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

18 November 2013
Discussion of Tsesmelidakis and Merton

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?

- 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…)*

Discussion of Tsesmelidakis and Merton

Reducing the moral hazard posed by SIFIs (2010)
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’.

Discussion of Tsesmelidakis and Merton

Joseph Noss, Bank of England
Discussion of Tsesmelidakis and Merton

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
Discussion of Tsesmelidakis and Merton

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))
Discussion of Tsesmelidakis and Merton

Why might this matter to policy makers? (3)

• Regulators can also impose regulation that otherwise seems ‘too costly’?
• For that you **need** 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
Discussion of Tsesmelidakis and Merton

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 one 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?