Equity versus Bail-in Debt in Banking: An Agency Perspective

by

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CEMFI, Madrid, 13 May 2016

Crisis and Regulatory Requirements

- Basel III:
- General increase in capital requirements
- Leverage ratio requirement
- Countercyclical capital buffers
- Liquidity requirements: LCR and NSFR
- New forms of capital getting popular:
- CoCos (going concern capital): Tier 1 and Tier 2 capital

Total Loss Absorbency Capacity (TLAC)

- Financial Stability Board (FSB)
- Globally systemically important banks (GSIBs) should have TLAC equal to 16% of RWAs from 2019 and to 18% by 2022.
- Prevent using tax payer money to bailout banks.
- Significant portion will come from liabilities other than common equity.
- Bail-in debt.

Bail-in Debt

- Capital in bankruptcy

- Equity wiped out, absorb losses before support from resolution funds.

- Cyprus:
- Deposits below 100K euros were insured.
- Depositors above 100K euros suffered losses.
- Going forward, regarded as a blue-print for resolution within the EU.

- Bail-in has been used in South Africa recently when African Bank failed.

Model

- Bank with the following balance sheet:

Assets	Liabilities
Risky assets	Insured deposits
	Bail-in debt
	Equity

- Returns < debt burden (insured + bail-in), bank is in default.
- Returns < insured deposits, Deposit Insurance (DI) fund is on the hook.
- Bail-in debt provides a buffer to protect the DI fund.

Composition of TLAC

- Demand for deposits because of liquidity/payment services.

- If we want payment services from deposits but do not want to use public funds to resolve banks, we need to increase TLAC.

- TLAC = Equity + Bail-in debt

- From a loss-absorbency point of view, the two are equivalent.

- Why not all equity?

Composition of TLAC

- Why not all equity?
- Is there something special about bail-in debt?
- Is the optimal a mix of the two?
- If so, what is the optimal share?
- Main questions the paper addresses focusing on incentives.
- Literature more about the optimal level of capital requirements or TLAC, but not the composition.

Composition of TLAC and incentives

- Insured deposits provide a convenience yield so they are a cheaper form of finance.

- Banks will issue too much shifting risk to the DI fund.

- Capital and TLAC requirements to prevent potential losses.

- And correct bank's adverse incentives.

Adverse incentives

- Risk shifting:

- Limited liability so that the bank chooses highly risky investments to get the upside.

- Private benefit extraction:

- Innes (1990): Forcing banks to issue outside equity reduces insiders' equity leading to private benefit taking.

- Both reduce the bank returns.

Composition of TLAC and incentives

- Risk shifting:

- Equity lowers leverage and helps mitigate risk shifting incentives

- Private benefit extraction:

- Innes (1990): Forcing banks to issue outside equity reduces insiders' equity leading to private benefit taking.

- Bail-in debt is the desired TLAC rather than outside equity.

Results

- We need both equity and bail-in debt.
- Optimal mix: 1/3 equity and 2/3 bail-in debt.
- Current regulation: Half-half
- Additional costs of failures
- Increase the level of TLAC but not equity.
- Once, TLAC is high enough, risk-shifting incentives are mitigated so that private benefit taking becomes the issue to tackle.

Design of regulation

- How do we design regulation?
- Prevent use of public funds during crises.
- Increase loss absorbency
- Incentives:
- How do we measure incentives?
- Different forms of regulation to correct different incentives.

Why not all equity?

- Equity is more costly
- Push from the industry
- New forms of capital: CoCos
- Very nice idea/instrument
- Complex
- Untested

Why not all equity?

- Regulator slow in closing banks.
- Bail-in debt provides the needed buffer in bankruptcy.
- Mc. Andrews et. al (2014)

Assets	Liabilities
A	D
	E: 2x

Assets	Liabilities
A	D
	Bail-in: x
	E: x

Overall

- The paper is on a very important topic.
- Goes to the heart of the issue.
- How should we design regulation?
- Loss absorption and/versus incentives?
- Nice paper, highly recommended!