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