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ABSTRACT

In the wake of the 2008 financial crisis, as the vulnerability of banks to withstand losses and the inefficiency of then-existing regulatory capital became evident, governments across developed markets had no choice but to inject billions of tax-payers money into the financial system to avoid its collapse. To prevent any similar scenario from repeating, regulators from all parts of the world agreed on new capital requirements for banks (Basel III) and introduced a new class of loss-absorbing instruments known as Contingent Convertibles, or CoCos, which main distinctiveness is the ability to convert into equity of the issuing bank or simply be partially or completely written-down when a predefined trigger is breached. With less than a decade since their introduction, CoCos have been welcomed by investors for their relatively high yields, but have also faced criticism and periods of stress mainly because of still some opacity on the way they are supposed to work and absorb losses. Putting an emphasis on the different takeaways for market practitioners, this paper presents the regulatory framework behind European banks' CoCos, describes and discusses their particularities, structure, and market, gives a review of the current literature on the subject, presents a valuation framework and finally analyzes the main different factors driving returns.

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