Lloyds Bank Issues a CoCo

The credit crisis of 2008-09 drove many of the world's largest banks to the brink of bankruptcy. Yet shareholders were reluctant to put up the cash that was needed to save them. If they did so, they would largely be getting the bondholders and the government off the hook.

If shareholders are reluctant to contribute new capital to a firm in distress, one solution may be for the firm to issue contingent securities (known as CoCos) that automatically convert into equity in times of trouble. In November 2009 the British bank, Lloyds Banking Group, arranged to swap £9 billion of its existing debt into 10-year "enhanced capital notes." These notes offered a high rate of interest, but, if the bank's top tier of regulatory capital ever falls below 5%, the contingent debt automatically converts into equity. Most convertibles have the effect of reducing leverage when the firm performs well; the Lloyd's reverse convertible reduces leverage when times are tough.[1]

Regulators and central bankers are fervent champions of CoCos. For example, the Governor of the Bank of England declared, "We, at the Bank, put a lot of weight on the potential contribution that contingent capital can make... I see real benefits in working to ensure that in future, contingent capital is a major part of the liability structure of the banking system." Bankers and shareholders were not so sure how popular they would be with bondholders.

[1] The terms "contingent convertible" and "CoCo" have been used to describe several very different securities. For example, in 2000 Tyco International issued a convertible bond that could only be converted after the stock price had risen well above the bond's conversion price. Such securities also became known as "CoCos."