XIII. The CoCo Compromise: Banks, Investors, and Regulators Settle for a Debt-Equity Hybrid as a Source of Capital

A. Introduction

The 2008 global financial crisis ushered in a period of economic uncertainty with the near collapse of the financial sector.[1] Banks that were global fixtures shuttered overnight,[2] were acquired by competitors,[3] or were bailed out by taxpayers.[4] Prior to the crisis, banks incurred substantial debt and were highly leveraged.[5] Banks generally favor debt over equity because debt is cheaper, as creditors are able to offer capital at a relatively low cost to the borrower.[6] Extending credit to banks is a low risk enterprise because creditors know that a bailout would protect their interests in the event that the bank fails.[7] Additionally, banks favor debt over equity because it does not dilute their control or ownership, and interest payments are tax deductible.[8] During the crisis, however, highly leveraged banks suffered magnified losses since they failed to have the equity needed to safeguard against eroding confidence in the marketplace.[9] For example, in 2007, global financial services firm Lehman Brothers's equity comprised only about three percent of its balance sheet with almost all of the remainder being debt, which led to its inability to remain solvent at the onset of the crisis.[10] Meanwhile, the federal government had to bail out many banks that became overly reliant on debt and "too big to fail."[11]

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[1] *Crash Course*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article [http://perma.cc/C9VM-U982].
[2] *See id*.
[3] *See, e.g.*, Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 14, 2008, at A1.
[4] *See Crash Course*, *supra* note 1.
[5] *Miraculous Conversion*, ECONOMIST, May 16, 2015, at 70.
[6] *Id*.
[7] *Id*.
[8] *Id*.
[9] *See id*.
[10] *Id*.
[11] *See* Eric S. Halperin, *CoCo Rising: Can the Emergence of Novel Hybrid Securities Protect From Future Liquidity Crises?*, 8 B.Y.U. INT'L L. & MGMT. REV. 15, 16 (2011).

After the crisis, regulators attempted to force banks to increase the amount of equity on their balance sheets.[12] Specifically, the Basel Committee[13], through a set of standards colloquially referred to as "Basel III," declared that banks must maintain certain levels of common equity with additional quality requirements for the remainder of the bank's regulatory capital, with the goal of shifting the risk of bank failure to investors rather than taxpayers.[14] As a result, banks increased equity reserves, used less traditional debt to finance investments, and increasingly utilized a new financing instrument known as a contingent convertible bond (CoCo [15]).[16] Despite some regulatory uncertainty, CoCos appeal to banks because they represent a balance between debt and equity that satisfies regulatory requirements without forcing banks to absorb the costs of holding pure equity.[17]

This article outlines the current use of CoCos, analyzes the composition of CoCos, and discusses the future use of CoCos despite some skepticism about whether the instrument will successfully prevent a crisis. Part B discusses the increasing utilization of CoCos in the aftermath of the crisis. Part C discusses the composition of CoCos and defines differences between possible points of conversion. Part D then analyzes the reasons that banks, investors, and regulators are in favor of CoCos. Finally, Part E concludes that banks will continue to utilize CoCos despite the uncertainty that they will prevent a future crisis.

B. CoCos Increasingly Utilized

CoCos have increased in popularity since their inception; large global banks, including Switzerland-based UBS and Credit

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[12] *Miraculous Conversion*, *supra* note 5.

[13] The Basel Committee is a council of global banking authorities tasked with "strengthen[ing] the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability." *About the Basel Committee,* BANK OF INT'L SETTLEMENTS, www.bis.org/bcbs/about.htmdrop (last visited Oct. 23, 2015) [http://perma.cc/7SRF-RVWU].

[14] Hillary J. Allen, *CoCos Can Drive Markets Cuckoo*, 16 LEWIS & CLARK L. REV. 125, 131-32 (2012).

[15] Although the literature on CoCos uses a variety of spellings (i.e.: cocos or Cocos), this article will use "CoCos" for consistency purposes.

[16] *Id.* at 126-127.

[17] *Id*.

Suisse, and Belgium-based KBC, have offered CoCos for sale.[18] Switzerland has required that both UBS and Credit Suisse "hold capital equivalent to [nineteen percent] of their risk-weighted assets," which is far greater than the Basel III minimum of ten percent.[19] The nineteen percent the banks are required to hold can consist of both equity ("ten percent") and CoCos ("nine percent").[20] Credit Suisse, as a result, sold $6.32 billion of CoCos to existing investors and then opened to the public an additional $2 billion of CoCos, which were oversubscribed.[21] In 2014, Chinese banks issued nearly sixty billion dollars' worth of CoCos, which is one third of the global volume of CoCos issued.[22] Belgium's KBC also successfully sold one billion dollars of CoCos.[23] Despite many banks' desire to issue CoCos, some investment firms like Goldman Sachs caution that CoCos are too complex to sell to retail investors and believe CoCos are only appropriate for "highly sophisticated investors."[24] Investors' penchant for CoCos is strong despite the risk. Ultimately, the international uptick of banks selling CoCos is well-documented and has been viewed as the means to strengthen the banking sector's viability in economic panics.[25]

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[18] Katharina Bart, *Credit Suisse Sells $2 Billion of CoCos to Public*, WALL ST. J. (Feb. 17, 2011, 6:44 PM), http://www.wsj.com/articles/SB100014 24052748704546704576150861690164484 [http://perma.cc/G6S3-9LMR]; Art Patnaude, *KBC Sells $1 Billion CoCo Bond*, WALL ST. J. (Jan. 18, 2013, 12:40 PM), http://www.wsj.com/articles/SB10001424127887323468604578249742702681694 [http://perma.cc/Y8Z5-4LUA].

[19] Simon Nixon, *Switzerland Goes Loco for CoCo Bonds*, WALL ST. J. (Oct. 5, 2010, 12:01 AM), http://www.wsj.com/articles/SB100014 24052748704631504575532332108151668 [http://perma.cc/S2ZU-ATGD].

[20] *Id*.

[21] Bart, *supra* note 18.

[22] Christopher Thompson, *Chinese Bank Issue Most CoCo Bonds*, FIN. TIMES (Feb. 11, 2015), http://www.ft.com/intl/cms/s/0/5a99b804-b135-11e4-9331-00144feab7de.html#axzz3mow9e4bB [http://perma.cc/3EEV-R848].

[23] Patnaude, *supra* note 18.

[24] William D. Cohan, *Wall Street Executives from the Financial Crisis of 2008: Where Are They Now?*, VANITY FAIR (Apr. 2015), http://www.vanityfair.com/news/2015/03/wall-street-executives-2008-jamie-dimon-cancer [http://perma.cc/KHD5-CVNM].

[25] Ash Bennington, *Cuckoo for Cocos*, CNBC (Mar. 10, 2011, 12:07 PM), http://www.cnbc.com/id/42004623 [http://perma.cc/CN7Z-PSKQ].

C. CoCos' Ingredients

i. Defined

A CoCo is a hybrid between debt and equity, and more specifically, a "debt instrument (like a bond) issued by a bank."[26] Unlike bonds, however, CoCos have the potential to become common equity shares of the issuing bank.[27] The point of conversion from debt to equity is determined by contract when banks issue the instruments, and is referred to as the "trigger event."[28] The trigger event is typically a period of "duress" where the "debt burden on banks" poses a risk to the bank's solvency because the bank might not be able to honor its debt obligations.[29] Thus, the convertible nature of CoCos from debt to equity eases the bank's debt burden, as the bank no longer needs to pay those creditors and has a source of equity readily available.[30] CoCos provide flexibility to banks and investors because they offer the upside of debt's low cost relative to equity, offer better than average returns for investors because they are riskier than traditional bonds,[31] and provide a safety mechanism for banks in that they can become equity in a crisis.[32] This flexibility of conversion, however, ceases once CoCos convert from debt to equity, as they cannot revert back to debt.[33]

ii. CoCo Conversion: Preventing a Bittersweet Rush to Equity

The precise point of conversion from debt to equity is variable.[34] Although many variations of the point of conversion exist, there are three notable points of conversion highlighted by the literature: the market value trigger, the micro-level and subjective

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[26] Allen, *supra* note 14, at 126.
[27] *Id*.
[28] *Id*.
[29] *See* Halperin, *supra* note 11, at 15.
[30] *Id*.
[31] Josie Cox, *European Bank Stress Tests Make 'CoCo' Bonds Sweeter*, WALL ST. J. (Oct. 27, 2014, 1:08 PM), http://www.wsj.com/articles/stress-tests-make-cocos-sweeter-1414417479 [http://perma.cc/JNL9-5CWL].
[32] Halperin, *supra* note 11, at 17.
[33] Allen, *supra* note 14, at 127.
[34] *See* Halperin, *supra* note 11, at 19.

macro-level dual trigger, and the dual market trigger.[35] These three trigger options all aim to find the ideal trigger without rushing to a premature conversion, which would be antithetical to investors' interest and make CoCos less appealing because a conversion indicates a weak market and a loss of faith in the issuing firm.[36]

The "market value trigger" causes the debt to convert to equity if the value of the issuing firm's common stock equity drops below a predetermined level.[37] At the time of conversion, an investor who owns a CoCo will receive a number of shares that has a current market value equivalent to the value of the debt.[38] This trigger point is immediately reactive to movement in the market, which is superior to the alternative of basing a trigger on accounting ratios or GAAP standards because such standards "omit [changes as they occur] due to the delay in processing information."[39] Additionally, a trigger based on accounting ratios instead of the value of common stock equity "would permit manager manipulation, and . . . delay the conversion, perhaps to a point where the firm's true value would leave it insolvent."[40] Proponents of the market value trigger highlight that this trigger only involves the value of the issuing firm's equity, as opposed to other triggers that the entire market impacts.[41] This trigger is tailored to the individual firm's financial stability and is not dependent on secondary signals from other firms, which comports with CoCos' aim to prevent bank collapse without a taxpayer-funded bailout.[42] However, many find the market value trigger undesirable in comparison to other triggers because it is vulnerable to "investor manipulation" where "the public equity price [serves as] a giant target for capital structure arbitrage."[43]

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[35] *Id*. at 19-21.
[36] *See* Allen, *supra* note 14, at 127-28.
[37] Halperin, *supra* note 11, at 18-19.
[38] *Id*. at 21.
[39] *Id*. at 19.
[40] *Id*.
[41] *Id*.
[42] *Id.* ("Other schemes . . . would wait until regulators declare a systemic crisis or for financial firms' indices to fall in addition to the individual firm's price. Waiting for secondary signals from the market at large may in fact allow certain firms to fail. Such a result is incongruent with the goal of CoCo, which is to stave off insolvency without requiring outside bailouts from the government.").
[43] Graham Bippart, *Market Value Triggers for Bank CoCos are Still a Bad Idea*, GLOBALCAP. (May 26, 2015), http://www.globalcapital.com/

The "micro-level and subjective macro-level dual trigger" occurs when regulators declare a crisis in the financial system and issuing banks violate agreements in the CoCo's contract.[44] At the time of conversion, an investor who owns a CoCo will receive a "preordained quantity of equity shares."[45] Proponents of this dual trigger believe it avoids the peril of the single market value trigger because debt is not prematurely converted to equity upon recoverable losses, which means that the inherent nature of debt is not undermined "by moving the obligation to meet coupon payments off the ledger."[46] This regulator-driven subjective approach allegedly safeguards against the "imprecise nature of the time-lagged data used by firms."[47] Advocates of the market value trigger, however, find this trigger unappealing because a regulator's declaration of a crisis might lead to "runs and sell-offs," but if regulators wait to announce such a crisis, then those banks that are failing must continue to suffer until given approval to trigger the CoCo's conversion.[48]

The "dual market trigger" occurs when both a firm's stock price and financial index fall below pre-determined values.[49] Finance scholars propose that at the point of conversion, an investor will also receive a "fixed-share quantity."[50] This trigger, unlike the single market value trigger, occurs "upon widespread decreases in firm value across the sector."[51] As a result, if a firm is "teetering on the edge of rescue," the firm might still collapse because the market will believe the firm will be saved by CoCos' conversion, which will fail to occur because such confidence will keep the financial index elevated and prevent the conversion from occurring.[52] Meanwhile, banks favor this approach because it is not dependent on regulators officially declaring a financial crisis, which could lead to panics.[53]

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article/rqyk5pxff8h0/market-value-triggers-for-cocos-are-still-a-bad-idea [http://perma.cc/72FY-ZHKK].

[44] Halperin, *supra* note 11, at 19-20.

[45] *Id*. at 22.

[46] *Id*. at 20.

[47] *Id*.

[48] *Id*.

[49] *Id*.

[50] *Id*. at 23.

[51] *Id*. at 21.

[52] *Id*.

[53] *See id*. at 21, 28.

Ultimately, neither the federal government nor regulators mandate specific triggers for conversions, as specific firms choose the CoCos' point of conversion through contract.[54] The implications, however, of these trigger points differ and may have unforeseen consequences.[55]

D. Banks, Investors, and Regulators Go "Cuckoo for CoCos"[56]

Basel III requires that banks have a "certain amount of . . . capital" in the form of pure equity and the remainder can be divided among a variety of other regulatory capital instruments.[57] Many banks satisfied Basel III's requirement of holding capital in other regulatory instruments by issuing CoCos, which spreads the risk amongst the bank's investors, rather than taxpayers, and bolsters regulatory capital.[58] Banks, therefore, are able to continue using a form of debt to finance investments with the long-term protection of the debt converting into equity, which lowers the risk of a taxpayer-funded bailout during a crisis.[59] In addition, banks favor CoCos because these instruments allow the banks "to recapitalize automatically and dependably" in a crisis.[60]

Investors find CoCos appealing because they offer "income well above that available from traditional debt" and because the risk of a conversion is reduced with increased bank stability.[61] Although many investors are in favor of CoCos, preexisting equity holders of firms issuing CoCos might be opposed to these instruments because the possibility exists that a conversion would dilute these shareholders' ownership stake in the firms.[62] Nevertheless, CoCos gained some marketplace approval by receiving a "passing grade on

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[54] *See id*. at 19.
[55] *See id.*
[56] Bennington, *supra* note 25.
[57] Allen, *supra* note 14, at 131.
[58] *Id.* at 129-30; Cox, *supra* note 31.
[59] Allen, *supra* note 14, at 132-35.
[60] Halperin, *supra* note 11, at 25, 28.
[61] Christopher O'Dea, *Investors Warm Up to Bank Contingent Convertible Bonds*, INV. & PENSIONS EUR. (April 2015), http://www.ipe.com/reports/investors-warm-up-to-bank-contingent-convertible-bonds/10007299.fullarticle [http://perma.cc/N6RL-DTEF].
[62] *Id*.; Halperin, *supra* note 11, at 26.

a [European bank] stress test."[63] This signals that the risk of conversion is low,[64] which makes CoCos more appealing for investors who are looking to "buy debt instruments with a significantly higher yield."[65] Even though the higher yield is intended to reflect a greater amount of risk than typical debt, investors would likely be more inclined to accept the risk for the return, given that the European Bank stress test indicates a low chance of conversion.[66] Therefore, investors generally find that from a profitability perspective, CoCos' benefits outweigh their risk because the average "CoCo debt yields around 5.96%", which far exceeds the "less than 1%" average yield for covered bonds.[67]

E. Conclusion and The Future: CoCos Favored Despite Uncertainties

CoCos' capacity to prevent the need for taxpayer-funded bailouts has not been fully tested because such a test would require a 2008-style crisis.[68] For example, CoCos could disrupt the market as the instruments might "incentivize trading strategies that destabilize confidence in the very financial institutions that [CoCos] are intended to help," as investors attempt to force or prevent conversion in accordance with their individual financial interests.[69]

Regulators and banks, however, favor CoCos as a means to bolster capital reserves.[70] In the aftermath of the crisis, regulators have found that CoCos provide the necessary shift away from banks holding pure debt, as the convertible nature of CoCos will spread the risk of a bailout amongst investors instead of taxpayers with a crisis-driven conversion to equity.[71] Thus, regulators view CoCos positively as a "compromise" between debt and equity instruments

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[63] Cox, *supra* note 31.
[64] *Id.*
[65] Allen, *supra* note 14, at 157.
[66] Cox, *supra* note 31; O'Dea, *supra* note 62.
[67] Cox, *supra* note 31
[68] Allen, *supra* note 14, at 126.
[69] *Id*. at 167.
[70] Halperin, *supra* note 11, at 28 ("The Federal Reserve, the Basel Committee of Bank Supervisors and leading bankers have all spoken in favor of adopting some form of CoCo . . . . [T]he need for higher reserves should be tempered through contingent convertible capital.").
[71] *See* Cox, *supra* note 31.

that enhance banks' viability in economic downturns.[72] Despite the uncertainties surrounding CoCos, banks, investors, and regulators alike are generally supportive of CoCos as they are less risky than debt, provide greater yields for investors, and will likely reduce the potential burden on taxpayers during the next financial crisis by lessening the need for large bank bailouts.[73]

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[72] Halperin, *supra* note 11, at 28; *Mass Conversion*, ECONOMIST, Sept. 13, 2014, at 81.
[73] Allen, *supra* note 14, at 156-57.
[74] Student, Boston University School of Law (J.D. 2017).