Financial Stability:
Contingent Capital as one of the Building Blocks

by

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Solving Too-big-to-fail

- Current policies towards systemically important financial firms is neither economically efficient nor politically viable
- Candidates for solution of TBTF should
  - Involve minimal or no taxpayer dollars
  - Support efficient delivery of financial services
  - Not hide potential systemic issues
  - Provide a mechanism that is workable and that will be credible with policymakers during a crisis

Outline of the presentation

1. **Why consider contingent capital**
   - **Ex ante risk reduction**
   - Making resolution credible
2. Contingent capital overview
3. Loss guarantee type plans
4. Common equity purchase
5. Comparative analysis
6. Conclusion

Ex Ante Risk Reduction
Limit Banks' Activities

- Examples
  - Safe bank
  - Reinstate Glass-Steagal prohibitions
- Weaknesses
  1. Economies of scope
  2. Shift risks outside domestic banking system
- Bottom line – Consider only if desperate

Ex Ante Risk Reduction Countercyclical capital requirements

- Require higher capital adequacy ratios during good times and reduce requirements during bad times
- Concerns
  1. How high would the requirements go in good times?
  2. When would they be allowed to reach their minimums.
  3. Different countries may be at different points in the cycle
- Bottom line – countercyclical capital may have a limited role but it is not a panacea

Ex Ante Risk Reduction
Regulate compensation

- Examples
  - Forbid excessive salaries
  - Make payments more sensitive to risk
- Weaknesses
  - No much evidence that salaries are a major cause
- Bottom line
  - Attack the problem directly

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Make Resolution Credible
Expand Special Resolution

- Examples
  - Give the government the same power to resolve systemically important financial firms as it has for commercial banks (special resolution)
- Concern
  - This would lead to government bailouts of firms outside the traditional safety net
- Case for special resolution
  - If the firm is perceived to be systemically important it will not be allowed to go into bankruptcy court resolution
  - Special resolution increases potential for limiting bailout so that equity holders and some creditors take losses
  - Procedures should make any bailouts procedurally more difficult and subject to automatic ex post reviews

Make Resolution Credible
Expand Special Resolution

Special resolution authority is not a complete solution

1. Smaller problem – Government may still have to bailout some uninsured creditors
2. Bigger problem – Resolution of cross-border groups
   A. Systemically important almost all have substantial cross-border operations
   B. Cross-border groups maximize economies of scale and scope by operating on an integrated basis for some key services
   C. Resolution needs to be international

Make Resolution Credible
Reduce bank size

- Reduce size and/or range of activities so that proven techniques would work for all banks?
- Concerns
  1. Economies of scope in the provision of some services
  2. Breaking single large firm up could create pack of smaller financial firms following a highly correlated strategies
  3. Or break-up could force into less regulated firms or off-shore
- Recommendation
  – Larger / more complex banks should be subject to somewhat more restrictive regulation and/or modestly higher insurance premiums

Make Resolution Credible "Living Wills"

- Banks would be required to say how they would resolve themselves
- Concern
  - Ideal plan from bank perspective is one that requires minimal changes to operations but would prove unworkable
- Banks should be required to write living wills to provide information to supervisors but these will not solve the problem

Bottom Line for Alternatives

- Many of the available ideas have merit and should be implemented—at least to a limited degree
- Doubtful that any of these are at the stage where they would individually or collectively prevent problems
  - The only ones that are guaranteed to make bank failure manageable are likely to force important financial activities outside the banks
  - **Effective solution to cross-border resolution is critical but it depends on cross-border agreement that countries will honor in a crisis because doing so is in each country's interest**
- Desirable addition to the package would be a measure that maintained or enhanced market discipline at a lower cost than higher equity capital requirements

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Contingent Capital

- Higher equity requirements may have at least three costs
  1. More costly due to loss of tax shield from debt interest payments
  2. Agency cost of suboptimal financing structure
  3. Reduces value of the safety net
- We want to minimize the first two costs and contingent capital may help

Contingent Capital

- Culp (2002) defines “company *pays an investor* a fixed price or premium for the right (but not the obligation) to issue paid-in capital *later*”
- Contingent capital minimizes loss of tax shield
- Contingent capital can be structured to impose costs on shareholders and management
- Contingent capital is not a complete solution because it provides limited loss absorption ability

Contingent Capital

- Some critics ask the question: “Why reduce costs of higher capital?”
- Two answers

1. To avoid forcing important activities into unregulated firms
2. Why include securities in capital with very limited loss absorption ability given reluctance to force resolution?

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Loss Guarantee

Loss guarantee

- Bank receives a payment or is allowed to cancel debt if it becomes sufficiently distressed
- Guarantor receives nothing return for making the payment or having its debt claim cancelled
- Existing proposals include
  - Kayshap, Rajan and Stein (2008)
  - Caballero & Kurlat (2009)
  - Shadow Financial Regulatory Committee (2009)

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Common equity purchase

- Investor/insurer is obligated to purchase equity if the bank becomes sufficiently distress
- Existing proposals implement this with via reverse convertible securities
  - Bank issues claim other than common equity
  - Claim converts to equity if the bank becomes sufficiently distressed
- Proposals
  - Stanton (1991) – for GSEs
  - Flannery (2005, 2009)
  - Squam Lake Working Group (2009)
  - Wall (2009)

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Comparative analysis

1. Observable pricing of risk
   – Price of **guarantee** when sold may provide a market measure
   – Signal muted with **reverse convertible securities** because holders receive common equity

Comparative analysis

2. Risk taking disincentives
   – **Guarantee structures** provide incentives to minimize risk prior to the sale of the guarantee but may encourage risk taking after the sale
   – **Reverse convertible securities** may not provide any disincentives prior to sale but threat of conversion should provide a disincentive after sale
     • May encourage bank to issue common equity to forestall conversion depending upon terms of conversion
     • Disincentives to take risk include incentive to shrink the loan portfolio as the bank approaches the trigger for conversion

Comparative analysis

3. Concerns with the trigger – <u>loss guarantee structures</u>

- If guarantee is triggered then
  - Providers of the guarantee lose
  - Shareholders and management of the bank gain
  - Supervisors may also perceive gain as bank is less likely to fail and may face less pressure to cut back on lending
- Thus, providers concern is that guarantee will be prematurely triggered
- Proposed solution is to make the trigger partially dependent upon the condition of other banks

Comparative analysis

3. Concerns with the trigger – <u>Common equity purchase</u>

- If guarantee is triggered then
  - Reverse convertible securities holders obtain stock
  - Shareholders and management lose part of their interest in the bank but also obtain a reduction in debt
- If an accounting ratio is triggered the concern is whether the supervisors would force timely loss recognition
- If market value trigger is used, concern is that reverse convertible securities holders will try to manipulate the stock to force conversion at a favorable time
  - And at a favorable price if conversion ratio depends on current stock price

Comparative analysis

3. Concerns with the trigger – <u>Common equity purchase</u>

- Responses to stock manipulation
  - Set trigger (and maybe the conversion ratio)based on average stock price over some period of time
  - Three triggers
    - Accounting as primary trigger
    - Market ratio as failsafe trigger
    - Government capital injection as a second failsafe trigger

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Conclusion

- None of the plans out there meet all of the key criteria
  - Efficient delivery of financial services
  - Does not mask potential problems by driving them out of the banking system
  - Credible before resolution and workable in resolution
  - Requires minimal to no taxpayer dollars
- Interim solution is adopt a package of measures
- Contingent capital can make an important contribution

Conclusion

- My preference is for a plan with the following elements

1. Only newly issued securities included in regulatory capital are common equity and contingent capital.
2. Contingent capital limited to the common equity purchase form
   - If loss guarantee is included their purpose would be to trigger conversion of reverse convertible securities.
3. Trigger for conversion to equity would be accounting capital ratio based with market based fail-safe trigger
4. Conversion of subordinated debt beyond some point would also trigger changes in corporate governance
5. Subsidiary reverse convertible securities would convert to parent equity

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