Credit Insurance, Bailout and Systemic Risk

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Overview

- Very nice paper, legibly written and easy to follow.
- A very important question: how do systemic risks build up in the financial system?
  - Severe build ups can lead to large asset bubble bursts
  - In a panic, solvent banks can suffer insolvency
  - Recent example: AIG in 2008 Facts
- **Key contribution**: show a novel channel
  - *Expectation* of bailout of a *large* insurer can lead to *ex-ante* coordination of bank investments
  - Given the expectation of bailout, the results are endogenous in the model
- **Key policy takeaway**:
  - Curtail the size of insurers

Anatomy of Systemic Risk Creation

<u>Assume</u>: if the insurer is insolvent, banks expect it to be bailed out.

In anticipation,

- Every bank wants asset that performs poorly when insurer is bailed out $\implies$ bank "herding"
- Banks insure only against shocks in good time $\implies$ under priced insurance contracts
- Herding creates aggregate risk

When there is an aggregate shock,

- Many banks' assets underperform at the same time
- Underpriced insurance $\implies$ premium does not cover payouts to banks $\implies$ insurer progresses towards insolvency
- Regulator bails out the insurer, it is the best *ex post* policy

The circle is complete

Comments

Differences compared to Acharya and Yorulmazer (2007)

In AY 2007, regulator is forced to bailout banks.

- Source of moral hazard

Best ex-post policy: make solvent banks buy insolvent ones.

- Regulator can identify solvent and insolvent banks
- Increases value (for banks) of staying solvent ex-ante

In this paper, insurer's insolvency generates run on *all* counterparty banks.
Regulator can not distinguish between solvent and insolvent banks.

Causes of Bank Herding

Ex-post insurer bailout
This paper

Monetary policy
Farhi and Tirole (2012)

Ex-post bank bailout
Acharya and Yorulmazer (2007)

Limited liability and cross-bank externalities
Acharya (2009), Acharya and Yorulmazer (2008)

Reputation concerns
Rajan (1994)

Comments

Some numbers on how important this channel is will be helpful.

- Compare with bank bailouts, bank sizes

Are bailouts always optimal during fire sales?

- Regulators made profits after normal conditions returned?

In the spirit of this conference, any comments on how relevant is the paper in the context of India, or broadly in South Asia?

AIG Bailout - A Summary of Facts

- AIG had insurance and debt contracts across the globe
- Over $1 trillion in assets prior to crisis
- Written CDSs on over $500 billion worth of assets ($78 billions of CDOs)
- CDSs a major player in the collapse; $30 billion losses due to CDSs
- Second major contributor was securities lending causing $21 billion in losses
- Sep-Dec 2008: Federal Reserve assisted with over $100 billion in loans and liquidity

Catch: Loan was paid back in full in 2013; Fed made a nominal profit of $23 billion with stock sales.

Sources: McDonal and Paulson (JEP 2014): "AIG in Hindsight"

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