# What to do with the "Too Big to Fail" Doctrine: U.S. and Europe

A presentation by

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# Certain realities of the real world

- Large banks and other types of large financial institutions are <u>not</u> 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, <u>failed</u> (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, <u>may</u> be wiped out
- Unsecured counterparties <u>may</u> be wiped out

**The BIG question about a**

**<u>failed</u> TBTF institution:**

# What to do with the corpse?

# What can, cannot be done with a <u>failed</u> 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 <u>unsecured</u> 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, <u>free of charge</u>
- 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 <u>all</u> liabilities of TBTF institutions

- Since unsecured liabilities in a failed TBTF institution are likely to 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

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