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# Too big to fail in banking: What does it mean?☆

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ABSTRACT

Interest in too big to fail (TBTF) resolutions of insolvent large complex financial firms has intensified in recent years. TBTF resolutions protect some in-the-money counterparties of a targeted insolvent firm from losses that they would suffer if the usual bankruptcy resolution regimes used in resolving other firms in the industry were applied. Although special TBTF resolution regimes may reduce the collateral spill-over costs of the failure, the combined direct and indirect costs from such "bailouts" may be large and often financed in part or in total by taxpayers. Thus, TBTF has become a major public policy issue that has not been resolved in part because of disagreements about definitions and thereby the estimates of the benefits and costs. This paper explores these differences and develops a framework for standardizing the definitions and evaluating the desirability of TBTF resolutions more accurately.



## 1. Introduction

Business firms fail all the time with direct adverse consequences for stakeholders and possible indirect adverse externalities (collateral damage). For most failures, the adverse externalities are not very great and resolution of the failure by the usual resolution process provided in a Federal bankruptcy code or elsewhere that allocates losses to the firm's counterparties in a predetermined order does not cause significant problems. But, for some large firms, particularly financial (banking) firms, there is dissatisfaction both with the effectiveness of their regulation to prevent failure while alive and with the consequences for collateral damage of applying the usual resolution process when dead. These are the firms to which an alternative "too big to fail" (TBTF) resolution regime that is intended to reduce collateral damage may be applied.

Despite the recent increase in interest, too big to fail in banking remains a vague and fuzzy concept. TBTF means different things to different people (Hurley, 2010). It is easier to define ex-post than ex-ante – "I know a TBTF firm when I see one". (a taxonomy of TBTF appears in Seelig, 2004.) A TBTF firm is generally a large firm that is perceived to require either or both special enhanced government regulation to discourage failure while alive and/or a special resolution (bankruptcy) regime that does not have the insolvent firm resolved through the usual resolution processes that apply to other firms in the same industry, at least with respect to allocating losses, when dead. The special resolution regimes applied to insolvent TBTF firms permit some stakeholders (in-the-money counterparties) of the insolvent firm to be allocated more than the present value recovery amounts that they would receive otherwise under the regular no-TBTF resolution regime generally to maintain critical services and reduce collateral damage. Thus, everyone may not "fail" in the failure. The question is who should and who, if anyone, should not be permitted to fail? A TBTF resolution regime modifies the loss allocation in insolvency. Except when an insolvent firm's shareholders are paid something and all creditors are paid in full, that is, are fully protected, TBTF applies only to the firm's creditor counterparties, not to the firm per se.

For reasons discussed later, TBTF has become highly controversial in recent years and numerous attempts have been made to end it, particularly in the United States. Proposals to end TBTF by

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modifying the resolution regime need to be differentiated from proposals to reduce the probability of select large financial firms that may impose large indirect losses from failing (PF) through requiring higher capital and liquidity requirements, strengthening prompt correction action and enhanced supervision provisions, and imposing incentives to limit size by legislation, such as the Dodd–Frank Act, or by regulation, such as by the Basel Committee on Banking Supervision, the Federal Reserve, or the FDIC. These are ex-ante measures. In contrast, modifying the resolution regime assumes failure and is ex-post. It is intended to reduce and/or redistribute the direct and indirect losses given failure (LGF).

This paper focuses only on the costs and benefits of resolving insolvent large financial firms by special TBTF resolution regimes versus the resolution regimes applied to all other insolvent firms in the industry. That is, the firms' insolvency is not in question, only the allocation of the associated losses among in-the-money creditor counterparties is.[1] The paper does not consider either insolvent nonfinancial firms or financial firms that may receive government assistance but are not legally insolvent or not officially recognized as such and not placed in receivership or sold with losses to uninsured and unsecured counterparties.[2] As creditors do not suffer losses and existing shareholders may not be wiped-out totally, the latter solution may be classified more accurately as rescues rather than resolutions.

The direct dollar cost of TBTF resolution is the difference between the amount paid to particular counterparties protected under special TBTF resolution regimes and any lower prorata recovery amount computed under the resolution regime usually applied. This "protection" is paid by third parties, generally by other large firms in the industry and/or taxpayers, and primarily represents redistribution, not a change, in the loss. TBTF has been particularly applied in banking, because losses suffered by some large counterparties of an insolvent large bank, including other banks, may have disproportionately large negative externalities on the economy served by the bank. For the largest banks, this may include much of the country and even beyond to other countries. William Dudley, President of the Federal Reserve Bank of New York, has recently stated that

> The root cause of "too big to fail" is the fact that in our financial system as it exists today, the failure of large complex financial firms generate large, undesirable externalities. These include disruption of the stability of the financial system and its ability to provide credit and other essential financial services to households and businesses. When this happens, not only is the financial sector disrupted, but its troubles cascade over into the real economy. (Dudley, 2012, p. 1)

But because the final all-in cost of providing such protection may be higher than the initial direct cost in terms of, among other things, fairness to other stakeholders at that or competing firms, who do not receive such protection, and reduction in the cost of failure to some counterparties that may lead to serious moral hazard excessive risk-taking concerns, TBTF has become a major public policy issue. However, numerous attempts to end TBTF have been unsuccessful, in part because definitions of TBTF differ. TBTF means different things to different users of the term with resulting different winners and losers in the resolution.

What represents TBTF lies in the eyes of the beholder. In banking, TBTF frequently also goes by other names, such as: "too big to unwind", "too big to liquidate", "too important to fail", "too complex to fail", "too interconnected to fail", and, most recently, "too big to prosecute or jail". Each of these terms implies a somewhat different reason for the rescue operation and each may have differing implications for which of the insolvent bank's stakeholders are perceived to be sufficiently important to be fully or partially protected against loss and which may not. As the insolvent bank's counterparties to be protected in a generic TBTF resolution regime may differ among different users of the term, the implications of TBTF also change and there is uncertainty about who precisely is being protected or "bailed out" in any particular TBTF resolution.

## 2. Differences in TBTF definitions

TBTF resolution clearly exists when an insolvent bank's stockholders are both protected against the loss they would suffer, if the usual bankruptcy resolution regimes were applied, and remain in control of the institution. The protection (share value in excess of zero) is funded by a third party. As the bank's capital is nonnegative, the bank does not fail and all depositors and other creditors are fully protected against loss and remain whole. Such a resolution is referred to as "open bank assistance". But the term TBTF is used more frequently to describe resolution regimes in which shareholders are not protected, so that the bank's capital is negative, the bank legally fails, its charter is revoked, and it is typically sold (including its assets being transferred to a "bridge" bank) or liquidated. But some or all ex-ante uninsured depositors and other unsecured creditors may be partially or fully protected by regulators within the boundaries of the relevant legislation. In the U.S., this limits the FDIC to providing protection to creditor counterparties of nonbank financial firms covered under Dodd Frank Act of 2010 against losses that they would experience if the usual resolution regime were applied, but only when doing so would reduce its own resolution losses. In addition, for insured banks under the FDIC Improvement Act (FDICIA) of 1991, protection may also be provided if doing so would avoid financial instability.

Which counterparties are to be so protected in a TBTF resolution and by how much may be determined, among other ways, by the nature and extent of the collateral damage estimated by the regulators to occur if the particular counterparties were not protected. If the benefits of avoiding financial instability exceed the costs of protection, some analysts may not view such resolution as TBTF resolutions. Some analysts make a further distinction between a TBTF and no-TBTF resolution on the basis of not only which counterparties are bailed out and which are not, but also on whether the funds for the bailout are provided by private (other institutions in the industry) or public (taxpayer) third party sources.[3] Even

[1] For purposes of the analysis in this paper, we abstract from including a faster closure process in the special resolution regime that may reduce total losses from insolvency.

[2] Large adverse externalities are at times also associated with the failure of troubled large nonfinancial firms and some unsecured creditors may be partially or totally protected. For example, in 2008, the U.S. government intervened to "rescue" insolvent General Motors and Chrysler by both making temporary public capital injections and effectively rearranging the legal priorities of their creditors with respect to loss sharing or "haircuts" in a prearranged resolution. These firms are not considered in this paper. Also not considered are financial firms that received government assistance but were not insolvent and put in receivership, such as those that received funding through Fed discount window facilities, which are technically limited to only "solvent" institutions and were not resolved, through Federal Reserve emergency assistance under section 13 (3) of the Federal Reserve Act, through federal government assistance provided to bank holding companies and other nonbank financial firms under the TARP program, and to Fannie Mae and Freddie Mac that received assistance under the Housing and Economic Reform Act (HERPA) of 2008 in 2008–2011. For a description and critical review of TARP see Bair (2012).

[3] Losses from protecting some unsecured counterparties may also be paid by other unprotected unsecured counterparties of the same bank. But this solution is generally prohibited in the U.S. The relevant legislation prohibits any counterparty from receiving less in a TBTF resolution than it would in a liquidation.