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Wake Me Up Before You Coco: Implications of Contingent Convertible Capital for Financial Regulation

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Summary

Contingent convertible capital (CoCos) are hybrid instruments that are designed to improve the loss absorption capacity of the issuer without involving transfusions from new equity or taxpayer bailouts. Because they are relatively new, their properties must be critically examined, as there may be undesirable and unexpected consequences. This dissertation is composed of three chapters (all jointly written with Sweder van Wijnbergen), that explore the impact of issuing CoCos for the financial system, and for financial regulation as a whole.

In Chapter 2, "CoCos, Contagion, and Systemic Risk," we explore how the news of conversion triggered by a regulator affects the behavior of depositors in the banking system. In our model, the omnipotent regulator forces the conversion of CoCos when she obtains information that the bank is unlikely to remain viable given the economic state. Therefore, conversion never delivers good news, and results in a higher probability of a bank run. As bank runs are observable ex post, they are contagious if the banks in the system have highly correlated assets. Such a result leads one to wonder whether it is ever credible for a regulator to convert the CoCos, given that doing so may lead to higher financial fragility.

Chapter 3, "CoCos, Risk-Shifting and Financial Fragility," explores how CoCos potentially worsen financial fragility, as they encourage banks to choose

higher risk levels than they otherwise would with regular debt instruments. This is because the issuer's residual equity can be expressed as residual equity with regular debt, plus an expected wealth transfer. For certain CoCo designs, we find that the expected wealth transfer is increasing in the risk level chosen by the bank. Therefore, whenever banks maximize their expected returns net of default costs, they would always choose higher risk levels under these types of CoCos than under the same amount of subordinated debt, or additional equity. The policy implication is that one cannot treat CoCos as true substitutes for equity, because they induce different incentives despite having the same loss-absorption capacity.

Finally in Chapter, 4, "Regulatory Forbearance in the Presence of Cocos," we explore whether it is ever credible that CoCos will be converted by the regulator in times of crises. CoCo conversion is essentially a tool used by the regulator to nudge the bank into choosing the socially optimal choice after the occurence of a negative shock. However, the bank's choice will only be aligned with the socially optimal one if its skin in the game is sufficiently high. Therefore, conversion is only effective if the amount of CoCos converted is sufficiently large. Otherwise, the threat of conversion may not lead the bank to make a safe choice at the beginning of the game. As a result of this limited effectivity, the regulator is likely to forbear on the conversion of the CoCos.