What to do about TBTF?

Mark J. Flannery
University of Florida

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Disclaimer:

It seemed like a good idea at the time.

'Twas.

Residual effect: TBTF.

Outline

1. Identify the residual problem’s
   - source
   - effects

2. Survey suggested fixes
   - Individual firms
   - Institutional setting

3. Recommendations

The Problem

- Fear of (messy) bankruptcy procedures.
- Possible insolvency threatens costly disruptions
- “Interconnected” losses
  - undiversified and/or
  - deprive customers of valuable services.

The Problem (phase 2)

- Government guarantees or re-capitalizes SIFIs.
- Like deposit insurance, but
  - More extensive than previously conjectured
  - Covers much of the system's assets
  - Does not cover many individual institutions, some of which compete with the SIFIs.
- Such protection conveys value to beneficiaries (O'Hara and Shaw (1990))

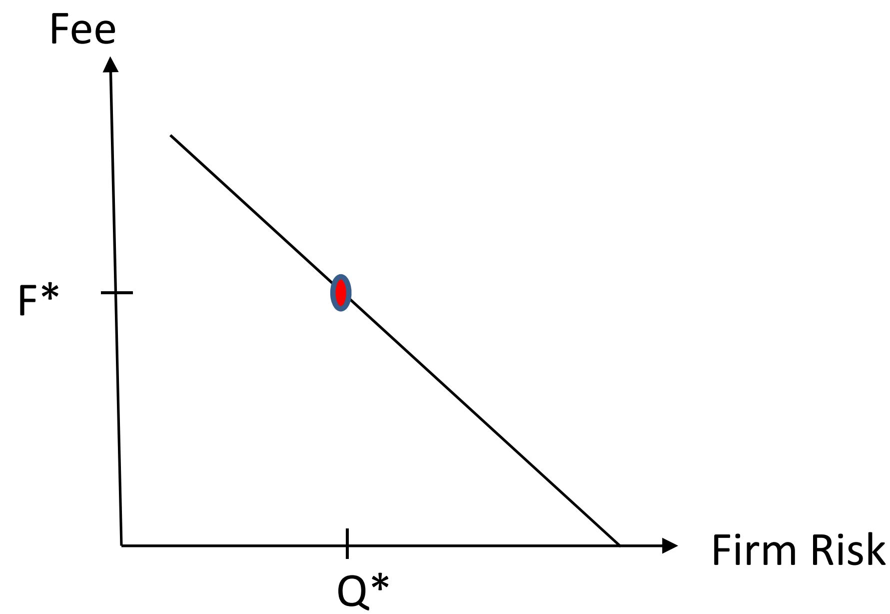
Effects of TBTF

- Risk-invariant borrowing
- Comparative advantage in making risky loans
  - Displace non-SIFIs
  - Transmit distorted risk-taking incentives to real sector.
- Lend for inappropriately risk real projects?

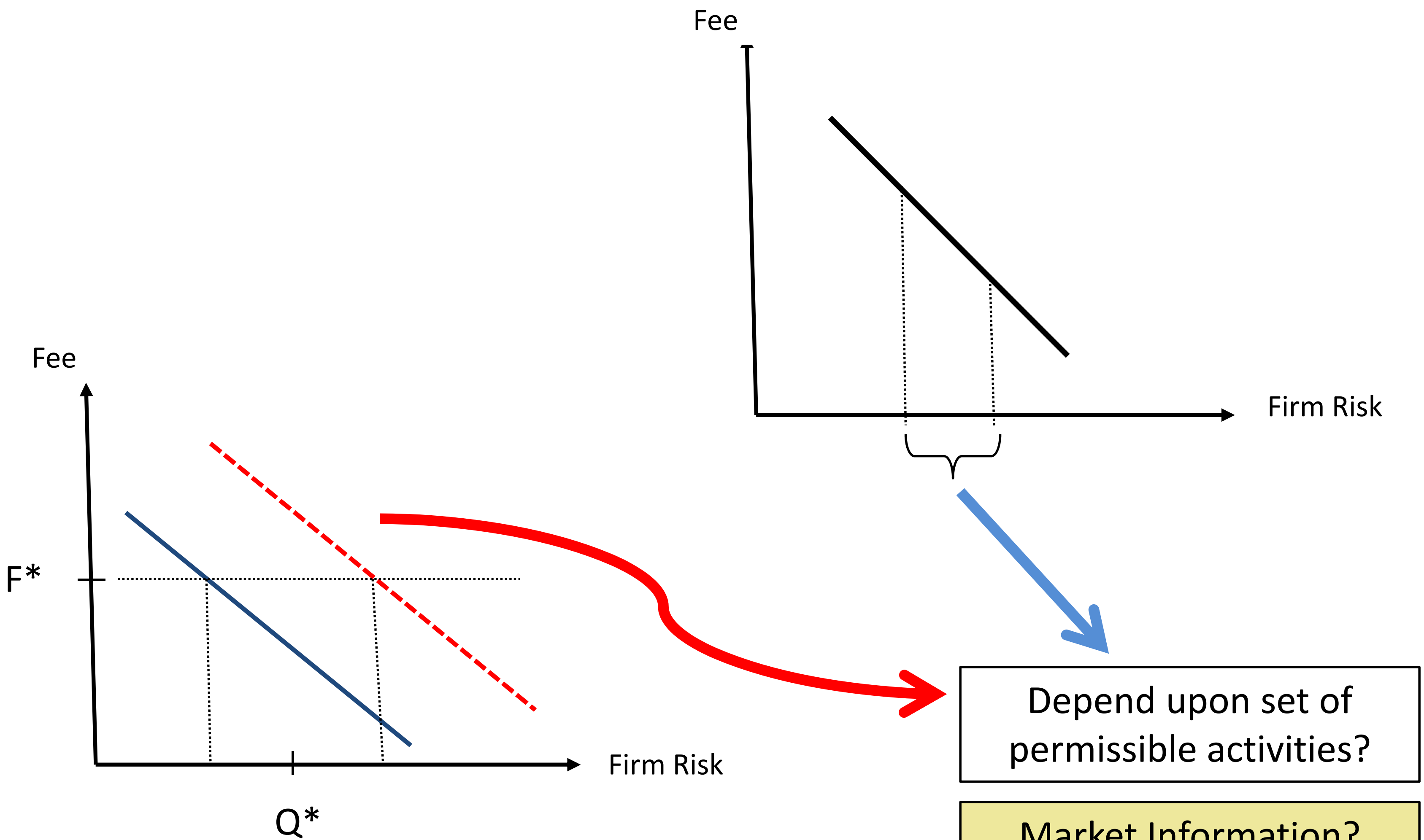
Solutions

- Negative externality
- Offset one government distortion with another.

- A fee (or capital charge)
- A quantity restriction



Imprecise Risk Measurement



Evaluating Solutions

- Recognize supervisors' information problems.
- Ask whether a firm's permissible activities are consistent with identifying risk exposures.
- Where will the risks go?
- Customers vs. investors

Customers vs. Investors (Merton 1995)

- Investors
  - No (necessary) product relationship
  - Diversified
  - Bankruptcy process separates production from investors' claims
- Customers
  - Invest as part of their product use
  - May be un-diversified
  - Bankruptcy delays disrupt customer businesses, destroy value for financial institution.

The Candidates (preview)

	Price	Quantity
Risk-based fee	x	
Risk-based capital	x	
Better supervision	X	X
Size/complexity limits		X
Volcker restrictions		X
Resolution	?	?
Derivatives CCP	X	X

Firm Level Solutions

1. Better supervision
   - Pros:
   - Cons: It’s really hard to do
     - Requires taking strong stands amidst uncertainty.
     - Wait and see.
     - Late can be too late.
     - Compare to M.P. rules (vs. discretion)

Market value based rules can discipline supervisors.

Firm Level Solutions

2. Size/complexity limits

- Unintended consequences?

- Probably infeasible
  - Move abroad
  - Political pushback

Firm Level Solutions

3. “Volcker” restrictions
   - Pros:
     - Multiple activities, with high vols, exacerbate risk-measurement challenges.
       - Better supervision?
       - Simplify the problem
   - Cons:
     - Uncertainty about economic effects
     - Regulated entities need to live with their supervisors’ limitations.

Systemic Improvements

1. Prompt Resolution
   – Pros: could restore debt market discipline
     - Clarify which claims are “haircuttable”
     - Living wills might help a little

   -- Cons: International impediments
     - Different bankruptcy priorities
     - Ring-fencing
     - Remaining uncertainty ➔ not (yet?) a credible general solution

Systemic Improvements (#2): CCP

- Cons:
  - probably re-arranges bankruptcy priorities
  - mutualizing counterparty risk
- Pros:
  - Who would have designed the current system from first principles?
  - Derivatives exchanges work
  - Need exceptions for rocky road or fish food
  - Capital charges, fees
  - Recognize systemic nature of the CCP
- Separate question: introduce a full exchange?

The Candidates

	Price	Quantity
Risk-based fee	x	
Risk-based capital	x	
Better supervision	X	X
Size/complexity limits		X
Volcker restrictions		X
Resolution	?	?
Derivatives CCP	X	X

Recommendations

1. Derivatives CCP
2. Limit volatile investments
3. Market information to force supervisory actions.
4. (Much) higher capital requirements

1. CCP

- Centralize performance monitoring and risk-bearing
- Information about individual firms' exposures

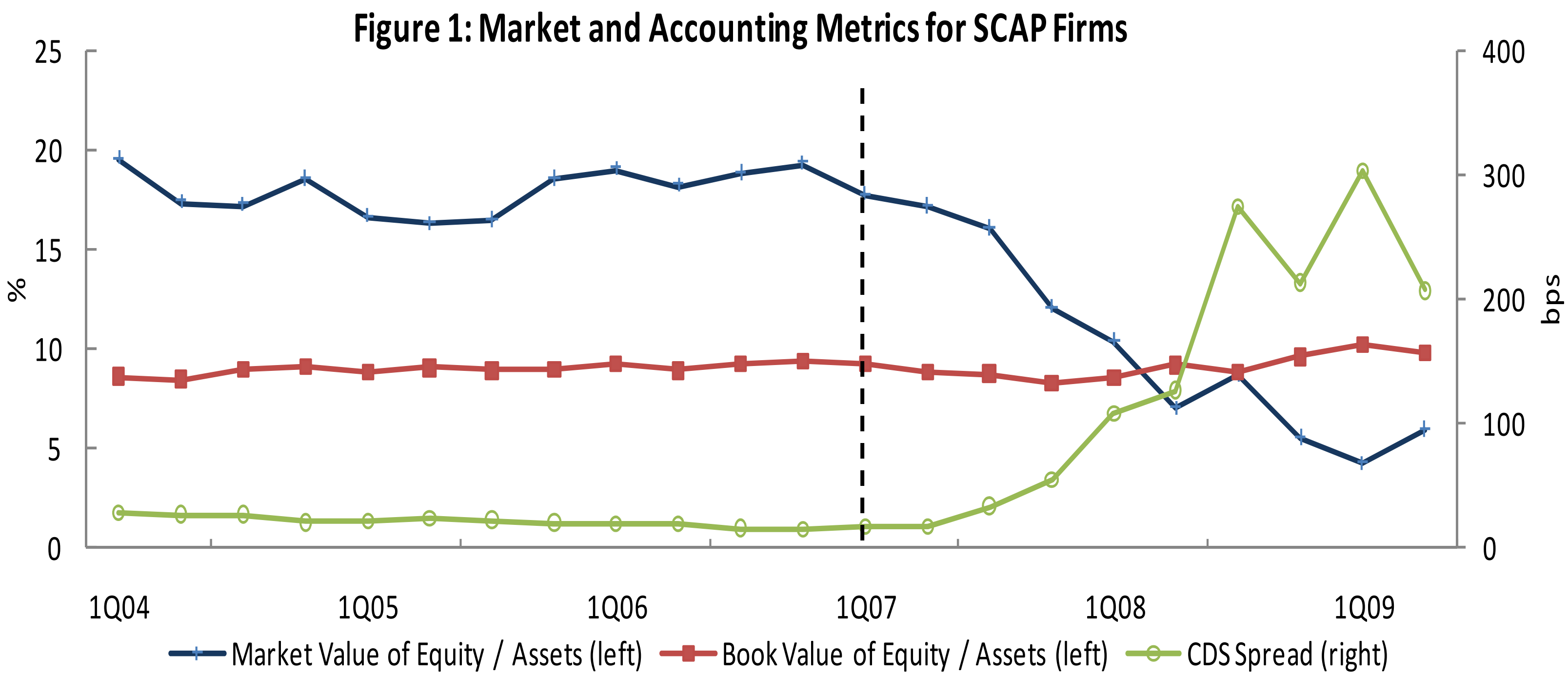
Mark Twain

2. Volcker Restrictions

- Variable risks make pricing difficult.
- Risk capital seems eager to do
  - prop trading
  - private equity

- Little social cost, some supervisory gain

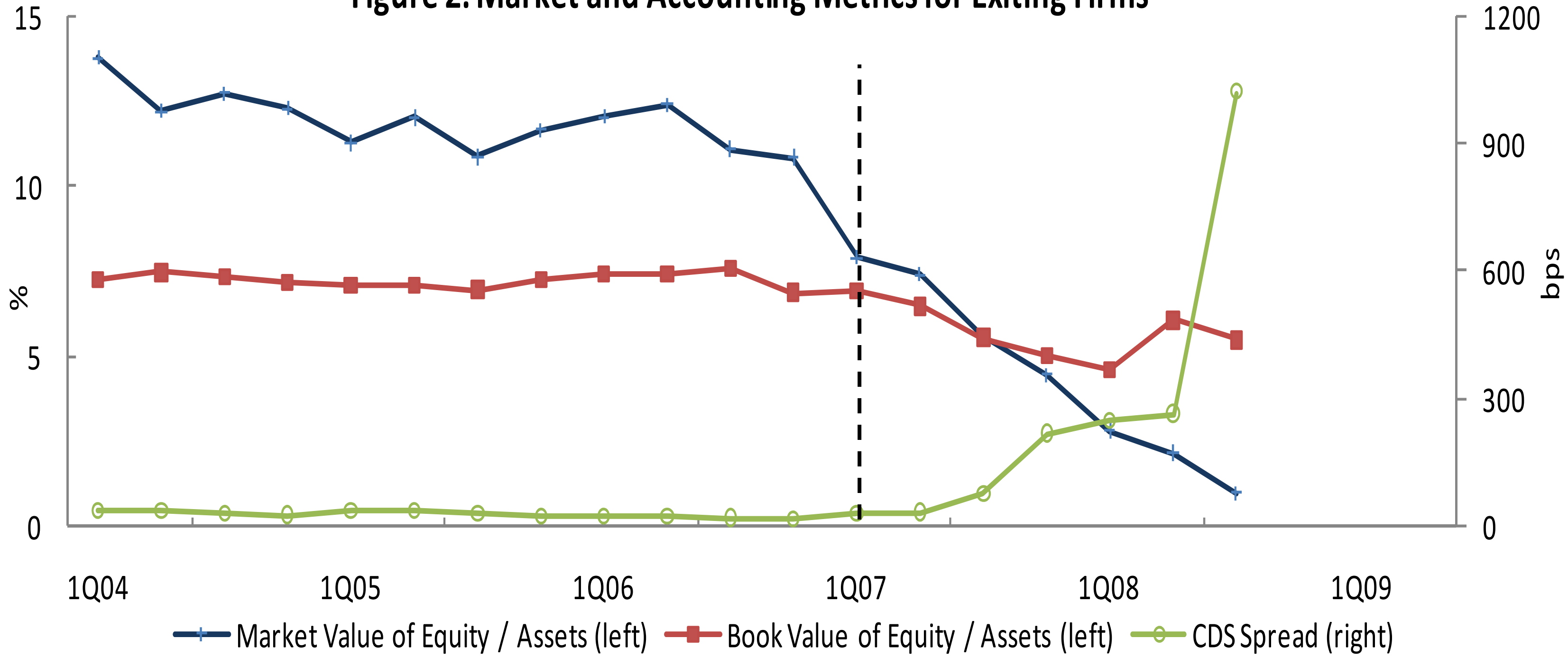
3. Market Information Can Discipline Supervisors



Notes: Market value and book value ratios are simple means for 18 FIs that participated in the SCAP, excluding GMAC. CDS spreads are simple means of available data.

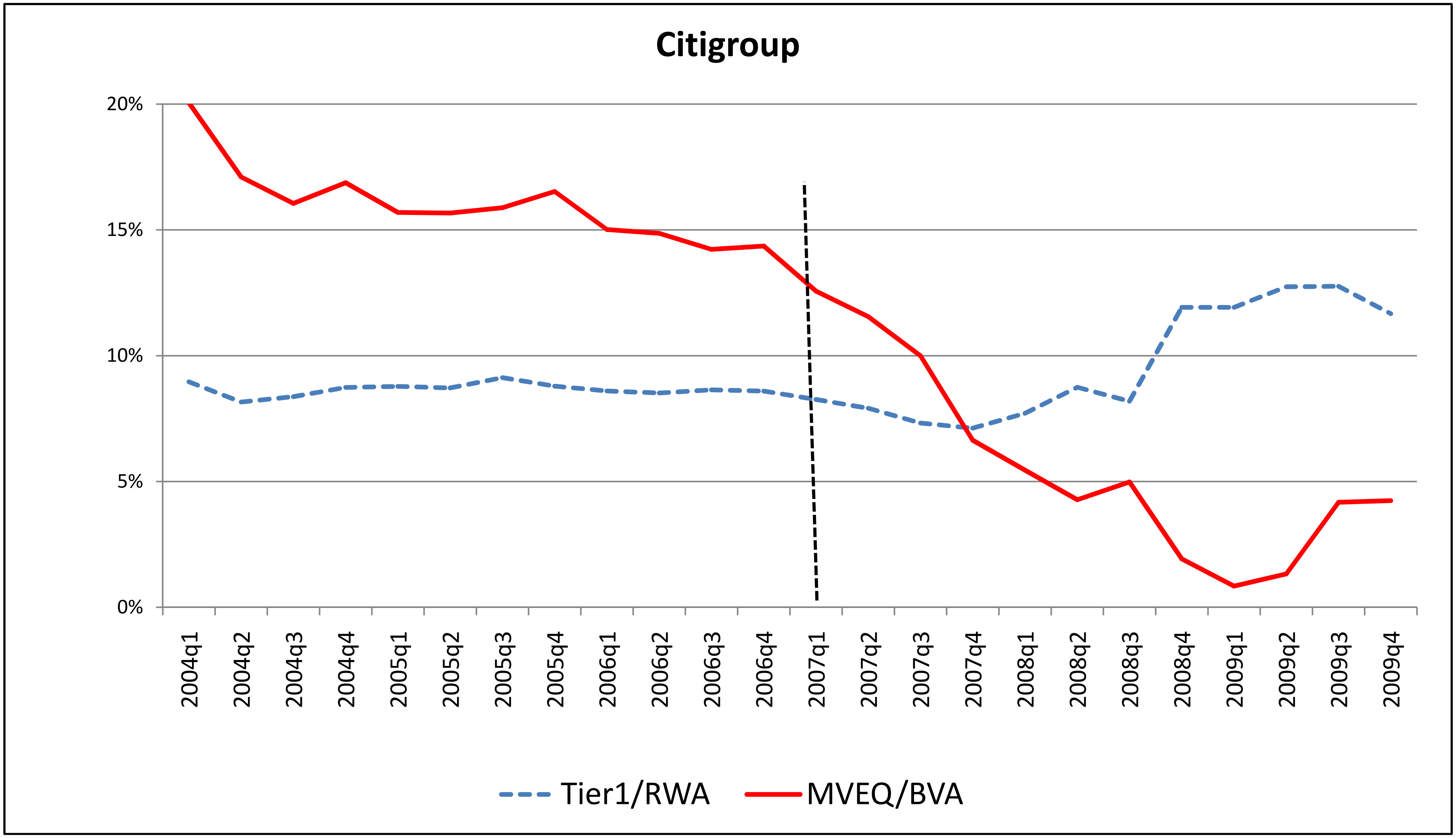
Source: Kevin Stiroh, FRB-NY

Figure 2: Market and Accounting Metrics for Exiting Firms



Notes: Market value and book value ratios are simple means for up to 11 firms that exited during the financial crisis. CDS spreads are simple means of available data.

Source: Kevin Stiroh, FRB-NY



Citigroup
20%
15%
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0%
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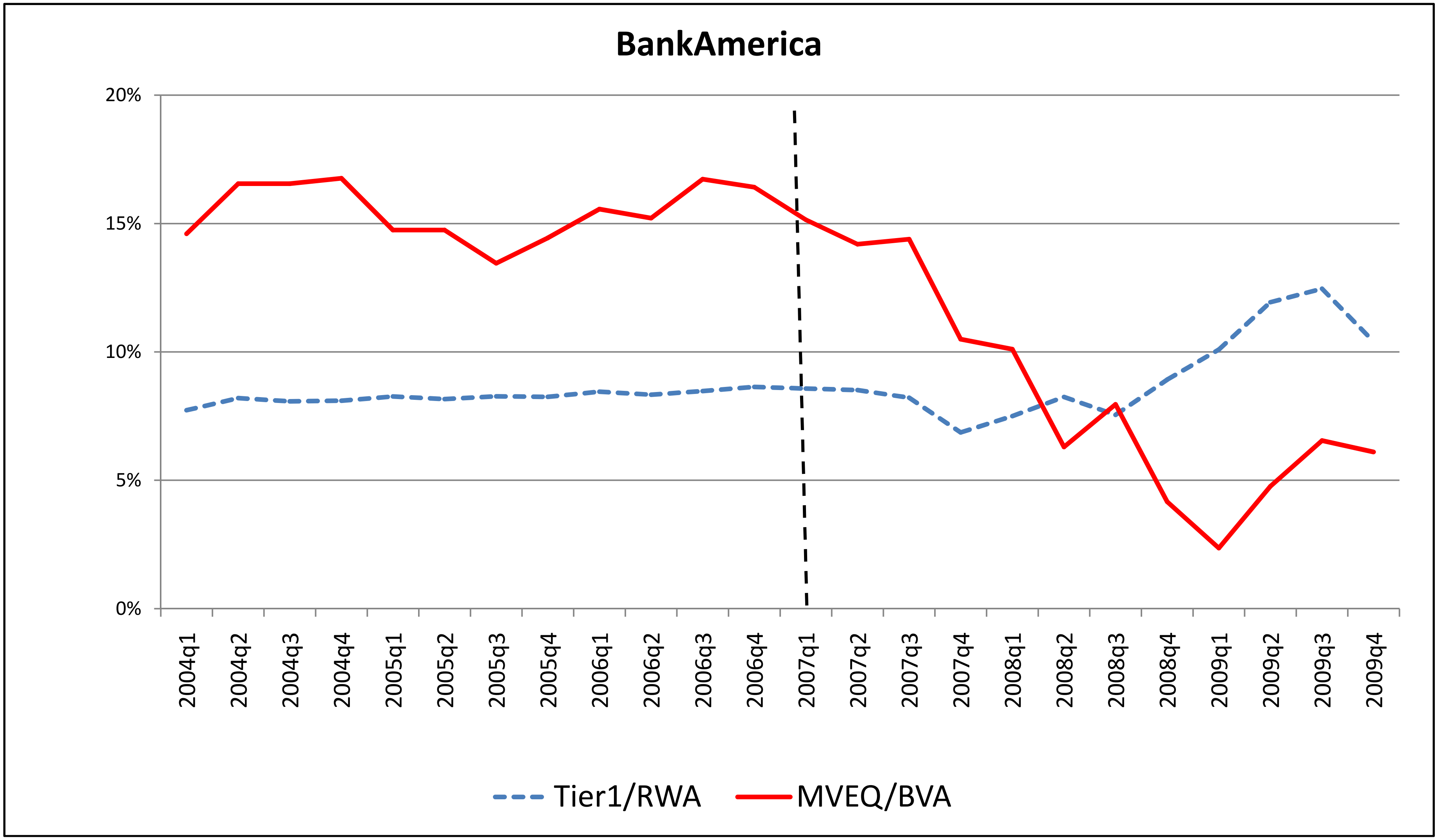
2009q4
Tier1/RWA
MVEQ/BVA


BankAmerica
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15%
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5%
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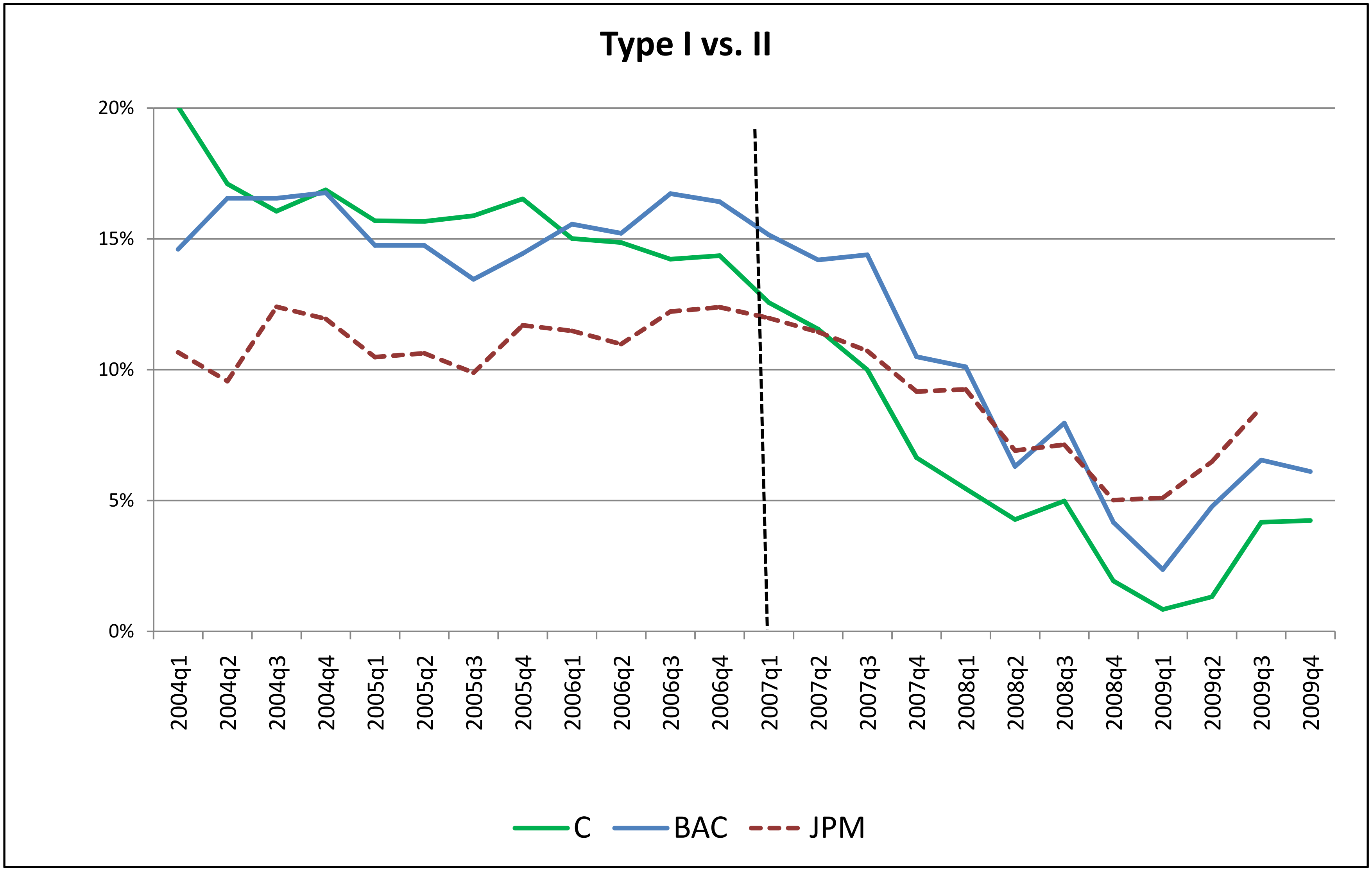
Tier1/RWA
MVEQ/BVA


Type I vs. II
20%
15%
10%
5%
0%
2004q1
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2009q4
C
BAC
JPM

4. Higher Capital

- Arguments for higher capital
- Arguments against:
  - WACC
  - Managerial discipline
  - Drive risks into the shadows

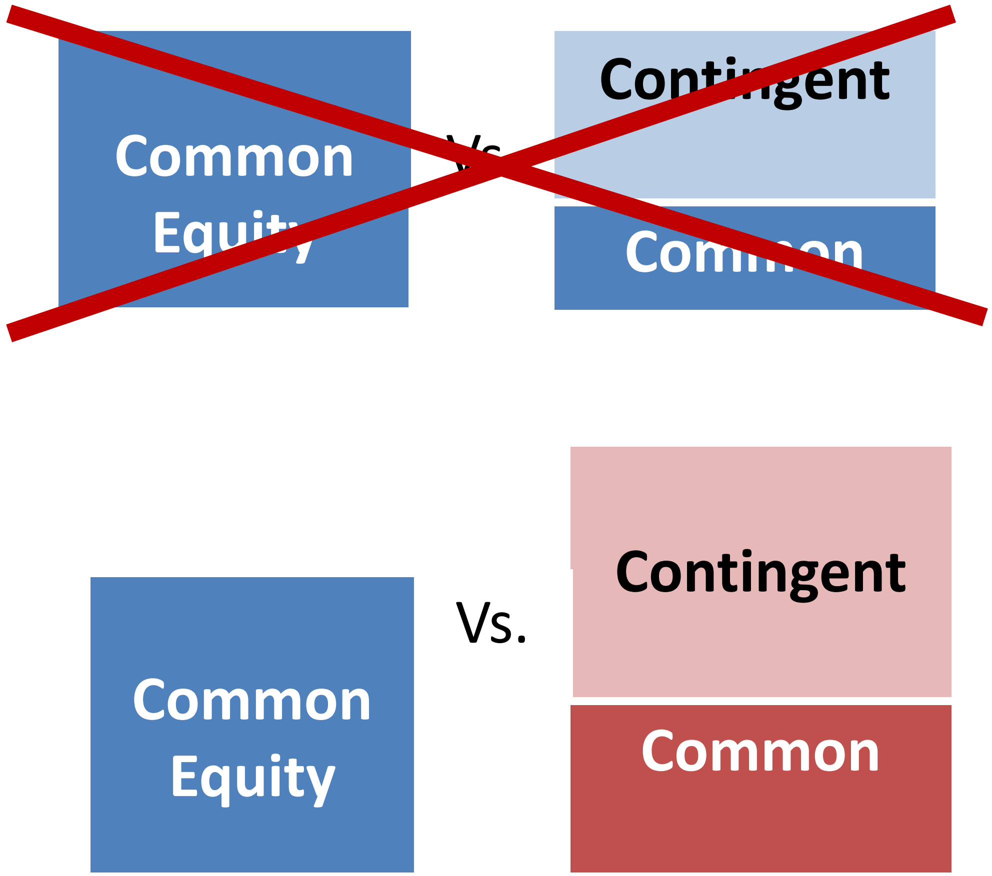
However …

4 ½. Contingent Capital Bonds

- Definition
- Mitigate drawbacks of higher capital
- Augment downside risk protection for bank depositors and for taxpayers.

- Market-valued trigger

The Bargain



Summary

- Specific recommendations:
  1. Derivatives CCP
  2. Limit volatile investments
  3. Market information to force supervisory actions.
  4. (Much) higher capital requirements

- No perfect guarantee
- Won’t eliminate from trading book or trust.
- Will drive risks into the shadows – effect on financial stability?