



Contents lists available at ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

An examination of investors' reaction to the announcement of CoCo bonds issuance: A global outlook[☆]



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ARTICLE INFO

Article history:

Received 20 October 2016

Accepted 31 December 2016

Available online 31 December 2016

JEL classification:

G13

G14

G15

Keywords:

Convertible bonds

Announcements effects

Abnormal returns

ABSTRACT

Major international financial institutions (FIs) are using contingent convertible (CoCo) bonds in the wake of the 2008 financial crisis to meet stricter national and international capital requirements. Beginning with UniCredit's €500 m 9.375% CoCo in July 2010, more than 40 publicly held financial institutions headquartered in 16 countries have issued 68 CoCos. According to S&P's 2010 report, by the year 2020, CoCo bond volumes are expected to reach to \$1 trillion. This paper examines investors' reactions to the announcements of CoCo bonds issuances by FIs. Using event-study methodology and measuring cumulative abnormal returns (CARs) following the announcements, we find FIs generally experience negative abnormal returns during the post-announcement period; however, the investors' reactions vary in a country-by-country analysis. These different reactions create opportunity for investors and issuers to launch global diversification and trading strategies.

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1. Introduction

Contingent convertible (CoCo) bonds are hybrid debt instruments that can be written-down or converted to common stock if the predefined conversion trigger event occurs. CoCo bonds were initiated by FIs in response to the 2008 financial crisis that reduced capital ratios of FIs and forced governments to bail out banking system since banks were not able to raise capital independently. In fact, CoCo bonds are considered as a readily available source of capital for FIs in the time when capital ratios of FIs shrink to insolvency level. When FIs have an adequate debt-to-equity ratio, presumably during a positive economic environment, CoCo bonds behave like a straight bond. They have a normal coupon payment, par value, and time to maturity; therefore, these bonds carry the same advantages and disadvantages of normal bonds prior to conversion. However, during economic downturns when FIs capital ratio fall below the threshold imposed by the regulatory authorities, the CoCo bonds conversion feature triggers and the bank either write-down the CoCo bonds or convert them to common stock. This write-down or conversion lowers the FI's debt-to-equity ratio, results in a higher capital ratio, and lowers the default probability. This special conversion feature not only reduces the default probability and its associated costs, but also internalizes the cost of an FI's poor performance. Specifically, it shifts the poor performance cost from bail-outs by taxpayers to bail-ins by the FI's capital providers. Therefore, CoCo bonds issued by FIs should be beneficial to the public, both economically and politically.

[☆] We thank Brad Mikus for his outstanding job in collecting and managing the data for this study.

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Most CoCo bonds issued by FIs have some form of accounting trigger.¹ For a detail discussion on the kinds of triggers used by FIs, and different conversion mechanism, please refer to [Spiegeleer, Schoutens, and Hulle \(2014\)](#), typically the ratio of Core Tier 1 Capital to the risk weighted assets. Because the write-down or conversion of CoCo bonds to common stock is automatic when the contingent triggering event occurs, CoCo bonds carry conversion risk which requires risk premium. Therefore, CoCo bonds offer a higher yield than the regular bonds with the similar characteristics.² [Avdjiev, Kartasheva, and Bogdanova \(2013\)](#) report that the yield to maturity of newly issued CoCos is on average 2.8% higher than that of non-CoCo subordinated debt and 4.7% higher than that of senior unsecured debt of the same issuer. [Ammann, Blicke, and Ehmann \(2016\)](#) and [Li, Liu and Siganos, \(2016\)](#) provide compelling theoretical argument that the announcement of CoCo bonds should be perceived by market participants as a positive news and should have a positive effect on the market value of FIs following the announcement.³ Research on the impact of CoCo bonds issued by non-financial institutions on the stock price, however, shows mixed results. [Kang, Kim, Park and Stulz \(1995\)](#), and [de Roon and Veld \(1998\)](#), for example, find that the announcement of issuing CoCo bonds has a positive effect on a non-financial firm's stock price. Conversely, the empirical results of several studies (e.g., [Dann and Mikkelsen, 1984](#); [Eckbo, 1986](#); [Mikkelsen and Partch, 1986](#); [de Roon and Veld, 1998](#); [Lewis, Rogalski and Seward, 1999](#); [Wolfe, Daliakopoulos and Gwilym, 1999](#); [Burlacu, 2000](#); [Dutordoir and Van de Gucht, 2004](#); [Cheng, Visaltanachoti and Kesayan, 2005](#); [Ammann, Fehr and Seiz, 2006](#); [Duca, Dutordoir, Veld, and Verwijmeren, 2012](#); [De Spiegeleer, Schoutens and Hulle, 2014](#)) provide evidence of a negative market reaction, shown by negative abnormal return of equity.

While existing research has focused on examining the announcement effect of CoCo bonds issuance of non-FIs' stock prices, limited attempts have been made to investigate investors' reaction to the announcement of CoCo bonds issued by FIs. We believe that the value of the convertibility feature of CoCo bonds issued by FIs is not the same as the value of the convertibility feature of non-FIs for several reasons. First, FIs are bound by different forms of capital adequacy requirements because of national and international regulations. Second, FIs are more exposed to financial downturns and possible conversion triggers because of the financial nature of the assets and liabilities on their balance sheets. Third, FIs are special economic units because they provide special services to diverse sectors of the global economy and are major players in stabilizing (or destabilizing) the financial system. Finally, the global financial crisis of 2008 clearly highlighted the vulnerability of the capital adequacy of financial institutions to an unexpected downturn of the economy, which in turn put a heavy burden on public funds to bail out the financial system. By internalizing the cost of FIs' poor performance, CoCo bonds may shift the cost from publicly supported insurance programs to the providers of capital, which may also introduce more market discipline on the operation of FIs. Therefore, the results obtained from the studies examining the non-FIs' stock price reaction to the CoCo bond announcement may not be applicable to FIs.

More recently, [Ammann, Blicke, and Ehmann \(2016\)](#) study the announcement effect of 87 CoCo bond issues by 34 FIs operating in 18 different countries on stock returns of issuers. They use 55 different announcement dates between 2009 to 2014. The authors report that investors react positively to the announcement of CoCo bonds issuance as the abnormal returns following the announcement are significantly positive. [Avdjiev, Kartasheva, and Bogdanova \(2013\)](#) and [Spiegeleer, Schoutens, and Hulle \(2014\)](#) warns that there is no standardization of CoCo bonds worldwide, but the issuance pattern and levels of triggers and conversion mechanism are affected by the way Basel III is applied by different nations. Therefore, comparison of CoCo bond between jurisdictions should be done carefully.

In this paper, we extend the present literature by exploring the announcement effect of CoCo bonds issuance by FIs at the global level. Specifically, this paper examines the effects of the announcement of CoCo bonds issuance on the issuers' stock value using market return data for sixteen countries categorized in two regions: the Asian Pacific region (AP-region) and the European region (E-region). The AP-region includes Australia, China, India and Malaysia, and the E-region includes Belgium, Britain, Denmark, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and Switzerland. We employ an event-study approach to determine the announcement effect of CoCo bonds issuance by FIs on issuers' stock value and the volatility of the stock returns over an adjustment period of 15-days following the date of announcement. This paper differentiates itself from prior research by extending the analysis to a global setting by using data sets that cover two regions consisting of 46 publicly traded FIs that operate in 16 countries. We report investors' reaction to CoCo bonds announcements at aggregate, regional and individual country basis. Our results provide evidence to indicate that the FIs' stock prices experience negative abnormal returns in the post-announcement period.

The rest of the paper is organized as follows: [Section 2](#) describes the data and methodology; [Section 3](#) discusses the empirical results; and [Section 4](#) contains a summary and conclusions.

¹ In addition to accounting trigger, FIs may use other measures such as market trigger, regulatory trigger, multi-variate trigger, and solvency trigger.

² The risk premium paid by issuer and the potential losses to which investors are exposed in case of trigger event depends on the conversion mechanism. For a detail discussion on the kinds of triggers used by FIs, and different conversion mechanism, please refer to [Spiegeleer, Schoutens, and Hulle \(2014\)](#).

³ For a comprehensive discussion on why CoCo bonds issues are beneficial to FIs and why both equity and credit markets may react to the announcement of new issue of CoCo bonds, refer to [Ammann, Blicke, and Ehmann \(2016\)](#).

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