

Asset Risk: Contingent C

NOVEMBER 17, 2009

As doubts linger over the payment of coupons on the hybrid capital of various British banks, BRAVE Partners is told that Contingent Capital is the new black. Is it the new black or the new black hole?

A structure for all occasions

Hybrid capital was a wonderful instrument for everyone. Cheap Tier 1 capital for financial institutions, rich bonds for investors (because a bank would never not pay a coupon, regardless of what the documents say), a trading profit for hedge funds who would subscribe to the new issue and flip to the real money investors and good fees for the banks. Too bad that the financial crisis has ruined the party.

In a previous commentary: “Mr. Bond we have been expecting you”, BRAVE Partners noted that some pension funds were discovering the impact that arises because the banks really don’t have to pay the coupon on their hybrid capital. In some cases the EU wishes to insist that the banks do not pay – which is perhaps a little rich as Credit Lyonnais was one of the precedent setters, paying the dividend on its preference shares even after being bailed out by the French government.

Not hybrid - Contingent

The basic idea of hybrid capital was that it turned into something like equity at times of stress. The details were different in each case, but in a nutshell a hybrid bond did not pay a coupon in times of financial stress for its issuer. The only problem was that it was bought, and therefore priced, on the assumption that this would never happen. As any good lawyer will tell you: “if all sides agree that something should never happen, then put it in the docs – no one should object”. Well, in this case the regulator would have objected and the instrument would not have contributed to Tier 1 capital.

So, the response to the demise of the hybrid bond is to make the financial nature of the instrument more explicit. Contingent Capital is emerging as the new innovative Tier 1 instrument. Here the deal is simple: An investor buys a bond, it pays coupons. On a pre-specified stress event, such as the Tier 1 capital ratio of the issuer falling below 5%, the bond converts to common equity.

The basic idea of hybrid capital was that it turned into something like equity at times of stress. The details were different in each case, but in a nutshell a hybrid bond did not pay a coupon in times of financial stress for its issuer. The only problem was that it was bought, and therefore priced, on the assumption that this would never happen. As any good lawyer will tell you: “if all sides agree that something should never happen, then put it in the docs – no one should object”. Well, in this case the regulator would have objected and the instrument would not have contributed to Tier 1 capital.

Sellers – and buyers??

The instrument is simple and logical enough. BRAVE Partners can see the attraction for the sellers – but what about the buyers?

Sophisticated investors

There is certainly a class of sophisticated investors who would invest hard if they thought that the risk was priced well to the conversion probability and loss. However, these investors do not represent huge blocks of capital. They are nimble and opportunistic buying value, then selling when that value is realised. In order for this market to thrive, there must be some real money investor demand somewhere.

The real deal

The real money investor demand for long dated bonds tends to be life insurance companies and pension funds. These institutions have long dated, supposedly bond-like (although that is another story) liabilities. Trouble is that Contingent Capital is only bond-like some of the time – and in fact at times of stress it suddenly becomes not just equity like, but equity.

Forced sellers

Life insurance regulation would make it hard for a life insurer to hold bank equity. In short, at the point of maximum stress, a life insurance company would have to sell. This is never a winning strategy. Again pension funds who were relying on the coupon income and duration for their ALM needs might find themselves in the same boat.

Conclusion on contingent capital

Contingent capital is a sound idea. It makes explicit what was always implicit in hybrid capital: the fact that in times of stress the instrument is supposed to be equity and not debt. Moreover by converting to equity, the investor gets to participate in the potential upside of the institution emerging from a period of stress. This is certainly more attractive than the debt payout of a hybrid bond.

"Contingent capital is a sound idea. It makes explicit what was always implicit in hybrid capital: the fact that in times of stress the instrument is supposed to be equity and not debt. Moreover by converting to equity, the investor gets to participate in the potential upside of the institution emerging from a period of stress. This is certainly more attractive than the debt payout of a hybrid bond."

Christopher Cloke Browne,
Managing Partner,
BRAVE Partners LLP

But who are the investors?

At BRAVE Partners we can understand who the speculators might be in this market – in fact the partners have spoken to some. However, speculators need investors and it is tougher to identify the real investor base here. Hybrid capital was attractive to long term bond investors precisely because it obscured the true nature of the instrument. It was bought on the basis that the risk event would never happen. It is harder to suspend disbelief for Contingent Capital.

BRAVE Partner services

BRAVE Partners can assist life insurance companies and pension funds to identify, analyse and mitigate ALM mismatches in their asset portfolios.

Weekly distribution

If you enjoyed this commentary and would like to receive a weekly E-Mail highlighting the latest discussion at BRAVE Partners – then send an E-Mail to: commentary@bravepartners.com

- *Financial institutions are looking to move on from hybrid capital to another form of cheap Tier 1 capital.*
- *Contingent capital is being touted to fill the void, but this instrument makes the implicit risk of hybrid capital explicit.*
- *All of a sudden, it might not be so attractive to the traditional investor base.*

- *BRAVE Partners can assist pension funds and banks analyse and develop their ALM strategies.*

enquiries@bravepartners.com

www.bravepartners.com