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Simpler banking rules would be safer: report; A C.D. Howe institute report argues in favour of using less complex market-based solutions and capping deposit insurance

JANET McFARLAND

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Modern banking regulation has become "highly complex and prescriptive" but doesn't deal with the fundamental problems that cause financial crises, a new report argues.

A study released Wednesday by C.D. Howe Institute vice-president Finn Poschmann proposes bold changes to the banking regulatory system. Notably, he argues in favour of reducing and capping government-provided insurance on bank deposits, and requiring major banks to issue a new form of bonds that would convert to equity to shore up banks in times of trouble.

"The key lesson is that there are simple alternatives and supplements to the current high prescriptive approaches to bank conduct and its regulation," Mr. Poschmann argues in the report.

"Thinking more deeply about the role of incentives in steering bank behaviour and market responses to it would likely be beneficial to all participants in the financial marketplace."

Mr. Poschmann writes fondly about the early days of bank regulation in North America, when shareholders – who were often also the bank's senior managers – held a now-defunct form of shares that required them to contribute funds if a bank was failing.

While small banks proliferated and failures were far more common than today, the report says depositors typically lost less than five cents on the dollar when the dust settled, according to studies of the U.S. banking system between 1865 and 1920. Though regulators were virtually non-existent and there was no deposit insurance, financial crises tended to be "sharp, brief and localized," while crises today are long and contagious.

But reverting back to such a system today, while not impossible "seems implausible; winding back clocks or putting genies back in bottles, rarely can be done," Mr. Poschmann acknowledges. Instead, the report says regulators should build in old-fashioned style incentives, in a more modern form.

A key step, Mr. Poschmann argues, is to cap the amount of insurance provided by governments to protect depositors' money in the event of a bank failure, saying excessive insurance reduces everyone's incentive to operate carefully.

Mr. Poschmann says federal deposit insurance that provides maximum coverage of $100,000 per bank account offers reasonable protection to small depositors. But he takes issue with moves by several provinces – including Manitoba, Saskatchewan, Alberta and British Columbia – to offer unlimited

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guarantees for credit union deposits, which are provincially regulated, as well as other provinces' moves to raise the cap on insured deposits to $250,000.

"This is dangerous, not least because deposit insurance rarely is priced according to risk: the system provides a taxpayer-backed subsidy to risky institutions at the expense of less-risky ones, and potentially at significant risk to taxpayers," he writes.

Mr. Poschmann says provincial coverage "must be wound back to a common and more prudent national standard."

An even more dramatic reform in the study would be the creation of a new form of bank debt to make banks more secure in case of failure.

Mr. Poschmann says recent reforms in Canada, the United States and Europe following the 2008 financial crisis focused on banks' required liquidity and capital ratios, but should have put more onus on the marketplace to curb unsafe behaviour.

He favours creating a new form of debt called Equity Recourse Notes (ERNs) – first proposed last year by academics Jeremy Bulow and Paul Klemperer – which would be long-term bonds issued by "large systemically important financial institutions" in amounts to match their unsecured debt. The bonds would see interest paid out in bank shares, rather than cash, if the institution's share price drops below a pre-determined price threshold.

If the share price recovers, cash interest payments would resume, but in the meantime banks would increase their liquidity when most needed at a time of major stress. The conversion to equity would be "entirely automatic" and determined by market forces, and would not require judgment calls on the part of a regulator, the report argues, which means there would be no behind-the-scenes lobbying and no reliance on valuations to determine a bank's regulatory capital ratios.

The conversion to equity would also automatically reduce a bank's leverage ratio and increase its regulatory capital ratio, avoiding the normal cycle of requiring banks to boost their capital at the exact time when the institution is under greatest financial distress, Mr. Poschmann argues.

"Regulators should rely less on capital adequacy rules, which are subject to lobbying and to gaming through regulatory capital arbitrage, and tend to be procyclical," the report says.

Mr. Poschmann concludes there is "value in simplicity: sometimes, perhaps often, simple is better."

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DOW JONES

NATIONAL POST

A better Basel mousetrap to protect taxpayers

FINN POSCHMANN

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Ottawa is soon to release proposals on bank bail-ins, the process by which bank bondholders, who seem always to get bailed out when banks get into trouble, instead might be bailed in, becoming shareholders. The idea is to avoid government bailouts of institutions that are thought too big to fail and to limit the damage to third or fourth parties if they fail anyway.

Bail-in debt may come to exist alongside, or even displace, debt now being issued in accordance with the Basel banking committee guidelines, known in banking circles as Basel III-compliant non-viability contingent capital, NVCC. Bail-in debt and NVCC serve similar, perhaps indistinguishable, financial stability goals.

NVCC , as envisioned by the Basel regulators and as they are now entering the market, is a form of debt that banks may issue. If a bank's equity capital dips low relative to its asset portfolio, the regulator may require NVCC to be converted to common equity shares. Convertible preferred shares, with quasi-guaranteed returns, are a form of such debt.

The idea is that the regulator - the Office of the Superintendent of Financial Institutions in Canada - will keep a close eye on key indicators of bank health, such as capital adequacy ratios. Should a bank's ratio of core capital to risk-weighted assets fall below a safe level, or the bank otherwise approaches the point of "nonviability," the nether region between being alive and dead, OSFI might pull the conversion trigger, and require that NVCC debtholders become common shareholders instead.

Not a bad idea, from a distance. Bondholders tend to be preferred creditors, and so provide banks cheap capital. When the going gets tough, why not have them share more risk, and go to the back of the creditor priority line, alongside common shareholders and other residual claimants on income and assets? Irrespective of how bond markets might feel about that, problems will arise in practice. The moment a regulator determines that a bank is on the cusp of nonviability, the bank's fate will be almost certain. The regulator's eventual announcement will have a devastating reputational impact.

Even before an institution reaches public nonviability, there will be fights and lobbying. What counts as capital? How risky are the bank's assets? What is the right capital ratio to watch? How quickly might the bank get back on the good side of the regulator? Knowing that regulators and their political masters are loathe to euthanize national financial institutions, investors have been snapping up the NVCC-compliant issues that have come to market in Europe and Canada. Analysts and ratings agencies acknowledge the existence of the regulatory conversion triggers, and go on to say that the possibility of a trigger's being pulled is a "remote event." They are right.

Moreover, because a regulator's shutdown of a major financial institution is indeed a remote event, NVCC

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is unlikely to do much for market risk-monitoring.

There is a better way. Jeremy Bulow of Stanford and Paul Klemperer of Oxford have proposed a better mousetrap, labelled equity recourse notes, or ERNs.

Bulow's and Klemperer's ERNs are also contingent capital, but without a regulatory capital trigger. ERNs are long-term bonds, issued by large systemically important financial institutions, and would displace some, most, or all of issuers' existing unsecured borrowing - meaning bonds, for the most part.

ERNs would specify equity conversion as a function of the stock price at the time of issue, not at the time of conversion, unlike Canada's NVCC to this point. Bulow and Klemperer suggest 25% of the stock price at the time of the note issue. If, at the time when interest or principal payments on the ERNs came due, the stock price was less than 25% of the amount specified in the notes' capital structure, the bank would issue stock at the prespecified price, instead of paying out cash.

It could go as follows: if a lender's stock price was $100 at the time of ERN issue, but less than $25 at the time that a $1,000 interest payment was due, the lender would issue stock as payment: 40 shares, being the number of shares at the preset conversion price required to equal $1,000. If and when the stock price was higher, interest payments could resume in cash.

This simple mechanism has impressive financial stability features. Suspending interest payments would increase firm liquidity exactly when needed - when under stress. The conversion of debt to equity would be entirely automatic, and determined by market forces: there would be no requirement for judgment calls with respect to a trigger point.

There would be no sudden shock; markets would hedge around a possible conversion, and place puts and calls on the debt; it would be a gradual process. The paymentat-a-time conversion feature will prevent gaming of the "death spiral" sort, whereby cagey investors might buy debt and short the shares at the same time.

Incremental conversion would automatically improve the bank's leverage ratio, and increase its regulatory capital ratio. This would avoid forcing firms to limit lending and increase capital ratios at exactly the time when the bank, and likely the broader financial system, was already under threat, and mitigate worries over institutions that are too big to fail.

As Ottawa contemplates new rules on bail-in debt, it is good to know that better mousetraps are always about.

Finn Poschmann is vice president, research, at the C.D. Howe Institute. "Shareholder Liability: A New (Old) Way of Thinking about Financial Regulation," is available at www.cdhowe.org.

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