Outline

1) The Economics of TBTF

2) Assessing DF and TBTF

3) What is left to do?

4) Can TBTF ever be fixed?
The Economics of TBTF

Costs of Failure: Left to their own devices, financial institutions do not consider the negative externalities of their failure on the whole financial system.

Leviathan Incentives: These negative externalities increase with size, so in the absence of any regulatory control, institutions grow larger than the “socially optimal” size.

Optimal Bailouts: If a large institution is on the brink of failure, then it is can be rational for the government to bailout some stakeholders and counterparties in order to minimize the externalities of failure.

Probability of Failure: Any chance of government support incents large institutions to take on more risks, and thus makes failures even more likely.
Costs of Failure

• The interconnections of CFIs implies negative externalities for their failure.
• DF steps to lower these costs:
  – Swaps clearinghouses reduce disruption of failure from gross exposures to net exposures.
  – Orderly liquidation (Title II) lowers costs of failure as compared to bankruptcy
  – Living wills to simplify liquidation and to signal costly problems before they occur.
  – Broader regulatory oversight by the Fed and the FSOC to allow more preparation for failure.
Leviathan Incentives

• As long as negative externalities grow with size, the optimal private scale will exceed the optimal public scale of FIs.

• DF steps to lower these incentives:
  – Stricter capital regulation for “systemically important” institutions can both reduce the probability of failure for large FIs and act as an implicit Pigouvian tax on their size (but a tax that does not raise any revenue!)
Interlude I

• This all seems very complicated. Why not just break up the big banks?
  – Why use quantity regulation (optimal quantities are unknown, regulations are very difficult to reverse or tweak), when price regulation (taxes, variable capital regulation) can be more flexible?
  – Where is the evidence that smaller banks would increase stability?
    • We had only small banks during the Great Depression. That did not work out so well either.
    • Lehman was not that big. And the first-order effect of the Lehman bankruptcy was to cause a run in the shadow banking system, not in big banks.
  – Other countries are not going to follow suit. Is the world financial system more stable if all the big banks are in Europe?
Optimal Bailouts

• Facing imminent collapse of the financial system, government bailouts (for some counterparties) can be the optimal solution.

• DF steps to reduce frequency/expectation of bailouts:
  – Add an option of “orderly liquidation” (Title II) (hugely important!)
  – Add restrictions that make bailouts more difficult and politically costly
• Why not make bailouts absolutely impossible under all circumstances?
  – I do not see how this can be done, even with a constitutional amendment. After all, Presidents seem to be able to go to “war” without Congress. Do we really think we can stop them from making below-market loans?
  – And why would we want to tie our hands this way? We would need a model of the world that did not ever admit a crisis caused by an exogenous shock.
Probability of Failure

- Any possibility of government support (deposit insurance, discount window, bailouts) will induce moral hazard by managers and counterparties.

- DF attempts to mitigate
  - Higher capital requirements
  - Stricter and more comprehensive oversight, explicit in the legislation (can we do it? We certainly have to try)
What is still left to do?

• Rulewriting
  – Lots of devils in the rulewriting details, particularly for bank capital, derivatives, and orderly resolution. (e.g., we could accomplish a lot with high capital requirements combined with some protections for short-term debtors. But this may require more interagency cooperation than we can muster.)

• Shadow banking
  – The interaction of TBTF incentives and regulatory arbitrage into shadow banking was the deadly combination in the last crisis. DF is focused on TBTF, but the interaction with shadow banking is still underregulated. (this relates to the costs of failure.)

• Reputation of Government
  – DF is an excellent start for changing the incentives of FIs to grow, the costs if they fail, and the non-bailout options for the government. But changing market expectations of bailouts will be harder, and will be even harder (fewer chances to demonstrate our resolve!) than was building Central Bank reputation on monetary policy.
Can TBTF be fixed?

• In principle, we CAN
  – Lower both the probability and costs of FI failure.
  – Force institutions to internalize some externalities of failure.
  – Give the government more “non-bailout” options and ... 
  – make the government more credible at using them (but this will take a while)

• We CANNOT
  – Permanently eliminate the tradeoff between optimal bailouts and induced moral hazard.