Reshaping the Global Banking Industry

By Richard Rousseau

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The subprime crisis – and the following global crisis – set in when a bank considered "too big to fail" was actually allowed to fail and go bankrupt. Despite five years of reform efforts, the too-big-to-fail syndrome is far from a memory, and it is imperative that economic decision-makers do not divert their attention from this issue so easily. On the contrary, more research into analyzing the costs and benefits of various structural reform schemes would help monetary authorities put the world's financial system back on the right track.

Prior to the subprime crisis, 29 large global banks saw their ratings raised to just over one point by credit rating agencies because markets expected that they would be able to get state support. Today, those same behemoths benefit from hidden support of nearly three notches, and expectations of public funds support have tripled since the beginning of the crisis.

In real terms, this amounts to an enormous subsidy to the world's largest banks at artificially low funding costs, ensuring greater profits. Before the financial crisis hit the world economy, tens of billions of dollars were put in big banks as reserves on an annual basis; today, it amounts to hundreds of billions. In other words, if we are to believe the financial market's expectations, the regulations put in place by governments and international institutions have not prevented the "too-big-to-fail" syndrome.

At first glance, such a finding can be bewildering to casual observers. The financial industry never misses an occasion to warn against oppressive regulations of the world's largest banks. What we know for sure, however, is that regulations to subdue the "too-big-to-fail" syndrome have come in from all sides, and rather quickly after the start of the 2008 crisis.

Three Current Financial Reforms and their Flaws

The first type of reform consists of overloading additional capital collected from the world's biggest banks based on their size and connectivity, or the way in which corporations and banks communicate electronically. This tax on systemic externalities is built on strong economic foundations and has been incorporated into sound public policy. Last year, the Financial Stability Board (FSB), an international agency established in Switzerland in 2009 after the G20 London summit, agreed to use a sliding scale approach in setting up systemic surcharges for the world's largest banks. The highest capital surcharge was established at 2.5%.

However, overloading additional capital is at the heart of the problem. Based on the estimates of Andrew G. Haldane, Executive Director at the Bank of England, the tax rate is insufficient to change the behavior of the world's largest banks. The probability of default with a more or less 2% tax is plausibly reduced, especially if the biggest banks are faced with an external shock. This amplified absorption capacity will likely entail riskier behavior by the largest banks and it does not constitute a reinforced protection of financial systems. The capital surcharge is simply being levied at rates that are not high enough to change risky behavior in banks.

The second type of reform is to modify the resolution regimes for financial institutions, particularly those found in banks. Effective resolution regimes for banks reduce the cost of such an operation and the cost for taxpayers. The banks should also treat the root cause of systemic risks. Significant progress has been made in public policy on this front; over the last 18 months, the Financial Stability Board has published a number of legislative proposals with G20 approval, entitled Key Attributes for Effective Resolution Regimes. One of the key "attributes" of these proposals is the so-called "bail-in," or the ability to impose losses on private creditors and shareholders rather than to ask taxpayers to incur these losses.

However, the problem with these proposals is not so much the principle, but, as with systemic surcharges, its application in practice. Whether it deals with large banks or public debt, a good resolution regime for a "bail-in" is liable to a serious time-consistency problem. Policymakers must choose between placing losses on a small group of taxpayers such as shareholders and bondholders today, or spreading out these losses across a wider number of taxpayers now and into the future—the "bail-out."

In general, risk-averse Western governments tend to adopt the bail-out. Throughout history, this strategy has been used in most cases as a response to financial crisis. Spreading the losses through a bail-out can postpone deadlines and allows financial institutions to avoid a direct conflict with influential groups, but the market is usually skeptical of politically-based rational choices. The Dodd–Frank Wall Street Reform and Consumer Protection Act, passed by the U.S. Congress on May 20, 2010 and the largest financial regulation overhaul since the 1930s, set out the obligation to use bail-in in the future and rules out future public bail-out for incompetent or irresponsible investors and market speculators. However, market expectations of state support for U.S. banks are higher today than they were before the 2008 crisis, despite the entry into force of the Dodd-Frank Act. In the eyes of the markets, the time-consistency problem is now more acute than ever.

Finally, the too-big-to-fail syndrome could be overcome with structural reforms. A way of mitigating the time-consistency dilemma may be to directly alter the scale and structure of the banking system itself. For instance, the "Volcker Rule" in the United States has sought to restrict U.S. banks from making certain kinds of speculative investments which are harmful to their customers. In the UK, the "Vickers Proposals" try to do the same, as well as the "Liikanen Plans" in Europe. Although they differ in details, each of these proposals shares a common goal: to achieve a degree of separation between investment and commercial banking activities.

In principle, these isolated initiatives generate benefits both ex-post with better resolution regimes or bankruptcy laws and ex-ante with improved risk management. As they affect the banking structure, the initiatives' chances of withstanding the test of time are increased. While this is a real step forward, the benefits will only be credible if the separation between investment and commercial banking activities is maintained in the long term. Indeed, many wonder if, in practice, the ring-fencing could prove porous over time without constant monitoring.

Improving Efficiency

Each of these reform initiatives is necessary, but none is sufficient in addressing the too-big-to-fail syndrome, both on an individual and collective scale. One solution to this problem might be to consolidate these proposals through re-sizing of the capital surcharge, possibly on the basis of quantitative estimates of the optimal capital ratio for banks, as David Miles, former Chief UK Economist of Morgan Stanley, and Jing Yang, senior economist at the Bank for International Settlements, argued in the Economic Journal in 2012.

A more radical approach would be to simply set a ceiling for the size of banks, either as a proportion of the financial system as a whole or, more reasonably, relative to GDP, as suggested by Daniel Tarullo, FED governor, and Thomas Hoenig, Director of the Federal Deposit Insurance Corporation. But how would an appropriate limit be calibrated? A recent IMF working paper by Jean-Louis Arcand, Enrico Berkes, and Ugo Panizza suggests that a negative impact on GDP starts to kick in at a certain level of the private-credit-to-GDP ratio; productivity growth is also affected negatively. By carefully analyzing this aggregate limit while focusing on the most appropriate concentration level in the banking industry, a proper threshold could be derived for each financial institution.

Yet the question remains, would limiting banks' size make them less efficient? Can smaller banks achieve economies of scale? Until recently, the literature suggested that the efficiency of banks starts to decline at a relatively small size, but David C. Wheelock and Paul Wilson debunk this theory in their 2012 Journal of Money, Credit and Banking article, "Do Large Banks have Lower Costs? New Estimates of Returns to Scale for U.S. Banks." The authors found that some banks with balance sheets over $1 trillion were still able to achieve economies of scale.

However, these results should be interpreted with caution, as none of them take implicit subsidies associated with "too-big-to-fail" into account. These subsidies tend to bring down big banks' financing costs and to drive up their value. In other words, the implicit subsidy increases the threshold at which the banks' efficiency begins to decline. A study by the Bank of England has recently shown that banks with assets upwards of $100 billion see their economies of scale disappear once implicit subsidies are taken into account. In fact, it would seem that banks' efficiency declines fairly rapidly with size because large banks are also "too big to manage."

The “too-big-to-fail” syndrome still prevails and regulators and investors must keep it in mind. Additional research on this crucial topic would do much in helping to occasionally refresh memories and keep banking industry reforms on track.