On the Design of Contingent Capital with a Market Trigger

Suresh Sundaresan* Zhenyu Wang†‡

April 2010
(Revised in May 2013)

Abstract

Contingent capital (CC), which intends to internalize the costs of too-big-to-fail in the capital structure of large banks, has been under intense debate by policy makers and academics. We show that CC with a market trigger, in which direct stake-holders are unable to choose optimal conversion policies, does not lead to a unique competitive equilibrium, unless value transfer at conversion is not expected ex-ante. The “no value transfer” restriction precludes penalizing bank managers for taking excessive risk. Multiplicity or absence of an equilibrium introduces the potential for price uncertainty, market manipulation, inefficient capital allocation, and frequent conversion errors. These results point to the need to explore alternative designs of a prudential capital structure for banks.

(JEL classification: G12, G23)

* Columbia University, Graduate School of Business, ms122@columbia.edu.
† Indiana University, Kelley School of Business, zw25@indiana.edu
‡ The authors are grateful for the comments from the seminar and conference participants in the NY Fed Workshop, BIS, ECB, Toulouse Economics Group, Columbia Business, Law, and Engineering Schools, Wisconsin (Madison), Richmond Fed, Indiana (Bloomington), Exeter, SAIF, Seattle, Drexel, Baruch, the Moody’s Conference, FIRS conference, IFMR, UBC Summer Conference, and FMC2 Bank Resolution Mechanism Conference. The authors especially thank Anat Admati, Pierre Collin-Dufresne, Doug Diamond, Mark Flammery, Bev Hirtle, Ken Garbade, Paul Glasserman, Larry Glosten, Charles Goodheart, Christopher Hennessy, Ravi Jagannathan, Weiping Li, Jamie McAndrews, Bob McDonald, Stewert Myers, George Pennacchi, Ned Prescott, Adriano Rampini, Marc Saidenberg, Joao Santos, Ernst Schaumburg, Chester Spatt, Kevin Stiroh, James Vickery, Cam Harvey (editor), the anonymous associate editor, and the anonymous referees for helpful remarks. Julia Dennett and Kevin Pan provided excellent research assistance.
One of the lessons learned from the financial crisis of 2007–2009 is that the capital structure and financial insolvency procedures of banks and financial institutions need a major overhaul. The bail-out of Bear Stearns and AIG, the public assistance to Citigroup and Bank of America, and the freeze of the financial system after Lehman Brothers’ bankruptcy have demonstrated the need to revisit the financial insolvency procedures. In particular, the extensive amount of implicit guarantees, outright infusion of taxpayer money and other benefits extended to large financial institutions have come under scrutiny. Recognizing these lessons, the U.S. Congress has passed the Dodd-Frank Act\(^1\) and the Basel Committee has moved to strengthen bank regulation with Basel III.\(^2\) A central issue in the debate on these new regulations is the design of a prudential capital structure that ensures enough loss-absorbing capital in large financial institutions and removes the need of public bailout.\(^3\)

In the pursuit of a prudential capital structure of banks, there has been considerable interest in contingent capital (CC), a debt security that converts into equity in periods of distress when a bank has low capitalization but can still be recapitalized as a going concern.\(^4\) Some academic researchers and regulatory agencies have argued that such a security may mitigate the “too big to fail” problem and reduce the systemic risk in financial industry for the following reasons: first, CC can overcome the reluctance of raising equity in a good state because it does not dilute earnings when it functions as debt (HM Treasury (2009)); second, a timely conversion of a sufficiently large CC restores the level of loss-absorbing equity in

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1 The Dodd-Frank Act is the Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), a federal statute in the United States signed into law on July 21, 2010 by President Barack Obama.

2 Basel III is a set of new capital and liquidity standards agreed by the Basel Committee. For a summary of its elements, see Bank for International Settlements (2011).

3 For example, Kashyap, Rajan, and Stein (2008) have proposed that banks buy “systemic risk insurance” and secure the payouts on insurance. Admati and Pfleiderer (2010) have argued for increasing the liability of owners (equity holders) and suggest that such a structure will mitigate the conflicts of interests between equity and debt holders and may help reduce the need for bailouts. Admati, DeMarzo, Helwig and Pfleiderer (2010) suggest a significant increase in equity capital.

4 It is necessary to distinguish CC from bail-in debt, another convertible security proposed by Credit Suisse (The Economist (2010)). Unlike CC, a bail-in debt converts into equity when the bank enters into resolution as a gone concern. Since pre-existing equity holders’ stake is wiped out at resolution, the analysis in our paper does not apply to a bail-in debt.
In a bad state, overcoming the difficulty of raising equity caused by debt overhang, recapitalizing the highly levered bank as a going concern, and reducing financial distress (Squam Lake Working Group (2010)); third, it has been argued that the potential for a “punitively dilutive” conversion of contingent debt sets the right incentives for managers to avoid excessive risk taking, and encourages them to maintain higher capital ratios (Himmelberg and Tsyplakov (2012)). Based on these arguments, some academics and industry lobbyists have urged the governments to let banks use CC as regulatory capital. Against this backdrop, Section 115(c) of the Dodd-Frank Act mandates that the U.S. regulators must study, with a two-year deadline, whether requiring banks to issue CC reduces the systemic risk caused by large financial institutions and what the proper design of CC contracts should be.

In the debate of a proper design of CC, the trigger for the conversion from debt to equity is perhaps the most important and controversial. Many trigger designs have been discussed in the literature, including triggers determined by accounting ratios (Squam Lake Group (2010)), regulatory discretion (Dickson (2010)), and bank management’s option (Glasserman and Wang (2011) and Bolton and Samama (2011)). There are concerns about each of these triggers. Accounting triggers tend to be backward looking and are prone to manipulation by managers. Regulatory discretion potentially suffers from insufficient information, ineffective monitoring, and political pressures. Giving the option to convert to bank managers may result in an overdue conversion or no conversion, especially if the conversion is dilutive and the managers anticipate a bail out.

Because of these concerns, many academics and regulators have turned attention to

\[^{5}\text{Currently, economic theory does not offer a coherent theoretical framework on just how punitive the conversion should be in order to curtail the incentive for excessive risk-taking, but scholars, regulators, and practitioners refer to punitive conversion as a desirable feature for CC to be used as a tool to manage both the agency problem and the capital structure.}\]

\[^{6}\text{The use of Repo 105 by Lehman Brothers and the SPVs by Enron are two visible cases of such manipulation, with disastrous consequences. In the month of bankruptcy, Lehman Brothers tier-one capital ratio was 10.1%. In the month immediately before Bear Stearns was bailed out, its capital ratio was estimated to be 13.5%. These capital ratios were even above the new capital requirement in Basel III.}\]
triggers placed on market prices, which are our focus.\footnote{To our knowledge, Flannery (2002, 2009) was an early advocate of CC with a market trigger for mandatory conversion.} Placing a mandatory-conversion trigger on an observable market value of a publicly-traded security is thought to ensure that conversion is based on a criteria that is informative, objective, timely, difficult to manipulate, and independent of regulators’ intervention, avoiding the problems associated with other types of triggers. For this purpose, the price of the security serving as a trigger should be a timely indicator of the expected financial difficulties of the bank that issues the CC, and thus the security should be junior to CC as a claim on the firm. Since CC becomes common equity after conversion, the only financial claim that is junior to CC is common equity. This makes common equity the natural choice for placing the market trigger.

We show that a CC with a market equity trigger does not in general lead to a unique competitive equilibrium in the prices of the issuing bank’s equity and CC. Multiplicity or absence of an equilibrium arises because the stakeholders are not given the option to choose a conversion policy in their best interests. This problem exists even if banks can issue new equity to avoid conversion. The equilibrium problem is more pronounced when a bank’s asset value has jumps and when bankruptcy is costly. Jumps in asset values and bankruptcy costs are considered in our analysis because they are the reality of banking industry.

We prove that for a unique competitive equilibrium to exist, a mandatory conversion must not transfer value between equity holders and CC investors. This necessary condition for a unique equilibrium causes two problems. First, this condition prevents punishing equity holders at conversion. This is problematic because punitive conversion is referred to by regulators and academics as a desirable feature to generate the incentives for bank managers to avoid excessive risk taking. Second, the necessary condition implies that CC cannot be practically designed so that the market has a unique equilibrium because the conversion ratio in the contract has to be a function of the market value of the contract. In particular, a CC
contract with a constant conversion trigger and conversion ratio generally does not have a unique equilibrium.\textsuperscript{8} We also show that multiple equilibria exist even when financial distress costs are present. In this case, CC can even cause multiple equilibria in firm value and senior bond because an early conversion equilibrium, if it exists, may reduce the expected dead-weight loss associated with financial distress.

In the case of multiple equilibria, our analysis shows that equity holders prefer the “late/no conversion” equilibrium whereas the CC holders prefer the “early conversion” equilibrium. If a CC of this design were to be issued by a bank, and the stock price subsequent to the issuance were to approach the trigger level, equity holders would have an incentive to manipulate the stock price up and keep it above the trigger. By the same token, contingent capital holders would have the incentive to manipulate the stock price down so that it hits the trigger to force conversion.

Intuitively, and in view of the classic microeconomic theory, the lack of a unique competitive equilibrium should be a serious concern to the regulators: if CC with a market trigger is used for regulation, it may introduce the potential for price uncertainty, market manipulation, and inefficient capital allocation. The recent experiments conducted by Davis, Prescott and Korenok (2011) underpin this concern and report that conversion errors occur regularly in the absence of a unique equilibrium. In addition, the multiple equilibria may invite market manipulation, as mentioned earlier. Price manipulation of this kind has been witnessed in barrier options (\textit{The Economist} (1995)). These results suggest that regulators should use caution in pursuing CC with market triggers in the design of capital structure for banks, and also point to the need to explore alternative designs of prudential capital structure for banks.

\textsuperscript{8}In contrast, under the \textit{unrealistic} assumptions that asset value has no jump risk and the conversion condition can be verified continuously, we show that it is possible to design a CC contract with a constant conversion trigger and ratio so that a unique equilibrium exists.
Our paper is related to Bond, Goldstein and Prescott (2010), who show that potential intervention by regulators who make decisions based on asset price can lead to loss of information about the asset value. The two papers share a similarity in the no-equilibrium case. With a mandatory trigger placed on the market price of equity, one can think of regulators responding to the information in the equity price.\footnote{Bond, Edmans, and Goldstein (2012) provide a survey and general discussion of these issues.} One of the distinct features of our analysis is that multiple equilibria may arise in the case of CC.

The road map for this paper is as follows. In section I, we provide intuition for the equilibrium problem and discuss the concerns. In section II, under the assumption that the asset value exhibits smooth diffusive shocks as well as jump risk and bankruptcy costs, we derive the condition for an equilibrium to exist and be unique and numerically illustrate the range of multiple equilibria. In Section III, we analyze equilibria under alternative market conditions. In Section IV we conclude.

I The Intuition for the Pricing Problem

The main thrust of our paper is the following: When triggers for mandatory conversion are placed directly on the market value of equity, there is a need to ensure that conversion does not transfer value between equity holders and CC holders when equity value hits exactly the trigger level. The economic intuition behind this design problem is as follows. A contingent capital is essentially a junior debt that converts to equity shares when the stock price reaches a certain low threshold. This sounds like a normal and innocuous feature. However, the unusual part of the CC design is that conversion into equity is \textit{mandatory} as soon as the stock price hits the trigger level from above. Since common equity is the residual claim of the bank’s value, it must be priced together with the CC. Keeping the firm value and senior bond value fixed, a dollar more for the CC value must be associated with a dollar less for
the equity value. Therefore, a transfer of value between equity and CC disturbs price by moving the stock value up or down depending on the conversion ratio. To have a unique equilibrium, the design of the conversion ratio must ensure that there is no such transfer of value.

If the transfer of value never pushes the stock price across the trigger, there is no problem because, given each asset value, investors always know whether or not there will be a conversion. However, if the transfer of value pushes the stock price across the trigger from above to below, there are two possible equilibria. In the first one, all investors believe conversion will not happen, leading the equity value to stay above the trigger. In the second one, all investors believe conversion will happen, leading the equity value to hit the trigger. Since two values are possible whenever the firm’s value drops to a certain level, by combining these dual equilibria around the trigger at different times in the future, numerous expected equity values are possible well before conversion happens. These numerous values can form a range, and the whole range can be above the trigger.

There are also economic conditions in which CC with a market trigger may not even have an equilibrium price. This happens if equity value would fall below the trigger without conversion but conversion would push the stock price above the trigger level by transferring value from the CC holders to the equity holders. In this case, investors cannot believe that conversion will not happen because with such a belief, equity value will fall below the trigger and the CC must convert. Investors cannot believe that conversion will happen either because with such a belief, the equity price will stay above the trigger level and the CC must not convert. Therefore, there is no belief and stock price that are consistent with the mandatory conversion rule of the CC. Then, there is no rational expectations equilibrium in the values of equity and CC.

The only way to prevent multiplicity or absence of equilibrium is to ensure that no value
is transferred when the equity value hits the trigger. If economic agents are permitted to convert in their self interest, they would select the optimal conversion strategy endogenously by comparing the value of conversion with the value of holding CC unconverted but taking into account optimal future conversion strategies. This, however, is prevented by the design of CC in which conversion is mandatory and dictated by the equity value. The zero value transfer condition requires that, at all possible conversion times, the value of shares converted at the trigger price must be exactly the same as the market value of the non-converted CC.

Although methods for pricing of subordinated debt and equity are established, the pricing of contingent capital with a market trigger poses special challenges. In this section, we illustrate these challenges in discrete time, leaving the formal analysis in dynamic continuous-time models to the next section. The analysis in discrete time demonstrates that the conversion trigger and ratio cannot be chosen arbitrarily if we want a unique equilibrium price to exist.

Let us first describe a bank that has a capital structure with CC. Consider a bank that has senior bondholders and common-equity holders who have claims on an asset (or a business). The asset requires an investment of $A_0$ dollars today (time 0). The asset is typically risky; its value at time $t$ is a random number $A_t$. At time 0, the bank has also issued a security called “contingent capital.” The security is in the form of a debt (or preferred equity) with face value $\bar{C}$, which is junior to the bond but converts to common equity when certain pre-specified conditions are met.\(^\text{10}\)

The contingent capital with market trigger sets the conversion condition on the bank’s equity value. Suppose $S_t$ is the stock price of this bank and there are $n$ shares outstanding. At any time $t$, the bank converts the junior debt under the contingent capital to $m_t$ shares of common equity as soon as the equity value $nS_t$ falls to the level $K_t$ or lower. The quantity $m_t$

\(^{10}\)To keep the analysis simple, we assume in this section that the contingent capital does not pay a coupon or dividend. We make a similar assumption for the bond. Also, we assume that the asset does not generate cash flow. We will relax these assumptions in the next section.
is referred to as the conversion ratio and $K_t$ as the conversion trigger. The conversion trigger is hit if the stock price reaches $K_t/n$, which is referred to as the trigger price. If $n = 1$, the conversion trigger and trigger price are the same. In general, the conversion ratio and trigger are either constant or pre-specified functions of observable variables. A particular contract specifies the conversion ratio $m(\cdot)$ and trigger $K(\cdot)$ as functions of observable variables over time.

The following are two examples of contingent capital contracts. The simple form of contingent capital can have a constant trigger $K$ and a constant conversion ratio $m$. The contingent capital contracts proposed in the literature typically have a time-varying conversion trigger and ratio. The one suggested by Flannery (2002) specifies that $K_t = z \cdot \text{RWA}_t/n$, where RWA$_t$ is the most recent risk-weighted asset value and $z$ is a constant related to regulatory capital ratios. To ensure that the converted shares and the CC have the same value if conversion happens at the trigger price on maturity date, the conversion ratio should be set to $m_t = n\bar{C}/K_t$. Since the risk-weighted asset changes only at the end of each quarter, this contingent capital takes the simple form after its last change of risk-weighted asset, if it is not converted by then.

I.A The Pricing Restriction at Maturity

First consider the equilibrium stock price at the maturity, which is time $T$. The bank’s asset will finish at certain value $A_T$, which is random. The par value of the bank’s senior bond is $\bar{B}$, at maturity. The bank’s contingent capital, which also matures at the same time, has a par value of $\bar{C}$. The trigger of the contingent capital is $K$. The bank has $n$ shares of equity. We suppose that the contingent capital has not been converted because the asset value has been so high that the equity value is above the trigger. At maturity, if the CC is still not
converted, the stock price should be

$$S^u_T = (A_T - \bar{B} - \bar{C})/n.$$  \hfill (1)

If the CC is converted, the stock price should be

$$S^c_T = (A_T - \bar{B})/(n + m).$$  \hfill (2)

The above pricing formula and the CC’s trigger rule lead to the non-conversion and conversion criteria in terms of asset value: (a) Since the CC stays unconverted at maturity if and only if $ns^u_T > K$, equation (1) implies that there is no conversion if and only if $A_T > \bar{B} + K + \bar{C}$; (b) Since the CC should be converted at maturity if and only if $ns^c_T \leq K$, equation (2) implies conversion happens if and only if $A_T \leq \bar{B} + K + (m/n)K$.

From the conversion criteria in terms of asset value, we can see the pricing restriction on the CC’s conversion ratio. If $\bar{C} < (m/n)K$, the asset value $A_T$ can fall into $(\bar{B} + K + \bar{C}, \bar{B} + K + (m/n)K]$. Then, both criteria for non-conversion and conversion are met. In this case, there are multiple equilibria in stock prices. One price is above the trigger price and the other is below. If $\bar{C} > (m/n)K$, the asset value $A_T$ can fall into $(\bar{B} + K + (m/n)K, \bar{B} + K + \bar{C})$. Then, neither the criteria for non-conversion or conversion is met. In this case, there is no equilibrium stock price. If and only if $\bar{C} = (m/n)K$, will we have either $A_T > \bar{B} + K + \bar{C}$ or $A_T \leq \bar{B} + K + (m/n)K$, but not both, for all asset value $A_T$. In this case, there is always a unique equilibrium. Therefore, a unique equilibrium always exists at maturity if and only if $\bar{C} = mK/n$ or $m = n\bar{C}/K$. The last equation implies that the conversion ratio is restricted by other parameters if we want to assure a unique equilibrium.

As a numerical example, let $n = 1$, $\bar{B} = 90$, $\bar{C} = 10$ and $K = 5$. Notice that $n\bar{C}/K = 2$. If $m = 3$, which is higher than 2, then there can be multiple equilibria when the asset value turns out to be $A_T = 106$. One equilibrium stock price is $S^u_T = (106 - 90 - 10)/1 = 6$, which
is above the trigger, and the other is $S_T^c = (106 - 90 - 10)/(1 + 3) = 4$, which is below the trigger. If $m = 1$, which is smaller than 2, then there is no equilibrium when the asset value turns out to be $A_T = 104$. This is because the stock price associated with non-conversion is $S_T^u = (104 - 90 - 10)/1 = 4$, lower than the trigger, and stock price associated with conversion is $S_T^c = (104 - 90)/(1 + 1) = 7$, higher than the trigger. However, one can easily verify that these cases of multiple or no equilibrium do not occur if $m = 2$.

The above analysis of zero value transfer condition at maturity is simple because if the contingent capital does not convert at maturity, the value of contingent capital is simply its face value $\bar{C}$. The conversion ratio $m = n\bar{C}/K$ does not transfer value at trigger price on maturity date because if the stock price hits on the trigger, the contingent capital investors receive $mS_T = m(K/n)$ dollars, which is the same $\bar{C}$ dollars they would have received in the absence of conversion.

I.B The Pricing Restriction Before Maturity

The conversion ratio that guarantees zero value transfer at the trigger price on maturity date may still transfer value at the trigger price on some days before maturity, causing multiple equilibria. To ensure a unique equilibrium, the pricing restriction needs to hold at any possible conversion time $t$: $C_t = mK/n$. To see this intuitively, we can repeat the previous analysis by switching $T$ to $t$. Then, with $\bar{C} = mK/n$, two possibilities may arise. The first possibility is $C_t = \bar{C} = mK/n$ at any time before conversion and before default.\(^\text{11}\) The other possibility is $C_t \neq mK/n$ at some possible conversion time. This can lead to multiple or no equilibrium at this time, translating to multiplicity or absence of equilibrium in the initial price.

In a one-period discrete-time model, it is easy to show that keeping conversion ratio fixed

\(^{11}\)For this to happen, the economic system needs to satisfy certain restrictive conditions later described by Theorem 3 in Section III-III.A.
as \( m = n\bar{C}/K \) through the period allows multiple equilibrium in the initial equity and CC prices. In the discrete model, all securities are priced and traded at the initial time of the period, \( t = 0 \), and the terminal time, \( t = T \), when both the bond and CC matures. The initial asset value is \( A_0 \), and the terminal value, \( A_T \), is a random variable. Let \( P(\cdot) \) and \( p(\cdot) \) be the CDF and PDF, respectively, of the risk neutral distribution. To keep things simple, assume the risk-free rate is zero. With face value \( \bar{B} \), the initial value of the bond is

\[
B_0 = \bar{B}(1 - P(\bar{B})) + \int_0^{\bar{B}} A_T p(A_T) dA_T. \tag{3}
\]

With face value \( \bar{C} \), the initial value of the CC, if it is not converted at time 0, is

\[
C^u_0 = \bar{C}(1 - P(\bar{B} + \bar{C} + K)) + \frac{m}{n + m} \int_{\bar{B}}^{\bar{B} + \bar{C} + K} (A_T - \bar{B}) p(A_T) dA_T. \tag{4}
\]

Given \( m = n\bar{C}/K \), the maximum payoff the CC holders may receive is \( \bar{C} \). This implies \( C^u_0 \leq \bar{C} \), which can also be verified by some trivial algebra.

The stock value at time 0 depends on whether the CC is converted. If the CC is not converted, the stock value is \( S^u_0 = (A_0 - B_0 - C_0)/n \). It follows from the condition for no-conversion, \( nS^u_0 > K \), that the CC is not converted if and only if \( A_0 > B_0 + C_0 + K \). If the CC is converted, the stock value is \( S^c_0 = (A_0 - B_0)/(n + m) \). Because the condition for conversion is \( nS^c_0 \leq K \), the CC is converted if and only if \( A_0 \leq B_0 + (m/n)K + K \). This inequality is equivalent to \( A_0 \leq B_0 + \bar{C} + K \), in view of \( m = n\bar{C}/K \). Since \( C_0 < \bar{C} \), the interval \( (B_0 + C_0 + K, B_0 + \bar{C} + K) \) is nonempty. For every \( A_0 \) in this interval, both the conditions for no-conversion and conversion hold, and thus there are two equilibrium stock prices, \( S^u_0 \) and \( S^c_0 \). The CC price associated with \( S^u_0 \) is \( C^u_0 \). With conversion at time 0, the value received by the CC holders is the value of \( m \) shares: \( C^c_0 = mS^c_0 \).

As a numerical example, let \( \bar{B} = 90 \), \( \bar{C} = 10 \), \( K = 5 \), \( m = 2 \), and \( n = 1 \). Notice that \( m = n\bar{C}/K \) holds for these parameters. Assume that the probability distribution of \( A_T \) is discrete: \( p\{A_T = 80\} = 0.25 \), \( p\{A_T = 100\} = 0.50 \), and \( p\{A_T = 120\} = 0.25 \). It
follows that $A_0 = E[A_T] = 100$. Straightforward calculation, using equations (3) and (4), gives $B_0 = 87.50$ and $C_0^u = 5.83$. Then, no conversion at time 0 is an equilibrium because $nS_0^u = 100 - 87.50 - 5.83 = 6.67$, which is higher than the trigger $K = 5$. Conversion is also an equilibrium because $nS_0^c = (100 - 87.50)/(1 + 2) = 4.17$, which is below the trigger. The CC values associated with the two equilibria are $C_0^u = 5.83$ and $C_0^c = 8.33$. To visualize the two equilibria intuitively, this example is displayed as a trinomial tree in Figure 1.

In the numerical example, the two equilibria leave the stock price and CC value undetermined before maturity. Multiple equilibria occurred on a node before maturity because the conversion ratio, $m = 2$, is too high at time 0 and transfers value from equity holders to contingent capital investors. To prevent such a value transfer, we need to set the conversion ratio so that, at time 0, the value of the converted shares at trigger price equals the value of the non-converted contingent capital. As shown in Figure 1, the non-converted contingent capital is valued as $5.83$ on this node. Accordingly, the conversion ratio should be set to $m = 5.83/K = 5.83/5 = 1.166$. To use this conversion ratio, we need to know the value of the non-converted contingent capital on this node. To know the value of non-converted CC at every time and in every state is not practical for two reasons: first, the conversion ratio is typically specified ex-ante, and second, relying on a market price of CC for every future state to determine the conversion ratio is not judicious because the specification of a contract should not depend on the future market price of the contract itself.

The above example illustrates an important problem. With a CC based on market triggers and mandatory conversion, equity holders prefer the “late/no conversion” equilibrium as their value is higher in that equilibrium. On the other hand, contingent capital holders prefer the “early conversion” equilibrium as their values are higher in that equilibrium. If a CC of this design were to be issued by a bank, and the stock price subsequent to the issuance approaches the trigger level, equity holders would have an incentive to manipulate the stock
price up and keep it above the trigger. By the same token, contingent capital holders would have the incentive to manipulate the stock price down so that it hits the trigger to force conversion. For this reason, CC holders have an incentive to sell the bank stock short. If they succeed in forcing the stock to hit the trigger, they can cover their short positions using the new shares that have been issued by the bank to fulfill the mandatory conversion. Consequently, a bank’s equity price can be volatile when it approaches the trigger level.

The discussion in this section is meant to illustrate the challenge in the design of CC. To formally establish the pricing restriction, in the next section we use a dynamic continuous-time framework in which the bank asset value follows a general stochastic process, which allows for both continuous changes and discontinuous jumps. We also assume that bankruptcy is costly, deviating from Modigliani and Miller’s world. In such a dynamic setting we show the pricing restriction under which we can obtain a unique equilibrium. When the restriction is breached, multiplicity or absence of equilibria may occur in the market.

I.C The Issues with the Equilibrium Problem

In general, what will be the consequence of the equilibrium problem associated with contingent capital? The classic economic theory tells us that a unique competitive equilibrium is generally associated with stable prices and efficient allocation. Stability follows from the law of supply and demand. When a market price deviates from the unique equilibrium point, the forces of supply and demand will push the price towards the equilibrium. This dynamics is modeled as a tatonnement process. Efficiency follows from the welfare theorems of competitive equilibrium. When there are multiple equilibria, the economic system is unstable. An example of multiple equilibrium is the Diamond and Dybvig (1983) model, in which there can be an equilibrium with bank runs. More restrictions can be imposed on Diamond and Dybvig’s economy to allow a unique equilibrium, but such an equilibrium is inefficient.
In the case of a derivative security, a deviation from its equilibrium price is often associated with arbitrage opportunities, leading to arbitrage activities of rational investors which will force the price toward the equilibrium. Without a unique equilibrium price, contingent capital does not fit into the basic economic theory. Consequently, we conjecture the following. First, unlike a security with a unique equilibrium price, CC may not preclude the potential for price instability and inefficient capital allocation. Second, in the case of multiple equilibria, we note that the incentives of CC-holders are aligned towards the equilibrium with early conversion, whereas the incentives of equity holders are aligned towards the equilibrium that delays or avoids conversion. The conflicting incentives of the CC and equity holders towards different equilibria may cause price instability. Third, the lack of a unique equilibrium for the price to converge may leave the price to be determined by uncertain forces, leading to uncertainty in investors’ formation of price expectations. As a result, it is possible that the final distribution of capital may be inefficient in the sense that capital is not held by those who value it the most.

Will the equilibrium problem of contingent capital actually cause price uncertainty and inefficient allocation? There is no economic framework available to answer this question analytically. In this situation, researchers typically search for empirical evidence, but relevant data are not available because CC with a market trigger is still a regulatory proposal, not yet implemented in practice. However, the recent development in experimental economics sheds some light on our earlier conjectures. Davis, Prescott and Korenok (2011) have recently conducted laboratory experiments in trading contingent capital. In their experiments, a security’s intrinsic value, which is random, takes a haircut of a fixed amount if the aggregate market price of the security is below a certain threshold, resembling the equity of a bank that has issued a punitive CC with a market trigger. The results of their laboratory experiments are broadly in conformity with the observations made in the preceding paragraph. They show
that excessive price uncertainty and inefficient allocation reign in their experimental market when the security has multiple equilibrium prices. In addition, they document frequent conversion errors; a conversion error is a situation when the security’s intrinsic value is above the threshold but the haircut takes place or a situation when the security’s intrinsic value is below the threshold but the haircut does not take place. They also experiment with a security that resembles a CC that rewards equity holders at conversion and find that price uncertainty, allocation inefficiency, and conversion error still reign in their experimental market. Very interestingly, Davis et al. also report that after introducing regulators who make conversion decisions by inferring the intrinsic value from trading prices, the problems of price uncertainty, allocation inefficiency, and conversion error stay the same. This underlines the potential weaknesses in a regulatory trigger in the design of contingent capital.

Will multiple equilibrium invite price manipulation in practice as we have discussed in Section I.B? Although there has been no issuance of market-triggered CC, such manipulation problem has been already witnessed in the markets of securities such as barrier options, which have payoffs when a trigger is reached. During 1994–1995, “knock-in” barrier options on Venezuelan Brady bonds, which pay when the underlying bonds reach a high enough level (trigger) experienced manipulation (The Economist (1995)). The fund owning the option attempted to push the price up by buying the bond, and the investment bank that sold the option attempted to keep the prices down. During the height of manipulation, about 20% of the outstanding bonds changed hands, and the prices went up by 10%.12 In the context of our model, such manipulative behavior may arise due to the possibility of value transfers, which pits the equity holders against the holders of contingent capital. It may be argued that the market should be able to anticipate such value transfers ahead of time and incorporate

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12 When arbitragers create excessive pressure on the issuer’s stock price toward the trigger point, there can also be a negative effect on price, as the death spiral effects of reverse convertible bonds analyzed by Hillion and Vermaelen (2004).
them before the equity price approaches the trigger. This, however, is not possible when there are multiple equilibria, as there is no credible way to tell which equilibrium will result in the future.

II The Analysis in Dynamic Continuous-Time Model

II.A The Dynamic Continuous-Time Model

Valuation of contingent capital can be performed using the analytical approach developed in structural models of default pioneered by Merton (1974) and extended by Black and Cox (1976) who value default-risky senior and subordinated debt securities. These models work with the asset value of the issuing firm as the state variable and derive simultaneously the equity and debt values. The paper by Black and Cox, is particularly relevant as they explicitly model a safety covenant as a trigger for bondholders to take over the firm. The contingent claims approach has been standard for pricing corporate debt and hybrid securities in industry, as presented in detail by Garbade (2001).

We develop the ideas in the context of a structural model of default, along the lines of Merton (1974) and Black and Cox (1976). We assume that the asset value process, denoted by $A_t$, is observable, but the trigger for the CC is specified in terms of the stock price $S_t$. Consistent with these models, we assume that pricing should exclude arbitrage profits and thus operate in a risk-neutral probability. Let the assets generate cash flows at the rate of $a_t$. Our analysis allows the bank asset value $A_t$ to have time-varying drift $\mu_t$ and volatility $\sigma_t$. The analysis also allows the stochastic process of bank asset value to have jumps\(^{13}\) because large downward changes in asset value are often associated with financial or economic crisis.

\(^{13}\)Duffie and Lando (2001) have developed a framework in which the true $A_t$ process is continuous, but stock and bond prices exhibit discontinuities due to imperfect information. To keep our analysis simple, we work with an asset value process that exhibits jumps and is observed by the agent.
Following Merton (1976), we assume

\[ dA_t = \mu_t A_t dt + \sigma_t A_t dz_t + A_t(y_t - 1) dq_t, \]  

(5)

where \( z_t \) is a Wiener process, \( q_t \) is a Poisson process with expected arrival rate \( \lambda_t \), and \( y_t \) follows a log-normal distribution with parameters \( \mu_y \) and \( \sigma_y \). Let \( r_t \) be the instantaneous risk-less interest rate at time \( t \). In risk-neutral probability measure, we should have \( \mu_t = r_t - a_t - \lambda E[y_t - 1] \).

We assume that the bank has issued a senior bond with a par value \( \bar{B} \) and maturity \( T \). The coupon rate of the senior bond is \( b_t \), which can be constant or time-varying. This allows both fixed- and floating-rate debt. Let \( \delta \) be the time when the senior bond defaults. We model bankruptcy through a default barrier. Generally, the default barrier is set to limit the loss of the bond holder’s investment. Upon default, bond holders take over the firm and receive its liquidation value. No value is left to securities that are subordinate to the bond. There are several ways to specify default condition, which determines the default time. In general, the time of bankruptcy is

\[ \delta = \inf \{ t \geq 0 : A_t \leq \Gamma_t \} . \]  

(6)

where \( \Gamma_t \) is the default barrier. We define \( \delta = +\infty \) if \( A_t \) is above the barrier all the time. As an example, we can let the default barrier at time \( t \) be \( \Gamma e^{-\gamma(T-t)} \), where \( \Gamma \) and \( \gamma \) are positive constants. This is the barrier in Black and Cox (1976). Alternately, we can model default as the choice of equity holders, who default when the value of their stake in the firm is zero. In this case, the default time is \( \delta = \inf \{ t \geq 0 : A_t \leq B_t \} \). The theorems derived in this section apply to both types of default conditions.

Bankruptcy is costly in practice. To bond holders, the loss after default consists of three parts: the loss of asset value relative to the par value, the liquidation discount, and legal
expenses. We refer to the last two parts as bankruptcy cost. For banks and financial institutions, which may be interconnected, the expected costs of bankruptcy may be significant.

When a bank defaults at time $\delta$, the loss of asset value relative to the par is $\bar{B} - A_\delta$. Let $\omega$ represent bankruptcy cost as a fraction of the asset value. The sum of the liquidation discount and legal expenses is $\omega A_\delta$. The value received by bond holders is $(1 - \omega)A_\delta$.

The value function of the senior bond can be expressed in terms of the risk-free discount factor and an event indicator. Given that the instantaneous risk-free interest rate is $r_t$, the risk-free discount factor from time $t$ to $s$ is $P(t, s) = \exp(-\int_t^s r_u du)$. The event indicator $1_{\text{event}}$ equals either 1 or 0, depending on whether or not the event happens. The value of the bond before default ($t < \delta$) is, in rational expectation,

$$B_t = E_t \left[ \bar{B}P(t, T) \cdot 1_{\delta > T} + (1 - \omega)A_\delta P(t, \delta) \cdot 1_{\delta \leq T} + I_t^B \right] ,$$

where $E_t[\cdot]$ denotes the expectation, conditional on the information up to time $t$, and $I_t^B$ is the discounted value of interest income:

$$I_t^B = \int_t^{\min\{\delta, T\}} b_t \bar{B}P(t, s)ds .$$

Besides senior bond, the bank capital structure consists of $n$ shares of common equity and a contingent capital in the capital structure of the bank. The par value of contingent capital is $\bar{C}$, and it pays coupon at a rate $c_t$ until the contingent capital converts to $m_\tau$ shares of common equity if conversion happens at time $\tau$. After conversion, the number of outstanding shares of common equity is $n + m_\tau$. Both $K_t$ and $m_t$ are given functions of observable variables at time $t$, and they are assumed to be finite and positive.

Conversion to common equity is mandatory when the value of equity hits or runs below a trigger. The trigger condition is specified in terms of the value of common equity relative to the risk-weighted asset of the firm. The general form of conversion rules is that the
contingent capital converts to $m$ shares of common equity if the value of equity falls to or below $X$ percent of risk-weighted asset (RWA$_t$). Let $K_t = \text{RWA}_t \times X/100$, which is referred to as the conversion trigger. Conversion happens when stock price hits or runs below $K_t/n$, which is referred to as the trigger price.

Theoretically, equity value can be compared to conversion trigger at any time, but practical CC contract must compare equity value and trigger at specified times such as daily market close. Let $\Lambda$ be the set of time points when the equity value is compared to the trigger and assume $T \in \Lambda$. The first time when a stock price is found to be equal or lower than the trigger is

$$\tau = \min \{ t \in \Lambda : nS_t \leq K_t \} . \quad (9)$$

If $nS_t > K_t$ for all $t \in \Lambda$, we define $\tau = +\infty$. If condition in (9) is verified continuously, i.e., equity value is compared to the trigger at any time, then use $\Lambda_{\text{continuous}} = [0, +\infty)$ for $\Lambda$. For the contingent capital contracts that verify the conversion condition with daily or weekly closing stock prices, we use $\Lambda_{\text{daily}} = \{ i/252 : i = 0, 1, 2, \cdots \}$, assuming there are 252 trading days in a year, or $\Lambda_{\text{weekly}} = \{ i/52 ; i = 0, 1, 2, \cdots \}$, respectively. The theorem derived in this section applies to both continuous and discrete verification of the conversion condition.

After contractual coupons on the senior bond and contingent capital are paid, the cash flow generated from the assets of the bank will be paid to equity holders as dividends. Therefore, before conversion, the total dividend paid to equity holders during a short period $dt$ is $(a_t A_t - b_t \bar{B} - c_t \bar{C}) dt$. After conversion and before default of the senior bond, the total dividend paid to equity holders (including those new equity holders after conversion) during an infinitesimal period $dt$ is $(a_t A_t - b_t \bar{B}) dt$.

At any time $t$ before the contingent capital converts ($t < \tau$), the per-share value of
common equity is, in rational expectation,

\[ S_t = E_t \left[ \frac{1}{n} \left( (A_T - \bar{B} - \bar{C}) P(t, T) \cdot 1_{\min(\tau, \delta) > T} + I_t \right) \right] + E_t \left[ \frac{1}{n + m_\tau} \left( (A_T - \bar{B}) P(t, T) \cdot 1_{\min(\tau, \delta) > T} + J_\tau P(t, \tau) \cdot 1_{\tau < \min(\delta, T)} \right) \right], \]  

(10)

where \( I_t \) is the time-\( t \) value of total dividends before conversion, and \( J_\tau \) is the time-\( \tau \) value of the total dividends after conversion:

\[ I_t = \int_t^{\min(\tau, \delta, T)} (a_s A_s - b_s \bar{B} - c_s \bar{C}) P(t, s) ds \]  

(11)

\[ J_\tau = \int_\tau^{\min(\delta, T)} (a_s A_s - b_s \bar{B}) P(\tau, s) ds. \]  

(12)

The value of the contingent capital before conversion is

\[ C_t = E_t \left[ \bar{C} P(t, T) \cdot 1_{\min(\tau, \delta) > T} + H_t \right] + E_t \left[ \frac{m_\tau}{n + m_\tau} \left( (A_T - \bar{B}) P(t, T) \cdot 1_{\min(\tau, \delta) > T} + J_\tau P(t, \tau) \cdot 1_{\tau < \min(\delta, T)} \right) \right], \]  

(13)

where \( H_t \) is the present value of coupon interests that the CC holders receive before conversion:

\[ H_t = \int_t^{\min(\tau, \delta, T)} c_s \bar{C} P(t, s) ds. \]  

(14)

After the contingent capital converts to \( m_\tau \) shares and before the senior bond matures or defaults (\( \tau \leq t < \min(\delta, T) \)), the per-share value of common equity becomes

\[ S_t = \frac{1}{n + m_\tau} E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\delta > T} + J_t \right]. \]  

(15)

II.B The Pricing Restriction

Since the value function \( B_t \) defined in equation (7) exists and is continuous in \( t \) and \( A_t \), we focus on the value function of equity share \( S_t \) and the value of the contingent capital \( C_t \) before conversion. Given conversion trigger \( K_t \) and conversion ratio \( m_t \), a pair of value
functions, \((S_t, C_t)\), that satisfy equations (9), (10), (13) and (15) is called a \textit{dynamic rational expectations equilibrium} or, simply, an \textit{equilibrium}. The equilibrium is \textit{unique} if each of \(S_t\) and \(C_t\) has a unique value for every realization of \(A_t\) at any time \(t\). In fact, such an equilibrium does not always exist for arbitrary specification of \(m_t\). The next theorem presents the pricing restriction of a unique equilibrium.

**Theorem 1** For any given trigger \(K_t\) and conversion ratio \(m_t\), a necessary condition for the existence of a unique equilibrium \((S_t, C_t)\) is \(nC_t = m_tK_t\) for every \(t \in \Lambda\).

This necessary condition is also sufficient in the following sense:

**Theorem 2** For any given trigger \(K_t\), there exists a conversion ratio \(m_t\) and a unique equilibrium \((S_t, C_t)\) satisfying \(nC_t = m_tK_t\) for every \(t \in \Lambda\).

The pricing restriction of unique equilibrium has important implications to the design of contingent capital. These theorems say that if conversion is at the trigger price, there should be no transfer of value from CC holders to equity holders, or vice versa. To see this, we can rewrite the pricing restriction as \(m_t(K_t/n) = C_t\) for every \(t \in \Lambda\). If equity value hits right on the trigger at the conversion time \(t\), we should have \(S_t = K_t/n\). Then, the value of \(m_t\) shares of stock at conversion time is \(m_tS_t\), which equals \(C_t\). More importantly, the theorems imply that conversion cannot be punitive to equity holders. At conversion time \(t\), we have have \(nS_t \leq K_t\). Then, \(m_tS_t \leq m_tK_t/n = C_t\), which means that the value of the converted shares, \(m_tS_t\), will never exceed the CC value, \(C_t\). Therefore, in a contingent capital that entertains a unique equilibrium, conversion may punish the CC holders but never punish the equity holders.

The pricing restriction becomes \(n\bar{C} = m_TK_T\) at maturity. If the conversion trigger and ratio are both constant and denoted by \(m\) and \(K\) respectively, the restriction becomes
\( m = n\bar{C}/K \), as seen in section I.A. When this restriction is violated, multiplicity or absence of equilibrium may occur at maturity, as shown by the examples in the previous section. We have also seen that the restriction at maturity does not guarantee that it will be met before maturity. The above two theorems require that the pricing restriction be satisfied at every possible conversion time. As long as the restriction can be violated at some conversion time, unique equilibrium is not assured. When the restriction is violated, conversion is either punitive or rewarding to the equity holders, causing the contingent capital to have either multiple equilibria or no equilibrium.

The situation of no equilibrium for contingent capital is closely related to Bond, Goldstein and Prescott (2010). In a two-period model, they show the absence of equilibrium when regulators choose to intervene based on the observed market prices. Similar to their result, equilibrium may be absent for a contingent capital when conversion is based on a market price, although the CC can also have multiple equilibria, which is different from their model. In a similar two-period model with regulator intervening only once at a fixed time, Birchler and Facchinetti (2007) note that a unique equilibrium can be preserved, if the haircut of asset value equals the benefit to asset holders provided by the intervention. This is somewhat in the same spirit of our Theorem 1—the intervention should have not transfer value to or from the asset holders.

It is important to point out that even without bankruptcy costs or jumps, multiplicity or absence of equilibrium may arise when the pricing restriction in Theorems 1 and 2 is violated. Thus, even in a Modigliani-Miller’s world, violation of the pricing restriction can lead to multiple or no equilibrium. Since Theorems 1 and 2 still hold if the assets value follows a geometric Brownian motion, a contingent capital that violates the pricing restriction may cause stock prices to jump in a capital market even when the underlying asset prices have no jumps. Consequently, a contingent capital that violates the pricing restriction can disturb the
continuity of the stochastic process of the stock price. From this point of view, contingent capital can potentially be a factor of instability, rather than an instrument to maintain stability.

If the pricing restriction is violated at many potential conversion points, the possible equilibrium prices may span a wide range on the initial day. We demonstrate this with a numerical example, in which the asset follows a simple geometric Brownian motion: 

\[ dA_t = rA_t + \sigma A_t dz_t \]

and a conversion condition is verified using daily closing prices: \( \Lambda = \Lambda_{\text{daily}} \). In Table I, the column with the heading “GBM” presents the parameters used in this example and the equilibrium values.\(^{14}\) We assume that the bank’s initial asset level is 100. Its volatility is 4%. To keep things simple, we assume a flat term structure, anchored at 3%. The par value of the senior bond is 87 percent of the current asset, and its coupon rate is 4%. We chose the default barrier to be the par value of the bond plus the accrued coupon. There is a unique equilibrium value for the senior bond, which is 88.03, showing that the 3.34% coupon rate prices the bond over par. The par value of the CC is 5% of the bank’s current asset value, and the CC converts to equity if equity value based on the daily closing price is less than or equal to 1 percent of the initial asset value. To avoid running into the case where no equilibrium exists, we set the coupon of the CC to zero. The maturities of both the senior bond and CC are five years. The range of prices generated by multiple equilibria seems substantial. Multiple equilibria produce equity values ranging from 5.86% to 6.46% of the initial asset value. They are associated with CC values ranging from 3.86% to 4.46% of initial asset value. The range of the multiple equilibrium prices is 0.6% of the initial asset value.

The range of multiple prices depends on the asset volatility, the senior bond, and the contract parameters of the CC. In Appendix E, we explain our choice of parameters for the

\(^{14}\)We calculate the prices with a binomial tree that approximates the diffusion process, following Cox, Ross and Rubinstein (1979).
example in Table I. Recognizing that the parameters are potentially different among banks, we examine how the range of multiple prices changes as each parameter varies. In Figure 2, panel A shows that the price range is an increasing function of the bank’s asset volatility. Panel B shows how the range is related to the bank’s leverage with the senior bond. In the first part the range is wider for a bank that has higher leverage, and in the later part the range decreases. These panels demonstrate that the bank-specific information such as asset volatility and leverage play important roles in determining the severity of multiple equilibria. In Panel C, the range widens as the par value of the CC increases. Therefore, the larger CC a bank issues, the wider its range of equity prices. Panel D shows how the range is related to the conversion trigger. The range is wider for a lower trigger than for a higher trigger, because the time to reach the trigger is longer in expectation, incorporating more conversion points in generating the multiple equilibria. The last two panels demonstrate that the severity of multiple equilibria depends on the amount and characteristics of the CC.

With jumps in the asset value, there can still be a wide range of multiple equilibrium prices. We demonstrate this by letting the asset follow the jump diffusion process in equation (5) and using conversion time $\Lambda_{\text{daily}}$. In Table I, the column with the heading “JD” presents the parameters used in this numerical example. We assume that the arrival rate of jumps is 4 times per year, reflecting the quarterly regulatory and accounting filings. The mean of logarithm jump size is $-1$ percent and its volatility is 3 percent to reflect possible large losses. With the presence of jumps, we assume that the volatility of the continuous process is 4%, lower than the volatility assumed for the GBM. To calculate the equilibrium prices, we follow Hilliad and Schwartz (2005) to build a bi-variate tree that approximates the jump diffusion process. With jumps, the yield 3.34% prices the bond at par, which is 87% of the initial asset value. The contingent capital and equity have a bigger range of equilibrium prices. An equilibrium equity value can be as low as 3.84% or as high as 5.44% of the
initial asset value, and the CC value ranges from 2.30% to 3.90% of initial asset value. The pricing range is 1.6% of the initial asset value. Since JD is different from GBM only in the parameters about jumps, these examples show that jumps enlarge the pricing range of the multiple equilibria.

It is useful to provide some perspective on why the multiple equilibria arise in the above example but do not generally arise in the pricing of convertible bonds or options. With a convertible bond, the investor has the “option” to convert and get a pre-specified number of shares of common stock. In each state, the investor can compare values associated with different conversion decision and select the maximum. Likewise, the holder of the option can also make the optimal decision in each state. These optimal decisions can be modeled by the “smooth pasting” or the “high contact” condition pioneered by Merton (1973) and further elucidated by Dixit and Pindyck (1994). In such models, the exercise boundary itself is endogenous and not mandated, and the stake holder, acting in his self interest will select the conversion decision optimally so that there is no value transfer at the trigger price.

With mandatory conversion, no stake holder is allowed to optimally act at the trigger. This absence of a “smooth pasting” condition then leads to the problems we have articulated above. The smoothness breaks down if the mandatory conversion transfers value between the equity holders and CC holders at the trigger price. The state-contingent conversion ratio presented in the theorems prevents the value transfer and, in effect, keeps the prices

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15 It should be noted that there are some studies of the multiple equilibrium in convertible bonds and options. Constantinides (1984) shows the possibility of multiple competitive equilibria, and Spatt and Sterbenz (1988) have examined sequential exercise strategies and gains to hoarding warrants. In these papers, however, multiplicity of equilibrium is caused by the distribution of ownership of warrants and reinvestment policies. Furthermore, in the context of bank runs, the possibility of multiple equilibria has been identified by Diamond and Dybvig (1983).

16 The effect of value transfer at mandatory conversion is similar to an exogenous value transfer caused by tax distortion. Albul et al (2010) have shown that differential tax treatment of CC’s coupon interest and equity’s dividend can cause multiple equilibria for a mandatory convertible debt with the trigger on asset value.
“smooth” at conversion. However, conversions that are mandatory only at maturity do not pose any essential difficulty as the bond trades at par at maturity and hence the zero value transfer restriction at maturity can be satisfied with a fixed conversion trigger and ratio. The mandatory convertible preferred security in the Treasury’s Capital Assistance Program in 2009 has such features at maturity.

Several papers have proposed pricing models of CC with unique a equilibrium. Those models either avoid placing the conversion trigger on the market value of equity or make additional assumptions so that the equity value is unaffected by the conversion of contingent capital. Albul et al. (2010) and Himmelberg and Tsyplakov (2012) obtain a unique equilibrium by placing the trigger directly on the asset value. Pennacchi (2010) and Pennacchi et al. (2011) place the conversion trigger on the ratio of the asset value to the combined value of the CC and equity. In order to have a unique equilibrium, these papers make additional assumptions so that the ratio is exogenously determined and unaffected by the CC’s conversion. McDonald (2010) calculates a unique price for CC by assuming that the firm’s equity value follows a geometric Brownian motion exogenously. Glasserman and Nouri (2012) place the conversion trigger on the ratio of “book value” of equity to the asset value, where the “book value” is obtained by subtracting, from the asset value, the par values and coupon obligations of the bond and CC. These studies corroborate the importance of placing the conversion trigger on exogenous variables in order to steer clear off the multiplicity and absence of equilibrium and to price the contingent capital. However, a trigger placed on an exogenous variable does not assure timely conversion because the exogenous variable may not signal a bank’s potential large losses.

17 In the valuation of barrier options, the exercise boundary is exogenous and their structure shares some of the features of CC. But the exercise of such options does not influence the underlying stock price itself, as there are no dilution effects to consider. These options are also in zero net supply.  
18 See Glasserman and Wang (2011), who describe and value the capital assistance program.  
19 In a bank with short-term, but not long-term, debt, they assume that the short-term debt is always priced at par and the total par value follows an exogenous stochastic process.
Our focus is on the contingent capital with a mandatory conversion feature and a trigger for conversion placed on the value of securities issued by the bank. This design does not leave conversion as an option to the bank’s equity holders, the CC holders, or the regulators, preventing them to behave optimally to determine the trade off between conversion and continuation. We have discussed the reasons for taking the conversion option away from these stake holders. However, it is important to understand when the mandatory conversion is based on the market price, whether conversion happens or not depends on the aggregate behavior of the agents in the market. Our model uses the no-arbitrage pricing framework, in which the agents in the market make optimal investments and take advantage of arbitrage opportunities.

Although all our numerical examples demonstrate the case of multiple equilibrium, we should emphasize that the absence of equilibrium is equally important. While the range of multiple equilibrium offers a sense of the severity of the problem, there is no simple way to characterize the severity of no equilibrium. This does not imply that the absence of equilibrium is not a serious concern. The problem with the absence of equilibrium is demonstrated in the laboratory experiments conducted by Davis, Prescott and Korenok (2011). They let groups of heterogeneous agents trade an asset in a market where there is no equilibrium due to intervention by a market regulator and compare the results obtained in a market where there is a unique equilibrium without intervention. They observe large uncertainty in trading prices and inefficient allocation of the asset, with efficiency in their analysis measured by how much assets are allocated to the traders who value them the most. In the case of the multiple equilibria caused by regulator intervention, their experiments also show price uncertainty and allocation inefficiency.
III Equilibria under Alternative Market Conditions

III.A Implementation in a Restrictive Market Condition

The pricing restriction presents a challenge to the implementation of the CC design: the restricted conversion ratio is tied to the market value of the contingent capital if we want a unique equilibrium. Since we cannot tell what the future market value will be, the value $C_t$ of the nonconverted CC can be different from a pre-specified $m_t K_t/n$ at any time $t \in \Lambda$. If we set the conversion ratio to $m_t = nC_t/K_t$, it depends on the future market value of the nonconverted CC. However, if the unconverted CC is always priced at the par value, the problem will be solved by setting $m_t = n\bar{C}/K_t$.

To make a CC priced at par all the time before conversion, we need to focus on a structure that makes the market value of the CC immune to changes in interest rates and default risk. For example, if the CC had no default risk until conversion, by selecting the coupon rate at each instance to be the instantaneously risk-free rate we can ensure that the CC will trade at par. See Cox, Ingersoll, and Ross (1980) for a proof of this assertion.\(^{20}\) In this case, CC will work well, because we can determine the conversion ratio ex-ante as $m_t = nC_t/K_t = n\bar{C}/K_t$. Since $\bar{C}$ and $K_t$ are known ahead of time, we can specify the conversion ratio ahead as well. Without jumps in asset value, CC can be designed to be default-free during its life before conversion, even though the bank may have a positive probability of default on its debt claims subsequent to the expiration of CC. This idea is formalized in Theorem 3 below.

**Theorem 3** Suppose a bank’s asset value follows a geometric Brownian motion, $dA_t = \left( r_t - \alpha_t \right) A_t dt + \sigma A_t dz_t$, where $\alpha_t$ is the rate of cash flow from the asset, $r_t$ is the instantaneous risk-free interest rate, and $z_t$ is a Wiener process. Given any conversion trigger $K_t$ that is a continuous function in time, the contingent capital with coupon rate $c_t = r_t$, continuous \(^{20}\)In the context of a CC that is exposed to default risk, the appropriate indexed coupon may also require a compensation for the mandatory conversion in addition to the risk-free rate.
verification \( \Lambda = [0, +\infty] \), and conversion ratio \( m_t = n\bar{C}/K_t \) has a unique equilibrium value, which equals the par value.

This theorem generalizes the immunization results of Cox, Ingersoll, and Ross (1980) to a setting where there is mandatory conversion and a positive probability of default after the expiration date of CC. Since the coupons float with the risk-free rate and the principal is guaranteed at conversion, the CC is fully immunized and therefore sells at par. The economic rationale is also intuitive. Since the CC sells at par, we can design the CC with an ex-ante conversion ratio that guarantees that, upon conversion, the CC holders will get par. This theorem demonstrates the existence of simple CC design that gives a unique equilibrium. In this CC, conversion trigger \( K \) and ratio \( m \) can be constant. To assure a unique equilibrium, we only need to set \( K \) and \( m \) so that \( m = n\bar{C}/K \).

Theorem 3 appears to make a CC with market trigger implementable, but it is impracticable. Theorem 3 needs the asset price process to be continuous and the verification to be continuous. In reality, the underlying process of an asset value can have discontinuous jumps. Consequently, the bond is not free of default risk before conversion, and the theorem does not hold. Also, continuous verification is impractical; practical contract specifications are always based on closing or settlement prices, sampled over daily or other regular intervals. In addition, bank-issued CC will be less liquid than risk-free assets such as Treasury securities, and hence the coupon will have to include a component for the liquidity premium in order to make the CC value equal to par. Theorem 3 indicates the restrictive assumptions that are needed to design a CC with market trigger that produces a unique equilibrium.

### III.B Equity Issuance and Conversion

In the analysis so far, we assume that the bank does not issue new equity shares during the life of the contingent capital, particularly when the bank’s equity level is low. It is a
reasonable assumption because the reason for regulators to require contingent capital stems from their belief that it is too expensive or difficult for a bank to raise equity capital when the bank is under stress and highly leveraged. However, it is still interesting to ask whether the absence of a unique equilibrium may occur if banks can issue new shares to avoid conversion.

Attempting to solve the equilibrium problem demonstrated in this paper, Calomiris and Herring (2011) argue that the option to issue new shares and avoid conversion eliminate the equilibriums that are disadvantageous to equity holders and assures a unique equilibrium. They also assert that the need to avoid a disadvantageous equilibrium forces banks to issue common equity. They suggest that regulators should require banks to hold contingent capital mainly to force banks to issue equity in bad times or states. They recommend that CC with a market trigger and a punitive conversion ratio gives incentives to equity holders and bank managers to issue new equity to avoid conversion.\textsuperscript{21} Based a one-period numerical example, they suggest that issuance of new equity can remove the conversion equilibrium at the trigger point. Unfortunately, their suggestion is correct only if the bank is unlevered as assumed in their example.\textsuperscript{22}

In this subsection, we will show that equity issuance may eliminate some of the equilib- rium in which the CC converts and ensure unique equilibrium at maturity but not before maturity. This result at maturity is of limited interest as the bank becomes unleveraged at maturity. In demonstrating this, we assume a frictionless world where issuing new shares does not incur additional cost beyond the shares’ fair value. Finally, we show that the additional cost of issuing new shares will make multiplicity of equilibrium even more likely.

\textsuperscript{21}Himmelberg and Tsyplakov (2012) also advocate avoiding conversion by issuing new equity but place the trigger on bank asset instead of equity.

\textsuperscript{22}Another problem in this proposal is that we cannot impose a limit on new share issuance. Unlimited share issuance may cause a death spiral in equity prices, which is a serious concern in industry (see Hillion and Vermaelen, 2004, for an analysis of death spiral associated with floating price convertibles.) In fact, a cap on new share issuance is one of Basel’s minimum requirements for contingent capital contracts (Basel Committee on Banking Supervision, 2011).
Therefore, the proposal by Calomiris and Herring (2011) is not a solution to the equilibrium problem discovered in our paper.

We first show how equity issuance eliminates a conversion equilibrium at the maturity of the senior bond. Let us use the same notations in Section I. To have multiple equilibria at maturity, we need to set $m > n\bar{C}/K$ so that conversion is punitive. As we have discussed before, for every $A_T \in (\bar{B} + \bar{C} + K, \bar{B} + (m/n)K + K]$, there are two equilibria. In one equilibrium the CC does not convert, and the stock price is $S_T^u = (A_T - \bar{B} - \bar{C})/n > K/n$. In the other equilibrium the CC converts, and the stock price is $S_T^c = (A_T - \bar{B})/(n + m) \leq K/n$. If the bank issues enough (say $l$) new shares to avoid conversion, the second equilibrium cannot sustain. Since conversion can be avoided, the share price with new issuance must be $S_T^u$. Since $S_T^c < S_T^u$, the bank will choose to issue new shares as otherwise everyone may believe conversion could happen. Consequently, the only possible equilibrium stock price is $S_T^u$ for every $A_T \in (\bar{B} + \bar{C} + K, \bar{B} + (m/n)K + K]$.\(^{23}\)

Equity issuance ensures a unique equilibrium in the above example because the bank is not leveraged after stock issuance. If the firm continues to be leveraged at time $T$, issuing new shares of equity will increase the safety of the outstanding bond and CC and raise their values. This transfers some value from equity holders to bond holders. Suppose, at time $T$, the bond value without issuing equity turns out to be equal to $B$ and the bond gains $\Delta B > 0$ with the issuance of $l$ shares of new equity. Then, the bond value with equity issuance at $T$ is $B_T^i = B + \Delta B$. The equity price with the issuance of new equity, denoted by $S_T^i$, should satisfy $(A_T + l \cdot S_T^i - B_T^i - \bar{C})/(n + l) = S_T^i$. Solving for $S_T^i$, we obtain that the stock price should be $S_T^i = (A_T - B_T - \bar{C})/n = (A_T - B - \Delta B - \bar{C})/n$, which is smaller than $S_T^u$.

\(^{23}\)It is worth pointing out that no matter how large the conversion ratio $m$ is, equity issuance does not eliminate the chance of conversion. Conversion must happen when $A_T \leq \bar{B} + \bar{C} + K$ because $S_T^u \leq K/n$ in this case. Issuing new shares will not increase $S_T^u$. Therefore, the probability of conversion is at least as large as $P\{\bar{B} + \bar{C} + K\}$, which is independent of $m$. 
Then, for every $A_T \in (B + \bar{C} + K, B + (m/n)K + K]$, there are two equilibria. In the first equilibrium, all investors believe that CC will not convert. In this case, bank management does not issue new shares because new issuance will lead to lower stock price. Without conversion and issuance, the stock price is $S^u_T$. In the second equilibrium, all investors believe that the CC converts if no new shares are issued to avoid the conversion. In this case, the result of the equilibrium depends on the magnitude of $\Delta B$. If $\Delta B$ is so small that $S^i_T > S^c_T$, then the bank management prefers issuing new shares to conversion. Consequently, CC does not convert, new shares are issued, and the stock price is $S^i_T$, which is larger than $S^c_T$ but smaller than $S^u_T$. However, if $\Delta B \geq n(A_T - B)/(n + m) - \bar{C}$, it is easy to verify that $S^i_T \leq S^c_T$. In this case, the bank management will be better off by letting the CC convert. Therefore, the converted share price $S^c_T$ should be the equilibrium price, and no new shares are issued.

The above analysis suggests that equity issuance does not ensure a unique equilibrium in a dynamic setting. Take the example of one-period discrete model in Section I.B but set conversion ratio to $m = 3$. Recall that $\bar{B} = 90$, $\bar{C} = 10$, $K = 5$, and $n = 1$. The probability distribution of $A_T$ is: $p\{A_T = 120\} = .25$, $p\{A_T = 100\} = 0.50$, and $p\{A_T = 80\} = 0.25$. With the assumption of zero risk-free rate, the initial asset value is $A_0 = 100$, and bond value is $B_0 = 87.50$, as shown in panel A of Figure 3. Similarly as in Section I.B, without issuance of new shares, we obtain two equilibria: $(C^u_0, S^u_0) = (6.25, 6.25)$ and $(C^c_0, S^c_0) = (9.38, 3.13)$, as shown in panel B of Figure 3.

Now, assume that the bank plans to issue new shares today so that the total number of shares enlarges by fifty percent. Suppose the issuance price is $5.26$, which will be shown in the next paragraph to be the equilibrium stock price with the issuance. For simplicity, assume that the proceeds of the new shares can be reinvested to enlarge the bank asset
and earn the same return. The asset value with reinvestment of the proceeds is \( A_0^i = 100 + 0.5 \times 5.26 = 102.63 \). If the original asset value \( A_T \) is 120, 100, or 80, the value of the enlarged asset, \( A_T^i \), is 123.16, 102.63, or 82.10, respectively. These asset values are shown in panel A of Figure 3. The enlarged asset makes the bond safer and increases the bond value from 87.50 to 88.03, as shown in the same panel.

With new equity issuance being allowed, no conversion today is still an equilibrium as shown in panel B of Figure 3 because the stock price, \( S_{0u} = 6.25 \), is above the trigger. However, if all investors believe that conversion would happen if the bank does not avoid it, issuing new shares today is another equilibrium as shown in panel C of Figure 3. Issuing new shares is a strategy that dominates conversion because \( S_{0i} = 5.26 \) is higher than \( S_{0c} = 3.13 \). Also notice that \( S_{0i} = 5.26 \) is the same as the issuance price we assumed at the beginning of the previous paragraph. This confirms that \( S_{0i} = 5.26 \) is an equilibrium price with issuance. Therefore, using equity issuance to avoid conversion, we still have two equilibria: \((C_{0u}, S_{0u}) = (6.25, 6.25)\) and \((C_{0i}, S_{0i}) = (6.71, 5.26)\).

It is difficult to analyze a dynamic continuous time model with optimal equity issuance, but the above analysis and example in discrete models are sufficient to demonstrate that optimal equity issuance does not guarantee a unique equilibrium, even if we assume equity issuance is possible and costless. Given the complicated pricing dynamics of contingent capital, the incentives of contingent capital to bank managers are largely uncertain. Therefore, using a contingent capital requirement appears to be an indirect way to force banks to issue common equity. It may be more direct and simple to set a regulatory policy that requires banks to issue common equity when the market equity ratio is low.

\[ ^{24}\text{That is, we assume that the bank asset has constant returns to scale. If we assume that the asset has a decreasing return to scale, it strengthens the case for multiple equilibria.}\]
III.C Financial Distress

When deriving the condition for the existence of a unique equilibrium, we allow for costly bankruptcy but not for financial distress. For the one-period and two-period examples in Section I, we consider zero-coupon bond and contingent capital so that the firm does not need cash or other liquid assets to meet coupon obligations before the maturity date. For the theorems in Section II, we assume that the cash outflows for paying coupons of the bonds and contingent capital come from operating cash flows and, when needed, from equity holders. This assumption ensures that the firm value and senior bond value are not path-dependent and thus allows us to derive the necessary and sufficient conditions for the unique equilibrium in a general setting.

An argument frequently cited in favor of contingent capital is, however, that it can be converted into equity if the bank is under financial distress. The conversion thereby conserves capital as the bank is relieved of paying the coupons associated with the CC. In periods of financial distress when banks may not be able to raise capital, contractual coupon obligations may be a burden and carry significant costs. In particular, meeting such obligations may result in asset depletion, which may further exacerbate the financial distress. One reason for introducing contingent capital is to reduce the likelihood for a financial institution to experience default because the chance of costly bankruptcy destroys the value of the firm that is under financial distress.

Given that financial distress is assumed away in Section II, it is natural to ask whether there are multiple equilibria under financial stress if the contingent capital has a constant conversion ratio. This question is technically difficult to analyze in a setting that is as general as in Section II because selling asset to meet coupon payments makes the asset value dependent on its path in the past. Nevertheless, using a two-period discrete model, we are
able to demonstrate that under financial distress when debt service depletes assets, there can still be multiple equilibria of CC and equity values. In the case of financial distress, there can even be multiple equilibria of firm values and senior bond values. In other words, contingent capital can lead the equity, bond and firm values to be all different in different equilibria.

More generally, the analysis in this two-period model suggests that with financial distress a contingent capital does not always have unique equilibrium even if we place the conversion trigger on any combination of the claims of the firm. For example, Pennacchi (2011) suggests that placing the trigger on the sum of the equity and CC values may ensure a unique equilibrium. This section shows that his trigger design does not solve the problem in the presence of bankruptcy costs and financial distress, which are assumed away in his paper.

Our two-period model has three dates: dates 0, 1 and 2. For simplicity, we assume that the risk-free rate is zero. During each period, the risky asset value either has positive return $R$ or a negative return $-R$ with equal probability. Thus, on date 1, the asset value will be $A_1 = A_0(1 \pm R)$ with equal probability for each value. On date 2, however, the asset value will depend on what happens to the bond and CC on dates 0 and 1. Assume there is a bond with face value $\bar{B}$ and coupon rate $b$ per period and a CC with face value $\bar{C}$ and coupon rate $c$ per period. Both the bond and CC start from date 0 and mature on date 2. Unlike in the previous section, we assume that the bank has to sell assets to serve debt obligations. Then, if neither the bond defaults nor the CC converts on date 0 or 1, the asset value on date 2 is $A_2 = (A_1 - b\bar{B} - c\bar{C})(1 \pm R)$, which has four possible values with equal probability. If the bond does not default on date 0 or 1 but the CC converts on date 0 or 1 when the asset value is $A_1$, the asset value on date 2 is $A_2 = (A_1 - b\bar{B})(1 \pm R)$, which has two possible values with equal probability conditioning on $A_1$.

The firm and bond values also depend on whether the bond is defaulted. If the bond is
not defaulted up to date $i$, the firm and bond values on date $i$ are

$$F_i = \begin{cases} A_2 & \text{if } i = 2 \\ E[F_{i+1}] & \text{if } i = 0, 1 \end{cases} \quad \text{and} \quad B_i = \begin{cases} (1 + b)\bar{B} & \text{if } i = 2 \\ E[B_{i+1}] + b\bar{B} & \text{if } i = 1 \\ E[B_{i+1}] & \text{if } i = 0, \end{cases} \quad (16)$$

where $E[F_{i+1}]$ and $E[B_{i+1}]$ are the expected firm and bond values on date $i+1$, respectively. Notice that the bond value is “cum-dividend.” In this model, we assume that default happens if and only if the equity value is zero. Thus, the condition for default on date $i$ is that the firm value $F_i$ is smaller than or equal to the bond value conditioning on the bond not defaulting. This default strategy maximizes the shareholders value. Bankruptcy is costly, and the cost is a fraction ($\omega$) of the assets. Then, if the bond has defaulted by date $i$, the firm and bond values on date $i$ are

$$F_i = B_i = (1 - \omega)A_i. \quad (17)$$

The CC and equity values depend on whether the CC is converted, besides depending on the status of the bond. Let $K$ be the trigger level for contingent capital and $m$ the conversion ratio. Assume there is one share outstanding on date 0. If the CC has not been converted on date $i$, the CC and equity values on date $i$ are

$$C_i = \begin{cases} (1 + c)\bar{C} & \text{if } i = 2 \\ E[C_{i+1}] + c\bar{C} & \text{if } i = 1 \\ E[C_{i+1}] & \text{if } i = 0 \end{cases} \quad \text{and} \quad S_i = F_i - B_i - C_i. \quad (18)$$

If the CC has been converted on date $i$ but the bond has not been defaulted, the CC and equity values on the date are

$$C_i = mS_i \quad \text{and} \quad S_i = \frac{1}{1 + m}(F_i - B_i). \quad (19)$$

If the bond has been defaulted on date $i$, the CC and equity value on date $i$ are

$$C_i = 0 \quad \text{and} \quad S_i = 0. \quad (20)$$

The set of the firm, bond, CC, and equity values, \{$(F_i, B_i, C_i, S_i)$\}$_{i=0,1,2}$, is a dynamic rational expectations equilibrium in the model if the values satisfy equations (16)–(20). The
equilibrium in this model is not always unique. This can be shown by a numerical example. Let $A_0 = 100$, $R = 0.06$, $\omega = 0.1$, $B = 85$, $b = 0.02$, $C = 6$, $c = 0.04$ and $K = 1$. We have two equilibria, which are displayed in Figure 4. Panel A is an equilibrium in which conversion does not occur, and the bank has to pay coupons to CC holders on date 1. This reduces the assets and as a consequence increases the likelihood of default on date 2. Panel B is an equilibrium in which conversion occurs on date 1, and hence the bank is able to conserve its capital and avoids bankruptcy on date 2.

The following are worth noting. First, the trees in Figure 4 are not recombining as the assets are reduced to meet contractual coupon payments under financial distress. Studies of a multi-period model with non-recombining trees are often difficult, and this is the reason we limit ourselves to a two-period model. Second, the asset value at each node is potentially different from the bank’s firm value since the latter will be the asset value minus the expected costs of default, which are the financial distress costs.

Of the two equilibria, the conversion equilibrium in panel B is welfare improving in the sense that it results in lower dead-weight losses. Notice that the date 0 firm value (100) in the equilibrium with conversion is higher than the value (97.84) in the equilibrium without conversion. This shows that the conversion equilibrium results in lesser dead-weight losses as the bank avoids paying coupons when “bad states” are reached. On the other hand, the no-conversion equilibrium results in higher dead-weight losses. This example suggests that contingent capital can be potentially welfare improving in the sense of reducing the expected dead-weight losses, but there is no credible way to select this equilibrium ex-ante. In fact, equity holders would prefer the no-conversion equilibrium because the equity value in this equilibrium is 6.00, which is larger than the equity value (5.36) in the other equilibrium.
IV Conclusion

Our paper shows that depending on the design and the underlying asset dynamics, one can obtain unique, multiple, or no equilibrium when a bank’s capital structure contains a contingent capital with a market trigger for mandatory conversion. Since contingent capital and other securities are claims on the same assets, their prices (which reflect conversion policies) often need to be determined simultaneously. Because no stakeholder is given the option to act in his best interest, conversion rules must ensure that, at the trigger price, conversion does not change the value of the security on which the trigger is placed. Since the conversion ratio that gives a unique equilibrium must produce no value transfer, the design of “dilutive” ratios in order to penalize bank managers or to promote coercive equity issuance will lead to multiple equilibria. In multiple equilibria, the CC holders and equity holders have precisely the opposite motives, which can lead to potential manipulation of market prices when the equity price approaches the trigger level. Under some conditions, we show that CC with a market equity trigger can also result in no equilibrium, which does not promote stability.

The pricing problem demonstrated in this paper shows the challenge regulators typically face when they interact with markets. The challenge can come in two ways: (1) regulation with a good intention may interfere with the markets and cause instability with unintended consequences; and (2) regulation’s function may be constrained by the markets, causing it to become ineffective. In the example of contingent capital with a market trigger, a conversion that is punitive to equity holders may introduce instability because it creates multiple equilibria. On the other hand, the unique equilibrium restriction strips off the incentive function of the CC. In view of the problems that we have discussed earlier regarding designing CC with bank manager’s option to convert, or with a trigger placed an accounting
ratios, or with regulator’s discretion, and the challenges that we have shown regarding the design of a CC with a market trigger it may not be practical to design the security so that it converts to common equity in a timely and reliable manner when a bank is under stress.

The equilibrium problem demonstrated by our theoretical analysis, the instability and uncertainty shown by the lab experiments, and the experience of manipulation in barrier options suggest that the contingent capital with a market trigger can potentially be problematic if used widely as a regulatory tool. Regulators should exercise caution in allowing banks to use the contingent capital with a market trigger, instead of common equity, in satisfying regulatory capital requirement. Some have argued that contingent capital is a cheaper substitute for equity because the CC’s coupon payments qualify for tax deduction. We should point out that the contingent capital with a market trigger is unlikely to be tax deductible in the U.S. unless the government changes its tax code to exempt CC particularly.\textsuperscript{25} We should also keep in mind that bank’s savings from tax deduction are taxpayers’ costs. The foregoing observations suggest that the role of CC with a market trigger as a capital instrument to internalize large losses of systemically important financial institutions must be examined carefully. The design of an effective and efficient bank capital regulation is still a continuing and challenging work in progress.

\section*{IV.A The Current State of the Regulations Regarding CC}

Regulators around the world have taken positions on the credibility and practicality of contingent capital as a loss-absorbing capital for banks and financial institutions. We summarize

\textsuperscript{25}According to Revenue Ruling 85-119, the feature of paying back the par value at maturity, if a CC is not converted, appears to make the CC a debt for tax purpose. However, the coupon payments are not tax deductible according to Section 163(l) of the Internal Revenue Codes. A security is a disqualified debt instrument in IRC Sec. 163(l) if (a) a substantial amount of the principal and interest of the security is required to be paid in or converted into the equity of the issuer, (b) a substantial amount of the principal or interest is required to be determined by reference to the value of such equity, or (c) the indebtedness is part of an arrangement which is reasonably expected to result in a transaction described in (a) or (b).
below the recent development of policies related to contingent capital. This provides a context for our study and helps us to put a perspective on the policy debate.

Basel III has concluded that contingent capital should not be used by global systemically important banks (G-SIB) for loss-absorbency, on the ground that absorbing losses at the point of non-viability violates the spirit of the “going-concern” objectives. The Basel committee noted several similarities between equity capital and CC (such as the possibility that both can be issued in good states so that they can offer protection in bad states, and both are pre-funded, which increases the liquidity of the banks in good states). After enumerating the pros and cons of CC, the Basel committee concluded that the G-SIB be required to meet the loss absorbency requirement with common equity capital only. Their recommendations exclude CC from the core 7% capital requirements and the $0\sim2.5\%$ additional capital requirement for G-SIB.

Although Basel III delegates to regional regulators the decision on the use of CC in any additional capital requirements, it has issued guidelines on the design of CC. The guidelines contain three important requirements. First, conversion should be triggered at an equity ratio not lower than 7% to qualify for “additional tier-1” capital. Second, a regulatory trigger that forces conversion when the bank is non-viable without public assistance should be included. Third, a cap on share issuance should be imposed. The first requirement forces banks to use accounting trigger on equity. The second requirement reveals the Basel Committee’s lack of confidence in the accounting trigger. The third requirement is a result of concerns about death spiral.

Regional regulators around the world have issued rules that are consistent with Basel III and echo the concerns expressed by the Basel committee. The Swiss regulator (FINMA, 2011) requires its large banks to maintain at least 19% capital ratio, comprised of 10% equity and 9% CC. The European Commission (2011) proposed to mandate that their banks
maintain capital ratios above 8%, of which 4.5% should be in equity and 3.5% in CC, along with surcharges of 7.5%, which may only be in common equity. The U.K.’s Independent Commission on Banking (2011) concluded that equity is the only form of loss-absorbing capacity that works both pre- and post-resolution and expressed concerns about the potentially destabilizing effects of contingent capital. Bank of Canada (2010) and the OFSI (Dickson, 2010) extend support for a convertible security structured for the resolution of failing banks but does not endorse the contingent capital with early conversion features for going concerns. China Banking Regulatory Commission (2011) took a simple approach, requiring systemically important banks to have at least 11.5% equity or other liquid capital.

The U.S. bank regulators jointly proposed rules on implementing Basel III’s capital requirements. On the second anniversary of the Dodd-Frank Act, the Financial Stability Oversight Council (2012) submitted its study to the Congress and recommended “that contingent capital instruments remain an area for continued private sector innovation,” after discussing “a range of potential issues that could be associated with contingent capital instruments, depending on their structure and, in particular, the structure and timing of conversion triggers.” Particularly, the Council warned that “market-based triggers can exacerbate the problem of death spiral.”

Appendix  Proofs of the Theorems

Before proving the theorems, it is useful to make the following observation. If there were no CC, at any time \( t \) before maturity and default \( (t \leq \min\{\delta, T\}) \), the equity value would have been

\[
U_t = E_t \left[ (A_T - \bar{B})P(t, T) \cdot 1_{\delta>T} + J_t \right],
\]

(A1)
where $J_t$ is defined in equation (12) by replacing $\tau$ with $t$. Since it is known from Merton (1974) and Black and Cox (1976) that $U_t$ is a measurable function of $t$ and $A_t$, we can define another hitting time based on $U_t$ and the given $K_t$ and $m_t$:

$$ v = \inf \left\{ t \in \Lambda : \frac{n}{n + m_t} U_t \leq K_t \right\}. \quad \text{(A2)} $$

The following lemma will be useful for all the proofs.

**Lemma 1** If $(S_t, C_t)$ is the stock and CC prices in an equilibrium, then $nS_t + C_t = U_t$ when $t < \min\{\tau, \delta\}$, and $S_t = U_t / (n + m_t)$ when $\tau \leq t < \delta$.

**A Proof of Lemma 1**

Suppose $t < \min\{\tau, \delta\}$. It follows from equations (10) and (13) that

$$ nS_t + C_t = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\min\{\tau, \delta\} > T} + I_t + H_t \right] $$

$$ + E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\tau \leq T < \delta} + J_t P(t, \tau) \cdot 1_{\tau < \min\{\delta, T\}} \right]. \quad \text{(A3)} $$

Substituting equations (11), (12) and (14) for $I_t$, $J_t$ and $H_t$, respectively, in equation (A3), we obtain

$$ nS_t + C_t = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\min\{\tau, \delta\} > T} \right] $$

$$ + E_t \left[ \int_{t}^{\min\{\tau, \delta, T\}} (a_s A_s - b_s B - c_s \bar{C}) P(t, s) ds \right] $$

$$ + E_t \left[ \int_{t}^{\min\{\tau, \delta, T\}} c_s \bar{C} P(t, s) ds \right] $$

$$ + E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\tau \leq T < \delta} \right] $$

$$ + E_t \left[ \int_{\tau}^{\min\{\delta, T\}} (a_s A_s - b_s B) P(\tau, s) ds P(t, \tau) \cdot 1_{\tau < \min\{\delta, T\}} \right]. \quad \text{(A4)} $$

Combining the terms in equation (A4), we obtain

$$ nS_t + C_t = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\delta > T} \right] $$

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\[ E_t \left[ \int_{t}^{\min\{\tau, \delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \right] + E_t \left[ \int_{\tau}^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \right] = (A5) \]

In equation (A5), we can rewrite the integral in the second term into
\[ \int_{\tau}^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \cdot 1_{\tau < \min\{\delta, T\}} \cdot 1_{\min\{\delta, T\}}. \]  

(A6)

Combining the integrals of the last terms in equations (A5) and (A6), we obtain
\[ nS_t + C_t = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\delta > T} \right] + E_t \left[ \int_{t}^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \cdot 1_{\min\{\delta, T\}} \right] + E_t \left[ \int_{t}^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \cdot 1_{\min\{\delta, T\}} \right]. \]  

(A7)

The last two terms in equation (A7) can be combined to give
\[ nS_t + C_t = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\delta > T} \right] + E_t \left[ \int_{t}^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B}) P(t, s) ds \right] = E_t \left[ (A_T - \bar{B}) P(t, T) \cdot 1_{\delta > T} + J_t \right] = U_t. \]  

This proves \( nS_t + C_t = U_t. \)

For \( \tau \leq t < \delta \), equations (15) and (A1) imply \( S_t = U_t/(n + m_T) \). \( \text{Q.E.D.} \)

**B Proof of Theorem 1**

For \( \tau < \min\{\delta, T\} \), it follows from Lemma 1 that \( S_\tau = U_\tau/(n + m_\tau) \). Since \( nS_\tau \leq K_\tau \) by equation (9), we have \( nU_\tau/(n + m_\tau) \leq K_\tau \), which implies
\[ v \leq \tau \]  

(A8)

in view of equation (A2). On the other hand, equation (A2) implies \( nU_\nu/(n + m_\nu) \leq K_\nu \), and thus conversion is an equilibrium at time \( \nu \). If \( nS_\nu > K_\nu \), then no conversion is also
an equilibrium at time $v$, contradicting to the assumption of unique equilibrium. Thus, the uniqueness of the equilibrium implies $nS_v \leq K_v$. It follows that

$$\tau \leq v,$$

(A9)

in view of equation (9). Combining equations (A8) and (A9), we have $\tau = v$. It then follows from equations (9), (A2) and Lemma 1 that

$$\inf \{ t \in \Lambda : U_t \leq K_t + C_t \} = \inf \{ t \in \Lambda : U_t \leq K_t(n + m_t)/n \}.$$  

(A10)

The above equation holds for all possible paths of $U_t$ if and only if $K_t + C_t = K_t(n + m_t)/n$ for all $t \in \Lambda$, which implies $m_t = nC_t/K_t$ for all $t \in \Lambda$. Therefore, in order to have a unique equilibrium, the conversion ratio must satisfy $m_t = nC_t/K_t$ for $t \in \Lambda$. Q.E.D.

**C Proof of Theorem 2**

To prove Theorem 2, we use the hitting time $v$ defined in (A2) as the conversion time of a CC. For any conversion ratio $m_t$, in rational expectations, the stock price and the CC value before conversion, default, and maturity ($t < \min\{v, \delta, T\}$) are

$$S^*_t = E_t \left[ (A_T - \bar{B} - \bar{C})P(t, T) \cdot 1_{v < \min\{v, \delta, T\}} + I^*_t \right],$$

(A11)

$$C^*_t = E_t \left[ CP(t, T) \cdot 1_{v < \min\{v, \delta, T\}} + H^*_t \right]$$

$$+ E_t \left[ \frac{m_v}{n + m_v} \left\{ (A_T - \bar{B})P(t, T) \cdot 1_{v < \delta} + J^*_v P(t, v) \cdot 1_{v < \min\{\delta, T\}} \right\} \right],$$

(A12)

$$H^*_t = \int_t^{\min\{v, \delta, T\}} c_s CP(t, s) ds$$

(A13)

$$I^*_t = \int_t^{\min\{v, \delta, T\}} (a_s A_s - b_s \bar{B} - c_s \bar{C})P(t, s) ds$$

(A14)

$$J^*_v = \int_v^{\min\{\delta, T\}} (a_s A_s - b_s \bar{B})P(v, s) ds.$$  

(A15)

The stock price after conversion ($v \leq t < \min\{\delta, T\}$) is

$$S^*_t = \frac{1}{n + m_v} E_t \left[ (A_T - \bar{B})P(t, T) \cdot 1_{\delta > T} + J^*_t \right].$$

(A16)
Following the proof of Lemma 1, we can use equations (A11)–(A16) to derive similarly
\[ nS_t^* + C_t^* = U_t, \]
which implies
\[ nS_t^* = U_t - C_t^*. \]  
(A17)

Now, we use \( S_t^* \) to define another hitting time: \( \tau^* = \inf\{t \in \Lambda : nS_t^* \leq K_t\} \). In view
of equation (A17), we have \( \tau^* = \inf\{t \in \Lambda : U_t \leq K_t + C_t^*\} \). Setting \( m_t = nC_t^*/K_t \) for all
\( t \in \Lambda \), we have
\[ \tau^* = \inf\{t \in \Lambda : U_t \leq K_t(n + m_t)/n\} = \nu. \]  
(A18)

Therefore, \((S_t^*, C_t^*)\) satisfies equations (9), (10), (13) and (15) and thus is an equilibrium.

If \((S_t, C_t)\) is another equilibrium with the conversion ratio \( m_t = nC_t/K_t \), following similar
reasoning in the derivation of equation (A18), we can show that the conversion time \( \tau = \inf\{t \in \Lambda : nS_t \leq K_t\} \) equals \( \nu \), which gives \( \tau = \tau^* \). Therefore, the values of the common
stock and CC calculated in equations (10), (13), (A11) and (A12) imply \( S_t = S_t^* \) and \( C_t = C_t^* \).
This proves the uniqueness of the equilibrium. \( Q.E.D. \)

**D  Proof of Theorem 3**

In this theorem, \( c_t = r_t \) for all \( t \). With the conversion ratio \( m_t = n\bar{C}/K_t \), we first show
that, in any equilibrium, the value of unconverted contingent capital equals its par value,
i.e., \( C_t = \bar{C} \) for all \( t \leq \tau \).

Let \((C_t, S_t)\) be an equilibrium. The value of the unconverted contingent capital satisfies
equation (13). Using \( c_t = r_t \) and the definition of the discount factor, we can write equation (14) as
\[
H_t = \int_t^{\min\{\tau, \delta, T\}} r_s C e^{-\int_t^s r_u du} ds = -\bar{C} \int_t^{\min\{\tau, \delta, T\}} e^{-\int_t^s r_u du} d \left(-\int_t^s r_u du\right).
\]  
(A19)
It follows from the fundamental law of calculus that
\[ H_t = -\bar{C} e^{-\int_t^s r_u du} \min_{\{\tau, \delta, T\}} \quad = \bar{C} [1 - P(t, \min\{\tau, \delta, T\})]. \quad (A20) \]

The last term can be split into two terms to give
\[ H_t = \bar{C} \left[ 1 - P(t, T) \cdot 1_{\min\{\tau, \delta\} > T} - P(t, \min\{\tau, \delta\}) \cdot 1_{\min\{\tau, \delta\} \leq T} \right]. \quad (A21) \]

Substituting the above expression for \( H_t \) back into the valuation function of \( C_t \) in equation (13) and using the properties of iterated expectations, \( P(t, T) = P(t, \tau) P(\tau, T) \) and \( 1_{\tau \leq T < \delta} = 1_{T < \delta} 1_{\tau \leq \min\{\delta, T\}} \), we obtain
\[
C_t = \bar{C} - E_t \left[ \bar{C} P(t, \min\{\tau, \delta\}) \cdot 1_{\min\{\tau, \delta\} \leq T} \right] \\
+ E_t \left[ \frac{m_\tau}{n + m_\tau} \left\{ (A_T - \bar{B}) P(\tau, T) \cdot 1_{T < \delta} + J_\tau \right\} P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right], \quad (A22)
\]

Since equation (15) implies
\[
\frac{1}{n + m_\tau} E_\tau \left[ (A_T - \bar{B}) P(\tau, T) \cdot 1_{T < \delta} + J_\tau \right] = S_\tau, \quad (A23)
\]
the value of contingent capital with the floating coupon rate \( r_t \) equals
\[
C_t = \bar{C} - E_t \left[ \bar{C} P(t, \min\{\tau, \delta\}) \cdot 1_{\min\{\tau, \delta\} \leq T} \right] + E_t \left[ m_\tau S_\tau P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right]. \quad (A24)
\]

Since the asset follows a continuous process and the verification is continuous, default cannot occur before conversion, i.e., \( \tau \leq \delta \). Hence, the above equation can be written as
\[
C_t = \bar{C} - E_t \left[ \bar{C} P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right] + E_t \left[ m_\tau S_\tau P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right]. \quad (A25)
\]

The continuous process and verification also imply \( n S_\tau = K_\tau \) at the conversion time \( \tau \). Substituting \( S_\tau = K_\tau / n \) and \( m_\tau = n \bar{C} / K_\tau \), we obtain
\[
C_t = \bar{C} - E_t \left[ \bar{C} P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right] + E_t \left[ \frac{n \bar{C} K_\tau}{K_\tau} P(t, \tau) \cdot 1_{\tau \leq \min\{\delta, T\}} \right] = \bar{C}, \quad (A26)
\]
which shows that the CC is priced at par.

Since the contingent capital is always priced at par, the equilibrium price of CC is unique. Then, Lemma 1 implies $S_t = (U_t - \bar{C})/n$ before conversion and $S_t = U_t/(n + m_t)$ after conversion. Consequently, the equilibrium price of the common stock is also unique. Q.E.D.

E The Parameters for the Examples in Table I

The parameters chosen in the example are broadly consistently consistent with the characteristics of large banks. The par value of bond is chosen to be 87 because it is consistent with the average leverage ratio (6.8) of the 50 largest U.S. bank holding companies during 2008–2011, based on FR Y-9C filings. A leverage ratio of 6.8, which is the ratio of debt to equity, implies that the debt-to-asset ratio is $6.8/(6.8 + 1) = 0.87$.

Estimation of bankruptcy costs is difficult, and academic literature on the estimation is rare. A well-known reference is the study of Altman (1984), which examines a sample of 19 industrial firms which went bankrupt over the period of 1970-1978 and estimates the bankruptcy costs to be 19.7% of the value of the firm measured just prior to bankruptcy. However, Bris, Welch and Zhu (2006) show that bankruptcy costs are heterogeneous across firms and types of bankruptcy. The estimation of the costs is also sensitive to the methodology. They conclude that the total bankruptcy costs range between 0% and 20% of firm assets. It is difficult to know the magnitude of bankruptcy costs of large financial institutions. Based on court filings, the total legal expenses of Lehman Brothers on its 2008 bankruptcy is about $1.6 billion as of May 2012. Although this is a small fraction of the $307 billion assets held by Lehman Brothers prior to bankruptcy, it is still growing and it does not include other costs. In light the study by Bris et al. and the uncertainty of potential bankruptcy costs of large banks, we chose the mid point of the range, 10%, as the bankruptcy costs in our example.
The risk-free rate is set to 3% because it is approximately the average five-year constant maturity Treasury bond rate during the past ten years as of 2011. The average is based on the monthly data provided on the Web page of the Federal Reserve Bank of St. Louis. We choose a ten-year average for interest rate because the interest rate since 2008 is abnormally low, which is generally not regarded as an interest rate environment in a normal economy.

It is impossible to calibrate the parameters of contingent capital from banks’ current and past balance sheets because contingent capital is not yet widely held in banks. We set the par value of the contingent capital to 5% in our example to leave room for 7-8% equity value in view of the seven percent baseline equity capital requirement in Basel III.

The hypothetical addition of contingent capital will reduce corporate bond yield. For this reason, we simply chose a bond yield that is moderately higher than the risk-free rate and then set the parameters of asset volatility and jumps so that the bond is priced at par.
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Table and Figures

**Table I**
Numerical Examples for the Range of Multiple Equilibria

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Notation</th>
<th>GBM</th>
<th>JD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial asset value</td>
<td>$A_0$</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Risk-free interest rate</td>
<td>$r$</td>
<td>3.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Asset volatility</td>
<td>$\sigma$</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Arrival rate of jumps</td>
<td>$\lambda$</td>
<td>4.00</td>
<td></td>
</tr>
<tr>
<td>Mean of log(jump size)</td>
<td>$\mu_y$</td>
<td>−1.00%</td>
<td></td>
</tr>
<tr>
<td>Volatility of jump size</td>
<td>$\sigma_y$</td>
<td>3.00%</td>
<td></td>
</tr>
<tr>
<td><strong>Bond</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Par value of bond</td>
<td>$\bar{B}$</td>
<td>87.00</td>
<td>87.00</td>
</tr>
<tr>
<td>Coupon rate of bond</td>
<td>$b$</td>
<td>3.34%</td>
<td>3.34%</td>
</tr>
<tr>
<td>Years to Maturity</td>
<td>$T$</td>
<td>5.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Bankruptcy cost</td>
<td>$\omega$</td>
<td>10.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td><strong>CC</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Par value of CC</td>
<td>$\bar{C}$</td>
<td>5.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Coupon rate of CC</td>
<td>$c$</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Years to Maturity</td>
<td>$T$</td>
<td>5.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Trigger on equity value</td>
<td>$K$</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Conversion ratio</td>
<td>$m$</td>
<td>5.00</td>
<td>5.00</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of shares</td>
<td>$n$</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td><strong>Value</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm value</td>
<td>$F_0$</td>
<td>98.35</td>
<td>94.74</td>
</tr>
<tr>
<td>Bond value</td>
<td>$B_0$</td>
<td>88.03</td>
<td>87.00</td>
</tr>
<tr>
<td>Equity value</td>
<td>$S_0$</td>
<td>[5.86 , 6.46]</td>
<td>[3.84 , 5.44]</td>
</tr>
<tr>
<td>CC value</td>
<td>$C_0$</td>
<td>[3.86 , 4.46]</td>
<td>[2.30 , 3.90]</td>
</tr>
<tr>
<td>Price range</td>
<td></td>
<td>0.60</td>
<td>1.60</td>
</tr>
</tbody>
</table>
Figure 1  Multiple Equilibria in a One-Step Trinomial Tree Model

A. Bank’s asset value and bond value

\[ A_0 = 100.00 \]

- 120.00  Probability = 0.25
- 100.00  Probability = 0.50
- 80.00  Probability = 0.25

\[ B_0 = 87.50 \]

- 90.00  no default
- 90.00  no default
- 80.00  default

B. No conversion is an equilibrium

\[ C_0^u = 5.83 \]

- 10.00  no conversion
- 6.67  convert to 2 shares
- 0.00  default

\[ S_0^u = 6.67 \]

- 20.00  = \((120 - 90 - 10)/1\)
- 3.33  = \((100 - 90)/(1 + 2)\)
- 0.00  default

C. Conversion is another equilibrium

\[ C_0^c = 8.33 \]

- 20.00  = 2 shares × $10
- 6.67  = 2 shares × $3.33
- 0.00  default

\[ S_0^c = 4.17 \]

- 10.00  = \((120 - 90)/(1 + 2)\)
- 3.33  = \((100 - 90)/(1 + 2)\)
- 0.00  default
The range of multiple equity and CC prices depend on the asset volatility, the leverage in terms of bond and CC, as well as the trigger level. The solid lines represent the upper and lower bounds of the multiple equity prices, and the dot lines represent the bounds of CC values. The parameters used for the figure are the same as those in the second-last column of Table I, except the one that varies in a range indicated by the horizontal axis. For the varying parameter, the value in Table I is indicated by the vertical dash line.
Figure 3  Multiple Equilibria When Equity Issuance Is Allowed

A. Bank’s asset value and bond value

\[
\begin{bmatrix}
A_0 = 100.00 \\
A'_0 = 102.63
\end{bmatrix}
\]

\[
\begin{bmatrix}
120.00 \\
123.16
\end{bmatrix}
\quad \text{probability} = 0.25
\]

\[
\begin{bmatrix}
100.00 \\
102.63
\end{bmatrix}
\quad \text{probability} = 0.50
\]

\[
\begin{bmatrix}
80.00 \\
82.10
\end{bmatrix}
\quad \text{probability} = 0.25
\]

\[
\begin{bmatrix}
90.00 \\
90.00
\end{bmatrix}
\quad \text{no default}
\]

\[
\begin{bmatrix}
80.00 \\
82.10
\end{bmatrix}
\quad \text{default}
\]

B. If no issuance, there are two equilibria: \((C^u_0, S^u_0)\) and \((C^c_0, S^c_0)\)

\[
C^u_0 = 6.25
\]

\[
C^c_0 = 6 \times 3.13 = 9.38
\]

\[
S^u_0 = 6.25
\]

\[
S^c_0 = (100 - 87.50)/(1 + 3) = 3.13
\]

\[
\begin{bmatrix}
10.00 \\
20.00
\end{bmatrix}
\quad \text{no conversion}
\]

\[
\begin{bmatrix}
7.50 \\
2.50
\end{bmatrix}
\quad \text{convert to 3 shares}
\]

\[
\begin{bmatrix}
0.00 \\
0.00
\end{bmatrix}
\quad \text{default}
\]

\[
\begin{bmatrix}
100 - 90 - 10
\end{bmatrix}/1 = 20.00
\]

\[
\begin{bmatrix}
100 - 90
\end{bmatrix}/(1 + 3) = 2.50
\]

\[
S^c_0 = (100 - 87.50)/(1 + 3) = 3.13
\]

C. Issuing half share gives \((C^i_0, S^i_0)\), which dominates \((C^c_0, S^c_0)\).

\[
C^i_0 = 6.71
\]

\[
S^i_0 = 5.26
\]

\[
\begin{bmatrix}
8.42 \\
15.44
\end{bmatrix}
\quad \text{convert to 3 shares}
\]

\[
\begin{bmatrix}
0.00 \\
0.00
\end{bmatrix}
\quad \text{default}
\]

\[
\begin{bmatrix}
123.16 - 90
\end{bmatrix}/1.5 = 15.44
\]

\[
\begin{bmatrix}
102.63 - 90
\end{bmatrix}/(1.5 + 3) = 2.81
\]

\[
\begin{bmatrix}
0.00 \\
0.00
\end{bmatrix}
\quad \text{default}
\]
Figure 4  Multiple Equilibria under Financial Distress

A. *An equilibrium without conversion*

\[ A_1 = 106.00 \]
\[ F_1 = 106.00 \]
\[ B_1 = 88.40 \]
\[ C_1 = 6.72 \]
\[ S_1 = 10.88 \]

\[ A_2 = 110.30 \]
\[ F_2 = 110.30 \]
\[ B_2 = 86.70 \]
\[ C_2 = 6.24 \]
\[ S_2 = 17.36 \]

\[ A_0 = 100.00 \]
\[ F_0 = 97.84 \]
\[ B_0 = 86.20 \]
\[ C_0 = 4.64 \]
\[ S_0 = 6.00 \]

\[ A_2 = 97.82 \]
\[ F_2 = 97.82 \]
\[ B_2 = 86.70 \]
\[ C_2 = 6.24 \]
\[ S_2 = 4.88 \]

Bond defaults

\[ A_1 = 94.00 \]
\[ F_1 = 89.67 \]
\[ B_1 = 83.99 \]
\[ C_1 = 3.60 \]
\[ S_1 = 2.08 \]

\[ A_2 = 86.54 \]
\[ F_2 = 77.88 \]
\[ B_2 = 77.88 \]
\[ mS_2 = 0.00 \]
\[ S_2 = 0.00 \]

B. *An equilibrium with conversion*

\[ A_1 = 106.00 \]
\[ F_1 = 106.00 \]
\[ B_1 = 88.40 \]
\[ C_1 = 6.72 \]
\[ S_1 = 10.88 \]

\[ A_2 = 110.30 \]
\[ F_2 = 110.30 \]
\[ B_2 = 86.70 \]
\[ C_2 = 6.24 \]
\[ S_2 = 17.36 \]

\[ A_0 = 100.00 \]
\[ F_0 = 100.00 \]
\[ B_0 = 88.40 \]
\[ C_0 = 6.24 \]
\[ S_0 = 5.36 \]

\[ A_2 = 97.82 \]
\[ F_2 = 97.82 \]
\[ B_2 = 86.70 \]
\[ C_2 = 6.24 \]
\[ S_2 = 4.88 \]

\[ A_1 = 94.00 \]
\[ F_1 = 94.00 \]
\[ B_1 = 88.40 \]
\[ mS_1 = 4.80 \]
\[ S_1 = 0.80 \]

CC converts

\[ A_2 = 86.76 \]
\[ F_2 = 86.76 \]
\[ B_2 = 86.76 \]
\[ mS_2 = 0.05 \]
\[ S_2 = 0.01 \]