Andreas Dombret: In support of coco bonds

Op-ed by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, published in *Frankfurter Allgemeine Zeitung*, 21 February 2015.

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One of the key outcomes of regulatory reform in the banking industry, launched in 2008, is that banks need more and more capital. To illustrate this point, the new Basel III regulatory framework requires credit institutions to hold significantly more higher-quality capital than before. In addition, global systemically important banks need to additionally strengthen their capital base so that they can bear potential losses unassisted.

The idea is to enhance banks' resilience and avoid putting taxpayers back on the hook for banks' losses in future crises. Although these reforms are good, they raise the question of how banks will be able to cover growing capital requirements.

With this in mind, we should turn our attention to a different kind of capital instrument. Known as "contingent convertible bonds", or "coco bonds" for short, they are bonds which convert automatically from debt to equity upon a specific trigger event – for instance, if an institution is faced with insolvency or if its tier 1 capital ratio drops below a certain threshold. In such cases, coco bonds increase the bank's capital buffer.

This new type of bond is attractive to credit institutions for several reasons. One is that, under certain conditions, coco bonds are recognised by supervisors as capital. These conditions hinge on the category to which the capital is to be assigned and reflect, for instance, subordinated status and long-term availability of the capital. The issuing bank's discretionary scope for deciding whether or not to make coupon payments to investors is a further condition. Another selling point for coco bonds to banks is that interest payments on the bond are tax-deductible.

Coco bonds can be attractive to institutional investors as well; owing to their particular risk, they promise superior returns to those on normal bonds – which accounts for much of their appeal to investors, particularly in the current low-interest-rate setting.

So are coco bonds a "silver bullet" for banks? In Germany at least, their importance has been marginal up to now. Up until the end of last year, these bonds were issued mainly by large banks in Spain, Switzerland and the United Kingdom. Their total volume amounted to some €50 billion. Only two German institutions issued coco bonds in 2014.

Uncertainties surrounding the tax treatment of these instruments – which have now been cleared up – were one of the reasons why German banks were so slow to issue such bonds. In addition, German companies legislation has thus far not explicitly provided for mandatory convertible instruments where the right to convert lies with the issuer. The 2014 draft Act Amending the Companies Act, which is currently making its way through the legislative process, will make it legal here in Germany, too, to issue coco bonds, which would then convert to equity shares. Banks' growing need for capital could be precisely the catalyst that might increase the importance of coco bomds in Germany, too – which is all the more reason to be careful.

Attractive as these instruments may be to banks and investors, we must remember that these are very complex capital instruments, especially since they are governed by such disparate areas of the law as companies law, debt law, tax law and supervisory law. There is a risk that retail investors in particular, mesmerised by the relatively high returns on coco bonds, could lose sight of the risks involved. Banks are aware of the danger: Deutsche Bank, for instance, issued its coco bonds in denominations of €100,000 in order to restrict entry into coco bond business to institutional and professional investors. In the United Kingdom, the sale and distribution of coco bonds to retail investors is even prohibited by law.

Now is the time for supervisors to develop a code of best practices for issuing coco bonds. While taking national legal systems into account, we supervisors need to strive for as much standardisation as possible in order to achieve convergence in the EU. It is important, though, that coco bonds actually be used to absorb the losses that the issuing banks could potentially incur.

This challenge has been recognised by EU lawmakers and supervisors. The key tasks facing supervisors now are to observe the market very closely and to press ahead with efforts to improve the legal framework for coco bonds. Once these tasks have been accomplished, coco bonds can be a useful addition to banks' capital structure. By helping to strengthen the capital base, they will make an added contribution to enhancing banks' resilience to future crises.