

# CoCo Bond Issuance and Bank Funding Costs\*

Stefan Avdjiev      Patrick Bolton      Wei Jiang      Anastasia Kartasheva

Bilyana Bogdanova

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## Abstract

We conduct a first comprehensive empirical study of the bank contingent convertible (CoCo) issues market from 2009 to 2015. Large banks with relatively adequate core capital bases are among the early adopters of CoCos. CoCo issuance leads to an average of 8 basis point drop in the issuers' CDS spreads, indicating that CoCo issuance reduces banks' credit risk. The reduction in CDS spreads is increasing in the trigger ratio. In contrast, there is no significant impact on equity prices of CoCo issuers, though the trigger ratio is significantly positively (negatively) related to stock returns for principal write down (mandatory conversion) CoCos. An analysis of bank's securities pricing post CoCo issuance reveals

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\*Avdjiev, Kartasheva, and Bogdanova are affiliated with the Bank for International Settlements, Basel, Switzerland; Bolton and Jiang are affiliated with Columbia Business School, New York, U.S.A. The study has benefitted from comments and suggestions from the seminar participants at the the Bank for International Settlements, Bundesbank, the Committee on the Global Financial System Workshop on Contingent Convertible Instruments, Conference on Financial Regulation at the University of Chicago, European Finance Association, NBER Risks of Financial Institutions, Western Finance Association, University of Geneva, and University of St. Gallen. The authors benefit from discussions with and inputs from Ruth Doubleday, Ingo Fender, Ulf Lewrick, Noel Reynolds, and Kostas Tsatsaronis. We thank Minchen Zheng (Columbia) for excellent research assistance. For contact information, Avdjiev can be reached at [Stefan.Avdjiev@bis.org](mailto:Stefan.Avdjiev@bis.org); Bolton at [pb2208@columbia.edu](mailto:pb2208@columbia.edu); Jiang at [wj2006@columbia.edu](mailto:wj2006@columbia.edu); Kartasheva at [Anastasia.Kartasheva@bis.org](mailto:Anastasia.Kartasheva@bis.org); and Bogdanova at [Bilyana.Bogdanova@bis.org](mailto:Bilyana.Bogdanova@bis.org). The views expressed in the paper are those of the authors and do not necessarily represent the views of the Bank for International Settlements.

that investors in CoCos view instruments as risky and place a significant likelihood on the possibility of conversion.

## 1 Introduction

The financial crisis of 2007-09 has revealed that bank equity-capital requirements were too low to provide any meaningful loss absorption capacity for banks to be able to survive even a moderate negative macro-economic shock. There has since been a sustained global drive to introduce significantly higher capital requirements. Part of banks' recapitalization effort has been through the issuance of contingent convertible bonds (CoCos), which provide banks with higher capital cushions in adverse contingencies by automatically converting debt liabilities into equity. These CoCo instruments are favored for the greater flexibility they offer in endowing banks with higher capital cushions when they are most needed. Issuance of CoCos has been encouraged by regulators in a number of jurisdictions and CoCos have been incorporated in regulatory capital requirements in some of these jurisdictions. This is still a relatively small market segment, but it has been growing rapidly in recent years. Between January of 2009 and September 2015 banks around the world have issued a total amount of \$450 billion in CoCos through 519 different issues. As a comparison, the asset quality review (AQR) of the largest European financial institutions undertaken by the European Central Bank in October 2014 revealed that out of a total of 92 billion Euros of new securities issues by the reviewed banks from July 2013 to August 2014, 32 billion Euros (or over one third) were through CoCo issues, and just under two thirds were through equity issues.

There has been a lively debate in academia and among policy makers on the pros and cons of CoCos in stabilizing the banking system. A key advantage of CoCos emphasized by early commentators on bank regulatory reform (in particular, Flannery, 2005, 2009, Raviv, 2004, Duffie, 2009, McDonald, 2010, Coffee, 2010, Pennacchi, Vermaelen and Wolff, 2010, and the Squam Lake Report, 2010) is that the conversion or write-down of CoCos is a quick and effective way of delevering a bank that has incurred losses and to put it back on a sounder financial footing. In other words, CoCos were seen as a simple way of *bailing in* a bank

and of cutting through all the existing institutional complexities hindering bank debt restructuring on an ad-hoc basis in the midst of a crisis.

Skeptics of CoCos (most notably, Admati, DeMarzo, Hellwig and Pfleiderer, 2012) on the other hand have argued that CoCos are excessively complex and unlikely to provide adequate loss absorbing capacity to banks. The size of the losses that CoCos can absorb will either be too small or will expose investors in CoCos, who are assumed to be primarily fixed income investors, to large losses they are less equipped to manage than equity-holders. Moreover, Sundaresan and Wang (2010) have pointed out that the design of early CoCo proposals, with an equity price trigger for automatic conversion, has an important flaw, as the stock price trigger can give rise to multiple equilibria, whereby the simple expectation that the price boundary will be crossed can be self-fulfilling. Concerns were also raised about the apparent lack of “natural buyers” of CoCos. Due to pricing complexities and the likely high correlation of trigger events with systemic events in the economy, CoCos represent a marginal asset class for most investors and investors’ demand is highly sensitive to CoCos return performance.

Given the cumulative volume of issuance, a comprehensive empirical analysis of the growing CoCo market is called for. It can shed light on the above controversies and indicate which concerns have so far proved to be relevant and which have proved less important than feared by commentators. In addition, this empirical study will also begin to fill two gaps between the early theoretical analyses and the ongoing CoCo market development. First, while almost all the theoretical papers thus far have focused entirely on conversion-based CoCos, a majority (54%) of the CoCos by issuance-volume in our sample actually takes the form of principal writedowns to absorb losses. Even though principal writedown contracts have different incentive effects than equity-conversion contracts, they are treated equally by regulators. To the best of our knowledge, there are no theoretical analyses that compare the two conversion mechanisms. Second, none of the recently issued CoCos rely on stock-price based triggers widely discussed in the theoretical literature. All issues that qualify for Tier I and Tier II capital have an accounting-based rule trigger with discretion on conversion given to bank regulators. Furthermore, a deeper understanding of the CoCo market is all the more urgent in light of regulatory developments around bank resolution models based on single point of entry at the holding

company level, which rely on total loss absorbancy capital (TLAC) resembling CoCos.

In our study we assemble the first comprehensive dataset on all the CoCo issues undertaken by banks from 2009 to September 2015 using information from Bloomberg, Dealogic and supplemental sources. Beyond providing an overview of the market, the issues, and the participants, our study seeks to address three important questions: First, what motivates the banks to issue CoCos in the first place? To answer this question we construct a sample of "potential" CoCo issuers and perform several duration analyses of how the decision to issue depends on bank size, financial strength and business model characteristics. Second, how do CoCos issues affect bank funding cost? To address this question we analyze the financial market responses to new CoCo issues and the cross-sectional heterogeneity in the responses associated with differences in contractual designs and issuer characteristics. Finally, we assess the position of CoCos relative to other debt and equity securities of the same bank, and use market prices to infer the market perception about the propensity of CoCos to be triggered and thus exposing CoCo investors to losses. These analyses provide a comprehensive assessment of the CoCo market from three phases: pre-issuance and the decision to issue, at-issuance and the impact of the issuance on banks' CDS and equity prices, and post-issuance and the assessment of the market perception about CoCos.

Applying duration and hazards models, we find that large banks with stronger Tier 1 capital bases coming out of the financial crisis are most likely to issue CoCos, and so are the banks with more risky assets in trading securities. Such results suggest that CoCos are potentially beneficial for the relatively strong bank to hedge against possible future distress, but are a hard sell for an issuer who is already experiencing capital shortage.

Applying a similar method to James (1987), who analyzes the effect of new loans on banks' stock price, we examine the effect on banks' CDS spreads and stock prices of the announcement of an upcoming CoCo issue. We find that CDS spreads (on non-CoCo senior unsecured debt) of the issuing banks fall significantly for a range of event windows (up to 21 days) around the issue date. The CDS spread response is negative relative to the benchmark in over two-thirds of the cases, consistent with the hypothesis that CoCo issuance increases bank loss absorbency capacity. Moreover, the impact of CoCo issuance on the CDS spreads for

GSIBs tends to be considerably stronger in the lead-up to the issuance than on and after the issuance date. On the equity price side, the effects are more delicate and depend on CoCo contract design. While there is a lack of overall first-order effect due to confounding factors, the stock market reaction to principal writedown CoCos is significantly increasing in the trigger value while the opposite is true for mandatory conversion CoCos. In other words, current shareholders welcome principal writedown CoCos that would offer an automated delevering before equity gets seriously impaired (due to the high trigger), and disfavor the most mandatory conversion CoCos at high triggers which impose high dilution risk on the shareholders. Both relations are consistent with theory.

We also develop a simple analytical framework to derive empirical predictions about market perceptions on the propensity of CoCos to convert and absorb losses. In particular, we narrow down predictions about the sign of correlations between changes in CoCo prices and changes in the issuing bank's other security prices (equity, senior unsecured debt, subordinated debt, and CDS spreads on senior unsecured debt). We show that the sign of correlations depend on whether current shareholders will be wiped out or not upon conversion. The estimated correlations reveal that the pricing of CoCos and other bank securities is sometimes consistent with expectations that CoCos may convert and that investors may face losses upon conversion.

The closest study to ours is Vallee (2013), who focuses on hybrid bonds issued by European banks between 1998 and 2012, which have similar features to CoCos structured as reverse convertible bonds. He studies the effects of ex-post conversion of these hybrid bonds during the financial crisis of 2007-09 and finds that conversion had the intended effects predicted by CoCo theories. Contrary to Vallee (2013) our dataset consists entirely of post-crisis CoCos issued between 2009 and 2013, whose activation is triggered by a regulator or a mechanical trigger. The difference in the trigger mechanism leads to different signaling effects of CoCos issues to those for hybrid bond issues. Relatedly, the "event" in Vallee (2013) is the contingent debt relief achieved by bank's decision to exercise the non-call option of the first generation of hybrid instruments. The counterpart to this "event" in our dataset would be the activation of the loss-absorption mechanism for CoCos. However, no such event has yet taken place for the CoCos in our data set, and hence our study focuses on the ex ante effects of CoCo issuance.

The remainder of the paper is organized as follows. Section 2 provides the institutional background and describes the current state of CoCo issuance as well as the context of post-crisis policy debates around bank regulatory reform. Section 3 presents the sample and empirical analyses. Section 3.2 contains several duration analyses on the propensity of a bank to issue a CoCo. Section 3.3 reports the estimates of CDS and stock price responses to CoCos issuance and discusses the differential effects of CoCo contract features. Section 3.4 presents an empirical analysis of correlations between changes in CoCo prices and other bank securities prices depending on the likelihood of CoCos to convert. Finally, Section 4 discusses open questions about the future design of CoCos and offers concluding comments.

## **2 Institutional Background and Hypotheses**

### **2.1 The CoCo market post financial crisis**

The experience of the recent financial crisis illustrated that resolving banks during the crisis is complex and costly to taxpayers. It initiated several reforms that aim to enhance the loss-absorbing capacity of banks by imposing more stringent capital requirements and simplifying the resolution of banks in case of insolvency (eg. Basel III and TLAC). Banks can choose among different capital instruments to satisfy the requirements. Contingent convertible bonds (CoCos) is one of these choices.

CoCos are hybrid capital securities that absorb losses when the capital of the issuing bank falls below a certain level. CoCos are designed to provide a source of capital to the banks in distress when private investors are reluctant to supply external capital. CoCos can thus facilitate balance sheet repair or orderly resolution of the bank for bank management as well as supervisors. For banks, CoCos provide an additional and potentially cheaper source of funding compared to other sources. If CoCos are tied to management compensation, the instruments may also improve risk management incentives. For investors, CoCos offer an alternative higher yield exposure to bank's credit risk compared to other bank debt instruments.

CoCos have two defining characteristics: (i) a conversion mechanism that specifies how losses are absorbed; and (ii) a trigger that activates the conversion. As we mentioned in the Introduction there are two

major classes of conversion mechanisms: conversion into common equity and a principal writedown. For conversion-into-equity CoCos, the conversion formula can be based on the equity price on the day when the CoCo converts or on a pre-specified formula of number of shares for each bond, or on some combination of the two. For principal writedown CoCos, the principal can be either fully or partially written off when the CoCo trigger is hit.

The trigger is often defined in terms of the ratio of common equity Tier 1 capital to risk-weighted assets. In principle, it can be based on either the book-value (accounting-value) or the market value, though in practice none of the existing issues relies purely on market valuations. The “point of non-viability trigger” (PONV) is usually at the discretion of the supervisors, that is, the loss absorption mechanism is not activated upon a specific and predetermined numerical value, but rather upon the supervisors’ judgment about bank solvency and hence whether the trigger has been breached, leading to discretionary PONV triggers.

The pressure on banks to recapitalize following the financial crisis and the regulatory treatment of CoCos are the main drivers of CoCo issuance. The current Basel III framework has two contingent capital components: (i) a PONV trigger requirement, which applies to all “Additional Tier 1” (AT1) and T2 instruments; and (ii) a “going concern” contingent capital requirement which applies only to AT1 instruments classified as debt liabilities (Graph 1).

[Insert Graph 1 here.]

As regulatory pressure on banks to boost their Tier 1 capital increased, the volume of CoCo issues has surged since the start of 2012 (Figure 1a).

[Insert Figure 1 here.]

Regulatory capital eligibility considerations are also crucial for the choice of maturity of a CoCo instrument. Under Basel III, all AT1 instruments must be perpetual and fixed maturity instruments qualify only as T2. Currently, over half of the instruments have no maturity date. For fixed-maturity instruments, most have a maturity of approximately 10 years. Moreover, for a CoCo to qualify as AT1, the trigger has to be at

least 5.125% of risk-weighted assets. As market participants became more familiar with CoCo instruments, the share of CoCos with a trigger of at least 5.125% has been steadily increasing (Figure 1b). Needless to say, the interest servicing cost of a CoCo increases in the trigger level, to compensate investors for the higher probability of conversion.

As we have already highlighted, the current equity-capital eligibility rules do not distinguish between CoCos with different loss absorption mechanisms. Even though in early years of the market mandatory conversion to equity (MC) CoCos dominated, the issuance of principal write-down (PWD) instruments picked up over time (Figure 1c). The growing demand by fixed-income investors for CoCos is a key factor that contributed to this trend. These investors are often restricted by mandate from investing in instruments that have a non-negligible possibility to convert to equity and PWD instruments do not fall under this restriction. In addition, PWD instruments involve less uncertainty about the payoff after the trigger is breached which may facilitate their pricing and risk management.

The geographical distribution of CoCo issuance mainly reflects the way Basel III regulations are applied and supplemented by national regulators. For example, in Switzerland the new regulatory regime requires Swiss banks to have 9% of risk-weighted assets in loss-absorbing instruments. Similar rules apply in Denmark. UK regulators also adopted loss absorbing capital requirements in 2012. One major jurisdiction where CoCos do not qualify for AT1 or AT2 capital is the US. Not surprisingly, approximately 80% of the CoCo issuance in our sample has been by European banks, primarily UK and Swiss institutions (Figure 1d).

To become a significant alternative source of bank capital CoCos need to build a solid investor base. Participation of institutional investors, asset managers, insurers and pension funds, is essential if any market depth, volume and liquidity is to be achieved. Unfortunately, information on the evolution of CoCo investors base is not systematically collected by supervisors and is rather scarce. According to market participants, the early CoCo issues were absorbed largely by retail and private bank investors in Asia and Europe, who were mostly motivated by search for yield in a low interest rate environment. In our dataset, a subsample of issues with a combined volume of \$13 billion (primarily AT1 issues originated between April 2013 and March 2014) contains an institutional breakdown at the initial placement provided by Dealogic. In this subsample,

private banks and retail investors were responsible for 52% of the total demand in the subsample. Asset management companies purchased another 27% of the volume. The remainder is split among hedge funds (9%), banks (3%) and insurers (3%).

Figure 2 provides another illustration of the potential investor base by investor type and by geography for a selected subsample of AT1 instruments. These data reveal that a significant amount of CoCos were purchased by asset managers and hedge funds. It also indicates banks' holding of CoCos issued by other banks. However, these holdings are purely for intermediation purposes where banks act as underwriters and facilitate the initial placement of securities.<sup>1</sup> In terms of geographic distribution, investors from the UK, Europe, and the US are among the largest holders.

## 2.2 Policy debates and related literature

What role can CoCos play in strengthening financial stability? And, to what extent should bank regulations be structured around CoCos? As we have already hinted, there is no consensus yet on CoCos in either policy circles or academia. The main benefit of CoCos that has initially been put forward is that they are an effective way of facilitating restructuring of a distressed bank. But the effectiveness of CoCos to provide a reliable source of contingent capital depends on several considerations.

From the perspective of a bank and its managers and supervisors, CoCos additional layer of capital must offer sufficient loss absorption capacity and be activated on timely basis. Under Basel III framework, AT1 and Tier 2 CoCos would represent 1.5% and 2%, respectively, of bank's risk-weighted assets (RWA).<sup>2</sup> For AT1 instruments, the minimum trigger level is set at 5.125% of CET1 to RWA. In some jurisdictions (eg. Switzerland), national supervisors complement these minimum requirements with an additional layer of higher trigger CoCos. Clearly, the thicker is the layer of CoCos and the further the trigger is from PONV, the more likely it is that CoCos will ensure bank's balance-sheet repair on a going-concern basis.

Issuance of CoCos can impact bank's risk taking incentives. Following Flannery (2005), Calomiris and

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<sup>1</sup>Under Basel III banks are subject to a prohibitive capital charge to hold CoCos.

<sup>2</sup>As illustrated on Graph 1, the regulatory minimum capital requirements under Basel III framework are 4.5% ratio of CET1 to RWA, a Tier 1 capital ratio of 6%, and the total capital ratio of 8%.

Herring (2011) propose designs that emphasize the potential of CoCos to encourage effective risk governance by banks and reduce regulatory forbearance risk. In their proposals, CoCos conversion to equity should be dilutive to preexisting equity holders and convert well before the bank faces insolvency and is excluded from access to capital markets. Martynova and Perotti (2012) investigate how different contract designs can have different impact on bank's risk-taking incentives. In practice, high trigger equity conversion instruments account for only 16% while over 55% of CoCos are principal write down. For principal write down instruments, high trigger could incentivise more risk-taking by banks by subordinating CoCo holders to equity holders. Admati et al. (2012) argue that CoCos with principal writedowns offer inadequate loss absorption which will either be too small or will excessively expose investors in CoCos. To some extent this effect can be mitigated by embedding CoCos in compensation of senior management, and by an overall disciplining effect of CoCo trigger events for bank's management. A wide variation of contract features of outstanding CoCo issues and the prevalence of principal write down CoCos raise a broader corporate governance question on whether managers or shareholder are responsible for bank's risk-taking.

Requiring banks to issue CoCos can affect bank's capital structure in that this can undermine calls for greater equity capital issuance (Admati et al. 2012). In more recent papers (notably Chen et al. (2013) and Albul et al. (2012)) researchers start to endogenize capital structure decisions when the bank is either required or has an option to issue CoCos along with the usual debt and equity instruments. Such analyses reveal that the equity holders can have a positive incentive to issue CoCos, and CoCos reduce the debt overhang problem. The reason is that the benefits of lower default risk accrue not only to bond holders but also to equity holders due to the lower cost of debt rollovers.

In the current regulatory environment, the issuance of CoCos is limited by the amount of capital that banks need to meet regulatory capital requirements and the leverage ratio. For example, according to market participants European banks were expected to issue up to 100 billion Euros of AT1-compliant CoCos in the next few years, with newly issued instruments typically replacing the Tier 1 capital instruments that no longer qualify under Basel III. Other regulatory changes, in particular TLAC requirements for GSIBs and MREL in the European Union, are likely to substitute the low trigger Tier 2 - compliant CoCos with

statutory bail-in terms instruments (eg. bailinable bonds) for banks subject to these regulations.<sup>3</sup>

The next set of issues that can undermine the effectiveness of CoCos are related to the investor base. While in the current low-yield environment investors are eager to hold CoCos, the demand for CoCos can decrease in the environment of higher global interest rates and during the periods of higher volatility. In theory, the optimal risk sharing arrangement would require that risks associated with holding CoCos are transferred outside the financial system. As CoCos are unit beta type securities and the trigger events are likely to be associated with systemic events in the economy, CoCos represent a marginal asset class for most institutional investors, making these investors very sensitive to changes in the likelihood of trigger events. Another aspect of the investor base is that conversion to equity CoCos that received most favorable assessment in the academic literature can have limited market due to restrictions on equity holdings under the mandates of some institutional investors. The demand for CoCos from pension funds and insurance companies whose investment strategy is driven by asset-liability matching is curbed by the uncertain duration of securities. Finally, complexity and pricing uncertainty of CoCos (see below) reduce the suitability of this asset class for retail investors. Some jurisdictions, eg. the UK, imposed bans on marketing CoCos to retail investors.

CoCos are structured instruments with many embedded options and some degree of regulatory discretion which makes their pricing rather complex. While the market discipline approach (also reflected in Martynova and Perotti (2014)) favors a market-based trigger, Sundaresan and Wang (2010) have shown that the conversion design based on a stock price trigger can give rise to multiple equilibria. That is, the simple expectation that the price boundary will be crossed can be self-fulfilling and give rise to multiple equilibria. Pennacchi et al (2011) propose a modification of CoCos that avoid the problem of market death spirals by providing shareholders an option to buy the shares from bondholders at the conversion price. Corcuera et

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<sup>3</sup>Total Loss Absorption Capacity (TLAC) is the minimum requirement for loss absorbing liabilities applied to GSIBs. Under current TLAC proposal, banks are required to hold at least additional 8% securities bailinable in resolution. The proposal aims to facilitate the resolution of entities in multiple jurisdictions.

Minimum Required Eligible Liabilities (MREL) applies to all European credit institutions and investment firms. Unlike TLAC which is based on a common Tier 1 standard, MREL is assessed individually per institution and it will take into account the recapitalization needs based on the institution's preferred resolution strategy.

al. (2014) suggest that the destabilizing effect of market trigger CoCos is reduced if instead of conversion to equity CoCos cancel the coupon payments. In addition to spillover effects, pricing of CoCos can be complicated by other risks, in particular, coupon cancellation and the ultimate discretion of the supervisor to activate the trigger.

To foster financial stability, CoCos need to become a form of counter-cyclical equity buffer. This latter perspective on CoCos is underlined in Bolton and Samama (2012), who suggest that a design of CoCos as a true convertible bond (where the issuer has the option to convert) would at the same time mitigate the risk of a “death spiral”, allow for a classical pricing approach using standard option pricing tools, and would offer the issuer a capital line of credit commitment. That is, a CoCo structured as a reverse convertible bond would be equivalent to giving the issuer a commitment to augment its equity capital at will at favorable terms in recessions, thus implementing a form of counter-cyclical equity buffer. While no bank issuer has to date adopted this CoCo design, the notion that CoCos could also be an alternative to equity issuance has gained prominence, especially given the difficult context European banks have faced in recent years in recapitalizing in the midst of a recession. In a closely related paper, Vallée (2013) has argued European banks’ issues of hybrid debt before the crisis are similar to a reverse convertible bond, and, as he has shown, issuers took advantage of the attractive convertibility option in hybrid debt to convert these debt issues in the middle of the crisis of 2007-09 and thus partially recapitalize their stressed balance sheets.

Macro prudential regulation of banks relies on multiple regulatory tools, and thus CoCos cannot be considered in isolation from other capital requirements and liquidity regulations. With few exceptions, there is little guidance on the interaction among multiple regulatory tools. Zheng (2013) derives the optimal counter-cyclical capital requirements. Walter and White (2015) show how tighter capital and liquidity regulation, and having an effective lender of the last resort, can improve the efficacy of bail-in policies.

In summary, if adequately designed, CoCos can improve banks’ risk management ex-ante and support balance sheet repair or resolution ex-post. Yet it is important to recognize that the market reaction to trigger events and the sustainability of the investor base remain untested. The risks of CoCos exposures and the interaction of AT1 and Tier 2 capital requirements with other regulations need to be recognized and

monitored.

## 3 Empirical Analyses

### 3.1 Data overview

Our data set covers \$450 billion worth of CoCo issues in advanced and emerging economies between January of 2009 and September 2015. Our sample consists exclusively of CoCos issued by banks and excludes CoCos issued by insurance companies and other non-bank financial institutions. Data are obtained from Bloomberg and Dealogic.

The first set of variables characterize individual CoCo instruments. The most important contractual characteristics include the loss absorption mechanisms, the trigger level, and the point of non-viability (PONV) trigger inclusion. Other characteristics include: the maturity of the instrument; the issuance volume; the issuance currency; and whether an instrument is classified as Additional Tier 1 (AT1) or Tier 2 (T2) capital by the regulator; the issue date; maturity date; price and yield at issuance; coupon; coupon tax deductibility; amount outstanding; rating by the three major credit rating agencies (S&P, Moody's, and Fitch) whenever available, and payment rank classification (subordinated debt, preferred equity, etc.). Finally, we have daily market information at the instrument level including daily closing prices, yield-to-maturity, and the spread over a government bond rate (the G-spread).

In order to facilitate the comparison of CoCo yields with those of other debt instruments, we form matches, wherever possible, for each CoCo instrument from subordinated and senior unsecured bonds by the same issuer, denominated in the same currency. When comparing CoCos and their matches at issuance, we require that the match bonds to have issuance dates and maturity at issuance to be as close as possible. When comparing yield-to-maturity, we require that the match bonds to have remaining maturity and coupon rates to be as close as possible.

The second set of variables characterize the issuing banks. The market price information includes daily closing data on equity prices and on CDS spreads (for senior unsecured debt). The balance-sheet information,

at the annual level, include total assets, risk-weighted assets, regulatory Tier 1 capital, and total regulatory capital.

Figure 2 presents an overview of the market from 2009 to late 2015. Figure 2a shows the time series of CoCo issuance by regulatory capital classifications, i.e., whether the CoCos qualify as Tier 1 or Additional Tier 1 (AT1) capital. Tier 1 CoCos represent 54% of total issued amount and seem to be the predominant type of instrument over the last four quarters, after the increase in Tier 2 issuance in 2013 and 2014. Figure 2b plots the percentage of CoCos with high triggers (i.e., greater or equal to 5.125%). There is a clear upward trend where the percentage increases from slightly over 20% in late 2009 to almost 60% in the third quarter of 2015. Figure 2c shows the composition of CoCos by loss absorption mechanisms over time. Conversion to equity was the dominant form in most quarters at the beginning and the end of the sample, while principal writedown CoCos were mainly issued in 2013 and 2014. Finally, Figure 2d provides the country composition by CoCo issuance amount. China and Britain stand out as the top two, with total issued amount of \$96.4 billion and \$56.4 billion respectively; followed by Switzerland (\$48.9 billion), Australia (\$32.3 billion) and France (\$25.7 billion). European banks account for 50% of the total CoCo volume in our sample. Until Q3 2014, European banks were the main issuers. But then the Asian issuance surged.

[Insert Figure 2 here.]

Table 1 presents more detailed summary statistics. There are 519 distinct CoCo instruments in our sample, issued by 203 banks. The size of the average CoCo issue is approximately \$0.9 billion, with a wide interquartile variation.

[Insert Table 1 here.]

### **3.2 Determinants of CoCo Issuance**

Our first empirical analysis concerns banks' propensity to issue CoCos so as to reduce the probability of default by providing an additional layer of loss-absorbing capital at the time of financial distress. To conduct such an analysis, we need an "unconditional" sample of banks that are reasonable "potential" CoCo issuers,

regardless of whether they turned out to issue such instruments within our sample period. Based on the fact that small banks had not joined the CoCo issuers and to make the data collection feasible, we start with a sample of 500 banks with the highest total assets in advanced economies (i.e., excluding euro area peripheries), plus the CoCo issuers in our sample from the advanced economics that are not among the top 500. The resulting sample consists of 523 banks. We then take Q1 2009 as the beginning of the era where CoCos became a viable tools for bank risk management, and follow all the banks to Q1 2015. A bank that issued CoCo for the first time will exit the sample right after; and banks that never issued are considered to be censored at the end of the sample period (i.e., there is a possibility that they would issue post Q1 2015).

We perform several duration analyses in Table 2. The first analysis, reported in Panel A, is a simply one cross-section Tobit regression of *Time to Issue*, the number of months from January 2009 to the time of first CoCo issuance for each bank, on the following independent variables: *Total Assets* (in logarithm), *Tier1* (Tier 1 capital), *Gross Loans*, *Total Deposits*, *Total Long Term Funding*, and *Total Trading Securities*. All variables are measured at the beginning of the period, i.e., January 2009. The last four variables are all scaled by total assets, expressed as percentage points. A larger coefficient indicates a longer delay to issuance, or a low propensity to issue. The coefficient on *Total Assets* turns out to be negative and significant, suggesting that larger banks are quicker in jumping on the CoCo bandwagon. This is consistent with the anecdotal evidence that smaller banks take longer to test their market for such a new financing vehicle.<sup>4</sup>

[Insert Table 2 here.]

The coefficient on *Tier 1* might appear counterintuitive. To the extent that CoCo bonds represent a financial innovation to recapitalize troubled banks, one might have expected that banks with inadequate capital are eager to issue. In fact, data indicate that a one percentage point increase in the Tier 1 capital (including core equity Tier 1 and additional Tier 1, with an average ratio of 7.0% in 2009) is associated with about a five-month shortening in the time to issue. The effect is significant at the 1% level across all specifications. On the other hand, the magnitude of loans-to-assets ratio, consumer deposits and long

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<sup>4</sup>See, e.g., "Coco bonds: Mass conversion," *Economist*, September 13th, 2014.

term funding (both proxying for the reliable and “sticky” funding sources banks have) do not predict the duration to CoCo issuance. Interestingly, every percentage point increase in the *Total Trading Securities* (an indication for risk taking, with an average of 17.8%) predicts a 1.5 months delay to issuance (significant at the 1% level). The combined results suggest that banks with a relatively strong balance sheet out of the financial crisis but with risky assets were among the front-wave CoCo issuers. In other words, banks which were already in serious capital deficiency would also find it difficult to raise contingent capital in the market, presumably because the prospects of value impairment on the contingent capital would be too high at issuance for the issue to be appealing to investors.

Panel B resorts to the Cox (1972) proportional hazards model to estimate the banks’ propensity to issue CoCos in each month during January 2009 - December 2014. Here a higher coefficient suggests a high probability to issue in a given month, conditional on no-issuance till the previous month. As in Panel A, larger banks are more frequent issuers, and the exposure to marketable securities positively predicts issuance. Both effects are significant at the 1% level. Tier 1 capital adequacy and liabilities (deposits or long-term funding) are not significant, but the effect of *Gross Loans* becomes positive and significant in the time series. The overall results suggest that banks are more likely to issue CoCos when their assets and lending expand, and when more assets are devoted to trading securities.

Panels C and D break down CoCo issuance into principal write-down issuance and mandatory conversion issues using the Find and Gray (1999) competing risk model. That is, the first issuance of a CoCo with a particular loss-absorbing mechanism (PWD or MC) is considered an event with the other type of issuance (MC or PWD) as the “competing risk.” Such a model analyzes the propensity to issue a particular type of CoCo bonds, taking into consideration that an issuance of a PWD (or MC) CoCo effectively excludes an issuance of an MC (or PWD) CoCo by the same bank at the same time. Some interesting contrasts between PWD and MC issuance emerge. First, *Tier1* positively predicts PWD but not MC issuance, suggesting that capital-strong banks are in an advantageous position to issue PWD CoCos which are more favored by fixed-income investors. Such instruments will lose all its value in distress and hence are more popular when the issuers demonstrate strong capital base. Second, *Total Deposits* negatively predicts principal write-down

but not mandatory conversion issuance. On the other hand, Gross Loans positively predicts mandatory conversion with marginal significance but not principal write-down issuance.

### 3.3 Effects of CoCo Issuance on Bank Default Risk

#### 3.3.1 Empirical set-up

The issuance of a CoCo has two effects on a bank's balance sheet. First, it reduces the probability of default by providing an additional layer of loss-absorbing capital in the contingency of financial distress. This effect is most relevant for banks' debt-holders and is expected to be reflected in lower CDS spreads. Second, issuing a CoCo affects the risk-taking incentives of the bank's management. Greater risk-taking incentives can increase the probability of default and thus adversely affect debt holders. We therefore measure the impact of issuing CoCos on the CDS spreads and equity prices of issuing banks by employing the methodology employed in James (1987).<sup>5</sup> We test to what extent CoCo issuance changes an issuing bank's default risk, given that both loss-absorbency and incentive effects are at work.

In addition, we analyze how the effect of CoCo issuance depends on the CoCo's main contract features, including the conversion mechanism and the trigger level. We estimate whether MC and PWD CoCos have differential effects on market assessments of banks' default risk. Although both instruments provide additional capital buffer, they differ in terms of the risk-taking incentives for current shareholders (and management). While an MC CoCo curbs risk taking incentives of current shareholders by introducing the possibility of equity dilution, PWD CoCos may have the opposite effect by shielding shareholders from bank insolvency. We also estimate the potential differential market reaction to other CoCo or issuer characteristics, including the trigger level, the CoCo issuer and issue size, and a global systemically important bank (GSIB) status.

As for the effect on the issuer's stock price, that is more difficult to determine a priori. Applying

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<sup>5</sup>Appendix A contains a detailed description of the estimation methodology. The main advantage of applying the methodology in our study is that it is capable to accommodate for the limited sample size and the limited information available prior and post issuance. It allows us to extract information from a limited sample by underweighting noise.

Modigliani-Miller logic, adding more leverage should result in a lower stock price to compensate for the lower claims held by equity holders. On the other hand, signaling considerations may well lead to the opposite effect, if the announcement of a CoCo issue is understood by the market to mean that a new equity issue is less likely. Similarly, investors' narrow exclusive focus on earnings-per-share could artificially boost stock price if it is not understood that the increase in earnings per share is accompanied by a greater risk exposure. These mixed signals that CoCo issues could send to equity markets suggest that it is unlikely that CoCo issues will have a clear predictable effect on the issuer's stock price. However, the main CoCo design characteristics allow us to isolate the marginal impact sorted on the issuer's stock prices. More importantly, due to their different dilutive effects, the impact of issuing principal writedown CoCos on the stock price should be more positive (or less negative) than that of issuing CoCos that are convertible into equity.

Unlike for the typical event study, the "event date", when all relevant information is simultaneously announced to all market participants at a clearly defined point in time, is not well-defined and the optimal length of the event window to identify the full impact of a CoCo issue is not obvious either. There is no single point in time at which an upcoming CoCo issue is publicly announced. Instead, information about a typical upcoming CoCo issue spreads among market participants in a diffusion-like process. According to market participants and regulators, the information about the intention of a bank to issue a CoCo is revealed to a small group of potential buyers over the course of two weeks prior to the date of the issuance. As the book is being built, the information is also likely to diffuse to a wider set of investors and get incorporated in equity prices and CDS spreads prior to the actual announcement. Still, the issue date often reveals additional value-relevant information, such as the over-subscription status of the issue.

Hence, we consider three event windows: the full 21-day (from  $t - 15$  to  $t + 5$ ), the pre-issuance 15-day ( $t - 15$  to  $t - 1$ ), and the post-issuance 6-day ( $t$  to  $t + 5$ ), all defined relative to the issue date ( $t$ ) of the CoCo instrument (as recorded on Bloomberg). In addition to letting us examine the sensitivity of our results to different event-window specifications, varying the size of the announcement window also allows us to evaluate how quickly information about CoCo issuance is incorporated in market prices. Though the market is usually informed about the new CoCo issuance about one week prior to the issue date, new critical and

value-relevant information keeps coming after the announcement, such as the subscription status of the new issues. Therefore, the three different windows take into account that information revelation is a diffusion process starting days before the issue date.

In our benchmark estimation, we consider CoCos issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain). We exclude CoCos issued by banks from the euro area periphery due to the high uncertainty surrounding many of these issues. Also, their CDS spreads and equity prices tend to be much more volatile than those of banks from the core of the euro zone and other parts of the developed world. Including these issues in our benchmark sample may therefore distort the estimates of the impact of CoCo issuance on CDS spreads and equity prices.

### **3.3.2 Evidence from credit default swaps**

We begin by estimating the change in issuers' CDS spreads around CoCo issuance dates. Table 3 reports the results. Panel A shows that the overall impact of a CoCo issue on the CDS spread on the senior unsecured debt of the issuing bank is negative. The z-value for the cumulative change vis-a-vis the benchmark during the 21-day window is negative and statistically significant (at the 5% level). The economic significance is also meaningful – the average prediction error for the full sample is equal to approximately 8 bps. This implies that if the compression in CDS spreads is fully passed through to senior unsecured debt yields, issuing CoCos reduces the annual interest costs associated with each \$10 billion of (non-CoCo) bank debt by \$8 million. The second statistic we examine is the proportion of negative prediction errors. It has a value of 68% and is statistically significant at the 1% level (according to the Wilcoxon signed ranks statistic). An inspection of the results for the other two event windows (reported in Panels B and C in Table 3) that we examine reveals that most of the compression in CDS spreads tends to happen in the period leading up to the issue date, as opposed to on or after the CoCo issuance date, suggesting that the market mostly digested the news of CoCo issuance before the actual issue date and there is no uniform "event date" for the information release for all CoCos.

[Insert Table 3 here.]

We next break down the full sample into subsamples sorted by the most important CoCo contracting terms and issuer characteristics. Our first sorting variable is the loss absorption mechanism (mandatory conversion or principal write-down). The impact of mandatory conversion (MC) CoCos on CDS spreads tends to be more negative than the impact of principal write-down (PWD) CoCos but the difference is not large. The trigger level is crucial for the CDS market reaction. The spread drops significantly only when the CoCo has a high trigger (above 6%) but hardly changes if otherwise, and this contrast is more stark among the PWD CoCos. The difference in impact of issuing MC or PWD CoCos points to the potential importance of the conversion mechanism for banks' risk-taking incentives. Conversion to equity increases the cost of risk taking for current shareholders and management due to equity dilution. In contrast, no such costs are imposed by PWD CoCos. In fact, PWD CoCos may increase risk taking incentives by shareholders, as the downside risk is now shared with CoCo investors.

The next sorting variables assesses whether the CDS price reaction depends on the amount of CoCos issued (scaled by the risk-weighted assets of the issuing bank), the overall size of the issuing bank (proxied by the US dollar value of its total assets) and whether the issuer is designated as a Global Systemically Important Bank (GSIB)<sup>6</sup>. Our results suggest that issuing CoCos tends to have a more significant negative impact on the CDS spreads for GSIB (z-value of  $-1.94$ ) than for non-GSIB issuers ( $-1.14$ ). However, there is a larger proportion of non-GSIB (77%) issuers experience a drop in the CDS spread than that of GSIB issuers (58%). This result could be interpreted as evidence that the credit-risk channel of CoCo issuance is more prevalent for the less "important" banks, because the senior debt-holders in the GSIBs may be perceived as benefitting from an implicit government guarantee.

Interestingly, the impact of CoCo issuance on CDS spreads for GSIBs tends to be considerably stronger in the lead-up to issuance (between  $t-15$  and  $t-1$ ) than on and after the issuance date (between  $t$  and  $t+5$ ). There is a couple of possible explanations for this finding. First, information about the upcoming CoCo issuance is

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<sup>6</sup>For the latter data split, we use the latest GSIBs list issued by the Financial Stability Board (FSB, 2015).

more efficiently incorporated into the CDS spread of GSIBs than into those of non-GSIBs (since the former tend to be more liquid and covered by more analysts than the latter). Second, once an upcoming CoCo issuance is announced, the probability of a successful placement is higher for GSIBs than for non-GSIBs.

Consistent with the effects of the GSIB status, our results show that the impact is also stronger for larger banks. Using three breakdowns for issuer size: median, \$500 billion and \$1,000 billion, the results consistently show that the effect is stronger for issuers of larger size. Interestingly, regarding the sensitivity of the results to the size of CoCo issues relative to the risk-weighted assets of a bank, the effect is stronger when CoCo issues are smaller, suggesting that the issuance announcement may also have a “signalling” effect on the tightness of the capital constraint of the issuer.

The final Panel D of Table 3 presents the cross-sectional variation in CDS spread change (from  $t - 15$  to  $t + 5$ ) in a regression format. Results show that while larger issuers experience bigger drop in the CDS spread, the magnitude of risk-weighted assets is positively associated with the spread change (or less decrease in the spread), suggesting that banks that hold less risky assets (conditional on total asset size) benefit more from contingent capital in further reducing default risk. Trigger ratio turns out to be important: a one-percentage point increase in the trigger ratio is associated with about 4 basis point drop in the CDS spreads, suggesting that the current creditors value CoCo bonds that would be triggered before the bank gets into serious distress, hence offer them effective protection.

Figure 3 depicts the main results in Table 3 by plotting the cumulative abnormal returns (CARs) on the issuing banks’ CDS spreads for a 21-day window, which starts 10 business days before the CoCo issuance date and ends 10 business days after the CoCo issuance date. The  $CARs$  are calculated based on the daily changes in the CDS spreads of both the issuers (subscript  $i$ ) and the market (subscript  $m$ ). For each issuer  $i$  and date  $t$  (where  $t = -10, \dots, 0, \dots, +10$  is index for trading days where day 0 is the CoCo issuance date) the abnormal return is  $AR_{i,t} = \Delta CDS_{i,t} - \Delta CDS_{m,t}$ . The figures plot the average cumulative abnormal returns  $CAR_{\tau} = \sum_{t=-10}^{\tau} \left( \frac{1}{n_t} \sum_{i=1}^{n_t} AR_{i,t} \right)$  for  $\tau = -10, \dots, +10$ , where  $n_t$  is the number of CoCo issues (with non-missing return data) on date  $t$ . The pattern in CARs during the time window echo the ones reported in Table 3. More specifically, the CARs for the CDS spreads of CoCo issuers are steadily moving into negative

territory throughout the event window, reaching  $-8$  to  $-9$  bps by  $t + 10$ . Figure 4 plots the same process in CDS spread levels rather than changes. The average CDS spread of CoCo bonds issuers decreases steadily from 134 to 126 basis points.

[Insert Figure 3 here.]

[Insert Figure 4 here.]

### 3.3.3 Evidence of equity price changes

A priori the theoretical predictions of CoCo issuance on equity prices are not as conclusive as those for the CDS spreads. First, a CoCo issue could be seen as a negative signal about the bank's balance sheet (even if it is less negative than an equity issue). Second, the CoCo may be seen by investors as having too low a trigger to have any credible risk of being converted. A CoCo issue would then just be seen as more leverage, with an ambiguous effect on stock price. Furthermore, the CoCo issue could dilute existing equity-holders upon conversion (for those CoCos that are seen as having a credible risk of conversion). Hence the effects are likely to be sensitive to the terms of the CoCo contract, in particular on whether CoCos will be diluting at conversion.

Table 4 reports the results using the same methodologies as in Table 3, replacing CDS spreads with stock returns. The benchmark regional indices (for Europe, Asia excluding Japan, Australia and Latin America) are calculated using the respective DataStream regional equity indices. It turns out that none of the  $z$ -scores and the Wilcoxon signed rank statistics are statistically significant, and there is no consistent pattern between the pre- and post-issuance returns. This set of results seem to reflect the ambiguous predictions of the theoretical literature regarding the first order effect.

[Insert Table 4 here.]

Panel D of Table 4 presents the regression that explores the cross-sectional variations in the stock returns during the  $(t - 15, t + 5)$  window, which reveals an interesting interactive relation between trigger level and loss absorption mechanism. First, the effect of PWD CoCos on stock prices is significantly negative when the

trigger ratio is very low, but turn into positive when the trigger ratio rises (around 5.9%). The interaction effect of trigger level on the PWD CoCos' effect on stock prices is significantly positive (at the 1% level). This is consistent with the hypothesis that when the trigger value is very low (and so is the probability of triggering), the PWD CoCos are perceived as a mere addition to leverage. On the other hand, shareholders welcome PWD CoCos with high triggers which serves as loss absorption via an automated delevering *before* equityholders are seriously impaired. On the other hand, the effect of trigger ratio for MC CoCos on equity prices is significantly (at the 1% level) negative. Such an effect is also intuitive in that high trigger MC CoCos imposes high dilution risks on the current shareholders, which depresses the stock price.

### **3.4 Investors' assessment of the risk of conversion**

To offer loss absorption capacity without creating unintended risks, CoCo investors need to understand the risks and be ready to absorb the losses should the trigger be breached. As the market for CoCos grows, so do the warnings that investors may underestimate the risk that their investment can be lost upon conversion. An increasing number of market participants claim that the demand for CoCos is driven by search for yield during the post-crisis accommodative monetary policy and the low returns of the fixed income market.

To assess these claims we explore market perceptions of conversion risk of CoCos by empirically testing the CoCo correlations with equity prices and non-CoCo debt spreads. In Appendix B, we develop an analytical framework to determine theoretically how the signs of these correlations depend on the CoCo propensity to convert. We build a simple model of bank's balance sheet in which the value of bank claims depends on two factors. The first factor is the market's perceived risk of CoCos being triggered in case of a loss and the effect of loss on other bank claims. The second factor is the interest rate. Furthermore, we assume that an increase in the probability of loss on the asset side of the balance sheet is associated with a small decline in interest rate. The assumption captures the idea that lower interest rates reflect the slow down phase of the economy.

The framework leads to four possible scenarios. In scenario 1, bank is well capitalized and CoCo is never triggered. In scenario 2, CoCo is triggered but the equity following conversion has the same value as the face

value of CoCo; other claims are not affected. In scenario 3, CoCo is triggered and the loss is large enough to disfigure the CoCo (but leaves subordinated debt untouched). In scenario 4, CoCo is triggered and the loss is so large that it disfigures not only CoCo but also subordinated and senior unsecured debt.

For each of these scenarios, we derive the signs of correlations between CoCo bonds spread and other debt spreads and equity returns. In the simplest case of no risk of conversion, all debt instrument prices are driven by the interest rates and thus they co-move. As the propensity of CoCo conversion increases and the conversion disfigures other debt claims of the bank, the prices are driven by interest rates and the risk that bank incurs a loss.

We estimate pairwise correlations between the daily changes in the CoCo bond spreads and the daily changes in subordinated debt spreads, the CDS spread (on senior unsecured debt) and the equity return of the same issuer. Table 4 reports the results. The empirical correlations reveal that investors place a significant probability that CoCos will convert or that there will be a loss at conversion on CoCos and subordinated debt. The signs of correlations are coherent with the analytical predictions in scenario 4, where the equity capital ratio is expected to fall below the trigger level and the loss is large enough so that it disfigures the CoCo and subordinated debt. As predicted by the analysis in this case, the correlation between the changes in CoCo spreads and equity returns is negative, while the correlations between the changes in spreads of CoCo and senior unsecured debt, subordinated debt and CDS prices are all positive.

[Insert Table 5 here.]

The results show that CoCo instruments are perceived by investors as risky instruments with a non-negligible likelihood of conversion. This implies that the incentive and the capital buffer effects of CoCos are not sufficiently strong to drive the CDS spread to zero and eliminate the credit risk in subordinated debt. The reaction of CDS spreads to CoCo issuance is indeed negative, as depicted on Figure 3. Figure 4, plotting the level of CDS spreads during the event window, further shows that the CDS spreads remain significant post CoCo issuance (126 bps). In other words, they reflect positive credit risk, which is inconsistent with the CoCo price movements (correlations) if there were no expectation of conversion. Thus, while CoCos are

able to provide additional capital buffer, the current market prices/spreads reveal both that the disciplining effect of CoCo issuance on bank risk-taking incentives and the expected ex post loss absorption is assessed by the market to be rather weak.

These results also shed some light on some commentators' suggestions that the demand for CoCos is driven by an irrational search for yield. Though we cannot directly address the question whether investors' demand for CoCos is "excessive", the analysis of CoCo pricing shows that investors are aware of the risks in CoCo instruments. Their decisions to invest do not appear to arise from a complete disregard of the risk that CoCo instruments may convert, but rather from a rational decision to take on more risk, probably due to the absence of better risk-return profile alternatives.

[Insert Table 5 here.]

## 4 Conclusion

We put together and analyze the first comprehensive data set of contingent convertible instruments (CoCos) issued by banks after the financial crisis. In addition to reporting basic stylized facts about this market, we conduct tests analyzing banks' motives to issue CoCos as well as the impact of CoCo issuance on bank CDS spreads and equity prices. We find that the effect of CoCo issuance on bank funding costs depends crucially on CoCos contract features and bank characteristics. In particular, issuing conversion-to-equity CoCos has a negative impact on issuer's CDS spreads, while issuing CoCos with a principal-write-down has less of an impact. Importantly, in spite of this differential effect and the differences in incentives of the two CoCo contract designs, there is no distinction in their regulatory treatment. As for the reaction of equity prices, CoCo issuance has no clear overall effect, in line with the predictions of corporate finance theory.

The assessment of pricing of banks' securities post CoCo issuance shows that investors place a significant likelihood that CoCos will convert and the loss will be sufficiently high to disfigure not only CoCos but also subordinated debt. Thus market participants view CoCos as risky investments with a strong possibility of conversion. Although CoCos provide additional capital buffers to issuing banks, as reflected in the lower

CDS spreads, their effect on overall loss-absorbency and risk-taking incentives is rather weak.

We have explored only a subset of issues concerning the effects of CoCos on issuing banks' cost of capital. An important open question for the immediate future concerns the investor clientele of CoCos. We only have sketchy information on the buy side and cannot determine which investors of CoCos are mainly chasing yields and are attracted by the higher remuneration of the bonds without adequate consideration for the risks they may be exposed to. Second, CoCos enhance the stability of issuing banks and the banking system at large mainly if the holders of CoCos are non-bank investors. To the extent that CoCos are held by banks, all that is achieved is a transfer of risk from the issuing bank to the investor bank, so that no net risk reduction in the banking system has been achieved. It is therefore also important to know what fraction of the CoCo market is purely a risk transfer within the banking system.

Another question of immediate importance is what is the right fraction of CoCo issues for a typical bank issuer? Have banks been too conservative in their issues of CoCos? Have they held back due to the unfavorable regulatory or tax treatment of CoCos? Have they issued CoCos only to be in strict compliance with capital regulations? Or on the contrary, have some of the larger issuers of CoCos built up excessively large CoCo liabilities? Going forward, other important questions that remain to be answered are what differentiates banks that have decided to issue CoCos and those that have not. Are banks that issue CoCos more financially sophisticated? Or are these primarily issuers that are running out of recapitalization options?

## 5 Appendix A: Methodology

We calculate the following regional indices – Europe, Asia excluding Japan, Australia and Latin America. The regional financial equity index is calculated using the DataStream regional equity indices. The CDS indices are calculated using the equally weighted iTraxx Senior Financials constituents, which have been augmented with additional liquid bank names. The construction of indices aims to build a market portfolio that is congruent with the profile of banks issuing CoCos. These are relatively large financial institutions with a substantial share of interregional and international activities.

The prediction error of a security for bank  $j$  at day  $t$  is defined as

$$PE_{jt} = R_{jt} - R_{mt},$$

where  $R_{jt}$  is the return on equity or a change in the CDS spread on day  $t$  and  $R_{mt}$  is the corresponding return on equity or CDS index. The prediction error is used as a proxy for the abnormal returns during the event window.

The average prediction error at date  $t$  ( $APE_t$ ) is obtained by averaging the prediction errors across all CoCo issues in the sample,

$$APE_t = \frac{1}{N} \sum_{j=1}^N PE_{jt},$$

where  $N$  is the number of banks in the sample.

Tests of statistical significance of the average prediction errors are based on standardized prediction errors that account for the number of days in the estimation period and the length of the event window. The standardized prediction error for bank  $j$  when the event window lasts  $T$  days and the control window is  $M$  days is defined as

$$SPE_j = \sum_{t=-(T-1)}^0 \frac{PE_{jt}}{S_j},$$

where

$$S_j = \left[ TV_j^2 \left[ 1 + \frac{1}{M} + \frac{(R_{mt} - R_m)^2}{\sum_{i=1}^M (R_{mi} - R_m)} \right] \right]^{\frac{1}{2}}$$

and  $V_j^2$  and  $R_m$  are the residual variance for firm  $j$  and the mean market return over the control window, respectively.

The average standardized prediction error on date  $t$  is

$$ASPE_t = \frac{1}{N} \sum_{j=1}^N SPE_{jt}.$$

Assuming the individual prediction errors are independent across banks (this may be a strong assumption for our sample as bank's decision to issue a CoCo depends on a common regulatory treatment of CoCos) and the average prediction errors are equal to zero, the  $Z$  statistics

$$Z = \sqrt{N}(ASPE_t)$$

is distributed  $N(0, 1)$ .

## 6 Appendix B: A simple analytical framework

It is helpful to formulate a simple formal description of the balance sheet of a bank to determine how the issuance of CoCos strengthens the bank, and how different securities that the bank has issued are affected by the bank's operating profits or losses. Thus, consider the following simple balance sheet for a bank: At  $t = 0$  the bank has assets in place  $A$ . These assets yield a profit  $\pi$  at  $t = 1$  with probability  $(1 - \theta)$  and a loss  $l$  with probability  $\theta$ . Suppose also that the interest rate is  $r > 0$ . Under risk-neutral preferences (or probabilities) the ex-ante market and book value of assets is then:

$$\frac{A[1 + \pi - \theta(l + \pi)]}{1 + r}.$$

On the liability side, the bank may have senior debt with face value  $D$ , subordinated debt with face value  $B$ , CoCo bonds with face value  $C$ , which either convert into equity or involve a principal write-down of  $(1 - \lambda)$  should the bank's equity capital ratio fall below a trigger  $\tilde{\kappa}$ .

### 6.1 CoCos never convert

Suppose to begin with that the bank is adequately capitalized, so that there will be no CoCo conversion upon the realization of loss:

$$\frac{A(1 - l) - L}{A(1 - l)} > \tilde{\kappa},$$

where  $L = D + B + C$  denotes the total face value of the bank's liabilities and where the trigger  $\tilde{\kappa}$  is greater than or equal to the minimum equity-capital requirement  $\kappa$ . In this case, the  $t = 0$  market value of the various debt instruments is:

$$V_D = \frac{D}{1 + r}, \quad V_B = \frac{B}{1 + r}, \quad \text{and} \quad V_C = \frac{C}{1 + r}.$$

Following a loss, the bank has equity capital worth  $E_{1l} = A(1 - l) - L$ , and following a profit the bank has equity capital worth  $E_{1\pi} = A(1 + \pi) - L$ , so that at time  $t = 0$  the equity value of the bank is given by:

$$V_E = \frac{1}{1 + r}[A[1 + \pi - \theta(l + \pi)] - L].$$

## 6.2 CoCos convert but equity holders are not wiped out

Consider second the case where the bank's equity capital ratio falls below  $\tilde{\kappa}$  when the bank incurs a loss  $l$ , but equity still has strictly positive value following the loss, so that:

$$\tilde{\kappa} > \frac{E_{1l}}{A(1-l)} > 0.$$

Given that conversion is triggered following the realization of a loss, the post-conversion total equity value becomes:

$$E_{1c} = A(1-l) - (D+B),$$

if the CoCo is a conversion to equity instrument, and

$$E_{1pwd} = A(1-l) - (D+B+\lambda C),$$

if the CoCo is a principal write-down instrument. An important question around the conversion event is whether CoCo conversion into equity dilutes old shareholders. Suppose that after conversion CoCos represent a fraction  $\alpha \in (0, 1]$  of the bank's equity  $E_{1c}$ . Conversion, in effect, adds  $C$  to the equity buffer. If absolute priority is strictly enforced then we must have:

$$\alpha = \alpha_C \equiv \frac{C}{C+E}.$$

The only effect of conversion then is to relabel the fixed-income claim  $C$  as an equity claim. Thus, there is no dilution of old equity holders as long as  $\alpha \leq \alpha_C$ . If  $\alpha < \alpha_C$  then equity-holders benefit from the conversion of CoCos, and CoCo-holders along with equity-holders are affected by the loss  $l$ . If, however,  $\alpha > \alpha_C$  then equity-holders are diluted as a result of the conversion. Interestingly, for principal write-down CoCos, when the CoCo is triggered equity-holders always benefit, as the value of their claim rises from the pre-trigger level  $E_{1l} = A(1-l) - L$  to the post-trigger level  $E_{1pwd} = A(1-l) - L + (1-\lambda)C$ .

## 6.3 CoCos convert and equity holders are wiped out

Consider next the case where, as a result of the loss:

$$0 < \frac{A(1-l) - (D+B)}{A(1-l)} < \kappa,$$

and

$$\frac{A(1-l) - D}{A(1-l)} > \kappa.$$

In this case the old equity holders are completely wiped out. The CoCo holders become the sole equity holders, but their claim also gets disfigured as they are junior to the subordinated bondholders. For simplicity suppose that a “haircut” is imposed on subordinated bondholders such that: i) their bond claim going forward is reduced from  $B$  to  $\hat{B}$ , where  $\hat{B}$  is given by

$$\frac{A(1-l) - D - \hat{B}}{A(1-l)} = \kappa,$$

and ii) they receive an equity stake  $\gamma$  such that

$$\gamma = \frac{(B - \hat{B})}{(B - \hat{B}) + E_1} = \frac{B - \hat{B}}{B - \hat{B} + \frac{A(1-l) - (D+B)}{A(1-l)}}.$$

Note that when there is credit risk not only for CoCos but also for subordinated debt, the latter claims, in effect, also become contingent claims. Also, in case the subordinated debt piece  $B$  is too small, or the bank has not issued any subordinated debt, then the senior unsecured debt  $D$  can also be disfigured. In this case, the CoCo holders, subordinated debt holders, and senior unsecured debt-holders jointly become the new equity-holders in the bank and the senior unsecured debt-holders incur a “haircut”  $(D - \hat{D})$ . The conditions for this case to obtain are:

$$0 < \frac{A(1-l) - D}{A(1-l)} < \kappa,$$

and

$$\frac{A(1-l) - \hat{D}}{A(1-l)} \geq \kappa.$$

Finally, if the subordinated (or senior unsecured) bond-holders have bought CDS protection and the haircut  $(B - \hat{B})$  (or  $(D - \hat{D})$ ) is not compensated through a debt-equity swap but by the CDS writer, then the ‘spread’ on the CDS is equal to:

$$s_B = \frac{1}{1+r} \frac{\theta(B - \hat{B})}{1 - \theta}, \text{ for a CDS on subordinated debt, and}$$

$$s_D = \frac{1}{1+r} \frac{\theta(D - \hat{D})}{1 - \theta}, \text{ for a CDS on senior unsecured debt.}$$

## 6.4 Correlation Predictions for CoCo, Equity, Bond and CDS Prices

We can use the formal description of the balance sheet above to derive predictions on the correlations between equity returns and the spreads<sup>7</sup> of CoCos, CDS, the bank's debt securities, and how these depend on the market's perceived risk of a CoCo being triggered.

1. When the bank's equity capital ratio is expected never to fall below the CoCo trigger  $\tilde{\kappa} \geq \kappa$  the market value of equity is:

$$V_E = \frac{1}{1+r} [A[1 + \pi - \theta(l + \pi)] - L],$$

so that an increase in the probability of a loss  $\theta$  negatively affects  $V_E$  by:

$$\frac{\partial V_E}{\partial \theta} = -\frac{1}{1+r} A(l + \pi).$$

Furthermore, if the increase in  $\theta$  is associated with a decline in interest rates  $r$  (as a result, say, of counter-cyclical monetary policy) then simultaneously securities values  $V_i$ ,  $i = D, S, C$  increase, and therefore their yield to maturity,  $\frac{1}{V_i} - 1$  decreases. Thus, in this case, a simple prediction is that changes in  $\theta$  would result in a *positive correlation* between equity returns and CoCo spreads, and a *positive correlation* between CoCo and CDS spreads. As, in this case, the value of debt claims depends only on changes in interest rates, CoCo spreads and senior and subordinated debt spreads are also *positively correlated*.

2. These predictions on correlations extend to situations where the CoCo is triggered when the bank's equity capital ratio falls below  $\tilde{\kappa}$  as a result of an operating loss, provided that the equity conversion results in the same equity value as the face value of the CoCo  $C$ , and provided that the subordinated debt and senior unsecured debt is expected not to be disfigured following conversion.
3. When the loss  $l$ , however, is so large that it disfigures the CoCo (but leaves subordinated debt untouched) then the correlation predictions change. First, the market value of equity at time  $t = 0$  is

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<sup>7</sup>For each security, we consider the daily changes in the spread between the yield to maturity of a security and the corresponding government bond matched by currency and maturity.

now:

$$V_E = \frac{1}{1+r}(1-\theta)[A(1+\pi) - L],$$

so that:

$$\frac{\partial V_E}{\partial \theta} = -\frac{1}{1+r}[A(1+\pi) - L].$$

Second, the market value of the CoCo at  $t = 0$  is now:

$$V_C = \frac{1}{1+r}[(1-\theta)C + \theta\kappa(1-\gamma)A(1-l)],$$

so that:

$$\frac{\partial V_C}{\partial \theta} = -\frac{1}{1+r}(C - \kappa(1-\gamma)A(1-l)).$$

(Note that we evaluate the marginal effect of  $\theta$  against proportionally small changes in interest rates  $r$ , so that that the marginal effect with respect to  $r$  is negligible). Now changes in equity returns, subordinated and senior bond spreads are *negatively correlated* with CoCo spreads.

4. When the loss  $l$  is even larger, so that it not only disfigures the CoCo but also subordinated debt, then the correlation predictions are as follows:

(a) As before:

$$\frac{\partial V_E}{\partial \theta} = -\frac{1}{1+r}A[(1+\pi) - L],$$

and

$$\frac{\partial V_C}{\partial \theta} = -\frac{1}{1+r}(C - \kappa A(1-l)).$$

(b) But,

$$\frac{\partial V_B}{\partial \theta} = -\frac{1}{1+r}(B - \hat{B}),$$

and

$$\frac{\partial s}{\partial \theta} = \frac{1}{1+r} \frac{B - \hat{B}}{(1-\theta)^2}.$$

In words, a perceived increase in the probability of default lowers equity, CoCo, and subordinated debt returns. The same would be true for the price of senior unsecured debt if default also involves

a loss given default for this more senior debt. Debt prices move inversely with spreads, so that the main theoretical prediction for this case regarding correlations in equity returns and debt spreads is that equity returns are *negatively correlated* with CoCo spreads, senior unsecured, subordinated debt, and CDS spreads when the market perceives that there is a positive credit risk associated with these instruments.

In summary, if we denote the changes in spreads of CoCos and debt as, respectively  $\Delta s_C$ ,  $\Delta s_D$ , and  $\Delta s_S$  then the empirical predictions on the *sign of correlations* between changes in CoCo spreads and changes in banks' security prices,  $Corr(\Delta s_C, \Delta V_E)$ ,  $Corr(\Delta s_C, \Delta s_i)$   $i = D, S$ , and  $Corr(\Delta s_C, \Delta s)$  are as follows.

	Cases 1 and 2	Case 3	Case 4
$Corr(\Delta s_C, \Delta V_E)$	+	-	-
$Corr(\Delta s_C, \Delta s_i)$	+	-	+
$Corr(\Delta s_C, \Delta s_S)$	+	-	+
$Corr(\Delta s_C, \Delta s)$	+	+	+

For principal write-down CoCos the analysis is slightly different. Unlike for equity-conversion CoCos, when the bank incurs a loss and as a result breaks through the  $\kappa$  trigger, the holders of CoCos instead of getting  $C$  only receive  $\lambda C$ , so that the ex ante value of the CoCo is now:

$$V_C = (1 - \theta)C + \theta\lambda C,$$

and

$$\frac{\partial V_C}{\partial \theta} = -(1 - \lambda)C.$$

The effect of the write-down is to increase the equity-capital buffer from:

$$\frac{A(1 - l) - L}{A(1 - l)},$$

to

$$\frac{A(1 - l) - (D + B + \lambda C)}{A(1 - l)}.$$

If

$$\frac{A(1-l) - (D + B + \lambda C)}{A(1-l)} > \kappa$$

then no further equity infusion is needed. In this case the value of equity is

$$E_{1pwd} = A(1-l) - (D + B + \lambda C)$$

after the loss, so that:

$$E = (1-\theta)[A(1+\pi) - (D + B + C)] + \theta[A(1-l) - (D + B + \lambda C)]$$

and

$$\frac{\partial V_E}{\partial \theta} = -A(l + \pi) + (1 - \lambda)C.$$

It is plausible that  $(1 - \lambda)C < A(l + \pi)$ , so that for this type of CoCo equity and CoCo prices are positively correlated.

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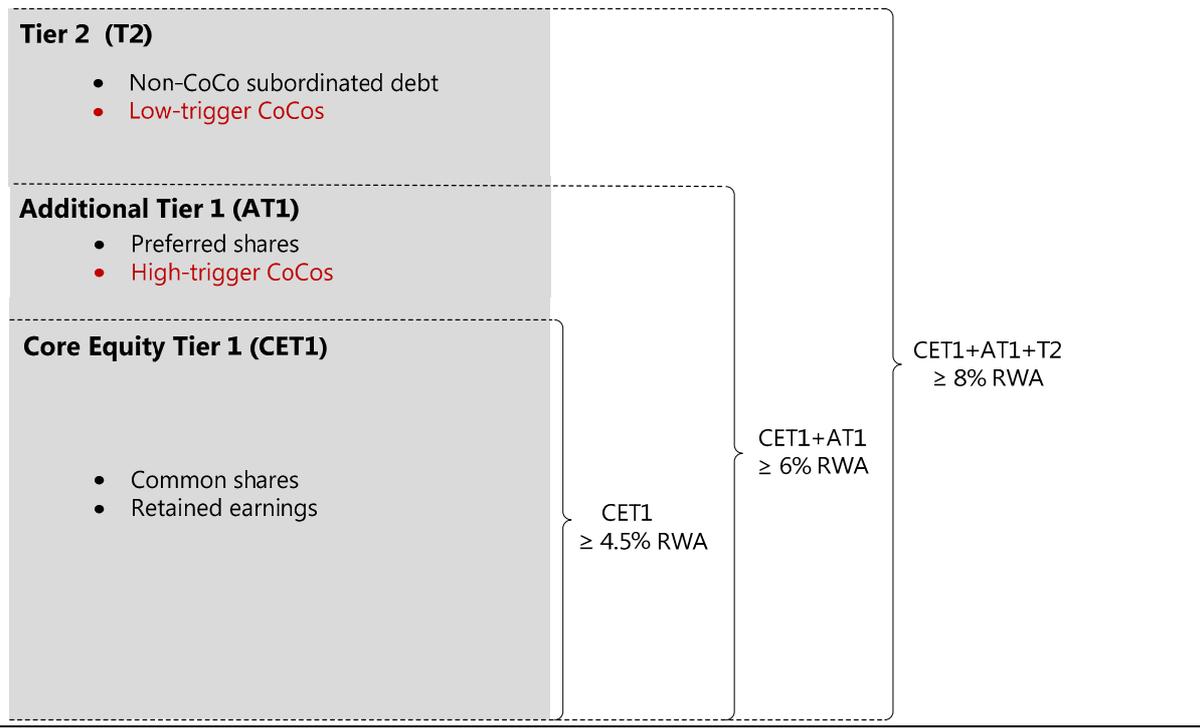
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### Figure 1.CoCos position in Basel III capital requirements

The graph is an illustration of the position of CoCo instruments under Basel III requirements. The list of instruments in this graph is not exhaustive and is included solely for illustrative purposes. For a complete list of instruments and associated criteria for inclusion in each of the three capital buckets, see [BCBS \(2011\)](#). The above shares of RWA represent the bare minimum capital requirements and do not account for any add-ons, such as the capital conservation buffer, the countercyclical buffer and the SIFI surcharge.



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## Figure 2. Overview of CoCo Bond Issuance: Trends and Compositions

The four charts in Figure 1 present the trends and compositions of CoCo bonds issuance from the post-financial crisis era of 2009 to September 2015. The information source is Bloomberg Dealogic. Figure 2a shows the time series of dollar amount of all CoCo issues, broken down by CoCos which qualify for Additional Tier 1 (AT1) and those only to Tier 2 capital. For a CoCo to qualify as AT1, the trigger has to be at least 5.125% of risk-weighted assets. Figure 2b presents the same time series except breaking down all issuances by their loss absorption mechanisms: A “principal write-down” CoCo’s principal can be either fully or partially written off when the trigger is hit; A “conversion-to-equity” CoCo is converted into equity when triggered where the conversion formula can be based on the equity price on the day of conversion or on a pre-specified formula of number of shares for each bond, or on some combination of the two. Figure 2c shows the composition of CoCo issues during the sample period by nationality of the issuers. Finally, Figure 2d plots the time series of the percentage of CoCos with trigger greater than 5.125% (and hence qualify as AT1).

Figure 2a. CoCo issuance by regulatory capital classification (in million dollars)

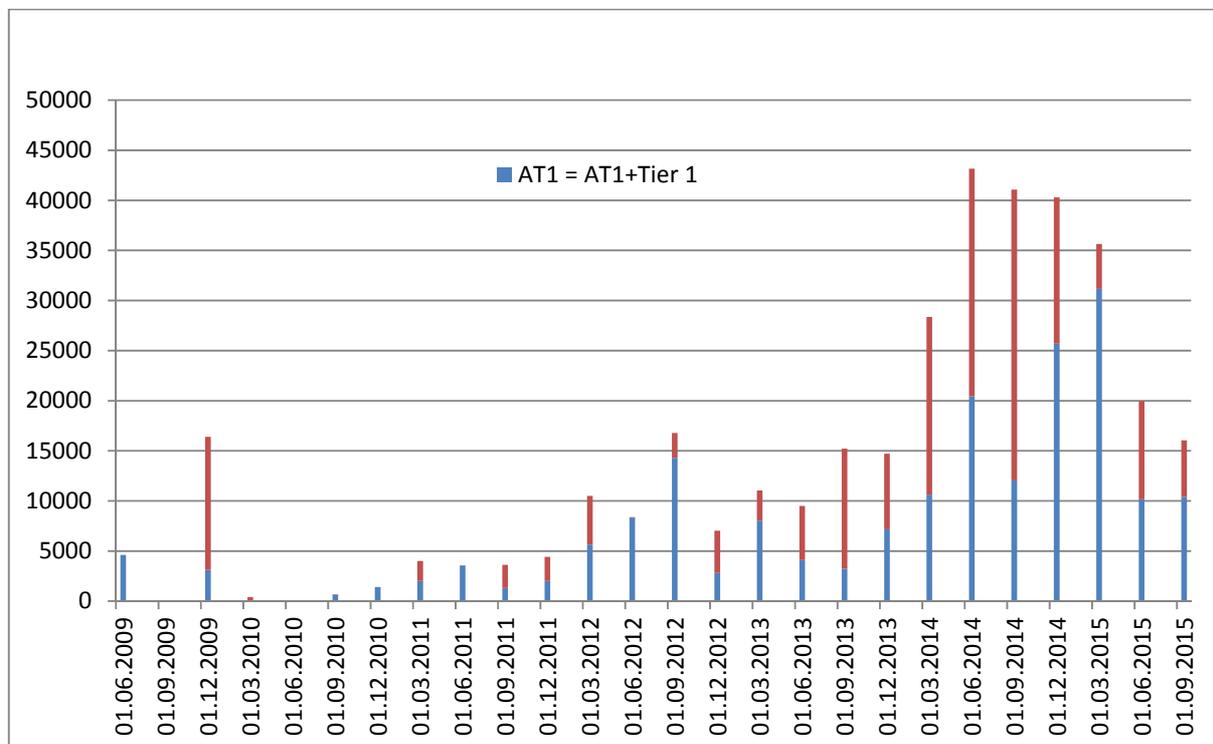


Figure 2b. Percentage of CoCos with a trigger greater or equal to 5.125%

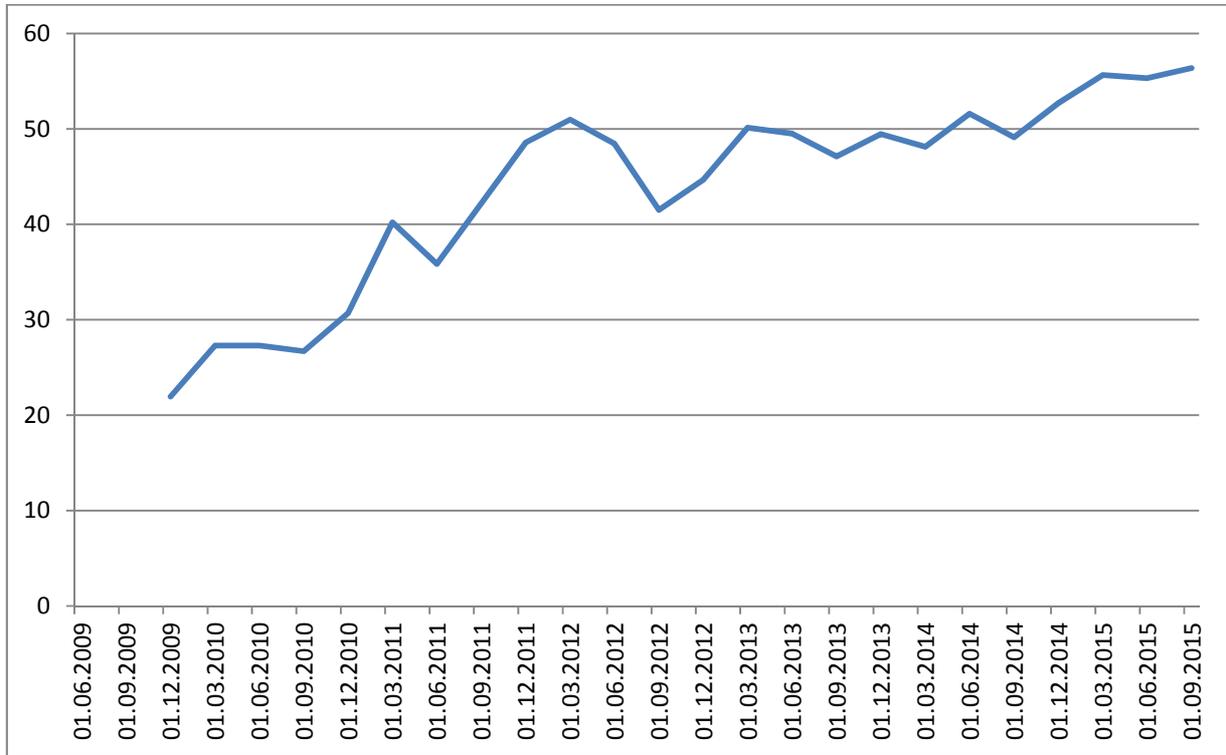


Figure 2c. CoCo issuance by loss absorption mechanism (in million dollars)

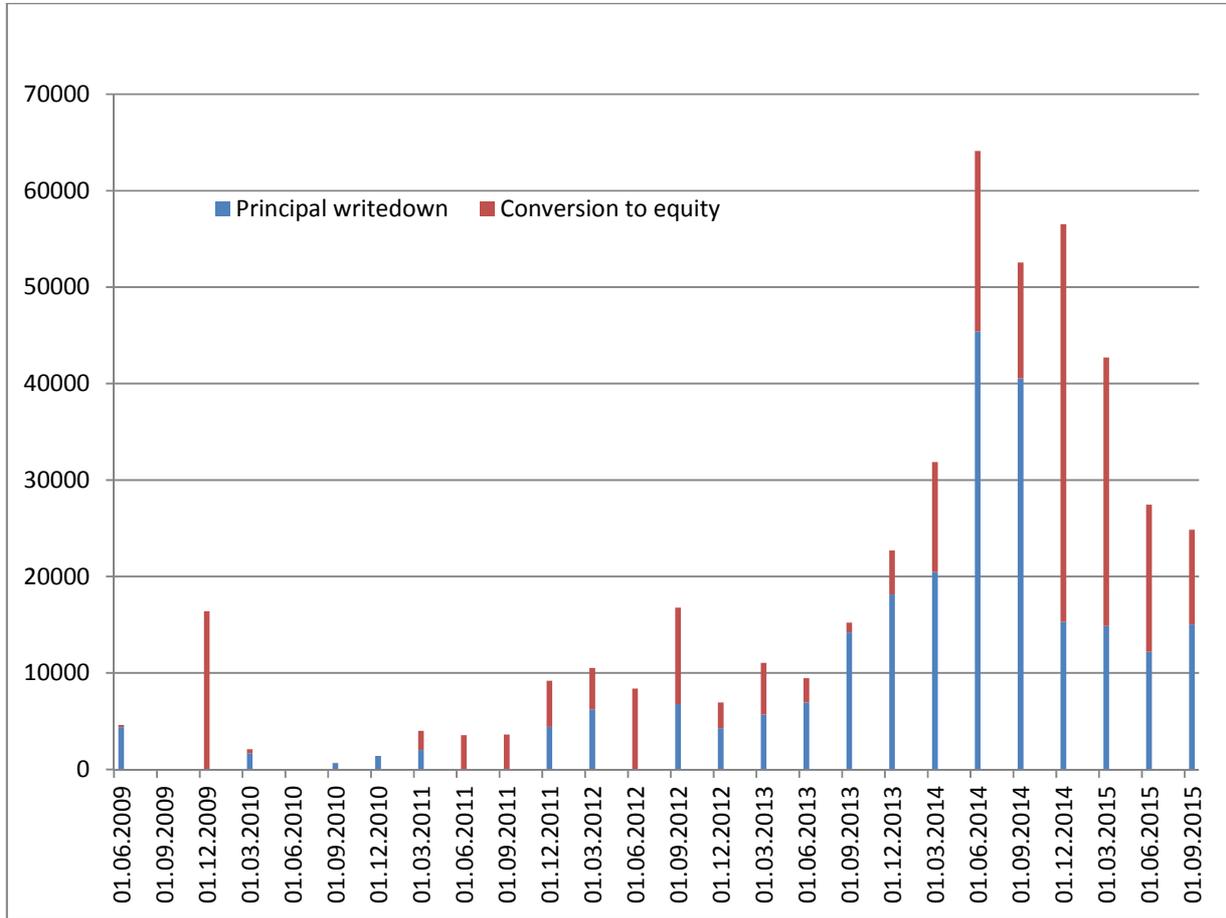
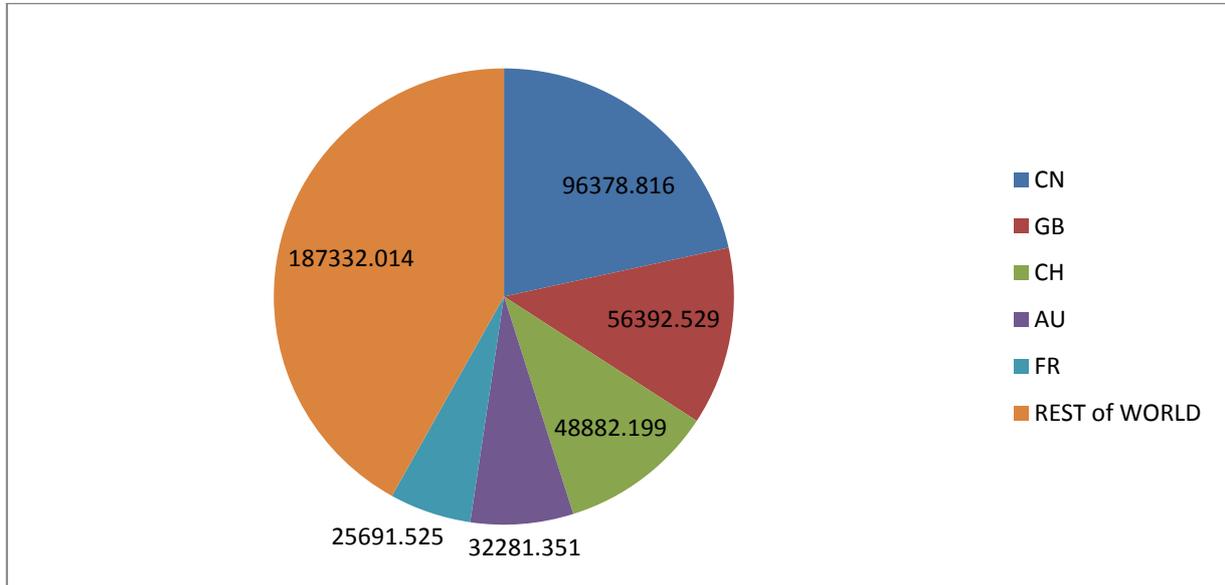


Figure 2d. CoCo issuance by nationality of issuer (in billion dollars)



### Figure 3. Distribution of Primary Market CoCo Bond Investors

For a selected subsample of CoCo bonds (primarily Additional Tier 1 issues originated between April 2013 and March 2014) for which information is available, Figure 3 plots the distribution of the investors in the primary market. The issues are marked by their issuance dates, issuers, and the currencies. Figure 3a presents distribution by investor type while Figure 3b presents that by region.

Figure 3a. Distribution by investor type

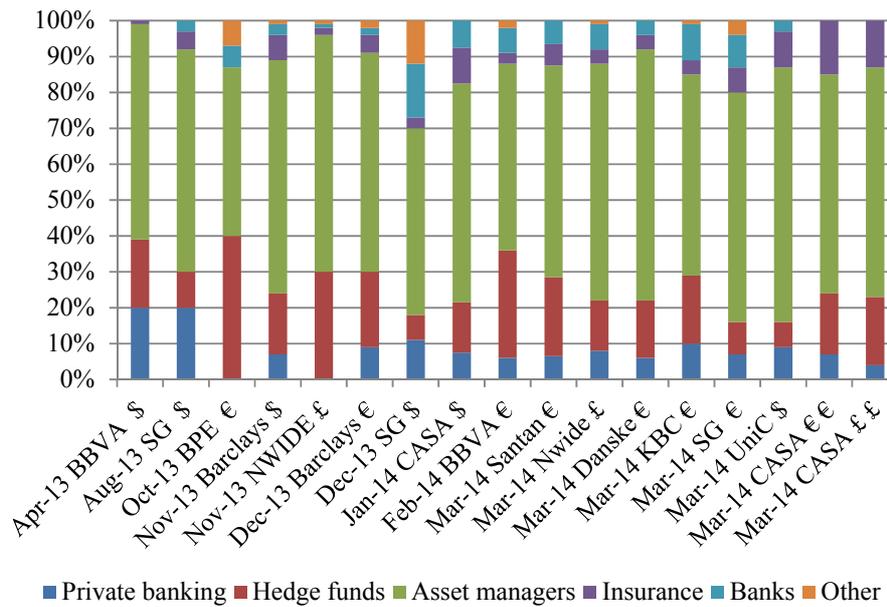
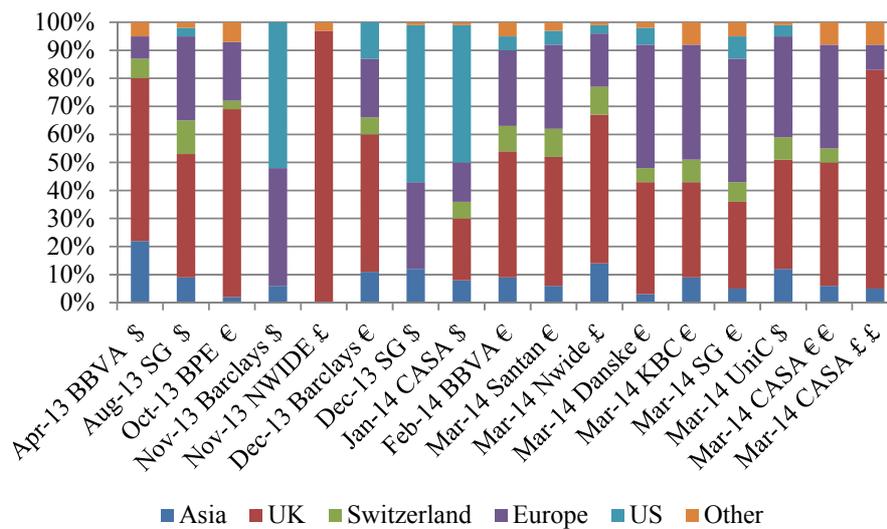
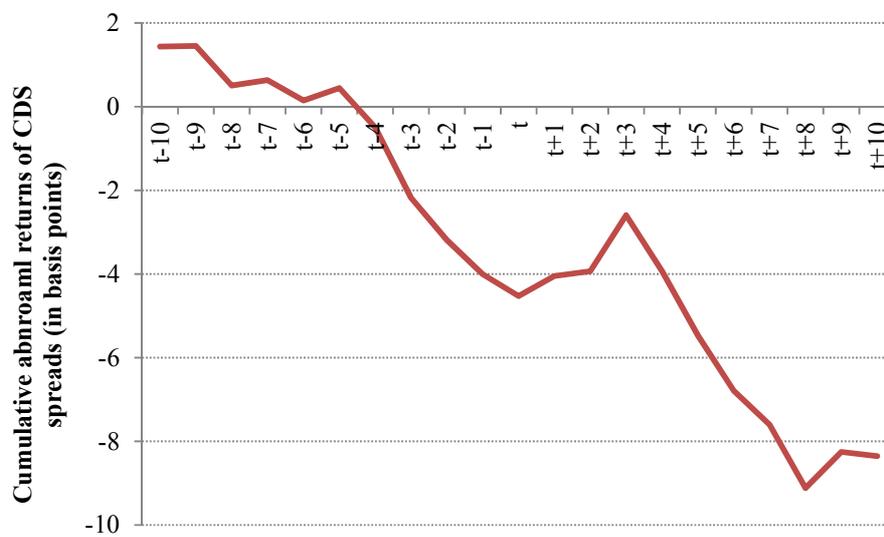


Figure 2b. Distribution by region



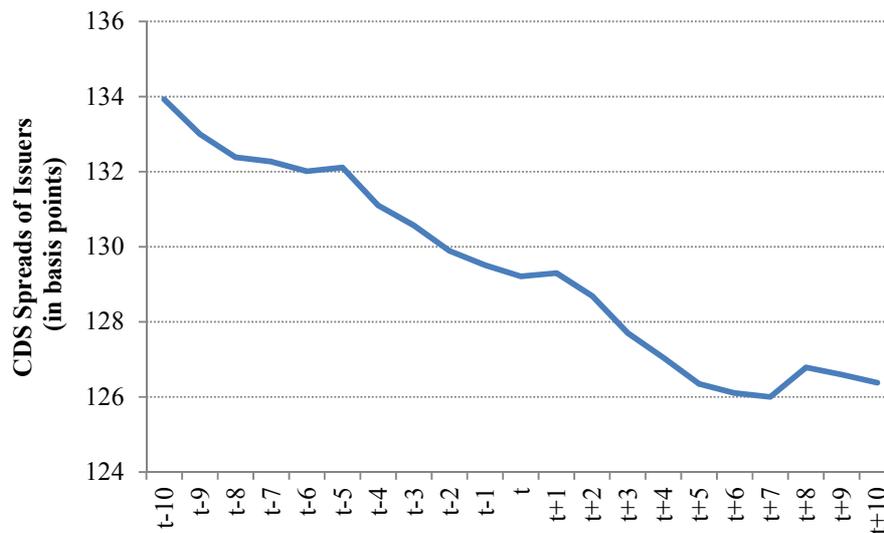
**Figure 4. Credit Default Swap (CDS) Spread Changes around CoCo Bond Issuance**

This figure plots the cumulative abnormal changes (in basis points) in the CDS spreads of the issuers of the CoCo bonds from t-10 to t+10 days where t is the date of issuance as recorded on Bloomberg. The benchmark regional indices (for Europe, Asia excluding Japan, Australia and Latin America) are calculated as equally weighted averages of the iTraxx Senior Financials constituents and additional liquid bank names from the same region. Figure 4 shows the CDS spreads for the subsamples of 29 CoCos using mandatory conversion to equity issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain).



**Figure 5. Credit Default Swap (CDS) Spreads around CoCo Bond Issuance**

This figure plots the level of CDS spreads of the issuers of 72 CoCo bonds from t-10 to t+10 days where t is the date of issuance as recorded on Bloomberg. The benchmark regional indices (for Europe, Asia excluding Japan, Australia and Latin America) are calculated as equally weighted averages of the iTraxx Senior Financials constituents and additional liquid bank names from the same region. The sample include CoCos issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain).



**Table 1. Summary Statistics of CoCo Issues**

This table reports the number of issues and issued amount of different categories of CoCo bonds from January 2009 to September 2015, classified by loss absorption mechanism, trigger level, denomination currency, regulatory classifications, and maturity at issuance.

	Issued amount, in USD mn	% of total issuance for each category	Number of issues
Total	446,958		519
Loss absorption mechanism			
Principal writedown	240,688	53.9	321
Mandatory conversion	205,990	46.1	195
Trigger, in %			
< 4.5	10,911	2.5	28
4.5 – 6	213,068	48.0	201
> 6	80,178	18.0	61
No numerical trigger	128,178	29.6	213
Currency			
USD	186,472	44.6	158
EUR	75,781	18.1	79
CNY	75,725	18.1	26
Other	80,588	19.3	256
Regulatory classification			
Additional tier 1	192,797	54.0	187
Tier 2	163,985	46.0	248
Original maturity, in years			
< 5	12,560	2.8	4
5 – 10	7,920	1.8	10
≥ 10	171,157	38.3	264
Perpetual	255,321	57.1	241

**Table 2. Propensity to Issue CoCos: Duration Analyses**

This table analyzes the propensity of banks to issue CoCos using duration analysis. The sample consists of “potential” issuers which include the 500 banks with the highest total assets in advanced economies (i.e., excluding euro area peripheries), plus the CoCo issuers in our sample from the advanced economics that are not among the top 500. The starting time is January 2009 and the end of observation is December 2014. Panel A presents results from regressions of *Time to Issue* (in months from January 2009) on the determinants using a Tobit regression. Panel B presents results from the Cox (1972) proportional hazards model using time-varying covariates at the bank-month level. Panel C (D) presents results from the Fine and Gray (1999) competing risk hazards model at the bank-month level where the issuance of any principal write-down (mandatory conversion) CoCos as the “main risk” with the issuance of any mandatory conversion (principal write-down) CoCos as the “competing risk.” For Panels B – D, observations drop out of the sample right after a bank issues any CoCo for the first time. Banks without any issuance are treated as being censored at the end of the sample period. The independent variable are as following: *Total Assets* (in logarithm), *Tier1* (Tier 1 capital), *Gross Loans*, *Total Deposits*, *Total Long Term Funding*, and *Total Trading Securities*. The last four variables are all scaled by total assets, expressed as percentage points. The t-statistics are in parentheses. \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

## Panel A. Duration to Any Issuance [Q1 2009 – Q1 2015]

	(1)	(2)	(3)	(4)
Total Assets	-8.071*** (-2.73)	-8.754*** (-3.00)	-9.108*** (-2.74)	-9.512*** (-2.90)
Tier1	-4.977*** (-2.88)	-5.334*** (-3.06)	-4.881*** (-2.71)	-5.117*** (-2.81)
Gross Loans	-0.159 (-0.82)	-0.0785 (-0.40)	-0.407 (-1.74)	-0.349 (-1.47)
Total Deposits	0.210 (1.26)		0.123 (0.68)	
Total Long Term Funding		-0.277 (-1.37)		-0.195 (-0.91)
Total Trading Securities			-1.475*** (-3.01)	-1.461*** (-3.00)
# Observations	515	515	513	513

Panel B. Hazards to Any Issuance with the Cox Model

	(1)	(2)	(3)	(4)
Total Assets	0.361 <sup>***</sup> (3.16)	0.386 <sup>***</sup> (3.42)	0.434 <sup>***</sup> (3.79)	0.432 <sup>***</sup> (3.75)
Tier1	0.0677 (1.13)	0.0789 (1.32)	0.0663 (1.10)	0.0641 (1.03)
Gross Loans	0.0167 <sup>**</sup> (2.05)	0.0145 <sup>*</sup> (1.68)	0.0247 <sup>***</sup> (2.95)	0.0253 <sup>***</sup> (2.81)
Total Deposits	-0.00922 (-1.53)		-0.00615 (-0.95)	-0.00658 (-0.94)
Total Long Term Funding		0.00511 (0.66)		-0.00150 (-0.17)
Total Trading Securities			0.0481 <sup>***</sup> (3.35)	0.0484 <sup>***</sup> (3.35)
# Observations	2983	2983	2974	2974

Panel C. Hazards to Principal Write-Down Issuance (with Mandatory Conversion as Competing Risk)

	(1)	(2)	(3)	(4)
Total Assets	0.264 <sup>*</sup> (1.65)	0.304 <sup>*</sup> (1.82)	0.247 (1.33)	0.256 (1.35)
Tier1	0.0852 <sup>**</sup> (2.28)	0.0972 <sup>***</sup> (2.72)	0.0767 <sup>**</sup> (2.01)	0.0821 <sup>**</sup> (2.10)
Gross Loans	0.00369 (0.44)	-0.00174 (-0.20)	0.00875 (1.06)	0.00716 (0.87)
Total Deposits	-0.0147 <sup>***</sup> (-2.67)		-0.0118 <sup>**</sup> (-2.09)	-0.0101 <sup>**</sup> (-1.98)
Total Long Term Funding		0.0143 <sup>**</sup> (2.57)		0.00528 (0.99)
Total Trading Securities			0.0356 <sup>***</sup> (2.77)	0.0345 <sup>***</sup> (2.67)
# Observations	2983	2983	2974	2974

Panel D. Hazards to Mandatory Conversion Issuance (with Principal Write-Down as Competing Risk)

	(4)	(5)	(6)	(8)
Total Assets	0.494*	0.489*	0.696***	0.690***
	(1.72)	(1.71)	(3.01)	(3.01)
Tier1	0.0524	0.0369	0.0493	0.0375
	(0.76)	(0.48)	(0.59)	(0.42)
Gross Loans	0.0251	0.0279	0.0363**	0.0390*
	(1.46)	(1.39)	(2.10)	(1.92)
Total Deposits	0.00253		0.00616	0.00434
	(0.50)		(1.02)	(0.91)
Total Long Term Funding		-0.00809		-0.00685
		(-0.81)		(-0.73)
Total Trading Securities			0.0487***	0.0500***
			(2.95)	(2.93)
# Observations	2983	2983	2974	2974

**Table 3. Impact of CoCo Issuance on Issuer CDS Spreads**

This table reports the normalized abnormal CDS spread changes of CoCo issuers of the full and various subsamples of CoCo bonds during the three event windows: the full 21-day (from t-15 to t+5), the pre-issuance 15-day (t-15 to t-1), and the post-issuance 6-day (t to t+5), all defined relative to the issue date (t) of the CoCo instrument (as recorded on Bloomberg). The benchmark regional indices (for Europe, Asia excluding Japan, Australia and Latin America) are calculated as equally weighted averages of the iTraxx Senior Financials constituents and additional liquid bank names from the same region. The sample includes CoCos issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain). “Z-value” is defined as  $Z = \sqrt{N} (ASPE)$ , where *ASPE* is the average standardized prediction error and *N* is the sample size, following James (1987). “Proportion negative” is the proportion of negative prediction errors, where the null equals 0.5. The test statistic is a Wilcoxon signed rank statistic. \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A. Abnormal returns in the cross-section of CDS spreads changes [Q1 2009 – Q3 2015]

<b>(A) 21-day window (-15, 5)</b>						
Group		Z-value	P-value	Proportion negative	Wilcoxon test pvalue	Sample size
All CoCos		-2.17**	0.03	0.68***	0.00	117
CoCo Issue size	< median	-2.11**	0.03	0.69***	0.00	59
(Amt issued/ RWA)	>=median	-0.95	0.34	0.66***	0.01	58
Issuer size	< median	-0.19	0.85	0.73**	0.03	44
(=total assets)	>=median	-2.60***	0.01	0.64***	0.00	73
Issuer size	< \$500 bn	0.33	0.74	0.67	0.22	21
(=total assets)	>=\$500bn	-2.55**	0.01	0.68***	0.00	96
Issuer size	<\$1000bn	-0.82	0.41	0.72***	0.00	65
(=total assets)	>=\$1000bn	-2.33**	0.02	0.62***	0.00	52
Issuer	GSIB	-1.94*	0.05	0.58**	0.02	57
	no GSIB	-1.14	0.25	0.77***	0.00	60
Loss absorption	PWD	-2.14**	0.03	0.65***	0.00	66
	MC	-2.38**	0.02	0.73***	0.00	41
Trigger	<6%	-0.05	0.96	0.66*	0.05	58
	>=6%	-2.67***	0.01	0.68***	0.00	37
PWD and trigger<6%		-0.79	0.43	0.61	0.15	33
PWD and trigger>=6%		-2.20**	0.03	0.72***	0.00	18
MC and trigger<6%		-1.32	0.19	0.81**	0.03	16
MC and trigger>=6%		-1.59	0.11	0.63**	0.04	19
Distance to trigger	< median	-1.40	0.16	0.72***	0.00	65
RegulatoryT1Capital/RWA	>= median	-1.22	0.22	0.59**	0.04	37
Tier 1		-1.27	0.20	0.68**	0.02	50
Tier2		-1.14	0.26	0.64***	0.01	45
First-time issuer		-1.81*	0.07	0.73***	0.00	41
Repeated issuer		-1.36	0.17	0.64	0.01	76

**(B) 15-day window (-15, -1)**

Group		Z-value	P-value	Proportion negative	Wilcoxon test pvalue	Sample size
All CoCos		-2.84***	0.00	0.68***	0.00	118
CoCo Issue size (Amt issued/ RWA)	< median	-2.32**	0.02	0.70***	0.00	60
	>=median	-1.69*	0.09	0.66***	0.01	58
Issuer size (=total assets)	< median	-0.73	0.47	0.68*	0.07	44
	>=median	-3.02***	0.00	0.68***	0.00	74
Issuer size (=total assets)	< \$500 bn	-0.02	0.98	0.57	0.41	21
	>=\$500bn	-3.12***	0.00	0.70***	0.00	97
Issuer size (=total assets)	<\$1000bn	-1.70*	0.09	0.69***	0.00	65
	>=\$1000bn	-2.35**	0.02	0.66***	0.00	53
Issuer	GSIB	-2.31**	0.02	0.62***	0.00	58
	no GSIB	-1.70*	0.09	0.73***	0.00	60
Loss absorption	PWD	-2.60***	0.01	0.70***	0.00	67
	MC	-2.00**	0.05	0.68***	0.01	41
Trigger	<6%	-1.19	0.23	0.62**	0.03	58
	>=6%	-2.26**	0.02	0.71***	0.00	38
PWD and trigger<6%		-0.94	0.35	0.61*	0.09	33
PWD and trigger>=6%		-2.32**	0.02	0.84***	0.00	19
MC and trigger<6%		-1.79*	0.07	0.75**	0.02	16
MC and trigger>=6%		-0.88	0.38	0.58	0.42	19
Distance to trigger	< median	-1.85*	0.06	0.69***	0.01	65
RegulatoryT1Capital/RWA	>= median	-1.86*	0.06	0.68***	0.01	37
Tier 1		-1.36	0.17	0.63**	0.03	51
Tier2		-1.98**	0.05	0.69***	0.01	45
First-time issuer		-1.27	0.20	0.68***	0.00	41
Repeated issuer		-2.58***	0.01	0.68***	0.00	77

**(C) 6-day window (0,5)**

Group		Z-value	P-value	Proportion negative	Wilcoxon test pvalue	Sample size
All CoCos		0.48	0.63	0.59	0.26	117
CoCo Issue size (Amt issued/ RWA)	< median	-0.21	0.84	0.56	0.42	59
	>=median	0.89	0.37	0.62	0.41	58
Issuer size (=total assets)	< median	0.81	0.42	0.59	0.60	44
	>=median	-0.02	0.99	0.59	0.35	73
Issuer size (=total assets)	< \$500 bn	0.65	0.52	0.71	0.19	21
	>=\$500bn	0.23	0.82	0.56	0.49	96
Issuer size (=total assets)	<\$1000bn	1.14	0.26	0.54	0.97	65
	>=\$1000bn	-0.55	0.58	0.65	0.12	52
Issuer	GSIB	0.11	0.91	0.61	0.42	57
	no GSIB	0.56	0.57	0.57	0.43	60

Loss absorption	PWD	0.19	0.85	0.62	0.32	66
	MC	-1.29	0.20	0.61*	0.10	41
Trigger	<6%	1.79*	0.07	0.60	1.00	58
	>=6%	-1.31	0.19	0.62*	0.08	37
PWD and trigger<6%		0.02	0.98	0.76**	0.04	33
PWD and trigger>=6%		-0.26	0.80	0.56	0.81	18
MC and trigger<6%		0.35	0.72	0.50	0.57	16
MC and trigger>=6%		-1.58	0.11	0.68**	0.04	19
Distance to trigger	< median	0.31	0.75	0.63	0.26	65
RegulatoryT1Capital/RWA	>= median	0.65	0.51	0.54	0.67	37
Tier 1		-0.15	0.88	0.58	0.52	50
Tier2		1.00	0.32	0.64	0.25	45
First-time issuer		-1.38	0.17	0.71*	0.05	41
Repeated issuer		1.61	0.11	0.53	0.98	76

Panel D. Determinants of total CDS spread changes in [t-15, t+5]

The tables in this section analyzes the determinants of cross sectional CDS spread changes and equity return changes of CoCos during the 21 days event windows ( from t-15 to t+5), defined relative to the issue date (t) of the CoCo instrument. The sample includes CoCos issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain), between January 2009 to October 2015. The independent variable are as following: *CoCo Issue Size* (issue amount scaled by issuer total assets), *RWA* (issuer risk weighted assets in logarithm form), *Trigger ratio*, *PWD* (PWD=1, if CoCo is issued with principal write down feature; PWD=0, if CoCo is issued with mandatory conversion feature), *GSIB*(GSIB=1, if CoCo is issued from a global systemically important bank),*Issuer Size*(issuer total assets in logarithm form), and the interaction term between *trigger ratio* and *PWD*. Note here both the units of *RWA* and *Issuer Size* are denoted in USD billion, comparing to USD million in the rest of the paper. The t-statistics are in parentheses. \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

	(1)	(2)	(3)
CoCo Issue Amount	54.29 (0.14)	231.6 (0.60)	231.7 (0.60)
RWA	5.218** (2.54)	17.02*** (3.08)	17.02*** (3.05)
Trigger Ratio	-4.310*** (-3.51)	-3.775*** (-3.07)	-3.794 (-1.44)
PWD	-1.882 (-0.70)	0.791 (0.27)	0.626 (0.03)
GSIB	-5.456* (-1.74)	-0.750 (-0.20)	-0.739 (-0.19)
Issuer Size		-12.12** (-2.29)	-12.11** (-2.23)
Trigger Ratio*PWD			0.0261 (0.01)
Constant	-40.41 (-1.70)	-30.35 (-1.28)	-30.32 (-1.25)
Observations	109	109	109

**Table 4. Impact of CoCo Issuance on Issuer Equity Prices**

This table reports the normalized abnormal equity returns of CoCo issuers of the full and the various subsamples of CoCo bonds during the three event windows: the full 21-day (from t-15 to t+5), the pre-issuance 15-day (t-15 to t-1), and the post-issuance 6-day (t to t+5), all defined relative to the issue date (t) of the CoCo instrument (as recorded on Bloomberg). The benchmark regional indices (for Europe, Asia excluding Japan, Australia and Latin America) are calculated using the respective DataStream regional equity indices. The sample includes CoCos issued by banks from all advanced economies with the exception of the euro area periphery (Greece, Ireland, Italy, Portugal and Spain). “Z-value” is defined as  $Z = \sqrt{N} (ASPE)$ , where *ASPE* is the average standardized prediction error and *N* is the sample size, following James (1987). “Proportion negative” is the proportion of negative prediction errors, where the null equals 0.5. The test statistic is a Wilcoxon signed rank statistic. \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

Panel A. Abnormal returns in the cross-section of equity price changes

<b>(A) 21-day window (-15, 5)</b>						
Group		Z-value	P-value	Proportion negative	Wilcoxon test p-value	Sample size
All CoCos		-0.06	0.96	0.47	0.71	175
CoCo Issue size	< median	0.18	0.86	0.48	0.66	92
(Amt issued/ RWA)	>=median	-0.06	0.95	0.47	0.84	70
Issuer size	< median	1.20	0.23	0.43	0.17	68
(=total assets)	>=median	-0.81	0.42	0.50	0.64	96
Issuer size	< \$500 bn	0.35	0.73	0.42	0.31	38
(=total assets)	>=\$500bn	-0.02	0.99	0.48	0.88	126
Issuer size	<\$1000bn	1.01	0.31	0.43	0.16	93
(=total assets)	>=\$1000bn	-0.92	0.36	0.52	0.48	71
Issuer	GSIB	0.62	0.53	0.48	0.45	77
	no GSIB	-0.63	0.53	0.46	0.98	98
Loss absorption	PWD	0.59	0.56	0.46	0.40	96
	MC	-0.06	0.95	0.47	0.77	45
Trigger	<6%	0.65	0.52	0.46	0.35	68
	>=6%	-1.00	0.32	0.54	0.49	39
PWD and trigger<6%		0.15	0.88	0.49	0.83	39
PWD and trigger>=6%		0.06	0.96	0.53	0.90	19
MC and trigger<6%		0.69	0.49	0.41	0.27	17
MC and trigger>=6%		-1.45	0.15	0.55	0.26	20
Distance to trigger	< median	-0.28	0.78	0.49	0.76	89
RegulatoryT1Capital/RWA	>= median	0.78	0.43	0.44	0.32	62
Tier 1		0.52	0.60	0.47	0.40	58
Tier2		-0.51	0.61	0.52	0.55	46
First-time issuer		-0.57	0.57	0.48	0.95	62
Repeated issuer		0.35	0.73	0.46	0.56	113

**(B) 15-day window (-15, -1)**

Group		Z-value	P-value	Proportion negative	Wilcoxon test p-value	Sample size
All CoCos		0.86	0.39	0.45	0.20	175
CoCo Issue size (Amt issued/ RWA)	< median	1.59	0.11	0.41*	0.05	92
	>=median	0.07	0.95	0.49	0.91	70
Issuer size (=total assets)	< median	1.32	0.19	0.40	0.19	68
	>=median	0.57	0.57	0.47	0.33	96
Issuer size (=total assets)	< \$500 bn	-0.06	0.95	0.47	0.96	38
	>=\$500bn	1.50	0.13	0.43*	0.08	126
Issuer size (=total assets)	<\$1000bn	1.30	0.19	0.41	0.14	93
	>=\$1000bn	0.47	0.64	0.48	0.49	71
Issuer	GSIB	1.90*	0.06	0.43**	0.03	77
	no GSIB	-0.53	0.60	0.46	0.78	98
Loss absorption	PWD	1.28	0.20	0.42*	0.08	96
	MC	0.52	0.61	0.44	0.48	45
Trigger	<6%	1.02	0.31	0.41	0.21	68
	>=6%	-0.49	0.63	0.51	0.80	39
PWD and trigger<6%		0.35	0.72	0.44	0.66	39
PWD and trigger>=6%		0.28	0.78	0.47	0.78	19
MC and trigger<6%		1.11	0.27	0.35	0.18	17
MC and trigger>=6%		-0.95	0.34	0.55	0.48	20
Distance to trigger	< median	0.60	0.55	0.44	0.46	89
RegulatoryT1Capital/RWA	>= median	1.54	0.12	0.42*	0.07	62
Tier 1		1.41	0.16	0.38*	0.09	58
Tier2		-0.50	0.62	0.54	0.52	46
First-time issuer		-0.36	0.72	0.50	0.97	62
Repeated issuer		1.34	0.18	0.42	0.10	113

**(C) 6-day window( 0, 5)**

Group		Z-value	P-value	Proportion negative	Wilcoxon test p-value	Sample size
All CoCos		-1.47	0.14	0.53*	0.07	175
CoCo Issue size (Amt issued/ RWA)	< median	-2.18**	0.03	0.57**	0.02	92
	>=median	-0.22	0.83	0.51	0.63	70
Issuer size (=total assets)	< median	0.16	0.88	0.47	0.87	68
	>=median	-2.41**	0.02	0.59***	0.00	96
Issuer size (=total assets)	< \$500 bn	0.75	0.45	0.45	0.46	38
	>=\$500bn	-2.41**	0.02	0.57***	0.00	126
Issuer size (=total assets)	<\$1000bn	-0.17	0.87	0.47	0.88	93
	>=\$1000bn	-2.47**	0.01	0.63***	0.00	71
Issuer	GSIB	-1.83*	0.07	0.57**	0.03	77
	no GSIB	-0.33	0.74	0.49	0.62	98

Loss absorption	PWD	-0.93	0.35	0.47	0.43	96
	MC	-0.92	0.36	0.60	0.10	45
Trigger	<6%	-0.41	0.68	0.49	0.76	68
	>=6%	-1.10	0.27	0.62*	0.07	39
PWD and trigger<6%		-0.27	0.78	0.44	0.96	39
PWD and trigger>=6%		-0.33	0.74	0.53	0.47	19
MC and trigger<6%		-0.45	0.65	0.53	0.52	17
MC and trigger>=6%		-1.21	0.23	0.70*	0.07	20
Distance to trigger	< median	-1.48	0.14	0.57	0.13	89
RegulatoryT1Capital/RWA	>= median	-0.96	0.34	0.50	0.25	62
Tier 1		-1.26	0.21	0.59	0.10	58
Tier2		-0.16	0.87	0.48	0.76	46
First-time issuer		-0.49	0.62	0.52	0.60	62
Repeated issuer		-1.46	0.14	0.53*	0.08	113

Panel D. Determinants of total equity returns during [t-15, t+5]

	(1)	(2)	(3)
CoCo Issue Amount	15.46 (0.09)	24.66 (0.14)	184.5 (1.13)
RWA	-0.431 (-0.70)	0.0578 (0.02)	0.308 (0.14)
Trigger Ratio	0.692 (1.31)	0.691 (1.30)	-1.936*** (-2.74)
PWD	1.389 (1.02)	1.493 (1.03)	-27.87*** (-4.67)
GSIB	-1.461 (-0.91)	-1.346 (-0.80)	2.553 (1.49)
Issuer Size		-0.441 (-0.21)	-0.895 (-0.48)
Trigger Ratio*PWD			4.707*** (5.04)
Constant	1.950 (0.25)	1.704 (0.22)	18.70** (2.40)
Observations	114	114	114

**Table 5. Correlation between CoCo Bonds and Other Securities**

This table reports the summary statistics of the pairwise correlation coefficients between Coco Spread (i.e., the daily changes in the spread between the yield to maturity (YTM) of a CoCo bond and a corresponding government bond (matched by currency and maturity)) and the following return/spread measures: (1) Equity return, expressed in percentage changes at the daily level. (2) Senior unsecured spread, which is the daily changes in the spread between the YTM of a senior unsecured bond and a corresponding government bond (matched by currency and maturity). (3) Subordinated spread, which is the daily change in the spread between the YTM of a non-CoCo subordinated bond and a corresponding government bond (matched by currency and maturity). (4) CDS spread, which is expressed as daily changes. The numerical numbers in the parenthesis indicate the four scenarios modeled in Section 3.1.4: (1) The bank’s equity capital ratio is expected never to fall below the CoCo trigger. (2) The CoCo is triggered, but the equity obtained following conversion has the same value as the face value of the CoCo. (3) The CoCo is triggered and disfigured but was sufficient to absorb loss (i.e., the subordinated debt is not disfigured). (4) The CoCo is triggered and disfigured and the CoCo was not sufficient to absorb loss (i.e., the subordinated debt is disfigured).

	Mean	Median	Min	Max	No of observations
<b>CoCo spread – Equity return</b>	-0.25 (3&4)	-0.22	-0.57	0.11	67
<b>CoCo spread – Senior unsecured spread</b>	0.45 (1&4)	0.58	-0.65	0.96	34
<b>CoCo spread – Subordinate spread</b>	0.53 (1&4)	0.54	-0.62	0.98	37
<b>CoCo spread – CDS spread</b>	0.36 (all)	0.30	-0.03	0.85	74