Mega-Banks' Self-Insurance with Cocos: A Work in Progress

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Summary

When contingently convertible debt securities trigger and convert into common equity well before the capital ratio of a financial institution has reached its regulatory minimum, they are known as going-concern or go-cocos. Their objective is to recapitalize an institution under stress and not to facilitate its resolution as would be the task of low-trigger goner-cocos. Because cocos are an "infant instrument" that grew out of the 2007-2009 crisis, few of their design features, their tax treatment or role in bond indexes are settled. Their portfolio fit with unsecured senior non-contingent debt on the one hand and common equity on the other is also an open question. Its resolution has much to do with how adding go-cocos may affect debt overhang in a firm.

This paper attempts to clarify such underexposed open issues. Its chief contribution, however, lies in sifting through the experience with cocos triggers and conversion methods in order to link both actual, and one proposed, conversion methods to the recovery rates on cocos likely to be obtained from the common shares received by conversion. Experimenting with sparsely parameterized survival patterns that reach specified survival-rate levels after 10-years, and with the implied hazard rates and default rates conditional on survival, then allows a schedule of CDS premiums to be derived. These provide insight into the competitiveness of pricing the loss-of-value risk in go-cocos, instead of in the common-equity premium, over AAA-rated bonds.