Ownership and Control in Bail-In and Special Resolution

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Bail-in

Our interest in "bail-in" as a possible way of addressing the too-big-to-fail problem is based on the idea that it may be much less costly to tax payers and to society generally than resolution under standard bankruptcy law or under special resolution in the absence of bail-in. Wilson Ervin's sketch of the alternative to the Lehman liquidation seems very persuasive.[2] Instead of some $150 billion of asset value destruction through messy fire-sales in the Lehman liquidation, the bank could have been resolved "over the weekend" by a rapid recognition of the $25 billion losses and the conversion of a sufficient amount of debt of various categories into common equity. Avoiding $125 billion of losses certainly seems like a good thing to do, but one must ask whether doing so will be easy to do through special resolution. Put otherwise, after being developed and refined over centuries of real-world experience how is it that existing bankruptcy law can be so colossally inefficient?

The answer seems to be that existing bankruptcy law is unable maintain the bank as a going concern. Instead, bankruptcy leads inevitably to liquidation and to selling off bank assets piecemeal. In doing so, the value created through synergies among the various lines of business is destroyed. But how can this destruction be avoided? I think that Jensen's and Meckling's notion that the firm is a "nexus of contracts" is probably most telling in the context of a bank. The reason bankruptcy destroys value is that it has a radical impact on a whole wide range of existing and future contracting relationships.[3]

The recent literature on bail-in, contingent capital and special resolution has emphasized the way alternative instruments and legal environments allocate *cash-flow rights* across various classes of bank investors. Absent transactions costs and given a specific choice of what triggers the financial restructuring of the bank, the same allocation of state-contingent cash flow rights can be obtained with bail-in, cocos or other combinations of more conventional liabilities.[4] Thus the choice among

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[1] Comments are welcome, r.w.anderson@lse.ac.uk. This note was prepared in advance of the LSE FMG Workshop on Bail-in and Special Resolution on March 14, 2011. These reflections were prompted by discussions with Wilson Ervin, Malcolm Knight, and, Tom Huertas, who has given me advanced sight of his work on bail-in. I thank Wilson, Malcolm and Tom for comments on an earlier draft. Responsibility for all views expressed and any errors is my own.

[2] Ervin "Bank Resolution and Too Big To Fail: Is Bail-in the Best Answer?"

[3] Diamond and Rajan (2001) develop a theory of banking that emphasizes the superior ability of the bank (i.e., the "relationship lender") to extract value of assets when a liquidation is necessary. A key insight of their model is that efficient intermediation is achieved when the bank is committed to retaining ownership and control over these assets and that the structure of the banks liabilities plays a crucial role in assuring that commitment.

[4] Pazarbasioglu *et al* (2011) show in a simple model the equivalence of a bail-out insurance or resolution fund can be replicated in a world without transaction cost by a properly designed coco bond.

alternative structures would seem to turn on matters of transaction cost and the definition of triggers.[5]

I would argue that the differences among regimes are probably greatest in regard their impact on the total asset value of the bank in distress. This is because I believe they would have different impacts on the existing and future contracting relationships of the bank.

For example, consider a bridge bank ("orderly resolution" under Dodd-Frank). This involves a completely new bank into which some of the old bank's assets have been transferred. But what happens to all the employment, real estate, and service contracts etc. of the old bank? Is it clear to all the old bank's stakeholders how their existing contracts will be treated and what their prospects are for new contracts once their old ones expire? It seems like a bridge bank could be very destructive of asset value just like ordinary bankruptcy.

In contrast, bail-in would seem to hold the prospect of keeping most if not all of the bank's existing contracts in place and to provide a relatively high level of transparency as to future contracts. However, I am not sure that the discussions of bail-in until now have totally resolved the question of how resolution authorities will assure continuity and set the bank's future course.

For example, Wilson Ervin argues that under bail-in "top management is removed". But who is put in their place? Is it to be a government expert on liquidation or rather a new banker that is meant to provide leadership and vision as to the future? Tom Huertas focuses resolution as an alternative to liquidation which allows the bank to continue as a going concern so as to permit an orderly winding down of bank assets.[6] But is it possible to maintain bank value as a going concern without providing a prospect of an open-ended continuation of banking relationships? Doesn't the resolution authority need a pathway to developing the bank's new business plan?

For me these are the big issues that need to be addressed. It could be that under special resolution the person or group that is in charge will have a freer hand to maximise firm value than is available to a court-appointed liquidator.[7] But this needs to be squared with the fact that post bail-in, equity in the firm will be held principally by the bank's former creditors. These new shareholders will now have controlling interest in the firm and will have the right under normal contract law and under the still-standing corporate charter to appoint the new senior management.

Furthermore, the notion that bail-in should be focussed on maximizing firm value relates to the issue of when is the "right moment" to start resolution. In the discussions of bail-in there is always a hypothetical moment when suddenly there is

[5] See, T. Huertas "The Road to Better Resolution: From Bail-Out to Bail-In", January 23, 2011, p.19.
[6] "The Road to Better Resolution: From Bail-Out to Bail-In", pp., 8, 18.
[7] For example, Robert Benmosche as President and CEO of AIG is an example of a "going-concern" appointment. However, such appointments carry substantial risks, witness the recent debate on the public authorities' alleged failure to liquidate banks as required under Prompt Corrective Action. It is an open question whether the Orderly Liquidation Authority introduced by the Dodd-Frank Act will give the Fed more or less latitude in dealing with a distressed SIFI than PCA does for smaller institutions.

an amount of losses that needs to be recognized which will mean that the firm is non-viable. But there is considerable judgement in valuing these losses. So this does not really resolve the question of timing. Wilson Ervin argues that the moment for bail-in should be very late, just prior to regular bankruptcy. But is that consistent with try to maintain the firm as a going concern? Won't stakeholders be turning their backs on the firm long before that?[8] Since under bail-in creditors other than depositors hold equity like cash flow claims shouldn't they be given enhanced control rights in the run-up to bail-in?

To deal with these issues it is useful to focus attention squarely on the important matter of who owns and who controls the bank in special resolution and subsequently when it stands on its own two feet again.[9]

This is important because the potential of bail in to avoid value destruction through fire sales of assets depends on the ability of senior management in charge of the bank during special resolution to maintain continuity in the bank's operations and to set the bank going in a new direction (growth path) subsequently.

Simply announcing an equity-for-debt swap which increases "over the weekend" the bank's loss absorbing capital does not do this because the new shareholders will not have time to meet and agree upon the new senior management team to replace the old which has been removed in special resolution.

There seems to be a need for the public authorities to play an active role, temporarily, at that stage. However, for this to be acceptable to investors and to be compatible with contract law, the role of the authorities needs to be properly defined and properly circumscribed.

One solution is to give the regulator (e.g. Treasury?) a "golden share" which has the cash flow claim of one ordinary share but gives it a decisive vote in shareholder meetings for the duration of special resolution. Upon entering special resolution, the regulator uses its golden share to appoint the acting CEO of the bank who in turn makes senior management changes as required and convenes shareholder meetings involving the new shareholders (ex-creditors) who have been bailed-in. The job of the acting CEO in special resolution is to maintain continuity. The job of the board of directors in special resolution is to develop the business and financial plan for the bank post-special resolution.

When the reorganization plan is accepted by the owner of the golden share this share expires (possibly replaced by other claims such as an amount of ordinary shares in compensation for liquidity support provided in special resolution) and the bank emerges from special resolution.

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[8] The case for a late bail-in trigger can be made on pragmatic grounds. Regulators who hope to avoid political pressure may prefer to delay intervening until it is obvious to all that the bank is on the verge of failing. And traditional credit market investors might feel leaving bail-in until very late means the debt affected by bail-in can be valued more easily. However, this is a consensus based on convenience and private interests. It does not necessarily maximize the value of the bank.

[9] The distinction between cash-flow rights and control rights attached to financial claims has been emphasized in the incomplete contracts approach to security design since P. Aghion and P. Bolton " An Incomplete Contracts Approach to Financial Contracting" *Review of Economic Studies*, 1992.

Note that this is a dynamic process which potentially can be repeated if following the initial bail-in further losses are found but only if sufficient non-deposit debt remains. Otherwise, the choices are bail-out or liquidation.

No doubt there are other institutional arrangements that would achieve similar results as the "golden share". The latter has been put forward here to underline the importance of coordinating special resolution with contract law. The golden share would give the authorities' rights an explicit basis from a contractual viewpoint and thus creates scope to limit those rights through application of contract law.

Contingent capital

These comments on control rights are relevant to contingent capital (cocos) and to the use of contingent capital in addition to or instead of making some forms of debt subject to bail-in.

An important issue is whether cocos have social net benefits that are greater than the net benefits of increasing capital of banks through equity issues. The main argument in favour of cocos is that they have much the same loss absorbing capacity as equity capital but that they are less costly. But why is contingent capital less costly than equity?

One reason that can be put forward is that bestows a tax benefit comparable (deductibility of interest for the purposes of corporate income taxation) to other debt. This will be the first thing on the minds of practitioners. However, this would appear to be a pure private benefit. A possible reply is that apparently there is some social benefit to using debt that justifies deductibility of interest for other forms of debt. If so, this should apply to cocos. But not all are convinced by this; witness the recent decision of the US IRS to not permit interest deductibility of cocos.

A second line of argument has been put forward by Bolton, Santos, and Scheinkman. The nub of the argument can be summarized briefly as "insurance is cheaper than self-insurance". Specifically, Cocos give a *committed* line of equity priced in good times when it is cheap not because times are good (i.e., the distress barrier is distant) but rather because problems of asymmetric information are slight. Later, in distress, problems of asymmetric information are great and the dilution costs of equity are great. Note that this reasoning supposes exogenous information arrival for example that insiders receive news about losses which they may have an incentive to hide, hence giving rise to asymmetric information.

An alternative argument, apparently new to the literature, is also based on asymmetric information, but in this case with endogenous information acquisition. Cocos are good because they incentivize another class of investors to monitor the bank. Specifically, equity is highly information sensitive. Senior debt is information insensitive (see Gorton and Pennachi). Cocos are intermediate. Away from distress, there is little prospect that the coco-creditor will ever run the firm (or more generally

have effective control rights). However as distress is approached the possibility of transfer of control becomes more real. Then coco creditors will extend more effort.[10]

Why does this information effect work more for cocos than for subordinated debt?

1. Subordinated debt will be given control rights only through the operations of bankruptcy. Usually in bankruptcy they will receive cash or restructured debt. Less often they will get equity. So receiving control rights is a low probability event. Furthermore, they receive the rights only after a substantial delay in most bankruptcy processes which would yield diminished assets where the information that might have been acquired earlier is not likely to be relevant. In contrast, cocos receive control rights when the trigger is hit. This is before bankruptcy. This is a higher probability event and the information would be put to use quickly.
2. Also, it may be that cocos could be given enhanced control rights outside of distress through restrictive covenants. This may have the effect of incentivizing incumbent shareholders and management to issue equity as price of cocos drops and greater interference from coco creditors kicks in.
3. This argument could apply even if cocos are combined with bail-in for other unsecured, uninsured creditors. Specifically the market based trigger for cocos could be set at a level that is likely to be hit before severe financial distress which would induce bail-in based on a regulator's decision. In this case there would be a waterfall of recapitalizations and ownership changes as the losses of the firm become progressively worse. The intent is that as the vice tightens tough (financial and real) restructuring decisions will be taken by the firm. In the Lehman example, Dick Fuld's grip on the firm would have been loosened by the conversion of cocos and the firm would have been forced to realize write-downs earlier.

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[10] See, Boot and Thakor for a theory of financial structure emphasizing the role of alternative security designs in creating incentives to invest in information gathering (i.e., monitoring).

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