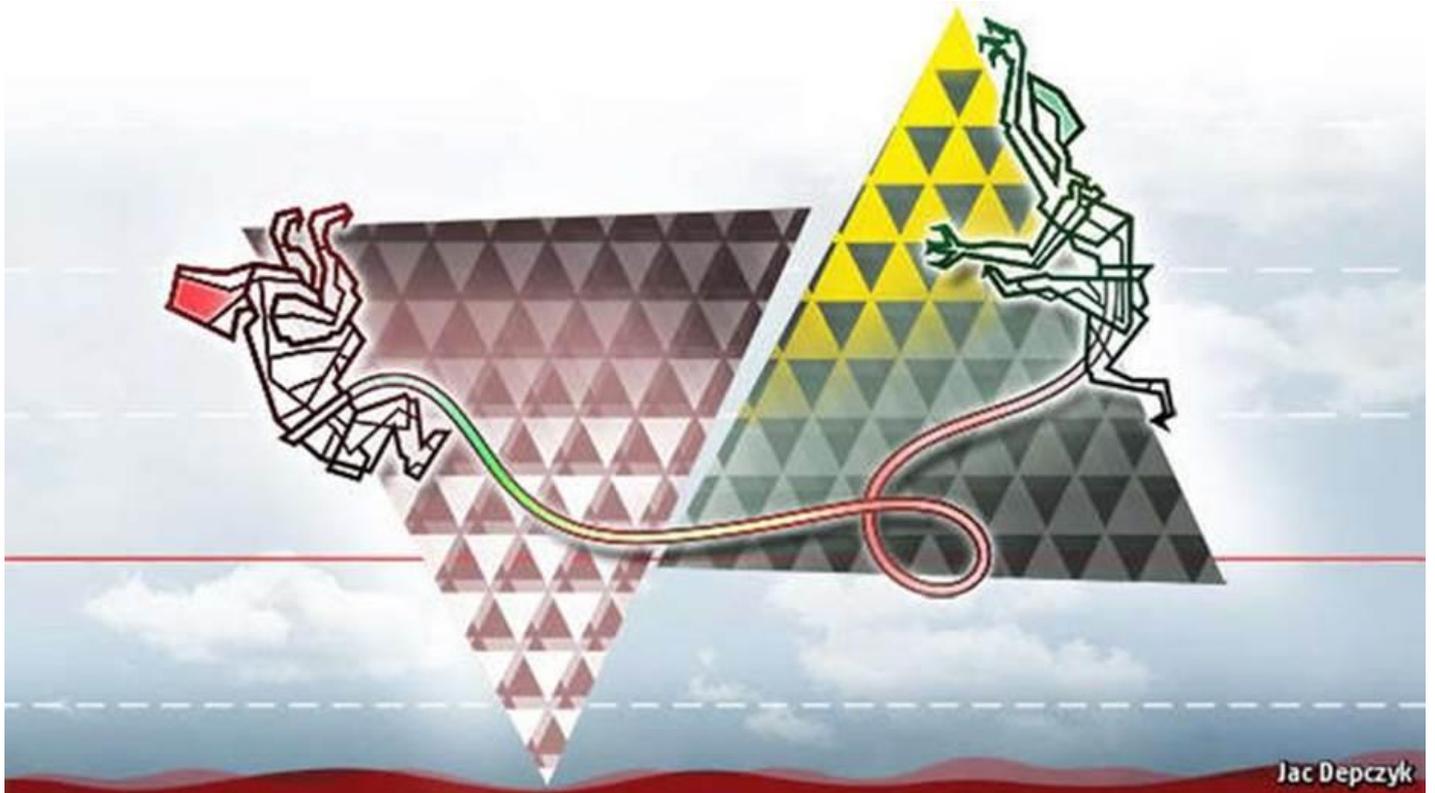


Free exchange

Miraculous conversion

A new proposal seeks to make banks safer but keep regulators at a distance

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ALMOST everyone agrees: before the financial crisis, banks were hooked on debt. In 2007, a year before its failure, Lehman Brothers held equity (the money shareholders put into the business) worth just 3.3% of its balance-sheet; virtually all the rest was financed by borrowing. Leverage is an elixir that makes profits soar when times are good, but magnifies losses when the economy sours. Since the crisis, regulators have cranked up their supervision of banks and ordered them to hold more equity and less debt. A new proposal would tweak this model, making banks safer using the discipline of the market rather than the heavy hand of the state.

Banks like debt for several reasons. First, it is cheap compared to equity: banks' creditors charge relatively little because they know they are likely to be bailed out if the bank fails. Tax breaks for interest payments make debt cheaper still (see this week's briefing). And unlike equity, issuing it does not entail any dilution of control. But regulators prefer equity, which can absorb losses in downturns and thus ward off bail-outs.

A new breed of hybrid instruments is billed as the best of both worlds. So-called contingent convertible bonds, or "cocos", turn into equity when a bank is struggling, trimming its debts and interest payments. Coco issuance has soared since 2010, as banks have sought to keep regulators happy by bolstering their ability to withstand losses. These fancy bonds have the upsides of debt in good times, but provide a cushion in a crisis.

Or so the theory goes. Cocos usually convert when regulators decree that a bank's capital has fallen below some threshold. In the height of a crisis, that puts regulators in a bind: announcing that a bank is weak can cause panic. A conversion also imposes sudden losses on bondholders, who find themselves holding shares worth much less than the bonds that spawned them. If the bondholders are themselves in distress, those losses can reverberate around the financial system.

Jeremy Bulow of Stanford University and Paul Klemperer of Oxford University see a way to overcome these problems with a new instrument called an equity recourse note, or ERN. Like a coco, an ERN functions as debt in normal times. But the trigger for the conversion is the bank's share price, rather than a regulatory measure of capital. When the share price falls by enough—say, to 25% of its initial value—the bank can make repayments on the bond with new shares rather than with cash.

For example, suppose a bank issues a \$50m ERN when its shares are worth \$100 each. The ERN would pay interest like a normal bond unless the share price stood below \$25 on the day a payment was due or the bond was to be redeemed. In that case, investors would be paid in shares valued at \$25 each—even if the market price was lower still. So to redeem the \$50m ERN, the bank would issue 2m new shares. Since the share price is below \$25, those new shares would be worth less than \$50m, meaning the conversion would be a good deal for the distressed bank.

This avoids several problems with cocos. There is no uncertainty about how regulators will behave. Abrupt losses are minimised: investors can see when the share price is nearing the trigger, and if it recovers, cash payments resume. Because the new shares are worth no more than the cash saved, ERN conversions should shore up a bank's share price (by contrast, when cocos convert, enough new shares are created to push the price down).

ERNs might benefit the economy, too. Distressed firms usually struggle to raise new funding thanks to a problem known as “debt overhang”: new cash is diverted to pay off debts rather than fund new investments. That makes funding pricier, so banks would rather shrink their loan books than issue shares, starving the economy of credit. This problem does not arise with ERNs. If the distressed bank issues new ERNs when its share price falls to \$25, the conversion point for the new note would be only \$6.25, meaning with a share price between \$6.25 and \$25, new investors would receive cash payouts while old ones still get shares. That puts debt overhang into reverse, helping to tame credit booms and busts—something not even more equity can do.

The best of all worlds

This might seem too good to be true; indeed, ERNs are untested. It is not certain, for instance, that investors would be keen to swap conventional bonds for riskier, more complex instruments. However, the two economists argue that, for firms, issuing ERNs is just like issuing normal debt bundled with options allowing them to sell shares at the conversion price if they so wish. That should make ERNs easy to value. It also means investors can turn ERNs back into riskless debt by buying their own options to sell the shares on, so that they end up with cash in any event.

A better criticism of ERNs applies to all hybrid instruments: if banks' preference for debt is artificial—the tax benefit, for instance, is a distortion in its favour—then a simpler solution is to require much more equity. Bankers may complain, but only because they have to pay more for funding.

Yet hybrids allow firms, not regulators, to decide on the best funding mix. And harnessing the benefits of both debt and equity is a laudable aim that has applications beyond banks. For instance, Robert Shiller of Yale University has called for governments to use bonds with interest tied to GDP growth, so that government debt is less burdensome in a slump. Others want mortgage debts to be automatically written down when property values fall, so that house-price risk is borne not solely by indebted homeowners. Rigid debt contracts may seem good in booms. But in a downturn, flexibility is everything.