

WHY COCOS ARE LESS PROBLEMATIC THAN BAILING-IN OF LIABILITIES

THE FOURTH SYMPOSIUM ON ENDING TOO BIG TO FAIL,
FEDERAL RESERVE BANK OF MINNEAPOLIS
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PROFESSOR EMILIOS AVGOULEAS
CHAIR IN INTERNATIONAL BANKING LAW & FINANCE
UNIVERSITY OF EDINBURGH
MEMBER, STAKEHOLDER GROUP,
EUROPEAN BANKING AUTHORITY

ADVANTAGES (AND SOME DISADVANTAGES) OF EQUITY CAPITAL

- BEST LOSS ABSORPTION CAPACITY – SHAREHOLDERS RANK LAST IN INSOLVENCY

- EASIER TO SUSPEND SHAREHOLDER RIGHTS THAN CREDITORS'
- SERIOUS GOVERNANCE GAINS – REDUCTION OF THE LEVERAGE RACHET
- BETTER MONITORING OF MANAGEMENT – MORE MEASURED REMUNERATION POLICIES TO RESTRAIN VIS-À-VIS RISK-TAKING
- LOWERS LEVERAGE AND INCREASES INSTITUTIONAL AND SYSTEMIC RESILIENCE
- **CONS**
- DUE TO TAX CONFIGURATION IT'S EXPENSIVE
- CONSTANT FEAR OF DILUTION COULD MEAN THAT SHAREHOLDERS ARE STILL AFTER HIGHER YIELD INSPITE ITS CORRELATION WITH RISK LEVELS
- REQUIRES COMPETITIVE R_{oE} BUT ESP. EUROZONE BANKS ARE LOADED WITH NPLS AND THEIR R_{oE} IS MINISCULE

COCOS AT A GLANCE

- CoCos are securities, issued by a bank, that are designed to absorb the bank's losses during a period of financial stress, thereby improving its capital position.
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- Private investors are usually reluctant to provide additional external capital to banks in times of financial distress so CoCos offer a way to address this problem.
 - CoCos absorb losses by automatically converting to equity or having their principal written down (either partially or in full) when a pre-specified trigger event occurs.
 - Absent a trigger event, the securities are hybrid financial instruments with debt-like characteristics (such as a specified coupon rate). CoCos are subordinated to senior debt within the bank's capital structure.
 - Lloyds Banking Group's November 2009 offering of enhanced capital notes (ECNs) is generally recognised as the first issuance of CoCos.
 - Depending upon the specific features of the security, CoCos can qualify as Additional Tier 1 (AT1) or Tier 2 (T2) capital under the Basel III.
 - CoCos must be perpetual instruments with coupon payments that can be deferred or cancelled at the issuer's discretion without causing an event of default.
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TO TRIGGER OR NOT TO TRIGGER


- An **accounting-based trigger** (Book-value triggers typically set contractually in terms of the book value of CETI capital as a ratio of RWA). It is activated if CETI drops below a specified level. A higher trigger is intended to provide additional equity capital at earlier intervention points.

- Buyers of CoCos with accounting-based triggers will have to calculate the nearly impossible to fathom future evolution of the issuer's capital ratios.
- A **discretionary trigger** gives the bank's regulator responsibility for triggering the CoCoS when the issuer is about to reach or has reached the point of non-viability. It prevents bank insolvency (instant recap) or results in reduction of resolution losses for other creditors. It allows regulators to trump any lack of timeliness or unreliability of book-value triggers. E.g., had Citibank issued CoCos with even a high book-value trigger before November 2008, those instruments would not have been activated prior to the government's injection of capital. The bank's accounting regulatory capital ratios remained comfortably above the regulatory requirements even when its stock market capitalisation amounted to merely 1% of its reported risk-weighted assets.
- Regulatory discretion can create pricing uncertainty – but, otherwise, is it very hard to predict the regulator's use of its discretion when a bank's capital buffers are diminishing?
- **Market-value triggers** could address the shortcoming of inconsistent accounting valuations. These triggers are set at a minimum ratio of the bank's stock market capitalisation to its assets. As a result, they can reduce the scope for balance sheet manipulation and regulatory forbearance.

COUPON PAYMENTS & REDEMPTIONS

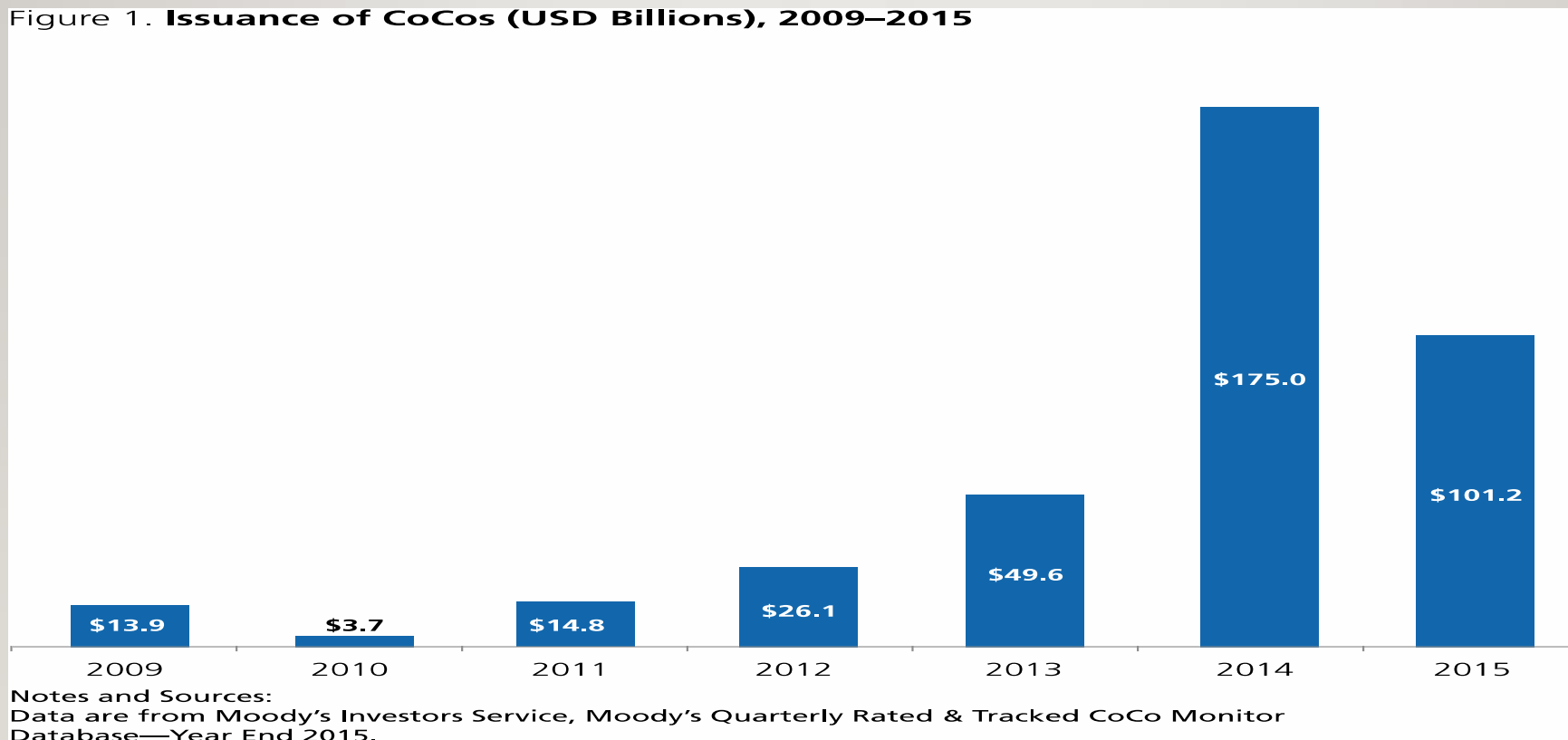
- For ATI CoCos even when an issuer is able and willing to make interest payments on ATI CoCos, it could be prevented from doing so by the regulator. Through a restriction of distributions' order to build the issuer's CET1 buffer or the countercyclical and G-SIB (buffer/charge)
- ATI CoCos, while perpetual in nature, are generally callable by the issuer after a stated period (a minimum of five years in order to qualify as ATI).
- Under the CRD IV Tier 2 CoCos are also callable by the issuer subject to restrictions and regulatory approval. TIER 2 CoCoS are low trigger instruments

PRICING CHALLENGES AND THE POTENTIAL FOR MANIPULATION

- Market-value triggers may be difficult to price and could create incentives for stock price manipulation.
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- The pricing of conversion-to-equity CoCos with a market-value trigger could suffer from a multiple equilibria problem. More specifically, since CoCos must be priced jointly with common equity, BUT a dilutive CoCo conversion rate could make it possible for more than one pair of CoCo prices and equity prices to exist for any combination of bank asset values and non-CoCo debt levels.
 - Finally, under certain circumstances, holders of CE CoCos may have an incentive to short-sell the underlying common stock in order to generate a self-fulfilling death spiral and depress the share price to the point at which the market-value trigger is breached.
 - It is not a remote scenario – Bondholders in Italian Banks fearing bail-in have shorted the stock
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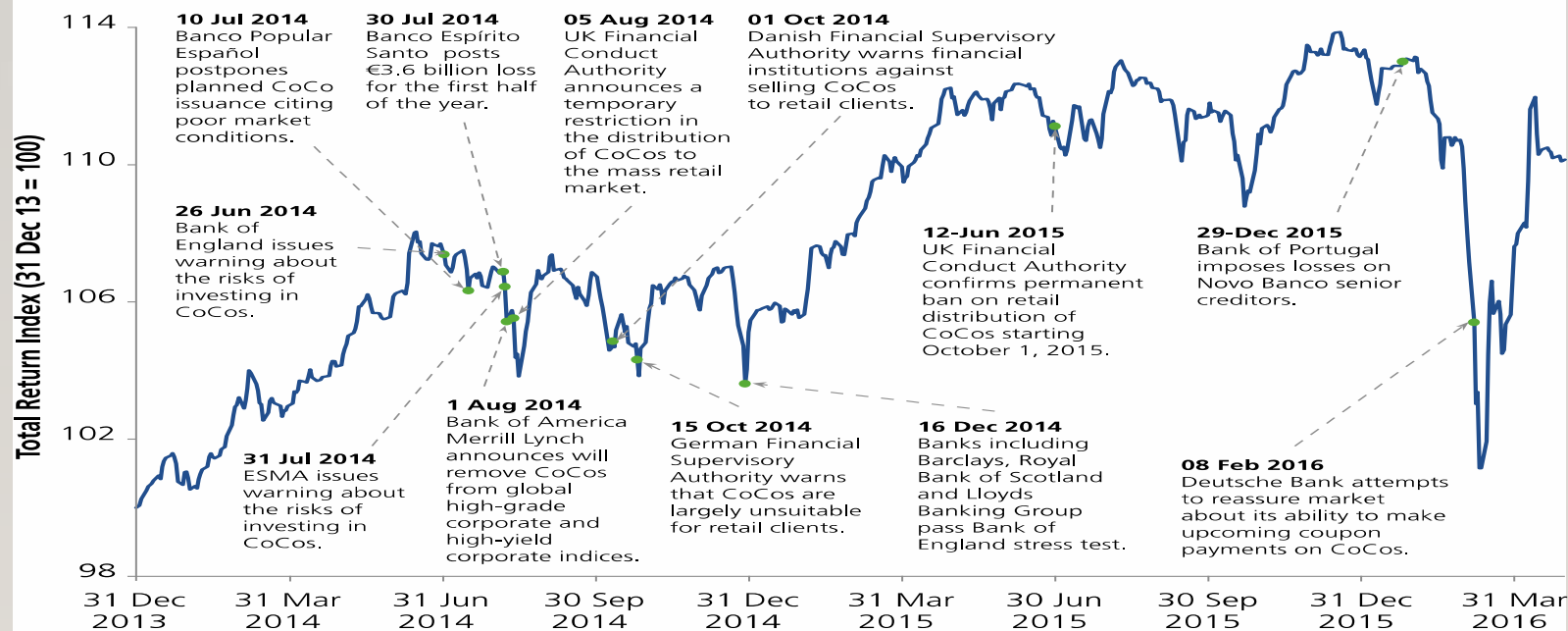
COCOS TEND TO BE POPULAR BUT DEMAND FOR THEM IS SATIATED BY A SUPPLY GLUT

Figure 1. Issuance of CoCos (USD Billions), 2009–2015




YIELDS (AS EXPECTED) ARE VOLATILE

Figure 4. Total Return on BofA Merrill Lynch Contingent Capital Index, 31 December 2013–31 March 2016



Notes and Sources:
Data are from Factset and Factiva.

HOW DEEP IS THE POOL OF BUYERS?

- UBS, Société Générale, Credit Suisse, Deutsche Bank and Royal Bank of Scotland have issued about €91 billion (\$102 billion) of additional tier-1 capital from April 2013 until early 2016.
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- Private banks and retail investors – before they were banned by the FSA in 2014 – were the main buyers of AT1 instruments followed by asset management companies, hedge funds and banks.
 - Investors are still trying to understand the mechanical trigger levels, loss-absorption mechanism and discretionary triggers that influences AT1 yields.
 - UK challenger bank Aldermore issued a £75 million perpetual non-call 5.5 year bond with a CET1 trigger of 7% in December that offered a whopping 11.875% yield via Deutsche Bank. "For Aldermore, the cost of equity is higher than the cost of AT1, and there is a small group of private equity investors that is very willing to buy this risk,"
 - Fellow UK challenger bank Shawbrook (which had also been considering an IPO in 2014) nearly doubled the size of its regulatory capital to £178 million last year via the issuance of a tier-2 bond, which is believed to have been placed with US private equity house CarVal. The latter, along with Pimco and BlueBay, is one of a number of US investors that have set up funds targeting new-style bank capital.
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SELLING RESTRICTIONS

- Regulators' concerns regarding potential mis-selling of CoCos to retail investors could result in investigations and/or enforcement actions.
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- The complex pricing mechanics have forced several regulatory authorities to ban the product from the retail investor markets under their product review powers
 - On 31 July 2014, the European Securities and Markets Authority issued a statement explaining the risks of investing in CoCos and stating that their analysis “can only take place within the skill and resource set of knowledgeable institutional investors.”
 - On 5 August 2014, the UK's Financial Conduct Authority announced a temporary restriction on the distribution of CoCos to the mass retail market, effective 1 October 2014 to 1 October 2015. The ban has now become permanent!
 - On 1 October 2014, Denmark's Financial Supervisory Authority warned financial institutions against selling CoCos to retail clients.²¹ And on 15 October 2014, Germany's Federal Financial Supervisory Authority stated that “[i]n general, [CoCos] are not suitable for active distribution to retail clients.”²²
 - CoCos have been reported to be popular with retail investors in Australia - the regulator offers extensive explanations of the product has not restricted their sale.
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COCO ADVANTAGES OVER BAIL-IN OF LIABILITIES (I)

- If used to prevent resolution - they do not raise issues of valuation – intra-resolution valuations normally drop as auditors are replaced
- Make a generalized creditor run post-resolution less likely than bailing in liabilities
- Do not affect deposits or senior bondholders – do not damage confidence in the savings industry
- In principle, ex post liquidity should not be affected though the impact of the psychological may be unclear – certainly though less than bailing-in liabilities (Continental Illinois)
- At the same time prevent sharp deleveraging & possible firesales to avoid resolution (i.e., the alternative path to avoiding bail-in)

COCO ADVANTAGES OVER BAIL-IN OF LIABILITIES (II)

- Do not affect deposits or senior bondholders – do not damage confidence in the savings industry
- Thus, CoCos make early intervention/PCA more likely (and effective) – unlike MREL/bail-in regulators have the certainty of a capital cushion enabling them to hit NPLs early – the exact opposite result of the 8% bail-in requirement of the BRRD that has paralyzed tackling of NPLS in Italy, Greece and Portugal
- Augmenting bank solvency makes easier and less complicated/controversial LoLR liquidity assistance at the pre-resolution stage
- Appropriate design of triggers and lack of a a NWO conditions minimize fear of litigation
- They smooth up resolution if it comes to that - even if the bank fails in the end It reduces the possibility of successive bail-rounds as in the case of Novo Banco or Hypo Adria