NOTES FROM THE VAULT February 2010

Center for Financial Innovation and Stability

Too Big to Fail

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- "Too big to fail" is a policy that results from authorities' choices that shield creditors of failed banks from losses in the failed bank.
- Too big to fail creates a situation in which banks' creditors expect to receive funds from others, such as taxpayers, when banks are unable to pay their obligations.
- While the FDIC Improvement Act of 1991 was expected to reduce the likelihood of banks being too big to fail, events during the 2008 financial crisis clearly indicate that too big to fail is alive and well, at least in financial crises.

"Too big to fail" is much in the news these days. Some prognosticators had thought that concerns about too big to fail were past as a result of the FDIC Improvement Act of 1991 (FDICIA).[1] When too big to fail comes into play, government authorities generally guarantee payment to a failing firm's creditors or assist the bank so it can continue to operate. Such guarantees or assistance mainly concern banks—at least in the United States—and FDICIA was an attempt to reduce the frequency with which too big to fail was invoked for banks. The financial crisis of 2008 obliterated any thought that too big to fail was extinct.

Concern about banks being too big to fail has a fairly recent history. The possibility of banks being too big to fail first came up after the demise of Continental Illinois Bank in Chicago in 1984. At that time Continental Illinois was the seventh-largest bank in the United States in terms of deposits. It suffered losses on its loan portfolio, and large depositors pulled out substantial sums. Many other banks held deposits in Continental Illinois, and the claim at the time was that many of these smaller banks would have failed if Continental Illinois had been allowed to fail.[2] In hearings after the resolution of Continental Illinois, the Comptroller of the Currency indicated that the eleven largest banks in the Unites States were too big to fail and would not be allowed to fail.

Too big to fail: Sustaining failing institutions

Different charters, different rules for banks

Why would the Comptroller say this, and what does it imply? The situation is clearer with a little background knowledge. Commercial banks in the United States have never had corporate charters; they have banking charters instead.[3] Throughout U.S. history, these chartered banks have had special regulations (including periodic examinations, for example) compared to corporations. In addition, chartered banks have special processes to deal with their failure. Chartered banks do not

[1] Not all commentators were so sanguine; see, for example, Stern and Feldman (2004).

[2] This claim has not held up under subsequent analysis (Kaufman and Scott 2003, 377–78). Hindsight always is better than foresight, of course.

[3] Bank holding companies—companies that own commercial banks—are corporations and are subject to the bankruptcy code, as are any nonbank subsidiaries owned by the holding company.

go "bankrupt" in a legal sense. An insolvent bank is taken over by banking regulators—a process called resolution of the bank—and the bank is sold or the bank's affairs are wound up.

Just as in a bankruptcy, resolving a bank can involve paying off the bank's creditors, sometimes paying noticeably less than the face value of the obligations with a significant lag. This partial payment imposes losses on the bank's creditors; if those losses are large enough, a creditor can find itself in financial distress.

Reducing the effects of a policy of too big to fail requires examining the likely effects of suggested solutions as well as possible unintended consequences.

If a bank has numerous connections with other institutions, its failure could impose widespread and large losses on other institutions. A creditor of one of these other institutions may find it difficult to tell how large the losses suffered by his institution may be. The end result of the uncertainty can be a run on other banks, some of which are sound and some of which are not.[4] This subsequent financial disruption could also adversely affect economic activity in the rest of the economy, raising unemployment and lowering output.

Rather than allowing the possibility of cascading losses in banks to have serious adverse effects on the banking system and the economy, regulators confronted by a large failing bank can take actions to limit the losses for the bank's creditors or shore up the bank so that it can continue to operate. Sometimes the term "too interconnected to fail" is used instead of too big to fail to describe the policy. Too interconnected to fail makes the point that it is not the bank's size in and of itself that creates the problem; instead, it is the connections with other institutions—the presumed widespread losses to creditors, including other banks.

Who pays the piper?

When an insolvent bank's creditors are paid more than the bank's assets are worth, this excess value must come from someone. These funds may come from other, solvent banks, or they may come from taxpayers in general. Either way, the insolvent bank's creditors receive funds from other people who had no part in the bank's operation.[5]

Paying a failed bank's creditors with outside funds changes the incentives for those operating the bank. Suppose that a bank is too big to fail. If the bank is successful, stockholders in the bank and possibly customers and employees receive the benefit. If the bank fails, stockholders, customers, and employees suffer, but part of the cost of the failure is borne by others who received no part of the gain from success. This possibility changes the perceived costs and benefits of risky activities to the bank, a situation called "moral hazard" (a term of art imported from insurance). Effectively, others are insuring part of the bank's losses. FDCIA attempted to rectify this problem by making it more difficult for banking regulators to guarantee a bank's liabilities.

[4] The historical evidence indicates that customers ran on banks that ultimately failed and banks that did not fail, but the run on the banks was a result of reasonable concerns about the banks' solvency. See for example, Table 4 in Dwyer and Hasan (2007), which shows market prices of banks' liabilities as the sound banks were sorted out from the unsound banks.

[5] Even if the funds are raised from solvent banks, they must come from some individuals: either stockholders or customers of solvent banks. Employees of solvent banks might also be paid less for a time, in which case they bear part of the cost.

Confronted with the turmoil and possibilities inherent in the uncertainty during the financial crisis of 2008, the U.S. government took dramatic steps to stop banks from failing and defaulting on their commitments to creditors.[6]

As a consequence, too big to fail is back, at least in financial crises. While it would be reassuring to think that procedures could be designed to prevent government authorities from preventing a large bank failure, that option may not be realistic, especially given the uncertainty in a financial crisis.

Reducing the effects of a policy of too big to fail is not a trivial undertaking. It requires examining the likely effects of suggested solutions as well as possible unintended consequences. It's a safe prediction that proposals for reducing the moral-hazard implications of too big to fail will be prominent for quite a few years.

[6] The international aspects of the problem are not mentioned in this article. Nieto and Wall (forthcoming) summarize the issues nicely.

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