# Markets must force banks, like petulant toddlers, to grow up

**Tim Harford**

Like monstrous toddlers, the world's banks have stumbled from manic exuberance, destroying all they touch with clumsy glee, to petulant refusal to get off the floor. As any parent will tell you, round-the-clock supervision of toddlers is impossible and clearing up the mess is no fun. How can we force banking to grow up?

The problem is that governments – rightly, given the present set-up – regard certain banks as too big or too interconnected to fail.

From that single flaw springs all our troubles. Banks find it cheap to raise money as debt rather than as equity. That makes them fragile: any highly leveraged company flirts with bankruptcy. In a more respectable industry, that risk would encourage use of equity, a more resilient source of funds. But, with the government acting as backstop, who cares?

Regulators, then, craft rules to oblige banks to use enough equity capital. These rules do not work. Complex risk-weightings have failed; again and again, banks have collapsed despite meeting regulatory requirements. With hindsight, simpler rules gave better warning of trouble, as the Bank of England's Andrew Haldane has shown. But simpler rules would soon be exploited.

There is much to be said for the idea that banks should just use much more equity. But while the costs of using equity in place of debt are often exaggerated, they are not zero. And, even with a large equity cushion, the perverse incentives of "too big to fail" will assert themselves: bankers will find new ways to snuggle up with bankruptcy.

Fragility is not the only problem. Banking is pro-cyclical, fuelling booms and deepening slumps. Stressed institutions find it hard to raise capital, because new investors know they would stand behind debt holders in the queue to be repaid. Unable to raise equity, banks are reluctant to lend.

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The solution is obvious: we need to return to a market-based system of banking regulation – one in which banks will not be bailed out. In a market-based system, they would need to reassure backers they were acting like grown-ups – a process likely to be more robust than ticking regulatory boxes. The problem is that nobody believes a regulator could allow a big bank to fail.

But perhaps changing the way bank debt works would offer a way out. A new debt contract, the "equity recourse note", is at the heart of a proposal by market veteran Jacob Goldfield and two economists, Jeremy Bulow and Paul Klemperer.

An ERN would work like a traditional bond – except that, at times of stress, the interest payments would be made in equity rather than in cash. "Stress" is defined not by regulators, who might hold back for fear of causing alarm, but by the bank's share price.

Let us say the share price is $40 when the ERN is issued. The trigger price could be one quarter of that, or $10. At any point when interest payments were due but the share price was below $10, the repayment would be made in shares instead, at a nominal price of $10. (For the purposes of this scheme, depositors would be treated separately.)

Now adopt a simple rule: all bank debt must be in the form of ERNs. What then?

Banks will not "fail". They will not be able to go bankrupt because it will always be possible to issue new equity and repay ERN holders. Stressed banks will automatically acquire thicker equity capital cushions.

There will be no traumatic moment at which large chunks of debt convert to equity, possibly causing trouble elsewhere in the financial system. Only the interest payments convert, and not every ERN will convert at the same trigger price. Mismanaged banks will not collapse, but will be slowly starved of funds by disgruntled investors. "Too big to fail" banks will become small enough to drown in the bathtub.

Finally, banking becomes counter-cyclical. Because the ERN trigger price is tied to the current share price, even a stressed bank can raise new funds by approaching ERN investors: the new tranche of ERN would have a very low trigger price and so it would be at the front of the queue for cash repayments.

Of course, investors would prefer to receive cash, not shares, so bankers would have to work hard to prove their honesty and competence. All this sounds refreshing. Banking regulators should give it a try.



*From Prof Jeremy Bulow, Mr Jacob Goldfield and Prof Paul Klemperer.*

Sir: Two of your recent articles discuss the "equity recourse notes" that we propose in our paper "Market-based bank capital regulation" (VoxEU.org).

Patrick Jenkins is correct that ERNs "create counter-cyclical investment incentives" ("Five bitter pills", Analysis, September 13) as Tim Harford explains in his article describing how ERNs also solve the too-big-to-fail problem ("Markets must force banks, like petulant toddlers, to grow up", August 29). But Mr Jenkins' concern that they could trigger a "death spiral" is misplaced.

ERNs are specifically designed to have the opposite effect: because conversions are always for a fixed number of shares at prices above the current share price, they shore up that price.

Put another way, with ERNs, banks effectively buy puts from lenders every time they sell a bond. This transfers risk from shareholders to bondholders, which raises the required yield on bonds but stabilises the price of stock. And because conversion is payment-at-a-time, ERNs eliminate the well-known "multiple-equilibria" flaw of many coco designs – as we discuss in more detail in our paper.

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