How Big Banks Fail and What to Do about It

Darrell Duffie
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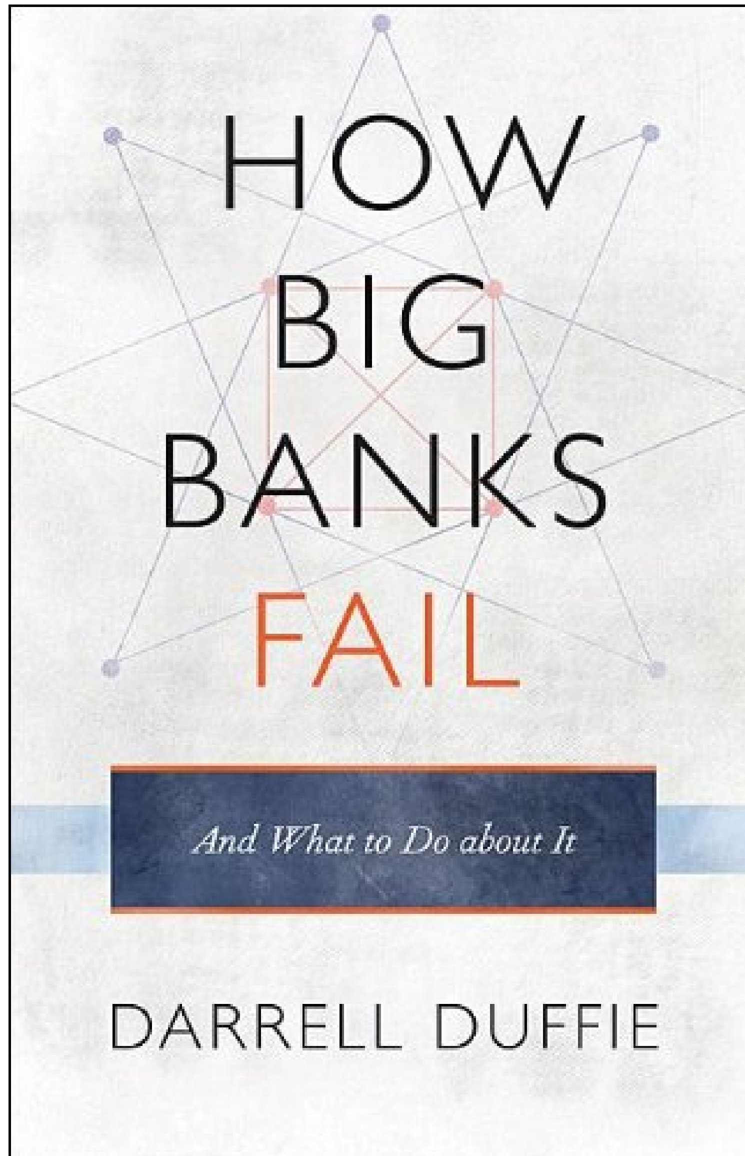

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Darrell Duffie : How Big Banks Fail and What to Do about It before purchasing it in order to gage whether or not it would be worth my time, and all praised How Big Banks Fail and What to Do about It:

13 of 13 people found the following review helpful. An important book for resolving large banks in futureBy Viral AcharyaThis book tackles a highly important theme facing regulation of large, complex financial institutions (LCFI's). Darrell Duffie is one of the leading scholars in institutions and markets in which these institutions participate, and which often render their bankruptcy resolution difficult. The combination of the topical theme and the scholarly work and thinking that Professor Duffie brings to the table make this book a great read. It is also likely to an influential

manuscript as regulators the world over grapple with developing a credible resolution authority for orderly liquidation of LCFI's.In the academic literature on bank and bank failures, a bank simply fails or it does not fail. When it fails, it is either liquidated at a cost or it is bailed out by regulators. In some cases, there is the issuance of equity possible at time of liquidation but by and large it is ruled out based on arguments that equity issuance is very costly. The liquidation point is also assumed to be reached suddenly and abruptly. As a result, this literature is somewhat distant from the actual realities and complexities of how banks fail, what is the set of chain reactions that arises, why certain types of banks (such as broker-dealers) fail so swiftly, and why it is so hard to restructure them. For instance, it is often assumed that renegotiation of debt in models is infeasible or fully feasible (as it is with a monolithic creditor). But when one talks about banks, there are all kinds of counterparties involved with different bankruptcy exemptions. The stage is thus set right for someone to lay at the outset what the issues are in some detail, and what the possible solutions might be.The book fills this important gap and in a manner that should interest not just academics but practitioners and policy-makers alike.I liked in particular the following aspects of the book:1. The beginning of the book with a simple case and narrative of how a large dealer bank may fail. The book breaks free from traditional banking views and clarifies at the outset that it is concerned with practical issues affecting failures of large, complex financial institutions.2. The focus on unconventional regulatory mechanisms that deal precisely with the recapitalization of distressed institutions close to - but sufficiently before - distress is realized. Mandatory debt-for-equity conversions and forced deep-discount rights issues are examples of these mechanisms, justified in a cogent way and explained with a lucid exposition style.3. The recognition that these mechanisms may not in all cases get triggered sufficiently in advance, or in the end be inadequate, and that therefore, prudential mechanisms are needed in good times to reduce the likelihood of distress and losses in some other ways. Centralized clearing of derivatives and greater liquidity requirements from dealers are examples of mechanisms proposed by the book to deal with these issues.4. Throughout the book, there are nice examples, graphs illustrating size of certain markets that have grown significantly, and simple schematics that help understand technical market-specific concepts. They help streamline the discussion significantly.Overall, I recommend the book highly. It is pithy, highly effective and on the central issue facing financial sector reforms today.3 of 4 people found the following review helpful. A Forensic Analysis of Bank FailuresBy E. AmerioIn this essay Stanford Professor Darrell Duffie makes the general public aware of the mechanisms that can bring big banks, identified above all as dealer banks, so rapidly to failure. Since such types of financial institutions rely heavily on more convenient short-term financing, mainly through repurchase agreements, it is essentially a lack of cash or liquidity that produces an almost sudden death for dealer banks. The analysis, carried almost like a forensic autopsy, recalling the collapses of Lehman Brothers and Bear Stearns, describes that the driving key force that leads to fatal consequences is of behavioral kind. Namely, once hit by huge unexpected losses, such big banks start dedicating more and more buffer stocks and liquidity securities just to signal their strength to their clients, while continuing to make two-sided market quotations as well in most cases, despite the associated increasing drain of cash. Such a mechanism of increased risk taking, while incurring losses, reminds in many aspects of the well known behavioral phenomenon of loss aversion, described by Kahneman and Tversky (1979). Therefore, we should consider solutions to mitigate ex-post the costs of the systemic risk intrinsic in bank failures, such as in particular, as suggested by Darrell, the full establishment of centralized counter parties (CCP's) or clearing houses. However, in order to at least attempt at preventing those disastrous failures, we should try to intervene ex-ante as well, and discourage excessive risk taken by dealer bank executives, by forcing them to share the negative outcomes of their sometimes reckless behavior. For example, the bonus scheme adopted in 2008 by the dealer bank Credit Suisse to pay their executives through the same bad assets they dealt with their clients could be considered as an enlightening case of such disincentive mechanisms.6 of 10 people found the following review helpful. 4.5 stars-Banker speculation leads to inflated bubbles and then the bubbles collapseBy Michael Emmett BradyThis book does give a detailed account of what happened to create the Great Recession and why the Great Recession of 2007-2009 is still going on ,irrespective of the nonsense claims peddled by economists that the recession ended at the end of June ,2009. The three major factors making the Great Recession inevitable were (a) the repeal of the Glass-Steagall Act(GS) of 1933 in 1999 , (b) the passage of the Commodities Futures Modernization Act (CFMA) of 2000,and (c) the planned and organized restructing of the American banking system ,started by Jimmy Carter in 1978,to create mega sized banks through periodic waves of mergers,acquisitions and takeovers.It should be emphasized that the major supporters of these actions in the late 1980's to 2000 were Bill and Hilary Clinton,F D Raines,Rubin ,Summers, Senator Dodd,Barney Frank,Senator Schumer and the usual array of Libertarian Republican supporters of Wall Street casino capitalisn ,such as Phil and Wendy Gramm.Repealing Glass Steagall allowed the private comercial banks to again set up investmant bank units to engage in financial speculation.This was the primary problem that occurred in the mid to late 1920's.Highly speculative,leveraged ,margin account loans financed the stock market bubble while balloon payment loan financing of mortgages created the bubble in housing.This double bubble led directly to the Great Depression of the 1930's. The same type of double bubble led to the Great Recession of the 2000's.The CFMA removed derivatives and credit default swaps(CDS's) from any regulation at the state and federal level.Derivatives,CDS's and CDO's(Collateralized Debt Obligations)played the role in the 2000's that margin account financing of stock options

had played in the 1920's.The subprime mortgage loans game ,along with the constant efforts of Countrywide Financial and Ameriquest to convert the fixed rate mortgages of low income citizens to adjustable rate mortgages by constant refinancing,played the role of the balloon payments game of the 1920's .One need only quote Warren Buffett's warning of 2002 : " The rapidly growing trade in derivatives poses a "mega _catastrophic risk...derivatives are financial weapons of mass destruction that could harm not only the buyers and sellers,but the whole economic system".(2002 Annual Report,Berkshire Hathaway).This is precisely what happened.The whole economic system has been severely damaged by the Wall Street supply side casino capitalism approach .I have deducted one -half star from my rating because this author,as well as innumerable others,appears to be unaware that Adam Smith had given practically the same analyses and conclusions as supplied in this book and many others that have been published since 2008 on the topic of Wall Street manipulation and speculation in the financial markets leading up to the Great Recession.Smith's analyses appears on pp.262-340 of the Modern Library (Cannan) edition of The Wealth of Nations with the forward by Max Lerner.Smith correctly foresaw that the banking system must be composed of a large number of small banks .The private bankers must be prevented from making loans to projectors,prodigals and imprudent risk takers by a private, fractional reserve, central banking system that will skew credit allocation towards the job creating ,sober, small businesses that create 80 % of the jobs in America.

Dealer banks--that is, large banks that deal in securities and derivatives, such as J. P. Morgan and Goldman Sachs--are of a size and complexity that sharply distinguish them from typical commercial banks. When they fail, as we saw in the global financial crisis, they pose significant risks to our financial system and the world economy. How Big Banks Fail and What to Do about It examines how these banks collapse and how we can prevent the need to bail them out. In sharp, clinical detail, Darrell Duffie walks readers step-by-step through the mechanics of large-bank failures. He identifies where the cracks first appear when a dealer bank is weakened by severe trading losses, and demonstrates how the bank's relationships with its customers and business partners abruptly change when its solvency is threatened. As others seek to reduce their exposure to the dealer bank, the bank is forced to signal its strength by using up its slim stock of remaining liquid capital. Duffie shows how the key mechanisms in a dealer bank's collapse--such as Lehman Brothers' failure in 2008--derive from special institutional frameworks and regulations that influence the flight of short-term secured creditors, hedge-fund clients, derivatives counterparties, and most devastatingly, the loss of clearing and settlement services. How Big Banks Fail and What to Do about It reveals why today's regulatory and institutional frameworks for mitigating large-bank failures don't address the special risks to our financial system that are posed by dealer banks, and outlines the improvements in regulations and market institutions that are needed to address these systemic risks.

"[T]his volume will give readers a deeper understanding of how modern banking works."--Choice"There are precious few manuals on global finance. To be sure, there are enough leaden textbooks and scholarly tomes to crush many a library, but there are few nuts-and-bolts guides. Darrell Duffie has performed a great service by attempting to explain in simple terms why and how major investment banks (what he calls 'dealer banks') collapse. . . . How Big Banks Fail is . . . a valuable addition to public literature on the global financial crisis."--Joel Campbell, International Affairs"This is a clear and readable account of the mechanisms and incentives at play."--Saxon Brettell, Business Economist"I highly recommend the book. I believe the text should be standard reading for anybody involved with regulating and supervising financial institutions as it offers valuable insights into the plumbing of financial markets and the mechanisms that can cause bank failures. The discussed mechanisms are thought provoking and can provide researchers and regulators with valuable ideas for future research on the financial system as well as banking regulation."--Jan Wrampelmeyer, Financial Markets and Portfolio ManagementFrom the Back Cover"In How Big Banks Fail and What to Do about It, Darrell Duffie tackles one of the central but often neglected issues in building a more resilient financial system. Duffie has that rare combination--the rigor of the academy and knowledge of how the plumbing of the financial system works. Anyone interested in regulatory reform will need to engage with his thinking."--Paul Tucker, deputy governor, financial stability, Bank of England"The book does an excellent job of explaining the institutional setting of big dealer banks and how things went wrong in the financial crisis. The issues are important and the policy suggestions sound. There is nothing quite like this out there."--Franklin Allen, University of Pennsylvania"Darrell Duffie is one of the leading experts on the problem of large-bank failures. He focuses on issues not addressed elsewhere, but which are being talked about everywhere. This book scores in a big way."--Viral V. Acharya, New York UniversityAbout the AuthorDarrell Duffie is the Dean Witter Distinguished Professor of Finance at Stanford University's Graduate School of Business. He is the author of Dynamic Asset Pricing Theory and the coauthor of Credit Risk: Pricing, Measurement, and Management (both Princeton).