

Devil in CoCo detail

Scope exists to design instruments that avoid problems inherent in the terms of contingent convertible debt capital, writes **Vince Heaney**

ment of CoCos across jurisdictions, the valuation uncertainty created by the presence of discretionary triggers, and the potential for certain high-trigger CoCos to invert the traditional capital structure hierarchy have all contributed to the credit rating agencies' reluctance to rate the instruments.

Given that it is the specific terms of CoCos that lead to their shortcomings, rather than the principle of having debt that can be bailed-in, scope may exist to design instruments that avoid some of the problems. One such alternative, which has been proposed by two economists, Jeremy Bulow and Paul Klemperer, together with Jacob Goldfield, a hedge fund manager, is that banks should replace all (non-deposit) existing unsecured debt with Equity Recourse Notes (ERNs).

These instruments would be similar to CoCos but with important differences. ERNs would be long-term bonds but, if the bank's stock price was below a pre-set level on any date when interest or principal were payable, the payments would be made in stock at the pre-set level, rather than in cash.

The trio suggest that the pre-set price would be required to be no less than, for example, 25 per cent of the share price on the date the bond was issued. If the bank's share price were \$80 when the bond was issued and the share price subsequently fell below \$20 by the time a \$1,000 principal or interest payment was due, the bondholder would receive 50 shares (1,000/20) at \$20 per share. If the stock rebounded in price, future payments could again be in cash.

By making the conversion trigger a pre-set share price, the problem of arbitrary regulatory conversion is avoided, although some critics have suggested that a pre-set share price trigger creates the same incentives for "death spiral convertibles" as CoCos. Klemperer, however, argues that "ERNs are specifically designed to have the opposite effect: because conversions are always for a fixed number of shares at prices above the current share price, they shore up that price". He notes that, historically, the worst spirals occurred when conversion gave creditors more than a dollar's worth of stock for every dollar's face value of debt. By contrast, with ERNs, bondhold-

ers receive stock with a market value less than the debt's par value, which increases the price of the stock, stabilising prices.

This share price stabilisation argument implicitly assumes that the world follows the rules of conventional financial models, in which the total value of all the claims against the firm is independent of how the firm is financed. In imperfect capital markets, any large-scale conversions into shares might reduce the share price and subsequently cause more conversions.

However, Klemperer points out that ERNs are designed – and would be required – to convert gradually, one payment at a time, rather than the entire bond converting at once. ERNs also avoid the negative impact on liquidity of significant cash bond repayments: banks cannot be pushed into a liquidity crisis that might, for example, lead to value-destroying fire-



sales of assets. Moreover, the bank might even use the cash saved by making bond payments in stock to repurchase its own shares – the expectation of which could help support the share price.

ERNs are also counter-cyclical – a good thing in itself, but which should also lend support to share prices. ERNs become cheaper to issue when the stock price falls, as the trigger is linked to the current share price. If, for example, the stock price declines from 100 to 40, new ERNs can be issued with a conversion price of 10 instead of 25 – so the new bonds will only suffer losses after the old bonds have already taken a 60 per cent haircut. With a lower trigger, the new ERNs will be senior to older, unsecured ERNs. So, Klemperer and his colleagues argue that ERNs help

avoid death spirals, even in imperfect capital markets.

"From a public-policy standpoint we are not directly concerned with whether bank shares are trading below "fair" or "intrinsic" value – we care about whether a low share price causes the bank to have trouble funding itself," says Klemperer. "But by making it easy and profitable to issue ERNs in bad times, and by ensuring companies never have to pay cash, our design also makes aberrantly low share prices less likely."

Altering the structure of contingent capital instruments along the lines of ERNs does appear to offer the potential to avoid some of the pitfalls of CoCos. While their proponents accept that there are outstanding issues regarding the tax treatment of ERNs and of regulators' understanding and acceptance, they are optimistic that progress can be made.

However, the obstacle to wider investor acceptance of contingent capital instruments lies more in the regulatory requirements that they be permanent capital, and that coupons can be suspended, than in the intricacies of the conversion trigger mechanisms. Faced with a realistic risk of suspended coupon payments and conversion or writedowns, investors' only protection is to ask for a higher interest rate. In a market where investors are still searching for yield, the higher coupons on CoCos have proved attractive to those investors able to hold them – issues have been subscribed several times over.

"At the moment, people have been happy to focus on the high coupon, but when a regulator tells a bank to stop paying the coupon on an AT1 eligible contingent capital bond for a few quarters, people will realise the protection offered by the coupon is very fragile," says Doig.

Regulators need to balance the requirement for permanent capital with the ability of institutional investors to hold the instruments that meet their criteria – otherwise the window in which banks can place contingent capital may prove short-lived.

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