

ADDRESSING “TOO BIG TO FAIL”: IT WILL TAKE MORE THAN NEW CAPITAL REQUIREMENTS

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December 16, 2009

Despite repeated assurances of capital adequacy from many quarters right up to the failure of Lehman Brothers, many large, complex financial institutions posed a systemic threat to the economy in the last recession. Leverage within the financial sector itself took many forms, creating a dense layering of commitments across the balance sheets of financial firms. The size of financial sector balance sheets was not the only element leading to solvency risks. The complexity of the financial instruments held, along with the maturity of the liabilities issued in order to place more assets on the balance sheets of financial institutions, contributed greatly to the degree of financial fragility. Limiting the complexity of financial instruments, while increasing the tangible capital requirements and the liquidity buffers of financial institutions will reduce the need for monetary and fiscal authorities to socialize losses or take on a lender of last resort role in future financial crises. Incentives or more direct measures to break up large financial institutions may also be required, rather than declaring them “systemically important” and therefore favored by policy makers. Ultimately, all such measures need to be nested within a larger, more preventative policy context. Central banks will need to place financial stability on par with price stability as a policy objective. Fiscal authorities will need to recognize the private sector cannot be kept off a deficit spending trajectory, with ever mounting private debt/income ratios, unless full employment and apt trade policies are pursued.

Sensible mechanisms have been proposed to introduce capital charges, restrict distributions to shareholders, or otherwise vary minimal capital ratios in a fashion that would dampen the amplifying or procyclical aspects of capital ratios embedded in the requirements of the Basel accords of 1988, a continued problem of the Basel II accords (see Parenteau, 2009). However, required capital ratios cannot be treated as the silver bullet of bank regulation, even though they have a role in reducing financial fragility. Higher capital ratios can provide the buffer that reduces solvency risk, but in the absence of foreknowledge of the size of future bank losses, it is difficult to identify a priori the appropriate capital ratio – except to say, on the basis of the recent experience, they were simply not high enough. Therefore, comprehensive reform should involve:

- Shrinking “too big to fail” financial institutions through the use of tax incentives, reserve and capital requirements scaled to the size of the firm, antitrust laws, or other mechanisms. If financial firms are too big to fail, then perhaps they are too big to be allowed to exist at their current scale.
- Simplifying financial instruments so that the underlying debt contracts can be analyzed by institutional investors, and consequently increase the ability of investors to assess more accurate prices for them, while also reducing the fundamental uncertainty investors may face when trying to value assets held by financial institutions.
- Reducing the reliance on third party assessments from rating agencies

- Considering financial stability alongside price stability in central bank deliberations.
- Reducing the amount of time the private sector spends on a deficit spending trajectory.
- Encouraging the rest of the world to reorient their economies toward domestic demand driven growth, while a fiscal led investment strategy is pursued at home.
- Recognizing that there are system stabilizing benefits when 1) fiscal deficit spending supports private net saving, and 2) private net saving allows private sector portfolios to accumulate default free Treasury securities.

Reference

Parenteau, Rob (2009). "Addressing "Too Big to Fail": It Will Take More than New Capital Requirements," Political Economy Research Institute, October.