Testimony

Examining the GAO Report on Expectations of Government Support for Bank Holding Companies

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Chairman Brown, Ranking Member Toomey and Members of the Committee, I am grateful for the privilege of appearing today. In my brief testimony today I would like to make four main points:

- Any expectations of government support for bank holding companies is at root a problem created by policymakers' discretionary actions;
- The history of federal government assistance is not a pattern of consistent intervention on behalf of large firms, but rather an erratic and unpredictable series of interventions on behalf of firms large, small, financial, and nonfinancial;
- Attempts to measure any "implicit too-big-to-fail (TBTF) subsidy" is an elusive quest due to the many confounding factors; and
- Any market TBTF expectation is hardly fixed, but is necessarily a changing reality.

To start, I should stipulate that I do not seek in this testimony to specifically criticize or address the Government Accountability Office report on government support for bank holding companies, nor the several other reports from other institutions on the same topic. Let me also stipulate that no firm (financial or otherwise) should ever benefit from an unfair advantage owing to policy-induced bias. Herein I only hope to provide the Committee with a brief conceptual discussion of some of the issues surrounding the question too big to fail (TBTF) and implicit subsidies.

THE POLICYMAKER-CREDITOR NEXUS

What is too big to fail? It is not a market failure, like an externality; it "is a rational market response to expectations set by government policy." The proximate beneficiaries of any perceived bailout expectations (the banks) benefit passively – the ultimate source of any implicit subsidy exists at the nexus of the banks' creditors and expectations imputed from policymaker choices. As Minneapolis Fed President Narayana Kocherlakota put it, the proper conception of too big to fail "emphasizes the role of creditor beliefs… The beliefs of other parties are much less relevant."

A creditor's belief that an institution will receive government support will be rooted in an expectation that policymakers will take extraordinary steps to prevent contagion from one firm's failure to spread to others. Financial interdependencies may be the transmission mechanism for shocks to spread throughout a system, but policymakers make the ultimate decision to intervene, creating the ex ante expectation in the first place. Thus policymakers attempting to eliminate any implicit TBTF subsidy will need to look to themselves – or more specifically they will need to consider the rules and regulations which open the door to future intervention, or even lead creditors to believe intervention is forthcoming.

UNPREDICTABILITY

The federal government has a dubious history of intervening in times of economic distress to save certain firms or otherwise mitigate their losses. Unfortunately for analysts and policymakers seeking to determine the financial effects of these interventions, this history is inconsistent, not hewing to any rule or regularity. In the most recent financial crisis, the federal government's response swung from pillar to post, intervening (Bear Stearns), then not (Lehman Brothers), intermittently providing assistance to investment banks, banks large and small (TARP), investment funds, and automakers (GM and Chrysler). If we go further back, we see intervention on behalf of a large, conventional commercial bank (Continental Illinois), a not particularly large or major money center institution (Long Term Capital Management), savings & loans, airlines, and even a city (New York City). It's the very breadth and variety of these interventions (not to mention the extreme infrequency relative to the gross number of large firm failures during the same period) that should lead one to be skeptical of claims purporting a robust relationship between certain firms' insolvency and government rescue.

And yet, even this incomplete list understates the highly heterogeneous nature of interventions. Loans, loan guarantees, capital infusions, stock purchases and warrants, direct transfers – all interventions are not born the same, and more to the point, have differing effects on different parties.

The larger point is that if, for example, investors in a bank holding company's bonds are pricing in a discount (lower yield) owing to some probability of a bailout conditional on insolvency, we must presume those investors have determined the likelihood not only that policymakers will in fact intervene, but that they have also correctly identified the firm that will receive assistance, and that the intervention will benefit them as opposed to shareholders, executives, employees, or even other classes of debtholders. Indeed, as we saw in the Chrysler bailout, some bondholders were in fact made worse off.

CONFOUNDING FACTORS

One prevailing line of thinking points to the fact that large financial institutions can borrow more cheaply relative to smaller ones, and thus this differential is evidence of TBTF. But there are many factors that affect the funding costs of various institutions. This large-small differential in fact exists across most industries, with the banking industry somewhere near the middle. Differences in the liquidity of debt, risk diversification, information limitations, and other factors may explain much or all of the differential. That said, there still might be a part of the differential that cannot be explained by size-dependent factors – a TBTF subsidy may still be embedded. But any attempt to quantify the TBTF subsidy using cost of funding will need to successfully separate out the non-TBTF factors, which is exceedingly difficult and perhaps even impossible.

If a TBTF subsidy does exist, it stands to reason that it exists on a continuum, rather than simply as a binary condition between those firms that are TBTF and those that are absolutely not. Thus properly determining the subsidy portion of the differential is beside the point if one cannot properly identify the two categories of institutions.

CHANGING EXPECTATIONS

The yield spread between firms may be ever changing; indeed, it has at times even become negative. As it changes, one must conclude either that: (1) the TBTF subsidy is in fact changing and transferring among institutions over time; (2) the yield spread attributable to TBTF is being swamped by other effects; or (3) the yield spread is not a reliable measure of the TBTF subsidy.

Consider what bank investors and creditors must have thought about the likelihood of rescue following the collapse of Bear Stearns as compared to after the collapse of Lehman Brothers. In just one year, real-time policy choices must have drastically changed the implied TBTF subsidy. Thus the outcome of any TBTF study will be directly affected by the window of time chosen to examine. But the larger point is that any policy chosen now or in the near future as a TBTF corrective may be (in the best case scenario) appropriately targeted for some fixed state of the world, but cannot easily adjust to changing conditions. In the extreme, would such a policy corrective (such as a tax) become a refund if and when the TBTF subsidy reverses?

FINAL THOUGHTS

Two wrongs do not make a right. Even if we presume the existence of a consistent and significant TBTF subsidy, one must consider the net effect of applying another distortion on top of the first. That is, proposed solutions such as a bank tax or a financial transactions tax applied to TBTF institutions are attempting to counteract a distorting dynamic created by policymaker expectations and creditors' response with a punitive measure which works along a somewhat different channel.

Discretion is the handmaiden of bailouts. Time consistency in policymaking is an age-old problem and is not limited to financial crises. Congress should focus its energy on those mechanisms which: (1) make bank failures easier and predictable; and (2) limit policy choices even in a time of crisis.

One particularly promising avenue in this regard is to replace Title II of the Dodd-Frank Act with a bankruptcy process for banks. This would place decisions in the hands of a court, and not either an agency or the Congress. In the process it would limit discretion and clarify the outlook for creditors.

The Dodd-Frank Act happened. Whether one considers the Dodd-Frank Act a positive or negative change to financial regulation, there is little argument that it has a significant effect on financial institutions. This includes numerous new requirements and restrictions on the industry, many of them directed specifically at the largest bank holdings companies. The upshot is that any perceived advantages must be considered on net with any of these new costs.

Thank you and I look forward to answering your questions.