Vulnerable Banks

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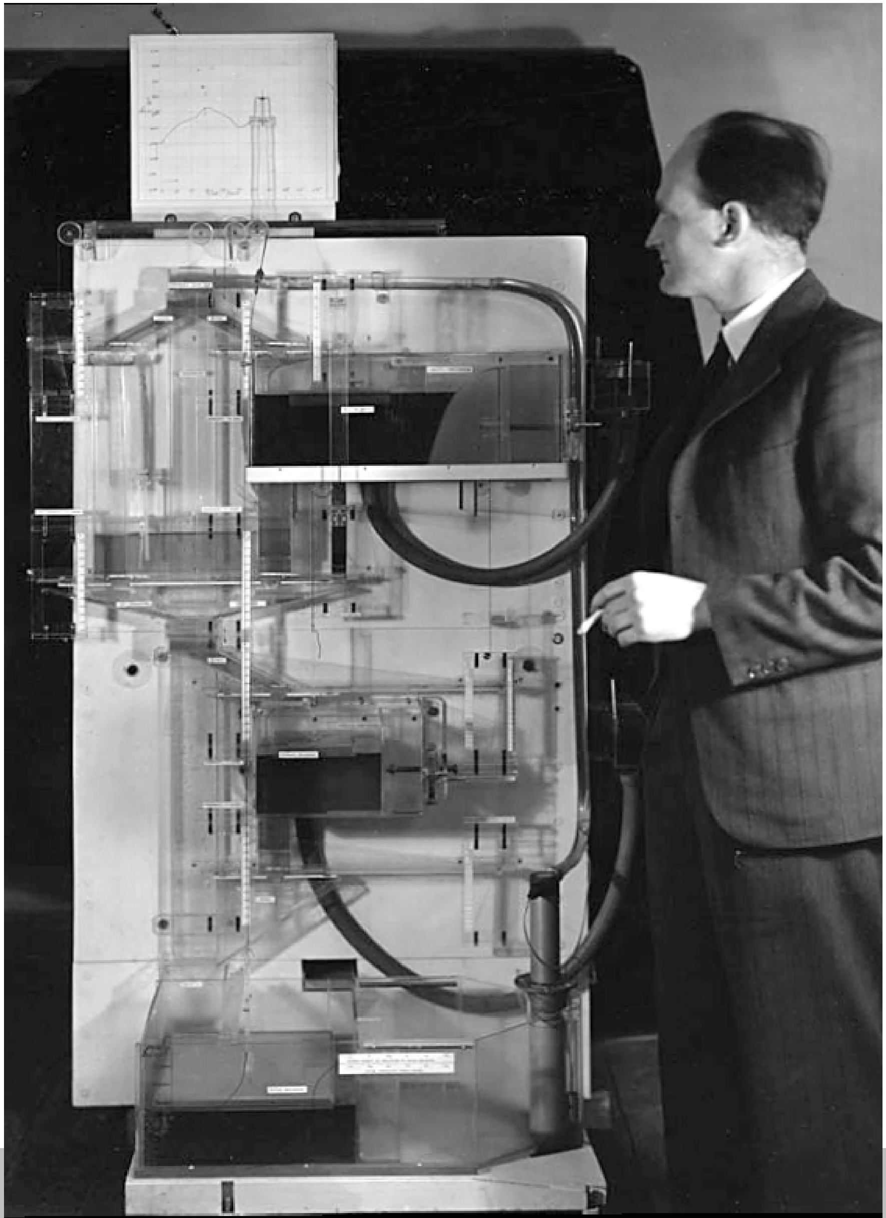
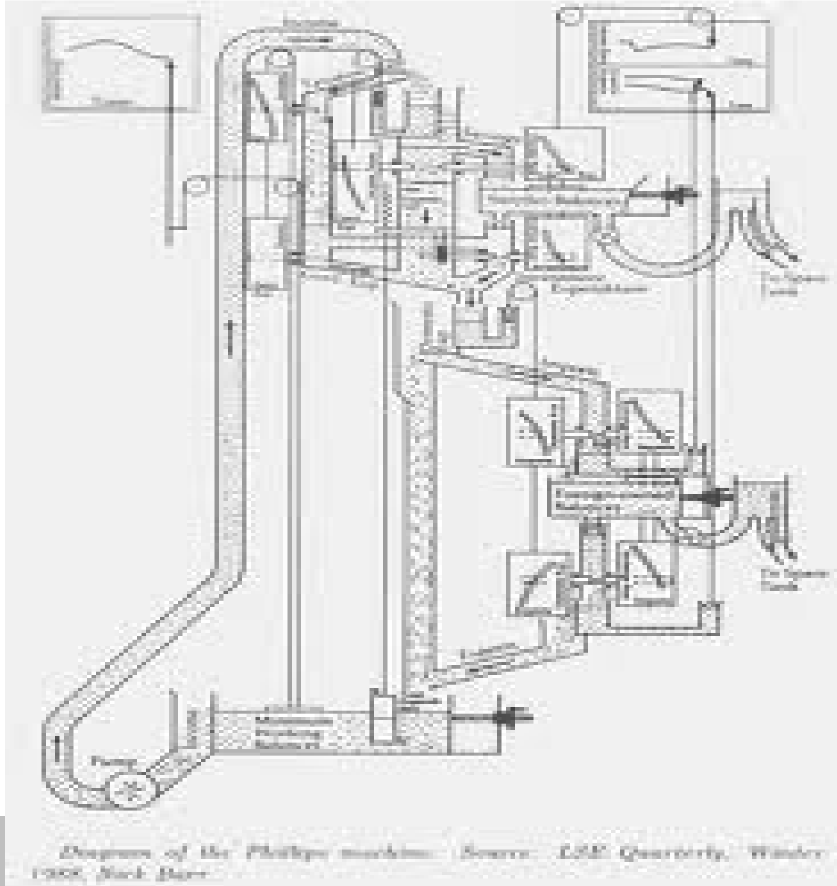
Hydraulic models: An ancient tradition in economics



Phillips with his analog computer. Each tank represented some aspect of the UK Economy and the flow of money around the economy was illustrated by coloured water. At the top of the board was a large tank called the treasury. Water flowed from the treasury to other tanks representing the various ways in which a country could spend its money.



Systemic Risk

- Goal: measuring systemic risk with model that can be brought to the data.
  - Two kinds of **linkages**:
    - **Inter-bank** contracts → *rare data (yet), lots of papers*
    - **Deleveraging externalities**: → *this paper*

- What we do:
  - **Quasi-structural, extremely stylized, model of liquidation spirals**
  - **Estimation on actual data:**
    - European banks & sovereign risk
    - To measure systemic risk & make policy experiments

- Why focus on deleveraging externalities?
  - Less empirical studies
  - We have data
  - Rise of shadow banks

Intuition: 2 Banks & 2 Assets

BANK 1

Assets	Liabilities
Italian bonds =40 bn	E = 10bn
Spanish bonds = 10 bn	D = 90bn

BANK 2

Assets	Liabilities
Spanish bonds = 50 bn	E = 10bn
	D = 90bn

Leverage = D/E = 9

Intuition: 2 Banks & 2 Assets

10% haircut on Italy

BANK 1

Italian bonds =40-4 = 36 bn	E = 10-4 =6bn
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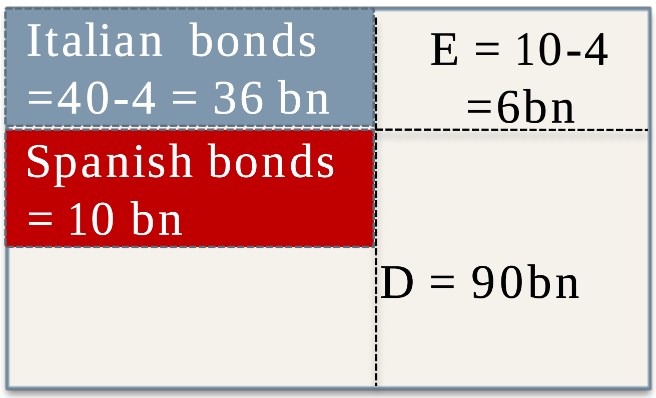

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→ ***Price impact on Spanish Bonds :***
λ x 3.75bn = 10e-13 x 3.75bn = 37.5bp

Intuition: 2 Banks & 2 Assets

10% loss on Italy

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Italian bonds =40 bn	E = 10bn
Spanish bonds = 10 bn	D = 90bn

3.75% loss on Spanish bonds
(liquidation impact)

Indirect contamination of Bank 2

BANK 2

Spanish bonds = 50 bn	E = 10bn
	D = 90bn

Loss on Spain = 3.75% x 50bn = 1.9 Bn
= 19% of equity

Assumptions Needed

- **What *amount* of assets do banks liquidate following shock?**
  - We assume they liquidate some assets to keep leverage constant
    - No equity issuance
- **In what *proportions* do they liquidate assets?**
  - We assume they liquidate in proportion of existing holdings
    - Keep assets' weighting unchanged
- **Price impact of fire sales?**
  - Assume exogenous Price-Impact ratios:
    - returns proportional to dollar sale (e.g. Amihud ratios)
- *(Model is flexible enough to accommodate more complex rules)*

Three steps

Step #1: From asset shocks to banks dollar losses

Step #2: From bank dollar losses to asset sales

Step #3: From asset sales to banks' assets

Three steps

Step #1: From asset shocks to banks dollar losses

$\$$ bank Losses$_t$ = - A x M x F$_t$

Step #2: From bank dollar losses to $ asset sales

$\$$ Asset sales = M' x B x $\$$ bank losses$_t$

(**B** = Leverage)

Step #3: From asset sales to banks' returns

Bank returns$_{t+1}$ = - M x L x $\$$ Asset sales

Portfolio weights

Diagonal matrix of liquidity factors (amihud)

What this framework delivers

Empirical measures of how much:

- 1 bank can be hurt by shock ("***Direct Vulnerability***")
- 1 bank can be hurt by others ("***Indirect Vulnerability***")
- 1 bank can hurt the others ("***Systemicness***")
- 2 banks are connected ("***Cross vulnerability***")
- Overall system is vulnerable ("***Aggregate vulnerability***")

Can perform policy counterfactuals:

- Systemic risk impact of Bank mergers?
- What happens if we cap size or leverage?

Literature and background: measuring structural risk

- Measuring bank default probability with CDS spreads
  - CDS spread contains counterparty risk → bank default probability
  - Ang and Longstaff (2010), Giglio (2011)
- Correlation of stock returns
  - When it is high, portfolios are very similar
    - Billio, Getmansky, Lo, Pelizzon (2010)
  - Bank return conditional on market crash
    - Acharya et al (2011) = vulnerability in our model
  - Market return conditional on bank crash
    - Adrian and Brunnermeier (2011) = systemicness in our model
- Fast growing literature on direct interconnectedness
- Our paper: Structural model
    - Focuses on deleveraging externalities
    - Uses simplified economic behavior
    - Uses data on these behaviors instead of market price movements

Combining the 3 steps

- From bank shock to each Bank

$$R_{t+1} = -M \times L \times (M'B) \times (A x M x F_f) = (MLM'BAM) \times F_t$$

price impact On assets

Deleveraging rule

Initial $ Shock to bank Assets

→ We focus only on 1-period dynamics:

Shock → deleveraging → bank returns

What we can measure

- R = (MLM’BAM) x F

- **“Indirect Vulnerability” of bank n** = nth element of (AMLM’BAM) x F
  - Normalize by bank n equity
  - Careful: different from “direct vulnerability” AMF

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- "Systemicness" **of bank n** = 1'x(MLM'BAδ_nM) x F
  - Normalize by aggregate bank equity
  - where 1 = vector of ones & δ_n =matrix of zeros with only (n,n) element=1
  - Different from indirect vulnerability
  - Big if n is levered, owns same assets as others, is big, is exposed

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- **"Aggregate systemicness"** = 1'x(AMLM'BAM) x F
  - Sum of individual banks' "systemicnesses"

Systemicness: decomposition

Connectedness x Size X Leverage X Direct Exposure

$$S(n) = \gamma_n \times \left(\frac{a_n}{E_1} \right) \times b_n \times r_{n1},$$

Size

Leverage

Direct Exposure

Connectedness

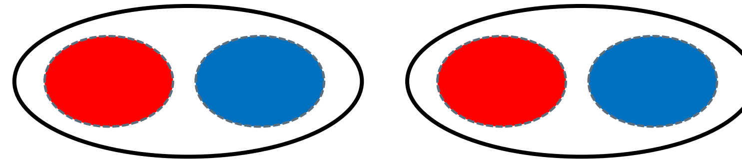
$$\gamma_n = \sum_k \left(\sum_m a_m m_{mk} \right) l_k m_{nk}$$

Bank holds illiquid assets that are held in large quantities by others

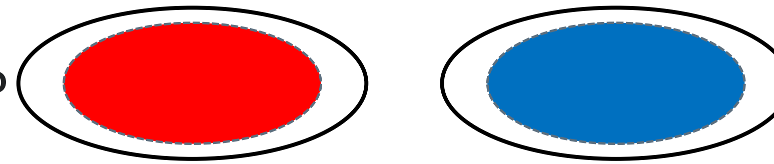
Some Intuition: Diversification can be bad

- Assume: 2 banks, identical leverage and 2 assets
- Which is best for "aggregate systemicness"?

  - Both banks have identical portfolios?



  - Or each bank owns 100% of one asset ?

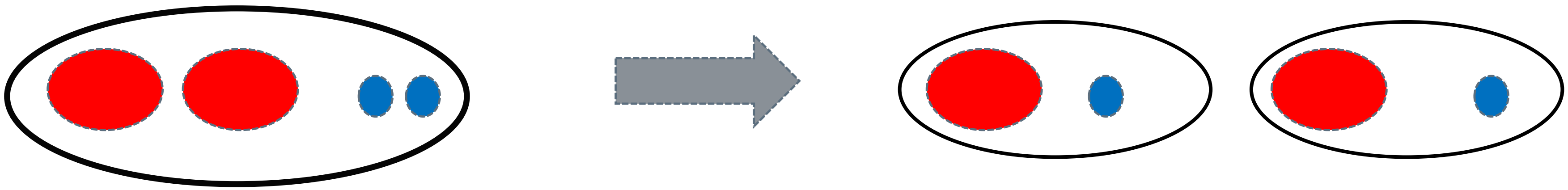


- **Two opposing effects:** Spreading **volatile** asset across banks
  → less average dollar liquidations of that asset
  …But now some of the other asset will get liquidated

→Diversification good when **stable** assets is the most liquid

Some Intuition: Too big to Fail ?

- **Cut a bank into 2 banks of *similar asset weights and leverage*:**



- **Effect of "slicing" bank on "Aggregate Systemicness": NONE**

  - Two opposite forces: too big to fail vs too many to fail
  - formally: the model is scale-free, a by-product of the price impact equation ($ → returns)

Some Intuition: Mergers

- **Merge 2 banks:**

  - *Heterogeneous assets and leverage*

- **2 effects :**
  - **Portfolio effect →** stabilizing if most **stable** asset is liquid
  - **Leverage effect →** stabilizing if most levered bank holds more illiquid asset

European Banks

- **M** matrix (portfolio weights)
  - EBA stress tests data (90 largest banks in the EU27; july 2011)
    - Sovereigns, per country
    - Mortgages, commercial real estate, corporate loans, retail SMEs, consumer loans
    - **Sovereigns=13% total assets**

- **B (leverages), A ($ sizes)** from Datastream
  - Use book leverage (→Can include private banks)

- Shock vector **F**
  - 50% write-down on the 5 GIIPS

- **L** = (10e-13) Id : Identical liquidity of all assets
  - 10 bn dollar trading → 10 bp return impact

Policy Interventions

- Size cap (€ 500, € 900, € 1300 bn)
  - Bad: contaminates smaller banks
- Debt re-nationalization
  - Good: because GIIPS banks are less levered in our sample
- Merge banks most directly exposed to shock
  - Nothing: our model is scale-free (no ring-fencing effect)
- "Euro-Bond": mix all euro sovereign debt and re-distribute according to initial total sovereign exposure
  - Bad: increases exposure to GIIPS debt of non GIIPS bank (contamination)
- Cap leverage
  - Good: but requires massive rebalancing: 480bn euros to cap leverage @ 15

Optimal Equity Injections

- Suppose we had **X** billion of euros to distribute in equity to banks, in an effort to stabilize system
  - Constraint: we can't take equity from healthy banks
- How would we distribute this capital?

- Optimal injection in given bank strongly correlated with its systemicness

Conclusion

- **Simple framework**
  - Yields several measures and insights about fragility
- **Key contributions** (relative to other measures):
  - Quasi-structural but highly tractable
  - Isolating specific mechanism (fire sale contagion)
  - Able to perform policy experiments
  - Plasticity:
    - Can plug-in more complex liquidation rules
    - Possibility to estimate M matrix from stock returns
- **Limitations & areas for future work**
  - Build in bank optimization problem
- **Regulation**: through liquidation constraints?