Research: No evidence for 'too big to fail' policies

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Jean Helwege, associate professor of finance in Smeal College of Business at Penn State. Photo Credit: Penn State Department of Public Information

The U.S. economy would be better served by letting failing firms file for bankruptcy rather than by bailing them out under presumptive federal policies that deem them to be "too big to fail," according to new research from Penn State's Smeal College of Business.

Washington regulators have justified several recent interventions in the financial realm by warning that firms like Bear Stearns and AIG are too big to fail. Allowing these firms to go bankrupt, the argument goes, would result in fire sales and a domino effect, which pose systematic

risks to the entire economy. But Jean Helwege, associate professor of finance, writes that there is little to no evidence to support these too-big-to-fail threats of counterparty risk and fire sales.

In "Financial Firm Bankruptcy and Systematic Risk," which Helwege will present April 18 at the FDIC's annual Derivatives Securities and Risk Management Conference in Arlington, Va., she finds that cascading failures are unlikely to occur because of diversification, and that U.S. bankruptcy law allows for plenty of time to avoid fire sales and dispose of assets slowly.

When justifying bailouts or other government actions in the finance sector, regulators warn of a domino effect: One bank's failure triggers another bank's failure, which triggers other failures, and so on. But, Helwege says, this result is, at best, unlikely in reality.

"While the idea of a domino effect of one firm failing and starting a cascade of addition failures seems eminently plausible," she writes, "the empirical evidence to date suggest that no such domino effect would take place were regulators to abandon TBTF policies." Helwege cites prior research that shows that second firms rarely fail because of a first firm's failure and "that there is never a third firm involved, let alone a fourth, fifth, sixth, seventh, eighth, ninth, or 10th."

"Cascades can only arise when firms' loans to other firms are very large as a fraction of their capital, a notion that is both at odds with bank regulations and good business practices regarding diversification," she writes.

Firms are more likely to be exposed to the same risk because they have made similar poor investment choices; such is the case with the current credit crisis and firms' common exposure to the subprime mortgage market. In this scenario, Helwege argues that "regulatory aid to one firm

is of little use to the entire economy. Such assistance might bolster confidence, but clearly increasing confidence among all such firms is more productive than merely attempting to boost confidence in one particularly weak firm."

Helwege writes that the best policy oftentimes is to allow a portion of firms to fail without any assistance. Regulators warn that failures like this will result in fire sales, so they often force failing firms into mergers like the Federal Reserve-assisted takeover of Bear Stearns by JPMorgan Chase. However, Helwege points out that bankruptcy law allows plenty of time for less desirable assets to be sold off slowly so that their true worth can be discerned. In fact, mergers like Bear and JPMorgan, which took place over the course of a weekend, actually allow less time for assets to be properly valued.

"Mergers like the Bear/JP deal are examples of fire sales, not paths to avoiding them," Helwege writes.

She concludes that the best way to maintain stable, liquid, and orderly markets — the ultimate goal of financial regulators — is to allow individual firms to file for bankruptcy and slowly sell off their distressed assets while allowing Congress to find ways to provide more general assistance to the overall economy.

A draft copy of Helwege's report is available online at ssrn.com/abstract=1315316 .

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