

# SOME REMARKS ON SYSTEMIC RISK AND TOO BIG TO FAIL PROBLEMS

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# INTRODUCTION

Main legacy from the crisis: generalized Too Big To Fail problem.

In the future, any large financial institution that encounters financial problems can expect to be bailed out by public authorities on the grounds that it is TBTF (or TITF).

In terms of moral hazard and (lack of) market discipline:  
Probably the worse situation in the whole history of banking.

## INTRODUCTION (2)

- ❑ Response of Public Authorities: create new agencies (Systemic Risk Authorities or SRA) and reinforce regulations (liquidity ratios, capital add-ons, systemic taxes).

What is not clear:

- ❑ The exact mandate to give to these SRAs?
- ❑ The precise content of these new regulations?

Hence the pressure on academic community to develop  
Measures of Systemic Importance (MSIs)

## INTRODUCTION (3)

What a Measure of Systemic Importance should provide:

- ❑ Ex ante: basis for calibrating new regulations (systemic tax, capital add-on) and deciding special scrutiny by supervisors.

As such it should be simple, transparent, and clearly related to banks' portfolio decisions

- ❑ Ex Post: basis for possible public intervention (bail-out, nationalization,...)

I am not sure that existing Measures of Systemic Importance satisfy these requirements.

## INTRODUCTION (4)

Existing Measures of Systemic Importance (CoVar, PAO, SII, VI, BIS ):

- ❑ Are based on losses distributions, not on a cost-benefit analysis of bail-out Vs resolution.
- ❑ Are elegant for statisticians (and even for game-theorists) but they are not related in simple and transparent way to banks' strategic decisions.
- ❑ They are not related to any clear objective of SRAs: what's the purpose of the whole exercise?

## WHAT ABOUT A DIFFERENT APPROACH?

I will argue here in favor of a totally different approach to the TBTF problem, which would have some advantages:

- providing a clear mandate to Systemic Risk Authorities
- allowing to use already existing risk measures and regulations
- by-passing the hurdle of international coordination of regulators in different jurisdictions
- largely solving the Too Interconnected To Fail problem
- TBTF is largely a political issue (ex-ante and ex-post)

# A PROBLEM OF MARKET STRUCTURE

Major mistake of prudential authorities:  
to have let banks develop large nexus of opaque OTC  
transactions on money and derivatives markets.

These markets do not work well, especially in a crisis period:

- opaque,
- plagued with externalities,
- counterparty risk makes price discovery impossible,
- likelihood of public intervention in case of problems makes market discipline ineffective.

# AN INDUSTRIAL ORGANIZATION APPROACH

Reason why Bear Sterns or AIG were bailed out:  
fear that their resolution could damage vital parts of financial  
infrastructure: interbank, derivative markets or LVPSs.

But main objective of systemic risk regulation should not  
be to protect private firms but only these vital infrastructures.

Private sector has found an efficient way to manage risk on derivative  
exchanges: Central Counterparty Clearing Platforms (CCPs).

My proposal is to adopt this model for interbank, repo and  
derivatives markets and to instruct the systemic risk authority  
to maintain the integrity of these markets. This would largely eliminate  
contagion.



# CENTRAL COUNTERPARTY CLEARING: PRINCIPLES AND RISK MANAGEMENT PROCEDURES

EC Study (2009): “CCP clearing is the most effective way of reducing credit risk and is broadly feasible in all market segments”.

Guiding principle of CCP clearing: **novation**.

Allows:

- netting of multilateral exposures,
- centralization of collateral,
- diversification of default risk.

Risk Management procedures: initial margins, periodic margin calls, capital and collateral requirements, default fund.

# SUMMARY AND CONCLUSIONS (1)

- TITF is a major concern for the future of banking.
- It is largely an avoidable consequence of inappropriate design of money and derivative markets.
- OTC derivative markets and liquidity markets do not function well in times of crisis:
  - externalities,
  - contagion,
  - opacity,
  - bundling of liquidity and counterparty risks.

## SUMMARY AND CONCLUSIONS (2)

- Contagion would disappear if money and derivative markets were organized in a centralized way under the control of the systemic risk authority (SRA)
- TBTF would largely disappear if the SRA had the power to decide which banks have access to the clubs of Clearing Members of these markets.
- Membership would be conditional to the adoption of strict Risk Management procedures analogous to those used by private CCPs.

## SUMMARY AND CONCLUSIONS (3)

- The Industrial Organization approach to systemic risk would give a clear mandate to the systemic risk authority.
- Instead of controlling systemic risk at the level of large banks it would do like the private sector does, i.e. controlling it at the level of each platform.
- Would reduce the need for international coordination
- New regulations would be the counterpart of existing Risk Management Practices of private CCPs.
- The SRAs would control the systemic fund in charge of absorbing possible losses due to tail events.