Discussion:
“How to Finance SIFIs?”

Denis Gromb
(INSEAD)
Bank Liquidity Management Model

- Retained earnings
  - uncertain P&L
  - cash holding cost (e.g. earns no interest)

- External funding
  - fixed issuance cost
  - uncertain availability (random issuance cost: finite v. infinite)
  - debt ➔ tax shield

- If run out of cash:
  - inefficient liquidation
  - SIFI ➔ social cost
Results

• Trade off theory of optimal capital structure:
  – Private: Some cash, some debt (ignores social cost)
  – Regulated: More cash, less debt
  – Social: Even more cash, no debt (ignores taxes)

• Contingent capital
  – On call, investors injects cash + gets shares (⇒ issuance cost)
  – Useful insurance against states where capital is not available

• Cocos:
  – Debt force-converted into equity (⇒ no issuance cost?)
  – Critique: Tax shield vs. lower distress cost ⇒ Higher leverage
What Issuance Costs?

• Cost of external finance vs. retained earnings
  – Salaries? Fees? Underpricing?

• Identical issuance costs for all claims
  – Unlikely empirically + Bankers’ concern about capital regulation
  – Might favor debt (beyond tax shield)

• Deadweight cost or transfers? Social cost? Internalized by regulator?

• Issuance cost might depend on regulation
  – E.g. Forced issuance ➔ less adverse selection?
Taxes and Optimal Security Design

• The paper considers set financial securities:
  – Taxable: Equity
  – Tax shielded: Straight debt, subordinated debt, cocos

• Security design problem should specify corporate tax law
  – What does it take to be “tax-shielded”?

• Else can’t equity be dressed up as debt?
  – Hybrid capital, PINKs, preferred stock... might dominate
    + straight and subordinated debt (for flexibility reasons)
    + equity (for tax reasons)
Contingent Capital

• Initial liquidity insurance contract
  – Investor commits to injecting cash if/when called upon
  – Receives new shares (⇒ issuance cost)

• Reduced form:
  – Why does calling contingent capital involve an issuance cost?
  – Cash has to be available: Why is there no cash cost for investors?
  – Capital can be called when capital would be unavailable
    + Why is issuance cost finite?
    + At what price will investors commit capital for such state?
**Tax Shield**

- Coco critique:
  - Tax shield vs. lower distress costs
  - Privately optimal C/S is more leveraged

- Is this about cocos?
  - Tax shield of debt is socially detrimental
  - Make regulator internalize tax cost

- Taxes do affect capital structure choices...
  - But cost of capital may be more important
  - Can be included in the framework