

COCO Classification and Measurement Under U.S. GAAP

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In regards to proposed new Basel 3 rules, Federal Reserve Chairman Bernanke said: "Capital is important to banking organizations and the financial system because it acts as a financial cushion to absorb a firm's losses. With these proposed revisions, banking organizations' capital requirements should better reflect their risk profiles, improving the resilience of the U.S. banking system in times of stress, thus contributing to the overall health of the U.S. economy."

<http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm> Some banks are hoping to rely on a new type of hybrid financial debt instrument, called Contingent Conversion Bonds (COCOs) to satisfy the Basel 3 capital cushion requirements in a way that is less demanding on their capital structure. These hybrids have conversion options with characteristics different than the conversion options attached to normal convertible bonds and require careful understanding as to how they are to be classified and measured.

The FASB guidelines for measurement and classification of hybrid financial instruments are complex. In its Feedback Summary of the May 2010 Exposure Draft regarding financial instruments, FASB observes: "Most users did not provide feedback on the proposed changes to the accounting for hybrid financial instruments because of technical complexity and their unfamiliarity with current bifurcation guidance for embedded derivatives". The current discussion is based on guidelines found in ASC 815 (originally FAS 133), ASC 825 and proposed changes to ASC 825.

To help illustrate the application of GAAP guidelines, we will use Credit-Suisse's Buffer Capital Notes (BCNs) as an example. There are two types of BCNs: one is called Tier 1 BCNs and the other Tier 2 BCNs (even though both are related to Tier 1 capital ratio). Unlike normal convertible bonds, conversion is not effected at the option of the bond holder; rather, there are two events which cause the conversion of BCN debt into CS common shares.

- (1) Credit-Suisse's Tier 1 capital ratio falling below 7% as reported in the quarterly financial statements.
- (2) If FINMA considers Credit-Suisse at risk of insolvency and in need of an equity boost.

Following is Credit-Suisse's description of their BCNs https://www.credit-suisse.com/publications/annualreporting/doc/2011/csg_ar11_treasury_risk_balance_en.pdf#page=15

"In February 2011, we entered into definitive agreements ... to issue Tier 1 Buffer Capital Notes (Tier 1 BCNs). The purchase or exchange will occur no earlier than October 23, 2013.... The Tier 1 BCNs will be converted into our ordinary shares if our reported CET1 ratio, as determined under BCBS regulations as (sic, should be "at") the end of any calendar quarter, falls below 7% (or any lower applicable minimum threshold), unless FINMA, at our request, has agreed on or prior to the publication of our quarterly results that actions, circumstances or events have restored, or will imminently restore, the ratio to above the applicable threshold. The conversion price will be the higher of a floor price of USD 20/CHF 20 per share (subject to customary adjustments) or the daily volume weighted average sale price of our ordinary shares over a five day period preceding the notice of conversion. The Tier 1 BCNs will also be converted if FINMA determines that we require public sector capital support to prevent us from becoming insolvent, bankrupt or unable to pay a material amount of our debts, or other similar circumstances.

In February 2011, we issued USD 2 billion 7.875% Tier 2 Buffer Capital Notes due 2041 (Tier 2 BCNs). The Tier 2 BCNs are subordinated notes and may be redeemed by the issuer at any time from August 2016. The initial coupon is reset every five years from August 2016. Interest payments will not be discretionary or deferrable. The Tier 2 BCNs will be converted into our ordinary shares if, prior to Basel III, our core tier 1 ratio falls below 7% or, under Basel III, our CET1 ratio falls below 7%. The conversion price will be the higher of a floor price of USD 20 per share (subject to customary adjustments) or the daily volume weighted average sale price of our ordinary shares over a 30-day period preceding the notice of conversion. The Tier 2 BCNs will also be converted if FINMA determines that we require public sector capital support to prevent us from becoming insolvent, bankrupt or unable to pay a material amount of our debts, or other similar circumstances.”

In this article, the term “normal convertible bond” will refer to a situation in which “an investor receives a below-market interest rate and receives the option to convert its debt instrument into the equity of the issuer at an established conversion rate. The terms of the conversion require that the issuer deliver shares of stock to the investor”. The fact that the issuer must deliver shares of stock to the investor as opposed to the cash equivalent will have important ramifications as to determining the classification of any convertible bond’s option as equity or derivative asset/liability.

Derivative Classification

For the uninitiated (and precluding those who are faint of heart), a brief summary of the relevant GAAP relevant to COCOs follows. First, we will discuss two concepts: hybrid instruments and derivatives.

A *hybrid* is a financial instrument with two parts: a host contract and an embedded component. In the case of a convertible bond, such as a COCO/BCN, the host is the bond and the conversion feature is the embedded component; the host bond essentially contains an inseparable call option on the issuer’s stock.

A *derivative* is a financial instrument is defined in ASC 815-10-15-83:

“A derivative instrument is a financial instrument or other contract with ...

- a. Underlying, notional amount, payment provision. The contract has both of the following terms which determine the amount of the settlement ... and, in some cases, whether or not a settlement is required.
 1. One or more underlyings
 2. One or more notional amounts or payment provisions or both
- b. *Initial net investment*. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. *Net settlement*”

An easily understood example of the characteristics of a derivative can be seen in a plain vanilla call option.

For example, consider an option which allows its owner to purchase 200 shares of stock at USD 50 per share.

- a. The *underlying* is the market price of a share of the stock; the notional amount is 200 shares.
- b. The *initial net investment* is less than the stock on which the option is based.

- c. Either the writer of the option can *net settle* the contract by not having to actually deliver shares of stock or, if he does have to, the shares are easily converted into cash on an exchange.

ASC 815-10-10-1 elucidates the nature of derivatives:

“Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.” This is a key point: derivatives are not equity even though they may be convertible into, or represent a right to buy equity, as in the case of convertible debt or options.

This article often refers to “derivatives” as “derivative assets or liabilities” to emphasize the point that derivatives are not equity.

FAS 133, paragraph 255 explains a basic philosophy behind the definition of a derivative. This philosophy is reflected in the above three characteristics.

“Providing the opportunity to participate in the price changes of an underlying without actually having to own an associated asset or owe an associated liability is the basic feature that distinguishes most traditional derivative instruments from nonderivative instruments.”

We will examine these three characteristics in terms of their relevance to COCOs and BCNs.

Derivative Characteristic 1: Underlyings:

ASC 815-10-15-88 “An underlying is a variable that ... determines the settlement of a derivative instrument. An underlying is usually is one or a combination of the following:

- a. A security price or security price index
- b. A commodity price or commodity price index
- ...
- h. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract)”

ASC 825-10-15-89: “However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. An underlying may be a price or rate of an asset or liability but it is not the asset or liability itself.”

FAS 133, explains more about derivative underlyings in Appendix C: Background Information and Basis for Conclusions.

“250. Derivative instruments typically permit the parties to participate in some or all of the effects of changes in a referenced price, rate, or other variable, which is referred to as the *underlying*, for example, an interest rate or equity index or the price of a specific security, commodity, or currency ... the *price* or *rate* of the associated asset or liability, which is used to determine the settlement amount of the derivative instrument, is the underlying.

252. In concept, any observable variable, including physical as well as financial variables, may be the underlying for a derivative instrument. For example, a contract might specify a payment to be made if it rains more than one inch on a specified day. However, throughout the project that led to this Statement, discussion focused on more traditional derivatives for which the underlying is some form of price, including an interest rate or exchange rate.”

Application of Derivative Characteristic 1 to COCOs/BCNs:

For a normal convertible bond, the embedded option is like the call option mentioned above. As the share price rises, the embedded option allows the bond holder “to participate in some or all of the effects of changes” of the share price. A COCO however, does not allow the bond holder to share in the rise in stock price since the share price is only used to calculate the number of shares that the bond holder will receive (the notional amount). Instead, the underlying for a COCO is the issuer’s Tier 1 ratio or FINMA decision. The Tier 1 ratio does not represent an effect that is shareable by an investor; it is simply a financial statistic describing one aspect of the company’s situation. There is no gain or loss resulting from Tier 1 ratio changes as there is with share price. This calls into question whether the conversion option of a COCO is truly a derivative even though it may have all three defining traits: should the overall financial function of the option be the over-riding defining criterion or do we go “by the book” and follow the strict definition?

Does the BCN capital ratio trigger qualify as an underlying? The Tier 1 capital ratio information for Credit-Suisse is based on management-issued quarterly reports and is not issued by a third party as are the above examples from ASC 815-10-15-88; even the event of a scheduled payment can be verified by the counter party. Is such information truly “objectively verifiable” when its source is management? Perhaps an auditor’s unqualified opinion as to the accuracy of financial statements will qualify them as “objectively verifiable”. Despite these doubts, it may be that information provided by management is acceptable. ASC 815-40-15-7(a).b accepts EBITDA and net income as acceptable indexes to fulfill a criterion related to derivative classification (“Evaluating Whether an Instrument is Considered Indexed to an Entity’s Own Stock”). The application of these indexes is not entirely valid however because in ASC 815-40-15-7(a).b we are not relying on the value of these indexes as we are here and also, these issuer-issued statistics are not mentioned in this part of the code.

Another concern is that the Tier 1 ratio number is derived from BCBS regulations which are long and complex. Here is an excerpt from a BCBS Consultative document about calculating Tier 1 capital, specifically in regards to derivatives: <http://www.bis.org/publ/bcbs214.pdf>

“However, the application of paragraph 75 to derivatives is not straightforward since their valuations depend on a range of factors other than the bank’s own creditworthiness, such as interest rates and other market factors that can affect the exposures value. It is not easy to separate out changes in value that are only due to changes in a bank’s own credit risk.”

Can an underlying that is based on “not straightforward” calculations that also may be open to multiple interpretations qualify as “objectively verifiable”?

If the answer to the above questions is no, then the conversion option component of a BCN would not be classified as a derivative asset or liability since its underlying would not fit within the guideline definition of a derivative.

The other cause of conversion, FINMA’s determination of Credit-Suisse being on the brink of bankruptcy, would presumably qualify as an “underlying” event, similar to a “scheduled payment” or “climatic condition” since it is produced and reported by a third-party.

Derivative Characteristic 2: Initial Net Investment:

This criterion requires that the cost of the derivative be less than the cost of the asset that the derivative is based on.

ASC 815-10-15-83(b) "The contract requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors."

ASC 815-10-15-97 "A contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is not a derivative instrument in its entirety."

ASC 815-10-10-95 "A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount ... For example:

- a. A commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred)."

Application of Derivative Characteristic 2 to BCNs:

In the case of a normal convertible bond, the embedded option is a call option; the bond holder pays, in the form of receiving lower interest or what would be the equivalent of paying the issuer a premium, for the right to convert the debt into the underlying stock at a price that is in-the-money if the stock price rises above the conversion price. However, in the case of a COCO the opposite is true. The bond holder does not pay the issuer for the conversion option; instead, the bond holder *receives* a higher rate of interest; the bond holder can be considered as having received from the issuer the value of a discount that results in the effective interest rate of the BCN. In return, the bond holder gives to the bond issuer the possibility of having his debt convert into common shares. If the price of Credit-Suisse stock is below USD 20 when conversion occurs, the bond holder loses his bet in terms of conversion share price; if the share price on the day of conversion is higher than the 5 day average then he wins. For example, let's say a bond holder has a USD 1000 BCN. If the price of CS stock is USD 10 on the day of conversion he could have bought 100 shares for USD 1000; at USD 20 however, he only receives 50 shares. On the other hand, let's say that on the day that the conversion rate is decided that the CS share price is USD 50 and the five day average is USD 25. With the price of USD 50 the bond holder would have received 20 shares but now he will receive 40. From a stock price point of view, the big risk to the bond holder and potential gain for the issuer is if the share price drops below USD 20. What are the chances of that happening? Since 1999 the share price of CS has been below USD 20 two times: from May 2012 to September 2012 and from October 2002 to April 2003. Presumably, the thinking is that if the CS Tier 1 capital ratio is suffering or CS is in danger of bankruptcy that its share price will drop below USD 20.

How would be the cost of such an option compare to the cost of the stock?

To calculate the value of an embedded call option:

"This allocation is done by first determining the carrying amount of the liability component based on the fair value of a similar liability excluding the embedded conversion option, and then allocating to the embedded conversion option the excess of the initial proceeds ascribed to the convertible debt instrument over the amount allocated to the liability component." (PWC, "IFRS and US GAAP", Oct. 2012, Page 138)

For example, a straight bond ("a similar liability excluding the embedded conversion option") may sell for USD 1,000 while a normal convertible bond ("the initial proceeds ascribed to the convertible debt instrument") may sell for USD 1,100. The price for the conversion component would be USD 1,100 minus USD 1,000 = USD 100 ("the excess of the initial proceeds ascribed to the convertible debt instrument over the amount allocated to the liability component"); the bond holder agrees to pay USD 100 more for the

convertible bond (which is the equivalent of receiving less interest) because he receives the conversion option.

However, in the case of a COCO the interest rate paid is *higher* than a straight bond; a straight bond without the conversion component may sell for USD 1,000 while a COCO may sell for USD 900. The price of the conversion option would be USD 900 minus USD 1,000 = USD -100.

The initial net investment in this case is USD -100 for the bond holder. Even if at the time of conversion, the share price is below USD 20 and the bond holder will receive less shares due to the notional amount calculation, the shares he receives will have value greater than USD -100.

Since USD -100, the initial investment, is obviously less than the value of the shares that he will gain upon conversion, the initial net investment characteristic is satisfied.

Derivative Characteristic 3: Net Settlement

ASC 815-10-15-99 gives the following characteristic of a contract that is considered to be “net settled”:

“c. Net settlement by delivery of derivative instrument or asset readily convertible to cash.”

FAS 133 explains the reasoning behind this requirement:

“265. Net settlement is an important characteristic that distinguishes a derivative from a nonderivative because it permits a contract to be settled without either party's accepting the risks and costs customarily associated with owning and delivering the asset associated with the underlying (for example, storage, maintenance, and resale). However, if the assets to be exchanged or delivered are themselves readily convertible to cash, those risks are minimal or nonexistent. Thus, the parties generally should be indifferent as to whether they exchange cash or the assets associated with the underlying.”

Application of Derivative Characteristic 3 to BCNs: Net Settlement

The question arises as to the definition of an “asset *readily* convertible to cash”. ASC 815-10-15-121 gives as an example of a readily converted asset: “a security or commodity traded in an active market”. Does this apply to a BCN? The conversion of a BCN may occur when FINMA decides that its issuer is in danger of insolvency; in such a scenario, would Credit-Suisse stock be considered to have an “active market”? If Lehman Brothers is any guide, the answer is “Yes”. The daily volume of Lehman shares traded one week before declaring bankruptcy averaged over 400 million shares. However, ASC 815-10-15-122 says:

“Parties should generally be indifferent as to whether they exchange cash or the assets associated with the underlying, although the term *indifferent* is not intended to imply an approximate equivalence between net settlement and proceeds from sale in an active market.” It is questionable as to whether a holder of a BCN would be indifferent to receiving equity in a company threatened by bankruptcy to replace his debt; after all, the holder only agreed to buy the bonds since they paid a higher rate of interest as compensation for the risk of conversion. In that case, the BCNs may not be considered readily convertible to cash and the embedded option would not qualify as a derivative.

Insurance Exception

ASC 815-10-15-13 lists financial contracts which are not considered derivatives. One of them is “certain insurance contracts”.

ASC 815-10-15-52 expands on this exception:

“A contract is not subject to the requirements of this Subtopic if it entitles the holder to be compensated only if, as a result of an identifiable insurance event (other than change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk... To qualify, the contract must provide for a legitimate transfer of risk, not simply a deposit or form of self-insurance”. Of note is that FAS 133 Paragraph 10(c) adds that this exception applies “whether or not they are written by insurance enterprises” while the ASC version does not have this “whether or not” clause. ASC 815-10-15-52 says that a financial instrument will not be classified as a derivative if

- a. Compensation is a result of an “insurance event”
- b. The insurance event is something “other than change in price”

ASC 815-10-15-53 gives two insurance contract examples which would not be derivatives:

- ”
- a. Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
 - b. Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.”

A question arises in that in ASC 815-10-15-52 the guidance excludes from being a derivative a contract concerning “an identifiable insurance event (other than change in *price*)”, while in ASC 815-10-15-53 the guidance says “an identifiable insurable event (for example, theft or fire) instead of changes in a *variable*”. This difference might affect the classification of a COCO/BCN whose conversion is caused by a change in a variable (Tier 1 capital ratio) but not in a change of a price; for a normal convertible, the variable *is* a price i.e. the price of a share of stock.

In addition, what is the definition an identifiable insurance event? Would a FINMA decision forcing a conversion of BCNs be such an event? MetLife offers Wedding Insurance with one of the covered insurance events being “a bridal salon going out of business” <https://www.metlifega.com/Products/WeddingInsurance/tabid/313/Default.aspx>. A bridal salon going out of business would seem to be similar to Credit-Suisse being deemed by FINMA of needing an equity boost to avoid going out of business.

Interestingly, in the case of a COCO, it is the embedded option and not the host debt contract that might qualify as an insurance contract; the host is merely a debt contract. The specific asset for which the holder is at risk would be the value of the embedded option itself if it was determined to be a derivative asset that would be valued independently of its host.

One characteristic of a COCO that at first blush may not satisfy the insurance exception is that the guidelines refer to the holder who is buying insurance to cover a risk, while in the case of a COCO, it is the issuer who is. However, looking at the substance rather than the form of a COCO may alleviate this objection. The bond issuer is effectively buying insurance from the bond holder by paying a higher rate of interest, which is similar to a traditional insurance policy where the policy holder pays the issuer of insurance.

A further point to be clarified is the definition of “compensation”: is conversion of debt into equity considered compensation for the bond issuer? On the one hand, the value of the equity that the debt is converted into is the same as the par value of the debt (a wash), but on the other hand, this conversion is considered a benefit for the issuer and in fact resulted in the issuer paying a higher rate of interest.

ASC 815-15-55-204 , 205, 206 refers to a “Disaster Bond” which is defined as:

“A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.”

This is similar to a COCO whose coupon is higher than a straight bond’s and in which the specified disaster would be the drop in the issuer’s Tier 1 capital.

The code continues:

“However, if the embedded derivative entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (see paragraphs 815-10-15-53 through 15-54, a separate instrument with the same terms as the embedded derivative would not meet the Statement's definition of a derivative in Section 815-10-15. In that circumstance, because the criterion in paragraph 815-15-25(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.”

This is similar to a COCO in which the bond *issuer* is being provided insurance by the bond holder.

Equity Exception to Derivative Classification

Derivatives are considered assets or liabilities and therefore a derivative-like instrument that has characteristics of equity will be excluded from derivative treatment.

Accordingly, according to ASC 815-10-15-74(a), a contract may have the characteristics of a derivative but nonetheless *not* be considered to be a derivative asset or liability by a reporting entity if it has both of the following two characteristics:

1. it is indexed to the reporting entity’s own stock
2. it is classified in the reporting entity’s stockholders' equity section in its balance sheet

It is important to note the phrase “reporting entity” and the difference it makes in applying the above exception. COCOs and other convertible bonds are typically convertible into the bond *issuer’s* stock and not the bond holder’s stock, so exception condition (1) would not apply to the bond holder, but would apply to the bond *issuer*. This means that the bond holder would typically never apply this exception, but a bond issuer could have this exception and as a result not classify a convertible bond’s option that he issued as a derivative. However, if the bond was convertible into the stock of a different company than the one that issued the bond then neither exception condition would apply to both the bond issuer and bond holder since an option on another company’s stock would not be on either’s balance sheet as equity and the option is not indexed to the issuer’s stock.

Equity Exception to Derivative Classification Characteristic 1 of 2: “Indexed to the reporting entity’s own stock” ASC 815-40-15-5 through 815-40-15-8

This criterion has two tests that must be passed to be satisfied.

SubTest 1.1: Evaluate the instrument’s conversion conditions: If the conversion component is based on either (1) an observable market, other than the market for the issuer’s stock, or (2) an observable index, other than one measured solely by reference to the issuer’s own operations, then it would not be considered indexed to the issuer’s own stock. For example, if the conversion becomes exercisable only if the S&P 500 increases by 10%, it would not be considered indexed to the issuer’s own stock; however, if

the conversion became exercisable only if the entity's stock price, sales revenue, EBITDA or net income increases by 10%, then it would be considered indexed to its own stock.

SubTest 1.1 Application to Credit-Suisse BCNs

A normal convertible bond passes this test because its conversion component is based on the issuer's stock price; a bond holder only elects to convert if the option's conversion price is in the money.

A BCN's embedded conversion component has two conversion causes. The first one passes this test because it is based on the bond issuer's operations, specifically its Tier 1 Capital ratio (ASC 815-40-15-7(A).b lists "total equity of the issuer" as an example of an "exercise contingency" which is considered indexed to an entity's own stock). The condition attached to this first condition: "unless FINMA, at our request, has agreed on or prior to the publication of our quarterly results that actions, circumstances or events have restored, or will imminently restore, the ratio to above the applicable threshold" also is acceptable since it is not based on a market or index that is unrelated to Credit-Suisse's stock and business.

The second cause for BCN conversion also passes this test because it is not based on a market or index that is unrelated to its stock or business; it is based on FINMA's determination regarding Credit-Suisse being in need of capital to prevent insolvency.

Therefore, if a COCO conversion option also passes the following, second sub-test, it will be considered to be indexed to the underlying stock.

SubTest 1.2: Settlement Terms ASC 815-40-15-7(C) The second test to determine if a conversion component is considered to be "indexed to the issuer's own stock" is based on the settlement terms of the conversion of debt into stock. In a nutshell, if the settlement involves a fixed number of stock shares for a fixed amount of debt, then it would be considered indexed to an entity's own stock. For example, if the conversion feature of a \$1,000,000 COCO specifies that the bond would be converted into exactly 1,000 shares.

SubTest 1.2 Application to Credit-Suisse BCNs:

As mentioned above, for Tier 1 BCNs "The conversion price will be the higher of a floor price of USD 20/CHF 20 per share (subject to customary adjustments) or the daily volume weighted average sale price of our ordinary shares over a five day period preceding the notice of conversion."

The conversion settlement does not seem to involve a fixed amount of shares to be exchanged for a fixed amount of debt; the amount of shares received by the bond holder is subject to a non-fixed calculation. However, the rules further state ASC 815-40-15-7(D),7(E) that even if the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument or embedded feature would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be variables that are typically used to determine the fair value of a "fixed-for-fixed" forward or option on equity shares, for example, the entity's stock price. According to this, since the settlement of shares for a fixed amount of debt is calculated using the share price, the BCNs would satisfy this test.

The "(subject to customary adjustments)" means customary anti-dilution adjustments which do not prevent the conversion component from being considered fixed-for-fixed.

The BCN has passed both parts and would therefore be considered indexed to the issuer's stock. If the BCNs also pass the next criterion, they will qualify for the Exception and therefore not be considered derivative assets or liabilities, from the point of view of the issuer's reporting.

Equity Exception to Derivative Classification, Characteristic 2 of 2: "Classified in stockholders' equity"
ASC 815-15-25-1, ASC 815-40-25, originally EITF 00-19

Sub test 2.1

ASC 815-40-25-1 gives the general rule that a contract that must be settled in shares is classified as equity on the balance sheet while a contract that requires "net cash settlement" is either an asset or a liability. Therefore, if the COCO/BCN embedded option is net cash settled it will fail this test and not be considered equity.

Sub Test 2.1 Application to Credit-Suisse BCNs

ASC 815-15-55-217 gives implementation guidance for a normal convertible bond in which the option is considered to be indexed to the issuer's own stock and the issuer is required to deliver shares of stock upon conversion. That guidance says that a normal convertible bond would be classified as equity in the issuer's balance sheet since the issuer is required to deliver shares upon conversion. A BCN is no different from a normal convertible bond in this aspect and therefore with identical settlement terms its conversion option would also be classified as equity from the point of view of the issuer and not as a derivative. This, however, is not intrinsic to COCOs; if the terms of the conversion allowed for a cash settlement rather than delivery of the issuer's shares, at the *investor's* option, the conversion option would not be classified in stockholders' equity in the issuer's balance sheet. This is per the following rule:

ASC 815-40-25-2

"a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.

b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares."

In other words, we assume that the issuer would prefer to settle in shares and that the bond holder would prefer to settle in cash.

Therefore, from the point of view of the issuer a BCN would not be classified as a derivative but, from the point of view of the bond holder, since the conversion option would not be considered equity on its balance sheet since it converts into the *issuer's* stock, a BCN would not be classified as equity on its balance sheet and therefore could be classified as a derivative.

To Boldly Go Where No Man Has Gone Before – Bifurcation

Now that we know that a BCN's conversion component might be classified as a derivative asset or liability from the point of view of the bond holder, we must face the next step in COCO accounting: should a COCO's value be measured as one, single debt instrument or must the host be separated from its embedded derivative and each part valued separately, a process christened "bifurcation" (*Origin: 1605-15; < Medieval Latin *bifurcātus*, past participle of *bifurcāre*, www.dictionary.com*). An embedded option is only separated from its host if it is a derivative asset or liability; if it has the characteristics of equity it is not separated.

FAS 133 explains the rationale behind not treating a host and its embedded derivative as one entity.

"293. The Board considers it important that an entity not be able to avoid the recognition and measurement requirements of this Statement merely by embedding a derivative instrument in a nonderivative financial instrument or other contract. Therefore, certain embedded derivatives are included in the scope of this Statement if they would be subject to the Statement on a freestanding basis."

One significant result of bifurcation is that:

“For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.” (FAS 133 Summary). This recognition of gain or loss is potentially different than if the embedded conversion option was accounted for under the rules governing its debt host.

ASC 815-15-25-1 gives the ground rules regarding bifurcation.

“An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument ... if and only if all of the following criteria are met.

- a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract.

...

- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument....”

In the case of a normal convertible bond, condition a. is met because the embedded conversion option's value is related to the price of the issuer's stock while the host contract's value is related to interest rates; equity is not closely related to interest rates. Similarly, a COCO's conversion option is related to the issuer's Tier 1 ratio which is not closely related to interest rates.

In terms of criterion b., this would depend on if the embedded conversion option would be considered a derivative if it was a freestanding instrument; if any of the above exceptions applied, the conversion option would not be considered a derivative and would not be bifurcated.

Classifying the Bifurcated Derivative

Now that we know that the BCN's host debt component and conversion option must be accounted by the bond holder separately, the question is: what is its classification?

The classification and measurement of the components of a convertible bond has been the matter of opaqueness for years. According to one counting, there are more than ten different legitimate ways to do this accounting. (Stevens, Volkan, Baker; Journal of Applied Business Research JABR, Vol. 10 No. 4)

The FASB clearly states that derivatives are either assets or liabilities.

ASC 815-10-10-1(a)

“Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements”.

FAS 133 goes more into depth:

“218. *Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.* Derivatives are assets or liabilities because they represent rights or obligations. FASB Concepts Statement No. 6, *Elements of Financial Statements*, describes the characteristics of assets and liabilities as follows:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. . . .

A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable

future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. [paragraphs 26 and 36].”

The JABR article phrases the question, in regards to a normal convertible bond this way: should commitments to issue stock be considered liabilities and similarly answers “Yes”. Since the conversion option of a normal convertible bond would be a liability for the issuer and an asset for the bond holder, then in the case of a COCO, the opposite is true: for the bond holder it is a liability and for the bond issuer it is an asset.

As Dr. Volkan emailed to me:

“I believe this is an asset and that as the risk of needing cash infusion goes down, the asset loses value and a loss is debited. This is because the management gambled and lost. Promised too much interest for a privilege that was not needed.”

Therefore, the conversion option should be classified by the bond holder as a liability and in a case where the COCO issuer would bifurcate he would classify the conversion option as an asset.

Fair Value Option

Even if a hybrid meets the guidelines to require being split apart, the FASB gives reporting entities the option of accounting for the hybrid as one unit, at fair value:

ASC 815-15-25-4

“An entity that initially recognizes a hybrid financial instrument that ... would be required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure the hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings)....”

ASC 825-10-15-5 “No entity may elect the fair value option for any of the following financial assets and financial liabilities.

...

f. Financial instruments that are, in whole or part, classified by the issuer as a component of shareholders’ equity

As shown above, BCNs are not classified as equity for the holder, so this preclusion from fair value accounting does not apply to the bond holder and similarly to the bond issuer in a case where a COCO would not be classified as part of shareholders’ equity.

Other COCO GAAP Treatment Issues: ASC 470-20 Debt with Conversion and Other Options

ASC 470-20 gives guidance for the accounting for debt with specific conversion features, including convertible securities.

ASC 470-20-25-11 which discusses Conversion Features that Are Not Beneficial says:

“The terms of convertible debt instruments addressed by the guidance in the following paragraph generally include all of the following:

- a. An interest rate that is lower than the issuer could establish for nonconvertible debt.

- b. An initial conversion price that is greater than the fair value of the common stock at time of issuance.
- c. A conversion price that does not decrease except pursuant to antidilution provisions.”

In the above paragraph, we see two differences between COCOs and normal convertible bonds which could have impact on how regulations are applied.

- a. By a normal convertible bond, the issuer pays a *lower* rate of interest than for a straight bond because he is offering to the bond holder an option to buy stock. In the case of a COCO, the opposite is true; the issuer must pay a *higher* price because the conversion is to the detriment of the bond holder since it is triggered due to issuer financial stress.
- b. By a normal convertible bond, the conversion in-the-money stock price is *higher* than the stock price at issuance, just like an option. In the case of a Credit-Suisse BCN, for example, the conversion ratio is at a *lower* price than at issuance. For example, in May 2013, the stock is available for USD 29 per share, while the conversion price is USD 20.

Because of these two differences, would the terms of ASC 470-20-25-11 not apply?

ASC 470-20-25-13 accounts for such non-standard instruments with a catch-all:

“Instruments not explicitly discussed in that paragraph (25-11) shall be dealt with in accordance with the substance of the transaction.”

Proposed Changes to ASU 825-10: “FASB In Focus”, February 14, 2013

Under proposed changes to ASU 825, bond holders would no longer split convertible bonds into their component parts; instead, the hybrid contract in its entirety would be measured at either fair value or amortized value, depending on certain criteria. Bond issuers, however, would have two possibilities: either they could bifurcate with the host bond being valued at amortized cost and the conversion component at fair value or the entire hybrid would not be split and would be measured at fair value.

In summary, we see that the uniqueness of COCOs raises questions as to the proper accounting treatment of their embedded conversion options.

Important characteristics of COCOs vis-à-vis normal convertible bonds, which contribute to these questions are:

- a. The conversion is not executed per the whim of the bond holder
- b. The conversion is not dependent on the share price but the Tier 1 capital ratio
- c. The conversion is viewed as an advantage for the issuer, not the bond holder
- d. Conversion is not only dependent on a variable but on a FINMA decision

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