13. Too Big to Fail

Entries in this section deal specifically with the implicit bank regulatory policy known as "too big to fail" (TBTF): its origins; its economic consequences; its effects on bank behavior and risk-taking, on banks' cost of funds, and on depositor behavior; and corrective policy prescriptions.

Angbazo, Lazarus, and Anthony Saunders. 1996. The Effect of TBTF Deregulation on Bank Cost of Funds. Salomon Center Working Paper no. S/96/39. New York University.

> This paper tests the hypothesis that the regulatory shift from full deposit coverage for some large banks to partial coverage for all banks, as mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), increased the risk and cost of bank deposits. The distribution of the wealth effects of FDICIA shows significant effects which were confined to the large bank segment. Specifically, the initial release of the President's plan, its initial approval in the House, and its passage by Congress generated negative abnormal returns for large banks, while the announcement of a less generous proposal by the Senate, and the President's final approval produced positive returns. Furthermore, the systemic risk estimate and the cost of funds for large banks declined after the Act. The data show no reaction by small banks, which is consistent with the hypothesis that small banks were not in a position to exploit the fairer cost of deposit insurance under the revised too-big-to-fail doctrine. (©1999 EconLit)

Black, Harold A., M. Cary Collins, Breck L. Robinson, and Robert L. Schweitzer. 1997. Changes in Market Perception of Riskiness: The Case of Too-Big-to-Fail. *Journal of Financial Research* 20, no. 3:389–406.

> In 1984, the Comptroller of the Currency stated that the eleven largest banking firms were "too big to fail," implying they would receive de facto 100 percent deposit insurance. The question is whether this announcement altered the market's perception of the riskiness of all banking organizations, not just those included in the Comptroller's statement. The authors address this question with two tests. First, through the examination of changes in institutional equity ownership from 1980 through 1988, they find that the announcement is associated with increases in institutional ownership at a time when a comparable set of nonfinancial firms saw reductions in institutional holdings. Second, through the examination of stock returns behavior of bank holding companies around announcements of dividend cuts and omissions from 1974 through 1991, they find that the Comptroller's 1984 announcement altered the market's reaction to dividend cuts and omissions by bank holding companies not specifically included in the Comptroller's statement. (©1999 EconLit)

Boyd, John H., and Mark Gertler. 1994. The Role of Large Banks in the Recent U.S. Banking Crisis. Federal Reserve Bank of Minneapolis *Quarterly Review* 18, no. 1:2–21.

The authors argue that the poor performance of the U.S. banking industry in the 1980s was due mainly to the risk-taking of the largest banks, which was encouraged by the U.S. government's too-big-to-fail policy. The article documents the recent trend toward riskier bank portfolios and the corresponding decline in bank profitability. A breakdown of the data by location and by asset size reveals that bank problems were concentrated in areas with troubled industries (oil, real estate, and agriculture) and among banks with the largest assets. In a statistical study controlling for location, asset size remains a significant factor in poor performance of large banks.

Feldman, Ron J., and Arthur J. Rolnick. 1998. Fixing FDICIA: A Plan to Address the Too-Big-to-Fail Problem. 1997 Annual Report. Federal Reserve Bank of Minneapolis.

In 1991, regulators indicated that in response to the failure of a very large bank, they would take extraordinary steps not otherwise allowed during a standard resolution. Such steps have included full protection of uninsured depositors and other creditors, as well as full protection of suppliers of funds to the bank's holding company and potentially even of shareholders, without regard to the cost to the FDIC. This practice has become known as "too big to fail" (TBTF). In this paper, the authors put forth a proposal to curtail the too-big-to-fail issue. The proposal requires uninsured depositors of TBTF banks to bear some losses when their banks are rescued. To further address moral hazard, the authors propose that the FDIC incorporate the market's assessment of risk, including the rate paid to uninsured depositors and other creditors, into insurance assessments.

Golembe, Carter. 1991. Too-Big-to-Fail and All That. *The Golembe Reports* 1991-4.

This report begins by describing how the TBTF concept came to be. The next section deals with suggested approaches to solving all or part of the too-big-to-fail problem, including several that have surfaced in draft legislative form. The final section offers concluding comments. The author's basic opinion is that TBTF is simply a small part of a larger problem within the banking industry and that solving the TBTF portion will not repair the banking industry.

Gray, Robert Parker. 1997. Failed Banks and Public Choice. Ph.D. diss., University of Sydney (Australia).

This dissertation examines the too-big-to-fail issue in bank failures from 1985 to 1994. The author uses public choice economic theories—particularly theories involving bureaucracies, interest groups, individual utility functions, regulations, and voting—to develop a model of choice made by the FDIC, and takes into consideration two landmark banking laws, FIRREA and FDICIA. He uses the logit econometric technique to test 20 variables in time periods delineated by FIRREA and FDICIA. The effect of the variables changes over time for the size of the bank. Between 1985 and 1989 the variable is statistically significant and positive, indicating the existence of a TBTF doctrine. However, size becomes statistically insignificant between the enactment of FIRREA (1989) and the enactment of FDICIA (1991). After FDICIA, size is again statistically significant but the sign of the partial first derivative changes to negative, that is, after FDICIA, owners of uninsured deposits in smaller banks are favored. The most consistent variable is the relative level of core deposits in the failed bank. The higher the level of core deposits in a bank, the more likely the uninsured deposits will be treated as insured deposits.

Gup, Benton. 1998. Too Big to Fail: An International Perspective. In *Bank Failures in the Major Trading Countries of the World: Causes and Remedies*, 69–91. Quorum Books.

A key point in this chapter is that the TBTF doctrine extends beyond banks and that it is a much older practice than the failure of Continental Illinois Bank in 1984 — the event often identified with the origin of the TBTF doctrine. Throughout the world, governments intervene in the economy when they believe that there is a high probability that any event, for example the failure of a large firm (financial or nonfinancial), will result in severe economic distress or when they believe it is in their national interest to do so. The chapter examines twenty-three methods governments have used to intervene in the markets and provides examples from a variety of countries, including numerous examples of the TBTF doctrine applied to nonbanks.

Hetzel, Robert L. 1991. Too Big to Fail: Origins, Consequences, and Outlook. Federal Reserve Bank of Richmond *Economic Review* 77, no. 6:3–15.

The policy of too big to fail arose in part from pressures created by the lack of satisfactory bankruptcy arrangements for banks. It prevented market forces from closing banks and protected all uninsured depositors of large banks from loss in the event of failure. The consequent risk-taking behavior of banks produced the systemic instability in banking that the policy was designed to prevent. It is debatable how the Deposit Insurance Reform Act of 1991 will affect the timing of bank closures, the risk-taking behavior of banks, and the contraction of the banking industry. (©1999 EconLit)

Hughes, Joseph P., and Loretta J. Mester. 1993. A Quality and Risk-Adjusted Cost Function for Banks: Evidence on the “Too-Big-to-Fail” Doctrine. *Journal of Productivity Analysis* 4:293–315.

The authors estimate a multiproduct cost function model incorporating measures of bank output quality and the probability of failure. They find evidence that the “too-big-to-fail” doctrine significantly affects the price a bank pays for its insured deposits.

Institute for Strategy Development. 1991. "Too Big to Fail": Who Will Bear the Cost in Other Industrialized Nations? A study prepared for the American Bankers Association by the Institute for Strategy Development.

In the United Kingdom, Japan, Germany, and most other countries whose banks compete directly with U.S. banks, the additional cost of protecting depositors above the deposit insurance limits is borne by the central bank and finance ministry, not the deposit insurance fund. A coherent response to the dilemma of which banks are "too big to fail" is vital if the U.S. deposit insurance system is to be truly restructured to avoid a repetition of its problems. A meaningful definition of the risk borne by the deposit insurance fund must precede any evaluation of the premiums it must charge and the resources it should control. Continuing the current practice of requiring the deposit insurance fund to bear the full cost of too-big-to-fail rescues results in premium levels that significantly reduce U.S. bank competitiveness.

Jacobe, Dennis. 1990. It's Time to End the Too-Large-to-Fail Doctrine. *Savings Institutions* 111, no. 2:23–25.

The "too-large-to-fail" (TLTF) doctrine is the theory that large banks enjoy 100 percent deposit insurance that fully protects all uninsured depositors and general creditors. The author explains that de facto insurance coverage for all depositors and creditors of large financial institutions raises serious questions about competitive equity, market efficiency, financial sector structure, and overall economic stability. Most suggestions for reform involve ways to bring more market discipline to federally insured depositories. These suggestions include (1) reducing the deposit insurance amount; (2) limiting each depositor to one insured account; (3) cutting the insurance coverage provided; and (4) combining federal with private deposit insurance. Increased market discipline would allow the deregulation process to continue. By placing depositors at risk and limiting taxpayer exposure, these suggestions would let the marketplace determine financial institution activities. If de facto 100 percent insurance is going to be provided, the author feels it should be applied to all banks.

Moyer, R. Charles, and Robert E. Lamy. 1992. "Too Big to Fail": Rationale, Consequences, and Alternatives. *Business Economics* 27, no. 3:19–24.

The "Too Big To Fail" (TBTF) doctrine was formalized in light of the liquidity crisis at Continental Illinois Bank in 1984. The objective of this policy is to preserve public confidence in banking institutions and thereby avoid the systemic problems associated with large bank failures. This article reviews the history of the TBTF policy, critically appraises its rationale and success, and discusses the serious economic consequences associated with TBTF. The moral hazard problems arising from the combination of TBTF, lax capital standards and a flat rate system of deposit insurance are examined. Alternatives to TBTF are suggested. (©1999 EconLit)

O'Hara, Maureen, and Wayne Shaw. 1990. Deposit Insurance and Wealth Effects: The Value of Being "Too Big to Fail." *Journal of Finance* 45, no. 5:1587–600.

> This article investigates the effect on bank equity of the Comptroller of the Currency's announcement that some banks were "too big to fail" (TBTF) and that for those banks, total deposit insurance would be provided. Using event study methodology, the authors find positive wealth effects accruing to TBTF banks, with corresponding negative effects accruing to non-TBTF banks. They demonstrate that the magnitude of these effects varies with bank solvency and size. Finally, they show that the policy to which the market reacted was the one suggested by *The Wall Street Journal* and not the one actually intended by the Comptroller.

Park, Sangkyun. 1991. The Behavior of Uninsured Deposits: Market Discipline of "Too Big to Fail." Research Paper no. 9130. Federal Reserve Bank of New York.

> This paper uses Call Report data of 1988, 1989, 1990, and 1991 to investigate the behavior of insured deposits. The focus is on the relationship among the quantity of uninsured deposits, interest rates, and the riskiness of banks. Cross-section analyses for each of the four years present two major findings: (1) The importance of bank size in explaining the quantity of uninsured deposits increased over time; and (2) riskier banks that offered higher interest rates on uninsured deposits attracted more uninsured deposits. Given these findings, uninsured deposits do not appear to be a reliable source of market discipline.

Randall, Richard E. 1990. The Need to Protect Depositors of Large Banks, and the Implications for Bank Powers and Ownership. Federal Reserve Bank of Boston *New England Economic Review* 78, no. 11:63–75.

> The author believes three fundamental issues should be carefully considered before decisions are made about altering the federal safety net or the structure of the U.S. banking system. The first is whether bank depositors and other creditors can exercise timely and meaningful restraint on excessive risk-taking by bank management. The second issue is whether the government should handle the orderly resolution of large-bank failures in such a way that uninsured depositors and other bank creditors are protected. The third issue is the degree to which banking should continue to be insulated from other financial and nonfinancial activities. A review of these issues suggests that, since market discipline cannot be effective in deterring excessive credit risks in banks, authorities must continue to give all depositors of large banks the implicit assurance that their funds will be protected. Bank involvement in investment banking and other financial activities should continue to be limited, and nonbank entry into banking should still be restricted to avoid broadening the federal safety net.

Ratway, David J. 1995. Note and Comment: National Depositor Preference. *Nova Law Review* 19, no. 1121.

> The Omnibus Budget Reconciliation Act of 1933 includes the National Depositor Preference provision that, for the first time, places both insured and uninsured

depositors of FDIC-insured institutions ahead of unsecured creditors in a bank liquidation. The author contends that the FDIC will be able to recoup most of the money it pays out to depositors before the first unsecured creditor receives anything, thus exposing unsecured creditors to great risk. The author expects that receipts to the federal deposit insurance funds from asset sales will rise, and insurance losses will be lower than under previous laws that divided the assets of a failed bank on a pro rata basis.

Robinson, Breck Ledo. 1994. Too-Big-to-Fail and Bank Holding Company Behavior. Ph.D. diss., University of Tennessee.

On September 19, 1984, the Comptroller of the Currency declared that some banks are "too big to fail" (TBTF). In the event of failure, the largest 11 banks would receive de facto 100 percent deposit insurance, which would minimize the possibility of bank runs by uninsured depositors. This dissertation explores the effect of TBTF on the market and on bank holding companies. The research examines the following areas: (1) the market's reaction to the TBTF doctrine in regard to the security price of bank holding companies, (2) the differences in the market's reaction to dividend cuts between the pre- and post-TBTF periods, (3) changes in bank holding companies' asset composition associated with the incentives related to the TBTF doctrine and (4) changes in the efficiency of bank holding companies caused by the TBTF doctrine.

Roth, Michael. 1994. "Too-Big-to-Fail" and the Stability of the Banking System: Some Insights from Foreign Countries. *Business Economics* 29, no. 4:43–49.

Systemic risk in case of a major financial crisis is an important issue in all industrialized countries. Each country addresses it differently by implementing a complex system of safety-net arrangements. In this article, the German approach of indirect deposit insurance through a liquidity bank is described. By comparing seven industrialized countries with regard to deposit insurance schemes, banking structures, and methods of handling a banking crisis, conditions are discussed under which such an approach is transferable to other banking systems in order to make a "too big to fail" scenario less likely to occur. (©1999 EconLit)

Scott, David F. Jr., William G. Jens, and Raymond E. Spudeck. 1992. Bank Reform: The Enduring Issues. *Business Economics* 27, no. 3:7–12.

The combination of a difficult aggregate economic environment, an increasingly competitive market for the delivery of financial services, and troublesome trends in both bank profitability and failure rates has focused national attention on bank reform. This article overviews several of the enduring issues that dominate bank reform proposals. The article then discusses the need for deposit insurance, the too-big-to-fail doctrine, and the entry of banks into non-traditional lines of business. The role of market discipline and bank survival in the 1990s is also considered. Less of a regulatory burden coupled with renewed market discipline are necessary for the banking industry and the economy to prosper during the remainder of the 1990s. (©1999 EconLit)

Stern, Gary H. 1997. The Too-Big-to-Fail Problem. Federal Reserve Bank of Minneapolis *Region* 11, no. 3:26–27.

In this commentary, Gary Stern, President of the Federal Reserve Bank of Minneapolis, argued that FDICIA, the 1991 banking reform legislation, did not go far enough in preventing de facto full coverage of uninsured depositors and creditors at large failed banks. Hence, he argues, the problem of moral hazard is unmitigated. The author strongly recommends that the law be changed so that whenever a TBTF-bank is rescued, depositors and creditors are able to recover only 80 percent of their uninsured deposits and claims, or the market value of these, whichever is greater.

Stern, Gary H. 1998. Deposit Insurance, Too Big to Fail, and Small Banks. Federal Reserve Bank of Minneapolis *Fedgazette* 10, no. 2:10–11.

This commentary discusses the issue of too-big-to-fail (TBTF). In 1991, Congress partially fixed the problem of moral hazard created by 100 percent coverage of uninsured deposits and creditors by passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Certain provisions of FDICIA substantially increased the likelihood that uninsured depositors and other creditors would suffer losses when their bank failed. However, the author argues that the fix was incomplete, because regulators can still provide full protection when they determine that a failing bank is TBTF. He feels the TBTF exception is too broad and still provides too much protection for large banks. The resultant moral hazard from 100 percent coverage at large banks could, he argues, encourage these institutions to take on excessive risk. The author proposes to amend FDICIA so that the government cannot fully protect uninsured depositors and creditors.

Todd, Walker F., and James B. Thomson. 1990. An Insider's View of the Political Economy of the Too Big to Fail Doctrine. Working Paper no. 9017. Federal Reserve Bank of Cleveland.

Understanding interbank exposure is the key to understanding the too-big-to-fail doctrine. In this paper, the authors argues in support of three principal hypotheses: high levels of interbank exposure reduce the safety and soundness of the banking system; interbank exposure affects the ability of the FDIC and bank regulators to use market discipline as a constraint on banks' risk-taking; and a rising level of interbank exposure indicates reduced stability of the financial system. In addition, the paper provides evidence that interbank exposure does not appear to be a generalized problem for U.S. banks; however, some banks in all categories of asset size still have comparatively high ratios of interbank exposure to capital, despite a general decline in these ratios since the Continental Illinois failure.

U.S. House. 1991. Committee on Banking, Finance and Urban Affairs. *Economic Implications of the "Too Big to Fail" Policy: Hearing*. 102d Cong., 1st sess., May 9.

> Witnesses include William H. Brandon Jr., Robert L. Clarke, Bert Ely, Johnny C. Finch, Robert R. Glauber, George G. Kaufman, John LaWare, William L. Seidman, and Howard L. Wright.

Wall, Larry. 1993. Too-Big-to-Fail after FDICIA. Federal Reserve Bank of Atlanta *Economic Review* 78, no. 1:1–14.

> In passing the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Congress sought to reduce both the potential for systemic problems in the banking system and bank regulatory agencies' incentives to follow a too-big-to-fail policy. FDICIA strictly controls regulators' ability to protect or extend the lives of large banks, while keeping other policy tools for dealing with systemic risk. Some systemic-risk issues remain, however, including the effect of a large bank's failure on financial derivatives markets and the effects of unexpected massive losses at one or more banks. This article reviews these concerns as well as FDICIA's provisions designed to reduce systemic risk.

Wilmarth, Arthur E. Jr. 1992. Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks. *Iowa Law Review* 77, no. 3:959–1081.

> The author considers the case for interstate branching, as well as the proposal for a nationwide consolidation of the banking industry. The article shows that interstate branching by itself (that is, without substantial consolidation through bank mergers and acquisitions) would provide modest net benefits to the banking industry and the public. In contrast, full-scale nationwide consolidation could impair the safety, efficiency, and profitability of the banking industry. Consolidation could also reduce competition among banks and restrict the availability of credit to smaller businesses and local communities. This article recommends, therefore, that interstate branching should be approved, but only with reasonable safeguards designed to prevent the potential adverse effects of consolidation. The author contends that the greatest risk posed by nationwide consolidation is that it would concentrate more of the nation's banking assets within a small number of "too big to fail" banks.