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Global Financial Policy Makers Push Closer to the End of "Too Big to Fail" Banking Era

By Myriam Denis, J.D. Candidate 2016 | November 20, 2015

An international group of financial policy makers, the Financial Stability Board (FSB), designed a framework seeking to keep 30 of the world's biggest banks from becoming "too big to fail" and having to resort to taxpayers-backed bailouts in the event of a future financial crisis. The "too big to fail" conundrum refers to the government having to bail out big banks because letting them fail would inflict collateral damage too severe for the economy to recover.

The proposed rules would require these banks to maintain "capital buffers" capable of absorbing potential losses when a bank is failing, thus preventing the spreading of further pressure in the global banking system. Most of this buffer would come in the form of shareholders' equity as well as long-term debt issued to investors. By making banks sell bonds explicitly exposed to losses, the risk would shift from the government to be borne by the banks' investors, and taxpayer-funded bailouts would, in theory, no longer be necessary.

After a bank crashes, losses often wipe out its equity. However, under those new rules, the long-term debt emitted as a buffer would absorb any losses left after the equity is gone, and the debt would be turned into new equity that would provide the financial backbone required for the new bank to be a solvent entity.

In 2019, a bank's loss-absorbing buffer would have to be equivalent to a minimum of 16 percent of its assets – increasing to 18 percent by 2022. The FSB estimates the aforementioned 30 banks would collectively need to raise $1.2 trillion by 2022, depending on what kind of debt would be considered appropriate by regulators. Mark J. Carney, Bank of England governor and FSB chairman, wrote in a letter addressed to the Group of 20, "[…] individual banks as well as their investors and creditors bear the costs of their own actions." G-20 leaders have already signed on this proposition at the Turkey summit, but the rule will not have any legal force until domestic regulators in the countries where the affected banks reside implement it.

Meanwhile, the US Federal Reserve has already announced its own rules regarding total loss-absorbing capital expected from the country's eight biggest banks, which are very similar, albeit slightly stricter than the analogous FSB rules. The eight concerned banks would need an estimated $120 billion to meet the new rule's requirements. Some experts wonder whether that buffer would be sufficient in a crisis and some analysts also worry that the Federal Reserve rules might increase costs for an industry that has already borne the burden of hundreds of new regulations, such as the Dodd-Frank Act.

Lastly, no matter how many regulations of this type are implemented, there will always remain a layer of uncertainty about future banking crises. New kinds of risks and vulnerabilities stemming from market structure and market-based finance can quickly spread to the banking system and affect banking in unpredictable ways. Mark J. Carney said recently: "[…] success in ending too

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big to fail may never be absolute because all financial institutions cannot be insulated fully from all external shocks."

While the FSB rule is a step in the right direction, it is not a total guarantee that no major bank will ever fail. In any such an event, all eyes will be on the political leaders. Hillary Clinton recently announced that she would let a bank fail if she had to, and political analysts expect other presidential candidates to adopt a similar stance.