Can Contracts Discipline Bankers? Bail-inable Securities and Financial Contracting

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The new Recovery and Resolution framework for banks was welcomed as a game changer in addressing financial stability concerns. In particular, the mechanism of internal recapitalisation through which junior and senior creditors are wiped-out and converted into ordinary shares to absorb losses (bail-in) was expected to significantly enhance the level of market discipline. Nonetheless, many studies cast doubts on the efficiency and feasibility of resolution. Similarly, new empirical evidence on market discipline are inconclusive. Moreover, both legal and economic literature so far only focused on price adjustment, neglecting any other possible channel that creditors make use of to discipline bankers, such as contracts.

In my paper, I bring to the spotlight “financial contracting” as a channel to discipline banks’ risk-taking given the incumbent financial regulation. Keeping incumbent regulation as a benchmark to assess the availability and efficiency of contractual clause is crucial in my setting. In fact, the new framework could not resolve the inherent tension between market discipline and financial stability. Indeed, for safeguarding the latter, both capital and resolution framework require financial instruments to comply with certain qualitative requirements in order to be counted as regulatory capital or bail-in eligible securities. Hence, the underlying contribution of the article is to shed additional light on the relationship between financial regulation and bank governance.

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First, I show how debt contracts are unable to discipline bankers since incumbent regulation prevents the parties from embedding in the agreement the tools usually employed to lower the agency costs of debt, such as covenants. Moreover, the resolution authority is endowed with considerable discretion, so that the course of action when a bank enters in distress is extremely uncertain and, accordingly, hindering market discipline.

In the second part of the paper, I argue that specific arrangements on contingent convertibles (Cocos) can enhance discipline both before and after the event of a bail-in. In fact, according to the incomplete contract theory, debt contracts serve the purpose of allocating control to (bail-inable) creditors, contingent to future and uncertain events (Aghion and Bolton, 1992). Through these lenses, I argue that cocos provide a way to contract out of unpredictability and efficiently allocate control when a bank approaches insolvency.

In the US debate, John Coffee had already highlighted the potential of cocos for bank governance, even though his proposal would have not been compliant with EU incumbent regulation. On the contrary, in continental Europe, cocos have been solely approached as instruments for early recapitalisation bypassing the equity market.

First, from a governance perspective, if cocos convert there is an immediate deleveraging of the bank, which has governance effects in terms of reducing risk-shifting incentives. Moreover, the governance status of cocos once they are converted into shares is not yet regulated (see CRR – Article 28), so that contractual arrangements can, at least partially, provide for it. The paper focuses on the importance of differentiating, within the possibilities granted by incumbent regulations, the voting and economic rights of the old and new shareholders. Moreover, it highlights the desirability of massive and early conversion, so to affect the control of the bank in a timely manner. Finally, it emphasises the desirability of an option to reconvert into cocos once the crisis has passed, so to elicit the actual risk-taking preferences of coco holders.

Nonetheless, cocos are not immune from problems either. Indeed, their potential to enhance both soundness and governance of the issuing institution has not been fully exploited yet. In fact, the first anecdotal evidence demonstrated a high aversion of both supervisors and regulators, scared by possible adverse market reactions, to let cocos suffer any early losses, which is – in the end – what they are designed for. For instance, in 2016 cocos issued by Deutsche Bank were not even allowed to skip a coupon, set aside conversion. If such a trend were confirmed, the governance potential of cocos would vanish as a soap bubble, making cocos nothing more than normal bail-inable securities. And, as discussed before, bail-inable securities have no potential of improving bank governance through contractual clauses.

In conclusion, I highlight the difference between cocos and bail-inable debt when it comes to governance: cocos, as long as contractual commitments are enforced, have the potential to contingently allocate control out of the discretion of the resolution authority, whereas bail-inable securities are radically unable to do so through contractual arrangements.

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