



Now More Absorbent!

*Five Principles to Make "Contingent Capital"
More Like Capital, and Less Contingent*

*Raj Date
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The Cambridge Winter Center for Financial Institutions Policy¹ is pleased to share this comment on the Basel Committee on Bank Supervision's "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability."²

The "Basel Proposal" relates to hybrid securities issued by banks that are not common equity, but nevertheless have traditionally qualified for regulatory capital treatment. The proposal contemplates requiring "that all regulatory capital instruments include a mechanism in their terms and conditions that ensures they will take loss at the point of non-viability."³ That mechanism would involve writing off the principal amount of

capital securities issued by a distressed bank, and possibly offering their holders, in exchange, shares of common equity.⁴

In essence, then, the proposal could give life to "contingent capital" instruments -- securities issued by banks that would function like debt in good times, but automatically convert into common equity during bad times.

Cambridge Winter's analysis suggests that the Basel Proposal has real merit, but that policy-makers should adopt five principles to ensure that such new capital securities do not simply replicate the myriad flaws of existing bank hybrid instruments.

¹ The Cambridge Winter Center for Financial Institutions Policy is a New York-based non-profit, non-partisan think tank focused exclusively on U.S. financial services policy. Raj Date is the Chairman and Executive Director of Cambridge Winter. He is a former McKinsey & Company consultant, bank senior executive, and Wall Street managing director.

² Basel Committee on Banking Supervision, Bank for International Settlements, "Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability" (Aug. 19, 2010) ("Basel Proposal"), available at <http://www.bis.org/publ/bcbs174.htm>.

³ *Id.* at page 1.

⁴ *Id.* at pages 4-5.

1.0 Background

In retrospect, it is painfully clear that banks were allowed to enter the cyclical downturn of 2007-09 with dramatically too little capital to absorb steep credit deterioration. Capital shortfalls are problematic in two ways. First, capital-constrained banks tend to, belatedly, conserve capital, so they drastically curtail credit at precisely the wrong time for the broader economy. Second, widespread skepticism of banks' financial health triggers a generalized skittishness in interbank lending markets, as well as the escalating probability of cascading bank-runs by retail and commercial depositors alike.

As capital positions deteriorate, regulators find themselves with a difficult decision: intervene, and thereby force taxpayers to prop up firms that have already shown themselves to be ineffective credit intermediaries; or do nothing, and risk that financial dominos continue to fall, deepening an already painful real economy downturn.⁵

With the memory of that dilemma fresh in their minds, global policy-makers are, naturally, gravitating towards the notion of higher capital requirements for banks --

particularly for the largest, systemically risky banks, whose failures would be especially painful, and whose taxpayer-funded rescues might seem the most inevitable. If banks were to carry bigger capital cushions, logically, there should be less probability that intervention or failure would become relevant.

Simply requiring more capital, however, has real systemic costs. During most times in the cycle -- when credit performance is within expected bounds -- debt funding is more efficient than equity funding (it is cheaper, at least in part because it is tax deductible). Requiring more capital, then, will necessarily, on the margin, reduce the availability of bank-supplied credit, and raise its cost.⁶ Moreover, in the face of higher capital requirements, banks will inexorably gravitate towards a higher risk, higher return asset mix (e.g. more sub-prime, less prime), in order to earn that incremental cost of capital. Given that most banks have not especially demonstrated their abilities to underwrite higher risk loans, this is a troubling dynamic.

Given the manifest need for higher capital ratios, and, at the same time, the painful

⁵ The creation of more expansive resolution authority, of course, mitigates some of this difficulty. See generally Raj Date, "The Killer G's: Resolution Authority, Financial Stabilization, and Taxpayer Bail-outs", Cambridge Winter Center (April 23, 2010) (evaluating Dodd-Frank Act's improvements to U.S. resolution authority). However, the Basel Proposal correctly points out that there "is no international insolvency framework for financial firms and a limited prospect of one being created in the near future." Basel Proposal, *supra* note 2, at p. 2.

⁶ Notably, though, some analyses suggest that such fears of higher credit costs might be exaggerated. See Douglas J. Elliott, "Quantifying the Effects on Lending of Increased Increased Capital Requirements", Brookings Institution, (Sept. 24, 2009), available at http://www.brookings.edu/papers/2009/0924_capital_elliott.aspx.

systemic impact of such higher requirements, it is perhaps natural that policy-makers are reaching for creative solutions.

One of those potential solutions is the concept of “contingent capital.” The basic concept was outlined in a widely read paper by the Squam Lake Working Group:

Our proposal, a long-term debt instrument that converts to equity under specific conditions, is a better solution. Banks would issue these bonds before a crisis and, if triggered, the automatic conversion of debt into equity would transform an under-capitalized or insolvent bank into a well capitalized bank at no cost to taxpayers. The costs would be borne by those who should bear them—the banks’ investors.⁷

Ideally, this hybrid security would be the best of both worlds: the efficiency of debt financing in good times; the loss absorption and stability of equity financing in bad times.

Given the unfortunate end result of many purported financial innovations over the past years, of course, a certain amount of skepticism over such alchemy is appropriate.⁸ To date, much of that skepticism has centered on two sets of considerations.

First, given that the conversion of this debt into equity would not actually infuse any new cash into a bank, it would not alleviate any panic-induced liquidity constraints. Indeed, the conversion itself might be viewed

as a harbinger of failure, and incite the very panic it was meant to prevent.

The second set of considerations are typically the province of Wall Street’s convertible bond trading desks: is there a natural investor for such a security? And, even if there is, is this a cost-effective source of capital for banks?

Both of these sets of issues are, ultimately, answered by addressing a more fundamental question: Given that the role of contingent capital is to serve as a buffer between common equity and debt financing (it is protected by existing common equity; it serves as a protection to debt holders), how is it any different or more effective than traditional bank preferred stock -- which was, more or less, a complete failure? The Basel Proposal should be commended for targeting that fundamental question.

2.0 Making Contingent Capital Work: Fixing the Flaws of Bank Preferred Stock

Preferred stock was issued in prodigious quantities by banks during the credit bubble. From the point of view of senior creditors or depositors, in bad times, traditional preferred stock, in theory, should have functioned just like contingent capital: it should not have received dividends, and it would have been subordinated to a bank’s creditors and depositors. In other words, the availability of that hybrid-debt-equity layer of preferred stock should have added

⁷ Squam Lake Working Group on Financial Regulation, “An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities”, page 3 (April, 2009).

⁸ See, e.g., Richard Barley, Heard on the Street, *Wall Street Journal*, “Basel Should Beware Seeking Holy Grail for Hybrid Debt” (Aug. 21, 2010).

to senior creditors' and depositors' confidence that they would get their money back in a downturn, and thereby forestalled any panic-driven runs on the banks.

In reality, though, hybrid capital did nothing of the kind. The preferred market failed in every important way: its pricing mechanism failed to discipline banks' risk-taking behavior (preferred stock tended to price relatively close to more senior debt, under the tacit assumption, encouraged by issuers and Wall Street alike, that banks would protect investors); it did not adequately absorb credit losses (banks continued to pay preferred dividends well after the magnitude of the crisis was clear); it created, instead of mitigated, systemic contagion between firms (because banks held large quantities of each other's hybrid securities).

The failures of the preferred market (and the convertible preferred market), though, create a useful roadmap for making contingent capital a successful part of systemic stability.

2.1 Eliminate management discretion: Regulatory trigger only.

The experience of the crisis demonstrated the inability or unwillingness of bank boards of directors to cut common or preferred stock dividends in the face of objectively deteriorating credit performance.⁹ Because preferred stock continued to receive dividends in the face of mounting losses, it ac-

tually drained capital away from banks, rather than serving as a source of stability.

In light of that experience, if contingent capital is ever intended to serve as "capital", and not merely "contingent", then the ability of bank management to forestall (or in some perverse circumstances, accelerate) its conversion from debt into equity must be eliminated. That means removing management discretion as a trigger event, but also removing trigger events that can be easily manipulated by management (like various covenant breaches).

2.2 Mitigate regulatory forbearance: Low conversion prices; require conversion before other support; change the default option.

That would leave regulatory decision-making as the sole criterion for conversion. And, because bank regulators (like, perhaps, all regulators over time) are prone to agency capture and a quiet, benevolent forbearance towards their charges, the conversion price from debt to equity should be fixed at a sufficiently punitive level (say, at an 80% discount to the common stock price today) that management would not be tempted to goad regulators into an unnecessary conversion.

As an added safeguard, the security could be structured such that it converts into equity upon the occurrence of quantitative triggers, absent an explicit regulatory decision to waive conversion. Much has been

⁹ See Raj Date and Holly Scott Atallah, "The Failure of Bank Board Governance", Cambridge Winter Center, pages 8-9 (Oct. 5, 2009) ("Foreclosure trends spiked, Bear Stearns collapsed, Fannie and Freddie were nationalized, Lehman declared bankruptcy -- and, amazingly, banks continued to pay dividends").

made lately of the power of “default options” on consumer behavior; the same is likely true for regulatory bodies as well.

Moreover, regulators’ decision (or non-decision) to convert contingent capital should be made a threshold requirement for *any* other extraordinary support for a bank’s assets (e.g. the credit guarantees given to Citigroup and Bank of America), a bank’s liabilities (e.g. the FDIC insurance provided to Goldman Sachs’ or GE’s unsecured bonds; the expansion of FDIC insurance for all transaction accounts), or a bank’s capital position (e.g. the original senior preferred investments under TARP). This is the general approach favored by the Basel Proposal, and it is a sound one.

This would both make conversion more likely in a crisis, and -- crucially -- it would ensure that equity investors know that they truly are on the hook for management performance. That is, equity investors would know that, even if depositors and creditors were bailed out in a crisis, a condition of such bailouts would be the drastic dilution of their equity holdings through the forced conversion of contingent capital at a punitively low conversion price.

2.3 Instill pricing discipline: encourage long investors, at the expense of less liquidity.

An extremely low conversion price has a second benefit beyond preventing management gamesmanship. It fundamentally changes the investor base for the instrument.

Most traditional convertible preferred investors -- certainly bank convertible preferred

investors -- are hedge funds that are not so much buying a long interest in the bank issuer’s equity, but rather are buying volatility, in the form of the option embedded in the convertible instrument. To hedge their equity risk, it is common practice for convertible buyers to immediately short the issuer’s common stock. That way, they are hedged to the bank’s stock price movements, and they are left, net of the hedge, with only an investment in a bond, plus the volatility-sensitive features of the option.

Unfortunately, when most investors are, in fact, not holding ultimate equity risk (because they shorted the stock at the time they bought the convertible), pricing discipline becomes attenuated. As long as sufficient “borrow” exists -- so that the bank’s stock can be efficiently shorted -- even quite dubious banks find themselves able to issue convertible instruments. As a result, the market fails to efficiently discipline bank risk-taking.

An extremely low conversion price disrupts this dynamic. Conversion prices that are deeply “out of the money” cannot be efficiently hedged by shorting common stock. This is, presumably, bad news for Wall Street convertible trading desks, which will necessarily find it expensive to hold inventories of difficult-to-hedge securities. But it should prove no particular problem for traditional long-only investors in bank preferred equity -- like mutual funds or pension funds. In reality, the risk profile of the contingent capital instrument is not especially different than traditional preferred stock -- it is simply more transparent: Both traditional preferred and contingent

capital carry equity-like risk in adverse scenarios. Given that transparency, long-only institutional investors will necessarily exert more pricing discipline on bank issuers than hedge fund convertible investors who intend to hold no net exposure to the issuer's equity.

Of course, removing large swaths of hedge fund and investment bank appetite will make contingent capital securities less liquid in the secondary markets. That means greater incremental cost -- a so-called "liquidity premium" -- associated with the embedded option. In other words, contingent capital investors will charge more for the risk that they will be converted into common equity, precisely because of the difficulty in hedging or trading away that risk. But because the option is so deeply out of the money, the absolute size of that risk should be small, so a substantial liquidity premium on that small risk should be relatively manageable.

2.4 Build crisis-resilience: Mandate perpetual, non-cumulative, pre-wired securities.

Some of the failure of existing bank preferred stock to absorb losses in the crisis cannot fairly be ascribed to bank management intransigence on dividend policy. It was instead the predictable result of structural flaws.¹⁰

Hybrid securities of a finite life (that is, bonds that must be repaid at some date certain) do not generate much stability in a

crisis of indeterminate duration. Because they must be refinanced upon maturity, the bank's more senior creditors must be mindful that liquidity will be drained from the firm to meet that repayment obligation.

Similarly, many hybrid securities allow for periodic interest payments to be halted, but provide that the unpaid amounts accumulate, and that the cumulative amount must be paid out eventually. The fact that the cumulative obligation continues to grow, even if a crisis forces payments to be suspended, means that the preferred stock doesn't actually absorb risk, so much as spread it out over time.

Finally, in a crisis, it is frequently quite difficult, outside the context of resolution or bankruptcy, to quickly restructure preferred obligations into common equity. "Holdout" preferred stock holders can frequently turn restructuring exercises into elaborate prisoner's-dilemma exercises: all preferred holders benefit if every investor exchanges his preferred for common; but the best payout is for that stubborn investor who holds on to his preferred stake, and gets paid out 100% after others recapitalize the bank. Naturally, this kind of gamesmanship renders the outcome of such exercises haphazard, at best. Pre-wiring the conversion of all contingent capital instruments can reduce the execution risk associated with such crisis-driven restructuring.

¹⁰ Because of such flaws, the credit rating agencies had often been more skeptical about the capital content of hybrids than were bank regulatory bodies. See generally Standard & Poor's, "Standard & Poor's Response to the Basel Committee's Proposals on Bank Capital and Liquidity", available at <http://www.standardandpoors.com/products-services/articles/en/us/?assetID=1245210157817> (April 15, 2010).

2.5 Reduce contagion: Discourage bank ownership of other banks' contingent capital.

One of the more bizarre aspects of the financial crisis was the impact of bank and GSE hybrid security valuation declines on other banks. Many banks, apparently, had loaded up on other banks' preferred securities, instead of, say, extending credit to actual real-life businesses and consumers. As a result, hybrid securities arguably did less to contain the crisis, and more to propagate the crisis from bank to bank.

More rational capital charges for contingent capital instruments in banks' portfolios should help remedy this problem.

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Contingent capital bears real promise. But unless the concept is cleansed of the deep flaws of the traditional preferred market, it cannot succeed. The Basel Proposal is a clear step in the right direction.