9/30/2020

Comments on “Evaluation of the Effects of Too-Big-To-Fail Reforms” by FSB

To whom it may concern:

I appreciate much this well-written, hard work on summarizing the current status on TBTF reforms. I just have a few comments below. Overall, I think the report could be more valuable if adding a bit more theoretical arguments and their relevance to empirical findings.

First, on the assessment of TBTF subsidy, I felt that the report could clarify better how different are the three (or more) methodologies on estimating the funding cost advantage. For example, IMF’s Global Financial Stability Report (2014), which I contribute as a lead author—by the way, it is mistyped in the bibliography—explains a key difference between the bond-price-difference approach vs theoretical-actual CDS spreads approach, as the latter controls the bank specific factors more perfectly.

Second, more importantly, I think that the report could warn more about the dependency of the funding cost advantage estimates on the macro-financial conditions. A key difference between the CDS approach vs the credit rating approach is to control the financial condition of a bank, which could be rated e.g. B in crisis but rated A in normal times. For the CDS approach or other approaches, a researcher should observe lower funding cost advantages in normal times (i.e., post GFC to pre COVID years), just because the bank becomes healthier. This would not guarantee that the funding cost of that bank remains low when it is suddenly drawn into crisis and back to B rating (by e.g., COVID crisis). Please note that I am not suggesting you to add the credit rating approach (as in Ueda and Weder di Mauro 2013), since it is probably no longer well suited for this type of exercise—I guess the credibility of government support rating has become more questionable partly because of political pressures on rating agencies and also because of uncertainties on resolution schemes.

Third, theoretical arguments, especially that by Chari and Kehoe (2016), could be treated more carefully. Chari and Kehoe (2016) view that bailout is ex post optimal for a government (i.e., politicians who care voters) to reduce the costs of bankruptcy of big banks. In other words, should a tremendously negative shock happen, many authorities might end up pouring public funds into those banks. However, TBTF reforms cannot prohibit such a political decision. Given this view, capital buffer surcharges (CAR and leverage ratio), TLAC (bail in), and resolution schemes could be also explained a bit differently. For example, larger capital buffer could anyway lower the probability of bank failure and crisis; TLAC (bail in) could lower public funds contribution, even if employed; and better resolution schemes could reduce political uncertainty on the size of ex post public funds injection.

Sincerely yours,

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