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A New Capital Regulation for Large Financial Institutions

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Abstract

We design a new capital requirement for large financial institutions (LFIs) that are “too big to fail.” Our mechanism mimics the operation of margin accounts. To ensure LFIs do not default on systemically relevant obligations, we require that they maintain a cushion of equity and junior long-term debt sufficiently great that the credit default swap (CDS) price on the long-term debt stays below a threshold level. If the CDS price moves above the threshold, either LFIs issue equity to bring it down or the regulator intervenes. This mechanism ensures that LFIs are always solvent, while preserving some of the benefits of debt.

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