Discussion: Anything but Equity? On Banks' Preference for Hybrid Debt

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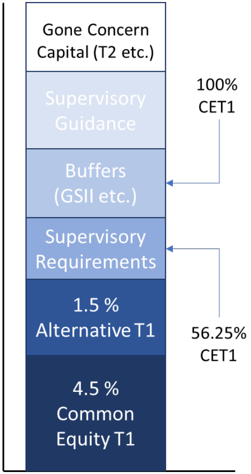
The Capital Stack

- Capital regulation mix of different requirements, liabilities and triggers.
- This paper focuses on going concern non-equity capital (AT1).
- Contingent convertible bonds (CoCo's):
  - junior.
  - writedown/conversion threshold (minimum CET 1 ratio $\leq 5.25\%$)
  - perpetual, callable after 5 years & called in practice.
  - discretion on payouts (banks + supervisors).
- Requirement 1.5% of RWA. Can be met by CoCos or convertible debt.



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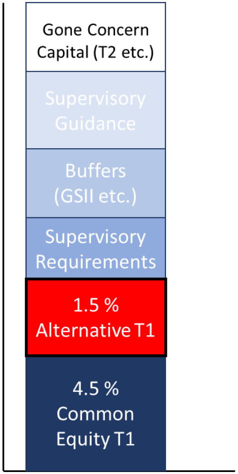
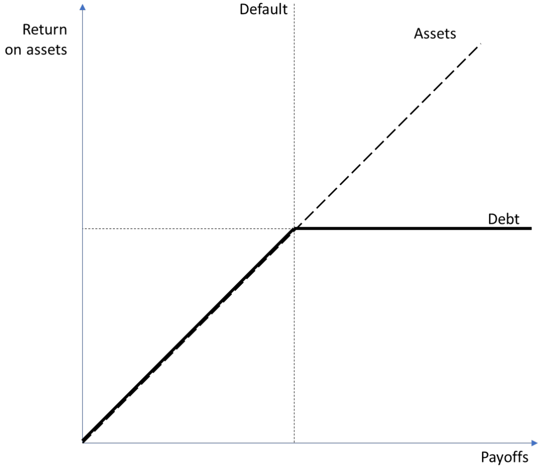


The Logic of CoCos



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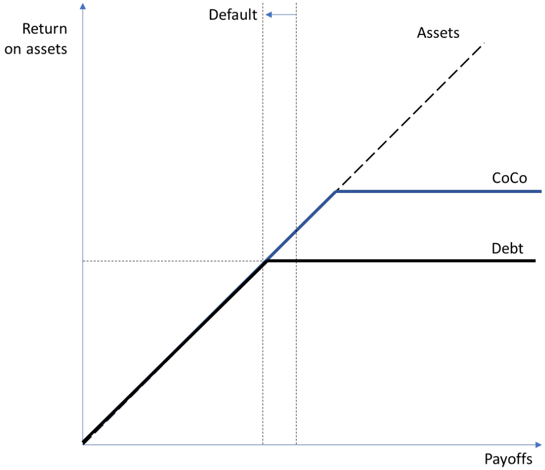

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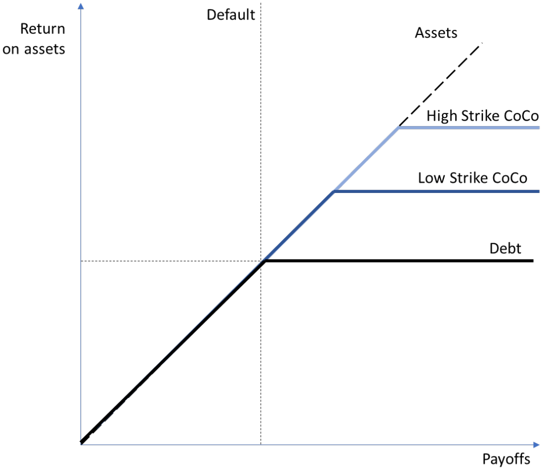

Research question: what determines a bank's choice of its AT1 capital structure?

Key Findings: What Correlates with CoCo Issuance?

Minimum-Trigger CoCos

- Issuers tend to have lower Adjusted Tier 1 capital ratios.
- More likely to be issued in low-tax jurisdictions.
- Issuers exhibit higher systemic risk.
- Larger banks are more likely to issue, possibly due to market access or regulatory arbitrage capacity.
- Junior CDS spreads do not decline post-issuance; in some cases, they increase.

Higher-Trigger CoCos

- Issuers have Tier 1 ratios similar or superior to non-issuers.
- Issued by banks with higher impaired loans to net loans.
- No strong tax sensitivity in issuance patterns.
- Markets have muted response to issuance.

Why I like the setting

Reasons why banks are adverse to issuing equity:

1. Tax shields
2. Deposit market power
3. Government guarantees
4. Adverse selection/issuance costs
5. Dynamic considerations (ratchet effect, overhang etc.)
6. Maturity transformation
7. Cognitive costs...

etc.

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Zooming on AT1 triggers compares liabilities of increasing similarity to equity, while killing off these mechanisms. Coupons also observable.

Comment 1: An organising framework is needed – what are bank's incentives? Use the setting to devise clean(er) tests of mechanisms.

Example: Tax shields

- A simplistic way of thinking through banker's incentives:
  - " 5.25% vs 7%, doesn't matter. When a trigger is hit, I am out of the money anyway."
- Choose AT1 to maximise the value of the tax shield:
  - Issuing 7% trigger commands a higher coupon, cheapest way to distribute earnings.
- Some evidence of this in the paper:
  - High tax jurisdictions see more high trigger issuance.
- Would be good to see bank-level variation – e.g. do banks with interest expenses $\approx$ EBITDA issue more low trigger AT1?

The role of convertibility types

- AT1 can be issued with different degrees of convertibility:
  - equity conversion.
  - temporary writedown.
  - permanent writedown.
- Call option to the investor. Ceteris paribus, should lower the coupon.
- Equity conversion most common (cheapest, goes against tax shield story).
- Customisation likely also reflects investor preferences.
  - who are the investors? do banks design securities to cater to their demand?
- Together, suggests not bundling across different forms of bonds.
  - Do more on

Is the AT1 structure a constrained choice?

- Basel rules prescriptive of what classifies as AT1. But still grants supervisors discretion.
- For example, pillar 2 requirement: supervisors have discretion to decrease the AT1 share.
  E.g. ECB guidance:

  Under Article 104a of the Capital Requirements Directive, banks can fulfil Pillar 2 requirements with a minimum 56.25% of Common Equity Tier 1 (CET1) capital. Competent authorities may require a bank to meet its additional own funds requirement with a higher portion of CET1 capital where necessary, taking into account bank-specific circumstances.

- Do supervisors have a say over triggers?
  - Can supervisory guidance be used to enforce higher triggers? Would generate a correlation with bank health.
  - Are investors concerned that supervisors could intervene to prevent low trigger debt being called? So the high trigger grants certainty/credibility.
- Use supervisory enforcement actions or Pillar 2 add-ons as explanatory variables for issuance decisions or trigger types.

Takeaways

- Need for a clearer organizing framework of bank incentives
- Suggest further exploiting bank-level variation (e.g., tax efficiency, regulatory pressure)
- More differentiation across CoCo design (trigger, loss absorption mechanism)

Very interesting paper! Thank you