Contingent Convertibles [CoCos]

A Potent Instrument for Financial Reform

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Contingent Convertibles [CoCos]

A Potent Instrument for Financial Reform

George M von Furstenberg

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Abstract

This is the first book on CoCos, an innovative instrument that has attracted growing attention since it was first issued in 2009. Henceforth spelled cocos, they represent debt that is subject to being converted automatically into common equity under pre-specified terms of conversion if the chosen regulatory capital ratio falls to a level triggering conversion. Cocos are that subspecies of contingent capital that references regulatory (Basel III) concepts in its triggers. From 2014 on, trigger points are set by common equity (Common Equity Tier 1 [CET1]) in percent of risk-weighted assets [RWA] or of more complicated measures of total exposure to a variety of risks, particularly credit risk. CET1 trigger levels of at least 7% are generally activated to fortify institutions in transitory difficulties that are expected to continue as going concerns. Lower trigger levels, near 5%, are characteristic of bail-in cocos that are intended to facilitate resolution outside of bankruptcy, although the chances of recovery would also be improved if the cushion of such cocos were substantial.

This study is mostly concerned with going-concern ‘recovery-’ rather than ‘resolution-’ cocos, because avoiding failure and costly disruption of financial networks without government financing is the first order of business. Cocos hold a high promise of providing fully loss-absorbing equity capital when it is most needed and least available to financial institutions. Yet, having grown out of the 2007–2009 financial crisis, they are still an ‘infant’ reform instrument in many respects. Few of the instrument’s design features (or even the rating, regulatory, and tax treatments) are entirely settled. This monograph seeks to

help move the discussion toward the main decision points. These must be passed before cocos can live up to their promise and prove their value for contingency planning and self-insurance. They should do so not only in Europe and Latin America but also increasingly in North America, Australia, South Africa, the Middle East and centers of high finance in Eastern and Southern parts of Asia, including Singapore and Hong Kong—come the next financial crisis.

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About the Author

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His research and teaching subjects have centered on international finance and open-economy macroeconomics, but he has also worked on a variety of public finance issues, the determinants of mortgage default risk, and aspects of financial reform. His latest book projects have dealt with *Regulation and Supervision of Financial Institutions in the NAFTA Countries*, *Learning from the World's Best Central Bankers*, and *Monetary Unions and Hard Pegs: Effects on Trade, Financial Development, and Stability*. He joined the G8/G20 Research Group in 1999 and in 2000 was President of the North American Economics and Finance Association.