

Does Financial Regulation Limit Excessive Risk-Taking of TBTF Banks?

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When a firm takes the decision to borrow, its financial risk rises and shareholders as a result require a higher rate of return. At high levels of debt, however, the probability of financial distress increases rapidly and may end up jeopardizing the firm. Just as the market rewards firms for success, it also penalizes excessive risk-taking. The history of corporate failures is indeed abundant with cases where shareholders lost all their investment. But when it comes to the banking industry, recent evidence shows that some institutions are not allowed to fail so that bank shareholders are not punished for irresponsible behavior. So what is it that is so special about banking and does it justify a too-big-to-fail policy (TBTF)?

Banks are highly leveraged institutions which are overwhelmingly funded by deposits. By default, a high debt to assets ratio exposes them to substantial financial risk, which in principle raises concerns about their ability to meet obligations. Banks, however, play a major role in payments settlement and in extending credit to the economy. The safety of depositors is also a major concern for policy-makers. For these reasons and in order to ensure the safety and soundness of the financial system, banks are heavily regulated institutions compared to other non-financial firms. In some instances, regulation might fail to curb risk-taking, possibly forcing governments to extend guarantees for large and interconnected banks that are deemed TBTF. Under such a policy, regulators commit to protect uninsured creditors from the losses that they would otherwise suffer if the TBTF bank fails, in an attempt to stop the failure before it occurs.

Why might regulators give this privileged status to some banks? There are broad guidelines that determine whether a large bank is deemed TBTF. If a bank has a substantial market share compared to its peers, if it has many customers, if it plays a significant role in funding the economy, or if it processes a significant amount of payments and security clearing transactions, then its failure may cripple other solvent institutions that are connected to it and to each other. An example of a large bank resolution is the failure of the US's seventh-largest bank in 1984, Continental Illinois National Bank and Trust Company. The bank had already been identified as taking excessive risks, but its performance had not yet been seriously compromised. Its failure forced regulators to recognize that not only very large institutions could fail but also that bank regulators needed to find satisfactory ways to cope with such failures. Regulators fully covered all deposits at Continental, and a great deal of controversy arose debating whether large banks had to be treated differently from smaller institutions. Still, some argue that an after-the-fact examination of the financial books of Continental shows that there was no real threat of contagion after all.

TBTF guarantees have several undesirable effects. First, they encourage excessive risk-taking and exacerbate moral hazard. Moral hazard is a basic concept in finance: if someone pays for your accidents, you will make less effort trying to avoid them. Under no TBTF guarantees, creditors are more likely to require higher return before turning

over their funds to banks, or they might even reconsider placing their savings at these institutions. As a result of these price and quantity signals, bankers might exclude from their portfolios some risky investments and loans that would otherwise be profitable. In addition modifying creditor behavior, government blanket guarantees for banks provide them with artificial incentives to grow and become perceived as TBTF. Knowing that they will not assume the full burden of their behavior, TBTF banks take on excessive risk and may act less responsibly than they would if the government does not bail them out in case they fail. Second, TBTF protection places smaller banks on uneven grounds with large banks because they do not have implicit government guarantees. Finally, TBTF schemes can be costly to current taxpayers and generations to come. The bottom line is that TBTF guarantees distort incentives, encourage imprudent banking practices and lead to a misallocation of resources.

The financial crisis has established that financial threats are genuine enough to bring down the real economy. From the regulator point of view, the spillover effects from the failure of a large and inter-connected bank motivate the decision to bail out creditors and extend TBTF guarantees. Therefore, a reduced threat of the risk of contagion is likely to remove TBTF blanket guarantees, which also reduces moral hazard and enhances stability. The issue remains as to how to reduce the incentives for financial firms to become TBTF.

It is important that regulators supervise systemically important banking firms to prevent excessive risk-taking and improve financial sector resilience. Typically, regulators are in a position to identify TBTF bank candidates, and they ought to hold them to high capital and liquidity standards. There are several serious proposals for changing banking regulations to ensure better overall capitalization. Some are recommending banks to build up counter-cyclical capital buffers- to build up more capital during periods of credit expansions, and which is to be later drawn upon during economic downturns. Others reforms additionally include requiring banks to hold more capital against their trading books. Nonetheless, it is also crucial that financial supervisors monitor large and interconnected financial institutions by ensuring that they manage their risks in a timely manner at all levels in the organization. Stress tests need to be conducted to assess the risk management efforts put in place and identify best-practices as well as areas of deficiencies that may impair performance.

While the possibility of a bank failure cannot (and maybe should not) be eliminated, financial regulators and supervisors have to work on reducing the threat that collapsing institutions can negatively affect the real economy. Only then would TBTF incentives be curbed and financial stability restored.