGS PLC | EUR | 16/09/2022 | 5.25 | 100.234 | 438.3 | Not yet |
| BANCO DE SABADELL SA | EUR | 23/11/2022 | 6.125 | 99.295 | 605.1 | Not yet |
| VIRGIN MONEY UK PLC | GBP | 08/12/2022 | 8 | 100.86 | 652.66 | Not yet |
| SHAWBROOK GROUP | GBP | 08/12/2022 | 7.875 | 96.369 | 675.2 | Not yet |
| RAIFFEISEN BANK INTL | EUR | 15/12/2022 | 6.125 | 80.6 | 595.4 | Not yet |
| BARCLAYS PLC | GBP | 15/03/2023 | 7.25 | 101.328 | 673.86 | Not yet |
| HSBC HOLDINGS PLC | USD | 23/03/2023 | 6.25 | 99.435 | 345.3 | Not yet |
| STANDARD CHARTERED PLC | USD | 02/04/2023 | 7.75 | 102.676 | 572.3 | Not yet |
| IBERCAJA BANCO SA | EUR | 06/04/2023 | 7 | 101.346 | 680.9 | Not yet |
| DEUT PFANDBRIEFBANK AG | EUR | 28/04/2023 | 5.75 | 97.048 | 538.3 | Not yet |
| UNICREDIT SPA | EUR | 03/06/2023 | 6.625 | 101.363 | 638.7 | Not yet |
| LLOYDS BANKING GROUP PLC | GBP | 27/06/2023 | 7.625 | 100.68 | 528.66 | Not yet |

**AT1 CoCo prices have suffered these last few months and their spreads have been affected as a result.** There are several issues whose calls are coming due in the next few quarters that have not been refinanced yet. **Some are already trading below par and are thus discounting the hypothesis of not being called** (Aareal Bank, Raiffeisen, Banco Sabadell, Deutsche Pfandbriefbank…). Some others trade close to, or above par, as they have already been refinanced

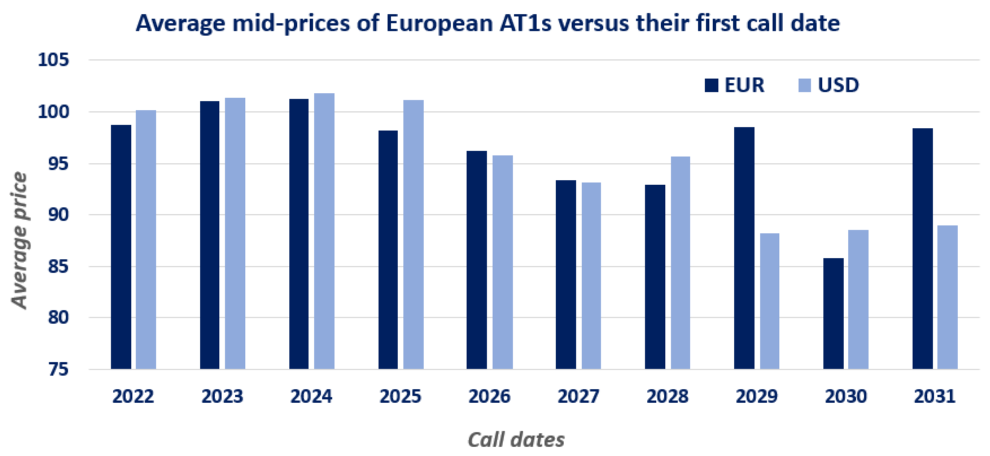
[3] Sources: Bloomberg, La Française. Data as of 15/03/2022. Prices are purely indicative.

or investors give the issuer more time to do so before it comes closer to the call date (BBVA, BNP Paribas, HSBC…). Some bonds have such elevated coupons and “reset spreads”, that their call option still looks in-the-money (UniCredit 9.25% call June 2022 for instance with a reset spread of 9.30%) and investors would be comfortable with the theoretical “reset” coupon.

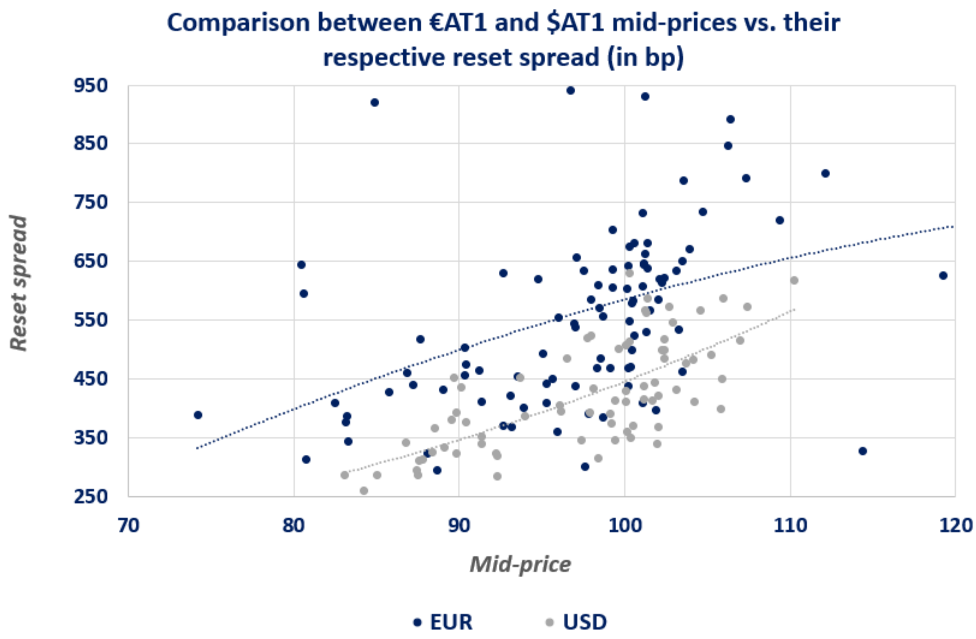
**The aim of this paper is not to assess the individual “callability” of one CoCo or another, but rather to state that the market is expecting several bonds to not be called. The question thus becomes: will the non-exercise of calls affect the valuations of other CoCos?**

### b/ Non-calls are already embedded within current CoCo prices

The answer to the former question is: not in our opinion. **Non-calls are already embedded within the current valuations of CoCos.** This is reflected into their prices (when they trade below par) and their spreads (when their Z-Spread trades above the bond’s “reset spread”). Of course, call exercises can only be ascertained when they are announced by the issuers (usually between three months and one month before the due date), but the markets deem a call to be “certain” when the par (100%) acts as a price floor.



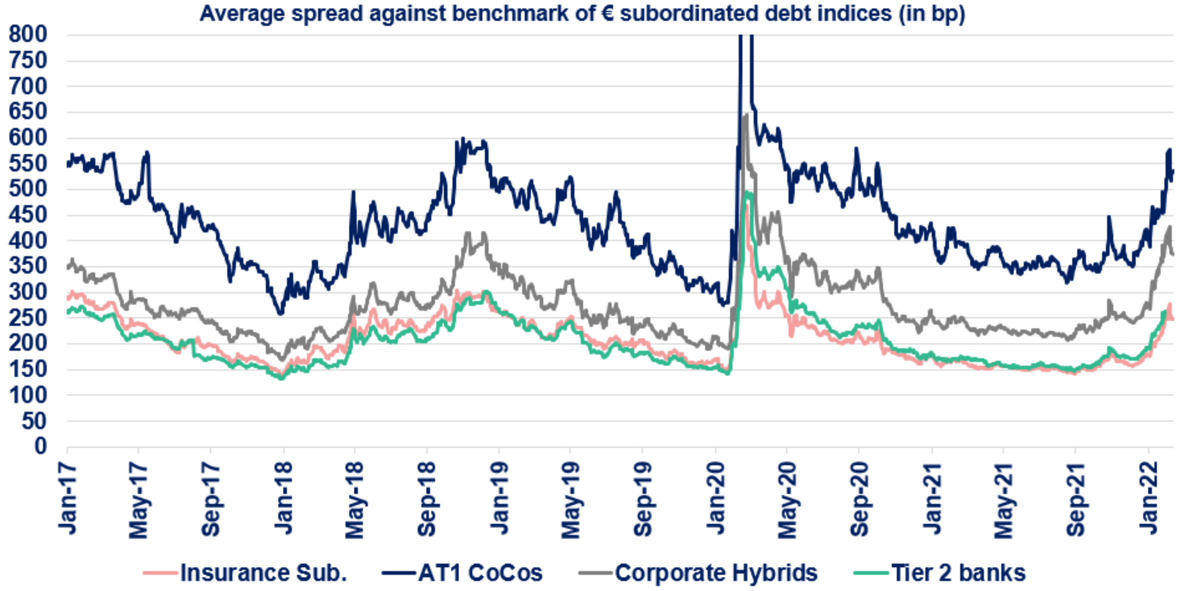

| Number of bonds | 21 | 15 | 32 | 46 | 27 | 22 | 12 | 9 | 4 | 7 |
|---|---|---|---|---|---|---|---|---|---|---|




Sources: Bloomberg, La Française. Data as of 15/03/2022. Prices are purely indicative.

**A majority of CoCos trade below par nowadays,** and the average price for CoCos tends to decrease as the call date gets further away from us (see chart above). That can be explained by the fact that the most recent vintage of new AT1s (those issued in S2 2021 and January 2022) usually bear lower "reset spreads" on average while getting longer call dates. We can witness **the correlation between the "reset spread" and the price of a bond: the lower the "reset spread" (i.e., its call probability), the lower its price (see chart above). This has come to a point where call probabilities matter sometimes much more than the intrinsic credit risk of an issuer to determine the volatility of a CoCo!**

Average spread against benchmark of € subordinated debt indices (in bp)

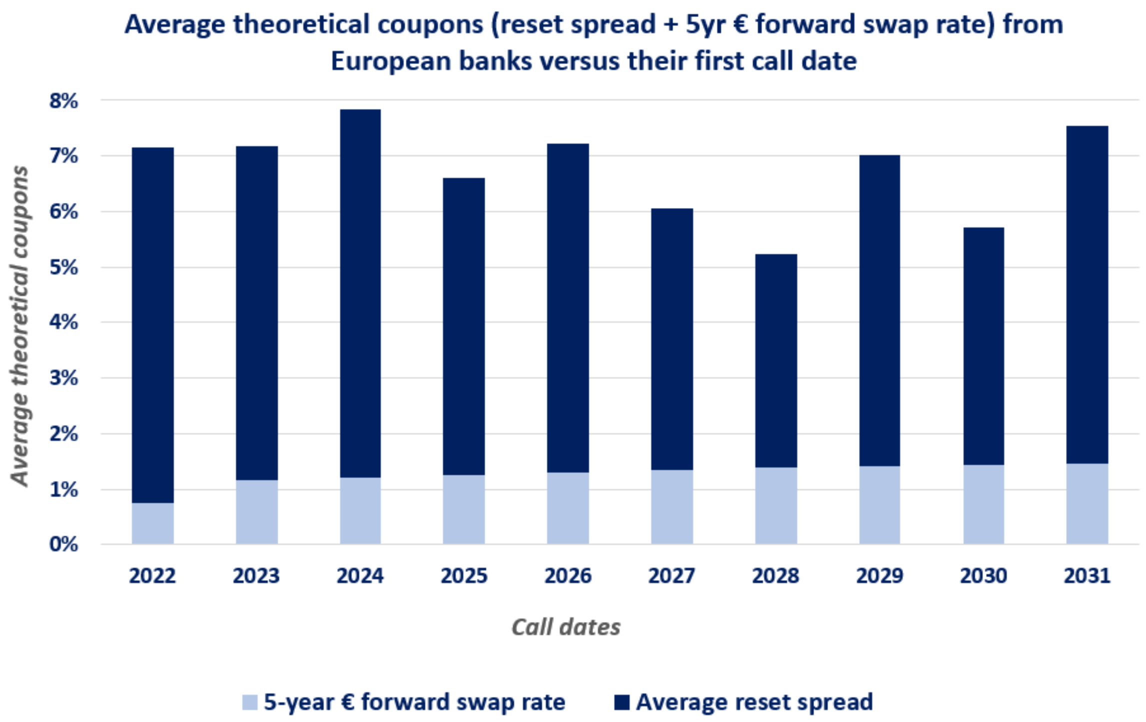



*Note: Spreads are expressed here against an average government rate and are not expressed against the swap rate.*
*Sources : Credit Suisse, La Française, Bloomberg. Data as at March 14th 2022.*

Since current valuations already contain depressed call probabilities due to the current elevated spreads on AT1s, **call probabilities can on average really improve if spreads recover for the whole segment.** Otherwise, call options shall be exercised on a pure economic basis, which should favor existing bonds when they trade above par. However, it does not mean that bonds that trade below par will necessarily suffer as their call date comes due. Prices should, in our opinion, adjust to the upcoming coupon formula beforehand to reflect their intrinsic carry component. In other words, **the non-exercise of a call does not make the carry disappear, which explains why prices are getting adjusted before the coupon reset.** The Aareal Bank AT1 CoCo whose next call date is on April, the 30th, is trading at 97.5% as of today (indicative mid price on Bloomberg) and thus reflects a spread margin of 735bp, which is equivalent to a 7.2% yield-to-maturity.

Do you remember the market impact of Santander's non-call on its CoCo is 2019? There was none. The market had been pricing that as an intrinsic risk for the said bond, and not the asset class. **This is what we can expect for the months to come: some bonds won't get called and you should not really expect any market impact (outside of some clickbait news headlines).** Actually, the European CoCo market is set to become like the US bank Tier 1 market (also known as US Preferreds), whose bonds trade solely on a pure call economics basis.

### c/ Carry shall be king




*Note: we have used solely €-denominated CoCos for this illustration, which are sorted by their call dates.*
*Sources: La Française, Bloomberg. Data as of 15/03/2022. Prices are purely indicative.*

On the chart above, we have compiled the average theoretical coupons for € CoCos, should NONE OF THEM be called at their first call date. We have used the euro forward swap rates, along with the average "reset spreads" in order to show that **investors would still get coupons above 6-7% for the next call vintages to come. This can be seen as a floor on the carry that you can get on these products.** This serves to prove that exercising calls is effectively equivalent to lowering the average theoretical carry on the segment, as calls can only come at a lower spread.

**In the end, we think that it is necessary to treat non-calls for what they should be: non-events for the segment. The intricacies of exercising calls are a matter of market pricing as soon as CoCos are being issued but are definitely not a matter of reputation for the issuer.** Pricing CoCos and their call probabilities is still more an art than a science and CoCo investors, such as us at La Française Asset Management, can still add value by selecting bonds that may not be called, but whose carry or price convexity may still prove relevant for a portfolio.

**Conclusion: some CoCos won't be called at their first call date. That is a fact that should not cause that much of a commotion. We do not expect any real market reaction, as non-calls are already being discounted for by a majority of CoCos. Remember that CoCos remain a carry product and that not being called means that you still get a very decent carry on the new coupon. Should no CoCo be called in S2 2022 and 2023, we would still get at least €6-7% coupons on average for the newly-reset bonds, which would still be very comfortable, in our view.**

**Jérémie Boudinet, Credit Portfolio Manager**

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