The Globalization of the US Financial Safety Net

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FOUR LESSONS I HAVE LEARNED

I. It is a mistake to think of safety nets as either government lending or insurance programs. Nets provide loss-absorbing equity funding to zombie firms at times when private parties will not.

II. This means that company law could conceive of US taxpayers as coerced equity investors in difficult-to-fail-and-unwind (DFU) firms and protect taxpayers against the willful and aggressive pursuit of tail risk at these firms by defining theft by safety net as a criminal activity.
III. Dodd-Frank Act, Basel III, and Central Clearing for swaps introduce new regulatory constraints. They will force changes in methods of regulatory arbitrage but reinforce managerial incentives to find ways to exploit taxpayers. Changing these incentives requires that the supervisory process be re-engineered to surface material information and actions that supervisors' obsession with accounting capital has allowed banks to conceal with impunity.

IV. DFA and Federal Reserve commitment to stopping financial markets from imploding generates a de facto commitment to “lending” generously to key firms in key countries in crises. But supervisory oversight remains largely national. So unless US rulemakers classify foreign affiliates of US firms as “US persons,” offshore operations can substitute compliance in foreign venues with advantageous foreign rules for unwanted US oversight.
I. IMAGE OF A CIRCUS SAFETY NET PROVIDES A POWERFUL METAPHOR FOR THE COSTS AND BENEFITS OF PROVIDING GOVERNMENT BACKING FOR THE LIABILITIES OF MAJOR FINANCIAL FIRMS

Avowed Purpose: To encourage socially beneficial (vs. destructive) risk-taking by skilled financial “acrobats” by limiting trauma generated by runs and “splats.”

Components of Physical Nets: How much weight net can bear without breaking depends on tensile strength and extent of the mesh and how well the net is supported and anchored at its edges.
CORRESPONDENCES TO THE FINANCIAL NET

Mesh and Buttresses: *Loss-absorbing* capacity comes from explicit and implicit short-run *equity “funding”* that a particular government’s fiscal authority and central bank can deliver to falling acrobats in a crisis and pass through to taxpayer “buttresses” in the long run.

Supporting Activity undertaken in this taxpayer-owned enterprise:

1. **Crisis Prevention**: Administrative costs of monitoring risk exposures of financial firms, penalizing unsafe and unsound acrobatics in the financial sector and repairing weak spots.

2. **Traditional Rescue Activity**: Established statutory arrangements for protecting counterparties and channeling emergency funding to insolvent firms: deposit insurance, discount-window “loans,” accounting relief (i.e., capital forbearance).

3. **Development of Innovative Rescue Options**: “We will do whatever it takes!” Bernanke and Draghi. But without explicitly balancing opportunity costs to households and nonfinancial business!
SAFETY NETS GO BEYOND INSURANCE: THEY ARE TAX-TRANSFER SCHEMES

• Costs and benefits of rescue programs impose future tax liabilities on ordinary folks to help higher-income financial-sector creditors and stakeholders. Funding of Central Banks and Distribution Effects are mischaracterized and not made observable.

• To avoid acknowledging anti-egalitarian effects, central bankers tell us that, as compared to doing nothing, highly extravagant transfers saved everyone from disaster.

• In and out of crisis, the availability of implicit and explicit government credit support subsidizes tail risk. It is time for the supervisory process to be re-engineered to identify the subsidies. Treating accounting capital as an inverse proxy for risk exposure is doomed to fail.
The Game of Safety- Net Management Is a Rigged Three-Party Contest

• Principal Players are Regulated Institutions, Regulators(including politicians), and Taxpayers.

• Ethically challenged institutions build political clout and feel entitled to hide salient information from other players in both time-tested and innovative ways. Have more skill, more information, and fewer scruples than other players.

• Regulators **join in a partial coalition with the Regulated** not only to help them with **concealment**, but also to cooperate in overstating the effectiveness and fairness of regulators’ own play (i.e., express too much confidence in their damage control strategies and enforcement).

• Taxpayers **own the agencies that operate the net**, but are deceived and are made to play from a poorly informed, **disequilibrium** position. They are equity investors of last resort, but are denied the protective rights of disclosure and redress accorded to explicit shareholders.
HOW TO ACCOUNT FOR AND SERVICE TAXPayers’ Equity Position?

• When one or more alleged “SIFI” experiences a level of financial distress that exceeds shareholder net worth, taxpayers are coerced by safety-net officials to step in as investors of last resort. Taxpayers’ position can be conceived as a short position in an implicit contract that allows creditors and SIFI shareholders to put the deep negative tail of profit outcomes to taxpayers as unrecorded government debt.

• The tax-transfer system the safety net represents a contra-liability for important firms. This contra-liability transfers responsibility for debts in excess of enterprise net worth to future taxpayers. Government commitments to protect unsophisticated depositors and to keep systemically important markets and institutions from breaking down in difficult circumstances enable taxpayer funds to be obligated without registering as part of the current fiscal deficit.

• Why is there no accountability at central banks for distributional effects?
TAXPAYERS’ EQUITY POSITION IS INFERIOR TO THAT OF SHAREHOLDERS IN 5 WAYS

• Taxpayers cannot trade their Positions Away.
• Downside liability is not contractually limited, but upside is.
• Positions carry no Procedural or Disclosure Safeguards.
• Taxpayer positions are not recognized legally as an “equitable interest.” This means protected firms may exploit them without fear of lawsuits.
• Managers can and do abuse taxpayers by Blocking or Delaying Recovery and Resolution.
THEFT BY SAFETY NET

To Rebalance Incentives in Government and Industry, Legislatures Could Re-characterize Deliberate Exploitation of the Safety Net Not as inevitable “moral hazard,” but as a **Prosecutable Form of Theft**. TBTF or SIFI Firm’s Funding Structure Contains A **Coercive** Taxpayer Put from Expected Crisis-Management Policy that Makes Taxpayers Into *De Facto* Minority Equity Investors.
ILLUSTRATIVE BALANCE SHEET WHEN RUINOUS LOSSES OCCUR AT A FIRM SUCH AS AIG THAT IS TOO DIFFICULT TO FAIL AND UNWIND (TDFU), ASSUMING NO CREDITOR HAIRCUTS

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>100</td>
<td>90</td>
</tr>
<tr>
<td>Surfacing Losses</td>
<td>Stockholder NW</td>
</tr>
<tr>
<td>(50)</td>
<td>2</td>
</tr>
<tr>
<td>Taxpayer Put</td>
<td>≈ 42</td>
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N.B. Stock price Remains Positive: Resembles a Lottery Ticket given to stockholders and managers.
CAPITAL REQUIREMENTS ARE NOT WORKING. AN ALTERNATIVE APPROACH WOULD BE TO MEASURE AND CALIBRATE SAFETY-NET SUBSIDIES DIRECTLY

• To align incentives, corporate law for protected institutions should recognize that the safety net makes taxpayers into unfairly compensated equity investors.
• Taxpayers deserve to be protected from expropriation.
• One way to do this would be to establish **trusteeships at DFU firms** that would require taxpayer equity stakes to be disclosed and explicitly serviced by managers of DFU firms.
Mean Annualized Value of Safety Net Benefits Per Dollar of Liabilities, 1974-2010

This figure reports quarterly average values of Hovakimian-Kane-Laeven estimates of fair percentage return to taxpayers for safety-net risk, using Merton model and assuming dividend continue to be paid. Averages are computed across a sample of U.S. bank holding companies over the 1974-2010 period and reported per-dollar of debt quarter by quarter in basis points. Financial statement data are from the Compustat database for U.S. banks and daily stock returns are from CRSP.

ECB AND IMF CANNOT ORDER PARLIAMENTS TO PUT EUROPEAN BANK LOSSES TO EUROPEAN TAXPAYERS. TITLE VIII OF DFA MAKES US TAXPAYERS DE FACTO BUTTRESSES FOR THE TIME-BUYING STRATEGIES BEING FOLLOWED IN EUROZONE.
ABSENT THIS CONJECTURAL DRAW ON US TAXPAYERS, DERIVATIVES AND SUPERVISORY REFORMS SEEKING TO AMELIORATE EUROZONE PROBLEMS AND CRISIS WOULD LACK CREDIBILITY

1. BASEL III capital requirements and stress tests are full of loopholes. Realizing this, Fed plans to toughen its oversight of foreign institutions operating in US.

2. 2010 G-20 Derivatives Strategy: Establish Centralized Clearing for Standardized OTC Derivatives, with reporting on all swaps trades to data repositories to increase post-trade transparency for regulators.

3. Dodd-Frank Act: Gave CFTC and SEC homework assignment to make this happen in US.

4. Delay in Finalizing European Actions: Empty calls for cooperation and harmonization.
SURVEY EVIDENCE SHOWS LITTLE CONFIDENCE IN THE EFFECTIVENESS OF PROPOSED FINANCIAL REFORMS

Given Moody’s recent downgrades and the passage of Dodd-Frank, Does Too Big to Fail still exist?

- YES - when push comes to shove, the government will prop up big banks (70%)
- NO - Regulators now have the tools to unwind a large bank (12%)
- I DON’T KNOW - Given all the market uncertainty, we will probably find out soon (18%)

Source: American Banker On-Line Subscriber Survey
Survey Questionnaire Was Posted online from 9/25/11 through 10/2/11
My View of DFA, Basel, and Swaps

Rule-Making

Regulators

Megabanks

HOw 'BOUT THIS? I PRETEND TO SPANK YOU, AND YOU PRETEND TO BE SCARED...
TAXPAYER REMAINS THE SUCKER IN THE RISK-TRANSFER GAME: DODD-FRANK ACT AND BASEL III DO NOT GIVE TAXPAYERS AN EVEN BREAK

• My Theme: Government “Loans” to zombie firms are equity investments of taxpayer funds and deserve equity-like returns and protections against abuse.

• A LAYERED BREAKDOWN OF PRIVATE MARKET DISCIPLINE AND GOVERNMENT SUPERVISION allows Risk Managers at protected firms skillfully to extract safety-net subsidies: regulation-induced innovation can always misrepresent and mask the extent a SIFI’s tail risk.

• SIFI counterparties didn’t mind and few Safety-Net officials see their job as adapting their surveillance systems dialectically to counter these moves. INCENTIVES to do this are weak.

• Incentive conflicts: 1) fueled the pre-crisis bubbles, 2) aggravated the crisis by preventing the haircutting of the creditors of systemically important zombie institutions, and 3) made it difficult for authorities to FORCE pre-packaged bankruptcies on politically powerful & complex Financial Holding Companies.

• New Resolution Authority and “Living Wills” established by DFA show promise, but don’t Compensate Taxpayers or Mitigate Underlying Policy Dilemmas Inherent in Asking Creditors in crisis circumstances to absorb losses incurred by zombie firms.
WHAT ABOUT CENTRAL CLEARING FOR SWAPS TRANSACTIONS?

• DFA, European Securities and Markets Authority (ESMA), and Asian regulators see central clearing of OTC derivatives and “data repositories” as means to control and monitor systemic risk (i.e., safety-net risk exposure in their jurisdictions).

• Profit opportunities envisioned for so-called “swaps execution facilities” and affiliated derivatives clearing organizations are being jumped by futures exchanges. Futures have some contractual advantages. When fails occur, they tend to require shorter time horizons to be liquidated and may be cross-margined with other futures contracts. This tends to result in less margin being required by DCOs between economically similar futures contracts and swap contracts.

• Creative new instruments (swaps written as futures contracts) are cementing exchanges that can write them in high volume into a new class of TDFU institutions.
• OCC has just given US bank derivatives dealers a 2-year reprieve from DFA requirement that FDIC-insured institutions relocate this business in holding-company affiliates.

• CFTC and SEC are market-structure and market-conduct regulators. Compliance staffs are small and have little expertise in managing the safety-net implications of their rule making. The interests of US taxpayers in global derivatives markets needs to be better represented.

• Current CFTC commissioners are split on cross-border issues and 3 of 5 commissioners are scheduled to be replaced during the next few months. SEC supports a dangerous approach to substituted compliance for foreign affiliates.
MULTINATIONAL FIRMS CAN AND DO HAMSTRING NATIONAL REGULATORS

• The largest US mega-institutions operate hundreds of affiliates outside the US. They book contracts in favorable regulatory and supervisory environments. Tolerance shown for tax and regulatory havens is hard to justify.

• Gary Gentsler has stressed London market makers’ sorry record. E.g., swaps deals originated in London by its London-based subsidiary brought AIG down in 2008, but US taxpayers got the bill.

• SEC and foreign arguments for a narrow definition of “US persons” and further delay are weak. US law already requires entities that exceed the swap-dealer threshold with US persons to register as swap dealers. The question concerns the definition of a US person. US persons ought to include a subsidiary or affiliate of a US person that may have guarantees from the US person. AIG could happen again if the US person definition is as narrowly defined as in the SEC’s proposal or the CFTC’s no action letter.

• Two-year postponement by OCC for implementation of DFA’s requirement to push OTC swaps out of major US bank dealers further limits potential disruption.
CONCLUSION: SAFETY-NET REFORM IN THE US AND G-20 IS ON THE WRONG TRACK

1. **Why? Economically Misfocused**
   a) It merely expands and relocates regulatory **authority** and **discretion** over capital positions that **incentive-conflicted** politicians and agency leaders mishandled egregiously during the housing and securitization bubble and its aftermath.
   b) Capital requirements are bound to fail and for predictable reasons.
   c) Central clearing concentrates risk at the clearinghouse whose managers can make mistakes and have incentives to game the safety net.
   d) The supervisory process does not directly confront the **predictable** way that crisis management incentives and **regulation-induced innovation** expand safety nets in booms and redistribute income across time and income classes.

2. **Why? Politically Dishonest**
   a) Forecasts of “Never Again” are gross exaggerations: sets up regulators rather than industry for blame.
   b) Ignores the need to clean up the dysfunctional cultures of Lobbying and financial industry’s sense of being entitled to subsidies.
III. REFRAMING THE POLICY PROBLEM

• How Can Society Incentivize and Monitor Private and Public Managers and Beneficiaries of National Safety Nets So that INCENTIVE DILEMMAS Do NOT Encourage Subsidies to flow to Firms that Actively Expand Socially Destructive Risk-Taking and Political Clout in Clever Ways?

Government officials face Many Incentive Conflicts

– Horizons (Obsession with near-term effects)
– Multiple Principals for Top Officials
– Asymmetric and Uncertain Information
– Truth vs. Opportunities for Truthiness: e.g., in Claims about Social Value of Financial Innovations and profitability of bailout programs
– Ethics: Lack of Accountability for Suppressing Information and for Tradeoffs made between Fairness to Taxpayers and Other Objectives
The financial machinery of Western Government is broken. The connection that has been lost is TRUST. Central Clearing, Higher Capital, and stress tests are not silver bullets for restoring trust. Supervisory Process Needs to Incentivize and Monitor Private and Public Managers of National Safety Nets So that INCENTIVE DILEMMAS DO NOT Subsidize Firms that actively Expand Their Risk-Taking and Political Clout in Socially Destructive Ways.

No Absolute Cure exists, only some Remedies: (1) Start screening existing derivatives and financial innovations for dangerous safety-net consequences, and (2) adopt a cocktail of incentive and informational adjustments. Government Officials and managers of protected institutions must be made at least as accountable to taxpayers for honestly measuring, disclosing, and servicing the equitable interest that the net imposes on taxpayers as corporate managers are accountable for disclosing value of operations to stockholders.

- Repair Ethics of DFU firms and regulatory agencies: Replace arrogance and sense of entitlement in industry and government with a delineation of the duties of disclosure, loyalty, care, and competence owed to taxpayers as equity investors in TBTF firms.
The effectiveness of any regulatory plans depends on the vigilance and conscientiousness of incentive-conflicted private and public supervisors and watchdogs. 

Moral fiber **and better** information are needed to overcome pressures that have forced officials into scary games of chicken that they have lost repeatedly in the past.

- Recruiting for Connections *vs.* for Expertise & Character
- Information Blockages: need to impose obligation of truth telling about safety-net subsidies on “banks”, CROs, GSEs, and agencies to enable effective outside Monitoring.
- Industry has been in the drivers seat throughout the rule-making process. Lessen influence of Campaign Contributions and post-government revolving-door compensation.
Key Defect Concerns Lack of Accountability Within and Across Countries: This is why US & EU need to Rework the Incentive Structure of private and government supervisors, and not focus on identifying and narrowing gaps in the existing web of Regulation

• In principle, perfectly selfless supervisors would bond themselves to disclose enough information about their decisionmaking to allow outsiders and agency Inspectors General to hold them politically and financially accountable for neglecting or abusing their responsibilities.

• In practice, information flows, institutional arrangements for credit rating organizations and government oaths of office do not hold other safety-net supervisors accountable for detecting safety-net subsidies or minimizing the costs and adverse redistributional effects authorities engender in resolving incentive conflicts.
As a matter of fairness, DFU Firms and Regulators should be Directed to Develop and Publicize: Market-Based Signals of Taxpayers’ Equity Stake; Observable Metrics for Institutional and Aggregate Safety-Net Exposure; and Automatic Stabilizers

**New Metrics and Duties for Institutions**: Estimates of fair taxpayer dividends can be constructed by Firms and Regulators from Combination of Stock Prices; Credit Spreads; CDS Spreads; Spreads on Equity Swaps.

**Better Signals**: Extending Stockholder Liability beyond Paid-in capital Can Improve Informativeness and Incentivize Stockholder Policing of Risk-Taking (Used in Past)

**Stabilizers**: DFA Envisages Compulsory Convertible Debentures (“Cocos”) but these will not change incentives unless they are triggered by Uncooked Market-based Metrics and Signals
FINANCIAL REGULATIONS ARE NEGOTIATED, NOT IMPOSED. MEGA-INSTITUTION “CRIMINALS” ARE FIGHTING TO KEEP TAXPAYER EQUITY POSITIONS UNDISCLOSED AND UNSERVICED.