Macrostability Ratings: A Preliminary Proposal

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Editor's note:
The too-big-to-fail problem has received much public attention in recent times, and of course Gary Stern and Ron Feldman, president and senior vice president of the Minneapolis Fed, have long warned of the TBTF problem in the Region *and elsewhere. Stern and Feldman emphasize that policymakers often feel compelled to bail out weak financial institutions because of concerns that spillovers from one failing institution will contribute to the collapse of linked institutions, leading to broader financial instability.*

In the following article, Stern and Feldman provide initial thoughts about managing such spillovers by devising a "macrostability" rating system for bank holding companies. A company's rating would assess the potential magnitude of financial spillover should that company fail.

Implementing this sort of rating system would focus the attention of the government agency designated as "macroprudential supervisor" on the mitigation of spillovers, argue Stern and Feldman, and ultimately diminish the motivation for bailouts. The article outlines their approach, explains the rationale and addresses possible critiques.

The proposal

1. The macroprudential supervisor (MS) would assign a macrostability rating to all or some holding companies (HCs) where the HCs or major subsidiaries engage in financial activities.[1] These entities would include, for example, bank HCs, thrift HCs, insurance HCs, HC-owned broker/dealers or investment banks, and HC-owned investment managers.

a. Assigning one rating per organization would keep the regime simple without curtailing the provision of key information. The text accompanying the rating (see below) would specify the organizational source of potential spillovers (e.g., at the HC or subsidiary level and which subsidiary). Supervisory or credit ratings would distinguish between HCs and subsidiaries to account for (1) legal entity distinctions that pervade the regulatory/legal environment in which HCs and subsidiaries operate, (2) the supervisory/regulatory assignments granted to various government agencies, (3) the inability of the subsidiary rating to capture the financial and operational condition of the overall organization, and (4) the issuance of securities by various legal entities. Because the macrostability rating does not purport to assess the financial condition of any legal entity or tie into a broader legal/regulatory framework, these rationales do not apply to it.

b. While the MS may decide to issue macrostability ratings for a large number of HCs, we assume it would do so largely by identifying those HCs that pose material risk of spillovers, analyzing these HCs in some detail

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and categorizing the vast majority of other HCs as posing no material risk of producing spillovers.

c. We would encourage the MS to take a broad and practical view of financial activities when determining which HCs to assess. The MS must determine whether a given firm's operational and financial challenges would create spillovers in the eyes of policymakers confronted with the firm's potential demise. Under this approach, the MS may find that a firm has the potential to produce spillovers even if the firm does not have classic signs of spillover potential (e.g., does not fund long-term assets with short-term funding).

2. The rating would assess the magnitude of potential spillovers that would arise if the HC or its subsidiaries faced serious operational and financial difficulties (i.e., spillovers conditional on failure or near failure). In assessing the rating, the MS would have to consider several types of spillovers, including but not limited to the following:

a. Spillovers that arise because of direct losses imposed on counterparties of the HC/major subsidiaries.

b. Effects that challenges at one HC/major subsidiary would impose on other financial institutions even if they do not have a direct exposure to it. For example, would concerns about the HC under consideration lead to run-like behavior at other institutions?

c. The potential effect that challenges at one institution would have on capital markets in terms of clearing, settlement and other "back office" operations, as well as other aspects of market operations (e.g., liquidity).

d. The vulnerability of the HC/major subsidiary to "fire sales" or other negative feedback loops arising out of capital market asset holdings or funding dependence (i.e., shocks to the value of an asset held by many large financial institutions lead to sales of the asset that depress the asset's value, leading to more sales).

e. Spillovers from the financial sector to the real economy. Such spillovers would include the effect of difficulties of a given financial institution on the liquidity of households and firms, the provision of credit and the availability of other services that provide material benefits to households and firms (e.g., hedging). Analysis of these spillovers would review both the immediate effects of disruption and the ability of other providers of services to compensate for supply reductions.

f. Finally, while perhaps not a spillover in the same sense as the previous items, additional factors that can prevent the least-cost resolution from occurring should also be considered by the MS. These factors would include, for example, the potential for ring-fencing in overseas operations that might prevent standard resolution techniques from being implemented.

We recognize the daunting nature of this task and discuss that challenge below.

3. The rating would not assess in any way the current condition of the HC or its subsidiaries.

4. Before assessing institutions for their potential for producing spillovers and rating them as such, the MS would publish for comment the factors it will consider in making the determination. Articulating these factors for consideration represents a core responsibility for the MS and, as such, we will not attempt to produce a list of the factors ourselves. That said, we would anticipate that factors such as organizational and legal structure, geographic scope of operations, the type of activities engaged in by the HC or its subsidiaries and the level of the firm's engagement in those activities would receive consideration, although certainly with more specificity in whatever final list the MS creates.

a. The initial list would go through the public comment process and incorporate feedback received from interested parties. We think the MS should revisit the factors on an annual basis, at least for the first several years of its existence.

b. We see merit in having the MS incorporate the factors believed to generate spillovers into the rating itself. One option the MS should consider is creating "subcomponents" for the macrostability rating based on the factors. Such a rating would contribute to transparency in the rating process.

c. We have supported and continue to support requiring financial institutions to document how a receiver could "wind down" its operations with minimal disruption to the financial system and the rest of the economy. A review of this plan should take a central role in assignment of the macrostability rating.

d. The rating should incorporate empirical measures of the interconnectedness of firms.[2]

5. The MS would provide a written document explaining the reasoning behind the rating(s) to the institution.

6. The MS would determine the form the rating takes, but we would encourage the MS to make it clear through the nomenclature used that the macrostability rating differs from existing supervisory ratings.

7. The MS would rely on the primary supervisor(s) for key information in setting the rating. That said, the MS has accountability for producing the rating and should have the legal authority to acquire whatever information it needs to produce the rating.

8. The MS would have an explicit statutory and/or regulatory objective of taking actions that reduce the rating (i.e., reduce the potential for spillovers). The MS would have to report to Congress semiannually on progress in meeting this objective.

9. Policymakers would have to consider the benefits and costs of making the rating public, a policy we discuss briefly at the conclusion of this document.

Rationales

We believe that the threat of spillovers drives the provision of ex post government support for uninsured creditors of systemically important financial institutions. This view has become the consensus assessment over the past year. The moral hazard created by this support can result in costly resource misallocation. We have long argued that addressing this problem requires policymakers to take steps in advance of a financial crisis to reduce the threat of spillovers, recognizing that government cannot eliminate spillovers completely and maintain a vibrant financial sector. Macrostability ratings would facilitate reductions of spillovers in several ways:

1. Provision of the ratings would focus the MS on assessment and management of spillovers. The ratings would help prioritize the activities of the MS in the likely face of significant pressure to take on a wide range of activities, including many traditional safety and soundness operations. The ratings would also require the MS to take on firm-specific activities and operations as opposed to focusing on general pronouncements on overall conditions, potential macro threats to stability and the like, which may not lend themselves as readily to action to reduce spillovers.

2. The need to report on action taken to reduce spillovers would help anchor creditor expectations, put public pressure on the MS to address costly perceptions of the potential for ex post government support and foster transparency in the activities of the MS. Transparency would force the MS to clearly identify those aspects of financial institution activity that pose systemic risk that makes action to address these factors more likely. These desired outcomes might also justify making the ratings themselves public.

3. The macrostability ratings would facilitate pricing of systemic risk/spillover potential through a deposit insurance premium or other tax. We prefer such pricing to "charges" for too-big-to-fail status, but supervisors could also incorporate the rating into the setting of capital charges and other standards applied to systemically important firms. The intent of such direct or indirect pricing, in our minds, is to encourage the financial institution to take steps that reduce systemic risk (e.g., adopting corporate structures that make spillovers less likely).

Response to potential weaknesses/ open questions

1. Some observers have argued that analysts cannot identify the potential for spillovers with material accuracy.[3] If true, the MS will waste resources producing macrostability ratings. While we agree that

our proposal faces real challenges in implementation, we do not find this view compelling. First, we think it runs counter to recent experience. For example, failure simulation exercises conducted by the Federal Deposit Insurance Corp. identified a number of the institutional factors that led policymakers to provide extraordinary support for creditors (e.g., complex legal organizations, overseas operations). The failure in policy arose from the lack of follow-up rather than from identification.

Second, while there has been some analytical work on spillovers, which we just noted, we have seen relatively few resources devoted to spillover identification and response. Claims of an inability to identify spillovers, therefore, rely on intuition rather than actual experience. We do not discount the value of intuition, but given the costs associated with systemic risk, trying a new approach—which also has its roots in our intuition—and reviewing our experience with it seems justified.

Third, alternative approaches to identifying spillovers seem as daunting as the one we recommend. Advocates for enhanced forms of traditional supervision and regulation must justify faith in a process that has failed, in an extreme and systemic way, twice in the past two decades. Moreover, such an approach requires government agencies to effectively determine optimal levels of risk-taking, which seems challenging to say the least.

Finally, rating agencies have long provided plausible assessments of the likelihood that governments will provide support to creditors of systemically important financial institutions, which suggests that the task is not impossible.

2. We have raised the potential of making the rating public. Even if an observer thought there was merit in assessing the potential for spillovers via a rating regime, the observer might object to making that rating public. Publicizing the ratings could make the moral hazard problem worse by clarifying which institutions, if they faced financial/operational difficulties, raise the greatest threat of spillovers. We agree that making the macrostability ratings public could have that effect, which might be an argument against such publication.

Alternatively, the ratings could reduce moral hazard by providing evidence to creditors that they will not receive the support they had anticipated.[4] On the margin, making the ratings public might put pressure on the government to reduce expected support, although our proposal seeks to create that pressure through a statutory/regulatory requirement as well. There is also the question, given the extensive amount of support provided by the government to creditors of systemically important banks over the past two years, of whether publicizing the ratings will actually expand expected support beyond what creditors already anticipate.

Deciding whether to make the ratings public ultimately depends on policymakers' success in otherwise making the potential for ex post government support for creditors ambiguous enough to justify a program of "constructive ambiguity." If creditors see little ambiguity or chance of taking losses, then making the ratings public could help. If policymakers can convince creditors that they have real chances of losses through other means, then identifying the potential for spillovers on a case-by-case basis may actually increase expectations of bailouts.

Summation

Trying to address the too-big-to-fail problem by better managing/mitigating spillovers should be among the highest priorities for policymakers. Directing the macroprudential supervisor to achieve this goal offers one strategy worth following. We have proposed creating and publishing a macrostability rating because we think it would focus the macroprudential supervisor on spillover mitigation and therefore help address the too-big-to-fail problem. R

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Endnotes

[1] Fed Chairman Ben Bernanke defined and provided a context for macroprudential supervision in a recent speech. “Financial stability, however, could be further enhanced by a more explicitly macroprudential approach to financial regulation and supervision in the United States. Macroprudential policies focus on risks to the financial system as a whole. Such risks may be crosscutting, affecting a number of firms and markets, or they may be concentrated in a few key areas. A macroprudential approach would complement and build on the current regulatory and supervisory structure, in which the primary focus is the safety and soundness of individual institutions and markets.” See Ben S. Bernanke, 2009, “Financial Reform to Address Systemic Risk,” March 10. Online at federalreserve.gov under “News & Events.”

[2] For one example, see Tobias Adrian and Markus K. Brunnermeier, 2009, “CoVaR,” Federal Reserve Bank of New York Staff Report 348, May 27. Online at newyorkfed.org under “Research.”

[3] See Alan Greenspan, 2009, “Remarks on ‘Systemic Risk,’” June 3. Online at aei.org/speeches.

[4] A traditional reason for not publicizing supervisory ratings—they focus on the underlying soundness of the institution—would not apply in the case of the macrostability ratings. These ratings have more similarities to the assessments of compliance with the Community Reinvestment Act, which supervisors do make public.