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SHARIYAH
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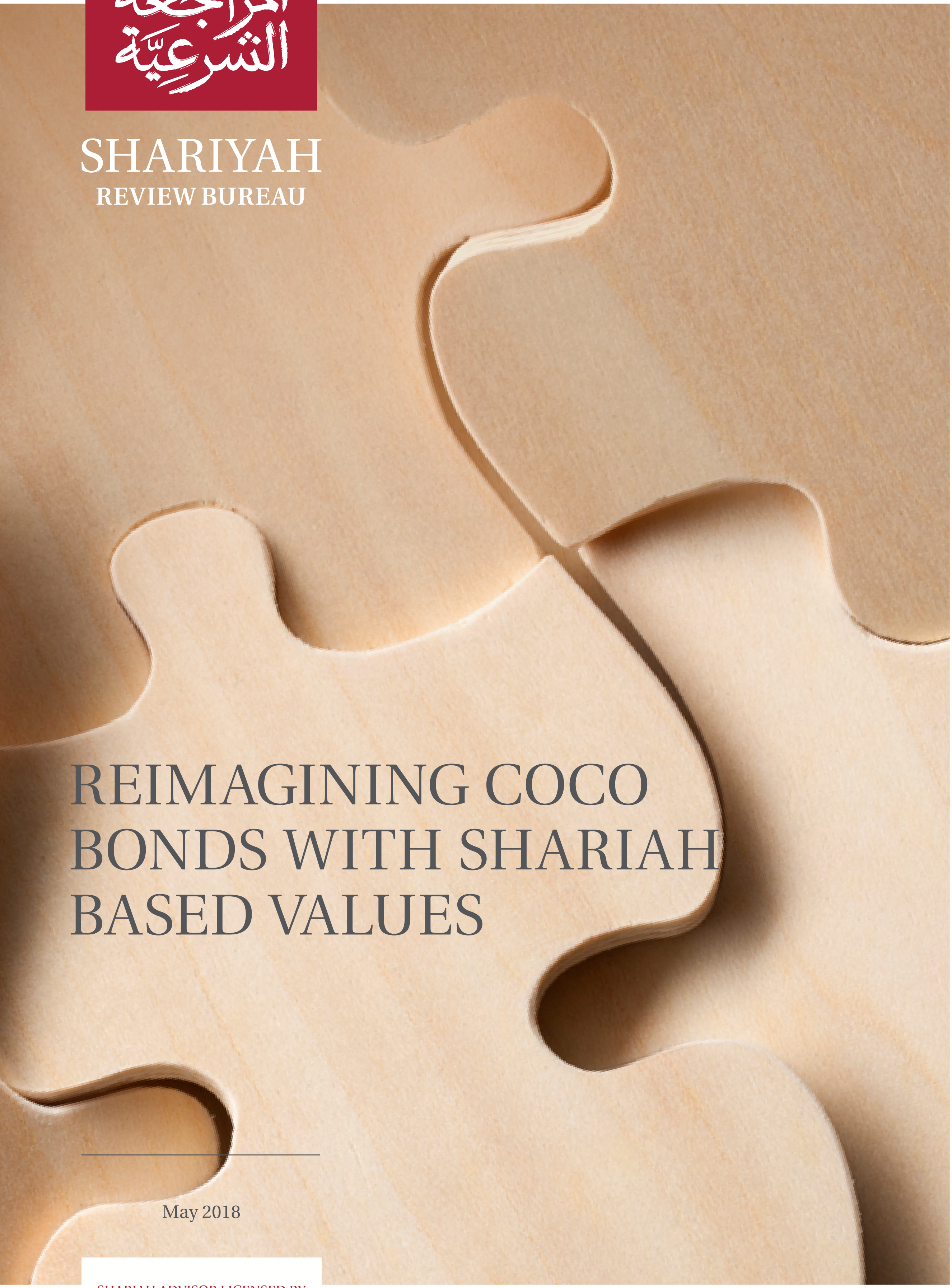

REIMAGINING COCO BONDS WITH SHARIAH BASED VALUES

May 2018

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THE CENTRAL BANK OF BAHRAIN

Introduction

Bonds are a type of debt security. They are effectively an IOU between a borrower (the issuer of the bond) and a lender (the investor who purchases the bond) – just as a bank deposit is effectively an IOU between the bank as borrower and the depositor as lender.

When a government, corporation or other entity needs to raise money, they can borrow money from investors by issuing bonds to them. Investors who purchase a bond from an issuer are essentially lending money to the issuer for a fixed period of time. In return, investors receive an instrument (the bond) promising that they will receive interest payments at certain intervals and also have their principal returned on a stated future date.

THE DIFFERENT TYPES OF BONDS[1]

Bonds include a very broad array of different products that have markedly different terms and conditions. They range from so-called ‘simple bonds’ to some very complex debt securities. A bond is regarded as a ‘simple bond’ if:

- it has a fixed or floating coupon rate that does not change for the life of the security;
- interest payments under the security are paid periodically and cannot be deferred or capitalised by the issuer;
- it has a fixed maturity date which is not more than 15 years after its date of issue;
- it is not subordinated to other debts owed to unsecured creditors generally; and
- it does not attach any options to convert it to equity or to extinguish it (so-called ‘knock -out’ options).

Examples of more complex bonds include:

- bonds that allow the issuer to defer or capitalise interest payments under certain conditions;
- bonds that provide for the coupon rate to be re-set at certain times (often called ‘re-set’ or ‘re-settable’ bonds);
- bonds that give the issuer the option to extend them but at the price of paying a higher coupon rate (typically called ‘step-up bonds’); and
- bonds that are more properly characterised as ‘hybrid securities’, in that they combine features of debt securities and equity securities. Examples include convertible or converting bonds (bonds that convert into shares or other securities under certain conditions), perpetual bonds (bonds which don’t have a maturity date), subordinated bonds (bonds that are subordinated to the claims of other creditors) and knock-out bonds (bonds that give the issuer or a third party a right to extinguish them under certain conditions).

1 ASX (2016), Understanding Bonds, Available from: https://www.asx.com.au/documents/products/Understanding_Bonds-_AGB_web_version.pdf

WHAT ARE COCO BONDS?

Contingent convertibles, also known as CoCo bonds, Cocos or contingent convertible notes, are slightly different to regular convertible bonds in that the likelihood of the bonds converting to equity is "contingent" on a specified event, such as the stock price of the company exceeding a particular level for a certain period of time. They carry a distinct accounting advantage as unlike other kinds of convertible bonds, they do not have to be included in a company's diluted earnings per share until the bonds are eligible for conversion. It is also a form of capital that regulators hope could help buttress a bank's finances in times of stress.

CoCos are different to existing hybrids because they are designed to convert into shares if a pre-set trigger is breached in order to provide a shock boost to capital levels and reassure investors more generally. Hybrids, including CoCos, contain features of both debt and equity. They are intended to act as a cushion between senior bondholders and shareholders, who will suffer first if capital is lost. The bonds usually allow a bank to either hold on to the capital past the first repayment date, or to skip paying interest coupons on the notes[2].

Sales of contingent convertible (Coco) bonds, a high-risk debt/equity hybrid offering an attractive option for banks to boost Tier 1 capital. Coco bonds are perpetual, fixed-coupon debt securities that can either be converted into equity or be permanently (or temporarily) written down in the event of a certain trigger — such as if the bank's Tier 1 capital falls below a certain margin — thus increasing the bank's equity and recapitalizing in the event of a crisis. The key feature here is that, unlike existing hybrid debt instruments, the conversion is compulsory with Coco investors forcibly changed from debt-holders to junior shareholders — making the bonds extremely high risk and thus, inevitably, giving them a high equivalent yield to make them worth holding.

This compromise between debt and equity represents an uneasy truce between banks and regulators, allowing banks to meet the more restrictive requirements of Basel III regulation while still taking advantage of the more favourable tax treatment and higher investor demand for debt over equity[3].

Private investors are usually reluctant to provide additional external capital to banks in times of financial distress. In extremis, the government can end up injecting capital to prevent the disruptive insolvency of a large financial institution because nobody else is willing to do so. Such public sector support costs taxpayers and distorts the incentives of bankers.

Contingent convertible capital instruments (CoCos) offer a way to address this problem. CoCos are hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level. Then debt is reduced and bank capitalisation gets a boost. Owing to their capacity to absorb losses, CoCos have the potential to satisfy regulatory capital requirements.

First, the main reasons for issuing CoCos are related to their potential to satisfy regulatory capital requirements. Second, the bulk of the demand has come from private banks and retail investors, while institutional investors have been relatively restrained so far. Third, CoCo yields tend to be higher than those of higher-ranked debt instruments of the same issuer and are highly dependent on their two main design characteristics – the trigger level and the loss absorption mechanism. Finally, CoCo yields tend to be more correlated with those of other subordinated debt than with CDS spreads (on senior unsecured debt) and equity prices[4].
It is pertinent to understand the Basel Accords to realise the function of CoCo bonds.

2 Financial Times Lexicon, Definition of Cocos, Available from: http://lexicon.ft.com/Term?term=cocos

3 IFN News (2014), Coco bonds: Chance or challenge, 11 (47), Available online from: http://www.academia.edu/9497718/Structuring_contingent_convertible_CoCo_Sukuk-_Interview_with_IFN

4 Avdjiev, S. et al. (2013), CoCos: a primer, BIS Quarterly Review, Available from: https://www.bis.org/publ/qtrpdf/r_qt1309f.pdf
Albul, B, D Jaffee and A Tchistyi (2012): "Contingent convertible bonds and capital structure decisions", University of California, Berkeley, working paper.
Bolton, P and F Samama (2011): "Capital access bonds: contingent capital with an option to convert", Economic Policy , pp 275–317, April.

THE BASEL ACCORDS

Regulators try to ensure that banks and other financial institutions have sufficient capital to keep them out of difficulty. This not only protects depositors, but also the wider economy, because the failure of a big bank has extensive knock-on effects. The risk of knock-on effects that have repercussions at the level of the entire financial sector is called systemic risk.

Capital adequacy requirements have existed for a long time, but the two most important are those specified by the Basel committee of the Bank for International Settlements.

The Basel Committee was formed in response to the liquidation of a Europe-based bank in 1974 This incident prompted the G-10 nations to set up the Basel Committee on Banking Supervision (BCBS), under the direction and supervision of the Bank of International Settlements, which is in Basel, Switzerland. As a result of the liquidation of the bank, this committee instigated the Basel 1 Accord in 1988.

The Basel I Accord was the outcome of a round of consultations and deliberations by central bankers from around the world, which resulted in the publishing by the BCBS of a set of minimum capital requirements for banks.

This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992.

Basel I was primarily focused on Credit Risk and Risk Weighted Assets (RWA). In order to offset risk, banks with an international presence were required to hold capital (which was classified as Tier 1, Tier 2 and Tier 3 to clarify the strength or reliability of such capital held) equal to 8% of their risk-weighted assets[5].

The Basel II Accord was introduced following substantial losses in the international markets since 1992, which were attributed to poor risk management practices. The Basel II Accord makes it mandatory for financial institutions to use standardized measurements for credit, market risk, and operational risk. However, different levels of compliance allow financial institutions to pursue advanced risk management approaches to free up capital for investment[6]. Basel II uses a three-pillars concept:

- Pillar 1 - minimum capital requirements (addressing risk)
- Pillar 2 - supervisory review
- Pillar 3 - market discipline

5 IBM (n.d.), Basel I Summary, Available from: https://www.ibm.com/support/knowledgecenter/en/SSN364_8.8.0/com.ibm.ima.tut/tut/bas_imp/bas1_sum.html
Basel Committee on Banking Supervision (2011): Basel III: A global regulatory framework for more resilient banks and banking systems , June.

6 IBM (n.d.), Basel II Summary, Available from: https://www.ibm.com/support/knowledgecenter/en/SSN364_8.8.0/com.ibm.ima.tut/tut/bas_imp/bas2_sum.html

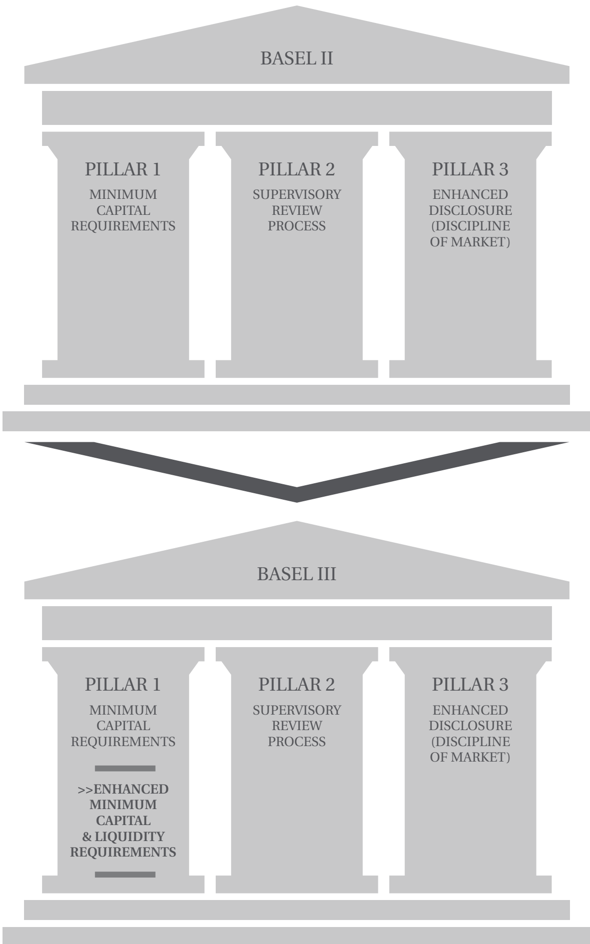
The 2008 financial meltdown impacted the financial industry on an unprecedented level. Following the collapse of Lehman Brothers, banks were reluctant to conduct business with one another. More financial institutions collapsed and the global economy fell into a recession. A response to remediate the banking system was required not only from central government banks and prudential regulatory bodies but also from the banking supervisory committees.

Accordingly, new sets of regulatory requirements were born in the form of Basel III. These new regulations were not only applicable to conventional banking but also to the Islamic banking sector. Existing regulatory frameworks, mainly Basel II, was deemed weak and lacking resilience with respect to Capital Adequacy, Liquidity Management and Solvency. Basel III is an extension of the existing Basel II Framework, and introduces new capital and liquidity standards to strengthen the regulation, supervision, and risk management of the whole of the banking and finance sector[7].

It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–2011, and was scheduled to be introduced from 2013 until 2015. However, changes made from April 2013 extended implementation until March 31, 2018. The Basel III requirements were in response to the deficiencies in financial regulation that is revealed by the 2000's financial crisis. Basel III was intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage. The global capital framework and new capital buffers require financial institutions to hold more capital and higher quality of capital than under current Basel II rules.

The new leverage ratio introduces a nonrisk-based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case there are other severe banking crises.

The figure below shows how Basel III strengthens the three Basel II pillars, especially Pillar 1 with enhanced minimum capital and liquidity requirements.



7 IBM (n.d.), Basel III Summary, Available from: https://www.ibm.com/support/knowledgecenter/en/SSN364_8.8.0/com.ibm.ima.tut/tut/bas_imp/bas3_sum.html

STRUCTURE OF COCO BONDS

The structure of CoCos is shaped by their primary purpose as a readily available source of bank capital in times of crisis.

In order to achieve that objective, they need to possess several characteristics:

First, CoCos need to automatically absorb losses prior to or at the point of insolvency.

Second, the activation of the loss absorption mechanism must be a function of the capitalisation levels of the issuing bank.

Finally, their design has to be robust to price manipulation and speculative attacks.

CoCos have two main defining characteristics – the loss absorption mechanism and the trigger that activates that mechanism. CoCos can absorb losses either by converting into common equity or by suffering a principal write down. The trigger can be either mechanical (i.e. defined numerically in terms of a specific capital ratio) or discretionary (i.e. subject to supervisory judgment)[8].

8 Avdjiev et al. (2013), CoCos: a primer, BIS Quarterly Review, Available from: https://www.bis.org/publ/qtrpdf/r_qt1309f.pdfBasel Committee on Banking Supervision (2011): Basel III: A global regulatory framework for more resilient banks and banking systems , June.

SHARIAH ANALYSIS OF COCO BONDS

A bond is a debt obligation for which the issuer pays a pre-determined rate of return to the bond holder. There is no investment in any underlying asset; rather, the issuer has a personal right and a liability on his legal personality. A repayment of debt with interest is due to the bond holder. The payment for the bond is effectively a loan (Qard) from a Shariah perspective.

In Islam, a loan (qard) is considered a gratuitous contract, and it is commendable for a lender to provide a loan to a borrower who is in need of money. Both the Qur'an and Sunnah promise reward to a lender who provides a loan to a person in need. The fact that the Shariah prohibits the lender to derive any conditional benefit from the loan further emphasises its gratuitous nature. It also implies that the loan contract should not be used for profiteering purposes. Thus, any profit or additional return in lieu of the loan is impermissible and non-Shariah compliant. Both the Qur'an and the Sunnah have prohibited the lender from charging the borrower any additional amount. The Qur'an emphasises that the lender is entitled to receive the principal amount. It states:

"O you who believe! Fear Allah, and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from Allah and His Messenger. But if you turn back, you shall have your capital sums: Deal not unjustly, and you shall not be dealt with unjustly" (al-Qur'an, 2:278-279).

A famous juristic maxim states:
"Any loan which draws an increment is Riba" (Ibn Abi Shaybah).

Riba is more than just simple interest and compound interest; Riba is an unjustified excess in a bilateral contract which is stipulated for one of the two transacting parties and is without consideration. To elaborate, there are two types of Riba:

1) **Riba al-Nasi'ah** is the advantage and excess gained without consideration by deferring delivery of any homogenous counter exchanges. This excess manifests upon default or delay in payment where time is factored as a consideration.

2) **Riba al-Fadhl** is a contractually agreed excess in units without any consideration in an exchange of homogeneous goods.

Shariah has not considered money to be a commodity but a medium of exchange. When money of the same genus is exchanged, it must be on spot and in equal quantity. Exchanging different amounts at different times brings into effect both forms of Riba: Riba al-Nasi`ah and Riba al-Fadhl.

Jabir stated that Allah's Messenger cursed the accepter of interest and its payer, and also one who records it and the two witnesses, and he said, "They are all equal." (Abu Dawud).

ISSUES WITH COCO FROM A SHARIAH PERSPECTIVE

Although CoCo bonds are not Shariah compliant due to being interest bearing investments, CoCos have features which can be explored and considered from a Shariah perspective.

The first aspect is the actual conversion from debt to common equity. In Shariah, there must be a transaction that takes place to convert the debt into equity. The debt owed the bond holders is settled by converting it to common equity.

The debtors can settle the debt by offering equity. This type of transaction is permitted as it is considered as a sale. A creditor can transact with the debtor and exchange the debt owed to him for consideration.

The trigger mechanism which is one of the main features of a CoCo bond requires a transaction based on contingency. The CoCos need converting to equity which is “contingent” on a specified event. Contingency conversion would be considered as a clause in the contract. in bilateral contracts, such a condition would create uncertainty in the contract. Uncertainty, known as Gharar, can make the contract irregular and voidable if the Gharar is gross and extreme (Fahish). In unilateral contracts (Tabarru’), Gharar is tolerable. However, a contingency clause in a unilateral contract is laghw (meaningless and immaterial). It has no legal consequence and the contingency is not enforceable in such a contract.

POSSIBLE STRUCTURING FOR AN ALTERNATIVE SHARIAH COMPLIANT PRODUCT

CoCo bonds are hybrid debt instruments that are intended to absorb losses when the capital of the issuing bank falls below a threshold level. The two main methods of applying losses are by principal write-down or converting to equity. An alternative product proposed for Islamic banks is CoCo Sukuk. This would attempt to have a Sukuk with a conversion feature to comply with Basel III requirements. The Sukuk would have to be convertible into shares of the issuer or where the Sukuk can be exchanged for shares of a company owned by the issuer.

For a financial institution to issue CoCo Sukuk, it would likely start with the AT1 sukuk structure which is Mudarabah based on what is effectively a pro-rata share of the bank's entire asset base. On this structure, the bank would then have to add a conversion feature to allow the entire Sukuk to have a mandatory conversion into equity[9].

A Mudharabah Sukuk provides an ideal Shariah compliant structure to accommodate the features of AT1 capital, such as the discretionary profit payments. The Mudharabah Sukuk are classified as equity, therefore, they do not include principal loss absorption or equity conversion features. Periodic distributions are fully discretionary and non-cumulative[10]. There are some challenges with these type of structures, for example:

1. The economic terms being offered are not economically preferable for the investors; and
2. Setting a fixed conversion price in advance to be tied to either the CET1 ratio or equity market capitalisation to total assets.

9 Thomson Reuters (2017), Sukuk Perceptions & Forecast Study 2017, Available from: https://ceif.iba.edu.pk/pdf/ThomsonReuters-SukukPerceptionsForecastStudy2017.pdf

10 Archer, S. et al. (2017), Islamic Capital Markets and Products: Managing Capital and Liquidity Requirements Under Basel III, Wiley

Conclusion

Coco bonds are different to regular convertible bonds in that the likelihood of the bonds converting to equity is “contingent” on a specified event. They carry a distinct accounting advantage as unlike other kinds of convertible bonds, they do not have to be included in a company’s diluted earnings per share until the bonds are eligible for conversion. It is also a form of capital that regulators hope could help buttress a bank’s finances in times of stress. CoCo bonds have become popular due to their ability to absorb losses and satisfy regulatory requirements. CoCos are hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level. Then debt is reduced and bank capitalisation gets a boost. Owing to their capacity to absorb losses, CoCos have the potential to satisfy regulatory capital requirements. However, CoCo bonds, like all bonds, are non-Shariah compliant due to their bond features. Possible Shariah compliant structures as an alternative for Islamic banks to absorb losses and meet Basel III requirements are AT1 Sukuk. However, there are challenges in respect to such Sukuk. There is still a debate on which structure to use for this type of Sukuk. Furthermore, the pricing of the conversion is another area which needs further research. Overall, Islamic banks need viable Shariah compliant alternatives to be able to compete, grow and meet regulatory requirements laid down by the Basel accords. Sukuk products currently seem to be the most viable and plausible to deal with capital requirements.

ABOUT SRB

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We've been preparing our clients for a new world in which Shariah Advisory rapidly becomes the currency of choice. From faster Certification programs, to direct Shariah Supervisory access, and perhaps most critically, navigating through the economic structures of clients offerings within a matter of days. We've have been working hard to help clients like you capitalize on opportunities in global Islamic financial markets.

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The future of Shariah Advisory and Audit is exciting and we are very lucky to be a part of this business!

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