Ending TBTF: Symposium #4
A Place for TLAC?

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Basel Standards for "Adequate Capital"

- **Defining Adequate Capital**
  - Complicated Pillar 1 computations, expressed as ***book***-measured equity ratios

- **Maintaining Adequate Capital**
  - Pillar 2 requires national supervisors...

    "to intervene *at an early stage* to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require *rapid remedial action if capital is not maintained* or restored" (BCBS (2006), page 212)."

  - Among the "range of actions" supervisors should consider is "requiring banks to raise additional capital immediately" (BCBS (2006, page 212)).

How has it worked out for us?

Bear Stearns
Washington Mutual
Lehman Brothers
Wachovia
Merrill Lynch

“failed” in 2008

Tier 1 capital ratio
was **12.3% - 16.1%**

Lloyds Banking Group
Royal Bank of Scotland
Dexia
UBS

Tier 1 capital ratio
was **6.55% - 10%**

These examples reflect a common problem

- Research indicates that in the U.S. and in Europe, supervisors have chronically permitted the largest banks to operate with quite high default probabilities, for extended periods of time.
  - For the U.S. (1986-2011), *JMCB* February 2014
  - For Europe (1997-2011), *JBF* October 2015 (with Emanuela Giacomini)

Why hasn't supervisory discretion worked to maintain adequate capital?

- Monetary policy analogy fails.
- Forcing a bank to issue new shares imposes losses on identifiable investors and managers.
  - So supervisors want to feel very confident
- Noisy estimate of true loss absorbing capacity
  - Opaque assets (or opaque trading strategies)
  - When markets are in disarray, asset values become even more uncertain.
  - Challenging the firms' audited financial statements

It's Just Too Hard

The value of a bank run

- In fact, supervisors have most often acted aggressively only in response to a funding crisis – often at taxpayer expense.
- The funding crisis reflects *market* beliefs about the borrower’s solvency.
- At least the run gets the capital problem addressed.

The Trouble with TLAC

- Supervisors must take action, to the detriment of bank shareholders, at an ill-defined “point of non-viability”.
- Book capital ratios likely to be “adequate”.
- No run to force action: if short-term liability holders believe TLAC will absorb losses ahead of them, they won’t run at the point of non-viability.
- Shareholders control an insolvent firm.

What would work better?

- A trigger far from the point of non-viability, but near where the bank's PD becomes unacceptably high. (Say, 5%?)
- Convert TLAC bonds at something like the current share price.
  - Increases demand by making the bonds less risky
  - Therefore, transfers more risk to shareholders
- Incorporate equity's *market* value into the conversion, as a constraint on supervisory inaction.

Regulatory View: “Banks are opaque. So market valuation of bank claims are often

- wrong
- noisy
- manipulated”

Response: Book values are

- also noisy and manipulated
- always biased the same way
- more biased as the firm’s true condition gets worse.

Convertible bonds with a market trigger

- Much maligned
- High trigger reduces nearly all the “bad” effects.
- Averaging equity value over many days also reduces “bad” effects.
- Sundaresan and Wang (JF, March 2015) vs. subsequent designs and model assumptions.

Debt-equity conversion with (some sort of) market value trigger

- Prompt re-capitalization ➔ lower initial level of required capital provides same protection to taxpayers.

- Therefore, less pressure to move risk-taking into the shadows (recognizing corporate tax effects on MM I).

Conclusions

- TLAC at the point of non-viability exposes supervisors to the sort of pressure they have not handled well in the past. Oversold as a solution to TBTF.

- Defining "adequate" capital in book value terms substantially weakens supervisors' ability to act quickly to restore adequate risk-bearing.

- Possible improvements:
  - Higher trigger (well above point of non-viability)
  - Some market valuation affecting the trigger for conversion