

Federal Reserve Bank of Cleveland

Subordinated Debt: Tough Love for Banks?

by Joseph G. Haubrich

Good parents understand the perils of overprotection. They know that letting their children grow up often means letting them take their lumps. The past two decades have reinforced a similar principle with respect to the safety and soundness of banks. Government protection sometimes does as much to create the problem as to solve it. Here is the economics of moral hazard: Banks, secure in the safety net offered by the government, feel free to take increasingly risky positions. Depositors, knowing their deposits are safe, don't care and will neither withdraw their funds nor demand a higher interest rate. The deposit insurance system then effectively insulates the bank from market discipline.

One proposed solution, or rather set of solutions, to this problem aims at restoring a measure of market discipline to the banking sector—the regulatory equivalent of cutting the apron strings. Several recent proposals hope to restore discipline by forcing banks to issue debt that is not guaranteed by the government—what they term subordinated debt.¹

This *Economic Commentary* examines the reasoning behind such mandatory subordinated-debt proposals and assesses the evidence on their possible success.

■ Incentives and Information

Subordinated-debt proposals would require, indeed force, banks or bank holding companies to issue some amount (usually 2 percent to 5 percent of total assets) of debt that is junior to deposits. In case of failure, the bank would be barred from making any payments on the subordinated debt until all depositors

(and any other senior debt holders) were paid off in full. Currently, many banks do issue some amount of subordinated debt, but there is no requirement to, and not all banks (or even all large banks) do so. The actual sub-debt proposals also specify further details, such as the debt's maturity, how much banks should issue, and so forth, but it's not worth examining those details without a clearer idea of how, in general, subordinated debt would increase market discipline. It does so by creating better incentives and providing better information.

The key incentive problem that regulators face in banking crises is the tendency to "go for broke." When a bank gets into trouble, often its best strategy for returning to health and profitability is to take big bets that might pay off. If that new shopping mall in the desert doesn't catch on, well, you were going to get closed down anyway. If it does succeed, you're back in business. In a phrase, the managers and owners (the stockholders) get all the upside gain from the risky loan, without bearing any downside risk. They're like a football team losing late in the fourth quarter: Time to try a "Hail Mary" pass that might win the game. Ordinarily, such a pass would be too risky, but now it gives the team a chance, whereas three yards in a cloud of dust up the middle certainly won't win.

What's wrong with a bank trying to return to profitability? The trouble is that when it goes for broke and ends up deeper in the hole than before, the FDIC—and ultimately other banks or the taxpayer—must pick up the bill.²

People who think banks could use some market discipline have proposed that subordinated debt could provide it. Are their proposals likely to succeed?

Subordinated debt is a way to change the incentives. It has some maximum pay-off—the promised principal and interest payments. This means that it does not share in the upside potential of equity. If the bank generates high profits, it doesn't give debt holders any more money. If a bank's income is low, all of it is used to pay depositors (or the FDIC). If income is somewhat higher, the bank can pay the holders of subordinated debt. Above that, when sub-debt holders are paid in full, stockholders get whatever remains. Stockholders like increased risk, because they get the upside gains but don't share in the downside losses. Depositors don't care, because they are insured. Subordinated-debt holders do care, because they don't share in the increased profits if the risky project succeeds, but they share in the loss if it does not. Thus, like the FDIC, which will be left holding the bag if the bank cannot pay depositors, sub-debt holders dislike risk.

How does this change the bank's incentives? Whereas before the bank could raise money for that desert mall by increasing deposits, it now must raise some of the money by placing subordinated debt. Potential investors, sensitive to the risk, will demand a higher interest rate, and the bank will find it harder to grow. Subordinated debt thus reintroduces market discipline and punishes the bank for taking on inappropriate risk. Furthermore, subordinated-debt holders' incentives are more closely aligned with those of the FDIC, which also dislikes increased risk at banks.

Subordinated debt changes the political incentives as well. Bank equity holders have an incentive to keep a poorly performing bank open as long as possible, even if that means greater losses for the FDIC; otherwise, they have no chance of recouping their losses. Subordinated-debt holders, however, want the bank closed down so they don't lose more. If the owners put political pressure on regulators, in the form of PAC contributions and so forth, sub-debt holders have an incentive to apply countervailing pressure.

The changed incentives lead directly to subordinated debt's other advantage—increased information. Because sub-debt holders put their money on the line, they have an incentive to monitor and observe the bank. It's as if banking regulators (FDIC, Federal Reserve, Comptroller's Office, the states) have enlisted a group of "Baker Street Irregulars,"³ an auxiliary force of interested persons who monitor changes in bank performance between regular examinations. The results of the "irregulars'" investigations become public knowledge through the price of subordinated debt. When the bank's behavior gets riskier, investors demand a higher premium for bearing that risk, and the interest rate on that debt increases. (Of course, all interest rates go up and down, so a better measure is the spread between a bank's subordinated debt and a Treasury note of similar maturity.)

Perhaps just as importantly, regulators themselves may find the increased information useful. Some proposals have suggested that the spread on subordinated debt be used to price deposit insurance or to signal supervisors that a bank needs closer attention. Some people even suggest that the market will do a better job of evaluating bank risk than will government regulators. Investment banks, hedge funds, and other large, sophisticated investors may well know more about how to value exotic options, interpret complex hedge provisions, or judge the viability of state-of-the-art systems for risk management. So, aside from more frequent monitoring, the "irregulars" may well catch things the regulators won't.

■ Proposals and How They Differ

Advocates for mandatory subordinated debt have not united behind any one specific plan. Proposals differ in the amount of subordinated debt required, what size banks would be subject to the requirement, how supervisors will use the information, and details about the debt's maturity, how often it is issued, and who may hold it.

The proposals generally call for a subordinated debt requirement of between 2 percent and 5 percent of total assets. Proponents who would require the debt in addition to banks' current capital favor the lower end of that range, while those who would allow it to substitute for current capital favor the higher end. Adding a 2 percent subordinated-debt requirement to the current capital requirements, for example, would oblige a well-capitalized bank to maintain a 12 percent capital ratio instead of the current 10 percent. The trick lies in setting a requirement large enough to make the discipline matter, yet not so large as to burden the bank unduly. While a larger number would probably make banks safer, it might reduce their lending and retard economic growth. The proposals also differ regarding the assets used to calculate the percentage. Some want to use a fixed percentage of a simple balance-sheet item like total deposits, while others want to use risk-weighted assets.

Some proposals want to subject all banks to the requirements. Others only want big banks, with definitions of "big" that range from more than \$2 billion to more than \$10 billion in total assets. A major concern is that the costs of issuing such subordinated debt would be too heavy for small banks, and so the requirement would impair their health and profitability directly. Moreover, it's unlikely that a secondary market for small banks' debt would develop, so that very little information would be contained in the spreads of any but the largest banks. A related argument concerns whether the bank itself or the bank holding company should issue the debt. Holding-company debt may be more liquid, but because the holding company might own finance companies, stock brokers, or a host of other businesses, such debt may not provide information or incentives important for the bank itself.

How regulators would use subordinated-debt requirements to enforce market discipline also varies. Many proposals would rely on a higher cost of debt to slow the growth of a bank that took a course the market deemed too risky. Others would tie the spread on sub debt

more directly to items under the supervisor's control, such as deposit insurance premiums or restrictions on bank dividends, deposit growth, or deposit rates. Yet other proposals would place a rate cap on the debt, so that if the market demanded a 5 percent spread over Treasuries when the cap limit was 3 percent, the bank could not issue the debt and so could not grow. If the debt is of a short maturity, this might even mean that the bank would have to shrink its loans in order to meet the sub-debt requirement.

Questions of maturity, issue frequency, and so on may have a technical quality that only a bond trader or a policy wonk could love, but such details will be crucial in determining whether subordinated-debt proposals would work as planned. For example, consider the maturity of the debt. If the maturity is too short, it might be expensive for banks to continually issue. Investors consequently would have less incentive to monitor, knowing their bond would be paid off before anything bad could happen. Too long a maturity would allow the bank to go years without issuing the debt, thus dodging the market's judgment. Most proposals argue for a maturity of between two and five years, and some argue for overlapping debt, where a fraction matures each year or each month.

Some proposals have other special features, such as making the debt puttable, that is, giving investors the right to sell the debt back to the bank at a previously specified price. If enough people did sell their debt back, then the bank would fall below the minimum level of outstanding subordinated debt. This might be a signal for regulators to close the bank, perhaps after giving it a 90-day grace period to reduce its assets or issue more debt.

■ Will It Work?

It is still too early to assess and choose between individual proposals. Though it is undeniably important to choose, at some point, between puttable five-year debt issued yearly and nonputtable two-year debt issued monthly, certain larger issues must be addressed first. Primarily, these are two: Does the spread on subordinated debt contain useful information? Will regulators follow through on the required discipline?

The answer to the first question is a strong yes. Spreads vary across banks and across time. In 1990, a recession year, spreads on banks' subordinated debt ranged from 0.92 percent to 32.53 percent.⁴ Some banks were borrowing at a rate near that of the U.S. government; others faced rates almost as high as those exacted by the local mobster. Considering that many investors have suffered losses on subordinated debt when a bank failed, those spreads should not be surprising. Exactly how regulators would use the information in spreads, however, varies by proposal, and several details need to be hammered out.⁵ Still, the information is there to be used.

But to return to the question of how regulators use that information: Some possibilities, like increased supervisory scrutiny of banks with high (or growing) spreads, are relatively straightforward. Tougher issues arise when something more drastic must be done. If the bank cannot issue enough sub debt to meet the 2 percent minimum, will regulators continue to enforce that minimum requirement? If a bank that already is considered too big to fail has an "unreasonably" high spread, what actions will regulators take? The history of regulatory forbearance during the thrift crisis may engender some pessimism on this score.⁶

To their credit, however, many proposals address these hard questions explicitly, providing three reasons for cautious optimism. First, some proposals take important actions out of regulators' hands. Once investors sell their puttable bonds back to the bank, a definite event has occurred, and a clock starts ticking. Presumably regulators could give the bank extra time, or even waive the requirement, though doing so might be harder if the put triggers cross-default clauses in other bonds. How does this differ from regulators' postponing the action of closing down a bank or thrift known to be insolvent? The puttable debt drags the bank (and the regulators) into the public eye and thus increases accountability.

The second reason for optimism is that subordinated debt may make such forbearance politically more difficult. Some proposals argue for restricting sub-debt holdings to institutions with less political clout, such as foreign banks. But more importantly, as mentioned before, the sub-debt holders themselves will oppose this forbearance, because they also have downside risk; their opposition will set up a countervailing political influence.

Finally, to the extent that sub debt acts as an early-warning device, banks may be closed before the FDIC—and taxpayers—lose large sums money. Otherwise, facing large losses, the government could be tempted to try the same "go for broke" strategy that got the banks in trouble. Early closure is then the solution. This is important, since there is a chance that sub-debt holders too would want the bank to go for broke, if it were so far under water that even they could not be paid back.

These last two considerations suggest why many people prefer sub-debt proposals to other methods of enforcing market discipline, such as regulators' commitment not to bail out uninsured depositors. Uninsured deposits give regulators less information because investors who leave the bank can do so unnoticed, in a "silent run," by simply transferring their balances to another bank, or even to the stock market. Dumping a comparable amount of subordinated debt would affect the price and alert regulators. Likewise, subordinated debt may create a "bright line" that makes it politically harder to bail out investors. It is a more blatant and obvious step from depositors to investors than it is from one type of depositor to another.

■ Conclusion

Subordinated debt is only one way to increase market discipline on banks.⁷ It is not the only or necessarily the best way, and serious issues about how to use information and how to provide proper incentives must be resolved before any such proposals could be adopted. But it provides one realistic, intriguing way to adapt banking regulation to the demands of the twenty-first century.

■ Footnotes

1. See, for example, Charles W. Calomiris, *The Postmodern Bank Safety Net: Lessons from Developed and Developing Economies*. Washington, D.C.: AEI Press, 1997; Larry D. Wall, "A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt," Federal Reserve Bank of Atlanta, *Economic Review*, vol. 74, no. 4 (July/August 1989), pp. 2–17; and Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment: A Study of the Current System of Deposit Insurance*. Washington, D.C.: U.S. Government Printing Office, 1983.
2. A healthy bank, of course, like a team that is in the lead, need not implement such a risky strategy.
3. Arthur Conan Doyle, *The Sign of Four*, chapter 6.
4. These data are from Mark J. Flannery and Sorin M. Sorescu, "Evidence of Bank Market Discipline in Subordinated Debenture Yields: 1983–1991," *Journal of Finance*, vol. 51, no. 4 (September 1996), pp. 1347–77.

5. For example, sub debt issued directly by banks seems to behave somewhat differently from sub debt issued by bank holding companies. See Julapa Jagtiani, George Kaufman, and Catharine Lemieux, "Is the Safety Net Extended to Bank and Bank Holding Company Debt? Evidence from Debt Pricing," Federal Reserve Bank of Chicago (unpublished).

6. Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: The Urban Institute Press, 1989.

7. See for example, Ron J. Feldman and Arthur J. Rolnick, "Fixing FDICIA: A Plan to Address the Too-Big-to-Fail Problem," Federal Reserve Bank of Minneapolis, *The Region*, March 1998 (1997 Annual Report). For a summary and evaluation of several proposals, see R. Alton Gilbert, "Market Discipline of Bank Risk: Theory and Evidence: Federal Reserve Bank of St. Louis, *Review*, vol. 72, no. 1 (Jan/Feb. 1990), pp. 3–18.

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