A Note on 'TBTF' Banks

The banking sector is the engine that drives the economy. If the engine develops any fault, the train is bound to slow down and gradually come to a halt. If the engine has not developed any fault ever that does not mean it can never. The three largest banks in the Indian banking sector have already been declared as 'Too big to fail' (TBTF). This article considers how serious the matter is. Read on to know more…

What is 'TBTF'?

Too Big To Fail (TBTF) is a term used for the institutions that have grown so big and at the same time have attained such an important place in the economy of a nation that the nation may not afford to let them fail. The reason is that failure of such institutions has the potential of creating ripples in the whole economy of a country and, occasionally, on some other economies as well. The concept is particularly relevant to the banking sector. Further, when a bank is too important for the domestic economy, it is termed as Domestic Systemically Important Bank (D-SIB) and if it becomes too important to have an impact on the global economy it is called Global Systemically Important Bank (G-SIB). Broadly, they are called as 'TBTF' banks.

What the failure of a 'TBTF' bank can lead to?

The failure of a 'big bank' (big in terms of size, complexity, and interconnectedness with no close substitutes) has grave consequences. In such a situation, the depositors, investors, creditors (especially other banks) and other stakeholders are bound to get a big hit. Typically, when people have even a faint idea that a certain bank is about to fail, they tend to cause a run on the bank. This tends to further accelerate the speed of the failure; thereby increasing the chances for the stakeholders to lose most of their money. Further, it is not only about losing money but it has a bigger adverse consequence that it pierces the confidence of people in the banking system of the country, restoration of which is extremely difficult. People tend to think that if one bank fails, others too can. Not only that, in such a situation, banks are also likely to stop believing each other which dries the inter-bank lending market and at the same time, they more or less become conservative at lending to retail and industrial sectors of the economy and thereby triggering a slump in the economy. Thus, the cost of failure of a systemically important bank could be so huge and burdensome for the economy that no-body would want it to fail; least of all the Government. Therefore, it is perceived that the Government would somehow provide a shelter to such a bank and ensure that it does not fail due to any reason. Now, the problem is that a 'TBTF' bank also knows this. Since they do have such implicit guarantee of getting rescued by the Government during bad times; they think

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they can gamble with the public money. This is the 'Moral Hazard' associated with the TBTF banks and a big cause of worry for a Government. Such banks are likely to indulge in casino banking; take riskier positions in an attempt to get higher rewards with no worries as they believe Government is there to take care of the downside. "Return is mine and risk is yours" probably becomes the philosophy of living of the "Too- Big-to-Die" banks. Mostly, when such banks are at the verge of failure, Government either uses taxpayers' money (which surely could be used for better purposes) to bail them out or merges such banks with other banks by infusing some capital into the merged entity or the Government takes bad assets themselves or sets up the corporations to do the same. Hence, it can be said that the Government tries hard to not let such banks go under easily.

Governments' Dilemma!

The U.S Financial Crisis of 2007-09 made the term 'TBTF' gain prominence. When the U.S Government allowed Lehman to fail, they probably wanted to give a signal to the banking system that they would not shell money on zombie banks. However, what happened after that was terrible for the U.S economy. The decision of the Government came under severe criticism globally as Lehman was a 'G-SIB' and not preventing its failure led to all those adverse ripple effects (in several economies) that the failure of such a bank would generally lead to. This instance shows how difficult it can be for a Government to find the correct way and deal with the drowning TBTF banks. Supporting one TBTF bank would mean providing green signal to other institutions to act in the similar way and not supporting such institutions may invite severe criticism and hardships for the economies. As no Government would want any such unfavorable results, the question is how TBTF banks should be ultimately dealt with.

Dealing with TBTFs

It is said that 'prevention is better than cure' and that is why most of the countries believe that such banks must be regulated strictly from the beginning and should not be allowed to become alarmingly big and vulnerable. Considering this, some measures have been taken worldwide to prevent creation of 'TBTF' banks in future. Here is an account of some of the steps taken in U.S and U.K.

In U.S, after the crisis in 2010, 'Dodd Frank Act'[1] brought an important rule, that is, Volcker's rule[2] to prevent large banks from becoming too big to fail. This rule came into effect in 2015 after five years of haggling. It prohibits proprietary trading by banks. In simple words, it forbids the speculative use of customer deposits by banks for their own profits. The number of banks failing has gone down in U.S after this 'Act' came into place. But, banks themselves do not really seem to be happy with this 'Act' and especially with the Volcker rule. Wall Street has complained about it for years. In fact, according to them it is overly complex and does more harm than good for the economy. Moreover, the rule is blamed for banks' reduced margins, liquidity and lending share in the market. Not only that, regulators also find such rules inconvenient. Banks being opaque institutions, regulating them in the ordinary course is always a difficult proposition. Therefore, when such regulations come in place that put restrictions on certain trading activities of banks, checking banks whether they are adhering to such restrictions or not is even harder to make out. For instance, it can be challenging to judge and tell if a banker is speculating or filling customer's demand. The transaction can not disclose the intent and hence, it becomes impractical for the regulator to be able to identify the nature of activity only by looking at the balance sheet or the other financials of the bank. In view of these arguments, the Volcker rule is proposed to be scrapped for banks with $10 billion or less in assets. Now, how it would affect the U.S banking sector remains to be seen.

Similarly in U.K, to deal with TBTF banks, the focus has been on separating commercial and

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[1] money.cnn.com/2017/06/08/news/economy/house-dodd-frank-repeal/index.html
[2] fortune.com/2017/04/06/volcker-rule-banks-donald-trump/

investment banking. It is held that investment banking activities are inherently riskier than the regular commercial banking activities and that is why the former should not be allowed to impede the core banking functions. In light of this view, Vickers' Commission was established in U.K. in 2010; introducing ring fencing of core banking activities so as to minimise the risks of contagion from whatever non-core banking activities take place outside the ring fence. The logic is to protect the entire core area if any bank fails in future. It is applicable to all banks with deposits of 25 billion pounds or more and the deadline for such banks to be ring-fenced is January 2019. Such a separation may make sense but at the same time, it demands a grand structural change and hence is extremely difficult and costly to implement. So, whether ring-fencing is workable or not, cost-benefit analysis after a few years only can clear the picture.

India's precautionary approach to deal with 'TBTFs'

India too has adopted a precautionary approach to deal with 'TBTFs' which is given by Financial Stability Board (FSB). Soon after the U.S crisis FSB asked the Basel Committee on Banking Supervision (BCBS) in October 2010 to develop a precautionary framework for its 28 member nations, in an attempt to deal with the problem of 'Too big to fail' so that history does not repeat itself. An assessment methodology comprising both quantitative and qualitative indicators to assess the Global Systemically Important Financial Institutions (G-SIFIs) including banks was formulated so that such institutions are identified in time and are supervised and regulated in a manner that does not allow them to become vulnerable and pose risk for the economy of a nation/nations. This approach is based on the idea of detecting an infection in time so that can be cured before it spreads across and turns into any serious condition.

The BCBS provided a framework for identifying Global Systematically Important Banks (G-SIBs) and Domestic Systemically Important Banks (D-SIBs) in 2011 and 2012 respectively. The D-SIB framework is based on a set of principles, which complement the G-SIB framework. However, the D-SIB framework is based on the assessment conducted by the respective national authorities themselves. It is felt that national authorities are best placed to evaluate the impact of failure of such a bank on their local financial system and economy. Therefore, member nations have been given freedom to tailor the methodology according to their requirements for identifying D-SIBs and imposing necessary additional capital requirements on such banks.

Being a member nation, India also came out with its own methodology in July 2014. Starting from August 2015, it decided to identify TBTF banks every year. In accordance with the BCBS framework for identifying D-SIBs, Indian banks are evaluated on the basis of 4 broad indicators, namely size, interconnectedness, substitutability and complexity. However, what makes the RBI's methodology different is the weightage that it assigns to these indicators. Unlike the standard framework where all indicators are given equal weights, the Reserve Bank of India assigns maximum weight (40%) on size of a bank. Hence, size matters the most according to RBI and it appears to make sense as a large size is a pre-requisite to be a TBTF bank. Small banks can not be systemically important. Considering this, to begin with, RBI has a '2% criterion' which comprises of detecting banks with assets of more than 2% of India's GDP. Once banks are identified on this criterion, the next step is to evaluate such banks on the basis of other indicators to finally label the systemically important banks. However, the evaluation is not based on quantitative factors alone. Qualitative regulatory and supervisory judgements are also taken into consideration while finally designating a bank as 'D-SIB'. An interesting aspect is the bucket system that the BCBS framework follows in determining the level of systemic importance of a TBTF bank. Higher the bucket number, higher is the level of systemic importance.

In August 2015, SBI and ICICI were the first ones to be declared as TBTF. In August 2016, RBI ended with the same list. In 2017, it added HDFC along with SBI and ICICI.

Year	TBTF Banks	Bucket
2015	SBI, ICICI	3,1
2016	SBI, ICICI	3,1
2017	SBI, ICICI,HDFC	3,1,1

In 2017, the size of SBI, ICICI and HDFC was 16.90% and 4.82% and 5.40% of India's GDP (nominal, 2016-17) respectively. SBI is in bucket 3 and ICICI and HDFC are placed in bucket 1. It indicates that SBI is more systemically important for India than ICICI and HDFC and if all are in the

drowning boats at some point in time, Government would provide SBI with the life jacket given only one can be saved.

Once certain banks are declared as 'TBTF', certain capital charges are imposed on them and they are given a timeline to fulfil those capital requirements in a phased manner. These banks are subject to higher levels of supervision. However, such measures may prove to be inadequate since it is very important to realise that there are certain advantages to the banks after being declared as 'TBTF' that can make them even more prone to failure. Since it is believed that they would not be allowed to fail, such banks are likely to enjoy easier money inflows. Even if 'TBTF' banks offer lower rates of interest in comparison to other banks, they have a tendency to attract depositors and other lenders with ease. People probably feel that their money is secured by the Government itself and so even if the monetary return is lower against deposits made or other loans granted by them, default risk gets minimised. Due to this reason only, they are also not incentivised to monitor the activities of such banks. If 'TBTF' banks would get money like this and that too without any fear of getting monitored, there are increased chances of their behaving carelessly with the public's money. So, besides imposing additional capital requirements, the regulator should put stringent restrictions on the participation of 'TBTF' declared banks in risky activities so that these big banks don't get disturbingly bigger.

Hence, it is essential to understand that only adopting a framework to identify 'TBTF' banks is not enough. What is needed for the economy is to have the declared 'TBTF' banks running in a healthy way and not fall ill because of any infection.

Is the Government ready to deal with such banks?

The Indian Government appears comfortable at introducing capital infusion schemes for public sector banks. To deal with the growing NPAs in the banking sector, the Government, on 24th October 2017, has offered a recapitalisation scheme worth ₹2.11 lakh crore for PSBs[3]. Of course, such capital infusions are not new. Earlier in 2015, capital infusion of ₹70,000 crore through *Indradhanush*[4] scheme was also announced for PSBs. Repeated financial support declared, that too within a couple of years only, shows that the Government now seems to be really concerned about the problems faced by the banking sector. But, does that also mean that the Government would provide such capital infusions to 'TBTF' banks too if they face any problem in future?

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For now, the Government wants public sector banks to absorb losses caused due to NPAs so that they could start lending again at a good pace as credit creation is important for job creation and economic growth. But such a support on part of the Government tends to make the attitude of "not letting the economy suffer due to banking sector's adversities at any cost", stronger and thereby creating the problem of moral hazard amongst banks. This recapitalisation scheme is also one of the factors that have driven Moody's rating upwards to Baa2 from Baa3 for India[5]. But, this rating can face downward pressure if the banking system faces any deterioration in its health in future. Therefore, it is essential for the Government to ensure that the purpose for which the capital has been infused is met.

Besides recapitalisation, there is also a talk about consolidation of public sector banks. But, before taking the final call, certain facts have to be considered. In India, the combined top '10' banks only have assets of more than 50% of India's GDP and 3 amongst them have already been declared 'TBTF'. In such a scenario, mergers of PSBs can create more zombie banks and learnings from the financial crisis show that India must be careful not to do so. Hence, at this stage, the banking reforms need a critical evaluation and should be designed in such a way that no new names are added in the upcoming lists of 'TBTF' banks to be declared by RBI. Also, the Reserve Bank of India should keep on updating the framework to deal with 'TBTF' entities with time so that no stone is left unturned to make the banking sector pro-active at maintaining its stability. ■

[3] www.thehindu.com/business/Economy/government-to-infuse-rs-211-lakh-crore-into-psu-banks-over-two-years/article19912555.ece/amp/
[4] https://www.google.co.in/amp/wap.business-standard.com/article-amp/economy-policy/mission-indradhanush-to-infuse-capital-in-banks-not-the-last-step-jaitley-117041100713_1.html
[5] https://economictimes.indiatimes.com/markets/stocks/news/full-text-moodys-india-rating-upgrade-report/articleshow/61682706.cms