



Final Financial Reform Push

Christopher Papagianis | April 13, 2010

Some Democrats and their allies in the media are determined to pin the blame for financial reform's failure on Republicans who, according to Paul Krugman, "will always find reasons to say no to any actual proposal to rein in runaway bankers." Republicans recognize that financial reform is very popular among voters and that a partisan filibuster to block reform would play directly to the playbook of left-leaning bloggers. As a result, Republicans have a choice of either accepting reform as currently conceived or of convincingly articulating why their alternative is actually tougher on the large financial firms that the public blames for the crisis. This second strategy requires that Republicans: (1) explain why the Democrats' resolution proposal not only fails to solve the "too big to fail" problem, but could actually make matters worse; and (2) devise an alternative that more effectively deals with the core policy issue emerging from the financial crisis.

The Democrats' "resolution authority" proposal needs to be thought of in two discrete time periods: the "crisis" period, when the firm is on the verge of collapse, and the "ordinary" period when the firm is able to access external funding and otherwise function normally. During the "crisis" period, resolution authority is quite useful as it provides the government with greater legal authority to assume control of a firm on the brink of failure. As the Treasury has argued, current law forces the Administration and Federal Reserve to choose between two unpalatable options: (1) government capital injections and financial guarantees (as occurred with AIG), or (2) a bankruptcy filing (as occurred with Lehman Brothers). In the first case, the government uses taxpayer resources to keep

an insolvent firm afloat without the ability to alter contracts or otherwise wind-down the institution. In the second, the government takes a hands-off approach and allows an uncontrolled bankruptcy to occur with no ability to monitor or control the potentially significant collateral damage.

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The problem is that this crisis period is very short in duration relative to the "ordinary" period when the firm is not on the verge of collapse. During the ordinary period, the resolution authority and the accompanying "resolution fund" are likely to distort prices and capital allocation decisions. The result is subsidies for larger institutions that could make it harder for small banks to attract debt finance and a less stable financial system.

The question facing every lawmaker is whether creditors would feel more or less secure about their investment in a large financial firm if they were informed that a \$50 billion bailout fund (and tens of billions of dollars more, if necessary) stood ready to make them whole in the event of default? Viewed in this light, it is clear that if two institutions were otherwise identical in terms of their asset quality and risk profile, a creditor would prefer to invest in the debt securities of the "systemically significant" institution thanks to the added layer of protection afforded by the bailout fund. As a result, even if "resolution authority" improved current law by allowing for the orderly liquidation of failed financial

institutions during the crisis period, this benefit would come with the cost of subsidizing the borrowing of larger institutions during the ordinary period.

These subsidies could also destabilize the financial system if they create merger incentives or encourage systemic firms to issue more debt. In a fascinating paper, researchers at the Federal Reserve Bank of Philadelphia estimate the value of the too-big-to-fail (TBTF) subsidy using merger data. They find that deals involving banks whose combined size would exceed \$100 billion post-merger – roughly the threshold to be included in the Fed stress tests – involved premiums of nearly \$2 billion per deal. In short, this \$2 billion was the price the acquiring institution was willing to pay relative to other acquisitions to exceed the \$100 billion threshold and attain “systemically significant” status. And achieving this status was based on mere speculation; once the newly created “Financial Stability Oversight Council” formally defines which firms are “systemically significant” the TBTF subsidy would likely rise because the uncertainty about whether the firm was covered under the bailout umbrella would be removed.

Instead of acceding to this plan, Republicans should get behind a variant of a proposal offered by distinguished academics Oliver Hart and Luigi Zingales. Hart and Zingales would use credit default swap (CDS) spreads as a market-based default probability metric. The “spread” or premium on a CDS contract represents the market price of providing a financial guarantee against losses from a firm’s default. A rising CDS spread is a market signal that the probability of default is increasing because it is getting more expensive to purchase protection against default. In the Hart and Zingales framework, once the CDS spread rises above a pre-specified “critical threshold,” the regulator would force the institution in question to issue equity (offer new stock

for sale) until the CDS spread moves back below the threshold.

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Although CDS are often blamed for exacerbating the recent crisis, these problems tend to be related to the lack of transparency in the secondary market and the failure of some firms (like AIG) to post sufficient collateral to cover the cost of their financial guarantees. As a pure, market-based default probability monitor, there is no better instrument than credit default swaps. Stock prices fail to provide an unbiased view of a firm’s financial condition because they offer unlimited upside to buyers and are less sensitive to downside risks. Bonds prices are sensitive to default risk, but also move in response to changes in interest rates, changes in liquidity, and idiosyncratic factors. CDS spreads, by contrast, are perfectly correlated with market participants’ collective view of the probability of default.

While Hart and Zingales choose the right instrument for their trigger, their proposed remedial step should be strengthened. Instead of having the regulator demand that the institution issue new equity, the debt of the institution could automatically convert into equity. Say a large bank financed \$150 billion of assets with \$80 billion of deposits, \$40 billion of senior debt, \$20 billion of so-called junior debt, and \$10 billion of equity. When the CDS on this bank surpassed the critical threshold, half of the bank’s junior debt would automatically convert to equity. Instead of having 6.7% equity (15-to-1 leverage), the bank’s assets would be financed with 13.3% equity (7.5-to-1 leverage). If that failed to bring the CDS below the critical threshold, the other half of the junior debt would also convert to equity.



The mandatory conversion would enhance systemic stability for two reasons. First, the risk that the debt would convert to equity would be priced into the debt, raising the systemic institution's cost of capital and leveling the playing field with smaller banks. Secondly, the automatic conversion would eliminate the potential for regulatory forbearance caused by market conditions. When a number of banks are distressed at the same time, it may not be possible for all of them to issue enough equity to drive their CDS below the critical level. Regulators may allow the firm to wait until conditions improve or otherwise work to coordinate stock offerings. In the meantime, the threat to the institution and the financial system could grow. Mandatory conversion eliminates this risk by ensuring the bank's equity capital ratio can automatically increase to the desired level even under the most stressful market conditions.

Senate Banking Committee Chairman Dodd included the requirement that financial firms issue "contingent capital" in his original discussion draft (page 41). Although the debt would have converted to equity at the discretion of regulators instead of as a result of elevated CDS spreads, the underlying mechanism has already been considered and included in legislation. Unfortunately, the current bill includes only "a study of the feasibility, benefits, costs, and structure of a contingent capital requirement" (page 43 of 1336).

With the health-care bill having become law, Republicans are now confronted with the most significant policy choice they will make this Congress: listen to the polls and accede to the Democrats' version of reform despite the new risks it creates for the financial system, or take the initiative and embrace a variant of the Hart and Zingales proposal to end "too big to fail." The Democrats have left Republicans with an opening to be the party that's

actually "tougher" on big finance. The GOP should seize the opportunity.