EC248-Financial Innovations and Monetary Policy Assignment

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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?

Introduction

The idea of 'too big to fail' or 'TBTF' within the financial sector is a concept that has arguments in favour and against it. The first part of this essay will deconstruct the concept of what TBTF actually means, how it occurs and give some real life examples of where TBTF policies have actually happened. It will also mention what the Federal Deposit Insurance Corporation is, how they were formed and why they were necessary. The second and third parts of this essay will focus respectively on the main advantages to the financial sector and economy as a whole of 'TBTF' and then what the negative consequences are. The final part of this essay will briefly overview whether TBTF is still an issue, and measures being taken to counter act it. It will then conclude whether TBTF is a positive or negative policy.

What is 'too big to fail'?

The concept of 'TBTF in the financial sector is used to describe the idea that a financial institution has become so large that actions must be taken to prevent its failure. The main reason for this is because it is thought that if a company fails it could not only have a disastrous effect for that sector, but also a ripple effect throughout the whole of the economy. "If a large company fails, other companies that rely on it for portions of their income might also be brought down, and a number jobs eliminated." (Investopedia, Too Big To Fail).

A government or financial regulator provides guarantees of repayment to large uninsured creditors of the largest financial institutions, even when they are not entitled to the guarantee. The intervention that must occur when a bank is failing usually comes in the form of a government bailout. A bailout in the general sense is when the government offers money, in the form of cash loans or bonds, to stop the failure of the company. Large companies or financial institutions that employ huge numbers of people are the type of business that would receive a bailout, this is because it is thought that the economy couldn't sustain such a large increase in unemployment.

The main example of 'TBTF' occurred in the late 2000's when banks suffered huge losses on subprime mortgages, this is known as the financial market bailout. A lot of large firms are so interconnected, if one goes under almost a whole sector would collapse, for example in the United States, the Lehman Brothers or AIG. The US government has dispersed over 700 billion dollars to save companies like these. "The failure of a large institution not only can cause immediate failures of its counterparties in both the banking and the rest of the financial system, but can also lead to a crisis of confidence that may spill over….leading to a cascade of failure and a financial crisis" (Mishkin, F 2006, P989). This is why governments are reluctant to let banks fails.

The decision on whether to bailout or let the institution fail usually falls to a regulator such as the FDIC, they weigh up the consequences to the economy of failure and whether the cost of intervening is worth it. "Too big to fail refers to the practise followed by bank regulators of protecting creditors of large banks from loss in the event of failure" (Hetzel, R 1991, P3). In this case the regulator is the FDIC and the potential bailouts of large banks is like a safety net. If the cost of a bailout is less than the cost of failure to the economy the government or FDIC will decide that a bailout is the most effective option because it saves from larger losses. The FDIC stands for the Federal Deposit Insurance Corporation, it is an independent regulator that insures deposits in the US against bank failure. The FDIC was created in 1933 to help encourage stability and maintain public confidence in the country's financial system. Lack of confidence can be a problem, because it can lead to bank runs. This is the main reason for the FDIC being founded, “concerns about bank panics have led most governments throughout the world to provide a safety net for the banking system” (Mishkin, F, 2006 P989). The FDIC was originally created to regulate rural banks but it quickly evolved. The first main example of a bank bailout was in 1971 when Utility Bank Boston received a bailout. However in this case the “FDIC opposed the bailout on the grounds that bailouts were bad public policy and doing the first one would lead to many more, possibly an uncontrollable flood” (Hetzel, R 1991, P3).

By 1982 the FDIC had changed and “had the additional authority to prevent failures by arranging purchase and assumption transactions if it determines that liquidation of the bank is a costlier alternative. (Hetzel, R, 1991, P3). The FDIC as of 2016 insures deposits of $250,000 as long as the institutions are member firms. There are two main methods that the FDIC can use when it comes to failing banks. Firstly there is the payoff method, this is where the “FDIC allows the bank to fail and pays off depositors up to the $250,000 insurance limit” (Mishkin, F 2016, P262). The good thing about the payoff method is that “large depositors with more than $250,000 would suffer losses if the bank failed” (Mishkin, F 2016, P265). This would provide a big incentive for them to monitor the banks activities and pull their money out of the bank if there was too much risk. The method used by the FDIC is the purchase and assumption method, this is where the “FDIC reorganises the bank typically by finding a willing merger partner” (Mishkin, F 2016, P262). A healthy bank purchases assets and assumes liabilities from the unhealthy bank, because of this no creditors or depositors at the bank, even those over the insurance limit, don’t lose any money. A possible drawback of this however is that to find a merger partner the FDIC may have to find incentives for the partner to take on liabilities and the merger will wait until the latest moment to get the best deal for themselves.

The source of TBTF policies being adopted is generally believed to be that the regulators are worried about the worldwide economic consequences but it is also argued that policy makers are worried about themselves and personal gain so adopt “too personally important to fail”(Mishkin, F 2006, P993) policies. Regulators could have very different incentives compared to the public and hence may keep banks afloat for difference reasons. One reason could simply be they don’t want any failures because it could make them look bad. Another motivation by policymakers for keeping banks propped up is it helps the government to direct credit by protecting big institutions. They can “help encourage the public to put their funds in these institutions, thereby giving them the resources to lend to whomever the government want them too” (Mishkin, F 2006, P993). Thankfully in the case of the United States, the FDIC which is a separate non-government controlled regulator is responsible and it is mainly believed that the regulators do act in the public interest.

Why ‘Too Big to Fail’ is a useful policy.

The concept of TBTF has some advantages and there are many arguments in favour of deposit insurance and the policies of TBTF. The main argument for TBTF is that it helps to create stability and this is possibly the most important thing in the whole of the financial sector. Before there were any regulators like the FDIC, “a bank failure meant that depositors would have to wait until the bank was liquidated to get their deposit funds” (Mishkin, F 2016, P261). When this is the case any depositors “have a very strong incentive to be the first to show up at the banks, because if they are last in line, the bank may have paid out all of its funds and they will get nothing” (Mishkin, F 2016, P262).

Without TBTF policies and corporations like the FDIC there is more uncertainty about the safety of any deposits. This is a very bad thing because “uncertainty about the health of the banking system in general can lead to runs on both good and bad banks" (Mishkin, F 2016, P262), this could cause the collapse of the whole banking system. The biggest example of a bank run is possibly the Great Depression, there was no confidence in the financial systems so people ran to the banks to try and withdraw all their money. However when TBTF is present this can help counter act the confidence problem. "Concerns about bank panics have led most governments throughout the world to provide a safety net for the banking system" (Mishkin, F 2006, P989).

It can be argued that without TBTF, governments would not provide this safety net because any bank failures would not have an effect on the economy, so they could allow failure and liquidate, "regulators are reluctant to close down large financial institutions and impose losses on their depositors and creditors, because doing so might precipitate a financial crisis" (Mishkin, F 2016, P246) "when a depositor has fully insured deposits….the depositor doesn't need to run to the bank to make a withdrawal when she is worried about the banks health because her deposits will be worth 100 cents on the dollar no matter what" (Mishkin, F 2006, P989). Due to TBTF, this safety net can "short circuit runs on banks and bank panics" which is very good for the whole financial system. It can also help "overcome reluctance by depositors to put their funds into the banking system", which helps the system to thrive. (Mishkin, F 2006, P989).

Stability is the main advantage of TBTF, however there are also many others. One argument in favour is that the huge size of some institutions helps them reach a much larger consumer base. Large financial institutions can bring services to people all over the world that might not otherwise be reached by smaller institutions. Their larger size also means that they could benefit from economies of scale on some level, meaning they can provide services cheaper than others. TBTF can provide financial stability and encourage development around the world.

Drawbacks of 'TBTF'

Although TBTF can have some positive effects it also has some negative consequences. The main problem with TBTF is that it hugely increases the moral hazard problem for financial institutions. Moral hazard is defined as a lack of incentive to guard against risk, institutions and depositors who use the institutions are protected against consequences. This sounds like a good thing because depositors won't lose out but it can cause issues. TBTF means that depositors have less incentive to monitor the banks activities, "when a depositor is fully protected, she knows that she will not suffer losses if a bank fails and, thus, has little incentive to monitor". (Mishkin, F 2006, P989) This lack of monitoring gives the bank incentives to change behaviour. "Without this discipline from depositors, banks know that they can engage in risky activities with impunity and this can increase the probability of bank failures." (Mishkin, F 2006, P989).

If a regulator like the FDIC chose not to bail out a failing bank, and instead closed the bank, even with a deposit insurance, large depositors would make losses. The potential of losses gives any depositors incentive to monitor the banks activity very closely and at any sign of risk they would take all their money out. To stop this happening the banks would engage in less risky investments for example. However if depositors know the bank is TBTF, regulators are reluctant to close the bank as it could cause a financial crisis, now this incentive to monitor totally disappears along with the banks incentive to take less risk, therefore "large banks are likely to take on greater risks, thereby making bank failures more likely." (Mishkin, F 2006, P990). An example of this occurred in the US with institutions including Bear

Stearns, Lehman Brother and AIG. They took excessive risks which led to the global financial crisis, and the eventual collapse of these institutions “helped trigger the worst financial crisis since the Great Depression” (Mishkin, F 2016, P265).

Not only does TBTF increase the risk taking of banks and likelihood of a crisis “it also leads to resource misallocation” (Mishkin, F 2006, P991). If banks know they can operate without risk due to bailouts, they will not be as cost efficient as they would without a safety net. They may also lack any incentive to invest and innovate in things like technology because, “deposit insurance makes it possible for a bank to finance rapid growth with cheap deposits even if that growth is achieved by acquiring low quality and risky assets” (Hetzel, R 1991, P10). They can achieve desired growth through these risky measures due to the FDIC insurance. Technology has also allowed financial institutions that are small reach a much larger audience. It improves the information available and lets them become more important in the financial world, meaning even a failure of a small bank could cause issues.

Another issue created by TBTF the presence of a safety net encourages all banks, no matter how small to become TBTF so that they can take advantage of the policy itself, however “banks will be larger than is socially optimal and there will be too many bank mergers” (Mishkin, F 2006, P991). More big banks, means a higher chance failure and the FDIC having to bail them out.

Too many bank mergers can impose a large problem, “banking consolidation has led to the largest banks getting larger, so that a failure of one of these mega banks would pose even greater systematic risk” (Mishkin, F 2006, P994). If the biggest banks are interconnected so much the failing of one could wipe out the whole financial sector and would have disastrous effects on the whole economy. Consolidation doesn’t just occur between banks, it is between a whole range of financial institutions, these leads to larger and more complex institutions. “Financial consolidation of banks with other financial services firms means the government safety net may be extended to new activities, such as securities underwriting, insurance or real estate”. (Mishkin, F 2016, P266). Even though a larger safety net sounds like it would bring more stability it can cause the opposite. TBTF policies create a vicious circle effect, as seen earlier, protecting everyone from losses means no incentives to monitor activities, which means banks can hold onto very small amounts of capital and make risky investments. So it can be argued that TBTF policies can create instability in the financial system and make it more fragile.

Is ‘TBTF’ still a problem?

It seems the disadvantages outweigh the benefits of TBTF, however it can be argued the problem is becoming smaller. New regulations in 1991 meant that banks with capital-to-assets ratio of 2 percent or less must be close within 90 days. By 2004 large banks had increased their capital ratios by almost double, “the higher capital ratios for large banks suggests that they are no longer as willing to take on risk” (Mishkin, F 2006 P997), this is because they would have more to lose. Franchise values also have an effect, “A high franchise value acts like a large amount of capital. It limits risk taking” (Hetzel, R 1991, P10), so even if a bank is ‘TBTF’ and all deposits are insured but the bank is closed, they would lose their franchise value, this gives them an incentive to not take excessive risk.

In 2010 in response to the financial crisis of 2007/08, legislation was passed in the U.S known as the Dodd-Frank act. The Dodd-Frank Wall Street Reform and Consumer Protection Act details the provisions that are being implemented over several years that are intended to decrease risk in the U.S financial system. (Investopedia, Dodd-Frank) The main purposes of the act are to make the financial system more transparent and accountable, to prevent institutions becoming TBTF and stop government bailouts of these institutions. The act created agencies that are tasked with overseeing financial companies and monitor, restructure or break up financial firms that are TBTF, or too risky. It can be argued that the act lowers the profit making ability of firms but it is better for the public and can help stop financial crisis from happening.

Conclusion

There are many arguments in favour of TBTF, how it is good for the whole financial sector because it helps bring stability. Its main advantage is that it can short circuit any panics and bank runs which would cause a huge problem for the economy. However as seen above it can also be argued that TBTF in fact causes instability and uncertainty. Financial institutions take advantage of the government safety nets that are implemented and use it as an incentive to engage in high risk activities and consolidation which increases the chances of failure and a disastrous ripple effect that could not only devastate the financial sector but the whole world economy. TBTF provides advantages but there are more negatives. It can be a problem but with the right regulation such as the Dodd-frank act it can be managed.

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