An Insider's View of the Political Economy of the Too-Big-to-Fail Doctrine

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Understanding interbank exposure is the key to understanding the too big to fail doctrine. In this paper, we present arguments supporting three principal hypotheses: high levels of interbank exposure reduce the safety and soundness of the banking system; interbank exposure affects the ability of the Federal Deposit Insurance Corporation (FDIC) and bank regulators to use market discipline as a constraint on banks’ risk-taking; and arising level of interbank exposure is indicative of reduced stability of the financial system. In addition, we provide evidence that interbank exposure does not, at this time, 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 (1984).

The FDIC alone is not to be credited or blamed for the evolution of the too big to fail doctrine out of the FDIC’s “essentiality” doctrine: that is, “a bank that is essential could not be allowed to fail no matter what the cost.” The Federal Reserve, the Comptroller of the Currency, large U.S. and foreign banks, and politicians also deserve a share of the credit or blame. During Congressional testimony on the Continental failure, former Comptroller of the Currency Todd Conover “hinted that the eleven largest banks in the nation were immune from failure.” One of the principal justifications offered by FDIC officials for the Continental bailout was the alleged interbank exposure of 2,300 other banks that would have lost more than the insured amount of their deposits if Continental had been closed without a full guarantee of repayment to uninsured claimants. That, in brief, is how the federal bank supervisory authorities came to find themselves embroiled in the “disparate treatment/too big to fail” controversy that still is unresolved.

Interbank exposure may arise from normal, efficiency-promoting correspondent banking activities that are not inherently dangerous but that may become so if not closely monitored. The primary focus of this paper is overnight or term interbank exposure that is directly and deliberately undertaken, including sales of federal funds, loans to depository institutions, purchases of securities under agreements to resell (reverse repos), and purchases of acceptances of other banks. Various forms of indirect interbank exposure certainly are worth studying, but information regarding such exposure is difficult to capture from call report data; thus, indirect interbank exposure is mentioned only occasionally in this paper. However, all forms of interbank exposure lie at the heart of the too big to fail doctrine. Interbank exposure acts as a constraint on the FDIC’s ability to force its fellow regulators to close insolvent banks, which provides disconcerting guideposts as to probable future experience with cross-guarantee proposals that would be analogous to private deposit insurance schemes. Market-oriented corrective measures, such as market-value accounting for banks, strictly enforced minimum capital standards, per customer lending limits applied to banks as well as nonbanks, and netting out interbank holdings of capital instruments in calculating capital adequacy would go a long way toward reducing and controlling purported systemic failure risk arising from interbank exposure.

“Too big to fail” is a myth, shown by the fact that banks deemed as such weren't later made smaller or fractioned into smaller entities after being bailed out, merged, and bought out by the interactions of the US Gov and the Financial sector. The only way to fix the real problem, of few large corporations controlling too much wealth and having too much influence over US politics, is removing corruption in our government. Those with good hearts, who won't simply sacrifice their morals to the allure of “lots of green” can’t let themselves become deterred from b Alternatively, if we assume the economy of the areas it controls has only shrunk by half, then the Islamic State is only achieving a tax-to-GDP ratio of 6.3 percent, meaning that it has an incompetent taxation system. Over the last two decades, the field of political economy has come to a broad consensus about the political and economic institutions required for fostering economic growth. In particular, strong property rights, predictable taxation, functioning credit markets, and a clear regulatory framework are all necessary for economies to thrive. foreseeable that the economy under the Islamic State’s control would fail over time, as it has. Some posited that oil extraction could solve this shortfall.