

Really too big to fail?

Are bulge-bracket investment banks really too big to be allowed to fail? Despite the upheavals such a failure would cause, the consequences may have been overblown, argues David Rowe

The weekend of March 15–16 culminated in the dramatic bid for Bear Stearns by JP Morgan. In the aftermath of this stunning development, there has been much talk about the disastrous consequences that were avoided. It is clear the psychological consequences of such a failure would have compounded an already fragile liquidity problem. For this reason alone, the US Federal Reserve was well advised to seek a resolution that allowed the business of Bear Stearns to continue. In less fraught market conditions, however, the direct impact of a large investment bank failure can easily be overstated.

The reason most frequently cited as to why Bear Stearns could not be allowed to fail was that it was too entangled with the rest of the financial industry through its large book of derivatives. Sorting this out, it is said, would have led to prolonged uncertainty and the likely failure of other institutions. At the risk of sounding like a careless Pollyanna, I think this aspect of a major investment bank failure would be less serious than has been portrayed.

Having harped on about counterparty credit risk management for more than 15 years, it is somewhat gratifying to hear the words on the lips of bank chief executives, central bankers and even humble US senators. Unfortunately, I fear many now expressing such concern about counterparty risk have limited knowledge or understanding of how it works down in the trenches. Sometimes the subject is needlessly obscured, through ignorance or malice, by focusing on gross notional amounts of derivatives outstanding. Such gigantic notional amounts can certainly feed the ever-present appetite for journalistic sensationalism, but they greatly distort the true magnitude of the problem.

First, all derivatives transactions involve two-way flows. The market value of the transaction only reflects the mismatch in value between the two opposing flows. In some cases, such as credit default swaps, a small certain flow is offset by a large but highly unlikely counterflow. In any large market-maker's book, however, there are many offsetting trades that result in a small net open

exposure. If this were not so, the daily profit and loss swings would be far larger than we actually observe.

Second, every market-maker tracks its current and potential future exposure to individual counterparties. I have argued that this process has not received the full attention it deserves over the years, but the basics are in place everywhere. The counterparties of Bear Stearns knew how much they were owed and would have been able to close out their bilateral positions in short order. In some cases, dealers would have owed money to Bear Stearns. They would have replaced their trades at a net profit that would have been held in escrow pending transmission to Bear Stearns' bankruptcy trustee.

This leaves open the question of the sudden market risk imbalances that would have been created by these bilateral close-outs. There is no doubt this would have led to a surge in volume as firms rushed to eliminate unwanted market risk by offsetting these imbalances. The key point to remember, however, is that Bear Stearns' open positions would have been a small fraction of their gross notional outstanding amounts. Moreover, these small open positions correspond to the total market imbalance created by the positions being closed out. While the gross volume of new trades needed to re-establish acceptable market risk for Bear Stearns' counterparties would have been substantial, the gross demand and supply would have been roughly in balance. There is no reason to expect a major shift in prices for the underlying positions from a significant excess of demand over supply, or vice versa.

In the currently fragile state of market liquidity, the Fed was wise to intervene as it did. The modest risk it assumed to facilitate the acquisition of Bear Stearns by JP Morgan was a sensible price to pay to avoid worsening already shaky market liquidity. Indeed, if Bear Stearns had failed, the Fed would almost certainly have had to lend far greater sums to provide the liquidity needed to prevent another seizing up of the interbank money market.

None of this, however, should imply that a large investment bank cannot be allowed to fail in more normal times. Enron was a large and diverse player in derivatives markets and its failure was handled with comparatively little damage to the general economy.¹ There is no reason to believe that, without today's skittish psychological environment, the failure of a large investment bank would have any worse consequences. ■

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¹ See Rowe D, *Enron and systemic risk*, Risk January 2002, page 110