Discussion of "A Proposal for the Resolution of Systemically Important Assets and Liabilities: The Case of the Repo Market"

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1. Introduction

Over the past few years Viral Acharya and his colleagues at New York University have offered us a rich menu of papers on the financial crisis. The present one continues this tradition and proposes an ingenious scheme to strengthen a crucial part of the financial infrastructure, namely, the repo market.

The paper by Acharya and Öncü (henceforth AO) contains an analysis of the causes of the outbreak of the financial crisis, a critique of the Dodd-Frank Act's provisions with respect to orderly liquidation authority, and a proposal for a mechanism to protect the repo market against future instability. Along the way, there are useful descriptions of the evolution and structure of securitized markets. I will leave these to one side and concentrate on the three key elements of the paper: the analysis, the critique, and the proposal. I will then list a number of practical questions which may need to be considered if the proposal were to be implemented.

2. Analysis

The emergence and propagation of systemic financial stress can be traced to one (or both) of two key causes: (i) weaknesses at individual financial institutions, which are then spread through counterparty links to the rest of the financial system, and (ii) strains

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in markets that affect a range of financial intermediaries simultaneously. AO label the first the "microeconomic" perspective and the second the "macroeconomic" perspective. There is, as they note, no reason why the two should not coexist, but the relative importance assigned to each has important policy implications. If the principal risk is that strains at an individual institution will spread throughout the financial system via counterparty linkages, the response is a combination of stronger capital and liquidity standards, along with improved techniques for the resolution of institutions in difficulty. If, on the other hand, systemic disruptions are due to stresses in markets, then all institutions that are active in such markets are likely to be affected in a similar manner. In such a case, crisis response needs to focus on alleviating the sources of market stresses rather than addressing problems at the institution level.

I note in passing that if financial distress is spread by common exposures to market shocks, this has implications for which institutions are regarded as "systemically important." Smaller institutions, taken together, will be just as systemic as a single large institution. This in turn would imply that the protection provided by higher capital and liquidity standards should apply equivalently to all institutions, not necessarily disproportionately to large ones.

AO argue, in effect, that the second cause of instability—namely, stresses in markets for "systemically important assets and liabilities" (SIALs)—was the more important in the recent crisis. The evolution of the crisis seems to me to bear out this view. Securitized banking, to use the terminology of Gorton and Metrick (2009), has grown enormously in recent decades. Non-bank financial institutions, and banks themselves to a significant extent, used the repo market either to fund their portfolios or as an outlet for investment. And it was a generalized "run" on these instruments that was both the trigger for the crisis and the channel for its spread.

Before the crisis, it was thought that the structure of the repo market would make runs unlikely, because the cash provider was a secured lender. And the fact that repos were "qualified financial contracts" (QFCs) meant that they were exempt from automatic stay in bankruptcy. With claims that were both liquid and secured, repo counterparties should, so the thinking went, have no incentive to run. And in practice the repo market functioned smoothly over several decades during which it grew rapidly.

Over time, however, as AO point out, the range of securities backing repo transactions was gradually broadened beyond short-term government obligations to include a growing set of asset-backed securities. The size of the market and the number of participants also grew rapidly. A feature of the new securities backing repos was that they were longer term, harder to value, and less liquid than those used earlier. In some ways, the shadow banking system took on many of the characteristics of conventional banking, without the protections. Longer-term, illiquid assets were backed by short-term funding sources, without any lender of last resort being able to supply liquidity.

The latent risks materialized in 2007, when housing prices started to fall and market participants realized that the assets backing repo transactions might have impaired values. This set in motion a vicious spiral. Faced with the prospect of declining collateral values, providers of funds either insisted on more collateral or cut funding lines. Either way, borrowers had to liquidate assets, further depressing prices. And when lenders took possession of collateral, they were faced with losses if they tried to sell the collateral in a declining market. Eventually, as we know, the repo market dried up for many asset categories. Indeed, in the case of Bear Stearns, the company could not fund itself even with liquid collateral.

But should we care if shadow financial institutions get into trouble, so long as conventional banks, which manage the payments system, are protected? The answer is yes. In the first place, shadow financial institutions have become highly important in their own right. Secondly, banks have become intricately involved with the shadow financial system, and their health is closely related to its stability.

3. The Critique

The essence of the AO criticism of the Dodd-Frank Act (DFA) is that, by focusing on resolution of financial institutions in difficulties, it fails to deal with the underlying cause of stress in the market for SIALs. Moreover, they see the Orderly Liquidation Authority (OLA) provided for under DFA as containing problematic aspects. If the FDIC as the relevant agency delays in invoking OLA, it is likely to precipitate a run as creditors seek repayment while they can. To address this problem, AO believe the FDIC is likely to use its access to funding to stem panic by bailing out a wide range of creditors. Another avenue of criticism is DFA's treatment of money-market mutual funds (MMMFs).

In my view, while some of the criticism of DFA is valid, other parts are misdirected. The problem is less that the FDIC will fail to use its orderly liquidation authority, or that it will use its access to funding to bail out financial institutions in difficulty, but that legislation will prevent it doing so in a way that best protects the interests of creditors. Perhaps the most striking example of this is the requirement under DFA that existing management be terminated. Punitive action of this kind may be morally satisfying, but is unlikely to be in the best interest of preserving value in the institution. And money-market mutual funds can be protected from runs by requiring either capital cushions or variable net asset value. In the words of Adair Turner, if MMMFs walk like a bank and quack like a bank, they should be treated as banks. Still, the criticism that DFA will not stop future runs on securitized lending seems valid. So long as repos can take place with potentially illiquid collateral, a shock to confidence risks a self-fulfilling rush to terminate contracts.

Lastly, AO consider that DFA does not deal adequately with the international dimension of the failure of a financial institution. Once again, this criticism may be somewhat harsh. As AO recognize, work is under way in the Financial Stability Board to develop mechanisms that, while falling short of full compatibility of bankruptcy regimes, offer the promise of collaborative solutions across jurisdictions.

4. The Proposal

AO's proposal deals with the repo market but could be extended to other markets for SIALs. It involves several aspects. First, they suggest that QFC status (exemption from stay in bankruptcy) should go only to repos secured by highly liquid and value-certain instruments (e.g., short-term Treasury securities and government-guaranteed claims). These can be liquidated easily without significant market disruption or loss of value.

All other repos, i.e., those based on less-liquid collateral, would be subject to a stay in bankruptcy (or resolution). But those that are of high quality, somehow defined, would be eligible to be acquired by a “Repo Resolution Authority” (RRA). The RRA would make an immediate payout to creditors secured by these assets of an amount that represented a conservative assessment of the ultimate recovery value. All other repos would be stayed in bankruptcy and would await settlement in the same way as the firm’s other assets.

The proposal is intended to avoid fire sales of collateral and consequent loss in value. Holders of high-quality collateral would benefit from the knowledge that in the event of difficulties for the borrower, they would receive immediate payment (though with a discount) in respect of the collateral they held. The RRA would charge a market price for the liquidity enhancement it provided, thus avoiding moral hazard. By selling the collateral over time, and not in a distressed market, it would maximize recovery value. And if the conservative valuation of collateral proved to be optimistic, it would also have the right to “claw back” from creditors any losses it incurred in liquidating collateral.

5. Questions

Despite the scheme’s apparent attractions, a number of practical issues occur to me.

- **Would the RRA, as proposed, stop runs?** Repo lenders would still have an incentive to run when they had doubts about the solvency of a borrower and when they did not expect the RRA to pay out on the collateral immediately and in full. Of course, lenders would benefit from receiving *some* immediate payment, instead of having to liquidate collateral in a distressed market, so this would reduce the incentive to run, though not eliminate it.
- **How would the RRA value the collateral** against which it paid out to lenders? Under the scheme as proposed, the RRA would identify in advance the methods it would use to value collateral. How precise could it be, however? Experience suggests (residential mortgage-backed securities in the recent crisis) that the value of collateral could change over time. If the RRA gave precise estimates of collateral values, it would be turning itself into a rating agency. Decisions to change the

value of certain types of collateral, if made by an official body such as the RRA, would be market-moving events.

- **How great is the risk that collateral would decline in value after it had been acquired by the RRA?** This seems quite possible if one considers the slide in collateral values in the course of the recent crisis. In such a case, the RRA would have a claim (and therefore a credit risk) on creditors who had surrendered their collateral.
- **Who would have the right to present collateral to the RRA for redemption?** Would it be only those whose counterparties had defaulted, or anyone (as in a lender-of-last-resort facility)? If it was only the counterparties of defaulters, would it be sustainable to provide recovery amounts above the distressed market price?
- **How would the RRA distinguish between different types of collateral**, in particular between "high-quality" collateral (covered by the scheme) and low-quality collateral (not covered)? Would such a distinction in practice lead to "cliff" effects and lobbying by market makers to have a progressively wider range of collateral included?
- **Would participation be voluntary or mandatory?** And would the levying of fees be on the instruments or on the holders? If on the holders, would non-financial participants in the market be included? Even if the scheme is mandatory and starts with all currently important jurisdictions, would there not be an incentive for activity to migrate to non-participating jurisdictions? This could be the case if, in good times, the costs of participating in the scheme were perceived to be greater than the benefits.
- **What would the RRA do in the intervals between crises?** (Recall that the repo market functioned without systemic stress for many decades before the present crisis.) It may be some time before the next crisis, given that measures to strengthen capital and liquidity standards at financial institutions mean that it might be a long time before another crisis occurs. One option would be to give the RRA supervisory functions over markets, but exactly how would these work?
- **How would one deal with the development of new financing mechanisms?** Financial engineering will deal with

the challenge of fees by developing techniques that tap capital markets without having to pay liquidity insurance premiums.

- **Could fees be set so as to generate appropriate incentives?** The payment of a market-based fee to cover risks is intended to avoid moral hazard and internalize the externality of an instrument's contribution to systemic vulnerability. However, this is only true if the premium is an accurate reflection of the risk. This would not be easy to achieve. FDIC assessments do not offer much encouragement for the notion that risk premia can be closely related to actual risk.

These are not necessarily overwhelming objections to the AO scheme. There may be satisfactory answers to the questions I have raised, and anyway, there may be no superior alternative to the proposal AO have made.

References

Gorton, G., and A. Metrick. 2009. "Securitized Banking and Run on the Repo." Yale ICF Working Paper No. 09-14.