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Passage No 87

Directions: Read the passage and answer the questions that follow:

During the financial crisis, Western governments poured hundreds of billions of dollars into their banks to avert collapse. The search for ways to avoid future bail-outs started before the turmoil ended. One of the niftiest proposals was the "contingent convertible" (coco) bond, which turns into equity when the ratio of a bank's equity to risk-weighted assets falls below a predetermined danger point (since set at a minimum of 5.125% for cocos, although it can be up to around 7%). The ambition was grand. As the Squam Lake Group, composed of mostly American academics, put it in 2009, the automatic conversion of cocos would "transform an undercapitalised or insolvent bank into a well-capitalised bank at no cost to taxpayers".

At first, regulators were keen. In 2010 Mervyn King, then the governor of the Bank of England, said he wanted contingent capital to be a "major part of the liability structure of the banking system". Swiss regulators, too, pushed for coco issuance. The hybrid nature of cocos seemed a way to satisfy both regulators, who wanted banks to have bigger safety buffers, and bankers, who were reluctant to issue new shares because of the high cost of capital. The hope was that investors, too, might see the appeal of an asset that offered a higher yield than bank bonds but lower risk than bank shares.

Nine years after the first cocos were issued by Lloyds Banking Group in Britain, they have not fulfilled this promise. To be sure, they are now an established asset class, with around $155bn of issuance in 2017 in Dollars, Euros and Pounds. But this is a fraction of more than $1trn in bank debt issued that year. Cocos are issued by only around 50 banks in a dozen countries mostly in Europe. Although cocos are held by the world's largest asset managers, including BlackRock and PIMCO, few specialise in

them. Exceptions include niche funds run by Algebris Investment and Old Mutual Global Investors.

The main reason is that, despite early enthusiasm, regulators did not throw their weight behind cocos. In 2011, the Financial Stability Board, a global grouping of regulators, decided that they would not count towards the capital "surcharge" the biggest banks would be required to hold. Only equity would do. Rules on "total loss absorption capacity" finalised in 2015 require banks to have liabilities that can take a haircut or be wiped out if they are liquidated or restructured. But a wide range of liabilities, from shares to subordinated and even senior debt, is included. Cocos became part of a spectrum of at-risk liabilities, rather than a neat, catch-all solution.

The result is that cocos are a specialised investment proposition. They still offer fairly high yields—currently 5.3% for dollar cocos and 3% for those in euros, according to indices compiled by Credit Suisse, a bank. And they offer a premium over junior debt. They have appealing technical characteristics, too. Unlike bonds with a fixed maturity, they are perpetual, but redeemable after five years. If not redeemed, their coupon resets with reference to the mid-swap rate, a widely used rate related to interbank lending rates. That offers some protection against inflation. In 2016 investor jitters caused a spike in coco yields. But since then, nerves have calmed and spreads have narrowed.

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<u>Question:</u>

1. As per the passage, what is meant by 'coco'?

A. Coco refers to convertible bonds which can be converted from debt to equity after a certain number of years.

B. Coco refers to a special type of bond which gets converted to debt when the debt-to-equity ratio of the bank falls below a certain level.

C. Coco is used to refer to a situation where in the government forces a company to liquidate some of its shares so as to pay back its debt.

D. Coco is short for contingent convertible bonds which get converted to equity after the bank's equity to risk weighted assets fall below a certain level.

E. None of the above

2. As per the Squam Lake Group, what was the biggest benefit of the coco bonds?

I. It would keep the costs to manage customer accounts to a bare minimum.

II. It was an off-balance sheet item and would not increase the liability of the banks.

III. It would help in capitalizing the undercapitalized banks without any extra costs.

A. Only II B. Only III C. Only I and II D. Only II and III E. None of these

3. As per the passage, why would investors want to invest in coco bonds?

I. As cocos could play a major part in helping the banks become safer.

II. As they wanted banks to have bigger safety buffer.

III. As they were reluctant to invest in equity shares of the banks

IV. As cocos offered better yields than normal bank bonds with lesser risk.

A. Only IV B. Only I C. Only I, III and IV D. Only II, III and IV E. Only I, II and III

4. Refer to- 'Nine years after the first cocos were issued by Lloyds Banking Group in Britain, they have not fulfilled this promise.' What is meant by the author in the line above?

I. Cocos are not a reliable asset class.

II. Cocos form only a tiny fraction of the total bank debt issued.

III. Cocos do not seem to have made a big difference in the banking system.

A. Only I B. Only III C. Only II and III D. Only I and II E. All of the above

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5. As per the passage, why were cocos not popular despite the early enthusiasm?

I. Due to the danger emanating from them to financial stability across World's Central Banks.

II. Due to the lack of support from financial regulators.

III. They are too complicated to understand for retail investors.

A. Only III B. Only II C. Only I and II D. Only II and III E. All of the above

6. As per the last paragraph, which of the following is/are some features of the coco bonds?

I. They protect against inflation to a certain extent.

II. They are perpetual in nature and do not have a fixed maturity period.

III. They offer fairly high yields which also includes a premium over junior forms of debt.

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A. Only II B. Only III C. Only I and II D. Only II and III E. All of the above

7. Which of the following is/are true as per the passage?

I. The first cocos were issued by Lloyds Banking Group in Britain.

II. The Financial Stability Board decided not to include cocos in the capital the banks would be required to hold.

IIII. For investors already exposed to distressed banks, it generally makes sense either to buy equity to recapitalise the bank, or to lend to it in the form of safer senior debt.

A. Only II B. Only III C. Only I and II D. Only I and III E. All of the above

8. Which of the following is/are antonyms of the word "jitters"?

A. Anxiety B. Anger C. Storm D. Calm E. Sleepy

9. Which of the following is/are synonyms of the word "spectrum"?

A. Alcove B. Colors C. Gamut D. Effect E. Populist

10. Which of the following is/are synonyms of the word niftiest?

A. Marvelous B. Complicated C. Frivolous D. Unique E. Poor

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Correct Answers:

1	2	3	4	5	6	7	8	9	10
D	B	A	C	B	E	C	D	C	A

Explanations:

1.

Refer to:

... The search for ways to avoid future bail-outs started before the turmoil ended. One of the niftiest proposals was the “contingent convertible” (coco) bond, which turns into equity when the ratio of a bank’s equity to risk-weighted assets falls below a predetermined danger poi. ...

As per the fragment highlighted above, only option D mentions all the relevant points.

Hence, option D is correct.

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2.

Refer to:

... As the Squam Lake Group, composed of mostly American academics, put it in 2009, the automatic conversion of cocos would “transform an undercapitalised or insolvent bank into a well-capitalised bank at no cost to taxpayers”. ...

As per the fragment highlighted above, only III is correct while I and II have not been mentioned anywhere.

Hence, option B is correct.

3.

Refer to:

... The hybrid nature of cocos seemed a way to satisfy both regulators, who wanted banks to have bigger safety buffers, and bankers, who were reluctant to issue new shares because of the high cost of capital. The hope was that investors, too, might see the appeal of an asset that offered a higher yield than bank bonds but lower risk than bank shares. ...

As per the highlighted fragment, only IV is the reason for investors to invest in the bonds.

I and II are reasons for regulators to prefer cocos while III is irrelevant and not mentioned in the passage.

Hence, option A is correct.

4.

Refer to:

... To be sure, they are now an established asset class, with around $155bn of issuance in 2017 in Dollars, Euros and Pounds. But this is a fraction of more than $1trn in bank debt issued that year. Cocos are issued by only around 50 banks in a dozen countries mostly in Europe.Although cocos are held by the world's largest asset managers, including BlackRock and PIMCO, few specialise in them. Exceptions include niche funds run by Algebris Investment and Old Mutual Global Investors**.** ...

As per the fragments, I is clearly incorrect.

II and III are both correct. Cocos have not been able to fulfill the promise as they lack popularity and have not been effective.

Hence, option C is correct.

5.

Refer to:

... The main reason is that, despite early enthusiasm, regulators did not throw their weight behind cocos. In 2011, the Financial Stability Board, a global grouping of

regulators, decided that they would not count towards the capital “surcharge” the biggest banks would be required to hold. ...

II is correct as per the fragment highlighted above.

I and III have not been mentioned in the passage and are incorrect.

Hence, option B is correct.

6.

Refer to:

... The result is that cocos are a specialised investment proposition. They still offer fairly high yields—currently 5.3% for dollar cocos and 3% for those in euros, according to indices compiled by Credit Suisse, a bank. And they offer a premium over junior debt. They have appealing technical characteristics, too. Unlike bonds with a fixed maturity, they are perpetual, but redeemable after five years. If not redeemed, their coupon resets with reference to the mid-swap rate, a widely used rate related to interbank lending rates. That offers some protection against inflation. In 2016 investor jitters caused a spike in coco yields. But since then, nerves have calmed and spreads have narrowed. ...

All of the statements mentioned are correct as per the highlighted fragments above.

Hence, option E is correct.

7.

Refer to:

‘Nine years after the first cocos were issued by Lloyds Banking Group in Britain, they have not fulfilled this promise.’

I is correct.

‘In 2011, the Financial Stability Board, a global grouping of regulators, decided that they would not count towards the capital “surcharge” the biggest banks would be required to hold.’

II is correct.

III has not been mentioned in the passage.

Hence, option C is correct.

8.

Jitters means a state of anxiety/worry.

Of all the words mentioned, only calm is the opposite of jitters. Hence, option D is correct.

9.

Spectrum here refers to a range of things.

Alcove means a slot.

Gamut means a range/scope/extent.

Populist means representative.

Clearly, gamut is the closest in terms of meaning to spectrum.

Hence, option C is correct.

10.

Niftiest means excellent/terrific.

Marvelous means amazing/excellent.

Frivolous means playful.

The rest of the words clearly do not match.

Only marvelous is the closest to the word.

Hence, option A is correct.

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