



## The Value of the “Too Big to Fail” Big Bank Subsidy

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One outcome of the TARP and other bank rescue efforts following the collapse of Lehman Brothers in September of 2008 is that the United States has essentially formalized a commitment to a “too big to fail” (TBTF) policy for major banks. This paper uses data from the Federal Deposit Insurance Corporation (FDIC) on the relative cost of funds for TBTF banks and other banks, before and after the crisis, to quantify the value of the government protection provided by the TBTF policy.

Prior to the Lehman collapse, many investors may have assumed that the government would back up the debts of major banks if they ever faced bankruptcy, but there could be no guarantee that this would be the case. The collapse of Bear Stearns, in which creditors were protected through a takeover engineered and subsidized by the Federal Reserve Board, undoubtedly reinforced the expectation of government backing of the debts of major banks.

The decision to let Lehman collapse temporarily shattered this expectation. However, the consequences were so cataclysmic that it led the government to move aggressively to convince financial markets that the government would not allow another major bank to fail in this manner. After Lehman’s failure, Congress passed the Troubled Asset Relief Program (TARP) to funnel hundreds of billions of dollars to support banks in a period of extraordinary financial turbulence. In addition, the Federal Reserve Board lent hundreds of billions of dollars to the banks through a series of newly created special lending facilities. On top of these measures, the Fed and Treasury also took extraordinary actions to keep Citigroup and Bank of America solvent, at a time when they almost certainly would have collapsed without government support.

As a result of this recent history, TBTF is now virtually official policy. (President Obama’s financial reform proposal would make it official policy.) A predicted result of a formal TBTF policy is that the gap between the interest rate that smaller banks must pay to obtain deposits and otherwise borrow funds and the interest rate paid by the TBTF banks would increase, since the TBTF banks are now effectively able to borrow all their funds (not just smaller deposits) with the backing of the federal government.

Data from the FDIC on the cost of funds suggests that this may be exactly

what happened in the last year. The spread between the average cost of funds for smaller banks and the cost of funds for institutions with assets in excess of \$100 billion averaged 0.29 percentage points in the period from the first quarter of 2000 through the fourth quarter of 2007, the last quarter before the collapse of Bear Stearns. In the period from the fourth quarter of 2008 through the second quarter of 2009, after the government bailouts had largely established TBTF as official policy, the gap had widened to an average of 0.78 percentage points.

If this gap is attributable to the TBTF policy, it implies a substantial taxpayer subsidy for the TBTF banks. In effect, because of the government safety net being extended to investors who lend money to these banks, the TBTF banks are able to borrow at a much lower cost than banks who must borrow based on their own credit worthiness. The increase in the gap of 0.49 percentage points implies a government subsidy of \$34.1 billion a year to the 18 bank holding companies with more than \$100 billion in assets in the first quarter of 2009. (See the appendix for the derivation of this calculation.)

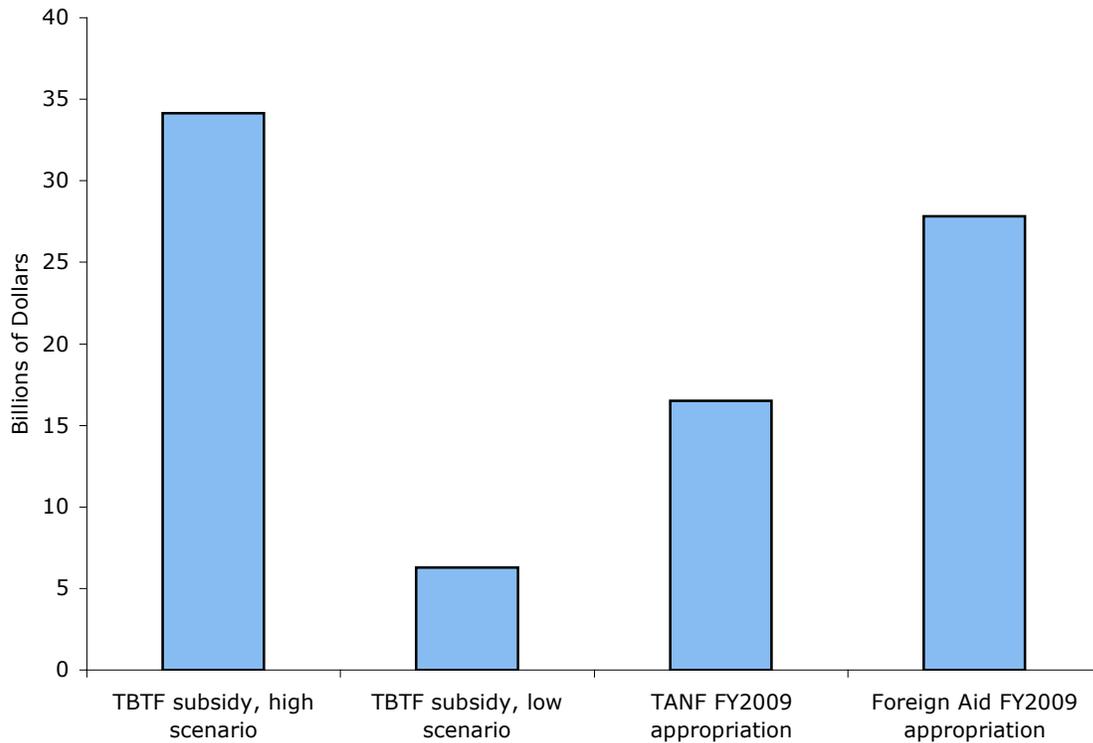
Of course the adoption of a TBTF policy is not the only possible explanation for the growth in the spread between the cost of funds for smaller banks and the cost of funds for the TBTF institutions. This spread has moved in unusual ways in the past. In the three quarters from the fourth quarter of 2001 through the second quarter of 2002, the period including the end of the last recession and two subsequent quarters, the gap between the cost of funds for smaller banks and banks with more than \$100 billion in assets rose to 0.69 percentage points. If we are just witnessing a temporary period of a high spread due to uncertainty in the economy, rather than an increase in the TBTF premium, then these three quarters may provide a better basis for comparison than the whole seven-year period from 2000 through 2007.

Using the spread in the cost of funds for these three quarters as the comparison, the spread would have increased by 0.09 percentage points as result of the near formalization of the TBTF policy. This would still imply an annual subsidy of \$6.3 billion to the TBTF banks. It is possible that even this seeming subsidy is only temporary and the gap in spreads will return to more normal levels when the financial markets have settled down. In this case, the implicit subsidy from TBTF protection may be viewed as a one-time event rather than an ongoing transfer of income.<sup>1</sup> If the larger spread endures through time, particularly after interest rates have begun to rise to more normal levels, then it will provide more compelling evidence that the growing spread is in fact a TBTF subsidy.

It is worth noting that the TBTF subsidy is substantial compared to other items in the federal budget that have often provoked controversy. **Figure 1** shows the amount of the TBTF bank subsidy compared to the amount that the Federal government is projected to spend in 2009 on the Temporary Assistance to Needy Families (TANF) block grant, the main government cash assistance program for poor families. Figure 1 also shows government spending on foreign aid for the year.

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<sup>1</sup> It is also possible that the lower interest rates and greater financial turbulence in the 2008-2009 recession explain the greater gap, rather than the adoption of a TBTF policy.

**FIGURE 1: Too Big To Fail (TBTF) Subsidy vs. TANF and Foreign Aid Appropriations**

Sources: Authors' calculations, U.S. Health and Human Services Dept. TANF Fact Sheet, U.S. State Dept. FY2010 Budget Request

As can be seen, in the high-subsidy scenario, which uses the entire seven-year period as the comparison, the TBTF bank subsidy is more than twice as large as the TANF block grant for 2009. The bank subsidy is almost 20 percent larger than spending on foreign aid.

Even in the low-subsidy scenario, which uses the three quarters from the fourth quarter of 2001 through the second quarter of 2002 as its base of comparison, the TBTF subsidy is more than one-third of the TANF block grant for 2009. In this case the subsidy is more than 20 percent of the amount that the United States is projected to spend on foreign aid this year.

The TBTF subsidy is also large relative to the profits of these banks. **Table 1** projects annual profit in 2009 for each of these institutions based on their profit in the first half. The table shows that in the high-subsidy scenario the TBTF subsidy is equal to 49.7 percent of projected profits for 2009. In the low-subsidy scenario the TBTF subsidy would be equal to 9.1 percent of projected profits. The ratio of the subsidy to profit varies across banks. In some cases, such as Morgan Stanley and SunTrust, the banks lost money in the first half of 2009 in spite of TBTF subsidies. In the case of Capital One, the value of the subsidy in the high subsidy scenario exceeded the projected bank profits.

**TABLE 1: Too Big To Fail (TBTF) Subsidy as a Percent of Bank Profits**

	TBTF subsidy, high scenario (billions)	TBTF subsidy, low scenario (billions)	2009 profits (billions)	Subsidy as a percent of profits, high scenario	Subsidy as a percent of profits, low scenario
American Express	\$0.46	\$0.08	\$1.92	23.9%	4.4%
Bank of America	\$7.20	\$1.33	\$15.51	46.5%	8.5%
BB&T	\$0.48	\$0.09	\$1.36	35.6%	6.5%
BNY Mellon	\$0.51	\$0.09	\$2.17	23.5%	4.3%
Capital One	\$0.58	\$0.11	\$0.35	166.1%	30.6%
Citigroup	\$4.39	\$0.81	\$15.65	28.1%	5.2%
Fifth Third Bancorp	\$0.50	\$0.09	\$2.18	22.8%	4.2%
GMAC	\$0.76	\$0.14	-\$9.15	N/A	N/A
Goldman Sachs	\$1.96	\$0.36	\$15.32	12.8%	2.4%
JPMorgan Chase	\$5.90	\$1.09	\$14.26	41.4%	7.6%
KeyCorp	\$0.47	\$0.09	-\$2.26	N/A	N/A
MetLife	\$1.44	\$0.26	-\$6.67	N/A	N/A
Morgan Stanley	\$1.37	\$0.25	-\$3.05	N/A	N/A
PNC	\$1.11	\$0.20	\$1.81	61.1%	11.2%
Regions Bank	\$0.51	\$0.09	\$0.56	91.9%	16.9%
SunTrust	\$0.71	\$0.13	-\$2.58	N/A	N/A
USB	\$1.02	\$0.19	\$2.46	41.3%	7.6%
Wells Fargo	\$4.77	\$0.88	\$18.73	25.5%	4.7%
<b>Total</b>	<b>\$34.16</b>	<b>\$6.28</b>	<b>\$68.56</b>		
<b>Average</b>	<b>\$1.90</b>	<b>\$0.35</b>	<b>\$3.81</b>	<b>47.7%</b>	<b>8.8%</b>

Sources: FDIC, Federal Reserve Board and authors' calculations.

The numbers in Table 1 suggest that to a large extent the recent rise in the profitability of the TBTF banks may be attributable to the fact that they enjoy the protection of the government's backing at a time when the banking system as a whole continues to experience substantial strains. This should concern policymakers, since it would imply that a substantial portion of the profits of the largest banks is essentially a redistribution from taxpayers to the banks, rather than the outcome of market transactions. It is not clear that Congress and the public would support this redistribution if they realized that it was taking place.

At this point, we do not have enough data to determine whether the lower cost of funds for TBTF is wholly or partially attributable to their implicit government protection. However, if the extraordinary gap between the cost of funds at smaller banks and TBTF banks persists for several more quarters and remains in place even as interest rates return to more normal levels, it would imply that the taxpayers are in fact giving a substantial subsidy to these large banks as a result of the TBTF policy.

## Appendix

The calculation of the TBTF subsidy is based on data provided by the FDIC which gives the average quarterly cost of funds for institutions with less than \$100 billion in assets and for institutions with more than \$100 billion in assets for quarters between the first quarter of 2000 and the second quarter of 2009. The period of TBTF being formalized is considered to be the period from the fourth quarter of 2008 through the second quarter of 2009. The average cost of funds for smaller banks in this period (less than \$100 billion in assets) was 1.93 percent, while the cost for TBTF banks (assets of more than \$100 billion) was 1.15 percent, for a spread of 0.78 percentage points.

The average cost of funds for smaller banks in the period from the first quarter of 2000 to the fourth quarter of 2007 was 2.80 percent compared to 2.51 percent for the TBTF banks, giving a spread of 0.29 percentage points. In the three quarters from the fourth quarter of 2001 through the second quarter of 2002, the cost of funds for the smaller banks averaged 2.91 percent compared to 2.22 percent for the TBTF banks, for a spread of 0.69 percentage points.

The TBTF subsidy in the high-subsidy case was calculated by taking the gap between the spread in the three quarters from the fourth quarter of 2008 through the second quarter of 2009 and comparing it to the average spread between the first quarter of 2000 and the fourth quarter of 2007. This gap (0.49 percentage points) was multiplied by the assets of the 18 banks with more than \$100 billion in assets that were subject to stress tests by the Federal Reserve Board in March of 2009. (These data can be found at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf>.) The number was multiplied by 0.9 under the assumption that bank capital was equal to 10 percent of banks' assets, and therefore did not have to be borrowed. For the low-subsidy scenario, the three quarters from the fourth quarter of 2001 to the second quarter of 2002 provided the basis for the calculation. The gap in spreads in this case was just 0.09 percentage points.

The 2009 profit projections for the banks double the banks' reported profits for the first two quarters.

Profit data for all banks except GMAC was obtained from: The Wall Street Journal Market Data Center. Available at: <http://online.wsj.com/mdc/page/marketsdata.html>.

GMAC profit data was obtained from: CNN Money. “GMAC posts \$675 million loss.” May 5, 2009. Available at:

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and CBS News. “GMAC Loses \$3.9B in Second Quarter.” August 4, 2009. Available at:

<http://www.cbsnews.com/stories/2009/08/04/business/main5211374.shtml>.

Data on TANF spending was taken from: U.S. Department of Health and Human Services. “Temporary Assistance for Needy Families Program Fact Sheet.” Updated April 2009. Available at: [http://www.acf.hhs.gov/opa/fact\\_sheets/tanf\\_factsheet.html](http://www.acf.hhs.gov/opa/fact_sheets/tanf_factsheet.html).

Data on Foreign Aid was taken from: U.S. State Department. “Fiscal Year 2010 Budget Request.” May 2009. Available at: <http://www.state.gov/documents/organization/122513.pdf>.