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Too Big to Fail: Review of Literature

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ABSTRACT *The following paper reviews some of the existing literature on "Too Big To Fail (TBTF)" financial institutions. The TBTF regime was recently highlighted in the economic crisis of 2007-08 and subsequently the issues associated with large sized banks were highlighted. Many countries are now taking steps to prevent a situation like that crisis by making stricter norms for TBTF banks. In this respect, it will be beneficial to look into the literature behind this policy reform.*

INTRODUCTION

Failure of a large bank has consequences not limited to the related parties but also has a spillover effect and systemic risk. To protect the public at large from such effects and to maintain financial stability, financially distressed large banks are rescued and such public recue is called TBTF policy (Drira & Rashid, 2013).

The Too Big To Fail (TBTF) debate started with the 1984 case of run on the Continental Illinois bank. The concern that the failure of this bank will have a contagion effect on other financial institutions also in the economy, led to issuance of a bailout package by Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, Comptroller of the currency and twenty four US banks. Subsequently, comptroller of currency indicated that the regulators will not allow the country's eleven largest banks to fail as their failure will have devastating effects on the whole economy. Such status of "Too Big To Fail" conferred upon banks gives them a competitive advantage as investors perceiving lower risk will be ready to lend to these banks at lower interest rate. The surety of being rescued in times of crisis also induces these banks to take on riskier investments which if succeed will be highly beneficial for the bank, but if it fails, the onus will fall on the government and the public (Afonso, Santos &Traina, 2014).

How are TBTF institutions identified?

For assessing systemically important financial institutions, The Basel Committee on Banking Supervision has developed a methodology which is as follows:

"The methodology is based on an indicator-based measurement approach. The indicators capture different aspects that generate negative externalities, and make a bank systematically important and its survival critical for the stability of financial system. The selected indicators are size, global (cross-jurisdictional) activity, interconnectedness, lack of substitutability or financial institution infrastructure, and complexity of the (institution)".

Thus, size may not be only indicator to identify TBTF institutions. The downside of labeling banks as systemically important, however, is that the label may further increase depositors' expectation of government support (Reserve Bank of India).

IMPACTS OF TBTF INSTITUTIONS

Cost to exchequer and fiscal problems

Banks bailout are costly for government as in addition to the direct administrative expenses of a bailout, governments are required to raise fresh money, and they borrow or raise taxes to do so. As a result, there is significant opportunity cost of funds that are diverted from alternative uses. This is especially true for developing country where social expenditure funds need to be diverted to bail out banks. This creates fiscal problems too. Acharya et al. (2010) examined the effect of bank bailouts upon systemic risk. Sovereigns that announced bank bailouts during the financial crisis saw substantial increases in market perceptions of their default risk, as measured by the prices of credit default swaps (CDSs). Acharya et al. also present preliminary evidence that, in addition to the transmission of risk from banking sector to sovereign borrower, increased sovereign default risk is transmitted to the banking sector via banks' holdings of sovereign debt (Morrison, 2011).

Excessive risk taking

The TBTF policy has an incentive, the effect of which is reflected in the day-to-day business decisions of these banks. There is tendency to assume higher risk when bankers expect sovereigns to bear cost of bank failure. In a TBTF institution, risk assessment process can be described as one of 'heads I win, tails the Government bails me out' (Morrison, 2011). This will have a counter effect on small banks also, as they will also have to take on higher risk to be able to compete and survive in the business. With the help of Support Rating Floors (SRFs: ratings given to banks by Fitch based on opinion about the ability and likelihood of a government supporting a bank), it has been proved that government support promotes risk taking. In fact the government's support to banks is not on the basis of risk they possessbut on the basis of sheer size (Afonso, Santos & Traina, 2014).

Interruption of monetary policy mechanism

This can be well explained with the help of the 2007-2009 crisis. To usher in growth and reduce unemployment, the central bank buys bonds leading to fall in interest rates thus inducing borrowers to spend more and banks to lend more. However, in the wake of the financial crisis, that erupted in the 2007 (due to housing market bubble), big banks froze lending and interest rates rose. In a time when investment and spending required a boost, they instead

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took a flight downwards. While businesses could not get funding from banks, they were unable to tap capital markets also, as the banks had started playing a pivot role in capital markets and the crisis had made investors wary of investing. In short, the TBTF banks with their wings spread across various sectors had failed the transmission process of monetary policy (Fisher, 2010).

Corporate degradation

When organizations become too big, it becomes operationally efficient to breakup those organizations into easily manageable subsidiaries and spin offs. However, these spun off organizations may not be sufficiently large to be able to make use of the government's TBTF subsidy (in the form of lower financing costs). If the costs of giving up the subsidy exceeds the operational benefits from restructuring, then shareholders will oppose such restructuring. In fact, the benefits from TBTF subsidy and subsequent lower borrowing costs make such organizations takeover proof. This leads to degradation of the corporates in terms of their operations and governance, which in turn is a social cost for the whole economy. The corporates further degrades in the following ways:

- Since financing costs are lower for TBTF firms, they tend to include higher amount of debt in their capital structure. When firms employ higher amount of debt, they are motivated to undertake riskier projects whose success results in additional profits for shareholders but failure results in costs for creditors. Thus organizations end up taking higher unnecessary risk
- Competition in capital markets incentivize the TBTF banks to use the TBTF subsidy for their private benefits. For this purpose, the TBTF banks not just make advances in their traditional markets but also in derivative markets which are inherently more risky. Thus TBTF banks again end up being riskier
- The importance of the TBTF banks saves them from being prosecuted. As their prosecution might "have a negative impact on the national economy". The knowledge about no punishment further degrades the TBTF banks (Roe, 2014)

Depositor behavior is affected by the perception of a too-big-to-fail policy

Oliveira, Schiozer and Barros (2014) indicated that the depositors value an implicit governmental guarantee to the systemically important banks over and above economic fundamentals. If a government bailed out a financial institution in times of crisis, then depositors will preferably put their money in such TBTF banks as they have higher surety that their money will be safely returned to them. This gives such institutions higher liquidity during the next crisis.

Added costs

Besides the costs of bailouts borne by taxpayers, TBTF regime highlighted another type of cost. When banks acquired other banks, they paid significantly higher amount in cases where the resulting entity would become TBTF which would be able to make use of TBTF subsidy. This means that they paid a price to get the TBTF status (Brewer III &Jagtiani, 2013).

WHAT CAN BE DONE?

There are two schools of thought regarding TBTF issue: "learn to live with 'em or get rid of 'em". Proponents of "learn to live with 'em" suggest that in the current era of globalization, such large organizations have become indispensable, to manage international cash flows efficiently. However, they do recognize the risks associated with such firms and hence suggest some steps that can be taken in this regard, which are as follows:

- Credibly dealing with unsecured creditors/lenders
- Debt issuance with contingent conversion to equity requirements
- Restrictions on dividends and other such policies to conserve capital
- Regulation of compensation
- Drawing a resolution regime for large failed organizations to ensure their smooth burial
- Overall better governance (Fisher, 2010)

The most important step that requires a special mention is increasing capital requirements, through which the incentive problem can be partly addressed. Regulators have started moving in this direction. The new Basel III capital regulations require banks to hold more and better capital. Bankers have argued that this will increase their overall cost of funding. But this argument is bogus. Debt funding is cheaper than equity funding for banks as the former has tax advantage and lower discounting of risk due to state support through bailout. Both of these reasons reflect taxpayer subsidies of the banking system, so arguing against higher equity capital requirements on the basis of increased costs of capital is tantamount to arguing against a withdrawal of state subsidies. As the rationale for increasing regulatory capital requirements for banking firms is precisely that doing so would shrink the level of distortionary state support extended to the banking sector, this counter argument is plainly ludicrous (Morrison, 2011).

Once the organizations are bailed out, the regulators must keep a tab on their operations. If they find that they are indulging in riskier activities such because of the assurance of always being bailed out, then penalties should be imposed on them. Gong & Jones (2013) suggested this imposition of penalty with a three tiered policy of bailouts. In this policy, large banks with high systemic risks will be bailed out surely; moderately risky banks "will be bailed out randomly with a positive probability" and the rest of the banks will not be bailed out in the event of their failure.

Proponents of "get rid of 'em" suggest that there should not be any TBTF institution which means that there should be no government guarantee for a bailout in the event of crisis. Banks should be allowed to take decisions about their own capital and risk hedging and should be allowed to fail.

What actually should be done is taking a mid-way wherein the government doesn't give guarantees and the steps suggested by first school of thought are also applied. In addition, activities which increase the risk for basic deposit and lending function of banks, should be curtailed (like proprietary trading). In short, banks should be disincentivized to become TBTF (Fisher, 2010).

A very popular solution to the TBTF problem is "limit on size" of the banks, as evident from the order of European commission to downsize large banks such as Lloyds and Royal Bank of Scotland. US also passed the Dodd Frank Act which limits size by prohibiting mergers under certain conditions. The apparent ease in implementing this solution is what makes it much cited. Banks' size can be easily measured and government can simply ask the banks for across-the-board shrinkage of balance sheets. However,

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a major problem with this solution is that governments cannot ensure that they efficiently break up the organizations into desired size. Large banks enjoy certain synergies benefits of which should continue even after disintegration. But it's difficult to ensure that the positive impacts of economies of scale and scope remain thereafter. Also, it's difficult to identify the TBTF banks in the first place and to define an optimal cut-off size (Stern & Feldman, 2009). Further, regulatory regionalism might hamper this policy as the disintegrated banks will be at a competitive disadvantage in comparison to large banks based in countries where such size limit is not imposed. To prove that "limit on size" might not be a very optimal solution, Drira & Rashid (2013) conducted an empirical analysis and showed that the risk of insolvency and the subsequent spillover might be positively or negatively affected by the size reduction depending upon how the balance sheet shrinkage is done. Also, reducing the risk of a bank doesn't necessarily require reduction in size; what matters is the composition of the assets and liabilities.

There might be a hidden incentive as well, for systematically important institutions in fiscally constrained countries to downsize to make themselves rely on bailout safety in the future. Demirguc-Kunt & Huizinga (2013) suggest this would increase bank valuation. Indeed, in 2008 banks has deleveraged relative to their economy's size, driven by a desire to increase stock market valuation in the face of a 'too big to save' effect (systemic size can make it too expensive for a country to bail out a bank).

Further, to level the playing field in the deposit markets, governments by increasing deposit insurance and its insurance credibility can make depositors feel equally safe in any bank. The downside of a generous deposit guarantee is increased moral hazard and sovereign debt concerns. Fisher and Rosenblum (2013) suggest that deposit insurance protection and discount window should be available only to traditional banks and not to non-banking institutions. The customers and creditors of non-banks (banks which are associated with commercial banks) should be made aware of the fact that these institutions are not protected by government guarantees. They can be made to sign disclaimer in this regard.

Large financial institutions should be restructured so as to make the bankruptcy process for each individual entity speedy and to make the entities "too small to save". The erstwhile complexities in the form of special purpose vehicles and off balance sheet financing will now be part of separate entities and will not be covered by government's safety net. This way government bailouts will not be required, financial institutions will die their natural deaths and TBTF regime will efficiently end (Fisher and Rosenblum, 2013).

Shareholder activism is another method to contain TBTF problem. Shareholders can agitate for replacing the management or even for breaking up a large conglomerate into manageable constituents (Roe, 2014).

As a discouraging factor, profits of too large banks can be charged taxes at a higher rate. In fact the whole tax structure needs to be reformed. Current structure is such that taxes are levied on profits after deducting interest payments. Thus higher debt leads to higher tax savings. Also, lower financing costs due to TBTF status further induce banks to take more debt. If the government wants to promote higher usage of equity, it needs to align its tax system with its efforts, such that debt is more taxed in comparison to equity (Roe, 2014).

However, there still will be very large banks whom regulators might consider to be systemically important. Also, we are well aware of the regulatory capture and the frequency of crises occurring in today's era. Given that we learn from each crisis and take steps to prevent it from happening again, we are usually unable to predict crises which happen over time because of newly emerged circumstances which we could not have foreseen. Thus solutions to end TBTF regime do not guarantee prevention of any more crises.

CONCLUSION

As a conclusion, we can find out what TBTF regime means for India. Indian banks are fairly capitalized, have substantially lower size as compared to their global counterparts and also lower risk as they are more involved in traditional lending business as compared to the largely interconnected financial products which cause high exposure. The global crisis was a result of this high interconnectedness and subsequently even large global banks have tried to shift their business models towards traditional banking. Nonetheless, the banks' loans and advances as a percentage of the country's GDP are significant and thus expose the country to risks and further the large banks dominate the country's banking industry (Sharma, 2015).

As a preventive measure for Indian economy, the Reserve Bank of India (RBI, India's central bank) will notify the TBTF banks of the country in August 2015 and thus will make more stringent rules for those banks. The rules, such as higher capital requirement, are based on those prescribed by the Basel Committee of Banking supervision for Global Systemically Important Banks. However, RBI molded those rules to cater to India's situation. Since the size of Indian banks as well as complexity are far less as compared to their global counterparts, the capital requirements are also lower i.e. the policies are less strict. This shows Indian government's proactive behavior to keep the market safe for the masses. Even though India was largely safe from the crisis of 2007-08, yet the government is leaving no stone unturned to ensure stability in the system.

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