UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

COMPLEX BONDS

U Wealth : Your partner in mastering financial instruments.

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

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FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk –but the higher, too, the opportunities for returns.

WHAT IS FIXED INCOME?

Fixed income instruments are financial **investments where the issuer is obliged to make payments** on a predetermined schedule.

These **debt obligations** do not represent any ownership in the company/institution of the issuer. For example, the borrower pays interest on a 'vanilla bond' at periodic intervals and eventually pays back the investment amount at a specified maturity date.

Fixed income instruments serve investment objectives that **target the generation of steady cash flows** and/or the preservation of capital. Examples are bonds and convertibles.

For a general introduction to fixed income investing, please consult the separately available document on fixed income / investment grade bonds. This document focuses on the specifics and risks of investing into complex bonds such as convertible bonds, contingent convertible ('CoCo') bonds, bonds with bail-in or loss absorption clause, or collateralized securities.

A CLOSER LOOK AT COMPLEX BONDS

CONVERTIBLE BONDS

Composed Product

A convertible bond is a **composed product** that combines a bond with a long call option (the right to buy a share).

- It is a **bond** that gives the bondholder the **right** (not the obligation) to convert the fixed investment into equity of the issuer (e.g. shares).
- Should the right be **exercised**, the bond ceases to exist, **and the investor becomes a shareholder** who invests in equity and bears all the risks and rewards of that instrument category.

Characteristics of Rights

The **characteristics of the rights** offered to the investor are:

- The **conversion period** is the period in which the conversion right can be exercised.
- The **conversion ratio** is the number of instruments (e.g. shares) the investor receives when exercising their right.
- The **conversion price** is the price at which the instrument can be bought (nominal divided by conversion ratio).
- The volatility of the underlying instrument (e.g. the share into which the bond would be converted) influences the price of the convertible bond.

Price, Returns, and Risks

Due to this built-in right, **the price, potential returns, and risks of a convertible differ** from a plain vanilla bond.

- **Fixed income:** like any other bondholder, the holder of a convertible is entitled to a fixed return in interest. Convertibles usually offer a lower yield in exchange for this right.
- **Potential for capital gain:** the holder of a convertible participates in the company's growth as shareholders do.
- **Ranking:** the convertible bond is a debt obligation that ranks higher than equities.

Mandatory Convertible Bond

A **mandatory convertible bond** is one where the holder of the fixed instrument does not have the right, but rather the obligation, to convert the convertible bond into the equity of the issuer.

CONTINGENT CAPITAL NOTES

Contingent convertible ('CoCo') bonds, are hybrid debt-equity instruments that have a **conversion or principal writedown** (or loss absorption) feature upon the occurrence of a trigger event.

A conversion, or 100% principal write-down, may be triggered when a bank or financial institution:

- Is deemed non-viable by the relevant regulator
- Breaches the trigger level of the capital ratio (CET1 (1) or equivalent)
- Breaches a trigger previously defined in the prospectus of the instrument, or
- Has regulator bail-in power exercised upon.

An investor should **understand** thoroughly **the terms** of the CoCo bond (in particular, the calculation of relevant ratio and determination of contingency and other events) and be familiar with the behaviour of the relevant financial markets, how capital ratios work, and the financial and regulatory position of the issuer.

The **risk** to the investor of a total loss must be considered **higher** than that for a plain vanilla bond because a write-off can be triggered even though the issuer is not in default.

The **issuer** of a CoCo bond is a **bank or financial institution** with the intent to buffer its capital adequacy as an ongoing concern.

(1) The common equity tier-1 (CET1) ratio is the percentage of risk-weighted assets (portion of the banks' assets or off-balance-sheet exposure that is subjected to risk) according to the BASEL III or CRD IV definition. Basel III (Third Basel Accord) is a global, voluntary regulatory standard on bank capital adequacy, stress testing, and market liquidity risk. It is used to strengthen bank capital requirements by increasing bank liquidity and bank leverage.

BAIL-IN/LOSS ABSORPTION (1/2)

- The purpose of the existence of bail-in bonds is to ensure sufficient loss-absorbing capacity to implement an orderly resolution of a bank or financial institution and to avoid exposing public funds (taxpayers) to loss with a high degree of confidence.
- For a debt instrument to be eligible for TLAC (total loss-absorbing capacity) or MREL (minimum requirement for own funds and eligible liabilities) it must be fully paid in, unsecured, issued by the resolution entity, and have a remaining maturity of at least one year.
- Deposits, structured notes, and liabilities arising from derivatives, or any liabilities that cannot be bailed in without material legal risk, are excluded from TLAC/MREL (excluded liabilities).
- The most relevant eligibility criterion is that TLAC/MREL generally must absorb losses prior to such exclusion of liabilities.
- In the US, the UK, and in Switzerland, banks make use of their legal entity structures and meet their TLAC requirements by issuing senior unsecured debt out of their holding companies (HoldCos), which is structurally subordinated to senior unsecured debt of their operating bank entities (OpCos).
- In France, Germany, and other European jurisdictions, a new debt category of senior non-preferred debt has been created, which ranks between subordinated and other (preferred) senior debt. This new type of senior non-preferred debt is eligible for TLAC as it will absorb losses prior to preferred senior debt and excluded liabilities. This contractual subordination method is applied by most global systemically important banks (G-SIBs) in the EU.
- The chart on the next slide provides a simplified overview of the different subordination approaches and the corresponding waterfall in the creditor hierarchy.
- The risks for an investor of bonds with bail-in/loss absorption features are significantly higher, and careful consideration of the individual terms and conditions of each instrument is strongly advisable.

BAIL-IN/LOSS ABSORPTION (2/2)

	Structural subordination	Contractual subordination
Going concern	Common equity tier 1 capital	Common equity tier 1 capital
	Additional tier 1 capital	Additional tier 1 capital
Gone concern	Subordinated debt / tier 2 capital	Subordinated debt / tier 2 capital
	Senior HoldCo debt	Senior non-preferred debt
	Senior OpCo debt	Senior preferred debt
	Excluded liabilities	Excluded liabilities

Higher risk

Lower risk

COLLATERALISATION (1/2)

Apart from the issuer quality and the actual ranking, **a bond may be collateralised or guaranteed**. The higher the degree of collateralisation/guarantee, the higher the possibility of recovering part of the investment if the issuer defaults. The risks and returns of such collateralised bonds depend mainly on the specific instruments used and can differ significantly from the simple bond described previously. Please refer to the corresponding product disclosure documentation for further details.

Examples:

Pfandbriefe

A special form of covered bond in Switzerland. They are issued by two special banks (Pfandbriefbank schweizerischer Hypothekarinstitute and Pfandbriefzentrale schweizerische Kantonalbanken). Loans issued serve the shareholding major Swiss banks for financing mortgages.

Mortgage-backed securities (MBS)

Instruments used to refinance mortgage business. There are different methods:

- **Mortgage-backed securities (US):** mortgages are pooled and transferred to a different entity. The collateral pool is kept static and may change value if individual debts from the pool default, i.e. there is no recourse to the originator. Mortgage-backed securities have payment schedules and risks that differ considerably from normal bonds. The bank acts as intermediator between mortgage holders and investors by passing on payments. The payments therefore include some amortisation that can also happen earlier than planned. So returns and maturities are calculated differently than for normal bonds.
- **European covered bonds:** coverage is done by a collateral pool of mortgages. Defaulting debt in this pool is exchanged, keeping the value of the collateral stable. In contrast to US mortgage-backed securities, the investor has the dual backing of the bank as an issuer and the collateral pool. The returns and repayments are basically independent of the performance of the collateral pool.

Guarantees

Bonds may have explicit guarantees from governments or companies other than the issuer. The exact terms determine how they influence the resulting rating. The prospectus shows whether the guarantee is unconditional, as do the terms and conditions that apply if the issuer defaults.

COLLATERALISATION (1/2)

Further examples:

Asset-backed security (ABS)

An ABS is a financial security collateralised by a pool of assets such as loans, leases, credit card debt, royalties, or receivables. For investors, ABSs are an alternative to investing in corporate debt. An ABS is similar to a mortgage-backed security, except that the underlying securities are not mortgage-based. ABSs allow issuers to generate more cash, which in turn is used for more lending while giving investors the opportunity to invest in a wide variety of income-generating assets. Usually, the underlying assets of an ABS are illiquid and cannot be sold on their own. But pooling the assets together and creating a financial security, a process called securitisation, enables the owner of the assets to make them marketable.

Collateralised mortgage obligation (CMO)

CMO refers to a type of mortgage-backed security (MBS) that contains a pool of mortgages bundled together and sold as an investment. Organised by maturity and level of risk, CMOs receive cash flows as borrowers repay the mortgages that act as collateral on these securities. In turn, CMOs distribute principal and interest payments to their investors based on predetermined rules and agreements.

Collateralised loan obligation (CLO)

A CLO is a security backed by a pool of debt, often low-rated corporate loans. CLOs are similar to collateralised mortgage obligations (CMOs), except that the underlying loans are of a different type and character. With a CLO, the investor receives scheduled debt payments from the underlying loans, assuming most of the risk in the event of a borrower's default. In return for taking on the default risk, the investor is offered greater diversity and the potential for higher-than-average returns.

Collateralised debt obligation (CDO)

A CDO is a structured financial product that pools together cash flow generating assets and repackages this asset pool into discrete tranches that can be sold to investors. It is named for the pooled assets — such as mortgages, bonds and loans that are essentially debt obligations that serve as collateral for the CDO. The tranches in a CDO vary substantially in their risk profiles. The senior tranches are generally safer because they have first priority on payback from the collateral in the event of default. As a result, the senior tranches of a CDO generally have a higher credit rating and offer lower coupon rates than the junior tranches, which offer higher coupon rates to compensate for their higher default risk.

OTHER BOND FEATURES

ISIN	Bonds are normally assigned an ISIN (International Securities Identification Number), which is a 12-character code that uniquely identifies a security.
144A	144A is a rule of the Securities and Exchange Commission (SEC) in the US. Bonds with the 144A rule are allowed to be bought and held by **qualified institutional investors only**, which are generally large institutional investors.
REGS	A bond with Regulation S (REGS) is offered to non-US residents under an exception to US securities laws. Non-residents do not get the same legal protection with new issues as US clients do. REGS bonds are **available for private investors.**
HKEx Chapter 37	Applicable to bond listings on Hong Kong Exchanges and Clearing Limited (HKEx) only. The debt is issued and distributed to **Hong Kong professional investors only.**
Denomination	The denomination is the face value of a financial instrument. For bonds, it is usually USD 1,000 or multiples thereof (in the case of a USD bond).
Change of control	Change of control (CoC) means that the ownership of the issuer is shifting from one party to another. In this event, bonds with a CoC clause will be redeemed at a predefined price.
Make whole	A ‘make whole’ allows the issuer to redeem a bond before maturity. However, the borrower has to pay a ‘fine’ in the form of an additional payment that is based on a predefined calculation.
Pay in kind (PIK)	A PIK bond allows the issuer to pay interest with additional bonds rather than cash. PIK bonds are speculative bonds, as the issuer is creating more debt, implying that the borrower is unable to pay the interest in cash.
Special purpose vehicle (SPV) with keepwell structure	A contract between a parent company and its subsidiary to maintain solvency and financial backing throughout the term set in the agreement. This is a method by which subsidiary companies may increase the creditworthiness of debt instruments and corporate borrowing.
Lock-in period	The period of time in which a loan may not be prepaid and when a lender will guarantee a certain interest rate on a loan to be extended by it in the future.
Callable	The bond can be redeemed by the issuer prior to its maturity.
Puttable	It allows the holder to demand early repayment of the principal from the issuer or a third party acting as an agent for the issuer, and the repurchase price is set at the time of issue.
Discretionary deferrable cumulative coupon	The issuer has the discretion to pay a coupon. Deferred cumulative coupons are interest that has not been paid but is accumulated and paid later, most of the time cash compounding.
Discretionary deferrable non-cumulative coupon	The issuer has the discretion to pay a coupon. Deferred non-cumulative coupons will be cancelled and hence not paid.
Extended maturity	A bond that includes the option to lengthen its maturity date.
Deferred interest payment	A bond that pays interest at a later date instead of in periodic increments.

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