Contingent Convertible Bonds:
Comments on the December 2009 Consultative Document -
Strengthening the Resilience of the Banking Sector

By: David Bishop, Ethan Zuofei Liu, Patrick Murray and Téa Solomonia
State University of New York at Buffalo Law School, New York City Program in Finance and Law

Disclaimer: Any and all views expressed in this comment letter reflect only the opinions of the authors, and not of SUNY at Buffalo Law School, the University at Buffalo, the program's director, or the program's other participants.

Table of Contents

I. Summary of Contingent Convertible Bonds

Contingent Convertible bonds (CoCos) are debt instruments that must transform into shares of equity or are written off upon a triggering event. A CoCo, in the same fashion as other hybrid securities, has both debt and equity-like features embedded within its structure. CoCos begin their life as ordinary bank bonds, and absent a triggering event will behave as such until maturity. To date, there have been two CoCo issuances, one by Lloyds Banking Group (Lloyds) and another by Rabobank Group (Rabobank). Upon triggering, Lloyds' CoCos convert to common stock while Rabobank's have a 25 percent principal write-down.

Currently, the Basel Committee is seeking to revise its capital structure whereby Tier 1 capital may only be composed of pure equity. As a result, instruments such as CoCos will only qualify for Tier 1 capital treatment *post*-conversion. It is the opinion of this comment that such treatment on behalf of the committee is wise, despite the favorable impact CoCos may have, not only on banks facing a crisis, but on the risk management incentives of bank financing participants.

a. The Function of CoCos

The most notable feature of CoCos is their debt-to-equity conversion trigger. CoCo triggers are designed so that conversion occurs when the bank is in crisis, as determined either by regulatory assessment or objective bank losses. The objective test is based on a measure of the bank's Tier 1 capital ratio. For the issuer, CoCos serve two functions: 1) they enable the issuer to raise leveraged capital in a tax efficient manner while 2) qualifying for Tier 1 or Tier 2 capital treatment. Issuers, investors, credit-rating agencies, and regulators must also be mindful of two conditions with respect to transformation: 1) the bond's maturity date, and 2) the debt to equity (or cash) transformation ratio.

b. The Importance of Hybrid Bonds

During the recent crisis, existing hybrid bonds failed to perform the way both regulators and investors expected when they failed to absorb losses at critical moments. Pre-crisis hybrid bonds allowed, but did not require: 1) the issuer to skip coupon payments, and 2) to avoid paying back the principal amount. When the crisis occurred however, banks chose not to invoke these features in order to mollify investors in the powerful bond market.

Hybrid bonds gained popularity during a period in which bond yields were at historic lows, inducing investors to accept the risks inherent in hybrid securities. According to data compiled by the Federal Reserve, from 2002-2009 corporate bond yields were at their lowest levels in almost thirty years. In 2005, the average corporate bond yield (for AAA-rated bonds) hit an all-time low of 5.23 percent. A rapid increase in the issuance of hybrid bonds began in 2005 corresponding to this historically low yield.

II. Risks Inherent in CoCos

The following risks should be sufficient indication that CoCo bonds are not likely to achieve the goal of shoring up Tier 1 capital in a time of crisis.

a. Regulatory Uncertainty

The three most widely cited credit rating agencies, Moody's, S&P, and Fitch, have deemed CoCos precarious because of their financial and regulatory risk. For example, Lloyd's CoCos have received the non-investment grade rating of Ba3 by Moody's while rating agencies are delaying rating Rabobank's CoCos until regulatory uncertainly is resolved. Rating agencies perceive CoCos as inherently risky because of the difficulty of: 1) predicting triggering events that would require the debt to convert to equity; 2) measuring losses the debt holder would suffer as a result of that trigger; 3) assessing the ability of CoCos to absorb bank capital losses; and 4) determining how CoCos will be treated in the regulatory capital reforms now being considered. Given these concerns it is unclear what role these securities may play in the banking industry.

There is also a dynamic that forms between rating agencies and regulators when determining how to treat new or innovative financial products. For instance, rating agencies take into consideration regulatory treatment of securities in determining how to rate a security. Regulators, on the other hand, require some institutions to invest only in securities that have been awarded a particular grade, or are remote from certain types of risks, including hybrid conversion or equity type risks. Any ambiguities or discrepancies in the treatment of innovative financial products on behalf of either regulators or credit-rating agencies may carry unintended consequences, both for CoCo issuers and investors alike.

b. Conversion Risks

Despite CoCos' potential to buttress bank capital in times of crisis, there remain many uncertainties as to how these securities will actually behave upon conversion. If the holder of CoCos happens to be an investor who is not allowed to hold equity instruments, conversion

triggers may generate forced sales of the newly converted equities. In the case of CoCos that convert to equity, the forced sale of the newly converted equities may potentially encounter a liquidity crunch as the market would be flooded with such securities, especially in a crisis like the one that banks faced in late 2008. Even in the absence of market liquidity problems, distress sales would presumably drive down the price of the stock of the troubled bank. The stock price would be under pressure in any event because of the dilutive effect of the equity coming into existence upon conversion. This downward pressure would be further aggravated in all likelihood by the effort of other shareholders to sell down their holdings, and perhaps by the efforts of short-sellers. This potential risk is especially dangerous for CoCos such as the ones issued by Lloyds because the triggered conversion calls for the CoCos to be converted to a fixed number of common equity shares, as opposed to the CoCos issued by Rabobank where CoCo holders receive cash, albeit only 25 percent of the principal value.

Although Rabobank's CoCos seem to escape the danger that newly converted securities might depress the market, the requirement that the bank pay the holders of the convertible securities in cash might subject it to liquidity pressure. A bank in such a position might well have to either borrow or sell some of its assets. As the crisis of 2008 made evident, however, other banks might not be willing to lend and any assets to be sold might be subject to further valuation and liquidity difficulties.

In the best case scenario, if CoCos convert to equity or are written-off, the question remains as to whether this will produce sufficient capital for a bank to avoid insolvency. Lloyds and Rabobank issued CoCos as "going concern" banks not facing declining capital levels. It is difficult, however, to predict whether the number of CoCos issued during calm economic times will have the ability to augment a bank's capital during a crisis. If regulators choose to require banks to issue CoCos, an important question is, therefore, how much should be issued? If banks are faced with a capital crisis similar to the 2007-08 period, where banks had assets on their balance sheets that were rapidly deteriorating in value and illiquid, a large amount of CoCos would have to convert to equity to make a difference. Since potential conversion of CoCos will negatively affect investor confidence in the bank, the re-capitalization effect of CoCos may be offset by a bank's inability to raise short-term funds or otherwise stabilize its financial situation. Similarly, having Rabobank type CoCos, which are written off at a quarter of the principal debt amount, might have a recapitalization effect but at the same time may significantly undermine the issuer's cash reserves.

III. Systemic Considerations

Creditors invest in bonds due to their regular interest payments and relatively high certainty of principal repayment. CoCo conversion will reduce or eliminate certain payments while, in some cases, locking up creditors' money in devalued and illiquid equity, potentially resulting in the financing costs of banks to rise substantially. This could in turn limit the availability of credit from the banks that issue CoCos, although it might also discourage excessive leveraging.

Although this comment is skeptical of the economic feasibility of CoCos, we do believe that they would have a positive impact on reducing moral hazard by changing the behavior of the financial system's participants. The proposed CoCo bonds have the capacity to expose

conversion risk to not only a bank's creditors, but to its shareholders and managers, thus inducing self-monitoring practices. Of course, it is also possible that increasing capital requirements may lead banks to engage in riskier activities in order to retain the same amount of return on equity. In addition, higher capital requirements could drive financing out of the banking sector into less regulated sectors. These risks, however, are ubiquitous to regulation that increases capital requirements and do not disrupt the means by which CoCos may improve the risk management of banking institutions.

While CoCos may protect the issuing bank from insolvency, the conversion comes at a high cost. Following the dilution of equity upon conversion, shareholders would lose a degree of control over the bank that they previously enjoyed. Facing this potential loss of control, existing shareholders will have a greater incentive to spend time and attention monitoring the performance of bank management in order to avoid approaching situations where conversion is imminent. This may help to change the corporate culture of issuers and avoid potential systemic harms.

Finally, the clearly defined trigger eliminates management discretion during a conversion. This avoids many of the problems, from a regulatory point of view, that hybrid bonds faced during the last crisis. No longer will management be able to delay conversion in the hopes that the government will provide assistance. Arguably, if management has no power to stop conversion should a triggering event occur, it will have a greater incentive to prevent emergencies from happening and to craft plans for any emergency that might nevertheless occur.

IV. Conclusion

Given the considerations enumerated above, it is the recommendation of this comment that CoCos be denied favorable capital treatment in the forthcoming Basel meeting. Admittedly, CoCos have the potential to reduce moral hazard and encourage more active monitoring and supervision of banks and do provide a capital buffer for issuers. However, the risks associated with these instruments appear too grave, too unpredictable, and, indeed, too systemic, to warrant their inclusion in mandatory bank capital requirements. Regulatory reform is direly needed given the world's experiences within the last three years but CoCos should be confined to a small part of the solution. Banks should have the option of issuing CoCos, but should not be required or given any significant regulatory encouragement to issue these instruments.