

CONTINGENT CONVERTIBLE BONDS AND BANKER COMPENSATION:  
POTENTIAL CONFLICTS OF INTEREST?

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Two issues related to financial regulation have received significant academic and regulatory attention since the financial crisis: Contingent Convertible Bonds (“CoCos”) and banker compensation. The discussion, however, has largely been silent on the interaction between the two. This brief note explores the potential conflicts that may exist in the design and implementation of CoCos because of the incentive structure created by managerial compensation. Regulators, academics and market participants will need to address these concerns in designing the regulatory framework for CoCo instruments and managerial compensation.

**Contingent Capital Instruments**

The financial crisis exposed the inadequacy of equity capital at the major financial institutions. In response, academics, regulators and banking executives have focused on bolstering banking capital requirements, partly through innovative capital instruments.<sup>1</sup> One such instrument is the Contingent Convertible Bond.<sup>2</sup> This bond converts into equity capital based on a pre-set trigger, thereby augmenting a bank’s capital during a financial crisis.<sup>3</sup>

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<sup>1</sup> See Hal S. Scott, *Reducing Systemic Risk Through the Reform of Capital Regulation*, 13 J. INT. ECON. L. 763, 763 (2010).

<sup>2</sup> See *id.* at 770.

<sup>3</sup> See *id.*

The trigger could be based on three different types of metrics: 1) capital-based triggers that rely on accounting measures of capital adequacy, 2) regulatory discretion-based triggers that allow regulators to mandate conversion of CoCos into common equity during a banking crisis, and 3) market-based triggers that are triggered by declines in stock prices or increases in the premiums of credit default swaps.<sup>4</sup> The potential problems with these different mechanisms have been discussed at length: accounting-based measures may respond too slowly in a financial crisis, market-based measures may be susceptible to banking runs and market manipulation and regulatory discretion-based triggers may lead to ad hoc decisions.<sup>5</sup> In response, some commentators have suggested a dual trigger mechanism—for instance, one that relies on accounting measures coupled with regulatory discretion.<sup>6</sup>

Regulators and banking executives are divided on the benefits of CoCos and their optimal design. The Basel III committee has recommended further study on whether contingent capital instruments should be counted towards equity capital for banking institutions.<sup>7</sup> Regulators in America and Britain have also been ambivalent about approving CoCo transactions.<sup>8</sup> Nevertheless, some regulators have embraced CoCos wholeheartedly. The Swiss National Bank has been particularly aggressive on capital ratios; it has mandated capital adequacy ratios of nineteen percent for the major Swiss banks, of which nine percent can be fulfilled with CoCo instruments.<sup>9</sup>

Banking executives are similarly divided on CoCos. Some are concerned

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<sup>4</sup> See Louise Pitt et. al, *Contingent Capital: Possibilities, Problems and Opportunities* 6, GOLDMAN SACHS GLOBAL MARKETS INSTITUTE (March 2011).

<sup>5</sup> See *id.*

<sup>6</sup> See Robert L. McDonald, *Contingent Capital with a Dual Price Trigger* (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1553430](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1553430).

<sup>7</sup> See *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* 3, BASEL COMMITTEE ON BANKING SUPERVISION (2010), available at <http://www.bis.org/publ/bcbs189.pdf>.

<sup>8</sup> See Anousha Sakoui & Patrick Jenkins, *Stability Concerns over Coco Bonds*, FINANCIAL TIMES, Nov. 6, 2009, <http://www.ft.com/cms/s/0/7982578c-ca75-11de-a3a3-00144feabdc0.html#axzz1IxBwhf2L>; Nicole Bullock & Francesco Guerrera, *Wall Street and Fed in Discussions Over CoCos*, FINANCIAL TIMES, Nov. 12, 2009, <http://www.ft.com/cms/s/0/f312d108-cf2a-11de-8a4b-00144feabdc0.html#axzz1IxBwhf2L>.

<sup>9</sup> See *Switzerland Gets Extra Tough With Its Banks. Others Will Follow*, THE ECONOMIST, Oct. 7, 2010, [http://www.economist.com/node/17202233?story\\_id=17202233](http://www.economist.com/node/17202233?story_id=17202233).

about the efficacy of Cocos or about the level of investor demand for such instruments.<sup>10</sup> Others, however, have embraced the instruments. For instance, Credit Suisse has announced that it will issue billions of dollars worth of CoCos; its initial plan to raise CoCo capital was highly successful and the bank successfully raised two billion dollars.<sup>11</sup>

Although there is continuing disagreement over the design of CoCos and their role in fulfilling capital adequacy requirements, these instruments are likely to play a significant role in providing capital support for banking institutions in future financial crises.

## Bankers Pay

Banker compensation levels and pay structures have come in for significant criticism since the crisis.<sup>12</sup> Previous compensation policies are said to have exacerbated risk taking and richly compensated bankers despite poor long term performance.<sup>13</sup> Some have viewed the problem of banker pay as a corporate governance problem.<sup>14</sup>

Bebchuk and Spamann have suggested that corporate governance reforms alone may not be sufficient to address these problems because shareholders are incentivized to take risks beyond the socially optimal level.<sup>15</sup> Furthermore, bondholders and other creditors are also not incentivized to monitor financial risks because of the implicit government guarantee of bank debt during a financial crisis.<sup>16</sup> Accordingly, the authors propose that banking executive

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<sup>10</sup> See Sara S. Muñoz, *A Hard Road for New 'Coco' Securities*, WALL ST. J., Oct. 15, 2010, <http://online.wsj.com/article/SB10001424052748703631704575552231208013398.html>.

<sup>11</sup> See Jennifer Hughes, *Credit Suisse Cocos Issue Deluged*, FINANCIAL TIMES, Feb. 17, 2011, <http://www.ft.com/cms/s/0/31da02a0-3ac6-11e0-9c1a-00144feabdc0.html#axzz1IxBwhf2L>.

<sup>12</sup> See, e.g., *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* 61-66, FINANCIAL CRISIS INQUIRY COMMISSION (2011), available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

<sup>13</sup> See *id.*

<sup>14</sup> See *id.* at 279.

<sup>15</sup> See Lucian A. Bebchuk and Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247, 274-75 (2010).

<sup>16</sup> See *id.* at 266-67.

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should be compensated through a broader basket of securities including common shares, preferred shares and debt instruments issued by the bank.<sup>17</sup>

### **Exploring the Link between CoCos and Banker Pay**

The academic literature has largely been silent on the interaction between CoCos and banker compensation. The socially optimal design and implementation of CoCos will be impacted by managerial incentives created by compensation structures. This problem is particularly acute when managerial compensation is partially or exclusively in the form of CoCo instruments. Several banks have announced that they are considering paying senior executives and bankers with such instruments.<sup>18</sup> Barclays, most prominently, has sought approval from the UK regulators for paying its bankers with CoCo instruments.<sup>19</sup> Before approving such plans, regulators need to understand what the proper incentive structure for bankers should be. In particular, they will need to address the following two problems.

First, are bankers incentivized to select the socially optimal design for CoCo instruments? Managers may have considerable influence in the design of CoCo instruments, including selecting the type of trigger (e.g. capital-based) and the trigger level at which the CoCo mandatorily converts into common equity (e.g. if capital adequacy ratio falls below seven percent). Managerial compensation structures will influence their preferences on these design choices. If bankers are primarily compensated with equity stock, they are likely to design CoCo instruments with weak triggers because they would not want their equity holdings diluted by the conversion of these instruments into common equity. If bankers, by contrast, are primarily compensated with CoCos instruments, they may design inefficiently strong triggers because they could potentially acquire

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<sup>17</sup> See *id.* at 253.

<sup>18</sup> See Francesco Guerrero et al, *Banks Keep Close Eye on Barclay's Cocos Plan*, FINANCIAL TIMES, Jan. 30, 2011, <http://www.ft.com/cms/s/0/e939a8a6-2ca2-11e0-83bd-00144feab49a,s01=1.html#axzz1IxBwhf2L>.

<sup>19</sup> See Jennifer Hughes & Patrick Jenkins, *Barclays Forced to Adapt Cocos Bonus Plan*, FINANCIAL TIMES, Feb. 14, 2011, <http://www.ft.com/cms/s/0/7e1cac78-387b-11e0-959c-00144feabdc0.html#axzz1IxBwhf2L> (noting that Barclay's initial plan had to be modified because the UK regulators were undecided on the efficacy of such compensation arrangements).

cheap stock during a crisis. Thus, the pay structure of bankers will determine their ex-ante preference for different design features of CoCo instruments.

Second, are banking executives incentivized to optimally trigger conversion during a financial crisis? Although the trigger may be “mandatory” in design, managers are likely to have significant discretion regarding the trigger point because of their ability to disclose (or withhold) material information, their use of other market signaling devices, and their discretion over when to approach financial regulators. During a financial crisis, will managers have the appropriate incentives to aid an optimal conversion of these instruments? How will this be impacted by whether managers are partially or solely compensated with equity or CoCo instruments? For instance, if managers are compensated primarily with equity instruments and a mandatory CoCo conversion dilutes equity holders, then managers may be incentivized to delay disclosure of material information to prevent such a conversion from taking place. By contrast, if they are compensated primarily through CoCo instruments, managers might view a financial crisis as a mechanism for acquiring cheap equity in their bank and therefore take overly conservative positions in the bank’s financial disclosures. Thus, different managerial compensation packages may determine the ex-post behavior of bankers when it comes to triggering the conversion of CoCo instruments into equity capital.

In designing and implementing a regulatory framework for CoCos, regulators need to be aware of the potential conflicts of interest that could be created by banker compensation structures. Potential solutions could include regulating both the level of discretion afforded to managers in designing and implementing CoCo instruments and the magnitude of executive compensation that is linked to or denominated in CoCo instruments.