

## THE COCONUNDRUM

*Frederick Ryan Castillo \**

Digging deeper into their analytical toolbox, policymakers, academics, and regulators are increasingly exploring whether, and to what extent, a system of contingent capital can strengthen the resilience of the banking sector. The global financial crisis unearthed fragile and troubled banks, riddled with excessive leverage, poor quality capital buffers, and liquidity problems. Because these institutions were deemed “too big to fail,” governments were forced to intervene and prop them up by way of costly, taxpayer-funded bailouts. With the benefit of hindsight, regulators are now looking at contingent capital as a potentially speedy and less costly alternative for recapitalizing banks in periods of financial distress.<sup>1</sup>

But is contingent capital a desirable, feasible and sustainable proposition, or is it an overly-simplified theoretical concept fraught with practical difficulties and unrealistic expectations?

Contingent capital—also known as “contingent convertibles” or “CoCos,”<sup>2</sup> “regulatory hybrid securities,”<sup>3</sup> “contingent capital certificates,”<sup>4</sup> or “embedded

---

\* LL.M. Candidate, 2011, Harvard Law School.

<sup>1</sup> See Damian Paletta, ‘Contingent Capital’ Idea Gaining More Steam Within Fed, WALL ST. J. (Oct. 13, 2009), <http://blogs.wsj.com/economics/2009/10/13/contingent-capital-idea-gaining-more-steam-within-fed>; Steve Slater & Clara Ferreira-Marques, *Contingent Capital: Cure or Cost for Banks?*, REUTERS (Oct. 27, 2009), <http://uk.reuters.com/article/idUKLNE59Q01K20091027>; Giuseppe De Martino, Masimo Libertucci, Mario Marangoni, & Mario Quagliariello, *A Proposal for Countercyclical Contingent Capital Instruments*, VOX (Oct. 30, 2010), <http://www.voxeu.org/index.php?q=node/5728>; *BoE’s Tucker-CoCos Could Transform Bank Landscape*, REUTERS (Nov. 16, 2009), <http://blogs.reuters.com/financial-regulatory-forum/2009/11/16/boes-tucker-cocos-could-transform-bank-landscape>. See also Press Release, Bank for International Settlements, Consultative Proposals to Strengthen the Resilience of the Banking Sector Announced by the Basel Committee (Dec. 17, 2009), <http://www.bis.org/press/p091217.htm>.

<sup>2</sup> See *CoCo Nuts*, THE ECONOMIST (Nov. 5, 2009), [http://www.economist.com/node/14816673?story\\_id=14816673](http://www.economist.com/node/14816673?story_id=14816673).

<sup>3</sup> Squam Lake Working Group on Financial Regulation, *An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities* (Council on Foreign Relations, Center for Geoeconomic Studies, Working Paper 2009) at 2.

<sup>4</sup> Mark J. Flannery, *Stabilizing Large Financial Institutions with Contingent Capital Certificates* (2009),

contingent capital”<sup>5</sup>—refers to debt instruments which mandatorily convert into equity upon the happening of one or more pre-defined events or triggers.<sup>6</sup> Regulators have tinkered with the idea of requiring systemically important banks to issue these instruments as integral components of their capital structures. When a bank encounters a liquidity or capital crisis, the CoCos will be converted into equity, thus increasing the bank’s capital buffers and avoiding the need to seek governmental intervention.

Proponents of contingent capital, who include Mark Flannery<sup>7</sup>, Robert McDonald<sup>8</sup>, the Squam Lake Working Group<sup>9</sup>, and John Coffee, Jr.<sup>10</sup>, view it as a desirable and workable mechanism. Contingent capital, it is argued, will ease financial distress, reduce bank leverage, minimize incidents of bank insolvency, avoid costly public bailouts, set up a speedy bank resolution regime, internalize bank failure costs, and insulate the rest of the financial system from possible systemic spillover effects.<sup>11</sup> The Basel Committee on Banking Supervision (BCBS) also observes that the use of contingent capital would lessen moral hazard by increasing private sector involvement in the resolution of future banking crises.<sup>12</sup>

In contrast, critics such as Anat Admati, Peter DeMarzo, Martin Hellwig and Paul Pfleiderer point out that contingent capital and related “bail-in” mechanisms are too complicated to design, pose difficult implementation concerns, and are less effective than the straightforward approach of requiring banks to have more equity capital.<sup>13</sup> The Association of British Insurers has also voiced its concerns as to how the instruments would work in practice, noting that investors in CoCos would be made to absorb “haircuts” or losses when conversion takes place.<sup>14</sup>

However, it may be said that on the balance, the reservations critics have with respect to contingent capital focus largely on the practical difficulties likely to be encountered once these instruments are put into use, and not on the desirability of

---

available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1485689](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1485689).

<sup>5</sup> Julie Dickson, Superintendent, Financial Institutions Canada, Remarks at Financial Services Invitational Forum (May 6, 2010) at 4, [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/jdlh20100506\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/jdlh20100506_e.pdf).

<sup>6</sup> *Id.*

<sup>7</sup> See Flannery, *supra* note 4.

<sup>8</sup> See Robert J. McDonald, *Contingent Capital with a Dual Price Trigger* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1553430](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1553430).

<sup>9</sup> See Squam Lake Working Group, *supra* note 3.

<sup>10</sup> See John Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1675015](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015).

<sup>11</sup> See Flannery, *supra* note 4, at 3; Coffee, *supra* note 10, at 10, 33; McDonald, *supra* note 8, at 2, 21.

<sup>12</sup> See Basel Committee on Banking Supervision, *Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability* (2010), available at <http://www.bis.org/publ/bcbs174.pdf>.

<sup>13</sup> See R. Admati, Peter M. DeMarzo, Martin F. Hellwig, & Paul C. Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is not Expensive* (2010), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1669704](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669704).

<sup>14</sup> Huw Jones, *UK Insurers Say CoCo Capital Poorly Thought Out*, REUTERS (NOV. 9, 2010), <http://www.reuters.com/article/idUSLDE6A812Z20101109>.

contingent capital as a potential tool for stabilizing banks. As Coffee points out, contingent capital is not an “abstract academic idea,” but “its optimal design remains open to legitimate and necessary debate.”<sup>15</sup>

Taking the debate a point further, it appears that the feasibility and sustainability of CoCos ultimately turns on a careful consideration and resolution of four key areas.

First, consensus with respect to the appropriate trigger (i.e. the point at which conversion of debt into equity takes place) needs to be reached. At present, there is a wide spectrum of proposals on this issue, with some advocating that the trigger be determined by a country’s regulatory authority, while others are arguing that a more objective measure, such as a reference to a market index or a specified capital ratio, be used.<sup>16</sup> For instance, in August, the BCBS issued a proposal that would allow capital instruments to be written off or converted to common shares at the discretion of the relevant authority if: (a) the bank was judged to be non-viable by the relevant authority or (b) the bank had received a public sector capital injection without which it would have become non-viable.<sup>17</sup> The Squam Lake Working Group suggests a double trigger: regulators must declare the existence of a systemic crisis, and the bank must fall below a given capital ratio.<sup>18</sup> In contrast, Flannery argues that the trigger should not depend on the state of the financial system, but rather on the contemporaneous market value of the firm’s outstanding common equity.<sup>19</sup>

Second, regulators must facilitate the market’s acceptance of CoCos by clarifying their essential investment features and, where appropriate, engaging in meaningful discourse with leading industry groups. For instance, a particular concern among investors is whether credit rating agencies are willing and able to adequately assess the risk features of CoCos.<sup>20</sup> In this regard, Fitch Ratings’ early November statement that it expects to be able to rate these new-generation bank hybrid securities may stimulate renewed interest in CoCos.<sup>21</sup> News last October

---

<sup>15</sup> Coffee, *supra* note 10, at 9.

<sup>16</sup> See Coffee, *supra* note 10, at 34–35.

<sup>17</sup> Basel Committee on Banking Supervision, *supra* note 12; see also Martin Dozier, *Basel Committee Commences Consultation Regarding Contingent Capital Requirement*, FINANCIAL MARKETS BLOG (Aug. 19, 2010), <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=3922>; Press Release, Bank for International Settlements, *Basel Committee Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability* (Aug. 19, 2010).

<sup>18</sup> Squam Lake Working Group, *supra* note 3, at 4.

<sup>19</sup> Flannery, *supra* note 4, at 11.

<sup>20</sup> See Tracy Alloway, *CoComplications*, FINANCIAL TIMES ALPHAVILLE (Nov. 18, 2010), <http://ftalphaville.ft.com/blog/2009/11/18/83946/cocomplications>; see also Tracy Alloway, *Will Rate CoCo Bonds for Food*, FINANCIAL TIMES ALPHAVILLE (Nov 9, 2010), <http://ftalphaville.ft.com/blog/2010/11/09/398811/will-rate-coco-bonds-for-food>; Tracy Alloway, *Cuckoo for CoCos*, FINANCIAL TIMES (Nov 11, 2010), <http://ftalphaville.ft.com/blog/2009/11/11/82756/cuckoo-for-cocos>.

<sup>21</sup> “Mark Brown, *Fitch Statement on Bank Hybrid Securities Seen as Constructive*, FOX BUSINESS (Nov. 8,

that Swiss authorities are open to the use of CoCos to fund the capital requirements of UBS and Credit Suisse is also a welcome development.<sup>22</sup>

Third, the appropriate tax treatment of CoCos needs to be settled. The primary issue here is whether tax authorities would be willing to recognize contingent capital as debt (thereby allowing tax-deductible interest expenses) despite the instrument's convertibility into equity.<sup>23</sup> If so, banks will enjoy the benefits of debt financing and will gravitate toward the use of CoCos in their capital structures.

Lastly, differences in the legal treatment of CoCos across relevant jurisdictions need to be sufficiently understood. Interestingly, the BCBS has already commenced this process by requesting feedback from market participants, including investors in bank capital instruments, on all aspects of its August proposal (on contingent capital and triggers), including "any legal or operational obstacles to their implementation."<sup>24</sup> The BCBS has even encouraged industry practitioners to work with regulators in drafting terms and conditions for contingent capital instruments while "respecting relevant national constraints."<sup>25</sup> Whether sufficient harmonization and acceptance of contingent capital across varying legal jurisdictions will be achieved, however, remains to be seen.

The discussion on contingent capital will likely continue and escalate in the coming weeks, but the ultimate verdict on its feasibility and sustainability will not be immediate. The conundrum of contingent capital presents broad challenges to the financial sector and to the economy as a whole, as stakeholders seek new and innovative ways of stabilizing the banking sector and preventing another financial crisis.

---

2010), <http://www.foxbusiness.com/markets/2010/11/08/fitch-statement-bank-hybrid-securities-seen-constructive/#ixzz16QleaUzf>.

<sup>22</sup> Jane Merriman, *Swiss Give Fresh Momentum to Contingent Bonds*, REUTERS (Oct. 4, 2010), <http://blogs.reuters.com/financial-regulatory-forum/2010/10/04/snap-analysis-swiss-give-fresh-momentum-to-contingent-bonds>.

<sup>23</sup> See Coffee, *supra* note 10, at 44; McDonald, *supra* note 8, at 16; Humphreys & Pinedo, *supra* note 2.

<sup>24</sup> Basel Committee on Banking Supervision, *supra* note 12, at 3.

<sup>25</sup> *Id.*