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CREATING ACCOUNTABILITY FOR CONTROLLING SYSTEMIC RISK BY ASSIGNING TAXPAYERS A *DE JURE* EQUITABLE INTEREST IN SIFI EARNINGS

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Four Main Issues

1. What is Systemic Risk?
2. Where does it come from?
3. Why is measuring it important-- not just economically-- but **ethically** to establish accountability to taxpayers for managing it?
4. How would giving taxpayers an equitable interest in SIFIs Change the Ethical Environments in which Giant Banks and Govt Regulators Operate and Interact?

Systemic Risk is Safety-Net Risk

- **When one or more giant "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 convert the deep negative tail of profit outcomes into implicit government debt.**
- **The tax-transfer system the net represents creates a contra-liability for important firms. This contra-liability transfers responsibility for debts in excess of enterprise net worth to unspecified taxpayers via government commitments to protect unsophisticated depositors and to keep systemically important markets and institutions from breaking down in difficult circumstances**. As long as Governments and SIFIs fail to record the value of this contra-liability on their balance sheets, firms will be incentivized to become inefficiently **large** and **fragile**.

What Happens when a Ruinous Shock to Asset Value Hits One TBFU Bank?

Assets	100 80	Debt	95
		(Guarantee	16)
		Market Cap	6 1

What Happens to Balance Sheets of Taxpayers and Solvent Banks when Shock Hits their Assets and Two TBFU Banks?

Assets	450 500	Debt	400 390
		TBTF Guarantees	3 2
		Economic Net Worth	97 28

Safety-Net Managers Have Been Allowing Mega-institutions to Exploit the Rest of Us

Macroeconomists conceive of the taxpayer side of financial institutions' right to be rescued as if it were an externality. But it is more **accurately** part of the industry's implicit contract for accepting regulatory services: it is an implicit "taxpayer put" that the financial sector understands as a **government-enforced obligation** for taxpayers to rescue large and politically powerful financial firms(SIFIs) and their counterparties when they are in difficult straits.

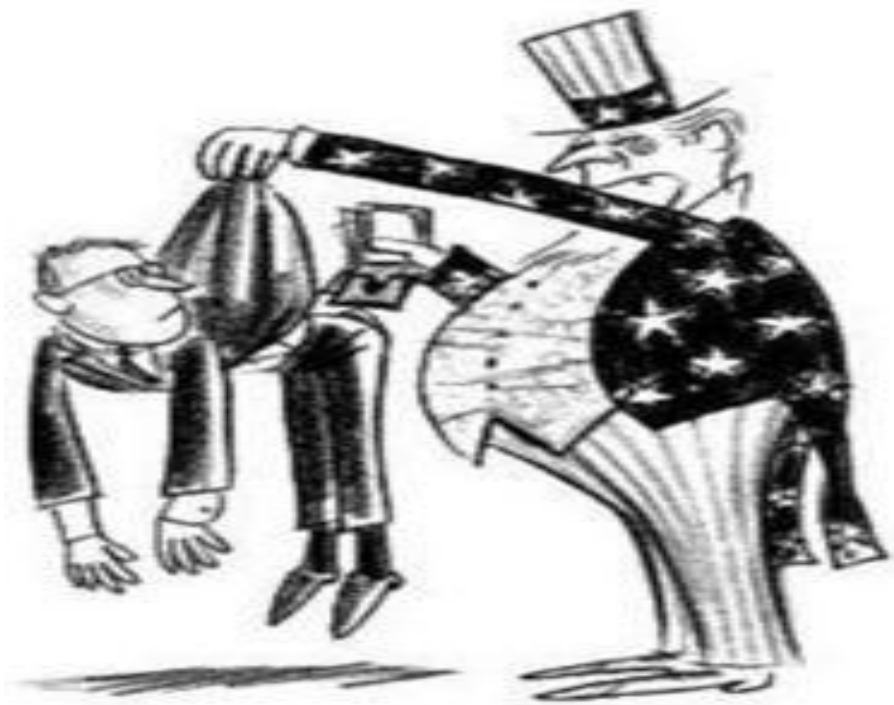
A nation's largest, most complex, and most politically powerful firms believe that, in exchange for accepting loophole-ridden regulatory requirements and paying deposit insurance premia, they can pressure central banks to exercise this put on their behalf when circumstances suggest they have incurred ruinous losses. In good times and in bad, confidence in authorities' RESCUE REFLEX keeps mega-firms' cost of funding inappropriately low and distorts the size distribution and fragility of the financial-services industry.

- In principle, systemic risk concerns both:
  1. **Financial fragility**: the probability that, without an explicit or implicit injection of government funds, the economy's financial sector might melt down, and
  2. The contingent cost to taxpayers of financing a **safety net** designed to prevent meltdowns.

  Fragility is under **join**t industry and government control, as is the **contingent cost** the government incurs in keeping meltdown probabilities low . If SIFIs are able to expand their size and risk-taking in hidden ways, fragility and safety-net costs both move unfavorably to the taxpayer.

- My research program interprets a firm's safety-net risk as the value of its option to "put" potentially ruinous losses and loss exposures to taxpayers. Its managers' ability to trigger forbearance for capital shortages and stand-alone "*tail risk*" (i.e., losses that exceed taxpayers' lame capital-requirement supervisory protections) **increases the value of the safety-net benefits it receives**.
- This creates an incentive for managers of giant financial firms **to search out, to lobby for, and to exploit weaknesses (i.e., loopholes) in risk-control arrangements.** This incentive is stronger the more strongly they believe that stockholders are the only stakeholders whose interests they have a duty to serve.

How Does Mega-Institution Fragility Turn into Systemic Risk? Every 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



Alternative Ways to Disarm SIFIs

- **Enforce Quantitative Limitations**: Break up Big Institutions and/or enhance the ability of financial regulators to limit firm size, geographic footprint, complexity, connectedness, risk-taking, lobbying activity, etc. going forward.
- **Squeeze Subsidies out of the Net**: Monitor Safety-Net Benefits in Timely Fashion and Price Safety-Net Services Appropriately.

How to Measure Systemic Risk

- From the point of view of Safety-Net management, Systemic Risk maps one-for-one into the value of the contingent credit enhancement that authorities' selective "**Rescue Option**" imposes on taxpayers.
- This enhancement gives taxpayers an **unrecognized** and **unserviced** equity position in all financial institutions that regulators regard as Difficult to Fail and Unwind. The difficulty of unwinding increases with a firm's size, complexity, interconnectedness, political clout, and maturity mismatch.

TAXPAYERS’ EQUITY POSITION IS INFERIOR TO THAT OF SHAREHOLDERS IN 5 WAYS

- Taxpayers cannot trade their Positions Away
- Their liability is not contractually limited
- Their 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.
- Shareholders can and do abuse taxpayers by Blocking or Delaying Recovery and Resolution

- In US and UK common law, an "equitable interest" is understood as a balance-sheet position that gives its owner a right to compensation for damages.
- It is useful to conceive of the compensation due on systemic risk as the dividend that taxpayers would be paid periodically on their **contingent equity stake** in a protected firm if taxpayers were fully informed and could enforce their interests. The value of a bank's "taxpayer put" increases with the extent to which creditors and stockholders are confident that they can *hide* risk taking and *scare* authorities into shifting ruinous losses to taxpayers without adequate compensation. [In the cartoon, Deception and Fear are the bullets in the gun the industry is holding to the government's head.]

ETHICALLY, THERE IS NO JUSTIFICATION FOR LETTING THE VALUE OF TAXPAYER EQUITY POSITIONS BE SERVICED LESS SURELY OR LESS FAIRLY THAN SHAREHOLDER CLAIMS

- From a contracting point of view, a SIFI's Taxpayer Put is **not an externality**. It is a market-completing IMPLICIT CONTRACT whose short side deserves-- as a matter of simple justice-- to be **serviced at market rates**. Drawing on the deposit-insurance literature, colleagues and I have shown that firms and officials can estimate the annual "Insurance Premium Percentage" that a DFU firm **ought to pay** on each $ or Euro of the par value of its debts.

Systemic Risk is a Portfolio Risk: *Not* the simple sum of Micro-prudential (i.e., stand-alone) Risks

What is called macro-prudential risk comes from a combination of industry risk-taking and authorities' selective exercise of a "Rescue Option" and the rescue option SIFIs enjoy **shifts** considerable risk to taxpayers and small banks.

- **Large banking organizations turn the rescue option into a conditioned "Reflex" by finding ways to make themselves harder and scarier for authorities to fail and unwind. They do this by increasing their size, earnings volatility, complexity, leverage, connectedness, and/or maturity mismatch.**

- Deposit insurers are accountable for Stand-alone or Micro-prudential Risk. But Safety nets subsidize "systemic" risk creation in good times partly because the accounting frameworks used by banks and government officials do not make anyone directly accountable for **reporting or controlling** safety-net subsidies until and unless markets sour.

In the US and UK, What Fiduciary Duties Would SIFIs Owe to **a *De Jure*** Equitable Interest?

Even for foreign securities that are cross-listed in these countries, Corporate Law crafts governance procedures that offer minority stockholders in SIFIs protections from exploitation by other stakeholders that-- ethically speaking-- ought to be accorded to taxpayers as well [e.g., Kant's 2nd categorical imperative forbids using other parties (i.e., taxpayers) merely as a means to another end].

Efforts to design effective procedural and disclosure rights for taxpayers need to take account of the greater capacity of other stakeholders to understand and promote their interests and to consider how access to such rights **varies across countries with differences in political and regulatory cultures.**

Ethical Consequences for Governments: Officials Would Owe Fiduciary Duties To Taxpayers as Minority Investors

- **In noncrisis times, Safety-net managers should monitor, contain, and finance safety-net risk, but –- with no accounting requirements for SIFIs to recognize its value and no one even tasked to develop ways to measure it --growth in a SIFI's taxpayer put lacks visibility in good times.**
- **In crisis times, the sudden surfacing of this value leads safety-net managers to panic.**

- Regulatory lags make it foolish to subject all SIFIS to the same penalties. For market and regulatory pressure to **discipline** and potentially to **neutralize** incremental incentives for SIFIs to ramp up the taxpayer put, two conditions must be met:
  1. Enterprise capital **must increase** with the volatility of returns
  2. Value of a SIFI's taxpayer put **must not rise** with increases in the volatility of its returns.
- The first condition is the minimal goal of the Basel system and usually holds. But the second condition is seldom met. Why? Because SIFIs do not have to estimate and service their taxpayer put and because Regulatory Arbitrage and Accounting Gimmickry expand return volatility in nontransparent ways that are designed to prevent capital requirements from being truly burdensome.

Cross-Country Differences in Costs of Loophole Mining Explain Why the Current Crisis Proved Most Severe in Financial Centers and Other High-Income Countries

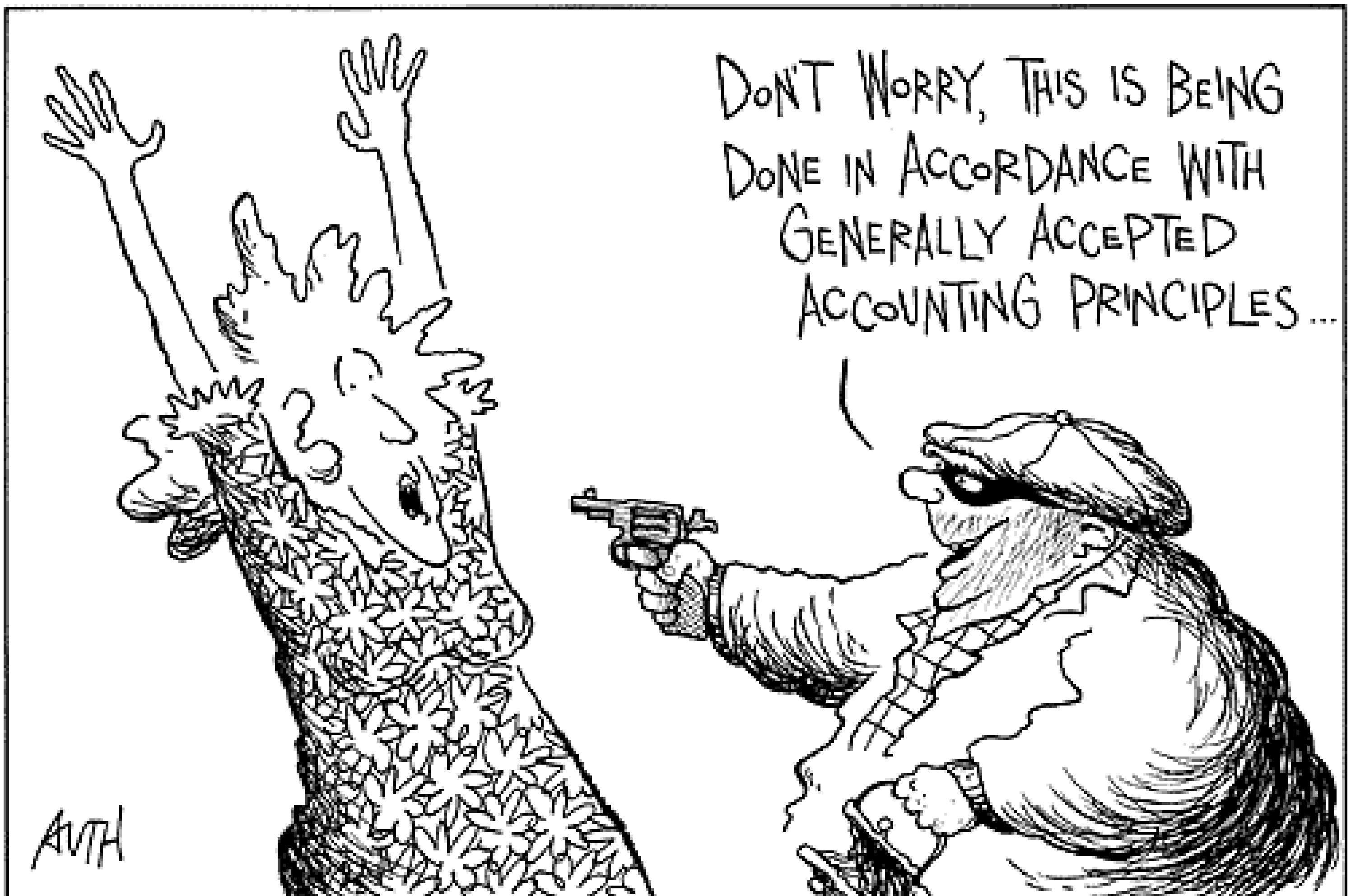
1. During the bubble in securitized credit, Banks in High-Income Countries faced **low avoidance costs:** [Creditors allowed them **great accounting leeway** and they could transact in a rich **array of risky nontransparent instruments** at low trading costs with little negative feedback about the imbedded guarantees from customers, regulators, or politicians.]
2. In the crisis, the **surge in nonperforming loans** simultaneously increased market discipline and panicked regulators. Conceptual Poverty of Basel's Risk-weighted capital approach became obvious. Basel ratios **did not predict** bank health or the need to restrain zombie-bank gambling for resurrection.

Bank and Regulatory Accounting Currently Surface only the Tip of an Iceberg of Taxpayer Exposure

Some Incremental Policy Improvements

- Regulating Leverage is not enough. Authorities could better control safety-net benefits if they **redesigned their information systems** to estimate specifically the value of taxpayer puts.
- Large Financial Firms should be obliged to build information systems that measure the value of the taxpayer put they enjoy. This would entail reporting data on earnings and net worth more **frequently** and under meaningful **penalties** for fraud and negligent misrepresentation.
- If the values of on-balance-sheet and off-balance-sheet positions were reported weekly or monthly to national authorities, rolling regression models using stock-market data could be used to estimate changes in the flow of safety-net benefits in ways that would allow regulators to observe and manage taxpayers' stake in the safety net in a more timely manner

The Alternative: Ethical Reporting Principles be Damned



THE ROOT FINANCIAL PROBLEM IS AN ETHICAL CRISIS: HOW LONG CAN SOCIETY TOLERATE AN ETHICALLY CHALLENGED FINANCIAL INDUSTRY AND CONFLICTED AND DECEPTIVE SUPERVISORY ARRANGEMENTS?