

Sub debt - silver bullet or a big dud?

The mandatory subordinated debt concept, which would use subordinated debt to inject market discipline into banking supervision, has become the "flavour du jour" among academics and regulators. Nonetheless, it is a bad idea, argues Bert Ely.

American academics and regulators have become quite infatuated with the notion of relying upon the mandatory issuance of subordinated debt as a tool to enhance government supervision of large banks. Bankers and regulators everywhere should familiarise themselves with the subordinated debt concept because, like many American innovations, good or bad, this concept may gain universal applicability even though it is fatally flawed.

Briefly, the mandatory subordinated debt concept envisions a regulatory requirement that large banks frequently issue publicly traded subordinated debt under highly prescribed rules rigorously enforced by government banking supervisors. If market signals sent by a bank's subordinated debt suggest that the bank has become too risky, and therefore prone to failure, supervisors would rein in the bank. The market signals would be the yield, relative to a benchmark yield, on the bank's newly issued subordinated debt as well as the yield on the bank's debt trading in the secondary market. In effect, the subordinated debt concept seeks to inject market discipline into government banking supervision.

The mandatory subordinated debt concept is fatally flawed because of the unstated premises on which it is based as well as its structure and operation. The next section of the article will discuss the concept's flawed premises. Structural and operational flaws will be examined after a

more detailed presentation of the concept. The final portion of the article will address the issue of developing better supervision of large, complex, and globally active financial organisations.

False premises

The subordinated debt concept founders on numerous false premises. Fundamentally, the concept is premised on the entirely untested belief that market signals sent by a risky bank's subordinated debt will publicly embarrass government supervisors to do the job they are being paid to do - crack down on weak banks and bad banking practices before insolvency occurs. There are many reasons why supervisors may fail to act in a timely manner - spinelessness, incompetence, corruption, knuckling under to political pressure, or occasionally, not being aware of problems inside a bank. Clearly, for whatever reason, banking regulators failed badly in the American savings-and-loan and Japanese banking crises. Would the market signals sent by subordinated debt have prevented those supervisory fiascos?

Government banking supervisors do not suffer from a lack of data about the condition of a bank. In fact, supervisors not only have, or certainly should have, sufficient access to non-public data about a bank's condition, but they can, if they want, have continuous access to that data. For example, a US national bank with \$100 billion of assets will pay its supervisor over

\$4 million annually in fees, which is sufficient to keep a crew of at least 16 examiners and supervisors constantly scrutinising the bank internally. On the other hand, the financial markets rely primarily upon quarterly releases of highly summarised data to monitor a bank's financial condition.

Supervisors can, of course, also weigh existing market signals, such as market-to-book ratios for common stock, yields on voluntarily-issued subordinated debt, and debt ratings issued by the rating agencies as well as gossip among bankers, to assess the degree to which a particular bank is being managed in a reckless manner. The advocates of frequent mandatory issuance of subordinated debt by large banks apparently believe, without solid evidence, that government supervisors will respond to signals sent by subordinated debt when they often fail dismally to respond to a multitude of existing signals, both public and private.

The second flawed premise is that subordinated debt yields will send a better market signal than common or preferred stock prices. Yet the evidence supporting that premise is mixed, at best. This may be the case because sometimes yields on subordinated debt reflect market conditions rather than changing credit assessments of their issuers. Further, as will be discussed below, the yield on subordinated debt can be manipulated in a manner that could send a false signal about a bank's financial condition.

The third flawed premise is that subordinated debt holders will act differently than stockholders because they only have downside risk, but no upside potential. But that is not true if a speculator buys a troubled bank's debt that already is selling at a substantial discount from its face value. That investor will have a significant opportunity for price appreciation, particularly if he borrowed a portion of his purchase price. Therefore, like common stockholders, he will favour actions that boost the bank's market value. As a creditor, he may even capture a relatively larger portion of the initial increase in the

bank's market value than will the bank's stockholders.

The fourth flawed premise is that banks should float entirely, or nearly so, on their own capital so as to minimize the risk of loss to government deposit insurance schemes or worse, taxpayers. Yet that notion runs counter to the fundamental principal of all insurances, which is to spread the risk of loss beyond the insured entity and over a large number of insureds. That risk-spreading permits each insured entity to operate with higher capital leverage than it could were it uninsured.

A marketplace-determined insurance premium gives an individual or business enterprise (which banks are) the basis for properly calculating the extent to which it will protect its creditors with its own capital versus buying insurance that shifts the entity's residual insolvency-risk to third parties. This balancing act optimises insurance losses instead of needlessly minimising them. Properly priced insurance delivers genuine economic value, as evidenced by the centuries-old existence of insurance and the robustness of today's insurance markets. The subordinated debt concept ignores the value added of insurance, thereby threatening the competitiveness of banks subject to a mandatory subordinated debt requirement designed to minimise deposit insurance losses.

Finally, premising a concept on the notion that banks are different from other types of financial services providers ignores the emergence of managerially-integrated financial firms, such as Citigroup. It will become increasingly difficult to differentiate the banking function from other financial activities as technology and cost reduction



Bert Ely, the principal in Ely & Company, Inc., is a financial institutions and monetary policy consultant in Alexandria, Virginia. His website is www.ely-co.com

pressures drive the integration of banking, insurance, securities, and asset management at the product level. The concept of a bank must expand to encompass all financial services activities or the term will become irrelevant. What is viewed as a silver bullet for banking supervision fails to address the challenge of properly supervising large, globally active, and highly integrated financial conglomerates.

The subordinated debt concept

I now examine the concept and demonstrate its flaws in more detail. Although details differ among the numerous subordinated debt proposals, what follows are their common features:

- All banks over a certain size (generally \$10 billion in assets, or more) must have subordinated debt outstanding at all times exceeding a certain percentage of their total assets, say two percent, or higher.
- Qualifying debt must be subordinate in all regards to the bank's depositors and other general creditors, it must be non-callable (but in some proposals puttable), not collateralized, and it must not be convertible into equity capital.
- Only debt with more than a minimum maturity (generally a year) would be qualifying subordinated debt.
- A bank must issue subordinated debt frequently, say at least quarterly, so that the bank is constantly testing the saleability of its debt. Further, the debt must carry a large minimum denomination so that only institutional investors can buy it.
- Generally, even if the bank is owned by a holding company, the subsidiary bank must issue the subordinated debt.
- Bank insiders (officers, directors, and key stockholders) cannot own any qualifying subordinated debt nor can the bank purchase any of this debt in the secondary market.
- Interest payments on, and principal repayments of, qualifying subordinated

debt can be suspended if the bank's financial condition has deteriorated significantly.

- Under some proposals, subordinated debt can count for a greater portion of a bank's total capital (common stock, preferred stock, and subordinated debt) than is permissible today under the Basle risk-based capital rules.
- The bank's supervisor is supposed to take punitive action against a bank if the financial markets send adverse signals about the bank through the yield on its subordinated debt. For example, if the yield on the bank's debt in the secondary market approaches junk-bond levels, say with a yield equivalent to BBB-rated corporate debt of a comparable maturity, then the regulator must take over the bank and treat it as an insolvent institution. Another, and possibly stronger market signal would be the inability of a bank to sell new subordinated debt except with a junk-bond yield.

Flaws in the concept

The subordinated debt concept contains numerous inherent flaws, some more evident than others. Principal flaws are as follows:

- Like all banking regulations, a mandatory subordinated debt requirement would be arbitrary, reflecting the one-size-must-fit-all nature of all government regulations. Therefore, such a rule could not be tailored to reflect the relative riskiness of a particular bank's assets, the quality of its management, or some unique feature of the bank.
- A bank owned by a holding company would face the additional expense of providing a level of disclosure already required of publicly-owned holding companies. All large US banks are owned by holding companies as are some large banks elsewhere. Although two-tier disclosure might not be required if the bank constitutes more than a specified percentage of the holding

company's total assets, increased conglomeration within the financial services industry would precipitate more two-tier disclosure. Facing a mandate to issue subordinated debt frequently, a bank experiencing some difficulties might be more tempted to mask its problems than if it could choose when it issued subordinated debt. More subtly, disclosures by a bank as detailed as the parent company's disclosures would not necessarily be symmetrical, which would make it easier for the holding company's management to obfuscate activities outside of the bank. While that might not concern the bank's supervisors, it could concern insurance and securities supervisors as well as investors in the holding company's stock.

- The advocates of mandatory subordinated debt assume an unlimited marketplace appetite for such debt, but that is an untested assertion. Hence, a mandatory issuance requirement might force too much subordinated bank debt into the financial markets, with two undesirable consequences. First, to the extent that investors wisely limit how much risk they assume in any sector of the economy, yields would be forced up on bank-issued subordinated debt. That artificial boost in yields would at least partially invalidate comparisons of bank subordinated debt yields with yields on non-bank subordinated debt. For example, a bank with yields comparable to a BBB-rated manufacturer might otherwise be an A or even AA-rate institution. Second, to the extent that higher yields on bank subordinated debt cause investors to relax their sector limits, non-bank firms might be crowded out of the subordinated debt market.
- The frequency-of-issuance requirement could further boost the cost of bank subordinated debt if a bank was forced to sell debt under adverse market conditions. The fall of 1998 certainly was a highly undesirable time to issue subordinated debt, in the aftermath of the Russian debt crisis and Long Term

Capital Management's problems. It is not clear how a supervisory requirement which hikes a bank's funding costs enhances that bank's safety and soundness. Trying to ease this problem by giving regulators the latitude to defer subordinated debt issuance during difficult market conditions introduces supervisory flexibility that the advocates of mandatory subordinated debt are trying to eliminate.

- Even in normal times, there is much noise in the financial markets that makes it difficult to accurately set trigger points for mandatory supervisory intervention. That noise includes changes in bond market supply and demand, volatility in adjacent stock markets, altered perceptions of sector risks, and macroeconomic conditions generally. Of course, giving regulators the latitude to reflect marketplace noise in their supervisory judgements creates the potential for regulatory forbearance. Also, setting intervention trigger points would become complicated if sound banks fell into different peer groups, based on the amount of subordinated debt they issue or their marketplace focus.
- Despite its intent to eliminate supervisory flexibility in banking regulation, the mandatory subordinated debt concept is as highly reliant on explicit supervisory action as any other arbitrary intervention rule. For example, in a paper, "Reforming Bank Capital Regulation," issued in March 2000 by the US Shadow Financial Regulatory Committee, its authors stated that mandatory subordinated debt "would provide an automatic source of market discipline over banks that also acts as a check against regulatory forbearance ... [b]ut such a market mechanism can work only if regulators can be depended upon to enforce compliance with the minimum requirement - hence the need for clear rules that make enforcement credible." No matter how clear the rules and how strong the market signals, only

a committed government banking supervisor can make a mandatory subordinated debt rule work. This is no different than any other capital rule.

- Perhaps the fatal, and deliciously ironic, flaw in the mandatory subordinated debt concept is that it becomes a tool for manipulation by mean-spirited short-sellers. This flaw stems from the bar against a bank, its holding company, or

restrict the universe of potential subordinated debt owners, driving up yields on mandatorily issued subordinated debt. In another manipulation, assuming he could borrow sufficient subordinated debt, the speculator would dump the debt in a short sale, driving down the debt's market value, and then close out his short position for a profit.

“Perhaps the fatal, and deliciously ironic, flaw in the mandatory subordinated debt concept is that it becomes a tool for manipulation by mean-spirited short-sellers.”

key insiders, repurchasing its subordinated debt or otherwise making a market in it, something that a bank generally can do with its common stock. The manipulation would work as follows: A speculator would quietly buy some portion of a bank's outstanding subordinated debt. Then, after short-selling the bank's common stock, he would dump the subordinated debt on a relatively illiquid bond market, driving down the debt's price. The secondary market yield on the debt would rise, possibly to a level that should spark supervisory intervention.

That intervention, or even the possibility of intervention, would depress the bank's stock price. The speculator would then close out his short position, taking a gain that would exceed his loss on the subordinated debt he had sold. Barred from buying its subordinated debt, the bank would stand by helplessly, unless it tried to frustrate this attack by buying back its common stock. However, it would then be paying out equity capital, thereby weakening itself. Barring the owner of a bank's subordinated debt from holding any position in that bank's stock would be unenforceable for a bank or holding company whose securities trade in the global marketplace. That bar would further

Improving supervision

The goal of the mandatory subordinated debt concept is laudable - place increased reliance on market forces for banking supervision. However, like other capital regulations, it will fail because it skirts, rather than confronts, the fundamental problem in government banking supervision - supervisors are not sufficiently reliable. Rules mean little if a supervisor declines to act or is blocked from acting by his political masters. There is no such creature as a politically independent government banking supervisor, nor should there be.

The supervision problem is compounded by the proliferation of financial products which incorporate banking, insurance, and/or securities features and by the growth of financial conglomerates offering these integrated products on a regional or global basis. Therefore, it is increasingly unrealistic to view banking as a business which can be regulated and supervised in isolation on a country-by-country basis. Arguably, the subordinated debt concept could be extended to encompass all the activities of a financial conglomerate, but that raises interesting yet unexplored questions about the breadth of government safety nets.

As financial market integration and globalisation increases, the reliability of government supervision of financial firms

becomes more questionable. Greater reliance should be placed on market forces in financial supervision by introducing them at the primary level — within individual financial institutions and based on continuous access to non-public data. Since taxpayers should not be subject to the insolvency risk of financial firms, even during times of great systemic disturbance, the insolvency risk of individual institutions as well as their supervision must be fully privatised, especially for large, globally active financial conglomerates.

One model for modernising financial supervision is the author's cross-guarantee concept for contractually delegating the supervision of individual financial companies to the private-sector in a manner that would create productive competition among private supervisory firms.

Freely negotiated cross-guarantee contracts, which would unconditionally guarantee all of a financial company's

liabilities, would fully privatise insolvency risk, company-by-company, by syndicating that risk to private-sector guarantors who would be paid a risk-sensitive premium. The guaranteed company and its direct guarantors would jointly select the supervisory firm that would, through its access to non-public data, monitor the company's compliance with its cross-guarantee contract. The cross-guarantee marketplace would have the flexibility to tailor supervisory requirements to the business strategy of each guaranteed company. Risk-sensitive premium rates would optimally allocate each guaranteed company's insolvency risk between its stockholders and its direct guarantors.

Other models for modernising financial supervision may yet emerge to successfully inject market forces into financial supervision. The mandatory subordinated debt concept fails to meet that test.

HOW COUNTRIES SUPERVISE THEIR BANKS, INSURERS AND SECURITIES MARKETS

As financial markets globalise, finance professionals must understand financial regulation in countries across the world.

How Countries Supervise their Banks, Insurers and Securities Markets is a brand new guide to the regulatory systems of 137 countries. It identifies which agencies supervise banks, insurers and securities markets, describes their activities and gives full contact details. It features 277 agencies, with detailed up-to-date information on recent institutional changes in the UK, Japan, Korea and Australia. Entries include information on budgets, staffing levels and key contacts.

Available now for £110 (UK), £120 (Non-UK)
To order please use the order form on the last page.

