In the wake of the financial crisis, policymakers redesigned the capital structures of banks to provide a more ready mechanism for bank recapitalization without government bailout funds. “Contingent capital,” or “CoCo” securities are one product of this redesign. These securities absorb losses via write-down or equity conversion when predetermined capital measures are breached and/or at the regulator’s discretion if it deemed the institution to be “nonviable.” As an untested asset class with complex features, CoCos offer high yields and have gained investor attention amid historically low interest rates. First issued in late 2009, we estimate that CoCos already comprise roughly 12% of the $875 billion global preferred securities universe, and we believe the market will continue to grow rapidly. This paper provides background on CoCos and discusses their potential benefits for investors.

Exhibit 1: Growth of the European Bank Market for CoCos

In € Billions


The chart above shows cumulative CoCo issuance in the European Bank market. See back page for additional disclosures.
Preferred Securities: Investing in CoCos

What are CoCos?
CoCos are an innovative type of bank capital, a new version of preferred or capital security, with explicit loss-absorbing features. CoCos were created to comport with the requirements of the Basel III guidelines issued by the Basel Committee on Banking Supervision in the wake of the financial crisis.(1) Like earlier versions of preferred or capital securities, CoCos typically sit above equity and below senior debt with respect to seniority. As such, they are designed to absorb losses before senior bank creditors are affected. The inclusion of new, explicit loss absorption features, which may include a capitalization-based “trigger,” creates what has come to be known as a contingent capital security, or CoCo.

CoCos are a new breed of bank capital security with unique loss-absorbing features.

The Evolution of Contingent Capital Securities
One of the central tenets of the Basel III guidelines is to prevent a repeat of the taxpayer-funded bank bailouts that occurred during the financial crisis. To help accomplish this, regulators have focused on a “bail-in” of the capital structure from equity and equity-like investors, as well as subordinated and senior debt holders, if necessary. Two new bail-in mechanisms have followed:

- Resolution regimes
- Contingent capital securities

Resolution regimes are legislated, government-led procedures for the wind down of a distressed financial institution without taxpayer support. Resolution regimes may provide for the write-down of even senior debt holders in order to recapitalize a foundering institution. Since Basel III guidelines must be interpreted and enacted at a national level, certain differences have emerged around the globe, with some countries choosing to implement both new mechanisms, while others have chosen to pursue only one.

The United States has enacted a resolution regime to process failing financial institutions outside of bankruptcy court, but the Federal Reserve has stopped short of requiring capital securities with explicit loss absorption features. Consequently, in the United States, banks may issue perpetual preferreds without explicit loss absorption language. Nevertheless, these securities will still be subject to the resolution regime, and hence, to a potential write-down should the regulator deem it necessary for bank recapitalization. By contrast, the European Union has been a proponent of both mechanisms, enacting a resolution regime and forcing the replacement of existing preferred and hybrid securities with CoCos. The rest of the world is somewhat mixed in approach, but most of the G-7 has opted for the use of some form of CoCo security.

(1) The Basel III guidelines are voluntary standards for the fundamental stability of banks agreed upon by members of the Basel Committee on Banking Supervision in 2010–11. They address capital adequacy, liquidity and potentially adverse scenarios in order to promote the overall health of the global financial system.
CoCo Features

CoCo features can exist within any security, even senior debt, but normally the host instrument is subordinated, and often perpetual, like other preferred or capital securities. There are an expanding number of structures in the CoCo market, but they can be separated by two main components:

- The trigger level and type of trigger
- The method for loss absorption

The defining characteristic of a CoCo is the trigger or the point at which the security can absorb losses. CoCo triggers can be “soft” or “hard” in format, and some CoCos feature both formats. Soft triggers may simply refer to a general “point of non-viability,” as determined by the regulator, as the tripwire for loss absorption. By contrast, the most common hard trigger is when a bank’s common equity ratio in relation to its regulatory risk-weighted assets falls below a specified level. Regulators generally characterize securities with hard triggers of this nature as being “going concern” or “gone concern” instruments. A going concern CoCo is meant to absorb losses at a bank that is still a viable or solvent institution, while a gone concern CoCo is expected to absorb losses at a nonviable or insolvent bank. Recently issued CoCos have generally had corresponding common equity ratios, a measure of a bank’s overall capital level, from 5.125–7%. For reference, we expect most banks issuing CoCos to have capital levels in the 10–14% context as they meet higher regulatory requirements, leaving most banks far from the trigger points.

The two methods for loss absorption are principal write-down and equity conversion. CoCos will either be written down or will convert to common stock of the bank if the trigger is breached. The write-down could be permanent or temporary, and it could be for the entire principal amount or for the amount necessary to return the bank to a solvent capital position. If the write-down is temporary, the principal amount of the CoCo can be recovered through bank profits over the years following a trigger breach. With an equity conversion CoCo, the extent of investor losses will depend on the stock price at which the CoCo is converted. It is possible that the stock received at the time of conversion will be worth less than the principal of the CoCo, making full recovery of the original investment dependent on future upside of the equity valuation.

Valuing CoCos—There is a great deal to say about CoCo valuation and analysis, much more than we can address in this paper. The trigger and loss absorption methods are just a start; like all preferreds, coupon cancellation may also be a risk, depending on the host instrument. Coupon cancellation is likely to occur well before capital triggers come into play. To simplify matters, from an investment standpoint, assuming all else being equal, a going concern instrument is more risky than one that is a gone concern, given that more capital would have to be eroded before the gone concern security is triggered. Additionally, equity conversion can be more favorable than a write-down. We note that risks associated with CoCos on the whole can be higher than those associated with non-CoCo preferreds, but, in some cases, this may not be the case. Notably, gone concern issues could present a similar outcome for an investor as a preferred that lacked a trigger, as a resolution authority could also lead to the write-down or equity conversion of the latter if a bank’s capital was eroded materially.

(1) The host instrument is the underlying security that would experience losses as a result of the activation of the contingent features, such as junior bonds, senior debt or a perpetual preferred security. (2) The common equity ratio is a measure of a bank’s core equity capital compared with its total risk weighted assets. The higher the ratio, the better the bank’s financial strength.
**Dramatic Market Growth and Opportunity**

Participation in the CoCo market appears to be selective but growing. Investors need time to become comfortable with the structure and may need to alter investment mandates to accommodate CoCo positions. Some fixed income managers, for instance, may be prohibited from investing in securities that could potentially convert to equity.

Two developments should help to broaden the investor base. The first is ratings agency coverage, which has historically improved investor interest. Ratings agencies have published their methodologies for rating CoCos and most issues are rated by at least one agency. The second is the roll out of indexes that specifically track the CoCo market. Indexes provide both the scope for active management and information about market behavior that can elicit investor interest.

Additionally, though today’s market is dominated by banks, we expect that future growth in CoCo issuance will come through the insurance sector. Europe is in the process of revamping the regulatory regime for its insurance companies via an initiative known as Solvency II. Implementation of the new regime is expected to begin in 2016, and it will require European insurers’ capital securities to have CoCo features as well. Other regions of the world, such as Asia Pacific, may also look to Solvency II as a template for regulating their insurance sectors, although this is not expected in the United States.

**Exhibit 3: CoCos Leading Preferred New Issuance Calendar in 2014**

2014 Total New Issuance by Type of Preferred

<table>
<thead>
<tr>
<th>Type of Preferred</th>
<th>Amount ($B)</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>CoCos</td>
<td>$49B</td>
<td>40%</td>
</tr>
<tr>
<td>Foreign Perpetual Preferreds</td>
<td>$33B</td>
<td>26%</td>
</tr>
<tr>
<td>U.S. Perpetual Preferreds</td>
<td>$25B</td>
<td>20%</td>
</tr>
<tr>
<td>Foreign Hybrid Preferreds</td>
<td>$19B</td>
<td>15%</td>
</tr>
<tr>
<td>U.S. Hybrid Preferreds</td>
<td>$2B</td>
<td>2%</td>
</tr>
</tbody>
</table>


Performance data quoted represents past performance. Past performance is no guarantee of future results.

New issuance calendar broken out by type of preferred security. CoCos include contingent capital securities with an explicit or “hard” trigger, but exclude those with a point of non-viability (PONV) trigger. CoCos with only a PONV trigger are included in the foreign perpetual preferreds or foreign hybrid preferreds buckets depending on whether or not the security has a stated maturity date. Foreign perpetual preferreds include preferred securities without a maturity date issued by non-U.S. companies. U.S. perpetual preferreds include preferred securities without a maturity date issued by U.S. companies. Foreign hybrid preferreds include subordinated debt instruments with a maturity date and the ability to defer interest payments if necessary, issued by non-U.S. companies. U.S. hybrid securities include subordinated debt instruments with a maturity date and the ability to defer interest payments if necessary, issued by U.S. companies. Issuance totals include both the institutional over-the-counter (OTC) and exchange-based retail markets. See back page for additional disclosures.

We expect better ratings agency transparency and the creation of CoCo indexes to support CoCo market expansion.
Why Invest in CoCos?

CoCos are a new and unique form of fixed income investment offering high income rates and, we believe, the potential for attractive total returns. The securities are complex, not well understood due to their short history and not captured in normal bond indexes. The market is also growing quite rapidly. While these characteristics clearly demand a wide risk premium, they also suggest investment opportunity. When managed actively in a diversified portfolio, we believe CoCos have the potential to offer investors many attractive characteristics.

**High rates of income**—CoCos can provide some of the highest yields among global fixed income securities. The Bank of America Merrill Lynch Contingent Capital Index yielded 6.6% at the end of June 2014, compared with 5.8% for the Bank of America High Yield Master II Index. While traditional high-yield bonds offer comparable levels of income, they often are issued by deeply speculative grade, highly cyclical companies. In contrast, the banks issuing CoCos are generally systemically important, highly regulated and often rated investment grade at the senior debt level.

CoCos offer unique features and benefits that can enhance income, reduce interest-rate risk and provide broad portfolio diversification.

### Exhibit 4: Current Yield Comparison

<table>
<thead>
<tr>
<th>Category</th>
<th>Investment-Grade</th>
<th>Below-Investment-Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Securities</td>
<td>5.7</td>
<td>6.6</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td>3.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>3.4</td>
<td>5.8</td>
</tr>
<tr>
<td>10-Year Treasury</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>Contingent Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High-Yield Preferred Secs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High-Yield Bonds</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


*Performance data quoted represents past performance. Past performance is no guarantee of future results.*

Preferred securities are represented by the BofA Merrill Lynch Fixed-Rate Preferred Securities Index. Corporate bonds are represented by the BofA Merrill Lynch Corporate Master Index. Municipal bonds are represented by the BofA Merrill Lynch Municipal Master Index. 10-year Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year, but not more than 10 years. Contingent capital is represented by a U.S. dollar subset of the BofA Merrill Lynch Contingent Capital Index. High-yield preferred securities are represented by the BofA Merrill Lynch High Yield Fixed Rate Preferred Securities Index. High-yield bonds are represented by the BofA Merrill Lynch U.S. High Yield Master II Index. Current yields are shown on a yield-to-maturity basis. See back page for index definitions and additional disclosures.
Attractive compensation for subordination in the capital structure—Rightfully so, CoCos offer a greater subordination premium than traditional subordinated debt or non-CoCo perpetual preferred securities. The subordination premium is measured by the credit spread differential between the subordinated instrument, the CoCo and the senior debt of the issuer. While a large subordination premium is warranted, recent premiums have been a multiple of senior debt spreads. In many cases, we believe that the additional credit spread more than compensates for the additional risks. It is our view that a portion of the greater credit spread compensation can be ascribed to a “complexity premium” associated with the newness of the CoCo market. We expect CoCo spreads to compress as the market grows and gains greater acceptance among investors.

Better management of interest-rate risk—Similar to other types of preferreds in the institutional over-the-counter (OTC) market, CoCos have characteristics that allow for more effective management of interest-rate risk. The coupon rate tends to float or reset at the call date, normally 5-to-10 years after issuance, thus offering lower durations than traditional preferred securities. Additionally, CoCos’ high-current income and wide credit spreads relative to traditional government and corporate bonds may provide a cushion against the impact of rising rates. Finally, many CoCos are issued in non-U.S.-dollar currencies, which can provide a way to diversify interest-rate risk, as countries’ economies may be at different points in the interest-rate cycle compared to the United States.

Exhibit 5: Duration

<table>
<thead>
<tr>
<th></th>
<th>Investment-Grade</th>
<th>Below-Investment-Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Securities</td>
<td>Corp. Bonds</td>
<td>Muni Bonds</td>
</tr>
<tr>
<td>Modified Duration</td>
<td>8.1</td>
<td>6.7</td>
</tr>
</tbody>
</table>


Performance data quoted represents past performance. Past performance is no guarantee of future results.

Preferred securities are represented by the BofA Merrill Lynch Fixed-Rate Preferred Securities Index. Corporate bonds are represented by the BofA Merrill Lynch Corporate Master Index. Municipal bonds are represented by the BofA Merrill Lynch Municipal Master Index. 10-year Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year, but not more than 10 years. Contingent capital is represented by a U.S. dollar subset of the BofA Merrill Lynch Contingent Capital Index. High-yield preferred securities are represented by the BofA Merrill Lynch High Yield Fixed Rate Preferred Securities Index. High-yield bonds are represented by the BofA Merrill Lynch U.S. High Yield Master II Index. Modified duration is shown on a modified duration-to-worst basis. See back page for index definitions and additional disclosures.

CoCos are primarily fixed-to-float or reset structures, with much lower durations until their call dates.

Participation in fundamental improvements at banks and insurance companies—Bank fundamentals have improved dramatically since the financial crisis, particularly with respect to asset quality and capital metrics. We expect this progress to continue, led by regulatory requirements that are considerably more stringent than pre-crisis standards. Considering that they are issued by financial institutions, CoCos provide a way for investors to benefit from the constructive changes occurring in the sector. The positive trend in bank fundamentals is further enhanced by recovering global economies. CoCos may be a source of enhanced total returns to the extent that they are issued by financial institutions in these improving regions. We believe insurance companies will also issue CoCos in coming quarters, which may provide additional investment opportunities. CoCo investors may also realize diversification benefits, particularly when combined with high-yield bonds, which offer scant investment opportunities in the improving financials sector.
The institutional OTC market offers greater access to a wider variety of structures.

Our Closing Perspective

In closing, the adoption of Basel III guidelines globally has led to significant CoCo issuance in recent quarters. We expect this issuance to continue and even accelerate as more banks seek to meet the new capital requirements and as the CoCo investor base grows.

CoCos offer unique features relative to traditional preferreds in that they contain triggers tied to the issuer’s financial health. CoCos also require high rates of income to compensate investors for equity conversion or write-down features, as well as a “complexity premium.” In view of our constructive outlook for bank fundamentals driven by regulatory and economic tailwinds, we find that many securities offer attractive compensation for the increased subordination in the capital structure and loss-absorbing features. Many CoCos also have lower-duration structures that allow for more effective management of interest-rate risk.

At Cohen & Steers, we believe the best way to access opportunities in the preferred securities market is through an actively managed portfolio. As an institutional investor, we can access the entire preferred securities marketplace, including CoCos and other OTC issues, securities rated below-investment-grade and issues denominated in foreign currencies. As an active manager, we can construct a more diversified portfolio with the potential for attractive income, while actively managing credit and interest-rate risks.

Our team is uniquely qualified to invest in CoCos based on our dedicated expertise that spans more than a decade in the preferred securities market. We seek to add value for our clients through a superior understanding of the credit, interest-rate and security structure risks associated with the market. As the preferred securities landscape continues to evolve, we expect new structures such as CoCos to be featured in our open- and closed-end mutual funds and for separately managed accounts.
An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

The BofA Merrill Lynch Contingent Capital Index tracks the performance of all contingent capital debt publicly issued in the major domestic and Eurobond markets, including investment-grade and sub-investment-grade issues.

The BofA Merrill Lynch Corporate Master Index tracks the performance of USD-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

The BofA Merrill Lynch Fixed-Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market.

The BofA Merrill Lynch High Yield Fixed Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market.

The BofA Merrill Lynch Municipal Master Index tracks the performance of USD-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

The BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of USD-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.

The 10-year Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year, but not more than 10 years.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

The views and opinions in the preceding commentary are as of the date of publication and are subject to change without notice. This material represents an assessment of the market environment at a specific point in time, should not be relied upon as investment advice, is not intended to predict or depict performance of any investment and does not constitute a recommendation or an offer for a particular security. We consider the information in this presentation to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment. Investors should consult their own advisors with respect to their individual circumstances. There is no guarantee that any historical trend illustrated herein will be repeated in the future, and there is no way to predict precisely when such a trend will begin. There is no guarantee that a market forecast made in this commentary will be realized.

Risks of Investing in Preferred Securities

Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations.

In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights.

Preferred securities may be rated below investment-grade or may be unrated. Below-investment-grade securities or equivalent unrated securities generally involve greater volatility of price and risk of loss of income and principal, and may be more susceptible to real or perceived adverse economic or competitive industry conditions than higher-grade securities.

Risks associated with preferred securities differ from risks inherent with other investments. In particular, in the event of bankruptcy, a company's preferred securities are senior to common stock but subordinated to all other types of corporate debt. Throughout this commentary, we make comparisons of preferred securities to corporate bonds and 10-year Treasury bonds. It is important to note that corporate bonds sit higher in the capital structure than preferred securities, and therefore in the event of bankruptcy, will be senior to the preferred securities. 10-year Treasury bonds are issued by the U.S. government and are generally considered the safest of all bonds since they are backed by the full faith and credit of the U.S. government as to timely payment of principal and interest.

This commentary must be accompanied by the most recent Cohen & Steers fund fact sheets if used in connection with the sale of mutual fund shares.

About Cohen & Steers

Founded in 1986, Cohen & Steers is a leading global investment manager with a long history of innovation and a focus on real assets, including real estate, infrastructure and commodities. Headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle, Cohen & Steers serves institutional and individual investors around the world.

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