Markets

Credit Suisse Crisis

Why $17 Billion in Credit Suisse 'CoCos' or AT1s Got Wiped Out in UBS Takeover

What Does the UBS-CS Deal Mean for the Bond Market?

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They're called contingent convertible bonds, or CoCos – and are often described as high-yield investments with a hand grenade attached. The takeover of Credit Suisse by UBS Group AG included pulling the pin on $17 billion of CoCos, which are also known as Additional Tier 1 (AT1) bonds. This is in keeping with the idea behind the birth of CoCos in the wake of the European debt crisis. CoCos are the lowest rung of bank debt, meaning that while they produce juicy returns in good times, they're designed to be among the first to feel pain if a bank's troubles get bad enough. The vaporizing of Credit Suisse's CoCo debt will strengthen the balance sheet of the newly combined bank – but could spell disaster for the wider CoCo market.

1. What is a CoCo bond?

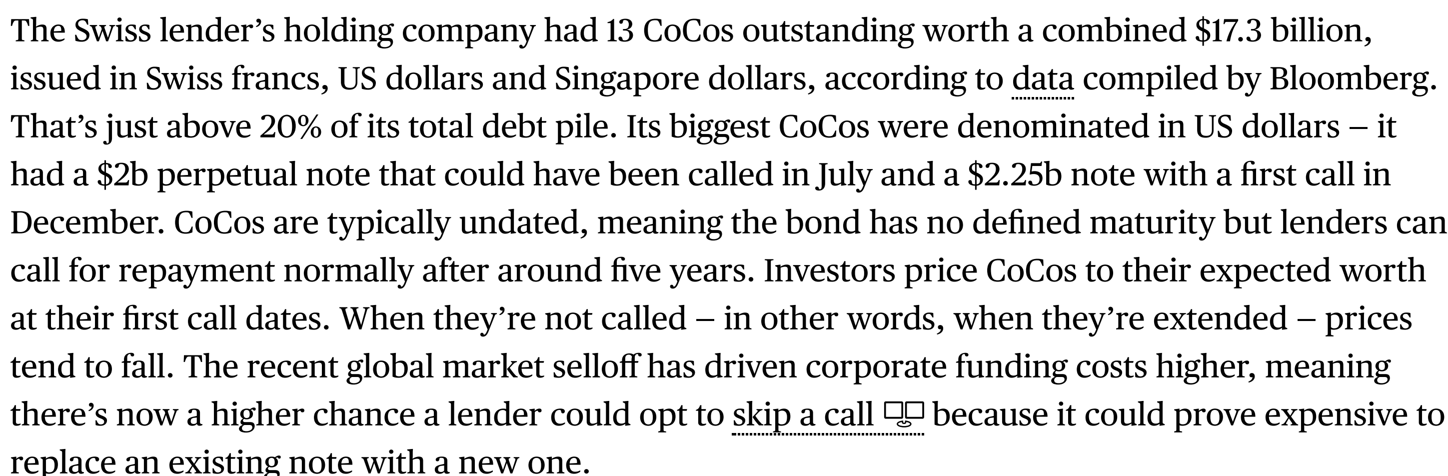
They're essentially a cross between a bond and a stock that helps banks bolster capital to meet regulations designed to prevent failure. They're contingent in the sense that their status can change if a bank's capital levels fall below a specified level; they're convertible because in many cases they

can be turned into equity – shares of the bank – if the shortfall gets big enough. In other cases CoCos are written down in whole or in part.

2. What are CoCos for?

They make up part of a buffer of debt and equity that's intended to prevent taxpayers from having to shoulder the bill for a bank's collapse. When they were dreamed up, CoCos were seen as giving banks a potentially bigger capital cushion without forcing them to issue new stock, amid concern in that many were over-leveraged. For regulators, CoCos are a way for banks to be pulled back from the brink without the cost falling on taxpayers and without diluting existing shareholders. CoCos are also known as Additional Tier 1 (AT1) bonds.

3. How many did Credit Suisse have?



The Swiss lender's holding company had 13 CoCos outstanding worth a combined $17.3 billion, issued in Swiss francs, US dollars and Singapore dollars, according to data compiled by Bloomberg. That's just above 20% of its total debt pile. Its biggest CoCos were denominated in US dollars – it had a $2b perpetual note that could have been called in July and a $2.25b note with a first call in December. CoCos are typically undated, meaning the bond has no defined maturity but lenders can call for repayment normally after around five years. Investors price CoCos to their expected worth at their first call dates. When they're not called – in other words, when they're extended – prices tend to fall. The recent global market selloff has driven corporate funding costs higher, meaning there's now a higher chance a lender could opt to skip a call because it could prove expensive to replace an existing note with a new one.

4. Why were Credit Suisse's CoCos wiped out?

UBS has agreed to buy Credit Suisse in a government-brokered deal aimed at containing a crisis of confidence that threatened to cascade across global financial markets. Because of the extraordinary government support, it will trigger a "complete write-down" of the bank's AT1 bonds in order to increase core capital, Swiss financial regulator FINMA said in a statement on its website. In simple terms, banks need to meet a minimum requirement for the amount of their own funds and eligible liabilities, more commonly known as MREL, to support an effective resolution in the event of a collapse. If a lender's capital ratios fall below a predetermined level, then CoCos can be written down.

5. Had investors been worried about a writedown?

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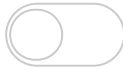

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Yes. Prices on Credit Suisse's CoCos had flip-flopped in the hours leading up to the announcement of a deal with UBS as traders weighed two contrasting scenarios: either the regulator would nationalize part or the whole bank, possibly writing off Credit Suisse's AT1 bonds entirely, or a UBS buyout with potentially no losses for bondholders. In the end, it ended up being a bit of both, after the government stepped in to facilitate the merger. Given that all of Credit Suisse's outstanding CoCos are writedown ones rather than the type that can be converted in to equity, the risk of losses was always there. Investors had been concerned that a so-called bail-in would result in the AT1s being written down, while senior debt issued by the holding company, Credit Suisse Group, would be converted into equity for the bank. Credit Suisse Group AG had about 78 billion Swiss francs ($84 billion) of holding company debt that includes both types of notes. Bail-in-able notes were devised a few years after CoCos emerged. They do the opposite of a bail-out – impose losses rather than bringing in aid.

6. Why are some bondholders angry?

In a normal writedown scenario, shareholders are the first to take a hit before AT1 bonds face losses, as Credit Suisse also guided in a presentation to investors earlier this week. However, under the terms of the government-brokered deal, Credit Suisse shareholders are set to receive 3 billion francs. That's provoked a furious response from some of the AT1 bondholders as it hasn't accounted for the seniority of CoCos over the lender's shares in the capital structure. And that's a big problem for a market that would expect holders to be paid before shareholders.

7. How does this impact the wider CoCo market?

The decision to ignore market convention – that shareholders are the first to take a hit before AT1 bonds face losses – could prove to be a huge blow to the $275 billion AT1 market and raises serious doubts about the prospects for other lenders' CoCos. To compound the misery, it's also the market's biggest loss, far eclipsing the one other instance of a lender's CoCos being wiped out. Back in 2017, junior bondholders of Spanish lender Banco Popular SA suffered an approximately €1.35 billion loss when it was absorbed by Banco Santander SA to avoid a collapse after failing to plug a big capital hole. On that occasion, the equity was also written off, while regulators forcibly wrote off its CoCos. Credit Suisse's writedown is far bigger and must raise serious questions about what comes next for the market. The huge uncertainty is likely to weigh on lenders' bond prices right across the ratings spectrum. Uncertainty about the health of several lenders in recent weeks had already weighed on CoCo bond prices, with the average AT1 now indicated at a price of just 82% of

face value, one of the steepest discounts on record. Yields on Credit Suisse's CoCos had surged to distressed levels in recent days.

The Reference Shelf

- QuickTakes on how perpetual bonds are rocking credit markets and worrying regulators.
- A primer on CoCos from the Bank of International Settlements.
- Andrew Haldane from the Bank of England and Piergiorgio Alessandri of the Bank of Italy set out the theoretical case for CoCos in a 2009 paper. Haldane, the BOE's chief economist, described them in a speech in 2011.
- QuickTakes on Capital Requirements and Too Big to Fail.
- The EU's Capital Requirements Directive.

– With assistance by Colin Keatinge, Ronan Martin and Paul Cohen

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