

What to do about TBTF?

Mark J. Flannery

University of Florida

flannery@ufl.edu

International Association of Financial Engineers
Annual Conference

June 18, 2010

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

- Asset value uncertainty raised prospect of insolvency (bankruptcy) →
 - Massive uncertainty about asset claims →
 - Short-term liabilities run →
 - Firm's value substantially diminished.
- Undiversified exposures elsewhere:
“externality” of contagion.
- Government guarantees or re-capitalizes SIFIs
 - No debt bears credit losses.
 - No debt market discipline.

Effects (social costs)

- Conjectured gov't guarantees are now confirmed.
- Like deposit insurance, but
 - More extensive
 - Institutions
 - % of system assets
 - ***Does not*** cover many individual institutions, some of which compete with the SIFIs.
- SIFIs' comparative advantage becomes making risky loans.

Solution

Either

1. Prevent large financial firms' failure

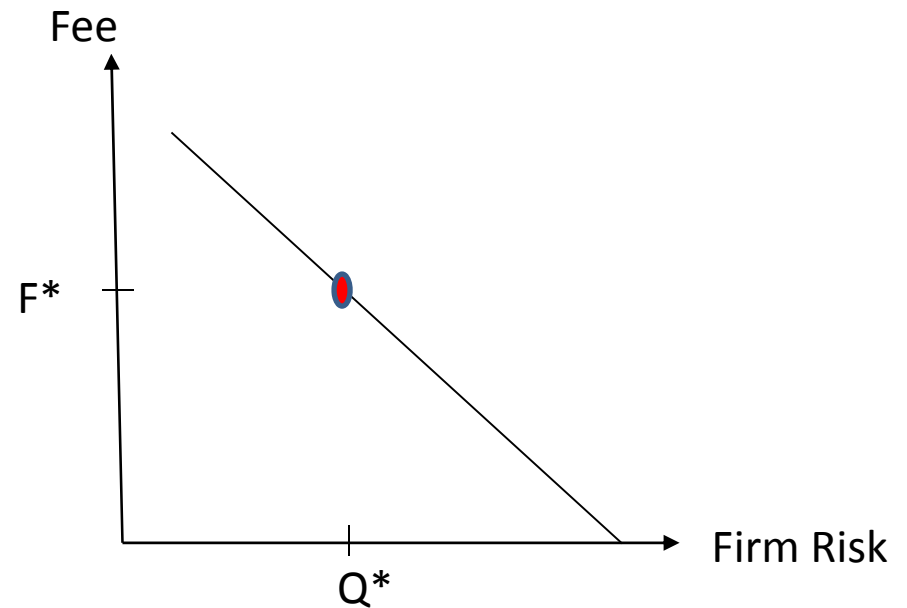
Or

2. Reduce the turmoil associated with bankruptcies that impose losses on some of the firm's claimants

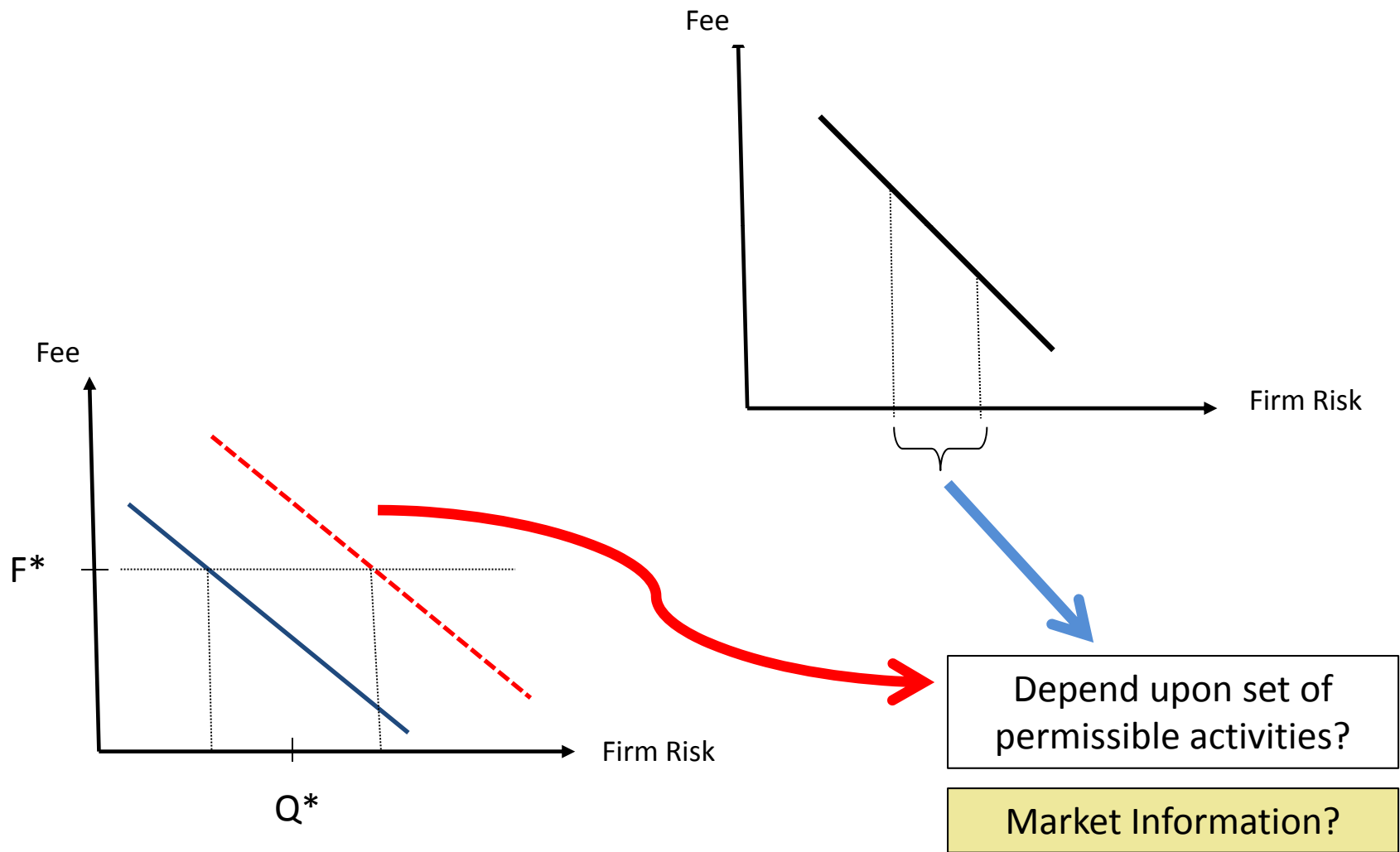
- Delays
- Who gets promised collateral?

Solutions

- Negative externality
- Offset one government distortion with another.
- A fee (or capital charge)
- A quantity restriction



Imprecise Risk Measurement



Evaluating TBTF Solutions: Principles

- Recognize supervisors' information problems: are the firm's activities consistent with identifying risk exposures?
 - Where will the risks go?
 - Safe regulated sector
- VS.**
- Risky financial system?

The Candidates

		Price	Quantity
PD	Risk-based fee	X	
	Risk-based capital	X	
	Volcker restrictions		X
	Better supervision	X	X
LGD	Size/complexity limits		X
	Expedited 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)

Firm Level Solutions

2. Size/complexity limits

- Unintended consequences?
- Probably infeasible
 - Move abroad
 - Downsize by cutting the “right” activities?
 - Political pushback

Firm Level Solutions

3. “Volcker” restrictions

– Pros:

- Multiple activities, with high vols, exacerbate risk-measurement challenges.
 - Simplify the problem of assessing risk exposures
 - » Supervisors
 - » Counterparties

– Cons:

- Uncertainty about economic effects
- Are we prepared to admit that 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: uncertainty, esp. with international firms
 - Definitely should NOT be adding to uncertainty
 - Different bankruptcy priorities
 - Ring-fencing
 - Not (yet?) a credible general solution

Systemic Improvements (#2): CCP

- Cons:
 - probably re-arranges bankruptcy priorities
 - mutualizes counterparty risk
 - creates a new “systemically important” institution
- Pros:
 - Derivatives exchanges work
 - Who would have designed the current system from first principles?
 - Resembles CLS Bank for FX
- Separate question: introduce a full exchange?

Recommendations

1. Derivatives CCP
2. Limit volatile investments
3. (Much) higher capital requirements
 - a. Market information
 - b. Contingent capital bonds

1. CCP

- Centralize performance monitoring and risk-bearing
- Similar to CLS Bank's actions in FX market
- Information about individual firms' exposures
- Capital charges, fees
 - Exceptions for rocky road or fish food
- Recognize systemic nature of the CCP: Mark Twain

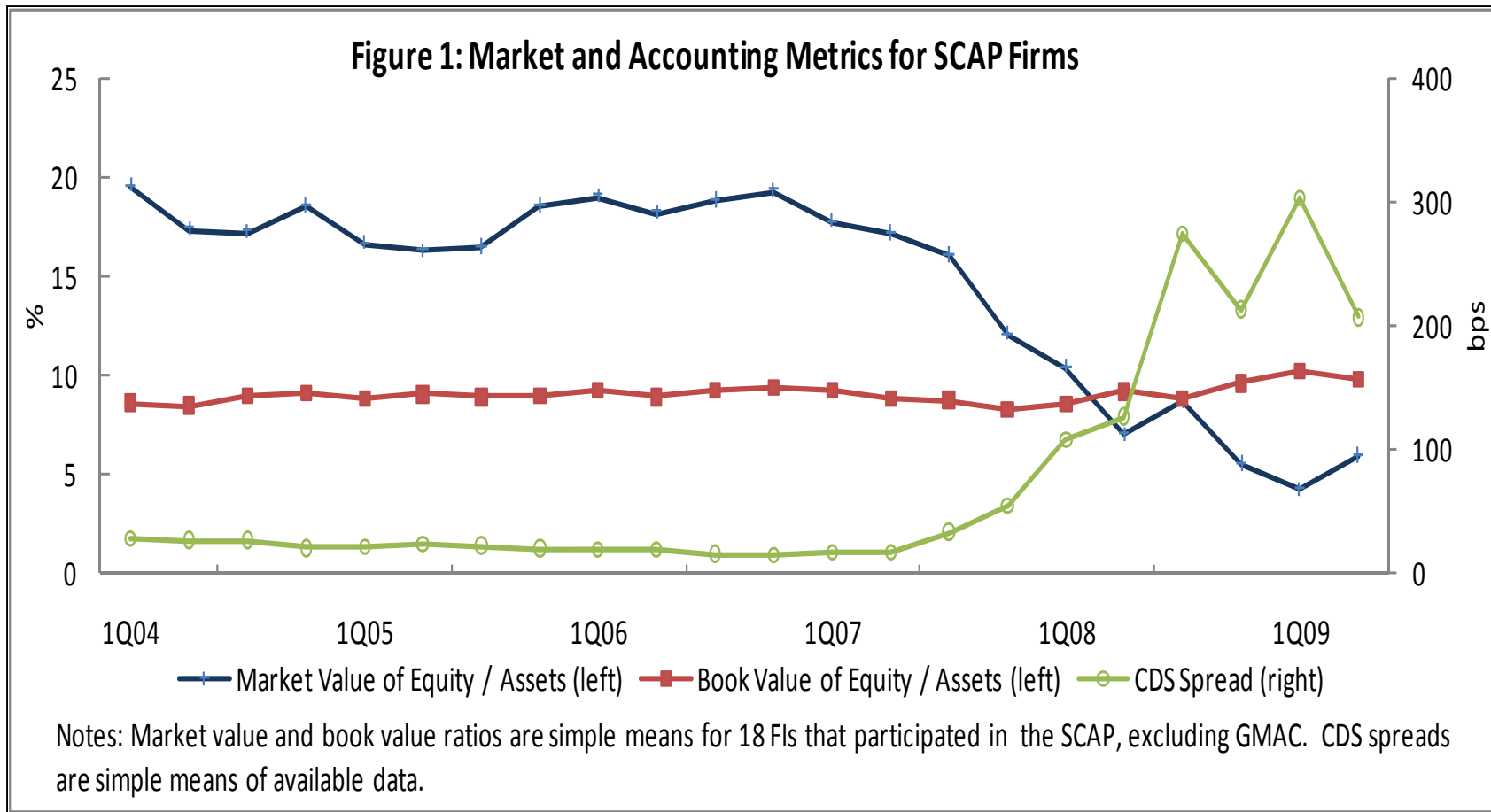
2. Volcker Restrictions

- Variable risks make pricing difficult.
- Risk capital seems eager to do
 - prop trading
 - private equity
- Little social cost, some supervisory gain

3. Higher Capital

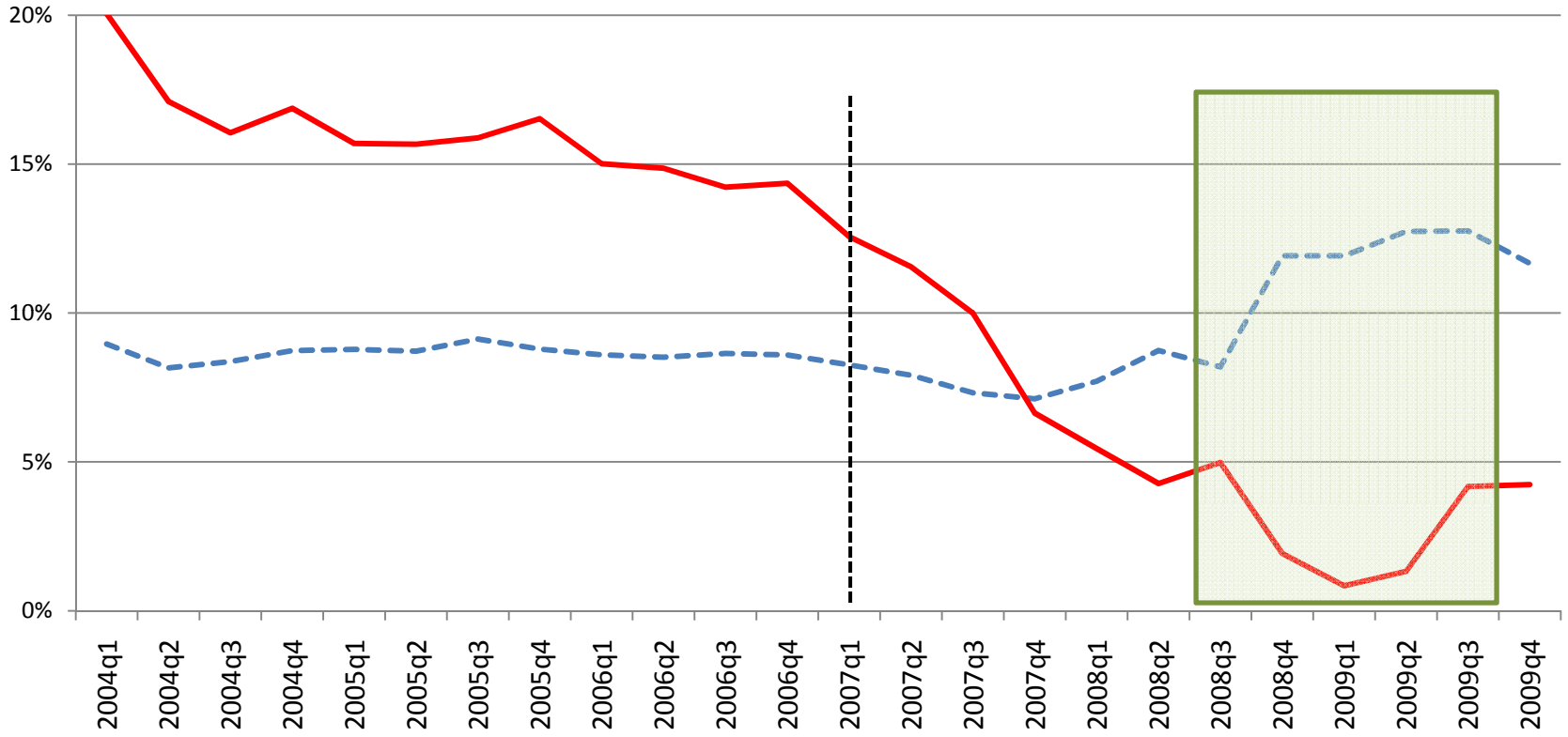
- Arguments for higher capital
 - Forces firm to internalize risks
 - Generic protection for taxpayers (and for the financial system)
- A supervisory challenge: assure compliance on a regular basis.

3a. Market Information



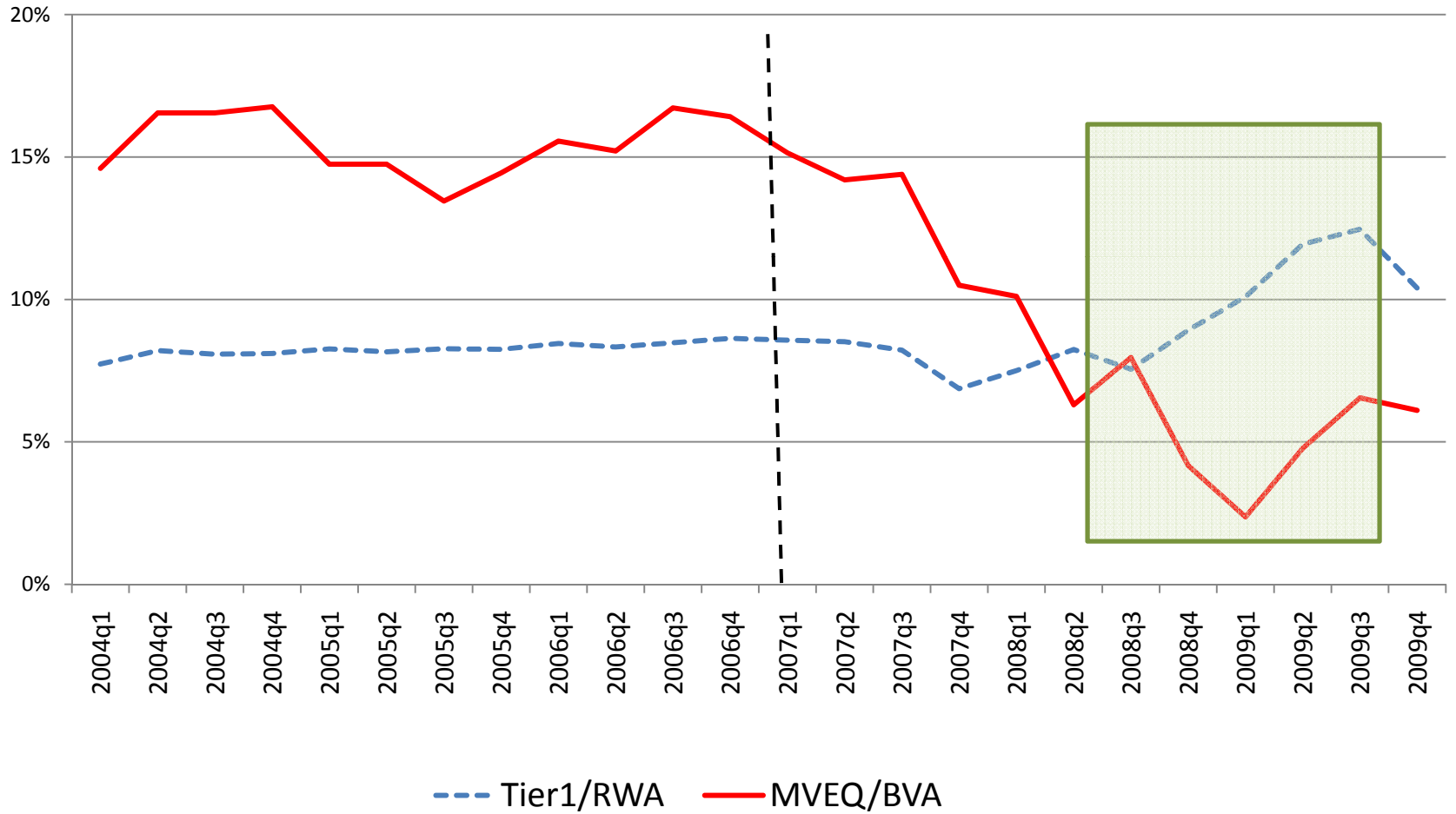
Source: Kevin Stiroh, FRB-NY

Citigroup



--- Tier1/RWA — MVEQ/BVA

BankAmerica



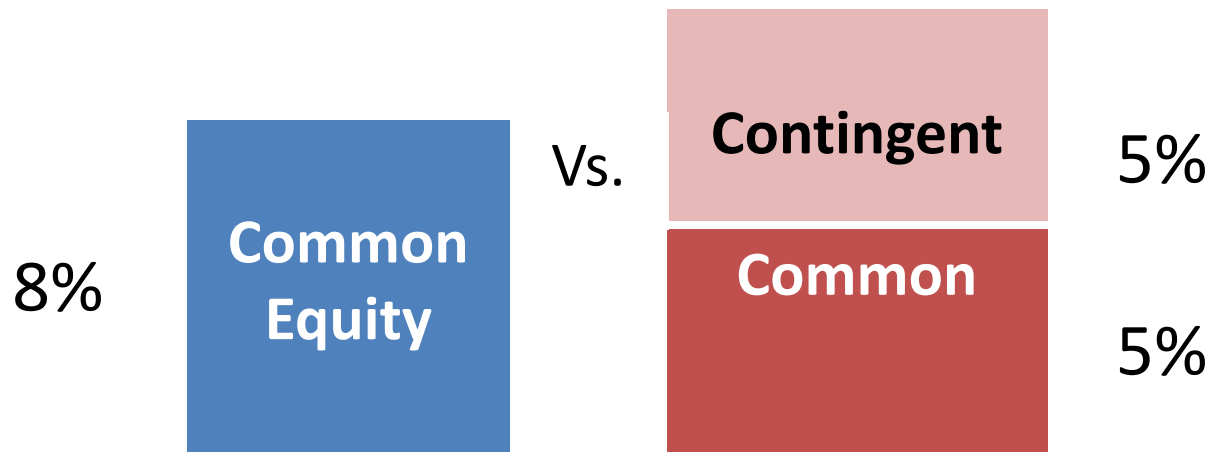
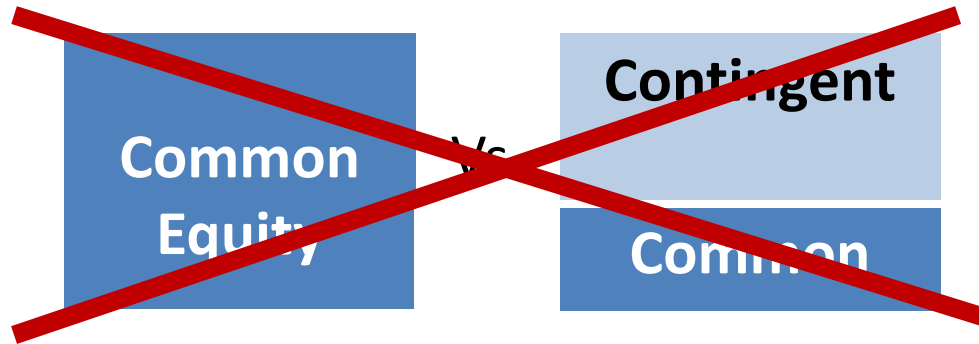
Arguments against raising capital requirements

- WACC \uparrow : real-sector effects
- Managerial discipline (?)
- Drive risks into the shadows

3b. Contingent Capital Bonds

- Definition
- Mitigate drawbacks of higher capital
- Augment downside risk protection for bank depositors and for taxpayers.
- Tax-deductible interest
- Market-valued trigger

The Bargain



Summary

Specific recommendations:

1. Derivatives CCP
 2. Limit volatile investments
 3. (Much) higher capital requirements – including market-value triggered contingent capital bonds.
- No perfect guarantee
 - Won't eliminate from trading book or trust.
 - Will drive risks into the shadows – effect on financial stability?