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Requiem for market discipline and the specter of TBTF in Japanese banking

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ABSTRACT

This study examines the reaction of private market participants to the enhancement of the “Too-Big-To-Fail” (TBTF) doctrine in the Japanese banking sector. The event justifying the use of the “TBTF” label occurred on May 17th, 2003, when the Japanese government decided to bailout *Resona Holdings*, the 5th largest financial group in the country. By using a sample of all Japanese listed banks and the standard event study methodology, we document significant and positive wealth effects in the stock market accruing to large banks and negative (though non-significant) effects accruing to smaller banks. Besides the effect on bank equity values, we also document a significant abnormal volume of trading on days following the bailout announcement date for the largest banks only. We extend our empirical analysis on stock prices and trading volumes by detecting a significant impact in the Credit Default Swap (CDS) market. This last result allows us to quantify, in a probabilistic sense, the effects of TBTF in addition to uncovering the mere presence of such a regulatory policy.

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1. Introduction

The "Too-Big-To-Fail" (TBTF) doctrine is an old but still actual topic in banking and a matter of great concern to bank regulators and supervisors around the world. From an historical perspective, the genesis of the TBTF doctrine is closely related to the Continental Illinois crisis of September 1984, when the nation's seventh largest bank was bailed out by the US government. The uninsured depositors and other creditors of both the bank and its financial parent were completely protected against the risk of loss and, at least initially, the shareholders were not wiped out. C.T. Conover, the Comptroller of the Currency at the time defended the use of public funds in the resolution process by acknowledging that the US regulators would be unable to let the largest banks in the country fail. His statement was perceived in the banking community as a clear confirmation that large (TBTF) banks will receive an inherently different treatment than smaller ones in case of financial distress.[2]

Besides the fairness considerations implicit in any TBTF-type policy, the critics of TBTF have argued that the doctrine is likely to exacerbate the moral hazard problem for the biggest banks by weakening the incentives of large and sophisticated creditors and other private counterparts to monitor risk taking behavior and impose market discipline on these banks.[3] On the other hand, the policy of TBTF has been defended in most cases by invoking systemic risk-based arguments. Specifically, bank regulators have always expressed fears that the failure of a large, systemically important bank, with a strong retail deposit network and broad interconnections in the interbanking market and payment system, would have serious negative consequences on other banks and the financial system as a whole.[4]

Nowadays, "TBTF" has become a taboo acronym among bank regulators and supervisors. In the vast majority of industrialized countries, the high-ranking officials rarely recognize that a large financial institution under their watch is "too big to fail." For instance, the enactment of the FDIC Improvement Act (FDICIA) at the beginning of 1990 was a clear signal that the US Congress intended to substantially reduce, if not eliminate, the practice of the TBTF doctrine (see Wall, 1993, for a careful analysis of FDICIA's provisions in the context of TBTF).[5] However, according to Stern and Feldman (2004), TBTF remains a serious problem because FDICIA has a systemic risk exception: a bank could be declared TBTF and rescued from failure if not doing so would have dramatic consequences on the economy.[6] In the same vein, Flannery (2007) notes that, given the importance of credible procedures for closing large, complex financial firms, the issue of TBTF (or "too big to re-organize quickly") should have a prominent place on the future research agenda on safe and soundness banking regulation.

Empirical studies on TBTF not related to the Continental Illinois crisis are quite rare, in part because of the absence of clear TBTF episodes during the recent history of banking crises (see BIS, 2004, for an extensive review). However, a noteworthy event that was likely to significantly influence investors' expectations of receiving TBTF protection occurred in Japan, on May 17th, 2003, when the government authorities decided to bailout *Resona Holdings*, the 5th largest financial group in the country. As a

[2] For an excellent discussion of the history of the TBTF doctrine in the US, its economic consequences, and the controversy around its adoption, the reader can refer to Kaufman (2002). Stern and Feldman (2004) provide a comprehensive analysis of the TBTF problem and critically examine several policy recommendations to cope with its negative economic effects. Also see Pollin (2005) for an interesting discussion of the key dilemmas faced by bank regulators when considering the application of the TBTF doctrine.

[3] In their book, Stern and Feldman (2004) also mention the resource misallocation problem arising under a TBTF regime. To be more precise, a bank that is more likely to be bailed out may not have incentives to innovate and will most probably operate in a cost-inefficient manner. Moreover, as the stakeholders of TBTF banks are fully protected in case of failure, they have no incentives to put the inefficient banks out of business.

[4] De Bandt and Hartmann (2002) is one of the rare references that explains in great detail the various transmission channels of systemic risk in banking and financial markets.

[5] In a recent article published in the *Wall Street Journal*, Berman (2007) quotes Julapa Jagtiani, a Federal Reserve economist, who cautions that nowadays, "*at the Fed, we don't have a list of Too Big To Fail banks*".

[6] The exception may be invoked only with the agreement of a two-thirds majority of the Board of Directors of the FDIC, a two-thirds majority of the Board of Directors of the Fed, and the Secretary of the Treasury (after consultation with the President). See Kaufman (2002) and Mishkin (2006) for more favorable views on the role of FDICIA in reducing the TBTF expectations.