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Important to Consider Net Competitive Advantage in Analysis of Large Bank Implicit Subsidies, Brookings' Elliott Finds

Focusing only on borrowing cost advantage is misleading

When considering whether large banks have a competitive advantage because of government policy, it is important to focus on the net number, not merely the direct borrowing cost advantage which can be misleading given the multitude of tougher regulatory requirements placed on the largest banks, according to a new primer by Brookings Fellow Douglas Elliott released today, in advance of a Government Accountability Office (GAO) report expected soon.

In "Implicit Subsidies for Very Large Banks: A Primer," Elliott notes that many observers argue that the largest banks receive preferential government treatment that brings down their funding costs, partly as a result of taxpayer-financed rescues that many of the banks received in the crisis years. He finds that while the largest banks had a significant funding cost advantage or implicit subsidy in the pre-financial crisis years, which became much larger when the government was explicitly providing support for them, this advantage appears to be much smaller today.

Elliott explains the debate over whether or not implied government support for the largest banks have distorted markets to their advantage and encouraged excessive risk-taking; defines what implicit subsidies are and why they are difficult to measure; evaluates previous research that has been done on these issues and suggests where the studies are flawed; and discusses the possibility that big banks will face a negative implicit subsidy as a result of post-crisis regulatory changes.

"It is virtually certain that there was a net positive subsidy [for large banks] prior to the crisis, rising greatly in value during the crisis … but many significant legislative and regulatory actions taken since the crisis have been aimed at least in part at hurting the competitive position of the largest banks," Elliott writes. Among these handicaps are higher capital requirements, higher deposit insurance premiums, potentially higher liquidity requirements, greater restrictions on credit exposure to counterparties, and closer supervision. "Adding up the estimates for just the more quantifiable of the new handicaps … suggests an impact equivalent to as much as 24 basis points in funding costs, significantly greater than the gross implicit subsidy that many studies find today as a funding cost advantage."

Elliott further points out that there are several instances where an implicit subsidy that applies to the large banks also applies to the small banks. Federal deposit insurance, for example, applies to banks large and small. Instances where implicit subsidies should also be netted out include preferences for a large bank that is not among the very largest, and the overarching possibility that policymakers will want to maintain the viability of the entire banking system, regional banks and significant banks alike.

He prescribes three main actions (or a combination of) which could tackle the competitive distortion in markets if a significant net subsidy still exists and is likely to remain. One would be to change the underlying causes of the distortion such as by fixing resolution mechanisms and taking away the implied government guarantee. "This could mean fixing potential problems in Title II of Dodd-Frank or introducing some other mechanism to handle distress at systemically important banks." Another would be offsetting subsidies with taxes or capital requirements. "Capital requirements would have the advantage that they would also increase the safety of banks, all else equal, at the same time as reducing any competitive distortion." Finally, changing market perceptions could even out the distortion. "Perhaps legislative and regulatory fixes have taken care of the Too Big To Fail problem, but markets do not recognize this … It may be impossible to completely correct such a misperception until there has been a future crisis and the government demonstrates that it will not rescue these banks."