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Directors
Financial Stability Board

Zurich, July 9, 2019

Comments on the FSB’s policies regarding too-big-to-fail

Dear Directors:

Hereby my comments on the FSB’s policies regarding too-big-to-fail (TBTF).

Summarizing the vast literature on this topic is a challenge. Given the short time frame, allow me to summarize therefor my own past and current research, which provides (representative) empirical evidence on how the new international regulation on Global Systemically Important Banks (G-SIBs) and Other Systemically Important Institutions (O-SIIs) impacted the market value of the affected banks, respectively.

In both cases, we observe that the new regulation negatively affects the value of the newly regulated banks, but that there are offsetting effects in the short term. Hence, these results suggest that even though the individual components of the regulation have been effective, revealing the identities of the banks eliminated ambiguity about the presence of the government guarantees, and thereby may have run counter to the regulators’ intent to contain the effects of TBTF. However as it seems difficult to arrange such regulation differently, this is seemingly an unavoidable “price to pay” for its deployment.
In Moenninghoff, Ongena and Wieandt (2015) we analyze the stock price reactions for the 300 largest banks from 52 countries across 12 relevant regulatory announcement and designation events. We observe that the new regulation negatively affects the value of the newly regulated banks, yet that the official designation of banks as “globally systemically important” itself has a partly offsetting positive impact. A cross-sectional analysis of the valuation effects with respect to, for example, government ownership of banks supports the view that the positive reaction to these designations can be attributed to a TBTF perception by investors. The fact that these valuation effects emerge from a regulation specifically designed to reduce the costs and risks of TBTF demonstrates the inherently paradoxical nature of the new regulation. These results further suggest that even though the individual components of the regulation have been effective, revealing the identities of G-SIBs eliminated ambiguity about the presence of government guarantees, and thereby may have run counter to the regulators’ intent to contain the effects of TBTF.

In Andrieș, Nistor, Ongena and Sprincean (2019) we address the question: “How do financial markets react to the disclosure of the list of Other Systemically Important Institutions by the European Banking Authority?” With an event study of bank stock prices, we document that the immediate reaction of the stock market is negative, suggesting that the included financial institutions are perceived to be less profitable because they are subject to tighter regulation. However, within a few days investors change their perception, both in the case of euro zone and non-euro zone banks which can be attributed to the TBTF status. CDS spreads react similarly, increasing first before decreasing almost immediately thereafter. On the day of the event, abnormal returns are more negative for banks selected using supervisory judgement and for large banks. In the long run, the market reacts more positively in case of financial institutions selected using discretionary information and in case of those with a lower capitalization.

Finally, allow me to refer to ongoing work on ratings and TBTF. In Kolaric, Kiesel and Ongena (2019) we aim to address the question: “Do credit ratings help enforce market discipline on banks?” Analyzing a uniquely comprehensive dataset consisting of 1,081 rating change announcements for 154 international financial institutions between January 2004 and December 2015 we find that rating downgrades for internal reasons, such as adverse changes in the operating performance or capital structure of the banks, are associated with a significant CDS spread widening. But this widening only occurs for banks that are not perceived to be TBTF. Our findings question the reliability of credit ratings as a tool to discipline TBTF banks and suggest that regulatory monitoring should remain the main mechanism for disciplining these banks.
Feel free to contact me if you need more information.

Yours sincerely,

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References