UNIVERSITY OF ESSEX

EC248 Financial Innovations and Monetary Policy

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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5/1/2015

Introduction

In 1981, Continental Illinois National Bank and Trust Company became the 6th largest US bank with US$45.1bn in assets[1]. A year later, due to irresponsible lending in the energy market a smaller financial institution, Penn Square Bank, failed and Continental had to write off more than US$500 million in loans purchased from Penn Square. Understandably, fear of Continental becoming insolvent increased which led to a run on the bank. *A bank run is a situation when many depositors simultaneously wish to reclaim their money because they fear the bank will default*. In 1984, the continued deterioration in the performance of Continental, including the withdrawal of over US$10 billion of deposits, led many to believe it was heading for failure; however, the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) were not willing to let this happen. Continental received a rescue package of US$4.5 billion from regulators as well as additional emergency loans from the federal government; the FDIC also implemented a new policy which provided full protection for all its depositors when only 10% of Continental's deposits were insured[2]. This huge bail-out was unique, started a trend for the (differential) treatment of large banks and sparked the "too big to fail" debate.

"Too big to fail", known as TBTF, is the idea that a financial institution is considered a systemic risk and so a government will provide assistance to prevent its failure. *Systemic risk refers to the possibility that an event in an institution, such as insolvency, could cause instability or collapse of an entire financial system.* A government that deems an institution as TBTF would intervene through the use of regulations and infusion of capital if there is an

[1] Richard J. Herring, Jacob Safra Professor of International Banking, The Wharton School, University of Pennsylvania (n.d.) The Collapse of Continental Illinois National Bank and Trust Company: The Implications for Risk Management and Regulation Online at: http://fic.wharton.upenn.edu/fic/case%20studies/continental%20full.pdf Accessed 29 April 2015

[2] Wikipedia (2015) Continental Illinois Online at: http://en.wikipedia.org/wiki/Continental_Illinois#Insolvency Accessed 29 April 2015

imminent risk of failure. They believe the cost of the bail-out is less than the cost of the failure to the economy. Examples of such institutions are: JP Morgan Chase, HSBC (commercial banks) and Goldman Sachs (investment bank).

In this paper I will be discussing the concept of "too big to fail". My focus will be on the arguments in favour of this idea and giving examples within the financial sector; as well as the negative consequences associated with this concept and possible alternative policies.

The Nation's Biggest Banks Are Too Big

Since 1984, on average, the size of the largest U.S. banks and their share of total banking system assets have risen, while the total number of banks has decreased substantially. Total assets of U.S. commercial banks increased from US$167 million in 1984 to US$893 million in 2011; but the number of banks fell by more than 50%. Since the turn of the new millennium, the share of total banking system assets held by the five largest commercial banks increased from 30% to 48%, in 2001 and 2011 respectively. The largest commercial bank, JPMorgan Chase Bank, had US$1.8 trillion of assets which is equal to 14% of the total assets of all U.S. commercial banks[3].

These figures clearly show the extent to which the very largest commercial banks dominate the banking system. The systemic risk associated with these institutions is incredibly high; there could be catastrophic consequences if one was to incur a sudden decline in depositor confidence or insolvency. Moreover, the action of bank regulators to offer support and bail-outs to financial institutions has created further problems, including: moral hazard and competitive imbalance.

[3] David C. Wheelock (2012) Too Big To Fail: The Pros and Cons of Breaking Up Big Banks Online at: https://www.stlouisfed.org/~/media/Files/PDFs/publications/pub_assets/pdf/re/2012/d/Too_Big_To_Fail.pdf Accessed 29 April 2015

Moral Hazard

The FDIC was established amidst the Great Depression in the U.S. with the main objective of providing a government safety net for the fragile banking system. Deposit Insurance was introduced to tackle bank panics by providing protection for depositors; a depositor with fully insured deposits of up to US$100,000 is guaranteed a repayment if the bank becomes insolvent. This greatly reduced the risk of a bank panic or a bank run from occurring. However, although deposit insurance has now been globally emulated it has not come without its consequences. A fully insured depositor has little incentive to monitor a bank's actions, and this lack of discipline causes banks to engage in risky activities. The government safety net of deposit insurance creates the problem of moral hazard.

Moral hazard arises when both parties, i.e. borrowers and lenders, have incomplete information about each other. It is a situation where one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost. An example of its occurrence is when a borrower knows that someone else will pay for the mistake (defaulting) he/she makes. This in turn gives them the incentive to act in a riskier way.

An example of the moral hazard problem in recent times occurred during the subprime mortgage crisis. *Subprime mortgages were granted to borrowers with lower credit rating and so were perceived as having a greater-than-average risk of defaulting on the loan*. Lenders sold these mortgages, as mortgage-backed securities, to other financial institutions that took on all the risk; as a result, mortgage originators had no incentive to screen borrowers before lending to them. The existence of moral hazard at such a large scale was a major factor in the collapse of the housing market in the U.S.

Another example: Continental Illinois, as mentioned previously, was considered a TBTF institution and so its deposits were protected by deposit insurance. The bank responded by taking on high-risk loans in the energy market worth US$1 billion which allowed it to grow rapidly in size[4]. This is clear evidence of moral hazard arising in the financial sector. Continental Illinois knew that its risk of insolvency was lowered considerably by the government safety net and so invested heavily in the energy market. If the risk of defaulting on these loans solely burdened on Continental Illinois itself, then it is likely the bank would never have undertaken this excessive risk of investing in a booming market.

The TBTF policy amplifies the problem of moral hazard. Depositors protected by deposit insurance have little incentive to monitor the bank's activities and withdraw their money if the bank is taking excessive risks; this is because depositors will not suffer any losses no matter the outcome of the bank's decisions. Consequently, as banks do not have to worry about being disciplined from depositors they are encouraged to undertake high-risk, high-return investments. The danger of this is that the risks taken increases the chances of the bank failing.

Competitive Imbalance

The banking sector is typically oligopolistic in an economy, this lack of competition means the dominant institutions are often TBTF and so are systemically important. As a result, TBTF banks benefit from preferential treatment within the economy and some receive subsidies from taxpayers. In 2012, Barclays and HSBC received £10bn and £5bn respectively; this translates into lower interest rates meaning big banks enjoy a lower cost of

[4] Robert L. Hetzel (1991) Too Big to Fail: Origins, Consequences, and Outlook Online at: http://www.rich.frb.org/publications/research/economic_review/1991/pdf/er770601.pdf Accessed 29 April 2015

borrowing which saves them large sums of money[5]. This subsidy encourages further growth, of already large banks, and concentration within the banking sector which weakens competition as smaller banks struggle to compete. Large banks also had a funding advantage by exploiting scale economies. The lower cost of raising funds which TBTF banks enjoy gives them a competitive advantage over smaller firms as well as being highly unfair. It is seen as being unfair as the subsidy inflates the bank's profits instead of the benefit being reflected onto their customers through lower prices. Also, smaller banks are usually healthier institutions and so deserve privileges like a subsidy. Smaller banks traditionally built personal relationships with borrowers for screening purposes but this is no longer an efficient means of obtaining information. Due to advances in communications and information processing technologies, large banks are able to heavily invest in the acquisition of information about potential borrowers.

Like most markets, competition is necessary to promote efficiency, innovation and better quality products or services. The financial sector is no different; competition in the banking sector could increase efficiency as more efficient banks could enter the market and replace existing inefficient banks. Inefficient banks are dangerous for the market because if they are allowed to grow they could pose a systemic risk. Innovation is an important feature of competitive markets, more R&D into financial services could reduce costs for banks which can then benefit consumers through lower prices.

Tackling TBTF

Overcoming TBTF has been problematic thus far, however there are measures in place which are reducing the risk of more banks becoming too big; measures include: The Dodd-Frank

[5] Lydia Prieg (2012) Banks are still too big to fail Online at: http://www.neweconomics.org/blog/entry/banks-are-still-too-big-to-fail Accessed 29 April 2015

Act of 2010, a change in the management of regulatory agencies and risk-based insurance premiums.

Following the global recession, in 2010 the Dodd-Frank Act became law in the U.S. and entails major reforms regarding regulation within the financial sector. Various government agencies were introduced to prevent another collapse of a large financial institution. The Financial Stability Oversight Council (FSOC) has the authority to break up large banks before they become a systemic risk. They also aid in the restructuring of banks with solvency problems by finding a willing merger, this will ensure the guarantee of all deposits in the bank. The council also looks out for risks that could affect the financial sector by monitoring the financial stability of TBTF institutions; rapidly growing banks deemed too big could be subject to demands by the Federal Reserve to increase its reserve requirement as a precautionary measure. More recently a section of the Dodd-Frank known as the Volcker Rule has been implemented. This rule prohibits banks from participating in particular investment activities such as sponsoring hedge funds or private equity funds for their own profit. The main purpose of this regulation is to prevent speculative investments undertaken by banks.

Providing a rescue package for a TBTF institution is less likely if "conservative" bank regulators were appointed who place great importance on controlling moral hazard. If such regulators announced their reluctance to provide bailouts then it would cause depositors to monitor and discipline large banks who take on excessive risks. The problem with this measure is that; bank regulators would need to have considerable expertise in dealing with financial market instability and there is a possibility these type of regulators could not be wanted by some politicians.

Risk-based insurance is deposit insurance with premiums based on the caution shown by banks' when making investment decisions; banks' that undertake riskier investments pay a higher insurance premium. It is believed that this premium assists the control of moral hazard present in deposit insurance and so helps to prevent bank failure.

Alternative Views

Many believe the only way to end TBTF is to impose strict limits on the size of individual financial institutions. However, breaking up big banks could increase the cost of providing banking services as these banks would be unable to exploit economies of scale. *Economies of scale occurs in a production process when the cost of producing one unit of output falls with an increase in the amount produced*. Also, due to the size of TBTF banks, they are able to provide services internationally, in particular, developing economies with a weak financial system.

Conclusion

In conclusion, the concept of "too big to fail" is a problem still existent in the financial system, though the implementation of various policies mean big banks are now regulated and supervised more than ever. The likelihood of a government bailout being necessary due to imprudent investments made by a major financial institution is very unlikely (in the near future). However, this concept should not be underestimated as changes still need to be made in order to achieve impartial treatment (to an extent) between small and large financial institutions. Also, more needs to happen to control the size of the biggest banks because TBTF banks continue to grow with evermore systemic risk.

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