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October 1, 2010

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

The motivation and starting point of this document is the important recognition of a serious problem in the current structure of capital regulation. Whereas the regulation allows instruments that are fundamentally debt securities to be considered "regulatory capital" under the Tier 2 classification, the recent crisis has shown that it is difficult or even impossible to rely on these securities to provide a "cushion," because in a crisis situation, and for a variety of reasons, governments may step in and prevent holders of these from bearing any losses relative to their "promised" payments. The proposal is then based on the notion that there is a way to build into the system a way to assure that before any public funds are spent, holders of any security that is allowed into the regulation as a form of "capital" would be wiped out or at least bear losses.

The proposal outlines in the introduction (p.1) three approaches to the problem of how to create "loss absorbency" for non-equity regulatory capital.

1. Efficient resolution mechanisms to sort out all claims in a timely manner and impose losses appropriately. I concur with the assessment that this is not a realistic option.
2. Prohibit "systemically important" banks from including Tier 2 instruments in their regulatory capital. The discussion on page 2 lists a number of problems with this approach. I will elaborate on my reaction to these below, because I believe the proposal dismisses this option, or even a more extreme version of it that disallows Tier 2 instruments for a larger set of banks, from considerations.

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3. Make sure there is a mechanism in place that would ensure that all regulatory capital instruments will take a loss "at the point of non-viability." Having dismissed the previous two approaches, the rest of the report mostly focuses on how this approach might work.

The basic point of my comment is as follows:

- There are numerous problems associated with the third approach, i.e., with creating a trigger event "at the non-viability point" where losses would be imposed on holders of non-equity regulatory capital holders.
- In fact, if we view the problem in a broader context, there is no reason to go through the complications associated with trying to create the desired mechanism, because concerns around the possibility of not allowing non-equity instruments to be counted as regulatory capital are not well founded. Moreover, the purported benefits associated with Tier 2 capital are questionable and do not rely on solid theoretical or empirical foundations. When everything is considered in the appropriate context, there is in fact no social cost associated with requiring all cushions to be in the form of equity and disallow anything else from being counted as regulatory capital.
- I urge the committee to consider seriously **not allowing any publicly held regulated bank to count non-equity instruments as regulatory capital**.

2. Hybrid securities with regulatory conversion triggers[1]

Hybrid "reverse convertible" securities reside in a space between debt and equity. One thing to keep in mind, which may have some legal and tax implication, is that, since a conversion event might lead holders of these securities to receive less than the promised payment embodied in the "debt-like" portion of the security, holders of such securities do not have the standard "creditor's right." This is different from the situation with standard (not "reverse") convertible bonds, where the bond holder has the option to convert to equity as his/her discretion, and thus at the point of conversion the holder prefers to become equity holder than remain a debt holder but they.[2]

The proposal, in the consultative report focuses on an approach that would give regulators the ability to wipe out or lead to the conversion to equity of any debt security that is considered "regulatory capital" at the discretion of the regulator, but only under conditions that essentially require the clear assessment that the institution is "not viable" and would not survive as an entity without either public funds or the protection of bankruptcy or resolution mechanisms. Some of the issues and difficulties that this entails are the following:

2.1 Issue around "the triggering event"

1. It seems extremely unlikely that regulators would be in a position to (i) determine with anything resembling certainty that the point of non viability has "just" been reached, and (ii) be in a position to actually pull the trigger. It is objectively extremely difficult, if not impossible, to determine, for a large and complex financial institution, what actually *is* the point of non viability. True economic viability depends critically on such things as the

[1] Hybrids of the "contingent capital" variety, where a trigger is set based on accounting or price information for the security to convert from debt to equity, have been proposed as well, and some of my comments apply to the use of such hybrids more broadly in addition to the type of mechanism proposed in the report.

[2] In fact, it is my understanding that unless the Internal Revenue Service makes an exception, contingent capital does not qualify as a debt instrument for tax purposes and interest payments may not be deductible to the issuing firm.

market value of numerous assets on the bank's balance sheet, many of which are likely to be quite illiquid. However intelligently this is attempted, there will be different ways to assess viability, and with self interested parties, regulators might have a very difficult time under the best of circumstances knowing when the point has arrived. Pulling the trigger too early might lead to complaints by security holders who would potentially lose when they believe conversion was not justified. It may also create a legal mess if at any point of time after conversion, default does occur and holders of these securities are wiped out while they believe they could have been paid prior to the trigger being pulled. Pulling the trigger too late might of course put the bank into sufficient distress that, if it is interconnected and important, would give rise to the type of systemic risk we observed in the crisis, freezing credit markets and compelling governments to inject capital and, in the process, pay off these "capital" providers, once again not imposing any losses on them when it matters.

2. In addition to the objective difficulty of determining the precise point of non viability, regulators are very likely to be subject to significant pressures from various involved parties with differing objectives, particularly the different security holders of the bank, and even from those outside the bank itself, with respect to whether and when the trigger should be pulled. To the extent that they would likely be wiped out in the event of default but possibly not if the trigger is pulled, shareholders will want conversion to occur early, but if holders of the "about to lose" capital, which could be important investors such as pension funds and others, would want to hold on to their debt-like securities as long as possible and would thus pressure regulators to delay any pulling of the trigger.[3] Moreover, in a world with interconnected financial system, pulling the trigger in one bank would likely lead to serious concerns that a triggering event is imminent at other banks, leading to a chain reaction that could itself be highly destabilizing to the system. As a result, regulators are more likely to postpone pulling any triggers until it might be too late. Meanwhile, distress and credit disruptions may cause economic damage as we have seen in the previous crisis.

3. There are a myriad of other questions that come to mind with respect to how the trigger would actually work if it is to work. Would the trigger event apply to all of the securities under this category of capital at the same time, or would there be some order of securities and the trigger would apply to the most "junior" among them? Would the exact determination of what happens to a particular security holders once the trigger event occur be made at the time the security is issued or would this too be left for regulators to figure out? It seems that the whole situation, which must be envisioned to see whether this proposal would work, puts regulators in a very difficult place. If the scenario involves concerns or fears of a potential financial crisis, regulators would most likely feel that pulling triggers of this sort would exacerbate the concerns and further destabilize the system.

2.2 Issue around ex ante valuation and pre-trigger trading

1. If the terms of securities issued by banks are to be changes by the introduction of trigger events and conversion, this of course will have to be factored into the valuation of these securities and might affect the investor base. There seems to be a level of segregation

[3] This is especially true if it is contemplated that these security holders would be wiped out, while equity might not be wiped out, upon the trigger being pulled, as this puts shareholders and contingent capital providers at extreme conflict.

when some institutional investors (such as some insurance companies or pension funds) focus on "fixed income" securities and face constraints regarding "equity-like" holdings. It is important for these investors to know that the trigger event can be thought of as something akin to a default event for a "straight" bond, and to that extent the constraints put on regulators regarding the definition of a trigger event, which focus on "non viability" represent the right approach.

2. Nevertheless, if there is uncertainty or lack of clarity regarding how the trigger event would be handled or what would happen once the trigger event is declared, this makes it more difficult for investors to value the security. This is related to the issue of priorities and collateral, which are in principle set at the time of the contract issuance for standard debt. Also, if investors do not process on the fact that they are meant to bear some market risk, indeed systemic risk, because it is in states of the world in which a downturn is likely and other markets decline, they might like any extra yield the security provides and yet be unwilling to assume the risk, expecting instead that in a true crisis situation, the government would still bail them out. This is related to the points above about the difficulty for regulators to determine the timing of a trigger event and to actually proceed with triggering conversion or wiping out of capital providers.

3. Once it is suspected that the trigger might be pulled, it is likely that trading in all the securities of the institution in question would be impacted by speculation regarding the triggers. This would complicate matters further both for investors and for regulators.

4. On using debt-like securities as regulatory capital

I'd like to return to the issue of alternatives to the approach of trying to make subordinated debt instruments serve as a cushion. The question I would like to raise is whether we actually have a basis for attributing to such securities a social value that is large enough to justify allowing them to be counted as capital despite the events of the recent crisis and the significant challenges and difficulties associated with the proposal, only a fraction of which are mentioned above, and some of which are also recognized in the document.

The report makes the following points on this matter (page 2), which I would like to take issue with.

1. Whereas it might be desirable to disallow any non-equity securities to be counted as regulatory capital for systemically important institutions, it is very difficult to determine which institutions are systemically important, and there would be moral hazard issues involved (presumably having to do with institutions wishing to not be classified as systemically important so as to avoid these restrictions).

Clearly systemically-important institutions present the biggest challenge because their leverage generates significant negative externalities for the system. Because of the costs their distress or failure would impose on the system, they are in a position to benefit from government support in the event of "non viability." This also translates into lower funding costs, giving them further incentives to use high leverage. For such institutions, it is particularly important to have reliable cushions, and such cushions are clearly best provided by common equity. I agree that it might be difficult to identify exactly which institutions are systemically important, and that there are issues that arise in trying to keep this set of institutions well defined over time. Clearly, if

systemically-important institutions are not allowed to use Tier 2 capital as regulatory capital, there would be incentives for institutions to become systemically important without being classified as such by regulators. The report briefly mentions the possibility of disallowing Tier 2 capital for all institutions, but gives reasons below for why this is not desirable. Since I will take issue below with these reasons and argue that, in fact, there is no reason to encourage institutions to issue Tier 2 securities because they do not actually serve a useful purpose, it would follow that not allowing any institutions (at least not those that are publicly held) to use any non-equity capital as regulatory capital is the best approach. I will elaborate on this below.

2. Subordinated debt provides "important market mechanism that leans against excessive risk taking." If these instruments are not recognizes as capital for non-systemically-important, this would be lost. (The point about spreads providing a source of "market discipline on undue risk taking" is essentially the same point.)

The notion that debt, and particularly long term subordinated debt, provides "market discipline" is extremely weak. *Specifically, there is neither any compelling theory nor is there any empirical support for the purported role of debt in controlling excessive risk taking*. The theories or claims to this effect rely on debt holders to invest in monitoring managers' action at a cost, something which they are unlikely to be either willing or able to do. In order to actually deter excessive risk taking, the models have to deliver a serious and credible threat to managers of institutions who, on the basis of their compensation contract, and even simply if they work for highly leveraged equity holders, have strong incentives to take high, sometime excessive risk. In order to have such a disciplining/deterrent effect, it cannot be the case that the manager is easily able, even at a high cost, to continually refinance. Even if financing "dries up" the consequences are not severe unless there is fragility and the threat of actual distress and bankruptcy. This of course does not work at all for systemically important institutions, whose debtholders would never invest resources to monitor, as their claims are effectively (or very likely) guaranteed by the governments. But even for other institutions, the models where debt is able to serve such a role are not satisfactory. It should also be noted that, *because even subordinated debt is a hard claim and increases the actual leverage of the institutions, incentives for taking excessive risk are actually exacerbated by its presence.* The notion that it serves to control risk shifting seems very implausible.

Even more, while the current report is based on the realization, learned the hard way through the crisis, that Tier 2 capital does not provide a cushion, and thus does not serve the objective of absorbing losses and creating a less fragile financial system, *it is also time for regulators to bury once and for all the idea that debt serves a positive role in resolving frictions associated with information and incentives*. This is because, again if we look at the crisis for lessons, it is obvious that even if one could theoretically imagine that, or construct a model where, debt serves such a role, empirically, *there is absolutely no evidence whatsoever that this is actually at play in the real world of financial institutions*. Clearly, many financial institutions were highly leveraged leading up to the crisis. By any measure, the amount of risk that was taken by these institutions was high, and by some measures excessive (e.g., investing, even indirectly, in subprime loans where relatively little appropriate due diligence on borrowers' ability to pay had been undertaken). It is difficult to see how the presence of any type of debt actually helped prevent excessive risk taking or solved any other governance problem for these institutions.

In addition to generally exacerbating the incentives to take excessive risk, high leverage is the source of the so called "debt overhang" problem, and subordinated debt contributes to this as well. The problem is that a highly leveraged institution finds it difficult to raise equity capital,

and generally may pass up profitable opportunities (and, indeed, restrict lending), because any new capital would benefit existing creditors. Since subordinated debt is still a hard claim, it also exacerbates this problem. So when we look at the positive and negative effect of subordinated (or any) debt on the frictions created by information and conflicts of interest, it is quite obvious that debt generates or exacerbates many more problem than it even has a chance of resolving. Unlike the purported disciplining role of debt, for which there is no empirical support, the incentives or equity to take on risk, and the debt overhang problem as manifested in the credit freezes during the financial crisis, point to the significant frictions and distortions to the lending and investment decisions of banks that leverage creates or exacerbates. Encouraging debt issuance, or allowing debt-like instruments to be counted as capital is thus going in the wrong direction in terms of attempting to alleviate such frictions.

There is no reason to believe that modifying debt so it converts to equity in some cases, as proposed here or in related "contingent capital" proposals, would enhance any potential disciplining role. In fact, if equity is not wiped out in an event that the trigger is pulled, any supposed discipline is weakened.

3. For a bank that is not taking excessive risk, subordinated debt "should be cheaper than common equity."

Since this statement was made without giving a specific rationale, I am not quite sure what it refers to for why subordinated debt being "cheaper" than equity. To the extent that subordinated debt does not represent either deposit or short term, liquid, "money-like" debt, it is not the type of instrument that banks are uniquely able to issue. In other words, the long term debt of financial institution is similar in nature, and generally substitutable, with the long term debt of other firms in the economy. It has a long maturity, specified coupon and principal, and relatively illiquid secondary market, at least relative to equity. In comparing the cost of funding relatively more with such debt vs common equity, one basic difference is that common equity generally bears more risk than debt. This by itself, however, is NOT a reason for debt to be a cheaper means of funding, because the more debt there is, the more risky equity becomes and thus the higher is the cost (in terms of required return) of equity. This is a basic insight that is well understood in corporate finance that goes back to 1958. While statements that seem inconsistent with this insight are still made today, I am assuming that this is not the reason for the statement in the report.

If the reason that subordinated debt "should be cheaper than common equity" is that it provides a tax shield to the bank, this is certainly true. However, this is not a reason for regulators to consider it desirable, because taxes are public funds, and thus whichever authority the taxes go to, can in principle determine the appropriate taxes or subsidies to the bank independent of the actual amount of debt. Of course, we typically take the tax code as given, but even in this case, an increase in the amount of taxes paid by a bank does not represent a cost to society. In fact, it is quite distortive and paradoxical that the tax code encourages leverage when in fact, in the context of large banks, leverage creates negative externalities.

All the above points, including the claims that debt serves a disciplining role, are discussed in detail in a paper I wrote with Peter DeMarzo, Martin Hellwig and Paul Pfleiderer, which is attached and is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669704 . The bottom line of this paper is that *bank equity is not expensive* when considered from a social cost perspective and that, even for banks, which take deposits and create liquid short term debt that is socially valuable and thus must be on the balance sheet, high leverage is *not necessary.* Banks

can not only engage in all their socially valuable activities even if they have significantly more equity than they currently are required to have, but in fact they would make better decisions and would be less subject to distortions in their decisions. The only exception I would make is for privately held institutions, for which equity funding might be more difficult to obtain on a regular basis. For all other institutions, systemically important or not, I see no reason to allow any non-equity security to be counted as regulatory capital. Quite simply, there is no reason, based on first principles to have to do so.

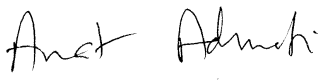
Conclusion

I applaud the committee for the establishing the important principle that all securities that are counted as regulatory capital be able to absorb losses, certainly ahead of any public support.[4] The attempts to create a mechanism that would almost "magically" change the balance sheet of the bank precisely in time to prevent government bailout is heroic, but it is fraught with implementation issues and, in the end, seems to create problems without providing reliable cushions. I am not optimistic that there is a good resolution to all the various issues that would achieve the intended goal.

The good news is that this complex undertaking is in fact unnecessary. The desire to make debt-like securities into "just in time cushion" it is based on the prevalent view that "equity is expensive." I hope that this view can be re-examined. I realize it is difficult to revisit the Tier 1 requirements, but this would still be desirable in the future, and I hope individual countries do consider imposing higher equity requirements on all publicly held regulated institutions. There are significant challenges involved in creating effective measures of risk over time and tracking true leverage on and off balance sheet. In my view the energy of the committee would be better spent on this issue than on the incredibly difficult challenge that it has started undertaking in this report.

Thank you for the opportunity to comment.

Sincerely,



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[4] On the point of whether mentioning government support within the document, I find this highly undesirable, because it "normalizes" something that we would all like to eradicate, namely costly and distortive bailouts. We know that there is no way, and that it would not even be advisable for governments to commit never to bail out an institution. But the mention of public funds in this regulation as something that would in some "normal" way follow if the bank becomes non viable, which may not even be true for non systemically important institutions, might create even more expectation for such support, quite the opposite of the intent. But this is a minor comment.