What lies behind the "too-small-to-survive" banks

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Extended Abstract

In September 2007, Northern Rock, one of the most significant retail and commercial banking institutions in UK and a substantial mortgage lender, after being largely affected by the problems in credit markets triggered by the US subprime crisis, sought for a liquidity support facility in order to replace money market funding. Bank of England took the decision to extend a loan facility to the distressed institution. Indeed, by January 2008, it had borrowed to Northern Rock more than USD 25 billion. A month later and after the weakness of Northern Rock to find a commercial buyer that would commit to repay taxpayers' money, the bank was eventually nationalised by the British Government that effectively took ownership away from its shareholders.

The government financial aid provided to Northern Rock has been officially recorded as the first bank bailout after the eruption of the crisis in August 2007. This was the prelude of a series of far-reaching and urgent rescue efforts that took place in the financial services industry during the late 2000s crisis. Nevertheless, as it is almost always the case, every coin has two sides. On 4 October 2007, Miami Valley Bank was hit by the credit crunch and shut down by the US federal regulatory authorities. The Federal Deposit Insurance Corporation (FDIC) took receivership of the failed bank and all insured deposit accounts (that is up to $100,000) were transferred to an assuming institution. Hence, Miami Valley was the first commercial banking institution to be failed in the financial meltdown. The collapse of Miami Valley Bank was followed by those of Douglas National Bank and Hume Bank in early 2008. Importantly, the number of failures increased in a geometric progression since then. In particular, for the period

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starting from early September 2007 and extending until March 2011, there have been recorded 293 commercial bank collapses in US and the FDIC has been appointed receiver of all these bankrupt institutions.

According to the above discussion, the U.S. federal authorities as well as the EU and several other national authorities have provided substantial financial support to many banking organizations while, at the same time, have let numerous others to go bankrupt that also incurred massive losses on the system. A question that comes up naturally is why this was allowed to happen. Was it simply because some particular institutions were considered important and big enough to save in the sense that a collapse of any of them could trigger contagious defaults, whereas some others were perceived as "too-small-to-rescue" in that their failure would have no material impact on their counterparts, let alone on the system as a whole?[1] Is, indeed, the size and the systemic importance of banking institutions the fundamental factors that make the authorities to treat them differently or it is also that the failed banks have gone really badly in terms of performance and risk-taking -even worse than those that were bailed out- and this was the main reason why no financial aid was provided to them. In other words, was it the authorities that were reluctant to help some part of the problem banks to stay afloat because they were considered as too-small-to-save, or these banks were of so poor performance that were not capable of withstanding some serious shocks whatsoever?

To provide concrete answers to the aforementioned questions, we empirically investigate the relationship between bank performance and risk with bank size using a sample that contains all troubled banks in the U.S. market in the late 2000s crisis. Put differently, we categorise all problem banks (both assisted and failed) in different size groups and then test for any differences in the performance and risk-taking behaviour among size groups. More specifically, we first identify all banking organisations that either failed or were bailed out during the late 2000s crisis. Failed banks are formally defined as the insured institutions that have been closed requiring disbursements by the Federal Deposit Insurance Corporation (FDIC). We collect the relevant information from

[1] In September 1984, the Office of the Comptroller of the Currency (OCC) in US made a public distinction for the first time between systemically and non-systemically important banking institutions announcing that eleven from a total of approximately 14,000 banks were considered as TBTF and as such they would be offered full deposit insurance, whereas all the rest would remain partially covered.

the official website of FDIC. Bailed-out banks, on the other hand, refer to those that received funding from TARP. The relevant list of TARP recipients is obtained from the U.S. Department of the Treasury.

We expect the rescued institutions to perform generally better and take lower risk compared to the failed ones. This could explain why the latter group of banks has been left by the authorities to go bankrupt. However, our empirical findings show that both groups performed equally bad before the onset of the crisis taking high-risk investment decisions and operating poorly in terms of efficiency and productivity. This is to say, it is not that the overall performance and the risk-taking behaviour of the non-rescued banks were so bad that they had no alternative but to go bankrupt. On the contrary, authorities provided no financial aid to the banks that failed during the crisis simply because they were of little or no importance for the financial system as whole. This implies that it is indeed the degree of systemic importance of the financial institutions, which makes the authorities to treat them differently. Along the same lines, size is found to be one of the main determinants of bail-out governmental policies. Such a bail-out strategy is very likely to create higher incentives for banking firms to become bigger rather than safer simply because regulators seem to be reluctant to help a well-performed, non-risky bank to stay afloat if the bank is not viewed as being important enough for the entire system. In addition, small-sized banks which are not considered by the authorities to be systemically important and hence are not protected by bail out policies is likely to take higher risk when the bailout probability of the protected banks is increased.