

Concocting Marketable Cocos

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Summary

Adding contingently convertible debt securities, cocos, in an amount equal to about 3% of tangible assets to the financing mix of financial institutions is a promising reform idea. It would also be inexpensive for these institutions to issue cocos and thus to be prepared to recapitalize and to avert imminent failure by rebuilding common equity and reducing leverage and debt overhang automatically in a crisis. For cocos to become readily marketable, much work is needed on their standardization and optimal design. That basic design should include a trigger couched in a regulatory capital ratio referenced in Basel III. It should also include conversion terms setting the rate of increase in the number of shares equal to the rate of growth of the book value of common equity through conversion. The result would be that the distribution of common shares just after conversion would match the distribution of the book value of equity contributed by existing and new shareholders and that book value per share of common stock would remain unchanged by the process of conversion. Such an outcome would be more friendly to new equity issues that could forestall conversion, as well as to the issuance of cocos themselves, than threatening shareholders with high dilution from the conversion of cocos which have gotten into the financing mix.

Investing in cocos like those issued by Lloyds Banking Group (LBG) requires a loss premium under risk neutrality over the rate of return on otherwise comparable long-term debt without the cocos conversion feature. Because the market price at conversion is likely to be below the conversion price set in better times, the immediate value of the shares received by conversion is likely to be less than the principal amount of the cocos converted. This conversion loss is priced by the put option, with strike price equal to the conversion price, in which cocos holders would have to invest to ensure receiving the face value of cocos in full, but at the cost of that option. The addition to the required rate of return on non-cocos debt turns out to be a little over 1/2 percentage point with conversion terms like those on LBG's 2009 cocos and with a remaining maturity of 9 years. Keeping the debt write-off but dropping the conversion feature would add another 1 percentage point for a full loss premium of 1-1/2 percentage point. This means that adding a debt-write-off trigger but dropping the conversion feature or making that feature worthless would cause the cost of issuing cocos to be three times as high on that account as on cocos with the optimally designed conversion method. Even if the extra private costs from cocos conversion would turn out higher for a firm for which the conversion probabilities are higher than assumed, they would still pale in comparison with the social costs of receivership or bankruptcy. These are costs which cocos help to avoid or at least to defer and reduce.