

Chapter 9*

Contingent Capital

Overview

"Contingent capital" (often also referred to as reverse convertible bonds or CoCo bonds) constitutes a form of uninsured debt that converts automatically to equity when certain pre-specified triggers are hit. In terms of requiring banks to hold additional capital, this appears to be a preferred route taken by regulators in the United States, as well as in the United Kingdom. For instance, Lloyds Bank, which is owned by the U.K. Government, recently issued such capital as part of its capital-raising exercise, whereby whenever its Tier 1 capital ratio fell sufficiently low, this debt will convert to equity. Discussions are under way between the Federal Reserve and the banking industry to introduce slivers of such contingent capital in the U.S. banks.

Contingent capital is designed to facilitate the transfer of losses when a firm's equity is being depleted to its creditors, and by simultaneously converting some debt into equity, to ensure that the bank will still have some capitalization. In other words, it forces a bank with deteriorating credit quality to recapitalize in a pre-arranged manner and thereby lowers the point of its default. Imposing losses on creditors implies that some of the market discipline will be restored, and lowering the point of default, implies that the need for regulatory forbearance would be reduced, in turn, lessening the too-big-to-fail or the too-interconnected-to-fail problem.

The Current Proposals

Both the House and Senate bills call for the issuance of contingent capital to be an additional standard potentially faced by systemically important institutions. In particular, the regulator may "require a financial holding company subject to stricter standards to maintain a minimum amount of long-term hybrid debt that is convertible to equity when—(1) a specified financial company fails to meet prudential standards established by the agency; and (2) the agency has determined that threats to United States financial system stability make such a conversion necessary."[†]

In addition, the House bill calls for a "study to determine an optimal implementation of contingent capital requirements to maximize financial stability, minimize the probability of drawing on the Systemic Resolution Fund in a financial crisis, and minimize costs for financial holding companies subject to stricter standards." In particular, the study includes "(1) an evaluation of the characteristics and amounts of convertible debt that should be required, including possible tranche structure; (2) an analysis of possible trigger mechanisms for debt conversion, including violation of regulatory capital requirements, failure of stress tests, declaration of systemic emergency by regulators, market-based triggers and other trigger mechanisms; (3) an estimate of the costs of carrying contingent capital; (4) an estimate of the effectiveness of contingent capital requirements in reducing losses to the systemic resolution fund in cases of single-firm or systemic failure; and (5) recommendations for implementing legislation."

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[†] H.R. 4173, Sec. 1609.

Evaluation of Current Proposals

As noted above, in the House bill, one key issue concerning contingent capital is how the triggers are defined. The Lloyds issue in the U.K. includes a trigger based only on its own Tier 1 capitalization levels. In contrast, the current discussions at the Federal Reserve include an institution-level capitalization trigger, as well as a systemwide trigger. The systemwide trigger must be rule-based, for example, when the average Tier 1 ratios in the financial system fall below 5%, rather than at the discretion of regulators. If discretionary, the systemwide trigger when hit would convey severe adverse news to the market, causing a possible downward spiral. In contrast, a rule-based trigger would be well-anticipated and would not have such consequences. Another issue is whether the capitalization should be based on book measures of equity or market measures of equity. While market measures of equity are somewhat vulnerable to short squeezes and manipulative efforts, book measures of equity are somewhat under managerial discretion and often lag true capitalization of firms. Hence, on balance, we prefer the market-based trigger as it is likely to be more timely.

Contingent capital is clearly a good idea, but in our opinion, it is not enough, especially in the form it is proposed. If there was a progressive conversion of debt to equity all the way down the capital structure of financial firms as conditions deteriorate, then indeed all firm losses could eventually be passed to creditors. Such progressive conversion could be a part of the firm's "living will" or resolution plan. Nevertheless, we envision several scenarios in which before such a plan can be fully executed, some counterparty risk or large-scale liquidation risk may arise necessitating receivership or bankruptcy of some form. In other words, we should not rule out yet the possibility that there will be systemic crises in the future that for lack of any other choice involve bailouts of certain systemically important financial firms. Furthermore, some part of bank debt is explicitly insured, and this debt cannot be converted to equity ex post.

While contingent capital restores some market discipline, it does not fully address the fact that beneath both contingent capital and equity capital of banks lie a significant portion of debt – deposits, secured debt (repos), non-contingent debt of other types, liabilities to derivatives transactions – that will remain explicitly and, in some exigencies, implicitly guaranteed by governments. The cost of such debt in good times will not reflect the true risks of banks, and as long as this is true, both contingent capital and equity capital will find it desirable to undertake excessive risks at the expense of guaranteed debt (taxpayer money).

It is important and high time to recognize that the real problem is not between unsecured creditors and bank shareholders, but between the government and uninsured capital providers. While resolution plans can be designed to limit the extent of government transfers to uninsured capital providers, some such transfers will necessarily arise in future. The moral hazard arising from such transfers is best addressed by imposing a fee based on systemic risk contributions of individual institutions. Unless banks are appropriately charged for losses they impose on the system during aggregate crises, they will not internalize these losses.

To summarize, we recommend that in addition to contingent capital and resolution plans, an explicit fee be charged to banks in good times based on their expected losses and their systemic risk contributions (measured as described in Chapter 4, "Measuring Systemic Risk").