Contingent Capital

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Disclaimer:

Contingent Capital Bonds under Consideration

President Dudley (October 13, 2009 speech)

"contingent capital would have been converted automatically into common equity … If these contingent buffers were large, … then the worst aspects of the banking crisis might have been averted."

Contingent Capital Bonds under Consideration

President Dudley

ChairmanBernanke (October 23, 2009 speech)

"systemically important institutions could be required to issue contingent capital, such as debt-like securities that convert to common equity…"

Contingent Capital Bonds under Consideration

President Dudley

Chairman Bernanke

U.S. Treasury white paper (September 3, 2009)

"Requiring banking firms to issue these sorts of contingent capital instruments to market participants could … expedite the private sector recapitalization of banking firms during a severe economic downturn. "

Contingent Capital Bonds under Consideration

President Dudley

Chairman Bernanke

U.S. Treasury

HM Treasury white paper (December 22, 2009)

"The Basel Committee is also taking forward work to consider the role in regulatory capital requirements of contingent capital instruments, which can convert into common equity during stress"

What is CC?

A de-levering mechanism that does

a) <u>not</u> involve uncertain bankruptcy proceedings
b) <u>not</u> primarily require asset sales/contractions
c) improve shareholder discipline.

- “Convertible” bond (e.g. Lloyd’s) or preferred
- CAT bond (Rabobank)
- Insurance payment (Kashyap *et al.* (2008))
- Put option on firm’s own stock (Culp (2009))

Example

- **$1,000**, 5-year coupon bond
- CC bonds compose (e.g.) 4% of BHC RWA
- If issuer's ***market*** equity value falls below (e.g.) 6% of RWA, bond converts …
- … to **$1,000** worth of common shares.

Initial shareholders thus bear the full cost of bad outcomes.

Taxpayers protected from liability for private debts – at least partially.

Why TBTF?

A potential bankruptcy causes financial firms' short-term claimants to run, destroying franchise value.

- Time
- Access to collateral
- Haircuts imposed
- Political jurisdictions
- Unreliable access to credit

TBTF, SIFIs displace market discipline.

Contingent capital (bonds) will permit us to obtain more downside protection from SIFIs when “bankruptcy” is not an option.

- De-levering when needed; transparent and foolproof.
- No liquidity provided.

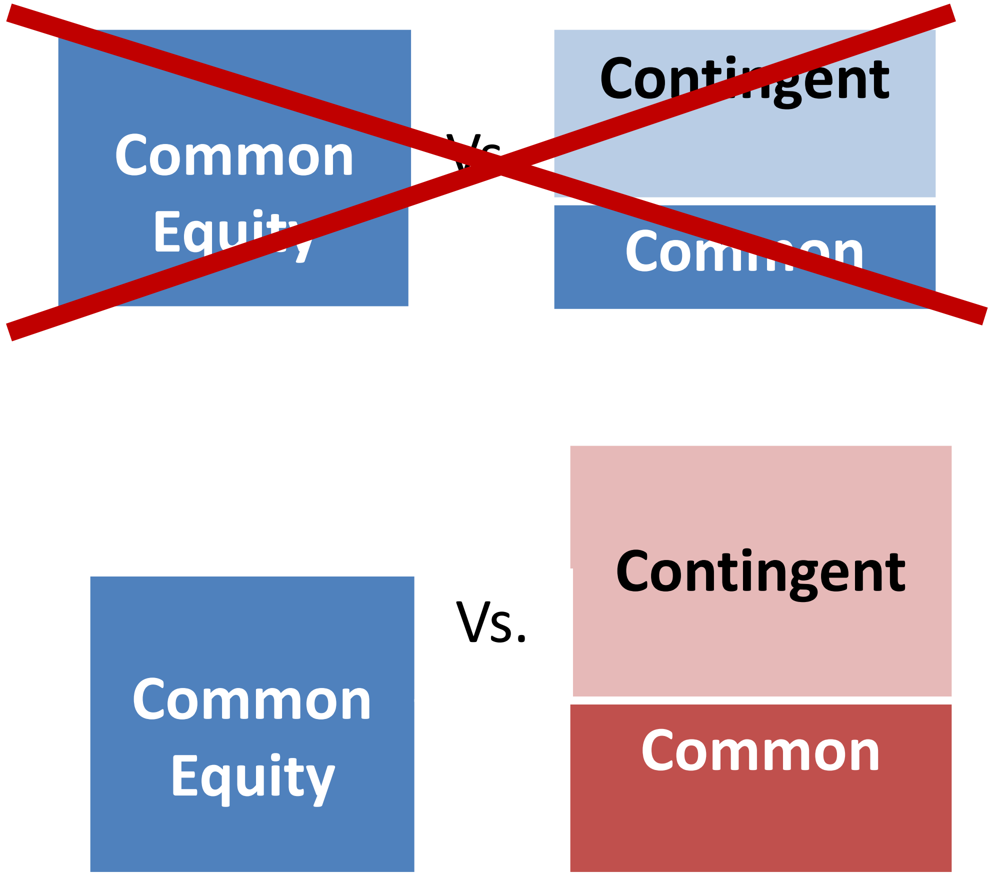
(But a solvent firm has better access to market liquidity…)

“We need higher capital ratios”

- Drawbacks to holding more capital (real and imagined)
  - Higher cost of funds
  - Remove managerial discipline
  - Drive risk-taking elsewhere

- Actually, we only need capital when firms have losses to be absorbed.
- CC provides private capital to absorb those losses, with fewer drawbacks (real or political).

The Bargain


Common Equity
Vs.
Contingent
Common
Common Equity
Vs.
Contingent
Common

Another Advantage

Need to replace the converted CC.

Could (should?) be easier to sell than common.

Therefore easier for supervisors to insist.

Improved supervisory incentives/ability to maintain capital buffer?

CC – Design Issues

1. Purpose

- Going concern?
- Gone concern?

- Offset TBTF distortions at a <u>single</u> firm?
- Protect against <u>systemic</u> collapse?

CC – Design Issues

1. Purpose
2. Trigger
   - Supervisory?
   - Accounting?
   - Market

Tier 1
TCE
Some specific feature, like loan

Equity ratio
Equity price (or decline)
CDS (bond) spread

CC – Design Issues

1. Purpose
2. Trigger
3. Conversion Price
    - Fix at CC issuance?
    - Vary with trigger price?
    - Need fixed number of shares per bond.

Some Key Questions

- Investor base: c. $400 bn
- Manipulation of market trigger?
- Incentive effects
- The IRS
- Pricing; effect on WACC