The Trouble with Bail-in: Pillar 2

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Basel Standards for "Adequate Capital"

- **Defining Adequate Capital**
  - Complicated Pillar 1 computations, expressed as ***book***-measured equity ratios

- **Maintaining Adequate Capital**
  - Pillar 2 requires national supervisors...

    "to intervene *at an early stage* to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require *rapid remedial action if capital is not maintained* or restored" (BCBS (2006), page 212)."

  - Among the "range of actions" supervisors should consider is "requiring banks to raise additional capital immediately" (BCBS (2006, page 212)).

How has it worked out for us?

Bear Stearns
Washington Mutual
Lehman Brothers
Wachovia
Merrill Lynch

"failed" in 2008

Tier 1 capital ratio was **12.3% - 16.1%**

Lloyds Banking Group
Royal Bank of Scotland
Dexia
UBS

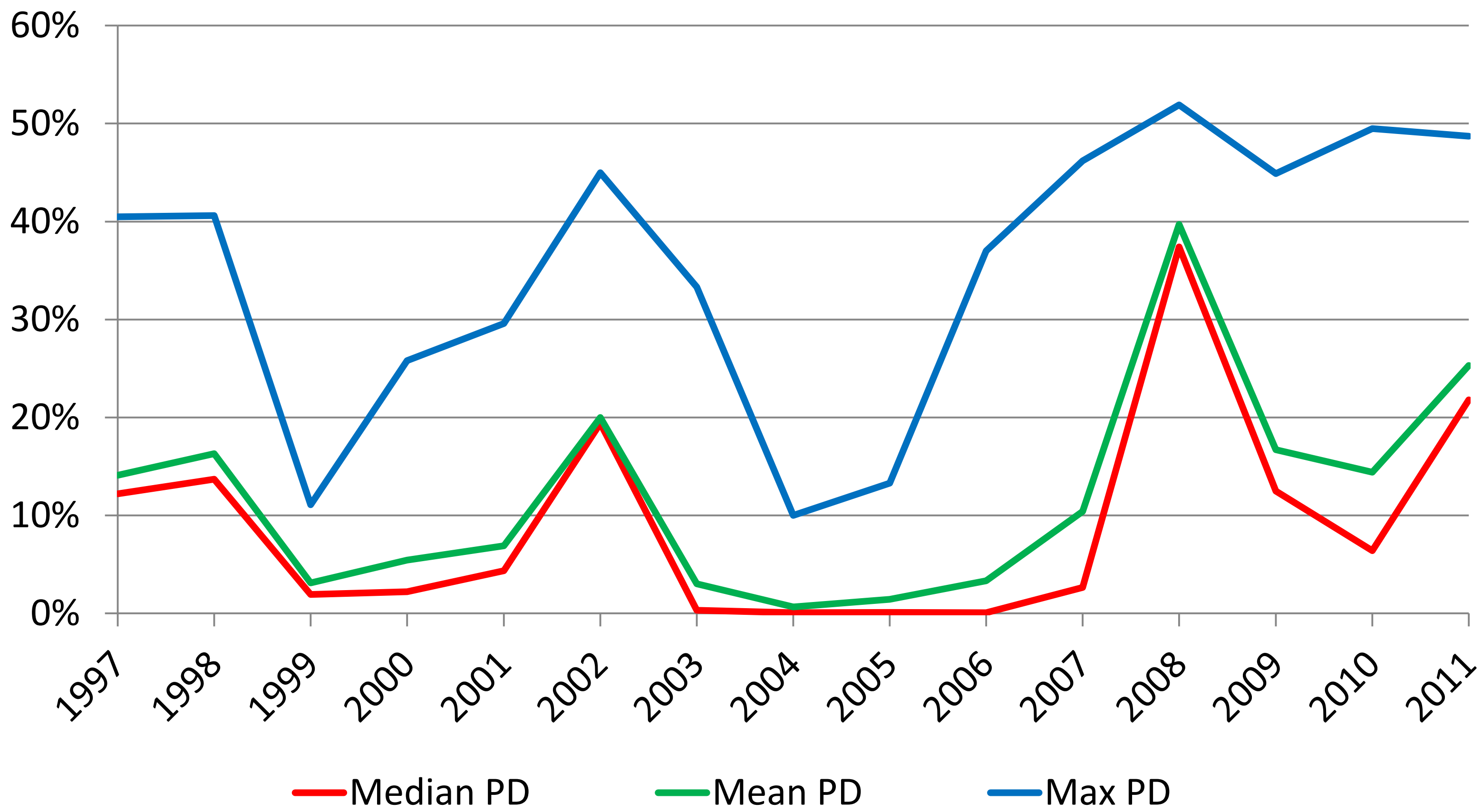
Tier 1 capital ratio was **6.55% - 10%**

Deutsche Bank today: 11% vs. 0.8%

These examples reflect a common problem

- Research indicates that in the U.S. and in Europe, supervisors have chronically permitted the largest banks to operate with quite high default probabilities, for extended periods of time.
  - For the U.S. (1986-2011), *JMCB* February 2014
  - For Europe (1997-2011), *JBF* October 2015 (with Emanuela Giacomini)

One Year PDs
Top European "Solvent" Banks, 1997-2011



Supervisory Discretion (Pillar 2) has not maintained adequate loss-absorbency

Why hasn't supervisory discretion worked to maintain adequate capital?

- Capital rules are expressed in <u>book</u> value terms, while bank survival depends on the <u>market</u> value of its equity – its loss absorbing capacity.
- Forcing a bank to issue new shares imposes losses on <u>identifiable</u> investors and managers.
  - So supervisors want to feel very confident
- Noisy estimate of true loss absorbing capacity
  - Opaque assets (or opaque trading strategies)
  - When markets are in disarray, asset values become even more uncertain.
  - Challenging the firms' audited financial statements

Why hasn't supervisory discretion worked to maintain adequate capital?

- Temptation to await more information. (Rational?)
- Implicit view that forcing over-capitalization on a bank is very costly?

It's Just Too Hard

Bank runs can be good

- The funding crisis reflects *market* beliefs about the borrower's solvency.
- Hobson's choice: supervisors have most often acted aggressively only in response to a funding crisis – often at taxpayer expense.
- A run has gotten the capital problem addressed.

Implications for TLAC Bail-in

- Bank supervisors must take action,
  - to the detriment of bank shareholders
  - at an ill-defined “point of non-viability”.
- Book capital ratios likely to be “adequate”.
- No run to force action: if short-term liability holders believe bail-in bonds will absorb losses ahead of them, they won’t run at the point of non-viability.
- Shareholders control an insolvent firm.

Orderly liquidation and bail-in debt seem unlikely to terminate TBTF distortions.

Automating Pillar 2 might work better

- A market-valued trigger far from the point of non-viability, but near where the bank's PD becomes unacceptably high. (Say, 5%?)
- Convert TLAC bonds at something like the current share price.
  - Increases demand by making the bonds less risky
  - Therefore, transfers more risk to shareholders
- A market-valued trigger constrains supervisory inaction.

Debt-equity conversion with (some sort of) market value trigger

- Prompt re-capitalization → lower initial level of required capital provides same protection to taxpayers.

- Therefore, less pressure to move risk-taking into the shadows (recognizing corporate tax effects on MM I).

Regulatory View: “Banks are opaque. So market valuation of bank claims are often

- wrong
- noisy
- manipulated”

Response: Book values are

- also noisy and manipulated
- always biased in the same direction
- more biased as the firm’s true condition gets worse.

Lobbying 101

- Cocos have some attractive features.
- They also have some actual or potential problems.
- Often, the following argument cuts off consideration of a new proposal: “there is one case in which the proposal might make things worse than the status quo. So let’s stay with what we know.”
- FSOC study of contingent capital (DFA-mandated):

  “a range of potential issues that could be associated with contingent capital instruments, depending on their structure, and, in particular, the structure and timing of conversion triggers.”

An alternative approach to reform

- Wrong comparison: the status quo isn't perfect either.
- Can we revise a flawed proposal to reduce its detrimental features?
  - Many examples have been put forward
- Which policy – the new one or the status quo – provides better <u>average</u> outcomes across all possible future situations?

Summary and Conclusions

- Regulators' decision to tie themselves to a BV definition of "adequate" capital is a big handicap.
- Important to incorporate MV into Pillar 2.
- MV-triggered coco is one way – and it bears investigation beyond what US supervisors have heretofore provided.
- Cocos differ importantly from bail-in bonds

    -- Going concern vs. gone concern

    -- PONV is a very bad place to start addressing the problem.

A role for Convertible Capital

Enrico Perotti
U Amsterdam and CEPR

The times they are a-changing

- Systemic risk arise when losses overwhelm the buffers of intermediaries and spill over the the real economy.
- Consensus after the crisis: no more taxpayer-funded rescues
  - Losses had to be absorbed by financial system
- Are we failing the first tests ?
  - Bail-in of subordinated debt in Italian banks (because held by small savers)
  - Conversion of Deutsche Bank's CoCo debt (well, it would create panic)
- Times are changing back…

Appreciation for CoCo debt

- Compare CoCo and bailin-able debt
  - Bailin-able debt absorbs losses when all is lost
  - CoCo debt converts ahead of distress
- Why is CoCo better ?
  - Because *going concern* deleveraging improves risk incentives before the default threshold
  - Gone-convern conversion does not
- CoCo debt reduces cost of risk absorption!

Misgivings about CoCo debt

- CoCo reviled for same reason it is appreciated !
- When conversion triggered, losses for CoCo debt inevitable
  - Impossible to convert at par (legal issues, value limits)
- But markets panic, none wishes to bear losses
  - Public bailout by the back door
- Back to square one, as with subordinated debt pre-2008

Deutsche Bank CoCo hysteria

- The whole world knew DB could use more capital
- In January, hint that DB may skip ONE COUPON
  - Chances of imminent conversions were zero
- Extreme market response led to concerns among regulators
  - Admittedly, DB is large…
  - But in general, it is essential to show that a bank may convert CoCo debt and yet survive !
- The market has to be made to accept this simple fact

What policy going forward ?

- Policymakers should state publically that skipping a CoCo coupon is a natural occurrence.
- Take away the fear upon conversion by issuing higher trigger CoCo (say, 7 or 8% instead of 5%)
  - Obviously, more expensive; greater equity content
  - Make them qualify for enhanced Basel 3.5 buffers
- Conversion would be de-mystified (made harmless) by encouraging more frequent, idiosyncratic trigger events