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Comments on Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability

Consultative Document of the Basel Committee on Banking Supervision, August 2010:

1. Introduction

1. The Basel Committee is certainly right in its finding that, in the financial crisis of the past few years, government support has pre-empted the loss absorption function of many securities that had counted as Tier 2 or even Tier 1 capital. The Basel Committee is also right in its assessment that this experience has worrisome implications for the interplay of bank finance and bank governance in the issuance of these securities and for their treatment as part of the regulatory capital of banks.

2. I fully support the basic principle underlying the Basel Committee's proposal, namely that only securities that are there to absorb losses should be counted as part of regulatory capital. Any strengthening of the loss absorption function of securities that are counted as part of regulatory capital must be welcomed. To the extent that, in the financial crisis, this function was impaired by a lack of frictionless procedures for invoking the loss absorption function, the Committee's proposal goes in the right direction.

3. This being said, I am not convinced that the proposal will achieve its objective. I see several weaknesses:
   - Insufficient account is taken of the political economy of government interventions in support of banks.
   - I am not convinced that the proposed mechanism for triggering conversion of hybrid securities into common stock will work.
   - There are a number of open questions concerning the details of the actual arrangements in the event of conversion.

4. In the following, I will discuss these points in turn. I will also provide a critical discussion of the Basel Committee's discussion of the impact of the proposal on the incentives of the different participants.

2. Political Economy of Government Interventions

5. In the analysis of the Consultative Document, the fact that Tier 1 and Tier 2 capital were not made fully liable for losses appears as a kind of accident: In order to forestall another Lehman event, governments had to provide support quickly, without taking the time to negotiate proper burden sharing with the holders of Tier 1 and Tier 2 securities, let alone go through the legal proceedings that would have been required to convert hybrid securities into equity. As they did, the funds and the guarantees that taxpayers were made to put up reduced or even eliminated the losses that holders of Tier 1 and Tier 2 hybrid securities, or even shareholders, would have had to bear without government support. The Consultative Document seems to suggest that this outcome, which was expensive for taxpayers and which undermines the loss absorption function of capital, would have been avoided if smoother procedures had been available to call on the loss absorption function of hybrid capital.

6. I agree with the assessment that it would be highly desirable to have smoother procedures. In particular, I agree with the assessment that a reform of bank resolution procedures is highly desirable. Such a reform must aim towards uncoupling the resolution of the claims of different securities from the "resolution", winding down or continued operation under another name, of the bank's financial activities. Unfortunately, I also have to agree with the assessment that such a reform is unlikely to come any time soon. Even when it does come at the national level, there is still the matter of international recognition, co-ordination, and, to some extent, harmonization of bank resolution procedures to be dealt with. On this matter, progress seems a long way off.

7. However, I disagree with the view that the lack of proper resolution procedures was the only factor – or even the main factor – behind the bailouts of hybrid-security holders that we have seen. In some cases, protection of the hybrid-security holders themselves seems to have been a major objective of government interventions. Hypo Real Estate in Germany is a case in point. According to an interview with Mr. Rehm, the Chairman of Soffin, that Frankfurter Allgemeine Zeitung published on March 15, 2009, government protection of Hypo Real Estate was needed in order to protect (i) holders of "Pfandbriefe", and thereby the instrument of the "Pfandbrief" itself and (ii) holders of unsecured loans amounting to some 100 bn. EUR; these holders included social retirement systems and churches. In the years prior to the crisis, low rates of return on long-term securities had induced many private and institutional investors to accept risk from unsecured and subordinated debt in order to obtain a return that would be somewhat closer to the rates of return that they had been used to in the past. The Rehm interview suggests that protection of these investors was a major concern of the government. A government's providing such protection runs precisely counter to the philosophy of the Consultative Document.

8. Given this observation, I am not convinced that the Basel Committee's proposal will achieve its objective. To be sure, there is an automatic trigger for conversion of hybrid capital into equity. However, the existence of such a trigger does not alter the political economy of government intervention in favour of certain classes of investors. Unless the legal and contractual rules are designed in such a way that conversion clauses *have to be* triggered before the first euro of taxpayer money is used, when push comes to shove, governments will find ways to circumvent the rules.

9. Under the given proposal, such circumvention might occur by having the government provide funding *in advance of* the triggering event. Whereas the Consultative Document makes automatic conversion of hybrid securities into common equity contingent upon a declaration by the regulator, it does not say anything about funds that the government might put in before such a declaration.

10. Within the European Union, the problem is to some extent reduced by the need to get the European Commission's approval of the state aid that is involved. However, in the wake of the financial crisis, the European Commission has been less concerned with preventing bailouts of undeserving (?) holders of securities than with preventing the continued operation of problem banks from distorting competition in the Common Market. State-aid control by the European Commission is thus not well suited to handling the concerns about bailouts of hybrid-security holders that are expressed in the Consultative Document. In any case, at a more general level internationally, there is not even an EU-type control of state aid.

11. To sum this point up: The Consultative Document is not exhibiting any mechanism that would effectively commit governments to not bailing hybrid-security holders out.

3. Specification of the Trigger

12. The proposal puts a lot of responsibility on the regulatory authority pulling the trigger. I am not convinced that regulatory authorities are in a position to perform this task effectively.

13. In a crisis situation, the regulatory authorities will be under tremendous pressure *not* to pull the trigger. This pressure will come not only from the banks themselves but also from the political authorities. The spectre of a new Lehman event will be raised by all interested parties. The holders of the affected securities will also raise questions about legal liability for any damages that they may suffer when the trigger is being pulled.

14. In the proposal, the trigger is conditioned on the regulatory authority finding that, without a suitable injection of capital or a suitable write-off, the institution would become nonviable. Assessments of nonviability involve an exercise of judgment based on a mixture of hard and soft facts. The soft facts leave room for interpretation – and hence for lobbying to make the authority see things in a more optimistic light. In this context, it is worth recalling that, in the financial crisis, supervisory authorities were quite slow to pull any triggers at all. Many problem banks stayed in business until their refinancing broke down.

15. To avoid a repetition of this experience, it seems desirable to introduce an extraneous indicator into the trigger mechanism. One such indicator might be the price of a credit default swap on the bank's junior long-term debt, as proposed by Hart and Zingales, A New Capital Regulation For Large Financial Institutions (http://www.economics.harvard.edu/faculty/hart/files/ANewCapitalRegulation-8-2010.pdf). In their analysis, an intervention mechanism is triggered once the price of the credit default swap on junior long-term debt exceeds a certain threshold and the regulatory authority confirms that the intervention mechanism should be put into operation. The intervention mechanism they envisage differs from the conversion of

hybrid securities considered here, but the notion of an extraneous trigger is applicable here as well as in their analysis.

16. As explained by Hart and Zingales, reliance on the price of the credit default swap only would raise the possibility of a bear raid designed to weaken the position of the bank, possibly with a view to gaining control against the wishes of management and incumbent shareholders. This is why they suggest that the trigger be conditioned on both, the extraneous indicator and the declaration of the regulatory authority.

17. There is a question, however, as to how these two components of the trigger mechanism would interact in practice. On the one hand, the regulatory authority's intervention is needed to avoid susceptibility to a bear raid. This intervention must involve an element of discretion. On the other hand, the extraneous indicator is needed to relieve some of the pressures under which the authority would be operating. Clearly, there is a tradeoff: The more discretion the authority has in affirming that the trigger needs to be pulled, the more susceptible it will be to political pressures. The less discretion is has, the greater is the danger of a bear raid.

18. In this context, it may be useful to think in procedural terms, allocating the burden of proof in legal proceedings on whether the authority's decision accords with the extraneous indicator or not: If the extraneous indicator exceeds the alarm threshold and the authority intervenes, then, in any legal proceedings, it is incumbent on the plaintiffs to give evidence why the intervention was inappropriate; if, in this situation, the authority fails to intervene, it is up to the authority to provide a sufficient reason why it remained inactive even though the alarm had rung. If the extraneous indicator does not hit the alarm threshold, allocation of the burden of proof would be just the opposite: The authority would have to show why they did intervene if they did, a plaintiff would have to show why the authority should have intervened if it didn't.

4. <u>How Does Conversion Work?</u>

19. The Consultative Document leaves the conversion rate open and merely mentions different possibilities such as zero conversion despite a full write-off or conversion into a high number of shares.

20. This raises several questions. First, how and when are conversion rates determined? Presumably, the rules for determining conversion rates must be chosen at the time of contracting, ex ante, but then the question is how to take account of the information that is available at the time of the trigger event, when the conversion occurs. Is the determination of such rules to be left to private contracts? Is this going to be subject to statutory regulations setting conditions for the inclusion of such securities in Tier 1 or Tier 2 capital?

21. Second, when multiple securities are involved, how will differences between the different securities that count against Tier 1 and Tier 2 capital be handled? Will there be a different triggering event for each security or will there be s single triggering event requiring conversion of all of them at once? How will differences in priority rankings between these securities be handled?

22. There may be a temptation to leave these matters to private contracting in order to gain some experience with how the proposed system will work. Against this temptation, I warn that there is a significant need for standardization. Standardization is useful for the markets in which these securities are traded. It is also important in order to reduce legal uncertainty and frictions arising if ever the trigger is pulled and a conversion is imposed on security holders. Legal uncertainty at this time would run counter to the very purpose of the proposal made in the Consultative Document.

23. Mentioning legal uncertainty, I wish to point out that the relation of the proposed regime to insolvency law must be clarified. Under insolvency law, there is a clear ranking so that, to take the simplest constellation, senior debt is served first, then junior debt is served, and finally shareholders get whatever is left. If available assets do not suffice to satisfy all creditors, shareholders get nothing, and the lowest priority class of creditors get whatever is left after all creditors ahead of them have been served. In this setting, conversion of low-ranking debt into equity is accompanied by the elimination of incumbent shareholders; they are completely wiped out, and low-ranking debt holders take their place. The Consultative Document's discussion of conversion rates suggests to me that, under the proposed procedure, these priority rankings will not be preserved; otherwise the case of zero compensation would not be mentioned as one possibility.

24. Given the potential discrepancy between the proposed regime and the rules stipulated by most insolvency laws, the relation between the two legal regimes ought to be made clearer. Otherwise, the difference may give rise to legal conflict. To see the issue, suppose that a bank is insolvent. The regulatory authority stipulates a conversion, presumably with the idea that this will keep the bank viable. In fact, this is not enough to keep the bank afloat, and it ends up in insolvency anyway. The holder of a hybrid security find that he would have been better off if the bank had gone into insolvency right away, giving him priority over incumbent shareholders. He will then want to sue the authority for damages because its intervention has deprived him of the rights he would have had in insolvency proceedings. .

25. The Consultative Document is silent on possible implications of the proposal for corporate governance. There are solid reasons why changes in corporate control play a key role in insolvency law. Neglect of this aspect of how to deal with banks in difficulties – and of its interaction with the proposed changes – seems like an gap in the proposal. The gap is important because some of the more wasteful episodes of recent banking history have involved bank executives denying that their bank was in trouble so as to prevent a change of control. The forbearance with which the US Savings and Loans Institutions were treated in the early eighties provides a case in point.

5. Potential Impact of the Proposal on Incentives

26. Speaking as someone whose original specialization lies in economic theory, I find Section 4 of the Consultative Document to be very theoretical, with some imprecision in the analysis and hardly any concern for empirical relevance. The basic argument boils down to the assertion that, under the proposed automatic-conversion regime for securities that count as Tier 1 or Tier 2 capital, bank shareholders will prevent bank management from taking excessive risks because either the buyers of these securities

will condition the rates they want on the prospect of failure, or the shareholders must fear the dilution of their positions in the event of conversion. I do not find this argument convincing.

27. First, the argument presumes that shareholders are actually in control. This is incorrect. Control is in the hands of bank management. Bank management may be guided by concerns about shareholder value, but this does not mean that shareholders are actually in control. At most, shareholders exert an indirect influence as they decide to buy or sell shares, and the stock market price as a measure of shareholder value is a concern for management.

28. Second, for the version of the proposal that involves high conversion rates, I fail to see why the automatic-conversion regime that is being proposed should be any more successful in making shareholders concerned about risk than an ordinary insolvency regime would. Indeed, as long as "dilution" of incumbent-shareholder positions is less than the total wipe-out under insolvency law, I would expect such concerns to be less than under insolvency law, i.e., there is bound to be excessive risk taking. With high conversion rates, shareholder incentives to avoid risk taking under the proposed regime will be weaker than they are under any other regime that does not provide them with protection. A strengthening of these incentives can only be presumed if the standard of comparison involves government support coming to the aid of incumbent shareholders as well as the holders of hybrid securities that count as Tier 1 or Tier 2 capital. This standard of comparison, however, does not seem to be what the Consultative Document presumes.

29. Third, for the version of the proposal that involve zero shares, i.e. a write-of of hybrid securities without compensation, the argument presumes that shareholders, presumed to be in control, worry about funding costs which they see as adapting rapidly to the riskiness of the bank's strategy. The Consultative Document here seems to be accepting the "Debt-Provides-Discipline" theory of Calomiris and others without taking account of the fact that the theoretical basis for this theory is extremely weak, involving only models in which there is no stock market and no form of market discipline by "shareholder value", and without taking account of the fact that the experience of the years prior to the crisis provides convincing evidence against the theory. In joint work with Anat Admati, Peter DeMarzo, and Paul Pfleiderer of Stanford University (http://papers.ssrn.com/abstract=1669704) we have thoroughly discussed the matter. Therefore, I merely sketch the main points of the argument here. For references to other authors, I refer to the paper.

30. In the first place, the argument given for the case of zero shares raises the question of what is the maturity of the securities in question and what is the average turnover rate per period. For the incentives considered in the Consultative Document to be fully effective, the average turnover rate should be high, i.e., the average maturity should be low. If hybrid securities have to be rolled over frequently, investors have a chance to adapt their financing decisions to the risk taking that they observe. This would in fact correspond to the original Calomiris-Kahn analysis of deposit finance as a mechanism of market discipline. With short maturities, however, the system is very fragile, as we have learnt in the crisis. To be sure, fragility can be reduced by having long maturities; this has been suggested among others by W. Poole. However, this suggestion neglects that whatever incentive effects are expected from investor decisions in the process of renewing their investments will be weakened if maturities are long and conditions on

the bulk of the hybrid capital are fixed for significant period of time. I have yet to see a satisfactory analysis of this trade-off in the literature.

31. Leaving aside the concern that discipline by debt comes at a cost in terms of fragility, there also is a question about who has what information. The "debt-as-discipline" theory assumes that debt holders are particularly well informed. Debt holder incentives to spend resources on information have been studied in models without stock markets, but not in models in which the bank also has outstanding shares and these shares are traded in the market. There are good reasons to believe that in a setting with both shares and debt, shareholders have greater incentives to invest in information than debt holders and debt holders have an incentive to free-ride on the information contained in the stock price. The reason is that equity returns are much more sensitive to news. Returns to debt depend on news only if there is a question about solvency. Otherwise, the bank just services the debt, and the debt holder can sleep quietly without worrying too much. He may also feel that the stock price, which aggregates the information collected by shareholders, provides enough of a clue as to what is going on so that he need not invest in information himself. If the stock price goes down, that will be soon enough to worry.

32. With a side-by-side of shareholders and debt holders as described, debt holders will not impose much discipline in the upturn. As they see share prices rising, they assume that things are going sufficiently well so that they do not need to worry. They will intervene and exert discipline by asking for haircuts on collateral, higher rates, or even refusing to lend altogether when share prices are declining and they appreciate that there is a problem. This is too late, however, to prevent management from engaging in a risky strategy that benefits shareholders (and themselves) at the expense of greater default risk. By the time the risks are recognized, the positions have been built up and cannot be eliminated from one day to the next. The experience of 2004 – 2007 and then again 2007 – 2009 illustrates the problem very well. I consider it scandalous that, in 2010, we have discussions of discipline by debt holders that completely ignore the experience of these years.

33. Going back from theory to political economy, if the holders of hybrid securities expect to be bailed out by the government, they will not even think about exerting discipline. I appreciate that the Basel Committee is well aware of this problem and that the proposal of the Consultative Document stems from this. However, as mentioned above, I am sceptical about the reliability of the proposed mechanism as a means of precluding new bailouts.

34. Underlying the experience that we have had is a constellation with a flush of savings putting pressure on long-term interest rates globally. This poses a problem for investors who want to fund expenditures from interest income. Rather than cutting expenditures, they will be tempted to go for securities offering higher yields, without fully appreciating the risks involved. Yield panic among investors is not a good basis for imposing discipline on borrowers. If these are investors with sufficient political clout, we are back to the political economy problem.

6. Summary

35. I agree with the Basel Committee's objective, but, for the reasons indicated in these comments, I am sceptical about the scope for achieving it. The proposal is a valiant attempt, but I do not believe that it will work.

36. This being said, I am fully in favour of imposing restrictions on the specifications of the securities that will be counted as Tier 1 or Tier 2 capital.

37. In the long run, the Basel Committee should consider going further and considering only equity as capital. This would avoid all questions about how to make effective the loss absorption function of other securities that are currently treated as Tier 1 or Tier 2 capital.

38. I appreciate that there is strong political resistance against such a development. Most of the arguments that are given, however, do not have a firm grounding in economic analysis. My joint paper with Admati, DeMarzo, and Pfleiderer discusses the matter in detail; I believe that Anat Admati will have some comments of her own, in which she spells these matters out.

Bonn, October 1, 2010,

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