

Chapter 13 – Policy Response to Systemic Intermediaries

Previously, we defined *systemic risk* as a threat to the financial system as a whole rather than to any individual institution (see the Chapter 5 module: Systemic Risk). Systemic risk arises when a set of vulnerabilities in markets and financial institutions endangers the general function of intermediation (matching savers with users of funds). Connections among financial institutions and markets, even when unseen, may transmit and amplify a shock across the system.

Systemically important institutions (SI) are financial intermediaries that are so closely connected to other firms and markets that their failure poses a systemic threat. Typically, such financial institutions are large and complex. They are sometimes called *too big to fail*. More accurately, they may be *too big or too interconnected to resolve* – to find a buyer or to close down and liquidate in a bankruptcy procedure that may involve losses by creditors – without posing a threat to the system.¹ If they cannot be closed safely and quickly in a crisis, the burden of sustaining them – and the financial system – will fall on the government.

The threats from an SI arise both directly or indirectly. Direct ownership of an SI's liabilities can lead to the failure of its counterparties, which may be large, numerous, or both. Indirect threats are more varied and subtle, but no less menacing. For example, the liabilities of an SI's counterparties can spread the disease to other intermediaries that are not directly linked to an SI. Infection is a useful analogy, because it highlights the possibility of *contagion*. No one can be confident that they are free of illness unless they are certain that those they contact – their counterparties – also are free of illness.

In the financial world, infection can spread through even more indirect paths than in the case of simple disease. If an SI is compelled to suddenly sell assets – what is known as a *fire sale* – the resulting plunge in asset prices can undermine the balance sheets of other intermediaries regardless of whether they trade directly with the SI, trade with the SI's counterparties, or whoever. These institutions will be infected by their *common exposure* to risks in asset markets.² Similarly, if an SI fails, heightened uncertainty about the solvency of other intermediaries can make borrowing for nearly everyone more difficult. In this example, the evaporation of funding liquidity leads to contagion.

¹ In Chapter 14, you will see that the U.S. Federal Deposit Insurance Corporation (FDIC) resolves an insolvency (when a bank's liabilities exceed its assets) by closing the institution or by finding a buyer. In the United Kingdom, the new "special resolution regime" also empowers the UK Treasury to place a bank into temporary public ownership.

(http://www.bankofengland.co.uk/financialstability/role/risk_reduction/srr/).

² Systemic risks need not arise from SIs. Imagine, for example, a large number of small, unconnected banks, none of which are SIs. That is, an individual bank's failure would not threaten the system. However, if these banks share a *common exposure* to a particular risk, that risk may be systemic.

Policymakers are naturally reluctant to highlight that an institution is too big or too interconnected to resolve safely. To declare openly that an intermediary is an SI could imply that government will protect its creditors in a crisis. The expectation of such protection would undermine core principle 2: Creditors would not require compensation for the risks posed by an SI, because they would be protected from those risks by government action. Worse, lenders would have incentive to avoid counterparties that are not SIs, because they lack implicit government backing. This is the essence of moral hazard and the effect would be to concentrate financial activity in SIs, while undermining other intermediaries. Ultimately, naming an intermediary an SI gives it a license to take large risks at the public's expense: If the SI wins, it keeps the profit; if it loses, the government provides a *bailout*. These poor incentives can boost, rather than tame, systemic risk.

Nevertheless, when the entire financial system is on the verge of collapse, government officials face painful choices. They naturally seek financial stability, in line with core principle 5, but their time horizons shrink. While they know that their actions – including subsidizing owners of a frail intermediary or bailing out its creditors – can cause problems later on, they feel compelled to act within their legal discretion when they perceive a serious threat. Faced with extreme time pressure and uncertainty, they become like emergency-room doctors trying to keep a critically ill patient alive.

In the recent financial crisis, subsidies of SI owners and bailouts of their creditors occurred in many countries. For example, when the crisis peaked in the autumn of 2008, governments in Europe and the United States were compelled to guarantee the liabilities of their largest banks. Without these guarantees, the evaporation of funding liquidity probably would have led to a rapid cascade of failures. Governments also provided public capital to some intermediaries that might otherwise have faced a run by their creditors. These “winners” were implicitly designated as SIs, while other, smaller financial institutions were allowed to fail.³

Bear Stearns vs. Lehman Brothers. The crisis of 2007-09 highlights the risky ad hoc nature of crisis policymaking and the potential for inconsistency that can add to uncertainty and to bad incentives. The stark contrast between the policy responses to the Bear Stearns (March 2008) and Lehman Brothers (September 2008) reveals some of the challenges and pitfalls policymakers face.

When Bear Stearns, the fifth largest U.S. investment bank, faced a run by its creditors in March 2008, the Treasury and the Federal Reserve judged that its failure threatened the entire financial system. Bear was closely connected with the largest global intermediaries through its over-the-counter derivatives contracts (see the Chapter 9 module: Centralized Counterparties and Systemic Risk). A key fear was that Bear Stearns' loss of funding liquidity – over a period of several days other

³ The Federal Deposit Insurance Corporation reports that, as of July, 53 depositories already have failed in 2009, the highest in any full year since 1992.

institutions became unwilling to engage in repurchase agreements with them – would quickly spread to other, similar, intermediaries. Against this background, the Federal Reserve used its emergency powers to lend directly to a nonbank for the first time since the 1930s.⁴ U.S. officials then arranged an orderly sale of Bear that protected its creditors, while limiting the downside risks of its acquirer.⁵ As a result of this aggressive policy response, market conditions improved for several months.

By mid-September, however, funding liquidity at the fourth-largest U.S. investment bank – Lehman Brothers – was evaporating. Indicators of size and interconnectedness suggest that Lehman was at least as systemically important as Bear Stearns. Yet, policymakers declined either to make direct loans to Lehman or to arrange an orderly liquidation that protected its creditors. Officials later argued that they did not have the authority to act. They also claimed that, despite their prior intervention in the Bear Stearns episode, creditors should have prepared for the possibility that government support would not be forthcoming, and that Lehman would fail.

In fact, Lehman's collapse triggered the broadest and most intense financial crisis since the Great Depression. The failure brought a swift end to the investment banking era that had prevailed since the 1930s, as the three largest remaining brokers were sold or transformed themselves into commercial banks in order to have direct access to Federal Reserve discount window lending. A variety of unprecedented government actions were needed to prevent an outright breakdown of the financial system as funding liquidity evaporated. For example, the U.S. government was compelled to guarantee the liabilities of money market mutual funds to stem a run by savers. But even with these actions, widespread financial disruptions and a collapse of confidence led to the sharpest six-month economic decline since World War II. Looking back, few observers doubt that Lehman Brothers was a systemically important institution.

The Future of SIs? Going forward, how will governments create incentives for financial institutions that are now seen as SIs to manage their businesses in a way that lowers systemic risk? How will authorities discourage creditors of these SIs from believing that government will protect them from losses in a future crisis?

At this stage, the answers are far from clear. Officials are still addressing the financial system's immediate frailties. In the United States, for example, new bank

⁴ The details of the Fed's emergency powers are delineated in Section 13 (3) of the Federal Reserve Act, and can be found at <http://www.federalreserve.gov/aboutthefed/section13.htm>. An interpretation of the Act by Fed staffers is provided by David H. Small and James A. Clouse, "The Scope of Monetary Policy Actions Authorized by the Federal Reserve Act," FEDS Working Paper No. 2004-40 (<http://www.federalreserve.gov/pubs/feds/2004/200440/200440pap.pdf>).

⁵ The Federal Reserve Bank of New York created the so-called Maiden Lane facility to aid the crisis acquisition of Bear Stearns by JPMorgan Chase. The New York Fed's \$28.8-billion 10-year loan to Maiden Lane was used to buy selected Bear Stearns assets, reducing JPMorgan Chase's market risk from acquiring Bear Stearns. As of March 14, 2008, the loan collateral was estimated at \$30 billion.

liabilities will be guaranteed by the FDIC for up to three years until autumn 2010. During this interval, creditors have little incentive to monitor the banks' lending practices or to charge them a premium for risky behavior.

Ultimately, addressing systemic risk probably requires a broad framework of supervision that includes: (1) rules and mechanisms that promote better risk management and reveal common exposures, and; (2) reforms that reduce the vulnerability of the financial system to the liquidation of any intermediary. At least two such mechanisms are already being pursued. First, the U.S. Treasury aims to shift trading from over-the-counter markets to exchanges that can and do monitor their members' risk-taking (see the Chapter 9 module: Centralized Counterparties and Systemic Risk). Second, the Treasury has proposed that large intermediaries themselves detail the means by which they could be resolved in a crisis without systemic damage. Such a "self-planned funeral" could make a government commitment to avoid crisis bailouts more credible.