SIFI Rules Are Recasting Global Banking

The Tension between 'Too Big To Fail' and Moral Hazard Continues

Knowledge@Wharton: Once you determine that these 28 [the G20 later identified 29] banks are the most important in the world, you set up all of these safeguards that hopefully prevent another meltdown. But at the same time, you've designated them as the most important banks in the world. Therefore, if one of these banks does get in trouble, is there a presumption in the market, that once again, everyone will pull out all of the stops to prop it up and prevent a single bank from causing a another systemic blowout of some kind?

Goldstein: Yes. I think this is one of the problems with designating this SIFI status ahead of time. Essentially regulators took a stand and said, "You know, this bank is really important and we can't let this bank fail." So yes, they will regulate it more and require more capital. But on the other hand, there are other forms by which banks can take risks that are not easily detectable by regulators. And now that this bank knows that it is a SIFI, it is a systemically important financial institution, and it is essentially too big to fail, then maybe the bank will have a higher incentive to take risks. Now all of the counterparties doing business with the bank will know that, and as a result they will govern it less and require the lower cost of capital.

Knowledge@Wharton: What are a couple of those areas that you talked about that they might want to move into that would allow them to do it?

Goldstein: The problem with regulation is you are designing a set of rules that prevent the bank from doing certain things. But then banks can do things within these rules. So for example, for a long time certain institutions had to hold a certain fraction of AAA securities. But we saw from the recent crisis that there are certain types of AAA securities that are not really that safe.

Knowledge@Wharton: Not all AAAs are created equal.

Goldstein: Right, exactly. So now once you've designed these rules that you have to hold AAA securities, banks can find creative ways to take risks within those AAA securities.... Another example is the risk weighted assets that we just talked about. So you restrict the SIFI banks — you ask them to hold a certain amount of capital against the risk-weighted asset. However, they then have some judgment into what is the level of risk of any particular asset. And they can design it in a way that they will take more risks.

This is exactly the problem. On the one hand, you designated this SIFI status and as a result banks are restricted to a certain amount of actions. On the other hand, within this range they now have the incentive to take more risks, perhaps.

Vangel: I would agree with that. There are a number of things that policy makers are trying to do around the so called SIFI question. Capital liquidity and other requirements are really intended to increase the resiliency of those institutions to stress. The other important point is to try and internalize the costs associated with that enhanced status within the institutions themselves so that, in theory at least, if one of them were to fail, it wouldn't be taxpayers who would be supporting it. Whether it's contingent convertible securities that would trigger and convert to equity, or a so-called bail in, where if the firm were to fail, in theory the regulators could go up the debt stack and effectively convert more debt to bail out the company – it would not be with taxpayer funds but with investor funds.

Knowledge@Wharton: So, bondholders would take a haircut.

Vangel: Right. I think that gets a little bit at some of the moral hazard in terms of those investors who would be looking at some potential downside. In addition, they're expecting these banks to have what are defined as credible resolution plans that would provide the regulators with information that could be used to resolve the firm in the event of its failure in a way that mitigated the externalities. That could be operating a bridge institution to maintain critically important functions, or breaking off and selling other parts, but not letting it be disruptive. That resolution piece is a challenge. These are across-border institutions, they're very complex, they're very interconnected.

So if you think of this in terms of likelihood and impact, the policy makers are trying to address both: Reduce the likelihood of a significant problem, and if there is a problem, mitigate the impact, particularly on the public — whether it's on the economy or on the taxpayer. The difficulties with the latter make policy makers focus very heavily on reducing the likelihood of failure to as close to zero as you can get.

So you end up with these institutions — pending some clear end game for resolving one of those [meltdowns] being very heavily capitalized and very closely supervised in a way that could be viewed as reducing the probability of failure effectively to zero.

Knowledge@Wharton: In the best of all worlds, that is a very tough balancing act.

Schlich: It is. And I agree with what's been said. I think very simply — and Don put it very well — they are trying to minimize the possibility of one of these banks going down, and then if you get to that situation, trying to get the softest landing possible. So I don't think the regulators are viewing this as these banks are the ones that are going to somehow get bailed out by taxpayers. Rather, it is how do we minimize the possibility and then how do we make sure it's as soft a landing as possible? And it's incredibly difficult to do.

Vangel: Indeed, the policy objective is to avoid at all costs any need for taxpayer bailout. Getting there operationally is much more of a challenge than stating it as a matter of policy.