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A Cooperative Approach on 'Too Big to Fail' Banks

By: Peter Eavis – December 10th, 2012

It is one of the thorniest problems hanging over the financial system: how should authorities deal with the collapse of a sprawling global bank to protect the financial system at large?

In an attempt to find ways to address this problem, regulators in the United States and Britain said on Monday that they were cooperating on measures that would be used to seize an ailing financial company that does a lot of business abroad.

The intent is to avoid the problems that occurred when Lehman Brothers failed in 2008. The unwinding of Lehman was complicated by the fact that it had substantial operations in London that were subject to British law. The same problem could recur because most of the largest American and British banks have major subsidiaries in each other's countries.

In a new joint paper, the Bank of England and the Federal Deposit Insurance Corporation laid out their preferred strategy for handling such bank crashes.

"It's great that these two organizations are pushing forward on it," said Phillip L. Swagel, a professor at the University of Maryland's School of Public Policy, who was assistant secretary for economic policy under Treasury Secretary Henry M. Paulson Jr. "If they do get it right, then, yes, 'too big to fail' has ended."

"Too big to fail" is the label for the problem that confronts governments when a large bank is on its last legs. Officials want to avoid a future large taxpayer bailout of the bank, but letting it collapse could cause a run on the financial system. In 2008, Lehman was allowed to fail but American International Group was saved because its collapse was seen as too much for the system to bear.

Since the crisis, legislators in the United States and Britain have passed laws intended to give regulators ways to avoid either outcome. In essence, they aim to take control of the sick bank and keep it operating while inflicting losses on its shareholders and, if necessary, its creditors.

The paper from the Bank of England and the F.D.I.C. focused on one way to accomplish this. The relevant regulator would take control of the bank's parent company, then embark on a restructuring. By saying they are focusing on the parent company, regulators hope to shape expectations in the market and minimize destabilizing uncertainty when a bank implodes. This approach, "will give greater predictability for market participants about how resolution authorities may approach a resolution," the regulators wrote.

The strategy then aims to put a seized bank back on its feet. In most cases, the bank would be insolvent, meaning that losses had eaten all its equity. To right the bank, the regulator would take the parent company's debt and turn it into enough equity to support the bank's operations in the future.

But questions surround the strategy. The paper is little more than a commitment to cooperate. In other words, it does not give either regulator the power to reach into a foreign jurisdiction to restructure a bank. Some of the jurisdictional problems that hampered the Lehman bankruptcy could therefore recur.

Some analysts doubt regulators would use the tools in the heat of a crisis. Fearing financial instability, officials may balk at doing anything to harm the interests of creditors and opt for some form of bailout instead. "It's about the courage to use those tools in the face of a panic," said Mark A. Calabria, director of financial regulation studies at the Cato Institute.

Whether bank parent companies have the financial resources to contribute meaningfully to balance sheet repairs is also a question. JPMorgan Chase's parent company, for instance, has $116 billion of long-term debt, which is 5 percent of the overall bank's $2.3 trillion in assets. At Goldman Sachs, the percentage is much higher at 14 percent.

Regulators would have to decide on the appropriate amount of parent company debt. As a result, they might press some banks to strengthen the financial standing of their parent companies.

But banks may resist, saying that action would make it harder for them to produce reasonable returns. "They need to consider the burdens that would be placed on banks' ability to provide credit for the global economy," said David Schraa, regulatory counsel for the Institute of International Finance, an industry group.

Skeptics also say the measures laid out Monday may not be able to cope with the collapse of several large global banks at once. "The big problems we've seen are almost always systemic," said Simon Johnson, professor at the MIT Sloan School of Management. "So, does it solve the core of the too-big-too-fail problem? No."

Still, the American-British cooperation could, in theory, cover a large majority of foreign business done in the country's banks. The five biggest American banks on average did 88 percent of their foreign activity in Britain, according to an F.D.I.C. presentation in July. "By and large, the same is true for U.K. companies," Michael H. Krimminger, a partner with Cleary Gottlieb Steen & Hamilton, wrote by e-mail. "This approach would have been invaluable in 2008," said Mr. Krimminger, whose previous job was general counsel at the F.D.I.C.