Imagine this: using credit-default swaps to solve "too big to fail."

Too good to be true? Could a product vilified as a cause of the 2008 financial crisis provide the solution to an intractable policy problem of how to regulate the largest firms?

Two professors have come up with an intriguing idea. And because it harnesses the power of the markets to do the regulating, rather than the federal government, it could catch on with newly empowered Republicans in Congress.

House Budget Committee Chairman Paul Ryan "is a big fan of the proposal," says Luigi Zingales, a professor of entrepreneurship and finance at the University of Chicago's Booth School of Business. "I've met with him and spoken with other Republicans. They want to legislate out 'too big to fail.'"

Zingales' partner in this research is Oliver Hart, who teaches economics at Harvard.

The Zingales-Hart plan envisions large financial companies holding roughly 20% of their capital in the form of long-term debt that is junior to all other debt. Such debt is typically held in the enormous portfolios of long-term investors like pension funds or mutual funds - not by other financial institutions - so a default would not have a domino effect among financial firms.

Investors who bought this junior debt would not be protected by any sort of federal bailout. They would know, up front, that they would take a haircut should the company fail.

Thus, the debt would be priced on the market's assessment of its risk, without the benefit of any sort of subsidy.

Credit-default swaps on this debt would serve as an early-warning system. They would trade on open exchanges, and when prices on the swaps rose, it would be a sign to both the firm and its regulator that investors see trouble brewing.

When the price of these swaps rose above a certain level - the professors have proposed 100 basis points - regulators would step in and require the company to issue more equity until the swap price fell back below the threshold. (At 100 basis points, it would cost $100 to insure $10,000 of that long-term debt for one year.)

If the company could not sell the equity or the swaps prices did not fall even after it did, then the government would intervene. It would replace existing management with a trustee who would either recapitalize or sell the company. Shareholders would be wiped out and the long-term debtholders would take a haircut.
Zingales and Hart have built in a safeguard against panic based on misinformation or misperceptions. Before appointing a trustee, the regulators would administer a stress test to determine if the company is truly in danger of failing. If the company passed the test and proved the swap price was inaccurate, the regulator could then declare the company adequately capitalized, which should restore investor confidence.

"It's a modified bankruptcy," Hart said. "It's not infallible, but the question is what's better? Is a regulator's view better? We say no. Let's use this price."

Hart added: "If you go back and look at what happened during the crisis, the credit-default swap prices were really pretty good" indicators of a firm's risk.

According to the professors, six major financial firms had credit-default swap prices exceeding 100 basis points six months before they either failed or had to be saved through some sort of intervention.

"We think of this as a kind of antidote to those who demonize credit-default swaps," Hart said. "That is one of the barriers we have in selling this proposal. Some people think credit-default swaps are the work of the devil and they don't want to hear anything more about it.

"This evidence does support our case that they are not crazy prices. They can be remarkably informative."

A credit-default swap is a claim that pays off if the underlying entity fails and creditors are not paid in full. The buyer makes periodic payments to the seller, which under the professors' plan would be a third party, not the bank itself, and receives a payoff if the bank defaults on that debt.

Among the benefits, the professors view their plan as relatively simple and one that builds on existing capital rules. Also, it could be applied to financial firms beyond banks, like hedge funds or insurance companies. And by providing a market trigger, regulators could not ignore a company's problems until it was too late.

"I see this as filling in the gaps of Dodd-Frank," Hart said. "We hope it would be appealing to both [political parties]. On the one hand, we are not saying you don't need regulation. ... But then the question is what kind of regulation can you have which is not going to be too onerous?"

"That is why this should appeal to conservatives as well as liberals. It is not heavy-handed."

The two men have been working on this for about a year, and their paper detailing it was just accepted for publication by the American Law and Economics Review. They presented their ideas earlier this month in Denver at the annual meeting of the American Economic Association, and Zingales has been shopping it to regulators, from the New York Fed to the Bank of England to the International Monetary Fund.

Zingales said Europeans are more interested in it than U.S. regulators or bankers mainly because many of those countries have no more money for bailouts.

"In Switzerland, Credit Suisse and UBS realize that the government does not have the money to bail them out, so they have been much more open to different proposals," Zingales said.

Bankers here, he said, like the current system too much to change it.

"The industry correctly sees that we are trying to force them to internalize" the cost of being big, Zingales said. "It is ironic, but the industry is terrified of being subject to market discipline. When you [explain the proposal], automatically they say the market is irrational. They really don't want to take away discretion from the regulators."

Barb Rehm is American Banker's editor at large. She welcomes feedback to her weekly column at Barbara.Rehm@SourceMedia.com [barbara.rehm@sourcemedia.com].