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WHO FOOTS THE BILL? AN ANALYSIS OF COCO BOND HOLDINGS WITH NEW EVIDENCE ON RISK-TAKING INCENTIVES

Abstract:

Contingent convertible bonds (CoCos) are regulatory debt securities mostly issued by systemic banks that convert into equity or are written down if the bank is in distress. They are hence designed to transfer the risk of loss-absorption from the tax-payer to financial markets. In light of this, it appears natural to take a closer look into the investor base of CoCos, but the related literature is surprisingly scarce. In the paper's first part, we fill this gap. Using a comprehensive data set of bond holdings, we give a descriptive overview of investors in CoCos issued by the 30 largest European banks. We specifically assess the degree of geographical and asset diversification that we find to be high. We then merge the data on CoCo bond investors with the registered shareholder base of the issuing banks. We find that an investor holds a significantly higher position if the investor is at the same time a shareholder and if the CoCo bond has an equity-conversion feature. We discuss the implications of this finding for the ongoing debate on risk-taking incentives provided by CoCos. To this end, we propose an extension of a theoretical model and show that risk-taking incentives remain high for write-down bonds, while they do not necessarily weaken with an increasing conversion ratio. Our findings can be of great importance for anyone concerned with CoCos as a macro-prudential tool.

Keywords:

Contingent capital, Banking regulations, Basel III, Risk-taking incentives

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