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In this month's HORIZON:

- **It's a Convertible Bond bonanza** – What could happen next?
- **T+1 moves into sharper focus** – increased failure risk and other considerations.

Convertible Bond bonanza

The conditions are right for Convertible Bond (CB) issuance. The recent issue by Uber was upsized from its original US$1.2bn to $1.5bn, capitalising on strong investor appetite. In September's edition of Horizon we looked at areas of risk around the CB issuance process. This month we take a look back at the CB history books and revisit some of the structures which have proved problematic.

Refinancing pressure has arrived at the worst point in the cycle. Standard & Poor's see a risk of stress in the US high-yield market, due to the large amount of refinancing which will need to take place in 2024 and 2025. They see a need for US$247.7bn in 2024 rising to US$389.3bn in 2025. Meanwhile US$7.6tn of US government debt will mature in the next 12 months, nearly a third of the amount outstanding. This should maintain pressure on US rates to remain high.

It seems likely that companies refinancing high-yield debt will look to the CB market. Those companies under the greatest stress may seek to find ways of preserving cash flow by deferring interest payments. Indeed, **premium redemption** CBs offer the possibility of settling all of the interest due on maturity of the CB. Premium redemption CBs are attractive to issuers because if the bonds are converted before maturity then no principal or interest will need to be repaid. With US stocks hitting near terms highs, it is foreseeable that some issuers could be counselled that the need to repay would be unlikely if they were to opt for this kind of issue. The problems arise when the underlying stock fails to perform, and a company finds that it needs to find 35% to 45%[1] more funds to cover the debt incurred at maturity.

[1] Estimate based on current market rates

Nicolas Corry, SKADI's MD, and a former head of CB trading, explains:

"20 years ago, zero coupon premium redemption CBs were the vogue in the Indian market. Investors were wooed by tremendous growth rates where Indian stocks were consistently performing. Indian issuers were resistant to paying coupons on bonds due to the tax liability these incurred. It took a domestic liquidity crunch in 2006, followed by the global financial crisis in 2008, for a wide range of issuers to become insolvent. In many cases outstanding CB debt exceeded the issuers' market capitalisations."

SKADI's Emerging Risks Outlook for 2024 predicts that insolvencies are an area of risk for the forthcoming year. For those listed companies under the greatest pressure to raise capital or refinance outsized debt loads, they may be tempted towards issuing **Moving Strike Convertible Bonds** (MSCBs). MSCBs are occasionally issued privately. Bond holders (though few remain holders) are attracted by the opportunity to acquire extremely cheap paper. Holders are able to convert their bonds into the underlying shares at a deep discount to the prevailing share price. The conversion price resets as the share price falls. This leads to persistent selling pressure on the shares until the bonds are fully converted. The outcome for the share price is typically catastrophic. Whilst bondholders reap a windfall gain, issuers achieve their objective of raising urgent financing, but shareholders suffer steep losses, which may be irrecoverable.

MSCBs were an innovation of the Japanese CB market, but similar issues were fraudulently issued in the US market a decade ago. The SEC filed charges against Magna Group for selling shares from fake promissory notes to unsuspecting retail investors. This all points to the need for enhanced due diligence when MSCB issues are being presented to Issuance Committees. Staff should also be aware of the impact to the wider franchise of a Privately Issued MSCB.

Nicolas Corry explains:

"Lehman Brothers privately financed a Yen 80bn MSCB to Japan's Livedoor in 2005. Livedoor was attempting to acquire Fuji Television Network. Livedoor was unsuccessful in its bid for Fuji TV and ultimately went bankrupt. Lehman faced a reputational firestorm from small investors in Livedoor stock, who suffered losses from the catastrophic fall in the share price. Meanwhile the customer facing flow businesses of Lehman Brothers Asia also faced heat from Hedge Fund customers, angry at not being given an opportunity to participate in an attractive deal."

For control staff at Wholesale Financial firms we feel the following areas should be considered:

- New Product Approval: Where MSCBs and Premium Redemption CBs are approved products, do those approvals take into consideration lessons learned since the approval was granted?

- Reputational Risk: Do reputational risk committees have adequate diversity, knowledge and understanding to assess the risk of issues being brought, particularly where innovations from one region are introduced into another.

- Modelling and Quants: In the case of CB businesses sitting within Equities Franchises, are the models adequately equipped to deal with accreting structures? Have bootstrapped models originally intended to be a short term fix, been assimilated as business as usual?

T+1 moves into sharper focus as we head into 2024

November saw a number of articles regarding the upcoming switch to T+1 settlement in the US (as well as Canada and Mexico) in 2024. As SIX Group noted in its "Future of Finance" report, there are "Differing Opinions on T+1" with 43% of respondents believing it could be a source of a higher rate of **settlement failures**. This is something we at SKADI also highlighted in our Emerging Risks 2024 Outlook that was sent to Audit heads back in October.

With many European/UK funds holding US stocks, the transition to T+1 poses significant operational, regulatory and financial challenges for market participants, particularly in the ETF sector. Many ETFs (think of sector-specific ones) will hold securities in both the EU/UK and US so the differing settlement cycles are going to cause all sorts of issues around **funding** as well as the increased danger of trade fails. As Ciaran Fitzpatrick at State Street pointed out in a recent FT article, EU UCITS regulations limit a fund to holding no more that 20% of its assets in cash or being 10% overdrawn, so there could be regulatory breach implications too.

As Damian Taylor, SKADI Director, ex-head of trading and hedge fund manager also notes …

"When trading dual-listed structures such as Carnival, Ryanair and the like which have listings in both the UK/EU and US, moving 1 of the legs to T+1 while the other moving parts (the local leg and the FX component) remain T+2 is going to have huge knock-on effects with regard to the overnight funding rates. Often these trades are done for quite small turns, so the additional costs will have to be factored in. Maybe not such an issue a year ago in a zero-rate environment, but not in the higher-rate world we now find ourselves in."

We see two areas of focus for the control functions…

- Has consideration been given to the increased burden of allocating and reclaiming costs associated with increased counterparty fails and the possible increase in capital in support of desks fulfilling customer transactions when counterparties have failed?

- What is the level of awareness and preparedness for those businesses utilising affected US markets and instruments as a peripheral part of their business?

The need for technological upgrades, increased automation and potentially significant changes in **operational and staffing** strategies are key areas of focus for institutions adapting to this change.

Previous **Horizon** editions can be found **here**

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Niral shares his insights on Transformations drawn from his career as the Chief Ethics Officer of DWS, Global Head of Group Audit Investigations for Deutsche Bank and a former Attorney with the SEC.

In this fascinating episode Niral explains how Corporate Investigations can be harnessed to bring about organisational change. How organisations can gain an ROI - "return on investigations"! and analyse the lessons learned.

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