Oliver Hart and Luigi Zingales's blog

To regulate finance, try the market

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As Timothy Geithner pushes for an overhaul, it's time to rehabilitate one of the tools that got us into this mess: the credit-default swap.

By Oliver Hart and Luigi Zingales

Just days after announcing his plan to clean up banks' balance sheets of toxic assets, U.S. Treasury Secretary Timothy Geithner hit the airwaves, priming audiences for his next big project: a regulatory system to ensure that this financial crisis is a one-time event. "[The] core thing is to make sure that the institutions at the center of our financial system are subject to much more conservative, much tougher requirements on capital and leverage," he told NBC's David Gregory on Sunday's *Meet the Press*. Geithner will be taking his show on the road this week as the G20 convenes in London, where regulation will be high on the agenda.

Should we welcome Geithner's regulatory rethink? In principle, yes. If there is one lesson to be learned from the 2008 financial crisis, it is that large financial institutions (LFIs) such as Citigroup or AIG are too big to fail. Whether this doctrine is based on economics -- the cost of LFI failure is too high -- or politics -- the pressure to save LFIs is too strong -- the conclusion is the same: We need to reimagine how we regulate these institutions.

We'll explain why a market-based system is the best way to achieve this, and how credit default swaps -- yes, the same financial tools that helped get us into this mess -- can play a role. But first, some basic principles.

So what's wrong with bankruptcy for financial giants? In a free-market economy, bankruptcy accomplishes two crucial goals: it resolves conflicting claims and it shifts control away from incumbent management. By penalizing owners and managers, bankruptcy gives firms an incentive to repay their debts, thus permitting them to raise capital in the first place. But for LFIs, bankruptcy is a dangerous option. Given their size and the dense web of derivative and short-term financing contracts that these institutions have, bankruptcy spreads uncertainty throughout the economy, as we saw in the case of Lehman Brothers. So, we want a system that achieves the goals of bankruptcy, but at the same time ensures that these other contracts are safe.

How do we thread this needle? Here, we can learn from a common market practice: margin accounts. In a margin account, an investor buys stock and puts down only part of the cost. When the stock price drops, the broker who extended a loan for the rest of the stock price asks the investor to post new collateral. The investor then has a choice: He can post the collateral, thereby re-establishing the safety of his position, or he can liquidate his holding, allowing the broker to be paid in full.

This analogy can help us figure out how much capital large financial institutions should be required to keep on hand. The answer: an LFI will have to post enough collateral (equity) to insure that its liabilities are always paid in full. When the fluctuation in the value of the underlying assets puts creditors at risk, the LFI's equity holders will be faced with a margin call: They will either have to inject new capital or lose their equity. In both cases the creditors will be protected.

The main difference between margin calls and our new capital requirement system is the trigger mechanism. In a margin account, the broker looks at the value of the investments (which is easily determined since all assets are traded) and compares the value of the collateral posted with the possible losses the position might have in the following days. Creditors of LFIs, however, are often dispersed and so unable to coordinate to make a margin call. And since most LFI assets, such as commercial loans and home equity lines, are non-standardized and not frequently traded, their value is hard to assess. Another mechanism will be needed to determine when the margin is too thin.

One possibility is to leave the decision of when to make a margin call in the hands of a regulator. However, the risk here is twofold. Either the regulator is powerful, leaving financial institutions exposed to the risk of abuse, or the regulator is weak and will be unduly influenced by failing institutions and intervene too late.

Regulators should therefore rely on a market-based trigger: a credit default swap (CDS). Despite being viewed by many as a "financial weapon of mass destruction," CDSs are like any tool that can be used wisely or foolishly. In this context, they are potentially some of the best regulatory instruments available. A credit default swap on an LFI is an insurance claim that pays off if that institution fails and creditors are not paid in full. Since the CDS

is a "bet" on the institution's strength (or weakness), its price reflects the probability that the LFI debt will not be repaid. Such CDSs, in essence, indicate the risk that a large financial institution will fail.

In our mechanism, when the CDS price rises above a critical value (indicating that the institution has reached an unacceptable threshold of weakness), the regulator would force the LFI to issue equity until the CDS price and risk of failure back down. If the LFI fails to do this within a predetermined period of time, the regulator will take over.

This regulatory takeover would not be dissimilar to a milder form of bankruptcy, and it achieves all the other goals of bankruptcy -- discipline on management and shareholders -- without imposing any of the systemic costs.

Credit-default swaps have been demonized as one of the main causes of the current crisis. It would be only fitting if they were part of the solution.

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