BANK OF ENGLAND

Discussion of Tsesmelidakis and Merton
'The Value of Implicit Guarantees'

Quantifying the 'Too Big to Fail' Subsidy

Workshop – Federal Reserve Bank of Minneapolis

Joseph Noss

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Outline

- **Why is the implicit guarantee a problem?**

- How does this paper measure it?
- Why is this a step forward?

- **Why is this question important to policy makers?**

- **Operationalising this methodology**

- **Further work**

Why is the implicit guarantee a problem?

FSB FINANCIAL STABILITY BOARD **Reducing the moral hazard posed by SIFIs (2010)**

- Too-big-to-fail institutions

- Leads to:

  i. Tax-payer injections **(relatively easy to measure)**

  ii. Cheaper funding causes distortions:

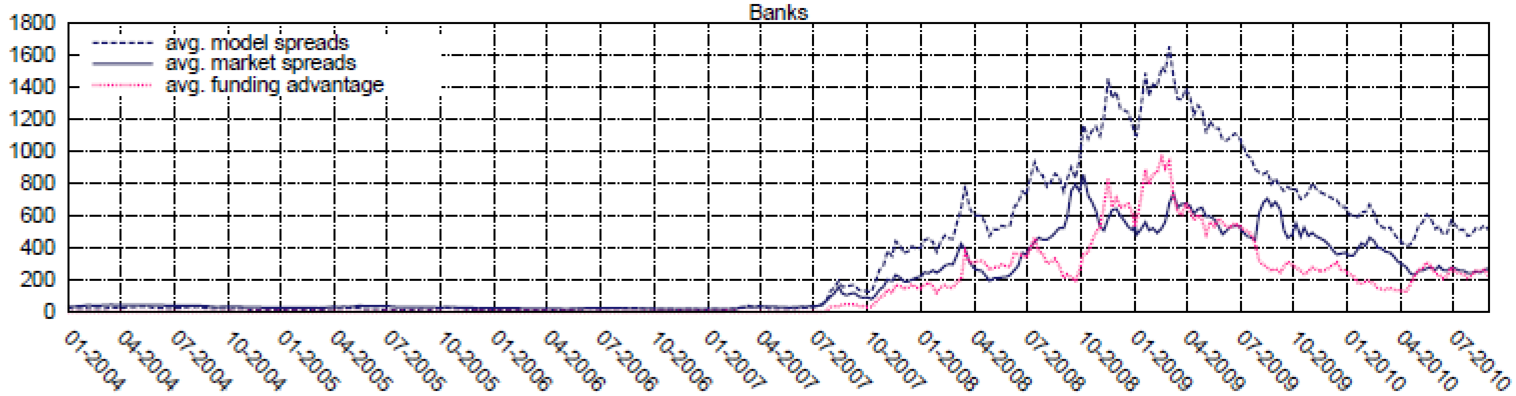
     a. Competitive advantage. Misallocation of resources. Pernicious spiral…

     b. Increased incentives to take risk

(harder to measure…)

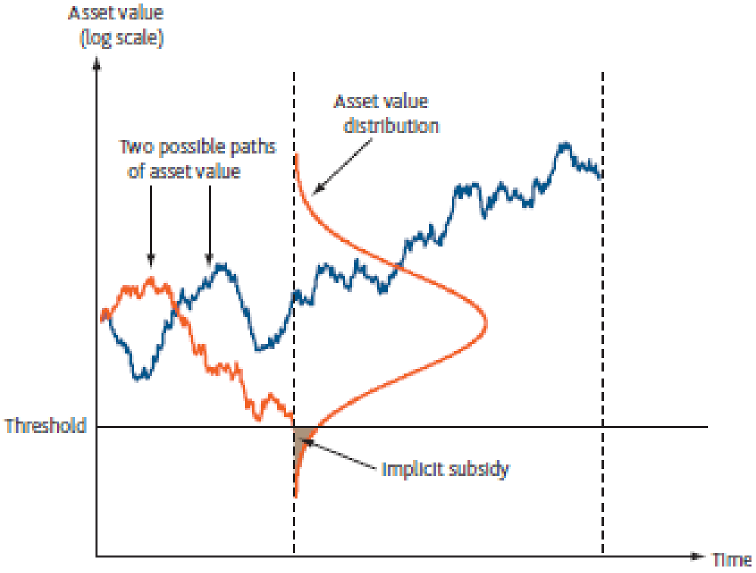
How does this paper measure the implicit guarantee?

- Compares bank CDS premia to that estimated by a structural model, based on the volatility of equities
- During the crisis: modelled spreads are higher than observed
- ‘Revalue’ bank debt to obtain ‘capitalised subsidy’



Why is this a step forward?

- Don't need to identify which institutions are TBTF
- Endogenises level of default threshold
- Adjusts for counterparty credit risk in CDS markets



Why might this matter to policy makers?

- How much remains to be done
- As a cross check on the numbers?
  - $365bn - $700bn to US banks during height of crisis
  - Comparable to Haldane (2010) ~ £100bn
- A rebuttal to industry response? Oxera (2011)

Why might this matter to policy makers? (2)

- Some recent policy initiatives:
  - Orderly resolution - root of the problem?
    - Make failure less costly ex-post; failure more credible ex-ante
    - US orderly resolution authority; PLAC requirements
  - Higher prudential standards
  - Removing funding advantage through regulation
    - A simple tax? (Acharya et al (2010))

Why might this matter to policy makers? (3)

- Regulators can also impose regulation that otherwise seems ‘too costly’?
- For that you <u>need</u> an estimate of the implicit guarantee

- Examples:
  - Capital surcharges for global systemically important banks (G-SIBs)
  - Leverage surcharges for US G-SIBs
  - UK ICB risk-based capital requirement for large banks

- Internal BoE work suggests the extra capital required results in an increased COC roughly in line with estimates of the guarantee

Operational issues

- Which period should we calibrate to?
- How does the premium for the implicit guarantee vary across countries?
  - Sovereign risk
  - Importance of local bank sector

Future work

- This targets <u>one</u> distortion: competitive/funding advantage

- But how does implicit guarantee affect banks' incentives to take risk?
  – More evidence of responsiveness of debt spreads to changes in risk-taking
  – Did banks lever up on short-term debt without internalising the cost? (Stein (2010))

- How should this distortion be targeted?
  – Structural reforms?
  – Restrictions on risk taking?
  – How should they be designed/calibrated?

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