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Financial firm bankruptcy and systemic risk☆

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ABSTRACT

Financial firm distress often leads to regulatory intervention, such as “too big to fail” (TBTF) policies. Two oft-cited channels to justify TBTF are domino effects (counterparty risk) and the effects of fire sales. We analyze the policy responses for avoiding systemic risk while considering the role of these two factors. Prior bankruptcies suggest that cascades caused by counterparty risk do not occur, as firms diversify their exposures. Instead, crises tend to be symptomatic of common factors in financial firms’ portfolios, which lead to widespread instances of declining asset values and which are often misinterpreted as resulting from fire sales.

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In Fall 2008 when the Federal Reserve and the Treasury injected $85 billion into the insurance behemoth American International Group (AIG), the money lent to AIG went straight to counterparties, and very few funds remained with the insurer. Among the largest recipients was Goldman Sachs, to whom about $12 billion was paid to undo AIG’s credit default swaps (CDSs). The bailout plan focused on repaying the debt by slowly selling off AIG’s assets, with no intention of maintaining jobs or allowing the CDS market to continue to function as before. Thus, the government’s effort to avoid systemic risk

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with AIG was mainly about ensuring that firms with which AIG had done business did not fail as a result. The concerns are obviously greatest vis-a-vis CDSs, of which AIG had over $400 billion contracts outstanding in June 2008.

In contrast, the government was much less enthusiastic about aiding General Motors, presumably because they believed its failure would not cause major macroeconomic repercussions by imposing losses on related firms. This decision is consistent with the view in macroeconomic research that financial firm bankruptcies pose a greater amount of systemic risk than nonfinancial firm bankruptcies. For example, Bordo and Haubrich (2009) conclude that "...more severe financial events are associated with more severe recessions..." Likewise, Bernanke (1983) argues the Great Depression was so severe because of weakness in the banking system that affected the amount of credit available for investment. Bernanke et al. (1999) hypothesize a financial accelerator mechanism, whereby distress in one sector of the economy leads to more precarious balance sheets and tighter credit conditions. This in turn leads to a drop in investment, which is followed by less lending and a widespread downturn. Were shocks to the economy always to come in the form of distress at nonfinancial firms, these authors argue that the business downturns would not be so severe.

We argue instead that the contagious impact of a nonfinancial firm's bankruptcy is expected to be far larger than that of a financial firm like AIG, although neither would be catastrophic to the U.S. economy through counterparty risk channels. This is not to say that an episode of widespread financial distress among our largest banks would not be followed by an especially severe recession, only that such failures would not *cause* a recession or affect the depth of a recession. Rather such bankruptcies are symptomatic of common factors in portfolios that lead to wealth losses regardless of whether any particular firm files for bankruptcy.

Pervasive financial fragility may occur because the failure of one firm leads to the failure of other firms which cascades through the system (e.g., Davis and Lo, 1999; Jarrow and Yu, 2001). Or systemic risk may wreak havoc when a number of financial firms fail simultaneously, as in the Great Depression when more than 9000 banks failed (Benston, 1986). In the former case, the failure of one firm, such as AIG, Lehman Brothers or Bear Stearns, could lead to widespread failure through financial contracts such as CDSs. In the latter case, the fact that so many financial institutions have failed means that both the money supply and the amount of credit in the economy could fall so far as to cause a large drop in economic activity (Friedman and Schwartz, 1971). While a weak financial system could cause a recession, the recession would not arise because one firm was allowed to file bankruptcy. Further, should one or the other firm go bankrupt, the nonfinancial firm would have the greater impact on the economy.

Such extreme real effects that appear to be the result of financial firm fragility have led to a large emphasis on the prevention of systemic risk problems by regulators. Foremost among these policies is "too big to fail" (TBTF), the logic of which is that the failure of a large financial institution will have ramifications for other financial institutions and therefore the risk to the economy would be enormous. TBTF was behind the Fed's decisions to orchestrate the merger of Bear Stearns and J.P. Morgan Chase in 2008, its leadership in the restructuring of bank loans owed by Long Term Capital Management (LTCM), and its decision to prop up AIG. TBTF may be justified if the outcome is prevention of a major downswing in the economy. However, if the systemic risks in these episodes have been exaggerated or the salutary effects of these actions overestimated, then the cost to the efficiency of the capital allocation system may far outweigh any potential benefits from attempting to avoid another Great Depression.

No doubt, no regulator wants to take the chance of standing down while watching over another systemic risk crisis, so we do not have the ability to examine empirically what happens to the economy when regulators back off. There are very few instances in the modern history of the U.S. where regulators allowed the bankruptcy of a major financial firm. Most recently, we can point to the bankruptcy of Lehman, which the Fed pointedly allowed to fail. However, with only one obvious case where TBTF was abandoned, we have only an inkling of how TBTF policy affects systemic risk. Moreover, at the same time that Lehman failed, the Fed was intervening in the commercial paper market and aiding money market mutual funds while AIG was downgraded and subsequently bailed out. In addition, the Federal Reserve and the Treasury were scaremongering about the prospects of a second Great Depression to make the passage of TARP more likely. Thus we will never know if the market downturn that followed

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