What to do about TBTF?

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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

Firm Risk

Fee

F* Q*

Depend upon set of permissible activities?

Market Information?
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)

<table>
<thead>
<tr>
<th>Feature</th>
<th>Price</th>
<th>Quantity</th>
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<tbody>
<tr>
<td>Risk-based fee</td>
<td>x</td>
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<tr>
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<td>Derivatives CCP</td>
<td>X</td>
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Firm Level Solutions

1. Better supervision
   – Pros:
   – Cons: It’s really hard to do
     o Requires taking strong stands amidst uncertainty.
     o Wait and see.
     o Late can be too late.
     o 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
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

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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

Figure 1: Market and Accounting Metrics for SCAP Firms

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
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

Common Equity Vs. Contingent Equity

Common Equity Vs. Common

Common Equity Vs. Contingent
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?