Contingent Convertible Capital Instruments (CoCos) – BIS Primer


■ Abstract

Contingent convertible capital instruments (CoCos) are hybrid capital securities that absorb losses when the capital of the issuing bank falls below a certain level. This article goes over the structure of CoCos, trace the evolution of their issuance, and examine their pricing in primary and secondary markets. CoCo issuance is primarily driven by their potential to satisfy regulatory capital requirements.

The bulk of the demand for CoCos has come from small investors, while institutional investors have been relatively restrained so far. The spreads of CoCos over other subordinated debt greatly depend on their two main design characteristics – the trigger level and the loss absorption mechanism. CoCo spreads are more correlated with the spreads of other subordinated debt than with CDS spreads and equity prices.

■ For the BIS Quarterly Review, please click here.

■ For the Primer (14 pages), please click here.

■ Background

Private investors are usually reluctant to provide additional external capital to banks in times of financial distress. In extremis, the government can end up injecting capital to prevent the disruptive insolvency of a large financial institution because nobody else is willing to do so. Such public sector support costs taxpayers and distorts the incentives of bankers.

Contingent convertible capital instruments (CoCos) offer a way to address this problem. CoCos are hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level. Then debt is reduced and bank capitalization gets a boost. Owing to their capacity to absorb losses, CoCos have the potential to satisfy regulatory capital requirements.

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This article examines recent developments and trends in the market for CoCos. The analysis is based on a data set that covers USD 70bn worth of CoCos issued between June 2009 and June 2013. Several trends stand out.

First, the main reasons for issuing CoCos are related to their potential to satisfy regulatory capital requirements. Second, the bulk of the demand has come from private banks and retail investors, while institutional investors have been relatively restrained so far. Third, CoCo yields tend to be higher than those of higher-ranked debt instruments of the same issuer and are highly dependent on their two main design characteristics – the trigger level and the loss absorption mechanism. Finally, CoCo yields tend to be more correlated with those of other subordinated debt than with CDS spreads (on senior unsecured debt) and equity prices.

The rest of this article is organized as follows. The first section describes the structure and design of CoCos. It discusses the reasons for CoCo issuance in the second section. The third section examines the main groups of investors in CoCos. The fourth and fifth sections, study the pricing of CoCos in primary and secondary markets, respectively. The final section concludes.

Structure and design of CoCos

The structure of CoCos is shaped by their primary purpose as a readily available source of bank capital in times of crisis. In order to achieve that objective, they need to possess several characteristics. First, CoCos need to automatically absorb losses prior to or at the point of insolvency. Second, the activation of the loss absorption mechanism must be a function of the capitalization levels of the issuing bank. Finally, their design has to be robust to price manipulation and speculative attacks.

CoCos have two main defining characteristics – the loss absorption mechanism and the trigger that activates that mechanism (graph 1). CoCos can absorb losses either by converting into common equity or by suffering a principal writedown. The trigger can be either mechanical (i.e. defined numerically in terms of a specific capital ratio) or discretionery (i.e. subject to supervisory judgment).

Read the full Primer (<click here>).

(Source: Bank for International Settlements – BIS).

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