

# Consolidation vs financial crisis and competition policies

Comments / Addendum

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# Too big to fail – eliminating competition for good !

## Criteria for TBTF

- Interconnectedness, lumpy risk
- Financial panic risk
- Essential lending function

TBTF: AIG/Lehman – interconnected globally via swap mkts; Bear Stearns – central hedge fund sponsor; LGDs huge

NOT TBTF: Northern Rock – badly designed public deposit insurance; Hypo Real Estate – badly designed private deposit insurance

→ even if TBTF never too big to be restructured!

→ main issue is not failure, but avoid fire selling into a downturn (US RTC vs. HOLC)

→ no ex-ante designation of TBTF in order to preserve competition, credible market exit key goal.

Q: is TBTF becoming a cover-up for crony capitalism?

Gov is big part of the TBTF problem

- Agencies, (Fannie, Landesbanken).
- Abuse of guarantees

# A bank insolvency regime proposal to revive competition between likes

Goals: reduce interconnectedness, greater precision of risk-capital allocation, predetermined LGDs to avoid 'Lehman lottery'

## Measures

- Minimum capital 10% (historic >20%), then risk-based to 15%
- Capital quality - force all parts accepted as capital to share loss (i.e. forced conversion of hybrid to shares),
- Mandatory insurance for non-deposit instruments, low recovery ratio (e.g. 30%),
- Mandatory deposit insurance with a higher recovery ratio,
- Asset-backed can remain exempt from insurance (limits),
- Insurance scheme industry-wide with considerable mezzanine capital, backstopped by a super FDIC,
- Banks and insurers transfer business with significant downside/duration such as trading, swaps to hedge funds,
- Other (Glass-Steagall) type of activity splits, i.e. bank focus on lending, insurers on insurance, funds on securities/hedging, investment banks on underwriting/market making.

# European Deposit Insurance System (EDIS)

Goals: regulation think-tank, information flow across supervisors, joint credible insurance promise, break of socialistic competition/financial market place arbitrage.

Measures:

- Step 1: Create European institute supervising cross-border groups: information clearinghouse for the supervision of cross-border financial groups; and a formal policy think tank for financial sector restructuring, financial sector subsidies, and regulatory reforms,
- Step 2: Empowerment of national supervisors through creation of national FDIC-type institutions (capitalized insurer, underwriting/monitoring rights, liquidity facility),
- Step 3: European Deposit Insurance System in analogy to ECB; capitalized with back-up capital/loss-sharing by Member States.