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Comments on "What to Do About TBTF?"

Dr. Robert A. Eisenbeis

Chief Monetary Economist

Cumberland Advisors

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What Is Typically Meant When It Is Said That An Institution Is TBTF?

- An institution whose failure would cause substantial problems for healthy other institutions and threaten their viability
  - Either through contagion effects (mainly psychological) or
  - Problems due to inter-competiveness
- And an institution that the government is unwilling to impose losses on its uninsured creditors (and perhaps shareholders) should it fail

Florida
One Sarasota Tower
2 N. Tamiami Trail, Suite 303
Sarasota, FL 34236

New Jersey
614 Landis Ave.
Vineland, NJ 08360

800-257-7013

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The Crisis Has Exposed Several Root Problems

- Break down in corporate governance,
  - Excess financial risk-taking in a limited liability structure
  - Abandonment of risk controls and
- Tax and other arbitrage incentives leading to:
  - Organizational complexity
  - Instrument complexity
  - Regulatory arbitrage
- Regulatory complexity due to overlapping jurisdictions for international firms and
  - Weak supervisory standards, oversight and poorly structured book value capital requirements

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Four Recommendations in Professor Flannery's Paper

1. Centralized OTC settlement

   Derivatives were a problem but most of the problem derivatives were heterogeneous

2. Tie supervisory actions to market information

   PCA was supposed to be the heart of supervision, but regulators imposed book rather than market capital standards

   Many of the important institution (Bear Stearns, Lehman Brothers, AIG weren't banks and not subject to PCA

3. Impose Volcker type restrictions on volatile investments

   Activity restrictions essentially close the barn door. There is a deeper issue especially since it is not clear that proprietary trading was at the root of their problems. This was clearly not the reasons that Bear Stearns, Lehman Brothers or AIG failed.

4. Institute higher capital ratios and require properly constructed contingent capital

   This is related to 2. but most of the discussion focuses on banks not on other institutions that were the sources of most of taxpayer losses – AIG, Bear Stearns, Freddie and Fannie.

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Where This Leads

- Addressing the complexity and supervisory issues head on are central to financial reform if TBTF is to be set aside or greatly reduced.
- Effecting change in insolvency regimes at the international level is difficult and slow
- Suggest to start with a blank slate in terms of thinking about the issues and when this is done it seemed that a new financial institution charter for LCBOs that could be internationally agreed and
  - Rests atop the current regulatory and insolvency regime structure
  - Addresses the underlying incentive problems

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What Should We Do About TBTF

- Set up a regime that
  - Makes failure isolated events
  - Deals with the complexity incentives
  - That attempts to improve corporate governance
  - Minimizes the negative externalities due to inter-connectiveness
  - Imposes costs on uninsured creditors and shareholders when failure occurs in an ex ante predictable fashion, but
  - Keeps the firm as a going concern
- The current approaches to dealing with these issues are incomplete and mainly involve tweaking the current regulatory and financial structure but don't really address the TBTF issues.

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Attributes of New Charter

New Simplified, Single Entity Federal Charter

- Required for institutions greater than some size threshold ($100 B)
- Optional for all other US institutions

Permissible Activities

- Activities permissible determined by chartering authority subject to same standards as those for BHSs.
- Subsidiaries and Affiliates would not be permitted

Federal Deposit Insurance would be require if the firm accepts deposits

- Coverage on same bases as exiting banks for deposits
- Fed would be prohibited from extending credit to insolvent institutions analogues to rules governing banks.

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Attributes of New Charter

- Bonus and Incentive Compensation
  - Payments to be made only to the extent they can be funded out of current consolidated profits after allowance for loan losses but at same time as dividend decisions are made
- Creation of New Stakeholder Class
  - Senior management and significant risk-takers required to hold a claim on the firm, such as contingent capital or tradable subordinated debt or escrowed funds, that would absorb future losses for a protracted period.
- Market Priced Debt
  - Institution would be required to issue tradable sub debt and/or tradable contingent capital certificates
  - Contingent capital certificates would have one of two possible triggers depending upon function
    - Recapitalization or
    - Cushion to absorb losses as bankruptcy is evoked
- Taxation
  - Dividends would be subject to same tax treatment as interest payments on debt
- Accounting – all contracts and liabilities must appear on balance sheet regardless of whether they are contingent claims or not

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Attributes of New Charter

- Supervision and Regulation
  - Federal-level designee
- Supervisory Policy
  - Guided by PCA and early Intervention provisions of FDICIA 1991
    - Intervention would be mandatory rather than discretionary if 1) market value of entity fell below a pre-specified value or 2) mark-to-market value of assets relative to liabilities falls below a per-specified by positive value/
    - Guiding principle should be to minimize loss to FDIC and/or taxpayer and to make failures isolated events
- Advance Resolution
  - Federal Regulator would be required to have in hand a current plan to seize and resolve an institution in no less than a weekend
- Supervisory Fees
  - Institution would be charged for supervision based upon time and complexity
- Supervisory Loss
  - Should FDIC incur a loss the supervisory agency would be responsible to make some compensation and public review would be required

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Attributes of New Charter

- Failure resolution
  - Key question is whether failure resolution should be given to regulators to exercise considerable discretion in resolving claims or whether it is better to provide for a modified bankruptcy procedure
  - Those the opt for an FDIC bank-type regime would grant
    - Powers would be the same as available to resolve bank failures
    - Settlement of short term contracts of maturity less than a given number of days would be settled and closed out prior to settlement of claims of other creditors to protect short term market disruption
  - Guiding principle would be universality regardless of nationality of debt holders

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What Else Might the Fed Do?

- Single most significant act would be to begin continuous intra-day Fed Funds purchases and sales with all qualified counter parties
- This would place the Fed at the clearing and settlement mechanism for not only Fed Funds but the RP market
- Transactions would take place at a 2 or 3 bp spread around the FF target rate

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What Would It Accomplish

- Reduce inter-connectiveness in the key interbank market Fed Funds and RP markets to a great extent
- Enable continuous real time transactions monitoring
- Would diversify and expand the Fed's counterparties
  - Eliminate the primary dealer function and open the system to all qualified counterparties
- Provide a safety valve should another 9/11 type event occur and essentially enable each reserve bank to serve as the desk.

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Conclusion

- The proposed charter is designed to limit complexity
- It ameliorates the incentive alignment problem in the firm
  - It makes loss responsibility of management clear
- It treats foreign and domestic creditors equally
- It deals with supervisory incentive problems
- It focuses supervisory attention on monitoring and risk assessment rather than on setting capital standards
- It provides for advance planning in the event of a likely failure with the onus on the regulators to prepare the plan
- It leaves management to management
- It is forward looking rather than backward looking
- It could accommodate different regulatory regimes internationally
- The Fed would be at the center of the inter bank market and function as the effective clearing and settlement house for some of the most critical currently interconnected transactions with real time monitoring of the financial positions of large complex institutions

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