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?

EC248 Essay

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Introduction:

This essay will present a detailed analysis of the concept ‘too big to fail’ together with rational arguments in favour and oppose the policy. Essay begins with a throughout discussion of the problems periodically faced by the banking sector that might lead to the failure of a large chain of banks. It will continue explaining the meaning of the Government Safety Net, problems it faces and their consequences. The essay continues explaining the ways in which FDIC deals with troubled banks followed by an introduction of the ‘too big to fail’. This is followed by an explanation of the origins of the policy and the example of the Continental Illinois Bank. Essay presents the positive reasons for the existence of TBTF policy followed by negative consequences of the policy. Ending provides an explanation of why and how the USA government is regulating the TBTF and discuses its future.

Problems with the Banking sector:

Banks have an important role in the work of financial markets because they can easily provide information about activities that ease the productive investment for the economy. The lending of the bank depends on its balance sheets, because if the banks’ balance sheets exhibit deterioration it leads to a significant reduction in its controlled capital, which means that bank will have a shortage of lendable funds and therefore, the lending will decline. This shortage of lendable funds is followed by a decline in investment spending and therefore the overall economic activity may slow down.

If this deterioration of the banks’ balance sheets becomes harsh enough, a bank run can occur, when many depositors wish to withdraw their deposits at the same time, out of fear that if they wait, the bank will default. This fear of failure can spread contagiously among other banks, making even the strongest ones to go under. The simultaneous bank runs that result, are known as bank panic, which is also caused by asymmetric information. This is a huge economic problem, because when a high number of banks fail in a short period of time, it creates a huge loss of information production in financial markets and a loss of financial intermediation by the banking sector. The outcome of the bank panic is an increase in adverse selection and moral hazard problems in the financial market, that lead to even sharper decline in lending to facilitate productive investments that result with even worse contractions in economic activity. (Mishkin, 2004: 191-192).

Problems with Government Safety Net:

The government safety net has proven to be successful at protecting depositors and detaining the problem of bank runs and panics, because it ensures that deposits are protected, thereby, encouraging depositors to put their funds into the banks. However, the safety net creates adverse selection and moral hazard problems. Adverse selection creates a trouble with a safety net like deposit insurance when those who are most likely to create adverse outcome insured against bank failures are those who are intend to take advantage of the insurance. Moreover, due to the insurance against loss the banks can be seen as attractive industry to get away with fraud and embezzlement. The moral hazard is a major worry while providing a safety net. This is because, when depositors are safely protected they are aware that bank failure will not affect them, therefore, they would not withdraw their deposits when a suspicion, that the bank is taking on too much risk occurs. This allows banks that are protected by the government safety net to act riskier. (Mishkin, 2004: 260-264).

The ways FDIC resolves issues with failing banks:

Before the year 1950 the FDIC (Federal Deposit Insurance Corporation) had two main ways of handling failed or failing banking institutions. One of them, was called the payoff method, when depositors of a bankrupted organization are paid off up to the $100,000 insurance limit, bank gets liquidated and the FDIC together with other creditors of the bank are paid with income from liquidated assets. The second way, was the purchase and assumption method, when a willing merger partner is introduced, who takes over all of the failed bank's deposits and not a single depositor loses any funds. Additionally, FDIC may provide help to the merger company, whilst giving subsidized loans or buying some of the bank's troubled loans. (Burton and Brown, 2009: 266-267) However, in XX century FDIC came up with a third option. If the failing bank was acknowledged as an essential industry to its community it had to be kept open with direct infusion of funds. This option was first agreed upon and used in practice while dealing with the failure of the Continental Illinois Bank, that will be overviewed further in the essay.
(URL: http://www.fdic.gov/bank/historical/history/235_258.pdf pg.14)

The explanation of the term 'too big to fail':

The problems created by the deterioration of balance sheets, asymmetric information and moral hazard, that have been described earlier in the essay, are the main reason for the slower functioning of the banking system and even failure. Some banks fail without any notice, others before failing, due to the large size and their vital role in the financial system, become a concern of policymakers. In the context of this essay the word 'large' do not necessarily refer to the size of an institution, but mainly to the important role played in the financial system and the overall economic performance. The collapse of an important banking establishment is considered to be a serious risk to other financial institutions and even the financial system itself, therefore, the determination of a correct strategic response to a failing significantly important bank has been a concerning issue faced by the government. (Mishkin, 2004: 192). These deteriorating banks are described using the 'too big to fail' term – 'a policy under which the federal government does not allow large financial firms to fail for fear of damaging the financial system'. (Burton and Brown, c2006, 365) The failure of the bank might result with a drastic decrease in the money supply and catastrophic consequences on the overall economic activity. This is because monetary authorities rely on the bank, as it is a tool for transmission of monetary policy by making loans. Moreover, the bank failure raises the costs of intermediaries, can reduce aggregate demand and has an important role in payments, lending, settlements and clearance systems. The banking system has a central role in the economy therefore, if those systems failed the payments of goods and services, securities transfers and international capital flows would be negatively affected. (Gup, 2004: 30-31)

Continental Illinois Bank and the origin of 'too big to fail':

Term 'too big to fail' is considered to be firstly referred to during the bailout of the Continental Illinois Bank in 1983, when bank regulators were afraid that the failure of the bank might cause a systematic crisis. From the 1970s till 1980s Continental Illinois Corporation was one of the biggest and the most aggressive wholesale banks in the USA by selling large-denomination certificates of deposits and making corporate loans. The bank system seemed to be working properly for some time however, it had two deep problems with its risk management: it had an out of order assessment of banks credit risks and no core deposits to tide itself over if the bank experienced difficulties. The difficulties began in 1982, when a small Penn Square bank was closed. This bank sold to Continental loans for more than a $1 billion, however, a huge part of them were defaulted. In addition, Continental has made a huge amount of bad loans to less-developed countries. The stories started to spread in public about the banks losses, people started withdrawing their funds and the liquidity crisis occurred. This bank run started to concern regulators, because of a fear that Continental's will contagiously spread to more than a 1,000 of other banks making them fail together with Continental. This made U.S Congress in year 1984 consider a proposal of Comptroller of the Currency Todd Conover that the Continental and 10 other large banks were 'too big to fail', because of the fact that this organization was too big to liquidate and the government had to bail out this organization. The proposal stated that the Federal Deposit Insurance Corporation would bail out the banks so that neither creditors nor depositors would suffer any loses. This would be done by using the purchase and assumption method, by giving a failing bank an infusion of money from the FDIC and then finding a merger partner to take over the bank and cover its depositors. The regulators of the bank were concerned that failure of the Continental would result with a drastic decrease in the money supply and disastrous consequences on the overall economic activity. Therefore, the FDIC took control of the Continental in 1984 by guaranteeing depositors up to $100,000 insurance limit, insured accounts exceeding $100,000 and prevented losses for Continentals bondholders. (Gup, 2004: 29-38)

Reasons why 'too big to fail' is a useful policy:

Protection provided by the 'too big to fail' policy is very expensive, however ignoring those problems can result in even bigger expenses. If the policymakers reasonably and thoroughly provide the 'too big to fail' support, the benefits of it compensate the costs. The failure of the bank can lead to systematic risk, which is threatening the whole banking system. The failure of large institutions can immediately cause failures of other industries in the whole financial system. The failure may also cause a crisis of confidence that may contagiously travel over to other financial institutions leading to a financial crisis. The cost occurring from the failure of the large banks is the main reason why government is willing to protect them. (Moosa, 2010: 124-125)

There are three main reasons, that play some role in explaining why bailing out large banks is a positive incentive from the point of view of the policymakers and the organizations:

1. The benefits of protection outweigh the costs after preventing unsteadiness in the banking structure from arising and possibly expanding to the rest of the economy, in other words, it is a common belief that 'the too big to fail' policy is a key element to preserve well-functioning economic activity.

2. It is important for policymakers to bail out large banks, because by doing so they might be increasing their individual welfare. For example, providing help to uninsured creditors may advance the career some policymakers.
3. The government allocation of credits may increase society's long-run welfare. Those long run benefits from protecting uninsured creditors exceed the costs of moral hazard created by them, according to policymakers.

The personal motivations can be one of the reasons for the protection of the 'too big to fail' policy, but the assumption is that it is less important than the concerns over losses in the economy. One reason why policymakers bail out the failing banks is due to the fear that the creditor loses from one bank can contagiously spread to other banks creating huge losses in the financial system that result in a major decline in the national output. Banks play major roles in markets that allow firms not related to finance manage their risks, such as managing cash, foreign transactions and many other administrative roles. The halt of the banking system will lead to the malfunctioning of lending, payment processing and many other daily functions. The instability in the banking system may have a tightening effect on the availability of the credit. For example, banks may respond to their own deterioration by reducing the overall amount and shortening the repayment time for loans. This decrease in bank credit makes small firms which have no other financing than taking credit, to reduce production and employment, as there is no funding for expansion. All these problems if spreading quickly, may lead to significant consequences for the economy and the financials system. Therefore, government instead of liquidating the firm and dividing it in the market is more committed to protect ongoing organization, at the same time way saving jobs and protecting from spillovers in the economy. (Stern and Feldman, c2009: 40-89)

Reasons why TBTF is a bad policy:

The most seriously considered problem with institutions that are 'too big to fail', is the uninsured creditors, of a large and important banking institutions, who expect that governments policies will protect them in an critical scenario from all loses that might occur. Therefore, they reduce attention in observing and responding to possible harmful activities, the banks exercise less of market control and take on more risk while making loans or other activities that have a high risk of failure. Bailing out failing financial institutions that are

TBTF is a problem not only because it is very expensive, but for the serious financial burden it oblige the future generations to payoff. Instead of allocating the funds to health or education, government directs those funds to revive the balance sheets of the failed bank. (Stern and Feldman, c2009: 11-28)

According to the Imad A. Moosa there are seven arguments against the TBTF policy:

1. There is no certain way to determine which institution should be considered worthy to be TBTF. This creates an environment of size distortion, when bigger banks get more protection that encourages lobbying for personal gain and making some institutions more powerful just because of close relations with the government.
2. The money spent on bailing out failing banks could be used more efficiently, for example creating more job spaces in the productive sectors of the economy, helping education system or other important sectors of the country.
3. TBTF policy creates moral hazard, meaning that relieving individuals or institutions from the band economic decisions gives them an idea that their actions are risk free, since they will always be bailed out. The inclination to engage in risky behaviour is reinforced by the fact that they are protected from the bad outcomes, while if everything goes good, they have a possibility to increase gains. The TBTF policy results in banking institutions taking on greater risks that make bank failures more likely.
4. The financial bailouts of banking institutions may follow a few courses of actions: rising taxes, borrowing funds or even printing money. This happens when government cannot raise taxes, too pay the costs of bailing out, it may fund the action by issuing and selling bonds this way borrowing funds. However, those interest payments and the repayment of principals increase the taxes paid by the future generations. Sometimes when governments finances bailouts, they make Central Bank print money and that may result with hyperinflation.
5. The TBTF has serious consequences on long term financial stability. However, rescuing a bank in trouble makes others think that they would be helped out if needed as well. This thinking weakens their incentive to maintain their own financial health and increases chances of getting in trouble, because it enables managers to engage in riskier activities that might raise the overall risk in the financial system. Bailing out may calm down the financial marker in the short run, but in the long run the stability is weakened.

6. The TBTF policy can have a harmful effect on the efficiency of banks. It is believed that, small and medium size banks over-perform the large banks, because banks protected by the TBTF are less risk sensitive and perform in costly manner. This happens because TBTF institutions know they will be protected in the long-run.
7. TBTF makes large institutions even larger and more powerful, and therefore has a negative effect on the market competition. This happens, because large institutions have an implicit subsidy that gives them a possibility to borrow funds at a lower cost, as lenders believe that government will always protect their obligations.
8. The TBTF problem is considered to be a cause of degeneration and corruption of the financial system. This is because TBTF enhances the ability of the financial system to misallocate the recourses from the productive parts of the economy. (Moosa, 2010: 124-139)

Regulations imposed to handle problems with 'too big to fail':

FDICIA made attempts to regulate the related actions with TBTF, but still left the means for the regulators to invoke if very necessary. This happened due to the events similar to the resolution of the Bank of New England, when members of Congress started to question the fairness and the depository discipline of the TBTF policy and how to restrict it. FDIC was prohibited to protect any uninsured deposits or non-deposit bank debts, when loses of insured funds would increase, meaning that uninsured depositors had to bear losses for most of the time, this was called least-cost test. The most important effect of the test was that the FDIC would not be able to keep failing bank open if it would be cheaper to keep it closed. This regulation law increased the percentage of unprotected uninsured depositors throughout the 1990s, it increased government accountability and limited the application of the expectation. In order to bail out the bank, at least two thirds of both the FDIC Board of Directors and the Board of Governors of Fed must agree that the exceptions need to be made and then must be agreed upon by the secretary of the treasury and the president. The General Accounting Office reviews actions taken and reports to the Congress. The law moves towards eliminating the TBTF as principle policy, this way reducing the possibility of future large bank bailouts. (URL:<http://www.fdic.gov/bank/historical/history/235_258.pdf>, 20-22)

The possible end to the 'too big to fail' policy:

The actions of the Federal government, Treasury and the FDIC received good responses from many economists and policymakers for their aid restoring stability of the financial system However, many Congress members criticized the so called 'Wall street bailout' that occurred, as they believed, due to the actions taken to prevent big institutions from deteriorating. Therefore, in the year 2010, the Wall Street Reform and Consumers Act (also known as the Dodd- Franc act) was passed, where provisions to end the too big to fail policy were stated. This act allows for the Treasury, Fed and FDIC to sell all failing firms assets in a way that would not have a negative effect on any financial markets. This solution gives policymakers a third option of how to deal with a large failing institution rather than letting it bankrupt or take means to save it. However, if this act will end the 'too big to fail' policy is still to be seen in the future. (Hubbard and O'Brien, c2012: 364-366)

Conclusion:

The essay presented an accurate discussion of the problems faced by the banking sector, and the different ways in which government deals with them. The essay presented the explanation of the TBTF and how the government deals with failing banks if they are considered to be TBTF, together with an explanation of the origin of this policy. Essay examines both the positive and negative effects of the TBTF policy, giving explanations and overview of the effect on the economy. The conclusion is made that there more negative consequences' occurring from the TBTF policy, therefore the essay ends with the brief summary of regulations taken in order to restrict TBTF policy, and the means taken in order to end it.

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