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Statement No. 303

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Statement of the Shadow Financial Regulatory Committee

The Case for a Properly Structured Contingent Capital Requirement

December 13, 2010

The recent crisis has shown the inadequacy of the Basel approach to strengthening the financial system. Under Basel II the quantity of "high-quality" capital fell, the risk-based denominator in the ratios proved totally unreliable as a measure of risk, and the minimum acceptable ratios -- whether expressed in terms of Tier 1 (4%) or Tier 1 plus Tier 2 capital (8%) -- were much too low. Indeed in every major failure that required government intervention, the primary supervisor made the embarrassing statement that the firm had greatly exceeded all minimum regulatory capital ratios in the last reporting period. In the end, the market simply ignored regulatory book value capital ratios and focused on tangible common equity.

Although Basel III is attempting to repair some of the more egregious errors in risk weights, the main emphasis has been on more and higher quality capital. Currently the plans are to raise the minimum acceptable ratio of equity to risk-weighted assets from what had become 2% (down from an original 4% under Basel I) and to add a capital conservation buffer of another 2.5% plus a discretionary counter-cyclical buffer of from 0-2.5% and a possible add-on for systemically important banks. If implemented, this could raise (risk-based) regulatory capital requirements to as high as 10 to 12% for systemically important banks. But it would not materially address the inherent flaws in the Basel approach.

The Dodd-Frank Act mandated a study on contingent capital (CoCos) as a possible addition to the regulatory tool kit. The Committee believes that a properly structured CoCo requirement could have important incentive benefits that would nicely complement the new higher minimum capital requirements. A properly-structured CoCo requirement would provide an automatic, market-based incentive for banks to recapitalize or restructure before they encounter serious difficulty rather than delay until heavy losses have to be realized and little can be done without government intervention.

Numerous forms of CoCo have been proposed and they all differ with respect to at least four key features:

1. The amount a bank should be required to issue.
2. The trigger for conversion.
3. The amount converted when the trigger is crossed.
4. The price at which CoCos are converted into equity.

These parameters should be specified by the regulators with the aim of giving banks strong incentives to take corrective actions promptly such as raising additional capital, selling assets or other restructuring before they hit the trigger. The key to selling the new instruments is to ensure that the probability of loss is no greater than that on subordinated debt (which has the disadvantage of requiring that the firm go through bankruptcy before it could absorb losses). Unfortunately, the recent pattern of protecting even subordinated debt-holders in most bail-outs may have undermined the signaling and market discipline that otherwise accompanied issues of subordinated debt.

The Committee's recommendations for the key features that a well-structured CoCo should incorporate include the following:

1. The amount of CoCos should be sufficient to cause significant dilution to shareholders if the conversion is triggered. The Committee suggests an amount of CoCos equal to 10% of the "quasi-market value" of the bank's assets, defined as the market value of equity plus the face value of debt. In order to remove some of the noise from equity prices and to deter market manipulation in the form of selling the firm's equity short, the Committee would use a 90-day moving average of the firm's equity prices. This measure of the amount of CoCos to be issued differs markedly from most other proposals because it uses a market estimate of the value of assets instead of relying exclusively on the book value of assets.

2. The trigger for conversion should be set at a relatively high level, before the bank has encountered serious difficulties and still has options to recapitalize or restructure to avoid hitting the trigger. The Committee suggests a trigger point at 10 % of the quasi-market value of assets. (This is roughly equivalent to the Basel III equity requirement for systemically important banks.) This high trigger point has the advantage that in this range equity prices should be based predominantly on expected future earnings rather than being infected by expectations of a bailout when equity prices are very low. By contrast, many other proposals depend on a decision by regulators to pull the trigger or, even worse, a decision by management (or some combination of the two).

The two largest rating agencies are already on record stating that they cannot rate any instrument that converts as the result of the discretion of either management or the regulators. Since many institutional investors cannot hold unrated instruments, this is an important defect. Moreover, even if they are permitted to hold unrated instruments they may be reluctant to hold bonds that are subject to conversion at the discretion of either managers or regulators.

3. The amount converted should be the full amount of the issue rather than simply enough to put the bank back into compliance with the regulation. The rationale is to maximize the incentive for shareholders and managers to take corrective action before conversion. A conversion of this size would result in severe dilution. After conversion, the new shareholders, in combination with the disgruntled old shareholders, are likely to demand a change in management. This may help resurrect the market for corporate control in the banking sector, where it has been nearly dormant.

4. The conversion rate should be an amount of equity equal, at current (weighted average) market value, 5% greater than the face value of the debt. That makes the CoCos a more attractive asset to potential buyers of the instrument and may be used to increase the dilution of existing shareholders. This feature, contrasts starkly with the only two CoCos which have been issued. Each converts on extremely unfavorable terms for the debt holders. As a result, they were very expensive to issue.

In addition, the Shadow CoCo proposal would have some additional benefits. First, upon conversion the bank will receive the equivalent of an injection of liquidity equal to the interest and amortization payments formerly owed to holders of CoCos. Second the CoCo requirement has some highly desirable counter-cyclical properties that are not addressed adequately in either the Dodd-Frank bill or the Basel III proposal. Because the CoCo ratio is specified as a percentage of the quasi-market value of assets it will rise during booms, thus slowing the rate of lending and fall during busts, thus offsetting to some extent the pressures from rising risk-based capital requirements that discourage additional lending.

How might a CoCo requirement have worked in the recent crisis? All of the six large US financial institutions that failed, required massive intervention, or were forced into mergers would have triggered the CoCo conversion requirement several months or even years before they required intervention. But this does not take account of the incentive effect of CoCos. Presumably a firm like Lehman Brothers, where the managers and employees had a very large ownership stake, would have been highly motivated to restructure or recapitalize before hitting the trigger point. But even if they did not achieve a sufficient recapitalization or restructuring, triggering the CoCo would provide them with roughly double the amount of equity capital and new shareholders who would undoubtedly demand significant changes. This amount of equity might buy new managers (or reformed old managers) sufficient time to restructure. If it did not, at least the regulators and supervisors would have plenty of warning to prepare a strong resolution plan rather than engage in the the all-too-typical scramble over a sleepless weekend to organize an ad hoc bailout.