Too Big to Fail:

Discussion of "Quantifying Subsidies for SIFIs"

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Distortions for TBTF borrowers

- Debt is <u>too cheap</u> for TBTF firms and not <u>too insensitive</u> to failure risk →
- Too much leverage
- Too much risk
  - Distortion propagates to non-financial firms
- Financial firms grow inefficiently large
  - To capture subsidy
- Small firms competitively disadvantaged

What this paper shows

- Overall rating for banks (by Fitch) reflects:
  - Individual Rating (bank's own financial strength)
  - External Support Rating (embeds all forms of support)
  - What about Support Floor? (embeds govt. support)

- External support raises rating 2/3 notches
  - Hard to see how it could come out any other way (Why would Fitch ignore its own external support assessment?)

- Paper translates the rating advantage to a yield-spread advantage based on Soussa (2000)
  - Soussa also does not look at yields (infers yield from historical default+model).

What this paper <u>does not</u> show

- How important is the Fitch external support rating for yields?
  - Yields may respond <u>more</u> to external support if such support lowers systematic risk of bonds
  - Yields may respond <u>less</u> to external support if markets do not believe them

- So, not clear how much (or even whether) external supports affects magnitude of safety net subsidies

Regressions I would have liked to see in this paper

- $\text{Spread}_{i,t} = \alpha + \beta^1\text{Individual-Rating}_{i,t} + \beta^2\text{External Support-Rating}_{i,t} + \text{Control Variables}_{i,t} + \varepsilon_{i,t}$
  - What component of the rating matters most to the market?
  - Also consider *Support Floor*, to focus on govt. bailouts.
- $\text{Spread}_{i,t} = \alpha + \beta^1\text{Individual-Rating}_{i,t} + \beta^2\text{External Support-Rating}_{i,t} + \beta^3{*}\text{Post-Crisis}_t{*}\text{Individual-Rating}_{i,t} + \beta^4\text{Post-Crisis}_t{*}\text{External Support-Rating}_{i,t} + \text{Control Variables}_{i,t} + \varepsilon_{i,t}$
  - Has the market *changed* its assessment of the value of safety nets post crisis?

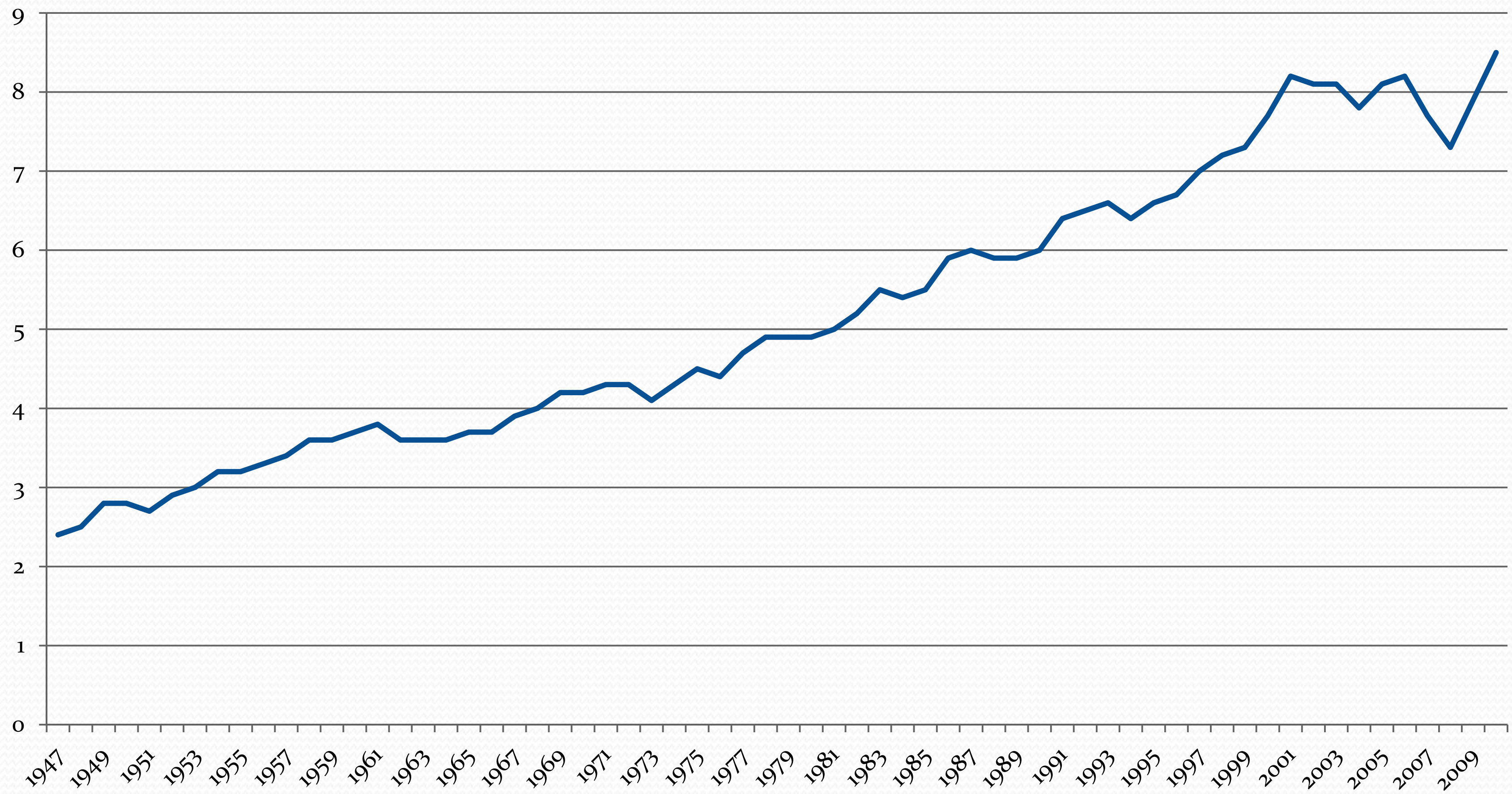
Regressions I would have liked to see in this paper (cont.)

- $Spread_{i,t} = \alpha + \beta^1 Individual\text{-}Rating_{i,t} + \beta^2 External\ Support\text{-}Rating_{i,t} + \beta^3 {*} Size_{i,t} {*} Individual\text{-}Rating_{i,t} + \beta^4 Size_{i,t} {*} External\ Support\text{-}Rating_{i,t} + Control\ Variables_{i,t} + \varepsilon_{i,t}$
  - Does Individual-Rating matter more for <u>smaller</u> banks?
  - Does External-Support matter more for <u>TBTF</u> banks?

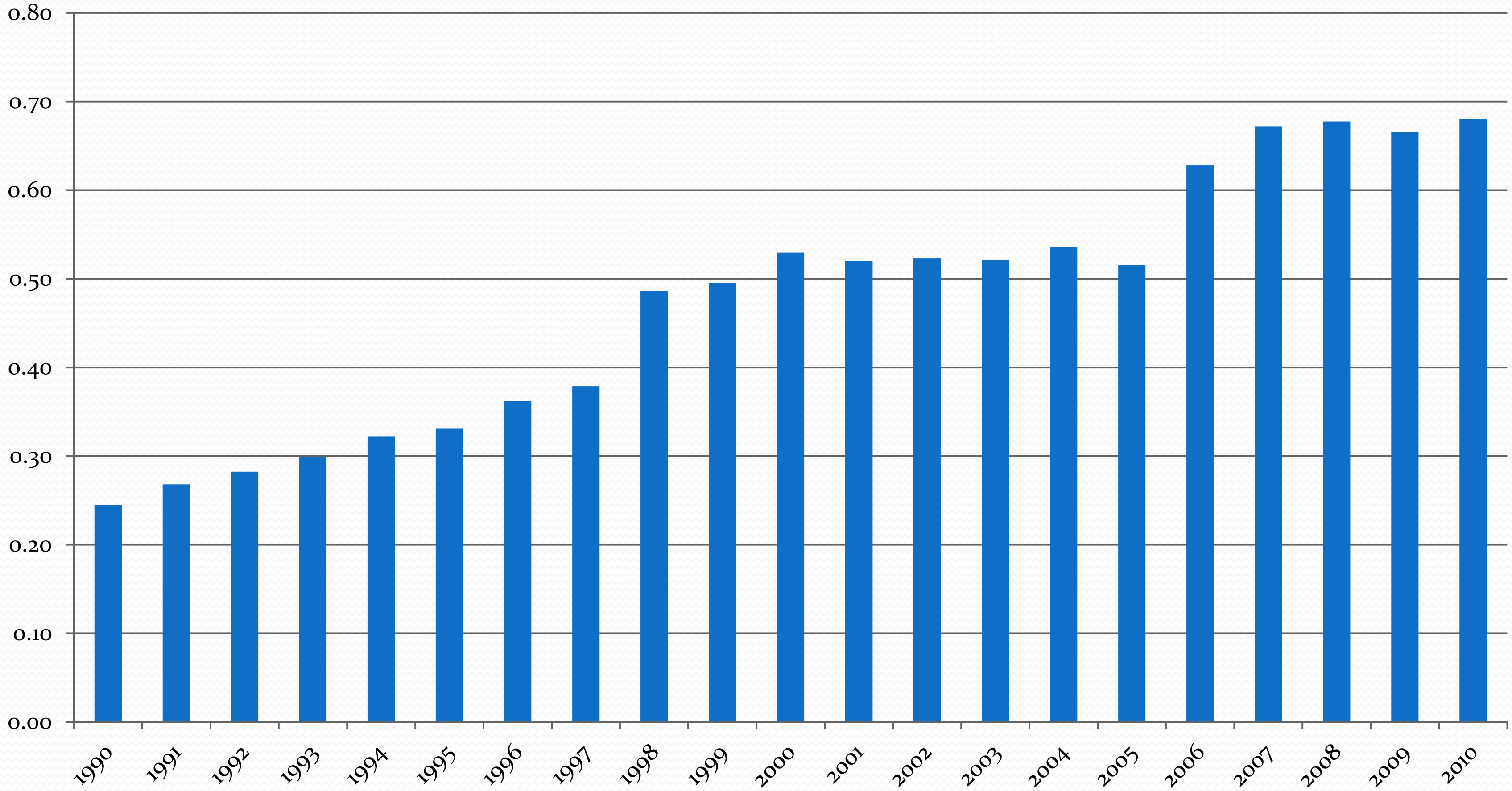
Is TBTF Getting Worse?

- Greater importance of finance to the economy
  - Credibility problem has its roots in concern about spillovers
- Greater concentration in the financial and banking system
  - Morgan+Bear+WaMu
  - Bank of America+Countrywide+Merrill Lynch
  - Wells Fargo+Wachovia

Finance value-added increasing: Finance / GDP (%)



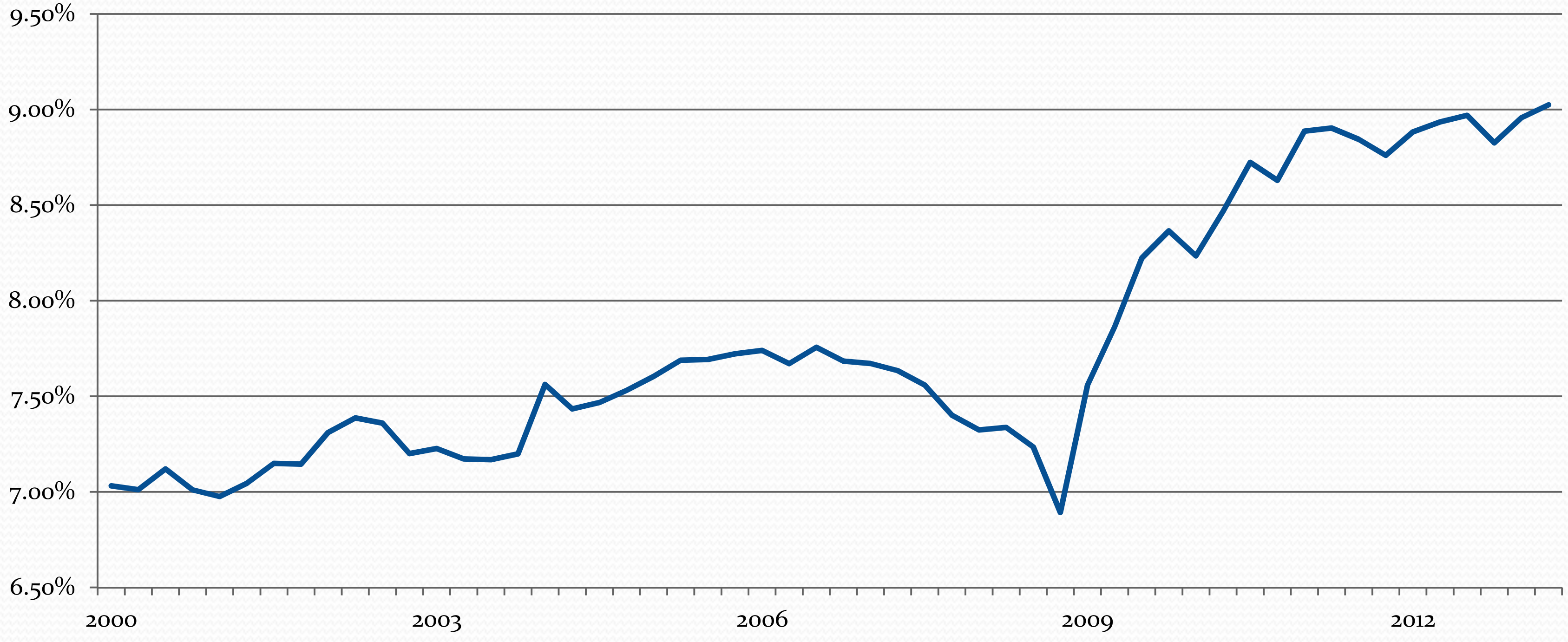
Concentration increasing: Top-10 Bank Share



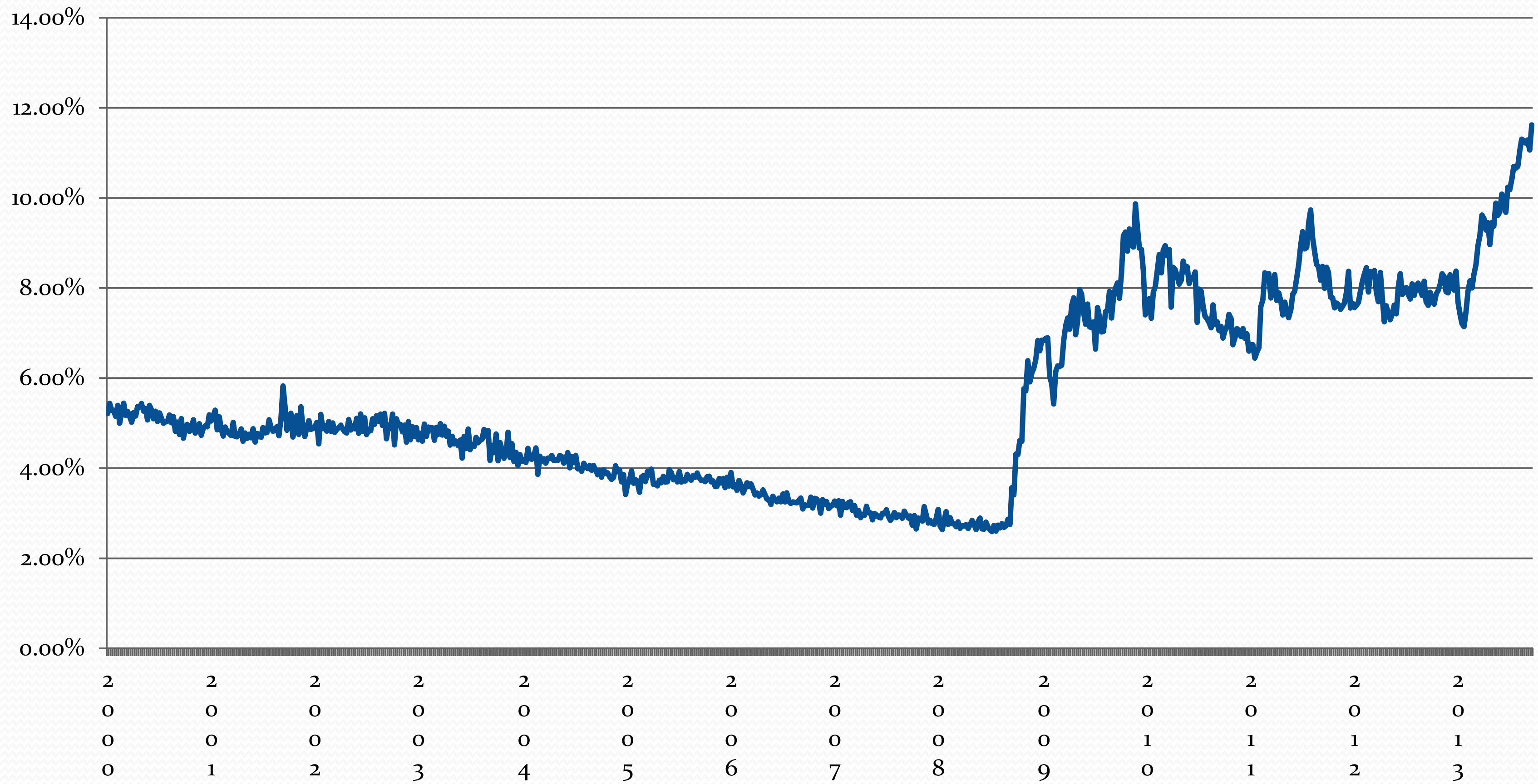
But post-crisis adjustments have made system more robust

- More Capital
- More Liquidity
- More Stable Funding
- Less Off-Balance Sheet Leverage

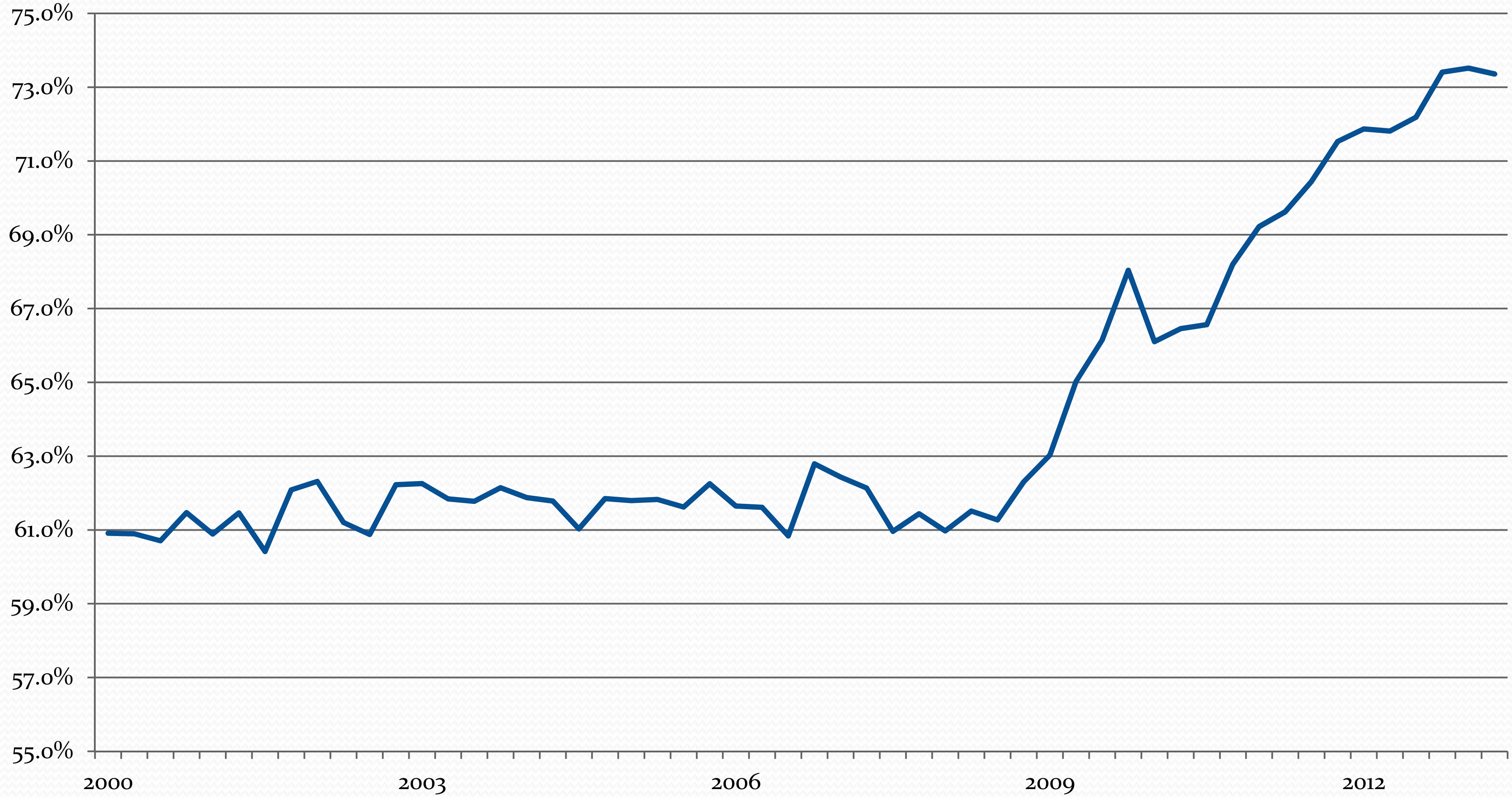
Capital ratios have increased at large banks



Large banks hold more cash



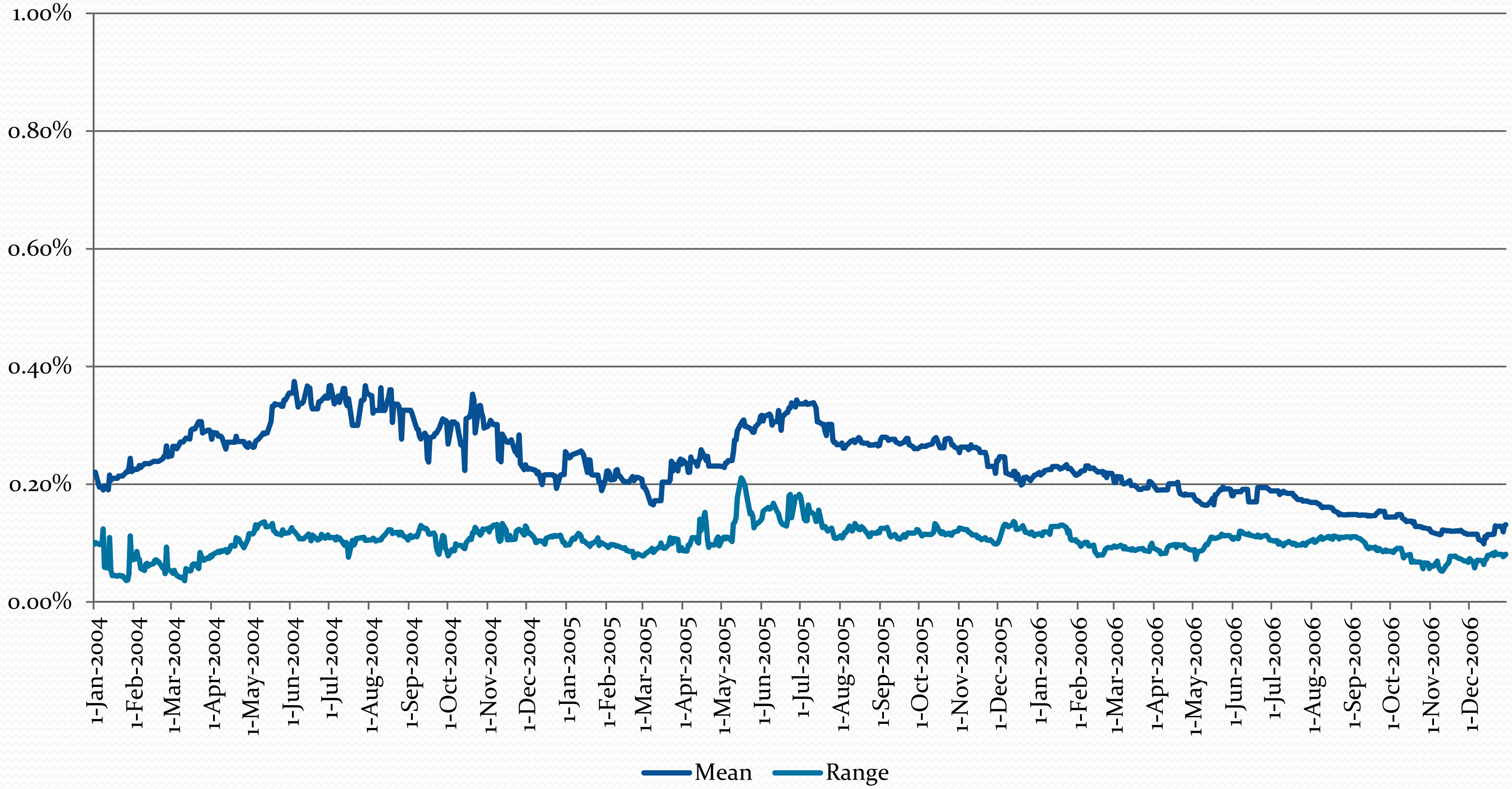
More stable funding: Deposit/assets at large banks



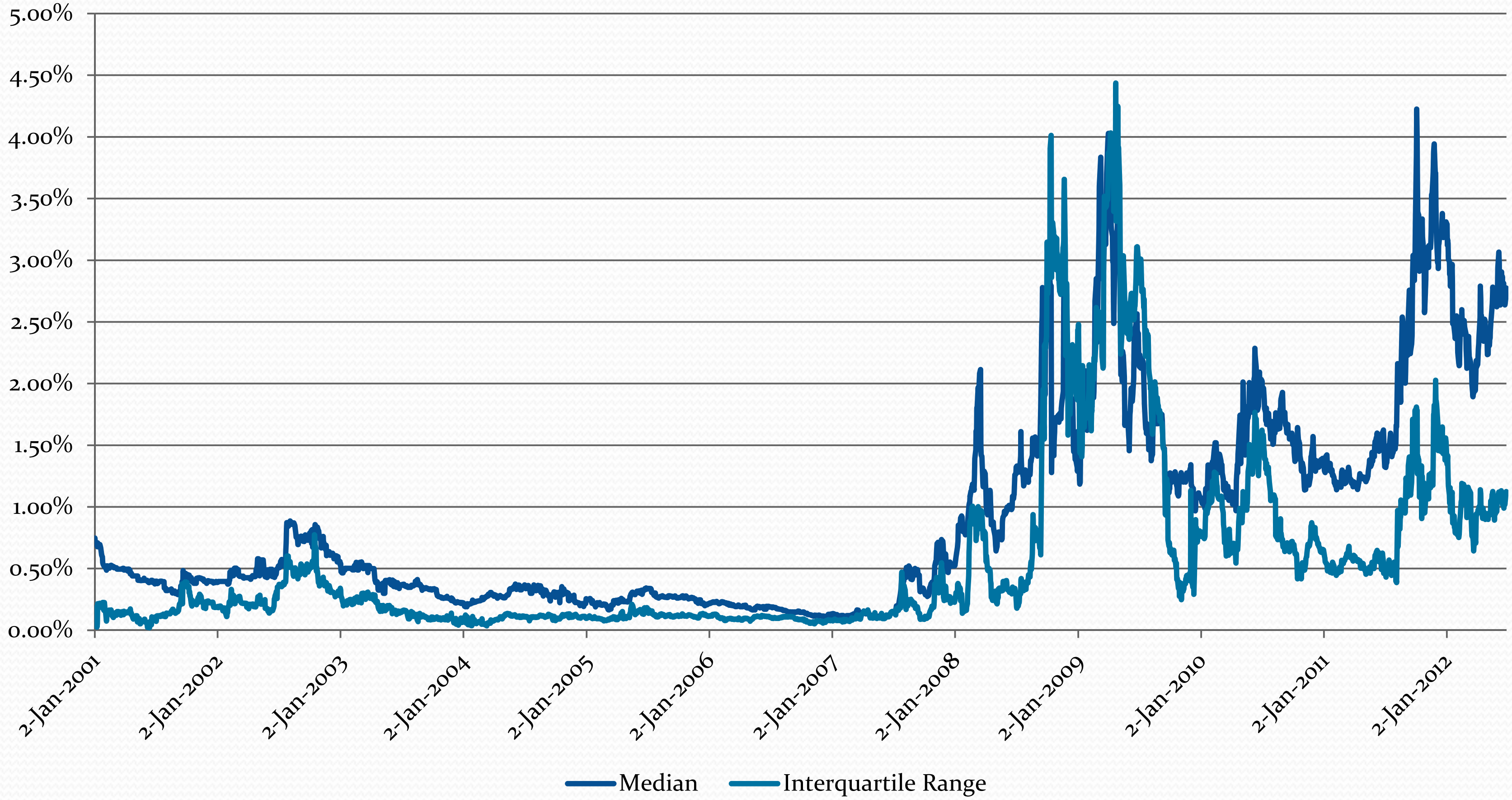
Have expectations of bailouts have declined?

- CDS Markets now price large-bank risk
- Natural experiment: Removal of TAG at the end of 2012
  - Money flowed into small banks (not large ones)

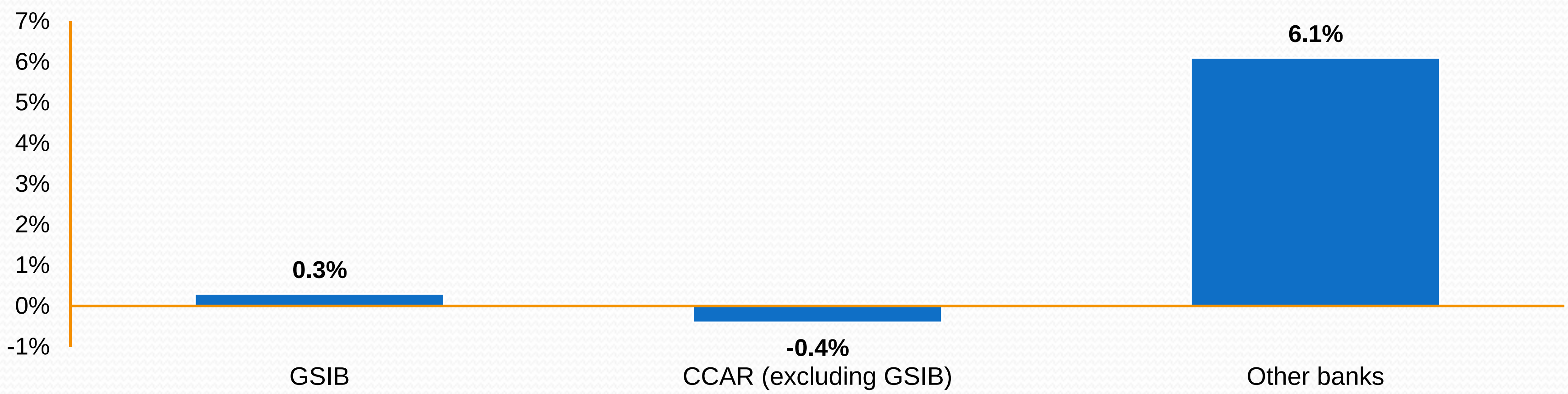
CDS Spreads for Top 10 Banks, 2004 to 2006



CDS Spread pre- v. post-crisis, Top 10 banks



Changes in Transactions Deposits with the Expiration of TAG (Kroszner, 2013)



Conclusion

- This paper:
  - Fitch embeds external support into its rating
  - Need to understand how different dimensions of rating affect yields
    - Own v. External Support
    - Support from Parent v. govt.
    - Time variation (pre v. post crisis)
    - Variation across banks types (large v. small)

- TBTF going forward:
  - Financial system is stronger
  - Expectations of bailouts seem diminished
    - New tools to deal with distress
    - Political pressure not to bailout (Tea Party)
    - Fiscal pressures (too big to save?)

THANK YOU!