DEBT CAPITAL MARKETS

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Sector is braced for volatility

The industry is busy embracing issues from the impact of quantitative easing to the emergence of a bond bubble, writes **Jennifer Hughes**

Debt capital markets are rarely dull, since their sheer breadth and variety means that if one corner is quiet, something is heating up somewhere else.

Yet, this year it is fair to say there is hardly a corner that has not seen interest.

From the debate raging about the impact of quantitative easing via questions over the emergence of a bond bubble, particularly in emerging markets, to the argument over the role that borrowing plays in capitalising banks, debt-related themes are rarely far from the headlines.

The looming year-end provides a natural break-point where participants can look forward to the coming year. At the moment, most expect an extension of this year's trends.

Financial Markets series

"The immediate future looks like it will continue to be a period of low interest rates, which will be constructive for the credit market and for those looking to raise funds," says Miles Millard, global head of debt capital markets at Deutsche Bank.

Risks to this benign scenario would include a pick-up in growth that might raise inflation expectations – potentially causing central banks to tighten policy more quickly than expected and sending bond yields leaping in the process.

"Those are potential threats, but I don't think many people have a particularly strong conviction that these are likely to affect the market soon," says Mr Millard.

If there has been a quiet corner this year, it has perhaps been investment-grade corporate debt. Last year saw record volumes, as companies took advantage of investor appetite for non-equity investments and the subsequent slide in borrowing costs to bolster their balance sheets, as they emerged from the depths of the financial crisis.

This year the negative cost of carry – the gap between a company's borrowing costs and what it can earn on cash deposits – has led executives to look for new ways to tap the attractive terms on offer. Some have raised funds to buy back older, more expensive, debt while others have been looking to swap existing debt for longer-dated paper or to finance equity buy-backs.

"All these trends we expect to continue," says Christopher Marks, European head of debt capital markets at BNP Paribas, who also expects a series of smaller companies, even without ratings, to debut in the markets.

New names traditionally crop up in the fourth quarter, as investors seek different opportunities,

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Sector braced for volatility

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but this could also be a trend for coming year.

Mr Marks adds: "This is not only an ongoing move by companies away from relying on bank financing, but also a sustained interest from investors who are mindful of pressures on public finances in several European jurisdictions."

That said, the ultra-low interest rate environment has produced record low corporate borrowing costs for the largest companies.

Recently Walmart, the US supermarket group, issued $750m three-year bonds with a coupon of 0.75 per cent and five-year notes at 1.5 per cent. Colgate-Palmolive soon beat that; its five-year notes offered an interest rate of 1.375 per cent.

Low-coupon notes – those offering less than 5 per cent – are now making up more than half of issuance. In the third quarter, before the Federal Reserve announced its new $600bn bond-buying programme, low-coupon bonds made up 57 per cent of those issued – the highest percentage on a record going back to 1970, said Thomson Reuters.

Low coupons among the more established household names have led to a return to one of the bond market's favourite themes: the search for yield.

Emerging markets and high-yield bonds saw record issuance in the third quarter. For the year to date, issuance in the two sectors stood at $514bn and $221bn respectively – also a record, according to Thomson Reuters.

At its more extreme, the yield search has encouraged issuers to offer ultra-long-dated bonds, including a $350m 100-year, or "century" deal from Rabobank, the Dutch mutual and, in the biggest century, $1bn from the Mexican government.

Pension funds and others with long-dated liabilities have gobbled up the deals, which the cynics have nicknamed the "somebody-else's-problem" bond.

Low yields have not been enough to resuscitate the securitisation market, however. While issuance of ultra-safe covered bonds has reached record levels, the regular market has emerged from its frozen crisis state only very slowly, leaving the market as something bank treasurers can tap occasionally for funding, but not one they can yet rely on.

Capital buffer: Swiss regulators have called on UBS to raise billions in Cocos Bloomberg

For bank treasuries in general, it has been a tricky year and the outlook is not much clearer. A virtual freeze in the European market for senior unsecured debt – the bread-and-butter of a bank's borrowing plans – in May and June was an uncomfortable reminder that conditions are still far from their pre-crisis norms.

Bank executives have also been wrestling with regulators' plans to reform the role of debt, notably hybrid bonds.

Policymakers have made it clear bondholders will be expected to share in the pain in an effort to ease the burden on the taxpayer and to encourage investors to better price the risks they take.

But how best to do this?

Ideas include contingent capital, improved subordinated bonds that convert to equity when a pre-defined trigger is breached, or bail-in, the notion that all bondholders, including senior noteholders, could be forced into losses by regulators if a bank needed to be recapitalised.

> 'Banks are becoming a very positive credit story right now if you think about it'

Recently, Swiss regulators backed contingent capital, commonly known as Cocos, calling on Credit Suisse and UBS to raise billions in contingent capital to provide a buffer. Other regulators are waiting for guidance from the Basel committee of banking supervisors, which is studying the issue.

Whichever way it goes – and the two solutions are not mutually exclusive – bankers are expecting a slew of hybrids in some form next year.

"Banks are becoming a very positive credit story right now if you think about it," said Sandeep Agarwal, head of European financial institutions debt capital markets at Credit Suisse.

He adds: "All the regulatory focus on equity and capital means anyone in the debt structure should feel safer. They don't, because of recent history; but that's just what it is – history, notwithstanding the risks posed by sovereign issues currently in the market."

Risk-taking rises, as the search for yield goes on

Slim pickings: alternatives for investors are limited Dreamstime

Returns

Richard Milne considers investors' options in a low interest rate environment

This past year for investors in capital markets can be summed up in one phrase: the search for yield.

With the perceived risk-free rates offered by US, UK or German government bonds at or close to record lows, investors wanting decent returns have had to go elsewhere to find yield.

That in turn has sent the interest rates for emerging markets and the lowest-rated companies lower and lower.

"Yield is becoming a very scarce commodity," says Johan Jooste, a strategist at Merrill Lynch Wealth Management. Gary Jenkins, head of fixed income at Evolution Securities, adds: "Either we are going to have to get used to lower returns or people are going to have to take more risk."

> 'Either we are going to have to get used to lower returns or people are going to have to take more risk'

So far, it looks like most investors are plumping for the latter option and heading into the riskier parts of the debt markets.

Total returns for the riskiest companies, those rated CCC by rating agencies, have totalled 16 per cent this year, compared with just 7 per cent for the safest AAA-rated companies, according to Citi.

The big question is how dangerous this hunt for yield is. For some investors, the weak state of most western economies justifies a focus on credit. Abdullah Sheikh, director of research at JPMorgan's strategic investment advisory group, says: "Asset classes that may well outperform during periods of anaemic growth and moderately low inflation seem to be, while not obvious, those in the fixed-income universe."

Another argument in favour of the search for yield is that while absolute interest rates paid by high-yield companies or emerging markets are low, the spreads – the difference between the yields and the risk-free rate of US Treasuries – are in line with historical averages.

The problem for many asset managers is that the return targets they use to attract investors are still mostly absolute rather than relative ones. Thus, many funds still have 6-8 per cent targets, although that now implies a much higher return relative to government debt.

Mr Sheikh says the problem of too high return targets is "front and centre in people's minds. Potentially, we are in a new paradigm where the passive 8 per cent number is too high".

The head of one of the world's largest insurers, and by extension one of the biggest investors, says the result is panic, as investors try to ignore the implications of their targets.

This person says: "Asset managers are panicking, absolutely panicking. The margin for error is gone. Before, you could make a few errors and still earn 8 per cent. Now, if you make an error you are below the benchmark, and the benchmark today is zero."

That is where the biggest worries come from. Investors are now chasing lower and lower yields. The EMBI+ emerging market index reached 2.31 percentage points over US Treasuries in early November, compared with 9 percentage points 18 months ago.

It is far from certain that all investors are comfortable with what they are buying. A leading emerging-markets banker says: "It is unsustainable. They are buying things that they tell you they don't like. We can't hit records every month for yields or flows."

Rod Davidson, head of fixed income at Alliance Trust Asset Management, is steering clear of high-yield. He says: "We think at the moment that the additional yield isn't sufficient for the additional volatility you take on."

Still, the alternatives for investors are slim in a world of uncertainty. Mr Sheikh highlights the "persistent reluctance" of many investors to buy equities. With a double-dip recession at the moment looking relatively unlikely, bondholders are taking comfort from low levels of company defaults.

Some, however, are starting to think about what to hold when the hunt for yield comes to an end.

Hans Lorenzen, credit strategist at Citi, says: "The reach for yield in 2011 may be inevitable, but, at these lofty levels, think twice about what you choose to hold on to – it's a long way down."

Or, as Mr Jooste says, be aware of who is holding the risk in this search-for-yield environment: "It is very much an issuers' market, not an investors' one."

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Achieving more together

Fed seeks ‘wealth effect’ with bout of QE2

US

The central bank is flirting with inflation as it tries to ensure a robust recovery, says **Michael MacKenzie**

For some time, buyers of US government bonds have debated whether low yields are symptomatic of a nascent “bubble”. Now, with the Federal Reserve buying more Treasuries, key benchmark yields have hit record lows and are set for further declines.

Under the Fed’s second round of quantitative easing, dubbed QE2, the central bank will buy $600bn of Treasury debt until the end of next June. That buying will come on top of some $300bn in additional Treasury purchases from the Fed, as it reinvests the proceeds from maturing mortgage bonds back into government bonds.

The underlying rationale of the Fed’s policy action is to lower Treasury yields, force banks to lend money and push investors out of government debt into riskier securities. A further rally in equities and other risk assets translates into a “wealth effect” on consumers and companies. This, in turn, it is hoped, will boost confidence and stimulate economic activity.

“The Fed wants to push cash into risky assets such as stocks which, it is hoped, will facilitate a virtuous cycle of spending, investment, and hiring,” says Eric Green, chief US rates strategist at TD Securities.

All told, the bond market expects the Fed will be buying some $110bn of Treasuries each month, an amount that will offset monthly sales of new debt by the US Treasury. The Fed will target 86 per cent of its impending purchases in the 2.5-year to 10-year sector of the market.

That supply and demand equation should result in lower yields out to the 10-year sector of the market, as this is where the Fed is targeting the bulk of its buying.

‘The Fed’s buying puts a floor under the market but it is not a guarantee’

Rick Klingman, Managing director at BNP Paribas

Not surprisingly, yields on two-, three-, five-, and seven-year Treasury notes have recently fallen to record lows since the Fed announced QE2. Analysts at Deutsche Bank believe yields for the five-year – currently at 1.45 per cent – and less can compress towards 0.50 per cent.

However, against the backdrop of having the Fed as a big buyer of Treasuries and supporting the market, there are risks.

“The Fed’s buying puts a floor under the market, but it’s not a guarantee,” says Rick Klingman, managing director at BNP Paribas.

“If we get a string of stronger data, there is a chance that the Fed decides to ease back on buying bonds and you will see 10-year rates rise pretty quickly,” he says.

After signs of solid private-sector hiring in the October unemployment report at the start of November, the yield on the benchmark 10-year note sits at 2.85 per cent. Since the start of QE2, the benchmark yield has not been able to break its October low of 2.33 per cent.

Many in the bond market expect that as QE2 unfolds, the benchmark yield will fall towards 2 per cent and eclipse its modern low of 2.04 per cent, set in December 2008 at the height of the financial crisis.

With the Fed buying more 10-year paper than the US Treasury will sell through to June, Deutsche Bank, for example, targets 2 per cent on 10-year yields by early 2011.

But the success of QE2 depends on boosting growth and inflation, a combination that will also push long-term yields much higher.

“The real message is that the Fed will do what it takes to ensure a robust recovery and it doesn’t mind if this leads to a dose of inflation,” says David Shairp, global strategist at JPMorgan Asset Management.

Evidence of rising inflation will weigh more on long-term Treasuries and other long-term bonds, as their fixed returns are at the greatest risk of being eroded over time by a climate of rising prices.

All of this suggests that bond investors, who have flocked to the sector in the past two years – thus raising the spectre of a “bond bubble” – are best served by selling out to the Fed and subsequently steering clear of bonds in case inflation rises.

“‘Don’t fight the Fed’ is a valuable maxim that investors have come to recognise over the almost 100 years of the central bank’s existence,” says George Goncalves, head of rates strategy at Nomura Securities.

“Our version of this adage is: ‘Don’t join the Fed, sell it your Treasuries’,” he adds.

Scene set for new era of M&A and leveraged buy-outs

Dealmaking

Activity raises the risk for bondholders of releveraging, writes **Anousha Sakoui**

The recovery in credit markets over the past year has set the scene for the return of M&A and leveraged buy-outs.

Their volumes are already rising, but the return of dealmaking has raised the risk for bondholders of the releveraging of borrowers.

When it emerged in July that the two controlling shareholders in Abertis, along with private equity group CVC, were working on a leveraged buy-out of the Spanish infrastructure group, it reminded the market once again of the risks to bondholders.

The company’s bonds fell in value in reaction to the news. Its 2016 bonds had been trading steadily at €102.16 just before the deal was announced, but dropped to €89.50 on the news – a price below par, indicating investors’ fear they will not be repaid in full when the bonds mature.

Investors were spooked and some were prompted to re-examine the covenants on their debt – the protection they have against suddenly finding themselves lending to a riskier entity.

Giles Hutson, head of EMEA Corporates, Debt Capital Markets at Bank of America Merrill Lync, says: “The use of proceeds from the financings we are executing is moving slowly from a pay-down of debt into a general corporate purposes, capex, or dividend recap, type transaction. The shift is not extreme, but it is happening and has implications for bondholders in 2011.”

The value of M&A deals worldwide reached $1.75bn during the first nine months of 2010, a 21 per cent increase on the same period last year, according to data from Thomson Reuters.

A potentially greater risk for bondholders is the rising number of leveraged buy-outs, which has rebounded from a 25-year low last year.

There was £12.5bn ($19.9bn) of private equity deals in the UK in the year to September, up from £4.7bn in the same period last year, according to research from the Centre for Management Buy-out Research at Nottingham University.

Buy-outs are typically negative for bondholders of a target company because private equity firms more often use high levels of debt to fund acquisitions.

> ‘Corporates will use cash and new debt to pay for acquisitions, rather than shares; debt financing is currently cheap’

However, bondholders do not necessarily have reason to worry. Mr Hutson thinks corporate balance sheets are in very good shape, particularly among large caps.

He says: “I’m not concerned for bondholders overall, because the lack of bond supply and the liquidity on corporate balance sheets is unprecedented and will support spreads. On single-name basis, there are potential examples of releveraging and that may put pressure on ratings.”

Valentijn van Nieuwenhuijzen, head of strategy in ING Investment Management’s Strategy & Tactical Asset Allocation Group, says the pick-up in dealmaking could be a positive sign for credit investors.

“We are seeing a releveraging in corporate credit, with more M&A but the amounts involved indicate this is just the early stages,” says Mr van Nieuwenhuijzen.

He adds: “If it increases then it will also demonstrate an increase in corporate confidence, which is positive for credit.” Moreover, he says, so far 60 per cent of M&A deals are being financed out of cash.

“At some point, improved confidence combined with an increase in equity financing could be a sweet spot for bondholders,” says Mr Van Nieuwenhuijzen. “But there will probably be some releveraging and capex that may be a risk for bondholders in 2012.”

Hakan Wohlin, co-head of European debt capital markets at Deutsche Bank, believes that next year more companies will use bond markets to fund acquisitions.

“Corporates will use cash and new debt to pay for acquisitions, rather than shares. Debt financing is currently cheap, and a lot of companies have cash on their balance sheet that they need to put to work,” says Mr Wohlin.

In recent months, companies such as IBM, Johnson & Johnson and Coca-Cola have secured some of the lowest ever costs of bond market funding.

However, Mr Wohlin does not believe companies will put at risk their long-term credit ratings to do deals, and does not expect a pick-up in M&A to lead to a big increase in leverage.

He says: “Some companies’ ratings may be under short-term pressure as a result of an acquisition, but they will be disciplined and won’t trade away good ratings to do a deal.

“They will keep within a long-term rating perimeter,” he says. “Companies won’t give ratings up and they don’t have to.”

Mr Wohlin believes companies may look to alternative financing routes such as hybrids for funding. “Many are considering these,” he says.

In recent months there has been a revival in the sale of corporate hybrid bonds. These can count as equity from a credit perspective, and have been used by companies such as Scottish and Southern Energy, which in October raised £1.2bn with a hybrid bond issue to help shore up its credit rating.

Alternative financing routes: Scottish and Southern Energy raised £1.2bn in October with a hybrid bond issue to help shore up its credit rating PA

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EUR 300,000,000	EUR 150,000,000	EUR 330,000,000 USD 250,000,000	EUR 700,000,000	EUR 1,500,000,000
Senior Bond 4.125% due 2017 Non-rated	Senior Bond 5% due 2017 Non-rated	due 2015/17 Issue Rating B3/B	Senior Bond 4.000% due 2016 Issue Rating Baa2/BBB-	2-Tranche Senior Bond due 2017 & 2025 Issue Rating A3/A-
Joint Bookrunner	Joint Bookrunner	Joint Bookrunner	Joint Bookrunner	Joint Bookrunner
October 2010	October 2010	October 2010	October 2010	September 2010

Lenzing	Renault	Continental	Alstom	Rheinmetall
EUR 120,000,000	EUR 650,000,000	EUR 1,250,000,000	EUR 1,000,000,000	EUR 500,000,000
Senior Bond 3.875% due 2017 Non-rated	High Yield Bond due 2015 (including tap) Issue Rating Ba1/BB	2-Tranche High Yield Bond due 2016 & 2018 Issue Rating B1/B	2-Tranche Senior Bond due 2015 & 2018 Issue Rating Baa1/BBB+	Senior Bond 4.0% due 2017 Issue Rating Baa3
Sole Bookrunner	Joint Bookrunner	Joint Bookrunner	Joint Bookrunner	Joint Bookrunner
September 2010	September 2010	September 2010	September 2010	September 2010

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Samurais make a comeback

Japan

Volumes have come back even without US issuers, writes **Lindsay Whipp**

In demand: the market for yen-denominated debt is extremely strong Dreamstime

Japan's so-called samurai bond market has faced tough times since Lehman Brothers collapsed in September 2008, not only spooking investors but removing one of the staple issuers from the market: US investment banks.

However, this year the market for yen-denominated debt issued by foreign institutions has made a strong comeback, with issuance volumes nearly matching those before the collapse of Lehman.

The twist is that issuance volumes have returned despite the absence of US investment banks.

Instead, that hole is being filled by more issuance from highly rated European institutions, and government debt of south-east Asia and Latin America that is almost fully guaranteed by the Japan Bank of International Cooperation (JBIC).

Dealogic data show that in the year to date, samurai issuance has reached $20.6bn, a 56 per cent jump from the same period in 2009. In 2008, the market reached $21.8bn, but closed for about three months in September after Lehman's demise.

While it is far from 1996's record full year of $34.2bn, the figures suggest that supply is returning, with this year showing the third-highest volume.

Deals have also come from Australian banks, which are regular issuers, and Korean institutions and companies. Barclays issued the biggest samurai since the Lehman shock, selling Y143bn ($1.74bn) in September.

"There are quite active deal flows [now] without sectors that were a significant part of the market just two years ago," says one senior Nomura debt capital markets official.

Investors have been choosier over what they will buy from Europe given the worries about the Greek debt crisis.

Bankers say that sentiment has been improving since the second quarter, when eurozone anxieties were at their most intense. However, investors are monitoring the situation closely still given the recent worries about Ireland and Portugal.

Demand for samurai bonds is extremely strong. Institutional investors, who buy the debt, are conservative, and tend to purchase only bonds of companies and institutions with the highest credit ratings.

Domestic institutional investors, particularly banks, are suffering from weak loan demand and thus have excess deposits to invest.

Already filled to the brim with Japanese government bonds (JGBs) that have benchmark 10-year yields of barely 1 per cent, they are looking elsewhere as well.

The domestic corporate bond market is small relative to the size of the economy, and spreads over JGBs have become extremely narrow. This has made samurai bonds even more attractive, as in general investors will demand additional spread relative to comparable domestic institutions.

Although samurai spreads are also narrowing, "the gap remains wide between a samurai and a domestic credit," notes Kenji Setogawa, debt syndicate manager at Barclays Capital Japan.

"We're seeing lots of new investors," Mr Setogawa says. "[There are more] regional banks in the market these days because they are suffering low yields on JGBs and narrow spreads [for domestic corporate bonds]."

The move by JBIC this year fully to establish a programme partially to guarantee samurai bonds of developing economies on an ongoing basis has helped augment much-needed issuance.

Normally, governments of countries such as the Philippines, Indonesia and even Mexico, which has an investment-grade credit rating, would find it difficult to tap the samurai market, because of the conservative nature of investors.

> 'We're seeing lots of new investors. There are more regional banks'

However, with a partial guarantee that is about 95 per cent by JBIC, investors are more confident to invest, getting a wider spread than they would with more highly rated issuers. The guarantee reduces the funding costs for the issuer as well.

With investor demand still strong, Barclays is working on deals with companies of lower credit ratings, which should help diversify the market.

One such deal came form Hyundai Capital of Korea, which sold Y30bn of samurai bonds on November 12. The company is rated BBB+ by Standard & Poor's, one notch higher than Mexico's sovereign rating.

"This shows investors are getting more comfortable with BBB names and [moving] down the credit curve," says Barclays' Mr Setogawa, joint lead manager of the deal.

Bankers expect more demand to come from the highly rated financial institutions. The Nomura official says: "Because of the amount of financing we saw with government guarantees during the financial crisis, there will be continued pressure for refinancing over the next two or three years. So it's quite important for institutions to continue diversifying and extend their duration from very short-term funds to longer-term funds."

In for the very long term

Century bonds

There are pros and cons to taking a 100-year view, says **Nicole Bullock**

In 1910, Portugal became a republic, S Duncan Black and Alonzo G Decker started a hardware store and Henry Ford sold more than 10,000 Model Ts.

Such historical factoids are fun trivia, but the staying power of countries and companies has become the topic of debate in the credit markets with the return of century bonds and other ultra-long-term borrowing.

Low-interest rates and strong investor demand for yield have prompted a smattering of debt sales that do not come due for 100 years. Century bonds are not unprecedented, but they are not common.

A niche market exists, with companies and investors perennially weighing the pros and cons of such long-term bets.

"There will be sporadic issuance of institutional century bonds," says Jonny Fine, head of Goldman Sachs' US investment-grade syndicate desk. "There is a small number of borrowers who can issue into this market and a reasonably small number of investors who are willing to buy."

When Norfolk Southern reopened the century bond market in August after about five years without such issuance, some market participants wondered whether transport will still involve rails and rolling stock 100 years from now (Norfolk added on to an existing century bond from 2005) and if investors should accept just 5.95 per cent for the wager.

But the operator of about 21,000 route miles in 22 states and the District of Columbia sold more than twice the amount of bonds it announced.

In the ensuing months, it was followed into the century market by Rabobank of the Netherlands and the Mexican government, the latter with a $1bn deal at 6.1 per cent.

For borrowers, century bonds are not necessarily cheap, even if absolute rates are low. Mexico paid a premium of about 85 basis points to its 30-year debt, says Jacob Gearhart, head of emerging markets syndicate for the Americas at Deutsche Bank, which co-managed the deal.

"You have to take a view on rates to justify that premium," he said. "But in the grand scheme of things, it is not too irrational for Mexico to think that locking in circa 6 per cent for 100 years is good for the country and its borrowing strategy."

Bragging rights also provide some of the incentive for issuers periodically to test the appetite for these long-term loans.

Sandeep Agarwal, head of financial institutions debt capital markets within Europe at Credit Suisse, says that century bonds also have "a signalling effect".

"Those able to sell them, do it," he says. "Not only because it is necessary to match the asset base, but because it demonstrates to the market that the business is so strong it can issue at the very long end."

For investors, century bonds can represent a way to boost returns in a climate of low rates.

But some have questioned the logic of lending for such a long time, particularly when interest rates are so low.

> Some have questioned the logic of lending for such a long time

A rise in rates at some point during the next century will mean a drop in the price of these bonds. The century bond market also is not without its rogues' gallery, highlighting the difficulty of predicting the future of a business even 10 years out.

Among the past issuers were Chrysler and Ambac, the bond insurer, which both seemed solid when they sold the bonds in the late 1990s, but have since gone bankrupt.

Nonetheless, there have been eager buyers of century bonds. The very long-term income stream is a good match for investors with very long-term liabilities, such as insurance companies and pension funds.

But retail investors looking for alternatives to low-yielding money-market funds and bank accounts also have been drawn by long-term issues from well-known borrowers.

Goldman Sachs tailored a recent sale of 50-year bonds to individuals rather than institutions by pricing it in $25 increments, raising $1.3bn for interest of just 6.125 per cent.

Banks explore innovative structures

Contingent capital

Regulators want new tools to shield taxpayers from bail-outs, says **Jennifer Hughes**

What's in it for bondholders? Investors have expressed reservations about Cocos and bail-in Getty

Bert Bruggink, chief financial officer of Rabobank, counts the week his team met investors to discuss a new form of contingent capital as one of the hardest in his working life.

In early March, two teams from the Dutch mutual met more than 100 investors in less than a week – a whirlwind "roadshow" by any debt issuer's standards.

"This deal was really different," he says. "Bond deals are all exciting, but investors usually know about the product. On this, we had to explain about the product and investors really had to do their own maths, too."

The roadshow resulted in a €1.25bn ($1.7bn) bond that pays a regular coupon unless the bank breaches a pre-agreed capital ratio, at which point investors permanently forfeit 75 per cent of their investment.

Eight months on, and Rabobank is still one of only two examples of a new breed of so-called contingent capital, a structure being carefully considered by regulators around the world as part of their efforts to buttress the financial system and protect taxpayers from future bail-outs.

As in the Rabobank deal, contingent capital deals, or Cocos, act like bonds in good times, but theoretically provide a struggling bank with a capital cushion in times of stress. In the case of a listed bank such as Lloyds Banking Group, the only other to have issued Cocos, the shares convert into common equity.

Cocos' supporters hope they will replace old-style hybrid bonds, which were designed with the same intention, but failed to help banks bolster their capital before they were forced to turn to taxpayers.

The bonds received a boost when the Swiss regulator recommended its systemically important banks, Credit Suisse and UBS, issue billions' worth as part of its efforts to buttress its banking system.

New bond structures are not, however, the only idea. Others have advanced the notion of a so-called "bail-in", whereby regulators would force losses on all bonds – including senior debt, previously considered untouchable – before taxpayers were forced to bail a bank out.

The Association for Financial Markets in Europe, an industry body, has supported bail-ins and has calculated the cost if it had been applied to Lehman Brothers, the US bank whose failure helped drag the financial system to the brink of collapse in 2008.

It calculates that $25bn of shareholders' equity would have been wiped out and replaced with $25bn from converting all outstanding preferred shares and subordinated debt.

Senior debtholders could have retained nearly 90 per cent of their investment – compared with 20 per cent of face value they can now get in the market for their claims of the bank's estate.

The conversion would have given the bank a core capital ratio of 20 per cent – at least double many bank's current levels – which, with liquidity from a central bank, would in theory have allowed it to open its doors on the Monday for business.

But not everyone is convinced that the turmoil surrounding a struggling bank could be resolved so simply. "Would that bank be able to go to the market for funding the next day? I think not," says one debt banker.

Bail-ins run into practical problems, too, not least the need for each country to provide a legal framework for it and, so it covers the most systemically important institutions, to be operable across borders. Banks operate from hundreds of legal entities, a number of which will have issued debt. The speed of collapse for a financial institution means that for a bail-in to work, it will have to be done over a weekend.

"Most of the too-big-to-fail banks are global and, if investors are worried about being automatically converted, they'll try to find ways to avoid it," says a senior financial services lawyer, who suggests this could be done by issuing bonds out of subsidiaries in bail-out-free jurisdictions.

Investors have voiced concerns about bail-ins. Many have reservations about Cocos, too, but there is a feeling that, while these could be made to work, the vague, permanent threat of a bail-in is far worse.

A survey by JPMorgan showed investors reckon bail-ins would add, on average, an extra 87 basis points to the senior debt costs of single-A rated banks – a considerable cost to bank funding.

"Trigger points need to be transparent and automatic," says one investor. "If not, you leave it to regulators and management to decide when a bond should be bailed in and they're always likely to go too early.

"From bank executives' point of view, it's cheap equity. For regulators, they'll do anything to prevent a failure. What's in it for bondholders?"

Sovereign credit Greece's woes have transformed the government bond world, making it more difficult to categorise

What a difference a year makes. The eurozone government bond market has seen a transformation in the past 12 months as all the rules have been turned on their head, **writes David Oakley**.

The market, once safe and predictable, has seen swings in price and volatility more akin to an emerging-market "basket case" economy, as mounting public debt levels have created unprecedented risks for investors.

Critically, it may even have created a new class of investor – one that straddles the developed-world economies of the eurozone and those traditionally more risky in the emerging markets.

Bill Northfield, head of sovereign, supranational and agency origination at Deutsche Bank, says: "Investors' approach to risk has, rightly, shifted in the past two years, and that has impacted spreads across all asset classes."

This has meant bankers and investors have had to carry out more research into the weaker eurozone economies, such as Greece, Ireland and Portugal, on the periphery of the single currency.

In essence, the bonds of these countries are being treated more like those of corporates or emerging markets in the so-called credit markets. This is because the risk of default, which was considered unthinkable for an advanced eurozone economy last year, is now a real danger for anyone holding bonds of the peripheral governments.

However, in spite of the greater risks, Mr Northfield says there is still "good investor appetite for peripheral eurozone countries' debt". What has become harder has been pricing it, he says.

As the eurozone periphery is being considered almost like a new asset class in itself, separate from the bigger industrialised economies and the emerging markets, it has become more difficult to determine what yields investors should receive.

Should they receive yields similar to advanced-economy bonds or those more like emerging markets or corporate bonds, which are higher?

For those who like the safety of big industrialised-world products, which are only influenced by inflation and growth, they are too unpredictable.

But even investors in corporates and emerging markets are not sure that these peripheral bonds should be priced at the same levels as their markets.

For some of these investors, peripheral bonds are considered riskier than those in the corporate and emerging market world.

In short, the travails of Greece, which first sparked the problems in the periphery, have transformed the sovereign-bond world and made it harder to categorise.

It was in September last year, when Athens revealed that its public finances were much worse than the markets had been led to believe, that the transformation process began.

Over the ensuing months, Greek economic data deteriorated to the point that many investors refused to buy the debt of Athens, forcing the government to turn to the international community for financial support in May.

Contagion from Greece has also spread to the rest of the periphery, with fears that Ireland and Portugal could become as vulnerable as Athens.

There are even worries among some of the gloomiest investors that Spain or Italy, which both have economic problems, are vulnerable, because of banking problems in Madrid and the high debt burden in Rome.

Steven Major, head of global fixed income research at HSBC, says: "We need to be aware of the problems in Spain and Italy too.

"The problem for all these economies is that they are struggling to return to growth because of the savage fiscal austerity measures that are needed to cut public debt."

In contrast, many companies and emerging-market countries have much lower levels of debt, much stronger cash-flows, while often offering similar yields to those of Ireland, Portugal and Greece.

"Everything is very uncertain at the moment," says Mr Major. "It makes sense to wait and see what happens in the periphery before making decisions about whether they constitute a new asset class."

If nothing else, the eurozone's debt woes have taught investors the dangers of bold forecasts in an extremely uncertain world.

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