# A Market-Based Regulatory Policy to Avoid Financial Crises

*Luigi Zingales*

When it comes to "saving capitalism," dealing with the "too big to fail" doctrine is a top priority. This doctrine has increasingly become the government policy on this issue, and it is probably the most dangerous policy for capitalism we can imagine. It undermines capitalism in many ways: not only does it make the system less stable, but it also undermines the moral basis of capitalism. If you have a sector or a set of institutions where losses are socialized but where gains are privatized, then you destroy the economic and moral supremacy of capitalism. Either we deal with the perverse incentives created by this doctrine or we undermine the long-term sustainability of capitalism. So it is really important to think what we can do against this too-big-to-fail policy.

## What to Do about Too Big to Fail

I have spoken with many members of Congress and the best intentioned ones want to legislate the too-big-to-fail policy away by introducing enough constraints that will make it impossible in the future to do what the government has done in the recent crisis. In spite of their good intentions, I do not think that these members of Congress understand the essence of the problem. Let me use an analogy. As parents we know that we should let our children learn from their mistakes. We should not be too interventionist and bail them out, because they won't learn. However, when they get into

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real, serious trouble, when their life is in danger, it is impossible for us as parents not to intervene. It would be against nature not to intervene. And no matter how we can try to commit not to intervene because we know that this has good incentive effects on our children, when our son or daughter's life is in danger, we will intervene. And that's a little bit like the situation we are in with large financial institutions. No matter how much we try to tie our hands, when a major crisis comes it is impossible to stop the politicians from intervening. Part of the reason is that during a banking crisis a government intervention can actually *create* value (or at least avoid that value is dissipated) ex post. Politicians find it difficult not to intervene even in situations where they destroy value; imagine when they can create some value because they stop a bank run! As with the children example, however, this beneficial intervention has perverse incentive effects. For this reason, we need to introduce mechanisms to minimize the damage that this incentive will create in the system. If we ignore it, if we live under the illusion that we can legislate this away, we're making the problem only bigger.

## The Rationale for Too Big to Fail

Why do we think that GM can go under with no problem but Citigroup cannot go under with no problem? The answer is that whenever there is the possibility of bankruptcy, there are two effects on competitors. One is a substitution effect: When GM goes under, Ford celebrates because it can grab a larger market share, so that is beneficial to Ford. Then there is a sort of complementary effect: If the failure of GM brings down suppliers of GM, then this will also impact the survival of Ford, to the extent they share the same suppliers (as they do). In addition, there is an information spillover: If you see GM going under, you start doubting whether the car industry is viable in the long term, and that has a negative effect on Ford as well.

Now, what is unique about financial institutions is that the complementary effect is much, much bigger. They have a lot of interlinking contracts so that when Citigroup goes under the probability that other banks will go under at the same time is very large. And while we can afford to live without Citigroup, we cannot afford to live without a banking sector. So the risk is what I call "the fear of Armageddon." Whether this fear is a realistic possibility or not, it is too powerful: no policymaker will take this risk when faced with a choice. No matter what your ideology is, you don't want to go down in history as the Treasury secretary or the Federal Reserve chairman who was watching as the U. S. financial system went down. So even if it is not rational, you are going to intervene no matter what.

Another reason this course of action is so irresistible to policymakers is that we know that there are bank runs and that in a bank-run situation there is inefficiency—some assets are liquidated too fast and too soon, and some value is dissipated. So there is some value to be created in avoiding a bank run. There are very few situations, if any, when the government can create value, but I think this is actually one in which it can create value. Yet, the government has a huge tendency to intervene even when it destroys value, so it is very hard to prevent intervention when it can create some value. It seems like a free lunch and is irresistible. This situation is actually very similar to the time inconsistency that policymakers have studied so much for monetary policy. When push comes to shove, a Treasury secretary or a politician wants to increase the money supply to try to buy a little bit of employment today, at the cost of much higher inflation in the future. The same is true here. When you are close to a financial meltdown you want to intervene, even if this will have dramatic costs in the future.

Trying to legislate this incentive away is unrealistic. We need to find a solution because the cost of inaction is skyrocketing. In 1998 it took the Fed only coffee and donuts to organize the rescue of Long-Term Capital Management. In 2008 it took the federal government more than $700 billion to organize the rescue of the financial system. I don't want to think about what the bill will be in 2018.

## The Debt Problem

We need to act and act now to stop the perverse incentives created by the too-big-to-fail policy. The moral hazard is not only that managers invest excessively in risky activity, it is also that creditors lend to financial institutions too cheaply because they factor in the government guarantee. If you are a manager of a large bank and you see that you can issue debt at extremely attractive prices, you will find it irresistible to leverage up as much as possible.

The first thing that needs to be done to solve this problem is to find a way to recreate the proper market incentives for creditors to pay attention to risk. In a normal situation creditors limit debtors' risk taking by introducing covenants and by restricting the amount they lend. Once the creditors know that they will be bailed out by the government they have no incentive to do so. How do we recreate creditors' incentives to monitor when they know that in the worst situation the government will intervene? By creating a regime that distinguishes between systemic and nonsystemic obligations.

## A Solution to Systemic Debt

There is no reason why long-term debt of financial institutions should be systemic. Pension funds, mutual funds, and foreign investors who hold long-run debt can absorb losses just as they did during the Internet bubble. So there is no reason to bail banks out. The only reason to bail them out is that we do not have in place a procedure to differentiate between systemic and nonsystemic obligations. And of course, when you start to bail out a group, there is a huge queue of people who say, "I want to be bailed out too. I belong to the same group. I'm no different. Why don't you bail out me too?"

So the first mechanism we need is a resolution system that, while protecting in full the systemic obligations, is able to impose losses on the nonsystemic ones. Without any additional provision this will be a recipe for disaster, since the private sector will abuse this guarantee. To avoid this from happening, however, Oliver Hart and I have devised a market-based mechanism that will avoid any costly bailout.

This mechanism is based on two layers of protection for systemic obligations. One layer is represented by equity and one layer by a mandatory buffer of long-term junior debt. To ensure that these layers will never be fully exhausted we have thought of a mechanism that mimics the margin call system used by banks with their clients.

When you borrow on the margin, your broker is no fool. He updates the position every day on the basis of the market price and if the collateral is too low, he makes a margin call—either you put down more collateral, or your assets are liquidated so the broker gets his money back. We need a similar system for banks.

The equity of banks is like the collateral in a margin call. What we need to do is to devise a system that makes this margin call timely. Regulators cannot be trusted to intervene on time. So the system that Oliver Hart and I have in mind is a system that piggybacks on junior long-term debt, using prices of credit default swaps on this debt to provide a timely market-based signal. If the holders of junior long-term debt actually can be penalized, then the price of CDSs on that debt would be a very credible signal that the equity buffer is running thin. Regulators would then intervene and do a stress test, and if the financial institution is indeed in trouble, start to unwind it—paying off in full the systemic obligations but penalizing the long-term junior debt.

If an institution were deemed "safe," then no action to unwind the institution would be taken. To avoid the risk that when they perform a stress test the regulators are too forgiving in judging the risk, we require the regulator to invest some money (in the form of junior long-term debt) in the institution when she deems it to be safe. If an institution is only facing a liquidity crisis, this investment would be enough to calm the market. If the regulator incorrectly assess that the institution is safe when it is not, the CDS rate will go up and the regulator will be forced to intervene again, increasing the political cost of declaring it safe.

## A Balanced System

This system is very balanced. We don't give too much power to regulators because we know two things: (1) they will abuse it, and (2) they will be late to the game, as regulators always are. For this reason we rely on a market trigger—namely, the CDS price of an institution's junior long-term debt. When that price reaches a certain threshold, regulators should intervene—make a margin call—and wind down the failed institution. We don't want to abuse the market trigger either, because we are afraid of what are called "self-fulfilling prophecies"—the market gets very worried, regulators intervene, penalize the debt, and this fulfills the prophecy. For this reason we have introduced the stress test as a circuit breaker to prevent this escalation. This circuit breaker, however, can create perverse incentives for the regulators. So we need a system to penalize them if they make mistakes—namely, the loss of their investment in junior long-term debt.

This system should apply only to very large financial institutions, because other institutions can and do fail, subjecting them to the normal market discipline. Will it be costly? Yes, it will, and it should be costly. It should be costly to undo a major distortion that now exists, a distortion that favors large institutions at the cost of small institutions. Today the implicit too-big-to-fail doctrine is a subsidy to large financial institutions, with a lot of negative effects. In particular, there is more concentration in the financial sector, which is bad for consumers and taxpayers. More institutions will have to be bailed out in the future. Moving to a market-based regulatory regime would remove the too-big-to-fail bias and reintroduce a fair marketplace.

## Reference

Hart, O., and Zingales, L. (2009) "A New Capital Regulation for Large Financial Institutions." University of Chicago Booth School of Business Working Paper.