INCREASE in Systemic Risk or Bank Bailouts

Eighteen global banks agree not to terminate derivative contracts when regulators seize their failing bank counterparty. Is that a bad idea? (Suggested sub-title / deck)

ISDA (the *International Swaps and Derivatives Association*) reports that eighteen large global banks have agreed not to terminate derivatives transactions when regulators seize the bank counterparty with the goal of "resolving" the failing institution. Both the ISDA announcement and another news article claim that this agreement will "reduce systemic risk." The FSB (*Financial Stability Board*) had requested this accommodation in the September Consultative Document "Cross-border recognition of resolution action."

What about the *healthy* banks?

But what about derivatives risk management for the *healthy* banks that are counterparties to the failing bank?! Termination of derivative trades *before* failure has been a standard tenet of risk management for decades. See, for example, this BIS (*Bank for International Settlements*) 1994 document "Risk management guidelines for derivatives" that explicitly discusses early termination. On its face, this new FSB-ISDA opposition to early termination drastically increases risk to the healthy banks in the name of assisting resolution of the failing bank.

The risk to a healthy bank in a derivative trade with the failing bank is that the former cannot know if the latter will ultimately perform on the derivative hedge or not. If the failing bank does default on the trade, the healthy bank will have an unhedged risk position and will lose some or all of the positive value of the trade. The healthy bank cannot hedge its risk with another derivative counterparty as long as the original trade remains in place. Given the critical importance of hedging to bank operations and stability, this hedge uncertainty to a large global counterparty is a huge threat to safety and soundness. Systemic risk *increases* due to this hobbling of risk management at healthy banks.

One may sympathize with the dilemma of the regulators

If one believes that a proper role of regulators and governments is to control the resolution or liquidation of large financial institutions, then the FSB-ISDA initiative has its merits. It would likely be easier to "save" a failing bank if it has all hedge (derivative) agreements in place. Just as we noted above for healthy banks, evaporation of derivative trades would leave the failing bank with ruinous open risk positions.

The FSB resolution plan appears to be to transfer some debt, some assets, and all derivatives to a "good bank" and leave distressed assets, shareholders, and bailed-in creditors in the "bad bank." In this positive scenario, the healthy bank derivative counterparties would find themselves facing the "good bank" such that, in the end, they would have suffered no harm. But there are too many assumptions here. First, the bank resolution may fail. Second, it is unreasonable to project that *all* derivative trades should go to the "good bank." Since some assets and debt will remain in the "bad bank," there should certainly be "bad bank" derivatives as well.

Perhaps the goal is to guarantee the derivative trades?

The FSB and ISDA do not state or hint that governments will guarantee the performance of the derivative trades as the *quid pro quo* for the agreement of the healthy banks not to terminate upon regulator seizure. But this is our conjecture. Otherwise, it is all too clear that the FSB-ISDA removal of early termination merely aids one weak bank – which likely *deserves* to fail – at the risk to and expense of the entire banking system. Surely the FSB would be averse to *increasing* systemic risk. Thus, our *ansatz* that governments will guarantee derivative performance rings true. Perhaps the regulators will simply squeeze bailed-in creditors to whatever degree is necessary to honor derivative contracts.

The irony splashes all around us! Once again, we find ourselves witnesses to governments bailing out and protecting the banks! The plan appears to be that regulators will protect the bank counterparties. At risk of raising a past controversy without room to dissect the details, this is AIG all over again! AIG the insurance company would have withstood the failure of

AIG FP (the "financial products" affiliated entity). The true AIG FP bailout beneficiaries were the bank counterparties.

Returning to more sober considerations, our conjecture implies that the FSB-ISDA plan gives higher priority of repayment to derivative liabilities than to senior debt liabilities. Derivatives and senior debt are currently *pari passu*. We remain unconvinced that derivatives merit such super-priority.

What about CCPs?

We wonder how the FSB-ISDA gutting of early termination impacts CCPs (central counterparty clearing facilities). The failing bank subject to regulatory resolution might be a counterparty to the CCP or a *member* of the CCP or even the CCP itself. In any of these cases, forcing a prolonged period of hedge uncertainty on all other presumably healthy parties would be chaotic.

(The author acknowledges numerous helpful conversations with Ce Shi, a graduate of the Quantitative Finance and Risk Analytics Master's program at the Lally School of Management of the *Rensselaer Polytechnic Institute*. Mr. Shi is now a candidate for a Master's in Applied Mathematics at *Rensselaer*.)

Joe Pimbley, FRM is a financial consultant in his role as Principal of Maxwell Consulting, LLC. His expertise includes enterprise risk management, structured products, derivatives, investment underwriting, training, and quantitative modeling. Joe is co-author of "Banking on Failure – Fixing the Fiasco of Junk Banks, Government Bailouts, and Fiat Money."