



Discussion of COLLECTIVE MORAL HAZARD, MATURITY MISMATCH AND SYSTEMIC BAILOUTS

by

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Contribution

- So far microeconomics of moral hazard: how a *single* financial institution responds to the possibility of being bailed out;
- Here the macroeconomics of moral hazard: incentives to take up (correlated) risk by *all institutions* when chances of generalized and unconditional bailing out policies become more likely=> triggers strategic complementarities
- “It is unwise to play safely when everyone else is gambling”
 - If you do not gamble when all do you lose the upside



Interesting parallel

- By the same argument, it is unwise to play honestly when everyone else is cheating
- If you do not cheat while all do, you miss the upside
- If you cheat when all do there is no downside
- Why? Not because there is not enough space in jail
- But because we need banks!
- ..and thus we need bankers
- Hence, if all cheat there must be a general pardon (=bail out)



Implications

- **Policy implications :**
 - Provides a rationale for macro-prudential supervision
- => impose minimum liquidity requirements across the board
- => heterogeneity matters: stronger requirements for larger and “connected” banks





Question

- Is this a model of the past? That is, does it explain behaviour prior to the crisis?

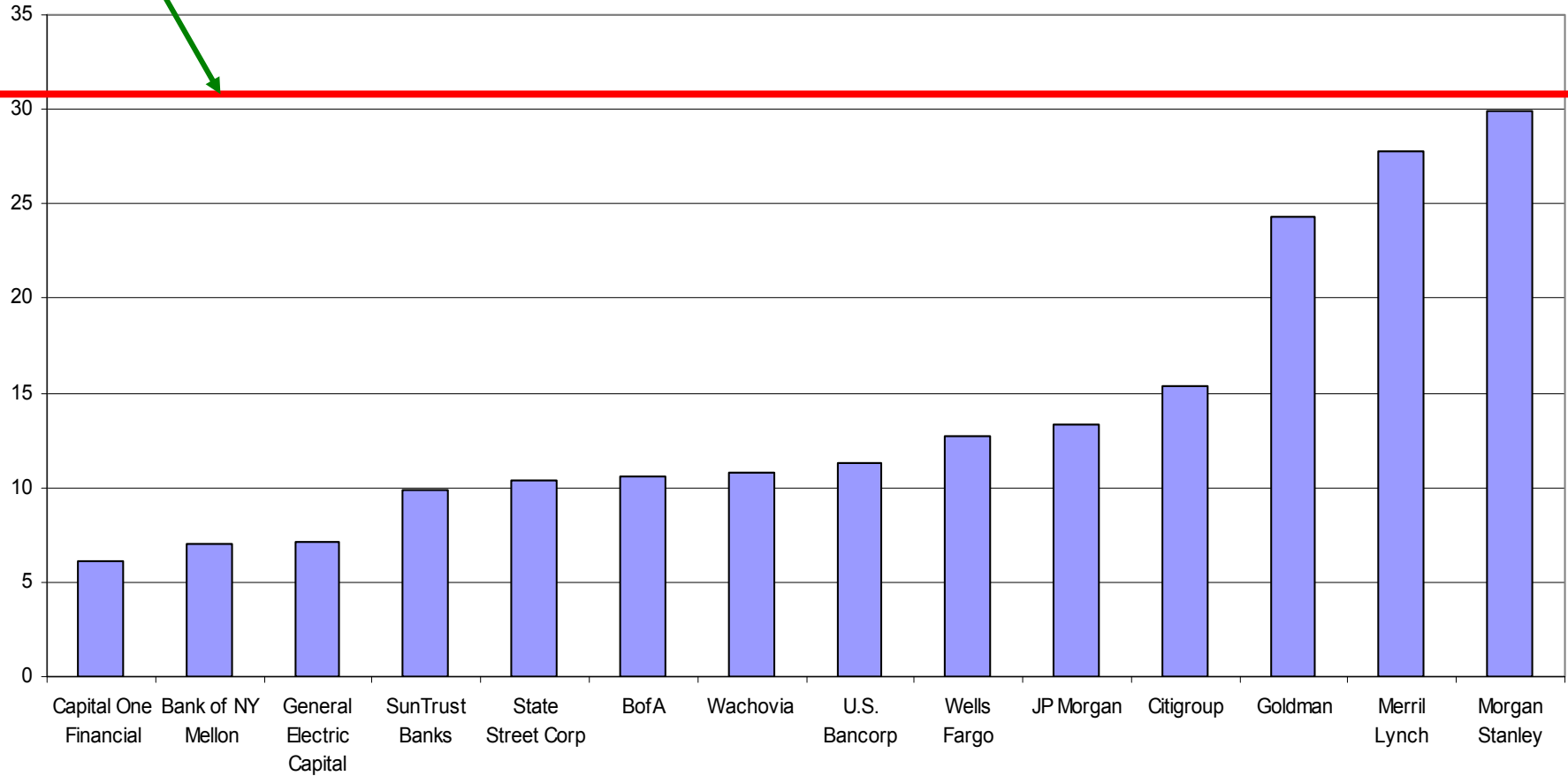
Try “test” implications (very roughly) :

- **Implication 1:** If CB more “captured” banks should be more leveraged and hold less liquidity :
 - Compare US/versus Europe: FED probably more captured than ECB:
 - financial stability is part of the main task of the FED
 - ECB has price stability as main target: financial stability not mentioned;
 - banks closer to regulators in the US
 - Separation of ECB from governments also separated it from banks
 - consistent with wider variation in interest rates in US
 - Model => US banks more leveraged than EU banks



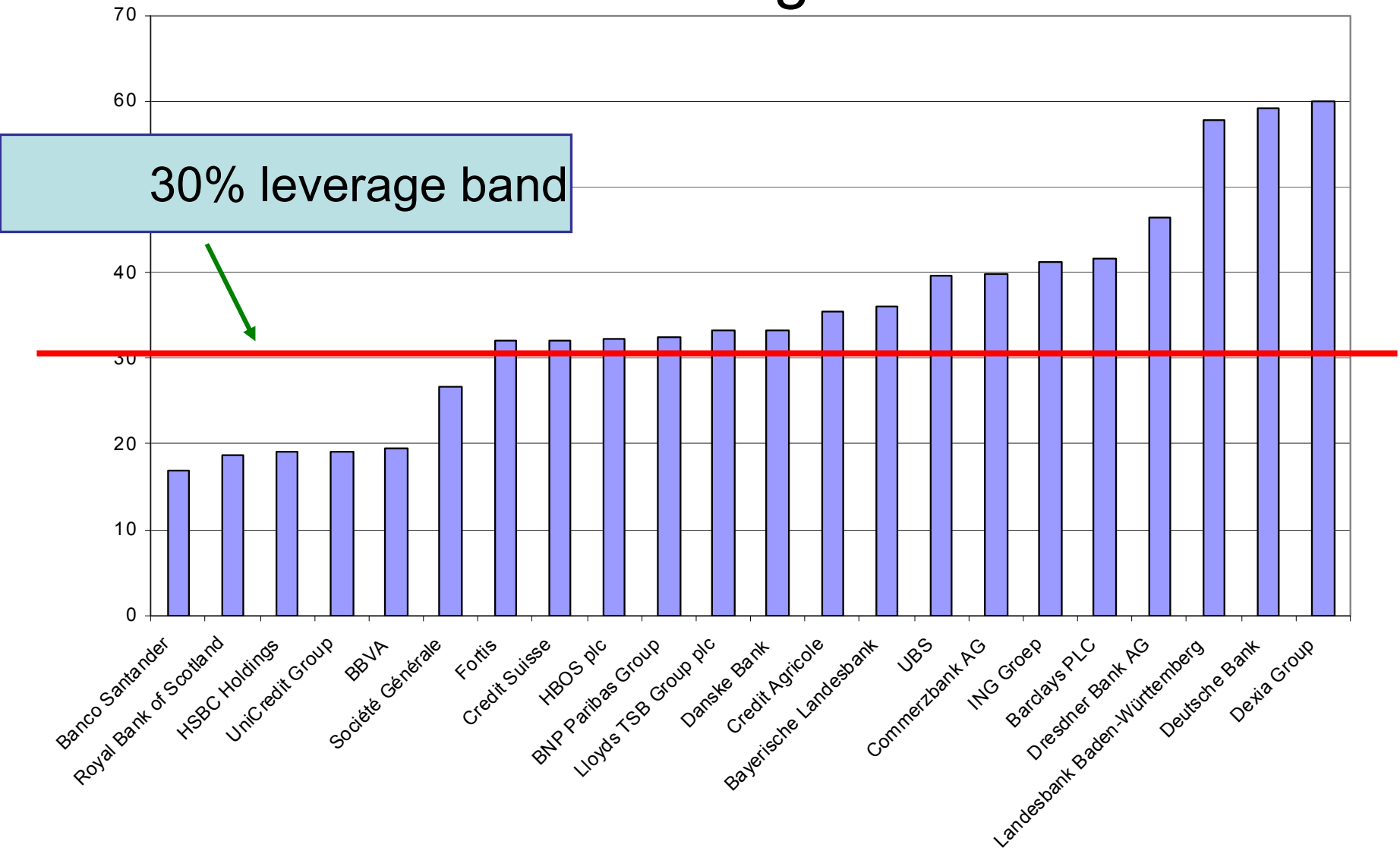
30% leverage band

US banks: Leverage



EU banks leverage

EU banks *more* leveraged than US banks



Implication 2

- **Implication 2:** Risk taking and higher leverage more likely when chances of a crisis higher
 - seems **inconsistent with great moderation**: large increase in leverage before the crisis but chances of crisis were perceived as small



Rephrasing

- Put differently, model assigns a critical role to lack of MP commitment in banks incentives to raise leverage and restrict liquidity
- But this feature has been around for many years
- **Why it has become more important now?**
- Did we just missed it and wrongly focused (only) on central banks lack of commitment vis-à-vis government debt monetization?
- What has changed that has made this issue more important?



Possible story

- Because of huge wave of mergers and acquisitions in banking, industry has become much more concentrated raising Central bank capture
- =>, i.e. β and A (bank size) have gone up and this has increased the scope for strategic complementarity:
 - **Implications** => leverage and liquidity should follow the same patten as mergers
 - Liquidity of larger banks should drop more than that of smaller banks
 - Because of strategic complementary also the liquidity of smaller banks should decrease (and leverage go up)

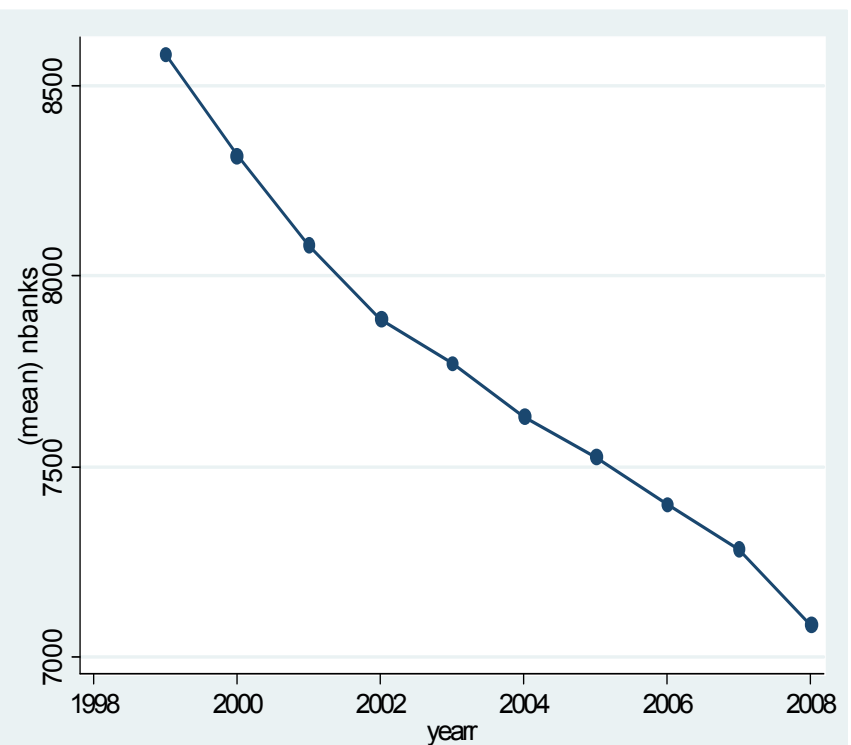


liquidity drops as number of banks declines

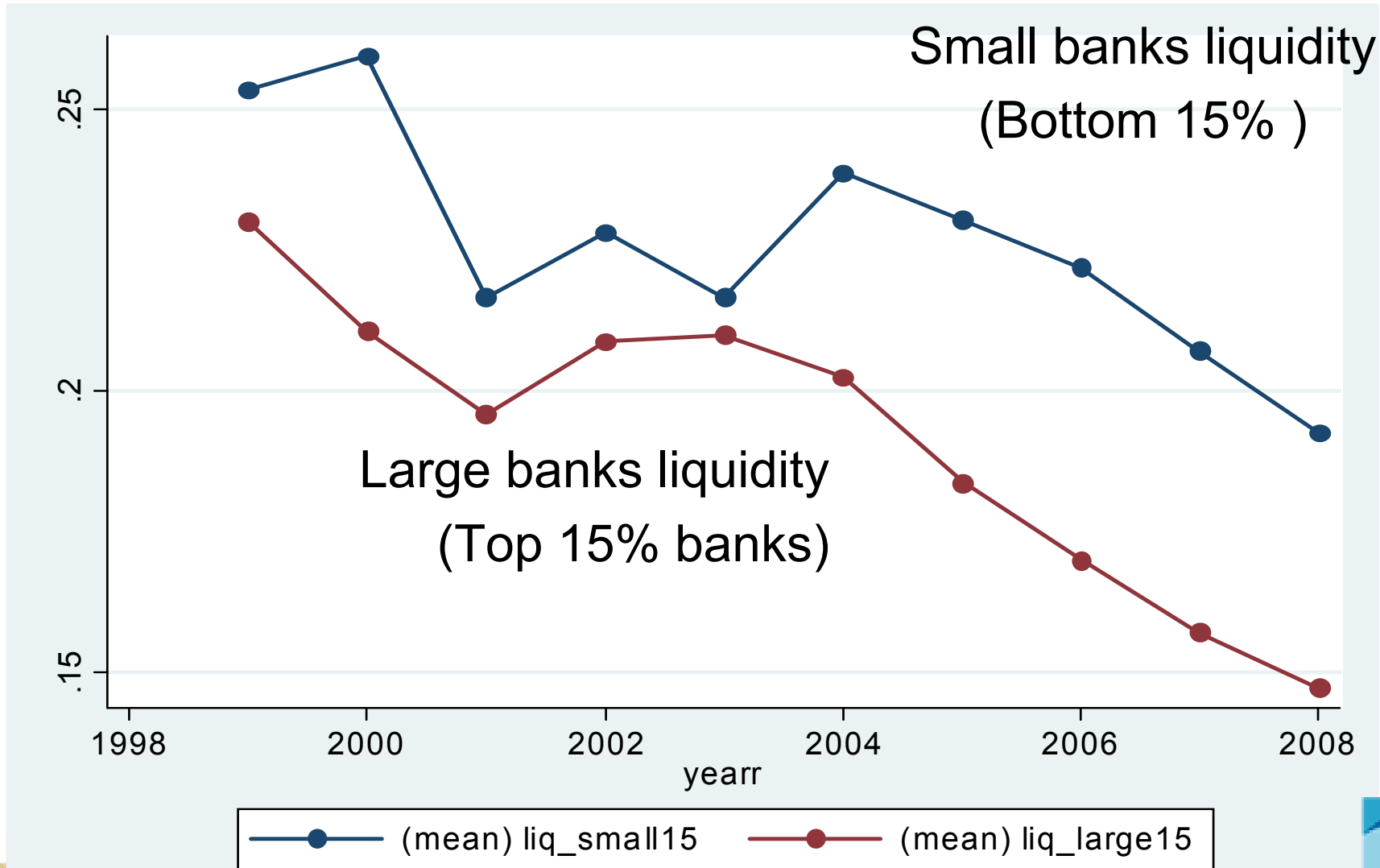
Median US bank liquidity ratio



N. of banks in the US



Large banks liquidity drops faster than small banks liquidity. But the latter also drops



Is this a model for the future?

- Crisis has brought important news
 - It has revealed that ECB and FED similar
 - Reversal in beliefs about crisis: the end of the great moderation?
 - Then the model can be seen as picturing the consequences for the future of the huge inherited moral hazard if nothing is done
 - The suggested policies in the form of minimum liquidity ratios would a be way out

Extension

- Model is a one country model, perhaps more inspired by the US than the EU case
- Proposed regulatory reforms refer to this single country.
- In practice we see lots of attempts to provide some common regulatory frameworks (this is what the Financial Stability Board and G20 has been doing).
- Extending the model to incorporate international linkages and across countries heterogeneity could shed light on the implications for coordination in regulation design



Conclusion

- Whatever the view about the paper this is an excellent contribution
- Provides a very useful conceptual framework for thinking about:
 1. why we may need macro prudential regulation
 2. How it could be designed



Is this a model for the future?

- Alternative: view this as a model of the future
 - The crisis has revealed that contrary to what was believed the probability of a crisis is far from negligible
 - Even more importantly it has revealed that central banks are not all that “tough” and that ECB and FED are similar
 - This leaves us with a huge inherited (collective) moral hazard
 - The model can then be seen as picturing what the future would look like if nothing is done
 - and what regulatory policies suggests : The suggested policies in the form of minimum liquidity ratios would a be way out

