FEDERAL RESERVE BANK *of* CLEVELAND

On Systemically Important Institutions and Progressive Systemic Mitigation

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Disclaimer

- The views expressed in this presentation are mine and do not represent the official views of the Federal Reserve Bank of Cleveland, the Board of Governors of the Federal Reserve System, or their respective staffs

Outline of Presentation

- Too Big to Fail – origins and evolution
- Going beyond a size-based classification for systemic importance
- The four C's of systemic importance
- A five-tier supervisory framework
- Progressive systemic mitigation

Prefatory Quotations

- We are living amid the vestiges of old controversies, and we speak their language, though we are dealing with different thoughts and different facts.

  Walter Bagehot,
  Lombard Street , p. 161 (1873)

- History is a good teacher, but there are inattentive pupils.

  George Stigler , quoted in Harold Lever and
  Christopher Huhne, Debt and Danaer, p.31(1986)

Prefatory Quotations

- I wonder if we might not be better off today if we had decided to let Continental fail, because many of the large banks that I was concerned might fail have failed anyway," he said. "And they probably are costing the FDIC more money by being allowed to continue several more years than they would have had they failed in 1984."

William Isaac, quoted in Robert Trigaux, "Isaac Reassesses Continental Bailout," American Banker, p. 6 (July 31, 1989)

Too Big to Fail

- The term ‘too big to fail’ (TBTF) results from the rescue of the Continental Illinois Bank and Trust Company of Chicago
  - In spring of 1984, Continental Illinois faced wholesale deposit runs leading to:
    - FDIC guarantee of all liabilities of Continental Illinois
    - Bailout of all creditors of the bank and its holding company through the direct infusion of capital

Too Big to Fail

- Continental follows a series of bailouts of banks by the FDIC
  - In each case, regulators were reluctant to close the bank and/or were unable to arrange an open bank merger
  - At the time of its bailout, Continental was the seventh largest U.S. bank with $41 billion in assets

Too Big to Let Fail

- The decision to bailout Continental resulted from fears that the official failure of a large banking organization could have large spillover effects
- These perceived spillover effects are the rationale behind the unofficial policy of TBTF and proposals for creating a class of systemically important institutions

Too Big to Let Fail

- Over time, TBTF has given way to the term Systemically Important Financial Institution (SIFI)
  - Systemic importance derives from characteristics other than size, and is therefore on its own an inadequate proxy for classifying a SIFI

Defining Systemic Importance

- On one level, the definition of ‘systemically important’ is fairly simple:
  - A firm is considered systemically important if its failure has economically significant spillover effects that if left unchecked could destabilize the financial system, with potential negative impact on the real economy
- This is the financial stability equivalent of the definition of obscenity – I don’t know what it is, but I know it when I see it

Why is defining SIFIs important?

- Delineating the factors that might make a financial institution systemically important is the first step towards:
  - managing the risk arising from it
  - establishing measures that reduce the number of such firms
  - developing procedures for resolving their insolvency at the lowest total cost (including the long-run cost) to the economy

The four C's

- Over the past 25 years, there has been extensive academic research on TBTF and a number of events in financial markets
- From these emerge four factors other than size that could cause a firm to be systemically important

The four C's

- We refer to these factors at the four C's of systemic importance:
  - Contagion
  - Correlation
  - Concentration
  - Conditions/Context

Contagion

- Contagion is the impact a firm's failure has on other firms or markets through interconnectedness
- The two classic cases of contagion as a source of systemic importance (both in 1984) are:
  - Herstatt Bank
  - Continental Illinois
- Recent examples likely include:
  - Bear Stearns
  - AIG

Correlation

- Correlation as a source of systemic importance is also known as the "too many to fail" problem
- Examples include:
  - 1980s thrift debacle, which resulted from common exposure to interest rate risk
  - Overexposure of large U.S. banks to borrowers in developing countries (Penati and Protopapadakis, 1988 JME)
  - Recent overexposure to residential real estate risk by large commercial and investment banks

Concentration

- A dominant firm's presence in key financial markets or activities can give rise to systemic importance if the failure of one of these firms could materially disrupt or lock up the market
- Two aspects of this include:
  - Size of the firm's activity relative to the market
  - Contestability of the market

Conditions/Context

- Cases where regulators are reluctant to allow the official failure (closure) of a distressed financial institution under specific economic or financial market conditions if its solvency could have been resolved under more normal conditions
- Examples include:
  - LTCM vs. Amaranth
  - Bear Stearns vs. Drexel Burnham Lambert
- Conditional correlated risks and phase-locking behavior

Establishing SIFI categories

- To the extent that two firms could be deemed systemically important for unrelated reasons, a one-size fits all designation such as ‘too big to fail’ will be inadequate
- We propose five systemically important classifications

The five-tier system

- Five tiers allow:
  - Similar institutions to be treated the same
  - Different institutions to be treated differently
  - Principles of horizontal and vertical equity
- We call the application of these principles as progressive systemic mitigation, which is analogous to prompt corrective action

The five-tier system

- Category 1
  - Systemically important on the basis of size or concentration
- Category 2
  - Systemically important due to contagion
- Category 3
  - Systemically important as a group because of correlated risk exposures or because of conditions or context

The five-tier system

- Category 4
  - Large financial institutions that are not systemically important, but whose failure could have economically significant implications for regional economies
- Category 5
  - Financial institutions not included in the other categories, consisting primarily of community-based financial institutions

Progressive systemic mitigation

- Additive system where regulatory treatments and supervisory oversight increases based on systemic importance
- Category 5
  - Basic level of safety-and-soundness regulation and supervisory oversight

Progressive systemic mitigation

- Category 4
  - Requirements of category 5 plus:
    - additional reporting requirements
    - requirement to implement risk management systems and maintain more sophisticated risk controls
    - higher level of supervision

Progressive systemic mitigation

- Category 3
  - Requirements of category 4 plus:
    - routine stress tests
    - requirements for contingency plans in place
    - additional regulatory treatments (portfolio limits, add-on capital requirements, and loan loss reserves) to mitigate the effects of activities driving the correlated risks

Progressive systemic mitigation

- Category 2
  - Requirements of category 3 plus:
    - reporting requirements that allow for tracking and measuring direct and indirect inter-bank/inter-firm exposures
    - limits on direct and indirect exposure to counterparties
    - specific reserves and add-on capital charges designed to limit contagion across firms

Progressive systemic mitigation

- Category 1
  - Requirements of category 2 plus:
    - mandatory debt-structure requirements, which could include a mandatory subordinated debt requirement and/or reverse convertible debentures
    - system of double indemnity for shareholders

Progressive systemic mitigation

- Objective is to tailor interventions to address specific sources of systemic risk
- Pricing of the net safety net benefits (implicit and explicit) should be also be considered
  - Improves the incentive compatibility of the five-tier system
  - Reduces incentives to game the cross-over points in each tier

Should the classifications be public?

- Transparency versus constructive ambiguity
- Constructive ambiguity is the use of ambiguous statements to signal intent while retaining policy flexibility
  - Some see this as a way to limit the expansion of the federal financial safety net in a world with SIFIs
- Constructive ambiguity is at odds with progressive systemic mitigation
  - Progressive systemic mitigation is the explicit use of regulatory treatments and supervisory oversight (and interference) to limit SIFIs

What type of information should be public?

- Anything that does not reveal proprietary business information
- At a minimum, the following information should be disclosed:
  - the list of SIFIs
  - categories and criteria for inclusion
  - watch list of financial institutions whose status as a SIFI might change

What type of information should be public

- An effective system of supervisory transparency entails more than simply disclosing information; it must also include producing information and disseminating it in a useful form

Conclusion

- One of the most important issues facing policymakers is that of systemically important financial institutions
- We propose the study and subsequent adoption of a financial-market supervisory infrastructure in which systemically important institutions are:
  - Identified and categorized according to the nature or source of their systemic importance
  - Subjected to specific regulatory treatments that address the risk these firms impose

Conclusion

- The ultimate objective of progressive systemic mitigation is to:
  - improve economic efficiency by promoting socially compatible risk incentives for SIFIs
  - increase fairness in the financial system by leveling the playing field
  - reduce or remove the advantages of being systemically important through regulatory taxes