# Systemic risk capital

*We have seen what can happen when the size of financial institutions rivals – or even surpasses – that of their home countries. It may be time to limit the size of institutions through imposition of systemic risk capital requirements, argues* ***David Rowe***

The still unfolding financial crisis has shown the horribly difficult policy dilemma posed by financial institutions that are 'too big to fail'. This is a situation that evolved gradually and was driven by some perfectly sound public policy arguments. The key driver of consolidation in the banking sector has been improved diversification of the balance sheet – banks that are constrained geographically are naturally prone to excessive portfolio concentration. Being especially familiar with their home territory, they are most effective at originating loans to local companies. Growing geographically, either organically or more commonly through merger and acquisition, tends to broaden the industrial and regional mix of a bank's exposures and reduce risk through greater diversification. Arguably, there also are economies of scale that reduce average operating costs, at least in the early phases of consolidation.

As institutional growth continues, however, it seems clear the marginal benefits of both improved diversification and greater economies of scale tend to decline. Furthermore, greater size eventually results in what can be called 'managerial diseconomies of scale'. A risk management friend of mine once left a top-10 global bank (where we both worked) to join a major regional bank about one-tenth as large. After a year, he marvelled at how his new team had been able to build much more effective risk systems than we had been able to do at the global bank. The key was that assembling the necessary data to provide a single-customer view encompassing all banking book and trading book exposures was far more feasible in a major regional bank than in a global mega-bank. In addition, effective management of a financial institution still demands considerable intuition and seasoned judgement. Exercising such judgement becomes harder as the chain of command lengthens and top management loses direct contact with many parts of the business.

All this would be a problem that could safely be left to market forces were it not for the systemic risk that develops when banks pass a given size relative to their domestic economies. Failure of a sufficiently large bank can serve to disrupt the essential payments mechanism of an advanced economy. It can also do grave damage to the process of recycling savings into productive physical investments – something we are experiencing currently. It is these societal threats that lead politicians and policymakers to regard some institutions as too big to fail. Furthermore, as banks have entered the capital markets in ever-more aggressive ways, being too big to fail engenders significant moral hazard. Having the benefit of explicit public deposit guarantees and an implicit promise of government support in a crisis leads to lower funding costs and fewer risk constraints grounded in management's self-interest.

One irony of the current situation has been pointed out by my colleague, Jonathan York. The very process of attempting to save shaky banks by forcing them into the arms of other less troubled firms is leading to even larger institutions with still greater systemic impact should they encounter problems. It is almost as if to reduce the likelihood of failure regulators and politicians are doubling down and increasing the potential impact of a failure if and when it occurs.

Much of the reaction to the current crisis has centred on more detailed and more intrusive regulation. As long as institutions are allowed to continue in their current size, there may well be no alternative. Frankly, however, given the size and complexity of these mega-institutions, it strikes me as unlikely that all chance of failure can be eliminated through detailed regulatory supervision. A much more reliable strategy would be to force a break-up of institutions presenting high systemic risk into several smaller institutions that could be allowed to fail if they ran into trouble. Ideally, it would be best to do this while preserving most of the gains in diversification and economies of scale that characterised the early phase of bank consolidation. A politically mandated break-up, similar to the 'trust busting' in the early twentieth century, is unlikely to be the best way to accomplish this.

A better method would be to impose an escalating systemic risk capital requirement on institutions that surpass a given size. This would create incentives for the management of such institutions to break themselves up in order to enhance shareholder value. Unfortunately, management does not always act in the best interests of the owners, so strengthening the legal rights of shareholders to impose initiatives on corporate boards may be needed. Whatever the approach, however, we need to take a hard look at the question of whether if it's too big to fail, should it be too big to exist? ■

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