

Limiting Bank Size is not the Answer

BY LISA KENNEY

“Too Correlated to Fail.” V.V. Chari and Christopher Phelan, Federal Reserve Bank of Minneapolis Economic Policy Paper No. 14-3, July 2014.

What’s the best way to ensure that banks don’t engage in the kinds of risky behavior that led to the bailouts of the 2007-2008 financial crisis? If you ask V.V. Chari and Christopher Phelan of the Minneapolis Fed, the answer is definitely not the conventional wisdom of limiting the size of individual banks.

Chari and Phelan argue, in a July 2014 policy paper titled “Too Correlated to Fail,” that it is the risk profile of the entire banking system that matters, not the actions of a single large bank. They believe policies that focus on bank size are misguided and that bank regulation should be focused on “whether that particular bank’s behavior is mitigating or aggravating the risk exposure of the entire system.”

Two reasons that banks feel comfortable engaging in risky behavior are deposit insurance and government bailouts. These explicit protections (deposit insurance) and implicit protections (bailouts) are sources of moral hazard. Since someone else bears the cost of failure, creditors of banks are less concerned about the risk.

One of the most significant kinds of risk that banks engage in when they feel protected by bailouts is what the authors call “herding” — which in itself increases the likelihood of a crisis. Herding is when banks invest similarly, correlating their risks. When bailouts exist, it makes the most sense for banks to mimic one another, because if they fail together, they will all be bailed out together. If just one bank fails, there will not be a big enough crisis to warrant a bailout.

One example of this herding behavior is securitization, where banks sell claims to a pool of loans. The catch is that they sell these claims to other banks. So even though this action diversifies the portfolio of that one individual bank, it ensures that all banks hold very similar portfolios.

Given the propensity of banks to herd when bailouts exist, Chari and Phelan conclude that limits on bank size cannot effectively solve the moral hazard problem — a highly correlated system of small banks would fail as easily as a highly correlated system of large banks. Instead, regulators “need to understand what kinds of events are likely to threaten a significant fraction of the aggregate assets of the entire banking system.”

“The Wage Growth Gap for Recent College Grads.” Bart Hobijn and Leila Bengali, Federal Reserve Bank of San Francisco *Economic Letter* No. 2014-22, July 21, 2014.

“Information Heterogeneity and Intended College Enrollment.” Zachary Bleemer and Basit Zafar, Federal Reserve Bank of New York Staff Report No. 685, August 2014.

In the wake of the Great Recession, wages for recent college graduates have remained flat while earnings for all full-time workers have increased at a steady pace. According to a recent San Francisco Fed *Economic Letter*, this data reveals a wage gap that is significantly larger and longer-lasting than wage gaps in previous recessions.

Why? Occupational distributions have remained stable between 2007 and 2014, so the gap can’t be blamed on recent grads shifting to lower-wage fields. Instead, the authors find that the current wage gap is caused by limited wage growth across all occupations.

With this kind of widespread wage slowdown, the authors note that “potential graduates, seeing the difficulties faced by current graduates in finding any job...might interpret this as a signal that it is not worth going to college.”

The false perception that there is now a low return on investment for a college education can hurt enrollment rates — which have remained stagnant in the United States over the last 20 years.

The possibility of such a misperception is explored in an August 2014 New York Fed Staff Report, which found that households generally underestimate the benefits and overestimate the costs of obtaining a college degree. The authors find that these beliefs directly influence whether a child in a household will attend college. This is particularly true in lower-income households as well as ones where the parents have not attended college themselves; the heads of these households tended to believe costs were much higher and benefits much lower than did higher-income, higher-educated households. The paper finds that “this is consistent with individuals’ own experiences shaping their perceptions.”

The authors believe information gaps may explain these misperceptions, as people tend to gather information from their local networks, which may be unreliable. In order to close these gaps, they suggest information campaigns that provide relevant information on the costs and benefits of a college education — particularly for disadvantaged households that have more skewed perceptions.

Expectations play a large role in decisionmaking, so ensuring individuals have the most accurate information about college is important for increasing enrollment rates. The benefits of a college degree still exist — despite the slow growth of wages for recent grads — as wage rates are still significantly higher for college graduates than for high school graduates.

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