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Too big to ignore: a review

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Too Big To Ignore[++] - A Review

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I. Introduction

The purpose of this paper was to study many of the complex issues and tradeoffs policymakers must put in place in evaluating reforms to the oversight of systemically important banks (SIBs). In particular, the author summarized a range of practical solutions covering two critical dimensions of debate: crisis prevention and crisis resolution. This study is important considering the extensive literature that has documented the impact of government policies on the financial institutions during and after the global financial and economic crises. The author, therefore, supports the notion that government play unprecedented role to shore up financial institution deemed to be too big to fail. He observed that government guarantees of bank debt, capital injections and cleansing of bank balance sheets, trigger a loss of public confidence in the financial system. A summary of the paper is presented below, followed by comments and lessons for Nigeria.

II. Summary of the paper

The author suggested that policymakers must consider moral hazard in crafting policies to address Too-BigTo-Fail bank, because systemically-important banks encourage their growth and remove some of the consequence of risk behaviour.
He also suggested that all national authorities must develop their approach to SIB oversight within the context of their country specific needs. The author believed that it will be a challenge to achieve international and domestic consensus on many issues but identified some common issues for policymakers and regulators in every jurisdiction, to include:

(i) how to define an SIB
(ii) whether SIBs should be held to higher regulatory and supervisory standards than non-SIBs and, if so and recognizing the trade-offs they present, what those standards should be; and
(iii) whether government policies can be developed to make SIBs problems to be solved but limit the effect of that problem on the real economy and financial stability.

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The author acknowledges that authorities must develop a workable and dynamic definition of systemically important banks. That is the definition of systemic institutions should cover the period of normal as well as times of stress of the institutions.

Therefore, he suggested that policymakers should identify a core group of banks considered SIBs under any conceivable circumstances, and apply higher regulatory and supervisory standard to them.

The paper emphasized that measures like tighter capital and liquidity requirements, heightened risk-management standards, limits on risky activities, improved governance of SIBs by boards of directors, prudent bank compensation programs, and strengthened consolidated supervision of banking groups are set of crisis prevention measures that better regulate and supervise SIBs and have to be adopted by government or policymakers.

It also suggested that authorities must develop more stringent capital and liquidity measures for SIBs to limit excessive growth during good times and allow for greater shock absorption during stressful times.

The author identify the first line of defense against financial instability as strengthening the risk management standards and practices of SIBs in order to rein in excessive risk taking, particularly during good time.

He also suggested that authorities should ensure that SIBs held to a higher standard than non-SIBs to ensure that SIBs' risk-management systems and underlying practices reflect their size, complexity, and role in the economy.

The paper also acknowledge that stronger financial buffers and better risk management alone cannot prevent higher-risk activities from causing another systemic crisis because global financial crisis has demonstrated that SIB's excessive risk taking can be catastrophic. As a result policymakers should set percentage of capital limit on SIBs' high-risk activities.

The author observed that inadequate oversight by SIBs' board of directors was the fundamental cause of financial crisis and, therefore, suggested that regulatory authorities must prescribe more stringent “fit and proper” criteria for board of directors of SIBs so that they can establish or enforce a suitable risk tolerance threshold.

The paper also suggested that a design compensation program that reward longer-term performance and promote sound risk management should be put in place to address the problem of excessive risk taking and reward short-term profits at the expense of longer-term viability as revealed by the financial crisis.

The paper was of the view that the inclusion of more stringent regulation, stronger risk management, and better board of director oversight must be followed by a robust consolidated supervision.

The policymakers must prepare for a death or near-death experience of SIBs in order to save the economy and financial institutions from stress. The author further suggested that policy put in place must allow for orderly unwinding of a failed SIB.

He acknowledged that key management of the bank should be replaced with government- appointed staff and government should have officials to block the payment of contractual bonuses to top management staff of failed SIBs.

The author also suggested that there should be explicit roles regarding who gets paid first and the minimum losses to be shared by creditors.
The author thought that SIBS could be required to pay fees to a resolution funds which would be used to offset some of the costs the government might incur in keeping a failed SIB operational.

The paper concluded that authorities should rethink their mind-set that some banks may be too big to fail.

I. Comments

The paper on "Too Big to Ignore" revealed that no bank is too big to fail but some banks may be too big to liquidate immediately. Therefore, authorities of any economy must formulate policies that will prepare for a death or near- death of an SIB to determine whether to allow an SIB to fail and if it does fail, how to minimize the damage to the real economy and the financial system as a whole.

Although the author did not suggest how countries that lack the technical capabilities to design sound and good policies can avail themselves of the technical assistance available in the institutions, yet the ability of any economy to withstand global economy crisis still depends on a basket of sound policies put in place by the authorities or policymakers of that economy.

II. Lesson For Nigeria

Important issues emerged from the paper, which the Nigeria authorities could adopt to safeguard the important financial institutions in the economy during and after any economic crisis. Among these were: first, authorities should belief in the reliability of SIBs risk models and sound risk management. Second, they should ensure risk-based supervision at regulatory authorities and market discipline.

Generally, the Nigeria authorities should showcase their perceived strength in areas like economies of scale, access to global wholesale funding, product innovation and application of sophisticated risk management practices and also, a long-term solution to the big-to-fail problems should warrant formulation of intrusive and more conservative regulatory constraint, combined with supervisor's greater willingness.

These preventive measures must be augmented with a credible insolvency regime that improves market discipline on management, shareholders and creditors, if the too big to fail doctrine is to be permanently eliminated.

References

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