Is There Still a Too-Big-To-Fail Subsidy?

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Identify TBTF support from spreads?

• Spread = p L q.
• Is the annual probability p of default lowered by TBTF expectations?
• The loss given default L for SIFI bonds could be raised by Single-Point-of-Entry resolution.
• The risk-premium multiple q is heightened by TBTF status.
• It may be difficult to identify SIFI support from bond spreads or CDS rates.
Basic Structure of a US GSIB Bank Holding Company
Single Point of Entry Failure Resolution

- Bridge New Co
- Old BHC

- U.K. Broker Dealer
- U.S. Broker Dealer
- U.S. Bank
Funding Mix for Large versus Small BHCs

Source: Kroszner (2013)
Do Investors Anticipate Support?

• Some degree of TBTF support remains a logical presumption by investors.
• The Fed has a mandate to reduce systemic failures caused by a loss of liquidity.
• Financial market infrastructure is not ready for the removal of all TBTF support.
• Single-point-of-entry failure resolution is not yet ready for safe deployment.
TBTF Liquidity Support

B2 → CB → B1 → B3

Broad Liquidity Program
US GSIFI BHC

Zone of Title II stay on swaps

U.K. Broker Dealer

Counterparty

U.S. Broker Dealer

U.S. Bank
Closing The Second Point of Entry

“We believe it is essential for ... ISDA documentation to provide for a short-term suspension of early termination rights on the basis of the commencement of an insolvency or resolution proceeding .... Such a provision would allow ... the exercise of all applicable types of resolution powers.”

Letter from FSB, FDIC, BaFin, and Swiss FMSA to ISDA Chairman. November, 2013.
Debtor

Counterparties

Swaps

Creditors

Loans
Would a stay that increases total value be adopted?

The total present value of all contracts to all parties, including the equity owners of B, is internalized by B.
Debtor

Creditors

Counterparties

Swaps

Other market participants subject to spillover costs such as fire-sale risk
Loss mutualization via CCP
When B Fails, the CCP is imbalanced
Tri-Party Repo

**BUYER**
(Cash investor e.g. MMF)

**Seller**
(Dealer)

**TRI-PARTY REPO FACILITY**

Cash
Securities

Securities
Cash
In a tri-party repo environment, the process involves:

1. Confirm trade
2. Select collateral
3. Transfer cash
4. Transfer securities

BUYER and SELLER are involved in this process.
Tri-party Repo Clearing
A systemic flaw
CPSS-IOSCO FMI Principle 9

“An FMI should conduct its money settlements in central-bank money where practical and available.

If central bank money is not used, an FMI should minimize and strictly control the credit and liquidity risk arising from the use of commercial bank money.”

“One way an FMI could minimize these risks is to limit its activities and operations to clearing and settlement and closely related processes.” (CHIPS)
Appendix Slides
Cross-industry comparison of funding costs for the largest versus smaller firms

Average differential in weighted average cost of debt for top 10 firms vs. others\textsuperscript{1,2}
2007Q1-2013Q2 (bp)

1. Top 10 institutions identified based on asset size (as of year end 2012), sample of firms based on companies in the Russell 3000 index; all firms are above the 20th percentile in debt / equity ratio (as of year end 2012).
2. Weighted average cost of debt differential = average cost for all others in the sector - average cost for top 10 firms; simple average of debt cost of capital across institutions in each time period

CCP Default Management Waterfall

- Failed member margin and default fund contribution.
- CCP capital.
- Surviving members default fund contributions.
- More CCP capital.
- Replenishment contributions to default fund.

Payment to surviving members to accept failed swaps
Liquidity to Financial Market Infrastructure
Central Bank Emergency Liquidity
Limited liquidity to an affiliated dealer

Bank holding company

Section 23A
Bear Stearns’ Liquidity Pool Over its Last Days ($ billions)

Data Source: Cox (2008)
Lehman’s tri-party repo book

Source: Copeland, Martin, Walker (2011) FRBNY
September 2008 Run on Money Market Funds

Institutional investment in prime money market mutual funds

Source: Duffie (2012)
Money Market Fund Capital Buffers

Market Value 99.60
Accounting NAV 100

100 + b
Buffer
Market Value

Squam Lake Group (2011)
Money Market Funds

“Stable” NAV

100
99.60

Market Value

Floating NAV

99.60

Market Value
Tri-party environment

Cash Investor Accounts

Transfers

Dealer Accounts

Cash

Securities

Cash

Securities
Are “With Support” Credit Ratings for BHCs Reflected in Market Pricing of Credit Default Swap (CDS) Spreads?

Source: Kroszner (2013)
Result: With simultaneous bargaining or this effect via covenants, the contracting maximizes total value, including the value of contingent default recoveries by creditors and swap counterparties, net of their incremental distress costs.
Tri-party Repo Infrastructure

• **Tri-party agent**: issues confirmations and instructions for cash and collateral transfers.

• **Securities custodian or depository**: maintains securities accounts.

• **Bank (or central bank)**: maintains cash deposit accounts; may also provide secured liquidity.

• **Settlement systems**: processes requests received for cash or securities transfers.