The Future of CoCos:

A role for going-concern conversion

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Basel III aims

1. Basel III rules increase buffers to limit taxpayer-funded rescues.
2. Novel approach: rules should recognize trouble in time
   - If bank risks are allowed to become systemic, some forms of bailout are inevitable.

⇒ **Risk has to be absorbed by the financial system**

Two ways to deal with bank risk

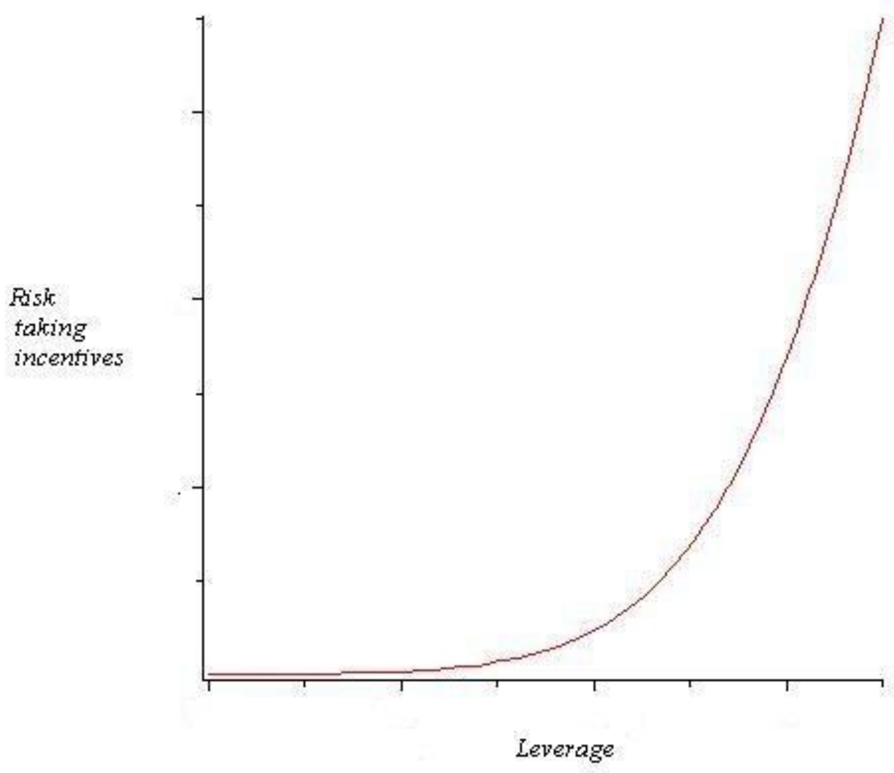
1) Wait till losses become evident, then clean up afterwards (Greenspan)
2) Lean against the wind

Basel III chose **prevention:**

SYSTEM LEVEL	INDIVIDUAL BANK
Countercyclical and systemic buffers	Going concern conversion (CoCo bonds)

Risk-shifting incentives

- As leverage rises, risk-shifting incentives increase non-linearly.

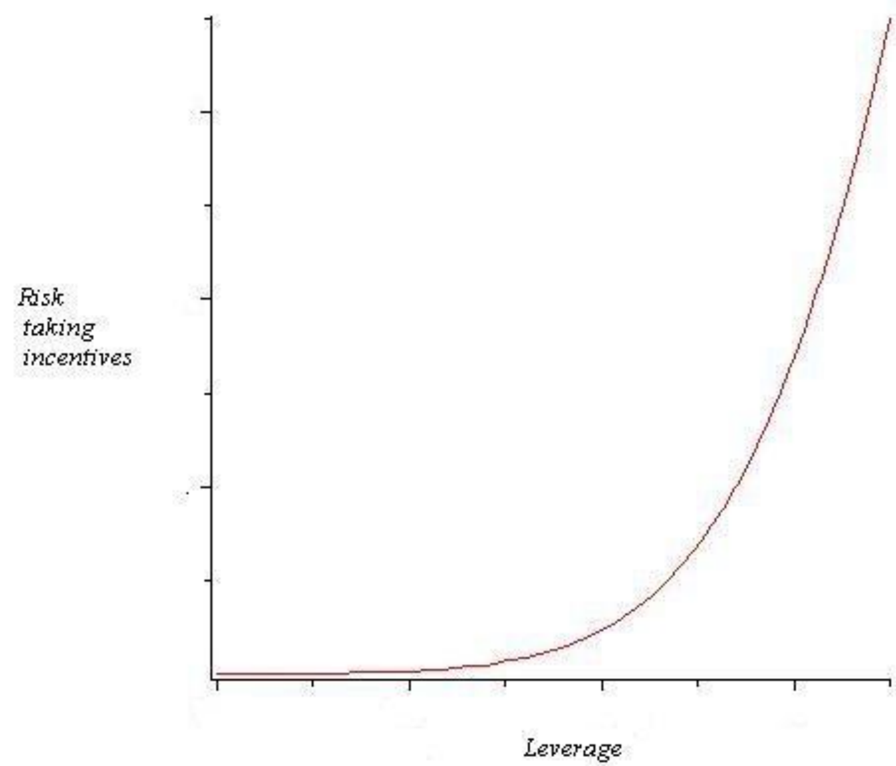


Reducing risk-shifting

- How to discourage risk-shifting in highly levered banks?
- Restoring buffers ? May be hard to raise equity

(Debt Overhang)

- Solution: force banks to pre-issue capital



CoCos: effect on leverage

- Upon CoCo conversion, leverage drops. This **reduces risk-taking while the bank is still alive (going concern)**

Before conversion			After conversion	
Assets	**Liabilities**		**Liabilities (PWD)**	**Liabilities**
	Deposits *D*		Deposits *D*	Deposits *D*
Assets *V*	CoCos *C*	**Debt**	*Reduced debt 0*	*Converted CoCo*
	Equity *E*		Equity *E*	Total Equity *C+E*
V	*V=D+C+E*		*V=D+C+E*	*V=D+C+E*
Leverage =(D+C)/E			**D/E**	**D/(C+E)**

Equity content of CoCo debt

1. Missing coupon payment (income loss).
2. *Going-concern* conversion upon trigger (small capital loss).
   - It is impossible to have conversion at par.
   - A higher trigger implies more equity content.
   - Upon PWD conversion, a larger write-down implies more equity.
3. *Gone-concern* conversion at default (larger or total loss).

CoCos vs bail-in-able debt

Bailin-able debt absorbs losses only at default

CoCo debt may convert upon distress, ahead of default

Going-concern deleveraging improves risk incentives
Gone-concern conversion does not !

⇨ But only if regulators allow the trigger to be activated (since ALL CoCo triggers are based on book equity)

What if regulators do not trigger?

- Regulators may avoid conversion as it causes strong market reaction
- Forbearance undermines distinction between going and gone-concern capital (McCunn, 2015)
- As risk is allowed to build up, the market reaction will only get larger!

- Anedoctal evidence: CoCo bonds do not price the risk of conversion, suggesting investors do not expect any risk bearing

Suddenly, misgivings about CoCo debt

CoCos have become reviled in 2016 for being risky.

Precisely the reason why they were introduced !

- No conversion of CoCo debt has ever occurred !
- No coupon has ever been skipped
- No loss has been suffered

Yet markets panicked at the first chance of minimal risk (missing a coupon payment)!

Deutsche Bank CoCo hysteria (1/2)

- The whole world knew DB could use more capital.
- In January 2016, a hint that DB may skip ONE COUPON created market panic.
- *Note: chances of imminent conversions were zero*.

➡ Extreme market response led to concerns among regulators

Deutsche Bank CoCo hysteria (2/2)

Regulatory forbearance

The market appeared to wake up to some chance of risk.

And what did regulators do?

- They criticized publicly CoCo bonds as creating instability
- They rushed to provide a legal interpretation to the EU directive to minimize the chance of missing a coupon
  - Admittedly, DB is large…
  - Yet it would have been essential to show that banks can convert CoCo debt and survive, in fact be better off!

The risk is another debacle
such as with subordinated debt pre-2008

Now a question on DB

Why do you think the market reaction on DB was so violent ?

- *The implication of the news was so bad as to make a default by DB much more likely*
- *Investors had not expected to bear any conversion risk*

What policy going forward ?

- Policymakers should state publically that **skipping a CoCo coupon is a natural occurrence**.

- **Higher trigger CoCo** (say, 7 or 8% instead of 5%) would have **more chance to be converted** as going concern.
  - ✓ Obviously, this is more expensive; greater equity content.

- **Conversion should be de-mistified** (made harmless) by encouraging more frequent, idiosyncratic trigger events.

Otherwise, CoCo bonds are useless

- If CoCo bonds are not allowed to absorb risk and take some losses ahead of default, they are just **very complicated bail-in-able debt**.
- Can be **beneficial only for lawyers**.
- They **should not qualify for Additional Tier 1 (AT1) capital buffer.**

Further readings

- Chan, Stephanie and van Wijnbergen, Sweder (2017) *CoCo Design, Risk Shifting Incentives and Financial* Fragility, European Capital Markets Institute Working Paper. Available at: https://www.ceps.eu/system/files/ECMI%20WP%20No%202_0.pdf
- Delivorias, Angelos (2016) *Contingent convertible securities - Is a storm brewing?* (May 2016), European Parliamentary Research Service (EPRS). Available at: http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/582011/EPRS_BRI(2016)582011_EN.pdf
- McCunn, Ayowande (2016) *Forbearance Incentives: Undermining the Distinction between Going and Gone-Concern Capital*. Available at SSRN: https://ssrn.com/abstract=2814969
- Perotti, Enrico, and Glasserman, Paul (2016) *The Unconvertible CoCo Bonds.* Available at: http://fbf.eui.eu/event/future-cocos-online-seminar/