What to do with the “Too Big to Fail” Doctrine: U.S. and Europe

A presentation by

Bert Ely

at the

19th Annual Hyman P. Minsky Conference

After the Crisis: Planning a New Financial Structure

Levy Economics Institute

April 14, 2010
Certain realities of the real world

- Large banks and other types of large financial institutions are **not** going away
- Which institutions are TBTF is highly contextual
- **THE** financial system is highly interconnected and increasingly global in nature
- It is financially and economically destabilizing to try to impose losses on creditors of large, **failed** (i.e., insolvent) financial institutions
- Electronic technology has made it increasingly easy and efficient to arbitrage government regulation
  - A unified, global regulatory regime for financial markets and institutions is a pipedream – witness the Basel process
What failure means in a TBTF context

• Stockholders of the TBTF institution – common and preferred – are completely wiped out – zero, nada
• Subordinated debt holders most likely are wiped out, too
  ▪ Fannie Mae and Freddie Mac are an unfortunate exception
• The institution’s directors are replaced
• Senior managers get fired
• Unsecured creditors, other than insured depositors and other “protected” parties, may be wiped out
• Unsecured counterparties may be wiped out
The BIG question about a failed TBTF institution:

What to do with the corpse?
What can, cannot be done with a failed TBTF financial institution

- Outright liquidation of the institution’s assets and liabilities would destroy its going-concern value while depressing asset values at other institutions
- Selling the failed institution in its entirety is not feasible as no entity will have the capital to buy it
  - Such a sale would reduce competition and increase concentration
- Dismembering the institution by selling its various businesses takes time
  - However, unsecured creditors and counterparties will flee the institution while it is being dismembered
  - Hence, in order to buy time to dismember the failed institution, unsecured creditors have to be protected against loss
    - Unsecured creditors effectively become guaranteed creditors, e.g. at Citigroup, AIG, Fannie Mae, and Freddie Mac
The public-policy challenge of protecting unsecured creditors in a failed TBTF institution against loss

- Today, unsecured creditors do not pay, *ex ante*, for the *ex post* protection they receive when the institution fails
  - This *ex post* protection creates “moral hazard” because some third party, most likely taxpayers, provides that *ex post* protection, free of charge
- The “unsecured creditor” problem is compounded by the uncertainty as to when and which unsecured creditors will or will not be protected
  - Systemic instability – market freeze-ups and a run on many large financial institutions – is the inevitable product of that uncertainty
  - A “run” on a TBTF institution includes unsecured creditors not rolling over their credits and counterparties demanding collateral
The bottom line in the TBTF debate

• TBTF institutions will continue to exist
• A TBTF institution can become insolvent
• As a practical matter, unsecured creditors and counterparties of TBTF institutions need to be protected against loss when TBTF failure occurs to
  ▪ Maintain systemic stability and keep markets functioning
  ▪ Minimize economic loss from the failure
• The moral-hazard implications of protecting unsecured parties can be dealt with only if
  ▪ Explicit provisions are made, _ex ante_, to protect those parties should a TBTF institution become insolvent
  ▪ This explicit protection should be paid for, _ex ante_
THE answer – guarantee all liabilities of TBTF institutions

• Since unsecured liabilities in a failed TBTF institution are likely to be protected, *ex post*, explicitly guarantee those liabilities, *ex ante*, for a fee
  • The guarantors should be banks and other private parties who are willing guarantors of that institution
    • This approach fully privatizes both gains and losses
  • The guarantee fee they receive should be market-based, not established by government fiat
• This system or network of private-sector guarantors could be called “The Cross-Guarantee System”
  • Federal deposit insurance is a cross-guarantee system, but the guarantors are draftees, not volunteers, and deposit insurance premiums are not market-based
Fifteen years ago, I presented a paper at a Levy conference titled:

“Financial Innovation and Risk Management: The Cross-Guarantee Solution”

Levy published it as Working Paper No. 141

Recent events have demonstrated the need for and workability of the cross-guarantee solution

I encourage you to read that paper, which can be found at: http://estes.levy.org/pubs/wp141.pdf
Contact information for Bert Ely

Ely & Company, Inc.
901 King Street, Suite 102
Alexandria, Virginia  22314
Mail: P.O. Box 320700
Alexandria, Virginia  22320
Phone: 703-836-4101
Fax: 703-836-1403
Email: bert@ely-co.com
Website: www.ely-co.com