Comments on “Equity Recourse Notes”

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Outline

• Why ERN are a very clever idea, which is better than the status quo, and better than bail-in CoCos.

• Are ERNs the best way to reform bank capital structure? Perhaps not.

• Calomiris and Herring (2013) approach.

• Other points.
A Clever Idea, Better than Status Quo or Bail-In CoCos

- Current system does not lean against systemic risk credibly through timely correction of over-leveraging in response to adverse shock.
- Book values fail for two reasons: inconvenient or ill-informed discretion, and tangible asset fetishism.
- ERNs reduce leverage automatically as equity value falls, and they are a security that banks can issue in wake of losses with advantageous (opposite to equity issuance) dilution effects.
- Bail-in CoCos have unattractive effects on ability to raise risky debt or equity in response to losses.
Overcoming Tangible Value Fetishism
Shortcomings of ERNs

• They do not ensure adequate MVE/MVA in response to adverse shocks.

• Equity conversion occurs gradually as coupons are paid. Perhaps much too gradually.

• Issuance of new ERNs is voluntary. Burning existing ERNs has adverse reputational consequences. There is no way to be sure how much banks would voluntarily issue, and in any case, it could take a long time for them to become accumulate sufficient equity.
What Would Have Prevented Crisis?

• Crisis did not occur overnight; losses accumulated over long time and were visible in declining market values of bank equity, but not fully recognized (Citi’s 11.8%).

• Lots of moments of calm in which capital could have been raised (fall-winter 2007, April-August 2008).

• Equity market was wide open to banks ($450 billion was raised prior to September 2008).

• Institutions limited offering because of dilution (my breakfast with senior manager).
Systemic Risk and Value Loss

90 Day Rolling Market Cap to Quasi Market Value of Assets
U.S. SIFIs that Failed, Were Forced into Mergers or Received Major SCAP Infusions

- Citigroup
- AIG
- Bank of America
- Lehman Brothers
- Merrill Lynch
- Goldman Sachs
- Morgan Stanley
- Bear Stearns
- Wachovia
- WAMU

4% Trigger
2% Trigger

Mar-06, Jun-06, Jul-06, Aug-06, Sep-06, Oct-06, Nov-06, Dec-06, Jan-07, Feb-07, Mar-07, Apr-07, May-07, Jun-07, Jul-07, Aug-07, Sep-07, Oct-07, Nov-07, Dec-07, Jan-08, Feb-08, Mar-08, Apr-08, May-08, Jun-08, Jul-08, Aug-08, Sep-08, Oct-08, Nov-08, Dec-08, Jan-09, Feb-09, Mar-09, Apr-09, May-09, Jun-09, Jul-09, Aug-09, Sep-09, Oct-09, Nov-09, Dec-09, Jan-10, Feb-10, Mar-10, Apr-10
CoCos (Calomiris and Herring 2013)

- Establish a **minimum uninsured CoCo requirement** for large banks, which improves risk management and capital raising incentives.

- If designed properly (with sufficient conversion dilution risk), CoCos would incentivize **timely recapitalization** of bank to avoid dilutive conversion of CoCos.

- Avoids unrealistic reliance on orderly liquidation.

- The combination of common equity and CoCo requirement **can achieve more** than a common equity requirement alone, and at a lower social cost.
Prompt Issuance Objective

• **Set trigger high** (issuance is not occurring near failure point)

• **Conversion should be dilutive** (to encourage alternative of voluntary issuance)

• Make required **amount of CoCos large** (to encourage alternative of voluntary issuance)

• Timely (costly) replacement of lost capital will not only protect against insolvency ex post, it will **incentivize good risk management ex ante**. **Buffer will reflect (and limit) risk**.
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<th>Details</th>
<th>Prompt Recapitalization</th>
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<td>Primary Goal</td>
<td>10% assets, 15% of RWA</td>
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<tr>
<td>Min Amt of CoCos</td>
<td>10 percent, 90-day MA</td>
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<td>Trigger QMVER</td>
<td>5 percent dilutive</td>
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<td>Conversion ratio</td>
<td>All CoCos convert (not eq)</td>
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<td>Conversion amt</td>
<td>Qualified institutions</td>
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<td>Holders</td>
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Other Points

• Calomiris and Herring criticized in footnote 2 (1.) off-balance sheet positions shift are relevant but risk incentives built into CoCos largely mitigate this, and additional reforms would prevent capital arbitrage; (2) sale of cash and deleveraging might not relax constraint and would have little effect on insolvency risk; (3) purchase of debt would have trivial effect and is not relevant for a well-capitalized bank).

• Sundaresan and Wang (Pennacchi 2016, and model is irrelevant to Calomiris Herring 2013)