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Is the New Regulation for Global Systemically Important Banks Effective in Limiting "Too Big to Fail"?

Following the recent financial crisis, G20 leaders called for new regulation of global systemically important banks. How effective are the reforms in limiting the costs and risks of "too big to fail"?

In response to the most recent financial crisis, G20 leaders tasked international regulatory bodies with developing new regulatory measures to reduce the costs and risks of "too big to fail" (TBTF). The resulting new regulation consists of enhanced supervision, additional loss absorbency in the form of capital surcharges, and the establishment of resolution regimes specifically for banks that would pose high risks to the financial system if they were to fail. In this context, the concept of the "global systemically important bank", or G-SIB, has emerged, characterizing those banks that are subject to the new additional regulation and ultimately resulting in an official list now of 30 global banks deemed too systemically relevant to fail.

Three authors, including SFI's Steven Ongena, examine the ultimate net effectiveness—from a policy perspective—of the current G-SIB regulation. Their study weighs the regulation's impact on G-SIBs against the strengthening of their TBTF designation due to the likely unintended consequences of the new regulation, which (almost unavoidably) designates individual banks as G-SIBs, thereby reinforcing existing TBTF perceptions in the market.

"To the extent that the observed future costs of the new regulation represent a reduction in implicit government guarantees, the results confirm the effectiveness of the announced reform proposals to limit TBTF. However, at the same time the official designation of banks as G-SIBs has a partly offsetting impact."

The authors analyze the stock price reactions for the 300 largest banks from 52 countries across 12 relevant regulatory announcement and designation events throughout the development phase of the new regulation from 2008 to 2011. They find that the new regulation negatively affects the value of the newly regulated banks.

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To the extent that the observed future costs of the new regulation represent a reduction in implicit government guarantees, the results confirm the effectiveness of the announced reform proposals to limit TBTF. However, at the same time the official designation of banks as G-SIBs has a partly offsetting impact, suggesting that investors did not believe that governments would allow those banks to fail.

"The study's results also confirm the importance of government ownership for the value of the G-SIB label. G-SIBs with higher government ownership react less positively to designation announcements compared to G-SIBs with low government ownership or no degree of government ownership at all."

A cross-sectional analysis of the valuation effects with respect to, for example, government ownership of banks supports the view that the positive reaction to these designations can be attributed to a perception of TBTF. Generally, government ownership could imply existing government guarantees and thus lower the value resulting from an additional designation of a government-owned bank as a G-SIB. This phenomenon, referred to as "too public to fail", implies that banks owned by governments are more likely to be bailed out should failure occur than are banks without any degree of government ownership. The study's results also confirm the importance of government ownership for the value of the G-SIB label. G-SIBs with higher government ownership react less positively to designation announcements compared to G-SIBs with low government ownership or no degree of government ownership at all.

The degree of systemic relevance as expressed by the required level of capital surcharge appears to have a dampening effect on returns, indicating that the additional costs of relatively higher capital requirements for more systemically significant G-SIBs compared to less systemically significant G-SIBs could have a muting effect on the designation event stock return, consistent with the TBTF hypothesis.

In contrast, the sovereign rating of the home countries of G-SIBs does not imply a clear relationship between home country rating and the value of G-SIB designation. In part, this may be due to the fact that supranational bank bailouts—as exemplified by rescue measures employed by the ESM and EFSF—may have been anticipated by markets and thus offset the importance of home country ratings.

In evaluating the new G-SIB regulation from a policy perspective, the results confirm the effectiveness of the announced reform proposals to limit TBTF to the extent that the observed future costs of the new regulation represent a reduction in implicit government guarantees. However, even though the individual components of the regulation have been effective, revealing the identities of G-SIBs eliminated ambiguity regarding the presence of government guarantees, and thereby may have run counter to the regulators' intent to contain the effects of TBTF. This illustrates the potentially unintended consequences of the new regulation. At the same time, the authors demonstrate that TBTF effects stem not only from government announcements or bank rescue measures, but can also be created by a regulation specifically designed to mitigate the costs and risks of TBTF—a somewhat paradoxical aspect of the new regulatory proposals.

"The study's findings bring into focus the importance of credible resolution regimes."

The study's findings bring into focus the importance of credible resolution regimes, as this may be the right conceptual tool for undoing the effects we observe as a result of designating banks as G-SIBs. The more recent proposal for total loss absorbing capacity (TLAC) made by the Financial Stability Board, and European banking supervision's concept of a minimum requirement for own funds and eligible liabilities (MREL), are significant steps in this direction.

The full paper can be found at http://bit.ly/1MBu89S.

Key Words
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Bank regulation
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