Corporate bond clawbacks as contingent capital for banks


Abstract
We propose a contingent clawback bond (COCLA) as an alternative source of contingent convertible capital (CoCo). We develop a utility maximization model in which a bank manager faces the following two trade-offs: one trade-off is between the private benefits of control and costs of financial distress when loans under-perform, and the other is between the costs and benefits of screening loan credit quality (effort). In our model, the supply of loans, amount of junior debt issued, level of effort exerted by a manager, and manager's decision to exercise the clawback option are endogenously determined in the maximization of the manager's utility function. We find that the manager optimally exercises the clawback following a low realization of cash flows, thereby solving the trigger problem presented in CoCos. In the model, the debt to equity conversion from the COCLA is an endogenous decision, the regulatory capital adequacy ratio (CAR) is satisfied, and the bank does not face distress costs. From a practical perspective, the conversion rate for the COCLA that jointly maximizes the manager's expected utility and stock holders’ pay offs is around 25%, a rate close to the typical percentage (30%–35%) that is often found in initial public offering clawback (IPOC) contracts used in the corporate world.

Keywords
IPO, Clawbacks, Contingent capital, CoCos and Financial stability.