

Comment

How to make a distressed bank raise equity

Oliver Hart and Luigi Zingales

In the struggle to identify how to avoid a repeat of last year's financial crisis there is an emerging consensus among regulators, academics and practitioners that contingent convertible (Coco) bonds are the way to go. The idea is to have some debt in the capital structure of banks that converts into equity when a bank faces financial distress.

These bonds have some benefits. If, in an extreme downturn, the conversion were triggered, debt-holders would be forced to absorb some losses without dragging other obligations (derivatives or repurchase agreement contracts, for instance) into a bankruptcy process, an event that could trigger a systemic panic. This would save taxpayers large amounts and create incentives for creditors to monitor the issuers, instead of lending freely under the assumption that the government would bail them out.

This approach also has serious shortcomings. A much discussed problem is the conversion trigger. If based on accounting numbers, it might not be activated when it ought to be. The trigger of less than 5 per cent Tier 1 capital, which was set in the first Coco bond issue – by Lloyds Banking Group in November – would not have been activated even at the peak of the crisis. If, instead, the trigger is activated when equity prices are low, the manager could deliberately talk down the bank's value to activate the trigger and obtain equity on the cheap.

A much bigger problem has been largely ignored. If a bank is losing money because of bad investments, a Coco bond will not prevent it defaulting on derivative and repo contracts (often called systemic obligations). It will only delay the timing of a default. In fact, one advantage of debt is that

it limits the resources an inefficient manager can waste: a default forces inefficient businesses to restructure and incompetent managers to be replaced. By eliminating defaults, Coco bonds increase inefficiency in the banking sector, without preventing defaults on systemic obligations and thus the risk of systemic crises.

If we want to prevent defaults on systemic obligations, we need a mechanism to induce banks to raise more equity when their capital cushion is running low. Unfortunately, this is precisely the time when raising equity is most costly, since the new funds will prop up the value of the existing debt rather than creating value for shareholders. How can we induce the banks to raise capital?

We can learn from banks themselves. When they finance the purchase of securities by investors on margin, they monitor daily the amount of collateral. If this ever drops below a threshold, they make a margin call, which forces the investor to choose between posting more collateral or losing the investment. As long as the call is made early enough (when the value of the security exceeds the amount borrowed), the investor will prefer the first option.

Banks are themselves like large margin investments. They buy most of their assets with borrowed money. The regulator could induce them to raise more equity by making a margin call at the appropriate time. Unfortunately, regulators on both sides of the Atlantic have been late to this game. Precisely because it is costly for a bank to raise equity in bad times, it is also politically difficult for a regulator to make a margin call.

This problem can be overcome, however, with an automatic trigger based on the much maligned credit default swaps. CDS prices provide up-to-date information about the risk that a certain debt will be paid. Hence we can require the regulator to make a margin call any time the CDS price of a bank's debt exceeds a certain threshold, let us say an average of 1 percentage point over the previous month. A verifiable market-based trigger makes it impossible for a regulator to delay the day of reckoning.

With all its failings, the CDS market has accurately predicted the financial institutions most at risk since the crisis began. Had this rule been in place, banks would have been forced to issue equity in the autumn of 2007 and beginning of 2008, avoiding the negative spiral we experienced in the autumn of 2008.

Not only does this rule eliminate the moral hazard present in banking, it is also fair. Why should regulators treat banks differently from the way banks treat their own customers?

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