Too Big To Swallow

It has been reported that the European Union is considering draft laws for substantial additional capital requirements for its large banks. This would be a broadening of similar Basel Committee recommendations for 29 large banks which it decided warranted designation as Globally Systemically Important Banks (G-SIBs).

What then about the big four Australasian banks which are domestic or regional SIBS, whose financial stability is so important to the smooth functioning of the Australian and New Zealand (and Pacific Islands) economies and financial systems? On the criteria used for the Basel Committee for G-SIB status of cross-jurisdictional activity, size, interconnectedness, possible substitutability of their role in providing financial system infrastructure, and complexity, they score quite highly (although not high enough to be G-SIBs).

The Australia-New Zealand Shadow Financial Regulatory Committee (ANZSFRC), an independent group of senior academics, has argued that there is a case for different regulatory treatment of the big four compared to smaller banks and deposit takers. Why? The reason is that the big four are "too big to swallow".

The ANZSFRC note that "it is the negative social externalities of failure of SIBs which give rise to proposals for special regulatory treatment." And "resolution arrangements (including "bail-outs" due to too big to fail considerations) which exist to shield stakeholders from loss have the moral hazard downside of reducing market discipline and allowing (if not inducing) socially excessive risk-taking by SIBs."

Possible competitive advantages from perceptions of government protection are also relevant, although in the case of domestic deposit markets the $250,000 deposit guarantee cap of the Financial Claims Scheme should make that less relevant.

Generally, APRA is able to limit externalities of failure of smaller troubled institutions by facilitating a smooth exit through takeover by another competitor. But this is not really a feasible option should one of the big four get into trouble (either in Australia or in the New Zealand subsidiaries).

While there is a budget appropriation of $20 billion for the Financial System Stability Special Account to assist in dealing with a troubled bank, that is unlikely to be adequate in the case of the big four (each with $400 billion or more assets in Australia). Given the opaqueness of large banks, the scale of possible hidden risks would make any potential acquirer hesitant.

There are also substantial Trans Tasman complications which would arise from financial distress in any of the big four. The New Zealand authorities have a quite different approach to resolving troubled large banks.

They have eschewed deposit insurance in favour of an "Open Bank Resolution" approach. Depositors and other creditors would be given a sufficient "haircut" (ie writing down of the value of deposits) such that the bank is restored to solvency and can continue operating. It has yet to be put to the test, and there are many sceptics, particularly when it is realised that government guarantees of the remaining deposits will be necessary to prevent depositors fleeing the bank.

While there is substantial Trans-Tasman regulatory cooperation (and each is required to consider implications of their actions for the financial systems of both) there seems little doubt that there would be cross-border spillovers from problems arising in either country.

So, failure of a large Australasian bank would create massive problems for financial stability. And while some would argue that is unlikely given recent shows of strength, this requires a longer term perspective (and the banking problems of the early 1990s should be a reminder of what can happen).

What is the appropriate regulatory response? Some argue that requiring downsizing such that no bank is too big to swallow is appropriate – but that seems like a political non-starter, and may involve economic costs.

Strong effective prudential supervision is a key component. And other regulatory responses should be kept simple, but effective. Higher capital requirements, perhaps in the form of contingent capital (hybrid securities which convert into equity when trouble strikes) fit that requirement.

(The ANZSFRC statement can be found at http://www.australiancentre.com.au/acfs-links/anzsfrc/)

Kevin Davis
Research Director, Australian Centre for Financial Studies
Co-chair of ANZSFRC
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