Evidence that Too Big to Fail Remains Firmly Entrenched in Europe

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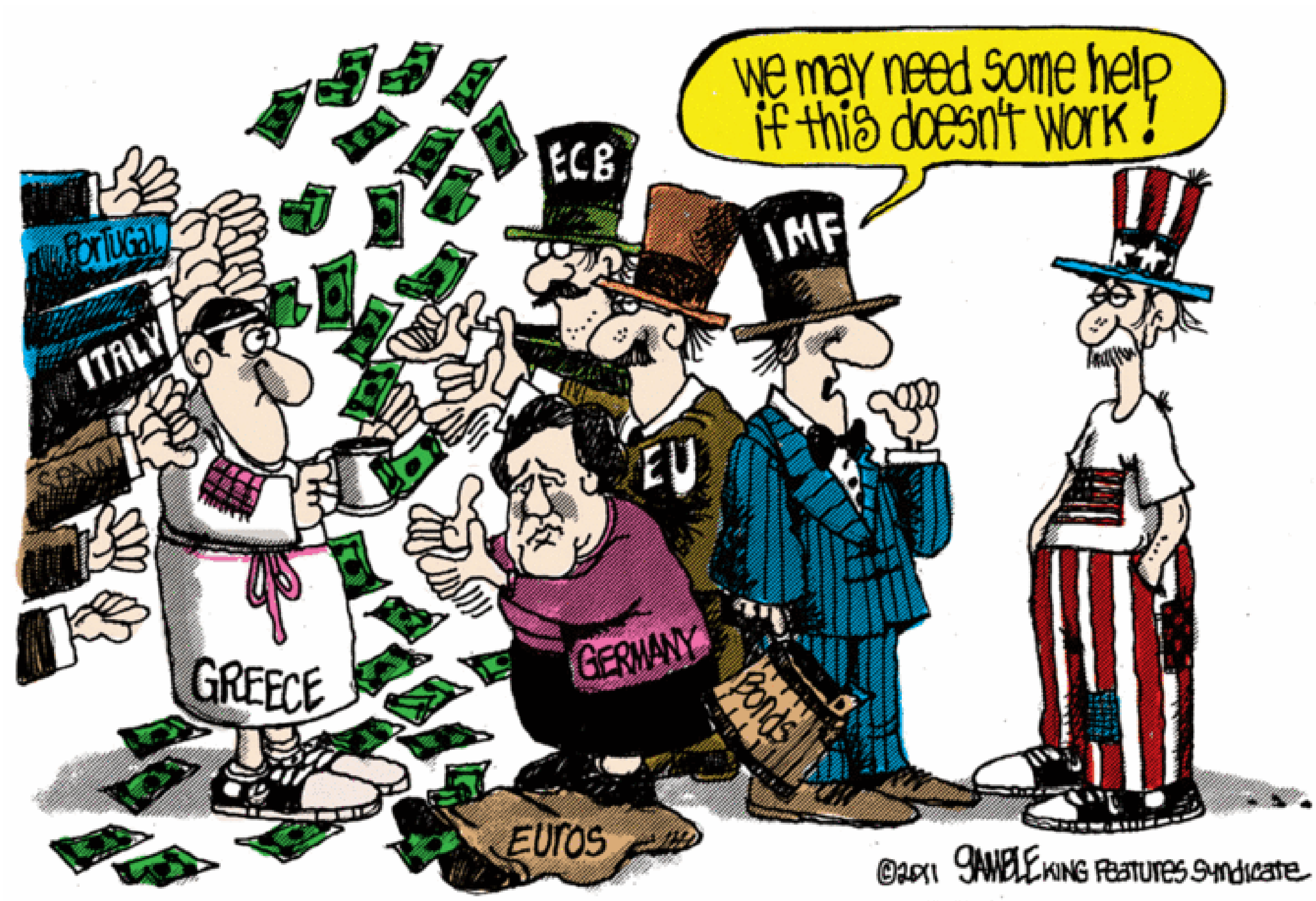
A Government's Safety Net has Three Components:

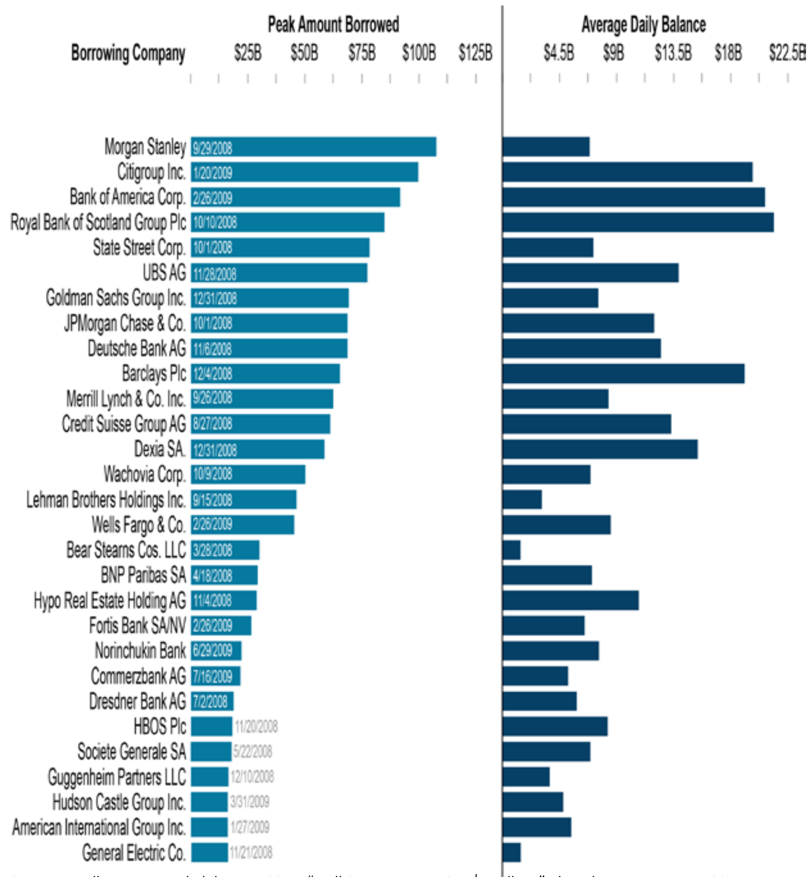
1. **Preventive Actions** officials take to restrict the risk of ruin that institutions assume;
2. **Remedial Measures** officials take to limit the damage creditors, customers, employees, and stockholders suffer when and if an institution becomes incurably insolvent
3. **Financial Ability**, in the event of financial turmoil, to **make taxpayers and surviving institutions pay** eventually for whatever rescue operations they undertake.

What Europe's Safety Net Looks Like



GLOBALIZATION OF US NET OCCURRED DE FACTO DURING 2007-10 CRISIS: THE FED, USED ITS LAST-RESORT LENDING POWERS CREATIVELY TO PROVIDE SUBSIDIZED FUNDING TO MANY OF THE LARGEST BANKS IN THE WORLD

(Fed Loans 8/2007-4/2010)



Source: Bradley Keoun and Phil Kuntz, 2011, “Wall St. Aristocracy Got $1 Trillion,” Bloomberg.com, August 22 (transmitted to me by Richard Herring).

But What About the Flood of Postcrisis Reforms?

In the wake of the Great Financial Crisis, authorities in the US and EU have waged war on the presumption that many of the world's most important banks are too vital economically, too complex structurally, and/or too politically powerful to fail and unwind(TBTFU).

In both venues, regulators extol new laws and directives designed to impede bailouts, to convey new resolution authority, and to require megabanks to strengthen their capital, their liquidity, and their "resolvability." But the incentives for top regulators and distressed bankers to paper over losses and delay resolution are as strong as ever. Fed braintrust is proud of their rescues and megabank creditors are confident that we will see this kind of behavior again.

How a Firm's Credit Spread Moves in Distress Depends on How Fully Its Creditors **Feel** They are Covered by the Safety Net

- The next set of slides will use graphs to illustrate credit-spread behavior in and out of crisis for: GE, Citi, Wells,
- JPM, Lehman, Merrill, DB, CS and Lloyd's.
- Blue dots: **Credit spread**, based on actual trades and calculated using matched-maturity Treasury (different from the convention which uses the nearest **shorter** US Treasury on-the-run yield)
- Light blue lines show **volume** of trading in each bond
- Orange line: **1 year** Kamakura Risk Information Services reduced-form default probability, version 6.0
- Green line: **10 year** (unless otherwise noted) KRIS reduced form default probability, version 6.0

- Finance is only a small part of GE operations.
- Blue line moves sharply with surges in orange line.
- Problems slowly resolved.

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CREDIT NAME
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MACRO FACTOR SENSITIVITY
PORTFOLIO MANAGEMENT
Hello: dvd | Logout
Overview
Default Probabilities
Bond Spreads
CDS Spreads
Implied Ratings
Chart
Watch List
Download
Security ID US172967EH05
Go
Date 2016 Aug 29
CITIGROUP INC
Issues
History
Term Structure
Entity Citigroup Inc Issue 6% NT REDEEM 15/08/2017 USD 1000 Callable N Seniority Senior
Most Recent Trade Date 08/29/2016 Price $104.42 Volume 5,210,000 Spread 0.73 % Yield 1.34 %
View By Spread
Based on Matched Maturity Closest on the run
Compare: + Add - Remove
Range: 1Mo 3Mo 6Mo 1Yr 2Yr 5Yr 10Yr Max Custom Date
Spread
Volume
C-jc6-1YR
C-jc6-10YR
30.0
22.5
15.0
7.5
0.0
Percent (%)
60,000,000
45,000,000
30,000,000
15,000,000
0
Daily Volume (USD)
01/2008
01/2010
01/2012
01/2014
01/2016
Month/Year
Source: Kamakura Corporation, TRACE, Market Axess, Exchange Data International


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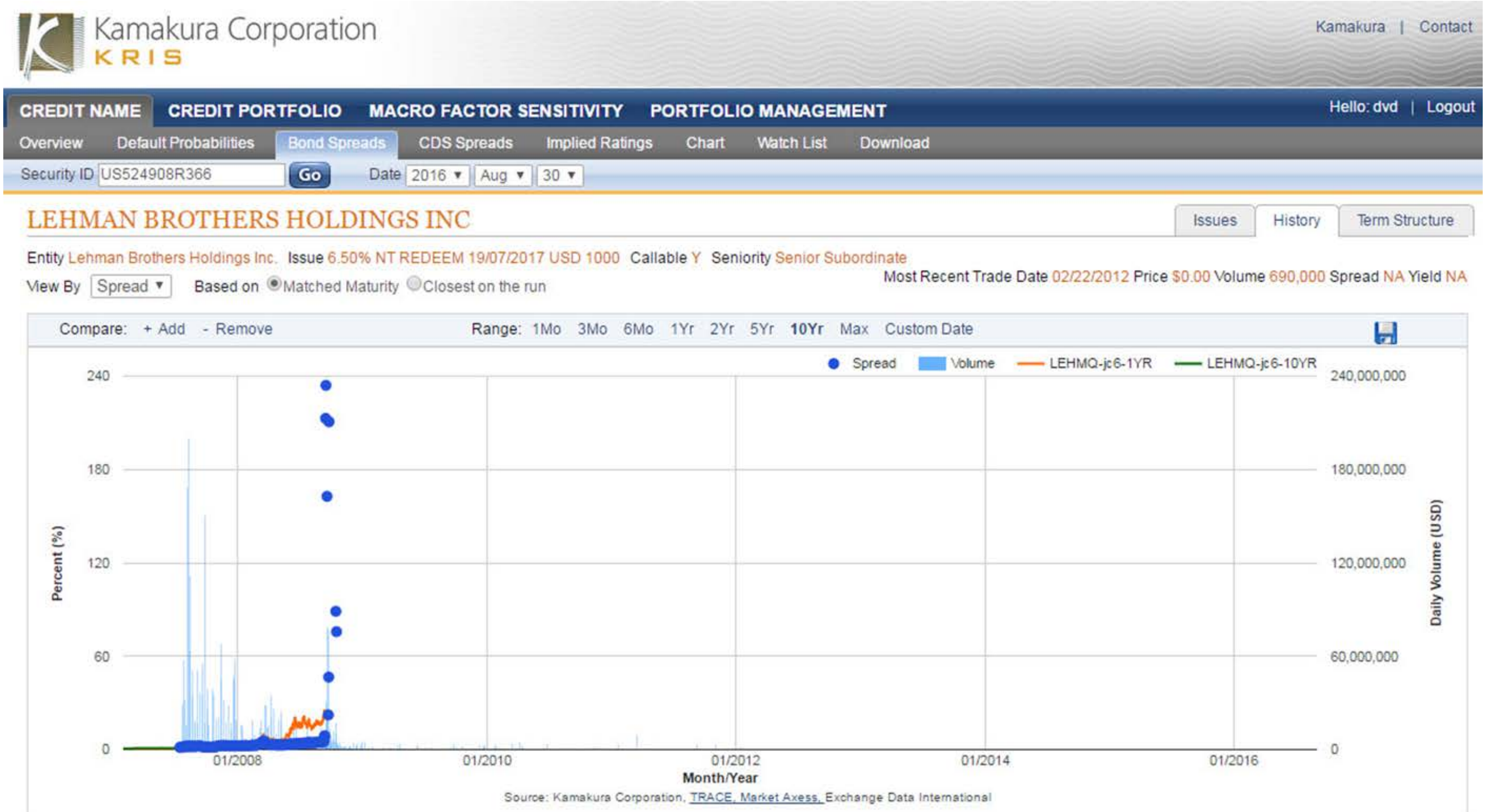
Overview
Default Probabilities
Bond Spreads
CDS Spreads
Implied Ratings
Chart
Watch List
Download
Security ID US060505DP69 Go
Date 2016 Aug 29
BANK OF AMERICA CORP
Issues
History
Term Structure
Entity Bank Of America Corp. Issue 5.75% NT REDEEM 01/12/2017 USD 5000 Callable N Seniority Senior
Most Recent Trade Date 08/29/2016 Price $105.22 Volume 10,785,000 Spread 0.84 % Yield 1.51 %
View By Spread
Based on Matched Maturity Closest on the run
Compare: + Add - Remove
Range: 1Mo 3Mo 6Mo 1Yr 2Yr 5Yr 10Yr Max Custom Date
Spread
Volume
BAC-jc6-1YR
BAC-jc6-10YR
30.0
22.5
15.0
7.5
0.0
120,000,000
90,000,000
60,000,000
30,000,000
0
Percent (%)
Daily Volume (USD)
01/2008
01/2009
01/2010
01/2011
01/2012
01/2013
01/2014
01/2015
01/2016
Month/Year
Source: Kamakura Corporation, TRACE, Market Axess, Exchange Data International

- Evidence of TBTF: Blue line responds only mildly to surges in orange or green lines.
- WF very profitable in postcrisis years.

This slide is for a Merrill-Lynch debt security. Once M-L was absorbed by BAC, Kris stopped calculating its default risks.

- Resembles Wells, but riskier posture in post-crisis era.

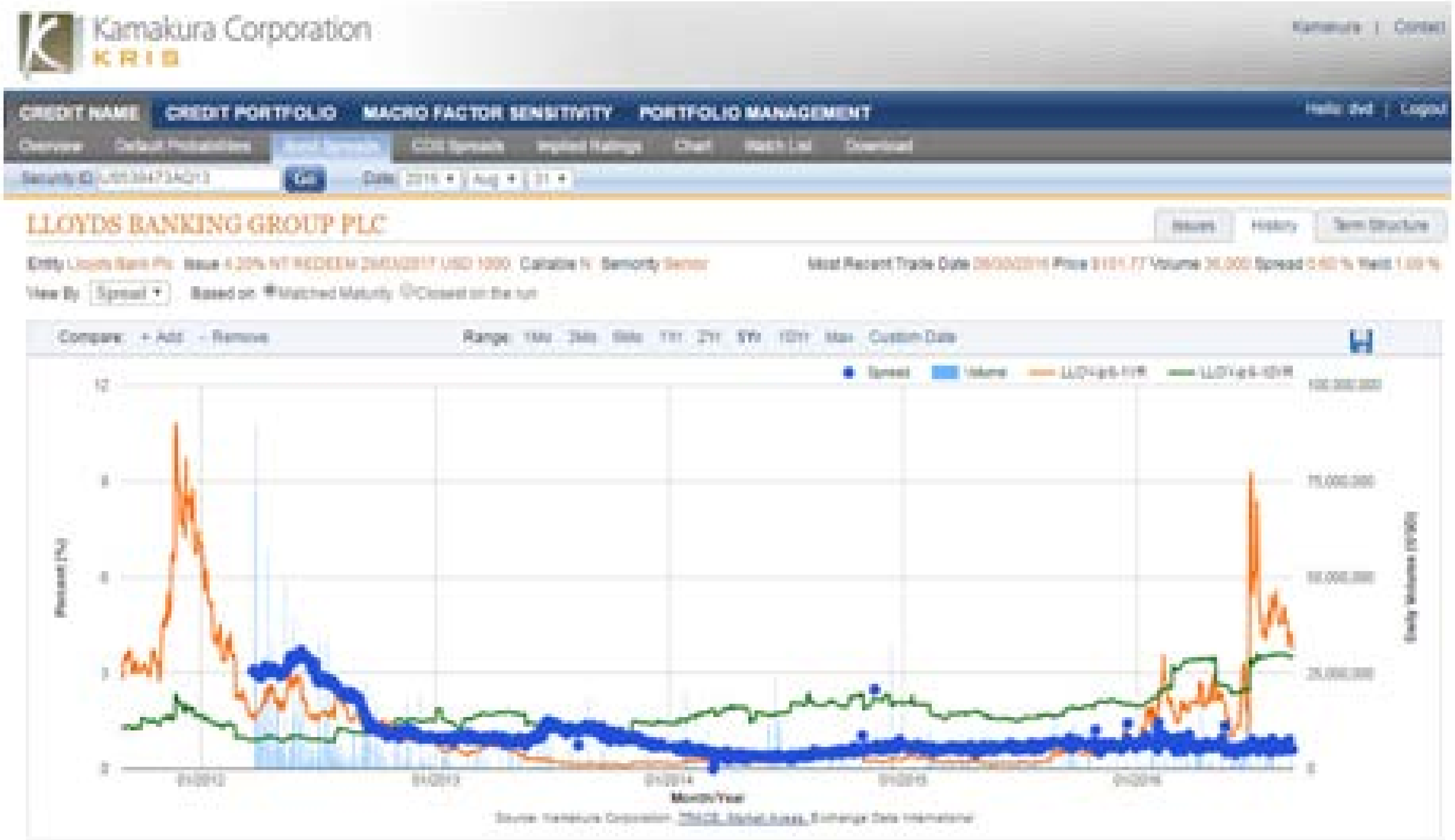


Evidence that expectations of federal rescue were let down. Debt price crashed.

With this **background**, I will now present evidence that indicates that several major European Megabanks were also TBTF during the Great Financial Crisis. Some failed, others merely limped along during the aftermath, and appear to be **in as fragile a state today** as they were during the GFC.

- Surge in Orange preceded GFC. Credit spread moved much less than surges in other lines. Evidence of TBTF.

- No US debt in GFC
- TBTF pattern today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Especially because distress is systematically under-reported, the high percentage of non-performing loans and deferred-tax assets on the books of leading banks in countries such as Italy, Spain, and Portugal supports two inferences:(1) that the EU is harboring a **horde of zombie institutions** that authorities are unwilling to put into resolution, and(2) that these zombies can continue in business only because creditors continue to believe that in a crisis **some government or other** will step up to protect them. Obviously, raising capital requirements and making bail-ins more feasible constitute only **half an answer**.

Introducing extended liability or other restrictions on bank stockholders and introducing bright-line tests and criminal penalties at the individual level for megabanker recklessness can curtail bankers' incentives to game the system.

Taxpayers have a badly structured **equity stake** in TBTF banks. This stake should be measured and serviced regularly. Reckless bankers should be subject to burdens of proof and penalties for "**reckless endangerment**" that parallel those imposed on reckless drivers.

The secular expansion of global safety-net liabilities will not stop until and unless here and abroad:

1. officials face up to the failure of capital and other balance-sheet restraints to stay effective over long periods. Toughening these restraints does not change the incentive to extract unwarranted subsidies from the safety net. This requires penalizing individual megabankers for their *de facto* crimes of reckless endangerment , and

2. officials foreswear extending new safety-net coverages without first making sure that:

(a) they can track and respond to the safety-net implications of changes in their country's financial environment and

(b) the tools and norms of their regulatory culture allow them to monitor and control the implicit safety-net expansion that, going forward, regulation-induced innovations in financial arrangements are otherwise bound to generate.

The Laddered Stock Options Reckless CEOs and Risk-Management Officers Ought to Face After Leading a Megabank into Insolvency