Dilute or die

May 14th 2009
From The Economist print edition

Using market signals to gauge a bank’s health

AS THE tab for bank bail-outs rises, the notion that a firm can be “too big to fail” has become almost too much to stomach. What is needed is a regulatory regime that disciplines banks without forcing them to the wall in such a way that their demise wrecks the payments system. One way is to make banks hold so much equity, and so little debt, that even huge losses would not lead to insolvency. Debt has its advantages, however. For instance, it can be cheaper than equity finance, thanks to tax breaks.

In new research, Oliver Hart, of Harvard University, and Luigi Zingales, of the University of Chicago, argue that the mix of debt and equity should fluctuate according to the risk of bank failure. Banks should hold less capital in good times and reduce leverage when losses loom. This could be achieved in the absence of an all-wise regulator by using the cost of credit-default swaps (CDSs), which insure against default, as a guide to the right capital structure.

In their scheme, when a bank’s CDS price stays above a certain threshold, the regulator forces managers to inject enough equity capital to cushion bondholders against losses. If the bank does not act swiftly to push the CDS price back down, the regulator seizes the assets, wipes out shareholders and sacks the management. The bank is recapitalised as a going concern and later sold. Creditors get some of the proceeds, but would not be made whole.

The appeal of this kind of capital regime is that regulators would be less prone to capture. The market does the monitoring job: CDS prices act as a check on excessively risky business strategies. But banks are opaque outfits and markets prone to panics, so CDS prices could easily be wrong. To counter the risk of a false alarm, the regulator would reserve the right to declare a bank solvent after an audit. That would give lobbyists an opening to sway the outcome, but the process would at least be transparent.

The idea’s main strength is that it creates a trigger for action. Banks are forced to raise equity, and regulators to intervene quickly, before trouble spreads. A rule based on CDS prices would have forced earlier interventions in this crisis—though perhaps not early enough. For such a scheme to work, everyone needs to believe that banks would be allowed to fail. The trouble is, who would credit that now?