Financial Innovations and Monetary Policy

EC248

3. Discuss the concept of "too big to fail" within the financial sector. What are the arguments in favour of this concept, and what are possible negative consequences?

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Abstract

To begin, the basic definition of "Too big to fail" was provided. In addition a few examples of TBTF were specified to gain an insight into real life situations. This paper explores the arguments in favour and against the concept of "too big to fail" and will be based on mainly, the public, the firms and the government. Moreover the paper will investigate the desirability of the concept of and ultimately find any effective solutions to the TBTF problem. A conclusion of breaking up the banks was reached, as it was rational and reasonable action. However this will be questionable in a real life situation.

Introduction

When defining 'Too big to fail' (TBTF) we need to understand the size of the financial firm. It is understood "Financial firms are said to be TBTF when policy makers judge that their failure would cause unacceptable disruptions to the overall financial system, and they can be TBTF because of their size" (Marc Labonte 2015 pg.2). This means that the government will intervene if a financial institution becomes bankrupt or collapses, especially if this 'hurts' or 'disrupts' the overall financial system or any other industry. Intervention by government in these cases means a bailout for large financial organisations, where they will ultimately avert failure. Examples of a bailout include the following.

Continental Illinois National Bank

The case of Continental Illinois National Bank, had given the term TBTF its early origin. Continental Illinois "was the largest bank failure in US history, and it remained so until the global financial crisis of 2007-2008. The Chicago-based bank was the

seventh largest bank in the United States and the largest in the Midwest, with approximately $40 billion in assets" (Renee Haltom 2013). The bank had made some risky investments as it was becoming larger therefore Continental Illinois had purchased $1 billion in speculative energy-related loans from Penn Square Bank, which eventually led to their failure, hence this led Continental Illinois's exposure to losses. Continental Illinois was facing insolvency, which initiated an eventual bank run. The bank had $28.3 billion in deposits of which $20.7 billion were larger than $100,000 and would not be insured by the Federal Reserve and Federal Deposit Insurance Corporation (FDIC). The bank run led to a withdrawal of $10.8 billion of deposits. As a result Continental Illinois received a $4.5 billion from sixteen of the nation's largest banks. The regulators had thought that this problem would spread to the other banks. As a result the FDIC gave Continental Illinois a lifeline and the bank received $4.5 billion.

Royal Bank of Scotland (RBS)

Royal Bank of Scotland (RBS) ultimately failed due to the acquisition of the biggest bank in the Netherlands, ABN Amro. One of the biggest motives for the purchase was due to Barclays PLC almost securing the deal. The takeover cost RBS £49 billion, which was heavily inflated. (Gordon Rayner 2009). RBS was under pressure from board directors and announced that they will shore up its capital by £12 billion. On 13 October 2008, RBS received a multibillion-pound bailout from the government and this resulted in the taxpayer becoming the majority shareholder, due to the almost near collapse. (Telegraph 2011)

TBTF Criteria

There must be a criteria set for TBTF banks if there are any arguments to be made. It is understood by the Federal Reserve that "The Fed proposes that all companies operating in the U.S. with at least $50 billion in assets and 85% of their business related to financial activities should fall under its purview as systemically important. The Fed is required to issue details of the "too big to fail" rule as part of the Dodd-Frank financial reform bill, which designated the Fed as the regulator of giant financial firms." (Lauren Tara LaCapra 2011). One of the criteria for a TBTF in the United States is that the bank must have at least $50 billion in assets and 85% of their business activities must be systematically important, meaning that 85% of their banking activities are too important to fail, because failure might trigger a financial crisis.

TBTF is a favourable concept

Liquidity

An argument in favour of the concept of TBTF is that liquidity improves. The financial institutions obtain huge cash injections from the government. This is an effective bailout as they can avoid a near collapse. If however the bank faces a potential collapse, they will affect many of the depositors' with cash and savings, of which many are tied in with loans and investments. If a collapse is certain, the depositor is most likely to not receive their money, and this will ultimately cause a huge economic downturn. The 'slump' of such magnitude will be huge and it will become a great feat for the country to recover from. It is apparent that these huge cash

injections will help avoid near collapses. Eventually the banks will be giving out loans and start investing so they can eventually turn profits.

Bank Runs

A favourable argument includes fewer bank runs. A bank run is "when a large number of depositors, fearing that their bank will be unable to repay their deposits in full and on time, simultaneously try to withdraw their funds immediately." (George G. Kaufman 2008). The banks only keep a small fraction of cash in hand. Majority of these deposits are either lent out to borrowers or used to purchase interest-bearing assets. When a bank run occurs, the bank cannot meet the demand of their depositors'. The bank will try to meet these demands and sell their assets very quickly, even at extremely low prices if demand is high enough. This will have an outcome of solvency (George G. Kaufman 2008).

In the case of Continental Illinois, there were fears of solvency. If a bank is too big to fail, depositors will be content with placing cash, savings and investments into the bank as they have knowledge of bailout packages from the government. This will make the depositors' more confident with the bank, as they know that their money will be safe if the bank faces insolvency. Moreover in this particular case for Continental Illinois, the depositors' will know that this bailout has happened in the past and the US government may bail out the bank if the solvency situation occurs again.

Furthermore the FDIC would insure depositors' all of their money of up to $100,000. In addition the bank had $28.3 billion in deposits. Of those deposits the FDIC insured $20.7 billion. This is around 73% of deposits, which were saved. This is a hefty amount considering there was $10.8 billion withdrawn from a bank run. This is

favourable towards depositors', as they will know that they are insured for up to $100,000. Subsequently it has been said "Not only did the FDIC guarantee depositors up to the $100,000 insurance limit, but it also guaranteed all accounts exceeding $100,000 and even prevented losses for continental Illinois bondholders." (Mishkin F 2006 pg. 989). More importantly it was said that "eleven of the largest banks would receive a similar treatment to that of Continental Illinois" (Mishkin F 2006 pg.990). Not only would they have depositors' money insured for no more than $100,000, but also they will insure everything that exceeds this amount and even prevent losses for bondholders. Knowing they will be covered, the banks may take more risks, which may yield higher rewards. It is apparent that this is a result of the bank becoming TBTF and they can take advantage of the FDIC.

Control

If a government gives a rescue package, they can expect to gain control of the bank and make important decisions such as change in the chief executive. The government will achieve more transparency in the bank and will attempt to solve problems. "Then prime minister Gordon Brown announces government bailout of RBS, which results in taxpayers taking a 78% stake at an average price of 502p" (Jill Treanor 2016). The British government used taxpayer's money to purchase 78% of RBS. They were the majority shareholders, so they would have the advantage in all decisions made.

Consequences of TBTF

Moral Hazard

The concept of TBTF has many consequences such as moral hazard. Moral hazard is "a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost. It arises when both the parties have incomplete information about each other. … It occurs when the borrower knows that someone else will pay for the mistake he makes. This in turn gives him the incentive to act in a riskier way." (The Economic Times). In both cases of Continental Illinois and RBS, moral hazard is explained as the banks assembling further risky investments and loans, and as a result the FDIC and the UK government, insure and bailout the banks. The banks know they will be covered.

In the example of Continental Illinois, The FDIC was created for the purpose of ensuring that people would not lose the money they had deposited in banks if those banks should fail (pohnpei397 2012). "The FDIC was created in 1933 in response to the thousands of bank failures that occurred in the 1920s and early 1930s."(fdic.gov 2014). It was mentioned previously that the bank was the seventh largest in the United States and the largest in the Midwest. This awareness made the bank take on additional risky events such as the purchase of $1 billion in speculative energy-related loans from Penn Square Bank. The reason for the risky purchase was because the bank knew the FDIC would insure their depositors' if the risks do not pay off. Moreover, the depositors' were content with the banks activities, as they know that the FDIC will insure them.

Additionally this is a huge consequence of a TBTF financial institution as this situation may occur more than once. It was stated previously that the FDIC insured Continental Illinois bank deposits. However this could result in the bank purchasing and selling additional risky investments and loans. The banks that are given the TBTF name may see this as an opportunity to take greater risks all the time, as they know that they will be insured. The approach towards TBTF banks is questionable; as there may be no limit to how many risks the banks take and how many times the FDIC will insure the depositors'.

Opportunity Cost

There is an opportunity cost for the UK government that spent billions in a rescue package. The government injected £46 billion into the RBS bailout (Harry Wilson 2014). This amount could have been spent elsewhere. "George Osborne says he is "repairing" the deficit to the tune of £113bn by 2014-15. That breaks down into £83bn of spending cuts and £29bn worth of tax rises that year." (Edwin Lane 2010). It is said by 'George Osborne', there would be spending cuts by the UK government of £83 billion. Much of this spending cut was on the welfare system, defence and education. The £46 billion injection in RBS could have been better spent on welfare, as people would not struggle for support (Benefits). The bailout package could have been spent in the education system where the UK can have better academic students and rise in the global education rankings. It will take many years to implement. Never the less, spending on education will impact positively amongst the youth even if it is a long-term plan.

The public

The TBTF banks affect the public. It was mentioned before that the FDIC at first would only insure depositors' up to $100,000. This would affect the wealthy depositors'. This would mean that they would be worse off as they will lose most of their deposit and may become bankrupt. Tax revenue will fall, as the depositors' will lose their money and will not be able to pay the higher rate of tax. The TBTF banks affected the society. "the externalities of large bank failures can be massive… the costs to society from the financial crisis in terms of lost jobs, lost income and lost wealth were staggering—many trillions of dollars and devastation for millions of families. Failures of large financial institutions pose massively asymmetric risks to society that policymakers must consider." (Neel Kashkari 2016)

This explains the extent to which society are affected as they are the ones who bail them out, and have to suffer from public spending cuts and as a result, society loses out on income and wealth. Neel made a very good analogy where he stated "a nuclear reactor. The cost to society of letting a reactor melt down is astronomical. Given that cost, governments will do whatever they can to stabilize the reactor before they lose control." (Neel Kashkari 2016). In addition Neel emphasized that "We had a choice in 2008: Spend taxpayer money to stabilize large banks, or don't, and potentially trigger many trillions of additional costs to society." (Neel Kashkari 2016). The Government had made the rational decision of spending taxpayer's money to prevent banks from failing, as it would have catastrophic consequences to society.

Can we solve the TBTF problem?

According to an article on the Financial Times website, there are a couple of ways to 'solve' the TBTF problem in the United States. (William Isaac and Cornelius Hurley 2013)

1) They can break up the bank. This will be a very demanding task as it might cause problems such as political 'horse-trading'. This is where both parties discuss the deal and get as much out of it as possible without deterring the deal. This will limit growth and expansion and ultimately the banks will offer fewer services.
2) The preferred approach by the US Federal reserve is to cap the growth of banks. This is not ideal, as the problem of TBTF may not be effectively solved.
3) The banks can issue unsecured long-term senior and subordinated debt. The creditors may not be protected if a bank faces insolvency. The discipline imposed by long-term creditors will result in less risk taking
4) Deploy a 'Subsidy Reserve Plan'. This is where the plan relies on market discipline rather than government intervention. This means that price setting is constrained and this will eventually entice the banks to maximize revenue and avoid insolvency.

Conclusion

To conclude, the term too big to fail has been used a lot by governments, especially in recent times. It is talked about a lot more as the government will want to avoid a bailout in the future, due to catastrophic events occurring. Since Continental Illinois bailout in 1984, there have been tighter controls implemented. To this day the public are talking about future bailouts and how they can be avoided. The arguments in favour of TBTF were prominent, as the bailout would avert a potential disaster to the banking system and economic system, as well as negative social costs. However it was argued that being TBTF is not what it seems, as there are many opportunity costs. The government can spend this money where it is needed urgently elsewhere. I personally agree with the opinion about breaking up the banks. It can limit the size of the banks, although this will limit growth and expansion. Consequently the depositors' will get fewer services. This is potentially a way forward if the governments want to avoid spending billions on a bailout.

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