**Killing them softly**

*International regulators are making progress on tackling too-big-to-fail banks.*

TALK is cheap when it comes to solving the problem of too-big-to-fail banks. From the luxury of even today's stuttering economic recovery it is easy to vow that next time lenders' losses will be pushed onto their creditors, not onto taxpayers.

But cast your mind back to late 2008. Then, the share prices of the world's biggest banks could halve in minutes. Reasonable people thought that many firms were hiding severe losses. Anyone exposed to them, from speculators to churchgoing custodians of widows' pensions, tried to yank their cash out, causing a run that threatened another Great Depression. Now, imagine being sat not in the observer's armchair but in the regulator's hot seat and faced with such a crisis again. Can anyone honestly say that they would let a big bank go down?

And yet, somehow, that choice is what the people redesigning the rules of finance must try to make possible. The easier part of their job is to make the dilemma less likely, by boosting banks' safety buffers. Here, they have done a good job of resisting the banking lobby and demonstrating that if put in place gradually, higher capital levels will only dent the economy a little now, and boost it in the long term. The final rules are due in November and will probably call for banks in normal times to carry core capital of at least 10% of risk-adjusted assets. This would be enough to absorb the losses most banks made during 2007-09 with a decent margin for error.

But that still leaves the outlier banks that in the last crisis, as in most others, lost two to three times more than the average firm. No reasonable safety buffer is big enough for them (a core capital ratio of some 20% would be required). Worse, the crisis has shown that if they are not rescued they can topple the entire system. That is why swaggering talk of letting them burn next time is empty. Instead a way needs to be found to impose losses on their creditors without causing a wider panic—the financial equivalent of squaring a circle.

America has created a resolution authority that will take over failing banks and force losses on unsecured creditors if necessary. That is a decent start, but may be too indiscriminate. The biggest banks each have hundreds of billions of dollars of such debt, including overnight loans from other banks, short-term paper sold to money-market funds and bonds held by pension funds. Such counterparties are likely to run from any bank facing a risk of being put in resolution—which, as the recent crisis showed, could mean most banks. Indeed, the unsecured-debt market is so important that far from destabilising it, regulators might feel obliged to underwrite it, as in 2008.

Using a knife, not an axe

A better alternative is to give regulators draconian power but over a smaller part of banks' balance-sheets, so that the panic is contained. The Basel club of regulators proposes to do just that by taking a type of debt at the bottom of the pecking order (known, confusingly, as Tier 2 capital), and giving supervisors power to write it off or convert it into equity without triggering a default if a bank is in serious trouble.

The idea is practical since it means amending banks' debt structures, not reinventing them, although banks would need roughly to double the amount of this debt that they hold. It also avoids too-clever-by-half trigger mechanisms and the opposite pitfall of a laborious legal process. Indeed it is conceivable that a bank could be recapitalised over a weekend.

The banks worry there are no natural buyers for such securities, making them expensive to issue. In fact they resemble a bog-standard insurance arrangement in which a premium is received and there is a small chance—of perhaps one in 50 each year—of severe losses. Regulators would, though, have to ensure that banks didn't buy each other's securities and that they didn't all end up in the hands of one investor. Last time round American International Group became the dumping ground for Wall Street's risk and had to be bailed out too.

Would it work? The one thing certain about the next crisis is that it will feature the same crushing panic, pleas from banks and huge political pressure to stabilise the system, whatever the cost. The hope is that regulators might have a means to impose losses on the private sector in a controlled way, and not just face a binary choice between bail-out or oblivion.

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